

## VERIFICATION OF COMPLIANCE WITH THE REQUIREMENTS OF ARTICLE 11 OF THE FISCAL DISCIPLINE LAW

According to Article 28 Part 7 of the Fiscal Discipline Law (hereinafter – FDL), the Fiscal Discipline Council (hereinafter – Council) shall prepare and submit to the Saeima and the Cabinet's attention of fiscal policy matters, where it finds them important to comply with the FDL terms.

According to the Regulation (EU) No 473/2013 of the European Parliament and of the Council of 21 May 2013 on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the Member States in the euro area (Regulation 473/2013<sup>1</sup>) Article 5 Part 2(a) an independent body shall provide public assessment related to the occurrence of circumstances leading to the activation of the correction mechanism. Article 11 of the FDL stipulates the requirements regarding the correction mechanism in the national legislation.

According to the Memorandum of Understanding<sup>2</sup> (hereinafter – MoU), the Council shall assess whether adjustment to the general government structural balance (hereinafter – the structural balance), shall be made according to Article 11 of the FDL through triggering the automatic correction mechanism to make adjustments and the future periods to which the correction applies.

According to Article 11 of FDL the Ministry of Finance (hereinafter – MoF) by 1 December 2016 has calculated the difference of the actual structural balance and the minimum planned general government structural balance, and according to the request supplied the calculations to the Council (see Table 1). **The Council on 6 December 2016 meeting, took note of the MoF leading experts explaining the compliance with Article 11 of the FDL requirements.**

**Table 1. Verifying compliance with the requirements of Article 11 of the Fiscal discipline law**

		2013	2014	2015	2016
		actual			forecast
1.	Nominal GDP, million euro	22 763.0	23 581.0	24 378.0	25 072.0
2.	Actual structural general government budget balance, % of GDP	-0.4	-0.7	-0.8	-0.4
3.	Actual structural general government budget balance, million euro	-96.6	-158.1	-188.3	-110.2
4.	Minimum planned structural general government budget, % of GDP	-1.3 <sup>3</sup>	-1.0 <sup>4</sup>	-1.0 <sup>5</sup>	-0.9 <sup>6</sup>
5.	Minimum planned structural general government budget balance, million euro	-307.0	-246.4	-248.8	-214.6
6.	Deviation from plan for the year, million euro (3-5)	210.5	88.3	60.5	104.4
7.	Deviation from plan for the year, % of GDP	0.9	0.4	0.2	0.4

<sup>1</sup> Regulation 473/2013 available at <http://eur-lex.europa.eu/legal-content/LV-EN/TXT/?qid=1446562236138&uri=CELEX:32013R0473&from=LV>, accessed on 07.12.2016.

<sup>2</sup> Paragraph 5.14.1. The Memorandum of Understanding available at [http://fiscalcouncil.lv/files/uploaded/FDP\\_1\\_09\\_969\\_20160729\\_MoU\\_FDC\\_MoF\\_consolidated.pdf](http://fiscalcouncil.lv/files/uploaded/FDP_1_09_969_20160729_MoU_FDC_MoF_consolidated.pdf), accessed on 07.12.2016.

<sup>3</sup> On medium-term budget framework 2013, 2014 and 2015, available in Latvian at <https://www.vestnesis.lv/op/2012/192.2?search=on>, accessed on 07.12.2016.

<sup>4</sup> On medium-term budget framework 2014, 2015 and 2016, available in Latvian at <https://www.vestnesis.lv/index.php?menu=doc&id=262267>, accessed in Latvian on 07.12.2016.

<sup>5</sup> On medium-term budget framework 2015, 2016 and 2017, available in Latvian at <https://www.vestnesis.lv/op/2014/257.25>, accessed on 07.12.2016.

<sup>6</sup> Notes to the draft Law on Medium-term budget framework for 2017, 2018 and 2019, available in Latvian at [http://www.fm.gov.lv/files/valstsbudzets/2017/FMPask\\_07102016\\_ietv2017\\_2019.pdf](http://www.fm.gov.lv/files/valstsbudzets/2017/FMPask_07102016_ietv2017_2019.pdf), accessed on 07.12.2016.

		2013	2014	2015	2016
		actual			forecast
8.	Accrued deviation from plan for all years starting with 2013, million euro	210.5	298.7	359.3	463.7
9.	<b>Accrued deviation from plan for all years starting with 2013, % of GDP</b>	<b>0.9</b>	<b>1.3</b>	<b>1.5</b>	<b>1.85</b>
10.	Rule in accordance with Article 11 of the FDL, % of GDP	-0.5	-0.5	-0.5	-0.5
11.	<b>Correction necessary if 9.&lt;10.</b>	<b>No correction</b>	<b>No correction</b>	<b>No correction</b>	<b>No correction</b>

Source: for 2013-2015: MoF assessment of the general government structural balance performance for the criteria of Article 11 of the FDL. For 2016 – Notes to the draft Law on Medium-term budget framework for 2017, 2018, and 2019.

Article 11 of the FDL stipulates the automatic upward adjustment in the structural balance of 0.5% of gross domestic product (hereinafter – GDP) in the third year of the next Medium-term budget framework law (hereinafter – MTBFL) after establishing that accumulated actual deviation from the structural balance in excess of 0.5% of GDP. According to the MoF estimate of structural balances adjustment does not apply, as accumulated deviations of actual structural balance from the planned balance are above Article 11 of the FDL threshold (-0.5% of GDP). **The total accumulated difference between the balances at the end of 2016 amounted to 1.85% of GDP. After examining the information provided, the Council establishes that it is not necessary to make the adjustment according to Article 11 of the FDL.**

The Council agrees with the assessment of the MoF and notes uncertainties caused by shifting values of the cyclical component as the key reason for evaluating ex-post the fiscal performance based on the structural balance rule comparing different results of the evaluation at end-2015<sup>7</sup> and end-2016 (see Chart 1 and Chart 2). The changes in the cyclical component have been affected both by the potential GDP revision and the Central Statistical Bureau revision of GDP. Accumulated deviation in the structural balance since December 2015 has improved by 0.7% of GDP in 2013, 1.4% of GDP in 2014, 2.0% of GDP in 2015 and estimated for 2016 by 2.3% of GDP.

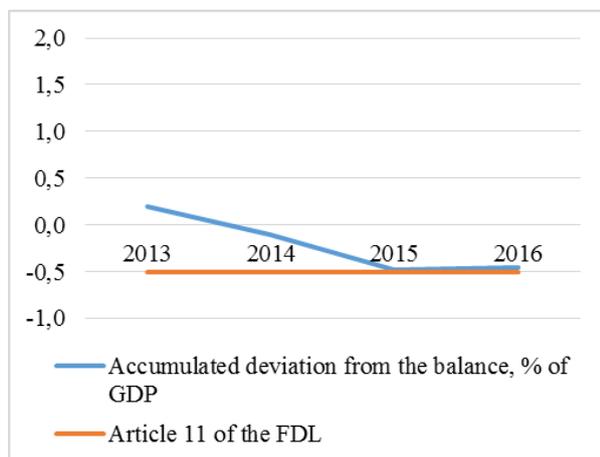


Chart 1. Accumulated deviation from the balance. Calculations of the MoF and the Council as of December 2015.

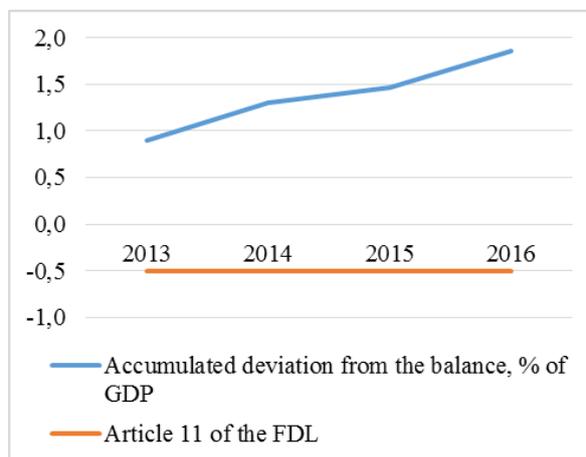


Chart 2. Accumulated deviation from the balance. Calculations of the MoF and the Council as of December 2016.

By comparing both assessments of each year deviation from plan together with the changes of the cyclical component, the adjustments in the assessment of the business cycle have been the main reason for the significant changes between the assessments of 2015 and 2016 in December (see Table 2).

<sup>7</sup> Fiskālās disciplīnas padomes (Nr.1-02/1016) viedoklis par FDL 11.panta prasību izpildi, pieejams: [http://fdp.gov.lv/files/uploaded/FDP\\_1\\_02\\_1016\\_20151218\\_FDL\\_11pants.pdf](http://fdp.gov.lv/files/uploaded/FDP_1_02_1016_20151218_FDL_11pants.pdf), accessed on 07.12.2016.

**Table2. Comparison of Article 11 of the FDL compliance at end-2016 and end-2015**

		2013.	2014.	2015.
		actual		
1.	Annual deviation in percent of GDP as assessed at end-2015	0.2	-0.3	-0.5
2.	Annual deviation in percent of GDP as assessed at end-2016	0.9	0.4	0.2
3.	<i>Change in the assessment from 2015 to 2016 (2-1)</i>	+0.7	+0.7	+0.7
4.	<i>change due to the shift in the cyclical component</i>	+0.7	+0.7	+0.5
5.	<i>Accumulated deviation from the structural balance target</i>	+0.7	+1.4	+2.0

Source. Calculations of the Council.

Having established the uncertainty of the structural balance method in the performance appraisal the Council carried out a further 2013 to 2015 budget performance assessment using expenditure growth rule<sup>8</sup> (see at the Council webpage technical calculations MS Excel<sup>9</sup>). Expenditure growth rule used also in MTBF planning is based on the requirement of general government expenditure not to exceed the 10-year average potential GDP growth rate. **It should be noted that resulting from the financial crisis potential GDP experienced negative growth and hence it also requires reduction of the estimates for the next few years, requiring very conservative pace for the State budget expenditure growth.**

The expenditure rule allows increase in the general government expenditure growth in excess of the increases in the potential GDP upon the condition of the government implementing additional revenue measures (so-called discretionary measures). In the budget performance appraisal additional revenue measures are not separated from the actual revenue performance simplifying the calculations.

The expenditure growth rule also allows smoothing subtracting some non-discretionary expenditure categories, e.g. interest payments, expenditures offset with EU funds revenue; government gross capital formation. Similarly, to the impact of the financial crisis affecting the average potential GDP growth assessment, the GDP deflator for 2013 to 2015 has substantial impact on the results on the expenditure rule performance. GDP deflator relatively insignificantly reduces nominal spending growth and thus creates a potential difference between the slow GDP growth and relatively larger general government expenditure growth momentum.

The general government fiscal balance during 2013 and 2014 has performed worse if measured by the expenditure growth rule compared to the structural balance rule. It points at the need for more stringent attention to the expenditure growth, unless adequate new discretionary measures to increase budget revenue are taken. In 2015 general government budgetary outcomes improved the balance of the accumulated deviations are calculated based on the expenditure growth rule.

<sup>8</sup> Vade mecum on the Stability and Growth Pact, edition 2016, available at: [http://ec.europa.eu/economy\\_finance/publications/eeip/pdf/ip021\\_en.pdf](http://ec.europa.eu/economy_finance/publications/eeip/pdf/ip021_en.pdf), accessed on 07.12.2016.

<sup>9</sup> Expenditure condition estimates 2013 to 2015, available at: [http://fdp.gov.lv/files/uploaded/FDP\\_1\\_08\\_1449\\_20161209\\_ex\\_post.xlsx](http://fdp.gov.lv/files/uploaded/FDP_1_08_1449_20161209_ex_post.xlsx), accessed on 09.12.2016.

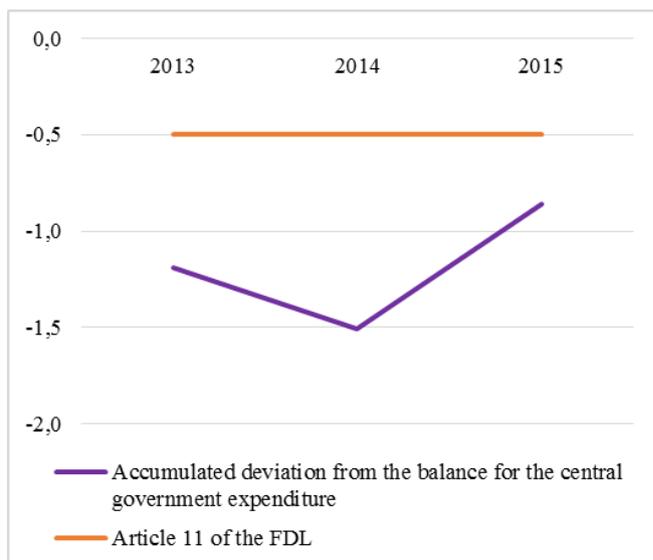


Chart 2. Accumulated deviation from the balance for the central government expenditure. Calculations of the MoF and the Council as of December 2016.

The general government budget execution results for 2013 and 2014, applying expenditure growth rule, would trigger the automatic correction mechanism increasing in the MTBFL for 2018 and 2019 the general government budget balance by 0.5% of GDP, taking into account the fact that the GDP output gap has been projected positive for these years. However, unlike the EU framework according to the FDL correction mechanism does not apply in respect of expenditure growth rule. It should be noted that the accumulated deviations according to expenditure growth rule after 2015 still exceeds the 0.9% of GDP and with no additional steps to curb spending, it would have triggered a correction mechanism in respect of the 2020 fiscal indicators in the next MTBFL.

The Council confirms that according to Article 11 of the FDL structural balance adjustment is not required, while it draws the Government's attention that conservative fiscal policy should be followed and increase in spending exceeding the Latvian economic potential discouraged, taking into account the performance assessment against the expenditure growth rule and the volatility of the cyclical component, assessing the structural balance.

**The Council recommends the MoF to consider the opportunity that at the verification process of Article 11 of the FDL should be taken into account not only structural balance rule but also the expenditure growth rule.**