Ministry of Finance of the Republic of Latvia

Convergence Programme of the Republic of Latvia 2007-2010

November 2007

Contents

1 Overall Policy Framework and Objectives

Latvia's Convergence Programme clearly reflects the objective of the Latvian Government to ensure compliance of the fiscal policy with the provisions of the Stability and Growth Pact.

The goal of the government's economic strategy is to ensure an improvement of the welfare of population by achieving convergence with the average EU level within a foreseeable period.

In order to attain the above, Latvia needs to ensure balanced and sustainable economic growth. The key economic policy areas to achieve these objectives are:

- ensuring macroeconomic stability;
- stimulation of knowledge and innovations;
- creation of a favourable and attractive environment for investment and work;
- promotion of employment;
- improvement of education and skills.

One of significant instruments for promoting economic development is implementation of a sound fiscal policy. The task of the government within the framework of the fiscal policy is to achieve a maximum balance between the amount and structure of the government's budgetary revenue and expenditure, favourable to economic development. Latvia's budget is an important tool helping to achieve the objectives identified by the National Development Plan, which are the basis for setting the budgetary priorities.

The Parliament (Saeima) approved a medium-term central government budget for the period of 2008–2010 with a surplus, and it is an important step towards ensuring sustainable economic growth.

In March 2007, the Cabinet of Ministers approved an action plan to curb inflation. The plan was supported by the Parliament through adopting a package of legislative amendments, including amendments to tax legislation, required for implementation of the tasks identified by the plan. Alongside with the short-term measures which are already being implemented, the plan also includes several significant medium-term economic policy changes to ensure gradual elimination of the domestic and external economic imbalances.

With a view to ensuring sustainable medium-term growth, the government decided to develop an Economic Stabilisation Plan. The Plan will feature a more detailed definition of the required economic, fiscal and tax policy measures to achieve the macroeconomic stability and convergence objectives.

Ensuring the long-term sustainability of public finances is another important national priority alongside with the medium-term objectives.

2 Economic Outlook

2.1 Current Economic Development

After joining the European Union, Latvia experienced vigorous economic growth. Average annual GDP growth within the period from 2004 to 2007 was over 10% at constant prices. In the first 9 months of 2007, the GDP grew by about 11% year-on-year. This is one of the highest growth rates in the European Union and, therefore, ensures the convergence of Latvia's welfare indicators with the average EU level.

The buoyant economic development within the period was primarily driven by the persistently expanding domestic demand. Investment and private consumption growth exceeded that of the GDP growth which was dampened by the growing trade deficit. The growth of the deficit in the current account of the balance of payments was mainly the result of the high demand for imports, yet the rise was fully offset by foreign direct investment and other long-term capital.

Private consumption was supported by rising employment and a high increase in the real income of population as well as by the expansion of lending. So far, consumers were also fairly optimistic about their future prospects, which, in turn, induced higher consumption and the willingness of the population to improve their life quality quicker. In 2007, the Government supported tighter economic policy measures aimed at restricting excessive private consumption growth, particularly by dampening the growth of lending, in order to eliminate the resulting economic disproportions.

Real growth of **investment** amounted to 18.3% in 2006 and remained high in 2007. Alongside with the increased demand for investment, the deflator was also relatively high. Foreign direct investment also grew considerably in 2006 and 2007.

Foreign trade turnover was following a constant upward trend. Trade integration was especially pronounced in the Baltic region, yet it increased considerably also with the Western Europe and CIS countries. Since the EU accession, the annual growth of Latvia's exports at current prices has been volatile, ranging from 15 to 35 percent. The growth of imports in the same period was at the level of about 30%, with a declining tendency emerging only in the recent months. Until 2007, the terms of trade were also unfavourable for Latvia. Such developments resulted in a significant increase of the trade deficit, particularly starting from 2006. In the first 8 months of 2007, exports were dominated by wood and articles of wood, (23.3% of all exports), iron and steel (9.6%), machinery and mechanical appliances (5.8%). The main imports were mineral fuel, oil and oil processing products (12.9% of all imports), land transport vehicles and parts thereof (12.3%), machinery and mechanical appliances (10.7%), and electrical equipment (7.4%).

The structural changes in the economy are well reflected by the distribution of the **value added by sector:** the share of private services sector is constantly growing as a result of the high growth rates in the sectors of retail and wholesale, real estate and commercial services and financial services. Construction is also developing vigorously. The shares of transport and communications, public services, industry and agriculture, on the contrary, have contracted.

Changes in the **labour market** indicators are driven by the buoyant economic growth. Economic activity reached 71.3% in 2006, with particular increase being recorded in the age groups of 15–24 years and over 60 years. Employment rate grew to 66.3% in 2006, representing a year-on-year increase of 5%. Employment growth continues in 2007, stimulated by the constantly rising economic activity and employment rate. Unemployment rate declined to 6% in the second quarter of 2007.

This tight labour market situation, aggravated by employment opportunities available in other EU Member States at higher remuneration has resulted in a steep increase in the average monthly gross wage and salary in the economy, which grew by 34% year-on-year in the first half of 2007.

Average annual **inflation** has been higher than 6% since 2004 due to the interaction of various factors. The main ones to be mentioned are the energy price rise on both the global market and particularly in Latvia with the principles for determining the prices on gas imports changing. Harmonisation of indirect taxes and particular legal provisions with the EU requirements also had a significant impact. The increase of prices on food initially stemmed from Latvia joining the common agricultural policy of the EU. Persistence of inflation is also supported by the high demand and existing inflation expectations. Consumer price increase accelerated from mid-2007, and in October the HICP had increased by 13.2% year-on-year. The rise of inflation in the recent months was additionally underpinned by growing prices on food on the global markets as well as the significant raising of the administered prices, primarily aimed at offsetting the high energy prices. The growing wage and salary, in turn, strengthens the inflationary pressure of demand and pushes up the services costs.

2.2 Macroeconomic scenario

The medium-term macroeconomic development scenario envisages changes in the importance of the factors behind the economic growth. Accession to the European Union in 2004 facilitated significant capital and labour market integration with the EU15 and resulted in lower prices of financial resources. It also promoted a sharp rise of the wages and salaries. Under the impact of those factors, domestic demand driven economic growth outpaced the potential growth rates. Yet already in the second half of 2007, it became obvious that several factors driving the demand lost their momentum, and it can be expected that the economic growth in the years to come will be below the potential growth rate of a sustainable economy. This will offset the accumulated positive output gap, thus easing the cyclical pressure on inflation and promoting quicker elimination of external imbalances. This course of development follows from both the measures implemented by the Government to ensure the macroeconomic stability and the logics behind the cyclical development of an economy.

The macroeconomic development scenario assumes that the medium-term objectives established in the National Development Strategy will be attained by implementation of the measures described in the national Lisbon programme. The structural reforms are bound to have a positive effect on the long-term potential growth, particularly on knowledge and innovation promotion, business environment improvement and employment policy measures.

Table 1. Growth and related factors

	ESA code	2006	2006	2007	2008	2009	2010
		million lats	Growth %				
1. Real GDP	B1*g	7881.3	11.9	10.5	7.5	7.0	6.8
2. Nominal GDP	B1*g	11264.7	24.3	24.2	20.0	15.6	13.3
Components for real GDP							
3. Private consumption expenditure	P3	5417.2	19.8	17.6	7.4	6.5	6.4
4. Government consumption expenditure	P3	1153.2	4.0	5.0	3.0	2.5	2.5
5. Gross fixed capital formation	P51	2950.1	18.3	13.9	8.8	7.9	7.5
6. Changes in inventories and net acquisition of valuables (% of GDP)	P52+P53	11.7	3.5	0.8	-0.8	-1.2	-1.1
7. Exports of goods and services	P6	3268.0	5.3	9.5	9.1	7.6	7.5
8. Imports of goods and services	P7	4918.9	17.5	22.1	8.9	7.5	7.4
Contribution to real GDP growth							
9. Final domestic demand		-	19.9	18.0	9.2	8.2	7.9
10. Changes in inventories and net acquisition of valuables	P52+P53	-	0.2	2.4	0.7	0.9	1.0
11. External balance of goods and services	B11	-	-8.1	-9.9	-2.4	-2.1	-2.1

2.2.1 Real sector

The medium-term economic growth will be driven by domestic demand; nevertheless, exports will have a significant role in restoring the macroeconomic balance in a longer term. External imbalance indicators of the Latvian economy have grown considerably in the recent years, and that raises concerns about the possibilities of a quicker adjustment towards achieving a balance, which, in turn, may affect the real sector. Nevertheless, the economic policy changes involving the adoption of the anti-inflationary action plan which addresses also important medium-term policies have changed the terms of the economic environment considerably, supporting a favourable solution to the problem. At the moment, the current account deficit is fully financed from foreign financial inflows. Yet with the foreign debt and its service costs growing, the borrowing opportunities will become scarcer. Credit institutions have also become more prudent when granting loans. Growing inflation and production costs negatively affect Latvia’s external competitiveness; yet at the same time they also serve as a catalyst for more rapid structural changes with the economy passing over to a higher level of technological development and productivity. Taking into account the potential risk factors, the central scenario of the macroeconomic development envisages gradual stabilisation of the economic situation in the medium term.

GDP by expenditure

Private consumption expansion exerts a significant impact on the GDP growth, and it can be expected that its share in the GDP will already exceed 68% in 2007. Private consumption increased mainly as a result of growing population income and employment as well as lending expansion. Long-term developments of wages and salaries depend on productivity growth; nevertheless, in 2006 and 2007 the real increase of wages and salaries outpaced the productivity growth for a short period of time as a result of cyclical fluctuations of the economy, including rapidly decreasing unemployment rate. The monetary conditions have so far favoured consumption and investment and have not encouraged accumulation of savings. Moreover, consumer behaviour was driven by the optimism stemming from improved financial and employment situation as well as confidence in further successful economic development. The growing value of real estate assets improved the self-assessment of the welfare level of the population, and part of the increase in the asset value was used for consumption. In mid-2007, the situation started to change when several measures came to effect dampening the attractiveness of real estate investments (particularly short-term speculative deals) and featuring a set of restrictions on private lending: compulsory first payment, confirmation of income legality etc. Moreover, interest rates on lending in both euro and lats increased. Several leading credit institutions also announced their intention to tighten their lending policies. These processes helped the real estate market to cool down, and according to information provided by market participants in October 2007 the prices declined to the level reported in January.

In the medium term, a moderate increase of private consumption can be expected, and it will be close to the GDP growth rate. The real increase of wages and salaries will coincide with the productivity growth. Lending growth will decelerate and asset value will stabilise, thus decreasing the increase of spending on consumption. It is forecast that in the medium term a larger share of the population's income will be turned into savings and used on productive investment.

According to forecasts, the real growth of **public consumption** will be moderate in the medium term and comparable with that of the previous years. Targeted surplus budgets will further dampen the rise of public consumption by 2010.

Gross fixed capital formation displayed high growth in the last years. Investment accounted for about 1/3 of the GDP and pointed to a very dynamic process of modernisation in the economy. Nevertheless, high demand for investment opportunities pushed up the prices, which may decrease the amount of real investment made and their return. Investment is expected to continue to grow rapidly in the medium term, as it is necessary to expand the productive production capital, there is a high demand for more housing, and sizeable investment in infrastructure is also required. Financing from the EU funds serves as an additional incentive for investment, and the objective of the Government is to make the most of the opportunities offered by this financing. Investment is to a large extent dependent also on the level of domestic savings. Stabilisation of the real estate market could increase the attractiveness of investment into the production sector.

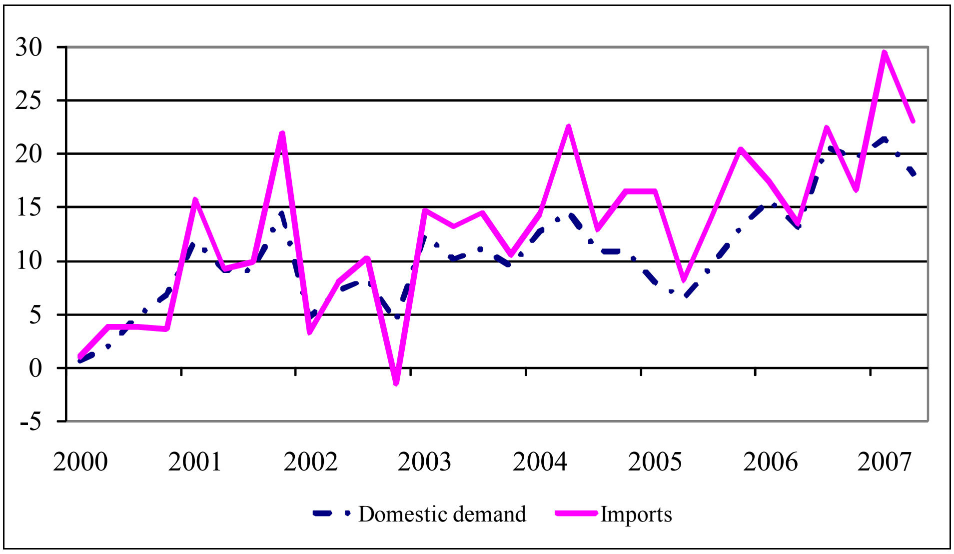

Chart 1. Growth of domestic demand and import (%)

Considering the size of the Latvian economy and its openness to external trade, a further increase in **foreign trade** turnover can be expected. Following the low export growth in 2006, exports accelerated in 2007 and are expected to be slightly above the GDP growth rates in the medium-term. Deceleration of the domestic demand will improve the attractiveness of the export markets. Current investment into production capital will improve the export potential significantly and will enable to address the problem of growing costs related to the increase of labour costs and energy prices. With the share of higher value added products in the exports expanding, it is expected that the terms of trade will become more favourable for Latvian producers. The Government will enhance policy measures aimed at promotion of exports and reduction of external imbalances. Export promotion instruments have been discussed in "Latvia's Export Promotion Programme 2005-2009" specifically developed for this purpose and aimed at active promotion of the international competitiveness of Latvian businesses, finding new market outlets and strengthening the positions in the existing ones. Implementation of the Export Promotion Programme is supervised by the Export Promotion Council including representatives of government institutions, sectoral associations and social partners.

Import growth is sustained by high domestic demand for both consumer and investment goods. The share of imported raw materials is also high in production of export goods. Import growth is explained also by the growth of prices on imports, which was largely driven by rising global prices on mineral products, other raw materials and food. In the future, the impact of growing import prices should fade away, except for a rise in prices on particular energy resources. In the medium-term, the imports will decelerate and the trade balance will gradually improve against the background of dampening private consumption and investment growth rates.

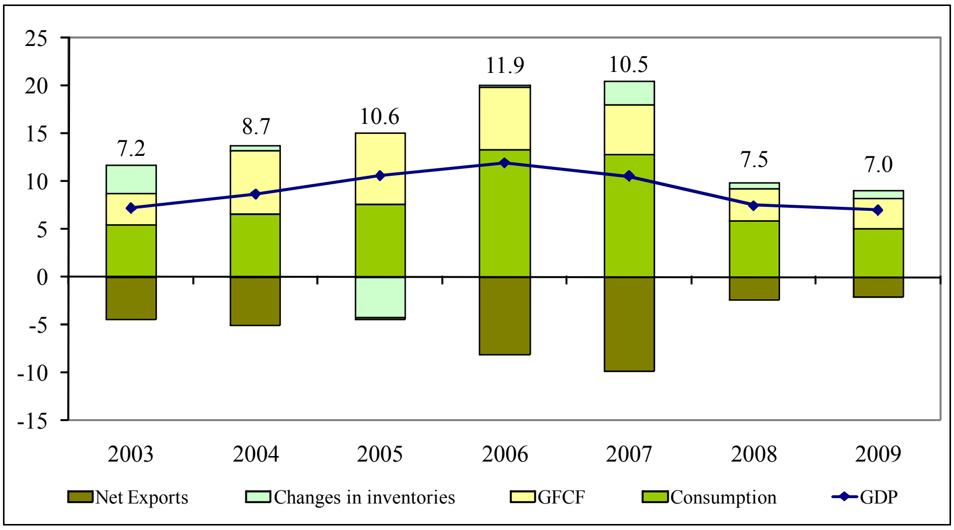

Chart 2. Contribution to GDP growth (%)

GDP by sector

The growth of **industry** is lower than that of the GDP, as this sector is widely open to international trade. The development of the sector is largely dependent on export opportunities and the prices of export goods on the major export markets. Industrial goods are exposed to significant competition on behalf of imports also on the domestic market. In 2007, the growth of industrial output was very slow, largely on account of a decrease in the woodworking sector and some other minor sectors. At the same time, the turnover of all major industrial sectors is growing on account of higher producer prices both on the domestic and the external market. Such developments can be partly explained by the current restructuring of the industrial sectors and a change of the selection of products to adapt to the existing market conditions and level of production costs.

In the medium term, the producers will be more inclined to produce technologically more complex products that are less subject to price competition. That could be achieved through modernisation of production processes, labour force improvement and larger investment in creation of new products. Development of the branches of industry will be facilitated by various governmental economic policy measures aimed at developing the entrepreneurial skill level, production of higher value added goods and promotion of innovations.

Construction sector has been reporting dynamic growth of 13%–15% at constant prices already for several years, regardless of the high construction deflator which exceeded 20 percent in the last years. The rapid development of the real estate market in the last years has resulted in a high demand for housing construction; therefore, this sector displays the highest growth rates. The major contributors to the overall growth and also characterised by buoyant development are the sub-sectors of construction of non-residential buildings and civil engineering constructions. In the medium term, the growth of the volume of construction in both construction of new buildings as well as in renovations is expected to remain high. The demand is high in all sectors of construction; nevertheless, stabilisation of the real estate market will dampen the construction volumes particularly in the segment of residential buildings, whose overall annual growth will decline to 8%–9 %. The construction sector also has a high potential for productivity growth and it could materialise through improving technologies and logistics.

The development of **agriculture** is highly dependent on weather conditions determining how big the crops are each year. The atypically dry summer of 2006 resulted in a decline in the sectoral outputs, whereas in 2007 the average yield improved again. At the same time, since the EU accession prices of agricultural products have been growing constantly, particularly in 2007, under the impact of the global food market changes. Such developments together with the support provided by the EU have raised the income of the producers from the agricultural sector considerably.

Provided that there are no contingency effects, agriculture will experience positive output growth in the medium term, and the prices on outputs will catch up with the average prices of other EU Member States. It is expected that the number of persons employed in agriculture will continue to decrease, *inter alia* under the impact of demographic factors. The medium-term and long-term development of the sector will be driven by the development of the Common Agricultural Policy of the EU and potential reforms. More moderate growth of the sector will be also determined by slower growth of forestry, as the optimum volume of timber cutting has been almost reached and further development of the sector will be driven by increasing efficiency.

Private services sectors account for about 60% of the total value added and are major contributors to the overall economic growth. Trade sector has been marked by rapid development already for several years, which is in line with the growing private consumption and the development of consumer behaviour. Transport and communication sector is characterised by growth in freight transportation, yet the overall growth of the sector is driven by rapid development of communication services. In the medium term, further moderation of the growth of trade can be expected against the background of market saturation, whereas the transport sector could be fostered by the expansion of Latvia’s external trade, growing exports to the CIS countries and global trade developments.

Business and financial services display higher growth figures alongside with increased overall economic activity. Rapidly rising domestic demand and financial market integration underpinned very dynamic growth in these sectors. Stabilisation of the real estate market alongside with deceleration of the growth of lending will result in lower growth rates in these sectors, which could still exceed the GDP growth. In the medium term, the financial market will mature and offer increasingly wider types of services. Several specialised types of services will also develop in the area of real estate and business services.

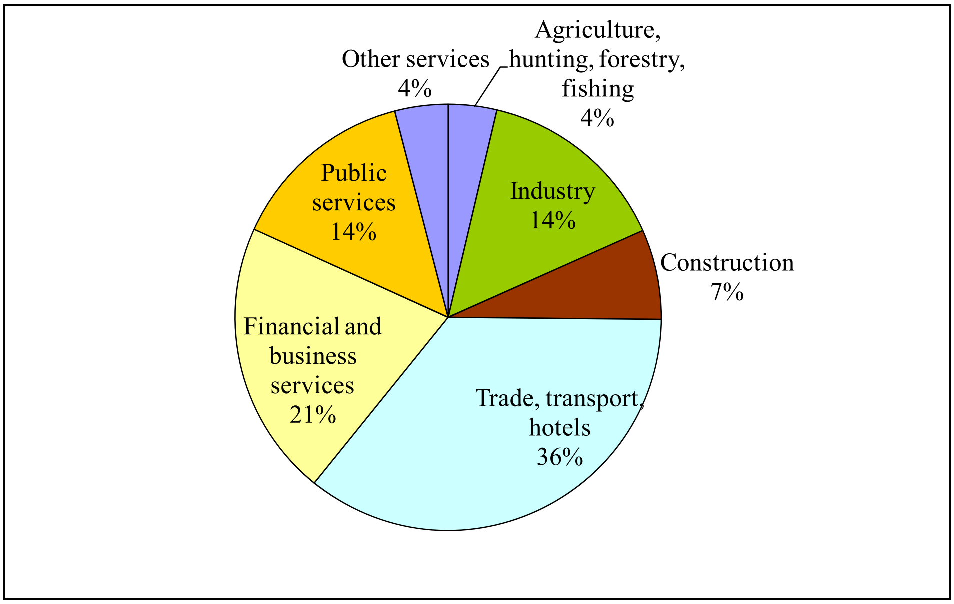

Chart 3. Value added by sector in 2006 (%)

Public services sectors usually report low growth rates at constant prices, yet higher growth rates at current prices. This relates to the high labour intensity in those sectors and limited opportunities to raise productivity by means of capital investment. Similar development trends will persist in the medium term, while the sectoral growth will be supported by demand for better quality services.

Labour market

Latvia's population continued to decrease. In the first nine months of 2007 alone, mainly as a result of natural movement, population declined by about 10 thousand to stand at 2272.3 thousand at the end of September.

Yet more recent years were marked also by some positive signs: the birth rates were gradually improving and in 2006 the highest birth rates within the last 10 years, with 22.3 thousand children born which is 0.8 thousand children more than in 2005, were reported. Birth rates continue to rise in 2007 as well. In the first nine months of 2007, 17.5 thousand children were born, which is 4.5% more year-on-year. Yet as a result of the death rates still exceeding the birth rates, in combination with the negative net migration, the population of Latvia will gradually decrease. Analysis of the demographic trends by age profile up to 2010 leads to a conclusion that the number of working-age population will decrease at a lower rate than the overall number of population.

Economic activity is growing year-by-year, and Latvia approaches the medium-term target for employment set in the Lisbon strategy. Yet regardless of the positive prospects for the economic activity, the medium-term growth of the number of employed will be increasingly more restricted by the impact of demographic factors.

In the last years, the increase in the number of employed has been very high both as a result of decreasing unemployment and economic activity growth. On average, a further high average increase in the number of employed is expected in 2007; nevertheless, in the years to follow the employment growth will gradually decelerate. Overall economic growth in Latvia is mainly underpinned by productivity growth; therefore, a lower increase of the number of employed will have no significant impact on the overall growth.

Last years there has been an increasingly smaller difference between the official registered unemployment and unemployment figures resulting from surveys. The macroeconomic development scenario provides for a further decrease in unemployment in 2008 and stabilisation in the years beyond as a result of lower growth rates and changes in the structure of sectors.

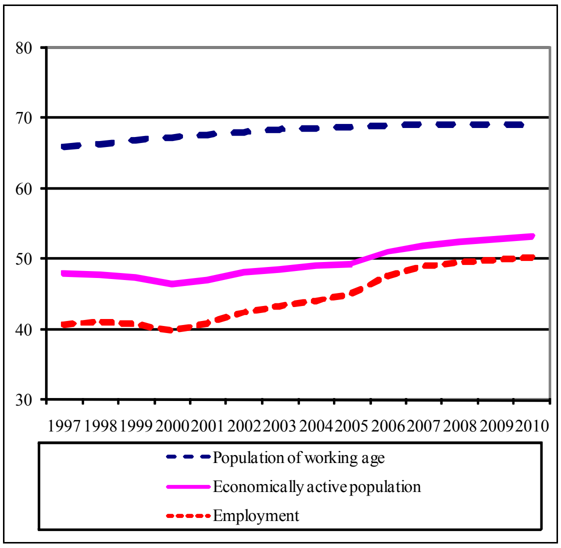

Chart 4. The ratio of working-age, economically active and employed population to total population (%)

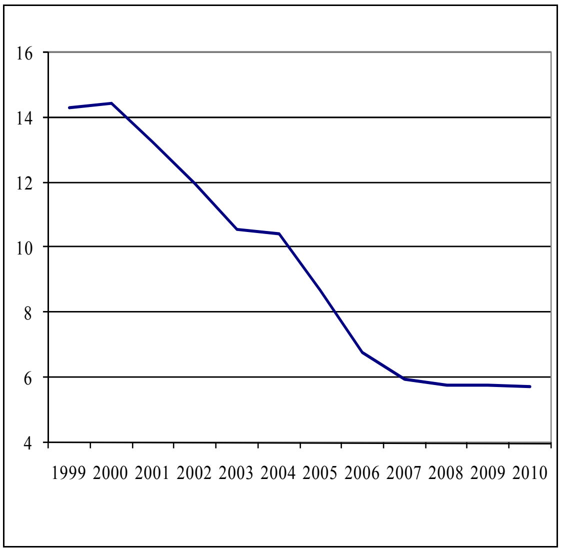

Chart 5. Job-seekers (% of economically active population)

In 2007, the average gross wage and salary in the economy could increase by 17.6% at constant prices. Such an increase would exceed the correlation between the real wage and salary and productivity growth, yet in the short-term these developments would pose no threat to the overall competitiveness of Latvia. There are several factors behind the recent rapid increases in wages and salaries: persistently high inflation, decreasing supply of labour force, alternative employment opportunities abroad, and activity of controlling institutions as well as rising of the minimum monthly wage. The increase of the real wage and salary is expected to be in line with the productivity growth in the medium term and will be about 5.5%–7%.

2.2.2. Inflation

The average annual inflation in 2006 was only slightly lower than the year before at 6.6% (HICP), due to the impact of costs on a gradual increase of administered prices and food prices, changes in indirect taxes as well as the stable domestic demand resulting in a rather high level of core inflation (5.1%), including a sharp rise of non-administered prices.

In 2007, 12 month inflation gradually climbed from 7.1% in December to 13.2% in October. It was affected by factors similar to those of the previous year, yet their intensity was different.

In the first 10 months of 2007, a large part of administered prices increased and food prices rose under the impact of higher costs, scarce crops and volatility observed on the global food markets. The impact of fuel prices, in turn, has weakened, which can be partly explained by a relative calm on the global oil market for the most part of the year and minimum changes in excise tax rates. The share of fuel in the composition of consumption expenditure has also shrunk considerably from 4.6% to 3.8% in comparison with the consumption basket used for estimating the 2006 inflation.

The overall inflation rise is primarily mirrored by the growing core inflation, a major contributor to this growth being the increase in non-administered service prices and the impact of indirect taxes. The high rise of non-administered service prices is determined by the previous period costs, tight labour market as well as the persistent domestic demand.

The impact of indirect taxes on inflation has strengthened in 2007: raising the excise tax on tobacco products increased the average 10-month inflation by more than 0.5pp (from ~0,3pp in January to ~1pp at the end of the year). At the same time, the impact of a decrease in the VAT rate on heating which was introduced in the summer of 2006 has disappeared.

Overall, it can be expected that in 2007 the average annual inflation will reach 10.1%, whereas the 12-month inflation will be about 14%, primarily as a result of a sharp rise of inflation in the second half of the year, when several administered prices (particularly that on the thermal energy, waste disposal and water supply and sewerage) and excise tax rates on tobacco goods were raised, and food prices rose dramatically.

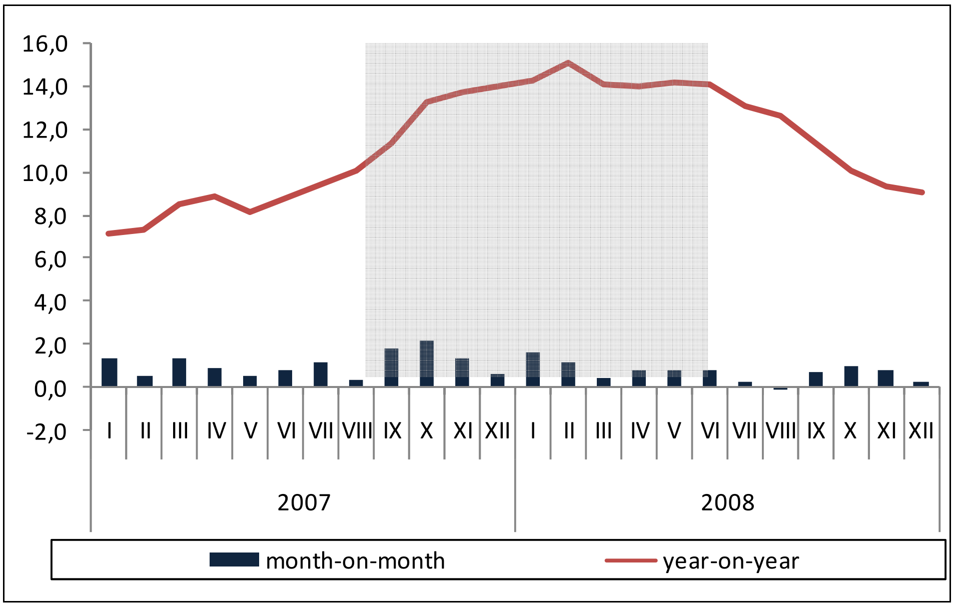

Chart 6. Inflation in 2007-2008 (%)

At the beginning of 2008, a further rise of inflation can be expected resulting from significant already approved or expected increases of administered prices. New public transport fares in Riga have been approved, electricity prices are bound to be raised in January 2008, a rise in administered rent and housing maintenance fees is expected, and natural gas prices could grow in May 2008 to a similar extent than in 2007. Energy resources will become more expensive to a larger extent than in 2007 also because the VAT rate will remain unchanged. In mid-2006, the rate on heating and at the beginning of 2007 that on electricity and gas was decreased. Electricity market will also be affected by a reduction of emission gas quotas for Latvia which is not in line with the economic development rates of the region and could push up the electricity production costs. Alongside with the pressure exerted by costs, the persistent domestic demand is another factor sustaining the high rise in non-administered service prices. At the beginning of 2008, inflation will also be affected by raising the excise tax on tobacco and fuel, in order to fulfil the minimum EU requirements. Therefore, the inflation can be expected to reach a peak in February. Afterwards it could gradually decline, as the impact of administered prices will weaken in the second half of the year and the domestic demand will dampen as a result of the implementation of the anti-inflation plan measures.

In 2009–2010, the inflation will continue to decrease gradually as a result of lower rises in administered prices and more moderate economic development rates.

Table 2. Changes in administered prices and their impact on CPI

	2006	**2007**	**2008**	**2009**	**2010**
	actual	forecast			
12 month growth; %	11.4	17.6	24.0	8.4	6.0
Impact on inflation; in percentage points	1.6	2.3	3.1	1.1	0.8

The above-described inflation scenario is based on the assumption that the natural gas prices will remain broadly unchanged from 2009 onwards, which will be determined by the high level reached and oil price stabilisation as reflected in the European Commission forecasts. It is also assumed that closing of Ignalina nuclear power plant in 2009 will not result in an excessively high rise of electricity prices in the region. Alongside with the uncertainty surrounding the global oil and food market developments, these are the main risk factors to the inflation scenario.

Successful implementation of the anti-inflation measures aimed at sustainable reduction of the inflation instead of short-lived administrative measures to merely delay the price rises will have a positive effect in the medium-term and long-term.

Table 3. Changes in consumer prices

	2006	**2007**	**2008**	**2009**	**2010**
	actual	forecast			
HIPC changes (year-on-year)	6.6	10.1	12.5	7.2	4.9
CPI changes (year-on-year)	6.5	10.1	12.5	7.2	4.9
CPI changes (12-month)	6.8	14.0	9.0	6.5	4.0

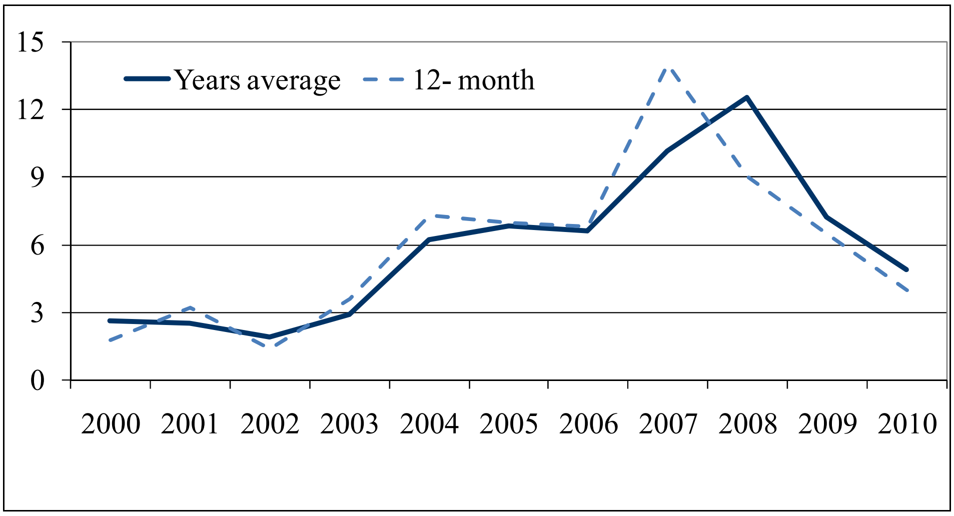

Chart 7. Consumer price index developments in 2000 –2010 (%)

2.2.3 Monetary and Exchange Rate Policy

Latvia's medium-term monetary and exchange rate policy largely relates to the monetary integration plans. Latvia joined the ERMII on 2 May 2005, undertaking a unilateral commitment to ensure a +/-1% exchange rate fluctuation corridor around the central parity rate against the euro (EUR 1 = LVL 0.702804). Duration of participation in the ERMII will depend on the ability of Latvian economy to meet the convergence criteria and the evaluation of the involved institutions of Latvia's readiness to join the EMU.

In order to implement the monetary policy effectively and without any shocks to the financial sector, the Bank of Latvia adjusts its monetary policy implementation instruments to the European Central Bank practice. Currently, the Bank of Latvia already uses the same indirect monetary policy instruments based on free market principles as the ECB and in the future, when joining the EMU, only the significance of some instruments in implementation of the monetary policy and procedural elements will have to be reviewed.

In order to mitigate the macroeconomic risks relating to the rapid economic growth of Latvia, lending expansion, high inflation and excessive current account deficit, the Bank of Latvia continued to implement a tight monetary policy in 2007. With the euro area interest rates rising, the Bank of Latvia also raised the refinancing rate on two occasions in March and May 2007, overall from 5% to 6%, by 50 basis points respectively. In order to manage the liquidity of the banking sector, the Bank of Latvia set quite restrictive limits on market operations; as a result, banks had also to resort to the marginal lending facilities with the Bank of Latvia. In addition, the Bank of Latvia continued to accept large amounts of time deposits in lats from the Treasury.

2.2.4 External sector

Table 3. Key items of the balance of payments (% of GDP)

% of GDP	ESA code	**2006**	**2007**	**2008**	**2009**	**2010**
1. Current and capital account	B.9	-21.1	-23.5	-20.3	-18.3	-16.4
including: - Balance of goods and services		-22.1	-24.0	-21.7	-20.0	-18.5
- Balance of income and transfers		-0,2	-0,8	0,1	0,4	0,7
- Capital account		1.2	1.3	1.3	1.3	1.4
2. Net lending/ borrowing of the private sector	B.9	-21.4	-23.8	-21.0	-19.3	-18.6
3. Net lending/ borrowing of the general government sector	EDP B.9	-0.3	0.3	0.7	1.0	1.2
4. Statistical discrepancy		0.6	0.2	0.0	0.0	0.0

The current account deficit of the balance of payments has increased significantly during the last years in Latvia pointing to domestic and external imbalance risks in the economy. On the one hand, the persistently high current account deficit is determined by the convergence process and the use of foreign savings to finance modernisation and development of the economy. On the other hand, cyclical factors have also exerted an upward pressure on the current account deficit in the last years, with Latvia's economy performing above the level of the potential output. Favourable financing terms and acceleration of the growth of private consumption prevent the domestic savings from expanding. With domestic prices and wages and salaries increasing, the cost-competitiveness of businesses deteriorates. Nevertheless, in terms of the absolute costs of labour, Latvia remains a country where the labour costs are considerably lower than the average level of other EU Member States. Alongside with a more rapid growth of export prices, the terms of trade improved in 2007.

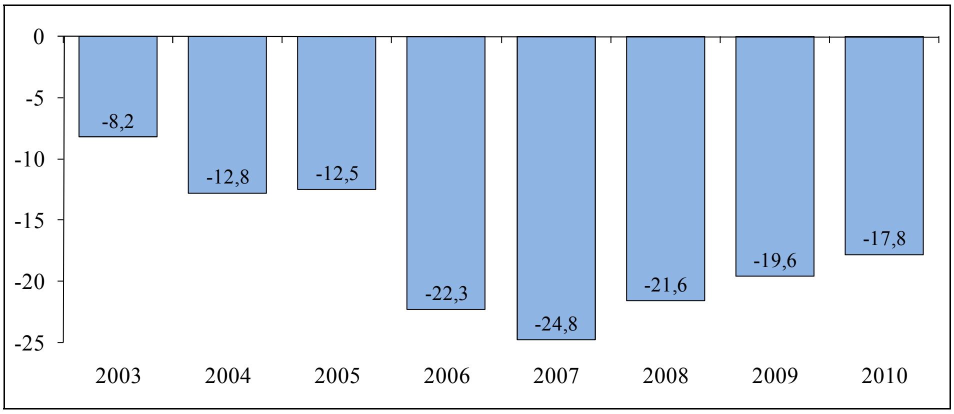

Chart 8. Current account deficit (% of GDP)

In 2006, the current account deficit amounted to 22.3% of GDP, and it edged up further to 24.8% in the first half of 2007. The main component behind the current account deficit remains the goods import/export gap.

The growth of exports of goods accelerated from 14.0% in 2006 to 21.0% in the first nine months of 2007 in nominal terms. The rise resulted from a significant increase in the exports of wood and articles of wood, the biggest group of export goods, on account of higher prices. Exports of base metals and articles of base metals, agricultural goods and foodstuffs, mechanical appliances and electrical equipment were also significant, whereas the exports of mineral products continued to shrink. This year, Latvia's overall market share in the EU market and also in Russia expanded. The growth of imports of goods amounted to 26.2% in the first nine months of 2007 in nominal terms, in comparison with 32.2% in the respective period of the previous year. The growth was driven by the domestic demand, although there are some signs of demand deceleration, and also by several large investment projects, like restoration of *Latvijas Kuģniecība* fleet and a one-off investment deal in an exporting company.

The balance of services is with a surplus in Latvia, yet the growth of imports of services outpaces that of exports. In the first half of 2007, services exports grew by 21.6%, whereas the imports by 33.4% mainly on account of a significant rise in received travel services. The surplus of transportation services increased primarily as a result of growing freight transportation by road and passenger transportation by air.

The income deficit grew by 93.7 million lats in the first nine months of 2007 in comparison with the corresponding period of the previous year, with non-resident investment income gained in Latvia rising. The increase in compensation to employees received by residents abroad offset only 1/10 of the non-resident income growth. The surplus of current transfers decreased by 75.4 million lats.

The financing structure of the current account deficit points to foreign investors' confidence in further economic growth and government policy implemented in Latvia. Rapid economic growth, accession to the EU and favourable geographical position help to secure foreign direct investment inflows into Latvia. In 2006, net inflows of foreign direct investment amounted to 7.4% of GDP, whereas in the first half of 2007 to 9.8% of GDP, with major investment being made in the financial intermediation sector. Overall, in the last years the current account deficit was fully covered by foreign direct investment and other long-term capital (mainly long-term bank loans from parent banks abroad). The capital account surplus also continues to grow, which can be explained by the inflows of the EU funding in Latvia. Reserve assets increased significantly in 2006 to 9.8% of GDP, which was influenced by the Bank of Latvia's policy to raise the minimum reserve requirement. In the next years, the banking sector borrowings abroad are expected to continue to be the main financing source for the current account deficit.

The trends so far suggest that the current account deficit of the balance of payments will amount to about 24.8% of GDP in 2007, and will then gradually decline at an annual rate of 2-3 percentage points. The results of the first nine months of 2007 point to a rise in the goods deficit as well as deterioration of the balance of income and current transfers. The services surplus has remained unchanged in comparison with the previous year. In the years to come, export growth will slightly decelerate as a result of moderate external demand and potential deterioration of the competitiveness of exporting businesses against the background of rising labour costs. As the domestic demand and lending are expected to dampen significantly, the import growth will decelerate considerably and will be lower than that of exports. There is no information available on any large-scale investment projects to be implemented in the nearest future, which could significantly affect the volume of imports. The growth of export prices will outpace that of the import prices and will have a positive effect on the export income, with the terms of trade continuing to improve.

2.3 Economic impact of the structural reforms

The structural reforms discussed in Latvia's national Lisbon programme are closely related to Latvia's National Development Plan, which is a medium-term planning document. Reform implementation will improve the economic growth potential and contribute to the attainment of the main development objectives. The reforms also have a positive effect on sustainability of public finances.

Latvia's national Lisbon programme focuses on the following priority areas of structural reforms:

- stimulation of knowledge and innovations;
- creation of a favourable and attractive environment for investment and work;
- promotion of employment.

Measures to promote **knowledge and innovations** are based on the Law on Scientific Activity providing for an annual increase of central government spending on scientific activity by 0.15% of GDP. In 2006, public financing for research and development amounted to 29.8 million lats, whereas in 2007 to 41.0 million lats. The planned medium-term funding is 45.5 million lats in 2008, 45.0 million lats in 2009 and 45.4 million lats in 2010 respectively.

In order to facilitate restoration and development of the intellectual potential of the scientific activity, it is planned that by 2013 the annual number of new Doctor of Science degree graduates will reach 500 (in 2006, 106 Doctor dissertations were successfully defended).

Latvia improves measure activities relating to technology transfer, strengthening cooperation between educational, research institutions and sectors of industry.

Progress with regard to increasing numbers of internet users points to development of an information society. Implementation of the current policies has secured a very good telecommunications network, ICT related legislation has been aligned, main registers and the most significant information systems have been established, integration of the public administration IS and establishment of on-line services is in progress.

Improvement of business environment also continues in Latvia within the framework of the National Lisbon Programme. This particularly concerns the improvement of business environment in small and medium size enterprises (SMEs). An Action Plan for Improvement of Business Environment is prepared every year in cooperation with organisations representing businesses in Latvia since 1999.

2007 Action Plan includes 27 measures. The main issues addressed within the framework of the Plan are improvement of the medium-term and long-term labour market forecasting, simplification of the procedure to evaluate compliance with work environment requirements, more effective handling of labour disputes, raising the efficiency of the real estate registration system and simplification of the registration procedures, development of the State Land Service infrastructure, creation of a planning and construction information system, development of the process to determine the cadastre value of buildings, improvement of information flows etc.

Another improvement of the business environment was the new Solvency Law taking effect on 1 January 2008. It will ensure the legal framework for balancing the interests of debtors and creditors by means of changing the procedures, principles and objectives to be applied in different insolvency situations, providing more favourable legal provisions for restoring the solvency of debtors and continuing their business.

In order the improve availability of funding for the SMEs, more attention is paid to granting funding to business development at very early stages and to availability of financing in the form of venture capital as well as to co-financing extended to business development projects in specially supported territories. In the programming period of 2007–2013, financial support to businesses and innovations in the amount of 480 million euro is planned from the structural funds.

Reforms improving the business environment have received a positive evaluation in various surveys. The survey *Doing Business in 2008: How to reform* conducted by the World Bank group ranked Latvia's business environment 22nd among 178 states, which is two positions higher in comparison with the previous year, due to the achievements made in the areas of taxes, licensing and business liquidation.

Latvia's **employment policy** is formulated on the basis of the following priorities:

- promote an inclusive labour market by expanding the range of active employment measures;
- stimulate economic activity in under-developed regions;
- address the problem of undeclared employment more intensively and encourage the population to work in the formal economy by raising the net wages and salaries for low-income population and by enhancing both the state control institutions and associations of the social partners (trade unions, employee associations etc.);
- expand education and training opportunities.

As a result of rapid economic development, improved and diversified active labour market measures and other factors, Latvia's labour market indicators improved significantly in the recent years. Already in 2006, all most important employment policy objectives for 2008 and partly for 2010 established in the National Lisbon Programme were attained. As a result of the rapid growth and labour emigration, some sectors of the economy started to be affected by the shortage of labour. In order to employ the existing labour resources more efficiently, active employment measures were expanded. In 2006, several existing measures were expanded and new measures were introduced relating to inclusion of young people, pre-retirement age population and women after the period childcare leave as well as the disabled and other socially-marginalised risk groups into the labour market. To improve the competitiveness of population on the labour market, in addition to the organised active employment measures, training will be offered not only to the unemployed but also employed and self-employed persons from 2008 onwards. Businesses and sectoral associations will be able to apply for the European Social Fund co-financing for training of their staff.

Support to business development in territories requiring special assistance is provided within the framework of both the national financing (Regional Fund) and the EU funding, thus promoting business in those regions, creating new jobs and preserving the existing ones. Growing activity of business people and the achieved performance indicators point to increasing business activity in the specially supported territories. Therefore, for the programming period 2007–2013 a new programme for support to business activities in specially supported territories is being prepared within the framework of the European Union's structural funds.

Undeclared employment is quite high in Latvia. The problem of undeclared employment is addressed using a broadly-based approach. The administrative capacity of the State Labour Inspection is raised, the role of trade unions and employer associations is increased and the minimum wage and non-taxable minimum are raised, in order to lighten the tax burden on low income population. Therefore, the Government raised the minimum monthly wage and the non-taxable minimum and relief for dependants for the personal income tax purposes both in 2006 and 2007. As of 1 January 2008, the minimum monthly wage will be raised to 160 lats and the minimum amount exempt from personal income tax to 80 lats.

With a view to ensuring sustainable economic development and economic growth, at the same time seriously evaluating the socio-economic consequences, up to 2010 work on improvement of the economic migration system will continue.

Investment in human capital plays a decisive role in raising the productive capacity to encourage movement towards knowledge-intensive economy. To secure an improvement of education and skills, cooperation between public administration institutions, educational establishments and employers in adjusting the supply of the education system to the needs of the labour market is strengthened. Cost-efficiency for all levels and types of education is raised, availability of all levels of education is improved, the overall level of technological skills and natural science knowledge is improved as well as the system of life-long learning.

3 General Government Balance and Debt

3.1 Fiscal Policy and General Government Balance

Latvia's integration into the European Union and implemented reforms have a positive effect on the economic development. Latvia's economy has been demonstrating high growth rates already since 2004, and it is one of the fastest developing Member States of the European Union.

The fiscal policy implemented by the Government is aimed at stable macroeconomic growth, at the same time ensuring successful fiscal consolidation. The main task of the Government's fiscal policy formulated in the previous periods was creating a balanced budget. Further improvement of the financial position is expected in the next planning period which will result in a surplus in the general government budget.

Cabinet of Ministers 21 March 2007 decree No.157 "**On medium-term budget targets and priority development areas 2008–2010"** stipulates that the medium-term budget objective for 2008–2010 is to facilitate the attainment of the objectives set in Latvia's National Development Plan. The decree sets the following priority development areas required for implementation of the medium-term objective of the general government budget:

1) formation of a knowledge-based society;

2) balanced and smooth economic development;

3) providing for the health, spiritual and social needs of an individual;

4) sustainable national development, balanced regional development and good governance.

On 2 May 2007, the Cabinet of Ministers approved the Medium-Term Macroeconomic Development and Fiscal Policy Framework for the first time, which is to be considered one of the most important steps towards implementation of medium-term budgeting. Implementation of the principles of medium-term budgeting is the basis of pursuing a tight fiscal policy, and thus the Government has shown its commitment to stabilise the situation in Latvia's economy.

The general government balance has a tendency to improve: in 2004, the general government budget ran a deficit in the amount of 1.0% of GDP, but with the financial position gradually improving it is planned to achieve a budget surplus in the amount of 0.3% of GDP in 2007.

The general government deficit was mainly the result of a deficit in the central government budget, where the decrease was gradual as it was necessary to continue the reforms started to improve the operational effectiveness of the healthcare and interior affairs systems, increase spending on national defence, security and NATO participation and provide co-financing for the European Union funding.

The financial position of the social security budget improved significantly in the last years. In 2002, this budget ran a surplus in the amount of 0.3% of GDP, whereas in 2007 it is planned to achieve a surplus in the amount of 2.3% of GDP.

The balance of the local government budget in recent years, in turn, was significantly affected by the launched construction works of Riga Southern bridge, where the planned costs of 2007 amount to 0.4% of GDP.

Table 5. General government budget (millions of lats)

	2006	2007	2008	2009	2010
	actual	estimate	forecast		
Revenue	4162.9	5220.7	6279.2	7310.3	8331.0
Expenditure	4193.8	5173.0	6168.7	7121.5	8067.6
Balance	-30.9	47.7	110.5	188.9	263.4

General government budget

2008 budget was formulated assuming the GDP growth of 7.5%, which could decelerate slightly to 6.8% in 2010. On 8 November 2007, the "Law on State Budget 2008" was adopted by the Parliament, providing for a significant surplus. Yet considering the high costs of the construction works of Riga Southern bridge, it is expected that the general government surplus could amount to 0.7% of GDP in 2008.

Long-term stabilisation of the Latvian economy has been set as one of the most important tasks of the general government budget in 2008. Therefore, the Government has proposed to start accumulation of a long-term stability reserve already in the end of 2007. All central government revenue (except self-earned revenue and foreign financial assistance) exceeding the provisions of the annual state budget as well as all privatisation receipts will be transmitted into this reserve fund.

The medium-term objective of Latvia's budget is to stabilise the national economy, yet preserving high development rates. At the same time, the Government continues to implement several national importance reforms. The medium-term budget will ensure socio-economic growth, improvement of population welfare, stability and predictability, continuing the raise the living standards of Latvia's population with a view to attain the average welfare level of the EU.

Central government budget

Looking at the structure of balance, it has to be noted that the central government budget will still run a deficit in the amount of 0.5% of GDP in 2008, yet it will be significantly lower than in the previous years.

If the priority objectives set by the Government are to be attained, a more dramatic decrease of the central government deficit is impossible. Large financing is planned in 2008 for completion of administrative and territorial reform (56.0 million lats or 0.3% of GDP). The reform will result in formation of local governments with a larger economic development and financial stability potential.

Nevertheless, it is expected that the central government deficit will continue to be gradually reduced in the medium-term. To achieve that, medium-term measures to limit the growth of expenditure will be implemented. For instance, with a view to dampening the buoyant consumption and restricting the inflation growth, the Government has undertaken a commitment to limit the wage increases in the public sector.

Amendments in legislation governing social benefits payable from the central government budget have been introduced.

According to the law "Amendments to the State Social Benefits Law", from 1 January 2008 benefits to disabled persons requiring care (100 lats per month) will be introduced. Benefits will be granted to persons with a status of a disabled person over 18 years of age, requiring special care as a result of severe functional problems. This disability care benefit required an annual expenditure increase in the amount of 8.9 million lats in the central government budget in 2008 and beyond. It is also planned to replace the childcare benefit for employed persons raising a child of up to 1 year of age by a parent benefit which will be granted and paid from the special state social security budget for socially insured persons. Changes relating to the procedure for granting the childcare benefit will result in an economy of funds in the central government budget: in the amount of 30.8 million lats in 2008, 37.5 million in 2009, 45.1 million lats in 2010. According to the law "Amendments to the law "On State Social Insurance"", as a result of changes in the procedure of granting childcare benefits, no state social security contributions for state pension insurance of persons raising a child of up to 1 year of age from the central government (transfer from central government budget to social security budget) will be made. The planned reduction of expenditure in the central government budget is: 1.7 million lats in 2008, 1.9 million lats in 2009, 2.0 million lats in 2010.

- According to the Cabinet of Ministers 28 August 2007 regulations No.576 "Amendments to the Cabinet of Ministers 13 December 2005 regulations No.940 "Regulations on the Size of Childcare Benefit for a Disabled Child, its Review Procedure, Procedure for Granting and Disbursement of the Benefit"", it is expected to increase the benefit to take care of a disabled child from 50 lats to 150 lats per month as of 1 January 2007. As a result of raising the amount of the benefit to take care of a disabled child, the following expenditure increase in the Ministry of Welfare basic budget is planned: 0.9 million lats in 2008, 1.0 million lats in 2009, 1.1 million lats in 2010.

The medium-term central government budget deficit is planned in the amount of 0.6%–0.7% of GDP.

Social security budget

The financial position of the social security budget has improved significantly in the last years. Social security budget is expected to retain its surplus also in the medium-term.

In 2008, a surplus in the amount of 1.5% of GDP is planned in the social security budget. The surplus is decreasing in comparison with what was achieved in the previous years, yet there are several objective reasons for that.

Shrinking of the surplus will be driven by a decrease in the size of social security contributions, as social security contributions to the funded pension scheme will grow significantly from 4% to 8%, amounting to 1.5% of GDP in 2008.

At the same time, several amendments to social insurance legislation are planned, which will impact on the social security budget expenditure in the medium-term.

- According to the Cabinet of Ministers 25 September 2007 regulations No.651 "Amendments to the Cabinet of Ministers 22 November 2005 regulations No.891 "Regulations on Monthly Bonus to Old-Age Pension"", it is expected that from 1 June 2008 the monthly bonus to the old age pension per one year of insurance record accumulated up to 31 December 1995 will be raised from 19 santims to 40 santims. As a result of raising the bonus to the old-age pension, the following expenditure increase in the social security budget is planned: 19.1 million lats in 2008, 32.4 million lats in 2009, 31.2 million lats in 2010.
- According to the law "Amendments to the Law "On Unemployment Insurance"", it is expected that from 1 January 2008 onwards the period of entitlement to unemployment benefit disbursements will be established on the basis of the length

of unemployment insurance record and the size of the unemployment benefit will be set taking into account the duration of unemployment and insurance record, providing that entitlement to unemployment benefit is granted to an unemployed person with the insurance record of at least 1 year, provided that compulsory state social insurance contributions for unemployment for this person were made or were supposed to be made for at least 12 months within the 18 month period prior to the day of requesting the benefit.

Table 6. Information on the size of unemployment benefit and duration of payment according to the amendments to the law "On Unemployment Insurance"

Insurance record	**Duration of benefit payment**	**Size of benefit**
1–9 years	**4 months**	
	First two months	Full amount
	Last two months	75%
10–19 years	**6 months**	
	First two months	Full amount
	Next two months	75%
	Last two months	50%
20 years and more	**9 months**	
	First three months	Full amount
	Next three months	75%
	Last three months	50%

In relation to implementation of the above provisions, the following expenditure reduction in the state social security budget is planned: 8.9 million lats in 2008, 10.2 million lats in 2009, 11.7 million lats in 2010.

- According to the law "Amendments to the Law "On Maternity and Sickness Insurance"", it is expected that from 1 January 2008 a new social security benefit (parent benefit) will be introduced, which will be granted and disbursed from the state special social security budget to socially insured persons raising a child of up to 1 year of age, provided that this person is on a childcare leave or does not earn income due to raising a child as a self-employed person, or continues to work in the above-mentioned childcare period. It is planned to grant the parent benefit in the amount of 70% of the average social security contributions wage of the benefit beneficiary, yet in the amount of at least 70% of the twofold amount of state social security benefit effective at the day of requesting the parent benefit and without any limitations imposed on the maximum size of the benefit. Implementation of the planned parent benefit will result in the following increase of expenditure in the social security budget: 36.2 million in 2008, 44.1 million lats in 2009, 53.0 million lats in 2010.

From 1 January 2009, according to the law "Amendments to the Law "On Maternity and Sickness Insurance"", the size of paternity benefit will be set in the amount of 100% of the average social security contributions wage of the benefit beneficiary. For an insured person, who in the period of establishing the average social security contributions wage or part of this period as prescribed under Article 31 of the Law "On Maternity and Sickness Insurance" was not registered as a person making state social security contributions or the person has not had an security contribution wage because of being on a leave without preserving work pay, when calculating the maternity benefit or paternity benefit, the average social security contributions wage for this period or part of the period will be established as 70% of the average monthly security contribution wage prevalent in Latvia. As a result of implementing the above provisions, the planned expenditure increase in the special social security budget will be as follows: 1.1 million lats in 2009 and 1.6 million lats in 2010.

- According to the law "Amendments to the Law "On State Pensions"", it is expected that from 1 January 2008 a person will no longer be able to receive two services simultaneously from the special social security budget: service pension and unemployment benefit, as the disbursement of the service pension will be suspended during the period of the service pension beneficiary receiving an unemployment benefit. As a result of implementing the above provisions, the planned expenditure decrease in the special social security budget will be as follows: 0.2 million lats in 2008 and beyond.

Considering that granting of service pensions is governed also by several special laws, these laws have also been amended to say that it is impossible to draw two payments, service pension and unemployment benefit, at a time.

- According to the law "On State Pensions", pension indexation twice a year (in April and October) will be continued in 2008. Pension indexation will required state social security budget expenditure in the amount of 160.2 million lats, including:

1) 2008 planned expenditure to ensure 2007 pension indexation in the amount of 122.3 million lats;

2) 2008 planned expenditure for 2008 pension indexation in the amount of 37.9 million lats.

Additional expenditure to ensure pension indexation in 2008 against the planned provisions of 2007 law "On State Budget 2008" is planned in the amount of 116.9 million lats.

The average increase of indexed state pensions (old-age pension, service pension, disability pension, loss of supporters pension) as a result of April 2008 indexation is expected to amount to 3.42 lats and as a result of October pension indexation to 11.88 lats. The average increase of the old-age pension, in turn, as a result of 2008 April indexation is expected to amount to 3.55 lats and as a result of October pension indexation to 12.35, whereas the average number of old-age pension recipients will be 472.1 thousand persons, representing a 3.8 thousand person decrease over 2007.

It is planned that the social security budget balance will improve in the medium-term and in 2010 there will be a surplus in the amount of 2.0% of GDP in the social security budget.

Local government budget

In 2002, the deficit of the local government budget amounted to 0.9% of GDP. Starting from 2003, the financial discipline of the local governments improved significantly; therefore, it is planned that the local government budget will be balanced in 2007. Nevertheless, considering the significant costs of the construction works of Riga Southern bridge, it is expected that the local governments will retain a small financial deficit in the medium-term of 0.1%–0.3% of GDP.

Evaluating the Government policy for more rapid dampening of consumption which at the same time envisages to pay exceptional attention to optimum spending of the central government budget, including more efficient spending of the local government budget, the share of the personal income tax revenue to be transferred into the local government budget based on the taxpayer's residence in 2008 was set at 80%, providing that the local governments undertake to limit the wage and salary growth for those categories of employees whose income exceeds the average wage and salary in the public sector and not to increase the wage fund by more than 10% in comparison with 2007.

Taking into account that it is expected that the actual collections of the personal income tax will be above the target of the initial plan in 2007, the local governments have committed themselves to accumulate a financial reserve in 2007 which will be used in 2008 to discharge the functions prescribed by the laws and regulations.

Currently, the process of local government mergers (formation of territories) has not been fully completed yet. If the local governments merge more intensively, creating local governments (territories) that are more capable of economic development and financially stronger, the financial development of the local governments could be even more successful in the years to come, as by forming larger local governments it is possible to use the existing funds more efficiently and raise additional funding.

Financing for implementation of the administrative and territorial reform is granted based on the Law on Administrative and Territorial Reform and in compliance with the Cabinet of Ministers procedure for distribution of funding to local governments for the purpose of developing the infrastructure of territories and for granting central government budget grants to develop the local government infrastructure of territories. Funding provided in the 2007 central government budget and planned in 2008 based on the estimates prepared by the Ministry for Regional Development and Local Governments will secure the completion of the administrative and territorial reform, create large territorial local governments, improve the urban environment and ensure sustainable urban development in the existing and potential territorial significance development centres, i.e. the improvement of local government infrastructure units required for implementation of their functions. In 2008, development-capable territorial local government infrastructure will be improved in 45 of the planned territories by merging 57% of civil parishes and towns as well as support will be provided to the infrastructural development of pre-school educational establishments regional, territorial and local significance development centres. As a result of the reforms, by 2009 elections of the local governments 96 territorial local governments will be established and 9 local governments of republican cities. Currently, there are 26 district local governments and 527 local governments in Latvia, including 7 republican cities, 53 district towns, 35 territories and 432 civil parishes.

Financing for implementation of the administrative and territorial reform has been granted in the central government budget (Ministry for Regional Development and Local Governments) already since 2005. In 2005 1.8 million lats were granted, in 2006 3.0 million lats, in 2007 33.2 million lats, and in 2008, 56.0 million lats.

According to the provisions of the Law on Administrative and Territorial Reform, financing required for territorial infrastructure development is estimated based on the assumption that 200 thousand lats are granted per territorial unit in territories which have formed as a result of local government mergers.

Table 7. General government budget developments

		2006	2006	2007	2008	2009	2010
	ESA code	Millions of lats	% of GDP				
Net lending (EDP B.9) by sub-sector							
1. General government	S.13	-30.9	-0.3	0.3	0.7	1.0	1.2
2. Central government	S.1311	-224.4	-2.0	-1.9	-0.5	-0.7	-0.6
3. State government	S.1312	-	-	-	-	-	-
4. Local government	S.1313	-36.4	-0.3	0.0	-0.3	-0.1	-0.2
5. Social security funds	S.1314	229.9	2.0	2.3	1.5	1.8	2.0
General government (S.13)							
6. Total revenue	TR	4162.9	37.0	37.3	37.4	37.7	37.9
7. Total expenditure	TE	4193.8	37.2	37.0	36.8	36.7	36.7
8. Net lending/borrowing	EDP B.9	-30.9	-0.3	0.3	0.7	1.0	1.2
9. Interest expenditure	EDP D.41	52.2	0.5	0.4	0.3	0.3	0.3
10. Primary balance		21.4	0.2	0.7	1.0	1.2	1.5
11. One-off and other temporary measures							
Selected components of revenue							
12. Total tax (12=12a+12b)		2377.7	21.1	21.7	21.8	22.0	22.0
12a. Taxes on production and imports	D.2	1430.1	12.7	12.8	13.0	13.1	13.1
12b. Current taxes on income, wealth etc	D.5	947.7	8.4	8.9	8.7	8.9	8.9
13. Social contributions	D.61	1005.7	8.9	9.0	8.4	8.4	8.5
14. Property income	D.4	64.2	0.6	0.7	0.9	0.7	0.7
15. Other		715.4	6.4	5.9	6.3	6.5	6.7
16. Total revenue	TR	4162.9	37.0	37.3	37.4	37.7	37.9
p.m. :Tax burden (D.2+D.5+D.61+D.91 – D.995)		3422.0	30.4	31.1	30.6	30.8	30.9
Selected components of expenditure							
17. Compensation of employees + intermediate consumption	D.1+P.2	1861.1	16.5	15.5	14.5	14.0	13.7
17a. Compensation of employees	D.1	1142.5	10.1	9.7	9.2	8.9	8.8
17b. Intermediate consumption	P.2	718.6	6.4	5.8	5.3	5.1	4.9
18. Social payments (18=18a+18b)		954.2	8.5	8.7	9.0	9.1	9.2
18a. Social transfers in kind supplied via market producers	D.6311, D.63121, D.63131	52.8	0.5	0.5	0.4	0.3	0.3
18b. Social transfers other than in kind	D.62	901.4	8.0	8.2	8.6	8.8	8.9
19.=9. Interest expenditure	EDP D.41	52.2	0.5	0.4	0.3	0.3	0.3
20. Subsidies	D.3	72.2	0.6	0.5	0.5	0.4	0.4
21. Gross fixed capital formation	P.51	484.5	4.3	4.8	5.4	5.6	6.0
22. Other		769.5	6.8	7.1	7.1	7.3	7.3
23.=7. Total expenditure	TE	4193.8	37.2	37.0	36.8	36.7	36.7
Government consumption (nominal)	P.3	1910.4	17.0				

3.2 Medium-Term Objective and Budgetary Implications of Structural Reforms

The Member States have to set their medium-term objectives for the general government budget position based on pre-defined basic principles. Based on the Council's decision[1], medium-term objectives of the Member States are defined in cyclically adjusted terms and they must provide:

- a sufficient safety margin with respect to the 3% of GDP deficit limit;

[1] Council report "Improving the implementation of the Stability and Growth Pact"

- quick progress in reducing the government debt to a sustainable level, taking into account the impact of population ageing on the government budget;
- taking into account the above-mentioned principles, they should ensure flexibility of budgeting, in particular considering the needs for public investment.

The Council has set additional restrictions in setting the medium-term objectives for the euro area and the ERM II Member States, considering the need for a more open and restrictive fiscal policy, in order to promote the long-term stability of the single currency: the medium-term deficit target for low debt/high potential growth Member States may not exceed 1% of GDP, whereas for high debt/low potential growth Member States it has to be close to balance or with a surplus.

Member States whose actual budgetary positions have not yet reached their medium-term objectives have to achieve it over the economic cycle, net of one-off and temporary measures. For the euro area and ERM II Member States annual adjustment must be 0.5% of GDP as a benchmark. Their adjustment effort must be higher in good times; it could be more limited in bad times. When defining the adjustment path, structural reforms and public investment with a verifiable and obvious positive effect on the future budgetary balance may be taken into account.

Taking into account the updated Stability and Growth Pact, methodology guidelines approved by the Economic and Finance Committee, commitments following from participation in the ERM II and the national policy aimed at ensuring the macroeconomic stability and growth, Latvia's Convergence programme 2005 for the period of the next four years defined the medium-term objective for the cyclically adjusted balance of the general government budget as -1% of the GDP. Latvia has fully met the pre-defined medium-term objectives in the above period, and the budgetary performance has exceeded the target.

In order to ensure sustainable macroeconomic development and taking into account the impact of various factors, including the rising cyclical, economic imbalance indicators, the Latvian Government took a decision in March 2007 to formulate the medium-term budget for the period of up to 2010 with a surplus. In November 2008, the Parliament approved the "Medium-Term Macroeconomic Development and Fiscal Policy Framework 2008–2010", providing for a budgetary surplus within the above period.

The costs of structural reforms and increasing public investment push up Latvia's central government budget expenditure. Nevertheless, this expenditure is essential for ensuring the medium-term and long-term sustainability of Latvia's central government budget and raising the economic potential.

Pension and healthcare reforms have to be mentioned as the most significant reforms with a clearly measurable impact on the government budget in the medium-term and long-term. Significant funding has been planned in 2008 for the completion of the regional reform.

The pension reform is expected to have the most notable impact on the government budget balance in the medium-term, as up to 2010 the share of the state social security contributions transmitted into the state funded pension scheme will gradually grow (from 2% in 2006 to 10% in 2010). Accordingly, this amount of collected social security contributions will not be included in the estimates of the general government budget balance. In compliance with the "Law on State Funded Pensions", from 1 January 2008 the rate of contribution to the state funded pension scheme will be at least 8% (4% in 2007) of the contribution object stipulated in the law "On State Social Insurance". Increased contributions into the state funded pension scheme will dampen the growth of social insurance contributions payable to the state social insurance budget. It is expected that in 2008 the contributions to the state funded pension scheme will increase to 1.5% of the GDP in comparison with 0.8% in 2007.

In the years to follow, this increase in contributions will be more moderate, and in 2009 they will edge up to 1.6% of GDP, whereas in 2010 to 1.8% of GDP. This drop in revenue will be partly offset by pension expenditure within the programming period growing at a slower rate than the GDP as a result of the ongoing raising of the retirement age, due to the pension indexation formula and a lower number of population within the pre-retirement cohorts. Moreover, in the long-term the implemented pension reform will ensure the sustainability of the pension system regardless of a significant increase in the number of pensioners and growing demographic burden, as part of the required pensions will be paid out through the funded pension's scheme.

Of other reforms impacting on the medium-term budget position, one can mention the healthcare reform. Its task is to improve the quality of services and create a sustainable financing model for the sector. Improvement of the quality and accessibility of services is important if we want to improve the general health condition of the population, which is particularly important considering the demographic situation faced by Latvia.

At present, the healthcare system reform continues. Within the framework of the reform, it is planned to close or transform the majority of the currently operational regional hospitals which are unable to implement their functions fully and provide quality services due to the small number of patients, infrastructural inadequacies and outdated equipment. The reform is implemented based on the "Programme for Development of In-Patient and Out-Patient Healthcare Service Providers". It is planned to complete the reform in 2010, when 11 regional and 22 local hospitals are supposed to be operational in Latvia. Thus, each of the regional hospitals would provide services to at least 100 000 inhabitants, whereas each local hospital to at least 25 000 patients. The healthcare reform also includes an improvement of the medicines purchase compensation system. Funding from the budget to ensure availability of medicines is increased year-by-year, with the planned 2008 budgetary spending increase for this purpose being 0.5 million lats. This compensation system is particularly important in cases of average to serious diseases, when spending on medicines takes up a large part of the person's income. In order to establish a high-quality emergency medical assistance (EMA) system in Latvia that would be accessible to the population and cost-effective, it is planned to introduce a uniform system, structured and functioning based on universal principles for EMA teams and operative management, and a national patient or victim hospitalisation management system, so that the patient or victim is delivered to the best suited hospital in due time. These measures will ensure that the share of in-patient services, which are the most expensive medical services, in total health financing will decrease, the average treatment period will decrease by 10% and the average occupancy of beds will increase to 85%. This will also improve the opportunities to implement the latest medical technologies. With a view to ensuring successful implementation of the healthcare reform, in 2008 central government budget an increase in the amount of 0.3% of GDP is provided for spending on healthcare promotion, including the spending on raising the wages and salaries of medical personnel will grow by 0.2% of GDP. The results of spending more on implementation of the healthcare reform will only become apparent in the medium-term and long-term as an improvement of the general health condition of the population which, in turn, will influence the quality and quantity indicators of labour availability.

The central government budget also includes expenditure required to implement the regional reform. In compliance with the provisions of the Law on Administrative and Territorial Reform, an administrative and territorial reform of the local governments will be implemented by the 2009 elections of the local governments, with a view to establishing administrative territories capable of economic development with local governments ensuring quality services to the population. The territories will be formed by merging civil parishes, or cities/towns or civil parishes and cities/towns, with one local government governing the whole territory. Civil parishes and cities/towns merged in a territory will preserve the pre-merger name and area. On 4 September 2007, the government approved a new administrative and territorial division, providing for creation of nine republican importance cities and 96 territories. The Law on Administrative and Territorial Reform provides that a territory formed as a result of merging local governments is granted a one-off grant from the central government budget amounting to 1%–5% of the total annual budget of the merged local governments. It is also planned to grant a payment from the central government budget in the amount of 200 000 lats for each territorial unit of a territory (city/town and civil parish) to the local government of the territory formed as a result of local government merger by 31 January 2009 or to each of the city/town civil parish and territory governments which took a decision to form a new territory and start operation as a new territory after the 2009 election of the local governments in 2007. Thus, to implement these measures, 2007 budget includes funding in the amount of 0.2% of GDP earmarked for implementation of the territorial reform, whereas that of 2008 includes funding in the amount of 0.3% of GDP.

Another essential objective of the national reforms is raising the economic development potential. Here an important role alongside with ensuring adequate legislation and favourable business environment is played also by public investment. It is planned to increase the government spending on gross fixed capital formation by 1.2% of GDP by 2010 in comparison with 2007, to 6% of GDP.

The above-listed reforms are important for attainment of the medium-term and long-term objectives and ensuring sustainability of public finances. The expected future gains from the implemented reforms outweigh the costs of today. Moreover, a significant increase of funding is planned also in other reform areas, where the reflection and estimate of the temporary expenditure and long-term gains is not that simple.

3.3 Structural Balance

To ensure that the particular fiscal policy is adequate for the particular economic cycle, the cyclical component is estimated and used to adjust the budgetary balance. This is done with a view to balancing tax revenue planning in ups and downs of the economic cycles. A fiscal policy which is symmetrical to the cyclical economic development secures tighter budgetary discipline during the periods of buoyant economic growth, while being accommodative in periods of lower growth.

The cyclically adjusted budget balance shows what the budget balance would be if the economy was performing at its potential level. Depending on the cyclical position of the economy, the cyclical component of the actual budget deficit is identified.

According to the Ministry of Finance estimate, using the production function method, Latvia’s positive output gap has been growing since 2005. Under the circumstances of a high domestic demand, the actual GDP growth outpaced that of the potential GDP growth in 2007 as well. Yet there are several factors underpinning also an increase in the potential output. The growing number of employed and real investment also supports the potential GDP growth. According to the macroeconomic development scenario discussed in the Convergence programme, high economic development will be supported by factors on the demand side in 2007; therefore, the positive output gap will persist at the level of 2.1%. The Ministry of Finance estimates that the positive output gap will decrease in 2008, and it is expected to turn negative in 2009.

Latvia’s potential GDP growth is primarily driven by capital and productivity growth, yet the contribution of employment growth has also increased in the recent years. In the medium term, deceleration of the growth of employment can be expected, which will help to decrease the potential output. Regardless of the need to increase and renew productive capital stock, the capital growth forecast based on the production function method is close to sustainable growth opportunities. In the medium term and in the long term, the economic growth will be primarily based on productivity growth. Taking into account the above-mentioned factors, a gradual deceleration of the potential GDP growth can be expected.

The estimate of the cyclical development of the Latvian economy and the sensitivity of the general government budget to cyclical economic development estimated by the European Commission show that the estimated cyclically adjusted budget is with a deficit in 2007, whereas the nominal budget balance is planned with a surplus. In 2008, the cyclically adjusted budget surplus is expected to be much lower than the actual budget balance. Yet in 2009 and 2010, the cyclically adjusted budget surplus will already be much higher than the targeted nominal balance.

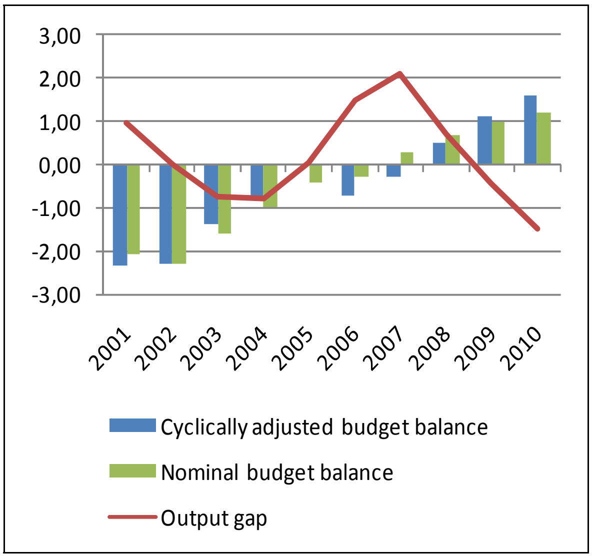

Chart 9. Cyclically adjusted budget balance (% of GDP)

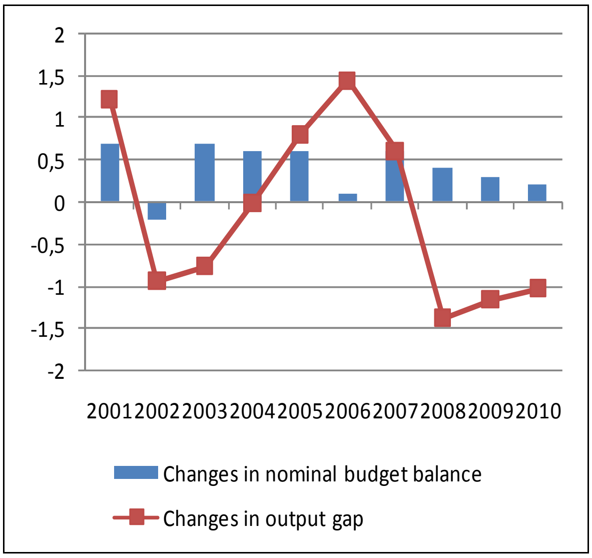

Chart 10. Changes in the fiscal position (% of GDP)

Since 2004, Latvia meets the medium-term budget target, and its fiscal position is continuously improving. Considering the long period of growth above the potential, the nominal budget targets have been significantly adjusted in 2007, providing for an improvement of the budgetary balance in comparison with the initial plan by 1.6 percentage points. In the years to follow, further improvement of the positive budgetary balance is planned regardless of the expected growth deceleration, which is underpinned by the need to quickly ensure the internal and external balance of the economy by reducing inflation and improving the current account of the balance of payments.

Table 8. Cyclical developments

% of GDP	ESA Code	2006	2007	2008	2009	2010
1. Real GDP growth (%)	B1g	11.9	10.5	7.5	7.0	6.8
2. Net lending of general government	B9	-0.3	0.3	0.7	1.0	1.2
3. Interest expenditure	D41	0.5	0.4	0.3	0.3	0.3
4. One-off and other temporary measures		0.0	0.0	0.0	0.0	0.0
5. Potential GDP growth		10.0	9.9	9.1	8.3	8.0
contributions:						
- labour		1.6	1.8	1.0	0.6	0.5
- capital		4.4	4.3	4.5	4.2	4.0
- total factor productivity		3.7	3.5	3.4	3.3	3.4
6. Output gap		1.5	2.1	0.7	-0.5	-1.5
7. Cyclical budgetary component		0.4	0.6	0.2	-0.1	-0.4
8. Cyclically-adjusted balance (2-7)		-0.7	-0.3	0.5	1.1	1.6
9. Cyclically-adjusted primary balance (8+3)		-0.2	0.1	0.8	1.4	1.9
10. Structural balance (8-4)		-0.7	-0.3	0.5	1.1	1.6

3.4 Government Debt

In 2006, the general government debt amounted to 1 191.7 million lats or 10.6% of GDP. General government debt is primarily affected by the central government debt, amounting to 1,001.1 million lats and 84.0% of the general government debt in 2006.

The objective of the central government debt management is to ensure the financing required for the purpose of financing the government budget execution and refinancing of the central government's debt commitments at the lowest possible costs on favourable terms and conditions by hedging the financial risks and taking into account the development of the Latvian national capital market and overall financial system.

The medium-term objectives, basic principles and tasks of the central government debt portfolio and borrowing management within the framework of the debt management are established by the Latvian national debt management strategy (hereinafter – Strategy) approved by the Minister of Finance. In accordance with the Strategy, the management of the central government's debt portfolio is prudent and focussed on hedging and prevention of financial risks, allowing for the use of financial derivatives listed within the Strategy only for the purpose of ensuring financial risk management. Approach to the management of the central government's borrowing, in turn, is focussed on ensuring borrowing opportunities, liquidity, beneficial terms and conditions for borrowing. Types of the financial instruments that may be used in the central government debt management and drawing of the funds required for financing and selection of terms and conditions is prescribed by the guidelines approved within the Strategy, providing for compliance with optimum parameters of the structure of the central government debt portfolio as regards the currency composition of the debt, maturity profile, average interest rate duration of the debt and the optimum share of the fixed interest rates in the debt portfolio. The optimum parameters of the central government debt portfolio have been set with a view to preventing a significant impact of the financial market volatility, including exchange rate and interest rate volatility, on the central government debt portfolio and its servicing costs.

The measures planned for ensuring the required funding for the government budget execution and central government debt commitments within the current year and the next two years, and the selection of the most appropriate financial instruments is prescribed by the annual Borrowing Plan approved by the Minister of Finance, which is developed for a three-year period based on the guidelines established in the Strategy and is agreed with the Bank of Latvia.

Within the time period of up to 2010, the required borrowing for the financing of the government budget execution and refinancing the central government debt commitments will be made both on the domestic as well as external financial market. Although the fiscal criteria established in the Maastricht Treaty are complied with and the fiscal policy implemented in Latvia is aimed at formulation of a budget with a surplus and meeting this target in the medium-term, the amounts of new borrowings depend also on the amount of budgetary loans to be granted as well as the maturity profile of the existing debt commitments and their repayments in the next years.

Latvia's central government debt management has been historically aimed at development of the domestic government securities market ensuring favourable terms and conditions for borrowing at relatively low costs. Regardless of the fact that with the foreign exchange risk on euro borrowings diminishing considerably following the lats repegging to the euro at the beginning of 2005 the lats and the euro interest rates converged considerably (especially on longer-term securities) reducing the borrowing costs, in 2006 the trend reversed. In 2007, it got stronger under the impact of rapidly growing inflation and higher uncertainty considering the realistic timeframe for the euro changeover. This has resulted in a significant difference between the lats and the euro interest rates, and the activity of domestic market participants on the primary market of government securities has considerably weakened. Therefore, in order to ensure the compliance of the central government debt portfolio composition with the targets set in the Strategy, the financing strategy of the next years could be aimed at refraining from increasing the amount of outstanding domestic government securities notably, at the same time taking into account the developments on Latvia's government securities market. Out of the domestic government securities, medium- and long-term government bonds with a 3-, 5- and 10-year maturity could be used for financing purposes from 2008 to 2010 and could be offered within the framework of issue programmes, as well as short-term Treasury bills with a 6- and 12-month maturity. With the planned euro adoption in Latvia approaching, it is possible that smaller, less liquid bond issues will be consolidated into larger, more liquid security issues, thus activating the secondary market of the domestic government securities. In addition to the above-mentioned financial instruments, in case if needed, to ensure short-term financial liquidity short-term loans and credit facilities offered by domestic financial institutions will be used, as well as introduction of additional short-term financial instruments is possible. Their amounts and issue calendar will be decided depending on the cash flow forecasts for the relevant central government budget execution period.

Drawing from foreign financial markets is anticipated mainly via public placement of security issues. In some cases, the use of private placements for security issues is also possible, and for the purposes of ensuring short-term liquidity credit facilities and short-term loans from foreign commercial banks could be used. Additional funds could be raised by borrowing from international financial institutions within the framework of previously concluded agreements. Eurobond issue is the most effective instrument to attract large amounts of funding by way of increasing the existing issue amounts or issuing new, liquid securities; therefore, a Eurobond issue has been scheduled for the first half of 2008. The timing of the borrowing, amounts and maturities will depend on the actual central government budget execution figures, domestic and international financial market developments, central government debt portfolio indicators and other influencing factors. One of the most significant factors when taking a decision on issuing Eurobonds would be the potential amount of issue, as increasing the total amount of a new or tap issue to at least 500 million euro would increase the liquidity of the securities and ensure an opportunity to launch this instrument on international securities trading platforms. In accordance with the concluded agreements, use of the borrowing from international financial institutions to finance central and local government investment projects will continue, and it is also expected that the borrowing possibilities offered by the European Investment Bank for the purpose of ensuring the national co-financing to projects financed from the European Union's structural funds and Cohesion Fund will also be used.

Considering all the above factors, it can be expected that in the medium-term the general government debt will remain well below the debt criterion of 60% of GDP set in the Maastricht Treaty.

Table 9. General government debt development

% of GDP	ESA code	**2006**	**2007**	**2008**	**2009**	**2010**
1. Gross debt		10.6	9.4	8.3	7.2	6.4
2. Change in gross debt ratio		-1.9	-1.2	-1.1	-1.1	-0.8
Factors impacting on changes in gross debt						
3. Primary balance		0.2	0.7	1.0	1.2	1.5
4. Interest expenditure	D41	0.5	0.4	0.3	0.3	0.3
5. Stock-flow adjustment:		-2.2	-0.9	-0.4	-0.1	0.4
of which - Differences between cash and accruals		-0.4				
- Net accumulation of financial assets		-0.6				
including privatisation revenue		0.1				
- Valuation effects and other		0.0				
p.m. implicit interest rate on debt		4.6	4.4	4.2	3.8	4.1
Other variables						
6. Liquid financial assets		2.9				
7. Net financial debt (7=1-6)		7.6				

4 Sensitivity analysis and comparison with the previous programme

4.1 Sensitivity analysis

The central macroeconomic scenario discussed in Section 2 of the programme reflects the most likely macroeconomic development outcome. Yet the actual development may be affected by several factors that can have both a positive and a negative effect. In the last years, economic indicators pointing to imbalanced economic growth have been on a rise.

Domestic sources of growth have a large role at the current stage of economic development; nevertheless, the terms of the external economic environment also have a significant impact on the domestic factors. Latvia's high economic growth is underpinned by increasing consumption and investment. Starting with the second half of 2007, it became obvious that part of the factors determining the high growth of the domestic demand started to lose their effect; nevertheless, the extent of those changes will depend on the interaction of various domestic and external factors.

Considering the above-mentioned risks, there is a high degree of uncertainty as regards the economic development trends. Within the framework of the sensitivity analysis, it is assumed that the overall medium-term GDP growth will differ from the central scenario by 1 percentage point, and these differences will be primarily based on a higher or lower private consumption growth. All scenarios assume the same export figures, whereas the imports will depend on the growth of the private consumption. Moreover, the development of the private consumption will also affect the consumer price movements: with lower growth, downward inflation adjustments will start sooner, whereas with higher growth, they will be slightly delayed.

Different growth scenarios show insignificant impact on employment and unemployment, whereas the changes in productivity growth are more considerable. Productivity growth relates closely to the increase of wages and salaries, which affects the purchasing power of the population and revenue from labour taxes.

According to the assumptions of the optimistic scenario, income tax revenue (D.5) could grow by about 11.8 million lats. Actual social security contributions (D.611), in turn, could increase by 16.8 million lats. In 2008, the growth of the income tax revenue will also be dampened by the notable increase of the non-taxable minimum and relief for dependants which are exempt from the personal income tax.

According to the assumptions of the pessimistic scenario, comparing with the central scenario, there is an opposite effect to that of the optimistic scenario. Income tax revenue (D.5) could decrease by about 8.4 million lats, whereas actual social security contributions (D.611) could shrink by 15.6 million lats.

Deceleration of imports could adversely affect the growth rates of the value added tax revenue (D.211). Alongside with slower growth rates for wages and salaries, domestic demand, which also is to be considered one of the most important macroeconomic indicators driving the value added tax revenue, will weaken as well. Under the pessimistic scenario, the value added tax receipts could shrink by 7.0 million lats, whereas under the optimistic scenario the value added tax collections could grow by about 27.3 million lats.

Table 10. Macro-economic indicators of the central scenario

		2007	2008
Real GDP	growth, %	10.5	7.5
Number of persons employed in the economy	growth, %	2.2	1.0
Unemployment rate	%	6.0	5.5
Average wage and salary	growth, %	29.3	18.1
Inflation	growth, %	10.1	12.5
Current account	% of GDP	-24.8	-21.6

Table 11. Macro-economic indicators of the optimistic scenario

		2007	2008
Real GDP	growth, %	10.5	8.5
Number of persons employed in the economy	growth, %	2.2	1.0
Unemployment rate	%	6.0	5.5
Average wage and salary	growth, %	29.3	21.4
Inflation	growth, %	10.1	13.0
Current account	% of GDP	-24.8	-21.8

Table 12. Macro-economic indicators of the pessimistic scenario

		2007	2008
Real GDP	growth, %	10.5	6.5
Number of persons employed in the economy	growth, %	2.2	0.7
Unemployment rate	%	6.0	5.8
Average wage and salary	growth, %	29.3	17.3
Inflation	growth, %	10.1	12.0
Current account	% of GDP	-24.8	-21.6

4.2 Comparison with 2006 Convergence Programme

Table 13. Comparison with 2006 Convergence Programme forecasts

	ESA code	**2006**	**2007**	**2008**	**2009**	**2010**
Real GDP growth (%)	B1g					
Previous update		11.5	9.0	7.5	7.5	
Current update		11.9	10.5	7.5	7.0	6.8
Difference		0.4	1.5	0.0	-0.5	-
General government net lending (% of GDP)	B.9					
Previous update		-0.4	-1.3	-0.9	-0.4	
Current update		-0.3	0.3	0.7	1.0	1.2
Difference		0.1	1.6	1.6	1.4	-
General government gross debt (% of GDP)						
Previous update		10.7	10.5	10.6	9.4	
Current update		10.6	9.4	8.3	7.2	6.4
Difference		-0.1	-1.1	-2.3	-2.2	-

At the end of 2006 and in 2007, the GDP growth was very buoyant and exceeded the initial forecasts, resulting in an upward revision of the forecasts. Growth forecasts remain unchanged in 2008, which means that the growth rates will decelerate more quickly. GDP growth is expected to moderate in the medium-term to stand at about 7%.

In 2005, the actual general government budget execution results were better than initially forecast and there was a minor deficit in the amount of 0.3% of GDP. Both the central government and social security budgets performed better than planned. Considering the decisions taken by the Government to tighten the fiscal policy in comparison with the 2006 Convergence Programme, significant improvement of the general government balance can be expected in the years to follow, reaching a surplus of 1.2% of GDP in 2010.

General government debt forecasts are lower in 2007, because in the last years the budgetary balance in Latvia has been considerably better than planned and a budgetary surplus is expected in 2007. Based on that, it is estimated that the general government deficit will decrease to 6.4% of GDP in 2010.

5 Quality of Public Finances

5.1 Revenue of the General Government Budget

One of the most important aspects of the quality of public finances is ensuring stable and predictable tax revenue flows to the budget required to finance the priority social and economic measures of the Government. Although the tax revenue increases in the recent years have been mainly supported by the rapid economic growth, changes in tax legislation also play an important role.

The key focus of the tax policy previously implemented in Latvia was on improvement of business environment, attraction of investment, improvement of competition and population income. As a result of the implemented policy, Latvia's corporate income tax rate currently stands at 15%, being one of the lowest rates in the European Union. From 2008, personal income tax paid by persons engaged in business activity will also be reduced to 15%.

The overall tax burden in Latvia is one of the lowest in the European Union. In 2005, it amounted to merely 29.2% of GDP, which is considerably lower than the EU average at 40.7% of GDP.

Personal Income Tax

In recent years, labour taxes accounted for about 49.0% of the total tax revenue. This points to the fact that the tax burden on the income of population remains high. In order to improve the income of the population and partly compensate the decrease of actual income resulting from the growth of inflation, from 2004 onwards various tax policy measures were gradually implemented, including raising the non-taxable minimum for the personal income tax purposes and relief for dependants. The minimum monthly wage and salary was also gradually increased. These measures have a particularly positive effect on low income population.

Table 14. Raise of the non-taxable minimum and relief for dependents and of the minimum monthly wage and salary (in lats)

	2005	2006	2007	2008
Minimum monthly wage and salary, lats	80	90	120	160
Monthly non-taxable minimum, lats	26	32	50	80
Monthly tax relief for a dependent, lats	18	22	35	56
Impact of changes in non-taxable minimum and relief for dependants in comparison with 2007, millions of lats				-107.0
Impact of changes in the minimum wage and salary in comparison with 2007, millions of lats				+28.8
Total impact of changes in comparison with 2007, millions of lats				-78.2
Total impact of changes in comparison with 2007, % of GDP				-0.5

Gradual raising the non-taxable minimum for the personal income tax purposes and relief for dependants is a tax policy measure highlighted in Latvia's National Lisbon Programme 2005–2008.

Corporate Income Tax

The rapid rise of corporate income tax collections observed in the recent years was primarily driven by successful economic development and growing corporate profits. It can be expected that the corporate income tax rate will remain unchanged in the medium term at 15%.

It is forecast that in 2008 the corporate income tax collections will be improved by the expected tax payment from the SJSC *Latvian State Radio and Television Centre* and *Lattelecom ltd.* amounting to 47.8 million lats as a result of privatisation of *Lattelecom ltd.* The above payment has a one-off effect on the corporate income tax revenue in 2008 and should not be considered a result of the implemented tax policy.

Social Security Contributions

According to the ESA 95 requirements, social security contributions channelled to the state funded pension scheme are not treated as the budgetary revenue of the general government.

In accordance with the law "On State Funded Pensions", up to 1 January 2007 the rate of contribution into the state funded pension scheme was 2%. Starting from 1 January 2007, the rate of contribution was gradually raised resulting in significantly higher revenue from social security contributions received in the funded pension scheme and a respective reduction in the social security budget revenue. In line with the provisions of the Law, the rate of contributions will be raised to 10% in 2010. The most notable increase in the rate of contribution to the state funded pension scheme is expected in 2008, when the rate will grow by 4 percentage points, i.e. from 4% to 8%.

Table 15. Social security contributions to the state funded pension scheme

Year	Rate of contribu tion	Social security contributions transferred to the funded pension scheme, in millions of lats	Social security contributions transferred to the funded pension scheme, % of GDP
From 1 January 2006	2%	41.8	0.4
From 1 January 2007	4%	105.0	0.8
From 1 January 2008	8%	243.7	1.5
From 1 January 2009	9%	314.0	1.6
From 1 January 2010	10%	397.6	1.8

Excise Tax

Although according to the transition period granted to Latvia excise tax on cigarettes had to be gradually raised by 1 January 2010, Latvia's Government resolved to speed up raising of the excise tax rate on cigarettes in 2006. Therefore, the minimum rate set in the European Union will be reached already in 2009. When reviewing the excise tax rates, the developments of the exchange rate of the lats vis-à-vis the euro since 2002, when the estimates for the previous excise tax raise were made, were also taken into consideration.

According to Paragraph 2 of Part I of Article 13 of the Law "On Excise Tax" and Paragraph 3 of the transition provisions, the following taxes will be applied to cigarettes:

- from 1 January 2008: 17.8 lats per 1000 cigarettes plus 32.2% of the maximum retail price instead of Ls 9.3 per 1000 cigarettes plus 23.5% of the maximum retail price previously stipulated by the law;
- from 1 January 2009: 22.5 lats per 1000 cigarettes plus 34.5 % of the maximum retail price instead of Ls 10.5 per 1000 cigarettes plus 27.9% of the maximum retail price previously stipulated by the law.

When preparing the medium-term forecasts of revenue from excise tax on tobacco products, the changes in the excise tax rates imposed on cigarettes were taken into account in against the schedule for raising the excise tax rates on tobacco products previously featured in the Law “On Excise Tax”. As a result of raising the excise tax rates, the forecast of revenue from excise tax on tobacco products for 2008 was revised upwards by 35.0 million lats, whereas that for 2009 by 44.3 million lats.

Considering that Latvia has been granted a transition period for application of the minimum EU excise tax rate on oil products, excise tax rates on oil products will be raised from 1 January 2008. According to the provisions of the Law “Amendments to the Law “On Excise Tax””’ (adopted by the Parliament on 8 November 2007), from 1 January 2008 the excise tax rate for lead-free petrol will be raised from 209 lats to 228 lats per 1000 litres, whereas for diesel fuel and kerosene from 178 lats to 193 lats per 1000 litres.

Higher rates from 1 January 2008 will result in the excise tax revenue from oil products growing by 21.6 million lats.

Table 16. Fiscal impact of main tax policy changes (% of GDP)

	2008	**2009**	**2010**
Personal income tax revenue (raising the non-taxable minimum , relief for dependents and minimum wage and salary)	-0.5	-	-
Social security contributions revenue (raising the rate of contributions payable into the funded pension scheme)	-1.5	-1.6	-1.8
Excise tax revenue (raising the rate on oil products and tobacco products)	+0.3	+0.2	-
Total impact of tax policy changes:	**-1.7**	**-1.4**	**-1.8**

The overall growth rates of tax revenue in the general government budget are forecast based on the medium-term economic development scenario and expected changes in legislation. It is forecast that the overall share of tax revenue in GDP will remain broadly unchanged: 30.6% in 2008 and 30.9% in 2010.

Table 17. Tax revenue in general government budget (S.13) (millions of lats)

	Code (ESA 95)	**2006**	**2007**	**2008**	**2009**	**2010**
Tax revenue						
1. Production and imports taxes	D.2	1430.1	1789.5	2186.2	2533.8	2876.0
2. Current income and property taxes	D.5	947.7	1246.9	1467.9	1733.6	1959.1
3. Social contributions	D.61	1005.7	1262.8	1414.3	1639.4	1878.9
Of which actual social contributions	*D.611*	979.1	1228.8	1372.8	1590.4	1822.4

The major share of tax revenue in the recent years in Latvia consisted of employment taxes (48.5% in 2006), yet this share has been on a downward trend since 1995. Considering the raising of the non-taxable minimum for the personal income tax purposes and relief for dependants which started in 2005, it can be expected that the share of labour taxes in the total revenue will continue to decline. This trend is expected to persist in the medium term, when the share of labour taxes in the total revenue will be also compressed by increasing the rate of contribution into the state funded pension scheme from 4% in 2007 to 10% in 2010.

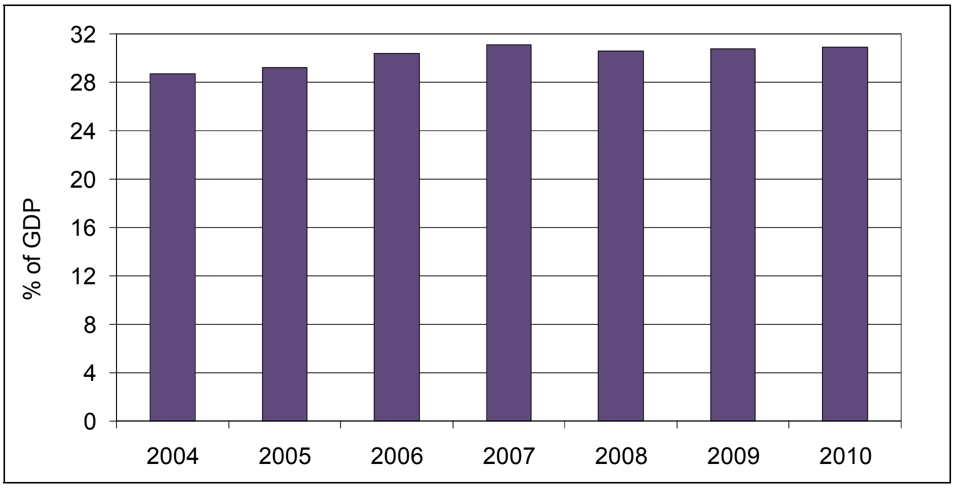

Chart 11. Tax revenue (% of GDP)

Consumption taxes accounted for 41.8% of the total tax collections in 2006. This group of taxes has been following an upward trend since 1995. The share of consumption taxes is expected to continue to grow in the medium-term, mainly under the impact of the planned changes in the excise tax legislation.

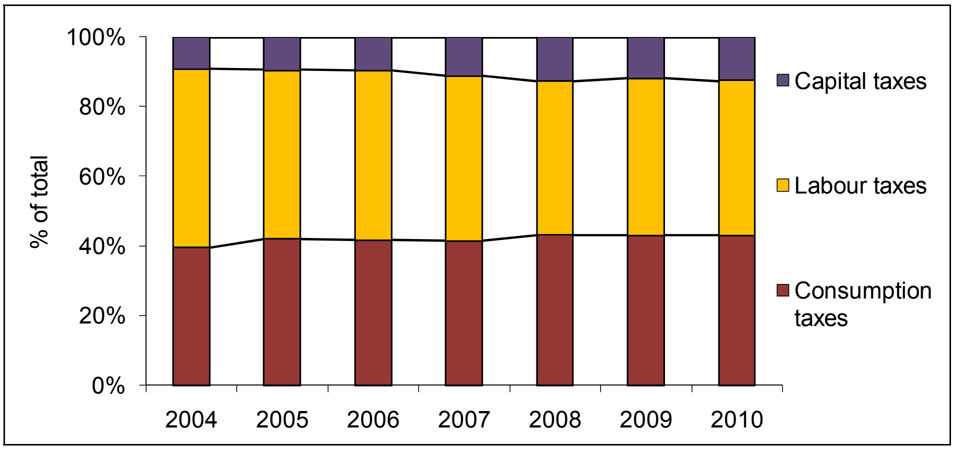

Chart 12. Tax revenue by economic function (% of total tax revenue)

5.2 Expenditure of the General Government Budget

Taking account the fiscal policy objectives defined by the Government, the growth of the central government budget expenditure is expected to decelerate in the medium-term. It is expected that the increase of spending on wages and salaries will also decrease, as the Cabinet of Ministers has taken a decision that funding will be provided in 2008–2010 only to those direct government administration institutions where the average wage of employees is lower than the average wage of those employed by direct government administration institutions, which is 400 lats per month.

It is anticipated that the budgetary spending on gross fixed capital formation will continue to grow in the medium-term. In 2008, large investment from Cohesion Fund is planned: investment projects for motorways, development of railroad infrastructure, implementation of local government projects in the field of environmental protection, airport and port development projects. Motorway projects financed from the Cohesion Fund include improvements on the *VIA Baltica* highway and West–East corridor aimed at improvement of the safety and convenience of population commuting and freight transportation in the busiest sections of international transportation routes, thereby supporting economic development and improvement of the quality of life. These projects will deal with widening of roads, reconstruction of crossroads, renovation of bridges, building new tarmac surfaces and other activities.

Three investment projects will be implemented in the railroad sector in 2008, including replacement of track turnouts, modernisation of train movement management system (including modernisation of the signalling and turnout centralisation system, level crossing equipment), modernisation of hot-box detection system. Environment projects financed from the Cohesion Fund provide for implementation of household waste management, water and sewerage service development as well as heating supply system development in Latvian cities and regions. Cohesion Fund projects also address reconstruction of access roads to Ventspils port terminals and Liepāja port as well as to the SJSC "International Airport RĪGA".

Large funding is planned in 2008 **for implementation of investment projects without any support from foreign financial assistance programmes**, including 23.1 million lats for preparation of and construction under urgent East–West transport corridor infrastructure projects, 20.5 million lats for the development of the National Armed Forces and 20.9 million lats for support to local government investment projects.

It is forecast that the spending on the **health sector** will continue to grow in the medium term, *inter alia* to ensure the implementation of the guidelines "Human Resource Development in Healthcare" approved by the government on 18 May 2005, based on which the programme "Human Resource Development in Healthcare 2006–2015" was developed.

The programme provides for implementation of the following tasks:

- effective planning of human resources in the healthcare sector;
- provision of the healthcare sector with the required human resources in terms of number, dislocation and required qualifications;
- development of an education system in the healthcare sector (higher, vocational, further education) in line with the labour market demand;
- improvement of the work pay system, creation of a system of social guarantees and professional risk insurance for medical personnel.

In addition to the above-mentioned programme, a "Programme for Development of In-Patient and Out-Patient Healthcare Service Providers" has been approved and the subordinated "Implementation Plan 2005–2010 for the Programme for Development of In-Patient and Out-Patient Healthcare Service Providers". The objective of the programme is to ensure further development of an integrated healthcare system by optimising the number and dislocation of service providers, thereby raising the quality of the delivered healthcare services, cost-efficiency and effective availability to patients. In order to implement the defined programme objective, the primary healthcare system will be developed and the network of the primary healthcare service providers will be improved, high quality and cost-efficient emergency medical aid system will be established, a highly specialised, high quality, mutually coordinated and cost-efficient secondary and tertiary level healthcare system will be created, the structure of the secondary and tertiary level healthcare service providers will be improved, a medical rehabilitation system with a network of regional medical rehabilitation institutions will be created as well as an efficient dislocation, good accessibility to population and efficient use of medical technologies will be secured.

With a view to relieving purchase of medicines and medical equipment for population, with the Cabinet of Ministers 20 December 2004 decree No.1002 the Concept on financial resources to ensure availability of medicines required for out-patient treatment in Latvia in the next 5–10 years was approved, setting the role and responsibilities of the state in this process, as well as Cabinet of Ministers 31 October 2006 regulations No.899 "Procedure to compensate the purchase costs of medicines and medical equipment required for out-patient treatment".

In order to implement the healthcare measures, the following increases were stipulated in the basic budget of the Ministry of Health for 2008 in comparison with 2007: the budget for the wages and salaries of the medical personnel was increased by 38.8 million lats, that for other employees of the health sector by 8.6 million lats, spending on ensuring the availability of healthcare services by 1.6 million lats, compensations for medications to population by 0.5 million lats.

An annual increase of spending on the **sector of education** is planned in the medium-term, taking into account the plan to continue to raise the wages and salaries of the teaching staff in line with the "Programme for Raising the Teaching Staff Salaries 2006–2010"approved by the Cabinet of Ministers on 29 August 2005, providing for continuous raising of the wages and salaries of the teaching staff. In addition, the Cabinet of Ministers decided to include the wages and salaries of teaching staff into the uniform system of public sector employees as of 1 September 2010, yet no additional funding provisions required for this purpose in 2010 have been made so far.

Provisions have been made in the general government budget 2008 and beyond for implementation of the measures stipulated in Latvia's National Lisbon Programme.

In order to stimulate scientific activity and development as envisaged by the Latvia's National Lisbon Programme, the 2008 budget contains additional spending provisions for the development of the **science** sector, including funding of scientific activity and scientific framework in the amount of 1.0 million lats, funding for a government financed scientific research programme in the amount of 3.4 million lats.

Latvia's National Lisbon Programme pays significant attention to raising employment by improving the ability of the **education system** to adjust to the labour market needs. Therefore, optimisation of vocational education establishments has been undertaken, in order to ensure improvement of the quality and tailor the education programmes to meet the labour market needs.

Latvia's National Lisbon Programme also contains measures aimed at **information society development**. In order to implement this measure, the 2007 budget has additional provisions in the amount of 1.2 million lats in comparison with the 2006 budget for national information system integration and e-service development. Implementation of these measures will continue in the new 2007–2013 European Union structural funds programming period with action programme 3 "Infrastructure and services" measure "ICT infrastructure and services" activities, "Public administration e-services and information system development", within the framework of which projects will be implemented to support the development of electronic administration, e-services and nation information systems (registers) and attainment of the information society objectives within the total budget for the period of three years amounting to 17.8 million lats.

6 Sustainability of Public Finances

Latvia's population started to shrink in 1990, with both natural movement of population (net balance of birth and death rates) as well as cross-country migration changing radically from positive to negative. The overall population living in Latvia at the beginning of 2007 was 2.28 million or 387 thousand (14.5%) less than 17 years ago (including a decrease in population by 193 thousand as a result of natural movement). In the last years, the decline of the population has decelerated; nevertheless, it is expected that this tendency will prevail in Latvia in the long-term as well.

According to Eurostat forecasts[2], by 2050 Latvia's population will decrease by another 18% and amount to a mere 1.87 million. The forecasts are based on the assumption that the birth rate will increase from the current 1.3 to 1.6, which will still be insufficient to stabilise the number of population. The negative balance of natural movement will decrease also due to growing life expectancy of population. According to the forecast, net migration will remain negative until 2020, when it will become positive, with Latvia's economy reaching a higher level of development.

Alongside with changes in the number of population, the age profile of population will also change significantly. The share of young people will gradually contract, determined by the birth rate which is constantly below the natural reproduction threshold and a decrease in the number of fertility age women. In the age group of 0–14 years, in 2050 the number of population will be 13% lower than in 2007. Moreover, as opposed to other age groups, changes in the number of young people are more pronounced already now as a result of the 10 year long low birth period. Working age (15-64) population will decrease by 35% or 465 thousand by 2050, whereas the number of senior people (65+) will grow by 25% or 98 thousand, including the number of very old people (80+) will increase more than twice or by 79 thousand by 2050. This suggests that the increase in the number of senior people will be primarily the result of higher life expectancy.

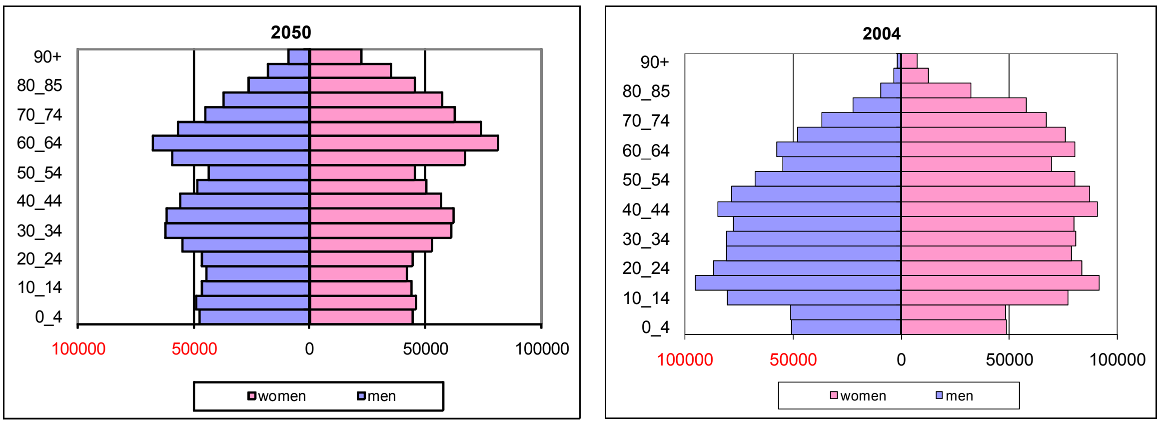

Chart 13. Changes in population by age group

Labour force and employment[3] will basically develop, based on changes in the number of working age population. Nevertheless, it will also be significantly affected by changes in participation and employment rates.

Changes in participation rate are affected by various factors, the most significant being the social (duration and quality of education, the role of women in the society etc.), demographic (birth rate, age profile), institutional (retirement age etc.) and economic (labour

[2] Hereinafter the base scenario of the Eurostat demographic forecast EUROPOP2004 is discussed.

[3] Latvia's employment and macroeconomic assumptions are based on the ones approved by the Ageing Working Group of the EU Economic Policy Committee.

demand, income level etc.) ones. In the next years, gradual rising of the participation rate, especially in the older groups of employed (over 55) is forecast, and these are the only groups where a real increase in the number of employed is expected by 2050. Unemployment will decrease gradually; nevertheless, in order to keep the forecasts prudent, it is assumed that it will be at least 7%[4].

Overall, these factors determine that the number of employed will be 20% lower in 2050 in comparison with 2004. Nevertheless, contrary to the demographic indicators, it is expected that the number of employed will continue to rise gradually until 2012 and start shrinking only after that (falling back to the level of 2004 again in 2021).

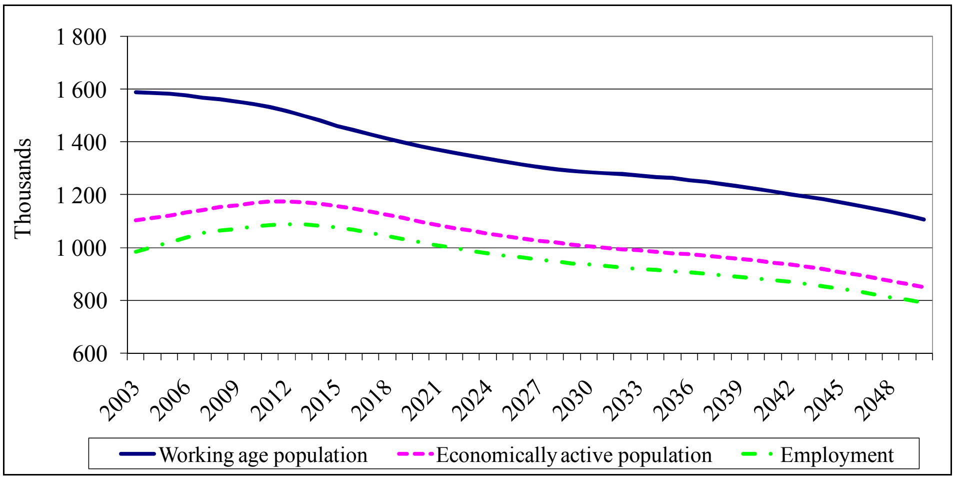

Chart 14. Working age population and employment in 2003-2050

In the last years, Latvia's economy has achieved high growth rates driven by a rapid increase in investment and productivity. Estimates based on production function method suggest that the development will be equally dynamic and buoyant in the medium-term as well, additionally supported by policies aimed at the cohesion of the EU Member States. Regardless of the fact that the decline of employment will start to exert a downward pressure on growth already from 2013, the average GDP growth in the period of up to 2050 is expected almost twice as high as in the EU15 countries, ensuring convergence of the living standards with the EU average. According to this scenario, in 2030 the GDP per capita in Latvia will reach 93% of the EU15 average, whereas in 2040 already 99%.

Changes in the number of population and especially in the age profile will exert a significant impact on the government budget, as the working age population will shrink and social expenditure will grow.

In order to address the financial problems of the pension system that may be caused by the emerging demographical changes, Latvia launched pension reforms already in 1996 by raising the retirement age and creating the state compulsory non-funded, security contributions-based generation solidarity pension scheme and further-on implementing the state compulsory funded pension scheme (in 2001) and creating the legislative framework for the private pension scheme (in 1998). Although all these three pension tiers are already operational, various transition provisions will still be in effect for a certain period of time, affecting both the existing as well as the new pensioners.

The current and expected costs of implementing the pension system reform are fully outweighed by long-term gains, enabling the employed to cope with the growing demographical burden, at the same time preserving a sufficiently high income substitution level for pensioners as well as ensuring sustainability of the pension budget.

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[4] Actual current EU15 NAIRU

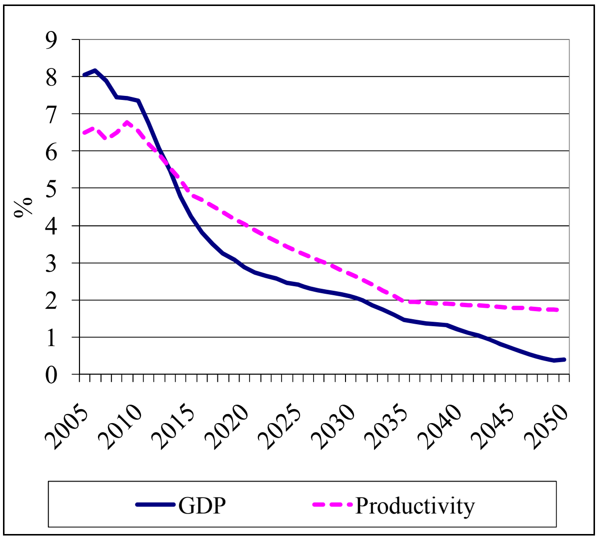

Chart 15. GDP and labour productivity growth at constant prices

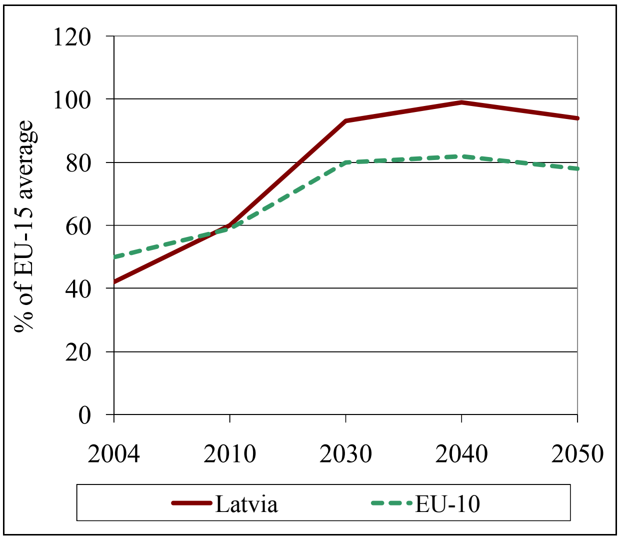

Chart 16. GDP per capita PPS % of EU15 average

Pension expenditure of the central government budget estimated based on the above-mentioned demographical and macroeconomic assumptions are expected to be by 1.2% of GDP lower in 2050 than in 2004, whereas the expenditure of the funded pension scheme will rise to 2.7% of GDP. At the same time, pension contributions to the central government budget will shrink, as already starting from 2010 half of the contributions will be channelled to the funded pension scheme. Therefore, starting from 2030 it is expected that contributions to the pension budget will be lower than the amount of expenditure, although the annual level of deficit in this budget will not exceed 0.5% of GDP. It has to be noted that in the period after that an improvement of the situation and a decrease in the burden on the pension system relating to both gradual improvement of birth rates and a decline in death rates in the working-age group can be expected. Stabilisation of the situation in a more distant future is driven also by the pension system becoming fully functional (i.e. past the transition period). Forecasts show that all pensions will become contribution-based generation solidarity pensions only around 2080.

At the same time, accumulated assets of the state funded pension scheme will expand significantly during the next 50 years and will serve as a driving force for economic development.

The below estimates suggest that the stability of the pension system can be preserved even under less favourable demographic and macroeconomic assumptions.

Table 18. Sustainability of the pension system

% of GDP	**2004**	**2010**	**2020**	**2030**	**2050**
Old-age pension expenditure	6.8	4.9	5.0	6.0	8.3
Tier 1 pensions	6.8	4.9	4.9	5.6	5.6
Tier 2 pensions	0.0	0.0	0.1	0.4	2.7
State social security contributions for old-age pensions	7.3	8.4	8.3	8.4	8.5
Tier 2 pensions	7.1	6.1	5.6	5.4	5.4
Tier 2 pensions	0.2	2.3	2.7	3.0	3.1
Accumulated assets of state funded pension scheme	0.3	7.7	28.7	50.9	75.4

Analysis of healthcare expenditure suggests that the largest costs are associated with elder people, especially during the last years of their lives. Therefore, the increase in the number and share of old and very old people may create an additional demand for healthcare services paid from the central government budget. In 2004, the central government expenditure on healthcare amounted to 5.1% of GDP[5]. Assuming that the current expenditure structure by age groups will remain unchanged in the future, it can be expected that the central government healthcare expenditure will grow to 6.2% of GDP by 2050. The previous experience, however, suggests that the demographic changes have not been the only reason for changes in the healthcare expenditure. Factors like public health condition, economic development, technological progress, changes in healthcare financing and organisation system etc. have been of an equal importance. The impact of those factors can both increase the pressure on healthcare spending as well as mitigate the adverse consequences of the demographic changes.

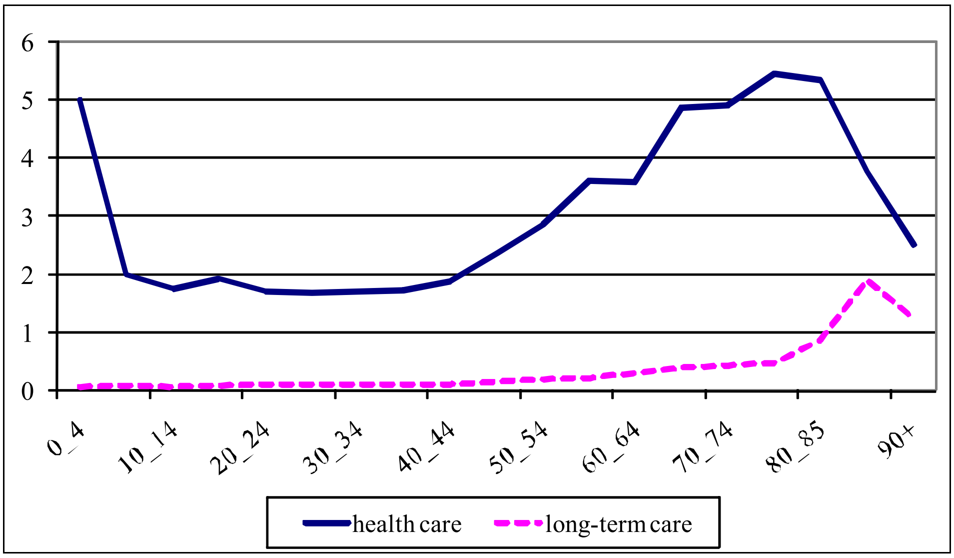

Chart 17. Healthcare and long-term care expenditure by age group (% of GDP per capita in 2003)

Long-term care services are primarily focussed on older people and, therefore, ageing of the population could affect the size of the given expenditure covered from the central government budget significantly. Nevertheless, although under the impact of demographic factors it could grow by more than twice by 2050, it will only amount to 0.7% of GDP as compared to the current 0.4% of GDP. The fact that the long-term care expenditure is low is pre-determined by the limited central and local government resources to be spent for this purpose as well as traditions and the system of community values. Therefore, with these factors changing, a more rapid expansion of the long-term care services and, consequently, also expenditure could still be expected in a more distant future.

Education services are primarily delivered to children and youths. Demographic changes within this age group have the most significant impact on the scale of education expenditure. The number and share of children and youths in Latvia has been on a constant decline already since 1990, which has become especially rapid after 1995. The cohorts of low birth rate years have already reached the school-age, and the number of school students will continue to shrink in the next years as well. In comparison with 2000, the number of school-age population will be almost 30% lower in 2010. This suggests that the demographic factor will promote a decrease in education expenditure, provided that the relative amount of education expenditure per recipient of education services remains unchanged. Consequently,

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[5] According to the OECD Health accounts system methodology.

the central government expenditure for education could decrease from 4.9% of GDP[6] in 2004 to 3.0 % of GDP in 2015. Yet as the number of children is expected to stabilise at a slightly higher level afterwards, the amount of expenditure could grow again to 3.5% of GDP. Thus, contrary to the pension and healthcare systems, the pass-through of demographic changes on the education system is much quicker, and the biggest changes are expected within the period of time up to 2015.

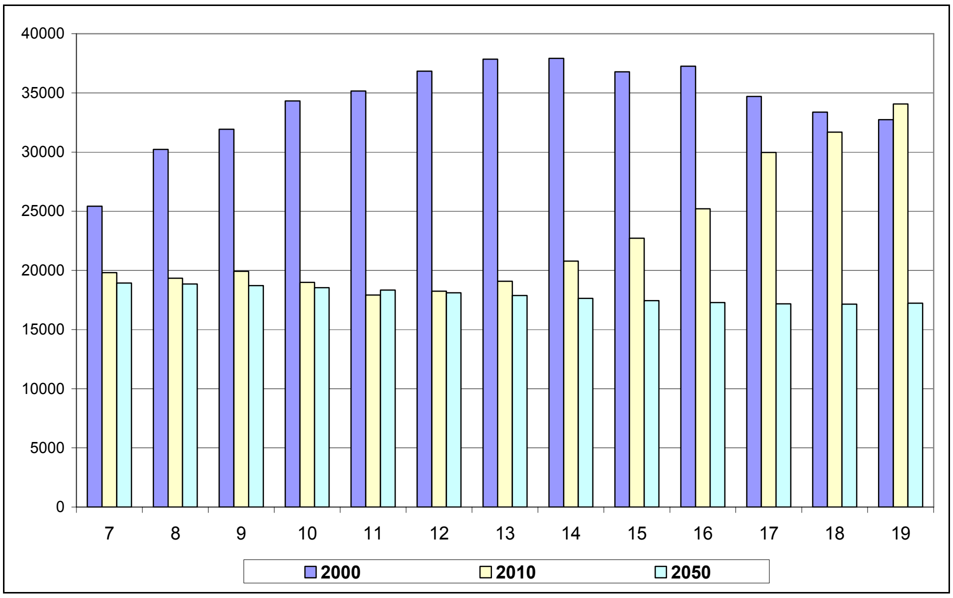

Chart 18. Number of population aged 7 –19 in 2000, 2010 and 2050

In addition to that, based on the methodology approved by the Ageing Working Group of the Economic Policy Committee, sustainability estimates take into account changes in public expenditure on unemployment benefits. Considering that the macroeconomic assumptions provide for a decline in unemployment rate in Latvia, these changes will have a positive effect on the government budget balance; nevertheless, due to the modest size, the impact will be insignificant (expenditure will decrease from 0.3% of GDP to 0.2% of GDP).

The reform of the pension system and the impact of a decline in the number of children on education expenditure are the key factors determining that, given a no-change of the current policy, population ageing tendencies will have no adverse impact on public finances. Only after 2015, public expenditure directly relating to the age profile of population will deteriorate the overall general government budget balance.

Thus, the estimates of the system of public finances based on the Eurostat's demographic forecasts and the 2006 Ageing Report of the Economic Policy Committee, do not point to significant long-term sustainability risks and confirm the positive long-term effect of the pension reform. At the same time, they also reveal that all the potential developments in public policies and financing need to be carefully considered, as the expected demographic changes are very dramatic and any policy adjustments may bear significant long-term consequences.

[6] ISCED levels 1–6, pre-school education excluded

Table 19. Sustainability of public finances

% of GDP	2004	2010	2020	2030	2050
Total expenditure	36.2	39.0	38.9	40.3	40.5
Of which: age-related expenditures	17.2	13.8	13.8	15.1	15.3
Pension expenditure	6.8	4.9	4.9	5.6	5.6
Social security pension	6.8	4.9	4.9	5.6	5.6
Old-age and early pension	5.7	4.3	4.3	4.9	4.9
Other pensions (disability, survivors)	1.1	0.6	0.6	0.7	0.6
Occupational pensions (if in general government)					
Healthcare	5.1	5.3	5.4	5.5	5.9
Long-term care	0.4	0.4	0.4	0.4	0.5
Education expenditure	4.6	3.3	3.1	3.5	3.3
Other age-related expenditures	0.33	0.3	0.2	0.2	0.2
Interest expenditure					
Total revenue	35.3	39.0	38.6	38.4	38.5
of which: property income					
of which: pension contributions	7.1	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	6.4	6.5	4.0	2.7	1.1
Real GDP growth	7.5	7.4	2.9	2.1	0.4
Participation rate males (20–64)	83.4	87.6	89.6	89.5	87.6
Participation rate females (20–64)	71.9	76.2	79.0	79.8	76.6
Total participation rate (20–64)	77.4	81.7	84.1	84.5	82.0
Unemployment rate	9.8	7.6	7.0	7.0	7.0
Population aged 65+ over total population	16.2	17.4	18.4	21.3	26.1

In order to ensure compatibility and comparability across the EU Member States and taking into account the time-consuming nature of the methodology preparation process, the Ageing Report of the Economic Policy Committee is based on the actual data up to 2004, but starting from 2005 the demographic and macroeconomic assumptions are forecasts. This allows the first comparisons of the scenario with the actual developments beyond 2005. The first analysis reveals that the actual macroeconomic indicators and the development of ageing-related expenditure have been better than planned, whereas the demographic development slightly worse. Overall, it suggests that the long-term sustainability risk assessment based on the EPC Report, is adequate and could further improve. Yet at the same time, it has to be admitted that the decrease of ageing-related expenditure (% of GDP) has not been fully reflected in the general government budget balance in these years.

7 Institutional Features of Public Finances

7.1 General description

The Constitution of the Republic of Latvia (*Satversme*) stipulates that the Parliament (*Saeima*) decides on the central government expenditure and revenue budget every year, before the start of the next financial year. The draft budget is submitted to the Parliament by the Cabinet of Ministers. The budgetary process consists of four main stages, i.e. **drafting of the budget, discussion of the draft budget and approval on legislative level, budget execution and implementation monitoring**. The process of budget formulation, execution and monitoring is governed by the Law on Budget and Financial Management as well as other related legislative acts (Cabinet of Ministers regulations, instructions, methodologies etc.)..

Starting from the preparation of the central government budget 2008, medium-term budgeting was introduced in Latvia. Medium-term budgeting is a process, whereby the required funding is allocated for several years ahead and the spending of this funding according to the pre-set government priorities is ensured by legislative means. A medium-term budget consists of a budget law for one year and maximum spending amount for the following two years broken down by ministry.

The budget formulation process starts at the beginning of the year, when the Ministry of Finance together with the State Chancellery drafts the legal acts for the following three financial years highlighting the medium-term objectives and priority development areas, which is subsequently approved by the Cabinet of Ministers.

Ministries and other central government institutions submit their developed or updated business strategies of the institution to the Cabinet of Ministers. The strategies feature a list of new policy initiatives in a priority order.

The Ministry of Finance, in consultation with the Ministry of Economy and the Bank of Latvia, prepares the medium-term macroeconomic development and fiscal policy framework for the next three financial years and submits it to the Cabinet of Ministers. The Cabinet approves it at the beginning of May. The Minister of Finance reports on the approved medium-term macroeconomic development and fiscal policy framework to the Parliament.

By July, ministries and other central government institutions develop and submit their proposals for the central government budget to the Ministry of Finance based on the instruction on the basic principles for drafting budget proposals.

The prepared draft law on central government budget and explanations thereof are submitted to the Cabinet of Ministers in September. At the beginning of October, the Cabinet of Ministers submits the annual draft law on central government budget for the next financial year, proposals for legislative amendments, explanations of the draft law as well as the medium-term macroeconomic development and fiscal policy framework to the Parliament for adoption. After the budget law is approved by the Parliament, it is signed by the President of the Republic of Latvia.

The next stage of the budgetary process is budget execution. It consists of collecting the planned revenue and incurring expenditure in compliance with the provisions of the law on budget. The main institutions in charge of ensuring budget execution are the Treasury and the State Revenue Service. Each budget institution plans the spending of the appropriation granted to it by way of an estimate. The budget institutions have the responsibility to ensure that the actual expenditure does not exceed the planned expenditure, thus ensuring efficient spending of the financing. When the financial year has ended, the Government prepares a report on central government budget execution and submits it to the Parliament for reviewing, together with an opinion of the State Audit Office. The opinion of the State Audit Office addresses the compliance of the budget institution spending with the reported data, highlights any gaps and provides recommendations for eliminating them. The concerned budget institutions prepare an action plan for implementation of the State Audit Office's recommendations.

With a view to improving the stability of the national economy, the Cabinet of Ministers has decided on implementation of a new fiscal instrument: establishment of a long-term stabilization reserve. The long-term stabilization reserve will include proceeds from privatisation and the unspent balances of the revenue stipulated in the annual budget law, except foreign financial assistance funds, as well as of the revenue from service charges and other self-generated revenue of the budget institutions. Decisions about incurring spending from the long-term stabilisation reserve will be taken by the Cabinet of Ministers based on a proposal of the Ministry of Finance.

The following objectives will qualify for drawing funds from the long-term stabilization reserve:

- mitigation of general economic risks;
- missing financing for long-term investment and structural reforms;
- prevention of a socio-economic crisis of mitigation of its effects;
- ensuring the availability of funds in a contingency situation.

In the course of government budget formulation, negotiations between the Latvian Association of Local and Regional Governments (hereinafter – LALRG) and the Ministry of Finance are held. As a result, a document highlighting the issues of dispute between the Cabinet and the LALRG and documenting their agreement is drafted (hereinafter – draft protocol). The draft protocol consists of six sections: "Local government basic budget", Local government social budget", "Financial cohesion of local governments", Local government borrowing and guarantees", "Implementation of provisions stipulated by legal acts and amendments to legal acts", "Draft legal acts". Statement is reviewed at a Cabinet meeting. It is obligatory to attach the statement of disputes and agreement between the Cabinet and the LALRG to the draft budget of the next year, when the government submits it to the Parliament. When drafting the budget, the Ministry of Finance cooperates with practically all line ministries responsible for the relevant issues and prepares a draft opinion of the Cabinet of Ministers. In cases when the central government budget contains provisions for a measure identified by the LALRG, an agreement is prepared and a remark "The parties agree" is put into the draft protocol. When no agreement can be reached, all opinions are highlighted in the draft protocol as issues of dispute. When drafting the protocol, the Ministry of Finance evaluates the particular situation in detail, including the problems relating to any legislative provisions which have to be implemented without any funding from the central government budget, and seeks to address the situation in cooperation with the LALRG. As a result, the draft protocol offers optimum solutions which take into account both the interests of the state as well as the local governments. The draft protocol is submitted to the Cabinet of Ministers to be reviewed at its session. There is a mandatory requirement for the protocol of agreement and issues of dispute between the Cabinet of Ministers and the LALRG to be attached to the draft budget of the following year when the government submits it to the Parliament.

7.2 Medium-term budgeting

Starting from 2007, a three-year macroeconomic development and fiscal policy framework is prepared containing the following information:

1) medium-term macroeconomic outlook;

2) medium-term fiscal policy objectives of the government;

3) medium-term central government budget revenue forecasts;

4) medium-term maximum total central government expenditure threshold;

5) medium-term appropriation reserve to be planned in the central government budget;

6) maximum medium-term spending limits from the central government budget for each ministry and other central government institutions.

Alongside with the medium-term budgeting, an appropriation reserve was introduced, which ministries, other central government institutions and local governments will be able to use under a specific procedure, for example, on completing procurement procedures that have been planned in the annual law on central government budget, have started but have not been completed due to reasons beyond the control of the budget executor, public investment projects.

The Cabinet of Ministers has the rights to reallocate the appropriations established for a ministry or other central government institutions in the annual law on central government budget across programmes, sub-programmes and economic classification codes within the limits of the set appropriation.

In the context of introducing the medium-term budgeting, the public administration needed to improve the performance management system. Its operational principles were approved by 13 March 2003 Cabinet of Ministers decree No. 162 “On Key Concepts of Performance Management System”. With a view to developing new key concepts of the performance management system based on an improved existing performance management system, the Minister of Finance established a working group, comprising representatives from the Ministry of Finance, State Chancellery, Ministry of Justice, Ministry of Economy, Ministry of Agriculture and the Treasury. The working group has drafted new Key concepts of performance management system attempting to systematise the establishment of performance indicators, in order to improve the quality of information and their practical application in the policy-making and budgeting process. The approach identified in the draft key concepts will be used to provide information on the extent to which the objectives set in various planning documents have been attained to the community, government and Parliament, as well as to characterise the spending efficiency of the central government budget and compliance with the planning documents and objectives set in institutional management documents. Currently, the draft is being agreed with ministries and other central government institutions to be subsequently approved by the Cabinet of Ministers. In the process of preparing the draft, the World Bank was consulted concerning the best international practice in developing similar systems.

The State Chancellery has also prepared the instruction “Procedure for Development, Update and Evaluation of an Institution’s Business Strategy”, which will replace the currently effective “Methodology Recommendations for Development of an Institution’s Business Strategy” approved by the Cabinet on 12 March 2003, which were previously used as a basis for the development of business strategies of institutions. The draft instruction stipulates that strategies have to be updated every year after the adoption of the central government budget.

The attainment of the objectives and tasks identified in the strategies will be evaluated once every four years, developing a new business strategy of the institution.

It is also planned that to ensure linkage between the medium-term budgeting, performance management system and strategic planning process of public institutions starting from the next year.

Implementation of a medium-term budget also provides for introduction of a modern and effective solution for the budget process in public administration. Starting from 2007, all ministries prepare their annual central government budget proposals in a uniform central government budget planning and execution (SAP) system. The Ministry of Finance is responsible for the implementation and maintenance of this system. As the SAP system to be implemented is a broad-based system, it is planned to gradually expand the system by introducing new functionality, thereby ensuring more effective linking of the central government budget planning with strategy and policy planning.

Annex

Table 1a. Macroeconomic prospects

	ESA code	2006	2006	2007	2008	2009	2010
		million lats	Growth %				
1. Real GDP	B1*g	7881.3	11.9	10.5	7.5	7.0	6.8
2. Nominal GDP	B1*g	11264.7	24.3	24.2	20.0	15.6	13.3
Components for real GDP							
3. Private consumption expenditure	P3	5417.2	19.8	17.6	7.4	6.5	6.4
4. Government consumption expenditure	P3	1153.2	4.0	5.0	3.0	2.5	2.5
5. Gross fixed capital formation	P51	2950.1	18.3	13.9	8.8	7.9	7.5
6. Changes in inventories and net acquisition of valuables (% of GDP)	P52+P53	11.7	3.5	0.8	-0.8	-1.2	-1.1
7. Exports of goods and services	P6	3268.0	5.3	9.5	9.1	7.6	7.5
8. Imports of goods and services	P7	4918.9	17.5	22.1	8.9	7.5	7.4
Contribution to real GDP growth							
9. Final domestic demand		-	19.9	18.0	9.2	8.2	7.9
10. Changes in inventories and net acquisition of valuables	P52+P53	-	0.2	2.4	0.7	0.9	1.0
11. External balance of goods and services	B11	-	-8.1	-9.9	-2.4	-2.1	-2.1

Table 1b. Price developments

	ESA code	2006	2006	2007	2008	2009	2010
		level	Growth %				
1. GDP deflator			11.1	12.3	11.7	8.1	6.0
2. Private consumption deflator			8.5	10.7	12.0	7.2	4.9
3. HICP			6.6	10.1	12.5	7.2	4.9
4. Public consumption deflator			15.8	25.3	14.0	8.5	5.0
5. Investment deflator			18.0	16.4	9.0	8.0	6.0
6. Export price deflator (goods and services)			9.2	12.4	10.0	7.0	5.0
7. Import price deflator (goods and services)			9.5	7.0	6.5	4.5	2.8

Table 1c. Labour market developments

	ESA code	2006	2006	2007	2008	2009	2010
		level	Growth %				
1. Employment, thousands of persons		1087.6	5.0	2.2	1.0	0.2	0.1
2. Employment, hours worked [7]							
3. Unemployment rate (%)			6.9	5.6	5.2	5.3	5.3
4. Labour productivity, persons			6.2	6.8	6.4	6.8	6.7
5. Labour productivity, hour worked [8]							
6. Compensation of employees, millions of lats, current prices	D.1	4845.0	27.7	36.3	19.2	13.9	12.1
7. Compensation of employees, lats		302	23.0	29.3	18.1	13.7	11.9

[7] EU Commission estimate

Table 1d. Sectoral balances

% of GDP	ESA Code	2006	2007	2008	2009	2010
1. Net lending/ borrowing vis-à-vis the rest of the world	B.9	-21.1	-23.5	-20.3	-18.3	-16.4
of which : - Balance of goods and services		-22.1	-24.0	-21.7	-20.0	-18.5
- Balance of primary income and transfers		-0.2	-0.8	0.1	0.4	0.7
- Capital account		1.2	1.3	1.3	1.3	1.4
2. Net lending/ borrowing of the private sector	B.9	-21.4	-23.8	-21.0	-19.3	-18.6
3. Net lending/ borrowing of the general government	EDP B.9	-0.3	0.3	0.7	1.0	1.2
4. Statistical discrepancy		0.6	0.2	0.0	0.0	0.0

Table 2. General government budgetary prospects

		2006	2006	2007	2008	2009	2010
	ESA code	Millions of lats	% of GDP				
Net lending (EDP B.9) by sub-sector							
1. General government	S.13	-30.9	-0.3	0.3	0.7	1.0	1.2
2. Central government	S.1311	-224.4	-2.0	-1.9	-0.5	-0.7	-0.6
3. State government	S.1312	-	-	-	-	-	-
4. Local government	S.1313	-36.4	-0.3	0.0	-0.3	-0.1	-0.2
5. Social security funds	S.1314	229.9	2.0	2.3	1.5	1.8	2.0
General government (S.13)							
6. Total revenue	TR	4162.9	37.0	37.3	37.4	37.7	37.9
7. Total expenditure	TE	4193.8	37.2	37.0	36.8	36.7	36.7
8. Net lending/borrowing	EDP B.9	-30.9	-0.3	0.3	0.7	1.0	1.2
9. Interest expenditure	EDP D.41	52.2	0.5	0.4	0.3	0.3	0.3
10. Primary balance		21.4	0.2	0.7	1.0	1.2	1.5
11. One-off and other temporary measures							
Selected components of revenue							
12. Total tax (12=12a+12b)		2377.7	21.1	21.7	21.8	22.0	22.0
12a. Taxes on production and imports	D.2	1430.1	12.7	12.8	13.0	13.1	13.1
12b. Current taxes on income, wealth etc	D.5	947.7	8.4	8.9	8.7	8.9	8.9
13. Social contributions	D.61	1005.7	8.9	9.0	8.4	8.4	8.5
14. Property income	D.4	64.2	0.6	0.7	0.9	0.7	0.7
15. Other		715.4	6.4	5.9	6.3	6.5	6.7
16. Total revenue	TR	4162.9	37.0	37.3	37.4	37.7	37.9
p.m. :Tax burden (D.2+D.5+D.61+D.91 – D.995)		3422.0	30.4	31.1	30.6	30.8	30.9
Selected components of expenditure							
17. Compensation of employees + intermediate consumption	D.1+P.2	1861.1	16.5	15.5	14.5	14.0	13.7
17a. Compensation of employees	D.1	1142.5	10.1	9.7	9.2	8.9	8.8
17b. Intermediate consumption	P.2	718.6	6.4	5.8	5.3	5.1	4.9
18. Social payments (18=18a+18b)		954.2	8.5	8.7	9.0	9.1	9.2
18a. Social transfers in kind supplied via market producers	D.6311, D.63121, D.63131	52.8	0.5	0.5	0.4	0.3	0.3
18b. Social transfers other than in kind	D.62	901.4	8.0	8.2	8.6	8.8	8.9
19.=9. Interest expenditure	EDP D.41	52.2	0.5	0.4	0.3	0.3	0.3
20. Subsidies	D.3	72.2	0.6	0.5	0.5	0.4	0.4
21. Gross fixed capital formation	P.51	484.5	4.3	4.8	5.4	5.6	6.0
22. Other		769.5	6.8	7.1	7.1	7.3	7.3
23.=7. Total expenditure	TE	4193.8	37.2	37.0	36.8	36.7	36.7
Government consumption (nominal)	P.3	1910.4	17.0				

Table 3. General government expenditure by function

% of GDP	COFOG code	2005	2010
1. General public services	1	5.1	4.9
2. Defence	2	1.3	1.3
3. Public order and safety	3	2.1	2.1
4. Economic affairs	4	4.9	5.1
5. Environmental protection	5	0.8	0.8
6. Housing and community amenities	6	0.7	0.7
7. Health	7	3.9	4.2
8. Recreation, culture and religion	8	1.2	1.3
9. Education	9	6.2	6.5
10. Social security	10	9.9	10.0
11. Total expenditure	TE	36.1	36.7

Table 4. General government debt developments

% of GDP	ESA code	2006	2007	2008	2009	2010
1. Gross debt		10.6	9.4	8.3	7.2	6.4
2. Change in gross debt ratio		-1.9	-1.2	-1.1	-1.1	-0.8
Factors impacting on changes in gross debt						
3. Primary balance		0.2	0.7	1.0	1.2	1.5
4. Interest expenditure	D41	0.5	0.4	0.3	0.3	0.3
5. Stock-flow adjustment:		-2.2	-0.9	-0.4	-0.1	0.4
of which - Differences between cash and accruals		-0.4				
- Net accumulation of financial assets		-0.6				
including privatisation revenue		0.1				
- Valuation effects and other		0.0				
p.m. implicit interest rate on debt		4.6	4.4	4.2	3.8	4.1
Other variables						
6. Liquid financial assets		2.9				
7. Net financial debt (7=1-6)		7.6				

Table 5. Cyclical developments

% of GDP	ESA Code	2006	2007	2008	2009	2010
1. Real GDP growth (%)	B1g	11.9	10.5	7.5	7.0	6.8
2. Net lending of general government	B9	-0.3	0.3	0.7	1.0	1.2
3. Interest expenditure	D41	0.5	0.4	0.3	0.3	0.3
4. One-off and other temporary measures		0.0	0.0	0.0	0.0	0.0
5. Potential GDP growth		10.0	9.9	9.1	8.3	8.0
contributions:						
- labour		1.6	1.8	1.0	0.6	0.5
- capital		4.4	4.3	4.5	4.2	4.0
- total factor productivity		3.7	3.5	3.4	3.3	3.4
6. Output gap		1.5	2.1	0.7	-0.5	-1.5
7. Cyclical budgetary component		0.4	0.6	0.2	-0.1	-0.4
8. Cyclically-adjusted balance (2-7)		-0.7	-0.3	0.5	1.1	1.6
9. Cyclically-adjusted primary balance (8+3)		-0.2	0.1	0.8	1.4	1.9
10. Structural balance (8-4)		-0.7	-0.3	0.5	1.1	1.6

Table 6. Divergence from previous update

	ESA code	2006	2007	2008	2009	2010
Real GDP growth (%)	B1g					
Previous update		11.5	9.0	7.5	7.5	
Current update		11.9	10.5	7.5	7.0	6.8
Difference		0.4	1.5	0.0	-0.5	-
General government net lending (% of GDP)	B.9					
Previous update		-0.4	-1.3	-0.9	-0.4	
Current update		-0.3	0.3	0.7	1.0	1.2
Difference		0.1	1.6	1.6	1.4	-
General government gross debt (% of GDP)						
Previous update		10.7	10.5	10.6	9.4	
Current update		10.6	9.4	8.3	7.2	6.4
Difference		-0.1	-1.1	-2.3	-2.2	-

Table 7. Long-term sustainability of public finances

% of GDP	2004	2010	2020	2030	2050
Total expenditure	36.2	39.0	38.9	40.3	40.5
Of which: age-related expenditures	17.2	13.8	13.8	15.1	15.3
Pension expenditure	6.8	4.9	4.9	5.6	5.6
Social security pension	6.8	4.9	4.9	5.6	5.6
Old-age and early pension	5.7	4.3	4.3	4.9	4.9
Other pensions (disability, survivors)	1.1	0.6	0.6	0.7	0.6
Occupational pensions (if in general government)					
Healthcare	5.1	5.3	5.4	5.5	5.9
Long-term care	0.4	0.4	0.4	0.4	0.5
Education expenditure	4.6	3.3	3.1	3.5	3.3
Other age-related expenditures	0.33	0.3	0.2	0.2	0.2
Interest expenditure					
Total revenue	35.3	39.0	38.6	38.4	38.5
of which: property income					
of which: pension contributions	7.1	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	6.4	6.5	4.0	2.7	1.1
Real GDP growth	7.5	7.4	2.9	2.1	0.4
Participation rate males (20–64)	83.4	87.6	89.6	89.5	87.6
Participation rate females (20–64)	71.9	76.2	79.0	79.8	76.6
Total participation rate (20–64)	77.4	81.7	84.1	84.5	82.0
Unemployment rate	9.8	7.6	7.0	7.0	7.0
Population aged 65+ over total population	16.2	17.4	18.4	21.3	26.1

Table 8. Basic assumptions of external environment[8]

	2006	2007	2008	2009	2010
Short-term interest rate (LVL) (annual average)	4.4	8.7	10.0	8.5	7.0
Long-term interest rate (LVL) (annual average)	4.1	5.3	5.3	5.1	5.0
USD/€ Exchange rate (annual average) (euro area and ERM II countries)	1.26	1.36	1.42	1.42	1.42
Nominal effective exchange rate, % change	0.0	-0.3	-0.3	0.0	0.0
World excluding EU, GDP growth	6.0	5.6	5.3	5.4	5.4
EU GDP growth	3.0	2.9	2.4	2.4	2.4
Growth of relevant foreign markets	9.5	7.3	6.8	6.6	6.6
World import volumes, excluding EU	8.0	7.8	7.1	7.7	7.7
Oil prices (Brent, USD/barrel)	66.2	70.6	78.8	76.0	76.0

[8] Technical assumptions