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ANNEX 13

ANNEX

Country annex

LATVIA

to the

REPORT FROM THE COMMISSION

**presented under Article 8 of the Treaty on Stability, Coordination and Governance in
the Economic and Monetary Union**

LATVIA

Latvia deposited its instruments of ratification of the Treaty on Stability, Coordination and Governance in Economic and Monetary Union (TSCG) with the General Secretariat of the Council of the European Union on 22 June 2012.

The national provisions considered in the assessment are mostly those provided for by:

- the Law ratifying the TSCG adopted on 31 May 2012,
- the Fiscal Discipline Law (FDL) adopted on 31 January 2013.

1. Legal status of the provisions

The law ratifying the TSCG was approved by qualified majority procedure in accordance with Article 68 of the Constitution – the legal basis for ratification of international agreements which delegate part of the competencies of the State to international organisations. Latvia has a monist legal system, in which provisions of a duly ratified international agreement prevail over national law (Article 13 of the Law on International treaties of the Republic of Latvia). Moreover, a judicial review is available before the Constitutional Court in case there would be incompatibilities between the provisions of national law and the TSCG. The law ratifying the TSCG has higher legal status than ordinary law, including budget laws.

The FDL sets a framework for medium-term and annual budget legislation. The FDL serves as an operational law establishing procedures and rules. It is an ordinary law approved by simple majority procedure.

Against that background, Latvia's provisions comply with the criterion of being of "binding force and permanent character, preferably constitutional, or otherwise guaranteed to be fully respected and adhered to throughout the national budgetary processes".

2. Balanced budget rule

Formulation: The balanced budget rule is enshrined in Article 10 of the FDL.

Article 10 of the FDL provides that the mid-term budgetary framework bill cannot set the structural balance of the general government below -0.5% of GDP. That requirement is consistent with the -0.5% lower limit envisaged in the TSCG for the structural balance. Moreover, the FDL does not foresee the possibility for a wider structural deficit (-1% of GDP) in case of debt significantly below 60% and low risks in terms of fiscal sustainability as envisaged in the TSCG.

The FDL does not refer explicitly to the medium-term objective (MTO), or to the Stability and Growth Pact (SGP) or the TSCG. While the current MTO of -1% of GDP for Latvia is consistent with the target of -0.5% of GDP, the provisions do not explicitly account for a possible revision of the MTO above -0.5% of GDP, should such a revision be required to satisfy the conditions laid out in Regulation (EC) No 1466/97. However, as confirmed by the Latvian authorities, the provisions stemming from the TSCG are of direct effect in national law and would prevail over any potential conflicting national provision. This implies that Latvia will be bound by the MTO if it were revised above -0.5% of GDP. Moreover, the authorities further clarified that in case of a revision of the MTO above the level currently

envisaged in the FDL, the FDL would be amended to ensure consistency between Union law and national law.

Those requirements for the mid-term budgetary framework bill are translated into annual budget bills according to Article 7 of the FDL, which provides that the annual State budget bills are prepared in accordance with the framework law.

Convergence towards the MTO: The FDL contains a number of transition rules. In particular, point 1 of the transition rules lays down that the structural balance rule set in Article 10 is implemented when the structural deficit for the previous year is planned to be below 1% of GDP. Before that condition materialises, the planned structural adjustment should be at least 0.5% of GDP annually. The transitional provisions further specify that in case an "international agreement" ratified by the Parliament determines a different rate of structural adjustment, the latter prevails. The authorities confirmed, in further exchanges with the Commission, that the provision in question aims at taking into account cases where the convergence towards MTO, as envisaged in Article 3(1)(b) of the TSCG, would require a higher adjustment path than 0.5% of GDP.

Escape clauses: Article 12 of the FDL sets out the circumstances in which the mid-term budgetary framework bill does not need to comply with the structural balance requirement set in Article 10. They comprise: (i) measures eliminating material losses arising from natural disasters, emergencies and other natural or social processes, whose forecast costs in one year exceed 0.1% of GDP; (ii) measures eliminating threats to national security within the meaning of Article 62 of the Constitution; (iii) severe economic downturn defined as in Regulation 1467/97. In cases (i) and (ii), the deviation from the structural balance requirement should not exceed the incurred costs. In case (iii), the deviation should not exceed the amount necessary to overcome the downturn, which should not be greater than the forecast revenue shortfall; the size of the allowed deviation is determined taking into account an opinion of the Fiscal Council. The provisions concerning natural or social processes may lend themselves in practice to a wide range of interpretations, some of which could go beyond the definition of exceptional circumstances included in the SGP. However, the Latvian authorities formally committed that the provision regarding "exceptional circumstances" of Article 12 will always be interpreted in line with the relevant provisions of the SGP and of the TSCG¹. Moreover, the Latvian authorities have stated they will introduce amendments to the FDL that make explicit reference to the SGP when defining exceptional circumstances.

Overall, the balanced budget rule complies with the TSCG requirements in light of the formal commitment provided by the Latvian authorities to interpret the "exceptional circumstances" in line with the SGP and the TSCG. Despite the formulation of the rule not referring to the MTO, if the MTO were to be revised above the current level, it would be legally binding as the TSCG is of direct effect in national law. Moreover, the authorities clarified that in case of such a revision, the FDL would be amended. Finally, the convergence path towards the MTO is defined in a way that is consistent with the TSCG.

3. The correction mechanism

The provisions relating to the correction mechanism are mostly found in Articles 10 and 11 of the FDL.

Activation: The obligation to adopt annual budgets that respect the balanced budget rule, as set in Article 10, creates an in-built correction mechanism. Article 10 implies that in the event

¹ Letter from the Latvian authorities of 28 July 2016.

of an observed deviation, the balanced budget must be restored as soon as the following year. In consequence, the FDL requires automatically the presentation and adoption of budgets consistent with the structural balanced budget rule, irrespective of possible deviations in previous years. A national method is used for measuring potential output and structural balances.

In addition, Article 11 puts in place a system of the so-called "control account". The control account records differences between required structural balance targets and observed outcomes. A threshold of -0.5% of GDP for cumulated deficits registered in the control account triggers an additional correction.

Substance of the correction: Article 10 implies that following any possible deviation, corrective action is taken for re-establishing a structurally balanced budgetary position within one year. By construction this captures the notions of proportionality and MTO adherence encapsulated in the common principles. That corrective rule applies irrespective of the size of possible deviations. In particular, there is no basis in the provisions for spreading out over time the correction following a large deviation.

In addition, once the threshold of the control account is reached, a compensation has to be planned in the subsequent medium-term framework law. The compensation is set at 0.5% of GDP and takes place the third year of the medium-term framework, subject to the condition that the output gap be positive. No compensation has to take place if the output gap is forecast to remain negative.

The Fiscal Council is mandated to monitor compliance with the fiscal rules and is expected to monitor in particular the activation and application of the correction mechanism (see Section 4).

Overall: The correction mechanism is compliant with the TSCG requirements and the common principles. The FDL implies a binding ex ante structural balanced-budget rule, which as such constitutes an automatic correction mechanism in the event of deviations, with no basis for flexibility even in the event of large deviations. The system is complemented by a partial debt brake mechanism based on a control account, which provides a safeguard against cumulated deviations over time.

4. The monitoring institution

The Latvian monitoring institution is the Fiscal Discipline Council (FDC).

Set-up and statutory regime: The FDC was created on 1 January 2014 on the basis of the FDL as an independent collegiate institution for the purpose of monitoring public finance developments and compliance with fiscal rules. Its first meeting took place on 25 February 2014. The FDC is composed of six members and is supported by a secretariat, which consists of the FDC secretary and a supporting team of experts.

Mandate: The FDC's general mandate provides the necessary basis for carrying out the tasks foreseen by the Fiscal Compact and the common principles. The FDC has been assigned the duties of monitoring compliance with fiscal rules (including the structural balanced-budget rule), issuing an opinion on the degree of permissible deviation from the balanced budget rule during severe economic downturn, and preparing regular fiscal discipline monitoring reports and, in case of breach of the FDL, of irregularity reports. The FDC prepares a report on fiscal discipline surveillance, which according to the FDL must be submitted to the Parliament as an annex to the Medium-Term Budget Framework Draft Law. In case of any infringement of provisions of the FDL, the FDC will prepare an irregularity report including recommendations

for correction of non-compliance. While the legislation does not describe in detail the specific detailed arrangements of the involvement of the FDC in the activation and application of the correction mechanism, such a description is provided in the Memorandum of Understanding² signed between the Fiscal Council and the Ministry of Finance on 8 January 2016 and amended on 29 July 2016.

Comply-or-explain principle: The Memorandum of Understanding signed between the FDC and the Ministry of Finance lays down the government's obligation to 'comply-or-explain' in relation with the findings and recommendations of the FDC contained in the reports on fiscal discipline surveillance and irregularity reports. The Memorandum specifies that, after having received the FDC's fiscal policy assessments, the Ministry has to prepare corrective action or explain why it does not intend to act in accordance with the opinion of the FDC within 20 working days. The assessment of the FDC and the Ministry's opinions and explanations must be made public on their websites within five working days.

Freedom from interference and capacity to communicate: Chapter III of the FDL defines the FDC as an independent collegial body. The members of the FDC must be experts in financial and economic matters, with experience in fiscal policy issues. According to the FDL they are forbidden to hold an office in a political party, and additional safeguards which preclude interference in the independence of FDC are laid down in the law on prevention of conflict of interest in activities of public officials. The FDL defines instances when the members can be dismissed by a Parliament decision, including on the grounds of neglect of their duties, incapability to perform their tasks, or cases of criminal conviction. The reports of the FDC are published on its website³ and according to Article 29 of the FDL they must also be published on the website of the Ministry of Finance⁴. Regular monitoring reports are submitted to Parliament and irregularity reports are submitted to Parliament and the Cabinet of Ministers.

Nomination procedure: The FDC is composed of six members appointed by the Parliament, three of which are nominated under the joint proposal of the governor of the Central Bank and the Minister of Finance and the other three by the Parliament. Members have a six-year term and can be re-elected no more than twice in consecutive order. Members elect with a simple majority the Chairman of the Council for a period of three years. The same person can hold the Chairman's post for no more than six consecutive years.

Resources and access to information: Beside its members, the FDC has a Secretary and a supporting team of experts (currently three); in addition, the FDC may employ experts based on procedures foreseen by the public procurement legislation. According to Article 31 of the FDL, the Ministry of Finance is responsible for ensuring the technical operation of the FDC. Regarding financial autonomy, the operational expenditure of the FDC is planned in a separate budget programme of the Ministry of Finance's budget and the FDL establishes precise rules for remuneration of the Council's Members and the Secretary, as well as other operational funding provisions to ensure financial independence. In terms of access to information, according to Article 28 of the FDL the FDC has the right to request and receive necessary information from State institutions to perform its tasks, whereas more detailed provisions regarding the exchange of information between the FDC and the Ministry of

² http://fiscalcouncil.lv/files/uploaded/FDP_1_09_969_20160729_MoU_FDC_MoF_consolidated.pdf

³ <http://fdp.gov.lv/padome>

⁴ Both regular and irregularity reports are published at http://www.fm.gov.lv/lv/sadalas/tautsaimniecibas_analize/fiskala_politika/fiskalas_disciplinas_padome/

Finance are laid down in the Memorandum of Understanding signed between the two institutions.

Overall, the set-up of the Latvian monitoring institution is compliant with the TSCG requirements and common principles. It is grounded in law with a broadly delineated mandate providing the basis for carrying out the tasks foreseen by the Fiscal Compact and the common principles; the mandate is further elaborated by means of specific provisions in the Memorandum of Understanding between the FDC and the Ministry of Finance. The legal framework includes appropriate safeguards for functional autonomy. The 'comply-or-explain' principle is enshrined in the Memorandum of Understanding between the FDC and the Ministry of Finance. Adequate provisions on the FDC's endowment with resources and access to information are in place.

5. Conclusion

The national provisions adopted by Latvia are compliant with the requirements set in Article 3(2) of the TSCG and in the common principles in light of the formal commitment provided by the national authorities on the scope of escape clauses.