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NOVEMBER 2005 UPDATE OF THE CONVERGENCE PROGRAMME OF LATVIA (2005-2008)

AN ASSESSMENT

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SUMMARY AND CONCLUSIONS[1]

The third updated Latvian convergence programme was sent to the Commission on 30 November and covers the period 2005 to 2008. The programme broadly follows the model structure for stability and convergence programmes specified in the new code of conduct. The programme has gaps in the optional data prescribed by the new code of conduct (in particular, data are not given for labour productivity and hours worked).

Over the last decade, annual real GDP growth in Latvia has averaged over 6%, marking an impressive recovery after the transition-related economic disruption. Real GDP in 2005 is expected to have finally exceeded the pre-1991 level. This growth performance has been characterised by strong productivity developments and more recently also by employment growth. However, evidence of overheating from developments in the external imbalance, inflation and credit expansion has mounted. High external imbalances have left Latvia reliant on capital inflows, and the foreign debt-to-GDP ratio has risen. The programme update projects real GDP growth ease to 7.5% in 2006, down from 8.4% in 2005, followed by a further slight deceleration to 7.0% in both 2007 and 2008. Private consumption and investment are expected to remain the main driving forces of growth, while net exports contributions are expected to turn modestly positive. Overall, projected GDP growth is plausible when compared to the Commission services autumn forecast (to 2007) and to calculations of potential growth. Using the commonly agreed method, on the basis of the figures in the updated programme, indicates that potential GDP growth should remain high but on a slightly declining trend in the medium term; a negative output gap would appear from 2007 onwards. However, the calculation of potential growth (and therefore of the output gap) needs to be interpreted with caution for countries going through a rapid catching-up process. By contrast, the programme's projection for HICP inflation (declining rapidly from 6.9% in 2005 - the highest among the Member States - to 3.5% in 2008) and the current account deficit (declining from 13.0% of GDP in 2004 to 8.0% of GDP in 2008) both seem optimistic, assessed in particular against the Commission services' autumn forecast. Overall, the macroeconomic scenario presents non-negligible risks, to which attention should be given in the context of the convergence process.

Since the lats entered ERM II on 2 May 2005 it has remained well within the fluctuation band of plus or minus one percent declared by the Latvian authorities against the central rate. Spreads of 3-month money rates for lats vis-à-vis the euro came down markedly in the course of the year from over 100 basis points in early January to around 40 basis points in late November. Money market spreads increased sharply in late December, but this seems to have been due to temporary liquidity factors related to the increase in the reserve ratio from 6 to 8 percent effective from 24 December 2005. For most of 2005

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[1] This technical analysis, which is based on information available up to 24 January 2006, accompanies the recommendation by the Commission for a Council opinion on the update of the convergence programme, which the College adopted on 1 February 2006. It has been carried out by the staff of and under the responsibility of the Directorate-General for Economic and Financial Affairs of the European Commission. Comments should be sent to Kristine Vlagsma (Kristine.Vlagsma@cec.eu.int). The analysis takes into account (i) the Commission services' autumn 2005 forecast, (ii) the code of conduct (Opinion of the Economic and Financial Committee on the "Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes", endorsed by the ECOFIN Council of 11 October 2005), (iii) the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances and (iv) the broad economic policy guidelines for the period 2005-2008.

spreads of sovereign bonds vis-à-vis euro area benchmarks have remained at low levels of around 50 basis points.

In its opinion of 8 March 2005, the Council endorsed the budgetary strategy presented in the previous update of the convergence programme, covering the period 2004-2007. While not giving policy invitations, the Council nevertheless considered that the assessment of the appropriate fiscal position was dependent on its contribution to demand pressures in the economy being appropriate to consolidating the moderation in inflation from its then recent peak. As regards budgetary implementation in 2005, the Commission services' autumn 2005 forecast estimated a general government deficit of 1.2% of GDP (based on GDP growth of 9.1%) against a target set in the previous update of the convergence programme of 1.6% of GDP (with GDP growth of 6.7%). However, recent data on a cash basis on the execution of the government budget indicates that the outcome will be even stronger. Hence, the 2005 deficit outturn is very likely to be lower than the present update's estimated general government deficit for 2005 of 1.5% of GDP (based on real GDP growth of 8.4%).

Based on the very cautious estimate of the 2005 outturn for the general government deficit, the update aims at a modest reduction of the deficit later in the programme period. The update foresees the deficit remaining at 1.5% in 2006, declining to 1.4% in 2007 and 1.3% in the final year, 2008. Both revenue- and expenditure-to-GDP ratios are planned to increase over the programme period (by 2 p.p.). Public investment and not separately identified "other expenditure" are set to increase the most and social transfers other than in kind to decrease the most. The primary balance is set to decrease by 0.1 percentage point over the same period. The November 2005 update broadly confirms the previous update's planned adjustment, both as regards modest scale and timing, in spite of a considerably stronger macroeconomic scenario in the most recent update.

Based on Commission services' calculations on the basis of the programme according to the commonly agreed methodology, the structural balance, i.e. the cyclically-adjusted budget balance net of one-off and other temporary measures, is planned to improve only slightly over the programme period (by about ¾ percentage points of GDP). The planned fiscal effort is back-loaded and concentrated in years in which the output gap is estimated to be negative. The update identifies a medium-term objective (MTO) for the budgetary position, as meant in the Stability and Growth Pact, of a structural deficit of "around 1% of GDP", and aims at achieving this position in the final year of programme period. As the programme's MTO is more demanding than the minimum benchmark (estimated at a deficit of around 2% of GDP), its achievement should fulfil the aim of providing a safety margin against the occurrence of an excessive deficit. The programme's MTO could be judged to be at an appropriate level because it adequately reflects the debt ratio and average potential output growth in the long term. However, taking into account the risks to sustainable economic convergence highlighted above, a more demanding MTO would seem appropriate.

The budgetary outcome could be worse than projected in the programme. On the positive side, a cautious track record for budgetary planning suggests that outcomes could be better than targeted (as was the case in 2004 and is also expected by the Commission services for 2005). In particular, growth forecasts as well as assumed tax elasticities underlying the budget have hitherto usually proved on the low side. In addition, budgeted expenditures have not always been fully executed, mainly due to delays in implementation of projects partly financed by EU funding. On the other hand, tax elasticities in the present update appear on the high side; moreover, the programme refers

to several (proposed) social policy measures which would result in increased expenditure, whereas the programme projects the ratio of such expenditure to fall.

In view of this risk assessment, the budgetary strategy outlined in the programme may not be sufficient to achieve a budgetary position in structural terms that can be considered as appropriate under the Pact by the end of the programme period. Also, set against the assessment that the 2005 outturn is likely to have been substantially stronger than assumed in the programme, and possibly close to the MTO, the budgetary target for 2006 could imply a departure from the MTO by up to roughly ½% of GDP in 2006 and also 2007. Moreover, if a stronger 2005 outturn is confirmed and the target for 2006 is maintained, there is also a concern that the fiscal stance in 2006 would then be expansionary and inappropriate, given that the 2005-06 period may qualify as "good times". For euro area and ERM II Member States, the SGP requires an annual improvement in the structural balance of at least 0.5% of GDP (as a benchmark), with a higher adjustment in periods of good times. A stronger structural adjustment path than planned would also seem appropriate to ensure a stable macroeconomic convergence process.

According to the Stability and Growth Pact, "major structural reforms" with a verifiable impact on the long-term sustainability of the public finances should be taken into account when defining the adjustment path to the programme's MTO or for allowing a temporary deviation from the programme's MTO. The programme notes that the ongoing pension reform and introduction of a second pillar, in particular, will gradually reduce social security contributions in the general government balance compared to the 2004 level. The net cost of the pension reform is estimated in the programme at ¼% of GDP in 2005, rising progressively to 1¼% of GDP in 2008. This could allow a temporary deviation from the required yearly adjustment path of 0.5% of GDP towards the programme's MTO because the structural reforms on which it is based are sufficiently detailed in the programme and have a significant beneficial impact on the long-term sustainability of the public finances. Moreover compliance with the budgetary requirements of the Treaty and the Stability and Growth Pact appears ensured as regards the provision of a safety margin against breaching the 3% of GDP deficit reference value in all years of the programme. Nevertheless, the suggestion above for a more demanding pace of adjustment towards the programme's MTO than implied by the programme seems feasible given that in the early programme years the estimated net cost of the pension reform is modest.

The debt ratio is estimated at 14.9% of GDP in 2005, well below the 60% of GDP Treaty reference value. The debt ratio is projected to decrease very slightly over the programme period, to 14.7% of GDP in 2008, with the effects of deficits substantially dampened by high nominal GDP growth.

With regard to the sustainability of public finances, Latvia appears to be at low risk on grounds of the projected budgetary costs of ageing populations. The currently very low level of gross debt is projected to remain below the 60% reference value throughout the 2005-2050 projection period. Latvia's pension reform launched in 1996 contributes significantly to contain the budgetary impact of an ageing population..

The envisaged measures in the area of public finances are broadly consistent with the broad economic policy guidelines included in the integrated guidelines for the period 2005-2008. In particular, the convergence programme outlines measures to support jobs and growth by changes in the revenue and expenditure structure (especially a shift of the tax burden from direct to indirect taxation and a cut in transfers) and by making public

investment a spending priority. Nonetheless, the potential role of the fiscal stance in delivering key objectives, in particular containing inflation and addressing the external account imbalance has not been sufficiently explored.

The National Reform Programme of Latvia, submitted on 21 October 2005, in the context of the renewed Lisbon strategy for growth and jobs, identifies securing macro-economic stability as the main challenge with implications for public finances and to that end allots a major role to the strengthening of fiscal discipline and budgetary planning procedures. The budgetary implications of the limited number of concrete reform measures specified in the National Reform Programme are reflected in the budgetary projections of the convergence programme. The public finance measures envisaged in the convergence programme are in line with the actions foreseen in the National Reform Programme. As mentioned above, the convergence programme outlines measures to support growth and employment by changes in the revenue and expenditure structure (especially a shift of the tax burden from direct to indirect taxation and a cut in transfers) and by making public investment a spending priority.

In view of the above assessment, and in the light of the need to ensure sustainable convergence, including by reducing the external imbalance and containing inflation, it would be appropriate for Latvia to consider the achievement of more ambitious budgetary positions than currently planned, notably by bringing forward the attainment of the MTO set in the programme, maintaining it during the programme period, and avoiding pro-cyclical fiscal policies in "good times".

Comparison of key macroeconomic and budgetary projections

		2004	2005	2006	2007	2008
Real GDP (% change)	**CP Nov 2005**	**8.5**	**8.4**	**7.5**	**7.0**	**7.0**
	COM Nov 2005	8.3	9.1	7.7	7.1	n.a.
	CP Dec 2005	*8.1*	*6.7*	*6.5*	*6.5*	*n.a.*
HICP inflation (%)	**CP Nov2005**	**6.2**	**6.9**	**5.6**	**4.3**	**3.5**
	COM Nov 2005	6.2	6.8	6.0	4.8	n.a.
	CP Dec 2005	*6.2*	*4.3*	*3.0*	*3.0*	*n.a.*
Output gap (% of potential GDP)	**CP Nov 2005[3]**	**0.5**	**0.8**	**0.4**	**-0.5**	**-1.1**
	COM Nov 2005[5]	0.1	0.8	0.3	-0.7	n.a.
	CP Dec. 2005[3]	*1.6*	*0.9*	*0.0*	*-0.5*	*n.a.*
General government balance[1] (% of GDP)	**CP Nov. 2005**	**-1.0**	**-1.5**	**-1.5**	**-1.4**	**-1.3**
	COM Nov 2005	-1.0	-1.2	-1.5	-1.5	n.a.
	CP Dec.2005	*-1.7*	*-1.6*	*-1.5*	*-1.4*	*n.a.*
Primary balance (% of GDP)	**CP Nov 2005**	**-0.2**	**-0.7**	**-0.8**	**-0.6**	**-0.6**
	COM Nov 2005	-0.2	-0.5	-0.8	-0.8	n.a.
	CP Dec 2005	*-0.9*	*-0.8*	*-0.8*	*-0.7*	*n.a.*
Cyclically-adjusted balance= Structural balance[2] (% of GDP)	**CP Nov. 2005[3]**	**-1.1**	**-1.7**	**-1.6**	**-1.3**	**-1.0**
	COM Nov 2005[4]	-1.0	-1.5	-1.6	-1.3	n.a.
	CP Dec 2005	*n.a.*	*n.a.*	*n.a.*	*n.a.*	*n.a.*
Government gross debt (% of GDP)	**CP Nov 2005**	**13.1**	**14.9**	**13.6**	**13.7**	**14.7**
	COM Nov 2005	14.7	12.8	13.0	13.2	n.a.
	CP Dec 2005	*14.2*	*14.5*	*15.8*	*15.0*	*n.a.*

Notes:

[1]The net costs of the ongoing pension reform (introduction of a second pillar) are included in the deficit. The costs are estimated at 0.27% of GDP in 2005, 0.37% of GDP in 2006, 0.62% of GDP in 2007 and 1.32% of GDP in 2008.

[2]Cyclically-adjusted balance (as in the previous rows) excluding one-off and other temporary measures. The year-on year improvement in the cyclically-adjusted balance foreseen in the programme, adjusting for the impact of the phased implementation of the pension reform, would be 0.2% of GDP in 2006, 0.6% in 2007 and 1.0% in 2008, an average of 0.6% in the period 2006-2008. Since there are no other one-off and temporary measures specified in the programme, the cyclically-adjusted balance and the structural balance are identical.

[3]Commission services calculations on the basis of the information in the programme.

[4]There are no one-off and other temporary measures in the Commission services' forecast.

[5]Based on estimated potential growth of 7.9%, 8.3%, 8.3% and 8.2% respectively in the period 2004-2007.

Source:

Convergence programme (CP); Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations

1. INTRODUCTION

The second update of the Latvian convergence programme, covering the period 2005-2008, was submitted on 30 November 2005, following approval by the government on 29 November.[2] The programme was sent to the Latvian Parliamentary Committee on Budget and Finance (Taxation). It was based on the 2006 budget law adopted by Parliament on 20 October 2005 and on the policy document approved by Parliament "Statement on macroeconomic development and fiscal policy in 2006–2010"[3].

The programme broadly follows the model structure for stability and convergence programmes specified in the new code of conduct. The programme provides all compulsory and most optional data prescribed by the new code of conduct. However, in particular, the programme does not provide the optional data on employment, such as hours worked and labour productivity per hours worked (Table 1c of the Annex 2 of the new code of conduct.)[4]: Annex 2 provides a detailed overview of all aspects of compliance with the new code of conduct.

2. ECONOMIC OUTLOOK

After achieving progress in economic reforms and in stabilisation and enjoying a period of high economic growth in the mid-1990s, the Latvian economy suffered a downturn from mid-1998 as a result of the Russian currency crisis. However, supported by successful exports reorientation toward EU market and helped by comprehensive structural reforms in the financial and enterprise sectors, the economy has recovered since early 2000, with industrial output and investment growing and business confidence improving. In the period 1995-2005 real GDP averaged 6% per year on the back of strong productivity developments and more recently also of employment growth. In 2005, GDP per capita in purchasing power standards is estimated to have reached over 45% of the EU average, up from 30% in 1996, and real GDP is expected to have finally exceeded the pre-1991 level. Structural problems in the labour market remain an important impediment to economic growth, in particular low geographical mobility of workers and skills mismatches. Emigration of those seeking employment in other Member States also risks constraining future growth even though this should result in some medium-term improvement of the current account deficit through a rise in remittance receipts[5]. Turning to the demand side, private consumption and investment in particular have been the major driving forces of recent economic development. However, given the economy's dependence on imports, net export contributions have been negative and high external imbalances have left Latvia reliant on capital inflows, and the gross external debt ratio has risen above 90% of GDP. The average annual rate of inflation fell from almost ten-fold in 1992 to a trough of 2.0% in 2002 (followed by 2.9% in 2003).

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2 The English translation of the programme was submitted on 9 December 2005.

3 "Makroekonomiskās attīstības un fiskālās politikas pamatnostādnes 2006. – 2010.gadam."

4 Optional data on "Stock-flow adjustment", "Liquid financial assets" and "Net financial debt" (lines 5, 6 and 7) in Table 4 of the code of conduct are also missing. "Interest expenditure", "pension reserve assets" and "consolidated pension fund assets" in Table 7 have not been provided.

5 It is estimated that currently some 50,000 Latvians (or about 5% of the economically active population) have found employment abroad.

However, inflation rose sharply in 2004 and remains above 6% (the highest in the EU), eroding the external competitiveness of the economy, since May 2005 within the setting of ERM II membership. Credit expansion at an annual rate of 40-60%, (with significant foreign currency denominated lending) is very rapid[6]. Overall, there now appears evidence of overheating.

In the programme update real GDP growth is forecast to be 8.4% in 2005, easing to 7.5% in 2006 and 7.0% in both 2007 and 2008. For the period to 2007, the growth outlook is essentially in line with the Commission services' autumn 2005 forecast (see Table 1). Specifically, final domestic demand is expected to continue to drive growth, primarily led by investment, with housing construction increasing strongly. Private consumption is also expected to remain strong, largely because of employment growth, substantially higher real wages and better access to consumer credit (private sector indebtedness is approaching 60% of GDP, with household sector indebtedness 22% of GDP). Subsequently released data for the third quarter of 2005 indicate that growth may come out stronger than assumed in the update[7]. For 2008, the growth projection of 7.0% seems relatively cautious, in particular when compared with the Commission services' estimate of potential GDP growth (see Table 2). Taking the programme period as a whole, the growth assumptions in the update are plausible. However, given the evidence of over-heating outlined above, all now within the context of ERM II membership, risks for sustainable economic convergence are non-negligible.

Table 1: Comparison of macroeconomic developments and forecasts

	2005		2006		2007		2008
	COM	CP	COM	CP	COM	CP	CP
Real GDP (% change)	9.1	8.4	7.7	7.5	7.1	7.0	7.0
Contributions:							
- Final domestic demand	10.8	10.6	8.6	8.8	8.3	8.3	8.0
- Change in inventories	-1.7	-3.2	0.0	-1.5	0.0	-0.9	-0.1
- External balance on g&s	0.0	0.9	-0.9	0.3	-1.2	0.4	0.9
Output gap[1]	0.8	0.8	0.3	0.4	-0.7	-0.5	-1.1
Employment (% change)	0.9	1.0	0.7	1.0	0.6	0.5	0.5
Unemployment rate (%)	9.7	9.9	9.4	9.3	9.3	9.0	8.7
Labour productivity growth (%)	8.1	7.3	7.0	6.5	6.5	6.5	6.5
HICP inflation (%)	6.8	6.9	6.0	5.6	4.8	4.3	3.5
GDP deflator (% change)	6.2	7.3	7.0	5.8	6.1	4.5	3.7
Compensation of employees (% change)	16.0	16.5	12.0	12.7	10.0	11.3	10.5
External balance (% of GDP)	-11.1	-10.0	-10.5	-8.9	-9.8	-8.1	-8.0

Note:
[1] In percent of potential GDP, with potential GDP growth as reported in Table 2 below.

Source:
Commission services' autumn 2005 economic forecasts (COM); convergence programme update (CP)

Commission services' calculations using the commonly agreed method on the basis of the figures in the updated programme indicate that potential GDP growth remains high but on a slightly declining trend in the medium term. Although it seems that the economy was operating above its potential in 2005, a negative output gap from 2007 onwards

6 Recent rates of credit growth in Latvia are among the very highest among the so-called "early risers" transition economies. See P. Hilbers et al (2005), *Assessing and Managing Rapid Credit Growth and the Role of Supervisory and Prudential Policies*, IMF Working Paper WP/05/151.

7 On 9 December the Latvian national statistical office released national accounts data for 2005 Q3. The figures showed a 2.1% quarterly growth in Q3 (implying a yearly rate of 11.4%) clearly above what was implied in the Commission autumn forecast.

indicates a projected easing of resources pressures. However, the calculation of potential growth (and therefore of the output gap) needs to be interpreted with caution for countries such as Latvia going through a rapid catching-up process. The updated programme projects positive labour market developments against the backdrop of the favourable economic performance. Employment is expected to increase during the entire programme period, though at a falling rate. The projected average labour content of GDP growth is broadly in line with historical values. Favourable growth conditions are expected to contribute to the decline in the rate of unemployment by more than 1 percentage point by the end of the programme period (from 9.9% in 2005 to 8.7% in 2008). Projections for HICP inflation (declining rapidly from 6.9% in 2005 to 3.5% in 2008) and the current account deficit (declining from 13.0% of GDP in 2004 to 8.0% of GDP in 2008) in the programme seem optimistic, assessed by comparison with the Commission services' autumn 2005 forecast. The programme assumes that real wage growth will be just marginally lower than productivity growth and that this factor alone will not generate additional inflationary pressures. This appears relatively optimistic against the backdrop of easy credit condition and inflow of remittances from the Latvian residents employed abroad. The Commission services' forecast foresees higher inflation, despite wage growth assumed to be slightly lower than that presented in the update.

Table 2: Sources of potential output growth

	2005		2006		2007		2008
	COM	CP[2]	COM	CP[2]	COM	CP[2]	CP[2]
Potential GDP growth[1]	8.3	8.0	8.3	8.0	8.2	7.9	7.6
Contributions:							
- Labour	0.9	0.9	0.9	0.9	1.0	0.9	0.7
- Capital accumulation	3.8	3.7	3.7	3.6	3.7	3.6	3.5
- TFP	3.4	3.3	3.4	3.3	3.4	3.3	3.3

Notes:
[1]based on the production function method for calculating potential output growth
[2]Commission services' calculations on the basis of the information in the programme

Source:
Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations

The current account deficit has been on an increasing trend since 1995, but according to the programme is expected to have declined to 10.0% of GDP in 2005, following 13.0% of GDP in 2004. This expected narrowing is the combined result of better export performance as well as a reduction in the income deficit. According to the most recent available estimates, the trade deficit is expected to have reached around 18% of GDP in 2005, despite strong exports growth. The services balance has remained positive, mainly reflecting transit earnings, and in 2005 is likely to have covered about 25% of the trade deficit. In terms of sectoral counterparts the external deficit corresponds to a persistent general government deficit (between 1995 and 2005 averaging 1.6% of GDP) and, of much larger size, a private sector saving-investment gap: increasing saving of the private sector has been outweighed by higher and more rapidly increasing private sector investment (up from 13% of GDP in 1995 to 32% of GDP in 2005).

Looking ahead, the update foresees a rather steep reduction of the current account deficit to 8% of GDP in 2008. When compared to the Commission services' 2005 autumn

forecast, this seems optimistic[8], in particular as regards the assumptions on the pace of deceleration of imports of goods and services.

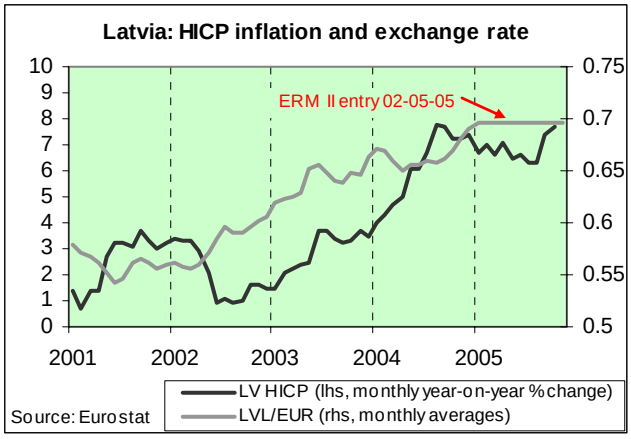
The key external assumptions underlying the programme's macroeconomic scenario include the exchange rate between the US dollar and the euro, GDP growth in the EU 25 and the development of oil prices. These assumptions can be considered as broadly similar to those underlying the Commission services' autumn 2005 forecasts.

3. MEDIUM-TERM MONETARY POLICY OBJECTIVES AND THEIR RELATIONSHIP TO PRICE AND EXCHANGE RATE STABILITY

Latvia continues to pursue the objective of price stability through a firm exchange rate anchor. The lats entered into ERM II on 2 May 2005, with the Latvian authorities having declared that they will maintain the exchange rate within a fluctuation band of plus or minus one percent against the central rate. In line with this commitment, the lats has not deviated outside this band rate through the subsequent period of ERM II participation. The peg continues to enjoy high credibility and remains supported by a reserve cover well above the statutory minimum. The convergence programme reaffirms Latvia's aim to enter the euro area on 1 January 2008 and underlines the authorities' commitment to sound policies in the run-up to euro adoption.

Since July 2004 HICP inflation in Latvia has been the highest among the Member States; core inflation has also progressively increased. Several external factors (notably high oil prices) contributed to the pick-up in inflation in the course of 2005. Food prices continued to increase at a high rate. Administrative price changes were less important in the first half of 2005, though newly approved gas tariffs contributed to upward price pressures in the second half.

Under the current arrangements, the room for the Bank of Latvia to set policy interest rates is very limited. Bank lending rates and spreads of sovereign bonds vis-à-vis euro area benchmarks have remained at low levels throughout 2005. Latvian money market rates have generally remained closely aligned to euro area rates, with spreads of 3-month rates vis-à-vis euro area rates fluctuating around 30 basis points since the re-peg to the euro at the beginning of 2005[9].



[8] However, this partly appears to reflect differences between the authorities' approach and that of the Commission services regarding the attribution of EU financing between the current and capital account accounts. After taking account of both capital and income account flows (mainly reflecting inflows from the EU), it seems reasonable to assume that Latvia's external net lending position should improve. In the programme the deficit narrows to 7.0% of GDP by 2008, down from 12% of GDP in 2004; this seems consistent with the Commission services forecasts, which project a narrowing to 7% of GDP by 2007.

[9] A sharp increase in interbank spreads in late December 2005 seems to have reflected a temporary shortage of liquidity on the increase in reserve requirements implemented on 24 December, for which banks appeared insufficiently prepared; this is expected to be resolved by the beginning of the next reserve period (end-January 2006).

The nominal effective exchange rate of the lats depreciated considerably between mid-2001 and the repegging to the euro, but recorded only limited fluctuations in 2005, reflecting the strong role of the euro and euro-linked currencies in its trade-weighted reference basket. By contrast, in real effective terms measured by export prices, the lats appreciated by just over 2 percent in the course of the first three quarters of the year, reflecting higher inflation rates compared to its trading partners.

4. GENERAL GOVERNMENT BALANCE

This section is in four parts. The first briefly compares the targets for the general government balance in the new update with those presented in the December 2004 update and the original May 2004 convergence programme; it also discusses budgetary implementation in 2005. The second part describes the budgetary strategy in the new update, including the programme's medium-term objective. The third part analyses the risks attached to the budgetary targets and assesses Latvia's position in relation to the budgetary objectives of the Treaty and the Stability and Growth Pact. The final part discusses the results of a sensitivity analysis.

4.1. Targets in successive programmes and implementation in 2005

The updated programme aims at a modest reduction of the general government deficit from an expected outturn of 1.5% of GDP in 2005 to 1.3% of GDP in 2008. Although projected 2005 GDP growth was revised considerably upwards and the 2004 deficit outturn was substantially narrower than projected a year ago, the expected 2005 deficit and the deficit reduction path in the update are essentially unchanged from those foreseen in the December 2004 programme[10]. Both the expenditure-to-GDP and revenue-to-GDP ratios are nevertheless almost 2 percentage points on average lower than indicated in the previous update. Tax revenue as percentage of GDP has been revised upwards, while more than compensated by a downward revision in foreign financial assistance (all as percentages of GDP). On the expenditure side, subsidies and EU funds-related expenditure have been reduced. Similarly, for 2006, both the expenditure-to-GDP and revenue-to-GDP ratios are on average almost 2 percentage points lower than indicated in the previous update. However, the situation is expected to reverse in 2007 when both ratios increase sharply (Table 3).

The outcome for the 2005 deficit estimated in the programme of 1.5% of GDP includes budgetary amendments adopted in August 2005 foreseeing increases in spending within the year of about 1½% of GDP, which were not included in the 2005 deficit target in the December 2004 update of the convergence programme update. However, even after taking account of the additional expenditures, in the light of the very positive cash developments in the state budget recently recorded this estimated outcome appears likely to be overachieved. The Commission services' autumn 2005 forecasts projected a 2005 general government deficit of 1.2% of GDP based on slightly higher output growth assumptions than those of the programme; the recent cash information for the general government budget indicates that the outcome will be even better (see section 4.3.2). On

[10] The 2005 deficit is a slight exception: the December 2005 update projects a deficit of 1.5% of GDP, compared with 1.6% of GDP in the 2004 programme.

the basis of this information, it does not seem unlikely that, in the end, the 2005 deficit may be closer to 1% of GDP than 1.5%.[11]

Table 3: Evolution of budgetary targets in successive programmes

		2004	2005	2006	2007	2008
General government balance (% of GDP)	**CP Nov 2005**	**-1.0**	**-1.5**	**-1.5**	**-1.4**	**-1.3**
	CP Dec 2004	-1.7	-1.6	-1.5	-1.4	n.a.
	CP May 2004	-2.1	-2.2	-2.0	-2.0	n.a.
	COM Nov 2005	-0.9	-1.2	-1.5	-1.5	n.a.
General government expenditure (% of GDP)	**CP Nov 2005**	**36.2**	**36.8**	**37.5**	**38.8**	**38.7**
	CP Dec 2004	36.0	39.3	38.8	36.5	n.a.
	CP May 2004	37.4	38.1	37.2	37.3	n.a.
	COM Nov 2005	36.1	36.4	36.8	36.8	n.a.
General government revenues (% of GDP)	**CP Nov 2005**	**35.2**	**35.3**	**36.1**	**37.4**	**37.4**
	CP Dec 2004	34.3	37.7	37.3	35.1	n.a.
	CP May 2004	35.6	35.9	35.2	35.3	n.a.
	COM Nov 2005	35.2	35.2	35.3	35.3	n.a.
Real GDP (% change)	**CP Nov 2005**	**8.5**	**8.4**	**7.5**	**7.0**	**7.0**
	CP Dec 2004	8.1	6.7	6.5	6.5	n.a.
	CP May 2004	6.7	6.7	6.5	6.5	n.a.
	COM Nov 2005	8.3	9.1	7.7	7.1	n.a.

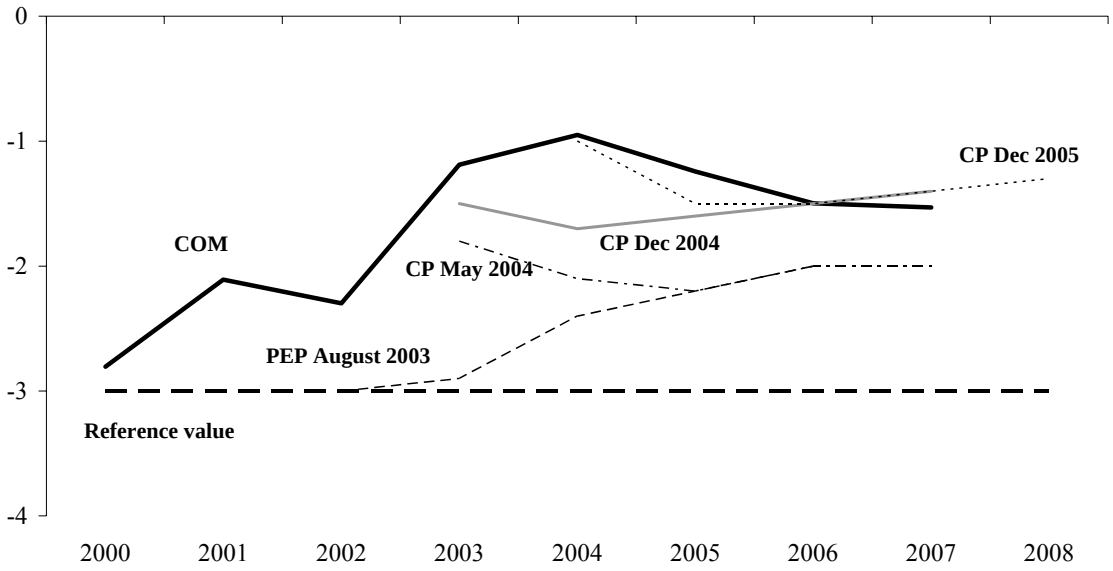
Source:
Convergence programmes (CP) and Commission services' autumn 2005 economic forecasts (COM)

In 2005, the expenditure-to-GDP ratio is roughly 2.5 percentage points lower than indicated in the previous update. The revenue-to-GDP ratio is 2.4 percentage points lower, resulting in a 0.1 percentage point improvement in the general government balance compared to the previous target. The differences on both - the revenue and the expenditure - sides are explained by more cautious projections regarding the implementation of EU funds financed projects than estimated in the previous update. In sectoral terms, the improvement reflects stronger-than-budgeted social security and local government sector balances, offset by a slightly weaker performance of the central government sector

In nominal terms, tax revenues have come in better than expected. This is to a large extent explained by higher corporate tax revenues determined by a significant increase in total turnover and profit in 2004. Other tax revenues such as VAT also look better than forecast last year. General government expenditures are higher in nominal terms than projected in the previous update, given the continued practice of mid-term budgetary amendments. However, upwards revisions in some budget items to compensate for high inflation also contributed to the increase.

[11] For 2004, the deficit outcome of 1.0% of GDP was likewise considerably lower than expected in the December 2004 convergence programme (-1.7% of GDP).

Figure 1: General government balance projections in successive convergence programmes (% of GDP)



Source : Commission services' autumn 2005 forecast (COM) and successive convergence

4.2. The programme's medium-term budgetary strategy

This section covers in turn the following aspects of the medium-term budgetary strategy outlined in the programme: (i) the main goal of the budgetary strategy; (ii) the composition of the budgetary adjustment, including the broad measures envisaged; and (iii) the programme's medium-term objective and the adjustment path towards it in structural terms.

4.2.1. The main goal of the programme's budgetary strategy

The main stated goal of the programme is to preserve high and sustainable economic growth. The programme sets out to ensure implementation of the Maastricht criteria and a gradual improvement of the fiscal outlook.

While both the revenue and expenditure to-GDP-ratios are planned to increase over the programme period, the update targets a decrease in the general government deficit by 0.2 percentage points between 2005 and 2008 and a 0.1 percentage point decrease in the primary deficit over the same period (Table 4). The bulk of the planned fiscal adjustment on the revenue and the expenditure side is back-loaded, expected to take place in 2007 and 2008. Furthermore, given the likelihood of a much better outturn for 2005 than estimated in the programme, the achievement of the 2006 target would in this case imply a significant fiscal easing against the background of persisting very high demand pressures and sustainable economic convergence risks.

Compared with the previous programme update, the November 2005 update broadly confirms the previously planned nominal adjustment, although assumed GDP growth is stronger.

Table 4: Composition of the budgetary adjustment

(% of GDP)	2004	2005	2006	2007	2008	Change: 2008-2005
Revenues	35.2	35.3	36.1	37.4	37.4	**2.1**
of which:						
- Taxes & social contributions	28.8	28.9	30.2	31.1	31.4	**2.6**
- Other	6.4	6.4	5.8	6.3	6	**-0.5**
Expenditure	36.2	36.8	37.5	38.8	38.7	**1.9**
of which:						
- Primary expenditure	35.5	36.1	36.8	38.1	38.0	**1.9**
of which:						
Consumption	10.7	11.7	11.8	11.7	11.6	**-0.1**
Transfers other than in kind & subsidies	9.8	9.8	9.6	9.3	9.3	**-0.5**
Gross fixed capital formation	1.5	2.3	2.5	2.9	3.3	**1.0**
Other (particularly, co-financing of EU-funds related expenditure, payments to international organizations)	13.5	12.3	12.9	14.2	13.8	**1.5**
- Interest expenditure	0.7	0.7	0.7	0.7	0.7	**0.0**
General government balance (GGB)-	**-1.0**	**-1.5**	**-1.5**	**-1.4**	**-1.3**	**0.2**
Primary balance	**-0.3**	**-0.8**	**-0.8**	**-0.7**	**-0.6**	**0.2**
One-off and other temporary measures	0.0	0.0	0.0	0.0	0.0	0.0
GGB excl. one-off & other temporary measures	**-1.0**	**-1.5**	**-1.5**	**-1.4**	**-1.3**	**0.2**
Source: *Convergence programme update; Commission services' calculations*						

4.2.2. The composition of the budgetary adjustment in the programme

The budgetary consolidation is expected to occur mainly on the revenue side. Both revenue and expenditure to-GDP-ratios are planned to increase over the programme period (by 2.1 p.p. and 1.9 p.p. respectively) with public investment and not separately identified "other expenditure"[12] increasing the most (from 2.3% of GDP in 2005 to 3.3% of GDP in 2008 and from 12.3% of GDP to 13.8% of GDP in 2008) and social transfers other than in kind decreasing the most (from 9.3% of GDP in 2005 to 8.9% of GDP in 2008). Furthermore, the programme notes that the ongoing pension reform[13] and introduction of a second pillar, in particular, will gradually increase the share of social security contributions accruing to the state-funded pension scheme until 2010; accordingly, social security contributions in the general government balance will decline by about 1% of GDP in 2008 compared to the 2004 level. The net cost of the pension reform is estimated in the programme at ¼% of GDP in 2005, rising progressively to 1¼% of GDP in 2008. Altogether, social security is expected to show stable surpluses, while the central government and the local government sub-sector deficits determine the changes in the general government position.

In the medium term, the programme assumes the tax structure to remain basically stable. Nevertheless, the programme expects that, as a result of raising the starting threshold for personal income tax, the share of employment taxes will gradually shrink, whereas the

[12] This includes financing of EU-funds related expenditure, payments to international organizations, subsidies.

[13] See chapter 7 for more detailed overview of the pension reform.

share of consumption and capital taxes will expand. Other changes to the tax system provide for the gradual harmonization (increase) of the excise tax rates on oil and tobacco products with EU rates and a reduction in the real estate tax base.

Box 1: The budget for 2006

The Latvian 2006 budget law was adopted on 20 October 2005. The draft budget targets a general government deficit of 1.5% of GDP in 2006.

The budget was presented in the framework of promoting economic growth and social welfare and the implementation of structural reforms. The impact of EU accession is most notably associated with an increase in the size of the budget. Accordingly, total general government budget revenues are set to increase by 19.5% in comparison with the amended 2005 budget and expenditure by 17.9%. Foreign financial assistance including receipts from EU funds account for LVL 459.9 million, 5.0% of GDP.

The main measures on the revenue side are the following:

Increase in the personal income tax-free threshold from LVL 26 (EUR 37) per month to LVL 32 (EUR 45) per month and the setting of income tax rebates for dependents at LVL 22 (EUR 31) per month (LVL 21.3 million 2006, 0.2% of GDP);

Increase in excise duties on oil and tobacco products and beer (LVL 9.7 million 2005, 0.1% of GDP);

The main measures on the expenditure side are the following:

Financing for EU structural funds and other financial instruments (LVL 374 million 2006, 4.0% of GDP);

Reform of the National Armed Forces and NATO integration related requirements (LVL 42.7 million 2006, 0.4% of GDP);

Modernization and restructuring of the healthcare system (LVL 31.1 million 2005, 0.3% of GDP);

Increased teachers' wages (LVL 33.1 million 2005, 0.3% of GDP);

Other measures to improve social conditions including pension indexation, increase in minimum wage (LVL 95.7 million 2006, 0.9% of GDP).

4.2.3. The programme's medium-term objective (MTO) and the adjustment path in structural terms

According to the Stability and Growth Pact, stability and convergence programmes should present a medium-term objective (MTO) for the budgetary position. The MTO should be differentiated for individual Member States, to take into account the diversity of economic and budgetary positions and developments as well as of fiscal risk to the sustainability of public finances. The country-specific MTO is defined in structural terms (i.e. cyclically-adjusted, net of one-off and other temporary measures) and should fulfil a triple aim: (i) provide a safety margin with respect to the 3% of GDP deficit limit; (ii) ensure rapid progress towards sustainability; and (iii), taking (i) and (ii) into account, allow room for budgetary manoeuvre, considering in particular the needs for public investment. Section I of the code of conduct further specifies that, as long as the methodology for incorporating implicit liabilities is not fully developed and agreed by the Council, the country-specific MTOs are set taking into account the current government debt ratio and potential growth (in a long-term perspective), while preserving a sufficient margin against breaching the deficit reference value of 3% of GDP. Member States are free to set an MTO that is more demanding than strictly required to achieve the triple aim set out above.

The November 2005 update of the convergence programme identifies an MTO of a deficit of around 1% of GDP which it aims to achieve by the end of the programme period. Based on Commission services' calculations on the basis of the programme according to the commonly agreed methodology, the structural deficit will reach about 1% of GDP in 2008. Following a deterioration in 2005, the structural balance (i.e. the cyclically-adjusted balance net of one-off and other temporary measures) is planned to improve modestly over the programme period (by ¾ percentage points of GDP). However, given the probably significantly better outturn in 2005 than assumed in the programme, the budgetary target for 2006 would also imply a deterioration of the structural balance in that year; followed by an improvement of about 1/3 of a percentage point of GDP in both 2007 and 2008. The fiscal effort planned in the programme is thus back-loaded. Given the uncertainty in the measurement of CABs and the positive risks to the 2005 outcome (see section 4.3.2), the MTO set in the programme may have been achieved already in 2005. If so, the expansionary budget for 2006 would shift the budget position away from the MTO by roughly ½% of GDP in 2006, with this divergence persisting in 2007.

According to the revised Stability and Growth Pact and the new code of conduct, Member States that have not yet reached their MTO can temporarily depart from the required adjustment path, while Member States that have already reached their MTO can temporarily deviate from it, in case of major structural reforms that have a verifiable positive impact on the long-term sustainability of the public finances. In both cases the budgetary position has to return to the MTO within the period covered by the programme. The claim to such a temporary deviation should be supported by a detailed quantitative cost-benefit-analysis (of the short-term costs and of the long-term benefits) from the budgetary point of view, to be presented in the programme.

The programme describes the ongoing pension reform endorsed by the Parliament in 1995 (see also Section 2 above and Chapter 6 and 7 below), which can qualify as a "major structural reform" in the meaning of the revised Stability and Growth Pact. According to the programme, a temporary deviation from the adjustment path towards the programme's MTO might be warranted. The ongoing pension reform and introduction of a second pillar, in particular, will gradually reduce social security contributions in the general government balance compared to the 2004 level. The net cost of the pension reform is estimated in the programme at ¼% of GDP in 2005, rising progressively to 1¼% of GDP in 2008[14]. On the basis of this reform, the programme indicates a possible departure from the annual structural adjustment of at least 0.5% of GDP, set out as a benchmark by the code of conduct for ERM II countries like Latvia, but envisages that the MTO level, set at -1% of GDP, will be achieved by the end of the programme period.

Moreover, the healthcare reform, which is in its early stages of implementation, is expected to increase efficiency of the services and thereby contribute positively to sustainability of the future healthcare expenditure. However, the programme fails to support the claim to a temporary deviation on basis of the healthcare reform with a detailed presentation of budgetary costs and benefits in the short and long term, as requested by the code of conduct.

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[14] The net costs of the ongoing pension reform (introduction of a second pillar) are estimated at 0.27% of GDP in 2005, 0.37% of GDP in 2006, 0.62% of GDP in 2007 and 1.32% of GDP in 2008.

Table 5: Output gaps, cyclically-adjusted and structural balances

% of GDP	2004		2005		2006		2007		2008	Change: 2008-2005
	COM	CP[1]	COM	CP[1]	COM	CP[1]	COM	CP[1]	CP[1]	CP[1]
Gen. gov't balance	-0.9	-1.0	-1.2	-1.5	-1.5	-1.5	-1.5	-1.4	-1.3	0.2
One-offs[2]	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-
Output gap[3]	0.1	0.5	0.8	0.8	0.3	0.4	-0.7	-0.5	-1.1	-
CAB[4]	-1.0	-0.6	-1.5	-1.7	-1.6	-1.6	-1.3	-1.3	-1.0	0.7
change in CAB	*0.1*	*0.9*	*-0.5*	*-1.1*	*-0.1*	*0.1*	*0.3*	*0.3*	*0.3*	-
CAPB[4]	-0.2	0.1	-0.8	-1.0	-0.9	-0.9	-0.6	-0.6	-0.3	0.7
Structural balance[5]	-1.0	-0.6	-1.5	-1.7	-1.6	-1.6	-1.3	-1.3	-1.0	0.7
change in struct. bal.	*0.1*	*0.9*	-0.5	*-1.1*	-0.1	*0.1*	0.3	*0.3*	*0.3*	-
Struct. prim. bal.[6]	-0.2	0.1	-0.8	-1.0	-0.9	-0.9	-0.6	-0.6	-0.3	0.7

Notes:
[1]Output gaps and cyclical adjustment according to the convergence programme (CP) as recalculated by Commission services on the basis of the information in the programme
[2]One-off and other temporary measures
[3]In percent of potential GDP. See Table 1 above.
[4]CAB = cyclically-adjusted balance; CAPB = cyclically-adjusted primary balance.
[5]CAB excluding one-off and other temporary measures
[6]Structural primary balance = CAPB excluding one-off and other temporary measures

Source:
Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations

4.3. Assessment

This assessment is in three parts. The first assesses the appropriateness of the programme's medium-term objective. The second analyses risks attached to the budgetary targets and the third examines whether the budgetary strategy laid down in the programme is consistent with the budgetary objectives of the Treaty and the Stability and Growth Pact.

4.3.1. Appropriateness of the programme's medium-term objective

As the programme's MTO is more demanding than the minimum benchmark, its achievement should fulfil the aim of providing a safety margin. The programme's MTO lies within the range indicated for euro area and ERM II Member States in the Stability and Growth Pact and the code of conduct and adequately reflects the debt ratio and average potential output growth in the long term. On these criteria the MTO set in the programme could be judged appropriate, even if on wider macro stability and convergence grounds a more demanding MTO could have been considered.

4.3.2. Risks attached to the budgetary targets

The budgetary outcome could be worse than projected in the programme.

The macroeconomic scenario is in line with the Commission services forecast and projected actual growth is below estimated potential growth towards the end of the programme period. Hitherto, the growth assumptions underlying the budgets and the assumptions about tax elasticities have usually proved cautious. The track record of cautious budgetary planning indeed indicates that outcomes could be better than targeted (as was the case in 2004 and is expected by the Commission services also for 2005). In addition, budgeted expenditures have not always been fully executed, mainly due to delays in implementation of projects partly financed by EU funding. Recent information

also points to some positive risks. National accounts for the third quarter of 2005 point to growth in both 2005 and possibly also 2006 higher than forecast by the Commission services in the autumn. More relevantly, and as already discussed in section 4.1, recent cash data indicate that 2005 tax revenues may be substantially stronger than included in the update figures. While it is still difficult to assess the magnitude of this in national accounts terms and its permanent impact on 2006-08 revenue figures, it is still likely to be positive.

On the other hand, tax elasticities assumed in the update for 2006 and 2007 appear high compared with those in the Commission services' forecasts (Table 6). Under a no-policy change scenario, the Commission services expect a fairly stable tax ratio throughout the programme period. However, the elasticity component[15] of the annual changes in the overall tax-to-GDP ratio projected in the programme is exceptionally positive. The apparently large and positive differences in the elasticity component would seemingly imply implementation of measures, such as increased tax rates, whereas the update states that no significant changes in the structure of taxes are planned for the programme period (although some measures *are* outlined in the programme, with the balance of these actually pointing towards reduced elasticities). The composition component[16] indicates that the update's macroeconomic framework underlying the projections of tax intensity based on economic activity is plausible, though again on the high side. Moreover, the programme refers to several (proposed) measures in the area of social spending which would result in increased expenditure under this heading, whereas the programme projects the ratio of such expenditure to fall. On balance, the budgetary outcome could thus be worse than projected in the programme.

Table 6: Assessment of tax projections

	2006		2007		2008	p.m.:
	COM	CP	COM[2]	CP	CP	OECD[1]
Total taxes						
Change in tax-to-GDP ratio	-0.2	1.5	0.0	1.1	0.3	/
Difference	1.7		1.1		/	/
of which[3]: - elasticity component	1.5		0.7		/	/
- composition component	0.2		0.5		/	/
p.m.: Observed elasticity to GDP	1.0	1.4	1.0	1.3	1.1	0.9

Notes:
[1] OECD ex-ante elasticity relative to GDP
[2] On a no-policy change basis
[3] The decomposition is explained in Annex 4

Source:
Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations and OECD (N. Girouard and C. André (2005), "Measuring Cyclically-Adjusted Budget Balances for the OECD Countries", OECD Working Paper No. 434)

The marginally declining tax revenue (indicated by the comparison of the observed and ex ante tax elasticities in Table 7) mainly reflects an assumed overall improvement in tax administration, the indirect tax adjustments and discretionary measures in direct income taxes and social contributions mentioned before. This is confirmed in more detail in Annex 4, which assesses tax elasticities by major tax category. The observed change in

[15] The elasticity component captures the tax elasticity of discretionary revenue measures relative to GDP.

[16] The composition component captures differences in the composition of GDP growth.

the tax-to-GDP ratio net of the effect of discretionary measures appears to be close to that implied by the OECD elasticities.

Table 7: Assessment of tax elasticities

	2006		2007	
	COM (observed)	**ex-ante[1]**	**COM[2] (observed)**	**ex-ante[1]**
Total taxes Change in tax-to-GDP ratio	-0.2	-0.4	0.0	-0.3
Difference	0.2		0.3	
of which[3]: - elasticity component	0.0		0.2	
- composition component	0.2		0.0	
p.m.: Elasticity to GDP	1.0	0.9	1.0	0.9

Notes:
[1]Tax projections obtained by applying ex-ante standard tax elasticities estimated by the OECD
[2]On a no-policy change basis
[3]The decomposition is explained in Annex 4

Source:
Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations and OECD (N. Girouard and C. André (2005), "Measuring Cyclically-Adjusted Budget Balances for the OECD Countries", OECD Working Paper No. 434)

4.3.3. Compliance with the budgetary requirements of the Treaty and the Stability and Growth Pact

In view of this risk assessment, the budgetary stance in the programme may not be sufficient to achieve the MTO - or to return to it if the 2005 outturn is confirmed as having indeed been close to the MTO - by the end of the programme period. In the case of a better than officially estimated 2005 outturn, the expansionary budget for 2006 would shift the budget position *away* from the MTO by roughly ½% of GDP in 2006 and 2007, increasing the risk that subsequent convergence back towards the MTO will take a somewhat longer time in a context of continuing very high demand pressures and some stability risks.

The budgetary stance in the programme seems to provide a sufficient safety margin against breaching the 3% of GDP deficit threshold with normal macroeconomic fluctuations throughout the programme period. However, even were the update's estimated 2005 budget confirmed – against the expectations referred to above - the pace of the subsequent adjustment towards the programme's MTO implied by the programme is not in line with the Stability and Growth Pact, which specifies that, for euro area and ERM II Member States, the annual improvement in the structural balance should be 0.5% of GDP as a benchmark and that the adjustment should be higher in good economic times and could be lower in bad economic times.

If the 2005 budget outturn is confirmed to be significantly better than estimated in the programme, there is also a concern that the planned fiscal stance in 2006 would then be pro-cyclical, evidenced by the estimated output gap being positive in 2005-2006. Overall, this period could qualify as "good times" using the terminology of the revised SGP. Therefore, taking into account the macroeconomic risks (i.e. risk to sustainable convergence) highlighted in section 2, a more demanding MTO would be appropriate.

The programme motivates a temporary deviation from the adjustment path towards the programme's MTO on the basis of "major structural reforms". It indicates a departure from the "benchmark" speed of structural adjustment based on the fiscal effort needed to cope with the net cost of pension reform[17].

The conditions to allow for a temporary deviation set out in the code of conduct seem to be satisfied. The structural reforms on which the deviation is based are sufficiently detailed in the programme and have a significant beneficial impact on the long-term sustainability of the public finances Moreover compliance with the budgetary requirements of the Treaty and the Stability and Growth Pact appears ensured as regards the provision of a safety margin against breaching the 3% of GDP deficit reference value in all years of the programme. Therefore, the indicated temporary deviation from the adjustment path towards the MTO might be admissible. Nevertheless, the suggestion above for a more demanding pace of adjustment towards the programme's MTO than implied by the programme seems feasible given that in the early programme years the estimated net cost of the pension reform is modest.

Overall, the programme is broadly consistent with the broad economic policy guidelines regarding economic stability and sustainability. Nonetheless, greater focus is needed on delivering the key objectives, such as containing inflation, addressing the external account imbalance and increasing activity rates by promoting an inclusive labour market. While a sufficiently strong medium-term budgetary position is planned to be maintained, the failure to move convincingly closer towards the MTO in 2006-2007 may risk being pro-cyclical and also put at risk the achievement of the MTO at the end of the programme period. More broadly, the continuing evidence of overheating points to the need for demand restraint to improve the saving-investment balance and slow external debt accumulation, to which the fiscal stance can usefully contribute, even if this has to be framed within a more comprehensive macroeconomic strategy.

4.4. Sensitivity analysis

The programme includes a sensitivity analysis of public finances, taking into consideration two alternative, symmetric growth scenarios. In the two scenarios, optimistic and pessimistic assumptions about the external environment, and their impact on domestic demand through private consumption and investment, result in a GDP growth variation of ±1.0 percentage points compared to the central scenario in 2006, 2007 and 2008. The analysis also assumes that inflation and real public consumption growth are the same across all scenarios. In the optimistic scenario, stronger economic activity results in higher revenues, coming from increasing income tax and social contributions, of the order of 16-17 million lats, equivalent on average to some 0.13% of GDP in 2008. The negative impact on public finances in the pessimistic scenario is a reduction of about 20 million lats (0.14% of GDP), due mainly to lower production and import taxes and, especially, value-added tax revenues. Even in the pessimistic case, the

[17] The net costs of the ongoing pension reform (introduction of a second pillar) are estimated at 0.27% of GDP in 2005, 0.37% of GDP in 2006, 0.62% of GDP in 2007 and 1.32% of GDP in 2008. The year-on year improvement in the cyclically-adjusted balance foreseen in the programme, adjusting for the impact of the phased implementation of the pension reform, would be 0.2% of GDP in 2006, 0.6% in 2007 and 1.0% in 2008, an average of 0.6% in the period 2006-2008.

deficit remains below the Treaty reference level. The programme does not analyse the potential effects of the alternative scenarios on the debt-to-GDP ratio.

Commission services' simulations of the cyclically-adjusted balance under the assumptions of (i) a sustained 0.5 percentage point deviation from the real GDP growth projections in the programme over the 2005-2008 period; (ii) trend output based on the HP-filter[18] and (iii) no policy response (notably, the expenditure level is as in the central scenario[19]) indicate that, by 2008, the cyclically-adjusted balance is 0.5 percentage point of GDP above/below the central scenario. Hence, in the case of persistently lower real growth, additional measures of more then ½ percentage point of GDP would be necessary to keep the public finances on the path targeted in the central scenario.[20] .

5. GENERAL GOVERNMENT GROSS DEBT

This section is in two parts: the first describes the debt path envisaged in the programme and the second contains the assessment.

5.1. Debt developments in the programme

The debt ratio is estimated at 14.9% of GDP at the end of 2005, clearly far below the 60% of GDP Treaty reference value. The debt ratio is projected to decline very slightly over the programme period, to 14.7% of GDP in 2008, with the effect of persisting deficits substantially offset by high nominal GDP growth.

Table 8: Debt dynamics

	average 2000-2004	2005		2006		2007		2008
	COM	COM	CP	COM	CP	COM	CP	CP
Government gross debt ratio	**14.3**	**12.8**	**14.9**	**13.0**	**13.6**	**13.2**	**13.7**	**14.7**
Change in debt ratio (1 = 2+3+4)	0.4	-1.9	0.2	0.2	-1.3	0.2	0.1	1.0
Contributions[1]*:*								
- **Primary balance** (2)	**1.0**	**0.5**	**0.8**	**0.8**	**0.8**	**0.8**	**0.7**	**0.6**
- **"Snow-ball" effect** (3)	**-0.6**	**-1.3**	**-1.3**	**-1.0**	**-1.1**	**-0.9**	**-0.7**	**-0.7**
- Interest expenditure	0.9	0.7	0.7	0.7	0.7	0.7	0.7	0.7
- Real GDP growth	-0.9	-1.2	-1.1	-0.9	-1.0	-0.8	-0.9	-0.9
- Inflation (GDP deflator)	-0.5	-0.8	-1.0	-0.8	-0.8	-0.7	-0.6	-0.5
- **Stock-flow adjustment** (4)	**0.0**	**-1.2**	**0.8**	**0.4**	**-1.0**	**0.2**	**0.1**	**1.1**
- Cash/accruals	0.0							
- Accumulation of financial	-0.3							
assets	-0.5							
of which: Privatisation proceeds	0.2							
- Valuation effects & residual adj.								
p.m.: Debt ratio excl. second-pillar	14.3	12.8	14.9	13.0	13.6	13.2	13.7	14.7

[18] In the absence of a fully-specified macroeconomic scenario that would underlie such deviations, it is obviously impossible to derive new estimates of potential growth from the agreed production function method.

[19] The effect of lower/higher growth on revenues is captured by using the conventional sensitivity parameters adopted in cyclical adjustment procedures.

[20] Unexpected changes in inflation are not assumed to affect the expenditure-to-GDP ratio as nominal expenditure should broadly move in lockstep with the price level.

pension scheme[2]								

Note:
The change in the gross debt ratio can be decomposed as follows:

$$\frac{D_t}{Y_t} - \frac{D_{t-1}}{Y_{t-1}} = \frac{PD_t}{Y_t} + \left(\frac{D_{t-1}}{Y_{t-1}} * \frac{i_t - y_t}{1 + y_t} \right) + \frac{SF_t}{Y_t}$$

where t is a time subscript; D, PD, Y and SF are the stock of government debt, the primary deficit, nominal GDP and the stock-flow adjustment respectively, and i and y represent the average cost of debt and nominal GDP growth. The term in parentheses represents the "snow-ball" effect.

Source:
Convergence programme update (CP); Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations

5.2. Assessment

The programme's projections for government debt are slightly above the Commission services' autumn 2005 forecasts. This is mainly due a lower primary (and overall) deficit projected by the Commission services in 2005 (see Section 4.1). The differences arise mainly in the size and the expected timing of stock flow adjustments, where the difference is particularly large in 2005. The programme does not provide any insights for its assumptions underlying stock-flow effects, which in the Commission services' autumn forecast was based on information regarding expected privatisations and available data on a cash basis.

6. STRUCTURAL REFORM, THE QUALITY OF PUBLIC FINANCES AND INSTITUTIONAL FEATURES

As highlighted above (Subsection 4.2.2), the reduction in the general government deficit ratio over the programme period is expected to occur in relative terms mainly on the revenue side. While both revenue and expenditure to GDP ratios are planned to increase over the programme period, the increase in the revenue ratio is expected to outpace that in the expenditure ratio. In the medium term, no significant changes in the structure of taxes are planned (though as indicated in Subsection 4.3.2 some measures are envisaged). Nevertheless, it is expected that, as a result of raising the starting tax-exempt threshold for personal income tax, the share of employment taxes will gradually shrink, whereas the share of consumption and capital taxes will expand. Within expenditure, the share of investment should increase while that of consumption and transfers diminishes.

Prioritising public investment and shifting the tax burden from direct to indirect taxation can be expected to be less distorting for economic activity and to have a positive effect on both economic growth and labour market participation, particularly among the low- and medium-income labour force. Furthermore, the need for continued institution-building and strengthening of public administration to ensure efficiency accounts for a large part of the increase in expenditure. Government priorities include: the modernization and restructuring of the healthcare system, requiring a sizable annual increase in public financing over the medium term; a significant increase in the financing of the fundamental research and higher education; ensuring pension indexation and an increase in childcare allowances. The programme also notes that pension reform will gradually increase the share of social security contributions accruing to the state-funded pension scheme until 2010; accordingly, social security contributions in the general government balance will decline by 1.1% points of GDP in 2008 compared to the 2004 level.

As regards institutional features of the public finances, the quality of the budgetary process in Latvia is influenced by two recently introduced innovations intended to enhance budgetary discipline: a medium-term budget framework, including budgeting of the structural policy measures recognized as government policy priorities and the establishment of limits on annual deficits; and further efforts to improve auditing. Further measures to simplify and improve tax administration are also being implemented.

As regards structural reform, the envisaged measures are broadly consistent with the broad economic policy guidelines in the area of public finances included in the integrated guidelines for the period 2005-2008. In particular, the convergence programme outlines measures to support jobs and growth by changes in the revenue and expenditure structure (especially a shift of the tax burden from direct to indirect taxation and a cut in transfers) and by making public investment a spending priority. Nonetheless, greater focus is needed on the potential contribution of the fiscal stance to delivering key objectives, in particular containing inflation and addressing the external account imbalance.

The National Reform Programme of Latvia, submitted on 21 October 2005, identifies securing macro-economic stability as the main challenge with implications for public finances and to that end allots a major role to the strengthening of fiscal discipline and budgetary planning procedures. The budgetary implications of the limited number of concrete reform measures specified in the National Reform Programme are reflected in the budgetary projections of the convergence programme. The public finance measures envisaged in the convergence programme are in line with the actions foreseen in the National Reform Programme. In particular, the convergence programme outlines measures to support growth and employment by changes in the revenue and expenditure structure (especially a shift of the tax burden from direct to indirect taxation and a cut in transfers) and by making public investment a spending priority. Nonetheless, as for the comparison with the broad economic policy guidelines, greater focus is needed on delivering the key objectives.

7. THE SUSTAINABILITY OF THE PUBLIC FINANCES

The assessment of the sustainability of the Latvia's public finances is based on an overall judgement of the results of quantitative indicators and qualitative features. The debt projections and sustainability indicators are calculated according to two different scenarios, to take into account different budgetary developments over the medium term. The "programme" scenario assumes that the medium-term budgetary plans set up in the programme are actually achieved. The "2005" scenario assumes that the structural primary balance[21] remains unchanged at the 2005 level throughout the programme period.

On the basis of the information in the update, age-related expenditure is foreseen to increase by only 0.3% of GDP between 2008 and 2050, to which the health-care expenditures contribute most by an increase of 0.6% of GDP (see Table A2 in the Annex). The Commission's analysis is based on the set of government expenditure items

[21] The primary balance where the effect of the cycle and any one-off or temporary measures have been netted out.

covered by the common projections carried out by the Economic Policy Committee[22]. Tax revenues and non-age related expenditures have been kept constant throughout the projection period.

The gross debt-to-GDP ratio, being considerably below the average level in the EU at present, is projected to remain below the 60% of GDP reference value throughout the projections period up to the 2050 in both the '2005' scenario and the 'programme' scenario (see Table A4 in the Annex)[23].

According to the S1 indicator, there is no sustainability gap for Latvia in both the '2005' and the 'programme' scenario. The projected future budgetary impact of ageing populations up to 2050 is very small.

The government's inter-temporal budget constraint, captured by the S2 indicator, reveals that a sustainability gap of about 1% of GDP emerges in the '2005' scenario. In the 'programme' scenario, a smaller sustainability gap emerges. This sustainability gap translates into a required primary balance (RPB) of about 1% of GDP, higher than the structural primary balance of about -¼% of GDP in the last year of the programme period.

According to the S2 indicator, the impact of ageing is very limited, due to the cost-saving impact of the pension reform. Nevertheless, a consolidation of the public finances would contribute to reduce them.

Moreover, the sustainability gap, as measured by S2, would increase marginally by up to 0.1% GDP if the (budgetary or structural) adjustment was to be postponed by 5 years (see table A3 in the Annex).

Table 1: Sustainability indicators and the required primary balance

	Sustainability indicators and RPB						
	2005 scenario			Programme scenario			
	S1	S2		RPB	S1	S2		RPB
Value (of which)	**-0.2**	**1.1**		**1.0**	**-0.9**	**0.4**		**1.0**
initial budgetary position	*1.0*	*1.2*			*0.3*	*0.5*		
debt requirement in 2050	*-0.8*	*:*			*-0.8*	*:*		
future changes in budgetary position	*-0.4*	*-0.1*			*-0.4*	*-0.1*		

Note: The S1 indicator shows the difference, the sustainability gap, between the constant revenue ratio as a share of GDP required to reach a debt ratio in 2050 of 60% of GDP and the current revenue ratio. The S2 indicator, which shows the difference, the sustainability gap, between the constant revenue ratio as a share of GDP that guarantees the respect of the inter-temporal budget constraint of the government, i.e. that equates the actualized flow of revenues and expenses over an infinite horizon, and the current revenue ratio[24]. The Required Primary Balance (RPB) measures the average primary balance over the first five years of the projection period that results from a permanent budgetary adjustment carried out to comply fully with the inter-temporal budget constraint. See European Commission ((2005), European Economy, 'Public finances in EMU – 2005, Section II.3 for a further description.

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22 Namely, government expenditure on pension, health-care, long-term care, education and unemployment benefits.

23 It should be recalled that, being a mechanical, partial equilibrium analysis, projections are in some cases bound to show highly accentuated profiles. As a consequence, the projected evolution of debt levels should not be taken as a forecast.

24 The sustainability gap indicators (S1, S2) do not necessarily suggest that taxes should be increased; strengthening the fiscal position by permanently reducing the level of non-age related primary spending could be preferable and has the same impact.

In interpreting these results, several factors need to be taken into account.

The underlying assumptions used when making the long-term projections are those commonly agreed and used by the EPC in the current common projections exercise. Overall, the underlying assumptions in the programme can therefore be considered to be plausible.

The update highlights two major public revenue-reducing effects. The revenue side of the public (pay-as-you-go) pillar is expected to be affected by lower contributions of the mixed system's members, as already starting from 2010 half of the contributions will be channelled to the funded pension scheme, resulting in a deficit of about 0.5% of GDP starting from 2030, when contributions to the state pension budget will be lower than the expenditure. Projections show that all pensions will become contribution-based generation solidarity pensions only around 2080. Another revenue-reducing effect is assumed to arise due to the decreasing number of employed persons explained by demographic changes (the old-age dependency ratio is forecast to increase from 24.1% in 2005 to 44.1% in 2050).

The reformed pension system would ensure sustainability of the system despite the projected increase in the old-age dependency ratio. An important contribution to the sustainability of the pension system comes from the parametric changes: both the gradual increase in the statutory retirement age for women scheduled until 2008 and the indexation system (PAYG expenditures are not fully indexed in line with wage growth) ensures a broadly stable share of PAYG expenditure to GDP. Moreover, the second pillar will become increasingly important. A relevant part of future pensions will be covered through the funded pillar without generating an additional deficit.

However, there could be some pressure on raising the quality of public services, such as health and long-term care and education. The implementation of the healthcare system reform (outlined in the development programme for healthcare service providers of in-patient and out-patient care for 2005-2010) is an immediate priority of the current government. Finalisation of the underlying action plan (listing activities such as mergers of hospitals, reduction of hospital beds and restructuring of institutions) is expected early this year. The total cost of reform is estimated at 323.4 million lats (3.8% of GDP in 2005 prices). However, further reforms that improve the quality of public services might be necessary, which could involve an increase in such expenditures.

With regard to the sustainability of public finances, Latvia appears to be at low risk on grounds of the projected budgetary costs of ageing populations. The level of gross debt is currently very low and is projected to remain below the 60% reference value throughout the projection period. Latvia has enacted a pension reform which contributes significantly to contain the budgetary impact of ageing populations.

* * *

Annex 1: Summary tables from the convergence programme update

Table 1a. Macroeconomic prospects

	ESA Code	2004	2004	2005	2006	2007	2008
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
1. Real GDP	B1*g	6269.1	8.5	8.4	7.5	7.0	7.0
2. Nominal GDP	B1*g	7345.8	16.3	16.2	13.8	11.8	11.0
Components of real GDP							
3. Private consumption expenditure	P.3	4024.0	9.3	8.5	8.0	7.5	7.0
4. Government consumption expenditure	P.3	1075.7	2.1	2.4	2.4	2.4	2.0
5. Gross fixed capital formation	P.51	2017.0	23.8	14.7	9.5	9.0	9.0
6. Changes in inventories and net acquisition of valuables (% of GDP)	P.52 + P.53	252.0	5.4	3.2	1.9	1.1	0.8
7. Exports of goods and services	P.6	2553.9	9.4	18.6	14.3	10.5	8.5
8. Imports of goods and services	P.7	3653.5	16.6	11.4	10.2	8.8	8.0
Contributions to real GDP growth							
9. Final domestic demand		-	13.0	10.6	8.8	8.3	8.0
10. Changes in inventories and net acquisition of valuables	P.52 + P.53	-	0.7	-3.2	-1.5	-0.9	-0.1
11. External balance of goods and services	B.11	-	-5.2	0.9	0.3	-0.4	-0.9

Table 1b. Price developments

	ESA Code	2004	2004	2005	2006	2007	2008
		level	rate of change	rate of change	rate of change	rate of change	rate of change
1. GDP deflator			7.1	7.3	5.8	4.5	3.7
2. Private consumption deflator			6.0	6.5	5.3	4.0	3.5
3. HICP			6.2	6.9	5.6	4.3	3.5
4. Public consumption deflator			6.1	6.0	6.0	5.0	5.0
5. Investment deflator			5.7	8.6	6.5	5.0	4.5
6. Export price deflator (goods and services)			11.0	7.0	3.5	3.0	3.0
7. Import price deflator (goods and services)			8.9	8.0	4.0	3.0	3.0

Table 1c. Labour market developments

	ESA Code	2004	2004	2005	2006	2007	2008
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
1. Employment, persons[25]		1018	1.1	1.0	1.0	0.5	0.5
2. Employment, hours worked[26]		-	-	-	-	-	-
3. Unemployment rate (%)[27]			10.4	9.9	9.3	9.0	8.7
4. Labour productivity, persons [28]			7.4	7.3	6.5	6.5	6.5
5. Labour productivity, hours worked[29]		-	-	-	-	-	-
6. Compensation of employees	D.1	2983.4	17.7	16.5	12.7	11.3	10.5

Table 1d. Sectoral balances

% of GDP	ESA Code	2004	2005	2006	2007	2008
1. Net lending/borrowing vis-à-vis the rest of the world	B.9	-12.0	-8.8	-7.7	-7.0	-7.0
of which: - Balance on goods and services		-16.0	-14.1	-12.6	-11.9	-11.7
- Balance of primary incomes and transfers		3.0	4.1	3.7	3.7	3.6
- Capital account		1.1	1.2	1.2	1.1	1.1
2. Net lending/borrowing of the private sector	B.9	-11.0	-7.3	-6.2	-5.6	-5.7
3. Net lending/borrowing of general government	B.9/ EDP B.9	-1.0	-1.5	-1.5	-1.4	-1.3
4. Statistical discrepancy		0.6	0.0	0.0	0.0	0.0

[25] Occupied population, domestic concept national accounts definition.

[26] National accounts definition.

[27] Harmonised definition, Eurostat; levels.

[28] Real GDP per person employed.

[29] Real GDP per hour worked.

Table 2. General government budgetary prospects

	ESA code	2004	2004	2005	2006	2007	2008
		Level	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
Net lending (EDP B.9) by sub-sector							
1. General government	S.13	-69.9	-1.0	-1.5	-1.5	-1.4	-1.3
2. Central government	S.1311	-140.3	-1.9	-2.2	-2.2	-1.8	-1.5
3. State government	S.1312	-	-	-	-	-	-
4. Local government	S.1313	-6.1	-0.1	-0.1	-0.2	-0.1	-0.1
5. Social security funds	S.1314	76.6	1.0	0.9	0.9	0.6	0.4
General government (S13)							
6. Total revenue	TR	2588.3	35.2	35.3	36.1	37.4	37.4
7. Total expenditure	TE[30]	2658.2	36.2	36.8	37.5	38.8	38.7
8. Net lending/borrowing	EDP B.9	-69.9	-1.0	-1.5	-1.5	-1.4	-1.3
9. Interest expenditure (incl. FISIM)	EDP D.41 incl. FISIM	55.1	0.7	0.7	0.7	0.7	0.7
pm: 9a. FISIM [31]							
10. Primary balance [32]		-14.8	-0.2	-0.7	-0.8	-0.6	-0.6
Selected components of revenue							
11. Total taxes (11=11a+11b+11c)		1457.8	19.8	20.1	21.4	22.5	23.3
11a. Taxes on production and imports	D.2	872.5	11.9	12.0	13.1	13.9	14.4
11b. Current taxes on income, wealth, etc	D.5	585.3	8.0	8.1	8.3	8.7	9.0
11c. Capital taxes	D.91						
12. Social contributions	D.61	661.0	9.0	8.8	8.8	8.6	8.1
13. Property income	D.4	56.0	0.8	0.7	0.4	0.4	0.4
14. Other (14=15-(11+12+13))		413.6	5.6	5.7	5.4	5.9	5.6
15=6. Total revenue	TR	2588.3	35.2	35.3	36.1	37.4	37.4
p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995)[33]		2131.8	29.0	29.2	30.5	31.2	31.7
Selected components of expenditure							
16. Collective consumption	P.32	767.7	10.5	11.6	11.7	11.6	11.5
17. Total social transfers	D.62 + D.63	695.1	9.5	9.4	9.3	9.0	9.0
17a. Social transfers in kind	P.31 = D.63	11.5	0.2	0.1	0.1	0.1	0.1
17b. Social transfers other than in kind	D.62	683.6	9.3	9.3	9.2	8.9	8.9
18.=9. Interest expenditure (incl. FISIM)	EDP D.41 incl. FISIM	55.1	0.7	0.7	0.7	0.7	0.7
19. Subsidies	D.3	38.4	0.5	0.5	0.4	0.4	0.4
20. Gross fixed capital formation	P.51	111.3	1.5	2.3	2.5	2.9	3.3
21. Other (21=22-(16+17+18+19+20))		990.6	13.5	12.3	13.0	14.1	13.8
22=7. Total expenditure	TE[34]	2658.2	36.2	36.8	37.5	38.8	38.7
Pm: compensation of employees	D.1	775.6	10.6	11.1	11.4	11.4	11.3

[30] Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.

[31] Up-to-date, FISIM data is unavailable.

[32] The primary balance is calculated as (EDP B.9, item 8) plus (EDP D.41 + FISIM recorded as intermediate consumption, item 9).

[33] Including those collected by the EU and including an adjustment for uncollected taxes and social contributions (D.995), if appropriate.

[34] Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.

Table 3. General government expenditure by function

% of GDP	COFOG Code	**2003**	**2008**
1. General public services	1	4.8	4.9
2. Defence	2	1.3	2.0
3. Public order and safety	3	2.4	2.5
4. Economic affairs	4	3.5	3.4
5. Environmental protection	5	0.4	0.5
6. Housing and community amenities	6	0.9	1.0
7. Health	7	3.3	4.0
8. Recreation, culture and religion	8	1.4	1.7
9. Education	9	6.2	6.8
10. Social protection	10	10.8	12.0
11. Total expenditure (= item 7=26 in Table 2)	TE[35]	**35.0**	**38.8**

Table 4. General government debt developments

% of GDP	**2004**	**2005**	**2006**	**2007**	**2008**
1. Gross debt[36]	13.1	14.9	13.6	13.7	14.7
2. Change in gross debt ratio	-1.6	1.8	-1.3	0.1	0.1
Contributions to changes in gross debt					
3. Primary balance[37]	0.2	0.7	0.8	0.6	0.6
4. Interest expenditure (incl. FISIM) [38]	0.7	0.7	0.7	0.7	0.7
5. Stock-flow adjustment	1.2	-1.0	2.0	-1.1	0.2
of which: - Differences between cash and accruals[39]	0.3				
- Net accumulation of financial assets[40] *of which:* *- privatisation proceeds*	0.6 0.1				
- Valuation effects and other[41]	0.3				
p.m. implicit interest rate on debt[42]	5.5	5.5	5.0	5.3	5.2
Other relevant variables					
6. Liquid financial assets[43]	3.5				
7. Net financial debt (7=1-6)	11.2				

[35] Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.

[36] As defined in Regulation 3605/93 (not an ESA concept).

[37] Cf. item 10 in Table 2.

[38] Cf. item 9 in Table 2.

[39] The differences concerning interest expenditure, other expenditure and revenue could be distinguished when relevant.

[40] Liquid assets, assets on third countries, government controlled enterprises and the difference between quoted and non-quoted assets could be distinguished when relevant.

[41] Changes due to exchange rate movements, and operation in secondary market could be distinguished when relevant.

[42] Proxied by interest expenditure (incl. FISIM recorded as consumption) divided by the debt level of the previous year.

[43] AF1, AF2, AF3 (consolidated at market value), AF5 (if quoted in stock exchange; including mutual fund shares).

Table 5. Cyclical developments

% of GDP	ESA Code	2004	2005	2006	2007	2008
1. Real GDP growth (%)		8.5	8.4	7.5	7.0	7.0
2. Net lending of general government	EDP B.9	-1.0	-1.5	-1.5	-1.4	-1.3
3. Interest expenditure (incl. FISIM recorded as consumption)	EDPD.41 + FISIM	0.7	0.7	0.7	0.7	0.7
4. Potential GDP growth (%)		7.9	8.1	8.0	7.6	7.2
contributions: - labour - capital - total factor productivity		 0.9 3.5 3.4	 0.7 3.8 3.4	 0.7 3.8 3.4	 0.3 3.7 3.4	 0.1 3.6 3.4
5. Output gap		0.3	0.5	0.1	-0.5	-0.7
6. Cyclical budgetary component		0.1	0.1	0.0	-0.1	-0.2
7. Cyclically-adjusted balance (2-6)		-1.1	-1.6	-1.5	-1.3	-1.1
8. Cyclically-adjusted primary balance (7-3)		-0.4	-0.9	-0.8	-0.6	-0.4

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Table 6. Divergence from previous update

	ESA Code	2004	2005	2006	2007	2008
Real GDP growth (%) **Previous update**		8.1	6.7	6.5	6.5	-
Current update		8.5	8.4	7.5	7.0	7.0
Difference		0.4	1.7	1.0	0.5	-
General government net lending (% of GDP) **Previous update**	EDP B.9	-1.7	-1.6	-1.5	-1.4	-
Current update		-1.0	-1.5	-1.5	-1.4	-1.3
Difference		0.7	0.1	0.0	0.0	-
General government gross debt (% of GDP) **Previous update**		14.2	14.5	14.8	15.0	-
Current update		14.7	13.1	14.9	13.6	13.7
Difference		0.5	-1.4	0.1	-1.4	-

Table 7. Long-term sustainability of public finances

% of GDP	2000	2005	2010	2020	2030	2050
Total expenditure	-	36.8	37.8	37.7	39.1	39.3
Of which: age-related expenditures	-	16.3	13.8	13.8	15.1	15.3
Pension expenditure	-	6.4	4.9	4.9	5.6	5.6
Social security pension	-	6.4	4.9	4.9	5.6	5.6
Old-age and early pensions	-	5.7	4.3	4.3	4.9	4.9
Other pensions (disability, survivors)	-	0.7	0.6	0.6	0.7	0.6
Occupational pensions (if in general government)	-					
Health care	-	5.2	5.3	5.4	5.5	5.9
Long-term care *(this was earlier included in the health care)*	-	0.4	0.4	0.4	0.4	0.5
Education expenditure	-	4.4	3.3	3.1	3.5	3.3
Other age-related expenditures	-	0.3	0.3	0.2	0.2	0.2
Interest expenditure	-					
Total revenue	-	35.3	36.9	36.5	36.3	36.2
Of which: property income	-					
of which: from pensions contributions (or social contributions if appropriate)	-	7.9	6.1	5.6	5.4	5.4
Pension reserve fund assets	-					
Of which: consolidated public pension fund assets (assets other than government liabilities)	-					
Assumptions						
Labour productivity growth	-	6.5	6.5	4.0	2.7	1.1
Real GDP growth	-	8.1	7.4	2.9	2.1	0.4
Participation rate males (aged 20-64)	-	84.4	87.6	89.6	89.5	87.6
Participation rates females (aged 20-64)	-	72.6	76.2	79.0	79.8	76.6
Total participation rates (aged 20-64)	-	78.2	81.7	84.1	84.5	82.0
Unemployment rate	-	9.1	7.6	7.0	7.0	7.0
Population aged 65+ over total population	-	16.5	17.4	18.4	21.3	26.1

Table 8. Basic assumptions

	2004	2005	2006	2007	2008
Short-term interest rate[44] (annual average)	4.2	3.0	3.0	3.0	3.0
Long-term interest rate (annual average)	4.9	3.9	3.5	3.5	3.5
USD/€ exchange rate (annual average) (euro area and ERM II countries)	1.24	1.25	1.23	1.24	1.24
Nominal effective exchange rate	6.1	0.8	1.7	0.5	0.5
(for countries not in euro area or ERM II) exchange rate vis-à-vis the € (annual average)	-	-	-	-	-
World excluding EU, GDP growth	5.9	5.1	4.9	4.6	4.6
EU GDP growth	2.4	1.5	2.1	2.4	2.4
Growth of relevant foreign markets	12.1	9.0	9.0	8.4	8.4
World import volumes, excluding EU	13.9	8.6	8.7	8.4	8.4
Oil prices, (Brent, USD/barrel)	37.8	56.4	65.6	63.5	63.5

[44] If necessary, purely technical assumptions.

ANNEX 2: COMPLIANCE WITH THE CODE OF CONDUCT

The table below provides a detailed assessment of whether the programme respects the requirements of Section II of the new code of conduct. It is in four parts, covering compliance with (i) the window for the date of submission of the programme; (ii) the model structure (table of contents) in Annex 1 of the code; (iii) the data requirements (model tables) in Annex 2 of the code; and (iv) other information requirements. In the main text, points (ii) and (iii) are grouped into the "format" requirements of the code, whereas point (iv) refers to its "content" requirements.

Guidelines in the new code of conduct	Yes	No	Comments
1. Submission of the programme			
Programme was submitted not earlier than mid-October and not later than 1 December[1].	**X**		
2. Model structure			
The model structure for the programmes in Annex 1 of the code of conduct has been followed.	X		
3. Model tables (so-called data requirements)			
The quantitative information is presented following the standardised set of tables (Annex 2 of the code of conduct).	X		
The programme provides all compulsory information in these tables.	X		
The programme provides all optional information in these tables.		X	
The concepts used are in line with the European system of accounts (ESA).	X		
4. Other information requirements			
a. Involvement of parliament			
The programme mentions its status vis-à-vis the national parliament.		X	
The programme indicates whether the Council opinion on the previous programme has been presented to the national parliament.		X	
b. Economic outlook			
Euro area and ERM II Member States uses the "common external assumptions" on the main extra-EU variables.	X		
Significant divergences between the national and the Commission services' economic forecasts are explained[2].			Not applicable
The possible upside and downside risks to the economic outlook are brought out.	X		
The outlook for sectoral balances and, especially for countries with a high external deficit, the external balance is analysed.	X		
c. Monetary/exchange rate policy			
The convergence programme presents the medium-term monetary policy objectives and their relationship to price and exchange rate stability.	X		
d. Budgetary strategy			

Guidelines in the new code of conduct	Yes	No	Comments
The programme presents budgetary targets for the general government balance in relation to the MTO, and the projected path for the debt ratio.	X		
In case a new government has taken office, the programme shows continuity with respect to the budgetary targets endorsed by the Council.			Not applicable
When applicable, the programme explains the reasons for possible deviations from previous targets and, in case of substantial deviations, whether measures are taken to rectify the situation, and provide information on them.			Not applicable
The budgetary targets are backed by an indication of the broad measures necessary to achieve them and an assessment of their quantitative effects on the general government balance is analysed.	X		
Information is provided on one-off and other temporary measures.			Not applicable
The state of implementation of the measures (enacted versus planned) presented in the programme is specified.	X		
If for a country that uses the transition period for the classification of second-pillar funded pension schemes, the programme presents information on the impact on the public finances.			Latvia does not use the transition period, however, the programme provides all details on pension reforms' costs and benefits.
e. "Major structural reforms"			
If the MTO is not yet reached or a temporary deviation is planned from the achieved MTO, the programme includes comprehensive information on the economic and budgetary effects of possible 'major structural reforms' over time.			Not applicable
The programme includes a quantitative cost-benefit analysis of the short-term costs and long-term benefits of such reforms.			Not applicable
f. Sensitivity analysis			
The programme includes comprehensive sensitivity analyses and/or develops alternative scenarios showing the effect on the budgetary and debt position of: a) changes in the main economic assumptions b) different interest rate assumptions c) for non-participating Member States, different exchange rate assumptions d) if the common external assumptions are not used, changes in assumptions for the main extra-EU variables.	 X	 X X	 Not applicable
In case of such "major structural reforms", the programme provides an analysis of how changes in the assumptions would affect the effects on the budget and potential growth.			Not applicable
g. Broad economic policy guidelines			
The programme provides information on the consistency with the broad economic policy guidelines of the budgetary objectives and the measures to achieve them.	X		
h. Quality of public finances			
The programme describes measures aimed at improving the quality of public finances on both the revenue and expenditure side (e.g. tax reform, value-for-money initiatives, measures to	X		

Guidelines in the new code of conduct	Yes	No	Comments
improve tax collection efficiency and expenditure control).			
i. Long-term sustainability			
The programme outlines the country's strategies to ensure the sustainability of public finances, especially in light of the economic and budgetary impact of ageing populations.	X		
Common budgetary projections by the AWG are included in the programme. The programme includes all the necessary additional information. (…) To this end, information included in programmes should focus on new relevant information that is not fully reflected in the latest common EPC projections.	X		
j. Other information (optional)			
The programme includes information on the implementation of existing national budgetary rules (expenditure rules, etc.), as well as on other institutional features of the public finances, in particular budgetary procedures and public finance statistical governance.	X		

Notes:

[1]The code of conduct allows for the following exceptions: (i) Ireland should be regarded as complying with the deadline in case of submission on "budget day", i.e. traditionally the first Wednesday of December, (ii) the UK should submit as close as possible to its autumn pre-budget report; and (iii) Austria and Portugal cannot comply with the deadline but will submit no later than 15 December.

[2]To the extent possible, bearing in mind the typically short time period between the publication of the Commission services' autumn forecast and the submission of the programme.

ANNEX 3: CONSISTENCY WITH THE BROAD ECONOMIC POLICY GUIDELINES

The table below provides an overview of whether the strategy and policy measures in the programme are consistent with the broad economic policy guidelines in the area of public finances.

Integrated guidelines	Yes	No	Not applicable
1. To secure economic stability			
– Member States should respect their medium-term budgetary objectives. As long as this objective has not yet been achieved, they should take all the necessary corrective measures to achieve it[1].	X		
– Member States should avoid pro-cyclical fiscal policies[2].			X
– Member States in excessive deficit should take effective action in order to ensure a prompt correction of excessive deficits[3].			X
– Member States posting current account deficits that risk being unsustainable should work towards (…), where appropriate, contributing to their correction via fiscal policies.	X		
2. To safeguard economic and fiscal sustainability In view of the projected costs of ageing populations,			
– Member States should undertake a satisfactory pace of government debt reduction to strengthen public finances.			X
– Member States should reform and re-enforce pension, social insurance and health care systems to ensure that they are financially viable, socially adequate and accessible (…)	X		
3. To promote a growth- and employment-orientated and efficient allocation of resources			
Member States should, without prejudice to guidelines on economic stability and sustainability, re-direct the composition of public expenditure towards growth-enhancing categories in line with the Lisbon strategy, adapt tax structures to strengthen growth potential, ensure that mechanisms are in place to assess the relationship between public spending and the achievement of policy objectives and ensure the overall coherence of reform packages.	X		

Notes:
[1]As further specified in the Stability and Growth Pact and the new code of conduct, i.e. with an annual 0.5% of GDP minimum adjustment in structural terms for euro area and ERM II Member States.
[2]As further specified in the Stability and Growth Pact and the new code of conduct, i.e. Member States that have already achieved the medium-term objective should avoid pro-cyclical fiscal policies in "good times".
[3]As further specified in the country-specific Council recommendations and decisions under the excessive deficit procedure.

ANNEX 4: ASSESSMENT OF TAX PROJECTIONS

Table 1 compares the tax projections of the programme with those of the Commission services' autumn 2005 forecast and Table 2 those of the Commission services' autumn forecast with tax projections obtained by using standard ex-ante elasticities, as estimated by the OECD. The tables summarise the results for the total tax-to-GDP ratio. The underlying analysis is carried out exploiting information for the four major tax categories, i.e. indirect taxes, corporate and private income taxes and social contributions (see tables below)[45]. Conceptually, the analysis draws on the definition of a semi-elasticity, which measures the change in a ratio vis-à-vis the relative change in the denominator. The semi-elasticity of the tax-to-GDP ratio of the *i-th* tax $\frac{T_i}{Y}$ can be written as:

.

$$\eta_i = \frac{d\left(\frac{T_i}{Y}\right)}{dY} Y = \left(\frac{dT_i}{dY}\frac{Y}{T_i} - 1\right)\frac{T_i}{Y} = \left(\frac{dT_i}{dB_i}\frac{B_i}{T_i}\frac{dB_i}{dY}\frac{Y}{B_i} - 1\right)\frac{T_i}{Y} = (\varepsilon_{T_i,B_i}\varepsilon_{B_i,Y} - 1)\frac{T_i}{Y}$$

where ε_{T_i,B_i} and $\varepsilon_{B_i,Y}$ denote the elasticity of the *i-th* tax T_i relative to its tax base B_i and the elasticity of the tax base B_i relative to aggregate GDP Y respectively.

To the extent that ε_{T_i,B_i} is derived from observed or projected data, it will typically reflect (i) the effect of discretionary measures (including one-offs) and (ii) the tax elasticity[46]. By contrast, if ε_{T_i,B_i} is the standard *ex-ante* elasticity, as estimated by the OECD, it will be net of discretionary measures.

The second elasticity $\varepsilon_{B_i,Y}$ can be used as an indicator of the tax intensity of GDP growth; for instance, a higher elasticity of consumption relative to GDP means that for the same GDP growth indirect taxes will be higher.

The definition of a semi-elasticity has two practical implications. First, any change in the tax-to-GDP ratio of the *i-th* tax can be written as the product of the semi-elasticity and GDP growth:

$$d\left(\frac{T_i}{Y}\right) = \eta_i \cdot \frac{dY}{Y}$$

and the change in the total tax-to-GDP ratio is the sum:

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[45]Private and corporate income taxes are generally not provided, neither in the programme nor in the Commission services' autumn 2005 forecast. Only the aggregate, direct income taxes, is given. For the purpose of this exercise the breakdown is obtained using the average shares over the past ten years, i.e. the composition of direct taxes is assumed to stay constant.

[46]The observed or projected elasticity (ex-post elasticity) of the *i*-th tax also includes the effect of other factors (OF) such as discretionary measures: $\frac{\Delta T_i}{T_i} = \varepsilon_{T_i,B_i ex ante}\frac{dB_i}{B_i} + \frac{OF_i}{T_i} = \varepsilon_{T_i,B_i ex\ post}\frac{dB_i}{B_i}$.

$$\sum_i d\left(\frac{T_i}{Y}\right) = \sum_I \eta_i \frac{dY}{Y}.$$

Second, differences between two tax projections can be decomposed into an elasticity component and a composition component:

$$d\left(\frac{T_i}{Y}\right)' - d\left(\frac{T_i}{Y}\right) \approx \left[\left(\varepsilon'_{T_i,B_i}\varepsilon'_{B_i,Y} - 1\right)\frac{T_i}{Y} - \left(\varepsilon_{T_i,B_i}\varepsilon_{B_i,Y} - 1\right)\frac{T_i}{Y}\right]\frac{dY}{Y}$$

If $(\varepsilon'_{T_i,B_i} - \varepsilon_{T_i,B_i}) = \alpha_i$; $(\varepsilon'_{B_i,Y} - \varepsilon_{B_i,Y}) = \beta_i$,

then $d\left(\frac{T_i}{Y}\right)' - d\left(\frac{T_i}{Y}\right) \approx \left[\left(\alpha_i\varepsilon_{B_i,Y} + \beta_i\varepsilon_{T_i,B_i} + \alpha_i\beta_i\right)\frac{T_i}{Y}\right]\frac{dY}{Y}$

where $\alpha_i\varepsilon_{B_i,Y}\frac{T_i}{Y}\frac{dY}{Y}$ determines the elasticity component and $\beta_i\varepsilon_{T_i,B_i}\frac{T_i}{Y}\frac{dY}{Y}$ the composition component. The third component in the equation $\alpha_i\beta_i\frac{T_i}{Y}\frac{dY}{Y}$ measures the interaction of the elasticity and the composition components. It is generally small but can become important in some cases. The tax elasticity relative to GDP of total taxes is obtained as $\varepsilon = \sum_i w_i\varepsilon_{T_iB_i}\varepsilon_{B_iY}$ with w_i the share of the *i-th* tax in the overall tax burden.

The tables below report the results of the assessment of the tax projections presented in the programme by major tax category, which, as mentioned above, are the basis for the aggregated results reported in Tables 1 and 2.

Table 1: Assessment of tax projections by major tax category

	2006		2007		2008	p.m.:
	COM	CP	COM[2]	CP	CP	OECD[1]
Taxes on production and imports:						
Change in tax-to-GDP ratio	0.0	1.3	0.1	0.9	0.6	/
Difference	1.3		0.8		/	/
of which[3]: - elasticity component	1.3		0.7		/	/
- composition component	0.1		0.1		/	/
p.m.: Observed elasticity:						
- of taxes to tax base[4]	1.1	1.8	1.1	1.6	1.4	1.0
- of tax base[4] to GDP	0.9	1.0	0.9	1.0	1.0	1.0
Social contributions:						
Change in tax-to-GDP ratio	0.3	0.0	0.2	0.2	0.6	/
Difference	0.3		0.1		/	/
of which[3]: - elasticity component	0.1		0.3		/	/
- composition component	0.1		0.2		/	/
p.m.: Observed elasticity:						
- of taxes to tax base[5]	1.0	1.1	1.1	0.8	0.4	1.0
- of tax base[5] to GDP	0.8	0.9	0.8	1.0	1.0	0.7
Personal income tax[6]:						
Change in tax-to-GDP ratio	0.1	0.2	0.0	0.3	0.2	/
Difference	0.1		0.3		/	/
of which[3]: - elasticity component	0.0		0.1		/	/
- composition component	0.1		0.2		/	/
p.m.: Observed elasticity:						
- of taxes to tax base[5]	1.3	1.3	1.3	1.5	1.4	1.4
- of tax base[5] to GDP	0.8	0.9	0.8	1.0	1.0	0.7
Corporate income tax[6]:						
Change in tax-to-GDP ratio	0.0	0.1	0.0	0.1	0.1	/
Difference	0.0		0.1		/	/
of which[3]: - elasticity component	0.1		0.2		/	/
- composition component	0.0		0.0		/	/
p.m.: Observed elasticity:						
- of taxes to tax base[7]	1.0	1.1	0.9	1.4	1.3	1.0
- of tax base[7] to GDP	1.1	1.1	1.2	1.0	1.0	1.3

Notes:
[1]OECD ex-ante elasticities
[2]On a no-policy change basis
[3]The decomposition is explained in the text above
[4]Tax base = private consumption expenditure
[5]Tax base = compensation of employees
[6]Taxes on income and wealth are split into private and corporate income tax using the average tax share over the past ten years, i.e. the share is assumed to be constant over the programme period
[7]Tax base = gross operating surplus

Source:
Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations and OECD (N. Girouard and C. André (2005), "Measuring Cyclically-Adjusted Budget Balances for the OECD Countries", OECD Working Paper No. 434)

Table 2: Assessment of tax elasticities by major tax category

	2006		2007	
	COM (observed)	**ex-ante[1]**	**COM[2] (observed)**	**ex-ante[1]**
Taxes on production and imports:				
Change in tax-to-GDP ratio	0.0	0.0	0.1	0.0
Difference	0.0		0.1	
of which[3]: - elasticity component	0.1		0.2	
- composition component	0.1		0.1	
p.m.: Observed elasticity:				
- of taxes to tax base[4]	1.1	1.0	1.1	1.0
- of tax base[4] to GDP	0.9	1.0	0.9	1.0
Social contributions:				
Change in tax-to-GDP ratio	0.3	0.4	0.2	0.3
Difference	0.1		0.1	
of which[3]: - elasticity component	0.0		0.1	
- composition component	0.2		0.1	
p.m.: Observed elasticity:				
- of taxes to tax base[5]	1.0	1.0	1.1	1.0
- of tax base[5] to GDP	0.8	0.7	0.8	0.7
Personal income tax[6]:				
Change in tax-to-GDP ratio	0.1	0.1	0.0	0.1
Difference	0.2		0.1	
of which[3]: - elasticity component	0.1		0.0	
- composition component	0.2		0.1	
p.m.: Observed elasticity:				
- of taxes to tax base[5]	1.3	1.4	1.3	1.4
- of tax base[5] to GDP	0.8	0.7	0.8	0.7
Corporate income tax[6]:				
Change in tax-to-GDP ratio	0.0	0.1	0.0	0.1
Difference	0.1		0.1	
of which[3]: - elasticity component	0.0		0.0	
- composition component	0.1		0.0	
p.m.: Observed elasticity:				
- of taxes to tax base[7]	1.0	1.0	0.9	1.0
- of tax base[7] to GDP	1.1	1.3	1.2	1.3

Notes:
[1]Tax projections obtained by applying ex-ante standard tax elasticities estimated by the OECD
[2]On a no-policy change basis
[3]The decomposition is explained in the text above
[4]Tax base = private consumption expenditure
[5]Tax base = compensation of employees
[6]Taxes on income and wealth are split into private and corporate income tax using the average tax share over the past ten years, i.e. the share is assumed to be constant over the programme period
[7]Tax base = gross operating surplus

Source:
Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations and OECD (N. Girouard and C. André (2005), "Measuring Cyclically-Adjusted Budget Balances for the OECD Countries", OECD Working Paper No. 434)

ANNEX 5: INDICATORS OF LONG-TERM SUSTAINABILITY

Table A1: Underlying assumptions compared

% of GDP	2010		2020		2030		2050	
	EPC	SCP	EPC	SCP	EPC	SCP	EPC	SCP
Labour productivity growth	6.5	6.5	4.0	4.0	2.7	2.7	1.7	1.1
Real GDP growth	7.4	7.4	2.9	2.9	2.1	2.1	0.4	0.4
Participation rate males (aged 20-64)	87.6	87.6	89.6	89.6	89.5	89.5	87.6	87.6
Participation rates females (aged 20-64)	76.2	76.2	79.0	79.0	79.8	79.8	76.6	76.6
Total participation rates (aged 20-64)	81.7	81.7	84.1	84.1	84.5	84.5	82.0	82.0
Unemployment rate	7.6	7.6	7.0	7.0	7.0	7.0	7.0	7.0
Population aged 65+ over total population	17.4	17.4	18.4	18.4	21.3	21.3	26.1	26.1

Table A2: Long-term projections

Main assumptions - programme scenario (as % GDP)	2008	2010	2020	2030	2040	2050	changes	Impact on S2
Total age-related spending	15.2	14.2	14.0	15.2	15.3	15.5	0.3	-0.1
Pensions	5.5	4.9	4.9	5.6	5.6	5.6	0.1	-0.1
Health care	5.3	5.3	5.4	5.5	5.7	5.9	0.6	0.4
Care of the elderly	0.4	0.4	0.4	0.4	0.4	0.5	0.1	0.1
Education	3.7	3.3	3.1	3.5	3.4	3.3	-0.4	-0.4
Unemployment benefits	0.3	0.3	0.2	0.2	0.2	0.2	-0.1	-0.1
Total primary non age-related spending	22.8	22.8	22.8	22.8	22.8	22.8	0.0	0.0
Total revenues	37.7	37.7	37.7	37.7	37.7	37.7	0.0	0.0

Table A3: The cost of a five-year delay in adjusting the budgetary position according to the S1 and S2

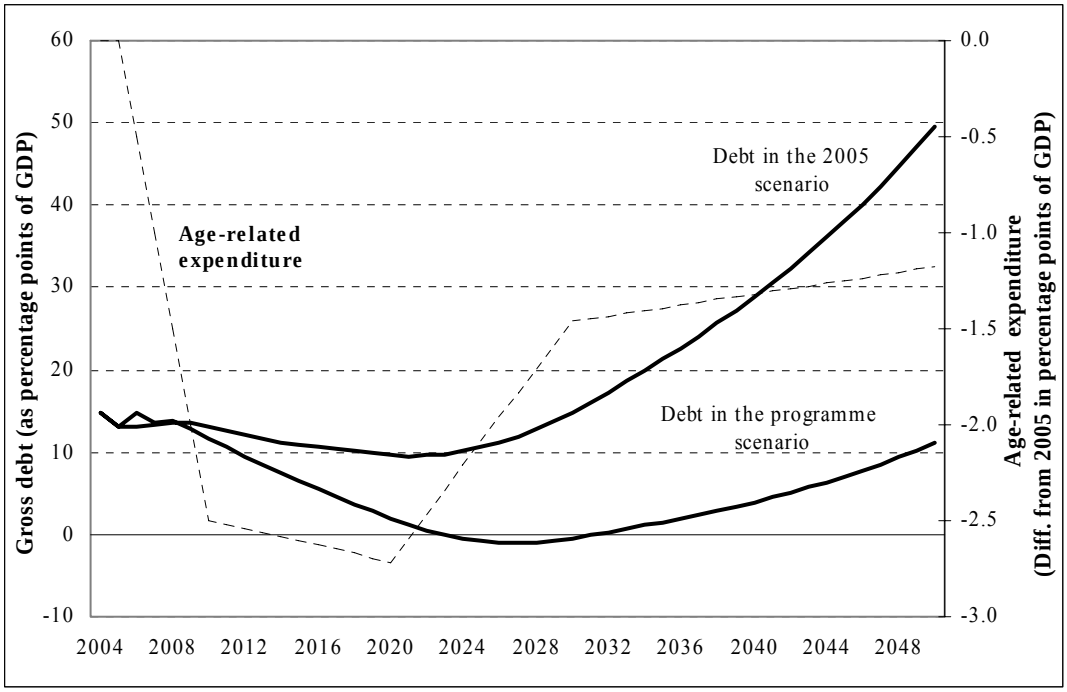
	S1	S2
2005 scenario	**0.0**	**0.1**
Programme scenario	**-0.1**	**0.0**

Note: the cost of a delay shows the increase of the S1 and S2 indicators if they were calculated five years later.

Table A4: Debt development

Results (as % GDP)	**2008**	**2010**	**2020**	**2030**	**2040**	**2050**	**changes**
Programme scenario							
Gross debt	13.7	11.7	1.9	-0.4	3.9	11.0	-2.7
*Gross debt, i + 1**	*13.7*	*12.0*	*2.7*	*0.6*	*5.3*	*13.6*	*-0.1*
*Gross debt, i - 1**	*13.7*	*11.5*	*1.1*	*-1.1*	*3.0*	*9.3*	*-4.4*
Adjusted gross debt	13.7	11.7	1.9	-0.4	3.9	11.0	-2.7
2005 scenario							
Gross debt	13.6	13.0	9.6	14.9	28.8	49.5	35.9
*Gross debt, i + 1**	*13.6*	*13.3*	*10.9*	*17.5*	*34.2*	*61.0*	*47.4*
*Gross debt, i - 1**	*13.6*	*12.8*	*8.5*	*12.8*	*24.6*	*40.9*	*27.3*
Adjusted gross debt	13.6	13.0	9.6	14.9	28.8	49.5	35.9

* *i + 1* and *i + 1* represents the evolution of debt under the assumption of the nominal interest rate being 100 basis points higher or lower throughout the projection period.



Box 1: Eurostat's decision concerning funded defined-contribution pension schemes

A number of Member States have switched a part of their social security pension schemes into funded schemes. According to the decision of Eurostat (2 March 2004) those schemes should be recorded in the private sector in the national accounts. The rationale underlying the decision is that these schemes, even when run by government, should be considered as owned by the pension beneficiaries, who are the ultimate economic owners, i.e., those bearing most of the risk, associated mainly with financial market developments. Member States are required to implement the Eurostat decision, by classifying funded, defined-contribution schemes outside the government sector, by March 2007 at the latest.

The reclassification of the funded defined-contribution pension schemes may significantly change short term general government revenue and therefore decrease the current general government balance, while changes in expenditure will only materialize in the long term. Therefore, such a reform would improve long-term government balances but would increase the short-term deficit. Reducing both current revenue and long-term expenditure should be, neutral or positive in terms of long-term sustainability and, theoretically, S2 should remain stable or decrease if revenue and expenditure were available in the very long-run.

Long-term pension projections included in Latvia's convergence programme cover public pension schemes, excluding private pension schemes. The current budgetary position should therefore be corrected for the short-term reduction of the corresponding revenue (which amounts to 0.4% of GDP in 2005-06, 0.7% of GDP in 2007 and 1.5% of GDP in 2008 according to the convergence programme).