

## Fiscal discipline surveillance report on interim budget for 2019

Article 15 of the Law on Budget and financial management stipulates the authorisation and restrictions for the minister of finance to determine the state budget expenditures, loans and borrowings in the circumstances if the annual state budget law has not entered into force. Such an interim budget was created for 2019.

On 13 December 2018 Fiscal discipline council (hereafter – Council) received from the Ministry of Finance (hereafter – MoF) calculations of fiscal rules (see Annex 1)<sup>1</sup> as well as on 19 December the interim budget for 2019 that has been prepared in accordance with Article 15 of the Law on Budget and financial management. In accordance with the Fiscal discipline law (hereafter – FDL) Council is responsible for the monitoring of compliance with FDL provisions in the annual state budget law and the medium-term budget framework law (hereafter – MTBFL) during their preparation, execution, and amendment. The Council has applied this regulation on the interim budget as well.

In the interim budget for 2019 the expenditure is the same as the maximum amount adopted in the medium-term budget framework law for 2018, 2019 and 2020 (hereafter – MTBFL 2018/20) – 9 322.9 million euro.

At the same time the MoF and the Council by considering fiscal rules outcome invites to reduce expenditure in the annual state budget for 2019 and in MTBF for 2020.

The fiscal rules calculations request to consolidate for 108.1 million euro and set in the level of 9 214.8 million euro. By establishing fiscal safety reserve in accordance with the FDL requirements the state budget expenditures might be set in the amount of 9 184.0 million euro (see Table 1).

Item	2019
Framework law maximum state budget expenditures	9 322.9
Interim budget law maximum state budget expenditures	9 322.9
State budget expenditure according to the strictest rule applied	9 214.8
Maximum allowed state budget expenditures, incl. fiscal safety reserve	9 184.0

Table 1. Summary of numerical rules fulfilment, million euro. Source: MoF and Council calculations.

The MoF and the Council came to conclusions that in 2019 and in 2020 the strictest rule to be applied is continuity rule and in 2021 – balance rule. This means that the maximum state budget expenditure as adopted by MTBFL 2018/20 adjusted for FDL requirements for 2019 and 2020 will determine the maximum government expenditure.

Based on the strictest rule for 2019 (continuity rule) general government headline balance is permissible at -0.73% of GFP and the structural balance at -0.57% of GDP. The Council calculations ask to admit the level of -1.08% of GDP, mainly because of diverging opinion regarding the one-off effect of tax reform deviation. The Council also notes that the Stability and growth pact (hereinafter – SGP) flexibilities for the health care reform deviation in 2019 do not allow the achievement of the medium-term objective of the FDL, i.e. at least -0.5% of GDP.

**The Council concludes that the interim budget prepared by the MoF is in line with the fiscal policy requirements set out in the Law on Budget and financial management and the framework law for the key parameters of the 2019 budget. However, when preparing the annual budget for 2019 budget revenue should be increased or expenditure reduced to cover the costs of the negative fiscal space and additional expenditure commitments accommodated in the interim budget in excess of approved in the MTBFL for 2019.**

<sup>1</sup> Fiscal rules calculations were performed on 6 November 2018 for general government draft budget plan.

## Continuity rule

The FDL stipulates that the annual state budget must be prepared on the basis of the framework law approved in the previous year, taking into account changes in the macroeconomic framework, adjusted and smoothed expenditure (continuity rule).

In accordance with the continuity rule the MoF invites to set the maximum expenditure ceilings for 2019 in the amount of 9 214.8 million euro and for 2020 in the amount of 9 789.0 million euro (see Annex 1<sup>2</sup> Table 4).

In the section below there are given and described changes in two parts: (i) detailed information regarding the corrected amounts in accordance with the Article 5 of the FDL; (ii) overall summary of the smoothed part of the expenditures. The budget planning (framework law) also covering both parts separately.

## Adjusted expenditure

Article 5 of the FDL requests to ensure yearly updates of the MTBFL expenditure ceilings with so called natural changes in the separated items of the budget as well as the price changes impact in the self-earned revenues of the state institutions.

In total corrections envisage to reduce expenditures by 140.9 million euro for 2019 and by 120.6 million euro for 2020.

Social basic budget and special budget expenditure in comparison with MTBFL 2018/20 decrease by 55.5 million euro for 2019 and by 22.7 million euro for 2020, thus contributing decrease in the maximum expenditures by 0.6% and 0.2% respectively. Observed decrease is despite of the amendments to the Law on state pensions and an increase in one of the programs (old age and disability pensions). The overall decrease shows that the contingent of pensions and allowances is diminishing and thus the planned budget expenditures are also decreasing.

Changes to paid services. Both years there is a slight rise to MTBFL 2018/20 in the amount of 4.6 million euro. Contribution to the changes in maximum expenditure is 0.05%.

EU fund project programs expenditures against MTBFL 2018/20 will decrease by 23.9 million euro for 2019 and 65.3 million euro for 2020, contributing decrease in the maximum expenditures by 0.3% and 0.7% respectively.

Government debt service programs against MTBFL 2018/20 expects to reduce expenditure for 2019 by 17.2 million euro and for 2020 by 21.0 million euro, which respectively reduces the maximum expenditure by about 0.2% in both years.

Changes in EU budget payments in comparison to MTBFL 2018/20 also decreased by 48.9 million euro for 2019 and by 16.3 million euro for 2020, reducing the maximum expenditure by -0.5% and -0.2% respectively.

## Smoothed expenditure

EU grants programmes and public debt servicing – as two items that are taken as the smoothed parts of the budget – are relatively stable figures, accounting for around 4.0% of GDP and 0.8% of GDP respectively.

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<sup>2</sup> Fiscal rules calculations available here:

[http://fdp.gov.lv/files/uploaded/FDP\\_1\\_08\\_1589\\_20181228\\_FDUZ\\_Piel1\\_Ann1.xlsx](http://fdp.gov.lv/files/uploaded/FDP_1_08_1589_20181228_FDUZ_Piel1_Ann1.xlsx), accessed on 28.12.2018

## Balance rule

The FDL sets a structural balance objective of at least -0.5% of GDP as one of the fiscal rules.

In accordance with the balance rule, the MoF calls for a maximum budget expenditure of 9 206.9 million euro for 2019, of 9 873.0 million euro for 2020 and 10 216.4 million euro for 2021 (see Annex 1 Table 2). Taken into account that the MoF calculations includes the impact of the 2017 tax reform as a one-off measure in the amount of 0.5% of GDP for 2019 and 0.3% of GDP for 2020, the Council nevertheless calls to include the impact of this tax reform in the ordinary calculations of the budget revenue and expenditure, thus setting the maximum expenditure for this amount lower, i.e. 9 188.8 million euro for 2019 and 9 791.0 million euro for 2020. The Council considers that the tax reform is a discretionary budgetary revenue measure and cannot be considered as a one-off measure within the meaning of the SGP and the FDL, adjusting the balance rule calculations.

The balance rule can also be viewed in two parts, according to: (i) the FDL methodology; (ii) the SGP methodology. The units are separated because the MoF also divides the calculations according to both methodologies.

## FDL requirements

Calculating the balance rule highlights one of the foundations of budgeting, i.e. the fact that the state budget compensates the fluctuations of all other general government budget balances. The Council does not dispute the estimates made by the MoF and following changes:

- Local government budget balance since MTBFL 2018/20 planning period has deteriorated by 40.3 million euro for 2019 and by 14.4 million euro for 2020, resulting in a reduction of the expenditures by 0.4% and 0.1% respectively.
- On the other hand, the budget balance of publicly-funded public entities and non-funded institutions has slightly improved for 2019 by 11.5 million euro and for 2020 by 0.6 million euro.
- ESA adjustments since MTBFL 2018/20 have been increased for 2019 by 36.7 million euro for 2020 by 105.2 million euro. It will increase the maximum budget expenditure by 0.4% and 1.1% respectively.

In the framework of the macroeconomic forecasting procedure<sup>3</sup>, the Council has also indirectly aligned the cyclical component of the budget, which increased by 0.2% by 2019, thus limiting budgetary expenditure of that amount.

However, unlike last year's decision, the Council calls for the effect of the tax reform implemented in 2017 in the amount of 0.5% points in 2019 and 0.3% in 2020 to be included in the expenditures. In 2018, the Council returned to the debate on the impact of the tax reform on budget expenditure, with a more critical assessment of the one-off nature. The Council notes that the tax reform has no time-boundness and that tax reform measures will have a long-term impact on budget revenues.

## SGP requirements

The main difference from FDL estimates is the difference between the potential GDP and the resulting cyclical component of the budget. Comparing the cyclical component of the budget to 2019, it also increased by 0.3%, making it necessary to limit budget expenditure for that amount. The SIP does not provide for one-off measures, which makes the balance rule stricter and thus prevailing.

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<sup>3</sup> 15.10.2018 macroeconomic forecast endorsement. Available here: <http://fiscalcouncil.lv/15102018-macroeconomic-forecast-endorsement>, accessed on 20.12.2018.

## Expenditure growth rule

Following the increase in expenditure, the MoF calls for maximum budget spending for 2019 in the amount of 9 555.6 million euro, for 2020 in the amount of 9 806.7 million euro and for 2021 in the amount of 10 567.3 million euro (see Annex 1 Table 3). Taking into account that also in the expenditure growth rule the MoF includes the impact of the 2017 tax reform as one-off measures of 0.5% of GDP in 2019 and 0.3% of GDP in 2020, the Council calls for the impact of this tax reform to be included in the calculation similarly as in the case of a balance rule, i.e. as ordinary revenues and expenditures, thus setting maximum expenditure for this amount lower – 9 397.9 million euro for 2019 and 9 712.1 million euro for 2020 (please see the elaborated explanation in the section above).

Except for the impact of the tax reform mentioned above, the Council does not oppose the other changes in the expenditure rule calculated by the MoF:

- Interest payments on general government debt. Since MTBF 2018/20 the planned amount for 2019 has decreased by 47.5 million euro and for 2020 by 19.9 million euro, thus reducing the maximum amount of expenditure for that amount accordingly.
- Expenditure on EU programs since MTBF 2018/20 were reduced by 60.4 million euro for 2019 and by 49.2 million euro for 2020. Similarly, to interest expenditure, EU fund expenditure also leads to a reduction in budget expenditure.
- Changes in the level of adjusted investments since MTBF 2018/20 has only slightly changed – for 2019 it has increased by 7.1 million euro, whereas for 2020 it has decreased by 6.7 million euro. Consequently, the years in question have also caused expenditure fluctuations in these volumes.
- Automatic budget expenditure stabilizer or non-discretionary changes in unemployment for 2019 decreased by 26.9 million euro and for 2020 by 31.1 million euro. Such a reduction is mainly due to improvements in unemployment rates, which further impact the plans to reduce unemployment benefits expenditure.
- Discretionary revenue measures compared to MTBF 2018/20 has been increased by 24.5 million euro for 2019 and by 67.0 million euro for 2020 so as to allow additional spending in these years to this extent.

The impact of the tax reform on the expenditure rule is included as a discretionary revenue measure (by reducing the revenue of the budget). Since MTBF 2018/20 the planned amount has remained unchanged at 0.5% and 0.3% of GDP in 2019 and 2020 respectively. As in the case of the balance rule, also in the expenditure growth rule, the Council calls to exclude this expenditure increase factor.