2017

Latvia’s Stability Programme for 2017-2020

MINISTRY OF FINANCE
REPUBLIC OF LATVIA

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CONTENT

Abbreviations

USA	United States of America
AWG	*Economic Policy Committee's* Working Group on Ageing Populations and Sustainability of Public Finances
FDI	Foreign direct investment
CSB	Central Statistical Bureau of Latvia
ECB	European Central Bank
EC	European Commission
ESA	European System of Accounts
EU	European Union
MoF	Ministry of Finance
FDL	Fiscal Discipline Law
Framework Law	Law on Medium-Term Budget Framework
PIT	Personal Income Tax
GDP	Gross domestic product
NPI	New policy initiatives
LALRG	Latvian Association of Local and Regional Governments
LBFM	Law on Budget and Financial Management
Cabinet	Cabinet of Ministers
NDP 2020	National Development Plan 2014-2020
OECD	Organisation for Economic Cooperation and Development
CPI	Consumer price index
VAT	Value added tax
Draft Protocol	Cabinet and LALRG Draft Protocol on Disputes and Agreements
PYLL	Potential years of life lost
CIT	Corporate income tax
SGP	Stability and Growth Pact
IMF	International Monetary Fund
SRS	State Revenue Service
Treasury	The Treasury of the Republic of Latvia
MTO	Medium-term objective of budget balance in structural terms
MTO SGP	Medium-term objective of budget balance in SGP terms
EC Communication	The 13 January 2015 Communication from the Commission 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 Stability and Growth Pact (COM(2015) 12)
VHC	Virus Hepatitis C

1. OVERALL ECONOMIC POLICY GUIDELINES AND OBJECTIVES

The Stability Programme of Latvia is a medium-term policy document, describing Latvian fiscal policy for 2017–2020 and which 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 April 15 of the current year, shall submit to the Saeima (Parliament) the Latvia's Stability Programme.

This Stability Programme has been prepared under the auspices of the planned tax reform. Even though the economic convergence of Latvia is one of the steepest in the EU, nevertheless its speed is not sufficient to achieve the average level of the EU economic development within a reasonable term. Economic breakthrough is necessary. This is provided for by the NDP 2020 and the current Latvian government has set as a priority the implementation of such economic policy that would increase the potential GDP growth of Latvia from 3% to 5%. The driving force of economy are the businesses and therefore the Minister for Finance is forming the fiscal policy of Latvia in close cooperation with the entrepreneurs' organisations, listening to the opinion of these social partners regarding the obstacles for fair entrepreneurship. Tax policy significantly affects the decisions of entrepreneurs. The scope and structure of taxes may considerably facilitate or hinder the decisions of the entrepreneurs, therefore the correct tax calibration is a significant instrument for achieving the economic breakthrough. In the circumstances of significant shadow economy it is not only important to efficiently combat the participants of shadow economy, but also to reduce the adverse consequences of this phenomenon on fair entrepreneurship. Additional effect from the correct tax system structuring is a smaller inequality among the employed population, as well as larger budget revenue in the medium term.

At the moment of preparation of the Stability Programme the tax reform is not yet approved in the Latvian government, and therefore the description of the reform provided herein is only that of a draft reform offered by the MoF on 3 April 2017. Therewith, both the planned measures and the fiscal impacts may still change. It is planned to review the tax reform in the Latvian government at the end of April. After the adoption of the tax reform, the adjustments to the Latvia's Stability Programme will be prepared and submitted to the EC.

The key measures of the planned tax reform entail transferring the tax burden from the labour force to capital, as well as the improvement of the competitiveness of entrepreneurs, by introducing 0% reinvested profit tax and arranging tax regimes of the small businesses. Tax reform provides for: a) equalizing PIT rates for labour income and capital income - reduction of the PIT rate on labour from 23% to 20%, concurrently increasing to 20% the PIT on dividend and capital income and capital gains; b) increase of the CIT rate from 15% to 20%, concurrently stating 0% rate on reinvested profit; c) abolition of the solidarity tax, introducing the second pillar for the social contributions ceiling and limiting the short-term social disbursements for large wage earners; d) raise of the minimum monthly wage by 13%; e) considerable increase of the PIT non-taxable minimum, stating the differentiation thereof and calibrating it more precisely for reducing inequality and reduction of the tax burden for the smallest wage earners; f) increase of the non-taxable minimum for pensioners by 28%; g) arrangement of the regime of micro-enterprise tax and other small scale economic activity regimes; h) increase of the excise duty and gambling tax, etc. measures. Set of measures is formed so as to raise, in a balanced way, both the demand and the supply side and to ensure structural changes, and not to strengthen the cyclical effects.

Economic breakthrough cannot be achieved by gradual and small steps. Economic process is affected by the behaviour of its participants - decision to invest in Latvia or not, to expand their business or not. The change of behaviour may be expected, if the impulse of the policy measure is large enough. Nevertheless, a large impulse has its fiscal price - 0.7% of GDP in 2018, in the subsequent years, correspondingly, 0.5% and 0.3%, and a natural question arises - whether Latvia can afford it, at all. Fiscal forecasts show that in 2017 the general government budget deficit will comprise 0.8% of GDP. In 2018, at no-policy scenario, it would decrease to 0.3%, but in 2019 and 2020 it would form the surplus of, correspondingly, 0.3% and 0.8% of GDP. The fiscal discipline objectives of the SGP state that general government structural deficit of Latvia in 2018 may not exceed 1.7% of GDP, in 2019 and 2020, correspondingly, 1.5% and 1.0%. The cyclical component of the balance approved by the Latvian Fiscal Discipline Council comprises 0.1% of GDP in 2018 and 0.3% in 2019 and 2020, meaning that the nominal deficit may not exceed 1.6% in 2018 and 1.2% and 0.7% in 2019 and 2020. Latvian FDL prescribes more rigid requirement in 2020- the permissible deficit of 0.5% of GDP. Therewith, the fiscal space is 1.3% of GDP in 2018, - 1.5% and 1.3% of GDP in 2019 and 2020. Fiscal development scenario of the Stability Programme provides that fiscal space in the amount of 1.3% will be used for the fiscal safety margin in the amount of 0.1% of GDP, 0.4% of GDP - for health reform and 0.7% of GDP - for tax reform. In subsequent years the fiscal space capacity allows not only to continue the reforms, but also the reserve part of the space for the NPI. Therewith, the planned tax reform can be implemented under the existing fiscal circumstances, it is desirable exactly in this period, in order to ensure the desirable growth circumstances after 2020, when the risk is present that the EU funding for national investments could be smaller than at present.

2. ECONOMIC SITUATION

2.1. EXTERNAL ECONOMIC ENVIRONMENT

The global economy growth in 2016 did not reach that which was projected before and fell to the lowest mark since the crisis of 2009, comprising 0.3%. The slow growth, being even slightly lower than in 2015, was mainly triggered by the slowdown of the growth rates in the developed countries of the world observed in the first half of the year, while the growth of developing countries, in general, corresponded to the forecasts.

Slow growth rates in the developed countries were mainly predetermined by the situation in the USA, where the growth of GDP in 2016 fell to 1.6%, as compared to 2.6% achieved in the previous year. Slowdown in the growth in the USA was influenced by fall in investments, *inter alia,* with investments into oil industry shrinking in light of the low oil prices, reduction in the government expenditure, as well as uncertainty regarding the result of the US presidential elections and concerns with respect to the slowdown of the growth rates in the large developing markets. Growth slowdown last year was also experienced by number of other leading countries of the world, including United Kingdom, which was adversely affected by political uncertainty regarding the vote on country' s membership in the EU, as well as Japan and Norway.

The growth in the developing countries, in turn, in general, in 2016 was corresponding to that which was expected, *inter alia*, the economic growth of China, thanks to the fiscal stimulus measures implemented by the government, turned out to be even slightly steeper than projected, whereas the economic recession in Russia, in light of the weakening fall in oil prices, was smaller than expected. In several other countries, though, the development was opposite, *inter alia,* growth in India did not reach the projections and the economic recession in Brasil was steeper than expected at the beginning of the year.

In general, the growth in the developed countries in 2016 slowed down to 1.7%, as compared to 2.3% the year before, and lagged behind the level forecasted at the beginning of the year by 0.5 percentage points. In turn, the overall growth of the developing countries in 2016 was slightly steeper than the year before, reaching 4.0%.

In 2016 economy of the **EU** managed to show comparatively good resistance to the impact of external and internal adverse circumstances, and the growth rates, even though still low, reached the level of 1.9% forecasted at the beginning of 2016. Also the Eurozone economy increased in accordance with that which was forecasted, achieving the growth of 1.7%. Nevertheless, both in Eurozone, and in the EU, as a whole, the rates were slightly slower than in 2015, when the Eurozone and the EU economy increased, correspondingly, by 2.2% and 2.0%. The growth invoking factors in the EU included low prices of raw materials, including, energy resources, stimulating monetary policy, low euro exchange rate, as well as the improvement of situation on the labour market and structural reforms in some EU Member States, which allowed overcoming such adverse factors as political instability with respect to the UK referendum and the US presidential elections, concerns regarding the slowdown of the growth rates in the large developing markets, weak global trade and terrorist attacks in several EU Member States.

Private consumption still remained the main growth trigger in the EU, while weak investment remained to represent the largest problem, causing concerns regarding the economic growth potential in the future. The rates of revival of investments in the Eurozone over the period of last years have been weaker that in other economies affected by the crisis, and the share of investments in the GDP in the Eurozone currently still remains by 1.8 percentage points lower than at the beginning of 2000s.

Table 2.1. GDP growth rates and forecasts in the largest economies of the world, % compared to previous year[1]

	2015	2016	2017f	2018f	Compared to the EC Winter 2016 forecasts	
					2016	2017
World	3.1	3.0	3.4	3.6	-0.3	-0.1
Developed countries	2.3	1.7	2.0	2.0	-0.5	-0.2
Eurozone	2.0	1.7	1.6	1.8	0.0	-0.3
Germany	1.7	1.9	1.6	1.8	+0.1	-0.2
United Kingdom	2.2	2.0	1.5	1.2	-0.1	-0.6
USA	2.6	1.6	2.3	2.2	-1.1	-0.3
Japan	1.2	0.9	1.0	0.5	-0.2	+0.5
Developing countries	3.9	4.0	4.5	4.8	0.0	+0.3
China	6.9	6.7	6.4	6.2	+0.2	+0.2
Russia	-3.7	-0.6	0.8	1.1	+0.6	+0.5

After the slowdown of the global economic growth rates in 2015 and 2016, over the period of next two years a steeper growth is being forecasted, which according to the EC forecasts on a global scale in total will reach 3.4% in 2017 and 3.6% in 2018. Stronger growth acceleration is expected in developing countries, but the leading indicators, *inter alia*, the business and consumer confidence indices and stock exchange indices, show the acceleration of the growth rates also in the Eurozone countries and USA. The highest GDP growth rates achieved already in the second half of 2016 are indicative of steeper growth rates to be expected in 2017. Forecasts regarding growth acceleration are attributable also to the already implemented and forecasted fiscal stimulus measures, including, in the USA and China.

The main negative risks for the global economic growth are currently related to the increasing protectionism trends, which might restrict the global trade, different monetary policy stages in the leading economies of the world, when the cycle of interest rate increase has already started in the USA, while in the Eurozone the interest rates remain at a record low level, and these differences might give rise to a higher volatility on the foreign exchange market. Negative risks also include the increasing geopolitical instability, armed conflicts in the Middle East region and separate African countries, growing migration, as well as steeper-than-forecasted slowdown of the economic growth in China. From the positive side, the global economic development may be facilitated by stronger fiscal stimulus measures in the USA and China, as well as steeper investments growth, as the confidence in steeper growth of global economy increases.

Growth rates in **the EU and Eurozone** will remain stable in 2017, and according to the EC projections, will, correspondingly, comprise 1.8% and 1.6%. As the steeper rise in prices revive, the growth rate of the private consumption becomes slightly slower, but the growing employment will, nevertheless, continue to maintain it. Growth of investments will be moderate, which will be promoted by the growing economic activity in the world, the existing high level of capacity utilisation, as well as the low interest rates and the Investment Plan for Europe. The high level of corporate and personal debt liabilities in several EU Member States, as well as the high uncertainty, in turn, will still remain to be among the hindering factors. In 2018 the economic growth in the EU will remain at the level of 1.8% and also the economy of the Eurozone countries will reach the same growth rate of 1.8%.

Economic growth in the USA, according to the EC forecasts, in 2017 will accelerate to 2.3%, which will be promoted by the fiscal stimulus measures, partially compensating the more

[1]European Economic Forecast - Winter 2017, EC

restrictive monetary policy and the interest rate increase already carried out and expected on the part of the Federal Reserve System. The main growth trigger in the USA will be private consumption, however also the recovery of investment activity is expected, by the investments in the oil industry growing along with the rise in oil prices and the business confidence indices improving also in other industries.

In **Japan** economic growth in 2017 will become slightly steeper, reaching 1.0%, as compared to 0.9% in the previous year. This will be ensured by the stronger growing domestic demand, thanks to stimulating monetary policy and additional fiscal incentives. In 2018, as the positive effects of these incentives come to an end, the growth rate will again fall to 0.5%.

Russian GDP in 2016 decreased less than forecasted - by 0.6% and for the year 2017 the growth of 0.8% is already forecasted. Over the period of the last months the prospects of Russian economy have improved, in light of the stabilisation of the oil prices and rouble exchange rate. Nevertheless, the steeper recovery of growth is limited by the macroeconomic policy - expected fiscal consolidations and limited monetary stimulation possibilities, and in 2018 the growth acceleration to 1.1% only is expected.

In **Germany**, which is the fourth largest Latvian export partner, the economic growth in 2016 accelerated to 1.9%. Taking into account the influence of the smaller number of working days, the expected growth in 2017 would be slightly slower - in amount of 1.6%, but it will be driven by the improvement of the situation on the labour market, favourable financing conditions, growing construction activity and growth of the State expenditure. In 2018 the economic growth in Germany will again become steeper, reaching 1.8%.

In **United Kingdom**, which is the sixth largest Latvian export partner and in June 2016 voted for exiting the EU, in 2017 the growth slowdown to 1.5% is forecasted and in 2018 - to 1.2%, as compared to 2.0% growth in 2016. Even though in the second half of 2016 the United Kingdom economic growth rates accelerated, in 2017 corporate investments will start to become adversely affected by high uncertainty regarding the process of exit of the country from the EU, while the private consumption growth will be limited by lower disposable income, as the rise in consumer prices will increase.

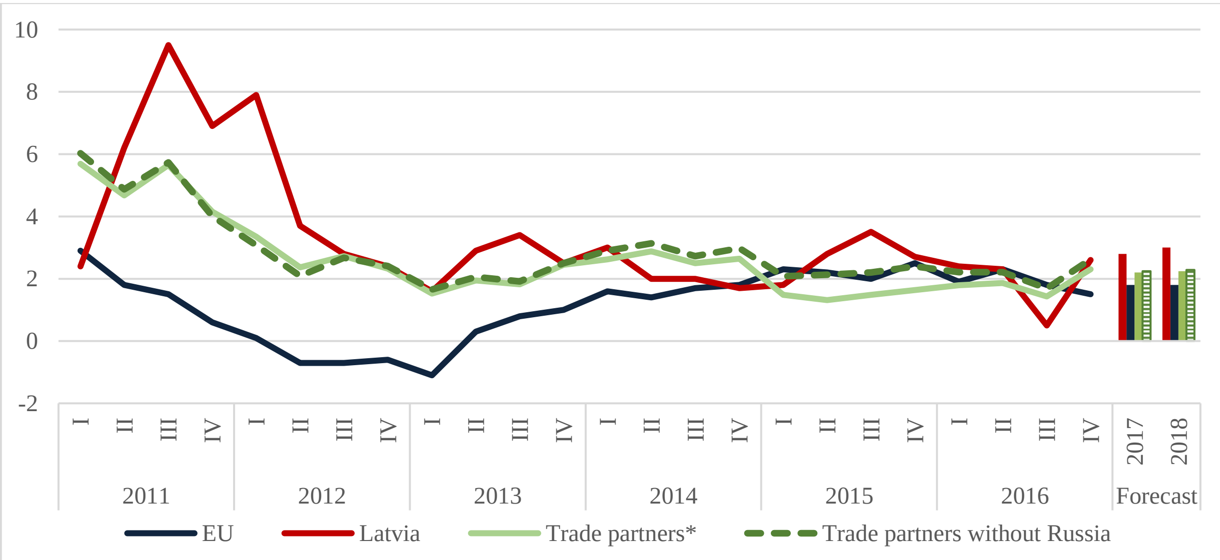

Figure 2.1. GDP growth rates and forecasts of Latvia's partner countries[2] and the EU, %

[2] Average growth in Latvia’s main external trading partners (Lithuania, Russia, Germany, Sweden, United Kingdom, Poland), weighted with the average export rate of particular country in 2016. Data source: *Eurostat; European Economic Forecast - Winter 2017, EC;* MoF calculations.

During the period of two previous years the overall growth of Latvia's main trade partners was slightly lower than the EU average, and such situation was determined by economic recession in Russia. In 2017 the growth of Latvia's trade partners becomes steeper again, increasing from 1.7 per cent in 2016 to 2.2 per cent in 2017 and 2.3 per cent in 2018, correspondingly facilitating the acceleration of the Latvian economic growth, as well.

In light of the law energy prices, **the inflation rate** in the world remained low in 2016, however, in the second half of the year, along with the increase in the oil prices, the consumer prices started to grow steeper again. In general, inflation in the developed countries of the world in 2016 comprised 0.7% and was slightly higher than the year before. In turn, inflation rate in the developing countries of the world in 2016 remained comparatively stable and higher than in the developed countries - 4.5%[3], affected also by the fall of exchange rates of the national currencies in majority of the countries exporting raw materials.

Inflation in the euro area last year remained at a very low level of 0.2%, however in 2017 the inflation growth is already forecasted to 1.7%, to be determined mainly by the influence of the rise in energy prices, while the core inflation will still remain comparatively low, increasing from 0.8 percent in 2016 to 1.1 percent in 2017. In the next year, 2018 the inflation in Eurozone is forecasted to be at the level of 1.4%.

The most significant influence on the inflation rate last year was that of the oil prices, which, after falling to the lowest level in the last 13 years, when *Brent* crude oil price was only 28 dollars per barrel in the middle of January, over the year resumed gradual increase, at the end of 2016 after the OPEC agreement on the reduction of oil extraction again reaching 55 dollars per barrel.

2.2. CURRENT ECONOMIC DEVELOPMENT

GDP growth in Latvia in 2016 was moderate, comprising 2.0%. Thus, the economic growth last year was weaker than 2.7% shown in 2015 and was closer to the level of 2014. The slowdown of the growth rates last year was determined by the short-term internal factors related to delay in the EU funds investments, as well as still unfavourable situation in the external environment, because the economic growth rates in majority of the main external trade partners of Latvia in the first half of the year were lower than expected before. In turn, the economic development of Latvia last year, just like in 2015, was positively influenced by the steadily growing domestic consumption.

The increase of private consumption in 2016 comprised 3.4%, thus ensuring the largest positive input to the GDP growth. Private demand was facilitated by still strongly growing wages, low inflation rate, increasing the disposable income of the population, as well as the more active lending activity, as the amount of the newly issued loans to households grew considerably in 2016. Also public consumption grew last year - by 2.7%.

It should be noted that in 2016 **export of goods and services at constant prices showed the rise by 2.8%**, which, in light of the not so convincing economic situation in the EU in the first half of the last year and the economic recession in Russia, is to be assessed as a very good result. In turn, import of goods and services last year experienced a more rapid growth than export - by 4.6%, as a result of which Latvia’s goods and services foreign trade balance in real terms deteriorated by 1.1 percentage point and the trade balance deficit increased to 2.4% of GDP.

The growth of exports in Latvia was ensured by the increase in exports of services, while exports of goods showed a slight reduction, invoked by the fall of reexports. Thus, Latvia’s exports of goods at current prices in 2016 was by 0.2% lower than in 2015. The sharpest export

[3] World Economic Outlook (WEO) Update, January 2017, IMF

falls were registered in the mineral products category - by 26.5% due to the falling oil prices, as well as in the electrical appliances and electrical equipment goods category - by 13.1%, which, in turn, was invoke by the legislative changes determining the reverse VAT payment procedures for electrical engineering. It should be noted that these two product categories, to a large extent, comprise the reexports, while the export value of output of the local producers, for example, wood and wood products, furniture, last year increased by, correspondingly, 4.9% and 16.1%. The largest export value growth in 2016 were registered to Germany (13.4%), Sweden (+14.8%) and Denmark (+15.0%). Whereas the largest goods export falls were recorded to Lithuania (-4.9%), Algeria (-55.1%) and Poland (-12.4%). The fall in exports of goods to Russia last year comprised 5.9%, but Russia, nevertheless, still remains the third largest Latvia's goods export market, following Lithuania and Estonia. At the same time, the fall in imports of goods, as compared to the reduction in exports, last year was larger - 1.6%, therewith Latvia's goods foreign trade balance in 2016 improved.

Current account

In 2016 the current account balance of Latvia's balance of payments became positive for the first time since 2010. If in 2015 the current account balance was still close to well-balanced, with 188.9 million euro deficit still present, then last year the surplus of 369.5 million euro was already registered in the current account. Thus, in 2016 the current account balance comprised 1.5% of the nominal GDP. The average three-year level of the current account of the balance of payments (-0.4% of GDP) is considerably lower than the threshold stated by the EU early warning mechanism (-4% of GDP) and is to be viewed as sustainable.

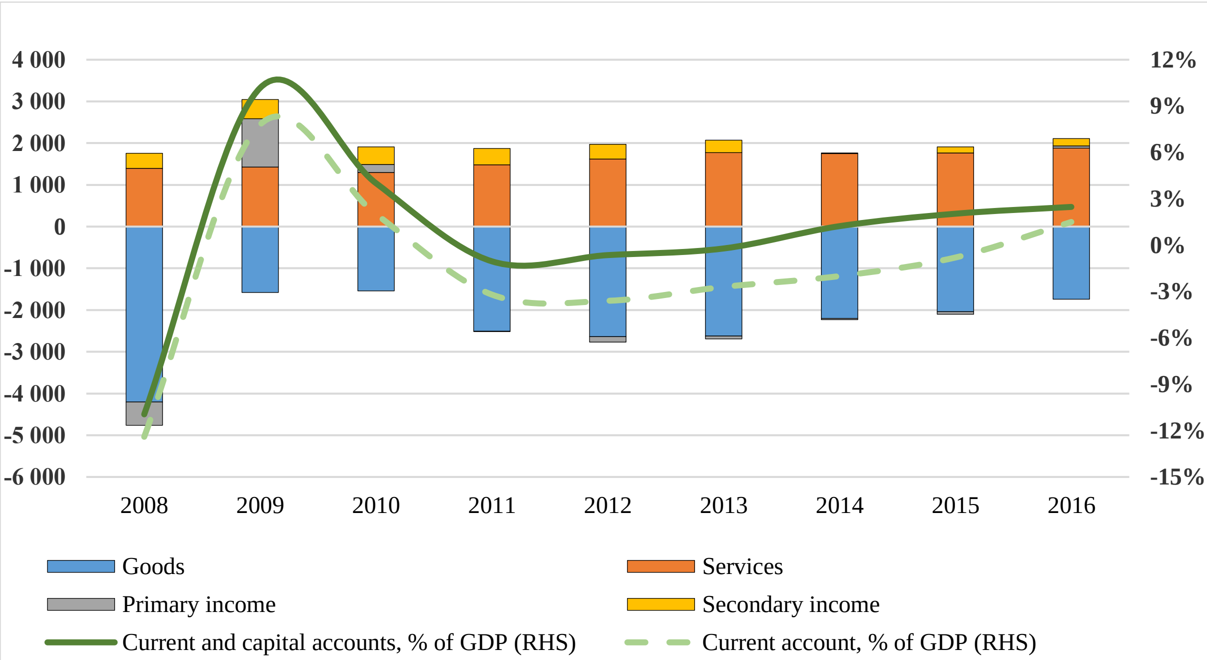

Figure 2.2. Components of the current account of Latvia's balance of payments (mln EUR) and current and capital accounts in percentage of GDP

As compared to 2015, the current account balance grew by 558.4 million euro. About one half of the current account balance growth was ensured by the goods account deficit decrease by 299.9 million euro, thus achieving the lowest deficit amount for the last six years - 1, 741.6 million euro or -7.0% of GDP. If the fall in the goods' account deficit during the previous years was mainly determined by export growth, then last year the improvement of the balance in the goods' account was determined by the fall in the value of imports of goods, while the value of exports remained practically unchanged.

According to the CSB data, the value of the goods' imports in 2016 reduced by 1.6%. The largest adverse effect in the fall in the value of the goods' imports was created by the fall in imports of mineral products, especially, oil products. The overall decrease of the value of imports of mineral products comprised 26.5% or 397.4 million euro, as compared to 2015, which is attributable to low prices of energy resources on the global markets. Imports of mineral products are reducing ever since 2013, in close correlation with the changes in oil prices. The average oil price has been decreasing on an annual basis ever since 2012. If the average *Brent* crude oil price in 2012 was 87.0 euro per barrel, then by 2016 the average price reduced to 40.4 euro per one barrel.

One more goods' category, which adversely affected the development of the imports of goods last year, was electrical equipment and electrical appliances, as their imports fell by 6.7% or 102.7 million euro. Fall in imports of electrical appliances is most likely related to the amendments to the *Value Added Tax Law* regarding the special tax application regime for electronics. Changes to the *Value Added Tax Law* stated that the mobile phones, tablets and laptops, integrated circuit devices (including microprocessors and central processor blocks before insertion into the end product) shall be subject to a special VAT application regime - reverse VAT payment procedures. Changes in the procedures for VAT payment reduced the number of fictitious transactions, thereby affecting the volumes of imports and exports. On the one hand, it adversely affected the foreign trade. Nevertheless, on the other hand, such adverse effect was observed only for a short-term and the prescribed changes will make the business environment in this sector more competitive. Even though the category of electrical appliances and electrical equipment goods' imports is versatile and for separate goods with a small share a slight rise in imports was recorded, nevertheless exactly the fall in imports value of the telephone devices (mobile telephones) by 100.0 million euro determined the total fall in imports of this category. As the base effect ended, starting from 2017 the development of these goods' category started to stabilize.

At the same time, a comparatively steep increase in imports was recorded for such goods' categories as agricultural and food products, especially fish, cereals , alcoholic beverages, as well as pharmaceutical products and vehicles other than railway or tramway rolling stock, therewith slightly reducing the total fall in imports.

Even though the overall value of goods' exports in 2016 reduced by only 0.2%, the exports dynamics by goods' categories is very heterogeneous. Taking into account the large share of reexports in the mineral products' and electrical equipment goods' categories, exactly these goods' categories, as well as imports showed the largest falls in the exports' value. The value of the mineral products exports reduced by 26.5% or 186.3 million euro. In turn, the value of the electrical equipment exports reduced by 13.1% or 177.4 million euro.

At the same time, it is important to note that wood and wooden products exports continue to grow, setting new records of the exported value. Last year the exports of wood and wooden products increased by 4.9%, reaching 1, 793.5 million euro, which is the highest value of exports of this goods' category for the last 25 years. It is significant that the wood exports increased, despite considerable fall in the value of the pound sterling in the middle of 2016, when the referendum results on the exit of United Kingdom from the EU were published. United Kingdom, with approximately one fifth part of the total share, is the main wood and wooden products' exports market. Overall, wood exports to this country last year grew by 8.4%, ensuring the largest positive input to the development of this goods' category. In turn, the overall goods' exports to United Kingdom in 2016 increased by 10.2%. Furthermore, it should be noted that other goods' categories related to wood grew, as well. Thus, the overall furniture exports grew by 16.1%, whereas the paper and printing and publishing products' exports growth was 0.1%.

Considerable exports increase by 21.4% is observed for vehicles and transport category goods which is mainly attributable to the new cars and associated transport equipment reexports growth, as well as a yacht marine exports.. The exports of pharmaceutical productsgrew by 23.8%, mainly ensured by the growth in reexports. When importing medicinal products, mainly, from the Western European countries, they were further reexported to the CIS countries.

In general, it is to be concluded that last year was full of challengers of the Latvian exporters, taking into account the fall in prices of raw materials, steep reduction of the value of the Russian rouble and pound sterling, as well as the fall in exports of separate goods' categories related to reexports. The above mentioned factors in 2016 slowed down the development of exports of Latvian goods. Nevertheless, if we exclude from the overall goods' exports the fall in exports of the category of goods related to reexports or mineral products and electrical appliances, then the value of exports of goods would be by 4.1% higher than in 2015.

Unlike the exports of goods, the dynamics of exports of services in 2016 was positive, with the overall increase by 5.1% as compared to 2015. The value of exports of services increase, despite the fact that the value of the transport services rendered to non-residents reduced by 3.8%. The growing competition in the transport sector in the Baltic Sea Region is reflected in the fall in transport flow, as well as the transport support services, thus adversely affecting the scope of port and railway services rendered to non-residents. The value of the rendered sea and railway transport services last year reduced, correspondingly, by 6.7% and 18.0%. This could not be compensated by the growth in exports of the road transport and air transport services. Nevertheless, thanks to the telecommunications, information and computer services, as well as the revenue from construction and other services, which are smaller in terms of share, the overall value of exports of services in 2016 reached the highest level since 2000 or 4, 243.7 million euro. It is important that the services with high added value (telecommunications, information and computer service, financial services) are increasing in the structure of the exports of Latvia's services, having significantly larger development potential than the transport services. If five years ago the share of the three above mentioned services in the overall structure of exports of services comprised 16.3%, then in 2016 it already comprised 23.3%. Even though the share of transport services is shrinking, with 35.9% share it still plays the leading role in the overall value of exports of services. The ability to both attract new cargoes in general, as well as to differentiate the cargoes will play a significant role in the future of this service sector development.

In 2016 the imports of services grew, as well, being mainly facilitated by the growth in spending of Latvia's population abroad and the growth in telecommunications services imports. Taking into account that the rise on the value of exports of services was steeper, the surplus of services account increased by 6.4%, thus fully compensating the deficit of the goods' account. On the whole, the surplus of services account in 2016 comprised 1, 878.4 million euro or 7.5% of GDP.

The surplus of primary income account grew by 116.3 million euro to 58.0 million euro, mainly influenced by the growing incoming flow of the EU agricultural funds. Furthermore, the account improvement was slightly promoted also by the reduction of the income gained by foreign residents from the investments previously made in Latvia. The changes in the balance of the secondary income account were determined by the inflow of resources from the EU European Social Fund. Therewith the secondary income account surplus increased by 29.7 million euro to 174.7 million euro.

In turn, investments represented the sole component on the side of the GDP spending showing the fall in 2016. **Investments into the gross fixed capital formation reduced significantly last year - by 11.7%,** which was determined by delays in the EU funds investments, thus adversely affecting the general growth of national economy. In general, investments in Latvia have not grown ever since 2013 (minimum increase of 0.1% was registered in 2014) and the overall fall in investments in the gross fixed capital over the period of these years comprises 18.5%.

About one half (in 2016 - 46%) of the total investments into the gross fixed capital formation is comprised of non-financial investments, and last year the volume thereof reduced by 23.9% at current prices, falling to the lowest level over the last years, namely, 2.1 billion euro. The largest share of non-financial investments was registered in the following sectors - public administration and defence (17% of the total non-financial investments in 2016), transport and storage (16%), electricity, gas and heating supply (13%) and the processing industry (13%). Out of the above listed sectors, only electricity, gas and heating supply sector showed increase in the non-financial investments last year as compared to 2015 (+12.1%), while the rest showed registered reduction of investments of, correspondingly, 18.3%, 41.5% and 27.2%. Non-financial investments reduced also in number of other sectors of national economy, while increase was recorded in information and communication services, financial and insurance activities, health and social care and certain other sectors, small in terms of their share.

Whereas the volume of incoming **FDI** in Latvia in 2016 has been in amount of 114.1 million euro, as opposed to the investments of 600.2 million the year before, which was determined by a one-off factor - significant reduction in the own funds of *Swedbank AS.* Therewith, the volume of the incoming FDI in the first half of the previous year was even negative. Negative FDI flow is created, when the liabilities of the subsidiary company towards the parent company exceeds the claims or when the subsidiary company reduces the share capital or repays the loan to the parent company. The reduction in the flow of incoming FDI in the first half of 2016 was determined by the fall in investments in own funds by 583.3 million euro. One of the main factors determining the reduction of own funds was the decision of the commercial bank *Swedbank AS* on the optimisation of the capital structure, by reducing the share capital by 367.9 million euro. At the end of 2015 the total capital adequacy ratio of the bank comprised 39.28%, comprising 23.22% after the reduction of the share capital, which still remains very high, as compared to the requirement set by the regulator of 12.8%[4]. Reduction of the share capital in the company with the foreign capital means the outflow of FDI from the country. This is also confirmed by the volume of the cumulative FDI in financial and insurance activities sector, which reduced in 2016. In turn, in the second half of 2016 the FDI flow into own funds was, generally, positive, and this, along with the increase of the reinvested profit, fully compensated the fall in FDI at the beginning of the year. Apart from the transaction of *Swedbank AS*, which can be viewed as a one-off factor, the FDI inflow last year was stable. By sectors of national economy, the largest activity of the FDI last year was recorded in the trade sector.

According to the assessment of the MoF, **the EU funds investments** (in the broader sense)[5] in 2015 increased the GDP growth by 1.4 percentage points. In turn, as the EU funds investments reduced significantly, in 2016 also the positive influence on the actual GDP reduced. It should be noted that in 2015, as the previous EU funds planning period for 2007 - 2013 was completed, the volume of the EU funds investments was at a comparatively high level of 752 million euro. In turn, the EU funds investment from the new 2014 - 2020 planning period, for the time being, are moderate and comprised only 419 million euro in 2016. Therewith, it is

[4]Data source: *Swedbank AS* (Latvia)

[5] According to the MoF model methodology the influence of the EUF, ERDF, CF/ISPA, EU pre-accession financial mechanisms Phare and SAPARD, INTERREG, Objective 3 of EU Cohesion Policy “European Territorial Cooperation” programme (ERDF), EEA/Norwegian Financial Mechanisms, as well as that of the Latvian - Swiss Cooperation Programme was assessed.

forecasted that the positive influence of the EU funds investments on the national economy of Latvia will comprise about 0.5 percentage points. Taking into account that all the data for 2016 are not yet available, it is not possible to carry out simulation for the entire year. It should be noted that the volume of the acquired EU funds resources last year was considerably lower than planned. If the funds resources would be acquired in the planned volume, then the positive influence on national economy in 2016 would be considerably higher.

The GDP analysis by sectors shows that in 2016 the added value reduced in two sectors - construction and real estate operations. Added value generated by the real estate operations last year was by only 0.6% lower than in 2015, while considerably larger fall was registered in construction. The decline of the construction sector at constant prices last year comprised 17.9% and it was determined by the above mentioned delay in the EU funds investments, because a considerable part of construction is being financed from the EU funds resources. Thus, for example, engineering buildings construction at current prices in 2016 shrank by one third, while the construction of the residential buildings, which is financed from the private financing sources, increased by 5.1%.

Other sectors of national economy, in turn, showed growth in 2016. The largest positive influence on the GDP's added value growth was created by the rise in the output of the manufacturing by 5.6%, which was ensured by steadily growing wood processing, as well as recovery of growth in the production of construction materials and fabricated metal products. Besides, at the end of the last year the growth manufacturing became even stronger, as the output growth came close to 10% year on year in the fourth quarter. The rise in the added value by 3.3% last year was recorded also in the largest sector of Latvia's national economy - trade, which is closely related to the growth in private consumption. Growth has been experienced also in number of other sectors related to domestic demand, for example, accommodation and food service activities (+8.9%), financial and insurance activities (+3.5%), arts and entertainment sector (+3.1%). At the same time, the added value generated in the transport and storage sector last year increased only by 0.5%, fostered by increase in road transport, while the railway and port activities last year were weaker than in 2015.

Last year **the loan portfolio of commercial banks** increased by 3.1% as compared to the end of 2015, and reached 15.1 billion euro at the end of 2016. The increase of the total loan portfolio was ensured by the increase in both resident and non-resident loan portfolio, reaching, correspondingly, 12.8 billion euro and 2.3 billion euro at the end of the last year. In 2016 the quality of the loan portfolio of commercial banks continued to improve, as the share of the loans overdue for more than 90 days in the total loan portfolio of the banks decreased from 6.0% at the end of 2015 to 4.4% at the end of the last year. Positive trends were observed both in the resident households’ portfolio and in business portfolio, where the share of the loans overdue for more than 90 days at the end of 2016 comprised, correspondingly, 5.3% and 2.3%, while the share of the non-residents' loans overdue for more than 90 days increased from 8.9% to 9.6%. In turn, the share of restructured loans has decreased both in the residents' and non-residents' portfolio. The share of the loans restructured for residents has shrank steeper and is considerably lower - 7.9% of the sum total of the portfolio of this category, while the share of the restructured loans in the non-residents' portfolio has fallen from the high level at the end of 2015 by only 0.2 percentage points and comprises 14.9%. Overall, during 2016 the banks wrote off the loans in the value of 180 million euro, which, like in 2015, comprised 1.2% of the total loan portfolio of the banks.

In 2016 the amount of the newly granted loans was 3.3 billion euros, which is an increase of 11.1%, as compared to 2015, *inter alia*, the amount of the new loans to residents grew by 45.9% and to non-residents - reduced by 20.5%. The amount of the newly issued loans to resident businesses last year grew by 32.6%, which might result in the rise in investments this year, and to households - by 28.4%, with a particularly strong increase in loans for house purchase and repair. By the end of 2016 the deposits in Latvian commercial banks in total comprised 21.4 billion euros, which, as compared to the year before, comprises a fall by 8.2%. This reduction was determined by the fall in non-resident deposits, in light of the more rigid supervision of the non-resident segment, as Latvia joined the OECD. At the same time, the resident deposits continued to grow, with the share thereof growing over the year from 47% to 57% of all deposits. Out of all non-bank deposits, 1.2% were long-term (more than 5 years) deposits, and long term deposit stock over the year increased by 1.7%, which was promoted by the rise in the resident long-term deposits as well.

Unemployment rate in Latvia has slightly decreased in 2016, forming 9.6% of the economically active population, according to the labour force survey data. This is by 0.3 percentage points less than in 2015. Also the registered unemployment rate continued to decrease at the same speed, in 2016, on average, forming 8.5% of the economically active population - by 0.2 percentage points lower than the year before. The number of registered unemployed during 2016 reduced by 4.2% to 78.5 thousand. In turn, the number of employed population, according to the labour force survey data, in 2016 was 0.3% smaller than in the respective period the year before, forming 893.3 thousand. New workplaces in 2016 were mainly created in the sectors of information and communications services, as well as administrative services, while in construction the number of workplaces has decreased last year.

Though slightly weaker than during the two previous years, **the wage growth continued last year.** Average monthly gross wage in 2016, as compared to 2015, increased by 5.0%, comprising 859 euros. Slower wage growth in 2016 is attributable to a smaller minimum wage increase at the beginning of the year (the minimum wage increase by 2.8%, as opposed to 12.5% rise starting from 1 January 2015) and slower economic growth in 2016. Similarly to the previous years the wage grew steeper in private sector - by 5.8% up to 845 euros, while in the public sector the wage growth was slower - by 3.7% up to 886 euro. The steepest gross wage increases last year were registered in the administrative and support service activities, as well as in accommodation and food services sector – by 7.3% and 7.2%, respectively. There was no wage decrease recorded in any sector last year, while the weakest wage increases have been for those employed in the sector of professional, scientific and technical services, as well as transport and storage sector. The highest gross wage last year remained in the sector of financial and insurance activities, while in the accommodation and food service activities it was more than three times lower.

In 2016 the **average inflation** in Latvia was low, comprising 0.1%. In the first half of the last year the price changes have been negative, but starting from July the inflation gradually resumed in the country. Last year the inflation dynamics was largely determined by the fluctuations in the prices of raw materials in the world markets. The sharp fall in prices of oil products at the beginning of the last year considerably reduced the fuel, heat and gas prices in Latvia. Nevertheless, equally rapid rise in prices of food at the end of last year slightly compensated the fall in prices of goods and services related to the energy resources. Furthermore, inflation was increased by a considerable rise in prices of water supply and other housing related services, starting from July 2016, which was influenced by the rise in prices of housing management services, in light of the application of 21% VAT rate to house managers. In general, the prices of goods last year were by 0.6% lower than in 2015, whereas the prices of services grew by 2.2%.

Overall, Latvia’s economic growth last year was weaker than expected, which occurred mainly under the influence of temporary internal factors. Besides, the risks were still caused by the situation in external environment. However, currently the internal and external environment preconditions are favourable for the economic growth to become considerably steeper in 2017, which is predetermined by both EU funds investments which are expected to become more active and the strengthening of economic situation in Latvia’s trade partners.

2.3. MACROECONOMIC DEVELOPMENT SCENARIO

The medium-term macroeconomic development scenario of 2017-2020 has been drafted in February 2017, based on 2016 Q4 GDP flash estimate and statistical information available till 3 February 2017. On 24 March 2017, the CSB published the adjusted macroeconomic data for 2015 and 2016. Therefore, taking into account these adjustments, the MoF technical correction of forecasts, preserving the actual growth rates and slightly changing the nominal data to align then with the fact of 2016.

During the forecasting process, the MoF organised discussions with the experts of the Bank of Latvia and the Ministry of Economics, as well as the EC and the IMF experts. The updated medium-term forecasts of macroeconomic indicators have been presented also to the Fiscal Discipline Council, which has approved them on 17 February 2017.

The macroeconomic development scenario has been based on the EC 2017 winter forecasts. The MoF scenario assumes that in 2017 the average oil price will be 52.3 US dollars per barrel of *Brent* crude oil, while in 2018 and following years it will be 56 US dollars.

According to the EC forecasts, the GDP of the EU Member States will grow on average by 1.6% in 2017 and by 1,8% in 2018. As compared to the 2016 autumn forecast, the growth has been increased by 0.1% due to better economic development as initially planned. Therewith, the MoF forecasts are based upon the assumption that the economic development of Latvia's main trade partners, *inter alia*, Russia, would be steeper than forecasted in June 2016, when preparing the forecasts and budget for 2017. Thus, it is expected that during the years to come the export growth will accelerate from 2.8% in 2016 to 3.3% in 2017, gradually reaching 4.1% in 2020.

Table 2.2. Growth and Related Factors

	ESA code	**2016**	**2016**	**2017f**	**2018f**	**2019f**	**2020f**
		mln euro	Growth %				
1. GDP at 2010 prices	B1*y	21781	2.0	3.2	3.4	3.2	3.0
2. GDP at current prices	B1*y	25021	2.7	5.2	5.2	6.0	5.7
GDP by expenditure at constant 2010 prices							
3. Private consumption	P3	13834	3.4	3.2	3.0	2.2	2.0
4. Public consumption	P3	3741	2.7	3.4	2.8	2.8	2.5
5. Gross fixed capital formation	P51	4023	-11.7	5.2	35.4	10.8	8.2
6. Changes in inventories and acquisition of valuables	P52+ P53	702	-	-	-	-	-
7. Exports	P6	13108	2.8	3.3	3.5	3.7	4.1
8. Imports	P7	13627	4.6	1.4	7.1	5.2	4.9
Contribution to GDP growth							
9. Final domestic demand			0.1	3.6	9.0	4.6	3.9
10. Changes in inventories and acquisition of valuables	P52+ P53		3.0	-1.5	-3.4	-0.2	-0.2
11. Exports-imports balance	B11		-1.1	1.1	-2.3	-1.1	-0.7

Investments dynamics was strongly influence the acquisition of the EU funds. It is planned that it will become more active in 2017 and, in terms of volumes, the EU funds acquisition might be two times larger than in 2016. The growth in the EU funds inflow is planned also in 2018 and 2019. It should be noted that there is a risk that the EU funds acquisition might slower at the beginning of 2017, but then, in 2nd half of the year, may become faster. Investments will be stimulated also by the increasing non-financial lending. It is also assumed that the geopolitical relations between Russia and the EU would not deteriorate, therewith the attraction of investments in the region would not deteriorate. Thus, it is expected that the investment growth rates would exceed the overall economic development rates.

The development of private consumption in the medium term will be closely linked to developments in the labour market. Employment growth will be very limited, in light of the demographic restrictions. A moderate wage growth will be observed, elevating the consumer sentiment. In 2017, the scope of newly issued loans to households will continue growing, however the influence of lending on consumption would still be limited. Population will remain cautious to undertake long-term liabilities. Thus, the private consumption growth rate in the medium term will be relatively close to the general economic development rate.

According to the MoF forecasts Latvia’s GDP in 2017 and 2018 will grow by 3.2.% and 3.4% correspondingly (in the Stability Programme for 2016 – 2019 the forecasted GDP growth in the above mentioned years was 3.3% in 2017 and 3.4% in 2018). In the following years the GDP growth rates will decelerate to 3% in 2020, becoming closer to the potential growth rate.

Inflation

In 2016 the average annual inflation remained at a very weak level, as consumer prices grew by only 0.1% as compared to the year before. It was very characteristic for the consumer price level last year that the price fluctuations were mainly attributable to the developments on the raw materials markets of the world. The sharp fall in prices of oil products at the beginning of the last year considerably reduced the fuel, heat energy and gas prices in Latvia. Overall, fuel prices in Latvia in 2016 reduced by 7.7%. In turn, heat energy and gas prices were lower by, correspondingly, 11.4% and 11.0%. Therewith, the negative contribution of the fall in fuel, heat energy and gas prices to the changes in consumer prices comprised -1.0 percentage point. Nevertheless, sharp rise in food prices at the end of the last year, especially, of fish, milk, oil products, vegetables and sugar, related to the levelling out of the volumes of food supply and demand on the world markets, slightly compensated the fall in prices of goods and services related to the energy resources. Taking into account that the share of food prices in the consumer goods basket was slightly more than one fifth part, exactly the rise in prices of these goods ensured the largest positive or 0.3 percentage points' input to the total increase of consumer prices, even though food prices in 2016, in general, were by only 1.2% higher than the year before.

Furthermore, inflation last year was largely influenced by the rise in prices of water supply and other housing related services, by 4.7% in total. Rise in prices was influenced by the rise in prices of housing management services, in light of the application of 21% VAT rate to house managers starting from 1 July 2016. Overall, commodity prices last year reduced by 0.7%, while the prices of services were by 2.2% higher, as compared to 2015.

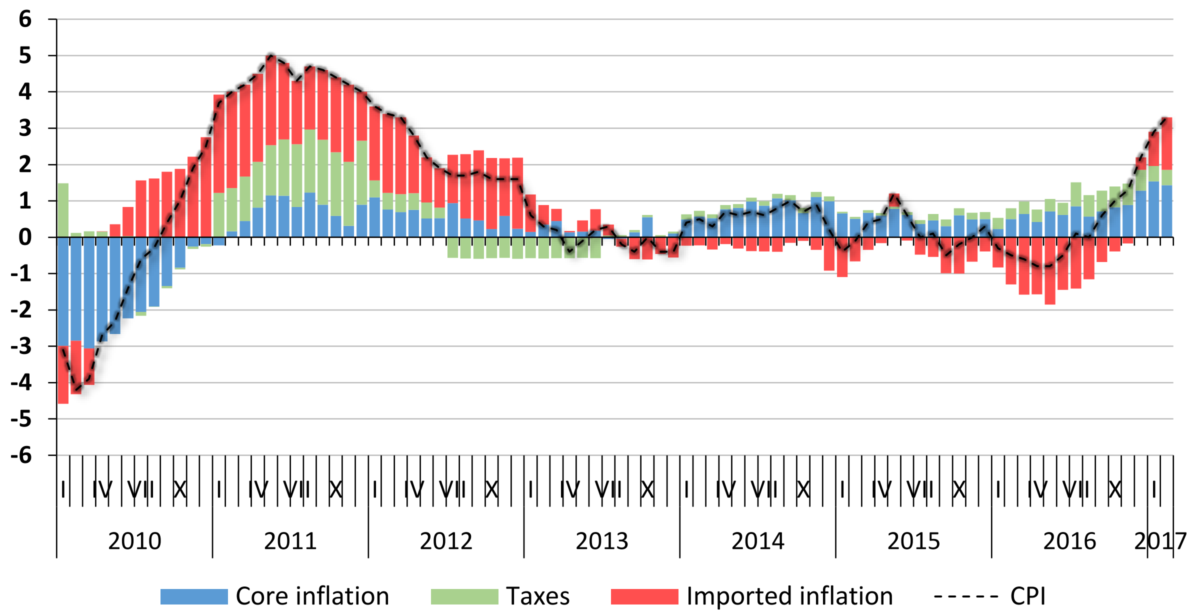

Figure 2.3. Annual inflation according to a source of origin

During the first two months of 2017 consumer prices increased on average by 3.1%, as compared to the respective time period in 2016. Comparatively sharp rise in prices is mainly related to the rise in fuel and food prices. Along with the stabilisation of the oil prices on the global markets starting from the end of 2016 and due to the low base of the last year, the fuel prices in Latvia during the first two months of this year were on average by 16.8% higher than during the respective time period last year. It is expected that in the first half of this year the rise in fuel prices will be high and close to the increase of the first two months of this year. If fuel prices comparatively quickly react to the changes in oil prices, then the influence on gas and heat energy tariffs reflects with the time shift. Taking into account that gas tariffs are reviewed on a semi-annual basis and they depend upon the prices of oil products (fuel oil and diesel fuel) on the world stock exchanges, which are calculated according to the quotation of fuel oil and diesel fuel in previous 9 months, during the e first half of this year gas will still remain cheaper, as compared to the year before. In turn, the heat energy prices are related to gas price applied to the industrial clients and the tariffs are reviewed on a monthly basis. Thus, it is expected that the heat energy tariff will increase starting from spring this year.

Nevertheless, the main consumer prices boosting effect in 2017 will be that of the rise in food prices. Taking into account that the majority of the household consumer goods basket is comprised exactly of food products, they have significantly influenced the changes in average consumer prices. During the first two months of this year food prices were on average by 6.6% higher than in the respective period of 2015, thus explaining almost one half of the total increase of consumer prices at the beginning of 2017. The rise in food prices may remain close to 6% for the entire first half of this year. However, there are no grounds to believe that such rise in food prices will be preserved by the end of the year. Food prices started to grow sharply since September of 2016, when the annual increase reached 2%. During the subsequent months the rise in food prices only increased and comprised already 5% in December. Thus, taking into account the base effects, the increase in food prices in the second half of this year will slow down.

Since the middle of the last year the rise in services prices has become more stable and is around 3%. Taking into account that the situation on the labour market remains stable, this, along with the stable wage increase of almost 5%, shows that equal rise in prices of services will be preserved also henceforth.

According to the MoF forecasts, in 2017 consumer prices will increase on average by 2.3%, which will mainly be influenced by the rise in fuel and food prices. In turn, during the time period from 2018 till 2020 the rise in prices is expected by 2.0% annually, which will be influence by various demand factors. It is expected that the situation on the labour market will gradually continue to improve and the wage increase will be close to 5% by 2020, thus stimulating the private consumption and moderate price rise. At the same time, the changes in consumer prices in the medium term will depend also on the fluctuations of oil and food prices on the global markets.

Labour market

Along with the slowdown of economic growth, improvement in the labour market in 2016 became slower, however the unemployment rate continued to fall, whereas the number of population employed in the national economy was slightly smaller than the year before.

Unemployment rate, according to the labour force survey data, in 2016 declined to 9.6% of the economically active population, which is by 0.3 percentage points less than in 2015. Unemployment rate decline has been determined by the decline in the number of economically active population, as the number of unemployed reduced steeper than the number of employed population. The number of unemployed population in 2016 was on average by 2.9% smaller than in 2015 and comprised 95.3 thousand, but the number of population employed in the national economy, according to the labour force survey, declined by 0.3% to 893.3 thousand.

As the number of the working-age population (15 - 74 years) over the last years decreased by about 1.5% annually, the level of economic activity of population is increasingly growing, with the economically active population in 2016 reaching already 68.2% of all population aged 15 - 74. In 2014 this indicator was 66.3% and in 2015 - 67.5% and the increase in economic activity is expected also in the subsequent years, reaching 69.9% by 2020. Increase of economic activity is concurrently indicative of both the increase in the labour force demand and further improvement in the labour market, when the offered workplaces and wage level is stimulating enough, for the previously economically inactive people to return to the labour market, as well as it shows the changes in the age structure of the working-age population, where the share of the economically inactive youth is decreasing.

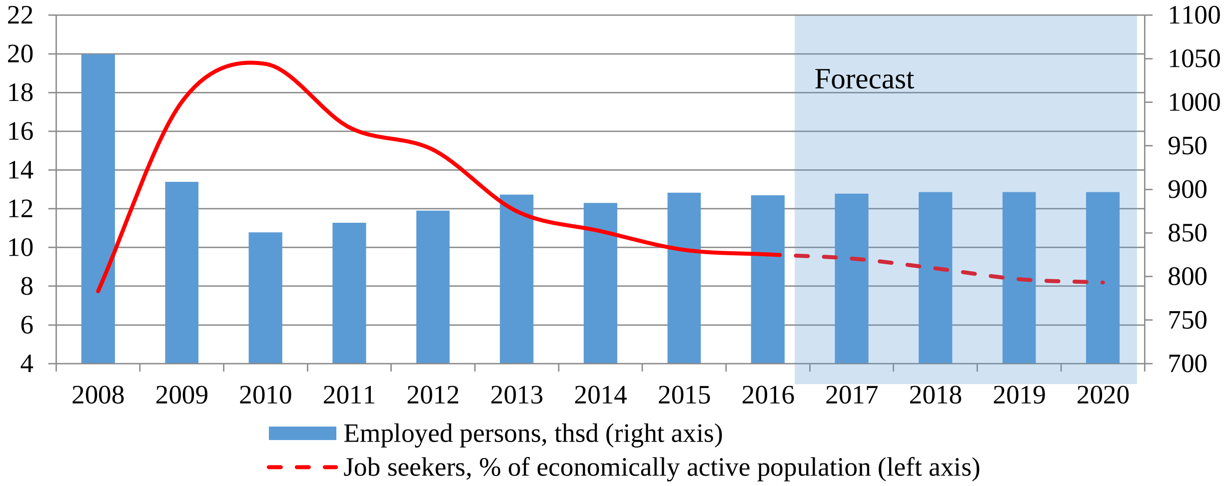

Figure 2.4. Employment and unemployment in 2008 - 2020

Similar trends as the year before will remain in the labour market also in the medium term. The growth in employment will still be impeded by the decline in the number of the working-age population. 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 42.6

thousand or 5%, but it is still significantly - by 164.1 thousand lower than in 2007, and a harsh growth of employment is not expected in the subsequent years, either. According to the forecasts of the MoF, in 2017 the number of population employed in the national economy will increase by 0.2%, reaching 895 thousand. With a slight increase still present also in the subsequent years, the number of employed population would grow to 897 thousand by 2020. The low employment growth rates will still be determined by the demographic situation and the lack of employees of corresponding qualification or wage level in the Latvian labour market.

The unemployment rate, in its turn, in the medium term will continue to decline gradually, which will be determined by the acceleration of the economic growth and will also be influenced by the decrease of the number of population aged between 15 – 74 years. However, in light of economic growth and demographic factors, also the rise in economic activity of the population will continue, as a result, the decline in the unemployment rate will become increasingly slower, falling from 9.6% in 2016 to 8.2% in 2020.

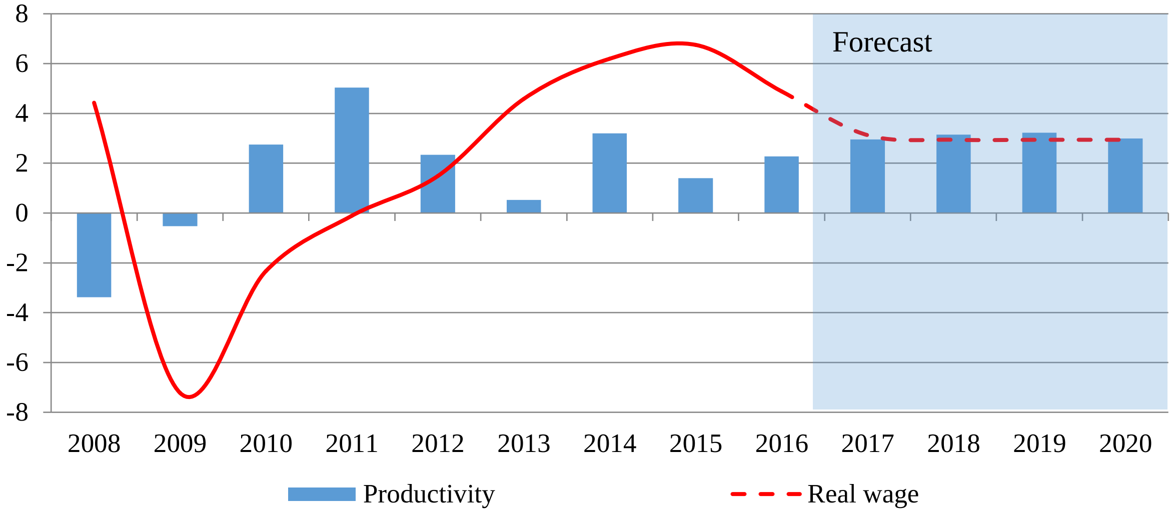

Figure 2.5. Changes in productivity and actual wage, % against the previous period

Over the recent years, the real wage growth has considerably exceeded productivity growth. Such situation is related to the rapid growth of national economy in the previous years, which improved companies' financial performance and provided resources for wage increases, as well as the very low level of inflation, which additionally ensured more rapid growth of the real wage, and the considerable rise in minimum wage in 2014 and 2015. As the influence of the above mentioned factors disappear, it is expected that in the medium term wage growth will be determined by increase in productivity, which is an essential prerequisite for ensuring competitiveness of Latvia.

Cyclical development of economy

MoF forecasts that the potential GDP growth will not exceed 3% in the medium term. It is based mainly on the growth of capital and total factors' productivity, while the employment growth contribution is close to zero. In 2015 and 2016, the potential growth was impeded by the delay in acquisition of the EU funds, restricting investments. It is expected that, along with the recovery of the EU funds low in the medium term, also the potential GDP growth will recover due to the capital increase. In turn, given the limited availability of the labour force, further potential GDP growth on account of the increase of the number of the employed population is limited. At the same time, the total factor productivity will remain constant within the range of approximately 2%.

According to the MoF assessment, the Latvian economy develops close to the potential level, namely, the output gap will be close to zero in 2017 and 2018. It is expected that also in the coming years economic growth will be close to its potential level, however, with a tendency to exceed it, namely, creating positive output gap up to 0.7% in 2020.

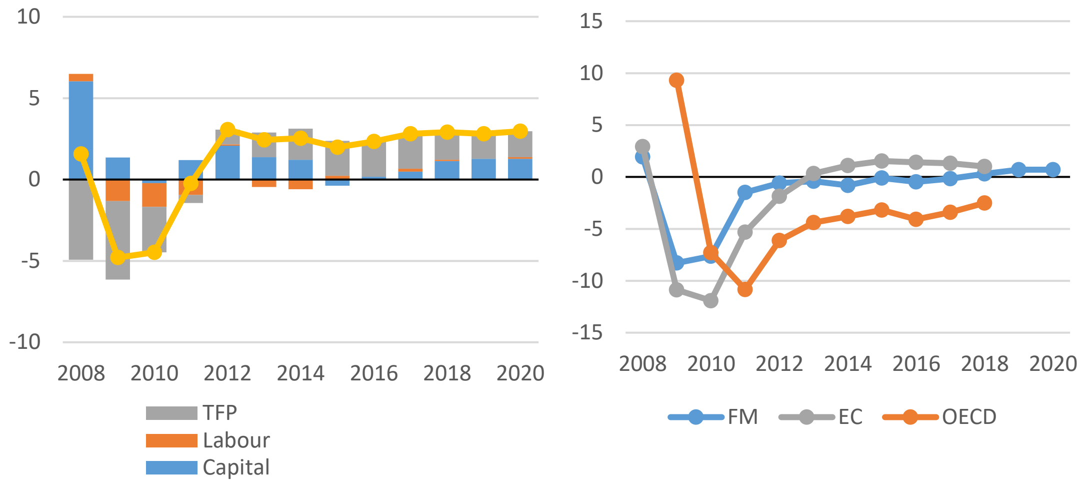

Figure 2.6. Potential GDP and the output gap

Similar is EC estimate of the output gap in medium term. Even though in 2016 and 2017, EC estimated the output gap is positive, which is based upon fast wage increase and decline in the unemployment rate. Nevertheless, other cyclical variables, such as, for example, low inflation, indicate the balanced output gap. Furthermore, also the current and capital account balance surplus is evidencing the balanced external position, namely, Latvia is not living on account of the external debt. Also the net external debt ratio to GDP ratio continued to fall over the recent years.

In addition, wage increase is more related to the income convergence with the EU, the increase of the minimum wage and reduction of shadow economy and not with the excessive demand increase. Besides, plausibility tool developed by the EC is indicate negative output gap in Latvia. The IMF and OECD output gap estimate is similar, as well.

The evidence of the balanced economic growth is also is the fact that the growth is close to the average EU, and it is not forecasted that it would exceed that of EU average in the medium term. The wage increase is also moderate, reflecting the income convergence with the EU, the increase of the minimum wage and reduction of shadow economy. Besides, it is forecasted that the actual wage increase in the medium term will not exceed the growth in labour force productivity.

3. GENERAL GOVERNMENT BUDGET BALANCE AND DEBT

3.1. CURRENT FISCAL SITUATION

According to the estimate of the MoF the general government budget nominal deficit in 2016 was 7.5 million euro or 0.03% of GDP, which is less than the amount planned in the law *On the State Budget for 2016*. According to the law *On the State Budget for 2016* the general government budget balance was planned with deficit in amount of 0.1% of GDP. The deficit level estimated by the MoF for 2016 is by 1.0 percentage points or 245.2 million euro less than prescribed in the previous Latvia's Stability Programme for 2016 - 2019. The most significant components of smaller than projected deficit are larger tax revenue, taking into account positive effect from combating shadow economy and measures for improvement of tax administration, as well as the expenditure reduction and lower expenditure for the implementation of the EU funds projects. Dynamically the general government budget balance in 2016 as compared to 2015 has improved by 1.2 percentage point of GDP, and is the lowest since 1998, when previously the balance showed a slight surplus.

In 2016, as compared to the year before, both revenue and expenditure of the general government increased. Revenue has grown by 3.7%, which is more rapid as compared to the economic growth last year, while expenditure grew only by 0.2%. Compared to the level of 2015, revenue to GDP increased by 0.4 percentage points, reaching 36.1% of GDP, whereas the redistributed resources through the general government expenditure decreased by 0.9 percentage points and also accounted for 36.1% of GDP.

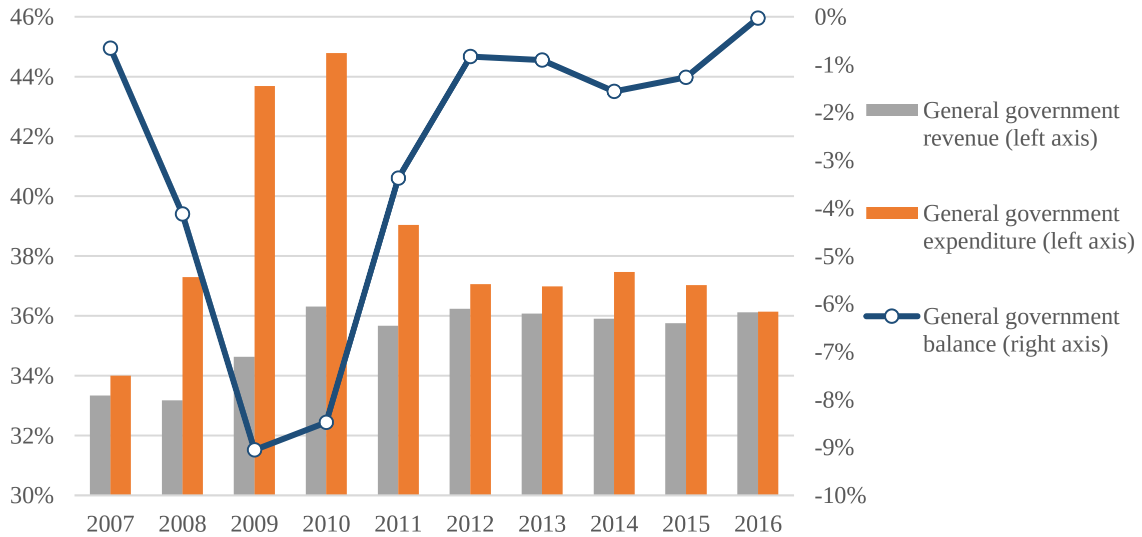

Figure 3.1. General government revenue, expenditure and budget balance[6], % of GDP

Unfavourable situation in the external environment and slower implementation of the EU funds projects are to be viewed as the main factors for lower-than-expected economic growth of Latvia in 2016, thus affecting the level of the State and local government expenditure. At the same time, the successful tax administration measures and combating shadow economy ensured the tax revenue in accordance with the planned level. Tax burden in 2016 was 29.7% of GDP, constituting the largest tax revenue level over the period of the last more than 15 years. Like the years before, also in 2016 one of the main economic growth boosters was domestic demand. The average wage growth contributed to the increase in private consumption and retail trade

[6] Data source: Notification on the General Government Budget Deficit and Debt in October 2016 (2007–2015) and Indicative Estimate of the MoF for 2016.

turnover. Increase in the tax revenue as a whole was observed for all tax types, however the most rapid increase was demonstrated by revenue from excise duty, PIT and VAT.

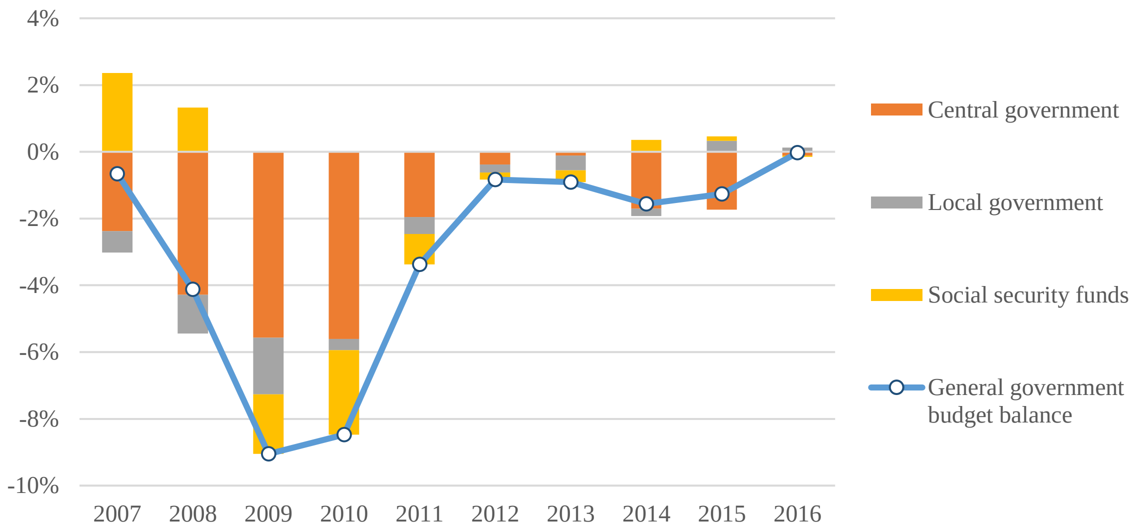

Figure 3.2. Budgetary balance of the general government by sub-sectors[7], % of GDP

Having analysed the input of the general government sub-sectors[8] into overall fiscal balance, it should be concluded that the level of all budget balances has been close to well-balanced. In local government the surplus of 0.1% of GDP was recorded, but in the central government - the deficit of 0.1% of GDP.

In the next years, as the expenditure grows, the increase of the central government deficit is forecasted, by the deficit reaching the average level of the last years. In the balances of the local government and social security funds no significant fluctuations are forecasted in the budget deficit and surplus in the direction to the Stability Programme.

3.2. Fiscal Policy Strategy and Medium-Term Objective

The fiscal policy strategy of Latvia is currently focussed on achieving two objectives:

(1) The fiscal policy strategy of Latvia, similar to previous years, is based on condition of a balanced budget during the economic cycle or a condition that the general government structural budget deficit in the long term (MTO) shall not exceed 0.5% of GDP.

(2) Nevertheless, this year, along with the condition of the balanced budget, the fiscal policy strategy of Latvia also entails the objective to achieve a sustainable economic breakthrough of the country - to provide a contribution through the fiscal policy measures for the potential growth to increase from 3% of GDP to 5% of GDP.

7 Data source: Notification on the General Government Budget Deficit and Debt in October 2016 (2007–2015) and Indicative Estimate of the MoF (2016).

8 Breakdown of the general government sector into sub-sectors is defined in accordance with the ESA in the EU. In the national accounts methodology of the consolidated general budget the central government is identified as the State basic budget, budgets of derived public entities partially financed from the State budget and budgets of the authorities not financed from the budget; social security funds - State social security special budget; local government - local government budgets.

3.2.1. DETERMINATION OF THE STRUCTURAL BALANCE OBJECTIVE

This section describes the ensuring of the first objective of the fiscal policy and the medium-term objective, but information on the second objective of the fiscal policy is provided in Section 3.2.4.

The achievement of the first fiscal policy strategic objective is ensured by the FDL and the SGP. The FDL adopted in 2013 created a system of setting objectives of the general government balance in compliance with the *top-down planning method of a budget balance*.

This method allows to set the objectives of general government structural balance for each year so that these objectives comply with the conditions of the SGP as well as to calculate minimum nominal balances accordingly (the maximum permissible general government deficit or the minimum permissible general government budget surplus).

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 **according to no-policy change scenario.** The general government budget balance is also forecasted in compliance with this method.

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 by the second method, at the disposal of the government there is the so-called fiscal space or possibilities to increase expenditure for the new initiatives of expenditure policy or to reduce revenue for new tax policy initiatives. If according to the first method, a general government budget balance is lesser than by the second method, the government shall carry out consolidation measures, taking discretionary measures for reducing expenditure or increasing revenue.

In Latvia, the key decisions of budget policy, affecting expenditure and revenue medium-term policy, are not taken in spring, but in autumn along with the *Annual State Budget Law*. During this time, not only the *Annual State Budget Law* is being elaborated, but also the *Framework Law* is being drafted for the 3 subsequent years. Thus, during an interval between the moment of drafting the Stability Programme for 2016 – 2019 and the moment of drafting the Stability Programme for 2017 – 2020, substantial decisions on fiscal policy have been adopted which have filled all the fiscal space of 2017 and provide basis for implementing the strategy of the Stability Programme for 2017 – 2020. The fiscal effect of these decisions has been included in this Stability Programme **according to no-policy change scenario.**

The potential decisions on the allocation of the available fiscal space were not described in the Stability Programmes of previous years, emphasising that these decisions will be adopted in autumn and reflected in the draft budgetary plan and the next Stability Programme. However, this year the Stability Programme includes the information on potential decisions with respect to the tax reform. It is because the fiscal impact of the tax reform is significant. Draft decisions are at a well-prepared stage and, as the tax reform is the most significant fiscal policy measure in 2017, the non-reflection thereof in the Stability Programme would considerably diminish the quality of this Programme. It should be noted that the changes related to the tax reform are reflected in the **policy scenario.**

Medium-term Objective

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 in the meaning of the SGP or MTO SGP, which is set as -1.0% of GDP.

Objectives of Structural Balance for 2018, 2019 and 2020

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 objectives of structural balance 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, which is a conditional point of reference, to which the deviations are being applied, which result from the increase in contributions to the second pension pillar and implementation of the health reforms. 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 structural budget 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. This rule, in the general case, may determine more ambitious objectives of the general government structural budget balance. The FDL also provides that the central government expenditure is determined in the *Framework Law* for the 3 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 general government structural budget balance. 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 general government structural budget balance and expenditure growth rules.

Balance objectives according to the balance rule (SGP methodology)

In this section it is determined what the maximum level of the general government structural budget balance objective could be in accordance with the above-mentioned SGP approach. As previously mentioned, the starting position for determining the general government structural budget balance objective in accordance with the SGP approach is MTO -1% of GDP. The following table reflects future adjustments.

Table 3.1. Structural balance objective according to the SGP approach

			2013	2014	2015	2016	2017	2018	2019	2020
(1)	MTO		**-1.0%**	**-1.0%**	**-1.0%**	**-1.0%**	**-1.0%**	**-1.0%**	**-1.0%**	**-1.0%**
(2)	Pension reform	from 2% to 4%	-0.5%	-0.5%	-0.5%	0.0%				
(3)		from 4% to 5%			-0.3%	-0.3%	-0.3%	0.0%		
(4)		from 5% to 6%				-0.3%	-0.3%	-0.3%	0.0%	
(5)	Structural reforms in the health sector						**-0.1%**	**-0.4%**	**-0.5%**	**0.0%**
(6)=sum(1;2;3;4;5)	Maximum structural balance							-1.7%	-1.5%	-1.0%
(7)	Cyclical component							0.1%	0.3%	0.3%
(8)=(6)+(7)	Cyclically adjusted balance							-1.6%	-1.2%	-0.7%
(9)	One-off measures			-0.3%						
(10)=(8)+(9)	Nominal balance		-0.9%	-1.6%	-1.3%	0.0%	-1.0%	-1.58%	-1.24%	-0.73%

With regard to the deviation model resulting from the increase in contributions to the second pension pillar, Latvia retains a similar principle as in the previous Stability Programme. The increase in contributions to the second pension pillar is still made in 3 stages: in 2013 increasing contributions from 2 to 4% (fiscal impact 0.50% of GDP), in 2015 increasing contributions from 4 to 5% (fiscal impact 0.3% of GDP) and in 2016 increasing contributions from 5 to 6% (fiscal impact 0.3% of GDP). The amount of deviations in three years remains the same as it was in the first year and the deviation is fully eliminated in the fourth year.

The granted deviations from the MTO due to the implementation of the health reform are preserved in the previous amount, namely, 0.1% of GDP in 2017, 0.4% of GDP in 2018 and 0.5% of GDP in 2019.

Summing up the MTO with the corresponding deviations, for the needs of future estimates the maximum structural balance is obtained, comprising -1.7% of GDP in 2018, -1.5% of GDP in 2019 and -1.0% of GDP in 2020.

After the determination of general government structural budget balance, the nominal balance of the general government budget is calculated, adding the cyclical component of the balance, which is determined by means of the output gap assessment. This Stability Programme applies different approach for calculating the nominal balance of the general government budget than in the previous Stability Programme, namely, the new EC procedure is applied for assessing the output gaps - plausibility tool and the constrain judgment procedure[9], which can be applied in cases, where the common EC methodology in the output gap assessment gives

[9] Along with the output gap estimates obtained as a result of application of the EC common methodology, the new EC procedure provides for the EU Member States to carry out an alternative output gap assessment, by applying the *plausibility tool*. As a result of application of the plausibility tool, the interval of the plausible values of the output gap and the central value thereof are determined. If it is concluded that the amount of the output gap calculated with the common methodology is outside the interval of plausible values, determined by means of the plausibility tool, the EC, by analysing country's macroeconomic indicators, country-specific factors and forecasts of other international institutions (IMF, OECD) on the output gaps, adopts the decision on the more suitable output gap assessment. The assessment is carried out within the range of the new interval, the upper threshold whereof is the value of the output gap obtained by means of the EC common methodology, whereas the bottom threshold is the central value of the plausible values of the output gap determined by means of the plausibility tool.

economically unjustified result. Please see Section 3.2.2 for more information on the plausibility tool and constrain judgment procedure.

Taking into account the new output gap assessment and by applying the elasticity coefficient of 0.38 the cyclical component is obtained, comprising 0.1% of the potential GDP in 2018, 0.3% of the potential GDP in 2019 and 0.3% of the potential GDP in 2020.

By applying the previously determined structural balance level and the assessed output gap, the general government budget nominal balance is obtained, which is -1.6% of GDP in 2018, -1.2% of GDP in 2019 and -0.7% of GDP in 2020.

Balance objectives according to the balance rule (national methodology)

In this section it is determined what the maximum level of the general government structural budget balance objective could be in accordance with the national methodology. As previously mentioned, the starting position for determining the general government structural budget 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

			2013	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**
(1)	MTO		**-0.5%**	**-0.5%**	**-0.5%**	**-0.5%**	**-0.5%**	**-0.5%**	**-0.5%**	**-0.5%**
(2)	Pension reform	from 2% to 4%	-0.5%	-0.5%	-0.5%	0.0%				
(3)		from 4% to 5%			-0.3%	-0.3%	-0.3%	0.0%		
(4)		from 5% to 6%				-0.3%	-0.3%	-0.3%	0.0%	
(5)	Structural reforms in the health sector						-0.1%	-0.4%	-0.5%	0.0%
(6)=sum(1;2;3;4;5)	Maximum structural balance							-1.2%	-1.0%	-0.5%
(7)	Cyclical component							0.1%	0.3%	0.3%
(8)=(6)+(7)	Cyclically adjusted balance							-1.1%	-0.7%	-0.2%
(9)	One-off measures			-0.3%				-0.74%	-0.51%	-0.31%
(10)=(8)+(9)	Nominal balance		-0.9%	-1.6%	-1.3%	0.0%	-0.8%	-1.82%	-1.26%	-0.54%

The deviation model resulting from the increase in contributions to the second pension pillar and implementation of health reforms is the same as for determining the general government structural budget balance objective according to the SGP methodology.

Summing up the MTO with the corresponding deviations, for the needs of further estimates the maximum structural balance is obtained, comprising -1.2% of GDP in 2018, -1.0% of GDP in 2019 and -0.5% of GDP in 2020.

After that, when the general government structural budget balance to be used in further calculations is determined, the nominal balance of the of the general government budget is calculated, by adding the cyclical component of the balance to the structural balance of the general government budget. The cyclical component of the balance is 0.1%, 0.3% and 0.3%, respectively, in 2018, 2019 and 2020.

In this scenario, the short-term revenue decline caused by the tax reform: -0.7% of GDP in 2018, -0.5% of GDP in 2019 and -0.3% of GDP in 2020 (see Section 3.2.4) 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 is -1.8% of GDP in 2018, -1.2% of GDP in 2019 and -0.5% of GDP in 2020.

It should be noted that the application and interpretation of the FDL provisions is under the competence of the MoF and the MoF holds the opinion that the short-term revenue decrease 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. It should also be noted that 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 *Vade Mecum on the SGP, Box 1.4: Calculating the structural balance*). Thus, the revenue decrease caused by the tax reforms within the SGP context will not be recognised as a one-off measure on the part of the EC and, therefore, it is not included in Table 3.1 as a one-off measure.

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

When general government structural budget balance objectives are determined and the general government nominal budget balance is calculated according to both methods, the obtained results in nominal terms are compared and the largest nominal balance of general government budget 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

		2018	2019	2020
(1)	1. Nominal balance (according to SGP approach)	-1.6%	-1.2%	-0.7%
(2)	2.Nominal balance (according to national methodology)	-1.8%	-1.2%	-0.5%
(3) = MAX (1;2)	The largest nominal balance value MAX (1;2)	-1.6%	-1.2%	-0.5%
(4)	Cyclical component (national methodology)	0.1%	0.3%	0.3%
(5)	One-off measures	-0.7%	-0.4%	-0.3%
(6)=(3)-(4)-(5)	**Structural balance objective**	**-1.0%**	**-1.0%**	**-0.5%**

Once the largest nominal balance of the general government budget is determined, the nominal balance is converted in structural terms (using the cyclical component and the defined one-off measures according to MoF estimates). Accordingly, the general government structural budget balance objectives are obtained, **which are -1.0% of GDP in 2018, -1.0% of GDP in 2019, and -0.5% of GDP in 2020.**

Balance objectives - follow-up verification in accordance with expenditure growth rule and rule of expenditure inheritance.

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 structural budget balance objectives are checked in accordance with the **expenditure growth rule**, nominal expenditure adjustments are subject to MoF forecasts including public debt servicing expenditure, investment expenditure, expenditure on EU programmes fully matched by EU funds revenue, discretionary revenue, as well as the GDP deflator. The permissible expenditure growth, in turn, is calculated by applying combined approach, namely, the initial permissible expenditure growth, corresponding to 10 years' average potential GDP growth in accordance with the MoF forecasts, by means of the EC approach is additionally adjusted by the increase of payments into second pension pillar, deviation from the MTO due to the implemented reforms in the health sector, as well as changes occurring, when applying the output gap assessment, which differ from the result of the EC common methodology. These conditions are essential for the expenditure growth rule to properly take into account permissible deviations from the MTO.

When the determined structural balance objectives are checked in accordance with the expenditure growth rule, we obtain that in 2018 expenditure growth, which is allowed by the expenditure growth rule according to the potential GDP growth, is 4.83%, while the previously determined structural balance objective states that net public expenditure could be increased by 4.71%. Consequently, in 2018 the initial general government structural budget balance objective of -1.0% of GDP is maintained.

In 2019, expenditure growth allowed by the expenditure growth rule is 3.76%, while the net public expenditure growth allowed by the previously determined general government structural budget balance objective is 0.87%. Consequently, in 2019 the initial general government structural budget balance objective of -1.0% of GDP is maintained.

In 2020, expenditure growth allowed by the expenditure growth rule is 1.98%, while the net public expenditure growth allowed by the previously determined general government structural budget balance objective is 0.69%. Consequently, in 2020 the initial general government structural budget balance objective of -0.5% of GDP is maintained.

Following the verification of the rule of expenditure inheritance, it was found that it is not necessary to change in any year the initial general government structural budget balance objective, obtained by applying the balance rule.

Therefore, the quantitative fiscal objectives for the next three years have been set, namely, to maintain the general government structural budget balance **at -1.0% of GDP in 2018, -1.0% of GDP in 2019, and -0.5% of GDP in 2020.**

3.2.2. PLAUSIBILITY TOOL AND CONSTRAIN JUDGMENT PROCEDURE

According to the EC 2017 winter forecasts, Latvia meets the conditions for the EC methodology output gap for 2016 to be viewed as not economically feasible. **In this Stability Programme it is assumed that also the EC 2017 spring forecasts will show that the EC methodology output gap for 2016 is not economically feasible and, therefore, in Latvia's case, the constrain judgment procedure is to be applied.**

Such approach ensures that in defining the initial general government structural budget balance the previous principles are still preserved, which comply with the SGP conditions. Additional benefit is the possibility to determine a less ambitious nominal balance objective level and, thus, to define larger initial fiscal space for funding government priorities. It should be noted that the ultimate amount of the balance objective and the scope of the fiscal space also depend upon the result of the national MTO scenario, as well as upon the result of testing other fiscal conditions. The table below shows the output gap assessment results.

Table 3.4. Output gap assessment for the needs of the Stability Programme

	EC common methodology (1)	Plausibility tool (2)	Distance (3)=(1)-(2)	MoF forecast (approved by the FDC)
2016	***1.4***	***-0.4***	***1.8***	-0.2
2017	1.6	-0.2	1.8	-0.1
2018	1.4	-0.4	1.8	0.3
2019	1.4	-0.4	1.8	0.7
2020	1.4	-0.4	1.8	0.7

In order to carry out the output gap assessment for the balance objective years, 2018, 2019 and 2020, it is necessary to obtain the output gap forecasts calculated according to the common EC methodology, as well as the output gap assessments of the plausibility tool for the respective years.

As the output gap forecasts calculated according to the common EC methodology are not available in the EC 2017 winter forecasts for 2019 and 2020, for the purposes of the forecasts it is assumed that the output gap in these years remains at the level of 2018, which is 1.4% of the potential GDP.

In turn, the plausibility tool of output gap assessment for the subsequent years is being extrapolated, on the basis of the solution offered by the EC, providing that the output gap forecast for the particular years obtained by means of the EC common methodology shall be subject to the constant distance calculated in 2016 and comprises the difference between the output gap assessment provide by the EC common methodology and the central value of the interval of the plausible values of the output gap obtained by means of the plausibility tool. This difference comprises 1.8 percentage points.

Therewith, according to both of the above mentioned methods, the assessments of the output gap are carried out for 2018, 2019 and 2020. As a result, new output gap plausibility interval is defined for each year, with the upper value whereof in 2018, 2019 and 2020 comprising 1.4; whereas the bottom value is -0.4%. Within the scope of this interval, by means of a constrain judgment approach, there is a possibility to assess the most suitable amount of the output gap.

The constrain judgment procedure provides for the possibility for the EC experts to adopt the decision on the amount of the output gap, which can be located at any point of the interval (plausibility tool output gap; common methodology output gap), thus the expert can determine any value within the range from -0.4% to 1.4%. **This Stability Programme has been prepared by assuming that the expert opinion in the constrain judgment procedure would coincide with the output gap assessed by the MoF itself and approved by the Fiscal Discipline Council, comprising 0.3% of the potential GDP in 2018, 0.7% of the potential GDP in 2019 and 0.7% of the potential GDP in 2020.** Please see Section 2.3 for more information regarding the output gap assessment carried out by the MoF.

It should be noted that, in the assessment of OECD, Latvia's output gap in 2016 comprises -4,1% of GDP and in 2017 and 2018, correspondingly, -3.4 and -2,5 % of GDP[10] [11].

[10]IMF World Economic Outlook Database, October 2016

[11] OECD draft report on Latvia 2017

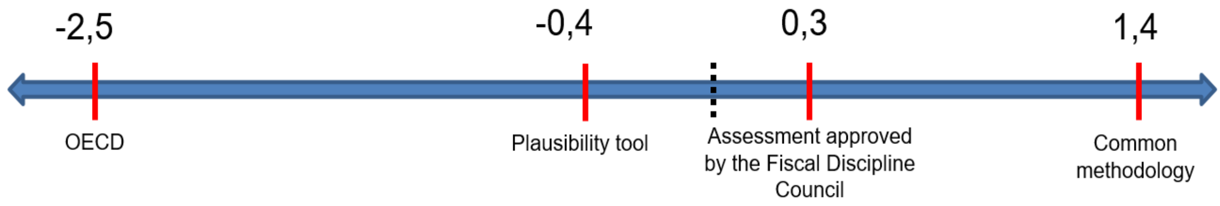

Figure 3.3. Output gap comparison for 2018 carried out by various institutions and by various assessment methods

3.2.3. General fiscal policy objectives and priority courses of development for 2017-2019 - the accomplishments after the previous Stability Programme

As previously mentioned, in Latvia the key decisions of budget policy regarding expenditure and revenue medium-term policy, are not taken in spring, but in autumn along with the *Annual State Budget Law*. Therewith this section further provides information on the fiscal policy decisions that have been adopted by the government preparing the state budget for 2017 and the *Framework Law* for 2017 – 2019.

The *Framework Law* for 2017-2019 implements the general fiscal policy objective - to raise sustainably the quality of life of population - with four medium-term budget priority courses of development:

1) to increase the public defence capacity, raising public defence funding to 2% of GDP in 2018 and ensuring the preservation of the funding in the achieved amount in 2019;
2) to provide sustainable and balanced country's economic development, by primarily ensuring, within the scope of the state budget possibilities, increase of funding for defence, internal security, health and education;
3) to reduce the inequality in population's income, by gradually increasing the minimum wage and introducing the progressive non-taxable minimum of the PIT;
4) to gradually increase the amount of tax revenue to 1/3 of GDP, basically improving efficiency of tax collection.

Implementation of the **first priority course of development** was commenced on 3 July 2014, by adopting the new *State Defence Financing Law*, which provided for a gradual increase in the national defence funding to GDP until it reaches 2% of GDP in 2020. Given the significant changes in the geopolitical risks, in the Latvia's Stability Programme for 2015 – 2018 the government planned to provide a more rapid increase in the national defence capacity reaching 2% target already in 2018. In the *Framework Law* for 2016 – 2018 the government approved such additional increase for defence expenditure, which in 2018 will ensure the increase of defence expenditure reaching 2% of GDP. The current *Framework Law* provides that the funding for defence determined in 2018 of 2% of GDP will be preserved also in 2019.

Table 3.5. Amount of budget expenditure for financing the defence sector stated in the *State Defence Financing Law*, % of GDP

Year	Amount of expenditure for defence provided for 2017 - 2019 by the law *On the State Budget for 2017* and the *Framework Law*, % of GDP
2017	**1.7**
2018	**2.0**
2019	**2.0**

Implementation of the **second priority course of development.** For the purposes of providing sustainable and balanced country's economic development, this year additional funding is granted to health, education, as well as internal security, which, under the given geopolitical conditions, is to be viewed as a prerequisite for promoting economic development.

Quality of life of population is determined not only by GDP per capita and income inequality, but also other factors, including public **health**, possibility to obtain appropriate education and leisure opportunities. The previous two *Framework Laws* granted a significant amount of the state budget funds for these sectors, especially for health. It should be noted that, according to the classification of the government expenditure in line with the functions of government (COFOG), funding for the government function "health" as a share of GDP in accordance with *Eurostat* data for 2015 in Latvia is the second lowest in the EU. Also the EC in the analysis of the implementation of the country-specific recommendations has concluded that the low public funding, as well as high patient co-payments significantly delay the satisfaction of the health needs of large part of the patients. Taking into account the existing problems, the government has set the healthcare sector as one of the key priorities. It is planned to solve the increase of the funding both in the medium term, which is ensured by the additionally granted funds, within the scope of the NPI, and the permit from the EC to apply the SGP flexibility tool with respect to the structural reforms, therewith ensuring temporary additional funding for solving the problem issues of the healthcare sector, and in the longer term, by developing sustainable health financing model. In the previous *Framework Law*, the government resolved upon granting additional funding to health sector, ensuring the payment of the reimbursable medicines and funds for the repayment of the State guaranteed loans to hospitals. Also in the current *Framework Law* the government has provided for a considerable amount of additional funds for the health sector, ensuring the state funding from reduction of queues to the specialist services in the outpatient and inpatient healthcare, as well as the provision of accessibility of the outpatient and inpatient healthcare services. Deficit deviation funding at the moment of the preparation of the State budget and the *Framework Law* was reserved in a separate budget programme, as the funding to be redistributed during execution of the annual State budget, and it was planned to be granted after measures to be implemented from this funding are developed on the part of the Ministry of Health and approved by the Cabinet. At present the Ministry of Health has developed and the Cabinet has reviewed and approved two reports, which provide for information on the action courses of the reforms in healthcare, by means of deviations from the MTO, and specify in detail the indicative indicators, by performing the reform in the field of oncology, reduction of queues and improvement of availability of medicinal products (see Section 3.2.5 for more detailed explication). After the approval of the respective reports, the additional funding has been delivered at disposal of the Ministry of Health, being secured on account of the deficit deviation and to be allocated for the respective reform courses specified in the reports.

In turn, the general government expenditure for the function "**education**" in Latvia according to COFOG exceeds the EU average significantly. This largely demonstrates that the funding for education is adequate, but the education system network and the number of pupils per one teacher is not optimal. Nevertheless, it is not possible to considerably increase the number of pupils per one teacher in a short term, without endangering the quality of education. Therefore it is necessary to invest additional resources into the system, in order to raise the remuneration of teachers, otherwise the quality of education would suffer significantly. Therewith, in the current *Framework Law* the government adopted the decision to reform the teachers' remuneration model. Initially additional funds for ensuring changes in remuneration were reserved in a separate budget programme and in the further process of revision and approval of the law *On the State Budget for 2017 and Framework Law* the redistribution of resources have been carried out to the budgets of the respective ministries.

When assessing **the implementation of the third priority course of development**, in the context of the quality of life of population, it is justified to analyse the average quality of life of population and differences in the quality of life between people with different income levels. An important indicator for the assessment of the average quality of life is GDP per capita, which in Latvia is one of the lowest in the EU (GDP per capita in 2015 is 12 300 euro), while the Gini coefficient, which characterizes the income inequality, in Latvia is one of the highest in the EU (35.4%).

A number of significant provisions were incorporated in the previous two *Framework Laws* to reduce income inequality of population, such as an increase in the PIT non-taxable minimum, increase in PIT allowances for dependents, improvements in the State social assistance system, and the support scheme to low income households to offset the rise in electricity costs due to the abolition of the initial rate since the electricity market was opened, increase of the minimum wage, as well as the introduction of the differentiated non-taxable minimum. Current government policy also prescribes continuing to provide assistance to population to offset the mandatory procurement component within consumer electricity tariffs, ensuring both horizontal support and additionally supporting the protected groups of population.

The current *Framework Law* provides for the continuation of the launched government policy, by increasing the minimum wage in 2017 to 380 euro, as well as number of measures for solving the problem issue of demography.

As regards the fourth priority course of development, Latvia has traditionally been the country with comparatively low tax burden, which is also one of the lowest in the EU. The government decisions in the current *Framework Law* regarding the increase of the revenue part of the budget were mainly based upon the necessity to finance the government priorities, at the same time ensuring that the existing tax policy is not considerably changed. However, notwithstanding the above mentioned, the tax policy measures approved both in the recent and also in the previous budgetary cycles allowed ensuring that the proportion of the tax revenue to GDP will be with a growing tendency in the subsequent years.

The situation at the moment of preparation of the current *Framework Law* was indicative of the following - ever since 2009 the tax revenue to GDP demonstrates a slow growing trend, while the forecasts for 2019 show decline of the tax revenue to GDP. The fall is mainly attributable to the following:

- smaller subsidised electricity tax revenue is forecasted, as the forecasts include that currently the tax is in effect till 31 December 2018. It should be noted that for the second reading of the Budget the changes are projected - it is planned that the tax will exist only by 31 December 2017. Therewith, it can be forecasted that after the amendments in the second reading the tax revenue to GDP might reduce, or at least not grow already in 2018;
- smaller vehicle operation tax revenue is forecasted, because the government has supported the proposal to introduce the change of the tax payment procedure - the tax shall be paid for the actual period, and not in advance for the calendar year - starting from 1 January 2019.

In the previous *Framework Laws* the government in its tax policy was mainly guided by the commitment to increase the contributions in the second pension pillar in accordance with the previously adopted decisions and not to introduce the changes in the most considerable tax rates. The second essential direction was to ensure the increase in tax revenue through more intensive work to increase tax collection, *inter alia*, through introduction of the necessary legislative changes.

In the current *Framework Law* the government has strengthened the commitment not to introduce considerable changes in the tax policy, postponing the adoption of such decisions till the preparation of the Tax Policy Guidelines for 2017 - 2021.

Essential aspect of revenue increase is **combating shadow economy**, whereof the reduction will contribute to ensure more fair competition conditions, as well as will enhance the State budget revenue. In the previous *Framework Law* the government continued the previously launched course of minimising shadow economy, ensuring improvement of information exchange process between the financial institutions and the SRS, as well as ensuring the necessary legislative changes, which will introduce new, more rigid technical requirements for cash register systems. The current *Framework Law* also prescribes several measures for reducing shadow economy, for example, introduction of the risk management system in the register of enterprises, introduction of a joint liability for a general contractor company or the subcontractor company in the field of construction, introduction fast, convenient and effective solution for directing collection to funds in the bank accounts of the debtors, by ensuring the electronic data exchange between the SRS and credit institutions, etc.

In order to grant additional funding for the priority courses of development of the medium-term budget, as well as to finance the urgent measures, the fiscal space is needed.

The fiscal space was calculated and reviewed at the 2 August 2016 Meeting of the Cabinet, where the report "On the forecasts of macroeconomic indicators, revenue and general government budgetary balance for 2017 - 2019" was reviewed. The correspondingly calculated amount of the "fiscal space" was - 4.9 million euro for 2017, +67.6 million euro for 2018 and +215.6 million euro for 2019.

Therewith, the Cabinet had to adopt the decisions, which would not only eliminate the negative fiscal space in 2017, but would also ensure the funding for urgent needs.

Table 3.6. Revenue increasing measures (above 1 mln euro)

Measure	2017	2018	2019
The currently effective vehicle operation tax procedure is preserved	34.2	0.0	-43.4
Improvement of collection of the road user charge (vignette)	7.3	7.3	7.3
Introduction of tax advance payments for the taxi sector	4.0	4.0	4.0
Introduction of the PIT allowance for the expenses of meals of the employees, if the collective agreement is concluded	-3.9	-7.9	-7.9
Raise of the monthly minimum wage (from 370 to 380 euro)	13.3	13.3	13.3
Limiting the CIT loss transfers	0.0	12.5	11.3
Abolition of the electricity tax exemption	5.4	5.4	5.4
Revision of the natural resources tax rates and abolition of exemptions	9.1	9.1	9.1
Introduction of joint liability for the general contractor company or subcontractor company in the construction sector	2.1	2.1	2.1
To introduce fast, convenient and effective solution for directing collection to funds in the bank accounts of the debtors, by ensuring the electronic data exchange between the SRS and credit institutions	2.1	2.2	2.4
To introduce the risk management system in the Register of Enterprises	3.8	3.8	3.8
To combat and restrict the illegal audiovisual market (television programmes and films) distribution	1.0	1.0	1.0
To enhance conditions for registration of used vehicles	1.3	1.3	1.3
Determination of the volume of the share to be paid as a dividend to the State capital companies	7.7	1.0	33.8
State fee for maintaining the oil products emergency stock	-2.4	-2.4	-1.2
State fee for issuance of passports	0.0	0.0	7.3
Adjustment of the natural resources tax revenue in accordance with 91 § Clause 6 of Minutes No. 48 of the Meeting of the Cabinet on 27 September 2016	0.7	1.1	1.5
Suspension of the subsidised electricity tax starting from 2020	-17.9	-21.7	43.3

Installation of new stationary speed cameras	0.5	1.9	2.0
Reduced revenue from the road user charge (vignette)	-4.5	0.0	0.0
Increase of the excise duty rate on cigars and cigarillos	0.6	0.9	1.2
Increase of the excise duty rate on cigarettes	0.8	2.5	2.3
Determination of the micro-enterprise tax rate in amount of 15%, mln euro	78.6	97.8	97.8
Abolition of determination of the employee's and employer's minimum MSSIC object for the reporting month starting from 2017, mln euro	-74.2	-99.5	-99.5
Other total	4.0	5.4	4.9
(-) contributions to the second pension pillar	*2.5*	*2.1*	*2.1*

In general, the revenue increasing measures adopted by the government allow to increase the tax revenue against to GDP by 0.3% of GDP in 2017, 0.1% of GDP in 2018 and 0.3% of GDP in 2019.

For the purposes of reducing negative fiscal space in 2017, in addition to the decisions on revenue increase, the government also resolved upon revision of the state budget expenditure, which allowed ensuring additional funds both for funding the priorities of the sectors itself, and for funding the general government priorities. Revision of the state budget expenditure will henceforth be carried out on a regular basis and it is prescribed by the amendments to the LBFM, entered into force on 1 January 2016.

The most considerable increase of funding is implemented in the sectors defined as priority sectors by the government, namely, internal and external security, health and education, however additional resources are also ensured in other significant sectors (see Table 3.7).

Table 3.7. Fields with the most considerable increase of funding (starting from 1 mln euro) and most substantial expenditure increasing measures

Name of the measure	2017	2018	2019
Ministry of Defence	**-8.9**	**-14.0**	**-16.1**
Other NPI	0.2	0.1	0.1
Decisions adopted by the Cabinet (reduction of expenditure, in order to ensure constant defence expenditure proportion to GDP)	-9.1	-14.1	-16.3
Ministry of Foreign Affairs	**2.1**	**4.9**	**4.9**
For making contributions to the OECD	0.0	2.9	2.9
Ministry of Economics	**1.4**	**-1.5**	**-0.1**
Other NPI	1.0	0.9	1.0
State guarantee for mortgage loans for acquisition or construction of the living space for families with children (housing programme provision)	2.8	0.0	0.0
Decisions adopted by the Cabinet (including, reduced expenditure for maintaining emergency stock of oil products)	-2.4	-2.4	-1.1
Ministry of Finance	**5.8**	**18.6**	**7.4**
Other NPI	0.5	0.5	0.6
Incentives to the most professional officers and employees of the elevated risk structural units of the SRS	1.8	1.8	1.8
Strengthening the SRS capacity	1.3	1.3	1.3
Enhancement of the SRS remuneration system	1.8	1.8	1.8
Overtaking of the obligations of the medical institutions guaranteed on behalf of the State	0.0	0.0	1.6
Decisions adopted by the Cabinet (including, increased expenditure for the implementation of the NPI "Radical Action for Combating Shadow Economy in the Field of Tax Administration and Customs Affairs" in 2018 and 2019)	0.4	13.2	0.4
Ministry of the Interior	**37.4**	**37.3**	**40.9**
Other NPI	1.2	1.1	1.1
Arrangement and maintenance of the State border zone of the Republic of Latvia and Russian Federation	2.9	2.7	2.6
Construction of the State border zone along the border of the Republic of Latvia and the Republic of Belarus	0.5	0.9	1.0

Scheduled restoration of the aircraft park (acquisition of two light single engine helicopters), staff training and maintenance	3.0	2.9	2.9
Capacity building in the Security Police (classified information)	3.0	3.0	3.0
Introduction of the new work remuneration system for the officials with special service ranks working in institutions of the system of the Ministry of the Interior and the Prison Administration	26.0	26.0	26.0
Decisions adopted by the Cabinet (including, increase of expenditure for ensuring the measure "Issuance of the Passports, Electronic identification Cards and Residence Permits Corresponding to the EU Requirements" in 2019)	0.8	0.7	4.3
Ministry of Education and Science	**16.0**	**19.9**	**18.9**
Other NPI	4.6	1.8	1.8
Ensuring of the wage reform of the teachers commenced on 1 September 2016	6.2	10.9	10.9
For construction of the Liepāja covered tennis courts	1.6	1.6	1.6
For implementation of the sports infrastructure development project for *Ventspils* Olympic Centre	1.6	1.6	1.6
For reconstruction of the J. Dalins Stadium of Valmiera and construction of the track-and-field athletics arena	1.1	2.1	2.1
For the development project of Ventspils International Radio Astronomy Centre "Construction of a next-generation sensor programmable antenna field radio telescope station *LOFAR*"	1.0	2.0	1.0
Ministry of Agriculture	**13.6**	**13.5**	**13.5**
Other NPI	0.6	0.5	0.6
Emergency State aid for milk producers	7.0	7.0	7.0
Capacity building of the State Forest Service	2.7	2.7	2.7
Ensuring of the wage reform of the teachers commenced on 1 September 2016	1.5	1.5	1.5
Decisions adopted by the Cabinet (including, hydroelectric station compensation for the damage caused to the fish resources)	1.8	1.8	1.8
Ministry of Transport	**11.7**	**13.4**	**13.4**
Other NPI	0.4	0.4	0.4
Motor Road Arrangement Programme 2014 - 2020	9.6	9.6	9.6
Large families as the new passenger category entitled to use the passenger fare allowances in intercity public transport	1.7	3.4	3.4
Ministry of Welfare	**14.6**	**14.5**	**14.7**
Other NPI	2.2	2.2	2.4
Development of alternative family care forms	4.9	4.9	4.9
Increase of support for beneficiaries of the survivor's pension	4.0	4.0	4.0
Increase of the family State benefit starting from the 4th child	3.5	3.5	3.5
Ministry of Justice	**-14.7**	**18.6**	**44.0**
Other NPI	3.7	2.7	3.4
Introduction of the new work remuneration system for the officials with special service ranks working in institutions of the system of the Ministry of the Interior and the Prison Administration	4.3	4.3	4.3
Ensuring operation of the Constitution protection Bureau (classified information)	2.5	2.4	2.5
Increase of the monthly wages for the employees of the judiciary system	3.8	3.8	3.8
Increase of remuneration of judges and prosecutors	0.0	3.6	3.6
Decisions adopted by the Cabinet (including, changes in funding for the long-term commitment measure "Construction of the new prison in Liepāja")	-28.9	1.9	26.5
Ministry of Environmental Protection and Regional Development	**3.1**	**2.8**	**3.1**
Other NPI	0.3	0.1	0.1
Maintenance of the information and communications technologies systems formed within the scope of the EU policy mechanisms and other foreign financial assurance means	1.2	1.2	1.5
For ensuring the infrastructure development of the State Ventspils Secondary Music School	1.6	1.6	1.6

Ministry of Culture	**20.1**	**23.6**	**20.2**
Other NPI	5.4	3.3	3.8
Implementation of Latvian Media Policy (media support fund and media literacy)	1.1	1.0	1.0
Programme of the Latvia's State Centenary	5.0	10.6	6.7
Ensuring of the wage reform of the teachers commenced on 1 September 2016	8.7	8.7	8.7
Ministry of Health	**10.8**	**8.9**	**17.1**
Other NPI	1.5	0.8	0.8
Reducing queues to specialist services in outpatient healthcare	2.0	2.0	2.0
Cutting waiting times in scheduled inpatient healthcare	1.0	1.0	1.0
Raise of the minimum monthly wage from to 380 *euro* starting from 1 January 2017	5.1	5.1	5.1
Ensuring availability of the outpatient and inpatient healthcare services	7.0	7.0	7.0
Ensuring of the wage reform of the teachers commenced on 1 September 2016	1.2	1.2	1.2
Decisions adopted by the Cabinet (including, reduced resources and expenditure for 2017 and 2018 grant for covering hospital commitments of 7, 000, 000 *euro* annually, redistributing the funding for ensuring availability of the outpatient and inpatient healthcare services)	-7.0	-8.2	0.0
Prosecutor's Office	**1.8**	**4.1**	**4.0**
Other NPI	1.8	0.9	0.8
Increase of remuneration of judges and prosecutors	0.0	3.2	3.2
Agency 62 "Earmarked Grants to Local Governments"	**25.5**	**9.4**	**9.4**
Other NPI	0.2	0.2	0.2
Ensuring of the wage reform of the teachers commenced on 1 September 2016	13.8	9.2	9.2
For implementation of the measures relevant to local governments	11.5	0.0	0.0
Agency 74 "Funding to be Redistributed within the Process of the Annual State Budget Fulfilment"	**44.0**	**-27.4**	**-7.8**
Decisions adopted by the Cabinet	44.0	-27.4	-7.8
incl., corrections in accordance with the proposals supported by the Cabinet	-19.3	-27.4	-7.8
for performance of compensation disbursement for fulfilment of the official duties in excess of the determined time for fulfilment of the official duties for the officials with special service ranks working in institutions of the system of the Ministry of the Interior and the Prison Administration	16.0	0.0	0.0
Funding for introduction of the healthcare system reform	34.3	0.0	0.0
For the State aid equalisation measures during the transitional period	13.0	0.0	0.0
Other total	**4.1**	**3.1**	**2.9**

3.2.4. Tax Guidelines for 2017 - 2021

Even though the speed of economic cohesion is one of the steepest among the Eastern European countries, in order to achieve the EU average GDP per capita, Latvia by developing at the current rate, would need another 30 years, which is an unsatisfactory lengthy time period.

Latvia's potential GDP growth is about 3% of GDP. NDP 2020 sets **economic breakthrough** as the key prerequisite to ensure the achievement of NDP 2020 vision on Latvia by 2020, meaning the average annual GDP growth of 5% of GDP.

Both the legal framework governing the entrepreneurial activity and the tax policy are important for ensuring the economic breakthrough. In the World Bank's *Doing Business 2017* study Latvia ranks 14th in the competition of 190 countries. This, basically, demonstrates business - friendly requirements for commencing the business and an acceptable burden to settle the obligations with the state. Tax policy is an essential factor for entrepreneurial activity. It is especially important for a small open economy, functioning under the conditions of free capital and labour force movement.

During the preparation of the Stability Programme, the tax reform is being developed, providing for the reduction of the PIT rate from 23% to 20% and 0% CIT for the retained profit and 20% CIT for allocated profit starting from 2018. Reform entails also other measures. Currently the agreement is achieved with respect to the most essential reform measures with the social partners and the reform is supported by the Bank of Latvia. It is planned that Latvian government will review and support it at the end of April this year and the reform will be adopted along with amendments in the laws in July this year.

Taking into account the importance and fiscal impact of the reform, it is included in this Stability Programme before the adoption of the final decision. **Information provided herein entails the tax reform proposals and fiscal calculations prepared and recorded at the moment of preparation of the Stability Programme - on 3 April 2017.**

The key solutions offered in the tax policy guidelines:

1) **to reform the CIT system**, stating two CIT rates (currently the rate is 15% applied to the taxable income):
    - **0% rate** - for retained profit;
    - **20% rate** - at the moment of profit allocation (i.e. costs not invested in the development of the company, including, dividends, representation costs exceeding certain ceiling, company liquidation quotas) (similar to Estonia);
    - to state a transitional period for the beneficiaries of the previously granted rebates: large investment projects (with special a Cabinet decision);
    - to preserve the possibilities for financing the public benefit organisation in amount of 10% of the company's profit, by not taxing the charitable donation: identical to Estonian system.
2) **to reform the labour tax system:**
    - *by introducing two PIT rates* (currently the basic rate is 23%):
        - **20%** PIT rate - for income up to 45 000 *euro* per year;
        - **23%** PIT rate - for income exceeding 45 000 *euro* per year;
    - *by significantly increasing the PIT non-taxable differentiated minimum,* (refusing from the application of the differentiated non-taxable minimum under summarising procedure, applying it to a full extent already during the course of the taxation year):
        - **0-250 euro per month** in the year of introduction (250 euro per month for income of up to 440 euro per month, for income from 440 to 1 350 euro per month - a non-taxable minimum according to the formula gradually decreases, until it reaches 0 by the income above 1 350 euro per month);
        - **0-300 euro per month** in the next year (300 euro per month for income of up to 440 euro per month, for income from 440 to 1 350 euro per month - a non-taxable minimum according to the formula gradually decreases, until it reaches 0 by the income above 1 350 euro per month);
    - *abolishing the solidarity tax and introducing the ceiling of the maximum amount of the MSSIC object to 85 400 euro per year:*
        - for income from 52 400 to 85 400 euro per year - short-term social benefits are not granted;
        - for income above 85 400 euro per year - social insurance contributions does not have to be paid;
    - *by increasing the minimum monthly wage* to **430 euro** (currently - 380 euro);

- *by increasing the non-taxable minimum for pensioners* to **300 euro per month** (currently - 235 euro per month);
- *by allocating 1% of the social contributions to health care financing.*

3) **to equate PIT rates for various types of income, determining them in amount of 20%/23%:**
   - **20%** PIT rate – for income from *capital and capital gain* (currently PIT rate for income from capital, other than capital gain (for example, dividends, interest income) is 10%, but for income from capital gain – 15%). Exception is dividends (0% rate), if they have already been taxed with 20% income tax rate at the corporate level at the moment of allocation of the profit;
   - **20/23%** PIT rate - *for economic operators* (currently - 23% rate);
     - 20% PIT rate - for taxable income of up to 45 000 euro per year;
     - 23% PIT rate - for taxable income exceeding 45 000 euro per year;
     - MSSIC object - taxable income, if it is below 430 euro per month, shall be exempt from MSSIC. If the taxable income reaches 430 euro per month, then the MSSIC object is determined in the amount of actual income (reduced MSSIC rate and reduced scope of social guarantees, for example, only pension insurance). For taxable income exceeding 430 euro per month - the existing procedure, i.e., freely determined contributions object, but at least in amount of a minimum wage, tax rate for taxable income of up to 430 euro - as up to now (depending on the status of the self-employed person), for taxable income exceeding 430 euro - 5%;
     - changes in the procedure for determination of the taxable income from economic activity, stating the restriction for expenditure from economic activity - up to 80% of the income from economic activity (correspondingly, also the carrying forward of the loss of pre-taxation years must be cancelled, stating the transitional period for the previously accrued losses). The said restriction does not apply, if the excess of the limit of expenditure is caused by the costs of the paid employment;
     - writing off of the fixed assets depreciation in accordance with the procedure laid down for the economic activity, however this procedure may be changed only upon certain conditions (for example, 5 years later, with special basis, etc.);
   - **20/23%** PIT rate - *for the payers, who obtain income on the basis of the work performance contract, but have not registered the economic activity* (currently - 23% rate), preserving the previous tax application procedure:
     - 20% PIT rate - for taxable income of up to 45 000 euro per year;
     - 23% PIT rate - for taxable income exceeding 45 000 euro per year;
     - MSSIC - similar to the payroll taxpayers;
   - **20/23%** PIT rate - *for the beneficiaries of royalties*, preserving the previous expenditure thresholds (in amount of 15-40%, depending on the type of the created work; not applied to copyright heirs):
     - 20% PIT rate - for taxable income of up to 45 000 euro per year;
     - 23% PIT rate - for taxable income exceeding 45 000 euro per year;
     - to state 5% MSSIC additional rate for contributions into the social budget - for pension insurance;
     - Economic activity does not have to be registered. If the employee status is not determined - the same regulation as that of the self-employed persons.
     - for copyright heirs - the previous procedure is preserved, i.e., no MSSIC contributions are to be made;

- **20%** PIT rate - *for income from leasing or letting, without registration of economic activity* (current PIT rate - 10%), stating 50% expenditure threshold (without supporting documents, notwithstanding the actual expenditure) (currently not in place, only RET for the real estate is in place);
- **20%** PIT rate - *for income from selling living forest/timber* (current PIT rate - 10%), stating 50% expenditure threshold (without supporting documents, notwithstanding the actual expenditure) (currently the expenditure threshold is 25% of income from selling growing forest (expenditure related to the restoration of the forest) and 50% of income from selling timber (expenditure related to the preparation/selling of timber));
- **20%** PIT rate - *for income from selling scrap* (current PIT rate - 10%), stating 50% expenditure threshold (without supporting documents, notwithstanding the actual expenditure) (currently the actual expenditure are not taken into account)).

4) **to reduce the micro-enterprise taxpayers' turnover threshold to 40 000 euro per year** (currently - 100, 000 euro per year), by equating it with the threshold for registration with the SRS VAT payers' register, as well as to state the micro-enterprise tax on dividends in amount of 20% PIT rate, to increase the maximum wage restrictions from 720 euro per month to 900 euro per month, to preserve the existing restrictions and to improve the SRS control with respect to micro-enterprises;
5) **to improve the patent fee regime for small or "lifestyle" businesses, by equating the rates** (currently the patent fees are stated in amount from 43 to 100 euro, depending on the breakdown by regions and professions), simplifying the payment and administration thereof, but preserving the existing restrictions, as well as to introduce the voluntary solution to everyone, paying turnover tax - **economic activity revenue account.**

Other measures:

1) **to arrange the real estate cadastral values** and to review the application categories of separate real estates;
2) **to increase the gambling tax rates** for slot-machines and gaming-tables by 30%;
3) to preserve the VAT standard rate of 21%, **to reassess the reduced VAT rate for accommodation services in tourist dwellings** and to apply the standard rate of 21%;
4) to gradually **increase the excise duty rates**, coordinating them with the sector organisations and taking into account the excise duty rate changes in other Baltic States;

Table 3.8. Planned changes in the excise duty rates for oil products

Oil products	1 January 2015	1 January 2016	*1 January 2018**	*1 January 2020**
Unleaded petrol, *euro* per 1, 000 l	411.21	436.0	*470.0*	*495.0*
Leaded petrol, *euro* per 1, 000 l	455.32	455.3	*564.0*	*594.0*
Diesel fuel, kerosene, fuel oil, *euro* per 1, 000 l	33.95	341.0	*378.0*	*425.0*
Liquefied petroleum gas, *euro* per 1, 000 kg	161.00	206.0	*231.0*	*278.0*

Table 3.9. Planned changes in the excise duty rates for tobacco products

	1 January 20 16	1 January 20 17	*1 January 20 18*	*1 January 20 19*	*1 January 20 20*
For cigarettes	From 1 July				
Specific rate, *euro*	56.20	67.00	***70.70***	***74.60***	***78.70***
Ad Valorem	25%	20%	***20%***	***20%***	***20%***
Minimum level, *euro*	93.70	99.00	***104.00***	***109.20***	***114.70***
For cigars and cigarillos, euro		58.0	73.00	88.00	***95.20***
For smoking tobacco euro per 1, 000 g, *inter alia*:					
Finely cut tobacco		62.00	66.0	70.0	***75.0***
Other smoking tobacco, tobacco leaves		62.00	66.0	70.0	***75.0***
Heated tobacco		62.00	66.0	70.0	***75.0***

Table 3.10 Planned changes in the excise duty rates for alcoholic beverages and beer

Alcoholic beverages and beer, euro per 100 l	**Planned**			**Proposal**		
	1 March 2016	**1 March 2017**	**1 March 2018**	**1 March 2018**	**1 March 2019**	**1 March 2020**
Wine, fermented beverages (above 6%), intermediate product of up to 15 per cent by volume	74.0	78.0	82.0	***92.0***	***101.0***	***111.0***
Intermediate products with 15 to 22 per cent by volume	120.0	130.0	135.0	***150.0***	***170.0***	***190.0***
Other alcoholic beverages, *for absolute alcohol %*	1 400.0	1 450.0	1 500.0	***1 670.0***	***1 840.0***	***2 025.0***
Beer, *per each per cent by volume of absolute alcohol*	4.2	4.5	4.8	***5.6***	***6.1***	***6.8***
Beer, *minimum rate*	7.8	8.2	8.6	10.3	***11.1***	***12.5***

5) **to state limitations for the PIT eligible expenditure;**
6) **to preserve the existing vehicle operation tax payment procedure** also in 2019;
7) **to implement the measures for combating shadow economy,** with the key vectors whereof arising out of the plan of combating shadow economy. The main directions for combating shadow economy (reaching 18.3% of GDP in 2020 (in 2016 according to the data from the F.Schneider's study the share of shadow economy in Latvia comprised 22.6% of GDP)) are:
   - expansion of the application of the VAT reverse payment procedure (in the trade of construction materials, household appliances);
   - reduction of the threshold for registration with the SRS VAT payers' register from 50 000 euro to 40 000 euro;
   - reduction of the threshold for the transactions to be itemised in the VAT return from 1 430 euro to 150 euro;
   - introduction of the online trade transactions register, etc.;

8) **to implement the tax administration measures,** with the main whereof being as follows:
   - introduction of a single account and savings principle;
   - introduction of the account of income from economic activity for small entrepreneurship;
   - accessibility and quality of the SRS services;
   - reform of the enhanced cooperation programme;
   - revision of the accounting requirements, depending on the turnover, status and type of activities;
   - optimisation of the PIT eligible expenditure administration.
9) **to enhance the collection processes and penal policies.**

Direct fiscal impact of the tax reform

The first course of action of the tax reform - reduction of the labour tax burden creates adverse direct fiscal impact on the revenue in amount of 318 million euro in the first year of the reform and by another 41 million euro and 12 million euro more in the second and the third year.

The second course of action of the tax reform - stimulating corporate investments and building the international competitiveness of enterprises creates adverse direct fiscal impact on revenue in amount of 150 million euro in the first year of the reform (substantially, due to the change in the CIT payment procedure, which also provides for refusing from the advance payment of the CIT) and by another 4 million euro in the second year, but in the third year the adverse impact reduces by 4 million euro.

Compensatory tax reform measures create a positive direct impact on the revenue in amount of 233 million euro in 2018 and increases the positive impact by another 67 million euro in 2018 and then reduces the positive impact by 9 million euro.

The **total** direct adverse impact of the tax reform in 2018 comprises **235 million euro.** In 2019 it reduces by **23 million euro** and grows again by 17 million euro in 2020. See Table 3.11.

Table 3.11: Direct discretionary impact of the tax reform on revenue (according to accruals method)

No.	Measure	Status	Revenue /expenditure	ESA code	2018	2019	2020	Assessment description
1. Course of action - to reduce the labour tax burden								
				total:	**-318.3**	**-41.0**	**-12.1**	
1	Reduction of the PIT burden	conceptual agreement with social partners	*PIT*	*D51*	-284.2	-33.8	-11.3	Introduction of the progressive PIT rate and the differentiated non-taxable minimum for the employed PIT rate - 20% for income up to 45 000 *euro* per year; - 23% for the part of income exceeding 45 000 euro per year. Differentiated non-taxable minimum (NTM) 0-250 euro in the year of introduction (minimum threshold-

								440 euro, maximum threshold - 1 350 euro); 0-300 euro in n+1 year
2	Abolition of the solidarity tax, by introducing the second pillar ceiling of the maximum amount of the MSSIC object	conceptual agreement with social partners	*PIT*	*D51*	5.5			Abolition of the solidarity tax with concurrent increase of the maximum amount of the MSSIC object from 52 400 to 85 400 euro
			MSSIC	*D61*	20.2			
			Solidarity tax	*D51A*	-44.1	-7.2	-0.8	
3	Raise of the minimum monthly wage	conceptual agreement with social partners	*PIT*	*D51*	7.9			Raise of the minimum monthly wage from 380 to 430 euro
			MSSIC	*D61*	19.5			
4	Increase of the non-taxable minimum for pensioners	conceptual agreement with social partners	*PIT*	*D51*	-43.1			Increase of the non-taxable minimum for pensioners from 235 to 300 euro
2. Course of action - stimulating corporate investments and raising international competitiveness of enterprises								
				total:	**-149.8**	**-3.5**	**4.2**	
5	Change of the CIT regime	conceptual agreement with social partners	*CIT*	*D51*	-322.9	173.5	6.3	Introduction of the reinvested profit model with respect to CIT, application of 0% PIT rate to the disbursed dividends after the expiry of the 5 years' transitional period (except for the dividends received from foreign countries and the dividends paid by the micro-enterprise, to be subject to 20% PIT rate)
			PIT	*D51*	134.7	-177	-2.1	
6	Equalising the PIT rates for various types of income	conceptual agreement with social partners	*PIT*	*D51*	30.7			Including - increase of the PIT rate for capital (income from interest from 10% to 20% and income from capital gains from 15% to 20%), income from selling growing forest/timber - expenditure norm and), changes in the PIT rate of 20% (PIT rate increase from 10% to 20%), etc. measures
			MSSIC	*D61*	7.7			
Additional compensatory measures								
				total:	**233.4**	**67.0**	**-8.9**	
7	Improvement of the VAT collection, as well as targeted and effective application of VAT allowances and reduced rate	conceptual agreement with social partners	*VAT*	*D211*	70.8			Reduction of the VAT registration threshold from 50 000 to 40 000 euro Reassessment of the reduced VAT rate for accommodation services in tourist dwellings; Reduction of the threshold for
			PIT	*D51*	3.4			
			MSSIC	*D61*	4.7			

								deciphering VAT transactions in the VAT returns; Expansion of the VAT reverse, introducing it in the trade of construction materials and machinery.
8	Revision of excise duty rates, transferring the tax burden to the consumption and environmental taxes	conceptual agreement with social partners	*Excise Duty*	*D214 A*	41.8	15.4	31.0	Increase of the excise duty rates: - for oil products used as fuel, in 2018 - 2020, by 11.5% on average; -for alcoholic beverages, in 2018 - 2020, by 12.6% on average; - for beer, in 2018 0 2020, by 14.9% on average; - for tobacco products, in 2018 - 2020, by 6.5% on average.
			VAT	*D211*	8.8	3.2	6.5	
9	Increase of the gambling tax rates	conceptual agreement with social partners	*Gambling tax*	*D214 F*	9.0			Increase of the gambling tax rates for slot-machines and gaming-tables by 30%
10	Revision of the RET (real estate tax) conditions	conceptual agreement with social partners	*RET*	*D29A/ D59*	7.0	2.0		Revision of the cadastral values of the real estate for separate categories of use of the real estate
11	The existing vehicle operation tax payment procedure preserved also in 2019	conceptual agreement with social partners	*VOT (vehicle operation tax)*	*D29/D 59*		46.4	-46.4	The existing payment procedure is preserved - the vehicle operation tax is paid in advance for the current year
12	To reduce the threshold of turnover of the micro-enterprise taxpayers, equalling it to the VAT registration threshold		*MSSIC*	*D61*	7.2			The micro-enterprise taxpayers' threshold is reduced from 100 000 to 40 000 euro per year
			CIT	*D51*	-0.4			
			PIT	*D51*	-2.7			
13	Discharge of the late interest and fine in case of debt repayment (tax debt amnesty)		*VAT*	*D211*	12.0			without additional qualifying criteria, the possibility will be provided for the period of up to 3 years to repay the debt, as a result discharging the late interest and fine
			CIT	*D51*	2.0			
			MSSIC	*D61*	13.6			
			PIT	*D51*	2.5			
14	Measures for minimising shadow economy				53.7			
	Total direct impact				**-234.7**	**22.5**	**-16.8**	

Macroeconomic impact of the tax reform

The assessment of the impact of the MoF tax reform on national economy is based upon detailed population and corporate data analysis and the MoF macroeconomic model.

Tax policy reform, by reducing the labour tax burden, as well as stimulating corporate investments and increasing the international competitiveness of enterprises, will have a positive impact on the economic growth of Latvia. The reform package entails vast range of labour taxes with an aim to reduce the PIT burden and increase the income of the working population. Having analysed the SRS data on the population income from work remuneration and the amount of the paid PIT, it can be detected that practically all population of the State will feel the reduction of the tax burden on labour income. In 2016 72% of the employed received the average or smaller wage and, in total, the annual income from wage of 99% of the employed did not exceed 45 000 euro - the level by which it is planned to apply the reduced PIT rate in the first year. Correspondingly, the PIT rate reduction from 23% to 20% will influence all of these employed persons, by increasing the income at their disposal, which would be possible to be used for consumption, investments and savings. The MoF scenario projects that, as a result of the PIT reform, enterprises would not optimise their revenue on account of the wage.

The increase of the PIT non-taxable minimum will have an additional positive impact on the income of the working population, which will most significantly influence exactly the income of the less paid population, at the same time, with the introduction of the differentiated PIT rate, reducing the inequality of income. Taking into account that majority of the working population gains income below the average wage, most probably, the income growth obtained as a result of the PIT reduction will be used exactly for consumption, therewith, along with the growth in private consumption, stimulating the total economic growth.

As the income of population will grow, also additional demand for loans could be facilitated. Already in 2015 and 2016 the amount of the newly issued loans grew very sharply - respectively, by 20% and 29%. By implementing the tax reduction measures, the amount of the newly issued loans for the next three years would grow by another 5 percentage points, correspondingly stimulating the private consumption.

Reduction of the labour tax burden, concurrently with the positive impact on the private consumption, will reduce also the **costs of enterprises**, by increasing their competitiveness and improving the possibilities to attract labour force. The reduction of the labour costs may also stimulate the corporate investments, releasing additional own funds for such purposes.

The planned raise of the minimum wage from the current 380 euro to 430 euro will also increase the income of the population, concurrently reducing the inequality among the employed population. Direct impact of such increase of the minimum wage on the private consumption growth is insignificant, however it will reduce the share of shadow economy, which has already been partially included in the PIT calculations. At the same time, it should also be noted that the raise of minimum wage to such extent, if it is implemented concurrently with the significant reduction of the labour tax burden, will not increase the labour costs of the enterprises and will not reduce their external competitiveness, nor will it deteriorate the financial condition of the enterprises, which is of utmost importance for Latvian regions, where the total wage level is considerably lower.

Also the impact of the consumption taxes, including, excise increase, VAT changes, on the nominal consumption is neutral, namely, it will not reduce the total expenditure of the population for acquisition of the particular excise goods, however it might reduce the scope of consumption of separate excise goods.

Tax reform package also provides for equating the PIT rates for various types of income. These measures, along with the raise of the minimum wage, do not leave direct considerable impact on the consumption growth, however they play a significant role in the context of combating shadow economy, preventing the possibilities to optimise tax payments, by disclosing different types of income. Equating tax rates also reduces the current inequality, when the tax rate for the part of the better off population obtaining income from their capital gains is lower than that of the working population for labour income.

In turn, the purpose of the CIT reform proposal is to promote the development of national economy, by stimulating the enterprises to retaining larger share of profit in the enterprise and promoting the growth of investments. By introducing 0% rate for the retained profit, the enterprises will have additional motivation and possibility to perform investments, for example to increase the production or service capacity, modify the production process.

Likewise, the profit retained in the enterprise will increase the amount of share capital and improve the balance of the enterprise, as a whole. Data on own funds of enterprises in Estonia show that the Estonian enterprises, in general, are much better capitalised, as compared to the Latvian enterprises. Therefore, there are grounds to believe that also the capitalisation of the Latvian enterprises will improve, besides they will be less motivated to hide the actual amount of profit. Thus, larger share capital, along with other entrepreneurial activity indicators (turnover, profit), will improve the approach of the enterprise to credit resources. In 2015 and 2016 the amount of the newly issued loans to enterprises grew, respectively, by 21% and 33%. By implementing the CIT reform, the amount of the newly issued loans over the next three years might grow by 5 percentage points sharper than in the baseline scenario, giving additional impetus for corporate investments.

As the balances of the enterprises improve, additional factor stimulating the investments could be the acceleration of the EU funds investments flow, on average, by 50 million euro per year, also increasing the corporate investments, as compared to the baseline scenario.

By implementing the measures projected in the tax policy reform, as well as if the positive development in the key Latvia's foreign trade partners is preserved and the EU funds inflow accelerates, the actual growth of Latvian GDP, during the period of implementation of the reform, by 2020 might reach 5%, as compared to the 3% growth provided for in the current Latvia's Stability Programme for 2017 - 2020 scenario.

The Bank of Latvia has carried out the modelling of the impact of some of the main tax reform measures (equating of the PIT and CIT rates), by means of the general equilibrium calculation model, entailing 32 sectors, 55 product groups and seven end consumer categories. On the fiscal side, it includes five types of government expenditure and five revenue sources, *inter alia*, four most important taxes - PIT, MSSIC, VAT and excise tax. The impact of the CIT changes has been modelled, by means of the assessed dynamic stochastic general equilibrium (DSGE) model with financial frictions and including the unemployment parameter in the model[12]. Figure 3.4 reflects the cumulative impact of the reform measures, as compared to the current situation:

[12] Tax Strategy 20/20: *https://www.makroekonomika.lv/nodoklu-strategija-2020*

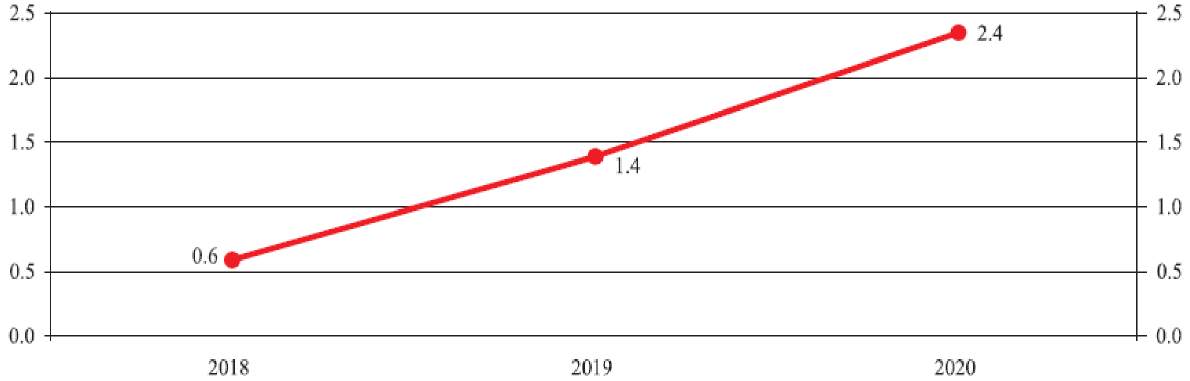

Figure 3.4. The cumulative impact of the reform measures on the GDP, as compared to the current situation, modelled by the Bank of Latvia

The MoF assessment, carried out, taking into account all the reform measures, as presented in Figure 3.5 and Table 3.12:

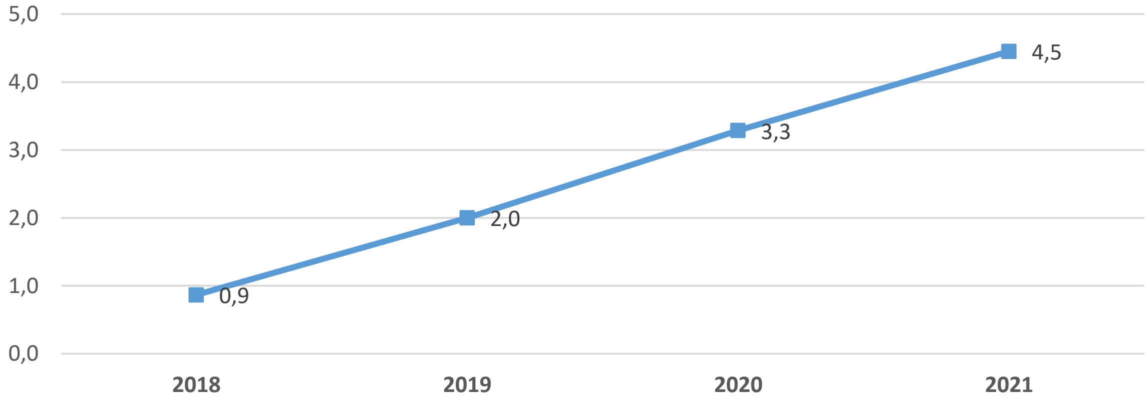

Figure 3.5. The cumulative impact of the reform measures on the GDP, as compared to the current situation, modelled by the MoF

Table 3.12. Macroeconomic impact of the tax reform

		Baseline scenario, Latvia's Stability Programme for 2017-2020, %				Tax reform scenario's full impact, %				Changes to the baseline scenario			
	2017	2018	2019	2020	2021	2018	2019	2020	2021	2018	2019	2020	2021
Real growth rate, %													
GDP	3,2	3,4	3,2	3,0	3,0	4,3	4,4	4,3	4,2	0,9	1,2	1,3	1,2
Nominal growth rate, %													
GDP		5,2	6,0	5,7	5,7	6,1	7,1	7,0	6,9	0,9	1,2	1,3	1,2
Private consumption		5,0	4,3	4,1	4,1	6,1	4,7	4,5	4,6	1,1	0,4	0,5	0,5
Government consumption		4,5	4,4	4,1	4,1	3,5	3,9	4,1	5,1	-1,0	-0,5	0,0	1,0
Gross fixed capital formation		41,7	16,0	13,3	13,3	50,5	17,5	14,7	16,8	8,8	1,5	1,4	3,5
Changes in inventories		-279,2	-5,0	-5,0	-5,0	-265,8	-10,0	-6,3	9,7	13,4	-5,0	-1,3	14,7
Exports of goods and services		7,7	7,8	8,2	8,2	7,7	9,3	9,9	9,3	0,0	1,5	1,7	1,1
..Exports of goods		7,9	7,6	8,3	8,3	7,9	9,3	9,9	9,3	0,0	1,7	1,6	1,0
..Exports of services		7,1	8,3	8,1	8,1	7,1	9,3	9,9	9,3	0,0	1,0	1,7	1,2
Imports of goods and services		12,0	10,0	9,6	9,6	14,3	10,6	10,2	11,1	2,4	0,7	0,6	1,5
..Imports of goods		11,9	9,8	9,8	9,8	14,3	10,5	10,2	11,1	2,4	0,7	0,5	1,3
..Imports of services		12,4	10,8	8,7	8,7	14,3	11,3	10,2	11,1	2,0	0,5	1,5	2,3
Nominal average wage		5,0	5,0	5,0	5,0	5,2	5,3	5,3	5,3	0,2	0,3	0,3	0,3
Nominal average wage, public sector		5,0	5,0	5,0	5,0	5,2	5,3	5,3	5,3	0,2	0,3	0,3	0,3
Operating surplus		5,6	6,9	6,2	6,2	6,5	8,1	7,5	7,4	0,9	1,2	1,3	1,2
Mln euro current prices													
GDP		27534	29175	30838	32596	27773	29759	31851	34047	239	584	1014	1451
Private consumption		17036	17766	18487	19237	17216	18021	18834	19696	179	255	347	459
Government consumption		4880	5097	5308	5528	4833	5024	5232	5501	-47	-73	-76	-27
Gross fixed capital formation		6500	7537	8539	9673	6905	8111	9303	10867	405	574	765	1194
Changes in inventories		-623	-592	-562	-534	-576	-519	-486	-534	47	73	76	0
Exports of goods and services		16023	17272	18692	20230	16023	17517	19248	21038	0	245	555	808
..Exports of goods		11552	12430	13456	14568	11552	12629	13877	15167	0	199	420	600
..Exports of services		4471	4842	5236	5662	4471	4888	5371	5871	0	46	135	209
Imports of goods and services		16281	17906	19626	21511	16627	18395	20279	22522	345	490	653	1010
..Imports of goods		13851	15213	16698	18329	14154	15644	17246	19153	303	431	548	824
..Imports of services		2430	2693	2927	3183	2473	2751	3033	3369	42	58	106	186
Nominal average wage		951	999	1049	1101	954	1004	1058	1114	2	5	9	13
Nominal average wage, public sector		1009	1059	1112	1168	1011	1064	1121	1181	2	5	9	13
Operating surplus		8938	9558	10152	10782	9015	9749	10485	11262	78	191	334	480

Indirect fiscal impact of the tax reform

Additional economic growth triggered by the tax reform creates positive fiscal impact (indirect fiscal impact) of **89 mln euro** in the first year of the reform, increasing by another **41 mln euro i**n 2019 and another **107 mln euro** in 2020. See Table 3.13.

Table 3.13. Indirect (macroeconomic) discretionary impact of the tax reform on revenue (according to accruals method)

Revenue/expenditure	ESA code	2018	2019	2020	information on assessment
PIT	D51	20.0	7.0	23.0	Impact assessment is carried out in accordance with the macroeconomic indicators of the tax scenario. As a result of the CIT and PIT reform, it is assessed that the funds at disposal of both the enterprises and the population will increase, therewith increasing the investments and consumption. Reduction of the labour tax burden, concurrently with the positive impact on private consumption, will reduce also the costs of enterprises, by increasing their competitiveness and improving the possibilities to attract labour force. The reduction of the labour costs may also stimulate the corporate investments, releasing additional own funds for such purposes. The CIT reform would create several positive effects on national economy, which, in turn, would increase the tax revenue in the State budget.
MSSIC	D61	30.2	10.5	34.7	
VAT	D211	35.0	10.0	30.0	
Excise Duty	D214A	2.4	1.2	2.4	
CIT	D51	0.0	10.0	15.0	
Gambling tax	D214F	0.4	0.3	0.3	
RET	D29A/D59	0.0	1.0	0.0	
Vehicle Operation Tax	D29/D59	0.2	0.2	0.2	
Customs Duty	D212	0.4	0.2	1.2	
Company light vehicles tax	D29	0.1	0.1	0.1	
Natural resources tax	D29	0.4	0.3	0.3	
Total:		**89.1**	**40.8**	**107.2**	

Total revenue dynamics of the tax reform shows the decline in revenue over the first two years of the reform, but in the third year of the reform the impact is neutral, and, starting from the fourth year, as a result of reform, the increase of revenue is forecasted in the general government budget.

Table 3.14. Total discretionary impact of the tax reform on revenue (accruals method)

	2017	2018	2019	2020
Discretionary direct impact	0	-234.7	22.5	-16.8
Discretionary indirect impact	0	89.1	40.8	107.2
Discretionary total impact	0	-145.6	63.3	90.4
Cumulative total impact	0	-145.6	-82.3	8.1

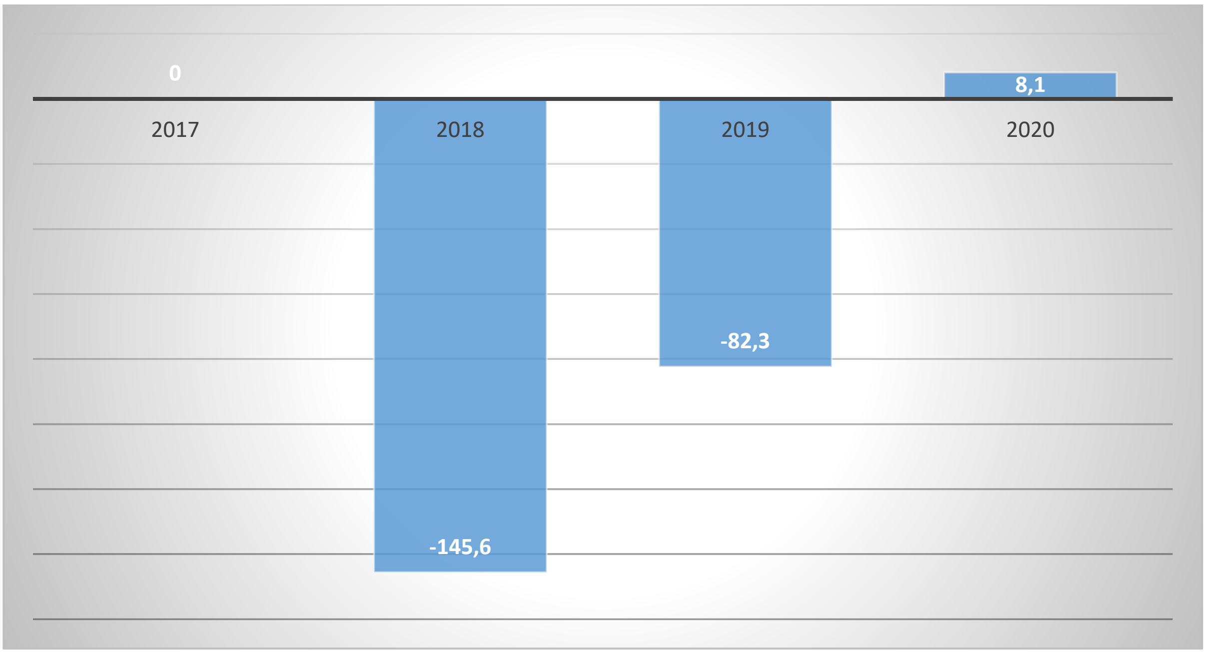

Figure 3.6. Cumulative impact of the tax reform on revenue (changes against the baseline scenario)

Impact of the tax reform on balance

Taking into account that there are several positions, where the changes in the tax policy cause more or less "automatic" increase of expenditure, these circumstances are to be considered, in order to assess the impact of the reform on the budgetary balance and, therewith, on the available fiscal space for other policy initiatives.

The fiscal assessment of the tax reforms takes into account that (1) by increasing the minimum monthly wage, it is necessary for the public administration to increase expenditure for funding this measure, (2) as the MSSIC increase, the contributions to the second pension pillar automatically increase, (3) as the MSSIC increase, the expenditures from the social budget automatically increase. In addition to the above mentioned, expenditure related to the tax reform also include the additional expenditure for maintenance of the roads. It is also planned that the revenue short-fall related to PIT reforms is reimbursed to the local governments, being assessed against the baseline scenario, but restricting that the local government revenue remains in the constant proportion against the total general government revenue.

Table 3.15. Discretionary impact of the tax reform on expenditure (cash flow method)

Revenue/expenditure	ESA code	2018	2019	2020	Information on assessment
Expenditure growth for ensuring the raise of minimum wage		-32.2			Raise of the minimum monthly wage from 380 to 430 euro
Expenditure growth, arising out of the growth of contributions to the special budget		-27.0	-4.0	-9.7	
Expenditure growth for road maintenance		-25.0	0.0	0.0	
Expenditure correction for local governments		24.9	-5.3	-27.0	
Total:		**-59.3**	**-9.3**	**-36.7**	

It should be noted that in the provided estimates the contributions to the second pension pillar are excluded from the revenue from the MSSIC.

Table 3.16. Total discretionary impact of the tax reform on balance

2018	2019	2020
-204.9	**54.0**	**53.7**

As shown, if the impact of the tax reform measures on the revenue dynamics gives a positive effect already in the third year of the reform, the total negative fiscal effect, including also the expenditure growth, comprises about 200 million euro for the first year of the reform, and then it continues to diminish, on average, by 50 million euro, reaching the neutral effect in the fifth year of the reform.

Tax reform and expenditure for maintenance of motor roads

Tax reform also includes the increase of expenditure for maintenance of motor roads. On the one hand, the tax reform, as a compensatory measure, provides for the increase of the excise duty on fuel, with total fiscal effect of 30 million euro in 2018. On the other hand, Latvian government has adopted the decision on introducing amendments to the *Law on Motor Roads*, providing for a stable increase of funding for maintenance of motor roads, and these rules prescribe to increase the motor road maintenance funding in 2018 by 25 million euro. At the same time, there are discussions regarding the necessity to restore the motor road fund as a special budget. Even though the decision on linking the motor road fund funding with the excise duty is not yet adopted, the MoF in its tax reform package is willing at least theoretically mark the planned increase of the excise duty with the planned additional funding for maintenance of motor roads.

3.2.5. Fiscally Significant Structural Reforms within the Meaning of Regulation No 1175/2011

3.2.5.1. Reform of the pension system

In 2012, amendments were made to the *Law on State-Funded Pensions* prescribing a gradual increase in the contribution rate to the second pillar of the pension system, i.e., amounting to 4% in 2013 - 2014, 5% in 2015 and 6% in 2016. The policy does not change. In view of this, Latvia continues to use the possibility of deviation from MTO prescribed by SGP, when implementing these structural reforms.

The pension reform, however, is more extensive and comprises also other measures apart from the increase in the contribution rate to the second pension pillar.

Fiscally the most substantial structural reforms are related to improvements of the pension system. In 2012, amendments were introduced to the *Law on State-Funded Pensions* prescribing:

- gradual increase in the retirement age up to 65 years: as of 1 January 2014 it will increase by 3 months annually, reaching a retirement age of 65 from 1 January 2025;
- simultaneously with the increase in the retirement age, the early retirement age also will be increased from 1 January 2014;
- increase in the minimum period of insurance for entitlement to the state retirement pension to 15 years as of 1 January 2014 and to 20 years as of 1 January 2025.

On 3 April 2014, the Saeima adopted the law *Amendments to the Law on State-Funded Pensions*, according to which changes in the pension indexation procedure have come into force, prescribing:

- to index on 1 October 2014 the amount of the state pension or its part thereof that does not exceed 285 euro, taking into account the actual CPI and 25% of the real increment rates of insurance contributions wage;
- to index hereinafter once a year on 1 October the amount of the state pension or its part thereof that does not exceed 50% of the average insurance contributions wage in the state for the previous calendar year (rounded-off to whole euro), taking into account the actual CPI and 25% of the real increment rates of insurance contributions wage.

The fiscal impact of the above mentioned changes in the pension indexation procedure on the general government budget balance compared with the *Framework Law for 2014 - 2016* was estimated respectively 0.01% of GDP in 2014, 0.04% of GDP in 2015 and 0.08% of GDP in 2016.

In turn, on 10 March 2016 the Saeima adopted the law *Amendments to the Law on the State Pensions*, prescribing that starting from 2017 the indexation of the state pensions shall take into account 50 per cent (instead of the previous 25%) of the real increment rates of insurance contributions wage. The fiscal impact on the general government budget balance compared with the *Framework Law for 2016 - 2018* is estimated respectively 0.01% of GDP in 2017, 0.06% of GDP in 2018 and 0.11% of GDP in 2019. Taking into account the estimated fiscal impact it can be concluded that these changes will not cause a significant effect on the sustainability of public finances. Even though the EC has not yet published a more updated *Fiscal Sustainability Report*, where the above described changes in the pension indexation system would be assessed, in accordance with the EC 2016 autumn forecasts Latvia still rank among the low risk countries in terms of the sustainability of public finances.

3.2.5.2. Reform of the Health System

In the Stability Programme 2016 – 2019 Latvia declared reform of health system as a significant structural reform with a long-term positive effect on the sustainability of public finances, with a view to use in this reform the possibility of deviation from MTO provided in the EC Communication. The EC reviewed Latvia's declaration and supported granting the deficit deviation for the health system reform. In order to comply with the structural deficit safety margin with respect to the reference value in amount of 3% of GDP[13] defined by the

[13] For Latvia this index is determined in amount of 1.7% of GDP.

Treaty on the Functioning of the EU, 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.

Table 3.17. Permissible budgetary deficit deviation for implementation of the health system reform, %

		2013	2014	2015	2016	2017	2018	2019	2020
MTO		-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00
Pension reform	from 2% to 4%	-0.50	-0.50	-0.50	0.00				
	from 4% to 5%			-0.27	-0.27	-0.27	0.00		
	from 5% to 6%				-0.29	-0.29	-0.29	0.00	
Maximum structural balance		-1.80	-1.80	-1.80	-1.80	-1.69	-1.69	-1.69	
Health reform deficit deviation						**-0.13**	**-0.40**	**-0.50**	

It should be noted that currently there are three reforms in the healthcare sector on the agenda in Latvia:

1. Implementation of the Public Health Guidelines for 2014 - 2020;
2. Reform of the health system administration;
3. Reform of the health funding.

Implementation of the Public Health Guidelines for 2014 - 2020

Deficit deviation was requested and received for the implementation of the Public Health Guidelines for 2014 - 2020. The healthcare reform is being implemented from 2014 in accordance with the Public Health Guidelines for 2014 - 2020 approved by the Cabinet, and the main 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.

Weaknesses of the Latvian health system mainly refer to the following indicators:

- **Low public funding.** The amount of public funding for health as a percentage of GDP is significantly below the EU average and points to insufficient funding for this sector (see Figure 3.7).
- **Inequality.** The proportion of public funding of the total funding for the health financing system is considerably below the EU average (in Latvia – 63,2%, in the EU – 77,8%)[14]. This means that availability of medical services more than in other countries depends on person's income.
- **Large number of premature deaths due to health problems.** In 2015, the total PYLL (0 - 64 years) was 5 541 years per 100 000 inhabitants, which is a high indicator among the developed countries. A significant part of this indicator can be explained by health problems.

[14]World Bank, 2014.

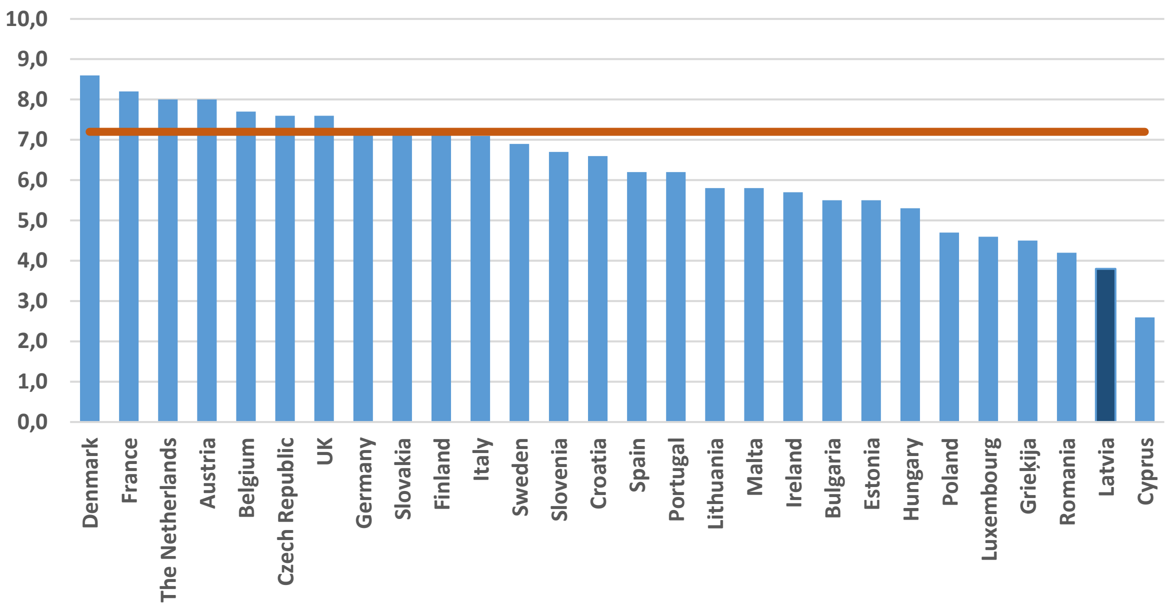

Figure 3.7. Public expenditure for healthcare in 2015 in the EU member States, [15], % of GDP

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.

The above mentioned Latvian health system challenges have been identified already in the context of the country-specific recommendations 2014, when the Council pointed out that limited progress is achieved in improving cost-effectiveness, quality and accessibility of healthcare system. Besides, it is pointed out that there is a clear under-financing of the healthcare sector that negatively affects access to healthcare services for vulnerable members of society.

In the country-specific recommendations 2015 the Council has repeatedly recommended to Latvia to improve the availability, cost-effectiveness and quality of the healthcare system. The analysis of fulfilment of the recommendations states that accessibility to healthcare services has been reduced for a major part of population, which is due to a small public funding to sector, high patient co-payments, as well as the weak care coordination and sector effectiveness level.

In the country-specific recommendations 2016 the Council repeatedly recommends to Latvia "to improve the availability, quality and cost-effectiveness of the healthcare system". In the analysis of the fulfilment of recommendations the EC points out that the access to healthcare is impeded by a low public funding and considerable payments to be performed by the patients themselves, therefore the healthcare needs of a major part of population are not being satisfied. Poor health condition causes loss of the potential labour force. The current progress in improving the accessibility of the healthcare system has been assessed as limited by the EC.

Within the scope of development of Public Health Guidelines for 2014 - 2020, the Ministry of Health commissioned a study “Evaluation for the Development of the Public Health Guidelines 2014 - 2020”, developed by the University of Latvia. Within the scope of the study **the evaluation was carried out with respect to the economic benefit** of the target indicators to be included in the Public Health Guidelines for 2014 - 2020, following from NDP 2020. As a result, we conclude that by ensuring the necessary funding for achievement of the reduction

[15]Data source: *Eurostat*

of the PYLL rate stated in NDP 2020 by 2020, the discounted economic benefit value in 2014 will comprise 137.4 million euro. At the same time, the study specifies that a positive effect on the national economy would be created by the persons "saved" up to 2020 for the next 20 years to provide productive return as a labour force, thus ensuring the GDP growth at least in the amount of 443.8 million euro (the discounted value of 2014). Within the scope of the study also the **cost-benefit analysis** was carried out, resulting in the finding that the additional amount of expenditure to be allocated for achievement of the target for the age group of up to 64 years for the period from 2013 – 2020 at present value comprises 577 million euro. Therewith, according to the study it can be concluded that additional estimated amount of expenditure from 2013 to 2020 exceeds the economic benefits of the respective period.

Table 3.18. Summary of the cost-benefits analysis of the study, mln euro

Indicator	Economic benefit		Costs
	2013 - 2020	2013 - 2040	2013 - 2020
PYLL reduction until 2020 according to NDP 2020 – pessimistic scenario[16]	137.4	443.8	577
PYLL reduction until 2020 according to NDP 2020 – realistically optimistic scenario[17]	254.9	823.5	

Looking at the results of the study from the perspective of cost-efficiency of the implemented reforms, it is concluded that until 2020 in case of the pessimistic scenario 10, 059 PYLL will be prevented, but in case of realistically optimistic scenario – 18, 666 PYLL, so the average cost per PYLL prevented in this age group is respectively 57, 361 euro in case of pessimistic scenario and 30, 925 euro in case of realistically optimistic scenario.

According to the performed estimate successful implementation of the health reform till 2023 will ensure the growth of GDP rate by 2.2% and will increase the employment of population by 0.6%. In turn, the positive impact of the reform till 2038 might ensure the growth of GDP rate already by 11.28% and the growth of employment, respectively, by 1.82%. In light of fiscal costs, net positive impact on national economy in 2038 will reach 3.87% of GDP.

As compared to other sectors, Latvia during the period of time from 2014 to 2019 has managed to ensure significant increase of funding for the healthcare sector. It has been specifically attained, by means of the SGP flexibility clause in the implementation of the health reform.

Table 3.19. Additional funds allocated in the health sector according to the medium-term budget framework laws, mln euro

	2014	2015	2016	2017	2018	2019	2020
Framework Law for 2014 - 2016	42	48.9	51				
Framework Law for 2015 - 2017		30.6	30.6	30.6			
Framework Law for 2016 - 2018			23.3	23.3	23.3		
Framework Law for 2017 - 2019				34.3	110.7	146.6	
Additional expenditure increase in comparison with previous year (cumulative)	42	37.5	25.4	34.3	76.4	35.9	

With the above mentioned increase of the funding Latvia has, in general, managed to ensure the growth of funding for the healthcare sector in accordance with the growth of funding planned in the Public Health Guidelines for 2014 - 2020.

[16]The amount of benefits, assuming that the aim of NDP 2020 to reduce PYLL (up to 64 years of age) indicator to 5 300 per 100 000 inhabitants in 2020 is fulfilled.

[17]Amount of benefits, assuming that the PYLL reduction forecasted by the Centre for Disease Prevention and Control till 4 786 years per 100 000 inhabitants is achieved in 2020.

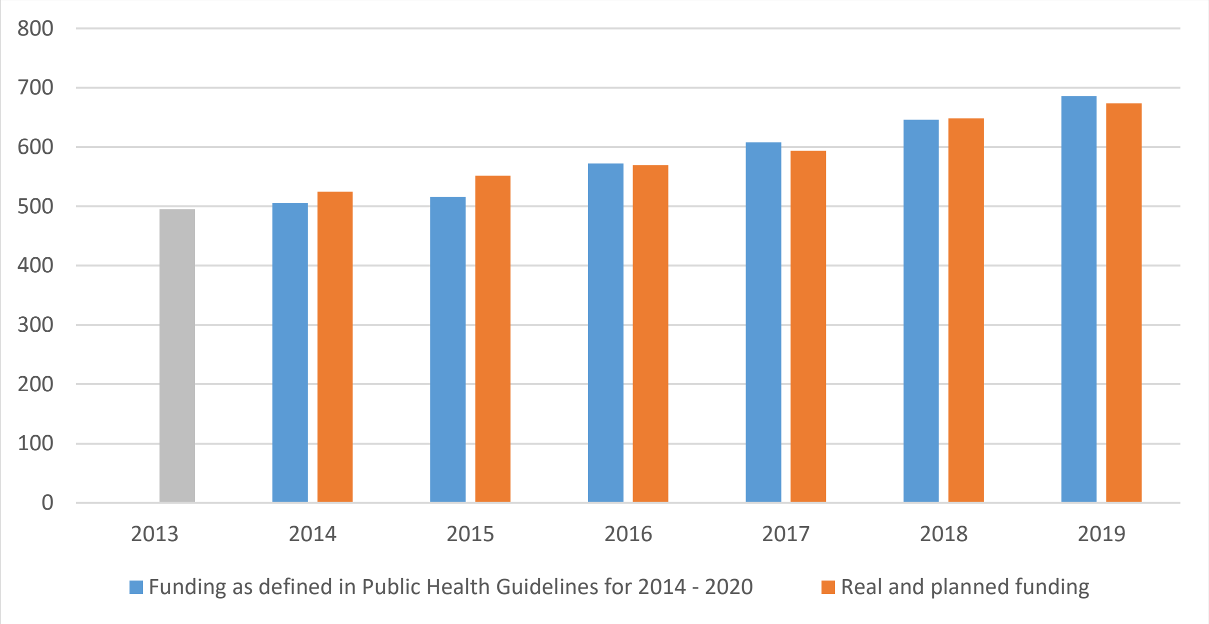

Figure 3.8. Scenario of the growth of funding applied in the Guidelines and the actual growth of funding[18]

Scenario shown in the figure was used in the previous Stability Programme, 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 that the assessment of the fiscal impact of the reform provided for in the previous Stability Programme remains effective and the achievement of the PYLL objective is ensured.**

Deficit deviation funding for the period of 2017 - 2019, which is available due to implementation of the healthcare reform - implementation of the Public Health Guidelines 2014–2020 - is being used for a group of certain healthcare measures, arising out of the Public Health Guidelines 2014–2020. This group of measures is separated from the rest of measures for improvement of healthcare, stipulating a special procedure for granting and supervision of allocation of resources. Deficit deviation of 2017 of 0.13% of GDP (34 million euro) in the law *On the State Budget for 2017* was distinguished in the separate budget programme, as the financing to be redistributed as a result of the annual State budget execution. For the Ministry of Health it was redistributed in two stages - on 20 December 2016 and on 14 February 2017 with separate Cabinet decisions, on the basis of informative notifications, coordinated with the MoF and specifying the output and outcome indicators. Decisions of the Cabinet minutes provide that the Ministry of Health shall control the fulfilment of the outcome indicators specified in the informative notification and by 1 September 2017 shall submit to the MoF the progress report in achievement of the output indicators in the first half of 2017 and by 1 March 2018 - on the fulfilment of the output indicators in 2017. The Ministry of Health must carry out the data accumulation, in order to ensure the audit traceability for the fulfilment of the output indicators. It is planned that Latvia will provide information to the EC on the use of the deficit deviation in the first half of 2017, by submitting the draft budget plan.

When choosing the health reform measures, for which the deficit deviation funding is to be used, the following criteria are set:

1. The measure must correspond to the Public Health Guidelines 2014 - 2020;

[18]The total MoH budget for core functions, mln EUR, 0-64 years: scenario in accordance with the study of the University of Latvia: "Evaluation for the Development of the Public Health Guidelines 2014 - 2020" and the actual growth of funding for the above mentioned target group, including the deficit deviation funding.

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 healthcare system. Measures, which provide for an insignificant effect in solving the problem, may not be financed - such intervention is not to be regarded as reform;
3. Problem to be solved must be recognised as the healthcare problem in the EC analytical documents;
4. It is possible to create a traceable inputs - outputs - outcome indicator system.
5. The solvable problem provides for an input to achievement of a positive fiscal effect of the Public Health Guidelines 2014 - 2020.

On the basis of the above mentioned criteria, the Cabinet adopts the decision to finance the following health reform measures from the deficit deviation funding in 2017:

1. *Measure. Improvement of availability of diagnostics and treatment of oncological diseases*

In the structure of causes of death in 2015 the oncological diseases comprised 21.3% out of all death cases in Latvia. Taking into account this situation, the prophylaxis (popularising healthy nutrition and physical activities, reducing the addictive substances and processes in the society), diagnostics and treatment of oncological diseases is marked also in the Public Health Guidelines 2014 - 2020, providing for the development and introduction of the guidelines for healthcare chains in the priority healthcare fields, for improvement of the healthcare availability and quality, *inter alia*, in oncology.

The measure consists of 6 activities and provides for a substantial improvement of the availability of diagnostics and treatment of oncological diseases, **increasing the number of services on average by 56%**.

Table 3.20. Measure 1 Improvement of availability of diagnostics and treatment of oncological diseases. Input and output indicators.

	Average costs per service	**Planned financing**		**Financing to be additionally granted**	**Planned number of services**		**Planned number of services by allocation of**
	(*euro*)	**2016** (*euro*)	**2017** (*euro*)	**2017** (*euro*)	**2016**	**2017**	**2017**
Introduction of the primary diagnostics algorithms	68 159	-	-	**1 499 506**	-	-	**22 000**
Increase of the costs for specialist consultations according to the set algorithms	59 116	1 861 209	1 861 209	**650 278**	31 484	31 484	**42 484**
Introduction of the secondary diagnostics and examination algorithms	159 120	-	-	**2 332 565**	-	-	**14 659**
Increase of the number of oncology patents and the forecasted medical treatment	356 297	5 890 295	5 890 295	**1 178 058**	16 532	16 532	**19 838**

costs in outpatient care							
Increase of the number of oncology patents and the forecasted medical treatment costs in inpatient care	714 883	24 630 580	24 630 580	**2 463 058**	34 454	34 454	**37 899**
Increase of the patients who have received reimbursable medicines and resources in oncology	920 960	20 695 813	20 695 813	**4 138 795**	22 472	22, 472	**26 966**
Sum total		**53 077 897**	**53 077 897**	**12 262 260**	**104 942**	**104 942**	**163 846**

Better diagnostics and availability of medical treatment of oncological diseases will allow identifying and starting the treatment at the earliest stage of the disease.

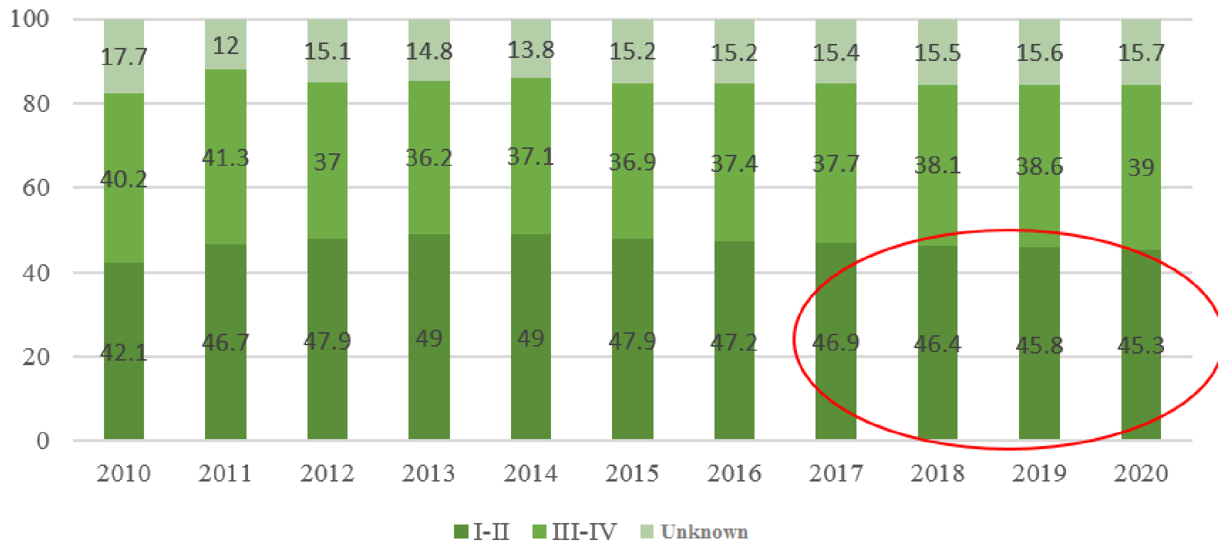

Figure 3.9. Breakdown of patients by stages at the moment of diagnosing the malignant tumour, if Measure 1 is not implemented. *Source: Centre for Disease Prevention and Control (CDPC)*

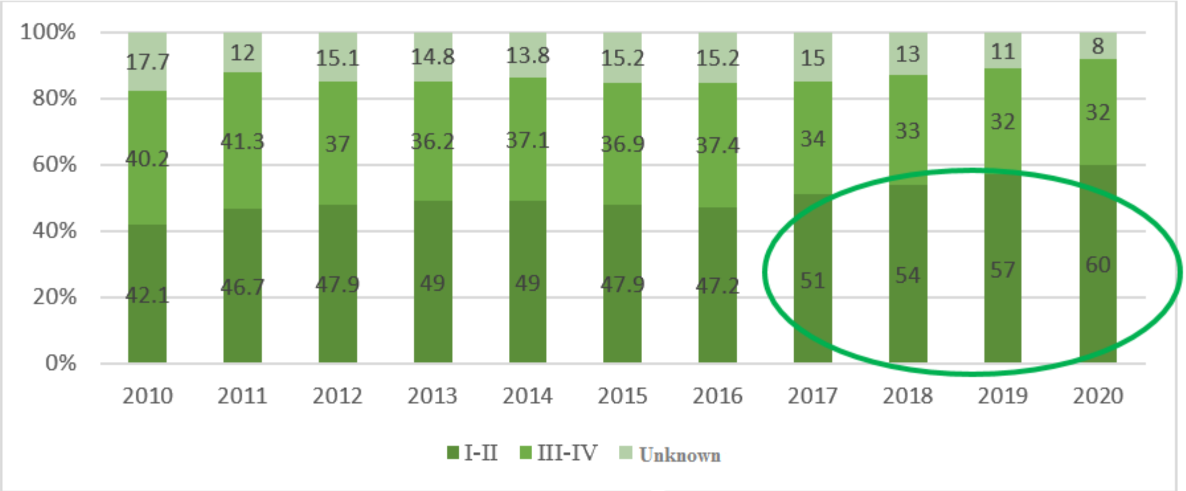

Figure 3.10. Breakdown of patients by stages at the moment of diagnosing the malignant tumour, if Measure 1 is implemented. *Source: CDPC*

By the accessibility to diagnostics of the oncological diseases improved as a result of the reforms it is possible to forecast the reduction of the indicators of the PYLL due to tumours.

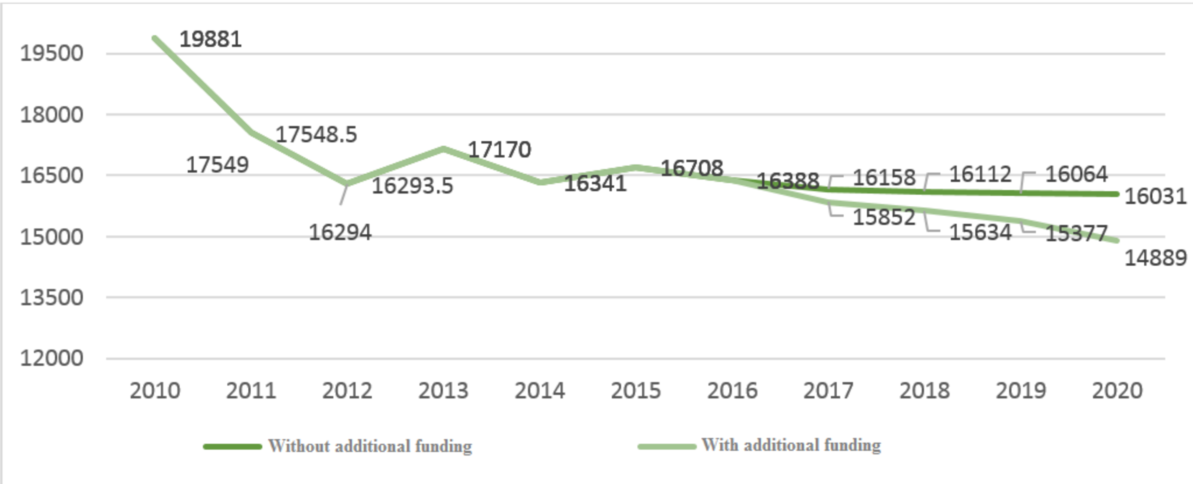

Figure 3.11. PYLL due to tumours. *Source: CDPC*

As already mentioned herein above, by implementing the Public Health Guidelines, the average costs per each prevented PYLL range between 30 to 60 thousand *euro*. The efficiency of implementation of Measure 1 is **32 thousand *euro* per each prevented PYLL**.

Funding granted from the deficit deviation in amount of 12 million euro, as a result of successful implementation of the reform measure will be granted also in 2018 and 2019 and it is planned that starting from 2020 it will be included in the budgetary base. At present the decision on granting 12 million euro for 2018 and 2019 will depend upon the progress of implementation of the measure.

Measure 2. For reducing queues to specialists, diagnostic examinations, day patient facility and outpatient rehabilitation

Patient demand for outpatient examinations and specialist consultations significantly exceeds the State funding allocated for this purpose. Thus, for example, in order to receive specialist consultation, as on 1 December 2016 the patient waiting queue to endocrinologist is up to 117 days, to gynaecologist - up to 75 days, to cardiologist - up to 133 days, to rheumatologist - up to 107 days, to ophthalmologist - up to 150 days, to traumatologist, orthopaedist - up to 97 days, to vascular surgeon - up to 146 days, to urologist - up to 114 days, to child surgeon - up to 30 days, to micro-surgeon - up to 70 days, to cardiac surgeon - up to 31 day, to pneumonologist - up to 75 days, to otolaryngologist - up to 62 days, to narcologist - up to 31 day, to neurologist - up to 92 days. As a result of encumbered accessibility of tests, exact diagnoses for patients are belated and it is not possible to ensure quality supervision of the course of diseases.

The purpose of Measure 2 is to reduce the volume of queues - both to receive the specialist consultation and to carry out the diagnostic tests and manipulations.

Table 3.21. Measure 2. Reducing queues to specialists, diagnostic tests, day patient facility and outpatient rehabilitation. Input and output indicators.

	Average costs per treatment	**Planned financing**		**Additional financing**	**Planned number of services**		**Planned number of services by allocation of financing**
	(*euro*)	**2016** (*euro*)	**2017** (*euro*)	(*euro*)	**2016**	**2017**	**2017**
Specialist consultations	12 530	24 962 514	28 104 954	3 386 187	1 992 204	**2 243 013**	**2 513 259**
Outpatient tests and therapy	22 987	42 405 017	42 405 017	7 541 491	1 844 705	**1 844 739**	**2 172 815**
Services rendered in the day patient facility	82 648	38 319 547	39 677 107	5 163 159	463 650	**480 073**	**542 545**
Outpatient rehabilitation	7 261	5 104 087	5 104 087	508 470	702 919	**702 945**	**772 973**
Sum total		110 791 165	115 291 165	16 599 307	5 003 478	**5 270 770**	**6 001 592**

It is forecasted that, as a result of implementation of Measure 2, the number of services will grow from 5 270 770 to 6 001 592 or by 14%. The Ministry of Health has assessed that, as a result of this increase in the number of services, the queue will reduce by 25%. For the queue not to grow again, the funding of Measure 2 in amount of 16.6 million euro must to be granted also in the subsequent years and starting from 2020 it must be included in the budget base.

It should be noted that the growth of the number of services of 14% or the education of queues of 25% is not sufficient, in order to ensure, by intervention of Measure 2, the solution or significant reduction of the problem - the queues and waiting times are still inadequate. At the 14 February 2017 Meeting of the Cabinet the decision was adopted that, within the scope of the health reform, the reduction of the queues for the secondary outpatient healthcare services is to be continued in 2018 and 2019, until the average amount thereof reduces by at least 50%. In this respect, the Cabinet assigned to the Ministry of Health to prepare and by 18 March 2017 to submit to the Cabinet the informative notification, containing the analysis and proposals on the measures to be taken and the additionally required funding, in order to ensure further reduction of queues for the secondary outpatient healthcare services, without reviewing the service fee tariffs, including the forecasts on changes of the proposal due to the change in the patient behaviour, by choosing the state-paid services. It should be noted that at the moment of preparation of the Stability Programme the said informative notification is not yet submitted to the Cabinet, and, therewith, it is not described.

The correlation between the number of the rendered services and the volume of the queue is not simple. The volume of the queue is determined both by the supply and the demand for the state-paid services. On the supply side, apart from financial resources, the second restricting factor are the available human resources.

In December 2016 the National Health Service has carried out the survey of the service providers regarding the possibilities to henceforth provide additional outpatient healthcare services.

Table 3.22. Possibilities of medical treatment institutions to provide additional healthcare services

No.	Type of services	Number of services per year
1	Tests	615 663
2	Rehabilitation services	334 154
3	Specialist consultations	550 548
4	Day patient facility	113 640
	Total	**1 614 005**

Source: NHS, Data of the December 2016 Survey

According to the data of these surveys, there is a possibility to significantly increase the supply of the state-paid services also by the existing volume of human resources. Nevertheless, further increase of the state-paid services is possible, if the number of medical personnel providing state-paid services increases. The health policy makers consider that it can be achieved, by increasing the service provision tariff.

On the demand side, it can be forecasted that the reduction of the queues will change the patient behaviour and part of the patients, currently receiving the service at their own expenditure, might choose to wait for the state-paid service, which would correspondingly increase the queue. Along with the decline in the demand for the privately paid service, it is possible that the medical personnel might migrate to the field of the state-paid services. Taking into account that the healthcare services funded by the state and own funds are not identical, it can be projected that, as a result of implementation of Measure 2, the structure of the lengths of queues will change. Currently it is planned that the above mentioned processes will be modelled, in order to resolve upon the particular measures to be financed from the deficit deviation in 2018 and 2019, to achieve the reduction of the queues in the most effective way.

By allocating the funding to the secondary outpatient healthcare services, to availability thereof would improve, resulting in better health indices in society, reducing the PYLL.[19] By currently planned Measure 2 funding, assuming that it will be granted in the same amount also in 2018 and 2019, it is forecasted that in 2019 the PYLLL would reduce by 804 years. The efficiency of the measure is **60 thousand euro per one prevented PYLL.**

[19] The total impact of intervention is assessed, taking into account the diversity of the outpatient services and the impact thereof on various disease diagnoses.

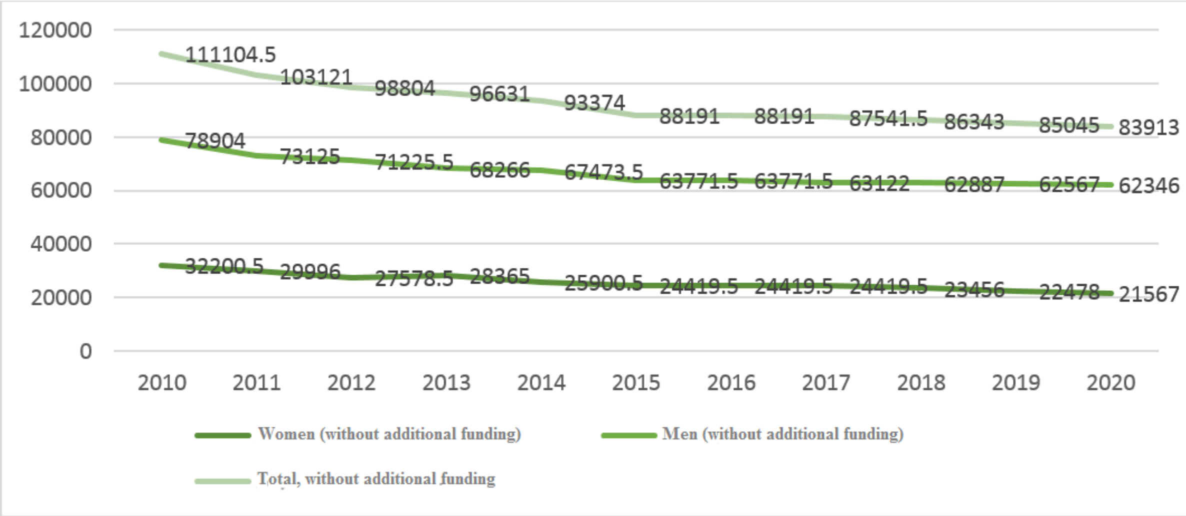

Figure 3.12. PYLL forecast, if Measure 2 is not implemented

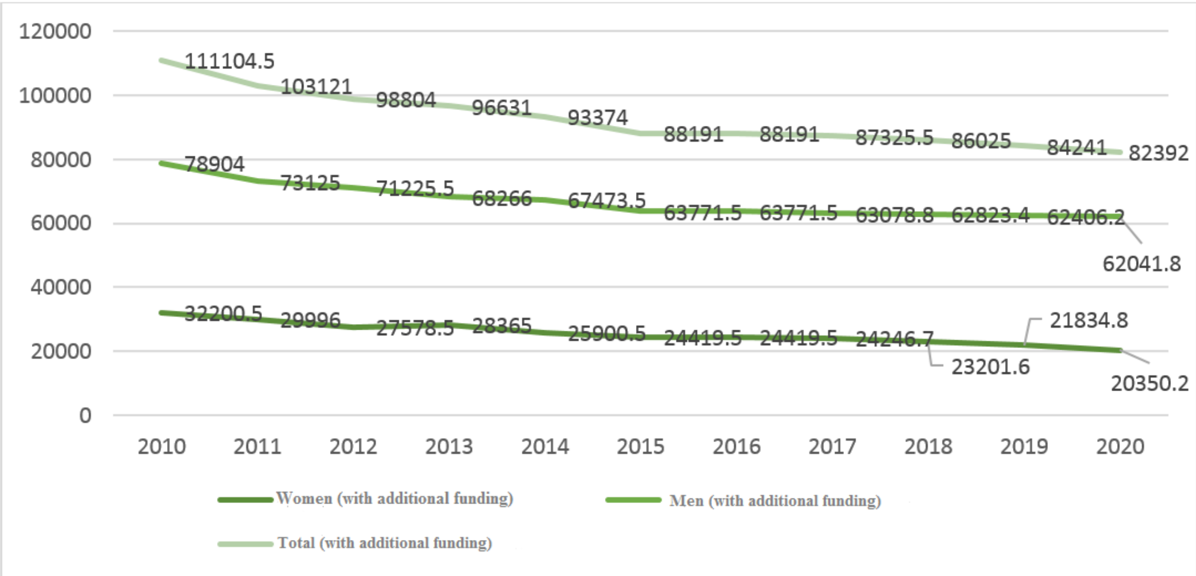

Figure 3.13. PYLL forecast, if Measure 2 is implemented

Measure 3. Reforms for ensuring the State reimbursable medicines for VHC patients at F3-F4 stage.

The task of the system of reimbursement of the State-paid acquisition of medicines is to ensure the corresponding necessary medicines mainly for the patients suffering from chronic diseases, taking into account the nature and level of severity of the disease, as well as the medicinal devices, as a result of the use whereof it would be possible to extend the lifespan or the period of well-controlled features of the disease of the patients with chronic diseases, to minimise the frequency of acute conditions, reduce the risk of disability, number of hospitalisation cases due to acute conditions or complications of a chronic disease, as well as to control and improve the health condition.

The purpose of the reform is, by contributing additional State funds, to continue the launched reform in ensuring the availability of medicinal product and, at the same

time, improving of the epidemiological situation in the State, by structurally changing the approach to the organisation of the VHC patient care and treatment.

When modelling the VHC spread in public, in the study carried out by the infectious diseases specialists it was concluded that the VHC antigen is to be detected in the blood of 1.7% of Latvian inhabitants. More than 1 000 newly discovered VHC infection cases are registered each year. In majority of these people the VHC is in the latent form, meaning that they do not have the clinical manifestations of the disease, but they are infectious, and in the long run these people might become the VHC patients with liver damage of various stages.

According to the studies of the World Health Organisation, 33% of the VHC infected persons over the period of 30 years develop the hepatic cirrhosis or malignant liver tumours, which are severe liver diseases and restrict the working capacities of a person, and lead to a lethal outcome [20]. Therefore, in May 2016 at the World Health Assembly 194 countries, including Latvia, adopted the Global health sector strategy on viral hepatitis restriction, **containing the commitment by 2030 to liquidate VHC as the public health problem** and to achieve that 80% of the infected persons receive the treatment.

Latvian experts, in collaboration with the representatives of the Center for Disease Analysis[21], carried out the calculations, which demonstrate - if a sufficiently effective VHC treatment would not be ensured in Latvia, there is a risk present that in 2030 almost 50 thousand patients would be infected with VHC in Latvia, out of which about 10% VHC patients (5 000 VHC patients) would have hepatic cirrhosis, hepatic cirrhosis at a decompensated stage, liver cancers or the need to perform liver transplantation. Patients with hepatic cirrhosis, decompensated hepatic cirrhosis and liver cancer are disabled persons, who are not capable to work and considerable State budget financial resources are expended for their treatment.

As shown by the data of the Centre for Disease Prevention and Control, the majority of the VHC infected persons are in the age from 18 - 60 years.

Referring to the results of clinical studies, proving that by applying the interferon containing treatment schemes at VHC F3/F4 stage, the curing is ensured only in 70% and less cases, but by choosing to apply in the therapy of these patients **the direct effect interferon-free aids, the curing of VHC is ensured in 95% and more cases,** as well as taking into account that the duration of the interferon containing therapy is longer (24 weeks and more) than the course of treatment with direct effect antivirus aid (8 - 12 weeks), as well as, having assessed the impact of both treatment schemes on formation of complications and risk not to complete the course of treatment due to generated side effect, in Measure 3 it is basically planned to apply in the treatment of VHC the schemes of medicines involving direct effect interferon-free preparations.

[20] Global health sector strategy on viral hepatitis 2016-2021

[21] A US based public health research company, with the main areas of expertise being epidemiology and disease spread modelling, including the analysis of economic impact of diseases. http://centerforda.com/about_us.htm

Table 3.23. Planned allocation of the State reimbursable medicines for the treatment of VHC, within the scope of Measure 3

	Average costs per treatment	Planned financing		Additional financing	Planned number of services		Planned number of services by allocation of
	(euro)	**2016** *(euro)*	**2017** *(euro)*	*(euro)*	**2016**	**2017**	**2017**
Reimbursable medicines for treating hepatitis C	26 842	6 600 000	5 100 000*	5 462 883	**228**	**190**	**393**

* *According to that which is stated in the abstract of the 8 December 2015 Cabinet Regulation No. 706 Amendments to the 31 October 2006 Cabinet Regulation No. 899 Procedures for the Reimbursement of Expenditures for the Acquisition of Medicinal Products and Medicinal Devices Intended for Out-patient Medical Treatment, the funding for ensuring the VHC next generation therapy in 2017 has been granted by 1, 486, 168 euro smaller amount that in 2016.*

The implementation of Measure 3 will increase the number of services by 100%.

By ensuring additional therapy for 203 patients, **30% of the VHC patients recorded in stage F3 - F4 in 2015 and 2016** will be additionally treated, which, together with the existing funding, will ensure the **treatment of 57% of patients**. According to information provided by the specialists of the Riga Eastern Clinical University Hospital, therewith the mortality from VHC will be reduced by 8% or 11 patients, whereas the total number of the infected would reduce by 4% or **1 600 infected, reducing the mortality by another 117 patients.** 50% of the VHC patients are at stage F3-F4, being potentially incapacitated population. Therewith, by promoting the treatment for F3-F4 stage patients, they are returned to the labour market. PYLL are reduced by 1 433 years in accordance with the forecasted age structure of the deceased. Reform for the VHC patients treatment will additionally also in 2018 and 2019, when, after having cured of the registered stage F3-F4 patients, stage F2 patients will be treated additionally.

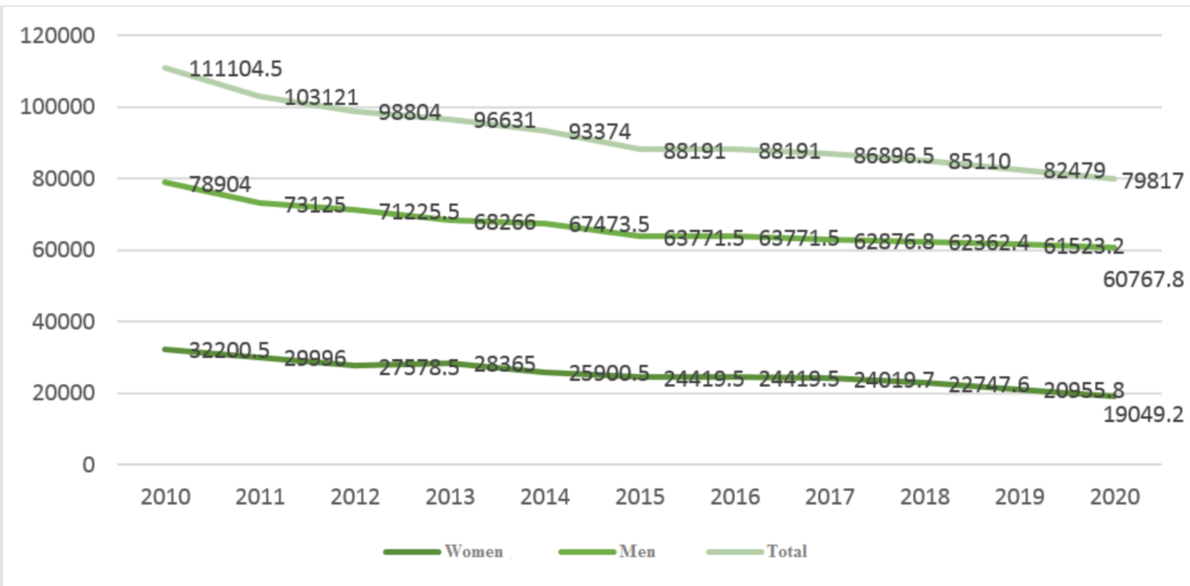

Figure 3.14. PYLL forecast, if Measure 3 is implemented (please see Figure 3.12 for the PYLL, if the measure is not introduced)***Source: CDPC***

By Measure 3 funding, assuming that it will be granted in the same amount also in 2018 and 2019, it is forecasted that in 2019 the PYLLL would reduce by 2 566 years. The efficiency of implementation of the measure is **6 thousand euro per each prevented PYLL.**

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It should be noted that the decisions on the reform measures and the measures to be supported in 2018 and 2019 will be adopted later.

The previous Stability Programme included the assessment of the fiscal impact of the Public Health Guidelines 2014 - 2020. Currently the assessment of the fiscal impact is being adjusted, taking into account the amount of adjusted expenditure in 2016 and the adjusted forecasts for 2017, 2018 and 2019.

Table 3.24. Adjusted 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**[22]				
	X[23]+5 years	**X+10 years**	**X+15 years**	**X+20 years**	**X+25 years**
GDP[24]	0.55%	2.21%	4.77%	7.87%	11.25%
Gross fixed capital formation	-	-	-	-	-
Employment[25]	0.24%	0.62%	1.02%	1.41%	1.81%
Direct fiscal impact on primary balance (10)[26]	-0.49%	-1.34%	-1.57%	-1.34%	-0.76%
Total impact on primary balance (11)[27]	-0.25%	-0.38%	0.43%	1.93%	3.90%

Reform of the health system administration

Even though the reform of the health system administration is not the issue of deficit deviation and therefore it is not described in this Stability Programme, it is, nevertheless, important, in order to ensure more efficient allocation of public funding. Therewith this reform supplements the two other reforms, forming a stable basis for quality and cost-efficient healthcare services.

Reform of the health funding

Deficit deviation funding will end in 2020, and, if the compensatory funding source is not found, the healthcare funding will reduce by 0.5% of GDP. To avoid it, as well as to ensure even larger increase of the funding, it is necessary to adopt the decision in the additional funding course for the healthcare system. At present, various proposals have been expressed, such as the mandatory private health insurance, marking and allocating 1 percentage point of the existing MSSIC to health, increase of contributions by 1 percentage point and allocation thereof to health, etc., but the decision is not yet adopted.

[22] Discounted at values of 2014; cumulative effect.
[23] X means 2013.
[24] National economy output divided by GDP of 2014 at current prices.
[25] Employment growth divided by number of employed persons in age group 15 – 64 (2012).
[26] Direct fiscal impact applicable to the age group of 0 – 64 years.
[27] When assessing the indirect impact on budget, the budgetary balance flexibility is applied - 0.43 (for 5 years) and 0.41 (for 10 and more years).

3.3. Fiscal Development Scenario

The fiscal development scenario is based upon the condition of compliance with the fiscal discipline and implementation of the responsible fiscal policy in Latvia. According to the provisions of the *Financial Discipline Law* the fiscal policy principles prescribe the formation of a balance budget in the economic cycle or the condition that the structural deficit, in the long term, may not exceed 0.5% of GDP.

Scenario for the medium term is drafted on the basis of the established general government budget balance objectives in structural terms and considering the cyclical component of the budgetary balance in compliance with the updated macroeconomic development scenario. Compared with the years of rapid economic growth and recession when the cyclical component, taking into account significant fluctuations in the economy, was considerable, in 2017 the cyclical component is forecasted close to zero, but in the next two years it becomes positive (0.1-0.3% of GDP).

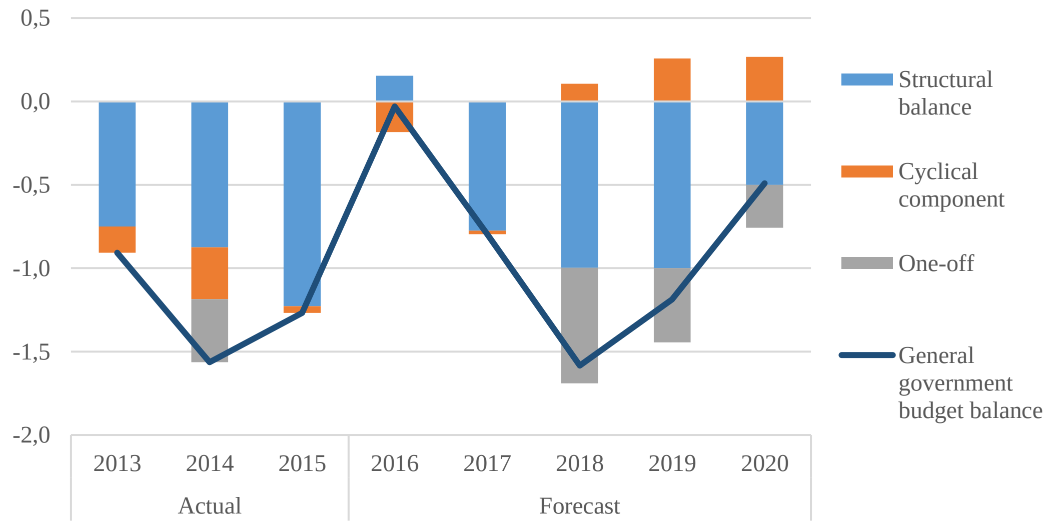


Figure 3.3. Budgetary balance of the general government by components[28], % of GDP

When developing the general government budget balance projections for the medium term, in accordance with the latest revenue and expenditure forecasts, the forecast for 2017 was updated. It is expected that the general government budget deficit in 2017 will make 0.8% of GDP and it is smaller than during the preparation of the budget, namely, in autumn 2016.

The general government budget balance projections for the medium term at no-policy policy were prepared, taking into account the updated macroeconomic development scenario forming the basis for the revenue and expenditure forecasts, as well as by means of the approved central government baseline expenditure for the next three years and the expected development of expenditure in the local government budget. It should be noted that the scenario at constant policy provides for a more rapid expenditure growth for defence, by the funding reaching 2% of GDP in 2018 and remaining at the level of 2% of GDP also further on. As a result, in the scenario at no-policy policy in 2018 the general government budget deficit is forecasted to be 0.3% of GDP, and the budget surplus in 2019 is expected in amount of 0.3% of GDP and in 2020 - in amount of 0.8% of GDP.

[28]In the calculation of a cyclical component of a budgetary balance, there was budget semi-elasticity of 0.38 used (Data source: Adjusting the budget balance for the business cycle: the EU methodology, Economic Papers 536, November 2014).

Table 3.1. Medium term at no-policy scenario

		2016	2017	2018	2019	2020
	ESA code	% of GDP				
Net lending (+) or borrowings (-) (B.9) by sub-sectors						
General government	S.13	0.0	-0.8	-0.3	0.3	0.8
Central government	S.1311	-0.1	-1.0	-0.4	0.3	1.0
Local government	S.1313	0.1	0.2	0.1	0.0	0.0
Social security funds	S.1314	0.0	0.1	0.0	-0.1	-0.2
General government (S.13)						
Total revenue	TR	36.1	36.8	36.8	36.5	36.0
Total expenditure	TE	36.1	37.6	37.1	36.3	35.2
Interest expenditure	D.41	-1.1	1.0	0.9	1.0	0.9
Cyclical development						
Cyclical component of the budgetary balance		-0.2	-0.1	0.1	0.3	0.3
Structural balance		0.2	-0.7	-0.4	0.0	0.5
Cyclically adjusted primary balance		1.3	0.2	0.5	1.0	1.4

The general government budget development in the coming years, at a no-policy scenario, will be determined by the situation in the central government, social security funds and local government budgets. It is forecasted that in the medium term the proportion of the general government revenue to GDP will remain stable – around 36% of GDP, *inter alia*, tax burden will exceed 30.7% of GDP. Tax revenue increase in the general government budget in the medium term will reach 5.3% - 6%. Tax revenue increase will be determined by the tax revenue in all groups, except that the revenue from the subsidised electricity tax according to the existing procedures are planned till 2019 only. It is expected that the general government expenditure in the coming two years will be above 36.3% of GDP, while in 2020 it will decrease, taking into account a low level of the permissible general government budget deficit arising out of the structural budget balance objective.

In the central government budget:

- In 2017 the deficit in amount of 1.0% of GDP is expected. The revenue and expenditure level is forecasted similar to the actual trends in the previous year, when both the revenue and the expenditure slows down. The central government budget forecasts are based upon the revenue and expenditure level planned in the law O*n the State Budget for 2017*.
- From 1 January this year, 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 allowance (benefit) disbursed from the State basic budget funds.
- In 2018 the central government budget deficit is expected in amount of 0.4%. In turn, in 2019 and 2020, at no-policy scenario, the surplus in the central government budget is expected. In the medium term the revenue increase will be ensured by the production and import taxes, as well as the revenue for the income, capital and property, except for 2020, when the revenue from property mainly comprised of the received payments for the use of the State capital will reduce, because the currently approved procedure provides for the reduction of the profit share to be paid into the budget (in 2018 80% of the profit gained in 2017 must be paid into budget, in 2019 - 70% and in 2020 - 50%). The medium term expenditure forecasts are based upon the macroeconomic development scenario updated in February 2017, updated tax revenue and expenditure plans, as well as the baseline funding for the next three years submitted by the line

ministries and approved in the government, *inter alia*, more rapid increase in funding in the field of defence in 2018, 2019 and 2020, ensuring 2% of GDP. The possible development of the budgets of the derived public entities for the coming years has also been taken into account.

In social security funds:

- In 2017 revenue is forecasted at a slightly lower level than in the law *On the State Budget for 2017*, thus reducing the previously planned surplus, which is currently being planned in amount of 0.1% of GDP. As the population income grows, also the expenditure for social benefits continue to increase. It should be noted that the pension expenditure is planned, taking into account the actual fulfilment data for 2016. Moreover, also the most recent legislative changes have been taken into account, which provide for both recalculation of the pension capital with respect to the negative capital indices and the new pension indexation procedure, taking into account the CPI and 50% of the real increment of the insurance contributions wage instead of the previous 25%, thus increasing the average amount of the pension.
- In 2018 and 2019 the revenue and expenditure in the social security funds are planned lower than in the law *On the Medium Term Budget Framework for 2017, 2018 and 2019*, nevertheless the revenue reduction is more significant than the expenditure reduction. It should be emphasised that in 2018 a slight surplus is projected in the social security funds, whereas in 2019 and 2020 it is forecasted that expenditure will exceed the revenue, forming the deficit. In the medium term the revenue, mainly made up of the social security contributions, will demonstrate a growth. Likewise, increase is expected also in expenditure, taking into account the projected changes in the number of beneficiaries, as well as in the average amount of the disbursed pensions and benefits.

In the local government budget:

- In 2017 it is forecasted that the surplus will form in the budget. Unlike the previous years, the expenditure forecast was reduced, taking into account the fulfilment data for 2016, as well as an interruption is forecasted in the implementation of the investment projects, triggered by the local government elections planned in June 2017. In turn, as regards expenditure related to the acquisition of the projects co-financed by the EU funds of the 2014 – 2020 planning period more rapid increase is expected in the second half of this year. At the same time, in 2017 the local government budget expenditure will be unloaded by payments for the Southern Bridge construction, because expenditure was recognized already in previous years during the actual construction of the object;
- After 2017 it is forecasted that the budget surplus will shrink, but the budget will, nevertheless, at no-policy scenario, form a slight surplus. With respect to the tax from income, which makes the largest position of local government budget revenue, possible evolution of the labour market is taken into account. In the medium term a stable increase is being projected in the tax revenue – in amount of 5-6%. At the same time, it should be noted that according to the updated forecasts major changes are not expected in other revenue positions. It is projected that local government expenditure in the medium term will increase in all positions, except for social benefits and subsidies for business persons. The level of expenditure for investments in the coming years will grow mainly

on account of the increasing activity in implementing the EU funds co-financed projects. At the same time, also in the medium term the local government budget expenditure will continue to be unloaded by payments for the Southern Bridge construction, because expenditure was recognized already in previous years during the actual construction of the object.

According to the fiscal discipline rules in the next three years larger deficit is permissible in the general government budget than it is expected in the scenario at no-policy scenario. At the currently forecasted economic growth rate it creates the possibility for the government to adopt decisions on allocation of additional funding to implementation of sectoral policies. As currently, when preparing the fiscal development scenario, the discussions in the government take place on the introduction of the health reforms and tax policy guidelines, then part of the fiscal space is reserved for the implementation of these measures. The remaining fiscal space, comprising 0.4% of GDP in 2019 and 0.9% of GDP in 2020 (in all years, when determining the fiscal space, the minimum fiscal security reserve of 0.1% of GDP, as defined in the FDL, has already been taken into account), is used for additional expenditure.

Thus, **the fiscal development scenario provides for the general government deficit of 0.8% of GDP in 2017, 1.6% of GDP in 2018, 1.2% of GDP in 2019 and 0.5% of GDP in 2020.**

Table 3.2. Medium term fiscal development scenario

		2016	2017	2018	2019	2020
	ESA code	**% of GDP**				
Net lending (+) or borrowings (-) (B.9) by sub-sectors						
General government	S.13	0.0	-0.8	-1.6	-1.2	-0.5
Central government	S.1311	-0.1	-1.0	-2.0	-1.5	-0.7
Local government	S.1313	0.1	0.2	0.1	0.0	0.0
Social security funds	S.1314	0.0	0.1	0.3	0.2	0.2
General government (S.13)						
Total revenue	TR	36.1	36.8	36.2	36.2	36.0
Total expenditure	TE	36.1	37.6	37.8	37.5	36.6
Interest expenditure	D.41	1.1	1.0	0.9	1.0	0.9
Cyclical development						
Cyclical component of the budgetary balance		-0.2	-0.1	0.1	0.3	0.3
Structural balance*		0.2	-0.7	-1.7	-1.5	-0.8
Cyclically adjusted primary balance		1.3	0.2	-0.8	-0.5	0.1

* structural budget balance here is presented by including one-off measure – short-term revenue short-fall caused by tax reform, as in line with SGP, EC will not recognize it as one-off measure.

In the fiscal development scenario, the fiscal impact of the tax reform is broken down by the relevant sub-levels of the general government budget. Likewise, it is assumed that in 2018 and 2019 the reforms will be implemented in the health sector in amount of the granted funding of the deficit deviations, respectively, 0.4% and 0.5% of GDP. In turn, the remaining fiscal space (out of the total fiscal space the planned additional funding for implementation of the health reform and introduction of the tax policy guidelines is reserved) is used for additional expenditure. As the decisions on the allocation of the fiscal space are adopted during the process of budget preparation and it is not known for the time being, it is assumed that it is distributed in proportion by expenditure categories in respective years, assuming as the basis the share of separate expenditure categories to the total expenditure at no-policy scenario. When calculating the share of separate expenditure categories to the total expenditure at no-policy scenario, the following expenditure categories are excluded from the calculation: interest expenditure and capital expenditure transfers. Such approach is applied, because it is assumed that a fiscal space is not being redistributed to these expenditure categories.

The above mentioned set of assumptions will influence the situation in the central government, social security funds and local government budgets. In the medium term the share of the general government revenue in GDP as a result of implementation of the tax reform in 2018 and 2019 will reduce, correspondingly, by 0.5 percentage points and 0.3 percentage points, as compared to the no-policy scenario, whereas in 2020 it will be by 0.03 percentage points larger. Changes in tax burden and tax revenue are the same as the changes in the total revenue and also arise out of the implementation of the tax reform.

General government expenditure in 2018, 2019 and 2020 will grow, respectively, by 0.7 percentage points, 1.2 percentage points and 1.4 percentage points, as compared to the no-policy scenario, which will mainly be determined by the increase in expenditure, arising out of the implementation of the tax reform, implementation of the health reform and the proportionate allocation of the remaining fiscal space.

In the central government budget:

- In 2018, as well as in the next two years the central government budget deficit will increase by, correspondingly, 1.6 percentage points, 1.8 percentage points and 1.7 percentage points. The top-down changes in revenue will be determined by decrease in the tax revenue, in light of the introduction of the tax reform. The most significant adverse impact is expected from the fall in PIT revenue (correspondingly, -0.1% of GDP; -0.2% of GDP; -0.2% of GDP), fall in solidarity tax revenue (-0.2% of GDP in all three years) and fall in CIT revenue (correspondingly, -1.2% of GDP; -0.5% of GDP; -0.4% of GDP), whereas positive impact is forecasted from increase in VAT revenue (correspondingly, +0.5% of GDP, +0.5% of GDP; +0.6% of GDP) and increase in the excise duty revenue (correspondingly, +0.2% of GDP, +0.2% of GDP; +0.3% of GDP).
  Increase of the central government expenditure over the next years will be determined by expenditure prescribed as a result of the introduction of the tax reform for ensuring the raise of the minimum wage (0.1% of GDP annually), as well as the planned increase of expenditure for maintenance of the motor roads (0.1% of GDP annually). Implementation of the health reforms will also have a significant impact on increase of expenditure, increasing the expenditure in 2018 and 2019, correspondingly, by 0.4% and 0.5% of GDP. To reduce the adverse impact on the local government budget from the reduction of the PIT rates, the compensation on the part of the central government is planned. Compensatory mechanism provides to ensure for the local government fixed tax revenue proportion to the total government tax revenue in amount of 19.5%. Therewith, the central government expenditure growth by, correspondingly, 0.3% of GDP; 0.8% of GDP; 0.8% of GDP is expected. It is assumed that for the next three years the remaining fiscal space will be allocated only to the increase of the central government expenditure (correspondingly, 0.03% of GDP; 0.39% of GDP; 0.95% of GDP).

In social security funds:

- In 2018, 2019, as well as 2020 the social security funds balance will improve, correspondingly, by 0.3 percentage points each year, as compared to the no-policy scenario.
  On the revenue side, due to introduction of the tax reform, positive impact is forecasted from the increase in the MSSIC (correspondingly, +0.4% of GDP; +0.4% of GDP; +0.5% of GDP), whereas on the expenditure side the increase is planned (0.1% of GDP annually), arising out of the circumstance that in separate cases, along with increasing contributions to the social security system, the

disbursements from the social security system related to the growth of contributions increase, as well.

In the local government budget:

- In 2018, 2019, as well as 2020 the local government budget balance, in general, will remain practically unchanged.
  On the revenue side, the reduction is mainly influenced by the reduction of the PIT rate prescribed by the tax reform from 23% to 20%, as a result whereof PIT revenue will decrease significantly (correspondingly, -0.4% of GDP; -0.9% of GDP; -0.8% of GDP). In turn, the compensation from the central government will, to a large extent, compensate the fall in the local government revenue due to reduction of the PIT rate. Additionally, it is assumed that the central government is not performing the compensation of the fall in revenue to a full extent, therewith it is assumed that in 2018 and 2019 the growth of the local government expenditure would be slightly lower than in the no-policy fiscal scenario. Therewith, in 2018 and 2019 a positive impact is formed, correspondingly, +0.1% of GDP; +0.1% of GDP, whereas in 2020 the situation occurs, where the central government compensation exceeds the fall in the local government revenue, which creates adverse impact of -0.02% of GDP.

It should be noted that in the fiscal development scenario it is assumed that the legislator will not try to transform the positive fiscal impact in the social security fund created by the tax reform into new, expenditure increasing policy initiatives, however it should be noted that it is a fiscal risk, upon occurrence whereof, the fiscal discipline rules would be violated.

Fiscal space

The difference between the maximum permissible deficit and deficit at a no-policy scenario, deducting the fiscal safety margin, is comprised of the initial fiscal space. Taking into account the health reform and tax reform included in the scenario, the fiscal space for the NPI for the period of time from 2018 till 2020 comprises, correspondingly, 0.1% of GDP; 0.4% of GDP and 0.9% of GDP.

Table 3.27. Fiscal space

	2018	2019	2020
General government budget balance - fiscal development scenario	-1,58	-1,24	-0,55
General government budget balance according to no-policy scenario	-0,31	0,27	0,81
Fiscal security reserve	0,10	0,10	0,10
Initial fiscal space	1,17	1,41	1,26
Health reform	-0,40	-0,50	0,00
Tax reform	-0,74	-0,51	-0,31
Fiscal space	**0,03**	**0,39**	**0,95**

3.4. DEVELOPMENT TRENDS OF GOVERNMENT DEBT IN THE MEDIUM TERM

According to the general government budget deficit and debt notification data of April 2017, prepared in accordance with the ESA 2010 methodology, the general government debt at the end of 2016 reached 10.0 billion euro or 40.1% of GDP. The general government debt level is mainly affected by the central government debt, which at the end of 2016 was 9.2 billion euro[29], growing by 1.2 billion euro during the period of 2016, mainly, because in 2016 the Eurobonds in amount of 1.3 billion euro have been issued on the international financial markets, raising the funding for both covering the financing requirement of the current year and debt repayment planned at the beginning of 2017 in amount of 1.0 billion US dollars.

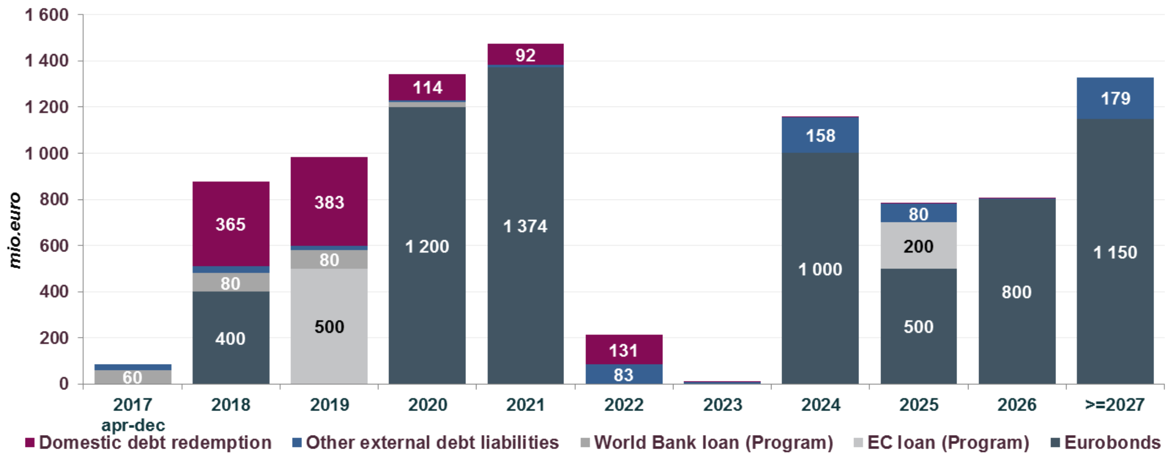
The key principles and medium-term objectives of the central government debt management are defined in the Central Government Debt Management Strategy approved by the Minister for Finance. According to the Central Government Debt Management Strategy the objective of the central government debt management is to ensure the necessary financial resources for the refinancing of central government debt, central government budget execution and ensuring on-lending at the lowest possible costs while hedging financial risks and taking into account the development of the Latvian economy and integration of the domestic financial market into the common financial market of the Euro area. For meeting the central government debt obligations and fulfilling budget liabilities, a strategic approach to ensuring state borrowing and debt management process is applied, maintaining the greatest possible flexibility in the choice of borrowing conditions on 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 resources to cover the total financing requirement at as favourable and attractive conditions as possible.

The stabilisation of the country's credit rating in A rating group, the investors` high evaluation on the accomplishments in the economy of Latvia in the previous years and the confidence in the development of Latvia in the long-term, allows the country to borrow financial resources in the international markets at favourable conditions. This is also confirmed by the borrowing transactions in the international financial markets, in 2016 reaching the lowest yield and the coupon payments among the Central and Eastern European, as well as majority of Western European countries for the respective term of debt securities in 2016. Keeping in mind that in 2016 both the United Kingdom referendum on the EU membership (in June) and the USA presidential elections (in November) are planned, the amount of planned borrowing in amount of 1.3 billion euro was diversified, dividing it in two equal parts, first of all organising the issue of a longer term Eurobonds. On the basis of the above mentioned borrowing risk diversification approach, in May 2016 20-years Eurobonds were issued in amount of 650 million euro, with the fixed interest (coupon) rate 1.375% and in October 10-years Eurobonds were issued in amount of 650 million euro with the historically lowest fixed interest (coupon) rate for Latvian bonds of 0.375% per year. In order to capitalize the long-term benefits from the existing comparatively low *euro* interest rate levels and to maintain *euro* yield curve as a reference for new borrowings, in February 2017 the Eurobonds with the longest maturity ever - 30 years - were issued for the first time in the international financial markets -, fixing the interest (coupon) rate at 2.250%. Concurrently with the 30-years Eurobond issue of 500 million euro, 10-year Eurobonds issued in October 2016 were tapped in amount of 150 million euro with the yield of 1.062%. The funding raised at the beginning of 2017 will be used for both central government debt refinancing planned at the beginning of 2018 and for covering financing requirement in the current year.

[29] Taking into account the currency outcome of the derived financial instruments attracted for the foreign borrowings and debt securities administered by the Treasury

In the domestic financial market the auctions of government domestic debt securities continue, mainly focussing on bonds. In 2016 the rates fixed at auctions reached new historically lowest levels. Negative rates in the initial placement were fixed not only for the T-bills, but, for the first time, also for the 3-year T-bonds. Given the possibility in the current financial market situation to attract short-term funding with negative interest rates, in order to ensure the liquidity for the state budget execution as efficiently as possible , the Treasury, at the beginning of 2016, introduced new short-term borrowing instrument - T-bills with maturity of 21 days, which, according to the current financing requirement are issued with premium and redeemed within the same calendar month. In addition, the short-term money market borrowing from domestic and foreign credit institutions is used for liquidity management purposes. In order to promote private investments into the domestic financial market instruments, Latvian government savings bonds are available for residents (private individuals) .

Taking into account the central government debt obligations outstanding as of 31 March 2017, in accordance with the central government debt repayment schedule in the period between April 2017 – December 2020 the central government debt obligations should be refinanced in amount of 3.3 billion euro (see Figure 3.16). A significant portion of the debt to be refinanced consists of Eurobonds issued in international financial markets, as well as the the World Bank and the EC loans received within the framework of the international loan programme.



**does not include sectors S130130, S130140, S130330, S130340, as well as on-demand and short-term deposits; According to ECB FX rates of 30 March 2017*

Figure 3.16. Central government debt repayment schedule

(liabilities assumed by 31 March 2017, nominal value)

In order to cover the total financing requirement in the medium term the following borrowing activities are planned:

- to ensure timely borrowing in international financial markets, through public issuance of government debt securities, maintaining flexibility in terms of borrowing time, currency and maturity, thus to ensure borrowing with favourable conditions;
- to ensure diversification and broadening of government investor base through a regular, constant dialogue and long-term work with the investors and cooperation partners to promote active participation of investors from various regions of the world in the primary placement of the government foreign debt securities;
- to promote the development of the domestic financial market and to ensure appropriate investment opportunities for the local investors thus making better

use of the borrowing potential in the domestic financial market and facilitate the development of the domestic financial market.

Taking into account the borrowing strategy and the government debt repayment schedule in the medium term (see Figure 3.16), in the next few years, foreign borrowing instruments will provide major share of the total financing. It is planned to base the borrowings on public transactions in global financial markets issuing benchmark Eurobonds mainly in the European financial market, as well as the financial markets of other regions. It is planned to also henceforth ensure an offer of government securities on the domestic financial market, thus promoting the activity of the government securities market within the framework of the primary dealers system.

In 2016, by raising the funding not only for the financing requirement of the current year, but also for central government debt repayment at the beginning of 2017 in amount of 1.0 billion US dollars, general government debt level has grown at the end of 2016, correspondingly slightly reducing in 2017. In turn, in 2020 the timely borrowing is planned for the redemption of the Eurobonds planned at the beginning of 2021 in amount of 1.0 billion euro, as a result the growth of the debt level is expected at the end of 2020. Nevertheless, in general, by ensuring timely borrowing for the debt refinancing in the medium-term and sustaining responsible fiscal policy, the stabilisation of the debt level is excepted at a sustainable level, convincingly complying with the debt condition defined by the FDL.

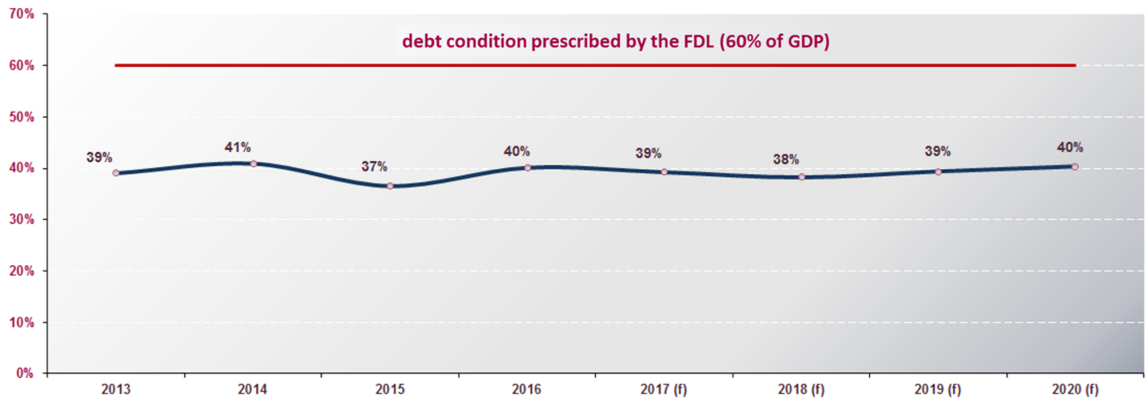


Figure 3.17. General government debt development trends (% of GDP)

4. SENSITIVITY ANALYSIS AND COMPARISON

4.1. MACROECONOMIC SCENARIO RISKS

Macroeconomic development scenario is based upon cautious forecast and balanced positive and negative risks.

Positive risks:

- Sharper-than-expected investment growth is possible, if the acquisition of the EU funds resources develops more rapidly than projected in the baseline scenario. Up to now the factors impeding the commencement of investment projects included also delays in adoption of corresponding statutory regulation, and after prevention of these problems the inflow of the EU funds resources into economy might become considerably more rapid than projected in the baseline scenario.
- In addition to the increase in the EU funds financing, also the demand for loans might increase, ensuring additional possibilities for investments and restoration of fixed assets.
- Faster-than-expected improvement of the economic situation in the EU and other Latvian trade partners, given already protracted stability of the world commodity markets and economic recovery in the developing markets.
- Opening of the new export routes will promote more rapid growth of exports, increase in investments and economy.
- Structural reforms implemented in Latvia (for example, in education, healthcare, public administration, tax system reform) will ensure more efficient financial management and strengthen future economic potential.

Negative risks:

- Delay in the acquisition of the EU funds, similar to 2016, might considerably slow down the economic growth. Delay in investments may be caused by later commencement of the investment projects based upon the EU funds, as well as possible challenging of the tender procedure results. Therewith, the delay in implementation of the investment projects, in order to, for example, increase the production capacities, might adversely affect the potential economic growth.
- More rapid inflow of the EU funds resources in the economy as compared to the year before and increase in demand, especially, in the construction sector, might lead to the lack of a qualified labour force and create pressure on the wage increase in the entire national economy.
- The wage increase is protractedly not corresponding to the productivity growth. The real wage increase, which protractedly exceeds the productivity growth, might reduce the competitiveness of economy and slow down the economic growth.
- Deterioration of the economic situation in Russia and in the EU, as well as political disagreements between these two main Latvia's trade partners might reduce the foreign trade activity. This and the next year are important election years in number of the EU Member States (for example, parliamentary elections in Germany and France in 2017, and in Sweden and Italy in 2018) and in Russia (presidential elections are expected in 2018). High uncertainty and risks with respect to the expected elections might adversely affect the exports and investment activity of Latvia.

4.2. Sensitivity Analysis

On the basis of the possible impact of macroeconomic risks on the national economy described in the previous chapter, two alternative scenarios of macroeconomic development have been worked out for 2017-2020.

4.1.1. Optimistic Scenario

In light of the possible risks for the economic growth, the MoF has prepared an alternative economic development scenario, which is based upon optimistic assumptions, upon implementation of several positive risks.

Impact on economy. The main positive risk for higher-than-expected economic growth is related to more rapid acquisition of the EU funds resources than projected in the baseline scenario. In 2016 the regulatory barriers for the acquisition of the EU funds were already prevented, therewith it is possible that number of large infrastructure projects could be implemented, facilitating more rapid economic growth, especially in the construction sector. As the financial performance indicators of the businesses improve, more rapid lending of investments in the industries not related to the EU funds is also possible, thus increasing the competitiveness and exportability of Latvian entrepreneurs. Optimistic scenario provides that the acquisition of the EU funds for the entire period of projections would be by 10% higher than projected in the baseline scenario.

Already from the middle of 2016 international organisations have been gradually improving the growth forecasts for the global economy at large and for individual countries, indicating that the growth of the global economy, starting from 2017 might be stronger. Therefore, in addition to the investment growth, the optimistic scenario assumes that the increase of the export revenue would be by 1 percentage point stronger than in the baseline scenario.

According to the optimistic scenario, as the income from exports increase, also the wage increase of the employed in the projection period would be by about 0.1 percentage point larger than in the baseline scenario. Faster wage increase would improve the households' sentiment and would also promote the demand for loans. Therewith, the private consumption increase in the projection period would be by 0.3 percentage points faster than in the baseline scenario.

Table 4.1. Optimistic macroeconomic scenario

	2016	2017f	2018f	2019f	2020f
GDP, at current prices, mln *euro*	25021	26429	27854	29647	31486
growth at current prices, %	2.7	5.6	5.4	6.4	6.2
growth at constant prices,%	2.0	3.7	3.8	3.7	3.5
CPI, (annual average), %	0.1	2.3	2.0	2.0	2.0
Average wage in the national economy, *euro*	859	904	951	999	1050
growth at current prices, %	5.0	5.3	5.1	5.1	5.1
Employment, thousand people	893	895	897	897	897
growth, %	-0.3	0.2	0.2	0.0	0.0
Unemployment rate (annual average), % of the economically active population	9.6	9.4	8.9	8.4	8.2
Export growth rates at current prices, %	1.0	4.8	8.7	8.9	9.3
Import growth rates at current prices, %	-1.8	3.3	3.5	3.7	4.1

As a result, the business and investor sentiment would improve, promoting investments even more. Thus, compared to the baseline scenario, faster growth of investments and exports would be expected, which together with factors stimulating consumption such as the increase in wages would ensure faster than projected in the baseline scenario the growth private consumption. In this scenario, the real growth of Latvian GDP in the medium term would be, on average, by 0.4 percentage points faster than in the baseline scenario.

Impact on budget and debt service. In the case of the optimistic scenario, the tax and non-tax revenue would be higher and the general government budget balance would improve. As compared to the baseline scenario in case of unchanged policy, the general government deficit in 2017 would decrease by 35.9 mln euro or 0.1 percentage point of GDP. By contrast, in 2018, 2019 and 2020 the general government balance would improve, respectively, by 0.2 (50.3 mln euro), 0.3 (92.1 mln euro) and 0.4 (138.3 mln euro) percentage points of GDP as compared to the baseline scenario.

About one half of the medium term general government revenue increase would be attributable to the central government budget. Correspondingly, the central government balance, as compared to the baseline scenario at unchanged tax policy, would improve by 19.7 mln euro in 2017, 27.5 mln euro in 2018, 50.3 mln euro in 2019 and 74.5 mln euro in 2020. In proportion to GDP, positive changes in the central government budget would be in amount of 0.1 percentage point in 2017 and 2018, as well as in amount of 0.2 percentage points in 2019 and 2020.

In turn the tax revenue would increase by 34 mln euro in 2017 or 0.1 percentage point of GDP more than in the baseline scenario. By contrast, in 2018, 2019 and 2020, tax revenue would be respectively by 0.2 (47.7 mln euro), 0.3 (87.5 mln euro) and 0.4 (133.8 mln euro) percentage points of GDP higher than in the baseline scenario.

Due to tax revenue increase the general government budget financial balance would improve, as a result whereof the overall funding need would reduce and, correspondingly, also the lending volume for the respective periods, as compared to the baseline scenario. Smaller borrowings would generate savings in the interest expenditure. In case of the optimistic scenario, the interest expenditures would be by 0.4 mln euro or 0.001 percentage point of GDP smaller in 2018, by 1.9 mln euro or 0.006 percentage points of GDP in 2019 and by 4.7 mln euro or 0.015 percentage points of GDP smaller in 2020 than in the baseline scenario.

4.1.2. Pesimistic Scenario

In light of the possible risks for the economic growth, the MoF has prepared an alternative economic development scenario, which is based upon pessimistic assumptions, upon implementation of several negative risks.

Impact on economy. The main risk for the economic growth is related to weak rates of acquisition of the EU funds. Considerable delay in the acquisition of the EU funds of the new financing period in the previous years has caused uncertainty with respect to the preparation and implementation of the projects, postponing significant investment projects over to a later time. Pessimistic scenario provides that the acquisition of the EU funds for the period till 2020 is by 20% smaller than projected in the baseline scenario. In case of implementation of the pessimistic scenario the project implementation might be delayed due to several reasons, including, due to appeals of the tender procedure results. Also the infrastructure and labour force resources in the construction sector might turn out to be insufficient, thus hindering the investments and steeper economic development.

In addition to these internal factors, the scenario also assumes the slowdown of the global and the EU economic growth rates, during the period till 2020 reducing the growth of exports of Latvia by 1 percentage point. Pessimistic scenario also assumes that the slowdown of the investment activity observed in the last years in the EU might continue also in the subsequent years, which is related, *inter alia*, also to the political uncertainty in number of the

EU Member States, in light of the expected elections. The USA, in its turn, as the inflation rate increases, would select to increase the interest rates higher than market expectations, and this, due to increasing debt payments, would adversely affect the economic growth of the emerging economies.

According to the pessimistic scenario, as the income from exports decrease as compared to the baseline scenario, also the wage increase of the employed would be, on average, by 0.4 percentage points smaller. Therewith, also the private consumption growth for the entire period of projections would be by 0.3 percentage points smaller than projected in the baseline scenario.

Table 4.2. Pessimistic macroeconomic scenario

	2016	2017f	2018f	2019f	2020f
GDP, at current prices, mln *euro*	25021	26112	27267	28774	30281
growth at current prices, %	2.7	4.4	4.4	5.5	5.2
growth at constant prices,%	2.0	2.5	2.9	2.8	2.5
CPI, (annual average), %	0.1	2.3	2.0	2.0	2.0
Average wage in the national economy, *euro*	859	904	948	990	1035
growth at current prices, %	5.0	5.3	4.8	4.5	4.5
Employment, thousand people	893	895	897	897	897
growth, %	-0.3	0.2	0.2	0.0	0.0
Unemployment rate (annual average), % of the economically active population	9.6	9.4	8.9	8.4	8.2
Export growth rates at current prices, %	1.0	2.6	6.6	6.7	7.2
Import growth rates at current prices, %	-1.8	3.3	3.5	3.7	4.1

In case of the pessimistic scenario, Latvian GDP real growth in 2017 would be by 0,7 percentage points less than in the baseline scenario and in 2018, as well as in subsequent years – by 0.5 percentage points less. According to the scenario, the economy would not be able to resume the previous growth rates, because the delay in investments would considerably affect the economic potential.

Impact on budget and debt servicing. According to 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 with no policy change the general government deficit in 2017 would increase by 54.1 mln euro or 0.2 percentage points of GDP. By contrast, in 2018, 2019 and 2020 the general government balance would deteriorate, correspondingly, by 0.4 (97.2 mln euro), 0.5 (140.4 mln euro) and 0.6 (186.5 mln euro) percentage points of GDP as compared to the baseline scenario. In nominal terms, the general government deficit in 2017 would increase to 1.0% of GDP, in 2018 – to 0.7% of GDP, and in 2019 – the deficit of 0.2% of GDP, while in 2020 the surplus in amount of 0.2%.

According to this scenario, about one half of the medium term general government revenue decrease would be attributable to the central government budget. The central government budget balance against the baseline scenario, at constant policy, would deteriorate by 29.7 mln euro or 0.1 percentage point of GDP in 2017, by 53.2 mln euro or 0.2 percentage points of GDP in 2018, by 76.7 mln euro or 0.3 percentage points of GDP in 2019 and by 100.5 mln euro or 0.3 percentage points of GDP in 2020.

According to Section 25, Part (2^2) of the LBFM, in the case 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 GDP set 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 set in the annual *State Budget Law*, or there is no sufficient amount of funds in the budgetary accounts with 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.

Implementation of the pessimistic scenario would reduce the economic growth, which would also mean the reduction in separate expenditure items, for example, lower contributions to the EU budget pegged to GDP.

In case of the pessimistic scenario, the tax revenue would decrease sharply. At constant policy, the tax revenue in 2017 would be by 51,3 mln euro or 0.2 percentage points of GDP lower than in the baseline scenario. By contrast, in 2018, 2019 and 2020, tax revenue would be respectively by 0.3 (92.1 mln euro), 0.5 (133.3 mln euro) and 0.6 (180.4 mln euro) percentage points of GDP lower than in the baseline scenario.

The tax revenue decrease and the deficit increase projected in the pessimistic scenario would increase the overall funding need and the volumes of borrowing for the respective period. Additional borrowing would generate the interest expenditure growth in the medium term. In this scenario, the interest expenditure in 2018 would be by 0.7 mln euro or 0.003 percentage points of GDP larger, in 2019 – by 3.3 mln euro or 0.011 percentage points of GDP and in 2020, respectively, by 7.5 mln euro or 0.025 percentage points of GDP larger than in the baseline scenario.

5. COMPARISON WITH THE LATVIA'S STABILITY PROGRAMME FOR 2016-2019

GDP growth in 2016 has been slower than envisaged by the Latvia's Stability Programme for 2016 – 2019 scenario. Weaker economic growth is related to the considerable fall in investments as compared to the previously forecasted growth, which was determined by delay in implementation of the EU funds investments last year. Likewise, the export growth, as well as the public consumption growth in 2016 was slightly slower as compared to that which was forecasted a year before. At the same time the forecast of the import growth was lower than the actual increase. According to the latest growth scenario GDP increase forecast for 2017 is 3.2%, which is by 0.1 percentage point lower than projected by the previous Stability Programme 2016 - 2019 scenario. In turn, the growth forecasts for 2018 remain constant at 3.4% level, however in subsequent years the economic growth is reduced according to the potential growth rate in the medium term.

Table 5.1. Comparison with the forecasts of the Stability Programme for 2016–2019

	ESA code	2016	2017	2018	2019	2020
GDP growth (%)	B1y					
Stability Programme for 2016 - 2019		3.0	3.3	3.4	3.4	-
Stability Programme for 2017 - 2020		2.0	3.2	3.4	3.2	3.0
Difference		-1.0	-0.1	0	-0.2	-
Actual budget balance (% of GDP)	B.9					
Stability Programme for 2016 - 2019		-1.0	-1.0	-1.0	-0.5	-
Stability Programme for 2017 - 2020		0	-0.8	-1.6	-1.2	-0.5
Difference		1.0	0.2	-0.6	-0.7	-
Total general government debt (% of GDP)						
Stability Programme for 2016 - 2019		40.3	38.3	37.5	38.2	-
Stability Programme for 2017 - 2020		40.1	39.2	38.2	39.4	40.4
Difference		-0.2	+0.9	+0.7	+1.2	-

According to the assessment of the MoF the general government budget deficit in 2016 was by 1 percentage point lower than forecasted in the Stability Programme for 2016 - 2019. Almost well-balanced budget in 2016 was ensured by both higher tax and non-tax revenue, as well as lower expenditure, as the funds have been saved, mainly, for goods and services, contributions into the EU budget and lower investments in EU co-financed projects.

The updated general government budget forecasts provide for the deficit in amount of 0.8% of GDP in 2017, 1.6% of GDP in 2018, 1.2% of GDP in 2-019 and 0.5% of GDP in 2020. General government budget forecasts are based on updated structural budget balance objectives, the changes in the cyclical component of the budgetary balance, as well as the tax policy reform planned by the government starting from 2018.

General government debt forecast for 2017 - 2020 has been increased, as compared to the forecasts in the Stability Programme for 2016 - 2019, in line with updated forecasts of the general government budget financial balance, "fiscal space" or available budget funds for financing new policy priorities, adjusted borrowing strategy for the medium term, as well as updated economic development forecasts. General government debt increase was determined also by the inclusion of the euro coins in turnover in Latvia, issued by the Bank of Latvia, into the general government debt, starting from April 2017 notification, in order to ensure the uniform data reflection in all EU Member States in accordance with the requirements of the ESA 2010 5.2.accounting framework.

6. QUALITY OF PUBLIC FINANCES

6.1. 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 of Finance shall ensure the development of the Draft Annual State Budget Law, on the basis of the Framework Law and budgetary requests. The Minister of Finance shall evaluate the conformity of the budgetary requests with the budgetary purposes and development priorities prescribed by the Framework Law, as well as with the principles of economy and efficiency and, if necessary, shall request necessary additional information. On the basis of evaluation and the provided information, the MoF (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 of 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 be responsible for the organisation 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 shall inform the Budget and Finance (Tax) Committee of the Saeima during the development of the Draft Annual State Budget Law or amendments thereof on the course of 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 utilisation 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 optimising 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, takes a decision on the scope of the revision of the State budget expenditure, concurrently with the approval of schedule of development and submission of the Draft Framework Law and the Draft Annual State Budget Law. The Minister of Finance in turn, in accordance with the referred to schedule, are submitting 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 Framework Law and the Draft Annual State Budget Law.

State budget consists of budget programmes where the structure are 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 regulatory enactments has been amended to improve the existing 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.

When preparing a report on the analysis on the State budget execution, ministries and other central State institutions shall provide explanations about previously planned operating 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 shall summarize, evaluate and ensure the accumulation of the operational results and performance indicators of the State budget programmes (sub-programmes).

LBFM determines the following budget execution organizational aspects:

- 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, on the basis of the appropriations 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.
- the State budget 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.
- the 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 and derived public persons partially financed from the State budget, as well as capital companies in which a State or local government capital share is invested may open current accounts with the Treasury.
- Ministries and other central state instructions and local government according to the procedures prescribed by the Cabinet shall prepare and submit to the Treasury the monthly, quarterly and annual 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 execution informing 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 period up to three months if at least one of the following conditions exist:

- 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 GDP determined in the Annual State Budget Law;
- 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;
- there is no sufficient amount of funds in the budgetary accounts of the Treasury to cover payment commitments planned for the next month.

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 per cent 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; or 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 authorisation 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 Equalisation 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 equalisation 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 equalisation 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.

6.2. Efficiency of Revenue Structure and System

The work on the development of the State tax policy guidelines for 2017 - 2021 has been launched in the previous years and will be completed in 2017. The goal of the State tax policy guidelines is to introduce stable and predictable tax policy focussed on the growth of national economy and competitiveness, as well as limitation of income inequality in the country, at the same time ensuring stable and sufficient tax revenue for funding of public administration and services.

Table 6.1. Tax Revenue in General Government Budget (S.13), million *euro*

	Code (ESA)	2016	2017	2018	2019	2020
Tax revenue						
1. Production and import taxes	D.2	3359.9	3589.2	3763.9	3963.7	4195.0
2. Current income and wealth taxes	D.5	2096.8	2226.6	2344.2	2456.4	2627.1
3. Capital taxes	D.91	2.8	2.8	3.0	3.3	3.3
4. Social contributions	D.61	2172.1	2314.6	2487.3	2630.5	2760.4
Of which actual social contributions	*D.611 and D.613*	2085.5	2228.0	2400.7	2543.9	2673.8

In Latvia, the biggest part of all tax revenue is attributed to labour taxes. The share of labour taxes increases from 46.7% in 2016 to 47.3% in 2020, therefore, the share of revenue from consumption and capital taxes in total tax revenue gradually decreases from 53.3% in 2016 to 52.7% in 2020.

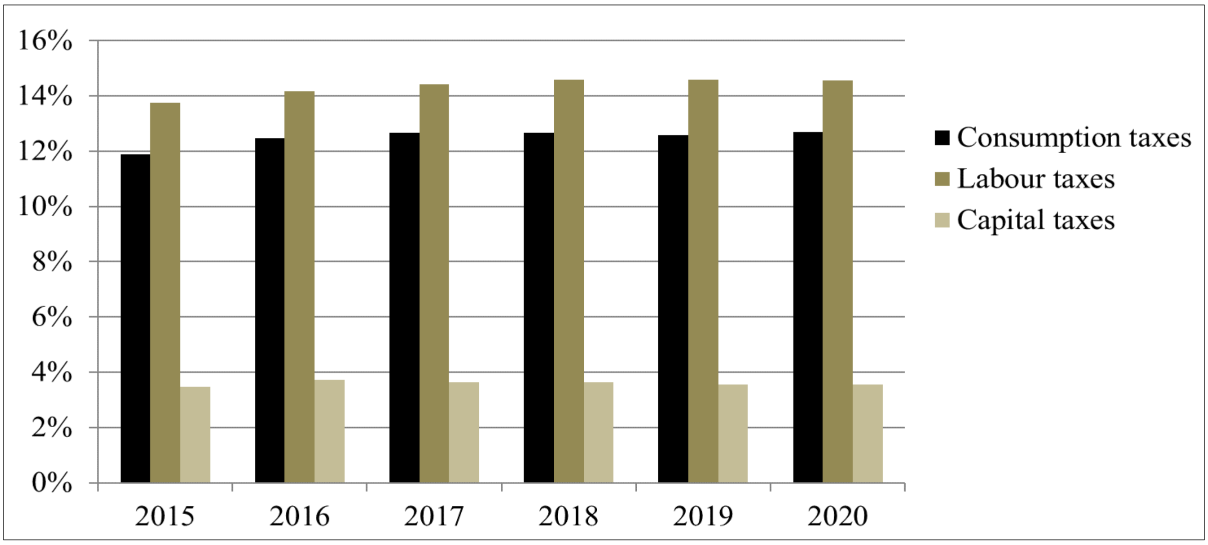


Figure 6.1. Tax Revenue According to Economic Functions, % of GDP

Combating the shadow economy, more effective use of resources, limitation of tax optimisation, as well as enhancement of the competitiveness and business environment have been set as the main vectors in the medium-term tax policy.

Therewith, during the drafting of the budget for 2017, the introduction of tax measures directed towards reducing the shadow economy was supported, and the application of separate tax exemptions and rates was reviewed, without creating major changes in the largest taxes.

In the field of tax policy the **vehicle tax policy was "reformed"**, by abolishing the car and motorcycle tax, at the same time reviewing the rates of the vehicle operation tax, concurrently preserving the existing procedures for tax payment, when the vehicle operation tax is paid for the calendar year.

Also **the natural resources tax rates are increased**, concurrently implementing the international recommendations on the transfer of the tax burden from the labour force to the environmental and consumption taxes.

Agreement is achieved regarding **CIT exemption for the losses carried forward.** Starting from the taxation period commencing in 2017 and in the subsequent taxation periods the losses of the previous taxation periods (starting from the losses incurred during the taxation period as of 2008 and in the subsequent taxation periods) may be covered to an extent not exceeding 75% of the CIT taxable income of the relevant taxation period.

From 2017 the Law on Aid for Start-Up Companies has come into force. The purpose of the Law is to **promote formation of the start-up companies in Latvia**, thus facilitating research, as well as the use of innovative ideas, products or processes in the economic activities (commercialisation of the research products).

Electricity tax exemptions are abolished for the electricity generated from renewable energy resources; in hydroelectric power plants and cogeneration electric stations, as well as exemptions for the electricity used for electricity generation and generation of heat energy and electricity in cogeneration. The electricity tax exemptions for electricity used for carriage of goods and public carriage of passengers, including on rail transport and in public carriage of passengers in towns, and for the household users are being kept in force.

As of 1 January 2017 **the excise duty rates were increased for cigars and cigarillos, other smoking tobacco, tobacco leaves and finely cut tobacco for rolling of cigarettes.**

As of 1 March 2017 **the excise duty rates for alcoholic beverages were increased.**

As of 1 July 2017 **the excise duty rates for cigarettes will be increased.**

In the field of labour taxes **the provisions have been introduced preventing the tax planning, when making contributions into private pension funds.** Henceforth it would not be possible to apply the PIT relief, if the money paid into the pension fund will be withdrawn in the same or the following year.

New **personal income tax relief** has been introduced, stipulating to exempt from the personal income tax the catering expenses of the employees paid for by the employer and stated in the collective agreement, if they do not exceed 480 euro per year (40 euro per month).

The shadow economy has a negative impact on the country's overall economic growth, as well as it endangers the rule of law in the country and fair competition among businesses. Consequently, one of the government's priorities is the reduction of the shadow economy in the country for the achievement whereof, on 16 September 2014 a Shadow Economy Combating Council was set up. The Council's task within the field of combating the shadow economy is to coordinate and monitor responsible institutions in order to significantly reduce "envelope wages", combat tax fraud schemes and other unfair business principles. In the medium term particular attention will be paid to these tasks, especially by active work of the SRS against tax evasion, thus improving tax collection.

As of 2017 the following measures to combat the shadow economy came into effect:

- introduction of the risk management system in the Register of Enterprises;
- introduction of joint liability for the general contractor company or subcontractor company in the construction sector;
- limiting cash transactions among natural persons;

- expansion of the circle of subjects obliged to report suspicious transactions and ensuring the supervision thereof;
- introduction of fast, convenient and effective solution for directing collection of funds in the bank accounts of the debtors, by ensuring the electronic data exchange between the SRS and credit institutions;
- ensuring the supervision and control over the e-commerce and expansion of the SRS rights;
- combatting and restriction the illegal audio visual market (television programmes and films) distribution;
- improvement of the conditions for registration of used vehicles;
- limitation of unfair business persons' engagement into the transaction schemes of security services;
- reduction of the possibilities in the territory of Latvia to discharge, store and trade fuel imported with relieves (in the fuel tanks of the international cargo carriage by road vehicles);
- introduction of reverse VAT in the field of precious metals;
- introduction of tax advance payments for the taxi sector.

Declaration of the Government's Action Plan prescribes that in the medium term the set of measures promoting motivation of the entrepreneurs and the public will be taken for reduction of the shadow economy, by annually increasing the efficiency of tax collection and increasing tax collection to GDP by 1 percentage point in 2018.

Value Added Tax

According to the forecasted national economic growth, as well as taking into account the increase of the share of the VAT revenue in the GDP over the recent years, a stable VAT revenue growth is expected. In addition, in the medium term the VAT revenue growth will be facilitated by the continued implementation of the measures adopted by the government – the fight against tax evasion and tax avoidance, by improving efficiency of tax collection. Improvements in tax collection will result in gradual increase in the amount of tax revenue to GDP.

The VAT revenue in 2017 will also be influenced by the amendments to the *Value Added Tax Law* adopted in recent years:

- according to the amendments adopted on 30 November 2015:
  - as of 1 April 2016 the reverse VAT payment procedures were introduced for mobile telephones, laptops, tablets and integrated scheme devices;
  - according to the EC infringement procedure starting from 1 July 2016 the VAT is applied also to the services of maintenance and administration of residential houses rendered to the members of the cooperative societies of the flat owners, applying the standard VAT rate in amount of 21%;
- according to the amendments adopted on 16 June 2016 starting from 1 July 2016 the reverse VAT payment procedures are introduced for the deliveries of crops and industrial crops (*inter alia*, oil plant seeds).

In turn, according to the amendments adopted on 23 November 2016 to the *Value Added Tax Law*, starting from 1 January 2017:

- withholding of the input VAT is abolished for N1 category trucks with full weight of up to 3 tons, the value whereof concurrently exceeds the value of the representation car prescribed in the legal framework governing the CIT;

- the reverse VAT payment procedures are introduced for deliveries of the crude precious metals and semi-finished products thereof, precious metal alloys and semi-finished products thereof, precious metal coated metals, precious scrap and shivers.

In addition to the above mentioned changes, the VAT revenue is also influenced by the measures, which are not directly related to the changes in the *Value Added Tax Law*, but will promote the increase of the revenue thereof, for example, changes in the application of the excise duty, raise of the minimum monthly wage (see Table 6.2 reflecting all the measures of tax policy influencing the VAT revenue).

Table 6.2. Impact of the Changes in Tax Policy [30] on VAT Revenue, million *euro*

	2017	2018	2019	2020
Enhancement of the technical requirements for cash registers, hybrid cash registers, cash systems, specialised devices and equipment	+18.1			
Imposition of VAT on the management of residential premises (in accordance with the EC infringement procedure)	+11.2			
Introduction of the reverse VAT payment procedure for mobile telephones, laptops, tablets and integrated circuit devices	+1.0			
Increase of the excise duty on alcoholic beverages and beer	+1.2	+1.2	+0.2	
Introduction of the reverse VAT payment procedure for deliveries of crops and industrial crops (starting from 1 July 2016)	+2.8		-4.3	
Combating the shadow economy and other measures to improve tax administration	+7.8			
Raise of the monthly minimum wage from 370 euro to 380 euro	+1.1			
Limiting tax evasion risks in the sector of vehicle maintenance and repairs, when the repairs service compensation is selected as the type of insurance indemnity	+0.1			
Abolition of the input VAT withholding for N1 category trucks with full weight of up to 3 tons and, concurrently, the value whereof exceeds the representative value of the car prescribed in the legal framework governing the CIT	+0.2			
Introduction of the reverse VAT payment procedure for deliveries of the crude precious metals, precious metal alloys, precious metal coated metals, precious scrap and shivers	+0.5		-0.5	
Introduction of the *Law on Aid for the Activities of Start-Up Companies*	+0.4			
Increase of the excise duty rates for cigarettes, cigars and cigarillos and the smoking tobacco	+1.1	+1.2	+0.3	
Other changes (application of excise duty to refill liquids of electronic smoking devices, revision of restrictions of the excise duty and VAT exemptions for diplomats and staff of international organisations, etc.)	-0.4			
Total impact of changes:	**+45.0**	**+2.4**	**-4.3**	

Corporate Income Tax

As the economy developed successfully and corporate financial results improved, the CIT revenue has increased considerably since 2011 and their increase is forecasted also in the coming years.

Changes which will influence the CIT revenue in 2017 are related to combating the shadow economy and other measures to improve tax administration, restrictions in withholding the input VAT for the passenger cars, introduction of the PIT relief for covering catering expenses of the employees, if the collective agreement is concluded.

In 2017 such legislative changes are also introduced that would influence the cooperate income tax revenue also in the subsequent years - abolition of the input VAT withholding for N1 category trucks with full weight of up to 3 tons and, concurrently, the value whereof exceeds

[30] Here and in subsequent tables, showing the impact of tax policy changes, the annual impact of introduction is presented.

the representative value of the car prescribed in the legal framework governing the CIT and limitations of carrying forward the losses of previous years, as well as the increase of the micro-enterprise tax rate.

Table 6.3. Impact of the Changes in Tax Policy on CIT Revenue, million *euro*

	2017	2018	2019	2020
Fight against the shadow economy and other measures to improve tax administration	+1.4			
Limitations of the input VAT withholding for the passenger cars	-1.2			
Introduction of the PIT relief for catering expenses of the employees	-0.8			
Increase of the micro-enterprise tax rate	+0.1	-0.4		
Abolition of the input VAT withholding for N1 category trucks		+0.02		
Limitations of carrying forward the losses of previous years		+12.5		
Total impact of changes:	**-0.5**	**+12.1**		

Excise Duty

Gradual increase of the excise duty for tobacco products has been already planned with the amendments to the *Law on Excise Duties* adopted in the previous years:

– according to the amendments introduced on 14 April 2011, as of 1 January 2018 it was planned to increase the excise duty rate on cigars and cigarillos from 42.69 euro to 45.0 euro per 1 000 cigars or cigarillos;

– according to the amendments introduced on 6 November 2013, as of 1 January 2017 it was planned to increase the specific tax rate on cigarettes from 56.2 euro to 58.2 euro and the minimum duty level from 93.7 euro to 97.0 euro per 1 000 cigarettes, but as of 1 July 2018 - to increase the specific tax rate on cigarettes to 60.0 euro and the minimum duty level to 100.00 euro per 1 000 cigarettes. It was planned to preserve the percentage proportion of the tax rate (Ad Valorem) on cigarettes unchanged - at the level of 25%.

– according to the amendments adopted on 30 November 2015, the increase of the excise duty rates was planned for smoking tobacco, tobacco leaves, by increasing tax rates as of 1 January 2017 from 58.0 *euro* to 60.0 euro, and as of 1 January 2018 – to 62.0 euro per 1 000 grams of tobacco. Additionally, it was stated as of 1 July 2016 to impose excise duty on the refill liquids of the electronic smoking devices.

Nevertheless, by the 23 November 2016 amendments to the L*aw on Excise Duties*, more rapid increase of the excise duty was determined for all tobacco products (see Table 6.4).

Table 6.4. Excise Duty Rates for Tobacco Products

Excise duty object	**Effective date of the rate**		
Cigarettes	**1 July 2016**	**1 July 2017**	**1 July 2018**
Duty rate, euro per 1 000 pieces	56.2	67.0	69.5
Minimum duty level, euro per 1 000 pieces	93.7	99.0	103.5
Percentage rate of the retail trade price (Ad Valorem)	25%	20%	20%
Cigar and cigarillos	**1 January 2017**	**1 January 2018**	**1 January 2019**
Duty rate, euro per 1 000 pieces	58.0	73.0	88.0
Smoking tobacco	**1 January 2017**	**1 January 2018**	**1 January 2019**
Finely cut tobacco, other smoking tobacco, tobacco leaves, heated tobacco, euro per 1000 kg	62.0	66.0	70.0

As seen in Table 6.4, as of 1 July 2017 it is planned not only to increase the specific part of the excise duty on cigarettes and the minimum level thereof, but also to reduce the percentage proportion of the tax (Ad valorem) from 25% to 20% of the minimum retail trade price.

Along with the amendments to the *Law on Excise Duties* adopted on 23 November 2016, as of 1 January 2017 the maximum quantity of the tobacco products and alcoholic beverages was determined, which can be acquired by the diplomatic and consular agents of the diplomatic and consular representative missions, administrative and technical staff thereof and the family members of the above mentioned persons, as well as the employees of the representative offices of international organisations, by applying the excise duty exemption or refund. The prescribed monthly acquisition limits per person are as follows:

- for tobacco products:
    - cigarettes - 600 pieces;
    - smoking or heated tobacco - 600 grams;
    - cigars / cigarillos - 150 pieces;
- for the liquid to be used in electronic cigarettes - 600 milligrams of nicotine or not more than 600 millilitres of the liquid to be used in electronic cigarettes;
- for alcoholic beverages:
    - beer, fermented drinks, wine, intermediate products with the absolute alcohol content up to 15 per cent by volume - 25 litres (in total);
    - intermediate products with the absolute alcohol content from 15 to 22 per cent by volume, other alcoholic beverages - 8 litres (in total).

Gradual increase of the excise duty is also prescribed for the excise duty on alcoholic beverages and beer. According to the amendments adopted on 30 November 2015 to the *Law on Excise Duties*, starting from 1 March 2016 the increase of the excise duty rates on alcoholic beverages and beer was planned – tax rates have been increased as of 1 March 2016 and 1 March 2017 and they will be increased also as of 1 March 2018 (see Table 6.5).

Table 6.5. Excise Duty Rates on Alcoholic Beverages

Type of alcoholic beverage	Effective date of the rate		
	1 March 2016	1 March 2017	1 March 2018
Wine, fermented beverages with the absolute alcohol content exceeding 6 per cent by volume and intermediate products with absolute alcohol content of up to 15 per cent by volume, euro per 100 litres	74.0	78.0	82.0
Fermented beverages with the absolute alcohol content up to 6 per cent by volume, euro per 100 litres	64.0	64.0	64.0
Intermediate products with the absolute alcohol content from 15 per cent by volume to 22 per cent by volume, euro per 100 litres	120.0	130.0	135.0
Other alcoholic beverages, euro per 100 litres of absolute alcohol	1400.0	1450.0	1500.0
Beer, euro per each per cent by volume of absolute alcohol per 100 litres	4.2	4.5	4.8
Minimum level of excise duty per 100 litres of beer	7.8	8.2	8.6

Along with the amendments to the 30 August 2005 Cabinet Regulation No. 662 *Procedures for the Circulation of Excisable Goods*, adopted on 29 November 2016, starting from 1 January 2017 the definition of the process of production of alcoholic beverages was adjusted, stating that it shall mean the processing, refinement and packaging of the alcoholic beverages. In addition, the permissible loss norm for the prepacked alcoholic beverages during the process of storage and transportation thereof was reduced from 0.2% to 0.1%. This results in reducing unjustified writing off of the alcoholic beverages to losses at each stage of their production.

According to the decision on amendments to the Cabinet Regulation No. 194 adopted by the Cabinet on 26 May 2016, stating that, when administering the granting of fuel with reduced excise duty rate for the operating year 2017/2018 and the subsequent years, the sums of payments received in the EU support measures "Organic farming" and "Agro-environment and Climate" will not be included in the revenue. Therewith in the operating year 2017 / 2018 and the subsequent years the land areas, for which the rights are granted to acquire the diesel fuel with the reduced excise duty rate will reduce and the excise duty revenue from the diesel fuel will grow.

Along with the amendments adopted by the Saeima on 23 November 2016 to the law *On Excise Duties*, it is planned, starting from the operating year 2017 / 2018, to abolish the rights to acquire the diesel fuel with the reduced excise duty rate for the land areas, where the corn is cultivated for the generation of the biogas (cultivated plants code 791).

According to the amendments adopted by the Saeima on 23 November 2016 to the *Customs Law*, starting from 1 January 2017, the control over the fuel tanks of the international cargo carriage by road vehicles will be strengthened, reducing the possibility in the territory of Latvia to discharge, store and trade fuel imported with relieves.

Table 6.6. Impact of the Changes in Tax Policy on Excise Duty Revenue, million euro

	2017	2018	2019	2020
Increase of the excise duty rate for cigarettes, cigars, cigarillos and smoking tobacco	+5.4	+5.9	+1.7	
Increase of the excise duty on alcoholic beverages and beer	+5.5	+5.6	+0.9	
When administering the granting of fuel with reduced excise duty rate for the operating year 2017/2018 and the subsequent years, the sums of payments received in the EU support measures "Organic farming" and "Agro-environment and Climate" will not be included in the revenue	+0.9	+0.9		
Revision of the permissible loss norms of alcoholic beverages in the processes of storage, transportation and production thereof	+0.2			
Imposition of excise duty on the re-fill liquids of electronic smoking devices	+0.3			
Revision of the limitations of the excise duty and VAT exemptions for diplomats and staff of international organisations	+0.2			
Strengthening the control over the fuel tanks of the international cargo carriage by road vehicles, which reduces the possibility in the territory of Latvia to discharge, store and trade fuel imported with relieves	+0.3			
As of operating year 2017/2018 the rights to acquire the diesel fuel with reduced excise duty rate for the land areas, where the corn is cultivated for acquisition of biogas, are cancelled	+0.1	+0.1		
Total impact of changes:	**+12.9**	**+12.4**	**+2.6**	

Real Estate Tax

Since 2012, local governments are entitled to determine by binding regulations the tax rate from 0.2 to 3.0 per cent of the cadastral value of the real estate. The tax rate may exceed the threshold of 1.5 percent only in case the real estate is not being managed according to the procedure prescribed by regulatory enactments. Local governments are also entitled to continue applying a restriction on increase in the tax amount for land or to keep the tax amount for land at the level of a previous taxation year as well as to determine the amount of restriction and conditions for application.

The latest most substantial legislative changes came into force on 1 January 2016, stipulating that the increase of the cadastral value of the rural land in an area exceeding 3 ha may not exceed 10% of the cadastral value of the rural land determined in the previous taxation year.

Personal Income Tax

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

The most significant changes that will affect the PIT revenue in 2017 refer to the raise of the minimum monthly wage from 370 *euro* to 380 *euro*.

In addition, the PIT revenue in 2017 will be affected also by other legislative changes taking effect on 1 January 2017:

- introduction of the PIT relief to one of the social guarantees of the employees prescribed by the collective agreement;
- change of the regulation of the PIT with respect to the disbursements from the private pension funds, limiting the application of relief in case of tax planning, stating that the contribution into the pension fund must be for at least one year, otherwise the taxpayer must repay the received PIT refund for the eligible expenditure;
- introduction of tax advance payments for the taxi sector in amount of 130 *euro*;
- limiting tax evasion risks in the sector of vehicle maintenance and repairs, when the repairs service compensation is selected as the type of insurance indemnity;
- introduction of the co-liability of the general construction contractor for the payment of taxes for the employees of the sub-contractor employed in the construction object of the general construction contractor;
- introduction of fast, convenient and effective solution for directing collection of funds in the bank accounts of the debtors, by ensuring the electronic data exchange between the SRS and credit institutions;
- raise of the minimum monthly wage by 10 euro;
- introduction of the *Law On Aid for the Activities of Start-up Companies*, the purpose whereof is to promote formation of the start-up companies in Latvia, thus facilitating research, as well as the use of innovative ideas, products or processes in the economic activities;
- it is stated that the micro-enterprise, which is willing to obtain or regain (if the status is not lost) the status of the micro-enterprise taxpayer, or to relinquish the status of the micro-enterprise taxpayer, shall submit a relevant application to the SRS by 31 January 2017.

The PIT revenue in 2017, 2018 and 2019 will be also influenced by the legislative changes adopted in the previous years:

- introduction of a differentiated non-taxable minimum (during the year all taxpayers are subject to minimum monthly non-taxable minimum, but at the end of the year the SRS, on the basis of the data aggregated regarding person's income, recalculates the PIT, applying differentiated non-taxable minimum and the taxpayers with lower wages, by submitting Annual Tax Return to the SRS, may receive the tax refund. Therewith, the amount of the non-taxable minimum differs for each taxpayer according to the amount of the taxable income of the taxpayer):
  - ➢ as of 1 January 2017 the monthly non-taxable minimum will be reduced from 75 euro to 60 euro and it will be applied to the wage above 1 100 euro

per month, and the maximum non-taxable minimum will also be increased from 100 euro to 115 euro and it will be applied to the taxable income of up to 400 euro per month. For the employed receiving the wage from 400 to 1 100 euro per month the non-taxable minimum, by applying the formula, will gradually decrease to 60 euro per month.

- as of 1 January 2018 and as of 1 January 2019 the maximum non-taxable minimum will be increased, the minimum non-taxable minimum will be reduced and the changes will be introduced in the limits of the taxable income subject to the non-taxable minimum (see Table 6.7). As of 1 January 2020 the monthly non-taxable minimum will be zero and it will be applied to income above 1 500 euro per month, but the maximum non-taxable minimum will be 160 euro per month, to be applied to income of up to 460 euro per month.

Table 6.7. Differentiated Non-Taxable Minimum for 2017 - 2020

	2017	2018	2019	2020
Maximum non-taxable minimum	115	130	145	160
Minimum non-taxable minimum	60	40	20	0
Maximum limit of taxable income	1 100	1 200	1 350	1 500
Minimum limit of taxable income	400	420	440	460

- the PIT relief for received amounts paid out as the state or the EU aid for agriculture and rural development is prolonged till 2018;
- application of eligible expenditure for acquisition of children hobby education programmes;
- application of eligible expenditure to the amounts transferred in the form of charitable donation or gift to a political party or association of political parties registered in the Republic of Latvia;
- inclusion of the scheduled healthcare service (obtaining the ovum (obtaining the follicle) through puncture and production and acquisition of other kind of prosthetic appliances connected to the human body) to a full extent into the PIT eligible expenditure;
- rounding up of the amount of expenditure for the use of educational and medical treatment services to be included in the PIT eligible expenditure from 213.43 euro to 215 euro.

Table 6.8. Impact of the Changes in Tax Policy on PIT Revenue, million *euro*

	2017	2018	2019	2020
Pension indexation in 2017	+1.7			
Determination of the monthly minimum object of mandatory State social security contributions as of 2017	+8.7	-3.3		
Introduction of the differentiated non-taxable minimum	+2.7	+5.6	-0.5	-6.9
Application of eligible expenditure to the amounts transferred in the form of charitable donation or gift to a political party or association of political parties registered in the Republic of Latvia	-0.3			
Legislative changes in the PIT eligible expenditure for the use of educational and medical treatment services	-4.3			
The PIT relief for received amounts paid out as the state or the EU aid for agriculture and rural development is prolonged		-2.2		+2.2
Raise of the minimum monthly wage from 370 *euro* to 380 *euro*	4.6			
Combating shadow economy and other measures to improve tax administration (including introduction of fast, convenient and effective solution for directing collection of funds in the bank accounts of the debtors, by ensuring the electronic data exchange between the SRS and credit institutions, etc.)	1.4			
Introduction of the PIT relief to one of the social guarantees of the employees prescribed by the collective agreement	-1.2			
Change of the regulation of the PIT with respect to the disbursement from the private pension funds		+0.9		
Introduction of tax advance payments for the taxi sector.	+1.5			
Introduction of the *Law on Aid for the Activities of Start-Up Companies*	+0.1			
Determination of the micro-enterprise tax rate in amount of 12% / 15%	+8.9	-4.6		
As of 2017 - abolition of determination of the employee's and employer's minimum mandatory State social security contributions object for the reporting month	-8.7	+3.3		
Total impact of changes:	**+15.1**	**-0.3**	**-0.5**	**-4.7**

Medium-term macroeconomic development forecasts for 2017 provide for a stable increase in the wage fund, which, in turn, will increase labour tax revenue over the period of subsequent years, and the PIT revenue will be also influenced by the legislative changes made.

Social Security Contributions[31]

The medium term dynamics of revenue from social security contributions will be determined not only by the forecasted increase in the wage fund, but also by legislative changes.[32]

The most substantial legislative changes in 2017 affecting the social security contributions revenue are related to the increase in the minimum monthly wage from 370 *euro* to 380 *euro* and the increase of the maximum amount of the object of the mandatory state social security contributions from 48 600 *euro* to 52 400 *euro*.

In 2016 it was planned that, as of 1 January 2017 the employee's and the employer's minimum mandatory State social security contributions object will be introduced, stipulating that the minimum mandatory State social security contributions object is determined for the

[31] Excluding contributions to the State-funded pension scheme.

[32] According to the methodology of the European System of Accounts, social security contributions that are being transferred to the State-funded pension scheme are not being accounted as the general government budget revenue.

employer per each employee, which is not less than the amount of the minimum monthly wage determined by the Cabinet. In 2017 – ¾ of the referred to amount and in 2018 – to a full extent. Having assessed the advantages of abolishing the introduction of the above mentioned changes, it was concluded that those working in the micro-enterprise regime would be able to continue their entrepreneurial activity as before, because, by reducing the tax burden, a smaller number of companies would be forced to dismiss employees. Besides, this would prevent the situation, when the micro-enterprises tax payers, whose entrepreneurial activity is of seasonal nature, have to pay the taxes also for the period, when the entrepreneurial activity is not actually carried out.

Therewith, starting from 1 January 2017 the legislative changes are abolished which were adopted in the previous years and included in the contributions base forecasts for 2017 – the introduction of the minimum object of the mandatory state social security contributions of the employee and the employer. Instead, the amendment to the legal framework with fiscally neutral impact has come into force - amendment to the *Micro-enterprise Tax Law*, stipulating that starting from 1 January 2017 the micro-enterprise tax rate for the turnover of the micro-enterprise of up to 7, 000 euro would be 12% and the micro-enterprise tax rate for the turnover of the micro-enterprise from 7 000.01 to 100 000 euro would be 15%. Starting from 1 January 2018 the micro-enterprise tax rate will comprise 15 per cent. Likewise, from 1 January 2017 the procedure for distribution of the micro-enterprise tax has been changed - increase of the micro-enterprise tax will be allocated to the social security contributions. The social security contributions paid for the employees of the micro-enterprise will increase, on average, (as compared to the current situation) by 62% in 2017 and by 84% in 2018, correspondingly increasing the scope of both short-term and long-term social security services for the employees, at the same time facilitating the sustainability of the social budget.

Table 6.9. Impact of the Changes in Tax Policy on the Revenue from Social Security Contributions[33], million euro

	2017	**2018**	**2019**
Determination of the monthly minimum object of mandatory State social security contributions as of 2017	+76.3	+21.7	
Increase of the maximum amount of the object of the mandatory State social security contributions from 48 600 euro to 52 400 euro	+5.3		
Raise of the monthly minimum wage from 370 *euro* to 380 *euro*	+6.3		
Combating shadow economy and other measures to improve tax administration (including introduction of fast, convenient and effective solution for directing collection of funds in the bank accounts of the debtors, by ensuring the electronic data exchange between the SRS and credit institutions, etc.)	+1.7		
Introduction of the PIT relief to one of the social guarantees of the employees prescribed by the collective agreement	-1.6		
Introduction of tax advance payments for the taxi sector	+2.1		
Introduction of *Law on Aid for the Activities of Start-Up Companies*	+0.4		
Determination of the micro-enterprise tax rate in amount of 12% / 15%	+57.7	+20.0	
As of 2017 - abolition of determination of the employee's and employer's minimum mandatory State social security contributions object for the reporting month	-57.2	-40.8	
Total impact of changes:	**+90.9**	**+0.9**	

The amount of social security contributions to the State special budget is substantially affected also by the rate of contributions to the State-funded pension scheme, which in 2016 was increased from 5% to 6%, but there are no changes of the rate planned in the subsequent years.

[33] Excluding contributions to the State-funded pension scheme.

Electricity Tax

Electricity tax is applied starting from 1 January 2007 and it is governed by the *Electricity Tax Law*, laying down the procedures for imposition of the electricity tax on the electricity.

Electricity tax forms a part of costs, which are included in the trade service price, because the taxpayer is the electricity trader and the electricity producer. The tax rate for electricity is 1.01 euro per megawatt hour, namely, 0.10 euro per 100 kilowatts.

The electricity stock exchange *Nord Pool Spot* started operating in Latvia on 3 June 2013. Electricity bought or sold by the stock exchange participants, by means of the stock exchange platform, in accordance with the stock exchange operating principles, is not being identified by stating its origin, namely, when buying the electricity on the stock exchange it is not possible to determine the resources it was generated of. Along with the commencement of operation of the stock exchange, it has become burdensome to apply in the Latvian market the electricity tax exemptions to electricity generated from renewable energy resources.

Taking into account the above mentioned, the electricity tax exemptions were abolished for the electricity generated from renewable energy resources, in hydroelectric power plants and cogeneration electric stations, as well as for the electricity used for electricity generation and generation of heat energy and electricity in cogeneration.

Therewith, if up to now the tax rate for electricity generated from renewable energy resources - in hydroelectric power plants or in cogeneration electric stations complying with the efficiency criteria, and for the electricity used for electricity generation and generation of heat energy and electricity in cogeneration was 0.00 euro per megawatt hour, then starting from January 2017 the traders will have to pay the electricity tax in full amount.

Table 6.10. Impact of the Changes in Tax Policy on Subsidised Tax Revenue, million *euro*

	2017
Abolition of the electricity tax exemption	+5.4
Total impact of changes:	**+5.4**

Subsidised Electricity Tax

The subsidised electricity tax is applied as of 1 January 2014 and its purpose is to restrict increase in the total electricity price, in order to ensure the competitiveness of the national economy and not to increase the expenditure of households as well as to ensure the implementation of aid measures for electricity users. Indirect purpose of the subsidised electricity tax is to facilitate competitive generation of electricity from renewable energy resources and in efficient co-generation, motivating energy generation in the most efficient way and ensuring that in the future only competitive technologies enter the market.

The subsidised electricity tax is imposed on the income gained from sold energy within the framework of mandatory procurement, from the received guaranteed payment for installed electrical capacity in a co-generation station or electric power station, as well as from sold electricity that is being sold to public trader (to a licenced enterprise for transmission or distribution of electricity).

There are three differential rates set for the subsidised electricity tax – 15% for natural gas stations, 10% for stations of renewable resources and 5% for stations providing thermal energy to centralised systems and whose subsidised electricity tax rate has a direct impact on the final tariff of thermal energy for the users.

According to the Transitional Provisions of the *Subsidised Electricity Law* the tax is imposed on the taxable income gained between 1 January 2014 and 31 December 2017.

Table 6.11. Impact of the Changes in Tax Policy on Subsidised Electricity Tax Revenue, million *euro*

	2018
Abolition of the subsidised electricity tax	-35.8
Total impact of changes:	**-35.8**

Natural Resources Tax

Payments of natural resources tax are directly linked to the economic activities of the Latvian enterprises and the environmental loads caused thereby, as well as the environmental protection measures taken. Therewith, the tax revenue both increases, as the total economic activity grows, and also reduces, as the enterprises and municipalities take the environmental protection measures.

To promote effective and well-considered use of resources, on 23 November and 15 December 2016 the amendments to the *Natural Resources Tax Law* have been adopted in the Saeima (Parliament). According to the said amendments, starting from 1 January 2017 the natural resources tax rates were increased for number of natural resources tax objects:

- coal, coke and lignite (brown coal);
- packaging of goods and products and disposable tableware and accessories of polystyrene;
- extraction of mineral deposits (soil, dolomite for decoration, limestone, travertine, pigmentary soil, sapropel, medicinal mud);
- medicinal mineral water or mineral water used for medical treatment in thermal or hydrotherapy institution in the territory of extraction of water;
- ground water, also freshwater and spring waters sold further on;
- ground water, also freshwater and spring waters used in water supply;
- surface water;
- emissions of carbon dioxide (CO2);
- vehicles registered permanently for the first time in Latvia;
- all types of tyres;
- plastic purchase bags;
- waste disposal. Natural resources tax rate for disposal of the municipal waste and production waste not considered hazardous is increased to 25.0 euro per ton, but for the disposal of hazardous and production waste the natural resources tax is increased to 45.0 euro per ton. It is planned that the tax rate for disposal of the municipal waste and production waste not considered hazardous in 2020 will reach 50.0 euro per ton, but for the disposal of hazardous and production waste - 60.0 euro per ton (see Table 6.7).

Table 6.12. Natural Resources Tax Rates for Disposal of Waste

Type of waste	Effective date of the rate			
	1 January 2017(*euro*/ton)	1 January 2018(*euro*/ton)	1 January 2019(*euro*/ton)	1 January 2020(*euro*/ton)
Municipal waste and production waste not considered hazardous waste in accordance with the legal framework on the waste classification and properties making waste hazardous	25.00	35.00	43.00	50.00
Hazardous waste and production waste considered hazardous waste in accordance with the legal framework on the waste classification and properties making waste hazardous	45.00	50.00	55.00	60.00

On the basis of the adopted amendments, also other changes came into force starting from 1 January 2017:

- natural resources tax is imposed also on the use of water resources for generation of electricity in the hydro-electric power plants, with the total capacity exceeding two megawatts;
- natural resources tax is imposed also on the by-products extracted during the process of extraction of mineral deposits;
- the use of useful characteristics of subterranean depths, by pumping into geological structures the greenhouse gases, is exempt from the objects of the natural resources tax, because such activity is prohibited;
- distribution of the tax revenue is changed among the State and local government budgets from the revenue for emissions of carbon dioxide (CO2), providing for the tax payment in amount of 60% into the State basic budget and in amount of 40% into the special environmental protection budget of such local government in the territory of which the relevant activity is performed.

It is planned to increase the natural resource tax rate for coal, coke and lignite also starting from 1 January 2018 and 2019 (see Table 6.8).

Table 6.13. Natural Resources Tax Rates for Coal, Coke and Lignite

Classification of coal, coke and lignite (brown coal)	**1 January 2017 (*euro*)**	**1 January 2018 (*euro*)**	**1 January 2019 (*euro*)**
Coal, coke and lignite (brown coal) with the calorific capacity specified in the supporting documents (Gj/t)	0.35	0.36	0.38
Coal, coke and lignite (brown coal), if the calorific capacity is not specified in the supporting documents, t	9.80	10.25	10.65

In turn, starting from 1 July 2018, according to the adopted amendments to the Natural resources Tax Law, the natural resources tax rates will be aligned for electric and electronic appliances within the scope of the category, by increasing them for separate sub-categories by 27%, on average.

Table 6.14. Impact of the Changes in Tax Policy on Natural Resources Tax Revenue, million euro

	2017	**2018**	**2019**	**2020**
Increase of the natural resources tax rates for extraction of natural resources and water, disposable tableware and accessories, for plastic purchase bags, for emissions of carbon dioxide, for vehicles registered permanently for the first time in Latvia, for all types of tyres and application of the natural resources tax for the use of the water resources for generation of electricity in the large hydro-electric power plants	+9.5			
Increase of the natural resources tax rates for disposal of waste	+5.0	+2.8	+1.1	
Increase of the natural resources tax rates for coal, coke and lignite	+0.5	+0.02	+0.02	
Alignment of the natural resources tax for the electric and electronic appliances		+0.03		
Total impact of changes:	**+15.0**	**+2.9**	**+1.1**	

Solidarity Tax

As of 1 January 2016 a new labour tax was introduced – solidarity tax, having as its aim the prevention of regressive labour tax system, originating from the restoration of the maximum amount of the mandatory State social security contributions object on 1 January 2014. Along with restoration of the maximum amount of the mandatory State social security contributions object, the tax burden for the taxpayers with income above the defined maximum amount of the contributions object became smaller as compared to those persons, who performed tax payments from the entire work income (see Figure 6.2).

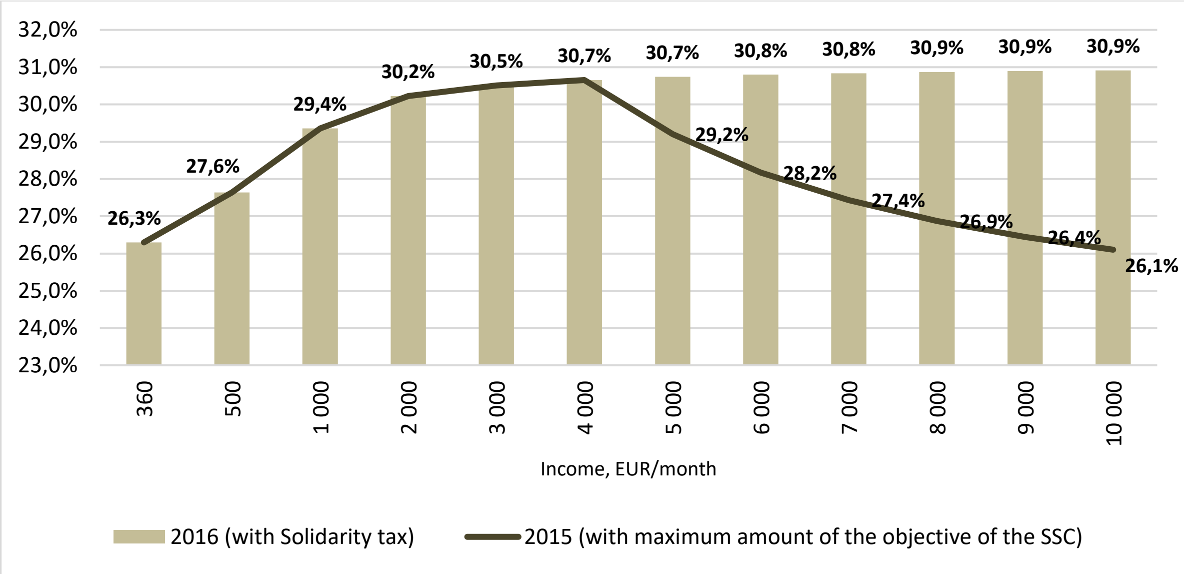


Image 6.2. Labour Tax Burden by Various Income Levels in 2015 and 2016

Solidarity tax rate is the same as the rate of mandatory State social security contributions (34.09%) and it is applied to the part of income exceeding the maximum object of the mandatory State social security contributions. Solidarity tax payments are included in the State special budget along with the mandatory State social security contributions. Afterwards, on the basis of information provided by the SRS, the State Social Security Agency, taking into account the maximum amount of the object of the mandatory State social security contributions, calculates the part of surplus of the mandatory State social security contributions (solidarity tax) for each person, to be transferred into the State basic budget.

Starting from 1 January 2017 the maximum amount of the object of the mandatory State social security contributions is increased from 48 600 to 52 400 *euro*, thus reducing the solidarity tax revenue.

In August of 2016 the Cabinet assessed the proposals on possible changes in the solidarity tax. Taking into account that none of the proposals were supported, the government agreed to preserve the existing procedure for payment of the solidarity tax and, at the same time, to continue assessing the possible reform of this tax within the context of the tax guidelines.

Table 6.15. Impact of the Changes in Tax Policy on Solidarity Tax Revenue, million euro

	2017
Increase of the maximum amount of the object of the mandatory State social security contributions from 48 600 euro to 52 400 euro	-5.3
Total impact of changes:	**-5.3**

Vehicle Operation Tax

Vehicle operation tax has been introduced since 2004 and forms a significant component of the general budget revenue.

Changes influencing the vehicle operation tax revenue in 2017 are related to the change of the rates of the vehicle operation tax (concurrently the passenger car and motorcycle tax is abolished), as well as to expanded definition of the large families for the receipt of the vehicle operation tax relief.

In 2017 also such legislative changes have been introduced that influence the tax revenue also in subsequent years - the changes of the procedure for payment of the vehicle operation tax is adjourned to 2019.

Table 6.16. Impact of the Changes in Tax Policy on Vehicle Operation Tax Revenue, million *euro*

	2017	**2018**	**2019**	**2020**
The change of the procedure for payment of the vehicle operation tax			-43.4	+43.4
Changes of the vehicle operation tax rates	+11.4			
Expanded definition of the large families for the receipt of the vehicle operation tax relief	-0.3			
Total impact of changes:	**-11,1**	**-**	**-43.4**	**+43.4**

7. SUSTAINABILITY OF PUBLIC FINANCES

7.1. THE LONG-TERM DEVELOPMENT SCENARIO OF PUBLIC FINANCES

The ability of the government to administer its finances and act so as to be able to fulfil both its current and future expenditure commitments, without creating inadequate and inconsiderate burden for the future generations of taxpayers, characterises the importance of sustainability of public finances in the national economy of each country. Sustainable public finance system means stable and foreseeable budget and tax policy, as well as the government's solvency. Fiscal sustainability is affected by the general government budget and debt commitments, their trends and future commitments, for example, for disbursement of pensions and benefits. The increase of the budget expenditure in the long term may be affected by demographic changes, including, the increase in expenditure related to the ageing of population. The process of ageing of population, insufficient funding in the social protection and healthcare systems, as well as poverty and social exclusion risks in separate groups of population are long-term challenges for the sustainability of Latvia's public finances, which should be considered already today. The competent authorities are currently working on the reforms in the field of healthcare, in order to be able to adapt the available financial flow to the available and quality scope of services, taking into account the increasing share of older population in the society.

In February 2016 the EC published the updated *Fiscal Sustainability Report 2015*. In this report a potentially low fiscal sustainability risk is identified for Latvia in all three risk categories (short-term, medium-term and long-term). This is based upon low general government budget deficit and debt, as well as low expenditure related to the population ageing in the long term.

The EC, in collaboration with the Member States (within the scope of the AWG), once per three years develops the long-term forecasts of the public sector expenditure related to the population ageing, as well as assesses the sustainability of public finances for each Member State. The long-term budget projections are based upon demographic projections, developed by *Eurostat*, and assumptions regarding economic growth and the factors determining it in the long-term. The long-term population ageing related projections on all the Member States are included in the Ageing Report of the EC.

The risk assessment included in the updated Fiscal Sustainability Report is based upon results, arising out of the latest Ageing Report 2015, prepared by the EC and developed by the EC in collaboration with the Member States. The long-term budget projections are based upon demographic projections EUROPOP 2013, developed by *Eurostat*, and assumptions regarding economic growth and the factors determining it in the long-term. Therewith the Stability Programme for 2017 - 2020 still incorporates data from the Ageing Report 2015, because, at the moment, the current projection cycle is taking place within the scope of the AWG and it is planned to publish the next report in spring of 2018.

It should be noted that the economic growth, in general, plays a significant role in ensuring the sustainability of public finances. It is forecasted that under the influence of demographic changes the changes in the development of employment will be observed. It is expected that in the long-term both the rate of participation in the labour market will increase and the current trend will continue, namely, unemployment will reduce. This will partially allow compensating the influence of decrease in the number of working-age population on employment. 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, the level of economic activity of population is increasingly growing, with the economically active population in 2014 reaching 66.3%, in 2015 - 67.5%, but in 2016 reaching already 68.2% of all population aged 15 - 74. Such increase of economic activity is concurrently indicative of both the increase in the labour force demand and further improvement in the labour market, when the offered workplaces and wage level is stimulating enough, for the previously economically inactive people to return to the labour market. It is also forecasted that the productivity growth in the long run will be a decisive factor for the economic growth and will form the basis for convergence in the long run.

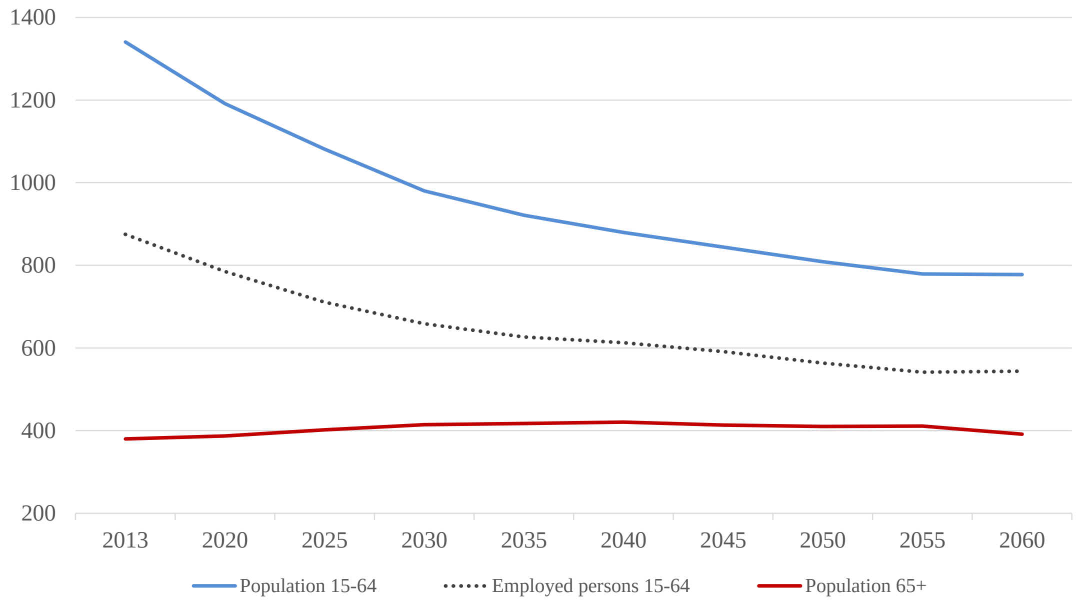


Figure 7.1. Number of Population and Employed Persons in the Age from 15 – 64 and the Number of Population in the Age of 65+ in Latvia, thousands (Data source: *Eurostat*, EC)

According to the *Eurostat* projections, forming the basis for the projections included in the Ageing Report 2015, the reduction in the number of population is being projected in Latvia by 2060. According to the *Eurostat* baseline scenario it is forecasted that the total number of Latvia's population will decrease from 2.0 million in 2013 to 1.4 million in 2060. It is forecasted (see Figure 7.1) that the number of working-age population (15-64) will decrease by 42.0% or from 1.3 million in 2013 to about 0.8 million in 2060. In turn, the number of population aged over 65 will increase by 3.0% in 2060 compared to 2013 and will total to 0.4 million.

The long-term projections developed by *Eurostat* are based upon comparison of the data on the trends observed during the previous years, however the actual data show that the employment trends in Latvia are more positive than projected before. Even though the number of employed population projected by *Eurostat* for 2013 was 875 thousand, nevertheless the actual data show that the number of employed population has been by 19 thousand larger than forecasted by *Eurostat*, actually reaching 894 thousand. This positive trend continued also in 2015, when, in fact, there were 896 thousand employed. The MoF, in its macroeconomic forecasts for the medium term is currently forecasting that, along with the acceleration of the economic growth expected during the coming years, the positive trends will be preserved and the number of population employed in national economy in 2020 will grow to 897 thousand, which is by 22 thousand more than evidenced by the *Eurostat* projections. Likewise, by various labour market stimulating measures, the employment for separate risk groups is facilitated, for example, for inhabitants, who have reached the threshold of 55 years.

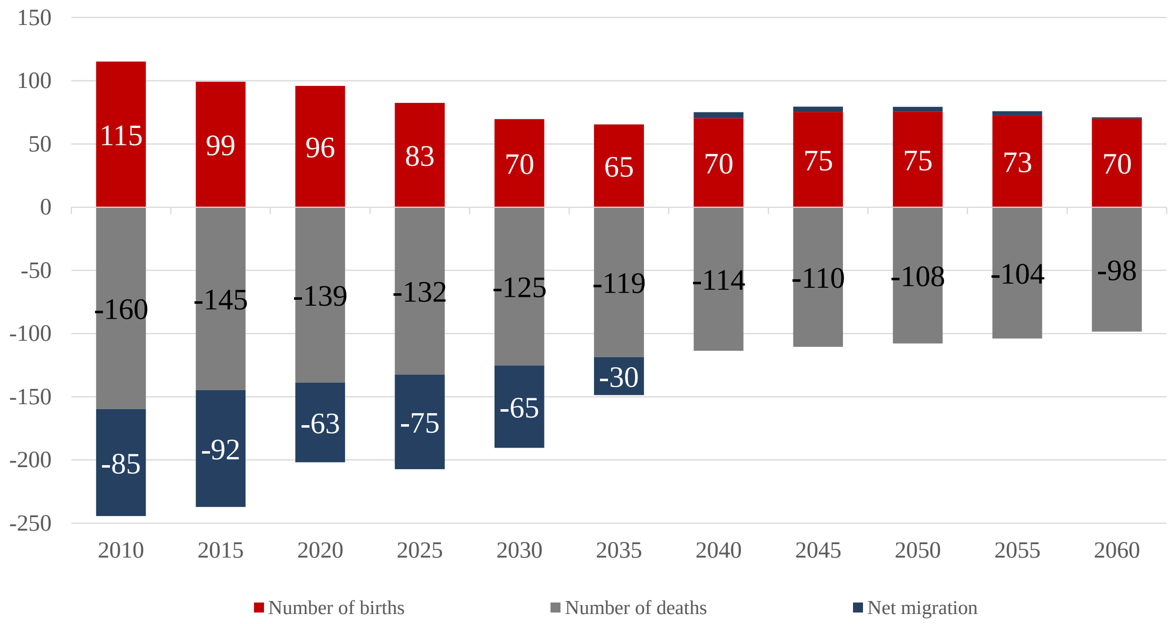


Figure 7.2. The Cumulative Impact of the Changes in the Number of Population Over the Period of 5 Years till 1 January of the Current Year by Factors: number of births, number of deaths and net migration, thousands
(Data source: CSB of Latvia, *Eurostat*)

The decrease of the overall number of population in the subsequent decades (see Figure 7.2) is determined by both negative natural growth and negative migration balance. According to the *Eurostat* forecasts the number of deaths by 2060 in Latvia will gradually decrease, but it will, however, continue exceeding the number of births. Natural decrease of the number of population is strengthened by negative migration balance, which means that the number of inhabitants leaving the country will exceed the number of those entering the country, and according to the *Eurostat* forecasts this trend will continue in Latvia till 2035.

As the number of working-age population in the age from 15 to 64 years decrease, the changes in the number of the employed persons will be observed, as well (see Figure 7.1). Nevertheless, in accordance with the AWG macroeconomic assumptions it is forecasted that in the long term both the employment rate in this age group will increase (from 65.3% in 2013 to 69.9% in 2060) and the unemployment will decrease. It is forecasted that in the long run productivity growth will be a decisive factor for economic growth.

As regards the long-term general government budget expenditure forecasts, in accordance with the base scenario included in the Ageing Report 2015, it is forecasted that in Latvia the proportion of expenditure related to population ageing in GDP in 2060 compared to 2013 will decrease from 16.2% of GDP to 14.5% of GDP. Decrease will be mainly determined by the decline in the proportion of the State pension expenditure in GDP. The long-term public expenditure base scenario provides for:

- decline in the proportion of the State pension expenditure in GDP from 7.7% of GDP in 2013 to 4.6% of GDP in 2060;
- increase in the proportion of the healthcare expenditure in GDP from 3.8% of GDP in 2013 to 4.4% of GDP in 2060;
- increase in the proportion of long-term care expenditure in GDP from 0.6% of GDP in 2013 to 0.8% of GDP in 2060;
- increase in the proportion of education expenditure in GDP from 3.8% of GDP in 2013 to 4.5% of GDP in 2060;

- decline in the proportion of expenditure for unemployment benefits in GDP from 0.3% of GDP in 2013 to 0.1% of GDP in 2060.

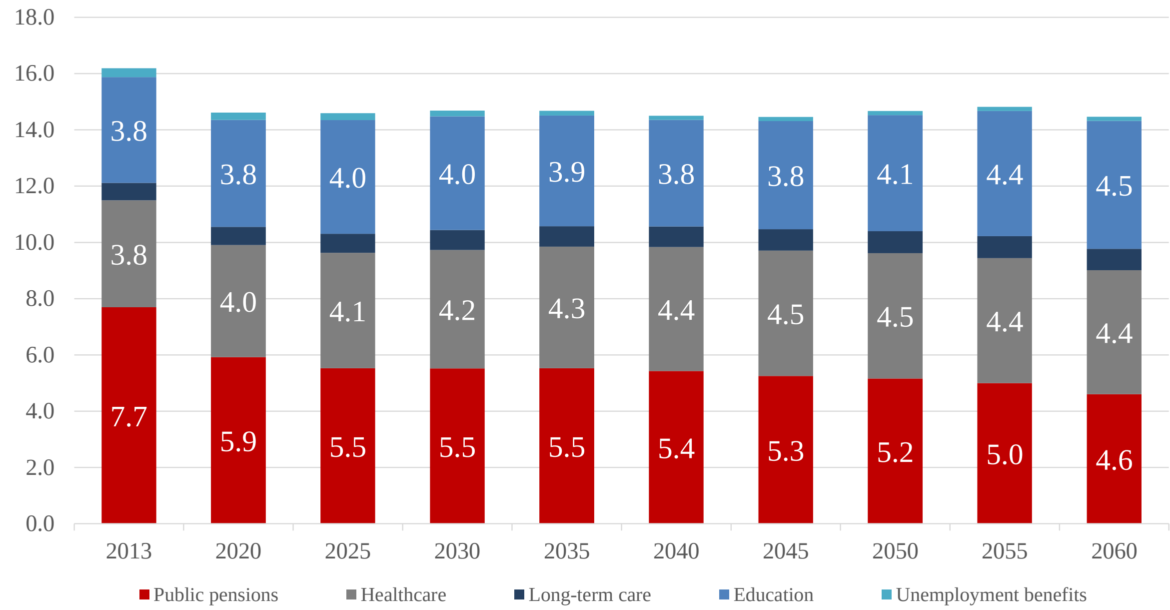


Figure 7.3. General Government Budget Expenditure Related to the Population Ageing, % of GDP (Data source: Ageing Report 2015)

For a preventive restriction of the negative impact of population ageing on the public sector (budgetary) expenditure in the long term, in 2012 there was a considerable reform performed in the Latvian pension system, determining a gradual increase in the retirement age up to 65 years in 2025. This factor substantially influenced the forecasted decline in the proportion of the State pension expenditure in the GDP. Despite the fact that the proportion of budgetary expenditure for State pensions in the GDP decreases in the long term, which improves the evaluation of the fiscal sustainability, at the same time the sufficiency or adequacy of pensions should be assessed. According to the OECD forecasts included in the *Pension Adequacy Report 2015*, in Latvia the theoretical income interchangeability level for a 65 year old inhabitant with 40 years working career will decrease significantly, for example, in the low income group from 69.2% of gross income in 2013 to 43.9% in 2053, in the average income group from 52.9% in 2013 to 43.9% in 2053, in turn in the high income group from 44.8% in 2013 to 32.8% of gross income in 2053. Latvia is also among those countries, which face high poverty risk level among the older population, which, in turn, shows that these persons, while 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 result in increasing poverty among senior citizens in the future.

As regards the improvement of the living standards of those receiving pensions and increase of the old-age pensions, number of measures are being taken, *inter alia*, in 2012 amendments were introduced to the L*aw on State-Funded Pensions* providing for, after financial and economic crisis, gradual restoration and increase of the contributions rate in the State-funded pension scheme. In 2016 the contributions rate has been increased for the last time to 6%. According to the AWG forecasts expenditure for the old-age pensions that would be disbursed from the funded pension scheme or the second pillar might reach 2.2% of GDP in 2060.

When preparing the long-term pension expenditure forecasts, within the scope of the Ageing Report 2015, the following legislative changes have been taken into account:

- gradual annual increase in the retirement age every 3 (three) months reaching 65 years by 2025. At the same time there is still a possibility to request an old-age pension prematurely two years before the regular retirement age;
- increase in the necessary minimum insurance period for entitlement to the old-age pension from 15 to 20 years as of 2025. The increase in the minimum insurance period necessary to receive an old-age pension also stimulates the payment of State social security contributions;
- since 2013 the indexation of the granted pensions has been restored, first of all indexing small pensions, but already since 2014 indexing the amount of the pension or the part thereof that does not exceed 285 *euro*.

It should be noted that the long-term pension expenditure forecasts included in the Ageing Report 2015 do not take into account the following latest most substantial legislative changes:

- According to the amendments to the *Law on State-Funded Pensions* (approved in the Saeima on 18 June 2015),which provide for substituting the negative and positive security contributions wage index determined from 2009 till 2015 by “1”, starting from 1 January 2016 the recalculation of the pension capital accrued by the insured persons will be performed for the period from 1996 till 2014 (inclusive);
- Pensions and insurance indemnities are subject to annual revision on 1 October, by performing the indexation of pensions and insurance indemnities. The *Law on State-Funded Pensions* prescribes that the state pension or its part that does not exceed 50% of the average insurance contribution wage in the state for the previous calendar year shall be reviewed on October 1, taking into account the actual CPI and part of the real increment rates of insurance contributions wage; As regards politically repressed persons, Group I disabled persons, and participants in liquidation of the consequences of the accident at the Chernobyl Atomic Power Plant, the entire amount of the state-funded pension will be reviewed;
- According to the amendments to the *Law on State-Funded Pensions* (approved in the Saeima on 10 March 2016) as of 1 January 2017 the amount of pension indexation has been increased from 25% to 50% of the real increase of wages on which contributions are paid;
- Starting from 1 January 2017, 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* (amendments to the Law were adopted by the Saeima on 18 June 2015), reach the retirement age prescribed by the *Law on State-Funded Pensions,* they shall be granted by the State social security allowance (benefit) disbursed from the State basic budget funds.

It should also be noted that by the 7 September 2016 Cabinet Decree No 507 the concept note was approved *“Active Ageing Strategy for a Longer and Better Working Life in Latvia"*, prescribing to commence activities entailing the labour market support measures for population aged 50 and more, especially till reaching the retirement age, who face considerable hindrances for involvement into the labour market. Implementation of informative measures is planned, aimed at promoting the understanding of the employers and older employed persons, as well as the understanding of the society as a whole regarding the trends of ageing of the population and the labour force and possible solutions for promoting longer and better working life. At the same time, the support focuses on the preservation of working capacities and employment of older employed persons, determining the processional suitability, providing for the training and adult education possibilities, adapting the workplaces and introducing flexible work forms, as well as promoting the transfer of the inter-generation skills, thus facilitating longer working life.

7.2. State Guarantees

The law *On the State Budget for 2016* states that the Minister for Finance, on behalf of the State, may issue the guarantees for students and study lending in amount of 35.9 million euro, *inter alia*, study loans with the State guarantee in amount of 25.2 million euro and student loans with the State guarantee in amount of 10.7 million euro.

In 2016 the study loans with the State guarantee in amount of 6.8 million euro were actually issued, and the student loans with the State guarantee - in amount of 1.4 million euro.

State guaranteed loans outstanding at the end of 2016 reached 432.9 million euro, which, as compared to the State guaranteed loans outstanding at the end of 2015, has increased by 6.6 million euro (see Figure 7.4).

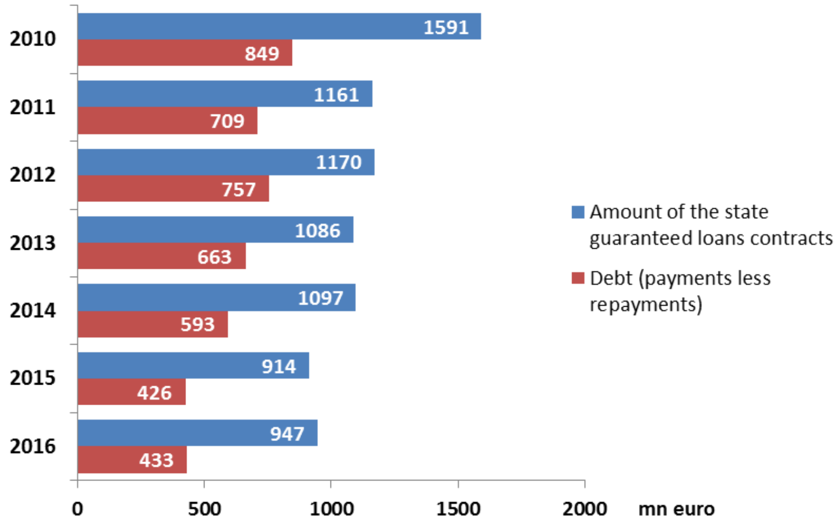


Figure 7.4. State-guaranteed loans outstanding at the end of respective year (million euro)

The law *On the State Budget for 2017* provides for the State guarantees in amount of 41.8 million euro, *inter alia*, for student lending in amount of 10.8 million euro and study lending in amount of 25.2 million euro, as well as for increasing of the guarantees for the Investment Projects financed by the Nordic Investment Bank and the Environmental Investment Projects in amount of 5.8 million euro.

Having assessed the borrowers' financial position, previous credit history, collateral liquidity and amount, as well as other available information, at the end of 2016 the provisions for five guarantees were formed. The outstanding guarantees issued to the mentioned beneficiaries on 31 December 2016 accounted for 16% of the total amount of the outstanding guaranteed loans. According to the law *On the State Budget for 2017*, on 31 January 2017 State guaranteed obligations of the hospitals, which existed towards the Nordic Investment Bank, have been taken over into the central government debt, as a result whereof as on 28 February 2017 the provisions for four guarantees have been formed. In light of the above mentioned assessment, there is a possibility that the four State-guaranteed loan obligations or a part thereof could not be met within the prescribed period and amount.

In the law *On State Budget for 2017* allowable limit on government actions to cover expenditure that may occur in the performance of State-guaranteed debt obligations attributable to the State budget in 2017 is set at 1.5 million euro (~ 0.01% of GDP).

8. INSTITUTIONAL FEATURES OF PUBLIC FINANCES

8.1. 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 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. 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. In case of Latvia, the EC asked for additional explanations with respect to the interpretation of the term "natural or social processes" and the observance of the "*Comply-or-explain*" principle.

On 22 February 2017 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.

8.2. 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. Medium term – 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 Framework has been prepared in the State for the next three financial years, in which there was 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 has 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. Furthermore, 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 are specified for the achievement of the purposes and introduction of the priorities determined in the NDP 2020, formulation of the fiscal policy objectives of the government, the maximum permissible total amount of the State budget expenditure (the maximum permissible total amount of the expenditure for each ministry and other State institution), 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.

According to the deadlines prescribed by the regulatory enactments, the Saeima approved the draft Framework Law for 2017 – 2019 and the draft law On State Budget 2017 on 24 November 2016.

8.3. Budget Procedures, including Public Finance Statistical Management

8.3.1. Budget Procedure

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 Cabinet Regulation No. 867 of 11 December 2012 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. Cabinet approves the base expenditure.

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.

If in the coming financial years according to the most actual macroeconomic development forecasts will be available resources for development expenditure, ministries and other central State institutions shall draw up proposals for supported priority actions. Proposals for measures are prepared on the basis of priorities and objectives defined in the NDP 2020, National Defence 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 base expenditure and funding for priority measures approved by the Cabinet, ministries and other central State institutions prepare and submit budget requests to the FM.

In order to provide the society with a clear idea of the resources used for 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 as a whole 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 government debt ceiling 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 subsidies for local governments, as well as the amount of the State budget subsidy for the local government financial equalisation 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 ministries' expenditures, 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 State basic budget or State special budget indicates the objective, main activities and performers, operating results and performance indicators, financial indicators and total expenditures changes.

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 governments 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, and the Cabinet shall submit it to the Saeima.

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 at the beginning of a financial year the Annual State Budget Law has not come into force, the Minister for Finance shall approve the necessary State budget expenditure for local governments, provided that expenditure per month shall not exceed one twelfth of previous year's appropriation.

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.

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.

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.

8.3.2. Management of government finance statistics

The 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 ESA 2010 in the EU.

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 Manual on Government Deficit and Debt*, which foresee that the capital corporations that are controlled and mostly financed by central and local governments belong to the general government sector.

As of 31 December 2015 the general government sector included 1060 independent budgetary institutions, of which 227 institutions belonged to the central government sub-sector; 832 institutions belonged to the local government sub-sector, and 1 institution - to the social security fund sub-sector. Moreover, there were 127 capital corporations controlled and financed by the central and local governments, of which 49 capital corporations were controlled by the central, and 78 - 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 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. Growth and its Factors

	ESA code	2016	2016	2017	2018	2019	2020
		mln euro	Growth %				
1. Real GDP (at prices of the year 2010)	B1*y	21781	2.0	3.2	3.4	3.2	3.0
2. Nominal GDP	B1*y	25021	2.7	5.2	5.2	6.0	5.7
Real GDP by expenditure (at Prices of the year 2010)							
3. Private consumption expenditure	P3	13834	3.4	3.2	3.0	2.2	2.0
4. Government consumption expenditure	P3	3741	2.7	3.4	2.8	2.8	2.5
5. Gross fixed capital formation	P51	4023	-11.7	5.2	35.4	10.8	8.2
6. Changes in inventories and net acquisition of valuables	P52+P53	702	-	-	-	-	-
7. Exports of goods and services	P6	13108	2.8	3.3	3.5	3.7	4.1
8. Imports of goods and services	P7	13627	4.6	1.4	7.1	5.2	4.9
Contribution to real GDP growth							
9. Final domestic demand			0.1	3.6	9.0	4.6	3.9
10. Changes in inventories and net acquisition of valuables	P52+P53		3.0	-1.5	-3.4	-0.2	-0.2
11. External balance of goods and services	B11		-1.1	1.1	-2.3	-1.1	-0.7

Table 1b. Price developments

	ESA Code	2016	2016	2017	2018	2019	2020
		level	Growth %				
1. GDP deflator			0.7	1.9	1.8	2.7	2.6
2. Private consumption deflator			0.9	2.3	2.0	2.0	2.0
3. HICP			0.1	2.3	2.0	2.0	2.0
4. Public consumption deflator			-2.9	1.9	1.6	1.6	1.6
5. Investment deflator			-1.1	2.8	4.7	4.7	4.7
6. Export price deflator (goods and services)			-1.7	0.5	4.0	4.0	4.0
7. Import price deflator (goods and services)			-6.1	1.5	4.5	4.5	4.5

Table 1c. Labour market development

	ESA code	2016	2016	2017	2018	2019	2020
		Level	Growth %				
1. Employment, persons		893	-0.3	0.2	0.2	0.0	0.0
2. Employment, hours worked		1306792585	0.6	0.2	0.2	0.0	0.0
3. Unemployment rate (%)			9.6	9.4	8.9	8.4	8.2
4. Labour productivity, persons			2.3	3.0	3.2	3.2	3.0
5. Labour productivity, hours worked			2.3	3.0	3.2	3.2	3.0
6. Compensation of employees	D.1	11505	6.2	5.7	5.2	5.0	5.0
7. Compensation per employee		859	5.0	5.5	5.0	5.0	5.0

Table 1d. Sectoral balances

% of GDP	ESA code	2016	2017	2018	2019	2020
1. Net lending/borrowing vis-à-vis the rest of the world	B.9	2.0	3.4	1.5	-0.3	-0.8
of which:						
- Balance on goods and services		0.5	1.0	-1.3	-2.5	-3.4
- Balance of primary incomes and secondary incomes		0.1	0.5	0.5	0.4	0.5
- Capital account		1.4	1.9	2.2	1.8	2.0
2. Net lending/borrowing of the private sector		2.1	4.1	3.1	0.9	-0.4
3. Net lending/borrowing of general government	B.9	0.0	-0.8	-1.6	-1.2	-0.5
4. Statistical discrepancy	EDP B.9	0.0	0.0	0.0	0.0	0.0

Table 2a. General government budgetary prospects

	ESA code	2016*	2016*	2017	2018	2019	2020
		mln euro	% of GDP				
Net lending (+) or borrowings (-) (B.9) by sub-sectors							
1. General government	S.13	-7.5	0.0	-0.8	-1.6	-1.2	-0.5
2. Central government	S.1311	-29.0	-0.1	-1.0	-2.0	-1.5	-0.7
3. State government	S.1312						
4. Local government	S.1313	30.5	0.1	0.2	0.1	0.0	0.0
5. Social security funds	S.1314	-9.0	0.0	0.1	0.3	0.2	0.2
General government (S.13)							
6. Total revenue	TR	9 036.6	36.1	36.8	36.2	36.2	36.0
7. Total expenditure	TE	9 044.0	36.1	37.6	37.8	37.5	36.6
8. Net lending/borrowing	B.9	-7.5	0.0	-0.8	-1.6	-1.2	-0.5
9. Interest expenditure	D.41	278.0	1.1	1.0	0.9	1.0	0.9
10. Primary balance		270.5	1.1	0.2	-0.7	-0.2	0.4
11. One-off and other temporary measures							
Components of revenue							
12. Total taxes (12=12a+12b+12c)		5 459.5	21.8	22.1	21.2	21.2	21.6
12a. Taxes on production and imports	D.2	3 359.9	13.4	13.6	14.5	14.6	14.6
12b. Current taxes on income, wealth etc.	D.5	2 096.8	8.4	8.5	6.7	6.6	6.9
12c. Capital taxes	D.91	2.8	0.0	0.0	0.0	0.0	0.0
13. Social contributions	D.61	2 172.1	8.7	8.8	9.4	9.4	9.4
14. Property income	D.4	196.9	0.8	0.6	0.7	0.7	0.2
15. Other		1 207.9	4.8	5.3	5.1	5.0	5.0
16. Total revenue	TR	9 036.6	36.1	36.8	36.2	36.2	36.0
Tax burden (D.2**+D.5+D.61+D.91-D.995)		7 592.0	30.3	30.7	30.4	30.4	30.8
Components of expenditure							
17. Compensation of employees and intermediate consumption	D.1+P.2	4 097.7	16.4	16.9	17.2	16.8	16.5
17a. Compensation of employees	D.1	2 548.5	10.2	10.6	10.5	10.3	10.0
17b. Intermediate consumption	P.2	1 549.2	6.2	6.3	6.7	6.6	6.5
18. Social payments (18=18a+18b)		2 921.7	11.7	11.7	12.0	12.1	12.3
of which unemployment benefits		116.5	0.5	0.5	0.5	0.5	0.5
18a. Social transfers through market producers	D.6311, D.63121, D.63131	282.4	1.1	1.1	1.2	1.2	1.2
18b. Social transfers, other than transfers in kind	D.62	2 639.2	10.5	10.6	10.8	11.0	11.1
19.=9. Interest expenditure	D.41	278.0	1.1	1.0	0.9	1.0	0.9
20. Subsidies	D.3	133.6	0.5	0.6	0.5	0.5	0.4
21. Gross fixed capital formation	P.51	809.5	3.2	3.7	4.2	3.9	3.6
22. Capital transfers	D.9	31.3	0.1	0.1	0.1	0.1	0.0
23. Other expenditure		772.3	3.1	3.7	2.9	3.1	2.8
24.=7. Total expenditure	TE	9 044.0	36.1	37.6	37.8	37.5	36.6
Government consumption	P.3	4 617.1	18.5	19.2	19.0	18.4	18.4

*The MoF estimate

** Including share of taxes collected by the EU budget

Table 2b. No-policy change projections

	2016	2016	2017	2018	2019	2020
	mln euro	% of GDP				
1. Total revenue at unchanged policy	9 036.6	36.1	36.8	36.8	36.5	36.0
2. Total expenditure at unchanged policy	9 044.0	36.1	37.6	37.1	36.3	35.2

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

	2016	2016	2017	2018	2019	2020
	mln euro	% of GDP				
1. Expenditure on EU programmes fully matched by EU funds revenue	374.2	1.5	1.8	1.8	1.8	1.8
2. Cyclical unemployment benefit expenditure	-19.6	-0.1	-0.1	-0.1	-0.1	-0.1
3. Effect of discretionary revenue measures	73.4	0.3	0.5	-0.1	0.0	0.1
4. Revenue increases mandated by law						

Table 3. General government expenditure by function

% of GDP	COFOG code	2015	2020
1. General public services	1	5.2	4.9
2. Defence	2	1.0	2.0
3. Public order and safety	3	2.0	1.9
4. Economic affairs	4	4.2	4.1
5. Environmental protection	5	0.7	0.7
6. Housing and community amenities	6	1.0	0.9
7. Health	7	3.8	3.8
8. Recreation. culture and religion	8	1.6	1.5
9. Education	9	6.0	5.7
10. Social protection	10	11.5	11.0
11. Total expenditure	TE	**37.0**	**36.6**

Table 4. General government debt developments and contributions to change in gross debt in 2016 - 2020

% of GDP	ESA code	2016	2017	2018	2019	2020
1. Gross debt		40.1	39.2	38.2	39.4	40.4
2. Changes in gross debt ratio		3.6	-0.9	-1.0	1.2	1.0
Contributions to changes in gross debt						
3. Primary balance		1.1	0.2	-0.7	-0.2	0.4
4. Interest expenditure	EDP D.41	1.1	1.0	0.9	1.0	0.9
5. Stock-flow adjustments, of which		3.6	-1.7	-2.6	0.0	0.5
Implicit interest rate on debt		3.1	2.6	2.5	2.8	2.4
Other relevant variables						
6. Liquid financial assets		5.4				
7. Net financial debt (7=1-6)		34.7				
8. Debt amortization (existing bonds) since the end of the previous year		1.0	3.8	2.8	1.2	4.3
9. Percentage of debt denominated in foreign currency		21.0	12.0	9.9	9.6	5.7
10. Average maturity		5.43 years				

Table 5. Cyclical development

% of GDP	ESA code	2016	2017	2018	2019	2020
1. Real GDP growth (%)	B1y	2.0	3.2	3.4	3.2	3.0
2. Net lending of general government	B.9	0.0	-0.8	-1.6	-1.2	-0.5
3. Interest expenditure	D.41	1.1	1.0	0.9	1.0	0.9
4. One-off and other temporary measures						
5. Potential GDP growth (%)		2.3	2.8	2.9	2.8	3.0
contributions:						
labour		0.0	0.2	0.1	0.0	0.1
capital		0.2	0.5	1.1	1.3	1.3
total factors productivity		2.2	2.1	1.7	1.6	1.6
6. Output gap (% of potential GDP)		-0.5	-0.2	0.3	0.7	0.7
7. Cyclical budgetary component		-0.2	-0.1	0.1	0.3	0.3
8. Cyclically-adjusted balance (2-7)		0.2	-0.7	-1.7	-1.5	-0.8
9. Cyclically adjusted primary balance (8+3)		1.3	0.2	-0.8	-0.5	0.1
10. Structural balance* (8-4)		0.2	-0.7	-1.7	-1.5	-0.8

* structural budget balance here is presented by including one-off measure – short-term revenue short-fall caused by tax reform, as in line with SGP, EC will not recognize it as one-off measure.

Table 6. Divergence from previous update

	ESA code	2016	2017	2018	2019	2020
Real GDP growth (%)	B1y					
2016		3.0	3.3	3.4	3.4	-
2017		2.0	3.2	3.4	3.2	3.0
Difference		-1.0	-0.1	0.0	-0.2	-
General government net lending (% of GDP)	B.9					
2016		-1.0	-1.0	-1.0	-0.5	-
2017		0	-0.8	-1.6	-1.2	-0.5
Difference		1.0	0.2	-0.6	-0.7	-
Total general government debt (% of GDP)						
2016		40.3	38.3	37.5	38.2	-
2017		40.1	39.2	38.2	39.4	40.4
Difference		-0.2	+0.9	+0.7	+1.2	-

Table 7. Sustainability of public finances[34]

% of GDP	2013	2020	2030	2040	2050	2060
Age -related general government budget expenditure	**16.2**	**14.6**	**14.7**	**14.5**	**14.7**	**14.5**
Pension expenditure (public pensions)	7.7	5.9	5.5	5.4	5.2	4.6
Social security pensions	7.6	5.9	5.5	5.4	5.1	4.6
Old-age and early pensions	6.9	5.2	4.9	4.9	4.7	4.1
Other pensions (incl., disability, survivor's pension)	0.7	0.6	0.6	0.5	0.4	0.4
Non-earning related pensions (incl., minimum pensions and minimum income guarantee)	0.1	0.1	0.0	0.0	0.0	0.0
Healthcare expenditure	3.8	4.0	4.2	4.4	4.5	4.4
Long-term care expenditure	0.6	0.6	0.7	0.7	0.8	0.8
Education expenditure	3.8	3.8	4.0	3.8	4.1	4.5
Expenditure for unemployment benefits	0.3	0.3	0.2	0.1	0.1	0.1
Social security contributions to the State special pensions budget	7.0	6.3	6.2	6.3	6.2	6.2
Systemic pension reforms						
Social security contributions to the State-funded pension scheme	0.8	1.6	1.7	1.6	1.7	1.7
Pension expenditure from the State-funded pension scheme	-	0.0	0.3	0.7	1.5	2.2
Assumptions						
Labour productivity growth (per hour), %	2.4	4.0	2.4	1.9	1.8	1.5
Real potential GDP growth (%)	1.9	2.6	1.1	1.3	0.9	1.6
Participation rate, males (aged 20-64)	82.7	84.1	84.7	84.9	84.8	86.4
Participation rate, females (aged 20-64)	76.2	77.6	78.6	78.5	78.8	80.6
Total participation rate (aged 20-64)	79.3	80.8	81.6	81.7	81.8	83.6
Unemployment rate (aged 20-64)	11.9	12.2	10.1	7.3	7.3	7.3
Population (aged 65+), % of total population	18.9	20.7	25.5	27.9	28.3	28.0

Table 7a. Contingent liabilities

% of GDP	2016
Public guarantees	1.5
Of which: linked to the financial sector	0.6

[34] 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).

Table 8. Basic assumptions

	2016	2017	2018	2019	2020
Short-term interest rate in eurozone (annual average)		-0.3	-0.2	0.0	0.1
Long-term interest rate in eurozone (annual average)		0.5	0.7	0.9	1.0
EUR/USD exchange rate (annual average)	1.11	1.07	1.07	1.07	1.07
Nominal effective exchange rate in the EU	-7.3	-1.3	0.0	0.0	0.0
World excluding EU, GDP growth	3.0	3.4	3.6	3.6	3.6
EU GDP growth %	1.9	1.8	1.8	1.8	1.8
World export volumes, excluding EU	1.4	2.7	3.2	3.2	3.2
World import volumes, excluding EU	0.8	3.0	3.7	3.7	3.7
Oil prices (Brent, USD/barrel)	44.8	52.3	56.0	56.0	56.0