

Ministry of Finance of the Republic of Latvia

**Convergence Programme of
the Republic of Latvia
2008-2011**

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1 Overall Policy Framework and Objectives

The Convergence Programme of Latvia is based on Economic stabilisation and growth programme and General Government budget of 2009 with the amendments that were approved by the Parliament on 12th of December. The global financial and economic crisis has brought new challenges for the economy of Latvia, particularly in the short-term and medium-term. The structural changes which begun already in the end of 2007 were accelerated by global finance market shocks, what caused the economic development scenario to a move aside from a rapid correction, what lead to a sharp GDP (Gross domestic product) growth decline in the second part of 2008. To reduce the effects of economic downturn and to achieve sustainable development of the economy, the economic policy of Government of Latvia the has to face the following challenges:

- to stabilize the economy of Latvia;
- to resolve the liquidity problems and to strengthen the banking sector;
- to ensure sustainable external equilibrium, by maintaining unchanged currency policy;
- to implement responsible and tight fiscal policy, balancing the expenditures with the revenue possibilities, together with ensuring the investments and the usage of the EU funds;
- to improve the international competitiveness level of the economy and to promote the development of a sustainable economy structure.

To ensure the implementation of measures introduced in the Economic stabilisation and growth programme Latvia plans to receive a loan from European Union, International Monetary Fund, World Bank, as well as from partner countries in amount of 7.5 billion Euros, what will essential contribute to the implementation of the Programme till 2011.

A successful implementation of the measures will contribute to the Latvia's medium term economic policy objective –accession to the Euro-zone as soon as possible.

Broad structural reforms will uphold the balance of the economy of Latvia. The implementation of the measures that are introduced in the National Lisbon Programme is important, among them – the promotion of new product and technology development, the increase of the labour market elasticity, heading to the general objective – notably strengthen the business environment, in this way ensuring that the ability of Latvia to attract investments will be improved.

Alongside with importunate short-term and medium-term objectives, ensuring of sustainability of public finances should be mentioned along the priorities of the Government, especially taking into account, that the Government debt will be contingent on economic stabilisation measures.

2 Economic Outlook

2.1 Current Economic Development

After joining the European Union (EU), Latvia experienced vigorous economic growth. Average annual GDP growth within the period from 2004 to 2007 was over 10% at constant prices. This was one of the highest growth rates in the European Union and, therefore, ensured significant 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.

As of the fourth quarter of 2007, the domestic demand started to decline, what caused the deceleration of the economic growth rates. By analyzing the seasonally adjusted GDP figures compared to the previous period, it can be seen, that it declined for three quarters in a row, as from the beginning of 2008. In the nine months of 2008, comparing to the previous period, GDP decreased by 0.6 percent in constant prices, what was determined by a decrease by 4.6% in the third quarter of 2008. The available short term indicators are showing that a further economic activity decline was observed in the last quarter of 2008. In along with the decrease of domestic demand, the slowdown of Latvia's main trade partner economies in the end of the year became urgent, what affected the development possibilities of the export orientated branches.

The deterioration of the growth indicators in 2008 was underpinned by decreasing private consumption and investment. At the same time, external trade balance improved significantly on account of exports continuing to grow and imports shrinking.

Private consumption has been one of the main contributors to the growth in the previous years, yet in 2008 it started to shrink. Although the employment and wages indicators showed notable growth, the aggregate domestic demand was negatively affected by the high inflation, significant decline in lending and loss of consumer confidence.

The amount of **investment** decreased at constant prices in 2008 due to businesses losing optimism and lending becoming more expensive. The decline was also affected by deterioration of the real estate market and particularly from the third quarter of 2008 – also by harder access to capital on the global financial markets. In the first nine months of 2008 the foreign direct investment inflows totalled 7% of GDP.

The structure of **foreign trade** underwent significant changes in 2008: the amount of export have continued to grow on an upward trend, whereas imports declined at both current and constant prices. This resulted in a positive net exports contribution to the GDP developments.

The changes in demand and confidence are well reflected by the distribution of the value added **by sector**. It has shrunk for sectors which are basically demand-oriented: trade, real estate and commercial services. Output of manufacturing is also decreasing under the impact of both falling domestic consumption (food industry, manufacture of building materials etc.) and changes in external demand (wood processing), as well as impaired competitiveness in labour-intensive sectors (textile industry). Positive growth rates are reported by transport and communications sector as well as public services sector. Construction output is mostly forming of higher public and EU funds investment in infrastructural development. In the first half of 2008 the financial sector reported good growth rates, yet the intensification of the global financial crisis in autumn 2008 has demanded

government interventions in the banking sector: the government has taken over the majority stock of the second largest commercial bank in Latvia.

Labour market indicators improved significantly during the years of rapid economic growth. The economic activity went up to 72.9% in 2007. Employment grew to 68.4% in 2007. In the first half of 2008, employment was still growing, with the unemployment rate remaining low. In the second half of the year, unemployment gradually increased, reaching 7.2% in the third quarter of 2008, what was higher than in the same period previous year. Changes in the economic situation were marked in the labour market by a rapid decline in the number of available jobs and deceleration of wage growth.

Inflation rates increased in 2008, and inflation peaked in May at 17.9% year-on-year. The price hike was largely the result of the rising global energy and food prices. A significant role was also played by a increase of the excise tax on tobacco products. The growth of service prices outpaces that of the prices on goods, reflecting also the high growth rates of wages. In the following months, with both the global prices falling and domestic consumption pressure easing, the annual inflation decreased to 10.5% in December. Inflation expectations also decline gradually.

The data for 2008 pointed to a significant breaking point in the economic development: after a period of rapid growth a deteriorating economic activity showed up, what expressed itself even stronger in the second part of the year. Nevertheless, the uncertainty concerning the future development prospects remains high.

2.2 Macroeconomic Scenario

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 by economic growth outpaced the potential growth rates. Nevertheless, already in the second half of 2007 the factors contributing to higher demand started to loose their effect. In 2008, the domestic demand contracted, thereby pushing the level of economic growth down below the level of potential growth, offsetting the accumulated positive output gap¹, eliminating the cyclical pressure on inflation and facilitating rapid unwinding of the external imbalances. The global financial crisis has significantly hindered the development of a gradual adjustment, limiting the movement of capital, including investment.

¹ Output gap is the gap between the actual GDP and its long-term trend or the potential GDP.

Table 1. Growth and related factors

	ESA code	2007	2007	2008	2009	2010	2011
		millions of lats	Growth %				
1. GDP at 2000 prices	B1*g	8717.3	10.3	-2.0	-5.0	-3.0	1.5
2. GDP at current prices	B1*g	13957.4	24.9	9.4	-1.2	-1.3	1.3
GDP by expenditure at 2000 prices							
3. Private consumption	P3	6240.9	13.9	-6.3	-7.5	-6.0	-0.6
4. Public consumption	P3	1218.0	4.8	3.5	-0.5	1.5	2.5
5. Gross fixed capital formation	P51	3143.7	8.4	-10.0	-12.0	-8.5	1.0
6. Changes in inventories and net acquisition of valuables (% of GDP)	P52+P53		4.7	2.0	2.0	3.8	3.9
7. Exports	P6	3675.7	11.1	4.5	-3.0	2.1	3.7
8. Imports	P7	5748.1	15.0	-6.1	-9.5	-5.2	0.4
Contribution to GDP growth							
9. Aggregate domestic demand		-	13.4	-8.0	-9.5	-7.0	0.0
10. Changes in inventories and net acquisition of valuables	P52+P53	-	1.8	0.0	-0.1	0.0	0.0
11. External balance of goods and services	B11	-	-4.8	5.9	4.6	4.1	1.5

2.2.1 Real Sector

The GDP is expected to shrink in the period from 2008 to 2010, what will be determined by lower private consumption and investment. The economy will start to recover at the end of 2010 and in 2011. The main role in recovery will be played by the tradable sectors which will increase their competitiveness on both the domestic and external markets. It is expected that investment will start to pick up already in 2011, in the same way the private consumption will resume growth only in 2011. Although such developments will have a negative effect on Latvia's economic convergence processes, at the same time there will be a significant turn towards macroeconomic balance: the deficit of the current account of the balance of payments will decrease significantly, the demand driven pressure on inflation will disappear, wages growth will be linked to productivity changes. Although it will be impossible to avoid higher unemployment during this adjustment period, a gradual shift of the labour force to sectors servicing external demand is expected.

GDP by Expenditure

Private consumption mainly depends on the disposable income of households and their perspective on the amount of the future income. Disposable income consists of the household income (wages, transfers, income from capital, borrowing, etc.) less interest payments (interest on mortgage and consumer credits) and debt repayments which have increased dramatically during the last years as a result of an improved access to lending. With new loans shrinking and debt service costs growing, the growth of the disposable income of households lags behind that of the net wage. The future confidence of households is yet a more complicated indicator which is largely dependent on the level of current inflation: the higher the inflation, the more negative the future outlook of households and the lower the level of consumption in the current period. In the same way it depends on the point of view of the households according to the future level of income and the availability of a salaried work.

Negative growth of private consumption is expected in 2009 and 2010 under the effect of the banks tightening their lending policies and setting higher demands on the potential borrowers as well as significant deceleration of the growth of the real wage and employment. The private consumption will also be dampened by the negative future outlook of households according to the future level of income, the availability of a salaried work and the high inflation in 2008 and 2009 as well as in the first half of 2010. Growth of the private consumption will be observable in 2011 with the resumed growth of wages and employment and improvement of consumer confidence. The banking sector can be expected to implement more prudent lending policies in the medium-term based on the lessons learned from the financial crisis. The private sector will also accumulate greater savings than before.

The real growth of **public consumption** will be negative in the medium-term. A negative growth of 3% in constant prices is expected in 2009 considering the sizeable budget consolidation measures. In 2010 there is expected a further decrease of public consumption by another 3% in constant prices. **Gross fixed capital formation** is expected to decline in 2009 and 2010 at constant prices, reflecting the investor caution in the complicated circumstances, as well as the collapse of the real estate market. The main objective of the administration is to maximize the advantages of the EU fund usage, what is reflected in the State budget 2009 and in the Economic stabilisation and growth programme. In the previous years, investment was rather dependent on foreign capital inflows than the level of domestic savings, yet, with the consumption shrinking and the optimism about the future income waning, the level of savings will grow gradually over the coming years, what will be affected by the increase of propensity to save of the households, what in his turn in medium term can give a boost for the economy.

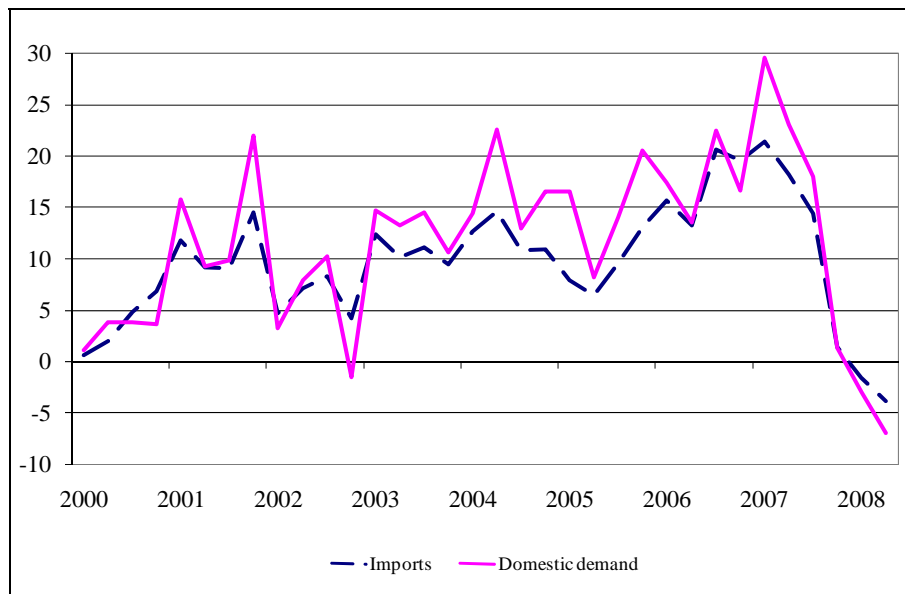


Chart 1. Growth of domestic demand and imports (%).

Considering the shrinking of the private consumption and demand also in the largest external trade partner countries, the growth of **external trade** will become negative in 2009. It is expected that export contribution to GDP growth will remain positive for the further years as well. That will be ensured by reorientation of the Latvian manufacturers towards external markets during the period of contracted domestic demand. With the negative growth of domestic demand persisting, Latvia's external trade balance will improve rapidly in 2008 and 2009. In the medium-term, upon the decrease of the domestic demand, a further gradual decline of the trade deficit can be expected.

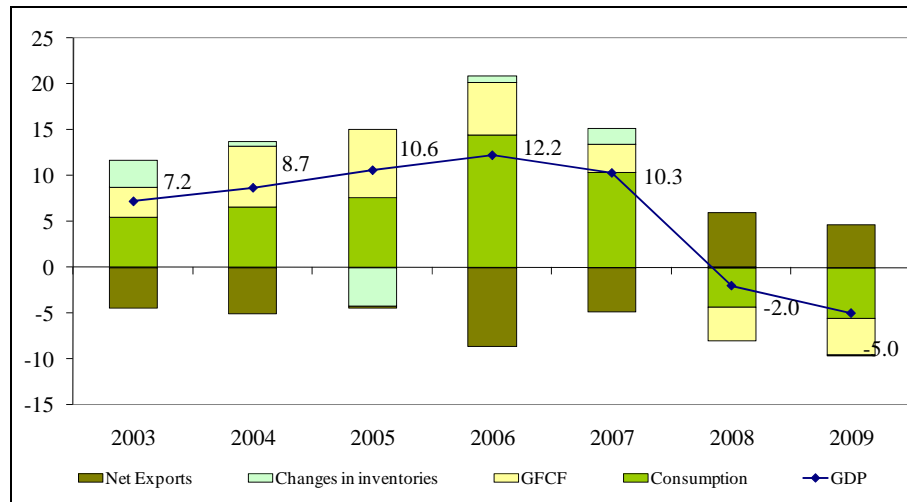


Chart 2. Contribution to GDP growth (%).

GDP by Sectors

Overall growth of **industry** has been lower than the development in other sectors in the recent years. Even more so, it has become negative. This is mainly the result of a sharp increase in unit production costs, as well as employment wages and prices on raw materials. The growth of industry is also hampered by the shrinking domestic demand as well as the adverse conditions in the principal trade partner countries. Industry will resume growth in 2010, with the situation both on the domestic and external markets stabilising and businesses adjusting to the new competition conditions. The situation in the labour market will be favourable for the industry also in the upcoming years – the surplus of the labourforce and the absence of a pressure on wages will contribute to the level of international competitiveness.

In the medium term, the manufacturers 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 industrial sectors will be facilitated by planned governmental economic policy measures aimed at developing the entrepreneurial skills, the business environment, production of higher value added goods and encouraging innovations.

Construction sector reported buoyant growth in the previous years. In 2007, construction expanded by 14.4% at constant prices, despite of the high price rise by 26.2%. In 2008, a gradual deceleration of the growth of construction was observed and it is expected that the overall annual increase of the value added of the sector will be negative at constant prices for the whole year. It is expected that the construction sector output in 2009 will be the lowest for the Programme period. Construction will resume growth in the medium-term, what will be affected by the increase in the availability of the EU funds after the implementation of the measures that are introduced into the Economic stabilisation and growth programme. The construction sector also has a high potential for productivity growth and it could be put to use by improving technologies and logistics.

The development of **agriculture** is highly dependent on weather conditions. In 2007, the weather conditions were comparatively good. As a result, taking into account the increased areas of sowings, the yield of agricultural crops grew. The overall increase of the sector of agriculture, forestry and fishing amounted to 8.2% year-on-year in 2007. In the first

quarter of 2008, the purchase prices of cereals and milk reached their historical highs, yet by November the purchase prices of milk dropped 26% as compared to February and those of cereals by 43%. The added value of agriculture decreased by 1.7% constant prices in the nine months of 2008.

In the medium term agriculture will experience positive output growth, and the differences in prices on outputs will reduce comparing to average prices of other EU Member States. It is, though, expected that employment 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 nearly reached and further development of the sector will be targeted at increasing efficiency.

Private services sectors account for about 55% of the total value added and are major contributors to the overall economic growth. Trade sector experienced rapid development for several years on account of the growing private consumption. Yet in 2008 trade started to decline. The development of this sector can be expected to depend on changes in the private consumption, therefore no growth can be anticipated until 2011. The situation in commercial services sectors will be similar. Transport and communication sector was characterised by gradual deceleration of growth in freight transportation both through ports and by rail and road. The medium-term growth of the sector will be slightly higher than the GDP growth rates and it will largely depend on the political and economic situation in Russia and EU Member States, principal transit partners. The financial services sector will experience shrinking profits in 2009 as a result of the limited lending opportunities as well as growing costs of leverage. The sector will return to positive growth in the medium-term.

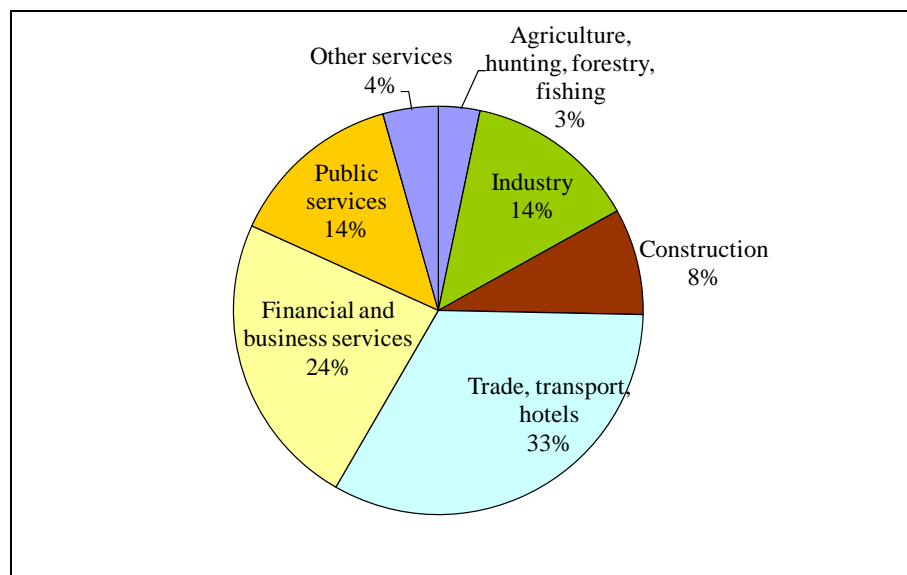


Chart 3. Value added by sector in 2007 (%).

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. In 2009 and 2010, the budget consolidation measures will further decrease the growth of those sectors. The growth will remain low in the medium-term as well, because no significant growth of public spending can be expected.

Labour Market

The population of Latvia amounted to 2.27 million at the beginning of 2008, representing a 0.5% decline over the beginning of 2007. As a result of natural movement, the population declined by 9.8 thousand during 2007, whereas due to migration by 0.6 thousand. The population is expected to shrink at a similar rate in the period under review up to 2011, mainly on account of natural movement.

Working age population (15-74) will decrease at an even higher rate in comparison with the overall population by 2011, mainly on account of a major decrease in the age group 15-24 which relates to the low birth rates in 1990-ties. Nevertheless, such developments do not mean that any significant shrinking of the supply on the Latvian labour market can be expected in the medium-term, as the number of population in the most active working age group (25–57 years) with the labour market participation rate exceeding 80% will increase.

At the same time, with the improvement of birth rates and higher number cohorts of the population born after the WWII reaching the age of retirement, from 2011 the demographic burden on the working age population will start to grow.

The level of economic activity has increased during the last decade, particularly in the last years, on account of the reasonable growth and rising wages. In 2008, despite of the significant deceleration of the economic growth, the share of the economically active population continues to expand, yet with weak development period continuing, the labour market indicators are bound to deteriorate in 2009 and 2010. The scenario provides for a modest increase the share of the economically active population in the coming years which will partly offset the decrease in the number of young people in the working age, yet from 2010 the economically active population will start to shrink.

In the previous years, alongside the growth of the economically active population and decrease of unemployment, employment increased. Nevertheless, starting from the second half of 2008 as a result of the adverse economic developments, employment started to decline. The scenario expects that in 2009 employment will shrink by 2.8%. In 2010 a further decrease in the employment level will continue – by another 3.0 percent.

With employment on a decline, unemployment is expected to grow. The rate of jobseekers of economically active population could reach approximately to 11.0% in 2009. Registered unemployment will be slightly lower than the rate of jobseekers.

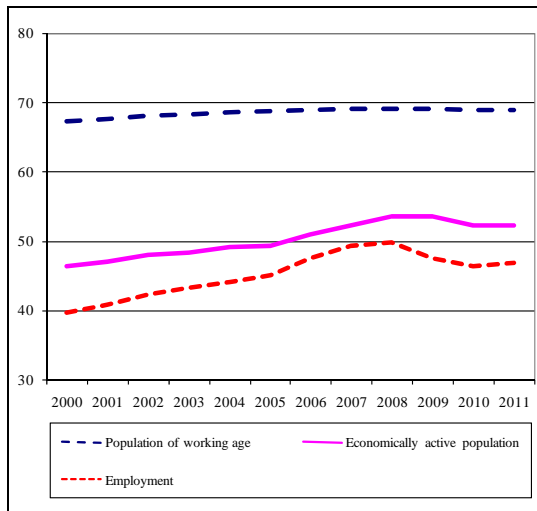


Chart 4. The ratio of working-age, economically active and employed population to total population (%).

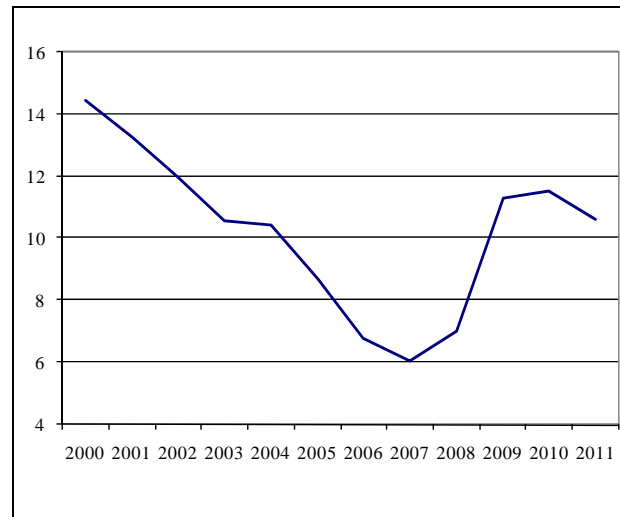


Chart 5. Jobseekers (% of the economically active population).

In 2006, the average gross wage and salary in the economy increased by 23%, whereas in 2007 by 31.5%. The rise continued in the nine months of 2008 and amounted to an average of 23.8%. Such an increase exceeds the correlation between the real wage and productivity growth, thereby diminishing the external competitiveness of the Latvian economy. Starting from 2009, the figure changes for growth of labour productivity will be better than wage and salary figures under the impact of the significantly tighter labour market conditions. As the inflation is expected to decrease in the coming years, the productivity growth will also be lower than in the previous years, the growth of wages at current prices will become negative.

2.2.2 Inflation

In 2007, the growth of consumer prices accelerated in Latvia (particularly in the second half of the year), and the average annual inflation was 3.6 percentage points higher than in 2006 and amounted to 10.1% (HICP). The high level of inflation was almost entirely achieved on account of the core inflation (9.3%) determined by the high level of demand (particularly the prices of non-administered services) and rising global prices on raw materials (particularly food prices). Moreover, the rise of inflation was significantly fuelled by the changes in indirect tax rates (particularly by the rise of excise tax rates on tobacco products making tobacco products 37.8% more expensive).

The trends observed at the end of 2007 continued at the beginning of 2008, and the annual inflation hit the peak in May (17.9%). The most significant factor behind it was the rapid growth of the administered prices (particularly those of energy), as well as the further rise of prices on many food industry raw materials on the global markets. As a result of tax harmonisation with the EU, the excise tax on tobacco was raised again significantly.

The annual inflation started on a downward trend from June 2008, and it amounted to merely 10.5% in December. Such a turning point was largely the result of the easing pressure from domestic demand and falling prices on food and energy on the global markets. The annual average inflation, on the contrary, started to decline only in the last months of the years and accounted in 2008 to 15.4%.

It is anticipated that in 2009 under the impact of falling demand the inflation will continue on a downward trend. Yet the downside will be gradual, and a further raise in the

beginning of the year is possible, what will be caused by relevant increases in value added tax (VAT) and excise tax rates.

In October 2008 energy tariffs were raised and this will preserve a significant effect in 2009 as well. It can be expected that raising the gas and heating tariffs will push the 2009 average inflation up by ~0.9 percentage points. It is also expected that the energy tariffs will be raised again significantly in 2009. The contribution of indirect tax increase on consumer price index can reach 3 – 4 percentage points.

The downward trend of the global oil prices which started in July 2008 could pass through to the tariffs of administered energy prices by the second half of 2009, yet the macroeconomic development scenario is based on the assumption that the oil prices will be on average slightly higher in 2009 than around the end of 2008.

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

	2007	2008	2009	2010	2011
	actual	forecast			
12 month growth; %	13.1	28.5	22.0	9.9	7.0
Impact on inflation; in percentage points	1.7	3.3	2.5	1.1	0.8

Starting from 2008, the procedure for regulating the utility services is changed, stating that the heating and energy tariffs are linked to the variable price of natural gas. That means that the tariff changes will be levelled out over the year and the expected one-off tariff changes within any single month are much smaller.

In 2010 and 2011, the inflation can be expected to continue to decrease gradually as a result of the economic recovery, a more moderate growth of wages and a rise of productivity. The minimum level of indirect tax rates stipulated by the EU legislation will be reached gradually, therefore this factor will cease to have a significant impact on prices in Latvia in the medium-term. The global prices on food and energy are expected to remain high in the future, yet the price fluctuations will be less dramatic. Forecasting lower global growth, the scenario provides that upon the overall global demand declining, the prices on consumer goods will also be adjusted downwards. Technological growth is also a positive sign, which could enable to reduce inefficient consumption of resources and energy. The ability of the supply side to react to the changes in demand could also play a significant role in the future.

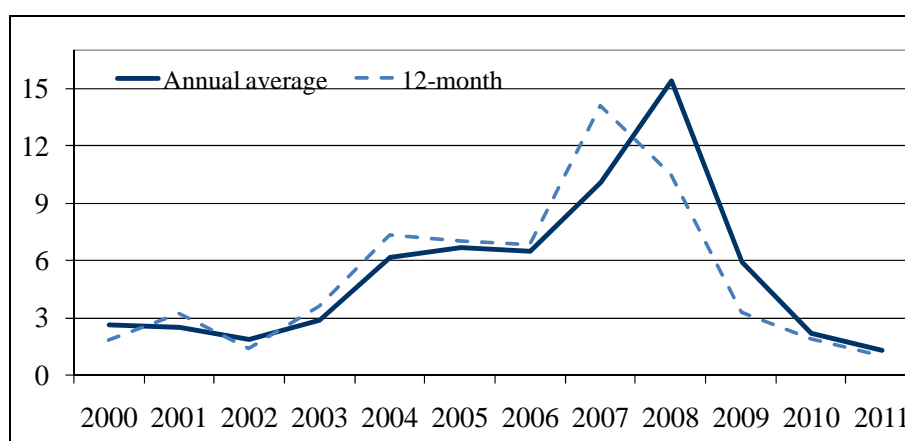


Chart 7. Consumer price index developments in 2000–2011 (%).

2.2.3 Monetary and Exchange Rate Policy

Medium-term monetary and exchange rate policy of Latvia largely relates to the monetary integration plans. Latvia joined the Exchange Rate Mechanism II on 2 May 2005, undertaking a unilateral commitment to ensure a +/-1% exchange rate fluctuation corridor around the central parity (1 EUR = 0.702804 LVL). Duration of participation in ERM II will depend on the ability of the Latvian economy to meet the convergence criteria and the evaluation given by the competent authorities regarding the compliance of Latvia to join the Economic and Monetary Union (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 (ECB) practice. Currently, the Bank of Latvia is already using the same indirect monetary policy instruments based on the 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 2008, with the signs of economic cooling becoming increasingly clearer, as well as intensification of the turmoil on the global financial markets the Bank of Latvia started to loosen its tight monetary policy. As the macroeconomic risks related to the high inflation and overall current account deficit were still valid, then the Bank of Latvia made a decision not to change the refinancing rate (6%), but the reserve requirement of banks was changed on several occasions, thereby ensuring the liquidity of banks when the global banking sector lacked of liquidity.

On 24 February 2008, the reserve ratio for bank liabilities with a maturity of over 2 years was decreased from 8% to 7%. On 24 April 2008, the reserve ratio for bank liabilities with a maturity of over 2 years was further decreased from 7% to 6%. On 24 October 2008, the reserve ratio for bank liabilities with a maturity of over 2 years was decreased from 6% to 5%, whereas for liabilities with a maturity of under 2 years it was decreased from 8% to 7%.

On 24 February 2008, the Bank of Latvia raised the rate of deposit facility from 2.0% to 3.0%. This rate also serves as a rate of remuneration on the banks' reserve requirements. As a result of the global financial market developments, banks, likewise as in most developed countries, engaged in more business with the Bank of Latvia than it was experienced earlier.

2.2.4 External Sector

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

% of GDP	ESA code	2007	2008	2009	2010	2011
1. Current and capital account	B.9	-21.8	-13.4	-5.4	-2.6	-2.3
including:						
- Balance of goods and services		-21.8	-13.9	-7.3	-4.9	-4.5
- Balance of income and transfers		-2.1	-0.9	0.0	-0.5	-1.0
- Capital account		2.1	1.5	1.9	2.9	3.2
2. Net lending/ borrowing of the private sector	B.9	-21.9	-9.9	-0.1	2.3	0.6
3. Net lending/ borrowing of the general government sector	EDP B.9	0.1	-3.5	-5.3	-4.9	-2.9
4. Statistical discrepancy		-0.7	-1.5	0.0	0.0	0.0

The current account deficit of the balance of payments has increased significantly during the last two years in Latvia, pointing to internal and external economic imbalances. On

the one hand, the persistently high current account deficit is determined by the convergence process and using foreign savings in order to finance modernisation and development of the economy. On the other hand, cyclical factors have also exerted an increased 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 prevented the domestic savings from expanding. With domestic prices and wages and salaries increasing, the cost-competitiveness of businesses deteriorated. Nevertheless, in terms of the absolute costs of labour, Latvia remains a country where the labour costs are still considerably lower than the average level of other EU Member States. Alongside a more rapid growth of export prices, the terms of trade improved in 2007 and in the nine months of 2008.

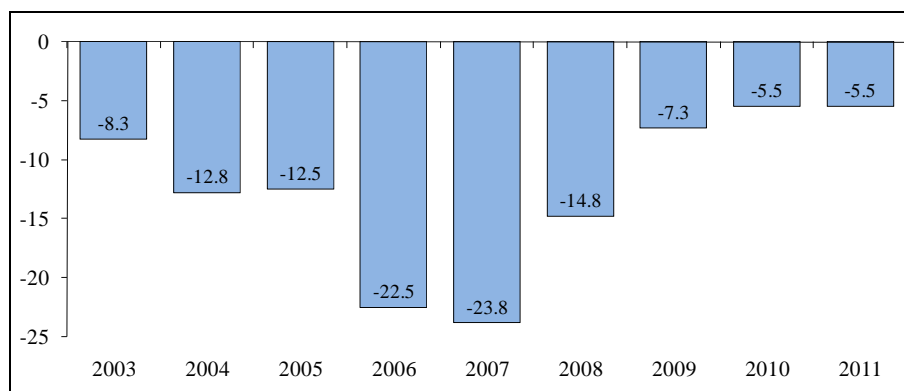


Chart 8. Current account deficit (% of GDP).

In 2007, the current account deficit peaked at 23.8% of GDP, yet in the nine months of 2008 it dropped significantly to 15.4% of GDP (12.6% of GDP in the second quarter). The negative balance of external trade remains the main contributor to the current account deficit, although it has narrowed significantly this year: from 27.1% of GDP in the respective period of the previous year to 19.0% of GDP in the nine months of 2008, thereby also significantly pushing down the current account deficit. Imports-exports gaps shrank rapidly with the domestic demand weakening.

The growth of export of goods decelerated from 22.7% in 2007 to 10.3% in the eleven months of 2008 in nominal terms, against the background of dampening demand and growing costs. Exports grew on account of the exports of base metals and articles of base metals, agricultural goods and foodstuffs, mechanical appliances and electrical equipment, whereas the exports of wood and articles of wood and textiles shrank. The exports of wood and articles of wood dropped as a result of lower demand for lower value added goods, yet the exports of higher value added goods grew significantly, although it does not offset fully the shrinking exports of sawn timber. In 2008, Latvia's overall market share in the EU market and also in Russia was sustainable. Yet the imports of goods decreased by 3.4% in the eleven months of 2008 in nominal terms as a result of a weaker demand. The imports of all significant commodities decreased, with the exception of mineral products, agricultural goods and foodstuffs and also metals.

The balance of services is still positive with some slight improvements in Latvia because the services exports (16.4%) outpaced the services imports (12.7%) in the nine months of 2008. The surplus of transportation services increased significantly primarily as a result of notably growing freight transportation by road and rail, passenger transportation by air and other transportation related services by sea and rail. The other services balance decreased for a smaller margin.

The income deficit in nine months of 2008 comparing to the corresponding period of previous year grew only by 6 million lats. The surplus of current transfers (192.9 million lats) was the result of a significant decline in current transfers received by non-residents in other sectors.

The financing structure of the current account deficit has experienced a change since the beginning of 2008: banks have significantly shifted from short-term to long-term financing. This can be partly explained by the deceleration of the economic growth which foreseeably will persist also in 2009, as well as the gradual reduction of the reserve ratio for bank liabilities with a maturity of over 2 years implemented last year by the Bank of Latvia. It is expected that with the overall lending growth continuing to decelerate, long-term capital will improve the ability of the banks to cover their short-term liabilities in 2009.

In the nine months of 2008, the proportion of foreign direct investment in the covering of the current account deficit even increased slightly in comparison with the respective period of the previous year, yet foreign direct investment an GDP ratio decreased. Changes have also affected the structure of the direct investment. In the previous years, the surplus of the direct investment was dominated by equity and reinvested earnings, whereas in 2008 it was mostly lending across affiliated companies. In general this points to a decline in direct investment in the form of capital investment. It is also expected that the importance of the capital account in covering the current account deficit will increase notably in the coming years (8.7% in 2007), as the EU funding granted within the programming period 2007–2013 exceeds the funding appropriated in the 2004–2006 period more than twice.

The former tendencies show that the current account deficit of the balance of payments will decline by about 10% of GDP in 2008 and will continue to shrink gradually in the years beyond. The results of the first nine months of 2008 point to a significant decline in the goods deficit as well as an improvement of the balance of services and current transfers, and an increase of the income deficit. A further improvement of the current account deficit can be restricted by a weak growth in main external trade partner countries and a lower amount of investments into export orientated corporations, what won't allow to modernize the production process faster. It is more credible that the growth of export prices will outpace that of the import ; therefore, the terms of trade will remain positive. The balance of services will improve slightly, with the exports of services expanding more rapidly. No significant changes across the items of income and current transfers are anticipated.

2.2.5 Risks to the Macroeconomic Scenario

Starting from 2005, the Latvian economy has developed above its potential, thereby supporting the increase of imbalances in the economy. Thus, both an upward pressure on inflation as well as in the size of the current account deficit of the balance of payments was observed in the recent years. Rapid growth and labour emigration exerted a large upward pressure on wages, which exceeded the average growth of productivity, thereby impairing Latvia's external competitiveness. At the current juncture, continued accumulation of these risks in combination with the deterioration of the global environment has contributed to the economic downslide, which has stopped Latvia's rapid convergence process with the EU average level.

The described macroeconomic scenario looks upon a situation, where the adjustment of the macroeconomic imbalances and adapting of the economic structure to the new situation takes place during 2009 and 2010, with growth resuming in the end of 2010 and returning to a positive growth phase 2011. Yet there are several significant risks that may delay the positive development as well as aggravate the economic downturn.

Unit labour costs have increased rapidly during the last three years, which, in turn, has a direct effect on the competitiveness of the Latvian industry on the common market of the European Union. Previously, the low costs, indeed, were one of the main competitiveness factors on the common market, but in the nearest future Latvian manufacturers will have to reorient themselves to the production of higher quality and value added goods. Yet as a result of scarcer lending opportunities with banks tightening their standards and the capital prices growing, there is a risk that businesses will be unable to implement modernisation and development plans in due time and full amount, thereby negatively affecting their competitiveness.

2008 was marked by deterioration of the economic activity in most global economies, including in the European Union and Russia, which are the principal trade partners of Latvia. Most EU Member States report lower GDP growth rates this year, which was underpinned by a crises of the global financial markets. As a result, the domestic demand in those countries will shrink and consequently also the demand for imports, which can have a negative impact on Latvia's external trade balance. The effect of economic deterioration in Estonia and Lithuania, together accounting for about 25% of Latvia's external trade turnover can be particularly serious.

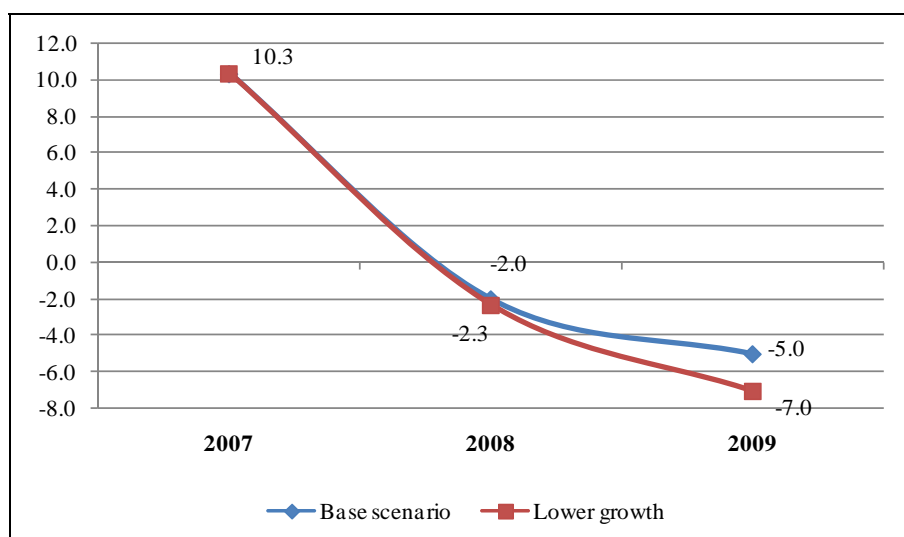


Chart 8. Forecast of GDP at constant prices (%).

There is a significant risk of second-round effects that through a notable decline in employment can aggravate the existing economic downturn, if the reorientation of businesses from servicing the domestic demand to external markets is significantly delayed. In that case, we can expect a decrease of wages to a level that will secure international competitiveness for Latvian workers.

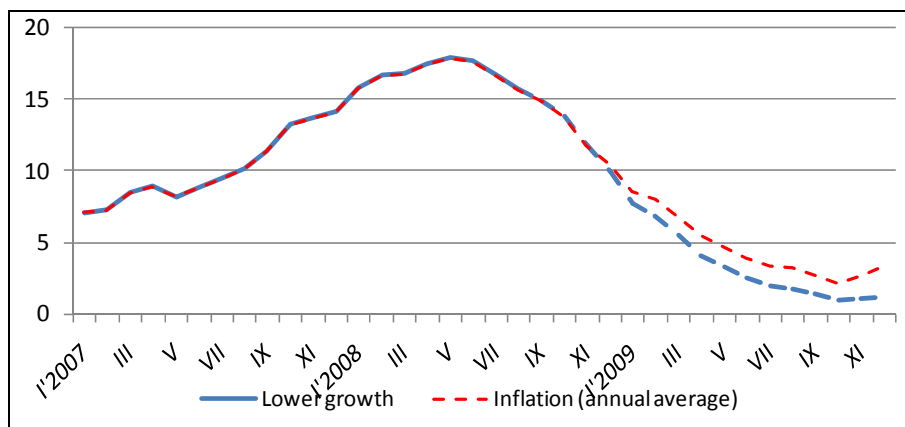


Chart 9. Forecast of average annual inflation (%).

In the second half of 2008, prices decreased both on the energy market and food commodities market. At the beginning of the fourth quarter of 2008, the prices on the global commodities markets have dropped to the level of 2007. Yet there is a risk that the prices may resume growing, thereby exerting a direct impact on the Latvian economy as well as the overall EU economy.

Currently, the world is experiencing a financial market crisis visible mainly on the securities, insurance and interbank markets, yet it also affects the real sector of the economy: production and services. In order to prevent the spill-over effects of the crisis, major world economies implement financial stabilisation measures worth of hundreds of billions of euro. If these measures do not achieve the expected, significant intensification of the global crisis can be expected, which will be reflected in Latvia's indicators as well.

2.3 Economic Impact of the Structural Reforms

The structural reforms discussed in the National Lisbon Programme of Latvia are closely related to the National Development Plan of Latvia, which is a medium-term planning document. The implementation of reforms 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 the public finances.

Considering the current economic growth trends – both worldwide and in Latvia, the government has set the facilitation of economic recovery as soon as possible to be one of the main tasks, at the same time ensuring the conditions required for sustainable medium-term growth. To this end, continuing with the implementation of targeted structural reforms is of a particular importance. The National Lisbon Programme of Latvia 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;
- improvement of education and skills.

The government has highlighted several tasks as priority directions to build the national innovations capacity in the field of **stimulation of knowledge and innovations**. With a view to facilitating the cooperation of science, education and the private sector,

commercial companies have an opportunity to submit project to receive support for research project implementation within the framework of the EUREKA Programme encouraging the development of high technology, new, competitive products and services since 2006. The implementation of the Market-oriented Research Project Programme also continues. In 2007, the implementation of 28 new research projects was supported within the framework of the Programme and the implementation of 48 previously launched projects continued. In the first half of 2008, financial support was extended to 18 Market-oriented Research Programme projects. In 2007, the implementation of Innovation Centres and Business Incubators Development Programme began. Its objective is to promote infrastructural improvements, support innovation centres and the establishment and operation of business incubators. Within the framework of the Programme, 11 innovation centre and business incubator projects have been supported.

Successful development of knowledge-based economy cannot be imagined without the intellectual potential of science, which is measured by the number of people employed in science and research and their qualifications. 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 2007, 146 Doctor dissertations were defended (106 in 2006).

The objective of the support programme is to achieve an increase in the number of innovative businesses to 32% of all businesses in 2010 and an increase in the number of national patents to 95, of which international to 24.

Creation of a favourable and attractive environment for investment and work also continues in Latvia within the framework of the National Lisbon Programme. This is achieved by reviewing and improving the legal framework, harmonising it with the EU requirements and monitoring the impact of administrative procedures on business. Significant reforms and improvements in business registration, tax policy, customs legislations, procedures and border-crossing, construction, real estate development and other areas have been achieved.

A survey of business environment improvement measures is run biannually in order to assess the business environment since 2001. The survey is prepared based on the World Bank methodology. According to the results of the 2007 survey, the average time consumed by a business manager to deal with issues relating to administrative requirements was 12.4% in 2007, representing 33.2% over the 2005 result of 37.3%.

Latvia is one of the best performing EU Member States in terms of implementing the internal market directives. As at 13 May 2008, 99.4% of the internal market directives were consolidated into Latvian legislation.

One of the political priorities of the government is promoting the availability of financing to small and medium-sized enterprises (SMEs). The Latvian Mortgage Bank (LMB) plays an important role in the SMEs support system. Preferential loans are granted to viable SMEs with good prospects, which are oriented towards the international market, produce products or provide services with a high value added. The total investment under the programme will amount to 200 million lats, including almost 50 million lats in 2008.

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 special support territories.

In order to speed up the administrative processes, from 1 July 2008 the executive summaries of legislation contain an evaluation of the administrative burden on businesses and physical persons.

According to the results of the World Bank group survey “Doing Business in 2008”, the business environment in Latvia has generally improved (Latvia ranks 22nd among 178 states in the business environment rating, which is two positions higher in comparison with the previous year survey).

Despite of the progress achieved in the area of **employment promotion** (from 2005 to 2007, when employment increased by an annual average of 2.9%, whereas unemployment decreased from 10.4% in 2004 to 6% in 2007), the government is aware of the existing challenges. These relate to both the cyclical development of the economy as well as the decline in the working age population and aging of the population. Therefore, it is planned to focus on the implementation of a range of measures based on the following priorities in the next years:

- labour market flexibility and employment security issues;
- activation of labour;
- ability of the education and training system to react to the needs of the labour market;
- regional mobility.

In order to facilitate the implementation of the principle of labour market flexibility and employment security or flexicurity in Latvia, amendments to several Cabinet of Ministers regulations were drafted and adopted in 2007, complementing and further specifying the number of cases in which fixed term employment contracts can be concluded. Improvements of legislation governing the employment rights in the area of flexicurity will continue in 2009 and 2010.

Implementation of active employment measures plays an important role in labour activation. The State Employment Agency in cooperation with municipalities and social partners continuously expand the active employment measures, in order to make them better accessible and more appropriate for the customer needs. These include training and retraining opportunities for the unemployed, organising measures to support the regional mobility of those employed by businesses. In 2008–2010, the groups of population which so far have not been under direct attention of the State Employment Agency (inactive population and employees threatened by lay-offs) will be also involved in the active employment measures.

The purpose of promoting the regional mobility is to reduce the risk of unemployment relating to commuting of the employed between the place of residence and the place of employment. Overall, it is planned to engage 3542 persons in the complex support measures in 2009, the total number by 2013 being 13 900 persons.

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 2007 and 2008. As of 1 January 2009, the minimum monthly

wage is raised to 180 lats and the minimum amount exempt from personal income tax to 90 lats.

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 authorities, 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.

Increasing the number of students under natural science and engineering science study programmes is one of Latvia's objectives. Therefore, a significant goal is to improve the training quality in the disciplines of natural sciences, mathematics and technologies at the secondary education stage in Latvia, in order to prepare knowledgeable and competitive youths when completing the secondary education level, create pre-requisites for national development in science and technology-intensive sectors, promote the development of education in line with the strategy guidelines of the Lisbon Programme.

The system of life-long learning is also being developed, which would enable the population to adjust to the changing labour market conditions. The life-long learning strategy is implemented with a view to ensuring labour market inclusion, active participation in the civic society and personal growth. In order to ensure the implementation of the guidelines, a Programme for Implementation of the Life-long Learning Policy Guidelines 2007–2013 in 2008–2010 has been developed. The main targeted outcome of the Programme implementation is to ensure that the number of persons involved in the life-long learning process in 2010 is 12.5% of the life-long learning target group. In 2006, the number of persons involved in the life-long learning process was 6.9%. According to the EUROSTAT Labour market survey data, in comparison with 2006, the number of persons aged 25–64 and engaging in life-long learning increased in 2007 and amounted to 7.1%.

3 General Government Balance and Debt

3.1 Fiscal Policy and General Government Balance

During development of the 2009 budget a number of expenditure cuts were made, to ensure that the budget reflects the recent sharp economic downturn. Initially in compliance with the decision taken by the Cabinet of Ministers at its session of 4 September 2008 concerning the central government budget preparation, ministries and other central government budget authorities were instructed to reduce their planned central government funding as a ratio to the total adjusted maximum allowable spending.

In order to calculate the amount of expenditure cut for each ministry and central government authority, a decision was made that no spending cuts will be implemented in the following areas: implementation of the EU structural funds and other policy instrument projects and programmes, contributions to the EU budget, central government debt management and interest payments, social benefits, expenditure financed from service charge incomes and their balances, state special pension budget, special employment budget, special employment accident budget, special disability, maternity and sickness budget. For the rest of the expenditure of the central government and state social insurance budget programme of 04.05.2000 "Special Budget of State Social Insurance Agency", a universal cut in the amount of 10.67% was stipulated. At the same time, the Cabinet took a decision not to go through with the previously decided increase of wages (keeping the spending at the level of 2008) for educators, medical personnel, persons employed in the sector of culture, judges and court employees, prosecutors.

When adjusting the 2009 draft budget for the second reading at the Parliament, the Cabinet decided that additional spending cuts are required. To this end, it was decided to reduce the ministry spending on wages by 5% and by the amount equal to 3% of spending on goods and services. Additionally, spending was cut under certain programmes of the Ministry of Transport and Ministry of Defence budgets.

In order to reduce the wages fund as per the Cabinet resolution, the ministries and their dependent institutions have to carry out redundancy measures by at least 10% by 30 June 2009, of which by at least 5% by 31 December 2008.

The 2009 budget was adopted in the Parliament on 14th November of 2008. In the beginning of December, by evaluating the fiscal forecasts, a decision was made, that urgent amendments are need to be made, which would implicate additional expenditure decrease with a objective of a further stabilisation of fiscal situation. The amendments of 2009 budget were adopted in Parliament on 12th December of 2008. Accordingly to the amendments made, the previously planned expenses on wages were reduced by 15% and the expenses on goods and services as well for subsidies and endowments reduced by 25% comparing to the previously adopted 2009 budget. The expense cuts weren't made for finances, which are destined for the absorption of the EU funds.

To ensure the decrease of the remuneration fund, together with the 2009 budget amendments a Law on Remuneration of governmental and local government institution functionaries and workers in 2009 was adopted. The law defines, that in 2009 premium wages and bonuses, vacation pay for a vacation in 2009 won't be paid, as well new managerial agreements won't be signed, and the already valid managerial agreements are considered to be closed. In the same way constraints on additional benefits defined by laws and regulations are forbidden.

To ensure a further stabilization and monitoring of the fiscal situation, the Cabinet of Ministers adopted a Regulation No 882 of 29th December of 2008 “On the measures to ensure the fiscal discipline and monitoring”. According to the adopted Regulation, the ministries have to create a financial security reserve in an amount of 10% of the appropriation that is allocated in the budget of the ministry for 2009 (excluding the expenses on the EU fund absorption, Government debt maintenance, for the instalments to the EC budget, social expenses etc. cases mentioned in the Regulation). The Cabinet of Ministers will decide on the usage of the financial security reserve. To ensure the monitoring of the fiscal discipline, the Minister of Finance creates a Committee of Fiscal discipline monitoring. The Committee will weekly evaluate the execution of Government budget and taking into account the actual budget accomplishment and its correspondence to the planned indicators, will decide on the recourses and the amount of them for the further period.

Table 4. General government budget (million of lats)

	2007	2008	2009	2010	2011
	actual	estimate	forecast		
Revenue	5268.8	5362.0	4902.2	5215.3	5695.4
Expenditure	5260.2	5889.0	5696.7	5951.5	6140.6
Balance	8.7	-527.0	-794.4	-736.2	-445.2

Central government budget

In the medium-term, the central government budget will be affected by expenditure decrease, including wages. At the same time amendments have been adopted in legislation governing social benefits payable from the central government budget, that will determine that the social expenditures will increase.

According to the Cabinet of Ministers Regulation No 756 of 16 September 2008 “Amendments to the Cabinet of Ministers Regulation No 561 of 26 July 2005 “Regulations on the Size of State Social Security Benefit and Burial Benefit, its Review Procedure, Procedure for Granting and Disbursement of the Benefit””, it is expected to increase the state social security benefit for a disabled person since childhood from 50 lats to 75 lats per month as of 1 January 2009 as well as to increase the burial benefit for a disabled person since childhood from 100 lats to 150 lats. As a result of raising the state social security benefit for a disabled person since childhood, the central government budget spending will increase by 3.1 million in 2009, 3.3 million lats in 2010 and 3.5 million lats in 2011. At the same time, according to the Cabinet of Ministers Regulation No 576 of 28 August 2007 “Amendments to the Cabinet of Ministers Regulation No 831 of 7 October 2008 “Amendments to the Cabinet of Ministers Regulation No 562 of 26 July 2005 “Regulations on the Size of State Family Benefit and Additional Payment to Burial Benefit, its Review Procedure, Procedure for Granting and Disbursement of the State Family Benefit for a Disabled Child, its Review Procedure, Procedure for Granting and Disbursement of the Benefit””, it is expected to increase the additional payment to the state family benefit to take care of a disabled child from 50 lats to 75 lats per month. As a result of raising the additional payment to the state family benefit to take care of a disabled child, the central government budget spending will increase by 2.3 million in 2009, and by 2.2 million lats in 2010 and 2011 respectively.

The central government budget 2009 includes expenditure required to complete the administrative and territorial 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 18 December 2008, the Parliament approved a new administrative and territorial division, providing for creation of nine republican importance cities and 109 territories. Central government budget financing in the amount of 200 000 lats is granted 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 in 2007 to form a new territory and start operation as a new territory after the 2009 election of the local governments. Thus, to implement these measures, funding for implementation of the administrative and territorial reform in the amount of 12.8 million lats was provided in the 2007 budget, 55.6 million lats were planned in the 2008 budget and 3.2 million lats in the 2009 budget.

Social security budget

The financial position of the social security budget has improved significantly during the last years.

In 2008, significant amendments to social security legislation were introduced, which will increase the social security budget expenditure in the medium-term.

- According to the Law on State Funded Pensions, it is expected that from 1 January 2009 the monthly bonus to the old age pension per one year of insurance record accumulated up to 31 December 1995 will be raised from 40 santims to 70 santims. As a result of raising the bonus to the old-age pension, the following expenditure increase in the social insurance budget is planned: 71.6 million in 2009, 71.6 million lats in 2010, 74.2 million lats in 2011.
- According to the Law on State Funded Pensions, it is expected that from 1 January 2009 a monthly bonus to the disability pension per one year of insurance record accumulated up to 31 December 1995 will be in the amount of 70 santims. As a result of setting the bonus to the disability pension, it is planned to increase the social insurance budget expenditure starting from 2009 by 9.7 million lats annually.
- According to the Law on State Funded Pensions, an option of an early retirement is provided for repressed persons with the insurance record of at least 30 years and for an extension of the early retirement option deadline. In relation to ensuring the option of an early retirement for repressed persons and an extension of the early retirement option deadline, the following expenditure increase in the social insurance budget is planned: 2.8 million lats in 2009, 6.8 million lats in 2010, 7.7 million lats in 2011.
- In order to implement the measures provided in the Law On Agreement between the Republic of Latvia and Russia Concerning Cooperation in the Area of Social Security, and relating to disbursements of old age and disability pensions, the following expenditure increase in the social insurance budget is planned: 9.6 million lats in 2009, 10.3 million lats in 2010, 11.0 million lats in 2011.
- According to the Law On Maternity and Sickness Insurance, and Law On Compulsory Social Insurance against Employment Accidents and Vocational Diseases from 1 January 2009 the number of sickness days paid by employer will

be reduced from 14 days to 10 days. As a result of reducing the number of sickness days paid by employer, an expenditure increase in the social insurance budget is planned in 2009 amounting to 5.5 million lats.

A pension indexation was made in 2008, in the result an amount of 194.8 milion lats is apprehended in the social insurance budget for 2009.

Local government budget

To ensure stable and predictable situation in the general government budget, a expenditure decrease also in local government budgets in 2009 is planned. On 9th December of 2008 an additional covenant to Disagreement and Understanding Protocol between the Cabinet of Ministers and the Latvian Association of Local and Regional Governments was signed. The additional covenant defines, that taking into account the Governmental policy and economic promotion measures, as well as taking into account the principles and tasks implemented in the Economic stabilisation plan, by local authorities and government facing up a solitaire responsibility in solving the problems, the local authorities pledge to reduce substantially in 2009 the total expenditures, including wage fund for at least 15% compared to 2008.

To ensure the control of the local government budgets, in the Regulation No 882 of 29th December of 2008 "On the measures to ensure the fiscal discipline and monitoring" it is defined, that local authorities will twice a month fill-in to the Ministry on Finance information about the performance of the budget for the previous two weeks and the planned incomes and expenses for the further two weeks.

Table 5. General government budget developments

		2007	2007	2008	2009	2010	2011
	ESA code	million lats	% of GDP				
Net lending (EDP B.9) by sub-sector							
1. General government	S.13	8.7	0.1	-3.5	-5.3	-4.9	-2.9
2. Central government	S.1311	-320.2	-2.3	-4.3	-3.2	-3.5	-2.3
3. State government	S.1312						
4. Local government	S.1313	-85.6	-0.6	-0.7	-0.6	-0.1	-0.1
5. Social security funds	S.1314	414.5	3.0	1.5	-1.4	-1.3	-0.5
General government (S.13)							
6. Total revenue	TR	5268.8	37.7	35.1	32.5	35.0	37.7
7. Total expenditure	TE	5260.2	37.7	38.6	37.7	39.9	40.7
8. Budget balance	EDP B.9	8.7	0.1	-3.5	-5.3	-4.9	-2.9
9. Interest expenditure	EDP D.41	67.2	0.5	0.6	1.5	1.5	1.6
10. Primary balance		75.9	0.5	-2.9	-3.7	-3.5	-1.4
11. One-off and other temporary measures							
Selected components of revenue							
12. Total tax (12=12a+12b)		3164.8	22.7	21.8	20.3	21.0	22.6
12a. Taxes on production and imports	D.2	1805.4	12.9	11.7	13.2	13.7	15.4
12b. Current taxes on income, wealth etc	D.5	1357.2	9.7	10.2	7.1	7.4	7.2
12c. Capital taxes	D.91	2.2	0.0	0.0	0.0	0.0	0.0
13. Social contributions	D.61	1325.4	9.5	9.5	8.0	7.8	7.7
14. Property income	D.4	103.0	0.7	0.9	0.7	0.7	0.7
15. Other		675.5	4.8	2.9	3.5	5.4	6.8
16. Total revenue	TR	5268.8	37.7	35.1	32.5	35.0	37.7
Tax burden (D.2+D.5+D.61+D.91 – D.995)		4542.2	32.5	31.7	28.6	29.2	30.7
Selected components of expenditure							
17. Compensation of employees + intermediate consumption	D.1+P.2	2481.8	17.8	17.9	15.6	15.6	15.2
17a. Compensation of employees	D.1	1606.6	11.5	11.6	10.0	9.9	9.6
17b. Intermediate consumption	P.2	875.2	6.3	6.4	5.6	5.7	5.7
18. Social payments (18=18a+18b)		1126.6	8.1	8.8	10.2	11.7	12.2
18a. Social transfers in kind supplied via market producers	D.6311. D.63121. D.63131	70.8	0.5	0.6	0.6	0.7	0.7
18b. Social transfers other than in kind	D.62	1055.8	7.6	8.3	9.6	11.0	11.5
19.=9. Interest expenditure	EDP D.41	67.2	0.5	0.6	1.5	1.5	1.6
20. Subsidies	D.3	89.9	0.6	0.6	0.6	0.6	0.6
21. Gross fixed capital formation	P.51	792.1	5.7	5.4	6.0	6.8	7.3
22. Other		702.7	5.0	5.2	3.9	3.8	3.7
23.=7. Total expenditure	TE	5260.2	37.7	38.6	37.7	39.9	40.7
Government consumption	P.3	2532.7	18.1				

3.2 Medium-Term Objective and Budgetary Implications of Structural Reforms

The Member States have to set their medium-term targets for the general government budget position based on specific core principles. Based on the Council's decision², medium-term objectives of the Member States have to be cyclically adjusted and they must provide:

- a sufficient safety margin with respect to the 3% of GDP deficit limit;
- rapid progress in reducing the government debt to a sustainable level, taking into account the impact of ageing population 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, the Convergence Programme of Latvia 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 largely met the pre-defined medium-term objective in the beginning of the period, and the budgetary performance has exceeded the target. A sharp worsening of the economic situation, which was observed in 2008, regardless of the budget consolidation measures that were taken, will determine an increase of the budget deficit in the Programme period.

The Economic stabilisation and growth programme determines notable budget consolidation measures, though at the same time it defines to keep a considerable financing for the investment expenditures, especially in relation with the absorption of the EU funds. That will allow to raise the productive capacity of the Latvia's economy and to return faster to a sustainable growth.

The reforms in the educational system and health care system will be notably expedited and updated taking into account the new circumstances, what in the same time with medium-term efficiency and restriction of expenses objectives, will be directed to ensure a long-term sustainable public spending.

² The Council report "Improving the implementation of the Stability and Growth Pact"

The efficiency raise and the restriction of expenses is another essential priority of the governments structural reforms. The completion of the administrative reform will improve the efficiency of public finances.

The implementation of the measures that are introduced in the National Lisbon Programme is important, among them – the promotion of new product and technology development, the increase of the labour market elasticity, heading to the general objective – notably strengthen the business environment, in this way ensuring that the ability of Latvia to attract investments will be improved. The administrative burden will be notably reduced, especially in branches, that are preventing the development of small and medium enterprises. Measures to promote export will be taken.

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 the 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.

Preparing an estimate of the output gap is one of the main tasks in establishing the cyclical position of the national economy in relation to its long-term potential development trend. This output gap can be used to adjust the medium-term decisions which can help to absorb the economic shocks. In a classical variant, looking at the cyclicity of the economy, the behaviour of the government and households should be counter-cyclical: savings have to be accumulated in 'good times' and be used in 'bad times'. Due to this reason, the cyclically adjusted budget balance is widely used in Europe, showing the position of the general government balance, taking into account the current cycle of the national economy. The size of the cyclically adjusted budget balance depends on the size of the budget balance, tax elasticity and the size of the output gap.

According to the Ministry of Finance estimate, using the production function method, Latvia's positive gap between the actual and potential GDP was on a rise since 2005, and it peaked in the second half of 2007. This was mainly underpinned by the high level of the domestic demand expanding at a rate consistently above the long-term economic growth potential for several years.

According to the macroeconomic development scenario featured in the Convergence Programme, from 2008 the economic downturn set in. That was mainly the result of the falling domestic demand, which thereby affects almost all economic sectors and, which is more important, has a negative effect on investment and labour market: two main factors determining the level of the economic potential. Although towards the end of 2008 employment started to shrink rapidly, the average employment level for the year should remain positive, thereby having a quite large contribution to the level of the potential. The growth rate of the gross fixed capital formation was also negative in 2008, resulting in a smaller contribution to the potential level. The national economic potential is judged though by using the accumulated capital, which means that the reaction of capital contribution to investment decline will only become obvious in the medium-term. Due to the above mentioned reasons, a negative output gap amounting to -2.1% of GDP can be expected in 2008. According to the macroeconomic development scenario featured in the Convergence

Programme, it is also obvious that the economic growth will be below the potential, thereby making a further contribution to the negative output gap, also in the coming years.

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 both the cyclically adjusted and nominal general government budget will run a deficit in 2008 - 2010. Yet in 2011, the cyclically adjusted budget is expected to be in surplus, while the nominal budget will still be with a deficit.

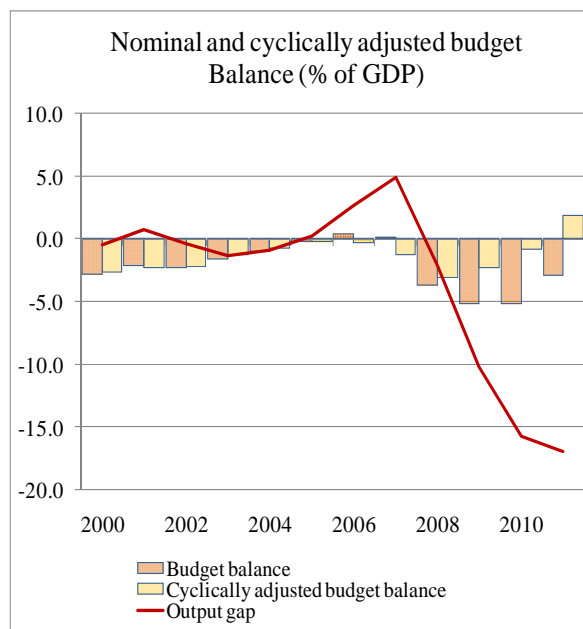


Chart 10. Cyclically adjusted budget balance (% of GDP).

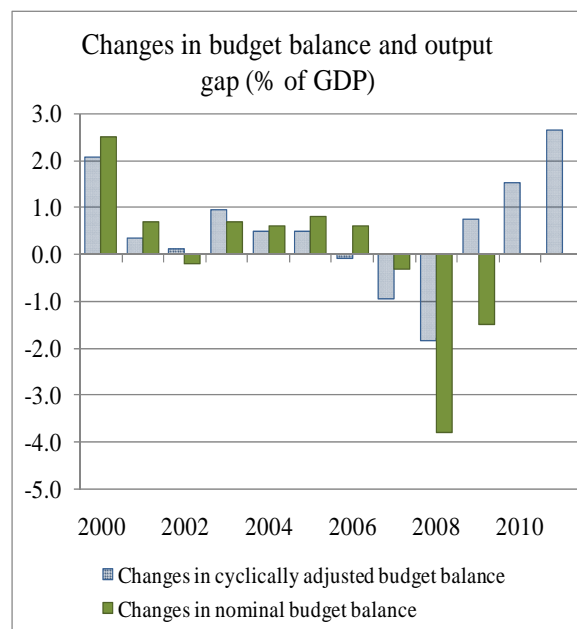


Chart 11. Changes in the fiscal position (% of GDP).

It is expected that the medium-term actual GDP growth will be considerably lower than the economic potential, which will result in a sizeable output gap. As a result, starting from 2009 the cyclical component of the budget balance will range from 2.8 to 4.7 percentage points.

Table 6. Cyclical developments

% of GDP	ESA code	2007	2008	2009	2010	2011
1. GDP growth at constant prices	B1g	10.3	-2.0	-5.0	-3.0	1.5
2. Actual budget balance	B9	0.1	-3.5	-5.3	-4.9	-2.9
3. Interest expenditure	D41	0.5	0.6	1.5	1.5	1.6
4. Potential GDP growth		7.9	5.0	3.6	3.3	3.0
contributions:						
- employment		2.3	1.6	1.6	1.7	1.4
- capital		4.3	3.2	2.4	1.9	1.6
- total production factor productivity		1.2	0.1	-0.4	0.3	0.0
5. Output gap as a percentage of potential GDP		4.9	-2.1	-10.2	-15.7	-16.9
6. Cyclical budgetary component		1.4	-0.6	-2.8	-4.4	-4.7
7. Cyclically-adjusted balance (2-6)		-1.3	-2.9	-2.5	-0.5	1.8
8. Cyclically-adjusted primary balance (7+3)		-0.8	-2.3	-1.0	1.0	3.4

3.4 Government Debt

In 2007, the general government debt amounted to 1 331.3 million lats or 9.5% of gross domestic product. General government debt is primarily affected by the central government debt, amounting to 1 031.9 million lats and 77.5% of the general government debt in 2007.

The objective of the central government debt management policy is to ensure the financing for the government budget execution and refinancing of the central government debt commitments at the lowest possible costs, at the same time hedging the financial risks and taking into account the development of the Latvian national capital market and the overall national 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, providing for adherence to a set of optimum parameters concerning 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 amount of borrowing and central government debt level in the medium-term is determined by total financing requirements, which consist of funding required for the government budget execution and refinancing of central government debt commitments.

Looking at the results of the primary placement of government securities, it can be concluded that the demand for government securities has been fairly unstable since the second half of 2007, thereby limiting the amount of financing that can be potentially drawn from the domestic financial market. Furthermore the demand of the investors, taking into account the fluctuations and decrease of transaction activities in the global financial market, is concentrating in the short-term, that restricts the possibility to attract long-term funding in the domestic market. In spite of that the total issue of government domestic securities in 2008 reached 904.5 million lats by nominal value, that is historically largest increase of government domestic debt liabilities during a period of a year. During the period of 2009 to 2011 government short-term domestic T-bills (6 or 12 month) could be used for covering financing requirements. In case of necessity to ensure a short-term financial liquidity additionally to the previously mentioned instruments the short-term loans and credit facilities offered by domestic financial institutions could be used.

Decision to draw funding from the external financial market by organizing the issue of a new 10-year Eurobonds was already taken in 2007. Taking into account increasing uncertainty at international financial markets, the issue was accomplished in February 2008, and amounted to 400 million euro. The funding drawn from Eurobonds issue were primarily used for redemption of previously issued Eurobonds in the amount of 200 million euro in November 2008, as well as to ensure other budget commitments.

As well in October 2008 new agreement with the European Investment Bank was signed, according to which 500 million euro will be available in the medium-term for the purpose of ensuring the national co-financing to projects financed by the EU structural funds and Cohesion fund of the new programming period. In accordance with the agreement, 150 million euro were already acquired in 2008, as well as further allocation of the loan is planned in 2009 – 2011.

Sharp worsening of budgetary execution indicators, influenced by downswing of the economy and decrease of budget revenues, as well as by rendering of financial assistance by

the government for stabilisation of the national financial sector, caused notable growth of total financing requirements in the last quarter of 2008. The deepening of negative economic development trends, which is forecasted also for the next years, is forcing to take into account larger total financing requirements also in 2009 and 2010. Taking into account the unstable situation in the financial markets and the downgrade of the country's credit rate by the major international rating agencies, at the moment borrowing possibilities at the financial markets are limited for Latvia. Wherewith the decision to start negotiations with International Monetary Fund and European Commission was taken for providing international financial support for stabilisation of macroeconomic and financial situation in Latvia . At the end of 2008, International Monetary Fund, European Commission, World Bank, European Bank for Reconstruction and Development and a number of EU countries have agreed to allocate financial support in the amount of 7.5 billion to Latvia euro on the basis of the economic stabilisation and growth programme. The allocated funding will be available in the period of 2008 to 2011 to stabilise and recover the financial system of Latvia, to prevent further deterioration of the economic situation and to restructure the economy of Latvia by raising its competitiveness, as well as to lower disincentive risks for economic growth.

Although the economic downslide trends of the Latvian economy affect the general government budget execution figures and financing requirement, it can be expected that in the medium-term the general government debt will remain below the debt criterion set in the Maastricht Treaty.

Table 7. General government debt development

% of GDP	ESA code	2007	2008	2009	2010	2011
1. Gross debt		9.5	19.4	32.4	45.4	47.3
2. Change in gross debt		-1.1	9.8	13.1	13.0	1.9
Factors impacting on changes in gross debt						
3. Primary balance		0.5	-2.9	-3.7	-3.5	-1.4
4. Interest expenditure (consolidated)	D41	0.5	0.6	1.5	1.5	1.6
5. Stock-flow adjustment:		-1.1	6.4	7.9	8.0	-1.1
of which		-0.3				
- Differences between cash and accruals						
- Net accumulation of financial assets		1.4				
including privatisation revenue		0.1				
- Valuation effects and other		0.0				
p.m. implicit interest rate on debt		5.7	6.3	7.7	4.5	3.5
Other variables						
6. Liquid financial assets		4.0				
7. Net financial debt (7=1-6)		5.5				

4 Sensitivity Analysis and Comparison with the Previous Programme

4.1 Sensitivity Analysis

The macroeconomic scenario discussed in Section 2 of the programme reflects the macroeconomic development outcome, considering both the overall development trends and the economic policy measures of the government. Yet the actual development may be affected by many factors that can have both positive and negative effect. At the time of developing the scenario, the development of the macroeconomic situation was uncertain, particularly within the context of the global financial crisis: to what extent it will affect Latvia and Latvia's trade partners, what the effect of the anti-crisis measures taken by Latvia and the international community will be.

It is obvious that uncertainty affects both the domestic and external demand; therefore, there can be significant differences as to how deep and long the economic recession phase will be before returning to the growth phase of the cycle.

In order to look at the effect of potentially negative development on the budgetary revenue and thus on the scope of the required budget consolidation, the sensitivity analysis is based on the pessimistic development scenario.

The pessimistic scenario provides that several significant macroeconomic development risks will materialise both on the domestic and the external market. This will determine that in 2009 the drop of the private consumption and gross fixed capital formation will be considerably stronger, 10.2% and 15.6% respectively. Exports at constant prices will also shrink by 3.6%, whereas public consumption will shrink by 4.7%. Rapid decline of the domestic demand will result in a decrease in imports by 15.7%. In the result the decrease of GDP will reach 7.0%.

The pessimistic scenario provides that unemployment will grow notably and the real wage growth will be negative. This will result in a quick unwinding of the existing macroeconomic imbalances: the inflation and current account deficit will decline rapidly.

A longer GDP contraction and stabilisation period before resuming growth in comparison with the base scenario, which is based on a significant shrinking of the domestic demand and results in notably weaker labour market indicators, will have a significant effect on the budget revenue base as well. According to the estimate, if the economic development follows the pessimistic scenario, budget revenue will be by 0.2% of GDP lower in 2009 as compared to the base scenario. The government is aware of the magnitude of the risks relating to the budget forecasts in such changing and uncertain domestic and external environment and in case of need to be able to correct fast the budget expenditures, a financial security reserve in the beginning of the year is created in the general government budget.

4.2 Comparison with the 2007 Convergence Programme

Table 8. Comparison with the 2006 Convergence Programme forecasts

	ESA code	2007	2008	2009	2010	2011
GDP growth (%)	B1g					
2007		10.5	7.5	7.0	6.8	-
2008		10.3	-2.0	-5.0	-3.0	1.5
Change		-0.2	-9.5	-12	-9.8	-
Actual budget balance (% of GDP)	B.9					
2007		0.3	0.7	1.0	1.2	
2008		0.1	-3.5	-5.3	-4.9	-2.9
Change		-0.2	-4.2	-6.3	-6.1	-
General government gross debt (% of GDP)						
2007		9.4	8.3	7.2	6.4	-
2008		9.5	19.4	32.4	45.4	47.3
Change		0.1	11.1	25.2	39.0	-

The 2007 Convergence Programme provided for a decrease in the growth rate by 10% to the potential level, upon the decrease of domestic demand factors determining the rapid growth after the EU accession. However, actual 2008 growth indicators shrank at a much more rapid rate as a result of the domestic demand and investment decreasing. The growth will become positive again only in 2011 as a result of the structural changes in the economy, which will adjust to the new situation on the domestic and external markets.

The change of the general government budget balance from a surplus to a deficit within the programme period is related to a significant deterioration of the economic situation. Yet the situation is considerably influenced by the budget cuts implemented in the 2008 and 2009 budgets, including limiting the wage fund of the public sector and implementing the necessary redundancy measures.

Starting from 2008, the forecasts of the Latvian central government debt have increased, as the downside trend of the Latvian economy affect the general budget execution figures. In the same way the amount of the government debt will be affected by the loan amount which will be provided by the International Monetary Fund, European Commission, World Bank, European Bank for Reconstruction and Development and a number of partner-countries according to the Economic stabilisation and growth programme.

Yet it can be expected that the general government debt will remain below the Maastricht Agreement criterion which is 60% of GDP in the medium-term.

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.

In the recent years, the tax revenue growth has been mostly supported by the buoyant economic growth. Currently, with the economic growth decelerating, the growth of the tax revenue also decelerates; therefore, the role of the tax policy in reducing the tax burden on the population and stimulating business at the same time ensuring revenue flows to the budget becomes increasingly more important.

It has to be noted that the overall tax burden in Latvia has been one of the lowest in the European Union for several years. In 2006, it amounted to 30.4% of GDP, which is considerably lower than the EU average at 40.0 % of GDP.

Table 9. Tax revenue in general government budget (S.13) (millions of lats)

	Code (ESA 95)	2007	2008	2009	2010	2011
Tax revenue						
1. Production and imports taxes	D.2	1805.4	1781.8	1990.3	2034.5	2322.5
2. Current income and property taxes	D.5	1357.2	1551.4	1067.5	1097.4	1081.4
3. Capital taxes	D.91	2.2	2.0	2.0	2.0	2.0
4. Social contributions	D.61	1325.4	1449.4	1210.2	1168.7	1157.2
<i>Of which actual social contributions</i>	<i>D.611</i>	1286.2	1402.7	1156.0	1107.0	1088.0

The forecast of the tax revenue flow to the general government budget was prepared taking into account the expected tax legislation amendments as well as the base scenario of the economic development. The decrease of the economic activity also affects the tax revenues, which in 2009 will be notably lower than in 2008.

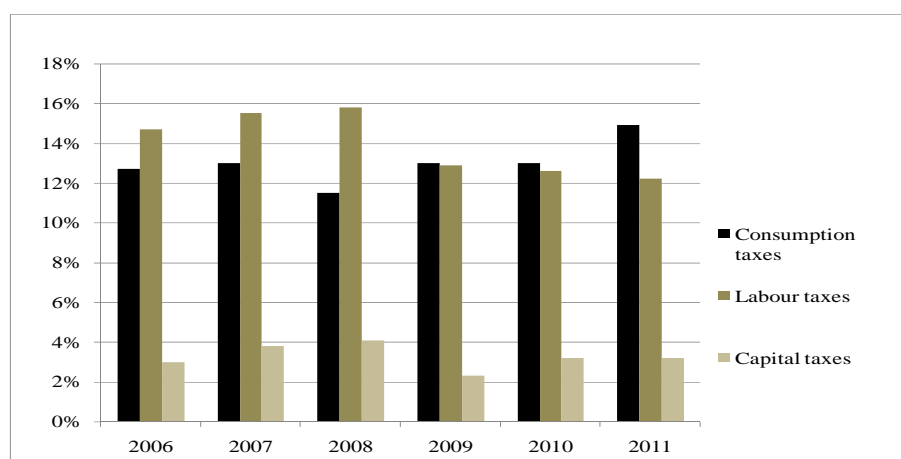


Chart 12. Tax revenue by economic function (% of GDP).

To restrict the decrease of tax revenues caused by the unfavourable economic situation and to stimulate the investments, in the Programme period, but especially in 2009, essential tax policy changes are planned.

The major share of total tax revenue in Latvia is comprised of labour taxes and it has followed on a downward trend (from 52.0% in 1995 to 48.1% in 2007), whereas the share of consumption taxes in total tax revenue has increased (from 36.8% in 1995 to 40.3% in 2007).

In the recent year, considering the rapid economic development rates, the share of the overall tax revenue in gross domestic product expanded, including revenue from labour and consumption taxes. In view of the forecast development of the macroeconomic situation, it is expected that the share of the tax revenue in gross domestic product will notably shrink in the medium-term.

Table 10. Fiscal impact of main tax policy changes (% of GDP)

	2009	2010
Value added tax	+1.92	-
Corporate income tax	-0.04	-0.20
Excise tax	+0.74	-
Real estate tax	-	+0.54
Personal income tax	-0.63	+0.26
Social security contributions	+0.34	-
Total impact of tax policy changes:	+2.33	-0.60

Value Added Tax

Value added tax (VAT) revenues have a notable share in the total tax revenues. During the last years the value added tax revenues showed-up high growth rates. Though in year 2008, taking into account the slump of retail trade, the value added tax revenues were lower comparing than in year 2007. According to the information of State Revenue Service the largest tax payers by division of economic sectors were: wholesale, excluding automobiles and motorcycles, the retail trade, excluding automobiles and motorcycles, and construction.

As of year 2009 the standard rate of value added tax is increased by 3 percentage points from 18% to 21%, the reduced rate from 5% to 10%, furthermore the reduced rate is continued only to the following transactions:

- supplies of medicaments;
- supplies of medical devices and medical goods;
- supplies of specialized products intended for infants;
- the inland public transport services;
- supplies of heating, electricity, and natural gas to households.

Value added tax rate of 10% shall be applied to the supplies of print media until December 31,2009.

Table 11. Tax policy impact changes on value added tax revenues (millions of lats)

	2009
The increase of VAT flat rate from 18% to 21%	+183.0
VAT revenues from the increase of the excise tax	+14.3
The increase of VAT reduced rate from 5% to 10% (for individual service groups), as well from 5% to 21%	+91.7
Total impact of changes:	+289.0

Corporate Income Tax

It is expected that the corporate income tax rate which is in force from 2004 and currently stands at 15%, and is one of the lowest rates in the European Union, will remain unchanged. In the recent years, the declared corporate profits increased significantly, which was one of the objectives of the policy of reducing the corporate income tax rate. With the economy developing successfully and the corporate financial results improving, the revenue from the corporate income tax grew notably.

In the medium-term, it is forecast that the growth of the corporate income tax revenue will decelerate as a result of the expected deterioration of the corporate performance. In order to support and stimulate business, several tax policy measures are planned starting from 2009. Although the planned corporate income tax relieves will have a negative effect on the budget, they will serve as significant incentives encouraging business.

- An incentive for acquiring new machinery. In order to stimulate manufacturing which is the main export-oriented sector, companies will be allowed to continue (up to taxation year 2013) to apply a significant tax incentive, i.e. to apply for depreciation purposes an increase coefficient of up to 1.5. to the value of acquired new machinery;
- An incentive for investment in research and development. In order to promote registration of patents and trademarks, thereby increasing the contribution of the private sector to research and development. A target – to reach the EU average level of research and development costs in the gross domestic product. An increase coefficient of 1.5 will be applied to the depreciation value of intangible assets resulting in registration of a patent or trademark;
- Allowance for corporate equity. In order to encourage owners of companies not to distribute the profit in dividends but invest in the development of the company by increasing the equity capital, it is planned to allow to reduce the taxable income for a deemed interest payment that a taxpayer would have to pay for a similar size loan (equal to the amount of increase of the corporate equity);
- Replacement of fixed assets. In order to encourage taxpayers to replace inefficient and outdated technological equipment with new and efficient equipment, the payment of tax on the income received from the disposed asset will be deferred until the disposed asset is replaced by a similar asset ;
- Extending the loss carry-forward period (from 5 to 8 years);
- An incentive to develop air traffic services. Exemption from withholding tax of payments to non-residents for lease of aircraft used in international air traffic.

Table 12. Impact of tax policy changes on corporate income tax revenue (millions of lats)

	2009	2010
Extending the loss carry-forward period	-4.6	-5.5
An incentive to develop air traffic services	-1.2	-1.4
An incentive to acquire new machinery	-	-7.9
An incentive for investment in research and development	-	-0.02
Allowance for corporate equity	-	-14.6
Total impact of changes:	-5.8	-29.4

Excise Tax

So far the excise tax policy has been primarily focused on harmonising the excise tax rates with the European Union requirements. In line with the transition periods granted to Latvia, the excise tax rates on several excise goods were raised considerably, including on mineral oil products and tobacco products. Increase of excise tax rates mainly helped to secure a stable and high growth rate of the excise tax revenue.

In order to ensure the budgetary revenue flows and to reach the EU minimum tax rate level, changes in the excise tax are planned for 2009 as well.

According to the Law on Excise Duties, the rates on cigarettes are gradually increased every year and are about to reach the EU minimum tax rate on 1 January 2009 (from 17.8 lats to 22.5 lats per 1000 cigarettes plus 32.2% to 34.5% of the maximum retail selling price). Currently, no further increase of excise tax on cigarettes is planned for 2010–2011.

To ensure additional budget revenues, as of 1st February of 2009, a quicker increase of the tax rate is planned on alcoholic beverages (till 825 lats per 100 litres of absolute alcohol on other alcoholic beverages, from 30 lats to 40 lats per 100 litres on wine and fermented beverages, from 1.3 lats to 1.45 lats for each per cent of absolute alcohol per 100 litres on beer), other smoking tobacco (from 14 lats to 23 lats per 1000 grams of tobacco), mineral oil products (from 228 lats to 269 lats on petrol, from 193 lats to 234 lats on diesel fuel (gas oil) and kerosene per 1000 litres etc.), as well the increase of the rate on coffee (from 50 lats to 100 lats per 100 kilograms) and on non-alcoholic beverages (from 2 lats to 4 lats per 100 litres).

Table 13. Impact of tax policy changes on excise tax revenue (millions of lats)

	2009
Previously planned raising of rate on cigarettes	+32.0
Raising of rate on other smoking tobacco	+0.1
Raising of rate on other alcoholic beverages	+11.3
Raising of additional tax rate on alcoholic beverages	+13.4
Raising of rate on mineral oil products	+50.2
Raising of rate on coffee and non-alcoholic beverages	+4.4
Total impact of changes:	+111.4

Real Estate Tax

In 2009 it is planned to prepare amendments to the Law on Real estate tax, under which the tax base will be widened from year 2010 by including the residential buildings, and applying tax exemption for living space of 40 square meters.

Table 14. Impact of tax policy changes on real estate tax revenue (millions of lats)

	2009	2010
Imposition of the real estate tax on residential buildings	-	80.0
Total impact of changes:	-	80.0

Personal Income Tax

Labour taxes account for almost a half of all tax revenue, which points to a high tax burden on employment income. Since 2005, the personal income tax policy measures have been aimed at reducing the tax burden on low-income population: the non-taxable minimum as well as relief for dependents has been raised.

Nevertheless, it has to be noted that despite the negative impact of the above mentioned tax policy measures on the budget, the personal income tax revenue has increased in the recent years and its growth rate has been very high. The rapid increase of employment taxes was mainly supported by strong growth of the average wages and salaries in the economy. Labour tax revenue was positively affected also by regularly raising the minimum monthly wage already starting from 2006.

The current medium-term macroeconomic forecasts reveal deceleration of the wage bill, which, in turn, will decrease the development of the labour tax revenue in the coming years.

In 2009, the previously started personal income tax policy will be continued, aimed at reducing the tax burden and increasing the income of the population.

- The decrease of the personal income tax rate from 25% to 23%;
- Raising of the minimum monthly wage from 160 lats to 180 lats;
- Raising the non-taxable minimum from 80 to 90 lats per month and raising the relief for dependants from 56 to 63 lats per month;
- Raising the tax deductions for education and medical expenses from 150 lats to 300 lats per annum;
- It is planned to raise the additional relief for the disabled, politically repressed persons and participants of the national resistance movement;
- Raising the exemption for income from agricultural production and providing rural tourism services from 3 000 to 4 000 lats per annum;
- It is planned to expand the special wages tax regime for sailors. The special wages tax regime will be applied to all sailors regardless of the flag their vessel is sailing.

Table 15. Impact of tax policy changes on personal income tax revenue (millions of lats)

	2009	2010
The reduction of the personal income tax rate	-66.0	-
Raising of the minimum wage	+10.8	-
Raising of the non-taxable minimum and relief for dependents	-36.0	-
Raising the tax deductions	-4.1	-
Additional relieves for the disabled etc.	-0.7	-
Raising the exemption for income from agricultural production and rendered rural tourism services	-1.2	-
Extension of applicability of the special wages tax regime for sailors	+2.4	-
Personal income tax on capital gains and income from capital	-	+38.0
Total impact of changes:	-94.8	+38.0

Social Security Contributions

In the recent years, the growth of the social security contributions has been the main factor underpinning a significant surplus in the social security budget. Likewise with the personal income tax, the growth of the social security contributions was supported by rapidly growing wages in the economy and raising of the minimum wage.

The medium-term development of the social security contributions will depend on both the deceleration of the growth of the wage bill as well as legislative changes. It has to be noted that according to the ESA 95 requirements, social security contributions channelled to the state funded pension scheme are not treated as general government budget revenue.

In 2009 the contributions to the state funded pension scheme has remained at the previous level of 8% of the GDP instead of the planned 9%. These changes will affect the revenue growth in the central government social security budget comparing to the previous planned. In line with the provisions of the Law on State Funded Pensions, the rate of contributions will be 9% in 2010 and will be raised to 10% in 2011.

Table 16. Impact of tax policy changes on social insurance contribution revenue (millions of lats)

	2009
Raising of the minimum wage	+15.7
Preserving the rate of contribution to the funded pension scheme at 8% as before	+35.0
Total impact of changes:	+50.7

5.2 Expenditure of the General Government Budget

Taking into 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 anticipated that the spending on administrative costs of the ministries, including wages, will decrease in the medium-term.

Raising the efficiency of the general government budget spending is an important task of the medium-term. Education is one of the target areas. Considering the need to cut down the general government budget considerably, the government took a decision not to go through with the previously planned wage raise for teaching staff in 2009. The changes made to the Cabinet of Ministers Regulation "Amendments to Cabinet of Ministers Regulation No 746 of 24 December 2008 "Regulation of educator wages"" withdraw the appointment lists of the all-around education institutions, giving the local authorities freedom of action to evaluate and appoint the necessary administrative etc. pedagogic (excluding the pedagogues of special educational institutions, preschool educational institutions and discipline pedagogues of all-around educational institution) personnel for each educational institution. In that way the amendments provide the local authorities to develop optimal system of educational institutions with a more effective spending of finances, at the same time maintaining the availability of education. The regulations provide to reduce the additional payment fund for the performance quality of pedagogues and supervisors of educational institutions included in the "Regulation of educator wages" from 10 percent to 7 percent as of 1st January of 2009. At the same time the regulation provides to decrease the additional payment to the supervisors of educational institutions for the performance quality from 20 percent to 10 percent of monthly wage.

As well it is planned to define all additional payments for the performance quality twice a academic year – on 1st of September and on 1st on January. The regulations are supplemented with a new point, which defines a possibility to appoint the wages of supervisors of educational institutions and pedagogues twice a year – by the situation on the 1st of September and the 1st of January, according to the actual number of persons in the process of education.

Improvement of the spending efficiency in the sector of education is particularly important, taking into account that according to the results of researches on Latvia's demographic situation the number of students will continue to decrease until 2013 and the current number could be restored only in 2025. At the 15 January 2008 Cabinet of Ministers meeting, it was decided that the Ministry of Education and Science has to prepare proposals for the development of the network of educational establishments. The information report "On Proposals for the Development of the Network of Educational Establishments" was reviewed at the 16 September 2008 Cabinet of Ministers meeting. As compared to other states, Latvia is marked by a very small number of students per teacher; therefore, the report concluded that, by using a differentiated approach and gradually yet purposefully raising the number of students per teacher, we arrive at a real opportunity to raise the wages of teaching staff. In its report the Ministry of Education and Science stated that the moment has come to review the current financing model (the so called tariffication) and a differentiated approach to setting financing for education is required, which would be ensured through the implementation of the model 'money follows the student'.

Public administration is another important sector. In 2008, Public sector policy development guidelines 2008–2013 were prepared, which were approved by the Cabinet of Ministers decree No 305 of 3 June 2008 on Public Sector Policy Development Guidelines 2008–2013. The guidelines address a considerable number of issues relating to public administration and its performance management: policy planning and financial management, preventing corruption, institutional issues, service quality, quality management, reducing the administrative burden, e-administration development, public and private partnerships, administrative proceedings, human resources development, strengthening civic society and other issues. The Cabinet of Ministers decree features specific tasks and the authorities responsible for their implementation.

At the same time, it is important to ensure central government funding for both the EU fund co-financing as well as other investment. As a result, it is projected that the budgetary spending on gross fixed capital formation will continue to grow in the medium-term. The most substantial contribution to investments in 2009 is planned using the resources of the Cohesion fund.

6 Sustainability of Public Finances

The population of Latvia 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 2008 was 2.27 million or 397 thousand (14.9%) less than 18 years ago (including a decrease in population by 203 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 forecasts³, by 2050 the population of Latvia 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 Latvian economy reaching a higher level of development.

Alongside 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 women of fertility age. 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.

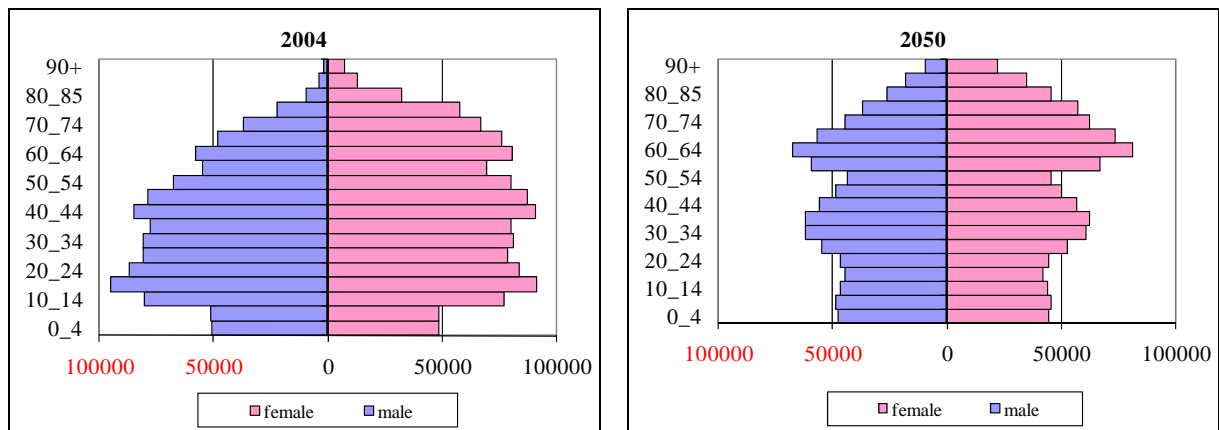


Chart 13. Changes in population by age group.

³ Hereinafter the base scenario of the Eurostat demographic forecast EUROPOP2004 is discussed.

Labour force and employment⁴ 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 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 also decrease gradually; nevertheless, in order to keep the forecasts prudent, it is assumed that it will be at least 7%⁵.

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).

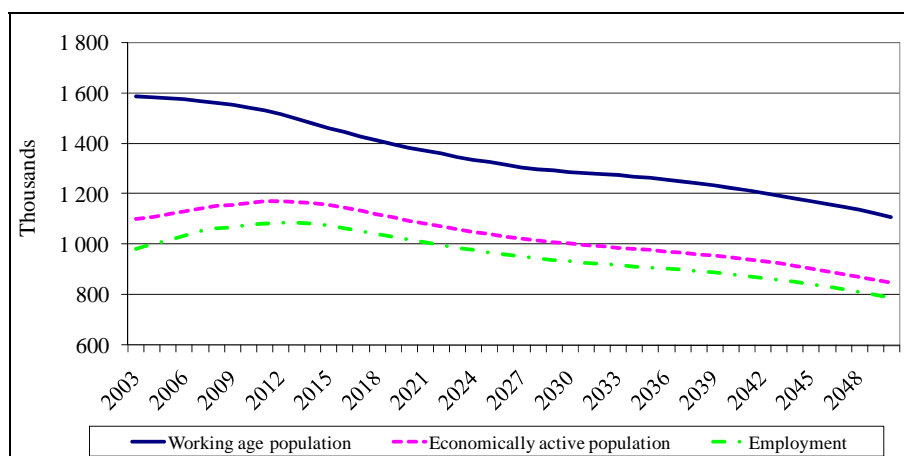


Table 14. Working age population and employment in 2003-2050.

In the recent years, Latvian 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%.

⁴ The employment and macroeconomic assumptions of Latvia are based on the ones approved by the Ageing Working Group of the EU Economic Policy Committee and 2006 report of the European Commission “The impact of aging on public expenditure: projections for the EU25 Member States on pensions, health care, long-term care, education and unemployment transfers (2004–2050)”.

⁵ Estimated EU15 NAIRU in 2008.

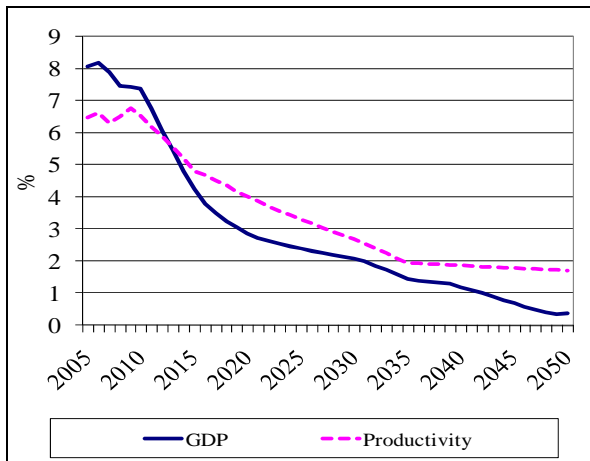


Chart 15. GDP and labour productivity growth at constant prices.

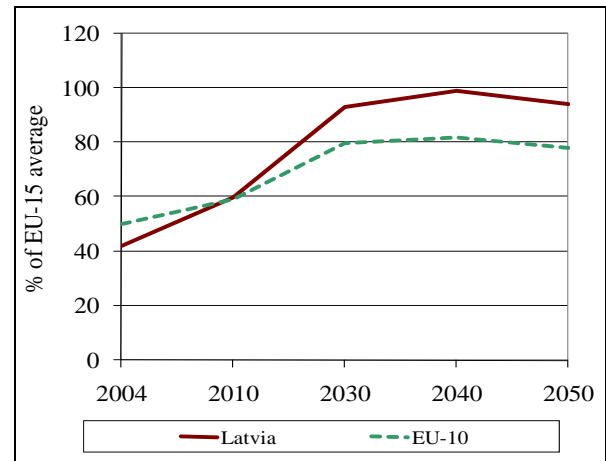


Chart 16. GDP per capita PPS % of EU15 average.

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.

Pension expenditure of the central government budget estimates 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 mature (i.e. the transition period will be over). 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 17. 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 elderly 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 GDP⁶. 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.

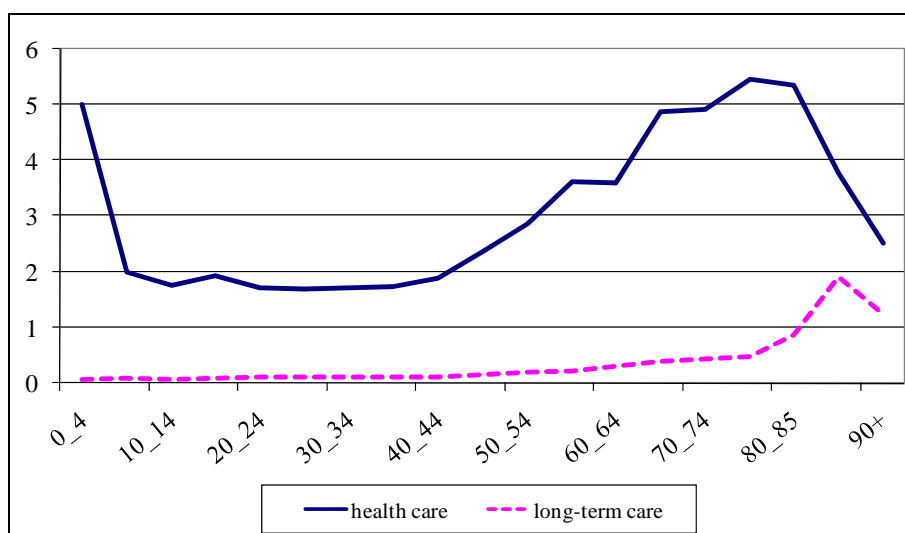


Chart 17. Healthcare and long-term care expenditure by age group (% of GDP per capita in 2003).

⁶ According to the OECD Health accounts system methodology.

Long-term care services are primarily focussed on elderly 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 almost 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, the central government expenditure for education could decrease from 4.9% of GDP⁷ 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.

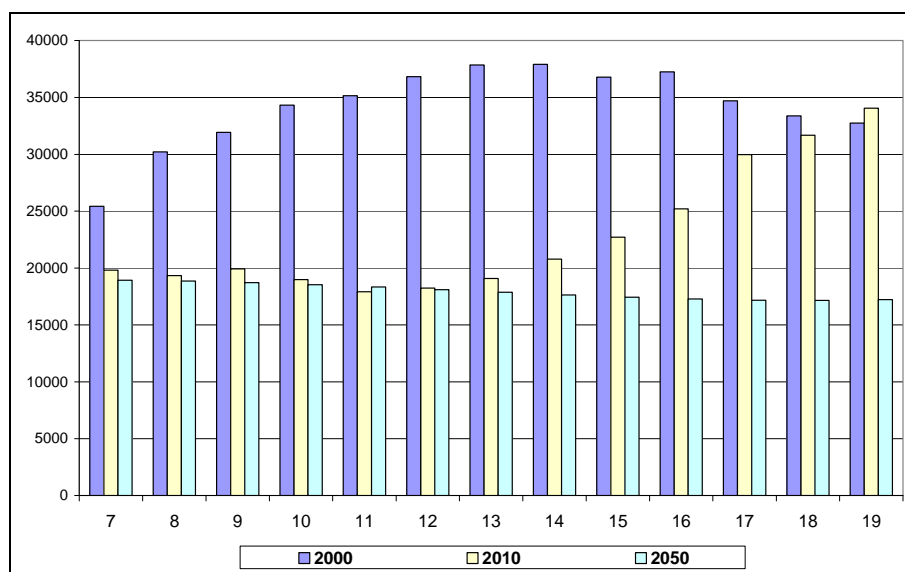


Chart 18. Number of population aged 7 –19 in 2000, 2010 and 2050.

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 the unemployment rate in Latvia, these changes will have a positive effect on the government 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).

⁷ ISCED levels 1–6, pre-school education excluded.

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 aging 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 Eurostat's demographic forecasts and the macroeconomic assumptions approved by the Aging Working Group of the Economic Policy Committee for Latvia, do not point to significant 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.

Table 18. Sustainability of public finances

% of GDP	2004	2010	2020	2030	2050
Total expenditure	35.6	39.9	40.9	42.3	42.5
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
Healthcare					
Long-term care	5.1	5.3	5.4	5.5	5.9
Education expenditure	0.4	0.4	0.4	0.4	0.5
Other age-related expenditures	4.6	3.3	3.1	3.5	3.3
Total revenue	0.33	0.3	0.2	0.2	0.2
of which: income from property					
of which: pension contributions	35.2	35.0	39.4	39.2	39.2
Assumptions					
Labour productivity growth	6.4	6.5	4.0	2.7	1.1
GDP growth at constant prices	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 to carry out the first comparisons of the scenario with the actual developments beyond 2005. The first analysis reveals that till 2007 the actual macroeconomic indicators and the development of ageing-related expenditure have been better than planned, whereas the demographic development slightly worse. The economic indicators in 2008 have notably worsened, regarding also to the funded pension scheme.

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 etc.).

Starting from the preparation of the central government budget 2008, medium-term budgeting is introduced in Latvia. Medium-term budgeting is a process, whereby the required funding is allocated for three years ahead and the spending of this funding according to the pre-set government priorities is ensured. 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 Law on Budget and Financial Management stipulates that 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 draft law on central government budget and explanations thereof are submitted to the Cabinet 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 the Budget. The main authorities in charge of ensuring budget execution are the Treasury and the State Revenue Service. Each budget authority plans the spending of the appropriation granted to it by way of an estimate. 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 authority spending with the reported data, highlights any gaps and provides recommendations for eliminating them. The concerned budget authorities prepare an action plan for implementation of the State Audit Office's recommendations.

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 protocol 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. When drafting the protocol, 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 tries 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 an analysis of the medium-term macroeconomic outlook, medium-term fiscal policy objectives of the government, medium-term central government budget revenue forecasts and maximum medium-term spending limits from the central government budget for each ministry and other central government authorities.

On 26 May 2008, the Cabinet of Ministers adopted the Cabinet Regulation No 359 “Regulations on the Key Principles for Drafting and Submission of Budget Proposals”. The above Regulation set the key principles to be used by the ministries and other central government authorities when preparing and submitting budget proposals for the medium-term to the Ministry of Finance in line with the maximum central government budget spending limit set in the medium-term macroeconomic development and fiscal policy framework.

The following Cabinet Regulations also relate to the medium-term budget preparation and implementation:

- Cabinet Regulation No 198 of 20 March 2007 “Regulations on Methodology for Establishing the Maximum Total Central Government Expenditure and Maximum Spending Limits from the Central Government Budget for Each Ministry and Other Central Government Authorities for the Medium-Term”, outlining the procedure for calculating and agreeing the central government budget baseline expenditure and development part as well as defining new terms (maximum total expenditure and maximum spending limits for each ministry and other central government authorities; reduced base; budget and development part);
- Cabinet Regulation No 594 of 28 August 2007 “Regulations on Using the Central Government Budget Appropriation Reserve”, providing for a reallocation procedure for the newly-established programme “Appropriation reserve” following the examination of proposals by ministries and central government authorities;
- Cabinet Regulation No 584 of 28 August 2007 “Procedure for Ministries and Other Central Government Authorities to Prepare and the Ministry of Finance to Review the Requests for Reallocation of Appropriation Across Programmes, Sub-programmes and Expenditure by Economic Classification Codes”. The regulations provide that the Cabinet of Ministers has the right to reallocate the appropriation

approved for ministries and central government authorities in cases and amounts prescribed by the Parliament.

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 the Cabinet of Ministers Decree No 162 of 13 March 2003 “On Key Concepts of Performance Management System”. On 18 June 2008, by the Cabinet of Ministers Decree No 344 “On Basic Concepts of the System of Results and Performance Measures for 2008–2013”, the “Basic Concepts of the System of Results and Performance Measures for 2008–2013” were approved. The purpose of the basic concepts is to improve the system of results and performance measures, in order to improve the information quality of the results and performance measures and their practical application in policy planning, implementation and monitoring as well as budget planning, implementation and monitoring. Results and performance measures provide the public administration and community with information about the planned objectives and objectives achieved within the limits of allocated resources. In order to ensure the implementation of the basic concepts, the Ministry of Finance is currently working on:

- draft Cabinet of Ministers regulations based on which the ministries and other central government authorities will be planning, implementing, monitoring and recording the results and performance measures of the central government budget programmes (sub-programmes) as well report on them;
- draft Cabinet of Ministers instruction setting the methodology for setting objectives and developing, planning, using and analysing the results and performance measures.

In order to improve the policy and budget planning processes, implementation of the **system of institutional operation strategy (IDS)** is ensured in public administration.

Institutional operation strategy, in accordance with the priorities established by the government, defines the medium-term development objectives and directions and specific ministry programmes and sub-programmes matching the above and their financing. In implementation of the operational strategy, **budgetary programmes and policy programmes are gradually integrated**, as one of the medium-term tasks of the IDS is to achieve consistency between the budgetary programmes and policy programmes. Strategies enveloping also the year 2009 have been approved for all ministries.

The strategy for the next programming cycle (2010–2012 programming cycle) will be prepared by the ministries already based on the requirements of the Cabinet of Ministers Instruction No 7 of 30 June 2008 “Procedure for Developing, Updating and Evaluating the Institutional Operation Strategy”. The new strategies will feature a new section “Central Government Budget Programme Section of the Strategy”, which will reflect the central government budget programmes and sub-programmes approved in accordance with the Law on Central Government Budget for the year n+1 for the authority, objectives set for each programme and sub-programme, achieved and expected results and performance measures, applied new policy initiatives as well as the granted financing.

Annex

Table 1a. Macroeconomic prospects

	ESA Code	2007	2007	2008	2009	2010	2011
		million lats	rate of change				
1. Real GDP	B1*g	8717.3	10.3	-2.0	-5.0	-3.0	1.5
2. Nominal GDP	B1*g	13957.4	24.9	9.4	-1.2	-1.3	1.3
Components of real GDP							
3. Private consumption expenditure	P.3	6240.9	13.9	-6.3	-7.5	-6.0	-0.6
4. Government consumption expenditure	P.3	1218.0	4.8	1.0	-3.0	-3.0	0.5
5. Gross fixed capital formation	P.51	3143.7	8.4	-10.0	-12.0	-8.5	1.0
6. Changes in inventories and net acquisition of valuables (% of GDP)	P.52 + P.53		4.7	2.0	2.0	3.8	3.9
7. Exports of goods and services	P.6	3675.7	11.1	4.5	-3.0	2.1	3.7
8. Imports of goods and services	P.7	5748.1	15.0	-6.1	-9.5	-5.2	0.4
Contribution to real GDP growth							
9. Final domestic demand		-	13.4	-8.0	-9.5	-7.0	0.0
10. Changes in inventories and net acquisition of valuables	P.52 + P.53	-	1.8	0.0	-0.1	0.0	0.0
11. External balance of goods and services	B.11	-	-4.8	5.9	4.6	4.1	1.5

Table 1b. Price developments

	ESA Code	2007	2007	2008	2009	2010	2011
		level	rate of change				
1. GDP deflator			13.3	11.6	4.0	1.8	-0.2
2. Private consumption deflator			9.3	13.0	3.9	1.5	1.0
3. HICP			10.1	15.4	5.9	2.2	1.3
4. Public consumption deflator			30.3	16.5	3.9	1.5	1.0
5. Investment deflator			15.0	8.4	-0.1	-0.8	-2.5
6. Export price deflator (goods and services)			11.2	5.9	-7.0	1.6	2.0
7. Import price deflator (goods and services)			5.8	4.9	-6.8	3.1	2.7

Table 1c. Labour market developments

	ESA Code	2007	2007	2008	2009	2010	2011
		level	rate of change				
1. Employment, persons		1119.0	2.9	-0.5	-2.8	-3.0	1.2
2. Employment, hours worked ⁸		46159670	1.2	-0.6	-2.9	-3.0	1.4
3. Unemployment rate (%)			5.7	7.0	11.2	11.4	10.8
4. Labour productivity, persons			7.2	-1.5	-2.2	0.0	2.7
5. Labour productivity, hours worked			9.0	-1.4	-2.1	0.0	3.0
6. Compensation of employees	D.1	6833.6	39.2	18.8	-1.7	-5.4	0.2
7. Compensation of employees, lats		398	31.5	21.5	1.0	-3.3	-0.3

⁸ EU Commission estimate

Table 1d. Sectoral balances

% of GDP	ESA Code	2007	2008	2009	2010	2011
1. Net lending/borrowing vis-à-vis the rest of the world	B.9	-21.8	-13.4	-5.4	-2.6	-2.3
of which :						
- Balance of goods and services		-21.8	-13.9	-7.3	-4.9	-4.5
- Balance of primary incomes and transfers		-2.1	-0.9	-0.0	-0.5	-1.0
- Capital account		2.1	1.5	1.9	2.9	3.2
2. Net lending/ borrowing of the private sector	B.9	-21.9	-9.9	-0.1	2.3	0.6
3. Net lending/ borrowing of the general government	EDP B.9	0.1	-3.5	-5.3	-4.9	-2.9
4. Statistical discrepancy		-0.7	-1.5	0.0	0.0	0.0

Table 2. General government budgetary prospects

		2007	2007	2008	2009	2010	2011
	ESA code	million lats	% of GDP				
Net lending (EDP B.9) by sub-sector							
1. General government	S.13	8.7	0.1	-3.5	-5.3	-4.9	-2.9
2. Central government	S.1311	-320.2	-2.3	-4.3	-3.2	-3.5	-2.3
3. State government	S.1312						
4. Local government	S.1313	-85.6	-0.6	-0.7	-0.6	-0.1	-0.1
5. Social security funds	S.1314	414.5	3.0	1.5	-1.4	-1.3	-0.5
General government (S.13)							
6. Total revenue	TR	5268.8	37.7	35.1	32.5	35.0	37.7
7. Total expenditure	TE	5260.2	37.7	38.6	37.7	39.9	40.7
8. Net lending/borrowing	EDP B.9	8.7	0.1	-3.5	-5.3	-4.9	-2.9
9. Interest expenditure (incl. FISIM)	EDP D.41	67.2	0.5	0.6	1.5	1.5	1.6
10. Primary balance		75.9	0.5	-2.9	-3.7	-3.5	-1.4
11. One-off and other temporary measures							
Selected components of revenue							
12. Total taxes (12=12a+12b)		3164.8	22.7	21.8	20.3	21.0	22.6
12a. Taxes on production and imports	D.2	1805.4	12.9	11.7	13.2	13.7	15.4
12b. Current taxes on income, wealth etc	D.5	1357.2	9.7	10.2	7.1	7.4	7.2
12c. Capital taxes	D.91	2.2	0.0	0.0	0.0	0.0	0.0
13. Social contributions	D.61	1325.4	9.5	9.5	8.0	7.8	7.7
14. Property income	D.4	103.0	0.7	0.9	0.7	0.7	0.7
15. Other (15=16-(12+13+14))		675.5	4.8	2.9	3.5	5.4	6.8
16=6. Total revenue	TR	5268.8	37.7	35.1	32.5	35.0	37.7
p.m.: Tax burden (D.2+D.5+D.61+D.91 – D.995)		4542.2	32.5	31.7	28.6	29.2	30.7
Selected components of expenditure							
17. Compensation of employees + intermediate consumption	D.1+P.2	2481.8	17.8	17.9	15.6	15.6	15.2
17a. Compensation of employees	D.1	1606.6	11.5	11.6	10.0	9.9	9.6
17b. Intermediate consumption	P.2	875.2	6.3	6.4	5.6	5.7	5.7
18. Total social transfers (18=18a+18b)		1126.6	8.1	8.8	10.2	11.7	12.2
18a. Social transfers in kind	D.6311. D.63121. D.63131	70.8	0.5	0.6	0.6	0.7	0.7
18b. Social transfers other than in kind	D.62	1055.8	7.6	8.3	9.6	11.0	11.5
19.=9. Interest expenditure (incl. FISIM)	EDP D.41	67.2	0.5	0.6	1.5	1.5	1.6

		2007	2007	2008	2009	2010	2011
	ESA code	million lats	% of GDP				
20. Subsidies	D.3	89.9	0.6	0.6	0.6	0.6	0.6
21. Gross fixed capital formation	P.51	792.1	5.7	5.4	6.0	6.8	7.3
22. Other		702.7	5.0	5.2	3.9	3.8	3.7
23.=7. Total expenditure	TE	5260.2	37.7	38.6	37.7	39.9	40.7
Government consumption	P.3	2532.7	18.1				

Table 3. General government expenditure by function

% of GDP	COFOG code	2006	2011
1. General public services	1	7.6	5.7
2. Defence	2	1.6	1.5
3. Public order and safety	3	2.5	2.6
4. Economic affairs	4	4.1	6.9
5. Environmental protection	5	1.1	1.2
6. Housing and community amenities	6	0.8	0.6
7. Health	7	3.9	3.9
8. Recreation, culture and religion	8	1.0	1.3
9. Education	9	5.5	5.6
10. Social protection	10	9.8	11.4
11. Total expenditure (=item 7=26 in Table 2)	TE	37.9	40.7

Table 4. General government debt developments

% of GDP	ESA code	2007	2008	2009	2010	2011
1. Gross debt		9.5	19.4	32.4	45.4	47.3
2. Change in gross debt ratio		-1.1	9.8	13.1	13.0	1.9
Contributions to changes in gross debt						
3. Primary balance		0.5	-2.9	-3.7	-3.5	-1.4
4. Interest expenditure (incl. FISIM)	D41	0.5	0.6	1.5	1.5	1.6
5. Stock-flow adjustment, of which:		-1.1	6.4	7.9	8.0	-1.1
- Differences between cash and accruals		-0.3				
- Net accumulation of financial assets		1.4				
including privatisation proceeds		0.1				
- Valuation effects and other		0.0				
p.m. implicit interest rate on debt		5.7	6.3	7.7	4.5	3.5
Other relevant variables						
6. Liquid financial assets		4.0				
7. Net financial debt (7=1-6)		5.5				

Table 5. Cyclical developments

% of GDP	ESA code	2007	2008	2009	2010	2011
1. Real GDP growth (%)	B1g	10.3	-2.0	-5.0	-3.0	1.5
2. Net lending of general government	B9	0.1	-3.5	-5.3	-4.9	-2.9
3. Interest expenditure (incl. FISIM recorded as consumption)	D41	0.5	0.6	1.5	1.5	1.6
4. Potential GDP growth (%) (1)		7.9	5.0	3.6	3.3	3.0
contributions:						
- labour		2.3	1.6	1.6	1.7	1.4
- capital		4.3	3.2	2.4	1.9	1.6

% of GDP	ESA code	2007	2008	2009	2010	2011
- total factor productivity		1.2	0.1	-0.4	0.3	0.0
5. Output gap		4.9	-2.1	-10.2	-15.7	-16.9
6. Cyclical budgetary component		1.4	-0.6	-2.8	-4.4	-4.7
7. Cyclically-adjusted balance (2-6)		-1.3	-2.9	-2.5	-0.5	1.8
8. Cyclically-adjusted primary balance (7+3)		-0.8	-2.3	-1.0	1.0	3.4

Table 6. Difference from previous update

	ESA code	2007	2008	2009	2010	2011
Real GDP growth (%)	B1g					
2007		10.5	7.5	7.0	6.8	-
2008		10.3	-2.0	-5.0	-3.0	1.5
Difference		-0.2	-9.5	-12	-9.8	-
General government net lending(% of GDP)	B.9					
2007		0.3	0.7	1.0	1.2	
2008		0.1	-3.5	-5.3	-4.9	-2.9
Difference		-0.2	-4.2	-6.3	-6.1	-
General government gross debt (% of GDP)						
2007		9.4	8.3	7.2	6.4	-
2008		9.5	19.4	32.4	45.4	47.3
Difference		0.1	11.1	25.2	39.0	-

Table 7. Long-term sustainability of public finances

% of GDP	2004	2010	2020	2030	2050
Total expenditure	35.6	39.9	40.9	42.3	42.5
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 pensions	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	35.2	35.0	39.4	39.2	39.2
of which: property income					
of which: from pensions 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 environment⁹

	2007	2008	2009	2010	2011
Short-term interest rate (LVL) (annual average)	8.6	8.2	8.5	7.0	6.0
Long-term interest rate (LVL) (annual average)	5.3	6.3	6.5	6.0	5.0
World, excluding EU, GDP growth	5.6	3.7	2.2	2.8	3.3
EU GDP growth	2.9	1.5	-0.2	0.6	1.2
Growth of relevant foreign markets	7.3	4.1	1.2	2.1	3.5
World import volumes, excluding EU	7.2	1.8	-0.1	1.4	2.8
Oil prices (Brent, USD/barrel)	72.5	104.0	60.7	68.4	70.4

⁹ Technical assumptions