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Approved
at the meeting of the
Fiscal Discipline Council
on 4 October 2017
Minutes No 6 (25) §2.1

FISCAL DISCIPLINE SURVEILLANCE REPORT
ON LATVIA'S MEDIUM TERM BUDGET FRAMEWORK
2018-2020

Riga, 2017

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Abbreviations

BoL	Bank of Latvia
Council	Fiscal Discipline Council
EC	European Commission
ESA	European system of accounts
EU	European Union
FDL	Fiscal discipline law
SFR	Statement of Fiscal Risks
IMF	International Monetary Fund
Surveillance report 2018-2020	Fiscal Discipline Surveillance Report 2018-2020
MoF	Ministry of Finance
MTBF	Medium term budget framework
MTBFL 2018/20	Medium term budget framework law for 2018-2020
GDP	Gross domestic product
NA	Not applicable / not available
OECD	Organization for Economic Cooperation and Development
SB	State budget
SBL	State budget law
SBL 2018	State budget law for 2018
SGP	Stability and growth pact
SP	Latvia's Stability Programme
SP 2017/20	Latvia's Stability Programme for 2017-2020
VAT	Value added tax

Executive Summary

It is expected that the Government of Latvia will achieve its fiscal policy targets in 2017, but there are several risks associated with expenditure planning and the recent tax reform. The Latvian economy is growing and the growth rate will be above potential. In the current period of rapid economic growth, public finances must be strengthened, government debt levels should be reduced, and reserves for the next cyclical downturn should be built.

In 2016, the general government budget balance was better than anticipated. Latvia is one of several EU member states that outperformed their budget balance targets in 2016. The general government budget of Latvia was balanced, despite the fact that the budget balance target for 2016 was -1.0% of GDP.

The Saeima adopted a comprehensive tax reform. On July 28, the Saeima approved a tax reform package aimed at strengthening economic growth and reducing the labour tax burden.

The tax reform will reduce the tax burden on low and medium income earners. The PIT rate was lowered to 20% (for income up to 20 000 euro per year) as part of the tax reform and the differentiated non-taxable allowance was increased to 200 euro (for people who earn up to 440 euro per month). Together, these measures reduce the labour tax wedge, which is relatively high for low income earners.

The Council welcomes the second iteration of the expenditure review and underlines that increased expenditure efficiency will be crucial in the future. As a result of the expenditure review, it was concluded that around 81 million euro could be used for other purposes in 2018. The amount is slightly lower for 2019 (73 million euro). The practice of reviewing expenditures is welcome and work on improving the efficiency of budget expenditures needs to continue.

The 2017 budget balance is worsened by several government decisions that entail additional spending. The payment to Latvenergo for the purpose of reducing mandatory procurement component payments for electricity consumers will reduce the possibilities for improving the budget balance in 2017. There was additional expenditure on addressing various sectoral problems, mainly through the redistribution of savings from "Contributions to the budget of the European community", which the Council considers to be inconsistent with the requirements of the FDL.

The Council notes that expenditure plans need to better reflect expenditure needs. In the medium term, the government will have limited resources to increase staff remuneration and maintain the attractiveness of positions in the public sector. In addition, conditions in financial markets and higher interest rates may increase interest expenditure, thus limiting the resources available for other needs.

Reforms with significant fiscal impact should not be separated from the budget preparation process. Submission of tax reform laws to the Saeima was suspended from the budget preparation process. The Council contends that the fragmentation of important fiscal policy decisions should be avoided by ensuring their simultaneous adoption with a new MTBFL.

The Council notes risks associated with the lack of a medium-term vision regarding the resources necessary to perform government functions. The approved tax policy changes will not increase revenues to achieve the desired tax-to-GDP ratio by 2020 and their long-term effects are unclear. Moreover, several details (for example, in relation to corporate income tax) have yet to be fully formulated. It is necessary to assess the impact of the reform on government revenues, taking into account the financial resources that will be required to effectively deliver services and perform administrative functions.

The capacity of the State Revenue Service should be aligned with changes in the tax system in order to facilitate and encourage compliance. The current administrative and technical arrangements of the State Revenue Service need to be adjusted to ensure the institution's ability to administer the tax system, collect tax revenues and effectively communicate with taxpayers. At the same time, targeted efforts to limit tax evasion must play a significant role in improving Latvia's tax-to-GDP ratio.

The Council welcomes the decision to establish a fiscal security reserve for 2018 and 2020, and urges the government to observe the law and establish a fiscal security reserve for 2019 in the amount of 0.1% of GDP. Citing insufficient fiscal space, the Cabinet of Ministers decided not to establish a reserve for 2019. The Council insists that the lack of funds is not a sufficient reason not to establish a reserve. The reserve serves as a buffer against the negative effects of fiscal risks and, without creating a reserve, the government exposes public finances to sudden shocks at a moment of rapid economic growth.

The Council notes that further improvements to fiscal risk analysis are needed. Although the Council is pleased with improvements to forecasting special budget expenditure, a number of previously identified weaknesses have not been resolved. For example, the analysis should be comprehensive and avoid excessive reliance on qualitative assessment and the wide application of the principle of symmetry should be abandoned.

Bold reform measures are needed to boost potential growth. Although the MoF's potential GDP growth rate forecast for 2021-2024 is 3%, the Council believes that the current economic structure is not conducive to sustainable long-term growth at 3%. The pace of potential growth is likely to gradually fall below 3%. There is a need for radical reform measures to ensure a skilled and competitive labour force, promote productivity and ensure sustainable economic growth.

The Council believes that the favourable economic conditions mean that the Government should plan a budget with a surplus. From 2018 onwards, the economy will grow above its potential, creating an output gap. If the current real growth rate persists, the government will have to set more ambitious budget balance targets with a smaller deficit and even a surplus in the near future. Under favourable economic conditions, a high level of government debt, that has been accumulated during the crisis and a period slow economic growth, has to be reduced.

Positive 2016 budget performance indicators reduce the risk of having to adjust the budget balance. After comparing actual expenditure and structural budget balance indicators with the plans for 2013-2016, the Council acknowledged that the methodological update of macroeconomic data for previous periods, as well as the balanced outcome in 2016, means that there is no need to correct the budget balance in the foreseeable future.

The Council continues to object to the use of deficit financing to implement the health care reform. The Council agrees that funding for health care should be increased. However, official information on reform measures that will be implemented with the additional funding (113.4 million euro in 2018; 149.9 million euro in 2019) and the expected results is currently insufficient.

The Council considers that the Government should recalculate expenditure ceilings, respecting the fiscal rule calculation methodology. The Council contends that methodological errors lead to a expenditure ceiling discrepancy of 187.7 million euro for 2019 and 369.0 million euro for 2020. The difference derives from the fact that the Council cannot agree to the MoF's treatment of the impact of the tax reform in the calculation of the expenditure growth rule.

1 FISCAL POLICY CHALLENGES

In 2016, the general government budget balance¹ exceeded expectations, and the budget was balanced, while the budget balance target for 2016 was -1.0% of GDP. The positive outcome is mainly due to slightly higher revenues, and lower expenditures as a result of the slow implementation of EU-funded projects.

	2014	2015	2016
General government budget balance (target)	-1.0	-1.0	-1.0
General government budget balance (actual)	-1.6	-1.3	0

Table 1: General government budget balance. Source: Ministry of Finance.

Latvia is among several EU member states that outperformed their balance targets in 2016. An EC publication² notes that in 2016 expenditure levels generally remained at planned levels, revenue ratios decreased less than expected, and revenues outperformed plans. Consequently, many member states concluded the year with better than anticipated budget balances.

1.1 Revenues

The tax revenue plan was exceeded in 2016 despite slower than forecasted economic growth. According to the State Revenue Service plan, 7.55 billion euro were expected to be collected in tax revenues in 2016. However, 7.59 billion euro were collected, despite lower than forecasted nominal growth. While revenues from VAT and PIT were lower than planned, these were compensated by higher excise and corporate income tax revenues.

	2014	2015	2016
Total tax revenues (inc. social security contributions)	100.1%	100.2%	100.6%
VAT revenues	101.3%	98.3%	99.7%
PIT revenues	102%	101.5%	99.3%

Table 2: Execution of the State revenue service revenue plan. Source: State revenue service.

The Saeima passed a comprehensive tax reform. The Minister of Finance presented a tax reform proposal on 28 February 2017. After lengthy debates with social partners, consultations with political parties and several revisions, it was approved by the Cabinet and sent to the Saeima, where it was expeditiously passed on July 28. The approved tax reform package contains significant modifications to all major taxes, including PIT and CIT.

The implementation of reforms with significant fiscal impact should not be separated from the budget preparation process. The tax reform package that was sent to the Saeima increased the budget deficit for 2018 and 2019 above levels stipulated in the MTBFL 2017-2019. This is specifically prohibited by the FDL, and the Council promptly identified and pointed at the non-conformity. Fragmentation of important fiscal policy decisions should be avoided by ensuring the simultaneous adoption of key policies with a new MTBFL.

¹ According to the CSB notification of April 21, 2017, based on ESA 2010 methodology.

² See *An Overview of the 2017 Stability and Convergence Programmes and an Assessment of the Euro Area Fiscal Stance for 2018*, https://ec.europa.eu/info/publications/economy-finance/overview-2017-stability-and-convergence-programmes-and-assessment-euro-area-fiscal-stance-2018_en, accessed on 03/10/2017.

The tax reform aims to reduce the labour tax burden on people with low and medium incomes. The PIT rate was lowered to 20% for income up to 20 000 euro per year as part of the tax reform. In addition, the differentiated non-taxable allowance was raised to 200 euro for people who earn up to 440 euro per month. In conjunction, these measures reduce the tax wedge on low wage earners, which is comparatively high.

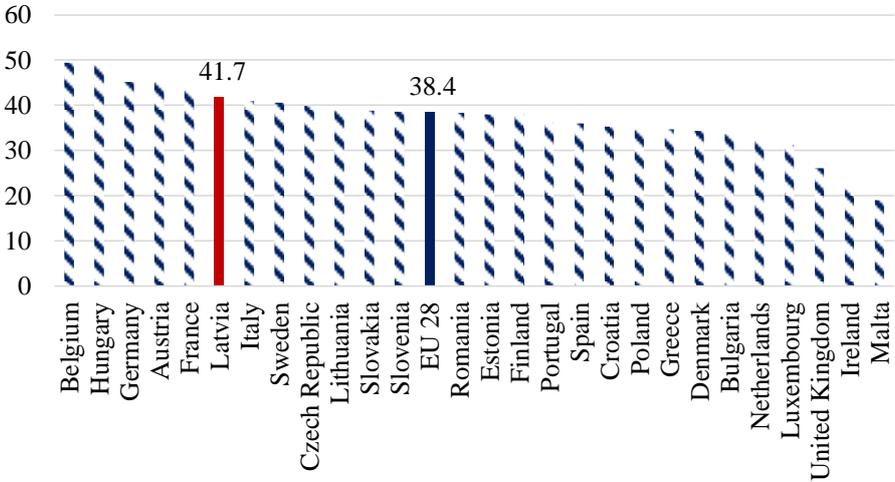


Chart 1: Tax wedge on low wage earners in 2015. Source: Eurostat

The impact of PIT changes on the reduction of income inequality is unclear. The introduction of a 31.4% PIT rate for people who earn above 55 000 euro per year means that high-income earners would have to pay a larger proportion in taxes. However, the abolishment of the solidarity tax eliminates the effect of the higher PIT rate. Furthermore, both local and international researchers have indicated that the differentiated non-taxable allowance has a more significant impact on the reduction of income inequality in this particular tax reform package. Meanwhile, the increase in the rate of social security contributions is reducing the effect of increasing the progressivity of income taxation.

Modifications to the corporate income tax may have positive long-term effects, but they will also have negative fiscal effects in the short term. The revised revenue estimates show that the decision to levy a 0% tax rate on reinvested profits will significantly reduce corporate income tax revenues. While the decision may improve the ability of businesses to develop and successfully weather future crises, these effects will most likely manifest themselves in the long term, beyond the horizon period of the draft MTBF.

Measures to reduce the shadow economy need to be spelled out in full. In addition to legal changes, the tax reform also aims to incentivise behavioural changes that would reduce the shadow economy. However, more specific measures should be outlined and approved to limit informal activity, increase government revenues and lend credibility to the Government’s stated stance on combatting the shadow economy.

The Council notes risks associated with the lack of a medium-term perspective regarding the resources necessary to perform government functions. The current Cabinet has declared that it intends to achieve a tax-to-GDP ratio of 1/3 by 2020. However, the proposed tax policy changes will not increase revenues to reach the desired tax revenue levels by 2020, and their long-term impact is unclear. The tax reform has not been supplemented with a comprehensive review of the medium-term fiscal outlook and implemented without regard for the financial resources required to effectively provide services and perform government functions.

Improving compliance will be crucial for increasing revenues. The tax reform aims to make the tax system growth-friendly and stimulate economic activity, but it entails a significant revenue loss. This

suggests that targeted attempts to limit opportunities for tax avoidance and reduce tax evasion should be the cornerstone of increasing Latvia's tax-to-GDP ratio.

Uncertainty surrounding core elements of the tax reform may erode public trust. The reform passed by the Saeima differs considerably from the proposal that was made public on 28 February. Furthermore, several specific details (e.g. regarding CIT) have yet to be spelled out in full. Attempts have to be made to ensure that the new tax framework is clearly communicated to the public to avoid misunderstandings and foster voluntary compliance.

The capacity of the State revenue service should be aligned with the revised tax framework. The reform package foresees significant changes to all the main taxes. The current administrative and technical arrangements in the State revenue service have to be adjusted to ensure the agency's ability to administer the tax system, collect tax revenues and communicate with taxpayers efficiently.

The revenue potential of property taxes remains underutilised. Taxes levied on immovable property have a limited negative effect on economic growth prospects and the potential to reduce economic inequality. However, due to public resistance to increasing tax rates and eliminating tax breaks, the share of tax revenues generated from immovable property remains minor, even though international observers (e.g. OECD) have repeatedly noted the revenue potential of property taxes.

	2014	2015	2016
Property tax revenues (million euro)	191.3	197.0	219.9
Property tax revenues (% of total tax revenues)	2.8%	2.8%	3.0%

Table 3: Property tax revenues 2014-2016. Source: Treasury

1.2 Expenditures

The Council applauds the second iteration of the expenditure review and notes that efficiency gains will be crucial in the future. The Government carried out an expenditure review and concluded that in 2018 approximately 81 million euro could be used for other purposes. The amount is slightly lower for 2019 – 73 million euro. While the practice of reviewing expenditures is commendable, more comprehensive analyses of the way government funds are spent will be necessary. If government revenues are not increased through taxation, making spending more efficient will allow the Government to maintain crucial public services without increasing the deficit.

The Council is concerned by the government's practice of modifying annual expenditure plans and approving unplanned expenditures. Appropriations for these categories are not constrained by the amount allocated in the budget if expenditures are higher than planned, and any savings in these categories should not be reallocated for other purposes. The Council has advised the Government of this non-conformity with FDL requirements. In addition, payments to Latvenergo for the purpose of reducing mandatory procurement component payments for electricity consumers will reduce the possibility of improving the budget balance in 2017. Meanwhile, recent experience suggests that the Government takes up commitments that are not adequately reflected in planning documents and have to be met by reallocating savings from protected budget programmes.

Medium-term expenditure plans should reflect wage pressure created by rapid economic growth. Latvia's economy appears to be on the upswing of the business cycle. This will likely stimulate sustained wage growth in the private sector. However, in the medium term there will be limited resources at the disposal of the government to increase the compensation of employees. A shrinking working-age population will make the reduction of the number of public sector employees the main tool for implementing pay increases to maintain the attractiveness of jobs in the public sector.

Conditions in financial markets and higher interest rates may drive up interest expenditure, thus reducing the resources available for other expenditures. Public debt management has been

facilitated by accommodating European Central Bank policies and historically low interest rates. This is expected to change in the near future. Nonetheless, Government plans still rely upon lower interest expenditure in the outer years of the MTBF³.

Policy measures have to be brought into alignment with the requirements of countercyclical fiscal policy. The pace of economic growth suggests that the economy is now on the upswing of the business cycle. In such circumstances further stimulation of the economy with fiscal tools is potentially dangerous as it exposes public finances to sudden shocks without adequate reserves. Expansionary fiscal policy should be avoided to build fiscal buffers for the next cyclical downturn, and policy measures have to be aligned with the requirements of the FDL.

1.3 Health care

The Council maintains its objection to increasing the deficit in order to implement health care reforms. The Government has received permission from the EC to temporarily deviate from the budget deficit target in order to continue implementing health care reforms. The Council agrees that reforms are necessary. However, it holds that deficit-financing can only be used to implement changes that are based on a clear long-term vision, specific outcome indicators and make a significant contribution to the long-term growth of the economy. The Council contends that the information that has been made available is not sufficient to support the deficit increase.

Plans to increase funding for health care are salutary, but additional revenues will be required. Public funding for health care in Latvia substantially lags behind other EU member states. In order to provide additional funding, the Government has decided to increase the social security contribution rate by 1pp and allocate the revenues to health care. Estimates suggest that this would provide an additional 85.3 million in 2018, 99.6 million in 2019 and 105.5 million in 2020. However, this may not be enough to cope with the growing pressure to increase funding for health care.

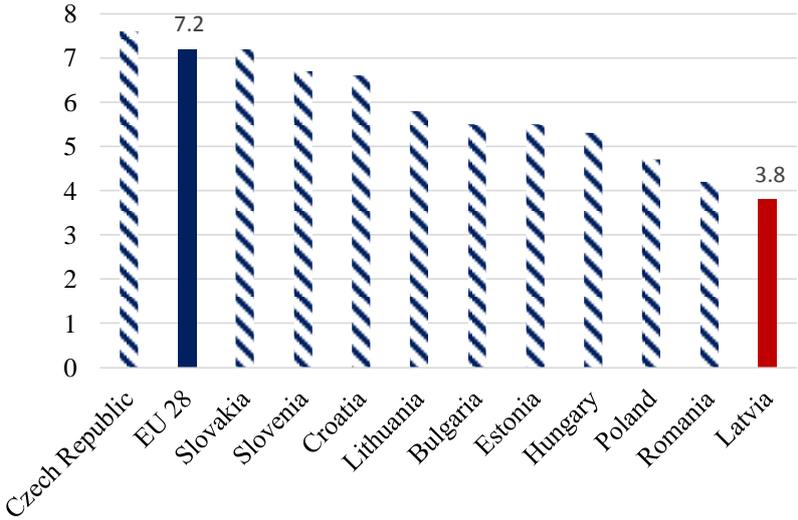


Chart 2: General government funding on health in 2015. Source: Eurostat

The Council applauds the decision to identify the necessary funds to ensure stability after the permitted deviation has expired. The permission from the EC to temporarily deviate from the budget deficit target in order to continue implementing health care reforms is set to expire at the end of 2019,

³ See *An Overview of the 2017 Stability and Convergence Programmes and an Assessment of the Euro Area Fiscal Stance for 2018*, https://ec.europa.eu/info/publications/economy-finance/overview-2017-stability-and-convergence-programmes-and-assessment-euro-area-fiscal-stance-2018_en, accessed on 03/10/2017.

and a significant proportion of the funds have been earmarked for regular expenditures. During the Cabinet meeting that took place on 8 September it was announced that 144 million have been earmarked for health in 2020, thus ensuring a steady flow of funds without increasing the budget deficit.

Long-term health care expenditure plans should be mindful of demographic changes and future expenditure needs. Data provided by Eurostat clearly show that Latvia's population is ageing, and Latvia's public health indicators are poor. Coupled with the fact that pensioners generally have higher health care needs, this means that there will be increasing demands upon the provision of public health care. This is also important in relation to social expenditures. Even though the long-term expenditure level on social protection is considered fiscally sustainable, the low adequacy of pensions may create political pressure to increase spending.

1.4 Assessment of the Statement of Fiscal Risks

The Government has a responsibility to carry out a comprehensive assessment of fiscal risks, prepare a Statement of Fiscal Risks (hereafter – Statement) and establish a fiscal security reserve. The management of fiscal risks requires the identification of specific sources of risk and their potential impact on the general government balance. This information is included in the Statement, which is attached to the draft MTBFL upon submission to the Saeima. Based on the Statement, a fiscal security reserve should be calculated and included in the budget to counter the fiscal impact if any of the risks should materialise and cause the general government balance to deviate from the objective approved in the MTBFL.

The FDL stipulates that a fiscal security reserve should be established at least in the amount of 0.1% of GDP. The FDL states that the fiscal security reserve for 2017 should be established in the amount of 0.1% of GDP, and a fiscal security reserve of no less than 0.1% of GDP should be established for subsequent years.

Robust risk management frameworks can limit fiscal impact and raise credibility. Sound practices for managing fiscal risks and a better understanding of the sources of risk can allow governments to put in place policies that reduce the exposure of public finances to sudden shocks. Furthermore, fiscal transparency can increase confidence that the Government is a responsible partner.

Risk management should be underpinned by sound institutional arrangements. The risk management policy should define clear responsibilities and accountabilities, and aim to establish control mechanisms for major sources of risk. All risk management policies should aim to minimise moral hazard and incentivise prudent decisions⁴.

The Council welcomes the decision to establish a fiscal security reserve for 2018 and 2020 and believes that the amount allocated to the fiscal security reserve is currently sufficient. At the Cabinet meeting on 22 August 2017 the Government committed to establishing a fiscal security reserve for 2018 and 2020 in the amount of 0.1% of GDP for each year. The reserve will serve as a buffer against the impact of fiscal risks.

The Council urges the Government to establish a fiscal security reserve for 2019 in the amount of 0.1% of GDP. While a decision was made to establish a reserve for 2018 and 2020, the Cabinet did not establish a reserve for 2019. This decision runs counter to the requirements of the FDL and

⁴ See *Analyzing and Managing Fiscal Risks - Best Practices*, <https://www.imf.org/en/Publications/Policy-Papers/Issues/2016/12/31/Analyzing-and-Managing-Fiscal-Risks-Best-Practices-PP5042>, accessed on 03/10/2017.

increases the exposure of public finances to sudden shocks during a time of rising economic activity when such provisions are easier to establish.

The Council welcomes improvements to expenditure estimates for the special budget. The Council has previously noted that special budget expenditures have recently been higher than the targets approved in SBLs. The Statement acknowledges this forecasting error and claims that the necessary measures have been taken to improve the quality of forecasts.

The Council reiterates its objection to the wide application of the symmetry principle. Several risks are treated as symmetrical, meaning that they can either deteriorate or improve the overall budget balance in any given year; in the long term, however, they should have a neutral effect. The application of the symmetry principle may be legitimate in some cases, but fiscal risks tend to be biased towards the downside. Furthermore, some risks should be approached cautiously (e.g. risks related to the tax reform) because there is no historical data to establish that they are symmetrical. This suggests that the application of the symmetry principle to such a significant portion of the risks included in the Statement requires further justification.

Recent experience suggests that the symmetry principle is not applied consistently. Fiscal risks associated with payments to the EU budget are treated as symmetrical. However, in September 2017 the Government approved the redistribution of savings from the MoF's budget sub-programme "Contributions to the budget of the European community" to meet the financial needs of several line ministries. This suggests that the symmetry principle is not applied in the case of savings, while additional funding would have to be provided if expenditures were higher than planned.

Few risks are adequately quantified. While the Statement looks at a wide range of fiscal risks, the majority are not assessed in terms of their potential impact and likelihood of occurrence. The exceptions are the risks managed by the Treasury.

The Statement should aim to be more comprehensive and avoid understating the need for a quantitative assessment. The Statement includes several risks whose potential fiscal impact has been assessed qualitatively. While the use of expert judgement is not in itself problematic, it should be supplemented by quantitative estimates that would establish a clear link between the potential impact of the risk in question, the likelihood that it will materialise and its contribution to the size of the fiscal security reserve.

The Council urges the Government to move forward with the proposed improvements to the management of state- and municipality-owned enterprises. A quantitative assessment of risks associated with municipality and state-owned enterprises is not provided in the Statement, and it is noted that the impacts have generally been on the upside – balances have been better than planned. While the Statement outlines a number of measures for improving the management of risks associated with such enterprises, these have yet to be implemented.

The Statement should include an assessment of the impact of macroeconomic shocks. While macroeconomic shocks do not materialise often, they constitute the most significant threat to the stability of public finances. IMF research on fiscal risks highlights that public finances are typically hit by a macroeconomic shock once every 12 years and the average fiscal "cost" is around 9 percent of GDP⁵. The risks of adverse cyclical developments are frequently downplayed before these materialise. Slow growth, disruptions in the financial sector or collateral impact from geopolitical instability may adversely affect the health of public finances and lead to a deterioration of the general government

⁵ See *Analyzing and Managing Fiscal Risks - Best Practices*, <https://www.imf.org/en/Publications/Policy-Papers/Issues/2016/12/31/Analyzing-and-Managing-Fiscal-Risks-Best-Practices-PP5042>, accessed on 03/10/2017.

balance. The development of a robust sensitivity analysis (see section on Macroeconomic outlook) would assist in the assessment of the fiscal impact of cyclical downturns and macroeconomic shocks.

Recommendations

1. Establish a fiscal security reserve for 2019 to strengthen the ability of public finances to absorb fiscal shocks.
2. Observe the requirements of responsible countercyclical fiscal policy by implementing policy measures appropriate to the current (expansionary) period of the business cycle.
3. Improve the sensitivity analysis by including an assessment of the risks associated with the tax reform.
4. Ensure transparency and improve voluntary compliance by clearly communicating changes to the tax system.
5. Carry out in-depth expenditure reviews to further strengthen the efficiency of government spending.
6. Develop and implement reform measures to improve the capacity of the health care system to respond to demographic changes without increasing the budget deficit.
7. Improve fiscal risk management by supplementing qualitative assessments with quantitative estimates of potential impacts, incl. commitments that are not adequately reflected in budget planning documents.
8. Implement proposed measures to improve the management of state- and municipality-owned enterprises.

2 MACROECONOMIC OUTLOOK AND OUTPUT GAP

⁶According to the MoU⁷, the Council has assumed the responsibility of endorsing MoF's macroeconomic forecast. An early review and endorsement of the MoF's macroeconomic projections by the Council has been agreed upon to support the Government in the preparation of two annual documents – the SP and the MTBF. Most recently, the Council endorsed MoF's macroeconomic forecast on 4 August 2017. The full endorsement text is available in Annex 2. The Council assessed the forecast as a whole, and provides an endorsement of the key macroeconomic indicators (see Table 2.1).

	2017	2018	2019	2020
Real GDP growth	3.7	3.4	3.2	3.2
Nominal GDP growth	6.6	6.3	5.7	5.6
Inflation	2.8	2.8	2.4	2.1
GDP deflator	2.8	2.8	2.4	2.3
Potential GDP growth	2.8	3.0	3.0	3.0
Output gap	0.0	0.3	0.5	0.8

Table 2.1 Macroeconomic forecast indicators endorsed by the Council in August 2017, %.

Medium-term growth targets are not in line with actual forecasts. In August, the Council endorsed the macroeconomic forecast for 2017-2020, including the potential GDP growth forecast. The forecasted annual potential GDP growth rate for 2018-2020 is 3%. However, official medium-term budget planning documents still refer to a 5% potential annual growth target in the medium term⁸.

The Council invites the MoF to revise potential the GDP growth forecast for 2021-2024. While

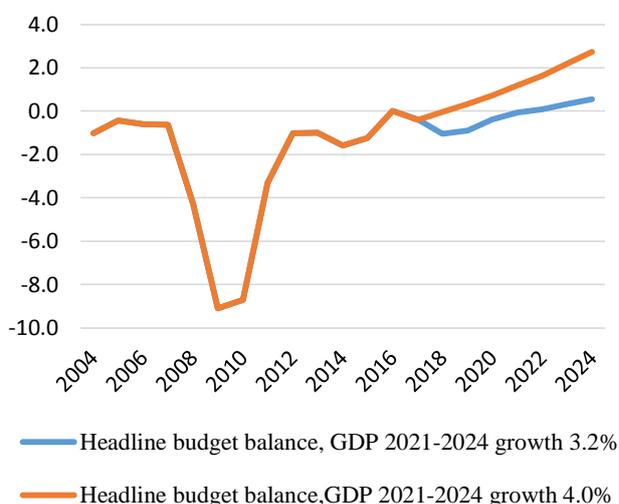


Chart 2.1. Budget balance forecasts 2021-2024, % of GDP.

Source: Council calculations

the official forecast for annual potential GDP growth for 2021-2024 is 3%, the Council believes that the current structure of the economy is not conducive to sustainable long-term growth at 3%. It is likely that potential growth will gradually fall further below 3%.

Current growth forecasts indicate a positive output gap from 2018 onwards. While the most recent MoF medium-term forecast suggests that there is no output gap in 2017, there are signs of overheating. From 2018 onwards the economy will grow above its potential, thus creating an output gap. Consequently, even a real growth rate of 3.2% will require the government to approve more ambitious headline balance targets with smaller deficits and even

⁶ This part of the report has been prepared in cooperation with specialists from "Ernst&Young Baltic", in accordance with the agreement, available at: http://fdp.gov.lv/files/uploaded/FDP_1_15_1427_20170915_FDP2017_3_Ligums_makro.pdf, accessed on 15/09/2017.

⁷Memorandum of Understanding. Available: http://fiscalcouncil.lv/files/uploaded/FDP_1_09_969_20160729_MoU_FDC_MoF_consolidated.pdf, accessed on 15.09.2017.

⁸ See Informative report "Par makroekonomisko rādītāju, ieņēmumu un vispārējās valdības budžeta bilances prognozēm 2018.-2020.gadā." Available: <http://tap.mk.gov.lv/lv/mk/tap/?pid=40434652&mode=mk&date=2017-08-22>, accessed on 03.10.2017.

surplus for 2023-2024 (Chart 2.1).

Raising potential output requires bold reform measures. The prospect of converging to EU average levels is hampered by a declining workforce and skill mismatch in the labour market. Radical reform measures are necessary to ensure a skilled and competitive labour force, boost productivity and ensure long-term economic growth prospects in a sustainable manner.

Key domestic risks are related to pressure in the labour market and excessive wage growth. In 2016, the unemployment rate reached 9.6%, the lowest level since 2008. Economic growth is accelerating, but negative demographic trends continue, thus limiting the availability of labour. This will likely create further pressure on wage growth as businesses compete over qualified professionals. The average monthly salary increased from EUR 772 in the 3rd quarter of 2014 to EUR 927 in the 2nd quarter of 2017 (Chart 2.2 and Chart 2.3).

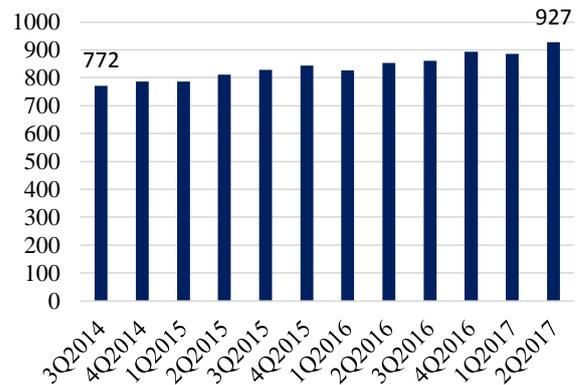
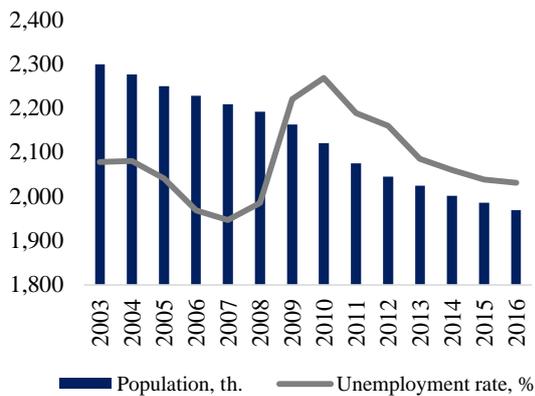


Chart 2.2 Population and unemployment rate 2003-2016. Source: CSB

Chart 2.3 Gross average salary, Q3/2014 – Q2/2017. Source: CSB

The Council underlines the growing productivity gap, which may exacerbate economic overheating. According to a recent report from the OECD⁹, productivity growth in Latvia has slowed down in recent years. There are several potential reasons for this, including the shadow economy, participation in global value chains concentrated on low value-added activities and persistent emigration. If the pace of productivity growth and output growth continue to trail wage growth, the productivity gap will increase.

Backloading of EU-funded projects may have adverse effects on quality, volume and their contribution to raising economic potential. The Latvian economy has been slow in absorbing the EU funds made available during the current planning period. While the pace of absorption is above the average EU level, there are several challenges. The disbursement of most of the funds during the final years of the programme may affect the quality of investments, and, coupled with difficulties in attracting qualified labour, will put pressure on the ability of industries to develop and implement quality projects.

Projects supported with EU funds should be carefully reviewed to minimise inefficient investment. The Council has previously pointed at potential problems with the absorption of EU funds. Furthermore, care should be taken to ensure that EU funds are invested in projects that can stimulate the growth potential of Latvia's economy. Long-term demographic trends and regional development prospects should be borne in mind when making decisions to avoid wasteful investments.

⁹ OECD Economic surveys: Latvia 2017, http://www.oecd-ilibrary.org/economics/oecd-economic-surveys-latvia-2017_eco_surveys-lva-2017-en, accessed on 04/10/2017.

Sensitivity analysis should allow the government to better plan for the effects of a downturn. The Council has previously recommended that the MoF develop a sensitivity analysis that considers a broader set of economic indicators . This tool would allow the Government to gain a more complete understanding of potential shocks and the measures required to absorb them without placing undue stress on public finances. This is especially crucial for managing the effect of the cyclical downturn that will follow the current period of rapid economic growth.

Recommendations

1. Implement well-targeted reform measures to address skill-mismatch and low productivity growth, thus ensuring long-term growth prospects.
2. Reassess potential output forecasts and develop more in-depth analyses of potential growth to ensure prudent fiscal planning beyond the horizon period of MTBF 2018/20.

3 ASSESSMENT OF COMPLIANCE WITH NUMERICAL FISCAL RULES

According to Section 28, Part 1 of the FDL, the Council has the responsibility (i) to verify the application of the numerical fiscal rules stipulated by the FDL in the preparation of the draft laws of the SB and the MTBF, (ii) to assess the impact of the amendments thereto and also (iii) to verify rules after the budget has been executed (so called – ex post assessment). The Council has performed an assessment of fiscal rules based on the data received from the MoF on 15 August 2017.

The objective of the fiscal rules is to establish expenditure ceilings for the central government at a level that would take into account certain conditions (e.g. the economic cycle, natural changes in recipients, one-off measures), with the achievement of the MTO in mind.

3.1 Ex-post assessment of compliance with fiscal rules 2013-2016

The assessment of fiscal rules for previous periods allows one to judge (i) the ability of the Government to observe the requirements of the FDL, such as a structural balance of -0.5% of GDP, (ii) the ability of the Government to achieve fiscal targets defined in the annual state budget and MTBF laws and (iii) assess the quality of the planning and execution of fiscal policy, including the preparation and approval of macroeconomic forecasts.

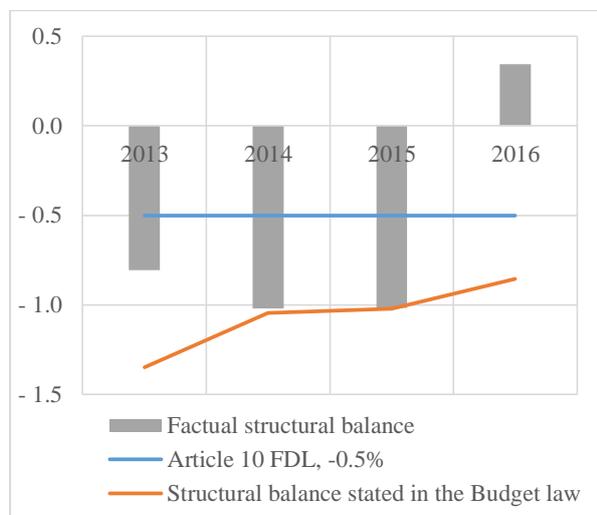


Chart 3.1. Structural balance level and medium-term objective. Source: MoF.

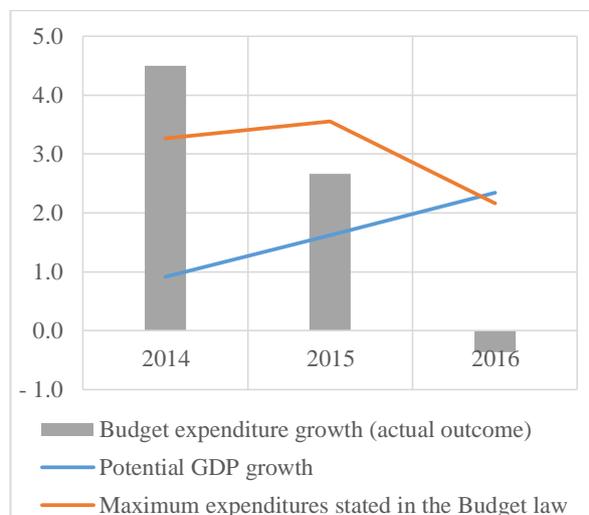


Chart 3.2. Government expenditures and economic growth comparison, y-t-y, %. Source: Council calculations.

In 2013-2015, the Government prepared and passed state budgets that did not achieve the MTO stipulated by the FDL (Chart 3.1). Departures from the MTO arise from the fact that the Government consistently uses all the permitted deviations¹⁰. Concurrently, the positive trend of setting ever-stricter structural balance targets should also be noted, even though the targets were below the -0.5% of GDP requirement of the FDL. The exception, both in Latvia and elsewhere in Europe, was 2016, which significantly improved the Government's fiscal discipline outturn.

¹⁰ Latvia is eligible for the pension reform clause. The allowed deviation from the MTO represents a sum of costs incurred by the three consecutive reform steps with each step leading to a deviation lasting for three years. The allowed deviation amounts to 0.5% of GDP in 2013-14, 0.8% in 2015, 0.6% in 2016-17 and 0.3% in 2018. Latvia is also eligible for an additional deviation of 0.1% of GDP in 2017 and 0.4% of GDP in 2018 under the healthcare reform clause.

The pace of expenditure growth outstripped the growth of Latvia's economic potential¹¹. The discrepancy between the growth rates is mainly due to the fact that fiscal rule calculations exclude several Government expenditure items that are not directly affected by Government current decisions, such as public debt interest expenditure, EU funds, nationally-financed investment fluctuations and unemployment benefit fluctuations. In 2016, the execution of expenditure plans was better than planned, which meant that, for the first time, total expenditure grew slower than economic potential (Chart 3.2).

Section 11 of the FDL stipulates that, starting in 2013, the MoF shall annually calculate the difference between the actual structural balance of the general government budget and the minimum planned structural balance of the general government budget. As this contradicts the requirement to assess all fiscal rules at the state of budget formulation when the strictest structural balance objective has been evaluated by all fiscal rules assessment methods outlined in the FDL, thus all fiscal rules should be also used during the budget execution and ex post assessment.

The Council concludes that, according to the balance and expenditure growth rules, correction of the structural balance is not necessary for the coming years (Chart 3.3). The 2016 outcome had a positive impact in cases for both fiscal rules. In the case of the expenditure rule, 2014 and 2015 saw negative deviations (i.e. expenditures were higher than planned), but these deviations were compensated in 2016.

In order to increase the transparency of execution results (e.g. estimate the impact of forecasting errors), the Council performed additional calculations for both rules. A significant and variable component of the structural balance rule is the assessment of the business cycle. Depending on whether the economy is growing above or below its potential, a stricter or looser structural balance is required. Revisions to the assessment of budget execution results were largely due to the re-assessment of the business cycle, carried out in the spring of 2016. This means that the assessment of the business cycle for 2013-2015 was the main reason behind the revisions of the execution assessment, rather than a more responsible approach to fiscal policy (blue bar in Chart 3.4, improvement in budget balance).

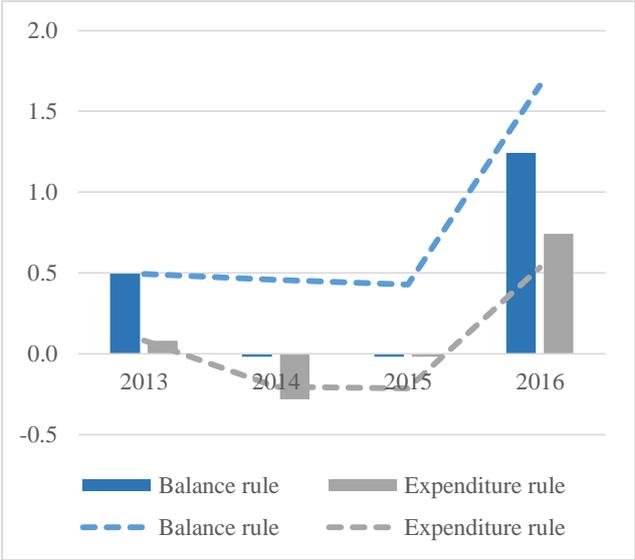


Chart 3.3. Ex post balance rule and expenditure rule, % of GDP. Source: Council calculations

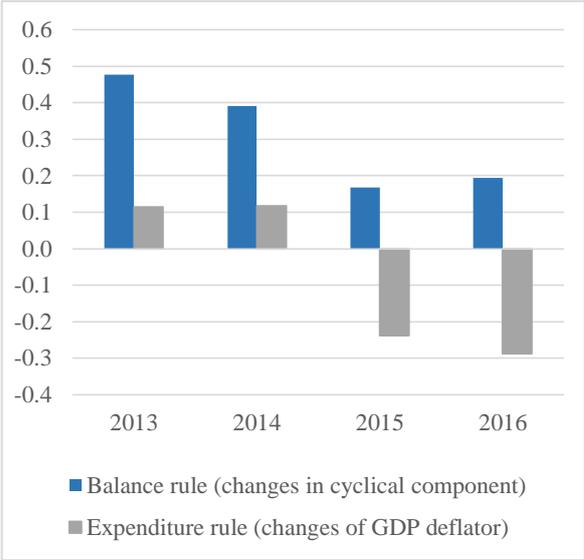


Chart 3.4. Forecasts impact on budget balance performance assessment, % of GDP. Source: Council calculations

¹¹ Calculations done in constant prices, as potential GDP growth is also evaluated in constant prices. Calculations available in Annex 4 of this report (MS Excel format).

In the case of the expenditure rule, GDP deflator (MTBFL 2016/18) has been underestimated for 2013-2014 and overestimated for 2015-2016 (Table 3.1). GDP deflator outcome (MTBFL 2018/20) improved budget balance around 0.1% of GDP for 2013-2014, but for 2015-2016 the impact was more negative (expenditures more tight) in comparison to the previous plans (grey bar in Chart 3.4). It should be noted that the revised GDP deflators for 2013 and 2014 are mainly due to methodological corrections, rather than forecasting errors. However, the same cannot be said for 2015 and 2016.

	2012	2013	2014	2015	2016
GDP deflator MTBFL 2016/18	3.6	1.1	1.2	1.1	2.1
GDP deflator MTBFL 2018/20	3.6	1.5	1.6	0.4	0.7
Changes since MTBFL 2016/18	0	-0.4	-0.4	0.7	1.4

Table 3.1. GDP deflator changes, Source: MoF.

In summary, the above ex post assessment allows one to conclude that macroeconomic forecasts and the quality of statistical data has substantial impact in evaluating budget execution results and comparing to fiscal plans.

Recommendation

1. The Council reiterates its request that the MoF perform a retrospective assessment of all fiscal rules (as outlined in Section 11 of the FDL) since benchmark year of 2013.

3.2 Ex-ante assessment of compliance with fiscal rules for MTBF 2018/20

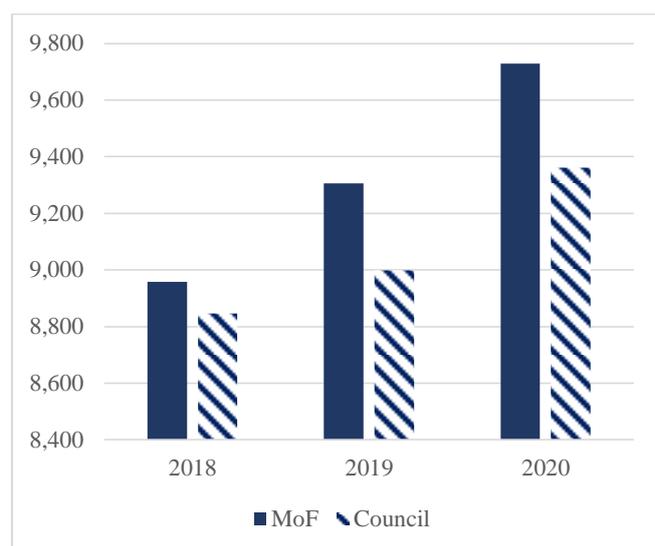


Chart 3.5. State budget expenditure according to the strictest rule applied, million euro. Source: MoF and Council.

The Council performed independent assessment of fiscal rules for 2018-2020¹². The preliminary results of the assessment were discussed in the Council meeting on 4 September and confirmed at the Council meeting on 4 October.

The Council noted the MoFs main suggestions regarding deviations from the MTO and made the following decisions:

- (1) **to accept the pension reform deviation** (0.3 of GDP) in 2018. The Council contends that this deviation from the MTO is in compliance with Section 5 of Regulation (EC) 1175/2011¹³;
- (2) **to decline support for the health care reform deviation** (0.1% of GDP in 2017, 0.4% of GDP in 2018 and 0.5% of GDP in 2019). The Council has not received reform plans for the coming years

¹² On 15 August 2017 Council received initial fiscal rules assessment from the MoF.

¹³ Regulation (EC) 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 13/09/2017.

from the Ministry of Health, outcome indicators for 2017 and a monitoring framework has yet to be developed. The Council contends that the deviation does not violate Section 5 of Regulation (EC) 1175/2011, but it does not comply with the principles of the FDL;

- (3) **to decline support for the inclusion of discretionary measures (the tax reform) in expenditure rule calculations in their current form.** The Council contends that the justification provided by the MoF (discretionary measures increase fiscal space because of their one-off effect) is insufficient. In the Council's assessment, expenditure rule calculations should be adjusted by more than 1% of GDP in 2019 and 0.1% of GDP in 2020. The Council insists that the MoF's method of increasing permissible expenditures is not in accordance with the methodology employed for assessing compliance with fiscal rules;
- (4) **to decline support for the Government's decision not to establish a fiscal security reserve in the amount of 0.1% of GDP for 2019.** This decision violates Section 17, Part 2 of the FDL.

In view of the above decisions, the Council's assessment of expenditure ceilings (maximum permissible expenditure) differs from the MoF's calculations. The difference is 113.4 million euro in 2018, 337.6 million euro in 2019 and 369.0 million euro in 2020. After performing the calculations necessary for assessing compliance with fiscal rules, the MoF concludes that the Government's maximum permissible expenditures are 8 929.8 million euro for 2018, 9 306.0 million euro for 2019 and 9 697.0 million euro for 2020.

In the assessment of the balance rule, the main difference is due to the health care reform deviation. In the case of the expenditure rule, in addition to the health care reform deviation, the Council does not agree with the calculation of the impact of discretionary measures, i.e. the tax reform.

Much like the ex-post assessment for 2013-2016, the Council has assessed how future plans compare to the structural balance target stipulated by the FDL (Chart 3.6) and how expenditure growth compares to potential GDP growth (Chart 3.7). Unfortunately, medium-term structural balance targets do not meet FDL requirements and in 2017 expenditure growth has been estimated faster than the pace of economic growth, nevertheless in 2018-2020 expenditure growth is below the potential GDP growth.

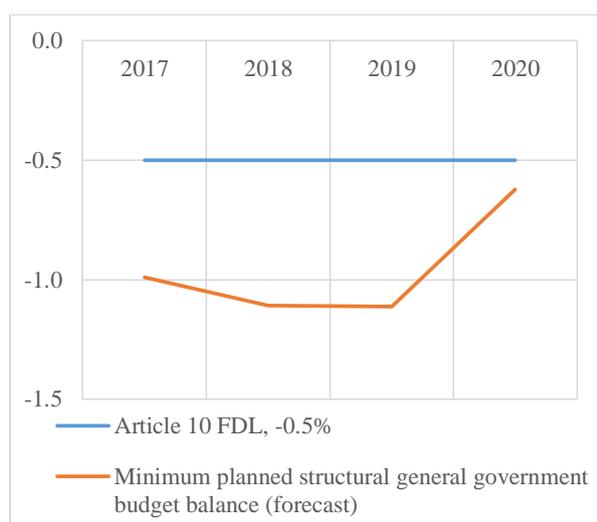


Chart 3.6. Structural balance level and medium-term objective, % of GDP. Source: MoF.

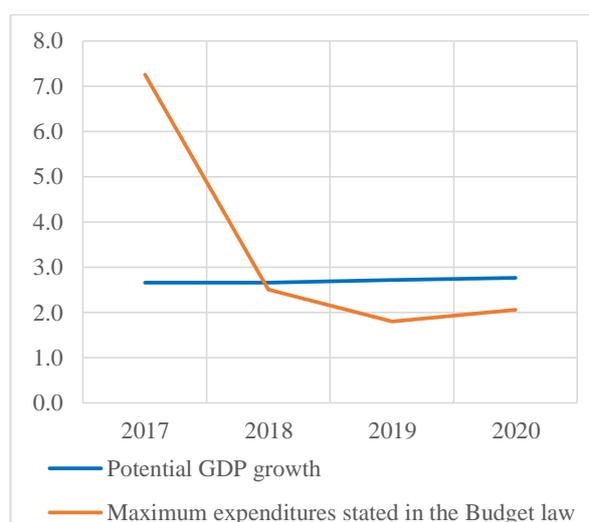


Chart 3.7. Government expenditures and economic growth comparison, y-t-y %. Source: Council.

The expenditure rule calculated by the MoF allows to increase spending in 2019, the Council's calculations shows that there is no substantial gap among the applicable and real adjusted expenditure growth in all years 2018-2020. Adjusted expenditures are obtained by netting out from the government expenditure all items that are not in the government direct decision (Chart 3.8 and Chart 3.9).

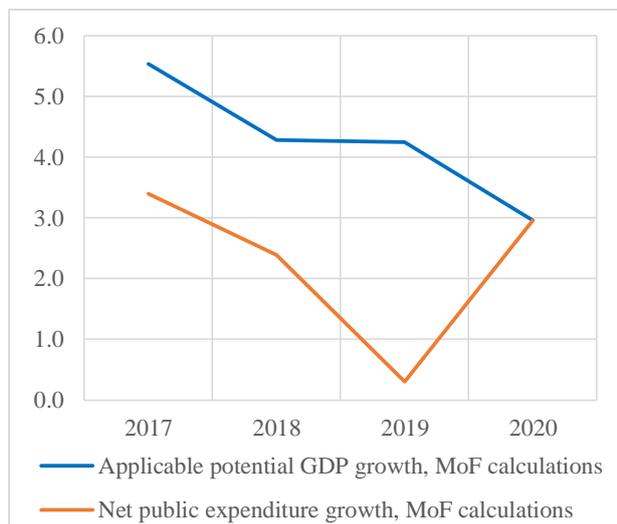


Chart 3.8. Government adjusted expenditures and economic growth comparison, %. Source: MoF calculations.

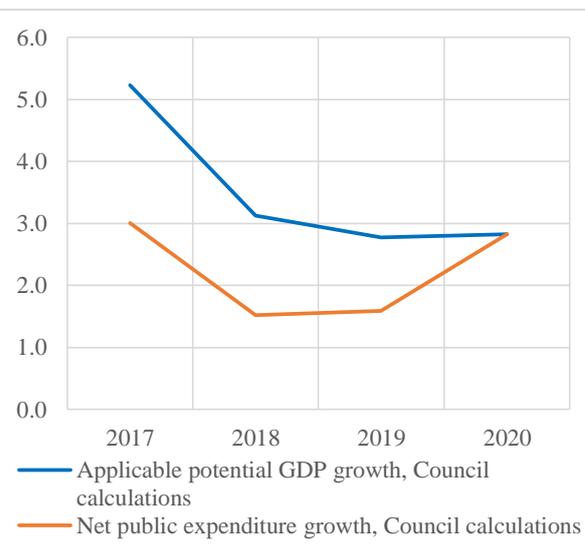


Chart 3.9. Government adjusted expenditures and economic growth comparison, %. Source: Council calculations

Table 3.2. summarises the differences between the Council's and MoF's calculations, including the substantial deviation in structural balance assessment (a difference of 0.4% of GDP in 2018, 1.0% of GDP in 2019 and 1.2% of GDP in 2020).

	2017	2018	2019	2020
General government structural budget deficit (-) / surplus (+), % of GDP				
MTBFL 2015/17	-0.8	x	x	x
SP 2015/18	-0.9	-1.2	x	x
MTBFL 2016/18	-1.0	-0.8	x	x
SP 2016/19	-1.05	-1.2	-0.8	x
MTBFL 2017/19	-1.0	-1.1	-1.0	x
SP 2017/20	x	-1.0	-1.0	-0.5
MTBFL 2018/20	x	-1.2	-0.6	-0.4
<i>Council</i>	<i>x</i>	<i>-0.8</i>	<i>0.4</i>	<i>0.8</i>
<i>Deviation among the MoF and the Council</i>	<i>x</i>	<i>-0.4</i>	<i>-1.0</i>	<i>-1.2</i>
Central government budget expenditure ceiling, in millions euro				
MTBFL 2015/17	7 930.8	x	x	x
SP 2015/18	8 025.8	8 480.5	x	x
MTBFL 2016/18	8 243.8	8 749.5	x	x
SP 2016/19	8 240.9	8 767.0	8 844.8	x
MTBFL 2017/19	8 328.4	8 807.7	9 001.6	x
SP 2017/20	x	8 960.5	9 276.3	9 446.5
MTBFL 2018/20	x	8 929.8	9 306.0	9 697.0
<i>Council</i>	<i>x</i>	<i>8 816.3</i>	<i>8 968.4</i>	<i>9 328.0</i>
<i>Deviation among the MoF and the Council</i>	<i>x</i>	<i>-113.4</i>	<i>-337.6</i>	<i>-369.0</i>

Table 3.2 General government budget structural balance and central government budget expenditure ceiling in accordance with the fiscal rules assessment.

The MoF's bottom-up calculations (see Table 3.3) suggest that health reform deviation and also other political initiatives have been already included into the government expenditures. In comparison with

spring this year (since SP2017/20) expenditures for 2018-2020 have been increased significantly and thus to worsen the budget balance for all years.

	2017	2018	2019	2020
General government headline budget deficit (-) / surplus (+)				
MTBFL 2015/17	0.4	x	x	x
SP 2015/18	-0.2	0.2	x	x
MTBFL 2016/18	-0.71	0.3	x	x
SP 2016/19	-0.75	-0.2	0.8	x
MTBFL 2017/19	-1.0	-0.6	0.2	x
SP 2017/20	x	-0.3	0.3	0.8
MTBFL 2018/20	x	-0.9	-0.8	-0.2
<i>Change since SP 2017/20</i>	<i>x</i>	<i>-0.6</i>	<i>-1.1</i>	<i>-1.0</i>
Basic budget deficit (-) / surplus (+)				
MTBFL 2015/17	-1.3	x	x	x
SP 2015/18	-1.7	-0.2	x	x
MTBFL 2016/18	-1.7	0.2	x	x
SP 2016/19	-1.0	0.4	0.9	x
MTBFL 2017/19	-1.1	0.4	0.4	x
SP 2017/20	x	-0.1	0.2	1.1
MTBFL 2018/20	x	-1.1	-0.9	-0.0
<i>Change since SP 2017/20</i>	<i>x</i>	<i>-1.0</i>	<i>-1.1</i>	<i>-1.1</i>

Table 3.3 General government and basic budget headline balance, % of GDP (by bottom-up approach)

Recommendation

1. In view of the differences in the application of fiscal rules in the MTBF 2018/2020, the Council contends that Section 15 of the FDL, which stipulates that fiscal rules should be observed when calculating maximum permissible government expenditures, has been violated. Consequently, the Council urges the Government to reduce expenditure ceilings for 2018 for 113.4 million euro, for 2019 for 337.6 million euro and for 2020 for 369.0 million euro until the recalculation of fiscal rules.

3.3 Government Debt 2013-2020

The Section 14 of the FDL establishes the fiscal rule for government debt, which may not exceed 60% of GDP. There are no separate provisions for conducting fiscal policies in conditions where government debt is approaching or exceeding this specified level.

	2013	2014	2015	2016
Initial MTBF	44.0*	40.0	35.0	40.0
Actual outcome	39.0	40.9	36.5	40.1
<i>Deviation</i>	<i>+5</i>	<i>-0.9</i>	<i>-1.5</i>	<i>-0.1</i>
<i>Cumulative deviation</i>	<i>+5</i>	<i>+4.1</i>	<i>+2.6</i>	<i>+2.5</i>

Table 3.4. Debt level ex post assessment, % of GDP. Source: Eurostat, MoF

* Here MTBF 2014/16

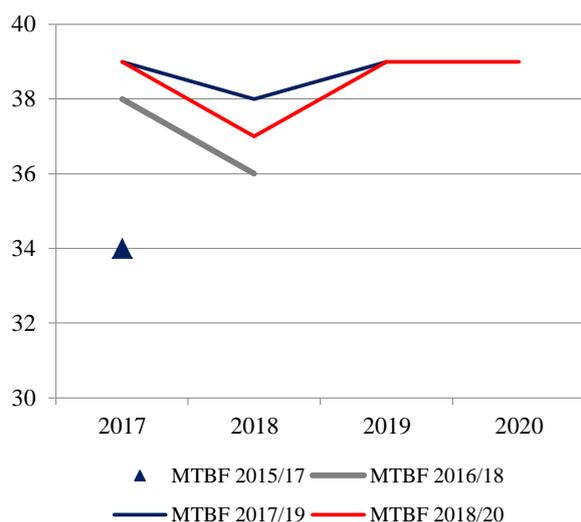


Chart 3.10. General government debt forecasts, % of GDP, Source: Treasury.

The Council would like to see the debt levels decreasing faster during the period of faster economic growth and in the view of cyclical nature of the economic development of the market economy.

Recommendation

1. Strong government commitment, evidenced by specific plans to bring down the level of the public debt and taking into account the current phase of the economic cycle, is required. Plans need to include a more aggressive reduction of budget deficits and borrowing for the purposes of investment activities, by accommodating investment and financing activities in the MTBF.

	2017	2018	2019	2020
MTBF 2015/17	34	x	x	x
MTBF 2016/18	38	36	x	x
MTBF 2017/19	39	38	39	x
MTBF 2018/20	39	37	39	39
Change since MTBF 2017/19	+/-0	+1	+/-0	x

Table 3.5. Debt to GDP forecast changes. Source: Treasury.