MINISTRY OF FINANCE
REPUBLIC OF LATVIA

Draft budgetary plan of the Republic of Latvia

2015

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Contents

Tables:

Introduction

Within the framework of the European Semester Latvia submitted the first draft budgetary plan according to the European Parliament and Council Regulation No.473/2013. The Regulation provides for a coordination and strengthening of the process of budgetary surveillance in the euro area as a whole:

- ensuring common budgetary timeline – surveillance of budgetary process, which is carried out in the spring within preparation and submission of Convergence and Stability Programmes to the European Commission (EC), is supplemented by the second surveillance phase, which is implemented in autumn when euro area Member States are preparing annual state budgets;
- establishing common principles for the budget based on fiscal rules in accordance with strengthened Stability and Growth Pact.

Due to general elections that took place on October 4, 2014, elaboration of Annual state budget is still in process and currently the Annual State Budget Law has not been prepared. Thus on October 15 Latvia submits shortened draft budgetary plan prepared on the basis of the Ministry of Finance (MoF) updated macroeconomic scenario and fiscal projections based on a no-policy change scenario. This draft budgetary plan is approved by the current government on October 14 and by Parliament’s European Affairs Commission on October 15. A full draft budgetary plan will be resubmitted to the EC and Eurogroup after the Annual State Budget Law will be prepared by incoming government for the submission to the parliament.

Macroeconomic growth scenario

After recovery of Latvia's economy in the second half of 2010 and 3 years of strong economic growth, expansion of the economy has become slower in the first part of 2014. In 2013, GDP increased by 4.2%, but in the first quarter of this year it slowed down to 2.8%, and to 2.3% in the second quarter, however this is still above the EU average GDP growth rate.

Economic slowdown in the first quarter of 2014 was largely determined by short-term factors, including shutdown of the largest metallurgic factory *Liepājas Metalugs* and weaker demand for energy and heating supply due to warm winter season. In the second quarter of 2014, geopolitical situation in the region and weakening of Russia's economic situation started to negatively influence development of Latvia's economy. As a result, export volumes to Russia and other Commonwealth and Independent States (CIS) fell. However, economy was supported by construction sector, as well as retail trade became stronger in the second quarter of 2014 after weak performance observed in the first quarter.

Economic growth in 2014 was supported primarily by private consumption, which is prompted by continuous improvements in the labour market and rising wages. Nevertheless, economic model will gradually transform and growth will be more balanced between domestic and external demand since the economic situation in the EU is expected to improve, as well as negative impact of the closure of *Liepājas Metalurgs* and large base effect in agriculture will vanish.

Taking into account macroeconomic indicators on the first half of 2014, as well as tensions between Russia and the EU, Russia's trade sanctions and its indirect implications, forecasts for economic growth of Latvia has been revised from 4% to 2.9% in 2014, and from 4% to 2.8% in 2015.

Latest macroeconomic forecasts were developed in August 2014 based on the macroeconomic data available up to 18 August 2014. In order to ensure independence of macroeconomic forecasts, macroeconomic growth scenario has been agreed with the Ministry of Economics and the Bank of Latvia. Moreover, there were consultations with experts from the commercial banks as well as international partners – EC and International Monetary Fund (IMF).

In developing macroeconomic forecasts, MoF has taken into account EU's sanctions against Russia, as well as import ban on several food products introduced by Russia in the beginning of August. However, there is extremely large uncertainty in the external environment and it is impossible to foresee how the situation is going to develop, hence latest macroeconomic forecasts were created assuming that neither further escalation, nor rapid de-escalation of geopolitical situation happen. It is also assumed that the sanctions imposed by Russia will remain in place and will negatively affect growth until the end of 2015, following by gradual recovery of economic growth to 3.3% in 2016 and 3.6% in 2017.

Geopolitical tensions in the region still remain the most significant risk to economic growth of Latvia. In case of the further escalation of tensions between Russia and Ukraine, and additional sanctions or larger than expected indirect impact of current round of sanction on Latvian economy, contraction of economic growth could be larger than currently forecasted. In addition to geopolitical risks, dynamics of the economic sentiment indicator

(ESI) in the European Union suggest that consumers and businesses have become more cautious since in September the indicator demonstrated a fall for the fourth consecutive month. On positive side, resumption of production at *Liepājas Metalugs* in November 2014 could provide significant positive boost to GDP growth.

Table 1a: Macroeconomic prospects

	ESA Code	2013	2013	2014	2015
		bln. euro	Rate of change		
1. Real GDP	B1*g	20.8	4.2	2.9	2.8
of which					
Attributable to the estimated impact of aggregated budgetary measures on economic growth					
2. Potential GDP		20.7	2.6	3.0	3.3
Contributions					
Potential GDP contributions:Labour			0.2	0.4	0.5
Potential GDP contributions:capital			1.2	1.1	1.1
Potential GDP contributions: total factor productivity			1.1	1.5	1.7
3. Nominal GDP	B1*g	23.2	5.3	3.8	5.2
Components Of real GDP					
4. Private consumption expenditure	P.3	13.1	6.2	3.1	3.2
5. Government consumption expenditure	P.3	3.3	-4.2	2.8	2.8
6. Gross fixed capital formation	P.51	4.7	-5.2	1.6	0.6
7. Changes in inventories and net acquisition of valuables (% of GDP)	P.52 + P.53	-0.5	215.0	-5.0	1.5
8. Exports of goods and services	P.6	12.0	1.5	0.6	1.0
9. Imports of goods and services	P.7	12.8	0.3	0.2	0.7
Contribution to real GDP growth					
10. Final domestic demand			1.7	2.7	2.6
11. Changes in inventories and net acquisition of value	P.52 + P.53		1.8	-0.1	0.0
12. External balance of goods and services	B.11		0.7	0.2	0.2

Table 1b: Price developments

	ESA Code	2013	2013	2014	2015
		Levels	Rate of change		
1. GDP deflator			1.1	0.9	2.4
2. Private consumption deflator			0.4	1.0	2.4
3. HICP			0.0	0.8	2.4
4. Public consumption deflator			3.8	0.0	2.0
5. Investment deflator			2.7	1.5	2.4
6. Export price deflator (goods and services)			1.3	-0.5	0.0
7. Import price deflator (goods and services)			0.7	-0.3	0.0

Table 1c: Labour market developments

	ESA Code	2013	2013	2014	2015
		Levels	Rate of change		
1. Employment, persons ('000)		893.9	2.1	0.3	0.2
2. Employment, hours worked		1289793194.0	2.4	0.4	0.2
3. Unemployment rate (%)			11.9	10.8	10.1
4. Labour productivity, persons			2.1	2.6	2.5
5. Labour productivity, hours worked			1.7	2.5	2.5
6. Compensation of employees, bln.euro	D.1	9.6	11.6	7.3	4.7
7. Compensation per employee (Gross wage), euro		716.2	4.6	7.0	4.5

Table 1d: Sectoral balances

	ESA Code	2013	2014	2015
		% of GDP		
1. Net lending/borrowing vis-a-vis the rest of the world	B.9	0.1	0.6	0.5
of which				
- Balance on goods and services		-3.3	-2.9	-2.8
- Balance of primary incomes and transfers		1.0	1.1	0.9
- Capital account		2.5	2.4	2.4
2. Net lending/borrowing of the private sector	B.9	0.3	2.0	1.7
3. Net lending/borrowing of general government	EDP B.9	-1.0	-1.5	-1.0
4. Statistical discrepancy		0.8	0.0	0.0

Fiscal strategy and structural balance objective

Latvia's fiscal policy has not changed and has been described in the Latvia's Stability Programme for 2014-2017.

Structural balance objective for 2015 has been set in accordance with the Fiscal Discipline Law: -1.0% of GDP, which corresponds to the objective for 2015 specified in the Latvia's Stability Programme. The cyclical component of a budget balance for 2015 has decreased against Stability Programme projection from 0.2% of GDP to 0% of GDP. Thus, the permissible general government nominal deficit has increased from 0.8% of GDP to 1.0% of GDP.

Table 2.a: General government budgetary targets broken down by subsector

	ESA Code	2014	2015
		% of GDP	
Net lending (+) / net borrowing (-) (B.9) by sub-sector			
1. General government	S.13	-1.5	-1.0
2. Central government	S.1311	-1.9	
3. State government	S.1312		
4. Local government	S.1313	-0.2	
5. Social security funds	S.1314	0.6	
6. Interest expenditure	D.41	1.4	1.3
7. Primary balance		-0.04	0.3
8. One-off and other temporary measures		-0.4	
9. Real GDP growth (%) (=1. in Table 1a)		2.9	2.8
10. Potential GDP growth (%) (=2 in Table 1.a)		3.0	3.3
contributions:			
- labour		0.4	0.5
- capital		1.1	1.1
- total factor productivity		1.5	1.7
11. Output gap (% of potential GDP)		0.7	0.1
12. Cyclical budgetary component (% of GDP)		0.2	0.0
13. Cyclically-adjusted balance (1 - 12) (% of GDP)		-1.7	-1.0
14. Cyclically-adjusted primary balance (13 + 6) (% of GDP)		-0.3	0.2
15. Structural balance (13 - 8) (% of GDP)		-1.4	-1.0

Table 2.b: General government debt developments

% of GDP	ESA Code	2014	2015
1. Gross debt		39.7	34.6
2. Change in gross debt ratio		2.8	-3.1
Contributions to change in gross debt			
3. Primary balance		-0.04	0.3
4. Interest expenditure	EDP D.41	1.4	1.3
5. Stock-flow adjustment, i.e.		1.4	-4.3
Implicit interest rate on debt		3.9	3.3
Other relevant variables			
6. Liquid financial assets			
7. Net financial debt (7=1-6)			
8. Debt amortization (existing bonds) since the end of the previous year		1.8	0.7
9. Percentage of debt denominated in foreign currency		24.4	31.7
10. Average maturity		4.81 years	
For information - in calculations used GDP data:			
Nominal GDP. mln euros		24 107.0	25 365.6

Table 2.c: Contingent liabilities

% of GDP	2014	2015
Public guarantees	2.0	1.9
GDP	24 107.0	25 365.6

Table 3: General government expenditure and revenue projections at unchanged policies broken down by main components

	ESA Code	2014	2015
		% of GDP	
1. Total revenue at unchanged policies	TR	34.7	33.0
Of which			
1.1. Taxes on production and imports	D.2	12.0	11.9
1.2. Current taxes on income, wealth, etc.	D.5	7.6	7.3
1.3. Capital taxes	D.91	0.0	0.0
1.4. Social contributions	D.61	8.6	8.2
1.5. Property income	D.4	0.7	0.5
1.6. Other		5.8	5.0
p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995)		28.5	27.8
2. Total expenditure at unchanged policies	TE	36.2	34.0
Of which			
2.1. Compensation of employees	D.1	9.4	9.1
2.2. Intermediate consumption	P.2	6.5	6.2
2.3. Social payments	D.62 D.632	10.3	10.3
of which Unemployment benefits		0.4	0.4
2.4. Interest expenditure	D.41	1.4	1.3
2.5. Subsidies	D.3	0.6	0.6
2.6. Gross fixed capital formation	P.51	4.0	3.5
2.7. Capital transfers	D.9	0.4	0.0
2.8. Other		3.5	3.0

Table 4.a: General government expenditure and revenue targets, broken down by main components

	ESA Code	2014	2015
		% of GDP	
1. Total revenue target	TR	34.7	33.0
Of which			
1.1. Taxes on production and imports	D.2	12.0	11.9
1.2. Current taxes on income, wealth, etc.	D.5	7.6	7.3
1.3. Capital taxes	D.91	0.0	0.0
1.4. Social contributions	D.61	8.6	8.2
1.5. Property income	D.4	0.7	0.5
1.6. Other		5.8	5.0
p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995)		28.5	27.8
2. Total expenditure target	TE3	36.2	34.0
Of which			
2.1. Compensation of employees	D.1	9.4	9.1
2.2. Intermediate consumption	P.2	6.5	6.2
2.3. Social payments	D.62 D.632	10.3	10.3
of which Unemployment benefits		0.4	0.4
2.4. Interest expenditure (= Table 2.a.9.)	D.41	1.4	1.3
2.5. Subsidies	D.3	0.6	0.6
2.6. Gross fixed capital formation	P.51	4.0	3.5
2.7. Capital transfers	D.9	0.4	0.0
2.8. Other		3.5	3.0

4.c.i) General government expenditure on education, healthcare and employment

	2014		2015	
	% of GDP	% general government expenditure	% of GDP	% general government expenditure
Education	5.4	15.0	5.1	14.9
Health	3.8	10.6	3.6	10.5
Employment	0.2	0.5	0.2	0.5

4.c.ii) Classification of the functions of the Government

	COFOG Code	2014	2015
		% of GDP	
1. General public services	1	4.5	4.2
2. Defense	2	0.9	1.0
3. Public order and safety	3	1.8	1.7
4. Economic affairs	4	5.2	4.9
5. Environmental protection	5	0.7	0.7
6. Housing and community amenities	6	1.2	1.1
7. Health	7	3.8	3.6
8. Recreation, culture and religion	8	1.5	1.4
9. Education	9	5.4	5.1
10. Social protection	10	11.2	10.4
11. Total Expenditure (= item 2 in Table 2.c.i)	TE	36.2	34.0

Table 4.b: Amounts to be excluded from the expenditure benchmark

	ESA Code	2013	2013	2014	2015
		mln.euro	% of GDP		
1. Expenditure on EU programmes fully matched by EU funds revenue		1100.5	4.7	5.2	4.4
2. Cyclical unemployment benefit expenditure					
3. Effect of discretionary revenue measures		-58.0	-0.2	0.0	-0.2
4. Revenue increases mandated by law					

The general government budget deficit for 2014 is projected at 1.5% of GDP, which compared to Stability programme's projections is by 0.5 percentage points higher. Deficit increase was mainly due to tax revenue decline according to the latest macroeconomic development scenario, as well as expenditure increase for social support, payments into EU budget, as well as projections of other expenditure items, based on actual performance in eight months of 2014, and other one-off factors.

The general government budget deficit under no policy change scenario for 2015 is projected at 1.0% of GDP, which is by 0.2 percentage points higher, compared to Stability programme's projections. That is mainly due to lower tax revenue projections based on the latest macroeconomic development scenario and higher expenditure for social support, and increased defence expenditure in line with the law.

Given that the cyclical component in 2015 is projected to be 0% of GDP, the general government structural balance at unchanged policy is projected to be 1.0% of GDP, which corresponds to the structural balance target. Thus, the fiscal space for additional revenue decreasing and expenditure increasing measures is 0.

Table 5: Divergence from Stability Programme 2014-2017

	ESA Code	2013	2014	2015
		% of GDP		
Target general government net lending/ net borrowing	**B.9**			
Stability Programme		-1.0	-1.0	-0.8
Draft Budgetary Plan		-1.0	-1.5	
Difference		0.0	-0.5	
General government net lending projection at unchanged policies	**B.9**			
Stability Programme		-1.0	-1.0	-0.8
Draft Budgetary Plan		-1.0	-1.5	-1.0
Difference		0.0	-0.5	-0.2

Table 6.a: CSR recommendations

Information will be updated. See Latvia’s National Reform Programme: **http://ec.europa.eu/europe2020/pdf/csr2014/nrp2014_latvia_lv.pdf**

Table 6.b: Targets set by the Union’s Strategy for growth and jobs

Information will be updated. See Latvia’s National Reform Programme: **http://ec.europa.eu/europe2020/pdf/csr2014/nrp2014_latvia_lv.pdf**

Annex: Methodological aspects

Macroeconomic forecasts are developed by a medium-term macro-economic model, which ensures proper macroeconomic relationships within the forecasts and employs short-term and medium-term results of econometric models as well as expert assessment.

Preparing tax revenue projections, widely known forecasting methods and assumptions are applied, however the most used is specially developed tool, i.e. the model LATIM-F. The most frequently tax revenue forecasting techniques are as follows:

- using a detailed tax revenue estimations;
- forecasting of tax revenue share in GDP, %;
- forecasting the actual taxable base/base modelled relationships;
- using expert assessment;
- using other techniques.

In order to project tax revenue, as stated above, the MoF uses tax revenue forecast model LATIM-F, whose main components are data base of macroeconomic indicators, actual tax revenue and legislative changes (including tax rates, etc.). Moreover in the process of analysis the information from the Treasury, the State Revenue Service, the Central Statistics Bureau and other sources is used.