Latvia's
Stability Programme
for 2014 - 2017

Contents

Abbreviations

AWG	*Economic Policy Committee's* Working Group on Ageing Populations and Sustainability of Public Finances
BoL	Bank of Latvia
CSB	Central Statistical Bureau of Latvia
CIP	Corporate income tax
Convergence Programme	Latvia's Convergence Programme 2013 - 2016
Cabinet	Cabinet of Ministers
Council	Fiscal Council
Draft Protocol	Cabinet and LALRG Draft Protocol on Disputes and Agreements
EC	European Commission
ESA	European System of Accounts
EU	European Union
Framework Law	Law on Medium-Term Budget Framework
Framework	Medium-term Framework of Macroeconomic Development and Fiscal Policy
FDL	Fiscal Discipline Law
GDP	Gross domestic product
IMF	International Monetary Fund
LALRG	Latvian Association of Local and Regional Governments
LBFM	Law on Budget and Financial Management
Loan Programme	International Loan Programme
MoF	Ministry of Finance
MTO	Medium-term objective of budget balance in structural terms
NDP	National Development Plan 2014-2020
NPI	New policy initiatives
NRP	National Reform Programme
PIT	Personal income tax
Regulation No 1175/2011	EUROPEAN PARLIAMENT AND COUNCIL REGULATION (EU) No 1175/2011 (16 November 2011) amending Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies
SRS	State Revenue Service
ST	State Treasury
USA	United States of America

VAT	Value Added Tax

1. Overall Economic Policy Guidelines and Objectives

In 2010, Latvia has set an objective to introduce the euro until 2014, what at the same time was both a strategy for overcoming the crisis and one of the major driving forces in order to facilitate economic stability of Latvia and to implement structural reforms. Implementation of counter-cyclical fiscal policy is a substantial precondition for the sustainable development of Latvia. Along with implementing such policy since September 2012, Latvia has fulfilled all Maastricht criteria what is considered as a quality mark, acknowledging that the state economy is able to provide sustainable growth, what is a substantial precondition for increasing the attraction of Latvian economic environment among foreign investors. Also hereafter, Latvia is full of determination to provide sustainable fulfilment of the Maastricht criteria what is demonstrated by Latvia's ability to introduce the principles of counter-cyclical fiscal policy.

On 1 January 2014, Latvia has become the 18th euro area member state and this year it submits the Stability programme of Latvia instead of Convergence Programme for the first time.

The Stability programme of Latvia is a medium-term policy document, describing Latvian fiscal policy for 2014–2017 and which has been prepared following the conditions and guidelines of the Stability and Growth Pact. The Stability programme is focused on implementation of strict and sustainable fiscal policy and on the provision of macroeconomic stability.

Within the cycle of the EU economic policy supervision and coordination or the European Semester, the Stability programme is being prepared and submitted to the EC simultaneously with the NRP and the activities included therein.

The Stability programme has been prepared, taking into account the requirements of the Stability and Growth Pact and the EU regulations included therein as well as its Code of Conduct. At the same time, the Programme has been prepared taking into consideration the priorities mentioned in the Annual Growth Survey as well as in macroeconomic and fiscal guidelines.

The medium-term macroeconomic scenario of the Stability programme has been developed on the basis of conservative assumptions and in the scenario the data of the EC winter macroeconomic forecasts have been used. A macroeconomic scenario provides that in a medium term economic growth will be equal to potential growth in an amount of 4.0%.

Specific objectives of Latvian fiscal policy in a medium term are as follows:

- to provide responsible and sustainable fiscal policy, observing fiscal discipline;
- to raise the quality of life of population and to facilitate the development of the state economy.

From the fiscal policy principles, included in the FDL, it follows that **a general objective of medium-term fiscal policy is to raise sustainably the quality of life of population** what includes welfare of inhabitants, availability of medical services, nature environment, developed infrastructure and culture as well as elimination of excessive inequality in population's income. It is essential to provide that in the state there will be conditions for improving the quality of life not only now, but also in the future. Therefore, in the objective of fiscal policy there is sustainability emphasised. A sustainable raising of a quality of life means that public financial resources are being shifted not only to current measures for improving a quality of life, but also are being planned and allocated in a manner, providing conditions for the state to raise a quality of life also in subsequent 10 and 50 years. This may be achieved, first, by refusing to cover current expenditure at the cost of next generations or refusing to increase public expenditure on the cost of a deficit; second, by shifting public resources in order to form a favourable environment for economic development, for example investing resources in science.

Already in 2012, Latvia has strengthened its positions of a regular borrower in international financial markets, making two bonds issues in the US market – in February (USD 1 billion) and December (USD 1.25 billion). In January 2014, after a six-year pause and shortly after the introduction of the euro, Latvia issued seven-year bonds amounting to one billion euros at a fixed interest (coupon) rate of 2.625% a year. Unlike previous borrowings in international financial markets, this transaction was mainly focused on European investors. Economic growth, accession to the euro area, improvements in Latvia's credit ratings, high evaluation of investors as regards the accomplished work in Latvian economy during previous years and faith in Latvia's long-term development has allowed Latvia to borrow financial resources in international markets under very favourable conditions.

The Stability programme as a policy document has been approved by the Cabinet as well as presented and approved in the corresponding commissions of the Saeima.

2. Economic Situation

2.1. External Economic Environment

Since the middle 2013 of there has been a gradual improvement in the global economic situation. It is expected that this trend will continue also in 2014 and 2015. Currently, increase in total demand in developed countries has become the major driving force of growth, especially in the USA where an uncertainty about fiscal policy has decreased and improvements in the labour market facilitate increase of private consumption that currently is the major driving force of growth. Positive trends are observable also in the euro area which in the last quarter of 2013 has returned to positive growth and has become more balanced among countries and growth promoting factors.

Meanwhile the prospects of economic growth for developing countries have become more unclear and the risks for global growth related to these countries have increased. On the one hand, developing countries economically depend on export possibilities that are directly connected with processes in developed countries, where recently there have been positive trends observable and it is forecasted that in the future their growth will become stronger. On the other hand, in developing countries growth will be limited by expected changes in the monetary policy of developed countries, which due to improvements in the economic situation could become less stimulating and in a medium term there is also an expected increase in interest rates. Such changes will facilitate changes in global capital flows that in general will delay crediting and decrease domestic demand in developing countries, which will be intensified by unbalanced external positions of particular countries.

Table 2.1. Main Macroeconomic Indices, Annual Growth, %[1]

	2012	2013	2014p	2015p
GDP growth of global economy, %	3.2	3.0	3.6	3.9
GDP growth of developed countries, %	1.4	1.3	2.2	2.3
GDP growth of developing countries, %	5.0	4.7	4.9	5.3
International trade, %	2.8	3.0	4.3	5.3
Inflation in developed countries, %	2.0	1.4	1.5	1.6
Inflation in developing countries, %	6.0	5.8	5.5	5.2

Taking into account that Latvia has the close economic relations with the EU countries, economic development in Europe directly influences Latvia's prospects of growth. In the third quarter of 2013, the EU economy after recession, lasting for five quarters, has returned to positive growth. Although a growth rates among European countries remains different, it is forecasted that differences between European countries will continue to decrease in subsequent years. Thus, in general the development of the EU economy will become more balanced.

News on positive EU growth to a large extent is a result of successful implementation of economic adjustments in the countries in which previously there were large imbalanced positions. Substantial fiscal consolidation measures were conducted and structural reformed were started. The countries that previously had a very high level of a current account deficit, characterising an economic imbalanced position of these countries, has achieved a substantial progress in relation to implementing structural reforms and shifting resources to a tradable sector. Such trend is well observable in Spain and Portugal where strong export growth has currently become a driving force of growth. However, it is expected that along with a gradual

[1] Source of data: World Economic Outlook Update, 8 April 2014, IMF.

improvement in the labour market and increase in real income, that will be determined by low inflation, the increase of private consumption will become more rapid and therewith growth will become more balanced between external and internal demand. At the same time, in the countries where rapid economic adjustments took place, unemployment rate will still remain high. If high level of unemployment persists it has a tendency to become structural unemployment that, in turn, may influence the growth perspectives of countries in a long term. To solve this problem, crucial importance is attributed to the ability of countries to continue implementing reforms, thus, helping to eliminate a high unemployment rate before it becomes structural.

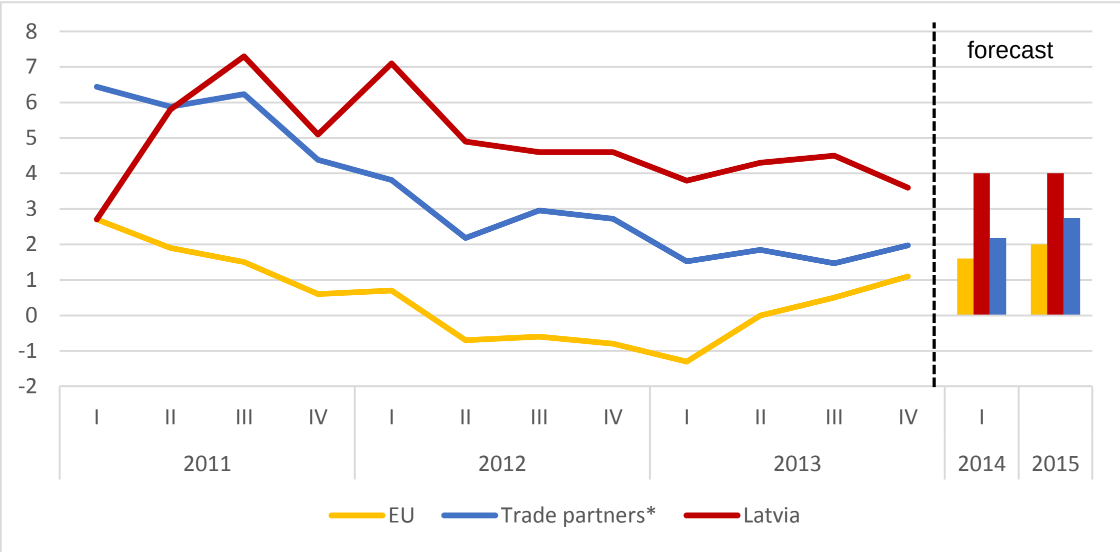

Figure 2.1. GDP Growth Against the Corresponding Quarter in the Previous Year; Forecasted Annual Growth, %[2]

In previous years, rapid growth of Latvian export was largely determined by a favourable structure of the export market – its growth rate was substantially higher than on average in the EU that provided stable increase in demand for Latvian export, explaining Latvia's stability against worsening of the external environment. However, the growth rate of partner countries gradually decreases. Although growth rate remains higher than on average in the EU, a difference between the growth of Latvia's trade partner countries and the EU average growth has decreased. Therefore, in order to provide export growth and increase a market share, even larger significance is attributed to the development of Latvia's competitiveness.

As a major risk for Latvia's growth is development of a geopolitical situation in the Ukraine – Russia, that may substantially affect growth of Latvian export. Although Latvian export to the Ukraine constitutes only 0.9% of total export of goods, bigger risks are created by uncertainty as regards an imposition of sanctions on Russia as 11.5% of Latvia's total export of goods are directed to Russia. Considering that Russia is a substantial trade partner for many EU countries, this situation may substantially worsen the development prospects of both Latvia and the EU.

[2] Average growth of aggregated partner countries (Estonia, Lithuania, Russia, Germany, Poland, Sweden) weighted by the average proportion of export in 2013.
Source of data: European economic forecast - winter 2013, European Commission.

2.2. Current Economic Development

After implementation of the structural reforms and wide austerity measures for the settlement of consequences of the global economic and financial crisis in Latvia, the state economy shows growth already for three consecutive years, achieving growth of 5.3% and 5.2% in 2011 and 2012 respectively. Last year, the rate of economic growth stabilized at the level of 4.1% that is near to the potential GDP. With such economic performance, Latvia has shown the most rapid growth among the EU Member States.

In 2011-2012, growth was largely based on foreign trade because improvements in the global economic environment, which was weakened by the crisis, facilitated increase in demand in the major partner countries of Latvia, despite the euro area crisis. This was an important precondition for raising volumes of output in export-oriented sectors and for regaining competitiveness, allowing corresponding sectors to take a larger proportion in the development of the national economy. However, the last year was more favourable for the enterprises servicing the local market as in 2013 private consumption was the major driving force of economic growth.

Last year, stability of private consumption facilitated development of the sectors oriented on the domestic market – a contribution of construction, trade and transactions with real estate to GDP growth amounted to 40%. In turn, the growth rate of manufacturing industry in 2013 slowed down due to the closure of Latvia's largest enterprise in the basic metal subsector JSC Liepājas metalurgs. However, manufacture of food products, wood-processing and manufacture of fabricated metal products, which are the major manufacturing subsectors in the country, have shown a substantial positive growth rate, thus mitigating the drop in basic metal sector. Overall manufacturing has grown by 0.6% in 2013. In general, in 2013 almost all sectors have shown positive growth, except for agriculture, mining and quarrying, and heating.

A substantial role in facilitating growth was attributed also to the implementation of the Cohesion Fund's activities, using 3.3 billion euros (2.3 billion lats) for 2007-2014. An evaluation of the impact of the EU funds shows that a positive impact of the Cohesion Policy on dynamics of GDP reached 1.5 percentage points in 2013. According to a sectoral division, the largest stimulating impact of the EU funds in 2013 was observed in construction, increasing the growth rate of value added for the sector by 3.4 percentage points. This considerable impact of the EU funds on construction is explained by the fact that in the post-crisis period, orders in the construction and renovation of civil engineering and public sector buildings were largely funded by the EU. A substantial influence of the Cohesion Policy has been observed also in the industry comprising annual increase of 2.3 percentage points. Within the sector, the development of the national economy was facilitated by considerable investments in innovative industrial enterprises.

Evaluating GDP from the expenditure side, growth of private consumption in an amount of 5.4% was facilitated by increase in domestic demand, provided by improvements in the labour market as well as raise in wages. After cuts in the 2012 budget expenditure, a substantial contribution to GDP growth in 2013 was also provided by public consumption, increasing by 3.6%. In turn, lower growth rate was shown by export, which was mainly influenced by a high base effect as well as by the termination of production at JSC Liepājas metalurgs that considerably reduced the export of metal and its products. At the same time, it should be noted that the export value of wood-processing increased by 10.1%, but the food and agricultural sectors remained at the level of 2012. Furthermore, negative growth in the volumes of imported goods and services guaranteed that in 2013 deficit of the foreign trade declined to 9.0% of GDP. Decrease of import is also explained by decline in investments since investments in gross fixed capital fell by 4.3%. However, with regard to the future prospects, it is reasonably to think that economy will gradually switch from the private consumption to balanced growth where an increasingly larger role in growth will be provided by export and increase of investment activity.

It should be mentioned that implementation of the EU funded projects has facilitated increase in an average real wage – in 2013 by 1.7 percentage points, thus, facilitating rise in the growth rate of private consumption by 1.2 percentage points a year. Expansion of the private consumption and demand for foreign investment goods (raw materials, construction materials, etc.) has increased import by 1.9 percentage points a year. However, a role of the EU funds was not large in facilitating export, since the projects co-funded by the EU were mainly directed on the improvement of infrastructure. Activities of the Cohesion Policy have provided increase in the growth rate of export volumes of goods and services by 0.6 percentage points in 2013.

Along with the stable economic growth, a situation in the labour market continues to improve. The number of employed people in the national economy in 2013 increased to 893.9 thousand which is by 2.1% more than a year before. According to the labour survey data, a proportion of job seekers during a year has decreased by 3.1 percentage points, to 11.9% of economically active population, which is the lowest level since 2008. During the year, registered unemployment rate also continued to decrease, falling to 9.5% of economically active population at the end of December 2013, which is 1 percentage point less than at the end of 2012. However, in a slightly longer term, problems may be caused by negative dynamics in the number of population and by the expected fall in the number of working-age population. Therefore, in the future, economic growth should largely rely on increase in productivity rather than rise in the number of employees. A positive influence on dynamics of employment was attributed to the investments of the EU funds – in 2013 the implementation of the EU funded projects has increased the number of employees by 0.4 percentage points on average.

Stable economic growth contributed to the low inflation level in 2013 on average, consumer prices remained at the level of 2012. Meanwhile annual inflation had a downward trend - from 0.6% in January 2013 decreasing to -0.4% in December 2013. Similarly to 2012, last year core inflation remained constantly low. Nevertheless, price fluctuations are still affected by external processes, namely, by an imported inflation. It mainly consists of prices on energy resources and unprocessed food in global markets, and currently price dynamics occur in the opposite directions.

Last year was a time of big challenges and changes for Latvia’s economy not only due to the cease of production at the state largest manufacturing enterprise, which negatively affected many fields and sectors. It is important that Latvia by keeping prices and the exchange rate low and stable as well as fulfilling other Maastricht criteria for introducing the euro, has joined the euro area on 1 January 2014. This opens new opportunities and prospects for local enterprises and Latvian economy in general.

2.3. Macroeconomic Development Scenario

A medium-term macroeconomic scenario has been developed in February 2014. In the scenario, a decision of the Cabinet to postpone a liberalisation of the electricity market until 1 January 2015 has been taken into account. The scenario of macroeconomic development has been worked out by consulting with the experts of the Ministry of Economics, the BoL and commercial banks as well as with international partners – the EC and the IMF. The scenario has been drafted on the basis of conservative assumptions and the data of the EC winter forecasts.

The macroeconomic scenario considers that economic growth in a medium term will be close to potential growth amounting to 4.0%.

Table 2.2. Growth and Its Related Factors

	ESA code	2013	2013	2014	2015	2016	2017
		million euros	Growth %				
1. Real GDP	B1*g	20983.1	4.1	4.0	4.0	4.0	4.0
2. Nominal GDP	B1*g	23315.5	5.6	5.7	6.9	6.6	6.6
GDP by expenditure in the prices of 2010							
3. Private consumption expenditure	P3	13415.9	5.4	5.1	4.6	4.0	3.9
4. Government consumption expenditure	P3	3494.1	3.6	2.5	2.5	2.5	2.5
5. Gross fixed capital formation	P51	4412.4	-4.3	3.8	5.0	5.7	5.8
6. Changes in inventories and net acquisition of valuables (% of GDP)	P52+P53	113.6	-26.2	0.0	0.0	0.0	0.0
7. Exports of goods and services	P6	12096.5	1.0	4.0	4.6	5.0	5.3
8. Imports of goods and services	P7	12553.5	-1.7	4.5	5.1	5.2	5.4
Contribution to GDP growth							
9. Final domestic demand			2.4	4.4	4.4	4.2	4.1
10. Changes in inventories and net acquisition of valuables	P52+P53		0.0	0.0	0.0	0.0	0.0
11. External balance of goods and services	B11		1.7	-0.4	-0.4	-0.2	-0.2

In 2014, growth still will be determined by domestic demand, however, compared to 2013, growth will become more balanced between domestic and external demand. This is determined by the better economic situation in the EU as well as by decrease of a negative impact in annual growth data in relation to the closure of the largest metal working enterprise JSC Liepājas metalurgs in May last year. These factors as well as even more steady improvements in the labour market in 2013 allow forecasting a stable growth rate also in 2014. In a medium term, growth will be driven by investments and external trade, which mainly will be determined by increase in productivity, not by increase in the number of employees.

According to the medium-term macroeconomic scenario, changes in the private consumption growth will depend on changes in the income of the population that will be determined by a situation in labour market. It is expected that in a medium term changes in wages will not exceed growth of productivity; however, given that unemployment rate will keep decreasing and taking into account the trends of demographic development, the growth rate of employment will slow down. As a result, a contribution of private consumption in a medium term will gradually decrease. In addition, within the framework of the scenario it is assumed that substantial changes are not expected in the level of households' savings and in crediting trends.

In a medium term, growth rate of public consumption will slow down compared to GDP growth that reflects the chosen fiscal policy, reducing a tax burden in the national economy and at the same time providing for fulfilment of the structural objectives of a budget deficit.

Dynamics of short-term investments will be influenced by prudent crediting policy of commercial banks and by a sentiment of entrepreneurs. In the investments of the private sector, there is still caution in relation to future prospects. Although lately there has been an improvement in a situation in the euro area, currently the largest uncertainty is connected with development in the Ukraine and possible economic sanctions between the EU and Russia. In a medium term, increase of investments will be determined by growing domestic and external demand as well as by high levels of the production capacity utilization in particular subsectors of manufacturing. In addition, it is expected that in a medium term the introduction of the euro also will positively affect the dynamics of investments. Thus, it is forecasted that a proportion of investments in GDP will continue to increase, but it will still remain below the pre-crisis level.

Development trends and a scenario of the external sector

From all-time highest level of current account deficit in 2006 and a surplus following it in 2009 and 2010, current account has become negative again for several years, however, taking into account the structure and growth possibilities of Latvian national economy, a current level of a deficit is considered sustainable. By decrease in an external trade deficit and in the income gained in Latvia by non-resident enterprises, in 2013 current account deficit of balance of payments decreased to 0.8% of GDP. Such deficit of a current account does not raise doubts about its financing and sustainability because it is being completely covered by the inflows of foreign direct investments and by the resources of the EU funds that do not create external obligations.

If during rapid adjustments of the external sector changes in a current account were mainly determined by changes in an income account, then since Latvian economy has returned to growth, the major changes in a current account is determined by development of the external trade of goods and services. Despite rapid increase in private consumption due to weak investment activities and slowdown of export growth, import of goods in 2013 has decreased by 0.4%. Also a growth rate of the export of goods in 2013 was considerably lower than in previous years and constituted only 1.4%. Considerably lower growth rate of the export of goods was determined by weak external demand, closure of the largest metallurgical enterprise JSC Liepājas metalurgs as well as by a high base determined by the agricultural harvest of 2012. As the export of goods grew more rapidly than import, last year a foreign trade deficit decreased to the lowest level since 2010 – to 9.0% of GDP. Despite a negative trend in the sector of transport services provided to non-residents, strong growth in tourism and other commercial services provided increase in the positive balance of services to 7.1% of GDP.

Changes in an income account are mainly related to changes in the profit gained in Latvia by non-resident enterprises. In 2009 and 2010, a positive surplus of an income account was determined by losses of foreign enterprises, but by returning to economic growth, income of foreign enterprises increased and since 2011 a balance of an income account is negative. Although in 2013, a balance of an income account remained negative, it was slightly smaller than in previous years amounting to 1.4% of GDP and positively affecting a position of the overall current account.

Dynamics of Latvian import depends on domestic demand formed from private and government expenditure, investments and export that has a direct influence on changes in the import of intermediate consumption goods. Due to increasing uncertainty in the external environment, in 2013 entrepreneurs took a wait-and-see position in implementing investment projects, what along with a completion of several big state investment projects determined negative dynamics in the amount of investments. In turn, weaker external demand and closure of the largest metallurgical enterprise JSC Liepājas metalurgs determined a lesser need for the import of intermediate consumption goods. In 2014, when a situation in the external environment has become stable and external demand has grown, increase in the amount of investments will become more rapid. Taking into account that the capacity utilization is near to a historical maximum, increasing demand will require a need for larger production capacities in order to raise productivity. At the same time, situation in the labour market continues to improve, which along with price stability will determine increase in real purchasing power and consumption. Taking into account the proportion of imported goods in the structure of consumption, increase in consumption will provide a upward effect in import growth. On the basis of the aforementioned assumptions, it is forecasted that in 2014 the import of goods and services will increase in actual prices by 6.6%, but in 2015 – by 7.2%.

In 2014, export growth will depend on external demand and will be connected with the development of competitiveness of Latvian manufacturers. Export growth will not be influenced by the agricultural harvest of 2012 and decline in volumes in the metal sector anymore, which along with increase in external demand will determine a more rapid rate of export growth. The forecasts published by the EC indicate that economic development in the EU countries has become more stable and in the majority of European countries the macroeconomic growth forecasts are increased. At the same time it should be mentioned that until now export growth was also boosted by positive economic development of Latvian trading partner countries as their growth rate was higher than on average in the EU and they were less affected by the euro area crisis. However, the growth rate of Latvian trading partner countries gradually decreases and in the latest EC forecasts, the economic growth forecasts of Latvian major trading partner countries, except for Poland, are slightly decreased. Although it is forecasted that their growth rate will be higher than in the EU on average, a difference between the average growth of Latvian trading partner countries and the EU has decreased. Therefore, in order to provide export growth and increase a market share, even bigger importance will be attributed both to the development of non-price competitiveness factors (quality, complexity of export, etc.) and to increase of productivity, necessary for keeping the competitiveness of costs. This, in turn, will determine a need for new investments.

As a substantial risk is an escalation of a geopolitical situation in the Ukraine – Russia, which may substantially affect Latvian export growth. Although Latvian export to the Ukraine constitutes only 0.9% of the total export of goods, bigger risks are caused by an uncertainty as regards imposing sanctions on Russia that is one of the three Latvia's largest export markets.

In 2014, export growth of goods and services in actual prices is forecasted in an amount of 6.1%, but in 2015 amounting to 6.7%.

Inflation

In 2011 and 2012, dynamics of consumer prices was mainly determined by an external pressure of prices, the prices of both electricity and unprocessed food increased substantially. Prices were influenced by changes in tax policy. However, fundamental factors have not created rise in prices and a core inflation was consistently low during the entire period.

On average, consumer prices remained unchanged in 2013. In the groups of prices there were tangible fluctuations, however, increase compensated decline and on average showed a neutral result. For foodstuffs there was an average increase of 1.3%. Looking even more explicitly, prices on unprocessed food increased by 3.4%. In other words, increase in the food prices was mainly influenced by regional fluctuations of prices, not by internal market processes. A fairly similar situation is observable also for non-foodstuffs, only in the opposite direction. Average prices of non-foodstuffs decreased by 1.3%, from which decrease in prices of energy goods constitutes 2.4%. Prices of energy goods are mainly determined by global processes.

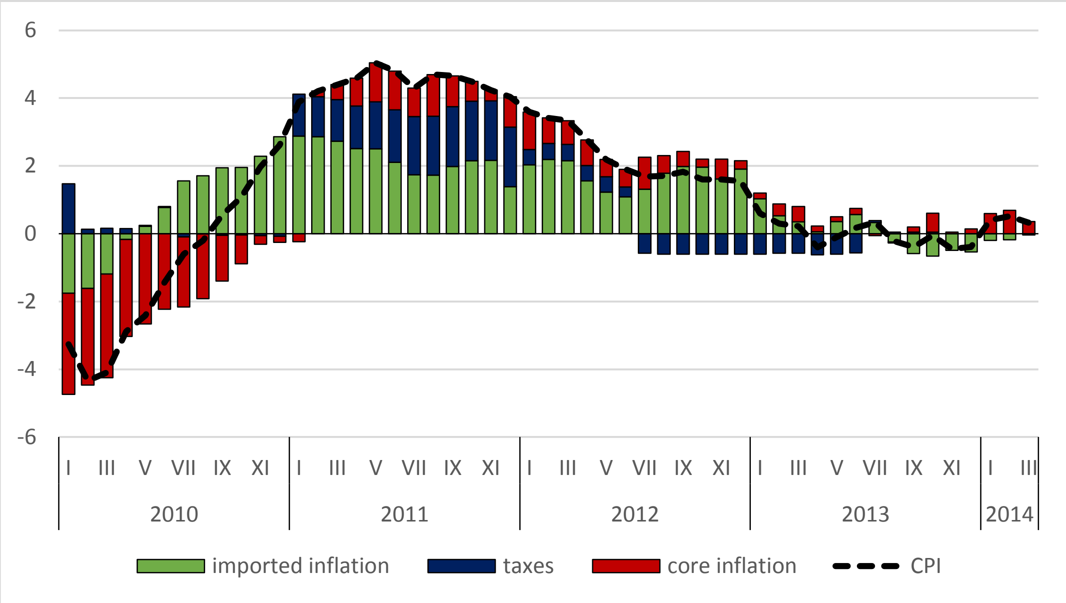

Figure 2.2. Annual Inflation According to a Source of Origin, %

Fundamental domestic factors that determine dynamics of prices still are comparatively weak. Core inflation has not recovered as the pressure of domestic market on prices greatly depends on labour costs. While unemployment is comparatively high, a pressure on growth of wages is not strong enough in order to substantially influence the costs of enterprises relatively against the profit earned by entrepreneurs. Therefore, also in 2014, an annual average inflation mainly will be determined by the factors of the external environment, which, taking into account the overall dynamics of prices in the EU, will not cause an additional pressure on prices this year. It is expected that further decline of an unemployment rate and growing wages, mainly through prices of services, will start to influence a core inflation. It is forecasted that in a medium term an inflation will be around 2.5%, what, taking into account the ongoing convergence process, is an index that corresponds to the economic development of Latvia.

Furthermore, the introduction of the euro took place very successfully and rise in prices, according to the data for the first two months, is 0.1 percentage points lower compared to the forecasts. Anticipated impact of the introduction of the euro is approximately 0.3 percentage points. An extent to which this assumption will prove true, can be evaluated more precisely closer towards the middle of the year.

Labour market

As Latvian economy has overcome the crisis and returned to the period of strong growth, the situation in the labour market has improved even more tangibly. The number of people employed in the national economy has increased for three consecutive years and in 2013 it has increased by 2.1%, reaching 893.9 thousand.

During last years, new workplaces were mainly created in the private sector where the number of occupied workplaces in 2013 was by 4.4% bigger than in the previous year, while in the public sector the number of occupied workplaces during the year has increased only by 0.5%, inter alia in state institutions it has decreased by 0.9%. Diverse dynamics of employment growth by sectors results from changes experienced during the crisis when entrepreneurs of the private sector preferred a reduction in the number of workplaces rather than a reduction of wages, while in the public sector wages were reduced more. At present, there is a return to the employment structure of previous years with a larger share of the private sector, which is also stimulated by a lower level of remuneration in the general government sector.

By kind of economic activity, in 2013 the number of employed population has increased most rapidly in the sector of art, entertainment and recreation and in construction where the number of occupied workplaces was respectively by 10.9% and 8.9% higher than in the previous year. In turn, the sector of financial services is the only sector where the number of occupied workplaces has decreased by 2.0%. Last year, the largest creators of new workplaces were construction, manufacturing and transportation sector where the average number of occupied workplaces, compared to 2012, has increased respectively by 4.9 thousand, 2.7 thousand and 2.5 thousand.

As employment increased, in 2013 the jobseeker rate has decreased to 11.9% of economically active population that is by 3.1 percentage points less than in 2012. Decrease in the jobseeker rate was slightly more rapid than in the previous year. In addition, one should positively evaluate the fact that the number of economically active population has increased, that on one hand, hindered the decline of unemployment; but on the other hand, shows an improvement in an overall situation in the labour market, when due to growing prospects to find a job and higher salary people who previously had given up the attempt to find a job started a job search again.

In the coming years, the expected economic growth will continue to positively influence the situation in the labour market – the number of employees will continue to increase and the job seeker rate will decrease. However, these changes will be slowed down because decrease in the number of working-age population start to influence the situation more tangibly as well as the fact that possibilities of economic growth driven by the increase of employment growth will decrease further. In the coming years, decrease in unemployment will also be affected by the changes in the age structure of working-age population when by decrease of the share of economically less active youth (aged 15-24) the overall level of economic activity will increase.

It is forecasted that in 2014 the number of population employed in the national economy will increase by 1.2% while in the three subsequent years it will increase by 0.5% on average. Thus, GDP growth, like in the previous years, will be more determined by increase in productivity rather than by increase in the number of employees.

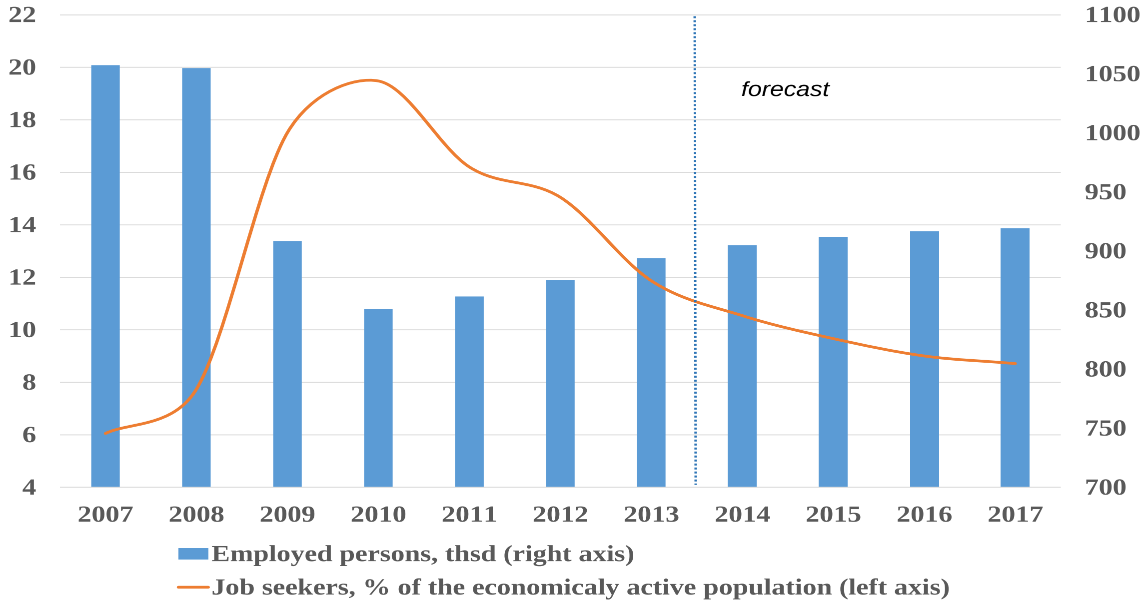

Figure 2.3. Employment and Unemployment in 2007–2017

As employment gradually increases, unemployment rate in the medium term will decrease, which will be additionally affected by the decline of working-age population. In 2014, decrease in the rate of job seekers to 10.5% of economically active population is expected, but already from 2015, the unemployment rate will fall below 10%. In subsequent years, along with slower employment growth, unemployment decrease will slow down, that will be also affected by expected increase in the economic activity of population when there are improvements in opportunities for finding a job and improvements in a remuneration level as well as when the age structure of working-age population changes, by decrease in the proportion of an age group of traditionally economically passive youth therein.

Since 2010, when due to the economic crisis, enterprises were forced to reduce substantially the number of employees as well as to rationalise work processes and to introduce new technologies, productivity growth in the national economy has resumed which will continue up to 2017. After overcoming the economic crisis, productivity in the national economy has grown faster than the real wages of employees, facilitating increase in Latvia's competiveness in the external markets, and it is expected that in subsequent years, increase of wages will not exceed productivity growth.

Cyclical development of economy

According to calculations by the MoF, the output gap closed in 2013 and in subsequent years there will be a moderately positive output gap, reflecting an inertia effect caused by a comparatively fast return of the economy to its potential level. Although in general the inclusion of unemployed in the labour market went successfully, a situation is different when compared by sectors. It is possible that some imbalances might emerge in labour market in a form of skill mismatch and geographic mismatch as well as due to demographic effects. For solving these problems, the state is implementing comparatively wide labour inclusion activities oriented on increase of employees' competitiveness in current occupations, activities on the requalification and training of employees as well as on the promotion of a commercial activity and self-employment.

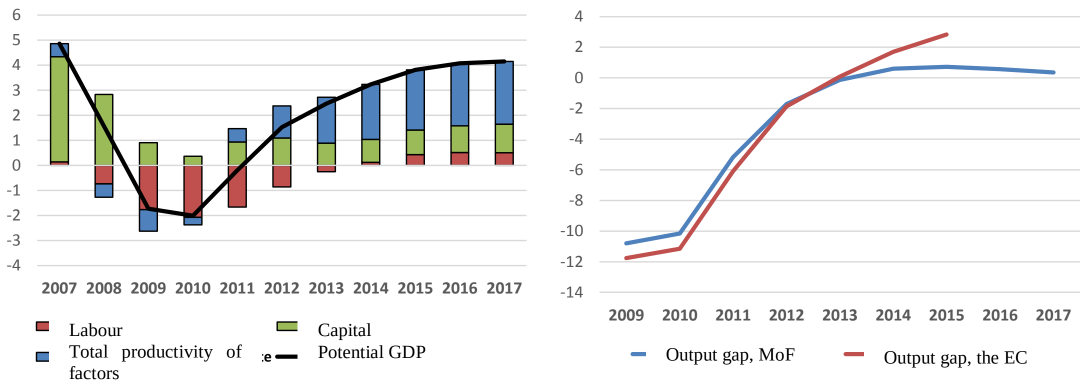

Figure 2.4. Potential GDP and the Output Gap

Analysing the macroeconomic forecasts published by the EC, it may be concluded that growth in a medium term will fluctuate around 4%, what is a slight deceleration if compared to 2011 and 2012 when it was exceeding 5%. After very steep fall in 2009, a low GDP base allowed to show strong growth, but in a medium term, forecasts of economic development will return to a normal growth rate of around 4% (for 1994–2009, average growth of real GDP is 4.1%), which also corresponds to the MoF' estimate of the growth of potential GDP growth.

Although calculations by the EC show that in a medium term, there will be substantial positive output gap in Latvia (in 2015 amounting to 2.8%), neither actual data nor forecasts can support this claim. In a medium term, neither inflation indices nor wages have a pronounced acceleration trend, increase in the index of real labour costs is close to zero, a deficit of a current account basically is formed only from the resources of the EU funds thus can be considered balanced, the ratio of an external debt to GDP keeps decreasing. In addition, the winter forecasts by the EC and the spring macroeconomic forecasts by the MoF and conclusions resulting from them on a development scenario are very similar. One cannot conclude that currently Latvian economy starts to overheat as it is provided by the EC forecasts on the output gap. It should be noted that in compliance with the Early Warning Mechanism no excessive macroeconomic imbalances threatening stability of the economy were identified.

Taking into account the aforementioned factors, we are of opinion that the EC calculations on the output gap do not reflect the actual economic situation in Latvia. Therefore, by working out of the Stability programme, the MoF will continue to use a national methodology for the calculation of the output gap.

3. General Government Budget Balance and Debt

3.1. Current Fiscal Situation

The actual results for 2013 of the general government's national accounts show that in the last year the general government budget deficit did not exceed a threshold of 1.0% of GDP or 223.8 million euros, what by 0.1 percentage points exceeds a result planned in the previous Convergence Programme. In general, evaluating the development of public finances, in the last year there was one of the lowest deficits observable since 2007.

In 2013, there was a nominal increase in revenue and expenditure when during the year the government budget revenue increased by 5.8%, but expenditure – by 4.7%. At the same time, last year's revenue against economic growth remained at the level of 2012, reaching 35.1% of GDP, but redistributed resources in the general government budget expenditure decreased by 0.3 percentage points and amounted to 36.1% of GDP.

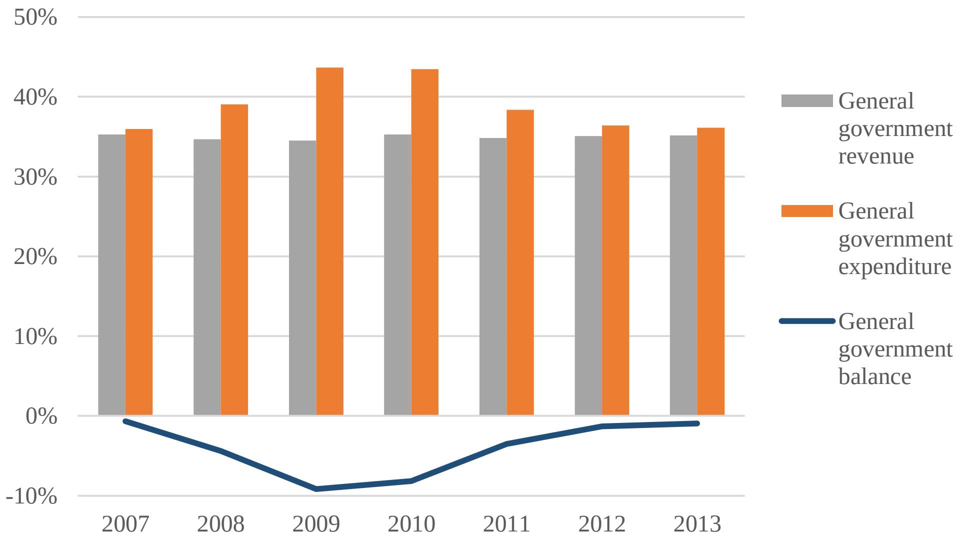

Figure 3.1. Revenues, Expenditures and Balance[3] of the General Government, % of GDP

In 2013, increase in tax revenue (according to the ESA methodology) comparing to 2012 was 5.7%. The most significant contribution in the increase of budget revenue was provided by production and import (+6.1%) taxes, what was facilitated by stable private consumption, as well as by current taxes on income and property (+5.2%), what are basically formed from the revenue of personal income tax. Increase in the revenues of personal income tax in 2013 compared to 2012 basically was determined by increase in wages and in the number of employees in spite of a reduction of the rate and increase of dependant-care benefits.

As the expenditure of the general government's final consumption increased (mainly for remuneration of employees and for intermediate consumption), the total level of expenditure increased by 4.7% during the year. Starting interest payments after two successful issues of debt securities in the USA financial markets in 2012, the general government's interest expenditure increased from 295.1 million euros in 2012 to 388.2 million euros in 2013.

[3] Source of data: **Notification on the G**eneral **Government Budget Deficit and Debt in April 2014**.

Similarly, in 2013 a risk identified already at the beginning of the year materialised in relation to the previously largest metallurgy enterprise in the State, as a result, there were made a capital transfer in the amount of 73.6 million euros in order to fulfil call on debt guarantee on behalf of insolvent Liepājas Metalurgs PLC.

Analysing a contribution of the general government sub-sectors[4] in the total balance, it is concluded that a deficit of a local government in 2013 considerably increased in comparison with 2012. This was mainly determined by increase in gross fixed capital formation, taking into account that local governments implemented more intensively the projects of the EU funds as well as borrowed more actively for implementation of different investment projects, for example for renovation of educational institutions.

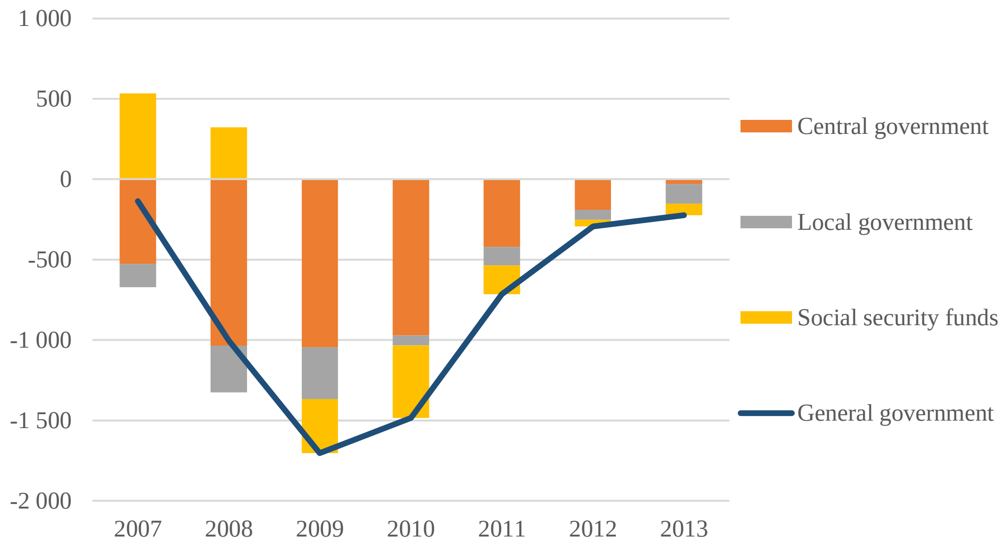

Figure 3.2. Budgetary Balance of the General Government by Sub-Sectors[5], Million Euros

3.2. Fiscal Policy Strategy and Medium-Term Objectives

Latvian fiscal policy continues to rely on the following principles:

1) the principle of economy — available resources should be used reasonably and efficiently;

2) the principle of savings — if an economic situation allows, the budget is being planned and executed with surplus, what in its turn allows to cover future economic liabilities in case if an economic situation becomes worse or in case of non-execution of the budget;

3) the principle of countercyclical fiscal policy — fiscal policy that works contrary to the trends of the economic cycle, namely, in the upward phase of the economic cycle there

[4] Division of the general government sector by sub-sectors is defined in accordance with the European System of National and Regional of Accounts in the EU. Within the meaning of the national budget methodology, the central government is the state basic budget, budgets of derived public persons which are partially financed from the State budget and the budgets of institutions not financed from the budget (including state-funded enterprises), social security funds – state social security special budget, and a local government – budgets of local governments (including enterprises funded by local governments).

[5] Source of data: **Notification on the G**eneral **Government Budget Deficit and Debt in April 2014**.

is restricting fiscal policy implemented, but in an downward phase – stimulating fiscal policy;

4) the principle of stability — financial policy is predictable and successive and, thus, it facilitates an economic development and financial stability;
5) the principle of sustainable fiscal policy — the purpose of fiscal policy is to provide that the amount of the general government debt does not impose a disproportionate burden on economy, but facilitates its development in a long term;
6) the principle of generation mutual responsibility — in fiscal policy, its financial impact on a society is considered both at present and in future generations;
7) the principle of transparency — publicly available information is provided on the objectives of fiscal policy, the methods and results of their achievement;
8) the principle of fiscal discipline solidarity — institutions included in the general government sector solidarily comply with the fiscal conditions that are prescribed by the FDL and attributable to the general government sector.

On the basis of the strategy of Latvian fiscal policy is a condition of a balanced budget during the economic cycle or a condition that a structural deficit in a long term (MTO) shall not exceed 0.5% of GDP.

The FDL adopted in 2013 creates a system for setting objectives of the general government balance in compliance with the *top-down planning method of a budgetary balance*.

This method allows to set the objectives of structural balance for each year so that these objectives comply with the conditions of the Stability and Growth Pact as well as to calculate nominal balances accordingly (the maximum permissible general government deficit or the minimum permissible general government budget surplus).

At the same time, there is the *bottom-up planning method of a budgetary balance* applied according to which the general government budgetary balance is forecasted in case of an immutable policy. The general government budgetary balance is also forecasted in compliance with this method.

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

Taking into account that Latvia has successfully overcome the crisis and already for several years is one of the most rapidly growing EU Member States as well as the fact that the government debt is less than 60% and that Latvia already in 2012 has reached its MTO, the previous Convergence Programme for 2013-2016 showed positive fiscal space.

In Latvia, the key decisions of budget policy, affecting the medium-term policy on expenditure and revenue, are not taken in spring, but in autumn along with the Annual State Budget Law. During this time, not only the Annual State Budget Law is being worked out, but also the Framework Law is being drafted for 3 subsequent years. Thus, during an interval between the moment of elaboration of the previous Convergence Programme and the moment of drafting this particular Stability programme, the substantial decisions of fiscal policy are being adopted which have filled all the fiscal space of 2014 and 2015 and provide a basis for implementing the strategy of this particular Stability programme. More detailed information is provided in the section “The Objectives and Key Measures of Fiscal Policy”.

In this Stability programme, fiscal space for 2016 is planned in amount of 0.7 % of GDP and 1.5% of GDP for 2017. Accordingly, decisions on the allocation of this fiscal space will be taken in autumn 2014 and, therefore, they are not presented in this particular Stability programme.

Objectives of Structural Balance for 2015, 2016 and 2017

When setting the objectives of structural balance, a two-stage method is being applied. At first, the MTO amounting to -0.5% of GDP is taken as a point of reference and the deviations are being applied which result from increase in contributions to the second pension pillar.

Latvia keeps unchanged the model of deviations adopted in the previous Convergence Programme:

Increase in contributions to the second pension pillar is being made in 3 stages: in 2013 increasing contributions from 2 to 4% (fiscal impact 0.50% of GDP), in 2015 increasing contributions from 4 to 5% (fiscal impact 0.27% no GDP) and in 2016 increasing contributions from 5 to 6% (fiscal impact 0.29% of GDP).

According to the conditions of Regulation No 1175/2011, a Member State may deviate from the MTO by the amount corresponding to the fiscal impact of a reform, and this deviation shall be ‘extinguished’ in 3 subsequent years.

In compliance with this condition, the objective of a structural deficit in 2014 and 2015 is determined in an amount of 1.0% of GDP and in 2016 amounting to 0.9% of GDP. Latvia will completely extinguish deviations and will return to the MTO in 2019. A scenario for the creation and decrease of deviations is presented in Table 3.1.

Table 3.1. Amount of the Deviations of Structural Balance From the MTO as Regards Increase in Contributions to the 2nd Pension Pillar and a Scenario for Decrease of These Deviations

		2013	2014	2015	2016	2017	2018	2019
MTO		-0.500%	-0.500%	-0.500%	-0.500%	-0.500%	-0.500%	-0.500%
Permissible deviation	from 2% to 4%	-0.500%	-0.500%	-0.250%	0.000%			
	from 4% to 5%			-0.274%	-0.137%	-0.069%	0.000%	
	from 5% to 6%				-0.286%	-0.191%	-0.095%	0.000%
Objective of structural balance		**-1.0%**	**-1.0%**	**-1.0%**	**-0.9%**	**-0.8%**	**-0.6%**	**-0.5%**

In 2013, it is planned to increase contributions to the 2nd pension pillar from 2% to 4%. A fiscal impact or decrease of revenue in the social insurance budget this year according to the ESA is 0.5% of GDP, thus, in compliance with Regulation 1175/2011, a possible level of a deviation in 2013 is 0.5% and the objective of structural balance is -1.0% of GDP. According to Regulation 1175/2011, a deviation in an amount of 0.5% shall be eliminated within 3 years. Accordingly, a fiscal development scenario prescribes that in 2014 a deviation will remain 0.5% of GDP, in 2015 amounting to 0.25% and in 2016 a deviation will be 0.

In 2015, it is planned to increase contributions to the 2nd pension pillar form 4% to 5%. A fiscal impact or decrease of revenue in the social insurance budget this year according to the ESA methodology is 0.274% of GDP, thus, in compliance with Regulation 1175/2011, a possible level of a deviation in 2015 is 0.274%. According to Regulation 1175/2011, this deviation shall be eliminated within 3 years. Accordingly, a fiscal development scenario prescribes that in 2016 a deviation will be 0.137% of GDP, in 2017 amounting to 0.069% and in 2018 a deviation will be 0.

In 2016, it is planned to increase contributions to the 2nd pension pillar form 5% to 6%. A fiscal impact or decrease of revenue in the social insurance budget this year according to the ESA methodology is 0.286% of GDP, thus, in compliance with Regulation 1175/2011, a possible level of a deviation in 2016 is 0.286%. According to Regulation 1175/2011, this deviation shall be eliminated within 3 years. Accordingly, a fiscal development scenario prescribes that in 2017 a deviation will be 0.191% of GDP, in 2018 amounting to 0.095% and in 2019 a deviation will be 0.

Summing up the three aforementioned permitted deviations, the objectives of structural balance are obtained that in 2013–2015 are accordingly -1.0 of GDP and they decrease further, until in 2019 they return to the MTO amounting to -0.5% of GDP.

It should be noted that in any year the objective of structural balance does not exceed the minimum MTO, established according to the Stability and Growth Pact, which in Latvia's case amounts to -1% of GDP, and a sufficient safety margin is being observed against a deficit reference value that in Latvia's case is -1.8% of GDP in structural terms[6].

Afterwards, the objectives of structural balance are being corrected, if necessary, in order to provide the conditions mentioned below.

FDL prescribes that observance of the MTO is not an only fiscal condition. Expenditure growth rule shall also be observed, what is prescribed by Regulation No 1175/2011. In a general case, this condition may set more ambitious objectives of structural balance. The FDL also provides that the central government expenditure are being determined in the Framework Law for 3 subsequent years and this is legally binding. Therewith a situation may occur that retention of the central government expenditure at the level prescribed by the previous Framework Law can change the objective of structural balance. However, changes are restricted by a provision of the FDL that if deviations of expenditure exceed 0.1% of GDP, expenditure are not being preserved, but are being recalculated in compliance with the objective of structural balance and according to updated macroeconomic forecasts.

Having examined the condition of expenditure increase and the condition of expenditure inheritance, it was established that corrections are not necessary.

Thus, fiscal objectives for three subsequent years are set, i.e. to provide in 2015 the structural deficit of the general government budget in an amount of 1.0% of GDP, in 2016 amounting to 0.9% of GDP and in 2017 in an amount of 0.8% of GDP.

A Medium-Term Objective

The structural balance forecasts of the previous Convergence Programme and the EC economic forecasts of autumn 2013 and winter 2014 as regards the general government structural balance were considerably different:

Table 3.2. A Comparison of Latvia's and the EC Forecasts on the General Government Budgetary Balance

	2013	2014	2015	2016
Previous Convergence Programme	-1.1	-1.0	-1.0	-0.9
Framework Law for 2014-2016		-1.0	-1.0	-0.9
EC forecasts of autumn 2013	-1.5	-1.5	-1.7	
EC forecasts of winter 2014	-1.3	-1.5	-1.8	

At the same time, Latvia and the EC have similar forecasts on the general government nominal balance. A reason for differences in forecasts on a structural deficit occurs from diverse

[6] The Stability and Growth Pact determines the maximum possible structural deficit in order to ensure that there is no risk that a nominal deficit could exceed the Maastricht criteria' limit of 3% or the so-called safety margin in relation to a deficit reference value. This safety margin is specific to each Member State and for Latvia it constitutes 1.8% of GDP. According to Regulation 1175/2011, any deviation shall not exceed this safety margin, consequently, for Latvia any cumulative deviation from the MTO shall not allow a structural deficit exceeding 1.8% of GDP.

forecasts on the cyclical component of a balance, what is connected to a diverse evaluation of an output gap. According to Latvia's estimation, there is a small output gap and it remains at a constant level, however, according to the EC estimation, conducted in compliance with a standardised methodology, an output gap is positive and it opens rapidly. Latvia does not see economic justification for such evaluation as does not see indications of economic overheating. That is testified, for example, by a low level of inflation. More detailed information is provided in the section II "Cyclical development".

At the same time, it is clear that the EC will evaluate structural balance according to the common evaluation methodology for output gaps and will make conclusions on the compliance of Latvian fiscal policy with the conditions of the Stability and Growth Pact in accordance with own evaluation of structural balance. Thus, there is a high risk that when recalculating structural balance according to the EC methodology, deviations from the medium-term objective, which is -0.5% of GDP, will considerably exceed the level permitted in the conditions of the Stability and Growth Pact, what may cause penalties to Latvia as the euro area member state. At the same time, the MTO amounting to -0.5% of GDP is more ambitious than it is allowed to Latvia by the Stability and Growth Pact. Thus, a situation may occur that penalties may be imposed on Latvia due to non-observance of its own MTO, despite the fact that this objective is more ambitious than it is required by the Stability and Growth Pact.

In order to eliminate the aforementioned risk, there are two different MTOs introduced in Latvian fiscal policy: the first is national MTO that remains -0.5% of GDP, but the second is the MTO in the meaning of the Stability and Growth Pact MTO^{SGP} , which is determined at a level of -1.0% of GDP.

The Objectives and Key Measures of Fiscal Policy

The year 2013 and subsequent years are marked in the economy of Latvia as a post-crisis period in which it is necessary to restore the level of funding reduced during the consolidation period for a full-fledged implementation of state functions.

From the fiscal policy principles, included in the FDL, it follows that **a general medium-term fiscal policy objective – to raise sustainably the quality of life of population** what includes welfare of inhabitants, availability of medical services, nature environment, developed infrastructure and culture as well as elimination of excessive inequality in population's income. It is essential to provide that in the state there will be conditions for improving the quality of life not only now, but also in the future. Therefore, in the objective of fiscal policy there is sustainability emphasised. A sustainable raising of a quality of life means that public financial resources are being shifted not only to current measures for improving a quality of life, but also are being planned and allocated in a manner, providing conditions for the state to be able to raise a quality of life also in subsequent 10 and 50 years. This may be achieved, first, by refusing to cover current expenditure at the cost of next generations or refusing to increase public expenditure on the cost of a deficit; second, by shifting public resources to form a favourable environment for an economic development, for example investing resources in science.

Specific objectives of Latvian fiscal policy for medium term result from the aforementioned information:

1. to provide responsible and sustainable fiscal policy, observing a fiscal discipline;
2. to raise the quality of life of population and to facilitate the economic development of the state.

<u>The first course of actions</u> for achieving this objective is a correction of tax policy, revising the burden of labour taxes with a purpose to reduce income inequality of population and to raise a quality of life, especially in families with children. The most substantial measures in this field, which are worked out in the Framework Law for 2014, 2015 and 2016', is increase

in the non-taxable minimum of personal income tax, increase in personal income tax allowance for dependant persons, decrease in the rate of the state mandatory insurance contributions of an employer and an employee as well as reduction of the rate of personal income tax in a medium term.

Table 3.3. The Most Substantial Revenue Measures That Increase Fiscal Space

Measure that increases revenue	2014	2015	2016
Introduction of a tax on subsidised electrical energy	32.8	36.9	39.7
Increase in a minimum monthly wage	36.7	35.7	35.7
Raising the efficiency of tax control and administration	40.1	47.4	46.5
Expanding a natural resources tax base	3.3	2.7	2.1
VAT (for a security)	6.7	6.7	6.7
Motor road using tax for the use of state main motor roads	4.3	11.4	15.7
Increasing the rate of excise tax on auto gas	4.0	4.3	4.4
Increasing the rate of excise tax on tobacco products and restructuring the rate for cigarettes	0.7	2.9	3.9

The second course of actions is a rational shifting of the amount of available public resources to the priority courses of development of the medium-term budget which in the law Framework Law for 2014, 2015 and 2016 were defined according to:

- Latvian National Development Plan, in which there are three priorities determined– economic growth, human securitability and regional development;
- State defence concept;
- Other policy initiatives to solve the questions of remuneration for the employed in the public sector, provision of funding for the development of science, a development of a cultural environment.

Table 3.4. Fields for Which Funding Was Considerably Increased (over LVL 10 Million) and the Most Substantial Measures That Increase Expenditure

Field	2014	2015	2016
Transport	**44.7**	**47.3**	**65.8**
including Motor Roads Reconstruction Programme for 2014-2020	*30.8*	*47.0*	*65.5*
Health	**42.0**	**48.9**	**51.0**
including for increase in the remuneration of medical staff	*22.0*	*22.0*	*22.0*
Economic development	**34.9**	**49.8**	**58.2**
including an establishment of the Support Fund for the Generation of Electricity (EAF) to provide the total price of competitive electricity	*29.3*	*47.7*	*56.1*
Welfare	**26.3**	**57.9**	**56.1**
including implementation of demography measures	*9.0*	*32.1*	*29.1*
including for state social benefits to disabled persons	*6.7*	*14.0*	*14.7*
Culture	**19.4**	**21.8**	**24.6**
Education and science	**17.1**	**28.4**	**35.0**
including for increase in the funding of science base	*4.4*	*12.2*	*16.4*
Defence	**16.0**	**36.2**	**41.0**
Internal affairs	**13.9**	**17.9**	**32.4**
Finances	**9.2**	**29.6**	**18.7**
including for the improvement of tax collection	*3.6*	*20.0*	*10.0*

Implementing the second course of actions in order to provide a quality of life to the population and to facilitate an economic development of the state, it is substantial to note that this should be viewed together with the decisions on tax policy as traditionally Latvia is a state with a relatively low tax burden, and the proportion of tax revenue against GDP is one of the lowest in the EU. Forecasts of currently effective tax policy indicate that in subsequent years the proportion of tax revenue against GDP will continue to decrease.

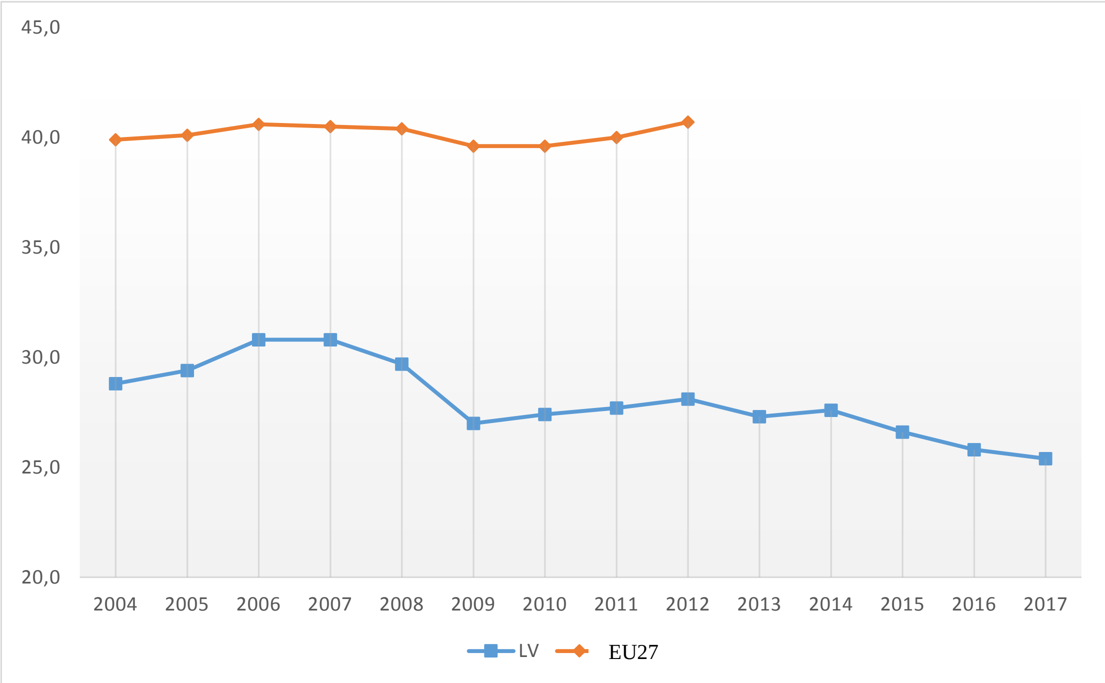

Figure 3.3. Tax burden % of GDP[7]

Therefore, adopting a decision on decrease in labour tax, Latvia has chosen an economic development as a key priority in 2014-2016. In such situation, publicly available resources against GDP are considerably lower than in other EU countries, making it difficult to fulfil a task – to find financial resources for the development of services provided by the state - in compliance with standards adopted in the EU.

Fiscally Significant Structural Reforms in the Meaning of Regulation No 1175/2011

The most fiscally capacious structural reforms are connected with a development of the pension system. In 2012, there were amendments to the law 'On State Pensions' made, prescribing:

- gradual increase in a retirement age to 65: as from 1 January 2014 it will increase by 3 months annually, reaching a retirement age of 65 from 1 January 2025.
- Simultaneously with increase in a retirement age, an early retirement age also will be increased from 1 January 2014.
- Increase in minimum period of insurance for an entitlement to the state retirement pension to 15 years beginning from 1 January 2014 and to 20 as from 1 January 2025.

In 2012, there were also amendments to the 'Law On State Funded Pensions' made, prescribing gradual increase in a contribution rate for II pillar of the pension system, i.e. in 2013-2014 amounting to 4%, in 2015 in amount of 5% and in 2016 amounting to 6%.

[7] A tax burden (D.2+D.5+D.61+D.91-D.995, including a part of taxes collected in the EU budget). Source of data – Eurostat until 2012 and Latvian stability programme for 2014-2017.

On 3 April 2014, the Saeima has adopted the law 'Amendments to the Law "On the State Pensions"', according to which changes in a procedure for pension indexation have come into force, prescribing:

- to index on 1 October 2014 the amount of the state pension or its part that does not exceed 285 euros, taking into account an actual consumer price index and 25% of the real increment rates of insurance contributions wage.
- to index hereinafter once a year on 1 October the amount of the state pension or its part that does not exceed 50% of the average insurance contribution wage in the state for the previous calendar year (rounded-off to whole euros), taking into account an actual consumer price index and 25% of the real increment rates of insurance contributions wage.

Further Measures

Fiscal forecasts show that the amount of the central government expenditure according to the approved base expenditure is lower than the maximum possible amount of the central government expenditure that has been calculated in compliance with the *bottom-up expenditure planning* approach. According to current calculations, this difference or the so-called fiscal space in 2015 is **0**, in 2016 amounts to **0.7% of GDP** and in 2017 constitutes **1.5% of GDP**.

In compliance with the provisions of the FDL, this fiscal space can be used when planning new expenditure policy measures that should be included in any of further Framework Laws. One may expect that a preparation of 2015 annual budget will be a substantial challenge, taking into account that according to current forecasts there is no fiscal space for NPI. Especially, one should take into account negative macroeconomic risks and the fact that geopolitical considerations force to increase rapidly expenditure on defence in order to move toward the objective of 2% of GDP.

3.3. Fiscal Development Scenario

The Fiscal Development Scenario for a medium term is developed, taking as a basis the objectives of the structural general government's budgetary balance and observing the forecasts of a cyclical component of a budgetary balance in compliance with a macroeconomic scenario. According to the calculations made, considering actual data, output gap has practically closed in 2013; as a result, a cyclical component of a budgetary balance was zero in 2013. Compared to the years of rapid economic growth and recession when there was a considerable cyclical component of a balance, taking into account substantial fluctuation in economy, the medium-term scenario provided for small positive output gap and, thus, a small cyclical component of a budgetary balance (around +0.2% of GDP).

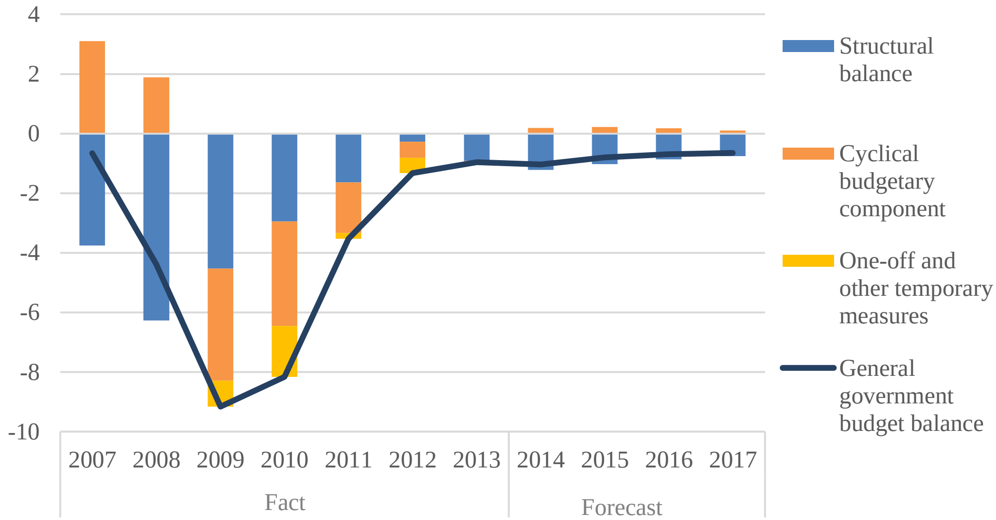

Figure 3.4. Budgetary Balance of the General Government Divided by Components[8], % of GDP

The medium-term scenario does not provide for one-off for the period of 2014-2017.

In order to work out the forecasts of the general government's budgetary balance for a medium term, initially there was a scenario by unchanged government policy prepared, which was based on updated forecasts on revenue according to the latest scenario of a macroeconomic development, previously adopted decisions in a tax policy and approved expenditure, inter alia 'base' expenditure, of the central government budget for three subsequent years. According to the scenario by unchanged government policy, there is a small surplus in the general government budget forecasted for 2016 and 2017, but according to conditions of the FDL, a deficit is permissible in these years. Accordingly, in compliance with current calculations, a difference ('fiscal space') occurs between the forecasted and permitted level of a deficit: in 2016 in an amount of 0.7% of GDP, in 2017 amounting to 1.5% of GDP.

When preparing the forecasts of the general government's budgetary balance for a medium term, it is assumed that the aforementioned difference is being fully used for additional expenses, bus as there are no decisions adopted on a distribution of this difference (decisions will be taken during a preparation of a current medium-tem budget framework), it is included in a position of the central government expenditure 'other expenditure'. Taking into account the aforementioned, in 2015 the budget deficit of the general government is forecasted in an amount of 0.8% of GDP, in 2016 amounting to 0.7% of GDP and in 2017 in an amount of 0.7% of GDP.

[8] 1) One-off and other temporary measures: capital transfers in Parex Banka PLC (in 2009 in an amount of 0.9% of GDP, in 2010 amounting to 1.7% of GDP, in 2011 in an amount of 0.2% of GDP) and a financial adjustment in 2012 for a re-evaluation of assets as regards the inclusion of Reverta PLC in the general government sector in amount of 0.5% of GDP.

2) In the calculation of a cyclical component of a budgetary balance, there was budget semi-elasticity of 0.31 used (Source of data: The cyclically-adjusted budget balance used in the EU fiscal framework: an update, Economic Papers 478, March 2013).

Table 3.5. Medium-Term Fiscal Development Scenario

		2013	2014	2015	2016	2017
	ESA code	% of GDP				
Net lending (EDP B.9) by sub-sectors						
General government	S.13	-1.0	-1.0	-0.8	-0.7	-0.7
Central government	S.1311	-0.1	-1.4	-1.1	-1.2	-1.2
Local government	S.1313	-0.5	-0.3	-0.2	0.1	0.1
Social security funds	S.1314	-0.3	0.7	0.4	0.4	0.5
General government (S.13)						
Total revenue	TR	35.1	33.9	32.0	30.9	30.1
Total expenditure	TE	36.1	34.9	32.8	31.6	30.8
Interest expenditure	EDP D.41	1.7	1.6	1.2	1.2	1.1
Cyclical development						
Cyclical budgetary component		0.0	0.2	0.2	0.2	0.1
Structural balance		-0.9	-1.2	-1.0	-0.9	-0.8
Cyclically adjusted primary balance		0.7	0.4	0.2	0.3	0.3
Forecasts by unchanged policy						
General government budget balance		-1.0	-1.0	-0.8	0.0	0.9
Total revenue		35.1	33.9	32.0	30.9	30.1
Total expenditure		36.1	34.9	32.8	30.9	29.2

The Fiscal Development Scenario anticipates that in GDP the proportion of the general government budget revenue will decrease in a medium term, mainly by reducing a tax burden from 27.3% of GDP in 2013 to 25.5% of GDP in 2017 as well as by a reduction of the obtained payments from the EC at the end of 2007-2013 planning period. Forecast on tax revenue in the general government budget anticipates increase of around 4% for a medium term, except for the year 2016 when growth will be more moderate mainly due to increase in the rate of social insurance contributions for II pillar as well as due to a planned reduction of the rate of personal income tax. In order to achieve a permissible balance, it is forecasted that a proportion of the general government budget expenditure in GDP will also decrease in a medium term.

In 2014, the deficit of **the central government budget** is expected in an amount of 1.4% of GDP as increase in expenditure comparing with the previous year is forecasted to be more rapid than increase in the part of revenue. It should be noted that the central government budget expenditure are forecasted in compliance with an expenditure level planned in the law ‘On the State Budget for 2014’. In a medium term, increase in the central government budget revenue will be provided by collected resources from production and import taxes or consumption taxes as well as by a tax on income and property. However, the forecasted revenues from estate, mainly formed from revenue for a use of the state capital, will shrink until the year 2016 as the currently approved procedure provides for reducing a part of profit payable into a budget (in 2015 amounting to 80% of gained profit and beginning with 2016 - 27%). The central government budget expenditure in 2015-2017 will increase, but viewed according to percentage in GDP they will decrease, thus fulfilling requirements of legal instruments in relation to a provision of the fiscal discipline. In the expenditure forecasts there was the base funding, submitted by line ministries and approved by the government, taken into account for three subsequent years as well as there is possible additional funding (fiscal space) included on the usage of which there will be a decision adopted during a development process of a current medium-term budget framework.

In 2014, in **social security funds** there is a surplus of 0.7% of GDP expected, what is mainly explained by changes introduced this year when resources (transfer) for the payment of supplementary pensions are being received from the central government budget. It is forecasted that in social security funds also in 2015-2017 a surplus will remain, which will be slightly lower. This can be mainly explained by the fact that beginning with 2015, there will be a maximum threshold (‘ceilings’) for social insurance contributions introduced as well as the rate of social insurance contributions to II pillar will be increased, as a result, a larger amount of revenue will be shifted to a funded pension scheme and they will not be treated as budget revenue. In a medium term, there is gradual increase in budget expenditure expected. Forecasts contain an impact of the new pension indexation procedure, adopted by the Saeima in April this year, on budget expenditures. It prescribes a indexation of pensions, taking into account an actual consumer price index and 25% of the real growth rate of wage subject to insurance contributions.

In 2014, in a **local government budget** there is a deficit in an amount of 0.3% of GDP expected where a development of expenditures is forecasted similarly to the trends observable in previous years. It is expected that a high level of expenditures will remain in a local government budget, continuing intensive implementation of projects of the EU funds as well as investing into investments projects. In a medium term, as regards taxes on income, being the largest revenue position of a local government budget, there was a possible labour market development and an approved tax policy taken into account. The latter provides for a reduction of the rate of personal income tax annually by one percentage point in the two next years and it is forecasted that in 2015 and 2016 revenue of this tax will increase more moderately, however, in 2017 they will increase substantially, taking into account a base effect. At the same time, it should be mentioned that according to the updated forecasts, there are no considerable changes in other revenue positions expected. Budget expenditure of a local government are forecasted on the basis of an assumption that non-capital expenditure costs will increase almost in all positions, except for social benefits where by improvement of economic conditions there is a tendency for decrease both in the amount of benefits and in the number of recipients observable. In turn, expenditure on the fixed capital formation for 2015 and 2017 is forecasted with gradual decrease, taking into account that after an intense evaluation period in 2011-2014, at the disposal of local governments there will be a limited amount for investing. Evaluating the development of revenue and expenditure, a financial situation will improve in subsequent years and at present, it is forecasted that one will succeed in balancing local government budgets in 2016-2017. It should be mentioned that additionally to the indicators of cash flow, a positive effect on a local government budget will be provided by a repayment of credit obligations for constructing a significant investment object (the Southern Bridge) as expenditure were approved in the previous years (during a construction of the object).

3.4. Development Trends of Government Debt in the Medium Term

According to the notification data for April 2014 on the State budget deficit and debt, which were prepared according to the ESA’95 methodology, the general government debt at the end of 2013 reached 8 873.3 million euros or 38.1% of GDP. The level of the general government debt is mainly influenced by the central government debt, which at the end of 2013 amounted 8 092.9 million euros.

The objective of the central government debt management is to ensure necessary financial resources for refinancing of the government debt, execution of the State budget and for maintenance of the financial reserves at the lowest possible costs, by limiting financial risks and taking into account the macroeconomic development of Latvia and integration of the Latvian financial market into the common financial market of the euro area.

The objectives, fundamental principles and tasks of the central government debt portfolio and loan management within the framework of the debt management in the medium term are determined by the Latvian Government Debt Management Strategy, providing for observance of the optimal indicators of the central government debt portfolio structure regarding the a repayment profile, composition of the currency of a net debt, a structure of interest rates, the average weighted fixed period of interest rates and the amount of domestic borrowing securities.

In 2012, Latvia already strengthened the positions of a regular borrower in international financial markets making two bond issues in the US market – in February (1 billion USD) and in December (1.25 billion USD). Then on January 2014, Latvia after a pause of six years and shortly after the introduction of the euro successfully issued seven-year bonds amounting to one billion euros with a fixed interest (coupon) rate of 2.625% a year. Unlike the previous borrowings in international financial markets, this transaction was mainly oriented on European investors. Economic growth, accession to the euro area, obtained improvements in Latvia's credit rating, a high evaluation from investors as regards the accomplished work in Latvian economy during previous years and faith in Latvia's long-term development allowed Latvia to borrow financial resources in international markets under very favourable conditions.

In the domestic financial market, regular auctions of government debt securities are being continued, offering to domestic investors in auctions of 2013 T-bills and bonds with different maturities. As from February 2013, the Primary Dealer System is operating to stimulate the development of the government securities market and the activity of the secondary market.

To encourage private persons to invest in the instruments of the domestic financial market, as from June 2013 inhabitants have a possibility to purchase government saving bonds. At the end of March 2014, the amount of savings bonds outstanding reached 3.8 million euros.

In order to comply with Latvian Government Debt Management Strategy, eliminating the refinancing risk of the central government debt and optimising debt management costs in the medium term, the following priorities are set for the implementation of the medium-term borrowing strategy:

1) to continue a gradual and timely borrowing in international financial markets, mainly by organising regular public issues of government debt securities to ensure in compliance with the determined repayment schedules the refinancing of the central government debt obligations, assumed within the framework of the Loan Programme, with favourable conditions in terms of borrowing rates and tenors;
2) to ensure diversification and expansion of the base of government securities investors through regular, constant dialogue and a long-term work with investors and co-operation partners to facilitate active participation of investors from various world regions in the primary placement of government securities in international financial market;
3) to facilitate the development of the domestic financial market and to ensure appropriate investment possibilities for the participants of the domestic financial market, by improving the spectrum of the financial instruments offered in compliance with investors' demand and using a potential of borrowing in the domestic financial market.

In the first quarter of 2014, Latvia has repaid the first part of a loan, which was obtained from the EC within the framework of the Loan Programme, amounting to one billion euros. In the medium term (April 2014 - December 2017), the repayable central government debt obligations are 3.4 billion euros, in which the largest proportion constitute the loans granted by the EC and the World Bank within the framework of the Loan Programme, which shall be repaid in 2015-2017, as well as eurobonds repayable in April 2014 and in 2017 (see Illustration 3.5.). Taking into account the considerable amount of central government debt obligations repayable in the medium-term, timely attraction of appropriate funding shall be timely provided in compliance with the medium-term borrowing strategy to reduce the debt refinancing risk.

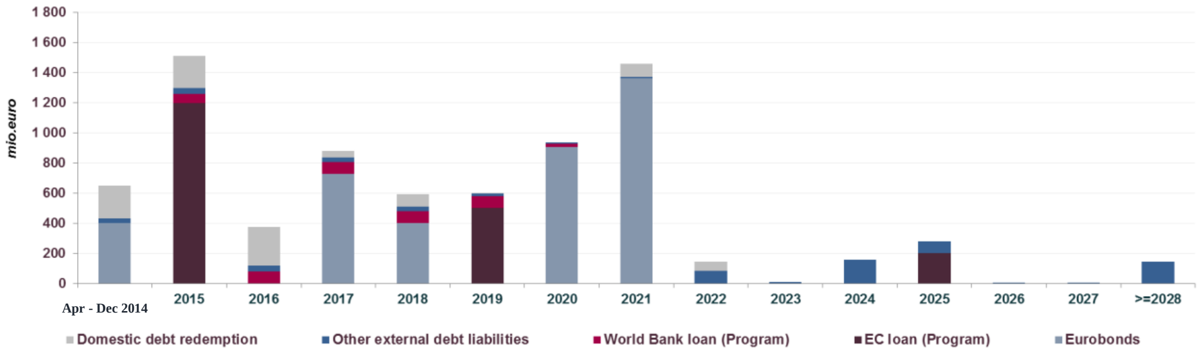

Figure 3.5. Central Government Debt repayment profile
(liabilities outstanding as of 31 March 2014, nominal value)

Taking into account the borrowing strategic objectives, in the coming years exactly the foreign borrowing instruments will form the most substantial part of the total amount of financial resources to be attracted. It is planned to ground borrowings in international financial markets on public transactions in global financial markets – in the USA and Europa, as well as to address investors in other regions.

In the domestic financial market, there is also a further regular offer consistent with a demand planned, providing government domestic borrowing securities and bonds, stimulating the development and activity of the government securities market within the framework of the Primary Dealers System.

By making timely borrowing activities according to the medium-term strategy as well as continuing the implementation of the sustainable fiscal policy, it is possible to refinance the current central government debt obligations with favourable conditions in terms of rates and tenors as well as to achieve in the long term the decrease and stabilisation of the government debt at a sustainable level, with certainty complying with a criterion that is prescribed by the Maastricht Treaty and related to the amount of the general government debt (see Illustration 3.6.).

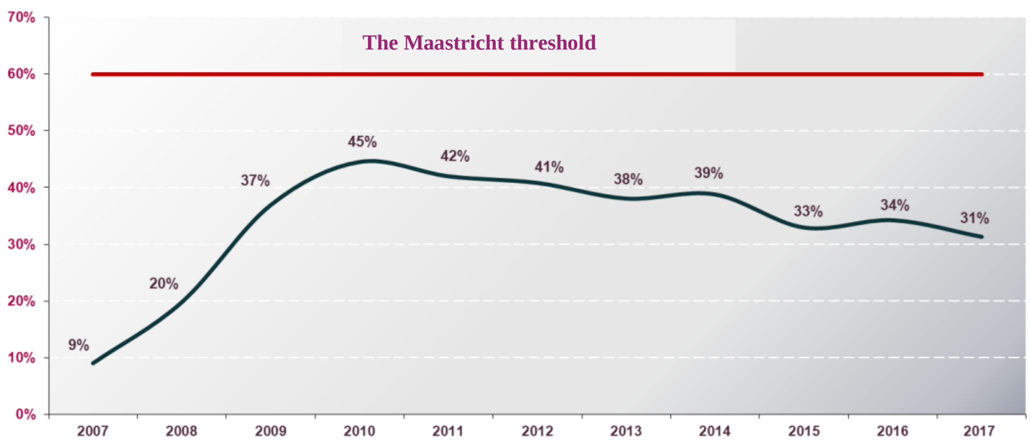

Figure 3.6. General Government Debt development trends (% of GDP)

4. Sensitivity Analysis and Comparison

4.1. Macroeconomic Scenario Risks

According to the scenario of macroeconomic development for 2014–2017, worked out by the MoF, currently Latvia's economic growth is at its potential level, however, in a medium term, growth may be affected by positive and negative risks. In the medium term, the positive and negative risks of macroeconomic development scenario are balanced, however, in a short term, negative risks prevail. This is mainly related to the developments in Ukraine during the last months as well as to possible bilateral or unilateral sanctions between the EU and Russia.

Among the risks, there are still external risks prevailing which may negatively influence Latvia's export volumes. Among the main external risks are the developments in Ukraine, slowing down of economic growth in Russia, threats of prolonged period of low inflation in the EU, decrease of economic growth in China and other developing countries as well as changes in the US monetary policy.

At the same time, it should be emphasised that a geopolitical risk caused by the situation in Ukraine currently is the most substantial risk for Latvia's economic growth. The MoF actively follows the most recent macroeconomic indices and analyses a potential impact of the developments in Ukraine on Latvia's economy. However, it should be noted that at the moment when the Stability Programme was being worked out, the first short-term macroeconomic indices were available only for January and February. A further impact of the developments in Ukraine on Latvia's economy is being carefully analysed and will be presented in the MoF's macroeconomic forecasts which will be updated in June. At that moment, complete GDP data for the first quarter of 2014 will be available as well as some individual short-term macroeconomic indices for the second quarter. It will allow to evaluate the impact of the situation in Ukraine on development of Latvia's economy more precisely.

In addition to external risks, an implementation of the macroeconomic scenario will be also influenced by internal factors – prospects for businesses to attract financial resources and to carry out investment projects in order to increase production capacity, the labour market situation, development of crediting and other factors that directly affect credit rating of the state, interest rates, confidence indicators and domestic demand.

Negative risks:

- **Situation in Ukraine – Russia** and related geopolitical risks are currently considered as the most substantial short-term risk for development of Latvia's economy, inter alia taking into account the large share of Latvia's export to Russia. Direct risks are connected with the depreciation of the Russian rouble's, which diminishes competitiveness of Latvian products in Russian market, as well as a growing uncertainty about the future prospects that impede investments. The highest risks are connected to potential sanctions between Russia and the EU, which could largely affect exactly the Baltic States. In case of the escalation of such sanctions, Latvia's economy may enter a recession.
- Notwithstanding the geopolitical risks, there are **recession threats in Russia** and further decline in the rouble's value that would mean lesser demand for Latvia's export goods and would negatively influence development of Latvia's economy.
- Expansion of external risks may influence economic development also indirectly, **negatively affecting business and consumer confidence level**. As a result, consumers could increase their savings at the expense of lower consumption, but entrepreneurs may

slow down their business activity and postpone investment decisions, thus decreasing a rate of economic growth.

- Lately, the **growth prospects of developing countries, including China, have become more unclear**. Lower growth rates in developing countries would negatively influence global economic growth, what would consequently affect economic situation in the EU and Latvia.
- **Weak investments create a potential risk for Latvia's economic growth.** In the last year, compared to 2012, investments in Latvia decreased by 4.3%, but a geopolitical tension in Ukraine and relationships between the Western governments and Russia may affect investment decisions of entrepreneurs also this year. Currently in Latvia's industry, production capacity utilisation is near to its historically highest level, however, a postponement of investment decisions may restrict not only short-term development prospects, but may also negatively affect the medium-term growth potential of Latvia.
- Improvements of the economic situation in the USA raise **a question about the US monetary policy** and its potential impact on the global economy. On the one hand, a more rapid growth rate of the world largest economy increases demand for other countries' export goods, thus facilitating growth of these countries. However, if the US monetary policy becomes less expansive, it will potentially cause changes to the world capital flows, which may force a number of other countries to implement a restrictive monetary policy, thus slowing down the world's growth rate.
- Despite positive data for the last months, **risks for economic growth remain also in the euro area**. There are still doubts about fiscal sustainability in particular European economies due to a high debt level in these countries and a necessity to continue further reduction of the budget deficit in particular countries. In addition to the fiscal risks, low inflation observed lately, which could change to deflation, is a potential risk in the euro area for medium-term growth and it impedes efforts of countries to balance their budgets as well as to reduce amounts of a debt.
- **Among the domestic risks, a substantial risk in medium term is the decrease in the number of working-age population**. Increase in the unit labour costs, fall in the number of economically active population, imbalances in supply and demand for the labour force in terms of skills and geographic availability, ageing of the labour force in particular occupations may cause problems to employers in the medium term to obtain necessary labour force, decrease growth of Latvia's export volumes, competitiveness of exports as well as investments.
- **Upward shocks of prices on world's energy resources and raw materials** as well as factors on the demand side in the local market may facilitate more rapid increase in prices than forecasted.

Positive risks:

- Although in the euro area there are still negative risks observable, recent confidence indicators suggest that a **more rapid recovery of the euro area is possible**, that would allow Latvia's economy to develop more rapidly than currently projected.
- **Successful attraction of an investor for JSC Liepājas Metalurgs,** and partial or full renewal of its production would allow to substantially increase a volume of the manufacturing, to regain lost workplaces as well as to raise export volumes.

- **If geopolitical risks decrease and growth of the euro area becomes more rapid, private investments could increase more substantially.** Business surveys and the increasing deposits of entrepreneurs indicate that demand is the most important factor, limiting investments. Taking into account that historically investments react to the changes in the economic situation as well as to the changes in the business sentiment to a larger extent than other indices, then, if external demand rises and other risks decrease, increase of investments could exceed the forecasted.
- **In the medium term, more rapid than forecasted increase in private consumption is possible**. Macroeconomic scenario is based on conservative assumptions about development of private consumption. Rapid increase in an average wage as well as in a minimum wage, reduction of a tax burden on labour, low inflation and increase of confidence levels with regard to the economic development during the last two years may facilitate more rapid increase in private consumption.
- In a medium term, **Latvia's accession to the euro area on 1 January 2014** is a substantial positive factor that may facilitate attraction of new investors, by increasing country's recognition and credibility. Together with an inflow of additional investments, decrease in a currency risk may also facilitate more rapid export growth.
- **A positive assessment by** international creditors and **credit rating agencies** of Latvia's national economy is one of the factors confirming that the business environment in Latvia continues to improve. That may facilitate inflows of investments, which may positively affect development of the manufacturing and export volumes.
- Better than expected **growth of the global economy**, including in the USA and developing countries, may provide an additional stimulus for development of European and Latvian economy.
- Increase in wages prompted by raise in productivity, and the **state aid for re-emigration, mobility, requalification, educational reforms and other measures balancing the labour market in a medium term may facilitate development of the balanced labour market**, that would stimulate a more rapid economic development than it was forecasted.

4.2. Sensitivity Analysis

On the basis of the possible impact of macroeconomic risks economy described in Chapter 4.1, two alternative scenarios of macroeconomic development have been worked out. The Stability Programme's central macroeconomic scenario has been developed in February 2014, before escalation of the events in Ukraine, and it does not take into account a potential impact of these risks on Latvia's economy. Therefore, in a short term negative risks prevail, but in a medium term – risks are considered to be balanced.

Realisation of the optimistic scenario is possible, if further escalation of the situation in Ukraine does not take place and the conflict is solved by diplomatic means As a result, the sanctions of Western governments against Russia do not continue and Russia's economy returns to a previous growth rate. In addition to that, an economic situation in the euro area continues to improve, outpacing currently forecasted growth rates, but in developing countries stable growth continues.

Such course of events would substantially improve the confidence of entrepreneurs and investors as well as would increase demand for Latvia's export goods. Thus, compared to the central scenario, more rapid growth of investments and exports would be expected, that along with such consumption-stimulating factors as increase in wages, a reduction of a tax burden and low inflation, would facilitate more rapid growth of private consumption than it was forecasted in the central scenario. More positive GDP growth rates would be based both on increase in productivity and on improvements in employment. In this scenario, an unemployment rate in a medium term would decrease faster, simultaneously with larger increase in wages.

Table 4.1. Optimistic Macroeconomic Scenario

	2013	2014	2015	2016	2017
GDP, at market prices, EUR million	23315.5	24880.0	26745.3	28503.8	30379.7
growth at market prices, %	5.6	6.7	7.5	6.6	6.6
growth at constant prices, %	4.1	5.0	4.5	4.0	4.0
CPI (annual average), %	0.0	1.1	3.0	2.5	2.5
Average wage in the national economy, euro	716.2	759.2	802.4	846.6	893.1
growth at market prices, %	4.6	6.0	5.7	5.5	5.5
Employment, thousand people	893.9	907.3	915.5	920.1	922.8
growth, %	2.1	1.5	0.9	0.5	0.3
Unemployment rate (annual average), % of economically active population	11.9	10.3	9.3	8.6	8.4
Export growth rates at market prices, %	2.3	6.6	7.1	7.1	7.4
Import growth rates at market prices, %	-0.9	7.1	7.6	7.3	7.5

The optimistic scenario of macroeconomic development provides for GDP growth at comparable prices in an amount of 5.0% in 2014 and amounting to 4.5% in 2015. In a medium term, a potential GDP growth rate would remain in an amount of 4%.

In case of the optimistic macroeconomic scenario, which provides for faster GDP growth than the central scenario and determines more positive indices of consumption and the labour market, a budget revenue base would also be considerably improved. If economic growth develops according to the optimistic scenario, budget revenues, compared to the central scenario, will increase by 0.2% of GDP during the entire forecasting period.

Realisation of the pessimistic macroeconomic scenario may be expected if the geopolitical situation in Ukraine remains unstable, however, further substantial escalation of the conflict does not take place, for example a military conflict between Russia and Ukraine or destabilisation of a situation in other Eastern European country are avoided. In case of a negative scenario, sanctions of Western governments against Russia remain in the medium term, however, they are not being substantially intensified from their initial level and Russia does not implement wide economic counter-sanctions against the EU Member States.

In this case, Russia’s economy in 2014 could face technical recession (negative growth for two consecutive quarters) in the first half of the year, returning to a positive growth in the second half of the year. Thus, demand for Latvia’s export goods and services would decrease both in Russian market and in other Latvia’s trading partner countries – Estonia, Lithuania and Poland, which would be also negatively affected by slower economic growth rates of Russia. Worsening of the confidence of entrepreneurs and investors would also be expected, that would substantially slow down the amount of investments in Latvia. If such scenario comes true, increase in employment and wages would be lower than in the central scenario, but an unemployment rate in a medium term would remain at a higher level.

Table 4.2. Pessimistic Macroeconomic Scenario

	2013	2014	2015	2016	2017
GDP, at market prices, EUR million	23315.5	24163.9	25568.1	27254.7	29053.9
growth at market prices, %	5.6	3.6	5.8	6.6	6.6
growth at constant prices, %	4.1	2.0	3.0	4.0	4.0
CPI (annual average), %	0.0	1.1	3.0	2.5	2.5
Average wage in the national economy, euro	716.2	748.4	778.4	821.2	866.3
growth at market prices, %	4.6	4.5	4.0	5.5	5.5
Employment, thousand people	893.9	897.5	902.0	906.5	909.2
growth, %	2.1	0.4	0.5	0.5	0.3
Unemployment rate (annual average), % of economically active population	11.9	11.2	10.6	10.0	9.7
Export growth rates at market prices, %	2.3	4.6	6.5	7.1	7.4
Import growth rates at market prices, %	-0.9	5.1	6.6	7.3	7.5

A development of the pessimistic macroeconomic scenario suggests that GDP could increase only by 2.0% in 2014, but in 2015 - by 3.0%, however, these geopolitical shocks would not affect the medium-term GDP growth potential of Latvia and in subsequent years GDP growth would be at the level of the central scenario.

If Ukraine or the East European region will face a substantial escalation of geopolitical risks or current risks will be supplemented by any other macroeconomic risks, for example worsening of economic situation in the EU or substantial decline in growth rates of developing countries, Latvia’s economic growth in a medium term could be even more lower than it is provided in the pessimistic scenario.

Lower GDP growth than in the central scenario that is based on a worse situation in the external environment and lower private consumption, as well as on weaker labour market conditions, will also negatively affect budget revenues. If economic development takes place according the pessimistic scenario, the budget revenues, compared to the central scenario, will decrease by 0.6% of GDP in 2014, but in 2015 and further in a medium term the revenue each year will decrease by 0.9% of GDP.

5. Comparison with the Latvia's Convergence Programme for 2012 – 2015

A forecast on general government debt is reduced in comparison with the forecasts of the Convergence Programme 2013–2016 (see Table 5.1.), taking into account an updated forecast on the state budget execution and an adjusted borrowing strategy for a medium term, according to which public benchmark eurobond issue was rescheduled from 2013 to 1 January 2014, as well as updated forecasts on economic development.

Table 5.1. Comparison with the Forecasts of the Convergence Programme 2013–2016

	ESA code	**2013**	**2014**	**2015**	**2016**	**2017**
GDP growth (%)	B1g					
2013		4.0	4.0	4.0	4.0	-
2014		4.1	4.0	4.0	4.0	4.0
Changes		0.1	0.0	0.0	0.0	-
General government net lending (% of GDP)	EDP B.9					
2013		-1.1	-0.9	-0.9	-0.9	-
2014		-1.0	-1.0	-0.8	-0.7	-0.7
Changes		0.1	-0.1	0.1	0.2	-
Total general government debt (% of GDP)						
2013		44.5	41.0	36.4	34.6	-
2014		38.1	38.8	32.9	34.2	31.3
Changes		-6.4	-2.2	-3.5	-0.4	-

In 2013, GDP growth was slightly more rapid than it was forecasted in the scenario of the Convergence Programme 2013. Despite economic downturn in the euro area and domestic problems in metal production sector, Latvia's GDP growth reached 4.1% as opposed to the forecasted 4.0%. The positive changes were provided mainly by strong increase in domestic demand.

In a medium term, economic growth is forecasted to be at the same level as in the scenario of the previous Convergence Programme, which presents the potential of Latvia's economic growth.

In 2013, the general government budget deficit was slightly lower than it was forecasted in the scenario of the previous Convergence Programme. Basically, it is explained by better development of national economy and accordingly by higher tax revenues than it was planned. The updated fiscal development scenario suggests that in 2014 the forecasted general government budget deficit is 1% of GDP. Forecasts on general government budget are based on updated tax revenue forecasts in compliance with the latest scenario of macroeconomic development. However, for subsequent years, the general government budgetary balance is determined taking into account the objective of structural budgetary balance and changes in the cyclical component of the budgetary balance in compliance with the scenario of macroeconomic development. Thus, in 2015 the general government budget deficit is forecasted to be 0.8% of GDP, in 2016 – 0.7% of GDP and in 2017 – 0.7% of GDP.

6. Quality of Public Finances

6.1. Efficiency of the State Budget Resources and Expenditure Control

Procedures for the working-out, approval and implementation of the State budget and a responsibility within the budget process are determined by the LBFM. Minister for Finance is responsible for the organisation and management of the State budget implementation process.

According to the LBFM, the heads of budget public authorities, institutions and local governments not financed by the state as well as of capital companies, in which there are shares of the State or local governments invested, shall be responsible for the observance, implementation and control of the procedures and requirements prescribed by the aforementioned Law as well as for the efficient and economic expenditure of budget resources in compliance with the planned objectives.

According to the LBFM, Minister for Finance provides for the working-out the Draft Annual State Budget Law. By the working-out of the Draft Annual State Budget Law, Minister for Finance evaluates the compliance of budget requests with the planned objectives, the results to be achieved, the principles of economy and efficiency and, if necessary, requests additional information. On the basis of the evaluation and the information provided, Minister for Finance (before the submission of the Draft Annual State Budget Law to the Cabinet) shall decide on the inclusion of budget requests in the Draft Annual State Budget Law. Minister for Finance at any stage of examination of the Draft State Budget Law may express his own opinion, add necessary conclusions as well as the results of particular audits.

According to LBFM, executors of the State budget may carry out the State budget expenditure or undertake short-term obligations only within the framework of the allocations, determined in their financing plans, which are issued by the Treasury. The Treasury in turn provides allocations for expenditure on the basis of the appropriations stated in the Annual State Budget Law and ensures their execution according to the procedures prescribed by the Cabinet. State-financed institutions may undertake long-term obligations of the State budget, not exceeding the ceilings of the State budget long-term obligations for a financial year that are prescribed by the Law On the State Budget.

To ensure supervision of the State budget execution as well as to facilitate control of budget expenditure, the Treasury prepares reports on execution of the State and local government budgets, informing ministries, other central state institutions, MoF and society about a budget execution process.

At the same time, in order to achieve budget objectives, line ministries and other central state institutions prepare quarterly reports on a budget execution process and submit them to the MoF. The report provides information on State budget execution during a particular reporting period – a comparison of the performed expenditure with a previous year's reporting period, a comparison with the plan of a reporting period, an overview of performed and non-performed activities, information on measures for improving financial management, etc.

During the working-out of the Draft Annual State Budget Law or its amendments, Minister for Finance informs the Budget and Finance (Tax) Commission of the Saeima about the State budget planning process and not rarely than once in a quarter – about the State budget execution process.

As from the working-out of the State budget 2012, a procedure for the planning and presentation of operational level results and their performance indicators has been improved in the budget requests of ministries and other central state institutions. This information is included in the explanations attached to the Annual State Budget Law, thereby informing the Parliament and society.

Ministries and other central state institutions set a definite objective for the budget programmes and sub-programmes, which they are implementing, together with operating results and performance indicators, characterising the attainment of such objective. For operating results and performance indicators, trends are being planned also in the medium term and, at the same time, historical information for a three-year period is being presented.

Policy results are primarily planned in development planning documents. Account documents about policy planning documents are being prepared in a form of informative reports both at a medium stage of the introduction of a policy planning document and after the end of its duration.

In order to develop the performance indicators' system and integrate it into the State budget management process, as from 2012, the analysis on execution of the State budget expenditure is supplemented with information on the achieved operating results and their performance indicators for budget programmes and sub-programmes within the framework of the set objectives, i.e. in the report about an analysis on the execution of operating State budget 2012, ministries and other central state institutions provided necessary explanations about the previously planned operating results and performance indicators, their implementation during a year as well as explanations about deviations in the execution of performance indicators' values from the planned performance indicators' values which exceed 15 per cent (both in positive and negative terms). In 2013, considering normative regulation and preparing an analysis on the execution of the State budget for a previous period, i.e. for 2012, budget sectors for the first time included information on operating results and actually achieved performance indicators, which was summarised and evaluated by the MoF.

On 31 July 2012, the Cabinet adopted Regulation No 523 'Regulation on Fundamental Principles for the Working-out and Submission of Budget Requests' providing for the introduction of principles for a formation of the structure of uniform State budget programmes, thus ensuring closer coherence of the structure of the State budget programmes with the system of policy planning and performance indicators. The structure of budget programmes is determined by the course of actions (activities), defined in the action strategy of a public authority or by the functions of a ministry or other central state institution according to its regulation, if the action strategy of a public authority is not approved. According to the aforementioned regulations, ministries and other central state institutions had to revise budget programmes (sub-programmes) and harmonise with the MoF the planned structure of execution programmes (sub-programmes) related to the State basic budget's principle functions. The majority of ministries did not suggest significant changes in the structure of budget programmes (sub-programmes) for 2014, although Cabinet Regulation No 523 'Regulation on Fundamental Principles for the Working-Out and Submission of Budget Requests' of 31 July 2012 prescribed to revise a structure of programmes (sub-programmes) according to the course of actions (activities) defined in the action strategy. However, it should be taken into account that pursuant to paragraph 14 of Cabinet Instruction No 1 'Procedure for Working-Out and Updating the Action Strategy of a Public Institution and for Evaluating its Implementation', ministries work out the updated action strategies and submit them for an approval to a corresponding member of the Cabinet within three months after a proclamation of the Framework Law. Therefore, it is expected that after the approval of institutions' strategies, when planning a budget for 2015, ministries could again revise the structure of their budget programmes/sub-programmes and suggest changes.

The Treasury provides allocations for expenditure in accordance with the appropriations determined in the Annual State Budget Law and ensures their execution according to the procedures prescribed by the Cabinet. However, ministries and other central state institutions are responsible for the establishment of a system controlling the execution of an appropriation determined in the Annual State Budget Law and for the control of expenditure of the State budget resources that are transferred to the Treasury's current accounts in compliance with the planned objectives.

In addition, in the LBFM it is prescribed that in order to receive allocations and carry out expenditure from the State budget resources, state-financed institutions shall open state basic budget and state special purpose budget accounts only with the Treasury. Institutions not financed by the state shall open current accounts only with the Treasury. Budget public authorities (except budget-financed institutions) shall open current accounts only with the Treasury in order to receive the State budget resources and make expenditure financed from these resources, unless otherwise provided in other regulatory enactments. Local governments and derived public persons partially financed from the State budget as well as capital companies, in which the State or local governments' share is invested, may open current accounts with the Treasury.

In order to strengthen control possibilities for the expenditure of resources, the LBFM includes a provision, stating that Minister for Finance may delay or reduce allocation for the period up to three months, by giving a corresponding order to the Treasury, if there is at least one of such conditions present:

- during a three-months period actual revenue of the State budget taxes and non-taxes against the planned revenue for a corresponding period decreases by more than 0.5 per cent of the GDP forecast stated in the Annual State Budget Law;
- actual accumulated State budget financial deficit in three-months period exceeds the State budget financial deficit, planned for a corresponding period, by more than 0.5 per cent of the GDP forecast stated in the Annual State Budget Law;
- if on the Treasury's budget accounts there is insufficient amount of resources to cover payment obligations that are planned for the next month.

Major sanctions determined by the LBFM for an improper action related to disposal of budgetary funds:

- for delayed or incomplete payment of the sums owed to the State budget that are payable into the Treasury's budget accounts – the Treasury (unless it falls within the competence of other public authority) shall collect the amount owed to the basic budget revenue and may collect late payment interest in the amount of 0.1% of the unpaid amount for each delayed payment day, if regulatory enactments do not prescribe otherwise;
- if losses occurred to the budget shall be covered – the Treasury may transfer amounts into the basic budget revenue, cancel or suspend 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 compliance with a procedure prescribed by a law, and they are not reported, if record keeping does not correspond to the set procedure and thus, funds owed to the budget are concealed as well as if the head of a budget public authority has assumed obligations, exceeding the allocation provided by the Treasury;
- if budget public authorities, institutions and local governments not financed by the state as well as capital companies, in which the State or local governments' share is invested, have violated financial management rules prescribed by the LBFM, Minister for Finance, Treasury Administrator, the heads of ministries and other central state institutions (according to their competence) may temporary deprive of the authorisation to allocate or organise the budget revenue or expenditure, may impose restrictions on the use of accounts, cancel or suspend allocations so that illegally disposed funds would be refunded, or may require the repayment of illegally disposed funds, may bring a civil

action to the court or submit materials to competent officials for a decision on the initiation of criminal proceedings as well as may cancel or suspend payments;

- The Treasury, pursuant to the Law 'On Local Government Financial Equalisation', is entitled to collect in unchallenged order the amounts of money from local government budget resources, which were not timely or fully transferred by a corresponding local government into the financial equalisation fund of local governments, writing off these amounts from the budget of a corresponding local government.

In order to preserve general economic balance and to provide a uniform state financial policy, there are separately amounts determined in the Annual State Budget Law for total increase in local governments' borrowings and guarantees. The Treasury is entitled to withhold sums from the amount, which is due to a local government from personal income tax or from a subsidy of the local government financial equalisation fund, in the following cases and in the following amount:

1) if a local government does not ensure on time the fulfilment of obligations prescribed by the state loan agreements – in the amount of the sum that was not paid in due time;
2) if a local government does not ensure the use of a state loan in compliance with the objective set in a loan agreement – by order of Minister for Finance, in the amount of the loan sum that was improperly used for the objective set in the agreement.

New amendments to the LBFM prescribe that the Cabinet regulates a procedure, according to which state-financed institutions provide the State budget funding to private persons, including non-governmental organisations, for the execution of state administration tasks, and supervise the expenditure of allocated funding. Thus, there will be uniform principles introduced for financing the delegated tasks of state administration, for the control of disposed funding, for reporting on disposed State budget funding, as well as for ensuring publicity of the aforementioned process.

6.2. Efficiency of Revenue Structure and System

One of substantial aspects as regards the quality of public finances is a provision of stable and predictable tax revenue to the budget for funding of the government's top-priority social and economic activities.

Table 6.1. Tax Revenue in General Government Budget (S.13), Million Euros

	Code (ESA)	**2013**	**2014**	**2015**	**2016**	**2017**
Tax revenue						
1. Production and import taxes	D.2	2587.2	2863.0	3033.8	3181.1	3332.5
2. Income and property current taxes	D.5	1785.5	1876.9	1921.0	1964.7	2071.2
3. Capital taxes	D.91	2.3	2.7	3.1	3.2	3.5
4. Social contributions	D.61	1932.7	2018.5	2035.7	2081.4	2166.4
Hereof actual social contributions	*D.611*	*1894.2*	*1980.0*	1997.3	2043.0	2128.0

It should be mentioned that for several years the overall tax burden in Latvia remains one of the lowest in the EU. In 2012, it was 28.1% of GDP, what is lower than the EU average index 40.6% of GDP.

Figure 6.1. Tax Revenue in Latvia and the EU in 2012, % of GDP[9]

The largest part of all tax revenue in Latvia is attributed to labour taxes. In recent years, tax policy is focused on reducing the share of labour taxes in total tax revenue that decreased from 50.6 % in 2011 to 50.1 % in 2013. Therefore, the share of revenue from consumption, capital taxes in total tax revenue gradually increased from 49.4% in 2011 to 49.9% in 2013.

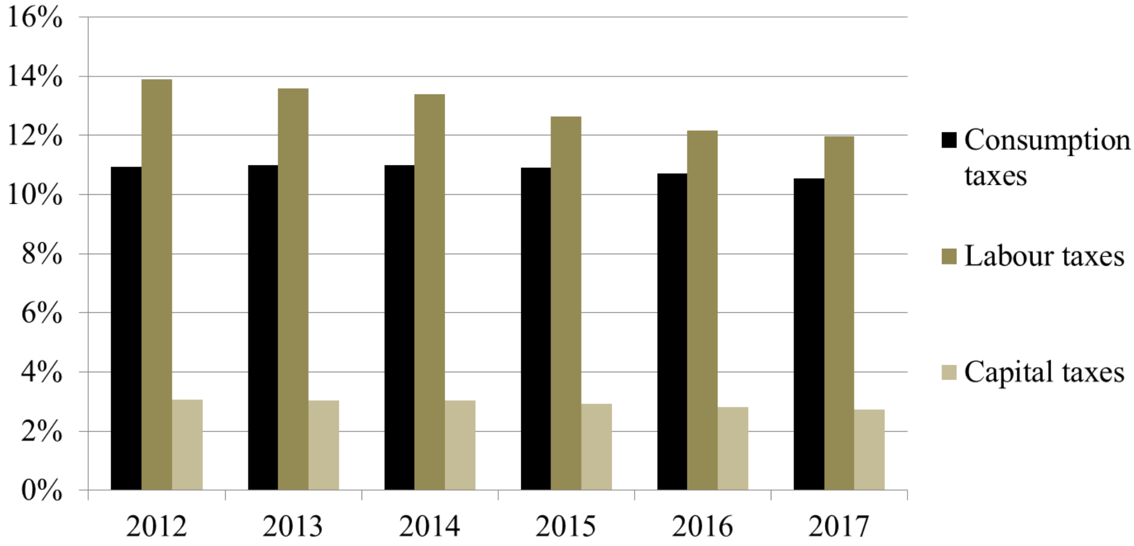

Figure 6.2. Tax Revenue According to Economic Functions, % of GDP

After joining the EU, increase in tax revenue was mainly facilitated by rapid economic growth, but in 2009, due to the economic crisis, tax revenue decreased. In order to ensure fiscal consolidation and achieve a reduction of the budget deficit, fiscal consolidation of the budget was started in 2008 and it continued until 2012. In turn, changes made in tax policy already in 2013 and 2014 are mainly focused on reduction of labour tax burden and restricting the shadow economy. Changes in medium-term tax policy are also focused on promoting economic activity, investments and employment.

In accordance with the Corporative Social Responsibility (CSR) Report for 2013 by the EC on implementing the direction and proposals to reduce a tax burden for population with low income, shifting it to excise duty and tax on natural resources as well as to improve tax compliance and to restrict the shadow economy, several changes have been introduced in legislation in 2014.

[9] Information from the Eurostat data base.

The labour tax reform, initiated in 2013, continued also in 2014, however, there were certain corrections made. Within the framework of labour taxes, as from 1 January 2014 the PIT rate has been preserved at the level of the year 2013. From 1 January 2014, the amount of allowance for dependants was increased from 113.83 euros (80 lats) to 165.00 euros (115.96 lats) and non-taxable minimum from 64.03 euros (45 lats) to 75 euros (52.71 lats), but the social security contributions rate has been reduced from 35.09% to 34.09 per cent.

As from 1 January 2014, the rates have been increased for particular objects of tax on natural resources as well as there have been two new tax objects introduced – fireworks and the use of water resources for generating electricity in a hydroelectric power station whose total installed capacity of hydroelectric station is less than two megawatts.

As of 1 January 2014, an excise duty rate has been increased for liquefied petroleum gas and other gas hydrocarbons as well as for cigarettes.

As from 1 January 2014, several shadow economy prevention measures have been introduced, for example the imposition of labour taxes on issued loans by economic operators (whose basic activity is not issuing loans) and the imposition of labour taxes on the minimum wage of members of the board as well as an improvement in the administration of capital tax.

From 1 January 2014, a new tax has been introduced - subsidised electricity tax.

As of 1 July 2014, a toll for the use of motorways will be introduced for the use of state major motor roads for vehicles and their combination whose full mass exceeds 3 500 kilogrammes and which are intended or used for the carriage of goods by road.

In order to promote research and development, a new deduction for CIT will be introduced from 1 July 2014, which will allow for the purposes of tax calculation to increase expenses, related to research and development, applying a ratio 3. Besides, a period for applying a deduction for CIT for big investments and for purchasing new technological equipment has been prolonged until 2020. At the same time in order to provide fiscally neutral approach, in 2014 some particular less efficient tax allowances have been abolished.

Also in the medium term, the most substantial task that should be made is to continue reducing tax burden on labour, at the same time providing stability in tax revenue – to reduce PIT rate from 24% to 23% as of 1 January 2015 and to 22% as from 1 January 2016 (according to provisions of the law). According to the Declaration of Government's Action Plan, it is planned that until July 2014, the MoF will work out and submit to the Cabinet an informative report 'Changes in Labour Taxes for Reducing Income Inequality – Evaluation of Changes Made and Proposals for Further Action' where, taking into account fiscal capacities of the state budget, a more efficient solution on reducing labour taxes will be offered, which would decrease a tax burden for taxpayers and at the same time would reduce income inequality in Latvia.

It is also planned that until June 2014 a report will be prepared and submitted, which will include an extended analysis of micro-enterprise tax impact on national economy, sectors involved as well as security of employees' social guarantees and a possibility to determine the validity period of taxation regime in legislative acts. It is also planned to work out amendments to the Micro-Enterprise Tax Law, providing amendments to the procedure of distributing micro-enterprise tax, increasing a part to be paid into account of state social security contributions.

In a medium term, the prevention of the shadow economy will be continued – especially active struggle of the SRS against tax evasion, paying special attention to the elimination of 'envelope' wages and illegal employment, thus deriving additional revenue.

Value Added Tax[10]

VAT revenue has a substantial share in total tax revenue. During the years of economic growth, VAT revenue had a high growth rate, however, when the economic recession began in 2008, which is characterized by decline in retail turnover as well as by decline in the amount of economic activity and import volumes, VAT revenue decreased. In addition, the impact of the economic crisis has been so significant that increase11 in the VAT standard rate could not compensate decrease in revenue that occurred due to the economic recession. By successful development of economy after the economic recession, VAT revenues have considerably increased since the year 2011. In 2012, VAT revenues increased by 16.5% compared to 2011, but in 2013 a growth rate decreased and VAT revenues increased by 4.9%.

In order to approximate indirect tax rates to the neighbouring countries that would particularly facilitate the regional competitiveness of Latvia's service sector and reduce the inflation pressure caused by increase in global prices on less wealthy inhabitants, as of 1 July 2012 the VAT standard rate was reduced from 22% to 21%.

According to the macroeconomic scenario, it is forecasted that in 2014 VAT revenue will increase by 7.0% compared to 2013.

The VAT revenue forecast for 2014 has been prepared, taking into account the expected development trends of national economy, increase in private consumption, successful VAT execution in 2013 and the impact of liberalization of the electricity market.

The most substantial VAT changes in 2014, affecting tax revenue, are related to restrictions on input VAT deduction for purchasing luxury cars and maintenance costs (a value has been determined in compliance with the regulation on corporate income tax), and restrictions (in an amount of 20%) on input VAT deduction have been abolished for passenger cars (also maintenance costs) that are used only for a provision of transactions liable to VAT. There has been also the introduction of guarantee for unpaid VAT determined for transactions with petroleum products (law 'On Taxes and Fees') and VAT revenue is influenced also by other activities that are not related to changes in the Law On Value Added Tax.

Table 6.2. Impact[12] of the Most Substantial Changes of Tax Policy on VAT Revenue, Million Euros

	2014	2015
Restriction on input VAT deduction for luxury cars	+1.4	
Input VAT deduction for automobiles used for economic activity	-1.7	
Introduction of guarantee for unpaid VAT	+6.7	
Impact on VAT from increase in excise duty	+0.8	
Changes in the procedure for using cash registers		+2.8
Increasing the efficiency of tax control and administration to prevent tax evasion, i.e. to reduce the number of fictitious enterprises related to risk addresses and to risk persons	+13.1	
Implementation of the activities 'Radical actions for combatting the shadow economy in the field of tax administration and customs matters', 'Introduction of new common requirements of the EU Customs Union', Reduction of an administrative burden for the clients of the SRS, improving the availability and quality of e-services provided by the SRS'	+10.5	
Adverse effect from increase in a minimum wage	+3.8	
Total impact of changes:	**+34.6**	**+2.8**

[10] Taxes and their changes reflected in this section are compared to projections included in the Law " On Medium Term Budget Framework for years 2014, 2015 and 2016”"

[11] as of 1 January 2009 from 18 % to 21 %;
as of 1 January 2011 from 21% to 22%.

[12] Here and in subsequent tables, showing the impact of tax policy changes, there is the annual impact of introduction presented.

Corporate income tax

It is expected that CIT rate – 15%, effective since 2004 and is one of the lowest in the EU, will remain unchanged. As the economy developed successfully and corporate financial results improved after the economic recession, CIT revenue have considerably increased since the year 2011.

As the economic situation improved in 2013, CIT revenue, compared to 2012, increased by 4.5%, what shows that enterprises closed the year 2012 with significantly better financial results than in 2011.

As economy continues to develop, in subsequent years CIT revenue is forecasted with an upward trend. In 2014, it is expected that CIT revenue will increase by 7.3% compared to 2013.

In 2014 and 2015, CIT revenue will be influenced by substantial and the fiscally most voluminous legislative changes, providing for imposition of labour taxes on the loans issued by economic operators (whose basic activity is not issuing loans), improvement of the SRS administration capacity, changes in the procedure for using cash registers and raising the efficiency of tax control and administration in order to prevent tax evasion as well as other measures.

The most substantial and fiscally voluminous legislative changes provide for the introduction or abolition of CIT reliefs:

- in order to facilitate investments and contributions in research and development, the possibility to apply a tax allowance to new manufacturing technological production equipment (applying a ratio of 1.5) has been prolonged (until 2020);
- as from 1 July 2014, an allowance, providing a possibility to apply a ratio 3 for definite research and development costs, will be introduced;
- a validity period of tax reliefs for investments made in the aided projects has been prolonged (until 2020), at the same time determining a minimum amount of a contribution amounting to 10 million euros;
- in 2014, such allowances as tax allowance (a reduction of taxable income) for a conventional amount of interest on credits as well as a possibility to transfer losses within the group of enterprises were abolished;
- as of 1 January 2015, the current less supported allowance for research and development costs will be abolished;
- as from 1 January 2017, tax allowance regarding grants received for agriculture will be abolished.

Table 6.3. Impact of the Most Substantial Changes in Tax Policy on CIT Revenue, Million Euros

	2014	2015	2016
Introduction or abolition of CIT reliefs		-10.8	-2.8
Imposition of labour taxes on the loans issued by economic operators (whose basic activity is not issuing loans)	-7.4		
‘Radical actions for combatting the shadow economy in the field of tax administration and customs matters’, ‘Introduction of new common requirements of the EU Customs Union’, Reduction of an administrative burden for the clients of the SRS, improving the availability and quality of e-services provided by the SRS’	+0.6		
Changes in the procedure for using cash registers		+2.8	

Increasing the efficiency of tax control and administration to prevent tax evasion, i.e. to reduce the number of fictitious enterprises related to risk addresses and to risk persons	+4.3		
Reducing the rate of state mandatory social security contributions	+1.7		
Imposing labour tax on the minimum wage of member of the board	-2.6		
Preferential regime of CIT for higher educational institutions, colleges and scientific institutions		-0.7	
Total impact of changes:	**-3.4**	**-8.7**	**-2.8**

In addition to the aforementioned, legislative changes in the law 'On Enterprise Income Tax' prescribe also other measures that do not influence tax revenue, for example, to apply as of 2014 the preferential regime of CIT to the cooperative partnerships of forestry services, which comply with definite criteria, the same regime is currently being applied to the cooperative partnerships of agricultural services, as well as that expenses of the aforementioned cooperative partnerships which are not related to economic activity are considered as the part of profit which is distributed among their members and which should be liable to a tax.

Besides, it is also planned not to withhold CIT from payments for the goods purchased in tax-free or low-tax territories if their value corresponds to a market price. It is also planned not to withhold CIT from payments for the purchase of securities that are in the public circulation of the EU or the European Economic Area and after 31 December 2013 to preserve withholding of tax for interest payments and payments for intellectual property which were made to a person who is formed or established in a low-tax or tax-free country or territory as well as other changes.

In order to provide supervision of those taxpayers for which there is a risk that remuneration for the income earned during an employment relationship is being transformed into royalties. The SRS in co-operation with the State Labour Inspectorate is instructed to implement a tightened control.

Excise Duty

As the economic situation of Latvia has improved since 2011, there are positive trends observable in the performance indicators of excise duty: in 2012, excise duty revenue increased by 2.7%, but in 2013 by 3.9 per cent.

In 2014, excise duty revenue are forecasted with the increase of 3.5% compared to 2013.

According to the amendments of 16 April 2013 to Cabinet Regulation No 344 of 3 May 2011 'Procedure, according to which diesel fuel (gas oil) that is used for manufacturing agricultural products, treatment of agricultural land and for the treatment of forest and marshland where cranberries or bilberries are cultivated as well as for the treatment of land under fish ponds is exempt from excise duty' in the financial year of 2013/2014 the maximum total amount of diesel fuel exempt from excise duty has been increased.

In compliance with the amendments of 6 November 2013 in the law 'On Excise Duty', as from 1 January 2014 an excise duty rate for liquefied petroleum gas and other gas hydrocarbons has been increased from 128.06 euros to 161.00 euros per 1000 kg.

According to the aforementioned amendments, in 2014 there is excise duty exemption preserved for natural gas used for the heat supply of the agricultural land covered areas (greenhouses) as well as for the heat supply of industrial poultry houses and incubators. However, to natural gas that is used to drive technological equipment for industrial production and the primary processing (compliant with the corresponding approved NACE classification codes prescribed by Regulation No 1893/2006) of agricultural raw materials and to provide a technologically necessary climate in the aforementioned premises for industrial production and for the primary processing of agricultural raw materials there is a reduced excise duty rate of 5.56 euros per 1000 m3 applied as of 1 January 2014.

In compliance with amendments made on 14 April 2011 to the law ‘On Excise Duty’, as from 1 January 2014 a specific excise duty rate for cigarettes has been increased from 35.57 euros to 39.84 euros per 1000 cigarettes as well as a percentage rate has been reduced from 34.00% to 33.50%, providing a minimum level of excise duty of 79.68 euros per 1000 cigarettes instead of 73.99 euros. A rate has been also increased for cigars from 36.99 euros to 39.84 euros and for smoking tobacco from 48.38 euros to 55.49 euros. Excise duty for cigarettes has been increased in order to achieve the minimum level of the EU in 2018.

To make excise duty revenue more efficient, in accordance with the law of 6 November 2013 ‘Amendments to the Law “On Excise Duty”’ there are substantial changes planned in the excise duty structure for cigarettes as of 1 July 2014 – a specific rate will be increased up to 51.80 euros, but a percentage rate will be reduced to 25 per cent. The minimum excise duty level per 1000 cigarettes will be increased to 85.60 euros.

In compliance with the transitional provisions of the law ‘On Excise Duty’, it is planned to increase a specific excise duty rate and the minimum tax rate per 1000 cigarettes also in subsequent years:

- as of 1 July 2015, a specific rate to 54.20 euros and the minimum level to 89.80 euros per 1000 cigarettes;
- as of 1 July 2016, a specific rate to 56.20 euros and the minimum level to 93.70 euros per 1000 cigarettes;
- as of 1 July 2017, a specific rate to 58.20 euros and the minimum level to 97.00 euros per 1000 cigarettes.

According to the amendments made on 14 April 2011 in the law ‘On Excise Duty’, as from 1 January 2016 excise duty rate for cigarettes and cigarillos will be increased from 39,84 euros to 42.69 euros per 1000 pieces.

Table 6.4. Impact of the Most Substantial Changes in Tax Policy on Excise Duty Revenue, Million Euros

	2014	2015	2016	2017
Increase in the amount of diesel fuel not liable to excise duty for farmers in the financial year of 2013/2014	-3.9	-	-	
Increase in excise duty rate for tobacco products and restructuring the rate for cigarettes	+0.6	+2.4	+3.2	+2.5
Excise duty for natural gas used in heating of greenhouses and industrial poultry houses exemption preservation and an establishment of the minimum rate for natural gas used in industrial production	-1.8			
Increase of an excise duty rate for liquefied petroleum gas	+3.3			
‘Radical actions for combatting the shadow economy in the field of tax administration and customs matters’, ‘Introduction of new common requirements of the EU Customs Union’, Reduction of an administrative burden for the clients of the SRS, improving the availability and quality of e-services provided by the SRS’	+2.6			
Total impact of changes:	**-0.8**	**+2.4**	**+3.2**	**+2.5**

Real Estate Tax

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

In 2014, real estate tax revenue is forecasted with the increase of 1.5%, compared to 2013.

The most substantial legislative changes, effective as of 1 January 2014, are related to state protected cultural monuments to which exemption from real estate tax will no more be applied if The State Inspection for Heritage Protection establishes that a corresponding cultural monument is not being maintained in compliance with the requirements for protecting cultural monuments and provides an opinion on that to a local government in the territory of which a monument is located.

Buildings that belong to the Free Trade Union Confederation of Latvia and that are being constantly used for implementing basic functions will also be exempt from real estate tax.

Real estate tax rate for residential houses will be applied only to those residential houses, apartments or the group of premises which are used for a living purposes and is owned by businesspersons, if the corresponding house or apartment will be rented out for living purposes and rental rights will be entered in the Land Register. In other cases, a tax rate of 1.5 per cent will be applied to such objects.

A procedure for the taxpayers’ identification for immovable property belonging or adjacent to the state or a local government also has been changed.

Personal Income Tax

With the economic recession, in 2009 PIT revenue significantly decreased. However, along with economic recovery, in 2011 PIT revenue increased, despite changes made in legislative provisions in 2011, including a reduction of the rate from 26% to 25%, increase in non-taxable minimum from 49.8 euros to 64.03 euros per month and increase in the amount of allowance for dependents from 89.64 euros to 99.6 euros per month.

In 2014, medium-term macroeconomic development forecasts provide for stable increase in the wage fund, what will increase labour tax revenue in subsequent years and PIT revenue will be affected by changes that have been made in legislation.

In 2014, PIT revenue is forecasted with the increase of 2.4% compared to 2013.

Legislative changes adopted on 24 May 2012 were included in Latvia’s Convergence Programme and provided that already from the year 2014, a PIT rate would decrease by two percentage points (22%) and in 2015 it would constitute 20%, however, for a reduction of a tax burden to provide a larger benefit to families with children, in 2013 the aforementioned tax reform was changed.

As of 1 January 2014 the legislative changes prescribe that the PIT rate instead of initially planned 22% remain at the level of 2013 – 24%, thus giving a positive fiscal impact in the amount of +102.8 million euros. In the year 2015 it is prescribed that the PIT rate instead of initially planned 20% will be 23%, thus giving the fiscal impact in the amount of +154,1 million euros and in the year 2016 the PIT rate will be 22% instead of initially planned 20%, thus giving the fiscal impact in the amount of +115.8 million euros.

A fiscal impact of legislative changes compared to the previous year is 0 euros in the year 2014 as the tax rate actually was not changed. In 2015, by reducing the rate from 24% to 23%, a fiscal impact is -48.9 million euros and in 2016, by reduction of rate from 23% to 22%, a fiscal impact is -53.4 million euros.

On 1 January 2014, legislative changes have come into force prescribing to increase the amount of allowance for dependents from 113.83 euros to 165 euros and non-taxable minimum from 64.03 euros to 75.00 euros.

PIT revenue will be also affected by other legislative changes prescribing:

- increase in a minimum wage from 284.57 euros to 320 euros;
- establishment of ceilings for social security contributions;
- indexation of pensions;
- improvement in the administration of capital tax;
- improvement in the administration capacity of the SRS;
- exemption of the amounts received and paid out as the state or the EU aid for agriculture and rural development from PIT in 2014, 2015 and 2016;
- expression of the (monthly) non-taxable minimum of pensioners and additional allowance for disabled persons and participants of national resistance movement in the whole euros, rounding off in favour of a taxpayer.

PIT revenue will be also affected by the measures combatting the shadow economy as well as by the imposition of PIT on the loans issued by economic operators (whose basic activity is not issuing loans) and the imposition of labour taxes on the minimum wage of members of the board.

The most substantial and fiscally voluminous legislative changes are presented in Table 6.5.

Table 6.5. Impact of the Most Substantial Changes in Tax Policy on Personal Income Tax Revenue, Million Euros

	2014	**2015**	**2016**
Changes of PIT rate	+102.8	+154.1	+115.8
Increase in minimum wage	+11.8		
Establishment of ceilings for social security contributions		+2.3	
Increase in non-taxable minimum	-17.7		
Increase of the amount of allowance for dependants	-35.3		
Impact on PIT from the reduction of social security contributions rate	+8.1		
Imposition of PIT on the loans issued by economic operators (whose basic activity is not issuing loans)	+7.8		
Imposition of PIT on the minimum wage of members of the board	+2.0		
The amounts exempt from PIT in 2014, 2015 and 2016 which were received and paid out as the state or the EU aid for agriculture and rural development		-2.2	
‘Radical actions for combatting the shadow economy in the field of tax administration and customs matters’, ‘Introduction of new common requirements of the EU Customs Union’, Reduction of an administrative burden for the clients of the SRS, improving the availability and quality of e-services provided by the SRS’	+0.7		
Total impact of changes:	**+80.2**	**+154.2**	**+115.8**

At the same time in 2014 the following changes in PIT are planned – PIT will be applied according to a general tax rate also for the income equalized to pensions, which in the meaning of the law is insurance compensation that is being paid to insurer according to a lifelong pension insurance contract.

A more fair and proportionate regulation has been introduced for natural persons which dispose the only immovable property in cases when parents carry out protection and cannot come to a mutual agreement, allowance regarding care for underage child is being provided to the taxpayer-parent who is indicated in the operative part of family tribunal’s decision on parental dispute settlement.

In 2014, provisions related to the fixed income tax regime are excluded from the law, prescribing a two-year transition period during which new payers of fixed income tax will not be able to register and there will be a possibility introduced for inhabitants to whom state old-age pension are granted to pay a reduced patent payment – 17 euros a year.

Social Security Contributions [13]

In a medium term, the dynamics of revenue from social security contributions will be determined not only by an expected increase in the wage fund, but also by legislative changes and by changes in contribution rates to the state-funded pension scheme.14

In 2014, social security contributions are forecasted with increase of 3.1%, compared to 2013.

The most substantial legislative changes in 2014 are related to the reduction of social security contributions rate form 35.09% to 34.09%, where the social security contributions of an employer decrease from 24.09% to 23.59% and the social security contributions of an employee from 11% to 10.50 per cent.

Revenue of social security contributions will also be influenced by:

- increase in a minimum wage from 284.57 euros to 320 euros;
- establishment of ceilings for social security contributions;
- imposition of social security contributions on the loans issued by economic operators (whose basic activity is not issuing loans);
- imposition of social security contributions on the minimum wage of members of the board;
- co-operation of the SRS with the State Labour Inspectorate in a tightened control of those taxpayers for which there is a risk that remuneration for the income earned during an employment relationship is being transformed into royalties;
- improvement in the administration capacity of SRS.

In 2014, it is planned to work out amendments to the Law On Micro-Enterprise Tax according to which the part to be paid into the account of social security contributions will be increased, therefore, increase in the revenue of social security contributions is forecasted. In 2014, legislative changes provide that micro-enterprise tax rates will increase from 9% to 11% in 2015, from 11% to 13% in 2016 and from 13% to 15% in 2017. Legislative changes will be applied to micro-enterprises whose turnover ranges from 7 000 to 100 000 euros, but for the turnover less than 7 000 euros – the previous rate of 9% will be preserved.

Table 6.6. Impact of the Most Substantial Changes in Tax Policy on the Revenue of State Mandatory Social Security Contributions, Million Euros

	2014	2015	2016
Reduction in the rate of social security contributions	-59.0		
Increase of minimum monthly wage	+21.1		
Imposition of social security contributions on the loans issued by economic operators (whose basic activity is not issuing loans)	+13.9		
Imposition of social security contributions on the minimum wage of members of the board	+5.4		
Establishment of ceilings for social security contributions		-33.7	
Increase of a micro-enterprise tax rate		+5.9	+5.0
Total impact of changes:	**-18.6**	**-27.8**	**+5.0**

[13] Not including contributions to the state-funded pension scheme.

[14]According to the methodology of the ESA, social security contributions that are being transferred to the state-funded pension scheme, are not being accounted as the general government budget revenue.

The amount of social security contributions into the state special budget not only in 2014 but also in a medium term is substantially affected by a contribution rate into the state-funded pension scheme, which in 2014 is 4 %, but in 2015 will be increased to 5% and in 2016 to 6 per cent.

Table 6.7. Social Security Contributions to the State-Funded Pension Scheme

Period	Contribution rate	Forecasted social security contributions to the state funded pension scheme, million euros	Forecasted social security contributions to the state funded pension scheme, % of GDP
2014	4%	244.2	1.0%
2015	5%	298.3	1.1%
2016	6%	382.8	1.4%
2017	6%	427.4	1.4%

Tax on Natural Resources

In 2014, tax on natural resources is forecasted with the increase of 21.7 % compared to 2013.

As from 1 January 2014, new tax on natural resources objects were introduced – use of waters (flow) in hydrotechnical and fisheries objects, also in hydroelectric power stations whose total installed capacity is less than two megawatts, in reservoirs, fish farms and pond management (a rate of 0.00853 euros for 100 cubic metres water, flown through a hydrotechnical building) and fireworks (a rate of 5% of the total sum for the planned import volume of equipment which has been presented in the import licence issued by the Control Committee of Strategic Goods of the Republic of Latvia).

As from 1 January 2014, tax on natural resources rates were also increased:

- for extraction of natural resources;
- for waste disposal;
- for pollution of air and waters;
- for environmentally harmful goods;
- for depreciated vehicles;
- for packing of goods and products as well as for disposable dishes and tableware.

Table 6.8. Impact of the Most Substantial Changes in Tax Policy on the Revenue of Tax on Natural Resources, Million Euros

	2014
Imposition of tax on natural resources on small hydroelectric power stations (HPS)	+1.3
Imposition of tax on natural resources on advertising publications and materials, fireworks	+3.1
Increase in a tax on natural resources rate[15]	+2.6
Changes in the previously planned amendments - advertising publications and materials are not subject to the tax; a rate of 5% of the planned total sum for the import volumes of these equipment is applied to all fireworks, for gypsum the rate will be raised gradually, for small HPS the rate amounts to 0.00853 euros for 100 cubic metres water, flown through a hydrotechnical building	-3.8
Total impact of changes:	**+3.2**

[15] There are all positions included, for which the rate has been increased.

Subsidised Electricity Tax

According to the law 'Subsidised Electricity Tax Law', subsidised electricity tax has been introduced as of 1 January 2014.

The purpose of subsidised electricity tax is to restrict increase in the total energy price, thus, ensuring competitiveness of the national economy and not increasing the energy poverty of households as well as providing additional revenue to the state budget, what would allow to support financially the implementation of aid measures for energy users. Indirect purpose of subsidised electricity tax is to facilitate competitive generation of electricity from renewable energy resources and efficient co-generation, motivating energy generation in the most efficient way and ensuring that in the future only competitive technologies enter the market.

Subsidised electricity tax is imposed on the income gained from sold energy within the framework of mandatory procurement, from a received guaranteed payment for installed electrical capacity in a co-generation station or electric power station as well as from sold electricity that is being sold to public trader (to a licenced enterprise for transmission or distribution of electricity) according to editions of Section 40 of the Energy Law, effective from 6 October 1998 to 7 June 2005, and according to a procedure prescribed by the Cabinet.

There are three differential rates determined for subsidised electricity tax – 15% for natural gas stations, 10% for stations of renewable resources and 5% for stations providing thermal energy to centralised systems and whose subsidised electricity tax rate has a direct impact on the users of the final tariffs of thermal energy.

Table 6.9. Impact of the Most Substantial Changes in Tax Policy on the Revenue of Subsidised Electricity Tax, Million Euros

	2014
Introduction of subsidised electricity tax	+32.8
Total impact of changes:	**+32.8**

7. Sustainability of Public Finances

7.1. The Long-term Development Scenario of Public Finances

Sustainable public finances take a substantial role in economic growth in a long term. That means stable and predictable fiscal policy as well as solvency of the government. This, in turn, allows attracting financial resources to the state, including investments. Demographic changes, particularly increase in the number of the elderly population, may facilitate increase in public sector's expenditures in a long term. The initial budgetary position also affects the sustainability of public finances. In 2012, there were considerable changes made in the Latvian pension system, including a gradual increase in the retirement age, thus partially restricting a negative impact of population ageing on Latvia's public finances in a long term.

According to the Fiscal Sustainability Report 2012 by the EC, Latvia is evaluated as a country with a low risk as regards the sustainability of public finances. It should be noted that in the Sustainability Report for the previous year 2009, Latvia was ranked among countries with a high risk as regards the sustainability of public finances, mainly due to the initial budgetary position that has been considerably improved over the last years.

The EC in co-operation with the Member States (AWG), every three years works out long-term forecasts on public sector expenditure related to population ageing as well as evaluates the sustainability of public finances for each Member State. Long-term forecasts are based on demographic projections provided by the Eurostat, and on assumptions regarding economic growth and its determinatives in a long term. The long-term forecasts of public expenditures related to population ageing for all Member States are being included in the Ageing Report by the EC. This Stability Programme contains data also from the report for 2012 as the next report is expected to be published in spring 2015, when a new forecasting cycle comes to an end.

At the end of March 2014, the *Eurostat* published **demographic projections** *EUROPOP2013* and in comparison with *EUROPOP2010* there is larger increase in the total number of population forecasted. According to actual data, on 1 January 2013 the total number of Latvia's population was 2023.8 thousand and it is expected that in 2060 it will decrease by 30.9% or 625.3 thousand. It is forecasted that the number of working-age population (15-64) compared to 2013 will be less by 42.6% or 576.2 thousand in the year 2060. In turn, the number of inhabitants aged over 65 will increase by 4.0% or 15.3 thousand in 2060 compared to the year 2013. New demographic projections include population census of 2011 and these will be taken into account by the development of the next Ageing Report.

Economic growth is essential for providing sustainability. It is forecasted that demographic changes will affect the development of employment. It is expected that in a long-term, the level of participation in the labour market will increase and unemployment will decrease. This will allow to compensate partially the impact of decline in working-age population on employment. It is forecasted that in a long term, productivity will be a determinative factor for economic growth and it will be the basis of convergence in a long term.

According to the latest projections of the AWG, the proportion of public sector expenditure related to population ageing in GDP (including pensions, healthcare, long-term care and education) in 2060 compared to 2010 will decrease by 3.4 percentage points, reaching 15.1% of GDP. Decrease will be mainly determined by forecasted decline in the proportion of pension expenditure in GDP.

According to forecasts, in 2060 compared to 2010, the proportion of pension expenditure in GDP will decrease by 3.7 percentage points, reaching 6.0% of GDP. Expenditure on pensions will continue to increase in nominal terms. However, the forecasted growth rate of public sector expenditure on pensions will be moderate in nominal terms, what is explained by changes made in the Latvian pension system as well as by a long-term forecasted increase in pension expenditure from the state-funded pension scheme.

In 2012, there were amendments to the ‘Law On State Pensions’ made, providing for:

- gradual increase in the retirement age to 65 - as of 1 January 2014, annual increase every 3 months, reaching the retirement age of 65 as from 1 January 2025.
- along with an increase in the retirement age, an increase in the early retirement age as of 1 January 2014.
- increase in the minimum insurance period to 15 years for entitlement to the state old-age pension as from 1 January 2014 and to 20 years as of 1 January 2025.

In 2012, there were also amendments made to the Law On State-Funded Pensions, providing for more gradual increase in a contribution rate to II pillar of the pension system, i.e. 4% in 2013-2014, 5% in 2015 and 6% in 2016.

At the beginning of the year 2013, the Ministry of Welfare has developed new long-term pension expenditure forecasts, taking into account the changes approved in 2012. According to these forecasts, the proportion of pension expenditure in GDP compared to the forecasts published in the 2012 Ageing Report will be lower by 0.2 percentage points during a period from 2010 to 2050. This will be mainly determined by an increase of participation in the labour market and by a decrease in the number of recipients of old-age pension, what is explained by a gradual increase in the retirement age.

On 3 April 2014, the Saeima has adopted the law ‘Amendments to the “Law On State Pensions”’, according to which changes in the procedure for indexation of pensions have come into force, prescribing:

- to index as of 1 October 2014 state pensions or their part that does not exceed 285 euros, taking into account the actual consumer price index and 25% of real increment percent from an insurance contributions wage.
- to index hereafter once a year on 1 October state pensions or their part that does not exceed 50% of the average insurance contributions wage in the state for a previous calendar year (rounded-off to whole euros), taking into account the actual consumer price index and 25% of real increment percent from an insurance contributions wage.

The approved changes will be taken into account in the next Ageing Report.

A lower proportion in gross domestic product in 2060 will be also attributed to expenditure on education (by 0.7 percentage points), what mainly will be determined by long-term demographic trends. However, the proportion of expenditure on healthcare services in gross domestic product will increase in a long term by 0.7 percentage points, compared to the year 2010, amounting to 4.4% of GDP. The proportion of expenditure on long-term care in gross domestic product will increase by 0.3 percentage points, reaching 1.0% of GDP. This is explained by the fact that health and long-term care services are basically attributable to elderly population whose proportion will increase in a long term. Along with demographic changes, expenses on both health and long-term care may be affected by technological progress and economic development. It should be mentioned that there is a slight proportion (4% in 2010) of expenditure on long-term care in the total expenditure related to population ageing.

It should be noted that the year 2010 was used as a base year in long-term forecasts, what, taking into account consequences of the economic and financial crisis of 2008-2009, has also influenced the result of the long-term forecasts. In comparison with the long-term forecasts worked out in 2009, there are similar trends observable in expenditure.

7.2. State Guarantees

In 2013, according to the law ‘On the State Budget for 2013’, it was planned to issue guarantees on behalf of the State only for the implementation of student crediting (amounting to 8 977 500 lats (12 773 832 euros)) and study crediting (19 750 500 lats (28 102 430 euros)) programmes. Therefore, in 2013 there were guarantees issued on behalf of the State for the commitments of studies and students in the total amount of 8.8 million lats (12.5 million euros).

At the end of 2013, the remaining amount of the State guaranteed loans was 466 million lats (663.1 million euros) which, in comparison with the remaining amount of the State guaranteed loans at the end of 2012, has decreased by 66 million lats (93.9 million euros) (see Figure 7.1.).

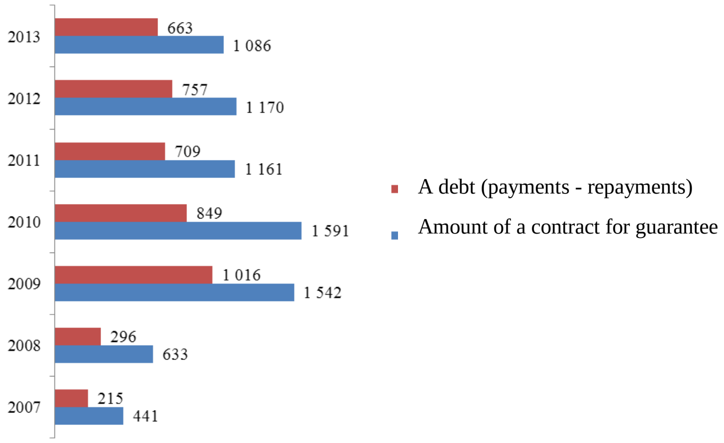

Figure 7.1. The Remaining Amount of State Guaranteed Loans at the End of a Corresponding Year (Million Euros)

In 2013, pursuant to concluded contracts for guarantee, the MoF has met commitments to UniCredit S.p.A on behalf of Liepājas Metalurgs PLC in an amount of 73.6 million euros as the borrower was not able to meet these commitments. The State entered into guarantee commitments already in 2009 in compliance with the law ‘On the State Budget for 2009’, anticipating the issue of the State guarantee for Liepājas Metalurgs PLC’s loan in order to implement a modernisation project of the steelworks.

On the basis of Cabinet Protocol Decision No 48 65.§ of 10 September 2013 ‘On the Inclusion of the List of Potentially Aided Applicants for the State Guarantee and Their Projects in the Draft Law “On the State Budget for 2014”’, there are State guarantees amounting to 40.9 million euros anticipated in the budget for 2014, inter alia for crediting of students in an amount of 12.8 million euros, for crediting of studies in an amount of 28.1 million euros.

Having evaluated during the preparation process of the draft law ‘On the State Budget for 2014’ information on the borrowers’ financial situation, previous credit history, the liquidity and amount of security as well as other available information, guarantees to 17 borrowers have been evaluated as relatively more risky, the largest part of them constitute guaranteed loans issued for the support of hospitals and the financial sector. On 31 December 2013, the outstanding remainder of guaranteed loans for the aforementioned borrowers constituted 49% of the total outstanding remainder of guaranteed loans. Taking into account the aforementioned evaluation, there is a possibility that the commitments of relatively risky State guaranteed loans or their part may not be met in the required time. Accordingly, in the law ‘On State Budget for

2014' the permissible limits of government's actions to cover expenditure that may occur in 2014, meeting the State guaranteed debt commitments attributable to the State budget, have been determined in an amount of 132.1 million euros (~0.5% of GDP).

Analysing an experience of other countries, potential recipients of state guarantees and purposes of guarantees as well as evaluating a risk rate and the security of state guarantees, the basic principles for the provision of State guarantees were determined during the improvement process of the State Guarantee Policy. These principles should be used in order to ensure an efficient use of the State guarantee as a support instrument, at the same time reducing the impact of this support instrument on the government debt and budget deficit. Accordingly, in 2013 there were amendments to the LBFM made, specifying the circle and purposes of potential recipients of the State guarantee, restricting the provision of State guarantees to private capital companies and prescribing that hereafter State guarantees are provided for projects that do not increase the government debt and budget deficit.

Continuing the improvement of the State Guarantee Policy, it is planned to replace the aforementioned provisions with a new regulation, anticipating more strict norms and introducing criteria for identification of an increased loan repayment risk, enhancing supervision of State guaranteed loans, increasing a responsibility of a line ministry for the implementation process of a draft business plan so that it complies with the achievement of the objectives stated in the policy planning documents of a corresponding line ministry. In the new regulation, it is also planned to determine actions when financial indicators of a business partner and a value of the subject of a commercial pledge become worse so that the maximum protection of the State interests is provided.

8. Institutional Features of Public Finances

8.1. Implementation of the Rules on the State Budget

On 31 January 2013, in the third reading the Saeima adopted the FDL, which came into force on 6 March 2013. Thus, it is ensured that as from the planning period of 2014-2016, the Framework Law and the Annual State Budget Law for 2014 is being worked out according to the conditions of the FDL, including the exceptional cases planned for a transitional period.

In addition to introducing strict fiscal conditions in medium-term planning, the FDL prescribes for introducing also a supervisory mechanism by means of which one may control whether the fiscal conditions determined by the law are being observed in the planning and execution of the Medium-Term Budget Law and the Annual State Budget Law. As of 2014, the Council, being an independent collegiate institution, has started its work in order to provide surveillance. On 19 December 2013, the Saeima approved a composition of the Council for six years – six members who are experts in fiscal policy from Latvia and other EU Members States.

The first session of the Council was held on 25 February 2014 during which the Council's internal regulations were approved, Chairperson of the Council and Deputy Chairperson were elected as well as a further model for the activity of the Council has been discussed.

The Council also prepared the first Non-Compliance Report in accordance with the FDL regulation and submitted the report to the Saeima, the Cabinet as well as published it on the home page of the MoF. The Non-Compliance Report was prepared about the draft law 'Amendments to the Law "On State Pensions"' submitted to the Saeima on 11 March 2014 because the adoption of such amendments would cause exceed of the budgetary balance objective prescribed by the Framework Law for 2015 as well as exceed of the level of the adjusted maximum permissible state budget expenditure, what is not related to specific cases prescribed by the FDL regulation which provide for the adjustment of expenditure ceilings stated in the Framework Law.

8.2. The Medium-term Budget Planning

Pursuant to the LBFM, the medium-term budget planning is a process during which the available resources for the medium term are determined and the expenditure of these resources is provided according to the priorities established by the government. The medium term – a three-year period comprising a financial year for which the State budget is planned and the subsequent two financial years.

As from 2007, the Framework has been prepared for the next three financial years, in which there is the analysis of the medium-term State macroeconomic situation presented as well as the objectives of the government fiscal policy for the medium term, the forecasts on the State budget revenue and the ceilings of the State budget total expenditure for each ministry and other central state institutions for the medium term. The Framework did not have legally binding nature; it only indicated the ceilings of the State budget total expenditure for the medium term. In order to strengthen the medium-term budget planning system, there have been corresponding amendments to the LBFM made and, from 1 January 2012, one has started to work out the Framework, which since 2007 has been approved by the Cabinet, in the form of a law like the Framework Law and it shall be approved by the Saeima. The achievable financial indicators, included in the Framework Law, have a legally binding force and the working out of the Annual State Budget Law and further working out of the Framework Laws shall be based on these indicators. The Framework Law is worked out every year for the next three-year period. Besides, for the first and the second year of each next period of the Framework Law, the indicators determined in the previous Framework Law are used, but the planned indicators for the third year are new.

The Framework Law, which is being associated with development planning documents, ensures the coherence of the available resources with the priorities of the government policy in the medium-term, and it complies with the fiscal rules prescribed by the FDL, providing for a transparent and responsible fiscal policy. The first year of the Framework Law's operation is being explored in detail in the Annual State Budget Law. According to the LBFM, in the Framework Law for each year of the Law's period one indicates the medium-term budget objectives and the priority course of development that is determined in the National Development Plan, as well as the formulation of the objectives of the government fiscal policy, the ceilings of the State budget total expenditure (also the total amount of expenditure for each budget sector), the forecasts on GDP, forecasts on the State budget revenue, the amount of the State budget financial balance (the maximum level of deficit or the minimum level of surplus). However, according to the FDL, other indicators also shall be indicated. For example, as from the year 2016, it is planned to supplement the content of the Framework Law with the fiscal safety reserve, the aim of which is to ensure the planned level, determined in the Framework Law for a particular year, of the general government budget balance in case of slight macroeconomic fluctuations and in case of covering the expenses caused by the quantifiable fiscal risks included in the declaration of fiscal risks.

Furthermore, as regards the medium-term objectives and initiatives, in the LBFM it is stated that ministries and other central state institutions prepare proposals for NPI if, according to the latest macroeconomic development forecasts, there will be resources available for the financing of NPI in the next corresponding financial years. The proposals for NPI are being prepared on the basis of the priorities and objectives defined in the National Development Plan, the State Defence Concept and other development planning documents, also taking into account a necessity to implement measures for strengthening the capacity of state-financed institutions (administrative capacities). The proposals are submitted in compliance with the schedule for the preparation and submission of the draft Medium-Term Budget Framework Law and the draft Annual State Budget Law.

Thus, the planning of public finances is being provided according to the defined course of development and priorities in the medium term. In order to substantiate the medium-term budget request, institutions annually plan and include in budget requests and budget amendment requests the results of budget programmes, which are planned pursuant to regulatory enactments on fundamental principles for the working-out and submission of budget requests.

According to the information prescribed in regulatory enactments, the explanations of the Framework Law for the medium-term period include the analysis of macroeconomic situation and a development scenario, a description of the measures to be implemented for the achievement of government fiscal policy objectives, a description of tax and non-tax revenue forecasts, the medium-term development trends of the government debt.

Adding of explanations to the Medium-Term Framework Law has started by a preparation of the draft law 'On the Medium-Term Budget Framework for 2014, 2015 and 2016' and explanations will be added also in subsequent years.

The first Framework Law has been worked out for the period of 2013 – 2015, and the Saeima approved it at the end of 2012. The LBFM prescribes that the Cabinet shall submit the draft Framework Law for three subsequent years to the Saeima until 15 May of a current year. However, as the new FDL has come into force from 31 January 2013 and one has to ensure complete and gradual implementation of its prescribed previsions, in new amendments to the LBFM there are transitional provisions planned regarding the year 2013 (a year of the FDL adoption), 2014 (a year of the Saeima elections) and 2015 (a year after the Saeima elections), stating that the corresponding draft Framework Laws shall be submitted to the Saeima together with the draft Annual State Budget Laws. Thus, on 1 October 2013, the Cabinet supported the draft Framework for 2014-2016 and the draft 'On the State Budget for 2014' and, on 7 November of a corresponding year, the Saeima approved it, however, in 2014 (in a year of the Saeima elections) pursuant to Section 21, Paragraph three of the LBFM – the draft Framework Law for 2015-2017 and the draft law 'On the State Budget for 2015' will be submitted to the Saeima not later than four months after the newly-formed Saima has expressed its trust to the Cabinet.

The medium-term budget planning and financial management is being implemented, observing the fiscal policy principles prescribed by the FDL.

8.3. Budget Procedures, Including Public Finance Statistical Management

8.3.1. Budget Procedures

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

When planning the expenditure of the State budget resources, the base expenditure initially is being calculated and harmonised. A calculation of the base expenditure and the principles of its coherence with the Framework Law is determined by Cabinet Regulation No 867 'Procedure for establishing ceilings on the total amount of the State budget expenditure and on the total amount of the State budget expenditure for each ministry and other central State institutions for the medium term" of 11.12.2012. Thus, the necessary amount of expenditure is determined in order to ensure execution of state functions at a constant level.

If the Cabinet has adopted a decision on NPI, the MoF when calculating ceilings of the total amount of the State budget expenditure, consisting of the State basic budget and the State special purpose budget and of the expenditure for development of the State basic budget and the State special purpose budget, relies on the Framework Law, forecasts on macroeconomic development as well as observes fiscal conditions that are determined in the state.

On the basis of the ceilings approved by the Cabinet on the total amount of expenditure for each budget sector, ministries and other central state institutions work out and submit budget requests to the MoF according to Cabinet Regulation No 523 'Regulation on Fundamental Principles for the Working-Out and Submission of Budget Requests' of 31 July 2012. Regulation prescribes uniform principles for the preparation of budget programmes, principles for a preparation of the requests of the State basic budget and the State special purpose budget as well as composition of a budget request.

In order to provide visualisation to a society showing which resources are involved in the implementation of the basic functions of the State and which – in the introduction of EU and other foreign policy instruments' activities, a budget is prepared according to the following sections:

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

2) the implementation of the projects and activities financed or co-financed by the EU policy instruments and other foreign financial aid.

Ministries and other central state institutions work out and submit state budget requests to the MoF according to the schedule for the working-out and submission of the Framework Law and the Draft Annual State Budget Law. Pursuant to the LBFV, Minister for Finance submits this schedule to the Cabinet.

During the preparation process of the Draft Annual State Budget Law, the following indicators are being evaluated as a whole and then presented in the State Budget Law:

- the State budget revenue divided according to the types of revenue (in the allocation among responsible ministries);
- the State budget expenditure divided according to programmes (sub-programmes) and the types of expenditure according to economic substance;
- a financial balance of the State budget;
- the government debt ceiling at the end of a financial year;
- the amount of guarantees to be issued on behalf of the State;
- total increase in State budget loans;
- the amount of State budget earmarked subsidies for local governments as well as the amount of the State budget subsidy for the local government equalisation fund;
- total increase of local governments' borrowings and total increase of the guarantees provided by local governments;
- other conditions, such as the contribution rate and contribution sum of the state funded pension scheme.

The explanations of the Draft Annual State Budget Law include the description of macroeconomic development scenario, fiscal review, analysis of revenue forecasts, the most substantial elements of the State budget expenditure planning, explanations of budget programmes, the State budget expenditure divided by functional, administrative and economic categories as well as information on the planned investment projects, information on state financial obligations (summary) and information on the amendments made to regulatory enactments within the package of draft budget laws. Budget explanations for each state basic budget or special purpose budget programme (sub-programme), included in the draft state budget law, are being prepared in a separate section, which contains information on the objectives of a programme (sub-programme), main activities and authorities, which will ensure the implementation of a programme (sub-programme), operating results and their performance indicators, additionally allocated funding for the implementation of NPI, financial indicators and changes in total expenditure. Explanations also contain information on the average number of staff positions and on remuneration in the budget sector.

During the preparation process of the Draft State Budget Law, negotiations between the LALRG and the MoF are being held, as a result of which the Draft Protocol is being prepared. In the Draft Protocol, there are questions included on financial resources for local governments' basic budget and special purpose budget, local governments financial equalisation, loans, guarantees and long-term obligations, an acquisition of the EU Structural Funds and the necessary funding to comply with the requirements stated in regulatory enactments. The Draft Protocol is submitted for consideration at the extended session of the Cabinet' Committee. A statement of agreement and disagreement between the LALRG and the Cabinet shall be mandatory attached to the next-year Draft Budget when the government submits it to the Saeima. The LBFM prescribes to negotiate with the LALRG also during the preparation process of the Draft Framework Law and to attach a result of the negotiations to the Draft Law in a form of a protocol.

In compliance with the Law 'On Local Government Budgets', local governments work out their budgets not later than within two months after a proclamation of the Annual State Budget Law.

The role of independent institutions (courts, the State Audit Office, Ombudsman and other) in the budget process has been strengthened. As from 2012, the LBFM prescribes that the Cabinet when preparing the Draft Framework Law and the Draft Annual State Budget Law shall hear the view of independent institutions about the financing sections of corresponding institutions, the opinion of the Cabinet shall be substantiated in case of a reduction of funding, and the results of the aforementioned negotiations shall be made known to legislative power in a form of protocols, attaching them to relevant draft laws.

If at the beginning of a financial year the Annual State Budget Law has not come into force, Minister for Finance approves the State budget expenditure, necessary for the functioning of the State, as well as loans and borrowing ceiling on condition that monthly expenditure does not exceed the twelfth part of the previous-year appropriation.

The Cabinet is entitled to determine additional conditions for the planning and execution of the State and local governments' budget in order to prevent and reduce increased fiscal, economic and social risks caused by macroeconomic processes and to ensure the fulfilment of fiscal criteria prescribed by international obligations.

8.3.2. Management of government finance statistics

CSB compiles government finance statistics which is calculated accordingly requirements of 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, 2013 in general government sector there were 1144 independent budgetary institution, of which 257 institution were in central government subsector; 887 institutions - in local government subsector and one institution - in social security fund subsection; moreover, there was 129 enterprise controlled and financed by central and local governments, of which 45 enterprises were controlled by central government, 84 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 defence; compulsory social security"), the unit is related to general government sector. Belonging to general government sector is determined by analysing data on financial activity provided in annual report. Data from reports of last five years is used for the analysis. If the condition fulfils 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 EU) three 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 carries out regular inter-institution working group meetings. Specialists from MoF, the Treasury and Ministry of Economy, as well as from the BoL are involved in the preparation of notification. If necessary additionally specialists from other institutions (the Ministry of Defence, the Ministry of Welfare, Riga City Council, etc.) are involved.

With government budget deficit and debt notification member countries of the EU inform EC 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 GDP at current prices must not exceed 3% and the ratio of the government debt to the GDP 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 MoF, 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").

8.4. Other Institutional Developments Regarding Public Finances

The FDL provides for establishing the general management system of fiscal risks, the purpose of which is to provide stability of fiscal indices in a medium term irrespective of changes caused by external factors as well as to reduce the impact of changes caused by external factors on fiscal indices in each year of the Framework Law period. General management of fiscal risks includes fiscal identification, the evaluation of their occurrence possibility and of a fiscal impact as well as development of corresponding measures for reducing or preventing fiscal risks.

The FDL provides that a declaration of fiscal risks will be attached to the draft Framework Law for 2015, 2016 and 2017. In the declaration, there will be fiscal risks identified, dividing them according to quantifiable and non-quantifiable risks. For quantifiable fiscal risks, there will be their occurrence possibility and fiscal impact determined. According to that, a fiscal security reserve will be calculated which shall not be less than 0.1 % of GDP. Preparing the Annual State Budget, the maximum permissible expenditure of the annual state budget will be reduced for the amount of a fiscal security reserve, thus decreasing a possibility that by an occurrence of fiscal risks, fiscal conditions of the FDL will be breached. When required, in order to compensate expenses caused by unquantifiable fiscal risks included in a declaration of fiscal risks and caused by the fiscal risks not included in the declaration and if their total amount exceeds 0.1% of GDP, the Cabinet works out proposals for reducing expenses in other expenditure items or for increasing revenue.

At the end of April, 2014, it is planned to approve Cabinet Regulation 'Regulation on General Management of Fiscal Risks and Methodology for Determining the Amount of Fiscal Security Reserve', providing for a division of fiscal risk management into three levels:

- general management of fiscal risks whereof the MoF is liable
- management of specific fiscal risks whereof central state institutions are liable
- management of particular fiscal risks whereof the executors of the projects and events financed by the state budget, the EU policy instruments and by other foreign financial aid are responsible as well as whereof executors of public and private partnership projects and the state commercial companies included in the general government sector are liable.

In compliance with the FDL, Cabinet Regulation also provides for summarising fiscal risks in the register of fiscal risks, which is one of the key instruments for general management of fiscal risks and which contains annually updated information. Every year, central state institutions are going to submit to the MoF reports on management of fiscal risks for both specific and particular fiscal risks in order to prepare a declaration of fiscal risks, which should be attached to the Framework Law.

Annexes

Table 1a. Growth and Its Factors

	ESA Code	2013	2013	2014	2015	2016	2017
		million euros	Growth %				
1. Real GDP (at prices of the year 2010)	B1*g	20983,1	4,1	4,0	4,0	4,0	4,0
2. Nominal GDP	B1*g	23315,5	5,6	5,7	6,9	6,6	6,6
Real GDP by Expenditure (at Prices of the Year 2010)							
3. Private consumption expenditure	P3	13415,9	5,4	5,1	4,6	4,0	3,9
4. Government consumption expenditure	P3	3494,1	3,6	2,5	2,5	2,5	2,5
5. Gross fixed capital formation	P51	4412,4	-4,3	3,8	5,0	5,7	5,8
6. Changes in inventories and net acquisition of valuables	P52+P 53	113,6	-26,2	0,0	0,0	0,0	0,0
7. Exports of goods and services	P6	12096,5	1,0	4,0	4,6	5,0	5,3
8. Imports of goods and services	P7	12553,5	-1,7	4,5	5,1	5,2	5,4
Contributions to real GDP growth							
9. Final domestic demand		-	2,4	4,4	4,4	4,2	4,1
10. Changes in inventories and net acquisition of valuables	P52+P 53	-	0,0	0,0	0,0	0,0	0,0
11. External balance of goods and services	B11	-	1,7	-0,4	-0,4	-0,2	-0,2

Table 1b. Price developments

	ESA Code	2013	2013	2014	2015	2016	2017
		Level	rate of change,%				
1. GDP deflator			1,4	1,6	2,8	2,5	2,5
2. Private consumption deflator			0,5	1,1	3,0	2,5	2,5
3. HICP			0,0	1,1	3,0	2,5	2,5
4. Public consumption deflator			1,3	2,0	2,0	2,0	2,0
5. Investment deflator			2,1	2,9	2,8	2,9	2,9
6. Export price deflator (goods and services)			1,3	2,0	2,0	2,0	2,0
7. Import price deflator (goods and services)			0,8	2,0	2,0	2,0	2,0

Table 1c. Labour market developments

	ESA Code	2013	2013	2014	2015	2016	2017
		Level	rate of change %				
1. Employment, persons		893,9	2,1	1,2	0,8	0,5	0,3
2. Employment, hours worked		1289793194	2,4	1,3	0,8	0,5	0,3
3. Unemployment rate (%)			11,9	10,5	9,7	9,0	8,7
4. Labour productivity, persons			2,0	3,1	3,5	3,4	3,6
5. Labour productivity, hours worked			1,6	3,1	3,5	3,4	3,6
6. Compensation of employees	D.1	9622,7	7,5	4,1	6,4	6,0	5,8
7. Compensation per employee		716,2	4,6	5,6	5,3	5,5	5,5

Table 1d. Sectoral balances

% of GDP	ESA Code	**2013**	**2014**	**2015**	**2016**	**2017**
1. Net lending/borrowing vis-à-vis the rest of the world	B.9	1,6%	1,2%	1,1%	0,8%	0,3%
of which:- Balance on goods and services		-1,9%	-2,2%	-2,5%	-2,6%	-2,6%
- Balance of primary incomes and transfer		1,0%	1,0%	0,9%	0,8%	0,6%
- Capital account		2,5%	2,0%	2,0%	2,0%	1,8%
2. Net lending/borrowing of the private sector	B.9	2,6%	2,2%	1,9%	1,5%	1,0%
3. Net lending/borrowing of general government	EDP B.9	-1,0%	-1,0%	-0,8%	-0,7%	-0,7%
4. Statistical discrepancy		*-0,8%*	*0,0%*	*0,0%*	*0,0%*	*0,0%*

Table 2a. General government budgetary prospects

		2013	2013	2014	2015	2016	2017
	ESA code	mln euros	% of GDP				
Net lending (EDP B.9) by sub-sector							
1. General government	S.13	-223,8	-1,0	-1,0	-0,8	-0,7	-0,7
2. Central government	S.1311	-29,6	-0,1	-1,4	-1,1	-1,2	-1,2
3. State government	S.1312						
4. Local government	S.1313	-121,9	-0,5	-0,3	-0,2	0,1	0,1
5. Social security funds	S.1314	-72,3	-0,3	0,7	0,4	0,4	0,5
General government (S.13)							
6. Total revenue	TR	8 194,4	35,1	33,9	32,0	30,9	30,1
7. Total expenditure	TE	8 418,2	36,1	34,9	32,8	31,6	30,8
8. Net lending/borrowing	EDP B.9	-223,8	-1,0	-1,0	-0,8	-0,7	-0,7
9. Interest expenditure	EDP D.41	388,2	1,7	1,6	1,2	1,2	1,1
10. Primary balance		164,4	0,7	0,6	0,4	0,5	0,4
11. One-off and other temporary measures							
Selected components of revenue							
12. Total taxes (12=12a+12b+12C)		4 493,1	19,3	19,2	18,8	18,3	18,1
12a. Taxes on production and imports	D.2	2 705,3	11,6	11,6	11,5	11,3	11,1
12b. Current taxes on income, wealth etc.	D.5	1 785,6	7,7	7,6	7,3	7,0	6,9
12c. Capital taxes	D.91	2,3	0,0	0,0	0,0	0,0	0,0
13. Social contributions	D.61	1 936,9	8,3	8,2	7,7	7,4	7,2
14. Property income	D.4	317,5	1,4	0,8	0,5	0,3	0,3
15. Other		1 446,9	6,2	5,6	4,9	4,8	4,5
16. Total revenue	TR	8 194,4	35,1	33,9	32,0	30,9	30,1
Tax burden (D.2+D.5+D.61+D.91 – D.995)		6 361,7	27,3	27,7	26,8	26,0	25,5
Selected components of expenditure							
17. Compensation of employees + intermediate consumption	D.1+P.2	3 629,5	15,6	15,7	14,9	13,9	13,1
17a. Compensation of employees	D.1	2 137,0	9,2	9,2	8,7	8,3	8,0
17b. Intermediate consumption	P.2	1 492,4	6,4	6,5	6,2	5,6	5,2
18. Social payments (18=18a+18b)		2 480,8	10,6	10,1	9,9	9,4	9,0
of which Unemployment benefits		74,3	0,3	0,3	0,3	0,3	0,3
18a. Social transfers through market producers	D.6311, D.63121, D.63131	249,1	1,1	1,0	1,0	0,9	0,9
18b. Social transfers which are no transfers in kind	D.62	2 231,6	9,6	9,1	8,9	8,5	8,1
19.=9. Interest expenditure	EDP D.41	388,2	1,7	1,6	1,2	1,2	1,1
20. Subsidies	D.3	144,3	0,6	0,6	0,6	0,6	0,7
21. Gross fixed capital formation	P.51	912,1	3,9	3,6	3,2	2,7	2,5
22. Capital transfers	D.9	101,4	0,4	0,1	0,0	0,0	0,0
23. Other		762,0	3,3	3,3	3,1	3,8	4,4
24.=7. Total expenditure	TE	8 418,2	36,1	34,9	32,8	31,6	30,8
Government consumption	P.3	3 842,4	16,5	16,8	16,0	14,9	14,2

Table 2b. No-policy change projections

	2013	2013	2014	2015	2016	2017
	mln euros	% of GDP				
1. Total revenue at unchanged policies	8 194,4	35,1	33,9	32,0	30,9	30,1
2. Total expenditure at unchanged policies	8 418,2	36,1	34,9	32,8	30,9	29,2

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

	2013	2013	2014	2015	2016	2017
	mln euros	% of GDP				
1. Expenditure on EU programmes fully matched by EU funds revenue	1100,5	4,7	4,6	4,1	3,8	3,6
2. Cyclical unemployment benefit expenditure	0,0	0,0	0,0	0,0	0,0	0,0
3. Effect of discretionary revenue measures	-58,0	-0,2	0,1	-0,2	-0,3	0,0
4. Revenue increases mandated by law	0,0	0,0	0,0	0,0	0,0	0,0

Table 3. General government expenditure by function

% of GDP	COFOG code	2012	2017
1. General public services	1	4,5	3,8
2. Defense	2	0,9	1,0
3. Public order and safety	3	1,8	1,5
4. Economic affairs	4	5,3	4,4
5. Environmental protection	5	0,7	0,6
6. Housing and community amenities	6	1,2	1,0
7. Health	7	3,9	3,2
8. Recreation, culture and religion	8	1,5	1,2
9. Education	9	5,5	4,6
10. Social protection	10	11,2	9,4
11. Total expenditure	TE	36,4	30,8

Table 4. General government debt developments and contributions to change in gross debt in 2013-2017

% of GDP	ESA code	**2013**	**2014**	**2015**	**2016**	**2017**
1. Gross debt		**38,1%**	**38,8%**	**32,9%**	**34,2%**	**31,3%**
2. Change in gross debt ratio		**-0,6%**	**2,9%**	**-3,2%**	**3,3%**	**-0,8%**
Contributions to change in gross debt						
3. Primary balance		**0,7%**	**0,6%**	**0,4%**	**0,5%**	**0,4%**
4. Interest expenditure	**EDP D.41**	**1,7%**	**1,6%**	**1,2%**	**1,2%**	**1,1%**
5. Stock-flow adjustment, *of which*		**-1,6%**	**1,8%**	**-4,0%**	**2,6%**	**-1,5%**
- Differences between cash and accruals*		-0,1%				
- Net accumulation of financial assets **		-1,6%				
of which: privatisation proceeds		*0,1%*				
- Valuation effects and other ***		0,1%				
Implicit interest rate on debt		**4,3%**	**4,4%**	**3,3%**	**3,8%**	**3,4%**
Other relevant variables						
6. Liquid financial assets		8,0%				
7. Net financial debt (7=1-6)		30,1%				
8. Debt amortization (existing bonds) since the end of the previous year		0,8%	1,8%	0,7%	0,9%	2,6%
9. Percentage of debt denominated in foreign currency		85,3%	27,3%	35,4%	38,1%	29,1%
10. Average maturity		4,06 years				
For information - in calculations used GDP data:						
Nominal GDP, mln euros		23315,5	24712,0	26502,7	28243,6	30100,7

According to the data of Table 3.A of the n**otification on** general **government budget deficit and debt in April 2014**:

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

** in the row "Net acquisition of financial assets",

*** in the row "Adjustments", except the data of the row "Difference between interest (EDP D.41) accrued (-) and paid (+)", and in the row "Statistical discrepancies".

Table 5. Cyclical development

% of GDP	ESA code	2013	2014	2015	2016	2017
1. Real GDP growth (%)	B1g	4,1	4,0	4,0	4,0	4,0
2. Net lending of general government	B.9	-1,0	-1,0	-0,8	-0,7	-0,7
3. Interest expenditure	D.41	1,7	1,6	1,2	1,2	1,1
4. One-off and other temporary measures						
5. Potential GDP growth (%)		2,5	3,3	3,8	4,1	4,2
contributions:						
- labour		-0,2	0,1	0,4	0,5	0,5
- capital		0,9	0,9	1,0	1,1	1,1
- total factor productivity		1,8	2,2	2,4	2,5	2,5
6. Output gap, % of potential GDP		-0,1	0,6	0,7	0,6	0,3
7. Cyclical budgetary component		0,0	0,2	0,2	0,2	0,1
8. Cyclically-adjusted balance (2-7)		-0,9	-1,2	-1,0	-0,9	-0,8
9. Cyclically-adjusted primary balance (8+3)		0,7	0,4	0,2	0,3	0,3
10. Structural balance (8-4)		-0,9	-1,2	-1,0	-0,9	-0,8

Table 6. Divergence from previous update

	ESA code	**2013**	**2014**	**2015**	**2016**	**2017**
Real GDP growth (%)	B1g					
2013		4,0	4,0	4,0	4,0	-
2014		4,1	4,0	4,0	4,0	4,0
Difference		0,1	0,0	0,0	0,0	-
General government net lending (% of GDP)	B.9					
2013		-1,1	-0,9	-0,9	-0,9	-
2014		-1,0	-1,0	-0,8	-0,7	-0,7
Difference		0,1	-0,1	0,1	0,2	-
General government gross debt (% of GDP)						
2013		44,5	41,0	36,4	34,6	-
2014		38,1	38,8	32,9	34,2	31,3
Difference		-6,4	-2,2	-3,5	-0,4	-

Table 7. Sustainability of public finances[16]

% of GDP	2010	2020	2030	2040	2050	2060
Total expenditure						
Of which: age-related expenditure	18,5	15,4	14,4	14,4	14,9	15,1
Pension expenditure	9,7	6,8	6,0	6,1	6,2	6,0
Social security pensions	9,7	6,8	6,0	6,1	6,2	6,0
Old-age and early pensions	8,7	6,1	5,4	5,6	5,8	5,6
Other pensions (disability, survivors)	1,0	0,7	0,6	0,5	0,5	0,4
Occupational pensions						
Health care expenditure	3,7	3,9	4,1	4,3	4,4	4,4
Long-term care expenditure	0,7	0,7	0,7	0,8	0,9	1,0
Education expenditure	4,4	4,0	3,6	3,2	3,4	3,7
Other age-related expenditure						
Interest expenditure						
Total revenue						
Of which: property income						
Of which: from pensions contributions[17]	6,9	8,9	8,9	9,1	9,0	8,9
Pension reserve fund assets						
Of which: consolidated public pension fund assets						
Social contributions diverted to mandatory private scheme	0,5	1,6	1,7	1,7	1,7	1,8
Pension expenditure paid by mandatory private scheme	0,0	0,1	0,3	0,8	1,8	2,9
Labor productivity growth	5,4	1,9	2,3	2,3	1,9	1,5
Real GDP growth	-0,3	2,1	2,1	1,4	0,3	0,5
Participation rate males (aged 20-64)	83,2	86,2	87,1	86,9	85,6	87,2
Participation rate females (aged 20-64)	76,7	80,3	82,3	82,5	81,9	83,7
Total participation rate (aged 20-64)	79,9	83,2	84,7	84,7	83,8	85,5
Unemployment rate (20-64)	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: AWG

Table 7a. Contingent liabilities

Mln euros	2013
Public guarantees[18]	**537,9**
Of which: linked to the financial sector	**241,0**
% of GDP	**2013**
Public guarantees	**2,3%**
Of which: linked to the financial sector	**1,0%**
GDP	**23 315,5**

[16] Source: AWG
[17] Including contributions to the State funded pension scheme.
[18] Central government and local guarantees

Table 8. Basic assumptions[19]

	2013	2014	2015	2016	2017
Short-term interest rate in eurozone (annual average)		0,3	0,4	0,4	0,4
Long-term interest rate in eurozone (annual average)		1,8	2,1	2,1	2,1
USD/€ exchange rate (annual average)	1,33	1,36	1,36	1,36	1,36
Nominal effective exchange rate	8,2	6,0	-0,1	0	0
World excluding EU, GDP growth	3,6	4,1	4,4	4,4	4,4
EU GDP growth	0,1	1,5	2,0	2,0	2,0
World export volumes, excluding EU	3,4	5,6	6,0	6,0	6,0
World import volumes, excluding EU	3,4	5,6	6,0	6,0	6,0
Oil prices (Brent, USD/barrel)	108,8	104,1	99,6	99,6	99,6

[19] Technical assumptions