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**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(2018) 8022 final}

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### *Accompanying the document*

#### COMMISSION OPINION

#### on the Draft Budgetary Plan of Latvia

### 1. INTRODUCTION

Latvia submitted its Draft Budgetary Plan for 2019 on 15 October in compliance with Regulation (EU) No 473/2013. The Draft Budgetary Plan was submitted by the outgoing government on the basis of unchanged policies. Following the general elections on 6 October, there is a caretaker government. The updated Draft Budgetary Plan including the measures to be proposed by the new government set to be submitted in due time. Latvia is subject to the preventive arm of the Pact 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.

Section 2 of this document presents the macroeconomic outlook underlying the Draft Budgetary Plan and provides an assessment based on the Commission 2018 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 2018 autumn forecast. Section 4 assesses the recent and planned fiscal developments in 2018-2019 (also taking into account the risks to their achievement) against the obligations stemming from the Stability and Growth Pact. Section 5 provides an analysis of implementation of fiscal-structural reforms in response to the latest country-specific recommendations in the context of the European Semester adopted by the Council in July 2018, including those to reduce 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 real GDP growth slowing down from 4.5% in 2017 to 4.2% in 2018, and then to 3.0% in 2019. A continued investment surge is expected to carry growth in 2018. Consumption and exports are also set to perform well. In 2019, investment growth is set to slow down considerably, while other demand components are also forecast to show more moderate growth. HICP inflation is forecast to reach 2.5% in both 2018 and 2019 down from 2.9% in 2017, while the GDP deflator is set to remain at around 3.0% over the period 2017 to 2019. Employment is set to grow by 1.2% in 2018, supported by the rapid growth of construction activity, but is forecast to remain unchanged in 2019 as the decrease in labour force will make it increasingly difficult to find new employees. The unemployment rate is set to continue decreasing and wage growth will remain relatively high in both 2018 and 2019, although it is expected to slow down as the pressure from the construction sector eases.

Compared with the scenario underlying the Stability Programme, GDP growth for 2018 has been revised upwards by 0.2 percentage point, primarily due to much better investment performance in the first half of 2018. Exports have also been revised upwards, but private consumption has been revised slightly downwards. For 2019, GDP growth has been revised downwards by 0.4 percentage point, compared with the Stability Programme mainly because a part of the investment growth expected in 2019 has been brought forward to 2018, but also because export growth is forecast to be more cautious due to a worsened external demand outlook. The GDP deflator has remained broadly unchanged for both 2018 and 2019, compared with the Stability Programme.

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 2.9% in 2018 and to diminish to 2.4% in 2019. Based on the Commission 2018 autumn forecast, the positive output gap is estimated to peak at 2.4% in 2018 before receding to 2.1% in 2019. The differences between the two sets of estimates are explained by small differences in macroeconomic assumptions.

Compared with the Commission 2018 autumn forecast, the Draft Budgetary Plan is slightly more optimistic about real GDP growth in 2018 and somewhat more cautious about nominal GDP growth for 2018. The forecasts for 2019 are broadly in line for both real and nominal GDP growth.

The Draft Budgetary Plan sees the risks to the macroeconomic forecast as balanced. On the positive side, higher lending activity, stronger non-EU fund related investment activity and a better than expected external environment are considered. On the negative side, supply side constraints on the labour market, adverse effects from the winding down of the non-resident banking business and increased global uncertainty are taken into account.

To conclude, in the Commission's view, the Draft Budgetary Plan is overall based on plausible macroeconomic assumptions.

#### **Box 1: The macroeconomic forecast underpinning the budget in Latvia**

The macroeconomic forecast of the Draft Budgetary Plan was prepared by the Ministry of Finance and endorsed by the Fiscal Discipline Council on 10 October 2018 in a letter from the Fiscal Discipline Council to the Ministry of Finance, which is also published on the Council's website<sup>1</sup>. The Fiscal Discipline Council is an independent body established with the purpose of monitoring the compliance with the Fiscal Discipline Law, which has also been charged with a task to endorse the macroeconomic forecasts underlying the budgetary plans.

Along with the endorsement, the Fiscal Discipline Council invited the Ministry of Finance to make a careful assessment of the cyclical position of the economy and to use several methods for assessment of the output gap, in view of the tightening labour market and increasing wage pressures. The Fiscal Discipline Council observed in its endorsement letter that the Latvian economy seemed to be obviously close to the height of the business cycle and such times called for fiscal tightening, not for fiscal easing.

In order to ensure compliance with the requirement of Regulation (EU) No 473/2013, the draft Budget Act to be transmitted to the national parliament should be based on an independently endorsed macroeconomic forecast.

<sup>1</sup> <http://fiscalcouncil.lv/15102018-macroeconomic-forecast-endorsement>

**Table 1. Comparison of macroeconomic developments and forecasts**

	2017	2018			2019		
	COM	SP	DBP	COM	SP	DBP	COM
Real GDP (% change)	4.6	4.0	4.2	4.1	3.4	3.0	3.2
Private consumption (% change)	4.1	6.1	4.2	4.5	3.5	4.2	4.0
Gross fixed capital formation (% change)	13.1	11.2	14.1	11.2	9.0	6.3	2.8
Exports of goods and services (% change)	6.2	4.0	5.0	3.6	3.9	4.1	3.3
Imports of goods and services (% change)	8.9	7.6	5.7	6.3	4.7	5.5	3.4
<i>Contributions to real GDP growth:</i>							
- Final domestic demand	5.8	6.6	4.8	5.7	4.6	4.1	3.3
- Change in inventories	0.3	-0.1	-1.4	0.0	-0.5	-0.6	0.0
- Net exports	-1.5	-2.5	-0.6	-1.7	-0.8	-1.1	-0.1
Output gap <sup>1</sup>	1.8	2.2	2.9	2.4	1.6	2.4	2.1
Employment (% change)	0.0	0.1	1.2	1.5	0.0	0.1	0.3
Unemployment rate (%)	8.7	8.0	7.7	7.3	7.7	7.4	6.7
Labour productivity (% change)	4.7	3.9	3.0	2.6	3.4	2.9	2.9
HICP inflation (%)	2.9	2.8	2.5	2.7	2.4	2.5	2.7
GDP deflator (% change)	3.2	3.1	3.1	3.7	3.0	3.1	2.1
Comp. of employees (per head, % change)	8.0	8.0	8.3	7.1	6.0	6.0	5.8
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	1.5	-1.6	2.7	1.8	-2.3	2.1	1.7
<b>Note:</b>							
<sup>1</sup> 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.							
<b>Source:</b>							
Stability Programme 2018 (SP); Draft Budgetary Plan for 2019 (DBP); Commission 2018 autumn forecast (COM); Commission calculations							

### 3. RECENT AND PLANNED FISCAL DEVELOPMENTS

#### 3.1. Deficit developments

The Draft Budgetary Plan estimates a headline deficit of 0.8% of GDP in 2018, as compared to the deficit target of 0.9% of GDP in the Stability Programme (Table 2). Both revenue and expenditure growth are projected to be higher than assumed in the Stability Programme, improving the government balance. Direct tax revenue overperformance is mostly linked to a better-than-expected company profits in the previous year. Dividends received by the government also surprised on the upside. This is partly offset by somewhat lower VAT revenue, which broadly corresponds to the slower private consumption growth and the assessment of the previously adopted measures. The Draft Budgetary Plan also includes a larger envelope for the EU-financed projects, as a safeguard in case their implementation exceeds the previous plans. The projects implemented by the government entities are reflected in both government revenue and expenditure and increase the government deficit for the co-financing part. The expenditure side shows reallocations from purchases of goods and services to current transfers and an expected strong increase in public capital spending.

The Commission 2018 autumn forecast of the government deficit of 0.8% of GDP corresponds to that of the Draft Budgetary Plan. However, the Commission estimates growth in government revenue and expenditure to be lower. In particular, the Commission assumes spending on the EU-financed projects in line with the previous plans, with the additional spending envelope allocated for 2018 not being used by the end of the year. Moreover, the Draft Budgetary Plan seems to assume that a larger share of the EU-financed projects will be implemented by the general government, appearing in both revenue and expenditure, than that is assumed by the Commission forecast. Revenue projections for direct taxes and social contributions differ between the Commission forecast and that of the Draft Budgetary Plan, but these differences are broadly neutral on balance. On the expenditure side, the authorities assume a steep increase in investment and subsidies, and a decline in current transfers, while the Commission forecast assumes a more moderate development of these elements<sup>2</sup>.

Based on unchanged policies, the Draft Budgetary Plan envisages a headline budget deficit of 0.7% of GDP in 2019, as compared to the target of 0.9% of GDP in the Stability Programme. The revised estimate takes into account the latest revenue and expenditure projections and the few measures adopted since the Stability Programme. Most of the improvement in the government balance stems from a lower contribution to the EU budget, interest expenditure savings and a reduced implementation of the EU-financed projects after the rush assumed for 2018. The revised revenue projections broadly reflect the revisions for 2018, but the positive corporate income tax and dividend surprises in 2018 are not expected to be repeated. The revised expenditure distribution assumes a lower share of current spending, while other expenditure elements are slightly increased as compared to the Stability Programme.

The Commission 2018 autumn forecast of the government deficit is 1.0% of GDP in 2019, under the no-policy-change assumption. Growth in total revenue and expenditure is assumed to be higher than that planned by the Draft Budgetary Plan. In particular, the Commission forecast expects a smoother distribution of the EU-financed projects between 2018 and 2019. Moreover, it also assumes an underlining trend of growth in current transfers paid and received to continue, as compared to a sharp decrease estimated by the Draft Budgetary Plan. Differences in assumptions for other revenue and expenditure elements are smaller.

The recalculated structural deficit<sup>3</sup> is estimated to decrease from 1.9% of GDP in 2018 to 1.6% of GDP in 2019. This reflects an improvement in the nominal government balance by 0.1 percentage point and a narrowing of the positive output gap. The Stability Programme assumed a similar decline in the recalculated structural deficit by 0.2 percentage point of GDP entirely on the back of shrinking of the positive output gap. However, the Commission forecast estimates the structural balance at 1¾% of GDP in both 2018 and 2019, because the effect of a lower positive output gap in 2019 is offset by the projected deterioration of the headline deficit.

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<sup>2</sup> The Draft Budgetary Plan was submitted before the finalisation of the October 2018 EDP notification. Therefore, the budgetary projections for the Draft Budgetary Plan presented in Table 2 use different data for 2017 as a starting point. The main differences in data for 2017 and by extension over the forecast horizon are in intermediate consumption and gross fixed capital formation.

<sup>3</sup> Cyclically adjusted balance net of one-off and temporary measures, recalculated by the Commission using the commonly agreed methodology.

**Table 2. Composition of the budgetary adjustment**

(% of GDP)	2017	2018			2019			Change: 2017-2019
	COM	SP	DBP	COM	SP	DBP	COM	DBP
<b>Revenue</b>	<b>37.2</b>	<b>36.8</b>	<b>37.5</b>	<b>36.8</b>	<b>36.1</b>	<b>35.8</b>	<b>36.4</b>	<b>-1.4</b>
<i>of which:</i>								
- Taxes on production and imports	13.9	14.3	14.1	14.0	14.4	14.2	14.3	0.3
- Current taxes on income, wealth, etc.	8.5	7.1	7.3	7.5	6.5	6.5	6.9	-2.0
- Capital taxes	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
- Social contributions	8.7	9.5	9.4	9.1	9.4	9.4	9.1	0.7
- Other (residual)	6.0	5.9	6.7	6.3	5.8	5.7	6.0	-0.3
<b>Expenditure</b>	<b>37.8</b>	<b>37.8</b>	<b>38.2</b>	<b>37.7</b>	<b>37.1</b>	<b>36.5</b>	<b>37.3</b>	<b>-1.3</b>
<i>of which:</i>								
- Primary expenditure	36.8	37.0	37.4	36.9	36.2	35.7	36.6	-1.1
<i>of which:</i>								
Compensation of employees	10.2	10.5	10.4	10.2	10.1	10.1	10.1	-0.1
Intermediate consumption	5.7	6.4	6.1	5.7	6.2	5.8	5.6	0.1
Social payments	11.7	11.7	11.7	11.8	11.7	11.9	12.0	0.2
Subsidies	1.3	1.6	1.7	1.3	1.5	1.5	1.2	0.2
Gross fixed capital formation	4.4	4.8	5.3	4.8	4.7	4.8	4.7	0.4
Other (residual)	3.6	2.0	2.2	3.1	2.0	1.6	3.0	-2.0
- Interest expenditure	0.9	0.8	0.8	0.8	0.9	0.8	0.7	-0.1
<b>General government balance (GGB)</b>	<b>-0.6</b>	<b>-0.9</b>	<b>-0.8</b>	<b>-0.8</b>	<b>-0.9</b>	<b>-0.7</b>	<b>-1.0</b>	<b>-0.1</b>
<b>Primary balance</b>	<b>0.3</b>	<b>-0.1</b>	<b>0.0</b>	<b>-0.1</b>	<b>0.0</b>	<b>0.1</b>	<b>-0.2</b>	<b>-0.2</b>
One-off and other temporary measures	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
<b>GGB excl. one-offs</b>	<b>-0.6</b>	<b>-0.9</b>	<b>-0.8</b>	<b>-0.8</b>	<b>-0.9</b>	<b>-0.7</b>	<b>-1.0</b>	<b>-0.1</b>
Output gap <sup>1</sup>	1.8	2.2	2.9	2.4	1.6	2.4	2.1	0.5
Cyclically-adjusted balance <sup>1</sup>	-1.2	-1.7	-1.9	-1.8	-1.5	-1.6	-1.7	-0.3
<b>Structural balance (SB)<sup>2</sup></b>	<b>-1.2</b>	<b>-1.7</b>	<b>-1.9</b>	<b>-1.8</b>	<b>-1.5</b>	<b>-1.6</b>	<b>-1.7</b>	<b>-0.3</b>
Structural primary balance <sup>2</sup>	-0.3	-0.9	-1.1	-1.0	-0.6	-0.8	-1.0	-0.4

Notes:

<sup>1</sup>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.

<sup>2</sup>Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.

Source:  
Stability Programme 2018 (SP); Draft Budgetary Plan for 2019 (DBP); Commission 2018 autumn forecast (COM); Commission calculations

Euro area sovereign bond yields remain at historically low levels, with 10-year rates in Latvia currently standing at 1.0%<sup>4</sup>. 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 decrease from 0.9% of GDP in 2017 to 0.8% in 2018 and is projected to stay at that level in 2019. This is well below the 1.7% recorded in 2012 at the peak of the euro area sovereign debt crisis. The

<sup>4</sup> 10-year bond yields as of 2 October 2018. Source: Bloomberg.<sup>5</sup> COM(2018)15 final of 12.1.2018.

Commission forecast of interest expenditure in 2019 is lower at 0.7% of GDP, in line with lower debt projections.

The Draft Budgetary Plan for 2019 is consistent with the national fiscal rules, except for a small deviation for the requirement for the fiscal security reserve. A consolidation effort of less than 0.1% of GDP would satisfy this requirement.

### 3.2. Debt developments

The Draft Budgetary Plan estimates gross public debt to increase from 37.5% of GDP at the end of 2018 to 38.5% of GDP at the end of 2019. The differential between nominal GDP growth and the government borrowing has a debt-ratio-reducing effect, but a higher debt ratio is underpinned by an assumed accumulation of financial resources ahead of a large debt redemption in early 2020. Based on the Commission 2018 autumn forecast the debt-to-GDP ratio is projected to decline to 35.5% of GDP by the end of 2019, which assumes a reduction of the previously accumulated cash reserves in 2018 and 2019.

**Table 3. Debt developments**

(% of GDP)	2017	2018			2019		
		SP	DBP	COM	SP	DBP	COM
<b>Gross debt ratio<sup>1</sup></b>	<b>40.0</b>	<b>38.4</b>	<b>37.5</b>	<b>37.1</b>	<b>37.4</b>	<b>38.5</b>	<b>35.5</b>
Change in the ratio	-0.3	-1.6	-2.5	-2.9	-1.0	1.0	-1.6
<i>Contributions<sup>2</sup>:</i>							
<b>1. Primary balance</b>	<b>-0.3</b>	<b>0.1</b>	<b>0.0</b>	<b>0.1</b>	<b>0.0</b>	<b>-0.1</b>	<b>0.2</b>
<b>2. “Snow-ball” effect</b>	<b>-2.0</b>	<b>-1.8</b>	<b>-1.9</b>	<b>-2.1</b>	<b>-1.4</b>	<b>-1.4</b>	<b>-1.1</b>
<i>Of which:</i>							
Interest expenditure	0.9	0.8	0.8	0.8	0.9	0.8	0.7
Growth effect	-1.7	-1.5	-1.6	-1.5	-1.2	-1.1	-1.1
Inflation effect	-1.2	-1.1	-1.1	-1.4	-1.1	-1.1	-0.7
<b>3. Stock-flow adjustment</b>	<b>2.1</b>	<b>0.2</b>	<b>-0.5</b>	<b>-0.8</b>	<b>0.4</b>	<b>2.5</b>	<b>-0.7</b>
<i>Of which:</i>							
Cash/accruals difference							
Net accumulation of financial <i>of which privatisation proceeds</i>							
Valuation effect & residual							

Notes:

<sup>1</sup> End of period.

<sup>2</sup> 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 2018 (SP); Draft Budgetary Plan for 2019 (DBP); Commission 2018 autumn forecast (COM); Commission calculations

### 3.3. Measures underpinning the draft budgetary plan

The Draft Budgetary Plan presents no new policy measures for 2019. It nonetheless updates the previously implemented measures and includes the measures adopted since the Stability Programme.

The measures implemented in summer of 2018 target pensioners by making pension indexation rules more generous, introducing survivors' pensions for one year and increasing the personal income tax allowance for pensioners in 2021. Moreover, a possibility to inherit accumulated state funded pension capital, if the person dies before pension age, is also implemented. The combined effect of these measures is slightly deficit increasing in 2019 (0.03% of GDP).

The effect of the previously adopted measures is updated in line with the reporting requirements for the Draft Budgetary Plan. In particular, the yield of some tax compliance measures has been lowered (the effect of less than 0.1% of GDP). The effect of the corporate tax reform is also updated over the transition period of 2018-2020 in line with the developments so far (0.2% of GDP positive effect in 2019 from withdrawal of accumulated dividends). These updates are also considered for the Commission forecast, while some differences in assessment of the discretionary measures persist. Notably, the Commission forecast accounts for larger costs related to the freeze of the cadastral values used for property taxation (0.1% of GDP) and the recovery in corporate income tax revenue under the new regime is assumed to be back loaded to 2020. The Commission forecast is also more cautious on the effectiveness of some tax compliance measures (less than 0.1% of GDP). The implementation of the VAT reverses charge mechanism for domestic supplies of consumer electronics and electrical household appliances is estimated to yield less than 0.1% of GDP in 2018 and over the forecast horizon both according to the authorities and to the Commission forecast. Given that this measure is objected by the European Commission as it violates EU VAT rules<sup>5</sup>, the Commission forecast flags a reversal of this measure and its impact on the government balance as a risk.

#### **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 addressed to Latvia**

On 15 June, 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 achieve the medium-term budgetary objective in 2019, taking into account the allowances linked to the implementation of the structural reforms for which a temporary deviation is granted.

The Commission 2018 autumn forecast includes a closer position to the MTO in 2019 than in spring 2018. This sets the nominal growth rate of net primary government expenditure of 4.6%, which corresponds to an improvement in the structural balance by 0.3% of GDP.

##### **Adjustment towards the MTO**

Latvia has been granted a temporarily increase in its structural deficit limit to finance the pension reform and the healthcare reform. 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

<sup>5</sup> Commission's communication COM(2018)15 final of 12.1.2018.



2019<sup>6</sup>. The combination of these two clauses allows for a deviation from the MTO (a structural deficit of 1% of GDP) by 0.7% of GDP in 2018 and 0.5% of GDP in 2019.

For 2018, the Draft Budgetary Plan indicates a breach of the expenditure benchmark by -0.5% of GDP and a gap to the structural balance requirement of -0.4% of GDP. The current fiscal requirement, which is frozen for the in-year assessment for 2018, is 0.2% of GDP stricter than that suggested by the actual budgetary outturn in 2017. This will be reviewed in the ex-post assessment for 2018 in spring 2019. Overall, the Draft Budgetary Plan indicates a risk of some deviation from the requirements of the preventive arm of the SGP in 2018.

For 2019, the Draft Budgetary Plan suggests compliance with both the expenditure benchmark (a positive gap of 0.2% of GDP) and the structural balance requirement. Some deviation from the expenditure benchmark and structural balance requirement over 2018 and 2019 on average is driven by the estimated deviation in 2018. Overall, Draft Budgetary Plan points to some deviation from the requirements in 2019

Based on the Commission 2018 autumn forecast, Latvia is expected to be close to its MTO in 2018 and 2019 (gap of 0.1 and 0.2% of GDP respectively). Thus, the current assessment points to broad compliance in both years.

At the same time, Latvia has a requirement that the nominal growth rate of net primary government expenditure should not exceed 6.0% in 2018 and 4.6% in 2019, corresponding to a maximum deterioration of the structural balance by 0.3% in 2018 and an adjustment of 0.3% of GDP in 2019. Based on the Commission forecast, the expenditure benchmark would currently point to a risk of a significant deviation from those requirements in 2018 and 2019. If compliance with the MTO can no longer be established in future assessments, an overall assessment would need to take into account a possible deviation from the requirement. A number of relevant factors could be considered in this assessment, in particular the ex-post unfreezing of the requirements, the different potential growth estimates underlying the structural balance and the expenditure benchmark, and the effect of public investment hikes in 2017 and 2018.

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<sup>6</sup> 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.

**Table 7: Compliance with the requirements of the preventive arm**

(% of GDP)	2017	2018		2019	
<b>Initial position<sup>1</sup></b>					
Medium-term objective (MTO)	-1.0	-1.0		-1.0	
Structural balance <sup>2</sup> (COM)	-1.2	-1.8		-1.7	
Structural balance based on freezing (COM)	-1.4	-1.8		-	
<b>Position vis-a-vis the MTO<sup>3</sup></b>	At or above the MTO	At or above the MTO		Not at MTO	
(% of GDP)	<b>2017</b>	<b>2018</b>		<b>2019</b>	
	<b>COM</b>	<b>DBP</b>	<b>COM</b>	<b>DBP</b>	<b>COM</b>
<b>Structural balance pillar</b>					
Required adjustment <sup>4</sup>	0.0	0.4		0.6	
Required adjustment corrected <sup>5</sup>	-1.4	-0.3		0.3	
Change in structural balance <sup>6</sup>	-1.0	-0.6	-0.5	0.3	0.0
<i>One-year deviation from the required adjustment<sup>7</sup></i>	0.5	-0.4	-0.3	0.0	-0.2
<i>Two-year average deviation from the required adjustment<sup>7</sup></i>	0.7	0.0	0.1	-0.2	-0.3
<b>Expenditure benchmark pillar</b>					
Applicable reference rate <sup>8</sup>	6.0	6.0		4.6	
<i>One-year deviation adjusted for one-offs<sup>9</sup></i>	-0.2	-0.5	-0.8	0.2	-0.7
<i>Two-year average deviation adjusted for one-offs<sup>9</sup></i>	-0.2	-0.4	-0.5	-0.2	-0.7
<b>Notes</b>					
<sup>1</sup> 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.					
<sup>2</sup> Structural balance = cyclically-adjusted government balance excluding one-off measures.					
<sup>3</sup> Based on the relevant structural balance at year t-1.					
<sup>4</sup> 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.).					
<sup>5</sup> Required adjustment corrected for the clauses, the possible margin to the MTO and the allowed deviation in case of overachievers.					
<sup>6</sup> Change in the structural balance compared to year t-1. Ex post assessment (for 20XX-1) was carried out on the basis of Commission 20XX spring forecast.					
<sup>7</sup> The difference of the change in the structural balance and the corrected required adjustment.					
<sup>8</sup> 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.					
<sup>9</sup> 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.					
<b>Source :</b>					
Draft Budgetary Plan for 2019 (DBP); Commission 2018 autumn forecast (COM); Commission calculations.					

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

The Draft Budgetary Plan plans stable government revenue and expenditure share in GDP between 2017 and 2018 and a sharp drop by 1.7 percentage points in 2019. Revenue developments are affected by the effect of the adopted tax reform, while expenditure developments reflect expenditure reallocations towards more capital spending and stronger use of EU project support in 2018 and less so in 2019. The Commission 2018 autumn forecast

has more gradual revenue and expenditure developments over 2018 and 2019 and applies a higher trend growth assumption where the policy is not yet specified.

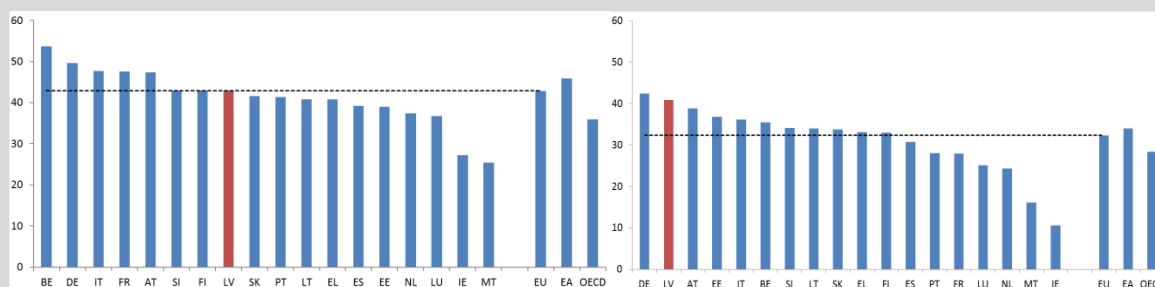
Latvia has not responded with any new measures to the fiscal-structural recommendation to shift tax burden from low-income earners to capital and property and to improve tax compliance, as no policy changes are presented at this stage. The Draft Budgetary Plan demonstrates continued implementation of the tax reform measures spanning over 2018-2020 (The 2018 country report for Latvia provides an assessment of the measures).

#### Box 4 – 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 at low wage (2017)



Notes: 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.

Benchmarking is only the first step in the process towards firm, country-specific policy conclusions. The tax burden on labour interacts with a wide variety of other policy elements such as the benefit system and the wage-setting system. A good employment performance indicates that the need to reduce labour taxation may be less urgent while fiscal constraints can dictate that labour tax cuts should be fully offset by other revenue-enhancing or expenditure-reducing measures. In-depth, country-specific analysis is necessary before drawing policy conclusions.

In the context of the 2018 European Semester, Latvia was issued the recommendation to "(..) Reduce taxation for low-income earners by shifting it to other sources, particularly capital and property, and by improving tax compliance."

Latvia's no-policy-change Draft Budgetary Plan does not include any new measures affecting the tax wedge on labour. A continued implementation of the tax reform over the period 2018-2020 is estimated to reduce the tax wedge on low wage to 36% by 2020.

## **6. OVERALL CONCLUSION**

Based on both the information contained in the Draft Budgetary Plan and the Commission 2018 autumn forecast, the structural balance is expected to be close to the medium-term objective both in 2018 and 2019, taking into account the temporary deviation allowance related to the implementation of structural reforms. If the structural balance is no longer projected to be close to the medium-term budgetary objective taking into account the temporary deviation allowance in future assessments for 2018 or 2019, the overall assessment of compliance will need to take into account a possible deviation from the requirement set by the Council.