Convergence Programme of the Republic of Latvia 2011-2014

April 2011

FMProg_29042011_LV_Konvergence_programme_2011-2014_EN

Contents

1 Overall Economic Policy Framework and Objectives

Latvian Convergence Programme is a medium-term policy document which describes Latvian fiscal policy for 2011 – 2014 and is prepared based on conditions for implementation of the Stability and Growth Pact. Latvian Convergence Programme is focused on implementation of a strong and sustainable fiscal policy and ensuring macroeconomic stability. Given the fact that this year the European semester has started, the Convergence Programme is carefully structured to be consistent with the Latvian National Reform Programme and measures included therein.

Latvian Convergence programme also contains some measures that demonstrate commitment of Latvia assumed by the accession to the Euro Plus Pact, such as promotion of draft fiscal discipline law and amendments to the Constitution.

Regarding Latvian Convergence Programme of previous period on April 24, 2010 the EU Council approved a call for Latvia to take a series of measures to ensure sustainable convergence and successful participation in the Exchange Rate Mechanism II. In this context, the government has taken measures such as further fiscal consolidation, strengthening of fiscal administration, promotion of EU funds acquisition and economic growth. In general, actions of Latvia have been focused on successful implementation of the recommendations of the EU Council.

Likewise, after the excessive budget deficit procedure proposed by the EU Council on July 7, 2009, at the beginning of 2010 budgetary situation stabilizing measures were evaluated and they were found to be effective, as appropriate results have been achieved in reducing excessive budget deficit, as a result in February 2010 the EU Economic and Financial Affairs Council decided that measures related to excessive deficit reduction procedure are not needed.

The new Latvian Convergence Programme 2011 – 2014 is based on cautious macroeconomic development scenario, which was also used in the preparation of Amendments to the State Budget Law for 2011, in order to make further fiscal consolidation through sustainable and qualitative measures. Based on the macroeconomic development scenario and the need for further stabilization of the budget balance in the coming years, fiscal objectives for the next three years have been approved, i.e., to ensure the budget deficit in 2012 below 3%, but striving for the budget deficit at 2.5% of GDP, in 2013 below 1.9% of GDP and in 2014 below 1.1% of GDP.

These fiscal targets are an essential prerequisite for Latvia to implement its strategic goal – to adopt the euro as of January 1, 2014. To ensure compliance with all the accession criteria for the euro area, as well as to demonstrate the quality and sustainability of policies implemented, Latvia is strongly committed to implement counter-cyclical fiscal policy to maintain a stable and well-functioning financial sector, to ensure effective and transparent EU funds acquisition, to continue structural reforms in areas such as education, employment, management of national assets, public administration, business environment, public procurement, sustainability of social budget and other areas.

The stability of financial sector is a necessary pre-condition for the economic growth renewal. In 2010, financial stability risks diminished, and the situation in the financial sector as a whole has become more stable. Banks were able to absorb losses, to increase capital sufficiency level and improve their liquidity ratios. Step by step, banks decreased provisions for non-performing loans. By the end of 2010, the share of overdue loans continued decreasing. Similarly, the amount of deposits in lats in total deposits has increased, reflecting growing public confidence in the national currency and banks. To ensure future financial stability, legal framework for banking regulation, capital base and liquidity requirements for banks will be improved, and work will be continued on implementation of transformation plan of the state joint-stock company "Latvian Mortgage and Land Bank" and restructuring plan of joint stock companies "Parex Bank" and "Citadele Bank".

In addition, improvements in the economic and financial situation have created favourable conditions for the government to gradually return to international capital markets.

By the end of 2011 Latvia plans to successfully conclude the international loan programme by implementing the Latvian Economic Stabilization and Growth Revival Programme, and will continue to implement the medium-term courses of action set in the Latvian Strategic Development Plan for 2010 – 2013 within the framework of the following priorities: economic growth, social security and efficiency of public administration and services.

Latvian Convergence Programme 2011 – 2014 as a policy planning document has been approved by the Cabinet of Ministers, presented in and reviewed by the relevant parliamentary committees. The Programme and relevant recommendations provided by the EU Council will form the basis for further work at preparation of the State Budget Law for 2012.

2 Economic Outlook

2.1 Current Economic Development

After seven quarters in recession at the end of 2009 growth of Latvian economy renewed due to economic stabilization measures and internal devaluation, as well as favourable situation in foreign markets, increasing the demand for Latvian export goods and services. In the first quarter of 2010, compared with the previous quarter, seasonally adjusted GDP increased by 0.2%, in the second quarter – by 0.6%, in the third quarter – by 1.6% and in the fourth quarter – by 1.1%. In the third quarter, yearly growth also recovered and in the fourth quarter it reached 3.6%.

While the economic downturn is over, and it is expected that in 2011 GDP growth will reach 3.3%, there are a number of internal and external risks that may negatively affect future economic development of Latvia. If initially economic growth was mainly driven by exports, in future GDP growth should also be ensured by private consumption and business investment, while public consumption due to consolidation measures will continue to decline till 2012. The structure of economic sectors changes, resulting in a higher share of manufacturing, while inappropriate high share of construction and trade has begun to decline.

As the economic activity increases the labour market situation gradually improves. The share of job seekers according to the labour force survey data from 20.4% peak in the first quarter has decreased to 16.9% in the fourth quarter, and the registered unemployment rate has also reduced from 17.3% in March, falling to 14.3% at the end of the year. At the same time, due to rising global market prices and taxe increase, the inflation rate has begun to rise; further inflation growth is still constrained by the weak domestic demand.

As the confidence of investors in the Latvian economy gradually recovers, in 2010 tension in the financial market was greatly diminished. Lats interest rates in the interbank market have dropped below the euro rate level, and Latvian credit default swaps (CDS) has fallen sharply. Current account balance has shown one of the biggest adjustments as the deficit was substituted by the surplus which allowed decreasing private sector external debt, and improved economic and financial market situation has reflected in improved credit rating and rating outlook by the rating agencies *Standard & Poor's*, *Rating and Investment Information* and *Fitch Ratings*.

2.2 Macroeconomic Development Scenario

After substantial decline in GDP in 2009, the situation stabilized in 2010 and there were significant changes in the Latvian economy. The competitiveness of Latvia significantly improved, the share of domestic consumption decreased, while export share increased.

Macroeconomic development scenario assumes that from 2011 the Latvian economy returns to growth in annual terms, which will be determined by the competitiveness position that improved during the crisis and by consistent deficit reduction. This will enable Latvia to improve the attraction of investment to ensure further development of export sectors and export growth. Medium-term growth is mainly based on productivity growth, while the labour market will still show considerable surplus of labour supply.

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

Table 2.1. Growth and related factors

	EKS code	2010	2010	2011	2012	2013	2014
		mln, lats	Increase %				
1. GDP at 2000 prices	B1*g	6805.0	-0.3	3.3	4.0	4.0	4.0
2. GDP at current prices	B1*g	12735.9	-2.7	5.3	5.3	6.0	6.1
GDP by expenditure at 2000 prices							
3. Private consumption	P3	4526.2	-0.1	3.0	4.0	4.0	4.0
4. Public consumption	P3	989.4	-11.0	-1.5	-1.0	1.0	2.0
5. Gross fixed capital formation	P51	1361.0	-19.5	11.0	10.3	8.9	8.1
6. Changes in inventories and net acquisition of valuables	P52+P53		-130.4	-3.5	-3.5	-3.2	-0.1
7. Exports	P6	3516.8	10.3	5.1	5.0	5.0	5.0
8. Imports	P7	3680.1	8.6	6.1	6.0	6.1	6.1
Contribution to GDP growth							
9. Final domestic demand		-	-6.7	4.0	4.7	4.8	4.9
10. Changes in inventories and net acquisition of valuables	P52+P53	-	5.8	0.0	0.0	0.0	0.0
11. External balance of goods and services	B11	-	0.6	-0.6	-0.7	-0.8	-0.9

The most important factors limiting growth in medium-term will be limited credit growth and high debt level, high unemployment and imbalances in labour demand and supply, as well as low investment level in science and innovations.

2.2.1 Real sector

In 2010 GDP at constant prices decreased by 0.3%, but in 2011 growth by 3.3% is expected. In 2011 the sources of growth will be mainly output growth in manufacturing and export growth. Currently, industrial capacity levels are approaching pre-crisis level, therefore businesses will need additional investment to cope with further demand. It is expected that in 2011 private consumption will remain weak and its growth rate will be lower than economic growth. Despite the weak domestic demand, investment needs will boost imports and the contribution of net exports in 2011 will be negative. In medium term exports and investment will continue to facilitate growth, while private consumption growth will be limited by high unemployment and low wage levels.

GDP by Expenditure

Private consumption mainly depends on disposable income of households and their expectations on future income. Now the expectations of the households, as well as employment rates, have improved. However, in medium term, strong wage and employment growth which could increase household incomes significantly is not expected, while households' liabilities will remain at high level. Substantial recovery of credit growth that would allow consumption to grow faster than revenues is not expected as well. Consequently, in 2011 the private consumption growth will be lower than GDP growth; however, in medium term it will reach the same level.

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

	2009	2010	2011	2012	2013	2014
	actual		forecast			
GDP	-18.0	-0.3	3.3	4.0	4.0	4.0
Public consumption	-9.2	-11.0	-1.5	-1.0	1.0	2.0
Private consumption	-24.1	-0.1	3.0	4.0	4.0	4.0
Gross fixed capital formation	-37.3	-19.5	11.0	10.3	8.9	8.1
Exports of goods and services	-14.1	10.3	5.1	5.0	5.0	5.0
Imports of goods and services	-33.5	8.6	6.1	6.0	6.1	6.1

As a result of increase in general government budget deficit, public consumption decrease in 2009 was smaller than the total decline in economic output. However, in 2010 as a result of further budget consolidation measures the decline in public consumption has already exceeded the GDP decline. Implementation of further consolidation measures will push public consumption down also in 2012, stabilization will be reached only in medium term.

Gross fixed capital formation volumes are usually very sensitive to changes in the overall economy and confidence of investors. That was reflected in declining investment in 2009 and 2010 while positive trends were observed and the slowdown in investment stalled in the second half of 2010. Non-financial investment and foreign direct investment data indicate a growth in investment in manufacturing, real estate and commercial services, as well as transport and communications sectors. Starting with 2011 it is expected that investment growth will again be positive. In medium term investments will become one of the main sources of growth. Investment need is determined by production capacity utilization, which is already close to pre-crisis level. Attraction of investment in medium term will be driven by low unit labour costs, as well as the successful reduction of budget deficit.

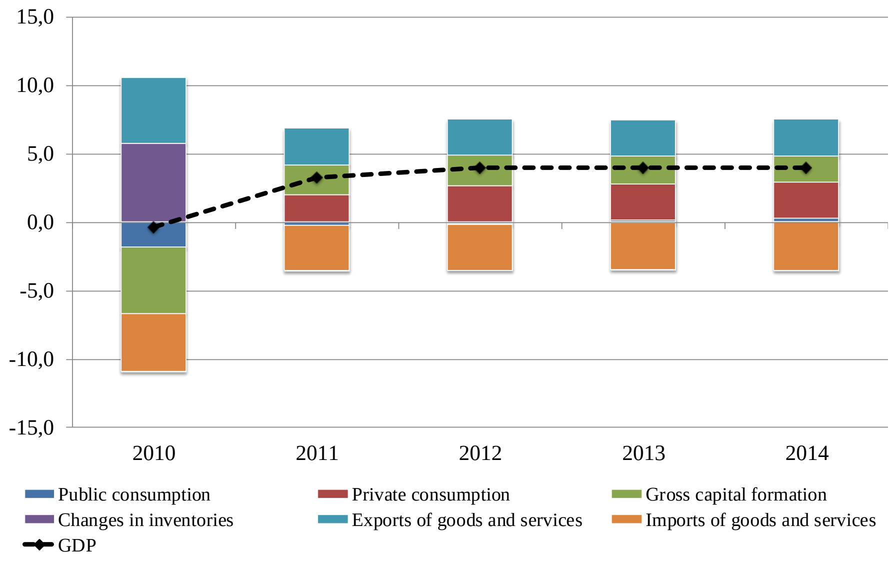

Fig. 2.1. Contribution of expenditure components on GDP, percentage points

In 2010 global trade volumes increased rapidly which enabled a rapid increase in Latvian exports. During the crisis, production costs reduced significantly, allowing companies to increase their exports not only because of growing external demand, but also because of improved competitiveness. In medium term, exports will continue to rise faster than GDP, but compared to 2010 growth will be moderate. It will be determined by limited production capacity and the need for new investment. But the need for investments and exports of raw materials will determine the increase in imports. In medium term, import growth will exceed export growth and trade balance will deteriorate.

GDP by Sectors

Among sectors in 2010 in general an increase was observed in manufacturing by 15.4%, wholesale and retail trade – by 3.3%, as well as transport and communications – by 3.0%. By contrast, construction fell by 24.2% and financial services – by 10.5%. In 2010 changes in economic structure continued and share of construction in GDP decreased from 6.1% to 4.6%, while the share of manufacturing rose from 9.9% to 11.5%.

In medium term it is expected that all sectors will return to positive growth, but the overall development of the industries will be determined by the export and private consumption developments. The continuing growth in exports will increase the share of export-oriented sectors - manufacturing and agriculture - in GDP, in turn, the share of financial services, real estate and commercial sectors may decrease. Medium term developments in construction sector will depend on investment in infrastructure; however, a significant increase in the share of construction industry is not expected. Moderate growth is expected in the transport sector, which will also depend on political relations with Russia, with transit playing a major role in the output. Trade, like private consumption as a whole, will be limited by the high unemployment and slow wage growth, which will not allow the sector growth rate to exceed the GDP growth. In public service sectors in 2011 and 2012 more cuts are expected due to the need for budget consolidation, but in the medium term the sectors will return to growth, however, this growth will be more moderate than the economy growth as a whole.

Inflation

Changes in the consumer price index in 2010 were affected by development in domestic market and changes in global prices. The domestic consumption still remained relatively low exerting downward pressure on prices, while the expanding global demand exerted upward pressure. In December 2010, compared with the previous year's corresponding month, the consumer price level rose by 2.5 per cent. The increase in prices was mainly caused by irising food prices which during the period increased by 8.0%, housing prices (including utilities) grew by 6.2%, while prices for passenger transport (including fuel) – by 7.2%. Core inflation[1] during this period was still negative, indicating annual decrease of 0.8 per cent. This shows a strong impact of changes in global prices on consumer prices in Latvia.

---

[1] Core inflation does not include changes in energy prices (electricity, natural gas, heating, solid fuel), fuel and unprocessed food (cereals, vegetables, fruits, fish, milk and eggs).

Assumptions about future changes in consumer prices over medium term envisage that there will be price adjustments in the global market, particularly food prices, which have soared at the end of 2010 and at the beginning of 2011. With the beginning of the next crop season, the average food price level will decline. In the energy sector the price level will be affected by increase in electricity tariffs in April 2011 and tax changes for natural gas starting from July 2011. The projections do not include fuel price fluctuations. Weak domestic demand will limit price increases for goods and services that are determined by domestic market. However, rising costs, particularly in the energy sector, will not allow prices to fall as well.

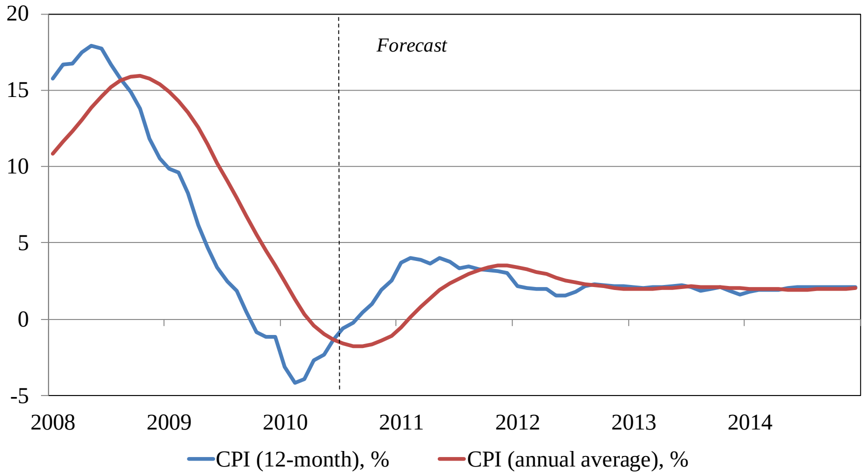

Fig 2.2. Consumer price changes in 2008-2014., %

Average annual inflation forecast for 2011 is 3.5%, however in 2012 inflation will stabilize at 2% and consumer price increase will remain moderate in the future.

The main upside risks are associated with sensitivity to changes in global commodity prices, as well as decisions on further consolidation of the general government budget by increasing tax rates or broadening the tax base. Tax changes for natural gas can cause revision of heating tariffs, since the prices are interrelated. Natural gas base tariff is tied to the nine-month average oil price index, and if there is no downward correction in global oil prices, there might be a necessity to review utility tariffs. In addition, by amending the State Budget Law for 2011 it was decided to increase excise tax on alcohol, tobacco and fuel by mid-2011.

In January 2011, consumer price index basket has been revised and updated, increasing the share of primary goods. The share of food, fuel and energy increased. Simultaneously prices of these goods and services also continued on an upward trend globally.

Labour Market

The population of Latvia decreases in average by 0.4 – 0.5% per year and in the beginning of 2011 it was 2.23 million. The decrease is mainly determined by the negative rate of natural increase, but in recent years emigration is of high importance. In 2010, compared with 2007, the number of emigrants has doubled and in the nearest years people will continue to leave the state for work abroad. Working age population decreases 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.

At the end of 2007 the employment rate peaked, but during the economic downturn the number of jobs and employed persons fell sharply, in the beginning of 2010 the unemployment rate reached its highest point during the crisis. The registered unemployment rate in March 2010 had risen to 17.3%, but the share of unemployed according to the labour force survey data in the first quarter of 2010 accounted for 20.4% of the economically active population. As the economic growth restored during 2010 the number of employed persons gradually started to raise again, the registered unemployment rate decreased from 17.3% in March to 14.3% in December and the share of unemployed in the fourth quarter decreased to 16.9% of the economically active population. Simultaneously with the creation of new jobs the unemployment level is decreased by emigration from the country, as well as increasing number of people who, after losing hope of finding a job, leave the job market.

In medium term employment will continue to rise; however, these changes will not be sharp, and return to the 2007- 2008 employment level in medium term is unlikely. GDP growth in the coming years will be mainly driven by the increase in productivity and working hours, while the number of employees will increase more slowly. After the rapid decline of employed persons in 2009 and 2010 by more than 16% in total, it is expected that in 2011 the number of employees will increase by 1.5% and in the coming years employment growth by 1.3% -1.4% per year is expected.

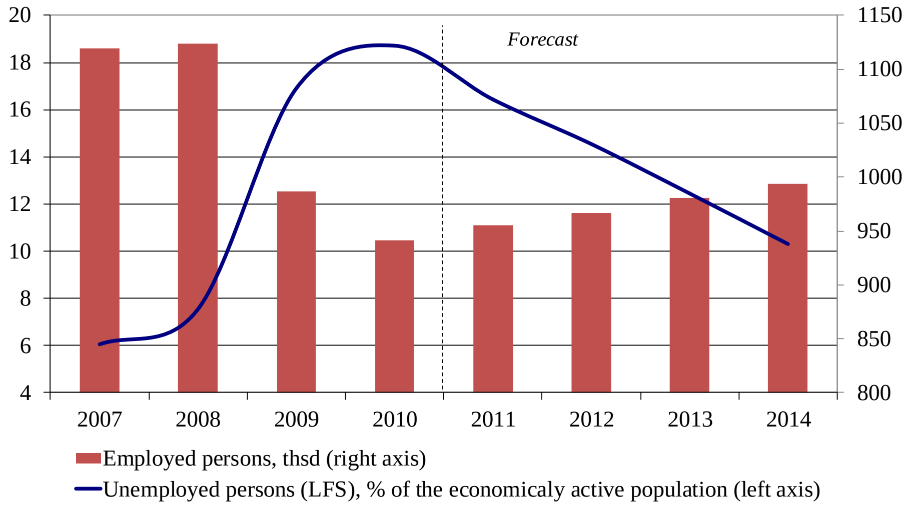

Fig. 2.3. Employment and unemployment in 2007-2014

With gradual rise of the employment the unemployment level in medium term will decline. It will be affected by diminishing working age population, while the proportion of economically active population, which in recent years was in slowly rising, will remain stable. As the overall unemployment rate declines, structural unemployment rate will remain relatively high, which together with potentially increasing population drain can lead to skill shortage in certain occupations and industries.

The economic crisis and economic stabilization measures implemented by the government, selecting the internal devaluation as a means to restore competitiveness, has initiated structural changes in the labour market. In recent years, proportion of construction workers sharply reduced increasing labour supply in industry and transport, thus reducing pressure on wages and enhancing competitiveness in these sectors.

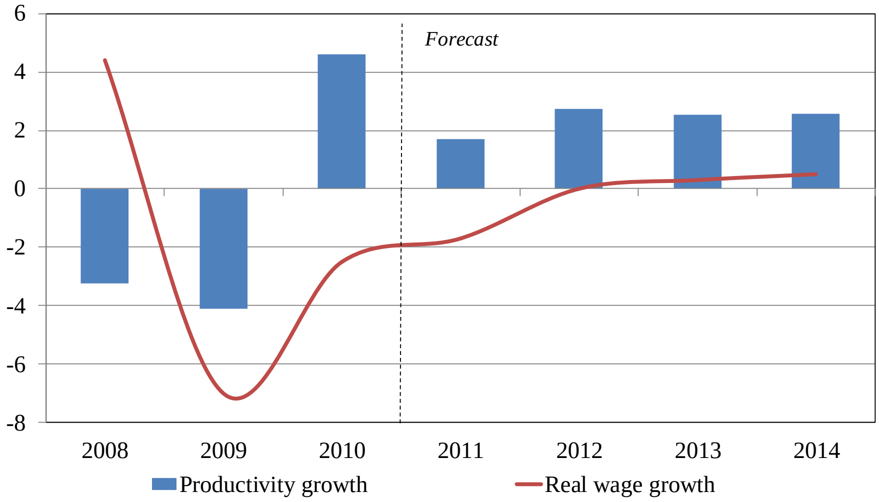

Fig 2.4. Productivity and actual wage rise in 2008 - 2014, %

Since 2010 productivity has been increasing, particularly in manufacturing, which will continue in the coming years. Since 2009 real wage growth has been lower than productivity growth stopping the negative trend which was observed in previous rapid economic growth period when wages and salaries grew faster than productivity and weakened external competitiveness of Latvia. From 2009 real wage growth has been negative and reduction in pay is expected also in 2011, while productivity growth rates will remain stable.

2.2.2 External Sector

In recent years there has been a significant adjustment in balance of payments – from the all-time high current account deficit in 2007 to a surplus in 2009. Slightly smaller current account surplus was observed in 2010 when the trade and services balance remained balanced, but the income account surplus fell as losses of foreign companies declined.

In 2010, compared with the previous year, the Latvian foreign trade situation has improved significantly. Economic structure has changed, switching to growth based on manufacturing and exports, capturing new foreign market niches and successfully competing with other countries. As consumption in the domestic market fell sharply, companies already in 2009 were forced to seek new markets and business partners outside the country. Together with the improving external environment and growing competitiveness it allowed companies to reduce costs and thereby increase productivity, it allowed the volume of exported goods to reach record levels in 2010.

In 2010 a significant growth in the manufacturing sector of Latvian economy was observed creating additional demand for imports, including for investment goods, energy resources and industrial raw materials, whereas in the second half of the year, as economic activity and domestic consumption improved, in the second half of the year growth of imports intensified and in 2010 total imports increased by nearly a quarter.

In 2011 the export growth will slow down as manufacturing capacity is approaching the peak reached previously and export growth this year will be more dependent on the growth of new investment in manufacturing. Import growth will decline together with the decline in export as domestic demand will remain low.

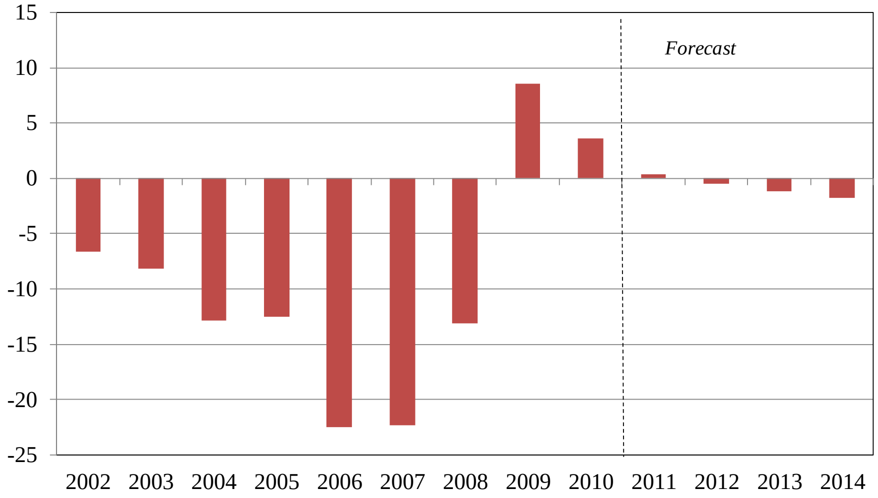

Fig. 2.5. Current account balance in 2002 - 2014, % of GDP

In 2011 decrease of current account surplus is expected, as result of current transactions between residents and non-residents will become more balanced – in 2011 around 0.4% of GDP, but in 2012 the current account balance will already be negative (-0,5% of GDP). It will be mainly determined by a worsening trade balance, because export growth will remain stable, but with recovery of domestic demand not only the import of intermediate goods will grow, but gradually – also consumer goods imports. In medium term, imports will grow faster than exports, which will be mainly determined by the inflow of foreign direct investment. As the economic situation will improve, investment income of non-residents will increase and income account in 2011 will return to deficit. In 2012 this process will continue and the income account deficit will still increase slightly. In current transfers account substantial changes are not expected. Overall, in 2013 – 2014 a small current account deficit is expected.

In 2010 the financial account, although at a lesser extent than in 2009, continued to reflect capital outflows, as the private sector reduced its foreign liabilities. This outflow was largely offset by the government foreign borrowings, increasing reserve assets of the Bank of Latvia. In 2010, following almost two-year period of decline non-residents' deposits started to rise as the confidence in the banking system was regained. The foreign banks' loan portfolio will continues to shrink in 2011 as well adversely affecting the financial account, however, a positive contribution is expected from the increased foreign direct investment.

2.4 Monetary and Exchange Rate Policy, Participation in the Exchange Rate Mechanism II

2.4.1 Monetary and Exchange Rate Policy

Medium-term monetary and exchange rate policy of Latvia is linked to the monetary integration plans – euro changeover 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 the Latvian economy to meet the convergence level envisaged in Maastricht criteria, and Latvia will participate in the ERM II till the euro changeover day. Latvia has set a goal to introduce the euro already in 2014. Supporting the economic stabilisation and sustainability ensuring policy implemented by the Government the Bank of Latvia will continue implementation of current fixed exchange rate policy till the euro changeover in Latvia.

To implement monetary policy effectively and without shocks to the financial sector the Bank of Latvia is adjusting monetary policy implementation tools to those used by the European Central Bank. The Bank of Latvia already uses the same indirect monetary policy tools based on free market principles as the ECB, and in future, following joining the EMU, it will be necessary only to review the role of separate tools in implementation of monetary policy and procedures.

In 2010, the global economic crisis and still weak and vulnerable global financial markets, including aggravation of financial stability issues in the euro area periphery countries, affected the Latvian economy and financial market at a lesser extent than in previous year. Significant fiscal consolidation and structural reforms which have been implemented in Latvia gained international approval ensuring gradual economic recovery.

In 2010 the Bank of Latvia conducted passive interventions on the foreign exchange market, buying euros and selling lats in net amount of 790.9 million lats (1 125.3 mln euro) by transaction date. These relatively large holding of lats accumulated in accounts of banks at the Bank of Latvia as banks were still cautious to grant new loans to economic agents. In order to reduce excess liquidity which at the end of the year exceeded 900 million lats (1 280.6 million euro) and to encourage lending, the growth rate of which was negative in 2010, the Bank of Latvia repeatedly cut interest rates – starting with March 24 the Bank of Latvia lowered the refinancing rate from 4.0% to 3.50%. On the same day a new tool was introduced - a 7-day deposit facility for, with 1.0% rate, while overnight deposit facility rate was reduced from 1.0% to 0.5%. Starting with July 24 the 7-day deposit facility rate was reduced to 0.5% and the overnight deposit facility rate was reduced to 0.375%, starting with November 24 these rates were subsequently reduced to 0.375% and 0.25%.

Lats exchange rate was close to the upper limit of unilateral fluctuation band, while EUR/LVL exchange rate fluctuations in 2010 were lower than in previous three years. Excess liquidity in lats decreased lats short-term money market rates below EURIBOR rates.

It is expected that excess liquidity will be observed more or less also in the coming years since banks will continue to be cautious in lending, but the increase in currency in circulation will be limited. Accordingly, the Latvian short-term money market indices will be close to EURIBOR rates, but long-term rates will gradually decrease.

Table 2.3 Forecasts of the Bank of Latvia (average annual % rates)

	2010	2011	2012	2013	2014
Short-term rate	2.0	1.1	2.0	2.2	2.4
Long-term rate	10.3	6.3	6.0	5.2	5.0

The Bank of Latvia does not forecast developments of nominal exchange rates. Assuming that nominal exchange rates of individual currencies remain at the same level (January 2011), in 2011 the nominal effective lats exchange rate would be 0.5% lower than the average in 2010; in 2012 change against the previous year - 0%.

2.4.2 Measures within the Framework of the Exchange Rate Mechanism II

Latvia continues implementation of measures in ERM II commitment areas. In 2009-2010 due to measures taken and other factors the economic situation stabilized and there are significant changes in the Latvian economy. The competitiveness of Latvia improved significantly, share of domestic consumption in the economy decreased, but export share increased. The macroeconomic development scenario assumes that from 2011 the Latvian economy will return to growth in annual terms, which will be determined by the competitiveness position which improved during the crisis and consistent deficit reduction. This will facilitate inflows of investments in Latvia to ensure further development of export sectors and export growth.

The Latvian government continues to implement structural reforms and set new directions for reforms. The government has identified three major directions of structural reforms: competitiveness of the state, development of public administration system and balanced social system. In order to promote national competitiveness it is expected to introduce a series of measures that will improve the business environment, for example, by improving access to financial resources, increase support for acquisition of foreign markets, implement support measures for micro-enterprises, to support development of innovative businesses, ensure building of scientific capacity, as well as continue implementation of measures to combat the shadow economy.

After the fast decrease in the number of employed persons in 2009 and 2010 in total by more than 16% it is expected in 2011 that the number of employees will increase by 1.5%, but the share of unemployed will fall to 16.4%. In medium term it is expected to implement various measures to achieve reduction of structural unemployment, reforms in higher and vocational education will continue to ensure supply of education according to economy needs.

Real wage growth, as in the previous two years, will be lower than productivity growth, increasing the competitiveness of Latvia.

In 2010 the average consumption price level was negative – 1.1%. As the economy exits recession, in 2010 the deflationary period was over and consumer prices have started to rise. With increasing global food and energy prices, as well as raising consumption tax, it is expected that the annual average inflation in 2011 will reach 3.5%. According to forecasts the inflation will stabilize at 2% in 2012 and consumer price increase will remain moderate in medium term. Downward pressure on inflation will be exerted by the low domestic demand.

To ensure sustainability of price stability changes in the tax policy that would facilitate growth of prices are not planned in the coming years. Also it is planned to limit public sector wage rise in the coming years. Negotiations are held with social partners on the possibility of not increasing the wage fund to ensure that wage increase does not exceed productivity growth.

Latvia, by approving the State Budget Law for 2011 and by providing additional measures of fiscal consolidation, expects that in 2011 the general government deficit will not exceed 4.5% of GDP. Implemented fiscal consolidation measures amounted to 2.6% of GDP. In addition, Amendments to the State Budget Law for 2011 envisage a legislative norm on the possibility to make necessary additional contingency appropriations in amount of 0.2% of GDP. In general, Latvia has established a free fiscal space in amount of 1.6% of GDP till the fiscal target set for 2011, i.e. ensure the general government deficit (according to ESA95 methodology) below 6% of GDP. In order to strive for the deficit target of 2.5% of GDP (according to ESA95 methodology) the government is committed to incorporate additional consolidation measures in amount of 150-180 million lats (213.4 to 256.1 mln euro) (1.1 - 1.3% of GDP).

By the end of 2010 the general government debt reached 5 693.6 million lats (8 101.3 mln euro) or 44.7% of GDP. By implementing sustainable fiscal policy and complying with fiscal discipline, in medium term the Maastricht criterion for the amount of debt (60% of GDP) will be strongly adhered to.

Financial stability risks have abated and the situation in the financial sector as a whole has stabilized. Capital adequacy and liquidity ratios are high. Banks have returned to profitability. Banking sector liquidity ratio at the end of March 2011 was 65.1%. Once the amount of loan loss provisions decreases and profitability of banks improves, banking sector capital adequacy ratio and Tier 1 ratio[2] have increased reaching 15.2% and 12% by the end of March, (end-December - 14.6% and 11.5%, respectively).

For the third consecutive month, the banking sector as a whole has been profitable and at the end of March the profits amounted to 33.5 million lats (47.7 mln euro) (in contrast to last year's loss of the respective period in the amount of 133.3 million lats (189.7 million euro)). There are signs of stabilization in relation to the credit quality, however borrowers' credit risks still remain high, and restoration of lending would require sustained economic growth. Although the tipping point in credit quality has been achieved, deterioration in borrowers' solvency and the need for provisioning cannot be excluded yet.

At the end of March, 73.3% of bank loans were without delayed payments. Total past due loans after the increase observed in January and February (by 1.4% and 2.3%) fell again in March – by 6.2% or 244.4 mln lats (347.7 million euro). Since the beginning of the year stock of such loans in total shrank by 2.7%, or 103 million lats (146.6 million euro). In the first quarter of 2011 the stock of loans having payments over 90 days past due also continued declining (by 4.7%) and the share of such loans

[2] Own capital included only capital elements of the highest quality: paid share capital and reserves, as well as undivided profit of previous years

in the loan portfolio at end-March was 18.7% (end-December – 19%). The balance of loan loss provisions continued to decline moderately, i.e. during the quarter in total shrank by 1.7% or 27.3 million lats (38.8 mln euro) and the end of March still were 1.6 billion lats (2.3 billion euro) or 11.5% of banks' total loan portfolio.

At the end of March 2011, the share of restructured loans in the banking sector's total loan portfolio amounted to 20.1%, while 15.5% of the total banks' loan portfolio were in work-out process (end of December – 19.9% and 15.3%).

In order to boost clearance of banks' balance sheets from bad loans and write-off of lost loans, in 2010 a number of legislative amendments were introduced. Significant improvements have been made in insolvency procedures, making them simpler, faster and more efficient, including more accessible insolvency process for individuals. Changes also have been made in the tax laws, including the introduction of a two-year temporary exemption from personal income tax liabilities resulting from individual's debt write-off, if certain conditions are met. Amendments to the Law on Enterprise Income Tax allow credit institutions, their subsidiaries and individual companies, without increasing the amount of taxable income, transfer debt to another person (assign) at the actual market value, as well as corporate taxpayers, under certain conditions, can make provisions for impaired loans (up to 3 years), without increasing taxable income by the same amount in the saving year.

3 Impact of Structural Reforms on the Economy and Public Finances

In order to achieve objectives of the general government budget, while ensuring the conditions for economic growth in medium term, the Latvian government continues to implement structural reforms and set new directions for reforms.

In summer of 2009 a Reform Management Group was established, for the Government together with social partners and NGOs to discuss the national budget preparation process and public sector structural reforms. The Reform Management Group is chaired by the Prime Minister and it is composed of line ministers, representatives of social partners – the Employers' Confederation of Latvia and Association of Free Trade Unions of Latvia, the Latvian Chamber of Commerce and Industry, Latvian Association of Local and Regional Governments, Head of the Parliamentary Budget and Finance Committee and others.

While working on the structural reform agenda for medium term, the Reform Management Group has identified three major directions for structural reforms: promotion of the competitiveness of the state (economy), development of public administration system (management), balanced social system (social sector).

During the period from 2011 – 2014 the structural reforms included in the Latvian Convergence Programme will have a direct impact on the Latvian economy and public finances. The structural reforms included in the Convergence Programme focus both on improving growth and efficient use of budgetary resources ensuring reduction of the budget deficit. However, given that the directions of the reforms envisage only partial implementation of specific measures, it is not possible to calculate complete and accurate impact of reforms on the economy and public finances. Also, some reforms which, for example, are related to the increase in retirement age or minimum insurance record, have a long-term effect and during the Convergence Programme period they will not have any impact, however these reforms are essential to long-term development.

Regarding promotion of national competitiveness the Convergence Programme includes reforms which should be viewed in conjunction with the Latvian National Reform Programme, with total EU funding for 2011 – 2013 2.0 billion lats (2.8 billion euro). It is expected that the measures implemented within the framework of the Convergence Programme and National Reform Programme will contribute to increase in investment and private consumption, which in turn will affect the annual GDP growth by 1.5% and will improve the budget balance by 0.4%.

It should be noted that the government's commitment to implement structural reforms is an integral part of the international loan program. The chapter on planned structural reforms was prepared on the basis of information provided by the State Chancellery and line ministries.

3.5.1 Promotion of Competitiveness of the State

In order to promote national competitiveness it is necessary to improve the **business environment**, which should focus on investment attraction and innovation.

- Access of companies to financial resources. The measure aims to provide financial resources to start and develop business. The measure envisage to continue provision of support to companies in 2009 – 2015 to improve their competitiveness and boost growth (loans to increase business competitiveness and growth, individual guarantees to increase business competitiveness, short-term export guarantees, risk capital instrument, seed capital and start-up capital facilities). The measure will increase access to finance, will promote creation of new businesses, acquisition of business skills, development of business environment, and will assist in entering new markets and strengthening of business positions in existing markets. The support will be provided in total to 900 merchants who will have access to EU structural funds and state budget resources in amount of 164.8 million lats (234.5 million euro);
- Support for entering new markets. The measure aims to increase Latvian export volumes and diversify export markets. During the period 2010 - 2015 direct export support services will be provided to entrepreneurs (training, consulting, seminars on foreign markets and opportunities for cooperation, assistance in finding partners – organisation of individual business visits, contact points, trade missions, business forums, support for participation in exhibitions, etc.). The network of foreign economic representations will also be extended (in 2011 it is planned to open 4 new representations), support will be provided to merchants to implement foreign marketing activities (including organization of national stands in foreign exhibitions). Envisaged EU co-financing for the measure in 2010 - 2015 is 17.4 million lats (24.8 mln euro). As a result, consultations will be provided to 530 Latvian companies on issues related to external markets, and support will be provided in looking for business partners, and 170 national merchants will be assisted in organization of stands in international exhibitions in foreign countries;
- Support measures for micro-enterprises. The measure aims to encourage formation and development of new, competitive micro, small and medium-size businesses, thereby supporting the creation of new jobs. The measure will be implemented in 2009 - 2015 by implementing the Start Programme (till 2015), granting loans and providing integrated support to business start-ups and newly established businesses – consulting, training and loans and grants for start-up, as well as providing start-up support services for new businesses within the Business Incubators (till 2014). As a result of the measure each year 270 jobs will be created (saved), 1800 new entrepreneurs will be trained and 600 new jobs will be created;
- Support for development of innovative merchants. The measure aims to increase the number of innovative enterprises. In 2010 - 2015 provision of support to businesses developing new products and technologies, as well as the projects on introduction of new products and technologies into production will continue. In 2011 conditions will be developed for a new support program “Technology incubator” and its implementation will start. The measure will increase the output and

export amounts in manufacturing industry, high-tech service sector, increase private sector investment in research and development (R&D), as well as increase turnover of and number of employees in support businesses. In total support will be provided to 300 companies, private sector funding in amount of 240.0 million lats (341.4 million euro) will be attracted, as well as financing of EU structural funds and the Norwegian financial instrument;

- Forming of long-term cooperation platform for entrepreneurs and scientists. The measure aims at establishing a framework for more effective cooperation between scientists and entrepreneurs, while improving research infrastructure and supporting collaborative research. During the period from 2009 - 2015 support will also be provided to joint research by entrepreneurs and scientists in competence centres and operation of 8 technology transfer contact points in universities will be supported. The measure will increase private sector investment in research and development (R&D), as well as increase turnover and number of employees in support businesses. In total it is planned to attract private sector funding in amount of 22.0 million lats (31.3 mln euro), as well as EU structural funds;
- Combating shadow economy. The measure aims at the reduction of the shadow economy and promotion of fair competition by implementing appropriate measures in 2010 - 2013. To make the operation within the shadow economy as disadvantageous as possible, but operating in legal economy – as advantageous as possible, by easing transition to the legal economy and improving communication between public administration and society, administrative requirements will be simplified which will create financial and administrative savings for entrepreneurs, companies in difficulties will be assisted to promote recovery of their business and operation in the future, and controlling the functions and tasks will be optimized shifting resources to monitoring of fraudulent operators. The measure will decrease the amount of shadow economy, will promote fair competition between operators within a sector, and will raise public awareness of the use of taxes paid.

In order to achieve quality and international competitiveness of educational institutions, as well as to link higher and vocational education with labour market demand, **education system** should be reformed.

- Optimization of educational institution network. The measure aims at increasing quality and availability of general and vocational education by optimizing the number of institutions, their placement in regions and by their differentiation. The measure will be implemented in 2009 - 2011 mostly by eliminating or merging schools, as well as by transferring institutions to local governments. The measure will contribute to efficient use of all types of resources (including the national budget), raising the quality and availability of general and vocational education;
- Modernisation of higher education. The reform is aimed to consolidate resources of higher education and science and ensure their efficient

use, while maintaining access to higher education, as well as to improve the competitiveness of study programmes. The reform will be implemented in 2011 - 2013, when it is planned to improve higher education funding mechanism by introducing a funding model based on performance indicators. It is also planned to examine at least 550 accredited programmes from quality, adequacy of resources and sustainability aspects, and to ensure development of new, innovative and interdisciplinary study programmes. The reform will increase efficiency and quality of studies and research, ensure compliance of qualifications and skills with the labour market requirements.

Strengthening of **fiscal discipline** and maintaining of fiscal sustainability in medium term is essential for national competitiveness to promote confidence of international investors in the financial system and creditworthiness of the state.

- Strengthening of fiscal discipline. The measure aims at ensuring sustainability of public finances. By 2014 it is planned to fully complete and complement legislation in fiscal discipline field (Fiscal Discipline Law, amendments to the Law on Budget and Financial Management, binding medium-term framework law). The measure will ensure long-term stability of public finances and contribute to compliance of budget deficit and national debt with Maastricht criteria and the Stability and Growth Pact. In addition the measure will raise awareness of people about the need for fiscal discipline to ensure national competitiveness and sustainability of social security. [See Clause 9.3]

3.5.2 Development of Public Administration System

One of defined directions was modernisation of the **public administration system** with a view to establishing a more effective and efficient public administration.

- Development of e-governance and e-services. The measures aim to improve the effectiveness of public administration processes by providing better access to public services for citizens and companies. During the period from 2011 till 2014 it is planned to promote complete electronic data and document transfer between institutions, consolidation and centralization of standard national IT services, development of cooperation between the national information systems. It is planned to refuse registration certificates, permits and operating licenses issued in paper form, as well as to ensure the use and development of centralized electronic procurement system. As a result of the measures companies and people will be able to access public administration services in more simplified, faster, remote manner, the number of people and companies who use the Internet for cooperation with state and local government institutions will increase, expenditure will decrease and government procurement processes will become more transparent;

- Introduction of “one-stop agency” principle in provision of state and local government services. The measures aim to improvement of state and local government service delivery by developing service access points in person and electronically through the development of uniform, people-oriented service culture that allows to meet people’s needs in one place, even if several institutions are involved in the provision of particular service. Work on a one-stop agency principle was launched in 2009 and it is planned to continue till 2014. The measure will reduce the administrative burden by promoting good governance and access of companies and people to public services. By creating single customer service centres, where in one place state and local services will be provided, will prevent duplication of costs. For example, the measure of the Ministry of Finance envisages till 2014 to reduce the number of institutions and agencies involved in the management of EU structural funds and Cohesion Fund by creating one EU fund administration institution;
- Further optimization of functions of public administration institutions. The measure aims at increasing the efficiency of public administration by reviewing functions of institutions. Work on the so-called functional audit was initiated in 2009 and will continue till 2014. As a result of the functional audit support functions in the public administration are being centralized (accounting, personnel, IT), functions are being transferred to another institution or the institution is liquidated. In total, in medium term state budget expenditure will be reduced significantly, and the number of public administration employees of the total number of employees will also decrease, as a result productivity of public administration employees will increase;
- Development of new model for management of state and local government capital companies. The measure aims at effective management of shares in state and local government companies. The measure envisages in 2011 to evaluate whether public persons need to continue to operate as merchants, distorting the market in areas where there is competition, as well as to evaluate possibilities to sell the shares. Measure will lead to a new model for management of state and local government capital companies.

3.5.3 Balanced Social System

Structural reforms in the **social field** reflect the need for development of a balanced social system by revising social protection criteria and enhancing targeted support measures.

- Sustainability of social insurance system. The measure aims at ensuring stability of social security system in medium and long term. The measure provides for restructuring of social insurance system expenditure to adjust to demographic trends and ensure sustainability of the system. The following major changes are planned:
    - raising retirement age gradually from 2016 every year by half a year and reaching 65 years in 2021;

- starting from 1st January, 2012 supplemental payments to the newly granted old-age and disability pensions will not be payed;
- increasing the minimum insurance period up to 15 years, beginning with 2016 (together with the retirement age increase), providing the right to state-guaranteed (minimum) pension, if the insurance period is not less than 20 years starting with the 2021;
- freezing of pension indexation until December 31, 2013.

As a result of these changes the situation in the state social security budget will improve, participation in the labour market will increase, as well as the burden on the social security system will decrease.

- Improvement of active labour market policy measures. The measure aims at ensuring effectiveness of active labour market policy measures. The measure will be implemented in 2011 - 2013 when it is planned to introduce "training vouchers" scheme in training of unemployed persons, increasing efficiency of supported employment (wage subsidy) measures, introduction of special support measures for young people – for unemployed persons to try to work in practice and for volunteer work. Also it is planned to develop a concept for paid temporary public works (in 2011) and implement it (in 2012) for gradual cancellation of the measure "Work practice with stipends in municipalities" at the end of 2011. Measures will lead to reduced high risk of structural unemployment and increased employment. In medium term it is planned to allocate mainly EU structural funds in amount of 50.4 million lats (71.7 mln euro) for the measures.

In order to ensure sustainability of the health care system, the government also plans reforms in the **health protection** field.

- Optimization of the network of health care institutions. The reform aims at increasing efficiency of health care institutions in order to ensure sustainability of the health care system. During the reform period 2010 – 2014 the following is planned:
  - strengthen primary health care as a cost-effective and comprehensive health care level, i.e., involvement of the second nurse in GP practice ensuring that the nurse serves patients independently, as well as introduction and maintenance the GP consultation phone. The measure will improve the care of chronic patients, will encourage patients to arrive for preventive examinations, and will ensure that patients after GP working hours and on holidays may receive telephone consultations in case of acute illness or exacerbation of chronic disease. In 2011 quality criteria for GP work will be introduced, thereby improving results of primary health care services, as well as improving access to GP services;
  - increase in efficiency of day hospitals and cost-effectiveness of provided services. The measure envisages developing cost-

effective health care services by setting the scope of health care services provided by day hospitals, by determining precise clinical indications for treatment in day hospitals and limitations on the treatment duration. The measure will increase the amount and activity of health care provided by day hospitals and increase the amount of health care services provided in day hospitals;

- develop the network of care hospitals (beds). The measure defines the number and location of care hospitals (beds). The measure will decrease the duration of treatment of acute patients and medical treatment expenses. Also services of care hospitals will be provided closer to the patient's place of residence.

▪ Improving mechanism for financing of health care institutions. The reform aims at ensuring effective use of health-care resources. During the reform period 2010 – 2014 the following is planned:

  - determine working hours and funding for injury care centres. In 2011 the measure envisages to ensure efficient operation of injury care centres and changes in the financing according to the workload. The measure will provide more efficient utilization of health care resources, the workload of emergency medical service will be reduced. Patients will be able to get timely and valuable assistance closer to their place of residence;

  - improve hospital financing mechanism. The measure provides for development of hospital funding mechanism to ensure that the amount of funding allocated to hospitals varies depending on compliance with the requirements (the quality and cost-efficiency). Within the framework of the measure, requirements for hospitals will be developed defining the number of specialists per 24 hours and division by specialties at different levels of hospitals; operating principles for receiving-rooms in hospitals; patient-care steps that are implemented within the framework of hospitalization – acute hospitalization, treatment, rehabilitation; provision of certain types of services in regional hospitals (such as stroke unit, rehabilitation). As a result health care resources will be used more efficiently by developing health care services which will be financially and geographically more accessible to patients. Equal access to the state budget-funded health care services will be ensured for all citizens.

4 General Government Budget Balance and Debt

4.1 Fiscal Policy and General Government Budget Balance

4.1.1 Budget Execution

The general government deficit target for 2009 is 10.0% of GDP, for 2010 – 8.5% of GDP and for 2011 – 6% of GDP.

The general government deficit target for 2009 was initially set 10.0% of GDP, however according to actual execution the general government deficit for 2009 is lower – 9.7% of GDP according to ESA95 methodology. Taking into account that an additional impact on the deficit was given by government investments in financial institutions, the general government deficit, without these budget expenditures, in 2009 was 8.6% of GDP.

In 2010 the general government deficit is 7.7% of GDP, which is by 0.8% of GDP less than the general government deficit target - 8.5% of GDP. Also in 2010 significant negative effect on the general government deficit was given by government investments in financial institutions which in total increased the deficit by 2.3% of GDP; as a result the budget deficit for 2010 is now estimated at only 5.5% of GDP.

In determining deficit targets relatively conservative macroeconomic scenario was applied, as well as by implementing fiscal policy more successfully than has been previously planned, Latvia, through effective fiscal consolidation measures of high quality, was better prepared to meet general government deficit targets in respective years. It should also be noted that in 2009 and 2010 changes in the general government deficit estimate were also influenced by review of ESA95 methodology adjustment, for example, the impact of state-owned greenhouse gas emissions trading has been excluded according to the Eurostat’s latest guidelines and funds received in the budget from EU funds and their use were modified according to monthly displacement method.

On December 21, 2010 the Saeima adopted the budget for 2011, which provided for the general government deficit of 5.4% of GDP, well below the deficit target 6.0% of GDP. On April 14, 2011 the Saeima approved the Amendments to the State Budget Law for 2011 reducing the general government deficit to 4.2% of GDP, however, given that the budget law provided the possibility of increasing additional contingency appropriations, the budget deficit estimate for 2011 is 4.5% of GDP. In total, the budget for 2011 comprises consolidation measures in amount of 350 million lats (498 million euro), which will allow meeting of budget deficit targets. For more detailed information about budget consolidation activities for 2011 see Clause 4.1.3.

4.1.2 Fiscal Policy Goals for the Coming Period

The most important fiscal policy goal and challenge for Latvia recently and in coming years is fiscal consolidation to decrease excessive budget deficit while ensuring sustainable development of the Latvian economy and restoring confidence in public finances.

The fiscal policy goal for 2012 is to prepare a budget which would ensure the general government deficit not exceeding 3% of GDP (according to ESA95 methodology), while aiming for deficit target of 2.5% of GDP, to support the commitment to fiscal discipline and ensure debt sustainability. It is expected that in 2013 the general government deficit will not exceed 1.9% of GDP and in 2014 – 1.1% of GDP (according to ESA95 methodology). Meeting these targets will prevent excessive budget deficit and allow meeting the Maastricht budget deficit criterion in a sustainable manner, making it an essential basis of Latvia’s opportunities to introduce the euro in 2014, which is the Latvian economic stabilization and growth recovery programme exit strategy.

4.1.3 Fiscal Consolidation

In 2010 fiscal consolidation was carried out in amount of 507.5 million lats (722.1 million euro), inter alia, within the framework of the fiscal consolidation budget revenues were increased by 262.9 million lats (374.1 mln euros) and expenditures were reduced by 244.6 million lats (348 mln euros), including state budget expenditures – 200.3 million lats (285 mln euros), local government budget expenditures – 44.2 million lats (62.9 mln euros).

In order to reach the budget deficit target for 2011 consolidation was carried out in amount of 350 million lats (498 million euro). To achieve it the Parliament approved the State Budget Law for 2011 in December of 2010 and Amendments to the State Budget Law for 2011 on April 14, 2011. Through the fiscal consolidation it is expected that in 2011 the general government deficit will not exceed 4.5% of GDP.

In order to achieve a general government deficit which in 2011 is less than 6% of GDP, following consolidation measures were implemented:

- **On revenue side (1.8 % of GDP):**
    1) increased revenue from value added tax (VAT), by increasing both standard and reduced VAT rates, as well as reducing the categories eligible for the reduced VAT rate;
    2) increased employees’ social security contributions;
    3) increased tax on private vehicles and company vehicles used for private purposes;
    4) introduced financial stability fee and fee for non-banking businesses providing consumer credit services;
    5) doubled real estate tax;
    6) increased excise duty and reduced product categories eligible for tax relief;
    7) increased dividend pay-out ratio in state-owned enterprises and maintained social security contribution rates in state-funded pension scheme at 2% level.

- **On expenditure side and reduction of net borrowings (0.8% of GDP):**
  1) reduced personnel and remuneration expenditure in public administration;
  2) reduced appropriations compared to 2010 in a number of areas, including health expenditure, social programmes and defence expenditure;
  3) reduced subsidies for general education, funding for innovative educational programmes and reduced grant to cover losses of rail service providers.

Through fiscal consolidation measures in amount of 2.6% of GDP and by providing a norm in the Amendments to the State Budget Law for 2011 for the possibility to increase additional contingency appropriations by 0.2% of GDP, Latvia has created a fiscal space of 1.6% of GDP in order to be protected against potential increased fiscal, economic and social risks caused by macroeconomic processes, and thus contributing to general government budget deficit targets.

Table 4.1. Fiscal space, % of GDP

	Execution in 2010	**State budget 2011 plan**	**State budget 2011 plan after amendments**
Balance, % of GDP	-7.7	-5.4	-4.2
Increase in contingency appropriations, % of GDP	0.5	0.4	0.2
Contingency safety reserve	-	-	0.1
Deficit target, % of GDP	-8.5	-6	-6
Fiscal space, % of GDP against deficit target	**+0.3**	**+0.2**	**+1.5**

Overall, during the period from 2008 till 2011 consolidation measures have been taken with the fiscal impact amounting to 16.6% of GDP, of which about 6.7% of GDP consists of actions taken on the revenue side, in turn, measures on the expenditure side as a whole accounted for about 9.9% of GDP (see Fig. 4.1).

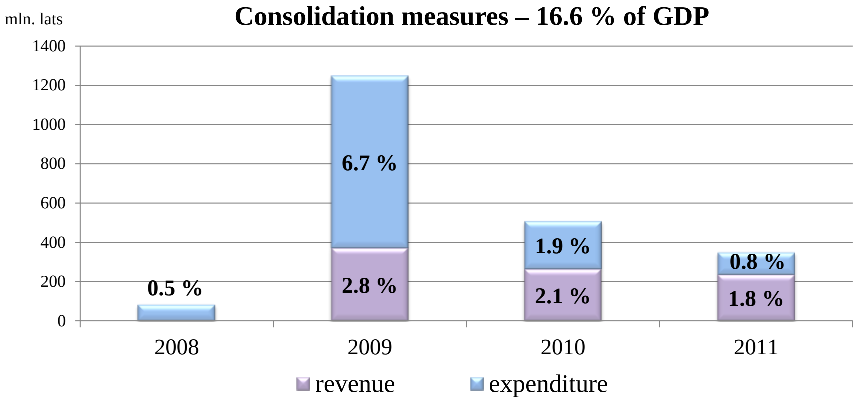

Fig. 4.1.att. Fiscal consolidation in 2008 - 2011, mln lats and % of GDP

Taking into account the fiscal policy implemented up to now, including Amendments to the State Budget Law for 2011, the general government budget deficit, without any additional structural and consolidation measures, in 2012 is projected 3.9% of GDP, while in 2013 and 2014 – 2.6% of GDP and 2.4% of GDP (see Fig. 4.2).

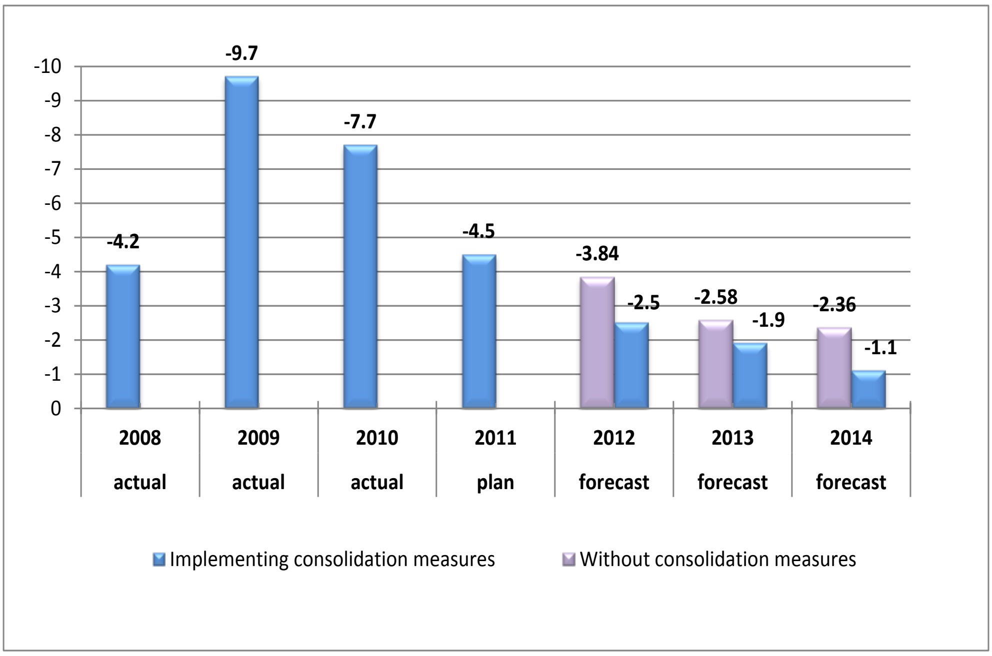

Fig. 4.2. General government budget balance (% of GDP)

In order to achieve the budget deficit target 2.5% of GDP in 2012, additional fiscal consolidation measures are planned in amount of 150 to 180 million lats (from 213.4 to 256.1 million euro) (respectively 1.1 and 1.3% of GDP). By taking additional fiscal consolidation measures commitment to fiscal discipline, sustainability of debt management and ability to meet Maastricht criteria in a sustainable way is demonstrated. A stronger focus on reaching the general government deficit target in 2012 is additionally supported by the commitment to the budget deficit of 4.5% of GDP in 2011.

4.2 Medium-term Objective and Structural Balance

Not necessarily the actual budget balance reflects the results of government's fiscal policy. The budget may also be affected by factors that are associated with cyclical economic development. For example, in good economic development conditions tax revenues may be higher, while in poor conditions - budget revenues decline more rapidly and expenditures increase.

In order to assess more accurately the state of public finances, budget balance is defined in structural terms excluding economic cyclical fluctuations and impact of one-off measures.

In order to facilitate formation of fiscal policy according to cyclical economic development, the Stability and Growth Pact requires Member States to set the medium-term general government budget balance target in cyclically adjusted terms, as well as for euro area and ERM II countries there is an additional restriction on setting the medium-term budget balance target – medium-term target in Member States with high growth potential and low debt level should not exceed 1% of GDP deficit, and in countries with low growth potential and high level of public debt it should be close to balance or in surplus.

Table 4.2. Cyclical development

% of GDP	ESA code	**2010**	**2011**	**2012**	**2013**	**2014**
1. GDP growth at constant prices	B1g	-0.3	3.3	4.0	4.0	4.0
2. Actual budget balance	B9	-7.7	-4.5	-2.5	-1.9	-1.1
3. Interest expenditure	D41	1.5	1.8	2.0	2.1	2.4
4. One-off and other temporary measures		-2.3				
5. Potential GDP growth		-3.6	-1.6	0.5	1.9	2.6
contributions:						
- labour		-1.8	-1.2	-0.4	0.0	0.2
- capital		-0.3	-0.1	0.1	0.3	0.5
- total factor productivity		-1.4	-0.3	0.8	1.6	1.9
6. Output gap		-10.3	-5.1	-1.5	0.5	1.8
7. Cyclical budgetary component		-2.9	-1.4	-0.4	0.1	0.5
8. Cyclically-adjusted balance (2-7)		-4.9	-3.1	-2.1	-2.0	-1.6
9. Cyclically-adjusted primary balance (8+3)		-3.3	-1.3	-0.1	0.1	0.8
10. Structural balance (8-4)		-2.6	-3.1	-2.1	-2.0	-1.6

Potential growth[3] rate of the Latvian economy after the crisis has changed significantly, indicating significant changes in the economic structure.

Before the crisis, the main contributing factor was the growth of capital, but capital inflows were considerably exaggerated, allowing large amounts of money flow into non-productive segments of the economy characterized by declining total factor productivity (hereafter – the TFP) already since the beginning of 2005. Counterproductive sector development, including formation of real estate bubble, cannot bring added value in the future, which could offset repayment of borrowed capital, while not slowing down economic development. The economic structure, which formed on the basis of high money supply, was able to exist only at the continuous capital inflows. In the result of the financial crisis capital inflows in the Latvian economy fell sharply, thus limiting significantly the ability of inefficient market segments to develop, such as the construction industry, related companies, as well as enterprises oriented towards high level of consumer purchasing power.

3 Potential GDP is an indication showing economic output at optimal use of labour and other resources. Potential growth is calculated using Cobb–Douglas production function.

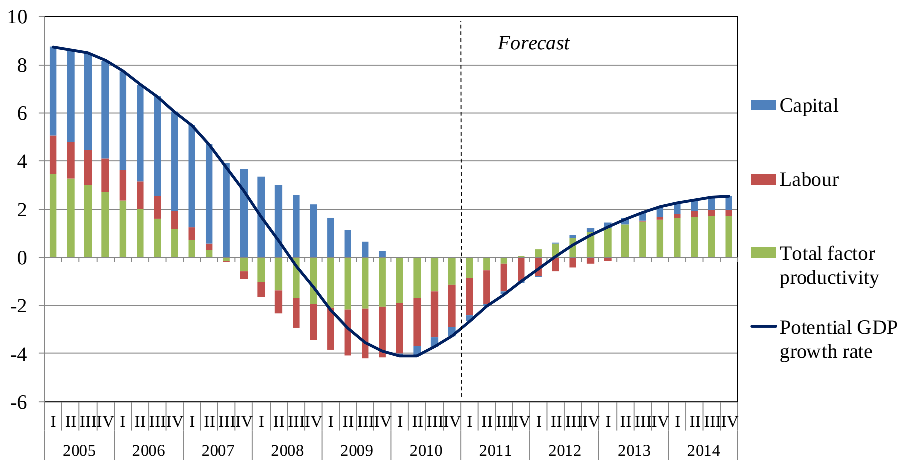

Fig. 4.3. Factor contribution to potential growth in 2005 - 2014, %

The medium-term macroeconomic development scenario does not provide a rapid inflow of investment in the Latvian economy, thus the capital stock contribution to potential growth is relatively low. Therefore, with the economic recovery the future growth base will mostly focus on efficiency improvement, as evidenced by the increase in total factor productivity growth. By contrast, the labour market adaptation period to the new economic structure is more gradual, bounded by labour supply and demand mismatch. During the crisis period structural unemployment increased significantly, reduction of which requires additional investment in labour re-training, or investment in producing capital that could respond to qualification of resources in the labour market.

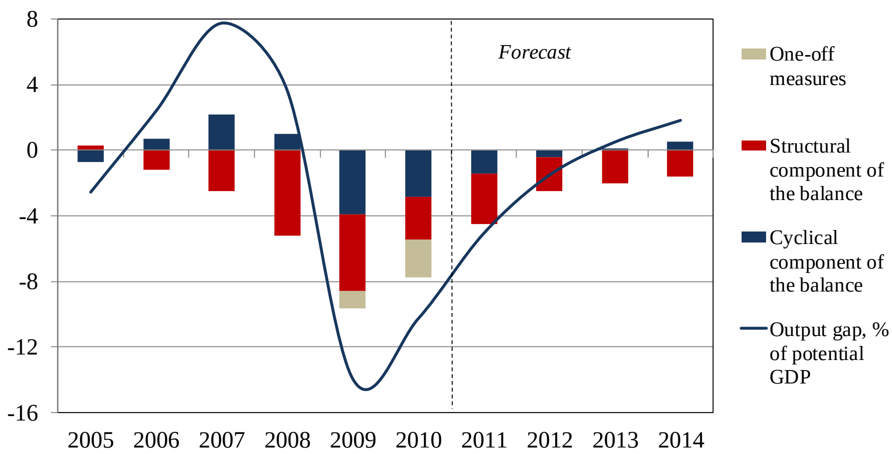

Fig. 4.4. Output gap and general government budget balance by components in 2005-2014, % of GDP

During the period from 2006 till 2008 Latvia had a positive output gap, reaching peak in 2007. Due to rapid economic growth, there was a substantial increase in tax revenues, which improved the actual budget balance. By contrast, the structural budget balance[4] during this period deteriorated increasingly. According to estimates of the Ministry of Finance the largest negative output gap (14.0% of GDP) was achieved in 2009, mostly driven by the economic and financial crisis. The economic

---

[4] Assumptions: 1) budget sensitivity according to the EC estimates in 2005; 2) one-off measures in 2009-2010 are government investments in financial institutions.

crisis increased substantially both actual and structural deficits, and also forced to revaluate structural position of previous years. It is forecasted that real gross domestic product located below the potential level will continue until 2013. During the period from 2009 till 2012 the cyclical budgetary component will range from -3.9% to -0.4%. By contrast, from 2013 the cyclical budgetary component will be positive.

If the impact of growing interest expenditure (from 1.5% of GDP in 2010 to 2.4% of GDP in 2014) is not taken into account, the budget balance would improve even more rapidly, which is shown by the cyclically adjusted primary budget balance indicator.

4.3 Debt Development Trends in Medium Term

By the end of 2010 the general government debt amounted to 5 693.6 million lats (8 101.3 million euro) or 44.7% of GDP. The general government debt level is mainly affected by the central government debt.

The central government debt management policy is aimed at providing necessary financial resources for refinancing of central government debt liabilities, financing of the central government budget execution and provision of liquidity reserve at the lowest possible costs, restricting financial risks and taking into account development of the Latvian economy, capital market and financial system which focuses on the joining the euro area in medium term. Central government debt portfolio and borrowing management targets, basic principles and objectives within the framework of the debt management in medium term are established by the Latvian central government debt management strategy, which provides for compliance with optimum parameters of the central government debt portfolio structure regarding currency composition of debt, maturity profile, duration and optimum proportion of fixed interest rates in the central government debt portfolio.

The amount of borrowing and central government debt level in medium term are determined by the amount of total financing requirement, which consists of funding necessary for government budget execution, refinancing of central government debt liabilities and provision of liquidity reserve in respective period.

Within the framework of the international loan programme from 2008 till the end of 2010 in total 3.1 billion lats (4.4 billion euro) has been received – slightly more than half of the total amount initially allocated to the programme (5.3 billion lats (7.5 billion euro)). According to the agreements funding of the international loan programme is provided for financing of general government financing needs (including financing of the central government execution, refinancing of the central government debt) and ensuring stability of financial sector. The assistance received within the programme since mid-2009 provided an opportunity to maintain a reserve of financial resources in the Treasury accounts at the Bank of Latvia in amount of ~ 10% of the GDP, which was a significant factor to prove solvency of the state, calm down fluctuations in financial market and regain confidence of investors during the period, when governmental borrowings possibilities in the financial markets were limited, taking into account the sharp economic downturn and series of Latvia's credit rating downgrades.

Although in 2010 the financing received within the framework of the international loan programme remained a major source to cover the financing need, however, taking into account improving country's macroeconomic indicators and financial reserve in the Treasury's accounts, in 2010 smaller than possible amount of funding was requested within the framework of the international loan programme. A significant share of funding (1.3 billion lats (1.9 billion euro)) was treated as a possibility to borrow concluding respective agreements with Nordic countries.

Current central government debt structure consists mostly of financing received within the international loan programme and the loans taken within the framework of the programme shall be repaid starting from 2012 (see Fig. 4.5 and 4.6).

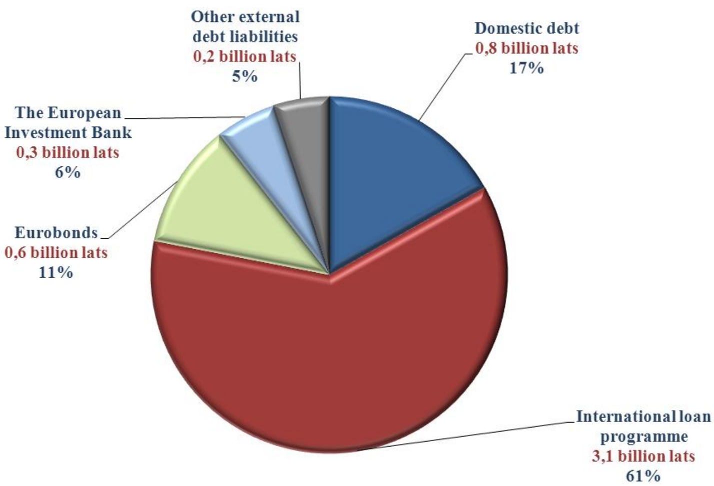

Fig. 4.5. Central government debt structure (end of IQ 2011)

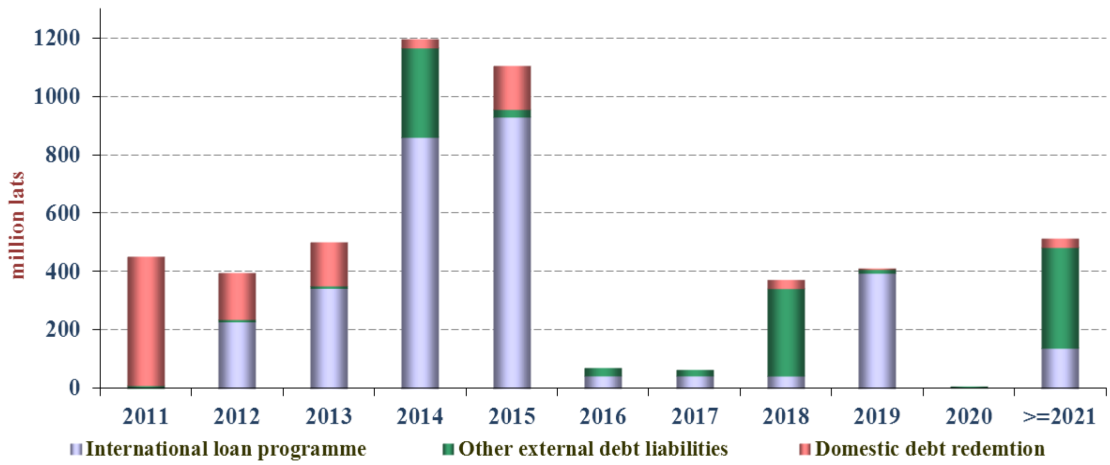

Fig. 4.6. Central government debt repayment profile (liabilities outstanding as of April 1, 2011, nominal value)

Although so far the international loan programme provided important support to ensure the country's creditworthiness, but in the medium and long term it is planned to cover general financing needs by borrowing activities in domestic and international financial markets, as well as using the resources available at the Treasury's accounts.

Taking into account consistently implemented fiscal consolidation, economic and financial sector stabilization measures, as well as financial reserve available to the government, both local and foreign investors consider such development of the situation as very positive, as reflected in significant decrease in the domestic money market rates and interest rates of domestic government securities starting already in the last quarter of 2009, reduction of Latvian credit default swap rates, as well as increased investors' interest in investments in the medium-term and long-term government securities.

As the situation in the domestic financial market stabilized and investors' confidence was restored, in 2010 the Treasury supplemented the offer of government's short-term (six-and twelve-month) T-bills with two, three and five, as well as a ten-year T-bonds already in 2011.

Focusing the offer of the Treasury mainly on longer-term securities reduced the country's domestic debt refinancing risk and ensured that borrowing rates are fixed (especially in the second half of 2010) at historical lowest levels. Thereafter, if the market situation remains stable and positive economic developments continue, it is planned to attract financing in the domestic financial market mainly by medium and long-term debt securities thus increasing the proportion of lats loans in the debt portfolio according to the Latvian central government debt management strategy. Short-term T-bills (with maturity less than one year) auctions are planned to be used primarily as a liquidity management and domestic financial market maintenance tool.

In order to avoid debt refinancing risks in the medium term and ensure timely provision of conditions for refinancing of government external debt liabilities (including international loan programme funding received) in 2014 and 2015 (see Fig. 2), borrowing activities in international financial markets will be gradually started already in 2011, by organizing regular (annual) public issues of sovereign debt securities and ensuring diversification of investor base (in Europe, USA and Asia), as well reaching optimal level of borrowing rates according to Latvia's credit rating.

Gradual starting of borrowing activities on international financial markets and accumulation of required resources to ensure repayment of external debt liabilities in 2014 and 2015 sets the government debt upward trend till 2014 and its gradual decline from 2015 (see Fig. 4.7).

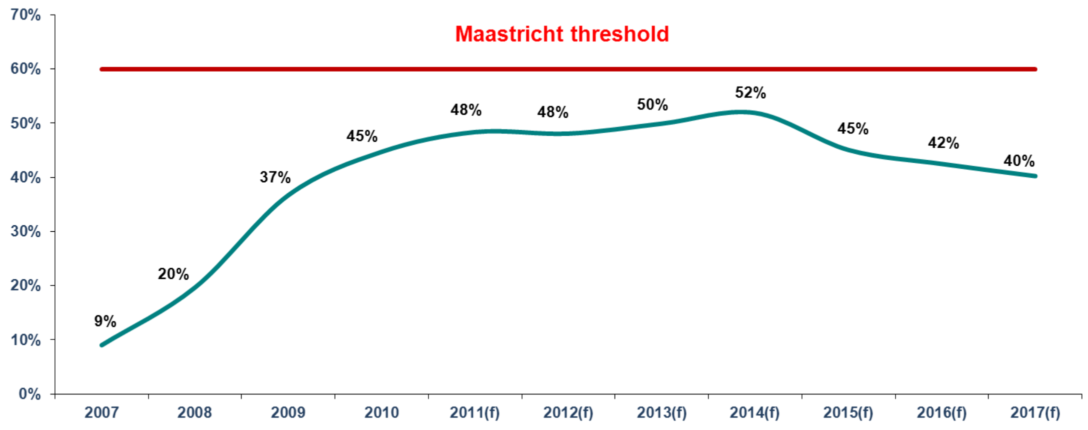

Fig. 4.7. General government debt development trends (% of GDP)

By implementing a sustainable fiscal policy and adhering to fiscal discipline, as required by the strategic commitment of the government to join the euro area in 2014, the Maastricht debt criterion (60% of GDP) in medium term will be strongly complied with.

4.4 Progress in Reduction of Excessive Budget Deficit

Regarding the Latvian Convergence Programme for previous period the EU Council asked Latvia to perform series of measures to ensure sustainable convergence and a smooth participation in the Exchange Rate Mechanism II. In this regard, the government has taken measures such as further fiscal consolidation, strengthening of fiscal management and promotion of economic growth. Overall, we believe that measures taken by Latvia have been focused on the successful implementation of the recommendations of the EU Council.

Using relatively conservative macroeconomic scenario, as well as by implementing fiscal policy more successfully than has been previously planned, Latvia, through effective fiscal consolidation measures of high quality, was better prepared to meet general government deficit targets in all target years, especially in 2011 when Amendments to the State Budget Law general government budget deficit estimate is 4.5% of GDP. According to the EU Council recommendations Latvia in the time period from 2009 till 2011 on average per year has implemented fiscal consolidation measures in amount of 5.4% of GDP, which is more than 2.7% of GDP set in EU Council recommendations.

To strengthen public finance management by improving the budgetary system, as well as by strengthening expenditure control, Latvia since 2009 has taken several important steps in this area:

- In order to build closer cooperation between the Ministry of Finance and the Saeima Budget and Finance (Taxation) Committee on budgetary matters, the Minister of Finance shall inform continuously the Saeima Budget and Finance (Taxation) Committee on the budget planning and execution;
- In view of rapid economic changes in the country, the Minister of Finance has the right to update the medium-term forecast of the macroeconomic situation and state budget revenue projections for medium term more than once a year;
- The Cabinet of Ministers has the power to determine additional conditions regarding state and local government budget planning and execution, as well as the Minister for Finance is entitled to delay for a specific period or reduce allocations to ensure mitigation and prevention of increased fiscal, economic and social risks caused by macroeconomic processes and ensure achievement of fiscal criteria set by international commitments;
- The Minister of Finance, under certain conditions, has the right to make the reallocation to ensure, if necessary, swift reallocation of state budget appropriations;
- In order to ensure implementation of the best practice in the fiscal discipline and economic growth field, the Ministry of Finance developed and in October 2010 submitted to the Cabinet of Ministers the draft Fiscal Discipline Law and amendments to the Constitution of the Republic of Latvia. The Ministry of

Finance intends to submit the draft Fiscal Discipline Law along with any amendments to the Constitution to the Parliament till end-November 2011 (see Clause 7.3.).

- The prepared draft Fiscal Discipline Law provides for preparing the medium-term budget framework law (Framework Law) for medium term. It will serve as a tool for sustainable fiscal policy planning and implementation in practice (see Clause 7.4.).

In Latvia fiscal policy has been implemented in accordance with EU Council recommendations and in 2012 it will meet Maastricht deficit criterion (less than 3% of GDP).

4.5 Medium-term Budget Development Scenario

To ensure compliance with Maastricht criteria and introduce the euro in 2014, the Parliament has asked the government in preparation of draft state budget laws for 2012, 2013 and 2014 to ensure that fiscal consolidation measures are implemented and the general government budget deficit, according to the European System of Accounts methodology in 2012 is less than 3.0% of GDP, in 2013 does not exceed 1.9% of GDP and in 2014 does not exceed 1.1% of GDP. It should be noted that the government's goal is to strive for budget deficit of 2.5% of GDP in 2012 in order to ensure compliance with the Maastricht deficit criterion.

In striving for deficit target for 2012, the government has carried out an initial assessment of the consolidation measures total 150-180 million lats (213.4 – 256.1 million euro), or 1.1 – 1.3% of GDP. Estimated consolidation amount will be revised in August 2011, when actual macroeconomic indicators and information on tax revenue performance will be available. The following consolidation directions have already been evaluated:

- on revenue side about 0.5% of GDP will be obtained by improving tax collection, implementing property tax reform, as well as by continuing implementation of a comprehensive strategy to fight the shadow economy;
- on expenditure side the public sector wage fund will be reduced by about 0.5% of GDP, state subsidies (including to the International Airport "Riga") will be reduced, measures to ensure sustainability of the state special budget will be implemented, and state co-financing to social protection measures in municipalities will be reduced (or the possibility to shift more of the personal income tax to the central government will be considered), as well as local government borrowing possibilities will be limited, such as for completion of infrastructure projects, for taking over vocational schools, investment projects of boarding schools and social programmes of local governments.

In order to achieve a final agreement on the already-designed fiscal consolidation directions and to develop additional consolidation measures to achieve the deficit target in 2012, the government has committed by mid-August 2011 to incorporate in the draft State Budget Law for 2012 fiscal consolidation measures which mainly will concentrate on expenditure cuts, thus ensuring fulfilment of the inflation criterion in 2012. It is expected that the list will contain elements from consolidation measures considered in 2011 (recommendations of the IMF, EC and World Bank, which were not included in the State Budget Law for 2011). Consolidation directions will include measures for rationalization of the social benefit system and improving the sustainability of the pension system, which in general will focus on the long-term stability of the social security system. In addition to the State Budget Law for 2012 would exclude a provision that allows the Parliament in the budget year to allow additional increase in contingency appropriations up to 0.2% of GDP, thus reducing potential shift from the deficit target. Draft State Budget Law for 2012 will be presented to the Parliament at the end of September 2011.

5 Sensitivity Analysis and Comparison

5.1 Macroeconomic Scenario Risks

Performance of macroeconomic scenario in 2011 – 2014 will be greatly affected by further development of external environment. Global growth still may be at risk of possible turbulence in the global financial system, financial sustainability of individual countries and debt servicing costs and raw material prices in the world.

In addition to external environment risks the performance of macroeconomic scenario will be affected by internal factors – possibilities of companies to attract and carry out investment projects to increase production capacity, lending development, impact of budget consolidation and other factors that directly affect the investment risk ratings, interest rates and confidence indicators.

Macroeconomic risks, which will determine the economic development during the programme period, can be divided into negative and positive. The macroeconomic development scenario is based on conservative assumptions about the increase in external and internal demand and takes into account both internal and external risks.

<u>Negative risks:</u>

- Financial system stability risks will still remain in Europe, which could negatively affect the real economy. These risks are reinforced by fiscal sustainability problems in several EU countries.
- Further increase in global food and energy, as well as domestic prices would reduce disposable income of population and negatively affect consumption.
- Consolidation measures implemented in several EU Member States may negatively affect the development of Latvian exports.
- Political or social instability risks may have a negative impact on the economy – by affecting the investment environment and households, businesses and trading partners' confidence indicators.
- Negative effects of budget consolidation may be stronger than expected – they may have more impact on overall economic activity level, especially in the labour market, tax revenue, household and business confidence indicators.

<u>Positive risks:</u>

- The most important positive risk refers to more rapid increase in investment, including attraction of direct foreign investment, which would ensure rapid growth in medium term.
- Similarly to 2010, better than currently projected development of external environment (particularly in the largest Latvian commercial partner countries) would give a positive impetus to the further growth of Latvian exports.
- In 2010 the positive impact of export growth on domestic demand may prove to be stronger than currently expected.

- Faster increase in lending volumes remains as a positive risk allowing companies to make additional investments to increase production capacity. This would have a positive effect on export and investment volumes. Similarly, lending may have a positive impact on private consumption.
- Currently export growth is based not only on increasing demand in trading partner countries, but also Latvian export share in these countries which is caused by greater competitiveness. If this trend continues, export growth could be stronger than it is currently projected.

5.2 Sensitivity Analysis

Based on the outline of potential impact of macroeconomic risks on the economy in Clause 4.1 two alternative macroeconomic scenarios have been developed. It is important to stress that the central macroeconomic scenario outlined in the Convergence Programme is developed based on conservative forecasts of macroeconomic developments, therefore probability of pessimistic scenario is considered to be more likely.

Table 5.1. Optimistic macroeconomic scenario

	2010	**2011**	**2012**	**2013**	**2014**
GDP in current prices, mln Ls	12735.9	13573.8	14523.9	15613.2	16784.2
Increase in current prices, %	-2.7	6.6	7.0	7.5	7.5
Increase in constant prices, %	-0.3	4.5	5.0	5.5	5.5
CPI, (average annual), %	-1.1	3.5	2	2	2
Average wage in economy, lats	444.7	460.3	472.7	487.6	505.4
Increase in current prices, %	-3.5	3.5	2.7	3.2	3.7
Employment, th people	941	959.5	974.9	992.4	1011.1
Increase, %	-4.6	2.0	1.6	1.8	1.9
Export growth rate in current prices, %	10.3	6.3	5.9	6.1	6.1
Import growth rate in current prices, %	8.6	7.3	6.9	7.3	7.3

Implementation of the optimistic scenario would be determined by better than currently projected development of external environment in short and medium term. In addition to the improved external environment situation, in the optimistic scenario a positive contribution is expected from attraction of higher level of foreign investment. Implementation of optimistic scenario would increase Latvian investment and export growth rates, which would also have a positive effect on private consumption. Better growth rates would be mainly based on productivity increase associated with the introduction of new technologies and improvements in employment would be more moderate. Despite faster growth, unemployment in medium term would remain relatively high and wage growth would not exceed productivity growth. Optimistic macroeconomic development scenario provided for the gross domestic product increase at constant prices in 2011 by 4.5%, while in medium term higher level of investment and productivity would increase GDP by 5.0 to 6.0% per year.

In case of the optimistic macroeconomic scenario, which provides faster GDP growth than the baseline scenario and provides more positive consumer and labour market indicators, budget revenue base would also improve significantly. It is estimated that if economic development progresses according to the optimistic scenario, the budget revenue, compared to the baseline scenario, in 2011 would be higher by 0.3% of GDP, while in 2012 - by 0.8%.

Table 5.2. Pessimistic macroeconomic scenario

	2010	**2011**	**2012**	**2013**	**2014**
GDP in current prices, mln Ls	12735.9	13181.7	13708.9	14325.8	14970.5
Increase in current prices, %	-2.7	3.5	4.0	4.5	4.5
Increase in constant prices, %	-0.3	1.5	2.5	3.0	3.0
CPI, (average annual), %	-1.1	3	1.5	1.5	1.5
Average wage in economy, lats	444.7	447.9	456.9	466.0	475.3
Increase in current prices, %	-3.5	0.7	2.0	2.0	2.0
Employment, th people	940.9	945.0	949.6	959.1	968.7
Increase, %	-4.6	0.4	0.5	1.0	1.0
Export growth rate in current prices, %	10.3	3.8	4.2	4.7	4.9
Import growth rate in current prices, %	8.6	4.8	5.2	5.8	6.0

Implementation of the pessimistic macroeconomic scenario is determined by unstable external environment in short and medium term, and new local financial shocks, intensified by consolidation measures in individual Member States, which generally would have a negative impact on the European Union economic development. Implementation of the pessimistic scenario would have an negative effect on Latvian major trading partner countries and the demand for Latvian exports would decrease. As a result exports would reduce and the inflow of money in the Latvian economy would decline, which would negatively affect the private consumption. Instability in financial markets and weak demand for Latvian export goods would significantly slow down investment inflow, thereby reducing growth, not only in short but also in medium term. If this scenario is implemented, employment and wage growth will decrease. The pessimistic macroeconomic scenario provides for GDP to grow in 2011 by only 1.5%, in 2012 by 2.5%, in medium-term growth would decline to 3%.

More moderate GDP growth than in the baseline scenario, based on weaker external demand and lower private consumption, as well as weaker labour market indicators, will also affect negatively the budget revenue base. It is estimated that, if economic development follows in the pessimistic scenario, the budget revenue, compared to the baseline scenario, in 2011 would decline by 0.5% of GDP, while in 2012 by 0.8% of GDP.

6 Comparison with the 2009 Programme

Latvia's action on EU Council's recommendations

Regarding the Latvia's Convergence Programme for the previous period on April 24, 2010 the EU Council approved the invitation to Latvia to take a series of measures to ensure sustainable convergence and smooth participation in the Exchange Rate Mechanism II. In order to implement the recommendations several measures have been performed:

a) EU Council's recommendation: to implement fully the State Budget Law for 2010 adopted on December 1, 2009, to prepare a number of budgetary solutions for savings or additional revenue gains to be able to adopt the State Budget Law for 2011 according to consolidation needs and adopt the State Budget Law for 2012 which also is in line with the fiscal framework pursuant to Council recommendations under Clause 7 of Article 104;

Latvia's action: in 2010 the general government deficit was 7.7% of GDP. Leaving aside the cost of bank restructuring, the 2010 budget deficit is currently estimated only 5.5% of GDP. The general government deficit target for 2010 was no more than 8.5% of GDP.

While working on the draft State Budget Law for 2011 proposals was prepared for revenue increase and expenditure cuts by an amount which was greater than the required amount of consolidation. In order to prepare a measure list methodology was developed for assessing the impact of measures. The State Budget Law for 2011 was approved projecting a deficit of -5.4% of GDP. While on April 14, 2011 the Saeima approved Amendments to the State Budget Law for 2011 envisaging additional consolidation measures. In the results of the amendment to the budget the budget deficit is planned considerably better (4.5% of GDP) than previously set fiscal target (6% of GDP).

b) EU Council's recommendation: to conduct a thorough and far-sighted analysis necessary for a comprehensive reform of social benefits in order to perform such reform in 2011 in combination with other revenue-related measures.

Latvia's action: given the current situation in the social budget it is proposed to determine maternity and paternity allowance in amount of 80% of the average insurance contribution salary as a permanent rule. Currently, the provision for maternity and paternity allowance has been established by the end of 2012. Now the indexation of pensions and benefits is also suspended. Regarding the planned measures, see Clause 3.5.3.

c) EU Council's recommendation: to improve fiscal management and transparency, including through the adoption of the draft Fiscal Discipline Law, strengthening binding nature of the medium-term budget programme and implementing effective sanction procedures to apply in cases where individuals abuse public funds, to strengthen monitoring, coordination and sanction mechanisms in order to combat the shadow economy;

Latvia's action: the Ministry of Finance developed and in October 2010 submitted to the Cabinet of Ministers the draft Fiscal Discipline Law (see

Section 7). It is expected that the draft Fiscal Discipline Law, along with any amendments to the Constitution will be submitted to the Parliament till end-November, 2011, because to ensure efficient operation of the law it is necessary to strengthen at the constitutional level basic principles related to the implementation of fiscal discipline. Currently debates continue in a high level working group, chaired by and consisting mostly of MPs.

Regard the utilization of state budget funds, a regulation is valid providing not only the responsibility for the utilization of the allocated funds, but also for proper utilization of the funds according to intended purpose. Sanctions are intended for inappropriate utilization of budget funds.

In order to combat the shadow economy several policy documents have been developed focused mainly on the promotion of voluntary tax payments and transition from informal economy to registered entrepreneurship. Practical implementation of various measures started already in 2010 and implementation of the set tasks will continue till 2013. Guidelines for application of administrative penalties have also been developed according to which penalty is imposed based on the proportionality of the offense.

In order to promote combating of the shadow economy, in 2010 regulation of the Cabinet of Ministers was adopted, which excludes from the procurement companies that might be operating in the shadow economy, and corresponding amendments were introduced to the Public Procurement Law.

d) EU Council's recommendation: to promote economic growth by promoting a shift to the tradable goods sector and productivity growth, including ensuring that available EU structural funds go into the real economy, and according to the medium-term strategy timely restructuring national banks.

Latvia's action: after substantial decline in GDP in 2009, the situation stabilized in 2010 and there are significant changes in the Latvian economy. The competitiveness of Latvian improved significantly, the share of domestic consumption has decreased in the economy, while the export share has increased. With overcoming the economic downturn in the structure of economic branches also changes, resulting in a higher proportion of industry, while inappropriately high share of construction and sales has begun to decline.
Under the current circumstances, one of the key economic development tools is EU funds, therefore EU funds were allocated to sectors so that to generate high returns for economic development, for example: to promotion of innovation, production of products with high added value, logistics, ensuring access of companies to finances and export support measures. The EU funds management system was also simplified, i.e. payment stream within projects was improved, as well as working practices and requirements of institutions involved in the EU funds implementation for the beneficiaries were unified and disproportionate requirements for beneficiary of EU funding were removed.

Comparison with the 2009 Convergence Programme

Having evaluated the implementation of the 2009 Convergence Programme, where the macroeconomic scenario forecasted that GDP in 2010 will continue to decline significantly and only from 2011 will return to low growth, this scenario is not realized, as the actual development was better than expected. Improvements in the external environment led to a rapid increase in amounts of industry and exports in Latvia, as a result GDP in 2010 fell only slightly – by 0.3%, while in the 4Q of 2010, compared with the previous year's corresponding quarter, there was already 3.6% growth. It is expected that in 2011 and 2012 the growth will be faster than forecasted in the 2009 Convergence Programme.

Performance of the general government deficit and debt criteria is more positive (for further details see Sub-clause 4.1.1 and Clause 4.3.), compared with the forecasts in the 2009 Convergence Programme, therefore the government committed to fiscal consolidation at higher rates and a deficit of 2.5% of GDP in 2012, contrary to previously defined – 2.9% of GDP. In addition to the above mentioned deficit target the current programme sets deficit targets also for 2013 and 2014 respectively – 1.9% and 1.1% of GDP.

Table 6.1. Comparison with the forecasts in the 2009 Convergence Programme

	2008	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**
GDP growth %							
2009-2012	-4.6	-18	-4	2	3.8	-	-
2011-2014	-4.2	-18.0	-0.2	3.3	4.0	4.0	4.0
Difference	0.4	0.0	3.8	1.3	0.2	-	-
Actual budget balance (% of GDP)							
2009-2012	-4.1	-10	-8.5	-6	-2.9	-	-
2011-2014	-4.2	-9.7	-7.7	-4.5	-2.5	-1.9	-1.1
Difference	-0.1	0.3	0.8	1.5	0.4	-	-
Government debt, % of GDP							
2009-2012	19.5	34.8	55.1	59.1	56.8	-	-
2011-2014	19.7	36.7	44.7	48.3	48.1	49.9	51.9
Difference	0.2	1.9	-10.4	-10.8	-8.7	-	-

7 Quality of Public Finances

7.1 Efficiency of state budget resources and expenditure control

Procedures for preparation, approval and implementation of state and local government budgets and responsibility within the budget process are stipulated in the Law on Budget and Finance Management. The Minister of Finance is responsible for organization and management of the state budget process, as well as monitors activities of the Treasury (authority directly subordinated to the Ministry of Finance).

According to the Law on Budget and Finance Management the Minister of Finance shall develop draft annual State Budget Law on the basis of medium-term macroeconomic development and fiscal policy framework (Framework) and budget requests. The Minister of Finance shall also review the budget requests according to intended purposes, economy and efficiency and, if necessary, request additional information for evaluation of the requests. Based on this evaluation and the information provided, the Minister of Finance shall decide on inclusion of the budget request in the draft State Budget Law before its submission to the Cabinet of Minister. The Minister of Finance in any stage of consideration of draft State Budget Law may express own opinion, add necessary findings, as well as individual audit results.

The Treasury, in cooperation with the State Revenue Service, shall ensure that all revenue owed to the state budget would be received at due time and in appropriate amount, and ensure that state budget expenditure is made in accordance with existing laws.

The Treasury grants allocations for expenditure according to appropriations set in the annual State Budget Law and ensures implementation of the expenditure according to the procedure of the Cabinet of Ministers, while the ministries and other central government institutions are responsible for establishing of control system regarding performance of the appropriation set in the annual State Budget Law and control of the use of state budget resources transferred to Treasury’s current accounts according to planned purposes.

In addition, in the Law on Budget and Finance Management it is stated that state budget institutions must open basic budget and state special budget accounts for receipt of assignations and making expenditure from state budget resources only at the Treasury, while the budget-funded institutions (other than state budget institutions and local governments) and the budget unfunded authorities shall open current accounts in the Treasury. Similarly, local governments and their institutions for receipt of state budget funds and implementation of investment projects and one-off measures financed from these funds shall open current accounts in the Treasury.

Key penalties envisaged in the Law on Budget and Finance Management for misappropriation of budget funds:

- for untimely or incomplete payment of sums owed to the state budget to the Treasury budget accounts – the Treasury shall recover due amount to the basic budget revenue and may recover the delay payment in amount of 0.1% of the overdue amount for each delayed day, if laws do not provide otherwise;

- if losses for the budget shall be covered – the Treasury may pay amounts to the basic budget revenue, revoke or suspend the allocation, if reports on budget and finance management are not submitted in time or are incomplete, if budget resources or transactions with these resources are not registered in the procedure prescribed by the law, and they are not reported, if records do not meet the set procedure and thus funds owed to the budget are hidden, as well as if the head of the budget-funded institution commits above the Treasury's allocation;
- if budget-funded institutions, budget unfunded institutions and local governments, and corporations where a share of state or local government capital has been invested, violate financial management requirements set in the Law on Budget and Finance Management, the Minister of Finance, Treasurer, heads of ministries and other central state institutions (according to their competence) may suspended authorization to assign or to operate budget revenue or expenditure, impose restrictions on the use of accounts, revoke or suspend the appropriations to reimburse misappropriated resources, or to require repayment of misappropriated money, file a civil claim to the court or submit materials to competent officials for making decision on criminal proceedings, as well as withdraw or suspend payments.

In order to control the use of addition resources in specific areas in the beginning of 2011 the Cabinet of Ministers instructed ministries to examine closely the need to request funds from individual budget reserves (budget program "Funds for Unforeseen Cases"), and the Cabinet of Ministers when taking decision on allocation of resources will evaluate more strongly the reasonableness and necessity of the allocation of funds.

7.2 Efficiency of revenue structure and system

One of essential aspects of the quality of public finances is ensuring stable and predictable tax revenue flows to the budget to finance priority social and economic activities of the government.

Table 7.1. Tax revenue in general government budget (S.13), mln lats

	Code (ESA 95)	**2010**	**2011**	**2012**	**2013**	**2014**
Tax revenue						
1. Production and import taxes	D.2	1 449.7	1 617.2	1 708.9	1 773.0	1 855.1
2. Income and property current taxes	D.5	940.7	917.2	945.0	980.8	1 018.8
3. Capital taxes	D.91	1.4	1.6	1.6	1.7	1.7
4. Social contributions	D.61	1 098.3	1 198.9	1 231.0	1 192.0	1 194.4
From actual social contributions	*D.611*	1 057.8	1 158.4	1 190.5	1 151.5	1 153.9

For several years the overall tax burden in Latvia remained one of the lowest in the European Union. In 2008 it was 29.1% of GDP, which is lower than the EU average of 40.5% of GDP.

The tax policy development directions in 2011 – 2014 envisage reducing the tax burden on labour, shifting it to consumption and property. In Latvia majority of all tax revenue is generated by the labour taxes, the share of which in total tax revenue in recent years tended to increase (from 48.2% in 2006 to 52.0% in 2010), however in medium term it is likely that the labour tax share will decline (to 47.8% in 2014). Consumption tax revenue in total tax revenue has decreased (from 41.8% in 2006 to 39.8% in 2010), however in medium term the share of consumption taxes is likely to increase (up to 43.4% in 2014).

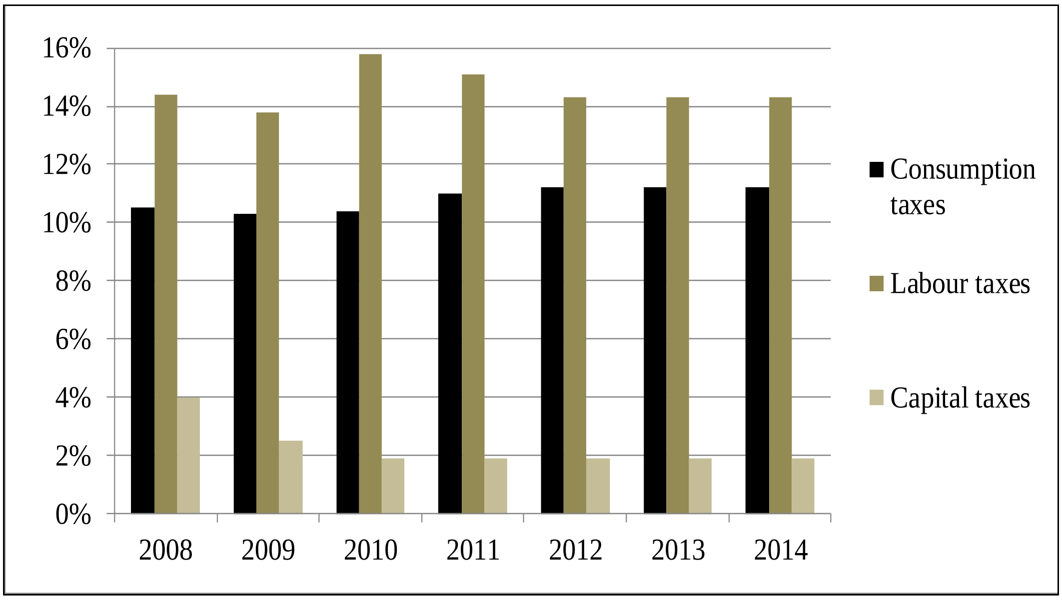

Fig. 7.1. Tax revenue according to economic functions, % of GDP

After joining the European Union tax revenue growth was mainly facilitated by rapid economic growth, but in 2009 due to the economic crisis, tax revenue fell. In order to ensure fiscal consolidation and achieve reduction of the budget deficit, in 2008 budget fiscal consolidation was launched. In 2011 fiscal consolidation measures are focused on tax revenue stabilization and growth.

Table 7.2. Impact of consolidation measures on the main tax revenue, % of GDP

	2011	**2012**
Value added tax	+0.6	+0.1
Excise duty	+0.2	+0.2
Real estate tax	+0.1	-
Personal income tax	-0.4	
Social security contributions	+0.9	-
Natural resource tax	+0.01	+0.03
Lottery and gambling tax	+0.01	+0.02
Other measures	+0.1	-
Total impact of changes:	**+1.4**	**+0.4**

In order to ensure better tax collection measures to combat the shadow economy are also taken in the result of which in 2011 additional 60.0 mln lats (85.4 mln euro) may be collected in the state budget.

This section discusses the main impact of tax changes according to the State Budget Law for 2011, as well as the amendments to the State Budget Law for 2011.

Value added tax

Substantial share of total tax revenue is made of value added tax revenue. During the years of economic growth the growth rate of value added tax revenue was high. However as retail trade started to decline in 2008 and continued to decline in 2009, together with the economic decline in other economic sectors, as well as decrease in the total transaction value and volume the value added tax revenues have also fallen. In addition, the impact of the economic crisis has been so significant that as of January 1, 2009 the increase in the value added tax standard rate by 3 percentage points from 18% to 21% could not offset the revenue reduction that occurred as a result of economic recession.

In 2010 gradual increase in the retail trade turnover and the level of economic activity in other sectors, as well the increase in imports gave a positive effect on value added tax revenues.

The value added tax revenue forecast for 2011 has been prepared taking into account expected economic development trends, growth in private consumption, value added tax performance in 2010 and taking into account consolidation measures given in Table 7.3.

Table7.3. Impact of consolidation measures on value added tax revenues, mln lats

	2011	2012
Total impact of changes according to the State Budget Law for 2011:	**+73.0**	
Increase in standard rate from 21% to 22%,	+37.5	-
Cancellation of reduced tax rate on electricity supplies to inhabitants from 10% to 22%	+13.9	-
Increase in reduced rate from 10% to 12%	+14.6	-
Changes in the value added tax application procedure on property alienation in auctions conducted by insolvency administrators and bailiffs	+7.0	-
Total impact of changes according to the Amendments to the State Budget Law for 2011:	**+5.4**	**+12.8**
Cancellation of reduced tax rate on natural gas from 12% to 22%	+1.6	+4.0
Application of reduced rate on medical equipment supplies according to the EU directive	+1.5	+3.0
Rise in the VAT revenue from increase in excise duty rates	+2.3	+5.8
Total impact of changes:	**+78.4**	**+12.8**

Excise duty

So far, the excise duty policy was implemented mainly towards excise duty harmonization with the European Union requirements. According to transitional periods given to Latvia, excise duty rates for certain excise goods were significantly increased, including oil products and tobacco products. Mainly increase in excise duty rates contributed to a sustained and strong excise duty revenue growth.

However in 2009 as a result of economic downturn which caused rapid reduction of excise goods sales, despite the increase in excise duty rates, excise duty revenues dropped substantially compared to 2008.

Within the framework of fiscal consolidation in 2010 and 2011 changes are introduced to excise duty rates. Assuming that in 2011 the tax base of the main types of excise goods will increase slightly, the excise duty revenue forecast for 2011 has been prepared taking into account budget consolidation measures to be implemented in 2011 (Table 7.4).

Table 7.4. Impact of consolidation measures on excise duty revenues, mln lats

	2011	2012
Total impact of changes according to the State Budget Law for 2011:	**+8.6**	-
Cancellation of reduced excise duty rates on oil products with 5% addition of biofuels	+7.6	-
Increase in excise duty rates on non-alcoholic beverages	+1.0	-
Total impact of changes according to the Amendments to the State Budget Law for 2011:	**+12.2**	**+30.6**
Reduction of excise duty rates and cancellation of tax exemption for natural gas used for production of electricity from July 1, 2011	+2.0	+8.3
Increase in excise duty rates on other alcoholic beverages from 890 to 940 lats per 100 litres of absolute alcohol	+1.8	+3.7
Increase in excise duty rates on tobacco products as of July 1,2011	+3.0	+7.2
Increase in excise duty rates on fuel (petrol) as of June 1,2011	+3.6	+7.1
Reduction of excise duty exemption for the diesel fuel used in agriculture, setting maximum amount of litres used in agriculture and exempted from excise duty in economic year as of July 1,2011	+1.7	+4.2
Total impact of changes:	**+20.8**	**+30.6**

Real estate tax

In 2011 the real estate tax revenue is projected with 10.9% increase compared to 2010, which is also determined by changes in legislation.

In 2010 amendments were made and approved to the Law on Real Estate Tax envisaging changes in real estate tax field as of 2011.

As of January 1, 2011 the real estate tax rate for residential buildings with cadastral value of up to 40 000 lats (up to 56 915 euro) was increased from 0.1% to 0.2%, with cadastral value from 40 001 to 75 000 lats (from 56 916 to 106 715 euro) from 0.2% to 0.4%, with cadastral value above 75 000 LVL (above 106 715 euro) from 0.3% to 0.6%.

Table 7.5. Impact of consolidation measures on real estate tax revenues, mln lats

	2011
Changes in rates for residential buildings	+6.9
Total impact of changes:	**+6.9**

Personal income tax

Since 2005 personal income tax policy measures were aimed at reducing the tax burden on low-income population: non-taxable allowances, as well as allowances for dependents was increased. However it should be noted that despite negative impact of the these tax policy measures on the budget, personal income tax revenues in recent years increased and their growth rate was high. The rapid labour tax revenue growth was mainly driven by rapid wage fund growth. Labour tax revenue was positively affected also by the minimum monthly wage increase, which is done already since 2006. However in 2009 to ensure strict fiscal consolidation, as of July 1, 2009 the non-taxable allowances was reduced from 90 to 35 lats (from 128 to 50 euro) per month.

Medium-term macroeconomic forecasts from 2011 envisage a wage fund increase, which in turn will increase labour tax revenues in coming years. However, personal income tax revenues in 2011 are considerably influenced by tax changes and consolidation measures (total negative fiscal effect 57.4 mln lats (81.7 mln euro), providing as of January 1, 2011 the following:

- reduction of personal income tax rate from 26% to 25%;
- increase in minimum wage from 180 to 200 lats (from 256 to 285 euro) per month;
- increase in non-taxable allowances from 35 to 45 lats (from 50 to 64 euro) per month and relief for dependents from 63 to 70 lats (from 90 to 100 euro) per month;
- increase in employee's social insurance contribution rate from 9% to 11%, if the employee is insured for all insurance types;
- change in personal income tax division share between the state basic budget (from 20% to 18%) and local government basic budget (from 80% to 82%);
- introduction of corporate vehicle tax, therefore starting with 2011 the benefit gained from using employer's (company's) car for personal needs is not taxed.

Social security contributions

Medium-term social security contribution revenue dynamics will be determined not only by predicted wage fund growth, but also by legislative amendments and changes in contributions to the state funded pension scheme made within the framework of the consolidation, because, according to ESA95 methodology, social security contributions, which go into the state funded pension scheme, are not treated as general government budget revenues.

As of January 1, 2011 employee's social security contribution rate was increased from 9% to 11% if the employee is insured for all insurance types.

Similarly, additional revenue is expected from increase in minimum monthly salary from 180 to 200 lats (from 256 to 285 euro).

Reduction of social security contributions is planned from introduction of corporate vehicle tax, because with introduction if this tax as of January 1, 2011 the benefit gained from using employer's (company's) car for personal needs is not taxed anymore.

Contributions to the state funded pension scheme in 2011 and 2012 will remain at the level of 2%, in 2013 the rate will rise to 6% and in 2014 will remain at previous year's level.

Table 7.8. Impact of consolidation measures on social security contributions revenues, mln lats

	2011
Increase in minimum monthly salary from 180 to 200 lats per moth	+8.4
Increase in social security contribution rate from 9% to 11%	+69.6
Maintaining contributions to the state funded pension scheme in 2011 and 2012 at the level of 2%, in 2013 in 2014the rate will rise to 6%	+44.9
Total impact of changes:	**+122.9**

Table 7.9. Social security contributions to the state funded pension scheme

Period	Contr. rate	Forecasted social security contributions to the state funded pension scheme, mln lats	Forecasted social security contributions to the state funded pension scheme, % of GDP
2011	2%	64.0	0.5
2012	2%	63.8	0.5
2013	6%	154.4	1.0

Vehicle use tax

As of January 1, 2011 the Law on Vehicle Use Tax and Company Car Tax became effective, which introduced the Vehicle Use tax replacing the annual vehicle fee payable to the state budget.

Taxable objects are all vehicles, except tractors, trailers and semi-trailers with full weight not exceeding 3500 kilos, trams, trolleybuses, off-road vehicles, snow motorcycles, mopeds and bicycles.

In preparing vehicle use tax revenue plan for 2011 tax rates and changes to the procedure for calculation of tax on motorcycles, tricycles and quadricycles provided for in the Law on Vehicle Use Tax and Company Car Tax were taken into account. As well as trends of revenue from annual vehicle fee in 2010 were taken into account and the number of vehicles registered in respect of which tax is due. Accordingly, additional revenue to the state budget is estimated 4.7 mln lats (6.7 mln euro).

Company car tax

The Company Car Tax entered into force on January 1, 2011 according to the Law on Vehicle Exploitation Tax and Company Car Tax.

The law aims to introduce a tax, which replaces the procedure in which the tax is levied on the benefit that the employee (beneficiary) gains from the use of the passenger car owned or held by the employer for personal needs.

According to the law the corporate vehicle tax is paid on the vehicle owned or held by the merchant, which by its structure and internal equipment is designed for passengers and their baggage, where the number of seats, excluding the driver's seat, is not more than eight seats, and which is registered as a car, a passenger car or car for own use, which is used for private purposes. The tax shall be paid into the state budget for the period in which the vehicle is owned or held by the merchant.

According to the State Budget Law for 2011 the Company Car tax revenue to the state budget is planned 17.0 million lats (24.2 mln euro).

The Company Car tax revenue forecast for 2011 was set taking into account the number of vehicles held by companies, corporate vehicle tax rates envisaged in the law, as well as tax exemptions.

Natural resource tax

Natural resource tax payments are directly related to economic activities of Latvian enterprises and environmental pressures caused by these activities. Consequently, the tax revenue increases with growth in overall economic activity, as well as decreases with environmental protection measures implemented by businesses and municipalities. Natural resource tax revenues are transferred to the state basic budget and local government special budget.

Natural resource tax revenue forecast for 2011 has been prepared taking into account fiscal consolidation measures by which the amendments were made to Natural Resource Tax Law, which provide for increase in certain natural resource tax rates as of January 1, 2011.

Table 7.10 Impact of consolidation measures on natural resource tax revenues, mln lats

	2011	**2012**
Increase in natural resource tax rates	+1.3	+4.1
Total impact of changes:	**+1.3**	**+4.1**

Lottery and gambling tax

Total lottery and gambling turnover in 2010 decreased by 3.4%[5] which is mainly based on the overall economic impact on the gambling industry. Currently, gambling organizers do their business optimization and restructuring closing unprofitable gambling halls and combining gaming companies, which will lead to closure of gambling halls with low profitability and reduction of gambling equipment, thereby reducing revenues from lotteries and gambling tax.

The projected lottery and gambling tax revenue growth in 2011 is mainly related to fiscal consolidation measures that are taken in accordance with amendments to the State Budget Law for 2011. See the impact of changes to the budget in Table 5.9.

Amendments to the Law on Lottery and Gambling Taxes and Fees, which are made in accordance with Amendments to the State Budget Law for 2011 envisage:

- as of June 1, 2011 gambling tax rate increase from 9 600 to 10 560 lats (from 13 660 to 15 026 euro) for each roulette game (cylindrical game) –

[5] According to the data of the Lottery and Monitoring Inspection data for 2010

for each game table attached to the rotating device of the roulette, and card and dice games – each year;

- raising the rate on video games and mechanic slot machines, for each game space on each machine – 1 680 to 1 920 lats (2 390 to 2 732 euro) per year.

Rate increase will not cause significant reduction of gambling equipment, which could influence gambling tax revenue.

Table 7.11. Impact of consolidation measures on lottery and gambling tax, mln lats

	2011	2012
Increase in lottery and gambling tax rates	+1.1	+3.3
Total impact of changes:	**+1.1**	**+3.3**

Other measures

In order to ensure fiscal consolidation and reduction of the budget deficit, starting with 2011 new types of fees have been introduced, including:

- according to amendments to the Energy Law (adopted on June 17, 2010) a state fee for maintenance of safety reserves is introduced (positive fiscal impact in 2011 7.5 mln lats (10.7 mln euro);
- in accordance with the Law of Financial Stability Fee a financial stability fee will be paid (positive fiscal impact in 2011 3.0 mln lats (4.3 million euro)). The duty rate is 0.036% per annum and it is applicable at the end of the taxation period on fee payer's total liabilities, from which the following is deducted:
  - ✓ deposits which are subject to the deposit-guarantee scheme of Latvia or other Member States;
  - ✓ mortgage bonds issued by the fee payer;
  - ✓ subordinated liabilities included in the calculation of own capital as subordinated capital in accordance with the regulations of the Financial and Capital Market Commission.
- state fee for procurement appeals (fiscal impact in 2011, 50.0 thousand lats (71.1 thousand euro)).

Budget measures to increase revenue by combating the shadow economy

In order to combat the shadow economy a number of policy planning documents have been developed envisaging tasks the implementation of which will result in positive changes in the Latvian economic environment. The tasks included in the documents are divided in several directions – promoting of fair competition, reduction of administrative burden, public awareness and education about the negative effects of the shadow economy, building capacity of controlling authorities, revision of penalties and other policy reforms. The focus is mainly on the promotion of voluntary tax payments and transition from informal economy to the registered business, rather than on punitive techniques, i.e., punishment. Implementation of tasks specified in the documents started already in 2010 and will continue till 2013.

To use the resources of the State Revenue Service more efficiently, according to the recommendations of the International Monetary Fund, a tax liability enforcement strategy has been developed which identifies key tax revenue risks, action areas and key measures to reduce tax revenue risks, including reduction of unregistered economic activity, economic activity outside the tax system, illicit trade and organized crime groups operating risks.

8 Sustainability of Public Finances

Demographic changes, particularly increasing number of the elderly population, in the long run may affect age-related general government expenditure growth and thus worsen the sustainability of public finances. Sustainability of public finances is also determined by the initial budgetary position, which due to the economic crisis has worsened, increasing both the Latvian general government deficit and debt level which was low before.

To ensure sustainability of public finances, the Latvian government as the main objective has stated reduction of the general government budget deficit, making the necessary budgetary consolidation and implementing structural reforms, including in social security, education and health care sectors, which is essential in the context of ageing.

The European Commission, in cooperation with the Member States, every three years makes long-term budgetary forecasts taking into account the impact of population aging, as well as assesses sustainability of public finances of each Member State. Long-term budgetary projections are based on demographic projections provided by *Eurostat*, and assumptions about economic growth and influencing factors in long-term. This section presents data that are published in the Ageing Report of 2009 of the European Commission[6]. It should be noted that long-term budgetary projections reflected in the report do not take into account the impact of the economic and financial crisis of 2008 – 2009, therefore these projections should be treated with caution. It should be noted, than at the end of 2010 a new forecasting cycle was launched, as a result of which in 2012 new long-term budgetary forecasts will be published.

Long-term demographic projections *(EUROPOP2008)* were made based on the actual data for 2007. According to *Eurostat* actual data, on January 1, 2010 total population in Latvia was 2.25 million or by 1.4% less than on January 1, 2007, and it was previously projected. It should be noted that the population over the past decade has steadily declined.

[6] EC 2009 Ageing Report: Economic and budgetary projections for the EU-27 Member States (2008-2060)

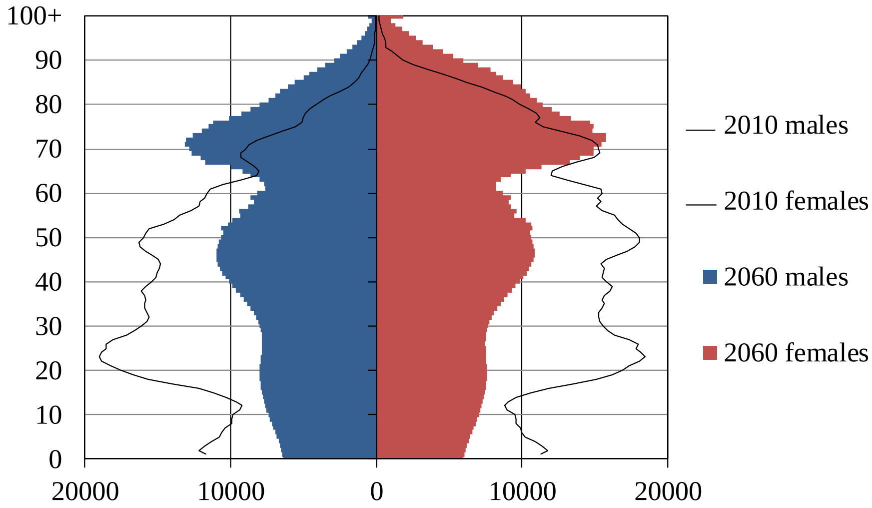

Fig. 8.1. Age structure of Latvian population in 2010 – 2060 (data source: *Eurostat*)

Population decline was mainly influenced by demographic changes and population emigration to the old countries of the European Union. According to *Eurostat's* demographic projections the total number of Latvian population will continue to decline and in 2060 will be by 25.2% less than in 2010. It is expected that the working age (15-64) population in 2060, compared to 2010, will be by 42.1% less. The number of children in Latvia will also continue to decline, and in 2060, compared to 2010, will be by 33.2% less. While the population aged over 65 in 2060, compared to 2010, will increase by 48.2%, aged over 80 will increase by 127.5%, which will be primarily based on life expectancy increases.

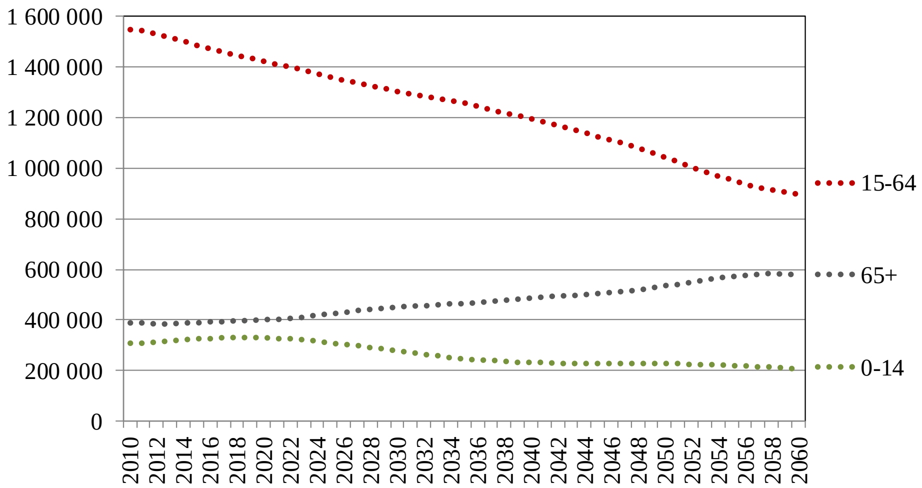

Fig. 8.2. Division of Latvian population by age groups in 2010-2060 (data source: *Eurostat*)

Life expectancy increase in Latvia, as in other new EU Member States, in times of convergence will be faster than the EU average. Taking into account the age composition changes, it is likely that the old-age dependency rate[7] of working age population in long-term will increase almost twice.

[7] Proportion of children and pension-age population against working-age population (15-64)

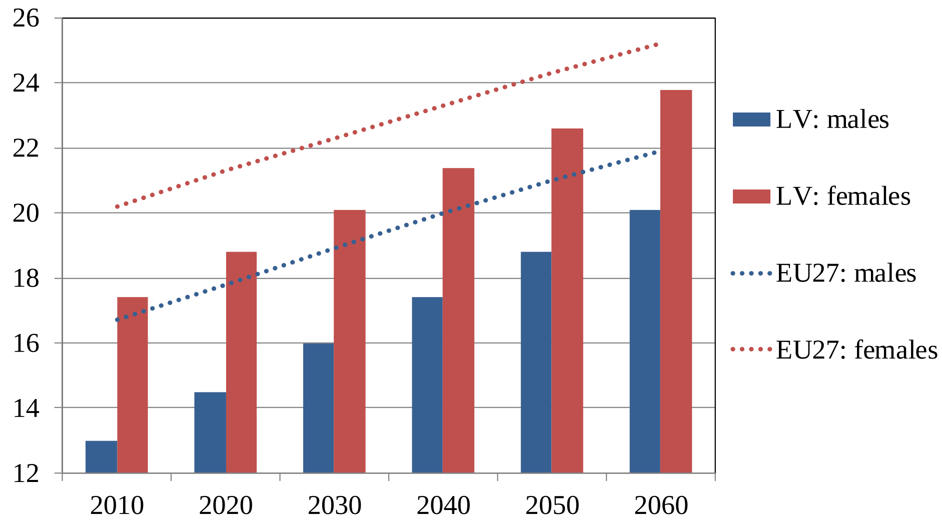

Fig. 8.3. Life expectancy in age of 65, in years (data source: *Eurostat*)

Long-term budgetary forecasts were made taking into account macroeconomic assumptions, including assumptions about changes in employment. Estimates of sustainability of public finances according to the Ageing Report of the European Commission for 2009 are based on assumptions that were developed at the beginning of 2008 and did not forecast a deep economic crisis in Latvia. Therefore, these macroeconomic assumptions should be treated with caution.

Economic growth is essential to ensure sustainability. It is expected that demographic changes will affect employment. It is expected that in long-term participation levels will increase[8] and unemployment will decrease. This will partly offset the impact of working age population decline on employment. It is expected that productivity in the long run will be a determining factor for economic growth and it will be a basis for convergence in long-term. Latvia, in view of its relatively low position in comparison with other countries, has significantly higher potential for productivity growth than the EU average. Productivity growth can be facilitated by structural reforms, technological progress, education and vocational training, effectiveness of resource allocation and capital stock.

When assessing the sustainability of public finances, general government expenditure is evaluated, which is associated with ageing population, i.e., expenditure on pensions, health care, long-term care, education and unemployment benefits, and long-term projections of budget expenditure are designed.

According to the Ageing Report of the European Commission for 2009 it was expected that in total general government expenditure on ageing in 2060, compared with 2007, will increase by 0.4% of GDP. The total expenditure increase in 2060, compared with 2007, will be mainly affected by an increase in costs for health care (0.6% of GDP) and long-term care (0.5% of GDP). This can be explained by the fact that health and long-term care services are primarily attributable to the elderly, whose proportion in the long run will increase. Both the health and long-term care expenditure together with significant demographic changes can be influenced by technological progress and economic development. Consequently, it is important to

[8] Proportion of the number of employed persons against total number of population in particular age group

implement reforms that are focused on the health care system, including funding mechanisms, optimization. It should be noted that long-term care expenditure as a share of common age-related expenditure is small.

By contrast, it was projected that expenditure on pensions and education in long-term will decline. Expenditure on pensions in 2007 accounted for the majority (40.9%) of total general government expenditure on ageing population. However, due to changes in the budget structure as a result of consolidation in 2008-2010, the share of expenditure on pensions is possible to change. It was predicted that, overall, in 2060, compared with 2007, expenditure on pensions will reduce by 0.3% of GDP. Although, given the demographic situation, there will be expenditure increase in the time period till 2040.

Economic and financial crisis, which led to reduced incomes of population, significantly affected the social insurance budget revenue. In order to stabilize the state social insurance budget in short term a number of changes was made, such as reducing the rate of contributions to the state funded pension scheme. Also in 2011 the contribution rate to the state funded pension scheme is fixed at 2% of the payment object. Although these changes solve short-term problems, they may hinder sustainability of public finances, because state funded pensions were introduced to relieve the state budget in long-term.

Key changes currently envisaged by the government in the social insurance system to adapt to demographic changes and ensure its sustainability are mainly related to restructuring of budget expenditure:

- Raising the retirement age gradually from 2016, each year increasing by half a year and reaching 65 years in 2021;
- Starting from 1st January, 2012 supplemental payments to the newly granted old-age and disability pensions will not be payed;Raising the minimum insurance record up to 15 years, beginning with 2016 (together with raising retirement age), given the right to state-guaranteed (minimum) pension, if the insurance period is not less than 20 years starting with 2021;
- Freezing of pension indexation till December 31, 2013.

As a result of these changes the situation in the state social security budget will improve, participation in the labour market will rise, as well as the social security system load will reduce.

Regarding educational expenditure it was projected that in total in 2060, compared with 2007, it will reduce by 0.4% of GDP. It will be mostly affected by reduction of the number of children in long-term in Latvia. Although as a result of demographic changes the education system adapts to a lower level of demand, the quality of education is still important as one of the productivity factors.

In assessing the general government budget expenditure related to ageing population, uncertainty in assumptions should be taken into account. Due to certain negative factors in the health and long-term care sector, the total amount of expenditure could increase by as much as 4-5% of GDP.

According to the Sustainability Report of the European Commission for 2009[9] Latvia is among the countries with a high risk attributed to the sustainability of public finances. This assessment is generally based on the initial budgetary position, which has significantly deteriorated as a result of the economic crisis. However, this assessment can be improved taking into account fiscal policy objectives reflected in the Convergence Programme.

[9] *EC 2009 Sustainability Report*

9 Institutional Features of Public Finances

9.1 Implementation of rules on the state budget

In Latvia the state and local government budget preparation, approval and implementation procedure, as well as responsibility for the budget process is laid down in the Law on Budget and Finance Management.

This law provides that the State Budget Law includes a state budget financial balance and public debt ceiling at the end of the financial year, as well as the proportion of the amount of guarantees issued on behalf of the state for fulfilment of obligations, public debt and the amount of guarantees to be issued during the financial year.

According to Article 24 of the Law on Budget and Finance Management budget executers can make state budget expenditures or undertake short-term obligations only within the framework of assignations set in their financing plans issued by the Treasury. At the same time, the Treasury grants assignations for expenditure according to the appropriations set in the annual State Budget Law and ensures their implementation according to the regulations of the Cabinet of Ministers. Budget institutions may undertake long-term budget liabilities, not exceeding long-term liability ceilings set in the financial year's State Budget Law.

In order to maintain the overall economic balance and to ensure uniform national financial policy, in the annual State Budget Law overall increase in government borrowings and guarantees is set. The Treasury is entitled to deduct sums from the amount due to local governments from the personal income tax share or from the local government equalization fund grants in the following cases and amounts:

1) If the local government does not ensure in proper time contractual obligations set in state loan agreements – in amount of overdue sum;

2) If the local government does not ensure the use of the loan according to the purpose specified in the loan agreement, – according to the decree of the Minister of Finance in amount of the loan used inconsistent with the goal.

To ensure continuity, strengthen the multi-annual budget planning, continue fiscal consolidation and meet Maastricht convergence criteria, with the Amendments to the State Budget Law for 2011a provision was implemented which provides that in preparation of draft State Budget Laws for 2012, 2013 and 2014 (the budget law package), the Cabinet of Ministers shall provide fiscal consolidation measures to achieve the general government budget deficit in 2012 according to the European System of Accounts methodology less than 3.0% of GDP, in 2013 below 1.9% of GDP, in 2014 below 1.1% of GDP.

In Latvia today no other numerical fiscal conditions have been set at legislative level. However, to avoid increased fiscal, economic and social risks due to macroeconomic processes and to ensure that international commitments and fiscal criteria, in cases when it is necessary to take prompt decisions, Article 25 of the Law on Budget and Finance Management empowers the Minister of Finance to order that the Treasury in a particular period (not longer than 3 months) shall hold or reduce appropriations, provided that such activities do not conflict with the Constitution, laws and regulations of the Cabinet of Ministers and there is at least one of the conditions:

- if within the three-month period, state budget tax and non-tax real income, compared to estimated amount of revenue for the relevant period, reduces by more than 0.5% of the gross domestic product forecast set in the annual State Budget Law;
- actual accumulated state budget deficit in the three-month period exceeds the budget deficit planned for the relevant period by more than 0.5% of the gross domestic product forecast set in the annual State Budget Law;
- in the Treasury's budget accounts there is not sufficient amount of funds to cover projected payment obligations in the next month.

9.2 Budget procedures, incl. public finance statistical management

9.2.1 Budget procedures

The Constitution of the Republic of Latvia provides that the Saeima annually before the beginning of the financial year decides on the national revenue and expenditure budget and submit the draft to the Cabinet of Ministers. According to the Law on Budget and Finance Management the Cabinet of Minister shall determine the timetable for submission of the annual draft State Budget Law so that before October 1 of respective year the annual draft State Budget Law (package of draft budget laws) is submitted to the Saeima for adoption for the next financial year, proposals for amending the laws to meet the budget requests, and explanations of the State Budget Law (package of draft budget laws), observations, as well as Framework.

During the annual State Budget Law drafting process the following indicators are evaluated in complex and then reflected in the State Budget Law:

- state budget revenue, broken down by types of revenue;
- state budget expenditure by programmes (sub-programmes) and types of expenditure according to economic nature;
- state budget financial balance;
- government debt ceiling at the end of the year;
- amount of guarantees to be issued on behalf of the state;
- total increase in the state budget loan;
- amount of state budget earmarked subsidies to local governments, as well as government grants to local governments financial equalization fund;
- total increase in government borrowings and total increase in government guarantees;
- other conditions, such as contribution rate to the state-funded pension scheme and amount of contributions.

Currently, the Latvian state budget planning process envisages approval of the State Budget Law for one year and maximum spending amount for the next two years. During the annual State Budget Law drafting process a medium-term macroeconomic development and fiscal policy framework is developed, which includes latest forecasts of economic growth, fiscal policy objectives, as well as the projected state budget revenue and maximum amount of total state budget expenditure for medium term.

In state budget expenditure planning expenditure base line is initially calculated and agreed. Thus total amount of necessary expenditure is set to ensure public functions at a constant level compared with the previous year. In addition, ministries and other public institutions may submit proposals for possibilities to reduce expenditure base line arising from the reorganization or review of functions.

The Cabinet of Ministers has the power to determine additional conditions for state and local government budget planning and execution to ensure mitigation and prevention of increased fiscal, economic and social risks caused by macroeconomic processes and ensure that international commitments and fiscal criteria are met.

In recent years, due to economic slowdown it was necessary to carry out fiscal consolidation, which will still be topical in the following period. Starting with drafting of the State Budget Law for 2010 a new approach has been applied to preparation of fiscal consolidation proposals – evaluation of expenditure from the perspective of functions implemented by ministries, analysing and assessing the significance of ministry's functions to determine the budget programmes (sub-programme) where expenditure should be reduced. In order to evaluate state-funded functions and prepare proposals for optimization of functions social partners have also been involved in the work. The decisions on fiscal consolidation measures to be implemented by ministries are adopted at the Cabinet of Ministers level. After reaching agreement on certain fiscal consolidation measures state budget expenditure ceilings for individual ministries and other central government institutions are set.

Ministries and other central government institutions develop and submit to the Ministry of Finance budget requests according to the allowed ceilings of state budget expenditure. Ministries prepare budget requests for certain programmes (sub-programmes) of the basic budget, special budget, broken down by expenditure economic classification codes. Ministries provide summary of budget allocations and use of the resources, as well as the financing by the following sections:

1) for implementation of state basic functions (with the exception of implementation of projects and activities co-funded from the European Union policy instruments and other foreign financial assistance);
2) implementation of projects and activities co-funded from the European Union policy instruments and other foreign financial assistance.

Budget breakdown in two aforementioned sections provides the public with an idea of what resources are used for the implementation of basic functions, and what – for the implementation of the European Union and other foreign policy instrument measures.

Explanations of the State Budget Law include information on the macroeconomic strategy description and fiscal review, revenue analysis and key elements of expenditure planning, planned investment and financial commitments, as well as legislative amendments made according to the package of draft budget laws. Explanations of each programme (sub-programme) of the state basic budget or special budget are prepared in a separate section, which include information about the objectives of the programme (sub-programme), planned outputs and performance indicators, institutions which provide implementation of the programme (sub-programme), beneficiaries (public target groups whose interests are covered, or institutions), as well as the proposed main activities, major projects, measures or services provided in accordance with laws and regulations to be implemented next year, as well as the performance of the previous year. Explanations of programmes (sub-programmes) also contain information on the average number of staff positions and average wage.

During the draft state budget development process negotiations between the Latvian Association of Local Governments (hereinafter – LPS) and the Ministry of Finance are held leading to the protocol on agreements and disagreements between the LPS and the Cabinet of Ministers (hereinafter – draft protocol). The draft protocol comprises issues on financial resources to be transferred to local government basic budget and special budget, local government financial equalization, loans, guarantees and long-term liabilities, social security strategy measures, acquisition of EU structural funds and necessary funding to comply with laws and regulations. The draft protocol is submitted to the enlarged meeting of the Cabinet of Ministers. The protocol on agreements and disagreements between the LPS and the Cabinet of Ministers shall accompany next year's draft State Budget Law when the government submits it to the Saeima.

Law on state budget shall be approved by the Saeima.

If, at the beginning of the financial year, the annual State Budget Law has not entered into force, the Minister of Finance confirms necessary budget expenditure, loans and loan limits necessary for national operations, provided that the expenditure per month does not exceed the twelfth part of the previous year's appropriations.

9.2.2 Public finance statistical management

The Central Statistical Bureau (CSB) compiles statistics on public finances, calculated in accordance with the European System of Accounts ESA95 methodology requirements.

The general government (S.13) framework in Latvia in accordance with ESA95 methodology consists of three sub-sectors: central government sub-sector (S.1311), local government sub-sector (S.1313) and social security fund sub-sector (S.1314).

The general government sector on December 31, 2010 consisted of 1264 independent budget institutions, including in the central government sub-sector – 321 institutions, in the local government sub-sector – 942 institutions and in the social security fund subsector – one body, in addition – 140 central and local government controlled and financed enterprises, including the central government-controlled – 39 enterprises, and local government controlled – 91 enterprises.

The list of enterprises referring to the general government sector is drawn up by the CSB checking the operator's compliance with the following criteria:

- whether it features signs of an institutional unit;
- whether it belongs to the public sector (central and local government participation in the enterprise's core capital is more than 50%);
- whether it is considered to be non-market public sector institutional unit.

If is the main function of the unit is to participate in redistribution of national income and wealth and it has been awarded the code of the Statistical classification of

Economic Activities NACE 1.1 beginning with “75” (classification division “Public administration and defence, compulsory social security”), the unit is associated with the general government sector. Belonging to the general government sector is determined by analysing financial data of the unit provided in the annual statement of the unit. The analysis covers data of the last five years. If unit meets (for at least last three years) the condition that the unit’s net turnover minus received central or local government budget allocation is less than 50% of unit’s operating costs, the unit is associated with the general government sector. In addition, if the main source of income of the unit is payments for services by other government units, it is attributed to the general government sector.

The CSB shall prepare on quarterly basis detailed information about the general government revenue, expenditure and financial accounts and government debt, which shall be submitted to the Statistical Office of the European Union *Eurostat* within three months after the reporting period.

In addition, within the prescribed period (twice a year – until April 1 (provisional data) and October 1 (final data)) the general government deficit and debt notification shall be prepared, which is regularly sent to EU institutions in a uniform format established for all EU Member States. The body responsible for preparing the notification is the CSB which during the notification preparation period conducts regular inter-institutional working group meetings. Specialists of the Ministry of Finance, the Treasury and Ministry of Economics, as well as the Bank of Latvia are involved in the preparation of the notification. If necessary, experts from other institutions may be attracted (Ministry of Defence, Ministry of Welfare, Riga City Council, etc.).

With government deficit and debt notification the European Union Member States inform the Commission of their available budget resources and their expenditure.

Notification results are used for evaluation of countries, how compliance of economic performance with Maastricht criteria is achieved, i.e., proportion of planned or actual general government deficit to gross domestic product at current market prices should not exceed 3% and proportion of government debt to gross domestic product at current market prices should not be more than 60%, calculated in accordance with ESA95 methodology.

The main data sources of all of the above information are “Annual report on central government budget and local government budget execution in year n-1” (for provisional data – the Treasury’s “Official monthly report on budget execution in January – December year n-1) of the Ministry of Finance, accounting balance sheet summaries of central and local government institutions at the end of year n-1 (for provisional data – summary of financial assets and liabilities in year n-1), as well as information from the CSB Statistics Report Form 1-FAP “Financial Assets and Liabilities in Year n-1” (for provisional data - 2-FAP “Financial Assets and Liabilities in Year n-1”).

To meet requirements of the new European System of Accounts ESA2010 methodology, the CSB is already working on the evaluation of existing data sources to identify potential problems and be able to respond adequately, improving data sources and the level of detail, in collaboration with other institutions involved in data preparation. Information according to the new ESA 2010 methodology shall be submitted starting with September 2014, which will also require other institutions to review their quarterly reporting deadlines to be able to meet reporting deadlines set in the draft regulation which is currently being reviewed – 80 days after the reporting quarter.

9.3 Other institutional developments regarding public finances

The Ministry of Finance developed and in October 2010 submitted to the Cabinet of Ministers the draft Fiscal Discipline Law. By adopting the Fiscal Discipline Law compliance will be ensured with draft EU legislative acts designed to strengthen the Stability and Growth Pact (within economic governance and supervision strengthening framework). Thus, Latvia will be prepared to take over the proposed provisions of the directive regarding national fiscal frameworks to its legislation. In order to complete the work on the draft Fiscal Discipline Law cooperation with the representatives of the European Commission and International Monetary Fund will be ensured.

The draft Fiscal Discipline Law establishes binding fiscal rules for the annual state budget and medium-term budget, strengthens basic principles for developing the fiscal policy framework (counter-cyclical fiscal policy, sustainable level of public debt), tools (medium-term budget framework law) and fiscal rules (balance and debt).

The draft Fiscal Discipline Law aims to ensure long term application of this systemically new approach to fiscal policy-making and discipline, without it being regularly changed or even abolished. The Ministry of Finance has also prepared amendments to the Constitution of the Republic of Latvia, because in consultation with constitutional law experts it was concluded that for effective operation of the law it is necessary to strengthen at the constitutional level basic principles related to fiscal discipline. This approach allows strengthening basic principles and key provisions of fiscal discipline in the Constitution as superior law in the country, to ensure that they cannot be changed or repealed by adopting other legislative measures, such as the annual State Budget Law, in the Parliament. It should be noted that the legal system of the Republic of Latvia provides that all laws adopted by the Saeima have the same effect, but in situations where the two laws include conflicting provisions, the latest adopted norm shall prevail, or a special legal provision, compared with a general legal provision shall prevail. Accordingly, only by strengthening certain fiscal discipline rules at the constitutional level long term validity of such norms can be ensured. It should be taken into account that amendments to the Constitution needs majority of support of Parliament Members, therefore achieving of changes in the basic national law requires a broad political consensus.

In order to gain significant political support in the Parliament for constitutional changes, and to improve the already developed draft amendments to the Constitution of the Republic of Latvia, in March 2011 the Cabinet of Ministers decided to establish a working group chaired by the Member of Parliament, Parliamentary Secretary of the Ministry of Finance. All parliamentary fractions will be represented in the working group.

The prepared draft fiscal discipline law provides for preparing of Framework Lawfor 3-year period. It will serve as a tool for sustainable fiscal policy planning and implementation in practice (see Clause 7.4.).

The Ministry of Finance projects that the draft Fiscal Discipline Law, along with any amendments to the Constitution, would be submitted to the Parliament till the end of November, 2011.

9.4 Medium-term budget planning

Beginning with 2007, the Framework) for the next three financial years has been prepared, which includes medium-term national macroeconomic analysis, government's fiscal policy objectives for medium term, state budget revenue projections and state budget expenditure ceilings for each ministry and other central government institutions for medium term.

Currently the Framework for 2011 – 2013 is in force, which was approved by the Cabinet of Ministers on December 6, 2010, and the Saeima was informed about it. The Framework was updated on February 9, 2011. The Framework is not legally binding, it only indicates state budget expenditure ceiling for medium term. It is expected that the framework (the law) will become legally binding as the Fiscal Discipline Law will enter into force, and that the State Budget Law for 2013 will be adopted according to the binding legal framework.

The Framework Law will define the following numerical fiscal indicators:

- central government consolidated budget expenditure ceiling for each year of the medium-term budgetary framework period;
- permissible level of central government consolidated budget financial balance as a percentage of gross domestic product for each year of the medium-term budgetary framework period;
- permissible level of general government consolidated budget financial balance as a percentage of gross domestic product for each year of the medium-term budgetary framework period in accordance with the balance calculation procedure prescribed by the Law on Budget and Finance Management and the single balance calculation methodology applied in the European Union.

Currently, it is expected that the Framework Law will developed by the Cabinet of Ministers and submitted to the Parliament not later than on April 30 of year 2012, which will coincide with the submission of the Convergence Programme to the European Commission. It will be approved every year at the end of the second quarter, which will coincide with the annual evaluation process within the framework of the EU semester and approval of Council's recommendations. As a consequence, the national and EU decision-making cycles regarding economic and fiscal issues will be basically harmonized.

The annual draft State Budget Law will be aligned with the Framework Law. In preparing the annual State Budget Law, the central government consolidated budget expenditure ceiling will be set lower than the central government consolidated budget expenditure ceiling set in the medium-term budget framework for relevant year.

Annexes

Table 1a. Growth and related factors

	EKS code	2010	2010	2011	2012	2013	2014
		mln, lats	Increase %				
1. GDP at 2000 prices	B1*g	6805.0	-0.3	3.3	4.0	4.0	4.0
2. GDP at current prices	B1*g	12735.9	-2.7	5.3	5.3	6.0	6.1
GDP by expenditure at 2000 prices							
3. Private consumption	P3	4526.2	-0.1	3.0	4.0	4.0	4.0
4. Public consumption	P3	989.4	-11.0	-1.5	-1.0	1.0	2.0
5. Gross fixed capital formation	P51	1361.0	-19.5	11.0	10.3	8.9	8.1
6. Changes in inventories and net acquisition of valuables	P52+P53		- 130.4	-3.5	-3.5	-3.2	-0.1
7. Exports	P6	3516.8	10.3	5.1	5.0	5.0	5.0
8. Imports	P7	3680.1	8.6	6.1	6.0	6.1	6.1
Contribution to GDP growth							
9. Final domestic demand		-	-6.7	4.0	4.7	4.8	4.9
10. Changes in inventories and net acquisition of valuables	P52+P53	-	5.8	0.0	0.0	0.0	0.0
11. External balance of goods and services	B11	-	0.6	-0.6	-0.7	-0.8	-0.9

Table 1b. Consumer price changes

	ESA code	**2010**	**2010**	**2011**	**2012**	**2013**	**2014**
		level	Increase %				
1. GDP deflator			-2.3	2.0	1.3	2.0	2.0
2. Private consumption deflator			-0.3	3.5	2.0	2.0	2.0
3. HICP changes (year-on-year)			-1.1	3.5	2.0	2.0	2.0
4. Public consumption deflator			-4.3	-2.5	0.5	1.2	1.7
5. Investment deflator			1.2	3.0	2.0	2.0	2.0
6. Export price deflator (goods and services)			7.3	3.0	2.0	2.0	2.0
7. Import price deflator (goods and services)			7.1	4.0	2.0	2.0	2.0

Table 1c. Labour market developments

	ESA code	**2010**	**2010**	**2011**	**2012**	**2013**	**2014**
		level	Increase %				
1. Employment, persons, thousand		940.9	-4.6	1.5	1.3	1.4	1.4
2. Employment, hours worked		1160842279	-8.9	4.1	3.3	3.4	3.3
3. Unemployment rate (%)			18.7	16.4	14.5	12.4	10.3
4. Labour productivity, per employee			4.6	1.7	2.7	2.5	2.6
5. Labour productivity, per hour worked			9.4	-0.8	0.7	0.6	0.6
6. Compensation of employees, mln lats, in current prices	D.1	5465.5	-11.0	3.1	3.3	3.9	3.9
7. Compensation of employees, lats		445	-3.5	1.7	2.0	2.3	2.6

Table 1d. Sectoral balances

% of GDP	ESA code	2010	2011	2012	2013	2014
1. Current and capital account	B.9	5.5	2.3	1.5	0.8	-0.4
Incl.: - Balance of goods and services		-0.3	-1.3	-1.6	-1.9	-2.3
- Balance of primary incomes and transfers		3.8	1.7	1.1	0.7	0.1
- Capital account		1.9	1.9	2.0	2.0	1.8
2. Net lending/ borrowing of the private sector	B.9	13.2	7.6	4.4	2.7	0.7
3. Net lending/ borrowing of the general government	EDP B.9	-7.7	-5.3	-2.9	-1.9	-1.1
4. Statistical discrepancy		-0.2	0.0	0.0	0.0	0.0

Table 2. General government budgetary prospects

		2010	2010	2011	2012	2013	2014
	ESA code	mln lats	% of GDP				
Net lending (EDP B.9) by sub-sector							
1. General government	S.13	-983.8	-7.7	-4.5	-2.5	-1.9	-1.1
2. Central government	S.1311	-636.1	-5.0	-2.4	-1.5	-0.7	-0.9
3. State government	S.1312						
4. Local government	S.1313	-32.5	-0.3	-0.1	0.0	0.0	0.0
5. Social security funds	S.1314	-315.2	-2.5	-2.0	-1.0	-1.1	-0.2
General government (S.13)							
6. Total revenue	TR	4484.3	35.2	38.2	36.9	34.5	32.2
7. Total expenditure	TE	5468.2	42.9	42.8	39.4	36.3	33.3
8. Net lending/borrowing	EDP B.9	-983.8	-7.7	-4.5	-2.5	-1.9	-1.1
9. Interest expenditure	EDP D.41	183.7	1.4	1.8	2.0	2.1	2.4
10. Primary balance		-800.1	-6.3	-2.7	-0.5	0.2	1.3
11. One-off and other temporary measures		-289.1	-2.3	0	0	0	0
Selected components of revenue							
12. Total taxes (12=12a+12b)		2391.8	18.8	18.9	19.3	18.8	18.2
12a. Taxes on production and imports	D.2	1449.7	11.4	12.1	12.6	12.3	11.8
12b. Current taxes on income, wealth etc.	D.5	940.7	7.4	6.8	6.7	6.5	6.4
12c. Capital taxes	D.91	1.4	0.0	0.0	0.0	0.0	0.0
13. Social contributions	D.61	1098.3	8.6	8.9	8.7	8.0	7.5
14. Property income	D.4	203.1	1.6	1.3	1.0	0.9	0.8
15. Other		780.4	6.1	8.2	9.6	9.0	8.5
16. Total revenue	TR	4484.3	35.1	37.3	38.0	36.3	34.9
Tax burden (D.2+D.5+D.61+D.91 – D.995)		3517.2	27.6	28.0	27.7	26.5	25.8
Selected components of expenditure							
17. Compensation of employees + intermediate consumption	D.1+P.2	2186.5	17.2	14.2	12.9	12.0	10.9
17a. Compensation of employees	D.1	1298.7	10.2	8.5	8.0	7.3	6.9
17b. Intermediate consumption	P.2	887.8	7.0	5.7	5.0	4.7	4.1
18. Social payments (18=18a+18b)		1681.0	13.2	12.4	11.2	10.5	9.8
18a. Social transfers through market producers	D.6311, D.63121, D.63131	83.6	0.7	0.6	0.6	0.5	0.5
18b. Social transfers which are no transfers in kind	D.62	1597.4	12.5	11.8	10.6	9.9	9.3
19.=9. Interest expenditure	EDP D.41	183.7	1.4	1.8	2.0	2.1	2.4

		2010	2010	2011	2012	2013	2014
	ESA code	mln lats	% of GDP				
20. Subsidies	D.3	74.6	0.6	0.3	0.3	0.3	0.2
21. Gross fixed capital formation	P.51	453.8	3.6	4.7	3.1	2.0	1.5
22. Other		888.6	7.0	9.3	10.0	9.5	8.4
23.=7. Total expenditure	TE	5468.2	42.9	42.8	39.4	36.3	33.3
Government consumption	P.3	2148.5	16.9	14.2	12.9	12.0	10.9

Table 3. General government expenditure by function

% of GDP	COFOG code	2009	2014
1. General public services	1	4.5	3.9
2. Defence	2	1.2	0.7
3. Public order and safety	3	2.1	1.4
4. Economic affairs	4	7.3	5.5
5. Environmental protection	5	0.9	0.7
6. Housing and community amenities	6	1.1	0.8
7. Health	7	4.7	3.6
8. Recreation, culture and religion	8	1.7	1.1
9. Education	9	6.6	5.0
10. Social protection	10	14.0	10.6
11. Total expenditure	TE	44.2	33.3

Table 4. General government debt developments

% of GDP	ESA code	2010	2011	2012	2013	2014
1. Gross debt		44.7	48.3	48.1	49.9	51.9
2. Change in gross debt ratio		7.0	5.9	2.2	4.6	4.8
Contributions to changes in gross debt						
3. Primary balance		-6.2	-2.7	-0.5	0.2	1.3
4. Interest expenditure	D.41	1.5	1.8	2.0	2.1	2.4
5. Stock-flow adjustment, of which:		-0.7	1.4	-0.3	2.7	3.7
- Differences between cash and accruals		-0.6				
- Net accumulation of financial assets		-0.6				
including privatisation proceeds		*0.1*				
- Valuation effects and other		0.5				
Implicit interest rate on debt		*4.0*	*4.2*	*4.4*	*4.7*	*5.1*
Other relevant variables						
6. Liquid financial assets		9.3				
7. Net financial debt (7=1-6)		35.4				

Table 5. Cyclical developments

% of GDP	ESA code	2010	2011	2012	2013	2014
1. GDP growth in constant prices	B1g	-0.3	3.3	4.0	4.0	4.0
2. Actual budget balance	B9	-7.7	-4.5	-2.5	-1.9	-1.1
3. Interest expenditure	D41	1.5	1.8	2.0	2.1	2.4
4. One-off and other temporary measures		-2.3				
5. Potential GDP growth		-3.6	-1.6	0.5	1.9	2.6
contributions:						

- labour		-1.8	-1.2	-0.4	0.0	0.2
- capital		-0.3	-0.1	0.1	0.3	0.5
- total factor productivity		-1.4	-0.3	0.8	1.6	1.9
6. Gap between potential and actual GDP in per cent of potential GDP		-10.3	-5.1	-1.5	0.5	1.8
7. Cyclical budgetary component		-2.9	-1.4	-0.4	0.1	0.5
8. Cyclically-adjusted balance (2-7)		-4.9	-3.1	-2.1	-2.0	-1.6
9. Cyclically-adjusted primary balance (8+3)		-3.3	-1.3	-0.1	0.1	0.8
10. Structural balance (8-4)		-2.6	-3.1	-2.1	-2.0	-1.6

Table 6. Comparison with forecasts of the 2009 Convergence Programme

	2008	2009	2010	2011	2012	2013	2014
GDP growth %							
2009-2012	-4.6	-18	-4	2	3.8	-	-
2011-2014	-4.2	-18.0	-0.2	3.3	4.0	4.0	4.0
Difference	0.4	0.0	3.8	1.3	0.2	-	-
Actial budget balance (% of GDP)							
2009-2012	-4.1	-10	-8.5	-6	-2.9	-	-
2011-2014	-4.2	-9.7	-7.7	-4.5	-2.5	-1.9	-1.1
Difference	-0.1	0.3	0.8	1.5	0.4	-	-
Government debt, % of GDP							
2009-2012	19.5	34.8	55.1	59.1	56.8	-	-
2011-2014	19.7	36.7	44.7	48.3	48.1	49.9	51.9
Difference	0.2	1.9	-10.4	-10.8	-8.7	-	-

Table 7. Sustainability of public finances (Ageing report of the European Commission for 2009)

% of GDP	2007	2010	2020	2030	2040	2050	2060
Total expenditure							
Of which: age-related expenditures	13.2	12.3	12.4	13.5	13.8	13.8	13.6
Pension expenditure	5.4	5.1	5.2	5.9	6.1	5.8	5.1
Social security pension	5.4	5.1	5.2	5.9	6.1	5.8	5.1
Old-age and early pensions	4.8	4.7	4.8	5.5	5.8	5.5	4.8
Other pensions (disability, survivors)	0.6	0.4	0.3	0.4	0.4	0.3	0.3
Occupational pensions (if in general government)							
Healthcare	3.5	3.5	3.7	3.8	3.9	4.0	4.1
Long-term care	0.4	0.4	0.4	0.5	0.6	0.7	0.9
Education expenditure	3.7	3.1	3.0	3.2	2.9	3.1	3.3
Other age-related expenditures	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Interest expenditure							
Total revenue							
of which: property income							
of which: from pensions contributions	6.8	6.2	6.0	5.8	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	6.4	5.1	3.4	2.7	1.7	1.7	1.7
GDP growth in constant prices	8.4	4.9	2.1	1.8	0.7	-0.1	1.1

% of GDP	2007	2010	2020	2030	2040	2050	2060
Participation rate males (20–64)	85.6	85.1	84.4	83.5	82.6	80.7	83.6
Participation rate females (20–64)	74.9	75.3	75.5	75.4	74.4	72.3	75.8
Total participation rate (20–64)	80.0	80.0	79.8	79.4	78.5	76.5	79.7
Unemployment rate	6.5	4.9	4.9	4.8	4.8	4.8	4.7
Population aged 65+ over total population	17.1	17.4	18.6	22.2	25.4	29.6	34.4

Table 8. Basic assumptions of external environment[10]

	2010	2011	2012	2013	2014
Short-term interest rate (LVL) (annual average)	2.0	1.1	2.0	2.2	2.4
Long-term interest rate (LVL) (annual average)	10.3	6.3	6.0	5.2	5.0
USD/€ exchange rate (annual average)	1.32	1.39	1.39	1.39	1.39
Nominal effective exchange rate	-6.7	0.3	0.3	0.0	0.0
World, excluding EU, GDP growth	5.6	4.6	4.6	4.1	4.0
EU GDP growth	1.9	1.8	1.9	1.8	1.8
World export, excluding EU	12.6	7.4	7.3	7.0	6.0
World import, excluding EU	13.8	8.2	8.0	7.0	6.0
Oil prices (Brent, USD/barrel)	80.2	110.7	109.7	110.0	110.0

Minister for Finance A.Vilks

29.04.2011. 11:05
25 730
Sudare
67083900, Inese.Sudare@fm.gov.lv

[10] Technical assumptions