



## LATVIJAS REPUBLIKAS FISKĀLĀS DISCIPLĪNAS PADOME

Reģistrācijas nr. 90010248231, Smiļšu ielā 1, Rīgā, LV-1919

### 3. Assessment of compliance with the numerical fiscal rules

Pursuant to the Fiscal discipline law (further – FDL) the Government's role is to follow a series of numerical rules to provide a counter-cyclical and balanced economic development.

FDL is based on three numerical fiscal conditions that shall be followed in the preparation and execution of medium-term budget framework law (further – the Framework law) and the annual state budget law (further – the Budget law) and any amendments thereto. FDL provides that the lowest value of the state budget expenditure ceilings derived according to the three fiscal calculations applies (see Annex Table 1) as the following:

1. **Balance rule** is defined in Article 10 of the FDL – the general government structural balance in the draft Framework law for each year of the period should not be set lower than -0.5% of the annual gross domestic product (further – GDP). On the other hand, FDL transitional rules provide that this provision shall apply from the previous year, if the planned structural balance is greater than -1.0% of GDP. In 2014, the structural balance was planned greater than -1.0%, and thus this rule for 2015 and forwards applies.

The balance rule (see Annex Table 2) is calculated by determining the total government budget balance, i.e.:

- the calculation of the applicable amount of the national budget revenues, municipal budget impact (balance) partly derived from the state budget public persons' and institutions not financed from the budget budgetary impact (balance) as well as adjustments for the European System of Accounts (further – ESA), the correction volume effects and –
- the permitted amount of the structural balance determined based on the deviation from structural balance from the medium-term objective (further – MTO) values because of the increase in the contribution to the second pillar of the retirement pensions and the departure scenario from the reductions (see Latvia's Stability Programme for 2014- 2017, page 20) and the revised data the Ministry of Finance (further – MoF) has provided the Council with.

Taking into account the two components of the calculation – revenue and conditions of the structural balance rule the expenditure ceiling for the state budget spending is established.

Pursuant to the revised data received from the MoF and, according to the balance condition, the expenditure ceilings are 7 471.3 million euro for 2015, 7 618.5 million euro for 2016 and 7 969.3 million euro for 2017.

2. **Expenditure growth rule** has been defined in Article 13 of the FDL , which states that the draft Framework law is developed based on expenditure growth conditions, accordance to the

European Parliament and of the Council of 16 November 2011, Regulation (EU) No. 1175/2011 amending Council Regulation (EC) No. 1466/97 on the surveillance of budgetary positions and the strengthening of surveillance of economic policies and the coordination of Article 9 is applied to the development of this Regulation referred to the European Commission's assessment. FDL provides that expenditure, excluding the GDP deflator should not grow faster than the potential GDP growth. Earlier in this paragraph mentioned Regulation provides expenditure categories that are dependent on the changes of the economic cycle and that to be taken into account while calculating the equalized expenditure (see Annex Table 3) including the following: government interest payments on loans from foreign governments and international financial institutions, including credit institutions; EU programs expenditure that fully comply with EU funds revenue, i.e. without any direct impact on the state budget, unlike the national share of the funding; total gross capital formation equalized with the previous three-year average.

Adjusted total amount of expenditure (nominal figures) is obtained by subtracting the cyclical unemployment benefit expenditure (non-discretionary changes in unemployment) and the impact from the Government tax policy changes (discretionary revenue measures). Excluding the GDP deflator (inflation) adjusted expenditure increase is established – in the amount of -0,4% for 2015, 1,3% for 2016, and -1,0% for 2017. Comparing this figure with the increase of potential GDP average growth for ten years, is obtained the expenditure ceiling based on the expenditure increase at the same pace with the growth rate of potential GDP. From this theoretical ratio the amount of the expenditure arising from the relationship between the central government budget, local government budgets and derived public persons budget, as well as ESA corrections are deducted.

Pursuant to the revised data from the MoF and according to the Expenditure growth rule, the expenditure ceiling is 7 662.6 million in 2015, 7 714.6 million euro in 2016 and 7 995.5 million euro in 2017.

**3. The continuity rule** is set in Article 5 of the FDL, which states that the Framework law provides the most important indicators of a public expenditure ceilings for the next three years. FDL says that these ceilings are constant for the next three years – a Framework law for the first and second year inherit ceilings from the previous year's Framework law on second and third year of the ceilings (see Annex Table 4). FDL provides that the continuity principle is not applied if, following the previous two methods specified public expenditure ceiling differs from the previous Framework law ceilings of 0,1% of GDP.

Article 5 of the FDL establishes ten cases that allow correcting the expenditure thresholds because of situations that are outside the usual economic activity, including social benefits and pension beneficiaries contingent changes, paid services revenue changes, the Constitutional Court decisions, etc.

Article of the FDL contains a leveling mechanism that prevents the public debt servicing costs and the EU Structural funds, the Cohesion fund, the Common agricultural policy and the Common fisheries policy expenditure fluctuation effects on other public expenditure. FDL Transitional provisions stipulate that, starting from 2016, the balancing mechanism applicable to the EU Structural funds, respect for the new programming period and the beginning of 2017 shall apply equalization of public debt servicing costs.

Pursuant to the revised data received from the MoF and, according to the Continuity rule, the expenditure ceilings are 7 352.8 million euro in 2015 and 7 601.8 million euro for 2016.

In assessing the FDL numerical fiscal conditions – the balance of expenditure growth and continuity conditions – computation method, the Council concludes that for the expenditure ceilings for 2015 balance rule applies, which is stricter than the expenditure growth rule, meanwhile, the continuity rule compared to the balance rule exceeds 0,1% of GDP and therefore the balance rule method applies.

Expenditure ceilings for 2016 should be established according to the continuity rule, the opposite to the 2015 calculation second step (the evaluation of the difference between the balance and continuity rule assessment of the amount to the GDP) – the difference in 2016 after the calculation does not exceed 0,1% of GDP and thus continuity rule applies.

By contrast, 2017 expenditure ceiling results from the two methods – balance rule and expenditure growth rule – as the previous year Framework law does not cover 2017 spending ceiling. Of the two methods in 2017 the balance rule is more stringent criterion from the two to calculate expenditure ceiling in drafting the budget framework.

The Council would like to note that it has not made comprehensive independent assessment of the government projections of individual indicators. Meanwhile, it would like to mention that the projections for the cost of paying pensions and other social insurance benefits appear to be underestimated in the draft budget based on the current trends in 2014, which may contribute to deterioration of the general government balance by 0,2-0,3 percent of GDP.

Due to the limited time frame to prepare the numerical fiscal conditionality assessment of the Council had to rely on the Government's analytical material without further independent evaluation. In the future the model of cooperation should be developed to allow the Council to obtain the necessary information at the earliest possible stage.

The Council recommends:

1. To adopt a Memorandum of Understanding with the MoF for the exchange of information and cooperation in the monitoring of fiscal discipline.
2. Prepare measures to achieve the budget balance targets in 2015 and 2016 to avoid the consequences of Article 11 of the FDL requiring compensation for the accumulated over three years shortfall exceeding 0,5% of GDP taking into account the estimated budget balance shortfall in 2014 of 0,3% of.