Convergence Programme of the Republic of Latvia 2012-2015

April 2012

Contents

1 Overall Economic Policy Framework and Objectives

Latvian Convergence Programme is a medium-term policy document which describes Latvian fiscal policy for 2012 – 2015 and is prepared according to the requirements of the Stability and Growth Pact and Code of Conduct. Latvian Convergence Programme 2012 – 2015 (hereinafter – the Convergence Programme) is focused on implementation of a strong and sustainable fiscal policy and ensuring macroeconomic stability.

Within the framework of the European Union (hereinafter – the EU) cycle of economic policy coordination **a**nd surveillance or the "European semester" the Convergence Programme is prepared and submitted to the European Commission (hereinafter – the EC) together with the Latvian National Reform Programme (hereinafter – the NRP) and measures presented therein.

The Convergence Programme is prepared in line with requirements of the Stability and Growth Pact and requirements of regulations it covers, as well as the Code of Conduct. At the same time it is prepared in the light of priorities set in the Annual Growth Survey 2012 and macroeconomic and fiscal guidance, as well as obligations set in the Euro Plus Pact.

Regarding the Convergence Programme for the previous period, on July 12, 2011 the Council of the EU made a recommendation to Latvia to continue to implement measures set out in the Memorandum of Understanding between Latvia and the EU (hereinafter – the Memorandum of Understanding) concluded on January 20, 2009 and following Supplemental Memorandums of Understanding. The last Supplemental Memorandum of Understanding was signed on December 21, 2011.

In this context, the government has taken a number of measures – in 2012 budget preparation process fiscal consolidation was carried out in order to meet prescribed general government budget deficit targets, work continued to strengthen fiscal management (draft Fiscal Discipline Law (hereinafter – the FDL) was approved by the Cabinet of Ministers (hereinafter – the CoM) and considered by the Parliament in the 1st reading), measures are being implemented to combat the shadow economy, ensure stability of the financial sector, facilitate EU funds acquisition and facilitate economic growth, inter alia, by further implementation of structural reforms. The overall conclusion is that the Latvian action has been focused on successful implementation of recommendations made by the Council of the EU..

Regarding the excessive budget deficit procedure initiated by the Council of the EU on July 7, 2009 it can be concluded that realized measures stabilizing the budgetary situation have been effective and have yielded relevant results in prevention of the excessive budget deficit. In 2011 the general government budget deficit was 3.5% of gross domestic product (hereinafter – GDP), according to the Notification on general government budget deficit and debt in April 2012, while 2012 state budget is prepared ensuring the general government budget deficit of 2.1% of GDP. Consequently, pre-conditions have been created for termination of the excessive budget deficit procedure in the end of 2012.

The medium-term macroeconomic development scenario of the new Convergence Programme is based on conservative assumptions about external environment developments. The GDP growth forecast for 2012, which was set 2.5% in autumn 2011, was revised in February 2012 and reduced to 2.0%. The macroeconomic development scenario is based on the assumption about the global growth rate decline in the first two quarters of 2012, followed by a return to previous growth rates.

Based on the macroeconomic development scenario, the need to continue to stabilize the budget balance in coming years and the commitment to implement counter-cyclical fiscal policy fiscal targets for the next three years have been determined, i.e. to ensure the general government budget deficit in amount of 1.4% of GDP in 2013, 0.8% of GDP in 2014, and 0.3% of GDP in 2015.

These fiscal targets clearly show that Latvia is strongly committed to ensure the budget deficit in structural terms of not more than 0.5% of GDP in coming years – starting already with 2015 the budget deficit in structural terms will be lower than the medium-term budget target for Latvia set by the EC.

The realization of this kind of fiscal policy is an essential prerequisite for Latvia to implement its strategic goal – to adopt the euro as of January 1, 2014. To ensure compliance with all the accession criteria for the euro area, as well as to demonstrate the quality and sustainability of policies implemented, Latvia is strongly committed to implement counter-cyclical fiscal policy, to maintain a stable and well-functioning financial sector, to ensure effective and transparent EU funds acquisition, to monitor closely budget expenditure increase, to plan structural reforms in the tax area aimed at increasing Latvia's competitiveness, promoting employment and growth, and reducing the inflation pressure, to continue structural reforms in areas such as education and science, employment, health care, public administration, sustainability of social budget and other areas.

The provision of stability of financial sector is a necessary condition for the economic growth renewal. In 2011 implementation of financial sector stability measures continued – to improve the regulatory framework to promote strengthening of banks' capital base, to provide control measures to ensure effective management of the credit risk through "horizontal" checks in banks, which evaluated activities of banks in the loan restructuring process, market risk management and policy implementation, as well as banks' internal capital adequacy assessment processes to determine whether the minimum capital requirements are adequate to cover the credit risk, market risk and operational risk in banks' activities, whether activities of the bank have no other significant risks coverage of which require necessity to provide additional capital.

In 2012 and coming years a number of legislative measures will be implemented throughout the field of the financial sector related to transposition of requirements of EU legislation and improvement of the regulatory framework. In order to improve the legal framework for credit institution insolvency and liquidation work will start on drafting amendments to the Credit Institutions Law. In the monitoring field it is expected to continue to provide an enhanced banking supervision framework.

Work continues on implementation of transformation plan of the state joint-stock company "Mortgage and Land Bank of Latvia" and restructuring plan of joint stock companies "Parex Banka" and "Citadele Banka".

In addition, Latvia has convincingly demonstrated a successful return to international capital markets – in June 2011 Latvia issued successfully 10-year Eurobonds in amount of 500 million USD even before the international loan programme (hereinafter – the Programme) was completed, and in February 2012 5-year bonds were issued in amount of 1 billion USD, which reaffirmed the assessment of international financial market participants, particularly investors, of the high progress achieved in the Latvian economy and confidence in the country's creditworthiness, which provides a solid foundation and confidence in the successful refinancing of the Programme in coming years.

In the end of 2011 Latvia concluded successfully the Programme by implementing the Latvian economic stabilization and growth revival programme, and it will continue to implement medium-term courses of action set in the Latvian Strategic Development Plan 2010 – 2013 (hereinafter – the LSDP) within the framework of the following priorities: economic growth, social security and public administration reforms.

The Convergence Programme as a policy planning document has been approved by the Cabinet of Ministers, presented in and reviewed by relevant parliamentary committees. The Convergence Programme and relevant recommendations provided by the Council of the EU to Latvia will form the basis for further work on the 2013 state budget preparation.

2 Economic Outlook

2.1 Current Economic Development

In view of significant changes in the Latvian economy and gradual global economic recovery from the sharp drop, already starting from mid-2010 the Latvian economy has returned to growth as a result of economic stabilization measures and internal devaluation, as well as favorable situation on external markets. Latvian GDP in 2011, in comparison with the previous year, increased by 5.5 per cent (at constant prices), but it must be noted that the GDP level achieved last year is still by 16.4% below the maximum achieved in the pre-crisis period.

Last year economic development was based on the exporting industry. Successfully making use of external demand and price increase, exports have already reached pre-crisis levels, while industrial output is close to that level. Increased income from export also stimulated demand growth on the domestic market. The largest contribution to GDP growth in 2011 was made by trade, manufacturing and transport and storage industry, but the construction industry, which in 2008 –2010 experienced a deep and prolonged recession, as one of the last returned to growth last year. Also the structure of GDP has become more balanced and more sustainable – the proportion of industrial sector in the structure of added value has increased, prevalence of imports over exports decreased.

As the economic activity increased, in 2011 Latvian exports and imports of goods grew at a similar pace (by 28.1% and 28.3%). Accordingly, the foreign trade deficit increased, but this increase was largely due to the increase in imports of investment goods. Expenditure for gross fixed capital formation in 2011 increased by 24.6%, in addition, a positive impact on the economy was provided by a faster increase in investment in export-oriented sectors of the economy (industry, transport).

As income from exports grows and investment inflows return, demand on the domestic market also recovers slowly, employment increases. The employment rate in 2011 rose by 2.2 percentage points and accounted for 55.3 per cent, but the unemployment rate decreased to 15.4% of the economically active population. However, the rapid growth in domestic demand is hampered by high unemployment, household debt burden and almost constant real wage. Although the average monthly wage in 2011 increased by 4.3%, the consumption increase is slowed down by almost as high inflation – consumer prices during this period grew by 4.0%, driven by growing world oil and food prices, as well as changes in tax policy.

Although the Latvian economic growth in 2011 was more rapid than previously expected, the macroeconomic scenario developed by the Ministry of Finance is built on conservative assumptions about external environment developments and for 2012 the GDP growth rate is expected 2.0%. The scenario is based on an estimate of the global economic growth rate decline in the first two quarters of 2012, followed by a return to previous growth rates. As a result, the negative impact on Latvian economic growth rates will be temporary, and in coming years economic growth rates will return to their potential level.

In 2011 the Ministry of Finance started to assess the impact of EU funding on the Latvian economy and concluded that EU funds are one of the most important sources of investment in the national economy, which so far reduced and amortized the economic slowdown during the crisis, as well as after that continued to have positive impact on economic stabilization and growth.

Evaluation results present the positive impact of the EU funds on key macroeconomic indicators, acquisition of the EU funds had reduced the investment decline by 6,7 percentage points which in 2009 due to the crisis drop by 37,4%. Besides, the decline of GDP by 17,7% in 2009 would have been even 3,7 percentage points deeper without contribution of the EU funds. The favorable impact of the EU funds on GDP dynamics appears also in following years corresponding to the amount of acquired funding (see Figure 2.1).

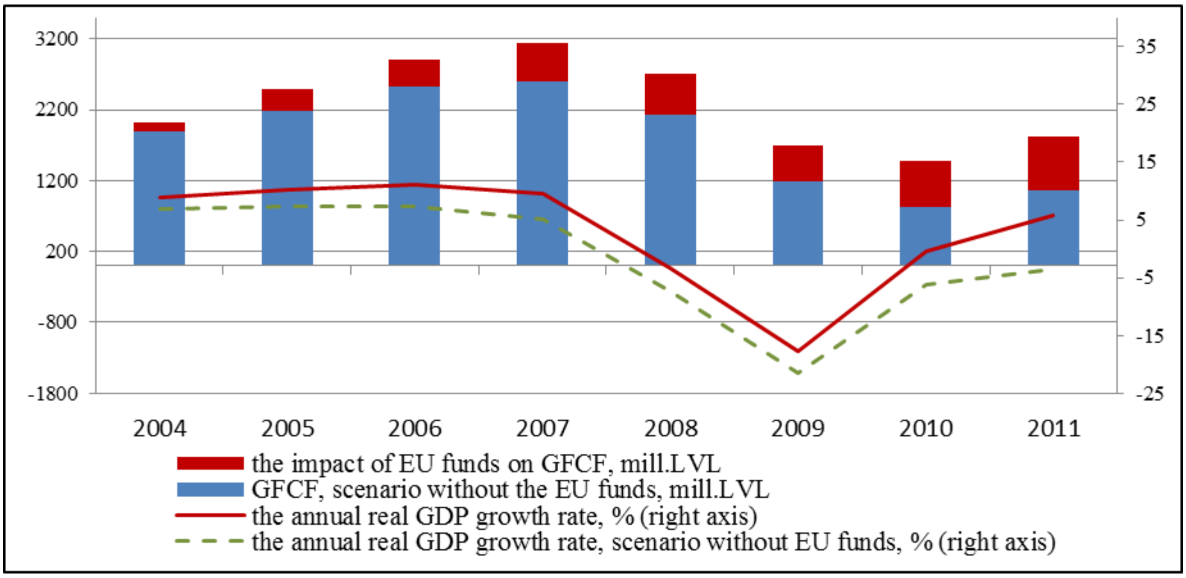

Figure 2.1. The impact of EU funds on the annual growth rate of real GDP and on the dynamics of investment

Before the crisis, the inflow of the EU funds in addition to easily available cheap credits contributed the rise of inflation rate, while during the crisis reduced the deflation. Overall, in the time period from 2004 to 2011 the EU funds resulted in a slight inflation-enhancing effect by 1 percentage point on average.

The acquisition of EU funds has had a positive impact on real wage growth, thus increasing the private consumption by 2,5 percentage points per year on average. Private consumption growth and demand for foreign investment goods (raw materials, construction materials, etc.) had stimulated import growth – by 4 percentage points per year on average. EU funds had mainly contributed to development of the internal market, including improvements of infrastructure.

The most stimulating effect on the value added growth rate has been in construction and private service sectors (on average ca. 4-5 percentage points per year). The great impact of EU funds on construction is due to the fact that projects, implemented in the construction field in the last 3 years, have mainly been ensured by orders for EU-funded civil engineering and public sector building construction and renovation work. Without absorption of EU funds, the decline in industry’s value added during the crisis would have been around 4,5 percentage points deeper. Significant effect on the growth of private services is due to the real income increase caused by EU funds investment.

Having assessed the impact of EU funds on labour market indicators, it is concluded that during the pre-crisis period implementation of EU funds projects had decreased the average unemployment rate by 1,6 percentage points. It should be noted that since 2009 the positive impact of EU funds on the unemployment dynamics is increasing significantly. The impact of EU funds on the increase of the number of employees is relatively small. Since

2001 as a result of EU funds activities around 25 thousand new jobs have been created, what can be explained by the fact that the EU funds investments primarily had stimulated labour productivity and human capital development.

2.2 Macroeconomic Development Scenario

After the growth recovery in 2010, in 2011 economic growth rate continued to accelerate and in 2011 the GDP growth was 5.5%. The growth continues to rely on the development of exporting industries, however, a significant growth can already be seen in service and trade sectors, although the output remains low.

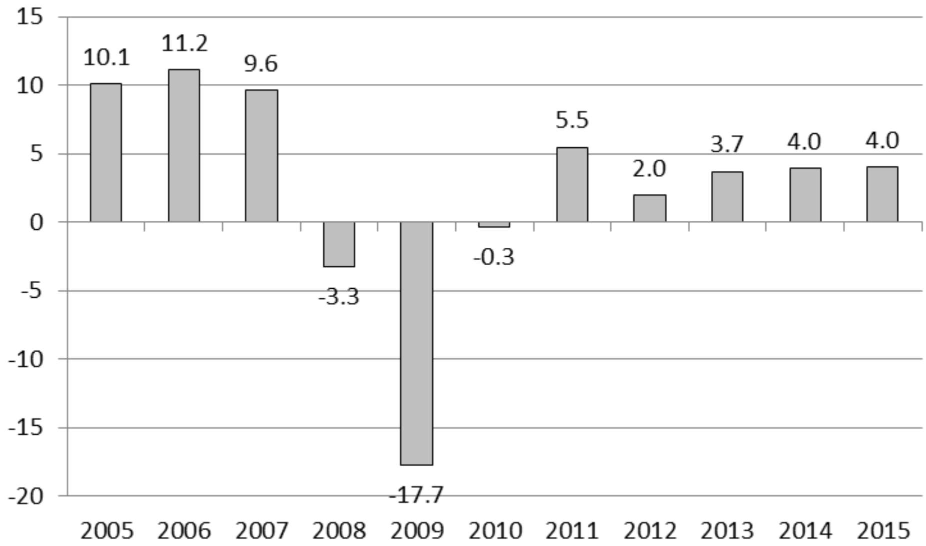

Figure 2.2. % GDP changes at constant prices, %

The medium-term macroeconomic development scenario is based on conservative assumptions about external environment developments. The GDP growth forecast for 2012, of 2.5% which was set in autumn 2011, was revised in February 2012 and reduced to 2.0%. The macroeconomic development scenario is based on the assumption about the slowdown in global economic growth in the first two quarters of 2012, followed by a return to previous growth rates. As a result, the negative impact on Latvian growth will be temporary, and in following years economic growth will return to their potential level of 4%. The scenario implies that euro area governments will be able to successfully resolve their debt crisis. Macroeconomic scenario is based on European Commission’s external environment assumptions.

2.2.1 Real sector

In the post-crisis period, the main economic driving force has been exports, but with return to the economic growth the private consumption has also returned to positive growth, although these increases are generally considered as moderate. The private consumption development is closely linked with changes in personal income, which is affected both by changes in the average wage and number of employees, and inflation, which reduces the real income of the population and hinders the growth in private consumption.

Table 2.1. GDP by expenditure
(growth rate in prices of 2000, % against the previous period)

	2009	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**
	actual			**forecast**			
GDP	-17.7	-0.3	5.5	2.0	3.7	4.0	4.0
Public consumption	-9.4	-9.7	1.3	0.0	0.0	0.5	1.0
Private consumption	-22.6	0.4	4.4	1.9	3.7	4.0	4.0
Gross fixed capital formation	-37.4	-12.2	24.6	7.4	7.3	6.5	6.4
Exports of goods and services	-14.1	11.5	12.6	3.8	5.4	5.9	5.6
Imports of goods and services	-33.3	11.5	20.7	5.1	5.8	6.0	5.8

In contradiction to 2011 in coming years the development of private consumption will be less influenced by consumption price changes, and the situation in external environment will play more important role in the development of private consumption. A more negative external environment and slower growth rates in export sectors will slow down wage and employment growth in respective sectors and the economy as a whole. In addition, opportunities for people to increase their consumption are also limited by the high volume of loans granted to households, which in June 2011 was 5.5 billion lats (7.82 billion euros). Limited wage growth and loan servicing costs undermine the potential for significant growth in private consumption, so it is forecasted that private consumption growth in 2012 and 2013 will not exceed the GDP growth and will be respectively 1.9% and 3.6%, but in medium term – equivalent to the GDP growth.

Changes in public consumption is directly dependent on the general government expenditure. According to the goals set by Latvia, in 2012 deficit reduction will continue, which will limit the total general government expenditure growth. In medium term in order to reduce the budget deficit, expenditure growth will be slower than GDP growth rates.

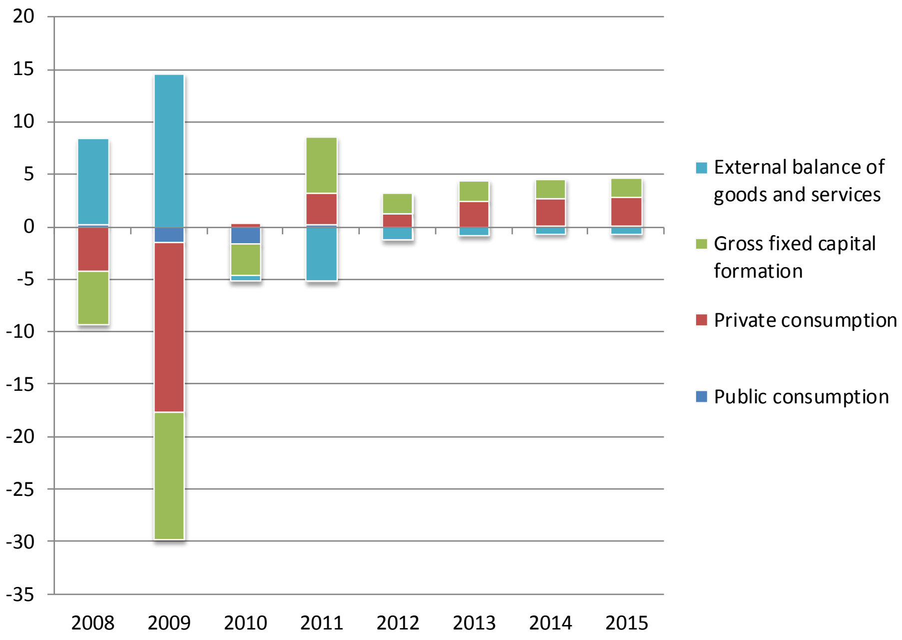

Figure 2.3. Contribution of expenditure components in GDP, percentage points

After 3 years of decline, during which the volume of investment decreased by 56%, its share in GDP fell from 34% to 18%. Decrease in the proportion of investment in part may be attributed to changes in the economic structure, resulting in a sharp reduction in the construction output. However, investment is largely attributable to investors' sentiment about the economic outlook and investment climate as a whole. The difficult economic situation and cautious attitude towards economic development prospects in 2009 and 2010 forced entrepreneurs to cut their expenditure. It is likely that most companies have saved means postponing replacement of worn-out assets. This is illustrated by the trend that was noticed already in 2011 when companies started to implement such, probably, deferred investment as renewal of the transportation fleet. While with resumption of the economic growth precaution forced local businesses to maximize the use of existing production capacity to increase output, as a result currently business surveys point to historically high capacity loads in major industrial sectors. As a result, in 2011 investment in Latvia increased by 24.6%. These factors create a climate favorable to investment growth in medium term. This in addition will be promoted by recovery of Latvian investment credit rating and foreign investors' confidence, which was facilitated by successful fiscal policy of the Latvian government reducing significantly the government deficit from 9.7% of GDP to 3.5% in 2011. Although the uncertainty in the external environment in short term can affect individual investment projects, the need for additional investment in the capacity expansion and modernization of infrastructure will increase. Thus, we expect that investment growth in medium term will exceed GDP growth and by 2015 its proportion of the GDP will reach 25%, which corresponds to the average investment level before the economic overheating in the time period from 1998 to 2004.

After the rapid growth of exports in 2010 and 2011, it is expected that in 2012 the export growth rate will decelerate significantly. This, first of all, will be determined by worsening of external environment, as well as export growth will be limited by internal factors. Currently, the volume of exported goods has already exceeded pre-crisis levels, and thus to achieve further increase new investments will have to be made to expand manufacturing capacity developing new products and expanding markets for existing products. This process is long, and it is not expected that the rapid pace of growth which was experienced in 2010 and 1011 will continue. In 2012 export growth rate will be affected by worsening external environment, but in coming years it is expected that the amount could increase by 5 – 6% per year.

Import volumes are directly dependent on the domestic demand made of government and private consumption, investment and exports. Investment needs, as well as further stabilization of private consumption and increasing growth rates will contribute to an increase in imports, which in medium term will grow faster than exports.

GDP by Sectors

From sectors it is expected that in medium term the industrial production will continue to show one of the highest growth rates. External demand and producers' competitiveness, as well as investment in increasing the output capacity will continue to determine the output. In 2012 the industrial added value growth rate will slow down to 3.3%, which will be determined by fluctuations in the external environment, but in medium term it will exceed the GDP growth rate, and the share of industry in the GDP structure will continue to increase.

Table 2.2. GDP by sectors
(growth rate in prices of 2000, % against the previous period)

	2009	2010	2011	2012	2013	2014	2015
	actual			forecast			
GDP	-17,7	-0,3	5,5	2,0	3,7	4,0	4,0
Agriculture, forestry and fishing	9,1	2,0	2,8	3,0	4,2	4,0	4,0
Industry	-14,5	13,7	8,7	3,3	5,4	5,3	5,3
Construction	-32,0	-23,9	12,4	4,0	4,0	4,3	4,0
Trade, transportation, accommodation	-16,6	4,1	8,9	3,3	3,6	4,3	4,4
Financial and commercial services	-8,0	-3,4	-2,1	-1,7	3,7	3,7	3,9
Public services	-16,9	-7,0	2,2	0,5	1,8	2,1	2,1
Other services	-20,7	-7,5	6,8	2,1	5,1	5,6	6,1

Construction, financial and commercial service, as well as other service sectors are focused primarily on servicing the domestic demand, which in medium term will remain at a low level. The growth of service sectors will be limited by the high private debt, as a result the value added of these sectors will not exceed the GDP growth, while the construction sector could contribute to the investment growth, which in medium term could enable the sector to grow faster than the economy as a whole.

Inflation

Inflation in 2012 will be largely determined by the external environment, while the Latvian internal market situation as a whole does not raise worries about the increase in prices caused by the demand.

Constant fiscal policy will provide a strong inflation-reducing effect in the first half of 2012, because significant part of inflation last year was determined by indirect tax changes that were introduced in the first half of 2011. Tax effect on inflation will gradually disappear by mid-2012. The slow private demand growth and relatively high unemployment rate on the internal market will not create additional inflationary pressure.

The largest uncertainty and risks associated with price increase in 2012 can be observed in the external environment. It is difficult to predict oil prices, which as a speculative investment object is projected to experience major fluctuations in response to events in the Middle East and compliance with growth prospects of European Union countries. EUR/USD cross-rate fluctuations also play an important role – due to a weak EUR rate energy prices might increase even more.

Growing energy prices may increase consumer costs directly related to goods and services (gas, fuel, heat, etc.), but this inflationary factor does not cause significant risks to directly affect chances of Latvia to meet Maastricht criteria. Comparing to other EU countries (which will determine the criterion), prices will not grow faster. In Latvia final consumer price formation mechanism for products that are directly influenced by oil price indices is not significantly different from majority of other EU countries, shares in consumption basket are also similar. Consequently, the overall impact on inflation will be nearly the same.

Distinctive features of inflation dynamics is related to the structure of the consumption basket and sensitivity of certain goods or services to energy price changes, or manufacturers' and traders' ability to absorb energy price increases without increasing the price of goods or services to cover additional costs. In Latvia the share of food is among the largest in the Europe consumption basket, and fuel prices have reached their peak just in sowing time, and since the food is in principle sensitive to changes in oil prices, it is possible that the effect on inflation in Latvian will be stronger than on average in Europe.

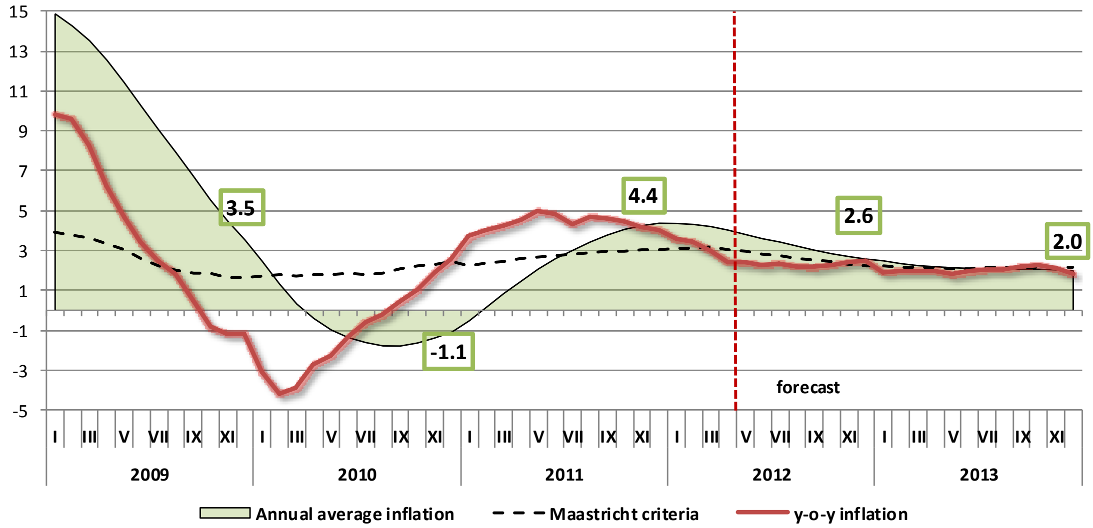

Figure 2.4. Consumer price changes in 2009–2013, %

Taking into account current situation and potential risks, inflation forecasts for 2012 have been increased by 0.2 percentage points (compared to forecasts of autumn 2011). Forecasted consumer price increase in 2012, compared to the previous period, is 2.6%.

Labour market

With gradual decline of Latvian population, which is determined by negative natural increase and growing emigration, the working age population continues to decrease in the country and this decrease is slightly higher than the overall fall in population. In the beginning of 2012, according to statistical data that does not yet include results of the population census of 2011, in Latvia there were 2.21 million people and last year population declined by 1.0%, compared to average reduction of 0.6% over the past five years. In recent years, population decline became more rapid, which apart from negative natural growth is increasingly affected by increasing emigration. According to provisional census results on March 1, 2011 in Latvia there were 2.07 million people, but the official census data, including summary data on population and employment, has not yet been published. The situation in the labour market is currently determined by Latvian economy exiting from the crisis and the strong revival of economic growth within the last year. So far, the highest employment rates were achieved in Latvia in the end of 2007, but after that due to the economic crisis the number of jobs and employed dropped sharply, and the market reached its lowest point in the first quarter of 2010. From spring 2010 the labour market situation gradually improves and the registered unemployment rate in the last two years has declined by nearly six percentage points. In the end of 2011 11.5% of the economically active population was registered with the State Employment Agency as unemployed, while in March 2010 the registered unemployment rate reached 17.3%.

A similar situation is showed by results of the Labour Force Survey carried out by the Central Statistical Bureau (hereinafter – the CSB), according to which the job seeker rate has fallen from 20.5 per cent in the first quester of 2010 to 14.3 per cent in the fourth quarter of 2011. Reduction of the unemployment rate is mostly affected by the increase in economic activity and job creation, but also by the decrease in economically active population, working-age people leaving the country or leaving the labour market.

In medium term labour market situation will be still positively affected by the economic growth – the number of employed will continue to rise and unemployment rate will fall. However, this change will not be fast and in 2012 the employment growth will be slowed down due the lowest growth rate set for the Latvian economy by the euro area financial crisis. In coming years also the employment growth will be moderate and the number of employees in medium term will not return to the level achieved before the crisis.

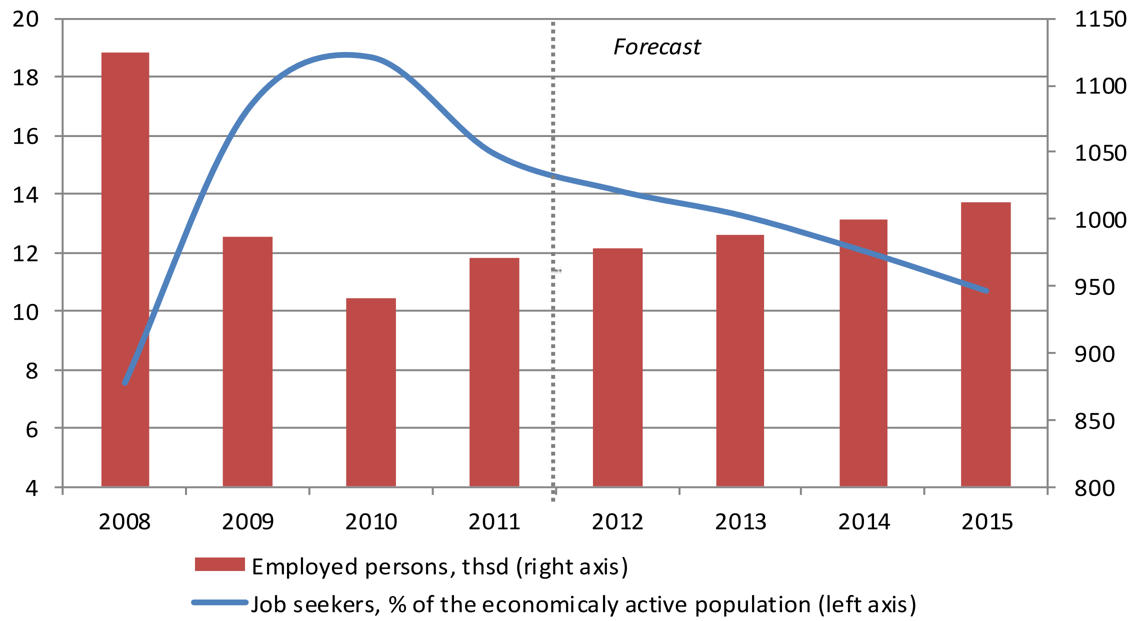

Figure 2.5. Employment and unemployment in 2008–2015

In 2012 it is expected that in the national economy number of employed people will increase by 0.7%, while in the following three years it will grow on average by 1.2% per year.

Thus, it is expected that GDP growth in coming years will be determined more by the increase in productivity and hours worked, rather than the number of employees.

With gradual rise in the employment level the unemployment in medium term will decline, which will be affected also by declining working-age population, including as a result of emigration. Although the overall unemployment rate will fall, the number of long-term unemployed people will remain relatively high and their share among the unemployed will rise. This points to demand and supply mismatches in the labour market and structural unemployment risks, and in perspective it may lead to shortage of skilled labour force in certain occupations and industries.

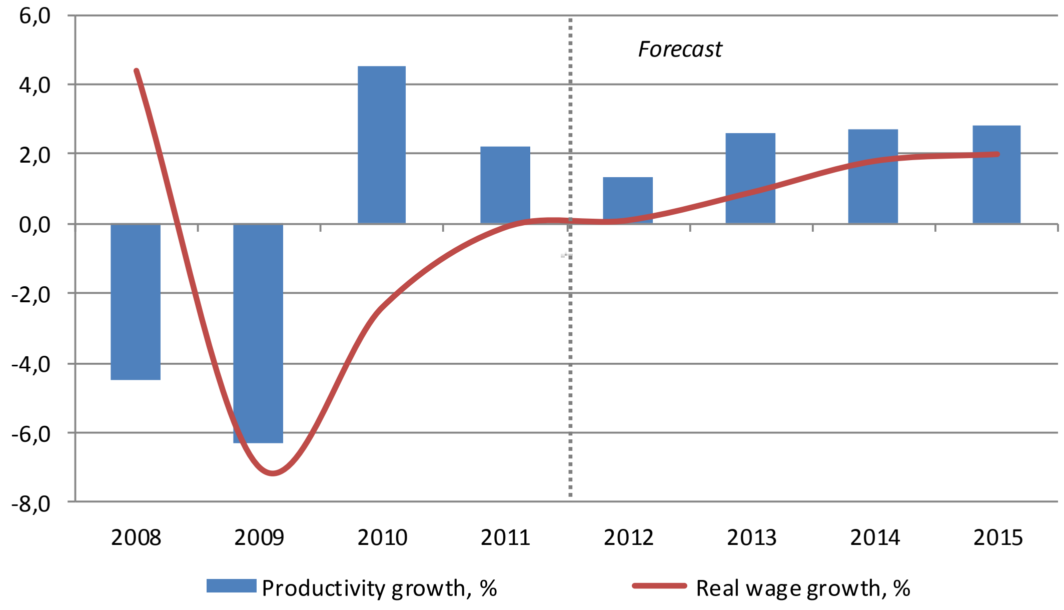

Figure 2.6. Productivity and real wage growth in 2008 – 2015, %

As during the economic crisis companies reduced the workforce significantly by streamlining work processes and introducing new technologies, since 2010 the productivity growth has resumed and it is expected that productivity will continue to increase also by 2015. Since 2009 productivity has grown faster than workers' real wages, increasing Latvian external competeviness. This situation will continue also in 2012 and coming years and productivity growth will exceed the real wage growth.

2.2.2 External sector

With increasing foreign direct investment, as well as local businesses expanding their business activities, the current account, contrary to the surplus observed in previous two years, in 2011 was again negative –1.2%. In 2012 imports will increase slightly faster than exports, thus the negative current account would increase slightly. It will be primarily determined by growing investment flows in rebuilding equity capitals of companies in producing and service sectors introducing new technologies that are most often imported from such high-tech producing countries as Germany, etc. However, despite the growing current account deficit, investment in rebuilding productive production makes a positive contribution to enhancing export competitiveness and increasing exports and improving the competitiveness of the domestic market, thus replacing imported goods.

Export volumes in 2011 on average exceeded pre-crisis export volumes, the volume of imports also approaches the level of 2008 lagging behind only about 10% of the pre-crisis level, which is mainly still determined by lower imports of mechanical equipment and transport vehicles. While the need for equipment and transportation fleet renewal determined the increase of import volumes exceeding exports in 2011, and thus also import growth rates in coming years.

As the economic growth globally and also in the main trading partner countries slows down, goods and service trade growth rate will be considerably slower in 2012, compared with the rapid growth in 2010 and 2011. However, still low purchasing power in the local market will determine that the export growth will continue to be a main factor of the economic growth. It is expected that exports of goods and services in 2012 will increase by 5.1% while imports of goods and services will grow by 7.0%.

2.3 Participation in the Exchange Rate Mechanism II

Monetary and exchange rate policy framework is expected to remain unchanged until Latvia's integration into the EMU. Latvia joined the Exchange Rate Mechanism II on 2 May 2005, undertaking a unilateral commitment to ensure a +/-1% exchange rate fluctuation corridor around the central parity (1 EUR = 0.702804 LVL). The Bank of Latvia will continue the implementation of the current fixed exchange rate policy until the introduction of the euro. Latvian authorities plan to achieve a sustainable degree of convergence and to fulfill Maastricht criteria ahead of 2014 which has been set by the Government as the target date for the euro introduction.

In recent years, Latvian economy underwent significant adjustment leading to correction of imbalances accumulated over the boom years. Following a recession, the economy started to recover already in 2010 and gained strength in 2011. The Programme led by the EU and International Monetary Fund (hereinafter – the IMF), helped to restore confidence and arrange the economy, was successfully concluded in the end of 2011. Moreover, Latvia regained access to international capital markets.

The adjustment strategy chosen by Latvia to regain competitiveness proved to be successful and the economy turned out to be sufficiently flexible to achieve a sustainable correction of the past imbalances. With regard to the policy commitments undertaken upon joining the ERM II, rigorous fiscal consolidation and structural reforms have been implemented to correct past imbalances and underpin macroeconomic stability and growth. Moreover, a Fiscal Discipline Law has been drafted to ensure fiscal sustainability going forward and avoid pro-cyclical fiscal policies in the future.

Most monetary policy instruments of the Bank of Latvia are similar to those of the ECB. As the lats is pegged to the euro, the Bank of Latvia provides local currency liquidity in limited amounts via market operations to ensure that the monetary base is fully backed by foreign exchange and gold reserves, and the banks use foreign exchange interventions to obtain long-term funds from the central bank. After joining the EMU, Latvia will start to use the full set of monetary policy instruments of the ECB.

With domestic price pressures receding and staying in a negative territory for most of the period since the previous Convergence Programme, the Bank of Latvia continued to accommodate its monetary policy to support stabilization of the economy and the financial sector. In 2010, the refinancing rate was decreased from 4.0% to 3.5%. The overnight deposit facility rate was decreased in three steps from 1.0% to 0.25%. Moreover, the Bank of Latvia introduced a 7-day deposit facility and gradually decreased its rate from 1.0% to 0.375%. In the beginning of 2012, the Bank of Latvia reduced the reserve ratio by one percentage point: from 3% to 2% for bank liabilities with a maturity of over two years and from 5% to 4% for other liabilities included in the reserve base. The marginal lending facility rate was not changed in 2010–2011.

As financial markets have stabilized, the lats money market rates have returned to the levels close to the corresponding euro money market rates, with the interest rates for most of the maturities being below 2%. Since 2011, Latvia has successfully returned to the international capital markets by issuing 10-year and 5-year USD-denominated bonds. It has also extended maturities to up to 10 years in the domestic bond market, with the corresponding yields decreasing significantly. High bid-to-cover ratios of well-above 5 in international bond auctions reflect the returned investors' confidence in Latvia and the strengthened ability to successfully tap the capital markets.

Table 2.3. Average short-term and medium-term interest rate forecasts of the BoL

	2012	2013	2014	2015
Short-term rate (%)	1.3	1.3	1.3	1.9
Long-term rate (%)	5.0	4.5	4.4	4.4

Meeting the inflation criterion

The annual average consumer price index growth in 2011, compared to 2010, amounted to 4.4%, which is above the criterion. It is expected to meet the Maastricht criterion by the end of 2012, because the indicator will be protractedly influenced by the effect of tax changes made in 2011. By the assessment period (it is expected that the last available data on inflation that will be used for the assessment will be for March 2013) this effect will disappear because the tax raise has just a one-off effect on inflation and it does not have lasting consequences.

Although the inflation criterion was not met at the beginning of 2012, Latvia has one of the lowest core inflation in the European Union, pointing to a permanent inflation slowing effect due to budget consolidation measures. However, the related weakened state of consumption has made the economy vulnerable to the rise in global energy prices.

Specific nature of the annual average inflation calculation methodology indicates that the strongest influence on inflation in the assessment period is in the first half of 2012. During this period, inflation dynamics will be determined by volatile energy prices in the world – primarily it will affect fuel and utility prices, and secondary – manufacturers and marketers might review prices according to the rise in costs.

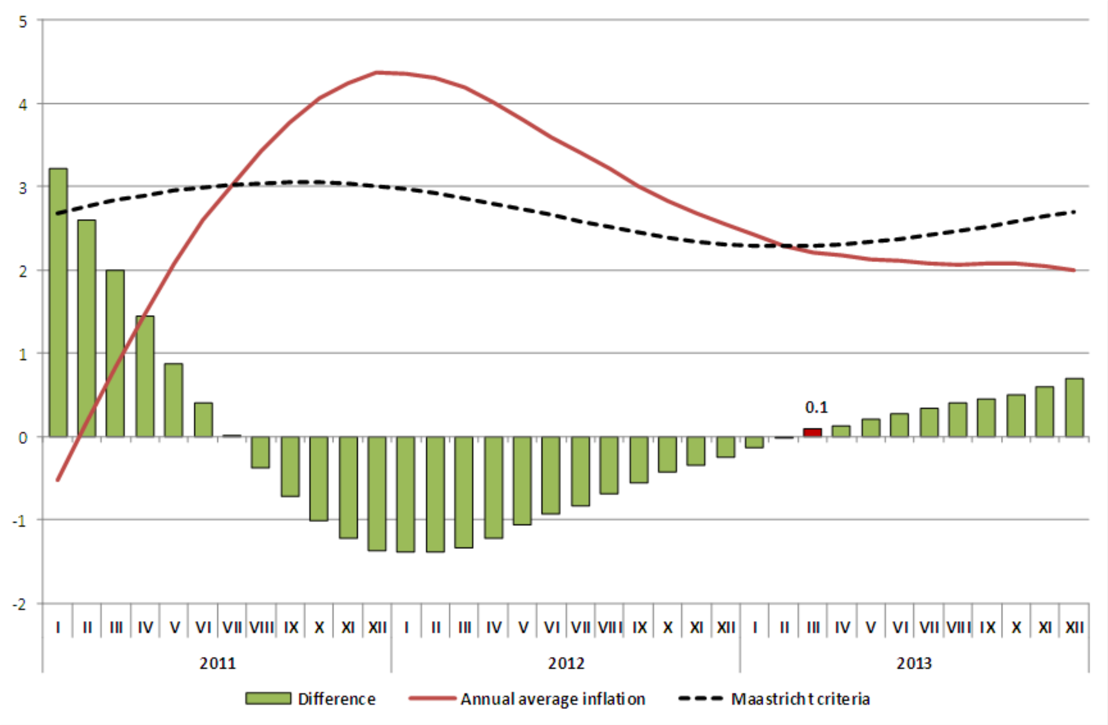

Figure 2.7. Compliance with Latvian annual average inflation indicator and Maastricht inflation criterion, and forecasts

According to the MoF forecasts, annual average inflation in the assessment period in March 2013 will decrease to 2.2 per cent, while the criterion according to the latest MoF estimates (based on the EC renewed macroeconomic forecasts in the interim report of February 2012) will be 2.3 per cent. It should be noted that the calculation takes into account the expected deflation in Greece, as EU legislation does not provide for a precise procedure for exceptions in countries that are taken as basis for the criterion.

3 Impact of Structural Reforms on the Economy and Public Finances

In order to achieve objectives of the general government budget, while ensuring conditions for economic growth in medium term, the Latvian government continues to implement structural reforms in the following key directions:

- Financial stability;
- Promotion of competitiveness;
- Balanced social system and employment;
- Health care;
- Education and science.

Structural reforms included in the Convergence Programme will have a direct impact on the development of Latvian economy and public finances. The structural reforms included in the Convergence Programme focus both on improving growth and efficient use of budgetary resources ensuring reduction of the budget deficit. However, given that the directions of the reforms envisage only partial implementation of specific measures, it is not possible to calculate complete and accurate impact of reforms on the economy and public finances. It should be noted that in the implementation of reforms availability of EU funds plays an important role.

Detailed directions of structural reforms and planned measures for 2012-2013 are given in the NRP.

The section has been prepared based on the information of the State Chancellery and line ministries.

3.1 Financial Stability

Strengthening fiscal discipline. The measure aims at strengthening the national regulatory framework to ensure formation of sustainable, counter-cyclical fiscal policy, strengthening medium-term budget planning, as well as setting out clear conditions for defining fiscal targets. By 2013 it is planned to fully develop and supplement laws and regulations in the field of fiscal discipline. As of today, amendments to the Law on Budget and Financial Management have already been made, stating that from 2012 a medium-term budget framework law will be developed. Development of the fiscal discipline law also continues. The FDL and draft law “Amendments to the Constitution of the Republic of Latvia” were approved on November 29, 2011 by the sitting of the Cabinet of Ministers and submitted to the Saeima on December 6, 2011. On January 12, 2012 the FDL was approved by the Saeima in the first reading and the period for submission of proposals for the second reading has passed. For the second reading in the Saeima in the FDL requirements of the new *Treaty on Stability, Coordination and Governance in the Economic and Monetary Union* (hereinafter – the Fiscal Treaty) were included, thus providing better compliance with EU level requirements. Amendments to the Constitution are still being considered by parliamentary committees. The measure will ensure sustainability of public finances and promote compliance of the general government deficit and public debt with Maastricht criteria and the Stability and Growth Pact (for details see Sub-section 9.3).

Sustainability of the social insurance system. The measure aims at ensuring stability of the social insurance system in medium and long term. The measure provides for restructuring of social insurance system expenditure to adjust to demographic trends and to ensure sustainability of the system. The following major changes are planned:

- Gradual increase in retirement age up to 65 years: from January 1, 2014 and January 1, 2015 increase by 3 months; from January 1, 2016 each year till 2020 increase by 6 months. Fiscal impact: savings in 2014 7.9 million lats (11.3 million euro) and in 2015 17.0 million lats (24.2 million euro);
- Together with the increase in retirement age increase also in early retirement age starting from 2014. Fiscal impact: savings in 2014 1.3 million lats (1.8 million euro) and in 2015 2.7 million lats (3.8 million euro);
- Increase in minimum insurance period to receive the right for state old-age pension up to 15 years, starting from 2014, and up to 20 years, starting from 2020. Fiscal impact: savings in 2014 0.1 million lats (0.1 million euro) and in 2015 0.3 million lats (0.4 million euro);
- Relieve of the social insurance special budget from uncharacteristic expenditure (not covered from social insurance contributions) – additional payments to old-age and disability pensions, transferring these payments to the state basic budget starting from 2014.

On March 27, 2012 amendments to the Law on State Pensions, which provide for the above mentioned measures, were approved by the Government and on April 19, 2012 supported by the Saeima in the first reading. These changes will improve the situation in the social security budget, participation of persons in the labour market will increase, as well as burden in the social insurance system will reduce.

3.2 Promotion of Competitiveness

3.2.1 Business environment, incl. modernization of the public administration sector

Reduction of administrative obstacles. The main aim of the measure is to create an excellent business environment, which should focus on investment attraction and innovation. The most notable measures performed in 2011 – reduced start-up time for businesses, a draft law developed aimed at reducing the duration of the construction administrative process, as well as detailed amendments developed to laws, which envisage to strengthen the rights of investors, individual tax payment process made easier. In 2012 in collaboration with entrepreneurs work is continuing on alignment normative acts governing the business environment, provision of new e-services, as well as introduction of “one-stop agency principle” in registering property data.

Reducing taxes on labour. The aim of the measure is to raise the competitiveness of Latvian businesses, reducing the labour tax burden to the level of other Baltic States. In 2012 a schedule will be developed to cut labour taxes over the period of next 3 years, in a fiscally responsible manner, promoting economic activity and employment.

Combating shadow economy. The measure aims at the reduction of the shadow economy and promotion of fair competition by implementing appropriate measures in 2010 - 2013. The main directions to combat the shadow economy are set – reducing the administrative burden, ensuring efficient operation of controlling authorities, imposing sanctions, cooperation with social partners, supporting honest businesses, promoting transfer of businesses from the non-registered economy to the registered economy. In 2010 “Action Plan to Combat Shadow Economy and Promote Fair Competition in 2010 – 2013” was prepared. In total the Plan currently includes 66 measures, 47 measures of which have been implemented in full (5 measures should be performed consistently) and implementation of other measures will continue (12 measures are in the process of reconciliation) as of January 1, 2012.

In 2011, inter alia, the following measures were implemented:

- as of July 1, 2011 taxpayers in wholesale are allowed to carry out only non-cash payments;
- as of July 1, 2011 the registration procedure for businesses and officials is improved;
- as of October 1, 2011 the reverse-charge VAT mechanism is introduced for scrap metal collection and processing, as well as starting from January 1, 2012 in all cases when the individuals hand over scrap metal, by deriving income, a payer of income shall withheld personal income tax at 10% rate;;
- as of January 1, 2012 legal provisions have come into effect which prevent the use of micro-enterprise tax regime for tax planning; ;
- as of December 15, 2011 the Law on Declaring Property Status and Undeclared Income of Individuals is effective envisaging that from March 1, 2012 till June 1, 2012 individuals shall submit a property status declaration.

In 2012 it is planned to implement and perform a number of important measures:

- intensify the fight against avoiding installation and use of tax and other payment electronic recording devices and equipment or non-compliance with the procedures of use thereof. In the Saeima proposals have been submitted to strengthen accountability for the above mentioned. Thus it is planned to eliminate current situation in Latvia with regard to unlawful interference in cash registers and cash register system software in order to hide or reduce taxable income;
- adopt normative acts to introduce tax support measure. The tax support measure will be a one-off measure to cancel a late penalty and partly cancel a fine to those taxpayers who pay the principal tax debt in a certain period of time;
- review of tax regimes for small businesses in order to raise the level of voluntary tax compliance among small enterprises, in order to simplify the tax system and make it more understandable for small businesses;
- restrict recognition of artificial transactions, when their legal form does not meet their economic nature, for the tax purposes. In the tax legislation anti-avoidance provisions will be included, namely, in the future transactions will be judged as a whole, despite the fact that each individual transaction does not prove tax evasion;
- examine the possibility to link a tax payment to conditions for receipt of public services, such as health care services, to motivate persons to pay taxes.

Measures will result in lower shadow economy, equal business competition within a sector will be ensured.

Further optimization of functions of public administration institutions, as well as development of human resources development concept. The measures aim to continue to build small, efficient, motivated and result-oriented public administration, providing citizens and businesses with quality and affordable public administration services, as well as reducing administrative obstacles and burdens in a planned manner. An example is the health sector administration reform started in 2009 when consolidation resulted in the reorganization of institutions subordinated to the Ministry of Health (incl. six institutions subordinated to the Ministry of Health were liquidated), and on that basis four institutions subordinated to the Ministry of Health were established. But at the end of 2011 two institutions subordinated to the Ministry of Health were reorganized and on the basis of the reorganization a new institution subordinated to the Ministry of Health was established. In order to ensure efficient and transparent use of resources in public administration, function audits will be conducted in various sectors. There will be withdrawal from functions uncharacteristic to the public sector, delegation of functions to the private sector and NGOs. The training system for public administration employees will be renewed.

Development of e-governance and e-services. The measures aim to improve the effectiveness of public administration processes by providing better access to public services for citizens and companies. In 2011 "E-governance Development Plan 2011 –2013" was developed, as well as work started at improving operation and availability of the national information system. During the period from 2012 till 2014 it is planned to introduce complete electronic data and document transfer between institutions, consolidation and centralization of standard national IT services, development of cooperation between the national information systems. It is planned to refuse registration certificates, permits and operating licenses issued in paper form, as well as to ensure the use and development of centralized electronic procurement system. As a result of the measures companies and people will be able to access public administration services in more simplified, faster, remote manner, the number of people and companies who use the Internet for cooperation with state and local government institutions will increase, expenditure will decrease and government procurement processes will become more transparent.

Introduction of "one-stop agency" principle in provision of state and local government services. The measures aim to improvement of state and local government service delivery by developing service access points in person and electronically through the development of uniform, people-oriented service culture that allows to meet people's needs in one place, even if several institutions are involved in the provision of particular service. Work on a one-stop agency principle was launched in 2009 and it is planned to continue till 2014. In 2011 "Concept on Introduction of "one-stop agency" principle in provision of state and local government services" was developed. In 2012 it is planned to start work on the draft Public Service Law. The measure will reduce the administrative burden by promoting good governance and access of companies and people to public services. By creating single customer service centres, where in one place state and local services will be provided, will prevent duplication of costs.

Reform of the management of state-owned shares and commercial activities of public persons. The measure aims to provide more efficient management of state-owned shares and to assess the need for public persons to carry out commercial activities in the future. The measure is intended to establish a centralized management institution under the supervision of the Cabinet of Ministers, which would manage and alienate shares, implement corporate governance principles, supervise setting of corporate financial objectives, advise the Government, ensure disclosure of information about activities of companies and efficiency of the use of state assets, as well as evaluate achieving of set objectives. It is also planned to establish new principles for commercial activities of public persons and to evaluate conformity of state participation in companies with these principles. In 2011 in order to create a new model for the management of state-owned companies a draft Concept on the Management of State-owned Shares was developed, as well as to reassess the issue of commercial activities of public person, a draft Concept on Commercial Activities of Public Persons was developed. On April 5, 2012 the meeting of the Reform Management Group agreed that the issue on the management of state-owned shares will be directed to the Cabinet of Ministers. After examining the issue at the Cabinet of Ministers line ministries will be given the task to evaluate the status and goals of companies under their subordination. It is planned that the central management institution could start to work on January 1, 2013.

3.2.2 Promotion of productive investment and exports

Access of companies to financial resources. The measure aims to provide financial resources to start and develop business. In 2011 a wide range of financial mechanisms were offered to businessmen, including loans and individual guarantees. In 2012 access of companies to financial resources will be ensured to improve their competitiveness and boost growth. The measure will increase access to funding, will promote creation of new businesses, acquisition of business skills, development of business environment, and will assist in entering new markets and strengthening business positions in existing markets.

Support for entering external markets. The measure aims to increase Latvian export volumes and diversify export markets providing direct export supporting services to companies (training, consulting, seminars on foreign markets and opportunities for cooperation, support for participation in exhibitions, etc.). EU co-financing is planned for measures. In 2011, according to the plan, direct export supporting services were provided to companies, as well as the network of foreign economic representations was extended (in Lithuania and Ukraine). In 2012 support is provided to merchants to enter external markets.

Support for small and medium-size enterprises. The measure aims to provide support to small and medium-size enterprises through micro lending programmes. Within the framework of "Micro lending programme for small and medium-size Latvian companies" from February 2009 till September 2011 395 loans were granted. Since October 2011 "Micro lending programme for small and medium-size Latvian companies" is replaced by a new programme – "Latvian-Swiss micro lending programme". The programme will operate till June 2015.

3.2.3 Innovations, research and development

Creating a platform for long-term cooperation between companies and scientists. The measure aims to create a framework for more effective cooperation between scientists and entrepreneurs, while developing the research infrastructure and encouraging joint studies. In 2011 cooperation contracts were concluded between 6 competence centres, work of 8 technology transfer contact points was supported. From 2012 till 2015 "Cluster programme" co-financed by EU Structural Funds will be implemented, as a result at least 8 clusters will be established. The measure will increase private sector investment in research and development, as well as the turnover and number of employees in supported companies.

Support for development of innovative enterprises. The measure aims to increase the number of innovative enterprises. In 2012 it is planned to develop conditions for a new support programme "Technology incubator" and begin its implementation, as well as to launch a "Programme for development of new products and technologies of micro, small and medium-size enterprises". Measures will increase output in manufacturing, high tech service industry and exports, increase private sector investment in research and development, as well as the turnover and number of employees in supported companies. To implement the measure it is planned to attract private financing, as well as EU Structural Funds and Norwegian Financial Mechanism. In 2010 – 2015 support is provided to enterprises for development of new products and technologies, as well as projects for putting new products and technologies in production.

3.2.4 Transport and energy

Transport and infrastructure. The measure aims to increase the competitiveness of logistics services and ensure carrying capacity of EU's external borders in accordance with potential freight and passenger traffic flow. In 2011 – 2013 the main directions of activities are reconstruction and improvement of the rail, road, port and air transport infrastructure, as well as development of the International Freight Logistics and Port Information System.

Energy and climate change. Now “Energy Strategy 2030” is being developed. This document will determine directions of actions in long term in energy security, competitiveness, energy efficiency and use of renewable energy. It is also planned to review state aid mechanisms for energy generation from renewable energy sources.

Increasing energy efficiency. The aim is to provide greater energy savings in buildings and transport sector, as well as to increase significantly the heat production efficiency, reduce heat losses in transmission and distribution systems and to encourage replacing fossil fuels with renewable or other forms of fuels. In 2009 – 2013 total available EU funding to improve heat insulation in apartment houses is 47.8 million lats (68.0 mln euros). To promote the measure an extensive information campaign is carried out encouraging apartment owners to participate in management of joint property and improving energy efficiency. In order to implement energy efficiency building measures, heating system modernization programmes with support of EU Structural Funds and the Cohesion Fund continue, as well as resources of the Climate Change Financial Instrument are attracted.

3.3 Balanced Social System and Employment

Reform of the social benefit system. The need for changes in municipal social benefit system was evaluated. In 2012 it is planned to develop proposals for the reform of the social benefit system. While developing proposals it will be taken into account that the social assistance system must be targeted, flexible and balanced enough to suit the assistance to individual needs, but at the same time to motivate people to get back to the labour market.

Improving active labour market policy measures. The measure aims to reduce high risk of structural unemployment, as well as to increase the level of employment and economic activity. In 2012 it is planned to evaluate effectiveness of employment measures and improve further measures. It is also planned to start paid temporary public work, as well as implementation of a support measures for young people without work. Providing unemployed with more valuable support and motivation to look for a job, methods of the Employment State Agency will be developed improving optimal adjustment between profiling of unemployed and vacancies. In order to improve the employment policy planning process, a high-level employment policy coordination council - will be established with participation of line ministries.

Support for micro-enterprises. The measure aims to encourage formation and development of new, competitive micro, small and medium-size businesses, thereby supporting the creation of new jobs. Within the framework of the Mortgage and Land Bank of Latvia “Start Programme” loans are granted and integrated support is provided to business start-ups and newly established businesses – consulting, training and loans and grants for start-up (including consulting, training). Since launching the programme 575 business start-ups projects have been supported and by the end of 2011 1145 participants of the programme were supported, as well as 1096 business plans were received. But in 10 business incubators 421 micro, small and medium-size companies have received incubation services. In these companies 1198 jobs are ensured (maintained).

3.4 Health Care

Within the framework of the health care system in the time period from 2012 till 2015 the following measures are planned:

Reform of the health insurance system. The measure aims to attract additional resources to the health care system and link personified tax payments to the state budget with receipt of planned health care services. In 2012 – 2015 it is planned to develop a Health Insurance System Concept. The measure will ensure availability of state-funded health care services to socially vulnerable persons and people who pay taxes.

Strengthening primary health care. The measure will improve overall health indicators of the population, including smaller number of chronic patients, which will contribute to the economic growth, for example, the total length of work disability and the disability risk will decline. The number of jobs in health care will increase.

- Involvement of the second nurse in GP practice ensuring that the nurse serves patients independently. The measure will improve the care of chronic patients, will encourage patients to arrive for preventive examinations. In 2011 the second nurse was involved in 465 GP practice. Fiscal impact: in 2011 2.6 mln lats (3.7 mln euro), in 2012 4.1 mln lats (5.8 mln euro), in 2013, 2014 and 2015 4.8 mln lats (6.8 mln euro).
- Introduction and maintenance of the GP consultation phone. It will ensure that patients after GP working hours and on holidays may receive telephone consultations in case of acute illness or exacerbation of chronic disease. The GP consultation phone service was introduced on May 1, 2011. Fiscal impact: in 2011 0.1 mln lats (0.1 mln euro), between 2012 and 2015 0.2 mln lats (0.3 mln euro) each year.
- Implementation of quality criteria for GP work. The measure aims to improve results of primary health care services, as well as to improve access to GP services. Fiscal impact: in 2011 0.2 mln lats (0.3 mln euro), in 2012 0.4 mln lats (0.6 mln euro), between 2013 and 2015 the measure will be provided within the framework of the budget.
- Increasing efficiency of day hospitals and cost-effectiveness of provided services. The measure envisages developing more cost-effective health care services by setting the scope of health care services provided by day hospitals, by determining precise clinical indications for treatment in day hospitals and limitations on the treatment duration. The measure will decrease the period of treatment in hospitals and the length of patient’s work disability. Developing day hospital services the outpatient health care will be developed, which is a more cost-effective way of providing health care services. Day hospital services are possible to provide closer to patient’s place of living, thus this service will be more convenient for patients. In the first half of 2011, compared to the first half of 2010, the number of unique patients who received assistance in day hospitals increased by 26.5%. Fiscal impact: the measure is provided within the framework of the annual budget.

Developing a hospital funding mechanism. The measure provides for development of hospital funding mechanism defining the number of specialists per 24 hours and division by specialties at different levels of hospitals; operating principles for receiving-rooms in hospitals; patient-care steps; provision of certain types of services in regional hospitals. As a result health care resources will be used more efficiently by developing health care services which will be financially and geographically more accessible to patients. Equal access to the state budget-funded health care services will be ensured for all the population in Latvia and labour force and medical equipment in the health care sector will be used more rationally.

3.5 Education and Science

Ensuring access to primary and secondary education. Since February 2011 uniform procedures have been introduced in the country by which an educational institution shall inform students' parents, local or national authorities, if the student does not attend the educational institution without good reason. In 2012 improvements in regulatory framework continue. In February 2012 procedures became effective by which students are enrolled in general education institutions and expelled (except boarding schools and special educational institutions). Procedures provide for mandatory support measures for students with learning difficulties so that leaving students for the second year takes place only in special cases. In school year 2011/2012 the proportion of students left for the second year in day schools fall from 2.5% to 1.7%, compared to the previous school year.

Structural changes in vocational education. The aim is to increase the quality of vocational education to ensure it meets the requirements of market, and promote more efficient use of available resources. It is planned to optimize and differentiate the number and location of vocational education institutions in regions from 56 institutions in 2010 to 29 institutions in 2015. It is also planned to ensure upgrading of training facilities and improve infrastructure in vocational education institutions. The measure is mainly implemented with support of the European Regional Development Fund (hereinafter – ERDF). In vocational education the funding model "money follows the student" operates – funding for a vocational education programme is calculated according to the number of students and implemented training programme. To ensure complete arrangement of infrastructure in vocational education institutions as a result of EU funds contribution, creating a fully upgraded, modern education institutions, the Ministry of Education and Science has resumed implementation of the ERDF fund activity "Modernization of equipment and improvement of infrastructure for implementation of vocational education programmes" preventing possible losses to the state budget and terminating implementation of projects lacking money for complete implementation. The Ministry of Education and Science is committed to focus available ERDF resources, therefore it has developed new principles for evaluation of vocational education institutions to select candidates within the second project selection round of the EU fund activity "Modernization of equipment and improvement of infrastructure for implementation of vocational education programmes".

Modernisation of higher education. The measure is aimed to consolidate resources of higher education and science and ensure their efficient use, while maintaining access to higher education, as well as to improve the competitiveness of study programmes. In 2011 international evaluation of higher education institutions in Latvia was started. It is planned to examine at least 550 accredited programmes from quality, adequacy of resources and sustainability aspects, and to ensure development of new, innovative and interdisciplinary study programmes. The reform will improve the higher education funding mechanism implementing a funding model oriented towards performance indicators. The measure will result in proposals for improving, consolidation, closure of study programmes. The measure will also increase efficiency and quality of studies and research, ensure compliance of qualifications and skills with labour market requirements.

Increasing the percentage of graduates. The measure aims to improve the quality of study programmes, promote preparation of high-quality master's and PhDs, as well as to modernize the material and technical basis to increase the number of disabled who can receive higher education. The measure will be implemented in 2009 to 2013 and is aimed to increase the number highly skilled specialists with master's degree, particularly in science, mathematics, information technology, engineering, health care, environmental sciences and creative industries, as well as the number of specialists with highest qualification of doctor's degree. Develop and implement in manufacturing high technology products, products and services with high added value, contributing to the economic development on innovation base. The measure will promote renewal and expansion of academic and research staff, as well as increase the number of persons who will receive higher education.

Attracting foreign students. In 2011 measures have been taken to facilitate possibilities of universities to attract foreign students, such as universities have statutory rights to develop and implement joint study programs with foreign universities and to issue joint diplomas, as well as to offer government scholarships to foreign students. In the Academic Information Centre a Higher Education Export Capacity Promotion Section is established providing information and advisory support to universities, as well as coordinating the participation of universities in foreign and international education exhibitions. An electronic catalogue is prepared with study programmes offered by Latvian higher education institutions in foreign languages. In 2012 Regulation "Procedures for awarding scholarships to foreigners" was approved. The Regulation provides for a possibility to grant scholarships to foreign students, therefore in the future Latvia will be able to fulfill provisions of signed international treaties on promotion of student mobility. It is expected that the above mentioned measure will increase the proportion of foreign students in Latvian in 2013 up to 3% of the total number of students.

Consolidation of public research institutions. The measure aims to carry out consolidation of public research institutions focusing resources in competitive public research institutions and creating three level scientific institutions, i.e. regional, national and European. In 2010 – 2011 in order to carry out the consolidation of scientific institutions methodology and evaluation criteria were developed, as well as 9 national research centers were determined. The measure will ensure more effective use of state budget resources and encourage further development of innovative enterprises, development of new technology-oriented products, attraction of foreign investment to research and development.

4 General Government Budget Balance and Debt

4.1 Current Fiscal Situation

The global financial crisis severely affected the Latvian economy. The most difficult period for the Latvian economy was late 2008 when a critical situation formed in the financial sector and state budget and it was necessary to ask for financial assistance of international organizations. The government did not allow the situation to get out of control in the financial sector and in December 2008 the Saeima passed the Latvian Economic Stabilization and Growth Revival Programme, which set out the main directions of managing the economic crisis, and launched the Programme within the framework of which Latvia concluded a Memorandum of Understanding with the EU, which set out the main measures for immediate and long-term fiscal consolidation, comprehensive strategy for solving bank issues, improving crisis management capabilities of supervising institutions, implementing comprehensive structural reforms, as well as performing other important measures. The Memorandum of Understanding was revised regularly entering into Supplemental Memorandums of Understanding.

Consequently, since 2008 Latvia has been implementing measures within the framework of the priorities set in the Programme and the Latvian Economic Stabilization and Growth Revival Programme Action Plan (since April 2010 within the framework of the Latvian Strategic Development Plan 2010 – 2013) – economic growth, social security and public administration reform, including compliance with general government budget balance targets and implementing significant fiscal consolidation measures.

Latvia in all years of the Programme implementation has been able to successfully comply with required general government budget balance targets and implement fiscal policy more successfully than had been previously planned. Latvia performed effective, high-quality fiscal consolidation measures, as well as in order to better safeguard against potential fiscal, economic and social risks caused by macroeconomic processes, economic growth was predicted based on a relatively conservative macroeconomic scenario.

Overall, during the time period from 2008 till 2012 fiscal consolidation measures have been performed with fiscal impact of 17% of GDP, of which about 6.8% of GDP consists of measures taken on the revenue side, while measures on the expenditure side as a whole account for about 10.2% of GDP (see Figure 4.1). On average in the time period from 2008 till 2012 Latvia has performed fiscal consolidation measures in amount of 3.4% of GDP.

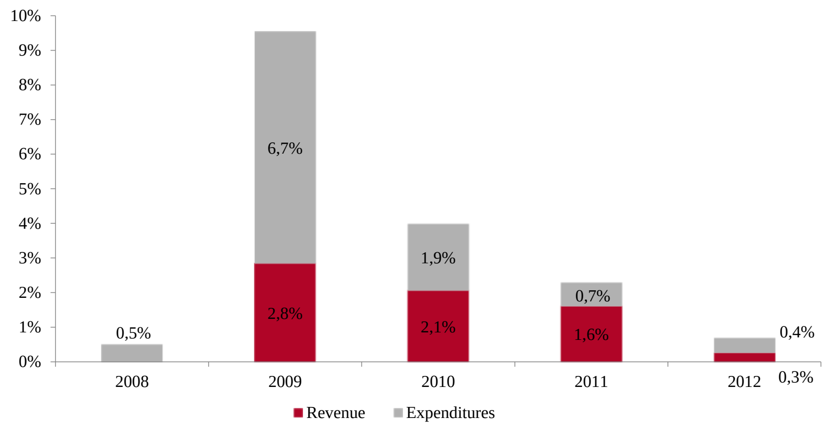

Figure 4.1. Fiscal consolidation between 2008 and 2012, % of GDP

The state budget 2011 was originally adopted to ensure the general government deficit of 6% of GDP (according to the European System of Accounts (hereinafter – ESA) methodology), but in April 2011 when state budget amendments were introduced providing addition fiscal consolidation, the general government deficit target was revised and set at 4.5% of GDP.

According to the Notification on general government budget deficit and debt in April 2012, the general government budget deficit in 2011 was 494.1 million lats or 3.5% of GDP (see Figure 4.2), which is 4.7% less than in 2010 and significantly less than the predetermined target. Improvements in the general government budget balance was mainly due to improvements in central government and social security budgets. Better fiscal situation was facilitated by the general government budget revenue growth as the economic activity increased and tax administration measures improved. In turn, in the social security budget, compared to 2010 and previous forecasts for 2011, expenditure associated with unemployment benefits decreased significantly taking into account the decline in unemployment rate.

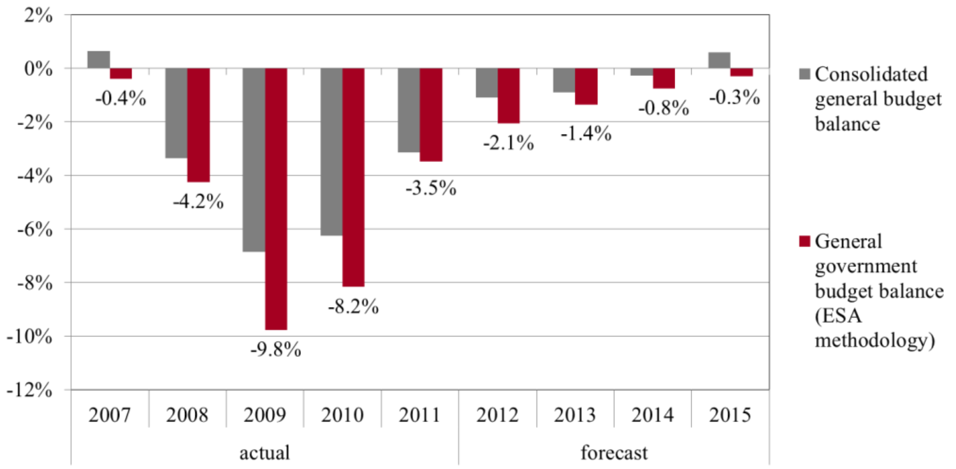

Figure 4.2. General government budget balance (according to ESA methodology) and consolidated general budget balance (according to cash-flow methodology) in 2007 – 2015, % of GDP[1]

It should be noted that the general government budget deficit according to ESA methodology compared to the consolidated general budget deficit in accordance with national (cash-flow) methodology in recent years has been influenced by negative corrections according to ESA methodology. In particular, significant adjustments were made in 2009 and 2010 and in the central government sector they were primarily driven by government investment in financial institutions as a result of the economic crisis (JSC Parex Banka, JSC Mortgage and Land Bank of Latvia), while in the local government sector – construction of major infrastructure objects (South Bridge). Also in 2011 government investments in companies and financial institutions caused a negative impact on the ESA corrections, although it was significantly lower than in previous years.

[1] Data source: Notification on general government budget deficit and debt in April 2012, forecasts of the MoF.

4.2 Fiscal Development Scenario

The main goal of the Latvian fiscal policy in coming years is to continue to implement economic recovery and growth promotion activities and to facilitate responsible and sustainable fiscal policy, ensuring strict fiscal discipline in coming years.

In view of the above said, Latvia will continue to implement commitments set in the Memorandum of Understanding, implement directions set in the LSDP within the framework of set priorities – economic growth, social security and public administration reforms, meeting priorities of the Annual Growth Survey and commitments of the Euro Plus Pact (see Sections 3 and 6, the NRP).

In accordance with the main target of the fiscal policy the Latvian medium-term budget balance target in structural terms (hereinafter – MTO) is a structural deficit of 0.5% of GDP.

Similarly, the Fiscal Development Medium-term Scenario envisages further improvements in the general government budget balance in 2013 – 2015 in line with the improvement pace 0.5% of GDP in structural terms specified in the Stability and Growth Pact and the EU Council Regulation No 1175/2011 till the medium-term target is achieved (see Table Cyclical development).

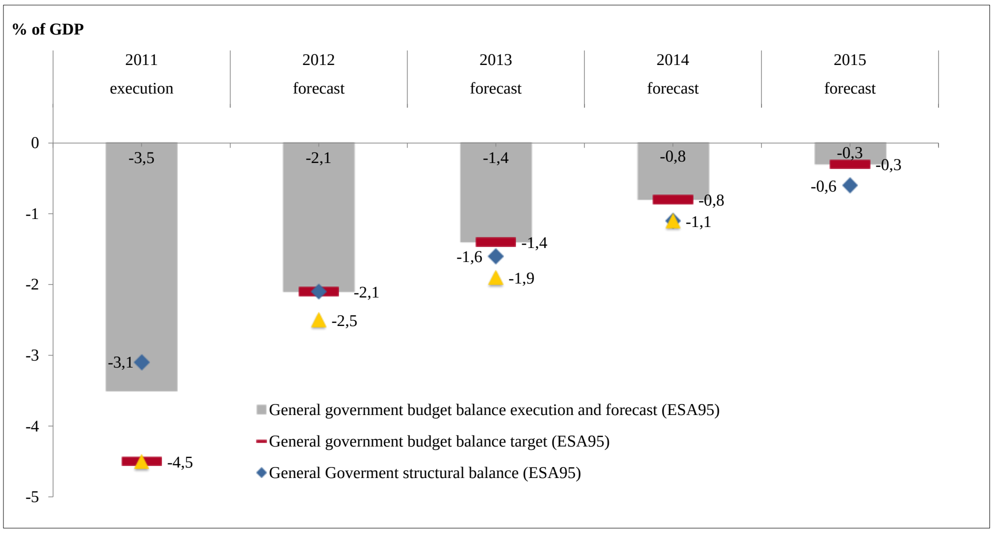

Figure 4.3. General government budget balance, its goal (according to ESA methodology) and structural balance in 2011 – 2015, % of GDP[2]

Consequently, according to the above mentioned conditions, general government budget deficit targets are the following: in 2013 1.4 % of GDP, in 2014 0.8 % of GDP, but in 2015 already 0.3 % of GDP. Obviously, the fiscal policy implemented successfully by Latvia in previous years allow getting closer to MTO faster than planned in the last year's Latvian Convergence Programme (see Figure 4.3).

In order to successfully continue the current direction – implementation of stable fiscal policy, in the annual budget process 2012 fiscal consolidation was continued, as a result the state budget for 2012 was adopted with the general government budget deficit of 2.1% of

[2] Data source: Notification on general government budget deficit and debt in April 2012, forecasts of the MoF.

GDP according to ESA methodology, thus ensuring better achievement of the deficit target set in April 2011 (– 2.5 % of GDP according to ESA methodology), and it is well below the Maastricht criterion – 3% of GDP.

Work on identification and analysis of 2012 budget deficit reducing measures was initiated in spring 2011, when the CoM approved the indicative list of fiscal consolidation measures, which was outlined in the previous Convergence Programme.

It should be noted that decisions on specific fiscal consolidation measures were difficult and unpopular, but they were absolutely necessary to prevent excessive deficit and in a long-term create conditions for a stable fiscal policy, stability of the banking system, country's economic growth and restoring confidence of the international environment in the country.

For 2012 the list of fiscal consolidation measures allows the most optimal solutions. The structure of the fiscal consolidation is mainly based on a review of expenditure rather than increase in revenue, apart from measures to improve tax administration, thereby not creating additional pressure on inflation, but continuing consistent fight against the shadow economy.

The main fiscal consolidation measures for 2012 are the following:

- Total public sector wage expenditure is frozen at the level of 2011, limiting vacation benefits for employees of state and municipal institutions to 25% of the wage by 2013, continuing to cap the daily provision allowance for employees of the Ministry of Defense, the Ministry of Justice and the Ministry of Interior at the level of 2011. A new public administration strategy is being prepared, inter alia arranging the distribution employees within the framework of the joint remuneration system based on effective assessment of knowledge and skills introducing central control over formation of new positions. Proposals are underway for the reform of the remuneration system making it more efficient regarding low-paid employees, rewarding for best performed duties and attracting highly skilled employees, as well as preparing proposals for the motivational system to reward employees of the public sector for well and excellent performed duties;
- Stimulate local governments to cut expenditure, at the same time providing the social safety net and investments, setting stricter limits on local government borrowing ceilings, while expanding opportunities for borrowing money for projects that are not co-financed from EU funds, reducing the personal income tax proportion for local governments from 82% to 80%, while providing payments to local governments with lower income levels and co-financing 50% of benefits to ensure the guaranteed minimum income (GMI) in year 2012, and reducing the national co-financing of housing benefits from 20% to 0% from the end of April 2012;
- Frozen payments to landowners engaged in environment protection measures at the level of 2011 by 2013;
- Reduced government funding for road maintenance and subsidies to cover losses of public transport operators;
- Reduced subsidies for agriculture and grants to the international airport "Riga";
- In the state social insurance special budget 2012 a consolidation measure is planned reducing expenditure for sickness benefits in amount of 3 000 000 lats due to the review of regulatory acts on temporary sick leave and the process of issuing sick-lists;

- Reduced expenditure of the Ministry of Interior and the Ministry of Health, as well as the Ministry of Welfare introducing control mechanisms to reduce the length of sick leave vacation and submitting a proposal to the Saeima to reduce long-term sickness benefit compensation rate;
- Introducing tax support measures, reducing movement of excise duty-free goods on non-EU borders from a day to a week, raising the tax on gaming machines and gaming tables by 15 per cent, improving legislation in the online gaming industry and ensuring better tax collection, strengthening the capacity of the State Revenue Service;
- The reverse-charge VAT mechanism is introduced on scrap metal and construction services, and 10% personal income tax imposed on revenue from scrap metal sales;
- Expanded real estate tax base, by including auxiliary premises (exceeding 25 square meters), buildings and land owned by religious organizations not used for religious purposes, and parking lots, as well as by removing 25 per cent limit concerning the annual increase in property tax on land, by simultaneously providing the opportunity to the local governments to apply tax increase limits;
- Simplified (presumptive) tax system for small and micro enterprises by ensuring that a general personal income tax regime applicable reduces the risk that large companies would establish microenterprises by thus reducing their costs; ;
- Doubled financial stability fee.

The CoM approved also fiscal consolidation measures to be performed in 2012 with results starting from 2013, and they are the following:

- To evaluate the possibility of reducing real estate tax rate thresholds for living space to ensure even distribution between the three tax intervals, remove 25% limit on annual real estate tax increase on land, allowing local governments to apply an increase limit within the set corridor and to carry out a cadastral reform to reflect properly housing depreciation and market value;
- By September 2012 it is planned to adopt a comprehensive family state benefit and social assistance reform aimed at improving the financial situation of the poorest families and to consider a review of tax exemptions for children;
- To reform the social safety net system to improve incentives and reduce the poverty traps;
- To continue to limit maximum maternity, paternity, parental and sickness benefits by 2014, decide to cap the replacement rate of maternity and paternity benefits at 80 percent starting from 2013, as well as to renew ceilings on social contributions for high income earners beyond 2014 thus reducing the maximum amount of social insurance that high income earners can receive.

Latvia will be able to reach set fiscal policy targets without further fiscal consolidation, as there is significant impact from general government deficit reducing measures and structural reforms implemented in previous years, which impacts economic growth and formation of growth-friendly expenditure policy.

It should be noted that within observing strict fiscal discipline Latvia evaluates carefully measures and certain fiscal constraints, such as, establishing new staff positions, measures for implementation of certain provisions of legal acts which are not envisaged as compulsory according to legal acts are not initiated, as well as procurement of computer equipment and other assets is not supported, with exception of equipment and assets necessary to fulfill functions of national importance, and wage bill increase is not supported, covering rise in utility, fuel and rent prices for state budget institutions is not supported.

In the context of fiscal constraints it should be noted that EU funds and Cohesion Fund financing is considered as an important source of financial resource for facilitating economic growth and in the future it is also planned to ensure adequate funding to absorb EU funds successfully.

At the same time, as the economic growth and revenue increase, the government will consider the possibility to support growth and employment-friendly changes in the tax burden structure, as well as funding new priority measures evaluating their compliance with existing commitments and priority liabilities, their relevance with emphasis on growth-enhancing measures and measures contributing to the increase in tax revenue, including investment, as well as evaluating the principle of growth-friendly expenditure policy. To ensure drafting a balanced and economic growth promoting budget, during the budgetary process measures affecting sustainability of the budget will be evaluated, including ensuring sustainability of the social insurance budget.

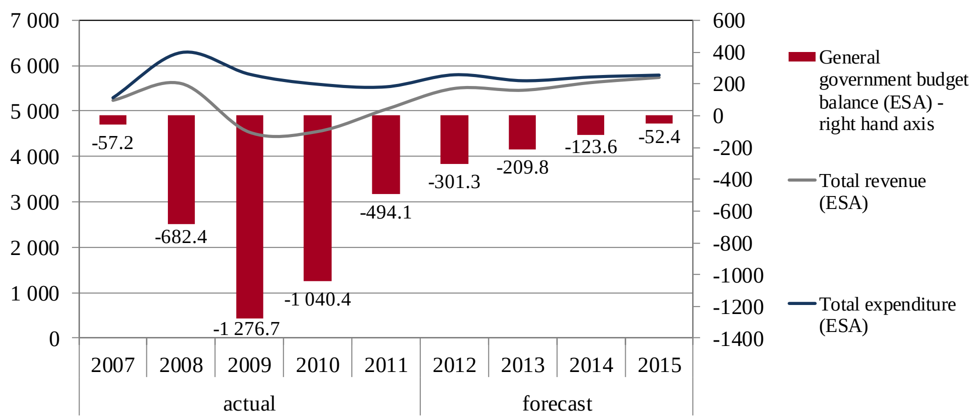

Figure 4.4. General government budget balance, total revenue and expenditure (according to ESA methodology) in 2007 – 2015, mln lats[3]

In view of the above said, it is forecasted that the general government budget balance over the Convergence Programme period will be improve in all sectors. The main assumptions taken into account when drafting budget balance forecasts by sectors are the following:

Table 4.1. General government budgetary prospects

		2011	2011	2012	2013	2014	2015
	ESA code	mln lats	% of GDP				
Net lending (EDP B.9) by sub-sector							
1. General government	S.13	-494.1	-3.5	-2.1	-1.4	-0.8	-0.3
2. Central government	S.1311	-307.5	-2.2	-0.6	-0.1	-0.6	-0.4
3. State government	S.1312						

[3] Data source: Notification on general government budget deficit and debt in April 2012., forecasts of the MoF.

		2011	2011	2012	2013	2014	2015
	ESA code	mln lats	% of GDP				
4. Local government	S.1313	-60.9	-0.4	-0.4	-0.1	0.0	0.0
5. Social security funds	S.1314	-125.7	-0.9	-1.0	-1.2	-0.2	0.1
General government							
6. Total revenue	TR	5039,6	35,6	37,4	35,1	34,1	32,8
7. Total expenditure	TE	5533,7	39,1	39,5	36,5	34,9	33,1
8. Net lending/borrowing	EDP B.9	-494.1	-3.5	-2.1	-1.4	-0.8	-0.3
9. Interest expenditure	EDP D.41	210.3	1.5	1.7	1.8	2.1	2.1
10. Primary balance		-283.8	-2.0	-0.4	0.5	1.4	1.8
11. One-off and other temporary measures		27.4	0.2	0	0	0	0

Central government

It is expected that over medium term the central government budget balance will improve. In preparing balance projections renewed tax revenue forecasts for 2012 – 2015, compared to the plan of autumn 2011, is taken into account. It was also considered that in 2014, compared to 2013, slight increase in the central government budget deficit will be determined by planned additional payments to old age and disability pensions, transfers from the social security budget to the state basic budget, from 2014. In turn, in 2015, compared to 2014, reduction of the central government deficit will be ensured by lower expenditure, for example, capital expenditure (formation of gross total fixed capital), which will be determined by the fact that in the light of the beginning of the new EU funds programming period at the moment expenditure for the implementation of foreign financial assistance programmes is planned conservatively.

Social security funds

In preparing the social security budget medium-term forecast it was taken into account that at the moment according to the law from 2013 onwards the social insurance contribution rate to the state funded pension scheme (2^{nd} pension pillar) is increased from 2% to 6% and in coming years is maintained at 6% level. These changes will primarily determine lower income in the social security budget (1^{st} pension pillar), which in turn will affect the deficit growth in 2013, compared to 2012. While in 2014, compared to 2013, in the social security budget substantial deficit reduction is projected, taking into account the planned transfer of additional payments to pensions to the state basic budget.

Local government

It is expected that the local government budget deficit in 2012 will remain at the level of 2011 or will be even slightly higher, given that in 2012 active implementation of EU fund projects is planned, as a result capital expenditure in the local government budget is likely to remain at the level of 2011 or will be even higher. It is projected that a similar trend may continue also in 2013. While in 2014 and 2015 it is forecasted that the local government budget will be balanced, taking into account the expected reduction in expenditure. Local government budget forecasts include the assumption of reduction in expenditure for capital expenditure, which will be determined by the fact that in the light of the beginning of the new EU funds programming period at the moment expenditure for the implementation of foreign financial assistance programmes is planned conservatively.

4.3 Medium-term Objective and Structural Balance

According to the Stability and Growth Pact the budget balance shall be measured in structural terms, excluding cyclic fluctuations of the economy and effects of one-off or other short-term measures. Thus the structural budget balance more accurately reflects the direction of government's fiscal policies.

For calculations of potential GDP Latvia uses a methodology different from that of the commonly agreed EC method. The main reason is that the EC common methodology cannot accurately capture macroeconomic data turning points that are characteristic to new Member States, for example, in the Latvian economy now unemployment is rapidly declining and growth is higher than expected, but since the EC common methodology uses yearly data in calculations, taking into account short time series, the available actual data still perceives disproportionate impact from crisis-years. To solve this problem, in calculations of the MoF medium-term forecasts were included, allowing for identification of the turning point and mark the correct trend of development of macroeconomic indicators.

Results obtained by using the EC common methodology would significantly overestimate the structural unemployment rate, which in turn would give a very low assessment of potential GDP growth in medium and long-term forecasts. Structural unemployment rate for needs of the Convergence Programme is estimated by using statistical method, which does not possess so much features of economic interpretation as EC method, but results are more relevant to real economic growth rates in Latvia and mark the convergence with the average EU level of development. Basic principles of the method were presented to EC representatives on March 20, 2012.

Results of the potential GDP calculation are given in Table 4.2.

Table 4.2. Cyclical development

% of GDP	ESA Code	2011	2012	2013	2014	2015
1. Real GDP growth (%)	B1g	5.5	2.0	3.7	4.0	4.0
2. Net lending of general government	B.9	-3.5	-2.1	-1.4	-0.8	-0.3
3. Interest expenditure	D.41	1.5	1.7	1.8	2.1	2.1
4. One-off and other temporary measures		-0.2				
5. Potential GDP growth (%)		-1.0	1.4	2.8	3.6	3.9
contributions:						
- labour		-1.0	-0.1	0.4	0.6	0.6
- capital		0.2	0.7	0.8	1.0	1.1
- total factor productivity		-0.2	0.8	1.6	2.0	2.2
6. Output gap, % of potential GDP		-0.7	-0.2	0.7	1.1	1.1
7. Cyclical budgetary component		-0.2	0.0	0.2	0.3	0.3
8. Cyclically-adjusted balance (2-7)		-3.3	-2.1	-1.6	-1.1	-0.6
9. Cyclically-adjusted primary balance (8+3)		-1.8	-0.4	0.3	1.1	1.5
10. Structural balance (8-4)		-3.1	-2.1	-1.6	-1.1	-0.6

High capacity utilization in the industry shows that the productive capital is used close to its potential level, however, vacancy rates are still relatively very low, indicating a strong demand for jobs. This means that there is a significant resource of free labour force available in the economy. Future potential GDP growth depends on investment inflows, which will ease the capacity constraints and allow inflow of available labour force into productive sectors.

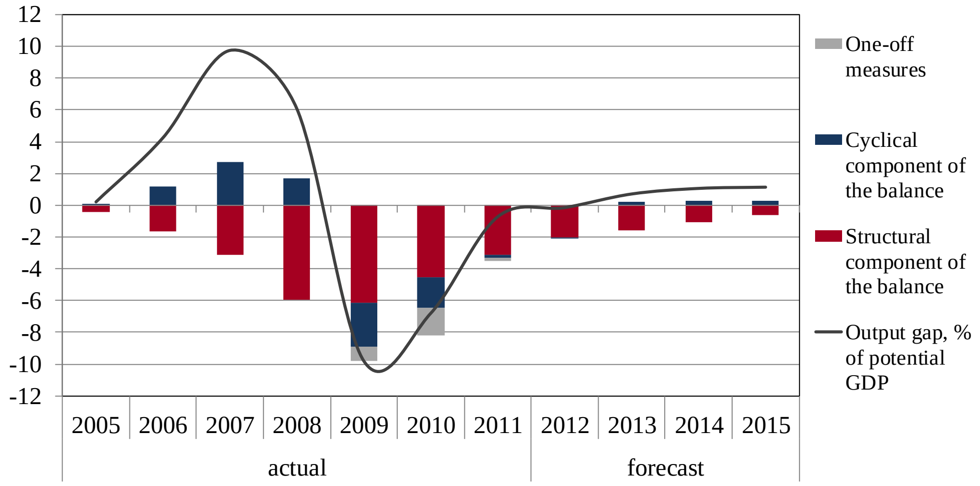

Figure 4.5. Output gap and general government budget balance by components in 2005-2015, % of GDP

From the analysis of the general government budget balance structure it appears that it is based on the structural component, but during rapid economic growth (in 2006 – 2007) and downturn (in 2008 – 2010) the impact of fluctuations in the economy increased. In years of economic growth the budget balance was improved by higher tax revenue, while during the economic crisis revenue decreased, but expenditure for social benefits increased, for example, due to increased unemployment rate.

According to estimates of the Ministry of Finance in 2010 the structural general government budget deficit[4] was 4.5% of GDP, which, compared to 2009, was improved by 1.6% of GDP, while in 2011 the structural deficit was 3.1% of GDP, which is about 1.5% of GDP less than in 2010. In addition, in 2012 it is forecasted that real economic growth will be at the level of potential growth and thus the actual budget balance will equal to the structural balance, i.e. a deficit of 2.1% of GDP. In 2013 – 2015 it is forecasted that the structural general government budget balance will improve, taking into account the improvement pace 0.5% of GDP each year. The structural budget balance improvements, as well as the positive cyclical component of the balance in coming years will provide improvements of the balance also in actual terms.

It should be noted that budget balance changes are affected also by interest expenditure and it is expected that in 2011 – 2015 it will rise from 1.5% of GDP to 2.1% of GDP. In cyclically adjusted primary budget balance calculations interest expenditure is not taken into account and therefore, excluding interest expenditure, budget balance improvements would be even more considerable.

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[4] In calculations the following is taken into account:

1) In the calculation of the budget balance cyclical component the budget sensitivity 0.28 is taken into account. (Data source: New and updated budgetary elasticity and sensitivity parameters for all EU Member States, REP/54284, 20.09.2005);
2) One-off measures: in 2009-2011 government investment in JSC “Parex banka” (in 2009 113.5 mln lats, in 2010 219.0 mln lats, in 2011 27.4 mln lats).

4.4 Government Debt Development Trends in Medium Term

According to the results of the general government budget deficit and debt notification of April 2012, prepared according to ESA methodology, the general government debt at the end of 2011 reached 6 028.2 mln lats or 42.6% of GDP. The general government debt was mainly affected by the central government debt, which at the end of 2011 was 5 216.3 mln lats.

The aim of the central government debt management is to ensure necessary financial resources for government debt refinancing, budget deficit financing and maintaining financial reserves at lowest possible costs, hedging financial risks and taking into account development of the Latvian national macroeconomic, capital market and financial system that focuses on the euro implementation over medium term.

Targets, principles and objectives of the central government debt portfolio and debt management within the framework of the debt management over medium term are determined by the Latvian government debt management strategy envisaging compliance with optimal indicators of the central government debt portfolio structure regarding the debt currency composition, maturity profile, average weighted fixed period of interest rates, and optimal share of the fixed interest rate in the debt portfolio.

The amount of borrowing and the central government debt level is determined by the total financing requirement (the amount of necessary resources to ensure execution of the government budget and refinancing of central government debt obligations over relevant period) and financing necessary to maintain financial reserves.

The current central government debt structure consists mostly of the financing in amount of 3.1 billion lats received within the framework of the Programme from 2008 till the end of 2011. Support of the Programme was an important source to cover the total financing need till 2011, and it provided an opportunity to maintain significant financial resources in reserve in Treasury accounts, which was one of the most important factors to prove solvency of the state, calm down volatility on the financial market and regain investors' confidence during the period when given the sharp drop in Latvian economic growth rates and reduction of its rating to the speculative level governmental borrowings on financial markets were severely restricted. Successful conclusion of the Programme at the end of 2011 and increased Latvian credit ratings gave a positive impulse for strengthening investors' confidence in country's solvency and further implementation of sustainable fiscal policy.

Renewal of internal market's confidence reflected in significant decline in the lats money market and rates of domestic borrowing securities already from the last quarter of 2009, as well as increase in investors' interest in investment in medium and long-term government securities. Already in 2010 the Treasury supplemented successfully the auction offer of domestic short-term T-bills (six-and twelve-month) with two, three, five, and also in 2011 already ten-year bonds, reducing the domestic debt refinancing risk and ensuring fixing borrowing rates at historically low levels.

International assessment of Latvia's performance and the results allowed Latvia in June 2011 to issue successfully 10-year Eurobonds in amount of 500 million U.S. dollars, convincingly demonstrating successful return to international capital markets before the end of the Programme. Successful issue of 5-year bonds in amount of 1 billion U.S. dollars, which took place in February 2012, reaffirmed the assessment of international financial market participants, particularly investors, of the high progress in the Latvian economy and confidence in the country's creditworthiness, which provides a solid foundation and confidence in the successful refinancing of the Programme in coming years.

Latvian successful return to international financial markets is a particularly important point of reference for implementation of the medium-term borrowing strategy, under which it is planned to perform the following measures:

- to carry out a gradual and timely borrowing on international financial markets organizing regular issuance of government debt securities in order to ensure refinancing of government debt obligations undertaken within the framework of the Programme in accordance with specific repayment schedules and with favourable conditions in terms of loan rates and timing;
- to earmark part of borrowed resources for the central government debt redemption over medium term, in order to prevent the debt refinancing risk;
- to diversify and expand the scope of government securities investors implementing a package of active investor communication measures and achieving participation of investors from various regions of the world (Europe, USA and Asia) in government eurobond auctions;
- on domestic financial market to raise funds mainly through medium and long-term debt securities, using T-bills as a securities market maintenance tool.

The medium-term borrowing strategy has been designed optimally balancing potential costs and risks according to the Latvian government debt management strategy and based on the following considerations:

– In 2012 – 2015 central government debt obligations in amount of ~ 3.3 billion lats (4.7 billion euros) must be refinanced (see Figure 4.6), which currently makes more than half of the total outstanding central government debt (most of the debt to be refinanced consists of the funding received from the EU and the IMF under the Programme). Given the substantial amount of debt obligations to be repaid in medium term, timely attraction of financial resources must be ensured accumulating gradually resources to repay debt obligations to reduce the government debt refinancing risk.

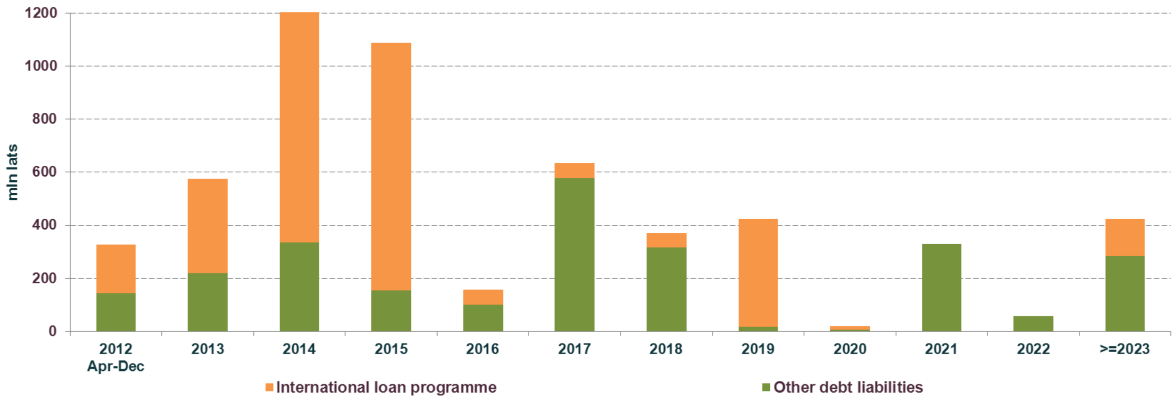

Figure 4.6. Central government debt repayment profile (liabilities outstanding as of March 31, 2012, nominal value)

– Timely and gradual borrowing, without delaying large-scale borrowing to the last minute, ensures flexibility in terms of the time, currency and maturity of the borrowing. This borrowing strategy allows to borrow with as favorable conditions as possible, including lower rates than if the borrowing is done just before the maturity of current large-scale debt obligations.
– Diversification of Latvian securities investor base will provide greater competition among investors for borrowing rates and expand regional borrowing spectrum.

– A coherent borrowing strategy and regular borrowings on financial markets help to enhance investors' confidence in the Latvian creditworthiness, which will provide the state with permanent borrowing possibilities on financial markets in the future.

The borrowing strategy chosen by Latvia will ensure prevention of the debt refinancing risk and ensure the possibility to optimize debt servicing costs over medium term.

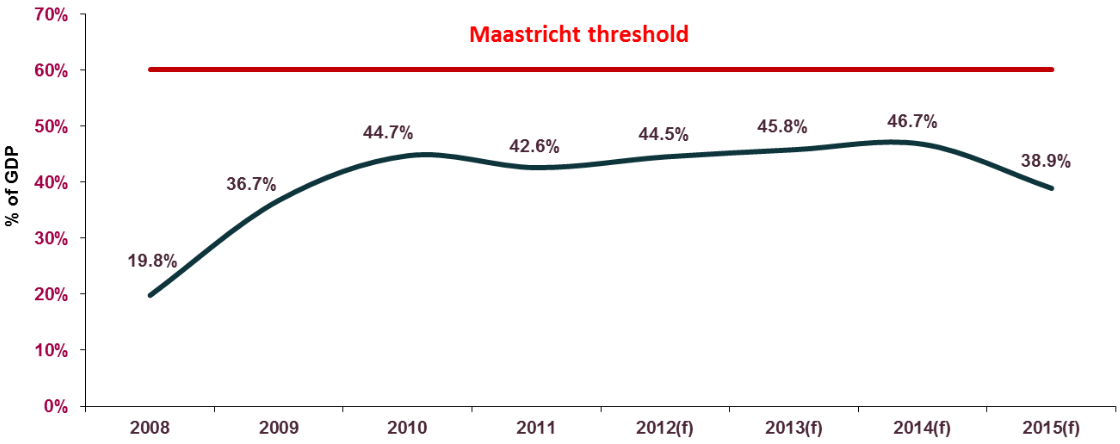

Figure 4.7. General government debt development trends, % of GDP

Making timely borrowing activities according to the developed medium-term strategy, as well as continuing implementation of responsible fiscal policy, it is possible to refinance current debt obligations with favorable conditions in terms of rates and maturity, as well as to achieve in long term reduction and stabilization of the government debt at a sustainable level complying confidently with the general government debt criterion provided in the Maastricht agreement (see Figure 4.7).

5 Sensitivity Analysis and Comparison

5.1 Macroeconomic Scenario Risks

Performance of macroeconomic scenario in 2011 – 2015 will be affected by further development of external environment. Dependence of the Latvian economy on external environment changes is determined by the big export share in GDP and share of Scandinavian banks in the Latvian banking sector. The main source of risk to the global economic growth is worsening of the situation in Europe – turbulence in the financial system, financial sustainability of individual countries and debt servicing costs, necessary fiscal consolidation measures, and raw material prices in the world.

In addition to external environment risks the performance of macroeconomic scenario will be affected by internal factors – possibilities of companies to attract and carry out investment projects to increase production capacity, lending development and other factors that directly affect country's credit ratings, interest rates, confidence indicators, and domestic demand.

Macroeconomic risks, which will determine the economic development during the Convergence Programme period, can be divided into negative and positive. The macroeconomic development scenario is based on conservative assumptions about the increase in external and domestic demand and takes into account both internal and external risks. It should be taken into account that simultaneous worsening of a number of risks may intensify the negative effect.

<u>Negative risks:</u>

- Solutions of Eurozone problems one-off monetary incentive and the European fiscal pact may not be sustainable and creates risk that Eurozone countries will experience low economic growth over medium term. This would mean significant deterioration of the external environment for Latvian exporters and thus significantly lower growth rate of the Latvian economy in medium term;
- As the Latvian banking sector is closely connected with Scandinavian banks, problems in financial markets of Eurozone countries may accelerate the deleveraging among parent banks or a tightening of credit conditions in Latvia creating a significant adverse impact on the Latvian financial market, inter alia reducing opportunities of entrepreneurs to borrow for implementation of investment projects (including implementation of EU co-financed projects), as well as raising costs of credits;
- Uncertainty regarding development of the Latvian economy may affect the overall demand in Latvia as households may choose to save (according to previously observed consumers' cyclical savings) and postpone consumption. Overall decline in demand may reduce the growth rate of the Latvian economy;
- Poor economic development outlook in Latvia's main export market the EU can have a significant negative impact on business investment in the Latvian economy. In addition a negative effect on the dynamics of investments may also result from rating agencies' assessment of the Latvia's outlook and decreasing forecasts regarding Latvia's growth by international institutions;
- Political tension and the threat of war in the Middle East and North African countries may delay delivery of oil, which would lead to significant increase in oil prices in the world. As oil prices have a major impact on overall consumer price changes in Latvia,

their increase reduces the purchasing power of people, consumption growth and hence economic growth. Increase in energy costs results in higher production costs, which reduces the competitiveness of Latvian exports;

- More likely that global raw material prices will affect the import value rather than export revenues;
- “Hard landing” of China and/or other emerging economies would substantially impair the external environment by reducing the overall demand in the world. Shrinking global economic growth, including diminishing demand for EU manufactured goods and decreasing investment flows, would cause a significant negative effect on the development of Latvian exports;
- Uncontrolled default and exit of one of Eurozone Member States from the Eurozone, breakdown of the Eurozone may have very serious negative effects on the economic growth of European countries and global economic growth, because previously applied possibilities to stimulate the economy would be exhausted at large extent. The negative impact on the Latvian economy would result in declining demand for Latvian exports and declining investments;
- ECB’s three-year bank refinancing programme may be insufficient to fully resolve liquidity problems of the Eurozone financial system. As a result of declining optimism and rising risk premiums it may become increasingly difficult for governments and banks to access financing.

<u>Positive risks:</u>

The main positive risks to the development of Latvian economy are associated with non-implementation of negative risks.

- Already taken and planned solutions to the Eurozone debt crisis may give better results than expected. The financial market recovery and structural reforms may quickly improve confidence indicators which would allow the EU economy return to growth faster than expected. This would improve significantly development prospects of the Latvian economy due to the rising export demand and improving consumer and investor confidence;
- Better than expected global economic development, including in the USA and developing countries, may provide additional incentives for high-income countries, inter alia may facilitate the crisis management in the Eurozone;
- Russia’s accession to the World Trade Organization may promote Latvian exports to Russia, but may also lead to increase of competition to Latvian exports in other countries;
- Latvian exports may respond flexibly to the worsening external environment and it may not experience significant reduction in demand, because Latvian export competitiveness has significantly improved and the structure of goods and export market after the crisis of 2008 has become more differentiated, adapted to changing external environmental conditions;
- Favourable assessment of international lenders and credit rating agencies of the Latvian economy confirms that the Latvian business environment stabilizes. It can lead to increase in investment inflows, which may increase the manufacturing and export capacity;
- Rapid credit growth still remains a positive risk that would allow companies to make additional investments to increase production capacity. This would have a positive effect on exports and investment levels. Similarly, lending may have a

positive impact on private consumption, especially in medium term, because the volume of loans granted to households in recent years has decreased.

5.2 Sensitivity Analysis

Based on the outline of potential impact of macroeconomic risks on the economy in Clause 5.1 two alternative macroeconomic scenarios have been developed. The central macroeconomic scenario outlined in the Convergence Programme is developed based on conservative forecasts regarding external environment, therefore probability of pessimistic scenario is considered as small.

Table 5.1. Optimistic macroeconomic scenario

	2011	**2012**	**2013**	**2014**	**2015**
GDP in current prices, mln Ls	14161,0	15095,1	16243,0	17482,8	18816,9
Increase at current prices, %	11,2	6,6	7,6	7,6	7,6
Increase at constant prices, %	5,5	4,0	5,0	5,0	5,0
CPI (annual average), %	4,4	3,0	2,5	2,5	2,5
Average wage in economy, lats	464	483	506	532	563
Increase at current prices, %	4,3	4,1	4,7	5,3	5,8
Employment, thsd people	970,5	983,0	1000,9	1019,3	1038,0
Increase, %	3,1	1,3	1,8	1,8	1,8
Export growth rate at current prices, %	22,6	7,8	8,0	7,9	7,8
Import growth rate at current prices, %	27,2	9,2	8,4	8,2	8,1

Realization of the optimistic scenario is possible if EU and Eurozone economies in short and medium term perform better that currently forecasted. Realization of optimistic scenario, compared to the base scenario, would increase Latvian investment and export growth rates, which would also have a positive effect on private consumption. Better growth rates would be mainly based on productivity increase and improvements in employment. Despite faster growth, unemployment in medium term would remain relatively high and wage growth would not exceed productivity growth. But with more rapid increase in domestic demand the pressure on inflation would increase as a result consumer prices in 2012 would increase by 3% and by 2.5% per year in medium term. The optimistic macroeconomic development scenario provides for the gross domestic product increase at constant prices in 2012 by 4.0%, while in medium term higher level of investment and productivity would increase GDP by 5.0% per year.

In case of the optimistic macroeconomic scenario, which provides faster GDP growth than the baseline scenario and more positive consumer and labour market indicators, budget revenue base would also improve significantly. It is estimated that if economic development progresses according to the optimistic scenario, the budget revenue, compared to the baseline scenario, in 2012 would be higher by 0.8% of GDP, while in 2013 – by 1.3%.

The pessimistic macroeconomic scenario is based on external environment risks materalizing. The main external environment risk is long-lasting period of instability in the Eurozone, where fiscal consolidation and structural reforms implemented by Member States are insufficient to regain confidence of financial markets. As a result the growth in the whole region remains low, thus causing adverse effect on development of the Latvian economy in medium term. This risk may be intensified by individual short-term external environment risks, thus decreasing the growth considerably also in 2012. Implementation of the pessimistic scenario would have an negative effect on Latvian major trading partner countries and the demand for Latvian exports would decrease. As a result export volumes and money inflows in the Latvian economy would decrease which would negatively affect also the private consumption. Instability in financial markets and weak demand for Latvian export goods would significantly slow down investment inflow, thereby reducing growth not only in short but also in medium term. If this scenario, employment and wage growth will decrease. The pessimistic macroeconomic scenario envisages that GDP does not grow in 2012, but starting with 2013 grows by only 2.0% per year. The low growth would also decrease the inflation pressure, and price increase in medium term would be 1.5% per year.

Table 5.2. Pessimistic macroeconomic scenario

	2011	**2012**	**2013**	**2014**	**2015**
GDP at current prices, mln Ls	14161,0	14296,4	14796,8	15317,4	15856,7
Increase at current prices, %	11,2	1,0	3,5	3,5	3,5
Increase at constant prices, %	5,5	0,0	2,0	2,0	2,0
CPI (annual average), %	4,4	2,0	1,5	1,5	1,5
Average wage in economy, lats	464	473	483	495	508
Increase at current prices, %	4,3	2,0	2,1	2,5	2,6
Employment, thsd people	970,5	969,9	975,1	980,4	986,8
Increase, %	3,1	-0,1	0,5	0,5	0,6
Export growth rate at current prices, %	22,6	2,9	3,2	3,5	3,5
Import growth rate at current prices, %	27,2	3,7	3,2	3,5	3,6

More moderate GDP growth than in the baseline scenario, based on poorer external environment assumptions and lower private consumption, as well as weaker labour market indicators, will also affect negatively the budget revenue base. It is estimated that, if economic development follows the pessimistic scenario, the budget revenue, compared to the baseline scenario, in 2012 would decline by 0.8% of GDP, in 2013 by 1.3% of GDP, but in 2014 and 2015 by 2.0% and 2.6%.

6 Comparison with the Latvian Convergence Programme 2011 – 2014

6.1 Comparison of General Government Budget Balance and Debt Forecasts

In 2011 GDP growth was faster than that envisaged by the 2011 Convergence Programme scenario. Despite the deteriorating situation on foreign markets, industry and exports maintained high growth rates, while the domestic demand recovery was faster than expected, bringing total GDP growth of 5.5% versus forecasted 3.3%.

But in 2012 the economic growth is forecasted lower than that forecasted in the previous Convergence Programme scenario, and these changes relate mainly to the global economic slowdown due to the Eurozone financial crisis. Also the GDP growth projected for 2013, compared to the previous Convergence Programme scenario, is slightly reduced.

Table 6. 1. Comparison with forecasts in the Convergence Programme 2011 – 2014

	ESA code	**2011**	**2012**	**2013**	**2014**	**2015**
Real GDP growth (%)	B1g					
2011		3.3	4.0	4.0	4.0	-
2012		5.5	2.0	3.7	4.0	4.0
Difference		2.2	-2.0	-0.3	0.0	-
General government net lending (% of GDP)	B.9					
2011		-4.5	-2.5	-1.9	-1.1	-
2012		-3.5	-2.1	-1.4	-0.8	-0.3
Difference		1.0	0.4	0.5	0.3	-
General government gross debt (% of GDP)						
2011		48.3	48.1	49.9	51.9	-
2012		42.6	44.5	45.8	46.7	38.9
Difference		-5.7	-3.6	-4.1	-5.2	-

Given the faster economic development in 2011, resulting in faster-than-expected increase in budget revenue, in 2011 the general government budget deficit was 3.5% of GDP, which is considerably lower compared to the forecasted deficit of 4.5% of GDP in the previous Convergence Programme. Better fiscal situation in 2011, and planned improvement of the balance in structural terms promote reduction of the general government budget deficit in coming years.

The updated general government debt forecast is more positive than forecasted in the Convergence Programme of 2011, mainly due to actual and projected growth of GDP, implemented fiscal consolidation, specified borrowing strategy, as well as lower net amount of borrowing in 2011 on the domestic financial market.

6.2 Latvia's Action on EU Council's Recommendations

On July 12, 2011 regarding the Convergence Programme 2011 – 2014 prepared by Latvia the European Council made a recommendation for Latvia to continue implementation of measures set out in Memorandum of Understanding and further Supplemental Memorandums of Understanding. The last Supplemental Memorandum of Understanding was signed on December 21, 2011. It includes measures that Latvia is committed to implement.

At the same time Latvia in the implementation of measures contained in the Memorandum of Understanding complies with the Annual Growth Survey and macroeconomic and fiscal guidance, as well as commitments provided in the Euro Plus Pact.

I Contribute further to the sustainability of public finances (Euro Plus Pact commitment) and pursuing differentiated growth-friendly fiscal consolidation (Annual Growth Survey priority).

Measures to ensure general Programme conditions and fiscal discipline:

According to the Notification on general government budget deficit and debt in April 2012 the general government budget deficit in 2011 is 3.5% of GDP (according to ESA methodology). But the 2012 state budget is prepared ensuring the general government budget deficit of 2.1% of GDP (according to ESA methodology). During the Programme Latvia with a responsible approach achieved general government budget targets set in the Programme. Moreover, Latvia has tried to ensure a lower budget deficit than that set in the Programme to ensure faster and better compliance with the Maastricht deficit criteria and ensure that the excessive budget deficit procedure is suspended. The Programme has proceeded in active cooperation with the EC and the IMF, significant decisions and decisions with fiscal impact were discussed with the EC and the IMF. The procedure was formalized with an internal procedure of the Ministry of Finance of August 12, 2011 No 12-29/33 12-29/33 "Evaluation and coordination with international loan Program partners of measures with fiscal impact planned or taken after the promulgation of the annual state budget". In the future all significant policy intentions reflected in the Programme will be discussed with Programme partners.

During the annual budget 2012 drafting period a list of deficit-reducing measures was prepared and draft state budget 2012 was submitted to the Saeima in early November, rather than late September, as originally planned, taking into account extraordinary parliamentary elections which took place in October 2011.

Given the above, what was said regarding budgetary targets in the Supplemental Memorandum of Understanding, the Annual Growth Survey and the Euro Plus Pact has been complied with.

The content of the FDL is aligned with the EC and the IMF, as well as lenders have been informed about the most important changes. The FDL and amendments to the Constitution were approved by the Cabinet of Ministers on November 29, 2011 (Prot. No 70, Par. 57) and submitted to the Saeima on December 6, 2011. On January 12, 2012 the FDL was reviewed and approved by the Saeima in the first reading. April 2, 2012 was the deadline for submission of proposals for the draft law for the second reading in the Saeima. The draft law comprises requirements of the EC Directive (2011/85/EU) of November 8, 2011 on requirements for budgetary frameworks of the Member States. By the second reading requirements of the new fiscal treaty have also been introduced in the FDL, thus ensuring better compliance of the Latvian system with EU level requirements.

But the draft law "Amendments to the Constitution of the Republic of Latvia" are still being reviewed by parliamentary committees. On January 17, 2011 it was reviewed by the Saeima Legal Affairs Committee, as a result further consideration of the amendments to the Constitution have been postponed till the moment when the working group established under the supervision of the Saeima Legal Affairs Committee will complete its work at alternatives to currently submitted draft amendments to the constitution.

Also, to ensure medium-term budget planning, the Law on Budget and Financial Management has been amended to provide that in the future each year a Medium-term Budgetary Framework Law (hereinafter – the Framework Law) will be prepared for three years, which will include the main medium-term budgetary objectives and priority development areas, as well as the main macroeconomic and budgetary indicators. Also principles of inheriting projected financial indicators have been set, thus ensuring a legally binding medium-term planning regulatory framework. The Framework Law 2013 – 2015 will be for the first time developed together with the draft annual state budget law 2013 and it will be submitted to the Saeima by October 1, 2012. From 2014 – 2016 period, the Framework Law will be prepared annually by April 30 and according to conditions set in the FDL.

With regard to the restoration of the contribution amount to the second level of pensions to 6 %, from 2013 onwards the social insurance contribution rate to the state funded pension scheme is expected to increase from 2% to 6%, according to current legislation.

In addition, to ensure sustainability of the social insurance system, which is also the Latvian commitment in the Euro Plus Pact, it is planned to increase the retirement age to 65 years, raise the early retirement age, as well as to increase in minimum insurance period to receive the right for state old-age pension up to 15 years (for details see sub-section 3.1).

Also, given the fact that reforms are made in education and science, employment, government, and business sector (for details see Section 3 and NRP), they produce effects on forming a growth-friendly expenditure policy. But in coming years, as the economic growth will increase and income will raise, they will be used assessing their compliance with existing commitments and obligations. While new policy initiatives will be supported evaluating their need, as well as the principle of growth-friendly expenditure policy.

Measures to combat the shadow economy:

"Action Plan to Combat the Shadow Economy and Promote Fair Competition in 2010 – 2013" is developed. In total the Plan currently includes 66 measures, 48 of which have been implemented in full and implementation of other measures will continue. Measures taken to date meet the directions set in the Euro Plus Pact to combat the shadow economy.

- ✓ as of January 1, 2012 in all cases when the individuals hand over scrap metal, by deriving income, a payer of income shall withheld personal income tax at 10% rate; ;
- ✓ as of January 1, 2012 the State Revenue Service (hereinafter – the SRS) is given the right to recover from the employer a fine in triple amount of tax determined in accordance with the State Revenue Service's information regarding to remuneration of the person, if it is greater than the minimum monthly wage set by the CoM, or from the minimum monthly wage set by the CoM if the calculated remuneration is equal to or less, or if its size cannot be determined. In cases when the duration of employment is not known the Member States consider that the employment relationship lasts at least three months, unless the employer or the employee can prove otherwise;
- ✓ as of January 1, 2012 imports of excise goods, including by trackless land vehicle, which is not a commercial vehicle, shall not be considered as commercial if it does not happen

on a regular basis (not more than once every seven days), thereby reducing the risk that a person misuses tax exemptions provided by laws and regulations;

- ✓ as of February 1, 2012 excise tax is applicable to certain oil groups, such as metal working compounds , mould release oils, anti-corrosion oils, other lubricating oils and other oils under the Combined Nomenclature (hereinafter – CN) code 27101991 and CN code 27101999, except if they are packed in a closed container with a capacity not exceeding 250 litres. This prevents the risk that these products (oils) falling under CN code 27101991 and CN code 27101999 are used as a motor fuel or heating fuel, thereby avoiding the excise tax;
- ✓ as of January 1, 2012 legal provisions have come into effect which prevent the use of micro-enterprise tax regime for tax planning;
- ✓ on December 15, 2011 the Law on Declaring Personal Property Status and Undeclared Income became effective, which envisages that from March 1, 2012 till June 1, 2012 individuals who meet the statutory criteria shall submit a property status declaration and allows individuals to declare previously undeclared income, subjecting it to 15 per cent personal income tax rate. At the same time regulations are adopted envisaging that individuals shall transfer cash savings exceeding the statutory threshold to the account of the credit institution so that state institutions would be able to verify that the declared cash exists;
- ✓ as of November 9, 2011 taxpayers who sell goods or offer services online, shall register their websites as entities of the taxpayer;
- ✓ as of January 1, 2012 the reverse-charge VAT mechanism is introduced on construction services.

On July 12, 2011 the CoM considered the informative report “On evaluation of current corporate income tax relief from the point of view of their effectiveness and tax administration” and the informative report “On implementation of the third measure – current personal income tax (hereinafter – PIT) relief from the point of view of their effectiveness and tax administration – of the “Action Plan to Combat the Shadow Economy and to Ensure Fair Competition 2010 – 2013”” (Prot. No 43, Par. 28 and 29). Within informative reports particular corporate income tax (hereinafter – CIT) and PIT relief were considered and it was decided that the MoF in developing the tax policy and 2012 – 2014 draft state budgets should take into account conclusions included in informative reports based on state and local government possibilities and coordinating with the Latvian Association of Local and Regional Governments (hereinafter – LALRG) and social partners.

With the CoM order of December 19, 2011 No 673 the concept “On an in-depth co-operation programme” was approved, on March 22, 2012 amendments to the Law “On Taxes and Fees” were adopted, which provide for launching the in-depth cooperation programme on July 1, 2012. The cooperation between the SRS and industry associations has been developed. During the period from August 2010 till the end of 2011 the SRS entered into 12 agreements on cooperation with industry associations. In 2011, according to information of industry associations, thematic reviews were taken at 47 taxpayers, 25 tax audits were conducted. Development of cooperation with industry associations will be continued in the future. Regulatory framework is being further developed.

The SRS at the institution level has developed several strategies to improve tax administration, as well as the action plan of the MoF, subordinated institutions and capital companies for improving tax administration in 2011 – 2013 was confirmed, which included recommendations made by the IMF in the report “Tax administration priorities to combat the shadow economy” of August 2011. Also to strengthen the capacity of the SRS in 2012 additional 4 million lats were allocated, as well as administrative improvements have been made to make work of the institution more efficient, accomplished specialization in the area of tax auditing, audit scope has been expanded, as a result tax audit effectiveness has increased by 5 percentage points – from 89% in 2010 up to 94% in 2011.

In order to strengthen the public administration capacity of crime detection and prevention in the field of smuggling, the Action Plan for State Law Enforcement Institutions for 2012 has been developed and approved on January 31, 2012. The plan identifies five priority areas, where 35 measures are planned.

With regard to the action – by end-September 2011 to assess the possibility of the Treasury to defer payments to companies with tax arrears till debt repayment or deferral – in accordance with Article 28 Paragraph two of the Law "On Taxes and Fees" overpaid tax amounts shall be refunded within a period of 15 days after submission of the request to the tax administration if specific tax laws do not provide for other refund times and procedures. In view of the above mentioned, overpaid tax is first of all directed to cover delayed or regular tax payments.

In addition, work has started on labour tax reform and it is planned to submit to the CoM an informative report on the labour tax reform proposals. This reform will address issues regarding reduction of the personal income tax rate and increase in the non-taxable minimum and allowance for dependents to boost economic activity, investment and employment, and to curb the shadow economy.

Measures to provide adequate financing to social needs and a transparent and cost-efficient delivery of social assistance:

Total funding provided for all social safety net strategy measures in 2012 is 44.6 million lats. All 2012 the benefit to ensure guaranteed minimum income level (GMI benefit) will be co-financed in amount of 50% from the central government budget and the housing benefit will be co-financed till end-April 2012.

At the same time in 2012 necessary changes to the local government social assistance benefit system will be evaluated (conditions to receive social assistance, responsibility of local governments and active involvement in solving social problems, personal responsibility and active solving of own situation, organizational system of social assistance). An application for the study "The initial impact (ex-ante) assessment of planned structural reforms in the social assistance policy field" has been developed, the procurement will be launched in the second quarter (end-April / beginning of May), while study results will be available in the fourth quarter of 2012 or first quarter of 2013. As a result of the study it is planned to develop proposals for the reform of the social assistance system. While developing proposals it will be taken into account that the social assistance system must be targeted, flexible and balanced enough to suit assistance to individual needs, but at the same time to motivate people to get back to the labour market.

II Reinforce financial sector stability (Euro Plus Pact commitment) and restoring normal lending to the economy (Annual Growth Survey priority).

Measures in the financial sector:

Work continues in the bank restructuring field, as well as measures have been taken to reinforce stability of the financial sector, which is in compliance with the measures mentioned in the Annual Growth Survey, Euro Plus Pack and Supplemental Memorandums of Understanding.

On April 12, 2011 the CoM approved the Mortgage and Land Bank of Latvia (hereinafter – the Mortgage Bank) conversion plan and it was submitted to the EC. At the same time the MoF was given a task to attract consultants for exhibition and implementation of the sales strategy. The commercial section sales strategy was coordinated by the high level Mortgage Bank's conversion management team, as well as for independent monitor of the conversion process a head of the Mortgage Bank's conversion was appointed. During the period of development of the commercial section sales strategy consultations have been held with the EC Directorate General for Competition and international lenders. The commercial section sales strategy developed by the consultant suggested to sell the commercial section of the Mortgage Bank, dividing it into six homogeneous batches. The sales process is organized as a large, international auction in two steps. On November 1, 2011 the government approved the Mortgage Bank's sales strategy and asked the consultant to initiate the sales process. By December 16, 2011 indicative bids were received from potential investors. Now the Mortgage Bank's commercial section sales process is continuing. Already in May 2012 it is planned to sign contracts with potential buyers of the commercial section of the Mortgage Bank on a part of offered batches. After signing contracts the process of transferring assets to the buyer will start. It is expected that the Mortgage Bank's commercial section sales process could be completed by the end of March 2013.

On November 23, 2011 according to the CoM minutes-decision an advisory council on coordination and development of state aid programmes was established. The main task of the council is to evaluate in terms of content and practice existing state aid instruments. The choice of institutional model that best suits the government declaration envisaging to create a full spectrum development financial institution centralizing implementation of aid programmes, focusing resources and establishing a professional monitoring mechanism in cooperation with the private sector, will be consistent with the summary information provided by the advisory council on state aid programmes, recommendations made for improvements in existing programmes and suggestions for new state aid programmes, and also the legal analysis to be carried out by an external expert. The task has been developed for the external analysis in the context of the legal analysis intended to find out possibilities to merge existing institutions, and the Ministry of Economics is making a procurement commission to outsource an expert; the Ministry of Finance has delegated its representative to the procurement commission. The Latvian government is committed to the development of a plan for establishing a single development financial institution by July 1, 2012, in order to establish it by the end of 2012. However, an essential prerequisite for the development of a plan for establishing a single development financial institution is successful implementation of the Mortgage Bank's transformation process, including expropriation of the commercial section of the Mortgage Bank. In view of complexity of the sales and asset transfer process, as well as the need for a legal analysis of possibilities to combine existing institutions, the current time schedule may be adjusted.

In 2011 the CoM supported the Citadele Bank and Parex Bank sales strategy envisaging a not interlinked sales process, applying the most appropriate solution to each bank. According to the sales strategy the Citadele Bank will be sold at an auction. However, given the situation in the Baltic banking market and the volatility on European financial markets, at the end of 2011 the CoM decided to postpone the Citadele Bank sales process. It is planned to return to the Citadele Bank sales issue later when the situation on financial markets will improve. According to the restructuring plan, Citadele Bank as a whole is intended to be sold by the end of 2014. By October 31, 2012 it is planned to submit to the CoM an evaluation of resuming the Citadel Bank sales process. Meanwhile consultations are held with the European Commission on commitments envisaged by the restructuring plan given the current situation in the banking sector.

In 2011 the model for future operations of Parex Bank was developed and provided for the change in Bank's status and waiver of the credit institution license. On March 15, 2012 the Council of the Financial and Capital Market Commission in a meeting took a decision to cancel the credit institution license issued to Parex Bank and allow Parex Bank to carry out restructuring of the bank into a commercial company with the activity not related to the business of credit institutions. Waiving of the status of the bank, in the future Parex Bank will not be bind by capital adequacy requirements, and it will not pay the financial stability fee to the Financial and Capital Market Commission (hereinafter – the FCMC) and make contributions to the deposit guarantee fund. Thus, the state will not be required to carry out further capitalization of state deposits, which was intended by the restructuring plan to ensure bank's activities in accordance with requirements applicable to credit institutions. According to the EC approved restructuring plan Parex Bank will continue to develop assets, i.e., credit collection and transfer of mortgages, to recover public funds invested in Parex Bank. The period of Parex Bank's activities is limited to 2017.

However, to ensure an independent assessment of the capacity of the Latvian Guarantee Agency (hereinafter – the LGA) by end-April 2012 it is planned to resubmit to the EC for agreement technical specifications of the adjusted LGA capacity audit, which was a prerequisite for carrying out the above audit. After receiving the agreement from the EC a procurement will be announced on conducting the LGA capacity audit and an audit report will be prepared which is planned to be submitted to the EC by end-June 2012. In February 2012, proposals were prepared for the policy of investing excess cash of the investment fund envisaging that deposits in a single credit institution may not exceed 10% of the total amount of the investment portfolio. The LGA excess cash investment policy has been coordinated with the MoF and the Treasury.

In 2011 measures to ensure stability of the financial sector continued. The FCMC continued to develop a regulatory framework to promote strengthening of banks' capital base. Also, monitoring measures continued to ensure effective management of the credit risk through credit restructuring. In addition to individual bank checks "horizontal" checks in banks were carried out to evaluate banks' activities in the loan restructuring process, market risk management and policy implementation in accordance with FCMC regulations, internal assessment of banks' capital adequacy was also carried out to determine whether minimum capital requirements are sufficient to the credit risk associated with bank's activities, market risks and operational risk and whether activities of the bank have no other significant risks requiring additional capital for coverage. In autumn 2011 the FCMC suspended financial activities of JSC "Latvijas Krajbanka" and in the beginning of 2012 an application was submitted asking for launching bankruptcy of JSC "Latvijas Krajbanka". 99.8% of "Latvijas Krajbanka" depositors received guaranteed payments.

As of November 1, 2011 a licensing system for non-bank lenders has been introduced guaranteeing existence of financially sound lenders on the market in long term. This task is performed by the Consumer Rights Protection Centre. The licensing system allowed to increase the overall level of consumer protection in the non-bank lending sector, ensuring that on this market service providers with a solid financial situation operate reducing potential financial risks and improving in general controls and surveillance by competent authorities over the non-bank lending market.

In 2012 and coming years a number of legislative measures throughout the financial sector will be carried out to transpose requirements of EU laws and improve the regulatory framework. In order to improve the legal framework for bankruptcy and liquidation of credit institutions work will start on drafting amendments to the Credit Institutions Law. In the field of surveillance in the period ahead it is expected to continue to provide enhanced banking supervision framework.

Latvian authorities continue to participate in working groups established by responsible ministries, central banks and financial sector supervision bodies of Nordic and Baltic countries. It has been agreed to continue work at the development of the public database of finance groups and start testing it in the first half of 2012.

In order to inform the public about the financial system and enhance its awareness of financial risks and importance of commitments, in 2011 a website “Klientu skola” (www.klientuskola.lv) was set up and continuously updated. In order to improve the exchange of credit information in Latvia, it is planned to establish a credit office. With the establishment of the credit office it is expected to improve the quality of credit capacity evaluation, provide access of a wider range of market participants to credit information, improve overall payment discipline in the country and reduce outstanding commitments, and reduce the credit risk. Currently these ideas are discussed in public.

III Promoting growth and of competitiveness for today and tomorrow (Euro Plus Pact commitment and Annual Growth Report priority)

Measures to ensure adequate, efficient and transparent management and implementation of EU funds:

In 2011 payments made within the framework of the European Social Fund (hereinafter – the ESF) and the ERDF exceeded the amount of the payments which was provided in the fourth Supplemental Memorandum of Understanding, commitments within the framework of the Cohesion Fund (hereinafter – the CF) were not met in full amount primarily due to procurement problems in major projects. However, the set total amount of payments to beneficiaries is met and exceeds the plan by 12%, as well as in total within the framework of the ESF, the ERDF and the CF by December 31, 2011interim payments made by intermediate bodies to beneficiaries for actual implementation of projects exceeded the set level. But from the European Agricultural Fund for Rural Development LVL 170,424,644 of public funding has been spent, from the European Fisheries Fund LVL 21,038,663 of public funding has been spent and from the European Agricultural Guarantee Fund 150,607,174 of public funding has been spent thus in total fulfilling obligations.

Also measures have been taken to improve the quality of evaluation (a EU funds evaluation conference, training, seminars were organized), implementation of activities continued, where EU funding was redistributed, and the possibility to reduce administrative burden was evaluated. To improve the EU Cohesion Policy management and acquisition an essential tool is evaluation. Therefore, in order to ensure the quality of evaluation, in May 2012 a seminar “Building EU funds evaluation capacity” will be held. During the seminar training will take place on applicable evaluation methods to implement results-based policy in the EU funds management, and future plans regarding evaluation work will be discussed, including ex-ante evaluation conditions and methods to be used.

The issue of optimization of the EU funds administration system is included in the Declaration of the intended activities of the Cabinet of Ministers, stating that in the programming period 2014 – 2020 EU funds implementing institutions should be consolidated. In the second quarter of 2012 it is expected that the CoM will consider and approve the Concept of the Institutional System of the ERDF, the ESF, the CF, the European Agricultural Fund for Rural Development and the European Maritime Affairs and Fisheries Fund in 2014 –

2020 in Latvia. The main task of the Concept is by providing and evaluating a number of possible models of the EU funds institutional system to reach an agreement on the most efficient model to promote optimization of the EU funds system, compared to the current programming period 2007 –2013. For further discussions before the decision eight potential models of the institutional system have been developed.

Regarding the ERDF activity "Development of Research Infrastructure" all contracts have been signed within the framework of the first project applications selection round, implementation of projects was launched in the first quarter of 2012, project applications of the second round have been evaluated and in the second quarter of 2012 contracts on project implementation will be concluded. By the end of 2011 beneficiaries were paid 20.7 million EUR, so it can be concluded that obligations set in the Memorandum of Understanding to pay 50 million euro to beneficiaries of the activity "Development of Research Infrastructure" will be met.

In order to provide an independent assessment of the quality of EU-funded road reconstruction independent JASPERS (Joint Assistance to Support Projects in European Regions) experts were involved. In the first quarter of 2012 the Strategy for Improving Quality of Roads was developed. It will provide for additional measures to improve the road-building surveillance system, improve construction and repair technological processes and specifications, extend the warranty commitment period up to five years instead of previous three years, as well as measures have been taken in procurement of construction design and construction supervision to ensure application of principles of economic benefit, i.e., involvement of engineers with higher qualifications and experience instead of current minimum qualification requirements and lower price.

Given the fact that the Saeima Legal Affairs Committee has not approved proposals for possibilities to introduce a new type of external regulatory enactment – Minister regulation, and therefore this issue will not be developed further, it is not planned to delegate decision-making provided in Annex 1, Clause 9(f) of the fifth Supplemental Memorandum of Understanding at the level of the managing authority. Since this is a systemic issue to be addressed within the framework of the whole public administration, it cannot be separated specifically in relation to the implementation of EU funds. This tasks can be executed only in addition to the task set in Annex 1, Clause 10(c) of the fifth Supplemental Memorandum of Understanding. First in the country as a whole the question of delegating technical and administrative decisions at ministerial level should be resolved, only after that it is possible to determine what decisions could be delegated to the Managing Authority. Please find additional measures taken to facilitate EU funds acquisition in the National Reform Programme.

Regarding suspension of EU funds payments at the beginning of 2012 the Managing Authority (hereinafter – the MA) and the Certifying Authority (hereinafter – the CA) prepared action plans pursuant to instructions given by the EC. Action plans were approved by the Audit Authority (hereinafter – the AA). The MA and the CA have taken the following actions to restore payments: controls by the Managing Authority have been strengthened; role of the internal audit the EU funds system has been strengthened, national procedures for suspension of payments have been developed for cases when institutions perform delegated functions in poor quality, process according to which the MA certifies to the SA eligibility of expenditure has been improved. It is planned that on April 26, 2012 the AA report and opinion on the implementation of the action plan will be submitted to the EC, which will decide on renewing payments to Latvia.

Measures to promote more efficient use of energy and natural resources:

Currently work is going on at development of the "Energy Strategy 2030". This document will determine directions of long-term actions in fields of energy security, competitiveness, energy efficiency and use of renewable energy. It is also planned to review state aid mechanisms for energy generation from renewable resources.

Work is going on at transposition of EU legislation on energy, particularly with regard to energy market liberalization and integration into the EU energy market. The Renewable Energy Directive has been transposed, measures are taken to improve energy efficiency – by 2013 measures will continue to improve heat insulation in apartment houses and social apartment houses (for details see Section 3 and the NRP).

Measures to implement the education policy:

The reform continues also in the education and science system. In 2011 activities were completed related to optimization of the network of vocational education institutions. In 2012 – 2015 within the framework of the education and science system reform the following measures are planned – modernization of the higher education, consolidation of public research institutions, reforms in the vocational education, measures to promote and support knowledge and technology transfer, as well as other measures (for details see Section 3, as well as the NRP).

Other measures to promote competition and growth:

Similarly, measures are taken to improve the business environment, promote productive innovations and exports, promote innovation, research and development, measures in the information and communication technology field, measures to improve transport and environmental infrastructure, promote free market competition, including measures within the framework of the Euro Plus Pact (for more details see section 3, as well as the NRP).

IV Foster employment (Euro Plus Pact commitment) and tackling unemployment and the social consequences of the crisis (Annual Growth Survey priority).

Measure to implement an effective active labour market policy:

Measures in the active labour market policy are being improved. The measure aims at reduction of the high structural unemployment risk, as well increasing the level of employment and economic activity.

Similarly, measures are taken to combat the shadow economy, and it is planned to implement a labour tax reform (for details see Section 3, as well as the NRP).

V Modernizing public administration (Annual Growth Survey priority).

Measures are taken in different areas – to improve management of state and local government-owned assets and real estate (management and administration of public companies, centralization of public property management), measures to strengthen the public procurement (allocation of funds to build capacity of the Procurement Monitoring Bureau and the Ministry of Environmental Protection and Regional Development, mandatory centralized local government procurement, legal acts on administrative liability / sanctions in cases of procurement process violations), as well as measures to improve human resource management and performance results, and decision-making in the public administration (a new public administration strategy, national planning system, extended compliance with subsidiarity principles in decision-making) (for details see Section 3, as well as the NRP).

7 Quality of Public Finances

7.1 Efficiency of State Budget Resources and Expenditure Control

Procedures for preparation, approval and execution of state and local government budgets and responsibility within the budget process are stipulated in the Law on Budget and Financial Management. The Minister of Finance is responsible for organization and management of the state budget process.

According to the Law on Budget and Financial Management heads of budget-financed institutions, budget non-financed institutions and local governments, as well as capital companies with state or local government capital shares shall be responsible for compliance with, execution and control of procedures and requirements envisaged by the above mentioned Law, as well as for efficient and economic allocation of budget resources according to set goals.

According to the Law on Budget and Financial Management the Minister of Finance shall develop draft annual State Budget Law. In developing the draft annual State Budget Law the Minister of Finance shall review budgetary requests according to intended purposes, economy and efficiency and, if necessary, request additional information for evaluation of the requests. Based on this evaluation and the information provided, the Minister of Finance shall decide on inclusion of the budget request in the draft State Budget Law before its submission to the CoM. The Minister of Finance at any stage of consideration of draft State Budget Law may express his own opinion, add necessary findings, as well as individual audit results.

To ensure the monitoring of the budget execution, as well as promote control over the budget use, the Treasury is preparing reports on the execution of state and local government budgets, thus providing information to ministries, other state central institutions, MoF experts and public about the budget execution process.

At the same time to achieve the above mentioned objectives line ministries and other state central institutions prepare quarterly reports on the budget execution process and submit them to the MoF. The report provides information on the state budget execution in particular reporting period – comparison of expenditure with the reporting period of the previous year, comparison with the plan of the reporting period, overview of performed and non-performed actions, information about finance management improvement activities, etc.

As from state budget 2012 the procedures for planning and reflecting operational level results and performance indicators (outputs) in budgetary requests of ministries and other central state institutions have been improved. This information is included in explanations annexed to the annual State Budget Law, thus providing information to the parliament and public.

Ministries and other state central institutions set goals and performance results and performance indicators (outputs) characterizing the degree of achievement for budget programmes and sub-programmes that they should implement. Trends of performance indicators are also planned in medium term and at the same time reflect the historical information in a three-year period. Policy results (outcomes) are primary planned in development planning documents. Review documents are prepared regarding policy planning documents in a form of informative reports in the policy planning document implementation interim stage and after the implementation deadline.

In order to develop the performance management system and integrate it into the budget management process, as from state budget 2012 the analysis of state budget expenditure will be updated with information on the achievement of performance results and indicators (outputs) in line with the goals set for budget programmes and sub-programmes, i.e., the ministry in the report on the analysis of current year's budget execution will include necessary explanations of planned results and performance indicators, their implementation during the year, as well as deviations of the value of achieved performance indicators from the value of planned performance indicators exceeding 15 per cent (both in positive and negative terms). Annual assessment of performance results and performance indicators of budget programmes and sub-programmes will provide the possibility to evaluate compliance of budget expenditure with the priorities defined by the government.

The Treasury grants allocations for expenditure according to appropriations set in the annual State Budget Law and ensures implementation of the allocations according to the procedures of the CoM, while ministries and other state central institutions are responsible for establishing a control system regarding execution of the appropriations set in the annual State Budget Law and control of the use of state budget resources transferred to Treasury's current accounts according to planned purposes.

In addition, in the Law on Budget and Financial Management it is stated that state budget institutions must open basic budget and state special budget accounts for receipt of allocations and making expenditure from state budget resources only at the Treasury. Institutions non-financed from the budget shall open current accounts only at the Treasury. Budget-financed institutions, except state budget institutions, shall open current accounts only at the Treasury for receipt of state budget funds and similarly, local governments and their institutions for receipt of state budget funds and making expenditure from these funds, unless otherwise provided in other laws and regulations. Local governments and public derived persons partly financed from the state budget, as well as capital companies with state or local government-owned shares may open current accounts at the Treasury.

Key penalties envisaged in the Law on Budget and Financial Management for misappropriation of budgetary funds:

- for untimely or incomplete payment of sums owed to the state budget to the Treasury budget accounts – the Treasury (unless falls within the competence of another public institution) shall recover due amount to the basic budget revenue and may recover the delay payment in amount of 0.1% of the overdue amount for each delayed day, if laws and regulations do not provide otherwise;
- if losses to the budget shall be covered – the Treasury may pay amounts to the basic budget revenue, revoke or suspend the allocations, if reports on budget and financial management are not submitted in time or are incomplete, if budget resources or transactions with these resources are not registered in the procedure prescribed by the law, and they are not reported, if records do not meet the set procedure and thus funds owed to the budget are hidden, as well as if the head of the budget-financed institution commits liabilities above the Treasury's allocations;
- if budget-financed institutions, budget non-financed institutions and local governments, and capital companies where a share of state or local government capital has been invested, violate financial management requirements set in the Law on Budget and Financial Management, the Minister of Finance, Treasurer, heads of ministries and other central state institutions (according to their competence) may suspended authorization to assign or to operate budget revenue or expenditure, impose restrictions on the use of accounts, revoke or suspend the appropriations to reimburse misappropriated resources, or to require repayment of misappropriated money, file a

civil claim to the court or submit materials to competent officials for making decision on criminal proceedings, as well as withdraw or suspend payments.

The Treasury, according to the law "On Financial Equalization of Local Governments", has the right to recover on an uncontested basis from local government budget resources amounts which the local government has not timely or fully transferred to the equalization fund by debiting these amounts from the local government budget.

7.2 Efficiency of Revenue Structure and System

One of essential aspects of the quality of public finances is ensuring stable and predictable tax revenue flows to the budget to finance priority social and economic activities of the government.

Table 7.1. Tax revenue in general government budget (S.13), mln lats

	Code (ESA 95)	**2011**	**2012**	**2013**	**2014**	**2015**
Tax revenue						
1. Production and import taxes	D.2	1 631,3	1 731,5	1 810,3	1 888,8	1 967,9
2. Income and property current taxes	D.5	1 053,6	1 109,0	1 160,3	1 213,1	1 268,4
3. Capital taxes	D.91	1,6	1,7	1,7	1,8	1,8
4. Social contributions	D.61	1 264,3	1 292,2	1 243,1	1 256,6	1 318,6
From actual social contributions	*D.611*	1 244,3	1 272,2	1 223,1	1 236,6	1 298,6

It should be mentioned that for several years the overall tax burden in Latvia remained one of the lowest in the EU. In 2010 it was 27.5% of GDP, which is lower than the EU average of 39.6% of GDP.

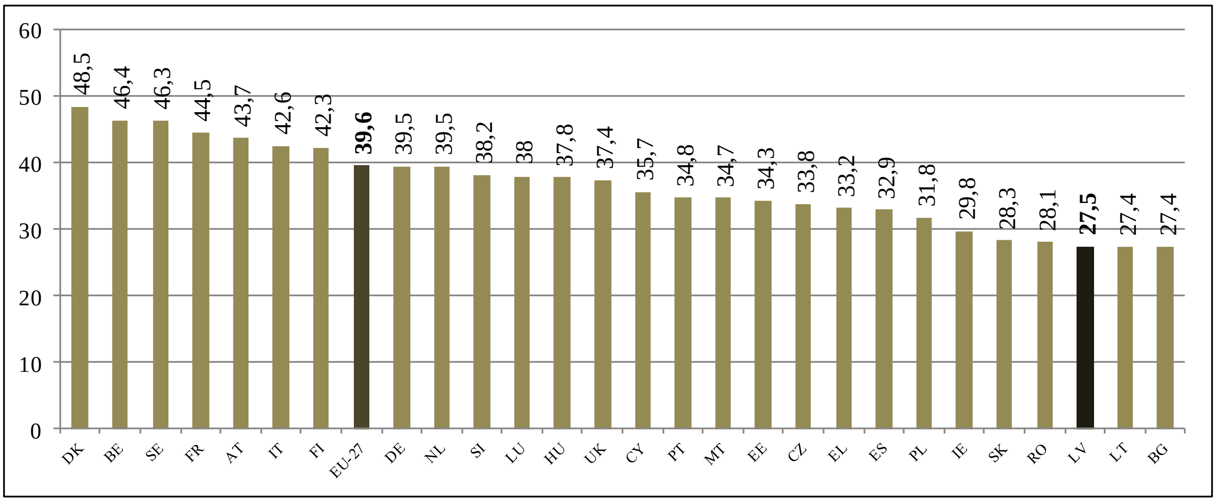

Figure 7.1. Tax revenue in Latvia[5] and European Union in 2010, % of GDP.

In Latvia majority of all tax revenue is generated by labour taxes. In recent years the tax policy is oriented towards reduction of the share of labour taxes in the total tax revenue (from

[5] Including contributions to the state-funded pension scheme

52.0 % in 2009 to 50.8 % in 2011) and increase in the share of consumption tax revenue in the total tax revenue (from 38.6 % in 2006 to 39.0 % in 2011).

The Declaration of the Intended Activities of the Cabinet of Ministers includes a task regarding further substantial reduction in the tax burden on labour – by nine percentage points in long term. Work on the labour tax reform is underway and it is planned to submit an informative report on the labour tax reform proposal to the CoM. Within the framework of this reform issues of personal income tax rate reduction and non-taxable minimum and allowance for dependents increase will be addressed to boost economic activity, investment and employment, and to curb the shadow economy.

If the budget situation will develop better than planned, the possibility to reduce the standard VAT rate is considered to bring indirect tax rates closer to levels in neighboring countries that would facilitate, in particular, regional competitiveness of the Latvian service sector and reduce the inflationary pressure on persons with low income caused by global price increases. Potential reduction in revenue will be covered primarily by further implementation of measures to improve tax administration measures as well as growth effects as a result of improving competitiveness of Latvian companies.

Proposals for changes in the tax burden will be elaborated as a whole and taking into account their mutual influence and impact on reaching of fiscal targets. In view of fiscal responsibility further action will be determined in accordance with priorities of the Annual Growth Survey and the Euro Plus Pact, taking into account the priority objective to reduce the tax burden on labour.

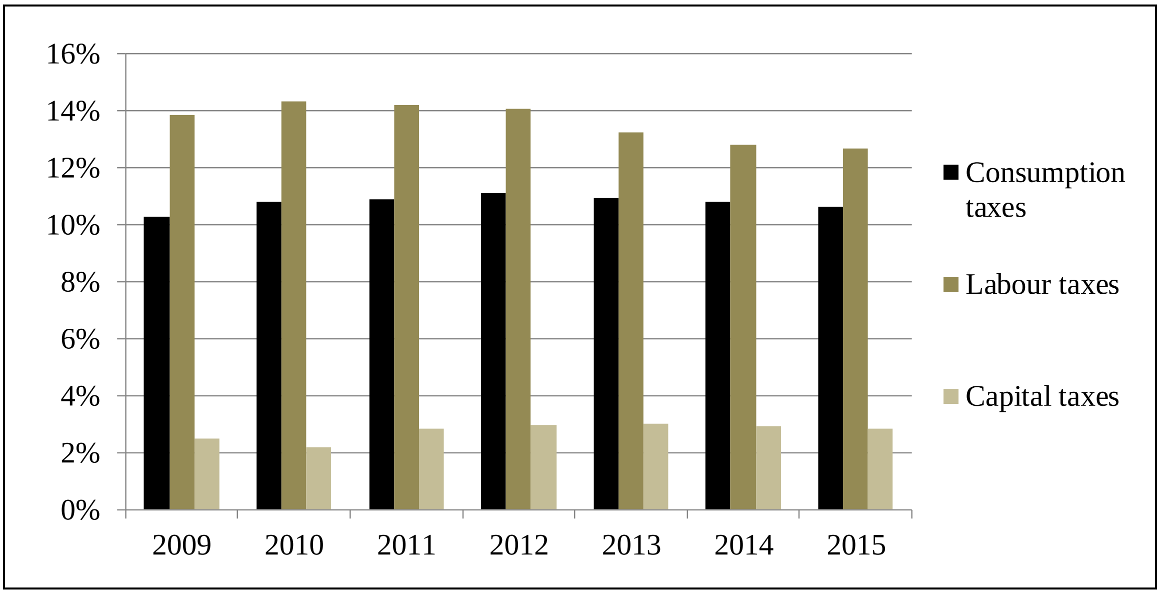

Figure 7.2. Tax revenue according to economic functions, % of GDP

After joining the European Union tax revenue growth was mainly facilitated by rapid economic growth, but in 2009 due to the economic crisis, tax revenue fell. In order to ensure fiscal consolidation and achieve reduction of the budget deficit, in 2008 budget fiscal consolidation was launched and continued till 2012. Tax policy changes introduced in 2012 are focused on tax administration improvements that would promote tax revenue stabilization and growth.

In 2012 tax administration improving measures were carried out such as changes in income tax payment arrangements for scrap metal (on-the-spot withholding), extending the reverse value added tax arrangements to buying of scrap metal and construction services, limiting import of excise duty free goods from third countries to once per day instead of once per seven days. In 2012 additional revenue is planned from such tax administration improving measures as strengthening administration of small and micro-enterprises, a tax support measure envisaging cancellation of delay payment and 90% penalty for taxpayers who pay the principal and respective share of the fine at a certain time, as well as building administrative capacity of the State Revenue Service. In 2012 only lottery and gambling tax rates changed.

Table 7.2. Impact of tax policy changes on the main tax revenue, % of GDP

	2012
Value added tax revenue	+0,08
Excise duty	+0,01
Real estate tax	+0,03
Personal income tax	+0,06
Social insurance contributions	+0,03
Lottery and gambling tax	+0,02
Corporate income tax	+0,01
Other measures	+0,02
Total impact of changes:	**+0,25**

This section discusses the main impact of tax changes according to the State Budget Law for 2012.

Value added tax

Substantial share of total tax revenue is made of value added tax revenue. During the years of economic growth the growth rate of value added tax revenue was high. However as retail trade started to decline in 2008 and 2009, together with the decline in economic activity and imports, the value added tax revenue also fell. In addition, the impact of the economic crisis has been so significant that as of January 1, 2009 the increase in the value added tax standard rate by 3 percentage points from 18% to 21% could not offset the revenue reduction that occurred as a result of the economic recession.

As of January 1, 2011 the value added tax standard rate was increased from 21% to 22%, the reduced rate from 10% to 12%, and the reduced rate on electricity supply to the population was increased from 10% to 22 per cent. As of July 1, 2011 the reduced rate on natural gas supplies was increased from 12% to 22 per cent. As of June 1, 2011, according to the EU directive, application of reduced rates on medical equipment supplies was limited. In 2011 the retail trade turnover and economic activities in other sectors increased gradually, as the volume of imports did, which showed a positive effect on value added tax revenue.

As the economy grows, in 2012 it is forecasted that the revenue from value added tax will increase by 9.0% compared to 2011.

The value added tax revenue forecast for 2012 has been prepared taking into account expected economic development trends, growth of private consumption, value added tax performance in 2011 and taking into account the impact of tax policy changes given in Table 7.3.

Table 7.3. Impact of tax policy changes on value added tax revenue, mln lats

	2012
Expanding application of the reverse VAT mechanism on scrap metal (+0.5 mln lats) and construction services (+5.4 mln lats)	+5,9
Tax support measure	+6,1
Total impact of changes:	**+12,0**

Corporate income tax

It is expected that the corporate income tax rate – 15%, which is effective since 2004 and is among the lowest in the EU, will remain unchanged. As the economy developed successfully and corporate financial results improved, significant corporate income tax revenue growth was observed. However, as a result of the economic recession corporate income tax revenue significantly reduced which was affected by reduction of corporate income tax payments and increase in repayments.

In 2011 as the economy recovered, corporate income tax revenue, compared to 2010, increased by 75.1%, suggesting that companies closed 2010 with significantly better financial results than in 2009.

As the economy continues to grow in coming years corporate income tax revenue is projected with an upward trend. In 2012 it is forecasted that corporate income tax revenue will increase by 7.6%, compared to 2011, which will be also affected by tax policy changes introduced in 2012.

Tax policy changes introduced in 2012 and affecting the corporate income tax revenue are given in Table 7.4.

Table 7.4. Impact of tax policy changes on corporate income tax revenue, mln lats

	2012
Tax support measure	+1,1
SRS administrative capacity improvement	+0,8
Total impact of changes::	**+1,9**

Excise duty

Evaluating excise duty revenue and the factors affecting it, it should be noted that aligning excise duty rates with EU requirements had a major role in the implementation of the excise duty policy. According to transition periods granted to Latvia, excise duty rate on oil products was substantially increased, as well as increase in rates on tobacco products continued.

The overall economic downturn had resulted in declining sales of excise goods, which directly affected excise tax revenue reduction in 2009 and 2010, while in 2011 as the Latvian economy improved, positive trends can be observed also in excise duty performance indicators. As a result, in 2011 excise duty revenue increased by 5.1%, compared to 2010.

Forecasting that in 2012 the tax base for the main types of excise goods will increase slightly, taking into account the tax rate increase from mid-2011 and the excise duty on natural gas, which took effect from July 1, 2011, excise duty revenue forecasts for 2012 have been prepared with a 2.7% increase, compared to 2011. In the forecast for 2012 tax policy measures to be implemented within the state budget 2012 (Table 7.5) are taken into account.

Table 7.5. Impact of tax policy changes on excise duty revenue, mln lats

	2012
Restrictions on the importation of excise goods from third countries, not more than once every seven days instead of once a day	+1,6
Excise duty exemptions on natural gas for certain purposes for companies located in industrial parks	-0,1
Tax support measure	+0,2
SRS administrative capacity improvement	+2,4
Total impact of changes:	**+4,1**

Real estate tax

In 2012 real estate tax revenue is forecasted to increase by 1.8%, compared to 2011, which is also influenced by changes in legislation.

In 2011 amendments to the law “Law On Immovable Property Tax” were developed and approved envisaging changes in the real estate tax in 2012.

As of January 1, 2012 residential auxiliary buildings exceeding $25m^2$ are subject to the real estate tax (unless the local government provides otherwise in its binding regulations) and the applicable tax rate is the same as on residential buildings. Similarly, as of January 1, 2012 the real estate tax is levied on civil engineering constructions – fields that are used as parking lots (if provided by the local government in its binding regulations), as well as the real estate tax is applied to residential buildings and land under the jurisdiction of religious organizations, if it is not used for commercial activities.

As of January 1, 2012 the real estate tax growth limit of 25% in respect of land is cancelled. In 2012 local governments with binding regulations have the right to apply the real estate tax growth limit or maintain the tax on land at the level of 2011, as well as to set the growth limit and conditions of application.

The impact of the above mentioned legislative changes on real estate tax revenue is estimated +4.0 million lats.

Currently the real estate tax policy is focused on extending the right of local governments to set real estate tax provisions. According to the informative report “On proposals for the application of the real estate tax in 2012 and subsequent years” approved by the CoM, in the future it is envisaged to grant more rights to local governments to set the real estate tax rate, to limit the real estate tax growth on land, as well as to set other provisions.

Personal income tax

With the economic recession, in 2009 personal income tax revenue declined significantly affected by the personal income tax rate reduction from 25% to 23%. It could not be offset by reduced non-taxable minimum from 90 to 35 lats per month (as of July 1, 2009). However, with the economic development, in 2011 personal income tax revenue grew, despite changes in legislation introduced in 2011, including the rate reduction from 26% to 25%, increase in the non-taxable minimum from 35 lats to 45 lats per month and increase in the amount of allowance for dependents from 63 lats to 70 lats per month.

Medium-term macroeconomic forecasts envisage increase in the wage fund from 2012, which in turn will increase labour tax revenue in coming years. Similarly, personal income tax revenue will be affected by changes in legislation.

In 2012 personal income tax revenue is forecasted to increase by 4.3%, compared to 2011.

As of January 1, 2012 a personal income tax payment procedure has been changed concerning scrap metal, by providing that personal income tax is withheld at the place of payment.

Similarly, as of January 1, 2012 the legislative changes have entered into force that were made in order to strengthen the administration of small and micro-enterprises by introducing a general personal income tax regime in respect of the service contracts, contracts for work-performance, labour hire and the receipt of other services from micro-enterprises.

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In 2012 the personal income tax proportion between the state and local government budgets was changed, respectively, from 18% to 20% and from 82% to 80 per cent. This legislative change does not affect total personal income tax revenue, however, it impacts personal income tax revenue in both state and local government budgets.

According to the draft law “Law on the Tax Support Measure”, in 2012 additional revenue is planned in personal income tax revenue from debt repayments.

Table 7.6. Impact of tax policy changes on personal income tax revenue, mln lats

	2012
Procedure changes for paying personal income tax on scrap metal	+3,7
Strengthening administration of small and micro companies	+1,0
Tax support measure	+4,4
Total impact of changes::	**+9,1**

Social insurance contributions[6]

Dynamics of revenue from social security contributions in medium term will be determined not only by the expected increase in the wage fund, but also by changes in legislation, which came into force in 2012, and changes in the rates of contributions to the state-funded pension scheme, because, according to ESA methodology, social security contributions, which are channeled to the state-funded pension scheme, are not treated as general government budget revenue.

In 2012 social security contributions are forecasted to increase by 3.3%, compared to 2011.

In 2012 revenue from social security contributions are affected by legislative changes made to strengthen administration of small and micro-enterprises introducing single personal income tax arrangements in respect of service contracts, business contracts, labour hire and other services received from micro-enterprises.

In 2012 additional revenue is planned from social insurance contributions due to debt repayments according to the draft law “Law on the Tax Support Measure”.

In 2013 it is planned to increase the rate of contributions to the state-funded pension scheme from 2% to 6% and in coming years to maintain the 6% level.

Table 7.7. Impact of tax policy changes on revenue from social insurance contributions, mln lats

	2012
Strengthening administration of small and micro companies	+1,7
Tax support measure	+3,1
Total impact of changes:	**+4,7**

Table 7.8. Social insurance contributions to the state-funded pension scheme

Period	Contr.	Forecasted social insurance	Forecasted social insurance

[6] Excluding contributions to the state-funded pension scheme.

	rate	contributions to the state funded pension scheme, mln lats	contributions to the state funded pension scheme, % of GDP
2012	2%	69,5	0,5
2013	6%	168,6	1,1
2014	6%	227,5	1,4
2015	6%	239,5	1,4

Lotteries and gambling tax

Total lotteries and gambling turnover in 2011 increased by 16.1%[7], which is mainly due to the overall economic impact on the gambling industry. Having analyzed operative economic indicators of the gambling industry in 2011 it may be concluded that operational indicators of the industry have improved and stability can be observed.

The forecasted increase in lotteries and gambling tax revenue in 2012 is mainly due to amendments to the law “On Lotteries and Gambling Tax and Fee” that are made in accordance with the law “On State Budget 2012” and provide:

- as of January 1, 2012 increase in the gambling tax rate from LVL 10 560 to LVL 12 144 for roulette (cylindrical game) – for each game table attached to the rotating device of the roulette, and card and dice games – for each table per year;
- increase in rate on video games and mechanical machines, per each gaming place at each machine – LVL 1920 to LVL 2208 per year.

Increase in rates will not reduce significantly the number of gaming machines, which could affect revenue from the gambling tax.

Table 7.9. Impact of tax policy changes on lotteries and gambling tax revenue, mln lats

	2012
Increase in gambling tax rates	+2,2
Lotteries and gambling tax and fee reform	+0,1
Total impact of changes:	**+2,3**

Other measures

In order to ensure fiscal consolidation and deficit reduction as of 2012 changes in these types of fees have been introduced:

- according to amendments to the “Financial Stability Fee law” the financial stability fee rate is doubled (from 0.036 per cent to 0.072 per cent per year) (fiscal impact in 2012 +2.3 mln lats);
- the lotteries and gambling fee and tax reform (fiscal impact in 2012 +0.6 mln lats).

According to CoM Regulation of December 27, 2011 No 1023 “Amendments to Cabinet of Ministers Regulation of June 14, 2011 No 450 “Regulation on the amount of state fee for maintenance of national oil product reserves, as well as its calculation, payment and administration procedure”” the procedure for forming and storing national oil reserves is

[7] According to the data of the Lotteries and Gambling Supervision Inspection for 2011.

being developed expanding the base of state fees for maintenance of safety reserves, from 2012 introducing a fee for the maintenance of gasoline reserves (fiscal impact in 2012 +3.3 mln lats).

8 Sustainability of Public Finances

8.1 Long-term budgetary projections

Demographic changes, particularly increasing number of the elderly population without changing the current system, in the long run may affect age-related general government expenditure growth. Sustainability of public finances is also determined by the initial budgetary position, which in recent years has improved due to budget consolidation and structural reforms in a number of sectors. To ensure sustainability of public finances, the Latvian government as the main objective has set reduction of the general government budget deficit, by implementing structural reforms and making changes in the existing system, including in social security, education and health care sectors, which are essential in the context of population ageing.

The European Commission, in cooperation with Member States, every three years makes long-term budgetary projections taking into account the impact of population ageing, as well as assesses sustainability of public finances of each Member State. Long-term budgetary projections are based on demographic projections provided by Eurostat, and assumptions about economic growth and growth influencing factors in long-term. At the end of 2010 a new projection cycle started, as a result in 2012 new long-term budgetary projections will be published. It should be noted that at the end of 2011 an interim report was published on underlying assumptions and projection methodologies.

Long-term **demographic projections** (EUROPOP2010) were made based on the actual data for 2010 before the population census, and according to Eurostat actual data, on January 1, 2010 total population in Latvia was 2.25 million. In 2011 the population census was carried out in Latvia, as a result of it on March 1, 2011 population was 2.07 million or 178.0 thousand less than given in long-term projections. The CSB is going to publish the demographic statistical data according to the results of the population census by May 2013.

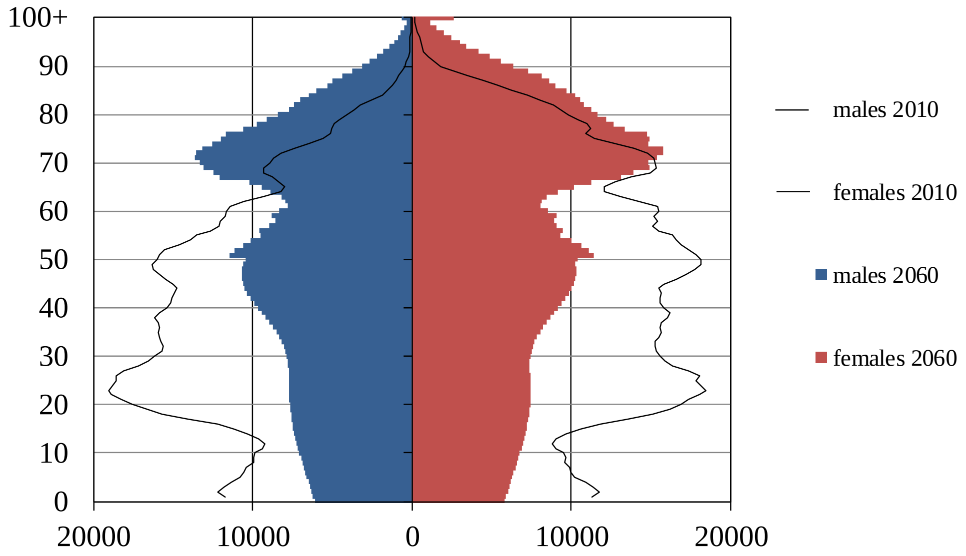

Figure 8.1. Age structure of Latvian population in 2010 – 2060 (data source: Eurostat)

According to Eurostat demographic projections the total number of Latvian population will continue to decline and in 2060 will be 25.6% less or 576.6 thousand less than in 2010. It is expected that the working age (15-64) population in 2060, compared to 2010, will be 43.4% less. The number of children in Latvia will also continue to decline, and in 2060, compared to 2010, will be 35.6% less. It can be explained by the comparatively low birth level and the improvement forecasted in long term is not sufficient to reproduce the population. While the population aged over 65 in 2060, compared to 2010, will increase by 52.7%, aged over 80 will increase by 140.3%. It can be concluded that, compared to previous Eurostat demographic projections (EUROPOP2008), significant changes in the total number of population are not projected, but bigger proportion of the elderly people is expected which can be explained by the life expectancy increase, which, in turn, is a condition of the convergence assumption. The convergence assumption in long term envisages that new Member States approach the EU average welfare level.

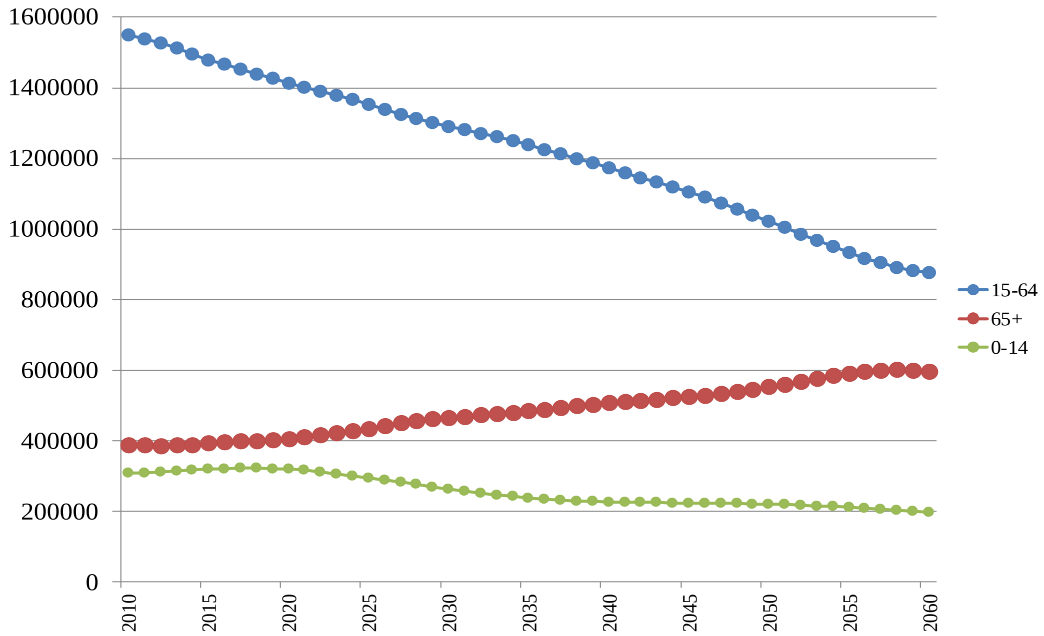

Figure 8.2. Latvian population by age groups in 2010-2060 (data source: Eurostat)

Taking into account the age composition changes, it is projected that the total dependency ratio[8] in long term will increase almost twice. Besides, in 2060 for 1 person aged over 65 there will be 1.5 persons of working age (in 2010 this proportion was 1:4). According to projections, the economic dependency ratio[9] will grow at slower rate than total dependency ratio, however already in 2010 this indicator was very high, determined by the increase in the number of persons receiving pensions and unemployment benefits and reduction of the

[8] Population under 15 and over 64 as a percentage of the population aged 15-64.
[9] Proportion of persons receiving pensions and unemployment benefits against employed persons.

number of employed persons. Although in 2011 the number of employed persons increased, projected economic dependency ratio in long term indicates the need to increase employment, which is envisaged also by the measures included in structural reforms.

Economic growth is essential to ensure sustainability. It is expected that demographic changes will affect employment. It is expected that in long-term participation rate[10] will increase and unemployment will decrease. This will partly offset the impact of working age population decline on employment. It is expected that productivity in the long run will be a determining factor for economic growth and it will be a basis for convergence in long-term. However, compared to previous long-term forecasts, the latest assumptions suggest slower productivity and economic growth. Productivity growth can be facilitated by structural reforms, technological progress, education and vocational training, effectiveness of resource allocation and capital stock.

When assessing the sustainability of public finances, general government expenditure is evaluated, which associated with ageing population, i.e., expenditure for pensions, health care, long-term care and education. In addition, forecasts of expenditure for unemployment benefits are assessed.

Table 8.1. Long-term budgetary projections (data source: EPC AWG[11])

% of GDP	**2010**	**2020**	**2030**	**2040**	**2050**	**2060**
Total expenditure						
Of which: age-related expenditure	19.2	16.5	15.4	14.9	15.4	15.4
Pension expenditure	9.7	7.3	6.5	6.3	6.4	5.9
Social security pensions	9.7	7.3	65	6.3	6.4	5.9
Old-age and early pensions	8.7	6.5	5.9	5.8	5.9	5.5
Other pensions (disability, survivors)	1.0	0.7	0.5	0.5	0.4	0.4
Occupational pensions						
Health care	3.7	3.8	4.0	4.1	4.2	4.3
Long-term care	0.7	0.7	0.7	0.8	0.9	1.0
Education	4.4	4.0	3.7	3.3	3.5	3.8
Other age-related expenditure	0.7	0.7	0.5	0.4	0.4	0.4
Interest expenditure						
Total revenue						
Of which: property income						
Of which: from pensions contributions	6.9	8.9	8.8	9.1	9.0	8.8
Pension reserve fund assets						
Of which: consolidated public pension fund assets						
Social contributions diverted to mandatory private scheme	0.5	1.6	1.7	1.8	1.7	1.7
Pension expenditure paid by mandatory private scheme	0.0	0.1	0.3	0.9	1.9	2.9
Labour productivity growth	5.4	1.9	2.3	2.3	1.9	1.5
Real GDP growth	-0.3	1.9	1.9	1.3	0.3	0.6
Participation rate males (aged 20-64)	83.2	85.5	85.2	84.6	82.8	85.3

[10] Proportion of the number of employed persons against the total number of population in particular age cohort.

[11] EPC AWG – European Council Economic Policy Committee Ageing Populations and Sustainability Working Group.

% of GDP	2010	2020	2030	2040	2050	2060
Participation rate females (aged 20-64)	76.7	79.4	79.6	79.2	78.1	80.9
Total participation rate (aged 20-64)	79.9	82.4	82.4	81.9	80.4	83.1
Unemployment rate	18.4	18.0	8.6	7.5	7.2	7.1
Population aged 65+ over total population	17.3	19.2	23.2	26.8	31.2	35.6

According to the latest projections of the Economic Policy Committee Ageing Populations and Sustainability Working Group (hereinafter – the AWG), which will be published in 2012, total share of general government age-related expenditure in GDP in 2060, compared with 2010, will decrease by 3.8% of GDP (from 19.2% to 15.4% of GDP). In long-term projections the base year was 2010, which in view of consequences of the economic and financial crisis of 2008–2009, influenced results of long-term projections. In comparison with long-term projections from 2009, trends in expenditure are similar.

According to projections the proportion of expenditure for pensions in GDP will decrease from 9.7% of GDP in 2010 to 5.9% of GDP in 2060. The decline will be primarily caused by the GDP growth, which will be faster than the pension expenditure growth. It is expected that in nominal terms expenditure for pensions will continue to grow, mainly due to increasing proportion of elderly. The forecasts take into account that the slower increase in pension expenditure in long term will be ensured by changes in the social insurance system such as cancelled additional payments to newly granted pensions, temporarily suspended indexation of pensions, as well as increase in the contribution rate to the state-funded pension scheme. The following changes were not included in pension expenditure projections:

- Gradual increase in retirement age to 65 years, from 2014: as of January 1, 2014 and January 1, 2015 increase by 3 months; as of January 1, 2016 each year until 2020 increase by 6 months;
- Simultaneously with the increase in the retirement age the early retirement age will also rise from 2014;
- Increase in the minimum length of insurance to have the right for the state-funded old-age pension up to 15 years starting from 2014, and up to 20 years starting from 2020.

On April 19, 2012 the draft law "Amendments to the Law "On State Pensions"" was approved by the Parliament in the first reading. As a result of these changes the situation in the social security budget would improve, participation of persons in the labour market would increase, as well as the burden on the social insurance system would decrease.

Decrease of the share in gross domestic product is projected also for education expenditure (by 0.6% of GDP), mainly determined by long-term demographic trends. It is expected that in 2060, compared to 2010, expenditure on health care will rise by 0.6% of GDP, while expenditure for long-term care will increase by 0.3% of GDP. This can be explained by the fact that health and long-term care services are primarily attributable to the elderly, the proportion of which in long term will increase. With demographic changes expenditure for health and long-term care may be significantly affected by the technological progress and economic development. Consequently, reforms focused on the health care system are important, including optimization of the funding mechanism. It should be noted that the proportion of expenditure for long-term care in total age-related expenditure is low (4%).

In assessing the general government budget expenditure related to ageing population, uncertainty in assumptions should be taken into account. Due to certain negative factors in the health and long-term care sectors, the total amount of expenditure could increase by 3-4% of GDP.

According to 2011 the Assessment of the European Commission[12] Latvia is among the countries with a medium risk attributed to the sustainability of public finances. It should be noted that in the EC 2009 Sustainability Report[13] Latvia was ranked among countries with a high risk attributed to the sustainability of public finances, generally due to the initial budgetary position, which has significantly improved in recent years.

8.2 State Guarantees

The Law on Budget and Financial Management requires that only the Minister of Finance has the right to provide guarantees on behalf of the state within the framework of the annual state budget law to commit public funds for public investment projects and business support programmes, as well as for study and student loans.

Transparency of the state guarantee provision process is governed by the regulation of the Cabinet of Ministers, stating that potential recipients of guarantees provided on behalf of the state and their projects shall be evaluated according to uniform criteria before the guarantee inclusion in the annual state budget law. Evaluation is done by the line ministry and the Ministry of Finance. The list of guarantees to be provided and recommended by the Ministry of Finance shall be approved by the Cabinet of Minister including it in the draft of annual state budget law.

The state guarantee risk management is carried out prior to the issuance of the guarantee in a form of an analysis of the business plan for guarantees to be provided, creditworthiness of the project executor, risk analysis of the project to be implemented, assessment of guarantee securing and decision of the Minister of Finance on provision of the guarantee and applicable interest rates. After issuance of the guarantee surveillance is conducted analyzing regular financial statements of the borrower, assessing likelihood of repayment of the guaranteed loan and making appropriate savings.

In 2011 state guarantees were provided in amount of 115 million lats, including 12 million lats for the education sector, 3.2 million lats for the sports sector, 5 million lats for the industry, 23.8 million lats for the public sector, and in accordance with the law “On State Budget 2011” a state guarantee was provided to the loan of the joint stock company “Parex Bank” in amount of 71.0 million lats from the European Investment Bank according to the JSC “Parex Bank” state aid restructuring plan approved by the European Commission.

As of end-December 2011 the state guaranteed outstanding debt is 498.4 million lats (see Figure 8.3), which has decreased by 98.7 million lats.

[12] EC Assessment of the 2011 national reform programme and convergence programme for Latvia, SEC(2011) 722 final.
[13] EC 2009 Sustainability Report.

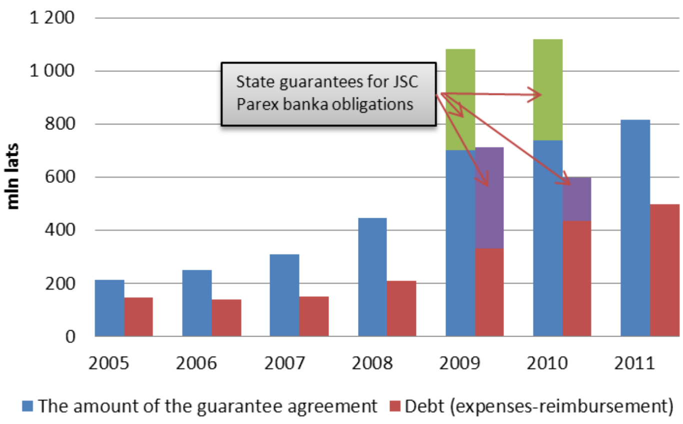

Figure 8.3. State guaranteed outstanding debt as of the end of respective year (mln LVL)

Figure 8.4 reflects on the use of regularly provided state guaranteed loans by sectors.

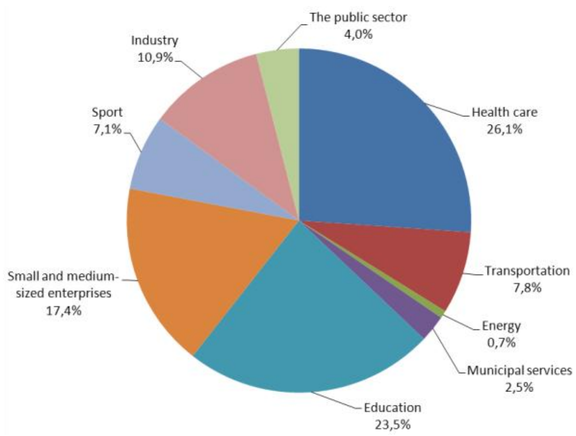

Figure 8.4. Use of regularly provided state guaranteed loans by sectors as of the end of 2011 (%)

Having evaluated current information on the borrowers' financial condition, previous credit history, liquidity and amounts of collaterals, and other information available, guarantees to 16 borrowers have been assessed as relatively the most risky; most of them are guaranteed loans granted to hospitals and for support of the financial sector. As of December 31, 2011 the outstanding balance of guaranteed loans granted to these borrowers made 54.7% of the total outstanding balance of guaranteed loans, or 272.5 million lats. Against this background, it is likely that the relatively risky state guaranteed debt liabilities will not be met by the set deadline. In the Law "On State Budget 2012" in 2012 a limit of 101.5 million lats (~0.7% of GDP) is imposed on the government to cover expenditure that may arise as a result of fulfilling state guaranteed debt liabilities associated with the state budget.

9 Institutional Features of Public Finances

9.1 Implementation of Rules on the State Budget

In Latvia the state and local government budget preparation, approval and implementation procedure, as well as responsibility for the budget process is laid down in the Law on Budget and Financial Management.

This law provides that the State Budget Law includes a state budget financial balance and public debt ceiling at the end of the financial year, as well as the proportion of the amount of guarantees issued on behalf of the state for fulfillment of obligations, public debt and the amount of guarantees to be issued during the financial year.

According to Article 24 of the Law on Budget and Financial Management budget executers can make state budget expenditures or undertake short-term obligations only within the framework of assignations set in their financing plans issued by the Treasury. At the same time, the Treasury grants assignations for expenditure according to the appropriations set in the annual State Budget Law and ensures their implementation according to the regulations of the Cabinet of Ministers. Budget institutions may undertake long-term budget liabilities, not exceeding long-term liability ceilings set in the financial year's State Budget Law.

In order to maintain the overall economic balance and to ensure uniform national financial policy, in the annual State Budget Law overall increase in government borrowings and guarantees is set. The Treasury is entitled to deduct sums from the amount due to local governments from the personal income tax share or from the local government equalization fund grants in the following cases and amounts:

1) If the local government does not ensure in proper time contractual obligations set in state loan agreements – in amount of overdue sum;

2) If the local government does not ensure the use of the loan according to the purpose specified in the loan agreement, – according to the decree of the Minister of Finance in amount of the loan used inconsistent with the goal.

In order to strengthen control over the allocation of resources, as well as to give the Minister of Finance the power to adapt payments quickly to rapid changes in the economy, in 2009 the Law on Budget and Financial Management was supplemented with relevant provisions regarding delay or reduction of allocations.

According to the Law on Budget and Financial Management, the Minister of Finance may delay or reduce the allocation for up to three months, giving the order to the Treasury, if at least one of the following conditions is met:

- if within the three-month period, state budget tax and non-tax real income, compared to estimated amount of revenue for the relevant period, reduces by more than 0.5% of GDP forecast set in the annual State Budget Law;
- actual accumulated state budget deficit in the three-month period exceeds the budget deficit planned for the relevant period by more than 0.5% of GDP forecast set in the annual State Budget Law;
- in the Treasury's budget accounts there is not sufficient amount of funds to cover projected payment obligations in the next month.

The Cabinet of Ministers has the power to determine additional provisions for state and local government budget planning and execution to ensure mitigation and prevention of increased fiscal, economic and social risks caused by macroeconomic processes and to ensure that international commitments and fiscal criteria are met.

9.2 Budget Procedures, incl. Public Finance Statistical Management

9.2.1 Budget procedures

The Constitution of the Republic of Latvia provides that the Saeima annually before the beginning of the financial year decides on the national revenue and expenditure budget which draft is submitted to them by the Cabinet of Ministers. **The State Budget Law shall be approved by the Saeima.**

By 2012 the Latvian state budget planning process envisaged approval of the State Budget Law for one year by the Saeima, but maximum spending amount for the next two years was accepted by the CoM.

According to the latest amendments to the Law on Budget and Financial Management, which entered into force on January 1, 2012, each year a medium-term budget framework law will be developed and approved by the Saeima. It will be developed each year for the period of the next three years, in addition for the first and second years of each new medium-term budgetary framework law indicators used in the previous medium-term budgetary framework law will be used, while the third year will have new indicators. In the medium-term budget framework law for each year of the period the main macroeconomic and financial indicators will be included, including the expenditure ceiling, as well as measures to be taken and results achieved regarding the objectives set out in the national development plan and the national defense concept. The first medium-term budgetary framework law will be developed for the period 2013–2015 and presented to the Saeima with the draft law “On State Budget 2013”, while all further medium-term budgetary framework laws will be submitted by the Cabinet of Ministers to the Parliament by April 30.

The annual budget law will clearly result from the financial indicators set out for the first year of the medium-term budget framework law. But overall, principles for calculation of budget expenditure of ministries and other central authorities are not substantially altered.

In planning state budget expenditure initially base budget expenditure is calculated and coordinated. Thus the amount of expenditure required to ensure the fulfilment of national functions at a constant level, compared to the previous year, is provided. In addition, ministries and other central government institutions may submit proposals for base budget expenditure reduction opportunities arising from reorganization or review of functions.

During the annual State Budget Law drafting process the following indicators are evaluated in complex and then reflected in the State Budget Law:

- state budget revenue, broken down by types of revenue;
- state budget expenditure by programmes (sub-programmes) and types of expenditure according to economic nature;
- state budget financial balance;
- government debt ceiling at the end of the year;
- amount of guarantees to be issued on behalf of the state;
- total increase in the state budget loan;
- amount of state budget earmarked subsidies to local governments, as well as government grants to local governments financial equalization fund;

- total increase in government borrowings and total increase in government guarantees;
- other conditions, such as contribution rate to the state-funded pension scheme and amount of contributions.

The Cabinet of Ministers has the power to determine additional conditions for state and local government budget planning and execution to ensure mitigation and prevention of increased fiscal, economic and social risks caused by macroeconomic processes and ensure that international commitments and fiscal criteria are met.

Cabinet of Ministers Regulation of October 3, 2009 No 1127 “On fundamental principles for preparation and submission of budget requests”, developed on the basis of Article 17 Paragraph one of the Law on Budget and Financial Management, provides procedures according to which ministries and other central government institutions shall develop and submit to the Ministry of Finance budget requests for medium term. On January 4, 2011 the Cabinet of Ministers approved amendments to this Regulation to include provisions regarding planning of performance results and indicators, thereby linking budgeting to policy planning. The aim of these amendments was to systematize definition of performance results and indicators to improve their information quality and practical use in policy planning, implementation and monitoring process, as well as budget planning, execution and monitoring processes.

Ministries and other central government institutions develop and submit to the Ministry of Finance budget requests according to the allowed ceilings of state budget expenditure for each ministry and other central state institutions. The budget shall be prepared within the following sections:

1) for implementation of state basic functions (with the exception of implementation of projects and activities co-financed from the European Union policy instruments and other foreign financial assistance)

2) implementation of projects and activities co-funded from the European Union policy instruments and other foreign financial assistance.

Budget breakdown in two aforementioned sections provides the public with an idea of what resources are used for the implementation of basic functions, and what – for the implementation of the European Union and other foreign policy instrument measures.

Explanations of the State Budget Law include information on the macroeconomic strategy description and fiscal review, revenue analysis and key elements of expenditure planning, planned investment and financial commitments, as well as legislative amendments made according to the package of draft budget laws. Explanations of each programme (sub-programme) of the state basic budget or special budget are prepared in a separate section, which include information about the objectives of the programme (sub-programme), planned outputs and performance indicators, institutions which provide implementation of the programme (sub-programme), beneficiaries (public target groups whose interests are covered, or institutions), as well as the proposed main activities, major projects, measures or services provided in accordance with laws and regulations to be implemented next year, as well as the performance of the previous year. Explanations of programmes (sub-programmes) also contain information on the average number of staff positions and average wage.

During the draft state budget development process negotiations between the Latvian Association of Local Governments (hereinafter – LPS) and the Ministry of Finance are held leading to the protocol on agreements and disagreements between the LPS and the Cabinet of Ministers (hereinafter – draft protocol). The draft protocol comprises issues on financial resources to be transferred to local government basic budget and special budget, local government financial equalization, loans, guarantees and long-term liabilities, social security strategy measures, acquisition of EU structural funds and necessary funding to comply with laws and regulations. The draft protocol is submitted to the enlarged meeting of the Cabinet of Ministers. The protocol on agreements and disagreements between the LPS and the Cabinet of Ministers shall accompany next year's draft State Budget Law when the government submits it to the Saeima. The Law on Budget and Financial Management envisages to hold negotiations with the LPS also regarding drafting the Medium-term Budget Framework Law and attach the result of the negotiations to the draft law in a form of a protocol.

To role of independent institutions (courts, the State Audit Office, Ombudsman and others) in the budgetary process has been strengthened. From 2012, the Law on the Budget and Financial Management determines that the Cabinet of Ministers in the preparation of draft medium-term budget framework law and draft annual state budget law shall listen to the view of independent authorities regarding sections of the funding for relevant authorities, shall justify the opinion of the Cabinet of Ministers in case the funding is reduced, as well as results of these negotiations in a form of protocols shall be made known to the legislature, attaching them to relevant draft laws.

If, at the beginning of the financial year, the annual State Budget Law has not entered into force, the Minister of Finance confirms necessary budget expenditure, loans and loan limits necessary for national operations, provided that the expenditure per month does not exceed the twelfth part of the previous year's appropriations.

9.2.2 Public finance statistical management

CSB compiles government finance statistics which is calculated accordingly requirements of European System of Accounts ESA' 95.

Framework of general government sector (S.13) in Latvia accordingly methodology ESA'95 consists of three subsectors: central government subsector (S.1311), local government subsector (S.1313) and social security fund subsector (S.1314).

In December 31, 2011 in general government sector there were 1205 independent budgetary institution, of which 295 institution were in central government subsector; 909 institutions - in local government subsector and 1 institution - in social security fund subsection; moreover, there was 143 enterprise controlled and financed by central and local governments, of which 39 enterprises were controlled by central government, 94 enterprises – controlled by local governments.

The list of enterprises related to general government sector is prepared by CSB by verifying enterprise compliance with the following criteria:

- either it has institutional unit features;
- either it is belonging to public sector (central and local government participation in enterprise equity capital exceeds 50%);
- either it is considered an institutional unit of non-market public sector.

If the main function of unit is participation in national income and treasure division and it has Classification of Economic Activities NACE 2 rev. code starting with „84" granted to it (classification section „Public administration and defense; compulsory social security"), the unit is related to general government sector. Belonging to general government sector is determined by analyzing data on financial activity provided in annual report. Data from reports of last five years is used for the analysis. If the condition fulfills stably (for the last three years) that unit net turnover minus received central or local government budget assignation is less than 50% of the unit activity costs, the unit is related to general government sector. Moreover, if main income source of the unit is price for services of other units of the government, it is related to general government sector.

Each quarter the CSB prepares detailed information on income, expenditure, as well as on financial accounts and government debt of general government sector, which is provided to *Eurostat* (Statistical Office of the European Union) 3 months after the end of reference period.

Moreover government budget deficit and debt notification, which is regularly sent to the EU institutions accordingly unified form established to all EU countries, is prepared in set terms (twice a year – until April 1 (provisional data) and until October 1 (final data)). Institution responsible for the preparation of notification is CSB, which during the preparation of notification carries out regular inter-institution working group meetings. Specialists from Ministry of Finance, the Treasury and Ministry of Economy, as well as from the Bank of Latvia are involved in the preparation of notification. If necessary additionally specialists from other institutions (the Ministry of Defense, the Ministry of Welfare, Riga City Council, etc.) are involved.

With government budget deficit and debt notification member countries of the European Union (EU) inform European Commission on public disposable budgetary means of own country and their expenditure.

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 government budget deficit to the Gross Domestic Product (GDP) at current prices must not exceed 3% and the ratio of the government debt to the gross domestic product at current prices must not be higher than 60% which are calculated in accordance with the requirements of ESA'95.

Main data sources for all previously mentioned information are "Annual report on implementation of central government budget and on budgets of local government in year n-1" (provisional data – the Treasury "Official monthly report on implementation of budget in January – December of year n-1") of the Ministry of Finance, Summaries on accountancy balance of central and local governments budgetary institutions at the end of year n-1 (provisional data – Summary on financial assets and liabilities in year n-1), as well as information from CSB statistics report form 1-FAP "Financial assets and liabilities in year n-1" (provisional data – 2-FAP "Financial assets and liabilities in n-1 year").

9.3 Other Institutional Developments Regarding Public Finances

On January 12, 2012 the Saeima in the first reading adopted the FDL. The government and the Saeima are working according to the plan to implement the law before parliamentary summer vacation. This will ensure that starting from the period 2014 – 2016 the Framework Law will be drafted in accordance with the rules of the FDL.

The FDL was developed between June 2010 and November 2011 and it was at large extent developed in close cooperation with IMF and EC experts. The FDL is based on the condition of a balanced general government budget over the economic cycle which is provided with a balance formula which, depending on whether GDP is growing faster or slower than the average growth rate, determines the minimum surplus to be created or the maximum permitted deficit. The second principle anticipates that with the Framework Law the allowed central government expenditure level for the next three years is fixed, thereby strengthening the medium-term expenditure policy planning.

During the period between the first and second reading, Latvia signed the Fiscal Treaty which at the EU level strengthened the principles of fiscal discipline setting particular fiscal rules that the contracting countries commit to integrate in national fiscal discipline regulatory acts. Consequently, the government found it useful already at this stage to coordinate the FDL with provisions of the Fiscal Treaty rather than adopt it in the current version and then modify in accordance with the Fiscal Treaty. Therefore, for the second reading proposals have been drawn up to introduce provisions of the Fiscal Treaty in the FDL.

The FDL is based on 3 numeric fiscal 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. Deviations are possible from this value down to -0.5% of GDP in case national scale productive public investment projects are implemented. In practice this means that the MTO corresponding to the FDL is -0.5% of GDP. In developing the Framework Law the structural balance was estimated as 0% of GDP (and thus higher than MTO) and as an exception, in case in the Framework Law will be identified a particular national scale productive public investment project, for the project implementation it will be possible to plan lower structural balance, but no more than on average -0.5 % of GDP in four years;
2. **Expenditure growth rule.** The FDL provides that, in addition to the limiting structural deficit, it is also determined that expenditure, excluding the GDP deflator (inflation), should not grow faster than potential GDP growth. Exceptions from this rule are provided in accordance with Article 9 of Council Regulation No 1175/2011 amending Council Regulation No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies. It should be noted that the FDL attributes this rule directly to the central government and social insurance budget expenditure. Application of this rule to other general government sectors will be ensured indirectly with limits on local government exceptions and guarantees, which are already being set in the State Budget Law;
3. **Setting state budget expenditure thresholds in medium term.** The FDL provides initial fiscal indicators, according to which the Framework Law is developed. In this law one of the key indicators is public expenditure thresholds for the next 3 years. The FDL provides that the rule regarding stability of these expenditure thresholds works as the standard rule – in the Framework Law the expenditure thresholds of the first and second year are inherited from the second and third years' expenditure thresholds of the previous Framework Law. As deviation from this rule – expenditure thresholds are not inherited if the size of the thresholds according to updated macroeconomic forecasts differs from inherited thresholds by more than 0.5% of GDP.

The FDL provides also a number of exceptions to the expenditure threshold rule (foreign financial assistance, income from the paid services provided and other revenue, etc.). Also an expenditure equalization mechanism is provided that prevents impact of fluctuations of EU structural funds and public debt servicing costs on other state budget expenditure.

According to the Fiscal Treaty the FDL provides for an automatic ex-post correction mechanism. If in the course of the budget execution the structural balance deteriorates more than expected to a certain limit, in coming years a correction is set to eliminate this deviation.

According to the Fiscal Treaty the FDL foresees to distinguish one-off revenue increasing or expenditure reducing measures from revenue increasing or expenditure reducing measures of a permanent nature. This is done in order to avoid the risk that deficit reduction of budget is achieved through measures that are not sustainable.

The FDL provides also conditions to be met if the structural deficit exceeds the medium-term objective. Council Regulation No 1175/2011 provides for conditions to be met if the structural balance of a Member State is worse than the medium-term structural balance objective. In this case, the structural balance should be improved by at least 0.5% of GDP per year. The Fiscal Treaty, in turn, foresees that the speed of structural balance improvement is determined individually for each country, mainly based on the principle that the structural balance during the stability programme period should reach the medium-term objective. According to the above mentioned Regulation and Fiscal Treaty the FDL requires that the speed of structural balance improvement is at least 0.5% of GDP per year or different speed if it is determined in accordance with an international agreement. Council Regulation No 1175/2011 and the Fiscal Treaty also provide that during the structural balance improvement period expenditure should grow more slowly than potential GDP growth. The FDL provides for similar regulation.

The FDL provides also for the fiscal risk management, envisaging that the medium-term budget framework law is supplemented with a fiscal risk declaration, which identifies fiscal risks broken down into quantifiable and unquantifiable risks. For quantifiable fiscal risks probability and fiscal impact are determined. Accordingly, the fiscal safety margin is calculated, which cannot be less than 0.1% of GDP and which is left in reserve when setting the government expenditure threshold.

Article 6, Paragraph one, Sub-paragraph (b) of the Fiscal Framework Directive 2011/85 envisages that Member States shall ensure monitoring of compliance with the fiscal discipline rules independently of bodies involved in the budgeting. The Fiscal Treaty provides for a similar condition. According to it the FDL provides for the establishment of a Fiscal Council in order to ensure independent monitoring of compliance with fiscal discipline rules.

The Fiscal Discipline Law aims to ensure long term application of this systemically new approach to fiscal policy-making and ensuring discipline, without it being regularly changed. The CoM has approved also amendments to the Constitution of the Republic of Latvia because in consultations with constitutional law experts it was concluded that for effective operation of the law core principles related to the implementation of fiscal discipline shall be strengthened at the constitutional level. This approach allows strengthening basic principles and key provisions of fiscal discipline in the Constitution as superior law in the country, to ensure that they cannot be changed or repealed by adopting other legislative acts, such as the annual State Budget Law, in the Parliament. It should be noted that the legal system of the Republic of Latvia provides that all laws adopted by the Saeima have the same effect, but in situations where the two laws include conflicting provisions, the latest adopted norm shall prevail, or a special legal provision, compared with a general legal provision shall prevail. Accordingly, only by strengthening certain fiscal discipline rules at the constitutional level long term validity of such norms can be ensured. Draft law “Amendments to the Constitution of the Republic of Latvia” has been submitted to the Saeima and Saeima committees continue consideration of it. On January 17, 2012 it was considered by the Saeima Legal Affairs Committee, as a result further consideration of the amendments to the Constitution have been postponed till the moment when the working group established under the supervision of the Saeima Legal Affairs Committee will complete its work at alternatives to currently submitted draft amendments to the constitution.

It should be taken into account that amendments to the Constitution needs majority of support of Parliament Members, therefore achieving of changes in the basic national law requires a broad political consensus.

9.4 Medium-term Budget Planning

Beginning with 2007, the Medium-term Macroeconomic development and Fiscal Policy Framework (hereinafter – the Framework) for the next three financial years has been prepared, which includes medium-term national macroeconomic analysis, government's fiscal policy objectives for medium term, state budget revenue projections and state budget expenditure ceilings for each ministry and other central government institutions for medium term.

Recent amendments to the Law on Budget and Financial Management, which entered into force on January 1, 2012, provide that current Framework, approved by the CoM, shall be develop in a form of a law as the Framework Law, to be approved by the Saeima, thus ensuring that financial indicators included in the Framework Law and to be achieved are legally binding and they should underpin the annual state budget law.

In the Framework Law for each year of the Law period maximum total central government expenditure, fiscal policy objectives, gross domestic product forecasts, state budget revenue forecasts, state budget financial balance (maximum level of deficit and/or minimum level of surplus), medium-term budget objectives will be specified and the national development plan priority development areas will be set out.

According to Article 16^1 of the Law on Budget and Financial Management regarding medium-term targets and initiatives it is stated that if funds are forecasted to the relevant subsequent financial years in conformity with the valid Framework Law for financing of new policy initiatives, ministries and other state central institutions shall submit the new policy initiatives in accordance with the schedule for development and submission of the draft Framework Law and draft State Budget Law. According to Paragraph three of the same Article ministries and other state central institutions shall prepare new policy initiatives based on priorities and objectives set in the national development plan and the national defence concept. This will ensure public finance planning according to development goals and priorities set for medium term.

The Minister of Finance will present the draft schedule for development and submission of the draft Framework Law and draft State Budget Law for the next year to the CoM by November 30 of current year (Article 16^1, Paragraph one of the Law on Budget and Financial Management).

Annexes

Table 1a. Macroeconomic prospects

	ESA Code	2011	2012	2013	2014	2015	2011
		Level, mln lats	rate of change %				
1. Real GDP	B1*g	7135.2	5.5	2.0	3.7	4.0	4.0
2. Nominal GDP	B1*g	14161.0	11.2	3.7	5.8	6.0	6.1
Components of real GDP							
3. Private consumption expenditure	P3	4780.4	1.9	3.7	4.0	4.0	1.9
4. Government consumption expenditure	P3	1035.5	0.0	0.0	0.5	1.0	0.0
5. Gross fixed capital formation	P51	1851.7	7.4	7.3	6.5	6.4	7.4
6. Changes in inventories and net acquisition of valuables (% of GDP)	P52+P53	117.2	2.7	2.3	1.0	2.1	2.7
7. Exports of goods and services	P6	3999.9	3.8	5.4	5.9	5.6	3.8
8. Imports of goods and services	P7	4649.5	5.1	5.8	6.0	5.8	5.1
Contributions to real GDP growth							
9. Final domestic demand		-	8.6	3.2	4.5	4.6	4.7
10. Changes in inventories and net acquisition of valuables	P52+P53	-	2.1	0.0	0.0	0.0	0.0
11. External balance of goods and services	B11	-	-5.2	-1.2	-0.8	-0.6	-0.7

Table 1b. Price developments

	ESA Code	2011	2011	2012	2013	2014	2015
		Level	rate of change,%				
1. GDP deflator			5.4	1.7	2.0	2.0	2.0
2. Private consumption deflator			4.9	2.6	2.0	2.0	2.0
3. HICP			4.2	2.6	2.0	2.0	2.0
4. Public consumption deflator			-2.1	0.5	1.0	1.0	1.0
5. Investment deflator			2.3	2.5	2.0	2.0	2.0
6. Export price deflator (goods and services)			8.9	1.3	1.0	1.0	1.0
7. Import price deflator (goods and services)			5.3	1.8	1.0	1.0	1.0

Table 1c. Labour market developments

	ESA Code	2011	2011	2012	2013	2014	2015
		Level	rate of change %				
1. Employment, persons		970,5	3.1	0.7	1.1	1.2	1.2
2. Employment, hours worked		1204716649	3.8	2.6	3.1	3.2	3.2
3. Unemployment rate (%)			15.4	14.1	13.3	12.1	10.7
4. Labour productivity, persons			2.2	1.3	2.6	2.7	2.8

	ESA Code	2011	2011	2012	2013	2014	2015
5. Labour productivity, hours worked			1.6	-0.6	0.6	0.8	0.8
6. Compensation of employees	D.1	5909,7	7.7	3.5	4.1	5.1	5.3
7. Compensation per employee		464	4.3	2.7	2.9	3.8	4.1

Table 1d. Sectoral balances

% of GDP	ESA Code	2011	2012	2013	2014	2015
1. Net lending/borrowing vis-à-vis the rest of the world	B.9	0.9	-0.5	-1.1	-1.4	-1.7
of which:- Balance on goods and services		-3.4	-4.8	-5.1	-5.1	-5.3
- Balance of primary incomes and transfer		2.1	2.3	2.1	2.1	2.0
- Capital account		2.1	2.0	1.8	1.7	1.6
2. Net lending/borrowing of the private sector	B.9	5.4	1.6	0.3	-0.6	-1.4
3. Net lending/borrowing of general government	EDP B.9	-3.8	-2.1	-1.4	-0.8	-0.3
4. Statistical discrepancy		-0.6	0.0	0.0	0.0	0.0

Table 2a. General government budgetary prospects

		2011	2011	2012	2013	2014	2015
	ESA Code	mln lats	% of GDP				
Net lending (EDP B.9) by sub-sector							
1. General government	S.13	-494.1	-3.5	-2.1	-1.4	-0.8	-0.3
2. Central government	S.1311	-307.5	-2.2	-0.6	-0.1	-0.6	-0.4
3. State government	S.1312						
4. Local government	S.1313	-60.9	-0.4	-0.4	-0.1	0.0	0.0
5. Social security funds	S.1314	-125.7	-0.9	-1.0	-1.2	-0.2	0.1
General government (S.13)							
6. Total revenue	TR	5039.6	35.6	37.4	35.1	34.1	32.8
7. Total expenditure	TE	5533.7	39.1	39.5	36.5	34.9	33.1
8. Net lending/borrowing	EDP B.9	-494.1	-3.5	-2.1	-1.4	-0.8	-0.3
9. Interest expenditure	EDP D.41	210.3	1.5	1.7	1.8	2.1	2.1
10. Primary balance		-283.8	-2.0	-0.4	0.5	1.4	1.8
11. One-off and other temporary measures		27.4	0.2	0	0	0	0
Selected components of revenue							
12. Total taxes (12=12a+12b)		2679.0	18.9	19.3	19.1	18.8	18.5
12a. Taxes on production and imports	D.2	1623.8	11.5	11.8	11.7	11.5	11.3
12b. Current taxes on income, wealth etc.	D.5	1053.6	7.4	7.5	7.5	7.4	7.3
12c. Capital taxes	D.91	1.6	0.0	0.0	0.0	0.0	0.0
13. Social contributions	D.61	1246.3	8.8	8.8	8.0	7.6	7.5
14. Property income	D.4	184.1	1.3	1.3	0.9	0.7	0.6
15. Other		930.3	6.6	8.0	7.1	7.0	6.1
16. Total revenue	TR	5039.6	35.6	37.4	35.1	34.1	32.8
Tax burden (D.2+D.5+D.61+D.91 – D.995)		3983.5	28.1	28.3	27.3	26.7	26.3
Selected components of expenditure							
17. Compensation of employees + intermediate consumption	D.1+P.2	2356.6	16.6	16.1	15.1	14.1	13.8
17a. Compensation of employees	D.1	1355.1	9.6	9.3	8.9	8.5	8.4

		2011	2011	2012	2013	2014	2015
	ESA Code	mln lats	% of GDP				
17b. Intermediate consumption	P.2	1001.6	7.1	6.8	6.2	5.7	5.4
18. Social payments (18=18a+18b)		1611.8	11.4	11.0	10.2	9.6	9.1
of which Unemployment benefits		43.7	0.3	0.3	0.3	0.3	0.3
18a. Social transfers through market producers	D.6311, D.63121, D.63131	80.2	0.6	0.5	0.5	0.5	0.5
18b. Social transfers which are no transfers in kind	D.62	1531.5	10.8	10.4	9.7	9.1	8.7
19.=9. Interest expenditure	EDP D.41	210.3	1.5	1.7	1.8	2.1	2.1
20. Subsidies	D.3	37.8	0.3	0.3	0.3	0.3	0.3
21. Gross fixed capital formation	P.51	593.9	4.2	4.2	2.9	1.5	1.2
22. Capital transfers	D.9	397.2	2.8	2.0	1.7	1.6	1.5
23. Other		326.1	2.3	4.3	4.5	5.7	5.1
24.=7. Total expenditure	TE	5533.7	39.1	39.5	36.5	34.9	33.1
Government consumption	P.3	2296.1	16.2	15.7	14.7	13.8	13.5

Table 2b. Breakdown of revenue

	2011	2011	2012	2013	2014	2015
	mln lats	% of GDP				
1. Total revenue at unchanged policies	4813.3	34.0	37.2	35.1	34.1	32.8
2. Discretionary revenue measures	226.3	1.6	0.3			

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

	2011	2011	2012	2013	2014	2015
	mln lats	% of GDP				
1. Expenditure on EU programmes fully matched by EU funds revenue	663.3	4.7	5.8	4.9	5.2	4.4
2. Expenditure fully matched by mandated revenue increases						
3. Non-discretionary changes in unemployment benefit expenditure	-45.1	-0.3	0.0	0.0	0.0	0.0

Table 3. General government expenditure by function

% of GDP	COFOG Code	**2010**	**2015**
1. General public services	1	4.5	3.3
2. Defense	2	1.0	0.8
3. Public order and safety	3	2.0	1.5
4. Economic affairs	4	9.0	6.7
5. Environmental protection	5	0.8	0.6
6. Housing and community amenities	6	1.3	1.0
7. Health	7	4.3	3.2
8. Recreation, culture and religion	8	1.6	1.2
9. Education	9	6.2	4.6

% of GDP	COFOG Code	**2010**	**2015**
10. Social protection	10	13.8	10.3
11. Total expenditure	TE	44.4	33.1

Table 4. General government debt developments

% of GDP	ESA Code	**2011**	**2012**	**2013**	**2014**	**2015**
1. Gross debt		**42,6%**	**44,5%**	**45,8%**	**46,7%**	**38,9%**
2. Change in gross debt ratio		**2,4%**	**3,5%**	**3,7%**	**3,6%**	**-5,2%**
Contributions to changes in gross debt						
3. Primary balance		**-2,0%**	**-0,4%**	**0,5%**	**1,4%**	**2,4%**
4. Interest expenditure	**EDP D.41**	**1,5%**	**1,7%**	**1,8%**	**2,1%**	**2,1%**
5. Stock-flow adjustment, *of which*		**-1,1%**	**1,4%**	**2,4%**	**2,8%**	**-4,9%**
- Differences between cash and accruals *		-0,2%				
- Net accumulation of financial assets, **		-1,1%				
of which: privatization proceeds		*0,1%*				
- Valuation effects and other ***		0,2%				
p.m.: Implicit interest rate on debt		**3,7%**	**4,1%**	**4,4%**	**4,9%**	**4,7%**
Other relevant variables						
6. Liquid financial assets		6,9%				
7. Net financial debt (7=1-6)		35,6%				
8. Debt amortization (existing bonds) since the end of the previous year		0,9%	0,3%	0,9%	1,9%	0,7%
9. Percentage of debt denominated in foreign currency		80,4%	83,5%	87,1%	88,7%	85,7%
10. Average maturity		5,25 years	4,80 years	-	-	-

According to 2012 April Notification data:

* "Difference between interest (EDP D.41) accrued (-) and paid (+)"

** "Net acquisition of financial assets"

*** "Adjustments", excluding "Difference between interest (EDP D.41) accrued (-) and paid (+)"), and "Statistical discrepancies".

Table 5. Cyclical development

% of GDP	ESA Code	2011	2012	2013	2014	2015
1. Real GDP growth (%)	B1g	5.5	2.0	3.7	4.0	4.0
2. Net lending of general government	B.9	-3.5	-2.1	-1.4	-0.8	-0.3
3. Interest expenditure	D.41	1.5	1.7	1.8	2.1	2.1
4. One-off and other temporary measures		-0.2				
5. Potential GDP growth (%)		-1.0	1.4	2.8	3.6	3.9
contributions:						
- labour		-1.0	-0.1	0.4	0.6	0.6
- capital		0.2	0.7	0.8	1.0	1.1
- total factor productivity		-0.2	0.8	1.6	2.0	2.2
6. Output gap, % of potential GDP		-0.7	-0.2	0.7	1.1	1.1
7. Cyclical budgetary component		-0.2	0.0	0.2	0.3	0.3
8. Cyclically-adjusted balance (2-7)		-3.3	-2.1	-1.6	-1.1	-0.6
9. Cyclically-adjusted primary balance (8+3)		-1.8	-0.4	0.3	1.1	1.5
10. Structural balance (8-4)		-3.1	-2.1	-1.6	-1.1	-0.6

Table 6. Divergence from previous update

	ESA Code	2011	2012	2013	2014	2015
Real GDP growth (%)	B1g					
2011-2014		3.3	4.0	4.0	4.0	-
2012-2015		5.5	2.0	3.7	4.0	4.0
Difference		2.2	-2.0	-0.3	0.0	-
General government net lending (% of GDP)	B.9					
2011-2014		-4.5	-2.5	-1.9	-1.1	-
2012-2015		-3.5	-2.1	-1.4	-0.8	0.3
Difference		1.0	0.4	0.5	0.3	-
General government gross debt (% of GDP)						
2011-2014		48.3	48.1	49.9	51.9	-
2012-2015		42.6	44.5	45.8	46.7	38.9
Difference		-5.7	-3.6	-4.1	-5.2	-

Table 7. Long-term sustainability of public finances

% of GDP	2010	2020	2030	2040	2050	2060
Total expenditure						
Of which: age-related expenditure	19.2	16.5	15.4	14.9	15.4	15.4
Pension expenditure	9.7	7.3	6.5	6.3	6.4	5.9
Social security pensions	9.7	7.3	6.5	6.3	6.4	5.9
Old-age and early pensions	8.7	6.5	5.9	5.8	5.9	5.5
Other pensions (disability, survivors)	1.0	0.7	0.5	0.5	0.4	0.4
Occupational pensions (if in general government)						
Health care	3.7	3.8	4.0	4.1	4.2	4.3
Long-term care	0.7	0.7	0.7	0.8	0.9	1.0
Education expenditure	4.4	4.0	3.7	3.3	3.5	3.8
Other age-related expenditure	0.7	0.7	0.5	0.4	0.4	0.4
Interest expenditure						
Total revenue						
Of which: property income						
Of which: from pensions contributions	6.9	8.9	8.8	9.1	9.0	8.8
Pension reserve fund assets						
Of which: consolidated public pension fund assets						
Social contributions diverted to mandatory private scheme	0.5	1.6	1.7	1.8	1.7	1.7
Pension expenditure paid by mandatory private scheme	0.0	0.1	0.3	0.9	1.9	2.9
Labour productivity growth	5.4	1.9	2.3	2.3	1.9	1.5
Real GDP growth	-0.3	1.9	1.9	1.3	0.3	0.6
Participation rate males (aged 20-64)	83.2	85.5	85.2	84.6	82.8	85.3
Participation rate females (aged 20-64)	76.7	79.4	79.6	79.2	78.1	80.9
Total participation rate (aged 20-64)	79.9	82.4	82.4	81.9	80.4	83.1
Unemployment rate	18.4	18.0	8.6	7.5	7.2	7.1
Population aged 65+ over total population	17.3	19.2	23.2	26.8	31.2	35.6

Data source: EPC AWG

Table 7a. Contingent liabilities

% of GDP	2011
Public guarantees	**2,4%**
Of which: linked to the financial sector	**0,5%**

Table 8. Basic assumptions [14]

	2011	2012	2013	2014	2015
Short-term interest rate in eurozone (annual average)	1.4	0.8	0.9	0.9	0.9
Long-term interest rate in eurozone (annual average)	2.6	1.9	2.2	2.2	2.2
USD/€ exchange rate (annual average)	1.4	1.3	1.3	1.3	1.3

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[14] Technical assumptions

Nominal effective exchange rate	1.2	-3.9	0.2	0.2	0.2
World excluding EU, GDP growth	4.2	4.2	4.3	4.3	4.3
EU GDP growth	1.5	0.1	1.4	1.4	1.4
World export volumes, excluding EU	8.5	4.9	6.0	6.0	6.0
World import volumes, excluding EU	7.5	5.6	6.2	6.2	6.2
Oil prices (Brent, USD/barrel)	111.5	119.9	113.5	113.5	113.5