LATVIJAS REPUBLIKAS FISKĀLĀS DISCIPLĪNAS PADOME

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FISCAL DISCIPLINE MONITORING REPORT 2015

Rīga, 2015

Contents

EXECUTIVE SUMMARY

The Council agrees with the assumptions employed when calculating the general government structural balance. The balance rule provides the lowest value of the expenditure ceilings for 2016, 2017 and 2018. Thus the balance rule establishes the expenditure ceiling for the MTBF 2016/18.

Despite political commitment to maintaining fiscal discipline, the Government's ability to adhere to fiscal objectives has deteriorated since 2013. The forecasted results of the general government structural budget balance for 2014 and 2015 are below the objectives. According to Article 11 of the FDL, if the accumulated deviation from the objective is above -0.5% of GDP, the correction mechanism is triggered, requiring a substantial increase in the budget balance to compensate for higher deficits in prior years.

The Council supports the Cabinet's initiatives for policy changes to increase budget revenues in 2016, but these only provide for a tax-to-GDP ratio of slightly above 28%. The Council believes that reducing the shadow economy is crucial for improving tax revenue and the tax-to-GDP ratio. The Council believes that Latvia is not fully utilising the revenue potential of VAT, property taxes and environmentally related taxes. The Council has previously commented on the Government's failure to shift the tax burden from labour taxation to the taxation of consumption and capital gains. However, income from dividends and other capital income is still taxed at much lower rates than income from labour.

The Council commends measures that seek to reduce income inequality, such as the so called solidarity tax, increasing the non-taxable minimum, as well as the plans to introduce a differentiated non-taxable minimum in 2017.

The Council points at the increased risks that will significantly encumber the attainment of fiscal objectives, in view of the decision to postpone establishing the FSR until 2017. When preparing the FRD, fiscal risks should be investigated in-depth, and their fiscal impact should be evaluated in order to improve risk management and reduce the necessary FSR. The Government has the responsibility to carry out a comprehensive assessment of fiscal risks, based on which the FRD is prepared. However, a number of fiscal risks have yet to be quantified, and their fiscal impact has not been determined. The Council is concerned that welfare sector expenditures have been underestimated in the past few years and exceeded the approved amounts at the budget. Specific strategies and measures for the prevention of fiscal risks should be carefully developed and implemented to reduce adverse impacts on the general government fiscal balance.

The Council does not object to the MoF's macroeconomic forecasts in the MTBF 2016/18 as the basis for drafting state budget for 2016. However, recent inflation indicators of the prices of goods and services suggest a realistic risk of lower nominal GDP and tax revenue levels than the MTBF currently projects. The Council encourages the Government to develop backup measures for the case of GDP and inflation growing at a slower pace than estimated. Key risks are related to less favourable developments globally, leading to weaker external demand.

Considering that there has been insufficient progress in the implementation of structural reforms, the Council does not see reasons for potential GDP growth to exceed 3-3.5% in the medium term. Key risks for potential growth are (1) the decreasing labour force due to negative demographic trends, (2) lagging investment sector and (3) skill mismatch in the labour market. Moreover, with the current structure of the economy, Latvia's convergence prospects to the EU average level remain limited.

The Council finds the Latvian economy growing broadly in line with its potential, while wage increases exceeding productivity growth could undermine the growth potential in the future.

ABBREVIATIONS

BoL	Bank of Latvia
Council	Fiscal Discipline Council
EC	European Commission
ESA	European system of accounts
EU	European Union
FDL	Fiscal discipline law
FRD	Fiscal risks declaration
FSR	Fiscal security reserve
IMF	International Monetary Fund
Monitoring report	Fiscal Discipline Monitoring Report 2015
MoF	Ministry of Finance
MTBF	Medium term budget framework
MTBFL 2016/18	Medium term budget framework law for 2016-2018
GDP	Gross domestic product
-	Not applicable / not available
NPI	New policy initiatives
OECD	Organization for Economic Cooperation and Development
PIT	Personal income tax
SB	State budget
SBL	State budget law
SBL 2016	State budget law for 2016
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

MANDATE OF THE COUNCIL

According to the FDL (FDL Chapter III Monitoring of fiscal discipline) the Council is an independent collegial institution which has been established to monitor compliance with the FDL. The Council's core competence is related to the assessment of fiscal discipline, and assess fiscal policy and issues related to macroeconomic developments.

Specifically the Council is responsible for:

- monitoring compliance with FDL provisions in the SBL and the MTBFL during their preparation, execution, and amendment;

- verifying whether the fiscal balance and the expenditure growth provisions have been properly applied, including an independent assessment of the potential GDP and nominal GDP, and the calculation of the structural balance;

- supervising the observance of FDL provisions in the implementation of the annual State budget law, conformity of total fiscal indicators of the consolidated budget of local governments and budgets of derived public persons with the forecasted values.

- preparing opinions regarding major permitted departures from the balance condition during a severe economic downturn;

- preparing an opinion on whether the FSR is set at an appropriate level to counter extant fiscal risks

- preparing a monitoring report on fiscal discipline and, if necessary, an irregularity report;

- preparing and submitting to the Saeima and the Government opinions regarding issues of fiscal policy and macroeconomic development if they pertain to compliance with the terms set out in the FDL.

- assessing and analysing the sustainability of fiscal policy for the purposes of preparing the reports stipulated by the FDL.

1. Fiscal policy challenges

The Council is in agreement with the Government regarding the assumptions employed when calculating the general government structural balance (see more in the *Assessment of compliance with numerical fiscal rules* section of this report). The Government has been preparing the draft SB 2016 and the MTBF 2016/18 with the general government structural deficit target of 1% of GDP in 2016 and 2017, while the structural deficit should be reduced to 0.8% of GDP in 2018.

The Government has been facing serious challenges while preparing the SB and the MTBF. The deterioration of macroeconomic conditions has imposed a necessity for fiscal consolidation compared to the baseline scenario in the amount of 96.8 million euro (0.4% of GDP); subsequently a decision was made to postpone establishing the FSR by one year, reducing the total consolidation effort to 0.3%. Moreover, Government priorities, including accelerated defence spending to reach 2% of GDP by 2018, funding for public security, education, and health care imposed additional expenditures whose fiscal impact exceeds the consolidation requirement.

Year	Objective	Actual (forecast)	Deviation (forecast)	Deviation accumulated since 2013
2013	-1.3	-1.0	+0.3	+0.3
2014	-1.0	(-1.3)	-0.3	0
2015	-1.0	(-1.4)	-0.4	-0.4
2016	-1.0	-	-	-

Table 1.1 Performance of the general government structural budget balance against the set objectives starting from 2013, % of GDP.

Despite political commitment to maintaining fiscal discipline, the Government's ability to adhere to fiscal targets has deteriorated since 2013. While in 2013 the actual general government structural budget balance exceeded the objective by +0.3 percentage points, the forecasted results for 2014 and 2015 are below the objectives (Table 1.1).[1]

According to Article 11 of the FDL, the accumulated deviation from the objective might trigger the correction mechanism requiring a substantial increase in the budget balance to compensate for higher deficits in prior years. Based on the estimate that the general government structural balance for 2015 will deviate from the objective by -0.4% of GDP[2], the accumulated deviation since 2013 is estimated to reach -0.4% of GDP. This is close to the situation where the correction mechanism is triggered, requiring an increase in the government budget balance by 0.5% in the third year after the significant deviation has been identified.

The draft SB and MTBF do not demonstrate significant improvements in the tax revenue to GDP ratio (hereafter – tax-to-GDP ratio)**.** With the policy changes set forth in the draft SB 2016 and the MTBF 2016/18, the ratio in the horizon period is expected to slightly exceed 28% – **still below the Government objective of 1/3 of GDP, established in the Declaration of Laimdota Straujuma's Cabinet.** The Government will fail to deliver its services and ensure continuous improvement in the provision of public goods without increasing government revenue collection to its objective – 1/3 of GDP, which would still be below the 38% EU average. Meanwhile, the Council welcomes the Government's plan to engage social partners in a discussion on a tax policy and administration strategy that is due to start in the first half of 2016 and finish in July 2017.

The Council believes that addressing tax avoidance and non-compliance is crucial for improving tax revenue and the tax-to-GDP ratio. Estimates of the shadow economy vary and should be treated

[1] In 2014, the structural general government balance (after excluding from the headline balance a one-off capital transfer to the European Bank of Reconstruction and Development in the amount of 88.2 million euro) reached -1.3% of GDP. In 2015 the deviation from the structural balance target set in the SBL 2015, approved in December 2014, has been estimated by including higher than anticipated ESA corrections (in the amount of 55.5 million euro), lower than expected tax revenues (in the amount of 55.1 million euro) and revised special budget expenditure projections (an additional 60 million euro).

[2] According to information provided by MoF on 25.09.2015.

with caution, but they do suggest that the informal sector in Latvia accounts for about 23%-24% of GDP, as compared to the EU average, which, according to F. Schneider[3], is 18% (Chart 1.1).

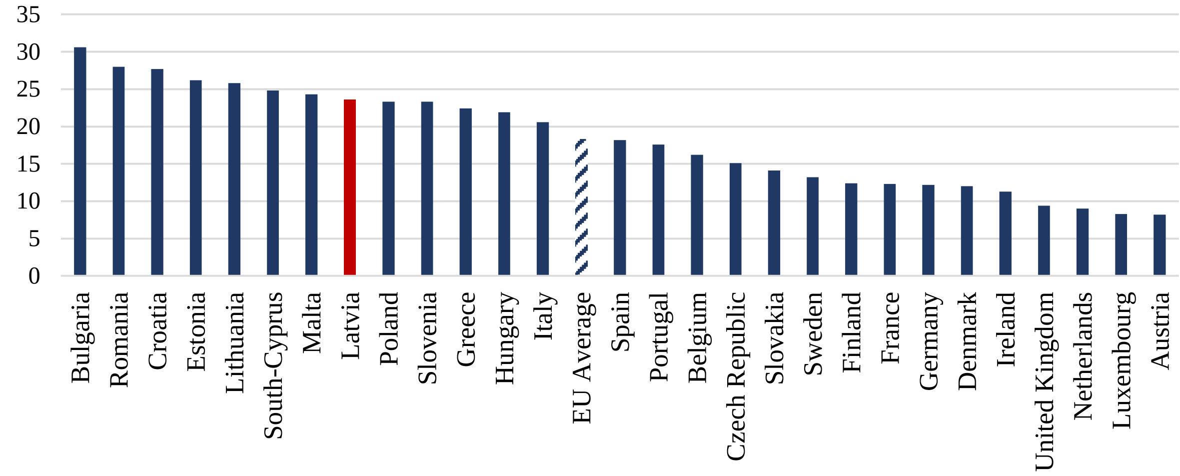

Chart 1.1 Size of the shadow economy of EU member states in 2015, % of GDP[4].

Year	Annual effect (million euro)	Accumulated effect (million euro)	% of GDP
2016	73	73	0.28%
2017	78	151	0.56%
2018	83	234	0.84%
2019	87	321	1.12%
2020	92	413	1.40%

Table 1.2 Fiscal impact from reducing the shadow economy to average EU levels by 2020 (Council's estimate based on MoF macroeconomic projections).

The Council encourages bold and clearly articulated plans for improving tax collection and reducing the shadow economy by 5% by 2020, as per the plans announced by the MoF. It is commendable that the plans recognise the importance of improvements to tax morale and increased trust in public institutions. Targeted attempts by the SRS to focus on areas where informality is prevalent also indicate that the government is making a coordinated effort to improve the efficiency of the tax system. However, specific measures for 2016 account for only a 21.7 million euro increase in revenue. **This implies that reducing the shadow economy will not be sufficient to reach the target tax-to-GDP ratio (33% of GDP)**, and other measures are required. An annual reduction of the shadow economy by 1% of GDP until 2020 will produce a cumulative effect of a 1.4% increase in the tax-to GDP ratio by 2020 (Table 1.2).

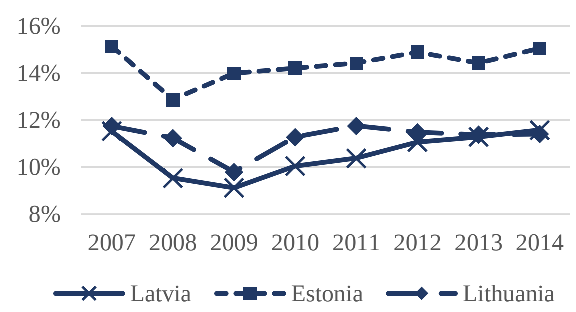

Chart 1.2 Effective VAT rates in the Baltic States. Council's calculations based on Eurostat data.

The Council believes that Latvia is not fully utilising the revenue potential of VAT, property taxes and environmentally related taxes.

A comparison of the effective VAT rates among the three Baltic States indicates that Latvia is not fully utilising its VAT revenue potential. In

[3] Schneider F. Size and Development of the Shadow Economy of 31 European and 5 other OECD Countries from 2003 to 2015: Different Developments. Available: http://www.econ.jku.at/members/Schneider/files/publications/2015/ShadEcEurope31.pdf, accessed on 24.08.2015

[4] Schneider F. Size and Development of the Shadow Economy of 31 European and 5 other OECD Countries from 2003 to 2015: Different Developments. Available: http://www.econ.jku.at/members/Schneider/files/publications/2015/ShadEcEurope31.pdf, accessed on 24.08.2015

2014, the effective VAT rate in Estonia was 15.05%, while it only reached 11.58% in Latvia (Chart 1.2). Moreover, the EC mentions Latvia as one of the states where the gap between the nominal VAT rate and the effective VAT rate is not only due to the extensive list of exemptions and reduced rates, but also pervasive non-compliance[5].

According to the EC, in 2012 revenues from property taxes in Latvia amounted to 0.9% of GDP, which is well below the EU average of 2.3% of GDP. A number of measures to increase revenue from immovable property have been introduced, such as reassessing cadastral values and introducing fines for non-use of agricultural land. Meanwhile, extensive issuance of tax exemptions and allowances from property taxation reduce revenues. There is still potential to increase revenue from the taxation of housing, which could be implemented in a socially responsible and growth friendly manner. Likewise, the rates of several environmentally related taxes are considerably below those of other EU Member States, and rate increases to some of them could be considered (Chart 1.3).

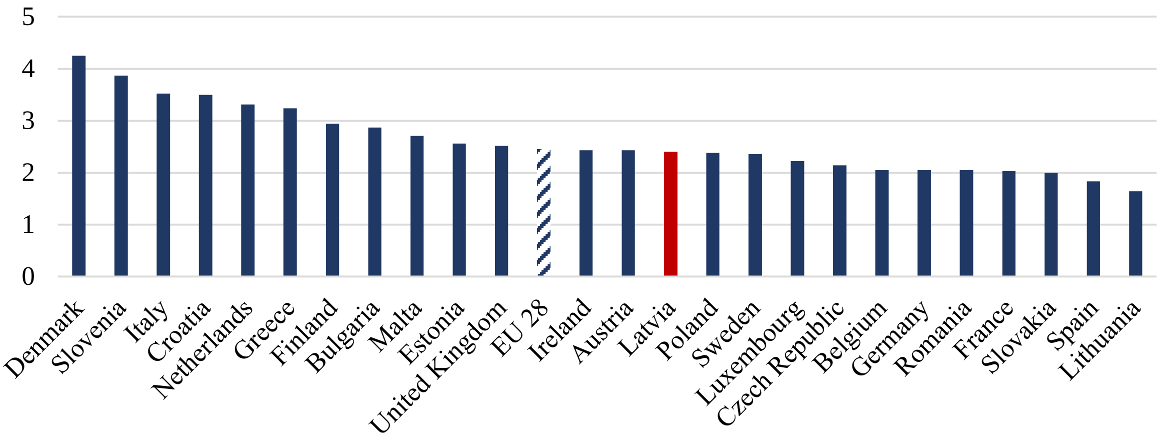

Chart 1.3 Total revenue from environmental taxes in 2013, % of GDP[6].

The Council supports the Cabinet's initiatives for policy changes to increase budget revenues, but these continue supporting the tax-to-GDP ratio at the historical low levels close to 28%. Excluding dividends from state owned enterprises and measures to combat informality, the proposed measures will increase budget revenues by 184.1 million euro in 2016. A number of tax rates have been raised, and the proposed PIT rate reduction has been abandoned. The Council has commented earlier[7] on the Government's failure to shift the tax burden from labour taxation to the taxation of consumption and capital gains. However, income from dividends and other capital income is still taxed at much lower rates than income from labour.

The Council commends measures that seek to reduce income inequality, particularly through addressing the regressiveness of income taxation by introducing the so called solidarity tax, increasing the non-taxable minimum, as well as the plan to introduce a differentiated non-taxable minimum from 2017. International publications have also identified inequality as a pressing issue for Latvia. Of special concern is the high tax burden for low income earners and Latvia's high Gini coefficient – the highest among EU member states, and income inequality has been growing since 2011. This should decrease the currently high tax wedge for low-income earners in Latvia (Chart 1.4).

[5] Tax Reforms in EU Member States 2014. European economy series. June 2014. Available: http://ec.europa.eu/economy_finance/publications/european_economy/2014/pdf/ee6_en.pdf, accessed on 11.09.2015
[6] Source: Eurostat.
[7] Fiscal discipline monitoring interim report (opinion) on the Latvia Stability programme 2015-2018. Available: http://fiscalcouncil.lv/files/uploaded/FDP_1_01_322_20150508_Starpzinojums_un_Piel1_EN.pdf, accessed on 23.09.2015.

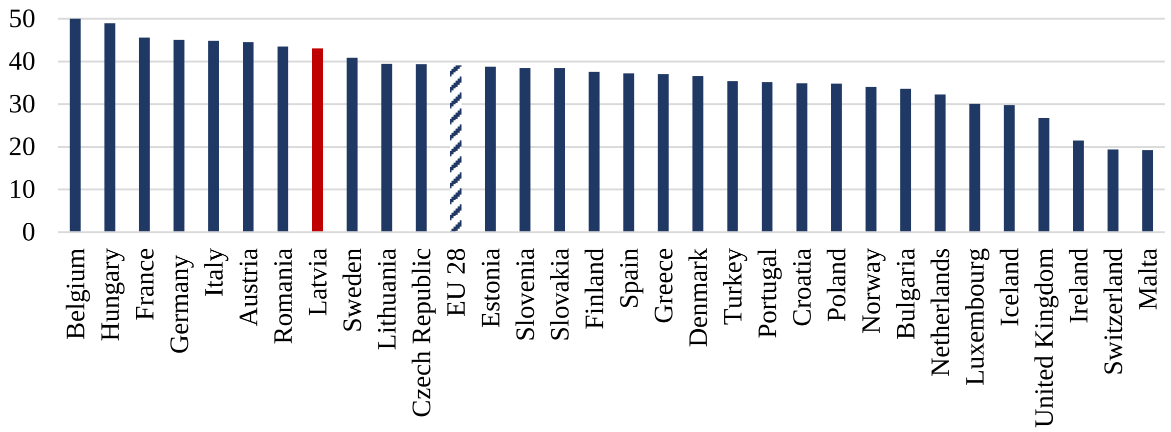

Chart 1.4 Tax wedge on labour costs for low income earners in 2013, %[8].

Simultaneously, the Council is concerned about the growth rate of minimum wage, which significantly outpaces the productivity growth rate.

The Government has named defence, education, health and internal security as priorities for 2016 and listed a number of policy changes that required a budget increase. These activities have earmarked additional funding from the sources of additional revenue and spending cuts – a combination of 3% across the board reductions in non-salary expenditures for ministries, postponement of several activities, tax increases and measures for reducing the shadow economy.

Future increases in funding for education and health sectors should be linked to structural reforms with a positive long term effect on the state budget and quality of life in Latvia. Latvia does not compare well with other EU countries in terms of public health outcomes. The poor population health status will likely have a significant impact on the economic growth of the country and will need to be addressed (more comprehensive overview in Annex 3).

Structural reforms in education should focus on the cost of delivering education services, improving the professional relevance of educational qualifications and addressing skill mismatch in the labour market. Additional funding for STEM disciplines is in line with government objectives, though appropriate measures should be developed in order to stimulate student interest in these areas (more comprehensive overview in Annex 2).

Recommendations

1. The Council recommends a cautious fiscal policy for the remainder of 2015, bearing in mind the likelihood of having to correct the fiscal balance for 0.5% of GDP in case of significant deviations.
2. Reaching a tax-to GDP ratio of 1/3 should be the key objective while developing a tax policy and administration strategy, focusing on the reduction of the shadow economy, improving the efficiency of tax collection, as well as reviewing tax rates and eliminating exemptions.
3. Consider the reduction of income inequality when designing future tax policy; in particular, look at increasing the tax burden on dividends and other capital income not used for reinvestment.
4. Increase budget revenues in a growth friendly manner by fully utilising the potential of property taxes and environmentally related taxes.
5. Consider eliminating skill mismatch by increasing the professional relevance of the skills and qualifications provided by educational establishments to improve the long term productivity of the Latvian labour force.
6. Consider addressing overall health system efficiency and sustainability by optimising the distribution of funding with the objective of improving population health status indicators and decreasing amenable mortality rates.

[8] Source: Eurostat.

Assessment of the Declaration of Fiscal Risks

The Government has the responsibility to carry out a comprehensive assessment of fiscal risks and prepare a report in the form of the FRD, which is attached to the draft MTBFL upon submission to the Saeima. Based on this report, the FSR should be calculated and included in the budget to counter the fiscal impact of any of the included risks, should they materialise and cause fiscal aggregates to substantially deviate from those included and approved as part of the MTBF.

The Council has assessed the FRD, as approved by the Cabinet of Ministers on 25 August.

The FDL stipulates that fiscal risks should be quantified if possible, and a FSR should be established to counter sudden shocks to the general government fiscal balance and to improve it if expenditure levels are higher than expected or revenues fall short of the target. FDL states that the reserve for 2016 should be established in the amount of 0.1% of GDP and no less than 0.1% of GDP for subsequent years. The Cabinet's decision against establishing the FSR for 2016 is contrary to Part 3 of the Transitional Provisions of the FDL.

The Council notes the decision of the Cabinet of Ministers to defer establishing the FSR until 2017 in the budget framework and points at elevated risks that will make it difficult to achieve the established fiscal objectives. The Council believes that not establishing the FSR sets an unfortunate precedent. Different risks may cause a deterioration of the government budget balance compared to the established objective, and the FSR provides a cushion for countering such unforeseen circumstances and reduces the accumulation of deficits in excess of the established objective. Government assistance to the banking sector and loan guarantees have been significant factors with adverse impacts on the government fiscal balance in the past, in addition to unexpected macroeconomic developments or omissions in fiscal estimates.

A limited number of risks has been quantified in the FRD.
For 2016 these include:

- the potential fiscal impact of state loan guarantees being called upon – 3 144 million euro;
- the potential fiscal impact of government loans not being repaid – 1 018 million euro.

A number of risks in the FRD have been classified as symmetrical, which means that the possibility of additional revenue or greater expenditure is believed to be equal. Furthermore, it is argued that these risks do not require a specific allocation in the FSR. Among these risks are:

- risks in the welfare sector;
- risks pertaining to EU funding and other foreign financial instruments.

The fiscal impact of other risks has not been determined in the FRD, because the probability that they will materialise is negligible. These include:

- repayment of state student loans and guarantees;
- capital on demand.

Finally, a number of fiscal risks have not been quantified in the FRD, and their fiscal impact has not been determined. These include:

- direct and indirect exposure resulting from public-private partnerships;
- risks associated with state joint-stock companies;
- risks associated with expenditure arising from rulings by international courts or the Constitutional Court (Satversmes tiesa).

The Council has assessed the fiscal risks under the assumption that the FSR has not been established in the MTBF for 2016, while it is critical that the FSR is formed for 2017 and 2018. Furthermore, the Council wishes to draw attention to a number of aspects of the FRD.

First, **the Council points at various fiscal risks that have not yet been fully assessed or quantified, while welcoming the increase in the number of public institutions engaged in risk assessment.** Agencies should be encouraged to adopt mitigation plans for the risks that may materialise into adverse fiscal impact depending on the rating of the risks.

Second, currently the FRD contains a very general description of the methodology employed to assess the probability of various risks. In the future the FRD should include a more detailed and explicit account of risk assessment procedures – particularly as they pertain to the assignment of specific probabilities, and the assumptions underpinning these judgements. Better assessment of fiscal risks and the quantification of their impact would lead to better strategies for countering the risks.

Third, **the Council has concerns that risks in the welfare sector have been underestimated in the last few years**. Estimates of pension and social insurance benefit costs tend to exceed the amounts approved in the SBL and MTBFL, while the adjustments to the budget during the year reflect updated estimates of the number of beneficiaries and the average amount of pensions and benefits. Due to the significant risks that the Special Budget poses for achieving fiscal objectives, the Council examined the associated fiscal risks in the 2014 Monitoring Report and expressed its concern regarding the assessment of fiscal risks in the welfare sector. The Council's research shows that expenditures have regularly exceeded annual budget allocations, on average by about 2% for the past 7 years (Table 1.3).

The Ministry of Welfare has revised up its budget estimates for 2015-2018 by an average of 50 million euro per year. Although the Council welcomes the upward revision of the expenditure estimates, the Council suggests following the trends closely and ensuring that the estimates are based on realistic assumptions. Further decisions on increases in social assistance should not be based on the positive balance in the special budget as a source of the necessary funds.

	2008	2009	2010	2011	2012	2013	2014
Employment social benefits	123%	190%	68%	50%	85%	111%	120%
Disability, maternity and illness social benefits	119%	94%	98%	90%	93%	105%	106%
Work accident social benefits	116%	110%	117%	122%	102%	105%	108%
State pensions	103%	89%	121%	101%	102%	103%	101%
Average (weighted)	**107.30%**	**94.78%**	**111.08%**	**96.05%**	**99.99%**	**103.30%**	**102.32%**

Average 2008 - 2014	**102.12%**
Average 2012 - 2014	**101.87%**

Table 1.3 Special budget expenditures, % of budget estimates set in annual budget laws.

Furthermore, **the Council perceives the claim that these risks are symmetrical as problematic** in view of the fact that in the last two years forecasts were lower than actual expenditures. Consequently, the assumption of equal probability for additional revenue or greater expenditure is not convincing without additional information or qualification.

Finally, **specific strategies and measures for the prevention of fiscal risks should be carefully developed and implemented to reduce adverse impacts on the general government fiscal balance**. The Council would encourage the Government to develop and implement such measures in order to reduce the FSR in the future.

The Council recommends that the FSR for 2017 and 2018 is established at least at the level of 0.1% of GDP, as per FDL. The level of FSR could be adjusted upwards, if the risk assessment requires so.

Recommendations

1. Accept the FRD approved by the Government, while reiterating the need for the FSR and stressing the need to survey all possible sources of fiscal risk.
2. Include risks arising from the financial sector in the FRD since these have been significant in the past. Risks related to possible capital calls from the European Stability Mechanism and their future impact should also be carefully assessed.

3. Improve the quality of risk assessment by collecting information pertaining to all fiscal risks and, if possible, quantify them in order to have a reliable estimate of their potential fiscal impact.
4. Provide a more detailed description of how probabilities are assigned to particular risks to facilitate the review process for independent institutions.
5. Ensure collection and exchange of information to improve risk management and develop procedures to prevent sudden impacts on the fiscal balance.

2. Macroeconomic outlook and output gap

Latvia's economy in 2015 has been lagging behind the projected growth (MoF revised down its real GDP growth forecast for 2015 from 2.8% in the MTBF 2015/17 to 2.1% in the MTBF 2016/18). Inflation has turned out to be substantially lower than expected as well (the forecast by MoF has dropped from 2.1% MTBF 2015/17 to 0.8% currently). This has contributed to a deterioration of the general government budget balance: MoF forecasts the deficit for 2015 to be larger than the target set forth in the 2015 BL (explanation about consequences of exceeded budget deficit in Annex 4).

	2015	2016	2017	2018
Real GDP growth				
MoF	**2.1**	**3.0**	**3.6**	**3.6**
BoL	2.3	2.7	-	-
EC	2.3	3.2	-	-
IMF	2.3	3.4	3.7	3.9
Nominal GDP growth				
MoF	**3.2**	**5.2**	**6.2**	**6.2**
BoL	-	-	-	-
EC	4.6	6.3	-	-
IMF	4.2	5.0	6.0	6.2
Inflation				
MoF	**0.8**	**2.0**	**2.5**	**2.5**
BoL	0.4	1.3	-	-
EC	0.7	2.2	-	-
IMF	0.5	1.7	2.3	2.2
Output gap				
MoF	**-0.2**	**-0.4**	**-0.1**	**0.0**
BoL	-	-	-	-
EC	1.4	1.6	-	-
IMF	-	-	-	-

Table 2.1 Key macroeconomic indicator forecasts by various institutions, % y-o-y.

The Council does not object the Ministry of Finance's (MoF) macroeconomic projections (Table 2.1) stated in the MTBF 2016/18 as the basis for drafting the SB for 2016 and MTDFL 2016/18. However, **the Council considers that, in view of recent developments in the global economy, there is a realistic risk of lower nominal GDP levels for the horizon period (2016-2018) than MoF currently projects, which would lead to lower than estimated tax revenues**.

The key risk for macroeconomic development of Latvia for the MTBF horizon period is related to unfavourable global economic development. The Council acknowledges that Latvia will experience developments in the global economy (Greece's possible insolvency and slow-down in China and Brazil) through a decrease in global demand, and thus a decrease in demand in Latvian export markets. Geopolitical risks and exports issues related to Russia are still the most topical. However, seeing that Latvia's exports have started to stabilise successfully in other exports markets, decreased dependency on Russia as one of the major export markets could be beneficial, as the new trade partners are potentially more reliable. The Council encourages MoF to develop a more profound sensitivity analysis of the macroeconomic scenario in order to evaluate the effects of possible unfavourable developments affecting Latvia's economic performance.

The Council points out a number of **impediments for Latvia's potential GDP growth**:

- First, the demographic situation, where problems are both the negative natural population growth rate and the negative migration balance (according to Eurostat projections, Latvia's population will reach 1.6 million by 2030 and 1.3 million by 2080, assuming no policy changes) leads to a decreasing labour force in the economy;
- Second, the inactive investment sector, and inordinately low research and development expenditures are obstacles to potential GDP growth (according to Eurostat data, in 2013 research and development expenditure in Latvia constituted 0.6% of GDP, while the EU average was 2.0% of GDP);
- Third, persisting issues regarding the mismatch of skills and abilities of the economically active population with the requirements of the labour market[9] restrict total factor productivity growth, and thus the potential GDP growth (detailed overview of the issue in Annex 3). This makes GDP growth rate forecasts above 3-3.5% in the medium and long run doubtful;

[9] Krasnopjorovs, O. Natural and cyclical unemployment in Latvia: New insights from the Beveridge curve model. Available: https://www.macroeconomics.lv/sites/default/files/dm_2_krasnopjorovs_2015_en.pdf, accessed on 24.09.2015. Discussion on occupational mismatch and skills mismatch issue in Latvia.

- Fourth, with the current structure of the economy, Latvia's convergence prospects to EU average levels remain limited[10].

The Council is sceptical about inflation reaching the levels that MoF forecasted for 2015 and 2016. Oil price dynamic is the key reason for concern: the average 2015 level will probably fall behind MoF's forecasted 59.4 US dollars per barrel[11].

The Council considers that a further minimum wage increase is likely to endanger the inclusion of the unemployed into the formal labour force, particularly outside Riga. An analysis of the economic impact of past minimum wage increases has neither been published nor publicly discussed by the government.

Output gap

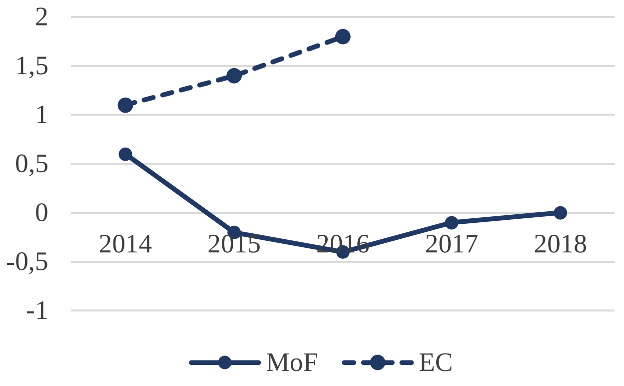

Chart 2.1 Output gap of Latvia evaluation by MoF and EC, % of GDP.

Opinions on the output gap of Latvia's economy vary among different institutions (Chart 2.1). While MoF believes that Latvia's economy is about balanced, with a slightly negative output gap falling somewhere between -0.5% and 0% of GDP for the horizon period, EC considers it to be positive - around 1.5%. The Council is not in agreement with EC's opinion that Latvia's economy is currently in an overheating stage – this is unlikely, given the relatively low real growth rate and low inflation. Similarly, as in the Council's Interim report published in May 2015, **the Council considers that the economy of Latvia is growing in line with its potential, with no significant deviations of the output gap from zero**.

Recommendations

1. While the Council generally approves the MoF's macroeconomic forecast as a basis for drafting the state budget for 2016 and setting the budget framework for 2017/18, it strongly encourages the MoF
   a) to provide a more profound sensitivity analysis of the macroeconomic scenario;
   b) to develop, based on the sensitivity analysis, a back-up plan for the realistic case of budget revenues falling short of the estimates.
2. Regarding medium and long term development, structural reforms in order to boost potential GDP growth should be implemented, addressing the issues of a decreasing labour force, a rigid investment sector and the mismatch of the economically active population's skills and abilities with the labour market's requirements.

[10] Bank of Latvia also points out at the same issue (Expert's conversations "Has economy of Latvia reached it's ceiling?", presentations available: https://www.makroekonomika.lv/ekspertu-sarunu-video-vai-latvijas-tautsaimnieciba-ir-sasniegusi-griestus)

[11] US Energy Information Administration forecasts Brent crude oil average prices to be 54.07 US dollars per barrel for 2015 and 58.57 US dollars per barrel for 2016, in contrast to MoF's forecasted levels of 59.5 and 66.0 respectively. Available: http://www.eia.gov/forecasts/steo/, accessed on 14.09.2015.

3. Assessment of compliance with numerical fiscal rules

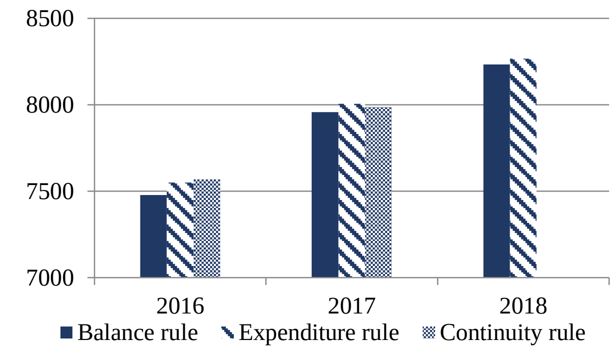

Chart 3.1 Adjusted maximally permissible state budget expenditure, million euro.

	2015	2016	2017	2018
(1) Fiscal space positive (+) / consolidation (-) (1) = (2)-(3)				
MTBFL 2015/17	1.0	39.3	288.2	
SP 2015/18		-51.3	152.9	259.6
MTBFL 2016/18		***0.0***	***54.4***	***287.4***
(2) Adjusted state budget expenditure ceiling *(top-down)*				
MTBFL 2015/17	7472.4	7636.9	7944.0	
SP 2015/18		7517.4	7920.4	8212.9
MTBFL 2016/18		***7654.5***	***8209.4***	***8711.9***
(3) State budget expenditure commitments *(bottom-up)*				
MTBFL 2015/17	7471.3	7597.6	7655.8	
SP 2015/18		7568.7	7767.5	7953.3
MTBFL 2016/18		***7654.5***	***8155.0***	***8424.5***

Table 3.1 Fiscal space, million euro. (MTBFL 2016/18: draft figures) (detailed data in Annex 6, Table P6.5).

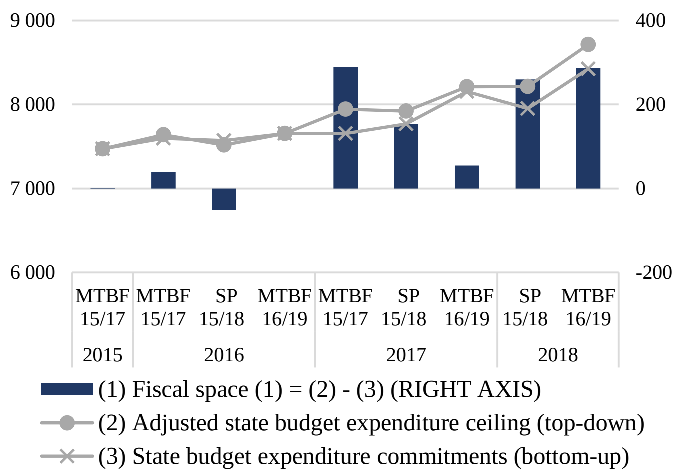

Chart 3.2 Fiscal space, million euro.

The Council has the responsibility to verify the application of the numerical fiscal rules stipulated by the FDL in the preparation of the SB and the MTBF. The Council has verified the calculations provided by the MoF and agrees with the manner of the calculation and the assumptions employed[12]. Out of the three exercised fiscal rules – balance rule, expenditure rule and continuity rule – **the balance rule provides the lowest value of the expenditure ceilings for 2016, 2017 and 2018. Thus the balance rule establishes the expenditure ceiling for the MTBF 2016/18** (Chart 3.1). Detailed calculations are provided in Annex 5 and data tables in Annex 6.

The Government has reviewed the SB 2016 and accepted the updated costing of ongoing activities presented in the MTBFL 2015/17. Despite growing budget resources and rising expenditure ceilings in 2016 compared to 2015, updated macroeconomic data and fiscal estimates have led to expenditure commitments exceeding expenditure ceilings. This has imposed a consolidation requirement for the draft SB 2016 in the amount of 96.8 million euro or 0.4% of GDP. In the first draft of the MTBF 2016/18 consolidation amount (96.8 million euro for 2016) included allocation for the FSR in the amount of 0.1% of GDP for 2016. The plan to allocate resources for the FSR was abandoned during the SB and MTBF approval process at the Cabinet of Ministers.

Upon receiving the revised data on the MTBF 2016/2018 (Table 3.1 and Chart 3.2), the Council noted that, regardless of new revenue measures, fiscal space for the first year of the MTBF is exhausted.

The Council considers that the FSR

[12] The calculation of numerical fiscal rules in this report has been based on inputs provided by the MoF on 3 August 2015 and are subject to change as the draft SBL 2016 and the MTBFL 2016/18 are being prepared and reviewed. At that time FSR has been taken into account also for SB 2016.

allocation should be taken into account while establishing expenditure ceilings. The Government's decision to postpone allocating funds for the FSR and exhausting fiscal space for 2016 increases the risk of not achieving the budget balance objective. Discussion on the assessment of fiscal risks and the calculation of the required FSR has been provided in the *Fiscal Policy Challenges* section of this report.

	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
MTBFL 2016/18	*-1.4*[13]	*-1.0*	*-1.0*	*-0.8*
Basic budget deficit (-) / surplus (+)				
MTBFL 2015/17[14]	-1.5	-1.6	-1.3	
SP 2015/18	-1.6	-2.0	-1.7	-0.2
MTBFL 2016/18[15]	*-1.6*	*-1.3*	*-0.7*	*1.1*
General government debt				
MTBFL 2015/17	35	37	34	
SP 2015/18	37	40	37.3	34.1
MTBFL 2016/18	Data not available			

Table 3.2 General government and basic budget headline balance and general government debt as % of GDP (MTBFL 2016/18: draft figures).

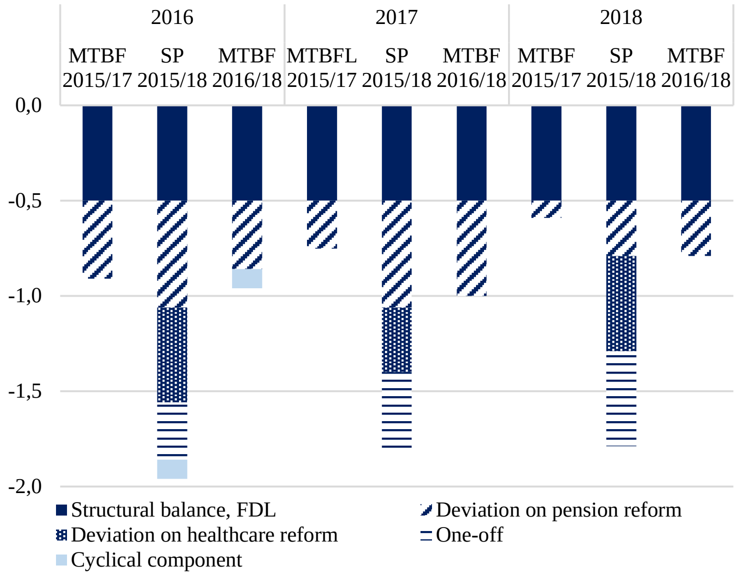

Chart 3.3 The general government budget headline balance by component according to the methodology of the FDL, % of GDP.

Article 11 of the FDL stipulates a correction mechanism requiring a 0.5% increase to the target general government structural budget balance, if the cumulative deviation from the established target has exceeded 0.5%. The Council is concerned that there is a serious risk of not achieving the structural balance objective for 2015. In autumn 2015 the structural budget deficit is forecasted to exceed the objective set forth in MTBFL 2015/17 by -0.4% of GDP (Table 3.2), but the final 2015 general government structural budget balance figure will only be established by December 2016. The Council reiterates that **deviations in the general government budget exceeding 0.5% of GDP may trigger the correction mechanism stipulated by Article 11 of the FDL**. This is to prevent continued accumulation of general government debt, which continues to grow unfortunately during the period of economic growth.

The Council commends the Government for not increasing the budget deficit target for the MTBF 2016/18 draft, as was planned in the SP 2015/18.

The improvement to the headline balance from SP 2015/18 to MTBFL 2016/18 draft is mainly due to two reasons envisaging a substantial deficit decrease (Chart 3.3) – (1) abandoning the allocation for reforms in health care[16] and (2) no longer treating the accelerated defence spending as a one-off budgetary measure and including it into the updated baseline instead.

[13] According to information provided by MoF on 25.09.2015.
[14] Cash-flow
[15] Cash-flow
[16] Council recommendation on the 2015 National Reform Programme of Latvia and delivering a Council opinion on the 2015 Stability Programme of Latvia. European Commission recommendation. Available:

Recommendations

1. The Council recommends to treat the allocation for the FSR as an activity related to the determination of the numerical fiscal targets and to determine the expenditure ceilings starting from 2017 including the allocation for FSR.
2. The MoF should develop a procedure for ex post of the structural balance and correction mechanism, preferably in consultation with the Council.

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http://ec.europa.eu/europe2020/pdf/csr2015/csr2015_latvia_en.pdf, accessed on 08.09.2015. The EC abandoned the health care reform because of the exceeded threshold deficit level.

ANNEX 1 RECOMMENDATIONS PROGRESS

25.09.2015 Progress report since 05.12.2015
26.01.2015 Council comments and suggestions
30.12.2014 The MoF reply
05.12.2014 Council recommendations

No	Report Chapter	Recommendation
1	3 Numerical fiscal conditionality assessment	Council's recommendation, 05.12.2014 Conclude a MoU with the MoF for the exchange of information and cooperation in the monitoring of fiscal discipline.
		MoF's reply, 30.12.2014 Council initiative about the Memorandum of understanding (hereinafter – MoU) on the exchange of information and cooperation on fiscal surveillance, calls for the proposals to prepare for the MoU
		Council's reply, 26.01.2015 Council's representatives held informal consultations on 7 January 2015 and 12 January 2015 with the MoF Fiscal Policy Department, the MoF Economic Analysis Department and Deputy State Secretary for Tax Policy, and informed the Council during meeting on 15 January 2015. The MoU would cover the information exchange for reviewing the key fiscal documents, while the Council feels it would not be able to devise independent assessment of the macro-economic forecasts and the output gap at the current level of funding provided.
		Progress report, 25.09.2015 From 27 January 2015 to 27 February 2015 the Council carried out a survey on the fiscal impact of the activities listed in the draft Declaration of the Cabinet. A summary was presented on 9 April, and it was indicated that the activities proposed in the Declaration do not have tangible sources of funding. All participating institutions provided information, with the exception of the Ministry of Environmental Protection and Regional Development who asked for methodological clarifications in order to provide more precise information. In order to encourage a regular exchange of information, on 13 May and 17 August 2015 the Council requested a number of reports from the Ministry of Finance that were necessary to fulfil the Council's duties. The Council received replies from the Ministry of Finance and the Treasury, as well as the requested information. Data exchange improvements will also be continued in upcoming periods. Assuming the availability of resources for hiring an expert on macroeconomics, the Council will provide an independent assessment of macroeconomic forecasts and the output gap as part of the MTBF process.
2		Council's recommendation, 05.12.2014 Prepare measures to achieve budget balance in 2015 and 2016, the appropriate adjustments in the annual budgetary

No	Report Chapter	Recommendation
		plans to avoid the consequences of Article 11 of the Fiscal Discipline Law (hereinafter – FDL), resulting into the increase in the budget target balance to compensate the accumulated budget balance lagging the target in excess of the 0,5% of GDP during three years consecutive years taking into account the estimated budget balance the shortfall by 0,3% of GDP in 2014.
		MoF's reply, 30.12.2014 According to the MoF 2014 forecasts the general government structural balance (hereinafter – the structural balance) is forecast at 1,3% of GDP, which is 0,3% above the law "On the medium-term budgetary framework for 2014, 2015 and 2016." 2014 projected value. An increase of 0,1 percentage points make up the balance of the cyclical components of an increase from 0,1% of GDP in the law "On the medium-term budgetary framework for 2014, 2015 and 2016" 2014 forecast values of 0,2% of GDP. Increase of the cyclical component is explained by the GDP changes resulting from changes in the methodology of calculating GDP and does not change as a result of the national economic situation. The state budget 2015 and the medium-term budgetary framework for 2015-2017 is prepared under the conditions of the FDL. Thus, the MoF believes that if there is no observable adverse deviation from the predicted macroeconomic growth scenario, the 2015 and subsequent fiscal years, the projected figures will be met. On the other hand, if the MoF identified downside macroeconomic risks and negative trends will be observed in the performance of fiscal indicators, the MoF will ensure that both the current budget year and also if necessary in the coming years the FDL fiscal conditions will be met. FDL Article 11 provides for the automatic correction mechanism triggering after an actual structural balance of the accumulated value of the offset from the minimum value of the planned structural balance of at least 0.5% of GDP. However, it is important to note that the assessment of a given year (n-1) the actual book value of the minimum forecast value is carried out in a given year to the following year (n) 1 December. At present, it is quite difficult to judge what will be the actual value of the structural balance in 2014 offset from the intended and whether it will be necessary to carry out the mentioned corrections from the FDL Article 11.
		Council's reply, 26.01.2015 The Council points at serious downside risks, which may trigger the effectiveness of the Article 11 mechanism for 2018 or 2019 taking into account the deterioration of the macroeconomic conditions unless the Government devises compensatory measures.
		Progress report, 25.09.2015 In accordance with Part 7 of the Transitional Provisions outlined in the FDL, the deviation of the actual general government structural balance from the minimal planned general government structural balance is calculated for 2013 and all subsequent years. The first calculation is made by the Ministry of Finance before 1 December 2014.
3	**4 Macroeconomic Outlook and the output**	Council's recommendation, 05.12.2014 Request the MoF to prepare a broader explanation of the output gap estimates, including the economic reasoning for

No	Report Chapter	Recommendation
	gap	the key assumptions.
		MoF's reply, 30.12.2014 Regarding to the output gap and potential GDP calculations, we inform that the MoF is ready to prepare and present information about the Council interest in addition to the issues of the output gap estimates. At the same time, taking into account that on 17 October and November 21 November 2014 Council working groups meetings the MoF has provided the explanation of the nature of these calculations and ask to prepare a more detailed request for information of interest to the Council or unclear issues related to MoF output gap estimates. Although such Council task is not assigned by the FDL to improve fiscal planning process, it is considered that it would be helpful if the Council to draw up a separate opinion on macroeconomic indicators forecasts before work starts on the other fiscal indicators forecasts preparation. We therefore invite the Council to consider the possibility, in preparation for the macroeconomic projections of the Stability program, the medium-term budget framework law and for the annual state budget law, prepare a separate opinion on the MoF macroeconomic indicators forecasts.
		Council's reply, 26.01.2015 The Council would require agreement with the MoF on endorsing the macroeconomic forecasts fixed in the MoU mentioned with the response to recommendation 1 and support to ensure adequate capacity of the Council to accomplish this task.
		Progress report, 25.09.2015 The Council intends to work on developing a framework that outlines the endorsement procedure of the macroeconomic forecasts by MoF.
4		Council's recommendation, 05.12.2014 Request the MoF to explain the second principle of the fiscal policy, i.e. savings requirement, according to which the budget should be prepared and executed with a surplus, while the economy preforms with positive output gap, to ensure balanced budget over the economic cycle, provided that the economic situation allows.
		MoF's reply, 30.12.2014 It should be noted that this principle FDL determined so that the surplus should be built if "the economic situation allows it." This principle requires the economic cycle balanced budgeting, which in theory means that the structural balance is zero. Positive output gap should be the case for the budget with the surplus, but in the case of negative output gap the budget may allow the deficit. In practice, however, has been a derogation from this principle, stating that the structural balance in the medium-term objective is -0.5% of GDP. This means that the general government budget in surplus is created only when the output gap is positive and exceeds 1.4% of GDP. It should be noted, too, that does not mean real savings with the Treasury accounts, because long-term stabilization reserve in accordance with the law received the cash flow surplus transfer, if any, established within the State general budget and is not earmarked for specific purposes and from the point of view of public debt service is more profitable to build savings, rather than reduce the public debt size.

No	Report Chapter	Recommendation
		Council's reply, 26.01.2015 Council draws attention that there is slight inconsistency in the FDL regarding the formulation of the balanced budget principle and the MTO of -0.5% of GDP.
		Progress report, 25.09.2015 The Council intends to cooperate with MoF on devising procedures for the assessment of the results of fiscal policy in order to foster compliance with fiscal discipline while working on the draft SB and the draft MTBF and executing budget plans.
5		Council's recommendation, 05.12.2014 Address the need for additional fiscal space in the medium-term budget framework for 2015-2017 in order to be able to respond adequately to the challenges and to realise the Government's priorities, taking into account that the 2015 and 2016 fiscal space actually has been already exhausted before the start of the budget process.
		MoF's reply, 30.12.2014 MoF agrees with the recommendation.
		Progress report, 25.09.2015 The Cabinet of Ministers has made the decision to not establish a FSR for 2016, but in 2017 and 2018 the FSR will be established in the amount of 0.1% of GDP. The Council will assess fiscal risks and cooperate with the Government to lower the probability that risks will materialise.
6		Council's recommendation, 05.12.2014 Attach to the draft Annual budget law and draft Framework law the explanation of the planned structural reforms to promote sustainable economic development and effective use of the budgetary resources.
		MoF's reply, 30.12.2014 EU economic policy surveillance and coordination cycle, called the European Semester up to 30 April of each year shall be submitted to the European Commission the national reforms and Stability / Convergence programs. Progress Report on the Latvian National Reform Program "Europe 2020" strategy in the context of the implementation of the EU Council reviews progress in the execution of the recommendations, as well as Latvian quantitative targets "Europe 2020". As the EU Council Recommendations and the "Europe 2020" goals are also drawn to the implementation of structural reforms, the National Reform Program also described progress in the implementation of structural reforms. At the same time the MoF draws attention that the Law on Budget and Financial Management provides that starting from the 2016 mid-term budget framework draft law preparation process will take place in parallel with the Stability program and National reform programs. In view of the foregoing considerations, the MoF sees no need to increase the administrative burden of duplicating information on the progress made in implementing structural reforms in a number of policy documents.
		Council's reply, 26.01.2015

No	Report Chapter	Recommendation
		Council in general agrees with the MoF reply hoping that the budget documents in the future will present adequate links with the National reform program review and update process. Progress report, 25.09.2015 The Council contends that further allocation of funds to priority areas, such as education, health care and the judicial system should be based on concrete structural reform plans, considering their impact on public health, education, strengthening the legal foundations and increased efficiency.
7	**5 Fiscal Policy Challenges**	Council's recommendation, 05.12.2014 Prepare tax policy strategy, to accompany the Stability Program for 2015 -2018 with the objective of allowing to achieve the Government's goal tax burden at 1/3 of GDP by 2018. MoF's reply, 30.12.2014 State Audit Nr.5.1-2-32 / 2013 "On the Latvian Republic 2013 report on the state budget and the budgets of local governments" implementation of the recommendations in Annex 1 Part II plan provides that the MoF until 15 June 2017 develops a medium-term tax policy that is associated with the medium-term Latvian National Development Plan 2014-2020. Currently, the MoF has started work on tax policy guidelines for the development of the medium term, which, inter alia, will provide analysis on trends in tax revenues increase up to 1/3 of GDP. Council's reply, 26.01.2015 Council reiterates that despite active MoFs work to reduce the shadow economy the Government lacks updated tax policy document, which leads to strengthening the capacity of public finances, to ensure national security and sustainable and adequate public services. Therefore the Tax policy strategy development should not be postponed until 2017, as proposed in the MoF's response. Current macroeconomic developments point at lower prices, which on one hand is good news for consumers, but on the other hand means less optimism in the business environment, in new project borrowing and accelerated economic development. Lower inflation and slower growth of the economy as a whole compared to the projections for 2015 approved the state budget threaten tax revenue plan, and points to the risks for increased budget deficit this year. The Government's action plan (draft available here) would not realistically allow meeting the Government commitments without move from the current less than 28% of the tax burden, that might not be satisfactory volume to perform at the necessary qualitative service level. As well as the currently used tax burden is not in line with the goals mentioned in the Government declaration. Since the most effective measures to reduce the shadow economy have been already incorporated in the 2015 budget, reducing the shadow economy alone may not be enough to overcome the decline in the share of tax revenues to GDP taking into account the current tax policy commitments. The Council has not yet assessed the full fiscal impact of priority measures in the welfare, education reforms, health care and defence reflected in the draft Government action plan, which could exceed the revenue potential at the current tax policy. Progress report, 25.09.2015

No	Report Chapter	Recommendation
		A number of tax rates have been raised, the personal income tax rate cut has been abandoned and a plan to combat the shadow economy has been outlined. These measures have the potential to increase the tax-to-GDP ratio, but it is unlikely that the government's objective - a tax-to-GDP ratio of 1/3 – will be achieved. A tax policy and administration strategy has not yet been developed, but there are plans to do so in 2016.
8		Council's recommendation, 05.12.2014 Consider the options for tax base expansion, including value added tax, which could be simultaneously accompanied by measures to alleviate the impact of higher rates on socially vulnerable population.
		MoF's reply, 30.12.2014 Law "On Personal Income Tax", Paragraph 90 of the Transitional provisions provide that personal income tax rate in 2015 will be reduced from the current 24% to 23%. In 2015 it is not expected to increase the non-taxable minimum. At the same time, according to decision of the Cabinet of Ministers of 10 November 2014 (minutes No 61, 29.§ "Informative report "The opportunities to increase revenue""), Paragraph 4 of the given task – the MoF until 30 April 2015 should submit to the Cabinet an informative report with proposals for the introduction of differentiated non-taxable minimum starting from 2016 where the complex assessment will be done about the personal income tax easements and the tax burden on labor reduction.
		Council's reply, 26.01.2015 Council draws attention that there has been no serious consideration of the tax policy measures to compensate for the risks of economic slowdown and falling tax revenue to GDP ratio.
		Progress report, 25.09.2015 A number of the proposed measures to increase fiscal space will increase the tax-to-GDP, while reducing inequality.
9		Council's recommendation, 05.12.2014 Strengthen the regulatory framework to contain the "shadow" economy.
		MoF's reply, 30.12.2014 As done up to now the most important measures of the shadow economy mitigation include economic operators (whose main activity is not lending) loans to the taxation of personal income tax (hereinafter – PIT), as well as board members in the minimum wage taxation of PIT. Similarly, significant measures of economic activity was the suspension of liquidation and the simplified mechanism for activation by preventing fictitious registration and use of the possibility of fraudulent transactions in chains, as well as the changes introduced in the regulation for the use of cash registers. Also this year, set up the Council to combat the shadow economy, which will include public authorities and non-governmental organizations is an important step towards the development of cooperation between the institutions involved in the fight against the shadow economy. In addition, the MoF in cooperation with the State Revenue Service (hereinafter –SRS) and the social partners has been elaborated a number of measures which will come into force on 1 January 2015. The most important of them is

No	Report Chapter	Recommendation
		the board members personal liability for the belated tax payments. It is also an improvement of the information exchange process between financial institutions and the SRS, the disclosure of information on taxpayers paid tax amount. The implementation of the Declaration for leasing and lending services (non-banks) companies.
		Council's reply, 26.01.2015 Council agrees with the reply.
		Progress report, 25.09.2015 Information exchange with the State Revenue Service has been improved, and technical regulations for cash registers and hybrid devices have been devised. The strategy to combat the shadow economy has been described in general terms, but there are few concrete measures.
10		Council's recommendation, 05.12.2014 Examine all options for the cancellation of the tax exemptions. Simplify the tax system by reducing the multiple rates and the number of exemptions in support of efficient State Revenue Service operation.
		MoF's reply, 30.12.2014 Given that the area of taxation is one of the most important aspects of evaluation of investment environment and attracting investment is stability, it is not clear what is meant by the recommendation – “Consider all the possible cancellation of tax relief." We agree that the tax system should be simple and effective to administer, and tax incentives should be of limited and should be routinely evaluated their effectiveness, but cannot accept the setting that all exemptions would be inadequate and should be assessed in the cancellation (this is also contrary to the further recommendations, such as an increase of non-taxable minimum). The tax system should be not only simple, but also fair. Exactly because of fairness there are introduced separately exemptions for tax incentives, such as the PIT exempt certain types of compensation (e.g. travelling allowance). The SRS enhancement is to be welcomed, but it has to be reasonable and in line with the interests of taxpayers. Most of the direct tax exemptions are targeted to specific groups of taxpayers and implemented for a specific purpose. For example, PIT reimbursement for medical and educational expenses are covered if the state does not fully cover the costs, but these are essential for the inhabitants. Contributions to private pension funds and long-term life insurance are facilitated to stimulate individuals to make savings.
		Council's reply, 26.01.2015 The Council regards the evaluation of the effectiveness of tax exemptions very important for ensuring social equity and delivering on the government policies. We are looking forward to receive such analyses from the MoF.
		Progress report, 25.09.2015 Several personal income tax rate exemptions have been cancelled.
11		Council's recommendation, 05.12.2014 Consider the options for replacing the personal income tax rate reduction with an increase in tax-exempt income, thus reducing the tax burden on lower paid workers, promoting the legalisation of employment and the general drive to

No	Report Chapter	Recommendation
		return to the formal labor market rather than relying on social benefits. The Council supports the plans for the progressive tax exemption.
		MoF's reply, 30.12.2014 We support the recommendation that further reduction of tax burden on labor should be moving to the range of persons with low incomes, however, a progressive income tax system alone does not guarantee that a person will choose to work instead of having to choose to receive benefits.
		Council's reply, 26.01.2015 The Council believes that further delays in reducing tax wedge on low paid workers would ultimately strengthen the hand of the proponents of progressive income tax rate as an alternative. Progressive income tax rates could jeopardize the implementation of the tax discipline and the need to limit the risks of tax evasion.
		Progress report, 25.09.2015 The recommendation has been implemented. The personal income tax rate cut has been abandoned, the non-taxable allowance has been increased and there are plans to introduce a differentiated non-taxable allowance in 2017.
12		Council's recommendation, 05.12.2014 Examine the options for property tax increase, together with the review of cadastral values, to improve the equity of income distribution. Long-term residents in areas with high cadastral values should be allowed to capitalize the increase of the property tax, the settlement of which may be deferred until the property is being transferred.
		MoF's reply, 30.12.2014 The recommendation states: 1) examine the possibilities of the property tax increase, together with the review of the cadastral value to improve the equality of income distribution; 2) long-term living residents in areas with high cadastral value, allow to capitalize on the growing property tax, payment for which is likely to be postponed until the re-registration of property. On the recommendations of the first part – allow us to draw attention to the real estate tax rate (for the tax rate corridor) has been transferred to local governments. We believe that with the recommended methods to achieve the objective in principle is not possible, bearing in mind the following: as this is contrary to the law "On the real estate tax" the essence and meaning. Firstly, the property tax base is the cadastral value of the property to be determined by the State Land Service, mainly based on the real estate market analysis data. So the primary factor that determines the amount of property tax is the real estate location and market value. Consequently, we believe that the cadastral value can not be used as a tool for the real estate tax revenue increase or reduction in the administrative or smoothing between different national territories. Secondly, all the revenue from the property tax are credited to the local government budgets, so the law is delegated to local authorities the right to tax administration within and determine the tax rate within the range prescribed by law

No	Report Chapter	Recommendation
		and to grant tax relief for certain categories of taxable person up to 90% of the tax amount calculated. On the recommendations of the second part – allow us to draw attention to the Law "On Real Estate Tax" already provides for the right of tax authorities to decide on suspension of payment of the declared place of residence and the forearm to the land property rights for the transition to another person, before assessing the taxpayer's social status and financial solvency. However, when assessing the possibility of extending the tax deferral right, please remember that the real estate tax of 100% is channeled into the local government budgets, so if it is intended for a wide range of tax deferral (in accordance with the recommendation), they have updated the question of new funding requests from the state budget authorities as delaying the tax, they will not be able to exercise their usual functions. It is for this reason, to extend this provision to a broader range of taxpayers are not expected. We would like to point out also that the Recommendation 10 suggests just the opposite – to examine all the possible cancellation of tax incentives rather than additional enforcement options. Although the property tax is administered by the municipality, in our opinion, the tax element of the review should follow a similar approach.
		Council's reply, 26.01.2015 The Council believes that the revenue potential of the residential property taxation has not been used as the revenue from this tax lags behind the average levels in the EU. The Council would like to invite the MoF tax experts for discussion on this matter.
		Progress report, 25.09.2015 A number of measures to increase revenue from immovable property have been introduced, such as reassessing cadastral values and introducing fines for non-use of agricultural land, so there has been an effort to better utilise the fiscal potential of property taxes, but more is required to reach EU average levels.
13		Council's recommendation, 05.12.2014 Transfer of certain state government services to the private sector, thus demonstrating a clear strategy to reduce public spending in the medium term, specifically, explore the possibility of using better targeted grants and services to support vulnerable groups, in order to increase the benefits and effectiveness of the delivery.
		MoF's reply, 30.12.2014 Development Planning System Improvement Action Plan 2014-2016 (approved on 25 February 2015 by the Cabinet Order No. 84), the MoF in cooperation with the Cross-Sectoral Coordination Centre the task to analyze the possibility of introducing a sectoral policy planning and evaluation expenditure. The deadline set 1st quarter of 2015. In addition to the recommendations expressed in the report Summary the Council indicates that one of the possible options of a tax increase would be to raise tax rates on capital, which is not used in production. Please pay attention that the law "On Corporate Income Tax" for increasing the corporation taxable income for expenses that are not connected with the economic activity and that the amount of expenditure by applying a multiplier factor of 1,5. By contrast, virtually impossible to raise tax rates on capital, which is not used in the production, because the corporate income tax applicable to income earned rather than capital. In turn, the appointing authority shall apply to distribution

No	Report Chapter	Recommendation
		of income, which in various combinations creates an effective tax rate of ~ 24% (15% corporate income tax at the level of + 10% personal income tax level).
		Council's reply, 26.01.2015 The Council believes that the revenue potential of taxing the owners of capital not employed has not been used as the revenue from capital taxation lags behind the average levels in the EU. The Council would like to invite the MoF tax experts for discussion on this matter.
		Progress report, 25.09.2015 There is a discrepancy between the desire for high quality public services from the national and municipal governments, and the unwillingness to pay taxes in full.
14	**6 Fiscal risk assessment and the adequacy of the fiscal stability reserve**	Council's recommendation, 05.12.2014 Endorse the Government's fiscal risk declaration taking into account the Council's proposals.
15		Council's recommendation, 05.12.2014 Provide the public with adequate information regarding the boundaries of the Government's obligations and promote the purchase of private insurance for businesses and households to reduce fiscal risks associated with natural disasters and business risks.
		MoF's reply, 30.12.2014 In general, the occurrence of natural disasters and unpredictable business risks, the government is not a direct obligation to the risk of the affected entities to provide support from the state budget (except in the laws and regulations assigned cases or in specific agreements in some cases). Such aid from the state budget rather specific risk cases can be described as a moral obligation to the government or public expectations, business / industry pressure to provide support. But for sure, one can not deny the specific cases in which, for example, in order to maintain a particular sector of regional competitiveness, the government's interest to provide support from the state budget (such as support for the dairy sector, the need for which arose due to increasing competition in the dairy sector due to the sanctions on imports to the Russian market). From a fiscal point of view of risk management to mitigate the impact of such risks on the state budget are difficult to predict, given the specific nature of the risk / probability of unpredictability. Currently, the solution to such unforeseen risks to mitigate the impact on the state budget can be made, or of specific state budget program "Funds for unforeseen events", or the allocation of funds from the fiscal space, if available.
		Council's reply, 26.01.2015 The Council agrees with the MoF opinion, while the promotion of private insurance should be promoted and the government actions compensating for unforeseen events occurring for businesses not discouraging the development of private insurance.
		Progress report, 25.09.2015

No	Report Chapter	Recommendation
		The transfer of compensation for international emergencies from the state budget to EU funds is commendable. Nonetheless, private insurance should be encouraged so as to avoid additional strain on the budget arising from unexpected compensation for emergencies.
16		Council's recommendation, 05.12.2014 Improve the risk management in the state owned corporations, which are classified to the general government sector to ensure access to timely information on activities that may have an impact on the fiscal balance management.
		MoF's reply, 30.12.2014 Corporations are one of the identified and fiscal risks contained in the Fiscal risks declaration. The MoF agrees that the general government sector included the state owned corporations need to improve risk management, and it was identified additional fiscal measure required to reduce the risk of ensuring enhanced quality control of the financial activities of the state owned corporations prepared projections, provided that for central public authority which holds shares in a specific corporation, manage and analyze financial performance risks affecting the next three years and provide to the MoF. Thus, using the information with a higher level of confidence there will be provided more accurate forecasts for the general government budget preparation and decrease the possible offsets between the financial data plan and the actual execution. At the same time informing that the MoF evaluate additional potential solutions to the fiscal projections for improving the review of the existing legal framework in order to ensure timely receipt of data on the general government sector state owned corporations' financial activities. Furthermore, it is also weighted probability to update the laws provide the restrictions that would minimize such corporation unintended consequences for the country's fiscal performance.
		Council's reply, 26.01.2015 The Council acknowledges the complication of assessing the government balance risks caused by the state and local government owned corporations classified to the general government sector. The Council will continue studying these risks and looks forward to cooperation with the MoF for mitigating such risks.
		Progress report, 25.09.2015 The Council concludes that no significant progress has been made regarding improvements in the governance of stat-owned enterprises.
17		Council's recommendation, 05.12.2014 Review the realism of the local government budget balance in the Framework law projections, taking into account the agreements reached for the local government borrowing and the past trends in the fiscal balance of the local government's sub-sector.
		MoF's reply, 30.12.2014 Municipal budget forecasts in 2015-2017 were discussed at the request of the Council at the Council's meeting on 21 November 2014. At this meeting the MoF explained what factors could affect the municipal budget balance over the

No	Report Chapter	Recommendation
		medium term forecasts. Local government budget on a cash flow basis in 2015 is projected a deficit in the coming years and a total revenue will be balanced with the expenditure that will provide stable revenue growth. Local government budget deficit is projected mainly in the light of the deficit of the EU funds side, a part of the basic functions are projected surplus, similar to what has been the actual performance of the previous years. Since today is not accurately known the new 2014- 2020 programming period and EU funds flow directly to local government budgets, so that the medium-term deficit is projected lower part at the EU funds. Given that the current projections, most of the EU funding is going to the State general budget, but it is not broken down by activity and thus it is not reflected in the municipal budget, thus it is difficult to provide precise forecast of the local co-financing of EU funds, but part of it has already been taken into account. As previously explained, the local government budget revenue and expenditure projections take into account the previous year execution trends, individual forecasts of macroeconomic indicators (for example, the average wage growth, inflation) as well as local government borrowing trends. Municipal budget projections for the medium term will be reviewed in April 2015 in the preparation of the general government budget forecasts for Latvia's Stability Program 2015-2018, and in the fall in the preparation of the draft law "On the medium-term budgetary framework for 2016, 2017 and 2018".
		Council's reply, 26.01.2015 The Council acknowledges the particular features of the cycle related to the implementation of EU funds and will continue following closely the developments related to the impact of local government financial operations on the general government fiscal balance.
		Progress report, 25.09.2015 The Council believes that risks pertaining to municipal budgets are well surveyed and managed. The new agreement regarding the financial redistribution mechanism for municipalities is commendable.
18		Council's recommendation, 05.12.2014 Propose establishing the fiscal safety reserve for 2016 in the amount of 26.9 million euro or 0.1% of GDP and in 2017 at 37.3 million euro or 0.13% of GDP.
		MoF's reply, 30.12.2014 2016 distributable fiscal space was about as big as the 2015 fiscal space. If in 2016 would be set fiscal safety reserve, in 2015 part of the additional new policy initiatives should be supported rather than from priorities perspective as evaluating the effect of the 2016 base year. Also take into account the fact that the macro-economic uncertainty creates a high probability that its current 2016 fiscal space for medium-term budget framework law 2016-2018 development time can vary considerably, and the differences can be both an increase and a reduction direction. Given these circumstances, the MoF took the view that it is more important to give funding priority needs, the fiscal reserves were abandoning.

No	Report Chapter	Recommendation
		The MoF does not agree with the Council analysis justifying the 0.13% fiscal safety reserve need, because as deviations from the approved expenditure in the social security budget is symmetric fiscal security reserve, this factor is not built. Recalling that, in accordance with the FDL, fiscal security reserve is created for those cases where deviations in the medium term unrelieved. According to the Medium-Term Framework Law 2015, 2016 and 2017, and in accordance with the FDL, Fiscal safety reserve for 2017 is 0.1% of GDP.
		Council's reply, 26.01.2015 The Council view's establishing the fiscal safety reserve for 2016 in the amount of 26.9 million euro or 0.1% of GDP and in 2017 at 37.3 million euro or 0.13% of GDP essential for achieving the objectives of the FDL. Meanwhile, the Council finds that the methodology applied by the Government regarding the risks of cost of the social insurance benefits exceeding the funds appropriated for this purpose with adverse impact on the fiscal deficit continuing on increasing direction. The Council is looking forward to cooperate with the MoF on the methodology of assessing the fiscal risks and providing adequate security in the forthcoming budgets.
		Progress report, 25.09.2015 The FDL stipulates the need for a fiscal security reserve starting from 2016. In view of recent deviations from the planned general government balance (-0.3 in 2014 and -0.5 in 2015), this aspect of counter-cyclical fiscal policy should be observed.

ANNEX 2 HEALTH CARE SYSTEM REFORM

The health care system has been named among the priorities in the Government's SB 2016 and MTBF 2016-2018. Meanwhile, tight fiscal conditions and expenses that health care institutions have accumulated over the past decade and allow very little room for allocating funding for improving the population's access to medical services and the delivery of effective services for those in need. The current model of health care is at a crossroads without a clear understanding of the underlying issues or a concrete vision as to what improvements additional funding could bring.

Latvia's headline population health status indicators are low and amenable mortality rates among the working-age population are high. Life expectancy has increased throughout the EU, but the gap between the highest life expectancies and the lowest ones (including Latvia) has not fallen since 1990. This trend is indicative of a broader issue, and numerous international publications paint a troubling picture of the overall health status and state of the health care system in Latvia. For example, according to Eurostat data, in 2013 Latvia had the second lowest public funding for health care among member states of the EU (Chart A2.1).

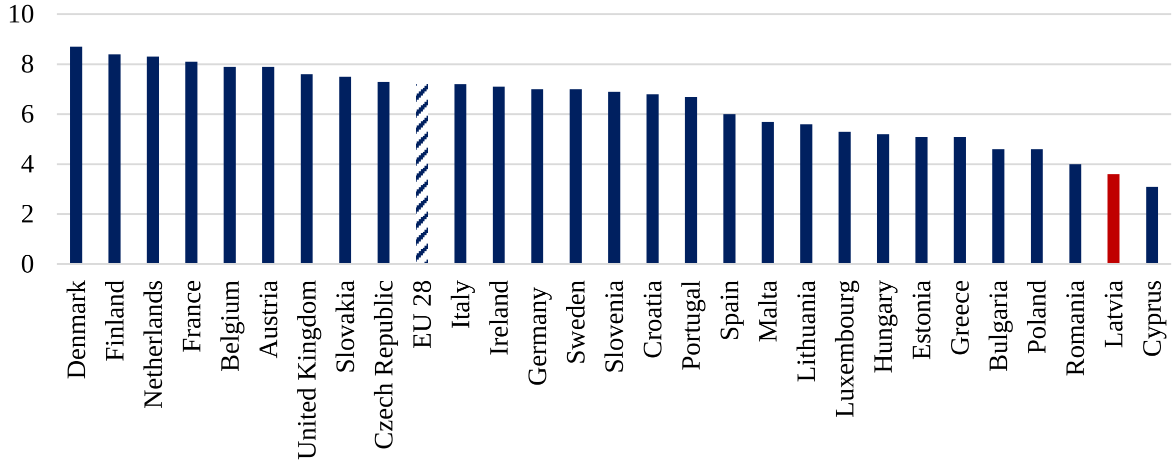

Chart A2.1 General Government Spending on Health in 2013 (% of GDP). Source: Eurostat.

What is more, this is not a recent phenomenon and illustrates a historical trend, even compared to the other Baltic States (Chart A2.2).

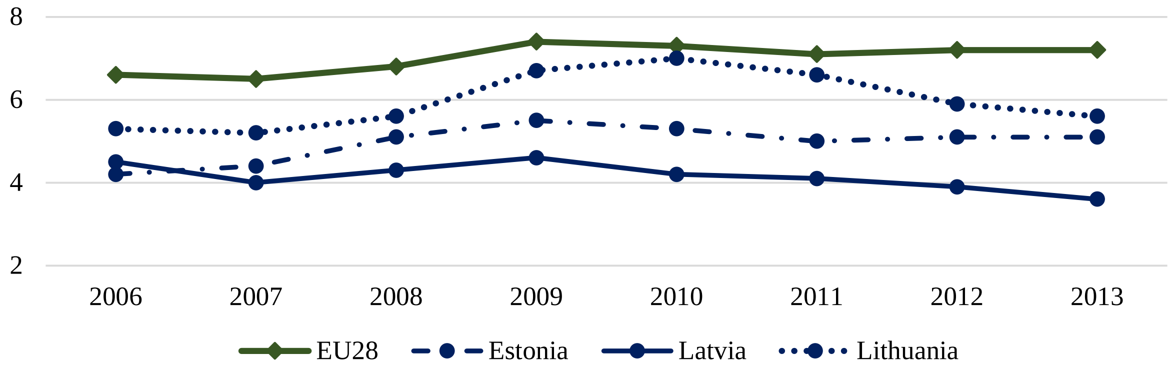

Chart A2.2 General Government Spending on Health Care in 2006-2013 (% of GDP). Source: Eurostat.

This is reflected in a corresponding low level of self-perceived health and a high level of self-reported unmet medical needs. Both of these indicators should be treated with caution due to the fact that they rely on self-assessment, but they do suggest a connection between the low level of available public funding and the overall health status of the Latvian population, especially if one takes into account the fact that a significant proportion of such unmet needs are due to the cost of medical services (Chart A2.3).

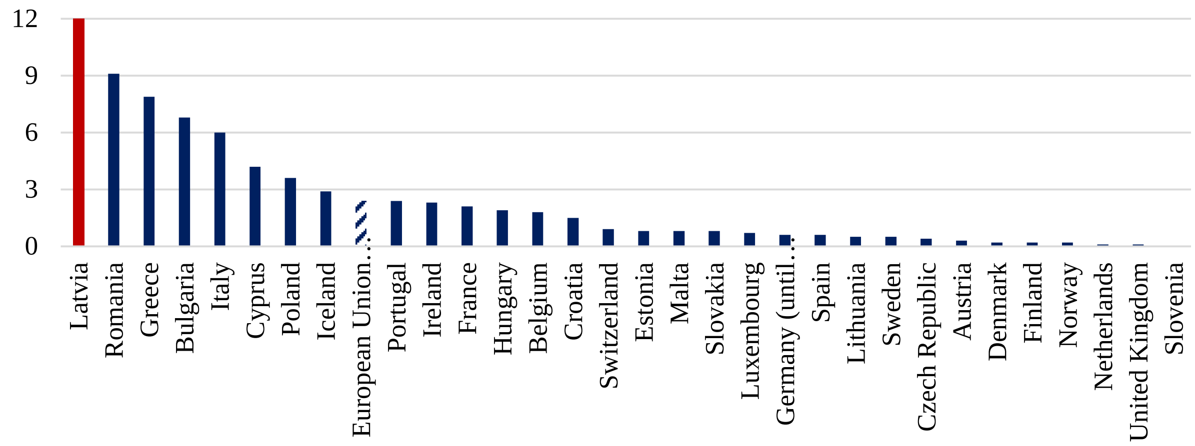

Chart A2.3 Self-reported Unmet Medical Needs due to Reasons of Cost in 2013. Source: Eurostat.

The above chart shows that Latvia has the highest proportion of expense-related unmet medical needs in the EU. Furthermore, OECD's *Health at a Glance: 2014*[17] illustrates that Latvia performs poorly when it comes to overall health status, access to health care and quality of care, and suggests that the situation is equally stark in official health statistics. A likely cause of this problem is the fact that the Latvian health system suffers from low public financing and high out-of-pocket payments. Furthermore, the EC contends that "even though additional funds were made available in 2014 to improve the accessibility of healthcare services, this is unlikely to translate into significant improvements"[18].

This suggests a need for reforms in the health sector, and a number of initiatives proposed in Latvia's *Stability programme 2015-2018* and *National Reform Programme* have been devoted to addressing long-standing issues in the provision of high quality health care.

In the *Stability Programme 2015-2018* in particular, the need for changes is justified on the grounds that it would decrease the loss of healthy (and productive) life years and the number of premature deaths in the long-term. In other words, the health of the population is viewed in the context of economic gains.

One should be cautious, however, of treating the low amount of available resources as the primary culprit for the current low level of headline population health status indicators and high amenable mortality[19] rates. Of particular note are efficiency indicators, which suggest that one should not focus solely on the amount of available funding, as a number of issues specific to Latvia have to do with inefficiencies of the health care system. In other words, while the amount of funding available for the provision of public health care is an important factor, the way it is used and managed can be equally significant[20]. For example, a paper by OECD[21] suggests that gains from a more efficient use of resources could be significant – about a 2 year increase in the average life expectancy. Likewise, the

[17] Health at a glance: Europe 2014. Available: http://ec.europa.eu/health/reports/docs/health_glance_2014_en.pdf, accessed on 11.09.2015.
[18] Country report: Latvia 2015. Available: http://ec.europa.eu/europe2020/pdf/csr2015/cr2015_latvia_en.pdf, accessed on 11.09.2015.
[19] Deaths that could have been avoided with timely access to health care.
[20] Grigoli, F. & Kapsoli, J. Waste not, want not: The efficiency of health expenditure in emerging and developing economies, Available: https://www.imf.org/external/pubs/ft/wp/2013/wp13187.pdf, accessed on 11.09.2015.
[21] Isabelle, J., Andre, C. and Nicq, C. Health care systems: Efficiency and institutions. OECD Economics Department Working Paper No. 769. Available: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1616546, accessed on 24.09.2015.

2015 edition of the *Ageing Report* [22] argues that the organisation of the health care system is one of a range of significant factors influencing public expenditure on health care.

A publication on the efficiency of health care systems suggests that Latvia performs poorly on efficiency scores[23]. Additionally, a study on the comparative efficiency of health systems suggests that Latvia could reap great benefits from emphasising primary and preventive care[24]. In other words, popularising healthy behaviours and lifestyles could reduce the strain on the health system and increase the number of healthy life years in a manner that is sustainable in the long term. In fact, the optimisation of the mix between preventive and curative care can provide further efficiency gains if additional funds are diverted for ambulatory care. This would contribute to identifying health issues in their early stages, bring down costs, reduce the time that patients spend in hospitals and, consequently, decrease the number of amenable deaths.

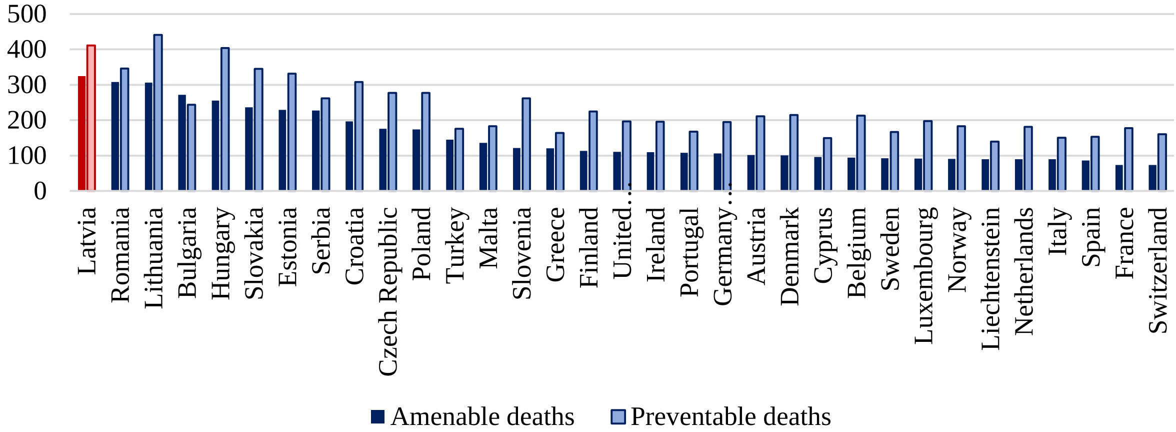

Chart A2.4 Amenable and Preventable Death Rates (per 100 000 inhabitants) in 2012. Source: Eurostat.

Lastly, a study on efficiency estimates of European health systems suggests that fraud and corruption are also significant sources of waste[25]. A similar assessment is evident in the most recent country report from the European Commission - the incidence of informal payments is high, and this is identified as a factor that increases health inequalities, as costs are already a significant barrier to healthcare access. The public frequently faces long waiting lines for health services the government has declared free of charge or available for a token co-payment.

Governance issues and wasteful investments in health care institutions has reduced public enthusiasm for additional funding for the provision public health care. Massive investments in modern equipment and improvement of premises in the past decade without due consideration of future demand for health services has been a burden for hospitals and diverts funding from providing medical services to those in need.

[22] The 2015 ageing report. European economy series. March 2015. Available: http://ec.europa.eu/economy_finance/publications/european_economy/2015/pdf/ee3_en.pdf, accessed on 11.09.2015.

[23] Medeiros, J. and Schwierz, C. Efficiency estimates of health care systems. Economic Papers 549. Available: http://ec.europa.eu/economy_finance/publications/economic_paper/2015/pdf/ecp549_en.pdf, accessed on 11.09.2015.

[24] Comparative efficiency of health systems, corrected for selected lifestyle factors, Available: http://ec.europa.eu/health/systems_performance_assessment/docs/2015_maceli_report_en.pdf, accessed on 11.09.2015.

[25] Medeiros, J. and Schwierz, C. Efficiency estimates of health care systems. Economic Papers 549. Available: http://ec.europa.eu/economy_finance/publications/economic_paper/2015/pdf/ecp549_en.pdf, accessed on 11.09.2015.

The Council would encourage the authorities to conduct a study to identify inefficiencies in the delivery of health care and devise a strategy containing priority measures for improvement based on their impact on population health status indicators and amenable mortality rates,

ANNEX 3 EDUCATION SYSTEM REFORM

Latvia's public expenditure on education was at 5.7% of GDP in 2013[26], which was above the EU average of 5.0% of GDP. The high cost of maintaining rural schools with a declining number of pupils has been the key factor for the high cost of education services and the discontent of teachers with their compensation. The proposed pay reform by Ministry of Education does not address the core issues and contains risks of continued discontent in the sector and demands for additional funding. Various issues persist in other sub-sectors of the education system.

A study by the Bank of Latvia[27] indicates that there is a discrepancy between the demand and supply sides of the labour market. In particular, there is a scarcity of highly qualified professionals and little demand for the considerable number of unemployed low-skilled workers. Consequently, the report argues that a significant reduction of the natural level of unemployment can be achieved by a better match between the skills of the unemployed and the available job vacancies. An analysis of international organisations' publications suggests that occupational and skill mismatch is a prevalent problem in Latvia and other Member States of the European Union. This has been identified as a pressing issue for Latvia, and education policy guidelines foresee cooperation with the employment sector[28].

A report by the *International Labour Office* claims that 43% of Latvian employees are overeducated for the position they hold[29]. However, the report by the *Bank of Latvia* suggested that the discrepancy between supply and demand was particularly pronounced in the case of low-skilled workers. What is more, there is an underproduction of highly qualified and highly skilled workers. This implies that overeducation itself does not guarantee a high skill level. It is often used as a proxy for skill mismatch, but the *OECD Skills Outlook 2013* shows that proficiency at various skills is not determined, though it is certainly influenced, by the level of educational attainment[30]. In other words, a diploma from an institution of higher education does not always mean high proficiency in numeracy or literacy – some countries' high school graduates perform better than those who hold a university diploma in another country. The Latvian case, therefore, suggests certain inefficiencies in the educational system[31], as it does not consistently provide graduates with professionally valued skills. Furthermore, this issue may not be restricted to higher education.

Both the EC and OECD argue that vocational education suffers from poor reputation. This is corroborated by a report on vocational training in Latvia[32]. The latter states that participation in vocational education has increased, but enrolment is still among the lowest in the European Union. However, even though the number of students in post-secondary vocational education programmes is still comparatively small, the report claims that such programmes have become more popular and the number of students has significantly increased. The report argues that this is linked to growing youth unemployment, as post-secondary vocational education offers labour-market relevant skills in a short period of time.

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[26] Source: Eurostat.
[27] Krasnopjorovs, O. Natural and cyclical unemployment in Latvia: New insights from the Beveridge curve model. Available: https://www.macroeconomics.lv/sites/default/files/dm_2_krasnopjorovs_2015_en.pdf, accessed on 11.09.2015.
[28] See *Izglītības attīstības pamatnostādnes 2014.-2020. gadam*
[29] Skill mismatch in Europe. Available: http://www.ilo.org/wcmsp5/groups/public/---dgreports/---stat/documents/publication/wcms_315623.pdf, accessed on 11.09.2015.
[30] Skills outlook: 2013. Available: http://skills.oecd.org/documents/SkillsOutlook_2013_KeyFindings.pdf, accessed on 11.09.2015.
[31] It is important to note that the problems faced by the Latvian labour market may not be reducible to skill shortages, as the quality of recruitment strategies, over-qualification and salary expectations may also play a role.
[32] Vocational education and training in Latvia. Available: http://www.cedefop.europa.eu/files/4134_en.pdf, accessed on 11.09.2015.

An initiative was approved in August 2015 by the Cabinet of Ministers that would stimulate student interest in vocational education and encourage employees to take on interns from such study programmes. This is in line with the objectives outlined in the *National Development Plan 2014-2020* and has the potential to improve the professional relevance of vocational qualifications. Proposed reforms in higher education also seek to promote the relevance of academic research to the needs of the private sector. Therefore, there are indications that the government seeks to address the connection between education and the labour market.

Latvia has a low adult participation rate in lifelong education and further learning. Both lifelong learning and vocational education have been identified as important factors for the long-term development of the European Union. A particular point of concern is the reputation of vocational education and, consequently, the underuse of its potential in redressing the balance between the skills valued and required in the Latvian economy and those provided by the education system (see above). The situation is equally problematic in the case of adult participation in lifelong learning. Latvian adults in the 25-64 age group are less likely to have taken a formal education course in the last twelve months than the European Union average – 4.3% as compared to 6.2% (Chart A3.1).

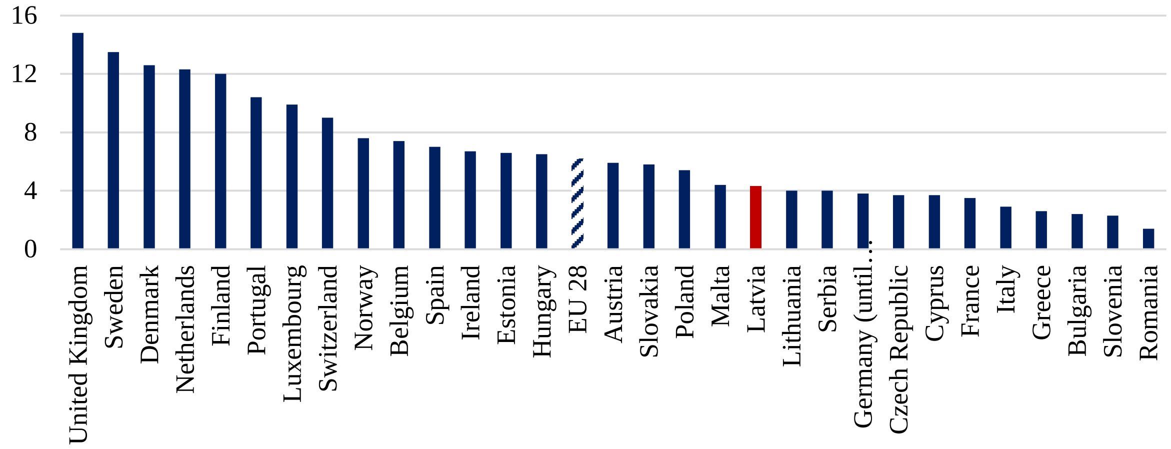

Chart A3.1 Adults (25-64) in Formal Education and Training in the Last 12 Months in 2011, % from adults (25-64). Source: Eurostat.

The report on vocational education stresses the need to **convince employers and employees that vocational training (e.g. in-company training) is an investment in future productivity, rather than purely as an expense.** A number of incentives currently exist (e.g. tax breaks) to stimulate interest both from employees and employees, and the Ministry of Education and Science seeks to improve adult learning, so there is evidence of an effort to rectify this situation[33].

The situation is similar, however, in the context of non-formal education (Chart A3.2), so it could be argued that the lack of interest and low participation in further education is prevalent, and could be a contributing factor to the discrepancy between the demand and supply sides of the labour market. Increasing the popularity of, and enrolment in, lifelong education courses has the potential to decrease unemployment and ensure that jobseekers, as well as low-skilled and low-productivity workers, can obtain the skills and competences needed to re-enter the labour market[34].

[33] Vocational education and training in Latvia. Available: http://www.cedefop.europa.eu/files/4134_en.pdf, accessed on 11.09.2015.
[34] OECD: Economic Survey of Latvia - 2015, Available: http://www.oecd.org/eco/surveys/Overview_Latvia_2015_Eng.pdf, accessed on 11.09.2015.

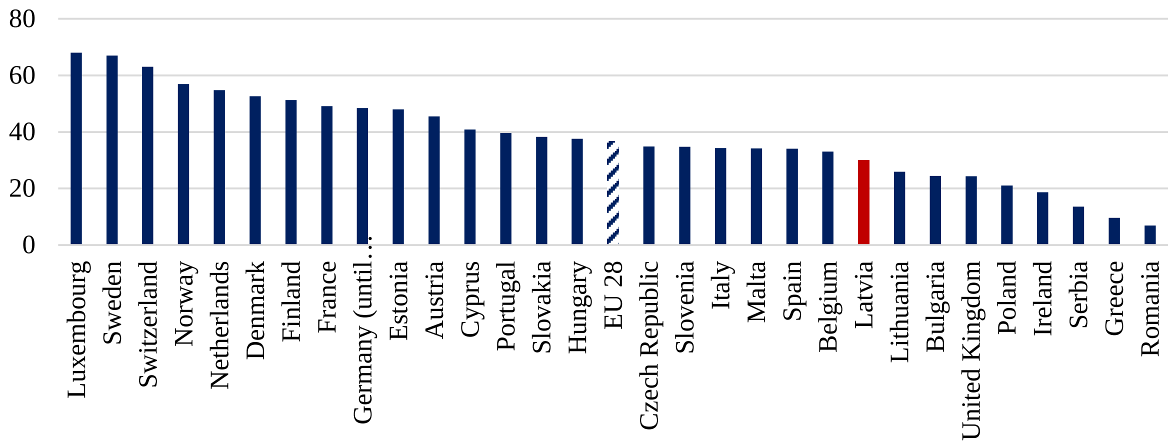

Chart A3.2 Adults (25-64) in Non-formal Education and Training in the Last 12 Months in 2011, % from adults (25-64). Source: Eurostat.

The current situation is unsatisfactory, however. As with vocational training more generally, a number of measures exist to encourage and support participation in lifelong learning, but overall interest is low, and OECD's 2015 report on Latvia suggests that **existing incentives may not be sufficient to encourage and develop adult education and training.**

The proportion of university graduates in science, technology, engineering and mathematics in Latvia is below the EU average (Chart A3.3)**.** Suggestions that focus on employability and increasing the quality and relevance of academic qualifications and competences are often discussed in relation to an issue facing the EU as a whole – the underproduction of students studying STEM[35] disciplines. However, even in the context of broader concerns regarding shortages of qualified professionals in knowledge-intensive sectors, Latvia's indicators are low. For example, the number of students studying engineering, manufacturing or construction was only at average EU levels in 2013; in the case of science, mathematics and computing the situation was even worse – 6.5% as compared to the European Union average of 10.7% (Chart A3.4).

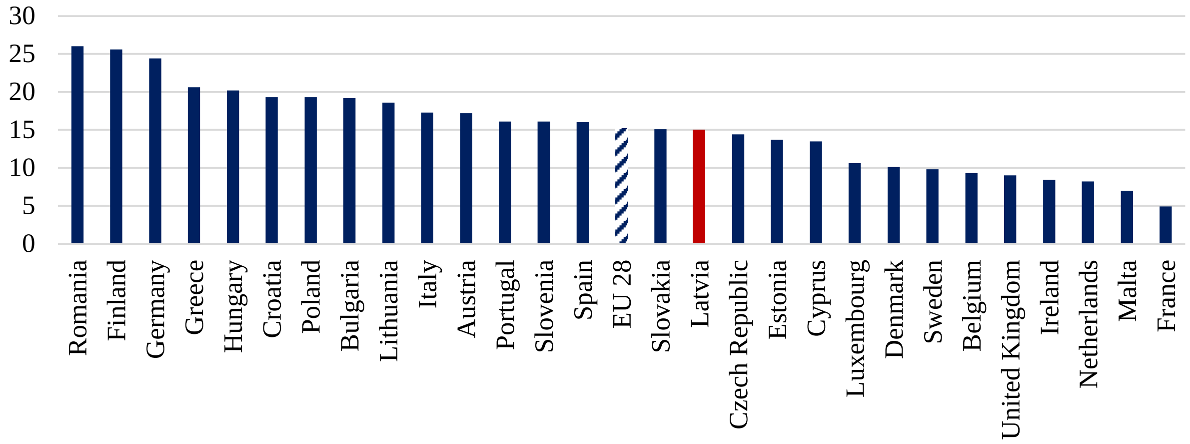

Chart A3.3 Students studying towards a Bachelor's or equivalent degree in Engineering, manufacturing and construction in 2013, % of all students. Source: Eurostat, Council's calculations.

[35] Science, technology, engineering and mathematics.

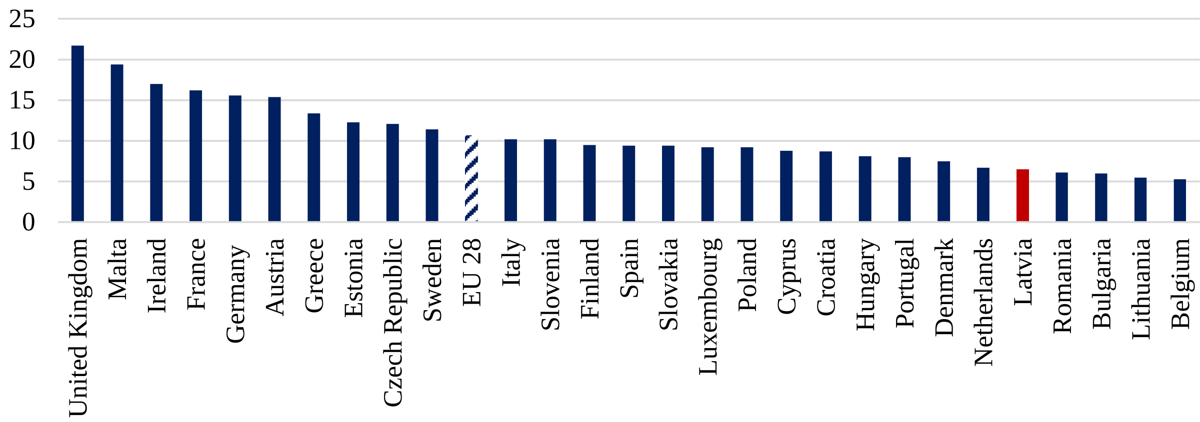

Chart A3.4 Students studying towards a Bachelor's or equivalent degree in Science, mathematics and computing in 2013, % of all students. Source: Eurostat, Council's calculations.

Student interest appears to be greater in the social sciences where Latvia performs better than most other Member States of the European Union (Chart A3.5).

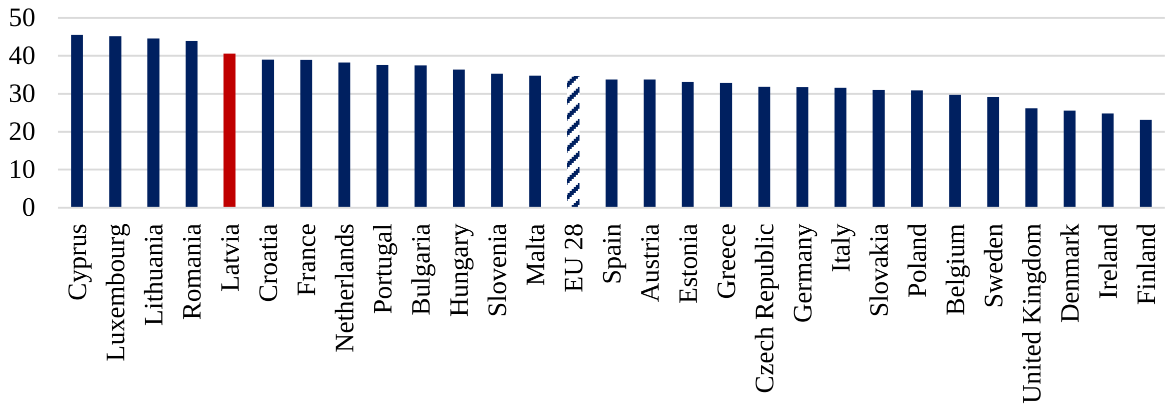

Chart A3.5 Students studying towards a Bachelor's or equivalent degree in Social sciences, business and law in 2013, % of all students. Source: Eurostat, Council's calculations.

The EC has argued that **labour shortages in the areas of health care, science and engineering will be a problem for Latvia in the near future**, and reforms in higher education have been identified as necessary for the long term development of the Latvian economy and the alleviation of future unemployment issues in knowledge-intensive sectors. The reforms proposed and approved in June 2015 seek to address the issues identified above by re-assessing the costs of different study programmes and redistributing funds - shifting resources away from the social sciences and humanities to STEM disciplines and introducing a performance-based component into the funding process. Furthermore, there are plans to introduce mandatory school-leaving exams in physics and chemistry in 2017 in order to stimulate student interest in STEM disciplines. Nonetheless, it remains to be seen whether these measures will be sufficient to gravitate students towards the natural sciences and engineering, rather than simply improve their proficiency in certain skill areas.

The Council finds that reforms leading to a consolidation of rural schools, effective encouragement to expand the share of students in STEM disciplines, improved vocational and lifelong learning as a combined effort of employers and the government would improve education outcomes and pave the way for sustainable development.

ANNEX 4 IMPACT OF LAGGING MACROECONOMIC PERFORMANCE ON BUDGET

Lower than forecasted nominal GDP level in 2016	Lower than expected tax base in 2016	Lower tax revenue in 2016	Budget deficit exceeds planned level
Two risks may cause lower than forecasted GDP nominal level in 2016: • Lower real GDP growth rate in 2016; • Lower inflation rate for 2016 than forecasted.	Nominal GDP level, generally speaking, is the most direct indicator for the potential levels of bases for most tax revenues.	Consequently, assuming no changes in tax policy (tax rates), if the GDP for 2016 does not reach the estimated nominal level, tax revenues would fall short of the planned amounts as well.	In case budget expenditure is not cut to compensate for the insufficient revenue and no additional income is raised, the ultimate outcome is exceeded budget deficit.

- **Stipulated in the FDL**: exceeded budget deficit may lead to the **automatic correction mechanism** coming into force (in line with article 11 of the FDL), which foresees budget balance adjustment in further years up to 0.5% of GDP.

ANNEX 5 NUMERICAL FISCAL RULES

FDL[36] establishes three numerical rules **to arrive to expenditure ceilings** as the basis for sustainable and balanced[37] budgeting for the next three years through imposing "a long-lasting constraint on fiscal policy through numerical limits on budgetary aggregates." [38].

Calculations are made according to all three methods to establish basis for the MTBF. FDL requires that the method is selected, which provides for most stringent conditions or lowest state budget expenditures from the results obtained according to all three methods.

One of the main data source is the MoF monthly macroeconomic and state budget survey, as well as the report "On macroeconomic indicators, revenues and general government budget balance forecasts 2016-2018" presented to the Cabinet of Ministers on 11 August 2015.

First method: balance rule.

Article 10 of the FDL defines that the general government **structural** balance shall not be set lower than -0.5% of the annual GDP[39].

Balance rule is one way how to measure whether the current fiscal policy will place a larger or smaller burden on future generations than it does on current generations[40]. Fiscal policy so-called *Golden rule* states that over the economic cycle, the Government will borrow only to invest and not to fund current spending[41]. At the same time it is acknowledged that to make corrections for cycle is difficult, especially for those countries undergoing structural changes[42].

The expenditure ceiling according to **the balance rule** is calculated by determining the total government budget balance consisting of the following:
– the amount of revenues pertaining to the State budget, the impact on the budget balance of the operations of (1) local governments, (2) partly derived from the State budget public persons' and (3) other entities classified to the general government sector, as well as adjustments for the ESA and
– the amount of the structural balance of no less than -0.5% of GDP determined in FDL Article 10 and the permitted deviation of structural balance from the medium-term objective (MTO) values because

[36] Fiscal Discipline Law, introduced in accordance with the Directive 2011/85/EU on requirements for budgetary frameworks of the Member States. Available in Latvian: http://likumi.lv/doc.php?id=254896, accessed on 29.07.2015
[37] By grammatical method "balanced budget" is synonymous with the words "budget without deficit", while applying the systemic method that allows to take into account the legal background- "balanced" means "allowing a deficit of not less than -0.5% of GDP" by the FDL Article 10 or "allowing a deficit of not less than -1.0% of GDP" by Regulation No. 1175/2011 Article 2a.
[38] Fiscal Rules in Response to the Crisis – Toward the "Next-Generation" Rules. A New Dataset. Andrea Schaechter, Tidiane Kinda, Nina Budina and Anke Weber. IMF WP, 2012. Available https://www.imf.org/external/pubs/ft/wp/2012/wp12187.pdf, accessed on 20.08.2015, p.5.
[39] MoF on numerical rules, incl. balance rule from the FDL. Available in Latvian: http://www.fm.gov.lv/lv/sadalas/tautsaimniecibas_analize/fiskala_politika/fiskalas_disciplinas_likums/, accessed on 07.07.2015
[40] From deficit delusion to the fiscal balance rule: looking for an economically meaningful way to assess fiscal policy. L.J. Kotlikoff. Working paper No.2841. NBER WP series 1989. Available: http://www.nber.org/papers/w2841.pdf, accessed on 07.07.2015, p.26.
[41] Golden Rule (fiscal policy). Available: https://en.wikipedia.org/wiki/Golden_Rule_(fiscal_policy), accessed on 07.07.2015
[42] Fiscal Rules in Response to the Crisis – Toward the "Next-Generation" Rules. A New Dataset. Andrea Schaechter, Tidiane Kinda, Nina Budina and Anke Weber. IMF WP, 2012. Available: https://www.imf.org/external/pubs/ft/wp/2012/wp12187.pdf , accessed on 20.08.2015, p.8.

of the increase in the contribution to the second pillar of the retirement pensions established according to the Regulation No1175/2011[43] Article 5 and the departure scenario from the reductions[44].

Taking into account the two components of the calculation – the revenue and the conditions of the structural balance rule **the expenditure ceiling for the state budget** (Chart P5.1) is established.

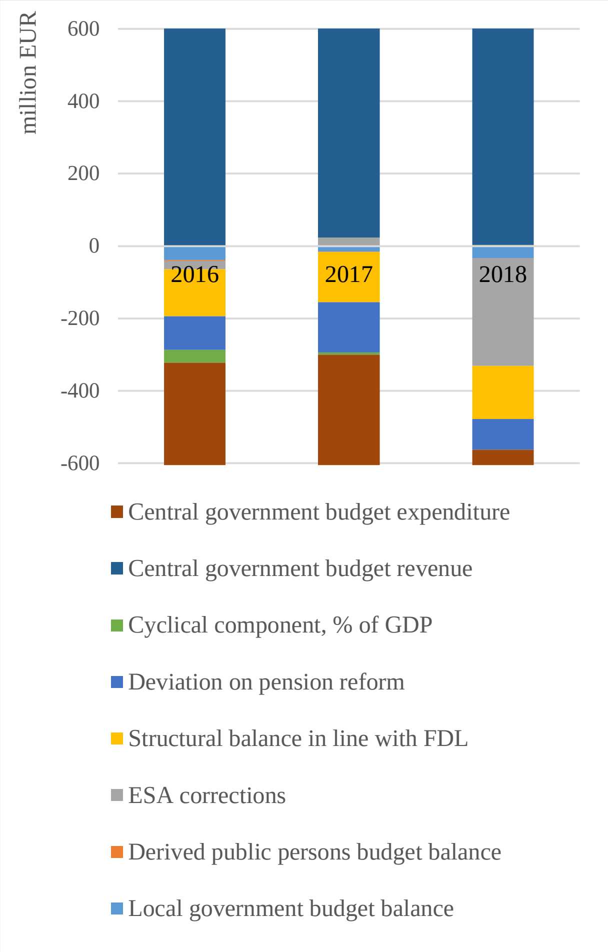

Chart P5.1 Balance rule at closer scale.[45]

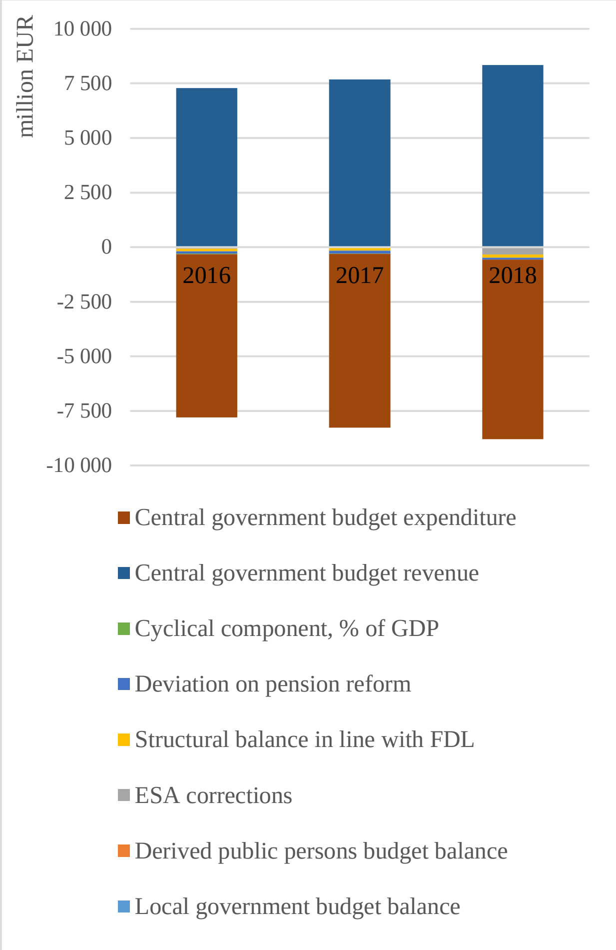

Chart P5.2 Balance rule.

The cyclical component in the calculation of the balance condition makes corrections to the structural balance to counter the effects of the economic cycle. If the economy develops above potential (cyclical component is positive), the Government consumption should be reduced to curb the overheating. Otherwise, if the cyclical component is negative, then the Government could increase spending to stimulate the economy. The cyclical component is shown as part of the headline balance (Chart P5.1). For the year 2016 – cyclical component has been assessed negative and thus the economy forecasted to develop below its potential. The corrections brought by the cyclical component to the structural balance allows the Government to spend more and thereby stimulate the economy.

[43] Regulation (EU) No 1175/2011 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies. Available: http://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:32011R1175&from=LV, accessed on 29.07.2015
[44] SP 2015/18 – Latvia's Stability Programme for 2015-2018. Ministry of Finance, April 2015. Available: http://www.fm.gov.lv/files/presesrelizes/FMInfo_10042015_SP.pdf, accessed on 20.07.2015. p.24.
[45] The scale of revenue and expenditure is limited to +/- 600 million euros to see closer the components of the balance rule.

Under the SGP fiscal policy performance is evaluated on the ESA methodology. ESA adjustments affecting SB balance recalculation of cash flows on an accrual basis and added to the general government sector eligible transactions that are not included in the general government accounts.

According to the Balance rule, the expenditure ceilings are 7 477.8 million euro for 2016, 7 956.8 million euro for 2017 and 8 233.7 million euro for 2018 as of the data provided by the MoF on 3 August 2015.

Second method: expenditure rule.

FDL Article 13 contains the reference to the Regulation No 1175/2011 Article 9.

In accordance with the Regulation No 1175 Article 9[46], **the expenditure, excluding the GDP deflator[47] should not grow faster than potential GDPgrowth**.

Regulation No 1175/2011 lists **expenditure categories[48] dependent on the economic cycle and these should be considered when calculating[49] smoothed total expenditure** –
– 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).

[46] "[…] for Member States that have achieved their medium-term budgetary objective, annual expenditure growth does not exceed a reference medium-term rate of potential GDP growth, unless the excess is matched by discretionary revenue measure. […] The expenditure aggregate shall exclude interest expenditure, expenditure on Union programmes fully matched by Union funds revenue and non-discretionary changes in unemployment benefit expenditure. […] The reference medium-term rate of potential GDP growth shall be determined on the basis of forward-looking projections and backward-looking estimates. Projections shall be updated at regular intervals. The Commission shall make public the calculation method for those projections and the resulting reference medium-term rate of potential GDP growth."
[47] The GDP deflator (implicit price deflator) is a measure of the level of prices of all new, domestically produced, final goods and services in an economy. Available: https://en.wikipedia.org/wiki/GDP_deflator, accessed on 26.08.2015
[48] Regulation (EU) No 1175/2011 Article 9 "[…] The expenditure aggregate shall exclude interest expenditure, expenditure on Union programmes fully matched by Union funds revenue and non-discretionary changes in unemployment benefit expenditure. […]"
[49] Vade mecum on the Stability and Growth Pact. European Economy. Occasional Papers 151. May 2013. Available: http://ec.europa.eu/economy_finance/publications/occasional_paper/2013/pdf/ocp151_en.pdf, accessed on 28.08.2015. p.35.

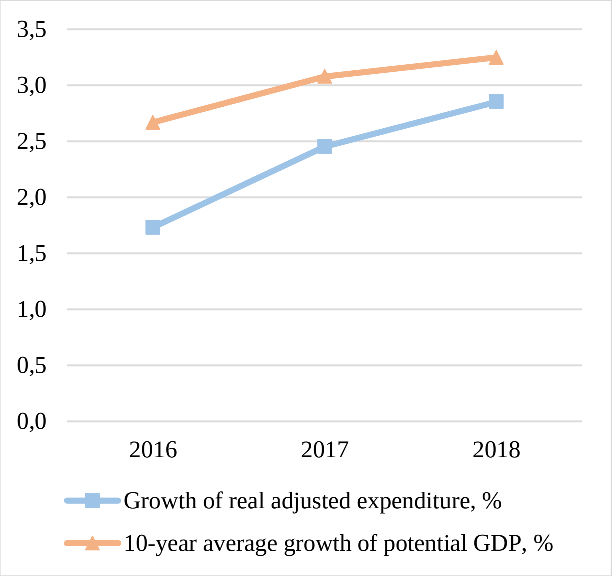

Chart P5.3 Growth of real adjusted expenditure and 10-year average growth of potential GDP, percentage

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) and the impact of changes in Government tax policy, as well as the impact of changes of pension reform deviation (discretionary revenue measures).

Excluding the GDP deflator adjusted general government expenditure increase is established – in the amount of 1.7% for 2016, 2.5% for 2017, and 2.9% for 2018. Comparing this figure with the increase of potential GDP average growth for ten years (Chart 3), is obtained **the expenditure ceiling based on the expenditure increase at the same pace with the growth rate of potential GDP**.

From this theoretical ratio of the general government potential expenditure the amount of the expenditure arising from the relationship between the central government budget, local government budgets and derived public persons budget, as well as ESA corrections are deducted. As the result there is obtained central government permissible expenditure ceilings.

According to the Expenditure rule, the expenditure ceilings are 7 549.9 million euro for 2016, 8 006.6 million euro for 2017 and 8 266.7 million euro for 2018 as of the data provided by the MoF on 3 August 2015.

Third method: continuity rule

FDL Article 5 states that the MTBF provides the most important indicators of a public expenditure ceilings for the next three years. FDL says that these ceilings are constant for the next three years – a MTBFL for the first and second year inherit ceilings from the previous year's MTBFL on second and third year of the ceilings. FDL provides that the continuity rule does not apply if, following the public expenditure ceiling derived by previous two methods differ from the previous MTBFL ceilings by more than 0.1% of GDP.

Adjustment of expenditure ceilings (Chart P5.4) is carried out twice a year – for the first time when the SP was prepared. The adjustment provides changes between the previous MTBFL adoption and SP. The second time – when the annual SB and the next MTBFL draft is prepared – providing changes between the SP and the draft MTBFL.

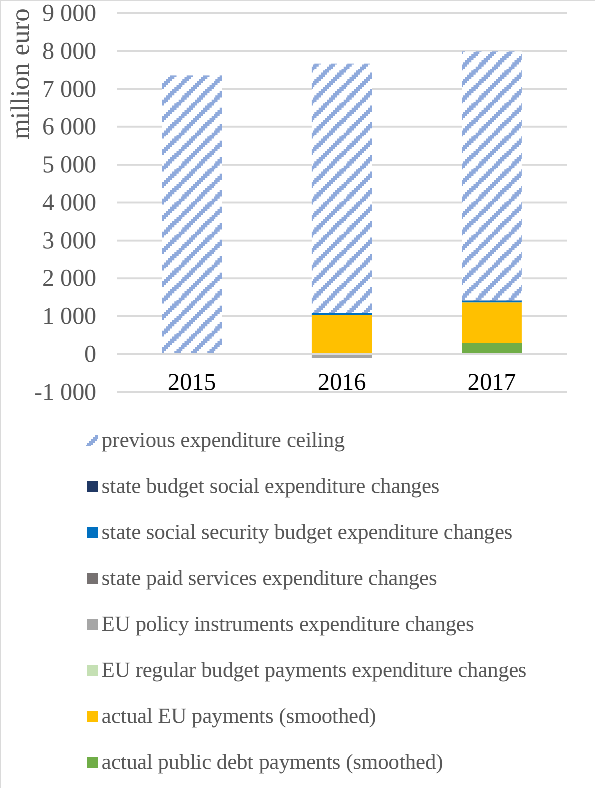

Chart P5.4 Continuity principle.

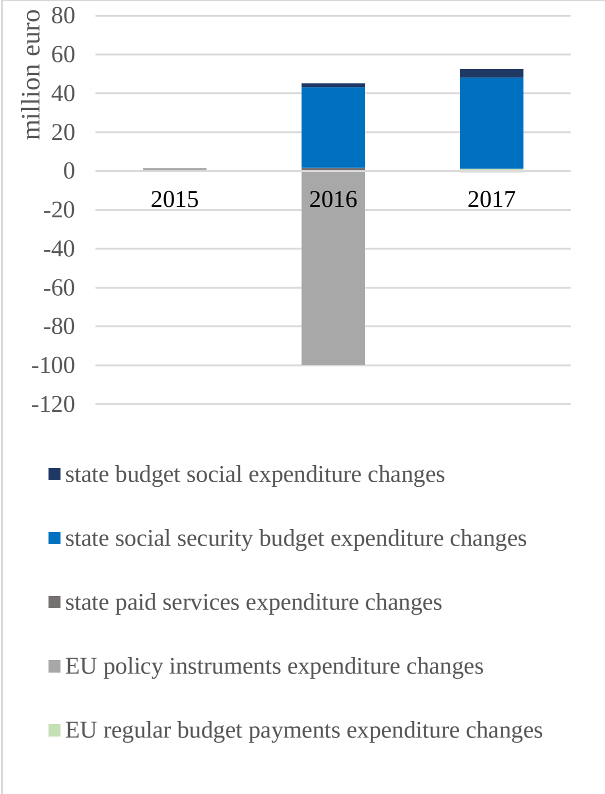

Chart P5.5 Continuity rule's contingent natural fluctuations.

Article 5 of the FDL establishes ten cases that allow correcting the expenditure thresholds because of unchanged policy but what are changing because of natural fluctuations and situations that are outside the usual economic activity, including social benefits and pension beneficiaries contingent changes, paid services revenue changes, the Constitutional Court decisions, etc. (Chart P5.5).

Various changes have occurred since the preparation of SP 2015/18 substantially affecting the contingent of state social benefit and pension beneficiaries. The Council notes that for 51.4 million euro for 2016 and for 52.7 million euro for 2017 has increased the special budget expenditure. At the same time for 101.1 million euro has decreased expenditures in relation to the EU policy instruments and other foreign financial assistance projects and measures.

Pursuant to the data from the MoF on 3 August 2015 and, according to the Continuity rule, the expenditure ceilings are 7 569.1 million euro for 2016 and 7 986.6 million euro for 2017.

<u>Summary</u>

Comparing the results of calculation of all three numerical fiscal rules (Chart P5.6) the Council concludes that for 2016-2018 the expenditure ceilings should be determined according to the Balance rule which provides the lowest value.

The Council notes that postponing the allocation for the fiscal security reserve in 2016 to 2017 and 2018 increases risks of not achieving the budget balance objectives due to numerous risks.

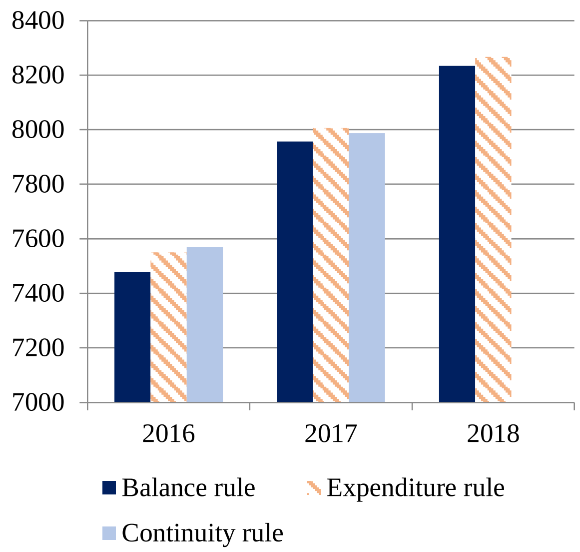

Chart P5.6 2016-2018 state budget maximum expenditure ceiling, million euro

The Council notes that at the Latvian economy development conditions stably prefer the balance rule, while assessing the numerical fiscal rules. The impact of expenditure rule vis-à-vis the balance rule has been reduced by the past ten years steady potential GDP growth (at about 3%), which according to the methodology requires at least at the same pace to allow the Government to increase budget spending. But the application of the continuity rule each time has been exempted because of the FDL limits the difference between the results of the calculations to the amount of 0.1% of GDP, thus requiring to apply the two other criteria.

Continuing drafting of the MTBFL the Government has been working with one numerical rule – as well this year with the balance rule – and after that there has been made corrections to the bottom-up forecasts already by using only balance rule conditions.

Skaitlisko nosacījumu izpildes kopsavilkums[1]
Summary of numerical conditions fulfilment[1]

P6.1.tabula
Table P6.1

(milj. eiro)
(million euro)

	2016			2017			2018		
	MTBFL 2015/17 (draft)	SP 2015/18	MTBFL 2016/18 (draft)	MTBFL 2015/17 (draft)	SP 2015/18	MTBFL 2016/18 (draft)	SP 2015/18	MTBFL 2016/18 (draft)	
(1) Bilances nosacījums	7 618,5	7 592,6	7 477,8	7 969,3	8 053,5	7 956,8	8 509,9	8 233,7	(1) Balance rule
(2) Izdevumu pieauguma nosacījums	7 714,6	7 864,7	7 549,9	7 995,5	8 050,6	8 006,6	8 529,3	8 266,7	(2) Expenditure growth rule
(3) Pārmantojamības nosacījums	7 601,8	7 624,0	7 569,1	x	7 934,7	7 986,6	x	x	(3) Continuity rule
(4) = MIN [(1);(2)]	7 618,5	7 592,6	7 477,8	7 969,3	8 050,6	7 956,8	8 509,9	8 233,7	(4) = MIN [(1);(2)]
(5) = (4) - (3)	16,7	-31,4	-91,4	x	115,9	-29,9	x	x	(5) = (4) - (3)
(6) = [5]	16,7	31,4	91,4	x	115,9	29,9	x	x	(6) = [5]
(7) Iekšzemes kopprodukts, faktiskajās cenās	26 850,9	26 081,5	26 126,5	28 513,3	27 694,2	27 750,2	29 407,8	29 476,7	(7) Gross domestic product, at current prices
(8) 0,1% no IKP, (8) = 0,1%* (7)	26,9	26,1	26,1	28,5	27,7	27,8	29,4	29,5	(8) 0,1% of GDP, (8) = 0,1%* (7)
(9) Valsts budžeta maksimālie izdevumi atbilstoši fiskālajiem nosacījumiem, (9) = IF [(6) > (8); (4); (3)]	7 601,8	7 592,6	7 477,8	7 969,3	8 050,6	7 956,8	8 509,9	8 233,7	(9) CG maximally permissible expenditure in accordance with fiscal rules, (9) = IF [(6) > (8); (4); (3)]
(10) Fiskālā nodrošinājuma rezerve	x	x	x	28,5	27,7	27,8	29,4	29,5	(10) Fiscal safety reserve
(11) Valsts budžeta izdevumi, ņemot vērā fiskālā nodrošinājuma rezervi, (11) = (9) - (10)	7 601,8	7 592,6	7 477,8	7 940,8	8 022,9	7 929,0	8 480,5	8 204,2	(11) CG expenditure, taking into account fiscal safety reserve, (11) = (9) - (10)

Avots: Finanšu ministrija, Fiskālās disciplīnas padomes aprēķini

Source: Ministry of Finance, Fiscal Discipline Council calculations

[1] *Padome veica FDL skaitlisko kritēriju izvērtēšanu balstoties uz SP 2015./18. un tās sagatavošanas stadijā 2015.gada 3.augustā no FM saņemtajem datiem. Tālākajā darbā pie VB 2016. gadam un VTBI 2016./18. gadiem sagatavošanas stadijā šie rādītāji varētu mainīties.*

[1] *The Council performed FDL numerical conditions evaluation on the basis of the SP 2015/18 and on 3 August 2015 received data from the MoF at the preparatory phase. During the further work on the SB 2016 and MTBF 2016/18 these figures could change.*

Bilances nosacījums
Balance rule
(milj. eiro)
(million euro)

P6.2. tabula
Table P6.2

	2016			2017			2018		
	MTBFL 2015/17 (draft)	SP 2015/18	MTBFL 2016/18 (draft)	MTBFL 2015/17 (draft)	SP 2015/18	MTBFL 2016/18 (draft)	SP 2015/18	MTBFL 2016/18 (draft)	
(1) Valsts budžeta ieņēmumi (naudas plūsmas metode)	7 326,4	7 176,7	7 282,6	7 483,5	7 480,5	7 664,8	8 128,3	8 335,7	(1) Central government budget revenue (cash-flow)
(2) Pašvaldību budžeta bilance	-0,2	-38,2	-38,6	0,9	30,5	-15,8	-2,1	-33,6	(2) Local government budget balance
(3) No valsts budžeta daļēji atvasināto publisko personu un budžeta nefinansētu iestāžu budžeta bilance	-0,2	-2,0	-2,0	-0,4	-0,3	-0,3	-0,8	-0,8	(3) Derived public persons budget balance
(4) EKS korekcijas	43,6	93,1	-23,0	273,8	183,0	23,8	-111,7	-296,4	(4) ESA corrections
(5) Minimāli atļautā strukturālā bilance, % no IKP	-0,91	-1,00	-0,86	-0,75	-0,90	-1,00	-1,20	-0,79	(5) Minimal structural balance, % of GDP
(6) Vienreizējie pasākumi, % no IKP	x	-0,3	x	x	-0,4	x	-0,5	x	(6) One-off, % of GDP
(7) Cikliskā komponente, % no IKP	0,0	-0,1	-0,1	0,0	0,0	0,0	0,0	0,0	(7) Cyclical component, % of GDP
(8) IKP, faktiskajās cenās	26 850,9	26 081,5	26 126,5	28 513,3	27 694,2	27 750,2	29 407,8	29 476,7	(8) GDP, at current prices
Kopā (1)+(2)+(3)+(4)-[(5)+(6)+(7)]*(8)	**7 618,5**	**7 592,6**	**7 477,8**	**7 969,3**	**8 053,5**	**7 956,8**	**8 509,9**	**8 233,7**	**Total** (1)+(2)+(3)+(4)-[(5)+(6)+(7)]*(8)

Avots: Finanšu ministrija, Fiskālās disciplīnas padomes aprēķini

Source: Ministry of Finance, Fiscal Discipline Council calculations

Izdevumu pieauguma nosacījums
Expenditure rule
(milj. eiro)
(million euro)

P6.3. tabula
Table P6.3

	2016			2017			2018		
	MTBFL 2015/17 (draft)	SP 2015/18	MTBFL 2016/18 (draft)	MTBFL 2015/17 (draft)	SP 2015/18	MTBFL 2016/18 (draft)	SP 2015/18	MTBFL 2016/18 (draft)	
(1) Vispārējās valdības kopējie izdevumi	8 930,6	8 970,8	8 965,5	9 093,9	9 419,3	9 471,1	9 998,0	9 856,1	(1) GG total expenditure
(2) Procentu maksājumi, D.41	332,8	323,4	310,4	324,6	308,0	293,3	300,4	290,2	(2) Interest expenditure, D.41
(3) ES programmu izdevumi, kuriem ir atbilstoši ES fondu ieņēmumi	1 035,1	1 001,2	992,4	1 086,1	1 058,7	1 099,1	1 084,4	1 104,9	(3) Expenditure on EU programmes fully matched by EU funds revenue
(4.1) Bruto pamatkapitāla veidošana (BPKV), t-3, P.51	917,9	917,9	1 005,1	1 007,8	1 036,4	1 038,4	985,5	1 048,4	(4.1) Gross fixed capital formation (GFCF), t-3, P.51
(4.2) BPKV, t-2, P.51	1 007,8	1 036,4	1 038,4	916,8	985,5	1 048,4	914,4	902,5	(4.2) GFCF, t-2, P.51
(4.3) BPKV, t-1, P.51	916,8	985,5	1 048,4	836,5	914,4	902,5	849,9	923,6	(4.3) GFCF, t-1, P.51
(4.4) BPKV, t, P.51	836,5	914,4	902,5	845,8	849,9	923,6	870,1	945,4	(4.4) GFCF, t, P.51
(5) Nediskrecionāras bezdarba izmaiņas	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	(5) Non-discretionary change in unemployment
(6) Diskrecionāri ieņēmumu pasākumi	-20,1	186,8	-74,6	-20,4	15,6	-15,7	34,5	-108,1	(6) Discretionary revenue measures
(6.1) Valdības nodokļu politikas izmaiņas	x	x	-19,7	x	x	-15,7	x	-28,5	(6.1) Government tax policy changes
(6.2) Pensiju reformas atkāpes izmaiņas	x	x	-54,9	x	x	0,0	x	-79,6	(6.2) Changes in deviation on pension reform
(7) Izlīdzinātie kopējie izdevumi (nominālie), (7) = (1)-(2)-(3)-(4.4.)+[VID (4.1) (4.2) (4.3)]	7 645,9	7 695,4	7 758,8	7 739,1	8 149,2	8 133,3	8 648,0	8 470,6	(7) Smoothed total expenditures (TE) (nominal), (7) = (1)-(2)-(3)-(4.4.)+[AVE (4.1) (4.2) (4.3) (4.4)]
(8) Koriģētie kopējie izdevumi (nominālie), (8) = (7)-(5)-(6)	7 666,0	7 508,6	7 833,3	7 759,5	8 133,5	8 149,0	8 613,5	8 578,7	(8) Adjusted TE (nominal), (8) = (7)-(5)-(6)
(9) Nominālo koriģēto kopējo izdevumu pieaugums, %	3,8	1,0	3,9	1,5	5,7	5,0	5,7	5,5	(9) Growth of nominal adjusted expenditure, %
(10) IKP deflators, %	2,5	1,9	2,1	2,5	2,5	2,5	2,5	2,5	(10) GDP deflator, %
(11) Reālo koriģēto izdevumu pieaugums, %	1,3	-0,9	1,7	-1,0	3,1	2,5	3,1	2,9	(11) Growth of real adjusted expenditure, %
(12) Potenciālā IKP 10 gadu vidējais pieaugums, %	2,8	2,7	2,7	3,3	3,1	3,1	3,3	3,3	(12) 10-year average growth of potential GDP, %
(13) Deficītu samazinošais faktors, %	-1,5	-1,5	-1,5	-1,5	-1,5	-1,5	-1,5	-1,5	(13) Deficit reduction factor, %
(14) Potenciālais pieaugums bez VTM, %, (14) = (12)+(13)	1,3	1,2	1,2	1,8	1,6	1,6	1,8	1,8	(14) Potential growth reference rate if not at MTO, %, (14) = (12)+(13)
(15) Potenciālais pieaugums ar VTM, %, (15) = (12)	2,8	2,7	2,7	3,3	3,1	3,1	3,3	3,3	(15) Potential growth reference rate, if at MTO, %, (15) = (12)
(16) Vispārējās valdības kopējie izdevumi, ja kopējo izdevumu pieaugums = potenciālā IKP pieaugumu	9 048,0	9 242,9	9 037,6	9 434,1	9 419,3	9 520,9	10 017,4	9 889,2	(16) GG total expenditure, if TE growth = potential GDP growth
(17) Vispārējās valdības kopējie ieņēmumi	8 703,0	8 607,8	8 706,8	9 196,3	9 062,4	9 187,0	9 501,8	9 627,5	(17) GG total revenue
(18) Valsts budžeta ieņēmumi (naudas plūsmas metode)	7 326,4	7 176,7	7 282,6	7 483,5	7 480,5	7 664,8	8 128,3	8 335,7	(18) CG budget revenue (cash-flow)
(19) Pašvaldību budžetu bilance	-0,2	-38,2	-38,6	0,9	30,5	-15,8	-2,1	-33,6	(19) Local government budget balance
(20) No valsts budžeta daļēji atvasināto publisko personu un budžeta nefinansētu budžeta iestāžu budžetu bilance	-0,2	-2,0	-2,0	-0,4	-0,3	-0,3	-0,8	-0,8	(20) Derived public persons budget balance
(21) EKS korekcijas	43,6	93,1	-23,0	273,8	183,0	23,8	-111,7	-296,4	(21) ESA corrections
Kopā (18)-[(17)-(16)-(19)-(20)-(21)]	**7 714,6**	**7 864,7**	**7 549,9**	**7 995,5**	**8 050,6**	**8 006,6**	**8 529,3**	**8 266,7**	**Total** (18)-[(17)-(16)-(19)-(20)-(21)]

Avots: Finanšu ministrija, Fiskālās disciplīnas padomes aprēķini

Source: Ministry of Finance, Fiscal Discipline Council calculations

Pārmantojamības nosacījums
Continuity principle
(milj. eiro)
(million euro)

P6.4. tabula
Table P6.4

	2016			2017		
	MTBFL 2015/17 (draft)	SP 2015/18	MTBFL 2016/18 (draft)	SP 2015/18	MTBFL 2016/18 (draft)	
(1) Koriģētie maksimāli pieļaujamie valsts budžeta izdevumi (precizētais Vispārējās valdības budžeta plāna projekts 2015.gadam)	6 495,4	6 597,6	6 584,6	6 578,8	6 569,4	(1) Adjusted maximum permissible state budget expenditure (updated Draft budgetary plan of 2015)
koriģēto maksimāli pieļaujamo valsts budžeta izdevumu korekcijas saskaņā ar FDL 5.pantu, t.sk.:						*adjustments of maximum permissible state budget expenditure according to the FDL Article 5, incl.:*
1) pamatbudžeta izdevumos sakarā ar aktuālākām valsts sociālo pabalstu un pensiju saņēmēju kontingenta prognozēm;	0,0	-2,8	2,0	-3,0	4,3	1) state budget expenditure due to more actual forecasts in contingent receiving state social allowances and pensions;
2) speciālā budžeta izdevumos sakarā ar aktuālākām sociālās apdrošināšanas pakalpojumu saņēmēju kontingenta, kā arī pensiju un pabalstu vidējā apmēra prognozēm;	0,0	-10,0	41,4	-5,7	47,0	2) state social security budget expenditure due to more actual forecasts in contingent receiving social security services, so as forecasts of average amount of pensions and allowances;
3) izdevumos, kuri izriet no prognozēto maksas pakalpojumu un citu pašu ieņēmumu izmaiņām, kā arī no kārtējā gada sākumā fiksētās maksas pakalpojumu un citu pašu ieņēmumu atlikuma summas;	0,0	-1,2	1,5	-1,2	-0,5	3) expenditure, which results from change in forecasted revenues from paid services and other self-earned revenues as well as fixed sum of remaining revenues from paid services and other self-earned revenues at the beginning of current year;
4) to izdevumu palielināšana, kuri nepieciešami Satversmes 62.pantā minētā apdraudējuma novēršanai, kā arī dabas katastrofu, avāriju un citu dabas vai sociālo procesu izraisītu materiālo zaudējumu novēršanai, — ievērojot FDL 12.panta otrās daļas nosacījumu;	0,0	0,0	0,0	0,0	0,0	4) increase of expenditure which is subject to the Constitution Article 62 as well as material losses arising from natural disasters, emergencies and natural or social processes complying with provision of second Paragraph of the FDL Article 12;
5) to izdevumu palielināšana, kuri nepieciešami, lai izpildītu starptautisko tiesu un Satversmes tiesas spriedumus;	0,0	0,0	0,0	0,0	0,0	5) increase of expenditure necessary for execution of verdicts of international courts and Constitutional court;
6) izdevumos saistībā ar Eiropas Savienības politiku instrumentu un pārējās ārvalstu finanšu palīdzības līdzekļu finansētiem projektiem un pasākumiem;	3,1	1,1	-100,0	0,6	-0,1	6) expenditure in relation with projects and measures financed from European Union policy instruments and other foreign financial assistance programmes;
7) izdevumos tās valsts parāda daļas apkalpošanai, kura ietilpst Valsts kases kompetencē;	0,0	0,0	0,0	0,0	0,0	7) expenditure for servicing that part of state debt falling under the competence of the Treasury;
8) kārtējos maksājumos Eiropas Savienības budžetā un starptautiskai sadarbībai;	0,0	0,0	0,2	0,0	1,2	8) regular payments in the budget of the European Union and for international co-operation;
9) FDL 16.panta piektajā daļā neminētu fiskālo risku izraisīto izdevumu palielināšana FDL 17.panta ceturtajā un piektajā daļā minētajos gadījumos, — ievērojot šo daļu nosacījumus;	0,0	0,0	0,0	0,0	0,0	9) increase of expenditure related to fiscal risks not mentioned in the fifth Paragraph of the FDL Article 16 in accordance with fourth and fifth Paragraphs of the FDL Article 17, by complying with provisions of these Paragraphs;
10) to izdevumu palielināšana, kuri izriet no normatīvā akta pieņemšanas saskaņā ar FDL 9.pantu, ja atbilstoši tā nosacījumiem pieņemts normatīvais akts, kas paredz palielināt valsts budžeta ieņēmumus, lai segtu attiecīgo izdevumu palielinājumu, vai izdevumu samazināšana apjomā, kas kompensē valsts budžeta ieņēmumu kritumu, ja tiek pieņemts normatīvais akts, kas paredz samazināt valsts budžeta ieņēmumus.	0,0	0,0	0,0	0,0	0,0	10) increase of expenditure resulting from adopting of normative act in accordance with the FDL Article 9, if according its provisions normative act is adopted which foresees to increase state budget revenues in order to cover respective increase of expenditure or reducing expenditure in amount compensating fall in state budget revenues, if normative act is adopted foreseeing to reduce state budget revenues.
(2) Faktiskie ES fondu izdevumi pozīcijās, kas pakļaujas izlīdzināšanai	1 103,3	1 039,3	1 039,3	1 071,9	1 071,9	(2) Expenditure of European Union structural funds, Cohesion fund, Common Agricultural Policy and Common Fisheries Policy as subject to the smoothing mechanism
(3) Valsts parāda vadības izdevumi pozīcijās, kas pakļaujas izlīdzināšanai	0,0	0,0	0,0	293,4	293,4	(3) Government debt service expenditure, what is in the Treasury's competence as subject to the smoothing mechanism
Kopā (1)+ [Summa no 1) līdz 10)]+(2)+(3)	**7 601,8**	**7 624,0**	**7 569,1**	**7 934,7**	**7 986,6**	**Total** (1)+ [Sum from 1) to 10)]+(2)+(3)

Avots: Finanšu ministrija, Fiskālās disciplīnas padomes aprēķini
Source: Ministry of Finance, Fiscal Discipline Council calculations

Fiskālie rādītāji, kas tiek izmantoti koriģēto maksimāli pieļaujamo valsts budžeta izdevumu aprēķināšanai[2]

P6.5.tabula

Fiscal indicators, that have been used to calculate the adjusted maximum permissible state budget expenditure

Table P6.5

(milj. eiro)
(million euro)

	2016		2017		2018	
	MTBFL 2015/17 (draft)	MTBFL 2016/18 (draft)	MTBFL 2015/17 (draft)	MTBFL 2016/18 (draft)	MTBFL 2016/18 (draft)	
(0) Iekšzemes kopprodukts, faktiskajās cenās	26850,9	26 126,5	28 513,3	27 750,2	29 476,7	(0) Gross domestic product, at current prices
(1) Minimāli atļautā strukturālā bilance, % no IKP	-0,9	-0,9	-0,8	-1,0	-0,8	(1) Minimal structural balance, % of GDP
(2) Cikliskā komponente, % no IKP	0,0	-0,1	0,0	0,0	0,0	(2) Cyclical component, % of GDP
(3) Vienreizējie un pagaidu pasākumi, % no IKP	x	x	x	x	x	(3) One-off, % of GDP
(4) Vispārējās valdības budžeta nominālā bilance, % no IKP, (4) = (1) + (2) + (3)	-0,9	-1,0	-0,7	-1,0	-0,8	(4) General government budget headline balance, % of GDP, (4) = (1) + (2) + (3)
(5) Vispārējās valdības budžeta nominālā bilance, (5) = (4) * (0)	-248,9	-258,7	-211,5	-284,2	-228,7	(5) General government budget headline balance, (5) = (4) * (0)
(6) Pašvaldību budžeta bilance	-0,2	-52,7	0,9	-27,3	-45,5	(6) Local government budget balance
(7) No valsts budžeta daļēji atvasināto publisko personu un budžeta nefinansētu iestāžu budžeta bilance	-0,2	-5,0	-0,4	-3,3	-3,8	(7) Derived public persons budget balance
(8) EKS korekcijas	43,6	85,3	273,8	145,3	-111,6	(8) ESA corrections
(9) Valsts budžeta bilance, (9)= (5) - (6) - (7) - (8)	-292,1	-286,3	-485,8	-398,9	-67,8	(9) State budget balance, (9) = (5) - (6) - (7) - (8)
(10) Valsts budžeta ieņēmumi (naudas plūsmas metode)	7 326,4	7 368,2	7 483,5	7 838,3	8 673,6	(10) Central government budget revenue (cash-flow)
(11) Maksimāli pieļaujamie valsts budžeta izdevumi, (11) = (10) - (9)	7 618,5	7 654,5	7 969,3	8 237,2	8 741,4	(11) Maximally permissible state budget expenditure
(12) Izlīdzinātie izdevumi, (12) = (12.1) + (12.2)	1 026,9	926,7	1 395,9	1 461,5	1 539,8	(12) Smoothed expenditures, (12) = (12.1) + (12.2)
(12.1) izlīdzinātie ES fondu izdevumi, (12.1) = (12.1.1) + (12.1.2)	*1 026,9*	*926,7*	*1 098,1*	*1 168,1*	*1 254,4*	*(12.1) smoothed EU funds expenditure, (12.1) = (12.1.1) + (12.1.2)*
(12.1.1) neatmaksājamā daļa	*115,9*	*148,9*	*115,9*	*184,9*	*127,1*	*(12.1.1) non-repayable part*
(12.1.2) atmaksājamā daļa	*911,0*	*777,8*	*982,2*	*983,2*	*1 127,2*	*(12.1.2) repayable part*
(12.2) Izlīdzinātie valsts parāda apkalpošanas izdevumi	*x*	*x*	*297,7*	*293,4*	*285,4*	*(12.2) Smoothed government debt service expenditure*
(13) Koriģētie maksimāli pieļaujamie valsts budžeta izdevumi, (13) = (11) - (12)	6 591,6	6 727,8	6 573,4	6 775,7	7 201,6	(13) Adjusted maximum permissible state budget expenditures, (13) = (11) - (12)
(14) Faktiskie izdevumi, (14) = (14.1) + (14.2)	1 039,3	926,7	1 365,3	1 461,5	1 539,8	(14) Actual expenditures, (14) = (14.1) + (14.2)
(14.1) ES fondu izdevumi (augšupvērstā metode), (14.1) = (14.1.1) + (14.1.2)	*1 039,3*	*926,7*	*1 071,9*	*1 168,1*	*1 254,4*	*(14.1) EU funds expenditures (bottom-up approach), (14.1) = (14.1.1) + (14.1.2)*
(14.1.1) neatmaksājamā daļa	*128,3*	*148,9*	*89,6*	*184,9*	*127,1*	*(14.1.1) non-repayable part*
(14.1.2) atmaksājamā daļa	*911,0*	*777,8*	*982,2*	*983,2*	*1 127,2*	*(14.1.2) repayable part*
(14.2) Valsts parāda apkalpošanas izdevumi	*x*	*x*	*293,4*	*293,4*	*285,4*	*(14.2) Government debt service expenditure*
(15) Fiskālā nodrošinājuma rezerve	x	x	28,5	27,8	29,5	(15) Fiscal safety reserve
(16) Valsts budžeta izdevumi, (lejupvērstā metode), (16) = (13) + (14) - (15)	7 630,9	7 654,5	7 910,2	8 209,4	8 711,9	(16) State budget expenditure (top-down approach), (16) = (13) + (14) - (15)
(17) Valsts budžeta izdevumi, (augšupvērstā metode)	7 597,2	7 654,5	7 655,4	8 155,0	8 424,5	(17) State budget expenditure (bottom-up approach)

Avots: Finanšu ministrija, Fiskālās disciplīnas padomes aprēķini

Source: Ministry of Finance, Fiscal Discipline Council calculations

[2] *2015.gada 25.septembrī no FM saņemtie dati.*
[2] *On 25 September 2015 received data from the MoF.*