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DECEMBER 2004 UPDATE OF THE CONVERGENCE PROGRAMME OF LATVIA (2004-2007)

AN ASSESSMENT

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SUMMARY AND CONCLUSIONS[1]

The first update of the Latvian convergence programme, covering the period 2004-2007, was adopted by the Latvian Cabinet of Ministers on 28 December and submitted to the European Commission on 30 December 2004. The programme is based on the economic projections in the 2005 budget law presented to the Parliament on 13 December 2004 and adopted by the Parliament on 20 December. The updated programme broadly complies with the data requirements of the "code of conduct on the content and format of stability and convergence programmes". However, the ESA95 classification of data on the composition of the general government revenue and expenditure needs to be improved.

In the update, GDP growth of 8.1% is estimated for 2004 and 6.7% foreseen for 2005, with domestic demand, in particular investment and private consumption, continuing to expand vigorously. For 2006 and 2007, GDP growth is set only slightly lower (6.5% in both years). Export growth has picked up strongly, reflecting global economic recovery and a positive impact from Latvia's accession to the EU; nevertheless, this has been outpaced by the growth of imports accompanying the surge in domestic demand. The growth contribution of net exports in the immediate term is set to be negative and the wide current account deficit to narrow only marginally. Unemployment is projected to fall only gradually despite the strong growth of economic activity. Overall, on the basis of currently available information, the macroeconomic scenario seems plausible and is broadly in line with the Commission services' evaluation including the autumn 2004 forecast.

To achieve the Bank of Latvia's price stability objective, from 1994 the currency (lats) was pegged to the SDR, with a normal fluctuation band around the central rate of ±1 percent. The Latvian authorities plan to join ERM II in early 2005 and aim for euro adoption at the earliest on 1 January 2008. On 1 January 2005, as a step in this strategy, the lats was re-pegged at market rates from the SDR to the euro, with a normal fluctuation band around the new central rate also of ±1 percent. Local currency interbank rates have fallen closer towards euro area levels following the re-pegging. The long-term bond yield vis-à-vis the euro area fluctuated during 2004 in the range of a premium of ½-1 percentage point. Up until 2003 HICP inflation was relatively low. In the course of 2004, however, HICP inflation accelerated substantially, peaking at 7.8 percent in August before easing slightly during the final quarter and averaging 6.2 percent for the year. The authorities consider inflation developments in 2004 to have been of a temporary nature; they expect CPI inflation to decline from 6.2 percent in 2004 to 3.0 percent in 2006.In 2005 inflation will continue to be influenced by increasing administratively regulated prices and indirect tax rate harmonisation measures. Nevertheless, due to favourable base effects, and provided that overheating is avoided, inflation should decrease gradually, though with the likelihood of slightly higher inflation than foreseen by the national authorities.

The programme update aims at keeping the deficit below the 3% of GDP reference value in each programme year, with the general government budget deficit gradually falling

[1] This technical analysis, which is based on information available up to 9 February 2005 accompanies the recommendation by the Commission for a Council opinion on the update of the convergence programme, which the College adopted on 16 February 2005. It has been carried out by the staff of and under the responsibility of the Directorate-General for Economic and Financial Affairs of the European Commission. Comments should be sent to Kristine Vlagsma (Kristine.Vlagsma@cec.eu.int).

from a programme estimate of 1.7% of GDP in 2004[2] to 1.4% of GDP in 2007. Reflecting the impact of EU transfers and associated spending, both expenditure and revenues are projected to peak in 2005, at 39.3% and 37.7% of GDP respectively, and thereafter gradually to decline to 36.5% and 35.1% of GDP respectively by 2007. The medium-term adjustment in public finances is based on a reduction of both the revenue and the expenditure ratios. The primary balance improves over the programme period, with the total expenditure ratio falling due to a decreased primary expenditure ratio and to some extent interest payments. The primary expenditure ratio falls mainly as a result of lower ratios of transfers and subsidies while at the same time allowing for an increase in the investment ratio. The revenue ratio falls as a consequence of tax reductions, mainly on income, lowering the tax burden moderately. While the overall strategy remained unaltered as compared with the May 2004 programme, the projected budget deficits have been revised downwards from around 2% of GDP each year in the former programme.

The risks to the budgetary projections in the programme appear broadly balanced. On the one hand, assumptions about the tax intensity of economic activity seem somewhat pessimistic, suggesting that revenues could be better than expected. Indeed, Latvia has established a track record of cautious forecasting, with repeated overshooting of fiscal targets over the past few years. Furthermore, as regards budgetary control, a special procedure exists which could facilitate relatively rapid in-year adjustment in the event of budgetary developments going off-track On the other hand, given the commitment of expenditures predicated on support from EU funding, the achievement of the deficit targets is conditional on the receipt of such funds in government revenues. Tight expenditure discipline (including in managing partly EU-funded projects) might be difficult given weaknesses in administrative capacity.

In the light of this risk assessment, the budgetary stance in the programme is insufficient to achieve the close-to-balance-or-surplus medium-term objective of the Stability and Growth Pact within the programme period. Furthermore, even though the programme outlines a relatively ambitious consolidation path, it may provide insufficient margin against breaching the 3% of GDP deficit threshold with normal macroeconomic fluctuations. However, it is sufficient to maintain the debt-to-GDP ratio at a very low level.

The debt ratio is estimated at 14.2% of GDP in 2004, clearly well below the 60% of GDP Treaty reference value. The slight increase in the debt ratio over the programme period, to 15.0% of GDP in 2007, mainly results from persisting deficits, substantially offset by nominal GDP growth.

The programme briefly reviews the government’s structural reform programme which focuses on measures to improve the business environment, competitiveness and development of energy and communication sectors, the education and healthcare systems, on active labour market policies as well as the promotion of innovation and research. The programme also outlines measures to strengthen further the budget process through a multi-annual budgeting framework, and to increase the transparency and reliability of the nominal expenditure ceilings through systematic evaluation mechanisms. The reforms, most of which are already underway or concerning which legislation is being prepared, can reasonably be expected to improve the growth

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[2] More recent information for central government cash accounts suggests a lower estimate of the general government budget deficit.

conditions of the Latvian economy: by raising productivity and strengthening incentives to work, facilitating job creation and discouraging tax evasion, as well as improving fiscal discipline both with line ministries and at local government level.

Latvia appears to be in a relatively favourable position with regard to long-term sustainability of the public finances, despite the projected budgetary costs of an ageing population. The relatively low debt ratio in Latvia, the pension reform measures enacted, including the introduction of the funded pillar, and the accumulation of assets in the funded pension scheme will contribute to limit the budgetary impact of ageing. The strategy outlined in the programme is based on a contained budgetary deficit over the medium term and the budgetary impact of the pension reform. Reforms in the field of health and long-term care could, however, involve higher expenditures. A risk to sustainability may emerge in the long run. Latvia's relatively low tax ratio should, however, ease the accommodation of any such sustainability gap that may arise.

Overall, the economic policies outlined in the update are broadly consistent with the country-specific broad economic policy guidelines (BEPGs) in the area of public finances. Under the challenge to address the sizable current account deficit, Latvia was recommended to reduce the general government deficit in a credible and sustainable way within a multi-annual framework. In the light of the narrowing current account deficit foreseen in the programme, the lower than previously budgeted deficit in 2004 and the consolidation path foreseen in the update are in line with the recommendation in the BEPGs. However, this assessment is conditional on the favourable development of the external balance and is thus subject to further monitoring. Furthermore, as was pointed out in the Council Opinion on the programme of last May, assessment of the appropriate fiscal position is also dependent on demand pressures in the economy, even if it is difficult to determine the country's position in the business cycle; the assessment is also therefore conditional on macroeconomic policy being appropriate to consolidating the moderation in inflation from its recent peak.

Table: Comparison of key macroeconomic and budgetary projections

		2004	2005	2006	2007
Real GDP (% change)	**CP Dec 2004**	**8.1**	**6.7**	**6.5**	**6.5**
	COM	7.5	6.7	6.7	n.a.
	CP May 2004	*6.7*	*6.7*	*6.5*	*6.5*
HICP inflation[1] (%)	**CP Dec 2004**	**6.2**	**4.3**	**3.0**	**3.0**
	COM	6.8	4.7	3.5	n.a.
	CP May 2004	*4.5*	*3.7*	*3.0*	*3.0*
General government balance (% of GDP)	**CP Dec 2004**	**-1.7**	**-1.6**	**-1.5**	**-1.4**
	COM	-2.0	-2.8	-2.9	n.a.
	CP May 2004	*-2.1*	*-2.2*	*-2.0*	*-2.0*
Primary balance (% of GDP)	**CP Dec 2004**	**-0.9**	**-0.9**	**-0.8**	**-0.7**
	COM	-1.2	-2.0	-2.0	n.a.
	CP May 2004	*-1.2*	*-1.3*	*-1.2*	*-1.2*
Cyclically-adjusted balance (% of GDP)	**CP Dec 2004[2]**	n.a.	n.a.	n.a.	n.a.
	COM	n.a.	n.a.	n.a.	n.a.
	CP Dec 2004[2]	n.a.	n.a.	n.a.	n.a.
Government gross debt (% of GDP)	**CP Dec 2004**	**14.2**	**14.5**	**14.8**	**15.0**
	COM	14.6	15.4	16.6	n.a.
	CP May 2004	*16.2*	*16.8*	*17.3*	*17.7*

Note:
[1] CPI inflation for convergence programme data

[2] Commission services calculations on the basis of the information in the programme

Sources:
Convergence programme (CP); Commission services autumn 2004 economic forecasts (COM); Commission services calculations

1. INTRODUCTION

The Latvian convergence programme was originally presented in May 2004, shortly after EU accession. The first update of the programme, also covering the period 2004-2007, was adopted by the Latvian Cabinet of Ministers on 28 December and submitted to the European Commission on 30 December 2004. The programme is based on the economic projections in the 2005 budget law presented to the Parliament on 13 December 2004 and passed on 20 December.

The updated programme broadly complies with the data requirements of the "code of conduct on the content and format of stability and convergence programmes"[3]. However, the ESA95 classification of data on the composition of the general government revenue and expenditure needs to be improved[4] and more information could be provided on medium-term fiscal objectives. The programme provides a useful overview of initiatives in different areas of structural policy.

2. MACROECONOMIC DEVELOPMENTS

The macroeconomic scenario provided in the programme estimates real GDP growth in 2004 of 8.1%. In 2005, real GDP is forecast to reach 6.7% and to ease slightly to 6.5% in 2006 and 2007. This is roughly in line with last year's programme and also close to the Commission services autumn 2004 forecast (Table 1).

The macroeconomic scenario in the update is based on strong growth of domestic demand, driven by investment and private consumption, continuing in the medium term. In 2004 household spending was boosted by increases in disposable incomes and substantial personal borrowing. Investment growth also accelerated in 2004 with housing investment increasing strongly. On the external side export growth has picked up strongly, reflecting the global economic recovery and a positive impact from Latvia's accession to the EU. Nonetheless, in view of the strong growth of imports accompanying the surge in domestic demand, the growth contribution of net exports throughout the programme period is set to be negative. This scenario is on the whole similar to that of the Commission services. Both foresee inflationary pressures to remain rather high in the coming years, though with the Commission services being more pessimistic. Similarly, both the updated programme and the Commission services project unemployment to fall only gradually despite strong growth of economic activity.

The current account deficit has been on an increasing trend since 1995 and according to the programme is expected to have reached 10.3% of GDP in 2004, following a 2003

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[3] Revised Opinion of the Economic and Financial Committee on the content and format of stability and convergence programmes, EFC/ECFIN/404/01 - REV 1 of 27.06.2001 endorsed by the ECOFIN Council of 10.07.2001.

[4] Classification of data on the composition of the general government revenue and expenditure does not provide a sufficiently detailed break-down of the components of general government expenditure and revenues, most notably, the categories "other revenues" and "other expenditure" are large and each close to 10% of GDP. Furthermore, only gross interest payments are provided; the projected inflation rate is the CPI and not the HICP; and harmonised unemployment data are missing. However, global general government debt and deficit figures adhere to the ESA95 methodology and have been validated by Eurostat.

deficit of 8.2% of GDP. This widening is the combined result of a large and increasing trade deficit, a declining services balance and emerging income deficit. According to the most recent available estimates, the trade deficit is expected to have reached around 18% of GDP in 2004, despite strong exports growth. The services balance has remained positive, mainly reflecting transit earnings, and in 2004 is likely to have covered about 25% of the trade deficit. In terms of sectoral counterparts the external deficit corresponds to a persistent negative general government net lending balance (between 1995 and 2004 averaging -1.7% of GDP) and, of much larger size, a private sector saving-investment gap: increasing saving of the private sector has been outweighed by higher and more rapidly increasing private sector investment (up from 13% of GDP in 1995 to 30% of GDP in 2004).

Table 1: Comparison of macroeconomic developments and forecasts

	2004		**2005**		**2006**		**2007**
	COM	**CP**	**COM**	**CP**	**COM**	**CP**	**CP**
Real GDP (% change)	7.5	8.1	6.7	6.7	6.7	6.5	6.5
Contributions:							
- Final domestic demand	9.6	11.4	9.4	9.1	9.0	8.0	7.6
- Change in inventories	0.8	-0.6	-0.2	-1.1	0.0	-0.7	-0.3
- External balance on g&s	-3.0	-2.8	-2.4	-1.3	-2.3	-0.9	-0.7
Employment (% change)	0.8	1.0	0.6	1.0	0.6	0.5	0.5
Unemployment rate (%)	9.9	10.3	9.7	9.7	9.4	9.0	8.3
CPI inflation (%)	6.8	6.2	4.7	4.3	3.5	3.0	3.0
GDP deflator (% change)	6.7	6.8	6.8	4.7	5.1	3.0	2.7
Current account (% of GDP)	-9.9	-10.3	-9.8	-9.5	-9.6	-9.1	-8.9
Sources: *Commission services autumn 2004 economic forecasts (COM); convergence programme update (CP)*							

The programme projections for the current account balance imply large net inflows of foreign capital throughout the programme period. Although FDI inflows dropped from around 5.5% of GDP in 2000 to around 3.0% (39% of the current account deficit) in 2003, EU accession seems to have promoted new inflows of foreign direct investment. In the first half of 2004, FDI grew significantly, reaching 5.3% of GDP. Currently, banking sector loans (principally, extended financing by parent banks) and FDI cover three-quarters of the current account deficit.

Containing the external deficit, as projected in the update, will be contingent on generating adequate national savings, since the structural part of the current account deficit reflects the domestic saving-investment gap arising from the need for technological innovation and catching up[5]. Though the level of domestic savings is increasing, its growth is still insufficient to meet rising investment needs. Public sector savings, given the policy stance represented in the programme, and despite the contribution of EU funds, are not expected to increase markedly in the medium-term. This emphasises the importance of maintaining a prudent fiscal policy and of pursuing structural reforms that will increase productive capacity including the export potential of the economy. It also emphasises the importance, if demand for credit continues to expand

[5] Labour productivity in Latvia is the lowest in the EU (under 40 per cent of the EU-15 average). Some of the underlying reasons include limited research and development activity, low capital intensity and a still relatively low level of physical infrastructure. All these factors contribute to Latvia being specialised in relatively low-tech sectors and in transit activities with low value-added.

rapidly, of prudential vigilance to ensure that imbalances in the private sector reflect sound resource allocation.

The programme's external assumptions on exchange rates and interest rates are in line with those of the Commission services autumn 2004 forecast.

Risks to the macroeconomic scenario include Latvia's particular sensitivity to changes in external demand and its terms of trade. Weaker than expected external demand could call into question the envisaged slight improvement of the current account balance, both in terms of lower real exports and in terms of lower export prices (a large share of Latvian exports consists of timber and wood products, subject to sharp price changes). In addition to vulnerability to external demand shocks, risks to growth stem from structural constraints (such as the low geographic mobility of labour force resulting from poor transport infrastructure and concentration of investment in the capital area).

On the basis of the data in the programme, Table 2 presents potential growth and output gap estimates using the commonly agreed methodology. The estimates, which are overall similar to those made on the basis of the Commission services autumn 2004 forecast, suggest that a positive output gap in 2004 will narrow and become negative. According to the autumn forecast, the output gap becomes negative already in 2005, whereas the Commission services calculations, based on the commonly agreed methodology applied to the programme's data, suggest a negative output gap two years later. Most importantly, both projections agree on the level of potential growth. However, it should be noted that estimates of output gaps and of potential growth on which they are based, in a transition economy such as Latvia, are subject to a particularly wide margin of uncertainty.

Overall, on the basis of currently available information, the macroeconomic scenario seems plausible and is broadly in line with the Commission services' evaluation including the autumn 2004 forecast.

Table 2: Sources of potential output growth

	2004		**2005**		**2006**		**2007**
	COM	**CP[3]**	**COM**	**CP[3]**	**COM**	**CP[3]**	**CP[3]**
Potential GDP growth[1]	7.2	7.2	7.6	7.5	7.7	7.5	7.0
Contributions:							
- Labour	0.6	0.5	0.9	0.7	0.9	0.7	0.4
- Capital accumulation	3.2	3.5	3.2	3.5	3.3	3.5	3.4
- TFP	3.3	3.1	3.3	3.1	3.3	3.1	3.1
Output gap[1,2]	0.7	1.6	-0.2	0.9	-1.1	0.0	-0.5

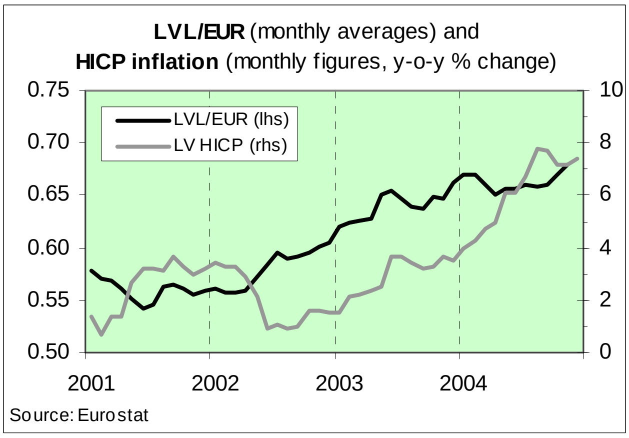
Notes:
[1]based on the production function method for calculating potential output growth
[2]in percent of potential GDP
[3]Commission services calculations on the basis of the information in the convergence programme update

Sources:
Commission services autumn 2004 economic forecasts (COM); Commission services calculations

3. MEDIUM-TERM MONETARY POLICY OBJECTIVES AND THEIR RELATIONSHIP TO PRICE AND EXCHANGE RATE STABILITY

The primary objective of the Bank of Latvia's monetary policy is to maintain price stability. To achieve this objective, the lats was pegged to the SDR basket of currencies at a fixed rate between 1994 and end-2004. As a step in the authorities' strategy to euro adoption, the lats was re-pegged from the SDR to the euro – in line with plans that had been in place for more than a year – on 1 January 2005 at market rates. Under the new euro peg, the lats' exchange rate is fixed at EUR 0.702804, with a fluctuation interval of ±1 percent as a unilateral commitment. The Latvian authorities plan to join ERM II in early 2005 and aim for euro adoption on 1 January 2008 at the earliest. Within ERM II, Latvia intends to unilaterally limit exchange rate fluctuations to ±1 percent around the central rate.

In the period between January 2004 and mid-March 2004, in line with the slight dollar appreciation vis-à-vis the euro, the lats strengthened vis-à-vis the euro. The lats subsequently lost ground vis-à-vis the euro and was re-pegged at EUR 0.702804, around 5 percent weaker than its level on 4 January 1999. When local markets opened for the first trading day in 2005 the LVL strengthened vis-à-vis the EUR to around 0.696, i.e. close to the Bank of Latvia's intervention limit. Since then, the lats has been trading on the stronger side of its pegged rate in the interval 0.696-0.697. Local currency interbank rates fell closer toward euro area levels following the re-pegging. The three-month RIGIBOR fell from 4.4 percent on 30 December 2004 to 4.0 percent on 28 January 2005 and the spread to the three-month EURIBOR had decreased to 1.9 percentage points on the latter date. The long-term bond yield spread vis-à-vis Germany fluctuated in the interval ½-1 percentage point during 2004, notwithstanding high inflation rates in Latvia.



Inflation has been rising since 2003. In the course of 2004, HICP inflation accelerated substantially and peaked at 7.8 percent in August before easing slightly to 7.4 percent in December. For 2004 as a whole, HICP inflation was 6.2 percent. The acceleration of inflation in 2004 can largely be accounted for by one-off events, such as increases in administratively regulated prices and amendments to tax and insurance laws. Supply-side factors, such as increasing world food prices, bad harvests in Latvia and higher oil prices, also contributed to rising inflation in the course of 2004. The substantial increase in pre-accession import demand may also have contributed. While it is not straightforward to conclude that buoyant domestic demand – inter alia due to strong credit growth – had a sizeable impact on inflation in 2004, some core inflation measures point to more substantial underlying demand pressures.

Against the background of ongoing strong domestic demand, the Bank of Latvia's Board of Governors decided on 15 July 2004 to raise the reserve requirement for banks and foreign bank branches from 3 percent to 4 percent with a view to curbing domestic demand growth. On 11 November, the Bank decided to raise the refinancing rate by 0.5 percentage points to 4.0 percent and to extend reserve base of minimum reserves including in the reserve base the financial institutions' liabilities to foreign banks and foreign central banks with an agreed maturity or redeemable at notice of up to 2 years. The authorities consider inflation developments in 2004 to be of a temporary nature and expect CPI inflation to gradually decline from 6.2 percent in 2004 to 4.3 and 3.0 percent in 2005 and 2006, respectively. The Commission recognises that, to some extent, inflation in 2005 will continue to be influenced by further increases in administratively regulated prices and by indirect tax harmonisation measures. Over the coming years, due to favourable base effects, inflation is expected to decrease gradually, based on the assumption that fiscal policy follows a prudent course to reduce the risk of overheating.

4. BUDGETARY IMPLEMENTATION IN 2004

The estimated general government deficit for 2004 in the present update is 1.7% of GDP[6] based on GDP growth of 8.1%. This compares with the higher deficit and weaker growth performance foreseen in the previous programme (deficit of 2.1% of GDP, growth of 6.7%). The Commission services autumn forecast estimated a deficit of 2.0% of GDP based on GDP growth of 7.5%.

The modest reduction of the deficit in 2004 compared to the target masks factors pulling in different directions. Pulling the expected deficit downwards in relation to the previous programme is a significantly higher estimated GDP growth. On the other hand, 2004 budget amendments implemented in December 2004 increased expenditure, including a number of one-off payments previously intended for 2005, such as direct payment to farmers, contributions to the EU 2005 budget and advancing of financing for some development and structural projects.

Budget positions across general government sub-sectors are broadly as envisaged in the previous programme, showing a modest surplus (0.6% of GDP) for the social security sub-sector, a sizable deficit (2.1% of GDP) for central government and a modest deficit (0.2% of GDP) in the local government sub-sector.

Revenues are estimated to be 34.3% of GDP in 2004, compared to 35.6% in the previous programme. Also expenditure is estimated in the present update to have been relatively lower in 2004, 36.0% of GDP compared to 37.6%. The fiscal situation in 2004 was strongly marked by various EU accession effects. Apart from changes to some taxes and administrative prices as of May, there was some uncertainty about the country’s ability to absorb EU transfer payments in its first year of membership, and related levels of co-financing[7]. Last but not least, following a revision of the national accounts[8] published after submission of the May programme, GDP figures were revised substantially upwards for the period 1995-2003, which renders very difficult a meaningful comparison of revenue and expenditure ratios, as well as the level of tax burden, between the two programmes.

5. BUDGETARY TARGETS AND THE MEDIUM-TERM PATH OF THE PUBLIC FINANCES

5.1. Evolution of budgetary targets in successive programmes

The updated programme foresees a gradual reduction of the general government deficit from 1.7% of GDP in 2004 to 1.4% of GDP in 2007. The deficit reduction path in the update is more ambitious than that in the pre-accession economic programme of August 2003. When compared to the May 2004 programme, there is a marked reduction of the deficit targets for 2004-2007 (as a percent of GDP). GDP growth was revised upwards considerably for 2004, but remains unchanged for subsequent years.

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6 More recent preliminary information for the general government deficit tentatively suggests a lower estimate.

7 The preliminary information on budget execution in 2004 indicates about 80% absorption capacity in 2004.

8 The major reason for the revision was methodological changes in the calculation of real estate services (including imputed rent) and the consumption of fixed capital.

Table 3: Evolution of budgetary targets in successive programmes

		2003	2004	2005	2006	2007
General government balance (% of GDP)	**CP December 2004**	**-1.5**	**-1.7**	**-1.6**	**-1.5**	**-1.4**
	CP May 2004	-1.8	-2.1	-2.2	-2.0	-2.0
	PEP August 2003	-2.9	-2.4	-2.2	-2.0	*n.a.*
General government expenditure (% of GDP)	**CP December 2004**	**36.0**	**36.0**	**39.3**	**38.8**	**36.5**
	CP May 2004	38.1	37.6	38.1	37.2	37.3
	PEP August 2003	45.1	44.7	44.4	44.2	*n.a.*
General government revenues (% of GDP)	**CP December 2004**	**34.5**	**34.3**	**37.7**	**37.3**	**35.1**
	CP May 2004	36.3	35.6	35.9	35.2	35.3
	PEP August 2003	42.2	42.3	42.2	42.2	*n.a.*
Real GDP (% change)	**CP December 2004**	**7.5**	**8.1**	**6.7**	**6.5**	**6.5**
	CP May 2004	7.5	6.7	6.7	6.5	6.5
	PEP August 2003	6.5	6.1	6.0	6.0	*n.a.*
Sources: *Convergence programmes (CP); pre-accession economic programme (PEP)*						

5.2. Budgetary targets in the updated programme

Maintaining a stable macroeconomic environment conductive to growth is a key objective of Latvian fiscal policy. The present programme aims at keeping the deficit below the 3% of GDP reference value in each year with the general government budget deficit gradually reduced from 1.7% of GDP in 2004 to 1.4% of GDP in 2007. The budget priorities of the Latvian government are to facilitate investment and the absorption of EU funds while at the same time reducing the overall tax burden. Reflecting the impact of EU transfers and associated spending, both expenditures and revenues are projected to peak in 2005, at 39.3% and 37.7% of GDP respectively, and thereafter to decline gradually to 36.5% and 35.1% of GDP respectively by 2007. This is, most importantly, a result of the front-loading of EU funds-related budgeting programmed for the period 2004-2007. As shown in table 4, the medium-term adjustments in public finances are composed of a reduction in both revenue and expenditure ratios. The primary balance improves over the programme period, with the total expenditure ratio falling due to a decreased primary expenditure ratio and to some extent lower ratio of interest payments. The primary expenditure ratio falls mainly as a result of lower ratios of transfers and subsidies. The revenue ratio falls through tax reductions, mainly on income, lowering the tax burden moderately. Starting from 2005, the government plans to commence the modernisation and restructuring of the healthcare system, requiring a 10-15% annual increase of public financing over the medium-term; to increase significantly the financing of fundamental research and higher education; to increase social expenditure to ensure pension indexation relative to a composite basket of wages and prices and increases in childcare allowances. Strong growth, changes to the spending structure including administrative reform, improved tax-collection and VAT increases implied by EU accession are expected to provide for financing of these reforms. While the social security budget is projected to remain in surplus over the entire programme period, the central government is expected to run sizable though declining deficits and local governments are expected to run modest and stable deficits. The programme does not provide an explicit estimate for the impact of EU accession on the fiscal balance. However, given that co-financing requirements had been incorporated into budgetary projections at an early stage and long-term plans for public investment adapted to EU funds, the impact of EU accession is most notably associated with budgetary expansion.

Table 4: Composition of the budgetary adjustment

(% of GDP)	2003	2004	2005	2006	2007	Change: 2007-2004
Revenues	34.5	34.3	37.7	37.3	35.1	**0.8**
of which:						
- Taxes & social security contributions	29.1	28.3	28.1	28.0	27.5	**-0.8**
- Other (particularly, foreign financial assistance and self-earned revenues)	5.4	6.0	9.6	9.3	7.6	**1.6**
Expenditure	36.0	36.0	39.3	38.8	36.5	**0.5**
of which:						
- Primary expenditure	35.2	35.2	38.5	38.1	35.8	**0.6**
of which:						
Gross fixed capital formation	1.5	1.6	1.8	1.9	1.9	**0.3**
Consumption	11.7	11.6	11.9	12.0	12.3	**0.7**
Transfers & subsidies	10.4	9.5	9.3	9.2	8.7	**-0.8**
- Other (particularly, co-financing of EU-funds related expenditure, payments to international organizations, investment)	11.6	12.5	15.5	15.0	12.9	**0.4**
- Interest payments	0.8	0.8	0.8	0.7	0.7	**-0.1**
Budget balance	**-1.5**	**-1.7**	**-1.6**	**-1.5**	**-1.4**	**0.3**
Primary balance	**-0.7**	**-0.9**	**-0.9**	**-0.8**	**-0.7**	**0.2**

Sources:
Convergence programme update; Commission services calculations

The Commission services autumn 2004 forecast was based on the draft 2005 budget that failed to be approved by the Parliament and which differs considerably from the 2005 budget featured in the updated programme. Accordingly, the Commission services 2005 budget deficit forecast of 2.8% of GDP is not comparable with the target of 1.6% of GDP set in the budget and the convergence programme. As regards 2006, the 2006 deficit was projected by the Commission services to be 2.9% of GDP under a no-policy-change assumption, 1.4 percentage points higher than the updated programme deficit.

Table 5: Budgetary targets and output gaps

	2003		2004		2005		2006		2007	Change: 2007-2004
	COM	CP[1]	COM	CP[1]	COM	CP[1]	COM	CP[1]	CP[1]	CP[1]
Budget balance[2]	-1.5	-1.5	-2.0	-1.7	-2.8	-1.6	-2.9	-1.5	-1.4	0.3
Output gap[1,3]	0.4	0.7	0.7	1.6	-0.2	0.9	-1.1	0.0	-0.5	-2.1

Notes:
[1] Commission services calculations on the basis of the information in the convergence programme (CP)
[2] in percent of GDP
[3] in percent of potential GDP

Sources:
Commission services autumn 2004 economic forecasts (COM); Commission services calculations

The risks to the budgetary projections in the programme appear broadly balanced. On the one hand, assumptions about the tax intensity of economic activity seem somewhat pessimistic, suggesting that revenues could be better than expected. Indeed, Latvia has established a track record of cautious forecasting, with repeated overshooting of fiscal targets over the past few years. In particular, earlier measures for improving tax-collection and simplifying legislation are finally showing results, with the corporate income tax and VAT elasticities increasing with respect to their tax bases. Furthermore, the business environment is improving and, thus, it is realistic to expect some increase in tax revenues. As regards budgetary control, a special procedure exists which could facilitate relatively rapid in-year adjustment in the event of budgetary developments going off-track (see below, Section 7). On the other hand, given the commitment of expenditures predicated on support from EU funding, the achievement of the deficit targets is conditional on the receipt of such funds in government revenues. Tight expenditure discipline (including in managing partly-EU-funded projects) might be difficult given limited administrative capacity. Furthermore, spending pressures might arise ahead of the next parliamentary elections scheduled for October 2006.

Box 1: The budget for 2005

The Latvian 2005 budget law, presented on 13 December, was adopted on 20 December 2004. The general government deficit in 2005 is estimated at 134.5 million lats (1.7% of GDP). The budget was presented in the framework of promoting economic growth and social welfare and the implementation of structural reforms. The impact of EU accession is most notably associated with budgetary expansion. Accordingly, total general government budget revenues are set to increase by 22.7% in comparison with 2004 budget and expenditure by 21.9%. Foreign financial assistance including receipts from EU funds account for LVL 449.5 million, 5.5% of GDP.

The main measures on the revenue side are the following:

- Increase in the personal income tax-free threshold from LVL 21 (EUR 30) per month to LVL 26 (EUR 37) per month and the setting of income tax rebates for dependents at LVL 18 (EUR 26) per month ((LVL 18.2 million 2005, 0.2% of GDP);
- Application of the reduced VAT rate (5% instead of 18%) to domestic public transport services (LVL 6.2 million 2005, 0.08% of GDP);
- Increase in excise duties on oil and tobacco products (LVL 22.5 million 2005, 0.3% of GDP);

The main measures on the expenditure side are the following:

- Financing for EU structural funds and other financial instruments (LVL 296.5 million 2005, 3.6% of GDP);
- Reform of the National Armed Forces and NATO integration related requirements (LVL 153.3 million 2005, 1.9% of GDP);
- Modernization and restructuring of the healthcare system (LVL 34.5 million 2005, 0.4% of GDP);
- Increased teachers' wages (LVL 27.8 million 2005, 0.3% of GDP);
- Other measures to improve social conditions including pension indexation (LVL 59.0 million 2005, 0.7% of GDP).

In the light of this risk assessment, the budgetary stance in the programme is insufficient to achieve the close-to-balance-or-surplus requirement of the Stability and Growth Pact within the programme period. Further, though the programme outlines a relatively ambitious consolidation path, it may not provide a sufficient margin against breaching the 3% of GDP deficit threshold with normal macroeconomic fluctuations.

5.3. Sensitivity analysis

The programme includes a sensitivity analysis of public finances, taking into consideration two alternative, symmetric growth scenarios. In the two scenarios, optimistic and pessimistic assumptions about the external environment, and their impact on domestic demand through private consumption and investment, result in a GDP growth variation of ±1.0 percentage points compared to the central scenario in 2005, 2006 and 2007. The analysis also assumes that inflation and real public consumption growth are the same across all scenarios. In the optimistic scenario, stronger economic activity results in higher revenues, coming from increasing income tax and social contributions, of the order of 11-12 million lats, equivalent on average to some 0.13% of GDP. The negative impact on public finances in the pessimistic scenario is a reduction of about 10 million lats (0.11% of GDP), due mainly to lower production and import taxes and, especially, value-added tax revenues. Even in the pessimistic case, the deficit remains below the Treaty reference level. The programme does not analyse the potential effects of the alternative scenarios on the debt-to-GDP ratio.

6. EVOLUTION OF THE DEBT RATIO

The gross debt ratio is already well under the Treaty reference level but will rise somewhat in the medium term, from 14.6% in 2004 to 15.0% in 2007, a profile that is broadly in line with although slightly more optimistic than the Commission services 2004 autumn forecast (Table 6).

Table 6: Debt dynamics

	average 2000-2003	**2004**		**2005**		**2006**		**2007**
	COM	**COM**	**CP**	**COM**	**CP**	**COM**	**CP**	**CP**
Government gross debt ratio	**14.1**	**14.6**	**14.2**	**15.4**	**14.5**	**16.6**	**14.8**	**15.0**
Change in debt ratio (1 = 2+3+4)	0.4	0.3	-0.2	0.8	0.3	1.2	0.3	0.2
Contributions:								
- **Primary deficit** (2)	**1.4**	**1.2**	**0.9**	**2.0**	**0.9**	**2.0**	**0.8**	**0.7**
- **“Snow-ball” effect** (3)	**-0.4**	**-1.2**	**-1.1**	**-1.0**	**-0.8**	**-0.7**	**-0.6**	**-0.6**
- Interest expenditure	0.9	0.8	0.8	0.8	0.7	0.9	0.7	0.7
- Real GDP growth	-0.9	-0.9	-1.0	-0.9	-0.9	-0.9	-0.9	-0.9
- Inflation (GDP deflator)	-0.4	-1.0	-0.9	-0.9	-0.6	-0.7	-0.4	-0.4
- **Stock-flow adjustment** (4)	**-0.5**	**0.2**	**0.1**	**-0.2**	**0.2**	**0.0**	**0.1**	**0.1**
- Cash/accruals	-0.3							
- Accumulation of financial assets	-0.5							
of which: Privatisation proceeds	-0.5		-0.1		-0.1		-0.1	-0.1
- Valuation effects & residual adj.	0.2							

Note:

The change in the gross debt ratio can be decomposed as follows:

$$\frac{D_t}{Y_t} - \frac{D_{t-1}}{Y_{t-1}} = \frac{PD_t}{Y_t} + \left(\frac{D_{t-1}}{Y_{t-1}} * \frac{i_t - y_t}{1 + y_t} \right) + \frac{SF_t}{Y_t}$$

where t is a time subscript; D, PD, Y and SF are the stock of government debt, the primary deficit, nominal GDP and the stock-flow adjustment respectively, and i and y represent the average cost of debt and nominal GDP growth. The term in parentheses represents the “snow-ball” effect.

Sources:

Convergence programme update (CP); Commission services autumn 2004 economic forecasts (COM); Commission services calculations

From 2004 to 2007 the debt ratio rises by 0.8 percentage points of GDP due mainly to negative primary balances, which contribute 2.4 percentage points to the rise, to interest payments (2.1 percentage points) and to the stock-flow adjustment (0.3 percentage points). Nominal GDP growth reduces the debt ratio by 4.1 percentage points.

7. STRUCTURAL REFORM AND THE QUALITY OF PUBLIC FINANCES

On the revenue side tax policy implemented to date by the Latvian government has been primarily aimed at reducing the tax burden on businesses, at the same time improving the efficiency of tax collection. Most notably, the corporate income tax rate has been progressively reduced from 25% in 2000 to 15% in 2004. Despite a considerable reduction of the rate, corporate income tax revenues have not decreased substantially: the preliminary estimates for 2004 show a 22% increase in nominal revenues against the 2003 and close to the 2000 level. Looking ahead, the updated programme details the government's intention to reduce the personal income tax burden[9]. This is in line with labour market recommendation in the BEPGs to revise the tax and benefit system in order to make work pay more. According to the authorities' estimates, implementation of these measures will cost 0.2% of GDP each programme year from 2005 onwards.

Other changes to the tax system provide for the application of a reduced VAT rate (5% instead of 18%) to domestic public transport services from January 2005; the gradual harmonization (increase) of the excise tax rates on oil and tobacco products with EU rates and a reduction in the real estate tax base. The total impact of these changes on the fiscal balance is estimated in the programme to be neutral. An increase in the share of the social security contributions that will be transferred to the state-funded pension scheme from 2007 will place additional pressure on the fiscal balance[10].

On the expenditure side, the room for savings seems limited, with the need for continued institution-building and strengthening of public administration to ensure efficiency; in the near term these will probably increase pressures for additional funding. Starting from 2005, the government plans as a priority to commence the modernization and restructuring of the healthcare system, requiring a sizable annual increase of the public financing over the medium term; to increase significantly the financing of the fundamental research and higher education; to ensure pension indexation and to increase childcare allowances.

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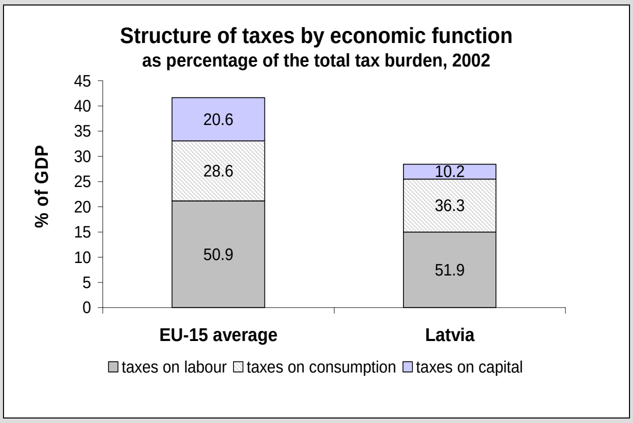
9 The schedule adopted in 2003 by the Latvian government after lengthy discussions with the social partners provides for a gradual annual increase of the minimum wage over a six-year period from EUR 120 per month in 2004 to EUR 210 by 2010. However, for the time-being, the government has deferred implementation of this agreement. The government has also approved a plan foreseeing a gradual increase of the personal income tax-free threshold from EUR 30 in 2004 to EUR 86 in 2009. At the same time income tax rebates for dependants will be raised gradually from EUR 15 in 2004 to EUR 65 in 2009.

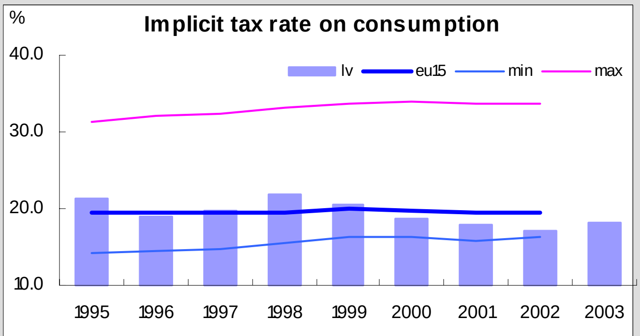
10 Starting from 1 January 2007, 4% instead of the currently applied 2% of the social security contributions will be transferred to the state-funded pension scheme, resulting in a 0.4% of GDP loss to the general government budget.

Box 2: Latvia's tax system

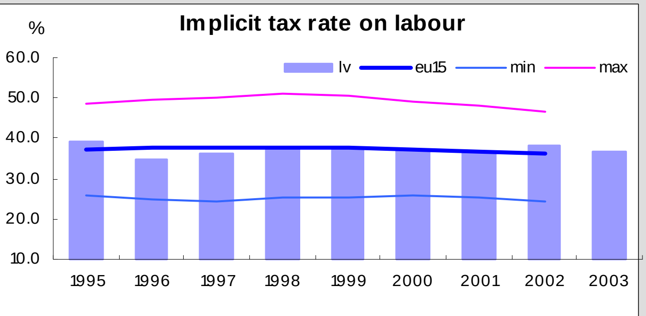
Over the last decade the fiscal policy of the Latvian government has been aimed at reducing the tax burden on the economy. Since 1995 the overall tax burden has declined from 33.7% of GDP to 29.1% of GDP in 2003. The programme foresees a further decline in tax revenues as a share of GDP to 27.5% by 2007. This would put Latvia in a position of having one of the smallest tax burdens among the EU Member States. In order to obtain a fuller picture of where in the Latvian economy the tax burden falls and how the proposed measures (see box 1 and section 7 of the assessment) might affect the future situation, a broad classification of the burden has been made into three economic functions (i.e. *consumption*, *labour* and *capital*) using methodology developed by the Directorate-General Taxation and Customs Union and Eurostat (http://epp.eurostat.cec.eu.int/cache/ITY_OFFPUB/KS-DU-04-001/EN/KS-DU-04-001-EN.PDF).

For Latvia, taxes levied on employment clearly represent the most prominent source of tax revenue. Not only did they account for 52% of all tax revenues in 2002 (compared with 51% for EU-15); also the implicit tax rate is relatively high even compared to the EU-15 average. The programme foresees a reduction of the tax burden on labour. Consumption-related taxes constitute the second most important source of tax revenues, providing for 36% of the total (compared to 29% in EU-15). The implicit tax rate on consumption is slightly lower than the EU-15 average. Taxes on capital are a far less important source of income, accounting only for 10% of all tax revenues in 2002 (compared to 21% in the EU-15). The implicit tax rate on capital is far below the EU-15's lowest rate, reflecting the progressive reduction in the corporate income tax rate from 25% in 2000 to 15% in 2004.

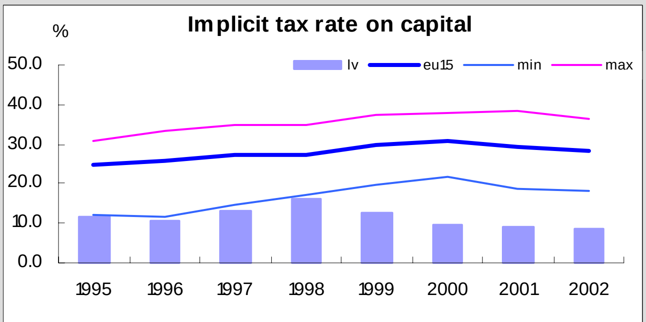




Source: Eurostat and Commission services calculations



Source: Eurostat and Commission services calculations



Source: Eurostat and Commission services calculations

The programme update contains an overview of recent structural policy measures as well as those foreseen for the programme period. Detailed information is provided regarding measures foreseen in the areas of Latvia's medium-term structural policy objectives[11], labour market and social policies. As regards policies to reduce unemployment and to raise labour supply, targeted areas are a better mobilization and integration into the labour force of the unemployed and the economically inactive population, the promotion of business activity and creation of new jobs, the promotion of life-long learning, the extension of working age and regional cohesion. In 2004-2006, 174 million euro from the European Social Fund together with the national co-financing will be allocated for the development of human resources. The reforms outlined in the programme are broadly consistent with the relevant country-specific recommendations in the area of public finances in the Broad Economic Policy Guidelines to improve conditions for increasing productivity[12] and to address structural problems in the labour market[13].

As regards budgetary control, a special procedure exists which could facilitate adjustment in the event of budgetary developments going off-track.[14] The effectiveness of this procedure has been tested and proved to be effective during the Russian crisis in 1998. Furthermore, Latvian government has adopted guidelines for the management of the public resources in the medium term. These guidelines include mandatory preparation of a medium-term budget framework, including budgeting of the structural policy measures recognized as government policy priorities, and the establishment of limits on annual deficits. Having already achieved considerable progress over recent years, the government is continuing its efforts to improve the management of public finances in all phases of the budget cycle. The 2005 budget is the first to be legally embedded into a multi-annual budget framework covering the period 2005-2007, in line with the May 2004 convergence programme. Further measures to simplify and improve tax administration are being implemented. Both the process of budget planning and that of internal audit are being further strengthened through the introduction of performance-based budgeting in all ministries[15]. A systematic improvement of co-ordination and modernisation of all public audit and evaluation functions, including the planned introduction of annual fulfilment reports by line ministries, is being gradually

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[11] The Latvian authorities have prepared the Development Plan (Single Programming Document) to optimise utilization of the EU Structural Funds finances in line with the priorities set by the government.

[12] Under this challenge, Latvia was requested to increase the efficiency, quality and accessibility of the education and training systems, and their responsiveness to the labour markets' needs (GL 13 and 14); to encourage R&D and innovation, in particular in the business sector (GL 13 and 14); and to encourage an entrepreneurial culture.

[13] Under this challenge, Latvia was requested to strengthen labour supply by pursuing efforts to better adapt the qualifications of the workforce to the requirements of the labour market and by facilitating labour mobility, especially through improvements in transport infrastructure.

[14] According to Article 25(2) of the 1994 law "On Budgetary and Financial Management", the Minister of Finance informs the Cabinet about a delay or decrease in the allocation of expenditure, if it is expected that the budget deficit will exceed the level approved in the annual state budget law. Within the period of seven days following reception of the report from the Minister, the Cabinet of Ministers makes a decision on a delay or decrease in the allocations, and not later than within three working days submits proposals on necessary amendments to the annual state budget law to the Parliament.

[15] Key concepts of the results and performance indicator system - a strategic planning tool, has been developed and approved by the government: decree No. 162, 13 March 2003.

implemented and developed. Apart from the spending limits already in force[16], budgetary discipline of local governments has been further strengthened through introduction of an early reporting and auditing procedure.

Effectively implemented, these structural public finance reform measures have the potential substantially to improve the quality of public finances.

8. THE SUSTAINABILITY OF THE PUBLIC FINANCES

The assessment of the sustainability of Latvian public finances is based on an overall judgement of the results of quantitative indicators and qualitative features. The quantitative indicators project debt development according to two different scenarios, to take into account different budgetary developments over the medium term. The "programme" scenario (baseline) assumes that the medium-term objective set up in the programme is actually achieved, while the "2004" scenario assumes that the underlying primary balance remains throughout the programme period at the 2004 level.

The graph below presents the gross debt development according to the two different scenarios. On the basis of the programme, age-related expenditure is foreseen to increase by 0.6% of GDP between 2008 and 2050, while over the same period pension expenditure from the first pillar is foreseen to increase by 0.2% of GDP (see annex for a breakdown of different age-related expenditures).[17] This latter trend benefits from the impact of the pension reform.

Gross debt is projected to gradually increase over the entire projection period and is expected to reach values above 100%of GDP in 2050[18].

On the basis of the debt projections, it is possible to calculate a set of sustainability indicators to measure the gap between the current policies and a sustainable one. The S1 indicator shows the permanent change in the primary balance in order to have a debt to GDP ratio in line with the Maastricht Treaty reference value in the very long run (year 2050).[19] S2 shows the gap between the current tax policies and those that would ensure respect of the intertemporal budget constraint given the future impact of ageing on public expenditure, namely the change in the tax ratio that would equate the present discounted

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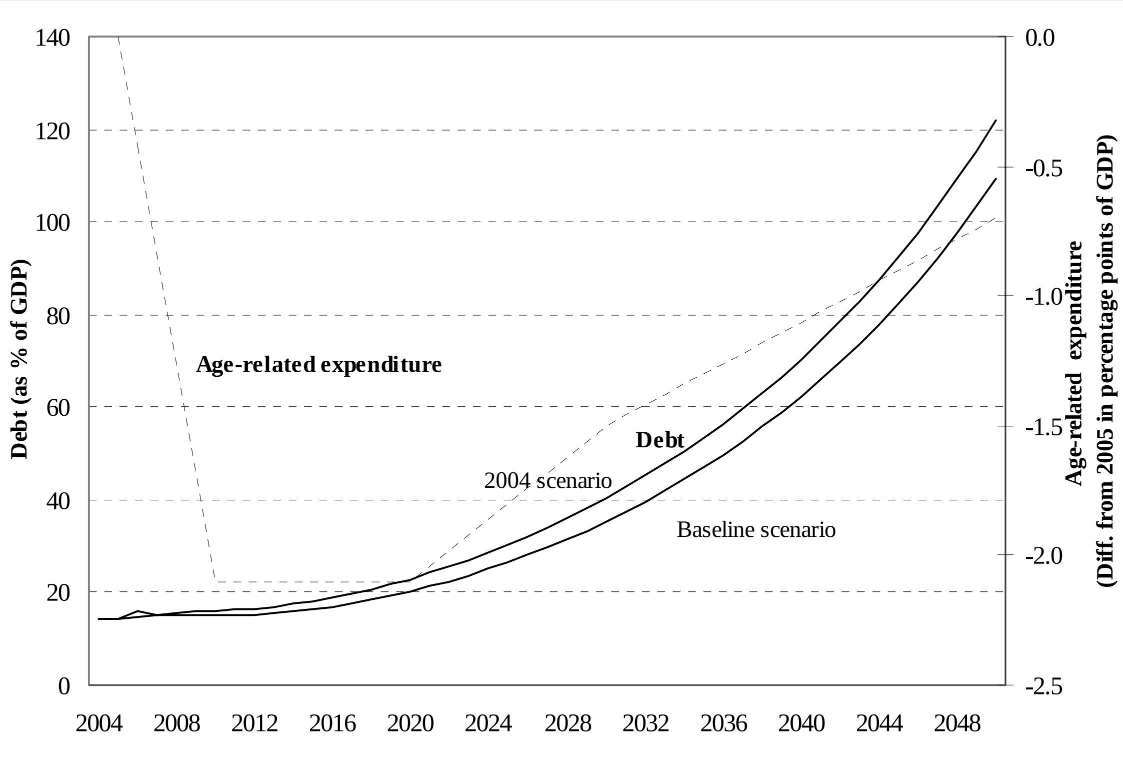
16 The maximum increase of local government borrowings and guarantees during the financial year are determined by the annual state budget law. All issues concerning local government borrowings and guarantees are monitored by the Council on Control and Surveillance of Local Government Borrowing and Guarantee.

17 In the long-term projections in the Latvian update of the convergence programme, pension expenditures from the second pillar were not considered. For consistency, the pension contributions to the second pillar were excluded from the projections. The update notes that the healthcare expenditure projections do not include long-term care, which could imply higher age-related expenditures in the period to 2050. It is also worth noting that in 2005 the projected level of the accumulated assets of state pension funds assets (held and managed by the Treasury and investment companies according to the Law on State Funded Pensions) is expected to reach 1% of GDP.

18 It should be recalled that, being a mechanical, partial equilibrium analysis, projections are in some cases bound to show highly accentuated profiles. As a consequence, the projected evolution of debt levels is not a forecast of likely outcomes and should not be taken at face value.

19 The respect of the underlying debt path does not ensure sustainability over an infinite horizon, but only that debt remains below 60% up to 2050. In most cases, this would imply an increasing trend and possible unbalances after the end of the projection period.

Long-term sustainability: summary results



Sustainability indicators

	S1*	S2**	RPB***
Baseline scenario	0.8	2.1	1.6
2004 scenario	1.0	2.3	1.6

Notes:

* It indicates the required change in tax revenues as a share of GDP over the projection period that guarantees to reach debt to GDP ratio of 60% of GDP in 2050.

** It indicates the required change in tax revenues as a share of GDP that guarantees the respect of the intertemporal budget constraint of the government, i.e., that equates the actualized flow of revenues and expenses over an infinite horizon to the debt as existing at the outset of the projection period; p.m. debt to GDP ratio in 2050: -21.1%

*** Based on S2, the Required Primary Balance (RPB) indicates the average minimum required cyclically adjusted primary balance as a share of GDP *over the first five years* of the projection period that guarantees the respect of the intertemporal budget constraint of the government.

value of future primary balances to the current stock of gross debt. According to the latter, in order to tackle the cost of ageing entirely through a budgetary strategy, Latvia should increase its tax ratio permanently by at least 2.1 percentage points compared with the projected one at the end of the programme period. This would lead to a sustainable debt ratio of around -20% by the middle of this century[20]. The budgetary effort over the first 5 years of projections (i.e. after the end of the programme period) to respect the intertemporal budget constraint requires a primary surplus of about 1.6% of GDP, compared with a primary deficit of 0.7% of GDP targeted for the last year of the programme period, considering the exclusion of the second pillar pension contributions.

In interpreting these results, several factors must be taken into account.

[20] The debt ratio of around -20% in 2050 according to the S2 indicator illustrates that the sustainability gap is higher in order to ensure a sustainable evolution of gross debt beyond 2050, compared with the S1 indicator, which illustrates that a lower budgetary strengthening is compatible with the 60% reference value in 2050.

The reformed pension system would ensure sustainability of the system despite the projected increase in the old-age dependency ratio. An important contribution to the sustainability of the pension system comes from the parametric changes: both the gradual increase in the statutory retirement age for women scheduled until 2008 and the indexation system (PAYG expenditures are not fully indexed in line with wage growth) ensures a broadly stable share of PAYG expenditure to GDP. Moreover, the second pillar will become increasingly important. A relevant part of future pensions will be covered through the funded pillar without generating an additional deficit.

However, there could be some pressure on raising the quality of public services, such as health and long-term care and education. The implementation of the healthcare system reform (outlined in the development programme for healthcare service providers of in-patient and out-patient care) is an immediate priority of the current government. Finalisation of the underlying action plan (listing activities such as mergers of hospitals, reduction of hospital beds and restructuring of institutions) and the schedule for activities is expected by March 2005. Reforms that improve the quality of public services might be necessary, which could involve an increase in such expenditures. In addition, the projected fall in education expenditure by 2010 may not materialise; the update notes that such savings could involve an increase in such expenditures.

Latvia appears to be in a relatively favourable position with regard to long-term sustainability of the public finances, of which the projected budgetary costs of an ageing population is an important element. The relatively low debt ratio in Latvia, the pension reform measures enacted, including the introduction of the funded pillar, and the accumulation of assets in the funded pension scheme will contribute to limit the budgetary impact of ageing. The strategy outlined in the programme is based on a contained budgetary deficit over the medium term and the budgetary impact of the pension reform. Reforms in the field of health and long-term care could however involve higher expenditures. Latvia’s relatively low tax ratio should, however, ease the accommodation of any such sustainability gap that arises.

Annex 1: Summary tables from the convergence programme update

Table 1. Growth and associated factors

	ESA Code	2003	2004	2005	2006	2007
GDP *growth* at *constant* market prices (7+8+9)	B1g	7.5	8.1	6.7	6.5	6.5
GDP *level* at *current* market prices	B1g	6322.5	7299.0	8155.1	8944.5	9784.9
GDP deflator		3.4	6.8	4.7	3.0	2.7
CPI change		2.9	6.2	4.3	3.0	3.0
Employment growth[21]		1.8	1.0	1.0	0.5	0.5
Labour productivity growth [22]		5.5	7.0	5.6	6.0	5.9
Sources of growth: percentage changes at constant prices						
1. Private consumption expenditure	P3	8.6	9.0	8.2	7.0	6.5
2. Government consumption expenditure	P3	1.9	2.0	2.0	2.0	2.0
3. Gross fixed capital formation	P51	10.9	19.2	11.3	9.9	9.1
4. Changes in inventories and net acquisition of valuables as a % of GDP	P52 + P53	3.7	3.1	1.9	1.2	0.8
5. Exports of goods and services	P6	5.0	9.3	8.4	8.2	7.9
6. Imports of goods and services	P7	13.0	12.0	8.4	7.5	7.1
Contribution to GDP growth						
7. Final domestic demand (1+2+3)		8.7	11.4	9.1	8.0	7.6
8. Change in inventories and net acquisition of valuables (=4)	P52 + P53	3.4	-0.6	-1.1	-0.7	-0.3
9. External balance of goods and services (5-6)	B11	-4.6	-2.8	-1.3	-0.9	-0.7

21 Occupied population, domestic concept, persons, national accounts definition

22 Growth of GDP at market prices per person employed at constant prices

Table 2. General government budgetary developments

% of GDP	ESA code	2003	2004	2005	2006	2007
Net lending (B9) by sub-sectors						
1. General government	S13	-1.5	-1.7	-1.6	-1.5	-1.4
2. Central government	S1311	-2.0	-2.1	-2.0	-1.9	-1.8
3. State government	S1312	--	--	--	--	--
4. Local government	S1313	-0.2	-0.2	-0.2	-0.2	-0.2
5. Social security funds	S1314	0.7	0.6	0.6	0.6	0.6
General government (S13)						
6. Total receipts	ESA	34.5	34.3	37.7	37.3	35.1
7. Total expenditures	ESA	36.0	36.0	39.3	38.8	36.5
8. Budget balance	B9	-1.5	-1.7	-1.6	-1.5	-1.4
9. Net interest payments		0.8	0.8	0.7	0.7	0.7
10. Primary balance		-0.7	-0.9	-0.9	-0.8	-0.7
Components of revenues						
11. Taxes	D2+D5	19.9	19.4	19.4	19.3	19.1
12. Social contributions	D61	9.2	8.9	8.7	8.7	8.4
13. Interest income	D41	--	--	--	--	--
14. Other		5.4	5.9	9.5	9.3	7.6
15. Total receipts	ESA	34.5	34.3	37.7	37.3	35.1
Components of expenditures						
16. Collective consumption	P32	11.0	11.0	11.3	11.4	11.8
17. Social transfers in kind	D63	0.7	0.6	0.6	0.6	0.5
18. Social transfers other than in kind	D62	9.6	8.7	8.6	8.4	7.9
19. Interest payments	D41	0.8	0.8	0.8	0.7	0.7
20. Subsidies	D3	0.8	0.8	0.7	0.8	0.8
21. Gross fixed capital formation	P51	1.5	1.6	1.8	1.9	1.9
22. Other		11.6	12.5	15.5	15.0	12.9
23. Total expenditures	ESA	36.0	36.0	39.3	38.8	36.5

Table 3. General government debt developments

% of GDP	ESA code	2003	2004	2005	2006	2007
Gross debt level		14.4	14.2	14.5	14.8	15.0
Change in gross debt		0.28	-0.15	0.25	0.32	0.22
Contributions to change in gross debt						
Primary balance		0.7	0.9	0.9	0.8	0.7
Interest payments	D41	0.8	0.8	0.7	0.7	0.7
Nominal GDP growth	B1g	-1.4	-1.9	-1.5	-1.3	-1.3
Other factors influencing the debt ratio		0.2	0.1	0.1	0.1	0.1
of which: Privatisation receipts		-0.1	-0.1	-0.1	-0.1	-0.1
p.m. implicit interest rate on debt		7.5	6.5	6.1	5.6	5.4

Table 4. Cyclical developments[23]

% of GDP	ESA Code	2003	2004	2005	2006	2007
1. GDP growth at constant prices	B1g	7.5	8.1	6.7	6.5	6.5
2. Actual balance	B9	-1.5	-1.7	-1.6	-1.5	-1.4
3. Interest payments	D41	0.8	0.8	0.7	0.7	0.7
4. Potential GDP growth		7.7	7.9	8.2	7.7	7.5
5. Output gap		-0.2	0.0	-1.5	-2.6	-3.5
6. Cyclical budgetary component		0.0	0.0	-0.3	-0.6	-0.8
7. Cyclically-adjusted balance (2-6)		-1.5	-1.7	-1.3	-0.9	-0.6
8. Cyclically-adjusted primary balance (7-3)		-0.6	-0.9	-0.5	-0.2	0.1

Table 5. Divergence from previous update

% of GDP	ESA Code	2003	2004	2005	2006	2007
GDP growth	B1g					
Previous update		7.5	6.7	6.7	6.5	6.5
Latest update		7.5	8.1	6.7	6.5	6.5
Difference		0.0	1.4	0.0	0.0	0.0
Actual budget balance	B9					
Previous update		-1.8	-2.1	-2.2	-2.0	-2.0
Latest update		-1.5	-1.7	-1.6	-1.5	-1.4
Difference		0.3	0.4	0.6	0.5	0.6
Gross debt levels						
Previous update		15.3	16.2	16.8	17.3	17.7
Latest update		14.4	14.2	14.5	14.8	15.0
Difference		-0.9	-2.0	-2.3	-2.5	-2.7

Table 6. Long-term sustainability of public finances[24]

% of GDP	**2000**	**2005**	**2010**	**2020**	**2030**	**2050**
Total expenditure		**39.3**	**37.0**	**37.2**	**38.1**	**40.3**
Old-age pensions		5.8	4.5	4.8	5.3	8.3
Healthcare (excluding care for the elderly)		4.0	4.1	4.1	4.2	4.5
Interest payments		0.8	0.6	0.8	1.1	2.5
Total revenues		**37.7**	**36.0**	**35.5**	**35.3**	**35.2**
of which: from pension contributions		5.8	5.9	5.9	6.0	6.1
National pension fund assets (if any)		**1.0**	**7.3**	**30.5**	**58.9**	**94.9**
Assumptions						
Labour productivity growth		**5.6**	**5.4**	**3.4**	**2.9**	**2.0**
Real GDP growth		**6.7**	**5.9**	**2.5**	**2.2**	**0.1**
Participation rate males (aged 20-64)		**n.a.**	**n.a.**	**n.a.**	**n.a.**	**n.a.**
Participation rate females (aged 20-64)		**n.a.**	**n.a.**	**n.a.**	**n.a.**	**n.a.**
Total participation rate (aged 20-64)		**n.a.**	**n.a.**	**n.a.**	**n.a.**	**n.a.**
Unemployment rate		**9.5**	**7.0**	**5.6**	**5.0**	**5.0**

23 Member States can fill in lines 4-8 using either own figures or Commission figures.

24 Information in this table, if provided, should be updated at least every 3 years.

Table 0. Basic assumptions[25]

(to be transmitted to the EFC and the Commission together with the SCP update[26])

		2003	2004	2005	2006	2007
Short-term interest rate[27] (annual average)		n.a.	n.a.	n.a.	n.a.	n.a.
Long-term interest rate[27] (annual average)		n.a.	4.6	5.2	5.0	n.a.
USA: short-term interest rate (3-month money market)		n.a.	1.6	2.9	3.6	n.a.
USA: long-term interest rate (10-year government bonds)		n.a.	4.3	4.7	5.3	n.a.
USD/€ exchange rate[27] (annual average)		n.a.	1.23	1.24	1.24	n.a.
Nominal effective exchange rate (euro area)		n.a.	2.8	0.6	0.3	n.a.
Nominal effective exchange rate (EU)		n.a.	5.9	0.8	0.1	n.a.
(for non-euro countries) Exchange rate vis-à-vis the € (annual average)[27]		n.a.	0.67	0.69	0.69	n.a.
World excluding EU, GDP growth		n.a.	5.7	4.8	4.6	n.a.
US		n.a.	n.a.	n.a.	n.a.	n.a.
Japan		n.a.	n.a.	n.a.	n.a.	n.a.
EU-25 GDP growth		n.a.	2.5	2.3	2.4	n.a.
Growth of relevant foreign markets		n.a.	11.3	8.9	8.0	n.a.
World import volumes, excluding EU		n.a.	11.6	8.8	8.3	n.a.
World import prices, (goods, in USD)		n.a.	n.a.	n.a.	n.a.	n.a.
Oil prices (Brent, USD/barrel)		n.a.	39.3	45.1	40.1	n.a.
Non-oil commodity prices (in USD)		n.a.	12.9	-2.9	-0.5	n.a.

25 Provision of data on variables in bold characters is a requirement. Provision of data on other variables is optional but highly desirable.

26 Member States may include their basic assumptions in their SCP updates if they so wish.

27 Technical assumptions.

Annex 2: Indicators of long-term sustainability

Main assumptions - baseline scenario (as % GDP)	**2008**	**2010**	**2020**	**2030**	**2040**	**2050**	**changes**
Total age-related spending	14.9	14.1	14.1	14.7	15.1	15.5	0.6
Pensions	5.0	4.5	4.6	4.9	5.1	5.2	0.2
Health care	4.1	4.1	4.1	4.2	4.4	4.5	0.4
Education	5.9	5.5	5.4	5.6	5.7	5.8	-0.1
*Total primary non age-related spending**	20.4						
Total revenues	34.8	34.1	33.6	33.4	33.4	33.3	-1.4

*constant

Results (as % GDP)	**2008**	**2010**	**2020**	**2030**	**2040**	**2050**	**changes**
Baseline scenario							
Gross debt	15.1	15.1	20.2	35.4	62.3	109.3	94.2
i + 0.5*	15.1	15.2	21.1	37.7	67.6	121.1	106.0
2004 scenario							
Gross debt	15.6	16.0	22.9	40.4	70.3	122.0	106.4
i + 0.5*	15.6	16.1	23.9	43.0	76.3	135.4	119.8

* i + 0.5 represents the evolution of debt under the assumption of the nominal interest rate being 50 basis points higher throughout the projection period.