



LATVIJAS REPUBLIKAS FISKĀLĀS DISCIPLĪNAS PADOME

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RĪGĀ

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**The Chairperson of the Saeima
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**Prime Minister
of the Republic of Latvia
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**Chairman of the Budget and Finance (Tax) Committee
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**The Minister of Finance
of the Republic of Latvia
Mr Jānis Reirs**
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Dear Mesdames Mūrniece and Straujuma,
Dear Messrs Šadurskis and Reirs,

Verifying compliance with the requirements of Article 11 of the Fiscal Discipline Law

According to Article 28 Part 7 of the Fiscal Discipline Law (FDL), the Fiscal Discipline Council shall prepare and submit to the Saeima and the Cabinet's attention of fiscal policy matters, where it finds them important to comply with the FDL terms.

According to the Regulation (EU) No 473/2013 of the European Parliament and of the Council of 21 May 2013 on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the Member States in the euro area (Regulation 473/2013¹) Article 5 Part 2(a) an

¹ Regulation 473/2013 available at <http://eur-lex.europa.eu/legal-content/LV-EN/TXT/?qid=1446562236138&uri=CELEX:32013R0473&from=LV>, accessed on 16.12.2015.

independent body shall provide public assessment related to the occurrence of circumstances leading to the activation of the correction mechanism. FDL Article 11 stipulates the requirements regarding the correction mechanism in the national legislation.

The FDL covers both the preventive and corrective arms of the fiscal rules, similar to the Fiscal Compact², which was adopted as a result of the lessons learned during the economic crisis of 2007-2009. While the preventive arm addresses compliance with fiscal rules during the preparation and adoption of the state budget, the corrective arm imposes additional restrictions based on the results of implementing the budget. Therefore, the corrective arm mostly focuses on the measurement of the degree to which the Government adheres to the fiscal targets established in the Medium-Term Budget Framework (MTBF) Laws to prevent loosening the general principles of fiscal policies during the execution of the budget.

The corrective arm of the FDL (Article 11) stipulates upward adjustment of the fiscal balance by 0.5% of gross domestic product (GDP) in the third year following the identification that the accumulated negative fiscal balance deviation exceeds 0.5% of GDP. The transitional provisions (Part 7) of the FDL establish that 2013 should be used as the reference year for measuring the accrued deviation against the benchmarks established in the medium-term budget frameworks.

Meanwhile, the correction is postponed, if the output gap is negative, meaning that the economy has been projected to perform below its potential for the year when the corrective measures should be enforced. In such a case, the correction is not cancelled but postponed until the economy starts performing above its potential, showing signs of overheating. The Government can implement a relaxed fiscal policy to stimulate the economy while it is in recession or grows slowly. Macroeconomic forecasts that were used as the basis for drafting the 2016/18 MTBF assessed the Latvian economy as currently performing slightly below its potential. The Fiscal discipline Council (Council) draws attention to several indicators which signal that Latvia's economy may be performing above its potential already in the near future (such as the cyclical unemployment component being close to zero, persistently higher wage growth than productivity growth, as well as a rather high [in the context of Latvian economy] capacity utilisation rate).

The budget execution for 2013 and 2014 can be evaluated as broadly compliant with the plan presented in the respective MTBF (for these two years the accrued budget balance deviation from the target reached -0.1% of GDP). Table 1 presents calculation of evaluation criteria stipulated in Article 11 for 2013 and 2014 (Ministry of Finance (MoF) calculation) and for 2015-2017 (the Council's projections based on the MoF data). The results suggest that the Government achieved a better than planned result in 2013 and underperformed in 2014. The accrued result for these two years form a negative deviation from the objectives set in MTBF in the amount of 30.7 million euro.

Unfortunately, budget execution continues to deteriorate further in 2015 resulting in a substantial excessive budget deficit. The MoF projections for 2015 indicate that the Government is rather close to the fiscal balance level that triggers the correction mechanism, as stipulated in Article 11 of the FDL. According to MoF's September forecast³, a minor negative deviation from the current forecast for the fiscal balance result (in the amount of 6.1 million euro) or a minor unfavourable fluctuation in the headline GDP of 2015 may trigger the correction mechanism.

There is a risk that, after an evaluation of the 2015 structural budget balance result, the accrued general government budget balance negative deviation may exceed the defined threshold of 0.5% of GDP⁴. In such a case, the corrective arm will be implemented in the MTBF 2018/2020, which will be approved in 2017 and foresee corrective measures that increase the budget balance for 2020.

² Fiscal compact, available at: <http://www.consilium.europa.eu/en/european-council/pdf/Treaty-on-Stability-Coordination-and-Governance-TSCG/>, accessed on 14.12.2015.

³ The estimate updated in end-September 2015 for the presentation of the annual draft budget of 2016 and the MTBF.

⁴ According to Article 11 of the FDL, MoF will have evaluated the general government budget structural balance by December 1, 2016.

Table 1. Verifying compliance with the requirements of Article 11 of the Fiscal discipline law

		2013	2014	2015	2016	2017
		actual		projections		
1	Nominal GDP, million euro	23 221.9	24 059.7	24 841.6	26 126.5	27 750.2
2	Actual structural general government budget balance, % of GDP	-1.2	-1.4	-1.37	-0.86	-1.00
3	Actual structural general government budget balance, million euro	-267.8	-327.5	-340.9	-223.6	-277.5
4	Minimum planned structural general government budget, % of GDP	-1.3 ⁵	-1.0 ⁶	-1.0 ⁷	-0.9 ⁸	-1.0 ⁹
5	Minimum planned structural general government budget balance, million euro	-313.2	-251.4	-253.5	-223.6	-277.5
6	Deviation from plan for the year, million euro (3-5)	45.5	-76.2	-87.4	0.0	0.0
7	Accrued deviation from plan for all years starting with 2013, million euro	45.5	-30.7	-118.1	-118.1	-118.1
8	Accrued deviation from plan for all years starting with 2013, % of GDP	0.2	-0.1	-0.48	-0.45	-0.43
9	Reserve before reaching the ceiling of 0.5% of GDP, million euro			6.10	12.52	20.64

Source: for 2013-2014: MoF assessment of the general government structural balance performance for the criteria of the FDL Article 11; for 2015-2017: the Council's assessment based on the MoF projections for the MTBF 2016-2018.

The Council would like to stress the need for a realistic assessment of government revenue estimates, as well as the impact of fiscal risks on the general government structural balance. To avoid a gradual accumulation of negative deviations from the fiscal balance, the Government should take specific steps. Revenue enhancing activities and expenditure reducing measures should be addressed not only during the budget adoption process, but also while executing the budget. A critical assessment of fiscal risks and establishment of an adequate fiscal security reserve would be a substantial preventive measure to avoid from accumulating negative deviations from the fiscal balance target.

While the deterioration of the fiscal balance in 2014 has been partially offset by a better than planned outcome for 2013, the Council is concerned about the estimated outcome for 2015, which may trigger the correction mechanism when drafting the MTBF 2017/2010. This underscores the need for responsible fiscal policies and keeping to fiscal objectives both during the adoption of budgets and their execution.

Council chairman

Jānis Platais

⁵ On medium-term budget framework 2013, 2014 and 2015, available in Latvian at <https://www.vestnesis.lv/op/2012/192.2?search=on>, accessed on 14.12.2015.

⁶ On medium-term budget framework 2014, 2015 and 2016, available in Latvian at <https://www.vestnesis.lv/index.php?menu=doc&id=262267>, accessed in Latvian on 14.12.2015.

⁷ On medium-term budget framework 2015, 2016 and 2016, available in Latvian at <https://www.vestnesis.lv/ta/id/271302-par-vidēja-termina-budzeta-ietvaru-2015-2016-un-2017-gadam>, accessed on 14.12.2015.

⁸ 2016-2018 years' MTBFL.

⁹ Ibid.