DRAFT BUDGETARY PLAN OF THE REPUBLIC OF LATVIA 2019

RIGA, 2018

Content

Abbreviations

EC	European Commission
ESA	European System of Accounts
EU	European Union
GDP	Gross domestic product
MoF	Ministry of Finance
MTO	Medium-term objective of budget balance in structural terms
VAT	Value added tax

Introduction

Within the framework of the European Semester and according to the Regulation No 473/2013 of the European Parliament and of the Council on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the Member States in the euro area Latvia submits the Draft Budgetary Plan for 2019.

Due to the Saeima elections on 6 October, 2018, the Annual State Budget Law has not yet been prepared. Accordingly, Latvia submits a shortened draft budgetary plan for the General Government, drawn up on the basis of the updated macro-economic scenario of the MoF and the updated fiscal forecasts based on a no-policy change scenario. This draft budget plan has been approved by the current Government on 15 October. With the establishment of the new Government, work on the budget will continue, and an expanded draft budgetary plan for the General Government will be prepared and submitted to the EC and the Eurogroup, together with the presentation of the draft Annual State Budget Law of 2019 in the Saeima.

Macroeconomic Development Scenario

The medium-term macroeconomic forecasts for 2018-2021 have been based on the data of the first half of 2018 gross domestic product and short-term macroeconomic information available until September 2018. In comparison to the forecasts of the Latvian Stability Program 2018-2021, Latvia's GDP growth forecast for 2018 has been increased by 0.2 percentage points but decreased by 0.4 percentage points for 2019. The upgrade of the 2018 forecast is due to a stronger than expected development of the construction and investments as well as to the more favorable outcome in the sectors of transport and financial services so far. Accordingly, taking into account these base effects and the slightly less favorable situation in the world economy growth in 2019 will be somewhat slower than previously forecasted.

Thus real GDP growth will increase to 4.2% in 2018 due to good performance in the first half of 2018, which was largely driven by faster than expected investment growth (the forecast increased by 2.9 percentage points to 14.1%) and export growth (the forecast increased by 1.0 percentage point to 5.0%). It is expected that investments will continue to grow in the second half of 2018 and in 2019, which is largely due to the growing inflow of EU funds. However, it will become more moderate and overall economic growth will decelerate in 2019-2021 and stabilize at a level of 3.0%, close to the economic growth potential.

The average annual inflation is projected at 2.5% for 2018 and 2019. In comparison to the forecasts of the Latvian Stability Program 2018-2021, the inflation forecast is lower by 0.3 percentage points for 2018 mostly due to lower food price inflation. For 2019, the inflation forecast increased by 0.1 percentage point.

Faster economic growth caused the unemployment rate to fall further. In 2018, the average unemployment rate will decrease to 7.7% and 7.4% in 2019, which is by 0.3 percentage points lower than in previous forecasts. Accordingly, the employment will grow faster – by 1.2% in 2018 and by 0.1% in 2019. Wages also will increase on average by 8.3% in 2018 and the average monthly gross wage will reach 1 003 EUR. Compared to the previous forecasts, the wage growth is higher by 0.3 percentage points in 2018.

The forecasts have been approved by an agreement protocol with the Bank of Latvia and the Ministry of Economics. In the preparation of the forecasts, the MoF consulted experts from the International Monetary Fund and the EC. The Fiscal Discipline Council has endorsed the forecasts in October 15, 2018. Thus, the developed macroeconomic indicators were used as a basis for the development of the Latvian Medium-Term Budget Framework for 2019-2021.

The forecasts are based on the technical assumptions of the Summer 2018 forecasts of the EC – the growth of Latvia's trade partners and the exchange rate. Overall, the the external economic situation remains favorable for the Latvian economy. According to the EC scenario, the GDP of the EU countries will increase by 2.1% in 2018 and by 2.0% in 2019, a slight slowdown from the 2.4% in 2017. Seven of Latvia's main foreign trade partner economies will grow faster than the EU average, reaching 2.7% in 2018 and 2.3% in 2019.

Relatively stable prices of raw materials and low interest rates are also favorable for the global demand and economic growth. In its forecasts, the MoF assumes that by mid-2018 the average crude oil price would be 73.9 UDS/b and 76.5 USD/b in 2019, while the EUR/USD exchange rate will be 1.19 in 2018 and 1.16 in 2019. Interest rates are projected to be stable and low, with short-term rates remaining negative at -0.3% and -0.2% respectively in 2018 and 2019.

Table 0.i) Basic assumptions

	2017	2018	2019
Short-term interest rate in euro area (annual average)		-0,3	-0,2
Long-term interest rate in euro area (annual average)		0,5	0,6
USD/EUR exchange rate (annual average)	1,13	1,19	1,16
Nominal effective exchange rate	0,8	7,3	0,3
World excluding EU, GDP growth	3,9	4,2	4,1
EU GDP growth	2,4	2,1	2,0
Growth of relevant foreign markets	4,7	4,2	4,1
World import volumes, excluding EU	5,3	4,9	4,4
Oil prices (Brent, USD/barrel)	54,3	73,9	76,5

Table 1a: Macroeconomic prospects

	ESA Code	2017	2017	2018	2019
		Level	Rate of change		
1. Real GDP	B1*g	22,8	4,6	4,2	3,0
of which					
Attributable to the estimated impact of aggregated budgetary measures on economic growth					
2. Potential GDP		22,7	3,3	3,4	3,4
Contributions:					
labour			0,0	0,0	0,0
capital			2,2	2,2	2,2
total factor productivity			1,1	1,1	1,2
3. Nominal GDP	B1*g	27,0	8,0	7,4	6,2
Components of real GDP					
4. Private consumption expenditure	P.3	14,0	4,1	4,2	4,2
5. Government consumption expenditure	P.3	3,9	4,1	3,8	3,5
6. Gross fixed capital formation	P.51	4,8	13,1	14,1	6,3
7. Changes in inventories and net acquisition of valuables (% of GDP)	P.52 + P.53				
8. Exports of goods and services	P.6	14,5	6,2	5,0	4,1
9. Imports of goods and services	P.7	15,0	8,9	5,7	5,5
Contribution to real GDP growth					
10. Final domestic demand			6,3	4,8	4,1
11. Changes in inventories and net acquisition of value	P.52 + P.53		0,5	-1,4	-0,6
12. External balance of goods and services	B.11		-1,7	-0,6	-1,1

Table 1b: Price developments

	ESA Code	2017	2017	2018	2019
		Level	Rate of change		
1. GDP deflator			3,2	3,1	3,1
2. Private consumption deflator			3,1	2,5	2,5
3. HICP			2,9	2,5	2,5
4. Public consumption deflator			2,9	4,1	2,9
5. Investment deflator			1,7	2,7	2,2
6. Export price deflator (goods and services)			3,5	3,2	3,1
7. Import price deflator (goods and services)			2,8	1,5	2,5

Table 1c: Labour market developments

	ESA Code	2017	2017	2018	2019
		Level	Rate of change		
1. Employment, persons ('000)		894,8	0,2	1,2	0,1
2. Employment, hours worked		1687,3	0,5	0,0	0,0
3. Unemployment rate (%)			8,7	7,7	7,4
4. Labour productivity, persons			4,5	3,0	2,9
5. Labour productivity, hours worked			3,7	3,0	2,9
6. Compensation of employees, bln.euro	D.1	12,5	8,2	9,6	6,1
7. Compensation per employee (Gross wage), euro		926	7,8	8,3	6,0

Table 1d: Sectoral balances

	ESA Code	2017	2018	2019
		% GDP		
1. Net lending/borrowing vis-a-vis the rest of the world	B.9	1,4	2,7	2,1
of which				
- Balance on goods and services		0,0	0,7	0,2
- Balance of primary incomes and transfers		0,6	0,3	0,3
- Capital account		0,8	1,7	1,6
2. Net lending/borrowing of the private sector	B.9	1,9	3,4	2,8
3. Net lending/borrowing of general government	EDP B.9	-0,5	-0,8	-0,7
4. Statistical discrepancy		0,0	0,0	0,0

Fiscal strategy and structural balance objective

Latvian fiscal policy principles, applied deviations from the MTO due to increase in contributions to the second pension pillar and the reform of the healthcare system have not changed and have been described in the Stability Programme for 2018-2021.

As previously mentioned, this draft budgetary plan has been prepared at a no policy change scenario. Thus, in table No 2a, the general government budget balance and its sub-sector balance sheet levels in 2019 are reflected at unchanged policy and fiscal data for 2019 in table No 3 incorporates discretionary revenue and expenditure measures included in the Law On the Medium-Term Budget Framework for 2017, 2018 and 2019 and the Law On the Medium-Term Budget Framework for 2018, 2019 and 2020.

In a no policy change scenario for 2019, in addition to the changes stemming from the updated macroeconomic scenario and the renewed revenue and expenditure forecasts, there have been included decisions which the Government and the Saeima have adopted during the period between the Latvian Stability Programme for 2018-2021 and this budgetary plan (see a more detailed presentation on page 15).

Table 2.a: General government budgetary targets broken down by subsector

	ESA Code	2018	2019
		% of GDP	
Net lending (+) / net borrowing (-) (B.9) by sub-sector			
1. General government	S.13	-0,8	-0,7
2. Central government	S.1311	-1,0	-0,8
3. State government	S.1312		
4. Local government	S.1313	-0,3	-0,3
5. Social security funds	S.1314	0,6	0,4
6. Interest expenditure	D.41	0,8	0,8
7. Primary balance		0,0	0,1
8. One-off and other temporary measures			
9. Real GDP growth (%) (=1. in Table 1a)		4,2	3,0
10. Potential GDP growth (%) (=2 in Table 1.a)		3,4	3,4
contributions:			
- labour		0,05	0,0
- capital		2,2	2,2
- total factor productivity		1,1	1,2
11. Output gap (% of potential GDP)		1,3	0,9
12. Cyclical budgetary component (% of GDP)		0,5	0,3
13. Cyclically-adjusted balance (1 - 12) (% of GDP)		-1,3	-1,0
14. Cyclically-adjusted primary balance (13 + 6) (% of GDP)		-0,5	-0,3
15. Structural balance (13 - 8) (% of GDP)		-1,3	-1,0

Table 2.b: General government debt developments

	ESA Code	2018	2019
		% of GDP	
1. Gross debt		37,5	38,5
2. Change in gross debt ratio		-2,5	1,0
Contributions to change in gross debt			
3. Primary balance		0,0	0,1
4. Interest expenditure	EDP D.41	0,8	0,8
5. Stock-flow adjustment, i.e.		-3,2	0,3
Implicit interest rate on debt		2,1	2,1
Other relevant variables			
6. Liquid financial assets			
7. Net financial debt (7=1-6)			
8. Debt amortization (existing bonds) since the end of the previous year		2,7	1,2
9. Percentage of debt denominated in foreign currency		11,4	10,4
10. Average maturity		7,6 years	
For information - in calculations used GDP data:			
Nominal GDP. mln euro		29 039,5	30 840,8

Table 2.c: Contingent liabilities

% of GDP	**2018**	**2019**
Public guarantees	1,0	1,0

Table 3: General government expenditure and revenue projections at unchanged policies broken down by main components

	ESA Code	2018	2019
		% GDP	
1. Total revenue at unchanged policies	TR	37,5	35,8
of which			
1.1. Taxes on production and imports	D.2	14,1	14,2
1.2. Current taxes on income, wealth, etc.	D.5	7,3	6,5
1.3. Capital taxes	D.91	0,0	0,0
1.4. Social contributions	D.61	9,4	9,4
1.5. Property income	D.4	0,9	0,6
1.6. Other		5,8	5,1
p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995)		30,8	30,1
2. Total expenditure at unchanged policies	TE	38,2	36,5
of which			
2.1. Compensation of employees	D.1	10,4	10,1
2.2. Intermediate consumption	P.2	6,1	5,8
2.3. Social payments	D.62 D.632	11,7	11,9
of which Unemployment benefits		0,4	0,4
2.4. Interest expenditure	D.41	0,8	0,8
2.5. Subsidies	D.3	1,7	1,5
2.6. Gross fixed capital formation	P.51	5,3	4,8
2.7. Capital transfers	D.9	0,1	0,1
2.8. Other		2,2	1,4

Table 4.b: Amounts to be excluded from the expenditure benchmark

	ESA Code	2018	2019	2020	2021
		mln. *euro*	% GDP		
1. Expenditure on EU programmes fully matched by EU funds revenue		480,4	1,3	1,4	1,9
1.a of which capital expenditure (gross fixed capital formation) corresponding to revenue received from foreign financial assistance received		310,8	0,9	0,9	1,3
2. Cyclical unemployment benefit expenditure		-40,7	-0,1	-0,1	-0,1
3. Effect of discretionary revenue measures		-70,2	-0,1	-0,2	0,0
4. Revenue increases mandated by law					

Table 4.c General government expenditure by function

4.c.i) General government expenditure on education, healthcare and employment

	2018		2019	
	% GDP	% general government expenditure	% GDP	% general government expenditure
Education	5,6	14,7	5,1	14,1
Health	4,0	10,6	4,0	10,9
Employment	0,2	0,4	0,1	0,3

4.c.ii) Classification of the functions of the Government

	COFOG Code	2018	2019
		% of GDP	
1. General public services	1	4,6	4,2
2. Defense	2	2,0	2,0
3. Public order and safety	3	2,2	2,0
4. Economic affairs	4	5,1	4,6
5. Environmental protection	5	0,6	0,4
6. Housing and community amenities	6	0,9	0,7
7. Health	7	4,0	4,0
8. Recreation, culture and religion	8	1,5	1,3
9. Education	9	5,6	5,4
10. Social protection	10	11,7	11,9
11. Total Expenditure (= item 2 in Table 2.c.i)	TE	38,2	36,5

Table 6.a: Country specific recommendations and Table 6.b: Targets set by the Union's Strategy for growth and jobs

As the budget plan is prepared upon a no policy change scenario, it does not include new measures related to the 2018 recommendations. A far as the 2018 recommendations continue implementation of the recommendations issued in previous years, the measures are described in the Latvian Stability Programme for 2018-2021, but the measures for the EU Strategy objectives for growth and jobs are described in the Latvian National Reform Programme for 2018:
https://ec.europa.eu/info/2018-european-semester-national-reform-programmes-and-stability-convergence-programmes_en#latvia

Considering the macroeconomic development scenario updated in September 2018 and the actual budgetary execution in the eight months of this year, the general government deficit in 2018 will be 0.8% of GDP, which is lower than the permissible general government budget deficit enshrined in the Law On the Medium-Term Budget Framework for 2018, 2019 and 2020 (1.0% of GDP) and lower than predicted in the Stability Programme for 2018-2021 (0.9% of GDP). Compared to the Stability Programme, lower budget deficits are based on higher than planned tax revenues. The biggest overflow of the plan has been observed in corporate income tax revenue, due to a steeper rise in contributions according to the declaration data for the results of 2017. The revenue of excise duty also have also performed well as the plan for alcoholic beverages and beer was exceeded, affected by the increase in the volume of goods passed.

In 2019, the general government budget deficit at a no-policy change scenario is projected to be 0.7% of GDP and is 0.3 percentage points lower if compared to the Stability Programme. While preparing the forecast for 2019, the updated macroeconomic development scenario was taken into account, as well as the actual implementation of the budget in the eight months of 2018. Compared to the previous forecast, higher tax revenue, such as that of excise duty and personal income tax, is projected in 2019. In 2019, higher personal income tax revenues are expected from dividends paid from the accumulated company profits of previous years. Similarly, a positive impact on the balance sheet, compared to the Stability Programme, is made up of lower interest expenditure and contributions to the EU budget. Interest expenditure has been reduced in 2019, taking into account the borrowing carried out in 2018, refinancing the liabilities of the previously admitted sovereign debt with historically lower interest rates, as well as by updating the planned borrowing measures in the financial markets in the medium term. In turn, Latvia's contribution to the EU budget for 2019 is mainly reduced due to the fact that, on the basis of the most recent data on the EU budget for 2019, the total EU budget has been significantly reduced compared to the previous forecast. Consequently the contributions from all Member States, including Latvia, decreased proportionally. It should be noted that the budget expenditure forecast for 2019 takes into account that expenditure for the defense sector is ensured in an amount of 2% of GDP and also takes into account the amendments to the Law on State Pensions adopted during this year (April and September), which mainly provides for higher pension premiums and the indexation of premiums.

Table 7: Divergence from Stability Programme 2018-2021

	ESA Code	**2017**	**2018**	**2019**
		% GDP		
Target general government net lending/ net borrowing	B.9			
Stability Programme		-0,5	-0,9	-0,9
Draft Budgetary Plan		-0,5	-0,8	-
Difference		0,0	0,17	-
General government net lending projection at unchanged policies	B.9			
Stability Programme		-0,5	-0,9	-1,0
Draft Budgetary Plan		-0,5	-0,8	-0,7
Difference		0,0	0,17	0,3

Annex: Methodological aspects

Macroeconomic forecasts are developed by applying the medium-term macro-economic model, which ensures proper macroeconomic relationships within the forecasts and employs short-term and medium-term results of econometric models as well as expert assessment.

In the preparation of tax revenue projections, widely known forecasting methods and assumptions are applied, however the most used is a specially developed tool, i.e. the model LATIM-F. The most frequently used tax revenue forecasting techniques are as follows:

- using detailed tax revenue estimations;
- forecasting of tax revenue share in GDP, %;
- forecasting the actual taxable base/base modelled relationships;
- using expert assessment;
- using other techniques.

In order to project tax revenue, as stated above, the MoF applies the tax revenue forecast model LATIM-F, the main components of which are a data base of macroeconomic indicators, actual tax revenue and legislative changes (including tax rates, etc.). Moreover, in the process of analysis the information from the State Treasury, the State Revenue Service, the Central Statistics Bureau and other sources is used.