2019

Latvia’s Stability Programme for 2019-2022

RIGA, 2019

LATVIJAS REPUBLIKAS
FINANŠU MINISTRIJA

CONTENT

Abbreviations

AWG	Economic Policy Committee's Working Group on Ageing Populations and Sustainability of Public Finances
Cabinet	Cabinet of Ministers
CIT	Corporate Income Tax
CPI	Consumer price index
CSB	Central Statistical Bureau of Latvia
EC	European Commission
ESA	European System of Accounts
EU	European Union
FDI	Foreign direct investment
FDL	Fiscal Discipline Law
Framework Law	Medium-Term Budget Framework Law
GDP	Gross domestic product
IMF	International Monetary Fund
LALRG	Latvian Association of Local and Regional Governments
LBFM	Law on Budget and Financial Management
MoF	Ministry of Finance
MPC	Mandatory procurement components
MTO	Medium-term objective of budget balance in structural terms
MTO SGP	Medium-term objective of budget balance in SGP terms
OECD	Organisation for Economic Cooperation and Development
PIT	Personal Income Tax
PYLL	Potential years of life lost
Regulation No 1175/2011	Regulation (EU) No 1175/2011 (16 November 2011) of the European Parliament and of the Council amending Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies
SGP	Stability and Growth Pact
SMSIC	State Mandatory social insurance contributions
SRS	State Revenue Service
USA	United States of America
VAT	Value Added Tax

1. GENERAL ECONOMIC POLICY GUIDELINES AND OBJECTIVES

In Latvia, public finance planning for the next budget year and medium term takes place in the autumn by adopting the annual State Budget Law and the Framework Law. Consequently, in the case of Latvia, the Stability Programme is not a policy planning document, but a forecasting tool, where for the medium-term, in line with the updated macroeconomic projections, fiscal forecasts for the years of the Framework Law currently in force are adjusted and fiscal forecasts are elaborated for the further years.

The Stability Programme of Latvia has been prepared following the conditions and guidelines of the SGP implementation and prepared in accordance with the requirements of Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies. Section 28 of the LBFM states that the Cabinet, till the 15th of April of the current year, shall submit to the Saeima (Parliament) the Latvia's Stability Programme.

After the slowdown of the economic growth rates in 2016 to 2.1%, over the period of next two years a considerable acceleration of growth rate of the Latvian GDP was observed. In 2017, Latvian economic growth reached 4.6%, facilitated by the growing external demand and restoration of investment flow, and a similar steep economic growth was preserved in 2018, when GDP increased by 4.8% at constant prices.

Steep economic growth in 2018 was ensured by both strongly growing investment volumes and still steeply growing private consumption, while the export growth rate slowed down, along with the slowdown of the global economic growth and under the influence of several one-off factors, such as a low grain harvest. Investments provided the largest input to the economic growth, which, as compared to 2017, increased by 16.4% last year, demonstrating even steeper growth than in 2017.

According to the MoF calculations, cyclical development of the Latvian economy has reached its maximum. In 2018, the output gap would have reached its maximum value, namely, 1.7% of GDP, and over the coming years, in light of the slowdown of economic growth rates, it is going to decrease. In 2018 Q4, the economic slowdown features already showed up, manifested, for example, in slower export growth rates, thus, similar to the EU, also 2019 marked itself with the slowdown of economic development.

Unlike other years, during the period from the preparation of the previous Stability Programme for 2018-2021 until the preparation of this Stability Programme, the Framework Law was not drafted. On the other hand, the 2019 State Budget was adopted only this April. Given the time constraints, the 2019 State Budget was developed as a “technical budget”, i.e. it included decisions taken by the previous government and the Saeima, as well as certain decisions taken by the new Saeima. The new priorities of the Saeima and the government will be funded by the State Budget Law 2020 and the Framework Law 2020-2022. In the light of the above, this Stability Programme does not provide information on the 2020-2022 fiscal policy strategy and the medium-term policy priorities for development.

Fiscal forecasts, based on the updated macroeconomic scenario, show that the general government budget deficit, excluding fiscal risks, will be 0.5% of GDP in 2019, which is at the same level as when preparing the national budget for 2019. In the medium term, the general government budget foresees a deficit of 0.4% of GDP in 2020, a deficit of 0.2% of GDP in 2021 and a deficit of 0.3% of GDP in 2022.

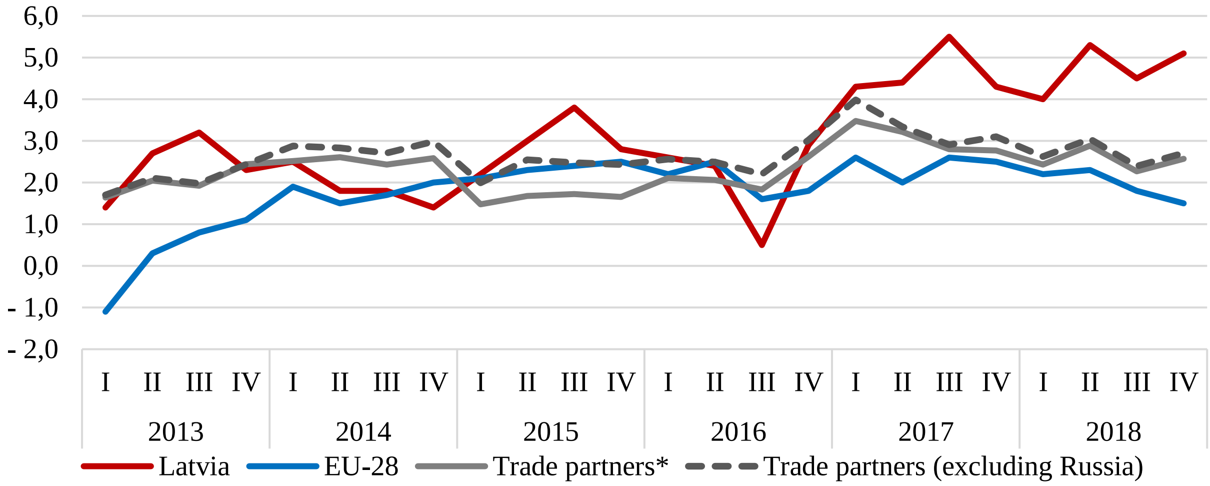
2. ECONOMIC SITUATION

2.1. EXTERNAL ECONOMIC ENVIRONMENT

The global economic growth last year has become weaker, especially in the second half of the year, when the slowdown of the growth rates had been stronger than projected by already lowered growth forecasts. The slowdown of the growth rates was determined by a weaker economic growth in Europe and certain countries in Asia, triggered by a set of various factors: weaker financial market sentiment, lower trade volumes, as the global industrial output reduced, and global trade policy uncertainty, as well as the unconvincing prospects of the Chinese economic growth. At the same time, growth rates in the USA, India and the developing countries of Asia remained stable.

In 2018, the economic growth of the largest Latvian export market, EU (EU-28), fell to 1.9%. It is a considerable slowdown, as compared to the 2.5% GDP growth achieved in 2017, and represents the weakest growth over the last four years. In addition to the external factors that adversely affected the EU economic performance last year, separate internal circumstances had not been favorable for the growth of the region, either. The EU economic confidence index has been reducing ever since June 2018 and has currently fallen to the lowest level since September 2016.

Economic growth rates of Latvia's main trade partners have also been weaker last year than the year before; even though, overall, they still considerably exceeded the EU total GDP growth (see Figure 2.1). Thus, for instance, economic growth in Estonia slowed down from 4.9% in 2017 to 3.8% in 2018, in Lithuania - from 4.1% to 3.4%, in Germany - from 2.2% to 1.4%, in Denmark - from 2.2% to 1.3% and the growth in the United Kingdom slowed down to 1.4%, as compared to the growth of 1.8% in the previous year. At the same time, Swedish GDP growth rate became stronger, achieving 2.3% in 2018. According to the IMF estimate, last year Russian economic growth was by 0.2 percentage points higher than a year ago, reaching 1.7%.



Data source: Eurostat; European Economic Forecast - Winter 2019 (Interim), EC; MoF calculations

Figure 2.1. GDP growth rates of Latvia's partner countries [1] and the EU, %

[1] Average growth in Latvia's main external trading partners (Lithuania, Russia, Sweden, Germany, United Kingdom, Denmark), weighted by the average export rate to particular country in 2018.

Leading international organizations have reduced global economic growth forecasts also for this and the next year. According to the latest IMF forecasts, developed in January of this year, in 2019, global economy will grow by 3.5% - by 0.2 percentage points slower than projected in the previous forecasts, and next year the growth will reach 3.6%. In turn, the OECD forecasts developed in March project even weaker growth of global economy - 3.3% in 2019 and 3.4% in 2020.

Growth slowdown in the medium term will be determined by faster slowdown of growth rates in certain developed countries, *inter alia*, Eurozone countries. It will be affected by insufficient business investment and unclear trade prospects with respect to political uncertainty and declining consumer and business confidence. Overall, according to the EC forecasts the weighted average economic growth of the seven main foreign trade partners of Latvia this year and next year is projected, correspondingly, at the level of 2.0% and 1.9%. Such GDP growth is lower than the growth in the previous year, however it still exceeds the EU average growth forecast for both this and the next year, which is projected, correspondingly, at the level of 1.5% and 1.7%, = Among the main Latvia's trade partners, the largest downward revision to the GDP growth in 2019 is made for the growth forecast for Germany and Sweden, and a minor forecast reduction has also been made to the economies of Estonia, Lithuania and Denmark.

Similar to 2017, also last year oil prices in the world market demonstrated considerable increase, with the average *Brent* crude oil price reaching 71.9 dollars per barrel in 2018, which is by 31.2% higher than in 2017. Therewith, also the inflation rate in the world continued growing. In 2018, inflation in Eurozone increased to 1.7%, as compared to 1.5% the year before. Nevertheless, at the end of the last year the oil price rise slowed significantly, thus reducing the inflation rate in the world, *inter alia*, in Eurozone. The oil prices are expected to continue shrinking this year, declining to about 60 dollars per barrel. Metal prices in the global markets this year will also be lower than the year before, and a minor price reduction is expected for the major part of the unprocessed food. Thus, this year inflation in Eurozone will fall to 1.4% (EC forecast), therewith moving away from the objective set by the European Central Bank regarding the inflation target, which is close to, but slightly below two per cent.

2.2. CURRENT ECONOMIC DEVELOPMENT

After the slowdown of the economic growth rates in 2016 to 2.1%, over the period of next two years a considerable acceleration of Latvian GDP growth was observed. In 2017, Latvian economic growth reached 4.6%, facilitated by the growing external demand and restoration of investment flow, and a similar steep economic growth was preserved in 2018, when GDP increased by 4.8% at constant prices.

Steep economic growth in 2018 was ensured by both strongly growing investment volumes and still steeply growing private consumption, while the export growth rate slowed down, along with the slowdown of the global economic growth and under the influence of several one-off factors, such as a low grain harvest. Investments provided the largest contribution to the economic growth, which, as compared to 2017, increased by 16.4% last year, demonstrating even steeper growth than in 2017, when the gross fixed capital formation had increased by 13.1%. Private consumption also grew steeper in 2018, - by 4.5%, as compared to 2017, promoted by considerable wage increase, employment growth and further reduction of the unemployment rate. Public consumption last year increased by 4.0%, but the export growth was comparatively slow, growing only by 1.8%.

The largest contribution to the GDP growth in 2018 was ensured by considerable **gross fixed capital formation or investment growth.** Notwithstanding that, a strong investment growth has been observed already in 2017, in 2018 investment growth accelerated even more and the contribution of investments into the real GDP growth reached 3.4 percentage points. The total amount of investments in absolute terms in 2018 at constant prices comprised 5570 million euro. Thus, the share of investments in the real GDP has increased to 23.3%, being the highest since 2013 and by only 1 percentage point below the average level over the last 15 years or since Latvia's accession to the EU.

It is worth noting that the investment activity has grown on the part of both the government and the private sector. Total scope of investments in current prices or considering the impact of the price changes comprised 6, 732 million euro, which is by 19.1% more than in 2017. Significantly, higher EU funds' investments flow has served as a considerable catalyst for investments in investment projects implement by both the government and the private sector. Last year, within the scope of 2014 - 2020 EU funds programming period, the state budget expenditure for the EU funds investment projects comprised 719 million euro, in contrast to 404 million euro in 2017.

The largest part or 44.1% of total investments in gross fixed capital in current prices in 2018 comprised the non-financial investments or corporate investments, and the scope thereof, as compared to 2017, increased by 496 million euro or 20.1%, comprising 2, 971 million euro. Sharp rise in non-financial investments last year was mainly determined by growth in construction activity. This is confirmed by both growth of construction output by 26.0%, as well as the fact that the majority of performed investments were buildings, structures and other constructions. Half of non-financial investments in 2018 was invested exactly in the buildings and structures, and the scope thereof, as compared to the previous year, grew by 37.9% or 403.8 million euro. Investment growth was also recorded in other assets, though considerably lower than in the buildings and structures. Thus, the scope of non-financial investments into equipment and machinery grew by 17.7% or 88.0 million euro, but in intangible assets - by 12.8% or 12.2 million euro.

Having analyzed the non-financial involvements in sectoral terms, these data also show that the investment growth is mainly related to the growing construction activity, because the steepest growths are recorded exactly in the construction sector and real estate activities. Investments in these sectors grew, correspondingly, by 3 and 1.5times. Considerable investment growth (+25.2%) was recorded also in the public administration and defense sector, ensured by significantly larger EU funds' investments inflow, implementing the infrastructure projects. At the same time, manufacturing was the sole sector of the large sectors of national economy, where the investment scope decreased last year, in total by 6.2%. Notwithstanding the growing private consumption and stable export development in the recent years, the scope of investments in the manufacturing in the recent years has been low and is within the range of about 280 million euro annually. Such scope of investments is considerably lower than even in the period of economic crisis and more than by half lower as compared to 2008. Investments made in the manufacturing in recent years are mainly focused on equipment replacing and rationalization of production processes.

FDI transactions or net incoming inflow in Latvia in 2018 constituted 744 million euro, in contrast to 650 million euro in 2017. Majority of the incoming FDI were debt instruments in the amount of 770 million euro. The amount of obtained profit from business activity conducted in Latvia, reinvested in the enterprise by foreign investors, last year slightly grew, comprising 227 million euro in total. Net FDI investments in equity were negative or - 252 million euro, meaning that the reduction of equity of foreign investors in subsidiaries in Latvia has been larger than investments inequity.

In 2018, **export of goods and services** at constant prices showed the rise by 1.8%, which is a considerably lower than in the previous year, when export grew by 6.2%. The previous year marked itself with the growth of protectionism in the global trade. If in the middle of the year the import customs duties introduced by the USA on steel, aluminum and other separate goods from the EU, China and other countries of the world and the response of the relevant countries has not yet considerably affected the global trade, then at the end of 2018 the adverse effects of these factors already became obvious. Thus, the real GDP growth of the EU in the first half of 2018 remained stable and comprised 2.3% y-o-y. Nevertheless, in the second half of 2018, the GDP growth fell to 1.6% y-o-y. While, the import of the EU goods and services at constant prices increased by only 3.0% last year, on the whole, representing the lowest growth since 2014. The EU is the largest trade partner of Latvia, ensuring 71.3% of Latvia's export of goods and 66.0% of the combined export of services in 2018. Thus, along with the slowdown of economic growth and domestic consumption in the EU, the growth rates of Latvia's export of goods and services started to reduce, as well, especially in the second half of the last year.

At the same time, the rise in prices of raw materials on the world stock exchanges, including energy resources, wood and metals, promoted the growth of export. The value of export of Latvia's goods at current prices in 2018 reached 12.4 million euro, which is by 7.4% more as compared to 2017. It is worth noting that the growth of export has been recorded in all largest product groups (wood, metals, mechanical appliances), except for food products.

The largest contribution into the growth of export of goods in 2018 among all product groups was ensured by wood and articles of wood, with the value of export thereof increasing by 17.7%, as compared to the year before, thus ensuring 2.9 percentage points of the total growth of export last year. Export of wood and wooden products has been constantly growing for the ninth subsequent year already, and in 2018, the value of export of these goods for the first time exceeded 2 billion euro. Considerable input in the growth of total export of goods was determined by the increase in export of mechanisms and technical appliances by 26.4%, as compared to 2017. However, this impressive growth was ensured by the growth of re-export of turbojet engines and turbo-propellers. Therewith, in total, the growth of export of these goods has a neutral influence on the foreign trade balance in the medium term, because the export of turbojet engines and turbo-propellers is related to the repairs of these goods in the USA and at the moment of completion of the repairs these goods are returned back to Latvia, which reflects on the import data. The export of metals, chemical industry and traffic vehicles has also grown, correspondingly, by 14.1%, 6.7% and 8.8%.

Mainly due to the deceleration of the growth rate of the transport services export, the growth rate of the total export of services in 2018 slightly slowed down, to 6.4%, as compared to the growth of 7.9% in 2017. Nevertheless, the registered growth of export of services last year, in general, corresponds to the average growth of the last five years and is to be assessed as stable. It is also important to note that the export growth has been recorded in all largest groups of services, except for financial services. Export of transport services, in 2018 comprising 40.2% of the total export of services and grew by 2.7%.

Foreign tourist spending growth by 7.0% last year was promoted by the growth of the number of foreign guests and the duration of their stay. Majority of foreign guests come to Latvia from Germany, Russia, United Kingdom, Lithuania, and Estonia. The sharpest export increases in 2018 has been recorded for telecommunications services, as well as information and computer services, correspondingly, by 48.7% and 13.7%. The total growth of export of services was reduced by already previously forecasted fall in export of financial services, by 15.1% in total, as compared to 2017.

In 2018, also the **import of goods and services** decelerated, as compared to the previous year. Nevertheless, import growth having been steeper than the export development.

The total value of import at constant prices grew by 5.1%, thus the net export contribution to the real GDP growth was negative last year, namely, - 2.9 percentage points.

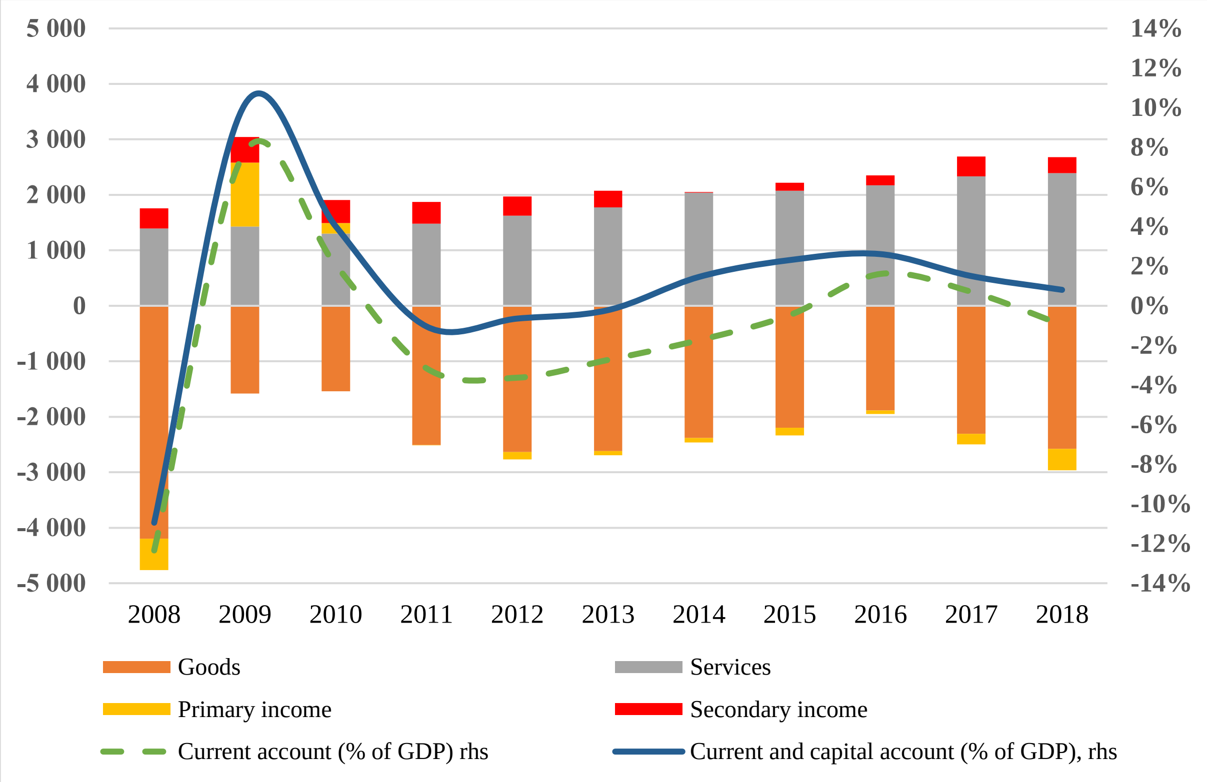
Import growth was steeper than the export growth also in current prices. Import of goods last year grew by 10.3%, as compared to 2017. One fourth of the total growth of import of goods was ensured by the growth of import of mechanisms and mechanical appliances by 24.9% or 360 million euro, which was mainly determined by the import of turbojet engines and turbo propellers. Since the end of 2016, Latvian airline *AS Air Baltic Corporation* has commenced the modernization of the aircraft fleet, acquiring new aircrafts. In 2017, six new aircrafts were acquired, and last year - seven more. When performing the testing and service of the aircrafts, their engines were sent back to the factory, which influenced the data of foreign trade. Import of food and agricultural goods also grew considerably, influenced by rise in import of alcoholic beverages from Great Britain and Italy, as well as import of grain crop from Russia and Lithuania. The total import of food and agricultural goods last year grew by 8.6%. Having analyzed other groups of import of goods, the growth of import of metal and its products by 19.0% should be noted. While import of wood and mineral fuel, oil and its refined products grew by 30.5% and 11.1% respectively.

Growth in 2018 was observed also in import of services - by 9.8%, as compared to the previous year. Increase of import was mainly determined by growth of import of transport services by 10.6%. It is important to note that import has grown steeply in almost all types of transport (air, rail and road transport), except for the sea transport, where it remained at the level of 2017. A notable rise in import was recorded also in information and communications technologies services. Thus, import of telecommunications services in 2018 increased by 46.2%, but import of information and computer services - by 20.0%. Import of financial services reduced by 18.2%.

Current account

Considering sharper rise in import of goods, as compared to the growth of export of goods, as well as increase of income obtained by foreign investors for the previously made investments in Latvia, a deficit of 283 million euro was recorded in the current account of the balance of payments in 2018, in contrast to the surplus of 191 million euro last year. Therewith, the current account balance comprised - 1.0% of the nominal GDP of Latvia in 2018.

Even though the current account balance was negative in 2018, in general, the current account development assessed as sustainable. First, the average three-year level of the current account is almost well balanced, comprising +0.4% of GDP. Thus, it does exceed the threshold stated by the EU Early Warning Mechanism (-4/+6% of GDP). Secondly, in 2018, the deficit of the current account was to a fully covered by the surplus of the capital account. In case of Latvia, the surplus of the capital account is ensured by the EU funds' investments inflow from the Cohesion Fund, European Regional Development Fund and Fisheries Funds.



Data source: Bank of Latvia

Figure 2.2. Components of the current account of Latvia's balance of payments (million EUR) and current and capital accounts in percentage of GDP

In recent years, the main changes in the current account are determined by the development of foreign trade of goods and services, and the last year was not an exception, either. As the import of goods grew considerably steeper than the increase of the value of export of goods, the goods account deficit grew by 268 million euro to 2, 576 million euro. Thus, the goods account deficit comprised 8.7% of the nominal GDP in 2018. It is important to note that a steeper growth of import of goods last year, in general, is related to the strong economic growth, which has reflected also in the higher investment and construction activity. Therewith, it is quite natural that the demand for machinery, metals and construction materials is growing, thus stimulating also the growth of import. In addition, import of goods was also increased by modernization of the aircraft fleet of the Latvian airline *AS Air Baltic Corporation*, acquiring new aircrafts.

Since 2011, the surplus of services account has been constantly growing and last year it reached 2, 394 million euro, which is by 62 million euro more than in the previous year. Therewith, the balance of services account comprises 8.1% of GDP in current prices. Even though the growth of import of services in the amount of 9.8% was steeper than the growth of export of services (6.4%), the account surplus has, nevertheless, increased. It is attributable to the various levels of export and import of services and growth in nominal terms. Thus, export of services reached 5292 million euro and it increased by 320 million euro in 2018. While, the value of import of services, in its turn, was 2899 million euro, with the increase of 259 million euro.

The deficit of primary income account grew from 190 million euro in 2017 to 386 million euro in 2018, thus comprising 1.3% of the nominal GDP. The growth of deficit by 196 million euro was mainly determined by increase of income obtained by foreign investors for the previously made investments in Latvia and, at the same time, reduction of income of Latvian investors for the previously made investments abroad. Nevertheless, the surplus of secondary income account in the amount of 286 million euro partially compensate the deficit of primary income account. Formation of the surplus of secondary income account was ensured by the EU funds' investment inflow. However, higher contributions to the EU budget reduced the surplus of this account, as compared to 2017, when the amount of surplus comprised 357 million euro.

In sectoral terms, the largest contribution to the economic growth in 2018 was ensured by the **construction sector**, in constant prices growing by 21.9%, which was ensured by steeper EU funds' investments inflow, as well as the growth of private investment activity. The volume of construction output in current prices in 2018 increased by 25.5%. The EU funds' investments promoted the implementation of the public construction projects; as a result, the construction volumes of civil engineering structures in current prices were by 25.5% higher than in 2017. The growth of construction of non-residential buildings by 21.8%, facilitated by both public and private investments, provided almost the same contribution to the total growth of the construction sector, and sharp increases last year were recorded in the construction of museums and libraries, trade, health protection and social security, as well as administrative building. Strong growth was also demonstrated by the construction of residential buildings, as the construction volumes thereof in 2018 grew by 38.7%.

The second largest contribution to the economic growth among the sectors in 2018 was ensured by the i**nformation and communications services**, which have reached the increase of 13.0% in total over the year. The **transport sector** in 2018 developed more successfully than it was initially expected, being the third largest economic growth driver with the growth of 5.3%. After having started the year unsuccessful y already from the middle of the year the transit of Russian cargoes, first of all, coal, through Latvian ports started to increase considerably, and Riga International Airport also operated successfully, sharply increasing the number of passengers. Overall, the cargo turnover in Latvian ports in 2018 grew by 7.0%, cargo volumes on railway increased by 11.8%, but the number of passengers in Riga International Airport grew by 15.7%. Notwithstanding the comparatively good results of 2018, further prospects of the sector are to be assessed prudently, considering that Russia has not refused from its strategy to reorient oil and coal cargoes to its Baltic Sea ports. At the same time, along with a steeper development of trade, also container transport has better prospects, as well as the cargo transport by road, in general, and, along with the development of tourism, also the passenger traffic in the Airport and in ports will continue growing.

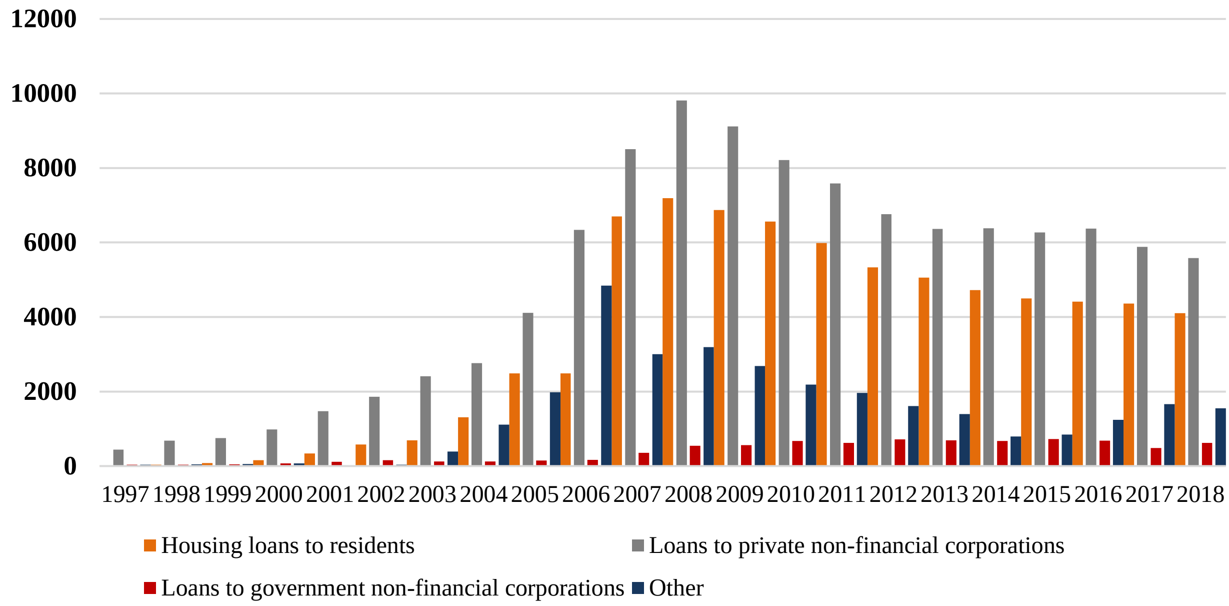
Unlike 2017, the manufacturing and the trade sectors played a smaller role in the growth last year. The added value in the manufacturing, after the rise of 8.0% reached in 2017, grew only by 2.7% in 2018. The key driver of the growth of manufacturing in 2018 was its largest subsector - wood processing, where the output volumes grew by 5.3% over the year. Considerable contribution to the growth of manufacturing was ensured also by metal processing and mechanical engineering subsectors, demonstrating a strong growth for the third year in a row already. In 2018, the output volumes in the manufacturing of fabricated metal products were by 5.1% higher than the year before, in manufacturing of machinery and equipment - by 7.9%, in manufacturing of electrical equipment- by 24.4%. High activity of the construction sector last year had triggered a steep growth in manufacturing of construction materials in the first half of the year, however, starting from July, the production volumes of non-metallic mineral products reduced, therewith, in 2018, as compared to 2017, the output of the subsector grew only by 1.9%. A good growth in 2018 was demonstrated by production of chemicals and chemical products, as well as production of rubber and plastic products. The growth of production of computers, electronic and optic equipment that has been very steep for the previous eight years, last year was more moderate, by its output growing only by 5.5%. In turn, the output volumes in the second largest subsector of manufacturing - manufacture of food products - last year reduced by 2.0%, which was to a large extent attributable to the fall in production of dairy products. Production volumes in 2018 have declined also in beverage production, repair and installation of machinery and equipment, printing industry and record reproduction.

The increase of added value by only 2.1% was recorded in the **trade sector** in 2018. Retail trade development in 2018 was slightly weaker than in 2017, as the retail trade turnover increased by 4.0%, while in 2017 the growth of 4.4% was recorded. The growth of retail trade in 2018 was ensured by both the rise in food products turnover and growing non-food sales volumes. Trade in food product stores in 2018 was by 4.2% higher than the year before, in turn, the total non-food goods' sales volumes had increased by 3.8%. Non-food goods' retail trade growth last year was limited by a weak fuel trade growth only by 2.9%, as compared by 2017. Similar to previous years, also in 2018 the retail trade growth was determined by the rise in the real wage of the employed, which had a positive effect on the purchasing power of the population and will continue promoting trade growth also this year.

As the non-resident servicing continued to decline in the banking sector, **the financial and insurance sector** in 2018 reduced by 7.3%. Looking at the development of the sector, it must be noted that in 2018 it experienced substantial changes in banking sector. These changes have partially started already in 2016 and 2017 and are related to restricting the activities of the high exposure non-resident shell companies in the Latvian banking market. In absolute figures, the total volume of assets of the Latvian banks over the period of 2018 reduced by 5.5 billion euro or 19.5% and the volume of non-resident deposits declined by 4.7 billion euro. Such a considerable fall was also related to the withdrawal of the license and commencement of the voluntary wind-up of the third largest Latvian commercial bank *ABLV bank*, caused by the 13 February 2018 proposal of the US Department of the Treasury's Financial Crimes Enforcement Network (Fin CEN) to impose sanctions on *ABLV Bank*. At the same time, it should be noted that the volume of resident deposits in 2018 continued growing and, over the year, grew by 805.5 million euro or 6.6%.

The lending of the Latvian private non-financial corporations and households has been quite slow in the recent years. Even though the total amount of the newly issued loans over the last 4 years to the Latvian households for home acquisition slightly grew, nevertheless the amount of the previously issued, but discharged loans had been steeper than the amount of the newly issued loans. Such trend in the housing lending segment has been observed for about 10 years till the middle of 2018, when from the peak of the issued loans in the amount of 7.2 billion euro in 2008the amount of the resident housing loans reduced to 4.1 billion euro in the middle of 2018, when *ABLV Bank* was excluded from the indicators. Data of the second half of 2018 shows that, since August 2018, a quite minor growth of this sector has commenced. At the same time, it should be noted that the share of loans guaranteed by the Latvian Development Financial Institution *Altum* (*Attīstības finanšu institūcija Altum*) in the total segment of the newly issued housing loans has increased from 19.1% in 2015 to 44.6% in 2018, which is partially related to the new specialists lending programme commenced in 2018, which supplemented the lending programme for families with children commenced already before.

As regards lending of the private non-financial businesses, the downward trend remained to be observed in 2018 and at the beginning of 2019.



Data source: Bank of Latvia

Figure 2.3. Loans to residents in 1997 - 2018, million *EUR*

It should be noted that, since the beginning of 2019, majority of banks in Latvia have been working in accordance with the new business models, supervised by the Financial and Capital Market Commission.

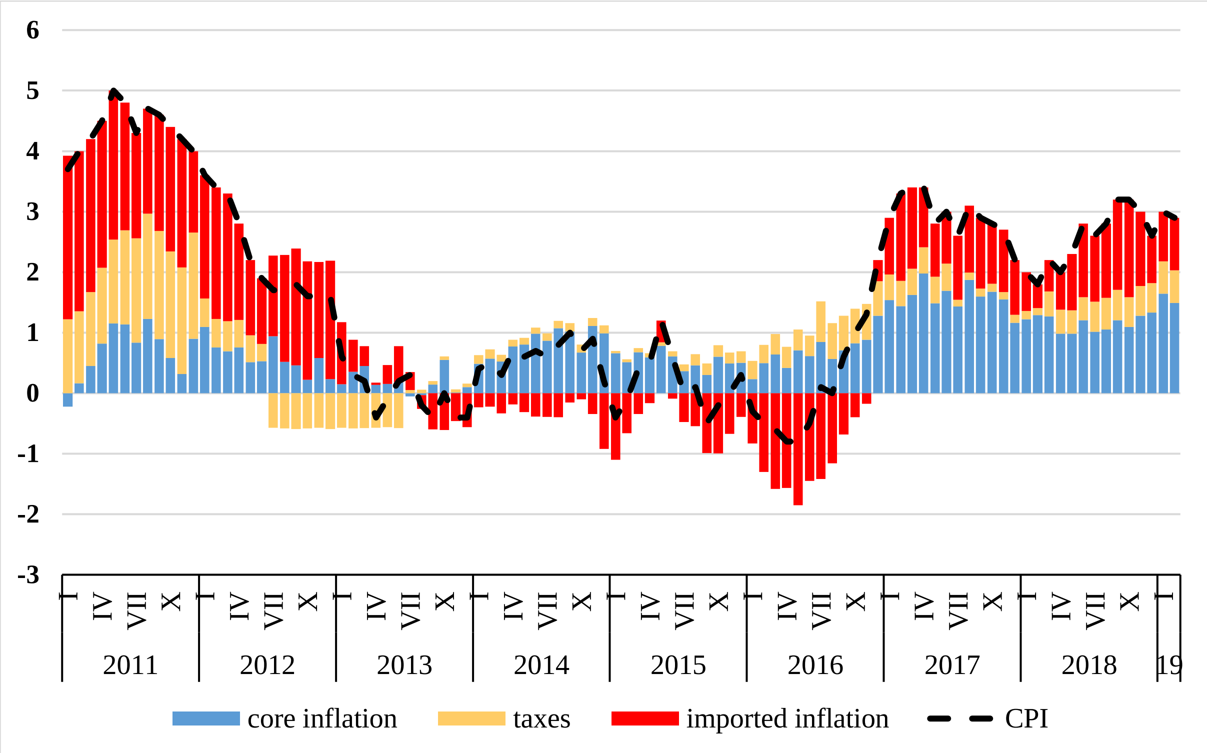
Agricultural sector (including agriculture, forestry and fishery), in 2018 grew by 3.4%, determined by a strong growth of forestry and fishery by 21%. At the same time, in the agricultural subsector fell by 12%, *inter alia*, crop production fell by 21%, largely affected by weather conditions and poor grain harvest, which was by 24% lower than in 2017. Animal farming, in turn, remained at the level of 2017, reducing by only 0.3%. The added value of fishery sector increased by 5% in 2018.

Increase of consumer prices in 2017 and 2018 in Latvia grew considerably as compared to the previous years, when inflation was close to zero. Increase of consumer prices was determined by both external factors or the rise of prices of energy resources and food on the world stock exchanges, and the macroeconomic processes taking place in the Latvian national economy. For instance, acceleration of the Latvian economic growth in the last two years had a positive effect on employment and wage increase, thus also the impact of private consumption on inflation gradually grew.

In 2018, consumer prices grew by 2.5% as compared to the previous year. It is important to note that, unlike the trends in 2017, when the increase of consumer prices was mainly triggered by the rise of food prices, in 2018, the price changes were affected several product and service groups, including the rise of prices of food, alcoholic beverages, energy resources and separate commercial services.

The largest input to the changes in consumer prices in 2018 was determined by the fuel price increase by 12.3% as compared to the previous year, thus increasing inflation by 0.7 percentage points. Short-term fluctuations in fuel prices are mainly determined by the crude oil prices on the world stock exchanges. Last year the highest oil price since 2015 has been reached - the average *Brent* crude oil price in 2018 reached 71.9 US dollars per barrel. As compared to 2017, when the average crude oi price per barrel was54 US dollars, increase is significant - 31.2%, thus considerably affecting also the fuel prices in Latvia.

Significant contribution to the increase of consumer prices in 2018 was also determined by the prices of housing related goods and services. Thus, the prices of such public utilities as gas and heat energy supply increased, correspondingly, by 5.4% and 2.3% largely determined also by the rise in prices of energy resources in the world. However, considering that the methodology for calculation of tariffs of these utilities differs from the fuel pricing mechanism, the rises in these prices are different. As regards public utilities, a comparatively steep rise in water supply service prices should also be mentioned. Mostly due to the new tariffs for water, management services of SIA *Rīgas ūdens*, which took effect from 1 June 2018, the average price of water supply service increased by 5.3%. Household spending was also affected by considerable increase of solid fuel prices (+16.9% y-o-y), due to the increase in wood prices.



Data source: CSB, MoF calculations

Figure 2.4. Annual inflation according to a source of origin

Among other services, the rise in prices of insurance services by 24.8% should be mentioned, which mainly related to the rise in prices of compulsory civil liability insurance of owners of motor vehicles. Prices of health care services grew by 3.3%, mainly attributed to the increase in prices of outpatient services. The prices of catering and cultural services, in turn, grew, correspondingly, by 3.2% and 3.4%. Overall, the prices of all services in 2018 grew by 3.2%. Except for the increase in prices of public utilities, the rise in prices of other services is mainly related to a stable private consumption growth and positive developments in the labor market, reflected in steep wage increase.

In 2018, inflation was influenced also by changes in the tax rates. Thus, rises in excise duty rates on oil products, alcoholic beverages and tobacco products influenced consumer prices in as upwards direction. In turn, VAT rate reduction to 5% for fruits and vegetables characteristic for Latvia slightly mitigated the rise in excise duty rates; therewith the changes in the tax rates in 2018 increased the consumer prices by 0.4 percentage points, overall.

Along with acceleration of economic growth, the situation in the **labour market** continued improving and in 2018 the decline in unemployment rate became considerably steeper and the amount of population employed in the national economy grew, as well. Unemployment rate, according to the labour force survey, in 2018 declined by 1.3 percentage points to 7.4% of the economically active population. It has been the steepest fall of unemployment rate since 2013. At the end of December of 2018, the registered unemployment rate had reduced to 6.4%, which is by 0.4 percentage points lower than at the end of December of 2017. The total number of registered unemployed over the period of last year had declined by 5.6% and comprised 59.6 thousand at the end of December.

Amount of population employed in the national economy in 2018 increased by 1.6% to 909.4 thousand, which was far steeper than in the previous years. As the number of working age population continued shrinking, the increase of the number of employees along with a lower unemployment rate was ensured also by the growth of economic activity of the population, with the share or the employed and jobseekers in the total number of working age population in 2018 reaching historically highest level - 69.7%.

Data on the occupied workplaces show that the most rapid formation of new workplaces in 2018 was observed in construction, sector of information and communications services, as well as the sector of accommodation and catering services, where the number of occupied workplaces in 2018 has been, on average, by 7.4%, 7.1% and 5.4% larger than the year before. In turn, a slight decrease in the number of workplaces in 2018 has been in the sectors of financial services, transport, trade and energy supply.

Average monthly gross wage in 2018 has increased by 8.4%, reaching 1, 004 euro. This has again been a slightly steeper increase than in 2017, when the average wage had grown by 7.9%. Steeper wage growth in 2018 is attributable to a strong economic growth, increase of the minimum wage by 50 euro to 430 euro, as well as the increase of funding for wages in separate categories of public sector employees in the defense and health institutions, as well as in the SRS.

In 2018, the wage growth in both public and private sector was approximately the same- correspondingly, by 8.5% and 8.4%, as compared to 2017. Average wage in public sector in 2018 comprised 1, 032 euro, but in private sector 991 euro. The real net wage in 2018 increased by 7.2%, demonstrating a significantly steeper growth than in the previous two years, and it was attributable to the gross wage increase, reduction of labour taxes and comparatively moderate inflation.

The sharpest gross wage increases last year were registered in the health and social care sector, as well as accommodation and catering sector - by, correspondingly, 15.9% and 11.8%. Wage decrease was not recorded in any sector, while, the smallest wage increase was observed in the sector of financial services - by 3.6%, nonetheless, remaining the highest among all sectors - in the amount of 1, 991 euro. The lowest wage, in turn, remained to be in the sector of accommodation and catering services - 709 euro.

In general, Latvian economic growth last year is to be assessed as very good, when, notwithstanding the problems in separate sectors, the economic growth rate was one of the sharpest in the EU. The growth will remain strong, though more moderate also in 2019, which will be determined by the stabilization of the EU funds' investments flow and a slower economic growth in the world and the EU.

2.3. Macroeconomic Development Scenario

The medium-term macroeconomic development scenario of 2019-2022 has been drafted in February 2019. When drafting the forecasts of macroeconomic indicators, the MoF has consulted the experts of the Bank of Latvia and the Ministry of Economics, as well as the experts of the EC and the IMF. Forecasts of the macroeconomic indicators have been approved by the Fiscal Discipline Council, by publishing its opinion on 15 February 2019. The latest EC and IMF 2019 winter forecasts were used as a basis for the external environment underlying the Latvia's export forecasts.

Table 2.1. Growth and Related Factors

	ESA code	2018	2018	2019	2020	2021	2022
		million euro	Growth %				
1. GDP at current prices	B1*g	29 424	8.8	6.4	5.9	5.5	5.5
2. GDP at 2010 prices	B1*g	23 860	4.8	3.2	3.0	2.9	2.9
GDP by expenditure at 2010 prices							
3. Private consumption	P3	14 660	4.6	4.3	3.6	3.6	3.6
4. Public consumption	P3	4 039	4.0	3.6	3.0	3.0	3.0
5. Gross fixed capital formation	P51	5 559	16.2	7.7	6.0	6.0	6.0
6. Changes in inventories and acquisition of valuables	P52+P53	758	-	-	-	-	-
7. Exports	P6	14 863	2.5	3.2	4.1	4.0	3.9
8. Imports	P7	16 019	6.8	5.7	5.2	5.0	4.9
Contribution to GDP growth							
9. Final domestic demand			6.9	5.0	4.2	4.0	4.1
10. Changes in inventories and acquisition of valuables	P52+P53		0.7	0.0	-0.2	-0.2	-0.2
11. Exports imports balance	B11		-2.9	-1.8	-1.0	-1.0	-1.0

Considering the sharp growth of Latvian economy in 2018, the GDP growth forecast for 2019 has been increased by 0.2 percentage points, as compared to the previous forecast developed in September of 2018, - to 3.2%, and the growth of 3% if being forecasted in 2020. The GDP growth will be decelerated by a weaker demand in external markets, because of the slowdown of a business cycle observed in the global economy. Investment growth, along with the stabilization of the EU funds inflow at the level of 2018, in the coming years will be more moderate than in 2017 and 2018, though still strong (7.7% in 2019 and 6% in 2020). Private consumption growth will remain stable in the amount of 4.3% in 2019 and 3.6% in 2020, facilitated by a comparatively steep average wage growth (by 6.5% and 5.5%, correspondingly, in 2019 and 2020) and a growing purchasing power of population.

Labour market will still be influenced by a growing demand for labour force and demographic trends. The number of employees in 2019 will grow by 0.5%, but in further years, the growth will be limited by the reduction of the number of working age population. Unemployment rate will decline to 7.0% in 2019 and to 6.5% in 2020.

Increase of consumer prices in Latvia in 2019 will remain at the level of the previous year and will comprise 2.5%. Price dynamics in 2019 will be determined by a higher increase in public utilities and food prices than in 2018, as well as the increase of the excise duty rate on tobacco products and alcoholic beverages, whereas the fuel price increase will be slower. In 2020, inflation will reduce to 2.2%.

Inflation

After a minor slowdown of inflation at the end of 2018, increase of the household consumer prices accelerated again at the beginning of 2019, reaching 3.0% in January and 2.9% in February, as compared to the relevant month of 2018. Unlike the factors affecting the consumer price dynamics in the previous year, in the first two months of 2019 the rise of prices of goods and services related to housing maintenance considerably accelerated, with an especially steep rise in the prices of public utilities. The rise of prices of these goods and services explain 0.9 percentage point of inflation in the first two months of 2019. In addition, the rise in consumer prices was also affected by the rise in prices of alcoholic beverages, tobacco products and food.

The rise in consumer prices at the beginning of this year was largely affected by the rise in gas prices by 19.9% as compared to the first two months of 2018. Such a sharp price increase was affected by two factors. First of all, starting from 1st of January 2019, distribution system operator applied new tariffs. Tariff now includes two components - a fixed part and a variable part. The fixed part will depend on the permitted maximum load, whereas the variable part will be based on the natural gas consumption, as it was previously. Secondly, the gas price was affected by a sharp rise in oil prices in the world last year. Considering the methodology for determination of gas tariffs for household, the impact of rise in prices of energy resources on the world stock exchanges reflect on the gas prices in Latvia with delay. Thus, the growth of gas prices by nearly 20%, as it was in January and February this year, would remain in the first half of this year, as the tariffs are revised only twice per year - in January and in July.

The prices of other services related to housing maintenance grew considerably, as well. Thus, refuse collection in January and February was, on average, by 16.2% more expensive than the year before, triggered by increased tax rates for waste disposal, starting from January 1 this year. The rise in water supply service prices by 14.0%, in turn, was influenced by the new tariffs for water management services of SIA *Rīgas ūdens*, which took effect from 1 June 2018. Considering the base effect, the augmentative impact on inflation will be preserved by May this year.

Price increase was also recorded for electricity, in general, by 7.9%, which was mainly determined by significant rise in electricity prices on *Nord Pool Spot* stock exchange, which was considered, when concluding new contracts on electricity supply for 2019. Rise in electricity prices by nearly 8% is expected also in the further months of this year.

Food prices in the first two months of this year grew by 1.4% y-o-y, which is twice as sharp rise on average, if compared to last year. Acceleration in the rise of prices is mainly attributable to untypically dry weather conditions in Summer of 2018 in Latvia and in Europe, at large, adversely affecting the volume of harvest of cereals and vegetables. This, naturally, has an augmentative impact on prices, especially, on flour, bread and cereals. It is expected that by the middle of the year the annual growth of food prices could reach 2%, however, on average, annually the rise in food prices will be close to 2%.

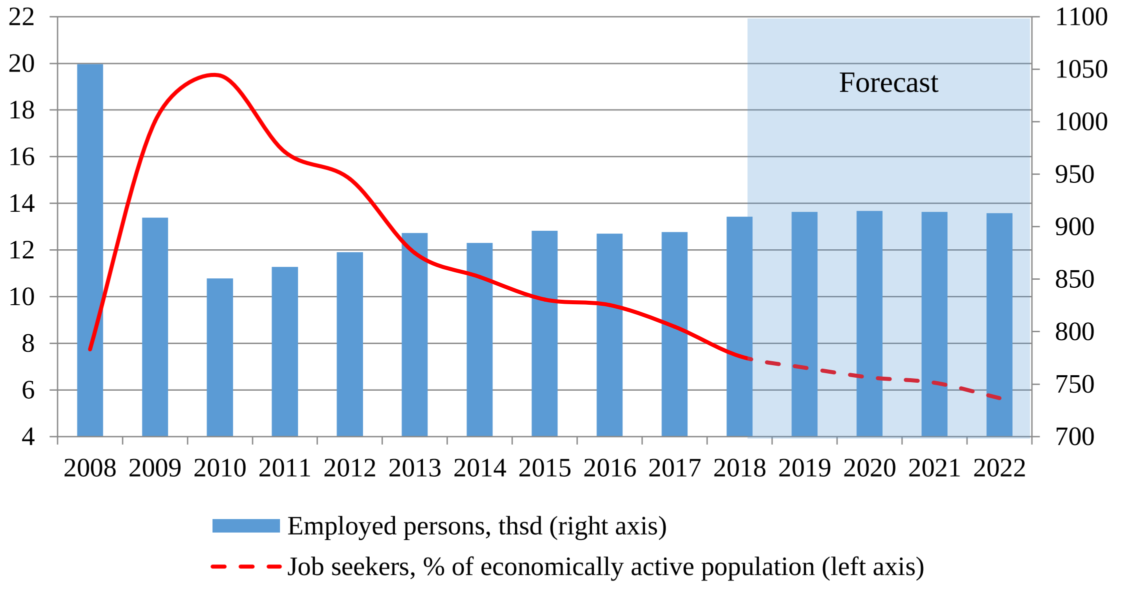
According to the MoF, forecasts inflation in 2019 will be preserved at the level of the previous year and consumer prices will increase by 2.5%. Rise in prices will be balances among the increase of prices on food products, public utilities, as well as other services related to housing maintenance. It is assumed that the average price of energy resources on the world stock exchanges will remain at the level of 2018, thereby their effect on fuel prices will be neutral or slightly augmentative. Nevertheless, given the methodology of calculation of tariffs, gas and heat energy prices will continue growing, even though the rise in prices of energy resources is not expected. Additionally, when forecasting inflation, the increase in excise duty rates on alcoholic beverages and cigarettes, correspondingly in March and June of 2019 was considered.

Labour market

Along with the steep economic growth in 2018, after the break of several years, the number of population employed in the national economy grew significantly again, and decline of unemployment became steeper, as well, as the unemployment rate according to the labour force survey fell by 1.3 percentage points to 7.4% of the economically active population. Along with the growing demand for employees and limited number of working age population, in 2018, concurrently with the increase of the number of the employed also the number of job vacancies, where the employers seek employees, grew quite considerably.

The development of the labour market also in the medium term will continue to be affected, concurrently, by both economic growth and declining number of the working-age population, when, during the times following financial crisis, the number of population aged between 15-74 years in Latvia has declined on average by 1.8% per year. Therewith, economic activity of the population will continue to grow, which, already in 2018, has reached its historically highest level, when already 69.7% of all population aged 15-74 have been actively involved in the labour market as employed or job-seekers. As compared to the year before, the level of economic activity in 2018 had grown by 0.7 percentage points. The increasingly growing involvement of population in the labour market is promoted by growing demand for employees and wage level, with the average wage last year growing at the steepest rate since 2008, gradual increase in the retirement age, changes in the age structure of population, where the share of economically less active youth among all working - age population is decreasing.

Considering the limited number of working - age population, the number of the employed in the medium term will remain at the reached level, according to the MoF forecasts, in 2019, increasing by another 0.5%, but without experiencing any considerable changes over the next there years.

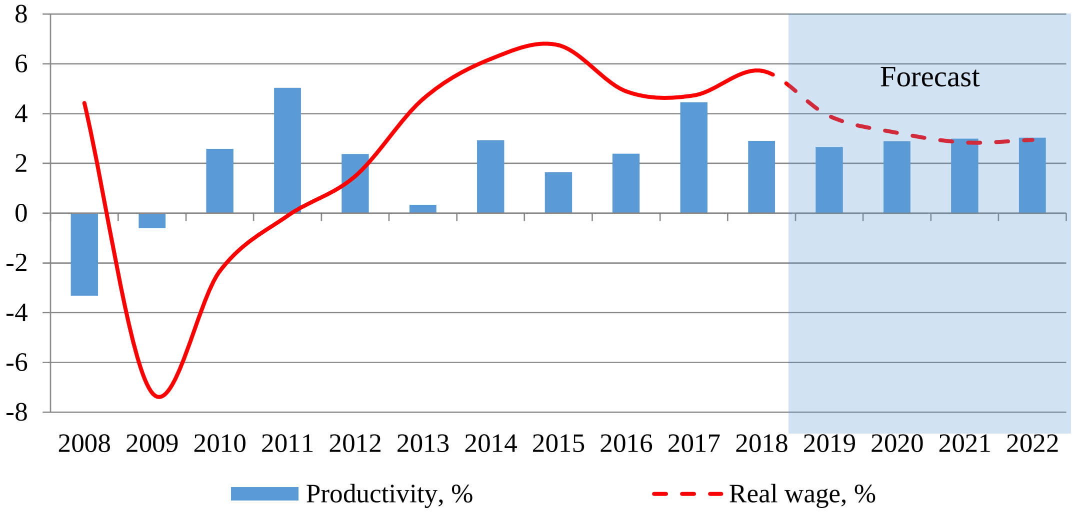


Data source: CSB. MoF forecasts

Figure 2.5. Employment and unemployment in 2008 - 2022

Overall, during the period since the peak of the economic crisis in 2010, the number of population employed in the national economy has increased by 58.7 thousand or 6.9%, but it is still significantly - by 148.0 thousand or 14.0% - lower than the level reached in 2007, based on both negative natural population growth and high emigration during the post-crisis period. During the period after the financial crisis, around 20 thousand people left Latvia annually, but the provisional data show that, in 2018, along with the improvement of the labour market situation and growth of the wage level, emigration has significantly reduced. Also during the next years, sharper expected growth of population income might limit emigration processes, but the growth of the number of the employed population will still be affected by demographic situation, as the number of people of retirement age exiting labour market will exceed the number of youth entering the labour market.

The unemployment rate in the medium term will continue to decline, which will also be determined by a steeper economic growth and influenced by the decrease of the number of population aged between 15-74 years. According to the MoF forecasts, in 2019, the unemployment rate will decrease to 7.0%, but over the period till 2022, it will gradually decline to 5.6% of the economically active population.



Data source: CSB. MoF forecasts

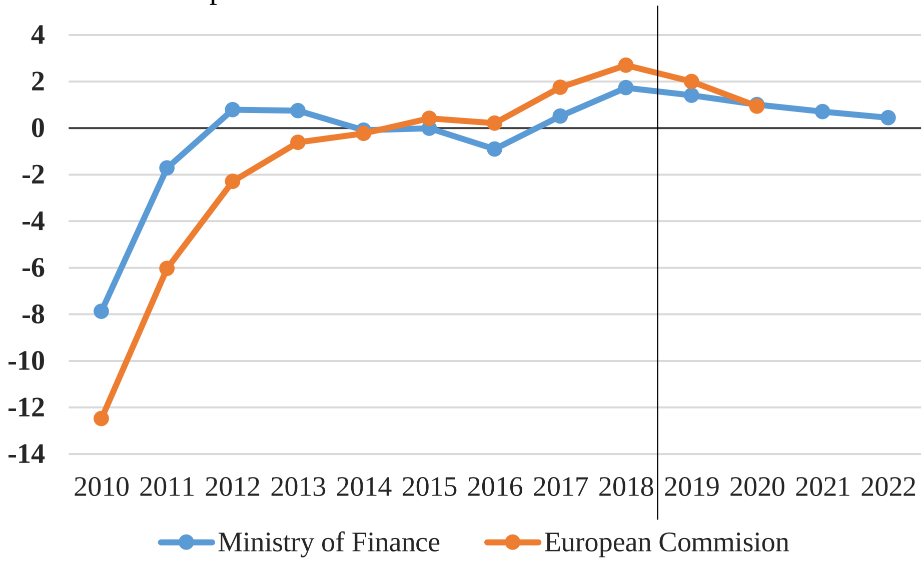
Figure 2.6. Changes in productivity and real wage, % against the previous period

It is expected that the monthly average gross wage, which had increased by 8.4% in 2018, in 2019 will grow at a more moderate rate - by 6.5%, determined by both lower economic growth and the non-increase of the minimum wage, preserving in at the level of 2018. Nevertheless, the wage increase will still be comparatively steep, which, among other factors, will also be influenced by the planned increase in the State budget expenditure for work remuneration, first of all, for the employees of the health care sector. In 2020, according to the MoF forecasts, the rate of the wage increase will slightly slow down, comprising 5.5%, and afterwards it will fall to 5.0% by 2022.

If in 2017 the wage increase did not considerably exceed the productivity growth anymore, then in 2018 the wage has again grown steeper than productivity. Such dynamics has been influenced by several one-off factors, *inter alia*, rapid growth of minimum wage, and in the coming years the MoF expects that the wage growth would gradually approach the productivity growth level and in 2021-2022 would already correspond to the productivity growth.

Cyclical development of economy

In 2017, Latvian economic growth reached 4.6%, facilitated by the growing external demand and restoration of investment flow, and a similar steep economic growth was preserved in 2018, when GDP increased by 4.8% at constant prices. According to the MoF calculations, cyclical development of the Latvian national economy has reached its maximum. In 2018, the output gap would have reached its maximum value, namely, 1.7% of GDP, and over the coming years, in light of the slowdown of economic growth rates, it is going to decrease. In 2018, Q4 the economic slowdown features already showed up, for example, in slower export growth rates, thus, similar to the EU, also 2019 marked itself with the slowdown of economic development.



Data source: EC. MoF calculations

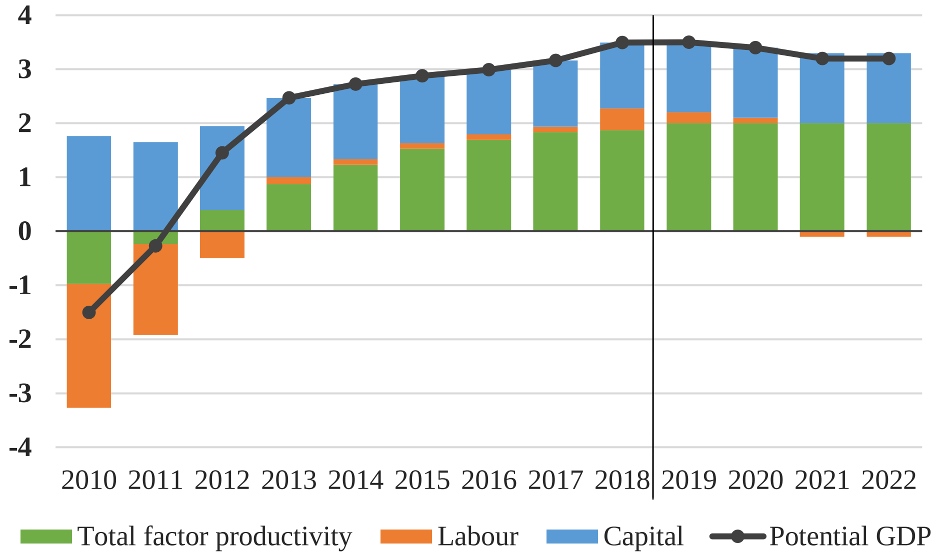
Figure 2.7. Output gap, %

Similar medium-term output gap estimate was also provided by the EC. More positive output gap since 2016 has also been determined by the fact that the EC estimate is mainly influenced by the wage increase. Nevertheless, other cyclical variables, such as, for example, low inflation, current and capital account balance surplus, as well as the reduction of the net debt against GDP and reduction of the volume of issued loans, show that by 2017 such a large output gap had not been formed in the economy. This is also confirmed by the estimates or the alternative output gap "plausibility tool [2]" developed by the EC. However, in general, starting from 2020, the MoF and EC forecasts regarding the amount of the output gap are identical, as it is not forecasted that the real wage increase in the medium term will exceed the growth in labour force productivity, namely, the real wage increase above the productivity, which might be indicative of high positive output gap, is not forecasted. Therefore, in the medium term, the output gap will reduce, because the GDP growth will gradually slow down to its potential growth.

The GDP potential growth during the period of projections will mainly be determined by the combined productivity growth. Since the last economic recession (in 2008-2010) it has reached the largest contribution to the potential GDP growth, providing for approximately one third of the potential GDP growth since 2016 and it will make up approximately the same amount also in the period of forecasts, namely, 2 percentage points. The capital contribution

[2] *Plausibility tool*

to the potential DP growth will also be positive. Rapid investment growth in 2017 and 2018 slightly increased the capital impact on the potential growth to 1.3 percentage points. In turn, due to demographic situation, the employment will have a neutral impact during the period of forecasts. According to the MoF calculations, the potential GDP growth will range from 3.2-3.5% in the medium term.



Data source: MoF calculations

Figure 2.8. Potential GDP growth and input of components, %

3. GENERAL GOVERNMENT BUDGET BALANCE AND DEBT

3.1. FISCAL POLICY STRATEGY AND MEDIUM-TERM OBJECTIVE

Unlike other years, this year no *Framework Law* has been drafted during the period from preparation of the previous Stability Programme for 2018-2021 till preparation of the Stability Programme for 2019-2022. In accordance with the 7 February 2019 amendments to the LBFM it was stipulated that in 2019 the draft Framework Law is to be prepared only for 2020, 2021 and 2022 and it is to be submitted to the Saeima jointly with the draft law On the State Budget for 2020. The State Budget for 2019, in turn, was adopted only in April this year, with the State Temporary Budget for 2019 being effective before that.

Considering the limited timeframe, the State Budget for 2019 was drafted as "Technical Budge", namely - it included the decisions adopted by the previous government and the Saeima, as well as the decision adopted by the new Saeima on the increase of wages for the health sector employees. The policy priorities of the new Saeima and the new Cabinet will be financed by the law *On the State Budget for 2020* and the *Framework Law for 2020-2022*.

Given the aforementioned, at the moment of drafting this Stability Programme there is no new fiscal policy strategy developed. Currently, the fiscal policy strategy described in the previous Stability Programme and the medium-term policy priority courses of development set by the Framework Law for 2018, 2019 and 2020, as described in the Stability Programme for 2018-2021 are in effect.

Given the aforementioned, this Stability Programme does not provide for information about the fiscal policy strategy and the medium-term policy priority courses of development for 2020-2022.

The principles of Latvian fiscal policy are laid down in the *FDL* and they are implemented, observing the numerical fiscal conditions laid down in this Law, as well as ensure the conformity thereof to the provisions of the SGP. The structural balance objective for 2020, 2021 and 2022 is set in accordance with the referred to conditions and more detailed information thereon is provided for in the next Section 3.2.1, but Section 3.2.2 provides information about the discretionary policy measures, adopted after the previous Stability Programme. Thus, during an interval between the moment of drafting the Stability Programme for 2018-2021 and the moment of drafting the Stability Programme for 2019 - 2022, decisions on fiscal policy have been adopted which have filled the fiscal space of 2019 and provide basis for implementing the strategy of the Stability Programme for 2019-2022. The fiscal effect of these decisions has been included in this Stability Programme **in a no-policy change scenario.**

Regarding MTO the same approach is applied, which was set in the previous Stability Programme, defining two different MTOs: national MTO, which remains -0.5% of GDP, and MTO within the meaning of the SGP or MTO SGP, which is set as -1.0% of GDP.

3.1.1. Structural Balance objectives for 2020, 2021 and 2022

The general approach provides that, when setting objectives of general government structural budget balance, a multi-stage method is being applied and objectives should concurrently provide for the compliance with both the national level fiscal rules (balance rule, expenditure growth rule and rule of expenditure inheritance), as defined in the FDL, and with the methodology applied by the EC.

First of all, the structural balance objectives are calculated by means of the balance rule. Two scenarios are developed for verification of the balance rule - one with the national MTO, and another with the MTO SGP. The introduction of two different MTOs in the Latvian fiscal policy is still rooted in the cautious approach, so that the defined objectives of the general government budget structural balance are consistent not only with the national approach, but also to ensure compliance with the SGP conditions.

FDL prescribes that compliance with the balance rule is not the only fiscal rule. When setting the objective of structural balance, also the expenditure growth rule has to be taken into account, as prescribed by Regulation No 1175/2011 (Regulation (EU) of the European Parliament and of the Council No 1175/2011 (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). This rule, in the general case, may determine more ambitious objectives of the general government budget structural balance.

The FDL also provides that the central government expenditure is determined in the *Framework Law* for the three subsequent years and this is legally binding (rule of expenditure inheritance). Therewith, a situation may occur that retention of the central government expenditure at the level prescribed by the previous *Framework Law* can change the objective of structural balance of the general government budget. However, changes are restricted by a provision of the FDL that if deviations of expenditure exceed 0.1% of GDP, expenditure is not preserved, but is recalculated in compliance with the structural general government budget balance and expenditure growth rules.

The afore-mentioned fiscal conditions set the objective of the general government budget structural balance and the nominal balance (the maximum permissible general government deficit or the minimum permissible general government budget surplus) in compliance with the *top-down planning method of a budget balance.* At the same time, there is also the *bottom-up planning method of a budget balance* applied according to which the general government budget balance is forecasted **in case of a constant policy.**

In a general case, general government budget balances differ according to both methods. If pursuant to the first method, a general government budget balance is larger than the balance set as a result of the second method, there is the so-called fiscal space or possibilities at disposal of the government to increase expenditure for the new priorities of expenditure policy or to reduce revenue for new tax policy initiatives. If according to the first method, a general government budget balance is smaller than by the second method, the government shall carry out consolidation measures, taking discretionary measures for reducing expenditure or increasing revenue.

Balance objectives according to <u>the balance rule</u>

First, the objectives of structural balance are calculated by verifying their conformity to **the balance rule**. Two scenarios are developed for verification of the balance rule - one with the MTO SGP, which is set as - 1.0% of GDP, and the second one with the national MTO, which is set as - 0.5% of GDP and being a stricter condition, as compared to the MTO SGP.

Structural balance objective according to the SGP approach

In this section, it is determined what the maximum level of the general government budget structural balance objective could be in accordance with the above-mentioned SGP approach. As previously mentioned, the starting position for determining the general government budget structural balance objective in accordance with the SGP approach is MTO -1.0% of GDP. The following table reflects further adjustments.

Table 3.1. Structural balance objective according to the SGP approach

		2020	2021	2022
(1)	MTO	**-1.0%**	**-1.0%**	**-1.0%**
(2)	Cyclical component	0.4%	0.4%	0.4%
(3)=(1)+(2)	Cyclically adjusted balance	-0.6%	-0.6%	-0.6%
(4)	One-off measures	0.0%	0.0%	0.0%
(5)=(3)+(4)	Nominal balance	**-0.6%**	**-0.6%**	**-0.6%**

During the period from 2013 to 2018, the deviations from the MTO has been granted to Latvia due to the implementation of the pension reform, which provided for a gradual increase of contributions to the second pension pillar. In turn, from 2017 to 2019, deviations from the MTO has been granted to Latvia due to the implementation of the structural reforms in the field of health care. Pension reform deviations were not applied anymore, when determining the structural balance objectives for 2019 and the following years, while the health reform deviations are not applied anymore, when determining the structural balance objectives for 2020 and the following years. Therewith, the maximum permissible structural balance corresponds to the MTO.

To obtain the nominal balance objective, the cyclical component of the balance and one-off measures are added to the MTO.

The cyclical component is calculated as the multiplication between the elasticity coefficient 0.38 and the EC output gap. For 2020, the EC output gap forecast is applied (-1.0% of GDP) and this value is also applied, when calculating the cyclical component for 2021 and 2022, because the EC forecasts are available only till 2020. Correspondingly, the value of the cyclical component for 2020 - 2022 comprises 0.4% of GDP. As the SGP scenario for 2020 - 2022 does not provide for one-off measures, then the nominal balance is equal to the cyclically adjusted balance, which is -0.6% of GDP for 2020 - 2022.

Structural balance objective according to national methodology

In this section, it is determined what the maximum level of the general government budget structural balance objective could be in accordance with the national methodology. As previously mentioned, the starting position for determining the general government budget structural balance objective in accordance with the national methodology is **MTO -0.5% of GDP**. The following table reflects future adjustments.

Table 3.2. Structural balance objective according to national methodology

		2020	2021	2022
(1)	MTO	**-0.5%**	**-0.5%**	**-0.5%**
(2)	Cyclical component	0.4%	0.3%	0.2%
(3)=(1)+(2)	Cyclically adjusted balance	-0.1%	-0.2%	-0.3%
(4)	One-off measures	-0.3%	0.0%	0.0%
(5)=(3)+(4)	Nominal balance	**-0.4%**	**-0.2%**	**-0.3%**

Like in the SGP scenario described herein above, the deviations from the MTO are no longer applied for determination of the structural balance objectives for 2020-2022; therewith the maximum permissible structural balance corresponds to the MTO.

After the amount of the maximum permissible structural balance of the general government budget to be used in future estimates is determined, the nominal amount of the general government budget balance is calculated. Similar to the previous scenario, the cyclical component of the balance is calculated, by multiplying the output gap with the elasticity coefficient of 0.38, only in this scenario the output gap forecasted by the MoF is applied. The calculated cyclical component of the balance is 0.4%, 0.3% and 0.2%, respectively, in 2020, 2021 and 2022.

In this scenario, the short-term revenue decline caused by the tax reform: In 2020, -0.3% of GDP is viewed as the one-off measure.

Thus, by applying the previously determined structural balance, the MoF forecasts on the output gap and the one-off measures, the nominal balance is obtained, which in 2020 is -0.4% of GDP, in 2021 is -0.2% of GDP and in 2022 is -0.3% of GDP.

As already specified in the previous Stability programme, the application and interpretation of the FDL provisions is under the competence of the MoF and the MoF maintains the opinion that the short-term revenue decline caused by the tax reform, in terms of its essence, is a one-off measure - the revenue decline has no lasting effect and therefore it should not be included in the structural balance. The EC observes a much more conservative policy with respect to one-off measures and it does not exclude from the structural balance absolutely all measures with the short-term fiscal effect (see EC Technical Handbook *Vade Mecum on the SGP, Box 1.4: Calculating the structural balance*). Thus, the revenue decline caused by the tax reforms within the SGP scenario will not be recognized on the part of the EC as a one-off measure and, therefore, it is not included in Table 3.2.

Balance objectives according to the balance rule – the choice of structural objectives

When general government budget structural balance objectives are determined and the nominal balance of the general government budget is calculated according to both methods, the results obtained are compared and the largest nominal value of general government budget balance is chosen in order to ensure compliance with fiscal rules according to both the national methodology and the SGP approach.

Table 3.3. The choice of structural objective

		2020	2021	2022
(1)	Nominal balance (according to SGP approach)	-0.6%	-0.6%	-0.6%
(2)	Nominal balance (according to national methodology)	-0.4%	-0.2%	-0.3%
(3) = MAX (1;2)	The largest nominal balance value (MAX (1;2))	-0.4%	-0.2%	-0.3%
(4)	Cyclical component (national methodology)	0.4%	0.3%	0.2%
(5)	One-off measures	-0.3%	0.0%	0.0%
(6)=(3)-(4)-(5)	**Structural balance objective**	**-0.5%**	**-0.5%**	**-0.5%**

Once the largest nominal balance value of the general government budget is determined, the balance is converted in structural terms (using the cyclical component and the defined one-off measures according to MoF forecasts). Accordingly, the structural general government budget balance objectives are obtained, **which are - 0.5% of GDP in 2020, -0.5% of GDP in 2021, and -0.5% of GDP in 2022.**

Setting the balance objectives in accordance with <u>expenditure growth</u> rule and <u>rule of expenditure inheritance</u>.

Then the obtained results are tested, to ensure also the fulfilment of the expenditure growth rule and rule of expenditure inheritance.

It should be noted that when general government budget structural balance objectives are checked in accordance with the **expenditure growth rule**, expenditure adjustments are subject to MoF forecasts of public debt servicing expenditure, investment expenditure, expenditure for EU programmes fully matched by EU funds revenue, discretionary revenue measures and one-off measures, as well as the GDP deflator and the potential GDP growth. Acceleration of the expenditure growth is determined so that it would correspond to the 10-years average potential GDP growth, additionally adjusting it by the coefficient that takes into account the actual structural balance deviations from the structural balance objectives in the previous years.

Having performed the verification of the objectives of the general government budget structural balance in accordance with the expenditure growth rule, it is obtained that the expenditure growth in 2020 allowed by the expenditure growth rule is 2.86%, in 2021 - 3.17% and in 2022 - 3.17%. The previously determined general government budget structural balance objective, in turn, states that the real adjusted expenditure may increase by 2.74% in 2020, by 0,46% in 2021 and by 1.81% in 2022. Having performed the verification of the rule of expenditure inheritance, it was detected that no additional adjustments are needed.

Thus, the structural balance objectives in accordance with the balance rule are preserved for 2020 - 2022.

Objectives of General Government Budget for 2020, 2021 and 2022

Considering the verification of the fiscal rules carried out herein above, the quantitative fiscal objectives for the next three years are set, namely, **to ensure the general government budget structural balance at -0.5% of GDP in 2020, -0.5% of GDP in 2021, and -0.5% of GDP in 2022. General government nominal balance, arising out of the structural balance objective, is set at: -0.4% of GDP in 2020, -0.2% of GDP in 2021, and -0.3% of GDP in 2022.**

3.1.2. Discretionary measures

Table 3.4 and 3.5 reflect the decision taken by the government, when preparing the State Budget for 2019. Detailed information is provided regarding the measures, the budgetary impact whereof is above 0.01% of GDP or 3.1 million euro.

Table 3.4. Revenue increasing discretionary measures (above 0.01% of GDP or 3.1 mln *euro*)

List of measures	Type of tax	2019	2020	2021
Changes in the Solidarity tax	SSC	6.4	-4.8	0.0
Increase in budget revenue from dividends, because of increase in State company “Latvijas valsts meži” payments	Non-tax revenue	36.0	-36.0	0.0
	CIT	9.0	-9.0	0.0
08.02.2019, meeting of the Committee of the Cabinet decision to decrease revenue forecast on State duty for keeping oil products` security reserves	VAT	-0.7	0.7	0.0
	Non-tax revenue	-3.4	3.4	0.0

Additional funding for raising healthcare workers' (Workers in health, Justice, education and welfare sectors) wages	PIT	12.6	0.0	0.0
	SSC	19.8	0.0	0.0
	SSC for the Health payment	0.7	0.0	0.0
	VAT	0.9	1.2	0.0
Additional funding for raising wages of judges and prosecutors, additional payment for long service for employees of The Corruption Prevention and Combating Bureau (KNAB) and long service benefits for employees of the Ministry of Interior	PIT	6.9	-5.6	0.4
	SSC	10.8	-8.9	0.6
	SSC for the Health payment	0.4	-0.3	0.0
Other tax revenue		8.1	27.3	15.7
Other non-tax revenue		2.1	-1.1	0.0

Table 3.5. Expenditure increasing discretionary measures (above 0.01% of GDP or 3.1 mln *euro*)

List of measures	**2019**	**2020**	**2021**
Ministry of Defence			
Technical clarifications* (incl. increase expenditure on maintanance of National Armed Forces, increased investment for NATO projects)	15.2	-15.2	0.0
Ministry of Economics			
Reduced funding for maintenance of oil stocks, in order to reduce fees	-4.2	4.2	0.0
Ministry of Finance			
Technical clarifications (incl. Increased expenditure for ERDF advance, interim and final payments, increased expenses for CF technical help projects)	55.4	-35.0	-2.8
Increased expenditure according to Cabinet Order No. 597-s of 08.11.2018	0.5	2.6	14.8
Ministry of the Interior			
Technical clarifications (incl. increased expenditure for "ABC Gate at International Airport "Riga" and financing for other EU policy instruments)	6.9	-3.8	0.1
Increased funding to provide benefits to officials with special service grades after every five years of continuous service	35.6	-34.2	0.5
Increased funding for the implementation of the priority measure for the prevention of laundering of proceeds of crime and financing of terrorism by 31 December 2019	3.8	-1.9	0.0
Ministry of Education and Science			
Technical clarifications (incl. increased expenditure for Erasmus+ projects)	13.8	-10.8	-2.0
Ministry of Agriculture			
Technical clarifications (incl. increased expenditure on implementing other EU policy instruments and measures)	22.5	-19.4	-2.8
Increased finanncing for ALTUM loan programme	3.3	-3.3	0.0

Ministry of Transport			
Technical clarifications (incl. increased spending on other EU policy instruments and projects)	7.1	-5.7	-0.4
Ministry of Welfare			
Technical clarifications	4.4	-2.9	-0.9
Increased expenditure in order to ensure the implementation of the priority measure for improving the quality of long-term social care service	4.8	1.6	0.0
Ministry of Justice			
Technical clarifications (incl. pincreased expenses to ensure the payment of state guaranteed maintenance from the Maintenance Guarantee Fund)	6.2	-1.5	-0.2
Increased spending to increase the salary of judges	4.2	-1.4	1.1
Increased expenditure according to Cabinet Order No. 597-s of 08.11.2018	2.4	0.1	22.6
Increased expenditure to provide benefits for prison administration officers with special service stages after every five years of continuous service	5.7	-5.2	0.1
Additional funding to ensure the payment of state-guaranteed maintenance from the Administration of the Maintanance Guarantee Fund	7.9	0.0	0.0
Ministry of Environmental Protection and Regional Developement			
Technical clarifications (incl. funding for cross-border cooperation programs, projects and activities)	14.1	-11.2	-0.3
Ministry of Culture			
Technical clarifications (incl. increased funding for the implementation of ERDF projects)	5.1	-4.4	-0.1
Ministry of Health			
Technical clarifications (incl. increased expenditure on the implementation of ERDF projects in the field of health, increased costs for the payments of reimbursable medical prescriptions)	10.7	-10.6	0.0
Increased expenditure in order to ensure an increase in the remuneration of other non-medical workers in relation to the provision of state-paid healthcare services	9.7	0.0	0.0
Increased expenditure in order to ensure an increase in the wages for medical workers, including in relation to the abolition of the extended normal working time	3.6	0.0	0.0
Increased expenditure in order to ensure an increase in the lowest monthly salary rate of medical workers	62.7	0.0	0.0
Increased expenditure in order to ensure an increase in the remuneration of medical workers and drivers of emergency medical vechicale working in the Emergency Medical Service	8.0	0.0	0.0
Prosecutor’s Office			
Increased expenditure to ensure the remuneration of prosecutors	4.6	-1.2	1.0

Grant to Municipalities			
Technical clarifications	-3.4	4.5	3.0
Changes to municipal grants according to the decision of the CofM No 5 30.§ point (05.02.2019.), which ensures that income tax and special subsidies to municipalities will not be less than 1.47 billion	-14.3	14.3	0.0
Financing to be redistributed in the annual budget execution process			
Technical clarifications (incl. reallocation of funding for the implementation of EU policy instruments and other foreign assistance projects and measures	-87.2	55.5	9.5
Special budget			
Reduction of expenses for maternity benefits	-4.5	-0.3	-0.2
Reduction of expenses for sickness benefits	-18.7	9.1	0.6
Decrease in expenses for parental benefits	-4.1	0.2	0.4
Decrease in expenditure on pensions	-20.8	15.5	0.1
Other priority measures	17.6	-8.8	0.4
Other technical clarifications	2.7	-0.8	-0.8
Other decisions of the Cabinet	13.4	5.6	1.9

3.1.3. Fiscally significant structural reforms within the meaning of Regulation No 1175/2011[3]

In the Stability Programme 2016-2019 Latvia declared reform of the health system as a significant structural reform with a long-term positive effect on the sustainability of public finances, with a view to use the reform as a possibility to deviate from MTO as provided in the EC Communication[4]. The EC reviewed Latvia's application and supported granting of the deficit deviation for the health system reform. In order to comply with the structural deficit safety margin with respect to the reference value prescribed by the Treaty on the Functioning of the EU in amount of 3% of GDP[5], the deficit deviation granted to Latvia comprises 0.13% of GDP in 2017, 0.40 % of GDP in 2018 and 0.50% of GDP in 2019, whereas in 2020 the deviation ceases to exist.

It should be noted that, in general, three reforms in the field of health care are being discussed in Latvia:

1. Reform, which is implemented, based on the medium - term policy planning document the Public Health Guidelines or 2014 - 2020;
2. Reform of the health care funding;
3. Reform of the health system administration.

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[3] European Parliament and Council Regul (ES) Nr. 1175/2011 (November 16th, 2011), amending Council Regulation (EC) No 1466/97

[4] The 13 January 2015 EC Communication to the European Parliament, the Council, the European Central Bank, the Economic and Social Committee, the Committee of the Regions and the European Investment Bank regarding Making the Best Use of the Flexibility Within the Existing Rules of the SGP

[5] For Latvia this index is determined in amount of 1.7% of GDP from 2017.

This Stability Programme describes the health care reform, which is based upon the implementation of the medium-term policy planning document Public Health Guidelines for 2014-2020 and, therewith, considering the practice introduced by the previous Stability Programme, the following subsections will outline the outcomes of the implementation of the reform in the previous year (namely, 2018) and the reader will be informed about the planned measures for the current year (namely, 2019).

Justification and implementation of the reform of the health care system

Deficit deviation has been requested and received for the reform being implemented, based on the medium - term policy planning document the Public Health Guidelines for 2014-2020. The health care reform is being implemented from 2014 in accordance with the medium-term policy-planning document the Public Health Guidelines for 2014-2020 approved by the Cabinet, and the overriding aim thereof is to prolong the healthy years of life of the Latvian population and to prevent premature deaths, while maintaining, improving and restoring health. The achievement of the referred overriding aim in Latvia is hindered by the weaknesses of the health system, mainly attributable to low public funding (see Figure 3.1), inequality in availability of medical care services and many premature deaths due to health problems.

It should be noted that these factors are interrelated. The low level of public funding causes a need to finance part of medical services through private funding, but it, in turn, discourages the citizens that cannot afford to invest their private funding to take timely treatment and increases PYLL.

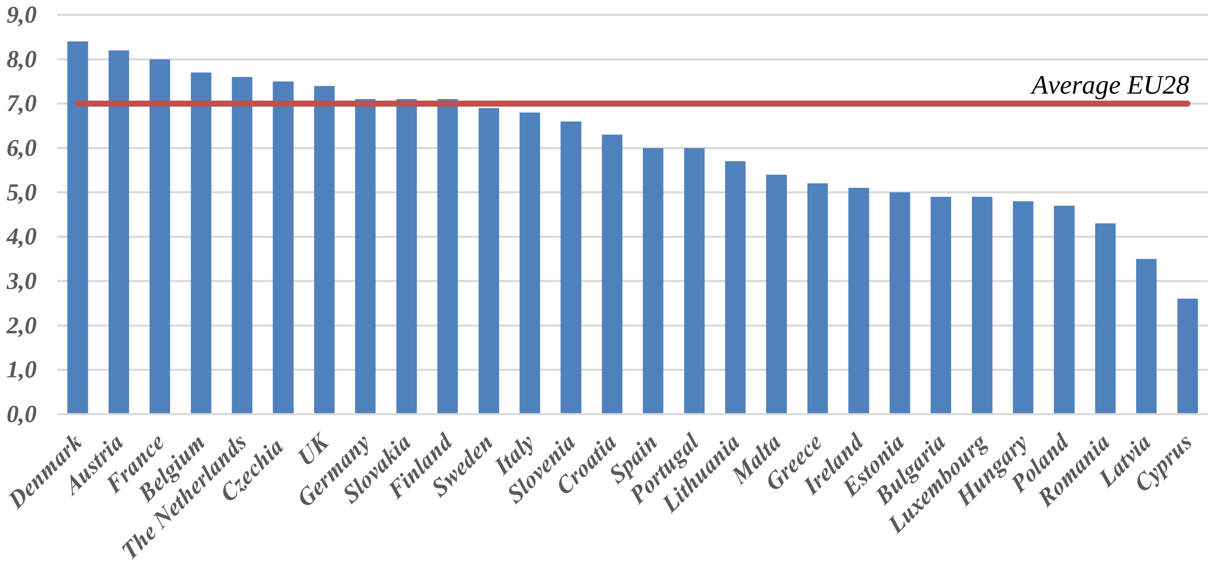

Figure 3.1. Public expenditure for health care in 2017 in the EU member States[6], % of GDP

The EU Council already from 2014 has pointed out the afore-mentioned shortcomings of the Latvian health system, in the context of country specific recommendations, identifying annually that it is necessary to improve the availability, cost-effectiveness and quality of the health care system. Besides, it is pointed out that there is a clear public under-financing of the

[6] Data source: *Eurostat*

health care sector that negatively affects access to health care services for vulnerable members of society.

In the country-specific recommendations for the last two years, 2017 and 2018, **the Council assesses the health care system reforms implemented by Latvia.** At the same time, it is noted that the public funding intended for health care is still far below the EU average, and the measures for improvement of effectiveness are still to be taken, *inter alia*, effective preventive measures, rationalization of the sector of hospitals, strengthening of the primary health care and solution of the quality management issue. The outcomes of the performance indicators to be achieved in the health sector are comparatively weak and ensuring of the timely access to health care for acceptable price for entire population still remains a matter of concern. The large share of the payments to be covered from personal means and the division of health care services into two baskets ("full" and "basic") may reduce the access for certain groups and create adverse effect on the health condition of separate groups of society.

As a result of the afore-mentioned, the Council recommends to Latvia to improve the availability, quality and cost-effectiveness of the health care system.

As compared to other sectors, Latvia during the period from 2014 to 2020 has managed to ensure significant increase of funding for the health care sector. It has been specifically attained, by means of the SGP flexibility clause in the implementation of the health reform. In addition, from 2018, substantial additional revenues from the increase of the SMSIC rate by 1 percentage point are allocated for the financing of the health system, as well as from 2019, additional funds have been found from the State budget resources.

With the increase of the granted funding Latvia has, in general, managed to ensure, the growth of funding for the health care sector in accordance with the growth of funding planned in the Public Health Guidelines for 2014-2020 (see Figure 3.2).

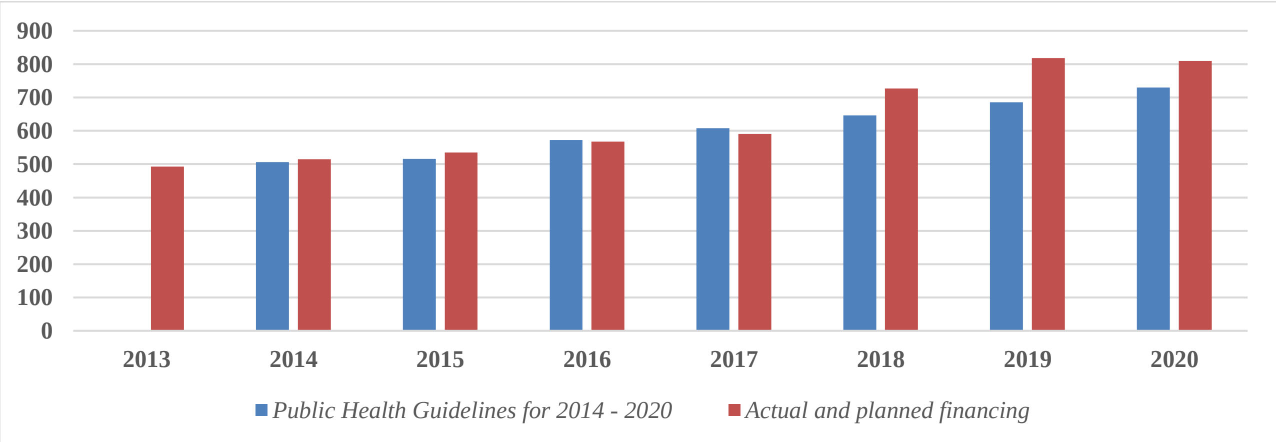

Figure 3.2. Scenario of the growth of funding applied in the Guidelines and the actual growth of funding, million EUR[7]

Scenario as shown in Figure 3.2 was used in the previous Stability Programmes, when carrying out the assessment of the fiscal impact of the proposed reform. Therewith, provided that the assumptions used in the assessment remain in effect, **there are grounds to believe**

[7] The total MoH budget for core functions, million EUR, years 0-64: scenario in accordance with the research of the University of Latvia: “Evaluation for the Development of the Public Health Guidelines 2014–2020” and the actual funding for the afore-mentioned target group, including the deficit deviation funding.

that the assessment of the fiscal impact is maintained and the achievement of the PYLL objective is ensured.

Implementation of the reform of the health care system in 2018

Deficit deviation funding for the period of 2017-2019, which is available due to implementation of the health care reform is being used for a group of certain health care measures, arising out of the Public Health Guidelines 2014-2020. This group of measures is separated from the rest of measures for improvement of health care, stipulating a special procedure for granting and supervision of allocation of resources.

At the same time, it should be noted, that, when choosing the health reform measures, for which the deficit deviation funding is to be used, the following criteria should be met:

1. The measure must correspond to the "Public Health Guidelines 2014 - 2020";
2. The outcome of the measures financed from the deficit deviation funding in the period of 2017-2019 must solve or considerably reduce a certain problem identified in the health care system. Measures, which provide for an insignificant effect in solving the problem, cannot be financed - such intervention is not to be regarded as reform;
3. Problem to be solved must be recognised as a health care problem in the EC analytical documents.
4. It is possible to create a traceable system of inputs - outputs - outcome indicators.
5. The solvable problem provides an input to achieving a positive fiscal effect of the Public Health Guidelines 2014-2020.

It should be noted that the allocated financing of the deficit derogation for the period 2017-2019 in the State budget law of the respective year was distinguished in the separate budget programme, as the financing to be redistributed as a result of the annual State budget execution. Only after the Ministry of Health's proposals regarding the use of funding are approved by the Cabinet, the reserved funding is reallocated to implement health reform.

For the financial resources to be reallocated for implementation of the health reform measures in 2018, the Ministry of Health, first of all, had to submit information regarding the measures taken and the outcomes achieved in 2017. To this effect, based on the informative notification “On the outcomes of the implementation of the health reform measures in health care for 2017” [8], describing the implemented reform measures and the outcomes, it was concluded that it is necessary to continue the commenced interventions also in 2018, to ensure successful treatment of patients and achieve considerable reduction of the PYLL over a longer period of time. Losses to national economy have also been emphasized, caused to the country on an annual basis by premature deaths of population. At the same time, considering the available additional funding, comprising in 2018 0.4% of the budget deficit deviation allowed by the EC or 113.4 million euro, it was concluded that it is necessary not only to continue the commenced reforms, but also to expand them by new initiatives for the improvement of efficiency and sustainability of health care.

Therewith, in order to continue the health care reform, as well as to expand it and to implement new reform areas, the Cabinet approved the informative notification "On implementation of the health reform measures in 2018" and in 2018 the funding in the amount

[8] More detailed information about the outcomes of the implementation of the health reform in 2017 is available on the website of the MoF at – http://www.fm.gov.lv/lv/sadalas/tautsaimniecibas_analize/fiskala_politika/stabilitates_konvergences_programma

of 113.4 million euro was granted to the Ministry of Health from the funds reserved under Programme 08.00.00 "Funding for the implementation of the health care system reform" of the budget line line "74.Funds for redistribution during the state annual budget implementation process" for the health care reform (66§ Clause 2 of Minutes No. 63 of the 19 December 2017 Meeting of the Cabinet), the allocation whereof has been adjusted, based on 30§ Clause 2 of Minutes No. 40 of the 28 December 2018 Meeting of the Cabinet, in the following areas and the following established amount:

1. ***For improving the availability of health care services and reduction of queues,*** 38, 373, 824 euro, including continuing the reduction of queues commenced in 2017;
2. ***For improving the availability of diagnostic and treatment of oncological diseases,*** 37, 163, 269 euro, including continuing and expanding the activities commenced in 2017;
3. ***For reducing the spread of infectious diseases,*** 16, 740, 741 euro, including continuing the reforms commenced in 2017 for the provision of state reimbursable medicines for VHC patients at F3-F4 stage;
4. ***For improving the quality and availability of primary health care system,*** 9, 664, 036 *euro*;
5. ***For reducing cardiovascular morbidity and improving the efficacy of disease treatment,*** 11, 458, 130 *euro*.

In Spring of 2019, based on the notification developed by the Ministry of Health “On the outcomes of the implementation of the health reform measures in health care for 2018”[9], it was concluded that, considering the timeframe required for commencement of reforms for change of the work organizational processes in the medical institutions and, in separate areas, the need to develop the service payment conditions, the implementation of the reform is to be assessed a successful.

Performance outcomes of 2018 demonstrate that the commenced reforms had been continued as planned, because the queues to specialist consultations, day patient facility services, as well as rehabilitation services have significantly reduced, in turn, in the segment of tests and therapy, a moderate reduction of queues was observed, attributable to the change in patient behavior, namely, the number of those residents reduced, who, due to distance, queues or finance, have not received the secondary outpatient health care services, as well as the patients, who, up to now, due to various reasons, had been using the paid health care services, currently start using more the state-paid health care services.

In 2018, oncology performance indicators have been exceeded, because the number of the performed specialist consultations grew according to the set algorithms, and more patients have been sent to carry out secondary diagnostics and tests, allowing to more timely diagnose the illness and commence appropriate treatment, *inter alia*, the growth of availability of medicines has been ensured.

The performed reforms for the formation of the Green Corridor for oncology have ensured that the patient’s way up to determination of diagnosis and commencement of treatment has become considerably shorter, in majority of cases ensuring that, after the performance of reforms, the initial consultations are provided, tests are carried out and the

[9] More detailed information about the outcomes of the implementation of the health reform in 2018 is available on the website of the MoF at –
http://www.fm.gov.lv/lv/sadalas/tautsaimniecibas_analize/fiskala_politika/stabilitates_konvergences_programma

treatment is commenced within the period for 10 days, while before the introduction of the Green Corridor patient was waiting, on average, 30 days for specialist consultation alone.

It should be noted that from 1 January 2018 all localizations of oncological diseases have been included in the Green Corridor and, as a result, the payment of tests necessary for diagnostics of malignant tumors of all localizations and doctor consultations is ensured under priority procedure, which is to be assessed as a positive aspect with respect to timely treatment of oncological diseases.

Within the scope of the area of limitation of the spread of infectious diseases, 1, 000 Virus Hepatitis C patients received treatment last year, which is by 600 persons more than planned. It should be noted that the treatment of persons at an earlier stage of morbidity has been commenced - already from liver damage at stage F2. Therewith, the epidemiological threats caused by disease in the state have been reduced and the patient coverage is gradually expanded, which, in turn, ensures basically a full recovery of the working age people and their return to society and labour market. At the same time, by increasing the number of people released from Virus Hepatitis C, the risks of getting infected are reduced for other members of society and the spread of infection is limited.

To improve the availability of medicines required for HIV outpatient treatment, starting from 1 January 2018, HIV treatment has been started at an earlier stage of morbidity, but from 1 October 2018, each person living with HIV receives treatment without limitation. This means that their treatment has been commenced as soon as infection was discovered. Therewith, it is achieved that the risk of further spread of infection is prevented at a possibly earlier stage of HIV infection.

In accordance with the measures of the primary health care course, the availability of family doctors has improved, *inter alia*, providing for the doctor practice activities both in the morning and in the afternoon, and family doctors are also systematically carrying out regular assessment of the health condition of persons registered in their patient list and the implementation of the necessary measures.

In the area of reduction of cardiovascular morbidity and improvement of the efficancy of disease treatment the prophylaxis of the cardiovascular morbidity and early diagnostics at a primary health care level has been improved, thereby reducing the consequences caused by cardiovascular morbidity. To this effect, the cardiovascular disease prophylaxis programme has been set up, focused on achieving particular medical purposes, to extend the lifespan of population. To implement and develop the programme, the prophylaxis of the cardiovascular morbidity and early diagnostics at a primary health care level was ensure for population in accordance with the intentionally recognized SCORE method or systematic coronary risk evaluation, providing for identification of high cardiovascular morbidity risk patients, performance of further necessary tests and prophylactic measures.

Besides, in 2018, the list of reimbursable medicines has been supplemented with new cardiovascular morbidity medicines. The provision of new innovative medicines was ensured for cardiac failure, atrial fibrillation and atrial flutter patients, availability of therapy was improved for the patients, who have undergone stenting after an acute coronary syndrome, inclusion of new diagnoses - pulmonary embolism, deep vein thrombosis, where the timely administration of new medicines prevents lethal complications.

When implementing the reform, it has been proven that for successful introduction of new programmes (for example, chronic patient care, cardiovascular programme) it takes a sufficiently long time for the service providers to be able to introduce changes in organization of service provisions, and for the appointing persons, in their turn, to understand the benefits of the new procedure and to actively engage in using thereof, as well as for the possibility to introduce corrections in the developed procedure, which would improve the patient flows’ organization according to the actual situation. Therewith, in 2019, an increased attention was directed to the supervision of introduction of new measures, which would promote effective application of the funds granted by the budget deficit deviation permitted by the EC.

Having assessed the information contained in the report regarding the outcomes achieved in 2018, it is to be concluded that it is necessary to continue the commenced interventions also in 2019, to ensure successful patient treatment and considerable reduction of the PYLL over the longer period of time.

Implementation of the reform of the health care system in 2019

Based on up to now successfully implemented health care reform, the commenced interventions will be continued, while for expansion thereof and commencement of the new reforms, in addition to the funding granted in 2018, the funding in the amount of 40.8 million euro is available in 2019.

The total intended funding in 2019 comprises 154.2 million euro, which, is to be used in line with the informative notification "On the implementation of the health reform measures in 2019" approved by the Cabinet on 8 January 2019.

Table 3.6. Breakdown of additional funding allocated to the health sector reform from the budget deficit of the EC for 2010

	Planned measure	Total funding (euro)
1.	Improving the accessibility of health care services (including continuing the reduction of queues to specialists, for diagnostic examinations, day patient facility, commenced in 2017 and 2018)	57 538 646
2.	Improvement of availability of diagnostics and treatment of oncological diseases (including continuing and expanding the activities commenced in 2017 and 2018)	29 215 914
3.	Reducing the spread of infectious diseases (including continuing the reforms commenced in 2017 and 2018 for the provision of state reimbursable medicines for VHC patients)	16 484 214
4.	Improving the quality and availability of primary health care system (including continuing and expanding the activities commenced in 2018)	15 433 208
5.	Reducing cardiovascular morbidity and improving the efficacy of disease treatment (including continuing the activities commenced in 2018)	10 460 873
6.	Reform of the medical treatment institutions level	6 928 936
7.	Strategic procurement of rehabilitation services	3 874 774
8.	Improvement of the mental health care	6 308 906
9.	Improvement of environment and effectiveness of infrastructure	7 959 529
	Total	**154 205 000**

Predicting the potential gain (not loss) of life years, in the case of absence of investment, it is believed that the gradual improvement of the health of the population will take place and taking into account minor improvements in previous periods, as well as improvement of the treatment process coordination, it is expected to slightly improve on the current situation. Ultimately, the referred factors will be reflected in data as minimal recession or even stagnation of the number of PYLL. In turn, through the above reforms, the PYLL will decrease, as the life expectancy of the population will increase, and the number of premature deaths will decrease (see Table 3.7). Taking into account the projections for the reduction of PYLL, it is to **be concluded that this corresponds to the reduction estimated in the study "Evaluation for the Development of Public Health Guidelines for 2014-2020" in line with the increase in funding**.

Table 3.7. Potential loss of life expectancy if investments are made

	2014	2015	2016	2017	2018	2019	2020	2021
PYLL without investing	93 374	88 297	84 670	83 876	83 037	82 207	81 385	80 571
PYLL with investing					80 612	78 223	75 542	73 355
Gained Potentially Lost Life Years					**2 425**	**3 984**	**5 843**	**7 216**
Improving the accessibility of health care services					518	932	1 553	1 631
Improvement of availability of diagnostics and treatment of oncological diseases					578	751	1 251	1 314
Reducing the spread of infectious diseases					534	1 181	1 645	2 748
Improving the quality and availability of primary health care system					102	114	216	227
Reduction of cardiovascular morbidity and to improvement of the efficacy of disease treatment					693	836	929	975
Strategic procurement of rehabilitation services						104	116	122
Improvement of the mental health care						66	133	199

Source: MoH and CDPC

The previous three Stability Programmes included the assessment of the fiscal impact of the Public Health Guidelines 2014-2020. Correspondingly, in this Stability Program the assessment of the fiscal impact is being updated, considering the amount of updated expenditure in 2018 and the updated forecasts for 2019-2022.

Table 3.8. Actual assessment of the macroeconomic impact of the Public Health Guidelines 2014 - 2020

Macroeconomic indicators	Annual and cumulative impact on GDP and other key macroeconomic variables[10]				
	X[11]+5 years	**X+10 years**	**X+15 years**	**X+20 years**	**X+25 years**
GDP[12]	+0.55%	+2.21%	+4.78%	+7.88%	+11.26%
Gross fixed capital formation	-	-	-	-	-
Employment[13]	+0.24%	+0.62%	+1.02%	+1.41%	+1.81%
Direct fiscal impact on primary balance (10)[14]	-0.37%	-0.89%	-0.82%	-0.33%	+0.47%

[10] Discounted at values of 2014; cumulative effect.
[11] X means 2013.
[12] National economy output divided by GDP of 2014 at current prices.
13 Employment growth divided by number of employed persons in age group 15 – 2012 (64).
14 Direct fiscal impact applicable to the age group of 0 – 64 years.

GDP[15]	-0.13%	+0.06%	+1.18%	+2.94%	+5.13%

3.2. Current Fiscal Situation

According to the MoF assessment, the general government nominal budget deficit in 2018 was 198.9 million euro or 0.7% of GDP. The amount of the general government budget deficit was by 0.3 percentage points smaller than specified in the previous Latvia's Stability Programme for 2018-2021. A lower level of the general government budget deficit is attributable to higher revenue, demonstrating growth in all revenue positions. Here it is worth highlighting current taxes on income and wealth, the growth whereof was promoted by high revenue from CIT, which, in turn, are attributable to the steeper rise in contributions according to submitted declarations for 2017. Also, the VAT and excise tax revenue was higher than projected, growing along the steeper economic growth. As compared to the previous Stability Programme, the state special budget expenditure was spent in a smaller amount than planned, mainly considering that the actual number of beneficiaries of the sickness, unemployment and childcare benefits was smaller than planned.

The analysis of contribution of the general government sub-sectors to the overall fiscal balance allows concluding that the negative balance was mainly formed by the central government and local government deficit, comprising, correspondingly, 0.8% of GDP and 0.5% of GDP in 2018. In turn, the social security fund surplus comprised 0.6% of GDP in 2018 (see Figure 3.3).

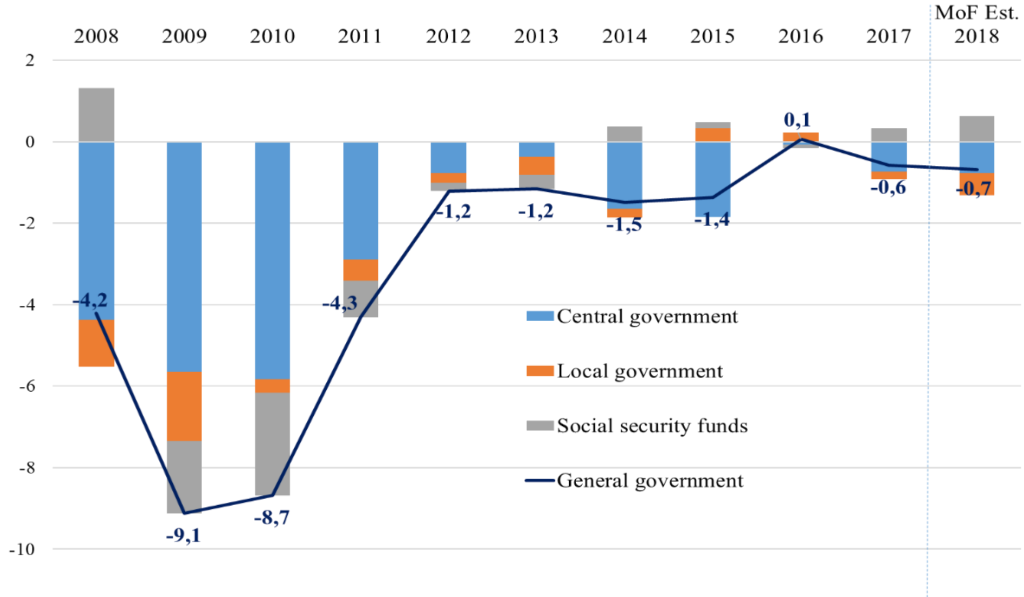

Figure 3.3. Budgetary balance of the general government by sub-sectors, % of GDP (Data source: *Eurostat*, MoF)

In 2018, as compared to the previous year, the general government budget balance deficit has grown by 0.1 percentage point. General government budget revenue has grown by 857.1 million euro or 8.5%, reaching 10.9 billion euro or 37.1% of GDP (see Figure 3.4). Revenue growth was promoted by the growth of tax revenue. Tax revenue[16] in 2018 reached

[15] National economy output divided by GDP of 2014 at current prices.
[16] Tax burden (D.2 (incl. EU share) +D.5+D.61+D91).

30.7% of GDP, which is by 0.7 percentage points less than in 2017. The fall in the share of the tax revenue in the GDP was affected by the tax reform, within the scope whereof the revenue from the current taxes on income and wealth (D.5) reduced significantly, reducing by 155.2 million euro or 6.7%, as compared to 2017. As a result of the tax reform, both PIT and CIT revenue has been significantly affected. While the PIT revenue demonstrated growth in the amount of 1.4% or 24.8 million euro, as compared to 2018, the CIT revenue declined by 28.6% or by 121.6 million euro. As a result of the PIT reform, several changes were introduced, for example, progressive income tax was introduced, differentiated non-taxable minimum as well as allowance for dependents and non-taxable minimum for pensioners was increased, also minimum wage was increased from 380 euro to 430 euro. In turn, as a result of the CIT reform, zero rate for reinvested profit was set and the CIT advance payments were not applied after 1 July 2018.

Taxes on production and imports (D.2), as compared to 2017, have grown by 324.4 million euro or 8.6%. As the economy develops and the purchasing power of population increases, VAT revenue has grown by 291.8 million euro or 13.5%, and the excise tax revenue, in turn, has grown by 125.1 million euro or 13.7%. Steep growth of the excise tax revenue was also promoted by rise in the excise tax rates, active trade in the border area and restriction of illegal circulation of the excise goods. In turn, the growth of taxes on production and imports was slowed down by the revenue form the real estate tax for land and buildings, which has decreased by 7.2 million euro and the subsidized electricity tax revenue, which declined by 25.8 million euro, because the subsidized electricity tax is no longer applied since 1 January 2018.

Social contributions (D.61), as compared to 2017, have grown by 377.5 million euro or 16%. The growth of social security contributions was promoted by a favorable situation in the labour market - in 2018 both the number of employees and the average amount of wage have grown, and a considerable share of growth was also ensured by the decision of the government to increase the rate of the social security contributions by 1 percentage point from 1 January 2018. Extra funds obtained were allocated to the increase of remuneration for those working in the health sector.

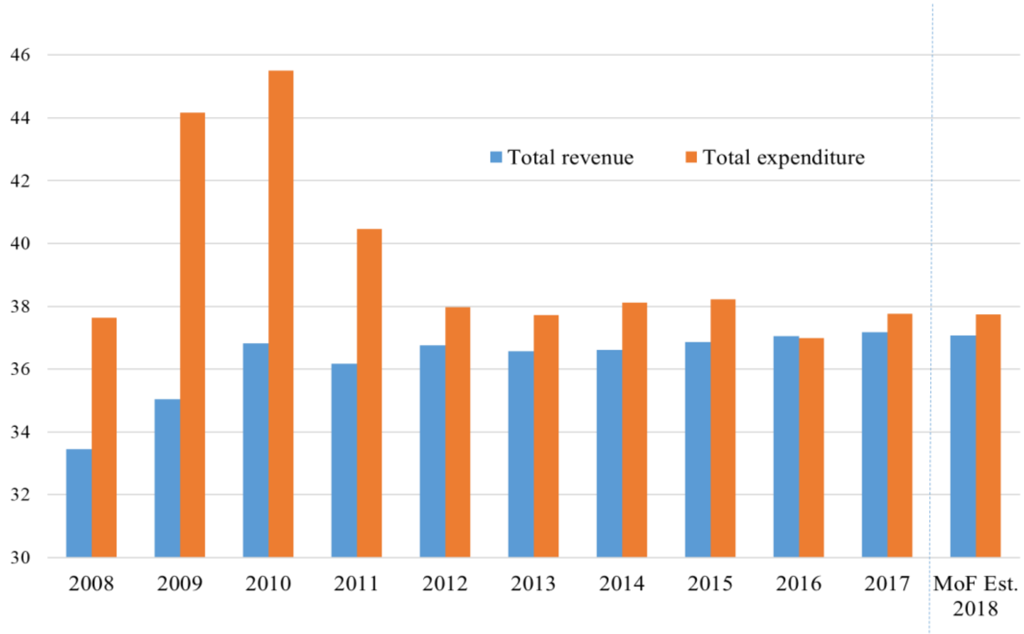

Figure 3.4. General government revenue and expenditure, % of GDP (Data source: *Eurostat*, MoF)

General government budget expenditure has grown by 900 million euro or 8.8%, reaching 11.1 billion euro or 37.7% of GDP. The largest share of growth was ensured by expenditure for gross fixed capital formation (P.51G), which has grown by 404.9 million euro or 34.2% and which, in turn, was facilitated by the growth of expenditure for the EU funds' investment projects. Total expenditure for remuneration (D.1) in 2018 have grown by 219.2 million euro or 7.9% and the growth was mainly determined by the increase of minimum wage from 1 January 2018, increase of remuneration for teachers and allocation of additional funding to increase the remuneration of those working in the health sector. Expenditure for intermediate consumption (P.2) has grown by 211.1 million euro or 13.7%, with the main reason of rise being the growth of expenditure for goods and services in the National Armed Forces and local governments. Expenditure for social payments (D.632 and D.62) has grown by 221.1 million euro or 7%, which was determined by the growth of expenditure for pensions and other social benefits. Rise in expenditure was influenced by the rise in the amount of average pension and benefits, as well as pension indexation starting form 1 October 2018, by applying larger indices. Given the successful government debt management and low interest rates, the interest expenditure (D.41) has reduced by 18.5 million euro or 7.4%. Subsidies (D.3) have grown by 149.2 million euro or 43.5%, attributable to additional subsidies to merchants providing public transport services, as well as subsidises to merchants producing renewable energy resources.

Expenditure of capital transfers (D.9) in 2018 has reduced by 98.1 million euro or 59.1%, significantly influenced by the discounted compensation payment performed in 2017 in the amount of 140 million euro for the installed electricity capacities for the renewable electricity producers. In 2018, a similar payment was performed in the amount of 51.7 million euro, which, in the medium term, will allow for saving up the state budget funds. Since the introduction if the MPC, the fee for electricity has been constantly growing, as a result whereof the Ministry of Economics, in line with the task assigned by the government, had prepared the solution for limiting further growth of the MPC after the abolition of the subsidised electricity tax. Thus, in 2017, one entity receiving guaranteed fee for the electric capacity installed in the cogeneration electric station (combined heat and power plant) and whose installed electric capacity exceeded 100 MW, partially refused from the guaranteed fee for the electric capacity installed in the cogeneration electric station for the remaining period, receiving the discounted payment, which was expressed as the discounted value of the state aid revenue not obtained in the future, applying the discounting factor of 9% to the reduction of the capacity fee, and for the remaining aid period continuing to annually receive 25% of the previous amount of the aid. It should be noted that the discounted payment (except for the compensation payment in the amount of 140 million euro) is pro rata recognised as the general government budget expenditure and the corresponding revenue of the entity up to the end of the aid period. In turn, the transaction closed in 2018 in the amount of 51.7 million euro reduced the amount of the one-off payment to be received by the renewable electricity producer till the end of the aid period.

3.3. FISCAL DEVELOPMENT SCENARIO

The general government budget **no-policy change** projections for the medium term were prepared in accordance with the updated macroeconomic scenario underpinning revenue and expenditure projections. The projections also took note of the approved central government basic expenses for the next three years as well as expected development in local government budgets taking into account current trends. It is expected that in 2019, the general government budget deficit will comprise 0.5% of GDP and it remains at the same level as forecasted when preparing the budget for 2019. In the medium term in the general government budget in the scenario at constant policy a deficit of 0.3% of GDP in 2020, a deficit of 0.4% of GDP in 2021 and a surplus of 0.2% of GDP in 2022 is being projected.

According to the forecasts, the share of the general government revenue in GDP in 2019 will comprise 36.2% of GDP whereas in 2020, 2021 and 2022 it will reduce correspondingly to 35.9%, 35.4% and 34.9% of GDP. Reduction of the revenue share will be affected by the fall in forecasted revenue in funding of rural and fishery programmes attributable to the closing stage of the 2014-2020 programming period. The share of the PIT revenue in proportion to GDP and the amount of the budgeted received dividends from public sector capital companies is reducing as well. It is expected that the share of the general government expenditure in GDP similar to revenue in the medium term will reduce on an annual basis even though in nominal terms the amount of both revenue and expenditure will grow.

Table 3.9. Medium term fiscal forecasts at no-policy change scenario, % of GDP

		2018	2019	2020	2021	2022
	ESA code	% of GDP				
Net lending (+) or borrowings (-) (B.9) by sub-sectors						
General government	S.13	-0.7	-0.5	-0.3	-0.4	0.2
Central government	S.1311	-0.8	-0.9	-0.7	-0.7	-0.1
Local government	S.1313	-0.5	-0.3	-0.1	0.0	0.0
Social security funds	S.1314	0.6	0.7	0.4	0.3	0.3
General government (S.13)						
Total revenue	TR	37.1	36.2	35.9	35.4	34.9
Total expenditure	TE	37.7	36.7	36.3	35.8	34.6
Interest expenditure	D.41	0.8	0.7	0.8	0.8	0.8
Cyclical development						
Cyclical budgetary component[17]		0.7	0.5	0.4	0.3	0.2
One-off and other temporary measures[18]			0.1			
Cyclical component of the budgetary balance		-1.3	-1.1	-0.7	-0.6	0.1
Cyclically adjusted primary balance		-0.5	-0.3	0.1	0.1	0.9
Structural balance[19]		-1.3	-1.1	-0.7	-0.6	0.1

In the central government budget:

- In 2019, a deficit of 0.9% of GDP is planned for the central government budget at a no-policy change scenario while a deficit of 0.7% of GDP is projected in 2020 and

[17] In a calculation of cyclical budgetary component a semi-elasticity of 0.38 was used (Data: An update of the semi-elasticities of the budget balance based on new weights. Note to the attention of the members of the Output Gap Working Group)

[18] The share of revenue of EUR 18.2 million from the EU ETS sale of emission allowances, which took place in November 2018 and is attributable to the increase in volume, is included in the Stability Programme as a one-off measure. On the other hand, the increase in revenue from this transaction, which is attributable to price fluctuations in 2019, is not considered a one-off measure.

[19] In order to facilitate data comparability, the structural balance in 2019 and 2020 is shown together with a reduction in net revenue from the tax reform 0.5% of GDP and 0.3% accordingly, which is temporary and recognised as a one-off measure from the perspective of Latvian fiscal framework, but the EC includes this effect in the structural balance, since revenue-reducing/expenditure-increasing measures by the EC as a rule are not recognised as one-off/short-term measures.

2021 and a deficit of 0.1% of GDP - in 2022. In 2019 and 2020, the revenue growth will be secured by taxes on production and imports, which will be mainly driven by increases in the VAT and excise tax revenue.

- In 2019, the revenue and expenditure growth in central government budget is expected to be more moderate than in 2018. The amount of tax revenue growth in the medium term is volatile over the year attributable to broad changes in legislation with respect to the approved tax reform measures. It should be noted that the abolition of the CIT advance payments would considerably affect the amount of the CIT revenue in 2019, as they would reduce by one third as compared to the amount of the CIT revenue in 2018. The growth rate of revenue will continue to be affected by the forecasted decrease in property income mainly due to received payments for the use of state capital due to the fact that no dividends from AS "Latvenergo" are planned in the projections for 2021 and 2022.
- In 2018, a sharper increase was observed in the foreign financial assistance revenues after a relatively lower revenue level in 2016 and 2017 attributable to the closure of the previous 2007 - 2013 EU funds programming period and the beginning of the new 2014 - 2020 programming period. In contrast, in 2019 it is expected that the foreign financial assistance revenue will be only slightly higher than in 2018.
- The growth of expenditure in the central government budget is triggered by raising remuneration to medical personnel as well as the disbursement of one-off benefits in 2019 to the officials of the institutional line of the interior and justice with special service ranks after each five years of uninterrupted length of service. To ensure the increase of funding of health sector inter alia for raising the remuneration of medical personnel starting from 2018 the SMSIC rate has been increased by 1 percentage point allocating the relevant additional revenue to funding health sector. Therewith the increase of the SMSIC rate resulted in receipt as additional revenue and allocation to the health sector of 85.6 million euro in 2018, but in 2019, another 97.8 million euro will be received in the basic budget from the SMSIC revenue.
- Capital expenditure in the central government budget in 2019 and henceforth will continue growing positively influenced by provision of expenditure to defense in the amount of 2% of GDP. In the medium term, expenditure for contributions to the EU budget also increases attributable to the amount of the GDP growth. Interest expenditure in 2019 will decrease in the state basic budget given the borrowing carried out in 2018 by refinancing the previously assumed government debt obligations at lower interest rates as well as updating the borrowing measures in the financial markets planned in the medium term.
- In 2018, the EU funds' investments from the state basic budget has been made at the highest level in the recent years (719 million euro) while in 2019 and for the entire medium term the growth of the EU funds' investments is not being forecasted, with the amounts thereof remaining approximately at the level of 2018.
- In 2022 in the central government budget, it is planned that the total amount of expenditure in nominal terms will be kept approximately at the level of 2021. It is attributable to the fact that currently no binding decisions are adopted on granting additional resources for 2022. At the same time, expenditure for defense also in 2022 is projected at the level of 2% of GDP. Central government budget balance at constant policy as compared to 2021 will improve considerably.

In the social security fund:

- The revenue mainly formed by the social security contributions will continue demonstrating growth. In 2019, it is forecasted that the revenue will grow by 7.5%.
- Ever since 2014, a surplus every year is in the social security fund and a surplus is also forecasted in 2019 and in the medium term. It is expected that in 2019, the amount for surplus in the social security fund will exceed the surplus of 2018, but in the medium term, the amount thereof will reduce affected by constantly growing expenditure for pensions and other social benefits.
- In 2019, expenditure will be by 7.2% higher than in 2018. Starting from 2020 a steeper growth of expenditure is expected given the rise in the average wage which will influence the average amount of the disbursed pensions and benefits projected changes in the beneficiaries of pensions and benefits and given the changes in legislation that have come into force both in 2019 and before and will continue influencing the amount of expenditure in the medium term:
    - Starting from 2014 the retirement age is gradually increasing - by three months annually until the age of 65 years will be reached in 2025. In 2019 persons who have reached the age of 63 years and 6 months will be entitled to receive the state old-age pension. Persons whose insurance period is at least 30 years are eligible to retire earlier - two years before reaching the general retirement age, thus in 2019 persons who have reached the age of 61 years and 6 months are entitled to retire prematurely;
    - From 2017 the eligibility period for unemployment benefit has been extended from 9 months within the 12 months' period to 12 months within the 16 months' period introducing the eligibility period for the sickness benefit as well as other changes in order to restrict systematic abuse of the procedure for disbursement of unemployment and sickness benefits;
    - From 2018 when the persons whose insurance period is less than 15 years and who are not eligible to the state old-age pension in accordance with the *Law on State Social Allowances* reach the retirement age they shall be granted by the State social security benefit disbursed from the State basic budget funds;
    - On 1 October 2018 the old-age disability length of service survivor's pensions and insurance allowances granted (recalculated) up to 30 September 2018 and the amount whereof does not exceed 382 euros have been revised (indexed) while as regards the pensions and insurance allowances the amount whereof exceeds 382 euro only the part thereof of 382 euro is indexed. At the same time the, following changes have been considered in the index calculation formula comprised of the actual CPI and the real growth percentage of the amount of wages of security (insurance) contributions. Where the insurance period of a person is from 30 to 39 years then the calculation formula takes note of 60% wage increase (previously - 50%), in turn where the insurance period is 40 and more years of work then 70% of the real wage increase (previously - 50%);
    - From 1 October 2019 the actual CPI and 80% (previously - 70%) of the real growth percentage of the amount of wages of security (insurance) contributions will be applied in pension indexation for the old-age pensions calculated for 45 and more years of insurance period;
    - From 1 October 2019 the amount of supplement per each year of insurance period accrued up to 31 December 1995 (1.50 euro for pensions granted up to

1996 and 1 euro for pensions granted from 1997) will be revised considering the actual CPI and 50% of the real growth of subject to insurance contributions;

  - From 2019, in case of death of a pension recipient the surviving spouse being the recipient of the old-age disability length of service or special state pension of the Republic of Latvia shall receive the benefit in the amount of 50% of the pension granted to the deceased spouse (including the supplement to the pension for insurance period. accrued up to 31 December 1995) and they shall be entitled to receive the benefit for the period of 12 months from the day of death of the pension recipient;
  - The inheritance of funded pension capital is planned to start from 2020. Participants of the funded pension scheme will be entitled to choose how their funded pension capital would be used if the relevant participant dies prior to the day of requesting the old-age pension. It will be possible to transfer the accrued funded pension capital into the State-funded pension special budget or to add to the funded pension capital of a person designated by the participant of the funded pension scheme or to inherit it under the procedure prescribed by the *Civil Law*. Concurrently with the referred to amendments the changes will come into force stipulating that the pension insurance contributions performed into the second pension pillar for the persons receiving the maternity, paternity, unemployment, sickness benefit and for the persons with disabilities will be henceforth allocated to the first pension pillar.

In the local government budget:

- In 2019, it is forecasted that the deficit of 0.3% of GDP will form in the local government budget. Given the increase of the non-taxable minimum and the allowance for dependents in 2019, the PIT revenue in the local government budget, forming the main source of revenue, will grow moderately and will stay approximately at the level of 2018. Lower deficit than in 2018 will be ensured by a steeper increase of the amount of the central government transfers, *inter alia*, special grant from the State basic budget - compensation for the adverse effect of the tax reform on the PIT revenue. The amount of compensation will ensure the local governments' tax revenue in the amount of 19.6% (19.4% - in 2019) of the actual general budget tax revenue, excluding the SMSIC into the State basic budget for the health care funding.
- High level of capital expenditure in 2018 means that the middle stage of the EU funds' 2014-2020 programming period has been reached and in the following years the capital expenditure in the local government budget is forecasted at a lower level. In 2018 the capital expenditure of local government budget increased for both the core functions and the projects co-financed by the EU funds, and it is expected that in 2019 and in the medium term, in general, the capital expenditure will decrease, given both a lower intensity of implementation of the EU funds' projects and more rigid co-financing rules for the local governments for implementation of other projects. Starting from 2019, the co-financing of local government budget, for the projects other than the EU funds' projects and the investment projects of educational institutions, where special rules apply, must be at least in the amount of 25%.
- In accordance with the forecasts, in 2019 and in the medium term, the expenditure for remuneration, goods and services, as well as subsidies and grants will continue growing. Expenditure for social benefits, in turn, will remain without considerable

changes, approximately at the level of 2018. At the same time, in 2019 and in the medium term the local government budget expenditure, based on ESA 2010 methodology will be reduced by payments for the Southern Bridge construction, because expenditure was recognized already in previous years during the actual construction of the object.

In accordance with the conditions of fiscal discipline, the maximum allowable structural deficit of the general government budget and the resulting headline deficit is determined using the top-down budget planning method, which ensures setting of balance targets that meet both the FDL and the SGP requirements.

Under these conditions, at the moment of preparation of this Stability programme deficit in the general government budget in 2020 and 2021 shall be lower, while in 2022 a higher deficit is allowed than projected in the no-policy change scenario, namely in 2020 and 2021, the fiscal space is negative, but in 2022 it is a positive. Consequently, if at the current moment the next Annual State Budget Law and the Framework Law were drafted, the Government would have to take discretionary decisions in 2020 and 2021 by cutting general government budget expenditures and/or increasing revenues by 0.04% of GDP and 0.23% of GDP respectively. In turn, in 2022, the government would have access to resources at a level of 0.48% of GDP to finance budget priorities. In all years, the minimum fiscal security reserve as defined in the FDL in amount of 0.1% of GDP is taken into account in determining the fiscal space.

Accordingly, the fiscal scenario foresees a general government deficit of 0.5% of GDP in 2019, 0.4% of GDP in 2020, 0.2% of GDP in 2021 and 0.3% of GDP in 2022.

Table 3.10. Medium term fiscal development scenario, % of GDP

		2018	2019	2020	2021	2022
	ESA code	% of GDP				
Net lending (+) or borrowings (-) (B.9) by sub-sectors						
General government	S.13	-0.7	-0.5	-0.4	-0.2	-0.3
Central government	S.1311	-0.8	-0.9	-0.8	-0.5	-0.6
Local government	S.1313	-0.5	-0.3	-0.1	0.0	0.0
Social security funds	S.1314	0.6	0.7	0.4	0.3	0.3
General government (S.13)						
Total revenue	TR	37.1	36.2	35.9	35.4	34.9
Total expenditure	TE	37.7	36.7	36.4	35.6	35.2
Interest expenditure	D.41	0.8	0.7	0.8	0.8	0.8
Cyclical development						
Cyclical budgetary component[20]		0.7	0.5	0.4	0.3	0.2
One-off and other temporary measures[21]			0.1			
Cyclical component of the budgetary balance		-1.3	-1.1	-0.8	-0.5	-0.5
Cyclically adjusted primary balance		-0.5	-0.3	0.0	0.3	0.3
Structural balance[22]		-1.3	-1.1	-0.8	-0.5	-0.5

[20] In a calculation of cyclical budgetary component a semi-elasticity of 0.38 was used (Data: An update of the semi-elasticities of the budget balance based on new weights. Note to the attention of the members of the Output Gap Working Group).

[21] The share of revenue of EUR 18.2 million from the EU ETS sale of emission allowances, which took place in November 2018 and is attributable to the increase in volume, is included in the Stability Programme as a one-off measure. On the other hand, the increase in revenue from this transaction, which is attributable to price fluctuations in 2019, is not considered a one-off measure.

The fiscal development scenario assumes that the budget consolidation required in 2020 and 2021 is carried out at the expense of the central government's spending cuts, while the fiscal space available in 2022 is used by the central government for additional spending. It is assumed that the fiscal safety reserve is used, i.e. fiscal risks in amount of 0.1% of GDP have materialized. Since the decisions on the development part of the budget are taken in the budgetary process and are currently unknown, the necessary spending cuts in 2020 and 2021 and the increase in expenditure in 2022 are carried out proportionally by expenditure categories over the years concerned, on the basis of the proportion of individual expenditure categories to total expenditure under a no-policy change scenario. When calculating the ratio of individual categories of expenditure to total expenditure under a no-policy change scenario, the following categories of expenditure are excluded from the calculation: interest expenditure and capital expenditure transfers. This approach is used because it is assumed that the decisions of the budget development section do not affect decisions on these expenditure categories.

Table 3.11. Fiscal space

	2020	2021	2021
Objective of the general government budget balance. % of GDP	-0.4	-0.2	-0.3
General government budget balance at no-policy change. % of GDP	-0.3	-0.4	0.2
Fiscal safety reserve:% of GDP	0.1	0.1	0.1
Fiscal space: % of GDP	**-0.04**	**-0.23**	**0.48**
Fiscal space EUR million	**-11.9**	**-81.1**	**176.3**

3.4. Development Trends of Government Debt in the Medium Term

According to the operational assessment, prepared in accordance with the ESA 2010 methodology, the general government debt at the end of 2018 reached 36% of GDP. The level of the general government debt is mainly affected by the government debt, which, at the end of 2018, comprised 10.0 billion euro[23], having grown by 0.5 billion euro since the end of 2017. In 2018, the Eurobonds issued in 2008 in the amount of 400 million euro and the domestic debt securities (T-bonds) in the amount of 220.9 million euro have been redeemed, using the resources of Eurobonds issued in the international financial markets in 2017. In 2018, the Eurobond issues have been performed in the amount of 1.0 billion euro, ensuring the resources for the funding needs of both current and next year, incl., for the repayment of the government debt planned in the first half of 2019 (redemption of T-bonds in February in the amount of 229.8 million euro and the repayment of the EC loan in April in the amount of 500 million euro).

The key principles and medium-term objectives of the central government debt management are defined in the Central Government Debt and Cash Management Strategy approved by the Minister for Finance. In accordance with the Central Government Debt and

[22] In order to facilitate data comparability, the structural balance in 2019 and 2020 is shown together with a reduction in net revenue from the tax reform 0.5% of GDP and 0.3% accordingly, which is temporary and recognised as a one-off measure from the perspective of Latvian fiscal framework, but the EC includes this effect in the structural balance, since revenue-reducing/expenditure-increasing measures by the EC as a rule are not recognised as one-off/short-term measures.

[23] Taking into account derivatives linked to the central government foreign borrowings and debt securities administered by the Treasury

Cash Management Strategy, the goal of government debt and cash management is to ensure the timely availability of financial resources to cover financing requirement at the lowest possible debt servicing costs while hedging financial risks and at the same time contributing to the development of the domestic financial market. A strategic approach is used for execution of central government debt and budget liabilities while maintaining as much flexibility as possible in selection of borrowing terms in financial markets (time of borrowing, currency, amount, maturity). It allows limiting financial risks in the medium term, as well as ensuring the amount of necessary financial resources to cover the total financing requirement at as favorable and attractive conditions as possible.

The stabilization of the country's credit rating in a rating group, the investor appreciation on the accomplishments in the Latvian economy in the previous years and the confidence in the long-term development of the state, allows the country to borrow financial resources in the international markets at favorable conditions. This is also confirmed by the borrowing transactions concluded in 2018 in the international financial markets, by issuing, in May and September, the Eurobonds in the total amount of 1.0 billion euro, *inter alia*, 10-year Eurobonds with maturity in 2028 in the amount of 500 million euro, fixing the coupon rate of 1.125% and two additional issues of 30-year bonds with maturity in 2047 in the amount of 500 million euro and a pre-fixed coupon rate of 2.250%.

In the domestic market, in 2018, two new 5-year T-bond programmes have been launched. The 5-year T-bond programme launched in January, at the end of 2018, was the most liquid T-bond programme in circulation, achieving 250 million euro, but the new 5-year T-bond programme launched in November, continuing also in 2019, by the end of 2018 reached 80 million euro. Liquid T-bond programme facilitates the trading in the secondary market, which, in turn, positively influences the pricing of securities in the primary market. The demand for Latvian government debt securities remained high in 2018, which means that investors' competition in all auctions ensured attraction of resources on financially advantageous terms. Yields at auctions remained close to historically lowest levels, attributable to the active participation of primary dealers in the auctions, high liquidity of Latvian credit institutions, as well as the continuation of the European Central Bank's bond-buying programme till the end of 2018.

Taking into account, the central government debt obligations outstanding as of 31 March 2019, in accordance with the central government debt repayment schedule, the amount of the central government debt obligations to be refinanced in the period from April 2019 till December 2022 comprises 3.8 billion euro (see Figure 3.5). A significant portion of the debt to be refinanced consists of Eurobonds issued in international financial markets, as well as the funding received from the World Bank and the EC within the framework of the international loan programme, the resources for the repayment whereof has already been ensured.

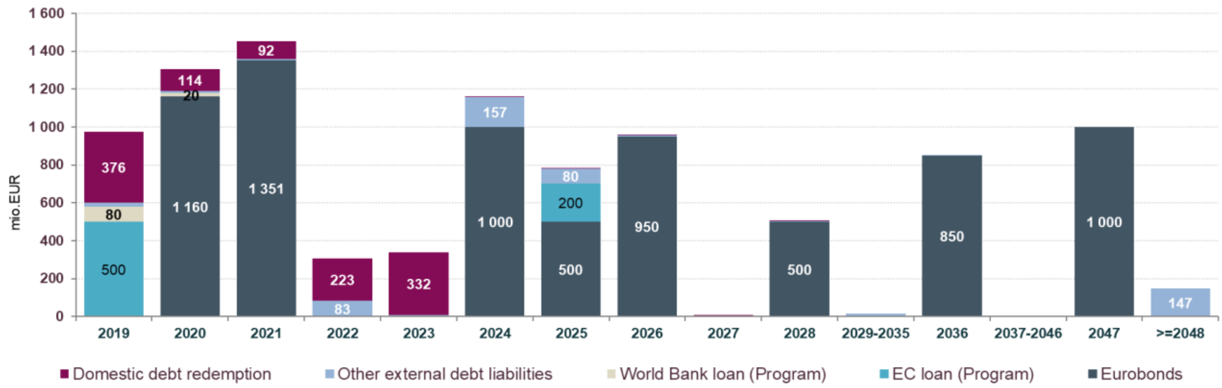

Figure 3.5. Central government debt repayment schedule
(Liabilities outstanding as of 31 March 2019. nominal value)

*excl. sectors S130130, S130140, S130330, S130340, as well as on-demand and short-term deposits; according to ECB FX rates of 29 March 2019

In order to cover the total financing requirement in 2019-2021, it is planned to organize timely borrowing in financial markets, so as, by managing the government debt refinancing risk in accordance with the Central Government Debt and Cash Management Strategy, to refinance the outstanding government debt liabilities under favorable conditions in terms of rates and maturity. Investor confidence in the creditworthiness of Latvia and a stable country's credit rating ensures a stable ground for successful refinancing of debt liabilities in the next years.

Taking into account the borrowing strategy, in order to manage government debt refinancing risk, as well as ensure optimization of government debt servicing costs in the medium and long-term, in the coming years, foreign borrowing instruments will still provide the major share of the total funding. The Treasury, by issuing new 30-year Eurobonds in the amount of 700 million euro with the fixed coupon (interest) rate of 1.875% in February 2019, under favorable conditions has fulfilled the major part of the borrowing plan in the international markets for 2019, ensuring resources for both the financing requirement of the current year and the redemption of the Eurobonds denominated in the US dollars in the 533.5 million euro equivalent planned in January 2020. It is planned that borrowing in international financial markets will also henceforth be based on public transactions in global financial markets, issuing the medium term and long-term benchmark Eurobonds mainly in the European financial market, as well as addressing other regional investors. It is planned to also henceforth maintain on the domestic financial market an offer of T-bonds, within the framework of the primary dealers system, consistent with the market demand thus promoting activity and liquidity of the government debt securities market.

In 2018, the decreasing trend of the general government debt ratio has been observed, facilitated by the GDP growth, government debt trends, as well as the reduction of debt liabilities of enterprises classified as the general government. Continuing the implementation of a sustainable fiscal policy, in the medium term, a stabilization and further reduction of the general government debt ratio in relation to GDP is projected, with a strong compliance with the debt condition set by the *FDL* (see Figure 3.6).

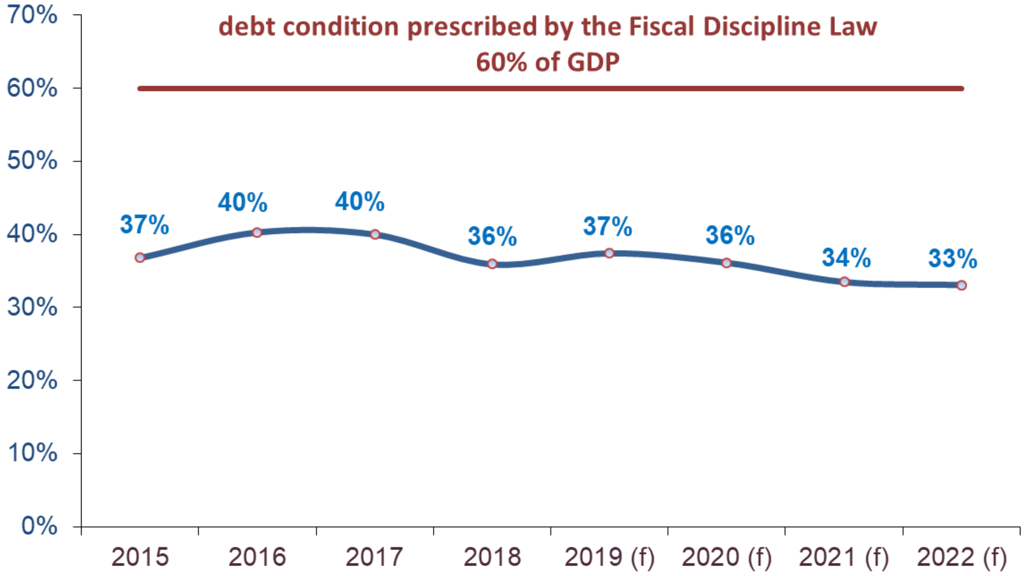

Figure 3.6. General government debt development trends (% of GDP)
f - forecast

4. SENSITIVITY ANALYSIS AND COMPARISON

4.1. MACROECONOMIC SCENARIO RISKS

The medium-term macroeconomic development scenario is based upon conservative assumptions regarding the economic development in the medium term, given that the economy is currently at the highest peak of a business cycle. Upward and downward risks of the macroeconomic development scenario, in general, are balanced.

The MoF, when developing its medium-term forecasts of macroeconomic indicators, has identified and assessed several internal and external environment risks, upon occurrence whereof the economic growth in Latvia may turn out to be sharper or slower than expected in the baseline scenario. Based on the macroeconomic risks outlined herein below, two alternative macroeconomic development scenarios are developed for 2019-2022. It is assumed that scenarios start to occur in the second half of 2019, because the economic development trend of 2018 continues in 2019. Therewith, the maximum risk impact is forecasted in 2020, while in 2022 the economic growth would return to the level of the forecasted rates.

Positive risks currently refer more to the medium-term. Among external factors, the improvement of economic condition in the EU and Latvia's trade partner countries is steeper than forecasted. Internal positive risks are related to steeper development of investments in Latvia, based on own resources of businesses and recovery of corporate lending, as well as more favorable-than-forecasted impact of the CIT exemption for reinvested profit on investment dynamics.

Negative risks for Latvia are currently related to a still high geopolitical uncertainty in the region and growing protectionism trends in the world, which might limit the global economic growth. Among the most topical general risks for the world as a whole, also the growing lending costs may be mentioned, as the USA is gradually increasing the basic interest rates, which might have an especially adverse effect on the developing countries with high levels of debts in US dollars, as it has, for instance, already manifested in financial crises in Turkey, and a high volatility on the world financial markets. Protractedly low investment level in Latvia should also be mentioned among internal risks, especially in the processing industry, limiting the total productivity growth of economy and the growth of economic potential, as well as the reduction of the number of population, limiting the employee resources and, along with the lack of investments, triggering the rise in wage not corresponding to the productivity growth.

4.2. SENSITIVITY ANALYSIS

4.2.1. Optimistic Scenario

Impact on economy. The MoF forecasts are traditionally cautious, and over the last two years, the economic growth had been steeper than forecasted. Furthermore, the previously forecasted factors decelerating the economic growth did not occur, for example, the adverse impact of the reorganization of the financial sector in 2018 was not as strong as forecasted. Thus, there is a possibility that the economic growth in 2019 could be steeper than forecasted. Also, in the medium term, though with a small probability, but, nevertheless, there is a possibility that the economic growth in the EU and Latvia's trade partner countries is steeper than forecasted.

Table 4.1. Optimistic macroeconomic scenario

	Optimistic Scenario				Deviation from the baseline scenario			
	2019	**2020**	**2021**	**2022**	**2019**	**2020**	**2021**	**2022**
GDP, growth at current prices, %	7.7	7.0	5.9	5.5	1.3	1.2	0.4	0.0
GDP, growth at constant prices, %	4.0	3.6	3.1	2.9	0.8	0.6	0.2	0.0
Private consumption, growth at constant prices, %	4.5	4.3	4.0	3.6	0.2	0.7	0.4	0.0
Public consumption, growth at constant prices, %	4.0	3.5	3.0	3.0	0.4	0.5	0.0	0.0
Gross fixed capital formation, growth at constant prices, %	9.0	7.0	5.2	5.0	1.3	1.0	0.2	0.0
Export of goods and services, growth at constant prices, %	4.1	4.4	4.4	3.9	0.9	0.3	0.4	0.0
Import of goods and services, growth at constant prices, %	6.0	5.9	5.8	4.9	0.3	0.7	0.8	0.0
Average wage in national economy, growth at current prices, %	7.5	7.0	6.5	6.0	1.0	1.5	1.5	1.0
Employment growth, %	0.8	0.2	-0.1	-0.1	0.3	0.1	0.0	0.0
Unemployment level, %	6.7	6.3	6.2	5.5	-0.3	-0.2	-0.1	-0.1

Steeper-than-forecasted improvement of economic condition in the EU and Latvia's trade partner countries will ensure steeper export growth from 2019 to 2021, which could be, correspondingly, by 0.9 percentage points, 0.3 percentage points and 0.4 percentage points higher than in the baseline scenario.

Scenario also provides for the recovery of lending, considering that the amount of loans issued to business has been constantly decreasing since 2007. Since the latest economic recession, the volume of loans issued in Latvia has been reducing and not promoting the economic growth. However, the fall in the volume of loans issued considerably slows down in 2018, and according to this scenario, the volume of corporate loans might grow steeper than forecasted in the baseline scenario.

Thus, the growth of investments in 2019 might be by 1.3 percentage points higher, in 2020 - by 1 percentage points higher and in 2021 - by 0.2 percentage points higher than in the baseline scenario. Besides, the CIT exemption for reinvested profit can more positively influence the investment dynamics, incl. based on own resources of the businesses.

Steeper economic activity will promote the growth of wages and employment, by unemployment reducing steeper than in the baseline scenario and achieving 5.5% in 2022. Considering the growing amount of average wage, we cannot exclude also considerably reduction of emigration. Under the impact of these factors, private consumption could grow by 0.5 percentage points steeper, on average.

As a result, in case of the optimistic scenario, Latvian GDP growth at constant prices in 2019 would be by 0.8 percentage points larger, in 2020 - by 0.6 and in 2021 - by 0.2 percentage points larger than in the baseline scenario.

Impact on the general government budget. Upon implementation of the optimistic scenario, where the tax and non-tax revenue increases, as well as interest expenses reduce, the general government budget balance would improve. As compared to the baseline scenario, in case of the optimistic scenario the general government deficit in 2019 would decrease by 144.9 million euro or 0.5 percentage point of GDP. By contrast, in 2020, 2021 and 2022 the general government balance would improve, respectively, by 0.8 (263.9 million euro), 0.9 (320.9 million euro) and 0.9 (349.1 million euro) percentage points of GDP as compared to the baseline scenario. The changes would be mainly observed in tax revenue, where they would most significantly increase in the state basic budget.

Table 4.2. Impact of optimistic scenario on the general government budget, million *euro*

	Risk scenario				Deviation from the baseline scenario			
	2019	**2020**	**2021**	**2022**	**2019**	**2020**	**2021**	**2022**
General government budget balance, % of GDP	**-0.1**	**0.4**	**0.7**	**0.6**	**0.5**	**0.8**	**0.9**	**0.9**
General government budget balance	-23.5	130.6	239.5	226.7	144.9	263.9	320.9	349.1
Tax revenue	9 183.9	9 919.5	10 496.4	11 033.2	136.9	248.0	298.2	313.6
PIT	1 770.3	1 769.5	1 852.6	1 948.3	27.9	46.7	55.4	57.3
CIT	194.5	359.8	381.7	403.5	3.1	9.5	11.4	12.1
VAT	2 703.0	2 919.8	3 133.6	3 326.8	42.6	77.0	93.8	99.6
Social security contributions[24]	2 874.8	3 089.8	3 285.3	3 458.9	45.3	81.5	98.3	103.6
Excise tax	1 142.4	1 264.3	1 313.5	1 351.5	18.0	33.3	39.3	40.0
Non-tax revenue	506.5	495.4	336.9	338.0	8.0	13.1	10.1	10.1
Interest expenditure	224.4	252.7	263.1	250.3	0.0	-2.8	-12.6	-25.4
General government debt[25]	-	-	-	-	-1.3%	-3.5%	-6.3%	-8.9%

Upon implementation of the optimistic scenario of the economic development, under the influence of the tax revenue increase the state budget financial balance would improve, as a result whereof the overall funding need would reduce and, correspondingly, also the borrowing amount for the respective period, as compared to the baseline scenario. Smaller borrowings would generate savings in the interest expenditure. In case of the optimistic scenario, the interest expenditure in 2020 would be by 2.8 million euro or 0.008% of GDP smaller, in 2021 - by 12.6 million euro or 0.035% of GDP and in 2022, correspondingly, by 25.4 million euro or 0.067% of GDP smaller than in the baseline scenario.

4.2.2. Pessimistic Scenario

Impact on economy. In accordance with the pessimistic scenario, Latvian economy may experience a sharper fall of growth rates, attributable to considerably slower economic growth in the trade partner countries. That is why the export growth rates in 2019 and 2020 might reduce, correspondingly, by 0.7 and 0.8 percentage points. Export growth will be slowed down also by reduction of the competitiveness of export goods, and the export market share might reduce, as well.

Despite the comparatively high level of the EU structural funds' investments, growth of private investments in economy can reduce, which would mean that the total fixed capital

[24] Deducting contributions into the state funded pension scheme and contributions into the 3rd pension pillar
[25] Changes in growth rates, as compared to the baseline scenario, in percentage points (%)

formation growth during the time period from 2019 till 2020 could be, correspondingly, by 1.7 and 1.0 percentage points slower than in the baseline scenario.

At the same time, there is a risk present that in separate sectors, *inter alia*, financial services and transport sectors, the development is less favorable than initially forecasted, creating adverse tension, weakening consumer confidence and private consumption, as well as reducing the volumes of export of services.

Table 4.3. Pessimistic macroeconomic scenario

	Risk scenario				Deviation from the baseline scenario			
	2019	**2020**	**2021**	**2022**	**2019**	**2020**	**2021**	**2022**
GDP, growth at current prices, %	5.4	4.9	5.0	5.5	-0.9	-1.0	-0.5	0.0
GDP, growth at constant prices, %	2.7	2.4	2.7	2.9	-0.5	-0.6	-0.2	0.0
Private consumption, growth at constant prices, %	3.8	3.0	3.5	3.6	-0.5	-0.6	-0.1	0.0
Public consumption, growth at constant prices, %	3.2	2.5	2.7	3.0	-0.4	-0.5	-0.3	0.0
Gross fixed capital formation, growth at constant prices, %	5.1	4.1	2.9	4.1	-1.7	-1.0	-0.5	0.0
Export of goods and services, growth at constant prices, %	2.5	3.0	3.2	3.9	-0.7	-1.1	-0.8	0.0
Import of goods and services, growth at constant prices, %	4.6	4.2	4.0	4.9	-1.1	-1.0	-1.0	0.0
Average wage in national economy, growth at current prices, %	5.0	4.2	4.0	5.0	-1.5	-1.3	-1.0	0.0
Employment growth, %	0.0	-0.7	-0.3	-0.2	-0.5	-0.8	-0.2	-0.1
Unemployment level, %	7.4	7.9	7.7	7.0	0.5	1.4	1.4	1.4

In general, according to the pessimistic scenario, as the income of population decrease, the wage growth of the employed, in 2019 and 2020, would be, on average, by 1.2 percentage points smaller. Therewith, also the private consumption growth, in 2019 and 2020, would be, on average, by 0.5 percentage points smaller than projected in the baseline scenario.

In case of the pessimistic scenario, the real GDP growth in 2019 would be by 0.5 percentage points less than in the baseline scenario and in 2020 - by 0.6 percentage points less.

Impact on the general government budget. Upon implementation of the pessimistic scenario, tax revenue would decrease significantly, and the general government budget balance would deteriorate. As compared to the baseline scenario, in case of the pessimistic scenario the general government deficit in 2019 would increase by 48.1 million euro or 0.2 percentage points of GDP. By contrast, in 2020, 2021 and 2022 the general government balance would deteriorate, correspondingly, by 0.4 (138.3 million euro), 0.6 (192.8 million euro) and 0.6 (209.8 million euro) percentage points of GDP as compared to the baseline scenario. In nominal terms, the general government deficit in 2019, 2020 and 2021 would grow to 0.7% of GDP, but in 2022 - to 0.8% of GDP.

Table 4.4. Impact of pessimistic scenario on the general government budget, million *euro*

	Risk scenario				Deviation from the baseline scenario			
	2019	**2020**	**2021**	**2022**	**2019**	**2020**	**2021**	**2022**
General government budget balance, % of GDP	**-0.7**	**-0.8**	**-0.8**	**-0.9**	**-0.2**	**-0.4**	**-0.6**	**-0.6**
General government budget balance	-216.5	-271.6	-274.2	-332.2	-48.1	-138.3	-192.8	-209.8
Tax revenue	9 001.6	9 541.0	10 017.7	10 529.8	-45.4	-130.5	-180.5	-189.8
PIT	1 733.1	1 698.2	1 763.6	1 854.7	-9.3	-24.6	-33.6	-35.3
CIT	190.4	345.3	363.4	384.1	-1.0	-5.0	-6.9	-7.3
VAT	2 646.3	2 802.3	2 983.1	3 167.0	-14.1	-40.5	-56.8	-60.2
Social security contributions[26]	2 814.5	2 965.5	3 127.5	3 293.0	-15.0	-42.9	-59.5	-62.4
Excise tax	1 119.4	1 213.4	1 250.4	1 287.2	-6.0	-17.6	-23.8	-24.4
Non-tax revenue	495.9	475.4	320.7	321.8	-2.6	-6.9	-6.1	-6.1
Interest expenditure	224.1	256.4	281.9	289.6	0.0	0.9	6.2	13.9
General government debt[27]	-	-	-	-	0.4%	1.6%	3.3%	4.9%

Upon implementation of the pessimistic scenario of the economic development, under the influence of the tax revenue decrease the state budget deficit would grow, as a result whereof the overall funding need would increase and, correspondingly the borrowing amount for the respective period, as compared to the baseline scenario. Additional borrowing would generate the interest expenditure growth. In case of the pessimistic scenario, the interest expenditure in 2020 would be by 0.9 million euro or 0.003% of GDP larger, in 2021 - by 6.2 million euro or 0.018% of GDP and in 2022, correspondingly, by 13.9 million euro or 0.039% of GDP larger than in the baseline scenario.

According to Section 25, Part (2^2) of the *LBFM*, in the event if within the time period of three months the actual revenues from the state budget taxes and non-taxes in respect to the anticipated revenues in the relevant period decreases by more than 0.5 per cent from the forecast of the GDP determined in the annual *State Budget Law* or the actual accumulated state budget financial deficit within the time period of three months exceeds the state budget financial deficit anticipated for the relevant time period by more than 0.5 per cent from the forecast of GDP determined in the annual *State Budget Law*, or there is no sufficient amount of funds in the budgetary accounts of the Treasury to cover payment commitments planned for the next month, the Minister for Finance has the right to issue an order to the Treasury to delay or reduce assignations for a certain period of time if such an act is not in contradiction with the Constitution, laws and the Cabinet regulations. Therewith, the legal framework provides for the regulation in cases, which might occur in the pessimistic scenario.

In case of occurrence of a pessimistic scenario, the economic growth rates would reduce, which would concurrently also imply the reduction in separate expenditure positions pegged to GDP, for example, lower GDP growth rates would imply lower contributions to the EU budget, as well as smaller expenditure in the defense institution.

[26] Deducting contributions into the state funded pension scheme and contributions into the 3rd pension pillar
[27] Changes in growth rates, as compared to the baseline scenario, in percentage points (%)

4.3. Comparison of the General Government Budget Balance and Debt Forecasts with the Latvia's Stability Programme for 2018 - 2021

GDP growth in 2018 has been considerably steeper than envisaged by the Latvia's Stability Programme for 2018-2021 scenario. Steeper economic growth in 2018 was mainly attributable to stronger-than-forecasted growth of investment activity, as the gross fixed capital formation increased by 16.4%, as well as more favorable-than-forecasted development in separate economic sectors, *inter alia*, transport and financial services. Growth of public consumption in 2018 has also been slightly steeper than envisaged by the scenario of Latvia's Stability Programme for 2018-2021. In turn, the private consumption and export growth rates have been slightly lower than forecasted in the scenario of the previous Stability Programme.

According to the latest growth scenario GDP increase forecast for 2019 is 3.2%, which is by 0.2 percentage points less than projected by the previous Stability Programme scenario. Reduction of the GDP growth forecast was mainly attributable to the economic growth slowdown in the world and main external markets of Latvia, as well as to the high basis achieved in 2018. The GDP growth forecasts for 2020 and 2021 are not changed and remain, correspondingly, at the level of 3.0% and 2.9%.

Table 4.5. Comparison with the forecasts of the Stability Programme for 2018 - 2021

	ESA code	2018	2019	2020	2021	2022
GDP growth (%)	B1g					
2018		4.0	3.4	3.0	2.9	-
2019		4.8	3.2	3.0	2.9	2.9
Difference		0.8	-0.2	0.0	0.0	-
Actual budget balance (% of GDP)	B.9					
2018		-0.9	-0.9	-0.4	-0.4	-
2019		-0.7	-0.5	-0.4	-0.2	-0.3
Difference		0.27	0.4	0.0	0.14	-
Total general government debt (% of GDP)						
2018		38.4	37.4	38.0	35.6	-
2019		36.1	37.4	36.1	33.5	33.1
Difference		-2.3	-0.0	-1.9	-2.1	-

According to the MoF assessment, in 2018, the general government budget deficit was 0.7% of GDP, which is by 0.27% of GDP less than forecasted in the previous Stability Programme. Lower deficit was mainly determined by higher-than-forecasted tax revenue, especially, CIT, where the revenue has grown steeper than forecasted, considering the tax return data for the results of 2017. Also, as compared to the previous Stability Programme, the expenditure for social benefits was spent in a smaller amount, considering that the actual number of beneficiaries of the sickness, unemployment and childcare benefits was smaller than forecasted.

The updated medium-term forecasts foresees for the budget deficit of 0.5% of GDP in 2019, 0.4% of GDP in 2020, 0.2% of GDP in 2021 and 0.3% of GDP in 2022. General government budget forecasts are based on updated structural budget balance objectives, as well as considering the changes in the cyclical component of the budgetary balance.

5. QUALITY OF PUBLIC FINANCE

5.1. EFFICIENCY OF THE STATE BUDGET RESOURCES AND EXPENDITURE CONTROL

Procedures for the development, approval and implementation of the State budget and responsibilities within the budgeting process are determined by the LBFM.

According to the LBFM, the Minister for Finance shall ensure the development of the Draft Annual State Budget Law, on the basis of the Medium-Term Budget Framework Law and budgetary requests. The Minister for Finance shall evaluate the conformity of the budgetary requests with the budgetary purposes and priority courses of development prescribed by the Framework Law, as well as with the principles of economy and efficiency and, if necessary, shall request necessary additional information. Based in the evaluation and the provided information, the Minister for Finance, till the submission of the Draft Annual State Budget Law to the Cabinet, shall take a decision regarding inclusion of the budgetary requests in the Draft Annual State Budget Law. The Minister for Finance may, at any stage of the examination of the Draft Annual State Budget Law, express his or her point of view; add the necessary opinions, as well as the results of separate audits.

The Minister for Finance shall also be responsible for the organization and management of the State budget implementation process, as well as the supervision of the operation of the Treasury in accordance with the requirements of the LBFM.

The Minister for Finance during the development of the Draft Annual State Budget Law or amendments thereof shall inform the Budget and Finance (Tax) Committee of the Saeima on the course of the State budget planning, as well as no less than once in a quarter - on the course of implementation of the State budget.

According to the LBFM, heads of bodies financed from the budget, institutions non-financed from the budget and local governments, as well as of capital companies, in which a State or local government capital share has been invested, shall be responsible for the observance, implementation and control of the procedures and requirements prescribed by the above mentioned law, as well as for the efficient and economic utilization of budgetary funds in conformity with purposes intended.

Starting from 1 January 2016 the LBFM includes the provisions prescribing for the Cabinet to ensure constant and systematic revision of the State budget expenditure, allowing for more efficient and economic implementation of the State policy, as well as optimizing of the budget expenditure and evaluating the conformity thereof to the priorities and objectives set in the development planning documents. The Cabinet, on an annual basis, adopts the decision on the scope of revision of the State budget expenditure, concurrently with the approval of the schedule for preparation of the budget. The Minister of Finance in turn, in accordance with the referred to schedule, submits to the Cabinet the State budget expenditure revision results and proposals regarding the use of these results within the process of development of the Draft Medium-Term Budget Framework Law and the Draft Annual State Budget Law.

Three thematic blocks are included in the scope for 2019, providing for the horizontal review of the State budget programmes, review of the sectoral policy funding and improvement of processes and systems (se Figure 5.1).

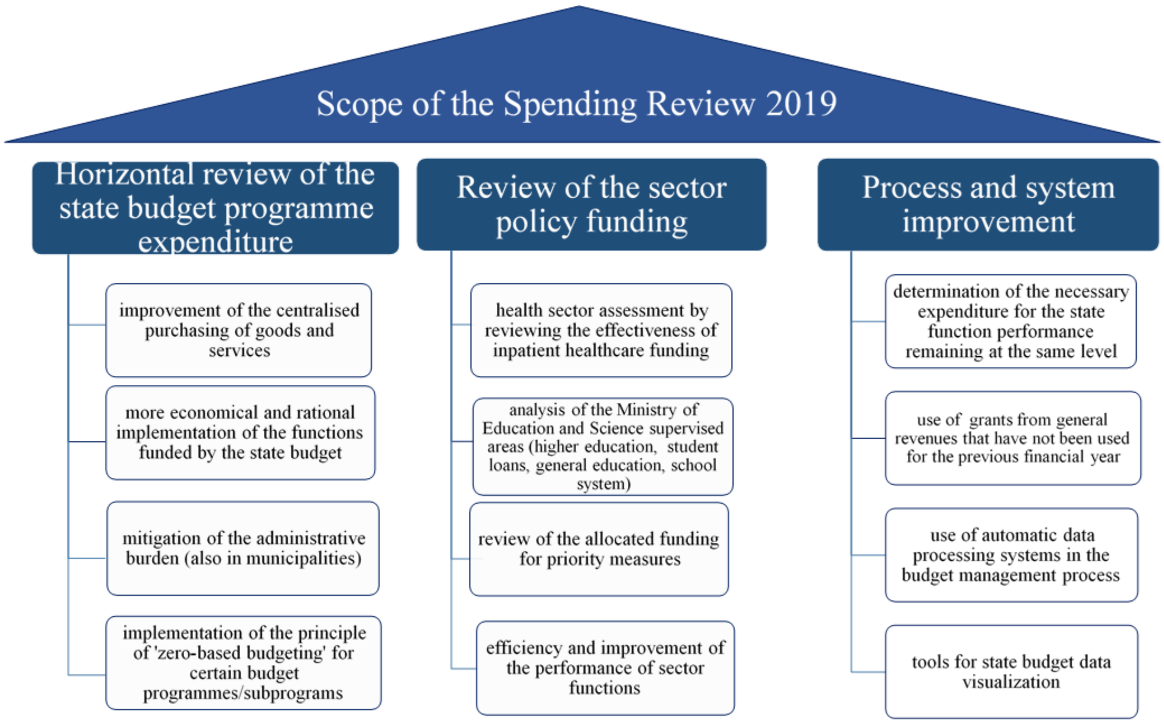

Figure 5.1. Scope of expenditure revision for 2019

State budget consists of budget programmes where the structure is determined by the operational (action) course defined in the institution's operational strategy or functions defined in the regulation of the ministry or other central State institution. Thus, the budget development is linked to the policy planning, as one of the institution's operational strategy objectives in the medium term is to ensure that budget programmes provide the achievement of objectives, planned results and performance indicators, which are defined in the development planning documents. Each year Ministries and other central State institutions in their budget requests include operating results of the budget programmes, which, whenever possible, are developed in accordance with planned operating results and performance indicators of the development planning documents. It should be noted that in 2017 and 2018 the changes have been introduced, which improve the content of the budget explanations in order to provide information on the state budget as a policy instrument, as well as to increase perceptibility of information in the budget explanations. The main innovation is the introduction of Policy and resource management cards, through which view is provided on invested resources (financial and human resources) to achieve sectoral policy outcomes and on the benefits for society in the result of sectoral activity.

In addition, the new budget format has provided for the possibility, in an interactive and demonstrative manner, to inform the population in Latvia about the fields where and the amount in which the taxpayers' money is being invested and what are the expected outcomes. Any interested person has access to the following on the MoF website:

- interactive budget infographics, letting the user to review nine budget contribution fields (for example, health, education, social protection, etc.) and the financing allocated thereto, as well as to get to know detailed information on directions of contribution in each of the sectors and sources or financing. Additionally, information on outcomes to be expected from contributing the State budget financing into the relevant field is provided;

- budgets of the ministries and other central state institutions are visualized both in summarized form and in more detail. The user can review the fields of operation of the ministries and other central state institutions and the financing allocated thereto, as well as to get an insight regarding the benefits for society in the result of sectoral activity. It is reflected in the Policy and resource management cards, which in a summarized form provide possibly comprehensive and characteristic information on sectoral activity in the relevant field - the goal, inputs for the achievement thereof, expected operational outputs and the highest-level sectoral policy and quality outcomes to be achieved.

When preparing a report on the analysis on the State budget execution, ministries and other central State institutions shall provide explanations about previously planned results and performance indicators thereof, their implementation during the year, as well as explanations about the deviations in values of the achieved and planned performance indicators if they exceed 15 per cent (both in positive and negative terms). The MoF aggregates, assesses and ensures the accumulation of the outcomes specified in the Policy and resource management cards and the performance indicators thereof, as well as the operational outputs of the State budget programmes (sub-programmes) and their performance indicators.

The LBFM prescribes the following organizational aspects of the State budget implementation:

- persons implementing the State budget may make the budget expenditure or assume short-term liabilities only within the limits of the assignations determined by financing plans issued by the Treasury. The Treasury in turn provides allocations for expenditure according to the appropriation stated in the Annual State Budget Law and ensures their execution according to the procedures prescribed by the Cabinet. Ministries and other central state authorities are responsible for the development of the system of control over the fulfilment of the appropriations determined in the Annual State Budget Law and for the control over expenditure of the State budget funds transferred into the current accounts of the Treasury in accordance with the purposes intended;
- State-financed institutions may undertake long-term liabilities of the State budget, not exceeding the ceilings of the State budget long-term liabilities for a financial year that are prescribed by the Law on the State Budget;
- State budget institutions for the receipt of assignations and for the making of expenditure from the State budget, funds shall open the State basic budget and State special budget accounts only with the Treasury. Institutions non-financed from the budget shall open current accounts only with the Treasury. Bodies financed from the budget, except for the State budget institutions, for the receipt of the State budget funds and for the making of expenditure financed therefrom shall open current accounts only with the Treasury, unless provided for otherwise in other regulatory enactments. Local governments, derived public persons partially financed from the State budget and capital companies in which a State or local government capital share is invested may open current accounts with the Treasury for the cash funds not received from the State budget;
- ministries and other central State budget instructions and local government according to the procedures prescribed by the Cabinet shall prepare and submit to the Treasury the quarterly reports, in turn, the Treasury shall arrange for the accounting of the State budget finances; The Treasury shall prepare regular official and operative statements and provide information regarding the State and local government budget statements and provide information regarding the State and

local government budget execution, ensuring the informing of the MoF, other institutions, as well as public regarding the process of the budget execution.

In order to strengthen the possibilities to control the utilization of resources, the LBFM provides that the Minister for Finance has the right to issue an order to the Treasury to delay or reduce assignations for a certain period if at least one of the following conditions exist:

- within the time period of three months the actual revenues from the State budget taxes and non-taxes in respect to the anticipated revenues in the relevant period decreases by more than 0.5% of the forecast of the GDP determined in the annual *State Budget Law* or the actual accumulated State budget financial deficit within the time period of three months exceeds the State budget financial deficit anticipated for the relevant time period by more than 0.5% of the forecast of GDP determined in the annual *State Budget Law,* or there is no sufficient amount of funds in the budgetary accounts of the Treasury to cover payment commitments planned for the next month;
- if the Minister for Finance has received a written notification, regarding the occurrence of the condition referred to in Clause 1 of this Section.

The LBFM provides for the following main sanctions in case of inappropriate utilization of budget resources:

- for late or incomplete payment of the amounts due to the State budget into Treasury budget accounts, the Treasury, unless this is under the competency of another State agency, shall recover the amount not paid into revenue of the basic budget and may charge the late charges in the amount of 0.1% of the amount not paid in time for each late day of payment unless provided otherwise by regulatory enactments;
- in order to cover losses caused to the budget, the Treasury may include amounts in the basic budget revenue and withdraw or suspend assignations, if the reports on budget and financial management have not been submitted in good time or are incomplete; the budgetary funds and transactions in such funds have not been registered in accordance with the procedures prescribed by law or notice has not been given regarding them; the accounting does not comply with the prescribed procedures and, thus, funds due to the budget are concealed; if a manager of a body financed from the budget has undertaken liabilities exceeding the assignation allocated by the Treasury;
- if bodies financed from the budget, institutions non-financed from the budget and local governments, as well as capital companies, in which a State or local government capital share has been invested, have violated financial management provisions provided for in the LBFM the Minister for Finance, the Treasurer or the heads of ministries and other central State institutions may in accordance with the competence withdraw for a period of time an authorization to assign or deal with budgetary revenue or expenditures; set limitations on the use of accounts; withdraw or suspend the assignations in order that the illegally used funds be refunded or require refunding of the illegally used funds; submit a civil claim to a court or provide materials to competent officials for deciding on the issue of initiation of criminal proceedings; or withdraw or suspend payments;
- the Treasury, in accordance with the Law on Equalization of Local Government Finances is entitled, by uncontested procedure, to recover from local government budget funds the amount, which the relevant local government has not in good time

or in full amount included in the local government finance equalization fund, by writing off such amounts from the budget of the relevant local government.

In order to maintain general economic balance and to ensure a uniform State financial policy, the amounts of total increase in local government borrowings and guarantees shall be separately prescribed in the Annual State Budget Law.

The Treasury has the right to withhold the sums from the amount, which is due to the local government from PIT, or from a grant of the local government financial equalization fund in the following cases and amount:

- if the local government does not ensure timely fulfilment of the liabilities specified in State loan agreements - in the amount of sum not paid timely;
- if local government does not ensure use of the State loan in compliance with the purpose specified in the loan agreement - according to the order of the Minister for Finance in the amount of the loan sum used in non-compliance with the purpose specified in the agreement.

5.2. Efficiency of Revenue Structure and System

The *Tax Reform* took effect starting from 1 January 2018. The purpose of the *Tax Reform* is to ensure stable and foreseeable tax policy at least till 2021; therewith no significant additional changes have been introduced to the tax policy. In turn, the minor changes introduced after the approval of the *Tax Reform* are to be classified as improvement and enhancement measures.

Table 5.1. Tax Revenue in General Government Budget (S.13), million euro

	Code (ESA)	2018	2019	2020	2021	2022
Tax revenue						
1. Production and import taxes	D.2	4 063.5	4 427.1	4 722.0	4 958.6	5 161.8
2. Current income and wealth taxes	D.5	2 157.7	2 047.4	2 193.0	2 297.4	2 422.1
3. Capital taxes	D.91	12.9	15.5	6.2	7.0	7.8
4. Social contributions	D.61	2 750.1	2 945.3	3 123.9	3 288.7	3 464.7
Of which actual social contributions	*D.611 and D.613*	2 653.5	2 848.6	3 027.3	3 192.1	3 368.0

In the recent years, the tax policy was focused on reducing the labour tax burden and income inequality.

As a result of the introduced changes, the share of labour taxes will decrease from 47.5% in 2018 to 46.3% in 2022, therefore, the share of revenue from consumption and capital taxes in total tax revenue will gradually increase from 52.5% in 2018 to 53.7% in 2022.

Therefore, also the share of the labour tax revenue from GDP in 2022, as compared to 2018, will be smaller than the share of the consumption and capital tax revenue from GDP. The labour tax revenue from GDP for the corresponding period will decrease by 0.6 percentage points, but the consumption and capital tax revenue from GDP will increase by 0.1 percentage point.

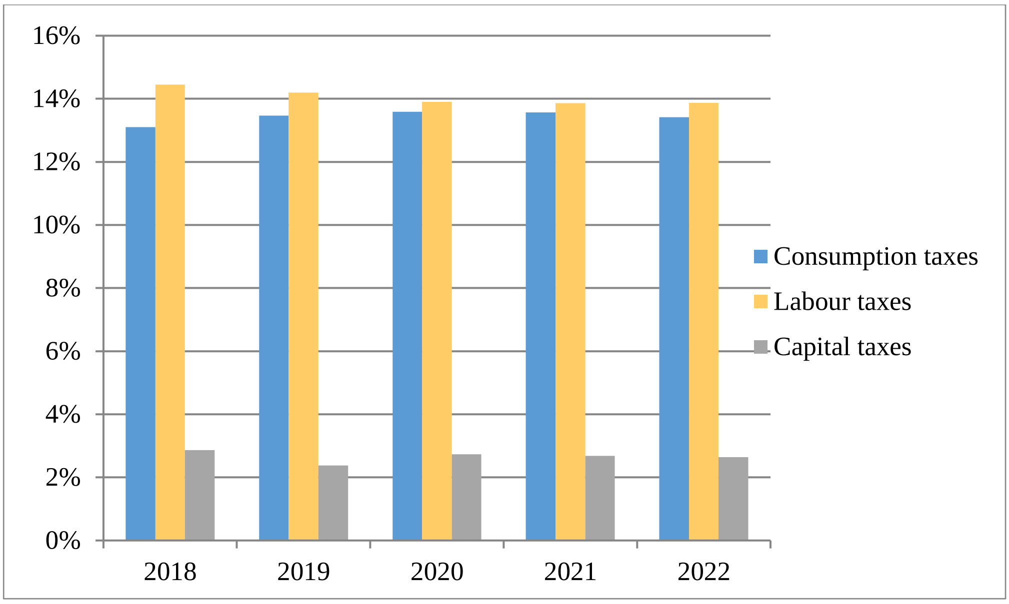

Figure 5.2. Tax Revenue According to Economic Functions, % of GDP

To emphasize the significance of the policy changes adopted within the scope of the Tax reform, in this Section of the report the tax reform measures are separated from the decisions adopted in the later period, which are also divided into two blocks - 1) measures resolved upon in the interim period from the *Tax Reform* and the budget for 2019; and 2) measures forwarded within the package of the budget for 2019.

5.2.1. Tax Reform measures

Table 5.2. Impact of the Changes in Tax Policy from the tax reform measures, million *euro*

	2018	2019	2020	2021	2022
Tax support measures - possibility for the period of up to 2 years to repay the debt, as a result discharging the late interest and fine*	28.0	-12.1	-16.0		
Measures for reducing the shadow economy	26.8	3.0	0.4		
Solidarity tax reform*	-19.9	0.0			
Increase of the SMSIC rate by 1% for healthcare funding*	85.6				
Increase of the differentiated NTM, increase of the NTM for pensioners, increase of the allowance for a dependant	-79.0	-56.6	-44.2		
Introduction of progressive PIT rates	-137.5				
Transitional period for disbursement of a dividend from retained profit of previous years in the amount of 10%*		74.4	-74.4		
Changes in the dividend policy*	4.2	-80.3			
Increase of the monthly minimum wage to 430 euro per month	28.8				
Determination of the PIT on capital in the amount of 20%	11.3				
Improvement of the patent fee regime, establishing a uniform amount of the patent fee	1.0				
Inclusion of the sum not exceeding 80% of the income from economic activity into expenses from economic activity	19.9				
PIT application to lotteries and gambling winnings exceeding 3, 000 euro (exception - the 100th anniversary lottery) *	2.0				

	2018	2019	2020	2021	2022
Restriction the ME operational threshold to 40, 000 euro per year	4.2				
Restriction of eligible expenditure	9.4				
Reform of CIT (reinvested profit)*	-235.1	114.4			
The CIT advance payments in the first half of 2018*	113.5	-113.5			
Increase of the gambling tax rates by 30% for gaming-tables and slot-machines as of 1 January 2018	9.0				
Application of the SMSIC to royalties	2.2				
Expansion of the VAT reverse, introducing it in supplies of construction materials, metals and household appliances*	30.9		-21.1		
Reduction of the VAT registration threshold from 50, 000 euro to 40, 000 euro	5.9				
Reduction of the threshold for deciphering VAT transactions in the VAT returns from 1 430 euro to 150 euro	38.0				
Increase of the excise duty on alcoholic beverages and beer as of 1 March 2018, 2019 and 2020*	33.9	13.1	22.9	3.8	
Increase of the excise duty rates for cigarettes as of 1 July 2018 and 1 July 2019*	5.6	11.0	5.4		
Increase of the excise duty rates for cigars, cigarillos and smoking tobacco as of 1 January 2020			0.7		
Increase of the excise duty rates for oil products, used as fuel. as of 1 January 2018 and as of 1 January 2020*	31.9		17.1		
Total impact of changes:	**20.6**	**-46.5**	**-109.2**	**3.8**	

**reestimated impact*

Within the scope of the Tax reform, the CIT regime has been significantly changed - tax is paid at the moment of profit allocation. To compensate *the fall in the CIT revenue in the year of introduction of the Tax Reform*, in the first six months of 2018, business continued with the CIT advance payments, thus actually reducing the CIT revenue in 2019.

PIT revenue is mainly influenced by the amount of population employed in national economic, income of the employed, the amount of the non-taxable minimum and exemptions of the PIT, minimum wage, as well as introduced legislative changes.

Nevertheless, the most significant changes in the recent years are related to the *Tax Reform* measures:

- Introduction of the progressive PIT rate of 20% for the annual income up to 20, 004 euro; 23% for the annual income exceeding 20,004 *euro*, but not exceeding 55, 000 *euro*; 31.4% for the annual income above 62, 800[28] *euro* (conditional rate, as it will not be applied during the taxation year, but, when filing the annual income declaration and performing the recalculation by three PIT rates. As it is not necessary to cover the state social security contributions above 62, 800 euro, but the conditional share of the employee's solidarity tax is being included into the paid PIT, the total tax burden for the payer will not exceed the referred to threshold);
- increase of the PIT - differentiated non-taxable minimum;

[28] From 2019, in 2018 - 55, 000 *euro*

Table 5.3. Differentiated non-taxable minimum 2018 - 2020

	2018	2019	2020
Max non-taxable minimum	200	230	250
Min non-taxable minimum	0	0	0
Max limit of taxable income	1 000	1 100	1 200
Min limit of taxable income	440	440	440

- increase of allowance for dependents - 200 euro per month in 2018, 230 euro per month in 2019, 250 euro per month in 2020;
- expansion of the circle of beneficiaries of allowance by the unemployed spouse, if he/she takes care of a child;
- revision of the norms of eligible expenditure, increasing the restriction for the PIT eligible expenditure for education, medicine and charitable donations of up to 600 euro per year (for a person him/herself and for each family member in the amount of 50% of the taxable income), as well as determining both proportionate (10% of the annual taxable income) and aggregate restriction - 4, 000 euro per year - for eligible expenditure for contributions into private pension funds and insurance premiums;
- increase of a non-taxable income for pensioners to 250 euro per month in 2018, to 270 euro per month in 2019 and to 300 euro per month in 2020;
- raise of the monthly minimum wage to 430 *euro* per month;
- equalization of the tax rate on capital and capital gains, stating it in the amount of 20% (except for the dividend, if it has already been taxed at the corporate level with 20% income tax rate at the moment of profit allocation);
- inclusion of the sum (not exceeding 80%) of income from economic activity into expenses from economic activity;
- PIT taxation, applying the tax rate of 20% for lotteries and gambling wins exceeding 3, 000 *euro*;
- improvement of the patent fee regime, stating a unified patent fee amount of 50 euro and 100 euro, refusing from too detailed itemization of the types of economic activity, as well as simplifying the payment thereof. To apply a reduced patent fee regime also on the persons with group I and II disability;
- changes in the dividend policy with respect to introduction of the reinvested profit regime in the field of corporate income;
- reduction of the micro-enterprise annual turnover threshold to 40 thousand *euro*;
- transformation of the solidarity tax for PIT (10.5% above the established SOC contributions ceiling).

Within the scope of the *Tax Reform*, on 27 July 2017, the amendments to the law On Excise Duties were adopted, stipulating changes in 2018 - 2020 with respect to the **excise duty** rates for alcoholic beverages, tobacco products and oil products used as fuel.

The referred to amendments stipulated the increase of the **excise duty for oil products** used as fuel, starting from 1 January 2018 and 1 January 2020 (see table 5.4).

Table 5.4. Excise Duty Rates on Oil Products

Excise duty object	01.01.2018.	01.01.2020.
Unleaded petrol, euro per 1, 000 liters	476.0	509.0
Leaded petrol, euro per 1, 000 liters	594.0	594.0
Diesel fuel, kerosene, fuel oil*, euro per 1, 000 liters	372.0	414.0
Diesel fuel used in agriculture**, euro per 1, 000 liters	55.8***	62.1
Liquefied petroleum gas, euro per 1, 000 kg	244.0	285.0

** for fuel oil, the colorimetric index of which is less than 2.0 and the kinematic viscosity of which at 50ºC is less than 25 mm2/s, and the substitute products and components thereof*
***labelled (marked) diesel fuel (gas oil), used for production of agricultural products, cultivation of agricultural land and cultivation of such forest or marshland where cranberries or blueberries are cultivated and for cultivation of land under fishing ponds*
**** rate is in effect as of 1 July 2018. Till 30 June 2018, the rate was 50.0 euro per 1, 000 liters.*

Within the scope of the *Tax Reform*, gradual increase of the rates has also been set for the excise duty on alcoholic beverages and beer. Starting from 1 March 2018, the rates have been increased more rapidly than previously planned, and a gradual growth of rates has been established also starting from 1 March 2019 and 2020. Table 5.5 reflects the schedule for increase of the rates.

Table 5.5. Excise Duty Rates on Alcoholic Beverages and Beer

Type of alcoholic beverage	Rates determined as of		
	01.03.2018	01.03.2019	01.03.2020
Wine, fermented beverages with pure alcohol content exceeding 6 volume percent and intermediate products with absolute alcohol content of up to 15 volume percent. euro per 100 liters	92.0	101.0	111.0
Fermented beverages with absolute alcohol content up to 6 volume percent, euro per 100 liters	64.0	64.0	64.0
Intermediate products with absolute alcohol content from 15 volume percent to 22 volume percent. euro per 100 liters	150.0	168.0	185.0
Other alcoholic beverages, euro per 100 liters of pure alcohol	1 670.0	1 840.0	2 025.0
Beer, euro per each volume percent of pure alcohol per 100 liters	6.8	7.4	8.1
Minimum level of excise duty, euro per 100 liters of beer	12.5	13.6	14.9

As regards **tobacco products**, the following increase of excise duty were established:

- **for cigarettes:**
  - from 1 July 2018, the specific duty rate were increased from 67.0 euro to 74.6 euro per 1, 000 cigarettes, but the minimum duty level - from 99.0 euro to 109.2 euro per 1, 000 cigarettes;
  - from 1 July 2019, the specific duty rate will be increased to 78.7 euro per 1, 000 cigarettes, but the minimum duty level - to 114.7 euro per 1, 000 cigarettes;
- **for cigars and cigarillos**, starting from 1 January 2020, the excise duty rate will be increased from 88.0 euro to 95.2 euro per 1, 000 cigars or cigarillos;
- **for smoking tobacco**, starting from 1 January 2020, the excise duty rate will be increased to 75.0 euro per 1, 000 grams of tobacco.

The result of all the changes with respect to the tobacco products is reflected in the Table 5.6.

Table 5.6. Excise Duty Rates for Tobacco Products

Excise duty object	Effective date of the rate		
Cigarettes	**1 July 2018**	**1 July 2019**	
Duty rate, *euro* per 1, 000 pieces	74.6	78.7	
Minimum duty level, *euro* per 1, 000 pieces	109.2	114.7	
Percentage rate of the retail trade price	20%	20%	
Cigars and cigarillos	**1 January 2018**	**1 January 2019**	**1 January 2020**
Duty rate, *euro* per 1, 000 pieces	73.0	88.0	95.2
Smoking tobacco	**1 January 2018**	**1 January 2019**	**1 January 2020**
Finely cut tobacco, other smoking tobacco, tobacco leaves, heated tobacco, *euro* per 1, 000 g	66.0	70.0	75.0

Interim results of the *Tax Reform*

Tax Reform is a complex set of measures, the key objective whereof is to raise the competitiveness and export ability of the country and to reduce income inequality, at the same time ensuring sufficient, foreseeable and high-quality tax revenue for funding the functions of the state and local governments.

To ensure the task assigned by Clause 11 of the 24 May 2017 Order of the Cabinet No. 245 "On the State Tax Policy Guidelines for 2018 - 2021", the MoF is currently working on the informative notification "Interim Assessment of 2018 of the State Tax Policy Guidelines for 2019 - 2021", which the Minister for Finance will submit for the review to the Cabinet in May 2019.

To provide a fully-fledged assessment of the measures of the *Tax Reform*, it is necessary to use more extensive data in the analysis; however, they are not available yet. Therewith, the report will not include a detailed assessment of the measures. Besides, the economic benefits of separate measures is expected within a longer time period.

One of the indicators demonstrating successful implementation of the *Tax Reform* is the execution of the tax revenue plan. The general budget tax revenue plan for 2018, in which a more rapid growth of macroeconomic indicators were already foreseen, has been executed by 100.9% - the tax revenue in the general budget exceeded the planned by 76.7 million euro.

It is important to note that the purpose of the *Tax Reform* has been accomplished - to reduce the labour tax burden and to increase income of population. In the first three quarters of 2018, the wage grew steeper than in the previous periods and the growth thereof reached 8.4%, and the average monthly gross wage comprised 991 euro. The reduction of the tax burden was partially limited by increase of the SMSIC rate by 1 percentage point, however, notwithstanding this, the tax burden for low income earners, for the first time over the last decade, will be below 40%, and, as compared to 2017, will be reduced by approximately 3 percentage points, which, in the EU context, is to be assessed as a considerable change.

In 2018, the tax wedge for the low wage earners (with the wage in the amount of 67% of the average wage in the state) without dependants, as compared to 2017, has reduced by 2.4 percentage points and comprised 39.5%, but the tax wedge for the low wage earners (with the wage in the amount of 67% of the average wage in the state) with one dependant has reduced by 2 percentage points and comprised 34.6% (see figure 5.3). Nevertheless, as shown in the Figure, if the non-taxable minimum is not increased in 2020, the tax wedge, as the wage increases, will start to increase again.

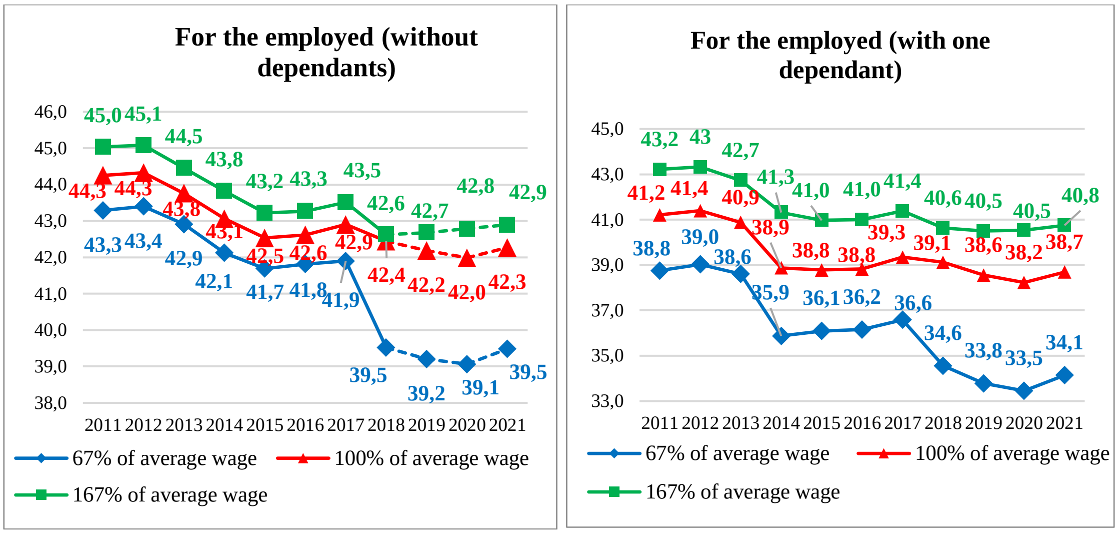

Figure 5.3. Changes in the tax wedge following the *Tax Reform*. %
Source: *MoF calculations. as of March 2019*

Positive changes in the wage structure were observed in 2018. Comparing the number of employees reported in the employer's reports in November 2018 and November 2017, it shows that both the number of employees and the percentage share thereof (in the wage group of up to 430 *euro*) reduced. This indicates a positive return of such *Tax Reform* measures as reduction of the shadow economy and improvement of tax administration, along with a concurrent increase of the number of employees in the higher wage groups.

Table 5.7. Changes the in wage structure

Wage group. *euro per month*	2017/11		2018/11		2018/2017	
	Number of employees	*Share %*	*Number of employees*	*Share %*	*Δ % number of employees*	*Δ % share*
0.01 - 430	199 746	24.5%	150 548	18.2%	-24.6%	-6.4%
430.01 - 800	224 997	27.6%	236 768	28.5%	5.2%	0.9%
800.01 - 1500	224 899	27.6%	249 320	30.1%	10.9%	2.5%
1 500.01 and more	103 802	12.7%	130 672	15.8%	25.9%	3.0%

The *Tax Reform* has also created changes in the dividend policy - for the PIT-taxed dividends the two-year transitional period has been established in 2018 and 2019, allowing to tax dividends for the profit obtained up to 2018 with 10% PIT rate (upon the expiry of the transitional period, the rate of 20% will be applied). In 2018, the growth of revenue from the tax deducted of dividends was expected, however the most recent data show that the tax on dividends has been charged in the amount of only +4.4% above the amount of 2017, thus the forecasted revenue in this position has not been obtained in 2018. At the same time, this allows to conclude that additional revenue form dividends for the profit of the previous years will be obtained in 2019; otherwise, twice-higher PIT rate will be applied to such kind of income already next year. This is also demonstrated by the PIT revenue from dividends in the two first months of 2019, which is by 22% higher than in the relevant period last year.

In the field of the CIT reform, it should be noted that the economic growth in 2018 has been considerably steeper than previously forecasted - as GDP increased by 4.7% according to the data of three quarters, while, prior to the tax reform, the economic growth for 2018 has been forecasted in the amount of 3.4%. Currently the actual impact of the CIT reform is not being assessed, as the available data for 2018 do not fully reflect the new essence of the CIT system. 2018 is to be considered as a transitional period, because in the first six months, thereof the CIT advance payments have been preserved, and the enterprises were still paying the CIT supplements for the taxation period of 2017. Revenue from profit allocation, constituting the most significant CIT revenue component, is also planned only in 2019 (enterprises usually allocate the profit of previous year after filing the annual statements). At the same time, CIT norms provide that, by using the FIFO method, first, the profit obtained up to 2018 is allocated, for which the CIT has already been paid. Considering that the enterprises have a comparatively high volume of profit accumulated for the previous years, in 2019 the profit of previous years will be allocated, thus reducing the CIT revenue. Given the afore-mentioned, the actual assessment of the CIT reform is possible only after 2020. In addition, by November 30 this year, the impact of the new CIT law on donations received by the public benefit organizations will be assessed.

Positive trends are also observed from introducing the VAT reverse charge procedure for the supplies of construction products, household electronic appliances and household electrical appliances - the sum to be paid in has increased, while the sum of refund has reduced, attributable to the reduction of fraud in transactions with the referred to goods.

Reverse system for the supplies of the referred to goods was introduced from 1 January 2018, as a result the share of fraudulent transactions in the sectors of relevant goods is being reduced, thus reducing the total level of shadow economy, not only in the field of VAT, but also in the field of labour taxes, as whole. However, the EC objected against the request of Latvia to grant deviation, in order to apply the VAT reverse charge system to supplies of construction products and household appliances.

Latvia informed the EC that it will prevent the violation, by abolishing VAT regulation with respect to the application of the VAT reverse charge procedure to supplies of construction products and household electrical goods, starting from 1 January 2020, concurrently continuing the discussion with the EC on preserving the reverse charge system for the referred to product groups.

By abolishing the referred to regulation from 1 January 2020, the volumes of shadow economy and fraud in these sectors are expected to be considerably smaller than before the introduction of the reverse charge procedure, especially, in the construction sector, as demonstrated by the reduction of the refund sum to be repaid from the budget. Thus, assessing in indicative terms, in the event of abolition of the VAT reverse charge procedure for the supplies of construction products, household electronic appliances and household electrical appliances starting from 1 January 2020, adverse impact would be created on the state budget revenue of -21.1 million euro.

Also the increase of the excise duty rates for fuel has achieved the desirable effect - tax revenue in 2018, as compared to 2017, grew considerably, and the increase of the rates had no adverse impact on the fuel consumption - over the year the total fuel consumption had been better than forecasted. Along with the reduction of illegal market, the increase of excise duty rates on cigarettes and alcoholic beverages, on the whole, has exceeded revenue forecasted within the scope of the *Tax Reform*.

5.2.2. Measures resolved in the interim between the *Tax Reform* and the budget for 2019

Table 5.8. Impact of the Changes in Tax Policy of the measures what was adopted in the interim between the *Tax Reform* and the budget for 2019, million *euro*

	2019	2020	2021	2022
Imposition of SMSIC ceiling at 62,800 euro in 2019 *	1.7			
Changes in the Solidarity tax	2.5			
Changes in the funded pension scheme structure as of 1 January, 2020		42.8		
Increase of the PIT non-taxable minimum for pensioners			-11.8	
Reduced VAT rate of 5% for vegetables, fruits and berries characteristic to Latvia*			3.8	
Reduced excise duty in the amount of 50% of the standard rate applied to other alcoholic beverages produced in the small alcoholic beverage distilleries	-0.05	-0.01		
From 2019 1 January marked diesel fuel (used in agriculture) allowed to be used in the commercial vehicles with up to four seats, excluding the driver's seat, does not exceed four seats (instead of two)	-0.3			
Cost recovery for *Lattelecom* universal service by dividend payments	-0.3	0.3		
Increase of the minimum share of profit to be disbursed in dividend for capital companies, where all capital shares are directly or indirectly owned by the State, to 85%	2.3			
Total impact of changes:	**5.7**	**43.1**	**-6.3**	

** reestimated impact*

The reduced VAT rate of 5% for fruits, berries and vegetables characteristic to Latvia has been introduced for a limited period of time - for 3 years (from 1 January 2018 till 31 December 2020). The purpose thereof is to reduce the shadow economy in the sector of crop and cattle production, hunting and related non-core activities and to increase the competitiveness of merchants operating in the legal market. Assessing the application of the reduced rate of 5% in 2018 in the sector of crop and cattle production, hunting and related non-core activities, the actual impact on the state budget is assessed in the amount of -3.8 million euro, which is by 2.2 million euro less than initially assessed.

In accordance with the 25 October 2018 amendments to the law On State Social Insurance, starting from 1 January 2019, the maximum SMSIC object is calculated and determined for the next three years and it comprises 62, 800 euro per year[29]. The three-year period has been established for the purposes of ensuring stable and transparent tax policy.

[29] The maximum SMSIC amount has been increased, based on 17 December 2013 Cabinet Regulations No. 1478 *Regulations Regarding the Minimum and Maximum Amount of the Object of Mandatory and Voluntary Contributions of State Social Insurance*, stipulating that the Ministry of Welfare shall calculate the maximum amount of the object of the SMSIC and the object of the voluntary insurance contributions for each calendar year (the maximum amount shall be calculated, applying the index of changes in the monthly average gross wage (in current prices) of persons employed in the national economy to the maximum amount of the object of contributions of the previous calendar year).

Revenue from the state social security contributions in 2019 will be influenced also by the changes in the solidarity tax rate, providing that, starting from 3 January 2019, the solidarity tax rate is 25.5 per cent. During the taxation period, the solidarity tax object is taxed by the same rate as the object of the SMSIC. The SRS by September 1 of the post-taxation year, under the summing-up procedure, refunds the solidarity tax (difference between the solidarity tax paid in the taxation period, calculated by applying higher rate of the SMSIC, and the solidarity tax calculated under the summing-up procedure, calculated by applying the solidarity tax rate (25.5%)). Starting from 3 January 2019, the new sequence of allocation of the solidarity tax has also been set, granting priority to the solidarity-related chapters:

- in the amount of 1 percentage point for funding health care services (in 2018 - 1 percentage point);
- in the amount of 14 percentage points - into the State pension special budget (in 2018 - 13.59 percentage points);
- in the amount of 10.5 percentage points - into the PIT account in the Treasury (in 2018 - 10.5 percentage points).

Solidarity tax revenue will no longer be transferred to the second and third pension pillar as it was in 2018.

Besides, starting from 1 January 2020, the contributions into the funded pension scheme will constitute a part of the contributions actually made for the State pension insurance, except for the mandatory contributions made from the social insurance special budgets and the State basic budget, therewith having a positive impact on the revenue from social security contributions.

In accordance with the amendments to the law *On Excise Duties* adopted in the Saeima on 25 October 2018, starting from 1 March 2019, a reduced rate of 50% of the standard rate is applied to other alcoholic beverages produced in small alcoholic beverage distilleries. By the said amendments, the changes with respect to marked diesel fuel intended for farmers took effect, as well - starting from 1 January 2019, it is permitted to use it also in commercial vehicles with up to four seats, excluding the driver’s seat (instead of the two seats before).

In accordance with the amendments to the law *On PIT* adopted in the Saeima on 27 September 2018, starting from 2021, the non-taxable minimum of pensioners will be increased to 330 euro per month.

Measures Passed in the Budget Package of 2019

Table 5.9. Impact from the Changes in Tax Policy from the measures that were adopted together with the Budget of 2019, million *euro*

	2019	2020	2021	2022
Measures to decrease the shadow economy and improve administration*	7.5	0.3		
Decrease of central government basic budget revenue from state fee revenue for maintenance of oil product safety reserves	-4.2	4.2		
Increase of the share of profit to be paid in dividends to the Joint Stock Company “Latvijas valsts meži” for 2018	45.0	-45.0		
Tax on natural resources from legalization of writting off of the vehicles, abolition of exemptions for plastic and composite materials and additional control measures in the area of sand-gravel extraction	1.0			

Total impact of changes:	**49.4**	**-40.6**		

* *The norm on cash limits with respect to reducing the transaction amount has been excluded from the draft law On Taxes and Duties*

In 2019, it is planned to introduce new measures for combating the shadow economy, contained in informative notification "On the Macroeconomic Indicators', Revenue and General Government Budget balance Forecasts for 2019-2021", reviewed at the 5 February 2019 meeting of the Cabinet:

- lowering the cash use prohibition threshold [30];
- reporting suspicious transactions;
- reducing the non-licensed gambling and lotteries market;
- effective use of the Electronic Application System of the Rural Support Service in carrying out supervision and control of circulation of oil products;
- arrangement of operation of the passenger taxi service sector;
- electronic accounts of working time in construction.

In 2019, the measures will continue to improve business environment and reduce shadow economy in the field of public catering and hospitality, in the field of passenger transport, as well as in the field of security guard services. To jointly combat tax evasion and "envelope wages", promote fair competition conditions, as well as motivate the merchants themselves to show initiative and understanding in arranging the issues of fulfilment of tax obligations in their sector, the MoF and the SRS are actively cooperating also with the trade associations.

In accordance with the decision taken at the 18 December 2018 meeting of the Cabinet, the share of profit of the Joint Stock Company *Latvijas valsts meži* for 2018 to be paid in dividends is increased (actual profit exceeds the planned one).

With respect to the dividends of the State-owned capital companies, it is important to note that, in 2019, the stare of profit to be paid out to the State for the profit of 2018 comprises 85%, while in the following years it will comprise 50%, considerably reducing the revenue forecast. It should also be noted that, while the government has not adopted the decision *On Complex Measures for the Development of Electricity Market*, *Latvenergo* dividend revenue in 2021-2022 is not included in the budget forecasts.

[30] The norm on cash limits with respect to reducing the transaction amount has been excluded from the draft law *On Taxes and Duties*.

6. Sustainability of Public Finances

6.1. The Long-Term Development Scenario of Public Finances

The volatile age structure of population will increasingly affect public finances in the coming years. Low birth rate, high death rate and labour force emigration over the last decades has caused consequences, which we face already today, and which are indicative to the need to carry out reforms in the pension, health care and education systems.

In January 2019, the EC has once more published *Fiscal Sustainability Report 2018*, with a potentially low fiscal sustainability risk repeatedly identified for Latvia in all risk categories (short-term, medium-term and long-term). This is based upon low general government budget deficit and debt, as well as low budget expenditure related to the population ageing in the long term.

Nevertheless, despite the fact that currently Latvia has been assigned by a low risk with respect to the fiscal sustainability, to ensure the stability of public finances in the future, over the period of recent years, significant reforms are already being implemented in Latvia. In the field of pensions, it is established that, starting from 2025, the retirement age is 65 years, gradually increasing it up to that moment, and the minimum insurance period must be 20 years. Within the scope of education reform, the optimization of the school network is implemented; the work is in progress on the introduction of the competency-based study content in comprehensive schools, as well as on increase of the remuneration of teachers. Health care reform entails the change of the funding model for the purposes of increasing the budget of the sector, control over strategic procurements, and revision of the functions of the state-funded institutions of the sector.

Labour market situation and demographic forecasts

Demographic and labour market situation will have a long-term impact on the sustainability of public finances, creating impact on both the tax revenue and the budget expenditure in the future. The scope of charged taxes will largely depend upon the trends in the number of the employed in the long term.

Since 2010, the amount of population in Latvia has reduced by 186 thousand, and, based on the CSB data, at the beginning of 2018; it comprised 1 million and 934 thousand. Overall, since 1991, the depopulation has been observed in Latvia, with the number of births annually exceeding the number of births by 8, 200 persons on average. In 2016, 21, 968 children were born, but in 2017, the number of births decreased by 5.2%, reaching 20, 828 newborn babies. In 2017, as shown by information aggregated by *Eurostat*, the general birth ratio in Latvia had been higher (10.7 births per 1, 000 residents) than in the other EU countries. Nevertheless, in 2017, the aggregate birth ratio in Latvia was 1.7, which is still far from the desirable number of children on average per woman for the change of generations: 2.1 - 2.2. To compare - in 1986-1987, when 42 thousand children were born over the year, the value of the aggregate birth ratio was 2.2.

High emigration had been observed starting from 2009, when, based on the CSB data, 38, 208 residents left the country, mainly motivated by economic considerations. In recent years, the number of emigrants decreased and in 2017 17, 724 persons left the country, which is by 13.9% less than in 2016. On the other hand, already since 2011, the increase of the number or immigrants has been observed, when, for instance, in 2017, 9, 916 persons immigrated to Latvia, which is by 19% more than in 2016, facilitated by improvement of the business environment and social and economic processes, *inter alia*, location of the financial and IT offices of foreign companies in Riga, as well as the import of labour force in the construction sector, this promoting the employment.

In accordance with the baseline scenario forecasted by *Eurostat* the overall decrease of the amount of population in Latvia in the coming decades will be determined by both negative natural growth and negative migration balance (see Figure 6.1). *Eurostat* assumes that the negative migration balance might be preserved in Latvia up to 2045. For 2070, *Eurostat* forecasts that there will be 1.4 million residents in Latvia.

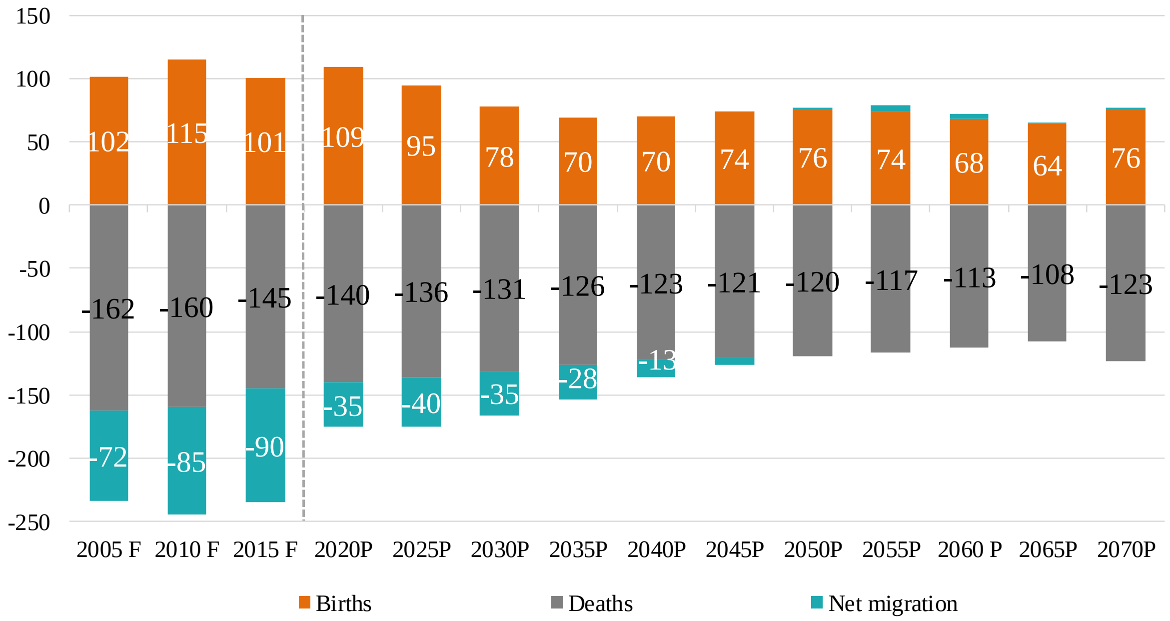

Figure 6.1. The cumulative impact of the changes in the amount of population over the period of 5 years till 1 January of 2070 by factors: number of births, number of deaths and net migration, thousands. F-fact, P-projection (Data source: CSB, *Eurostat*)

Along with acceleration of economic growth, the situation in the labour market continued improving and in 2018 the decline in unemployment rate became considerably steeper and the amount of population employed in the national economy grew, as well. Unemployment rate, according to the labour force survey, in 2018 declined by 1.3 percentage points to 7.4% of the economically active population. It has been the steepest fall of unemployment rate since 2013. In turn, at the end of December of 2018, the registered unemployment rate had reduced to 6.4%, which is by 0.4 percentage points lower than at the end of December of 2017.

Amount of population employed in the national economy in 2018 increased by 1.6% to 909.4 thousand, which was far steeper than in the previous years. Already now we see that, as the number of the working-age population (15-74 years) over the last years decreased by about 1.5% annually, however, along with acceleration of the economic growth, the level of economic activity of population is increasingly growing, with the economically active population reaching 67.5% in 2015, 68.2% in 2016, 68.9% in 2017, but in 2018 reaching already 69.7% of all working age population. The EC forecasts that, on the whole, the employment rate in Latvia will grow in the long term and will comprise 70.3% in 2070.

Significant part of the employed in 2018 was comprised of the age group of 55-64 years, which was 19.3% of the employed, and, compared to 2017, the number of employed in this age group grew by 6.0%. In 2018, the growth of the employed was observed also in the age group of 65-74 years - by 9.1%, reaching 36 thousand (see Figure 6.2).

For the purposes of promoting employment, especially in the age group of 55+, the Ministry of Welfare and the Ministry of Economics implement several measures stimulating the labour market, for example:

- Active ageing measures (educational seminars and conferences for employers and employees on how to extend the preservation of the working age and employment of the employed of older age, adaptation of the workplace according to the ergo-therapist's opinion, health improvement measures, mentoring and application of alternative job forms, inclusion of elderly employees in the team; emphasizing their advantages in the labour market).

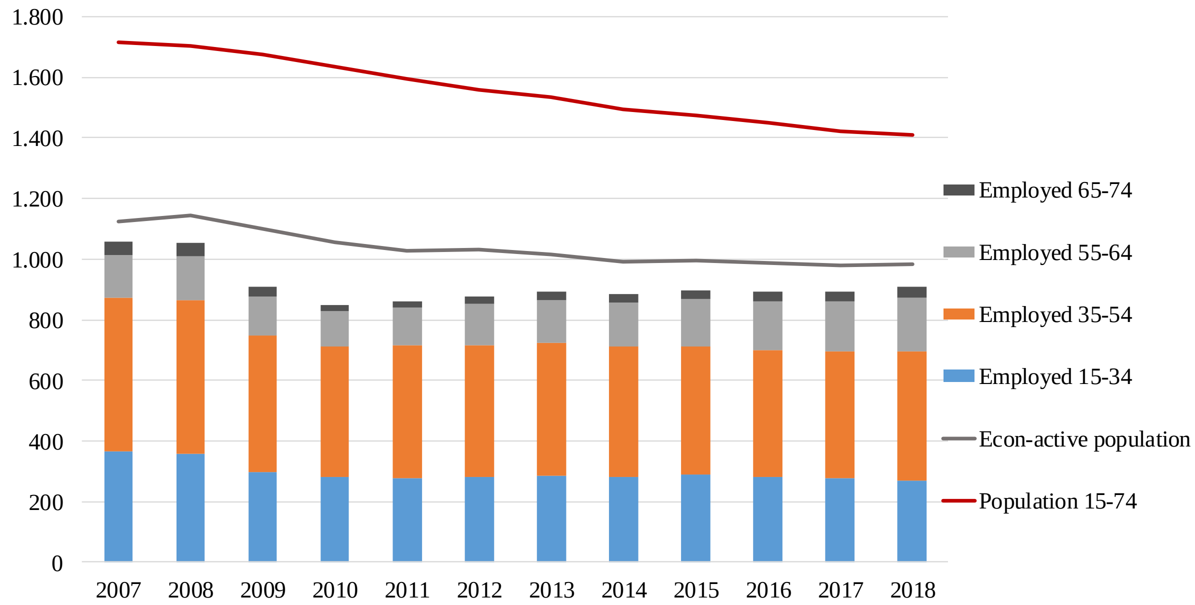

Figure 6.2. Number of working age population, economically active population, number of the employed by age groups, thousands
(Data source: CSB, EC, MoF)

- Measures for the persons exposed to unemployment risk over 50 years of age (the long-term unemployed, incl. the unemployed with disability and forecasted disability, as well as the unemployed with detected or potential addiction to alcohol, narcotic or psychotropic substances, are employed in the suitable permanent job, educated in the suitable training programme or involved in any of the measures offered by the State Employment Agency, promoting self-employment of the elderly unemployed (advice in preparation of a business plan, grant of up to 5, 000 *euro* for the developers of the most successful business plans, wage grant in the amount of the minimum age for the first 6 months of operation), co-financed workplaces for the unemployed with disability, the long-term unemployed and unemployed from 55 years of age, mobility support in regions).
- Support to social entrepreneurship (*ALTUM* European Social Fund project "Support to social entrepreneurship", the Social Enterprise Law took effect in 2018 - *inter alia*, the status of social enterprise has been granted to 9 enterprises, specifying the unemployed

with dependents, the unemployed over 54 years of age and the long - term unemployed as one of theirs target groups).

- Changes in immigration policy (on 2 February 2017 the *Saeima* (the Parliament) approved amendments to the Immigration Law with the aim to facilitate entry conditions for highly qualified employees, for example, engineers, builders, pilots, financial specialists, mid- and tip level managers, project managers, incl. including founders of *start-up*, as well as employees in professions with significant labour force shortages).

Long-term forecasts of the general government budget

Fiscal sustainability of Latvia is affected by the general government budget and debt commitments, their trends and future commitments, basically, for disbursement of pensions and benefits. The increase of the budget expenditure in the long term may be affected by the demographic changes already mentioned herein above, including, the increase in expenditure related to the ageing of population.

With regards to the long-term general government budget expenditure forecasts, in accordance with the baseline scenario that is included in the EC Ageing Report 2018, it is forecasted that in case of unchanged policy in Latvia the proportion of expenditure related to population ageing in GDP in 2070 compared to 2016 will decrease from 16.4% of GDP to 15.0% of GDP (see Figure 6.3).

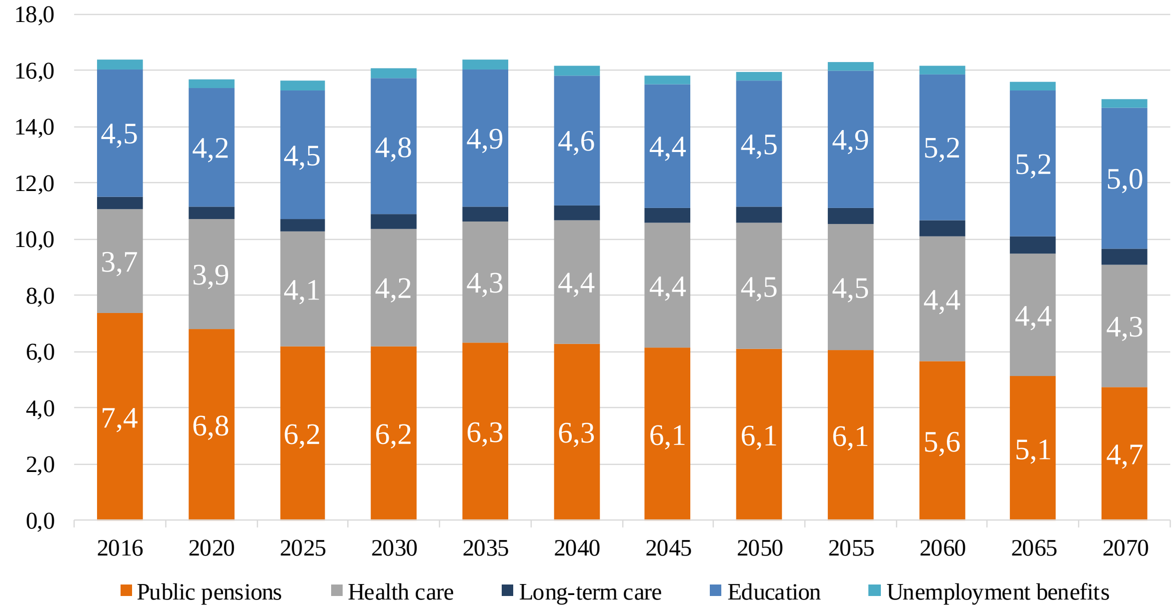

Figure. 6.3. General Government Budget Expenditure Related to the Population Ageing, % of GDP
(Data source: *EC-EPC The 2018 Ageing Report*)

The EC forecasts that in the long-term the decrease of the budget expenditure will be mainly determined by the decline in the share of the **state pension** expenditure in GDP. Despite the fact that the proportion of budgetary expenditure for state pensions in the GDP decreases in the long term (from 7.4% of GDP in 2016 to 4.7% of GDP in 2070), which improves the evaluation of the fiscal sustainability, at the same time the sufficiency or adequacy of pensions should be assessed.

According to the forecasts included in the Pension Adequacy Report 2018[31], in Latvia the theoretical income replacement level for a 65 year old inhabitant with 40 years working career will decrease significantly, for example, in the low income group (66% of the average wage in the State) from 59.1% of gross income in 2016 to 39.9% in 2056, in the average income group (correspond to the average wage in the State) from 46.3% in 2016 to 39.9% in 2056, in turn in the high income group from 38.0% in 2016 to 28.9% of gross income in 2056 (see Figure 6.4).

Likewise, the OECD estimates [32] that the number of people is growing in Latvia, for whom the number of worked years has been shortened or is insufficient to qualify for old-age pension. In Latvia the length of employment for 11% of working-age in the age of 50 years, during which a person has been socially insured, does not exceed 15 years. Latvia is also among those countries, which face high poverty risk level among the older population, which, in turn, shows that these persons, while they were in the working age, have been employed either for a short period of time or have received small income, of which the social security contributions were made. This might affect the adequate pension coverage and increasing poverty among senior citizens in the future.

The OECD also points out that micro-enterprise tax payers, patent fee payers, author's fees receivers and self-employed persons may appear in the risk group over the period of the next decades, because they pay reduced social insurance contributions or do not pay them at all.

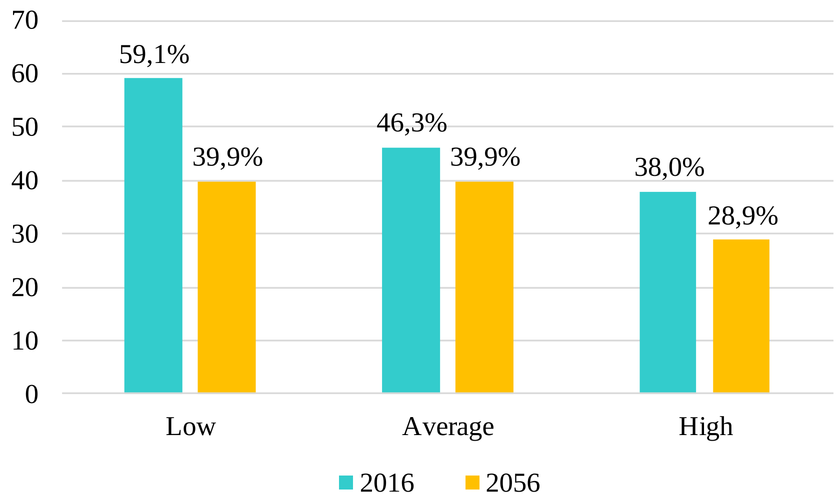

Figure 6.4. Theoretical income replacement level with 40 years working career, % of gross income (Data source: *Pension Adequacy Report, 2018*)

To solve the problem of pension adequacy and improve the welfare of retired persons, the following legislative changes have taken effect in the recent years:

- In 2012, amendments were introduced to the *Law on State-Funded Pensions* providing for, after financial and economic crisis, gradual restoration and increase of the contribution rate in the state-funded pension scheme. In 2016 the contributions rate has been increased for the last time from 5% to 6%.

[31] Pension Adequacy Report 2018

[32] Reviews of Pension Systems: Latvia, 2018

According to the AWG projections, expenditure for the old-age pensions that would be disbursed from the funded pension scheme or the second pillar might reach 2.6% of GDP in 2060.

- From 1 January 2018, the economic operators - beneficiaries of royalties, self-employed persons shall be subject to the SMSIC rate of 5% for pension insurance.
- On 1 October 2018, the old-age, disability, length of service, survivor's pensions and insurance allowances, granted (recalculated) up to 30 September 2018 and the amount whereof does not exceed 382 *euro*, have been revised (indexed), while as regards the pensions and insurance allowances, the amount whereof exceeds 382 *euro*, only the part thereof of 382 *euro* are indexed. At the same time, the following changes have been considered in the index calculation formula, comprised of the actual CPI and the real growth percentage of the amount of wages of security (insurance) contributions. Where the insurance period of a person is from 30 to 39 years, then the calculation formula takes note of 60% wage increase (previously - 50%), in turn, where the insurance period is 40 and more years of work, then 70% of the real wage increase (previously - 50%).
- From 1 January 2019, in case of death of a pension recipient, the surviving spouse, being the recipient of the old-age, disability, length of service or special state pension of the Republic of Latvia, shall receive the benefit in the amount of 50% of the pension granted to the deceased spouse (including the supplement to the pension for insurance period, accrued up to 31 December 1995), and they shall be entitled to receive the benefit for the period of 12 months from the day of death of the pension recipient.
- From 1 October 2019, the actual CPI and 80% (previously - 70%) of the real growth percentage of the amount of wages of security (insurance) contributions will be applied in pension indexation for the old-age pensions calculated for 45 and more years of insurance period.
- From 1 October 2019, the amount of supplement per each year of insurance period accrued up to 31 December 1995 (1.50 *euro* for pensions granted up to 1996 and 1 *euro* for pensions granted from 1997), will be revised, considering the actual CPI and 50% of the real growth percentage of the amount of wages of security (insurance) contributions.
- In 2019, the non-taxable minimum of a pensioner is increased by 20 *euro*, achieving 270 *euro* per month.

According to the baseline scenario forecasted by the EC the budget revenue for **health care** will grow in the long term - from 3.7% of GDP in 2016 to 4.3% of DP in 2070. In Latvia the healthy life expectancy is the shortest one among the EU countries. Number of oncological patients in Latvia is 1.3 times higher (3.55%) than in the EU on average (2.7%). Mortality from cardiovascular diseases in Latvia is 2.3 times higher than in the EU on average, mortality from malignant tumours - 1.18 times higher. Percentage of population assessing their health as good or very good in Latvia - 46,2%, in the EU on average - 67%. Mortality (all causes of death) in Latvia is 1.5 times higher than in the EU on average, with men this difference is even larger - 1.7 times. Waiting time for outpatient health care services ranges from 20 days to even 680 days[33]. Long waiting time for receiving of health services cause a significant impact on the service continuity and ongoing security options.

The field of health care has been set as one of the primary fields, where reforms are necessary, in order to improve the availability of the health care services:

- improvement the availability and quality of the outpatient and inpatient health care services;
- improvement of availability of diagnostics and treatment of oncological diseases;
- increase of funding for payment of reimbursable medicines and medicines subject to centralised procurement;
- limitation of the spread of infectious diseases, *inter alia*, Virus Hepatitis C and HIV infections;
- reduction of cardiovascular morbidity and improvement of the efficacy of disease treatment;
- increase of wages for medical persons.

Likewise, within the scope of the health reform, on 14 December 2017 the Saeima adopted the Health Care Financing Law, which provides to change the health care financing system and to introduce the national compulsory health insurance based on the solidarity of all public involvement for responsible payment of taxes in order to facilitate appropriate health care financing, reaching the level of funding 4% of GDP in 2020), thus facilitating access to health care and improvement of public health indicators, as well as taking care of the work remuneration for medical persons. Since 2018, the solution has been found for attracting additional funding, allocating 1 percentage point of the social tax contributions to health care. Thanks to this regulation, in 2018, it was managed to allocated 85.6 million *euro* for increasing the work remuneration of medical persons. By increasing the funding for health sector, the amount of the PYLL will reduce, creating additional revenue for economy.

6.2. State Guarantees

The law *On the State Budget for 2018* states that the Minister for Finance, on behalf of the State, may issue the guarantees for student and study lending in amount of 35.9 million euro, *inter alia*, study loans with the guarantee provided on behalf of the State in amount of 25.2 million euro and student loans with the guarantee provided on behalf of the State in amount of 10.7 million euro. In 2018 in accordance with the law the study loans with the guarantee provided on behalf of the State in amount of 7 million euro were issued, and the student loans with the guarantee provided on behalf of the State - in amount of 1.5 million euro.

According to the data of the Treasury the volume of obligations of the state - guaranteed loans, since 2015, has stabilized in the amount of 1.7% of the GDP, comprising 477.6 million euro at the end of 2018 (see Figure 6.5). The largest share of the State-guaranteed loan portfolio is comprised of the state guarantees for the obligations of the state-owned development finance institution *ALTUM* for implementation of the state-aid programmes (219.9 million euro), state-guaranteed loans of medical institutions (139.7 million euro) and state guarantees for student and study lending (80.8 million euro).

[33] Concept Note "On Health Care System Reform". the 7 August 2017 Cabinet Order No. 394

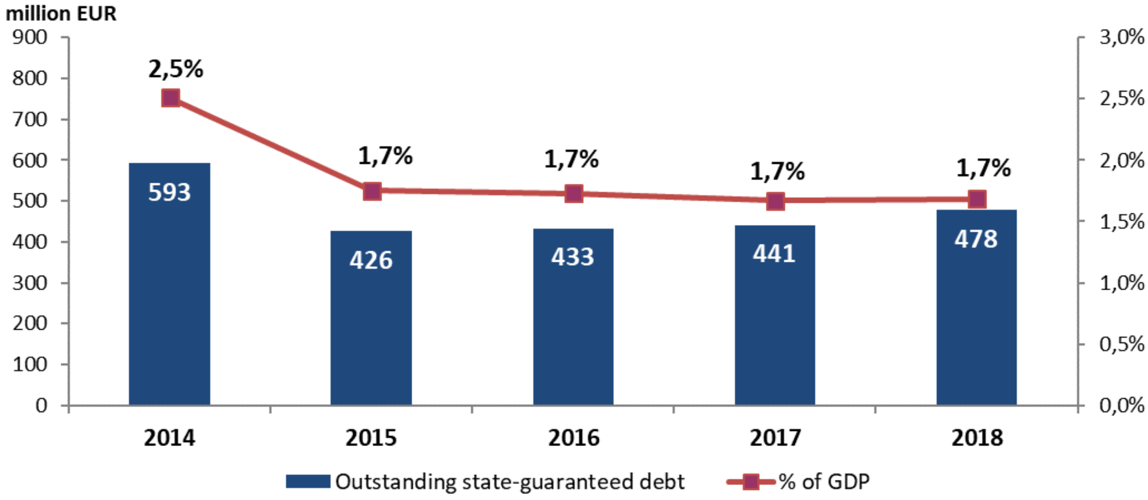

Figure 6.5. State-Guaranteed Loans Outstanding at the End of Respective Year (million euro)

Source: Treasury

Given the presence of the probability that the obligations of the high-risk State-guaranteed loans or the part thereof might not be fulfilled within the maturity term, the law On the State Budget for 2019 prescribes the allowable expenditure limit for fulfilment of the obligations of the state-guaranteed debt. In 2019, having assessed the financial condition of the borrowers, previous credit history, liquidity and amount of the collateral, as well as other available information, the above-mentioned allowable expenditure limit for the fulfilment of the obligations of the high-risk state-guaranteed loans is set in the amount of 0.3 million euro.

7. INSTITUTIONAL FEATURES OF PUBLIC FINANCES

7.1. IMPLEMENTATION OF THE RULES ON THE STATE BUDGET AND OTHER INSTITUTIONAL DEVELOPMENTS REGARDING PUBLIC FINANCES

Along with the strengthening of the EU economic and fiscal management, in light of the new EU fiscal discipline rules, Latvia introduced the regulation of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (hereinafter - the Treaty) with two regulatory enactments - the law *On the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union* and the FDL. Since the FDL entered into force in 2013, in the process of drafting the State budget and the *Framework Law* the introduction of fiscal rules is being ensured in accordance with the SGP rules:

1. **Balance rule** The FDL provides for a balanced budget in structural terms stating that the structural balance should not be less than -0.5% of GDP.
2. **Expenditure growth rate rule** The FDL provides that, in addition to the limitations for structural deficit, expenditure, excluding the GDP deflator, should not grow faster than average potential GDP growth. It should be noted that exceptions from this rule are provided in accordance with the deviations specified in Article 9 of Council Regulation No 1175/2011;
3. **Setting government expenditure thresholds for the medium term** The FDL provides initial fiscal indicators, under which the *Framework Law* is developed. In this Law, one of the key indicators is public expenditure thresholds for the next three years. The FDL provides that a standard condition for these expenditure thresholds is a stability condition - expenditure thresholds of the first and second year of the *Framework Law* are inherited from the second and third year of previous *Framework Law*. As a deviation from this condition - expenditure thresholds are not inherited, if the threshold value in accordance with the updated macroeconomic forecasts differs from inherited thresholds by more than 0.1% of GDP.

The EC is getting involved in the introduction of the fiscal rules into the national legislation of Latvia, which arises out of Clause 1, Article 8 of the Treaty, prescribing that the EC is invited to present in due time to the Contracting Parties a report on the provisions adopted by each of them. It shall be the task of the EC to supervise how each Contracting Party has introduced the rules of the Fiscal Compact into their national legal system.

On 7 March 2018 the EC Communication was published, where it was concluded that Latvia's national fiscal rules are consistent with the requirements of Article 3, Clause 2 of the Treaty, taking into account the explanations provided by Latvia on the discrepancies specified by the EC.

7.2. THE MEDIUM–TERM BUDGET PLANNING

According to the LBFM, medium term State budget planning is a process in which the resources accessible for the medium term are determined and the use of these resources is ensured in conformity with the priorities determined by the government. A medium term shall mean a three-year period formed by the financial year for which the State budget is planned and the subsequent two financial years.

Since 2007, the Medium Term Macroeconomic Development and Fiscal Policy Framework (hereinafter - the Framework) has been prepared in the State for the next three financial years, in which there is an analysis of the medium-term State macroeconomic situation presented, as well as objectives of the government fiscal policy for medium term, forecasts on the State budget revenue and ceilings of the State budget total expenditure for each ministry and other central State institutions for the medium term. In view of the fact that the Framework did not have legally, binding nature and it only indicated the ceilings of the State budget total expenditure for the medium term, a need arose to strengthen the medium-term budget planning system. Therefore, corresponding amendments to the *LBFM* have been made and since 1 January 2012 the Framework, which since 2007 had been approved by the Cabinet, is drafted as a Framework Law and approved by the Saeima. Therefore, the achievable financial indicators, included in the Framework Law, have legally binding force and the drafting of the Annual State Budget Law, as well as drafting of further Framework Laws shall be based on these indicators.

The Framework Law is developed every year for the next three-year period. Besides, for the first and the second year of each following period of the Framework Law, the indicators set in the previous Framework Law are used, adjusted is accordance with the cases stated in regulatory enactments, but the indicators planned for the third year are new. At the same time, the Framework Law is associated with development planning documents ensuring coherence of available resources with the priorities of the government policy in the medium term, and it complies with the fiscal rules prescribed by the FDL, providing for a transparent and responsible fiscal policy. Thus, the Framework Law is the main tool to ensure compliance with the fiscal discipline.

The first year of the Framework Law, operating period is elaborated in detail in the Annual State Budget Law. For each year of the Framework Law period the medium term budget objectives and priority development directions determined in the National Development Plan are specified, formulation of the fiscal policy objectives of the government, the maximum permissible total amount of the State budget expenditure (also the maximum total amount for each budget sector), forecasts of the GDP, forecasts of the State budget revenue, the amount of the State budget financial balance (maximum deficit level or minimum surplus level). According to the provisions of the FDL simultaneously with the Framework Law for 2015 - 2017 for the first time, the Fiscal Risk Declaration was developed aiming to ensure the overall management of fiscal risks, as well as stability of fiscal indicators in medium term. Even though the LBFM states that the Framework Law is to be developed in Spring and submitted to the Saeima by May 15 of the relevant year, in fact, in accordance with the Transitional Provisions, the Framework Law is prepared in Autumn and submitted to the Saeima concurrently with the State Budget Law by October 15 of the relevant year.

Latvia as the EU Member State is submitting the Stability Programme to the EC. Latvia, as the Eurozone Member State, prepares the Draft Budgetary Plan, specifying the forecasts of the key indicators of the next year's budget - revenue, expenditure, deficit and government debt, including the State budget, local government budget, the budget of the partially State budget-funded derived public persons and the corporations included in the general government sector. The purpose of the plan is to submit to the EC information, which would allow it assessing the compliance of the planned budget with the norms of law of the EU in the field of fiscal discipline. If the EC detects that the budget plan considerably violates the EU fiscal discipline rules, it may reject the budget plan and request the Member State to introduce the changes and submit it repeatedly. Likewise, the EC, may, by the corresponding opinion, provide recommendation for improvement of the plan. The procedure prescribes that the national parliaments consider the opinion of the EC, when adopting the State budget in its final reading.

7.3. Budget procedures, Including Public Finance Statistical Management

7.3.1. Budget procedures

The Constitution of the Republic of Latvia prescribes that the Saeima annually before the beginning of a financial year shall decide on the State revenue and expenditure budget, the draft of which is submitted to the Saeima by the Cabinet. The Annual State Budget Law shall be approved by the Saeima.

When planning the expenditure of the State budget, first the base expenditure is calculated and agreed. Calculation of the base expenditure and the principles of its coherence with the Framework Law is determined by the 11 December 2012 Cabinet Regulation No. 867 Procedure for establishing ceilings on the total amount of the State budget expenditure and on the total amount of the State budget expenditure for each ministry and other central State institutions for the medium term. Thus, the necessary amount of expenditure is determined in order to ensure execution of the State functions at a constant level. Base expenditure shall be approved by the Cabinet.

Since 2016, a constant and systematic State budget expenditure revision has been introduced as an integral part of the budgetary process, explained in more detail in Chapter 6.1 herein above.

The ministries and other central State institutions shall prepare proposals for the priority measures to be supported, if in the relevant following economic years funds are available for development expenditure in accordance with the latest macroeconomic development forecasts. Proposals for the measures shall be prepared, based on the priorities and goals set by the national Development Plan, the National Security Concept and other development planning documents. Thus, linking of the national priorities with the resources available within the State budget for the medium term is ensured.

When calculating ceilings of the total amount of the State budget expenditure, consisting of base expenditure of the State basic budget and the State special budget and of the expenditure for development of the State basic budget and the State special budget, the MoF shall rely on the Framework Law, forecasts of macroeconomic development, as well as observe fiscal conditions that are defined in the State. On the basis of the decisions approved by the Cabinet on the base expenditure and financing priority measures, the ministries and other central State institutions shall prepare and submit to the MoF the budgetary requests. The MoF shall prepare and submit the Draft Framework Law (with explanations, fiscal risks declaration, fiscal discipline supervision report of the Fiscal Discipline Council) and Draft Annual State Budget Law (with explanations) for the review to the Cabinet.

In order to provide the society with a clear idea of the resources involved in the execution of State basic functions and implementation of activities of the EU and other foreign policy instruments, the budget shall be prepared according to the following sections:

- execution of State basic functions (except projects and activities financed or co-financed by EU policy instruments and other foreign financial aid);
- implementation of projects and activities financed or co-financed by EU policy instruments and other foreign financial aid.

Within the process of preparation of the Draft Annual State Budget Law, the following indicators shall be evaluated in an aggregated form and then presented in the State Budget Law:

- the State budget revenue divided according to the types of revenue (divided by responsible ministries);

- the State budget expenditure divided according to programmes (sub-programmes) and the types of expenditure according to the economic nature;
- the financial balance of the State budget;
- the maximum permissible amount of the government debt at the end of a financial year;
- the amount of guarantees to be issued on behalf of the State;
- total increase in State budget loans;
- the amount of State budget earmarked grants for local governments, as well as the amount of the State budget subsidy for the local government financial equalization fund;
- total increase in local government borrowings and total increase in the guarantees provided by local governments;
- other conditions, such as the contribution rate and contribution sum to the State-funded pension scheme.

Explanations to the Draft Annual State Budget Law include a description of the macroeconomic development scenario, fiscal review, analysis of revenue forecasts, the most significant elements of the State budget expenditure planning, explanations of tasks of the ministries, State budget expenditure divided by functional, administrative and economic categories, as well as information about the planned investment projects, information about State financial obligations (summary) and information about the amendments made to the regulatory enactments within the package of draft budget laws. Ministries and other central State institutions in the budget explanations include the Policy and resource management cards, the priority measures and the operating results and performance indicators in the result of their implementation, the optimization measures, as well for each programme (sub-programme) of the basic budget or special budget indicate the objective, main activities and performers, operating results and performance indicators, financial indicators and total expenditures changes.

Independent institutions (courts, the State Audit Office, Ombudsman and other) play a special role in the budget process. The LBFM stipulates that the Cabinet when preparing the Draft Framework Law and the Draft Annual State Budget Law shall hear the view of independent institutions about the financing sections of corresponding institutions, justify the opinion of the Cabinet in case of funding reduction, and inform the legislator about the results of the aforementioned negotiations in a form of a protocol attached to relevant draft laws.

During the process of development of the Draft State Budget Law and Draft Framework Law, negotiations between the LALRG and the MoF are being held, as a result of which a Cabinet and LALRG Draft Protocol is being prepared, which is submitted for consideration at the extended session of the Committee of the Cabinet. In the Draft Protocol, there are questions included on the local governments' tax revenue and other revenue forecasts, central government budget transfers to local governments, amount and conditions of the local governments' loans, guarantees and long-term obligations, local government's financial equalization, and other issues related to the operations and finances of local governments. The Protocol is attached to the Draft Annual State Budget Law and Draft Framework Law, when the Cabinet submits it to the Saeima.

Where, at the beginning of the economic year, the Annual State Budget Law has not taken effect, the Minister for Finance shall approve the State budget expenditure necessary for the operation of the State, as well as the loan and borrowing limits, provided that the expenditure does not exceed the volume of the maximum permissible total State budget expenditure set for the relevant year by the Law on Medium-Term Budget Framework for each ministry and other central government institution, by introducing the corrections laid down in the LBFM.

In compliance with the Law on Local Government Budgets, local governments shall develop their budgets no later than within two months following the proclamation of the Annual State Budget Law.

If the local government budget is not approved by the beginning of the financial years, the local government expenditure per month shall not exceed one twelfth of previous year's expenditure provided that the amount of functions to be fulfilled by the local government does not decrease.

The Law on Local Government Budgets prescribes strict conditions for the local government in the field of budget planning and execution - the local government budget assignations may not exceed the amounts planned in the budget.

The Cabinet has the right to determine additional conditions for planning and implementation of the State and local government budgets in order to ensure measures for reduction and prevention of impact of the increased fiscal, economic and social risks caused by macroeconomic processes and ensure implementation of the fiscal criteria determined in international commitments.

7.3.2. Public finance statistical management

CSB compiles government finance statistics in accordance with the requirements of Regulation (EU) No. 549/2013 of the European Parliament and of the Council (21 May 2013) on the European system of national and regional accounts in the EU (hereinafter the ESA 2010).

The framework of general government sector (S.13) in Latvia according to the ESA 2010 methodology consists of three sub-sectors: central government sub-sector (S.1311), local government sub-sector (S.1313) and social security sub-sector (S.1314).

In accordance with Paragraph 6 of Cabinet Regulation No. 1456 of 10 December 2013 "Regulation regarding the Classification of Institutional Sectors", the CSB shall prepare and maintain a list of the general government sector. To prepare the list and decide on the units to be included, the CSB ensures compliance with ESA 2010 requirements, as well as the principles defined in *Eurostat* (Statistical Office of the EU) *Manual on Government Deficit and Debt*, which foresees that the corporations that are controlled and mostly financed by central and local governments belong to the general government sector.

As of 31 December 2018, the general government sector included 938 independent budgetary institutions, of which 226 institutions belonged to the central government sub-sector; 711 institutions belonged to the local government sub-sector, and 1 institution - to the social security fund sub-sector. Moreover, there were 131 corporations controlled and financed by the central and local governments, of which 52 corporations were controlled by the central, and 79 - by local governments.

Each quarter the CSB prepares detailed information about the following general government sector indicators: revenue, expenditure, deficit, debt, and compiles quarterly financial accounts of general governments. The information is published on the CSB home page, as well as sent to *Eurostat* three months after the end of the reporting period.

In addition, the CSB each year within the set deadlines - by 1 April (provisional data) and by 1 October (final data) - prepares the general government budget deficit and debt notification (hereinafter - Notification) and submits it to *Eurostat*.

The Notification is drafted in accordance with the provisions of Cabinet Regulation No.756 of 22 December 2015 "Procedure by Which the Notification of General Government Deficit and Debt Shall Be Prepared". The CSB is the authority responsible for the preparation and submission of the Notification to *Eurostat*; it also conducts regular inter-institutional working group meetings. The following institutions are involved in the process of preparation of the Notification: the MoF, the Treasury, the Central Finance and Contracting Agency, the Ministry of Defence and the State Social Insurance Agency. If needed, specialists from other institutions (the Ministry of Economy, the Ministry of Welfare, Riga City Council, etc.) are involved.

The results of the Notification are used for assessing how the countries observe the compliance of the economic indicators with the criteria established by the Maastricht Treaty; that is, the ratio of the planned and actual general government budget deficit to GDP at current prices must not exceed 3%, and the ratio of government debt to GDP at market prices must not be more than 60%, calculated in accordance with the ESA 2010 requirements.

Council Directive 2011/85EU (8 November 2011) on requirements for budgetary frameworks of the Member States lays down the detailed requirements for the EU Member States to strengthen the EU fiscal and economic surveillance, and to avoid an excessive budget deficit. The fiscal data are prepared and published with administrative support of the CSB. The homepage of the MoF offers a detailed transition table for budget data from the cash flow data according to the national classification to general government data according to the ESA 2010 methodology. The following information is published on a regular basis:

- fiscal data (monthly and quarterly data);
- government guarantees (annual data);
- non-performing loans (annual data);
- outstanding liabilities related to off-balance public-private partnerships (annual data);
- liabilities of government controlled corporations classified outside general government (annual data);
- participation of government in the capital of corporation (annual data).

Table 1a. Macroeconomic prospects

	ESA code	2018	2018	2019p	2020p	2021p	2022p
		mln euro	Growth %				
1. Real GDP (at prices of the year 2010)	B1*g	23 860	4.8	3.2	3.0	2.9	2.9
2. Nominal GDP	B1*g	29 424	8.8	6.4	5.9	5.5	5.5
Real GDP by expenditure (at Prices of the year 2010)							
3. Private consumption expenditure	P3	14 660	4.6	4.3	3.6	3.6	3.6
4. Government consumption expenditure	P3	4 039	4.0	3.6	3.0	3.0	3.0
5. Gross fixed capital formation	P51	5 559	16.2	7.7	6.0	6.0	6.0
6. Changes in inventories and net acquisition of valuables	P52+P53	758	-	-	-	-	-
7. Exports of goods and services	P6	14 863	2.5	3.2	4.1	4.0	3.9
8. Imports of goods and services	P7	16 019	6.8	5.7	5.2	5.0	4.9
Contribution to real GDP growth							
9. Final domestic demand			6.9	5.0	4.2	4.0	4.1
10. Changes in inventories and net acquisition of valuables	P52+P53		0.7	0.0	-0.2	-0.2	-0.2
11. External balance of goods and services	B11		-2.9	-1.8	-1.0	-1.0	-1.0

Table 1b. Price developments

	ESA Code	2018	2018	2019	2020	2021	2022
		level	Growth %				
1. GDP deflator			3.9	3.1	2.8	2.5	2.5
2. Private consumption deflator			2.6	2.5	2.2	2.1	2.0
3. HICP			2.5	2.5	2.2	2.1	2.0
4. Public consumption deflator			3.8	3.1	2.6	2.3	2.3
5. Investment deflator			2.3	2.3	2.1	1.9	1.9
6. Export price deflator (goods and services)			3.4	2.6	3.0	3.1	3.2
7. Import price deflator (goods and services)			1.3	2.5	3.0	3.0	3.0

Table 1c. Labour market development

	ESA code	2018	2018	2019	2020	2021	2022
		Level	Growth (%)				
1. Employment. persons		909	1.6	0.5	0.1	-0.1	-0.1
2. Employment. hours worked		1 608.8	-4.7	0.0	0.0	0.0	0.0
3. Unemployment rate (%)			7.4	7.0	6.5	6.3	5.6
4. Labour productivity, persons			2.9	2.7	2.9	3.0	3.0
5. Labour productivity, hours worked			6.9	2.7	2.9	3.0	3.0
6. Compensation of employees	D.1	12 584	10.4	7.0	5.6	4.9	4.9
7. Compensation per employee		1 004	8.4	6.5	5.5	5.0	5.0

Table 1d. Sectoral balances

% of GDP	ESA code	2018	2019	2020	2021	2022
1. Net lending/borrowing vis-a-vis the rest of the world	B.9	0.1	-0.7	-1.6	-2.1	-3.1
of which						
- Balance on goods and services		-1.2	-2.5	-3.2	-3.8	-4.4
- Balance of primary incomes and transfers		-0.5	0.3	0.0	0.0	-0.3
- Capital account		1.7	1.6	1.6	1.7	1.6
	B.9	0.7	-0.2	-1.2	-1.9	-2.8
2. Net lending/borrowing of the private sector	EDP B.9	-0.7	-0.5	-0.4	-0.2	-0.3
3. Net lending/borrowing of general government		*0*	*0*	*0*	*0*	*0*

Table 2a. General government budgetary prospects

	ESA code	2018*	2018*	2019	2020	2021	2022
		mln euro	% of GDP				
Net lending (+) or borrowing (-) (B.9) by sub-sector							
1. General government	**S.13**	**-198.9**	**-0.7**	**-0.5**	**-0.4**	**-0.2**	**-0.3**
2. Central government	S.1311	-226.0	-0.8	-0.9	-0.8	-0.5	-0.6
3. State government	S.1312						
4. Local government	S.1313	-158.5	-0.5	-0.3	-0.1	0.0	0.0
5. Social security funds	S.1314	185.6	0.6	0.7	0.4	0.3	0.3
General government (S.13)							
6. Total revenue	**TR**	**10 907.6**	**37.1**	**36.2**	**35.9**	**35.4**	**34.9**
7. Total expenditure	TE	11 106.6	37.7	36.7	36.4	35.6	35.2
8. Net lending/borrowing	B.9	-198.9	-0.7	-0.5	-0.4	-0.2	-0.3
9. Interest expenditure	D.41	231.8	0.8	0.7	0.8	0.8	0.8
10. Primary balance		32.8	0.1	0.2	0.4	0.5	0.5
11. One-off and other temporary measures[34]				0.1			
Selected components of revenue							
12. Total taxes (12=12a+12b+12c)		**6 231.2**	**21.2**	**20.7**	**20.9**	**20.8**	**20.6**
12a. Taxes on production and imports	D.2	4 082.6	13.9	14.1	14.3	14.2	14.0
12b. Current taxes on income, wealth, etc.	D.5	2 145.9	7.3	6.5	6.6	6.6	6.6
12c. Capital taxes	D.91	2.7	0.0	0.0	0.0	0.0	0.0
13. Social contributions	D.61	2 733.7	9.3	9.4	9.4	9.4	9.4
14. Property income	D.4	252.1	0.9	0.7	0.5	0.2	0.2
15. Other		1 690.7	5.7	5.4	5.2	5.0	4.7
16. Total revenue	TR	10 907.6	37.1	36.2	35.9	35.4	34.9
Tax burden (D.2**+D.5+D.61+D.91-D.995)		9 025.0	30.7	30.4	30.5	30.4	30.2
Selected components of expenditure							
17. Compensation of employees and intermediate consumption	D.1+P.2	**4 729.7**	**16.1**	**15.8**	**15.1**	**14.7**	**14.2**
17a. Compensation of employees	D.1	2 978.0	10.1	10.3	9.9	9.6	9.3
17b. Intermediate consumption	P.2	1 751.7	6.0	5.5	5.2	5.1	4.9

[34] The share of revenue of EUR 18.2 million from the EU ETS sale of emission allowances, which took place in November 2018 and is attributable to the increase in volume, is included in the Stability Programme as a one-off measure. On the other hand, the increase in revenue from this transaction, which is attributable to price fluctuations in 2019, is not considered a one-off measure.

18. Social payments (18=18a+18b)		3 383.1	11.5	11.6	11.8	11.7	11.9
of which Unemployment benefits		120.0	0.4	0.4	0.4	0.4	0.4
18a. Social transfers through market producers	D.6311. D.63121. D.63131	357.8	1.2	1.2	1.2	1.2	1.3
18b. Social transfers which are no transfers in kind	D.62	3 025.3	10.3	10.4	10.6	10.5	10.7
19.=9. Interest expenditure	D.41	231.8	0.8	0.7	0.8	0.8	0.8
20. Subsidies	D.3	492.5	1.7	1.6	1.5	1.4	1.4
21. Gross fixed capital formation	P.51	1 589.2	5.4	5.1	4.9	4.7	4.4
22. Capital transfers	D.9	68.0	0.2	0.1	0.1	0.1	0.1
23. Other		612.3	2.1	1.8	2.2	2.3	2.4
24.=7. Total expenditure	TE	11 106.6	37.7	36.7	36.4	35.6	35.2
Government consumption	P.3	5 300.9	18.0	17.8	17.2	16.9	16.1

*The MoF estimate

** Including share of taxes collected by the EU budget

Table 2b. No-policy change projections

	2018	2018	2019	2020	2021	2022
	mln euro	% of GDP				
1. Total revenue at unchanged policies	10 907.6	37.1	36.2	35.9	35.4	34.9
2. Total expenditure at unchanged policies	11 106.6	37.7	36.7	36.3	35.8	34.6

Table 2c. Amounts to be excluded from the expenditure benchmark

	2018	2018	2019	2020	2021	2022
	mln euro	% of GDP				
1. Expenditure on EU programmes fully matched by EU funds revenue	474.4	1.6	1.4	1.3	1.5	1.4
1.a Of which investment expenditure fully matched by EU funds revenue	306.4	1.0	0.9	0.9	1.0	0.9
2. Cyclical unemployment benefit expenditure	-10.1	0.0	0.0	0.0	0.0	0.0
3. Effect of discretionary revenue measures	-68.0	-0.2	0.2	-0.4	0.0	0.0
4. Revenues increased mandated by law						

Table 3. General government expenditure by function

% of GDP	COFOG code	2017	2022
1. General public services	1	4.1	3.9
2. Defence	2	1.7	2.0
3. Public order and safety	3	2.3	1.5
4. Economic affairs	4	5.5	5.4
5. Environmental protection	5	0.6	0.2
6. Housing and community amenities	6	1.1	0.7
7. Health	7	3.5	3.5
8. Recreation. culture and religion	8	1.7	1.0
9. Education	9	5.8	5.2
10. Social protection	10	11.7	11.9
11. Total expenditure*	**TE**	**37.8**	**35.2**

* Including fiscal margin (0.1% of GDP) and assumptions about fiscal space allocation

Table 4. General government debt developments

% of GDP	ESA code	2018	2019	2020	2021	2022
1. Gross debt		36.1	37.4	36.1	33.5	33.1
2. Change in gross debt ratio		-0.7	3.5	0.8	-0.8	1.3
Contributions to changes in gross debt						
3. Primary balance		0.1	0.2	0.5	0.4	1.0
4. Interest expenditure	EDP D.41	0.8	0.7	0.8	0.8	0.8
5. Stock-flow adjustment		-1.4	3.0	0.4	-1.1	1.6
Implicit interest rate on debt		2.1	2.2	2.3	2.2	2.5
Other relevant variables						
6. Liquid financial assets		8.4				
7. Net financial debt (7=1-6)		27.7				
8. Debt amortization (existing bonds) since the end of the previous year		2.6	1.2	3.8	4.1	0.6
9. Percentage of debt denominated in foreign currency		10.5	10.0	4.4	1.3	1.2
10. Average maturity		7.63 years				

Table 5. Cyclical development

% of GDP	ESA code	2018	2019	2020	2021	2022
1. Real GDP growth (%)	B1g	4.8	3.2	3.0	2.9	2.9
2. Net lending of general government	B.9	-0.7	-0.5	-0.4	-0.2	-0.3
3. Interest expenditure	D.41	0.8	0.7	0.8	0.8	0.8
4. One-off and other temporary measures[35]			0.1			
5. Potential GDP growth (%)		3.5	3.5	3.4	3.2	3.2
contributions:						

[35] The share of revenue of EUR 18.2 million from the EU ETS sale of emission allowances, which took place in November 2018 and is attributable to the increase in volume, is included in the Stability Programme as a one-off measure. On the other hand, the increase in revenue from this transaction, which is attributable to price fluctuations in 2019, is not considered a one-off measure.

- labour		0.4	0.2	0.1	-0.1	-0.1
- capital		1.2	1.3	1.3	1.3	1.3
- total factor productivity		1.9	2.0	2.0	2.0	2.0
6. Output gap. % of potential GDP		1.7	1.4	1.0	0.7	0.4
7. Cyclical budgetary component		0.7	0.5	0.4	0.3	0.2
8. Cyclically-adjusted balance (2-7)		-1.3	-1.1	-0.8	-0.5	-0.5
9. Cyclically-adjusted primary balance (8+3)		-0.5	-0.3	0.0	0.3	0.3
10. Structural balance* (8-4) [36]		-1.3	-1.1	-0.8	-0.5	-0.5

Table 6. Divergence from previous update

	ESA code	2018	2019	2020	2021	2022
Real GDP growth (%)	B1g					
2018		4.0	3.4	3.0	2.9	-
2019		4.8	3.2	3.0	2.9	2.9
Difference		0.8	-0.2	0.0	0.0	-
General government net lending/borrowing (% of GDP)	B.9					
2018		-0.9	-0.9	-0.4	-0.4	-
2019		-0.7	-0.5	-0.4	-0.2	-0.3
Difference		0.27	0.4	0.0	0.14	-
General government gross debt (% of GDP)						
2018		38.4	37.4	38.0	35.6	-
2019		36.1	37.4	36.1	33.5	33.1
Difference		-2.3	-0.0	-1.9	-2.1	-

Table 7. Long-term sustainability of public finances [37]

% of GDP	2016	2020	2030	2040	2050	2060	2070
Age-related general government expenditure	16.4	15.7	16.1	16.2	15.9	16.2	15.0
Pension expenditure (public pensions) incl. state social insurance benefits, but not incl. II pillar	7.4	6.8	6.2	6.3	6.1	5.6	4.7
Old-age and early pensions	6.6	6.1	5.6	5.8	5.6	5.2	4.2
Other pensions (incl. disability, survivors)	0.8	0.7	0.6	0.5	0.5	0.5	0.5
Non-earnings related pensions (incl. minimum pension and minimum income guarantee)	0.0	0.0	0.0	0.0	0.0	0.0	0.0

[36] In order to facilitate data comparability, the structural balance in 2019 and 2020 is shown together with a reduction in net revenue from the tax reform 0.5% of GDP and 0.3% accordingly, which is temporary and recognised as a one-off measure from the perspective of Latvian fiscal framework, but the EC includes this effect in the structural balance, since revenue-reducing/expenditure-increasing measures by the EC as a rule are not recognised as one-off/short-term measures.

[37] Data source: AWG, The 2015 Ageing Report: Underlying Assumptions and Projection Methodologies, 2014; The 2015 Ageing Report: Economic and budgetary projections for the 28 EU Member States (2013-2060)

Health care expenditure	3.7	3.9	4.2	4.4	4.5	4.4	4.3
Long-term care expenditure	0.4	0.4	0.5	0.5	0.6	0.6	0.6
Education expenditure	4.5	4.2	4.8	4.6	4.5	5.2	5.0
Unemployment benefits	0.4	0.3	0.4	0.3	0.3	0.3	0.3
Social security contributions in state pension budget (I pillar), incl. contributions in the case of disability. other revenue in state pension budget	6.8	7.5	6.7	6.6	6.5	6.5	6.5
Systemic pension reforms							
Social security contributions in state funded pension scheme (II pillar)	1.7	1.9	1.9	1.9	1.9	1.9	1.9
Pension expenditure from state funded pension scheme	-	0.0	0.3	0.7	1.5	2.3	2.6
Assumptions							
Labour productivity growth	1.6	4.8	3.9	2.4	2.0	1.8	1.5
Real potential GDP growth	1.4	4.2	2.7	1.7	0.9	1.2	1.5
Participation rate. males (aged 20-64)	83.8	82.9	83.3	83.8	84.2	86.3	85.0
Participation rate. females (aged 20-64)	78.6	79.2	81.2	81.4	82.3	84.7	83.3
Total participation rate (aged 20-64)	81.2	81.0	82.2	82.6	83.3	85.5	84.2
Unemployment rate (aged 20-64)	9.8	9.0	9.7	8.8	7.9	7.9	7.9
Population aged 65+ over total population	19.8	20.8	25.4	29.2	31.6	33.1	29.6

Data source: EC EPC AWG, The 2018 Ageing Report

Table 7a. Contingent liabilitie

% of GDP	2018
Public guarantees*	1.4%
Of which: linked to the financial sector	0.8%

* central government and local government guarantees

Table 8. Basic assumptions

	2018	2019	2020	2021	2022
Short-term interest rate (annual average)	-0.3	-0.3	-0.1	0.0	0.1
Long-term interest rate (annual average)	0.4	0.3	0.5	0.9	1.0
EUR/USD exchange rate (annual average)	1.18	1.15	1.15	1.15	1.15
Nominal effective exchange rate	4.8	-1.0	0.0	0.0	0.0
World excluding EU. GDP growth	3.9	3.8	3.8	3.7	3.6
EU GDP growth	1.9	1.3	1.6	1.8	1.8
Growth of relevant foreign markets	4.3	3.7	3.4	3.2	3.2
World import volumes. excluding EU	4.8	3.9	3.6	3.5	3.5
Oil prices (Brent. USD/barrel)	71.9	70.0	65.0	65.0	65.0