Brussels, 22.11.2017
SWD(2017) 522 final

COMMISSION STAFF WORKING DOCUMENT

Analysis of the draft budgetary plan of Latvia

Accompanying the document

COMMISSION OPINION

on the draft budgetary plan of Latvia

{C(2017) 8022 final}

COMMISSION STAFF WORKING DOCUMENT

Analysis of the draft budgetary plan of Latvia

Accompanying the document

COMMISSION OPINION

on the draft budgetary plan of Latvia

1. INTRODUCTION

Latvia submitted its Draft Budgetary Plan for 2017 on 11 October 2017 in compliance with Regulation (EU) No 473/2013 of the Two-Pack. Latvia is subject to the preventive arm of the Pact and should preserve a sound fiscal position which ensures compliance with the medium term budgetary objective (MTO) of -1.0% of GDP taking into account the allowances linked to the implementation of the systemic pension reform and of the structural reforms for which a temporary deviation is granted.

Section 2 of this document presents the macroeconomic outlook underlying the Draft Budgetary Plan and provides an assessment based on the Commission 2017 autumn forecast. The following section presents the recent and planned fiscal developments, according to the Draft Budgetary Plan, including an analysis of risks to their achievement based on the Commission 2017 autumn forecast. In particular, it also includes an assessment of the measures underpinning the Draft Budgetary Plan. Section 4 assesses the recent and planned fiscal developments in 2017-2018 (also taking into account the risks to their achievement) against the obligations stemming from the Stability and Growth Pact. Section 5 provides an analysis on the composition of public finances and on fiscal-structural issues, including reducing the tax wedge. Section 6 summarises the main conclusions of the present document.

2. MACROECONOMIC DEVELOPMENTS UNDERLYING THE DRAFT BUDGETARY PLAN

The macroeconomic scenario underlying Latvia's Draft Budgetary Plan (DBP) forecasts growth increasing from 2.0% in 2016 to 3.7% in 2017, and slowing down to 3.4% in 2018. This dynamic is primarily due to the EU fund-driven investment cycle which in 2017 recovers from the drop in previous years and moderates in 2018 as the EU fund disbursements reach their normal level. Also, increases in household consumption and exports are expected to further boost the GDP growth in 2017 and 2018 compared to 2016. In nominal terms, GDP growth is projected to accelerate considerably in 2017 and 2018 compared to 2016, as inflation is expected to increase as a result of high wage growth, substantial consumption tax increases and rising energy prices. Due to the shrinking of the working age population, the unemployment rate is forecast to decline somewhat although there is no growth in employment.

Compared to the scenario underlying the Stability Programme, GDP growth for 2017 has been revised upwards by 0.5 percentage point. mainly on the account of an earlier and stronger investment recovery, which will also wane sooner than expected in the Stability Programme. 2018 growth is left unchanged as a weaker investment contribution is countered by somewhat stronger public consumption and external demand. In nominal terms, GDP

growth has been revised up by around 1.0 percentage point. both for 2017 and 2018 compared to the Stability Programme.

The risks to the macroeconomic forecast are balanced, as the impact of the investment recovery may prove to be stronger and more sustained and the boost to exports provided by an improved external outlook may last longer than currently forecast. On the other hand, the result of the United Kingdom's vote on EU membership may prove to be more damaging to Latvian exports than currently assumed and the rapidly tightening labour market may constrain growth due to a lack of labour.

Overall, the updated DBP's macroeconomic projection for 2017 is somewhat cautious both compared to the actual growth in the first half of the year (+4.4%) and the Commission autumn forecast. The 2018 projection however is in line with the Commission's projections. In nominal terms, the DBP projection is also in line with the Commission's forecast. To conclude, in the Commission's view, the DBP is based on plausible macroeconomic assumptions.

Box 1: The macroeconomic forecast underpinning the budget in Latvia

The macroeconomic forecast of the DBP was prepared by the Ministry of Finance. The Fiscal Discipline Council, which was established in January 2014 as an independent body with the purpose of monitoring the compliance with the Fiscal Discipline Law, considered the forecast as realistic and endorsed it on 4 August 2017[1].

The Fiscal Discipline Council's surveillance report of 4 October 2017[2] argued that the potential growth rate of the economy would not exceed 3% in the medium term and thus the Latvian economy is expected to record a positive output gap from 2018, after having been close to its potential level in 2017. In view of the cyclical upswing from 2018, the Fiscal Discipline Council called for a prudence in fiscal planning and more ambitious budgetary targets, with smaller fiscal deficits or even surpluses in the near future, if favourable economic conditions persist.

[1] A letter to the Ministry of Finance, published on the websites of the Fiscal Discipline Council and the Ministry of Finance:
http://fiscalcouncil.lv/files/uploaded/FDP_1_08_1177_20170804_macroeconomic_forecasts_MoF.pdf
http://www.fm.gov.lv/files/files/FDP_1_08_1177_20170804_makroekonomikas_prognozes_FM.pdf

[2] http://fiscalcouncil.lv/files/uploaded/FDP_1_08_1499_20171004_FDSR.pdf

Table 1. Comparison of macroeconomic developments and forecasts

	2016	2017			2018		
	COM	SP	DBP	COM	SP	DBP	COM
Real GDP (% change)	2.1	3.2	3.7	4.2	4.3	3.4	3.5
Private consumption (% change)	3.3	3.2	4.8	4.3	4.0	3.1	4.0
Gross fixed capital formation (% change)	-15.0	5.2	11.4	17.8	43.1	8.4	5.5
Exports of goods and services (% change)	4.1	3.3	6.1	3.8	3.5	3.7	4.2
Imports of goods and services (% change)	4.5	1.4	5.4	7.9	9.2	5.0	5.1
Contributions to real GDP growth:							
- Final domestic demand	-0.8	3.6	5.5	6.6	10.2	4.4	4.1
- Change in inventories	3.2	-1.5	-2.1	0.0	-2.3	-0.1	0.0
- Net exports	-0.3	1.1	0.3	-2.4	-3.6	-0.9	-0.6
Output gap[1]	1.3	2.7	2.3	2.3	1.5	2.2	2.1
Employment (% change)	-0.3	0.2	0.0	0.2	0.2	0.0	-0.2
Unemployment rate (%)	9.6	9.4	8.9	8.4	8.9	8.2	7.9
Labour productivity (% change)	2.4	3.0	3.5	4.0	3.2	3.2	3.7
HICP inflation (%)	0.1	2.3	2.8	2.9	2.0	2.8	2.8
GDP deflator (% change)	0.3	1.9	2.8	2.2	1.8	2.8	3.4
Comp. of employees (per head, % change)	6.8	5.5	6.5	9.5	5.2	6.0	8.8
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	2.4	3.4	0.9	-0.1	0.6	0.7	0.0

Note:

[1]In percent of potential GDP, with potential GDP growth recalculated by Commission services on the basis of the programme scenario using the commonly agreed methodology.

Source:

Stability Programme 2017 (SP); Draft Budgetary Plan for 2018 (DBP); Commission 2017 autumn forecast (COM); Commission calculations

3. RECENT AND PLANNED FISCAL DEVELOPMENTS

3.1. Deficit developments

The DBP estimates the government deficit at 0.9% of GDP in 2017, as compared to 0.8% of GDP in the April 2017 Stability Programme[3]. The fiscal position is estimated to have improved by 0.4% of GDP due to better-than-projected revenues, largely linked to the pick-up in wages. However, the government's decision to early settle some support for electricity production carries previously unplanned costs of 0.5% of GDP into 2017. This will alleviate government expenditure in the coming years.

For 2018, the DBP targets a headline deficit of 1.0% of GDP – a notable improvement from the planned deficit of 1.6% of GDP in the Stability Programme. This improvement largely stems from the changes to the tax reform, in particular by partly delaying the transformation

[3] The EDP notification of 13 October 2017 reported the government deficit estimate of 0.8% of GDP in 2017.

of the corporate income tax from 2018 to 2019, lowering costs of the personal income tax changes and specifying additional revenue-increasing measures.

The DBP projects an increase in the government revenue-to-GDP ratio by 0.1 percentage point between 2017 and 2018, as compared to a contraction of 0.6 percentage point in the Stability Programme[4]. In view of the measures, the DBP projects a contraction in direct tax revenue ratio of 1.3 percentage points to be more than compensated by an increase in social contributions ratio (+0.8 percentage point of GDP) and indirect tax revenue ratio (+0.7 percentage point of GDP). All these elements have improved since the Stability Programme. The expenditure ratio to GDP is projected to increase by 0.2 percentage point of GDP in 2018, as in the Stability Programme. Subsidies, social payments and public investment are projected to increase their share in GDP, while other expenditure, compensation of employees and intermediate consumption is projected to be lower. As compared to the Stability Programme, subsidies are projected to rise notably, at the expense of investment and intermediate consumptions. This may demonstrate difficulties to establish a precise economic classification of the expenditure breakdown, rather than policy changes.

The Commission forecast projects a government deficit of 0.9% of GDP in 2017 and 1.0% of GDP in 2018, which corresponds to the DBP deficit targets. Under the Commission forecast, the government revenue-to-GDP ratio is projected to remain unchanged in 2017 and to decline by 0.5 percentage point of GDP in 2018. The assessment of 2017 is similar to that of the DBP, but the difference in 2018 is largely explained by lower indirect tax revenue projections of the Commission. Labour tax revenue in 2018 is marginally lower in the Commission forecast, even though wage growth is projected to be notably higher than in the DBP. This suggests that both indirect and direct tax revenue projections of the DBP assume higher elasticities than the Commission forecast, even accounting for somewhat different treatment of certain revenue measures.

The expenditure-to-GDP ratio is projected to increase by 0.9 percentage point of GDP in 2017 and to decline by 0.4 percentage point in 2018, based on the Commission forecast. The increase in 2017 is projected to be driven by a pick-up in investment and public sector wages and a temporary surge in subsidies, where the support for electricity production is recorded. In 2018, the ratios of social spending and public sector wages to GDP are projected to increase, while other items are expected to have lower growth rates than nominal GDP. The reduction in the expenditure ratio in 2018 relative to 2017 will largely reflect the discontinuation of the settlement on the electricity production support.

Risks to the DBP are mostly related to uncertainty over the tax policy changes and revenue projections. The transformation of the corporate tax regime from taxing annual profits to taxing only dividend pay-outs carries large fiscal costs in the first years following the implementation. During the transition period of 2018-2019, previously accumulated profits can still be paid out in dividends at the existing 10% tax rate, rather than the new 20% rate. This provides some certainty for tax revenue in 2018-2019, but from 2020 there is a risk of a large share of profits being retained by companies at a 0% rate, thus affecting tax revenue. In addition, revenue projections rely on higher tax compliance both through a compliance-friendly tax policy design and stricter tax administration requirements. While the tax

[4] The government revenue and expenditure ratio to GDP between the Stability Programme, the DBP and the Commission 2017 autumn forecast are not comparable in level terms, as each of them is based on different data for 2016, due to statistical revisions.

compliance seems to be generally improving and most of the measures appear realistic, the impact of such measures is uncertain. This seems to explain the more positive revenue projection of the DBP relative to the Commission forecast. The risks to the DBP are counterweighted by inclusion under budgetary expenditure of a fiscal security reserve of 0.1% of GDP to cover risks identified in the medium-term budgetary plan. Moreover, possible delays in implementation of the EU-funded projects may limit government co-financing expenditure.

Table 2. Composition of the budgetary adjustment

(% of GDP)	2016	2017			2018			Change: 2016-2018
	COM	**SP**	**DBP**	**COM**	**SP**	**DBP**	**COM**	**DBP**
Revenue	**37.4**	**36.8**	***36.4***	**37.3**	**36.2**	***36.5***	**36.7**	**-0.9**
of which:								
- Taxes on production and imports	14.3	13.6	*13.4*	14.2	14.5	*14.1*	14.4	-0.2
- Current taxes on income, wealth, etc.	8.4	8.5	*8.5*	8.5	6.7	*7.2*	7.3	-1.2
- Capital taxes	0.0	0.0	*0.0*	0.0	0.0	*0.0*	0.0	0.0
- Social contributions	8.6	8.8	*8.8*	8.7	9.4	*9.6*	9.2	1.0
- Other (residual)	6.0	5.9	*5.7*	5.9	5.6	*5.6*	5.9	-0.4
Expenditure	**37.4**	**37.6**	**37.3**	**38.2**	**37.8**	**37.5**	**37.7**	**0.1**
of which:								
- Primary expenditure	36.3	36.6	36.4	37.2	36.9	36.7	36.9	0.4
of which:								
Compensation of employees	10.2	10.6	10.7	10.6	10.5	10.5	10.7	0.3
Intermediate consumption	6.1	6.3	6.4	6.0	6.7	6.2	6.1	0.1
Social payments	11.5	11.7	11.6	11.5	12.0	12.0	11.7	0.5
Subsidies	1.2	0.6	0.5	1.3	0.5	1.0	0.9	-0.2
Gross fixed capital formation	3.5	3.7	4.4	4.4	4.2	4.5	4.2	1.0
Other (residual)	3.8	3.7	2.8	3.4	3.0	2.5	3.3	-1.3
- Interest expenditure	1.0	1.0	0.9	0.9	0.9	0.8	0.8	-0.2
General government balance (GGB)	**0.0**	**-0.8**	**-0.9**	**-0.9**	**-1.6**	**-1.0**	**-1.0**	**-1.0**
Primary balance	**1.1**	**0.2**	**0.1**	**0.0**	**-0.7**	**-0.2**	**-0.2**	**-1.3**
One-off and other temporary measures	0.2	0.0	0.0	0.0	0.0	0.0	0.0	-0.2
GGB excl. one-offs	**-0.1**	**-0.8**	**-0.9**	**-0.9**	**-1.6**	**-1.0**	**-1.0**	**-0.9**
Output gap[1]	1.3	2.7	2.3	2.3	1.5	2.2	2.1	1.0
Cyclically-adjusted balance[1]	-0.5	-1.8	-1.8	-1.8	-2.2	-1.9	-1.8	-1.4
Structural balance (SB)[2]	**-0.6**	**-1.8**	**-1.8**	**-1.8**	**-2.2**	**-1.9**	**-1.8**	**-1.3**
Structural primary balance[2]	0.4	-0.8	-0.9	-0.8	-1.3	-1.1	-1.0	-1.5

Notes:

[1]Output gap (in % of potential GDP) and cyclically-adjusted balance according to the DBP/programme as recalculated by Commission on the basis of the DBP/programme scenario using the commonly agreed methodology.

[2]Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.

Source:

Stability Programme 2017 (SP); Draft Budgetary Plan for 2018 (DBP); Commission 2017 autumn forecast (COM); Commission calculations

Euro area sovereign bond yields remain at historically low levels, with 10-year rates in Latvia currently standing at 0,72[5]. As a consequence, total interest payments by the general government have continued to decrease as a share of GDP. Based on the information included in the Draft Budgetary Plan, interest expenditure in Latvia is expected to fall from 1.0% of GDP in 2016 to 0.9% in 2017 and is projected to decrease further next year, to 0.8% of GDP, well below the 1.7% recorded back in 2012 at the peak of the euro area sovereign debt crisis. The picture stemming from Member States' plans is broadly confirmed by the Commission forecast.

The recalculated structural deficit[6] is estimated at 1.8% of GDP in 2017 and 1.9% of GDP in 2018. Compared to the Stability Programme, the projection of the recalculated structural deficit has improved in 2018, in line with the policy effort recommended in spring 2017. The Commission estimates of the structural balance are close to those of the DBP.

3.2. Debt developments

Government debt stood at 40.6% of GDP in 2016, including borrowing to accumulate financial resources for a large debt redemption in early 2017. The DBP estimates the debt ratio to decline to 38.7% of GDP in 2017 and 37.3% in 2018. This downward trend of the debt ratio mostly reflects the low government borrowing compared to nominal GDP growth. The Commission projects a government debt of 39% of GDP in 2017 and 35.5% in 2018, assuming much lower cash balances at the end of 2018.

5 10-year bond yields in September 2017 on average. Source: Eurostat

6 Cyclically adjusted balance net of one-off and temporary measures, recalculated by the Commission using the commonly agreed methodology.

Table 3. Debt developments

(% of GDP)	2016	2017			2018		
		SP	DBP	COM	SP	DBP	COM
Gross debt ratio[1]	**40.6**	**39.2**	**38.7**	**39.0**	**38.2**	**37.3**	**35.5**
Change in the ratio	3.7	-1.4	-1.9	-1.6	-1.0	-1.4	-3.5
Contributions [2] *:*							
1. Primary balance	**-1.1**	**-0.2**	**-0.1**	**0.0**	**0.7**	**0.2**	**0.2**
2. "Snow-ball" effect	**0.1**	**-1.0**	**-1.5**	**-1.6**	**-1.3**	**-1.5**	**-1.7**
Of which:							
Interest expenditure	1.0	1.0	1.0	0.9	0.9	0.8	0.8
Growth effect	-0.7	-1.2	-1.4	-1.6	-1.6	-1.2	-1.3
Inflation effect	-0.1	-0.7	-1.1	-0.9	-0.6	-1.0	-1.2
3. Stock-flow adjustment	**4.6**	**-0.2**	**-0.3**	**0.1**	**-0.3**	**-0.1**	**-2.0**
Of which:							
Cash/accruals difference							
Net accumulation of financial							
of which privatisation proceeds							
Valuation effect & residual							

Notes:

[1] End of period.

[2] The snow-ball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator). The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other residual effects.

Source:

Stability Programme 2017 (SP); Draft Budgetary Plan for 2018 (DBP); Commission 2017 autumn forecast (COM); Commission calculations

3.3. Measures underpinning the draft budgetary plan

The DBP presents the measures announced at the time of the budget preparation (see Table 4) and the tax reform measures adopted in July 2017. The net expenditure increase is reported at 0.3% of GDP. This includes an increase in the state family support (reported in the DBP as subsidies), an increase in grants to the local authorities to a new minimum level of 19.6% of the consolidated government revenue and several smaller expenditure measures (Table 4B). These spending increased are partly covered by expenditure saving from the postponement of a new prison building, interest expenditure savings and lower EU budget contributions. On the revenue side, the most recently announced measures include the introduction of a reduced VAT rate of 5% for vegetables and fruits typical to Latvia and adjusted projections of non-tax revenue, including dividends from the state-owned companies and the Bank of Latvia (Table 4A).

Table 4. Main discretionary measures reported in the DBP

A. Discretionary measures taken by General Government - revenue side

Components	Budgetary impact (% GDP) (as reported by the authorities)		
	2017	**2018**	**2019**
Taxes on production and	0.0	-0.1	0.0
Current taxes on income,	0.0	0.0	0.0
Capital taxes			
Social contributions			
Property Income			
Other		0.0	0.1
Total	0.0	-0.1	0.1

Note:
The budgetary impact in the table is the aggregated impact of measures as reported in the DBP, i.e. by the national authorities. A positive sign implies that revenue increases as a consequence of this measure.
Source: Draft Budgetary Plan for 2018

B. Discretionary measures taken by general Government- expenditure side

Components	Budgetary impact (% GDP) (as reported by the authorities)		
	2017	**2018**	**2019**
Compensation of employees	0.0	0.0	0.0
Intermediate consumption	0.0	0.0	0.0
Social payments	0.0	0.0	0.0
Interest Expenditure			
Subsidies	0.0	0.2	-0.1
Gross fixed capital formation	0.0	-0.1	0.0
Capital transfers			
Other	0.0	0.3	0.3
Total	0.0	0.3	0.1

Note:
The budgetary impact in the table is the aggregated impact of measures as reported in the DBP, i.e. by the national authorities. A positive sign implies that expenditure increases as a consequence of this measure.
Source: Draft Budgetary Plan for 2018

The measures of the tax reform were legislated on 28 July 2017 – before the DBP and are not presented in Table 4. The reform measures are expected to cost around 1.2% of GDP in 2018 and 2.3% of GDP by 2020; partly compensated by 0.9% of GDP in revenue-increasing measures in 2018 and 1.3% of GDP by 2020. The most expensive measure is the reduction of the standard personal income tax rate from 23% to 20% (cost of 0.8% of GDP) for annual income up to EUR 20 000. The income distribution in Latvia implies that majority of tax payers will pay only 20% rate and the progressive rates of 23% and 31.4% apply only to incomes above the threshold for the richest ten percent of households. This is a regressive

measure with largest gains for the higher income groups. The move to the 0% tax rate on reinvested profits implies a large revenue loss in 2019 (1.0% of GDP). It benefits the business owners and is expected to be highly regressive, given the very unequal wealth distribution. By contrast, increasing the progressive income-differentiated basic allowance has a positive income distribution effect from high-income earners to low and middle income earners (cost of 0.2% of GDP).

The revenue-increasing measures rely on higher excise duties and stricter requirements under the VAT system leading to an improved compliance, as well as other smaller measures. While these measures represent a certain element of shifting the tax burden from low-income earners to other tax bases, the potential to increase social equality and tackle inefficiencies in property valuation and taxation remains underused. The increase of mandatory social insurance contributions by one percentage point to finance healthcare means increasing labour taxes and does not solve the financing needs of the health sector in a sustainable way.

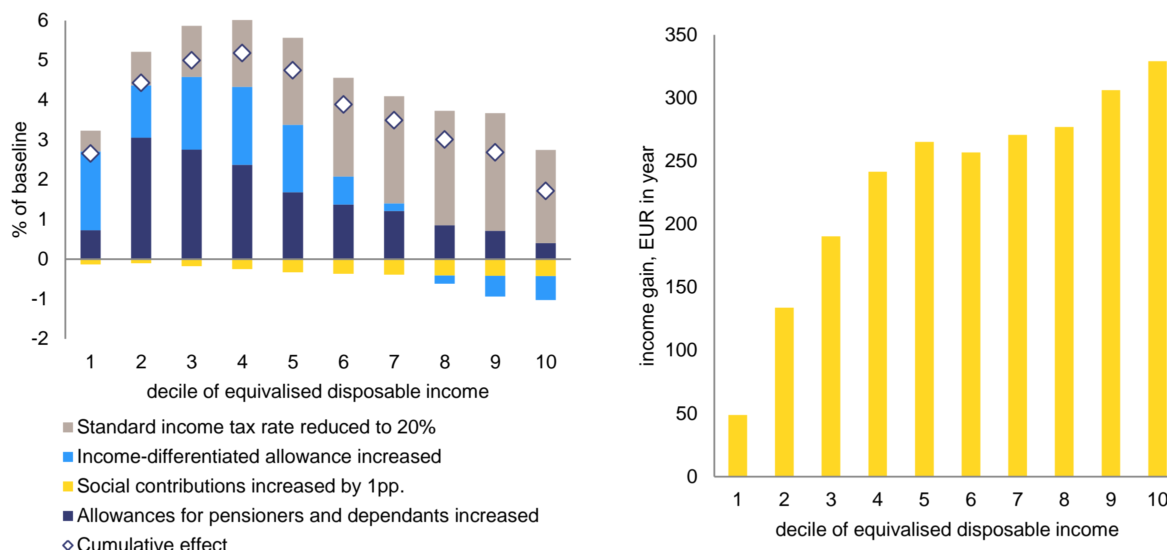
The tax reform measures do not sufficiently reduce the high tax wedge on low income earners, which remains relatively high compared with the EU average (see Box 3). The increase in the basic allowance is the most effective at reducing the tax wedge on low income earners, but it represents only a fraction of the total cost of the reform. The personal income tax measures benefit more medium-income households (see Graph 1). A large share of nominal income gains is handed to the richest households, while the poorest 30% receive only 10% of the benefits of the reform package (see Graph 2). Nevertheless, the revised reform measures are less costly and regressive than the proposals in the Stability Programme.

The tax reform also appears to go in the opposite direction of Latvia's stated policy objective of increasing tax revenue as a share of GDP. This restricts financings for many structural reforms and the redistributional function of the state through the social benefit system, in particular towards the most vulnerable groups.

The estimated effect of the measures is overall plausible. Some measures are not treated as discretionary fiscal measures in the Commission forecast, while their effect on the forecast is considered. This includes the second round effect of the increase in the national minimum wage on tax revenue and revisions to revenue and expenditure projections. The Commission forecast excludes a few measures with uncertain implementation or fiscal effects. Such measures include the expected higher labour tax revenue linked to the restriction of VAT avoidance, the new minimum health payment and the review of the cadastral value for property taxation.

Graph 1: Distributional effect of the personal income tax measures for each income group by 2020

Graph 2: Nominal gains of the personal income tax measures across income groups by 2020



4. COMPLIANCE WITH THE PROVISIONS OF THE STABILITY AND GROWTH PACT

Latvia is subject to the preventive arm of the Pact and should ensure sufficient progress towards its MTO. Box 2 reports the latest country-specific recommendations in the area of public finances.

Box 2: Council Recommendations[7] addressed to Latvia

On 11 July 2017, the Council addressed recommendations to Latvia in the context of the European Semester. In particular, in the area of public finances the Council recommended to pursue the fiscal policy in line with the requirements of the preventive arm of the Stability and Growth Pact, which entails achieving the medium-term budgetary objective in 2018, taking into account the allowances linked to the implementation of the systemic pension reform and of the structural reforms for which a temporary deviation is granted.

The Council recalled that based on the Commission 2017 spring forecast, this is consistent with a maximum nominal growth rate of net primary government expenditure of 6.0 % in 2018, corresponding to deterioration in the structural balance of 0.3 % of GDP.

4.1. Compliance with the MTO

In 2017, the planned real growth rate of net primary government expenditure is estimated to be well below the applicable expenditure benchmark rate of 5%, overachieving the requirement by 1.9% of GDP. On average in 2016-2017, both the structural balance and expenditure benchmark are complied with. However, in 2017, the recalculated structural balance is expected to fall short of the requirement by 0.1% of GDP, as the structural deficit is projected to increase from 0.6% of GDP in 2016 to 1.8% of GDP. This calls for an overall assessment. The different reading of the two indicators is largely explained by two elements:

[7] OJ C 261, 9.8.2017.

(i) investment fluctuations and (ii) a revenue shortfall. Regarding the first item, the nationally financed government investment is estimated to have dropped by 8% in 2016 and to have recovered by 12% in 2017, based on the information in the DBP. This investment swing is mitigated under the expenditure benchmark, where the investment expenditure is smoothed over four years. Conversely, it has a significant impact on the structural balance in both 2016 and 2017: the fiscal effort under the structural balance pillar appears to be overestimated by 0.3% of GDP in 2016 and underestimated by 0.2% of GDP in 2017. With respect to the revenue shortfall, the strong pick-up in investment is less tax rich than suggested by the standard elasticities to GDP, resulting in 2.5% of GDP lower revenues in 2017 as compared with standard elasticities. The opposite is true for 2016, where the drop in investment affected real GDP growth, while the underlying revenue growth was sustained by private consumption and wage growth. Overall, considering the investment fluctuations and the revenue shortfall, the overall assessment leads to a conclusion of compliance in 2017.

The Commission 2017 autumn forecast suggests an excess over the structural balance requirement of 0.1% of GDP in 2017, while the expenditure benchmark is estimated to be met (+0.3% of GDP). The explanation of the difference between the two indicators is similar to that of the DBP. The pick-up in investment and the revenue shortfall in 2017 are estimated to understate the fiscal effort under the structural balance pillar by 0.5% of GDP each. Overall, the Commission autumn forecast therefore confirms compliance with the preventive arm in 2017.

In 2018, the nominal growth rate of net primary government expenditure is estimated to exceed the applicable expenditure benchmark rate of 6%[8], leading to a deviation of 0.4% of GDP, while the recalculated structural balance suggests compliance with the fiscal requirement. This requires an overall assessment. Over 2017 and 2018 together, both the expenditure benchmark and the structural balance point to compliance. The different reading of the two indicators in 2018 is explained by the difference between the recalculated potential growth rate of 3.5% used for the structural balance and the 10-year average reference rate of 2.5% used for the expenditure benchmark. As regards the expenditure benchmark, the reference rate of potential growth is impacted by a period of exceptionally low potential growth of 1.2% on average in 2012-2016. This is linked to the post-crisis fiscal adjustments up to 2014, the external demand shocks in 2014-2015 and the 2016 investment trough. The annual potential growth rate is expected to accelerate to almost 4% in the medium term, based on the Commission estimates, which is supported by the end of the post-crisis deleveraging and the stable business outlook. Taking this into account, the gap under the expenditure benchmark would be reduced from 0.4% to 0.1% of GDP. In view of this, the overall assessment suggests some deviation from the rules of the preventive arm.

The Commission autumn forecast demonstrates a similar reading of the indicators for 2018 as the DBP. The expenditure benchmark is breached by 0.4% of GDP, while the structural balance requirement is met. The indicators over 2017-2018 on average suggest compliance. A similar reasoning on the reading of these indicators as explained above also applies to the Commission estimates. The exceptionally low potential growth used for the expenditure

[8] As part of the agreement on the EFC Opinion on "Improving the predictability and transparency the SGP: a stronger focus on the expenditure benchmark in the preventive arm", which was adopted by the EFC on 29 November 2016, the expenditure benchmark, that is the maximum allowable growth rate of expenditure net of discretionary revenue measures, is expressed in nominal terms as from 2018.

benchmark explains the deviation. The overall conclusion is expected to be one of compliance in 2018.

Table 5. Compliance with the requirements of the preventive arm

(% of GDP)	2016	2017		2018	
Initial position[1]					
Medium-term objective (MTO)	-1.0	-1.0		-1.0	
Structural balance[2] (COM)	-0.6	-1.8		-1.8	
Structural balance based on freezing (COM)	-0.6	-1.4		-	
Position vis-a -vis the MTO[3]	Not at MTO	At or above the MTO		Not at MTO	
(% of GDP)	**2016**	**2017**		**2018**	
	COM	**DBP**	**COM**	**DBP**	**COM**
Structural balance pillar					
Required adjustment[4]	0.6	0.0		0.4	
Required adjustment corrected[5]	0.0	-1.1		-0.3	
Change in structural balance[6]	0.9	-1.2	-1.1	-0.1	0.0
One-year deviation from the required adjustment [7]	0.9	-0.1	-0.1	0.2	0.2
Two-year average deviation from the required adjustment [7]	0.5	0.4	0.4	0.0	0.1
Expenditure benchmark pillar					
Applicable reference rate[8]	1.5	5.0		6.0	
One-year deviation adjusted for one-offs [9]	-0.2	1.9	0.3	-0.4	-0.4
Two-year average deviation adjusted for one-offs [9]	-0.1	0.9	0.0	0.8	0.0
PER MEMORIAM: One-year deviation [10]	0.0	1.8	0.1	-0.4	-0.4
PER MEMORIAM: Two-year average deviation [10]	0.0	0.9	0.0	0.7	-0.1
Conclusion					
Conclusion over one year	Overall assessment	Overall assessment	Overall assessment	Overall assessment	Overall assessment
Conclusion over two years	Overall assessment	Compliance	Compliance	Compliance	Compliance

Notes

[1] The most favourable level of the structural balance, measured as a percentage of GDP reached at the end of year t-1, between spring forecast (t-1) and the latest forecast, determines whether there is a need to adjust towards the MTO or not in year t. A margin of 0.25 percentage points (p.p.) is allowed in order to be evaluated as having reached the MTO.

[2] Structural balance = cyclically-adjusted government balance excluding one-off measures.

[3] Based on the relevant structural balance at year t-1.

[4] Based on the position vis-à-vis the MTO, the cyclical position and the debt level (See European Commission: Vade mecum on the Stability and Growth Pact, page 38.).

[5] Required adjustment corrected for the clauses, the possible margin to the MTO and the allowed deviation in case of overachievers.

[6] Change in the structural balance compared to year t-1. Ex post assessment (for 2016) was carried out on the basis of Commission 2017 spring forecast.

[7] The difference of the change in the structural balance and the corrected required adjustment.

[8] Reference medium-term rate of potential GDP growth. The (standard) reference rate applies from year t+1, if the country has reached its MTO in year t. A corrected rate applies as long as the country is adjusting towards its MTO, including in year t.

[9] Deviation of the growth rate of public expenditure net of discretionary revenue measures, revenue increases mandated by law and one-offs from the applicable reference rate in terms of the effect on the structural balance. The expenditure aggregate used for the expenditure benchmark is obtained following the commonly agreed methodology. A negative sign implies that expenditure growth exceeds the applicable reference rate.

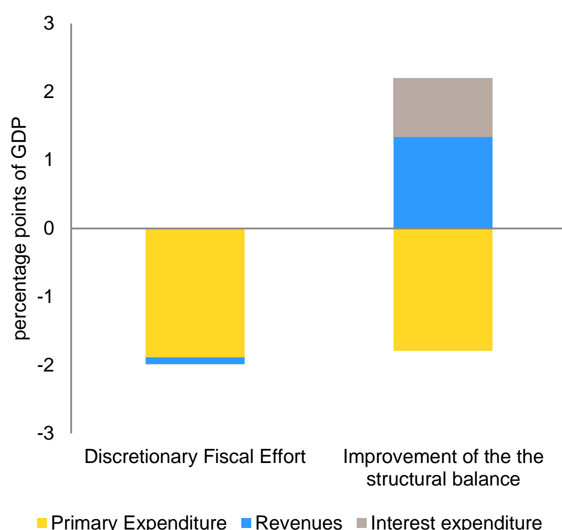
[10] Deviation of the growth rate of public expenditure net of discretionary revenue measures and revenue increases mandated by law from the applicable reference rate in terms of the effect on the structural balance. The expenditure aggregate used for the expenditure benchmark is obtained following the commonly agreed methodology. A negative sign implies that expenditure growth exceeds the applicable reference rate.

Source :
Draft Budgetary Plan for 2018 (DBP); Commission 2017 autumn forecast (COM); Commission calculations.

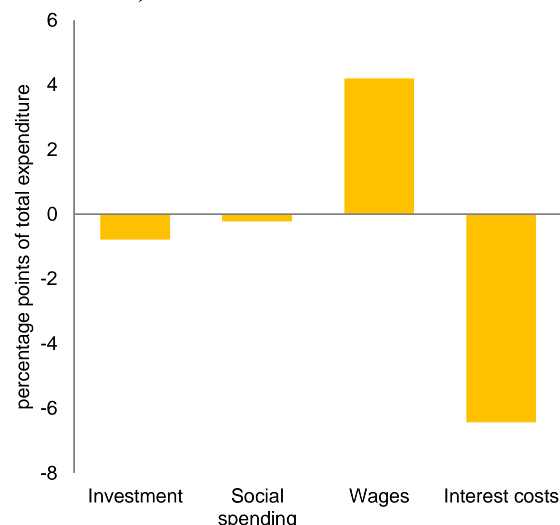
5. COMPOSITION OF PUBLIC FINANCES AND IMPLEMENTATION OF FISCAL STRUCTURAL REFORMS

The breakdown of the fiscal effort planned in the DBP for 2018 deviates from the past trends and the Commission autumn forecast. The fiscal effort in 2011-2017 relied on an increase in revenue share in GDP, with net discretionary revenue effort being slightly negative, and interest expenditure savings, while share of primary expenditure in GDP expanded (Graph 3). The increase in revenue share can be attributed to an expansion of wage share in GDP and declining shadow economy. In 2018, interest expenditure savings of 0.1% of GDP are expected both according to the DBP and the Commission forecast. However, an increase in ratio of primary expenditure to GDP by 0.4 percentage point in the DBP is not confirmed by the Commission forecast. Also, the projected increase in the tax-revenue-to-GDP ratio by 0.3 percentage point in 2018 is in contrast with the Commission forecast of a decline by 0.5 percentage point of GDP in 2018, in view of the revenue-reducing measures. The DBP assumes a higher share of subsidies, social and investment spending in total expenditure, partly financed by lower expenditure on public sector wages and the purchase of goods and services. The increase in social benefits coincides with that of the Commission forecast, but other elements are assumed to have a different dynamics. In particular, based on the Commission forecast, the compensation of employees is expected to expand, given the planned wage increases and raising the national minimum wage by 13%. This follows the past trend of rising share of wages in total government expenditure (Graph 4).

Graph 3: Composition of the fiscal effort (2011-2017)



Graph 4: Change in the share in total expenditure of selected expenditure items (2011-2017)



Notes:

Graph X shows the Discretionary Fiscal Effort (DFE) which combines a top-down approach on the expenditure side with a bottom-up or narrative approach on the revenue side. In a nutshell, the DFE consists of the increase in primary expenditure net of cyclical components relative to economic potential on the one hand, and of discretionary revenue measures on the other hand. See European Commission (2013): Measuring the fiscal effort, Report on Public Finances in EMU, part 3: http://ec.europa.eu/economy_finance/publications/european_economy/2013/pdf/ee-2013-4.pdf

Source:

Draft Budgetary Plans 2018, European Commission 2017 autumn forecast.

The annual expenditure review for the central government was carried out for the second time and identified expenditure of 0.3% of GDP for reallocations in 2018. Moreover, the review followed upon the implementation of the recommendations issued last year, including improvements in the budget preparation and reporting process.

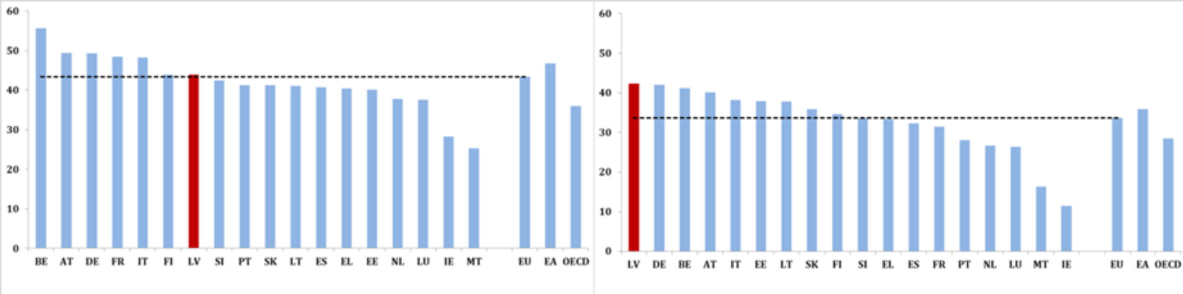
The DBP lists measures responding to the structural part of the fiscal recommendations contained in the Council Recommendation of 11 July 2017. The increase in excise taxes on alcohol, tobacco and gambling, and increasing tax compliance represents some of the recommended tax shift from low wages to other tax sources, but the high tax wedge challenge is not sufficiently addressed (see Box 3). The increase in basic allowance, which is the most effective at reducing the tax wedge, was scaled back in the adopted package as compared to the earlier plans presented in the Stability Programme. Moreover, the adopted measures do not sufficiently reach the stated policy aims of the reduction in income inequality and a higher tax revenue share in GDP. The recommendation on increasing access to healthcare is addressed by increasing the public financing for the sector, while improvements in the cost-effectiveness have not been observed. The social safety reform remains unimplemented due to financial constraints and being lower in the list of the government priorities.

Box 3 : Addressing the tax burden on labour in the euro area

The tax burden on labour in the euro area is relatively high, which weighs on economic activity and employment. Against this background, the Eurogroup has expressed a commitment to reduce the tax burden on labour. On 12 September 2015, the Eurogroup agreed to benchmark euro area Member States' tax burden on labour against the GDP-weighted EU average, relying in the first instance on indicators measuring the tax wedge on labour for a single worker at average wage and a single worker at low wage. It also agreed to relate these numbers to the OECD average for purposes of broader comparability.

The tax wedge on labour measures the difference between the total labour costs to employ a worker and the worker's net earnings. It is made up of personal income taxes and employer and employee social security contributions. The higher the tax wedge, the higher the disincentives to take up work or hire new staff. The graphs below show the tax wedge in Latvia for a single worker earning respectively the average wage and a low wage (50% of the average) compared to the EU average.

The tax burden on labour in Latvia at the average wage and a low wage (2014)



Notes: Data for Latvia, Lithuania and Malta is for 2013. No recent data is available for Cyprus. EU and EA averages are GDP-weighted. The OECD average is not weighted.

Source: European Commission Tax and Benefit Indicator database based on OECD data.

In the context of the 2017 European Semester, Latvia was issued the recommendation to "(..) Reduce taxation for low-income earners by shifting it to other sources that are less detrimental to growth and by improving tax compliance".

Latvia's DBP contains the following measures that affect the tax wedge on labour:

- The standard personal income tax rate is reduced from 23% to 20%. The progressive rate of 23% is applied to annual incomes above EUR 20 000 and 31.4% for annual incomes above EUR 55 000.
- The income-differentiated basic allowance is increased in steps in 2018-2020, exceeding the previously announced plans.
- Tax allowances for dependants and pensioners are increased in steps in 2018-2020.
- The tax wedge on a single person earning 50% of the average wage is estimated to be at around 36.5% in 2018-2020, which is lower than the 41% wedge in 2016, but is still high compared to other Member States.
- The income-differentiated basic allowance will be applied during the year on the estimated average wage, as opposed to the current system of large repayments based on the annual tax declaration. This measure will smooth income and consumption of low income earners over the year, while it does not change the overall tax burden.

Latvia has been allowed to temporarily increase its structural deficit limit to finance the healthcare reform. The allowed room in the government deficit is 0.1% of GDP in 2017, 0.4% of GDP in 2018 and 0.5% of GDP in 2019. The measures for 2017 were presented in the Stability Programme and were assessed to be in line with the requirements of the structural reform clause. The implementation of the 2017 measures will be assessed ex-post in spring 2018. The DBP provides an envelope for 2018, but the specific measures have not yet been pinned down. The Latvian authorities are expected to specify the measures eligible under the structural reform clause and to provide detailed and transparent documentation, including a quantitative analysis of the long-term budgetary and potential growth impact of the reforms.

6. OVERALL CONCLUSION

Following an overall assessment of the DBP, the planned structural adjustment is in line with the required adjustment path towards the MTO in 2017 and at risk of some deviation in 2018. The assessment based on the Commission 2017 autumn forecast points to compliance both in 2017 and 2018.