Convergence Programme of the Republic of Latvia 2009-2012

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1 Overall Policy Framework and Objectives

The Convergence Programme of Latvia is based on the Law on State Budget of 2010 adopted by the Parliament on December 1, 2009 and Economic Stabilisation and Growth Revival Programme.

In 2009, the economy of Latvia faced the economic crisis facilitated by structural, cyclic, as well as external environmental factors. By adoption of complicated, however tough policy decisions Latvia has managed to create a basis for economic stabilization and subsequent growth. During the year, unprecedented budget consolidation measures have been introduced, work has been carried out on structural reforms in education, health, public administration, social protection; territorial reform has been implemented. Financial sector stability has been achieved. The ongoing economic structural changes are the basis for increasing competitiveness and ensuring state's long-term growth potential.

Currently the Latvian Strategic Development Plan 2010–2013 is being developed setting key priorities and courses of action for economic growth and promoting social security, as well as for improving efficiency of public administration. The Plan defines medium-term courses of actions within three priorities: economic growth, social security and efficiency of public administration and services.

In 2010 and in the medium term strong stabilization policy will continue and already in the nearest time Latvia will return to growth. Main tasks and objectives of Latvian economic policy:

- tight fiscal policy, balancing expenditure with revenue opportunities, reducing the general government budget deficit below 3% of GDP in 2012;
- tight and stable monetary policy based on fixed national currency peg and the euro introduction in the medium term;
- continue work on structural reforms in health and education sectors, public administration and social security;
- strengthen financial sector regulation and supervision ensuring stability and reliability of financial institutions;
- activate use of the EU structural funds and improve their planning and management;
- improve international competitiveness of the economy and promote development of sustainable economic structure;
- ensure sustainability of public finances.

Latvian economic stabilisation and growth revival policy is supported by the medium-term 7.5 billion euro loan granted by the EU, IMF and other international financial institutions and partner states.

2 Economic Outlook

2.1 Current Economic Development

Very rapid economic development after joining the EU, which was largely caused by the domestic demand growth based on the increasing crediting, was superseded by the recession as the financial crisis began. Initially, the adjustment process was gradual, but already in 2008 it accelerated rapidly, especially after the escalation of the global financial crisis in autumn and the subsequent world trade shock. Thus Latvia experienced significant drop of both internal and external demand. In 2009, the economy of Latvia reached the peak rate of economic decline – according to the assessment the GDP fell by 18% in constant prices.

Economic decline severely affected the labour market – in the end of 2009 the ration of jobseekers exceeded 20% of the economically active population, wages decreased significantly, especially in the public sector. Due to labour market and crediting conditions disposable income of population decreased. Government expenditure was substantially limited in order to reduce the budget deficit which rose due to declining tax revenues. Household and business confidence level was markedly negative. These factors also determined negative effects of the second and third rounds of the growth spiral.

In 2009, levels of prices fell. Price and wage decline is the first step to the increase in national competitiveness and structural changes in the economy which would be more focused on external demand. Current account balance has shown one of the biggest adjustments as the deficit was substituted by the surplus which allowed decreasing private external debt of Latvia.

During the year financial market was subject to significant fluctuations, but in the second half of the year total stability and confidence increased which was caused by responsible behaviour of both the state and banks.

2.2 Macroeconomic Scenario

After the high growth period Latvian economy is currently experiencing a structural and cyclical adjustment. Resolution of macroeconomic imbalances accumulated in previous years is reinforced by the global financial and economic crisis, as well as the need to balance public finances quickly.

Macroeconomic development scenario envisages that the Latvian economy returns to sustainable growth improving significantly its competitive position through the decrease in unit labour costs and improvement of public finances which will allow investors to assess more accurately the positive return and stability of investments. Reforms performed by the government in education, medicine, public administration etc. are also significant and create a basis for productivity increase in future and sustainability of expenditure cuts.

In 2010, it is still expected that the GDP will decrease due to re-structuring of private sector liabilities and consolidation of public sector. Deflation and labour costs reduction is the basis for faster increase in external competitiveness.

As of 2011, the scenario envisages the GDP growth which during the programme period will approach the potential level.

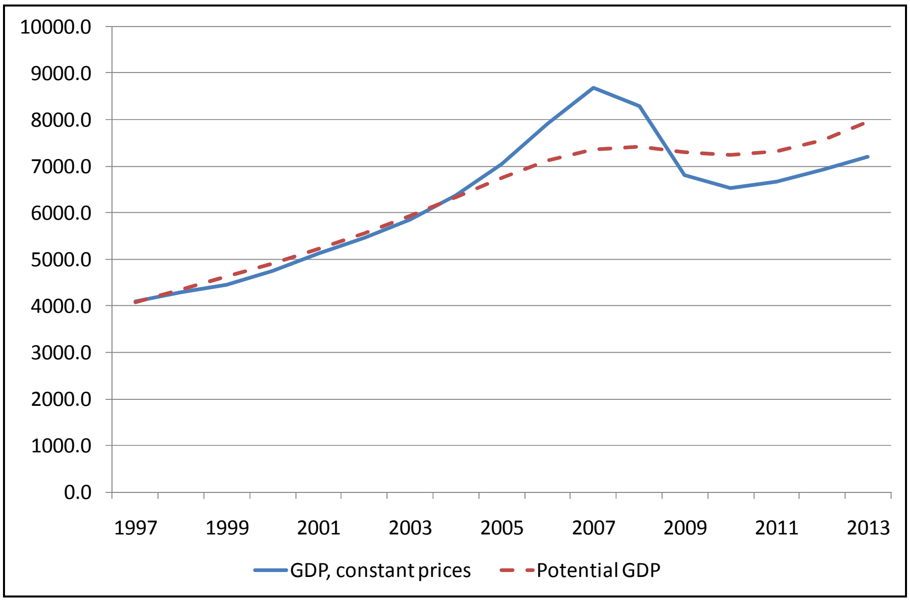

Chart 2.1. Potential and actual GDP dynamics in Latvia between 1996 and 2010.

Due to the economic crisis the actual output of the Latvian economy is lagging behind its potential level as the result of which currently the output gap is considerably negative. Part of the output volume loss is structural; also the potential growth rate over the medium term will be lower than in previous years.

Table 2.1. Growth and related factors

	EKS Code	2008	2008	2009	2010	2011	2012
		million lats	rate of change				
1. Real GDP	B1*g	8293.4	-4.6	-18.0	-4.0	2.0	3.8
2. Nominal GDP	B1*g	16243.2	9.9	-19.7	-8.8	-0.3	4.2
Components of real GDP							
3. Private consumption expenditure	P3	5601.3	-11.0	-22.0	-11.0	0.5	3.1
4. Government consumption expenditure	P3	1224.0	1.5	-9.0	-10.3	-4.0	0.8
5. Gross fixed capital formation	P51	2707.3	-13.2	-34.0	-12.0	3.0	7.0
6. Changes in inventories and net acquisition of valuables (% of GDP)	P52+P53		4.5	-1.7	0.8	1.3	1.2
7. Exports of goods and services	P6	3589.0	-1.3	-17.5	1.5	5.0	5.6
8. Imports of goods and services	P7	4953.9	-13.6	-35.0	-9.7	2.6	5.2
Contribution to real GDP growth							
9. Final domestic demand		-	-12.5	-27.3	-11.9	0.4	3.6
10. Changes in inventories and net acquisition of valuables	P52+P53	-	-0.6	-4.0	2.6	0.5	-0.1
11. External balance of goods and services	B11	-	8.5	13.3	5.2	1.2	0.3

2.2.1 Real sector

GDP at constant prices in 2009 according to the assessment fell by 18%, but in 2010 another 4 percent decrease is expected. Negative forecast for 2010 is determined by the weak domestic demand assessment resulting from the necessary government consolidation measures, impact of the banking sector losses on the financing available to the real sector, and the decline in purchasing power of households due to the their income fall. Furthermore, improvement of Latvia's relative competitiveness, which will be promoted by the deflation and labour costs fall, will give the biggest return in medium-term. It is expected that the external environment will improve gradually, besides Latvia will be able to use it in full only when negative expectations of investors will decrease and confidence in the Latvian fiscal and monetary policy will be regained.

GDP by Expenditure

Private consumption mainly depends on the disposable income of households and their perspective on the amount of the future income. During the programme period it is forecasted that the wage and employment will decrease. Furthermore, the low level of household confidence increases their tendency to accumulate. Household debt burden at the time their income decreases is also an important obstacle to increasing demand and reduces their opportunities for financing their consumption with a new borrowing. Thus, the private consumption rate will be lower that the GDP development and its level will stabilise only in 2011. Re-structuring of household debt is an important pre-condition for faster private consumption rise in future.

Table 2.2. GDP by Expenditure
(growth rate in prices of 2000, % against the previous period)

	2007	2008	2009	2010	2011	2012
			forecast			
Real GDP	10.0	-4.6	-18.0	-4.0	2.0	3.8
Public consumption	3.7	1.5	-9.0	-10.3	-4.0	0.8
Private consumption	14.8	-11.0	-22.0	-11.0	0.5	3.1
Gross fixed capital formation	7.5	-13.2	-34.0	-12.0	3.0	7.0
Exports of goods and services	10.0	-1.3	-17.5	1.5	5.0	5.6
Imports of goods and services	14.7	-13.6	-35.0	-9.7	2.6	5.2

Public consumption decrease in 2009 was smaller than the total reduction of economic output at the cost of increase in general government budget deficit. However, necessary consolidation measures will determine the public consumption reduction in 2010 and 2011 and stabilisation only in medium term.

Gross fixed capital formation volumes are usually very sensitive to changes in the overall economy and confidence of investors reflected by declining investments in 2009. Also in 2010 gross fixed capital formation volumes will decrease by 12% in constant prices; it will be caused by limited possibilities for entrepreneurs to raise considerable credit resources and hesitant attitude of investors. However in the medium term investments will become one of the main sources of growth. The investment environment will be made more attractive by lower unit labour costs, besides capital investments will be attracted by industries and businesses with greater efficiency and competitiveness creating a basis for future growth. More rapid improvements could be expected if stabilisation of political and economical situation in the first half of 2010 will be clear enough and reflected accordingly by credit rating agencies.

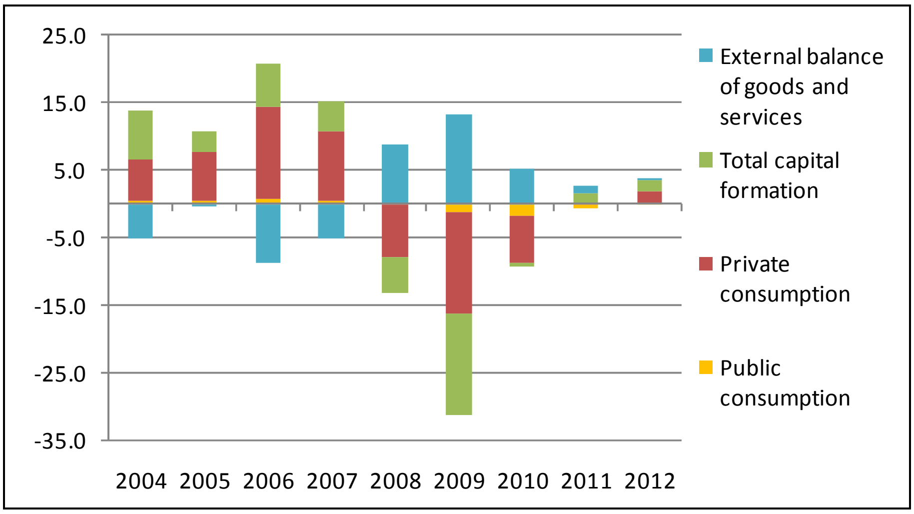

Chart 2.2. Impact of expenditure components on GDP, percentage points.

Global trade drop determined the export volume decrease in 2009. However, despite a significant drop in principal external trade partner countries of Latvia, export volumes have stabilised and they have begun to rise as the Latvia's market share increased in some countries. Reduction of manufacturing costs and increasing emphasis of Latvian companies on meeting external demand, as well as gradual recovery of the economy in principal trade partner countries of Latvia will increase export volumes already in 2010 and in medium term they will grow faster than total GDP. However import volumes will continue to decrease also in 2010 due to the fall in domestic demand which will be partly compensated by the demand for investments in the process of economic re-structuring and increase in demand for raw materials and components necessary for the export.

GDP by Sectors

In 2009, all major sectors experienced decline in the output, however in 2010 some sectors will show signs of recovery. In the economic growth years industry's weak growth rates were determined by rapid increase in the unit production costs promoted by both the sharp wage increase for employees and increase in raw material, especially imported materials, prices. In 2009, the industry decline was caused by a sharp fall in domestic demand and decrease in global demand resulting from the global economic crisis. In the result of decreasing unit labour costs and general price level, from 2010, competitiveness of Latvia will improve gradually. Industrial growth in medium term will be based on increasing export volume. Construction and retail trade sectors in previous years showed dynamic pace of development meeting demand determined by the increase in the domestic demand caused by the crediting and real estate bubble. After 2008 these sectors experienced the largest drop and the resumption of growth in these sectors is expected to start in 2011. Decreasing household income level and decrease in lending to these sectors will not allow reaching pre-crisis output volumes. However costs reduction in construction sector can contribute to higher real investment amounts. In 2009, in transport and communication sectors the output decline was determined by the decline in domestic transport volumes – mainly passenger transport and freight transport by road. Port and railway transport are mainly transit operations which in 2009 remained at the level of 2008. In medium term industry growth will slightly exceed GDP growth rate, and this will largely depend on political-economical situation in principal transit partner countries – Russia and the EU. Development of financial service sector in the coming years will be determined by the debt re-structuring process in the banking sector and economy in general. Foreign parent banks have confirmed their commitment to ensure long-term operation of their subsidiary banks in Latvia and ensure the required capital increase. Public service sector will be affected by the budget consolidation measures till 2012 setting negative growth rate.

Inflation

Trends of consumer price changes in 2009 point to strong deflation pressure in the economy, even despite the substantial rise in indirect tax rates in the beginning of the year, in general prices fell by 1.2 percent. Rapid deflation process was also facilitated by the reduction of import prices, especially for energy resources. However the price level decrease in the economy was mainly caused exactly by the drop in domestic demand.

Household income decline and low confidence will be a determining factor that will contribute to further deflation process in 2010 and 2011. It will be also supported by reduced producer prices that will be ensured by diminishing labour costs and increase in efficiency of the production process fighting for sales in internal and external markets.

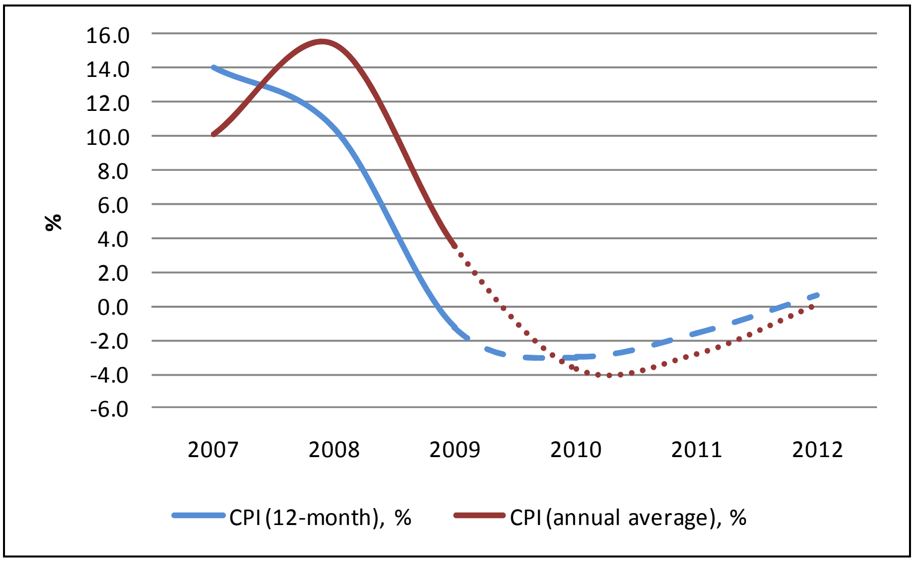

Chart 2.3. Consumer price inflation.

In general, till 2012, the price level in Latvia will reduce by 6-7% which will improve competitiveness of prices of Latvian entrepreneurs. Also in medium term, as the prices will start to increase, it will still be low due to negative output gap and only gradual improvement of the labour market.

Inflation forecast risks mainly stem from global price trends. Upon resumption of global demand and activation of international trade increase in resources prices could be seen which will directly affect price changes in the economy of Latvia, but to a lesser extent it will affect competitiveness because relative prices will hardly change.

Labour Market

The population of Latvia decreases in average by 0.4 – 0.5% per year and in the beginning of 2009 it was 2.26 million. The decrease is mainly determined by the negative natural movement, but the negative net migration is also important. Working age population (15-74) is decreasing at an even higher rate in comparison with the overall population, mainly on account of a major decrease in the age group 15-24 which relates to the low birth rates in 1990-ties.

In the end of 2007, Latvian labour market indicators reached their best results – the share of jobseekers 5.4% and employment rate 70.3%. Such a positive development was determined by the rapid economic growth and wage growth which facilitated involvement of population in the labour market.

Due to the economic crisis the labour market indicators deteriorated rapidly – proportion of jobseekers increased considerably and in the end of 2009 reached 20% (including the registered unemployment 16%), and, losing the hope to find a job, the economically active population also decreased. Taking into account that labour market indicators lag behind the real economic changes, it can be anticipated that they will begin to improve in the end of 2010 and the average number of employees during that period will decrease by 16% comparing with 2008. In medium term the labour market will also improve only gradually which will be determined by the fact that the growth will be based on increasing productivity and production efficiency, besides the economy will face considerable structural changes associated also with labour force migration between sectors.

In medium term decrease in working-age population will not hamper economic growth because of the high potential of employment growth reducing unemployment and restoring people's participation in the labour market.

Chart 2.4. Employment and unemployment.

Tense situation in the Latvian labour market intensifies the people's wish to seek job abroad to maintain their income level. Since the recovery of economic activity and hence the growth of demand for labour in migration target countries is likely faster than in Latvia, it is expected that the number of people seeking for job abroad will increase. In short term the migration will reduce the unemployment rate in Latvia reducing the social tension. A negative factor is possibly slower and lower wage and price level adjustment and hence slower recovery of external competitiveness.

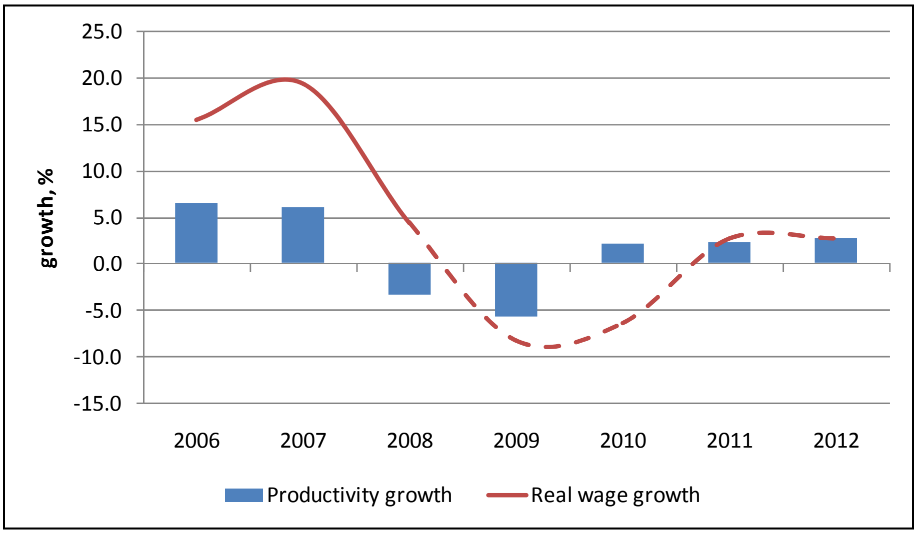

Chart 2.5. Productivity and wage.

The rapid increase in average gross wage in the economy between 2006 and 2008 contributed to internal imbalances when real wage exceeded productivity growth rates which also caused decrease in external competitiveness of the economy of Latvia. Since 2009, labour productivity indicators have improved and it was caused by tight labour market situation. Wage growth rate in current prices will remain negative till 2011.

2.2.2 External Sector

High current account deficit of the balance of payments in Latvia between 2004 and 2008 showed both convergence process and that the economy was above the potential output level and related excessive domestic demand. However, in the second half of 2008 due to the international financial crisis the capital outflow started and global trade volumes decreased rapidly.

Reduction of domestic demand in Latvia was greater than the drop in global demand resulting in decreasing imports exceeding notably negative changes in exports. Foreign trade deficit decreased significantly and together with positive income account (due to the losses of foreign direct investments in Latvia) caused current account surplus of the balance of payments in 2009.

Financial account reflected a capital outflow as the private sector reduced its foreign liabilities. This outflow was largely compensated by government’s foreign borrowing increasing reserve assets of the Bank of Latvia.

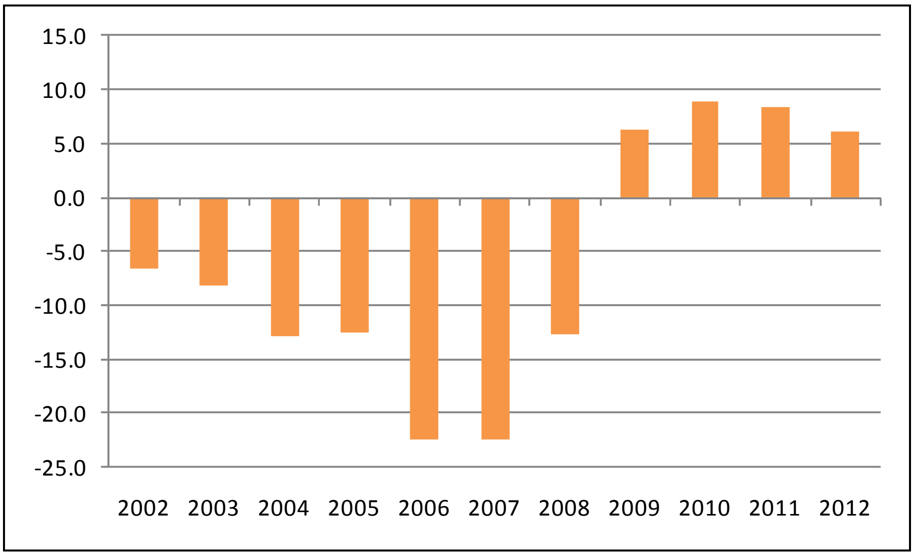

Chart 2.6. Current account deficit, % of GDP.

Already in the second half of 2009 export volumes showed gradual increase allowing forecasting positive development also in medium term. Export growth is facilitated by improvements in external environment and improvement of country's competitiveness. In 2010, import volumes will still decrease due to weak domestic demand, but even with the resumption of growth in coming years it will be less rapid than in previous periods. Thus, in 2010-2012 it is expected that goods and services balance will be with surplus.

Dynamics of the current account surplus will be additionally affected by the loss of foreign direct investments which will decrease gradually. In the position of current transfers no significant changes are expected.

2.3 Participation in the Exchange Rate Mechanism II

Medium-term monetary and exchange rate policy of Latvia largely relates to the monetary integration plans for the introduction of the euro in Latvia. 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 Latvia to attain the economic convergence level envisaged by Maastricht criteria, and it will continue till the euro introduction. Within the international borrowing programme Latvia has set a goal to achieve necessary economic convergence level allowing introduction of the euro in Latvia already in 2014. In support of the Government policy towards the economic stabilisation and sustainability, the Bank of Latvia will continue implementation of current fixed exchange rate policy till the introduction of the euro in Latvia.

By joining the ERM II in 2005 Latvia approved its goal to ensure macroeconomic stability by reducing inflation and promoting external balance sustainability. To achieve this goal strict fiscal policy, as well as measures to restrict domestic demand through both promotion of responsible crediting and compliance of wages with inflation goals were set as key policies. To strengthen economic competitiveness and flexibility structural reforms should be performed in a timely manner.

Rapid financial and labour market integration and real estate market expansion after joining the ERM II contributed to the increase in short-term imbalances and prevented from achieving the goals. Headline fiscal position was improved, however it was insufficient taking into account rapid increase in positive output gap which facilitated cyclic increase in revenue. Thus in the result of global financial and economic crisis negative adjustment of Latvian economy was very rapid.

Currently Latvia is implementing the economic stabilisation programme oriented towards improvement of Latvia's competitiveness, ensuring sustainable economic growth and restoration of international investors' confidence. To achieve Latvia's strategic goal – introduction of the euro in 2014 – and to implement recommendations within the framework of excessive budget deficit procedure Latvia is implementing fiscal consolidation which will ensure decrease in budget deficit in 2012 below 3.0% of GDP.

To implement monetary policy effectively and without shocks to the financial sector the Bank of Latvia is adjusting monetary policy implementation tools to the European Central Bank's practice. The Bank of Latvia already uses the same indirect monetary policy tools based on free market principles as the ECB, and after, joining the EMU in future, it will be necessary only to review importance of separate tools in implementation of monetary policy and procedural elements.

In 2009, the global economic crisis and still weak and vulnerable global financial markets continued affecting the Latvian economy. In the first half of 2009, in conditions of rapid economic slowdown and inflation reduction the Bank of Latvia continued softening of monetary policy decreasing the re-financing rate in two steps from 6.0% to 4.0%. The marginal lending facility rate, as well as reserve ratio were not changed, however the marginal deposit facility rate was decreased in two steps from 3.0% to 1.0%.

As the money demand decreased, in 2009, overall there was liquidity surplus in the Latvian banking system. Banks used deposit facilities in the central bank more than claimed lats liquidity from the central bank. Speculation on the budgetary consolidation and the political-economical stability in certain periods put pressure on the exchange rate, and the Bank of Latvia performed passive interventions on the foreign exchange market buying lats – in total in 2009 the Bank of Latvia's net purchases of lats amounted to 30.4 million euro. Sharp increase in uncertainty about the economic outlook resulted in significant rise of interest rates on money markets. However, in the result of government's huge budget consolidation, which completely dismissed concerns about the continuation of international support, tension in currency and money markets has reduced. Restoring of stability contributed to considerable fall of interest rates on money markets which in the beginning of 2010 already approached pre-crisis level.

2.4 Impact of Structural Reforms on the Economy and Public Finances

The structural reforms discussed in the National Lisbon Programme of Latvia are closely related to the National Development Plan of Latvia. Reform effect is taken into account in the Convergence Program. 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, 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 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:

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

To ensure macroeconomic stability, which is a necessary pre-condition for growth and job creation, the Latvian government has set the following key tasks: implementation of tight fiscal policy, improving efficiency of budget spending, promotion of wage compliance with macroeconomic stability and growth, Latvia's accession to the euro area, ensuring sustainability of public finances.

To achieve these objectives Latvia has performed budget consolidation measures aimed at reduction of budget deficit and ensuring sustainability. Structural reforms are being carried out in education and health sectors, public administration, where creation of wage bill for employees of public administration was one the main tasks, and other reform measures are being performed.

In 2009, reforms continued in health, education and public administration sectors aiming at improvement of sustainability of public finances.

The reform launched in the **health sector** in 2009 is aimed at ensuring operation of health care system in conditions of limited financial resources, optimise functions of management institutions, improve management of the health care system, as well as optimise financial resources administration mechanism.

In 2009, more rapid concentration of in-patient services has been achieved separating 24 hours emergency medical assistance from health care service provision while re-orienting in-patient services to out-patient care and home care thus achieving more rational and cost-effective distribution of available resources and workload.

In general, the number of in-patient health care providers has been reduced. As of September 1, 2009, till January 2, 2010, the number of medical institutions providing in-patient health care has been decreased from 59 to 42 hospitals. With these amendments it is provided that 24 hours emergency medical assistance is provided by 22 hospitals, patient care services – by 7 hospitals, however 13 hospitals ensure specialised assistance. As of October 1, 2009, contracts for in-patient health care services have not been concluded with 16 medical institutions; as of January 1, 2010 the contract has not been signed also with Riga municipality limited liability company "Riga 1st Hospital". On September 1, 2009, there were 1862 beds in these institutions, therefore in a short period of time the number of acute hospital beds has been decreased considerably. However, as of September 1, 2009, 1129 beds have been changed into care beds or have been used for provision of day-care in-patient services or paid services. Changing profiles of hospitals for provision of care services is particularly urgent now because of increasing proportion of older people in Latvia, therefore the demand for acute services decreases, but the demand for care services increases. To ensure availability of health care services in the result of changing profiles of hospitals 24 hours emergency assistance stations in hospitals have been created.

Health care services in out-patient medical institutions are being facilitated and they cost cheaper comparing with in-patient health care services. Certain medical rehabilitation services, oncology services are provided in out-patient conditions rather than stationary. The home care has been developed rapidly and the number of home-cared patients has increased (from 252 patients in January 2009 to 1364 – in October); therefore the number of hospitalised patients and average treating duration has decreased. Selection and contracting procedures have been launched with in-patient medical institutions on development of state-funded in-patient health care services including some quantitative and qualitative requirements – hospitals providing emergency medical assistance should provide hospitalisation of at least 7000 patients receiving state-funded health care services, ensure maternity assistance in at least 400 childbirth cases.

In concentration of health care services creation of Emergency Medical Assistance (EMA) Service was especially important. In the result of 24 hours emergency assistance separation from health care service provision state budget funds are used more efficiently because in hospitals providing health care services the number of specialists on duty 24 hours is smaller and less medical technologies are used. In the result of continued taking over of pre-hospital EMA functions, as of September 1, 2009 the EMA Service ensures already about 70% of all EMA calls in Latvia. Till July 1, 2010 it is planned to ensure that the EMA Service provides emergency medical assistance throughout the territory of Latvia. Merging of EMA providers allows to establish common principles and standards for the emergency medical assistance throughout Latvia, introduce common staff training and quality system, better plan material supply and development of human resources, as well as better develop and modernise the work of EMA Service in general.

To improve and make primary health care (PHC) services more available the quality indicator system for PHC physician performance evaluation has been updated and specified stating patient coverage indicators for adult patients, children, patients of type 2 diabetes, bronchial asthma patients, primary hypertension patients, thus putting greater emphasis on financial assessment of the work quality of PHC physicians. The PHC team has been enlarged supplementing practice of family doctors with the second nurse thus reducing the waiting time to receive services of the family doctor. “Second” nurse in the family doctor’s practice will mainly ensure care of chronic patients – educating the patient and his relatives about the health promotion and health care, taking care of patients at the family doctor’s practice and at the patient’s home, following and ensuring implementation of preventive check programme, making and implementing vaccination calendar together with the doctor etc. It is also planned to create paediatric practices in parallel with the network of family doctors’ practices thus increasing availability of paediatric health care services.

In 2010, it is planned to ensure hospitalisation of patients to provide emergency health care in 22 hospitals while promoting formation of hospital associations where multi-profile hospitals will make unions with regional multi-profile hospitals. It is planned to complete creation of the EMA Service.

Other hospitals have to re-orient their activities and ensure provision of care services which are particularly important as the proportion of older people increases, as well as to develop cost-effective health care services – out-patient, including services provided in day-care hospitals, as well as home health care services. It is planned to develop activities of hospitals in the out-patient sector.

Consolidation of in-patient medical institutions and reduction of their number should be done also in future although not very quickly. Prior to even greater consolidation of medical institutions it should be assessed whether hospitals have sufficient human resources and technologies to take over patient flows of other hospitals to prevent the so called *bottle neck effect* when hospitals cannot provide effective care of large number of patients (lack of staff, queues to examinations) and it results in negative consequences, for example, the treatment time increases.

In the result of structural reforms in the health care sector the budget expenditure is reduced by 0.6% of GDP in 2009 and by additional 0.2% of GDP in 2010.

In 2009, major reforms were launched in the **education sector** aiming at improving quality of education and optimisation of the use of existing resources (including financial). In preparation of reforms current economic situation and negative demographic trends in latest years in Latvia were taken into account.

As of September 1, 2009, in general education in Latvia a new financing model is introduced "money follows student" according to which earmarked grant from the state budget was divided for wages of teachers in municipalities. The objective of the principle "money follows student" is to promote quality and competitiveness of education and to ensure effectiveness of the financing allocated to education, as well as to ensure equal and transparent distribution of financial resources for each student. Implementation of this financing model and planned future development envisages fundamental benefits for students, municipalities and overall education system quality.

<u>Benefits</u> of the new financing model <u>to students</u>:

- schools will be motivated to ensure qualitative education to attract as many students as possible;

- schools will be encouraged to offer different education programmes (general and/or vocational) matching different interests of students, and students will be able to choose the most appropriate;

- opportunity to acquire a qualitative education in competitive secondary schools which will result from concentration of secondary education offer.

<u>Benefits to municipalities:</u>

- opportunity to maximise effective use of the financing for education allocating it for solution of most essential educational issues in their territories;

- opportunity to plan optimum development of school network within the region and among regions within the framework of allocated financing;

- opportunity to ensure transparent allocation of the financing thus reducing inefficient use of resources.

Introduction of the new financing principle creates pre-conditions for optimal organisation of basic and secondary education in Latvia: financing allocated to education is used most effectively enabling municipalities to ensure qualitative and competitive school development.

It is expected than in 2010 in average one pedagogic rate will be paid for 12 students. In 2008, there were in average 8 children per teacher, in 2009 – eight children. In school year 2009/2010 the Cabinet of Ministers has set that the ratio of the number of students and children from five years per teacher's wage rate in regions is 8 : 1, but in republican cities – 10.2 : 1.

In the result of reforms it is planned to reduce the number of pedagogical rates in general education institutions in municipalities from 38309 to 25022 rates and the number of general education institutions in municipalities from 982 to 873 institutions.

Average earmarked grant per student is 463 lats. As optimisation of the school network and work on improvement of the financing principle will continue as of January 1, 2010 the earmarked grant in average will increase up to 650 lats per year.

In the vocational education sector, on December 15, 2009, the Cabinet of Ministers approved plan for optimisation of the vocational education institution network for 2010 – 2015 (hereinafter – Plan). Optimisation of vocational education institutions is aimed at arrangement of the vocational education institution network, ensure effective spending of resources and increase availability of vocational education in regions according to expected demographic situation and regional needs. The Plan envisages renovation and equipping of 33 vocational education schools with modern facilities, as well as to ensure renovation of hostels. It is also planned to transform 14 out of 33 vocational education institutions into modern competence centres which will provide complex material and technical basis for students to acquire professional qualification in all basic professions of respective sector. In the result of optimisation of vocational education institutions the number of vocational education schools will reduce from 67 to 58 institutions and the number of pedagogical rates in state vocation education schools will also reduce from 5260 to 3671 rates.

For renovation and modernisation of vocational education institutions it is planned to use the financing of the European Regional Development Fund and Climate Change Financial Instrument. In the result of vocational school network optimisation process 9 schools were re-organised or closed joining inefficient and half-loaded schools to schools with appropriate facilities and sufficient material and technical basis. Vocational education institutions which will be loaded by less than 50% will be offered to municipalities to decide on possible integration of the education institutions thereby using the facilities in the most effective manner.

In the result of higher education reform three colleges were integrated into universities. One university branch was closed. In the result of reform the number of budget-financed positions was maintained decreasing costs of one study place and administrative costs. Inter alia, 60-70% of budget-financed positions were maintained at the level of 2009 in such important economic sectors as engineering, natural sciences, information technologies and medicine. In order to expand opportunities of receiving higher education, including for people from socially disadvantaged groups, the system for allocation of state budget resources for scholarships was changed setting social circumstances as a key additional criteria for successful students.

On December 1, 2009, Parliament adopted the **Law on Remuneration for Civil Servants and Employees of Central and Local Government Institutions**. At the same time amendments were adopted to special laws excluding all norms previously regulating the remuneration. The aim of Law on Remuneration for Civil Servants and Employees of Central and Local Government Institutions is to arrange remuneration system. With this Law the remuneration system has been made more transparent merging all regulations referring to wages and social guarantees for public sector employees under one law. The Law envisages common criteria for remuneration, bonuses and additional payments and common criteria for setting social guarantees – allowances, compensations.

Transitional provisions of the Law envisage special norms for restriction of expenditure for remuneration in 2010-2011, and continuing previous restrictions of 2009 on bonuses, material stimuli and vacation allowances.

In addition to wage changes, in 2009, the number of employees in central state institutions has also been decreased by 20%, and till the end of 2009 the number of agencies was also reduced from 79 to 25 agencies. Support functions (accounting, information technologies maintenance, public relations, personnel management) have been centralised in central ministerial institutions delegating separate functions to the non-governmental sector and handing over part of functions to municipalities.

In 2009, changes were also introduced in the **employment promotion sector**. In the result of economic crisis the number of unemployed persons has increased rapidly therefore the government has implemented a set of measures to decrease unemployment risks and consequences.

In 2009, additional ESF resources were allocated to the Ministry of Welfare to launch employment measures to eliminate consequences of social and economical crisis (new employment measures were offered in the labour market, part of them will be launched in 2010). In September 2009, when the number of persons not receiving unemployment benefits rapidly increased (on average 45% of total unemployed persons), work practising was started in municipalities with 100 lats scholarship to maintain professional skills. Total financing planned in 2009-2010 for the activity is 24 million lats, inter alia 8 million lats in 2009. It is planned to involve 42 000 persons in the activity.

New preventive unemployment reduction measures have been created using training voucher system: training programmes for persons with reduced working hours (available from September 2009), training programmes for adult life-long learning and opportunity to receive professional higher education (as of 2010).

Employed persons who have received the employer’s written statement on shortening of working hours due to decrease in the work amount in the result of economic crisis can participate in the training programmes for persons with reduced working hours. Within this activity persons are offered to participate in continuing professional education and professional development programmes which can last up to 6 months. Total financing planned for the activity in 2009-2013 is 9.9 million lats and it is expected to support 11 000 persons at risk of unemployment.

In adult life-long learning programmes it is planned to engage at least 25 years old persons having employment relationship and having received an opinion of a career advisor confirming the need to engage in the training programme to raise competitiveness in the labour market. Total financing planned for the activity in 2010-2013 is 5.4 million lats and it is expected to support 25 000 persons at risk of unemployment. It is planned to start the activity in the first quarter of 2010.

In 2010, it is planned to start the activity “Receiving professional higher education with a voucher system” where the maximum voucher amount will be 1000 lats (maximum participation in the activity 18 months). Persons who have interrupted 1st or 2nd level professional higher education studies at least a year before engagement in the activity can apply for education vouchers. Within the activity it will be possible to apply for 2nd semester of 2009/2010 academic year. In 2010, it is planned to involve 350 unemployed persons with higher or incomplete higher education, but in 2011 – 550 unemployed persons.

In 2010, it is planned to offer a new activity for young people – practicing at employer within the ESF project “Complex Support Measures”. Young people from 18 to 24 years old will be offered to get basic professional skills (the practice will last from 6 to 12 months).

In 2010, it is planned to implement an exit strategy for persons who will end participation in temporary crisis activities, especially practicing in municipalities. After practicing for 6 months persons will be involved in other active employment measures, especially in training with scholarship. Financially the biggest unemployment support measure in 2010 will be practicing with scholarship, reaching nearly 44% of all the financing planned for active employment measures.

3 General Government Balance and Debt

3.1 Fiscal Policy and General Government Balance

State budget for 2010 was adopted by Parliament on December 1, 2009. To ensure compliance of the state budget with economic downturn and adhere to the agreement of the Latvian government with international partners in drafting state budget for 2010 decisions were taken on considerable fiscal consolidation measures.

In total, state budget 2010 consolidation amounted to 507.5 million lats, i.e., the budget balance was improved by 4.3% of GDP. Within the fiscal consolidation budget revenue increased by 262.9 million lats, inter alia:

- personal income tax revenue – 154.0 million lats;
- real estate tax revenue – 30.2 million lats;
- excise duty revenue – 12.1 million lats;
- revenue from the tax on cars and motorcycles – 0.1 million lats;
- social insurance contributions – 36.7 million lats;
- revenue from transport annual duty – 18.9 million lats;
- revenue from payment for the use of state capital (dividends) – 11.0 million lats.

However, expenditure decreased by 244.6 million lats, inter alia:

- state budget expenditure – 200.3 million lats;
- local government expenditure – 44.2 million lats.

In total, in 2010 it is expected that general government financial deficit will not exceed 8.5% of GDP. However in medium term – moving towards the goal to introduce the euro – it is planned to decrease the general government budget deficit in 2011 down to 6.0% of GDP and in 2012 – down to 2.9% of GDP.

Central government budget

To draft central government budget for 2010 functions performed by the central government were evaluated. Ministries defined in total more than 1000 operational functions and sub-functions. Evaluation of functions involved social partners of the government, representatives of coalition parties, as well as general public. Having evaluated the functions the Cabinet of Ministers decided that the following expenditure will not be reduced:

- contributions to the European Community and NATO budget;
- financing for acquisition of foreign financial aid;
- teacher wages.

However, minimal reduction (3-5%) will be applied to the following expenditure:

- expenditure for health care, stating that this expenditure is planned in amount of 3.4% of GDP;
- expenditure for interiors.

Approximately 20% expenditure reduction will be applied to other functions.

<u>*Social security budget*</u>

In 2009, significant amendments to social security legislation were introduced, which will affect social security budget expenditure in 2010 and following years.

According to the <u>Law on Payment of State Pensions and Allowances in the Time Period from 2009 till 2012</u>:

- Amendments introduced to calculations of maternity and paternity allowances and the following limits imposed on allowances:
  - for children born after November 2, 2010 it is planned to calculate maternity and paternity allowances in amount of 80% of average wage of the insured person from which insurance contributions were made;
  - for children born after November 2, 2010 it is planned to impose limits on the amount of maternity and paternity allowances, i.e., if the allowance granted will exceed 11.51 lats per calendar day – the allowance per calendar day will be paid in amount of 11.51 lats plus 50% of the amount exceeding 11.51 lats per calendar day.

Due to the above mentioned changes it is expected that social insurance special budget expenditure in 2010 will decrease by 2.4 million lats (inter alia, for maternity allowances by 2.3 million lats and for paternity allowances by 0.1 million lats), in 2011 – by 14.7 million lats (inter alia, for maternity allowances by 13.8 million lats and for paternity allowances by 0.9 million lats).

- As of January 1, 2010, the following limits have been imposed on unemployment and sickness allowances – if the allowance granted will exceed 11.51 lats per calendar day – the allowance per calendar day will be paid in amount of 11.51 lats plus 50% of the amount exceeding 11.51 lats per calendar day.

Due to the above mentioned changes it is expected that social insurance special budget expenditure in 2010 will decrease by 18.0 million lats (inter alia, for unemployment allowances by 4.0 million lats and for sickness allowances by 14.0 million lats), in 2011 by 17.9 million lats (inter alia, for unemployment allowances by 3.9 million lats and for sickness allowances by 14.0 million lats)

- For a socially insured person on a child-care vacation or not receiving income as a self-employed person due to child-care it is planned to impose a limit on the parental allowance for a child born after November 2, 2010, i.e., if the allowance granted will exceed 11.51 lats per calendar day – the allowance per calendar day will be paid in amount of 11.51 lats plus 50% of the amount exceeding 11.51 lats per calendar day.

Due to the limit imposed on parental allowance it is expected that from 2011 the related expenditure will decrease by 3.7 million lats if the amendments regarding the limit will become effective as of November 3, 201, when parent will still receive maternity allowance for approximately two months.

- In the time period from July 1, 2009 until May 2, 2010, the person having a status of statutory insured person during the child-care period (employee of self-employed person) shall be paid parental allowance in amount of 50% of the granted allowance according to the Law on State Social Insurance.

In the result of the above mentioned legislative norm it is expected that in 2010 social insurance special budget expenditure will decrease by 1.4 million lats.

According to the Law on Maternity and Sickness Insurance, as of May 2, 2010 the parental allowance will not be paid to persons who are employed and receive income as employees or self-employed persons during the child-care period.

Due to parental allowances not paid to employed persons it is expected that social insurance special budget expenditure in 2010 will decrease by 8.6 million lats. However in 2011 it is expected that social insurance special budget expenditure will decrease by 44.3 million lats.

According to amendments to the Law on Payment of State Pensions and Allowances in the Time Period from 2009 till 2012, as of November 1, 2009, reductions of old-age and long-service pension amounts by 10% and for employed persons by 70% shall not be applied to receivers of old-age and long-service pensions with disabilities.

To ensure cancellation of limits previously imposed on old-age and long-service pension receivers with disabilities in 2010 social insurance special budget expenditure is planned in amount of 8.0 million lats.

Execution of the Constitutional Court Ruling on pensions

In 2009, with supplementary budget it was decided that, as of July 1, 2009, old-age and long-service pensions shall be paid in amount of 90% of the amount of granted pensions, however to receivers of old-age and long-service pensions who are statutory insured persons (employees or self-employed persons) shall be paid 30% of the amount of granted pensions.

Compliance of these norms with the Constitution was challenged in the Constitutional Court and according to the Ruling of the Constitutional Court on the Case No 2009-43-01 "On Compliance of Article 2 Clause 1 of the Law on Payment of State Pensions and Allowances in the Time Period from 2009 till 2012 with Articles 1 and 109 and Compliance of Article 3 Clause 1 with Clauses 1, 105 and 109 of the Constitution of the Republic of Latvia" made on December 21, 2009, it was stipulated that according to Article 2 Clause 1 and Article 3 Clause 1 of the Law on Payment of State Pensions and Allowances in the Time Period from 2009 till 2012 deductions from pensions shall be stopped until March 1, 2010, and until March 1, 2010 Saeima shall prescribe a procedure for compensation of deductions made on the basis of Article 2 Clause 1 and Article 3 Clause 1 of the Law on Payment of State Pensions and Allowances in the Time Period from 2009 till 2012.

Execution of the Constitutional Court Ruling will be started as of February 1, 2010 ensuring payments of old-age and long-service pensions in full amount, i.e., reductions of old-age and long-service pensions by 10% and for employed pensioners by 70% have been cancelled. Deductions made from pensions in the time period from July 2009 till January 2010 (including) will be repaid to pension receivers in April 2010. According to estimates of the Ministry of Welfare it is expected that in 2010 expenditure will increase by 184.6 million lats, inter alia, 110.9 million lats for payments of old-age and long-service pensions in full amount as of February 1, 2010 and 73.3 million lats for repayment of deducted pensions.

Resources planned for execution of the Ruling have been taken into account and reflected in the general government expenditure.

Local government budget

In past years, fiscal deficit of local government budgets did not exceed 1.5% of GDP, however in 2009 it is forecasted that local government budget deficit could reach 2.0% of GDP.

In Latvia, local governments develop, approve and execute their budgets independently and public administration institutions must not interfere in development and execution of budgets of local governments, if not provided in relevant legislative acts. To limit local government budget expenditure, from 2010 onwards, remuneration system for civil servants and employees of local governments are included in joint remuneration system for state and local governments. Joint Law on Remuneration for Civil Servants and Employees of Central and Local Government Institutions was adopted by Saeima on December 1, 2009.

Social security net

Increasing unemployment, wage fall, re-structuring of household debts increase the number of poor persons. Considerable reduction of budget expenditure influences availability of state and municipal services in education and health sectors. This particularly affects low-income people and people living remotely from schools and medical institutions. To satisfy basic needs of people – appropriate income, housing, health services and education opportunities – a social safety net strategy was developed. The Strategy coordinates activities of state and local governments to perform the following tasks:

- ensure guaranteed minimum income for poor persons at the same time increase the level of guaranteed minimum income and ensure payments of housing allowances;
- ensure transport services in education system, as well availability of pre-school education;
- ensure basic health care services and availability of medicine;
- ensure practicing opportunities in local governments thus promoting employment.

The duration of the Strategy is from October 1, 2009 until December 31, 2011. In 2009, total financing necessary for implementation of the Strategy (in state and local government budgets) was planned in amount of 0.15% of GDP, but in 2010 and 2011 in amount of 6% of GDP.

Table 3.1. General government budgetary prospects

		2008	2008	2009	2010	2011	2012
	ESA code	million lats	% of GDP				
Net lending (EDP B.9) by sub-sector							
1. General government	S.13	-672.2	-4.1	-10.0	-8.5	-6.0	-2.9
2. Central government	S.1311	-722.0	-4.4	-6.2	-4.8	-2.7	-1.4
3. State government	S.1312						
4. Local government	S.1313	-203.5	-1.3	-1.5	-1.3	-1.0	-0.5
5. Social security funds	S.1314	253.4	1.6	-2.3	-2.4	-2.3	-1.1
General government (S.13)							
6. Total revenue	TR	5635.9	34.7	33.8	36.2	38.6	39.4
7. Total expenditure	TE	6308.8	38.8	43.8	44.7	44.6	42.4
8. Net lending/borrowing	EDP B.9	-672.2	-4.1	-10.0	-8.5	-6.0	-2.9
9. Interest expenditure	EDP D.41	124.8	0.8	1.3	2.4	3.3	3.2
10. Primary balance		-547.4	-3.4	-8.7	-6.1	-2.7	0.3
11. One-off and other temporary measures							
Selected components of revenue							
12. Total taxes (12=12a+12b)		3323.4	20.5	17.9	19.0	19.7	19.7
12a. Taxes on production and imports	D.2	1749.7	10.8	10.6	11.0		
12b. Current taxes on income, wealth etc	D.5	1571.1	9.7	7.2	8.0		
12c. Capital taxes	D.91	2.6	0.0	0.0	0.0		
13. Social contributions	D.61	1399.8	8.6	9.0	9.4		
14. Property income	D.4	167.2	1.0	1.6	1.2		
15. Other (15=16-(12+13+14))		745.5	4.6	5.4	6.6		
16=6. Total revenue	TR	5635.9	34.7	33.8	36.2	38.6	39.4

		2008	2008	2009	2010	2011	2012
	ESA code	million lats	% of GDP				
p.m.:Tax burden (D.2+D.5+D.61+D.91 – D.995)		4773.8	29.4	27.1	28.7	28.6	28.0
Selected components of expenditure							
17. Compensation of employees + intermediate consumption	D.1+P.2	3049.9	18.8	18.6	18.3	18.4	18.2
17a. Compensation of employees	D.1	1946.6	12.0	11.9	11.7	11.7	11.7
17b. Intermediate consumption	P.2	1103.3	6.8	6.8	6.6	6.7	6.5
18. Total social transfers (18=18a+18b)		1395.1	8.6	12.3	13.5	12.9	12.0
18a. Social transfers in kind	D.6311, D.63121, D.63131	85.4	0.5	0.9	1.1	1.1	1.1
18b. Social transfers other than in kind	D.62	1309.6	8.1	11.3	12.4	11.8	10.9
19.=9. Interest expenditure	EDP D.41	124.8	0.8	1.3	2.4	3.3	3.2
20. Subsidies	D.3	149.2	0.9	1.1	1.1	1.0	1.0
21. Gross fixed capital formation	P.51	781.7	4.8	4.6	4.6	4.6	4.6
22. Other		808.1	5.0	5.9	4.8	4.3	3.4
23.=7. Total expenditure	TE	6308.8	38.8	43.8	44.7	44.6	42.4
Government consumption	P.3	3204.3	19.7				

3.2 Medium-term Objective and Structural Balance

Economy in the long term tends to grow, however the growth is usually not permanent, and growth periods alternate with periods of a decrease. However in average growth rates tend to vary around the long-term economic trend; that is a level corresponding to the full utilization of production factors. Potential GDP is an indicator which points to the volume of economic output in case of optimum employment and utilization of other resources. It is a mathematical projection of the GDP level the economy is able to achieve in case of highly effective utilization of resources.

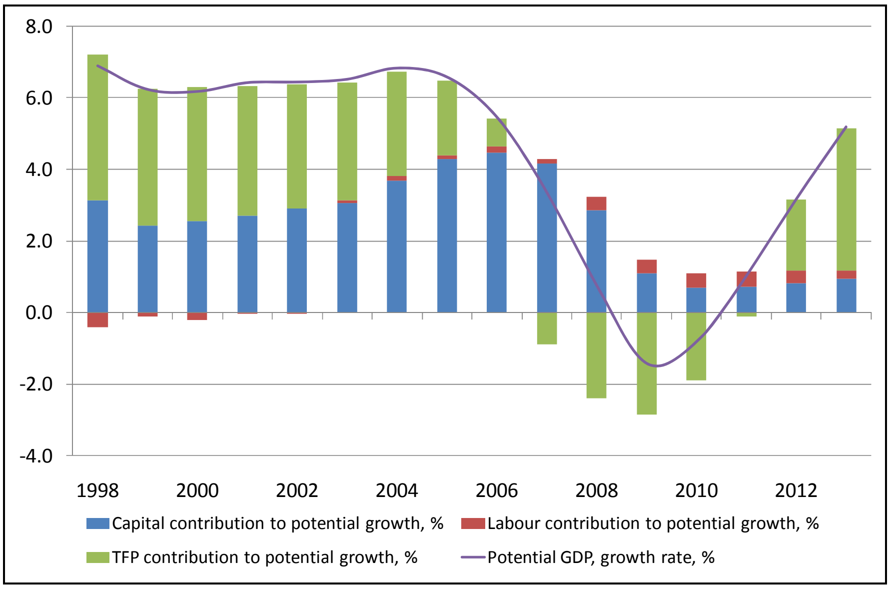

Chart 3.1. Factor contribution to potential GDP growth.

Potential GDP growth rate of Latvia has historically been relatively high – around 6% per year which was caused by a large amount of accumulated capital in the economy and growing total factor productivity (hereinafter – TFP). After accession to the European Union in 2004 potential GDP growth rates began to decline which was caused by a declining TFP growth and tight situation in the labour market due to migration effects. However in 2008 due to global economic crisis, cyclical and structural components the potential GDP growth dropped sharply. It was affected both by the low level of economic output and, particularly, the low gross fixed capital formation level and decline of the employment level in the economy. For the above mentioned reasons the potential GDP growth in 2009 and 2010 became negative - 1.4% and -0.8% respectively. In medium term according to the macroeconomic development scenario described in Chapter 2 it is expected that potential output will increase gradually in the result of an increasing TFP of structural reforms and increasing amount of domestic and foreign investments in the result of improving investment environment.

Potential GDP as an indicator is particularly important for the national economy to forecast medium-term results and policy evaluation. It refers to GDP growth in medium term, inflation pressure, as well as budget balance. The difference between actual GDP and its long-term trend or potential GDP is called output gap which shows cyclical position of the economy, direction of the inflation pressure and required policies.

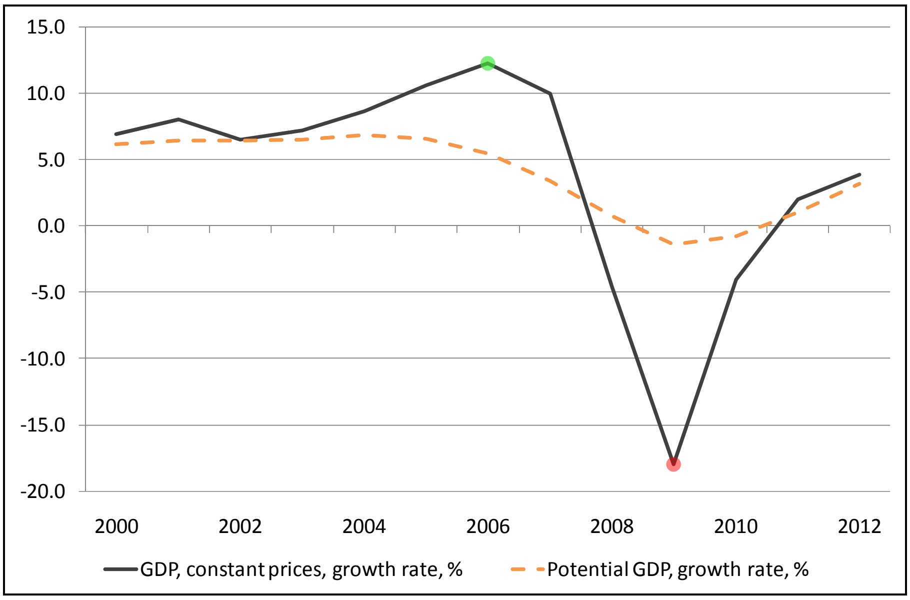

Chart 3.2. Potential and actual GDP growth rates, %.

Actual budget deficit is affected by various factors of cyclical economic development which can ensure higher tax revenue in better economic development conditions, but in poor conditions it can decrease budget revenue and increase expenditures even more rapidly. Fiscal policy appropriate for cyclical economic development ensures tighter budget discipline in periods of rapid economic growth, but is supportive during periods of lower growth.

Medium and long term objectives of the budget are expressed in structural terms to decrease impact of cyclical positions and one-off or short-term fiscal measures on them. It is necessary because of the cyclical nature of economic development, on the basis of actual data, sometimes does not allow sufficiently qualitative assessment of public finances and related progress. Changes in nominal budget balance can arise not only from structural and lasting changes, but also from economic fluctuations or some one-off fiscal measures.

In the time period from 2004 until 2008, in Latvia the output gap was positive and reached its peak in 2007. Starting from 2008 the accumulated positive output gap began to decrease rapidly and turned into a negative output gap. According to current macroeconomic development scenario it is forecasted that the largest negative output gap – around 9.9% of GDP – will be reached in 2010. It is expected that within the programme period the negative output gap will remain which will cause deflation pressure in the domestic market.

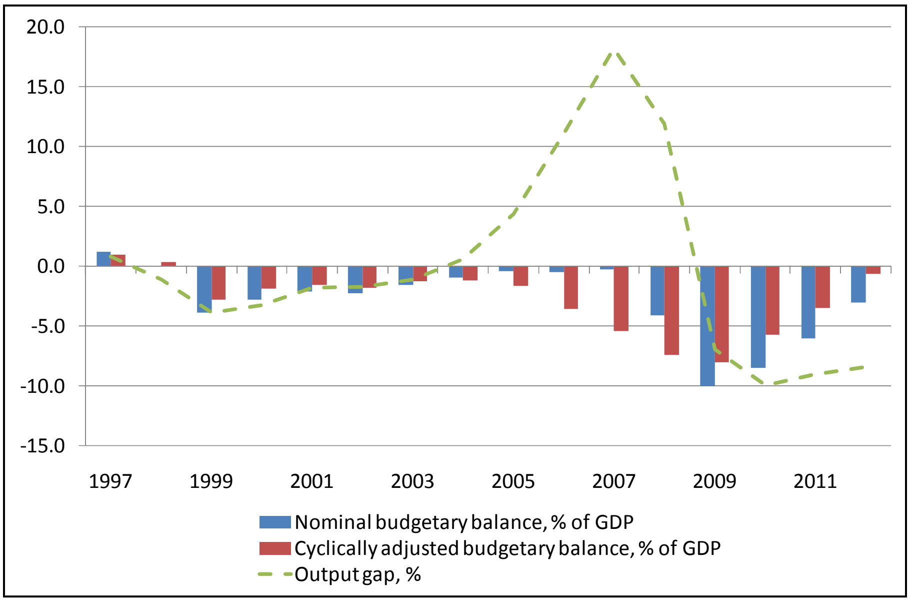

Chart 3.3. Output differences and cyclically-adjusted budget balance comparing to nominal budget balance.

Stability and Growth Pact calls on Member States to implement a responsible and coherent economic policy imposing restrictions on the general government fiscal position. Medium-term budget objective is defined in a cyclically-adjusted manner. It takes into account necessary safety gap from the budget deficit 3% of GDP and government debt 60% of GDP, as well as the expected budget expenditure rise in the result of population ageing and the need of the state for investments. Euro area and ERM II Member States, including Latvia, have agreed on additional restrictions – medium-term cyclically-adjusted structural general government budget objective cannot exceed 1% of GDP deficit threshold.

The expected expenditure increase due to population ageing and the amount of government debt in Latvia are lower than the EU average. The economic crisis has significantly increased both the actual and structural budget deficit, and has also led to considerable re-evaluation of structural positions of previous years. The medium-term budget objective should be sufficiently ambitious to comply with stability and sustainable development conditions, as well they should be really achievable. The medium-term objective of Latvia is to reduce the cyclically-adjusted structural general government budget deficit to 1% of GDP.

Table 3.2. Cyclical developments

% of GDP	ESA code	**2008**	**2009**	**2010**	**2011**	**2012**
1. Real GDP growth (%)	B1g	-4.6	-18.0	-4.0	2.0	3.8
2. Net lending of general government	B9	-4.1	-10.0	-8.5	-6.0	-2.9
3. Interest expenditure	D41	0.8	1.3	2.4	3.3	3.2
4. One-off and other temporary measures						
5. Potential GDP growth (%) (1)		0.8	-1.4	-0.8	1.0	3.2
contributions:						
- labour		0.4	0.4	0.4	0.4	0.3

% of GDP	ESA code	2008	2009	2010	2011	2012
- capital		2.9	1.1	0.7	0.7	0.8
- total factor productivity		-2.4	-2.9	-1.9	-0.1	2.0
6. Output gap		11.9	-6.9	-9.9	-9.0	-8.5
7. Cyclical budgetary component		3.3	-1.9	-2.8	-2.5	-2.4
8. Cyclically-adjusted balance (2-7)		-7.4	-8.1	-5.7	-3.5	-0.5
9. Cyclically-adjusted primary balance (8+3)		-6.6	-6.8	-3.3	-0.2	2.7
10. Structural balance (8-4)		-7.4	-8.1	-5.7	-3.5	-0.5

Due to negative output gap, since 2009, cyclical adjustment is done by improving nominal budget balance by reduction of the deficit. In the time period from 2009 until 2012 the cyclical adjustment component will range from -1.9% till -2.8 percents. However improvement of cyclically-adjusted primary budget balance will be determined by increasing interest payments each year which will mainly depend on the international loan utilization intensity. According to current macroeconomic development scenario in 2012 Latvia will achieve its pre-determined objective – cyclically-adjusted structural balance is forecasted at -1.5% of GDP.

3.3 Government Debt

At the end of 2008, the general government debt was 3 181 million lats or 19.5% of GDP. General government debt level is primarily affected by the central government debt which in 2008 was 2 645 million lats forming 83.2% of general government debt.

The objective of the central government debt management policy is to provide at lowest possible cost necessary financial resources for financing of the budget execution and re-financing of central government debt liabilities at the same time restricting financial risks and taking into account development of Latvian national capital market and general financial system which is oriented towards accession to the euro area in medium term. Objectives, basic principles and tasks of the central government debt portfolio and borrowing management within the framework of debt management are set in Latvia's government 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, repayment profile, average weighted fixed period of interest rates and optimal proportion of fixed interest rates in the debt portfolio.

The borrowing amount and central government debt level in the medium term is determined by the amount of total financing requirement, which consists of funding required for the government budget execution and refinancing of central government debt commitments in respective period.

Taking into account limited borrowing possibilities for Latvia on the financial markets as the result of global financial crisis and decrease of budget revenues influenced by economic downturn, at the end of 2008 Latvia addressed international creditors. At the end of 2008, the European Commission, International Monetary Fund, World Bank, European Bank of Reconstruction and Development and several Member States of the European Union have agreed on provision of financial assistance to Latvia in amount of 7.5 billion euro on the basis of Economic Stabilisation and Growth Revival Programme. The allocated funding will be available until 2011 to stabilise and recover financial system of Latvia, to prevent further deterioration of the economic situation, to re-structure Latvian economy increasing its competitiveness, as well as to reduce impact of risks slowing down economic development.

Till the end of 2009, 2 293 million lats of the international financial assistance were received; 1 320 million lats from that were used to cover total financial needs and perform financial sector stabilisation measures. According to the agreement with creditors the rest of the received assistance in amount of 973 million lats were reserved in the Treasury's accounts in the Bank of Latvia to ensure budget execution and refinance government debt liabilities (517 million lats), as well as to finance potential financial sector stabilisation measures (456 million lats).

In addition, in 2009, short-term domestic T-bills with maturity one, three, six and twelve months were issued to cover financing requirement. After the receipt of international financial assistance in the first quarter of 2009 the amount of domestic T-bills issue decreased considerably and mainly they were aimed at supporting of the domestic securities market and to ensure the amount of investments sufficient for institutional investors. In the second half of 2009, the situation in the domestic financial market has stabilised and improved significantly as interest rates of T-bills were on the decrease and demand for longer maturity bills went up. Since the second quarter of 2009, the Treasury ensures regular issue of government domestic securities offering three, six or twelve months T-bills.

In the medium term within the framework of the government debt and borrowing management it is planned to perform the following measures in domestic and international financial markets:

- continue regular issue of government domestic securities offering securities with longer maturity;
- as the macroeconomic situation in Latvia stabilises and pre-conditions for new issues improve it is planned to return to the international financial market.

To ensure compliance with Maastricht criterion regarding the general government debt level in the medium term, possibilities for performance of the following debt re-structuring measures will be evaluated:

- reduce the amount of the debt liabilities using marked resources of international financial assistance in case they will not be used completely;
- in reference to further acquisition of 7.5 billion euro international loan allocated to Latvia, possibilities to agree with international creditors on committed funding instead of allocation of loans will be evaluated.

Taking into account current forecasts and potential debt re-structuring measures it is expected that the general government debt in the medium term will not exceed the debt criterion set in the Maastricht Treaty.

Table 3.3. General government debt developments

% of GDP	ESA code	**2008**	**2009**	**2010**	**2011**	**2012**
1. Gross debt		19.5	34.8	55.1	59.1	56.8
2. Change in gross debt ratio		10.6	15.2	20.3	4.0	-2.3
Contributions to changes in gross debt						
3. Primary balance		-3.4	-8.7	-6.1	-2.7	0.3
4. Interest expenditure	D41	0.8	1.3	2.4	3.3	3.2
5. Stock-flow adjustment, of which:		6.4	5.2	11.8	-2.0	-5.2
- Differences between cash and accruals		0.2				
- Net accumulation of financial assets		7.3				
including privatisation proceeds		*0.1*				
- Valuation effects and other		-0.2				
p.m. implicit interest rate on debt		*9.3*	*5.5*	*6.3*	*6.0*	*5.7*
Other relevant variables						

% of GDP	ESA code	**2008**	**2009**	**2010**	**2011**	**2012**
6. Liquid financial assets		6.1				
7. Net financial debt (7=1-6)		13.4				

3.4 Progress in Reduction of Excessive Budget Deficit

General government budget deficit in Latvia in 2008 reached 4.1% of GDP, thus exceeding the criterion 3% of GDP. Although the budget deficit increase was caused by the economic downturn, the deficit was not close to the reference value and the excess cannot be considered temporary because the budget deficit in 2009 can reach 10%, in 2010 8.5% and in 2011 6% of GDP. Thus in the Council Decision of 7 July 2009 on the existence of an excessive deficit in Latvia (2009/591/EC) it is stated that the deficit criterion in the Treaty is not fulfilled, and the Council approved recommendations to Latvia to reduce excessive budget deficit.

Fiscal policy in Latvia is implemented in compliance with Council recommendations. According to evaluation tight consolidation measures in 2009 were sufficient to limit general government budget deficit at 10% of GDP. Budget for 2010 has been approved with additional consolidation measures ensuring reduction of the deficit down to 8.5% of GDP.

To prevent excessive budget deficit the Law on State Budget for 2010 states that the general government deficit target forecast according to ESA 95 methodology in 2012 shall be below 3.0% of GDP. To ensure that significant consolidation measures should be implemented in the next year’s budget.

To ensure adequate fiscal consolidation current social allowance system will be evaluated and solutions will look for to ensure allowances oriented more towards target groups.

In collaboration with the World Bank started health care, education, social protection reforms will be continued which will help to optimise public spending in medium term.

In 2010, it is planned to define necessary changes to the pension system to ensure financial stability of the pension system in medium and long term.

To ensure implementation of the best practice in fiscal discipline and economic growth the Ministry of Finance in collaboration with the Ministry of Regional Development and Local Government, Ministry of Justice and State Chancellery will develop and submit in the prescribed procedure to the Cabinet of Ministers the draft fiscal discipline law complying with the following guidelines:

1) set budget deficit level according to forecasted GDP changes and macroeconomic forecasts;

2) determine the state budget expenditure fluctuation range and maximum ceiling of changes ensuring countercyclical fiscal policy;

3) set competences of Parliament, Cabinet of Ministers, other institutions and municipalities to ensure fiscal discipline at all public administration levels.

According to forecasts the general government debt in 2012 will be close to but not below 60% of GDP reference value. To ensure compliance with this criterion in medium term possibilities to perform necessary debt re-structuring measures will be evaluated.

Ensuring stability of financial sector in global financial turmoil is an important pre-condition for economic growth revival and, taking into account public investments in the sector, also for sustainable development of public finances. In 2009, the Finance and Capital

Market Commission (FCMC) performed number of important measures related to finance market regulation and supervision. The control over banks was intensified, information exchange was improved, procedures were hastened and regular stress tests were carried out. In 2009, thirteen banks in Latvia invested additional 912 million lats in their capital (7% of GDP). Supervision of banks by the FCMC is focused on risk evaluation oriented approach to supervision controlling compliance with the best practice in loan quality evaluation systems and in making accruals in banks. In 2010, the work will continue on improving finance market regulation and supervision, inter alia, by implementation of several EU directives amending Capital Requirements Directive.

Latvia is implementing Council recommendations and planning to ensure that excessive budget deficit will be prevented till 2012.

4 Sensitivity Analysis and Comparison with the Previous Programme

4.1 Macroeconomic Scenario Risks

Performance of macroeconomic scenario will be at a large extent affected by further development of external environment. In the end of 2009, the world shows signs of recovery – major financial market indices increase, prices of raw materials increase gradually, majority of global economies concluded III and IV quarters of 2009 with positive statistical data. The macroeconomic scenario described in the Convergence Programme includes the assumption that in 2010 the external environment will improve, however the improvement will be linear, and growth slowdown is possible in some markets and time periods.

Performance of macroeconomic scenario will be also affected by internal factors – volume of fiscal consolidation effects, political situation and other factors directly affecting investment risk ratings, interest rates and confidence indicators. Macroeconomic risks which will determine economic development over the programme period can be divided into negative and positive risks.

Negative risks:

- Reduction of household real disposable income and worsening of future outlook may increase the household tendency to accumulate resources for the future resulting in even more decreased household activity level.
- Efficiency and positive impact of structural reforms may be less than expected resulting in hampered economic growth.
- Negative effects of budget consolidation may be stronger than expected – they may influence overall economic activity level, especially – labour market, tax revenue, confidence of households and business.
- Political or social instability risks may cause negative effect on the economy – in investment environment, as well as overall confidence of households, business and trade partners.
- Too rapid correction of prices on raw materials in global market may slow down the process of improving competitiveness of national economy. For the economy, increase in energy prices is the most unfavourable.
- Although currently the global economy shows positive signs, there is a danger that in the first half of 2010 it will fall back to the recession phase which will be determined by the stock cycle, restriction of incentive measures and consolidation measures performed by EU Member States.
- New shocks in domestic and/or global financial systems may cause both domestic financial market turmoil and additional negative impact on real sector.
- Potential changes in household behaviour and preferences – historical experience shows that in the crisis extraordinary household activities in the market are possible.
- Export growth can be negatively affected by increasing protectionism in foreign countries.

Positive risks:

- Export may grow faster as estimated in the result of faster adaptation of enterprises and increasing competitiveness which will allow increase in Latvian market share abroad.
- In 2010, as the macroeconomic indicators showing economic stabilisation signs will arise international credit rating agencies may change their future outlook assessment given to Latvian economy, which could, in its turn, improve considerably the investment environment.
- As the household confidence level will improve it is possible that accrued resources will return to the market more intensively which could facilitate faster growth of private consumption as it is planned in the central macroeconomic development scenario.

4.2 Sensitivity Analysis

The central macroeconomic scenario described in the Convergence Programme is developed on the basis of forecasted macroeconomic developments most likely to happen. Each macroeconomic scenario is based on a set of internal and external environment assumptions which determines its structure. Chapter 4.1 lists both positive and negative macroeconomic risks that may affect compliance of central scenario with the actual outcome. On the basis of potential effect of these macroeconomic risks on the economy two alternative macroeconomic development scenarios have been produced.

Table 4.1. Optimistic macroeconomic scenario

	2008	2009	2010	2011	2012
Gross domestic product, current prices, million of lats	16274.5	13073.7	12303.8	12588.1	13165.7
Growth in current prices, %	10.1	-19.7	-5.9	2.3	4.6
Growth in constant prices, %	-4.6	-18.0	-2.7	3.4	3.8
CPI, (year's average), %	15.4	3.5	-3.7	1.1	3.0
Average salary in the economy, lats	479	455	425	441	466
Growth in current prices, %	20.5	-5.0	-6.7	3.9	5.7
Employment, thousand people	1124.1	997.0	962.8	977.8	989.6
Growth, %	0.5	-11.3	-3.4	1.6	1.2
Export growth rates in current prices, %	8.8	-23.4	6.5	6.8	7.2
Import growth rates in current prices, %	-3.2	-39.4	-3.5	1.8	10.2

The optimistic macroeconomic scenario is based on an assumption that current correction in global markets will remain linear. Mostly it refers to the ability of Latvian foreign trade partners to recover from the global economic crisis and increase internal consumption and demand for Latvian export goods. In addition, the optimistic macroeconomic scenario envisages that economic confidence indicators growing in the end of 2009 will continue to improve and a tendency of households to accumulate funds will not grow anymore. The macroeconomic scenario envisages that economic reforms will contribute considerably to reduction of the unit labour costs and facilitate economic competitiveness and its recovery through the foreign trade channel. The optimistic macroeconomic scenario envisages that the private consumption of 2010 in constant prices will decrease by 7.6%, but the public demand – by 7.0 per cent. However in following years gradual recovery of the private consumption is expected which will be caused by gradual increase in household confidence about their future revenue and potential improvement of lending market conditions. In 2010, the amount of investments will also reduce by additional 8.6%, but it will show positive growth rate from 2011 which will be caused by improvement of overall market situation and stabilisation of credit ratings. This scenario envisages faster correction of the labour market and lower deflation level. In the result, this macroeconomic development scenario provides for gross domestic product reduction by 2.7% in constant prices in 2010 and increase in the GDP by 3.4% and 3.8% in 2011 and 2012, accordingly.

In case of optimistic macroeconomic scenario envisaging smaller GDP drop comparing to central scenario and more positive labour market indicators the budget revenue base could also be improved considerably. According to calculations, in case the economic development will comply with optimistic scenario the budget revenue in 2010 will be by 0.9% of GDP higher than in the central scenario.

Table 4.2. Pessimistic macroeconomic scenario

	2008	2009	2010	2011	2012
Gross domestic product, current prices, million of lats	16274.5	13073.7	11586.8	11349.9	11661.6
Growth in current prices, %	10.1	-19.7	-11.4	-2.0	2.7
Growth in constant prices, %	-4.6	-18.0	-5.6	1.1	2.7
CPI, (year's average), %	15.4	3.5	-4.7	-2.8	-0.8
Average salary in the economy, lats	479	455	401	390	396
Growth in current prices, %	20.5	-5.0	-11.9	-2.8	1.8
Employment, thousand people	1124.1	997.0	928.3	907.7	909.0
Growth, %	0.5	-11.3	-6.9	-2.2	0.1
Export growth rates in current prices, %	8.8	-23.4	1.6	4.4	5.5
Import growth rates in current prices, %	-3.2	-39.4	-11.4	0.4	5.5

Pessimistic macroeconomic scenario is based on an assumption that external environment will recover from the global economic crisis in a wavy manner, and in the first half of 2010 main Latvian trading partners will show negative growth rates or unsubstantial growth. The scenario envisages that majority of EU Member States will face decreasing internal consumption in 2010 due to budget consolidation and worsening of labour market situation. In this case prospects of Latvia to use external trade channels as main development accelerator are limited. The scenario also envisages that situation in the credit market will not improve substantially. As a result, it is expected that domestic demand will further decline (in 2010, private consumption will decrease by 15.1%, but public consumption – by 10.6%) till 2012 when a small growth is expected. The scenario envisages that gross fixed capital formation in 2010 in constant prices will reduce by 14.5%, and mainly it will be determined by the low credit ratings and low confidence levels in industry and service sectors. In this macroeconomic scenario slower labour market recovery and greater deflation are planned (also causing reduction of average wage in the economy). As a result the negative macroeconomic scenario envisages a gross domestic product reduction by 5.6% in constant prices in 2010. In medium term the growth will still remain low due to the low level of investments, weak situation in the labour market and low confidence level. The scenario reflects on the situation when performed structural reforms have not resulted in sufficient increase in competitiveness.

Greater fall in GDP and longer stabilisation period before the resumption of growth than in the central scenario based on significant drop in internal demand and setting considerably weaker indicators of the labour market will affect significantly also the budget revenue base. According to calculations, in case the economic development will comply with pessimistic scenario the budget revenue in 2010 will be by 0.7% of GDP less. The government is aware of the risks related to budget forecasts in a highly volatile and uncertain internal and external environment and regularly follows budget performance indicators to be able to adjust the budget expenditures quickly.

4.3 Comparison with the 2008 Convergence Programme

Table 4.3. Difference from previous update

	ESA code	2008	2009	2010	2011	2012
Real GDP growth (%)	B1g					
Previous update		-2.0	-5.0	-3.0	1.5	-
Current update		-4.6	-18.0	-4.0	2.0	3.8
Difference		-2.6	-13.0	-1.0	0.5	-
General government net lending(% of GDP)	B.9					
Previous update		-3.5	-5.3	-4.9	-2.9	-
Current update		-4.1	-10.0	-8.5	-6.0	-2.9
Difference		-0.6	-4.7	-3.6	-3.1	-
General government gross debt (% of GDP)						
Previous update		19.4	32.4	45.4	47.3	-
Current update		19.5	34.8	55.1	59.1	56.8
Difference		0.1	2.4	9.7	11.8	-

Macroeconomic scenario of the 2008 Convergence Programme provided for a break in the economic development from 2008 – after the rapid growth the economic activity will decline. This scenario has come true, however actual development was considerably weaker than expected; it was largely determined by a sharp deterioration in global financial and export situation.

Such a significant decline was a reason for worsening of general government budget balance and increased the amount of necessary consolidation. Reduction of the budget deficit below the pre-defined criterion – 3% of GDP in 2012.

From 2009, general government debt forecasts are higher than previously reflecting higher budget deficit in the result of weaker economic growth, as well as state aid to financial sector. Recovery of economic growth together with significant consolidation measures will stabilise the state debt below 60% of GDP.

5 Quality of Public Finances

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.

Table 5.1. Tax revenue in general government budget (S.13) (millions of lats)

	Code (ESA 95)	2008	2009	2010	2011	2012
Tax revenue						
1. Taxes on production and imports	D.2	1749.7	1387.9	1313.0	1376.2	1451.0
2. Current taxes on income and property	D.5	1571.1	940.4	947.4	954.2	982.7
3. Capital taxes	D.91	2.6	2.2	2.2	2.1	2.1
4. Social security contributions	D.61	1399.8	1170.6	1122.1	1031.9	991.7
Of which actual social security contributions	*D.611*	1330.0	1100.9	1052.1	956.9	916.7

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 2008, it amounted to 28.6% of GDP, which is considerably lower than the EU average at 39.2% of GDP.

The major share of total tax revenue in Latvia is comprised of labour taxes and it has followed on an upward trend (from 48.5% in 2005 to 49.8% in 2008), whereas the share of consumption taxes in total tax revenue has decreased (from 42.1% in 2005 to 36.4% in 2008).

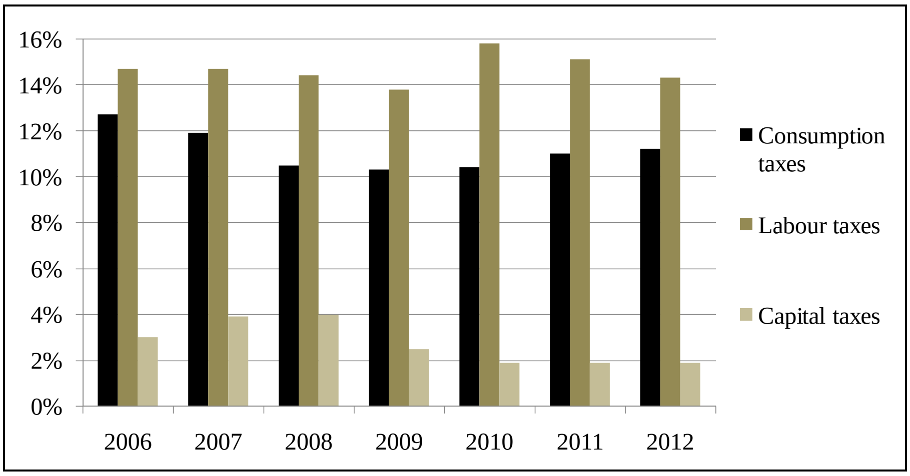

Chart 5.1. Tax revenue by economic function (% of GDP).

In recent years tax revenue increase was mainly influenced by the rapid economic growth, but now due to the economic crisis tax revenue declines. However budget fiscal consolidation launched in 2009 and fiscal consolidation measures continued in 2010 are oriented towards stabilisation of tax revenue.

Table 5.2. Fiscal impact of main tax policy changes (% of GDP)

	2010	2011
Personal income tax	+1.3	+0.2
Real estate tax	+0.3	-
Excise tax	+0.1	+0.1
Social security contributions	+0.3	-
Annual fee for cars and motorcycles	+0.2	-

	2010	2011
Corporate income tax	-	+0.1
Total impact of tax policy changes:	**+2.2**	**+0.3**

Value Added Tax

Value added tax (VAT) revenues have a notable share in the total tax revenues (in 2008, 23.0% of total tax revenue). During last years the value added tax revenues showed-up high growth rates. However taking into account the slump of retail trade which started in 2008 and continued in 2009, fall in economic activities in other sectors, as well as reduction of total value of transactions and amount of import the value added tax revenues have decreased. Moreover, the impact of economic crisis was so significant that the VAT standard rate increased by 3 percentage points from 18% to 21% as of January 1, 2009 did not compensate the revenue drop caused by the economic recession.

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, this 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. However the economic downturn which started in 2008 affected considerably corporate income tax revenue in 2009. In 2009, corporate income tax revenue decreased by 58.7% comparing to 2008 and made 1.6% of GDP. Notable decrease in the corporate income tax revenue can be explained with considerable reduction of the profit in 2008 resulting in reduced corporate income tax payments and increased repayments.

As the economic recession will continue it is forecasted that the corporate profit will also decrease considerably in 2009 which will directly affect corporate income tax revenue in 2010. In 2010, corporate income tax revenue is forecasted with 61.6% reduction and it will make 0.7% of GDP. In medium term the corporate income tax revenue is also forecasted in amount of 0.7% of GDP.

Amendments to the Corporate Income Tax Law, from 2010, envisage the following:

- proportion of representation expenditure deductable from the taxable income shall be reduced from 60 per cent to 40 per cent;
- for the corporate income tax calculation purposes the proportion of expenditure which is not related to economic activities and losses caused by maintenance of infrastructure objects and which is not included in the expenditure part shall be multiplied by 1.5. This coefficient shall not be applied to donations to which the donator applies corporate income tax relief provided for in the legislation.

It is estimated that the above mentioned amendments to the Law will affect corporate income tax revenue in 2010.

Table 5.3. Impact of tax policy changes on corporate income tax revenue (millions of lats)

	2011
Reduction of the amount of representative expenses, which may be deducted from taxable income from 60% to 40%	*+1.1*
Changed the taxation treatment for expenses not related to economic	*+5.8*

	2011
activity by taxing them equally as Personal income tax (26%)	
Total impact of changes:	***+6.9***

Excise Duty

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

Sharp drop in excise goods sales volume, compared with indicators of 2008, determined the excise duty revenue reduction, despite the increase in excise duty rates in 2009.

Within fiscal consolidation changes of excise duty rates are implemented in 2010, too.

As of January 1, 2010, minimum level of excise duty on cigarettes has been set 48 lats per 1000 cigarettes.

Similarly, as of February 1, 2010, excise duty rates on wine and fermented beverages will were increased from 40 lats to 45 lats per 100 litres and on intermediate products with absolute alcohol content till 15% (including) – from 42 lats to 45 lats per 100 litres.

However, as of May 1, 2010, a new excise duty will be imposed on natural gas envisaging the following rates on natural gas for heating purposes – 0.42 lats per GJ or 15.6 lats per 1000 m^3, and natural gas used as fuel – 1.84 lats per GJ or 70 lats per 1000 m^3.

Table 5.4. Impact of tax policy changes on excise tax revenue (millions of lats)

	2010
Establishment of minimum excise duty level for cigarettes - LVL 48 per 1000 cigarettes	+6.5
Raising of tax duty on alcoholic beverages	+0.6
Introduction of excise duty on natural gas	+5.0
Total impact of changes:	**+12.1**

Real Estate Tax

In 2009, amendments were adopted to the Law on Real Estate Tax envisaging significant changes in the real estate tax field.

As of January 2, 2010, real estate tax rate on land and buildings used for economic activities has been increased from 1% to 1.5% of cadastral value, maintaining the tax increase limit at 25% in 2010 comparing with previous taxation year.

Tax base has been widened by including residential buildings, applying tax rate 0.1% on objects with cadastral value below 40 000 lats, on objects with cadastral value from 40 001 lats till 75 000 lats – 0.2%, and on objects with cadastral value above 75 000 lats – 0.3%.

The tax base has been also widened by engineering constructions applying tax rate 1.5%.

A minimum tax payment of 5 lats per taxpayer in each municipality has been set if the estimated total tax after application of relief is less than 5 lats per taxation year.

Additional rate 1.5% will be applied to non-cultivated agriculture land.

Table 5.5. Impact of tax policy changes on real estate tax revenue (millions of lats)

	2010
Increase of tax rate for land and commercial buildings from 1% to 1.5%	+13.0
Broadening the real estate tax base by including residential property at a progressive rate	+8.5
Broadening the real estate tax base by including in it civil engineering structures	+6.7
Introduction of a minimum tax payment for each property	+1.0
Introduction of additional tax rate for uncultivated agricultural lands	+1.0
Total impact of changes:	**+30.2**

Personal Income Tax

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.

However, in 2009, to ensure tighter fiscal consolidation, as of June 1, 2009, the non-taxable minimum was decreased from 90 to 35 lats per month.

Medium-term macroeconomic development forecasts currently provide for reduction of the wage fund (resumption of growth is expected only from 2012) which, in its turn, will reduce revenue from labour taxes in coming years. However personal income tax revenue in 2010 will be influenced notably by performed consolidation measures envisaging the following:

- increase the personal income tax rate from 23% to 26%;
- apply 15% tax rate on capital increase; apply 10% rate on dividends and income from interests;
- apply personal income tax on personal benefit gained from employer’s (company’s) car used for personal needs;
- decrease the amount of personal income tax non-taxable present of the employer from the amount of nominal wage (Ls 180) to Ls 0;
- increase the tax rate on self-employed persons (performers of economic activities) applying common personal income tax rate, i.e., 26%;
- impose tax on presents exceeding 1000 lats per year if they were received from a person having no kinship relations with the presentee. If the presenter has marriage or kinship relations with the presentee up to third generation (in terms of Civil Law) and descending kin, then the present should not be subject to the tax;
- change tax incentives for reserves (in private pension funds, insurance companies and investment funds);
- apply tax on expropriation of growing forest for cutting and expropriation of wood materials obtained from such forest, apply 10% rate only to the owner of the forest (norms referring to economic activities should be applied to intermediaries).

Also measures in the personal income tax field having impact on personal income tax revenue in 2011 have been approved:

- decrease non-taxable amount of revenue from agriculture production and provision of rural tourism services from 4000 lats to 2000 lats per year;
- impose personal income tax on income from contributions to private pension funds and income from signed life insurance contracts with accumulation of funds;
- include in calculation of taxable income sums paid as state aid to agriculture or EU aid to agriculture and rural development.

However, personal income tax revenue forecast in 2012 will be influenced by revision of personal income tax eligible expenditure for education and treatment services referring to services received in 2010 decreasing the limit of expenditure from 300 lats to 150 lats per year.

Table 5.6. Impact of tax policy changes on personal income tax revenue (millions of lats)

	2010	**2011**	**2012**
Increase of general PIT (personal income tax) rate to 26%	+95.5	-	-
Broadening of PIT base including all capital income, dividends and interest	+24.5	-	-
Taxation of fringe benefit from using employer’s car for employee`s personal needs	+15.7	-	-
Introduction of taxation on employer’s gifts to employee by elimination of exemption	+8.8	-	-
Increase of tax rate for business income (up to the general PIT rate of 26%)	+3.3	-	-
Introduction of taxation of gifts, the value of which is in excess of LVL 1000,- per year from one donator, if received from persons other than relatives	+3.1	-	-
Change of tax incentives for savings (private pension funds, life insurance contracts, investment funds)	*+1.8*	*+0.2*	-
Taxation income from sales of round wood and grown-up forest (for cutting) by 10% rate (owners of grown-up forest, intermediaries will be taxed at 26% rate)	+1.4	-	-
Reduction of exemption for income from agricultural and rural tourism activities from 4000 to 2000 lats per year	-	+1.9	-
Change of tax incentives for savings (private pension funds, life insurance contracts, investment funds)	-	+4.1	-
Amounts paid to individuals as state aid to agriculture or EU aid to agriculture and rural development attributed to income of taxpayer	-	+12.1	-
Reduction of allowed PIT deductions (education and health services) from LVL 300 to LVL 150 in respect to services received in 2010	-	-	+4.0
Total impact of changes:	**+154.0**	**+18.4**	**+4.0**

Social Security Contributions

In 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 decrease in wage fund (resumption of growth in 2012) as well as legislative changes introduced within consolidation measures performed in 2010 and changes in the rates of contributions to state funded pension scheme because according to the ESA 95 requirements social security contributions channelled to the state funded pension scheme are not treated as general government budget revenue.

As of January 1, 2010, social insurance contributions are imposed on personal benefit gained from employer's (company's) car used for personal needs.

Also it is expected to gain additional resources from the decrease in the amount of personal income tax non-taxable present of the employer from the amount of nominal wage (Ls 180) to Ls 0.

However the rate of contributions to state funded pension scheme in 2010 will remain 2%; the rate will be increased in 2011 to 4%, but in 2012 to 6%.

Table 5.7. Impact of tax policy changes on social insurance contribution revenue (millions of lats)

	2010	**2011**	**2012**
Taxation of fringe benefit from use of employer's car for employee`s personal needs	+22.7	-	-
Introduction of taxation on employer's gifts to employee by elimination of exemption	+14.0	-	-
Total impact of changes:	**+36.7**		

Table 5.8. Social insurance contributions to state funded pension scheme

Period	Payment rate	Deposited social insurance contribution in funded pension scheme, million lats	Deposited social insurance contribution in funded pension scheme, million lats, % of GDP
2010	2%	68.8	0.6
2011	4%	123.6	1.0
2012	6%	192.6	1.6

Annual Transport Duty

To ensure fiscal consolidation and achieve reduction of budget deficit, as of January 1, 2010, state duty rates on motorcycles, tricycles and quadracycles, cars, buses and trucks have been changed, thus increasing general government revenue by 18.9 million lats or 0.2% of GDP.

6 Sustainability of public finances

In coming decades a gradual but considerable pressure on sustainability of public finances is expected resulting from demographic changes in Latvia. Deterioration of fiscal situation due to the economic crisis has caused increase in previously low government debt level. Therefore medium-term fiscal consolidation, as well as performance of structural reforms is also highly important to ensure long-term sustainability.

According to *Eurostat* demographic forecasts[1], by 2060 the population in Latvia will decrease by 26% comparing to 2007. The age profile of population will also change significantly, as the proportion of elderly people will increase notably. Stabilisation of demographic situation is unlikely after 2060 as well.

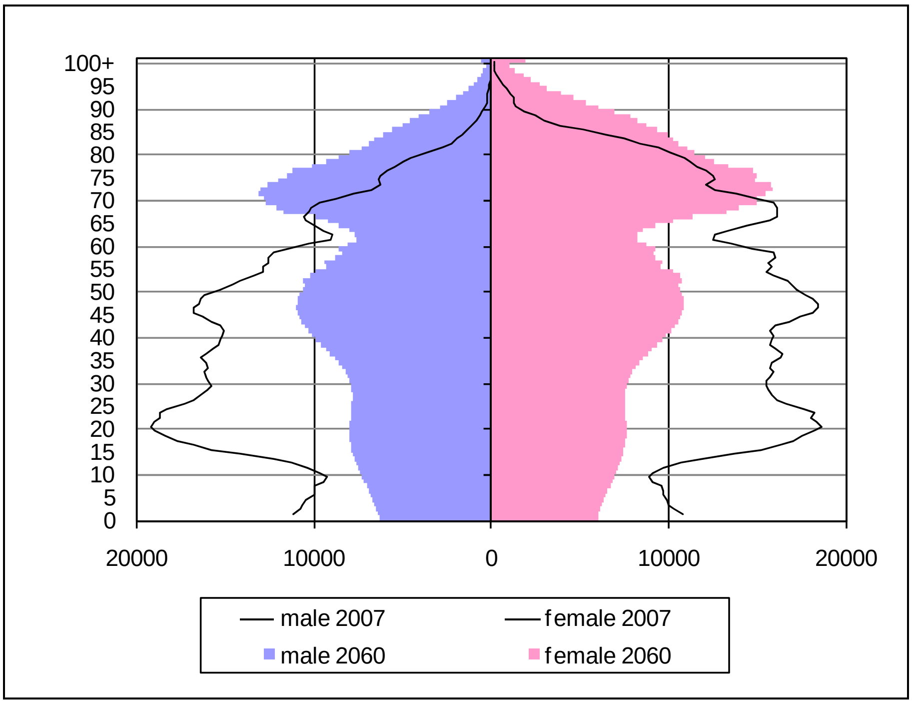

Chart 6.1. Changes in Latvian population by age groups in 2007-2060.

By 2060, working age (15-64) population will decrease by 43% comparing to 2007, whereas the number of elderly people (65+) will grow by 48%, including the number of very old people (80+) will increase even by 260%. The increase in the number of elderly people will be primarily the result of higher life expectancy. The number of children will continue to fall; summary birth rate will increase slightly till 1.54 which is still below the natural reproduction threshold. Therefore the main reason for changes in the population will be natural movement. According to assumptions the migration will cause adverse affect on the population growth in the coming decade, however it will turn into a positive effect later.

Due to the above mentioned changes in the age profile of population the demographic burden[2] on working age population will increase almost twice.

1 EUROPOP2008.
2 Proportion of children and pension age population against working age population.

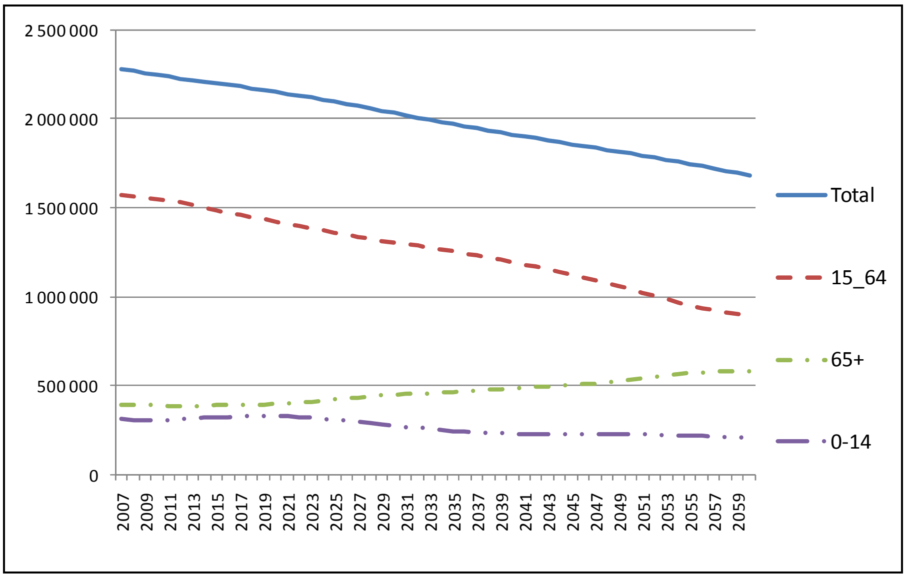

Chart 6.2. Latvian population by age groups 2007-2060.

The above described demographic changes will determine the employment development, although it will also be affected by labour market change. It is expected that in long term the participation level will increase and the unemployment will decrease. It will partially compensate the impact of the work age population decline on the employment.

The economic growth is also important to ensure sustainability. The productivity in long term will be a decisive growth source. Taking into account relatively low positions of Latvia comparing to other states its productivity growth potential is higher than the EU average which will create basis for the convergence in long term. Therefore structural reform measures facilitating higher participation and productivity growth are important. In medium term the economic growth will be promoted by the EU funds investments.

Long-term sustainability calculations are based on assumptions[3] developed in the beginning of 2008 and were not envisaging so deep and widespread economic crisis as Latvian economy is facing now. Therefore the described results should be approached with some caution because for the long-term growth also it will be highly important how quickly and successfully the economy and labour market will recover. Currently the GDP per capita is approximately 30% lower than was envisaged by the basic scenario in the Ageing Report. Although the impact of the crisis through the GDP fall on the long-term sustainability is negative, it is not so direct and is weaker because the social protection system adapts to current situation, for example, lower wage also reduces future pension liabilities etc. At the same time is it necessary to re-evaluate these policies and adoption to new conditions.

[3] The employment and macroeconomic assumptions according to the 2009 Ageing report of the Ageing Working Group of the EU Economic Policy Committee and the European Commission "Economic and Budgetary Projections for the EU27 Member States (2008-2060)"

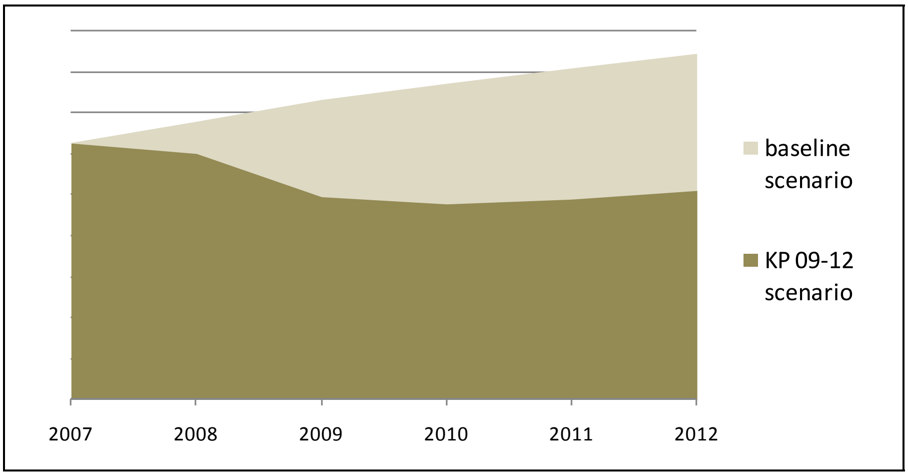

Chart 6.3. GDP in constant prices per capita.

Calculations of long-term sustainability of public finances include budget expenditure for pensions, health and long-term care, education and unemployment benefits.

In last decade Latvian pension system experienced significant reforms – three level pension system was implemented, the pension age was increased up to 62 years. Taking into account long-term nature of the pension system some transitional periods referring to both current, as well as new pensioners will be in force for some time.

Long-term pension expenditure against the GDP will increase, however the biggest increase will refer to the funded part of pensions concerning less the state budget expenditure.

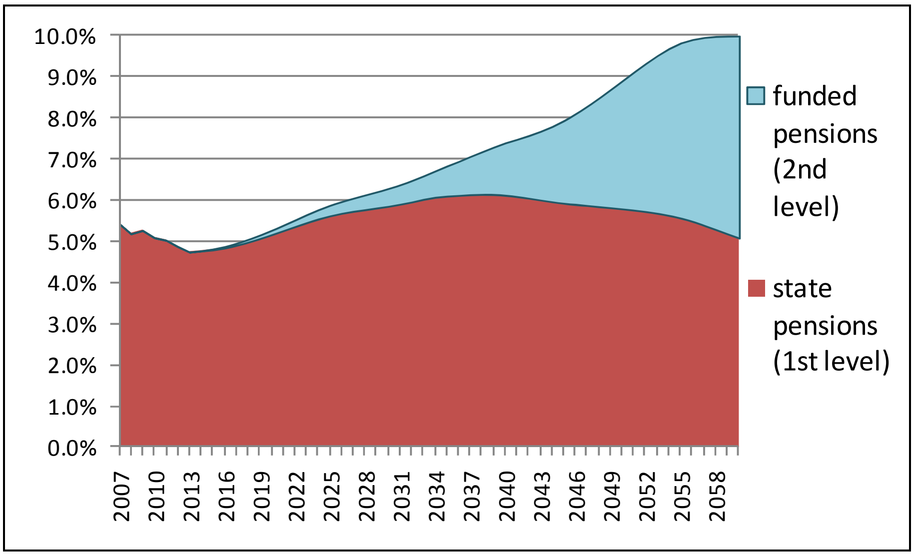

Chart 6.4. Pension expenditure against the GDP.

The economic crisis is a significant test for current pension system. Moreover, already now several short-term changes have been introduced to manage this difficult development period. Thus in the nearest future it is necessary to perform exhaustive analysis of the stability and further reform of the pension system.

As a result of demographic factors the health care expenditure increases gradually because higher costs refer to elderly people. In long term it is expected that the number and proportion of elderly and very old people will increase which may cause additional demand for health care services.

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. Currently these expenditures are comparatively small only 0.4% of GDP (2007) and it 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 society values.

The increase in health and long-term care expenditure may be affected more by technological progress, economic development and changes in the system of society values rather than demographic changes. Therefore these areas should be ready for additional costs. Therefore reforms aimed at optimisation of health care financing and organisational system are especially important.

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. Currently the number of children and youths stabilises, however during last 15 years the number of children decreased by more than 30%, and the education system should adapt to lower demand. It should be also noted that quality of education is a significant factor for the productivity increase which is important for long-term sustainability.

Estimates of the Ageing Report show that by 2060 the increase in ageing-related expenditure will be comparatively low – 0.4% of GDP, caused by reduced expenditure for state pensions and education, as well as increase in health and long-term care expenditure. However in so long time period it should be taken into account that assumptions are relatively uncertain. Therefore the Report also includes a number of sensitivity tests showing that certain unfavourable factors could have especially great impact on health and long-term care sectors, and the amount of total expenditure could increase even by 4-5% of GDP. Initial calculations of the impact of crisis on long-term sustainability also did not show notable impact – by approximately 1% of GDP larger expenditure in 2060, however it will be possible to carry out a wholesome crisis impact assessment only after the revival of economic growth.

In "Sustainability Report 2009" of the European Commission Latvia classified as a high-risk state regarding long-term sustainability of public finances. Since the estimated long-term impact of ageing on the budget expenditure increase in Latvia is one of the lowest among the EU Member States, this assessment is primarily based on the initial budget position which has deteriorated notably due to the economic crisis.[4] However Latvia clearly shows its commitment to move toward budget deficit reduction goal that will improve this assessment.

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[4] Sustainability assessment is based on indicator S2, taking into account both the initial budget position, as well as long-term ageing expenditure.

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.).

The draft law on central government budget and explanations thereof are submitted to the Cabinet in September. According to the Law on Budget and Financial Management, until October 1, the Cabinet of Ministers submits the annual draft law on central government budget (package of draft budget laws) for the next financial year, proposals for legislative amendments to ensure they correspond to budget requests, explanations of the draft law (package of draft budget laws) as well as the medium-term macroeconomic development and fiscal policy framework to the Parliament for adoption.

From 2010, it is planned that expenditures in the state budget law will be divided into the following two parts:

1) performance of basic state functions (except projects and activities co-financed and financed from the European Union policy instruments and other foreign financial assistance);

2) implementation of projects and activities co-financed and financed from the European Union policy instruments and other foreign financial assistance.

Hereinafter when preparing budget requests ministries should include in budget explanations the information about institutions which will ensure implementation of programmes (sub-programmes), beneficiaries (target public groups whose interests are covered, or institutions), as well as planned main activities, largest projects, activities or services provided in accordance with legislative acts which will be implemented next year. Explanations should also comprise information about the average number of positions and average wage.

To ensure transparency of budget expenditure, from 2010, it is intended that ministries and other central public administration institutions which are holders of shares will present to the Cabinet of Ministers an informative report on the plan and implementation of financial indicators, results and performance indicators of the state budget subsidies and grants which are allocated to capital companies with state capital share.

The Parliament is entitled to introduce amendments to the draft state budget law submitted by the Cabinet of Ministers. However the Law on Budget and Financial Management stipulates that decisions of the Parliament, the adoption of which involve expenditure unforeseen in the budget, should according to the Constitution also provide for resources to cover this expenditure. The draft state budget law (package of draft budget laws) adopted by the Parliament shall become effective in the beginning of the financial year. After the budget law is approved by the Parliament, it is signed by the President of the Republic of Latvia

If, at the beginning of the financial year, the annual state budget law has not entered into force the Minister of Finance shall approve state budget expenditure necessary for state operations, loans and borrowing limits on condition that expenditure per month does not exceed one twelfth of the appropriation granted in previous year.

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 seven sections: Local Government Basic Budget, Local Government Special Budget, Local Government Financial Equalisation, Local Government Borrowing, Guarantees and Long-term Liabilities, Activities of Social safety Strategy, Acquisition of WU Structural Funds, Implementation of Provisions Stipulated by Legal Acts and Amendments to 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 State central institution.

On October 3, 2009, the Cabinet of Ministers adopted the Cabinet Regulations No 1127 "Regulations on the Key Principles for Drafting and Submission of Budget Requests". The above Regulation set the key principles to be used by the ministries and other State central institution when preparing and submitting budget requests 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 State Central Institution 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 State central institution; reduced base; budget and development part);
- Cabinet Regulation No 594 of 28 August 2007 "Regulations on Using the State Budget Appropriation Reserve", providing for a reallocation procedure for the newly-established programme "Appropriation reserve" following the examination of proposals by ministries and other State central institutions;
- Cabinet Regulation No 1292 of 3 November 2009 "Procedure for Ministries and Other State Central Institution to Prepare, the Ministry of Finance to Review and the Minister of Finance to Approve the Requests for Reallocation of Appropriation Across Programmes, Sub-programmes and Expenditure by Economic Classification Codes". The Regulation provides that the Minister of Finance has the right to reallocate the appropriation approved for ministries and other State central institution across programmes, sub-programmes and expenditure by economic classification codes in the procedure prescribed by the Cabinet of Ministers and informing the Parliament about the re-allocation. The annual state budget law envisages provisions which the Minister of Finance shall comply with when deciding on re-distribution of the appropriation.

In the context of introducing the medium-term budgeting, the public administration needed to improve the performance management system. To continue mutual improvement of the system of institutional operation strategy and budget system, on June 18, 2008 the Cabinet of Ministers approved a Decree No 344 "On Basic Concepts of the System of Results and Performance Measures for 2008–2013". To ensure implementation of Basic Concepts the Cabinet of Ministers approved Regulation No 979 "Procedure for Implementation of the System of Results and Performance Measures" prescribing the construction of the System of Results and Performance Measures and procedure for ministries and central government institutions to plan, implement, supervise and account for their results and performance measures, as well as results and performance measures of their subordinated institutions, and to report on them. Also the above mentioned Regulation prescribes relation between the elements of current performance measure system and application of legal regulation issued beforehand. Thus the problem has been solved concerning the fact that until now legislative acts prescribed application of performance measures in the number of documents (operational strategies of various institutions, annual budget requests, policy planning documents, special annual decree of the Cabinet of Ministers etc.), as well as concerning to related requirements and procedures. As of November 17, 2009, the Cabinet of Ministers instruction no 16 "Methodology for Developing and Analysing the Results and Performance Measures of Ministries and Other State Central Institutions" setting methodology for developing and analysing hierarchy of results and performance measures.

In order to improve the policy and budgeting 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.

A legal act on medium-term budget objectives and priority directions is important to evaluate new policy initiatives submitted by the ministries according to priorities of the Government. However, taking into that funding for new policy initiatives in 2010 was not planned and keeping in mind the necessity to ensure fiscal consolidation measures, the development of the legal act on medium-term budget objectives and priority development directions was not topical in 2009.

Annex

Table 1a. Macroeconomic prospects

	ESA Code	2008	2008	2009	2010	2011	2012
		million lats	rate of change				
1. Real GDP	B1*g	8293.4	-4.6	-18.0	-4.0	2.0	3.8
2. Nominal GDP	B1*g	16243.2	9.9	-19.7	-8.8	-0.3	4.2
Components of real GDP							
3. Private consumption expenditure	P3	5601.3	-11.0	-22.0	-11.0	0.5	3.1
4. Government consumption expenditure	P3	1224.0	1.5	-9.0	-10.3	-4.0	0.8
5. Gross fixed capital formation	P51	2707.3	-13.2	-34.0	-12.0	3.0	7.0
6. Changes in inventories and net acquisition of valuables (% of GDP)	P52+P53		4.5	-1.7	0.8	1.3	1.2
7. Exports of goods and services	P6	3589.0	-1.3	-17.5	1.5	5.0	5.6
8. Imports of goods and services	P7	4953.9	-13.6	-35.0	-9.7	2.6	5.2
Contribution to real GDP growth							
9. Final domestic demand		-	-12.5	-27.3	-11.9	0.4	3.6
10. Changes in inventories and net acquisition of valuables	P52+P53	-	-0.6	-4.0	2.6	0.5	-0.1
11. External balance of goods and services	B11	-	8.5	13.3	5.2	1.2	0.3

Table 1b. Price developments

	ESA Code	2008	2008	2009	2010	2011	2012
		level	rate of change				
1. GDP deflator			15.2	-2.1	-5.0	-2.2	0.4
2. Private consumption deflator			15.6	3.0	-3.7	-2.8	0.0
3. HICP			15.4	3.5	-3.7	-2.8	0.0
4. Public consumption deflator			24.2	-6.0	-8.0	-3.1	-1.0
5. Investment deflator			13.7	-5.0	-3.0	-0.1	2.1
6. Export price deflator (goods and services)			10.2	-7.0	0.0	2.0	2.0
7. Import price deflator (goods and services)			12.0	-6.5	1.0	2.0	2.0

Table 1c. Labour market developments

	ESA Code	2008	2008	2009	2010	2011	2012
		level	rate of change				
1. Employment, persons		1124.1	0.5	-11.3	-5.6	-0.2	1.1
2. Employment, hours worked		1607800000	-2.2	-23.0	-3.6	1.8	3.3
3. Unemployment rate (%)			7.5	16.9	20.0	18.9	17.5
4. Labour productivity, persons			-3.3	-5.7	2.1	2.2	2.7
5. Labour productivity, hours worked			-0.6	8.6	0.1	0.2	0.5
6. Compensation of employees	D.1	6843.5	15.6	-18.8	-14.8	-0.4	4.3
7. Compensation of employees, lats		479	20.5	-5.0	-9.8	-0.2	2.7

Table 1d. Sectoral balances

% of GDP	ESA Code	2008	2009	2010	2011	2012
1. Net lending/borrowing vis-?-vis the rest of the world	B.9	-10.8	8.2	10.7	10.4	8.0
of which: - Balance of goods and services		-13.0	-1.6	2.9	4.2	4.5
- Balance of primary incomes and transfers		0.6	8.0	6.0	4.3	1.5
- Capital account		1.5	1.9	1.9	2.0	2.0
2. Net lending/ borrowing of the private sector	B.9	-6.7	18.2	19.2	16.4	10.9
3. Net lending/ borrowing of the general government	EDP B.9	-4.1	-10.0	-8.5	-6.0	-2.9
4. Statistical discrepancy		-1.8	-0.1	0.0	0.0	0.0

Table 2. General government budgetary prospects

	ESA Code	2008 million lats	2008 % of GDP	2009	2010	2011	2012
Net lending (EDP B.9) by sub-sector							
1. General government	S.13	-672.2	-4.1	-10.0	-8.5	-6.0	-2.9
2. Central government	S.1311	-722.0	-4.4	-6.2	-4.8	-2.7	-1.4
3. State government	S.1312						
4. Local government	S.1313	-203.5	-1.3	-1.5	-1.3	-1.0	-0.5
5. Social security funds	S.1314	253.4	1.6	-2.3	-2.4	-2.3	-1.1
General government (S.13)							
6. Total revenue	TR	5635.9	34.7	33.8	36.2	38.6	39.4
7. Total expenditure	TE	6308.8	38.8	43.8	44.7	44.6	42.4
8. Net lending/borrowing	EDP B.9	-672.2	-4.1	-10.0	-8.5	-6.0	-2.9
9. Interest expenditure	EDP D.41	124.8	0.8	1.3	2.4	3.3	3.2
10. Primary balance		-547.4	-3.4	-8.7	-6.1	-2.7	0.3
11. One-off and other temporary measures							
Selected components of revenue							
12. Total taxes (12=12a+12b)		3323.4	20.5	17.9	19.0	19.7	19.7
12a. Taxes on production and imports	D.2	1749.7	10.8	10.6	11.0		
12b. Current taxes on income, wealth etc	D.5	1571.1	9.7	7.2	8.0		
12c. Capital taxes	D.91	2.6	0.0	0.0	0.0		
13. Social contributions	D.61	1399.8	8.6	9.0	9.4		
14. Property income	D.4	167.2	1.0	1.6	1.2		
15. Other (15=16-(12+13+14))		745.5	4.6	5.4	6.6		
16=6. Total revenue	TR	5635.9	34.7	33.8	36.2	38.6	39.4
p.m.: Tax burden (D.2+D.5+D.61+D.91 – D.995)		4773.8	29.4	27.1	28.7	28.6	28.0
Selected components of expenditure							
17. Compensation of employees + intermediate consumption	D.1+P.2	3049.9	18.8	18.6	18.3	18.4	18.2
17a. Compensation of employees	D.1	1946.6	12.0	11.9	11.7	11.7	11.7
17b. Intermediate consumption	P.2	1103.3	6.8	6.8	6.6	6.7	6.5
18. Total social transfers (18=18a+18b)		1395.1	8.6	12.3	13.5	12.9	12.0
18a. Social transfers in kind	D.6311, D.63121, D.63131	85.4	0.5	0.9	1.1	1.1	1.1
18b. Social transfers other than in kind	D.62	1309.6	8.1	11.3	12.4	11.8	10.9
19.=9. Interest expenditure (incl. FISIM)	EDP D.41	124.8	0.8	1.3	2.4	3.3	3.2
20. Subsidies	D.3	149.2	0.9	1.1	1.1	1.0	1.0
21. Gross fixed capital formation	P.51	781.7	4.8	4.6	4.6	4.6	4.6
22. Other		808.1	5.0	5.9	4.8	4.3	3.4
23.=7. Total expenditure	TE	6308.8	38.8	43.8	44.7	44.6	42.4
Government consumption	P.3	3204.3	19.7				

Table 3. General government expenditure by function

% of GDP	COFOG code	**2007**	**2012**
1. General public services	1	4.0	6.6
2. Defence	2	1.5	1.2
3. Public order and safety	3	2.7	2.2
4. Economic affairs	4	5.0	6.9
5. Environmental protection	5	1.0	1.1
6. Housing and community amenities	6	1.3	0.6
7. Health	7	4.5	4.5
8. Recreation, culture and religion	8	1.8	1.5
9. Education	9	5.8	5.9
10. Social protection	10	8.4	11.9
11. Total expenditure (=item 7=26 in Table 2)	TE	35.9	42.4

Table 4. General government debt developments

% of GDP	ESA code	**2008**	**2009**	**2010**	**2011**	**2012**
1. Gross debt		19.5	34.8	55.1	59.1	56.8
2. Change in gross debt ratio		10.6	15.2	20.3	4.0	-2.3
Contributions to changes in gross debt						
3. Primary balance		-3.4	-8.7	-6.1	-2.7	0.3
4. Interest expenditure	D41	0.8	1.3	2.4	3.3	3.2
5. Stock-flow adjustment, of which:		6.4	5.2	11.8	-2.0	-5.2
- Differences between cash and accruals		0.2				
- Net accumulation of financial assets		7.3				
including privatisation proceeds		*0.1*				
- Valuation effects and other		-0.2				
p.m. implicit interest rate on debt		*9.3*	*5.5*	*6.3*	*6.0*	*5.7*
Other relevant variables						
6. Liquid financial assets		6.1				
7. Net financial debt (7=1-6)		13.4				

Table 5. Cyclical developments

% of GDP	ESA code	2008	2009	2010	2011	2012
1.Real GDP growth (%)	B1g	-4.6	-18.0	-4.0	2.0	3.8
2. Net lending of general government	B9	-4.1	-10.0	-8.5	-6.0	-2.9
3. Interest expenditure	D41	0.8	1.3	2.4	3.3	3.2
4. One-off and other temporary measures						
5. Potential GDP growth (%) (1)		0.8	-1.4	-0.8	1.0	3.2
contributions:						
- labour		0.4	0.4	0.4	0.4	0.3
- capital		2.9	1.1	0.7	0.7	0.8
- total factor productivity		-2.4	-2.9	-1.9	-0.1	2.0
6. Output gap		11.9	-6.9	-9.9	-9.0	-8.5
7. Cyclical budgetary component		3.3	-1.9	-2.8	-2.5	-2.4
8. Cyclically-adjusted balance (2-7)		-7.4	-8.1	-5.7	-3.5	-0.5
9. Cyclically-adjusted primary balance (8+3)		-6.6	-6.8	-3.3	-0.2	2.7
10. Structural balance (8-4)		-7.4	-8.1	-5.7	-3.5	-0.5

Table 6. Difference from previous update

	ESA code	2008	2009	2010	2011	2012
Real GDP growth (%)	B1g					
Previous update		-2.0	-5.0	-3.0	1.5	-
Current update		-4.6	-18.0	-4.0	2.0	3.8
Difference		-2.6	-13.0	-1.0	0.5	-
General government net lending(% of GDP)	B.9					
Previous update		-3.5	-5.3	-4.9	-2.9	-
Current update		-4.1	-10.0	-8.5	-6.0	-2.9
Difference		-0.6	-4.7	-3.6	-3.1	-
General government gross debt (% of GDP)						
Previous update		19.4	32.4	45.4	47.3	-
Current update		19.5	34.8	55.1	59.1	56.8
Difference		0.1	2.4	9.7	11.8	-

Table 7. Long-term sustainability of public finances

% of GDP	2005	2007	2010	2020	2030	2050	2060
Total expenditure	35.6	35.9					
Of which: age-related expenditures	13.0	13.2	12.3	12.4	13.5	13.8	13.6
Pension expenditure	5.9	5.4	5.1	5.2	5.9	5.8	5.1
Social security pension	5.9	5.4	5.1	5.2	5.9	5.8	5.1
Old-age and early pensions	5.1	4.8	4.7	4.8	5.5	5.5	4.8
Other pensions (disability, survivors)	0.8	0.6	0.4	0.3	0.4	0.3	0.3
Occupational pensions (if in general government)							
Healthcare	3.5	3.5	3.5	3.7	3.8	4.0	4.1
Long-term care	0.4	0.4	0.4	0.4	0.5	0.7	0.9
Education expenditure	3.3	3.7	3.1	3.0	3.2	3.1	3.3
Other age-related expenditures	0.0	0.2	0.2	0.2	0.2	0.2	0.2
Interest expenditure							
Total revenue	35.1	35.5					

% of GDP	2005	2007	2010	2020	2030	2050	2060
of which: property income							
of which: from pensions contributions	6.2	6.8	6.2	6.0	5.8	5.7	5.8
Pension reserve fund assets							
Of which: consolidated public pension fund assets (assets other than government liabilities)							
Assumptions							
Labour productivity growth	8.8	6.4	5.1	3.4	2.7	1.7	1.7
Real GDP growth	10.6	8.4	4.9	2.1	1.8	-0.1	1.1
Participation rate males (20–64)	82.4	85.6	85.1	84.4	83.5	80.7	83.6
Participation rate females (20–64)	71.9	74.9	75.3	75.5	75.4	72.3	75.8
Total participation rate (20–64)	76.9	80.0	80.0	79.8	79.4	76.5	79.7
Unemployment rate	9.0	6.5	4.9	4.9	4.8	4.8	4.7
Population aged 65+ over total population	16.5	17.1	17.4	18.6	22.2	29.6	34.4

Table 8. Basic assumptions of external environment [5]

	2008	2009	2010	2011	2012
Short-term interest rate (LVL) (annual average)	7.9	13.2	10.3	6.3	5.0
Long-term interest rate (LVL) (annual average)	6.4	12.4	11.0	9.0	6.0
USD/€ exchange rate (annual average) (euro area and ERM II countries)	1.47	1.39	1.48	1.48	1.48
Nominal effective exchange rate	1.1	2.1	-0.3	0.0	0.0
World, excluding EU, GDP growth	3.8	-0.4	3.8	4.1	4.0
EU GDP growth	0.8	-4.1	0.7	1.6	1.9
Growth of relevant foreign markets	7.0	-12.3	4.7	5.3	5.0
World import volumes, excluding EU	4.6	-12.6	4.6	5.0	5.0
Oil prices (Brent, USD/barrel)	98.5	61.3	76.5	80.5	86.0

[5] Technical assumptions