Fiskālās disciplīnas padome

PUBLIC DEBT IN LATVIA

Deficit and ageing

ABSTRACT

Latvia's government debt management strategy is based on the assumption that the government will continue to implement sustainable fiscal policies and abide by the principles outlined in the Fiscal Discipline Law. This report stresses that the government of Latvia has continually practiced deficit spending during times of economic growth and failed to reduce the burden of public debt incurred during the Great Recession. Furthermore, while the current level of public debt is still below the threshold specified in the Fiscal Discipline Law and the Maastricht Treaty, the persistence of deficit spending and a contracting labour force may create sustainability issues in the long term.

Elīna Veide and Emīls Ķīlis

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Introduction

Latvia's government debt management strategy[1] is based on the assumption that Latvia will continue to implement sustainable fiscal policies and abide by the principles outlined in the Fiscal Discipline Law.

The Fiscal Discipline Law promotes countercyclical fiscal policy, which prescribes that the government should run surpluses when the economy is expanding and allow deficits only when the economy is performing below its potential. The fiscal rules stipulated by the Fiscal Discipline Law were introduced to constrain the budget deficit, which is the main cause of the increase of government debt.

In particular, the debt rule limits general government debt to 60% of GDP, which corresponds to the limit established in the Maastricht Treaty. In the initial report on public debt published in December 2015[2] we noted that in recent years Latvia's public debt has stabilised and hovered at 38%-40% of GDP. Nonetheless, the Council continues to maintain that the persistence of deficit spending[3] needs to be addressed to allow for a more rapid decrease of public debt[4] and, consequently, increase of fiscal space[5].

Sufficient fiscal space is crucial for ensuring that countries have the ability to cope with adverse macroeconomic developments. Furthermore, the 2015 edition of the European Commission's *Fiscal Sustainability Report* argued that in the current macroeconomic climate of very low inflation and subdued GDP growth the reduction of public debt burdens can be achieved through growth-friendly fiscal consolidation.

In addition, while the *Fiscal Sustainability Report* argued that Latvia faced low levels of risk in the short, medium and long term, there were important qualifications (European Commission 2016a). From a debt sustainability analysis perspective, there was a low risk in the medium term. That is to say, Latvia does not appear to be facing clear sustainability challenges, but this is conditional upon maintaining the primary balance at the level expected to be reached in 2017[6]. Furthermore, although the total age-related expenditure showed stabilisation in the long-run, further analysis revealed that the expected decline in pension expenditure was offset by an increase in other age-related expenditures (e.g. health care expenditure).

This report builds on work commenced in late 2015 and analyses Latvia's public debt in relation to concerns over long-term sustainability. The first part of this paper is devoted to a review of the literature on public debt and potential sustainability challenges for Latvia, such as persistent deficit spending and population ageing. The second part looks at Latvia's public debt in the context of other European Union countries and the debt burden placed on individuals.

[1] See: http://www.kase.gov.lv/texts_files/Parada_vadibas_strategija_2015.pdf
[2] *How would a new crisis affect Latvia's government debt?*, available at: http://fiscalcouncil.lv/files/uploaded/20151210_GDebt_EN.pdf
[3] The government of Latvia has consistently practiced deficit spending, even during periods of economic growth, see: https://www.makroekonomika.lv/latvijai-jatiecas-uz-bezdeficita-budzetu-jau-2017-gada
[4] *Surveillance Report 2016*, available at: http://fiscalcouncil.lv/files/uploaded/FDP_1_08_1186_20161005_FCSR_without_annexes.pdf
[5] For more information see: http://www.imf.org/external/pubs/ft/fandd/2005/06/basics.htm
[6] According to the report, Latvia was expected to improve its structural primary deficit to -0.6% in 2017.

The growth of public debt[7]

According to Buchanan and Wagner (1967), public debt is ultimately an instrument that the state can use to finance expenditures and provides an alternative to increasing taxes or printing money. Contrary to printing money, which is the creation of new purchasing power, public debt is an exchange of purchasing power – the state borrows money from a lender who gives up current purchasing power in return for interest payments. Contrary to increased taxation, the payment for a particular expenditure is deferred.

Buchanan and Wagner stress that the decision to use borrowing, rather than taxes, to finance expenditures is a fundamentally normative issue. For example, deficit financing is inadvisable for consumption spending as it burdens future generations with the bill for the goods. It is different in the case of projects with long-term benefits (e.g. infrastructure), as future generations will simply be paying their share of the price.

Even in 1967 the authors argued that budget deficits had become common and the debt management problem was likely to increase. They noted that a fiscal policy of creating deficits in periods of recession and budgetary surpluses in periods of increased growth was more easily described than applied. By doing so, the authors had identified an important difficulty facing the consistent implementation of countercyclical fiscal policy. This is echoed in Mulas-Granados (2006), who noted that the past few decades have witnessed a common tendency to run deficits and accumulate debt.

The most recent global financial crisis continued the trend mentioned above and lead to significant increases of public debt**.** According to Ostry, Ghosh and Espinoza (2015), the average level of public debt rose by almost 27 percentage points[8] during the period between 2007 and 2012. In the EU, debt levels rose by 26 percentage points. The effect of the financial crisis and its aftermath was even more pronounced in Latvia, and its public debt level rose by 33 percentage points (Table 1).

	2007	2008	2009	2010	2011	2012	Increase in debt 2007-2012
EU 28	57.8	61.0	73.0	78.4	81.0	83.8	26.0
Estonia	3.7	4.5	7.0	6.6	5.9	9.5	5.8
Latvia	8.4	18.7	36.6	47.5	42.8	41.4	33.0
Lithuania	15.9	14.6	29.0	36.2	37.2	39.8	23.9

Table 1. General government gross debt, % of GDP. Source: Eurostat.

As noted in the introduction, Latvia's public debt has currently stabilised and continues to hover around the 38%-40% mark (Chart 1).

Both the Maastricht Treaty and the Fiscal Discipline Law require that public debt be no higher than 60% of GDP. Consequently, it could be argued that Latvia's current level of public debt is still in the "safe zone" and does not have a serious impact on Latvia's growth prospects. Furthermore, there is no agreement in the literature as to a context-invariant optimal level of debt – it depends on a number of factors, such as the vitality of the economy and prudent macroeconomic and fiscal policies.

[7] For the purposes of this report *public debt* and *government debt* are used interchangeably.
[8] Among the most widely used measures of public debt is the debt-to-GDP ratio.

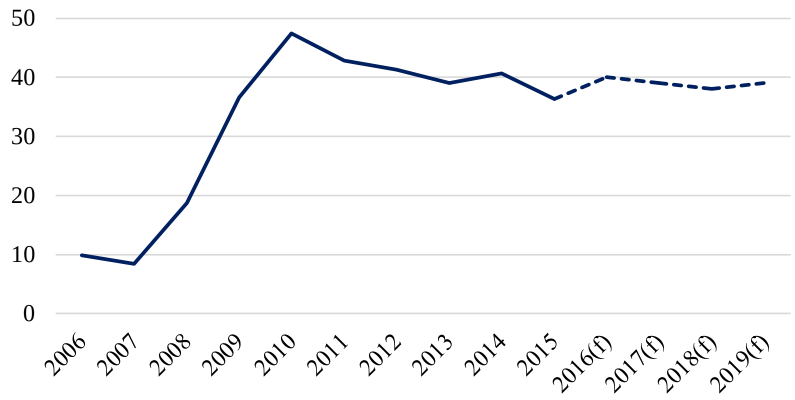

Chart 1. General government gross debt in Latvia, % of GDP. Source: CSB (2006-2015) and Medium Term Budget Framework 2017-2019 (forecast for 2016-2019. Source).

For example, an often cited paper by Reinhart and Rogoff (2010) has posited that government debt above 90% of GDP has a negative effect on growth, but this claim has also been contested (Panizza and Presbitero 2013). Other debt thresholds have been proposed in academic literature, and a clear relationship between debt and growth has not been established (Greiner and Fincke 2015).

Nonetheless, a rising debt trajectory has been shown to (i) have a negative effect on long-term growth prospects (Chudik et al. 2015; Greiner and Fincke 2015) and (ii) lead to increased interest rates (International Monetary Fund 2016). What is more, economic growth and the quality of public services are continually hampered by expenditure on debt servicing (see below), rising interest rates attached to higher debt levels and loans with longer maturation lengths, and increased costs to the private sector as a result of high public debt. The subdued growth of the past few years and the changing demographic composition of Latvia in particular and the EU in general are also factors to consider in relation to the sustainability of public debt.

Public debt and sustainability

A new approach to debt management emerged towards the end of the 20th century (Wheeler 2004). Improvements to the quality of, and a strategic approach to, the management of public debt were underpinned by the recognition that rising debt servicing costs will put a strain on budget expenditure. Furthermore, it was acknowledged that, in conjunction with prudent macroeconomic and fiscal policies, debt management based on clear objectives is a prerequisite for having ample fiscal space to absorb and contain sudden shocks.

Fundamentally, both the level and growth rate of public debt should be sustainable – meaning that debt can be serviced even as the economy enters into an unfavourable period of the economic cycle. During a crisis or recession, the government may have to run higher deficits to stimulate economic growth[9]. In addition, the impact of one-off measures should also be noted as they have a direct impact on the level of public debt.

In view of Latvia's recent experience (both the impact of the Great Recession and several one-off measures[10]), the Council maintains that a low debt level is essential to allow Latvia to weather another crisis – a downturn in the business cycle, disruption in the financial system, geopolitical shocks or a combination of the above. Countries with the capacity to borrow and service their debts will have

[9] See: https://en.wikipedia.org/wiki/Deficit_spending#Structural_and_cyclical_deficit
[10] Such as Parex Bank, Mortgage and Land Bank, airBaltic and Liepājas Metalurgs

better access to further loans at favourable interest rates. Access to such loans depends heavily on factors such as the perceived institutional strength, the capacity and track record of financial management, as well as the burden of previously accumulated debts.

It was previously noted that there is no universally applicable debt threshold or a context-independent sustainable level of government debt. Consequently, assessments of public debt sustainability should be context-specific. For this reason, the Council suggests (i) focusing on issues that impact Latvia's sustainability and (ii) setting a concrete long-term target for a prudent level of public debt. Two issues in particular require careful consideration. The first is the persistence of deficit spending during a period of growth. The second is the current demographic trend in the EU and the resulting impact on the state budget.

Debt in times of growth

The 2016 Surveillance Report highlighted the gradual increase of the forecasted level of general government debt. In the Medium-term budget framework 2014-2016 it was claimed that general government debt would reach 33% of GDP by 2015 and remain at this level in 2016. However, the Medium-term budget framework 2017-2019 shows that in 2016 public debt will be at 40% of GDP[11].

While this is partly caused by several one-off transactions (see above) and prudent investments (e.g. the acquisition of the State Revenue Service building in 2015), the failure to reduce public debt and run deficits during a period of sustained economic growth (Chart 2) is troubling and contrary to the principles of the Fiscal Discipline Law, which foresees a balanced budget over the economic cycle. According to the Medium-term budget framework 2017-2019, deficit spending will persist in the medium term[12]. Furthermore, the subdued growth in 2015 and 2016, and unclear growth prospects caused by global political and economic uncertainty (European Commission 2016b) may place additional strain on Latvia's public finances in the future, despite the currently "safe" debt-to-GDP ratio.

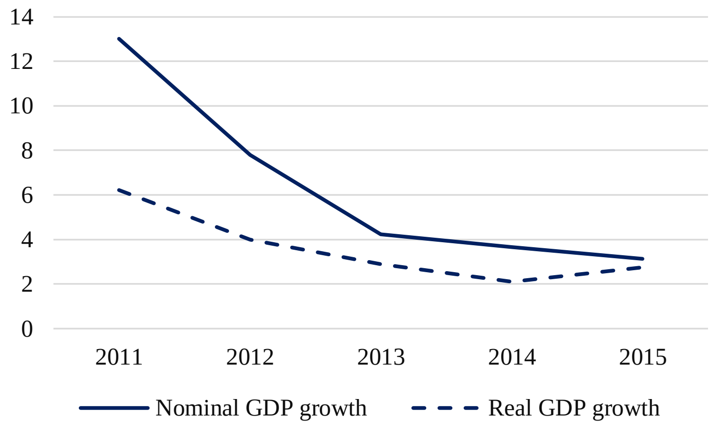

Chart 2. Nominal and real GDP growth in Latvia. Source: CSB.

Debt and ageing

The 2015 *Ageing Report* notes that the age structure of the EU will change rapidly in the coming decades. Even though the population of the EU as a whole will increase, the report argues that by 2060 Latvia's population will have declined by 31% (European Commission 2015). Furthermore, during

[11] *Surveillance Report 2016*, available at: http://fiscalcouncil.lv/files/uploaded/FDP_1_08_1186_20161005_FCSR_without_annexes.pdf

[12] http://www.fm.gov.lv/files/valstsbudzets/FMPask_D_131016_proj2017.pdf

that same period the demographic old-age dependency ratio in the EU is projected to increase from 27.8% to 50.1%. In Latvia it will increase by 20% in the next decade alone (OECD 2016).

A contracting working-age population has two important implications in relation to the sustainability of public debt and fiscal sustainability more generally. First of all, the overall decline in labour supply will impact government revenues and public finance as a whole – there will be fewer people paying taxes and contributing to the budget. Secondly, while pension-related expenditures in Latvia are expected to decrease, total age-related expenditure[13] will create additional strain on public finance. These factors will make it more difficult for the government to honour social security commitments, provide good quality public services and make interest payments on public debt.

Latvia's public debt in context

In the report on public debt published in December 2015 we concluded that the maximum economic downturn that Latvia could afford, while still complying with the Maastricht criterion on general government debt, was a 5.4% decline in nominal GDP for two consecutive years. Updated calculations show that the maximum permissible decline in nominal GDP has increased to 7.7% for two consecutive years. The calculations were updated using the most recent statistical data[14] and the general government debt level for 2015 has changed as the actual debt-to-GDP level for 2015 (36.3%) turned out to be substantially lower than it was assumed when carrying out the calculations in December 2015 (42.1%). There are, however, other considerations that need to be taken into account.

Latvia's general government debt compared to other European Union member states

Latvia is among the EU countries with the lowest level of government debt. By the end of 2015 Latvia's government debt reached 36.3% of GDP – it was the fourth lowest in the EU after Estonia, Luxembourg and Bulgaria (Chart 3).

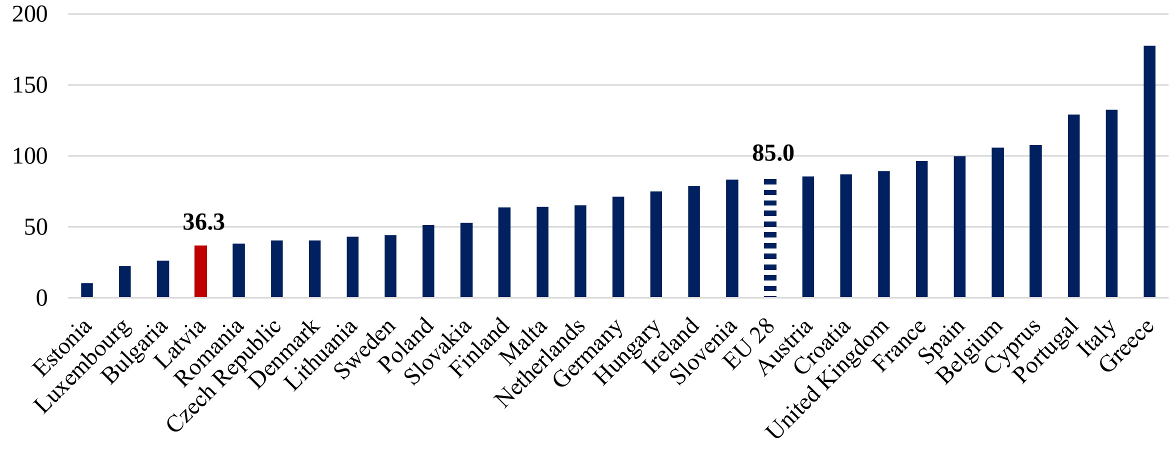

Chart 3. General government gross debt in 2015, % of GDP. Source: Eurostat.

Similarly, measured as the amount of debt per capita, without considering purchasing power parity[15] (PPP), it reached ~4.5 thousand EUR (corresponding to 18% of the EU average) and was the fourth

[13] Such as old-age pensions and expenditure on health-care, long-term care, education and unemployment benefits.

[14] The Central Statistical Bureau time series data for real and nominal GDP, as well as general government revenues and expenditures time series have been updated (http://www.csb.gov.lv/dati/statistikas-datubazes-28270.html).

[15] See: https://en.wikipedia.org/wiki/Purchasing_power_parity

lowest after Estonia, Bulgaria and Romania. Adjusting for PPP does not change Latvia's ranking as the country with the fourth lowest outstanding public debt per capita. However, after the adjustment it rises from 18% to 27% of the EU average, meaning that in real terms the debt burden is comparatively higher (Chart 4).

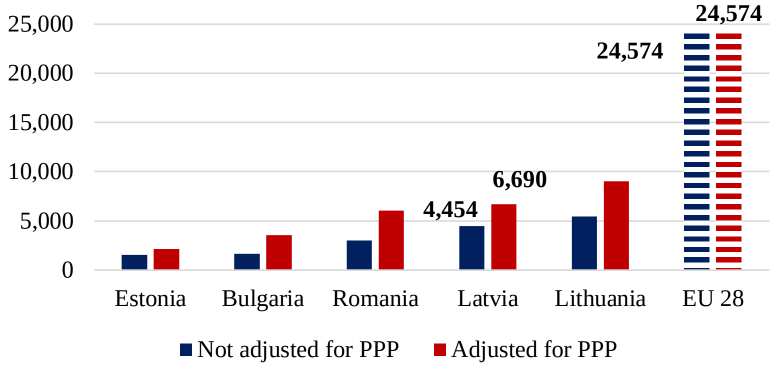

Chart 4. General government gross debt per capita in countries with the lowest debt per capita in 2015, EUR. Source: Eurostat, authors' calculations.

Low interest rates

Latvia's interest payments on general government debt increased from 80 million EUR annually before the Great Recession to more than 300 million EUR currently. This corresponds to an increase from 33 EUR to 162 EUR per capita (Table 2). Overall annual expenditure on interest payments (323 million EUR in 2015) is, therefore, higher than the amount invested in the new building of the Latvian National Library (268 million EUR[16]).

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Interest payments, million EUR	74	80	134	284	311	359	362	338	338	323
Interest payments per capita, EUR	33	36	61	131	146	173	177	167	169	162

Table 2. Interest payments on general government debt in Latvia.

The comparatively low level of public debt allows Latvia to keep interest payments low, both as a percentage of GDP and as an amount per capita when compared to other EU countries.

After adjusting the interest payments for PPP, Latvia maintains its position as the country with the fourth lowest interest payments per capita. However, the sum payable per capita increases from 25% to 37% of the EU 28 average (Chart 5).

[16] http://www.lsm.lv/lv/raksts/latvija/zinas/grafiks-gaismas-pils-izmaksas-vairak-neka-desmit-gados-268-miljo.a88285/

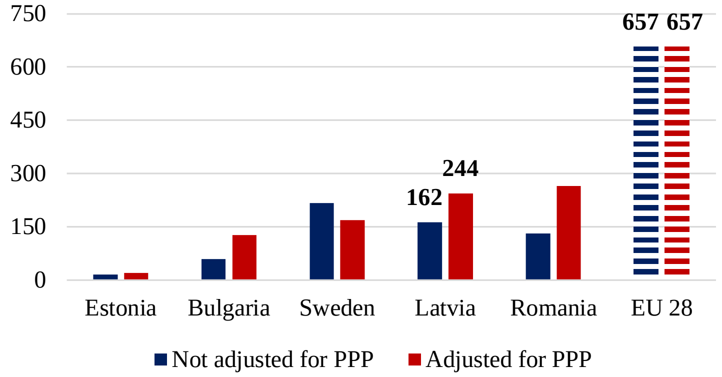

Chart 5. Interest payments on government debt per capita in countries with the lowest interest payments on general government debt per capita in 2015. Source: Eurostat, author's calculations.

Latvia's position becomes worse if interest payments are expressed as a percentage of government expenditure (Chart 6). This is a consequence of the comparatively small public sector (Latvia has one of the lowest government revenues as a proportion of GDP in the EU[17]), and this means that the public debt burden on the general government budget is larger than it was in the previous comparisons.

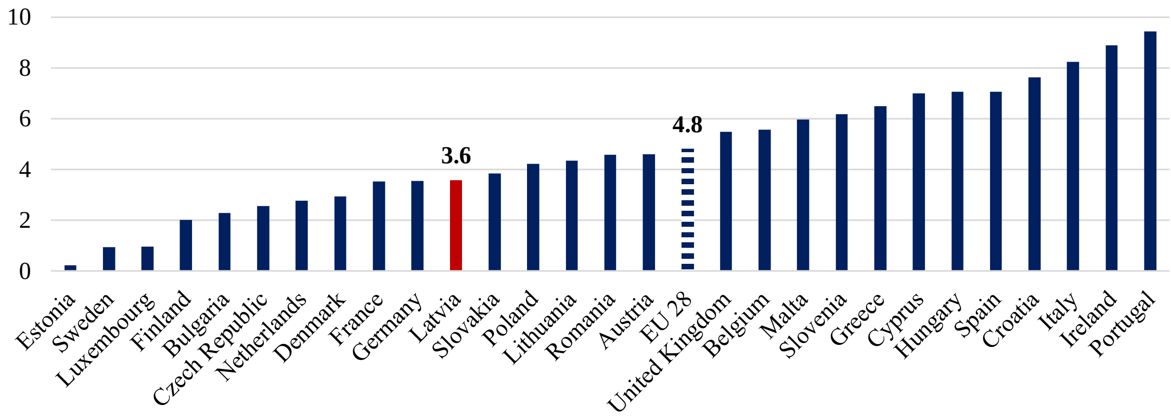

Chart 6. Interest payments on government debt as percentage of government expenditure in 2015. Source: Eurostat, author's calculations.

Moreover, the apparent cost, or in other words, the effective interest rate on public debt for Latvia (3.8% in 2015) is higher than the EU average (Chart 7).

[17] See: http://ec.europa.eu/eurostat/statistics-explained/index.php/Tax_revenue_statistics

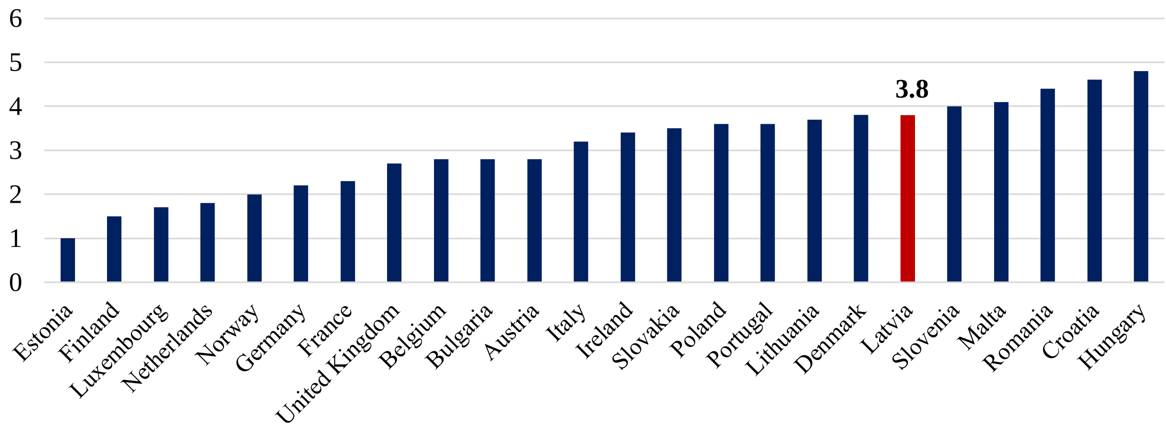

Chart 7. Apparent cost of general government gross debt (rate) in 2015. Source: Eurostat.

As noted above, interest rates on general government debt are determined by several factors. For example, Estonia has the lowest debt-to-GDP ratio in the EU (10%) and pays the lowest interest rate on its debt, despite having a worse credit rating than Luxembourg (Table 3). Similarly, Bulgaria, which has one of the lowest credit ratings among the countries in Chart 7 pays a lower than average interest rate, as its government debt is only 26% of GDP – the third lowest in the EU.

Country credit ratings

		S&P		Moody's		Fitch		TERating
1	Estonia	**AA-**	Stable	**A1**	Stable	**A+**	Stable	81
2	Finland	**AA+**	Stable	**Aa1**	Stable	**AA+**	Stable	96
3	Luxembourg	**AAA**	Stable	**Aaa**	Stable	**AAA**	Stable	100
4	Netherlands	**AAA**	Stable	**Aaa**	Stable	**AAA**	Stable	100
5	Norway	**AAA**	Stable	**Aaa**	Stable	**AAA**	Stable	99
6	Germany	**AAA**	Stable	**Aaa**	Stable	**AAA**	Stable	100
7	France	**AA**	Stable	**Aa2**	Stable	**AA**	Stable	90
8	United Kingdom	**AA**	Negative	**Aa1**	Negative	**AA**	Negative	95
9	Belgium	**AA**	Stable	**Aa3**	Stable	**AA**	Negative	88
	Latvia	**A-**	Stable	**A3**	Stable	**A-**	Stable	69
	Bulgaria	**BB+**	Stable	**Baa2**	Stable	**BBB-**	Stable	53

Table 3. Country credit ratings for low cost (rate) government debt countries and Latvia as of 14 November 2016. Source: http://www.tradingeconomics.com/country-list/rating.

Latvia's interest payments on general government debt (as a percentage of GDP) have been decreasing since 2011 (Chart 8). At the same time, if calculated per capita, interest payments on government debt increased rapidly from 2006 to 2011 and have not substantially decreased since 2011. Crucially, expenses on interest payments per working age individual have increased even faster during the last decade (Chart 9).

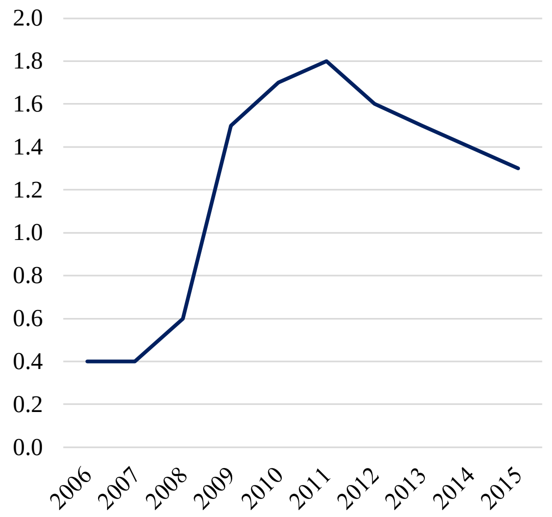

Chart 8. Interest payments on government debt in Latvia, % of GDP. Source: Eurostat, authors' calculations.

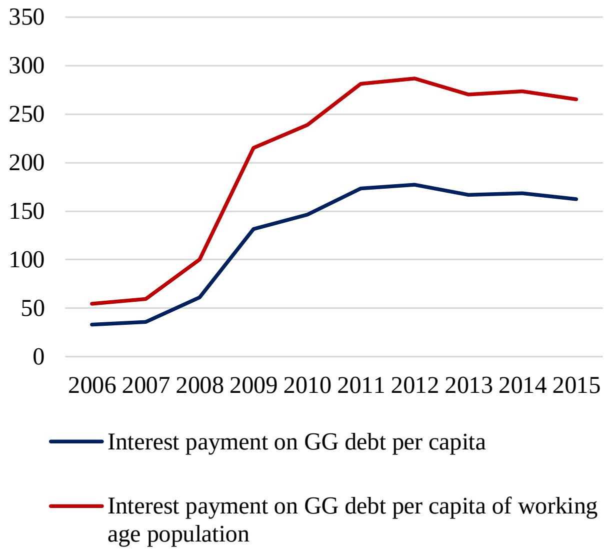

Chart 9. Interest payments on government debt per capita and per capita of working age (20-64) population in Latvia, EUR. Source: Eurostat, CSB, authors' calculations.

We can conclude that, although interest payments on government debt have been gradually declining in absolute terms and as percentage of GDP, per capita, and in particular - per working age person, the burden has increased over the last decade, exacerbated by the effects of the financial crisis and the current demographic trends.

The demographic impact

Current demographic trends are an issue often addressed in publications dealing with sustainability (e.g. European Commission 2016a; Office for Budget Responsibility 2015), and population ageing is a key demographic concern in the EU. In relation to public debt, the main issues related to ageing are (i) a contracting labour force and the resulting decrease in economic activity and (ii) increased age-related expenditure. In conjunction, this creates strain on public finance by reducing revenues and increasing expenditures.

The demographic changes over the last decade show that the proportion of Latvia's old-age population (65+) has increased, while the proportion of young people (0-19) has decreased by a similar amount (Chart 10).

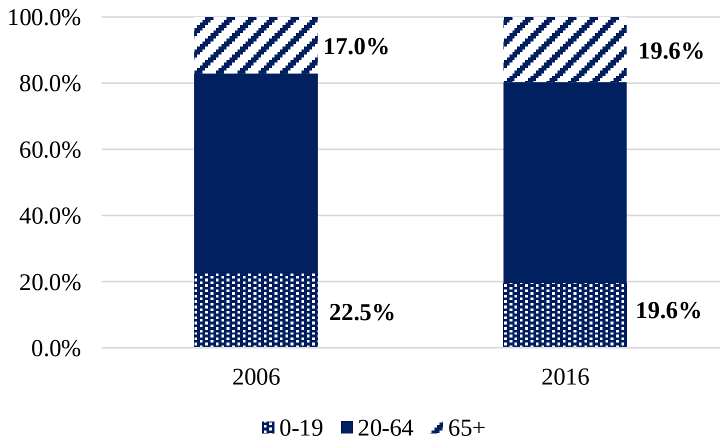

Chart 10. Changes in the proportion of the working age (20-64) population from 2006 to 2016. Source: CSB.

The number of old-age pension recipients in Latvia reached 467 thousand in 2015, corresponding to 23% of the population (Chart 11). Over the last 15 years, the share of the pension-age population has been sharply increasing: in 2001, there were four working age persons per pension-age person, and in 2016 there are three working age persons per pension-age person (Chart 12). As noted earlier, this has led to a faster increase of the debt burden for working age individuals. Furthermore, the *Ageing Report*'s forecast for the EU 28 states that by 2060 "the EU would move from having four working-age people for every person aged over 65 years to about two working-age persons" (European Commission 2015: 1).

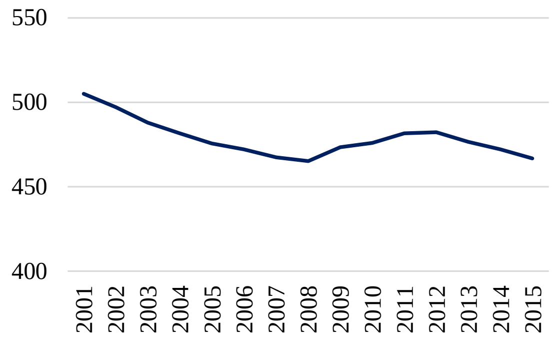

Chart 11. Number of pensioners – old age pension recipients in Latvia, thsd. Source: CSB.

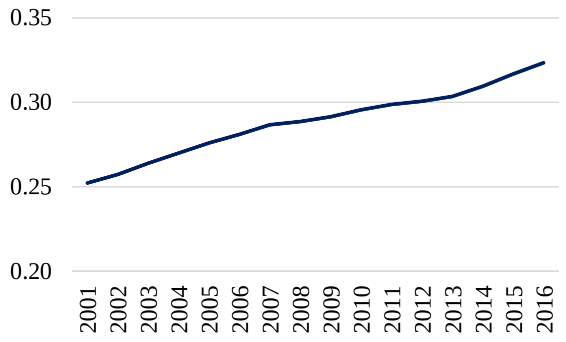

Chart 12. Number of old age persons (65+) per working age person (20-64). Source: CSB, authors' calculations.

It should be noted that the increasing participation rate for ages 50+ (European Commission 2015) and the already increasing expected working life[18] can be assumed to partly offset the trends and issues identified above. The fact that the proportion of early retirement old-age pensions[19] of all newly disbursed pensions has been decreasing further illustrates the increasing participation rate among the elderly (Chart 13).

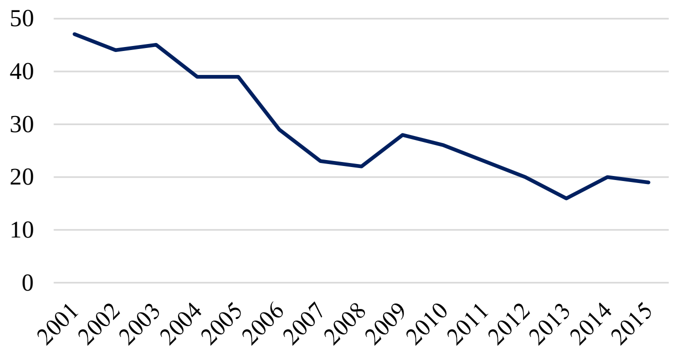

Chart 13. Proportion of early pensions of newly disbursed pensions; %. Source: Ministry of Welfare.

Nonetheless, given current demographic prospects, subdued economic growth, low government revenues and the persistence of deficit spending, Latvia may face public debt sustainability challenges.

[18] See: http://ec.europa.eu/eurostat/documents/2995521/7730722/3-14112016-BP-EN.pdf/3401e33e-7a1a-49f2-8acc-d9f6ce16a212

[19] Pension payments for retirees who have opted to retire before the regular statutory retirement age and have agreed to receive reduced monthly payments.

Conclusions

Latvia's government debt management strategy is based on the assumption that the government will continue to implement sustainable fiscal policies and abide by the principles outlined in the Fiscal Discipline Law. A key prescription of countercyclical fiscal policy is that the government should run surpluses when the economy is expanding and allow deficits only when the economy is performing below its potential – the budget should be balanced over the economic cycle.

Nonetheless, the government of Latvia has continually practiced deficit spending during times of economic growth and failed to reduce the burden of public debt incurred during the Great Recession.

The current level of public debt is still below the threshold specified in the Fiscal Discipline Law and the Maastricht Treaty. While this suggests that Latvia is still in the safe zone, the persistence of deficit spending and a contracting labour force may create sustainability issues in the long term.

In 2015 interest payments on public debt accounted for approximately 3.6% of Latvia's general government expenditure, while the funding for several government functions was below the EU average. The Medium-term budget framework 2017-2019 indicates that deficit spending will persist in the medium term. At the same time, implementation of growth-enhancing structural reforms is lagging Furthermore, the government of Latvia requested and received permission from the European Commission to further increase (i.e. from -1.0 to -1.1 in 2017) its general government budget deficit target to rectify problems in the health care sector. In other words, while Latvia's public debt is comparatively low, interest payments prevent adequate financing of key government functions (e.g. health care) and deficit financing is seldom used to implement reforms whose benefits will be experienced by future generations. They will, however, have to pay the bill[20].

[20] See Nils Sakss' comment from September 2016: https://www.youtube.com/watch?v=V4RxiB8OkzI

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