



LATVIJAS REPUBLIKAS FISKĀLĀS DISCIPLĪNAS PADOME

---

Reģ.nr. 90010248231; Smilšu ielā 1-512, Rīgā, LV-1919  
tālrunis: (+371) 6708 3650; e-pasts: info@fdp.gov.lv; mājaslapa: <http://fdp.gov.lv>

Approved  
at the written consultation by  
Fiscal Discipline Council  
on 5 March 2019  
Minutes No 3 (24)

FISCAL DISCIPLINE SURVEILLANCE REPORT  
ON LATVIA'S STATE BUDGET FOR 2019

Riga, 2019

---

# Content

- Summary ..... 3
- Abbreviations ..... 4
- Mandate of the Council ..... 5
- 1 Fiscal policy challenges..... 6
  - The interim budget for 2019 and the transition to the state budget for 2019 without a framework law ..... 6
  - State budget balances: comparative history and comparison of execution of the last years with planned ..... 6
  - State budget balance for 2019 ..... 8
  - Revenues ..... 9
  - Expenditures..... 10
  - Adjustment of tax reform in the calculation of fiscal conditions ..... 11
  - Health reform deviation..... 12
  - Assessment of the Fiscal risks statement..... 12
- 2 Macroeconomic outlook and output gap: weaknesses in adjustment of revised statistical data for budget balance summary ..... 13
- 3 Assessment of compliance with numerical fiscal rules ..... 14
- 4 Assessment of sustainability of new policy initiatives ..... 15
- Annex 1 The Ministry of Finance's response to the Council's request to justify a derogation from the tax reform as a one-off measure in the context of the FDL..... 16
- Annex 2 Health care reform performance indicators: deviation use ..... 18

## Summary

The Council finds the government's effort on the 2019 State budget insufficient to ensure that fiscal indicators are consistent with sustainable development needs and overcome pro-cyclical fiscal stance. The Council recognizes the existing legal framework insufficient to justify the solutions included in the 2019 national budget, and suggests that the government develops and approves an additional regulations for the treatment of compulsory (non-discretionary) expenditure and revenue as well as one-off measures in the calculation of fiscal conditions.

In spite of the decision not to increase state budget expenditures, the total amount of the state budget expenditures has significantly grown in 2019 compared to MTBFL for 2018-2020, as well as the Draft Budgetary Plan, which was submitted for evaluation to the European Commission in 2018 October.

The deficit budget in the context of rapid economic growth is not in line with long-term development interests and accumulates problems that will require painful consolidation measures to cope with the economic slowdown. Part of the rapid economic growth in recent years has been at the expense of fiscal discipline requirements. This explains the faster economic growth in Latvia compared to Lithuania and Estonia, where the budget is prepared and executed with surplus.

The Council does not find compliant with the FDL the justification prepared by the Ministry of Finance regarding tax reform one-off and considers it necessary to make appropriate adjustments in the preparation of the fiscal framework for 2020.

According to the Council's estimates, the general government budget balance for 2019 should reach a surplus of 0.2% of GDP. However, without applying the deviation to the budget balance to implement health care reform, the budget surplus in Latvia would be 0.7% of GDP - similar to Lithuania and Estonia.

The main reasons for the deficit situation in Latvia are the decisions taken previously to finance tax reform and health care reform by increasing the budget deficit and raising public debt out of line with the phase of the economic development cycle. The level of public debt is growing much faster than indicated in the previous medium-term fiscal policy plans, contrary to a very favorable economic development conditions.

In the economy in 2018 and 2019, rapid development continues due to favorable conditions for implementation of EU structural funds projects and implementation of expansionary fiscal policy. The Council considers that these cyclical conditions will have a negative impact on economic growth in the period when there will be no increase in EU structural funds in the current EU budget cycle, as well as improved fiscal conditions.

The Council notes positively the improvements in the government's fiscal risk declaration, including for the first time the quantified assessment of fiscal risks associated with the operation of public capital companies. However, the Council underlines the need to assess the risks of possible deviations from the fiscal policy objectives due to difficulties in assessing the start-up of the economic downturn or in the performance of the financial sector, including in the event of insufficient progress on the implementation of Moneyval recommendations.

The Council welcomes the work begun by the government to assess the long-term fiscal sustainability of the new policy initiatives and looks forward to further cooperation in this area.

## Abbreviations

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 2019
MoF	Ministry of Finance
MoU	Memorandum of Understanding
MTBF	Medium term budget framework
MTBFL	Medium term budget framework law
MTO	medium term objective
GDP	Gross domestic product
-	Not applicable / not available
PIT	Personal income tax
SGP	Stability and growth pact
SP	Latvia's Stability Programme
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)<sup>1</sup>, 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.

The Surveillance Report on the State Budget for 2019 was prepared on the basis of legislation reviewed by the Cabinet of Ministers for approval of the 2019 state budget, as well as information received from the Ministry of Finance.

---

<sup>1</sup> Memorandum of Understanding, available: [http://fiscalcouncil.lv/files/uploaded/FDP\\_1\\_09\\_849\\_20180619\\_MoU\\_FDC\\_MoF\\_consolidated.pdf](http://fiscalcouncil.lv/files/uploaded/FDP_1_09_849_20180619_MoU_FDC_MoF_consolidated.pdf), accessed on: 25/02/2019

## 1 Fiscal policy challenges

The interim budget for 2019 and the transition to the state budget for 2019 without a framework law

**The recalculation of fiscal rules for 2019 has not been made in accordance with FDL requirements.** It was also identified by the Council in its surveillance report<sup>2</sup>, assessing the interim budget for 2019<sup>3</sup>, which was determined by the Ministry of Finance on the basis of spending mandates set for 2019 in MTBFL for 2018-2020. In its monitoring report of 28 December 2018, the Council noted the need for consolidation in the 2019 interim budget of 138.9 million euro (Chart 1) to comply with the requirements recalculated fiscal rules.

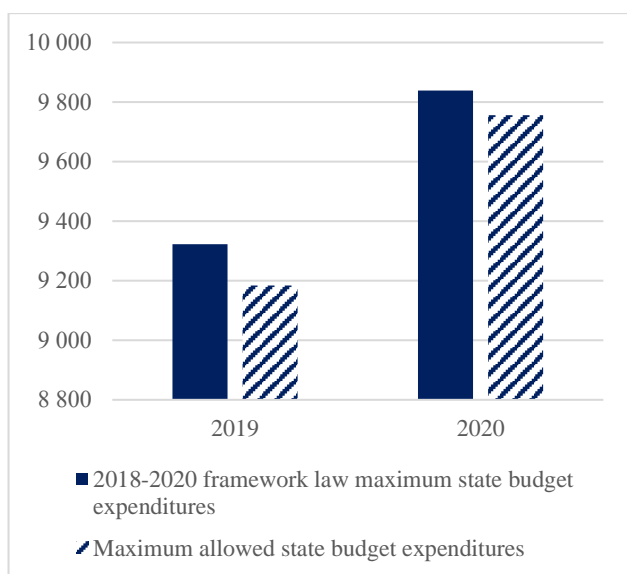


Chart 1. The maximum expenditures in framework law and maximum allowed state budget expenditures, million euro.  
Source: Council report (28/12/2018)

**Also in the preparation of the state budget, there is no MTBF, and in this situation violations of the FDL fiscal rules continue, with the government adopting decisions on additional revenue measures** (so-called discretionary revenue measures), which are expelled from the calculation of the total fiscal rules<sup>4</sup>. Hence, creating misconceptions about the structural balance improvement<sup>5</sup>. On 12 February 2019, the Council submitted a non-compliance report on the Government's decisions of 5 and 8 February 2019.

State budget balances: comparative history and comparison of execution of the last years with planned

**The objective of the structural balance set in the state budget for 2018 was not achieved even though it was lagging behind the planned small amount (Table 1)<sup>6</sup>.** It continues the practice of preparing and implementing a budget with revenue lagging behind and creating a deficit that needs to be financed by public debt.

<sup>2</sup> Fiscal discipline surveillance report on interim budget for 2019. Available at:

[http://fiscalcouncil.lv/files/uploaded/FDP\\_1\\_08\\_1589\\_20181228\\_FDSR.pdf](http://fiscalcouncil.lv/files/uploaded/FDP_1_08_1589_20181228_FDSR.pdf), accessed on: 20/02/2019

<sup>3</sup> The Budget and Financial Management Law determines the rights of this Finance minister in the event that the annual state budget is not approved by the beginning of the year.

<sup>4</sup> Non-conformity report regarding the maximum budget expenditure ceilings, 12/02/2019. Available at: [http://fiscalcouncil.lv/files/uploaded/FDP\\_1\\_08\\_192\\_20190212\\_non\\_conformity\\_OECD\\_social.pdf](http://fiscalcouncil.lv/files/uploaded/FDP_1_08_192_20190212_non_conformity_OECD_social.pdf), accessed on 20/02/2019

<sup>5</sup> Presentation of the Ministry of Finance in 19 February 2019 at the Cabinet of Ministers agenda item on general government draft budgetary plan for 2019.

<sup>6</sup> Here and below the 2018 budget execution results are based on the MoF assessment, but official CSB data will be published later.

**Fiscal policy in 2018 compared to 2017 was markedly pro-cyclical in the upturn of the economic cycle, with the structural balance deteriorating by 0.4% of GDP.** The structural balance for 2017 is -0.8% of GDP, while the 2018 structural balance is -1.2% of GDP, i.e. deteriorated by 0.4% of GDP (Table 1 and Figure 3). Already since 2016, the deterioration of the structural balance has continued, with execution reaching +0.2% of GDP. Consequently, the core objective set by the FDL is not achieved.

		Consolidated budget	ESA corrections	General government budget	Cyclical component	Structural balance
2018	plan <sup>7</sup>	-0.58	-0.36	-0.9	0.1	-1.2
	outcome	-0.73	0.05	-0.7	0.5	-1.2
	deviation	-0.15	0.41	0.5	0.4	0.0
2017	plan <sup>8</sup>	-1.1	0.1	-1.0	-0.1	-1.0
	outcome	-0.8	0.2	-0.6	0.2	-0.8
	deviation	0.3	0.1	0.4	0.3	0.2

Table 1. 2017-2018 state budget balances: plans and outcome, % of GDP. Source: Ministry of Finance.

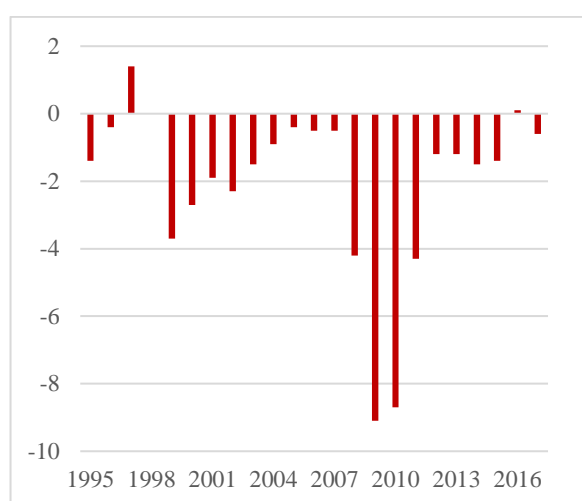


Chart 2. General government budget deficit (-) or surplus (+) 1995-2017, % of GDP. Source: Eurostat

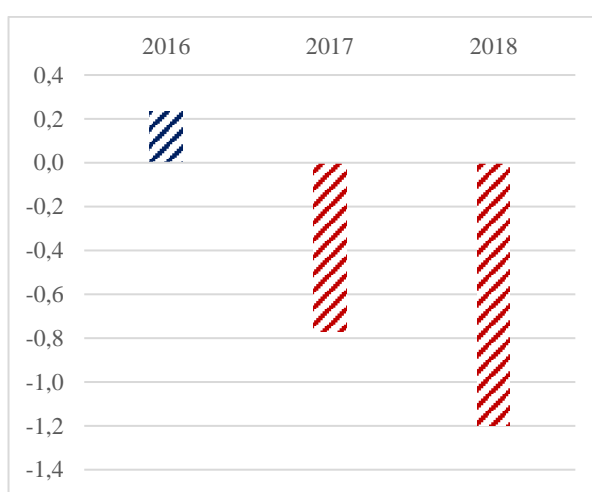


Chart 3. Structural balance outcome in 2016-2018, % of GDP. Source: MoF macroeconomics forecasts endorsement (15/02/2019)

**General government headline balance outcome for 2018 exceeds the plans.** It should be noted that when preparing the budget the MoF has not sufficiently assessed the risks to the deviation of the local government budget balance from the planned (by 182.1 million euro), while at the level of the general government budget balance the source of improvement was better tax revenues in comparison to the plans, European accounts system corrections, as well as better outcome of the special budget and derived public persons budgets comparing to the planned balances.

Balance	2018		2017	
	plan <sup>9</sup>	outcome	plan <sup>10</sup>	outcome
General government budget balance	-265.3	-198.9	-263.1	-155.7
ESA corrections	-101.6	16.2	38.3	66.2
Consolidated budget	-163.7	-215.1	-301.4	-221.9

<sup>7</sup> Law "On state budget for 2018" explanations. Chapter 2. Fiscal outlook. Available at: [http://www.fm.gov.lv/files/files/FMPask\\_D\\_050218\\_bud2018.pdf](http://www.fm.gov.lv/files/files/FMPask_D_050218_bud2018.pdf), accessed on: 25/02/2019

<sup>8</sup> Law "On state budget for 2017" explanations. Chapter 2. Fiscal outlook. Available at: [http://www.fm.gov.lv/files/valstsbudzets/FMPask\\_D\\_100217\\_bud2017.pdf](http://www.fm.gov.lv/files/valstsbudzets/FMPask_D_100217_bud2017.pdf), accessed on: 25/02/2019

<sup>9</sup> Law "On state budget for 2018" explanations. Chapter 2. Fiscal outlook. Available at: [http://www.fm.gov.lv/files/files/FMPask\\_D\\_050218\\_bud2018.pdf](http://www.fm.gov.lv/files/files/FMPask_D_050218_bud2018.pdf), accessed on: 25/02/2019

<sup>10</sup> Law "On state budget for 2017" explanations. Chapter 2. Fiscal outlook. Available at: [http://www.fm.gov.lv/files/valstsbudzets/FMPask\\_D\\_100217\\_bud2017.pdf](http://www.fm.gov.lv/files/valstsbudzets/FMPask_D_100217_bud2017.pdf), accessed on: 25/02/2019

Balance	2018		2017	
	plan <sup>9</sup>	outcome	plan <sup>10</sup>	outcome
State basic budget	-321.7	-302.1	-366.6	-357.0
Special budget	125.9	202.2	65.3	113.8
Local governments budget	31.6	-150.5	0.0	-14.2
Derived public persons budget	0.6	35.2	-0.1	35.6

Table 2. 2017-2018 budget balances plans and outcome, million euro. Source: the Ministry of Finance

A better result of the nominal balance in 2018, compared to the plans, has not been sufficient to offset the adjustment of the economic cycle by calculating the structural balance indicator. This means that the positive factors from faster economic development have not been sufficiently reflected in the better fiscal outcomes.

### State budget balance for 2019

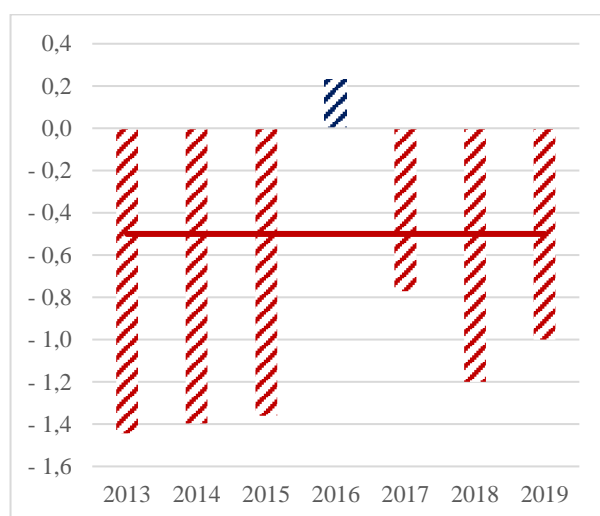


Chart 4. Structural balance, % of GDP, 2013-2019. Source: MoF macroeconomics forecasts endorsement (15/02/2019)

Latvia does not reach the structural balance target of -0.5% of GDP set by the FDL in the 2019 budget (Chart 4), because of the use of derogations for the implementation of structural reforms of health care and tax reforms. Although the MoF has formulated a legal basis for these derogations, the objective set by the FDL is not achieved by demonstrating insufficient government work to ensure macroeconomic stability. The objective of the structural balance established by the FDL has not been achieved since 2013, except for 2016, when delays in the implementation of EU funds projects improved the budget balance.

The structural balance indicator characterizes the budget balance ratio adjusted for the development of the economic cycle (Chart 4) and allows the assessment of government work in the area of fiscal governance, as well as the absence of counter-cyclical fiscal policy as the main FDL challenge.

In the 2019 Draft Budgetary plan (DBP) adopted by the Cabinet of Ministers on 19 February 2019, the structural balance deteriorates significantly (by 0.4% of GDP) since the previous medium-term budgetary framework law (Table 3). However, it is necessary to agree with the MoF, which indicates that it is improving compared to the outcome of the 2018 structural balance, although the structural balance in 2018 has significantly deteriorated compared to 2017 and 2016.

Budget balance indicators for	2019 DBP	2018-2020 MTBFL	2017-2019 MTBFL
Structural balance	-1.0	-0.6	-1.0
Cyclical component	0.5	0.2	0.3
General government budget balance	-0.5	-0.8	0.2
ESA corrections, million euro	82.1	-16.2	-26.1
Consolidated budget	-0.9	-0.7	0.2
State basic budget	-1.4	-0.9	0.4
Special budget	0.7	0.3	0.1
Local governments budget	-0.2	-0.1	-0.2
Derived public persons budget	0.01	-0.02	-0.03

Table 3. Budget balance for 2019, % of GDP. Source: Ministry of Finance.



**The budget plans prepared by the MoF envisage a significant deterioration of the basic budget balance mainly at the expense of a better special budget balance.** Favorable economic development conditions in the special budget provide better results as social security revenues increase and expenditures decrease due to the economic cycle.

## Revenues

**Almost all major tax revenue positions in 2018 have exceeded revenue projections.** In accordance with the plans by the State Revenue Service, in 2018 tax revenue had to be collected at 9.3 billion euro. In total, 9.4 billion euro was collected, exceeding the plan by 1.3% (120.4 million euro). The exception was the personal income tax, which lagged behind the planned 0.3% p. Non-tax revenues in 2018 also exceeded the target by 8.1% p (33.3 million euro) (Table 4 and Chart 5).

	2015	2016	2017	2018
Total tax revenues (incl. social security contributions)	100.2	100.6	101.5	101.2
VAT revenues	98.3	99.7	101.4	100.2
PIT revenues	101.5	99.3	103.8	99.7
CIT revenues	100.8	105.7	100.1	130.6
Non-tax revenues	96.5	111.4	92.4	108.1

Table 4. Execution of the State revenue service revenue plan. Source: State revenue service

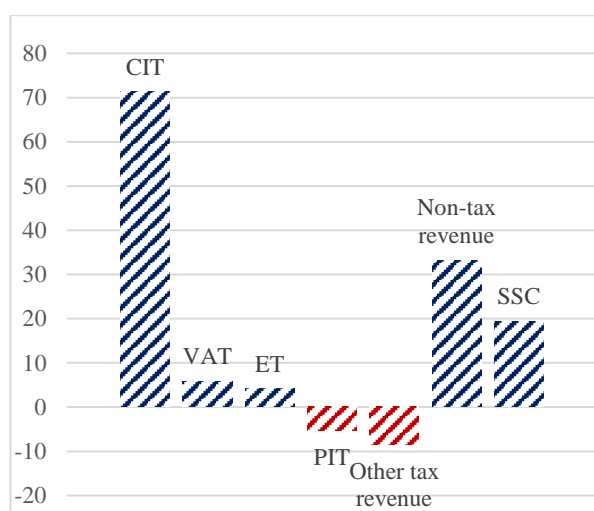


Chart 5. Difference among actually collected and planned revenues in 2018, million euro. Source: SRS

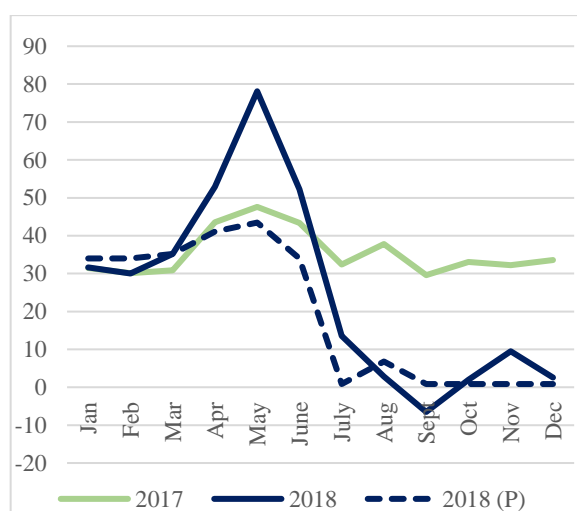


Chart 6. Corporate income tax, million euro. Source: State revenue service.

**Unlike previous governments, Artūrs Krišjānis Kariņš's government declaration no longer contains a specific target to reach 1/3 of the tax-to-GDP ratio in the medium term<sup>11</sup>.** The fiscal discipline agreement<sup>12</sup> between the political parties included in the coalition has lost one of the specific goals that were formulated but failed to reach the previous governments (Table 4).

	2013	2014	2015	2016	2017	2018	2019
Tax-to-GDP, %	29.6	30.0	30.4	31.4	31.4	30.9	30.4

Table 4. Tax revenues, incl. social security contributions, % of GDP. Source: Eurostat (2013-2017) and DBP (2018-2019).

<sup>11</sup> Declaration on Artūrs Krišjānis Kariņš's Cabinet of Minister's plans. Available at: [https://www.mk.gov.lv/sites/default/files/editor/kk-valdibas-deklaracija\\_red-gala.pdf](https://www.mk.gov.lv/sites/default/files/editor/kk-valdibas-deklaracija_red-gala.pdf), accessed on 25/02/2019

<sup>12</sup> The Cabinet of Ministers of the Republic of Latvia 13th Saeima's fractions Fiscal Discipline Agreement. Available at: [http://fiscalcouncil.lv/files/uploaded/20190123\\_Government\\_Fiscal\\_discipline\\_agreement.pdf](http://fiscalcouncil.lv/files/uploaded/20190123_Government_Fiscal_discipline_agreement.pdf), accessed on 25/02/2019.

**The impact of the 2017 tax reform cannot be judged within one or two years, its effects will have to be seen for a longer period of time**, as was the case with the turn of the century reform in Estonia. However, at least two consequences can already be identified: firstly, the revenues of capital taxes has diminished in 2018 (Chart 7) when compared to 2017, as corporate income tax fell by 40.0% (Chart 6); secondly, the growth in tax revenue for 2019 is below the nominal GDP growth rate (Chart 8). Such a change in growth has not been observed in other Baltic States, nor is it in line with customary practices in other countries<sup>13</sup>.

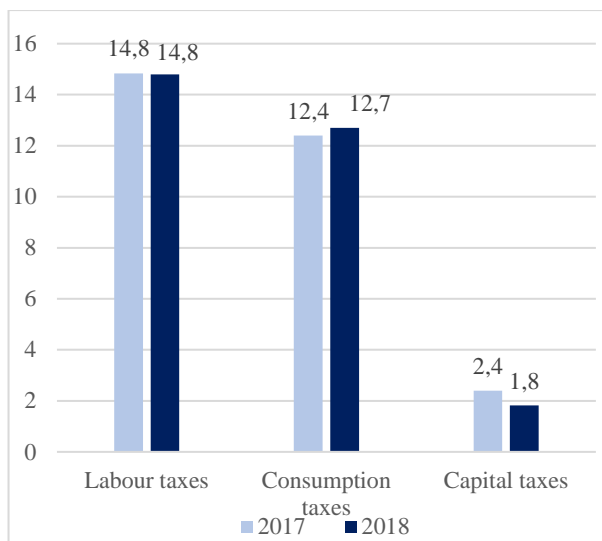


Chart 7. Tax revenue, incl. social contributions, structure, % of GDP. Source: Treasury

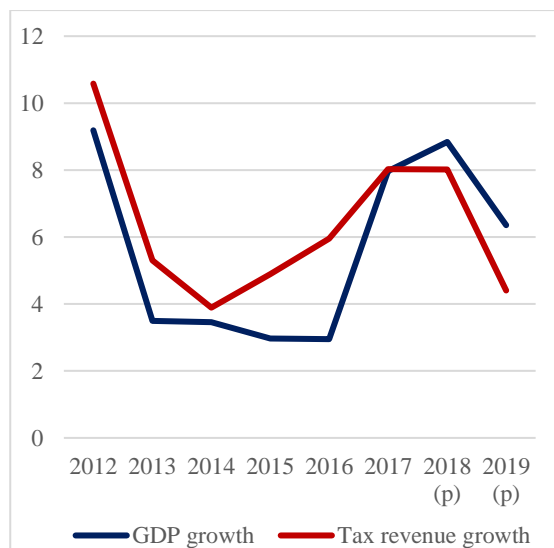


Chart 8. Tax revenue and GDP growth, %, y-t-y. Source: Council calculations.

## Expenditures

**In order to comply with the FDL fiscal rules, government budget expenditures should change in line with the growth potential of the national economy.** Regrettably, there is an annual practice of finding ways to raise spending above the potential of the economy (Chart 9), as well as government budgets regularly maintaining upward revisions when the medium-term ceilings for government budgets are revised (Chart 10). The Council calls for policy priorities and structural reform plans to be more accurately reflected in the spending calculations for the entire MTBF period, thus increasing the credibility of medium-term expenditure estimates.

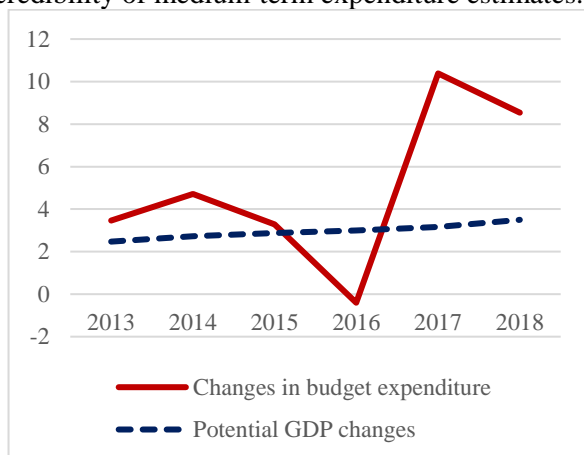


Chart 9. Budget expenditures and potential GDP changes, %, y-t-y. Source: Council calculations.

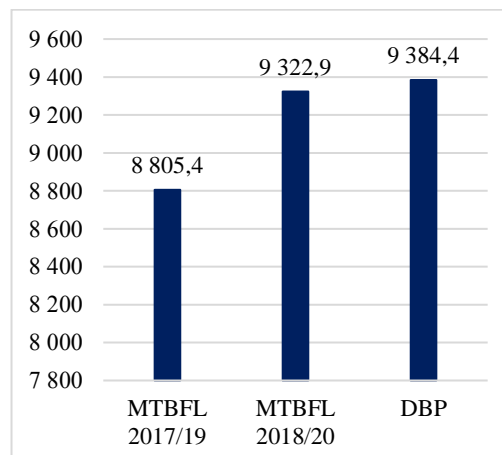


Chart 10. State consolidated budget expenditures for 2019, million euro. Source: Treasury:

<sup>13</sup> Revenue Statistics 1965-2017. OECD. Available at: [https://read.oecd-ilibrary.org/taxation/revenue-statistics-2018\\_rev\\_stats-2018-en#page1](https://read.oecd-ilibrary.org/taxation/revenue-statistics-2018_rev_stats-2018-en#page1), accessed on 25/02/2019. p. 24.

**Over the last five years, government general budget (cash flow) expenditures have risen by an average of 7% per annum.** Despite the rapidly rising labor costs in both the private and public sectors related to the upheaval of the labor market, the Council notes that the government general budget reimbursement costs have been able to exceed pre-crisis levels after a ten-year break. Specifically, in 2008, the state and local governments spent almost 2.4 billion euro on this item (an increase of 20.6% over 2007), while in 2018 this expenditure amounted to 2.5 billion euro (an increase of 7.2% over 2017).

#### Adjustment of tax reform in the calculation of fiscal conditions

**Ministry of Finance 2019 State Budget and VTBI 2018-2020** For years, the assessment of fiscal conditions in the meaning of the FDL is based on the assumption that the legislative package approved by the Saeima as a tax reform of 2017 has been influenced by the impact of the measure, setting the maximum amount of the state budget expenditure. At the request of the Council, the MoF provided justification for the compliance of the tax reform with the requirements of the FDL (Annex 1).

The Council concludes from the Ministry of Finance's arguments that:

- The FDL does not provide for the adjustment of one-off and temporary measures in the calculation of fiscal conditions;
- There is no legal framework in Latvia for the recognition of one-off and temporary measures in the calculation of fiscal conditions under the FDL;
- It would be acceptable to use the guidelines developed by the European Commission to recognize one-off and temporary measures in circumstances where an appropriate legal framework has not been developed and accepted in Latvia;
- The free translation and use of one-off and temporary measures jeopardizes the integrity of the FDL's fiscal governance mechanism and poses serious risks to the formulation and implementation of responsible fiscal policies;
- Both revenue and expenditure measures included in the calculation of the particular situation should be classified as discretionary with a specific impact on the budget balance and attributed to the maximum amounts of government budget expenditure;
- The government has failed to take adequate measures to offset the decline in revenues and expenditure by adopting legislation on tax reform, increasing the budget deficit at a rapid stage of economic development and acting pro-cyclically thereby worsening fiscal conditions.

**The Council does not recognize the legal basis prepared by the Ministry of Finance for the FDL corresponding to the fiscal balance of the tax reform and considers it necessary to make appropriate adjustments in the preparation of the fiscal framework for 2020.** The Council understands that in the context of the state budget of 2019 it is not practicable to implement measures that would effectively compensate for the reduction of the fiscal space due to the narrowing of the fiscal space by adopting the government decisions due to the 2017 tax reform. Therefore, the Council proposes strict adherence to the EC guidelines for the identification of one-off and temporary measures, symmetrically applied by both the FDL and the SGP, by calculating fiscal conditions and assessing their achievement starting from the specification of the national budgetary parameters for 2020 and beyond.

## Health reform deviation

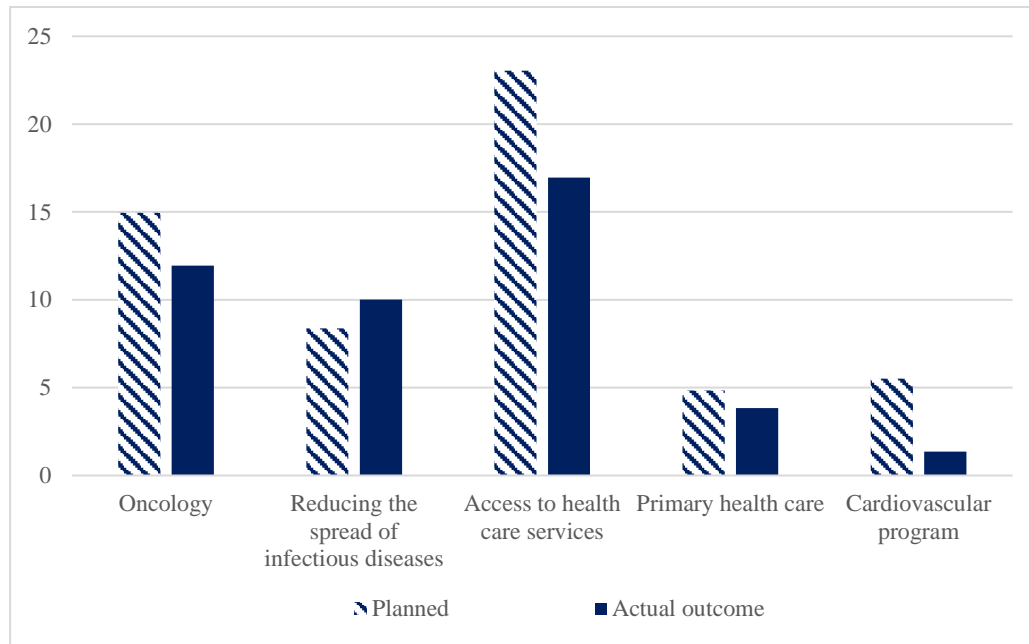


Chart 11. Use of the health care system reform deviation funding in the first half of 2018, million euro. Source: Ministry of Health, Council calculations (Annex 2)

**The Council agrees that the implementation of health care reform measures can provide a positive contribution to economic growth.** The Council welcomes the goals set by the Ministry of Health for the impact of the health reform on the economy, as the informative report on "Implementing Health Reform Measures in 2018" estimates that the benefits of the projected loss of potentially lost life years in the medium term will outweigh the investment in the healthcare system. Of course, the Council still expects adequate monitoring of the reform to ensure that the targets set for the reduction of potentially lost years of life continue to be met.

**The Council notes the challenges for the achievement of the fiscal targets for 2020, when the European Commission's endorsement of a derogation from the medium-term structural balance target for the implementation of the health reform will end.** MTBFL for 2018-2020 already predicted that a negative fiscal space will be formed in 2020 due to the need to continue access to health care services for the population after it will not be allowed to use additional deficit financing.

## Assessment of the Fiscal risks statement

**In previous reports, the Council criticized the work of the government by not deepening the assessment of fiscal risks in Fiscal risks statement (FRS).** From 2014, when the fiscal risk assessment was first time conducted and described in the FRS, a progressive trend is evident in the development of the FRS by 2016, with some improvements in the assessment of both quantifiable risks and non-quantifiable risks. However, there has been no significant change in the FRS over recent years compared to the initial FRS. Reflecting detailed statistics and evaluating risks in substance allows for better assessment of fiscal risk indicators and their impact on the state budget.

**The Council welcomes the progress made in drawing up the FRS for 2019, which includes the risks of state-owned companies in the quantifiable risks section.** After a long discussion with the Council, the Ministry of Finance has finally been able to quantify the risk of state capital companies, which was previously shown to be non-quantifiable. Such changes are to be welcomed and the Council calls on the Ministry not to stop these improvements, as there are still current fiscal risks that should be able to be properly assessed by including them in the quantifiable risks section.

When assessing the risks included in the FRS and the calculation of the fiscal safety reserve, the Council concludes that the minimum reserve set by the FDL of 0.1% has been adequately incorporated into the 2019 budget. However, the Council notes that the FRS does not foresee an assessment of significant risks, including macroeconomic development risk, where international practice notes the difficulty for forecasters to accurately predict the time of crisis and its scale. Likewise, serious economic shocks and negative fiscal impacts can be caused by risks if Latvia fails to make the necessary progress in implementing Moneyval recommendations.

## 2 Macroeconomic outlook and output gap: weaknesses in adjustment of revised statistical data for budget balance summary

On 15 October 2018, the Council approved the forecasts prepared by the MoF<sup>14</sup>, which were taken as the basis for preparing the state budget for 2019<sup>15</sup>. However, unlike the macroeconomic development scenario approved by the Council, it included an updated estimate of GDP growth rate in 2018 at current and constant prices as of 30 January 2019, after the fourth quarter of 2018 of GDP outcome was received and adjusted accordingly. GDP projections at current prices for 2019-2021, without changing previously predicted growth rates. Latvia's GDP growth in 2018 at current prices was 0.8 percentage points faster, and at constant prices by 0.6% points faster.

Indicator	2018		2019	
	Council endorsed forecasts, 15/10/2018	Informative report forecasts 05/02/2018	Council endorsed forecasts, 15/10/2018	Informative report forecasts 05/02/2018
GDP in nominal prices, million euro	29 039	29 524	30 841	31 005
GDP nominal growth, % of	7.4	8.0	6.2	6.2
GDP real growth, %	4.2	4.8	3.0	3.0

Table 5. GDP assessment for 2018 and 2019. Source: the Ministry of Finance

The MoF keeps unchanged in the informative report the remaining indicators approved by the Council, i.e. the potential GDP growth and inflation (here - GDP deflator). Given that GDP growth was more robust in 2018, it is necessary to clarify the cyclical effects that have also increased (see Table 6 below for the cyclical component of the budget). With this clarification, the budget's nominal balance should have been tighter than 0.22% of GDP.

Indicators	2019	
	Informative report forecasts 05/02/2018	Information that was not taken in the report
GDP in real prices, million euro	Not mentioned	24 587 (because 2018 data are updated)
Potential GDP, million euro	Not mentioned	24 219
Output gap, % of GDP	0.94	1.52
Budget cyclical component, % of GDP	0.36	0.58
Budget balance, % of GDP	-0.64	-0.42

Table 6. Changes in the budget balance due to changes in the cyclical component. Source: Council calculations.

<sup>14</sup> Informative report "On macroeconomic indicators, revenues and general government budget balance forecasts 2019-2021". Cabinet of Ministers 05/02/2019.

<http://tap.mk.gov.lv/lv/mk/tap/?pid=40469106&mode=mk&date=2019-02-05>

<sup>15</sup> Informative report "On macroeconomics indicators, revenues and general government budget balance forecasts for 2019-2021". Cabinet of Ministers, 05.02.2019.

<http://tap.mk.gov.lv/lv/mk/tap/?pid=40469106&mode=mk&date=2019-02-05>

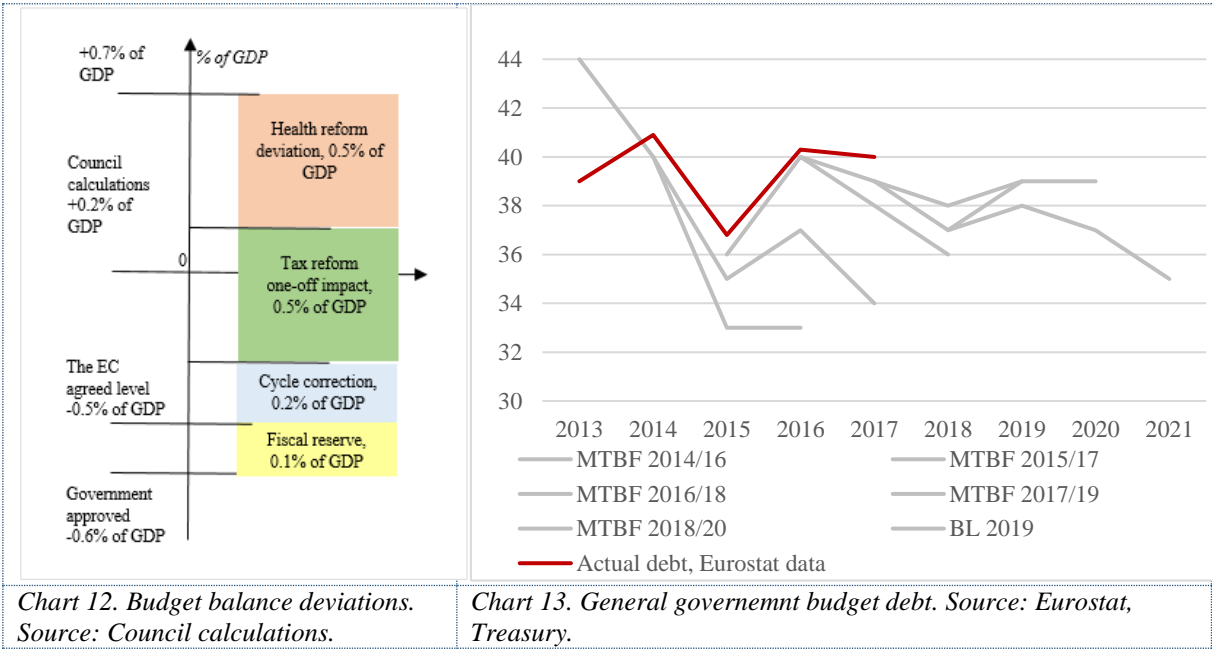
**Recommendation:**

The Council invites the MoF to carry out further coordination with the Council in all cases where the macroeconomic forecasts previously approved by the Council are specified, so as to avoid further divergences in the calculation of the budget balances.

**3 Assessment of compliance with numerical fiscal rules**

At the end of 2018, calculations of the fiscal rules by both – the MoF and the Council determined that in 2019 and 2020, the continuity rule, which according to the Article 5 of the FDL requires observance of changes in the prices of state-provided services, of changes in the number of benefits beneficiaries. In 2021, however, the stricter condition was the structural balance rule.

The FDL, as a structural balance target, foresees a target of -0.5% of GDP, which is regularly exceeded (see Chart 4 above), subject to the derogations allowed by the European Commission for structural reform of different objectives targets. The 2019 budget contains a derogation for the reform of the health care system (0.5% of GDP) and a tax reform derogation (also 0.5% of GDP), which significantly limits the possibilities for a balanced budget cycle. Without counting the impact of these two reforms and making a precise adjustment to the budget cycle (error of 0.2% of GDP, see the previous chapter for more details), Latvia – like Lithuania and Estonia – would be able to create a budget with a surplus, i.e. 0.7% of GDP (Chart 12). At the same time, the Council welcomes the capacity of the MoF to maintain the fiscal safety reserve.



**In the Council's view, allowing for a derogation from the medium-term objective of financing health care reform, the government balance in 2019 should have a surplus of 0.2% of GDP.** More difficult fiscal consolidation tasks are currently being postponed.

**Latvia's public debt (Chart 13), as a cumulative fiscal condition for the assessment of the sustainability of public finances, is not diminishing despite economic favorable conditions.** The Council notes that the debt level's management does not cover the objectives set by accumulating problems for future development. In the discussions of economics experts, setting the target for public debt and achieving it has become a central issue in the formulation and control of fiscal policy.

**The Council assesses the government's work on the 2019 national budget as insufficient to ensure that fiscal indicators are consistent with sustainable development needs and overcome pro-cyclical fiscal stance.** The Council recognizes the existing legal framework to justify the solutions included in the 2019 national budget, and suggests that the government develop and approve an additional framework for the classification of compulsory (non-discretionary) expenditure and revenue as well as one-off measures in the calculation of fiscal rules. These shortcomings are manifested in the Council's objections to government decisions to reallocate appropriations where such redistributions are made from programs whose expenditure is defined as the adjusted fiscal rules.

## 4 Assessment of sustainability of new policy initiatives

In line with the renewed MoU<sup>16</sup>, the Council received for the first time this year a fiscal sustainability assessment of new policy initiatives from the MoF.

The first part of the evaluation is a list of discretionary measures for which no significant long-term effect on the budget base has been calculated or such impact is assessed as unchanged. In this section, the MoF has listed all initiatives with an impact of 0.01% of GDP.

The second part of the evaluation highlights two policy initiatives for which the FM has calculated the long-term fiscal impact. First, the pension legacy in the event of the death of one pensioner; secondly, an increase in the percentage of real wage increases from 70% to 80% in the amount of contributions paid for working age year of 45 and more for the indexation of old-age pensions. Regrettably, based on the EC scenario on the number of pensioners in the aging report, the FM calculations point to an insignificant (first initiative) or even diminishing (second initiative) fiscal effect.

### **Recommendation:**

The Council calls for the assessment of fiscal sustainability to be combined with the vision of the MoW and the MoH, which could clarify how these initiatives could be implemented in practice, taking into account social inequality, poverty risk indicators and health care system reform in Latvia.

---

<sup>16</sup> Memorandum of Understanding. Amendment 19/06/2018. Available at: [http://fiscalcouncil.lv/files/uploaded/FDP\\_1\\_09\\_849\\_20180619\\_VPS\\_FDP\\_FM\\_papildinajums\\_EN.pdf](http://fiscalcouncil.lv/files/uploaded/FDP_1_09_849_20180619_VPS_FDP_FM_papildinajums_EN.pdf), consolidated version: [http://fiscalcouncil.lv/files/uploaded/FDP\\_1\\_09\\_849\\_20180619\\_MoU\\_FDC\\_MoF\\_consolidated.pdf](http://fiscalcouncil.lv/files/uploaded/FDP_1_09_849_20180619_MoU_FDC_MoF_consolidated.pdf), accessed on 25/02/2019



## Annex 1 The Ministry of Finance's response to the Council's request to justify a derogation from the tax reform as a one-off measure in the context of the FDL

In accordance with the Article 2, second section of the Fiscal Discipline Law (FDL), shall apply to the budget institutions, institutions non-financed from the budget and derived persons partially financed from the State budget laid down in the Law On Budget and Financial Management. The fiscal policy principles laid down in this Law shall be applicable also to other institutions to be included in the general government sector [within the meaning of Paragraph 2.70 of Annex A of Council Regulation (EC) No 2223/96 of 25 June 1996 on the European system of national and regional accounts in the Community].

Therefore, these institutions apply the FDL rules. In fact, however, the content of the norms narrows the application of the norms to the Cabinet of Ministers and the Ministry of Finance, as the FDL norms define the conditions and restrictions for the preparation of the medium-term budget framework law and state budget draft laws until they are submitted to the Saeima. Thereby, the Ministry of Finance and the Cabinet of Ministers are those who actually apply the FDL rules.

The theory of law<sup>17</sup> provides that an interpreter of a legal norm is an application of legal norms.

There are no legal norms in Latvia that regulate one-off revenue and expenditure measures. The term "one-off measure" is not used in FDL legal norms. The Article 5, third section, third point of the FDL introduces the term "structural balance" by stating that "A term "structural balance of the general government budget" within this Law is used in the same meaning as the term "structural balance" in the Regulation (EU) No 1175/2011 of the European Parliament and of the Council of 16 November 2011 amending Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies".

The term "medium-term budgetary objective" is used in the mentioned regulation: "the country-specific medium-term budgetary objectives shall be set within a defined range between -1% of GDP and a balance or surplus in cyclically-adjusted terms, excluding one-off and temporary measures."

The regulation also states that the structural balance measures the progress towards the medium-term budgetary objective. It follows from the regulation that the structural balance is a cyclically-adjusted nominal balance, from which one-off and temporary measures have been deducted.

It should be noted that there are no common standards in the world for what to recognize as one-off and temporary measures. Even EU Member States have not issued legislation on this issue. There is only the methodology adopted unilaterally by the European Commission that is set out in the document "Vade Mecum on the Stability & Growth Pact". This document refers to the European Commission and describes how the EC is conducting an assessment of the fiscal policies of EU Member States in line with the Stability and Growth Pact. Consequently, there are no legal provisions that require Member States to use the EC methodology for national fiscal frameworks.

The FDL regulation applies to the national fiscal framework. Fiscal policy must be in line with the national fiscal framework and must provide compliance with the Stability and Growth Pact.

Consequently, the Ministry of Finance, as the institution applying the FDL law, has the right to translate the relevant norms, including the measures to be considered as one-off measures.

Of course, the translation of norms cannot be arbitrary and the principles of translation of legal norms must be respected.

---

<sup>17</sup> Edgars Meļķis, *Tiesību normu iztulkošana* (Rīga: Latvijas Universitāte, 2000), p. 10.



Article 17 of the Administrative Procedure Law defines the principles of interpretation of legal norms:

(1) In interpreting (construing) the norms of law institutions and courts shall apply the following basic methods of interpretation:

- 1) grammatical (linguistic) interpretation method, that is, ascertaining the meaning of the norm of law linguistically;
- 2) historical interpretation method, that is, ascertaining the meaning of the norm of law, considering the circumstances on the basis of which it has been created;
- 3) systemic interpretation method, that is, ascertaining the meaning of the norm of law in relation to other norms of law; and
- 4) teleological (meaning and purpose) interpretation method, that is, ascertaining the meaning of the norm of law on the basis of the useful and equitable purpose as is to be attained pursuant to the relevant norm of law.

Although the application of the FDL legal norms is not part of the administrative process, the interpretation of the above-mentioned norms also applies to cases outside the administrative procedure.

It follows from a grammatical interpretation that a one-off measure can be considered as a measure that has a one-off nature, respectively, a measure whose positive or negative fiscal impact does not recur from year to year - "temporary"/"not lasting or needed for a long time".

Regarding the teleological interpretation of the legal norm, the introduction of the concept of a one-off measure in fiscal policy is aimed at "netting" the nominal balance from "non-essential" factors, namely, creating a size that gives an idea of the "basics" of fiscal policy. This indicator measures the average balance in the long-term, and it depends only on revenue and expenditure flows that have fundamental nature and that is determined by the structure of public financial revenues and expenditures in the long-term, which is governed by national rules. Therefore, it is logical that this balance should be netted from the cyclical effects of the economy and from one-off revenues and one-off expenditures. From this point of view, there are no differences in terms of one-off expenditures and one-off revenues.

However, the European Commission, in its approach, deliberately retreats from the equal treatment of one-off revenues and one-off expenditures; revenue is more likely to be recognized as one-off, but expenditure very rarely. The EC approach is also evolving over time, for example in the case of Latvia, EC did not treat the presidency costs as one-off expenditure but in the case of Malta, they did. Also, the EC has accepted that bank rescue costs are one-off measures. However, as already noted, an EU Member State is not obliged to use the EC approach within the national fiscal framework, including a different assessment of the one-off nature of revenues and expenditures.

The Ministry of Finance classifies the fall in tax revenue as a one-off. The meaning and essence of the tax reform is to stimulate potential growth and thus to generate higher revenue for the state budget. However, in the short-term, the tax reform triggers a fall in revenue (against revenue forecasts if the reform would not be implemented). Therefore, the temporary nature of the fall in revenue is fulfilled.

This is not only justified by the grammatical interpretation of the norm, but also by the effective fiscal policy aspect and the meaning of the FDL fiscal rules. The sense of a fiscal rule to withhold a structural deficit of 1% of GDP is to prevent excessive debt growth, and this fiscal rule aim is not to prevent the country from carrying out the necessary reforms. If we assume that the negative fiscal impact of the tax is not a one-off measure, it would only be possible to do so by consolidating other expenditures by 0.5% of GDP, saying "only temporary". First of all, such a consolidation "only temporarily" would call for a justified public dissatisfaction, and secondly, if the only way to implement the tax reform would be such consolidation, then the implementation of the reform is unlikely to happen because of the insufficient political support. In a result, the Ministry of Finance chose the translation of the one-off measure that corresponded to both grammatical and teleological translation.

## Annex 2 Health care reform performance indicators: deviation use

2.pielikums Veselības aprūpes sistēmas reformas progresa rādītāji: atkāpes izlietojums

#	Rādītājs	2018 / 1						Item
		Finansējums, eiro Financing, euro		Papildu skaits, pacienti Additional volume, patients		Rindu garums, dienās Waiting list, days		
		Plāns Planned	Faktiskā izpilde Actual outcome	Plāns Planned	Faktiskā izpilde Actual outcome	Pirms reformas Before reform	Faktiskā izpilde Actual outcome	
1.	<i>Onkoloģija</i>	14 948 297	11 952 609	31 876	68 592	x	x	<i>Oncology</i>
	Primārā diagnostika	749 760	590 397	11 000	21 503	x	x	Primary diagnostics
	Speciālistu konsultācijas	325 160	435 944	5 500	21 538	x	x	Expert consultations
	Sekundārā diagnostika un izmeklējumi	1 166 270	1 528 298	7 330	14 201	x	x	Secondary diagnostics and examinations
	Ambulatorā ārstēšana	588 948	588 937	1 653	1 082	x	x	Ambulatory treatment
	Stacionārā ārstēšana	1 231 088	1 301 727	2 999	3 171	x	x	Hospital treatment
	Kompensējamie medikamenti	5 604 070	7 281 056	3 047	6 779	x	x	Reimbursable drugs
	Pozitronu emisijas tomogrāfija/datoromogrāfija	117 737	0	217	0	x	x	Positron emission tomography / computer tomography
	Staru terapijas un ķīmijterapijas efektivitātes uzlabošana	4 487 436	0	0	0	x	x	Improving the effectiveness of radiation therapy and chemotherapy
	Valsts patoloģijas centra izveide	482 830	0	0	0	x	x	Establishment of a national pathology center
	Vēža skrīninga programmas reforma	195 000	226 250	130	318	x	x	Reform of Cancer Screening Program
2.	<i>Infekcijas slimību izplatības mazināšana</i>	8 370 371	10 022 474	31 719	32 231	x	x	<i>Reducing the spread of infectious diseases</i>
	Kompensējamie medikamenti	5 587 441	7 118 898	204	684	x	x	Reimbursable drugs
	References laboratorijas izmeklējumi VHC hepatīta pacientu terapijas uzsākšanai un terapijas monitoringam saistībā ar pacientu skaita pieaugumu	391 602	391 602	3 265	3 354	x	x	Reference laboratory tests for the initiation of treatment for VHC patients with hepatitis

#	Rādītājs	2018 / I						Item
		Finansējums, euro Financing, euro		Papildu skaits, pacienti Additional volume, patients		Rindu garums, dienās Waiting list, days		
		Plāns Planned	Faktiskā izpilde Actual outcome	Plāns Planned	Faktiskā izpilde Actual outcome	Pirms reformas Before reform	Faktiskā izpilde Actual outcome	
	Vīrusu molekulārās izmeklēšanas analītiskās jutības rādītāju uzlabošana HIV/AIDS medikamentozā ārstēšana	289 828 2 101 500	306 638 2 205 336	27 500 750	27 425 768	x x	x x	Improvement of analytical sensitivity of viral molecular investigations HIV / AIDS medication
3.	<i>Veselības aprūpes pakalpojumu pieejamība</i>	23 036 605	16 956 279	612 392	520 808	22 239	19 014	<i>Access to health care services</i>
	Speciālistu konsultācijas	2 712 912	2 708 751	189 456	153 912	100	85	Expert consultations
	Ambulatorie izmeklējumi un terapija	6 349 290	6 349 290	267 616	278 798	40	36	Ambulatory examinations and therapy
	Dienas stacionārs	4 517 867	4 516 867	48 781	32 028	407	149	Daily hospital treatment
	Ambulatorā rehabilitācija	444 940	444 940	49 777	39 215	500	295	Ambulatory rehabilitation
	Diabēta apmācības kabinetu izveide	69 956	55 647	16 632	6 541	x	x	Diabetic training cabinets
	Endoprotezēšanas operācijas stacionārā	1 307 343	1 307 215	446	570	21 191	18 450	Endoprosthetic surgery in a hospital
	Darbnespējas saīsināšana un pasākumi prognozējamās invaliditātes novēršanai ar mērķi novērst ilgstošu slimošanu personām darbspējīgā vecumā	1 281 959	1 120 304	834	666	x	x	Reducing incapacity for work and measures to prevent predictable disability
	Aknu transplantācijas	250 001	83 597	4	3	x	x	Liver transplantation
	Bioloģiskās terapijas nodrošināšana Krona slimībai, čūlainajam kolītam un psoriāzei	604 374	369 668	5 849	9 075	x	x	Providing biological therapy for Crohn's disease, ulcerative colitis and psoriasis
	Hronisko pacientu aprūpes reforma	5 497 965	0	33 000	0	x	x	Chronic Patient Care Reform
4.	<i>Primārā veselības aprūpe</i>	4 832 018	3 833 202	1 081 135	1 190 303	x	x	<i>Primary health care</i>
	Mērķa kritēriju izpildes iekļaušana kapitācijas naudā	1 565 858	1 694 927	652	1 306	x	x	Inclusion of the fulfillment of the target criteria in the capital's money

#	Rādītājs	2018 / I						Item
		Finansējums, eiro Financing, euro		Papildu skaits, pacienti Additional volume, patients		Rindu garums, dienās Waiting list, days		
		Plāns Planned	Faktiskā izpilde Actual outcome	Plāns Planned	Faktiskā izpilde Actual outcome	Pirms reformas Before reform	Faktiskā izpilde Actual outcome	
	Ģimenes ārstu kvalitātes maksājumu sistēmas reforma	1 398 511	358 864	661	1 254	x	x	Family doctors' quality payment system reform
	Bērnu zobārstniecības tarifu pārskatīšana	1 867 650	1 779 411	1 079 823	1 187 743	x	x	Child dentistry tariff review
5.	<i>Sirds un asinsvadu programma</i>	<i>5 512 710</i>	<i>1 355 820</i>	<i>14 570</i>	<i>3 695</i>	<i>x</i>	<i>x</i>	<i>Cardiovascular program</i>
	Kardiovaskulārā riska izvērtēšana un algoritmu ieviešana	799 963	0	11 926	0	x	x	Cardiovascular risk assessment and implementation of algorithms
	Aortālā vārstuļa transkatetrāla implantācija (TAVI) pakalpojuma ieviešana	937 500	900 000	38	36	x	x	Implantation of the Aortic Valve Transcatheter Implantation (TAVI) service
	Angiogrāfu iegāde	2 250 000	0	4	0	x	x	Purchase of angiographs
	SAS medikamenti	1 525 247	455 820	2 603	3 659	x	x	SAS medication
Σ	<b>Kopā atkāpe no vidēja termiņa budžeta mērķa</b>	<b>56 700 000</b>	<b>44 120 384</b>	<b>1 771 691</b>	<b>1 815 629</b>	<b>22 239</b>	<b>19 014</b>	<b>Total deviation from medium-term budget objective</b>

Avots: Veselības ministrija, Fiskālās disciplīnas padomes aprēķini

Source: Ministry of Health, Fiscal Discipline Council calculations