Fiskālās disciplīnas padome

Latvian Fiscal rules

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Agenda

- Historical background
- Key characteristics of numerical fiscal rules
- Numerical fiscal rules
  - Structural balance rule
  - Expenditure rule
  - Debt rule
  - Continuity rule
- The way forward

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Constitutional basis

- The fathers of the Constitution of 1922 and accompanying laws have established that the budget and taxation are strictly business between the legislative and executive
  - Only the executive may propose a budget
  - The executive has the responsibility for executing the budget as proposed to the legislative
  - The executive is deemed received the rejection of confidence, if the budget is rejected

- MPs are allowed to propose new expenditure only in case, if there is compensating reduction in other expenditure or increase in the government revenue

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A number of fiscal rules have already been formulated in the Budget and Financial Management Law adopted in 1994 and the following special legal acts

- Initially the rules regarding self-sufficiency have been established for all special budgets (operating with earmarked revenues) and local governments operating according to a special set of laws

- The local governments have been specifically restricted to borrow only with a permission of a special commission consisting of representatives of the central government, within an overall limit approved in the annual budget law, and the overall debt of each local government not exceeding 20 percent of the past year's revenues

- The local governments failing to observe the borrowing rules or failing to settle there payables on time have been subjected to the financial stabilization process until the issues have been rectified

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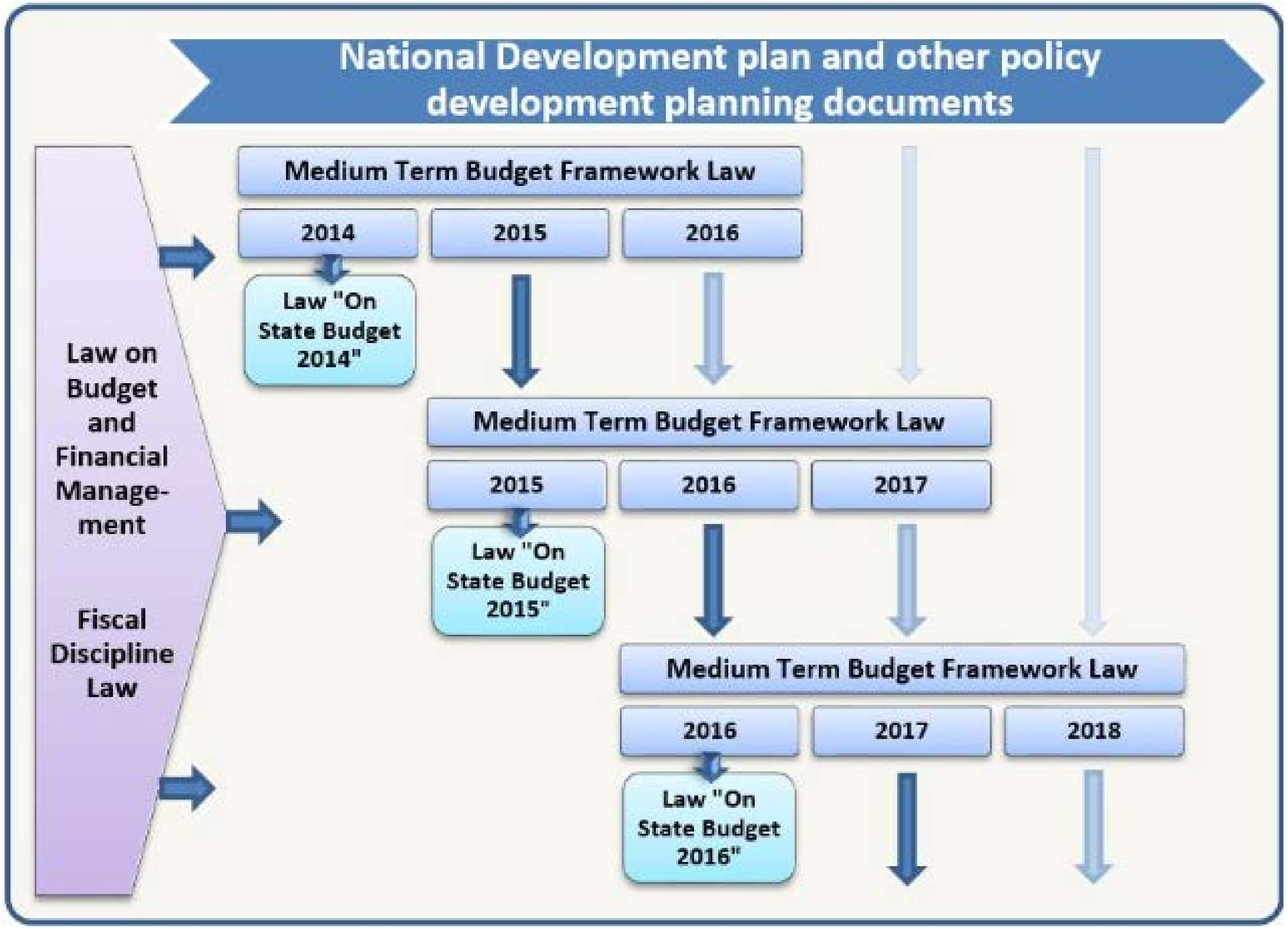
Medium-term budget framework



Source: the Ministry of Finance, http://www.fm.gov.lv/en/s/budget/medium_term_budget_planning/

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Key characteristics: legislative support

- **Statutory**, i.e. numerical fiscal rules are adopted by **Fiscal discipline law**. The Law enforced on 6 March 2013.
- Numerical rules are integrated into the Medium-Term Framework.
- Numerical rules **set central government expenditure ceilings**.
- Accountability procedures are additionally enhanced by the Memorandum of Understanding between the Council and the Ministry of Finance. The MoU signed on 8 February 2016.

Statutory Basis of Fiscal Rules 1/

	Type of Fiscal Rule			
	Expenditure	Revenue	Balance	Debt
Political Commitment	4	2	3	4
Coalition Agreement	4	1	3	4
Statutory	12	2	21	14
International Treaty 2/			41	47
Constitutional	0	1	2	1
Total	20	6	70	70

Sources: National authorities; and IMF staff assessment.
1/ Based on fiscal rules in effect by end-March 2012. The sum across columns can yield a higher number then the countries with rules as multiple rules are in place in many countries. All rules are national fiscal rules unless otherwise noted.
2/ These are all supranational fiscal rules.

[Schaechter et al, 2012]

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IMF – Overview of the Fiscal Rules

Latvia

Type of National Rules (Start date in brackets)	Key Characteristics (start date in brackets if different from implementation)					
	Statutory Basis	Coverage	Formal Enforcement Procedure	Independent Body Sets Budget Assumptions	Independent Body Monitors Implementation	Well-Specified Escape Clauses
Budget balance rule (2013)	Constitution	General Government	Yes	No	No	No

National rules (dates in brackets):

Under the "fiscal compact" signed March 1, 2012 (ratified in May 2012), the government adopted a structural budget balance rule which came into force on March 6, 2013.

BBR (since 2013): Constrains the structurally adjusted fiscal deficit to 0.5 percent of GDP or less.

Supranational rules (dates in brackets):
EU (2004)

Source: Fiscal Rules at Glance. IMF Background Paper, 2015

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Key characteristics: coverage of government

General government					
Central government			Local government		Social security funds
State basic budget	Derived public persons budgets	State owned enterprises	Local gov. budget	Local gov. owned enterprises	State special budget

Note: Enterprises here are only those classified as the part of the general government sector

Key characteristics: coverage of aggregate

Latvian Fiscal rules also **exclude certain revenue and / or expenditure items from the target variable**, i.e. from the central government expenditure ceilings:

- capital expenditure;
- expenditure on EU programmes;
- interest payments;
- cyclically-sensitive expenditure, like unemployment benefits.

Key characteristics: escape clauses (1/2)

Good news –

- the strictest numerical rule has to be applied (FDL, Article 15)

Usual force majeure principle is there –

- Natural disaster, war, severe economic downturn (FDL, Article 12) with restrictive ceiling – expenditures allowed only in the amount needed to offset the problem in question. In case of economic downturn the opinion of the Fiscal council opinion is necessary.

But! This is where the good news end, as there are various additional escape clauses → please see next slide.

FDL available in English here: http://fiscalcouncil.lv/files/uploaded/E2316-FiscalDisciplineLaw.pdf

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Key characteristics: escape clauses (2/2)

- **continuity rule** → deviation between years allowed in the amount of 0.1% (FDL, Article 5)
- **expenditure rule** → dependent on potential GDP forecasts, if too optimistic the expenditure is also allowed to grow the same pace.
- **balance rule** → pension reforms, healthcare reforms, etc.
- **debt rule** → 60% limit is disputable ceiling for Latvia. Isn't it already kind of escape clause for Latvia's economy (FDL, Article 14)?

FDL available in English here: http://fiscalcouncil.lv/files/uploaded/E2316-FiscalDisciplineLaw.pdf

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Key characteristics: automatic correction mechanism (1/2)

- The accumulated deviation from the structural balance target starting from 2013 should be corrected within the medium-term framework.
- Correction mechanism is triggered, if accrued deviation from the structural balance objective exceeds 0.5% of GDP.
- The correction applies to the third year of the next MTBF in the amount of 0.5%.
- Not applied in years with the negative output gap.

Key characteristics: automatic correction mechanism (2/2)

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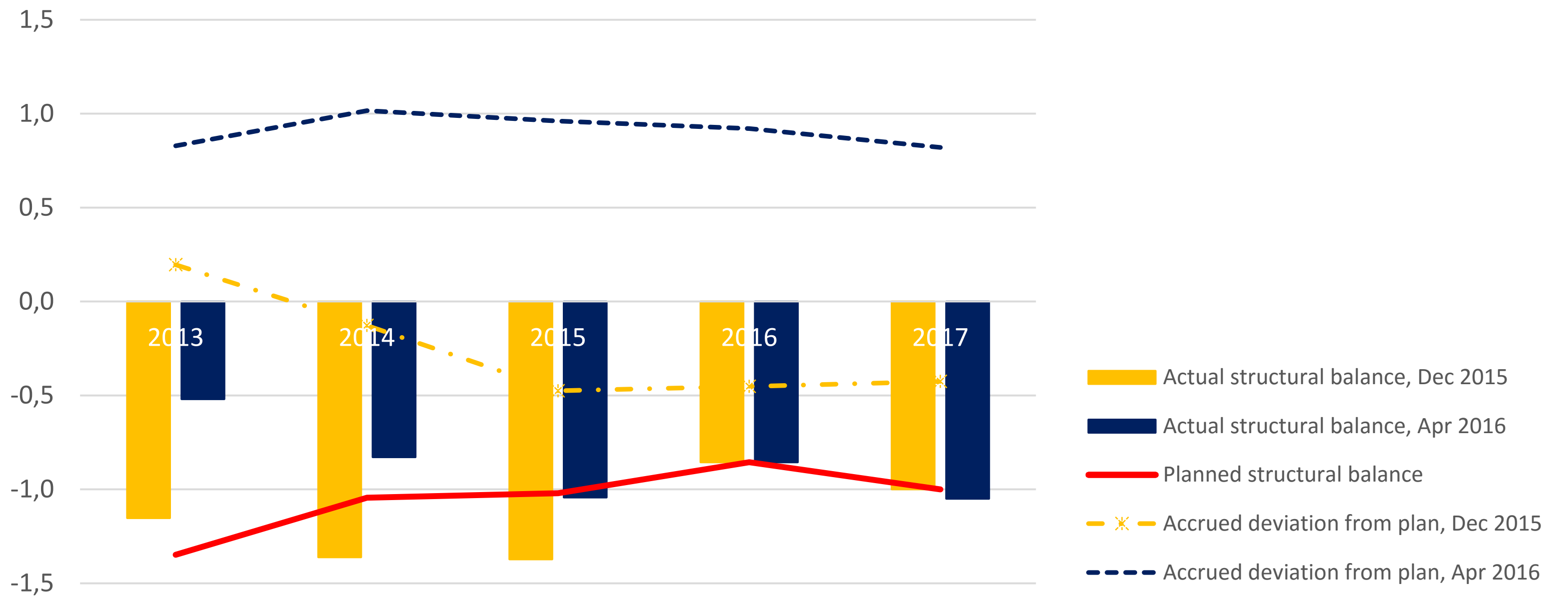
Due to the potential GDP updates the actual structural balance has been revised.

The accumulated deviation from the structural balance target is comfortably positive in the near future.



	2013		2014		2015		2016		2017	
	dec.15	apr.16	dec.15	apr.16	dec.15	apr.16	dec.15	apr.16	dec.15	apr.16
Actual structural balance	-1.2	-0.5	-1.4	-0.8	-1.4	-1.0	-0.9	-0.9	-1.0	-1.1
Planned structural balance	-1.3	-1.3	-1.0	-1.0	-1.0	-1.0	-0.9	-0.9	-1.0	-1.0
Accrued deviation from plan for all years starting with 2013, % of GDP	**0.2**	**0.8**	**-0.1**	**1.0**	**-0.5**	**1.0**	**-0.5**	**0.9**	**-0.4**	**0.8**

Source: Central statistical bureau, the Ministry of Finance, Council calculations

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Numerical fiscal rules: structural balance rule

Total CG expenditure ceilings come from →
- (1) CG revenue +
- (2) LocalGov balance +
- (3) Derived Public Persons balance +
- (4) ESA corrections –
- [(5) MinStr balance +
- (6) One-off +
- (7) Cyclical component] * (8) GDP

2018		
SP 2015/18	MTBFL 2016/18 (draft)	
8 128,3	8 335,7	(1) Central government budget revenue (cash-flow)
-2,1	-33,6	(2) Local government budget balance
-0,8	-0,8	(3) Derived public persons budget balance
-111,7	-296,4	(4) ESA corrections
-1,20	-0,79	(5) Minimal structural balance, % of GDP
-0,5	x	(6) One-off, % of GDP
0,0	0,0	(7) Cyclical component, % of GDP
29 407,8	29 476,7	(8) GDP, at current prices
8 509,9	**8 233,7**	**Total** (1)+(2)+(3)+(4)-[(5)+(6)+(7)]*(8)

Source: http://fiscalcouncil.lv/25-09-2015-monitoring-report

$$\text{CG exp}^{maxST} = (1) + (2) + (3) + (4) - [(5) + (6) + (7)] * (8)$$

$$\text{CG exp}^{maxST} = \text{CG rev} + \text{LGov bal} + \text{DerPP bal} + \text{ESA} - (\text{MinStr bal} + \text{One-off} + \text{CC})$$

Fiskālās disciplīnas padome

Numerical fiscal rules: expenditure growth rule

Total CG expenditure ceilings come from →

(1) GG expenditure smoothed taking out expenditures that are out of direct impact of the government –

- (2) interest payments;
- (3) EU programmes expenditures;
- (4) capital expenditure;
- (5) non-discretionary change in unemployment;
- (6) discretionary revenue measures.

From (7) to (16) GG expenditure leverage with the potential growth

(18) CG revenue –

[(17)-(16) GG revenues – GG expenditures = E^{max} –

(19) LocalGov balance –

(20) Derived Public Persons balance –

(21) ESA corrections]

CG exp^{maxEXP} = (18) – [(17) – (16) – (19) – (20) – (21)]

CG exp^{maxEXP} = CG rev – [E^{max} – LGov bal – DerPP bal – ESA]

2018		
SP 2015/18	MTBFL 2016/18 (draft)	
9 998,0	9 856,1	(1) GG total expenditure
300,4	290,2	(2) Interest expenditure, D.41
1 084,4	1 104,9	(3) Expenditure on EU programmes fully matched by EU funds revenue
985,5	1 048,4	(4.1) Gross fixed capital formation (GFCF), t-3, P.51
914,4	902,5	(4.2) GFCF, t-2, P.51
849,9	923,6	(4.3) GFCF, t-1, P.51
870,1	945,4	(4.4) GFCF, t, P.51
0,0	0,0	(5) Non-discretionary change in
34,5	-108,1	(6) Discretionary revenue measures
x	-28,5	(6.1) Government tax policy changes
x	-79,6	(6.2) Changes in deviation on pension reform
8 648,0	8 470,6	(7) Smoothed total expenditures (TE) (nominal), (7) = (1)-(2)-(3)-(4.4.)+[AVE (4.1) (4.2) (4.3) (4.4)]
8 613,5	8 578,7	(8) Adjusted TE (nominal), (8) = (7)-(5)-(6)
5,7	5,5	(9) Growth of nominal adjusted expenditure, %
2,5	2,5	(10) GDP deflator, %
3,1	2,9	(11) Growth of real adjusted expenditure, %
3,3	3,3	(12) 10-year average growth of potential GDP, %
-1,5	-1,5	(13) Deficit reduction factor, %
1,8	1,8	(14) Potential growth reference rate if not at MTO, %, (14) = (12)+(13)
3,3	3,3	(15) Potential growth reference rate, if at MTO, %, (15) = (12)
10 017,4	9 889,2	(16) GG total expenditure, if TE growth = potential GDP growth
9 501,8	9 627,5	(17) GG total revenue
8 128,3	8 335,7	(18) CG budget revenue (cash-flow)
-2,1	-33,6	(19) Local government budget balance
-0,8	-0,8	(20) Derived public persons budget balance
-111,7	-296,4	(21) ESA corrections
8 529,3	**8 266,7**	**Total** (18)-[(17)-(16)-(19)-(20)-(21)]

Source: http://fiscalcouncil.lv/25-09-2015-monitoring-report

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Numerical fiscal rules: continuity rule

Total CG expenditure ceilings come from →
(1)CG expenditure from previous MTBF +
1)-10) delta (△), i.e. sum of technical and contingent changes;

(2) expenditure of EU structural funds as subject to the smoothing +
(3) debt service expenditure as subject to the smoothing.

$$\text{CG exp}^{\text{maxCONT}} = (1) + [\text{sum from 1) to 10)}] + (2) + (3)$$

$$\text{CG exp}^{\text{maxCONT}} = \text{CG exp}_{t-1} + \triangle + e^{\text{EUfunds}} + e^{\text{debtserv}}$$

2017		
SP 2015/18	MTBFL 2016/18 (draft)	
6 578,8	6 569,4	(1) Adjusted maximum permissible state budget expenditure (updated Draft budgetary plan of 2015)
		adjustments of maximum permissible state budget expenditure according to the FDL Article 5, incl.:
-3,0	4,3	1) state budget expenditure due to more actual forecasts in contingent receiving state social allowances and pensions;
-5,7	47,0	2) state social security budget expenditure due to more actual forecasts in contingent receiving social security services, so as forecasts of average amount of pensions and
-1,2	-0,5	3) expenditure, which results from change in forecasted revenues from paid services and other self-earned revenues as well as fixed sum of remaining revenues from paid services and other self-earned revenues at the beginning of current
0,0	0,0	4) increase of expenditure which is subject to the Constitution Article 62 as well as material losses arising from natural disasters, emergencies and natural or social processes complying with provision of second Paragraph of the FDL Article 12;
0,0	0,0	5) increase of expenditure necessary for execution of verdicts of international courts and Constitutional court;
0,6	-0,1	6) expenditure in relation with projects and measures financed from European Union policy instruments and other foreign financial assistance programmes;
0,0	0,0	7) expenditure for servicing that part of state debt falling under the competence of the Treasury;
0,0	1,2	8) regular payments in the budget of the European Union and for international co-operation;
0,0	0,0	9) increase of expenditure related to fiscal risks not mentioned in the fifth Paragraph of the FDL Article 16 in accordance with fourth and fifth Paragraphs of the FDL Article 17, by complying with provisions of these
0,0	0,0	10) increase of expenditure resulting from adopting of normative act in accordance with the FDL Article 9, if according its provisions normative act is adopted which foresees to increase state budget revenues in order to cover respective increase of expenditure or reducing expenditure in amount compensating fall in state budget revenues, if normative act is adopted foreseeing to reduce state budget
1 071,9	1 071,9	(2) Expenditure of European Union structural funds, Cohesion fund, Common Agricultural Policy and Common Fisheries Policy as subject to the smoothing
293,4	293,4	(3) Government debt service expenditure, what is in the Treasury's competence as subject to the smoothing
7 934,7	**7 986,6**	**Total** (1)+ [Sum from 1) to 10)]+(2)+(3)

Source: http://fiscalcouncil.lv/25-09-2015-monitoring-report

Numerical fiscal rules: debt rule

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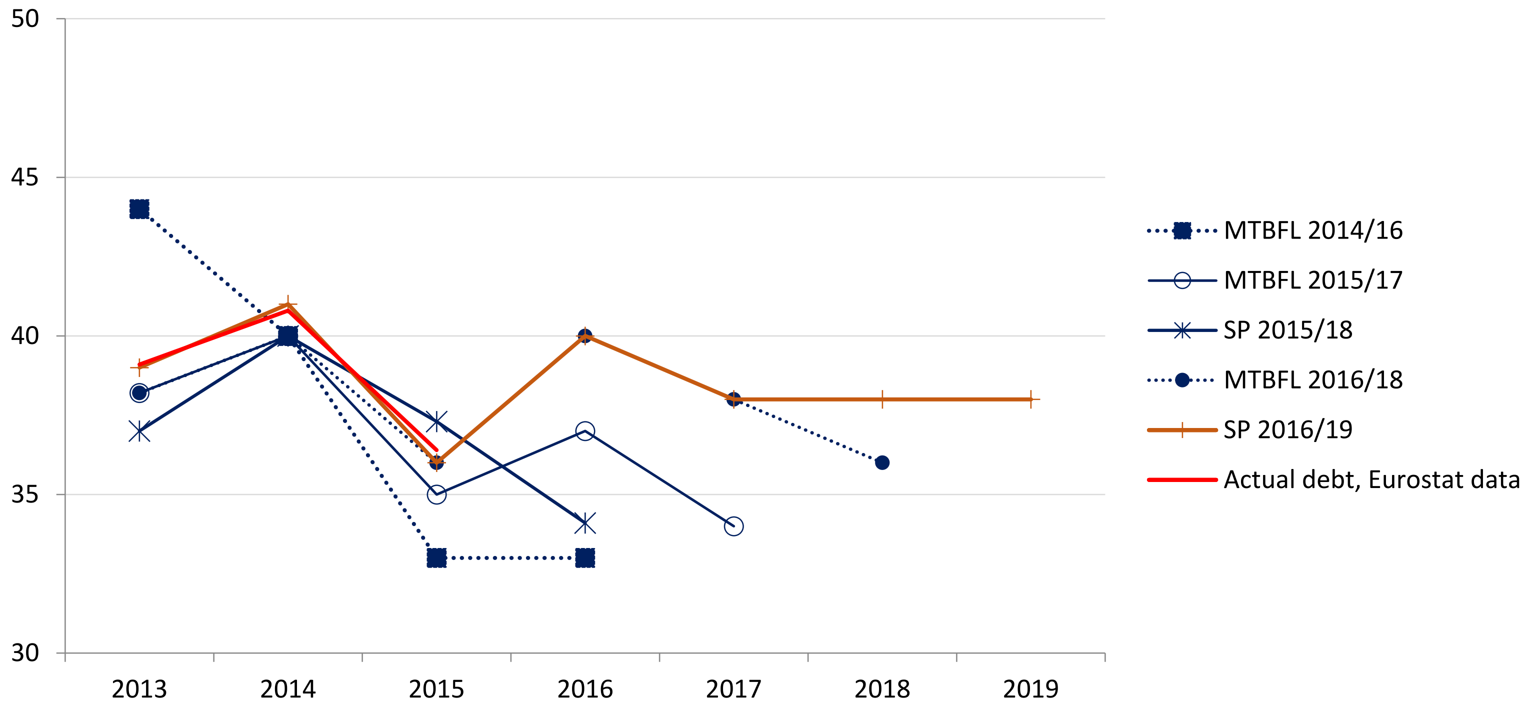
The Fiscal discipline law, Article 14 Part 1

Draft framework law shall be drawn up taking into account the criterion that the general government debt may not exceed 60 per cent of the gross domestic product in the end of the financial year.



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Procedural fiscal rules: out of the Fiscal discipline law

- Eight fiscal policy principles like the umbrella law for fiscal discipline.
- Fiscal safety reserve as the cushion in yearly budget law.
- Fiscal risks statement and fiscal risks registry stretching all details on fiscal risks and defending the amount of the fiscal safety reserve.
- Compensation principle for any updates in the budget and MTBF law, e.g., if the initiative demands additional expenditures there should be simultaneously adopted measures with compensating revenues.
- Establishment of the Fiscal council.

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The management of fiscal risks and fiscal safety reserve

- Problem – a number of fiscal risks realize outside the normal budget framework and the Government from time to time makes decisions that result into adverse impact on the fiscal balance

- The FDL requires the Government to complete a once a year Statement of Fiscal Risks and attach it to the draft budget submitted to the Saeima

- Fiscal Safety Reserve has been mandated to cover such risks and it should not be established at the amount less than 0.1% of GDP

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Fiscal rules – the way forward

- Latvia's set of fiscal rules have been developing in line with the EU framework for the implementation of the Stability and Growth Pact
- A gap between the EU rules and the Fiscal Discipline Law emerges, while we consider steps to close the gap
- The recent re-assessment of the past potential GDP and output gap has postponed the risks of the correction mechanism stepping in

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Thank You for Your attention!
Any questions?

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