LATVIJAS REPUBLIKAS FISKĀLĀS DISCIPLĪNAS PADOME

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Fiscal Discipline Council
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Fiscal Discipline Monitoring
Interim report (opinion)
On the Latvia Stability Programme 2015-2018

Content

Abreviations

Council	Fiscal Discipline Council
ECA	European system of accounts
EU	European Union
FDL	Fiscal discipline law
Monitoring report	Fiscal Discipline Monitoring Report 2014
MoF	Ministry of Finance
MTBF	medium Term Budget Framework
MTBFL 2015/17	Medium Term Budget Framework Law 2015-2017
GDP	gross domestic product
NPI	new policy initiatives
PIT	personal income tax
SB	state budget
SBL	State budget law
SGP	Stability and growth pact
SP	Latvia's Stability Programme
SP 2015/18	Latvia's Stability Programme for 2015-2018
SRS	State revenue service
VAT	value added tax

Summary

According to Article 28, Part 7 of the FDL, the Council shall prepare and submit to the Saeima and the Cabinet's attention of fiscal policy matters if they pertain to the compliance with the terms set out in the FDL.

The Council, while cooperating with the staff of the MoF in the process of the preparation of the SP 2015/18, has been trying to understand if SP 2015/18 complies with the requirements of the FDL. The FDL does not require the Council commenting on the annual SP. However, the Council is of the opinion that the SP 2015/18 is the key document outlining the Government's intentions for the preparation of the annual SB for 2016 and MTBF for 2016-2018. Therefore, the Council has studied the SP 2015/18 and has prepared this interim report (opinion).

The Council welcomes the MoF update of the macroeconomic outlook which reduces the estimated real growth and the price increases to lower – more realistic levels in line with the Council's observations in the Monitoring report.

The Council agrees that the economy has been developing in a generally balanced manner with no significant departure of the actual growth from the potential growth. The potential growth is stabilising at lower levels than predicted previously due to the complicated geopolitical situation, insufficient new investments, and slow growth in Latvia's traditional export markets. Meanwhile, the salary increases have been significant, but the Council does not yet see them as significantly eroding competitiveness. The Government should remain vigilant to ensure that the excessively fast wage growth does not create risks for competitiveness in the future. Only bold structural reforms enhancing growth could assist enabling better economic development perspectives and convergence towards the average income levels in the EU.

The Council has concerns regarding the plans outlined in the SP 2015/18 to reduce the headline balance below the levels fixed in MTBF 2015/17. The state basic budget headline balance would deteriorate from -1.6% of GDP to -2.0% in 2016 and from -1.3% to -1.7% in 2017. Higher fiscal deficit would result into the general government debt level in 2017 increasing from 34% projected under MTBF 2015/17 to 37.3% under SP 2015/18.

The reduction in the fiscal balance proposed in SP 2015/18, resulting from accelerated increase in defence expenditure to the planned 2% level of GDP should not be treated as one-off measure. This defence expenditure should be treated as a permanent expenditure. Moreover, the Council draws attention that the reduction in the fiscal balance related to structural reforms in health care does not comply with the FDL. The Council believes that the government's funding priorities, defence spending in particular, have to be financed by adopting effective measures to increase budget revenues or reducing spending of lesser priorities. Moreover, the Council considers that, in accordance with FDL provisions it is necessary to establish a fiscal safety reserve in the amount 0.1% of GDP, while in 2017 this reserve should be established in the amount of 1.3% of GDP.

According to the data provided in the SP 2015/18 and the Council's estimates, the Council finds it necessary to proceed with a fiscal consolidation (i.e. to increase expenditures slowly than planned, and to increase budget revenue faster than planned) in the amount of 113.8 million euro for the preparation of SB 2016 to meet FDL requirements. The scope of consolidation does not include additional funding for other government priorities, such as additional funding for defence and internal affairs, and structural reforms in health care and education as outlined in the SP 2015/18.

The general expectations regarding additional funding for different government priorities have been disproportionate. Line ministries have provided an assessment of costs of their measures included in the Government Action Plan adopted on 10 February 2015 in the amount of about 700 million euros for 2016, excluding the funding requirements for the defence budget. Public expectations regarding the increase of different government benefits have been enormous. These expectations have not been balanced with adequate revenue measures. The Council has not been informed about revenue measures that would allow the government to gradually close the gap between the target tax burden of 33% to GDP agreed at the Government declaration from the current 28%.

The Council supports the Government's efforts to improve tax collection by limiting the shadow economy. However, these measures alone will not help fill the fiscal space shortfall in 2016, and action may be needed postponing the previously planned PIT rate reductions in 2016, as well as other measures, such as smoothing tax burden among different income levels and transferring tax burden to consumption and real estate.

1. Macroeconomic overview and output gaps

In 2014, new trends emerged in Latvian economy that to a large extent are attributable to the escalation of geopolitical situation in the region and the decline in oil prices worldwide. In SP 2015/18, the forecast of Latvia's GDP growth at constant and market prices has been reduced compared to MTBFL 2015/17.

The Council supports updated macroeconomic projections in SP 2015/18, which exhibits lower level of GDP growth for 2015: reduction from 2.8% in MTBFL 2015/17 to 2.1% at constant prices and from 5.2% to 3.3% at current prices. (see Figures 1.1 and 1.2), and does not object to applying these figures in calculations taking into account currently available information. Reduction is justified by economic downturn in Russia and expected impact of economic sanctions.

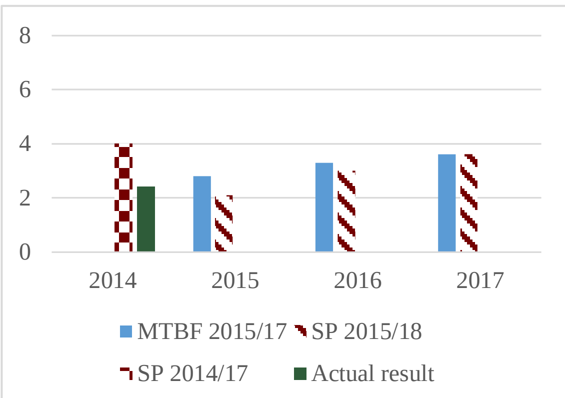

Figure 1.1 GDP growth projections at constant prices, % (2014 – also actual result)

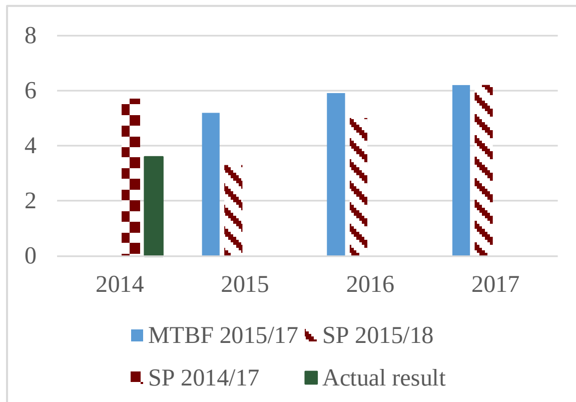

Figure 1.2 GDP growth projections at market prices, % (2014 – also actual result)

The Council is in agreement that, given favourable conditions, meeting of SP 2015/58 estimates of higher growth in 2016, 2017 and 2018 compared to 2015 is feasible (3.0%, 3.6% and 3.6% respectively). Resilient domestic consumption strengthened by positive terms of trade effect of lower oil prices, as well as gradual improvement of euro area growth indicators supports the case for optimism.

The Council supports substantially reduced price level forecast – for GDP deflator reduction, from 2.4% in the MTBFL 2015/17 to 1.2% in the SP 2015/18, and further increase to 1.9% in 2016. Commodity price level worldwide temporarily remains low, however, with optimism in household consumption and investment restoring at higher pace, a correction to faster growth of prices may be expected to follow, which will enhance GDP growth at market prices.

The Council draws attention to the labour unit cost growth, which simultaneously with higher inflation may threaten competitiveness of Latvian economy in case it is not compensated by increase in productivity. Latvian labour cost growth rate is one of the highest in the European Union (6% on average per year, trailing Romania and Estonia). This should be seen as a sign of a labour market approaching full employment,

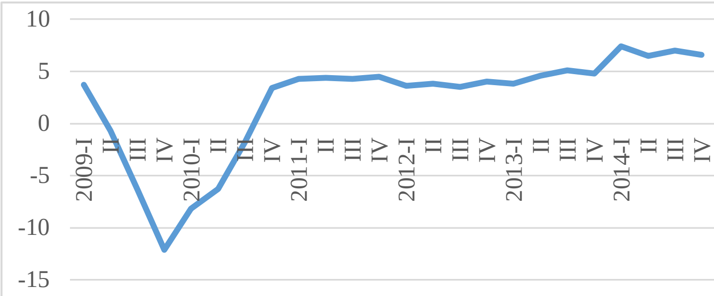

Figure 1.3. Growth of unit labour costs, y-o-y, %. Source: CSB.

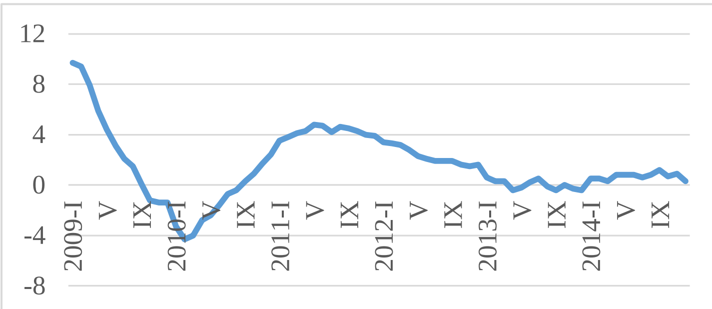

Figure 1.4. Price level changes, y-o-y, %. Source: CSB.

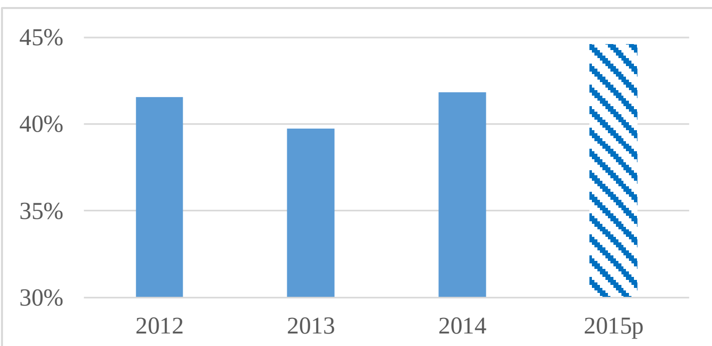

Figure 1.5. Proportion of minimum wage relative to average wage in Latvia (2012-2014 – actual data (source: CSB); 2015 – projection based on average labour cost projection in the economy in 2015 in the SP 2015/18)

which suggests that output gap figure could be close to zero in 2015. Labour costs have been growing comparatively rapidly since 2011 (see Figure 1.3).

Wage growth has not yet explicitly translated into inflation, (see Figure 1.4.), indicating that the labour market is not yet overheated, but it is hard to see that steadily sharp wage growth should not translate into any inflationary impact in future.

The labour cost growth is partly explained by minimum wage increase. The Council recommends to perform assessment of the effect on budget of minimum wage increases implemented in 2014 and 2015 to determine, whether the expected higher tax revenues and reduction in the shadow economy have come true in line with the expectations, and whether the minimum wage increase has not caused adverse effects on the budget, e.g., reduced the competitiveness of enterprises, caused businesses entering shadow economy, or created obstacles for employment of lower-skilled labour and business development in regions with high unemployment. Moreover, it should be assessed, whether productivity has grown in pace with the minimum wage. The ratio of minimum wage relative to the average wage should also be monitored. Substantial increase of this proportion can cause negative effects to economic growth (see Figure 1.5).

Latvian economic growth prospects in the coming years are to a large extent determined by the ability of entrepreneurs to promptly find new export markets to compensate for the risks of decline of market in Russia. Economic recovery in the euro area should assist the export recovery, while it is to be seen, if the growth rate of exports could pick up as projected in SP 2015/18 (from 0.8% in 2015 to 4.0% in 2016). Sustainability of export should be supported by government by providing access to potential export markets and granting export guaranties.

It should be noted that **there are risks of GDP growth to stabilize at lower growth rates than forecasted previously expected**. International Monetary Fund and the Organization for Economic Cooperation and Development have recently pointed at these risks. Without implementing effective structural reforms and efficient use of EU funds it might be hard to overcome this trend. The mentioned international organizations emphasize (1) education (especially higher and vocational education levels), (2) state-owned company sector and (3) judicial system as spheres where structural reforms are top priority in Latvia. The council recommends implementation of structural reforms primarily in these spheres.

Overall, the Council agrees with the macroeconomic forecasts presented in the SP 2015/18, at the same time encouraging the MoF to be cautious about the essential factors affecting the economic growth rate – export dynamics and structure, as well as salary growth rates and export competitiveness.

Economic growth so far can overall be characterized as balanced, with the potential and the actual GDP not differing significantly. The Council currently has no sufficient resources to develop a detailed evaluation of potential GDP, however, overall economic development indicators currently do not signalize of immediate overheating risks.

Recommendations

1.1. While risks of Latvian economic development to stabilize at slower growth rates are intensifying, **the Council recommends to unhesitatingly assess the possibilities of implementing structural reforms** aiming at sustainable economic growth and increase of competitiveness, including:
– **Education**, particularly higher and vocational education focusing reforms on eliminating the competences and skills gaps for the requirements of the economy;
– **State-owned company sector**, implementing a centralized management of state owned companies, promoting their transparency, reviewing their financing mechanisms, assessing options for enhancing their operational efficiency, including divestment of non-core activities;
– **Improving the efficiency of judicial system**, focusing on shortening terms of proceedings, including implementation of amendments to the civil and administrative procedure laws, to timely and fairly deal with contract and property rights protection issues.
1.2. **Evaluate the effect of minimum wage increases implemented in 2014 and 2015 on budget and on economy** prior to making decisions on possible further increase of minimum wage.
1.3. **Assess opportunities to accelerate export growth,** e.g., by supporting access to potential export markets, including increasing efficiency of export guaranties mechanism.

2. Assessment of compliance with the numerical fiscal rules[1]

The Council expresses its concern regarding the SP 2015/18 planning a reduction of the general government budget headline balance below the levels set out in the MTBF 2015/17 (see Table 2.1). The 2016 state basic budget headline balance would be reduced from -1.6% of GDP to -2.0% and in 2017 – from -1.3% to -1.7%. Higher headline deficit will increase the level of public debt in 2017 from 34% to 37.3% of GDP.

Table 2.1 General government and basic budget headline balance and changes in the general government debt as % of GDP

	2015	2016	2017	2018
General government budget deficit (-) / surplus (+)				
MTBFL 2015/17	-1.0	-0.9	-0.7	
SP 2015/18	-1.5	-1.6	-1.3	-1.7
Change	*-0.5*	*-0.7*	*-0.6*	
Basic budget deficit (-) / surplus (+)				
MTBFL 2015/17	-1.5	-1.6	-1.3	
SP 2015/18	-1.9	-2.0	-1.7	-0.2
Change	*-0.4*	*-0.4*	*-0.4*	
General government debt				
MTBFL 2015/17	35	37	34	
SP 2015/18	37	40	37.3	34.1
Change	2	3	3.3	

Key reasons for the deterioration of the basic budget headline balance for 2016 are the following –
– a decision to increase the budget deficit on account of structural reforms in health care including the adjustments to baseline budgets and funding for NPI allocated in 2014 and 2015 SB, and the corresponding MTBFLs;
– a one-off measure for the defence sector funding accelerated increase to the planned 2% of GDP in 2018 compared to the previously established target level for 2020;
– due to the actual GDP figure growing slightly slower than the economic potential, in 2016 the cyclical component is estimated negative at -0.1%;

For 2016 there are positive forecasts for the ESA corrections largely due to the improvements of the balance of state-owned enterprises classified to the general government sector.

Setting general government structural balance targets, SP 2015/28 provides calculations in accordance with both the SGP and the national FDL, choosing the strictest measure of

[1] The Council has performed FDL numerical criteria evaluation using the data of the SP 2015/18 and the data provided by the MOF during the SP preparation. These figures may further change during the further preparation of the SB 2016 and MTBF 2016/18.

deficit between the two, as well as sequentially applying the strictest numerical fiscal condition method – balance condition method. Consequently, the structural balance target for 2016 has been assessed at -1.0% of GDP, for 2017 at -0.9%, and for 2018 at -1.2% (see SP 2015/18 Section 3.2 *Fiscal policy strategy and medium-term objective*).

In turn, the Council has compared the headline balance and the structural balance results (see Appendix 1 and Appendix 2) following FDL provisions (see Figure 2.1 below), incl.
– The Council considers that the reduction of balance due to the increase in savings to the second pillar pension scheme complies with Article 5 of Regulation (EC) No 1175/2011 and is appropriately included in the SP 2015/18;
– The Council has no objections to the cyclical component assessment;
– **The Council cannot confirm that the deficit increase due to an increase in health care baseline expenditure and funding for NPI is in compliance with the FDL**;
– **The Council suggests to increase funding for the defence budget by increasing government revenue and without compromising the budget balance**. The Council does not find the proposed measure meeting the criteria of one-off measures according to the Article 5 of Regulation (EC) No 1175/2011;
– **The Council reiterates the requirement to form a fiscal stability reserve** in 2016 at 0.1% of GDP and at least 0.13% of GDP in 2017, as was previously stated in the Monitoring report.

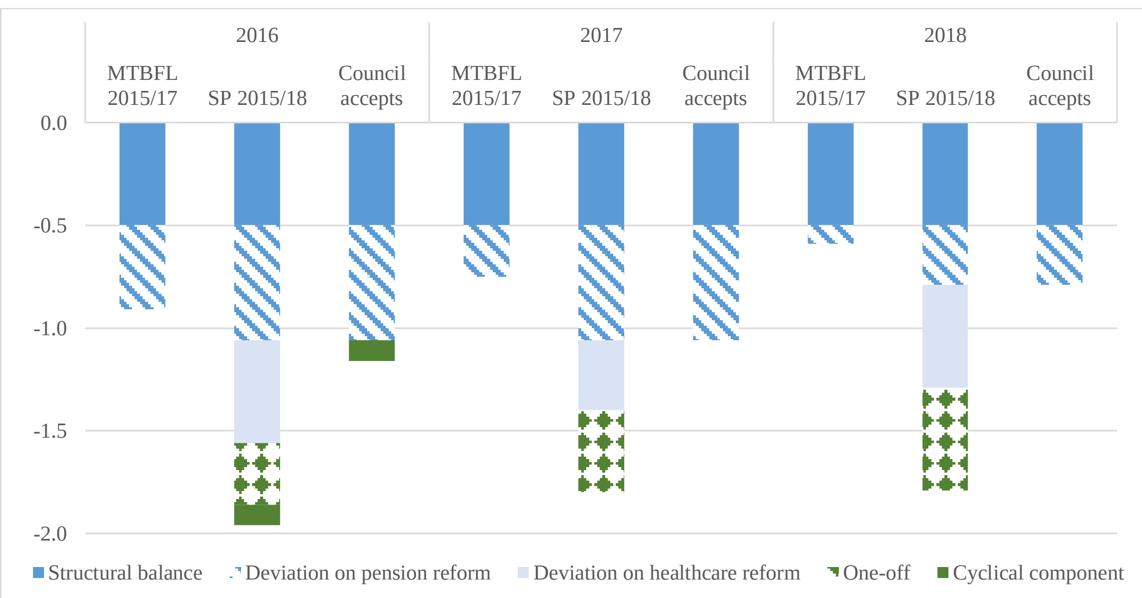

Figure 2.1 The general government budget balance by component according to the methodology of the FDL, % of GDP.

Therefore, the Council recognizes as substantiated the general government structural balance for 2016 not less than -1.06% of GDP and the headline balance at -1.16% of GDP as substantiated. This would provide for the central government budget expenditure ceiling at 7 531.0 million euro.

Table 2.2 General government headline budget balance and central government budget expenditure ceiling

	2016	2017	2018
General government budget deficit (-) / surplus (+)			
MTBFL 2015/17	-0.91	-0.75	
SP 2015/18	-1.6	-1.3	-1.7
Council's estimate	*-1.16*	*-1.16*	*-0.79*
Central government budget expenditure ceiling, in millions euro			
MTBFL 2015/17	7 601.8	7 969.3	
SP 2015/18	7 592.6	8 050.6	8 509.9
Council's estimate including the fiscal stability reserve	*7 531.0*	*7 978.7*	*8 212.9*
Consolidation volume	*61.6*	*71.9*	*297.0*

According to the SP 2015/18 determining for 2016 negative fiscal space -0.2% of GDP, the Council determines the consolidation requirement for 2016 in amount of 113.8 million euro.

The Council draws attention to the need to continue to follow whether the general government structural balance of 2014 and 2015 does not exceed the balance established in the MTBFL 2015/17 and by doing so triggers the correction mechanism stipulated in Article 11 of the FDL.

Recommendations

2.1. Take into account that health structural reform derogation is not included in the FDL or EU Regulations, and therefore these expenses cannot be attributed as the derogations pursuant to FDL. Both health expenditure, as well as defence one-off measures should be regarded as permanent expenditures.

2.2 The Council considers that there is a need for consolidation in 2016 in the amount of 113.8 million euro, not including the additional funding for the defence and internal affairs, and structural reforms in health care and education.

2.3. According to FDL Transitional rules Paragraph 3, fiscal safety reserve in the amount 0.1% of GDP for 2016 should be established, while for 2017 this reserve should be established not less than 1.3% of GDP, according to the Monitoring report.

3. The challenges of fiscal policy

Slight deterioration of the conditions for the economic growth in 2014 and unfavourable outlook for the fiscal balance increases the probability for a required fiscal consolidation in the process of preparing draft SB for 2016.

The review of fiscal policy numerical conditions leads to the conclusion that the preparation of the SB for 2016 will have to take a series of measures to increase the budget balance: either reducing the budget expenditure, or taking effective measures to increase budget expenditures. According to the SP 2015/18, and the Council estimates the amount of the consolidation required for 2016 in the amount of 113.8 million euro, not including amount of 78.2 million euro for defence calculated in the SP 2015/18

Budgetary consolidation will not be as drastic as in 2009, however, to maintain the required budget balance it is necessary to take action either by increasing tax revenue or expenditure budget reduction or a combination of both measures. **Priority here should be given directly to increasing the revenue potential, because Latvia is on the bottom part of the EU's list of countries with respect of the tax burden to GDP** (see Figure 3.1).

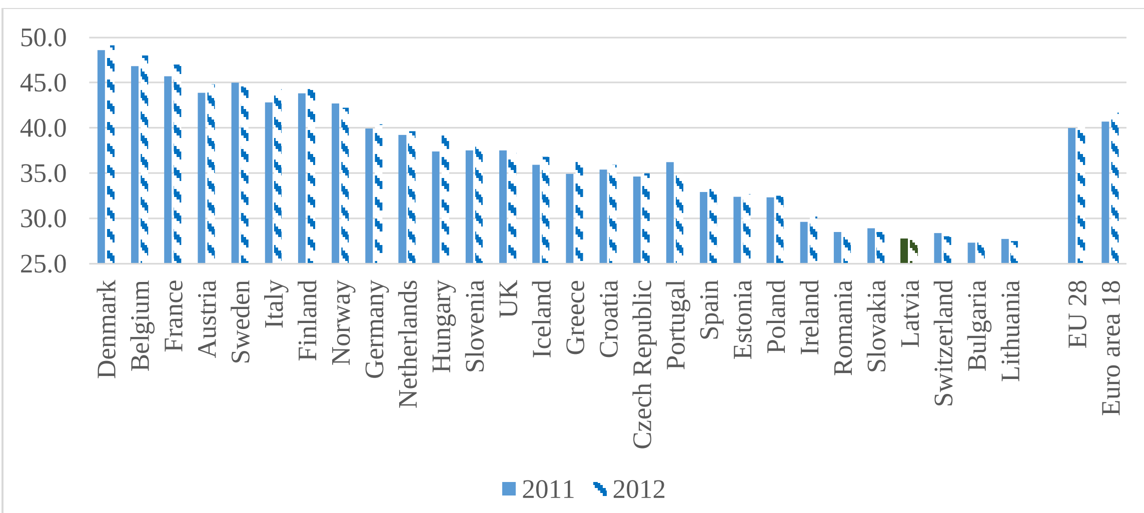

Figure 3.1. Total receipts from taxes and social contributions as % of GDP in 2011 and 2012.

SP 2015/18 does not present any new budget revenue initiatives that could help to overcome the scarcity of funding essential national priorities for 2016. The largest impact on the budget revenues will be planned personal income tax rate reduction from 23% in 2015 to 22% in 2016. Moreover, the newly adopted amendments to the micro-enterprise tax law increases the resource deficit.

SP 2015/18 budget revenue remains at about 28% against the GDP despite the government declaration formulated objectives: *to provide tax collection increase towards the level of tax revenues to one third of GDP*. SP 2015/18 confirms that at unchanged tax policies the tax revenue share to GDP would continue to slide thus reducing the national financial potential.

Council agrees with the Government policies that the tax collection improvement by reducing tax evasion and limiting the shadow economy is a major priority at present. Meanwhile the Council draws attention that without raising tax rates and the reduction of tax exemptions it would be impossible to achieve the fiscal targets. Limiting shadow economy could be long-term process, with the focus on improving taxpayer discipline, and gradually, one after another, are eliminated deficiencies in the system, which permit tax evasion and limit the capacity of the SRS to collect revenue due to the State. However, in the foreseeable period of time by reducing the shadow economy amounts to a level which is typical for Germany or the Scandinavian countries, in addition to the tax will not meet the target level of tax revenues – 1/3 of GDP without edits tax rates.

In recent years, popular view incorrectly has been focusing on the high income tax burden. Eurostat notes in its 2014 report on taxation trends in Europe[2] that **tax burden on labour as a percentage of GDP in Latvia at 13.7% level is lagging behind the EU average by 6% points**. In Latvia total personal income tax payments are actual lower than the average in the EU as well as the average level of the mandatory social insurance payments for both the employer's and the employee's part (see Figure 3.2). Moreover, the information concerns 2012, when personal income tax and social insurance payment rates for future years have been reduced. Income tax revenue decline took place without adequate compensatory measures to switch the tax burden to consumption as it was intended tax policy documents.

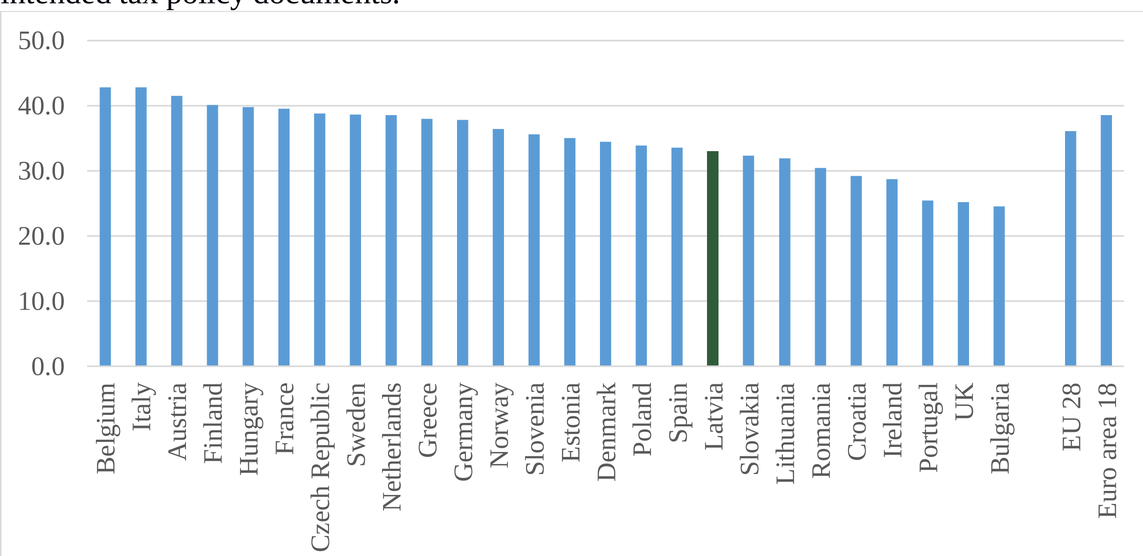

Figure 3.2. Tax burden on labor in EU countries, EU 28 and Euro area in 2012.

[2] Here and further comparisons of Latvia's and EU countries tax policies are taken from the following publication – http://ec.europa.eu/taxation_customs/resources/documents/taxation/gen_info/economic_analysis/tax_structures/2014/report.pdf.

Distortion has emerged with regard to low-wage earners. **The overall tax burden reduction on labour income was not taking into account the interests of low-paid workers.** For those employees who receive 67% of the average labour tax wedge in Latvia is at 43.5% and above the EU average of 6.8% in this population category compared to other EU countries. This points to the fact that the tax system does not fulfil the functions of the redistribution of income and inequality reduction, and is not conducive to long-term unemployed and those with insufficient professional qualifications waiting to join labour force.

The government should accelerate the increase of tax-exempt minimum income tax rate instead of the tax rate reductions. **The Council suggests not to proceed with the planned personal income tax rate reduction from 23% to 22% in 2016 in order to avoid a drastic reduction of budgetary expenditure in budget consolidation. Given the fact that most of the personal income tax revenue is transferred to local government budgets, additional fiscal space should be used primarily to introduce a differentiated tax exempt minimum income and to increase the tax-exempt minimum.** Financial improvement of situation in this category of the population is very important to stimulate domestic consumption. Moreover, the overall reduction in the personal income tax creates additional momentum for the overheating taking into account the trend of wage growth and strong private consumption.

The Saeima is currently reviewing amendments to the excise tax with positive effect on the fiscal balance expected from increasing the rates on selected excise goods. The effects would substantially depend on the capacity to contain smuggling and the violations in the circulation of the excise goods.

The recurrent taxation of capital, capital and business income is the lowest in Latvia compared to any EU country. Currently the implicit tax rate (ITR) on Capital and business income of households and self-employed equals 3 percent compared to 43.5% on employing low wage individuals. Estonia comes with the second lowest ITR for the capital and business income taxes at 4.2%, while it taxes withdrawals from companies at the rate established for the income tax.

The taxation of capital, including properties creates the least risks of avoidance and is untapped source of government revenue. **Measures to transfer the tax burden to the consumer and real estate taxes should be carefully considered when preparing the draft budget for 2016**, especially if other measures to increase budget revenue have not helped to ensure budgetary balance in accordance with the structural balance objective.

Despite the requirements for the budget consolidation the Government unlikely would face a situation that it would not have new priorities emerging. Geopolitical situation and international obligations of the country requires accelerating the defence spending to compensate for the most drastic spending cuts of this sector during the economic crisis (see Figure 3.3). A political support for increasing defence spending to 2.0% of GDP by 2018 has been expressed, while the revenue or expenditure measures for compensating the fiscal impact of this measure have not yet been determined.

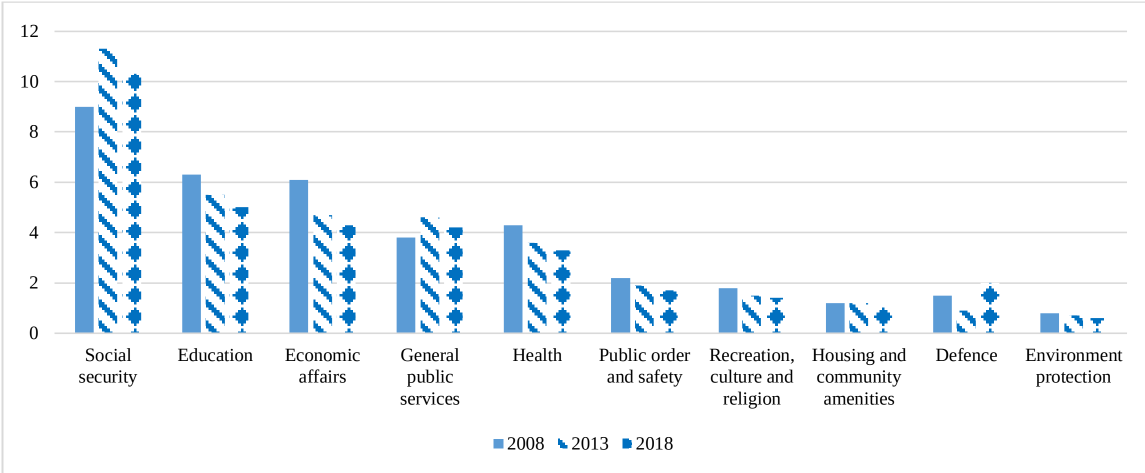

Figure 3.3. General government expenditure by function in Latvia, as % of GDP in 2008, 2013 and 2018.

The Council recognizes the need to increase the amount of the spending on health care in order to further improve the quality of and access to health services. However, given the rapidly growing opportunities to provide new health services and in particular the rapid rise in the cost of the new services, the Council suggests to clarify the basket of SB-funded health care services according to the budget resources allocated and to strengthen responsibility of officials for complying with the approved budget.

Latvian spending on education is 5.5% of GDP above the EU average of 5.3% of GDP, pointing at the need for structural reforms in the sector, specifically increasing the adequacy of graduates with the labour market and economic development needs. All the reasons for making the educational and scientific expenditures expensive should be assessed to increase their effectiveness.

Recommendations

Given the need to consider the budget consolidation in 2016, the Council recommends to consider the following measures:

3.1. Accelerate the effort on tax policy strategy with a view to achieve in the foreseeable period of time the government's aim of increasing tax revenue at one third of GDP.
3.2. Plan and implement effective measures to limit the informal economy, including reducing the tax payers' opportunities for tax evasion.
3.3. Enhance the capacity of the SRS action against companies and individuals, who fail to meet their obligations under the law for due tax assessment and payment.
3.4. Consider the options for postponing further reduction in the personal income tax rate as a priority for the faster increase of non-taxable minimum income and to reduce the necessary budget consolidation effort for 2016.
3.5. Support the review of the rates of excise tax simultaneously taking steps to limit excise illicit traffic control.

3.6. Examine the possibilities for revising consumption taxes' and real estate tax rates, if the aforementioned tax policy and administration measures fail to achieve the government's fiscal balance targets.
3.7. Consider, while preparing for a budget consolidation the need to provide additional funds to the state budget 2016 important national priorities, including accelerated increase of the defence budget to 2 percent of GDP.
3.8. Support increased funding for health care clearly defining the health services compensated from the state budget, by strengthening disciplined financial management in health care institutions, and clearly outlining the relationship between the specific structural reform measures and their funding from the budget.
3.9. Improving the relationship between education and research sectors' funding and their contribution to sustainable economic development, including reducing the knowledge and experience gap with the economic requirements and the practical application of scientific discoveries efficient technologies and new materials.

4. Progress of implementing Council's recommendations

The Council welcomes Government's plan of activities for fighting the shadow economy, and supports plans for 2015 to assess the possible introduction of differentiated non-taxable minimum and to reduce the tax burden on labour. Positively, budget balances for 2013 and 2014 are being realised within the planned limits, however, the Council recommends the government to develop an action plan for reaching the budget balance target in 2015 and appropriate adjustments for 2016. The Council has not distinguished any progress in tax revenue proportion to approach 1/3 of GDP. Ministry of Finance has not taken into account the suggestions of the Council concerning development a tax policy strategy, broadening the tax base and assessing possible cancellation of all tax relieves, as well as the calculation of fiscal reserve for 2016 and 2017 in the amounts of 0.1% of GDP and 0.13% of GDP respectively.

5. Fiscal impact of the Government action plan

On 10 February 2015, the Cabinet approved the Government action plan[3] (Action Plan). The Action Plan includes 572 measures providing for the Declaration of Mrs Laimdota Straujuma led the Cabinet of Ministers[4] (Declaration) implementation. The Declaration also provides that the budget investments will be made on the priorities of the Government, while maintaining a fiscally responsible budget policy and macroeconomic stability. Action Plan measures are related to a large extent (364 measures) to the Latvian National Development Plan[5], i.e. specific measures to be implemented in the upcoming years.

The Council asked the authorities related to the Action Plan to provide financial information related to the measures. To summarise estimates submitted by the institutions[6], the Action Plan for 2016 are needed about 700 million euro, representing 2.7% of the projected GDP (see Figure 5.1). In particular, it should be noted that the planned volumes of JPI does not include the defence expenditures that is currently Latvian highest priority, as well as many of the measures envisaged have not yet carried out cost estimates.

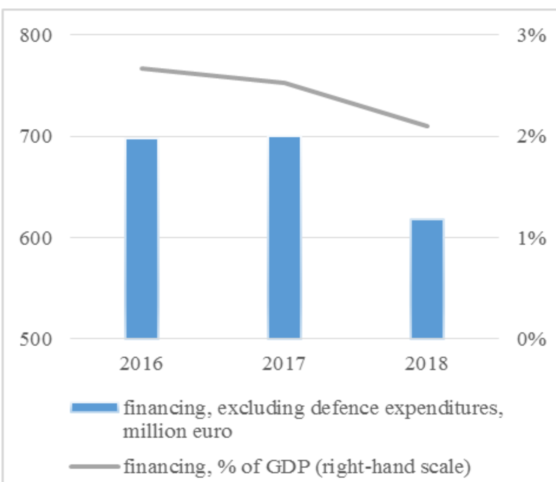

Figure 5.1. Additional financing necessary for Government action plan 2016-2018.

[3] Government action plan. 10 February 2015. Available (in Latvian): *http://www.pkc.gov.lv/images/vald%C4%ABbas_deklar%C4%81cijas/2014/VRP/Copy_of_PKCpielik1_100215_VRP.xls*.
[4] Declaration of Mrs Laimdota Straujuma led the Cabinet of Ministers. November 2014. Available (in Latvian): *http://www.pkc.gov.lv/images/LS_MK_deklaracija.pdf*.
[5] Latvian National Development Plan. 20 December 2012. Available (in Latvian): *http://www.pkc.gov.lv/images/NAP2020%20dokumenti/20121220_NAP2020_apstiprinats_Saeima.pdf*.
[6] Replies by the institutions. Available: *http://fiscalcouncil.lv/files/uploaded/20150331_VRP_atbildes.xlsx*.

Appendix 1. Assessment of the compliance with the numerical fiscal rules (extended)[7]

FDL numerical fiscal conditions require the selection of an expenditure calculation method which arrives at the lowest maximum expenditure ceiling. The numerical fiscal rules are intended to ensure a counter-cyclical and balanced economic development.

FDL establishes three numerical fiscal rules that shall be followed during the preparation and execution of MTBFL and SBL and any amendments to these. FDL mandates the application of the lowest value of state budget expenditure ceilings derived from the calculations of the three fiscal conditions (see Appendix 2 Table 1). Meanwhile, according to the second paragraph of Article 5 of the FDL the principle of continuity would not apply if the difference between the expenditure ceilings established by the previous MTBFL and the expenditure ceilings calculated by the other two methods would exceed 0.1% of GDP and the lowest expenditure ceilings determined by the other two methods would apply.

1. **The balance rule** has been defined in Article 10 of the FDL – the general government structural balance in the draft MTBFL for each year of the period should not be set lower than -0.5% of the annual GDP.
In accordance with the balance condition, the state budget expenditure ceiling is calculated based on the estimated state budget revenues by adjusting all the factors that affect the general government budget balance (see Appendix 2 Table 2) –
– general government structural deficit should not exceed the floor of -0.5% of GDP;
– overall budget balance of local governments;
– the impact on the general government balance of derived public persons and institutions not financed from the budget and
– the budget of state-owned enterprises attributed to the general government sector according to the methodology of ESA.

Thus, budget deficits or surpluses of local governments, derived public persons or state-owned enterprises attributed to the general government sector shall change the general government balance objectives for each year separately.
The SP 2015/18 includes a number of additional adjustments to the general government balance (see further this Appendix Figure 1):
– pensions' reform with an increase in contributions to the pensions' 2nd tier with cumulative effects[8] on the government balance in the amount of -0.56% in both 2016 and 2017 and -0.29% in 2018 (in MTBF 2015/17 accordingly in 2016 – -0.40%, in 2017 – -0.25% and in 2018 – -0,09%);

[7] The Council has performed FDL numerical criteria evaluation using the data of the SP 2015/18 and the data provided by the MOF during the SP preparation. These figures may further change during the further preparation of the SB 2016 and MTBF 2016/18.
[8] The contributions to the pensions 2nd tier have been increasing from 4% to 5% in 2015 and from 5% to 6% in 2016 both having cumulative effect on the general government balance (see SP 2015/19 p.24).

– structural reforms in health care with the effect on the government balance in the amount of -0.5% in 2016, -0.3% in 2017, and -0.5% in 2018;
– one-off measures related to the accelerated increase in defence spending with the effect on the government balance in the amount of -0.3% in 2016, -0.4% in 2017, and -0.5% in 2018;
– the cyclical component to adjust the government balance in 2016 by -0.1% due to negative output gap estimated in SP 2015/18.

In the meeting on 9 April 2015 the Council did not recognise the proposed adjustment to the fiscal balance due to the accelerated increase of defence funding to reach the planned 2% of GDP level as a one-off measure. Such costs should be considered a permanent expenditure, and government revenue should be increased to match these.
With respect to the fiscal balance reduction due to structural reform in health care, the proposed measures were not in compliance with the FDL. The Council recognizes that the European Commission has issued a number of communications (hereinafter – EC communications)[9] since FDL was put into effect, which explain SGP and provide additional flexibility in incurring additional deficit to enable additional structural reforms during SB and MTBF development. However, the Council uses the guidance of FDL as prevalent national normative act in making its analysis and conclusions.

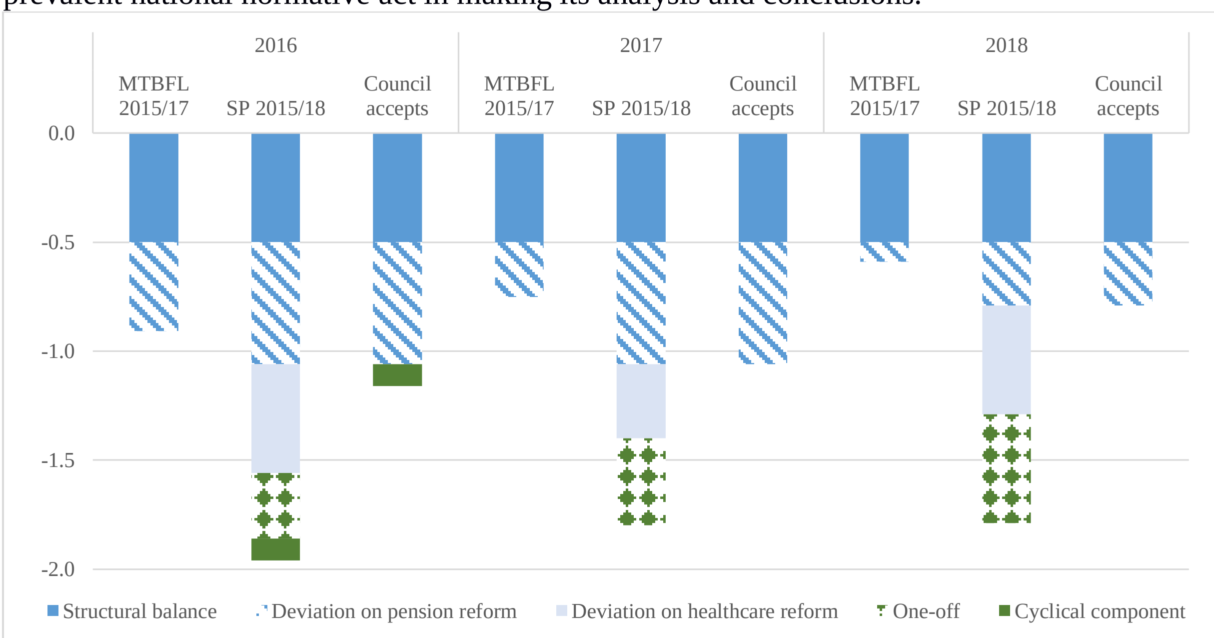

Figure 1 The general government budget balance by component according to the methodology of the FDL, % of GDP.

[9] Communication from the Commission to the European Parliament, the Council, the European Central Bank and the Eurogroup 2015 European Semester: Assessment of growth challenges, prevention and correction of macroeconomic imbalances, and results of in-depth reviews under Regulation (EU) No 1176/2011. 26.02.2015. Available: *http://ec.europa.eu/europe2020/pdf/csr2015/cr2015_comm_en.pdf*.
Communication from the Commission to the European Parliament, the Council, the European Central Bank, the Economic and Social Committee, the Committee of the Regions and the European Investment Bank. Making the best use of the flexibility within the existing rules of the Stability and Growth Pact. 13.01.2015. Available: *http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52015DC0012&from=LV*.

Health care structural reform assessment

It is the view of the Council that the health-care reforms outlined in the SP 2015/18 are salutary. However, there are a number of ambiguities that prevent the Council from determining whether the proposed changes can be considered structural reforms with a positive long-term effect on the state budget and quality of life in Latvia, and justify a deviation from medium-term goals.
The Council points out that the additional funds allocated to health-care reforms in the SP 2015/18 are lower than the increase in the budget deficit. Additional information is necessary that would clarify the use to which government funds devoted to health-care reform will be put.

The Council agrees and approves of the need to increase the cost-effectiveness, quality and accessibility of the health-care system in Latvia. This course of action is in line with country-specific recommendations from the European Commission where it was claimed that "the Latvian health system suffers from low public financing and high out-of-pocket payments, leaving a high proportion of the population with unmet healthcare needs"[10]

According to the Council, the main issue is that there is a lack of a clearly formulated and established link between the reforms and allocated funds proposed in the SP 2015/18 on the one hand, and the projected development of the national economy that would justify the additional funding necessary and deviation from the medium term objectives on the other hand.

The Council believes that the necessary funding to fund the government's priorities, particularly in the defence sector, should be provided through effective measures for revenue increase or a reduction in spending on other – lower priority tasks. The Council expresses its concern about the SP 2015/18 intention to reduce fiscal balance below the levels established in the recent MTBFL. In 2016 fiscal balance would be reduced from -1.6% of GDP to -2.0% and in 2017 – from -1.3% to -2.0%. Higher fiscal deficit will increase level of public debt in 2017 from 34% (in line with the MTBFL 2015/17) to 37.3% under the proposed SP 2015/18.

In view of the data provided by the MoF, in accordance with the Balance rule expenditure ceilings would amount to 7 592.6 million euro for 2016, 8 053.5 million euro for 2017, and 8 509.9 million euro for 2018.

In view of the above, the Council agrees to an additional deficit of 0.5% of GDP to support the pension reform, and does not object to the adjustment for the economic cycle (the cyclical component -0.1% of GDP), establishing, according to the according to the balance rule, expenditure ceilings – in 2016 7 557.1 million euro, in 2017 8 014.7 million euro and in 2018 8 242.3 million euro (see Appendix 2 Table 2).

[10] Commission staff working document. Country Report – Latvia (2015). 26.02.2015 Available: *http://ec.europa.eu/europe2020/pdf/csr2015/cr2015_latvia_en.pdf*. p.27.

2. **Expenditure growth rule** has been defined in FDL Article 13, stipulating that MTBFL should be drafted following the expenditure growth condition, in accordance with Article 9 of the European Parliament and of the European Council Regulation (EU) No. 1175/2011 of 16 November 2011, amending Council Regulation (EC) No. 1466/97 on strengthening the surveillance of budgetary positions and the surveillance of economic policies and coordination (hereinafter – Regulation No 1175/2011) is applied to the development of this Regulation referred to the European Commission's assessment. Regulation No. 1175/2011 provides that expenditure, excluding the GDP deflator should not grow faster than potential GDP growth.

Regulation No 1175/2011 lists expenditure categories dependent on the economic cycle and these should be considered when calculating smoothed total expenditure (see Annex 2 Table 3) – government interest payments on loans from foreign and international financial institutions, including credit institutions; EU spending programmes that fully comply with EU funds revenue (i.e. without any direct impact on the state budget, unlike the national share of the funding); total gross capital formation to the extent that has been smoothed with the moving average (from the previous three years).

The total amount of adjusted expenditure (headline figures) is obtained by subtracting the adjusted cost of cyclical spending on unemployment benefits (non-discretionary changes in unemployment) not considered in the next MTBF, and the impact of changes in government tax policy (discretionary revenue measures). The MoF, based on the EC communication, in addition to the discretionary measures, has added expenditure for one-off measures, as well as the adjustments for the pension and health care reforms. The increase of the amount of discretionary revenue compared to the MTBF for 2016 process has changed about EUR 206.8 million.

In accordance with the SP 2015/18 the Council has listed following discretionary measures –
– changes in government tax policy –109.7 million euro (see SP 2015/18 Section 6.2 *Efficiency of revenue structure and system*) – the Council agrees with SP 2015/18 proposals regarding their fiscal impact estimate;
– the adjustment for pension reform –146.1 million euro (SP 2015/18 page 24) – the Council agrees with SP 2015/18 proposals;
– the adjustment for health reform –81.6 million euro (SP 2015/18 page 41) – the Council does not agree with SP 2015/18 proposals;
– one-off measures for accelerated increase in defence expenditure – 78.2 million euro (SP 2015/18 page 24) – the Council does not agree with SP 2015/18 proposals.

There is determined the adjusted expenditure growth in constant prices in 2016 – -0.9%, in 2017 and 2018 each – 3.1%. If there is taken into account the Council decision on health care reform incomplete description in SP 2015/18 and one-off measure non-compliance with the criterion[11] – temporary and non-recurrent, the adjusted expenditure

[11] Public Finances in EMU 2006. European Economy. Occasional Papers 151. May 2013. Available: *http://ec.europa.eu/economy_finance/publications/publication423_en.pdf*. Pp. 111-113.

reduction for 2016 would be – -1.8% and growth for 2017 would be 1.5%, for 2018 – 2.2%.

If this figure is compared with the potential GDP average of ten years of growth, the maximum amount of expenses that would be required if the expenditures increased at the same pace as the potential growth rate of GDP is obtained. This theoretical indicator should be adjusted by the budgetary outcomes of local budgets and the budgets of derived public persons, as well as the impact of state-owned enterprises attributed to the general government sector according to the methodology of ESA. For 2016 there is positive forecasts for the ESA corrections largely due to the social security fund surplus forecasts. At the same time it should be taken into account that in 2016 similar to 2014 and 2015 to reckon with adjustments related to the costs to the second pillar pension scheme.

The MoF calculations for the expenditure growth rule would set expenditure ceilings at 7 864.7 million euro for 2016 8 050.6 million euro for 2017, and 8 529.3 million euro for 2018.

According to the Council's assumptions, the expenditure ceilings under the Expenditure growth rule should be 7 933.7 million euro in 2016, 8 177.6 million euro in 2017, and 8 605.6 million euro in 2018.

3. The **continuity rule** has been set by Article 5 of FDL, which states that MTBF establishes public expenditure ceilings for the next three years. The MTBF for the first and second year inherits the ceilings from the previous MTBF for the second and third year (see Appendix 2 Table 4). FDL provides that the continuity principle does not apply if expenditure ceilings derived using the previous two methods differ from the previous MTBF ceiling by more than 0.1% of GDP.

FDL Article 5 outlines ten cases which permit the adjustment of expenditure ceilings in view of situations that fall outside usual economic activity. These include changes affecting the contingent of recipients of social benefits and pensions, changes in fee revenue, decisions of the Constitutional Court, etc.

Various changes have occurred since the preparation of MTBF affecting the contingent of social benefit and pension beneficiaries, recipients of social services, the projected amount of service fees and another own-source revenues, as well as spending related to EU policy instruments. Accordingly, the MoF has provided data in accordance with the continuity rule calculating the expenditure ceilings for 2016 at 7 624.0 million euro and for 2017 at 7 934.7 million euro. The Council does not object the Continuity rule calculation of the MoF.

EC "Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes. 03.09.2012. Available: *http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/coc/code_of_conduct_en.pdf* . p.4.

Upon completing the calculation of all three numerical fiscal rules (see Annex 2 Table 1), the Council concludes that for 2016 (see Figure 2), as well as for 2017 and 2018 the expenditure ceilings (see Figure 3) should be determined according to the Balance rule which provides the lowest value of the ceiling. The Council draws attention to the FDL requirement to establish the Fiscal Stability Reserve in the amount of 0.1% in 2016, 0.13% in 2017, and at least 0.1% in 2018.

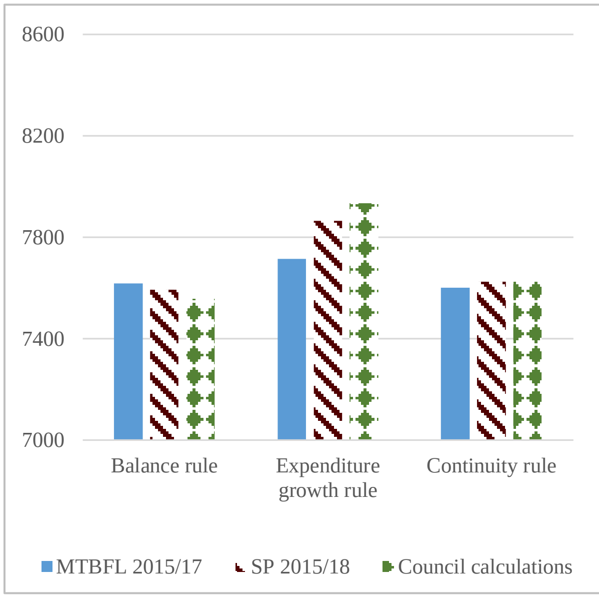

Figure 2. Budget expenditure ceilings in 2016 according to the fiscal rules, in millions of euro

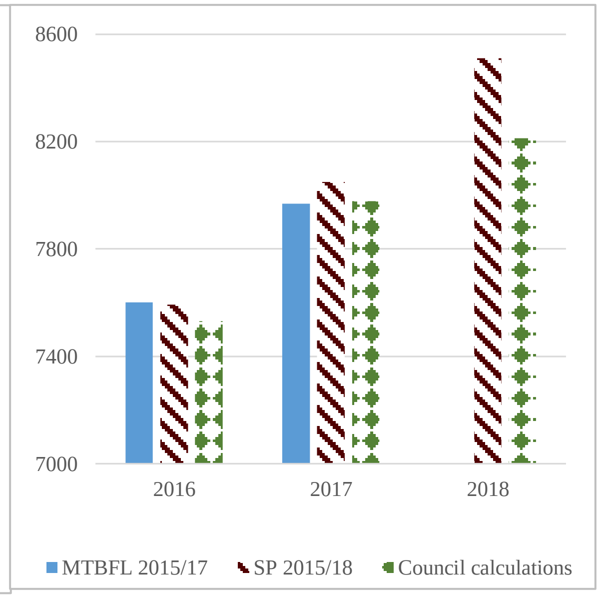

Figure 3. Budget expenditure ceilings in 2016-2018, in millions of euro.

Taking into account the requirements for the Fiscal Stability Reserve, the expenditure ceilings should be established without exceeding 7 531.0 million euro for 2016, 7 978.7 million euro for 2017, and 8 212.9 million euro for 2018.