2015

MINISTRY OF FINANCE
REPUBLIC OF LATVIA

Latvia’s Stability Programme for 2015-2018

RIGA, 2015

CONTENT

ABBREVIATIONS

AWG	*Economic Policy Committee's* Working Group on Ageing Populations and Sustainability of Public Finances
CSB	Central Statistical Bureau of Latvia
CIP	Corporate income tax
Cabinet	Cabinet of Ministers
Draft Protocol	Cabinet and LALRG Draft Protocol on Disputes and Agreements
EC	European Commission
ECB	European Central Bank
ESA	European System of Accounts
EU	European Union
Framework Law	Law on Medium-Term Budget Framework
FDI	Foreign direct investment
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
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
PYLL	Potential years of life lost
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
SGP	Stability and Growth Pact
SRS	State Revenue Service
USA	United States of America
VAT	Value Added Tax

1. OVERALL ECONOMIC POLICY GUIDELINES AND OBJECTIVES

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 SGP. 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.

In 2014 Latvia's growth was 2.4% of GDP. Economic growth became slower due to various internal and external factors, among which the most important is the escalation of the geopolitical situation, introduction of trade sanctions and the Russian economic recession. Despite the economic slowdown, Latvian GDP growth last year was one of the highest among EU Member States and 1.1 percentage points above the EU average growth rate.

The macroeconomic development scenario 2015–2018 is drafted on the basis of conservative assumptions about the increase in internal and external demand and takes into account both internal and external risks. In the medium term negative and positive risks of the macroeconomic development scenario are balanced, but in the short term negative risks dominate, the most significant being risks of the external environment, risks associated with the geopolitical situation in the region, recession in the Russian economy and weak economic growth in the euro area. At the same time, the macroeconomic scenario assumes that the sanctions imposed by Russia will be valid for one year from the date of their establishment.

MoF has reduced has reduced GDP growth forecasts for 2015 and 2016, provided that in 2015 GDP will grow by 2.1%, while in 2016 it will grow by 3.0%. In the medium term, as a result of declining external uncertainty, growth will once again be balanced between external and domestic demand. According to the forecasts of the MoF, Latvian GDP in 2017 and 2018 will increase by 3.6% per year.

Specific objectives of the Latvian fiscal policy 2016–2018 are:

- To provide responsible and sustainable fiscal policy in line with the fiscal discipline.
- To raise the quality of life of population.
- To ensure favourable environment for economic development.
- To ensure public defence capacity appropriate to geopolitical risks.

The overall objective of the Latvian fiscal policy does not change, and in 2016–2018 it is – to raise sustainably the quality of life of population. The quality of life 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. However, in this three-year period a new challenge has arisen – escalation of the geopolitical situation, which puts a different light on national security issues, creating the need to significantly increase funding for national defence.

In 2014, after a break of several years Latvia returned to euro financial markets since the Treasury organized two emissions of benchmark bonds in euro. In January 2014, 7-year bonds in amount of 1 billion euro were issued and in April there were 10-year bonds in amount of 1 billion euro issued. Eurobond emissions provided resources to cover the financing requirement and to repay part of funding received from the EC within the framework of the international loan programme (on March 25, 2014, part of the loan in amount of 1 billion euro was repaid to the EC and on January 16, 2015 the second part in amount of 1.2 billion euro was repaid). Both Eurobond emissions were made within the framework of the medium-term borrowing strategy, timely providing resources to cover the financing requirement, int.al. the largest central government debt obligations in terms of volume in 2014 and 2015. Economic growth, accession to the euro area, improved Latvia’s credit ratings, investors’ high assessment of the progress achieved in the Latvian economy in recent years, and trust in the Latvian long-term development allowed Latvia to borrow financial resources in international markets at favourable conditions.

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

2. ECONOMIC SITUATION

2.1. EXTERNAL ECONOMIC ENVIRONMENT

The global economy is still developing unevenly and overall global growth in 2014 reached 3.3% compared to 2013. Global economic development trends last year were determined by several global events – geopolitical instability in Ukraine and the Middle East, low economic growth in the euro area, as well as the sharp fall in oil prices in late 2014. Overall, global growth is slowly accelerating, but the growth rate is not as strong as expected.

Economic growth of the EU in 2014 reached 1.3%. Although still low, this growth rate is a step forward in comparison with previous years, when the EU GDP in 2012 dropped by 0.5% and in 2013 remained unchanged.

At the beginning of last year the level of confidence of EU consumers and businesses improved noticeably, signalling positive economic development trends, but in the second half of the year along with the escalation of the geopolitical conflict and sanctions imposed between the EU and Russia, confidence fell. This was also reflected in the dynamics of GDP, because at the end of 2014, growth was slightly weaker than at the beginning of the year. According to 2015 winter forecasts of the EC, the EU's economic growth rate will continue to improve, reaching a growth of 1.7% and 2.1% respectively in 2015 and 2016.

Russia's economic situation has been difficult already since 2013, but its vulnerability increased due to geopolitical tensions, thus last year Russia's GDP grew by only 0.6% and according to the EC forecasts Russia's economy will decline by 3.5% in 2015 and grow by only 0.2% in 2016. Russia's economy will be adversely affected by EU economic sanctions, decline in oil prices and depreciation of the ruble, resulting in a reduction of the Russian consumer purchasing power and demand for imported goods. This in turn adversely affected the exporting companies operating in the Russian market. In addition, in August 2014, Russia's trade embargo on certain agricultural and food products exacerbated even more the competition in the EU, causing also a negative impact on Latvia's export potential.

Economic development of the rest of the world is volatile and heterogeneous. For example, the USA is one of the few countries where economic growth has been stronger than expected, which is mainly affected by the sharp drop in energy prices. By contrast, in China the beginning of 2014 was marked by weak growth, in total the annual GDP growth rate declined to 7.4%. Meanwhile, in the Japanese economy in the middle of the last year there was even a decline, but as a whole, annual GDP growth reached only 0.4%. However, in these countries and the Asian region as a whole low oil prices will continues to contribute to growth, thus stimulating demand.

Table 2.1. GPD growth rates and forecasts, % compared to previous year[1]

	2013	2014	2015f	2016f
World	3.3	3.3	3.6	4.0
Euro area	-0.5	0.8	1.3	1.9
Germany	0.1	1.5	1.5	2.0
United Kingdom	1.7	2.6	2.6	2.4
USA	2.2	2.4	3.5	3.2
Japan	1.6	0.4	1.3	1.3
China	7.6	7.4	7.1	6.9

Rapid changes in oil prices, with a decrease by 44% during the period from early September 2014 until the end of December, had a positive effect on the EU countries, including Latvia, which are oil importers. Cheaper oil means lower production costs and more

[1] European Economic Forecast - Winter 2015, EC

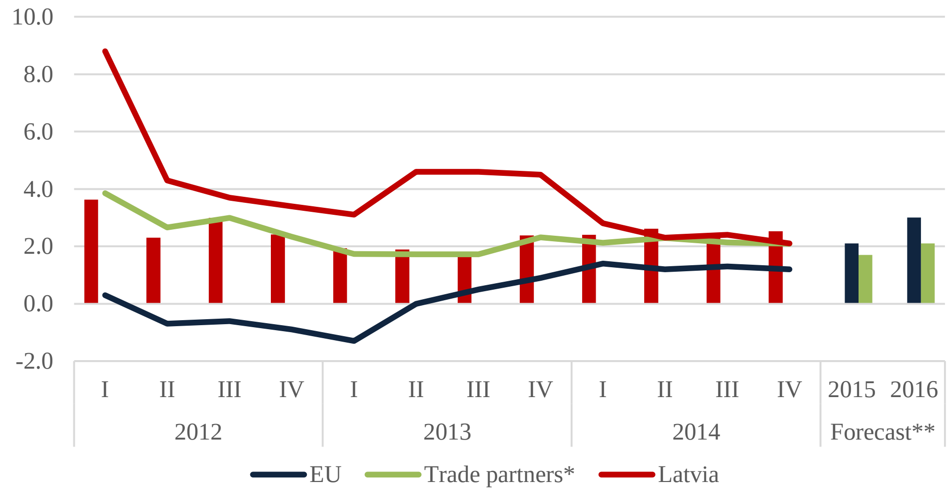
attractive fuel prices, thus contributing to the growth in private consumption. At the same time, these events reduce the inflation forecast for 2015, although the inflation rate in the EU is already very low. However, the oil-exporting countries, that are mainly developing countries, suffer losses due to the decline in oil prices because their budget revenue decrease significantly. In addition, the weaker economic situation in developing countries means a lower external demand in EU countries. Thus, changes in oil prices affect various countries of the world differently and will continue to emphasize regional differences.

However, despite different economic effects of oil prices on various regions, the forecasts of international financial institutions show that overall impact of the decline in oil prices on the global economy will be positive. For example, the IMF experts have calculated that the fall in oil prices by 60% in the period until 2019 will contribute to global GDP growth by about 0.3 to 0.8% in 2015 and 2016.2

Despite the positive impact of the decline in oil prices, at the beginning of the year the EC reduced its global growth forecast for 2015 from 3.8% to 3.6%, but for 2016 – from 4.1% to 4.0%. However, the euro area's GDP growth forecast, on the contrary, was revised upwards – by 0.2 percentage points to 1.3% and 1.9% respectively in 2015 and 2016. In addition to low oil prices, growth in the euro area will be facilitated by the implementation of the new EC investment plan, which aims to attract new public and private investment of at least 315 billion euro in the period until 2017.

Moreover, the ECB has extended its monetary stimulating measures including government securities on its asset acquisition programme as of March 2015 in order to prevent deflation and promote economic growth. Total volume of asset acquisitions will reach 60 billion euro per month, and the programme will run at least until the end of September 2016, in this way encouraging business and private lending, injecting additional funds in the economy and stimulating economic activity in the euro area. Also, depreciation of the euro against the US dollar will strengthen price competitiveness of the companies in the euro area and stimulate exports.

Weighted average economic growth of Latvia and its major trading partners at the end of 2014 was at the same level, at the same time exceeding the EU average, although the pace of growth rate dynamics indicates convergence of economic growth. Moreover, according to the forecasts in 2015 the total growth of the EU will exceed the growth of Latvia's trading partners, which can be explained by the negative GDP growth forecast for Russia.



[2] Data source: World Economic Outlook Update, January 20, 2015, IMF

Figure 2.1. GDP growth rates and forecasts of Latvia's partner countries[3] and the EU, %

At the same time it should be noted that the overall situation in the EU labour market is gradually improving and implemented structural reforms already provide results that despite the instability in the external environment and internal economic problems has a positive impact on region's growth in 2015.

2.2. CURRENT ECONOMIC DEVELOPMENT

After several years of strong economic growth, when the Latvian economy grew by 4-5% per annum between 2011 and 2013, in 2014 Latvian GDP growth rates slowed down, demonstrating 2.4% growth. Economic growth became slower due to various internal and external factors, among which the most important is the escalation of the geopolitical situation, introduction of trade sanctions and the Russian economic recession. Despite the economic slowdown, Latvian GDP growth last year was one of the highest among EU Member States and by 1.1 percentage points above the EU average growth rate.

During the post-crisis period, the Latvian economy was driven by exports and investment growth, however since 2013 the main engine of growth has become private consumption. Consequently, the industries that serve the domestic market are growing more rapid and make a greater contribution to total GDP growth. It should be noted that with the overall economic slowdown the private consumption growth in 2014 was significantly lower than in 2013.

Despite slower economic growth, in 2014 almost all sectors of the economy showed an increase, except for the real estate and industrial production. In view of the deterioration in the external environment, weaker growth has been observed in export-oriented industries. A decrease in industrial production by 0.9% was driven by the decline in electricity and gas supply, as well as manufacturing. Manufacturing output at the beginning of the year was still negatively affected by metal production due to JSC "Liepajas Metalurgs" idle standing, but in the second half of the year other manufacturing sub-sectors also encountered difficulties due to direct and indirect effects of the geopolitical conflict. Agriculture, despite last year's record high total yield of grain, registered an increase of only 1.8%. However, transport, in spite of the adverse external environment, last year showed growth of 3.2%, which is twice stronger than in 2013. The increase in cargo turnover in the port of Riga by 15.8% played the most important role in this growth, while the volume of rail freight increased by 2.2%.

In turn, the preconditions for growth in sectors serving the local market have been much more favourable, because construction, trade, financial and insurance activities have shown strong and stable growth. It should be noted that construction in 2014 was the fastest-growing sector of the economy (+ 8.1%), which, despite its not so large share, gave the largest contribution to the Latvian GDP growth in terms of value added. At the same time, trade grew by 2.2% and financial and insurance activities – by 4.7%.

Analysis of GDP from the expenditure side shows that, overall, in 2014 there was an increase in all components, but growth was mainly ensured by domestic consumption. Positive trends in the labour market as a result of declining unemployment and rising wages ensured households private consumption growth of 2.3% compared to 2013. Good growth rates were also maintained by public consumption, which last year showed a 3.6% rise.

[3] Average growth in Latvia's main external trading partners (Estonia, Lithuania, Russia, Germany, Poland, Sweden), weighted with the average export rate of particular country in 2014. Data source: Eurostat; European Economic Forecast - Winter 2015, EC; MoF calculations.

In view of the negative impact of the external environment, the slight increase in goods and services export volumes of 1.9% can be considered as good result. It should be noted that the main driver of exports in 2014 was the wood processing, which increased its export volumes by 8.1%. However, agricultural and food products, which has the largest share in good's exports, were exported 2.7% less during the year. In 2014, exports of goods to the third largest Latvian trade partner Russia decreased by 5.1%, but this is offset by growth in the export volumes to countries such as Lithuania, the United Kingdom, Spain, Sweden, the Czech Republic and Hungary. At the same time, imports of goods and services grew slightly slower than exports as a result of which last year goods and services foreign trade balance in Latvia improved and the trade balance showed a deficit of 3% of GDP.

In 2014 investment activity remained weak. Due to unsustainable external environment, investment in Latvia last year increased by only 1.6%. However, the dynamics of investment is not homogeneous. Investment in the manufacturing sector grew by 21.2%, driven by rapid growth of investment in the timber industry. Investment in transport and storage sector rose by 12.2%, while investment in the wholesale and retail trade sector grew by 29.7%. At the same time, the slowdown in investment was registered in electricity, gas and heating sector by 19.4%, which was affected by the completion of large investment projects carried out in 2013. For the second consecutive year, investment in the agricultural sector demonstrate a decrease of 18.4% compared to 2013, which is at least in part attributed to the Russian sanctions imposed in the EU agricultural sector.

The sanctions imposed by Russia and increasing geopolitical tensions in the region are the main negative factors affecting FDI in Latvia. In 2014 Latvia received FDI in amount of 355.2 million euro, which is less than half of the amount received in 2013. However, in mid-2014, a number of international rating agencies – Standard & Poor's, Moody's Investors Service and Fitch Ratings – once again raised Latvia's national credit rating and for the first time since the crisis it reached the above average risk level A. In the medium term it is a positive signal to foreign investors.

Investment in 2014 was also affected by the cautious lending policy of commercial banks, however, in comparison with previous years, the decline in the volume of the loan portfolio has slightly slowed down. Total amount of loans granted by Latvian commercial banks in 2014 decreased by 6.1%. Downward dynamics can be observed in both the resident business and resident households' portfolios, but non-resident loan portfolio increased by 4.1%. In 2014 the amount of loan portfolio of Latvian commercial banks declined by 37.9% or 8.9 billion euro compared to 2008, when the banks' loan portfolio reached its historical peak. In these years the volume of loans granted to residents decreased rapidly, hence the proportion of loans to non-residents in the total loan portfolio increased slightly, reaching 14%. The decline in the loan portfolio was determined also by smaller amount of new loans granted to residents – 1.3 billion euro in 2014, compared with 2.1 billion euro in 2013. If the amount of new loans granted to households even increased slightly, the amount of new loans granted to businesses, which make a higher proportion in the new loans portfolio, fall sharply.

Despite the economic slowdown, the labour market situation continues to show improvements. The proportion of jobseekers in 2014 decreased to 10.8% of the economically active population, which is the lowest level since 2008. Compared with the previous year, the unemployment rate decreased by 1.1 percentage points, but it is slower than in the previous three years. Last year, the registered unemployment rate continued to decline, forming 8.3% of the economically active population at the end of December 2014 – 1 percentage point less than at the end of 2013.

However, according to the labour force survey data, the number of employed population in 2014 decreased by 1% down to 884.6 thousand. This was determined by the methodological change and negative demographic trends because the proportion of the employed population has increased by 0.9 percentage points to 59.1% of the total population aged between 15-74 years. At the same time statistics on the occupied jobs shows that the number of employed persons, however, continued to increase slowly, and at the end of 2014, the number of occupied workplaces was about 0.7% higher than a year ago. The biggest job growth in 2014 was in the public sector, where the number of occupied workplaces during the year increased by 1.3%, while in the private sector the number of occupied workplaces grew by 0.4%.

During the whole 2014 average monthly gross wage continued rapid growth, and last year average gross wage increased by 6.8% to 765 euro, presenting a significantly steeper rise than in previous years. In contrary to previous years, the largest wage increase was in the private sector – by 7.4%, while public sector wages rose by 6.1%. In 2014, the most significant wage increase was in the real estate and the financial and insurance sector – by 11.0% and 9.8%, respectively, while the lowest increase was in arts, entertainment and recreation, as well as professional services sectors. Thanks to the low inflation and PIT reductions, real wage growth in 2014 was even faster than the gross wage rise and reached 8.0%.

In 2014, Cohesion Policy measures played an important role in boosting growth. The EU funds impact assessment shows that the positive impact of the Cohesion Policy on the dynamics of real GDP in 2014 amounted to 0.9 percentage points. In terms of sectors, the greatest stimulating impact of EU funds in 2014 was in the construction sector increasing the sector’s value added growth rate by 4.9 percentage points. It should be noted that last year the implementation of EU funded projects contributed to the increase in the average real wage by 0.9 percentage points, thus contributing to the increase in the private consumption growth rate by about one percentage point a year. Investment of EU funds also had positive effects on employment dynamics. Although the total number of employed persons in the economy fell last year, without the EU funds this fall would have been even greater, because in 2014 implementation of EU-funded projects stimulated the growth rate of the number of employed persons by an average of 0.3 percentage points.

Consumer price growth in 2014 remained weak mainly due to external factors. At the same time, inflation in Latvia was higher than the euro area average inflation rate. In 2014 consumer prices have risen by only 0.6%, while inflation in December fell to 0.2%. Commodity prices in 2014 decreased by 0.2%, while prices of services rose by 2.9%. Inflation decreased due to external factors – the rapid fall in oil prices at the end of the year and low prices of unprocessed food on world markets reduced imported inflation. By contrast, core inflation maintained a growing trend because the prices of services showed steady growth throughout the year, which is in accordance with the current Latvian economic development, as well as positive trends in the labour market.

Overall, the year 2014 in the Latvian economy is associated with challenges and risks in the external environment. The geopolitical conflict and its implications reduced economic growth last year, and will continue to have a negative impact on economic development trends in 2015.

2.3. Macroeconomic Development Scenario

The medium-term macroeconomic development scenario has been drafted in February 2015, based on 2014 Q4 GDP flash estimate and statistical information that was available by 11 February 2015. The macroeconomic development scenario includes technical updates for year 2014 after complete macro-economic data for 2014 had been received without changing the growth forecasts for the medium term.

The macroeconomic development scenario has been worked out by the MoF in consultation with experts of the Bank of Latvia, Ministry of Economics and commercial banks. The updated macroeconomic forecasts have been presented to the Fiscal Discipline Council.

The macroeconomic development scenario has been drafted based on the technical assumptions included in the EC 2015 winter forecasts. These assumptions anticipate that in 2015 the average oil price will be 53 dollars per barrel of Brent crude oil, while in 2016 it will be 61.5 dollars. It is also assumed that in the medium-term EUR/USD exchange rate will be 1.17.

The projections assume that slow but steady economic recovery will continue in the euro area and growth rates will gradually become faster in the medium-term approaching 1.5% – 2%. This will lead to increased demand for Latvian goods and services, which will contribute to the acceleration of economic growth in 2016 and 2017.

Given the changes in the external economic environment and actual growth rates for 2014, the MoF has reduced GDP growth forecasts for 2015 and 2016 if compared to 2015 budget forecasts. According to the MoF projections, in 2015 GDP will grow by 2.1%, while in 2016 it will grow by 3.0%. Due to external factors in the first half of 2015 economic growth will be slightly lower than in the second half of 2014.

It is expected that in comparison with the previous quarter, according to seasonally adjusted data, in the first two quarters of 2015 GDP will increase by 0.4% – 0.5%. The macroeconomic scenario assumes that the sanctions imposed by Russia will remain in place for one year from the date of their introduction, therefore in the second half of 2015 gradual acceleration of the growth rate is expected, which will be limited by the recession in Russia and the low value of the Russian ruble against the euro.

In the short term private consumption will continue to support economic growth, while investment in 2015 is expected to drop. Due to lower oil prices it is expected that Latvian trade conditions will improve and export price growth will exceed import price growth. In the medium term, as a result of declining external uncertainty, growth will once again be balanced between external and domestic demand. According to the forecasts of the MoF, Latvian GDP in 2017 and 2018 will increase by 3.6% per year.

Table 2.2. Growth and related factors

	ESA code	**2014**	**2014**	**2015**	**2016**	**2017**	**2018**
		mln euro	Growth %				
1. GDP at 2010 prices	B1*y	21333.4	2.4	2.1	3.0	3.6	3.6
2. GDP at current prices	B1*y	24058.1	3.6	3.3	5.0	6.2	6.2
GDP by expenditure at 2010 prices							
3. Private consumption	P3	13373.3	2.3	2.4	3.1	3.8	3.8
4. Government consumption	P3	3637.9	3.6	2.8	2.8	2.8	2.8
5. Gross fixed capital formation	P51	4751.4	1.6	-1.5	3.5	4.1	4.5
6. Changes in inventories and net acquisition of valuables	P52+ P53		-25.9	-0.4	0.8	1.0	1.1

7. Exports	P6	12242.2	1.9	0.8	4.0	4.5	5.0
8. Imports	P7	12882.0	1.5	0.0	4.2	4.6	5.3
Contribution to GDP growth							
9. Final domestic demand			2.4	1.6	3.2	3.7	3.8
10. Changes in inventories and net acquisition of valuables	P52+ P53		-0.3	0.0	0.0	0.0	0.0
11. External balance of goods and services	B11		0.2	0.5	-0.2	-0.2	-0.3

The development of private consumption in the medium term will be closely linked to developments in the labour market, where in the coming years more moderate wage growth is expected than in 2014. Similarly, in the medium term such a rapid increase in employment is not expected as in the period from 2011 to 2013, so the development of private consumption will be determined by the increase in productivity.

In addition to the dynamics of revenue of population, other important factors that may affect private consumption developments, are trends in lending and changes in consumer sentiment. When making forecasts it was assumed that in the next few years the lending policy of commercial banks will remain cautious. It is expected that the amount of household commitments will gradually stabilize, but its rapid growth is not expected. Also, the scenario does not foresee any major changes in consumer sentiment, which could affect the level of savings of citizens. Thus, the private consumption growth rate in the medium term will be relatively close to the general economic growth rate.

Geopolitical uncertainty, deteriorating economic situation in Russia and uncertain outlook in the euro area will continue to hinder the investment activity. Mutual sanctions between Russia and the EU will impact investment not only in the sectors affected by the sanctions, but also in other sectors of the economy, because further escalation of the situation, as well as the introduction of new sanctions cannot be excluded.

Due to external uncertainty entrepreneurs and investors have become more cautious with regard to the launch of new investment projects, therefore rapid investment growth in 2015 is not expected. However, a gradual improvement in the external environment and the current historically very high capacity utilization rates in manufacturing allow to project an increase in the investment growth rate in 2016–2018, when investment growth is expected to exceed overall economic growth rates. It should be noted that the prolonged low level of investment creates additional risks for growth, because the economic growth potential is reduced.

Development trends and scenario of the external sector

Negative effects of the last year's geopolitical turmoil can be seen quite vividly in balance of payments statistics. For several years, the current account recorded a deficit, but in 2014 for the first time in the post-crisis period net FDI inflow was not able to cover the current account deficit, which overall amounted to less than half of the current account deficit. Due to the decrease of EU funds inflow and Latvian's resident-owned corporate foreign income, as well as the higher contributions to the EU budget in 2014 the current account deficit increased to 749.1 million euro or 3.1% of GDP. Despite the fact that the deficit is increasing, the average three-year level of the current account (-2.9% of GDP) does not exceed the threshold of the EU early-warning mechanism (-4% of GDP) and is viewed as sustainable.

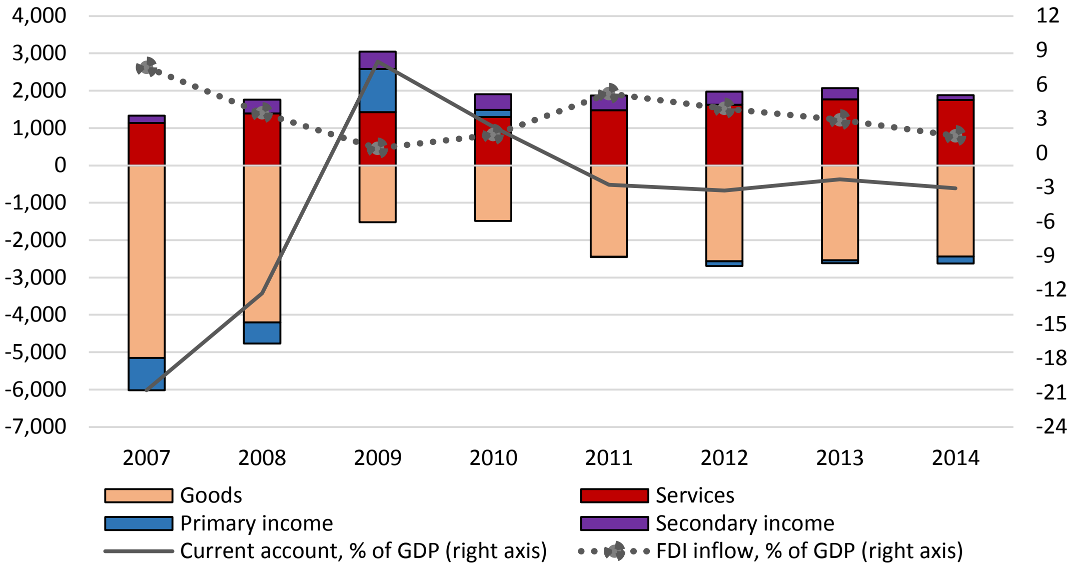


Figure 2.2. Current account of Latvia's balance of payments (mln EUR) and FDI

Since 2011, when the Latvian economy returned to growth the main changes in the current account were determined by the development of foreign trade of goods and services, but in 2014 significant changes were observed also in the income accounts. The most important factor in increasing deficit in the primary income account is associated with smaller inflow of EU funds. The primary income account was negatively affected also by deterioration in the external economic environment and weak growth in the euro area as a result of which foreign income of Latvian residents decreased.

It should be noted that EU funds are divided between a number of accounts of the balance of payments, so the declining surplus in the secondary income account can be explained also by the decrease in the amount of EU funds. In addition, the balance of the secondary income account was worsened also by increased contributions to the EU budget compared to the previous year. At the same time, in spite of decrease in total amount of EU funds, in the capital account the situation is opposite. The funds received directly from the ERDF and the Cohesion Fund contributed to the positive balance increase in the capital account.

Despite the rapid depreciation of the Russian rouble and weak economic development in the euro area, exports of Latvian goods in 2014 increased by 2.1% compared to 2013. Steady domestic demand, mainly in non-euro area countries – the UK, Sweden, Lithuania, allowed to compensate the fall in exports to Russia.

Reduction in the value of the euro against leading world currencies in the second half of 2014 only slightly improved export positions of Latvian goods and services making them more attractive in terms of price. A positive trend was observed in the British and the Turkish market but in relation to other major Latvian non-euro area trading partners, such as Poland, Sweden, Russia, the value of the euro either did not change or, on the contrary, it became even stronger.

In 2015 export growth will be closely linked to the region's economic and political development, as well as development of competitiveness of Latvian producers and opening of new markets. EC winter forecasts suggest that economic growth in EU countries remains low, however, in the medium term gradual increase of economic activity is expected.

A worse development scenario is observed on the eastern market. Russian sanctions are currently imposed until by the end of August 2015, which has fully suspended the export to Russia of goods that are subject to the sanctions. However, a greater negative impact on total export volumes will cause fluctuations in the Russian rouble exchange rate and recession in the Russian economy in 2015. Russia's economic downturn will cause an adverse effect also on other CIS countries, and it will affect Latvia's export opportunities in these countries. Given these factors, in 2015 a decrease of 0.5% of goods and services export at current prices is prijected, while in 2016 a 5% increase is expected.

The uncertainty in the external environment, weak investment activity and low oil prices will reduce the volume of imports in the short term run. However, given the high level of capacity utilization in manufacturing, as well as the growing internal demand and demand at the EU level, in the medium term an increase in the amount of investment is projected to increase the production capacity. In addition, the situation in the labour market will continue to improve gradually, which, together with low inflation rate, will determine the actual purchasing power and consumption growth. Consumer goods account for about a quarter of total imports, thus growing consumption will stimulate an increase in imports as a whole. Based on the above assumptions, it is expected that imports of goods and services at current prices in 2015 will decrease by 2%, but in 2016 it will increase by 5.2%.

Inflation

Changes in consumer prices in 2015 will be determined by the same factors as in 2014, and inflation will be mainly influenced by external factors. Changes in consumer prices in 2015 will remain at a low level, and they will be affected by the decrease in global energy and food prices, as well as certain one-off factors – an increase in electricity prices as a result of the electricity market liberalization and an increase in public transport prices.

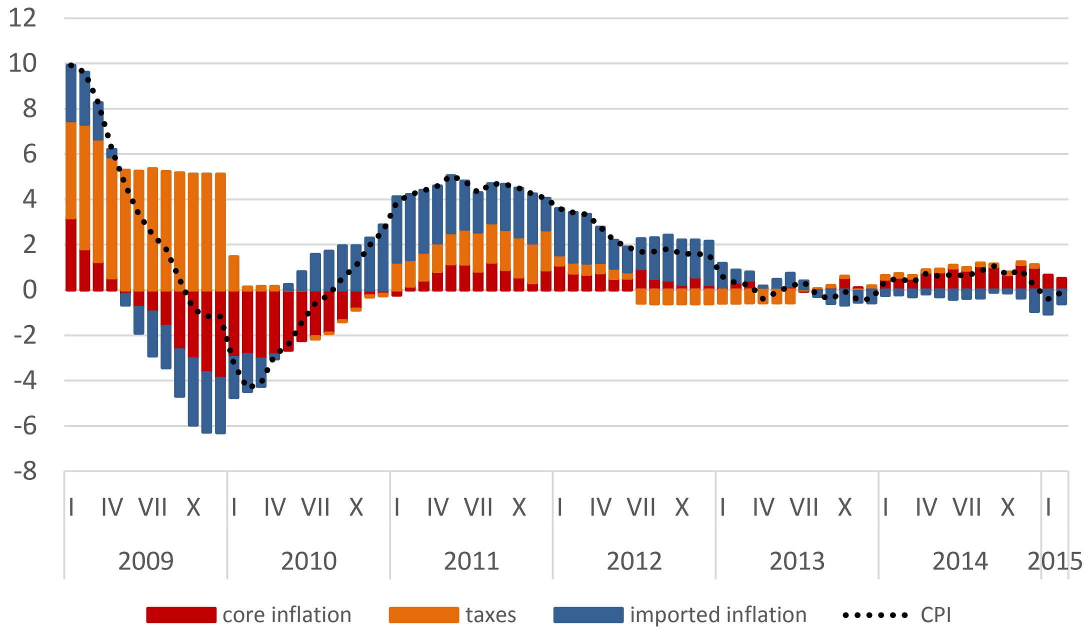


Figure 2.3. Annual inflation according to a source of origin, %

According to the MoF forecasts, in 2015 consumer prices will increase on average by 0.4%, while in 2016 – by 1.9%. The sharp fall in energy prices at the end of 2014 has already significantly reduced the fuel price, however, the global oil price drop will be completely reflected in consumer prices only in the second half of 2015. It will be determined by both the delayed reflection of the fall in energy price in heat tariffs and the time required for lower producer prices to affect consumer prices.

Forecasts of macroeconomic indicators for the Stability Programme are made on the basis of the technical assumptions of EC winter forecasts, which foresee a gradual increase in oil prices from the average of 53 USD per barrel of Brent crude oil in 2015 to 61.5 next year, while the EUR/USD exchange rate will be 1.17. Thus, as of 2016 increase in energy and food prices will become positive.

According to the contract signed up by JSC "Latvijas Gaze", the purchase price of natural gas from Russia and natural gas tariffs in Latvia depend on the prices of oil products (fuel oil and diesel fuel) on the world stock exchanges, which are calculated according to the quotation of fuel oil and diesel fuel in previous 9 months. Thus, if oil prices remain at current levels or even slightly increase, in Latvia heat prices will continue to fall until the second half of this year.

Inflation in 2015 will be affected also by the liberalization of electricity market as of January 1, 2015 which has already increased inflation by 0.88 percentage points. Also as of February 1, 2015, public transport fares in Riga increased, thus the average price level increased by about 0.2 percentage points. However, in the coming years rapid food and oil price changes are not forecasted, so the increase in consumer prices will be determined by the core inflation.

It is expected that together with further reduction in unemployment and wage growth core inflation will rise from 1.2% in 2014 to 2.9% in 2017. But the total increase in consumer prices over the medium term is expected at 2.5%, determined by the balanced economic development and convergence of the Latvian economy to the EU average.

Labour market

As the economic growth has slowed down slightly, improvements in the labour market in 2014 have become slower but still continues. Job seekers rate according to the labour force survey in 2014 has fallen to 10.8%, which is 1.1 percentage points less than in 2013 and the lowest since 2008. However, the decline in unemployment has been slower than in the previous year, when the job seekers rate decreased by 3.1 percentage points.

The fact that the labour market situation continued to improve in 2014 is proved also by the participation rate and employment rate. In 2014 the proportion of economically active population against all working-age population has increased to 66.3% compared with 66.0% in the previous year. This together with the changes in the age structure also shows that people's chances of finding a job have improved in recent years. The number of people who have lost hope of finding a job and become inactive has been steadily declining since 2010, and the share of such people in all economically inactive population has diminished.

At the same time, the increase in the number of employed persons in 2014 practically stopped, which was determined by both slower economic growth and total decrease in the number of people of working age. According to the labour force survey results, which were inter alia affected by the changes in methodology, the total number of employed persons in Latvia in 2014 decreased by 1.0% to 884.6 thousand. In turn, the SRS data on the number of employees shows that the number of working persons in 2014 continued to increase, but at a substantially slower pace than in previous years. The number of employees last year increased on average by 0.7%, while in the previous two years, the increase was higher 1.7% and 3.2% respectively.

By sectors, the largest job creators in 2014 were information technology, health and social care, as well as accommodation and food services sectors, where the number of occupied workplaces at the end of 2014 was respectively 8.5%, 6.7% and 4.8% higher than a year ago, and the total number of employees in these sectors during the year increased by 7.5 thousand.

It is expected that in 2015 the number of employed persons in the economy will not change, but in the next three years it is expected that growth will be slightly higher, respectively by 0.2% in 2016 and 0.4% in 2017 and 2018.

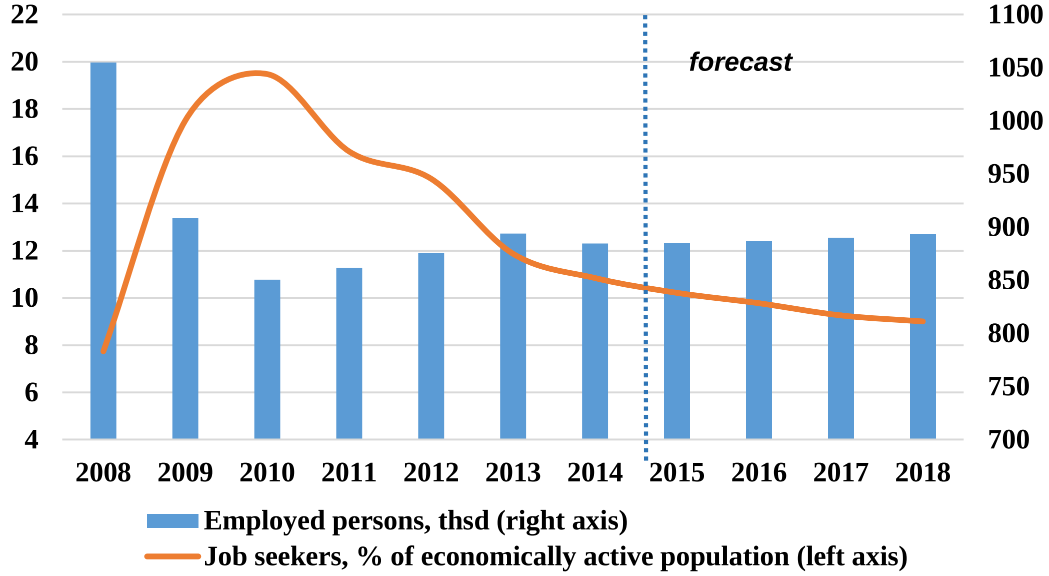


Figure 2.4. Employment and unemployment in 2008–2018

In the short term the decline in employment growth is caused by the economic slow-down and growing external risks, as a result, employers have become more cautious in hiring new employees. However, in the medium term, a more substantial role in the employment growth will be played by supply side factors as demographic situation and structural unemployment.

Declining birth rates in the nineties of the last century mean that in the next few years much smaller number of people will enter the labour market than it has been in previous years. As a result, the number of people in retirement age in the coming years will exceed substantially the number of young people entering the labour market. In addition, in recent years, the unemployment rate has decreased significantly compared with the crisis peak, and the most demanded job seekers on the labour market have already been employed. Thus, there is an increasing skills and regional mismatch on the labour market. Due to these factors economic growth in the future will increasingly rely on productivity growth, while the employment growth impact will be relatively minor.

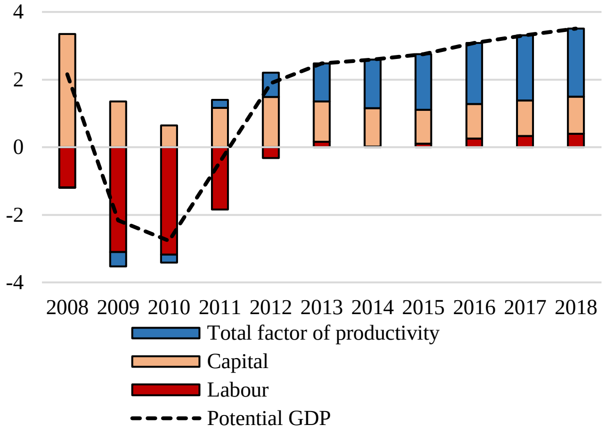
The unemployment rate will continue to decline gradually, however, due to economic growth and demographic factors it is expected that economic activity of the population will also rise, as a result, the unemployment rate will decline only gradually from 10.2% in 2015 to 9.0% in 2018.

Over the past two years, the real wage growth exceeded productivity growth, however, it is related to the very low level of inflation, which increases the purchasing power of wages, and the rapid growth of the economy in recent years, which improved companies' financial performance and provided resources for wage increases. However, these are short-term factors and it is expected that in the medium term wage growth will be determined by the increase in productivity, which is an essential prerequisite for the competitiveness of Latvia.

Cyclical development of economy

According to calculations by the MoF, potential GDP growth in the medium term will be around 3-3.5%, mainly determined by total productivity growth. Since 2013 the contribution of labour force to potential GDP growth remains low, but increasingly positive. Faster employment growth will be limited by relatively high structural unemployment and demographic challenges. It is expected that in the coming years economic growth will be close to its potential level. This year and next year there will be a negative output gap – respectively 0.1% and 0.3%, while the medium-term output gap will be neutral.

Average real GDP growth between 1996 and 2014 was about 4.5%. It is slightly – about one percentage point – higher than the MoF estimate of medium-term potential GDP growth. Compared with the previous year's Stability Programme and the 2015 budget plan, the MoF has reduced the potential GDP growth estimate from 4.1% to 3.3% in the medium term, while for 2015 it was reduced from 4.1% to 2.8%. Potential growth forecasts have been adjusted due to negative effects of increasing external geopolitical risks on medium-term economic growth forecasts and resulting lower levels of investment expected.



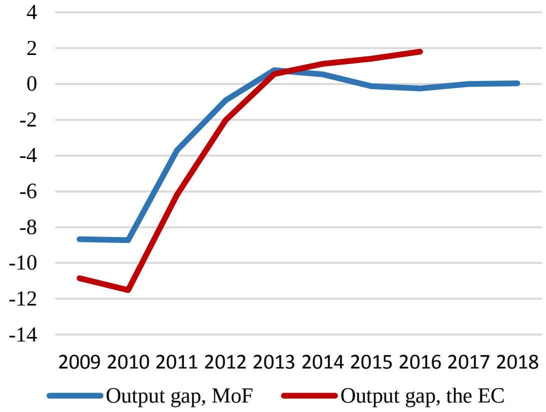


Figure 2.5. Potential GDP and the output gap

Although EC 2015 winter forecasts indicate that in the medium-term in Latvia the output gap will be positive (in 2015 – 1.4%, in 2016 – 1.8%), but neither the actual macroeconomic indicators, nor current forecasts prove it. Inflation in Latvia is low and close to the EU average, while in the medium term run inflation will comply with balanced economic development rates. The labour market situation continues to improve slowly, the net external debt to GDP ratio continues to fall. Wage increase in 2014 is related to positive economic growth rates in previous years and further wage convergence towards the EU average. It should be noted that in Latvia the wage share of GDP is significantly below the EU average, therefore a short-term wage increase over productivity does not prove overheating of the economy.

Based on the macroeconomic scenario it cannot be concluded that the Latvian economy starts to overheat, as provided in the EC calculations of the output gap. It should be noted that in accordance with the Alert mechanism report no macroeconomic imbalances have been identified, which could point to possible signs of economic overheating. In addition, the IMF estimates show that the output gap in the medium term will be very close to zero.

Taking into account the aforementioned factors, we believe that the EC output gap estimates do not reflect the actual economic situation in Latvia.

3. General Government Budget Balance and Debt

3.1. Current Fiscal Situation

According to the estimate performed by the MoF in January 2015, the general government budget nominal deficit in 2014 reached 1.4% of GDP or 339.8 million euro, an increase of 0.4 percentage points or 85.6 million euro more than planned in the Latvia's Stability Programme of the previous cycle. This deviation is mainly based on a one-off capital transfer to settle central government's liabilities towards the European Bank for Reconstruction and Development. Dynamically a deficit increase is also observed in relation to the results of 2013 when the general government net borrowing amounted to only 0.9% of GDP or 199.6 million euro.

In 2014 there was nominal revenue and expenditure growth. During the year general government budget revenue increased by 4.0%, while expenditure – by 5.6%. At the same time relatively to economic growth last year revenue remained close to the 2013 level, reaching 35.0% of GDP. In turn, redistributed resources through general government expenditure increased by 0.7 percentage points and accounted for 36.4% of GDP.

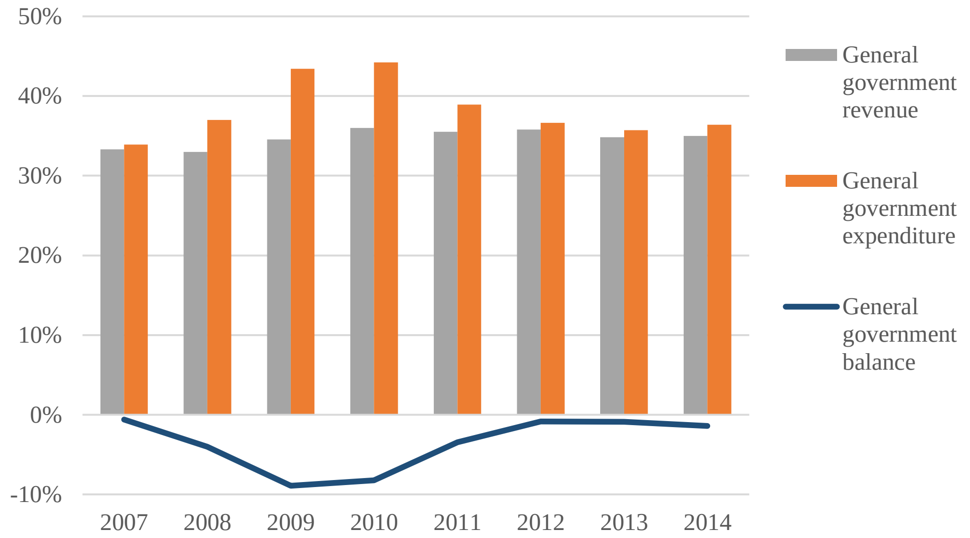


Figure 3.1. Revenue, expenditure and balance[4] of the general government, % of GDP

The situation in tax revenue in 2014 reflected economic developments, and as the growth slowed down, the tax revenue growth rate as a whole has become slower. However, the negative impact of the economic situation was mitigated by the measures introduced to make the tax administration more effective. With the average wage growth, which contributed to the increase in retail trade turnover, the biggest increase in revenue in 2014 was ensured by VAT, as well as revenue from PIT. Despite the fact that the social security contribution rate was reduced by 1 percentage point as of 2014, this type of tax revenue last year also increased.

Increase in the general government expenditure last year was ensured in equivalent proportions by higher remuneration expenditure and more intensive current transfers to EU funds beneficiaries. Increase in total expenditure was affected at a comparatively smaller extent by more active formation of gross fixed capital as well as higher social benefit payments.

[4] Data source: Notification on the General Government Budget Deficit and Debt in October 2014 (2007–2013) and Indicative Estimate of the MoF for 2014.

The assessment of contribution by general government sub-sectors to the overall fiscal balance shows that over the past year the central government deficit increased significantly. If in 2013 the central government revenue and expenditure was close to balanced, last year expenditure exceeded revenue by 1.7% of GDP. Diametrically opposite dynamics is observed in the other two sub-sectors, in particular in the social security fund, which last year ensured the shift from the deficit of 2013 to a fiscal surplus of 0.4% of GDP. Rapid improvement of the situation in the social security funds was facilitated by the fact that as of 2014 the central government through transfers finances supplementary pension payments from the social security fund. However, with regard to the local government sub-sector – steps towards a balanced budget were facilitated by virtually constant level of expenditure in combination with the above mentioned growing revenue from PIT.

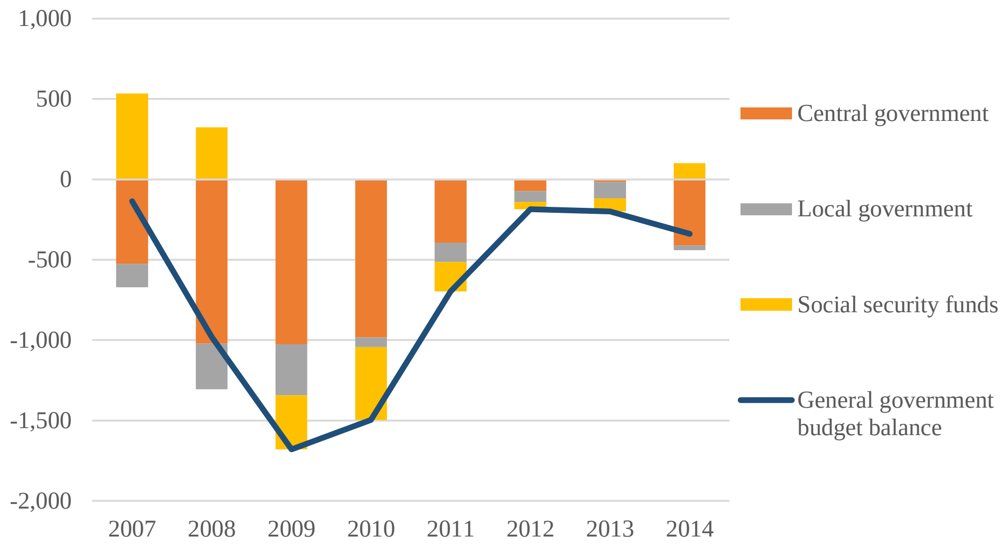


Figure 3.2. Budgetary balance of the general government by sub-sectors[5], million euro

3.2. Fiscal Policy Strategy and Medium-Term Objective

The fiscal policy strategy of Latvia is based on a condition of a balanced budget during the economic cycle or a condition that the structural deficit in the 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 budget balance*.

This method allows to set the objectives of structural balance for each year so that these objectives comply with the conditions of the SGP 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 budget balance* applied according to which the general government budget balance is forecasted **in case of an immutable policy**. The general government budget balance is also forecasted in compliance with this method.

[5] Data source: Notification on the General Government Budget Deficit and Debt in October 2014 (2007–2013) and Indicative Assessment of the MoF for 2014.

In a general case, budget balances differ according to both methods. If pursuant to the first method, a budget 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 budget balance is lesser than by the second method, the government shall carry out consolidation measures, taking discretionary measures for reducing expenditure or increasing revenue.

Taking into account that Latvia has successfully overcome the crisis and for several years now 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 reached its MTO, the previous Convergence Programme for 2013–2016 showed positive fiscal space.

In Latvia, the key decisions of budget policy, affecting expenditure and revenue medium-term policy, are not taken in spring, but in autumn along with the Annual State Budget Law. During this time, not only the Annual State Budget Law is being 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, substantial decisions on fiscal policy are being adopted which fill all the fiscal space of 2015 and provide basis for implementing the strategy of this particular Stability Programme.

Medium-term Objective

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

Objectives of Structural Balance for 2016, 2017 and 2018

When setting objectives of structural balance, a multi-stage method is being applied.

At first, MTO is taken as a point of reference (two scenarios are developed – one with the national MTO, and another with the MTO in the meaning of the SGP) and then deviations are being applied, which result from the increase in contributions to the second pension pillar. The result achieved is further adjusted with the deviations provided in the European Commission (EC) communication on making the best use of the flexibility within the existing rules of the SGP.

As already mentioned, in the previous Stability Programme, it was established that two different MTOs will be introduced in the Latvian fiscal policy. The aim of this approach was to create a safety reserve to ensure that the defined objectives of the structural balance are consistent not only with the national approach, but also to ensure compliance with the SGP conditions when the output gap is recalculated according to the EC standardized methodology.

The above mentioned safety reserve ensures that the structural balance objective is met until the moment when the difference of the cyclical component of balance, calculated according to national and EC standardized methodology, does not exceed 0.5%. During the development of this Stability Programme the difference exceed this limit and, therefore for setting the structural balance objective a more complicated method is used.

In this Stability Programme structural balance objectives for the medium term are set according to the principle providing for compliance with fiscal conditions in line with both the national methodology, the EC standardized methodology, regardless of the differences in the balance cyclical component caused by different methodologies. Similarly, the principles are reviewed for determining deviations from the MTO as regards the increase in contributions to the second pension pillar, as well as deviations for structural reforms are provided according to the EC communication on better application of flexibility of current SGP regulation.

The following sections give a more detailed description of the algorithm for determining structural balance objectives.

Balance objectives according to SGP methodology

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

Table 3.1. Structural balance objective according to the SGP approach

		2013	2014	2015	2016	2017	2018	2019
MTO		-1.00%	-1.00%	-1.00%	-1.00%	-1.00%	-1.00%	-1.00%
Permissible deviation	from 2% to 4%	-0.50%	-0.50%	-0.50%	0.00%			
	from 4% to 5%			-0.27%	-0.27%	-0.27%	0.00%	
	from 5% to 6%				-0.29%	-0.29%	-0.29%	0.00%
New deviations		-1.50%	-1.50%	-1.77%	**-1.56%**	**-1.40%**	**-1.29%**	**-1.00%**
Structural reforms					**-0.24%**	**0.00%**	**-0.11%**	**-0.40%**
Structural balance		-1.50%	-1.50%	-1.77%	-1.80%	-1.40%	-1.40%	-1.40%
Maximum structural balance		-1.80%	-1.80%	-1.80%	-1.80%	-1.40%	-1.40%	-1.40%
Cyclical component			0.40%	0.50%	0.70%	0.50%	0.20%	0.00%
Cyclically-adjusted		-1.50%	-1.10%	-1.27%	-1.10%	-0.90%	-1.20%	-1.40%
One-off measures			-0.30%		-0.30%	-0.40%	-0.50%	-0.25%
Nominal balance		-1.50%	-1.40%	-1.27%	-1.40%	-1.30%	-1.70%	-1.65%

With regard to the deviation model resulting from the increase in contributions to the second pension pillar, Latvia retains a similar principle as in the previous Stability Programme. The increase in contributions to the second pension pillar will be still 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). Changes affect the quantitative amount of deviations by years. Previously, it was expected that the amount of deviations in three years would decrease gradually. Since the SGP regulation does not provide for such condition and the EC does not provide for such condition in its regulation, this year in the Latvian Stability Programme the amount of deviations in three years remains the same as it was in the first year and the deviation is fully eliminated in the fourth year.

If MTO is summed up with the permissible amount of deviations the interim result of the structural balance objective is calculated, which is respectively -1.56% of GDP in 2016, -1.40% of GDP in 2017, and -1.29% of GDP in 2018. After that it is verified if the calculated interim result provides a sufficient safety margin with respect to the deficit reference value which is set in 2016 at 1.8%[6] of GDP in structural terms, according to the EC calculations, while in 2017 and 2018 it is 1.4% of GDP in structural terms, according to MoF estimates (see the footnote).

The verification concluded that a distance of 0.24% of GDP in 2016, 0.0% of GDP in 2017, and 0.11% of GDP in 2018 is maintained to the reference value of the deficit. The differences obtained are used as additional deviations from MTO, justifying them with the reforms in the health sector (see detailed description of the reforms in section “Fiscally Significant Structural Reforms in the Meaning of Regulation No 1175/2011”) according to the EC communication on better application of flexibility of current SGP regulation to structural reforms.

After the structural balance is determined, nominal balance should be calculated in the light of the EC estimated cyclical component of the balance and one-off measures in the defence sector (see section “One-off measures”). The result is a nominal balance -1.4% of GDP in 2016, - 1.3% of GDP in 2017, and - 1.7% of GDP in 2018.

Balance objectives according to national methodology

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

Table 3.2. Structural balance objective according to the national methodology

		2013	2014	2015	2016	2017	2018	2019
MTO		-0.50%	-0.50%	-0.50%	-0.50%	-0.50%	-0.50%	-0.50%
Permissible deviation	from 2% to 4%	-0.50%	-0.50%	-0.50%	0.00%			
	from 4% to 5%			-0.27%	-0.27%	-0.27%	0.00%	
	from 5% to 6%				-0.29%	-0.29%	-0.29%	0.00%
New deviation		-1.00%	-1.00%	-1.27%	**-1.06%**	**-1.06%**	**-0.79%**	**-0.50%**
Structural reforms					**-0.50%**	**-0.34%**	**-0.50%**	**-0.50%**
MTBFL SB objective		-1.30%	-1.00%	-1.00%	-1.56%	-1.40%	-1.29%	
Structural balance		-1.20%	-1.40%	-1.40%	-1.56%	-1.40%	-1.29%	-1.00%
Cumulative deviation		0.10%	-0.30%	-0.70%				
Maximum structural balance		-1.80%	-1.80%	-1.80%	-1.80%	-1.40%	-1.40%	-1.40%
Cyclical component		0.30%	0.20%	0.00%	-0.10%	0.00%	0.00%	
Cyclically-adjusted		-0.90%	-1.20%	-1.40%	-1.66%	-1.40%	-1.29%	-1.00%
One-off measures			-0.30%		-0.30%	-0.40%	-0.50%	-0.25%
Nominal balance		-0.90%	-1.50%	-1.40%	-1.96%	-1.80%	-1.79%	-1.25%

[6] The SGP 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 No 1175/2011, any deviation shall not exceed this safety margin, consequently, for Latvia any cumulative deviation from MTO shall not allow a structural deficit exceeding 1.8% of GDP. This number is calculated multiplying absolute value of the “typical” output gap with semi-elasticity coefficient and deducting the result from the Maastricht criteria’ limit of 3%. It should be noted that the semi-elasticity coefficient has be revised and in case of Latvia increased from 0.28 to 0.38. Because of this, in view of the fact that the value of the “typical” output gap does not change, the security reserve should decrease from 1.8% to 1.4%. According to the information available to Latvia, in 2015 the EC does not plan to revise the amount of the security reserve, therefore in 2016 the security reserve will remain at 1.8%. However, in line with prudent policy Latvia assumes that in 2016 the security reserve could be revised applying the new semi-elasticity coefficient, therefore in 2017 and 2018 the new security reserve of 1.4% is used.

The deviation model resulting from the increase in contributions to the second pension pillar is the same as for determining the structural balance objective according to the SGP methodology. The initial structural balance objective (interim result), if MTO is summed up with the permissible amount of deviations, is -1.06% of GDP in 2016, and -0.79% of GDP 2017 and 2018.

After that it is verified if the calculated interim result provides a sufficient safety margin with respect to the deficit reference value which is determined similarly to the SGP methodology – 1.8% of GDP in 2016, and 1.4% in 2017 and 2018.

Verification concluded that a distance of 0.74% of GDP in 2016, 0.34% of GDP in 2017, and 0.61% of GDP in 2018 is maintained to the reference value of the deficit. The differences obtained could be used as additional deviations from MTO, justifying them with the reforms in the health sector (see detailed description of the reforms in section "Fiscally Significant Structural Reforms in the Meaning of Regulation No 1175/2011") according to the EC communication on better application of flexibility of current SGP regulation to structural reforms. However, according to the EC communication deviations for structural reforms could not exceed 0.5% of GDP. Therefore in 2016 maximum deviation for structural reforms is 0.5%, in 2017 – 0.34%, and in 2018 – 0.5%.

Thus, the structural balance according to the national methodology in 2016, 2017 and 2018 is respectively -1.56%, -1.40% and -1.29%.

After that, when the structural balance to be used in following calculations is determined, the nominal amount of the balance should be calculated. In the calculations the cyclical component calculated by the MoF is used, as well as one-off measures in the defence sector are taken into account. Thus the nominal balance in 2016 is -1.96% of GDP, in 2017 – 1.80% of GDP, in 2018 – 1.79% of GDP.

The choice of structural objectives

When structural balance objectives are determined and the nominal balance is calculated according to both methods, the results are compared in nominal terms and the largest nominal value of balance is chosen in order to ensure compliance with fiscal rules according to both the national methodology and the SGP approach. Once the largest nominal balance value is determined, the balance is converted in structural terms (using the cyclical component according to MoF estimates). Accordingly, resulting structural balance objectives are: **-1.0% of GDP in 2016, 0.9% of GDP in 2017, and -1.2% of GDP in 2018.**

It should be noted that in all three years stricter rules are set by SGP rather than the FDL. Therefore, we can say that the structural balance objective is determined so that when the cyclical component of the balance is recalculated according to the EC single methodology, the structural balance corresponds to the permissible maximum structural deficit.

Table 3.3. Choice of the structural objective

	2013	2014	2015	2016	2017	2018
1. Nominal balance (according to SGP approach)	-1.50%	-1.40%	-1.27%	-1.40%	-1.30%	-1.70%
2. Nominal balance (according to national methodology)	-0.90%	-1.50%	-1.40%	-1.96%	-1.80%	-1.79%
Max (1;2)				-1.40%	-1.30%	-1.70%
Cyclical component (LV methodology)				-0.10%	0.00%	0.00%
One-off expenditure (additional expenditure for defence)				-0.30%	-0.40%	-0.50%
Structural balance objective (LV methodology)				**-1.0%**	**-0.9%**	**-1.2%**

The above mentioned calculation determined a structural balance that complies with the balance rule.

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

It should be noted that when structural balance objectives are checked in accordance with the **expenditure growth rule**, nominal expenditure adjustments are subject to MoF forecasts of public debt servicing expenditure, investment expenditure, expenditure for foreign financial assistance projects which match the received revenue from foreign financial assistance, discretionary revenue, as well as inflation and potential GDP growth rates. It should be noted that discretionary revenue is also adjusted by the increase in contributions to the second pension pillar, the effect arising from the possibility to apply deviations from MTO for the implemented structural reforms according to the EC communication on better application of flexibility of current SGP regulation to structural reforms, as well as the discretionary effect resulting from one-off expenditure in the defence sector. The last two conditions are essential for the expenditure growth condition to properly take into account permissible deviations.

When the determined structural balance objectives are verified in accordance with the expenditure growth rule, we obtain that in 2016 expenditure growth, which is allowed by the expenditure growth rule according to the potential GDP growth, in 2016 is 2.69%, while the previously determined structural balance objective states that actual adjusted expenditure should be reduced by 0.9%. Consequently, in 2016 the initial structural balance goal of -1.0% of GDP is maintained.

In 2017, expenditure allowed by the expenditure growth rule in accordance with the potential GDP growth rate is 3.12%, while the adjusted actual expenditure growth allowed by the previously determined structural balance rule is 3.16%. Consequently, in 2017 the initially determined structural balance objective is slightly adjusted, but as a result of rounding the structural balance objective of -0.9% of GDP is maintained.

In 2018, expenditure allowed by the expenditure growth rule in accordance with the potential GDP growth rate is 3.32%, while the adjusted actual expenditure growth allowed by the previously determined structural balance objective is 3.09%. Consequently, in 2018 the initially determined structural balance objective is -1.2% of GDP.

Following the verification of the rule of expenditure inheritance, it was found that taking into account the 0.1% limit in all years of the Stability Programme the inheritance rule is replaced with the re-calculated structural balance objectives.

Therefore, fiscal objectives for the next three years have been set, namely, to maintain the general government structural balance at **-1.0% of GDP in 2016, -0.9% of GDP in 2017, and -1.2% of GDP in 2018.**

One-off measures

The State Defence Financing Law, which was promulgated on July 10, 2014, provides for certain level of defence funding as a percentage of GDP, namely, 1% of GDP in 2015, 1.1% of GDP in 2016, 1.3% of GDP 2017, 1.5% of GDP in 2018, 1.75% of GDP in 2019, and 2.0% of GDP in 2020, anticipating to maintain 2.0% of GDP in following years. The defence funding increase stipulated in this Law is in line with the NATO Wales Summit Declaration on gradual increase in the defence funding up to 2% during the decade. This increase in expenditure is considered to be appropriate in standard security situations. Therefore, the amount of funding provided in the Law for respective years has already been taken into account in the Law on the Medium-Term Budget Framework 2015, 2016 and 2017.

However, given the significant increase in safety risks in Latvia in the context of the military conflict in Ukraine, as well as serious unannounced manoeuvres of Russian air and sea military technique near the Latvian border, Latvia should immediately ensure the protection capacity corresponding to the new security risks. Thus, the Latvian Stability Programme provides in 2016–2019 additional funding for defence in amount of 0.3%; 0.4%; 0.5% and 0.25% above the level set in the State Defence Financing Law. Thus it is ensured that the funding in amount of 2% is reached already in 2018.

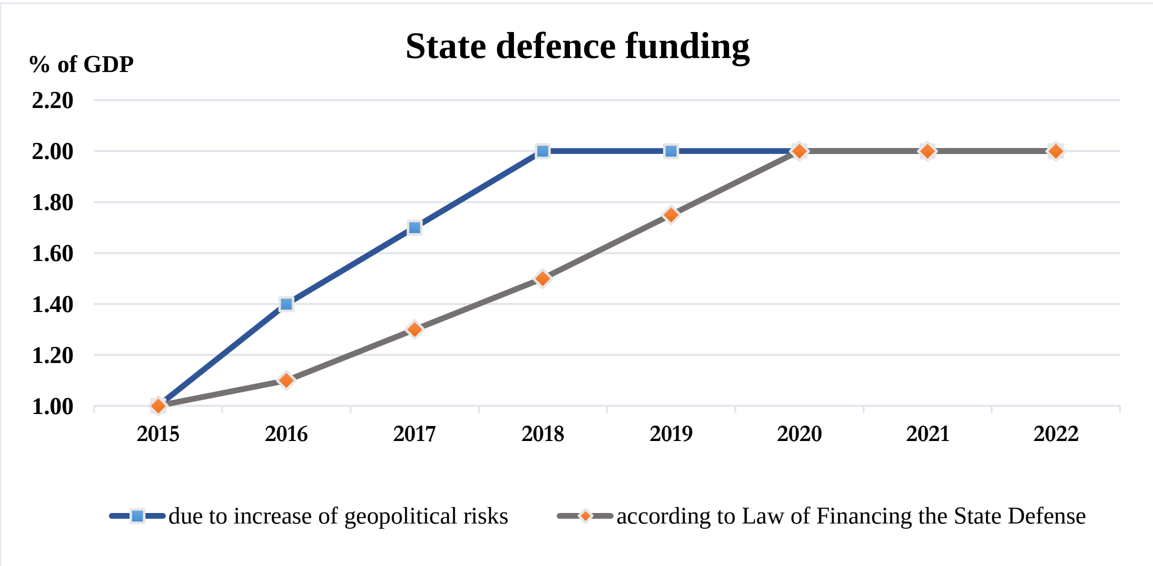


Figure 3.3. State defence funding, % of GDP

Latvia believes that additional defence funding should be considered as a one-off measure.

Latvia takes into account EC general considerations that the deficit-increasing one-off measures shall not be supported as a rule, because when the Council in 2005 decided on the exclusion of one-off measures from the structural effort estimates it wanted to reduce national efforts to carry out consolidation measures with one-off revenue-increasing measures and it had no intention to pave the way for deficit-increasing measures. At the same time, deficit-increasing measures are not excluded *a priori*. It would not be correct because the structural deficit parameter should comprise only structural measures and filter one-off measures, if there is reasonable assurance that one-off measures are not put as structural measures.

In a situation when the security situation has drastically changed, government's action to rapidly increase defence capabilities should be regarded as an act which is as important as the efforts to save the financial sector from the economic crisis by means of the state budget. The consequences of inaction would be as significant as in case of the banking crisis. Therefore, Latvia considers that the EC approach to consider as of 2008/2009 bank rescue expenditure as one-off deficit-increasing measures is adequate behaviour according to the situation at that time, and now the action should be similar in response to the radical changes in the security situation.

We believe that also at the technical level there are important arguments to considered additional defence expenditure as one-off measures.

1. Additional expenditure is associated with the response to unforeseeable events, and the response cannot be delayed.
2. Expenditure has a major fiscal impact. Additionally needed financing causes major fiscal impact on the state budget in each given year, as well as cumulatively 1.45% of GDP over the next four years.
3. There is no risk that one-off expenditure will become permanent expenditure. Since additional expenditure, by definition, is expenditure that exceeds expenditure provided for in the State Defence Financing Law, in 2020 and subsequent years expenditure growth will be zero, regardless of how well the state will comply with the expenditure conditions set in the State Defence Financing Law.
4. Expenditure refers to a short period of time. Although the expenditure period is four years and thus it exceeds the EC set maximum period of three years, the number of years is not specified neither in SGP regulations, nor in the documents approved by the Council, so compliance with the short-term criterion should be assessed individually, taking into account the nature of the measure. It is also noteworthy that in 2019 the amount of the one-off measure is significantly smaller than in previous years.

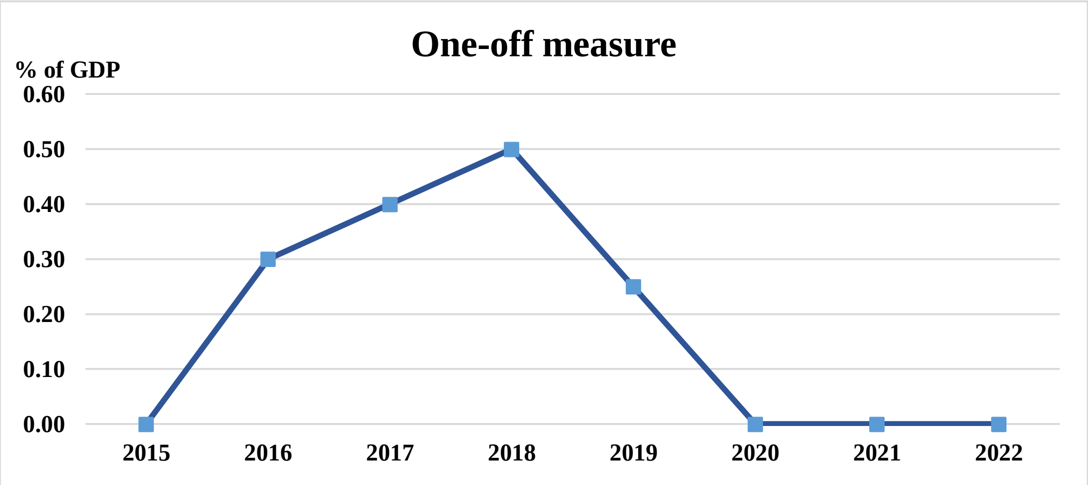


Figure 3.4. One-off measure, % of GDP

The Objectives and Key Measures of Fiscal Policy

The overall objective of the Latvian fiscal policy does not change, and in 2016–2018 it is – <u>to raise sustainably the quality of life of population.</u>

The quality of life 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 objective of fiscal policy emphasises sustainability. A sustainable increase in the quality of life means that public financial resources are being shifted not only to current measures for improving the quality of life, but also that public resources in 2015–2017 are being planned and allocated in a manner that provides conditions for the state to be able to raise the quality of life in the long term. 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 the deficit; second, by shifting public resources to create favourable environment for economic development.

However, in this three-year period a new challenge has arisen – war in Ukraine and increased Russian military presence near the Latvian border, which puts a different light on national security issues. The need to guard against the risks to national continuity requires a rapid and significant increase in the national defence funding, which cannot be done with the projected increase in tax revenue. In this situation, it is justified that in order to strengthen national defence capabilities current generation acts decisively and create expenditure financed at expense of future generations.

From the above mentioned it follows that specific objectives of the Latvian fiscal policy 2016–2018 are:

1. To provide responsible and sustainable fiscal policy in line with the fiscal discipline.
2. To raise the quality of life of population.
3. To ensure favourable environment for economic development.
4. To ensure public defence capacity appropriate to geopolitical risks.

The overall objective and specific objectives of Latvian fiscal policy are directly linked to NDP 2020 and create necessary fiscal conditions in order to put into practice the vision of NDP 2020[7]:

"The Latvian State was established to exercise the right of self-determination of the Latvian people. Latvia is open and welcoming to residents of all ethnicities that accept the meaning of the existence of Latvia: the development of the Latvian nation, its language and culture in its own land. In 2020, Latvia will be a country that is Latvian in character and self-confident, secure and resident-friendly, green and well-tended, prosperous, effective and competitive – and a home to industrious, well-educated, creative, healthy and happy people."

For the implementation of **the first specific objective of fiscal policy** a legal framework (FDL) and institutions (Fiscal Discipline Council) have been establishment. In

[7] NDP 2014-2020 [5].

2016–2018, changes are not expected and during this time it is essential to ensure implementation.

As regards **the second specific objective of fiscal policy,** there are now or in the next few years there will be a number of factors that can significantly impede achievement of the above mentioned objective.

In the context of the quality of life of population it is justified to analyse the average quality of life of population and differences in the quality of life between people with different income levels. An important indicator for the assessment of the average quality of life, is GDP per capita, which in Latvia is one of the lowest in the EU, while the Gini coefficient, which characterizes the income inequality, in Latvia is one of the highest in the EU.

Already in the Law on the Medium-term Budget Framework 2014, 2015 and 2016 a number of key measures were incorporated to reduce income inequality of population, such as an increase in the non-taxable minimum, increase in PIT allowances for dependents, improvements in the state social assistance system, as well as channelling part of subsidized energy tax revenue to low income households to offset the rise in electricity costs due to the abolition of the starting rate since the electricity market was opened. In addition to previously implemented government's policy, additional measures were incorporated in the Law on the Medium-term Budget Framework 2015, 2016 and 2017 to continue current policy direction levelling out income inequality – in 2015, to reduce income and social inequality the minimum wage was increased from 320 to 360 euro, with an aim to increase it gradually up to half of the average wage in the economy, as well as to introduce in 2016 a progressive non-taxable minimum, increasing it for small wage earners, maintaining it close to current level for average wage earners, while excluding the wages that exceed significantly the average salary in the country.

Quality of life is determined not only by GDP per capita and income inequality, but also by other factors, including **public health** and leisure. From this point of view, in order to increase budget expenditure for culture and health in the Law on the Medium-term Budget Framework 2014, 2015 and 2016 and the Law on the Medium-term Budget Framework 2015, 2016 and 2017 a significant increase in funding for these sectors, especially health, is provided. It should be noted that, according to the classification of the functions of government (COFOG), funding for the government function "health" of GDP in Latvia is one of the lowest in the EU, and it will be the task of following medium-term budget frameworks to increase it.

Reform of the health system is an essential element both for improving the quality of life of citizens and increasing national growth potential. Reform of the health system is one of the most important structural reforms in Latvia and for the implementation of this reform it is planned to use the SGP clause on structural reforms (see subsection "Reform of the Health System").

The third specific objective of fiscal policy – to ensure favourable environment for economic development, is essential not only to ensure a stable foundation for sustainability of the quality of life, but also to create **an immediate effect** on the quality of life increasing employment and personal income. One of the most important fiscal measures in the Law on the Medium-term Budget Framework 2014, 2015 and 2016 was the reduction of labour taxes, namely, reduction of the PIT rate in the medium term, as well as reduction of employer's and employee's mandatory social insurance contribution rate in 2014. The Law on the Medium-term Budget Framework 2015, 2016 and 2017 intends to continue the PIT rate reduction strategy in the medium term.

Well-arranged infrastructure is an important factor for the quality of life and economic development. Country's economic crisis has caused an adverse effect on the condition of roads. Although substantial EU funds are invested to improve roads, the condition of roads is not satisfactory. According to the World Economic Forum (WEF) Global Competitiveness Report[8], in terms of the quality of roads Latvia is ranked 108 among 144 countries of the world, which is a fall by 9 points in comparison with the previous report. In order to solve the current road quality issue, in the Law on the Medium-term Budget Framework 2015, 2016 and 2017, similarly to the Law on the Medium-term Budget Framework 2014, 2015 and 2016, extra funding was provided to improve the quality of roads, namely, additional funding is intended for the maintenance of local roads both in 2015 and in the medium term.

In order to achieve **the fourth specific objective of fiscal policy**, on July 3, 2014, a new State Defence Financing Law was adopted, which provides for a gradual increase in the national defence funding to GDP until it reaches 2% of GDP in 2020. Given the significant changes in the geopolitical risks, in this Stability Programme it is planned to provide a more rapid increase in the national defence capacity reaching 2% target already in 2018.

Table 3.4. Planned expenditure for financing of the defence sector

Year	Minimum statutory amount of state budget expenditure for defence, % of GDP	Planned increase according to the new geopolitical risks
2015	1.0	1.0
2016	1.1	1.4
2017	1.3	1.7
2018	1.5	2.0
2019	1.75	
2020	2.0	

An important factor to achieve specific objectives of fiscal policy is the amount of available public resources. The state budget baseline expenditure ensures performance of public functions at a constant level, and under the condition where there is no adverse external circumstances, which reduce the quality of life, we can say that it remains at a constant level. So, to avoid the impact of adverse circumstances on the average quality of life of population or to increase it, additional public financial resources are needed, but to reduce inequalities in the quality of life public finances should be redistributed.

Latvia has traditionally been a country with a relatively low tax burden. In Latvia tax revenue to GDP ratio is among the lowest in the EU and at the current tax policy the forecasts show that in the coming years the tax revenue to GDP ratio will continue to decline. Government's strategy is to solve this problem not by raising tax rates, but through more intensive work to increase tax collection, inter alia through necessary legislative amendments.

[8] Klaus Schwab, The Global Competitiveness Report 2014-2015, World Economic Forum: forumshttp://www3.weforum.org/docs/WEF_GlobalCompetitivenessReport_2014-15.pdf

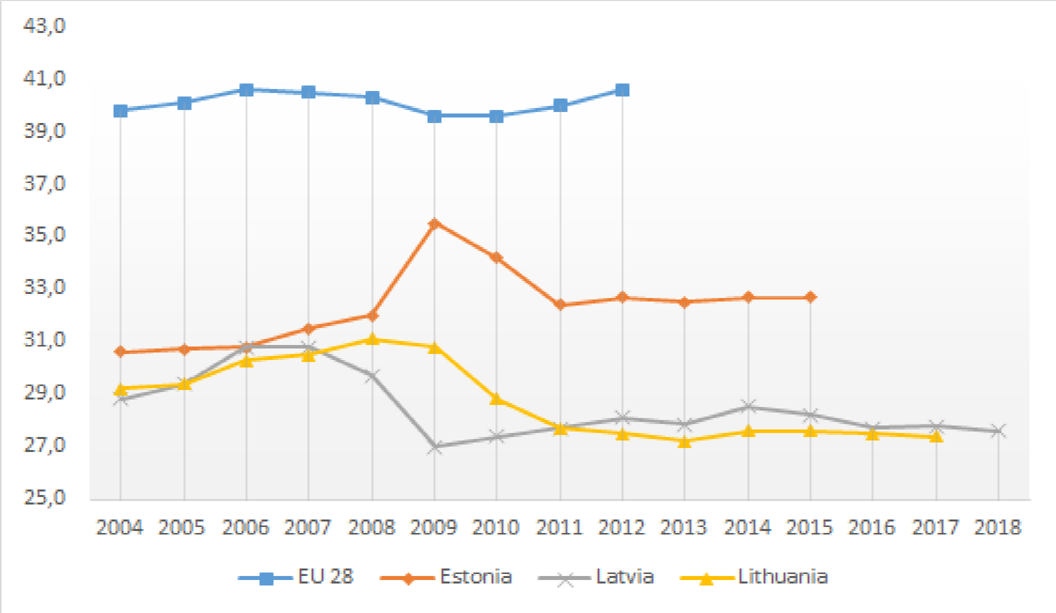


Table 3.5. Tax burden (D.2+D.5+D.61+D.91-D.995), % of GDP[9]

Therefore, adopting a decision on a decrease in labour tax, Latvia has chosen economic development as a key priority in the medium term. 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. In view of the above mentioned problem, the government has defined that in following years tax policy will be characterized by two main directions:

- Stability in tax policy;
- Increase in tax collection moving towards the situation when the proportion of tax revenue is 1/3 of GDP.

Table 3.5. The most substantial revenue measures increasing the fiscal space and the most substantial expenditure increasing measures adopted in the Law on the Medium-term Budget Framework 2015, 2016 and 2017

Revenue	2015	2016	2017
Measures to combat the shadow economy and improve tax administration, incl.: • to publish information about the amount of taxes paid by taxpayers; • to improve the information exchange process between financial institutions and the SRS; • to separate the economic activity of associations and foundations from the activity aimed at profit generation; • to introduce an informative declaration for consumer lenders; • to define the action of the Register of Enterprises after receiving information from the SRS about risk addresses; • to define criteria for risk persons (reachability of a foreigner – company's official); • in certain cases, to impose personal responsibility on a board member for late tax payments of a capital company;	53.9	52.6	52.0

9 Data source: Lithuania – Eurostat until 2012, Convergence Programme 2014–2017 for 2013–2017; Estonia – Eurostat until 2013, Draft General Government Budget Plan 2015 for 2014–2015; Latvia – Eurostat until 2012, CSB of Latvia for 2013, Stability Programme 2015–2018 for 2014–2018.

• in certain cases, to impose a ban on tax debtors to carry out cash transactions; • to impose excise duty on tobacco leaves; • to review excise tax exemption and relief.			
To increase the dividend rate for state-owned capital companies	10.3	55.6	-
To increase the minimum wage	23.4	23.4	23.4
To make changes in the application of non-taxable minimum of foreign pensioners	0.4	0.4	0.4
Expenditure	**2015**	**2016**	**2017**
MoA – measures to promote transitional state aid and investment in agriculture	33.0	26.2	1,6
MoT – additional funding granted, including:	30.7	27.0	27.0
• financing for NPI (earmarked grants for maintenance of local roads and provision of public transport services)	12.1	12.1	12.1
• additional funding from the Ministry for the proposals to increase revenue	18.6	14.9	14.9
MoH – financing of the health sector	30.6	30.6	30.6
MoD – implementation of the State Defence Financing Law	19.3	63.8	136.2
The minimum monthly wage increase up to 360 euro and adjustment of the minimum level of monthly wage scales as of January 1, 2015 (except MoH and MoC capital companies)	8.2	8.2	8.2
MoF – measures to combat the shadow economy	6.6	6.6	6.6
Joint budget programme 64 – grants to local governments	6.5		
MoI – remuneration based on equal principles	6.5	6.5	6.5
MoES – restoration of the state budget grant to ensure development of scientific activities in universities and colleges	4.0	5.0	5.0
MoW – assistant services for disabled persons in municipalities	3.0	3.0	3.0

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

Reform of the pension system

In 2012, amendments were made to the Law on State Funded Pensions prescribing a gradual increase in the contribution rate to the second pillar of the pension system, i.e. in 2013–2014 amounting to 4%, in 2015 in amount of 5% and in 2016 amounting to 6%. The policy does not change. In view of this, Latvia continues to use the possibility of deviation from MTO provided in the EC communication about better application of flexibility of current SGP regarding structural reforms.

The pension reform, however, is more extensive and comprises also other measures apart from the increase in the contribution rate to the second pension pillar.

Fiscally the most substantial structural reforms are related to improvements of the pension system. In 2012, amendments were introduced to the Law on State Funded Pensions prescribing:

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

On 3 April 2014, the Saeima adopted the Law "Amendments to the Law on the State Pensions", according to which changes in the pension indexation procedure 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 euro, taking into account the 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 euro), taking into account the actual consumer price index and 25% of the real increment rates of insurance contributions wage.

The fiscal impact of the above mentioned changes in the pension indexation procedure on the general government budget balance compared with the Law on the Medium-term Budget Framework 2014, 2015 and 2016 was estimated respectively 0.01% of GDP in 2014, 0.04% of GDP in 2015 and 0.08% of GDP in 2016. Taking into account the estimated fiscal impact it can be concluded that these changes will not cause a significant effect on the sustainability of public finances, as well as will possibly not change the conclusions of the next EC Fiscal Sustainability Report on Latvia as a low risk country in terms of the sustainability of public finances.

Reform of the health sector

This Stability Programme Latvia declares reform of the health system as a significant structural reform with a long-term positive effect on the sustainability of public finances, with a view to use in this reform the possibility of deviation from MTO provided in the EC communication about better application of flexibility of current SGP regarding structural reforms.

To improve the health system is one of the most important tasks in order to promote quality of life and increase potential growth.

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

- **Low public funding.** The amount of public funding for health as a percentage of GDP is significantly below the EU average and points to insufficient funding for this sector.
- **Inequality.** The proportion of public funding of the total funding for the health financing system is one of the lowest in the EU. This means that availability of medical services more than in other countries depends on person's income. In Latvia because of this reason part of the population cannot access health care when it is needed. In a population survey of the EU Statistics on Income and Living Conditions (EU-SILC) carried out in 2013, 20% of Latvian respondents answered that they have not visited any health care specialist, although it was necessary. Of these respondents, in 60% of cases the reason was the fact that

they could not afford medical examinations.[10] This is the highest indicator among the EU countries.[11] This suggests that lower-income households are more at risk of not receiving necessary medical treatment than others.

- **Large number of premature deaths due to health problems.** In 2012, the total PYLL was 5,960 years per 100 000 inhabitants, which is a high indicator among the developed countries. A significant part of the indicator can be explained with health problems.

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

These Latvian health system challenges are identified in the country-specific recommendations 2014:

To improve cost-effectiveness, quality and availability of the health care system.

Having analysed the progress the EC in its analysis of the implementation of the country-specific recommendations has pointed to the limited progress in this area: *"Limited progress in improving cost-effectiveness, quality and accessibility of health care system. In general, there is a clear under-financing of the healthcare sector that negatively affects access to healthcare for vulnerable groups".*

Latvia is serious about the need to improve quality and availability of health services. It fully complies with the objective of the Latvian fiscal policy to increase the quality of life. Quality and availability of health services, as well as public awareness and education on health prevention issues is vital in order to raise the quality of life, both directly and indirectly. Directly the quality of life would be built by increasing the number of healthy years lived. Indirectly the quality of life would be built with higher potential GDP growth that would result from larger number of citizens in the labour market following a decrease in PYLL.

This approach has been strengthened in a number of policy documents.

Health targets and measures are defined in the main medium-term development planning document of Latvia – **NDP 2020**, which is linked to the measures defined in the Government Action Plan and other planning documents of the health sector. Health of society is related to its capacity for work, since in the majority of cases the capacity for work is lost due to various health risks. If risk effects are mitigated, it is possible to increase the number of healthy years lived and quality of life, thus enhancing also the natural population growth and promoting employment in the country facilitating economic development.

In the NDP 2020 for the strategic objective "Healthy and Fit for Work" the following goal has been set: "*by promoting a healthy lifestyle and improving planning and coordination in the healthcare system and the quality and accessibility of out-patient healthcare, reduce the occurrence of risk factors of chronic diseases and external causes of death in the population, thus facilitating the preservation and improvement of people's health – which is the foundation of an enduring and productive working life*"[12]. For the achievement of this strategic objective for a 7-year period in the NDP 2020 indicative additional financing necessary is set in amount of **462.87 million euro**.

To improve public health indicators it is important to ensure that all citizens of the country have equal access to health care services. Thus, access to health care services

[10] EU-SILC (*The EU Statistics on Income and Living Conditions*) 2013, CSP
[11] *Eurostat* data.
[12] NDP 2014–2020

characterizes quality and efficiency of the health care system that is needed for the society to get continuous services at all levels of the health system according to the needs of people. One of the target indicators is PYLL that is set in NDP 2020 and the GAP providing that by 2020 PYLL per 100 000 inhabitants should be reduced to **5300 from 6746** in 2010.

In October 2014 the Cabinet approved **Public Health Guidelines 2014–2020**. In accordance with these guidelines it is planned to implement measures aimed at the implementation of more targeted measures with higher rates of return in solving specific problems related to better health of the population as labour force. Two key objectives are set in the Public Health Guidelines 2014–2020:

- to increase by **three years** the number of healthy lived years (to reach 57 years for men and 60 years for women in 2020);
- to reduce by **11%** the PYLL indicator (to 64 years) (to reach 5300 per 100 000 inhabitants in 2020).

For the purpose of the Public Health Guidelines 2014–2020 the Ministry of Health commissioned a study "Evaluation for the Development of the Public Health Guidelines 2014–2020", developed by the University of Latvia. The key task of the study was to provide evidence-based proposals for the implementation of sustainable health policy in the context of NDP 2020 and the EU funds draft planning documents, prepare conclusions and recommendations for the development of the Public Health Guidelines 2014–2020. The above mentioned study is also used as a basis for the cost-benefit analysis of the reforms implemented in the health sector.

Within the framework of the study an analysis was carried out of performance indicators of the Public Health Guidelines 2014–2020 following from NDP 2020. NDP 2020 provides for the reduction of PYLL per 100 000 inhabitants from 6476 in 2010 to 5,300 in 2020.

To determine the economic benefit in the period between 2013 and 2020 within the framework of the study a cumulative increase in the labour force was calculated, from which the projected GDP growth was reckoned. The economic benefit was presented at the current value of 2014 applying a 5% discount rate.

According to PYLL dynamics analysed within the framework of NDP in the period between 2008 and 2013 it can be concluded that if current trend is maintained and necessary investment in public health is provided, in the coming years PYLL goal for 2020 will be achieved.

If the PYLL reduction set in NDP 2020 is achieved by 2020 (pessimistic scenario), the discounted value of the financial benefit in 2014 will be 137.4 million euro.

Table 3.6. Expected GDP growth from PYLL reduction by 2020 – pessimistic scenario, million euro

	2020	2019	2018	2017	2016	2015	2014	2013
Additionally prevented PYLL until respective year, number of years	10059	8822	7579	6331	5076	3816	2550	1278
Including in the age group 15-64 y, number of years	8974	7871	6762	5648	4529	3404	2275	1140
Additionally prevented cases of premature death in the age group 15-64 y, number of people	2865	2281	1752	1283	877	539	276	94
Additional labour force (number of employed persons) in the age group	1785	1419	1088	795	542	333	170	58

15-64 y, number of people								
GDP growth, mln euro	49.5	38.9	29.5	21.3	14.4	8.7	4.4	1.5
Total GDP growth from 2013 to 2020, mln euro	168.2							
Discounted value of GDP growth in 2014, mln euro	137.4							

If the decrease is higher and in 2020 reaches 4768 years per 100 000 inhabitants as estimated by the Disease Prevention and Control Centre (realistically optimistic scenario), the discounted value of the financial benefit in 2014 will be 254.9 mln euro.

Table 3.7. Expected GDP growth from PYLL reduction by 2020 – realistically optimistic scenario, million euro

	2020	2019	2018	2017	2016	2015	2014	2013
Additionally prevented PYLL until respective year, number of years	18666	16371	14064	11747	9420	7081	4731	2371
Including in the age group 15-64 y, number of years	16653	14605	12547	10480	8403	6317	4221	2115
Additionally prevented cases of premature death in the age group 15-64 y, number of people	5316	4233	3252	2380	1627	1001	513	175
Additional labour force (number of employed persons) in the age group 15-64 y, number of people	3312	2633	2019	1475	1006	617	315	107
GDP growth, mln euro	91.8	72.2	54.7	39.5	26.7	16.2	8.2	2.8
Total GDP growth from 2013 to 2020, mln euro	312.1							
Discounted value of GDP growth in 2014, mln euro	254.9							

Assuming that all "saved" by 2020, who by 2040 will not reach 64 years, will live until this year and will have similar capacity for work as average Latvian inhabitants of the same age, discounted value of the overall GDP growth in the period from 2013 to 2040 will be **443.8 mln euro** in 2014 according to the pessimistic scenario and **823.5 mln euro** according to the realistically optimistic scenario.

Cost-benefit analysis. In a simplified cost-benefit analysis carried out within the framework of the study it was found that additional necessary funding for the health care until 2020, expressed in present value of 2014, is 813 mln euro. In the calculations of study authors' nominal cash flows until 2016 have been subject to a discount rate of 7.1%, from 2017 to 2020 – 7% according to the guidelines of the National Regional Development Agency.

Table 3.8. Total and additional expenditure in the health sector from 2013 to 2020[13]

Additional expenditure for health care until 2020, pessimistic scenario, mln euro									
	2020	**2019**	**2018**	**2017**	**2016**	**2015**	**2014**	**2013**	**2012**

[13] According to the study the pessimistic scenario provided for the health sector budget in amount of 3% of GDP as of 2014.

MoH basic budget for basic functions (nominal value), mln euro	1028	967	910	857	806	727	713	697	692
Additional MoH budget for basic functions (nominal value) in comparison with 2012, mln euro	336	275	218	165	114	35	21	5	
ERDF, ESF and FFP (with CFCA financing) financing (nominal value), mln euro	38	38	38	38	38	65	44	49	54
Additional ERDF, ESF and FFP (with CFCA financing) financing (nominal value) in comparison with 2012, mln euro	-16	-16	-16	-16	-16	11	-10	-5	
Total additional financing (nominal value) for health care in comparison with 2012, mln euro	320	259	202	149	98	46	11	0	
Discounted present value of 2014 of additional financing, mln euro	213	185	154	122	85	43	11	0	
Discounted present value of 2014 of additional financing, mln euro, total	813								
Additional expenditure for health care in the age group 0-64 years until 2020, pessimistic scenario, mln euro									
	2020	**2019**	**2018**	**2017**	**2016**	**2015**	**2014**	**2013**	**2012**
MoH basic budget for basic functions (nominal value), mln euro	730	687	646	608	572	516	506	495	491
Additional MoH budget for basic functions (nominal value) in comparison with 2012, mln euro	239	195	155	117	81	25	15	4	
ERDF, ESF and FFP (with CFCA financing) financing (nominal value), mln euro	27	27	27	27	27	46	31	35	38
Additional ERDF, ESF and FFP (with CFCA financing) financing (nominal value) in comparison with 2012, mln euro	-11	-11	-11	-11	-11	8	-7	-4	
Total additional financing (nominal value) for health care in comparison with 2012, mln euro	227	184	143	106	70	33	8	0	
Discounted present value of 2014 of additional financing, mln euro	121	131	109	86	61	30	8	0	
Discounted present value of 2014 of additional financing, mln euro, total	577								
Expenditure (euro) for one prevented PYLL	30925								

However, given that in the study economic benefits have been estimated for inhabitants up to 64 years old, costs also need to be calculated for this age group. Consequently, in the study using the data of the National Health Service about the breakdown of expenditure by age groups in 2011, it is estimated that for the age group up to 64 years expected additional expenditure for the period from 2013 to 2020 in present value is 577 million euro.[14]

Summary. According to the results of the study it can be concluded that additional estimated amount of expenditure from 2013 to 2020 (577 mln euro) exceeds the economic benefits of the respective period.

[14] In the study an assumption is used that during the period between 2013 and 2020, for the age group 0-64 years 71% of all health care expenditure is utilized.

Table 3.9. Summary of the cost-benefit analysis, mln euro

Indicator	Economic benefit		Costs
	2013–2020	2013–2040	2013–2020
PYLL reduction until 2020 according to NDP 2020 – pessimistic scenario	137.4	443.8	577
PYLL reduction until 2020 according to NDP 2020 – realistically optimistic scenario	254.9	823.5	

Looking at the results of the study from the perspective of cost-efficiency of the implemented reforms, it is concluded that until 2020 in case of the pessimistic scenario 10 059 PYLL will be prevented, but in case of realistically optimistic scenario – 18 666 PYLL, so the average cost per PYLL prevented in this age group is respectively 57 361 euro in case of pessimistic scenario and 30 925 euro in case of realistically optimistic scenario. According to the World Health Organisation’s guidelines, health care interventions are considered cost-effective if their costs are estimated between 1-3% of GDP per capita. Execution of GDP in 2014 is estimated in amount of 24 058 billion euro, which according to the number of inhabitants in census 2011 makes 11 620 euro per capita, hence 3% of GDP per capita amount to 34 860 euro.

Consequently, even according to the guidelines of the World Health Organization in case of the realistically optimistic scenario the reform of the Latvian health system is considered as **cost-effective.**

It should be noted that there is a high probability that at the level planned for investment of resources the PYLL reduction will take place according to the realistically optimistic scenario. The study also analysed the economic benefit from the point of view of another indicator – estimated reduction of the number of premature deaths (up to 64 years) as a result of the implementation of the Operational Programme “Growth and Employment”, where causes of death are heart and circulatory diseases, oncology diseases and suicide. Overall, it is expected that by 2020 the number of prevented deaths in the age group up to 64 years according to the pessimistic scenario, which corresponds to the PYLL reduction target defined in NDP 2020, is only about 9% higher than the expected number of prevented fatal events if the target to reduce the level of premature mortality due to the three priority causes as defined in the Operational Programme “Growth and Employment” is achieved. In 2012, the proportion of deaths caused by the three analysed causes in the given age group accounted for 64% of all deaths. The remaining 35% are due to other groups of causes, and it can be expected that the related mortality rate will also decrease. Consequently, if the objective of the Operational Programme “Growth and Employment” is achieved successfully, a steeper reduction of PYLL could be expected than provided according to NDP 2020 objective.

Estimated GDP growth is only part of the tangible economic return that will be obtained as a result of the public health promotion, the actual impact on GDP will be significantly higher, although it is difficult to quantitatively assess:

- Additional factors contributing to GDP growth:
  - ➢ It should be noted that the assessment of economic benefits within the framework of the study was conducted about the expected labour force growth in the period from 2012 to 2020. However, the positive effect of the investments in the public health will be greater due to the fact that after 2020 PYLL rates will be lower than in 2012. Even if in 2020 PYLL rate no longer falls back, thanks to investments made until 2020 **“additional” premature deaths will be prevented in the coming years** and thus “additional” human lives will be saved (compared with 2012.). It will

continue to have a positive impact on labour supply contributing to economic growth.
  - As the overall level of public health improves, not only mortality rates reduce, which directly affects the labour supply. As sickness leaves become less frequent and shorter, **productivity** of employees increases and thus GDP grows as well.
  - As the overall level of public health improves, **economic activity of people of pre-retirement age** will be promoted**.**
- Factors reducing the public funding:
  - As the overall level of public health improves, **expenditure for social benefits and sickness leaves will decrease.**

Additional expenditure for health care in the new policy initiatives

The reform of the health system put forward in NDP 2020 and "Public Health Guidelines 2014–2020" has been approved by the Cabinet and its implementation began in 2014 and substantial additional resources were allocated within the framework of the medium-term budget. In two successive medium-term budgeting cycles, both in the Law on the Medium-term Budget Framework 2014, 2015 and 2016 and the Law on the Medium-term Budget Framework 2015, 2016 and 2017, the government decided on the implementation of additional NPI. It should be noted that the below-mentioned additional expenditure allocated to the health sector have been carried out in view of the pre-defined base expenditure[15].

In the Law on the Medium-term Budget Framework 2014, 2015 and 2016 the government approved a total of **42 million euro in 2014, as well as 48.9 million euro in 2015 and 51 million euro in 2016** for NPI in the health sector to promote cost-effective, physically and financially available and quality health care services, thus continuing the implementation of the ongoing health care reform. Looking in more detail, the above mentioned funding was allocated to the following key measures:

- to increase wages of medical personnel and other staff, as well as to adjust monthly wage disparities between various categories of health care employees (about 30 mln euro, in 2016 – 32.2 mln euro*);*
- to reduce the waiting queue for outpatient and inpatient health care services (2.1 mln euro and 1.3 mln euro each year);
- to compensate expenses of medication for outpatient treatment and to ensure centralized purchase of medication (4.5 mln euro each year);
- to reimburse 100% of prescription medication for children to be compensated by the state (1.4 mln euro each year).

In turn, in the Law on the Medium-term Budget Framework 2015, 2016 and 2017, the government decided to allocate additional funding to the health sector in amount of **30.6 mln euro** for these three years in order to continue to increase availability, quality and cost-effectiveness of health care. Within the framework of the allocated funding the following main measures will be performed:

- to compensate the minimum monthly wage increase in the tariffs of health care services (7.7 mln euro each year);
- resident training (to 1.7 mln euro each year);
- to reduce the waiting queue for ambulatory health care services and to improve regional accessibility (9.8 mln euro each year);

[15] Performance of sectoral functions at a constant level

- to increasing the volume of hospital services increasing the volume of elective hospitalization (4.4 mln euro each year);
- to reduce patient fees and co-payments (2.7 mln euro each year);
- to improve the system of reimbursable medication and materials and the system of pharmacotherapy of rare diseases (2.5 mln euro each year).

Table 3.10. Expenditure of the health sector for NPI, mln euro

		2014	2015	2016	2017
Framework Law 2014-2016		42	48.9	51	-
Framework Law 2015-2017		-	30.6	30.6	30.6
Additional expenditure increase in comparison with previous year		42	37.5	2.1	-

As mentioned before, in 2017 and 2018 under the current fiscal scenario additional funds are available to be distributed to government's priorities. Although decisions on further expenditure measures in essential sectors of the economy will be adopted this autumn, namely, while preparing the budget and the medium-term framework, in view of the additional funding allocated in previous years with a sufficiently high probability it can predicted that the health sector will be one of the beneficiaries, therefore the course of the initiated health sector reform will continue.

"Fiscal space"

Fiscal forecasts show that the general government deficit, calculated in accordance with *the bottom-up planning method of a budget balance* and comprising central government expenditure in accordance with the approved base expenditure in 2016 (deficit at immutable policy) is higher than the general government deficit, calculated in accordance with *the top-down planning method of a budget balance* approach (deficit permissible in accordance with the fiscal discipline rules). According to current estimates, the difference is **-0.2% of GDP** excluding the fiscal security reserve provided by the FDL, which must be at least 0.1% of GDP. Consequently, in accordance with the fiscal discipline framework this autumn if macroeconomic forecasts still point to a negative fiscal space, the Latvian government will decide on appropriate revenue and expenditure discretionary measures to eliminate this gap.

By contrast, in 2017 and 2018 the general government deficit, calculated in accordance with *the bottom-up planning method of a budget balance* is respectively **1.1% of GDP and 1.9% of GDP** less than the state can afford in accordance with the *top-down planning method of a budget balance* approach or, in other words, fiscal space is positive. In accordance with the provisions of the FDL fiscal space in 2017 and 2018 can be used to plan new expenditure policy measures to be included in a subsequent Framework Law. **Medium-term fiscal plan and medium-term budget framework**

This Stability Programme is a medium-term fiscal plan within the meaning of Regulation No 473/2013 of the European Parliament and Council (EU) on common provisions for monitoring and assessing draft budget plans and ensuring the correction of excessive deficit of the Member States in the euro area.

Within the meaning of the same regulation the latest Framework Law within the meaning of the FDL is a medium-term budget framework.

3.3. FISCAL DEVELOPMENT SCENARIO

The Fiscal Development Scenario for the medium term is drafted on the basis of the structural balance objectives for general government budget, expected one-off measures and considering the cyclical component of the budgetary balance in compliance with the macroeconomic scenario. Compared with the years of rapid economic growth and recession when the cyclical component, taking into account significant fluctuations in the economy, was considerable, in 2015 and 2016 the cyclical component is forecasted at -0.1% of GDP, but in 2017 and 2018 it is zero. On the other hand, as a one-off event in the medium term it is planned to increase defence expenditure faster than currently stipulated in the State Defence Funding Law in view of the geopolitical situation. The amount of one-off expenditure is set at 0.3% of GDP in 2016, 0.4% of GDP 2017, and 0.5% of GDP in 2018.

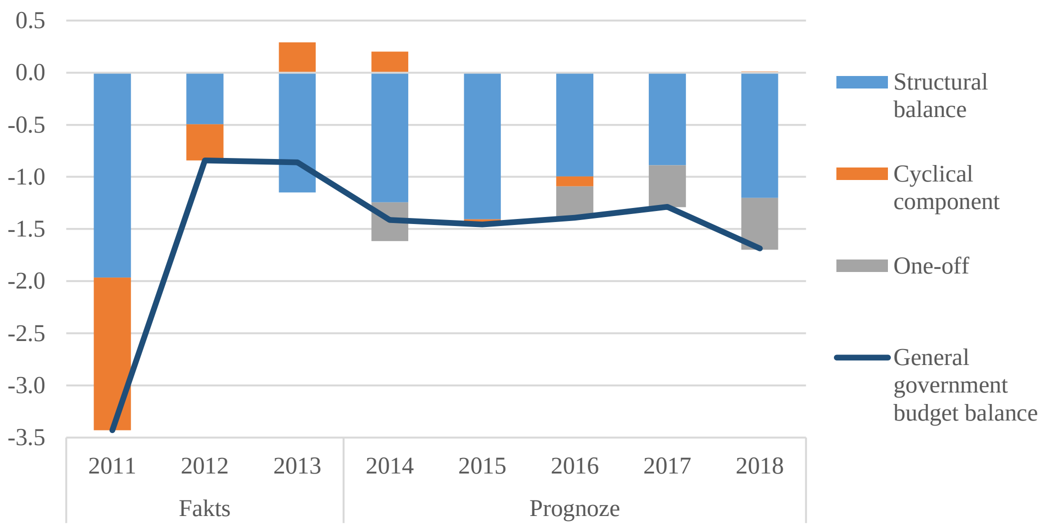


Figure 3.6. Budgetary balance of the general government by components[16], % of GDP

In order to prepare projections of the general government budget balance for the medium-term, a no-policy change scenario was developed based on updated revenue projections according to the latest macroeconomic scenario and approved central government budget, as well as social security funds baseline expenditure for the next three years. The scenario at unchanging policy comprises government's intention to increase faster than previously planned the defence funding providing 1.4% of GDP in 2016, 1.7% of GDP in 2017, and 2% of GDP in 2018. In the scenario at unchanging policy in 2016 the general government budget deficit would be 1.6% of GDP, 0.2% of GDP in 2017, while in 2018 there would be budget surplus of 0.2% of GDP.

[16] In the calculation of a cyclical component of a budgetary balance, there was budget semi-elasticity of 0.38 used (Source of data: The cyclically-adjusted budget balance used in the EU fiscal framework: an update, Economic Papers 536, November 2014).

Since the budget balance targets allow for higher general government budget deficit in 2017 and 2018 than the scenario at unchanging policy, it is assumed that all the positive difference or fiscal space (in 2017 – 1.1% of GDP, in 2018 – 1.9% of GDP) is used for additional expenditure. But since decisions are not made yet on the distribution of this difference (decisions will be made in autumn while developing current medium-term budget framework), it is assumed that it is divided proportionally among categories of expenditure in respective years on the basis of the proportion of certain categories of expenditure against total expenditure at the scenario of unchanging policy. In the calculation of the proportion of individual categories of expenditure against the total expenditure at the scenario of unchanging policy the following categories of expenditure are excluded: interest expenditure, subsidy expenditure and capital expenditure transfers. This approach is used because it is assumed that the fiscal space for these categories is not reallocated.

It should be noted that currently it is assumed that the entire fiscal space can be divided into additional expenditure because the fiscal security margin will be calculated during the next year's budget preparation process in accordance with the Declaration of Fiscal Risks.

Meanwhile the deficit projected for 2016 is equal to its level at unchanging policy, while recognizing that the structural budgetary balance target, which is -1.0% of GDP, is exceeded by 0.2% of GDP. The government undertakes during the next year's budget preparation process to discuss and decide on measures necessary to achieve the set structural balance target in 2016.

Thus, **the fiscal development scenario provides for the general government deficit of 1.5% of GDP in 2015, 1.6% of GDP in 2016, 1.3% of GDP in 2017, and 1.7% of GDP in 2018.**

Table 3.11. Medium-term fiscal development scenario

		2014	2015	2016	2017	2018
	ESA code	% of GDP				
Net lending (+) or borrowings (-) (EDP B.9) by sub-sectors						
General government	S.13	-1.4	-1.5	-1.6	-1.3	-1.7
Central government	S.1311	-1.7	-1.9	-2.0	-2.0	-2.5
Local government	S.1313	-0.1	0.1	0.0	0.1	0.1
Social security funds	S.1314	0.4	0.4	0.4	0.6	0.8
General government (S.13)						
Total revenue	TR	35.0	34.2	32.7	32.7	32.3
Total expenditure	TE	36.4	35.6	34.3	34.0	34.0
Interest expenditure	D.41	1.4	1.2	1.2	1.1	1.0
Cyclical development						
Cyclical budgetary component		0.2	-0.1	-0.1	0.0	0.0
Structural balance		-1.2	-1.4	-1.2	-0.9	-1.2
Cyclically adjusted primary balance		-0.2	-0.2	-0.3	-0.2	-0.7
No-policy change scenario						
General government budget balance	B.9	-1.4	-1.5	-1.6	-0.2	0.2
Total revenue	TR	35.0	34.2	32.7	32.7	32.3
Total expenditure	TE	36.4	35.6	34.3	32.9	32.1

It is forecasted that in the medium term the proportion of the general government budget revenue to GDP will fall mainly due to declining tax burden from 28.2% of GDP in 2015 to 27.6% of GDP in 2018, as well as a decrease in payments received from the EC at the end of the programming period 2007–2013. The increase in tax revenue of the general government budget in 2016 will be relatively modest, i.e. 3.1%. It will be affected mainly by the increase in the social security contribution rate to the second pension pillar, as well as the expected reduction of the income tax rate. Meanwhile, in 2017 and 2018 tax revenue growth will be faster – around 5-6%, as currently no changes in tax policy are planned with significant negative impact on revenue. It is forecasted that the proportion of the general government budget expenditure of GDP will decline and at the end of 2016–2018 will remain the same.

In the central government budget:

- in 2015, deficit of 1.9% of GDP is projected, with a more rapid increase in expenditure over the previous year than revenue growth. Central government budget projections are based on the expenditure level set in the Law on State Budget for 2015;
- meanwhile, in 2016– 2018, central government budget revenue growth will be ensured by revenue from taxes on production and imports, as well as taxes on income and property. Estimated revenue from property, made mainly of revenue from the state capital, will shrink until 2017, since current arrangements provide for the reduction of the profit share to be paid to the budget (in 2016 – 70% of the profit, and as of 2017 – 27%). Central government budget expenditure in 2016–2018 will increase, but as a percentage of GDP it will decrease slightly or remain at the same level, thus complying with regulatory requirements in relation to fiscal discipline. Expenditure projections take into account the baseline funding for the next three years submitted by line ministries and approved by the government and faster increase in defence funding. At the same time, expenditure forecasts comprise potential additional funding (fiscal space). A decision on the use of this funding will be made during the next medium-term budget framework development process.

In social security funds:

- in 2015, there is a surplus of 0.4% of GDP and this trend is observed since last year, when the changes came into force and now means to pay pension premiums are received from the central government budget (transfer);
- it is projected that in 2016–2018 in social security funds there will be a surplus that will rise slightly each year since revenue will grow faster than expenditure. It should be noted that in 2016 revenue growth would be minimal, because the social security contribution rate to the second pension pillar will increase for one percentage point, reaching 6%, resulting in a higher amount of revenue in the funded pension scheme and it will not be considered as budget revenue. In the medium term, a gradual increase in budget expenditure is projected, taking into account the expected change in the number of beneficiaries and the average amount of benefits.

Local government budget:

- in 2015, a surplus of 0.1% of GDP is projected, where an increase in tax revenue is expected, but the evolution of expenditure is projected according to the trends observed in previous years. It is projected that the amount of local government budget expenditure for the formation of gross fixed capital on the part of basic functions will remain at the level of 2014, as well as the implementation of EU funds projects will continue using advance payments received in previous years from the central government budget and taking into account the fact that the project implementation within the framework of the programming period 2007–2013 will end this year. At the same time, in 2015 local government budget expenditure will be unloaded by payments for the Southern Bridge construction, because expenditure was recognized already in previous years during the actual construction of the object;
- in 2016–2018, the local government budget is projected balanced or with a small surplus. With respect to the income tax, which makes the largest position of local government budget revenue, possible evolution of the labour market and existing tax

legislation is taken into account. In 2016, it is provided that the PIT rate will decrease by one percentage point to 22%, which will result in moderate tax revenue, while in 2017 and 2018 it will increase significantly due to the base effect. At the same time, it should be noted that according to the updated forecasts major changes are not expected in other revenue positions. It is projected that local government expenditure in the medium term will increase in all positions, except for social benefits. The level of expenditure for the gross capital formation on the part of basic functions in 2016–2018 is projected at the same level, assuming that in 2016–2017 borrowing could be made mainly for the implementation of projects related to basic functions (e.g., reconstruction of educational institutions, their sports facilities). At the same time, expenditure for the gross capital formation through the implementation of EU funds projects in 2016–2018 will be lower, given the fact that the acquisition EU funding within the new programming period 2014–2020 will be still not so intense. At the same time, in the medium term, local government expenditure will be also unloaded because expenditure was recognized already in previous years during the actual construction of the object.

3.4. DEVELOPMENT TRENDS OF GOVERNMENT DEBT IN THE MEDIUM TERM

According to the government budget deficit and debt notification data of April 2015, prepared in accordance with the ESA 2010 methodology, the general government debt at the end of 2014 reached 9 633.2 mln euro or 40.0% of GDP. The general government debt level is mainly affected by the central government debt, which at the end of 2014 was 9 012.3 mln euro.

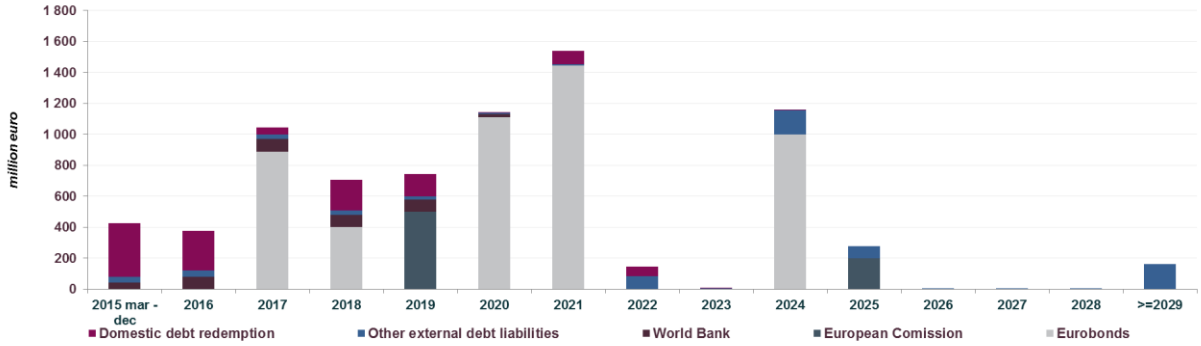
Principles and medium-term objectives of the central government debt management are defined in the Central Government Debt Management Strategy approved by the Minister of Finance. According to the Central Government Debt Management Strategy the objective of the central government debt management is to ensure availability of financial resources for the refinancing of central government debt, central government budget execution and maintenance of the financial resources reserve at the lowest possible costs while hedging financial risks and taking into account the development of the Latvian economy and integration of the domestic financial market into the common financial market of the Eurozone.

The amount of borrowing and the level of central government debt in the medium term are influenced by the total financing requirement, which consists largely of the amount of resources required for the execution of the central government budget and repayment of central government debt obligations in the respective period. In the borrowing and debt management process a strategic approach is applied maintaining the greatest possible flexibility in the choice of borrowing conditions on financial markets (time of borrowing, currency, amount, maturity). It allows limiting financial risks in the medium term, as well as ensuring the amount of necessary resources to cover the total financing requirement at as favourable and attractive conditions as possible.

In 2014, after a break of several years Latvia returned to euro financial markets since the Treasury organized two emissions of benchmark bonds in euro. In January 2014, 7-year bonds in amount of 1 billion euro were issued and in April there were 10-year bonds in amount of 1 billion euro issued. Eurobond emissions provided resources to cover the financing requirement and to repay part of funding received from the EC within the framework of the international loan programme (on March 25, 2014, part of the loan in amount of 1 billion euro was repaid to the EC and on January 16, 2015 the second part in amount of 1.2 billion euro was repaid). Both Eurobond emissions were made within the framework of the medium-term borrowing strategy, timely providing resources to cover the financing requirement, int.al. the largest central government debt obligations in terms of volume in 2014 and 2015. Economic growth, accession to the euro area, improved Latvia's credit ratings, investors' high assessment of the progress achieved in the Latvian economy in recent years, and trust in the Latvian long-term development allowed Latvia to borrow financial resources in international markets at favourable conditions.

In the domestic financial market, regular auctions of government domestic securities continued. In 2014, in auctions investors offered both T-bills and T-bonds. In order to promote the development of the government securities market and activity of the secondary market since February 2013 a primary dealer system has been put into operation. However, in order to promote private investment in domestic financial market instruments, since June 2013 Latvian citizens (natural persons only) have access to savings bonds issued by the government.

Taking into account the central government debt obligations outstanding as of 28 February 2015, in accordance with the government debt repayment schedule in the period between March 2015 and December 2017 central government debt obligations should be refinanced in amount of ~ 1.8 billion euro. A significant portion of the debt to be refinanced consists of Eurobonds emitted in international financial markets and the funding received from the World Bank within the framework of the international loan programme.



** does not include sectors S130130, S130140, S130330, S130340, as well as demand and short-term deposits*
ECB exchange rates of 31.12.2014 have been used in the calculations.

Figure 3.7. Central government debt repayment profile
(liabilities outstanding as of 28 February 2015, nominal value)

According to the medium-term borrowing strategy, in order to cover the total financing requirement in the medium term it is planned to take the following borrowing activities:

- to continue borrowing in international financial markets, mainly through regular public issues of government debt securities in order to ensure refinancing of government debt obligations with favourable conditions in terms of borrowing rates and maturity;
- to ensure diversification and expansion of the scope of government securities investors through a regular, constant dialogue and long-term work with the investors and cooperation partners to promote active participation of investors from various regions of the world in the primary placement of government securities in international financial markets;
- to promote the development of the domestic financial market and to ensure appropriate investment opportunities for the participants of the domestic financial market to make better use of the borrowing potential in the domestic financial market.

Taking into account the borrowing strategic objectives, as well as to ensure limiting of the central government debt refinancing risk and optimization of the central government debt service costs in the medium term, in the next few years, foreign borrowing instruments will provide major share of the total amount of attracted financial resources. It is planned that borrowing in international financial markets will be based on public transactions in global financial markets issuing benchmark Eurobonds mainly in the European financial market, as well as addressing other regional investors. It is planned to maintain on the domestic financial market an offer of securities consistent with the demand thus promoting activity of the government securities market within the framework of the primary dealers system.

By making timely borrowing activities in accordance with the medium-term strategy, as well as continuing the implementation of the sustainable fiscal policy it is possible to refinance current central government debt obligations with more favourable conditions in terms of rates and maturity, as well as to achieve a decrease in and stabilization of the government debt at a sustainable level in the long term ensuring compliance with the general government debt criterion set in the Maastricht Treaty.

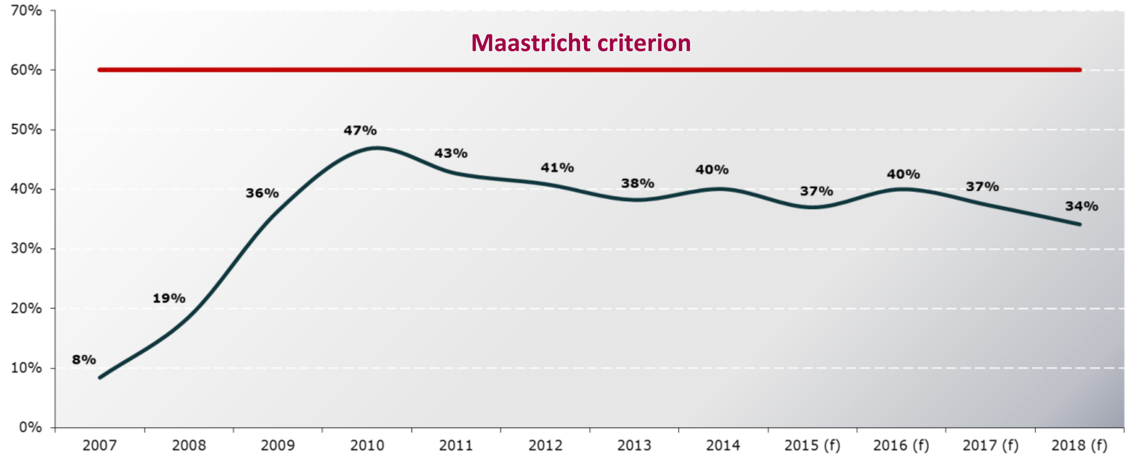


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Figure 3.8. General government debt development trends (% of GDP)

4. SENSITIVITY ANALYSIS AND COMPARISON

4.1. MACROECONOMIC SCENARIO RISKS

The macroeconomic development scenario 2015–2018 is drafted on the basis of conservative assumptions about the increase in internal and external demand and takes into account both internal and external risks. In the medium term negative and positive risks of the macroeconomic development scenario are balanced, but in the short term negative risks prevail, the most significant being external risks associated with the geopolitical situation in the region, recession in the Russian economy and weak economic growth in the euro area.

In addition to external risks, the fulfilment of the macroeconomic scenario will also be affected by internal factors – the situation in the labour market, companies' ability to attract financial resources and implement investment projects to increase production capacity, development of lending and other factors that directly affect the country's credit rating, interest rates, confidence indicators and domestic demand.

Negative risks:

- The main negative risk for the development of the Latvian economy is still **the geopolitical situation in the region.** Further escalation of the conflict between Russia and the West can significantly reduce both local and foreign investment in the region weakening Latvian economic growth in the short term and reducing the growth potential in the medium and long term.
- **Introduction of new EU-Russia mutual economic sanctions** may have a negative effect on certain sectors of the Latvian economy, including Russia-related processing industries, which have so far not been subject to the sanctions, such as machinery, metal, electronics, pharmaceutical industry. Potential sanctions can also affect the transport sector, an essential part of which consists of the Russian cargo transit through Latvian ports, and the financial services sector with its relatively high share of services provided to non-residents.
- **Further deterioration of Russia's overall economic situation** and further decline in the ruble exchange rate will decrease even more the demand for Latvian goods in the Russian market, as well as cause adverse effect on the economic situation and demand in other countries in the region.
- The external risks that have increased significantly may affect the economic development also indirectly substantially deteriorating **consumer and business sentiment.** This can lead to a slowdown of private consumption growth as people can postpone their spending and create greater savings, while entrepreneurs can take a wait and see position on investment decisions.
- Continuous **low investment growth may adversely affect the economic growth potential in the medium term.** Latvia has not experienced significant increase in investment since mid-2012, despite the fact that capacity utilization rates in many manufacturing industries have reached historic highs. In addition, this situation creates a risk that in a situation where the external environment is improving, Latvian businessmen will not be able to quickly increase production and thus export market shares could be lost.
- Although **economic growth rates** in the euro area are gradually improving, the risks associated with further economic development of the monetary union remain high and economic growth may not achieve the anticipated level. Inter alia economic and

monetary stimulus may prove insufficient to prevent the euro area from falling into deflation and prolonged stagnation. While political risks related to the implementation of structural reforms and uncertainty about the future of politics in Greece may create new turmoil in financial markets.

- **Deflation and prolonged low growth in the euro area, not only in the short term but also in the long term can significantly affect development of the Latvian economy.** As shown by the Japanese example since the nineties of the 20th century, deflation or very low inflation causes negative impact on investment and growth. Deflation increases real interest rates and hinders investment that is already at a very low level in the euro area right now. This combination can lead both to the resurgence of the debt crisis and to political shocks. In addition, there is an increasing concern that the low level of investment in the euro area has become a structural phenomenon which is better known as a secular stagnation when in a situation of decreasing economic growth rates the level of savings exceeds considerably the volume of investment and leads to a prolonged economic stagnation.
- As the US economy grows, **the Federal Reserve System may begin to exercise less expansionary monetary policy,** including raising of interest rates, which would mean changes in global capital flows and reduced money supply slowing down the global economic growth. On the other hand, an increase in the dollar exchange rate against other major currencies, including the euro, would be advantageous to euro area exports.
- **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.
- **Wage growth, well above productivity growth**, driven by rapid economic growth in previous years can undermine the international competitiveness of Latvian businesses further weakening the Latvian export capacity and slowing down overall economic growth.
- **Upward shocks of energy and raw materials prices on the world market** as well as demand side factors in the local market may facilitate more rapid increase in prices than forecasted.

Positive risks:

- **Renewal of production in the Latvia’s biggest metal production company “Liepajas Metalurgs”** would allow to increase the manufacturing output, to regain lost jobs, as well as to raise export volumes.
- Successful **implementation of the EC investment plan**, attracting to the economy at least 315 billion euro in additional public and private investment until 2017, as well as monetary stimulating measures implemented by the ECB extending the already implemented asset purchase programme with government securities, successfully implemented structural reforms can ensure **faster-than-expected economic growth in the euro area and the EU**, which would allow also the Latvian economy to grow faster than expected.

- **Further decline in the prices of oil and other raw materials**, reducing costs of Latvian producers as well as consumers' expenditure for fuel, heating and food, can ensure faster-than-expected growth of production and private consumption.
- **Euro depreciation** against other major currencies, as well as against the currencies of Latvian largest export partners may increase competitiveness of Latvian export, increasing manufacturing output and export volumes.
- **In case the geopolitical situation improves, stronger private investment growth in Latvia is expected.** In view of low investment level in previous years and the fact that capacity utilization in the Latvian industry is close to all-time highs, such a rise in investment would provide a basis for more rapid economic growth in the medium term.
- **More rapid increase in the lending volume** would allow companies to increase investment and households to increase slightly the consumption, because now part of the income goes to the repayment of loans. Despite positive economic growth in the last four years, the amount of loans granted to businesses and households continues to decline. Changes in lending trends would have a positive impact on exports and investment, as well as private consumption, especially in the medium term.
- Russia's economic downturn may delay its ports and rail transport infrastructure development projects. A as a result Russia may temporarily postpone plans of redirecting cargos to its Baltic Sea ports that would in the medium to ensure **greater-than-expected flows of cargos in the Latvian transit corridor**.
- **Higher-than-expected global economic growth**, including in the USA and developing countries, may give additional impetus to the development of European and Latvian economy.

4.2. Sensitivity Analysis

On the basis of the possible impact of macroeconomic risks on the economy described in previous chapter, two alternative scenarios of macroeconomic development have been worked out.

Faster-than-expected economic growth and realisation of the optimistic scenario is possible if in the first half of 2015 the external economic environment shows considerable improvements. The most important factors of the external environment that could improve indicators of the Latvian economic growth are reduction of geopolitical tensions and resolving the conflict in Ukraine, as a result, the Russian and EU mutual sanctions could be abolished. In addition to that, EU Member States continue to implement structural reforms that together with the stimulating monetary measures implemented by the ECB and execution of the EC's investment plan contribute to the EU economic growth rate.

Such developments would significantly improve the business and investor sentiment, as well as increase demand for Latvian export goods. Thus, compared to the baseline scenario more rapid investment and export growth rate would be expected, which together with factors that stimulate consumption such as the increase in wages would provide faster private consumption growth than projected in the baseline scenario.

Table 4.1. Optimistic macroeconomic scenario

	2014	2015	2016	2017	2018
GDP, at current prices, EUR million	24058.1	25304.7	26908.4	28682.9	30590.9
growth at current prices, %	3.6	5.2	6.3	6.6	6.7
growth at constant prices, %	2.4	3.5	4.0	4.0	4.0
CPI (annual average), %	0.6	0.9	2.4	2.5	2.5
Average wage in the economy, euro	765.2	807.2	855.7	907.0	959.6
growth at current prices, %	6.8	5.5	6.0	6.0	5.8
Employment, thousand people	884.6	889.0	894.4	899.7	905.1
growth, %	-1.0	0.5	0.6	0.6	0.6
Unemployment rate (annual average), % of economically active population	10.8	9.8	9.0	8.3	7.8
Export growth rates at current prices, %	0.9	4.4	5.2	6.7	7.2
Import growth rates at current prices, %	1.1	3.0	5.2	6.7	7.4

In case of the optimistic scenario, GDP at constant prices in 2015 would increase by 3.5%, while in the medium term by 4.0% each year. Upon implementation of the optimistic scenario tax revenue in 2015 would be about 126.7 million euro or 0.5% of GDP higher than in the baseline scenario. By contrast, in 2016, 2017 and 2018, tax revenue would be about 0.9% (227.8 mln euro), 1.0% (272.2 mln euro) and 1.1% (325.2 mln euro) of GDP higher than in the baseline scenario.

The realisation of pessimistic scenario would happen in case one or more of the negative risks occur, however the most important of the risks is still the geopolitical situation in the region. The pessimistic scenario has been developed based on the assumptions that the geopolitical situation in the region continues to worsen and warfare in Ukraine escalates. As a result, new mutual sanctions are imposed between the EU and Russia and due to these sanctions export volumes of Latvia, as well as Lithuania, Estonia and other major trading partners of Latvia to Russia continue to decline. These effects would be complementary, since slowdown in Lithuania and Estonia would hinder also economic growth in Latvia.

In addition to the direct effects, future economic growth would be affected also by indirect factors. Further slowdown of economic growth would worsen consumer and business sentiment. As entrepreneurs become cautious, the amount of investment would reduce, as well as the situation in the labour market would deteriorate since entrepreneurs would delay staff recruitment and further wage increase decisions. Thus household income would decrease and their vigilance regarding spending would increase that would discourage the growth of private consumption.

Table 4.2. Pessimistic macroeconomic scenario

	2014	2015	2016	2017	2018
GDP, at current prices, EUR million	24058.1	24289.9	24876.9	26140.8	27752.0
growth at current prices, %	3.6	1.0	2.4	5.1	6.2
growth at constant prices, %	2.4	0.0	1.1	2.8	3.5
CPI (annual average), %	0.6	-0.4	1.2	1.9	2.5
Average wage in the economy, euro	765.2	790.4	810.2	846.6	893.2
growth at current prices, %	6.8	3.3	2.5	4.5	5.5
Employment, thousand people	884.6	871.3	867.0	869.6	873.1
growth, %	-1.0	-1.5	-0.5	0.3	0.4
Unemployment rate (annual average), % of economically active population	10.8	11.6	11.2	10.5	10.3
Export growth rates at current prices, %	0.9	-2.2	1.5	7.1	7.1
Import growth rates at current prices, %	1.1	-3.6	1.9	7.1	7.4

In case of the negative scenario, Latvian GDP at constant prices in 2015 would remain at the level of 2014, while in 2016 and 2017 growth would be only 1.1% and 2.8%. Thus, the economy would return to previously forecasted growth rates only in 2018.

If the negative scenario happens, tax revenue would decrease significantly. Compared to the baseline scenario, in case of the negative scenario tax revenue in 2015 would be about 154.2 mln euro or 0.6% of GDP lower than in the baseline scenario. By contrast, in 2016, 2017 and 2018 tax revenue would be about 1.3% (332 mln euro), 1.5% (427.6 mln euro) and 1.5% (455.2 mln euro) of GDP lower than in the baseline scenario.

5. Comparison with the Latvia's Stability Programme for 2014-2017

GDP growth in 2014 has been slower than envisaged by the Stability Programme 2014 scenario. Slower economic growth is mainly due to the escalation of the geopolitical situation in the region, mutual economic sanctions between Russia and the EU and overall deterioration of the economic situation in Russia due to reduction in oil prices and depreciation of the ruble as well as slow recovery of economic growth in the euro area. As a result, investment and export growth has not reached projected levels, private consumption has slowed down, while public consumption growth has been stronger than predicted in the Stability Programme 2014 scenario. Due to external factors in 2015 and the subsequent two years, GDP growth is projected to be lower than in the Stability Programme 2014 scenario.

Table 5.1. Comparison with the forecasts of the stability programme 2014–2017

	ESA code	2014	2015	2016	2017	2018
GDP growth (%)	B1g					
2014		4.0	4.0	4.0	4.0	-
2015		2.4	2.1	3.0	3.6	3.6
Difference		-1.6	-1.9	-1.0	-0.4	-
General government net lending (% of GDP)	B.9					
2014		-1.0	-0.8	-0.7	-0.7	-
2015		-1.4	-1.5	-1.6	-1.3	-1.7
Difference		-0.4	-0.7	-0.9	-0.6	-
Total general government debt (% of GDP)						
2014		38.8	32.9	34.2	31.3	-
2015		40.0	37.0	40.0	37.3	34.1
Difference		+1.2	+4.1	+5.8	+6.0	-

According to the assessment of the MoF the general government deficit in 2014 was 0.4 percentage points higher than forecasted in the previous Stability Programme. An increase in the deficit was mainly influenced by lower tax revenue, taking into account the economic growth slowdown and increase in expenditure on social benefits, capital expenditure, as well as other one-off expenditure. Updated general government budget forecasts provide for a deficit of 1.5% of GDP in 2015, 1.6% of GDP in 2016, 1.3% of GDP in 2017, and 1.7% of GDP in 2018. General government budget forecasts are based on updated tax revenue projections according to the latest macroeconomic development scenario, which is significantly lower than previously expected. The general government budget balance in subsequent years is determined taking into account the structural budget balance target, changes in the cyclical component of the budget balance in accordance with the macroeconomic scenario as well as one-off expenditure for faster increase in the defence funding.

General government debt forecasts have been improved in comparison with the forecasts in the Stability Programme 2014–2017 in line with updated central government budget execution forecasted and adjusted borrowing strategy for the medium term, as well as updated economic development forecasts.

6. QUALITY OF PUBLIC FINANCES

6.1. EFFICIENCY OF THE STATE BUDGET RESOURCES AND EXPENDITURE CONTROL

Procedures for the development, approval and implementation of the State budget and responsibilities within the budgeting process are determined by the LBFM. The Minister of Finance shall be responsible for the organisation and management of the State budget implementation process.

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

According to the LBFM, within the process of development of the Draft Annual State Budget Law, the Minister for Finance shall evaluate the budgetary requests on the basis of their conformity with the purposes provided for, the results to be achieved, the conformity with the principle of economy and efficiency and, if necessary, request necessary additional information for the relevant evaluation. On the basis of the results of such evaluation and the information provided, the Minister for Finance shall take a decision regarding inclusion of the budgetary requests in the Draft State Budget Law up to its submission to the Cabinet. The Minister for Finance may, at any stage of the examination of the Draft Annual State Budget Law, express his or her point of view, add necessary opinions, as well as the results of separate audits.

According to the LBFM, persons implementing the State budget may make the budget expenditure or assume short-term liabilities only within the limits of the assignations determined by financing plans 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 liabilities of the State budget, not exceeding the ceilings of the State budget long-term liabilities for a financial year that are prescribed by the Law on the State Budget.

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

At the same time, in order to achieve budget objectives, line ministries and other central State institutions shall prepare quarterly reports on the State budget execution process and submit them to the MoF. The reports provide information on the State budget execution in the relevant reporting period – a comparison of the expenditure made with the previous year's reporting period, a comparison with the plan for the reporting period, an overview of the performed activities and activities not performed, information about the measures for improving financial management, etc.

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

As of the development of the State budget 2012, the procedure for planning and presentation of operational results and 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 shall 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 planned also in medium term and, at the same time, historical information for a three-year period is presented.

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

According to Cabinet Regulation No 523 adopted on July 31, 2012 "Regulation on the Fundamental Principles for the Development and Submission of Budget Requests", the structure of budget programmes shall be set in compliance with the operational course defined in the institution's operational strategy or functions defined in the regulation of the ministry or other central State institution.

Policy results shall be primarily planned in development planning documents. Reporting documents on policy planning documents shall be prepared in a form of informative reports both in the middle of the implementation of a policy-planning document and after the end of its duration.

The Treasury shall grant assignations for the expenditure in accordance with the appropriation determined in the Annual State Budget Law and ensure the implementation thereof according to the procedure determined by the Cabinet; in turn, ministries and other central State institutions are responsible for the establishment of implementation control systems for the appropriations specified in the Annual State Budget Law and for the control of the utilisation of the State budget funds paid into Treasury current accounts in conformity with purposes intended.

In addition, in the LBFM it is prescribed that State budget institutions for the receipt of assignations and for the making of expenditure from the State budget funds shall open the State basic budget and State special budget accounts only with the Treasury. Institutions non-financed from the budget shall open current accounts only with the Treasury.

Bodies financed from the budget, except for the State budget institutions, for the receipt of the State budget funds and for the making of expenditure financed therefrom shall open current accounts only with the Treasury, unless provided for otherwise in other regulatory enactments. Local governments and derived public persons partially financed from the State budget, as well as capital companies in which a State or local government capital share is invested may open accounts with the Treasury.

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

- if within the time period of three months the actual revenues from the State budget taxes and non-taxes in respect to the anticipated revenues in the relevant period decreases by more than 0.5 per cent from the forecast of GDP determined in the Annual State Budget Law;

- the actual accumulated State budget financial deficit within the time period of three months exceeds the State budget financial deficit anticipated for the relevant time period by more than 0.5 per cent from the forecast of GDP determined in the Annual State Budget Law,
- there is no sufficient amount of funds in the budgetary accounts of the Treasury to cover payment commitments planned for the next month.

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

- for late and incomplete payment of the amount due to the State budget into Treasury budget accounts, the Treasury, unless this is under the competency of another State agency, shall recover the amount not paid into revenue of the basic budget and may recover late charges in the amount of 0.1 per cent of the amount not paid in time for each late day of payment unless provided otherwise by laws and Cabinet regulations;
- in order to cover losses caused to the budget, the Treasury may include amounts in the basic budget revenue and withdraw or suspend assignations, if the reports provided for in accordance with this LBFM have not been submitted in good time or are incomplete; the budgetary funds and transactions in such funds have not been registered in accordance with the procedures prescribed by law or notice has not been given regarding them; the accounting does not comply with the prescribed procedures and, thus, funds due to the budget are concealed; or a manager of a body financed from the budget has undertaken liabilities exceeding the assignation allocated by the Treasury;
- if bodies financed from the budget, institutions non-financed from the budget and local governments, as well as capital companies, in which a State or local government capital share has been invested, have violated financial management provisions provided for in the LBFM the Minister for Finance, the Treasurer or the heads of ministries and other central State institutions may in accordance with the competence withdraw for a period of time an authorisation to assign or deal with budgetary revenue or expenditures; set limitations on the use of accounts; withdraw or suspend the assignations in order that the illegally used funds be refunded or require refunding of the illegally used funds; submit a civil claim to a court or provide materials to competent officials for deciding on the issue of initiation of criminal proceedings; or withdraw or suspend payments;
- the Treasury, in accordance with the Law on Equalisation of Local Government Finances is entitled, by uncontested procedure, to recover from local government budget funds the amount, which the relevant local government has not in good time or in full amount included in the local government finance equalisation fund, by writing off such amounts from the budget of the relevant local government.

In order to maintain general economic balance and to ensure a uniform State financial policy, the amounts of total increase in local government borrowings and guarantees shall be separately prescribed in the Annual State Budget Law. The Treasury has the right to withhold the sums from the amount, which is due to the local government from PIT, or from a grant of the local government financial equalisation fund in the following cases and amount:

1) if the local government does not ensure timely fulfilment of the liabilities specified in State loan agreements – in the amount of sum not paid timely; and
2) if local government does not ensure use of the State loan in compliance with the purpose specified in the loan agreement – according to the order of the Minister for

Finance in the amount of the loan sum used in non-compliance with the purpose specified in the agreement.

The LBFM also provides that the Cabinet shall determine the procedure by which a body financed from the budget shall allocate State budget financing to private persons, including non-governmental organizations for the implementation of tasks assigned by the public administration, and supervise the utilization of the allocated financing. Thus, common principles have been introduced for the financing of tasks delegated by the public administration, control of the utilized financing, reporting on the utilization of the State budget financing, as well as publicity of the above-mentioned process.

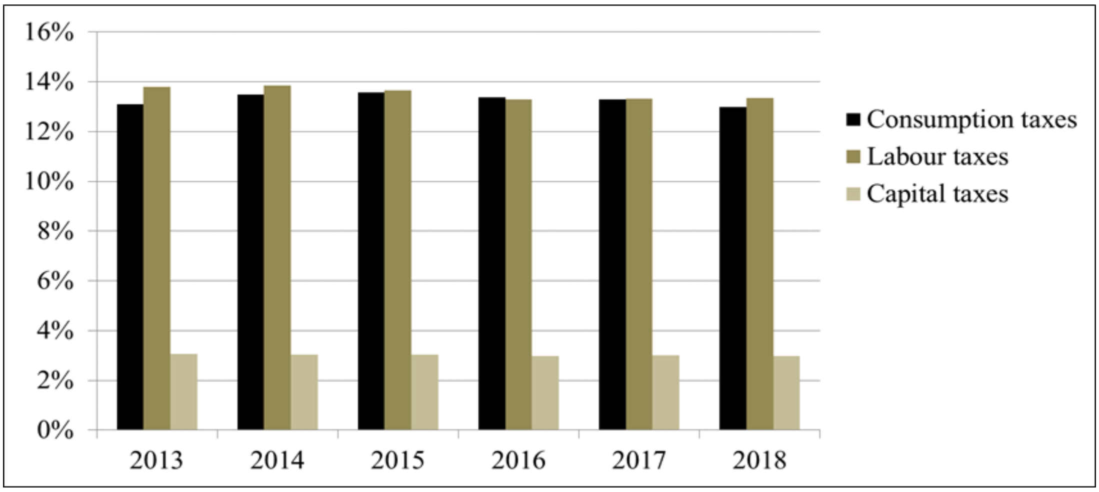
6.2. Efficiency of Revenue Structure and System

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

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

	Code (ESA)	2014	2015	2016	2017	2018
Tax revenue						
1. Production and import taxes	D.2	3424.5	3591.4	3731.8	3926.5	4072.1
2. Current income and real estate taxes	D.5	1834.4	1866.5	1896.9	2044.8	2177.2
3. Capital taxes	D.91	2.4	2.5	2.7	2.9	3.2
4. Social contributions	D.61	2041.5	2091.0	2132.5	2257.5	2400.2
Hereof actual social contributions	*D.611 and D.613*	*1981.3*	*2030.8*	*2072.3*	*2197.3*	*2340.0*

In Latvia, the biggest part of all tax revenue is attributed to labour taxes. In recent years, however, the tax policy is focused on reducing the share of labour taxes in total tax revenue. In the result of changes, the share of labour taxes decreased from 47.0% in 2012 to 45.6% in 2014. Therefore, the share of revenue from consumption, capital taxes in total tax revenue gradually increased from 53.0% in 2012 to 54.4% in 2014.



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

Changes in the medium-term tax policy are focused on reducing labour taxes and limiting the shadow economy, as well as promoting economic activity, investments and employment.

To reduce the **tax burden on labour**, as of January 1, 2014 the allowance for dependents was increased from 113.83 euro to 165 euro per month and non-taxable minimum from 64.03 euro to 75 euro, as well as the rate of mandatory state social insurance contributions was decreased from 35.09% to 34.09%.

As of January 1, 2015 the minimum monthly wage was raised from 320 euro to 360 euro, but the PIT rate was reduced from 24% to 23%.

Also in the medium term the most important tasks is to continue reducing the tax burden on labour, while ensuring stability of the tax revenue. In accordance with the law, as of January 1, 2016 it is planned to further reduce the PIT rate by 1 percentage point (from 23% to 22%). At the same time according to the Declaration on the Government's Action Plan ("Declaration on the Implementation of Actions Planned by the Cabinet led by Laimdota Straujuma") in 2015 the possibilities will be assessed for the implementation of differentiated non-taxable minimum and reduction of the tax burden on labour.

Another implemented direction of the tax policy is related to **the implementation of measures to limit the shadow economy**. As of 2015 a number of measures to combat the shadow economy came into effect:

- to improve the information exchange process between financial institutions, the Office for Prevention of Laundering of Proceeds Derived from Criminal Activity and the SRS (Paragraph 2 of Minutes No 62.2 of the Cabinet sitting on November 12, 2014 obligates until July 1, 2015 to submit to the Cabinet amendments to the Law on Credit Institutions which provide for electronic exchange of information between credit institutions and the SRS);
- to define that in certain cases board members are personally responsibility for company's late tax payments in order to reduce the practice introduced by unfair enterprises to avoid tax debt payments and accumulate debt;
- to define the action of the Register of Enterprises for receiving information from the SRS on the risk addresses, providing that the registration of a company is suspended if it is found that the address provided in the company's application is a risk address;
- to set principles regarding the cases when a tax debtor is prohibited from cash transactions;
- to set additional criteria for accessibility of the officials of foreigners-owned companies providing that if a legal entity is represented only by officials who are foreign nationals, at least one of them shall submit personally the documents to the Latvian Register of Enterprises prior an entry is made about the registration of the legal entity (amendments to the Law on Taxes and Fees have been adopted and will come into force simultaneously with the amendments to the Commercial Law);
- to make more transparent the business environment in Latvia information about the amount paid in taxes by businesses will be disclosed;
- to prevent unfair commercial practices and not cause adverse effect on the business environment, economic activity of associations and foundations is separated from the activity aimed at profit-making;
- a new informative statement has been introduced obligating the taxpayer, who provides leasing and lending services, to submit the informative statement about the leasing and/or loan payments and associated interest payments made by Latvian residents, if the amount per month exceeds 360 euro or the total amount of such payments per calendar year exceeds 4320 euro (the Cabinet has been delegated until June 1, 2015 to prescribe a procedure in which leasing and credit service providers shall provide information to the SRS);

- measures to improve tax administration, which include implementation of new and more efficient methods, to increase operational efficiency and productivity, as well as implementation of work organization reforms;
- excise duty on tobacco leaves and other raw materials for the production of tobacco products;
- impose excise duty on diesel fuel (gas oil), substitute products and components, to which biodiesel fuel acquired from rapeseed oil is added;
- certain types of agricultural equipment, in which it is allowed to use diesel fuel (gas oil), to which the excise duty rate of 50 euro per 1,000 litres is applied.

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

In addition, currently work is being done **to increase excise duty rates on alcoholic beverages and bear** as of July 1, 2015, considering the possibility to continue the increase also in coming years – as of April 1, 2016 and April 1, 2017.

Value Added Tax

In spite of the reduction of VAT revenue growth rate, stable VAT revenue growth is expected according to the forecasted country's economic growth.

In addition, in the medium term the VAT revenue growth will be facilitated by the continued implementation of the measures adopted by the government – the fight against tax evasion and tax avoidance improving efficiency of tax collection. Improvements in tax collection will result in gradual increase in the amount of tax revenue to GDP. The VAT revenue is affected also by the measures that are not directly related to the changes in the VAT Law, but contributing to revenue growth.

Table 6.2. Impact[17] of the Most Substantial Changes in Tax Policy on VAT Revenue, million euro

	2015	2016	2017	2018
Fight against the shadow economy and other measures to improve tax administration (measures to improve tax administration, improving the information exchange process between financial institutions, the Office for Prevention of Laundering of Proceeds Derived from Criminal Activity and the SRS, and other measures)	+34.3	+1.4		
Increasing the excise duty on cigarettes, cigars and cigarillos, as well as smoking tobacco	+0.5	+0.7	+0.8	+0.9
Impact of the increase in the minimum monthly wage from 320 euro to 360 euro	+2.7			
Total impact of changes:	37.5	2.1	0.8	0.9

[17] 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 the CIT rate – 15%, effective since 2004 and 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 has increased considerably since 2011.

In 2015, CIT revenue will be affected by the legislative changes adopted in 2014 providing for the introduction of new CIT reliefs or abolition of existing CIT reliefs, as well as the fight against the shadow economy, and other measures to improve tax administration.

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 certain research and development costs, is 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 euro;
- 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 is abolished;
- as from 1 January 2017, tax allowance regarding grants received for agriculture is abolished.

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

	2015	2016	2017
Introduction or abolition of CIT reliefs	+14.1	+0.03	
Preferential regime of CIT for higher educational institutions, colleges and scientific institutions	-0.7		
Fight against the shadow economy and other measures to improve tax administration (measures to improve tax administration, improving the information exchange process between financial institutions, the Office for Prevention of Laundering of Proceeds Derived from Criminal Activity and the SRS, and other measures)	+8.9	+1.9	+1.0
Total impact of changes:	+22.3	+1.9	+1.0

In addition to the aforementioned legislative changes in the Law on Enterprise Income Tax, in 2015 also other measures are planned that do not have considerable impact on the tax revenue:

- in order to avoid unequal approach to the application of the CIT to non-residents' income from the provided management and consulting services, as well as the Latvian from the use of property located in Latvia, non-residents are granted the right, when submitting a tax calculation report on that income (income earned as of January 1, 2015), to make a tax payment from the taxable income reduced by expenses associated with earning of such income and apply the 15% rate;

- the Law provides in respect of individuals to include in the partnership's distributable profit, calculated for the taxation period starting on January 1, 2015 and subsequent periods, capital income that at the partnership level has not been included in the company's calculation of income subject to the CIT. To ensure that this income is subject to the PIT, simultaneously amendments have been made to the Law on Personal Income Tax;
- a special corporate tax regime is set for the Development Financial Institution, essentially in terms of taxation equating it to a credit institution.

Excise Duty

According to the amendments of December 17, 2014 to the Law on Excise Duties a number of changes have been defined in the application of excise duty:

- as of April 1, 2015 excise duty will be levied on tobacco leaves and other raw materials for the production of tobacco products at the rate of 55.49 euro per 1000 grams of tobacco leaves, but as of January 1, 2018 the rate will be increased up to 60 euro per 1000 grams of tobacco leaves;
- as of January 1, 2015 an excise duty exemption will be applied to natural gas, which is used for heating greenhouses, regardless of what agricultural crops are grown there;
- as of January 1, 2015 the reduced excise duty rate of 233.35 euro per 1000 litres has been abolished on diesel fuel (gas oil), substitute products and components, to which biodiesel fuel acquired from rapeseed oil is added and this biodiesel fuel makes at least 30 per cent by volume of the total quantity of product. Instead the excise duty rate of 332.95 euro per 1000 litres of this diesel fuel is applied;
- as of July 1, 2015 diesel fuel (gas oil) and diesel fuel (gas oil), to which biodiesel fuel acquired from rapeseed oil is added and which is used the production of agricultural products, cultivation of agricultural land, as well as cultivation of such forest or marshland, where cranberries or blueberries are cultivated, and cultivation of the land under fish ponds (hereinafter – agricultural diesel fuel), will no longer be exempt from the excise duty, and the maximum total quantity of diesel fuel, which is subject to a different tax regime, will no longer be set. Instead, a reduced excise duty rate of 50 euro per 1000 litres of this diesel fuel will be applied. In addition, it is stated that in order to apply the reduced excise duty rate on agricultural diesel fuel it should be labelled. At the same time certain types of agricultural machinery such as tractors and self-propelled agricultural machinery, in which it is allowed to use agricultural diesel fuel, are defined, and differentiated limits have been set on the purchase of this diesel fuel depending on the agricultural sector.

Imposing excise duty on tobacco leaves and defining certain types of agricultural machinery, in which diesel fuel, which is subject to the reduced excise duty rate, can be used, is part of the measures limiting the shadow economy.

According to the Law of November 6, 2013 on Amendments to the Law on Excise Duty, as of July 1, 2014 the structure of excise duty on cigarettes was changed raising the specific rate and reducing the percentage rate to 25%. According to the Transitional Provisions of the Law on Excise Duty, it is planned to increase the specific excise duty rate and the minimum excise duty level per 1000 cigarettes in 2015 and subsequent years:

- as of July 1, 2015 the specific rate is set at 54.20 euro and the minimum level at 89.80 euro per 1000 cigarettes;
- as of July 1, 2016 the specific rate is set at 56.20 euro and the minimum level at 93.70 euro per 1000 cigarettes;

- as of July 1, 2017 the specific rate is set at 58.20 euro and the minimum level at 97.00 euro per 1000 cigarettes;
- as of July 1, 2018 the specific rate is set at 60.00 euro and the minimum level at 100.00 euro per 1000 cigarettes;

According to the amendments of April 14, 2011 to the Law on Excise Duty, as of January 1, 2016 the excise duty rate on cigars and cigarillos will increase from 39.84 euro to 42.69 euro, but as of January 1, 2018 up to 45.00 euro per 1000 cigars and cigarillos. As of January 1, 2018 excise duty will be increased also on smoking tobacco from 55.49 euro per 1000 grams to 60.00 euro per 1000 grams.

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

	2015	2016	2017	2018
Increase in the excise duty rate on cigarettes, cigars and cigarillos, and smoking tobacco	+2.6	+3.2	+3.8	+4.2
Imposition of excise duty on tobacco leaves	+0.3			
Defining the types of tractor machinery, in which it is allowed to use diesel fuel intended for the agricultural production, to which the reduced excise duty rate is applied	+0.7			
Measures to improve tax administration	+1.2			
Total impact of changes:	+4.8	+3.2	+3.8	+4.2

Real Estate Tax

Since 2012, local governments are entitled to determine by binding regulations the tax rate from 0.2 to 3.0 per cent of the cadastral value of real estate. The tax rate may exceed the threshold of 1.5 percent only in case the real estate is not being 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.

The most substantial legislative changes, effective as of 1 January 2015, stipulate that the building built or reconstructed for the purpose of economic activities will not be exempted from the real estate tax for the period of 12 months after the buildings are put into operation.

Personal Income Tax

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

The most significant changes that will affect PIT revenue in 2015 refer to the minimum monthly wage increase by 40 euro (from 320 euro to 360 euro), as well as the reduction in the rate by 1 percentage point (from 24% to 23%).

In addition PIT revenue in 2015 will be affected by other legislative changes:

- introduction of shadow economy combating measures;
- changes in the application of non-taxable minimum to foreign pensioners, which provides that a person, who has been granted a retirement pension in accordance with the Law on State Pensions or old-age pension in accordance with foreign

laws and regulations, is entitled to receive pensioner's non-taxable minimum 235 euro per month if he/she has reached the retirement age set in the Law on State Pensions;

- changes in the application of the allowance for dependents providing that tax exemptions for dependents could be applied to PIT payers if the dependent person learning in a general, vocational, higher education or special education institution is younger than 19 and receives a taxable income during summer holidays.

Table 6.5. Impact of the Most Substantial Changes in Tax Policy on PIT Revenue, million euro

	2015	2016	2017	2018
Reduction of PIT rate in 2015 from 24% to 23% and in 2016 from 23% to 22%	-53.8	-59.6		
Imposition of ceiling on state social insurance contributions in 2014 at 46,400 euro	+2.3			
Imposition of ceiling on state social insurance contributions in 2015 at 48,600 euro		-0.2		
Increase in the minimum wage from 320 euro to 360 euro	+8.6			
Changes in the application of the non-taxable minimum to foreign pensioners	+0.4			
Pension indexation in 2014 and 2015	+2.7	+1.9	+1.7	
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
Fight against the shadow economy and other measures to improve tax administration (measures to improve tax administration, improving the information exchange process between financial institutions, the Office for Prevention of Laundering of Proceeds Derived from Criminal Activity and the SRS, and other measures)	+7.9	+4.7		
Total impact of changes:	-31.9	-53.3	+1.7	+2.2

Medium-term macroeconomic development forecasts for 2015 provide for a stable increase in the wage fund, which, in turn, will increase labour tax revenue in following years; PIT revenue will be also influenced by the legislative changes made.

Social Security Contributions [18]

In the medium term, the dynamics of revenue from social security contributions will be determined not only by the expected increase in the wage fund, but also by legislative changes and changes in the rate of contributions to the state-funded pension scheme.19

The most substantial legislative changes in 2015 are related to the increase in the minimum monthly wage from 320 euro to 360 euro and implementation of measures to combat the shadow economy.

[18] Excluding contributions to the state-funded pension scheme.
[19] 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.

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

	2015	2016	2017
Imposition of ceiling on state social insurance contributions in 2014 at 46,400 euro	-33.7		
Imposition of ceiling on state social insurance contributions in 2015 at 48,600 euro		+3.2	
Increase in the rate of contributions to the state-funded pension scheme in 2015 from 4% to 5% and in 2016 from 5% to 6%	-68.6	-73.6	
Increase in the micro enterprise income tax rate from 9% to 11% in 2015, from 11% to 13% in 2016 and from 13% to 15% in 2017. Changes refer to micro enterprises with turnover between 7,000 and 100,000 euro	+7.0	+6.0	+5.1
Increase in the minimum monthly wage from 320 euro to 360 euro	+12.4		
Fight against the shadow economy and other measures to improve tax administration (measures to improve tax administration, improving the information exchange process between financial institutions, the Office for Prevention of Laundering of Proceeds Derived from Criminal Activity and the SRS, and other measures)	+4.1	+0.8	
Total impact of changes:	-78.8	-63.6	+5.1

The amount of social security contributions to the State special budget not only in 2015 but also in the medium term is substantially affected by the rate of contributions to the state-funded pension scheme, which in 2015 has been increased from 4% to 5%, but in 2016 will be increased to 6%.

Subsidised Electricity Tax

The subsidised electricity tax is imposed on the taxable income gained between January 1, 2014 and December 31, 2017. The tax has been introduced for the period until the end of 2017 providing that it should be decreased or abolished if the amount of subsidies to be paid within the framework of the mandatory procurement component is reduced.

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

The purpose of the 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 the 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.

There are three differential rates set for the 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 euro

	2014	2018
Introduction/abolition of the subsidised electricity tax	+32.8	-32.8
Total impact of changes:	+32.8	-32.8

7. SUSTAINABILITY OF PUBLIC FINANCES

7.1. THE LONG-TERM DEVELOPMENT SCENARIO OF PUBLIC FINANCES

Sustainability of public finances plays a key role in economic growth. Sustainability not only affects the initial budgetary position, but in the Europe one of the topical issue is about the demographic change impact on the budget, especially in the context of an aging population. It can have a significant impact on budget expenditure, contributing to an increase in the long term.

According to the Fiscal Sustainability Report 2012 of the EC, Latvia is evaluated as a low-risk country as regards sustainability of public finances. To restrict the negative impact of population ageing on Latvia's public finances in the long term, in 2012 there were considerable changes made in the Latvian pension system, including a gradual increase in the retirement age up to 65 years in 2025.

The EC in co-operation with Member States within the framework of the AWG every three years works out long-term forecasts on public expenditure related to population ageing as well as evaluates the sustainability of public finances for each Member State. Long-term forecasts are based on the demographic projections provided by the Eurostat and on the assumptions regarding economic growth and its determinatives in the long term. Updated long-term forecasts of public expenditure related to population ageing for all Member States are included in the Ageing Report 2015 of the EC, which will be approved and published in May 2015. However, the EC plans to publish the updated Fiscal Sustainability Report in the second half of 2015.

In 2014, the Eurostat published demographic projections EUROPOP2013, and in Latvia a decrease in the number of population is forecasted until 2060, in spite of the overall trend of growing number of population in the EU. According to the Eurostat base scenario it is forecasted that the total number of Latvia's population will decrease from 2.0 million in 2013 to 1.4 million in 2060. Inter alia, it is forecasted that the number of working-age population (15-64) will decrease by 42.0% or 1.3 million in 2013 to 0.8 million in 2060. In turn, the number of inhabitants aged over 65 will increase by 3.0% in 2060 compared to 2013 and will total to 0.4 million.

In accordance with the AWG macroeconomic assumptions it is forecasted that demographic changes will affect the development of employment. It is expected that in the 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 the long term productivity will be a determinative factor for economic growth and it will be the basis of convergence in the long term.

It is planned that the updated long-term public expenditure forecasts will be approved and published in May 2015 and according to the AWG base scenario, it is forecasted that in Latvian the proportion of public expenditure related to population ageing in GDP in 2060 compared to 2013 will decrease from 16.2% of GDP to 14.4% of GDP. Decrease will be mainly determined by the forecasted decline in the proportion of pension expenditure in GDP.

The long-term public expenditure base scenario provides for:

- decline in the proportion of pension expenditure in GDP from 7.7% of GDP in 2013 to 4.6% of GDP in 2060;
- increase in the proportion of health care expenditure in GDP from 3.8% of GDP in 2013 to 4.4% of GDP in 2060;

- increase in the proportion of long-term care expenditure in GDP from 3.8% of GDP in 2013 to 0.8% of GDP in 2060;
- increase in the proportion of education expenditure in GDP from 3.8% of GDP in 2013 to 4.5% of GDP in 2060;
- decline in the proportion of expenditure for unemployment benefits in GDP from 0.3% of GDP in 2013 to 0.1% of GDP in 2060.

Legislative changes that have been taken into account in long-term forecasts of pension expenditure comply with the Law on State Pensions and provide for:

- gradual annual increase in the retirement age every 3 months reaching 65 years on January 1, 2025 (62 years and 6 months in 2015). At the same time there is still a possibility to request an old-age pension prematurely two years before the regular retirement age (60 years and 6 months in 2015);
- increase in the minimum insurance period from 10 to 15 years for entitlement to the state old-age pension and from 15 to 20 years as of January 1, 2025. The increase in the minimum insurance period necessary to receive an old-age pension stimulates the payment of state social insurance contributions;
- since 2013 the indexation of granted pensions has been restored. First of all small pensions have been indexed, but already since 2014 state pensions or their part that does not exceed 285 euro is indexed, taking into account the actual consumer price index and 25% of the real increment percent from the insurance contributions wage. As of 2015 state pensions or their part that does not exceed 50% of the average insurance contributions wage of previous calendar year is indexed once a year on October 1, taking into account the actual consumer price index and 25% of the real increment percent from the insurance contributions wage.

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

7.2. State Guarantees

In 2014, in accordance with the Law on State Budget for 2014 it was planned to issue guarantees in amount of 40.9 million euro for the implementation of the student crediting (12.8 mln euro) and study crediting (28.1 mln euro) programmes. In 2014, the amount of actually issued state guarantees for study and student commitments was 10.6 million euro.

State-guaranteed loans outstanding at the end of 2014 amounted to 592.6 mln euro. Compared to the end of 2013, state-guaranteed loans outstanding have decreased by 70.3 mln euro.

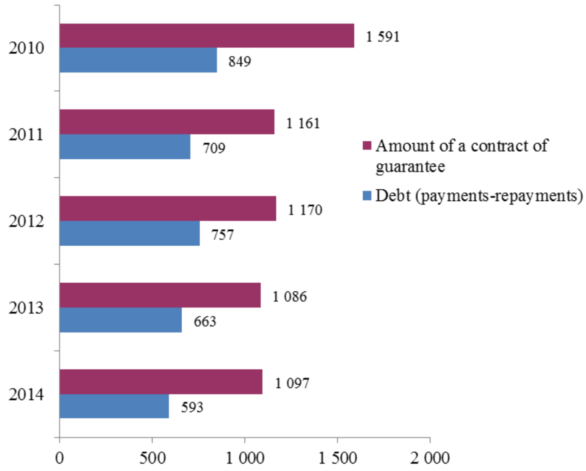


Figure 1. State-guaranteed loans outstanding at the end of respective year (mln euro)

There are state guarantees in amount of 37.8 million euro anticipated in the Law on State Budget for 2015, including 10.8 million euro for student loans, 25.2 million euro for study loans, 1.8 million euro for the funding of projects financed by the European Investment Bank in African, Caribbean and Pacific countries and overseas countries and territories.

According to the information on the borrowers' financial position, credit history, collateral liquidity and amount, as well as other available information, guarantees to 16 borrowers are considered relatively riskier, the largest part of which are guaranteed loans provided to support of hospitals. The outstanding guaranteed loans to these borrowers on 31 December 2014 accounted for 58% of the total amount of outstanding guaranteed loans. In light of this assessment, there is a possibility that the relatively riskier state-guaranteed loan obligations or their part could not be met within the prescribed period. Accordingly to the Law on State Budget for 2015 allowable limits on government actions to cover expenditure that may occur in the performance of state-guaranteed debt obligations attributable to the state budget in 2015 are set at 133.8 million euro (~ 0.5% of GDP).

On 8 July 2014 new Cabinet Regulation No 391 "Procedure by which the Requests for the Guarantees to be Issued on Behalf of the State shall be Included in the Draft Annual State Budget Law, and the Procedure for the Issuance and Supervision of the Guarantees" entered into force. The regulation was drafted during the process of improving the state guarantee policy thus tightening the standards and including criteria for identifying high loan repayment risks thus strengthening the monitoring of state guaranteed obligations and increasing responsibility of line ministries for the implementation of the project business plan to ensure its compliance with the objectives set in policy documents of the relevant line ministry, as well as defining the steps to be taken in case financial performance of the beneficiary of a state guarantee deteriorates and the value of the subject of the commercial collateral decreases to ensure maximum protection of public interests.

8. INSTITUTIONAL FEATURES OF PUBLIC FINANCES

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

Since the FDL entered into force on March 6, 2013, in the process of drafting state budget and the Framework Law in 2014 and 2015 fiscal rules were met. At the same time it should be noted that according to the EC assessment Latvia is one of the Member States, which is fully compliant with SGP provisions, placing it among such countries as Germany, the Netherlands, Luxembourg, Ireland and Slovakia.

Also, it should be noted that according to the EC database on fiscal governance in EU Member States[20] Latvia in 2013 was one of the two countries that had improved significantly its fiscal governance and took the sixth place as one of the best countries with high Fiscal Rule Strength Index. The Fiscal Rule Index is calculated taking into account existing numerical fiscal rules and their application to general government sectors, as well as institutional features, the rule of law, the public interest.

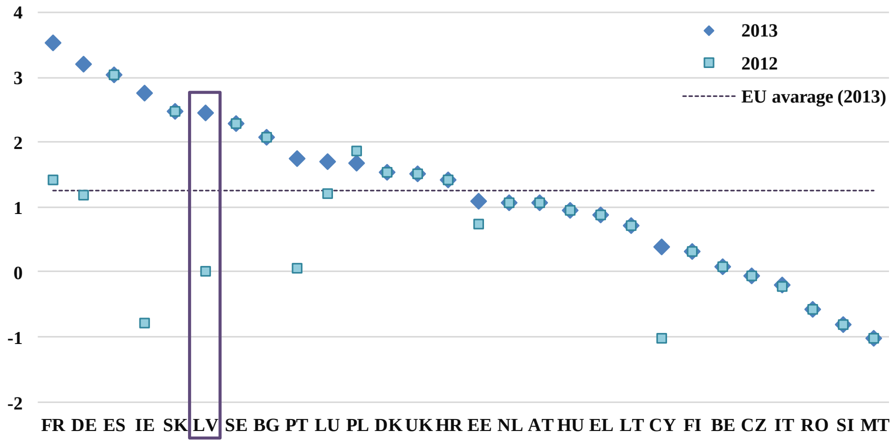


Figure 8.1. Fiscal Rule Index

According to the FDL, preparation and execution of the Framework Law and the annual state budget law, and any amendments thereto must comply with the following fiscal conditions:

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

[20] Fiscal governance in the EU Member States
http://ec.europa.eu/economy_finance/db_indicators/fiscal_governance/index_en.htm

thresholds are not inherited if the threshold value in accordance with the updated macroeconomic forecasts differs from inherited thresholds by more than 0.1% of GDP.

In addition to introduction of strict fiscal rules, Fiscal Discipline Council which was established in 2013 and became operational in 2014 is responsible for monitoring of the implementation of these rules both in the planning and execution process of the Framework Law and the annual state budget. While developing the Law on State Budget 2015 and the Law on the Medium-term Budget Framework 2015, 2016 and 2017 the Council prepared the first fiscal discipline monitoring report, where it was indicated that in general the principles and rules of the FDL are met.

In 2014 one of the FDL instruments was introduced – general governance of fiscal risks, which aims to ensure stability of fiscal indicators in the medium-term, regardless of changes caused by external factors, as well as to reduce the impact of changes caused by external factors on fiscal indicators in each year of the Framework Law period. In cooperation with the central public authorities information was compiled on the fiscal risks under the particular competence of the central public authorities, and on this basis a Fiscal Risks Statement was prepared where it was stated that the amount of the fiscal security reserve for 2017 is 0.1% of GDP. It should be noted that the draft Framework Law 2015, 2016 and 2017 was supplemented by the Fiscal Risks Statement where fiscal risks were broken down in quantifiable and unquantifiable risks.

Fiscal risks are summarized in the fiscal risks register, which is one of the main instruments of the general governance of fiscal risks, where the information is updated annually. As of 2015 central government institutions each year submit to the MoF fiscal risks governance reports on the monitored fiscal risks.

8.2. THE MEDIUM-TERM BUDGET PLANNING

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

Since 2007, a Medium-Term Macroeconomic Development and Fiscal Policy Framework (hereinafter – the Framework) has been prepared for the next three financial years, in which there is an analysis of the medium-term State macroeconomic situation presented, as well as objectives of the government fiscal policy for medium term, forecasts on the State budget revenue and ceilings of the State budget total expenditure for each ministry and other central State institutions for the medium term. In view of the fact that the Framework did not have legally binding nature and it only indicated the ceilings of the State budget total expenditure for the medium term, a need arose to strengthen the medium-term budget planning system. Therefore corresponding amendments to the LBFM have been made and since January 1, 2012 the Framework, which since 2007 has been approved by the Cabinet, is drafted as a Framework Law and approved by the Saeima. Therefore, the achievable financial indicators, included in the Framework Law, have legally binding force and the Annual State Budget Law and further Framework Laws shall be based on these indicators.

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

The first year of the Framework Law period is elaborated in detail in the Annual State Budget Law. For each year of the Framework Law period the following shall be specified: the medium term budget objectives and priority development directions for the achievement of the purposes and introduction of the priorities determined in the NDP and National Defence Conception; the fiscal policy objectives of the government; the maximum permissible total amount of the State budget expenditure (the maximum permissible total amount of the State budget expenditure for each ministry and other central State institution); forecasts of GDP; forecasts of the State budget revenues; the amount of the State budget financial balance (maximum deficit level or minimum surplus level). The first Framework Law approved by the Saeima was drafted for the period 2013–2015; however, explanations to the Medium-Term Framework Law were attached starting from the draft law "On the Medium-Term Budget Framework for 2014, 2015 and 2016". Besides, according to the provisions of the FDL simultaneously with the draft law "On the Medium-Term Budget Framework for 2014, 2015 and 2016" for the first time the Fiscal Risk Declaration was developed aiming to ensure the overall management of fiscal risks, as well as stability of fiscal indicators in medium term.

According to the deadlines prescribed by the legislative acts, the Saeima approved the draft Framework Law for the period 2014–2016 and draft law "On State Budget 2014" on November 7, 2013. The Saeima approved the draft Framework Law for the period 2015–2017 and draft law "On State Budget 2015" on December 17, 2014.

As regards medium-term objectives and initiatives, the LBFM stipulates that the ministries and other central State institutions shall prepare proposals for the NPI if in the relevant subsequent financial years funds are available for financing of the NPI in accordance with the latest macroeconomic development forecasts. The proposals for NPI shall be submitted in accordance with the Schedule for the Development and Submission of the Draft Medium Term Budget Framework Law and the Draft Annual State Budget Law. The proposals for NPI shall be prepared on the basis of the priorities and purposes determined in the National Development Plan, National Defence Conception and priorities and purposes set in other development planning documents, inter alia, taking into account the need to strengthen the capacity (administrative capacity) of budget institutions. Thus, national priorities are linked with the resources available within the State budget for the medium term.

8.3. BUDGET PROCEDURES, INCLUDING PUBLIC FINANCE STATISTICAL MANAGEMENT

8.3.1. Budget procedures

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

When planning the expenditure of the State budget, first the base expenditure is calculated and agreed. Calculation of the base expenditure and the principles of its coherence with the Framework Law is determined by 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" adopted on December 11, 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, when calculating ceilings of the total amount of the State budget expenditure, consisting of base expenditure of the State basic budget and the State special budget and of the expenditure for development of the State basic budget and the State special budget, the MoF shall rely on the Framework Law, forecasts of macroeconomic development, as well as observe fiscal conditions that are defined in the state.

On the basis of the ceilings approved by the Cabinet on the total amount of expenditure for each budget sector, ministries and other central State institutions shall develop and submit budget requests to the MoF according to Cabinet Regulation No 523 "Regulation on the Fundamental Principles for the Development and Submission of Budget Requests" adopted on July 31, 2012. The Regulation prescribes common principles for the preparation of budget programmes, preparation of requests of the State basic budget and the State special budget, as well as the composition of a budget request.

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

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

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

The ministries and other central State institutions shall in accordance with the Schedule for the Development and Submission of the Draft Medium Term Budget Framework Law and the Draft Annual State Budget Law develop and submit state budget requests to the MoF. According to the LBFM, the budget requests shall be submitted by the Minister for Finance to the Cabinet.

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

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

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

During the process of development of the Draft State Budget Law, negotiations between the LALRG and the MoF are being held, as a result of which a Cabinet and LALRG Draft Protocol on Disputes and Agreements (a Draft Protocol) is being prepared. In the Draft Protocol, there are questions included on financial resources for local governments' tax revenue, central government budget transfers to local governments, loans, guarantees and long-term obligations, local governments financial equalization, and other issues related to the operations and financing of local governments. The Draft Protocol is submitted for consideration at the extended session of the Cabinet' Committee. According to the Law on Local Government Budgets the Draft Protocol shall be attached to the Draft Annual State Budget Law and the Cabinet shall submit it to the Saeima. LBFM prescribes to negotiate issues related to the interests of local governments with the LALRG also during the process of development of the Draft Framework Law and to attach the result of the negotiations to the Draft Law in a form of a protocol and submit it to the Saeima.

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

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

If at the beginning of a financial year the Annual State Budget Law has not come into force, local government expenditure per month shall not exceed one twelfth of previous year's expenditure provided that the amount of functions to be fulfilled by the local government does not exceed.

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

8.3.2. Management of government finance statistics

CSB compiles government finance statistics which is calculated accordingly requirements of ESA 2010.

Framework of general government sector (S.13) in Latvia accordingly methodology ESA 2010 consists of three subsectors: central government subsector (S.1311), local government subsector (S.1313) and social security fund subsector (S.1314).

In December 31, 2014 in general government sector there were 1130 independent budgetary institution, of which 255 institution were in central government subsector; 874 institutions - in local government subsector and 1 institution - in social security fund subsection; moreover, there was 128 enterprise controlled and financed by central and local governments, of which 49 enterprises were controlled by central government, 79 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) 3 months after the end of reference period.

Moreover government budget deficit and debt notification, which is regularly sent to the EU institutions accordingly unified form established to all EU countries, is prepared in set terms (twice a year – until April 1 (provisional data) and until October 1 (final data)). Institution responsible for the preparation of notification is CSB, which during the preparation of notification carries out regular inter-institution working group meetings. Specialists from MoF, the Treasury and Ministry of Economy, as well as from the Bank of Latvia are involved in the preparation of notification. If necessary additionally specialists from other institutions (the Ministry of 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 2010.

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").

ANNEXES

Table 1a. Growth and its Factors

	ESA Code	2014	2014	2015	2016	2017	2018
		mln. *euro*	Growth %				
1. Real GDP (at prices of the year 2010)	B1*g	21333,4	2.4	2.1	3.0	3.6	3.6
2. Nominal GDP	B1*g	24058.1	3.6	3.3	5.0	6.2	6.2
Real GDP by Expenditure (at Prices of the Year 2010)							
3. Private consumption expenditure	P3	13373.3	2.3	2.4	3.1	3.8	3.8
4. Government consumption expenditure	P3	3637.9	3.6	2.8	2.8	2.8	2.8
5. Gross fixed capital formation	P51	4751.4	1.6	-1.5	3.5	4.1	4.5
6. Changes in inventories and net acquisition of valuables	P52+P53		-25.9	-0.4	0.8	1.0	1.1
7. Exports of goods and services	P6	12242.2	1.9	0.8	4.0	4.5	5.0
8. Imports of goods and services	P7	12882.0	1.5	0.0	4.2	4.6	5.3
Contributions to real GDP growth							
9. Final domestic demand			2.4	1.6	3.2	3.7	3.8
10. Changes in inventories and net acquisition of valuables	P52+P53		-0.3	0.0	0.0	0.0	0.0
11. External balance of goods and services	B11		0.2	0.5	-0.2	-0.2	-0.3

Table 1b. Price developments

	ESA Code	2014	2014	2015	2016	2017	2018
		level	rate of change %				
1. GDP deflator			1.2	1.2	1.9	2.5	2.5
2. Private consumption deflator			0.6	0.4	1.9	2.5	2.5
3. HICP			0.6	0.4	1.9	2.5	2.5
4. Public consumption deflator			-0.1	0.0	1.0	2.0	2.0
5. Investment deflator			1.8	2.0	2.6	2.9	2.9
6. Export price deflator (goods and services)			-1.0	-1.3	1.0	2.0	2.0
7. Import price deflator (goods and services)			-0.3	-2.0	1.0	2.0	2.0

Table 1c. Labour market developments

	ESA Code	2014	2014	2015	2016	2017	2018
		Level	rate of change %				
1. Employment, persons		884.6	-1.0	0.0	0.2	0.4	0.4
2. Employment, hours worked		1303265233	1.0	0.0	0.2	0.4	0.4
3. Unemployment rate (%)			10.8	10.2	9.8	9.3	9.0
4. Labour productivity, persons			3.4	2.1	2.8	3.2	3.2
5. Labour productivity, hours worked			1.3	2.1	2.8	3.2	3.2
6. Compensation of employees	D.1	10281.7	7.3	4.5	5.2	5.9	5.9
7. Compensation per employee		765.2	6.8	4.5	5.0	5.5	5.5

Table 1d. Sectoral balances

% of GDP	ESA Code	**2014**	**2015**	**2016**	**2017**	**2018**
1. Net lending/borrowing vis-à-vis the rest of the world	B.9	-0.6	0.5	0.3	0.2	-0.1
of which: - Balance on goods and services		-2.9	-2.2	-2.2	-2.3	-2.4
- Balance of primary incomes and transfer		-0.3	-0.2	-0.2	-0.2	-0.2
- Capital account		2.5	2.9	2.8	2.7	2.5
2. Net lending/borrowing of the private sector	B.9	0.8	1.9	1.9	1.5	1.6
3. Net lending/borrowing of general government	EDP B.9	-1.4	-1.5	-1.6	-1.3	-1.7
4. Statistical discrepancy		*4.1*	*0.0*	*0.0*	*0.0*	*0.0*

Table 2a. General government budgetary prospects

		2014*	2014*	2015	2016	2017	2018
	ESA Code	mln. *euro*	% of GDP				
Net lending (EDP B.9) by sub-sector							
1. General government	S.13	-339.8	-1.4	-1.5	-1.6	-1.3	-1.7
2. Central government	S.1311	-410.1	-1.7	-1.9	-2.0	-2.0	-2.5
3. State government	S.1312						
4. Local government	S.1313	-30.0	-0.1	0.1	0.0	0.1	0.1
5. Social security funds	S.1314	100.3	0.4	0.4	0.4	0.6	0.8
General government (S.13)							
6. Total revenue	TR	8414.3	35.0	34.2	32.7	32.7	32.3
7. Total expenditure	TE	8754.0	36.4	35.6	34.3	34.0	34.0
8. Net lending/borrowing	EDP B.9	-339.8	-1.4	-1.5	-1.6	-1.3	-1.7
9. Interest expenditure	EDP D.41	343.3	1.4	1.2	1.2	1.1	1.0
10. Primary balance		3.5	0.0	-0.2	-0.4	-0.2	-0.7
11. One-off and other temporary measures		-89.5	-0.4		-0.3	-0.4	-0.5
Selected components of revenue							
12. Total taxes (12=12a+12b+12C)		4722.2	19.6	22.0	21.6	21.6	21.3
12a. Taxes on production and imports	D.2	2888.6	12.0	14.5	14.3	14.2	13.8
12b. Current taxes on income, wealth etc.	D.5	1831.0	7.6	7.5	7.3	7.4	7.4
12c. Capital taxes	D.91	2.6	0.0	0.0	0.0	0.0	0.0
13. Social contributions	D.61	2067.5	8.6	8.4	8.2	8.2	8.2
14. Property income	D.4	184.3	0.8	0.7	0.5	0.3	0.2
15. Other		1440.2	6.0	3.1	2.4	2.7	2.6
16. Total revenue	TR	8414.3	35.0	34.2	32.7	32.7	32.3
Tax burden (D.2**+D.5+D.61+D.91 – D.995)		6861.7	28.5	28.2	27.7	27.8	27.6
Selected components of expenditure							
17. Compensation of employees + intermediate consumption	D.1+P.2	3674.1	15.3	15.9	15.4	15.8	16.1
17a. Compensation of employees	D.1	2243.9	9.3	9.4	9.1	9.2	9.1
17b. Intermediate consumption	P.2	1430.2	5.9	6.5	6.3	6.6	7.0
18. Social payments (18=18a+18b)		2508.6	10.4	10.6	10.3	10.3	10.2
of which Unemployment benefits		85.3	0.4	0.4	0.4	0.4	0.4
18a. Social transfers through market producers	D.6311, D.63121, D.63131	233.4	1.0	1.0	1.0	1.0	1.0
18b. Social transfers which are no transfers in kind	D.62	2275.3	9.5	9.6	9.3	9.3	9.2
19.=9. Interest expenditure	EDP D.41	343.3	1.4	1.2	1.2	1.1	1.0
20. Subsidies	D.3	143.8	0.6	0.6	0.6	0.7	0.8
21. Gross fixed capital formation	P.51	1036.4	4.3	4.0	3.4	3.2	3.1
22. Capital transfers	D.9	104.3	0.4	0.0	0.0	0.0	0.0
23. Other		943.6	3.9	3.3	3.3	3.0	2.7
24.=7. Total expenditure	TE	8754.0	36.4	35.6	34.3	34.0	34.0
Government consumption	P.3	4084.5	17.0	17.8	17.2	17.1	17.1

* Indicative estimate by the MoF

** Including taxes collected by EU budget

Table 2b. No-policy change projections

	2014	2014	2015	2016	2017	2018
	mln. *euro*	% of GDP				
1. Total revenue at unchanged policies	8414.3	35.0	34.2	32.7	32.7	32.3
2. Total expenditure at unchanged policies	8754.0	36.4	35.6	34.3	32.9	32.1

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

	2014	2014	2015	2016	2017	2018
	mln.*euro*	% of GDP				
1. Expenditure on EU programmes fully matched by EU funds revenue	1210.7	5.0	4.6	3.8	3.8	3.7
2. Cyclical unemployment benefit expenditure						
3. Effect of discretionary revenue measures	2.5	0.0	0.3	0.7	0.1	0.1
4. Revenue increases mandated by law						

Table 3. General government expenditure by function

% of GDP	COFOG code	2013	2018
1. General public services	1	4.6	4.2
2. Defense	2	0.9	2.0
3. Public order and safety	3	1.9	1.7
4. Economic affairs	4	4.7	4.3
5. Environmental protection	5	0.7	0.6
6. Housing and community amenities	6	1.2	1.1
7. Health	7	3.6	3.3
8. Recreation, culture and religion	8	1.5	1.4
9. Education	9	5.5	5.0
10. Social protection	10	11.3	10.3
11. Total expenditure	TE	35.7	34.0

Table 4. General government debt developments and contributions to change in gross debt in 2014-2018

% of GDP	ESA Code	**2014**	**2015**	**2016**	**2017**	**2018**
1. Gross debt		40.0	37.0	40.0	37.3	34.1
2. Change in gross debt ratio		1.8	-3.1	3.0	-2.8	-3.1
Contributions to change in gross debt						
3. Primary balance		0.0	-0.2	-0.4	-0.2	-0.7
4. Interest expenditure	EDP D.41	1.4	1.2	1.2	1.1	1.0
5. Stock-flow adjustment, *of which*		0.4	-4.5	1.5	-4.0	-4.8
- Differences between cash and accruals *		0.0				
- Net accumulation of financial assets, **		1.7				
of which privatisation proceeds		0.4				
- Valuation effects and other ***		3.8	3.1	3.4	2.8	2.8
Implicit interest rate on debt						
Other relevant variables						
6. Liquid financial assets		5.0				
7. Net financial debt (7=1-6)		35.0				
8. Debt amortization (existing bonds) since the end of the previous year		1.8	0.7	1.0	3.2	1.9
9. Percentage of debt denominated in foreign currency		25.9	27.7	26.8	22.8	24.9
10. Average maturity		4.79 years				

According to the data of Table 3.A of the n**otification on** general **government budget deficit and debt in April 2015**:
* 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 (+)"

Table 5. Cyclical development

% of GDP	ESA Code	2014	2015	2016	2017	2018
1. Real GDP growth (%)	B1g	2.4	2.1	3.0	3.6	3.6
2. Net lending of general government	B.9	-1.4	-1.5	-1.6	-1.3	-1.7
3. Interest expenditure	D.41	1.4	1.2	1.2	1.1	1.0
4. One-off and other temporary measures		-0.4		-0.3	-0.4	-0.5
5. Potential GDP growth (%)		2.6	2.8	3.1	3.3	3.5
contributions:						
- labour		0.0	0.1	0.3	0.3	0.4
- capital		1.1	1.0	1.0	1.1	1.1
- total factor productivity		1.4	1.6	1.8	1.9	2.0
6. Output gap, % of potential GDP		0.5	-0.1	-0.3	0.0	0.0
7. Cyclical budgetary component		0.2	-0.1	-0.1	0.0	0.0
8. Cyclically-adjusted balance (2-7)		-1.6	-1.4	-1.5	-1.3	-1.7
9. Cyclically-adjusted primary balance (8+3)		-0.2	-0.2	-0.3	-0.2	-0.7
10. Structural balance (8-4)		-1.2	-1.4	-1.2	-0.9	-1.2

Table 6. Divergence from previous update

	ESA code	2014	2015	2016	2017	2018
Real GDP growth (%)	B1g					
2014		4.0	4.0	4.0	4.0	-
2015		2.4	2.1	3.0	3.6	3.6
Difference		-1.6	-1.9	-1.0	-0.4	-
General government net lending (% of GDP)	B.9					
2014		-1.0	-0.8	-0.7	-0.7	-
2015		-1.4	-1.5	-1.6	-1.3	-1.7
Difference		-0.4	-0.7	-0.9	-0.6	-
Total general government debt (% of GDP)						
2014		38.8	32.9	34.2	31.3	-
2015		40.0	37.0	40.0	37.3	34.1
Difference		+1.2	+4.1	+5.8	+6.0	-

Table 7. Sustainability of public finances[21]

	2013	2015	2020	2030	2040	2050	2060
Assumptions							
Labour productivity growth	2.4	2.6	4.0	2.4	1.9	1.8	1.5
Real potential GDP growth	1.9	2.9	2.6	1.1	1.3	0.9	1.6
Participation rate, males (aged 20-64)	82.7	83.6	84.1	84.7	84.9	84.8	86.4
Participation rate, females (aged 20-64)	76.2	77.2	77.6	78.6	78.5	78.8	80.6
Total participation rate (aged 20-64)	79.3	80.3	80.8	81.6	81.7	81.8	83.6
Unemployment rate (aged 20-64)	11.9	9.4	12.2	10.1	7.3	7.3	7.3
Population aged 65+ over total population	18.9	19.4	20.7	25.5	27.9	28.3	28.0

Table 7a. Contingent liabilities

% of GDP	2014
Public guarantees	**1.7**
Of which: linked to the financial sector	**0.2**

Table 8. Basic assumptions

	2014	2015	2016	2017	2018
Short-term interest rate in eurozone (annual average)		0.0	0.1	0.1	0.1
Long-term interest rate in eurozone (annual average)		0.5	0.7	0.7	0.7
USD/€ exchange rate (annual average)	1.33	1.17	1.17	1.17	1.17
Nominal effective exchange rate	4.6	-7.0	-0.1	0.0	0.0
World excluding EU, GDP growth	3.7	4.0	4.4	4.4	4.4
EU GDP growth	1.3	1.7	2.1	2.1	2.1
World export volumes, excluding EU	3.2	4.5	5.2	5.2	5.2
World import volumes, excluding EU	2.3	4.2	5.2	5.2	5.2
Oil prices (Brent, USD/barrel)	99.7	53.0	61.5	61.5	61.5

[21] Data source: The 2015 Ageing Report: Underlying Assumptions and Projection Methodologies, 2014