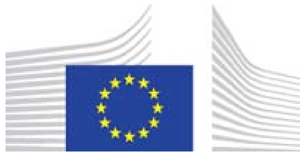

EUROPEAN COMMISSION
DIRECTORATE GENERAL
ECONOMIC AND FINANCIAL AFFAIRS

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Assessment of the 2018 Stability Programme for

Latvia

(Note prepared by DG ECFIN staff)

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1. INTRODUCTION

On 16 April 2018, Latvia submitted its 2018 Stability Programme (hereafter called Stability Programme), covering the period 2018-2021. The government approved the programme on 10 April and it was approved by the respective Parliamentary Committee on 11 April.

Latvia is currently subject to the preventive arm of the Stability and Growth Pact (SGP) and should ensure sufficient progress towards its Medium-Term Budgetary Objective (MTO) 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.

This document complements the Country Report published on 7 March and updates it with the information included in the Stability Programme

Section 2 presents the macroeconomic outlook underlying the Stability Programme and provides an assessment based on the Commission 2018 spring forecast. The following section presents the recent and planned budgetary developments, according to the Stability Programme. In particular, it includes an overview on the medium term budgetary plans, an assessment of the measures underpinning the Stability Programme and a risk analysis of the budgetary plans based on Commission forecast. Section 4 assesses compliance with the rules of the SGP, including on the basis of the Commission forecast. Since Latvia is flagged by the plausibility tool, this section includes a dedicated box. Section 5 provides an overview on long term sustainability risks and Section 6 on recent developments and plans regarding the fiscal framework. Section 7 provides a summary.

2. MACROECONOMIC DEVELOPMENTS

The Stability Programme projects a gradual slowdown in real GDP growth from 4.5% in 2017 to 4.0% in 2018, to 3.5% in 2019 and around 3% in 2020-2021. According to the programme, GDP growth in 2018 is set to be mainly driven by private consumption and investment. For 2019, private consumption is expected to slow down in line with a moderation in wage growth. Investment growth is expected to remain rapid on the back of a continued increase in EU funded projects. As from 2020 onwards, exports are forecast to take over as the main growth driver as domestic demand growth will subside due to stagnant employment, moderating wage growth and the levelling off of EU-funded investments.

HICP inflation is forecast at 2.8% in 2018, slightly lower than the 2.9% in 2017. It is expected to be driven by increase in excise tax on fuel, alcohol and cigarettes and by general energy price increases. The inflation rate is expected to moderate in 2019 as the impact of the tax hikes dissipate and energy price growth is expected to stabilise. Moreover, the slowing wage growth is also expected to exert less upward pressure on prices.

Employment is forecast to remain stagnant throughout the programme horizon, reflecting the rapidly falling labour supply. Wage growth is expected to accelerate to 8.0% in 2018, partly due to a rapid increase in minimum wages. However, it is expected to moderate in 2019 to 2021 as real wage growth is projected to fall in line with productivity growth.

The positive output gap, as recalculated by the Commission following the commonly agreed methodology, is estimated to widen from 1.8% of GDP in 2017 to 2.2% in 2018 before gradually closing (1.6% in 2019, 0.7% in 2020, and 0.0% in 2021). The output gap estimates of the Stability Programme are around 1 percentage point lower in 2017 and 2018, ½ percentage point lower in 2019, but similar in 2022-2021. The largest difference between the recalculated output gap and the face value output gap of the Programme is on the initial

position in 2017. The output gap estimate for 2017 based on the commonly agreed methodology has been identified as uncertain by the plausibility tool developed by the Commission in consultation with Member States. The analysis based on the constrained judgement approach can be found in Box 1 in section 4.

Table 1: Comparison of macroeconomic developments and forecasts

	2017		2018		2019		2020	2021
	COM	SP	COM	SP	COM	SP	SP	SP
Real GDP (% change)	4.5	4.5	3.3	4.0	3.3	3.4	3.0	2.9
Private consumption (% change)	5.1	5.1	4.7	6.1	3.6	3.5	2.8	2.6
Gross fixed capital formation (% change)	16.0	16.0	7.9	11.2	4.8	9.0	7.1	7.0
Exports of goods and services (% change)	4.8	4.4	3.7	4.0	3.4	3.9	3.8	3.8
Imports of goods and services (% change)	9.5	9.2	6.4	7.6	3.6	4.7	4.6	4.5
Contributions to real GDP growth:								
- Final domestic demand	6.8	6.8	5.0	6.6	3.6	4.6	3.9	3.7
- Change in inventories	0.5	0.8	0.0	-0.1	0.0	-0.5	0.0	0.0
- Net exports	-2.7	-3.1	-1.7	-2.5	-0.3	-0.8	-0.8	-0.8
Output gap[1]	2.0	1.8	2.1	2.2	2.0	1.6	0.7	0.0
Employment (% change)	0.6	0.2	0.4	0.1	0.2	0.0	0.0	-0.1
Unemployment rate (%)	8.7	8.7	8.2	8.0	7.6	7.7	7.2	7.0
Labour productivity (% change)	3.9	4.3	2.9	3.9	3.1	3.4	3.0	3.0
HICP inflation (%)	2.9	2.9	2.7	2.8	2.6	2.4	2.1	2.1
GDP deflator (% change)	3.1	3.0	2.6	3.1	2.8	3.0	2.7	2.5
Comp. of employees (per head, % change)	7.9	7.8	7.8	8.0	5.8	6.0	5.5	5.0
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	-0.3	0.0	-1.5	-1.6	-0.8	-2.3	-2.8	-3.7

Note:

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

Source :

Commission 2018 spring forecast (COM); Stability Programme (SP).

The Commission 2018 spring forecast projects a deceleration of the real GDP growth rate from 4.5% in 2017 to 3.3% in 2018. Growth in 2018 is notably lower than assumed in the Stability Programme, while it is broadly the same in 2019. For 2018, the Stability Programme and the Commission forecast broadly agree on the dynamics of GDP components, however the Commission forecast is generally more cautious about their growth rates, particularly so concerning the investment growth. For 2019, the Stability Programme is still much more optimistic on investment growth than the Commission forecast and assumes higher import growth. The GDP deflator for 2018 is higher in the Stability Programme than in the Commission's forecast - as a result the nominal GDP growth rate for 2018 of 7.2% is also higher than the 6.0% in the spring forecast. For 2019, both the GDP deflator and the nominal GDP growth rates are broadly in line with the Commission's forecast. The wage growth projections broadly correspond to those of the Commission, but the employment growth is more pessimistic than assumed by the Commission. The Stability Programme's more optimistic private consumption growth combined with the more cautious disposable income growth implies a lower household savings rate than under the Commission forecast. The differences in private consumption growth can partly be linked to a different assessment

of the impact of the tax reform. Overall, the Stability Programme's GDP growth projections are markedly favourable for 2018 and plausible for 2019.

3. RECENT AND PLANNED BUDGETARY DEVELOPMENTS

3.1. DEFICIT DEVELOPMENTS IN 2017 AND 2018

The government deficit in 2017 stood at 0.5% of GDP, better than the estimated 0.9% of GDP in the Draft Budgetary Plan for 2018. Most of this improvement came from the lower-than-estimated current expenditure, while capital expenditure was somewhat higher[1]. Revenues were also slightly higher than projected in the Draft Budgetary Plan. The outturn for 2017 also reflects a prepayment of electricity production support of 0.5% of GDP.

For 2018, the Stability Programme targets a deficit of 0.9% of GDP, as compared to 1.0% of GDP in the Draft Budgetary Plan. The security reserve of 0.1% of GDP provided in the Draft Budgetary Plan has been removed from the fiscal targets in the Stability Programme. Overall, revisions to revenue and expenditure estimates have a broadly neutral effect on the government balance — as somewhat lower revenue projections are offset by expenditure adjustments. The lower tax revenue growth planned in the Stability Programme corresponds to outturn data in the first quarter of 2018 showing a weaker revenue performance than previously budgeted. This is in contrast with more favourable economic growth projects in the Stability Programme than projected in the Draft Budgetary Plan. This seems to demonstrate a high uncertainty on the impact of the tax reform. The reform package includes personal income tax cuts and a transformation of the corporate income tax to taxing only distributed profits and some revenue-increasing measures. The implementation is phased over 2018 to 2020 with most costs accruing in 2018 and 2019.

While expenditure plans for 2018 have changed little since the Draft Budgetary Plan, the lower expenditure outturn in 2017 results in higher expenditure growth rates.[2] Expenditure is planned to increase across all the main expenditure items, except for a small redaction in debt servicing costs. The main drivers of the expenditure growth include an increase in the national minimum wage, an increase in social benefits and higher public spending on defence and healthcare, both of which contribute to growth of public consumption. The higher spending on healthcare is partly linked to the implementation of the reform for which the structural reform clause is granted to Latvia (see Section 3.3).

3.2. MEDIUM-TERM STRATEGY AND TARGETS

The Stability Programme targets the headline deficit to remain at 0.9% of GDP in 2019 before improving to 0.4% of GDP in 2020 and 2021. The structural deficit taken at face value is estimated to decline from 1.4% of GDP in 2018 to 1.3% in 2019, 0.7% in 2020 and 0.5% of GDP in 2021. The top-down deficit targets are established in line with the MTO of

[1] Revenue and expenditure levels in ESA terms have increased in view of statistical revisions, complicating comparison over time. The cash-based government finance reports are not affected by these revisions and are used for the analysis.

[2] The government revenue and expenditure ratio to GDP in Table 2 between the Stability Programme and the Commission 2018 spring forecast are not comparable in level terms, as the Stability Programme uses earlier estimates for 2017 than those published by Eurostat and used in the Commission forecast.

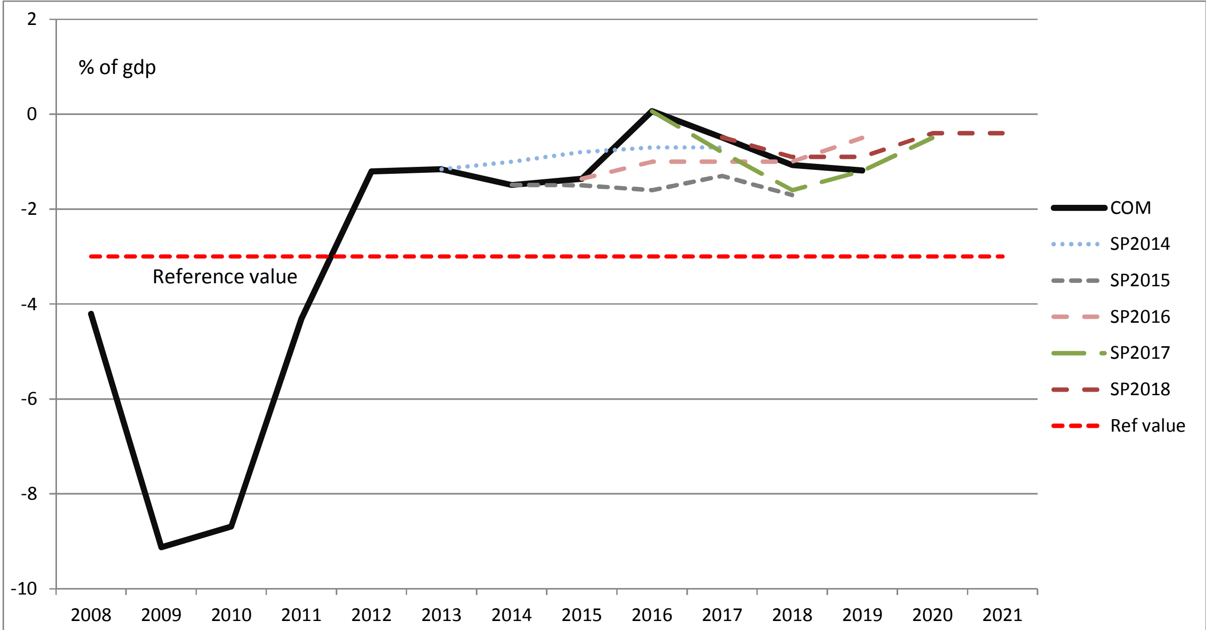
a structural deficit of 1% of GDP[3] and the temporary deviation allowances granted to Latvia. The allowance for the pension reform clause of 0.3% of GDP in 2018 expires in 2019, while the structural reform clause for the healthcare reform granted in 2017 allows for the deviation of 0.4% of GDP in 2018 and 0.5% of GDP in 2019. From 2020, no reform clauses have been applied for. Overall, this amounts to a structural deficit limit of 1.7% of GDP in 2018, 1.5% of GDP in 2019 and the MTO of structural deficit of 1% of GDP thereafter.

The deficit targets for 2019 and 2020 assume an unspecified consolidation effort of around 0.1% of GDP, including an allocation for the fiscal security reserve of 0.1% of GDP. This policy effort will be specified in the budget for 2019 latter in the year. At unchanged policies, the Stability Programme reports the nominal deficit at 1.1% of GDP in 2019 and 0.5% of GDP in 2020. This reflects that expenditure commitments in those years exceed the planned revenue.

The recalculated structural balance[4] stands at 1.7% of GDP in 2018, 1.5% of GDP in 2019 and then converging with the Stability Programme's estimates in 2020-2021.

The expansionary fiscal policy in 2018 and 2019 coincides with the cyclical upturn in the economy, reflected in a pick-up in the positive output gap. The fiscal expansion is largely related to the implementation of the tax reform, as tax cuts are only partly compensated by revenue-increasing measures. However, the planned deficits for 2018 and 2019 are lower than those of the 2017 stability programme (Figure 1), as the deficit-increasing effect of the tax reform has been lessened among other deficit-improving factors.

Figure 1: Government balance projections in successive programmes (% of GDP)



Source: Commission 2018 spring forecast; Stability Programmes

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[3] The MTO reflects the objectives of the Pact.

[4] The structural balance of the Stability Programme is recalculated by the Commission using information in the Programme and in line with the commonly agreed methodology.

Revenues are estimated to decline by 0.7 percentage points of GDP in 2019, to recover by 0.3 percentage points in 2020 and to decline once again by 1.1 percentage points in 2021. This revenue profile broadly reflects the net costs of the tax reform, which are expected to increase in 2019 before contributing to revenue growth in 2020. The revenue decline in 2021 is a result of undeveloped revenue and expenditure plans for that year, which will be specified in autumn 2018.

The Stability Programme projects the government expenditure share in GDP to decrease by 1.0 percentage point between 2018 and 2020. This is largely driven by an assumption of a lower public sector wage bill, presumably reflecting the implementation of the planned public sector reform. Intermediate consumption and subsidies are also assumed to contract as a share of GDP. The capital expenditure share in GDP is projected to decrease over the programme horizon, while other expenditure is assumed to increase by the same amount.

Table 2: Composition of the budgetary adjustment

(% of GDP)	2017	2018		2019		2020	2021	Change: 2017-2021
	COM	COM	SP	COM	SP	SP	SP	SP
Revenue	**37.5**	**37.7**	**36.8**	**37.2**	**36.1**	**36.4**	**35.3**	**-2.2**
of which:								
- Taxes on production and imports	14.0	14.3	14.3	14.4	14.4	14.5	14.4	0.4
- Current taxes on income, wealth, etc.	8.6	7.4	7.1	6.9	6.5	6.7	6.6	-2.0
- Social contributions	8.7	9.3	9.5	9.3	9.4	9.4	9.3	0.6
- Other (residual)	6.2	6.7	5.9	6.7	5.8	5.8	5.0	-1.2
Expenditure	**38.0**	**38.8**	**37.8**	**38.4**	**37.1**	**36.8**	**35.7**	**-2.3**
of which:								
- Primary expenditure	37.1	38.0	37.0	37.6	36.2	35.9	34.9	-2.2
of which:								
Compensation of employees	10.3	10.5	10.5	10.2	10.1	9.9	9.5	-0.8
Intermediate consumption	6.1	6.5	6.4	6.6	6.2	6.1	5.5	-0.6
Social payments	11.7	12.2	11.7	12.2	11.7	11.7	11.7	0.0
Subsidies	1.3	0.9	1.6	0.9	1.5	1.4	1.7	0.4
Gross fixed capital formation	4.0	4.5	4.8	4.6	4.7	4.4	4.3	0.3
Other (residual)	3.6	3.4	2.0	3.2	2.1	2.5	2.3	-1.3
- Interest expenditure	0.9	0.8	0.8	0.7	0.9	0.9	0.8	-0.1
General government balance (GGB)	**-0.5**	**-1.1**	**-0.9**	**-1.2**	**-0.9**	**-0.4**	**-0.4**	**0.1**
Primary balance	**0.4**	**-0.3**	**-0.1**	**-0.4**	**0.0**	**0.5**	**0.4**	**0.0**
One-off and other temporary	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
GGB excl. one-offs	**-0.5**	**-1.1**	**-0.9**	**-1.2**	**-0.9**	**-0.4**	**-0.4**	**0.1**
Output gap[1]	2.0	2.1	2.2	2.0	1.6	0.7	0.0	-2.0
Cyclically-adjusted balance[1]	-1.2	-1.9	-1.7	-1.9	-1.5	-0.7	-0.4	0.8
Structural balance[2]	**-1.2**	**-1.9**	**-1.7**	**-1.9**	**-1.5**	**-0.7**	**-0.4**	**0.8**
Structural primary balance[2]	-0.3	-1.1	-0.9	-1.2	-0.6	0.2	0.4	0.7

Notes*:*

[1]Output gap (in % of potential GDP) and cyclically-adjusted balance according to the programme as recalculated by Commission on the basis of the 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 (SP); Commission 2018 spring forecasts (COM); Commission calculations.

3.3. MEASURES UNDERPINNING THE PROGRAMME

The Stability Programme presents the effect of the adopted taxation changes in 2018-2021 and the expenditure decisions of the 2018 budget.

The majority of revenue measures were adopted as part of the tax reform. The standard personal income tax rate has been reduced from 23% of 20% in 2018 and the income-differentiated basic allowance and allowances for dependants and pensioners are increased in steps over the 2018-2020 period. As part of the corporate income tax reform, taxes on capital are aligned at 20% and the taxation of corporate income is deferred until the distribution of profits. The transformation of corporate taxation is phased in over three years, starting in 2018. The tax-cutting measures are partly compensated by stricter VAT reporting requirements and increases in excise duties. The Stability Programme assumes that VAT tax compliance improvements will also improve labour tax collection. Such second round effects are subject to high uncertainty. Latvia has introduced the reverse charging of VAT on building materials and consumer electronics from January 2018, while the Commission objects to approve this measure, considering that such measure is not a durable solution in the fight against VAT fraud, given the risk that the fraud shifts down the supply chain, to other products or other Member States[5]. As such this measure has not been included in the Commission spring forecast. The Commission assessment on the yield of tax compliance measures is also more cautious than that of the authorities. Moreover, the second round effect of the increase in the national minimum wage on tax revenue is not considered as a discretionary tax measure, although it is included in the Commission forecast.

The main discretionary expenditure increases in 2018 are related to higher social benefits and health spending. The healthcare sector benefits from the continued implementation of the healthcare reform (see Section 4.1), and an increase in the social contributions rate by 1 percentage point to be used for healthcare financing. An increase in defence spending by 0.2% of GDP to a total outlay of 2% of GDP in 2018 had been already provided in the previous budgetary plans.

Main budgetary measures

Revenue	**Expenditure**
2018	
• Corporate income tax reform (-0.4% of GDP) • Personal income tax cut and increases in allowances (-0.7% of GDP) • Improvements in VAT administration (+0.2% of GDP) • Reversed VAT charging for construction materials and consumer electronics (+0.1% of GDP) • Increase in excise duties on alcohol,	• Continuation of the health reform clause (+0.3% of GDP) • Health expenditure increase financed from the higher social contribution rate by 1 percentage point (+0.3% of GDP) • Increase in child benefits (+0.1% of GDP)

[5] COM/2018/015 final of 12 January 2018 and COM/2018/034 final of 18 January 2018.

tobacco and oil products (+0.3% of GDP) • Social contributions rate increased by 1 percentage point (+0.3% of GDP) • Subsidised electricity tax expires (-0.1% of GDP)	
2019	
• Corporate income tax reform (-0.2% of GDP) • Increases in personal income tax allowances (-0.2% of GDP) • Increase in excise duties on alcohol and tobacco (+0.1% of GDP)	• Continuation of the health reform clause (+0.1% of GDP)
2020	
• Corporate income tax reform (-0.1% of GDP) • Increases in personal income tax allowances (-0.1% of GDP) • Increase in excise duties on alcohol tobacco and oil products (+0.1% of GDP)	
Note: The budgetary impact in the table is the impact reported in the programme, i.e. by the national authorities. A positive sign implies that revenue / expenditure increases as a consequence of this measure.	

3.4. DEBT DEVELOPMENTS

Government debt stood at 40% of GDP at the end of 2017. The Stability Programme targets a decline in the debt ratio over the programme period to around 36% of GDP in 2021. The declining debt path is mainly driven by low primary borrowing and a positive differential between nominal GDP growth and debt servicing costs. Pre-financing at the end of 2020 of redemptions in 2021 would have a temporary upward effect on the debt ratio. The Commission forecast of the government debt ratio broadly follows a similar path.

Table 3: Debt developments

(% of GDP)	Average 2012-2016	2017	2018		2019		2020	2021
			COM	SP	COM	SP	SP	SP
Gross debt ratio[1]	**39.7**	**40.1**	**37.0**	**38.4**	**37.3**	**37.4**	**38.0**	**35.6**
Change in the ratio	-0.4	-0.3	-3.2	-1.7	0.3	-1.0	0.6	-2.4
Contributions[2] *:*								
1. Primary balance	**-0.4**	**-0.4**	**0.3**	**0.1**	**0.4**	**0.0**	**-0.5**	**-0.4**
2. "Snow-ball" effect	**-0.2**	**-1.9**	**-1.4**	**-1.9**	**-1.4**	**-1.4**	**-1.1**	**-1.1**
Of which:								
Interest expenditure	1.4	0.9	0.8	0.8	0.7	0.9	0.9	0.8
Growth effect	-1.0	-1.7	-1.3	-1.5	-1.1	-1.2	-1.1	-1.0
Inflation effect	-0.6	-1.1	-1.0	-1.2	-1.0	-1.1	-1.0	-0.9
3. Stock-flow adjustment	**0.2**	**2.1**	**-2.0**	**0.0**	**1.3**	**0.4**	**2.3**	**-0.9**
Of which:								
Cash/accruals diff.								
Acc. financial assets								
Privatisation								
Val. effect & residual								

Notes:

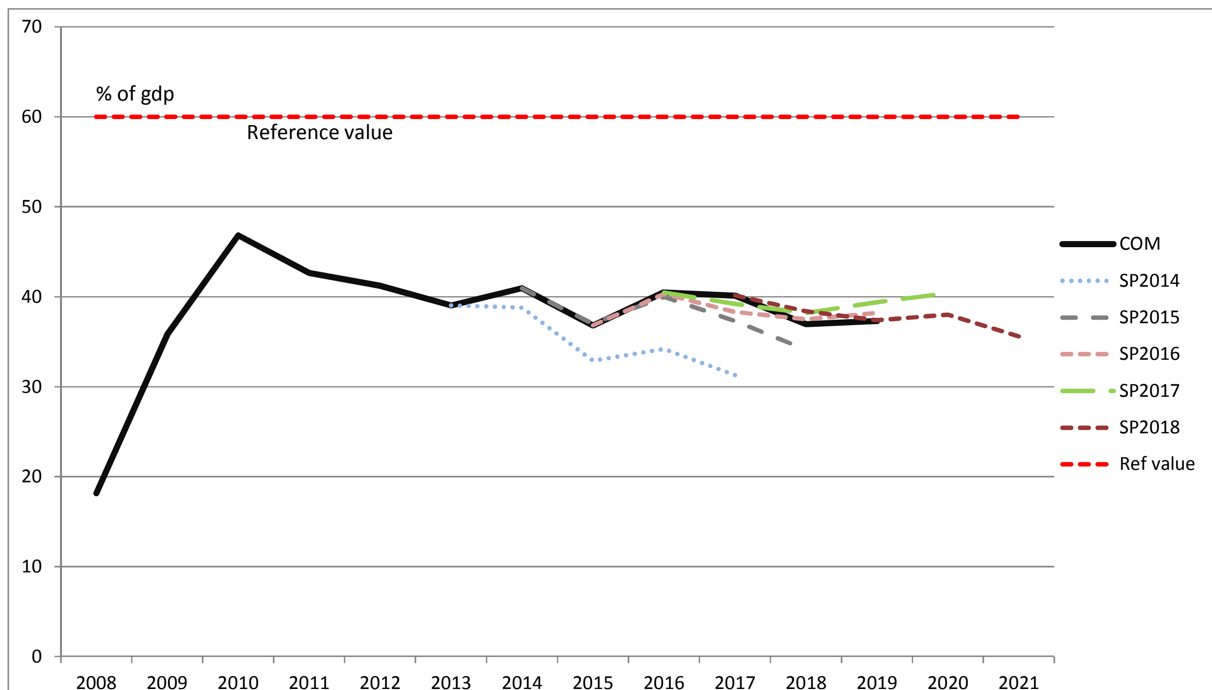
[1] End of period.

[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 :

Commission 2018 spring forecast (COM); Stability Programme (SP), Commission calculations.

Figure 2: Government debt projections in successive programmes (% of GDP)



Source: Commission 2018 spring forecast; Stability Programmes

3.5. RISK ASSESSMENT

The Commission 2018 spring forecast projects a government deficit of 1.1% of GDP in 2018 and 1.2% of GDP in 2019, which is above the deficit target of the Stability Programme of 0.9% in both 2018 and 2019. The main differences are related to diverging views on the yield of revenue measures, such as the reverse VAT charging mechanism and an unspecified consolidation effort in 2019. While the economic projections for 2018 have been revised up in the Stability Programme, revenue estimates do not follow the same pattern and appear to be more cautious and in line with the lower-than-expected revenue outturn in the first months of 2018. The Commission forecast assumes lower yields for tax compliance measures, related to the high uncertainty surrounding these measures. The expenditure plans beyond 2018 assume expenditure restraint. The public sector reform is crucial in this respect, while its effective implementation seems rather uncertain, given the internal opposition of line ministries. Moreover, some expenditure-increasing measures have been adopted since the Stability Programme or are planned to be adopted before the general elections in October 2018, worsening the budgetary position in the coming years. Overall, the risks to the budgetary position are tilted to the downside.

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

Box 1. Council Recommendations addressed to Latvia

On 12 June 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 noted that based on the Commission 2017 spring forecast, this was 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.

Assessment of requests for deviating from SGP requirements

Latvia has been allowed to temporarily increase its structural deficit limit to finance the pension reform and the healthcare reform. The implementation of the pension reform in several steps from 2013 allows for a deviation of 0.6% of GDP in 2017 and 0.3% of GDP in 2018, which ceases in 2019. Regarding the health 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[6].

The Stability Programme reports on the implementation of the healthcare sector reform in 2017 and plans for 2018. The implementation in 2017 broadly follows the announced plans to increase the provision of public health services and to reduce waiting times. In some areas a greater efficiency than planned has been achieved in terms of the number of patients treated

[6] The structural reform clause for the healthcare sector reform of 0.5% of GDP was granted to Latvia as from 2017, but the existing allowance for the pension reform and the minimum benchmark of a structural deficit of 1.7% of GDP limit the deviation granted under the structural reform clause to 0.1% of GDP in 2017 and 0.4% in 2018. The allowed deviation of 0.5% of GDP can be used in full in 2019.

and the average costs, while in other areas costs were higher due to a larger than planned share of difficult medical cases. Waiting times for services have decreased by some 40%, despite the fact that the use of public services has increased, suggesting an improvement in access to healthcare services overall. The measures for 2018 are broadly outlined in the Stability Programme with more details provided in national documents. The measures launched in 2017 are continued and expanded in 2018 and two new measures are included: (i) expanding screening by general practitioners and dental treatment for children and (ii) expanding diagnostics and treatment of coronary diseases. The increased financing is used to increase service provision, but also includes higher remuneration for medical personal, rising costs of medical supplies and purchase of equipment, all necessary for the planned delivery of services. The Stability Programme reconfirms a positive effect of the reform measures on economic growth, employment and public finances in the long run, which appears plausible.

Adjustment towards the MTO

In 2017, the distance between Latvia's structural balance and the MTO remained within the allowed temporary deviation related to the implementation of the pension reform and structural reform in the healthcare sector (Table 4).

In 2018, based on the information of the Stability Programme, the expenditure benchmark pillar indicates a significant deviation in 2018 (gap of 0.6% of GDP) and on average over 2017-2018 gap of 0.4% of GDP). The recalculated structural deficit is estimated to increase by 0.6% of GDP in 2018, exceeding the allowed deterioration of 0.3% of GDP, which is frozen for 2018 based on the Commission 2017 spring forecast[7]. Over 2017-2018 on average, the structural balance pillar is met, pointing to compliance. The reading of the indicators calls for an overall assessment. The recalculated structural balance is based on a higher potential growth estimate for 2018 than the 10-year average reference rate of 2.5% used for the expenditure benchmark and assumes interest expenditure savings, while revenue projections of the Stability Programme suggest a shortfall. In all, the expenditure benchmark provides a more consistent picture of Latvia's projected fiscal performance in good times. Therefore, the overall assessment at this stage points to a significant deviation. A similar conclusion can be drawn based on the Commission 2018 spring forecast. The net expenditure growth significantly exceeds the requirement (gap of 0.7% of GDP) pointing to a risk of significant deviation, while the structural balance points to a risk of some deviation. The structural balance pillar assumes a more positive point estimate of potential growth and some interest expenditure savings. Therefore, the expenditure benchmark is considered to reflect more appropriately Latvia's fiscal situation. The overall assessment points to a risk of significant deviation in 2018[8].

[7] Following the Opinion of the Economic and Financial Committee of 29 November 2016 and the subsequent discussion and endorsement by the Committee, the "unfreezing" of the required adjustment for year t may only take place in two occasions: in autumn t-1, which in principle allows the change to be taken into account in the Member State's budget for year t before it is finally adopted, and in spring t+1, at the time of the ex post assessment of compliance with the preventive arm. The "freezing" of the requirements for in-year compliance assessments safeguards against the volatility of the structural balance estimates and any structural budgetary improvement in the preceding year for the year that the budget is still being implemented.

[8] The assessment for 2018 has changed from the assessment of compliance with the preventive arm in autumn 2017 to a risk of a significant deviation currently. The structural deficit for 2018 has little changed since the Commission 2017 autumn forecast, but an improvement in the estimate for 2017 implies to a sharper

Table 4: Compliance with the requirements under the preventive arm

(% of GDP)	2017	2018		2019	
Initial position[1]					
Medium-term objective (MTO)	-1.0	-1.0		-1.0	
Structural balance[2] (COM)	-1.2	-1.9		-1.9	
Structural balance based on freezing (COM)	-1.4	-1.9		-	
Position vis-a -vis the MTO[3]	At or above the MTO	Not at MTO		Not at MTO	
(% of GDP)	**2017**	**2018**		**2019**	
	COM	**SP**	**COM**	**SP**	**COM**
Structural balance pillar					
Required adjustment[4]	Compliance	0.4		0.6	
Required adjustment corrected[5]		-0.3		0.4	
Change in structural balance[6]		-0.6	-0.6	0.2	-0.1
One-year deviation from the required adjustment[7]		-0.3	-0.4	-0.1	-0.4
Two-year average deviation from the required adjustment[7]		0.1	-0.2	-0.2	-0.4
Expenditure benchmark pillar					
Applicable reference rate[8]		6.0		4.3	
One-year deviation adjusted for one-offs[9]		-0.6	-0.7	-0.3	-1.0
Two-year deviation adjusted for one-offs[9]		-0.4	-0.4	-0.4	-0.8
PER MEMORIAM: One-year deviation[10]		-0.6	-0.7	-0.3	-1.0
PER MEMORIAM: Two-year average deviation[10]		-0.5	-0.5	-0.4	-0.8

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 2017 is carried out on the basis of Commission 2018 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 :
Stability Programme (SP); Commission 2018 spring forecast (COM); Commission calculations.

At the same time, two further elements for 2018 warrant consideration for the assessments based both on the Stability Programme and the Commission 2018 spring forecast. First, in line with the applicable "freezing" rules, the requirement for 2018 it is kept "frozen" for the compliance assessments during 2018, until the ex post assessment in spring 2019. As a result,

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deterioration between 2017 and 2018. The reading of the expenditure benchmark is less affected by the revisions and the difference with the structural balance pillar has narrowed. Notably, the potential growth estimate for 2018 has been revised down to 3.2%, still exceeding the 10-year average reference rate of 2.5% used for the expenditure benchmark, but to a lesser extent than in the Commission 2017 autumn forecast.

the structural improvement in 2017 by 0.2% of GDP, mostly due to underspending, cannot be taken into account at this stage. However, should it be confirmed ex post, it will lead to an equivalent reduction in the net expenditure and structural requirements. Second, the structural balance estimates are affected by a large uncertainty over output gap estimates. In particular, the plausibility tool, based on the Commission's spring forecast, indicates that the output gap for Latvia could be lower than the common methodology estimate (Box 1). However, given that there currently does not appear to be sufficiently strong grounds to depart from the common methodology and that the requirements for 2018 cannot be unfrozen at this stage, this element of uncertainty, if confirmed, will be considered in the ex post assessment of 2018 in spring 2019.

In 2019, the net expenditure growth of the Stability Programme exceeds the requirement by 0.3% of GDP suggesting a risk of some deviation, but the net expenditure growth in 2018-2019 on average surpasses the requirement by 0.4% of GDP, indicating a risk of significant deviation. The recalculated structural balance is estimated to improve to -1.5% of GDP from -1.7% of GDP in 2018, which is less than the required improvement by 0.4% of GDP, pointing to a risk of some deviation. This calls for an overall assessment. The difference between the structural balance pillar and the expenditure benchmark pillar reflects different potential growth estimates, an estimated revenue shortfall and the upturn in public investment. The Stability Programme's recalculated structural balance is estimated at -1.5% of GDP in 2019, which is in line with the MTO allowing for the temporary deviations. However, the ex ante requirement for 2019 is based on the Commission forecast to account for the risks related to the projections of the Stability Programme. On this basis, the requirements for 2019 are slightly stricter than those implied by the Stability Programme. The significant deviation from the expenditure benchmark in 2018-2019 on average takes into account the significant deviation in 2018, which will be reassessed in spring 2019. Currently, the overall assessment of the Stability Programme suggests a risk of significant deviation from the requirements of the preventive arm.

Based on the Commission spring forecast, a significant deviation from the expenditure benchmark is estimated in 2019 (gap of 1.0% of GDP) and some deviation from the structural balance requirement (gap of 0.4% of GDP). Over 2018-2019 on average both the structural balance pillar and the expenditure benchmark pillar point to a significant deviation (gap of 0.4% of GDP and 0.8% of GDP, respectively). This calls for an overall assessment. The reading of the structural balance pillar is improved by a more favourable potential growth estimate (accounting for 0.3% of GDP of the difference), a projected revenue windfall, interest savings and investment volatility (0.1% of GDP each). The expenditure benchmark is more appropriate than the structural balance pillar for the assessment. At the same time, the structural balance estimates are affected by a large uncertainty over output gap estimates. There does not appear to be sufficiently strong grounds to depart from the common methodology at this stage (Box 1). Based on the Commission forecast and considering the expenditure benchmark a more appropriate indicator in good times, the overall assessment points to a risk of a significant deviation from the requirements of the preventive arm in 2019.

Box 1: Implementation of the "constrained judgement" approach and its impact in the context of fiscal surveillance

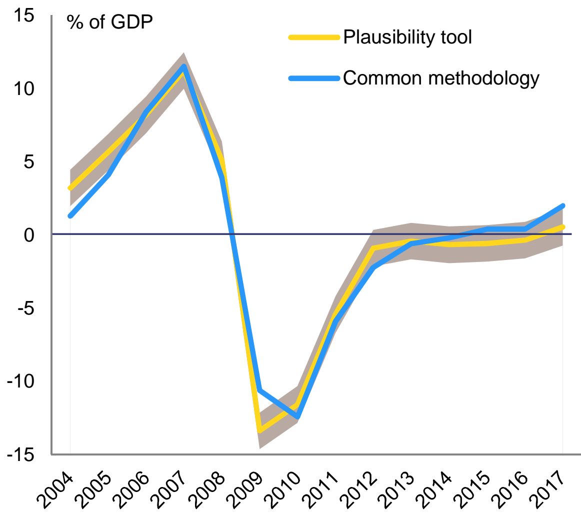
The objective of the "constrained judgement" approach is to have a transparent and economically grounded tool to statistically test the plausibility of the output gap estimates for individual Member States estimated on the basis of the common method. To this end, the Commission developed an objective screening tool – based on a set of cyclically relevant indicators as well as thresholds/ranges – to signal cases when the outcomes of the commonly

agreed methodology could be interpreted as being subject to a large degree of uncertainty and therefore deserving of further investigation on the part of the Commission. In such cases, the Commission carries out an "in depth" analysis which could lead to the application of a "constrained" degree of judgement in conducting Member States' budgetary assessments.

For Latvia, the plausibility tool returns a central estimate of the output gap of +0.3% of GDP in 2017. At the 68% confidence level, the output gap is estimated to be between -0.9% of GDP and +1.6% of GDP. The output gap based on the common methodology of +2.0% of GDP in 2017 is outside this confidence interval, which points to a possible overestimation (Figure 3). The cyclical indicators of the plausibility tool provide a mixed assessment of the cyclical position of the economy (Figure 4). Short-term unemployment rate in 2017 was below its long-term average value and capacity utilisation was at the historically high level, both pointing to a positive output gap. However, lagged GDP growth and wage inflation were below their long-term averages, thus suggesting a lower output gap. Considering the structural changes of the Latvian economy over time, including those induced by the boom-bust cycle, GDP and wage growth dynamics may not revert to their long-term average values in a sustainable way. Therefore, the positive output gap estimate could be somewhat higher than the central estimate of the plausibility tool, but lower than that of the common methodology. For comparison, the Stability Programme estimates the output gap in 2017 at 0.5% of GDP and the OECD's recent estimate is of 0.8% of GDP.

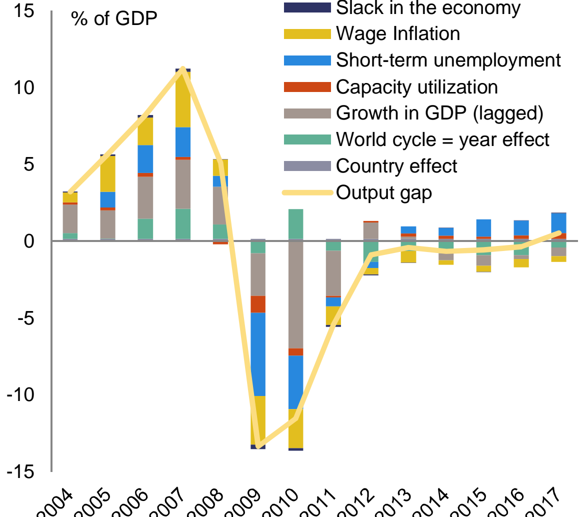
Compliance with the fiscal requirement in 2017 does not call for an application of the plausibility tool results. However, the compliance assessments for 2018 and 2019 can be impacted by the application of constrained judgement. The plausibility tool does not provide results for future years and an extrapolation of the results for 2017 for the coming years increases the uncertainty. The assumption is that the distance between the output gap estimates in 2017 persists in the following years. Under this assumption, the structural balance based on the common methodology appears to be overestimated by around ½ percentage point of GDP in 2017-2019. However, the output gap estimates and the results of the plausibility tool may change by the time of the ex post assessments, in view of the past volatility of the output gap estimates and the structural changes of the Latvian economy. Considering this, there does not appear to be sufficiently strong grounds to depart from the common methodology for the current fiscal assessment.

Figure 3: Output gap estimates and plausibility range



Source: European Commission

Figure 4: Breakdown of the output gap estimate of the plausibility tool



5. FISCAL SUSTAINABILITY

Latvia does not appear to face fiscal sustainability risks. Nonetheless, addressing the currently low pension adequacy and the underfinancing of the healthcare services might lead to higher public spending in the medium to long term.

Based on Commission 2018 spring forecasts and a no-fiscal policy change scenario beyond the forecast horizon, government debt, at 37% of GDP in 2019, is expected to rise slightly to 39% in 2028), thus remaining below the 60% of GDP Treaty threshold. Sensitivity analysis shows similar risks.[9] Overall, this highlights low risks for the country from debt sustainability analysis in the medium term. The full implementation of the Stability Programme would put debt on a decreasing path between 2022 and 2028, thus remaining below the 60% of GDP reference value in 2028.

The medium-term fiscal sustainability risk indicator S1[10] is at -1.5 percentage points of GDP, thus indicating low risks in the medium term, as a result of the low level of government debt. The full implementation of the Stability Programme would put the sustainability risk indicator S1 at -3.3 percentage points of GDP, leading to a lower medium-term risk. Overall risks to fiscal sustainability over the medium-term are, therefore, low. Fully implementing the fiscal plans in the Stability Programme would decrease those risks.

The long-term fiscal sustainability risk indicator S2 stands at 1.1 percentage points of GDP. In the long-term, Latvia therefore appears to face low fiscal sustainability risks, primarily related to the projected decline in ageing costs, in particular for pension expenditure. Full implementation of the programme would put the S2 indicator at 0.0 percentage points of GDP, leading to a lower long-term risk.[11]

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[9] Sensitivity analysis includes several deterministic debt projections, as well as stochastic projections (see Debt Sustainability Monitor 2017 for more details).

[10] See the note to Table 5 for a definition of the indicator.

[11] The projected costs of ageing used to compute the debt projections and the fiscal sustainability indicators S1 and S2 are based on the updated projections, endorsed by the EPC on 30 January 2018, and to be published in the forthcoming Ageing Report 2018.

Table 5: Sustainability indicators[12]

Time horizon			Commission Scenario		Stability / Convergence Programme Scenario	
Short Term			**LOW risk**			
S0 indicator [1]			0.2			
Fiscal subindex			0.0	LOW risk		
Financial & competitiveness subindex			0.3	LOW risk		
Medium Term			**LOW risk**			
DSA [2]			LOW risk			
S1 indicator [3]			-1.5	LOW risk	-3.3	LOW risk
of which						
	Initial Budgetary Position		0.5		-1.2	
	Debt Requirement		-1.8		-2.3	
	Cost of Ageing		-0.2		0.2	
	of which					
		Pensions	-0.8		-0.4	
		Health-care	0.2		0.2	
		Long-term care	0.0		0.0	
		Other	0.4		0.5	
Long Term			**LOW risk**		**LOW risk**	
S2 indicator [4]			1.1		0.0	
of which						
	Initial Budgetary Position		1.7		0.1	
	Cost of Ageing		-0.5		-0.1	
	of which					
		Pensions	-1.7		-1.3	
		Health-care	0.4		0.4	
		Long-term care	0.1		0.1	
		Other	0.6		0.6	

Source: Commission services; 2018 stability/convergence programme.

Note: the 'Commission' scenario depicts the sustainability gap under the assumption that the structural primary balance position evolves according to the Commissions' spring 2018 forecast covering until 2019 included. The 'stability/convergence programme' scenario depicts the sustainability gap under the assumption that the budgetary plans in the programme are fully implemented over the period covered by the programme. Age-related expenditure as given in the 2018 Ageing Report.

[1] The S0 indicator of short term fiscal challenges informs the early detection of fiscal stress associated to fiscal risks within a one-year horizon. To estimate these risks S0 uses a set of fiscal, financial and competitiveness indicators selected and weighted according to their signalling power. S0 is therefore a composite indicator whose methodology is fundamentally different from the S1 and S2 indicators, which quantify fiscal adjustment efforts. The critical threshold for the overall S0 indicator is 0.46. For the fiscal and the financial-competitiveness sub-indexes, thresholds are respectively at 0.36 and 0.49*.

[2] Debt Sustainability Analysis (DSA) is performed around the no fiscal policy change scenario in a manner that tests the response of this scenario to different shocks presented as sensitivity tests and stochastic projections*.

[3] The S1 indicator is a medium-term sustainability gap; it measures the upfront fiscal adjustment effort required to bring the debt-to-GDP ratio to 60 % by 2032. This adjustment effort corresponds to a cumulated improvement in the structural primary balance over the 5 years following the forecast horizon (i.e. from 2020 for Commission scenario and from last available year for the SCP scenario); it must be then sustained, including financing for any additional expenditure until the target date, arising from an ageing population. The critical thresholds for S1 are 0 and 2.5, between which S1 indicates medium risk. If S1 is below 0 or above 2.5, it indicates low or high risk, respectively*.

[4] The S2 indicator is a long-term sustainability gap; it shows the upfront and permanent fiscal adjustment required to stabilise the debt-to-GDP ratio over the infinite horizon, including the costs of ageing. The critical thresholds for S2 are 2 and 6, between which S2 indicates medium risk. If S2 is below 2 or above 6, it indicates low or high risk, respectively*.

* For more information see Fiscal Sustainability Report 2015 and Debt Sustainability Monitor 2017.

[12] To be updated by ECFIN C2 to incorporate the 2018 Ageing Report long-term budgetary projections and the COM spring 2018 forecast

6. FISCAL FRAMEWORK

The Fiscal Discipline Council (FDC), which is an independent monitoring body established on the basis of the Fiscal Discipline Law (FDL), monitors the application of the national fiscal rules. The FDC published its interim report on Latvia's Stability Programme on 6 April[13].

According to the authorities calculations' presented in the programme, the structural balance was -0.7% in 2017, below the -0.5% of GDP limit set in the FDL, with the deviation due to implementation of structural reforms. The FDC has issued six irregularity reports in 2017 and one in 2018, pointing out that redistribution of certain expenditure savings are not in line with the rules of the Fiscal Discipline Law. The debt-to-GDP ratio remained below 60% of GDP, satisfying the requirements in the FDL, while ex-post assessment of expenditure rules performed by the FDC leads to a more critical assessment.

The deficit targets for 2018-2021 of the Stability Programme are assessed by the FDC to be in line with the fiscal rules. However, the FDC notes that Latvia's fiscal policy is expansionary in 2018 and 2019 at a time of a cyclical upturn in economic growth. Moreover, the tax reform measures hinder achieving the government's target of a tax revenue share in GDP of one third and constrain the options for consolidation measures necessary to reach the deficit targets in 2019 and 2020.

The FDC endorses the use of the reform clause for the planned and implemented health care reform measures and invites a greater transparency on use of funding. Moreover the FDC asks to quantify the fiscal risk in relation to public-private partnership (PPP) projects, state and municipality owned enterprises and financial system risks when determining the size of the fiscal risk safety reserve.

The macroeconomic forecast underlying the stability programme was endorsed by the FDC on 14 February 2018[14]. The FDC considered the macroeconomic forecasts of the Ministry of Finance to be realistic, while highlighting that the price inflation and wage growth should be watched as an evidence of lower growth potential and widening positive output gap.

The Stability Programme points out that the document also serves as the national medium-term fiscal plan in the meaning of the Regulation 473/2013.

7. SUMMARY

In 2017, Latvia observed its MTO, after taking into account the temporary deviation related to the pension and structural reform in the healthcare sector. This shows compliance with the preventive arm.

The Stability Programme plans a structural deterioration by 0.6% of GDP in 2018 and an improvement by 0.2% of GDP in 2019, indicating the risk of significant deviation in both years. The Commission 2018 spring forecast indicates a similar structural deterioration in 2018, but no improvement in 2019. This suggests a significant deviation from the expenditure benchmark pillar and some deviation from the structural balance requirement in both 2018 and 2019. However, the better-than-expected outcome in 2017 point to a lower risk for 2018. Moreover, the plausibility tool based on the Commission 2018 spring forecast indicates a high degree of uncertainty surrounding the estimate of output gap for Latvia based on the common

[13] http://fiscalcouncil.lv/06042018-interim-report-opinion

[14] http://fiscalcouncil.lv/14022018-macroeconomic-forecast-endorsement

methodology. These factors will be considered in the ex post assessment of compliance, if still confirmed. At this point, the overall assessment concludes on a risk of significant deviation in both 2018 and 2019.

8. ANNEXES

Table I. Macroeconomic indicators

	2000-2004	2005-2009	2010-2014	2015	2016	2017	2018	2019
Core indicators								
GDP growth rate	7.1	2.9	2.2	3.0	2.2	4.5	3.3	3.3
Output gap [1]	-0.5	3.4	-4.3	0.4	0.4	2.0	2.1	2.0
HICP (annual % change)	3.2	8.4	1.2	0.2	0.1	2.9	2.7	2.6
Domestic demand (annual % change) [2]	8.0	1.6	2.1	2.4	2.5	7.3	5.0	3.4
Unemployment rate (% of labour force) [3]	12.7	9.7	14.7	9.9	9.6	8.7	8.2	7.6
Gross fixed capital formation (% of GDP)	26.2	31.3	22.5	22.1	18.2	19.9	21.2	21.7
Gross national saving (% of GDP)	20.3	22.6	21.8	21.8	21.0	20.5	19.7	20.2
General Government (% of GDP)								
Net lending (+) or net borrowing (-)	**-1.9**	**-2.9**	**-3.4**	**-1.4**	**0.1**	**-0.5**	**-1.1**	**-1.2**
Gross debt	**13.3**	**16.6**	**42.1**	**36.8**	**40.5**	**40.1**	**37.0**	**37.3**
Net financial assets	**5.3**	**1.4**	**-13.8**	**-17.5**	**-19.2**	**n.a**	**n.a**	**n.a**
Total revenue	33.2	34.3	36.6	36.9	37.2	37.5	37.7	37.2
Total expenditure	35.0	37.2	40.0	38.2	37.1	38.0	38.8	38.4
of which: Interest	0.8	0.7	1.6	1.3	1.0	0.9	0.8	0.7
Corporations (% of GDP)								
Net lending (+) or net borrowing (-)	**-3.7**	**-5.2**	**7.9**	**6.1**	**3.8**	**2.7**	**1.0**	**2.0**
Net financial assets; non-financial corporations	**-92.4**	**-107.1**	**-125.3**	**-118.7**	**-118.5**	**n.a**	**n.a**	**n.a**
Net financial assets; financial corporations	**-2.5**	**0.7**	**4.2**	**0.0**	**-1.3**	**n.a**	**n.a**	**n.a**
Gross capital formation	23.3	23.6	15.9	13.9	12.8	14.1	14.7	15.0
Gross operating surplus	33.6	28.6	31.9	28.4	26.6	27.1	25.5	25.1
Households and NPISH (% of GDP)								
Net lending (+) or net borrowing (-)	**-2.4**	**-2.2**	**-3.9**	**-2.6**	**-1.5**	**-2.5**	**-1.4**	**-1.6**
Net financial assets	**38.5**	**25.6**	**51.3**	**78.6**	**80.2**	**n.a**	**n.a**	**n.a**
Gross wages and salaries	33.3	39.1	36.7	39.9	40.8	40.3	40.8	40.6
Net property income	11.4	6.0	4.5	4.1	4.3	4.5	4.9	4.0
Current transfers received	17.6	17.5	18.0	16.5	16.6	16.5	16.9	16.9
Gross saving	0.5	3.7	-0.9	1.1	1.7	0.8	2.1	2.0
Rest of the world (% of GDP)								
Net lending (+) or net borrowing (-)	**-8.0**	**-10.4**	**0.8**	**2.3**	**2.4**	**-0.3**	**-1.5**	**-0.8**
Net financial assets	**51.1**	**79.4**	**83.4**	**57.5**	**58.8**	**n.a**	**n.a**	**n.a**
Net exports of goods and services	-11.3	-13.7	-3.2	-0.5	0.9	-1.3	-3.8	-4.0
Net primary income from the rest of the world	-0.4	-0.1	0.0	-0.6	-0.2	-0.7	-0.6	-0.5
Net capital transactions	0.6	1.6	2.6	2.8	1.0	0.6	1.5	2.1
Tradable sector	52.0	44.8	46.2	44.0	43.7	44.7	n.a	n.a
Non tradable sector	37.8	44.5	42.3	43.8	43.3	42.7	n.a	n.a
of which: Building and construction sector	5.8	7.7	5.4	5.7	4.6	5.2	n.a	n.a
Real effective exchange rate (index, 2000=100)	76.4	103.8	101.9	112.7	116.5	120.4	125.4	126.1
Terms of trade goods and services (index, 2000=100)	96.1	99.1	100.7	100.1	103.0	103.7	102.3	102.0
Market performance of exports (index, 2000=100)	78.5	93.7	103.8	105.0	104.8	102.9	101.3	100.3

Notes:

[1] The output gap constitutes the gap between the actual and potential gross domestic product at 2005 market prices.

[2] The indicator on domestic demand includes stocks.

[3] Unemployed persons are all persons who were not employed, had actively sought work and were ready to begin working immediately or within two weeks. The labour force is the total number of people employed and unemployed. The unemployment rate covers the age group 15-74.

Source :
AMECO data, Commission 2018 spring forecast