LATVIJAS REPUBLIKAS FISKĀLĀS DISCIPLĪNAS PADOME

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Content

Abbreviations

BoL	Bank of Latvia
Council	Fiscal Discipline Council
EC	European Commission
ESA	European system of accounts
EU	European Union
FDL	Fiscal discipline law
SFR	Statement of Fiscal Risks
IMF	International Monetary Fund
Surveillance report 2016-2019	Fiscal Discipline Surveillance Report 2016-2019
MoF	Ministry of Finance
MTBF	Medium term budget framework
MTBFL 2017/19	Medium term budget framework law for 2017-2019
GDP	Gross domestic product
NA	Not applicable / not available
OECD	Organization for Economic Cooperation and Development
SB	State budget
SBL	State budget law
SBL 2017	State budget law for 2017
SGP	Stability and growth pact
SP	Latvia's Stability Programme
SP 2016/19	Latvia's Stability Programme for 2016-2019
VAT	Value added tax

Executive Summary

The Government of Latvia remains broadly compliant with the principles of fiscal discipline, but both 2014 and 2015 saw negative deviations from budget balance targets approved in budget law. The outturn for 2014 and the estimate for 2015 for the general government balance and the special budget balance are below the balance targets for the respective years. The Council finds that the deviation from the general government budget balance target in 2015 was caused by an economically prudent decision to acquire the State Revenue Service building. However, the deterioration of special budget balance outcomes requires scrutiny to avoid future risks.

The Council urges the Government to develop a fiscally sustainable long-term approach to the provision of public health care and objects to the implementation of health care reforms by increasing the deficit objective for 2017. The Council has stressed that health care reforms are necessary to improve Latvia's public health indicators. Additional funding and reforms should be targeted at rectifying current inefficiencies in order to create a sustainable public health system that could improve the quality of life of both current and future generations. There are several challenges for the current funding model, and the Council urges the government to consider the long-term fiscal impact and sustainability of reforms to the provision and funding of health care. Nonetheless, the Council objects to the use of deficit financing for the expansion of the delivery of health care services, as envisaged in the draft budget for 2017.

The Council notes that the the current tax-to-GDP ratio forecast does not indicate that the Government's objective can be achieved by 2020, which is why the Council recommends developing a reform plan for the tax system to reach the intended tax-to-GDP ratio of 1/3. For 2017 the Government approved temporary measures, without significant improvements to the ratio of tax revenues and compulsory state social contributions to GDP. By repeatedly postponing the discussion on sustainable revenue flows and opting for temporary measures, the Government exposes the country to increasing fiscal uncertainty. A bold and coherent approach to (i) the reduction of the shadow economy, (ii) increasing revenues from non-distortionary taxes, (iii) reducing the scope of tax exemptions and (iv) adequately taxing income and capital is required to achieve the objectives set forth in the Declaration of Māris Kučinskis' Cabinet. The Council advises that all efforts should be directed at building a reliable and sustainable revenue flow and coherent tax policy framework.

The Council recommends regular efficiency assessments and more detailed expenditure reviews to better utilise budget funds. The Council welcomes the 2016 expenditure review and endorses the decision to incorporate this procedure into the budget drafting process. Line ministries should be encouraged to conduct their own assessment to divert savings towards important priorities and supporting growth-enhancing and cost-saving reforms. Furthermore, allocation of funding to priority areas should be contingent upon efficiency assessments and clearly specified performance indicators. Using proceeds from temporary revenue measures to finance permanent (baseline) expenditures should be avoided.

The Council welcomes the Government’s proposal to establish a fiscal security reserve for 2017-2019, invites the Saeima to accept it, and consents that **the minimum amount stipulated by the FDL (0.1% of GDP) is currently sufficient.** While additional efforts are required to improve the quantification, management and mitigation of several sources of risk, the Council welcomes the modifications to the Statement of Fiscal Risks. The Council endorses the decision to establish a fiscal security reserve for 2017-2019, as the fiscal security reserve is a safety measure against different risks that may cause a deterioration of the government budget balance. Furthermore, after carrying out a historical assessment of the impact of several items on the general government balance, the Council agrees that the fiscal security reserve can currently be established at the minimum amount, conditional upon savings and excess revenues being used to improve the general government budget balance.

The persistently slow GDP growth during recent years should be addressed by growth-enhancing policies, potentially overseen by a national productivity board. Real GDP growth since 2013 has been consistently lagging behind the forecasted numbers, and the slow growth pace is not sufficient to allow for convergence to average EU productivity and welfare levels. The Government's efforts with respect to implementing growth-enhancing policies so far has not had sufficient impact.

The macroeconomic forecast for the horizon period is considered realistic, while vigilance should be maintained with regard to real GDP growth and inflation. The slower growth outcome in the first half of 2016 is largely explained by the construction sector that suffered severely in the first half of 2016. The real GDP growth forecast for 2017-2019 is optimistic, but it is achievable if the investment sector recovers. Similarly, the average annual inflation forecast for 2017-2019 is realistic, but the recent experience of consistently optimistic inflation forecasts urges caution. The Council sees Latvia's economy as performing slightly below its potential level in 2016 and 2017, but a positive output gap is expected to open in 2018.

The Council reiterates the need for a sensitivity analysis in view of the risk of the nominal GDP falling short of the forecasted level. A sensitivity analysis should be integrated into the MTBF to assess the impact of lower nominal GDP level outcome on tax revenues, as well as estimate the necessary expenditure cuts to meet the medium-term budget balance objective.

The Council contends that the calculations of the 2017 expenditure ceiling should be based on the balance rule (instead of the continuity rule, which was proposed by the Ministry of Finance), resulting in the need to correct expenditures for 2017 by 30.1 million euro (0.1% of GDP. The Council assessed the execution of the fiscal rules, based on the data, which was submitted to the Cabinet of Ministers on 2 August. The main cause of the required correction is a stricter minimum permissible balance, which derives from the recommendation to not finance the health care reform by increasing the deficit target. The expenditure ceilings should be corrected by 111.6 million euro (0.4% of GDP) for 2018 and 148.1 million euro (0.5% of GDP) for 2019.

Responsible fiscal policy must also be observed in the future. The Council encourages the Government to consider prudent planning of the budget deficit below the maximum threshold permitted by legal acts in order to secure a downward trend of the government debt level, consequently securing an improved fiscal position to weather another potential financial and economic crisis in the future. Significant revisions to the time series of macroeconomic indicators require corrections to the execution of fiscal rules starting from 2013.

1 Fiscal Policy Challenges

The Government of Latvia remains broadly compliant with the principles of fiscal discipline, even though both 2014 and 2015 saw negative deviations from the budget balance target approved in the budget law. While in 2013 the actual general government structural budget balance exceeded the objective (by 0.3% of GDP), the outturn for 2014 and the estimate for 2015 are below the objectives set in the MTBFL for those years by 0.6% and 0.3% of GDP respectively.

	2013	2014	2015
General government budget balance target approved in the MTBF	-1.4[1]	-0.9[2]	-1.0[3]
Actual outcome[4]	-0.9	-1.6	-1.3

Table 1.1 General government budget balance 2013-2015 (% of GDP) Source: CSB.

While the Council notes that 2015 budget execution results were worse than anticipated in the SP 2016/2019, the Council finds that the reason was economically justified. During the preparation of the MTBF 2016/18, it was anticipated that the deviation from the approved budget balance for 2015 would reach 0.4% of GDP. However, in the SP 2016/19 the forecasted general government balance for 2015 was revised to -1.0% of GDP. The preliminary revision resulted from corrections according to ESA 2010 methodology. Nonetheless, CSB estimates (April 2016) suggest that the general government balance for 2015 was -1.3%, which is by 0.3% of GDP lower than planned. This is mainly due to the acquisition of the State Revenue Service building by the Government. The Council finds that this decision has clear long-term fiscal benefits, as it reduces future expenditures on rent.

The Council notes that special budget balance outcomes have been deteriorating. While the special budget balance outcome was better than planned until 2013, the outcomes for 2014 and 2015 indicate a deterioration compared to the plans, mainly due to expenditures exceeding estimates.

	2011	2012	2013	2014	2015
Approved budget balance target	-337.79[5]	-190.38[6]	-80.11[7]	132.40[8]	162.87[9]
Actual outcome	-177.66	-70.4	-57.91	100.35	91.13
Deviation:	160.13	119.98	22,2	-32.05	-71.74

Table 1.2 Special budget balance 2011-2015 (million euro) Source: MoF.

The Council has previously noted the need to assess the sustainability of, and the future risks associated with, the special budget. Population ageing and the shadow economy significantly impact

[1] On the medium-term budget framework 2013, 2014 and 2015, Article 5, available at: https://www.vestnesis.lv/op/2012/192.2?search=on, accessed on 27/09/2016.
[2] On the medium-term budget framework 2014, 2015 and 2016, Article 6, available at: https://www.vestnesis.lv/index.php?menu=doc&id=262267, accessed on 27/09/2016.
[3] On the medium-term budget framework 2015, 2016 and 2017, Article 5, available at: https://www.vestnesis.lv/ta/id/271302-par-videja-termina-budzeta-ietvaru-2015-2016-un-2017-gadam, accessed on 27/09/2016.
[4] http://www.csb.gov.lv/en/notikumi/general-government-budget-deficit-and-debt-decreased-2015-44057.html%20, accessed on 03/10/2016.
[5] "On the state budget for 2011", Annex 1, available at: https://www.vestnesis.lv/ta/id/223570-par-valsts-budzetu-2011-gadam, accessed on 03/10/2016.
[6] "On the state budget for 2012", Annex 1, available at: https://www.vestnesis.lv/ta/id/242017-par-valsts-budzetu-2012-gadam, accessed on 03/10/2016.
[7] "On the state budget for 2013", Annex 1, available at: https://www.vestnesis.lv/op/2012/192.1, accessed on 03/10/2016.
[8] "On the state budget for 2014", Annex 1, available at: https://www.vestnesis.lv/op/2013/232.1, accessed on 03/10/2016.
[9] On the state budget for 2015", Annex 1, available at: https://www.vestnesis.lv/op/2014/257.24, accessed on 03/10/2016.

revenues from compulsory state social insurance contributions and can create serious consequences for the sustainability of special budget commitments. The recent spending overrun in the special budget appears to be the result of discontinuing the policies for containing expenditures during the economic crisis, particularly in sickness and unemployment benefits. The effect of such an expansive policy has not received the required scrutiny regarding its social and fiscal impact.

1.1 Health Care Reform

The Council reiterates its objection to increasing the budget deficit objective to finance the implementation of health care reforms. The Government received permission from the EC[10] to increase the general government structural deficit objective for 2017 and, contingent upon the implementation of the proposed reforms, for the remainder of the MTBF 2017/19 to continue structural reforms in health care. The Council objects to the use of deficit financing for the expansion of the delivery of health care services, as envisaged in the draft budget for 2017.

The Council urges the Government to consider measures which would ensure the funding of the health care sector, without deteriorating the government budget balance and increasing the debt burden for future generations. While the Council objects to the deviation from the budget balance objective to implement health care reforms, the Council has stressed that health care reforms are necessary to improve Latvia's public health indicators. To this end, revenue measures or expenditure reviews should be considered, which would improve the cost-effectiveness of delivering health care services, without increasing the budget deficit during the horizon period of the MTBF 2017/19 and from 2020 onwards.

A recently published OECD review[11] notes that Latvia needs a data-driven approach to the health care system and a strategic vision for the sector as a whole. The OECD report on the Latvian health system states that Latvia needs to make significant improvements to the quality and accessibility of health care and increase the available funding, based on a strategic vision for the provision of public health care. Furthermore, more widespread use of data must be made to systematically to measure, compare and improve the performance of services, based on clearly defined indicators.

The Council invites the government to develop a fiscally sustainable long-term approach to the provision of public health care. Population ageing, developments in medical technology and Latvia's comparatively high economic inequality and poor population health indicators pose challenges for the current funding model and the provision of public health care. In the previous report the Council noted that the overall efficiency and sustainability of the health care system should be assessed. Additional funding and reforms should be targeted at rectifying current inefficiencies in order to create a sustainable public health system that could improve the quality of life of both current and future generations. Furthermore, several proposals for the provision and funding of public health care have been discussed[12] during the preparation of the MTBF 2017/19. The Council encourages the government to consider the long-term fiscal impact and sustainability of all such proposals when deciding whether to implement them.

The Council suggests continually assessing the outcomes of the implemented reforms in health care. As outlined in the National Development Plan 2020, one of the indicators of the success of the health care reform is a decrease in the annual loss of healthy life years. It was claimed that this indicator should decrease from 6746 in 2010 to 5300 in 2020. Estimates provided by the Ministry of Health about 2014 show that there have been gradual improvements in this regard. Furthermore, the funds allocated for the implementation of the health care reform between 2014 and 2016 exceeded the requirements of

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[10] http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32016H0818(20)&from=EN, accessed on 03/10/2016.
[11] OECD (2015) *OECD Reviews of Health Systems: Latvia 2016*, Paris: OECD Publishing.
[12] For example: https://www.makroekonomika.lv/latvijas-bankas-priekslikumi-veselibas-aprupes-sakartosanai-detalizeta-koncepcija, accessed on 03/10/2016.

the National Development Plan 2020. In view of this, the Council recommends regularly assessing the outcomes of health care reforms and clarifying whether the targets for the period in question have been reached.

1.2 Revenues

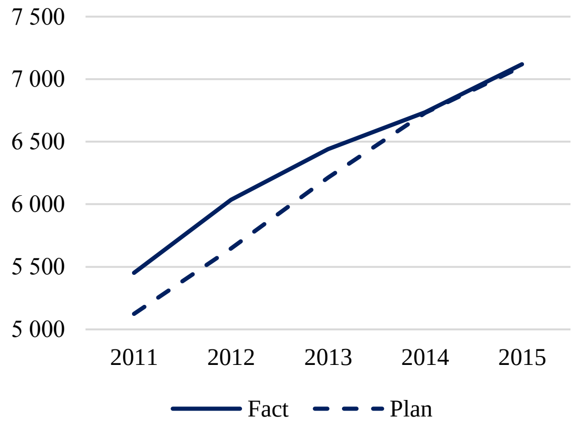

Chart 1.1 Execution of the tax revenue plan 2011-2015 (million euro). Source: State Revenue Service.

Tax revenue targets have been achieved despite deteriorating macroeconomic conditions and slower growth, while non-tax revenues have recently been lower than planned. After summarising the information published by the State Revenue Service on the execution of the revenue plan in the last five years, the Council concludes that tax revenues have consistently been higher than planned. The results of 2015 are of particular note, as revenue collection was executed according to the State Revenue Service plan, even though nominal GDP growth was lower than anticipated (5.2% forecasted growth in the MTBF versus 3.4% actual outcome). This may indicate a positive trend of the shadow economy shrinking faster as a result of State Revenue Service efforts.

Strong and professional leadership maintains public trust in the State Revenue Service. The previous Director General of the State Revenue Service resigned in May 2016, and the selection process of the new director has been complicated and fraught with controversy. This may have a damaging effect on the reputation of the Government and the perceived independence of the State Revenue Service. Research shows that trust in the revenue collecting agency influences compliance with tax law[13] and, consequently, tax revenues. This is why a transparent and merit-based selection of a professional Director General is crucial to maintaining the reputation of the institution. Furthermore, structural issues should be addressed to allow attracting and maintaining highly qualified professionals in the top management posts of the State Revenue Service.

The draft MTBF 2017/19 does not demonstrate significant improvements to the ratio of tax revenues and compulsory state social contributions to GDP (hereafter – tax-to-GDP ratio), but the new proposals indicate intentions to address issues identified in previous Council reports. With the policy changes set forth in the draft MTBF 2017/19, the tax-to-GDP ratio in the horizon period is currently not on track to reach the Government's objective of 1/3 of GDP, established in the Declaration of Māris Kučinskis' Cabinet. Furthermore, the Council is concerned that after the discussion on revenue measures for 2017 the Government approved temporary measures, rather than developed a plan containing long-term measures. By repeatedly postponing the discussion on sustainable revenue flows and opting for temporary fixes, the Government exposes the country to increasing fiscal uncertainty. Nonetheless, it is salutary that the adopted revenue measures address tax evasion and tax avoidance. Furthermore, revenues from environmental taxes have been increased, and more indications regarding reforms in taxation should emerge in early 2017. These are issues that the Council noted in previous Surveillance Reports.

The Government's plan to increase tax revenues primarily by reducing the shadow economy is commendable, but the Council believes that reducing the shadow economy will not be enough to reach the intended tax-to-GDP ratio. The Government aims to reduce informal economic. Limiting the shadow economy increases revenues without further burdening individuals and companies that already pay taxes in full. The Council contends that the intended tax-to-GDP ratio cannot be reached only by focusing on the reduction of the shadow economy. The options for increasing revenues from

[13] For more information see Annex 3.

non-distortionary taxes, reducing the scope of tax exemptions and adequately taxing income and capital should also be considered when working on revenue-increasing measures will have to be considered. Such an approach would allow for a stable and foreseeable revenue policy, which would not hamper economic growth or place additional burdens on participants of the formal economy.

Modifications to the current tax system should be mindful of the system as a whole. The MoF has stated that it will continue work on developing a tax policy in 2017, using the results of the tax system review carried out by the World Bank. The Council welcomes efforts to improve the existing tax system – particularly equalising the tax burden between different groups of taxpayers and reducing the regressive elements in the tax system (e.g. shifting the tax burden from low salaries to undertaxed income from capital). Moreover, the Council urges the government to approach the tax system as a whole and advises that all changes should be directed at building a coherent and reliable tax framework.

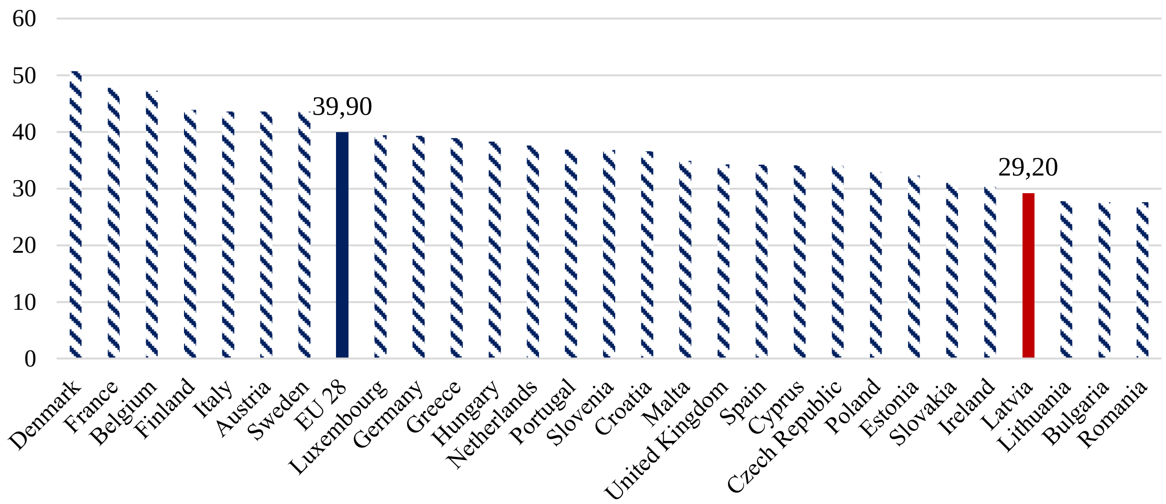

Chart 1.2 Tax revenues & social contributions in 2014 (% of GDP). Source: Eurostat.

The Council reiterates its suggestion that the revenue potential of taxes on immovable property should be fully utilised. A recent OECD publication[14] notes that property taxes are non-distortionary and, in many cases, have a positive distributional impact. In addition, an EC publication on tax reforms[15] states that taxes on immovable property are a way to increase revenues and move away from more distortionary (e.g. labour taxes) taxes. In view of this, the Council maintains its suggestion that property and real estate taxation should be carefully considered and the economic and social effects should be fully assessed when preparing policy changes.

The Council supports the Government's proposal that the micro-enterprise tax regime should be abolished at the end of 2018, and alternative measures should be introduced to support start-ups. The micro-enterprise tax regime has become an expensive instrument for encouraging entrepreneurship. The analysis performed by the Council indicates that the micro-enterprise tax regime currently has several significant deficiencies and creates a future strain on the special budget. In view of this, the Council supports the proposition to abolish the micro-enterprise tax regime and support start-ups.

The solidarity tax should be reconsidered in favour of alternative measures, which can be collected more effectively. While the Council commends the government for the attempt to reduce income inequality, the revised revenue forecasts and public backlash against the solidarity tax suggest a need to

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[14] Brys, B., Perrett, S., Thomas, A. and O'Reilly, P. (2016) *Tax Design for Inclusive Economic Growth,* available at: http://www.oecd-ilibrary.org/taxation/tax-design-for-inclusive-economic-growth_5jlv74ggk0g7-en, accessed on 03/10/2016.

[15] European Commission (2015) *Tax Reforms in EU Member States 2015*, available at: http://ec.europa.eu/economy_finance/publications/eeip/pdf/ip008_en.pdf, accessed on 03/10/2016.

reconsider it. Alternative inequality-reducing measures, which can be administered effectively, should be developed.

1.3 Expenditures

The Council could not identify strong support for structural reform measures when reviewing the new policy initiatives for incorporation into the draft budget. Following the Cabinet meetings of 16 August and 18 August, the decision was made to approve new expenditure measures for 2017 in the amount of 144.1 million euro[16]. While the approved measures address several important areas (such as teachers' salaries and the availability of ambulatory care), there is little evidence that growth-enhancing structural reforms will be implemented, which are crucial for stimulating economic growth.

The Council advises against using proceeds from temporary revenue measures to finance permanent (baseline) expenditures. After reviewing the new policy measures approved by the Government, the Council notes that several temporary or one-off revenue measures (e.g. 34.2 million from the vehicle exploitation tax and 20 million from sales of confiscated goods) are being used to finance permanent expenditures, including remuneration. The Council advises against such a practice, as it simply postpones the task of developing sustainable revenues or cutting inefficient spending.

The Council welcomes the 2016 expenditure review and endorses the decision to incorporate this procedure into the budget drafting process. An expenditure review was carried out in the first half of 2016. A report by the MoF claims that a total of 64.2 million euro became available for new expenditures in 2017, and 62.2 million euro in 2018[17]. Line ministries should be encouraged to conduct their own assessment to divert savings towards important priorities and supporting growth-enhancing and cost-saving reforms. The government-wide review led by the Ministry of Finance should continue and encourage responsible allocation.

The Council advises that allocation of funding to priority areas should be contingent upon efficiency assessments and clear performance indicators. While several areas of government spending are underfunded compared to EU average (e.g. health care and social protection), others compare favourably to the EU average, while the results and outcomes could be better. Further allocation of funding should be made based on outcomes and assessments of how efficiently the available funding is being used, in order to eliminate waste. Furthermore, additional funding should be allocated with clear outcomes and progress indicators in mind.

[16] http://www.fm.gov.lv/lv/aktualitates/jaunumi/budzets/53181-nakamgad-valdibas-prioritarajiem-pasakumiem-bus-pieejams-1441-miljons-eiro, accessed on 03/10/2016.
[17] http://www.fm.gov.lv/lv/aktualitates/jaunumi/budzets/52713-pirmo-reizi-padzilinati-izverteti-visu-ministriju-budzeti, accessed on 03/10/2016.

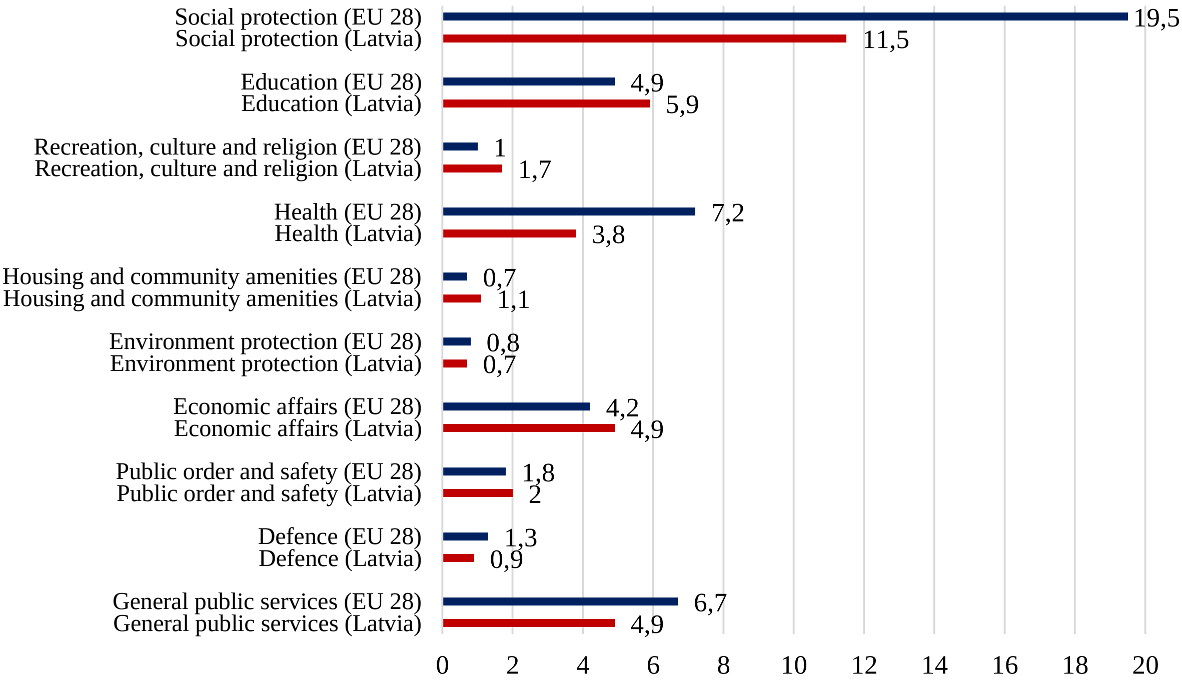


Chart 1.3 General government expenditure in 2014 (% of GDP). Source: Eurostat

The Council notes insufficient analytical support for the legislative process in the Saeima. The 2016 iteration of the *Sustainable Governance Indicators* survey[18] claims that the Latvian parliament lacks adequate resources to monitor government activity. The Council suggests that this situation can be rectified by strengthening the analytical support in legislation. This can help the parliament to obtain pertinent information and specialised expertise on, and a deeper understanding of, complex policy and legislative matters. This can include more in-depth international comparisons and using best practices as a point of reference. This would also allow parliamentarians to critically evaluate government policies and steer towards improvement[19].

Recommendations

1. Adopt a structural reform plan for the tax system, indicating a clear path towards reaching a tax-to-GDP ratio of 1/3, while supporting economic growth and equality, and broadening the tax base.
2. Develop and implement performance-enhancing reforms in the health care sector in a fiscally sustainable manner, without deviating from budget deficit targets.
3. Identify issues and adopt measures for containing the long-term risks for the special budget, in view of demographic trends, the situation in the labour market, impact of policy changes, and previous deviations from budget expenditure forecasts.
4. Carry out regular efficiency assessments and more detailed expenditure reviews to better utilise budget funds.

[18] http://www.sgi-network.org/2016/Governance/Executive_Accountability/Legislative_Actors%E2%80%99_Resources/Parliamentary_Resources, accessed on 03/10/2016.
[19] For more information see: http://www.ifla.org/node/9758, accessed on 03/10/2016.

1.4 Assessment of the Statement of Fiscal Risks

The Government has a responsibility to carry out a comprehensive assessment of fiscal risks, prepare a Statement of Fiscal Risks (hereafter – SFR) and establish a fiscal security reserve. The management of fiscal risks requires the identification of specific sources of risk and their potential impact on the general government balance. This information is included in the SFR, which is attached to the draft MTBFL upon submission to the Saeima. Based on the SFR, the fiscal security reserve should be calculated and included in the budget to counter the fiscal impact of all of the included risks, should they materialise and cause the general government balance to deviate from the objective approved in the MTBFL.

The FDL stipulates that a fiscal security reserve should be established at least in the amount of 0.1% of GDP. The FDL states that the fiscal security reserve for 2016 should have been established in the amount of 0.1% of GDP and a fiscal security reserve of no less than 0.1% of GDP for subsequent years.

The Council welcomes the decision to establish a fiscal security reserve for 2017-2019. Expenditure needs motivated the Cabinet's decision against establishing a fiscal security reserve for 2016 – a decision which was contrary to Part 3 of the Transitional Provisions of the FDL. In the Cabinet meeting of 2 August 2016 the decision was made to establish a fiscal security reserve for MTBF 2017/19 in the minimum amount stipulated by the FDL – 0.1% of GDP. The Council endorses this decision, as the fiscal security reserve is a safety measure against different risks not directly reflected in the budget and MTBF that may cause a deterioration of the government budget balance.

After conducting a historical assessment, the Council concurs that the fiscal security reserve for 2017 has been set at a sufficient amount. The Council carried out an analysis of the impact of several items (e.g. Southern Bridge and Parex Bank) on the general government balance. The Council concludes that the negative impact was partly offset by expenditure savings from the approved appropriations and revenues exceeding budget estimates. The Council agrees that the fiscal security reserve can currently be established at the minimum amount, conditional upon savings and excess revenues being used to improve the general government budget balance.

The Government has included in the SFR for 2017-2019 risks that were not previously reflected, while the impact of most risks remains unquantified. This year's SFR contains a section on risks stemming from the financial sector, which was not included in the previous SFR. While the Council welcomes attempts to broaden the range of fiscal risks, it notes that the probabilities and potential impact of most risks (e.g. public-private partnerships, state-owned enterprises) remains unquantified. The exceptions are state loans and state-guaranteed loans, whose potential fiscal impact has been determined.

The Council suggests more transparency in the analysis underpinning the required amount of the fiscal safety reserve. The SFR includes several risks whose potential fiscal impact has not been assessed. Furthermore, the analysis underpinning these judgements is sometimes vague, and the reasoning is not explicit. The SFR should include a more detailed account of risk assessment procedures – particularly as they pertain to the assignment of specific probabilities, and the assumptions underpinning these judgements. This would allow an independent observer to gain a better understanding as to why specific probabilities can be assigned in some cases, and insight into the reasons why a specific amount cannot be given in others.

Risk management would be improved by a clear establishment of responsibilities. Appropriate identification and quantification of fiscal risks is crucial for effective risk management and mitigation. The risks could be managed most effectively if clear responsibilities are established for line ministries[20]. By delegating risk management, making clear the benefits of appropriate risk management and encouraging a consistent methodological approach, the MoF can compel other line ministries and state

[20] For more information see Annex 5.

institutions to identify and assess sector-specific risks, and provide more accurate forecasts and information.

The Council advises caution and careful planning, drawing on international experience, to avoid unexpected complications regarding the Ķekava bypass public-private partnership project. More than 70% of all transport-related public-private partnerships are road projects[21]. The preparation and design phases should learn from previous projects and develop a clear and careful framework for managing the Ķekava bypass. This should contain a cautious cost and risk assessment, and provisions regulating the respective responsibilities of partners, and alterations of funding arrangements in case of significant changes in circumstances.

The applicability of the symmetry principle to government finance remains unclear. The Council has previously noted its concerns regarding the use of the symmetry principle in the SFR. After consulting with experts from Ernst & Young Baltic[22], the Council remains unconvinced that the symmetry principle is applicable in the way it is currently being used.

The continued use of the symmetry principle requires further refinement. Future SFRs should provide additional information and justification regarding the period of time chosen, and the role and impact of mitigating or exacerbating factors that influenced outcomes. Furthermore, evidence is required that positive outcomes contributed to lower deficits and less strain on public debt. This would establish that the symmetry principle is being implemented consistently.

The inclusion of a subsection dealing with ex post assessment of the MTO in the SFR is salutary. The SFR provides the main reasons for the deviation from the planned budget balance in 2015. This is consistent with the recommendation that the Council made in its previous Monitoring report.

Assessment

The Council suggests that the following improvements be made to future SFRs:

1. Endeavour to forge a more definite link between the potential impact of risks on the fiscal balance, mitigating factors (e.g. expenditure savings) and the required amount for the fiscal safety reserve.
2. Improve the quality of risk assessment by clearly establishing the responsibilities of the relevant institutions for assessing and managing fiscal risks in their respective sector, with a clear link to the necessary allocation in the fiscal safety reserve.
3. Provide a more detailed and precise description of how probabilities are assigned to particular risks so that the specific content of claims and conclusions can be evaluated by independent observers.
4. Draw on international experience to develop robust frameworks for public-private partnerships.
5. Establish and clarify the applicability of the symmetry principle in the context of government finance.

[21] http://ec.europa.eu/economy_finance/events/2016/20160302-pfn/documents/03_tomasi_presentation_on_en.pdf

[22] For more information see Annex 5.

2 MACROECONOMIC OUTLOOK AND OUTPUT GAP

According to the MoU[23], the Council has assumed the responsibility of endorsing MoF's macroeconomic forecast. An early review and endorsement of the MoF's macroeconomic projections by the Council has been agreed upon to support the Government in the preparation of two annual documents – the SP and the MTBF. Most recently, the Council endorsed MoF's macroeconomic forecast on 16 June 2016. The full endorsement text is available in Annex 2. The Council assessed the forecast as a whole, and provides an endorsement of the key macroeconomic indicators (see Table 2.1).

	2016	2017	2018	2019
Real GDP growth	2.5	3.5	3.4	3.4
Nominal GDP growth	2.8	5.3	5.7	6.1
Inflation	0.0	1.6	2.0	2.5
GDP deflator	0.3	1.7	2.2	2.7
Potential GDP growth	2.4	2.6	2.8	2.8
Output gap	-1.1	-0.3	0.2	0.7

Table 2.1 Macroeconomic forecast indicators endorsed by the Council in June 2016, %.

While real GDP growth has been consistently lagging behind the forecasted numbers since 2013, the slow growth pace is also not sufficient to provide for convergence to the average EU level of welfare. Lower than expected growth is attributable to external factors like weak global growth and political uncertainty, as well as local problems that could at least partly be resolved by introducing efficient growth-enhancing policies. The Council has repeatedly noted the need to develop and implement well-designed structural reforms to continue convergence to average EU levels in terms of income and welfare, however, the Government's progress in this respect so far has been limited.

Establishment of a national productivity board should be initiated to facilitate the development of growth-enhancing policies. After the Five President's Report[24]outlined the idea of enhancing countries' competitiveness through the creation of a euro area system of competitiveness authorities, in September 2016 the EC issued a recommendation to establish national productivity boards[25]. The key duties of such an authority would include assessing policies, tracking developments and contributing to the public debate on productivity and competitiveness.

Data for the first half of 2016 suggest that real GDP growth is slower than in the MoF forecast, which the Council endorsed on 16 June 2016. Real GDP growth in the first 6 months of 2016 reached 2.1% compared to the first half of 2015. One of the key underlying assumptions of the macroeconomic scenario presented by the MoF was a resumed flow of EU structural funds into the economy during 2016, which continues to lag. Consequently, the current slowdown is partly explained by the prolonged period without the inflow of EU funds into the economy: historically, EU funded programmes start demonstrating positive effects 3-4 years after an agreement between the EC and Latvia is reached – 2017-2018 for the current planning period.

The construction sector has suffered severely in the first half of 2016, but so far no major negative spillovers to other sectors of the economy have been observed. The construction industry dropped by 19% in the first half of 2016, compared to the first half of 2015, which is largely due to the delayed disbursement of EU funds. This contributes to a slump in investment activity. So far, this negative hit has largely been contained within the construction industry, without a major spillover to other sectors. For instance, consumption is still growing, wage growth (though slower and less steady than in the past year) still continues, the export sector continues to recover from the trade embargo with Russia and grew in the second quarter of 2016.

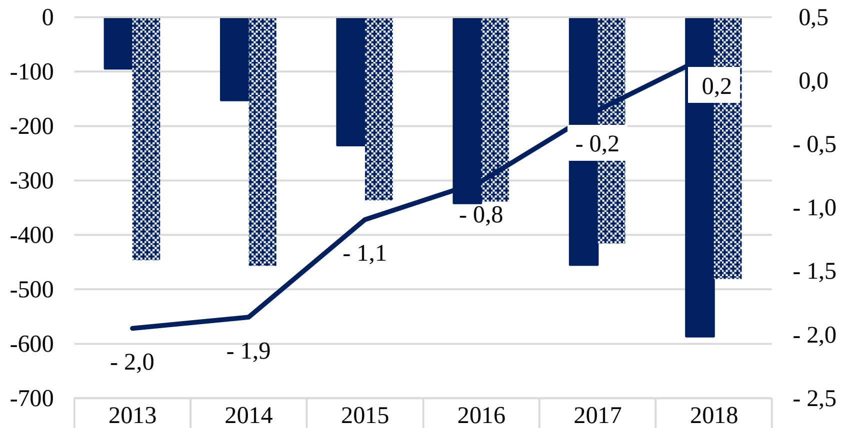
[23] http://fiscalcouncil.lv/files/uploaded/FDP_1_09_969_20160729_MoU_FDC_MoF_consolidated.pdf
[24] https://ec.europa.eu/priorities/sites/beta-political/files/5-presidents-report_en.pdf
[25] http://data.consilium.europa.eu/doc/document/ST-12330-2016-INIT/en/pdf

The Council sees a potential risk of imbalances appearing in the construction sector. With the disbursement of EU structural funds, a massive inflow of funding into the construction sector is likely. However, the uptake capacity of the construction sector has been reduced by this year’s recession. Consequently, there is a risk of bottleneck effects, resulting, among other things, in inflationary pressure.

The real GDP growth forecast for 2017-2019 is optimistic, but it is achievable if the investment sector recovers. With the inflow of EU funds, it is reasonable to expect growth acceleration. Lending to businesses more than doubled in the second quarter of 2016 compared to the same period in 2015. Unemployment continues to gradually decrease, the manufacturing industry is growing and confidence indicators are broadly stable, with the exception of the construction sector.

The average annual inflation forecast for the horizon period is realistic, but recent experience urges caution. In August 2016 the annual inflation rate was considerably lower than forecasted for 2016, reaching -0.3%. Major downward pressures come from the energy and food markets, while core inflation is positive at around 1%. In the remaining months of 2016 inflation is expected to recover as a result of the disappearance of base effects of energy prices and the end of the seasonal decline in food prices. Inflation performance in 2017-2019 highly depends on global oil prices and unprocessed food prices. Although the base effects causing low inflation have disappeared by now, the recent experience of consistently optimistic inflation forecasts suggest the need to maintain vigilance.

After downward revisions of the GDP time series by the CSB and revised potential GDP data, output gap estimates for 2013 – 2017 are more negative than when the MTBF 2016/18 was being drafted. In September 2015, CSB revised the whole GDP time series, which resulted in substantially lower GDP figures (e.g. both the nominal and real GDP figures for 2014 fell by ~2% after the revision). During the macroeconomic forecast endorsement procedure for the SP 2016/19 (in February 2016), after several rounds of consultations between the MoF and the Council, the potential GDP data (both historical and future) were revised slightly downwards. The total effect of these revisions is a more negative output gap for 2013-2017 than estimated previously (see Chart 2.1).



	2013	2014	2015	2016	2017	2018
Change in potential GDP	-95	-153	-235	-342	-455	-587
Change in real GDP (CSB data revision)	-446	-457	-337	-339	-416	-481
Change in output gap (right axis)	- 2,0	- 1,9	- 1,1	- 0,8	- 0,2	0,2

Change in potential GDP   Change in real GDP (CSB data revision)
Change in output gap (right axis)

Chart 2.1 Change in real GDP, potential GDP (mill EUR) and the resulting change in the output gap (as % of potential GDP) from MTBF 2016/18 to MTBF 2017/19. Source: CSB, MoF, Counicl’s calculations.

The Council sees Latvia's economy as performing slightly below its potential level in 2016 and 2017, but a positive output gap is expected to open in 2018. This is mainly related to the above-mentioned idleness in the investment sector. Assuming recovery of the construction sector and ongoing decrease in unemployment rate, according to current projections, a positive output gap is forecasted to start opening in 2018.

The Council reiterates the need for a sensitivity analysis in view of the risk of the nominal GDP falling short of the forecasted level. Lower than planned growth in 2016 can lead to lower nominal GDP levels in 2017-2019, even if the growth rates reach the forecasted figures for the horizon period of the MTBF 2017/19. The Council reiterates the need to integrate a sensitivity analysis into the MTBF to assess the impact of lower nominal GDP level outcome on tax revenues, as well as estimate the necessary expenditure cuts to meet the MTO.

Recommendations

1. Initiate the process of establishing a national productivity board to facilitate the implementation of growth-enhancing policies.
2. Develop a sensitivity analysis for the case of nominal GDP falling short of the forecasted level, the resulting lower tax revenues than planned and implications on government expenditures to meet the MTO.

3 Assessment of Compliance with Numerical Fiscal Rules

According to Section 28, Part 1 of the FDL, the Council has the responsibility (i) to verify the application of the numerical fiscal rules stipulated by the FDL in the preparation of the SB and the MTBF, (ii) to assess the impact of the amendments thereto and also (iii) to verify rules after the budget has been executed (so called – ex post assessment). Council has performed fiscal rules assessment based on the data received from the MoF on 2 August 2016.

The objective of the fiscal rules is to establish expenditure ceilings for the central government at a level that would take into account the conditions, e.g., of the economic cycle, of natural changes in recipients, of one-off measures, with the achievement of the MTO in mind.

3.1 Applicable Fiscal Rules in 2013-2016

The Council has carried out an assessment of the fiscal rules for 2015 and 2016 and has concluded that the expenditure ceilings have changed significantly. While preparing the state budget and the MTBF for 2015 and 2016, the balance rule was selected as the tightest and most appropriate criterion for determining fiscal space during budget preparation. The actual results of the fiscal rules were significantly influenced by macro-economic development, including lower than forecasted inflation, which is reflected in a lower than planned GDP deflator at a lower cost and the revised potential GDP, which influences the structural component. Retrospective assessment indicates that the maximum permissible budget expenditure level for 2015 and 2016 should have calculated employing the expenditure rule.

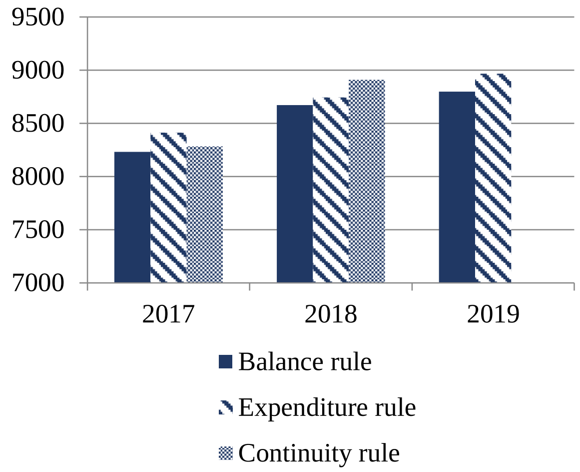
The calculations presented above will not affect the maximum government expenditure level for 2017. The calculation methodology and assumptions employed do not allow the Council to assess in sufficient detail whether the fiscal rules are applied appropriately for 2015 and 2016. Additionally, the Council expects the final CSB data on 2015 budget execution results according to ESA methodology prior to the approval of the final assessment in accordance with Article 11 of the FDL.

However, the calculation of fiscal rules will affect the assessment of the government's performance in relation to meeting fiscal objectives. The Council therefore calls on the MoF to make a calculation for all fiscal conditions for the period since 2013, in accordance with Article 11 of the FDL.

Recommendation

1. Perform a retrospective assessment of the application of the fiscal rules starting with 2013 in accordance with Article 11 of the FDL based on the actual results of the macroeconomic and fiscal indicators.

3.2 The Assessment of Fiscal Rules for MTBF 2017/19



3.1 Chart. State budget expenditure ceilings, MTBF 2017/19, million eiro. Source: Council calculus..

The Council contends that the balance rule provides the lowest value of the expenditure ceilings for all three years of the MTBF 2017/19 (see Chart 3.1). The Council agrees with MoF calculations for 2018 and 2019, while disagrees with the MoF that the continuity rule should be applied for 2017.[26] The Council continues to highlight that the proposed deviation from the MTO on account of the reform in the health care sector is not in line with the principles of fiscal discipline, which demand a sustainable approach to public finance. The Council contends that the balance rule should be applied for 2017. Pursuant to the Council's revised data and according to the balance rule, the expenditure ceilings are 8 205.1 million euro for 2017, 8 644.8 million euro for 2018 and 8 961.9 million euro for 2019.

The Council draws attention to slight differences in its approach compared to the MoF, resulting in a different assessment of the expenditure ceilings. They are as follows (see Table 3.1):

1) Similar to the Council's assessment of the SP 2016/19. for the calculation of the balance rule the deviation from the MTO on account of the health care structural reform should not be made, resulting in the following adjustments:

– 2017 -34.3 million euro,

– 2018 -111.6 million euro and

– 2019 -148.1 million euro compared to MoF's calculations (see discussion on the deviation from the MTO on account of the health care reform in Section 1 *Fiscal policy challenges*) (see Chart 3.2).

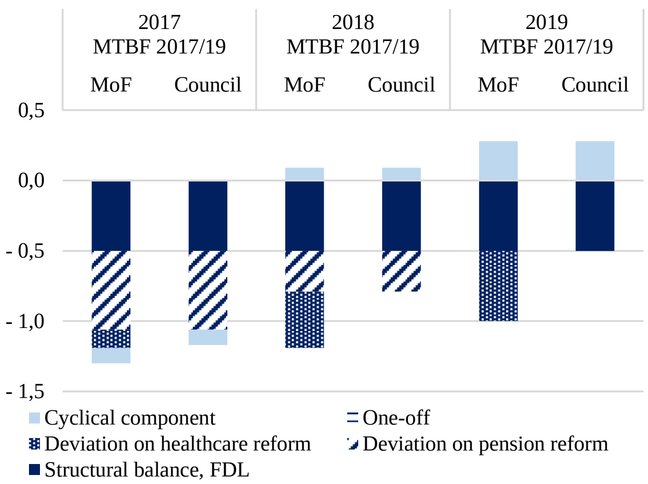


Chart 3.2 The general government budget headline balance by component, % of GDP. Source: MoF, Council calculus.

2) The Council does not challenge MoF's calculation of the expenditure rule. Nevertheless, the calculation of potential GDP growth, which takes into account the recalibrated convergence margin, is different in the national methodology and the EC methodology, and the latter is stricter. However, due to the limited public availability of data both methodologies are used for 2017, but only the national methodology is used for 2018 and 2019. The expenditure rule demands more transparency regarding the numerous assumptions behind the calibration procedures.

3) In the calculations of the continuity rule the Council has also included the expenditures arising from the decision of the Constitutional Court (in summer 2016) regarding the remuneration of the employees of the Ministry of Inferior (22 million euro). The continuity rule could not be applied for establishing

[26] According to the FDL the continuity rule is applicable if the difference among the continuity rule and the next strictest rule is less than 0.1% of GDP.

expenditure ceilings after the adjustment, because the resulting value of the expenditure ceilings would exceed 0.1% of GDP.

	2017 (draft MTBF)		2018 (draft MTBF)		2019 (draft MTBF)	
	MoF	Council	MoF	Council	MoF	Council
(1) Balance rule	8 265.8	8 231.5	8 784.3	8 672.7	9 139.5	8 991.5
(2) Expenditure growth rule	8 411.2	8 411.2	8 792.4	8 792.4	9 285.6	9 285.6
(3) Continuity rule	8 279.6	8 301.6	8 860.8	8 882.8	x	x
(4) = MIN [(1);(2)]	8 265.8	8 231.5	8 784.3	8 672.7	9 139.5	8 991.5
(5) = (4) - (3)	-13.8	-70.1	-75.0	-208.6	x	x
(6) = [5]	13.8	70.1	75.0	208.6	x	x
(7) GDP, at current prices	26 403.4	26 403.4	27 905.1	27 905.1	29 614.7	29 614.7
(8) 0.1% of GDP, (8) = 0.1%* (7)	26.4	26.4	27.9	27.9	29.6	29.6
(9) Central government maximally permissible expenditure in accordance with fiscal rules, (9) = IF [(6) > (8); (4); (3)]	8 279.6	8 231.5	8 784.3	8 672.7	9 139.5	8 991.5
(10) Fiscal safety reserve	26.4	26.4	27.9	27.9	29.6	29.6
(11) CG expenditure, taking into account fiscal safety reserve, (11) = (9) - (10)	8 253.2	8 205.1	8 756.4	8 644.8	9 109.9	8 961.9
Deviation:	x	-48.1	x	-116.6	x	-148.1

Table 3.1 Summary of numerical fiscal rules execution in MTBF 2017/19 (million euro). Source: Council calculus.

When calculating government expenditure ceilings, it becomes apparent that the balancing element is the basic budget (in ESA – central government budget), as special budget expenditures are specific entitlements not subject to appropriation ceilings and have special provisions according to the Budget and financial management law. The government requires additional instruments to monitor state owned enterprises and derived public persons. Historically, the deviations (see Table 3.2) are mainly due to policy changes concerning transfer principles between the special budget and the basic budget, starting from 2014.

	2011	2012	2013	2014	2015
Basic budget balance target approved in budget law	-478.7	18.1	-111.3	-275.5	-380.2
Actual outcome	-428.4	199.8	70.3	-406.0	-386.3
Deviation:	50.3	181.7	181.6	-130.5	-6.1

Table 3.2 Basic budget balance 2011-2015 (million euro). Source: MoF.

Recommendation

1. After assessing the implementation of fiscal rules the Council recommends the following during the preparation and execution of the MTBF 2017/19:
   - The Council disagrees with the MoF's view that for 2017 expenditure ceilings should be calculated on the basis of continuity rule and takes the view that for 2017 it should be done on the basis of the balance rule;
   - The Council does not find the proposed deviation from the MTO on account of the reform in the health care sector compliant with FDL principles and recommends excluding it from the calculations of the fiscal rules and central government expenditure ceilings;
   - The structural balance for 2017 should be improved by 30.1 million euro (0.1% of GDP), for 2018 – by 111.6 million euro (0.4% of GDP), and for 2019 – by 148.1 million euro (0.5% of GDP).

3.3 Government Debt

The Section 14 of the FDL establishes the fiscal rule for government debt, which may not exceed 60% of GDP. There are no separate provisions for conducting fiscal policies in conditions where government debt is approaching or exceeding this specified level.

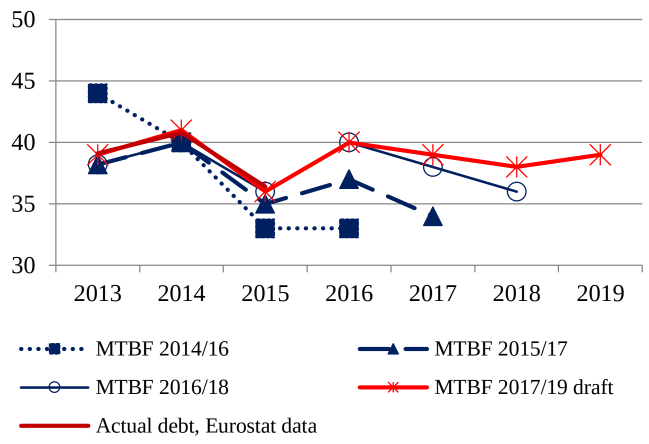


Chart 3.3 General government debt forecasts, % of GDP, Source: The Treasury, Eurostat.

Current forecasts of government debt have reached 40% of GDP (see Chart 3.3). The draft MTBF 2017/19 draft continues the practice of the previous years to increase the forecast substantially, e.g. for year 2016 – from 33% in MTBF 2014/16 to 40% in the current draft of the MTBF 2017/19, i.e. for 7% points.

The Council finds it necessary to reduce the debt level while economic growth persists. Policies envisaging increased debt levels would be irresponsible in view of the demographic situation in the country. The Council would encourage the Government to consider prudent planning of the budget deficit below the maximum threshold permitted by legal acts in order to secure a downward trend of the government debt level and, hence, ensure a better fiscal position if Latvia has to endure another financial and economic crisis in the near future.

The Council notes that, compared to the debt level for 2015 indicated in MTBF 2014/16, the actual debt level has increased by 3% points (see Chart 3.3). The practice of not reducing the debt to GDP ratio in so-called good years (and even increasing it by three percentage points of GDP) is not indicative of sustainable debt management, and it might increase the risk of incurring higher interest payments, reduces future fiscal space and the ability to absorb shocks.

The key reasons behind higher levels of debt have been (i) slower growth of nominal GDP, compared to earlier expectations, (ii) increased borrowing to cover higher than planned nominal deficits, as well as (iii) financing operations, including the provision of capital to airBaltic, the purchase of the SRS building, and the accumulation of liquid financial assets ahead of making large repayments of maturing debt.

Recommendation

1. The Council encourages the Government to consider prudent planning of the budget deficit below the maximum threshold permitted by legal acts in order to secure a downward trend of the government debt level, consequently securing an improved fiscal position to weather another potential financial and economic crisis in the future.