# ANNEX 5 NUMERICAL FISCAL RULES

FDL[1] establishes three numerical rules **to arrive to expenditure ceilings** as the basis for sustainable and balanced[2] budgeting for the next three years through imposing "a long-lasting constraint on fiscal policy through numerical limits on budgetary aggregates."[3].

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.

<u>First method: balance rule.</u>

Article 10 of the FDL defines that the general government **structural** balance shall not be set lower than -0.5% of the annual GDP[4].

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[5]. 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[6]. At the same time it is acknowledged that to make corrections for cycle is difficult, especially for those countries undergoing structural changes[7].

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

[1] 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

[2] 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.

[3] 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.

[4] 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

[5] 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.

[6] Golden Rule (fiscal policy). Available: https://en.wikipedia.org/wiki/Golden_Rule_(fiscal_policy), accessed on 07.07.2015

[7] 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.

– 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 of the increase in the contribution to the second pillar of the retirement pensions established according to the Regulation No1175/2011[8] Article 5 and the departure scenario from the reductions[9].

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.

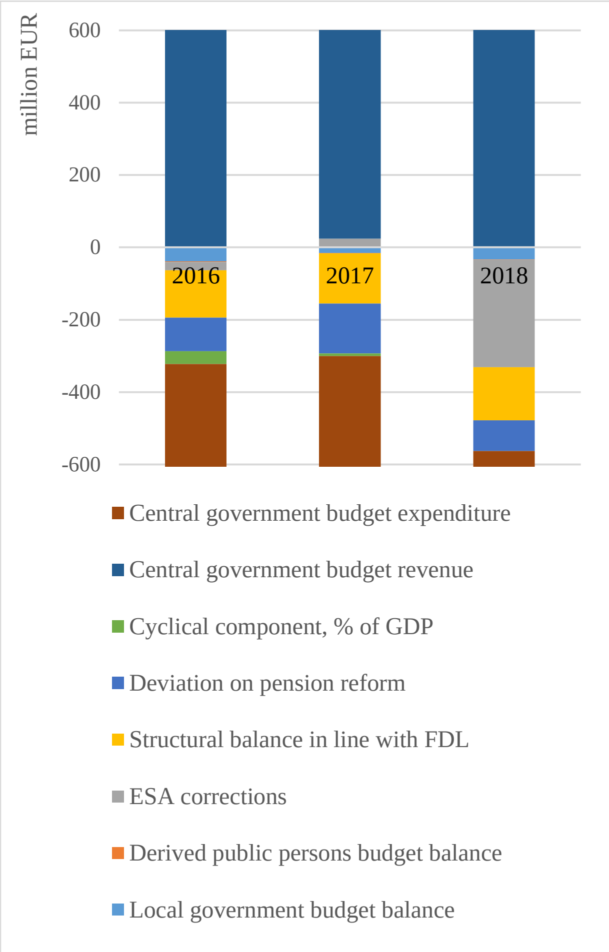


*Chart P5.1 Balance rule at closer scale.*[10]

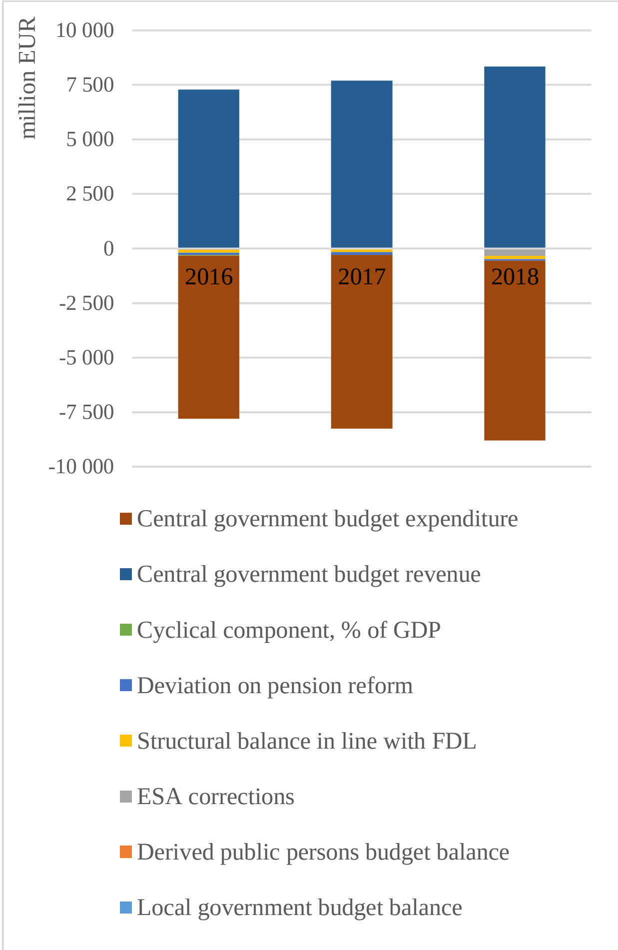


*Chart P5.2 Balance rule.*

**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.

[8] 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

[9] 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.

[10] 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[11], **the expenditure, excluding the GDP deflator[12] should not grow faster than potential GDPgrowth**.

Regulation No 1175/2011 lists **expenditure categories[13] dependent on the economic cycle and these should be considered when calculating[14] 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).

[11] "[…] 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."

[12] 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

[13] 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. […]"

[14] 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.

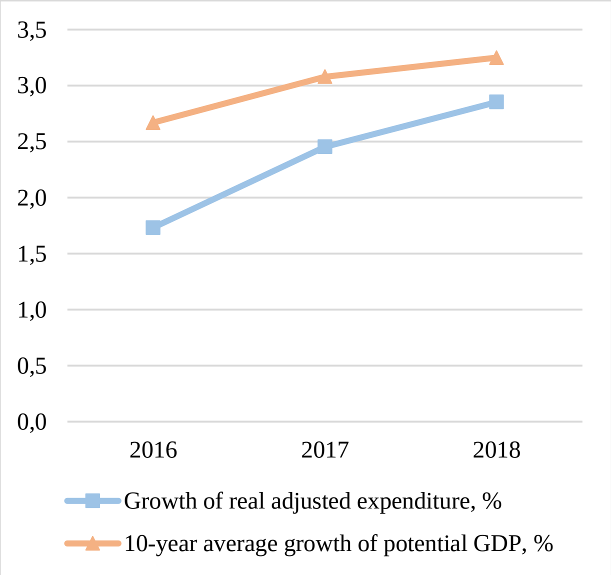


*Chart P5.3 Growth of real adjusted expenditure and 10-year average growth of potential GDP, percentage*

**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.

<u>Third method: continuity rule</u>

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.

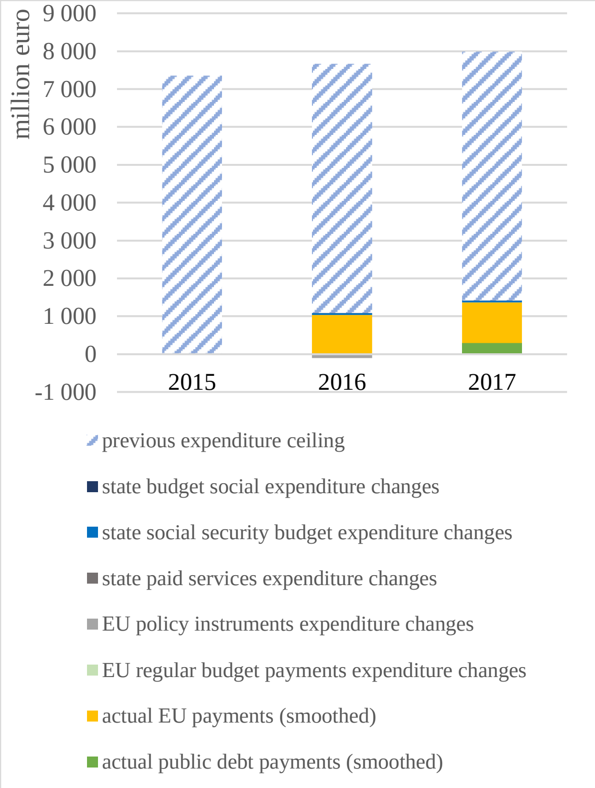


*Chart P5.4 Continuity principle.*

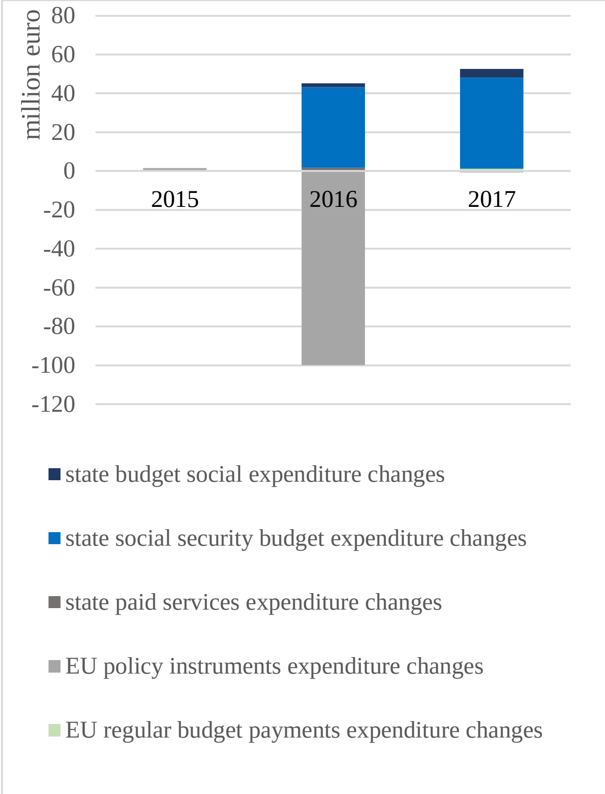


*Chart P5.5 Continuity rule's contingent natural fluctuations.*

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.

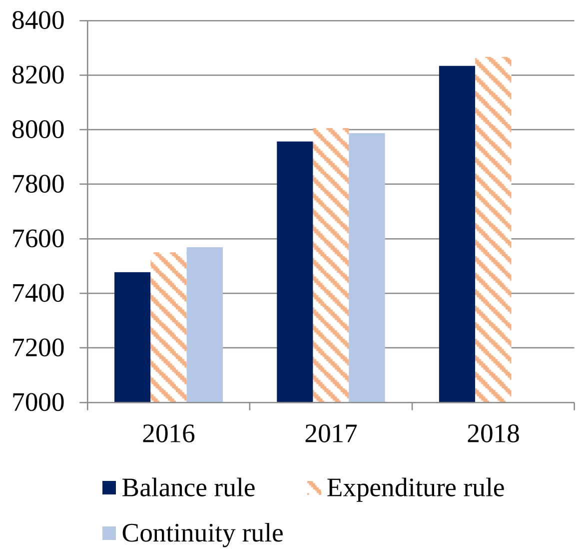


*Chart P5.6 2016-2018 state budget maximum expenditure ceiling, million euro*

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.