2016

Latvia's Stability Programme for 2016-2019

MINISTRY OF FINANCE
REPUBLIC OF LATVIA

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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
NRP	National Reform Programme of Latvia for the Implementation of the *Europe 2020* Strategy
CIS	Commonwealth of Independent States
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
Regulation No 1175/2011	EUROPEAN PARLIAMENT AND COUNCIL REGULATION (EU) No 1175/2011 (16 November 2011) amending Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies
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)

1. OVERALL ECONOMIC POLICY GUIDELINES AND OBJECTIVES

The Stability programme of Latvia is a medium-term policy document, describing Latvian fiscal policy for 2016–2019 and which has been prepared following the conditions and guidelines of the SGP implementation. The Stability programme is focused on implementation of strict and sustainable fiscal policy and on the provision of macroeconomic stability.

Within the cycle of the EU economic policy supervision and coordination or the European Semester, the Stability programme is being prepared and submitted to the EC simultaneously with the NRP and the activities included therein.

In 2015 Latvia's GDP grew by 2.7%, reaching stronger growth than the year before, when the economy grew by 2.4%. The growth rate accelerated in light of the steadily growing domestic demand, but the achievement of more rapid growth rate was impeded by complications in the external environment characterised by the geopolitical situation and weak growth in number of Latvia's trading partner countries.

Yet the forecasts remain highly uncertain despite the forecasted strengthening of the global economic growth. Therefore, the medium term Latvia's growth is forecasted be weaker than it was in the Stability programme for 2015 – 2018. According to the MoF forecasts Latvia's GDP will grow by 3.3.% and 3.4% respectively in 2017 and 2018 (in the Stability programme for 2015 – 2018 the forecasted GDP growth in the above mentioned years was 3.6%).

The overall objective of the Latvian fiscal policy does not change, and in 2016–2019 it is – to raise sustainably the quality of life of population. The quality of life includes welfare of inhabitants, availability of medical services, nature environment, developed infrastructure and culture as well as elimination of excessive inequality in population's income. However, in this three-year period a new challenge has arisen – war in Ukraine and increased Russian military presence near the Latvian border, which puts a different light on national security issues.

Therewith, the specific objectives of the fiscal policy, at the same time being also the medium-term budget policy priority growth directions, are as follows:

1) to increase public defence capacity, raising public defence funding against GDP to 2% in 2018;
2) to provide responsible and sustainable 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 against GDP to 1/3 of GDP, basically improving efficiency of tax collection.

The Stability programme for 2016 – 2019 repeatedly invokes the reform of the health system, as an important structural reform with a long-term positive effect on the sustainability of public finance, making use of the SGP flexibility in accordance with the EC Communication and the common understanding opinion of the Council regarding application of the flexibility.

The objective of the overall general government structural budget balance, entailing the applied deviations in the reform of the health system in making use of the SGP flexibility, in 2017 is – 1.1% of GDP, in 2018 – 1.2% of GDP and in 2019 – 0.8% of GDP.

The Stability programme for 2016 – 2019 as a policy document has been approved by the Cabinet as well as presented and approved in the corresponding commission of the Saeima.

2. ECONOMIC SITUATION

2.1. EXTERNAL ECONOMIC ENVIRONMENT

The global economy growth in 2015 was slower than expected, dropping to 3.0%, as compared to 3.3% in 2014. Growth forecasts for both 2015 and 2016 have been continuously decreased over the entire year. The main reasons for a slower growth were connected to the slowdown of economic development of the developing countries, inter alia, in China, as well as in the developing countries reliant on exports of oil and other raw materials. The growth of developing countries was impeded also by overall weakening of the global trade and capital flows, and the total growth of these countries dropped to 4.0% from 4.6% in 2014, being the slowest growth rate since the financial crisis of 2008 – 2009. In turn, the total growth of the developed countries in 2015 became slightly steeper than the year before, growing from 1.8% to 1.9%, facilitated by a stimulating monetary policy and low oil prices.

The total world's economic situation in 2015 was significantly affected by the slowdown in the world's second largest economy China, which is undergoing a gradual transition from the investment and production based growth to a more balanced economic model, with the larger focus on consumption and services. Chinese economic growth in 2015 declined to 6.9%, as compared to 7.3% a year before, falling below the average growth rate of 10% over the last 25 years. A significant factor in the previous year was also the fall in prices on oil and other raw materials, which, on the one hand, adversely affected the growth in majority of the developing countries, but, on the other hand, reduced the costs of resources in the developed countries, thus stimulating the production and consumption of these countries.

Significant changes were introduced last year in the USA monetary policy, when the Federal Reserve System in December 2015 raised the interest rates for the first time since 2006. At the same time the ECB and other central banks of the leading countries of the world continued implementing a highly stimulating monetary policy, and in March 2016 the ECB carried out current rate decrease, decreasing the interest rate for the main refinancing operations from 0.05% to 0% - the new all-time lowest level, as well as extended the amount of quantitative easing programme from 60 to 80 billion euros per month. Economic growth in the Eastern Europe continued to be influenced by the recession of the Russian economy and the depreciation of the rouble, as well as by the still strained relations between Russia and Western countries.

The referred to factor will continue determining the global economic development also in 2016 and it is expected that in 2016 and 2017 the total global growth will accelerate, however the growth rates will still be comparatively low. According to the latest EC forecasts (Winter of 2016), the total global economic growth in 2016 will reach 3.3%, but in 2017 - 3.5%. Growth acceleration will be determined by improving situation in the developing countries, and the growth rates in the developed countries will also generally become slightly steeper.

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

	2014	2015	2016f	2017f
World	3.3	3.0	3.3	3.5
Developed countries[2]	1.8	1.9	2.1	2.1
Euro area	0.9	1.6	1.7	1.9
Germany	1.6	1.7	1.8	1.8
United Kingdom	2.9	2.3	2.1	2.1
USA	2.4	2.5	2.7	2.6
Japan	-0.1	0.7	1.1	0.5
Developing countries[3]	4.6	4.0	4.3	4.7
China	7.3	6.9	6.5	6.2
Russia	0.6	-3.7	-1.2	0.3

Economic growth in the **euro area** reached 1.6% in 2015. Even though it is a considerable acceleration, as compared to the previous year, when the economy has grown by 0.9%, the euro area growth rates are still at a historically low level and lower than in other developed countries. Economic growth in Europe is currently being facilitated by several positive factors, *inter alia*, low oil prices, weak euro exchange rate , low interest rates and the monetary stimulating measures implemented by the ECB, as well as fiscal policy that has become slightly more growth invoking. At the same time, growth is being impeded by still low investment level, which is adversely affected both by economic and political instability in several euro area countries, and the high debt level.

In 2016 and 2017, providing that the previous growth invoking factors persists, the economic development in the euro area will slightly accelerate – to 1.7% and 1.9%, respectively. Nevertheless, still unfavourable situation in external markets will not allow achieving more rapid growth rates.

Economic growth rates in the **USA** will continue being comparatively strong, growing from 2.5% in the previous year to 2.7% in 2016. This will be ensured by still stimulating monetary policy and low interest rates, as well as constant improvement of situation in housing market and labour market. On the other hand, high US dollar exchange rate might adversely affect the activity in the manufacturing sector, whereas the low oil prices will limit investments in the oil extraction industry.

Growth will accelerate also in **Japan**, reaching 1.1% in 2016, which will be encouraged by the supportive monetary policy and favourable financing conditions, as well low oil prices, growing income and recovery of investment activity.

Russian economy fell into recession in 2015, when GDP declined by 3.7% as compared to 2014. The downturn of economy was affected by the economic sanctions of the Western countries, but the decisive factor was the fall in oil prices in the global market. Since autumn 2015 Russian economic perspectives have deteriorated even more, with the oil prices continuing further recession, and the GDP fall in Russia is expected also in 2016 – by 1.2%, with the growth restoring only in 2017.

Germany, which is the fourth largest Latvian export partner, preserves moderate growth rates, as the GDP growth gradually increases from 1.7% in 2015 to 1.8% in 2016. The main trigger of economic growth in Germany still is the domestic demand, driven by the favourable situation in the labour market and favourable financing conditions.

[1] European Economic Forecast - Winter 2016, European Commission.
[2] World Economic Outlook (WEO) Update, January 2016, IMF.
[3] World Economic Outlook (WEO) Update, January 2016, IMF.

Sound and stable economic growth is preserved in the fifth largest Latvian trade partner **Poland**, where the GDP growth in 2015 comprised 3.5% and it is expected to keep this level also in 2016 and 2017. Economic growth in Poland is also mainly ensured by strong domestic demand, encouraged by improvement in the labour market situation and fiscal incentives.

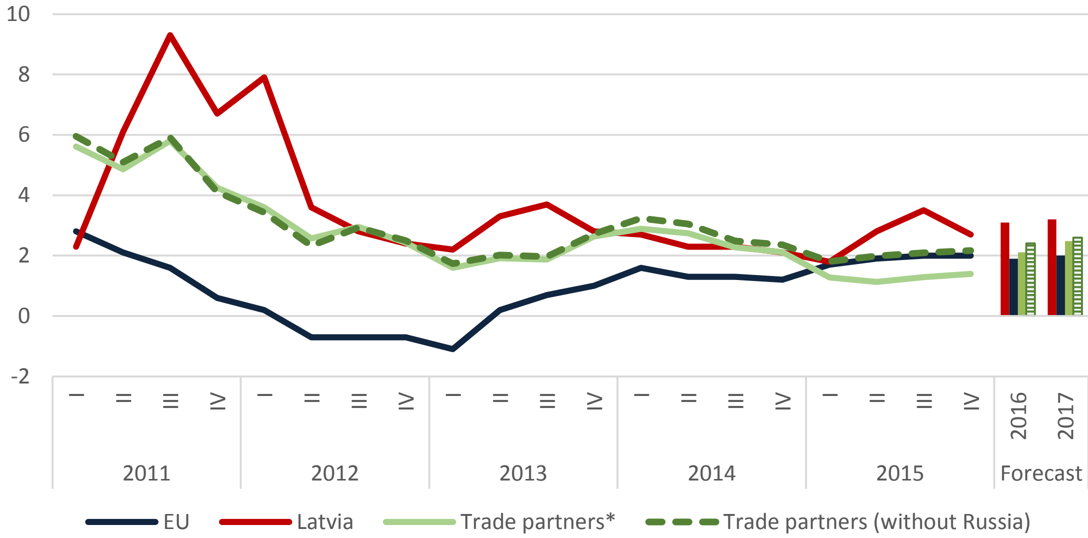

Table 2.1. GDP growth rates and forecasts of Latvia's partner countries[4] and the EU, %

Contrary to previous years, when the weighted average economic growth of Latvia's main trade partners considerably exceeded the average EU rate, in 2015 it was slightly lower than the EU average, and such situation was determined by economic recession in Russia. In turn, the overall growth of the rest of the partner countries of Latvia, except for Russia, in 2015 was at the average EU level. However, in 2016 the growth of Latvia's partner countries became steeper again, exceeding the average EU rate and facilitating the acceleration of the Latvian economic growth.

Along with the sharp fall of prices of energy resources, the overall **inflation level** in the world remained low in 2015. However, the dynamics was not homogeneous here, as well, and inflation in the developed countries in 2015 reduced to 0.3% as compared to 1.4% the year before[5], but the inflation rate in the developing countries, in turn, increased to 5.5%, affected by the fall of national currencies in majority of the countries exporting raw materials.

Inflation in the euro area last year declined to 0.0% and also in 2016 only a very moderate resumption of the rise in prices in expected, by inflation reaching 0.5%, but in 2017 - growing to 1.5%. The main trigger of low inflation in the euro area are decreasing prices of energy resources, nevertheless also core inflation in 2015 remained low, reflecting weak economic growth and low wage increase.

In general, prices of raw materials in the global market in 2015 experienced a sharp decline. According to *Bloomberg* data, the prices of raw materials on the world commodity market in 2015 have fallen on average by 25%, with *Bloomberg Commodities* index falling to the lowest level since 1999. The largest fall was in the oil prices, which in 2015 as compared to the previous year decreased by 45%. Prices declined for almost all groups of commodities included in the index - energy resources, grain, metals, meat products, except for cotton, the price whereof slightly grew. Fall in oil prices continued also at the beginning of 2016, when

[4] Average growth in Latvia's main external trading partners (Estonia, Lithuania, Russia, Germany, Poland, Sweden), weighted with the average export rate of particular country in 2015. Data source: European Economic Forecast - Winter 2016, European Commission; MoF calculations.
[5] World Economic Outlook (WEO) Update, January 2016, IMF.

Brent crude oil price in the middle of January fell below 30 US dollars for barrel – the lowest in the last 12 years, afterwards gradually increasing again to 40 US dollars in the second half of March.

2.2. CURRENT ECONOMIC DEVELOPMENT

In 2015 Latvia’s GDP grew by 2.7%, reaching stronger growth than the year before, when the economy grew by 2.4%. The growth rate accelerated in light of the steadily growing domestic demand, but the achievement of more rapid growth was impeded by complications in the external environment characterised by the geopolitical situation and weak growth in a number of Latvia’s trading partner countries. As a result thereof, last year Latvian GDP growth was the highest among the Baltic States and by 0.8 percentage points exceeded the EU-28 average growth rate.

Private consumption has been the main trigger of the Latvia’s economic growth ever since 2013, whereas export and investment increased slower, even though both achieved growth in 2015. These trends are invoked by a complicated external environment, therewith also the sectors mainly focussed on local market experienced a steeper growth last year.

In terms of the economic sectors, in 2015 the GDP value added growth was registered in the largest sectors - trade and manufacturing. The value added generated in the trade sector last year grew in total by 3.7%, being encouraged by increase in the income of the inhabitants combined with the low inflation, thus stimulating the domestic demand. The value added of the manufacturing last year grew by 4.3%, which was ensured by a steady growth in wood processing sector, as well as considerable increase in the manufacture of computers, electronic and optical equipment. In 2015, the value added rise was registered also in the real estate sector (+3.0%), professional and administrative services sector (+1.2%), as well as public administration and defence (+2.3%). Besides, good results were displayed also by agriculture, reaching 5.0% growth, thanks to the record grain yield harvested last year. Nevertheless, the previous year was not successful for cattle breeding due to sanctions imposed by Russia, mainly adversely affecting the dairy cattle breeding, while the swine breeders were affected by the protracted spread of the African swine fever.

Production volumes last year decreased in two sectors: in transport by 0.1% and in construction by 1.1%. Decrease in transport was mainly determined by the external environment situation and reduction of the Russian transit flow, but construction was influenced by the last year’s high base and reduction of activity in construction of the buildings.

Analysis of GDP from the expenditure side shows that, overall, in 2015 there was an increase in all components, but economic growth was mainly ensured by private consumption encouraged by strongly rising wages, a very low inflation rate and the PIT decrease from 24% in 2014 to 23% in 2015. In 2015 private consumption increased by 3.3%, and also public consumption grew strongly – by 3.1%. Last year also the investment revived, with the annual total gross fixed capital formation increase comprising 2.6%, as compared to 2014.

Half of the total gross fixed capital formation volume is comprised on non-financial investment, which grew by 2.5% at current prices in 2015. Investment in transport and storage sector made up one fifth of all non-financial investment in 2015, increasing by 14.9% as compared to 2014. Investment growth in transport sector was facilitated by completion of the Freeport of Riga infrastructure object in the second half of the last year. Even though slower than the year before, the growth of non-financial investment continued also in manufacturing sector – by 6.5%. Likewise, partially due to establishment of the Natural Sciences Centre of the University of Latvia, last year the volume of investments in education doubled as compared to the year before and investment in real estate operations grew by 79%. The fall in non-financial investments in 2015, in turn, continued in public administration and defence – by 20.1%, electricity and gas supply sector – by 14.1%. Investments decreased also in trade, information and communication services sector, and other sectors.

Whereas the FDI volume in Latvia in 2015 reached 577.9 million euros, which is by 129.3 million euros more as compared to the previous year, however concerns are raised by the tendency observed over recent years showing the decrease of incoming FDI flow in equity. FDI volume in equity in 2014 comprised 121.4 million euros, which is by 165.7 million euros less as compared to 2014 and by 428.4 million euros less than the FDI inflow in 2013. This shows that investments in enterprises owned by foreign investors decrease, which can, most likely, be explained by protracted political tension in the region. Opposite dynamics, in its turn, is observed with respect to the reinvested profit. The rise in the reinvested profit volume ensured almost four fifths (457.0 million euros) of the total FDI inflow in Latvia in 2015.

The latest World Bank *Doing Business 2016* report, measuring the business environment of the countries, ranks Latvia in the 22nd place among 189 world countries and ranks it as the 10th among the EU Member States. Even though compared to the results of the previous year, Latvia's position in the total ranking remained unchanged, the World Bank experts have appreciated the reforms carried out in Latvia for improving the business environment in such field as the enforcing contracts and registering property. In turn, considering that Latvia's credit rating has already reached the pre-crisis level and the future outlook has been defined as stable, it is providing a positive signal for potential foreign investors. Therewith, as the geopolitical situation becomes more stable, the FDI inflows to Latvia's national economy should increase.

Goods and services export has performed weaker last year, increasing by 1.0%, which was predefined by the geopolitical situation, sanctions imposed by Russia on food products produced in the EU and the deterioration of the overall economic situation of the CIS countries. In turn, imports of goods and services in 2015 experienced a more rapid growth than export - by 1.6%, as a result of which goods and services foreign trade balance in Latvia deteriorated by 0.3 percentage points and the trade balance showed a deficit of 2.5% of GDP.

Latvia's goods exports at current prices in 2015 increased by 1.3% and the fall of exports to Russia by 24.4% was offset by growth of exports to such markets as Lithuania, Algieria, United Arab Emirates, Denmark, Czech Republic and the USA. Growth of exports of goods was positively influenced mainly by the growth of exports of machinery and electrical appliances by 10.7%, as well as wood and wood products exports by 2.2% and chemical industry products exports by 5.1%. The main negative influence, in its turn, was left by the fall in exports of mineral products, textile materials, as well as food and agricultural goods by 14.0%, 8.9% and 1.3% respectively. At the same time, imports of goods last year reduced by 1.1%, as a result of which Latvia's goods foreign trade balance in 2015 improved by 262.3 million euros and the foreign trade deficit comprised 2.1 billion euros, making up 8.8% of Latvia's GDP at current prices (compared to goods foreign trade deficit of 10.2% of GDP in 2014).

Latvian financial sector is characterised by good level of banking capitalisation and liquidity, however the issue of availability of financial resources is still an issue. Considering that liquid bank assets last year grew more rapid than the current liabilities, the liquidity ratio of banking sector remains at a high level, growing by 3.6 percentage points and at the end of 2015 comprising 66.7% (minimum liquidity ratio requirement is 30%). Last year the decline of the loan portfolio of commercial banks finally stopped and at the end of 2015, as compared to the same period last year, loan portfolio grew by 0.1%, reaching 14.7 billion euros. It should be noted that this growth was ensured by the growth in non-residents loan portfolio by 9.9% to 2.3 billion euros at the end of 2015. The resident loan portfolio, in its turn, continued to decrease in 2015 - by 1.5%, comprising in total 12.4 billion euros at the end of the year. In 2015 the loan portfolio quality has improved, hence at the end of the year the proportion of over 90 days overdue loans in the bank loan portfolio decreased from 6.9% to 6.0%. Positive trends were observed both in the resident households' portfolio and in business portfolio, while the proportion of the non-resident loans overdue for more than 90 days increased from 5.3% to 8.8%, triggered by unfavourable economic situation in the non-residents' domiciles. At the same time, geopolitical tension in the region has encouraged the growth of restructured loans, more specifically with respect to non-resident loans. At the end of 2015 the proportion of restructured loans in the total loan portfolio comprised 8.7%, which is by 1.1 percentage point more than at the end of 2014. In turn, overall, during 2015 the banks wrote off approximately 1.2% of the loan portfolio.

In 2015 the amount of the newly granted loans was 2.9 billion euros, comprising the growth of 19.8%, *inter alia*, the amount of the new loans to residents grew by 10.2% and to non-residents - by 30.1%. The amount of the new loans granted to resident businesses last year grew by 5.4%, but to households – by 20.6%, thus, first of all, triggering the above mentioned investment growth in the Latvia's national economy last year and, secondly, strengthening the private consumption. By the end of 2015 23.3 billion euros were deposited in the Latvian commercial banks, comprising the growth by 4.8%, as compared to the end of 2014. Both resident and non-resident deposits increased by 1.0% and 8.3%, respectively. It should be noted that the non-resident deposits make up slightly more than one half of all deposits.

Even though less noticeably than in previous years, the labour market situation continued to show improvements also in 2015. The share of jobseekers according to the labour force survey data decreased to 9.9% of the economically active population, and was by 0.9 percentage points lower than the year before. The average registered unemployment rate in 2015 decreased by 0.2 percentage points, forming 8.7% of the economically active population. Nevertheless, at the end of December of 2015 the registered unemployment rate in the amount of 8.7% was by 0.2 percentage points higher than during the respective period of the previous year.

In turn, according to the labour force survey data, the number of employed population in 2015 increased by 1.3% up to 896.1 thousand. Besides, over the period of last year the proportion of the employed population has increased by 1.7 percentage points, reaching 60.8% of the total population aged between 15 - 74 years. The company data regarding occupied workplaces show that the number of workplaces in 2015 mostly increased in the health and social care, accommodation and food services sectors, administrative, professional and IT services sectors. In turn, in the manufacturing industry and construction the number of employed population has decreased.

Similarly to 2014, also last year average monthly gross wage continued rapid growth. Average gross wage in 2015 increased to 818 euros, reaching total growth 6.8%, coinciding with the growth rate registered last year. The steepest rise in 2015, like the year before, was observed in the private sector – by 7.9% to 799 euros, while in the public sector wages grew by 5.2% to 855 euros. The steepest gross wage increases last year were registered in the accommodation and food services sectors, real estate, as well as in arts and entertainment sectors – by 10.5, 9.9% and 9.2%, respectively. Whereas the weakest wage increases were observed among the employees of financial and insurance sector and administrative and maintenance services. Along with a low inflation and PIT reduction, the purchasing power of population also grew considerably, increasing by 7.4% in 2015.

In 2015, the implementation of Cohesion Policy measures played an important role in boosting economic growth. The EU funds assessment shows that the positive impact of the Cohesion Policy on the dynamics of real GDP in 2015 amounted to 1.4 percentage points. In terms of sectors, the greatest stimulating impact of the EU funds in 2015 was in the construction sector reducing the sector's value added decline by 4.0 percentage points. This considerable EU funds impact on construction can be explained by the construction sector's projects completed during the post-crisis period, the implementation whereof has been largely triggered by the work assignments in the field of construction and renovation of engineering structures and public sector buildings financed by the EU funds. Significant positive impact of the Cohesion Policy was also observed in industrial production sector – 1.4 percentage points in 2015. Within the sector, the development of the national economy was specifically facilitated by considerable investments in innovative industrial enterprises.

Consumer price growth in 2015 remained weak, with the average annual inflation reaching only 0.2%. At the same time, inflation in Latvia last year was higher than in majority of the EU Member States, with many countries even showing deflation. The weak consumer price growth in Latvia was continuously determined by external factors, including fall in oil prices and prices of unprocessed food in the world market, as a result whereof the commodity prices decreased by 0.7%. Prices of services, in their turn, rose by 2.5%, reflecting growing domestic demand, facilitated by the rise on income of population.

Overall, in light of the geopolitical tensions and economic complications in the external environment, Latvia's economic growth in 2015 is to be assessed as good. Even though the national economy growth last year was moderate, it nevertheless exceeded the forecasts of domestic analysts as well as international institutions. It should be noted that the external environment risks will remain present also this year, however Latvia’s economy has demonstrated its resilience, thus the economic growth is expected to slightly accelerate in 2016.

2.3. MACROECONOMIC DEVELOPMENT SCENARIO

The medium-term macroeconomic development scenario for 2016 – 2019 has been based on 4Q 2015 GDP flash estimate and the statistical information available by 5 February 2016. On the 1st of March, the macroeconomic development scenario were updated after complete macroeconomic data for 2015 had been available. It was technical update that slightly changed the nominal data, without changing the growth rates.

During the forecasting round the MoF organised discussions with the experts of the Bank of Latvia, Ministry of Economic, as well as the EC and the IMF experts. The updated macroeconomic forecasts have been presented also to the Fiscal Discipline Council, which has approved the medium-term forecasts of Latvian economy.

The macroeconomic development scenario has been based on the technical assumptions of the EC’s 2016 winter forecasts. According to these assumptions the average Brent oil price is set to 35.8 US dollars per barrel of in 2016 and 42.5 US dollars in 2017. It also assumes that EUR/USD exchange rate will remain unchanged at the level of 1.08 over the forecasting horizon.

The EC forecasts that the EU growth will be slower in 2016 than it was forecasted in June 2015 and, starting from 2017, the economic growth rates will accelerate. It is important that the GDP growth of Latvia’s main trading partners will be higher than the EU average . It is assumed that the sanctions imposed by Russia will not be escalated and Russian rouble will have reached its lowest value supportedby a slight rise in oil prices. Therewith, it was assumed that demand from Latvian goods and services will be stable and increasing. Along with the stabilisation of the external demand and more intensive acquisition of the EU funds, it is expected that investments will grow steeper than over the last two years. It is expected that in the medium-term the economic growth will become more balanced and it will be supported by the growth of both private consumption and exports.

Yet the forecasts remain highly uncertain despite the forecasted strengthening of the global economic growth. Therefore, the medium-term Latvia’s growth is forecasted to be weaker than it was in the Stability programme for 2015 – 2018. According to the MoF forecasts Latvia’s GDP will grow by 3.3.% and 3.4% respectively in 2017 and 2018 (in the Stability programme for 2015 – 2018 the forecasted GDP growth in the above mentioned years was 3.6%).

Table 2.2. Growth and related factors

	ESA code	2015	2015	2016	2017	2018	2019
		mln euro	Growth %				
1. GDP at 2010 prices	B1*y	21448	2.7	3.0	3.3	3.4	3.4
2. GDP at current prices	B1*y	24376	3.4	4.3	5.8	6.2	6.5
GDP by expenditure at 2010 prices							
3. Private consumption	P3	13458	3.3	3.4	3.3	3.4	3.5
4. Government consumption	P3	3742	3.1	3.1	2.8	2.8	2.8
5. Gross fixed capital formation	P51	4778	2.6	4.6	7.0	8.0	6.5
6. Changes in inventories and net acquisition of valuable	P52+P53	13	-	-	-	-	-
7. Exports	P6	12457	1.0	3.0	4.1	4.5	5.0
8. Imports	P7	12999	1.6	3.8	5.3	6.1	6.0
Contribution to GDP growth							
9. Final domestic demand			3.2	3.6	4.2	4.6	4.4
10. Changes in inventories and net acquisition of valuable	P52+P53		0.0	-0.1	0.0	0.0	0.0
11. Exports-imports balance	B11		-0.4	-0.6	-0.9	-1.2	-0.9

The medium term development of private consumption will closely follow the developments in labour market. No significant increase in employment rate is expected because the employment has reached its maximum due to demographic restrictions. Thus a moderate wage growth is forecasted, which will increase the consumer sentiment. The households' stock of loans will gradually stop to decrease, and it might even start slightly increase, nevertheless its economic impact will be limited. Population will, most likely, not be eager to undertake long-term liabilities, while the lending policy of commercial banks will still remain cautious. Thus, the private consumption growth rate will be relatively close to the general economic growth rate in the medium term.

Investment will be affected mainly by two factors: start of the issue of the EU funds for 2014 - 2020 planning period and geopolitical uncertainty. It is expected that the EU funds inflow will be slightly delayed in 2016 due to unapproved procedures of the new financing period. Nevertheless, already starting from 2017 the EU funds inflow is expected to become steeper. Russian sanctions against the EU and geopolitical tension reduce the economic attractiveness of the region impeding the investment inflow. Therefore rapid investment growth is not expected in 2016. This concerns not only the sectors influenced by sanctions but also other sectors of economy. According to scenario the geopolitical tension will not escalate further in 2016 and it is possible that the situation might gradually improve in 2017, thus the investment growth rates will exceed the general economic growth rates.

It should be noted that the prolonged low level of investment creates additional risks for growth lowering the growth of economic potential.

Development trends and scenario of the external sector

After considerable current account fluctuations, which were mainly determined by the negative impact of the global financial crisis on the profit indicators of Latvian banking sector, as well as a steep fall in domestic demand for foreign goods, starting from 2011 Latvia's current account balance improved. Decline in the external trade deficit along with minor corrections in the secondary income account, reduced current account deficit of Latvia's balance of payments from 466.8 million euro or 2.0% of GDP in 2014 to 299.6 million euro or 1.2% of GDP in 2015. Such current account deficit does not create concerns as to the financing and sustainability thereof, because the current account deficit is fully covered by the EU funds inflow in the capital account. Furthermore, also the incoming FDI play a significant role in the financing of the current account deficit. After decrease in 2014 the incoming FDI flow resumed, growing by 129.3 million euro to 577.9 million euro in 2015, thus fully covering the current account deficit.

It should be concluded that the average three-year level of current account (-1.9% of GDP) does not exceed the threshold of the EU early warning mechanism (-4% of GDP) and, overall, is viewed as sustainable.

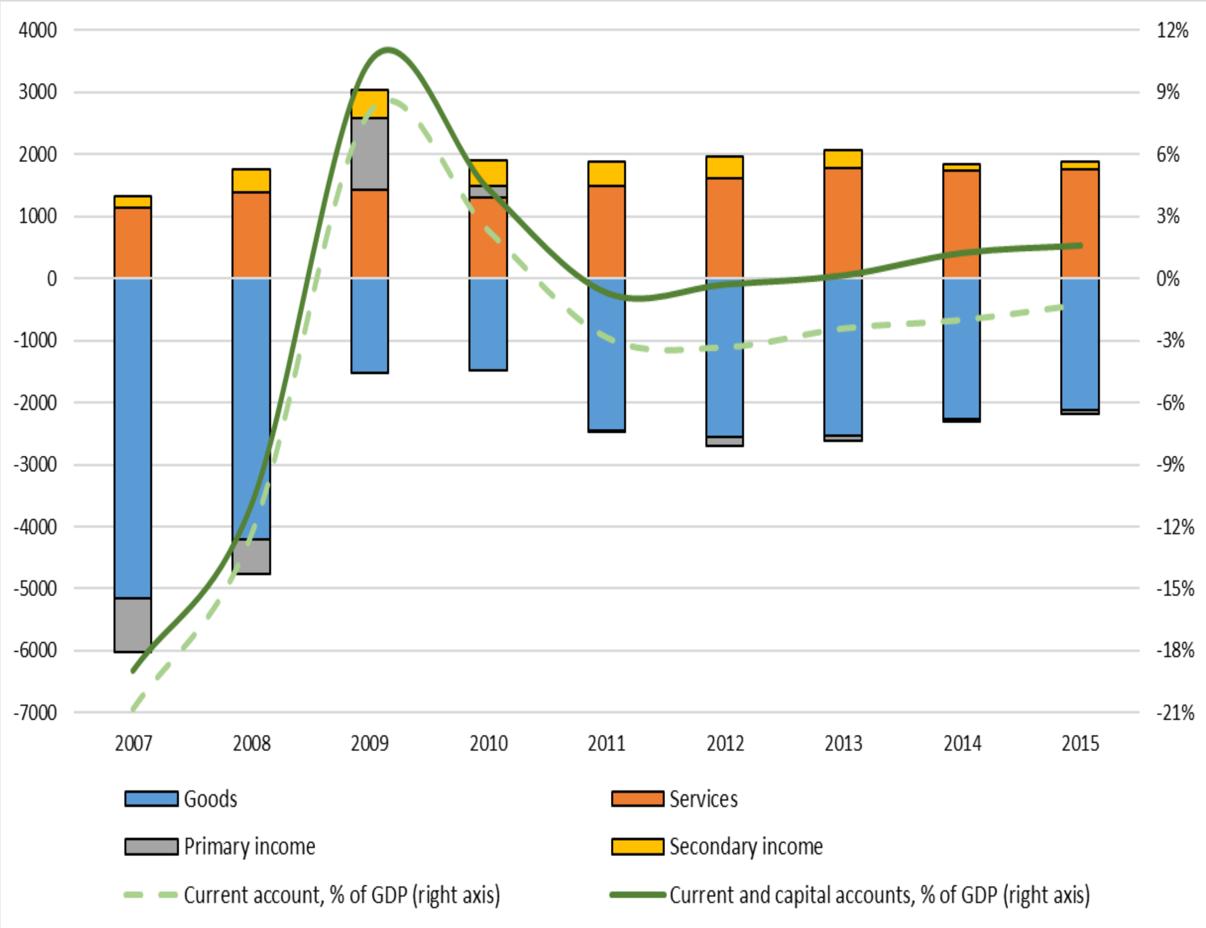

Figure 2.2. Components of the current account of Latvia's balance of payments (mln EUR) and current and capital accounts in percentage of GDP

Not accounting for a highly fluctuating changes in the income account balances, mainly connected to the irregular EU funds flow and income from direct investment, since 2011, when Latvian economy returned to growth the main changes in the current account were determined by the development of foreign trade of goods and services. Despite the steady private and government consumption growth rates in 2015, due to prolonged period of low prices on raw materials and slowdown in exports growth the import of goods in 2015 decreased by 1.3% in accordance with the CSB data. The major negative impact on the fall in the value of imports of goods was created by the fall in imports of mineral products, with their value decreasing by 19.5% or 359.3 million euro as compared to 2014, which is due to low prices of energy resources on world markets. At the same time, positive development dynamics is observed in imports of capital goods or goods with high value added, used both for further processing and re-export.

Also the growth rate of the exports of goods slightly slowed down in 2015, reaching only 1.3%, representing the weakest growth in the post-crisis period. Nevertheless, considering the rapid fall in the values of national currencies of the CIS countries, extension of sanctions by August 2016 for separate food products exported to Russia, as well as the new wave of sanctions, banning fish products exports to Russia, and abolition of milk quota system in the EU, the performance of the exports of goods in 2015 is viewed as good. The structure of growth of exports of goods is not homogenous, however the major input in exports development was ensured by the machinery and electrical appliances goods category, with their value in exports increasing by 10.7% or 184.6 million euro. It should be noted that the same growth in this goods category is recorded also in data on imports, showing that the strong development of machinery and electrical appliances exports is related to the growth of re-exports. Stable exports growth were in commodities related to timber industry, for example, wood and articles of wood , pulp of wood and paper , as well as furniture exports in 2015 grew by 2.2%, 13.6% and 5.1%, respectively. In turn, the largest decline in the value of exports of goods is recorded for mineral products – in total by 14.0% or 118.6 million euro.

Taking into account the opposed development dynamics of exports and imports of goods in 2015, the foreign trade deficit of goods fell to the lowest level since 2010 - 8.8% of GDP.

Despite the negative trend of the recent years in the sector of transport services provided to non-residents, related to growing competition in the transport sector in the Baltic Sea Region, the strong growth of tourism and other commercial services (financial services, as well as information and computer services) not only minimised the fall in income in the railway and road transport sectors, but even slightly increased the positive balance of the services account as a whole. The value of exports of services in 2015 increased by 4.9% or 190.3 million euro. The growth of equal value, though slightly smaller, was recorded also in imports of services, therewith the positive balance of the services account remained practically unchanged and in 2015 comprised 7.2% of GDP.

The primary income account deficit in 2015 grew by 29.7 million euro. Deficit growth is related to the increase of the reinvested earnings and dividend amount by 236.8 million euro, disbursed to foreign parent companies. The increasing flow of the EU funds subsidies and the improvement of profit indicators of Latvian companies abroad were not able to offset such growth rate. Therewith, the primary income account deficit in 2015 increased to 69.9 million euro.

The changes in the balance of the secondary income account on the credit side were determined by the EU funds inflows. Amount of resources from the European Fisheries Fund in 2015 slightly decreased, but the decrease was offset by increase in inflows from the European Social Fund and other foreign financial assistance mechanisms. The changes on the debit side of the balance, in their turn, are related to declining contributions to the EU budget as compared to 2014. Therewith the secondary income account surplus slightly improved, increasing to 117.3 million euro.

In 2016 export growth will depend upon the factors of external demand, as well as development of competitiveness of Latvian producers and expansion of markets. In 2015 milk and fish export to China was recorded, but these were, nevertheless, test orders, which do not per se form independent consistent and serious export volume. Besides, the growth of exports of goods will be affected by the high grain exports base due to record high grain harvest in 2015, as well as prolonged complicated situation in the metalworking industry. EC February forecasts suggest that in the medium term the economic growth in EU countries will remains moderate, but stable. It is forecasted that in 2016 the EU total GDP growth will remain at the level of the previous year or 1.9%. However, except for Germany, the economic growth of all other Latvia’s main trading partners will continue above the EU average level. However, despite the fact that the growth rates will be higher than on average in the EU, for separate significant Latvia’s trading partners, such as United Kingdom and Sweden, the difference between the EU average growth rate will reduce. Therewith, it will become increasingly more difficult to raise the growth of export value only in account of the physical amount. Moreover, taking into account that the possibilities of improvement of competiveness on account of reduction of labour costs have been exhausted, the major role in the future Latvian export development will be related to the possibility to improve quality of goods and to raise production efficiency. The forecasted growth of exports of goods and services at current prices in 2016 is 4.0%, but in 2017 - 5.8%.

Given the extensive proportion of import goods in the consumption structure and favourable price dynamics, the consumption growth will stimulate an increase in imports. This, along with the investment growth, will increase the growth rate of imports of goods and services at current prices to 4.8% in 2016 and to 6.9% in 2017.

Inflation

Similarly to 2015, also in 2016 changes in consumer prices will be mainly influenced by external factors, including low prices of energy resources and unprocessed food on world markets, and the total inflation level in Latvia will remain low. Inflation boosting effect, in its turn, will be caused by excise duty increase on oil products, tobacco products and alcoholic beverages, as well as imposition of VAT on housing management services.

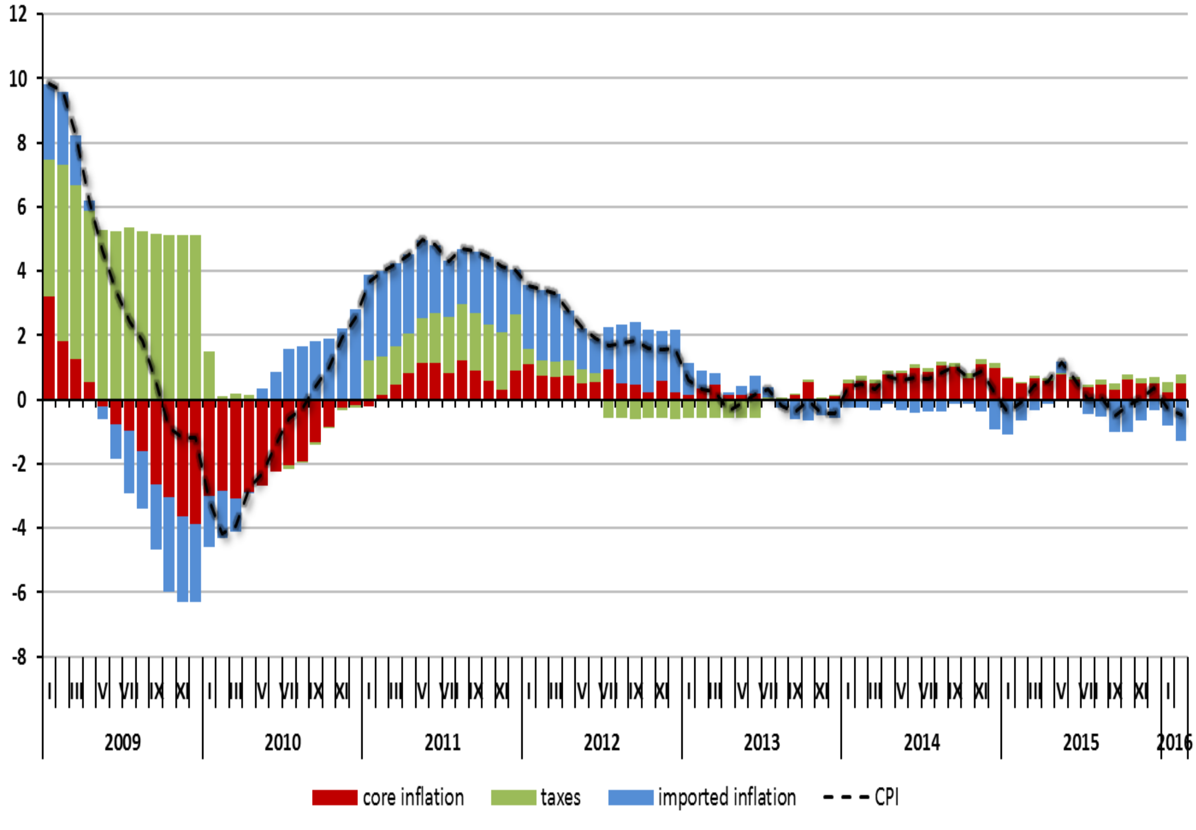

Figure 2.3. Annual inflation according to a source of origin

According to the MoF forecasts, in 2016 consumer prices will increase on average by 0.4%, while in 2017 the inflation increase to 2.0% is expected. Over the next two years consumer price growth will accelerate to 2.5%, which will be determined by the balanced economic development and convergence of the Latvian economy to the EU average.

The sharp fall in oil prices in 2015 and in the first months of 2016 has already showed up in fuel prices, however, the impact on consumer prices as a whole will continue appearing for the entire period of 2016, because the oil price drop reflects in gas and heat tariffs with time shift, and a certain time is also required for the total producer prices decline to start affecting the consumer prices. Along with the reduction in fuel, gas and heat prices, in 2016 the decline in electricity prices will also have an inflation diminishing effect, unlike the year before, when the electricity market liberalisation and price increase had the largest inflation boosting impact.

According to the contract signed up by JSC "Latvijas Gaze", the purchase price of natural gas from Russia and natural gas tariffs in Latvia depend on 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. Thus, if oil prices remain at current levels or even slightly increase, heat prices in Latvia will continue to fall until the second half of this year.

Forecasts of macroeconomic indicators for the Stability Programme for 2016 – 2019 are made on the basis of the technical assumptions of EC 2016 winter forecasts, which foresee a gradual increase in oil prices from the average of 35.80 USD per barrel of Brent crude oil in 2016 to 42.50 USD per barrel in 2017, while the EUR/USD exchange rate will be 1.08. Thus, it is expected that in 2017 the impact of energy prices on consumer price growth will be positive, which will also be one of the factors in the overall growth of the inflation level to 2.0%.

Provided that oil and food prices become stable in the coming years, the increase in consumer prices in Latvia will mainly be determined by the core inflation, which, along with the further improvement of situation on labour market and growth of average wages, will ensure the increase of overall inflation to 2.5% in the medium term.

Labour market

As the economic growth remains moderate, improvement in the labour market in 2015 continued, though at a slightly slower pace than before. Jobseekers rate according to the labour force survey data in 2015 has fallen to 9.9% of the economically active population, which is 0.9 percentage points less than in 2014 and the lowest since 2008. However, the decline in unemployment rate has been slower than in the previous years, when it decreased by 1.1 percentage points in 2014 and 3.1 percentage points in 2013, respectively. In the fourth quarter last year the decline in unemployment rate had slowed down noticeably, by the jobseekers rate reducing over the year by only 0.4 percentage points to 9.8% of the economically active population. In turn, the registered unemployment rate at the end of December 2015 was by 0.2 percentage points higher than the year before, comprising 8.7% of the economically active population.

At the same time, the improvement of situation on the labour market is confirmed also by number of other indicators, *inter alia*, the increase of the proportion of the economically active population among all population of working age. In 2015 this indicator has increased to 67.5%, as compared to 66.3% the year before, and demonstrates that the number of people who have become inactive, because they have lost hope of finding a job, is declining. The number of such economically inactive population has been steadily declining since 2010 and the share of such people in all economically inactive population has diminished, as well. The increase of the proportion of the economically active population also proves that the offered remuneration becomes increasingly stimulating to engage in the labour market. At the same time, for employers it becomes increasingly difficult to find suitable employees in certain sectors and occupations.

The number of employed persons according to the labour force survey in 2015 increased by 1.3% to 896 thousand, and also enterprise data regarding occupied workplaces show that the number of occupied workplaces in 2015 on average has been 1.2% larger than the year before. Inter alia in the private sector the number of occupied workplaces increased by 1.5%, but in the public sector the increase was lower – by 0.4%. By sectors, the largest job creators in 2015 were health and social care, accommodation and food services, as well as administrative and professional services sector. In turn, the number of occupied workplaces in manufacturing industry, public administration and construction in 2015 on average has been smaller than in 2014.

It is expected that in 2016 the number of population employed in national economy will grow at a slower pace – by 0.2%, determined by reduction in the number of population in working age and moderate economic growth rate. Also in the next three years the growth in the number of employed population will be insignificant, in light of the demographic situation and structural unemployment.

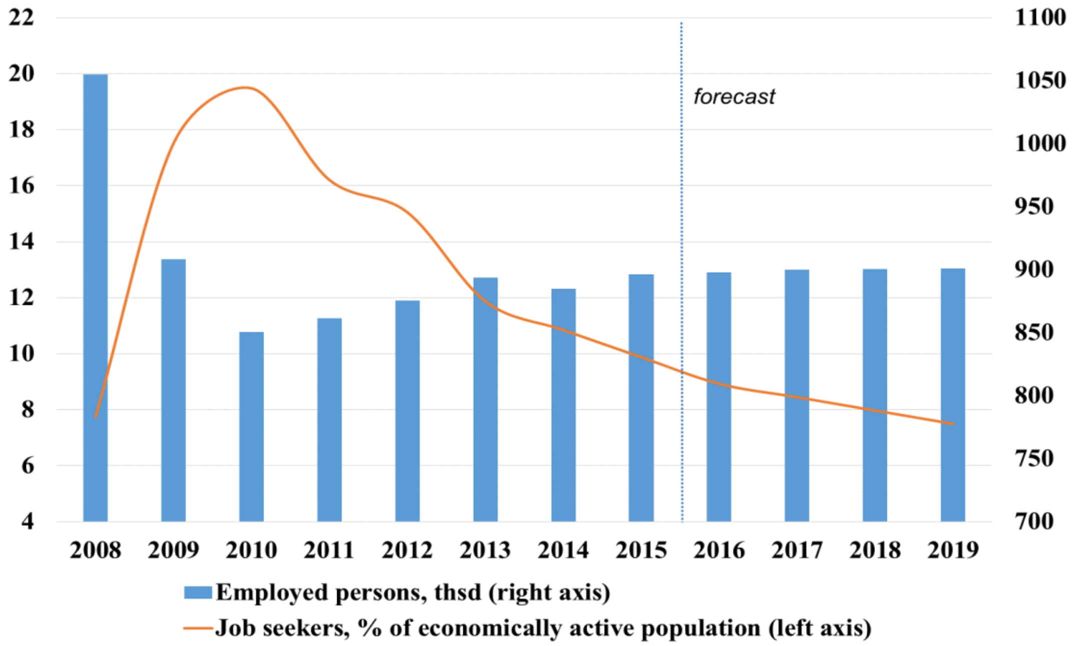

Figure 2.4. Employment and unemployment in 2008 - 2019

The unemployment rate, in its turn, will continue to decline gradually, also due to the decrease of the number of population aged between 15 – 74 years. However, due to economic growth and demographic factors it is expected that economic activity of the population will also rise, as a result, the decline in the unemployment rate will become increasing slower, falling from 9.9% in 2015 to 7.5% in 2019.

Over the past three years, the real wage growth considerably exceeded productivity growth. Such situation is related to the rapid growth of national economy in recent 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. However, as the above mentioned factors disappear, it is expected that in the medium term wage growth will be determined by the increase in productivity, which is an essential prerequisite for ensuring competitiveness of Latvia.

Cyclical development of economy

According to calculations by the MoF, potential GDP growth will be around 2.7-3% in the medium term, mainly due to growth of capital and total factor productivity. The contribution of employment is close to zero, as it is limited by relatively high structural unemployment and unfavourable demography.

Compared with the Stability Programme for 2015 – 2018, the MoF has reduced the potential GDP growth estimate from 3.5% to 3.0% in the medium term, while for 2016 it was reduced from 3.1% to 2.7%. Given the limited availability of the labour force, further potential

GDP growth is closely linked to total productivity growth. Thus, the adjustment of the potential growth forecasts is mainly influenced by the lack of investment, which have been at a relatively low levels since 2012 already.

Current economic indicators has no evidence that the Latvian economy is unbalanced and its growth rate is too high. It is expected that economic growth will be close to its potential level in the coming years, however, with a tendency to exceed it, namely, output gap will become slightly positive generated. This year the output gap will be -0.4%, but next year 0.1% and by the end of the forecasting period it will reach 0.9%.

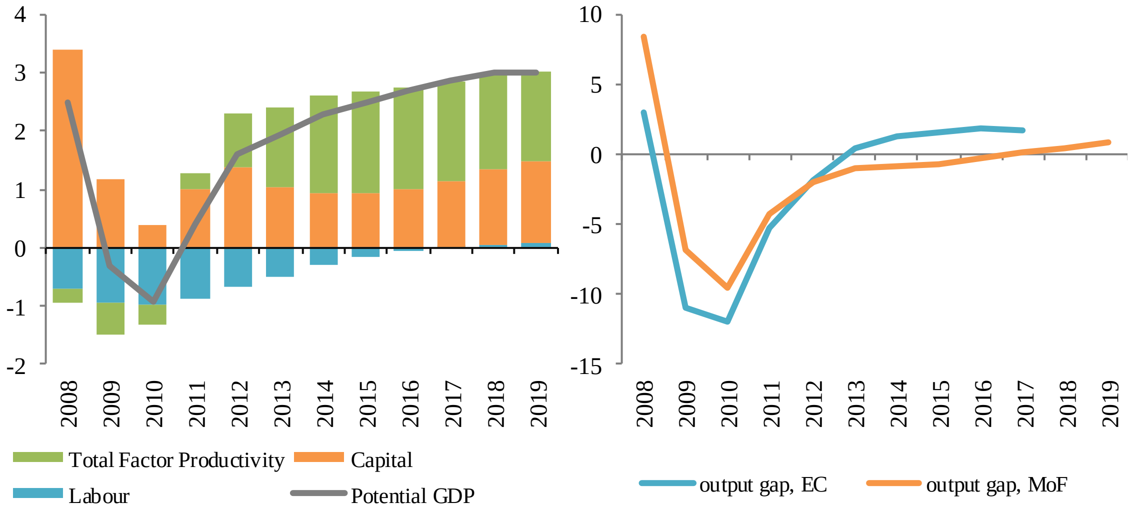

Figure 2.5. Potential GDP growth and the output gap

According to the EC, estimate positive output gap has been present in Latvia already since 2013 reaching 1.8% in 2016 and 2017. Nevertheless, the MoF is of the opinion that the actual macroeconomic data do not prove that Latvian economy would be overheating or the domestic demand of the economy would exceed the supply, given constant structural changes taking place therein.

Lack of excessive demand is proved by the low inflation, which is close to the EU average and which rapid growth is not forecasted in the medium term. Also the current and capital account balance is in surplus, evidencing that Latvia is not accumulating but rather decreasing on account of the external debt. The net external debt ratio to GDP ratio continued to fall in recent years.

Also the wage growth is not indicative of excessive demand growth but rather structural changes. The wage growth can largely be explained by the increase of the minimum wage and reduction of shadow economy. The latter factor is of importance because granting of loans is possible only against legal income, and it is of utmost importance for entrepreneurs to participate in public procurements. It should be noted that majority of the observed wage growth is allocated to pay back loans, rather than to consume.

Also the IMF and OECD estimate balanced output gap for Latvia in medium term. Furthermore, no macroeconomic imbalances have been identified by the EU early warning mechanism, i.e., Macroeconomic Imbalance Procedure. Taking into account the aforementioned factors, we believe that the EC output gap estimates do not reflect the actual economic situation in Latvia.

3. General Government Budget Balance and Debt

3.1. Current Fiscal Situation

According to the operative estimate of the MoF the general government budget nominal deficit in 2015 was 236.2 million euro or 1.0% of GDP, corresponding to the amount planned in the law *On the State Budget for 2015*. Deficit level estimated by the MoF in 2015 is by 0.5 percentage points less than prescribed in the Stability Programme for 2015 – 2018. Smaller deficit than forecasted was influenced by larger tax revenue, given more rapid economic growth, as well as smaller expenditure than initially planned, mainly for goods and services, as well as contributions to the EU budget. Dynamically the general government budget balance in 2015 as compared to 2014 has improved by 0.6% of GDP and is close to the level of 2012 and 2013, when the general government budget deficit was 0.8% and 0.9% of GDP, respectively.

Along with the economic growth in 2015 nominal general government revenue and expenditure growth was observed, with revenue increasing by 2.1%, while expenditure – by 0.6%. At the same time relatively to economic growth last year revenue remained close to the 2014 level, reaching 35.3% of GDP, and, in turn, redistributed resources through general government expenditure decreased by 1.0 percentage point and accounted for 36.3% of GDP.

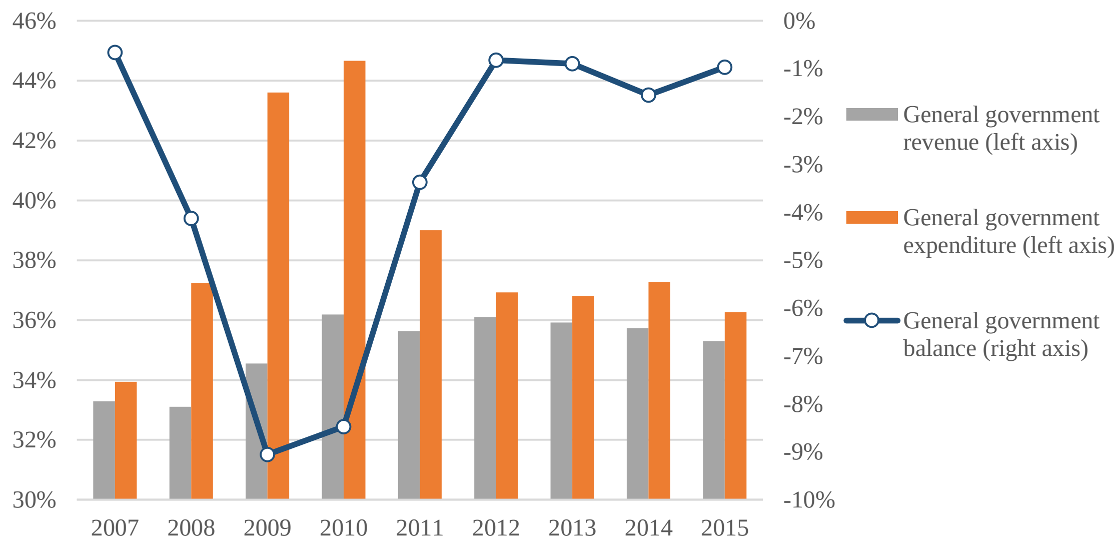

Figure 3.1. General government revenue, expenditure and budget balance[6], % of GDP

Despite the unfavourable situation in the external environment, Latvian economic growth in 2015 corresponded to the initial forecast and, along with successful tax administration measures, determined the tax revenue in compliance with the planned level. It is worth noting that the tax burden made up 28.8% of the forecasted GDP, being one of the highest tax revenue levels in recent years. Like the year before, also in 2015 one of the main economic growth boosters was domestic demand. The average wage growth contributed to the increase in private consumption and retail trade turnover. Increase in the tax revenue as a whole was observed for all tax types, however the most rapid revenue increase was observed for excise duty, social security contributions and corporate income tax.

[6] Data source: Notification on the General Government Budget Deficit and Debt in October 2015 (2007–2014) and Indicative Estimate of the MoF for 2015

Redistributed resources through general government expenditure was in line with the initial plan level. Increase in the general government expenditure in 2015 was mainly ensured by higher expenditure for social benefits and remuneration. Increase in total expenditure was affected at a comparatively smaller extent by increase of gross fixed capital formation.

The assessment of contribution of the general government sub-sectors[7] to the overall fiscal balance, allows concluding that the negative balance was mainly formed by the central government deficit, comprising 1.4% of GDP in 2015. If in 2012 and 2013 the central government balance was close to a balanced level, over the past two years central government shows tendency to spend more, which is mainly related by the government decision as of 2014 to finance supplementary pension payments through transfers. In 2014 also a one-off transfer was performed in the amount of 0.4% of GDP, settling the liabilities towards the European Bank for Reconstruction and Development.

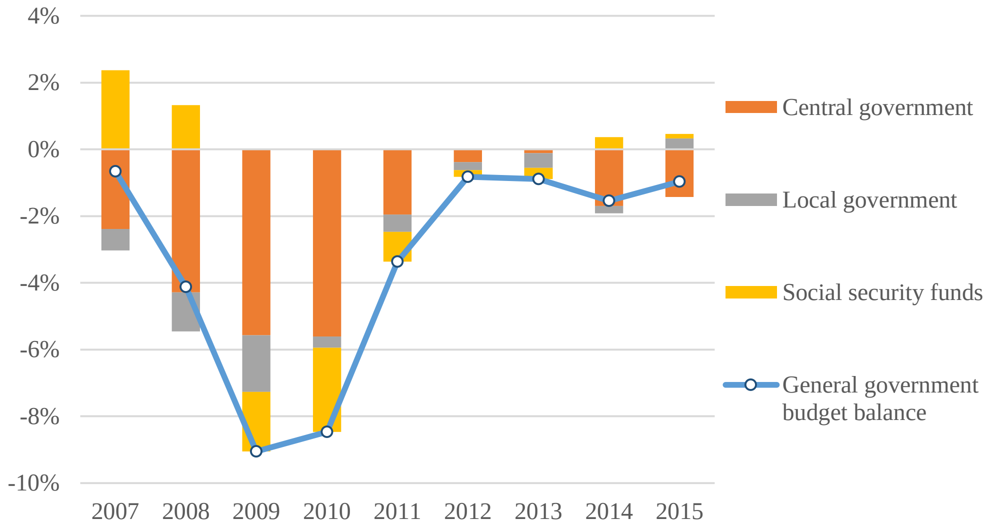

Figure 3.2. Budgetary balance of the general government by sub-sectors[8], % of GDP

While in the other two sub-sectors diametrically opposite dynamics is observed. Social security fund ended fiscal year with a slight surplus in the amount of 0.1% of GDP. The trend in the past four years shows that the social security fund revenue and expenditure are well-balanced. Improvement of the situation was facilitated by the already mentioned government decision, by which as of 2014 the central government through transfers finances supplementary pension payments from the social security fund.

The trend of the recent years also demonstrates the progress of the local government sector towards revenue and expenditure balance. Therewith, the local government sector has managed to shift from the deficit of 2014 to a fiscal surplus of 0.3% of GDP last year. It should be noted that up to now the local government sector had managed to achieve the balance surplus only in 1998. The surplus was facilitated by increasing revenue from real estate tax and PIT, as well as rapid decrease of expenditure for gross fixed capital formation, as the co-financing of the EU funds projects diminished along with approaching expiry of the planning period.

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[7] Breakdown of the general government sector into sub-sectors is defined in accordance with the European System of National and Regional Accounts 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 entity 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.

[8] Data source: Notification on the General Government Budget Deficit and Debt in October 2015 (2007–2014) and Indicative Estimate of the MoF for 2015.

3.2. FISCAL POLICY STRATEGY AND MEDIUM-TERM OBJECTIVE

The fiscal policy strategy of Latvia is based on a 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.

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 budget 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 3 subsequent years. Thus, during an interval between the moment of drafting the Stability Programme for 2015 – 2018 and the moment of drafting the Stability Programme for 2016 - 2019, substantial decisions on fiscal policy have been adopted which have filled all the fiscal space of 2016 and provide basis for implementing the strategy of the Stability Programme for 2016 – 2019.

Medium-term Objective

Regarding MTO the same approach is applied, which was set in the Stability Programme for 2015 - 2018, 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 2017, 2018 and 2019

When setting objectives of general government structural budget balance, a multi-stage method is being applied.

At first, MTO is taken as a point of reference (two scenarios are developed – one with the national MTO, and another with the MTO SGP) and then deviations are being applied, which result from the increase in contributions to the second pension pillar. The result achieved is further adjusted with the deviations provided in the EC Communication regarding structural reforms.

The introduction of two different MTOs in the Latvian fiscal policy is still rooted in the necessity to create safety margin to ensure 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 when the output gap is recalculated according to the EC standardized methodology.

The above mentioned safety margin ensures that the general government structural budget balance objective is met until the moment when the difference of the cyclical component of balance, calculated according to national and EC standardized methodology, does not exceed 0.5%. During the development of both the previous and the Stability Programme for 2016 - 2019 the above mentioned difference exceeds this limit and, therefore for setting the structural balance objective a more complicated method is used.

In the Stability Programme for 2016 – 2019 general government structural budget balance objectives for the medium term are set according to the principle providing for compliance with fiscal conditions in line with both the national methodology and the EC standardized methodology, regardless of the differences in the balance cyclical component caused by different methodologies. Similarly, the principles are preserved for determining deviations from the MTO as regards contributions to the second pension pillar, as well as deviations for structural reforms are included according to the EC Communication.

The following sections give a more detailed description of the algorithm for determining general government structural budget balance objectives.

Balance objectives according to 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
MTO SGP		-1.0%	-1.0%	-1.0%	-1.0%	-1.0%	-1.0%	-1.0%
Permissible deviations	from 2% to 4%	-0.5%	-0.5%	-0.5%	0.0%			
	from 4% to 5%			-0.3%	-0.3%	-0.3%	0.0%	
	from 5% to 6%				-0.3%	-0.3%	-0.3%	0.0%
Interim result for the structural balance objective		-1.5%	-1.5%	-1.8%	-1.6%	**-1.6%**	**-1.3%**	**-1.0%**
Structural reforms in the health sector						**-0.1%**	**-0.4%**	**-0.5%**
Structural balance		-1.5%	-1.5%	-1.8%	-1.6%	-1.7%	-1.7%	-1.5%
Structural balance (EC winter forecasts (2016)[9])				-1.9%	-1.7%	-1.6%		
Deficit reference value		-1.8%	-1.8%	-1.8%	-1.8%	-1.7%	-1.7%	-1.7%
Cyclical component			0.5%	0.6%	0.7%	0.7%	0.7%	0.7%
Cyclically adjusted balance		-1.5%	-1.0%	-1.2%	-0.9%	-1.0%	-1.0%	-0.8%
One-off measures			-0.3%					
Nominal balance		-1.5%	-1.3%	-1.2%	-0.9%	-1.0%	-1.0%	-0.8%

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 Stability Programme for 2015 – 2018. 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 0.27% of GDP) and in 2016 increasing contributions from 5 to 6% (fiscal impact 0.29% of GDP). Changes affect the quantitative amount of

[9] http://ec.europa.eu/economy_finance/publications/eeip/pdf/ip020_en.pdf

deviations by years. 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.

If MTO is summed up with the permissible amount of deviations the interim result of the general government structural budget balance objective is calculated, which is respectively -1.6% of GDP in 2017, -1.3% of GDP in 2018, and -1.0% of GDP in 2019. After that it is verified if the calculated interim result provides a sufficient safety margin (distance) with respect to the general government budget deficit reference value which is set in 2017, 2018 and 2019 at 1.7% of GDP in structural terms, according to the EC calculations.

The verification concluded that a distance of 0.1% of GDP in 2017, 0.4% of GDP in 2018, and 0.7% of GDP in 2019 is maintained to the reference value of the deficit. It should be noted that in 2019 the distance to the reference value of the deficit exceeds the amount, by which the additional deviations are permitted from the MTO according to the EC Communication (maximum amount for other reforms is 0.5% of GDP), therewith the obtained difference is adjusted to 0.5% of GDP. The differences obtained are used as additional deviations from MTO, justifying them with the reforms in the health sector (see detailed description of the reforms in section "Fiscally Significant Structural Reforms in the Meaning of Regulation No 1175/2011") according to the EC Communication regarding structural reforms.

After the amount of the general government structural budget balance, which is to be applied in future estimates, is determined, the amount of the nominal balance of the general government budget is calculated in the light of the EC estimated cyclical component of the balance. Therewith the nominal balance of the general government budget is obtained, which in 2017 is -1.0% of GDP, in 2018 is -1.0% of GDP and in 2019 is -0.8% of GDP.

Balance objectives according to 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
National MTO		-0.5%	-0.5%	-0.5%	-0.5%	-0.5%	-0.5%	-0.5%
Permissible deviations	from 2% to 4%	-0.5%	-0.5%	-0.5%	0.0%			
	from 4% to 5%			-0.3%	-0.3%	-0.3%	0.0%	
	from 5% to 6%				-0.3%	-0.3%	-0.3%	0.0%
Interim result for the structural balance objective		-1.0%	-1.0%	-1.3%	-1.1%	**-1.1%**	**-0.8%**	**-0.5%**
Structural reforms in the health sector						**-0.5%**	**-0.5%**	**-0.5%**
Structural balance objectives set in the Framework Laws		-1.3%	-1.0%	-1.0%	-0.9%	-1.0%	-0.8%	–
Structural balance according to the national methodology		-0.5%	-1.0%	-1.0%	-1.1%	-1.6%	-1.3%	-1.0%
Cumulative deviation from the structural balance objectives set in the Framework Laws		0.8%	0.8%	0.8%	0.6%			
Deficit reference value		-1.8%	-1.8%	-1.8%	-1.8%	-1.7%	-1.7%	-1.7%
Cyclical component		-0.4%	-0.3%	-0.3%	-0.1%	0.0%	0.2%	0.3%
Cyclically adjusted balance		-0..9%	-1..3%	-1..3%	-1..2%	-1.5%	-1.1%	-0.7%
One-off measures			-0.3%					
Nominal balance		-0.9%	-1.6%	-1.3%	-1.0%	-1.5%	-1.1%	-0.7%

The deviation model resulting from the increase in contributions to the second pension pillar is the same as for determining the general government structural budget balance objective according to the SGP methodology. The initial general government structural budget balance objective (interim result), if MTO is summed up with the permissible amount of deviations, is -1.1% of GDP in 2017, - 0.8% of GDP in 2018, and -0.5% of GDP in 2019.

After that it is verified if the calculated interim result provides a sufficient safety margin with respect to the deficit reference value which is determined similarly to the SGP methodology – 1.7% in 2017, 2018 and 2019.

The verification concluded that a distance of 0.6% of GDP in 2017, 0.9% of GDP in 2018, and 1.2% of GDP in 2019 is maintained to the reference value of the deficit. As the distance to the reference value of the deficit in all the reported years exceeds the amount, by which the additional deviations are permitted from the MTO according to the EC Communication, the obtained differences are adjusted to the maximum permissible amount, namely, 0.5% of in all three years.

The differences obtained are used as additional deviations from MTO, justifying them with the reforms in the health sector (see detailed description of the reforms in section "Fiscally Significant Structural Reforms in the Meaning of Regulation No 1175/2011") according to the EC Communication regarding structural reforms.

Thus the general government structural budget balance according to the national methodology in 2017, 2018 and 2019 is respectively -1.6%, -1.3% and -1.0%.

After that, when the general government structural budget balance to be used in following calculations is determined, the nominal amount of the general government budget balance is calculated. In the calculations the cyclical component calculated by the MoF is used. Therewith the nominal balance is obtained, which in 2017 is -1.5% of GDP, in 2018 is -1.1% of GDP and in 2019 is -0.7% of GDP.

The choice of structural objectives

When general government structural budget balance objectives are determined and the nominal balance of the general government budget is calculated according to both methods, the results obtained are compared in nominal terms and the largest nominal value of general government budget balance is chosen in order to ensure compliance with fiscal rules according to both the national methodology and the SGP approach. Once the largest nominal balance value of the general government budget is determined, the balance is converted in structural terms (using the cyclical component according to MoF estimates). Accordingly, the general government structural budget balance objectives are obtained, which are: **-1.1% of GDP in 2017, -1.2% of GDP in 2018, and -1.0% of GDP in 2019.**

It should be noted that basically in all three years stricter rules are set by SGP rather than the FDL, except in year 2019. Therefore, we can say that the general government structural budget balance objective is determined so that when the cyclical component of the balance is recalculated according to the EC single methodology, the general government structural budget balance corresponds to the permissible maximum general government structural budget deficit.

Table 3.3. The choice of structural objective

	2017	2018	2019
1. Nominal balance (according to SGP approach)	-1.0%	-1.0%	-0.8%
2. Nominal balance (according to national methodology)	-1.5%	-1.1%	-0.7%
The largest nominal balance value (1;2)	-1.0%	-1.0%	-0.7%
Cyclical component (national methodology)	0.0%	0.2%	0.3%
Structural balance objective	**-1.1%**	**-1.2%**	**-1.0%**

The above mentioned calculation determined a general government structural budget balance that complies with the balance rule.

FDL prescribes that compliance with the balance rule is not the only fiscal rule. **Expenditure growth rule** prescribed by Regulation No 1175/2011 should also be observed. In a general case, this rule may set more ambitious objectives of general government structural budget balance. The FDL also provides that the central government expenditure is determined in the Framework Law for 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.

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 of public debt servicing expenditure, investment expenditure, expenditure for foreign financial assistance projects which match the received revenue from foreign financial assistance, discretionary revenue, as well as inflation and potential GDP growth rates. It should be noted that discretionary revenue is also adjusted by the increase in contributions to the second pension pillar and the deviation from MTO for the implemented structural reforms in health sector – effects arising from the possibility to apply deviations from MTO for the implemented structural reforms according to the EC Communication regarding structural reforms. 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 verified in accordance with the expenditure growth rule, we obtain that in 2017 expenditure growth, which is allowed by the expenditure growth rule according to the potential GDP growth, is 2.56%, while the previously determined structural balance objective states that actual adjusted expenditure should be reduced by 1.64%. Consequently, in 2017 the initial structural balance objective of -1.1% of GDP is maintained.

In 2018, expenditure growth allowed by the expenditure growth rule in accordance with the potential GDP growth rate is 2.68%, while the actual adjusted expenditure growth allowed by the previously determined structural balance objective is 2.47%. Consequently, in 2018 the initial structural balance objective of -1.2% of GDP is maintained.

In 2019, expenditure growth allowed by the expenditure growth rule in accordance with the potential GDP growth rate is 2.76%, while the actual adjusted expenditure growth allowed by the previously determined structural balance objective is 3.33%. Consequently, in 2019 the initial structural balance objective is adjusted, determining it in the amount of -0.8% of GDP.

Following the verification of the rule of expenditure inheritance, it was found that in 2017 and 2018 the rule of expenditure inheritance is replaced with the re-calculated structural balance objectives, whereas in 2019 the structural balance objective is determined in accordance with the expenditure rule.

Therefore, the quantitative fiscal objectives for the next three years have been set, namely, to maintain the general government structural budget balance at **-1.1% of GDP in 2017, -1.2% of GDP in 2018, and -0.8% of GDP in 2019.**

Objectives and key measures of fiscal policy

As previously mentioned, in Latvia, the key decisions of budget policy regarding medium-term expenditure and revenue 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 Law for 2016 and the Framework Law for 2016 – 2018. At the same time, it should be noted that in recent years the government policy has a distinguishing feature of continuity, namely, government policy focusses on the implementation of objectives set by the previous policy planning documents and government declaration. Also the most recent change of the government did not changed this tendency. Thus, the specific fiscal policy objectives contained in the State Budget Law for 2016 and the Framework Law for 2016 - 2018 remain topical also within the context of the Stability Programme 2016 - 2019, as well as will ensure future basis for preparing in autumn the State Budget Law for 2017 and Framework Law for 2017 - 2019.

The overall objective of the Latvian fiscal policy does not change, and in 2016–2019 it is – to raise sustainably the quality of life of population.

The quality of life includes welfare of inhabitants, availability of medical services, nature environment, developed infrastructure and culture as well as elimination of excessive inequality in population’s income. It is essential to provide that in the state there will be conditions for improving the quality of life not only now, but also in the future. Therefore, the emphasis of the objective of fiscal policy is on sustainability. A sustainable increase in the quality of life means that public financial resources are being shifted not only to current measures for improving the quality of life, but also that public resources are being planned and allocated in a manner that provides conditions for the state to be able to raise the quality of life in the long term. This may be achieved, first, by refusing to cover current expenditure on account of next generations or refusing to increase public expenditure on account of the deficit; second, by shifting public resources to create favourable environment for economic development.

However, in this three-year period a new challenge has arisen – war in Ukraine and increased Russian military presence near the Latvian border, which puts a different light on national security issues.

<u>Therewith, the specific objectives of the fiscal policy, at the same time being also the medium-term budget policy priority growth directions, are as follows:</u>

1) to increase public defence capacity, raising public defence funding to 2% of GDP in 2018;
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.

The overall objective and specific objectives of Latvian fiscal policy are directly linked to NDP 2020 and create necessary fiscal conditions in order to put into practice the vision[10] of NDP 2020:

"The Latvian State was established to exercise the right of self-determination of the Latvian people. Latvia is open and welcoming to residents of all ethnicities that accept the meaning of the existence of Latvia: the development of the Latvian nation, its language and culture in its own land. In 2020, Latvia will be a country that is Latvian in character and self-confident, secure and resident-friendly, green and well-tended, prosperous, effective and competitive – and a home to industrious, well-educated, creative, healthy and happy people."

An important factor to achieve specific objectives of fiscal policy is the amount of available public resources. The state budget base expenditure ensures performance of public functions at a constant level, and under the condition where there is no adverse external circumstances, which reduce the quality of life, we can say that it remains at a constant level. So, to avoid the impact of adverse circumstances on the average quality of life of population or to increase it, additional public financial resources are needed, but to reduce inequalities in the quality of life public finances should be redistributed.

As already initially identified in the Stability Programme for 2015 – 2018, in the preparation of the State Budget Law for 2016, the government had to take into account the need to adopt discretionary measures, to eliminate the negative fiscal space in 2016. Furthermore, there was also the need to ensure the financing of the medium-term budget priorities.

Thus, in the preparation the State Budget Law for 2016 and the Framework Law for 2016 – 2018, the government adopted number of tax policy decisions, which not only ensured additional revenue in the state budget, but also allowed continuing the previously set course of action of the government – to reduce the inequality in population's income and continue combating shadow economy (see Sub-section 6.2).

For the purpose of reducing the negative fiscal space in 2016, in addition to the decisions on increase of the revenue, the government also decided upon the revision of the state budget base expenditure in 2016. The revenue increasing measures, as well as the reduction of base expenditure, allowed not only to reduce the negative fiscal space in 2016, but also to ensure additional resources for implementation of the medium-term budget priority courses of development both next year and in the medium-term.

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[10] NDP 2020 [5].

Table 3.5. The most substantial expenditure increasing measures (starting from 3 mln EUR), adopted in the Framework Law for 2016 - 2018

mln euro	***2016***	***2017***	***2018***
MINISTRY OF DEFENCE	**55.7**	**99.8**	**147.3**
incl., building of combat capacity of the National Armed Forces	53.1	95.1	143.5
MINISTRY OF THE INTERIOR	**36.6**	**37.1**	**35.7**
incl., ensuring remuneration for the officers of the authorities of the system of the Ministry of the Interior with special service ranks	26.2	26.2	26.2
providing the authorities under subordination of the Ministry of the Interior with the fire-arms necessary for the fulfilment of functions	3.0	3.0	3.0
arrangement, maintenance and settlement of the land ownership title of the national border of the Re[public of Latvia	3.1	3.1	3.1
measures for strengthening state defence	3.4	3.4	3.4
MINISTRY OF EDUCATION AND SCIENCE	**3.0**	**0.7**	**0.2**
MINISTRY OF TRANSPORT	**4.1**	**4.1**	**4.1**
MINISTRY OF JUSTICE	**6.2**	**7.2**	**6.0**
incl., ensuring supplementary remuneration for the officers of the Latvian Prison Administration with special service ranks	3.7	4.3	4.3
MINISTRY OF HEALTH	**23.3**	**23.3**	**23.3**
incl., ensuring the payment of the reimbursable medicines for Hepatitis C and HIV/AIDS patients	4.2	4.0	3.8
ensuring repayment of the state guaranteed loans to hospitals	7.8	8.0	8.2
increasing work remuneration for medical persons and other persons employed in the healthcare system in accordance with the increase of the minimum monthly wage	10.0	10.0	10.0
FUNDING TO BE REDISTRIBUTED WITHIN THE PROCESS OF THE ANNUAL STATE BUDGET FULFILMENT	**9.0**	**0.0**	**0.0**
incl., ensuring funding for implementation of the reform of work remuneration of teachers in the state, local government and private educational institutions starting from 1 September 2016	9.0	0.0	0.0
OTHERS TOTAL	**7.3**	**10.0**	**10.1**

Hereinafter the more detailed explication is provided regarding the action implemented for achieving specific fiscal policy objectives.

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, already in the 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. The additionally provided defence funding was defined as a one-off measure, thus, neutrally affecting the achievement of the structural balance objectives. The EC, having assessed this application of Latvia, recognised that the additional military expenditure is not to be deemed as one-off expenditure in accordance with the EU fiscal discipline framework rules, therewith the provision of additional defence expenditure would correspondingly worsen the general government structural budget balance.

Nevertheless, despite the EC decision, the Framework Law for 2016 – 2018 provides for such additional increase for defence expenditure, which will ensure the increase of defence expenditure reaching 2% of GDP in 2018. It is important to note that the increase of additional expenditure was ensured within the scope of the available fiscal space, ensuring the compliance with the fiscal rules.

Table 3.6. Amount of budget expenditure for financing the defence sector

Year	Amount of budget expenditure for financing the defence sector stated in the *State Defence Financing Law*, % of GDP	Amount of expenditure provided for in the *Framework Law* for 2016 – 2018 and forecast for 2019, 2020, % of GDP
2015	1.0	
2016	1.1	1.4
2017	1.3	1.7
2018	1.5	**2.0**
2019	1.75	**2.0**
2020	**2.0**	**2.0**

For the implementation of the **second priority course of development** – provision of sustainable and balanced country's economic development – in the last budget cycle the additional financing is granted to defence, as well as internal security, health and education.

Developments in Ukraine has brought to the agenda the issue on the ability of the state to adequately react to the events of the type of a "hybrid war", when the warfare is not conducted in the classical sense. Therewith, the issue on the agenda is the capacity of the state to ensure the state internal security – ability of the police to prevent "internal disturbances" and strengthen the Latvian border.

Quality of life of the 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 2014 in Latvia is the third lowest in the EU. Therewith, in the Framework Law for 2016 – 2018, 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. Furthermore, it should be taken into account that the new government declaration provides for ensuring in coming years the development of the sustainable healthcare funding system for improving availability of services at all healthcare levels, which correspondingly allows concluding that the process of the healthcare system reforms will also be the task of the further Framework Laws.

In turn, the general government expenditure for the "education" in Latvia according to COFOG exceeds the EU average. This is indicative of the need for structural reforms in education, for optimisation of this sector of public services. It should be noted that the Framework Law for 2016 – 2018 does not plan any significant expenditure reducing structural reforms. Notwithstanding the above mentioned, the persons employed in the education sector have grounds to expect that their remuneration grows along with the economic development of the state. In addition to the above mentioned, the work at the new teachers' remuneration model is being accomplished, the introduction whereof will create the need for additional funding from the state budget. Taking into account that the model is still pending, additional funding for this purpose will be granted after the approval of the model. Funds for additional funding have already been reserved in a separate budget programme, currently being included under the budget sector "Funding to be Redistributed Within the Process of the Annual State Budget Fulfilment".

As regards 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, while the Gini coefficient, which characterizes the income inequality, in Latvia is one of the highest in the EU.

A number of significant measures 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 starting rate since the electricity market was opened, as well as increase of minimum wage. In addition to the previously implemented government policy, the Framework Law for 2016 – 2018 incorporates additional measures to continue current policy direction levelling out population's income inequality – starting from 2016, to reduce income and social inequality, the minimum wage is increased from 360 to 370 euro, the no-taxable minimum is increased from 75 to 85 euro, as well as a differentiated non-taxable minimum is introduced. Current government policy also prescribes continuing to provide assistance to population to offset the mandatory procurement component within the electricity tariffs, ensuring both horizontal support and additionally supporting the protected groups of population.

As regards the **fourth priority course of development**, Latvia has traditionally been a country with a relatively low tax burden, which is also one of the lowest in the EU, however, the government decisions, when developing the Framework Law for 2016 – 2018, prescribed to revise separate aspects of tax policy, ensuring that the proportion of the tax revenue to GDP will become more stable over the coming years and will have the growing tendency in the medium term. The latest tax revenue forecasts contained in the Stability Programme for 2016 – 2019 show that in the medium term the tax burden has a growing tendency. The bottom-up changes in the tax burden level for 2016 – 2018, as compared to the Draft Budgetary Plan for 2016, basically result from the reduction of GDP (due to adjustment of historical data affecting the GDP level also in the coming years, as well as a lower economic growth as previously forecasted), to a smaller extent affecting the tax volume changes, however creating the fluctuations in the proportion of the tax burden due to denominator effect.

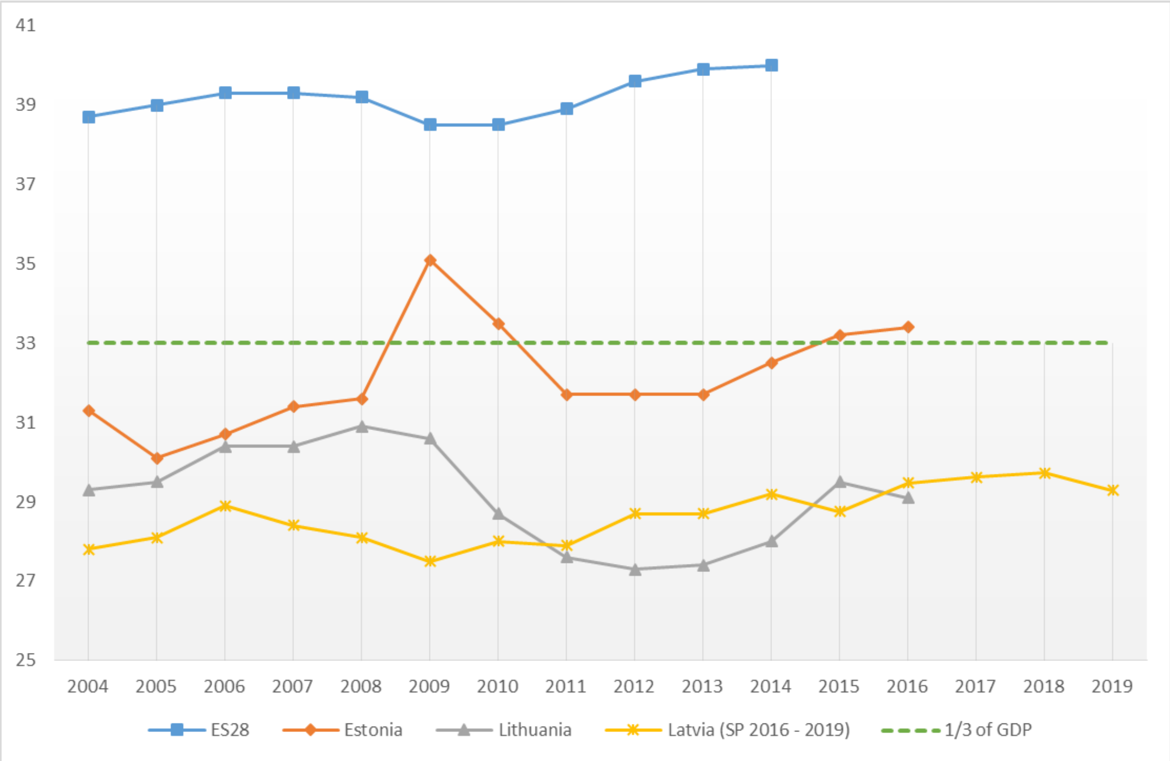


Figure 3.3. Tax revenue (D.2+D.5+D.61+D.91-D.995) proportion to GDP in percentage, ESA2010[11]

Tax burden changes in 2019, as compared to 2018, are mainly determined by the fact that, starting from 2019, the subsidised electricity tax is not applied anymore. Additional effect is created also by reduction of the labour tax proportion, because the work remuneration fund grows at a slower pace than GDP.

<u>The government declaration in effect at the moment of preparation of the Framework Law for 2016 – 2018</u> provided for three horizontal directions with respect to the tax policy strategy:

- to ensure increase in tax collection moving towards the proportion of tax revenue being 1/3 of GDP;
- to ensure the foreseeable development of tax policy;
- to implement the measures for combating shadow economy and to actively turn against tax evasion.

The emphasis on the tax policy in the previous Framework Law was on ensuring stable and foreseeable tax policy, retaining the previous commitment to carry out reduction of the tax burden for labour, to increase contributions to the second pension pillar in accordance with the previously adopted decision and not to introduce changes to other most significant tax rates. The second essential direction was to ensure the increase in tax revenue, which was planned to be achieved not by raising tax rates, but through more intensive work to increase tax collection, inter alia through necessary legislative amendments.

In the Framework Law for 2016 – 2018 the government has still upheld the previously defined commitment to continue measures for combating shadow economy, as well as to introduce further adjustments in tax policy, reducing the inequality of the income of population.

[11] Data source: Eurostat until 2014, for 2015 – 2016 Draft General Government Budget Plan 2016 (for Lithuania and Estonia) and Stability Programme for 2016 – 2019 (for Latvia).

Part of decisions adopted in the tax policy, for example, changes in number of excise duty rates, expansion of the VAT base and the previously planned non-reduction of the PIT rate, to a certain extent could be viewed as the deviation from the previously defined foreseeability in the tax policy, however it should be viewed in the context with changes in separate circumstances, namely, slowdown in the economic development growth rates, leading to the formation of negative fiscal space in 2016, as well as the need to considerably increase expenditure for the defence sector due to deterioration of the security situation in the region.

It is also important to note that the government tax policy decisions in the medium term ensure moving towards implementation of the tax policy strategy prescribed by the government declaration, which, inter alia, provides to ensure increase in the tax revenue proportion to GDP. In any case, this should not be considered as an end in itself, nevertheless, it should be understood that this way it is ensured that in the coming years the government has more available resources to be allocated to funding the priority courses of development of the budget policy. Essential aspect of revenue increase is combating shadow economy, the reduction of its share will contribute to ensuring more fair competition conditions, as well as enhance the state budget revenue. In the Framework Law for 2016 – 2018 the government continues 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 amendments, introducing new, more rigid technical requirements for cash register systems.

The government approved on 11 February 2016 plans to uphold the policy direction launched and implemented by the previous governments with respect to tax policy, prescribing:

- to ensure that the volume of collected taxes will reach 1/3 of GDP in 2020, primarily for achievement of this objective obtaining revenue from minimising shadow economy;
- to assess the Latvian tax system and in collaboration with social and cooperation partners to establish well-balanced and foreseeable tax policy, aiding in achievement of the state growth strategic objectives – economic growth, improvement of demographic situation and reduction of inequality;
- to implement the transfer of the tax burden from the labour force over to capital income and capital growth, to consumption, to the use of real estate and natural resources;
- combating shadow economy as a horizontal task of the government work, including the set of measures facilitating the motivation of entrepreneurs and public for reducing shadow economy, increasing the tax collection on an annual basis and reaching the tax collection increase of 1 percentage point to GDP in 2018.

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

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. in 2013–2014 amounting to 4%, in 2015 - 5% and in 2016 - 6%. 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 to 65: 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 as of 1 January 2025.

On 3 April 2014, the Saeima adopted the Law *Amendments to the Law on the State 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 that does not exceed 285 euro, taking into account the actual consumer price index 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 that does not exceed 50% of the average insurance contribution wage in the state for the previous calendar year (rounded-off to whole euro), taking into account the actual consumer price index 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, as well as will possibly not change the conclusions of the next EC Fiscal Sustainability Report on Latvia as a low risk country in terms of the sustainability of public finances.

Reform of the health system

In the Stability Programme 2015 – 2018 Latvia declared reform of the health system as a significant structural reform with a long-term positive effect on the sustainability of public finances, with a view to use in this reform the possibility of deviation from MTO provided in the EC Communication. Even though the reform of the health system was recognised as justified, Latvia did not qualify for the structural reforms clause, as the planned structural budget deficit exceeded the safety reserve with respect to the reference value of 3% of GDP[12] defined by the Treaty on the Functioning of the EU.

By this Stability Programme for 2016 – 2019 Latvia is repeatedly declaring the reform of the health system in the use of the SGP flexibility in accordance with the EC Communication regarding the use of flexibility in the implementation of the SGP and the common position of the Council regarding application of flexibility and **declares the deviation of 0.5% of GDP**.

[12] In Latvia this indicator for the respective period of time was defined as 1.8% of GDP.

Taking into account that the flexibility mechanism sets the restriction that the general government structural budget deficit together with the deviation may not exceed the structural budget deficit limit, ensuring the safety margin for Maastricht 3% deficit and for Latvia this limit is 1.7% of GDP, therewith the declared deviation, **respectively, in 2017 and 2018 is limited so that in none of the mentioned years the permissible structural budget deficit does not exceed 1.7% of GDP**. According to current forecasts it is not necessary to limit the deviation to be declared in 2019, because the forecasted structural budget deficit together with the deviation does not exceed the limit of structural budget deficit.

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 life years of the Latvian population and to prevent untimely deaths, while maintaining, improving and restoring health.

In the declaration on the planned action of the Cabinet led by Māris Kučinskis healthcare is determined as one of the two fields of reforms, putting as the main one the development of sustainable healthcare funding system for improvement of availability of the services at all healthcare levels. The said declaration supplements the **Public Health Guidelines for 2014 – 2020**, forming a stable financial basis for achievement of the main aim of the guidelines. Stability, in this case, is essential, because up to now the implementation of the guidelines was financed annually granting additional funding through NPI mechanism, which, in light of budget discipline rules, was insufficient to considerably improve the situation in the healthcare sector. This problem is expressly stated also in the analysis carried out by the EC regarding the fulfilment of the country specific recommendations (*EC staff working document, Country Report Latvia 2016).* Māris Kučinskis declaration provides for development of mandatory health insurance system model, stating the mandatory health contributions base source and amount of the rate thereof, as well as prescribes, after the assessment of the Latvian tax system, to consider the possibility to increase the health sector funding proportion from GDP. Work on implementation of the mandatory health insurance system cannot be managed over a period of one year and, therefore, does not solve the issue of funding of the coming years. Therewith, as regards the next few years we face the choice - either to grant funding for the healthcare reform within the limits of the existing deficit objectives, or to carry out a breakthrough - by means of the SGP flexibility mechanism. In the first case essential improvements in healthcare will come with delay, in the latter case it will be possible to achieve the objectives of the reform. Additional expenditure for healthcare will have a positive long-term effect on public finances, and the use of the SGP flexibility mechanisms at present will also create the necessary motivation to make a transition to the mandatory health insurance mechanism after the SGP flexibility deviation would come to an end.

To improve the health system is one of the most important tasks in order to promote quality of life and increase potential growth.

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 3.4).
- **Inequality.** The proportion of public funding of the total funding for the health financing system is considerably below the EU average (in Latvia – 58%, in the EU – 77%)[13]. 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 2012, the total PYLL was 5, 960 years per 100, 000 inhabitants, which is a high indicator among

[13] World Health Organisation data, 2011.

the developed countries. A significant part of the indicator can be explained by health problems.

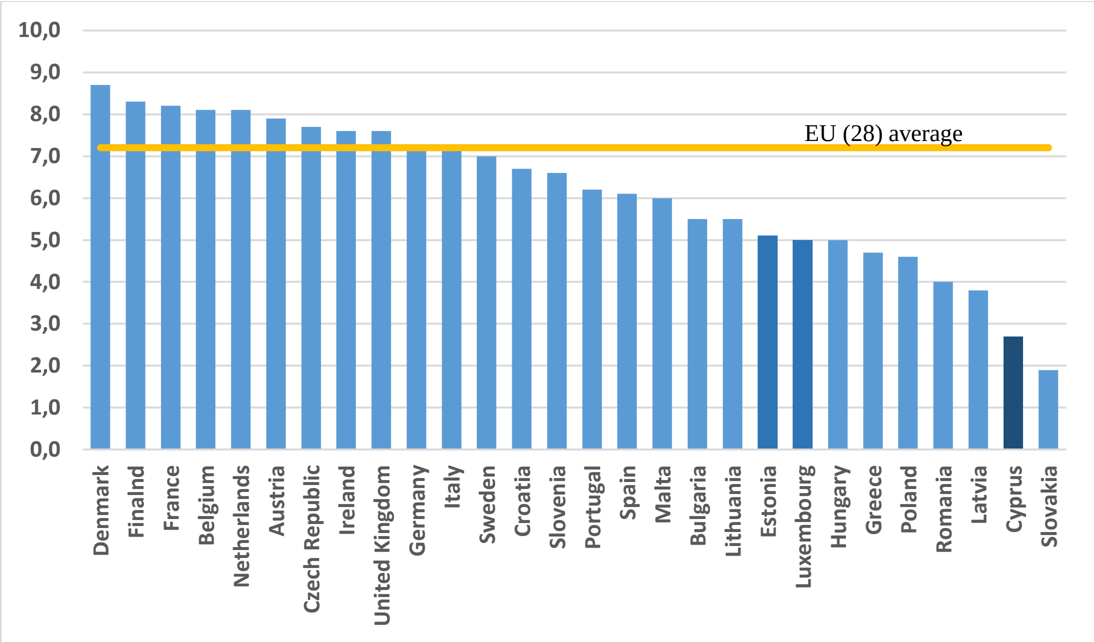


Figure 3.4. Public expenditure for healthcare in 2014 in the EU member states[14], % of GDP

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 in improving cost-effectiveness, quality and accessibility of health care 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.

Whereas, in the country-specific recommendation 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.

Latvia is serious about the need to improve quality and availability of health services. It fully complies with the objective of the Latvian fiscal policy to increase the quality of life of population. Quality and availability of health services, as well as public awareness and education on health prevention issues is vital in order to raise the quality of life, both directly and indirectly. Directly the quality of life would be built by increasing the number of healthy years lived. Indirectly the quality of life would be built with higher potential GDP growth that would result from larger number of citizens in the labour market following a decrease in PYLL.

This approach has been strengthened in a number of policy documents. Namely, Health targets and measures are defined in the main medium-term development *planning document* of

[14] Data source: Eurostat.

Latvia – **NDP 2020**, which is linked to the measures defined in the Government Action Plan and other planning documents of the health sector. In the NDP 2020 for the strategic objective "Healthy and Fit for Work" the following goal has been set: "*by promoting a healthy lifestyle and improving planning and coordination in the healthcare system and the quality and accessibility of out-patient healthcare, reduce the occurrence of risk factors of chronic diseases and external causes of death in the population, thus facilitating the preservation and improvement of people's health – which is the foundation of an enduring and productive working life*". To evaluate the achievement of this goal, the PYLL is defined as one of the target indicators, stating that by 2020 the PYLL per 100, 000 people should be reduced to **5, 300 from 6, 746** in 2010. For the achievement of this strategic objective for a 7-year period in the NDP 2020 indicative additional financing necessary is set in amount of **462.87 million euro.**

On the basis of NDP 2010, in October 2014 Cabinet approved the already mentioned *Public Health Guidelines for 2014 - 2020*, within the scope whereof it is planned to implement measures aimed at the implementation of more targeted measures with higher rates of return in solving specific problems related to ensuring better health of the population as labour force.

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. The study provides evidence-based proposals for the implementation of sustainable health policy in the context of that which is prescribed by NDP 2020 and the EU funds draft planning documents, to prepare conclusions and recommendations for the development of the Public Health Guidelines 2014–2020. The above mentioned study is also used as a basis for the cost-benefit analysis of the reforms implemented in the health sector (see more detailed description in the study[15] and the Stability Programme for 2015 – 2018).

Within the scope of the study the **evaluation** was carried out with respect to **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 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 development would be created by the persons "saved" up to 2020 being able for the next 20 years to provide productive return as a labour force, thereby 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 in present value comprises 577 million euro. Therewith, according to the results of the study it can be concluded that additional estimated amount of expenditure from 2013 to 2020 exceeds the economic benefits of the respective period.

15 http://www.vm.gov.lv/lv/nozare/attistibas_planosanas_dokumenti1/latvijas_universitates_izvertejums_sabiedribas_veselibas_pam/

Table 3.7. Summary of the costs-benefit 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 – 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 World Health Organisation's guidelines, health care interventions are considered cost-effective if their costs are estimated in a certain interval, namely, GDP per capita, multiplied by the coefficient from 1 to 3. Execution of GDP for 2014 is estimated in amount of 23, 581 million euro, which according to the number of inhabitants in census 2011 would make 11, 390 euro per capita, hence three times larger indicator amounts to 34, 170 euro.

Consequently, even according to the guidelines of the World Health Organization in case of the realistically optimistic scenario the reform of the Latvian health system is considered as **cost-effective.** At the same time, it should be noted that there is a high probability that at the level planned for investment of resources the PYLL reduction will take place according to the realistically optimistic scenario. The study also analysed the economic benefit from the point of view of another indicator – estimated reduction of the number of premature deaths (up to 64 years) as a result of the implementation of the Operational Programme "Growth and Employment", where causes of death are heart and circulatory diseases, oncology diseases and suicide. Overall, it is expected that by 2020 the number of prevented deaths in the age group up to 64 years according to the pessimistic scenario, which corresponds to the PYLL reduction target defined in NDP 2020, is only about 9% higher than the expected number of prevented fatal events if the target to reduce the level of premature mortality due to the three priority causes as defined in the Operational Programme "Growth and Employment" is achieved. In 2012, the proportion of deaths caused by the three analysed causes in the given age group accounted for 64% of all deaths. The remaining 35% are due to other groups of causes, and it can be expected that the related mortality rate will also decrease. **Consequently, if the objective of the Operational Programme "Growth and Employment" is achieved successfully, a steeper reduction of PYLL could be expected than provided according to NDP 2020 objective.**

Besides, estimated GDP growth is only part of the tangible economic return that will be obtained as a result of the public health promotion, because the actual impact on GDP will be significantly higher, although it is difficult to quantitatively assess. The following should be mentioned as some of the additional factors contributing to GDP growth:

- the assessment of economic benefits within the framework of the study was conducted about the expected labour force growth in the period from 2012 to 2020. However, the positive effect of the investments in the public health will be greater due to the fact that after 2020 PYLL rates will be lower than in 2012. Even if in

[16] The amount of benefit, 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 benefit, 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.

2020 PYLL rate no longer falls back, thanks to investments made until 2020 **“additional” premature deaths will be prevented in the coming years** and thus “additional” human lives will be saved (compared with 2012). It will continue to have a positive impact on labour supply contributing to economic growth;

- as the overall level of public health improves, not only mortality rates reduce, which directly affects the labour supply. As sickness leaves become less frequent and shorter, **productivity** of employees will increase and thus GDP will grow as well;
- as the overall level of public health improves, **economic activity of people of pre-retirement and retirement age** will be promoted.

The following circumstances, in its turn, should be mentioned as the public finance reducing factor:

- as the overall level of public health improves, **expenditure for social benefits and sickness leaves will decrease.**

According to the performed estimate (see Table 9 of the Appendix) 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.

Additional expenditure for healthcare

The reform of the health system put forward in NDP 2020 and explicated in more detail in “Public Health Guidelines 2014–2020” has been approved by the Cabinet and its implementation began in 2014, correspondingly allocating substantial additional resources within the scope of the Framework Laws. In three successive cycles of preparation of the Framework Laws, namely, in the Framework Law for 2014 – 2016, the Framework Law for 2015 – 2017 and the Framework Law for 2016 – 2018, the government decided on the allocation of additional financial resources to health sector. It should be noted that the below-mentioned additional expenditure allocated to the health sector have been carried out in view of the pre-defined base expenditure.[18]

In the Framework Law for 2014 - 2016 the government approved a total of **42 million euro in 2014, as well as 48.9 million euro in 2015 and 51 million euro in 2016** for NPI in the health sector to promote building available, quality and cost-effective health care services. Looking in more detail, the above mentioned funding was allocated to the following key measures:

- to increase wages of medical personnel and other staff, as well as to adjust monthly wage disparities between various categories of health care employees (about 30 mln euro, in 2016 – 32.2 mln euro);
- to compensate expenses of medication for outpatient treatment and to ensure centralized purchase of medication (4.5 mln euro each year);
- to reduce the waiting queues for outpatient and inpatient healthcare services (2.1 mln euro and 1.3 mln euro each year, respectively).

In turn, in the Framework Law for 2015 - 2017, the government decided to allocate additional funding to the health sector in amount of **30.6 mln euro** for these three years in order to promote ensuring cost-effective, physically and financially availability and quality health care services, thus continuing the implementation of the ongoing healthcare reforms. Within the scope of the allocated funding the following key measures will be performed:

[18] Fulfilment of the sectoral functions at a constant level.

- to reduce the waiting queue for outpatient healthcare services and to improve regional accessibility (9.8 mln euro each year);
- to compensate the minimum monthly wage increase in the tariffs of healthcare services (7.7 mln euro each year);
- to increase the volume of inpatient services increasing the volume of planned hospitalization (4.4 mln euro each year).

In turn, in the Framework Law for 2016 - 2018 additional 23.3 million euro each year were allocated to the health sector, to facilitate further improvement of the availability and quality of healthcare services. The key additional measures receiving additional funding are as follows:

- to increase wages of medical personnel and other health care system employees (10 mln euro each year);
- to ensure repayment of the state guaranteed loans to hospitals (from 7.8 to 8.2 mln euro in the medium term);
- to ensure the payment of reimbursable medicines for Hepatitis C and HIV/AIDS patients (from 3.8 to 4.2 mln euro in the medium term).

Table 3.8. Additional funds allocated in the health sector, mln euro

	2014	2015	2016	2017	2018
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
Additional expenditure increase in comparison with previous year (cumulative)	42	37.5	25.4	0	0

The additional budget funds allocated up to now to the health sector in cumulative terms exceed the necessary level of funding determined in the study that would ensure the achievement of the PYLL target. At the same time, when we look forward, it should be noted that the government has committed to also henceforth ensure the implementation of the health reforms, providing the increase of the funding for the sector.

Under the current fiscal scenario, in 2017 and 2018 additional funds are available to be distributed to government's priorities. What is more, the additional funding for the sector may be re-distributed from other fields or gaining savings in the process of revision of the current budget expenditure. Although decisions on further expenditure measures in essential sectors of the national economy will be adopted this autumn, namely, while preparing the budget and the Framework Law, in view of the additional funding allocated in previous years with a sufficiently high probability it can predicted that the health sector will be one of the beneficiaries, therefore the initiated course of the health sector reform will continue.

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 FDL rules the fiscal policy principles prescribe the formation of a balance budget in the economic cycle or the condition that the structural budget 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 2016 and 2017 the cyclical component is forecasted close to zero, but in the next two years it becomes positive (0.2-0.3% 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 2016 was updated. It is expected that the general government budget deficit in 2016 will be 1% of GDP and it is at the same level with the permissible amount of the deficit defined during the preparation of the budget, namely, in autumn 2015.

The general government budget balance projections for the medium term at constant government policy were prepared, taking into account the updated revenue forecasts in accordance with the latest macroeconomic development scenario, approved central government baseline expenditure for the next three years, updated forecasts for expenditure for the social benefits 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 same level also further on. As a result, in the scenario at constant policy in 2017 the general government budget deficit would be 0.8% of GDP, 0.2% of GDP in 2018, while in 2019 there is a budget surplus expected of 0.8% of GDP.

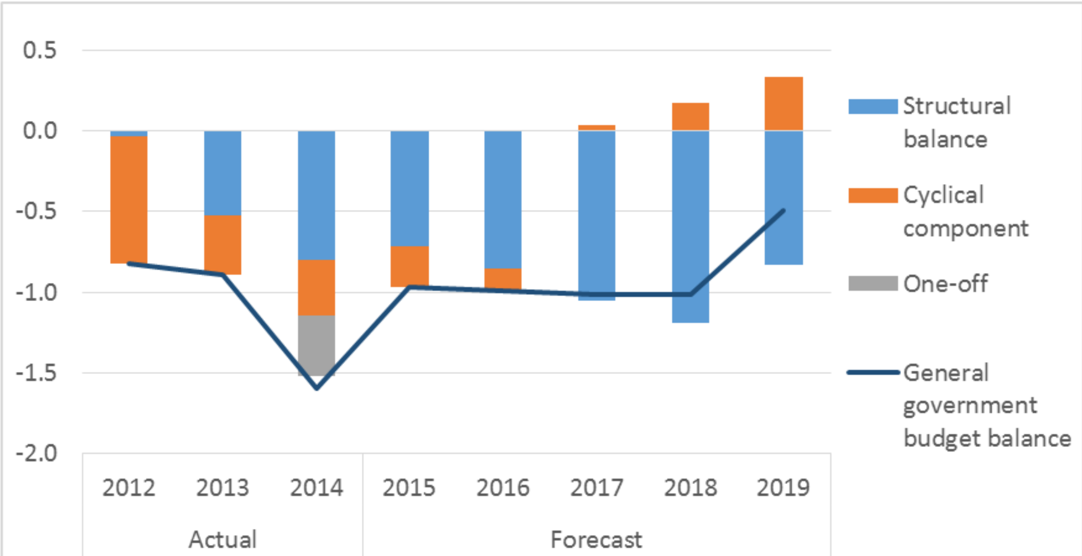


Figure 3.5. Budgetary balance of the general government by components[19], % of GDP

According to the fiscal discipline rules in the next three years larger deficit is permissible in the general government budget than it is expected at constant policy. 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. Since at the moment, when preparing the fiscal development scenario, this issue has not been discussed in the government, it is assumed that all the formed fiscal space, which in 2017 makes 0.2% of GDP,

[19] 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).

in 2018 0.8% of GDP and in 2019 1.2% of GDP (in all years, when determining the fiscal space, the FDL defined minimum fiscal safety margin of 0.1% of GDP has already been taken into account), is used for additional expenditure. However, it should be noted that the amount of the fiscal space is defined, assuming that the EC supports Latvia's application for health system reform in the use of SGP flexibility in accordance with the EC Communication and common position of the Council regarding application of flexibility. Therewith, if the EC does not support Latvia’s application, the amount of the available fiscal space correspondingly reduce by 0.1% of GDP in 2017, 0.4% of GDP in 2018 and 0.3% of GDP in 2019 (in 2019 the amount of the fiscal space does not reduce by the additional deviation from the MTO mentioned in Table 3.1, considering that, when carrying out the verification of fiscal rules in 2019, the expenditure rule was chosen as the strictest fiscal rule, which prescribed performing the adjustment of the initially defined structural budget objective by 0.2% of GDP stricter).

Thus, **the fiscal development scenario provides for the general government deficit of 1% of GDP in 2016, 2017 and 2018 and 0.5% of GDP in 2019.**

Table 3.9. Medium term fiscal development scenario

		2015	2016	2017	2018	2019
	ESA code	% of GDP				
Net lending (+) or borrowings (-) (B.9) by sub-sectors						
General government	S.13	-1.0	-1.0	-1.0	-1.0	-0.5
Central government	S.1311	-1.4	-1.1	-1.3	-1.2	-0.6
Local government	S.1313	0.3	0.0	-0.1	-0.1	-0.1
Social security funds	S.1314	0.1	0.0	0.3	0.3	0.3
General government (S.13)						
Total revenue	TR	35.3	35.1	35.3	35.5	34.5
Total expenditure	TE	36.3	36.1	36.3	36.5	35.0
Interest expenditure	D.41	1.5	1.2	1.0	1.0	1.0
Cyclical development						
Cyclical component of the budgetary balance		-0.3	-0.1	0.0	0.2	0.3
Structural balance		-0.7	-0.9	-1.1	-1.2	-0.8
Cyclically adjusted primary balance		0.7	0.3	0.0	-0.2	0.2
Forecasts at constant policy						
General government balance	B.9	-1.0	-1.0	-0.8	-0.2	0.8
Total revenue	TR	35.3	35.1	35.3	35.5	34.5
Total expenditure	TE	36.3	36.1	36.1	35.6	33.7

The general government budget development in the coming years 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 35% of GDP, *inter alia*, tax burden will make about 29.5% of GDP. The increase in tax revenue of the general government budget in the next two years will reach 6.4%, but in 2019 it is forecasted as more modest – 4.4%. Lower increase will be mainly determined by changes in the production and import taxes, because in accordance with the currently applicable procedure revenue from the subsidised electricity tax are planned till 2018. Likewise, more modest increase is forecasted also in the revenue from income and property, taking into account slower growth of the wage fund. It is expected that the general government expenditure in the coming years will be a bit above 36% of GDP, while in 2019 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 2016, deficit of 1.1% of GDP is projected, providing for a more rapid increase in revenue over the previous year than expenditure growth. Central government budget projections are based on the expenditure level set in the *Law on State Budget for 2016,* and they also include the projected savings from expenditure for servicing the debt and lower contributions to the EU budget. Savings from the debt servicing can be explained by partial re-financing of the debt liabilities assumed at the end of 2015 swapping US dollars to the euro bonds of the corresponding term, which will facilitate the savings also in the long term;
- in the 2017 – 2019 central government budget the deficit is expected. Revenue growth will be ensured by taxes on production and imports, as well as revenue from income and property. In 2019 the growth rate of taxes on production and imports is expected slower due to the reasons already mentioned before - according to the currently applicable procedure revenue from the subsidised electricity taxis planned till 2018. Tax revenue growth rate will also be influenced by the projected decrease in revenue from property, which is mainly comprised of the received payments for the use of the state capital, since current arrangements provide for the reduction of the profit share to be paid to the budget (in 2017 - 75% of the obtained profit, in 2018 – 70% and in 2019 – 50%). Central government budget expenditure in 2017 and 2018 will increase and as percentage of GDP will remain at the same level. To comply with the regulatory requirements in relation to ensuring fiscal discipline, in 2019 central government expenditure are projected lower both with respect to the previous year and to GDP. Expenditure projections take into account the baseline funding for the next three years submitted by line ministries and approved by the government, as well as faster funding growth for the field of defence, both in 2018 and in 2019 ensuring 2% of GDP. At the same time, expenditure forecasts comprise potential additional funding (fiscal space), the decision on the use whereof will be made during the development process of the next Framework Law.

In social security funds:

- in 2016 revenue and expenditure are projected to be at the same level. As the wage growth continues, also the growth in social security contributions is projected. Nevertheless, in light of the increase in contribution rate to the second pension pillar starting from 2016 by one percentage point to 6%, larger revenue amount will be allocated to the funded pension scheme, thus only an insignificant growth is expected in the first pillar or social security funds revenue. In turn, the expenditure increase will be influenced both by increase in the average amount of the social benefits and the larger number of beneficiaries, especially, in case of the child care, sickness and unemployment;
- it is projected that in 2017 – 2019 in social security funds there will be a surplus. In the medium term the revenue, mainly made up of the social security contributions, will demonstrate a stable growth. Likewise, increase is expected also in expenditure, taking into account the projected changes in the number of beneficiaries and the average amount of benefits. It should be noted that the projected expenditure includes the new pension indexation procedure approved in the Saeima in March this year, which provides to take into account in pension indexation the consumer price index and 50% of the actual growth of the insurance contributions wage instead of the previous 25%.

In the local government budget:

- in 2016 the local government budget is projected balanced. An increase in revenue is expected, but the evolution of expenditure is projected according to the trends observed in previous years. It should be noted that, unlike previous years, larger activity is projected in the implementation of investment projects, financing them form the received tax revenue and borrowings. 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 2016 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;
- in the 2017 – 2019 a light deficit is projected in the local government budget. With respect to the income tax, 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 the 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 items. It is projected that local government expenditure in the medium term will increase in all items, except for social benefits and subsidies to corporations. 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.

3.4. DEVELOPMENT TRENDS OF GOVERNMENT DEBT IN THE MEDIUM TERM

According to the general government budget deficit and debt notification data of April 2016, in accordance with the ESA 2010 methodology, the general government debt at the end of 2015 reached 8, 871.7 million euro or 36.4% of GDP. The general government debt level is mainly affected by the central government debt, which at the end of 2015 was 8, 412.0 million euro.

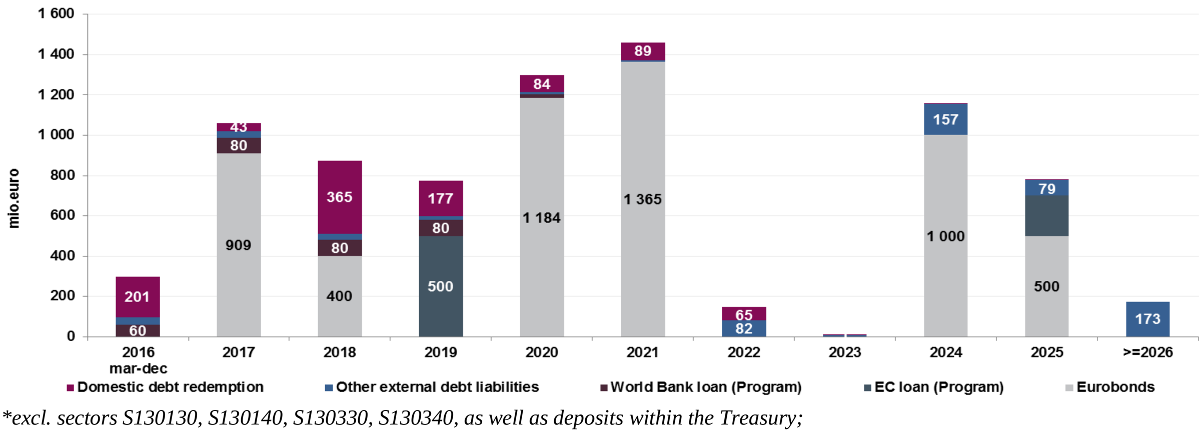
Principles and medium-term objectives of the central government debt management are defined in the Central Government Debt Management Strategy approved by the Minister for Finance. According to the Central Government Debt Management Strategy the objective of the central government debt management is to ensure the necessary financial resources for the refinancing of central government debt, central government budget execution and ensuring budget loans 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 central government debt obligations and fulfilling budget liabilities a strategic approach in state borrowing and debt management 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.

On September 2015 Latvia issued 10-year Eurobonds in the amount of 500 million euro with at that time historically lowest annual fixed interest (coupon) rate of 1.375% (yield 1.449%), thus representing international investors' view of the high creditworthiness of Latvia.

At the end of 2015 capitalising unique situation in financial markets and existing difference in credit spreads of Latvia government securities in US dollars and euros, Latvia has carried out partial re-financing of the bonds issued in US dollars with maturity in 2020 and 2021 with the new Eurobonds of similar tenor. In December 2015 the bonds issued in 2011 and 2012 were repurchased in the amount of 650 million US dollars, concurrently terminating the cross currency swaps concluded for the respective US dollars bonds currency risk hedging and issuing new five-year Eurobonds in the amount of 550 million euro with the new historically lowest annual fixed interest (coupon) rate of 0.5% (yield 0.532%). As a result liability management exercise savings in interest payments were achieved with a positive impact on the central government budget balance in the medium term (2016 - 2021), which is estimated at about 85 million euro. The liability management exercise was internationally recognised as the first transaction of such kind in the Central and Eastern Europe, serving as a landmark deal for other countries.

In the domestic financial market, in 2015 regular auctions of government domestic debt securities continued, offering to investors both T-bills and T-bonds. The supply of Latvia's government securities on domestic market remained at the level, which at the end of 2015 ensured the increase of outstanding amount of securities compared to the end of 2014, allowing investors to re-finance their exposures. Large investor competition in all auctions, as well as the quantitative easing implemented by the ECB since 2015 contributed to borrowing with historically lowest costs, for the first time in history of Latvia recording negative rates in the initial placing of government securities. In 2015 the Treasury launched two new bond programme – with three and five year maturity, as well as continued the auctions of the six and 12 months T-bills, to refinance the domestic short-term debt. Given the possibility under the current financial market environment to raise short-term funding with negative interest rates and in order to finance the budget execution cycle within a month as efficiently as possible, the Treasury, at the beginning of 2016, has introduced new short-term borrowing instrument - T-bills with 21 day maturity where auctions are taking place at the beginning of each calendar month. As a result of negative rates, T-bills with 21 day maturity are issued with premium. Within the scope of liquidity management, and in addition to the 21-day T-bills instrument, the Treasury also use short-term money market borrowing from local and foreign credit institutions.

Taking into account the central government debt obligations outstanding as of 29 February 2016, in accordance with the central government debt repayment schedule in March 2016 – December 2019 the central government debt obligations should be refinanced in amount of ~3.0 billion euro (see Figure 3.6). A significant portion of the debt to be refinanced consists of Eurobonds issued in international financial markets and the funding received from the World Bank and the EC within the framework of the international loan programme.



**excl. sectors S130130, S130140, S130330, S130340, as well as deposits within the Treasury;*
According to ECB FX rates of 26Feb. .2016.

Figure 3.6. Central government debt repayment schedule
(liabilities outstanding as of 29 February 2016, nominal value)

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

- to ensure borrowing in international financial markets, through public issuance of government debt securities, maintaining flexibility in terms of borrowing time, currency, amount 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 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 3.6), in the next few years, foreign borrowing instruments will provide major share of the total financing. It is planned that borrowing in international financial markets will be based on public transactions in global financial markets issuing benchmark Eurobonds mainly in the European financial market, as well as addressing other regional investors. Also it is planned to maintain an offer of securities on the domestic financial market consistent with the demand thus promoting activity of the market within the framework of the primary dealers system.

At the beginning of 2015, by ensuring the repayment of the EU loan in the amount of 1.2 billion euro, for which the required resources have been raised by issuing Eurobonds already in 2014, the general government debt at the end of 2015 has decreased to 36% of GDP, which is the lowest level since 2010 (see Figure 3.7.). In 2016 it is planned to raise funding not only to cover the financial requirement of the current year, but also for repayment of the government debt in amount of 1 billion US dollars at the beginning of 2017, as result whereof in 2016 the increase of the general government debt level is expected, and in 2017 - correspondingly, the decrease thereof. In the medium term the stabilisation of the general government debt at a sustainable level is projected, confidently complying with the debt condition prescribed by the FDL.

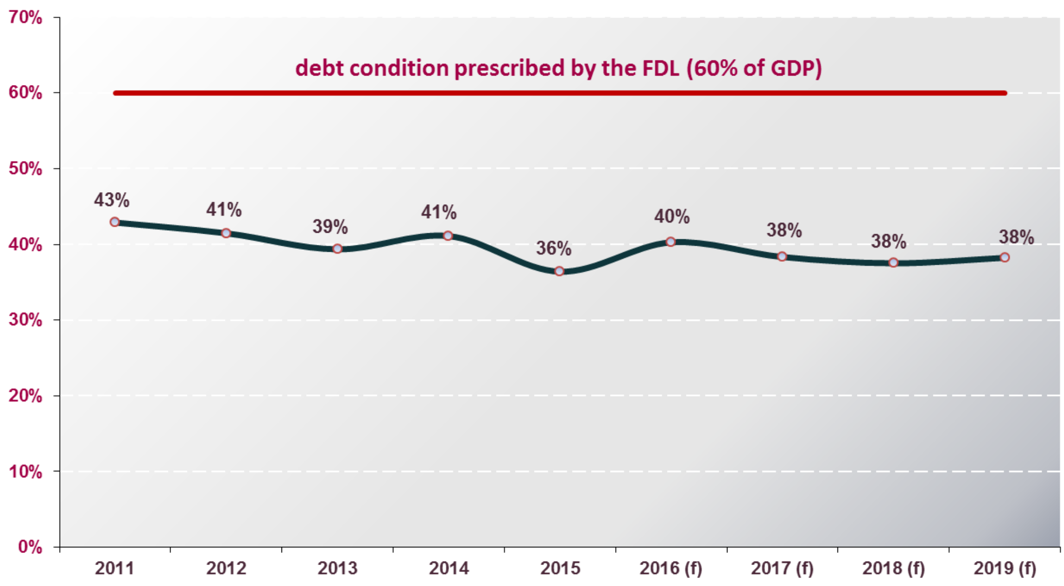


Figure 3.7. General government debt development trends (% of GDP)

4. SENSITIVITY ANALYSIS AND COMPARISON

4.1. MACROECONOMIC SCENARIO RISKS

The medium term macroeconomic development scenario is drafted on the basis of cautious assumptions. Nevertheless, taking into account large uncertainty in the external economic environment, macroeconomic development scenario risks are more top-on downside. For example, external environment risks associated with the geopolitical situation in the region - economic recession in Russia, weak economic growth in the euro area, still unsolved immigration issue, as well as the slowdown of the growth rates in China the world's second largest economy.

In addition to the external environment risks, the fulfilment of the macroeconomic scenario will also be affected by internal factors, such as the situation in the labour market, companies' ability to attract financial resources and implement investment projects to increase production capacity, development of lending and other factors that directly affect the country's credit rating, interest rates, confidence indicators and domestic demand.

Positive risks:

- Investment growth of Latvian entrepreneurs would be larger by using both EU structural funds and their own resources, thus building the competitiveness, successfully diversifying and finding new markets for their products. This would support exports and potential growth of Latvia in the future.
- More rapid increase in the lending volumes, including development of alternative funding and development of co-funding platforms promoting. increase in both investments and private (household) consumption.
- Successful implementation of the EC investment plan, and the ECB's continuation of quantitative easing. Successfully implemented structural reforms could ensure faster-than-expected economic growth in the euro area and the whole EU, which would allow also the Latvian economy to grow faster than expected in the basic scenario.
- Stabilisation of the geopolitical situation would increase regional safety and cooperation, as well as attraction of the region for investors.
- Higher-than-expected global economic growth, including in the USA and developing countries, giving additional push to European and Latvian economy.
- Structural reforms implemented in Latvia (for example, in education, healthcare, public administration) will ensure more efficient financial management and strengthen future economic potential.

Negative risks:

- The main negative risk to the Latvian economy is still the geopolitical situation in the region**.** Further escalation of the conflict between Russia and the West can significantly reduce both local and foreign investment in the region weakening Latvian economic growth in the short term and reducing the growth potential in the medium and long term.
- Introduction of new EU-Russia mutual economic sanctions may have a negative effect on certain sectors of the Latvian economy, including manufacturing, which have so far not been subject to the sanctions, such as machinery, metal, electronics, pharmaceutical industry. Potential sanctions can also affect the transport sector, damaging cargo transit to and from Russia through Latvian ports. They can also adversely affect the financial services with its relatively high share of services provided to non-residents. Further

depreciation of Russian rouble would decrease even more the Russian demand for Latvian goods.

- Continuously low inflation and weak growth in the euro area can significantly affect development of the Latvian economy, e.g., increased real interest rates hinder investments and consumption.
- Protracted wage growth, well above productivity growth, can undermine the competitiveness of the companies.
- Continuous low investment growth may adversely affect the economic growth potential in the medium term and its ability response to the changes in the external markets thus losing export market shares.
- Slower acquisition of the EU funds resources at the beginning of the new planning period in 2016 can adversely affect the total amount of investments in Latvia and development of some sectors, e.g., construction.
- Growing inflow of the asylum seekers from Africa and the Middle East countries may affect overall sentiment in the EU, e.g., weakening the consumer confidence. In turn entrepreneurship may be encumbered by border controls restored to limit migration in Schengen area countries. As the political risks grow, the EU and euro area economic growth may not reach the forecasted level as well, but the monetary stimulus may turn out to be insufficient to prevent the a continuous stagnation.
- The total global economic growth may be adversely affected by steeper slowdown of the economic growth in China, resulting in lower demand for exports from rest the world and by causing sudden fluctuations in financial markets.

4.2. SENSITIVITY ANALYSIS

On the basis of the possible impact of macroeconomic risks on the economy described in previous chapter, two alternative scenarios of macroeconomic development have been worked out. The scenarios provide that one or several risk factors materialise for a period of one year. The major impact is expected in 2016 then, in the coming years, the economic development returns to the growth rates of the baseline scenario.

4.1.1. OPTIMISTIC SCENARIO

Faster economic growth than expected in the baseline scenario, i.e., realisation of the optimistic scenario is possible, if the external economic environment show considerable improvements in the first half of 2016. This year, among the most important factors that could improve indicators of the Latvian economic growth are faster global and the EU economic growth. Starting from the second half of 2016 and in 2017, the geopolitical tension might ease, as a result of the abolishment of Russian and EU mutual sanctions, restoring the interrupted trade flows. In addition to that, EU Member States would continue to implement structural reforms that together with the monetary measures implemented by the ECB and implementation of the EC's investment plan would contribute to the higher EU growth rate.

Such scenario would significantly increase demand for Latvian export goods. As a result, the business and investor sentiment would improve, promoting investment. Thus, compared to the baseline scenario more rapid investment and export growth rate would be expected, which together with factors that stimulate consumption such as the increase in wages would provide faster growth of private consumption than projected in the baseline scenario.

Table 4.1. Optimistic macroeconomic scenario

	2015	2016	2017	2018	2019
GDP, at current prices, mln EUR	24376	25807	27467	29189	31077
growth at current prices,%	3.4	5.9	6.4	6.3	6.5
growth at constant prices,%	2.7	4.0	3.5	3.4	3.4
CPI (annual average), %	0.2	0.6	2.5	2.5	2.5
Average wage in the national economy, EUR	818	867	919	970	1023
growth at current prices,%	6.8	6.0	6.0	5.5	5.5
Employment, thousand people	896	899	901	901	902
growth %	1.3	0.3	0.2	0.1	0.1
Unemployment rate (annual average) % of economically active population	9.9	8.6	8.2	7.7	7.2
Export growth rates at current prices, %	1.7	6.1	6.6	6.2	6.7
Import growth rates at current prices, %	0.6	7.6	8.1	7.7	7.6

In case of the optimistic scenario, GDP at constant prices would increase to 4% in 2016 and in the medium term the growth rate would gradually decrease to 3.4%.

Upon implementation of the optimistic scenario tax revenue in 2016 would be about 111.7 million euro or 0.4% of GDP higher than in the baseline scenario. By contrast, in 2017, 2018 and 2019, tax revenue would be respectively 0.6% (166.8 mln euro), 0.6% (178.8 mln euro) and 0.6% (190.4 mln euro) of GDP higher than in the baseline scenario.

4.1.2. Pesimistic Scenario

One of the most essential risk to trigger the pessimistic scenario is the deterioration of the geopolitical situation in the region. As a result, new mutual sanctions could be imposed between the EU and Russia. Due to these sanctions export volumes of Latvia to Russia would decline more. Demand for Latvian exports would indirectly decline also due to lower export volumes of the trading partners of Latvia to Russia.

Scenario also assumes the slowdown of the world economy, triggered both by faster slowdown in China (from the forecasted 6.5% to 5% in 2016), and the decline in demand from emerging markets due to low prices of commodities. This would directly affect the demand for the EU exports and indirectly though the trade channel also Latvia's export.

In addition to the external effects, future economic growth would be affected also by internal factors. Lower economic growth would worsen consumer and business sentiment. This would result in lower investments and deterioration in labour market. companies would delay further wage increase decisions or, later alternatively, dismiss employees. Thus household income would decrease and their vigilance regarding spending would increase thus lowering private consumption.

Table 4.2. Pessimistic macroeconomic scenario

	2015	2016	2017	2018	2019
GDP, at current prices, mln EUR	24376	24979	26186	27804	29586
growth at current prices,%	3.4	2.5	4.8	6.2	6.4
growth at constant prices,%	2.7	2.0	3.1	3.3	3.4
CPI (annual average), %	0.2	0.0	1.5	2.5	2.5
Average wage in the national economy, EUR	818	851	876	924	975
growth at current prices,%	6.8	4.0	3.0	5.5	5.5
Employment, thousand people	896	896	897	898	899
growth %	1.3	0.0	0.1	0.1	0.1
Unemployment rate (annual average) % of economically active population	9.9	10.0	9.8	9.7	9.6
Export growth rates at current prices, %	1.7	0.1	4.9	6.1	6.7
Import growth rates at current prices, %	1.6	-1.2	5.2	6.1	6.0

In case of the negative scenario, Latvian GDP growth at constant prices in 2016 would be by 1 percentage point less than in the baseline scenario and– by 0.2 percentage points less in 2017. In the subsequent years the economy would return to the previously forecasted growth rates, however, without returning to the previous development trend.

In this scenario tax revenue would decrease significantly compared to the baseline scenario. Tax revenues would be about 130.2 mln euro or 0.5% of GDP lower than in the baseline scenario in 2016. By contrast, in 2017, 2018 and 2019, tax revenue would be respectively by 0.8% (212.2 mln euro), 0.8% (231.2 mln euro) and 0.8% (247.9 mln euro) of GDP lower than in the baseline scenario.

5. COMPARISON WITH THE LATVIA'S STABILITY PROGRAMME FOR 2015-2018

GDP growth in 2015 has been faster than envisaged in the scenario of Stability Programme for 2015 – 2018. Stronger growth is mainly due to higher-than-forecasted increase of private consumption as well as investments, despite the negative geopolitical situation. Export growth also has been slightly higher than forecasted, at the same time import growth exceeded the forecasted one more. In 2016, GDP growth is forecasted at the same level as in the Stability Programme for 2015 – 2018 scenario, but in the subsequent years the growth will be slightly lower than in the scenario of Stability Programme for 2015 – 2018.

Table 5.1. Comparison with the forecasts of the Stability Programme for 2015–2018

	ESA code	2015	2016	2017	2018	2019
GDP growth (%)	B1g					
2015		2.1	3.0	3.6	3.6	-
2016		2.7	3.0	3.3	3.4	3.4
Difference		0.6	0.0	-0.3	-0.2	-
Actual budget balance (% of GDP)	B.9					
2015		-1.5	-1.6	-1.3	-1.7	-
2016		-1.0	-1.0	-1.0	-1.0	-0.5
Difference		0.5	0.6	0.3	0.7	-
Total general government debt (% of GDP)						
2015		37.0	40.0	37.3	34.1	-
2016		36.4	40.3	38.3	37.5	38.2
Difference		-0.6	+0.3	+1.0	+3.4	-

According to the assessment of the MoF the general government budget deficit in 2015 was 0.5 percentage points lower than forecasted in the Stability Programme for 2015 – 2018. Less-than-forecasted deficit was influence by larger tax revenue, taking into account more rapid economic growth, as well as lower expenditure, on account of savings of funds mainly for goods and services, contributions to the EU budget, as well as better performance results of the general government business persons.

Updated general government budget forecasts provide for a deficit of 1.0% of GDP in 2016 - 2018 and of 0.5% of GDP in 2019. General government budget forecasts are based on updated structural budget balance objectives, as well as taking into account the changes in the cyclical component of the budgetary balance.

General government debt forecast for 2016 - 2018 has been increase in comparison to the forecasts in the Stability Programme for 2015 - 2018 in line with updated central government budget forecasts and adjusted borrowing strategy for the medium term, as well as updated economic development forecasts.

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. 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.

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.

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.

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 shall, on an annual basis, take 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, will submit 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.

According to the LBFM, persons implementing the State budget may make the budget expenditure or assume short-term liabilities only within the limits of the assignations determined by financing plans issued by the Treasury. The Treasury in turn provides allocations for expenditure, 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.

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.

In addition, in the LBFM it is prescribed that 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.

At the same time, in order to achieve budget objectives, line ministries and other central State institutions shall prepare quarterly reports on the State budget execution process and submit them to the MoF. The reports provide information on the State budget execution in the relevant reporting period – a comparison of the expenditure made with the previous year's reporting period, a comparison with the plan for the reporting period, an overview of the performed activities and activities not performed, information about the measures for improving financial management, etc.

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 Cabinet Regulation No 523 of 31 July 2012 *Regulation on the Basic Principles for the Development and Submission of Budget Requests*, the structure of budget programmes shall be set in compliance with 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. Ministries and other central State institutions shall set a definite objective for the budget programmes and sub-programmes, which they are implementing, together with operating results and performance indicators, characterising the level of attainment of such objective, for which operating results and performance indicators' trends are planned also in medium term and, at the same time, historical information for a three-year period is presented.

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).

Policy results shall be primarily planned in development planning documents. Reporting documents on policy planning documents shall be prepared in a form of informative reports both in the middle of the implementation of a policy-planning document and after the end of its duration.

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 2015 and is being continued in 2016. 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)	2015	2016	2017	2018	2019
Tax revenue						
1. Production and import taxes	D.2	3 085.0	3 300.4	3 490.2	3 701.3	3 839.4
2. Current income and real estate taxes	D.5	1 912.1	2 087.0	2 180.0	2 330.9	2 458.4
3. Capital taxes	D.91	2.6	2.6	2.8	3.0	3.3
4. Social contributions	D.61	2 108.9	2 143.8	2 333.1	2 495.4	2 643.5
Hereof actual social contributions	*D.611 and D.613*	*2 028.5*	*2 063.4*	*2 252.7*	*2 414.9*	*2 563.1*

In Latvia, the biggest part of all tax revenue is attributed to labour taxes. In recent years, the tax policy was focused on reducing the share of labour taxes in total tax revenue, and, in order to prevent the regressive labour tax system, starting from 2016 the solidarity tax is introduced, whereas for ensuring social protection the employer's and employee's monthly minimum mandatory State social security contributions object will be introduced starting from 2017. Though the referred to measures increase the share of labour taxes in total tax revenue, they are, nevertheless, introduced with an aim of reducing tax regressivity for the employed and self – employed persons with higher income level and to ensure social protection. As a result of the introduced changes, the share of labour taxes increases from 47.4% in 2015 to 48.2% in 2019, therefore, the share of revenue from consumption and capital taxes in total tax revenue gradually decreases from 52.6% in 2015 to 51.8% in 2019.

Therefore, also the labour tax revenue from GDP in 2019, as compared to 2015, will be larger than the share of the consumption and capital tax revenue from GDP. The labour tax revenue from GDP for the corresponding period will increase by 4 percentage points, but the consumption and capital tax revenue from GDP will remain at the level of 2015.

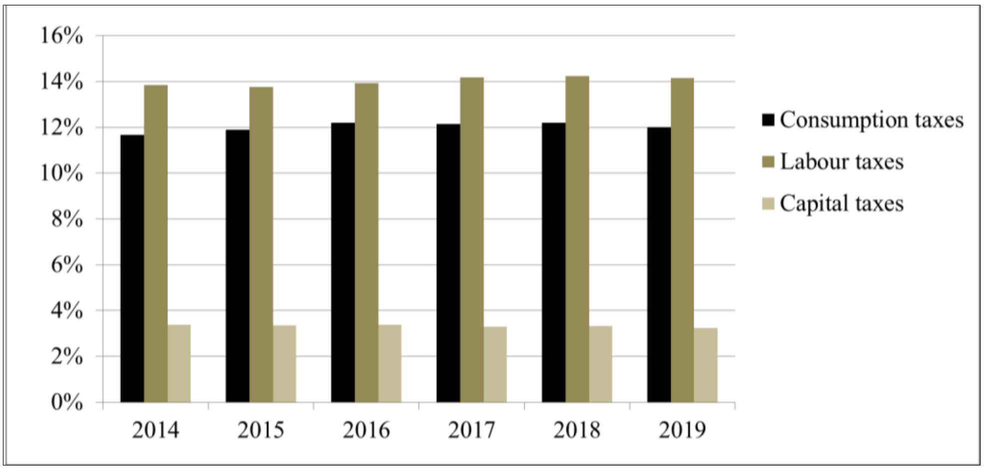


Figure 6.1. Tax Revenue According to Economic Functions, % of GDP

Changes in the medium-term tax policy are focused on reducing labour tax burden, income inequality and limiting the shadow economy.

To reduce the **tax burden on labour**, as of 1 January 2016 the allowance for dependents was increased from 165 euro to 175 euro per month and the differentiated non-taxable minimum was introduced, providing that the amount of the non-taxable minimum depends on the amount of the taxable income of the taxpayer.

As of 1 January 2016 the minimum monthly wage was raised from 360 euro to 370 euro, but the PIT rate was retained at the level of 2015 - 23%, instead of the planned 22% (amendments to the Law *On Personal Income Tax*, taking effect on 1 January 2014 prescribed that the PIT rate in 2016 will be reduced to 22 percent). Legislative changes were also introduced in the PIT allowances and eligible expenditure.

In the medium term the most important tasks is to continue reducing the tax burden on labour – according to Clause 24 of the Declaration of the Government's Action Plan ("Declaration on the Implementation of Actions Planned by the Cabinet led by Māris Kučinskis") the possibilities will be assessed for the implementation of the transfer of the tax burden from labour to the capital income and capital growth, to consumption, to real estate and to the use of natural resources, at the same time ensuring the stability of the tax revenue.

Also other measures influencing the tax revenue took effect in 2016:

- as of 1 January 2016:
  - the excise duty rate is increased for the unleaded gasoline, diesel fuel, kerosene, fuel oil, the colorimetric index whereof is less than 2.0 and the kinematic viscosity at 50°C is less than 25 mm^2/s, liquefied petroleum gasses and gasoline and ethyl alcohol compound, with the content of the added ethyl alcohol thereof comprising from 70 to 85 volume percentage of the total product volume;
  - the range of non-alcoholic beverages not subject to excise duty is extended, including the beverages with at least 10% juice content (except fruit juices made of concentrate), not more than 10% of added sugar and which do not contain food additives and flavourings;
  - 50% input tax deduction is determined for the business persons for passenger car acquisition and operating expenses, instead of the previous 20%;
  - the excise duty rate for smoking tobacco and tobacco leaves is increased;
  - vehicle operation tax rates are increased for the trucks with full weight of up to 12, 000 kg;

- tax rates are increased for the passenger cars, which are registered for the first time after 1 January 2005;
  - the company car vehicle tax is imposed on the trucks with the full weight of up to 3, 000 kg (category N1) and taxis;
  - the change of the procedure for payment of the vehicle operation tax is adjourned from the 2016 to 2017;
  - gambling tax rates are increased.
- as of 1 March 2016:
  - excise duty rate is increased for the alcoholic beverages and beer;
  - new excise duty object is introduced – heated tobacco.
- as of 1 July 2016:
  - the excise duty will be imposed on the liquids used in the electronic cigarettes;
  - the VAT will be imposed on the management of residential premises and the application of a special tax payment procedure will be prescribed for the housing management services.

The shadow economy has a negative impact on the country's overall economic growth, as well as 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 is within the field of combating the shadow economy to coordinate and monitor responsible institutions in order to significantly reduce "envelope wages", combat tax fraud schemes and other unfair business principles, to which particular attention will be paid in the medium term – especially active work of the SRS against tax evasion, thus improving tax collection.

As of 2016 the following measures to combat the shadow economy came into effect:

- stricter rules regarding improvement of technical requirements of the cash registers, cash systems, specialised devices and equipment, preventing the violations of malicious abuse thereof, as well as the reverse VAT payment procedure introduced for the computer hardware (tablets and laptops) and communications means;
- enhancement of the information exchange process among financial institutions and the SRS, providing for ensuring electronic information exchange between the credit institutions and the SRS.

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 in 2018 reaching the 1 percentage point of tax collection increase to GDP.

Inter alia, as of 1 January 2017 the employer's and the employee's minimum mandatory State social security contributions object will be introduced.

Value Added Tax

In spite of the reduction of VAT revenue growth rate, stable VAT revenue growth is expected according to the forecasted country's economic growth.

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 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 is affected also by the measures that are not directly related to the changes in the VAT Law, but contributing to revenue growth.

Table 6.2. Impact of the Changes in Tax Policy on VAT Revenue[20], million euro

	2016	2017	2018	2019
Fight against the shadow economy and other measures to improve tax administration (measures to improve tax administration, etc. measures)	+1.4			
Enhancement of the technical requirements for cash registers, hybrid cash registers, cash systems, specialised devices and equipment		+18.1		
Raise of the monthly minimum wage from 360 euro to 370 euro	+0.7			
Imposition of VAT on the management of residential premises (in accordance with the EC violation procedure)	+11.2	+11.2		
Determination of the 50% input tax deduction limitation for passenger car acquisition, maintenance and operating expenses, instead of the previous 20%	+11.0			
Introduction of the reverse VAT payment procedure for mobile telephones, laptops, tablets and integral scheme devices	+3.0	+1.0		
Increase of the excise duty rate for cigarettes, cigars and cigarillos and the smoking tobacco	+0.7	+0.9	+0.9	+0.3
Increase of the excise duty rate on alcoholic beverages and beer	+1.5	+1.2	+1.2	+0.2
Increase of the excise duty rate on fuel	+2.4			
Other changes (imposition of excise duty on the refill liquids of electronic smoking devices, etc. changes)	+1.1	-0.5		
Total impact of changes:	**+33.0**	**+31.8**	**+2.1**	**+0.5**

Corporate Income Tax

The CIT rate –15%, effective since 2014 and being one of the lowest in the EU, will remain unchanged also henceforth. As the economy developed successfully and corporate financial results improved after the economic recession, the corporate income tax revenue has increased considerably since 2011 and their increase is forecasted also in the coming years.

Changes to affect CIT revenue in 2016 are related to abolition of relief for research and development costs starting from 1 January 2015, as well as the fight against the shadow economy, and other measures to improve tax administration.

Legislative changes are introduced also in 2016 affecting the CIT revenue also in the coming years – the fight against the shadow economy and other measures to improve tax administration, limitations of the VAT input tax deduction for the passenger car, as well as the determination of the employee's and employer's minimum mandatory State social security contributions object.

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

	2016	2017	2018	2019
Abolition of the CIT relief for research and development costs	+0.03			
Fight against the shadow economy and other measures to improve tax administration	+3.1	+1.4		
Limitations of the VAT input tax deduction for the passenger car		-1.2		
Determination of the employee's and employer's minimum mandatory State social security contributions object		+0.2	-0.4	
Total impact of changes:	**+3.1**	**+0.3**	**-0.4**	

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

Excise Duty

According to the amendments adopted on 18 June 2015 to the Law on Excise Duty starting from 1 August 2015 the excise duty rates on alcoholic beverages and beer have been increased.

For wine, fermented beverages with the absolute alcohol content exceeding 6 volume percent and intermediate products with the absolute alcohol content of up to 15 volume percent the duty rate has been increased from 64.03 euro to 70.0 euro per 100 litres, for intermediate products with the absolute alcohol content from 15 volume percent to 22 volume percent – from 99.6 euro to 110.0 euro per 100 litre and for the rest of alcoholic beverages – from 1, 337.5 euro to 1, 360.0 euro per 100 litres of absolute alcohol, in turn for fermented beverages with the absolute alcohol content of up to 6 volume percent the rate has been retained at the previous level (rounding in up) - 64.0 euro per 100 litres. The rate for beer has been increased from 3.1 euro to 3.8 euro per each volume percent of absolute alcohol, at the same time increasing also the minimum rate from 5.69 euro to 7.4 euro per 100 litres.

According to the amendments adopted on 30 November 2015 to the Law on Excise Duties, also further increase of the excise duty rates on alcoholic beverages and beer is prescribed – rates have been increased as of 1 March 2016 and they are to be increased also as of 1 March 2017 and 2018 (see Table 6.4).

Table 6.4. Excise Duty Rates on Alcoholic Beverages, euro

	01.06.2011.	**01.08.2015.**	**01.03.2016.**	**01.03.2017.**	**01.03.2018.**
Wine, fermented beverages with the absolute alcohol content exceeding 6 volume percent and intermediate products with the absolute alcohol content of up to 15 volume percent, per 100 litres	64.03	70.0	74.0	78.0	82.0
Fermented beverages with the absolute alcohol content up to 6 volume percent. per 100 litres	64.03	64.0	64.0	64.0	64.0
Intermediate products with the absolute alcohol content from 15 volume percent to 22 volume percent, per 100 litres	99.6	110.0	120.0	130.0	135.0
Other alcoholic beverages for 100 litres of absolute alcohol	1 337.5	1 360.0	1 400.0	1 450.0	1 500.0
Beer, per each volume percent of absolute alcohol for 100 litres	3.1	3.8	4.2	4.5	4.8
Minimum level of excise duty for 100 litres of beer	5.69	7.4	7.8	8.2	8.6

By the amendments adopted on 30 November 2015 to the Law on Excise Duty, also other changes have been defined in the application of excise duty:

- as of 1 January 2016 the excise duty rates have been increased for particular petroleum products:
  - for unleaded gasoline – form 411.21 euro to 436.0 euro per 1, 000 litres;
  - for diesel fuel (gas oil), its substitute products and components, kerosene, its substitute products and components, fuel oil with the colorimetric index below 2.0 and kinematic viscosity at 500C below 25 mmr2/2, its substitute products and components – from 332.95 euro to 341.0 euro per 1, 000 litres;
  - for petroleum gases (autogas, LPG) and other gaseous hydrocarbons – from 161.0 euro to 206.0 euro per 1, 000 litres;

  - for gasoline and ethyl alcohol compound, with the content of the added ethyl alcohol thereof comprising from 70 to 85 volume percentage of the total product volume – from 123.36 euro to 131.0 euro per 1, 000 litres;
- more rapid increase of the excise duty rates is prescribed for smoking tobacco and tobacco leaves, as of 1 January 2016 increasing the rate from 55.49 euro to 58.0 euro, as of 1 January 2017 - to 60.0 euro and as of 1 January 2018 – to 62.0 euro per 1, 000 grams of tobacco. Previously it was planned to increase the rate only on 1 January 2018 to 60.0 euro;
- as of 1 January 2016 the range of non-alcoholic beverages not subject to excise duty is extended, including the beverages with at least 10% juice content (except fruit juices made of concentrate), not more than 10% of added sugar and which do not contain food additives and flavourings;
- as of 1 March 2016 a new tax object has been introduced – heated tobacco, subject to the rate of 62.0 euro per 1, 000 grams;
- as of 1 July 2016 the excise duty will be imposed on the liquids used in the electronic cigarettes. The duty rate is comprised of the sum of two components – rate per 1 millilitre of liquid – 0.01 euro and the rate per 1 milligram of nicotine – 0.005 euro.

According to the Law of 6 November 2013 on Amendments to the Law on Excise Duties, as of 1 July 2014 the structure of excise duty on cigarettes was changed raising the part of the specific rate and reducing the percentage rate (ad valorem) to 25% in 2014 and 2015. According to the Transitional Provisions of the Law on Excise Duty, it is planned to increase the specific excise duty rate and the minimum excise duty level per 1, 000 cigarettes also in subsequent years:

- as of 1 July 2016 the specific rate is set at 56.20 euro and the minimum duty level - at 93.70 euro per 1, 000 cigarettes;
- as of 1 July 2017 the specific rate is set at 58.2 euro and the minimum duty level - at 97.00 euro per 1, 000 cigarettes;
- as of 1 July 2018 the specific rate is set at 60.0 euro and the minimum duty level - at 100.00 euro per 1, 000 cigarettes.

According to the amendments introduced on 14 April 2011 to the Law on Excise Duty, as of 1 January 2016 the excise duty rate on cigars and cigarillos has been increased from 39.84 euro to 42.69 euro, but as of 1 January 2018 it will be increased up to 45.00 euro per 1, 000 cigars and cigarillos.

Table 6.5. Impact of the Changes in Tax Policy on Excise Duty Revenue, million euro

	2016	2017	2018	2019
Increase of the excise duty rate for cigarettes, cigars and cigarillos and the smoking tobacco	+3.3	+4.1	+4.2	+1.3
Increase of the excise duty rate for petroleum products	+11.3			
Increase of the excise duty on alcoholic beverages and beer	+7.0	+5.5	+5.6	+0.9
Imposition of excise duty on the refill liquids of electronic smoking devices	+0.3	+0.3		
Extension of the range of non-alcoholic beverages not subject to the excise duty	-0.003			
Total impact of changes:	**+21.9**	**+9.9**	**+9.8**	**+2.2**

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 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 for increase in 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 most substantial legislative changes, effective as of 1 January 2016, stipulate 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.

Table 6.6. Impact of the Changes in Tax Policy on Real Estate Tax Revenue, million euro

	2016
Limitation of the increase of cadastral value of the rural land (above 3 ha)	-5.2
Total impact of changes:	**-5.2**

Personal Income Tax

With the economic recession, in 2009 PIT revenue decreased significantly, however, along with the economic recovery, in 2011 PIT revenue increased, despite legislative changes made in 2011, including a reduction of the rate from 26% to 25%, increase in non-taxable minimum from 49.8 euro to 64.03 euro per month and increase in the amount of allowance for dependents from 89.64 euro to 99.6 euro per month

The most significant changes that will affect PIT revenue in 2016 refer to the abolition of the PIT allowances for adult and able-bodied persons, retaining the allowance of under aged children (*inter alia*, children up to 24 years of age, while they continue acquiring general, professional, higher or special education) and socially sensitive groups.

In addition PIT revenue in 2016 will be affected also by other legislative changes taking effect on 1 January 2016:

- raise of the monthly minimum wage from 360 euro to 370 euro;
- enhancement of information exchange process between the financial institutions and the SRS;
- introduction of the solidarity tax;
- 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 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 taxpayers):
  - as of 1 January 2016 the minimum monthly non-taxable minimum is 75 euro, but for persons with the taxable income of up to 380 euro the maximum non-taxable minimum is applied in the amount of 100 euro per month, for the employed receiving the wage from 380 to 1, 000 euro per month the non-taxable minimum, applying the formula, gradually

decreases, and for monthly income above 1, 000 euro is subject to monthly non-taxable minimum in the amount of 75 euro;

- 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;
- as of 1 January 2018 and as of 1 January 2019 the maximum non-taxable minimum will be reduced, the minimum non-taxable minimum will be increased 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 until 460 euro per month;

Table 6.7. Differentiated Non-Taxable Minimum for 2016 - 2020

Criteria	2016	2017	2018	2019	2020
Maximum non-taxable minimum	**100**	**115**	**130**	**145**	**160**
Minimum non-taxable minimum	**75**	**60**	**40**	**20**	**0**
Maximum limit of taxable income	1 000	1 100	1 200	1 350	1 500
Minimum limit of taxable income	380	400	420	440	460

- increase of the PIT allowance for dependant from 165 euro to 175 euro per month;
- 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 justified expenses 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 expenses 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

	2016	2017	2018	2019
Abolition of PIT allowance for dependants regarding the adult and able-bodied persons	+25.0			
Fight against the shadow economy and other measures to improve tax administration (including introduction of informative declaration for leasing and lending service providers and improving the information exchange process between financial institutions and the SRS)	+5.3			
Raise of the minimum monthly wage from 360 euro to 370 euro	+2.7			
Pension indexation in 2016 and 2017	+1.9	+1.7		
Imposition of ceiling on state social security contributions in 2015 at 48,600 euro	-0.2			
Introduction of the solidarity tax	-3.3			
Increase of the allowance for dependant (from 165 to 175 euro)	-5.5			
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
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		
PIT relief for received amounts paid out as the state or the EU aid for agriculture and rural development is prolonged			-2.2	
Total impact of changes:	**+25.9**	**+8.4**	**+0.2**	**-0.5**

Medium-term macroeconomic development forecasts for 2016 provide for a stable increase in the wage fund, which, in turn, will increase labour tax revenue in following years, and the PIT will be also influenced by the legislative changes made.

Social Security Contributions[21]

In the medium term, the dynamics of revenue from social security contributions will be determined not only by the expected increase in the wage fund, but also by legislative changes and changes in the rate of contributions to the State-funded pension scheme[22].

The most substantial legislative changes in 2016 affecting the social security contributions revenue are related to the increase in the minimum monthly wage from 360 euro to 370 euro.

Besides, as of 1 January 2017 the employee's and the employer's minimum mandatory State social security contributions objet will be introduced, stipulating that the minimum mandatory State social security contributions object is determined for the 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.

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

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

Table 6.9. Impact of the Changes in Tax Policy on the Revenue from State Security Contributions[23], million euro

	2016	2017	2018
Imposition of ceiling on State social security contributions in 2015 at 48,600 euro	+3.2		
Raise of the monthly minimum wage from 360 euro to 370 euro	+3.8		
Fight against the shadow economy and other measures to improve tax administration (introduction of informative declaration for leasing and lending service providers)	+0.8		
Increase in the rate of contributions to the State-funded pension scheme in 2016 from 5% to 6%	-73.6		
Determination of the monthly minimum object of mandatory State social security contributions as of 2017		+76.3	+21.7
Total impact of changes:	**-65.8**	**+76.3**	**+21.7**

The amount of social security contributions to the State special budget not only in 2015 but also in the medium term is substantially affected by the rate of contributions to the State-funded pension scheme, which in 2015 has been increased from 4% to 5%, but in 2016 it is increased to 6%.

Subsidised Electricity Tax

The subsidised electricity tax is imposed on the taxable income gained between 1 January 2014 and 31 December 2017. The tax has been introduced for the period until the end of 2017 providing that it should be decreased or abolished if the reduction of the amount of subsidies to be paid within the framework of the mandatory procurement component is actually achieved.

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) according to the editions of Section 40 of the Energy Law, effective from 6 October 1998 to 7 June 2005, and according to the corresponding procedure prescribed by the Cabinet.

The purpose of the subsidised electricity tax is to restrict increase in the total electricity price, thus, ensuring competitiveness of the national economy and not increasing the energy poverty of households as well as providing additional revenue to the State budget, what would allow supporting financially 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.

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 17 September 2015 Cabinet Decree No. 567 (minutes No. 43, § 2) On Conceptual Report "Complex Measures for the Development of the Electricity Market" the subsidised electricity tax forecast for 2018 has been increased by 30.0 million euro.

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

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

	2014	2019
Introduction of the subsidised electricity tax	**+35.8**	**-35.8**
Total impact of changes:	**+35.8**	**-35.8**

Solidarity Tax

As of 1 January 2016 a new labour tax is 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 all work income (see Figure 6.2).

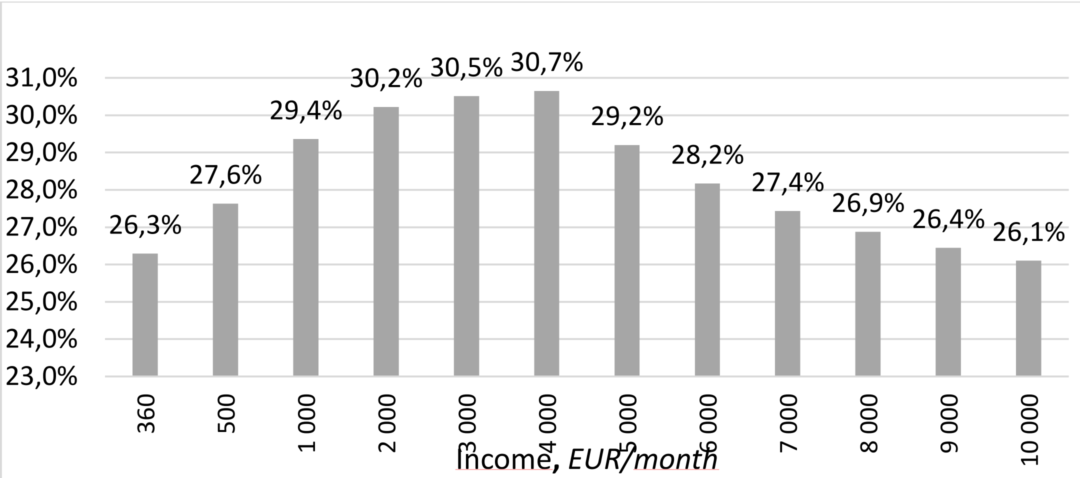

Figure 6.2. Labour Tax Burden by Various Income Levels in 2015

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, calculate the part of surplus of the mandatory State social security contributions (solidarity tax) for each person, to be transferred into the State basic budget.

Table 6.11. Impact of the Changes in Tax Policy on Solidarity Tax Revenue, million euro

	2016
Introduction of the solidarity tax	+49.4
Total impact of changes:	**+49.4**

7. Sustainability of Public Finances

7.1. The Long-term Development Scenario of Public Finances

Sustainability of public finances plays a key role in the growth of national economy. Fiscal sustainability is affected by the existing general government budget and debt position, 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. Both the process of ageing of population and insufficient funding in the social protection and healthcare systems are long-term challenges for the sustainability of Latvian public finances.

In 2016 the EC published the updated Fiscal Sustainability Report 2015, providing for the evaluation of sustainability of public finances in 26 Member States, i.e., those Member States which are currently not subject to the macroeconomic correction programmes. As compared to the previous report (2012), the methodology for assessment of the fiscal sustainability risks of the Member State has been improved. Risk assessment is divided into three risk categories: short-term, medium-term and long-term. The medium-term assessment also covers the debt sustainability, unlike before. The key results of the report reflect that low short-term risks are assessed for all Member States, 11 Member States have high medium-term risks related to large debts and weak initial fiscal position, and one Member State - Slovenia has a high long-term risk, the assessment whereof is based upon large expenditure for pensions and health with respect to the population ageing.

Latvia, like Denmark, Germany and Estonia, **has a low fiscal sustainability risk in all risk categories**. 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 risk assessment included in the updated Fiscal Sustainability Report is based upon results published in Ageing Report 2015, prepared by the EC in collaboration with the Member States AWG. The long-term budget projections are based upon demographic projections EUROPOP2013, developed by Eurostat, and assumptions regarding economic growth and the factors determining it in the long-term.

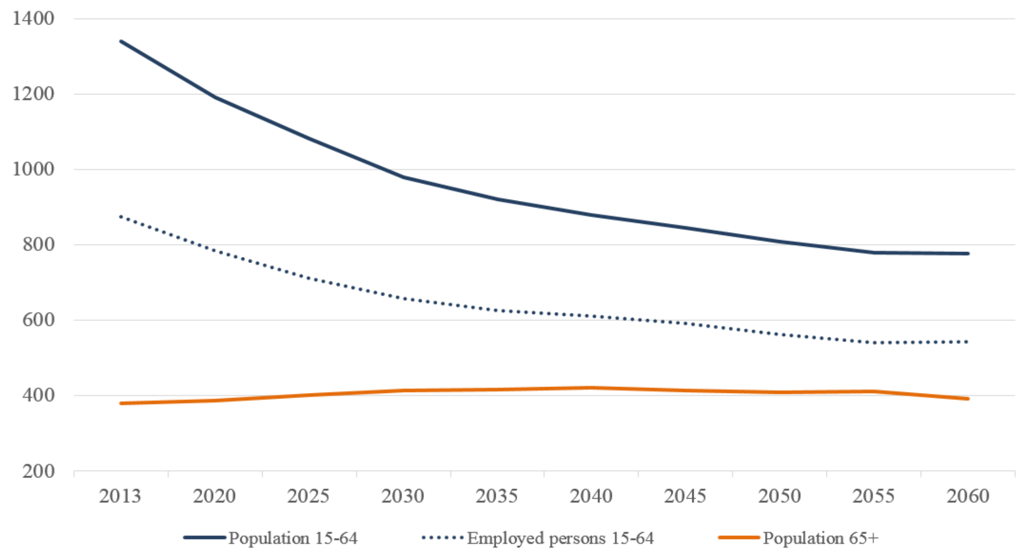

Figure 7.1. Number of Population and Employed Persons in the Age from 15 – 64 and the Number of Population in the Age of 65+ in Latvia, thousands (Data source: Eurostat, EC)

According to the Eurostat forecasts in Latvia a decrease in the number of population is forecasted until 2060, in spite of the overall trend of growing number of population in the EU. According to the Eurostat base 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. Inter alia, 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 inhabitants aged over 65 will increase by 3.0% in 2060 compared to 2013 and will total to 0.4 million.

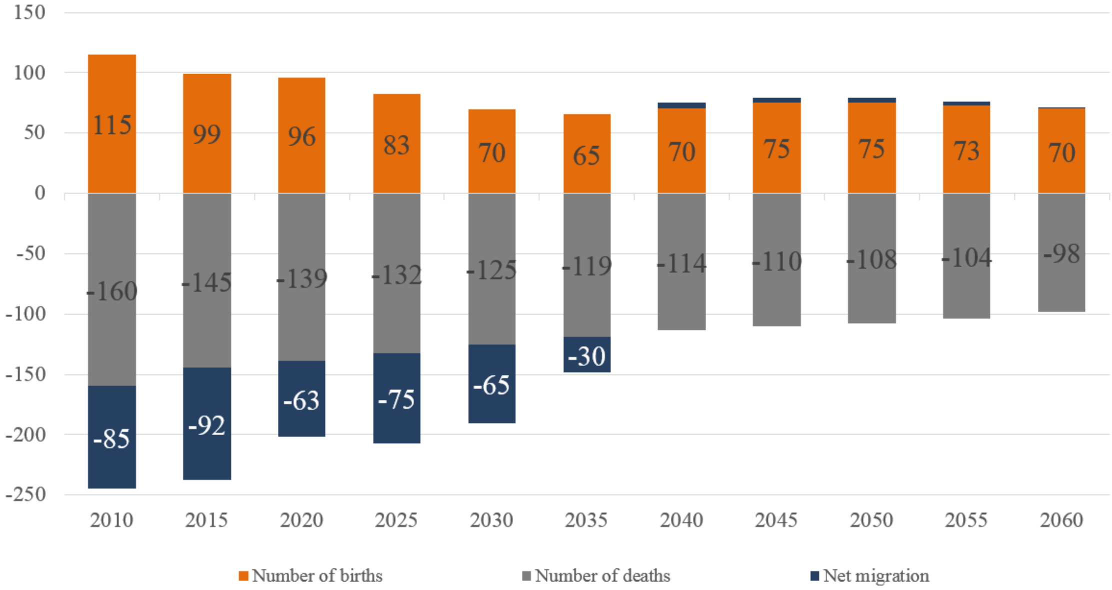

Figure 7.2. The Cumulative Impact of the Changes in the Number of Population Over the Period of 5 Years till 1 January of the Current Year by Factors: number of births, number of deaths and net migration, thousands (Data source: CSB, Eurostat)

The decrease of the overall number of population in the subsequent years (see Figure 7.2) is determined by both negative natural growth and negative net migration. 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 net migration, which means that the number of inhabitants leaving the country will exceed the number of those entering the country, and according to 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 term productivity will be a determinative factor for economic growth.

The updated long-term general government budget expenditure forecasts were published in Ageing Report 2015 and according to the AWG base scenario, it is forecasted that in Latvia the proportion of expenditure related to population ageing in gross domestic product 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 public pension expenditure in gross domestic product.

The long-term public expenditure base scenario provides for:

- decline in the proportion of the public 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.

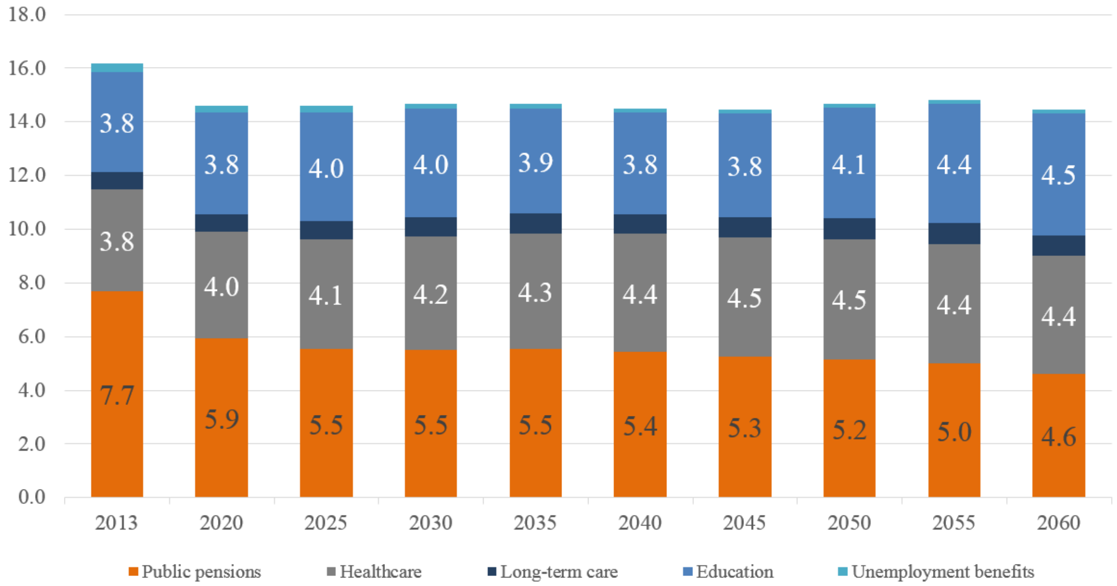

Figure 7.3. General Government Budget Expenditure Related to the Population Ageing, % of GDP (Data source: Ageing Report 2015)

To restrict the negative impact of population ageing on budgetary expenditure in the long term, in 2012 there were considerable reform performed in the Latvian pension system, determining a gradual increase in the retirement age up to 65 years in 2025. This was what mainly influenced the forecasted decline in the proportion of the public pension expenditure in the gross domestic product.

Legislative changes that have been taken into account, when preparing long-term pension expenditure forecasts, provide for:

- 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. Starting from 2015 the amount of 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, is indexed once a year on 1 October, taking into account the actual consumer price index and 25% of the real increase of wages on which contributions are paid.

Despite the fact that the proportion of budgetary expenditure for public pensions in the gross domestic product 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 replacement rate for a 65 year old inhabitant with 40 years working career will decrease significantly, for example, in the low income group from 62.9% 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.

To promote larger old-age pensions, in 2012 amendments were introduced to the Law on State-Funded Pensions providing for, after financial and economic crisis, gradual restoration and increase of the contribution rate in the State-funded pension scheme. In 2016 the contribution 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.

It should be noted that the long-term pension expenditure forecasts included in the Ageing Report 2015 do not take into account the 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 insurance contributions wage index determined from 2009 till 2015 by "1" 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);
- 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.

7.2. STATE GUARANTEES

In 2015, in accordance with the Law on State Budget for 2015 it was planned to issue guarantees in amount of 37.8 million euro, including for the implementation of the student crediting (10.8 million euro) and study crediting (25.2 million euro) programmes and funding of the projects financed by the European Investment Bank in Africa, Caribbean and Pacific Countries and Overseas Countries and Territories (1.8 million euro). In 2015, the actually issued State guarantees amounted to 10.3 million euro, including for study and student commitments - 8.5 million euro.

State-guaranteed loans outstanding at the end of 2015 amounted to 426.3 million euro, which compared to the State-guaranteed loans outstanding at the end of 2014 is a decrease of 166.2 million euro, determined by the repayments of the State-guaranteed loans performed in 2015, including the repayment of the State-guaranteed loan performed by the State Joint Stock Company Privatisation Agency (*VAS Privatizācijas Aģentūra*) in amount of 126.6 million euro.

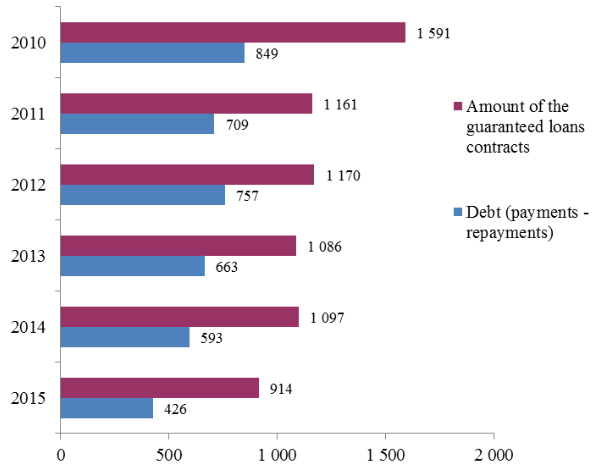

Figure 7.4. State-guaranteed loans outstanding at the end of respective year (million euro)

There are State guarantees in amount of 36.0 million euro anticipated in the Law on State Budget for 2016, in amount of 10.8 million euro for student loans and 25.2 million euro for study loans.

Having assessed information on the borrowers' financial position, previous credit history, collateral liquidity and amount, as well as other available information, as on 31 December 2015 the provisions for seven guarantees were formed. The outstanding guaranteed loans to the mentioned borrowers on 31 December 2015 accounted for 21.8% of the total amount of outstanding guaranteed loans. In light of this assessment, there is a possibility that the seven State-guaranteed loan obligations or their part could not be met within the prescribed period and amount. In the Law on State Budget for 2016 allowable limits on government actions to cover expenditure that may occur in the performance of State-guaranteed debt obligations attributable to the State budget in 2016 are set at 5.3 million euro (~ 0.02% 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, the FDL was developed in accordance with the SGP conditions. Since the FDL entered into force in 2013, in the process of drafting the State Budget Law and the Framework Law the introduction of fiscal rules is being ensured:

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.

Fiscal Discipline Council which became operational in 2014 is responsible for monitoring of the implementation of the fiscal discipline rules both in the planning and execution process of the budget. In 2015 Fiscal Discipline Council prepared:

- fiscal discipline monitoring report;
- irregularities report, which is prepared in accordance with the situation of violation of the fiscal discipline;
- three opinions on the issues of fiscal policy and macroeconomic development, recognised to be significant for meeting the FDL rules.

On 8 February 2016 in turn the agreement on cooperation was concluded between the Fiscal Discipline Council and the MoF, providing for procedure for cooperation and, inter alia, information exchange, as well as stating that the Fiscal Discipline Council approves the macroeconomic forecasts prepared by the MoF two times per year – when preparing the Stability Programme and the annual State budget and the medium-term budget framework.

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 gross domestic product, forecasts of the State budget revenue, the amount of the State budget financial balance (maximum deficit level or minimum surplus level). The first Framework Law approved by the Saeima was drafted for the period 2013–2015; however, explanations to the Framework Law were attached starting from drafting the Framework Law for 2014 – 2016. Besides, 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 2016 – 2018 and the draft law On State Budget 2016 on 30 November 2015.

As regards medium-term objectives and initiatives, the LBFM stipulates that the ministries and other central State institutions shall prepare proposals for the NPI if in the relevant subsequent financial years funds are available for financing of the NPI in accordance with the latest macroeconomic development forecasts. The proposals for NPI shall be submitted within the term prescribed by the Schedule for the Development and Submission of the Draft Framework Law and the Draft Annual State Budget Law. The proposals for NPI shall be prepared on the basis of the priorities and purposes determined in the NDP 2020, National Defence Conception and priorities and purposes set in other development planning documents, inter alia, taking into account the need to take measures for strengthening the administrative capacity of budget institutions. Thus, linking of the national priorities with the resources available within the State budget for the medium term is ensured.

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.

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.

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, if the Cabinet has adopted a decision on NPI, 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 ceilings approved by the Cabinet on the total amount of expenditure for each ministry and other central State institutions, they shall develop and submit budget requests to the MoF according to the 31 July 2012 Cabinet Regulation No. 523 *Regulation on the Basic Principles for the Development and Submission of Budget Requests*. The Regulation prescribes common principles for the preparation of budget programmes, preparation of requests of the State basic budget and the State special budget, as well as the composition of a budget request.

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.

The ministries and other central State institutions shall develop and submit State budget requests to the MoF in accordance with the Schedule for the Development and Submission of the Draft Framework Law and the Draft Annual State Budget Law, which the Minister for Finance submits to the Cabinet according to the LBFM.

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 budget programmes, 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. Budget explanations for each programme (sub-programme) of the State basic budget or State special budget included in the draft State budget law shall be prepared in a separate section, which contains information about programme (sub-programme) objectives, main activities and authorities, which will ensure implementation of the programme (sub-programme), operating results and performance indicators thereof, additionally allocated funding for the implementation of NPI, financial indicators and changes in total expenditure. Explanations also contain information about the average number of staff positions and remuneration in the budget sector.

During the process of development of the Draft State Budget 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. 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 Draft Protocol is submitted for consideration at the extended session of the Committee of the Cabinet of Ministers. According to the Law on Local Government Budgets the Draft Protocol shall be attached to the Draft Annual State Budget Law and the Cabinet shall submit it to the Saeima. LBFM prescribes to organise negotiations regarding issues related to the interests of local governments with the LALRG also during the process of development of the Draft Framework Law and to attach the result of the negotiations to the Draft Law in a form of a protocol, when passing 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.

With an aim of coordinating the terms for preparation and submission to Saeima of the Draft Framework Law and the Draft Annual State Budget Law with the terms for submission of the General Government Budget Plan to the EC, in 2016 the changes were introduced to the terms for submission of the referred to Draft Laws -–henceforth the Cabinet will submit the Draft Annual State Budget Law (the package of the budget draft laws) to the Saeima by 15 October.

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 European system of national and regional accounts 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 1093 independent budgetary institutions, of which 247 institutions belonged to the central government sub-sector; 845 institutions belonged to the local government sub-sector, and 1 institution - to the social security fund sub-sector. Moreover, there were 128 capital corporations controlled and financed by the central and local governments, of which 49 capital corporations were controlled by the central, and 79 - by local governments.

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

In addition, the CSB each year within the set deadlines - by 1 April (provisional data) and by 1 October (final data) - prepares the general government budget deficit and debt notification (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 gross domestic product at current prices must not exceed 3 %, and the ratio of government debt to gross domestic product 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).

ANNEXES

Table 1a. Growth and its Factors

	ESA code	2015	2015	2016	2017	2018	2019
		mln euro	Growth %				
1. Real GDP (at prices of the year 2010)	B1*y	21448	2.7	3.0	3.3	3.4	3.4
2. Nominal GDP	B1*y	24376	3.4	4.3	5.8	6.2	6.5
Real GDP by expenditure (at Prices of the year 2010)							
3. Private consumption expenditure	P3	13458	3.3	3.4	3.3	3.4	3.5
4. Government consumption expenditure	P3	3742	3.1	3.1	2.8	2.8	2.8
5. Gross fixed capital formation	P51	4778	2.6	4.6	7.0	8.0	6.5
6. Changes in inventories and net acquisition of valuables	P52+P53	13	-	-	-	-	-
7. Exports of goods and services	P6	12457	1.0	3.0	4.1	4.5	5.0
8. Imports of goods and services	P7	12999	1.6	3.8	5.3	6.1	6.0
Contribution to real GDP growth							
9. Final domestic demand			3.2	3.6	4.2	4.6	4.4
10. Changes in inventories and net acquisition of valuables	P52+P53		0.0	-0.1	0.0	0.0	0.0
11. External balance of goods and services	B11		-0.4	-0.6	-0.9	-1.2	-0.9

Table 1b. Price developments

	ESA Code	2015	2015	2016	2017	2018	2018
		level	Growth %				
1. GDP deflator			0.6	1.3	2.4	2.8	2.9
2. Private consumption deflator			0.4	0.4	2.0	2.5	2.5
3. HICP			0.2	0.4	2.0	2.5	2.5
4. Public consumption deflator			2.6	2.2	3.1	3.3	4.0
5. Investment deflator			0.3	2.1	2.5	2.5	2.5
6. Export price deflator (goods and services)			0.7	1.0	1.6	1.6	1.6
7. Import price deflator (goods and services)			-1.0	1.0	1.5	1.5	1.5

Table 1c. Labour market development

	ESA code	2015	2015	2016	2017	2018	2019
		Level	Growth %				
1. Employment, persons		896	1.3	0.2	0.2	0.1	0.0
2. Employment, hours worked		1311479086	0.6	0.2	0.2	0.1	0.0
3. Unemployment rate (%)			9.9	8.9	8.4	8.0	7.5
4. Labour productivity, persons			1.4	2.8	3.1	3.3	3.4
5. Labour productivity, hours worked			2.1	2.8	3.1	3.3	3.4
6. Compensation of employees	D.1	10585	7.4	5.2	6.0	6.0	5.9
7. Compensation per employee		818	6.8	5.5	5.5	5.5	5.5

Table 1d. Sectoral balances

% of GDP	ESA code	2015	2016	2017	2018	2019
1. Net lending/borrowing vis-à-vis the rest of the world	B.9	1.6	-0.4	-0.2	0.1	-1.4
of which:						
- Balance on goods and services		-1.4	-1.9	-2.5	-3.4	-3.9
- Balance of primary incomes and secondary incomes		0.2	0.1	0.2	0.4	0.2
- Capital account		2.8	1.4	2.1	3.1	2.3
2. Net lending/borrowing of the private sector		2.5	0.6	0.8	1.1	-0.9
3. Net lending/borrowing of general government	B.9	-1.0	-1.0	-1.0	-1.0	-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	2015*	2015*	2016	2017	2018	2019
		mln euro	% of GDP				
Net lending (+) or borrowings (-) (B.9) by sub-sectors							
1. General government	S.13	-236.2	-1.0	-1.0	-1.0	-1.0	-0.5
2. Central government	S.1311	-349.2	-1.4	-1.1	-1.3	-1.2	-0.6
3. State government	S.1312						
4. Local government	S.1313	78.9	0.3	0.0	-0.1	-0.1	-0.1
5. Social security funds	S.1314	34.1	0.1	0.0	0.3	0.3	0.3
General government (S.13)							
6. Total revenue	TR	8 604.1	35.3	35.1	35.3	35.5	34.5
7. Total expenditure	TE	8 840.3	36.3	36.1	36.3	36.5	35.0
8. Net lending/borrowing	B.9	-236.2	-1.0	-1.0	-1.0	-1.0	-0.5
9. Interest expenditure	D.41	353.6	1.5	1.2	1.0	1.0	1.0
10. Primary balance		117.4	0.5	0.2	0.0	0.0	0.5
11. One-off and other temporary measures							
Components of revenue							
12. Total taxes (12=12a+12b+12c)		4 965.8	20.4	21.2	21.1	21.1	20.7
12a. Taxes on production and imports	D.2	3 076.9	12.6	13.0	13.0	12.9	12.6
12b. Current taxes on income, wealth etc.	D.5	1 886.6	7.7	8.2	8.1	8.2	8.1
12c. Capital taxes	D.91	2.3	0.0	0.0	0.0	0.0	0.0
13. Social contributions	D.61	2 065.4	8.5	8.4	8.7	8.7	8.7
14. Property income	D.4	184.8	0.8	0.8	0.7	0.7	0.4
15. Other		1 388.0	5.7	4.7	4.8	5.0	4.7
16. Total revenue	TR	8 604.1	35.3	35.1	35.3	35.5	34.5
Tax burden (D.2**+D.5+D.61+D.91-D.995)		7 009.5	28.8	29.5	29.6	29.7	29.3
Components of expenditure* **							
17. Compensation of employees and intermediate consumption	D.1+P.2	3 941.9	16.2	16.2	16.2	16.1	15.6
17a. Compensation of employees	D.1	2 414.8	9.9	10.0	10.0	9.8	9.5
17b. Intermediate consumption	P.2	1 527.1	6.3	6.1	6.2	6.3	6.1
18. Social payments (18=18a+18b)		2 812.8	11.5	11.5	11.4	11.6	11.6
of which unemployment benefits		102.1	0.4	0.4	0.4	0.4	0.4
18a. Social transfers through market producers	D.6311, D.63121, D.63131	266.5	1.1	1.1	1.1	1.1	1.1
18b. Social transfers, other than transfers in kind	D.62	2 546.4	10.4	10.4	10.4	10.5	10.5
19.=9. Interest expenditure	D.41	353.6	1.5	1.2	1.0	1.0	1.0
20. Subsidies	D.3	144.5	0.6	0.6	0.6	0.6	0.5
21. Gross fixed capital formation	P.51	1 104.4	4.5	3.7	4.5	4.8	4.3
22. Capital transfers	D.9	19.0	0.1	0.0	0.0	0.0	0.0
23. Other expenditure		464.0	1.9	2.9	2.5	2.4	1.9
24.=7. Total expenditure	TE	8 840.3	36.3	36.1	36.3	36.5	35.0
Government consumption	P.3	4 469.0	18.3	18.4	18.3	18.0	17.2

*The MoF estimate

** Including share of taxes collected by the EU budget

*** It is assumed that the entire formed fiscal space in 2017 – 2019 is used for additional expenditure. As for the time being the government has not yet adopted any political decisions regarding the breakdown of this difference, 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 constant policy scenario. When calculating the share of separate expenditure categories to the total expenditure at constant 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 distributed to these expenditure categories.

Table 2b. Forecasts at Unchanged Policy

	2015	2015	2016	2017	2018	2019
	mln euro	% of GDP				
1. Total revenue at unchanged policy	8 604.1	35.3	35.1	35.3	35.5	34.5
2. Total expenditure at unchanged policy	8 840.3	36.3	36.1	36.1	35.6	33.7

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

	2015	2015	2016	2017	2018	2019
	mln euro	% of GDP				
1. Expenditure on EU programmes fully matched by EU funds revenue	1108.1	4.5	4.0	4.1	4.3	3.9
2. Cyclical unemployment benefit expenditure	-12.2	0.0	-0.1	-0.1	-0.1	-0.1
3. Effect of discretionary revenue measures	-29.4	-0.1	0.6	1.1	0.2	-0.4
4. Revenue increases mandated by law						

Table 3. General government expenditure by function

% of GDP	COFOG code	2014	2019
1. General public services	1	4.9	4.5
2. Defence	2	0.9	2.0
3. Public order and safety	3	2.0	1.8
4. Economic affairs	4	4.9	4.4
5. Environmental protection	5	0.7	0.6
6. Housing and community amenities	6	1.1	1.0
7. Health	7	3.8	3.4
8. Recreation. culture and religion	8	1.7	1.5
9. Education	9	5.9	5.3
10. Social protection	10	11.5	10.4
11. Total expenditure	TE	**37.3**	**35.0**

Table 4. General government debt developments and contributions to change in gross debt in 2015 - 2019

% of GDP	ESA code	2015	2016	2017	2018	2019
1. Gross debt		**36.4**	**40.3**	**38.3**	**37.5**	**38.2**
2. Changes in gross debt ratio		**-4.7**	**3.9**	**-1.9**	**-0.8**	**0.7**
Contributions to changes in gross debt						
3. Primary balance		**0.5**	**0.2**	**0.0**	**0.0**	**0.5**
4. Interest expenditure	EDP D.41	**1.5**	**1.2**	**1.0**	**1.0**	**1.0**
5. Stock-flow adjustments, of which		**-5.7**	**2.9**	**-3.0**	**-1.8**	**0.2**
Implicit interest rate on debt		**3.6**	**3.3**	**2.7**	**2.7**	**2.9**
Other relevant variables						
6. Liquid financial assets		5.0				
7. Net financial debt (7=1-6)		31.4				
8. Debt amortization (existing bonds) since the end of the previous year		3.2	1.0	3.6	2.7	0.5
9. Percentage of debt denominated in foreign currency		23.1	21.2	14.2	16.2	16.3
10. Average maturity		5.07 years				

Table 5. Cyclical development

% of GDP	ESA code	2015	2016	2017	2018	2019
1. Real GDP growth (%)	B1y	2.7	3.0	3.3	3.4	3.4
2. Net lending of general government	B.9	-1.0	-1.0	-1.0	-1.0	-0.5
3. Interest expenditure	D.41	1.5	1.2	1.0	1.0	1.0
4. One-off and other temporary measures						
5. Potential GDP growth (%)		2.5	2.7	2.9	3.0	3.0
contributions:						
labour		-0.2	-0.1	0.0	0.1	0.1
capital		0.9	1.0	1.1	1.3	1.4
total factors productivity		1.7	1.7	1.7	1.6	1.5
6. Output gap (% of potential GDP)		-0.7	-0.4	0.1	0.5	0.9
7. Cyclical budgetary component		-0.3	-0.1	0.0	0.2	0.3
8. Cyclically-adjusted balance (2-7)		-0.7	-0.9	-1.1	-1.2	-0.8
9. Cyclically adjusted primary balance (8+3)		0.7	0.3	0.0	-0.2	0.2
10. Structural balance (8-4)		-0.7	-0.9	-1.1	-1.2	-0.8

Table 6. Divergence from previous update

	ESA code	2015	2016	2017	2018	2019
Real GDP growth (%)	B1y					
2015		2.1	3.0	3.6	3.6	-
2016		2.7	3.0	3.3	3.4	3.4
Difference		0.6	0.0	-0.3	-0.2	-
General government net lending (% of GDP)	B.9					
2015		-1.5	-1.6	-1.3	-1.7	-
2016		-1.0	-1.0	-1.0	-1.0	-0.5
Difference		0.5	0.6	0.3	0.7	-
Total general government debt (% of GDP)						
2015		37.0	40.0	37.3	34.1	-
2016		36.4	40.3	38.3	37.5	38.2
Difference		-0.6	+0.3	+1.0	+3.4	-

Table 7. Sustainability of public finances[24]

% 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	2015
Public guarantees	**1.6**
Of which: linked to the financial sector	**0.5**

[24] 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

	2015	2016	2017	2018	2019
Short-term interest rate in eurozone (annual average)		-0.2	-0.2	0.0	0.1
Long-term interest rate in eurozone (annual average)		0.6	0.9	0.9	1.0
EUR/USD exchange rate (annual average)	1.11	1.08	1.08	1.08	1.08
Nominal effective exchange rate in the EU	-7.4	0.4	0.0	0.0	0.0
World excluding EU, GDP growth	3.2	3.6	3.8	3.8	3.8
EU GDP growth %	1.9	1.9	2.0	2.0	2.0
World export volumes, excluding EU	1.6	2.9	3.6	3.6	3.6
World import volumes, excluding EU	0.8	2.9	3.7	3.7	3.7
Oil prices (Brent, USD/barrel)	53.4	35.8	42.5	42.5	42.5

Table 9. Structural Reforms

Description of reform (1)	Methodological elements		Quantitative elements							In case of ex-ante implementation	
			Key macroeconomic simulation results (4)						Other influence / indicators (7)	Time schedule for approval and implementation of measures (8)	Process of institutional approval of measures (9)
	Description of the model assessment technique	Key macroeconomic / simulation assumptions (3)	Description (5)	Annual and cumulative impact on GDP and other key macroeconomic variables[25] (6)							
				X[26] + 5 years	X+10 years	X+15 years	X+20 years	X+25 years			
Healthcare reform	(a) Costs and benefits analysis (including economic benefit analysis and cost-efficiency analysis). (b) CSB, the Ministry of Data applied in annual breakdown.	1. The study assesses the GDP growth, triggered by the PYLL decrease (i.e., the implementation of the structural reform will create positive impact on the volume of available labour force, which in turn will leave an indirect positive impact on the national economy output.	**GDP**[27]	0.55%	2.22%	4.78 %	7.89 %	11.28 %	-	-	-
			Gross fixed capital formation	-	-	-	-	-	-		
			Employment[28]	0.24%	0.63%	1.03 %	1.43 %	1.82 %	-		
			Direct fiscal impact on primary balance (10)[29]	-0.38%	-1.15%	- 1.41 %	- 1.25 %	- 0.79 %	-		

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

		2. Analysis has been carried out in two time periods – for 2013 – 2020 and till 2040. 3. From 2014 till 2020 the specified health structural reform is being implemented, granting the funding within the NPI process. 4. Analysis for the period of time from 2020 – 2040 provides that all "saved" inhabitants during the next 20 years will be able to achieve productive return as an average Latvian employee in the respective age group. 5. Additional budget resources granted by 2020 will create positive effect also in the coming years, ensuring annual growth in the number of the employed in amount of 679 persons (i.e., it is assumed that the budget resources granted to the implementation of the structural reform from 2020 till 2040 will remain at the level of 2020 (taking into account inflation), as a result, on an annual basis, from 2020 till 2040 679 employed persons will be "saved"(comprising the	**Total impact on primary balance (11)[30]**	-0.15%	-0.20%	0.60 %	2.03 %	3.87 %	-		

[30] 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).

		number of the “saved” employed persons in 2020)). 6. The amount of additional expenditure for implementation of the structural reform is set in the model described in the study of the University of Latvia “Evaluation for the Development of the Public Health Guidelines 2014–2020”. The model has been developed, on the basis of the pessimistic scenario, providing that public expenditure for healthcare will increase, in order to preserve the amount of expenditure at the level of 3% of GDP. Besides, in the additional MoF estimates it is assumed that, in order to preserve the existing amount of the healthcare services, expenditure grows in amount of inflation. Thus, the structural reform expenditure is calculated in the form of difference between the above mentioned two scenarios. Structural reform is being implemented from 2014 till 2020. After 2020 it is assumed that additional expenditure related to the structural reform will grow in amount of inflation (GDP deflator), in order to ensure									

		that the services related to the reform remain at a constant level. 7. Economic benefit is expressed at current value of 2014, applying 5% discount rate. 8. Expenditure discount rate is determined in amount of 7%. 9. Costs and benefits analysis is based upon the analysis of the following age groups: a) 0-64 years age group, in order to evaluate the PYLL; b) 15-64 years age group, in order to evaluate the growth of employed persons, triggered by the “saved” inhabitants. 10. It is assumed that the PYLL decrease takes place gradually and in a linear way. It is also assumed that the PYLL is distributed in proportion among all age groups (i.e. the activities implemented within the scope of the structural reform have a proportionate outcome in each of the age groups). 11. Analysis provides that the PYLL level will decrease to 4, 768 years per									

		100, 000 inhabitants in 2020 (decrease by 20 %, if compared to the achieved level in 2012). 12. It is assumed that the amount of healthcare expenditure in 0 – 64 age group comprises 71% of the total expenditure of the sector. 13. When assessing the indirect impact on budget, the budgetary balance flexibility values have been applied - 0.43 (for 5 years) and 0.41 (for 10 years). 14. After 2020, the growth of annual output per employed person, ensured by the persons "saved" thanks to the activities implemented by the structural reform, will increase by 1.1% (the average forecasted level in 2018 – 2020). 15. Budgetary savings achieved due to the structural reform are generated by the benefits related to the health condition of people (i.e. sickness benefits, disability benefits, compensation for loss of working capacity and survivor's benefit, etc.). 16. It is assumed that expenditure for benefits annually increases above the									

		average forecasted level in 2018 – 2020. 17. It is assumed that due to a positive effect of the structural reform the expenditure for benefits will gradually decrease by even 20% in 2020. In turn from 2020 till 2040 the savings from expenditure for benefits will remain in amount of 20% of the annual forecasted amount of benefits. 18. The discount factor in amount of 5% was applied to the direct savings from the sums to be disbursed in benefits. 19. The government has approved the implementation of the structural reform from 2014. Stability Programme Chapter "Fiscally Significant Structural Reforms in the Meaning of Regulation No 1146/97" provides information regarding additional budget funds granted up to now. From a cumulative perspective, the funding granted additionally to the sector is consistent with the respective growth of funding determined in the study "Evaluation for the Development of the Public Health Guidelines 2014–2020".									