LATVIJAS REPUBLIKAS FISKĀLĀS DISCIPLĪNAS PADOME

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Fiscal Discipline Council
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FISCAL DISCIPLINE MONITORING REPORT 2015

Rīga, 2015

Contents

Executive summary

The Council agrees with the assumptions employed when calculating the general government structural balance. The balance rule provides the lowest value of the expenditure ceilings for 2016, 2017 and 2018. Thus the balance rule establishes the expenditure ceiling for the MTBF 2016/18.

Despite political commitment to maintaining fiscal discipline, the Government's ability to adhere to fiscal objectives has deteriorated since 2013. The forecasted results of the general government structural budget balance for 2014 and 2015 are below the objectives. According to Article 11 of the FDL, if the accumulated deviation from the objective is above -0.5% of GDP, the correction mechanism is triggered, requiring a substantial increase in the budget balance to compensate for higher deficits in prior years.

The Council supports the Cabinet's initiatives for policy changes to increase budget revenues in 2016, but these only provide for a tax-to-GDP ratio of slightly above 28%. The Council believes that reducing the shadow economy is crucial for improving tax revenue and the tax-to-GDP ratio. The Council believes that Latvia is not fully utilising the revenue potential of VAT, property taxes and environmentally related taxes. The Council has previously commented on the Government's failure to shift the tax burden from labour taxation to the taxation of consumption and capital gains. However, income from dividends and other capital income is still taxed at much lower rates than income from labour.

The Council commends measures that seek to reduce income inequality, such as the so called solidarity tax, increasing the non-taxable minimum, as well as the plans to introduce a differentiated non-taxable minimum in 2017.

The Council points at the increased risks that will significantly encumber the attainment of fiscal objectives, in view of the decision to postpone establishing the FSR until 2017. When preparing the FRD, fiscal risks should be investigated in-depth, and their fiscal impact should be evaluated in order to improve risk management and reduce the necessary FSR. The Government has the responsibility to carry out a comprehensive assessment of fiscal risks, based on which the FRD is prepared. However, a number of fiscal risks have yet to be quantified, and their fiscal impact has not been determined. The Council is concerned that welfare sector expenditures have been underestimated in the past few years and exceeded the approved amounts at the budget. Specific strategies and measures for the prevention of fiscal risks should be carefully developed and implemented to reduce adverse impacts on the general government fiscal balance.

The Council does not object to the MoF's macroeconomic forecasts in the MTBF 2016/18 as the basis for drafting state budget for 2016. However, recent inflation indicators of the prices of goods and services suggest a realistic risk of lower nominal GDP and tax revenue levels than the MTBF currently projects. The Council encourages the Government to develop backup measures for the case of GDP and inflation growing at a slower pace than estimated. Key risks are related to less favourable developments globally, leading to weaker external demand.

Considering that there has been insufficient progress in the implementation of structural reforms, the Council does not see reasons for potential GDP growth to exceed 3-3.5% in the medium term. Key risks for potential growth are (1) the decreasing labour force due to negative demographic trends, (2) lagging investment sector and (3) skill mismatch in the labour market. Moreover, with the current structure of the economy, Latvia's convergence prospects to the EU average level remain limited.

The Council finds the Latvian economy growing broadly in line with its potential, while wage increases exceeding productivity growth could undermine the growth potential in the future.

ABBREVIATIONS

BoL	Bank of Latvia
Council	Fiscal Discipline Council
EC	European Commission
ESA	European system of accounts
EU	European Union
FDL	Fiscal discipline law
FRD	Fiscal risks declaration
FSR	Fiscal security reserve
IMF	International Monetary Fund
Monitoring report	Fiscal Discipline Monitoring Report 2015
MoF	Ministry of Finance
MTBF	Medium term budget framework
MTBFL 2016/18	Medium term budget framework law for 2016-2018
GDP	Gross domestic product
-	Not applicable / not available
NPI	New policy initiatives
OECD	Organization for Economic Cooperation and Development
PIT	Personal income tax
SB	State budget
SBL	State budget law
SBL 2016	State budget law for 2016
SGP	Stability and growth pact
SP	Latvia's Stability Programme
SP 2015/18	Latvia's Stability Programme for 2015-2018
SRS	State revenue service
VAT	Value added tax

MANDATE OF THE COUNCIL

According to the FDL (FDL Chapter III Monitoring of fiscal discipline) the Council is an independent collegial institution which has been established to monitor compliance with the FDL. The Council's core competence is related to the assessment of fiscal discipline, and assess fiscal policy and issues related to macroeconomic developments.

Specifically the Council is responsible for:

- monitoring compliance with FDL provisions in the SBL and the MTBFL during their preparation, execution, and amendment;

- verifying whether the fiscal balance and the expenditure growth provisions have been properly applied, including an independent assessment of the potential GDP and nominal GDP, and the calculation of the structural balance;

- supervising the observance of FDL provisions in the implementation of the annual State budget law, conformity of total fiscal indicators of the consolidated budget of local governments and budgets of derived public persons with the forecasted values.

- preparing opinions regarding major permitted departures from the balance condition during a severe economic downturn;

- preparing an opinion on whether the FSR is set at an appropriate level to counter extant fiscal risks

- preparing a monitoring report on fiscal discipline and, if necessary, an irregularity report;

- preparing and submitting to the Saeima and the Government opinions regarding issues of fiscal policy and macroeconomic development if they pertain to compliance with the terms set out in the FDL.

- assessing and analysing the sustainability of fiscal policy for the purposes of preparing the reports stipulated by the FDL.

1. FISCAL POLICY CHALLENGES

The Council is in agreement with the Government regarding the assumptions employed when calculating the general government structural balance (see more in the *Assessment of compliance with numerical fiscal rules* section of this report). The Government has been preparing the draft SB 2016 and the MTBF 2016/18 with the general government structural deficit target of 1% of GDP in 2016 and 2017, while the structural deficit should be reduced to 0.8% of GDP in 2018.

The Government has been facing serious challenges while preparing the SB and the MTBF. The deterioration of macroeconomic conditions has imposed a necessity for fiscal consolidation compared to the baseline scenario in the amount of 96.8 million euro (0.4% of GDP); subsequently a decision was made to postpone establishing the FSR by one year, reducing the total consolidation effort to 0.3%. Moreover, Government priorities, including accelerated defence spending to reach 2% of GDP by 2018, funding for public security, education, and health care imposed additional expenditures whose fiscal impact exceeds the consolidation requirement.

Year	Objective	Actual (forecast)	Deviation (forecast)	Deviation accumulated since 2013
2013	-1.3	-1.0	+0.3	+0.3
2014	-1.0	(-1.3)	-0.3	0
2015	-1.0	(-1.4)	-0.4	-0.4
2016	-1.0	-	-	-

Table 1.1 Performance of the general government structural budget balance against the set objectives starting from 2013, % of GDP.

Despite political commitment to maintaining fiscal discipline, the Government's ability to adhere to fiscal targets has deteriorated since 2013. While in 2013 the actual general government structural budget balance exceeded the objective by +0.3 percentage points, the forecasted results for 2014 and 2015 are below the objectives (Table 1.1).[1]

According to Article 11 of the FDL, the accumulated deviation from the objective might trigger the correction mechanism requiring a substantial increase in the budget balance to compensate for higher deficits in prior years. Based on the estimate that the general government structural balance for 2015 will deviate from the objective by -0.4% of GDP[2], the accumulated deviation since 2013 is estimated to reach -0.4% of GDP. This is close to the situation where the correction mechanism is triggered, requiring an increase in the government budget balance by 0.5% in the third year after the significant deviation has been identified.

The draft SB and MTBF do not demonstrate significant improvements in the tax revenue to GDP ratio (hereafter – tax-to-GDP ratio)**.** With the policy changes set forth in the draft SB 2016 and the MTBF 2016/18, the ratio in the horizon period is expected to slightly exceed 28% – **still below the Government objective of 1/3 of GDP, established in the Declaration of Laimdota Straujuma's Cabinet.** The Government will fail to deliver its services and ensure continuous improvement in the provision of public goods without increasing government revenue collection to its objective – 1/3 of GDP, which would still be below the 38% EU average. Meanwhile, the Council welcomes the Government's plan to engage social partners in a discussion on a tax policy and administration strategy that is due to start in the first half of 2016 and finish in July 2017.

The Council believes that addressing tax avoidance and non-compliance is crucial for improving tax revenue and the tax-to-GDP ratio. Estimates of the shadow economy vary and should be treated

[1] In 2014, the structural general government balance (after excluding from the headline balance a one-off capital transfer to the European Bank of Reconstruction and Development in the amount of 88.2 million euro) reached -1.3% of GDP. In 2015 the deviation from the structural balance target set in the SBL 2015, approved in December 2014, has been estimated by including higher than anticipated ESA corrections (in the amount of 55.5 million euro), lower than expected tax revenues (in the amount of 55.1 million euro) and revised special budget expenditure projections (an additional 60 million euro).

[2] According to information provided by MoF on 25.09.2015.

with caution, but they do suggest that the informal sector in Latvia accounts for about 23%-24% of GDP, as compared to the EU average, which, according to F. Schneider[3], is 18% (Chart 1.1).

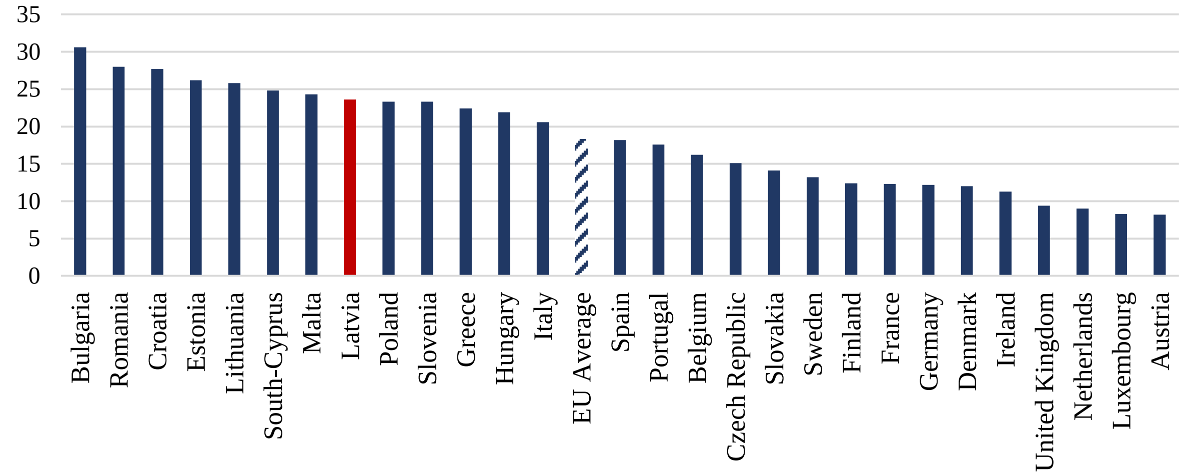

Chart 1.1 Size of the shadow economy of EU member states in 2015, % of GDP[4].

Year	Annual effect (million euro)	Accumulated effect (million euro)	% of GDP
2016	73	73	0.28%
2017	78	151	0.56%
2018	83	234	0.84%
2019	87	321	1.12%
2020	92	413	1.40%

Table 1.2 Fiscal impact from reducing the shadow economy to average EU levels by 2020 (Council's estimate based on MoF macroeconomic projections).

The Council encourages bold and clearly articulated plans for improving tax collection and reducing the shadow economy by 5% by 2020, as per the plans announced by the MoF. It is commendable that the plans recognise the importance of improvements to tax morale and increased trust in public institutions. Targeted attempts by the SRS to focus on areas where informality is prevalent also indicate that the government is making a coordinated effort to improve the efficiency of the tax system. However, specific measures for 2016 account for only a 21.7 million euro increase in revenue. **This implies that reducing the shadow economy will not be sufficient to reach the target tax-to-GDP ratio (33% of GDP)**, and other measures are required. An annual reduction of the shadow economy by 1% of GDP until 2020 will produce a cumulative effect of a 1.4% increase in the tax-to GDP ratio by 2020 (Table 1.2).

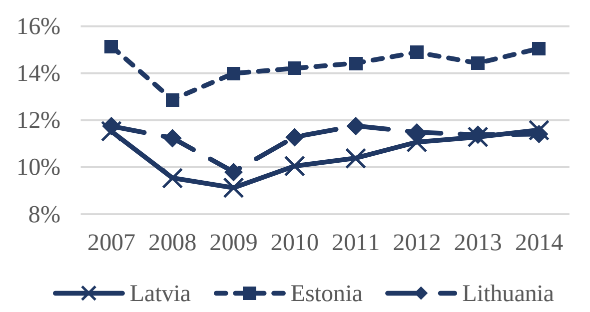

Chart 1.2 Effective VAT rates in the Baltic States. Council's calculations based on Eurostat data.

The Council believes that Latvia is not fully utilising the revenue potential of VAT, property taxes and environmentally related taxes.

A comparison of the effective VAT rates among the three Baltic States indicates that Latvia is not fully utilising its VAT revenue potential. In

[3] Schneider F. Size and Development of the Shadow Economy of 31 European and 5 other OECD Countries from 2003 to 2015: Different Developments. Available: http://www.econ.jku.at/members/Schneider/files/publications/2015/ShadEcEurope31.pdf, accessed on 24.08.2015

[4] Schneider F. Size and Development of the Shadow Economy of 31 European and 5 other OECD Countries from 2003 to 2015: Different Developments. Available: http://www.econ.jku.at/members/Schneider/files/publications/2015/ShadEcEurope31.pdf, accessed on 24.08.2015

2014, the effective VAT rate in Estonia was 15.05%, while it only reached 11.58% in Latvia (Chart 1.2). Moreover, the EC mentions Latvia as one of the states where the gap between the nominal VAT rate and the effective VAT rate is not only due to the extensive list of exemptions and reduced rates, but also pervasive non-compliance[5].

According to the EC, in 2012 revenues from property taxes in Latvia amounted to 0.9% of GDP, which is well below the EU average of 2.3% of GDP. A number of measures to increase revenue from immovable property have been introduced, such as reassessing cadastral values and introducing fines for non-use of agricultural land. Meanwhile, extensive issuance of tax exemptions and allowances from property taxation reduce revenues. There is still potential to increase revenue from the taxation of housing, which could be implemented in a socially responsible and growth friendly manner. Likewise, the rates of several environmentally related taxes are considerably below those of other EU Member States, and rate increases to some of them could be considered (Chart 1.3).

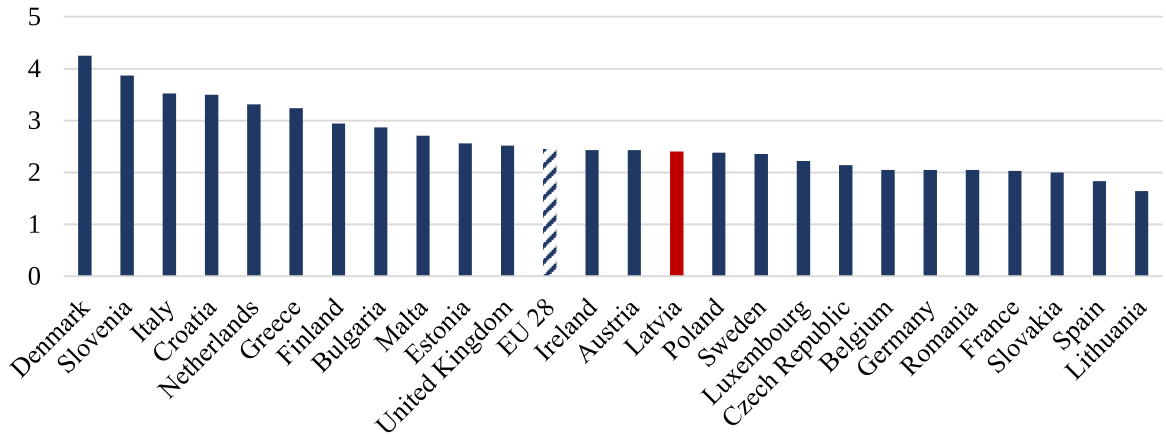

Chart 1.3 Total revenue from environmental taxes in 2013, % of GDP[6].

The Council supports the Cabinet's initiatives for policy changes to increase budget revenues, but these continue supporting the tax-to-GDP ratio at the historical low levels close to 28%. Excluding dividends from state owned enterprises and measures to combat informality, the proposed measures will increase budget revenues by 184.1 million euro in 2016. A number of tax rates have been raised, and the proposed PIT rate reduction has been abandoned. The Council has commented earlier[7] on the Government's failure to shift the tax burden from labour taxation to the taxation of consumption and capital gains. However, income from dividends and other capital income is still taxed at much lower rates than income from labour.

The Council commends measures that seek to reduce income inequality, particularly through addressing the regressiveness of income taxation by introducing the so called solidarity tax, increasing the non-taxable minimum, as well as the plan to introduce a differentiated non-taxable minimum from 2017. International publications have also identified inequality as a pressing issue for Latvia. Of special concern is the high tax burden for low income earners and Latvia's high Gini coefficient – the highest among EU member states, and income inequality has been growing since 2011. This should decrease the currently high tax wedge for low-income earners in Latvia (Chart 1.4).

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[5] Tax Reforms in EU Member States 2014. European economy series. June 2014. Available: http://ec.europa.eu/economy_finance/publications/european_economy/2014/pdf/ee6_en.pdf, accessed on 11.09.2015

[6] Source: Eurostat.

[7] Fiscal discipline monitoring interim report (opinion) on the Latvia Stability programme 2015-2018. Available: http://fiscalcouncil.lv/files/uploaded/FDP_1_01_322_20150508_Starpzinojums_un_Piel1_EN.pdf, accessed on 23.09.2015.

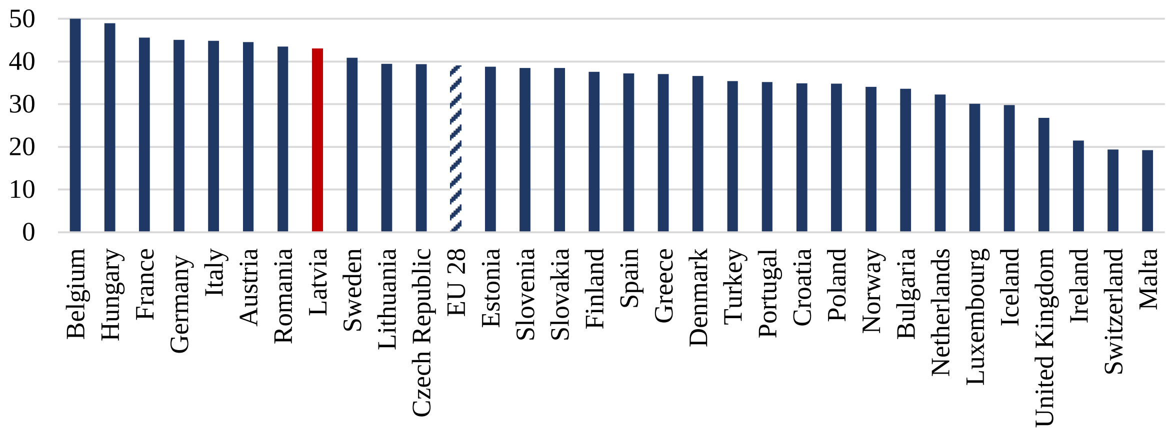

Chart 1.4 Tax wedge on labour costs for low income earners in 2013, %[8].

Simultaneously, the Council is concerned about the growth rate of minimum wage, which significantly outpaces the productivity growth rate.

The Government has named defence, education, health and internal security as priorities for 2016 and listed a number of policy changes that required a budget increase. These activities have earmarked additional funding from the sources of additional revenue and spending cuts – a combination of 3% across the board reductions in non-salary expenditures for ministries, postponement of several activities, tax increases and measures for reducing the shadow economy.

Future increases in funding for education and health sectors should be linked to structural reforms with a positive long term effect on the state budget and quality of life in Latvia. Latvia does not compare well with other EU countries in terms of public health outcomes. The poor population health status will likely have a significant impact on the economic growth of the country and will need to be addressed (more comprehensive overview in Annex 3).

Structural reforms in education should focus on the cost of delivering education services, improving the professional relevance of educational qualifications and addressing skill mismatch in the labour market. Additional funding for STEM disciplines is in line with government objectives, though appropriate measures should be developed in order to stimulate student interest in these areas (more comprehensive overview in Annex 2).

Recommendations

1. The Council recommends a cautious fiscal policy for the remainder of 2015, bearing in mind the likelihood of having to correct the fiscal balance for 0.5% of GDP in case of significant deviations.
2. Reaching a tax-to GDP ratio of 1/3 should be the key objective while developing a tax policy and administration strategy, focusing on the reduction of the shadow economy, improving the efficiency of tax collection, as well as reviewing tax rates and eliminating exemptions.
3. Consider the reduction of income inequality when designing future tax policy; in particular, look at increasing the tax burden on dividends and other capital income not used for reinvestment.
4. Increase budget revenues in a growth friendly manner by fully utilising the potential of property taxes and environmentally related taxes.
5. Consider eliminating skill mismatch by increasing the professional relevance of the skills and qualifications provided by educational establishments to improve the long term productivity of the Latvian labour force.
6. Consider addressing overall health system efficiency and sustainability by optimising the distribution of funding with the objective of improving population health status indicators and decreasing amenable mortality rates.

[8] Source: Eurostat.

ASSESSMENT OF THE DECLARATION OF FISCAL RISKS

The Government has the responsibility to carry out a comprehensive assessment of fiscal risks and prepare a report in the form of the FRD, which is attached to the draft MTBFL upon submission to the Saeima. Based on this report, the FSR should be calculated and included in the budget to counter the fiscal impact of any of the included risks, should they materialise and cause fiscal aggregates to substantially deviate from those included and approved as part of the MTBF.

The Council has assessed the FRD, as approved by the Cabinet of Ministers on 25 August.

The FDL stipulates that fiscal risks should be quantified if possible, and a FSR should be established to counter sudden shocks to the general government fiscal balance and to improve it if expenditure levels are higher than expected or revenues fall short of the target. FDL states that the reserve for 2016 should be established in the amount of 0.1% of GDP and no less than 0.1% of GDP for subsequent years. The Cabinet's decision against establishing the FSR for 2016 is contrary to Part 3 of the Transitional Provisions of the FDL.

The Council notes the decision of the Cabinet of Ministers to defer establishing the FSR until 2017 in the budget framework and points at elevated risks that will make it difficult to achieve the established fiscal objectives. The Council believes that not establishing the FSR sets an unfortunate precedent. Different risks may cause a deterioration of the government budget balance compared to the established objective, and the FSR provides a cushion for countering such unforeseen circumstances and reduces the accumulation of deficits in excess of the established objective. Government assistance to the banking sector and loan guarantees have been significant factors with adverse impacts on the government fiscal balance in the past, in addition to unexpected macroeconomic developments or omissions in fiscal estimates.

A limited number of risks has been quantified in the FRD.
For 2016 these include:

- the potential fiscal impact of state loan guarantees being called upon – 3 144 million euro;
- the potential fiscal impact of government loans not being repaid – 1 018 million euro.

A number of risks in the FRD have been classified as symmetrical, which means that the possibility of additional revenue or greater expenditure is believed to be equal. Furthermore, it is argued that these risks do not require a specific allocation in the FSR. Among these risks are:

- risks in the welfare sector;
- risks pertaining to EU funding and other foreign financial instruments.

The fiscal impact of other risks has not been determined in the FRD, because the probability that they will materialise is negligible. These include:

- repayment of state student loans and guarantees;
- capital on demand.

Finally, a number of fiscal risks have not been quantified in the FRD, and their fiscal impact has not been determined. These include:

- direct and indirect exposure resulting from public-private partnerships;
- risks associated with state joint-stock companies;
- risks associated with expenditure arising from rulings by international courts or the Constitutional Court (Satversmes tiesa).

The Council has assessed the fiscal risks under the assumption that the FSR has not been established in the MTBF for 2016, while it is critical that the FSR is formed for 2017 and 2018. Furthermore, the Council wishes to draw attention to a number of aspects of the FRD.

First, **the Council points at various fiscal risks that have not yet been fully assessed or quantified, while welcoming the increase in the number of public institutions engaged in risk assessment.** Agencies should be encouraged to adopt mitigation plans for the risks that may materialise into adverse fiscal impact depending on the rating of the risks.

Second, currently the FRD contains a very general description of the methodology employed to assess the probability of various risks. In the future the FRD should include a more detailed and explicit account of risk assessment procedures – particularly as they pertain to the assignment of specific probabilities, and the assumptions underpinning these judgements. Better assessment of fiscal risks and the quantification of their impact would lead to better strategies for countering the risks.

Third, **the Council has concerns that risks in the welfare sector have been underestimated in the last few years**. Estimates of pension and social insurance benefit costs tend to exceed the amounts approved in the SBL and MTBFL, while the adjustments to the budget during the year reflect updated estimates of the number of beneficiaries and the average amount of pensions and benefits. Due to the significant risks that the Special Budget poses for achieving fiscal objectives, the Council examined the associated fiscal risks in the 2014 Monitoring Report and expressed its concern regarding the assessment of fiscal risks in the welfare sector. The Council's research shows that expenditures have regularly exceeded annual budget allocations, on average by about 2% for the past 7 years (Table 1.3).

The Ministry of Welfare has revised up its budget estimates for 2015-2018 by an average of 50 million euro per year. Although the Council welcomes the upward revision of the expenditure estimates, the Council suggests following the trends closely and ensuring that the estimates are based on realistic assumptions. Further decisions on increases in social assistance should not be based on the positive balance in the special budget as a source of the necessary funds.

	2008	2009	2010	2011	2012	2013	2014
Employment social benefits	123%	190%	68%	50%	85%	111%	120%
Disability, maternity and illness social benefits	119%	94%	98%	90%	93%	105%	106%
Work accident social benefits	116%	110%	117%	122%	102%	105%	108%
State pensions	103%	89%	121%	101%	102%	103%	101%
Average (weighted)	**107.30%**	**94.78%**	**111.08%**	**96.05%**	**99.99%**	**103.30%**	**102.32%**

Average 2008 - 2014	**102.12%**
Average 2012 - 2014	**101.87%**

Table 1.3 Special budget expenditures, % of budget estimates set in annual budget laws.

Furthermore, **the Council perceives the claim that these risks are symmetrical as problematic** in view of the fact that in the last two years forecasts were lower than actual expenditures. Consequently, the assumption of equal probability for additional revenue or greater expenditure is not convincing without additional information or qualification.

Finally, **specific strategies and measures for the prevention of fiscal risks should be carefully developed and implemented to reduce adverse impacts on the general government fiscal balance**. The Council would encourage the Government to develop and implement such measures in order to reduce the FSR in the future.

The Council recommends that the FSR for 2017 and 2018 is established at least at the level of 0.1% of GDP, as per FDL. The level of FSR could be adjusted upwards, if the risk assessment requires so.

Recommendations

1. Accept the FRD approved by the Government, while reiterating the need for the FSR and stressing the need to survey all possible sources of fiscal risk.
2. Include risks arising from the financial sector in the FRD since these have been significant in the past. Risks related to possible capital calls from the European Stability Mechanism and their future impact should also be carefully assessed.

3. Improve the quality of risk assessment by collecting information pertaining to all fiscal risks and, if possible, quantify them in order to have a reliable estimate of their potential fiscal impact.
4. Provide a more detailed description of how probabilities are assigned to particular risks to facilitate the review process for independent institutions.
5. Ensure collection and exchange of information to improve risk management and develop procedures to prevent sudden impacts on the fiscal balance.

2. Macroeconomic outlook and output gap

Latvia's economy in 2015 has been lagging behind the projected growth (MoF revised down its real GDP growth forecast for 2015 from 2.8% in the MTBF 2015/17 to 2.1% in the MTBF 2016/18). Inflation has turned out to be substantially lower than expected as well (the forecast by MoF has dropped from 2.1% MTBF 2015/17 to 0.8% currently). This has contributed to a deterioration of the general government budget balance: MoF forecasts the deficit for 2015 to be larger than the target set forth in the 2015 BL (explanation about consequences of exceeded budget deficit in Annex 4).

	2015	2016	2017	2018
Real GDP growth				
MoF	**2.1**	**3.0**	**3.6**	**3.6**
BoL	2.3	2.7	-	-
EC	2.3	3.2	-	-
IMF	2.3	3.4	3.7	3.9
Nominal GDP growth				
MoF	**3.2**	**5.2**	**6.2**	**6.2**
BoL	-	-	-	-
EC	4.6	6.3	-	-
IMF	4.2	5.0	6.0	6.2
Inflation				
MoF	**0.8**	**2.0**	**2.5**	**2.5**
BoL	0.4	1.3	-	-
EC	0.7	2.2	-	-
IMF	0.5	1.7	2.3	2.2
Output gap				
MoF	**-0.2**	**-0.4**	**-0.1**	**0.0**
BoL	-	-	-	-
EC	1.4	1.6	-	-
IMF	-	-	-	-

Table 2.1 Key macroeconomic indicator forecasts by various institutions, % y-o-y.

The Council does not object the Ministry of Finance's (MoF) macroeconomic projections (Table 2.1) stated in the MTBF 2016/18 as the basis for drafting the SB for 2016 and MTDFL 2016/18. However, **the Council considers that, in view of recent developments in the global economy, there is a realistic risk of lower nominal GDP levels for the horizon period (2016-2018) than MoF currently projects, which would lead to lower than estimated tax revenues**.

The key risk for macroeconomic development of Latvia for the MTBF horizon period is related to unfavourable global economic development. The Council acknowledges that Latvia will experience developments in the global economy (Greece's possible insolvency and slow-down in China and Brazil) through a decrease in global demand, and thus a decrease in demand in Latvian export markets. Geopolitical risks and exports issues related to Russia are still the most topical. However, seeing that Latvia's exports have started to stabilise successfully in other exports markets, decreased dependency on Russia as one of the major export markets could be beneficial, as the new trade partners are potentially more reliable. The Council encourages MoF to develop a more profound sensitivity analysis of the macroeconomic scenario in order to evaluate the effects of possible unfavourable developments affecting Latvia's economic performance.

The Council points out a number of **impediments for Latvia's potential GDP growth**:

- First, the demographic situation, where problems are both the negative natural population growth rate and the negative migration balance (according to Eurostat projections, Latvia's population will reach 1.6 million by 2030 and 1.3 million by 2080, assuming no policy changes) leads to a decreasing labour force in the economy;
- Second, the inactive investment sector, and inordinately low research and development expenditures are obstacles to potential GDP growth (according to Eurostat data, in 2013 research and development expenditure in Latvia constituted 0.6% of GDP, while the EU average was 2.0% of GDP);
- Third, persisting issues regarding the mismatch of skills and abilities of the economically active population with the requirements of the labour market[9] restrict total factor productivity growth, and thus the potential GDP growth (detailed overview of the issue in Annex 3). This makes GDP growth rate forecasts above 3-3.5% in the medium and long run doubtful;

[9] Krasnopjorovs, O. Natural and cyclical unemployment in Latvia: New insights from the Beveridge curve model. Available: https://www.macroeconomics.lv/sites/default/files/dm_2_krasnopjorovs_2015_en.pdf, accessed on 24.09.2015. Discussion on occupational mismatch and skills mismatch issue in Latvia.

- Fourth, with the current structure of the economy, Latvia's convergence prospects to EU average levels remain limited[10].

The Council is sceptical about inflation reaching the levels that MoF forecasted for 2015 and 2016. Oil price dynamic is the key reason for concern: the average 2015 level will probably fall behind MoF's forecasted 59.4 US dollars per barrel[11].

The Council considers that a further minimum wage increase is likely to endanger the inclusion of the unemployed into the formal labour force, particularly outside Riga. An analysis of the economic impact of past minimum wage increases has neither been published nor publicly discussed by the government.

Output gap

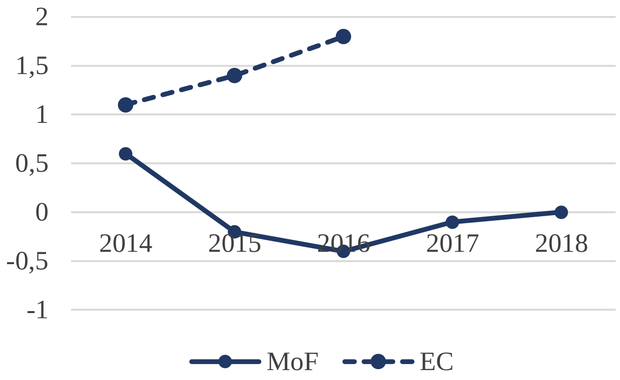

Chart 2.1 Output gap of Latvia evaluation by MoF and EC, % of GDP.

Opinions on the output gap of Latvia's economy vary among different institutions (Chart 2.1). While MoF believes that Latvia's economy is about balanced, with a slightly negative output gap falling somewhere between -0.5% and 0% of GDP for the horizon period, EC considers it to be positive - around 1.5%. The Council is not in agreement with EC's opinion that Latvia's economy is currently in an overheating stage – this is unlikely, given the relatively low real growth rate and low inflation. Similarly, as in the Council's Interim report published in May 2015, **the Council considers that the economy of Latvia is growing in line with its potential, with no significant deviations of the output gap from zero**.

Recommendations

1. While the Council generally approves the MoF's macroeconomic forecast as a basis for drafting the state budget for 2016 and setting the budget framework for 2017/18, it strongly encourages the MoF
   a) to provide a more profound sensitivity analysis of the macroeconomic scenario;
   b) to develop, based on the sensitivity analysis, a back-up plan for the realistic case of budget revenues falling short of the estimates.
2. Regarding medium and long term development, structural reforms in order to boost potential GDP growth should be implemented, addressing the issues of a decreasing labour force, a rigid investment sector and the mismatch of the economically active population's skills and abilities with the labour market's requirements.

[10] Bank of Latvia also points out at the same issue (Expert's conversations "Has economy of Latvia reached it's ceiling?", presentations available: https://www.makroekonomika.lv/ekspertu-sarunu-video-vai-latvijas-tautsaimnieciba-ir-sasniegusi-griestus)

[11] US Energy Information Administration forecasts Brent crude oil average prices to be 54.07 US dollars per barrel for 2015 and 58.57 US dollars per barrel for 2016, in contrast to MoF's forecasted levels of 59.5 and 66.0 respectively. Available: http://www.eia.gov/forecasts/steo/, accessed on 14.09.2015.

3. ASSESSMENT OF COMPLIANCE WITH NUMERICAL FISCAL RULES

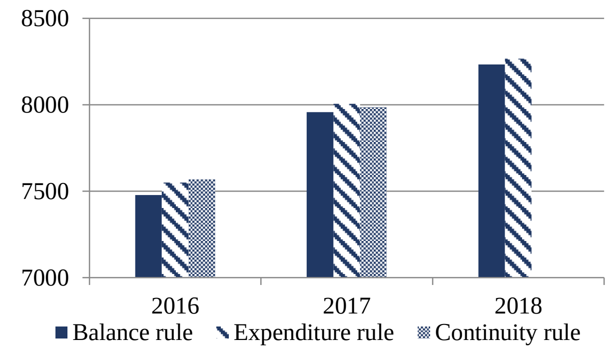

Chart 3.1 Adjusted maximally permissible state budget expenditure, million euro.

	2015	2016	2017	2018
(1) Fiscal space positive (+) / consolidation (-) (1) = (2)-(3)				
MTBFL 2015/17	1.0	39.3	288.2	
SP 2015/18		-51.3	152.9	259.6
MTBFL 2016/18		***0.0***	***54.4***	***287.4***
(2) Adjusted state budget expenditure ceiling *(top-down)*				
MTBFL 2015/17	7472.4	7636.9	7944.0	
SP 2015/18		7517.4	7920.4	8212.9
MTBFL 2016/18		***7654.5***	***8209.4***	***8711.9***
(3) State budget expenditure commitments *(bottom-up)*				
MTBFL 2015/17	7471.3	7597.6	7655.8	
SP 2015/18		7568.7	7767.5	7953.3
MTBFL 2016/18		***7654.5***	***8155.0***	***8424.5***

Table 3.1 Fiscal space, million euro. (MTBFL 2016/18: draft figures) (detailed data in Annex 6, Table P6.5).

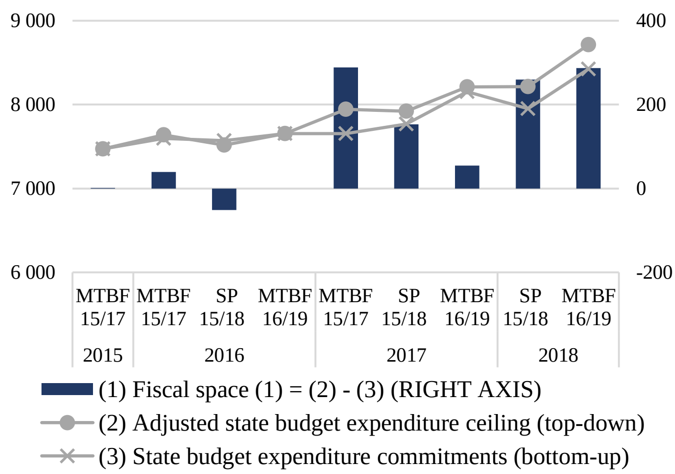

Chart 3.2 Fiscal space, million euro.

The Council has the responsibility to verify the application of the numerical fiscal rules stipulated by the FDL in the preparation of the SB and the MTBF. The Council has verified the calculations provided by the MoF and agrees with the manner of the calculation and the assumptions employed[12]. Out of the three exercised fiscal rules – balance rule, expenditure rule and continuity rule – **the balance rule provides the lowest value of the expenditure ceilings for 2016, 2017 and 2018. Thus the balance rule establishes the expenditure ceiling for the MTBF 2016/18** (Chart 3.1). Detailed calculations are provided in Annex 5 and data tables in Annex 6.

The Government has reviewed the SB 2016 and accepted the updated costing of ongoing activities presented in the MTBFL 2015/17. Despite growing budget resources and rising expenditure ceilings in 2016 compared to 2015, updated macroeconomic data and fiscal estimates have led to expenditure commitments exceeding expenditure ceilings. This has imposed a consolidation requirement for the draft SB 2016 in the amount of 96.8 million euro or 0.4% of GDP. In the first draft of the MTBF 2016/18 consolidation amount (96.8 million euro for 2016) included allocation for the FSR in the amount of 0.1% of GDP for 2016. The plan to allocate resources for the FSR was abandoned during the SB and MTBF approval process at the Cabinet of Ministers.

Upon receiving the revised data on the MTBF 2016/2018 (Table 3.1 and Chart 3.2), the Council noted that, regardless of new revenue measures, fiscal space for the first year of the MTBF is exhausted.

The Council considers that the FSR

[12] The calculation of numerical fiscal rules in this report has been based on inputs provided by the MoF on 3 August 2015 and are subject to change as the draft SBL 2016 and the MTBFL 2016/18 are being prepared and reviewed. At that time FSR has been taken into account also for SB 2016.

allocation should be taken into account while establishing expenditure ceilings. The Government's decision to postpone allocating funds for the FSR and exhausting fiscal space for 2016 increases the risk of not achieving the budget balance objective. Discussion on the assessment of fiscal risks and the calculation of the required FSR has been provided in the *Fiscal Policy Challenges* section of this report.

	2015	2016	2017	2018
General government budget deficit (-) / surplus (+)				
MTBFL 2015/17	-1.0	-0.9	-0.7	
SP 2015/18	-1.5	-1.6	-1.3	-1.7
MTBFL 2016/18	*-1.4*[13]	*-1.0*	*-1.0*	*-0.8*
Basic budget deficit (-) / surplus (+)				
MTBFL 2015/17[14]	-1.5	-1.6	-1.3	
SP 2015/18	-1.6	-2.0	-1.7	-0.2
MTBFL 2016/18[15]	*-1.6*	*-1.3*	*-0.7*	*1.1*
General government debt				
MTBFL 2015/17	35	37	34	
SP 2015/18	37	40	37.3	34.1
MTBFL 2016/18	Data not available			

Table 3.2 General government and basic budget headline balance and general government debt as % of GDP (MTBFL 2016/18: draft figures).

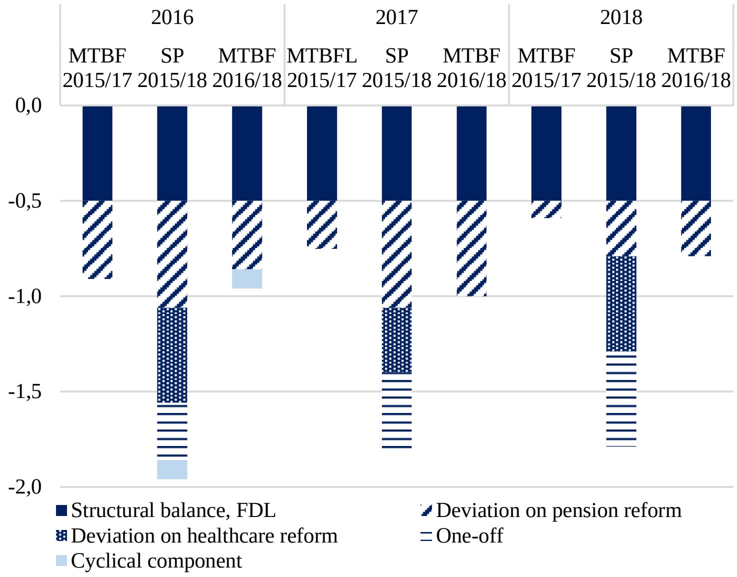

Chart 3.3 The general government budget headline balance by component according to the methodology of the FDL, % of GDP.

Article 11 of the FDL stipulates a correction mechanism requiring a 0.5% increase to the target general government structural budget balance, if the cumulative deviation from the established target has exceeded 0.5%. The Council is concerned that there is a serious risk of not achieving the structural balance objective for 2015. In autumn 2015 the structural budget deficit is forecasted to exceed the objective set forth in MTBFL 2015/17 by -0.4% of GDP (Table 3.2), but the final 2015 general government structural budget balance figure will only be established by December 2016. The Council reiterates that **deviations in the general government budget exceeding 0.5% of GDP may trigger the correction mechanism stipulated by Article 11 of the FDL**. This is to prevent continued accumulation of general government debt, which continues to grow unfortunately during the period of economic growth.

The Council commends the Government for not increasing the budget deficit target for the MTBF 2016/18 draft, as was planned in the SP 2015/18.

The improvement to the headline balance from SP 2015/18 to MTBFL 2016/18 draft is mainly due to two reasons envisaging a substantial deficit decrease (Chart 3.3) – (1) abandoning the allocation for reforms in health care[16] and (2) no longer treating the accelerated defence spending as a one-off budgetary measure and including it into the updated baseline instead.

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[13] According to information provided by MoF on 25.09.2015.
[14] Cash-flow
[15] Cash-flow
[16] Council recommendation on the 2015 National Reform Programme of Latvia and delivering a Council opinion on the 2015 Stability Programme of Latvia. European Commission recommendation. Available:

Recommendations

1. The Council recommends to treat the allocation for the FSR as an activity related to the determination of the numerical fiscal targets and to determine the expenditure ceilings starting from 2017 including the allocation for FSR.
2. The MoF should develop a procedure for ex post of the structural balance and correction mechanism, preferably in consultation with the Council.

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http://ec.europa.eu/europe2020/pdf/csr2015/csr2015_latvia_en.pdf, accessed on 08.09.2015. The EC abandoned the health care reform because of the exceeded threshold deficit level.