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FISCAL DISCIPLINE SURVEILLANCE INTERIM REPORT

ON LATVIA'S STABILITY PROGRAMME FOR 2018-2021

Riga, 2018

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EXECUTIVE SUMMARY

The proposed Latvia's Stability Program (SP) for 2018-2021 shows that the Government continues to implement responsible fiscal policy and in general respects the requirements of fiscal discipline. It provides both nominal and structural balance improvements from 2019 as compared to previous plans. SP requires to create a fiscal safety reserve in line with the minimum requirements of the FDL, although it is necessary to approve the reserve for all years of the medium-term budgetary framework law (MTBFL) to eliminate the FDL violation.

Meanwhile, the Council highlights a significant expansion of the fiscal policy plans compared to 2015 and 2016, which is not in line with the current favorable economic conditions and facilitates pro-cyclical directions. Plans should be made for a more effective reduction of sovereign debt against GDP, where currently the planning documents for the longer-term continuously aims to be revised upwards of the debt-to-GDP ratio.

The tax reform in 2018 and 2019 does not strengthen the revenue side of the state budget and departs from the government's target of 1/3 of tax-to-GDP. Strong economic growth undermines the negative effects of the tax reform, but in the medium term, the issue of revenues level will become more and more relevant with the decreasing share of EU funds. The upturn in the economic cycle also leads to a more critical assessment of the shadow economy reduction pace.

The Council underlines the Government's practice of redistributing savings to budget items used to determine the maximum amount of budget expenditure as stated by the FDL. In 2017, the Council issued six irregularity reports, with a total impact of 44.9 million euro and in 2018 – one irregularity report. Such redistribution without revision of spending ceilings violates FDL requirements. In addition, measures for the development of the electricity market worsened the budget balance by 140 million euro. Actual outcome of the structural balance for 2017 is estimated at -0.7% of GDP – better than approved in the budget law, but below the FDL ceiling of -0.5% of GDP.

The Council has reviewed the negative opinion on the additional deviation from the government's balance objective for the implementation of the health reform. The Council refrains from evaluating the quality of the content of the reform, but positively evaluates the performance indicators included in the Ministry of Health's progress reports.

The Council points to the need to improve the assessment of fiscal risks. Public-private partnership (PPP) projects, state and municipal owned enterprises and financial system risks need to be quantified and taken into account in determining the amount of fiscal risk safety reserve. An in-depth analysis of fiscal risks facilitates the development and implementation of an effective risk management strategy.

The Council points to a negative fiscal space in the calculation of SP in 2019 and 2020. Taking into account the Government's commitments not to increase the tax burden in the coming years at the time of the adoption of the tax reform, the Government will have at its disposal limited instruments for balancing MTBF.

The counter-cyclical fiscal policy is a guarantee of stable economic growth in the future. The Council agrees with the MoF forecasts that, at present, Latvia's economy is growing faster than potential and is in the upswing phase, based on high confidence indicators and employment, which also exerts pressure on rising wage inflation expectations. These conditions indicate that changes in the economy are not so much linked to structural change, but are cyclical in nature when considering and implementing fiscal policies.

The Council considers that further analysis is needed on the developments of the public sector and the adjustment of public service scope in line with long-term demographic projections. In the short term, it would be useful to reduce the number of employees in the public sector, especially in a situation where the labor market is in the good condition for worker migration to the private sector. Relevant strategies should also be reflected in the long-term fiscal framework.

The Council notes a significant improvement in the macroeconomic scenario and its sensitivity analysis compared to the SP reports of previous years. First, it presents the changes in the GDP growth in each of the scenarios at the level of GDP components and it provides the forecast on the tax and other revenues by the type of tax/income. Secondly, it shows the effect on the government budget deficit and debt, if risks emerge. Finally, it includes both the forecast in absolute terms and in comparison to the base line scenario.

The Council invites the Government to use the updated fiscal and potential GDP estimates for the assessment of budget implementation and to adjust the maximum amount of budget expenditure in line with the requirements for ex post fiscal assessment set out in Directive 2011/85 / EU.

The Council considers it necessary to establish the implementation mechanism to the debt rule, despite the fact that in the near future there is no direct risk of violating the 60% of GDP debt level. There is a risk that interest payments will increase in the medium term.

ABBREVIATIONS

JSC	joint stock company
BoL	Bank of Latvia
Council	Fiscal Discipline Council
EC	European Commission
ESA	European system of accounts
EU	European Union
FDL	Fiscal discipline law
Surveillance report	Fiscal Discipline Surveillance Report 2017
MoF	Ministry of Finance
MoU	Memorandum of Understanding
MTBF	Medium term budget framework
MTBFL 2018/20	Medium term budget framework law for 2018-2020
MTO	medium term objective
GDP	Gross domestic product
-	Not applicable / not available
OECD	Organization for Economic Cooperation and Development
PIT	Personal income tax
PPP	Public-private partnership
SGP	Stability and growth pact
SP	Latvia's Stability Programme
SP 2018/21	Latvia's Stability Programme for 2018-2021
SRS	State revenue service
VAT	Value added tax

MANDATE OF THE COUNCIL

According to the FDL (FDL Chapter III Fiscal Discipline Surveillance) 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 annual state budget law 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 surveillance report on fiscal discipline and, if necessary, a non-conformity 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;
- endorsing the MoF macroeconomic forecasts twice a year – while preparing the SP, and the annual state budget and while preparing the MTBF (according to the Memorandum of Understanding (hereafter – MoU)[1], signed on 8 February 2016);
- preparing interim report (opinion) on SP (according to the MoU);
- assessing and analysing the sustainability of fiscal policy for the purposes of preparing the reports stipulated by the FDL.

[1] Memorandum of Understanding, available: *http://fiscalcouncil.lv/files/uploaded/FDP_1_09_281_20160208_MoU_FDC_MoF.pdf*, accessed on: 17/03/2018

1 FISCAL POLICY CHALLENGES

1.1 FISCAL STANCE

FDL violation
The decision not to create a fiscal reserve for 2019 in the MTBFL for 2018-2020 is a violation of FDL. The second paragraph of Article 17 of the FDL establishes a requirement to create a fiscal safety reserve for MTBFL of at least 0.1% of GDP.
Recommendation
The Council strongly recommends that the Government comes up with a comprehensive plan leading to achieving the tax revenue collection target at the level of 1/3 of GDP by 2020.

The Council welcomes the SP 2018/21 including the fiscal safety reserve for 2019 as part of the fiscal framework for 2019-2021. The SP 2018/21 includes fiscal safery reserve in the amount of 0.1% of GDP for 2019-2021 and the Council agrees that this is adequate taking into account currently estimated fiscal risks, while further assessment may indicate higher provision necessary for this purpose. Meanwhile, the SP 2018/21 does not yet ammend the MTBFL 2018/20, which has not established fiscal reserve as part of the fiscal framework.

In 2017 the consolidated government budget balance was better than planned, i.e. instead of 301.4 mln. euro the year ended with 221.7 mln. euro budget deficit (see Table 1.1 below). However, other Government decisions on the reduction of liabilities of Riga's thermoelectric stations TEC-1 and TEC-2 in relation to the government support of cogeneration electricy production against one-off compensation would cause substantial deterioration in the general government balance according to the methodology of European System of Accounts for 2017. Government government budget balance was worsened by a series of decisions on the re-distribution of savings in some items of the budget (see Chapter 1.2 "Increasing irregularity reports").

	2013	2014	2015	2016	2017
Consolidated government budget balance (estimate at the moment of the state budget approval)	-160.0	-175.2	-286.6	-341.9	-301.4
Consolidated government budget balance (actual)	-127.6	-397.3	-373.5	-100.3	-221.7
from these					
Special budget balance (estimate at the moment of the state budget approval)	-56.3	132.4	162.9	104.6	65.3
Special budget balance (actual)	-57.9	100.4	91.1	47.8	113.8
Consolidated local government budget balance (estimate at the moment of the state budget approval)	-27.1	-22.3	-55.4	-52.7	0.0
Consolidated local government budget balance (plan in January of the appropriate year budget)	*-135.4*	*-181.0*	*-124.3*	*-119.9*	*-209.7*
Consolidated local government budget balance (actual)	-119.3	-85.0	-26.2	57.4	-14.4

Table 1.1. Budget plan outcomes 2013-2017, million euro (cash basis). Source: MoF and Treasury.

The local government consolidated budget balance was comparatively slightly worse than estimated by the MoF at the time of approval of the state budget, with a year ending at 14.4 million euro deficit, rather than the balance, as planned. In the planning of municipal budgets, it is possible to observe so called *years' beginning syndrom*, which for the period under review (2013-2017), without exception, is projected to be considerably weaker than it concludes by fact. Other general government budgets (for the state budget, the budgets of the derived institutions) do not have such planning fluctuations.

SP provides estimates that the local government consolidated budget balance in 2018 may reach 18.3 million euro deficit in comparison with projected at MTBF 2018/20 as 31.6 million euro

surplus. The compilation of the local government monthly data by the Treasury indicates (see Table 1.2 below) significant increase in the borrowing plans for 2018. The Council expects that the mechanisms governing the local government borrowing will not cause a significant deterioration of the fiscal balance, despite potential increases in local government borrowing in the near term.

Year	***Consolidated local government budget, yearly borrowing estimates***		***Changes***
	reported at the end of January	***reported at the end of February***	
2017	86.0	124.5	*38.5*
2018	159.3	222.0	*62.7*
Changes	*73.3*	*97.5*	*24.2*

Table 1.2. Local governments's borrowing estimates, million euro (cash basis). Source: Treasury.

Latvia's fiscal policy shows significant fiscal easening sharper than most other EU countries comparing changes to their primary balances. Thesepolicies are pro-cyclical despite the economy performing rather strongly (see Chapter 3 on fiscal rules). Comparing the plans for 2017-2019 with the outcomes of 2015-2016, the budget balance, unfortunately, is also becoming "loose" in the European Union as a whole (see Chart 1.1 below).

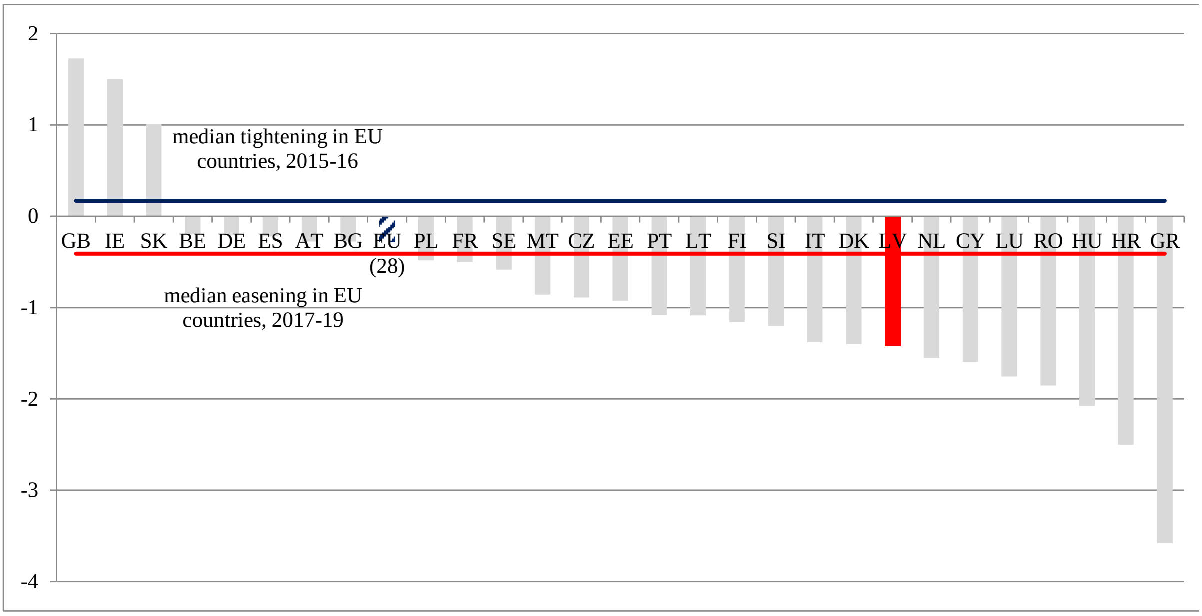

Chart 1.1 The fiscal stance in EU countries. Change between 2015 and 2019 in the underlying primary balance[2], in % of potential GDP. Source: Ameco, European Commission database.

The government should use the economic upturn to create a fiscal space through reduced debt levels for the downturn phase in the economic cycle. Previous periods also indicate a counter-cyclical effect of government fiscal discipline (see Chart 1.2 below) for 2009-2010 years, as well as particular pro-cyclical fiscal expansion in 2006-2008 years. After the entry into force of the FDL pro-cyclical fiscal expansion decreased but still remained.

The Council welcomes the 2018 priority spending reviews in real estate, information technology, apropriation changes and public servants optimisation issues, and expects the Government ensures significant efficiency improvements in these areas as fiscally, as well as legally grounded. Also in 2017, the Government continued the expenditure review and made a saving to the state budget

[2] Organisation of economic co-operation and development January 2018 macroeconomic outlook, p.47.

of 77.1 miln euro. however, the development of more substantial improvements has been postponed for some two years[3].

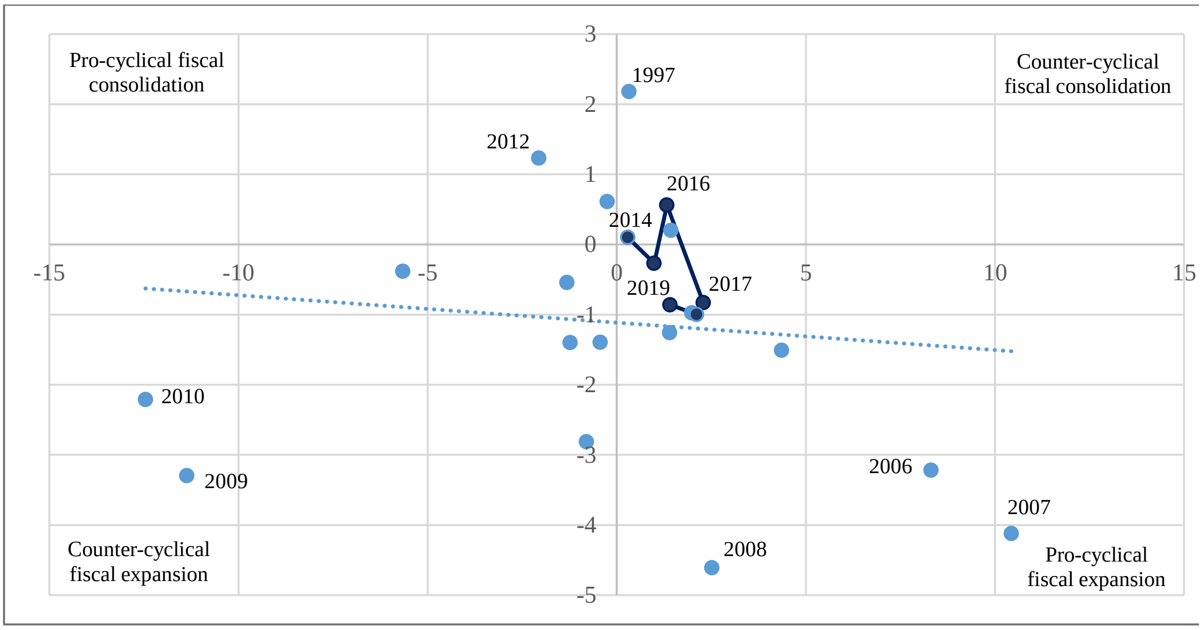

Chart 1.2 Latvia's cyclically adjusted primary balance (vertical axis) vs. the output gap (horizontal axis), in % of potential GDP[4]. Linked bullets represent years after the FDL enforcement. Source: Ameco, European Commission database.

In case of funds of unforeseen events, the increase from the appropriations in the last quarter of 2017 did not provide an opportunity for further improvements to the budget balance by 18.6 miln euro[5]. In the first version of the state budget law there was foreseen 41.0 miln euro in this program. By 2017 year's end additional remaing funds from other programms were allocated to unforeseen events totaling 68.0 mln. euro (65.8% increase).

[3] On 28 August 2017 the Cabinet of Ministers session protocol (prot. No. 41 §1). On the results of the review of the state budget expenditures for 2018, 2019 and 2020 and the proposals on the use of these results in the draft law "On Medium term budget framework for 2018, 2019 and 2020" and fulfillment of the task specified in Paragraph 15 of the draft law "On the State Budget for 2018"". Available: *http://tap.mk.gov.lv/lv/mk/tap/?pid=40445001&mode=mk&date=2018-01-23*, accessed on 14.03.2018

[4] European Fiscal Board Annual report 2017. Available: *https://ec.europa.eu/info/sites/info/files/2017_efb_annual_report_en_0.pdf*, page 53, accessed on 07.02.2018

[5] 2017 IV quarterly report about the resource allocation from funds for unforeseen events. Available: *http://fiscalcouncil.lv/quarterly-report-on-fue*, accessed on 08.03.2018

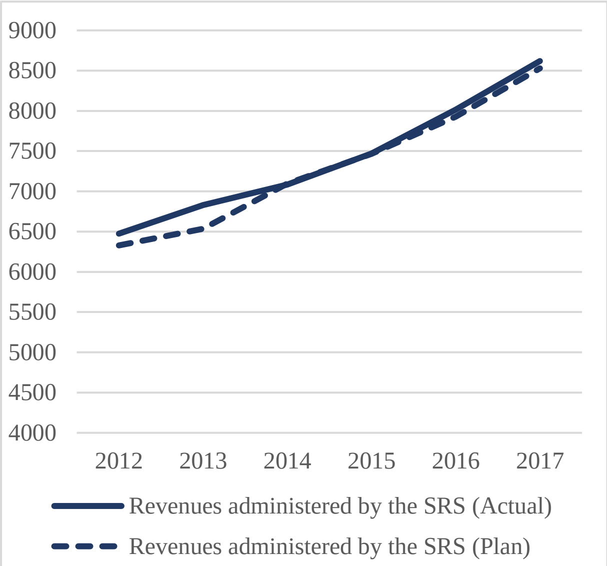

Chart 1.3. Execution of the revenue plan (mln. euro). Source: SRS

The Council commends the MoF for reliable and prudent tax and social insurance contributions revenue projections. In 2017 the tax revenues and social security contributions remained stable and slightly exceeded the estimated level, as was the case in previous periods (see Chart 1.3). Indeed, the independence of tax policy from the economic cycle could indicate its structural viability. Meanwhile, the lack of breakdown of the revenue estimates to segregate the impact of the policy changes does not contribute to high quality of assessment of the policy changes and their implementation. SP 2018/21 in details provides the fiscal impact of changes in the overall tax policy and providing estimates of the impact of tax reform measures in the medium term.

Tax reform generally has a negative impact on total tax revenues during the SP planning period, although favorable economic conditions allow a gradual increase the total tax revenues. Total tax revenues of SP 2018/21 in comparison with MTBFL 2017/19 brings slightly positive increase (see Table 1.2 below). The tax reform impact on the government fiscal balance has been assessed as slightly positive, as strong economic performance has offset negative effects and provided higher headline revenue figures. Strong economic conditions confirm that correct timing has been chosen to implement changes in the Latvian tax system, while disregard to the increasing demands on the public funds should also be noted.

Taxes and social contributions	MTBFL 2017/19	SP 2018/21	Difference, against MTBFL 2017/19 %	Difference, mln euro
Corporate income tax				
2018	461.1	222.1	-51.8	-239.0
2019	486.8	244.0	-49.9	-242.8
2020	x	384.4	x	x
Personal income tax				
2018	348.1	345.1	-0.8	-2.9
2019	367.9	328.1	-10.8	-39.8
2020	x	335.0	x	x
Value added tax				
2018	2 297.0	2 434.0	6.0	137.0
2019	2 447.5	2 633.6	7.6	186.1
2020	x	2 830.5	x	x
Excise tax				
2018	929.0	1 026.5	10.5	97.5
2019	973.8	1 101.7	13.1	127.9
2020	x	1 201.9	x	x
Lottery and gambling tax				
2018	27.0	35.5	31.5	8.5
2019	27.0	37.3	38.0	10.3
2020	x	38.4	x	x
Solidarity tax				
2018	44.1	32.0	-27.4	-12.1
2019	44.1	x	-100.0	-44.1
2020	x	x	x	x

Vehicle exploitation tax				
2018	104.5	101.4	-3.0	-3.1
2019	64.7	108.0	66.9	43.3
2020	x	113.8	x	x
Other taxes (customs, business vehicles, electricity, natural resources, subsidised electricity)				
2018	102.8	106.2	3.3	3.4
2019	101.5	106.9	5.3	5.4
2020	x	112.0	x	x
Social contributions				
2018	2 413.6	2 529.4	4.8	115.8
2019	2 552.8	2 683.4	5.1	130.6
2020	x	2 840.2		
			Total impact in 2018	**105.1**
			Total impact in 2019	**176.9**

Table 1.2. Tax reform impact. Source: MTBFL 2017/19, MTBFL 2018/20 and SP 2018/21.

The Council notes reduction in the tax revenue to GDP ratio over the horizon of the SP 2018/21 (see Chart 1.4 further). This reduction in the public financial resorces relative to GDP does not contribute to the government long-term objective of achieving tax revenues at 1/3 of GDP critically necessary for supporting important public priorities.

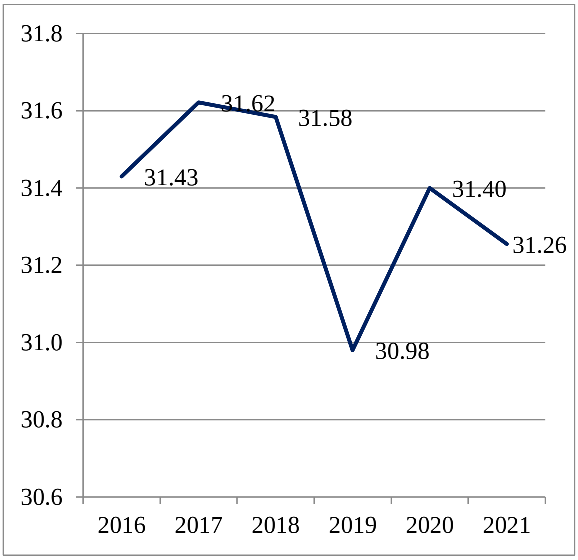

Chart 1.4. Tax revenues and social contributions to GDP, % of GDP. Source: MoF.

The tax and social contributions income to GDP will not increase in the coming years, which is a critical issue, taking into account the impact of EU grant (current and capital transfers) revenues. When assessing this reduction in external revenue and the need to replace with the local tax revenues, in order to maintain at least the previous level of public services provided, the Government needs to develop an action plan to maintain a sustainable income level.

Measures to reduce the shadow economy provide a good basis for increasing budget revenues, although they should accelerate due to the current upswing in the economic cycle[6]. Referring to the debated at the MoF's Taxpayer Forum, the current decline in the shadow economy is not sufficient for this upturn in the economic cycle. However, further improvements in tax collection will require more resorces.

1.2 Increasing number of irregularity reports

FDL violation
The Government has instituted a practice of re-distributing savings achieved in different budget appropriation categories specified in Part 1 of Article 5 of the FDL for spending on other priorities, including from categories, used in determining budget expenditure ceilings.

Unauthorized redistribution of appropriations reduces the maximum expenditure stipulated in the 2017 for 44.9 miln euro. Consequently the elimination of these expenditures would improve for

[6] MoF Taxpayer Forum 2017. A.Sauka's presentation *Neuzskaitītā ekonomika, korupcija publiskajā sektorā un noziedzīgi iegūto līdzekļu legalizācija Latvijā*. Available: *http://www.fm.gov.lv/files/files/Arnis%20Sauka_LTRK_ppt.pdf*, accessed on 09.03.2018

the corresponding amount (44.9 million euro is 0.17% of GDP) the state budget balance. On 6 September, 15 September, 20 September, 4 October, 18 October and 23 November 2017, non-conformity reports were drawn up for breach of the first paragraph of Article 5 of the FDL regarding the redistribution of appropriations from the MoF budget sub-programs "Contributions to the European Community budget" and "Government debt management". On 22 September 2017 the MoF delivered an opinion that it did not agree with the Council's interpretation, while on 4 October 2017 the Council, in its reply, maintained its views on FDL violations and the need to clarify the legal framework for appropriations in both of these budget sub-programs[7].

Consolidated government budget balance (estimate at the moment of the state budget approval)	-301.4
Consolidated government budget balance (actual)	-221.7
Impact of non-conformities reports in 2017	-44.9
Consolidated government budget balance, corrected after non-conformities	-176.8

Table 1.3. Impact of non-conformities reports on the actual outcome of the potential reduction of the budget balance. Source: Council calculations.

In 2018 the Cabinet of Ministers continues to take decisions that violate the restrictions set out in the first paragraph of Article 5 of the FDL. The Council continues to adopt non-conformities reports related to such redeployment of appropriations, which is contrary to the provisions of Chapter II of the FDL. On 30 January 2018 the Cabinet of Ministers by adopting the conceptual report "On proposals of the Cooperation Platform "Demogrāfisko lietu centrs" in support of families with children in 2018-2020"[8] allowed to reallocate funds intended for state family benefits to other priority measures proposed by "Demogrāfisko lietu centrs". The Council concludes that the decision taken on 30 January by the Cabinet of Ministers to reallocate funds from the Ministry of Welfare's family state benefits program does not comply with the FDL.

1.3 Health care

Recommendation
The Council calls for improved transparency of the additional funding for the health care and specific measures implemented specifically bringing to better health outcomes.

The action by Ministry of Health identifying progress indicators in public health[9] including reduced potentially lost years of life has allowed the Council to withdraw its objections to use deficit financing for the helath care refrorm[10]. Performance indicators show improvements in the priority areas identified by the Ministry of Health. During 2017, the number of investigated patients oncology has risen nearly by 89 thousand, the number of patients receiving reimbursable drugs for infectious diseases has increased by 400, and the waiting list in secondary ambulatory care has been reduced by 90 days, thus facilitating availability of the health care services. These indicators reflect progress in the short term, but it is equally important to assess the benefits of the deficit financing in the longrun. Longterm performance indicators are defined as the overarching goals of the "Public Health Guidelines for 2014-2020" and aim to increase the number of healthy life years of the population of Latvia and prevent premature death by preserving, improving and restoring the health of the population.

[7] Non-conformity reports and MoF reply available at Council's website: *http://fdp.gov.lv/zinojumi*, accessed on 07.02.2018

[8] 30 January 2018 the Cabinet of Ministers meeting minutes 25.§. Available: *http://tap.mk.gov.lv/mk/mksedes/saraksts/protokols/?protokols=2018-01-30*, accessed on 07.02.2018

[9] On 19 December 2017 Cabinet considered the Informative report by the Ministry of Health "On performace of the health system reform in the first half of 2017". Available here in Latvian: *http://tap.mk.gov.lv/lv/mk/tap/?pid=40443903&mode=mk&date=2017-12-19*, accessed on 29.01.2018

[10] 6 December 2017 Council decision to withdraw its objection to the use of deficit financing to implement structural reforms in health care. Available here: *http://fiscalcouncil.lv/files/uploaded/FDP_1_08_1756_20171206_viedoklis_veseliba_EN.pdf*, accessed on 29.01.2018

Deviation from the MTO allowed for additional 113.4 million euro for health care system reform for 2018, and the Ministry of Health estimaes an immediate financial benefit from the reform measures. In addition to the three priority areas outlined above, structural benefits are planned in primary health care and in the cardiovascular program. The Ministry of Health provides an assessment of the impact of each of the groups on the potential loss of life, with a total financial benefit of 35.6 million euro already in 2018, 93.3 million euro in 2019 and 186.5 million euro in 2020.

The Council welcomes the fact that the Cabinet of Ministers already in the MTBFL 2018/20 approved the financing of the continuation of health reform measures in 2020, envisaging the amount of 144 million euro in 74 budget programme "Reserve to be redistributed in the course of the annual state budget implementation"[11]. On 14 September 2017, the Cabinet of Ministers approved 144 million euro funding for the continuation of the health reform measures. Additional financial support is also the income revenues from the increase of the state social contributions rate by 1 percentage point. The increase in the rate in 2018 amounts to 85.3 million euro, in 2019 for 99.6 million euro and in 2020 for 105.5 million euro.

1.4 EMERGING FISCAL RISKS

FDL violation
The Council notes that the requirements of Article 16 of the FDL have not been met regarding specific identification and quantification of fiscal risks emerging from public-private partnerships (PPP), operations of public corporations, and the financial sector. The Fiscal Risks Statement attached to the MTBFL 2018/20 does not include an assessment of such risks as well as a probability of the risks impacting the government fiscal balance.

Public private partnerships projects fiscal risk

Information on PPP projects and their risk assessment should be publicly available and respective managers – full accountability for ensuring the interests of the government. The government should understand the possible consequences of the decisions that are taken, regarding full cost of the project within its life-cycle, and the public has the right to be informed about the efficiency and potential risks of the taxpayer's funds. The International Monetary Fund[12] and the World Bank[13] have developed recommendations on transparency for PPP projects.

The Council finds the government engagement of private partners in launching sustainable energy projects where fiscal risks exist similar to PPP. Starting from mid-2000s in line with the Government rules there has authorized a number of private sector providers to establish electrical power projects aiming at different degrees of sustanability with substantial markups committed as the projects come live. The lack of adequate monitoring and the lack of clear rules for identifying compliant projects has resulted into public complaints regarding high cost of the sustainable energy added to the regular user charges. Moreover, a number of fraud cases on the side of the private partners have been uncovered.

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[11] On 14 September 2017 Cabinet considered the Informative report "On expenditures on priority measures for the state budget for 2018 and the framework for 2018-2020". Available here in Latvian: *http://www.fm.gov.lv/files/documents/FMZino_140917.docx*, accessed on 29.01.2018

[12] IMF The Fiscal transparency code. Available: *http://blog-pfm.imf.org/files/ft-code.pdf*, accessed on 07.03.2018

[13] World Bank. Disclosure of project and contrac information in public-private partnerships, January 2013. Available: *http://documents.worldbank.org/curated/en/190901468159906133/pdf/762780WP0Box370osure0of0Project0PPP.pdf*, accessed on 07.03.2018 and World Bank A Framework for disclosure in public-private partnerships. Technical guidance for systematic, proactive pre- & post-procurement disclosure of information in public-private partnership programms. Available: *http://pubdocs.worldbank.org/en/773541448296707678/Disclosure-in-PPPs-Framework.pdf*, accessed on 07.03.2018

The steps made by the government to clarify the practices and to rule a number of private participants not compliant with the terms of the scheme cause risks of litigation and compensation payments. In addition, fiscal risks remain due to government commitments to provide subsidies to electricity providers where these subsidy schemes have proved to be very unpopular due to significant costs of electricity for consumers

In the public media, information was available (as of 11 January 2018) on four registered[14] PPP projects. The Ministry of Finance only indicates one project in the fiscal risk declaration – "Construction and management of pre-school educational establishments". It is not clear what PPP projects are registered in Latvia and what their financial impact is. It should be noted that after the exchange of letters at the beginning of 2018 with the Ministry of Finance, information from the Register of Enterprises was removed. In addition, information about the fact that in Latvia there are a total of three PPP projects and 62 concessions are also available in an international study for 2016[15], where information about Latvia was provided by Klavins Ellex (one of the leading law firms in Latvia).

Work on the development of risk quantification methodologies should start immediately, ensuring adequate risk calculation and transparency of process. In view of trends in the world and available information in Latvia, demand for PPPs, as a solution for funding important public investment, is expected to increase. It should be taken into account that the possibilities for co-financing from the European Union will decrease and there will be a desire to attract other financing. For planned PPP projects, information is available on "Ķekavas apvedceļš"[16] (Ķekava's bypass) and "Acoustic Concert Hall"[17] (published in the "Latvijas Vēstnesis"). Unclear remarks are about the management of waste in Riga[18] and the development of the Agenskalns market[19]. According to the Public-Private Partnership Association letter[20] to the Saeima of the Republic of Latvia, 60 potential PPP projects for 2012 have been identified. Consequently, it can be concluded in general that only a few successful PPP projects are needed to make this financing mechanism more widely applied with all its negative consequences.

The failure of other countries shows that the lack of attention in Latvia, which is focused on this risk, could lead to significant fiscal losses. The current available information point out the lack of transparancy and quantifiable estimates of joint PPP project commitments and hence the shortcomings of fiscal impact and risk assessment. Most countries have worked to improve the PPP strategy, accounting, risk management, etc. based on negative experiences from failures with significant fiscal impacts. Several countries have experienced many unsuccessful projects[21], including United Kingdom, Australia, France, Portugal, Croatia, Slovakia, Bulgaria, etc.

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[14] Concession, public and private partnership contracts by its type. Register of Enterprises. Available here: *http://www.ur.gov.lv/?a=1110*, accessed on 11.01.2018

[15] Global Public-Private partnership guide. Available: *http://www.cakmak.av.tr/books/Global%20Public-Private%20Partnership%20(PPP)%20Guide%202016.pdf*, accessed on 27.03.2018

[16] Information on PPP project of Ķekava's bypass available: *www.sam.gov.lv/images/modules/items/.../item_6208_Kekava_PPP_SM_VA_07.ppt* and *https://lvceli.lv/projekti/#kekavas-apavedcela-ppp-projekts*, accessed on 27.03.2018

[17] Information about the acoustic concert hall project available: *https://www.vestnesis.lv/op/2016/224.2*, accessed on 27.03.2018

[18] Rīga's municipality assesses the opportunity to apply PPP model in waste management projects. Article available: *http://abc.lv/raksts/rigas-pasvaldiba-verte-iespeju-sadzives-atkritumu-apsaimniekosana-izmantot-ppp-modeli* and *http://www.pilsetvide.lv/lv/jaunumi/jurgis-ugors-komente-ppp-modela-ieviesanu-atkritumu-apsaimniekosana-riga*, accessed on 27.03.2018

[19] Rīga's municipality have to assess the public private partnership approach for Āgenskalns's market development. Article available: *http://www.pppa.lv/statuti/jaunumi/jaunumi-latvija/agenskalna-tirgus-riga-ppp-2018,* accessed on 27.03.2018

[20] On PPP mechanism inclusion in NRP. Letter available: *http://titania.saeima.lv/livs/saeimasnotikumi.nsf/0/e186962748eeff4ac2257ab50035d9dc/$FILE/PPP%20prieksl ikumi%203_2982-11_12.pdf*, accessed on 27.03.2018

[21] Chile — Transantiago; Australia — Port Macquairie Base Hospital, La Trobe Regional Hospital, Queenslands ST Vincent's Hospital, Fiona Stanley Hospital, Sydney Cross City Tunnel, Airport Link Toll Road in Brisbane,

PPP projects are linked to increased risks due to private partnerships, erroneous cash flows, demand estimates, an inadequate distribution of risks between public and private partners and lack of knowledge of institutions. PPP projects are legally complex because of the fact that part of the regulation is on the Government side and also because of the nature of the special obligations agreements. The long contract enforcement period increases the probability that it may be affected by the economic/financial crisis and other unpredictable conditions. The private partner target will always be profit-making rather than ensuring public benefit or government functions, particularly in the face of obstacles and difficulties during the implementation of the project. International experience shows that PPP projects cost more than originally planned and are less transparent compared to traditional investments.

The average cost to the government from the PPP project, which has not succeeded, can reach 1% of GDP and, at the most extreme case, even 2% of GDP[22]. It should be take into account that, in general, governments tend to save large projects, so the state budget takes most of the risks. In several countries, PPPs have been created not because of their effectiveness but to circumvent budgetary constraints and postpone fiscal costs in the present for the provision of infrastructure services and have led the governments of several countries to low-quality and fiscally expensive projects[23].

PPP projects create an "affordability illusion" that is exacerbated when a project is found to be off-balance sheet of the central government budget. The illusion is reinforced by the postponement of present public sector expenditures and expenditure division in the longer term in the future. When the project is out of the central government's budget, there is a risk that the fiscal commitments that result from it are not adequately managed. For example, identification/accounting of central government commitments[24]. Local government PPP projects must also be equally managed. More information on PPP projects' fiscal risk is available in Annex 2.

Fiscal risks from public corporations

The fiscal risks from the operation of public coprporations are not adequately assessed at the moment. Some of these risks may have significant impact on the government balance, mostly because these are not adequately reflected in the budget appropriations or do not specifically require any authorization in the government budget plan.

The 2017 general government balance deteriorated by 140 million euro (0.5% points of GDP) against budget plans resulting from reducing the claims of JSC Latvenergo related to installed electrical capacity of cogeneration unit. On 22 September 2017 the Cabinet of Ministers by order Nr. 530 approved the conceptual report "Complex measures for the development of the electricity market",

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Melbourne city link, Melbourn East link, Sydney Lane Cove tunnel; England - Eidinburgh School Project, Carderdale Royal Hospital, Cumberland Hospital, Walsgrave Hospital, North Durham Acute Hospital, Royal Liverpool and Broadgreen Hospital, Norwich and Norfolk Hospital, Hexam PFI redemption; Isle Skye toll road redemption; London subway – Metronet and Tubelines; Croatia - Zagreb sewage project, motorway Bina Istra and Zagb-Macelj, Arena Zagreb; Slovakia – D1 motorway; France – Water Consessional; Bulgaria – Sofia Water Concession, Trackla Highway Project; Hungary – M1/M15 and M5 Highway, Place of Art; Moscow - St. Petersburg motorway part 15-58 km; Poland – A1 Toll highway project; Argentina - Water system project Buenos Aires, etc. (more detailed in Annex).

[22] IMF Staff paper, June 2016. Analyzing and managing fiscal risks – best practices. Available: *https://www.imf.org/external/np/pp/eng/2016/050416.pdf*, accessed on 07.03.2018

[23] IMF Policy paper, May 2015. Making public investment more efficient. Available: *http://www.imf.org/en/Publications/Policy-Papers/Issues/2016/12/31/Making-Public-Investment-More-Efficient-PP4959*, accessed on 07.03.2018

[24] European Investment Bank, November 2016. Hurdles to PPP investments. A contribution to the third pillar of the investment plan for Europe. Available: http://www.eib.org/attachments/thematic/epec_hurdles_to_ppp_investments_en.pdf, skatīts: 07.03.2018.

which foresaw a 140 mln. euro (0.5% of GDP) transaction in 2017 for waiving the guaranteed fee for the installed electrical capacity of the cogeneration unit, reducing the share capital of joint stock company Latvenergo[25].

Financial system fiscal risk

Recent events in the financial sector in Latvia show the risks related to the banking sector activities. Although at the end of 2017 we could say that the Latvian banks have done a lot in the last two years regarding the prevention of money laundering due to legislative changes and the introduction of new regulatory requirements. However, developments in the financial sector in the first half of 2018 show that this has prevented all risks from being eliminated. Increased capital and reserve requirements for banks, which mainly provide customer service to non-residents, protect the state budget and the Deposit Guarantee Fund from direct losses. However, refusals to access the international payment system and reputational risks might create real economic losses. Certainty in the risk identification, its numerical assessment and inclusion in the fiscal risks statement is an essential priority.

The Council is convinced that the FRS risk assessment of the Latvian financial sector should be intensified by being able to quantify the occurrence and probability of risks. As the "Deposit Guarantee Law", under the circumstances, provides for the availability of state budget funds to the Deposit Guarantee Fund, the FRS should be able to reflect the occurrence of such risks and its impact on the state budget resources. Since the inclusion of the Deposit Guarantee Fund in the general government sector, it should be assessed by a symmetric approach to revenue and expenditure sides. Following the restructuring of the banking sector, reducing the risks of risky counterparties, risk assessment and management should make greater use of international experience.

Debt interest cost risks

Global financial markets have a tendency to increase interest rates in the coming years from currently very low interest rates. The Council finds necessary to assess the fiscal impact of increasing interest cost within medium term to reflect the recovery of debt markets and the prospects of central banks increasing benchmark interest rates.

1.5 SUSTAINABILITY OF PUBLIC FINANCES IN LONG-TERM

Recommendation
Improve a long-term fiscal framework to improve the assessment of the fiscal policy options in long-term, including realistic workforce assessment based on demographic trends.

The Council finds demographic outlook used in the long-term projections should be reviewed. In view of the renewed demographic data of the EU, the long-term indicators of the Latvian labor market and the related derivative assumptions about the labor market structure should also be reviewed. A more accurate forecast of current trends would enable an analysis to be developed for policy options and assessment.

The SP 2018/21 does not reflect the long-term projections of the tax burden and debt assumptions. Council recommends in line with the EC guidelines[26] for long-term sustainability of public finances data

[25] 4 October 2017 Council opinion *On the fiscal impact of measures for the development of the electric energy market in 2017*. Available: *http://fiscalcouncil.lv/files/uploaded/FDP_1_08_1505_20171004_Opinion.pdf*, accessed on 08.03.2018

[26] Revised Specifications on the implementation of the Stability and Growth Pact and Guidelines on the format and content of Stability and Convergence Programmes (Code of Conduct of the Stability and Growth Pact). 18.05.2017. Available: *http://data.consilium.europa.eu/doc/document/ST-9344-2017-INIT/en/pdf*, page 30. Accessed on 04.04.2018.

also to include total expenditure and revenue indicators, interest expenditures, as well as the accrual amount of the pension funds.

The current projections do not reflect the assets position of the public pension funds, while optimistic assessment of the social security sustainability has been prevalent despite of substantially low proportion of social and health care expenditures. The Council in its fiscal sustainability report 2017-2037[27] highlights that as living standards rise, public services will have to be improved to meet expectations, leading to higher expenditures. The Council notes that reaching a tax-to-GDP ratio of 1/3 can compensate expenditure increases on health care and social protection. However, expenditure at 75% of the EU average on health care and social protection leads to a gradual deterioration of the general government budget balance and puts public debt on an upward trajectory, even with a 1/3 tax-to-GDP ratio. This means that higher revenues or other expenditure reviews will be necessary to stabilise public debt and ensure fiscal sustainability.

[27] Fiscal sustainability report 2017-2037. Available: *http://fiscalcouncil.lv/files/uploaded/FDP_1_08_1986_20171218_fiscal_sustainability_report.pdf*, accessed on 04.04.2018.

2 MACROECONOMIC OUTLOOK AND OUTPUT GAP

Council recommends

To follow the counter cyclical fiscal policy rules by implementing more restrictive fiscal policy, because of risks that have emerged due to recent developments in the non-resident banking sector and their potential fiscal impact, as well as currently estimated positive output gap.

To implement further structural reforms with focus on increasing the productivity and efficiency of the public sector, including reducing the level of employment by expanding and improving digitalisation of services, continuing administrative reforms, and other. It would also ease the pressure on the wage increase caused by the tightening of the labor market.

To begin a transparent evaluation on macroeconomic forecast accuracy, where MoF analyses the most important deviations in the latest macroeconomic forecast from the actual data, and presents information on the changes made in the assumptions or limitations of the forecast model.

On 14 February 2018 the Council endorsed MoF's macroeconomic forecast for SP 2018/21 development. In accordance with the MoU that was concluded on 8 February 2016, Council is responsible for the MoF's macroeconomic forecasts endorsement. Within the early review and endorsement of the MoF's macroeconomic projections, the Council has agreed to support the efforts by the Government in preparation of annual documents – the Stability Programme and the Medium-term Budget Framework. The Council assessed the forecast as a whole, and provided an endorsement of the key macroeconomic indicators (Table 2.1). Full endorsement text is available in the Annex 1.

The economic forecast was not changed despite revisions in the GDP time series. After the Council endorsed the macroeconomic forecast, CSB published a revised GDP time series on 28 February 2018. Accordingly, the MoF submitted the recalculated macroeconomic forecast to the Council on 6 March 2018; however, the forecasted base line scenario remains the same. After data revision, the seasonally adjusted real and nominal GDP growth rates have improved by 0.1 percentage point for 2015 and 2016.

	2018	2019	2020	2021
Real GDP growth	**4.0**	**3.4**	**3.0**	**2.9**
Nominal GDP growth	**7.2**	**6.5**	**5.8**	**5.4**
Inflation	**2.8**	**2.4**	**2.1**	**2.1**
GDP deflator	**3.1**	**3.0**	**2.7**	**2.5**
Potential GDP growth	**3.4**	**3.4**	**3.3**	**3.3**
Output gap	**1.1**	**1.0**	**0.7**	**0.3**

Table 2.1 Macroeconomic indicators forecast endorsed by the Council on 14 February 2018, %

The economic growth in 2017 has been faster than expected, though the tightening in labour market continued. The Council welcomes the reform on labour taxation introduced by the Government, which will stimulate entering the labour market and the net wage increase especially for the low-income quartiles. However, the tightening in the labour market because of labour deficit and fiscal easing has already pushed up the wages and resulted in slower productivity growth than the wage growth in recent years. In the long term, the problems of high structural unemployment and regional differences remain.

Productive and efficient public management can be ensured only by further improvement of structural reforms. The demographic conditions require careful review of the scope of public sector and the efficiency of services provided. Following the opportunities of digitalisation, one of the central priorities is the reduction of the number of personnel. Currently there is visible labour shortage in the private sector, which would ease the employment shift between the sectors. Any expansion of government services or transfers should be carefully considered in terms of their fiscal sustainability in longer term.

At the beginning of 2018 risks to economic growth appeared due to developments in the financial (non-resident banking) sector. Referring to the recent visit by Marshall Billingsley, Assistant US

Treasury Secretary for Financing of Terrorism (8 and 9 March 2018 in Latvia)[28] and the opinion expressed to Latvian officials on the need to reduce sharply the non-residents portfolio share in banking sector[29], the forecasted GDP growth rates could fall short of the current forecast for 2018. Evenmore, a direct impact on the state budget is expected – the expenditure (of special budget) will increase because of unemployment benefits payed to the former employees of non-resident banks, and the revenue will decrease because of lower tax income in the context of a temporary drop in high-paying jobs in the banking sector.

The macroeconomic scenario analysis and sensitivity analysis has been significantly improved since the last SP reports. First, it presents the changes in the GDP growth in each of the scenarios at the level of GDP components and it provides the forecast on the tax and other revenues by the type of tax/income. Secondly, it shows the effect on the government budget deficit and debt, if risks emerge. Finally, it includes both the forecast in absolute terms and in comparison to the base line scenario.

[28] Assistant Secretary for Terrorist Financing Marshall Billingslea meets with Latvian Counterparts on Threats to the International Financial System. Available at website of US embassy in Latvia: *https://lv.usembassy.gov/announcement-centennial-logo-contest-win-ipad-pro/*, accessed on 20.03.2018

[29] Media: Stāsts par Latvijas Šveici ir beidzies. Available: *https://irir.lv/2018/03/14/stasts-par-latvijas-sveici-ir-beidzies*, FKTK priekšsēdētājs: Latvijas bankās pieļaujamais ārvalstu klientu biznesa apmērs ir ap 5%. Available: *https://diena.lv/raksts/viedokli/latvija/fktk-priekssedetajs-latvijas-bankas-pielaujamais-arvalstu-klientu-biznesa-apmers-ir-ap-5-14193350* and other media, accessed on 20.03.2018

3 ASSESSMENT OF COMPLIANCE WITH NUMERICAL FISCAL RULES

3.1 EX-POST ASSESSMENT OF FISCAL RULES 2013-2017

Recommendation
The Council calls on the Government to use the updated fiscal and potential GDP estimates for the budget ex post assessment and to adjust the maximum amount of budget expenditure to comply with the ex post analysis requirements of Directive 2011/85/EU.

Ex-post assessment of the the numerical fiscal rules is part of improving macro-fiscal planning and forecasting process. Subject to the requirements set out in Article 4 Part 6[30] of Directive 2011/85/EU on requirements for the budgetary frameworks of the Member States, the component of the fiscal planning is the ex post assessment of the numerical rules. In the planning period (see more in Chapter 3.2 below), the three numerical rules set by the FDL are used and a similar approach needs to be maintained in the ex post assessment. Directive 2011/85/EU sets out the objective of the performance evaluation – by detecting the biases of at least four consecutive years – being able to identify the causes of biases and to eliminate them in future planning.

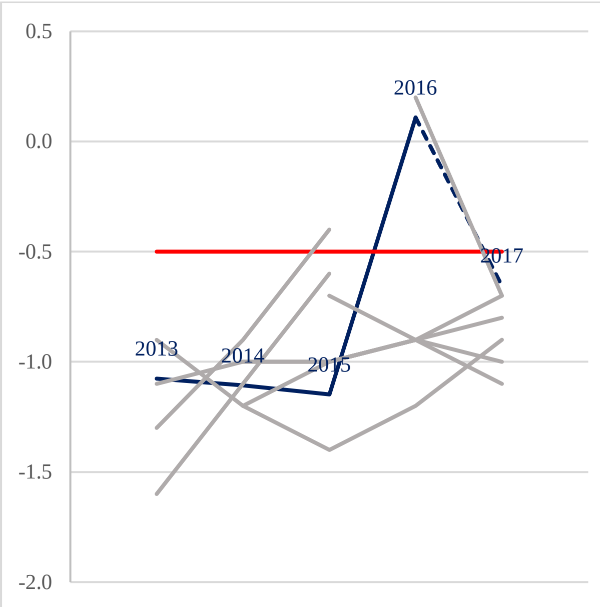

Chart 3.1. Structural balance estimates and outcome, 2013.-2017., % of GDP. Source: Stability programmes and MTBFLs.

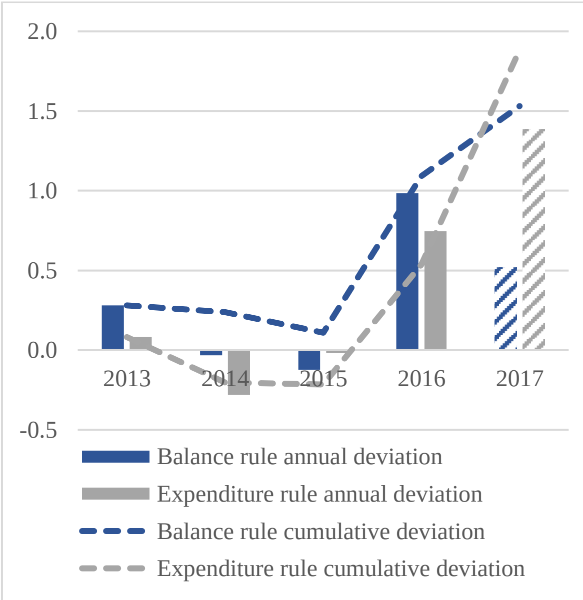

Chart 3.2. Ex post balance rule and expenditure rule, % of GDP. Source: MoF data, Council calculations.

After achieving the structural balance target established by FDL at no less than -0.5% of GDP in 2016 the Government has returned in 2017 to the practice of 2013-2015 with actual structural balance not meeting this benchmark. The structural balance is one of the indicators that helps to assess the budget balance irrespective of the current phase of the economic cycle. If the structural budget is in balance, this means that the Government is able to shape fiscal policies to prevent fluctuations in the economic cycle. The only exception is 2016 (see Chart 3.1 below), while 2013-2015 ended with over

[30] "6. The macroeconomic and budgetary forecasts for fiscal planning shall be subject to regular, unbiased and comprehensive evaluation based on objective criteria, including ex post evaluation. The result of that evaluation shall be made public and taken into account appropriately in future macroeconomic and budgetary forecasts. If the evaluation detects a significant bias affecting macroeconomic forecasts over a period of at least 4 consecutive years, the Member State concerned shall take the necessary action and make it public." Available: *http://eur-lex.europa.eu/legal-content/EN-LV/TXT/?qid=1432812425053&uri=CELEX:32011L0085&from=EN*, accessed on 29.03.2018.

1.0% of the structural deficit. In order to assess the structural balance of 2017, the results of the CSB notification are necessary (expected in April and October 2018).

The Government decisions on 140 million euro additional expenditure to reduce the subsidies' liabilities on electricity production in cogeneration stations and 44.9 million euro breach of the expenditure ceilings by allocating appropriations from "protected" expenditure categories would result in the deterioration of the 2017 structural balance to -0.7% of GDP in opposite of achieving budget balance in structural terms. In headline terms the Council forecasts the deterioration of general government balance from +0.2% to -0.5% of GDP. Despite the additional expenditures improvement has been achieved compared to the estimates in MTBF 2017/19 mostly due to good economic performance.

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 3.2). However, the Council draws attention to the fact that the positive accumulated deviation in 2017 is expected to decrease according to the balance rule and the exact assessment of 2017 is not yet known.

The result of the ex post assessment of the expenditure rule leads to a more critical assessment of the previously overly optimistic budget expenditure ceiling. Recalculating the growth of expenditure is necessary to use the revised potential GDP data. Replacing the potential GDP indicators again raises the question of the need to adjust the budget expenditure ceiling as soon as possible (see Chart 3.3 and 3.4). More detailed information available in Annex 4.

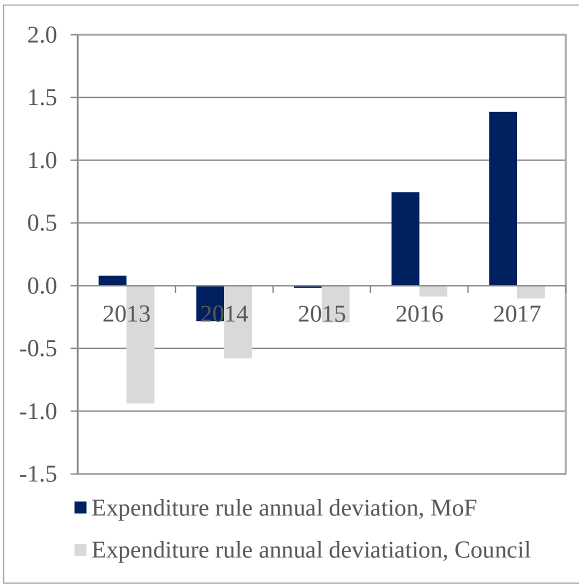

Chart 3.3. Expenditure rule ex post assessment, annual deviation, % of GDP. Source: Council calculations.

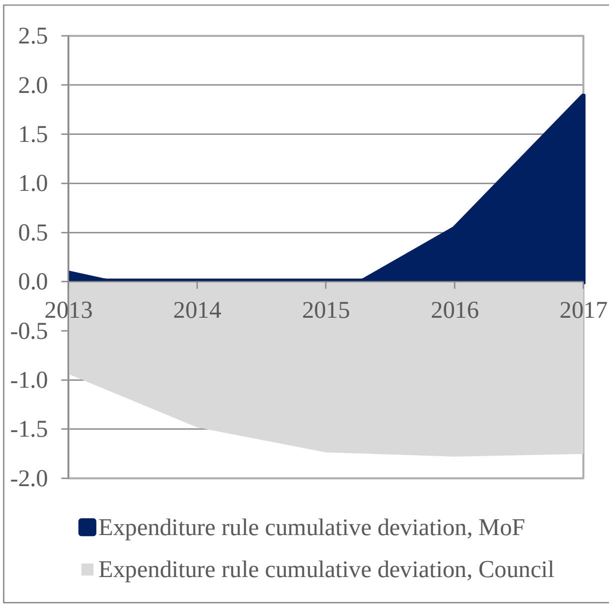

Chart 3.4. Expenditure rule ex post assessment, cumulative deviation, % of GDP. Source: Council calculations.

3.2 Ex-ante assessment of fiscal rules 2018-2021

Recommendations
The fiscal safety reserve should be set in the process of calculating the expenditure ceilings.
The basic budget balance projections indicate a cyclical fiscal policy and, therefore, the structural balance projections raise concerns about the incorrect inclusion of the tax reform.

The Council has made an alternative assessment of numerical fiscal rules for 2019-2021 in line with the Council's decisions approved in the Council meeting on 6 April 2018.

The Council has considered the MoF's core proposals regarding deviations from the MTO –

(1) **the health reform deviations** in the amount of -0.5% of GDP for 2019 **has not been objected**. More information about the helath reform in Chapter 1.4;

(2) **the deterioration of the fiscal balance resulting from classifying the tax reform as a one-off measure** in the amount of -0.5% for 2019 and -0.3% for 2020 **has not been objected.** More information about the tax reform in Chapter 1.2;

(3) **to reiterate the importance of establishing a fiscal security reserve in the amount of at least 0.1% of GDP for 2019.** The Council notes increase in the fiscal risks, while these have not been adequately assessed.

Council has not objected the MoF calculated fiscal rules results for SP 2018/21. As a result of the calculations of the numerical rules by the MoF, the maximum government expenditure ceiling was set at 9 360.7 million euro (continuity rule) for 2019, 9 868.8 million euro for 2020 (expenditure rule) and 10 048.0 million euro (structural balance rule) (Table 3.1). More detailed information available in Annex 5.

	2018	2019	2020	2021
Central government budget expenditure ceiling, in millions euro				
SP 2015/18	8 480.5	x	x	x
MTBFL 2016/18	8 749.5	x	x	x
SP 2016/19	8 767.0	8 844.8	x	x
MTBFL 2017/19	8 807.7	9 001.6	x	x
SP 2017/20	8 960.5	9 276.3	9 446.5	x
MTBFL 2018/20	8 954.2	9 322.9	9 838.8	x
SP 2018/21	x	9 360.7	9 868.8	10 048.0

Table 3.1. Central government budget expenditure ceiling in accordance with the fiscal rules assessment. Source: the MoF, Council calculation.

	2018	2019	2020	2021
General government structural budget deficit (-) / surplus (+), % of GDP				
SP 2015/18	-1.2	x	x	x
MTBFL 2016/18	-0.8	x	x	x
SP 2016/19	-1.2	-0.8	x	x
MTBFL 2017/19	-1.1	-1.0	x	x
SP 2017/20	-1.0	-1.0	-0.5	x
MTBFL 2018/20	-1.2	-0.6	-0.4	x
SP 2018/20	-1.4	-0.8	-0.4	-0.5
Changes since SP 2017/20	*-0.4*	*0.2*	*0.1*	*x*
Cyclical component impact (changes since SP 2017/20)	*0.3*	*0.1*	*-0.1*	*x*
Tax reform impact (changes since SP 2017/20)	*0.7*	*0.0*	*0.0*	*x*

Table 3.2. General government structural balance 2018-2021. Source: MoF.

Since the last stability program, the structural balance has improved from 2019 to 2020. but significantly deteriorated in 2018 (see Chart 3.5 and Table 3.2). Taking into account the changes in the potential GDP estimates, which indicate an upturn in the economic cycle, from the year 2017 (see more in Annex 1), the cyclical component of the budget also changed. The changes in the cyclical component make it necessary to curb the structural balance between 2018 and 2019, but by 2020 it allowed it to run a little looser again. Comparing both of the Stability Programmes the tax reform impact in 2019 and 2020 have not changed, but the most significant changes are related to the 2018 structural balance. Both the cyclical component (with an impact of 0.3% of GDP) and the Government's amended tax reform decisions (with an impact of 0.7% of GDP) had to improve the structural balance since last spring. But it is not. The structural balance deteriorated by -0.4% points, indicating a significant deterioration of the nominal balance for 2018 (see Table 3.3 below a deterioration of -1.4% of GDP).

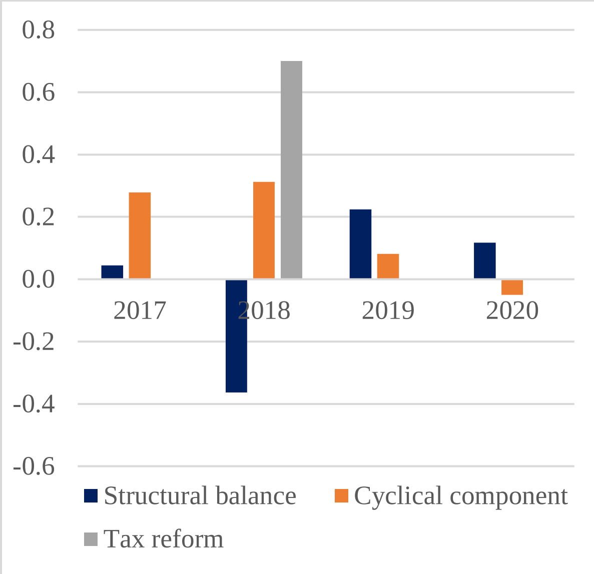

Chart 3.5. Changes between SP 2017/20 and SP 2018/21, % of GDP. Source: Council calculations.

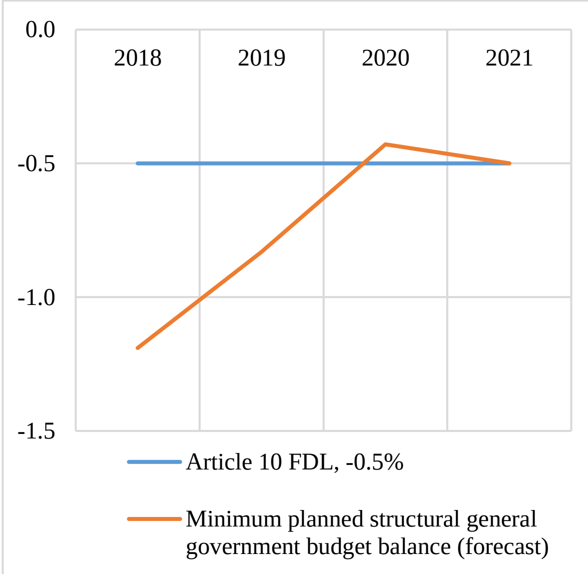

Chart 3.6 Structural balance level and medium-term objective, % of GDP. Source: MoF.

The planned levels of the structural balance for 2020 and 2021 are in line with the FDL (see Chart 3.6). The Council also considers that a further improvement in the balance in 2019 should be foreseen in line with the counter-cyclical fiscal policy of Article 1 of the FDL.

	2018	2019	2020	2021
General government headline budget deficit (-) / surplus (+)				
SP 2015/18	0.2	x	x	x
MTBFL 2016/18	0.3	x	x	x
SP 2016/19	-0.2	0.8	x	x
MTBFL 2017/19	-0.6	0.2	x	x
SP 2017/20	-0.3	0.3	0.8	x
MTBFL 2018/20	-0.9	-0.8	-0.2	x
SP 2018/21	-0.9	-1.0	-0.4	-0.3
Changes since SP 2017/20	*-0.6*	*-1.3*	*-1.2*	*x*
Basic budget deficit (-) / surplus (+) *				
SP 2015/18	-0.2	x	x	x
MTBFL 2016/18	0.2	x	x	x
SP 2016/19	0.4	0.9	x	x
MTBFL 2017/19	0.2	0.4	x	x
SP 2017/20	-0.3	0.1	1.2	x
MTBFL 2018/20	-1.1	-0.9	0.0	x
SP 2018/21	-1.7	-1.2	-0.3	-1.0
Changes since SP 2017/20	*-1.4*	*-1.3*	*-1.5*	*x*

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

Substantial deterioration of the basic budget since the previous Stability Programme further indicates a significant easening of fiscal policy and a "cosmetic" improvement of the structural balance. The easening of fiscal policy is currently pointing to a pro-cyclical pattern and insufficient contribution to deficit and debt reduction in a context of rapid economic growth. For example, the budget balance in the years 2019 and 2020 is worsening duet i the significant deviation because of the tax reform.

3.3 Public debt

Recommendation
The debt rule needs to develop the implementation mechanism to ensure the public debt into the overall fiscal policy governance.

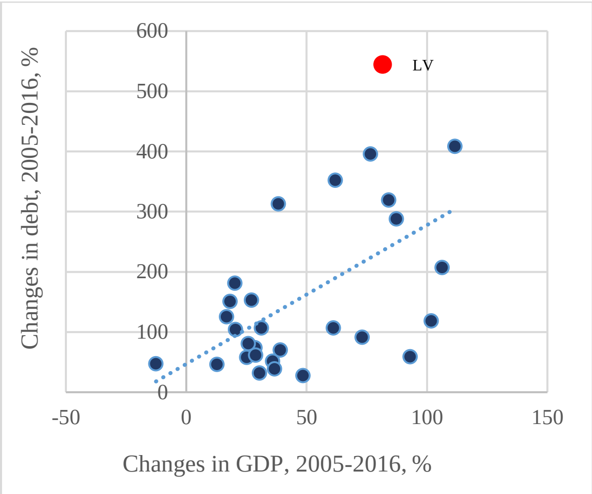

Chart 3.7. Increases in general government debt and nominal GDP between 2005 and 2016, EU countries. Source: Eurostat.

The global financial crises and the following period EU countries' general government debt has increased relative to GDP, however Latvia's debt increase between 2005-2016 is outstanding at the rate of 544.1% (Chart 3.7). Despite of the nominal GDP growth of 81.6% during that period, the Latvia's debt dynamics was 6.7 times.

The current level of debt may not represent an imminent threat to solvency, but it weakens Latvia's ability to withstand demand fluctuations in case of funding shocks. During good economic times the government can take advantage of revenue excess for deficit and debt reduction and build up fiscal buffers.

The Council points to the debt rule missing an implementation mechanism. Such mechanism should be developed and implemented to ensure the integration of public debt into the fiscal policy governance.

The Council welcomes the Government's general government target of reducing general government debt to 36% of GDP in 2021 (see Chart 3.8 below). However, such a level of government debt may mean a shortage of savings in situations if the rapid economics growth is replaced by its slowdown.

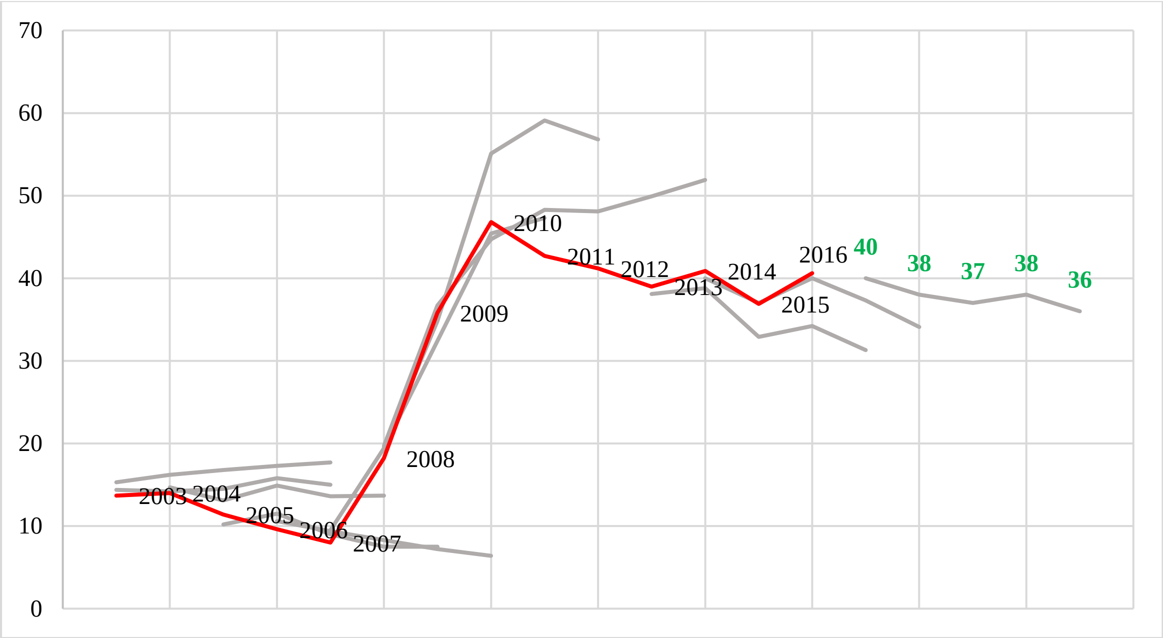

Chart 3.8. General government debt: forecasts and actual outcome, % of GDP. Source: The Treasury.