EUROPEAN COMMISSION
DIRECTORATE GENERAL
ECONOMIC AND FINANCIAL AFFAIRS

Brussels, 26 May 2016

Assessment of the 2016 Stability Programme for

Latvia

(Note prepared by DG ECFIN staff)

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1. INTRODUCTION

This document assesses Latvia's Stability Programme (hereafter called Stability Programme), which was submitted to the Commission on 14 April and covers the period 2014-2019.[1] The Stability Programme was approved by the government and adopted by the parliamentary committee on European Affairs.

Latvia is subject to the preventive arm of the Stability and Growth Pact and should ensure that the deviation from the medium-term objective is limited to the allowance linked to the systemic pension reform.

This document complements the Country Report published on 26 February 2015 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 2016 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 the Commission forecast. Section 4 assesses the compliance with the rules of the SGP, including on the basis of the Commission forecast. Section 5 provides an overview on long-term sustainability risks and Section 6 on recent developments and plans regarding the fiscal framework and the quality of public finances. Section 7 provides a conclusion.

2. MACROECONOMIC DEVELOPMENTS

The macroeconomic scenario underlying the Stability Programme points to a gradual acceleration of economic growth from 2.7% in 2015 to 3% in 2016, 3.3% in 2017, and 3.4% in 2018 and 2019. This is driven by domestic demand, while imports are projected to rise faster than exports. Private consumption is projected to grow at a steady annual rate of 3.3-3.5% over the forecast horizon while investments in fixed assets are set to accelerate substantially to 7% in 2017 and 8% in 2018. The upturn in investments reflects the cycle of the estimated absorption of EU funds as well as some improvement in the credit conditions and the external environment. Unemployment is expected to decline from 9.9% in 2015 to 7.5% in 2019 reflecting a modest increase in employment and continuous contraction in the labour force linked to the negative dynamics of the working age population. Inflation is projected to stay low at 0.2% in 2016 as low energy prices from the beginning of the year are having lagged downward effects on a wide range of consumer items. However, inflation is expected to increase to 2% in 2017 and 2.5% in both 2018 and 2019, due to the assumed rebound in oil prices and strong domestic demand pushing up service prices.

The positive output gap, as recalculated by the Commission based on the information in the programme following the commonly agreed methodology, is estimated to decline from 1.9% of GDP in 2015 to 1.8% in 2016 and 1.4% in 2017. A faster closure of the positive output gap is foreseen afterwards to -0.1% in 2019, as potential output is estimated to rise faster than actual output.[2]

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[1] The English version of the stability programme was submitted on 11 May.

[2] The output gaps presented in the programme differ from the recalculated gaps used for the purpose of the Commission assessment. According to the national calculations, the output gap is -0.4% in 2016 and is gradually turning positive to 0.9% in 2019.

Table 1: Comparison of macroeconomic developments and forecasts

	2015		2016		2017		2018	2019
	COM	SP	COM	SP	COM	SP	SP	SP
Real GDP (% change)	2.7	2.7	2.8	3.0	3.1	3.3	3.4	3.4
Private consumption (% change)	3.3	3.3	3.8	3.4	3.9	3.3	3.4	3.5
Gross fixed capital formation (% change)	2.7	2.6	3.1	4.6	4.1	7.0	8.0	6.5
Exports of goods and services (% change)	1.4	1.0	1.2	3.0	2.8	4.1	4.5	5.0
Imports of goods and services (% change)	1.8	1.6	2.5	3.8	3.8	5.3	6.1	6.0
Contributions to real GDP growth:								
- Final domestic demand	3.2	3.2	3.6	3.6	3.8	4.2	4.6	4.4
- Change in inventories	-0.1	0.0	0.0	-0.1	0.0	0.0	0.0	0.0
- Net exports	-0.3	-0.4	-0.8	-0.6	-0.7	-0.9	-1.2	-0.9
Output gap[1]	1.7	1.9	1.8	1.8	1.7	1.4	0.7	-0.1
Employment (% change)	1.4	1.3	0.3	0.2	0.5	0.2	0.1	0.0
Unemployment rate (%)	9.9	9.9	9.6	8.9	9.3	8.4	8.0	7.5
Labour productivity (% change)	1.4	1.4	2.4	2.8	2.6	3.1	3.3	3.4
HICP inflation (%)	0.2	0.2	0.2	0.4	2.0	2.0	2.5	2.5
GDP deflator (% change)	0.6	0.6	1.0	1.3	2.2	2.4	2.8	2.9
Comp. of employees (per head, % change)	7.0	6.8	5.2	5.5	5.5	5.5	5.5	5.5
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	1.6	1.6	0.0	-0.4	0.1	-0.2	0.1	-1.4

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 2016 spring forecast (COM); Stability Programme (SP).

The growth projections in the Stability Programme are close to the scenario of the previous programme while inflation for 2016 is revised considerably down from 1.9% to 0.4% in view of the revised oil price assumption. The updated macroeconomic scenario is broadly in line with the Commission 2016 spring forecast. The latter indicates a slightly lower GDP growth of 2.8% in 2016 and 3.1% in 2017. In particular, private consumption is projected to grow at a slightly lower rate in the Stability Programme compared to the Commission forecast. On the other hand, investment and export projections of the national authorities appear on the optimistic side and are facing downside risks related to the volatile external environment. These components of the forecast are however of lower relevance to the fiscal projections. Inflation projections appear in line with the Commission forecast and the latest price developments.

Overall, the programme's macroeconomic assumptions are plausible.

Ongoing and planned structural reforms, in particular those in education, healthcare and public administration, are outlined in the Stability Programme as positive risks to the macroeconomic forecast. The total impact of these reforms on GDP is not quantified. The healthcare reform is expected to have a positive effect on employment and GDP in the long run. However, the expected gradual implementation of the reform over the Stability Programme period implies that only a limited macroeconomic effect can be expected by 2019.

3. Recent and planned budgetary developments

3.1. Deficit developments in 2015

The general government deficit stood at 1.3% of GDP in 2015. The Stability Programme provides a deficit estimate of 1% of GDP, as it was drafted before the Eurostat validated data became available[3]. The difference mostly comes from the recording of the previously unaccounted public-private partnership project of the State Revenue Service building, leading to a temporary increase in the 2015 deficit by 0.3% of GDP. Considering this, the underlying government deficit has notably improved relative to the estimates of the April 2015 Stability Programme and the September 2015 Draft Budgetary Plan of 1.5% of GDP and 1.4% of GDP, respectively. The improvement is notably driven by better-than-expected tax revenues (0.3% of GDP as compared to the April 2015 Stability Programme) and positive cash-accrual adjustments, while expenditure reallocations have had a limited effect on the balance. Strong revenue growth from taxes on labour is related to higher-than-projected wage growth, while VAT revenue outperformed private consumption growth on the back of improved tax collection. Excise duties benefited from an increase in fuel consumption linked to the low oil price. On the expenditure side, capital spending as well as wage and social transfers were higher than planned, but this was broadly offset by lower spending elsewhere. Corrections relative to the plans in EU-related transfers and spending contributed to changes across revenue and expenditure composition.

3.2. Medium-term strategy and targets

The Stability Programme sets out the annual fiscal targets in line with the fiscal rules and using flexibility of the existing pension reform clause and the requested structural reform clause for the health sector reform (see Section 4.1). The targets are based on the most stringent requirements, which according to the Stability Programme estimates are the structural balance rule of the Stability and Growth Pact for 2017 and 2018 and the national expenditure rule for 2019. The resulting headline deficit targets amount to 1% of GDP between 2016 and 2018 and 0.5% of GDP in 2019. The Stability Programme estimates a room for deficit-increasing measures of 0.2% of GDP in 2017, 0.8% of GDP in 2018 and 1.2% of GDP in 2019, relative to the adopted policies.

According to the Stability Programme, the structural deficit targets are expected to increase from 0.9% of GDP in 2016 to 1.1% of GDP in 2017 and 1.2% of GDP in 2018, before declining to 0.8% of GDP in 2019. As recalculated by the Commission on the basis of the information in the programme according to the commonly agreed methodology, the structural deficits are estimated to decline from 1.7% of GDP in 2016 to 0.4% of GDP in 2019. The difference between the authorities' estimate and the recalculated structural balance mostly comes from the different profile of output gap estimates.

The current budgetary targets are more ambitious than those of the previous Stability Programme, representing the effect of the deficit-reducing effort of the 2016 budget package (see Figure 1). Relative to the Draft Budgetary Plan for 2016, the headline deficit estimate of 1% of GDP for 2016 remains unchanged, as the higher tax revenue forecast is broadly offset by a somewhat higher expenditure estimate and negative cash-accrual adjustments.

[3] The revenue and expenditure breakdown is also not updated in line with the latest data release. This makes a comparison on general government basis difficult; therefore analysis of fiscal estimates of the Stability Programme rely more on cash-based data.

Table 2: Composition of the budgetary adjustment

(% of GDP)	2015	2016		2017		2018	2019	Change: 2015-2019
	COM	COM	SP	COM	SP	SP	SP	SP
Revenue	**35.9**	**35.8**	**35.1**	**36.4**	**35.3**	**35.5**	**34.5**	**-1.4**
of which:								
- Taxes on production and imports	12.7	13.0	13.0	13.1	13.0	12.9	12.6	-0.1
- Current taxes on income, wealth, etc.	7.8	8.2	8.2	8.2	8.1	8.2	8.1	0.3
- Social contributions	8.7	8.5	8.4	8.8	8.7	8.7	8.7	0.0
- Other (residual)	6.8	6.1	5.5	6.2	5.5	5.7	5.1	-1.7
Expenditure	**37.2**	**36.8**	**36.1**	**37.3**	**36.3**	**36.5**	**35.0**	**-2.2**
of which:								
- Primary expenditure	35.8	35.7	34.9	36.3	35.3	35.5	34.0	-1.8
of which:								
Compensation of employees	9.9	10.1	10.0	10.1	10.0	9.8	9.5	-0.4
Intermediate consumption	6.4	6.4	6.1	6.5	6.2	6.3	6.1	-0.3
Social payments	11.5	11.6	11.5	11.4	11.4	11.6	11.6	0.1
Subsidies	0.4	0.5	0.6	0.5	0.6	0.6	0.5	0.1
Gross fixed capital formation	4.4	3.7	3.7	4.3	4.5	4.8	4.3	-0.1
Other (residual)	3.1	3.4	2.9	3.5	2.5	2.4	1.9	-1.2
- Interest expenditure	1.3	1.1	1.2	1.0	1.0	1.0	1.0	-0.3
General government balance (GGB)	**-1.3**	**-1.0**	**-1.0**	**-1.0**	**-1.0**	**-1.0**	**-0.5**	**0.8**
Primary balance	**0.1**	**0.1**	**0.2**	**0.0**	**0.0**	**0.0**	**0.5**	**0.4**
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	**-1.3**	**-1.0**	**-1.0**	**-1.0**	**-1.0**	**-1.0**	**-0.5**	**0.8**
Output gap[1]	1.7	1.8	1.8	1.7	1.4	0.7	-0.1	-1.8
Cyclically-adjusted balance[1]	-1.9	-1.7	-1.7	-1.6	-1.5	-1.2	-0.4	1.5
Structural balance[2]	**-1.9**	**-1.6**	**-1.7**	**-1.6**	**-1.5**	**-1.2**	**-0.4**	**1.5**
Structural primary balance[2]	-0.6	-0.5	-0.5	-0.6	-0.5	-0.2	0.6	1.1

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 2016 spring forecasts (COM); Commission calculations.

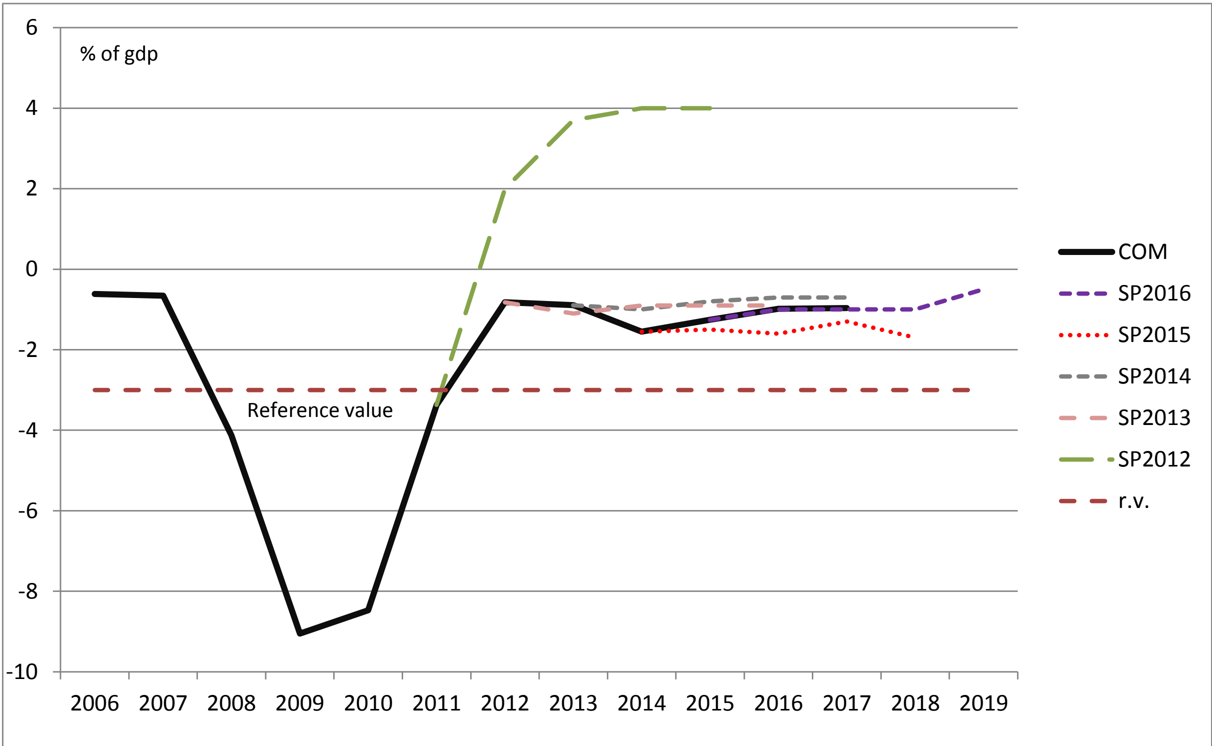
The Stability Programme defines four fiscal priorities: (i) increasing defence spending to the NATO target of 2% of GDP by 2018; (ii) supporting sustainable growth by increasing spending on security, health and education; (iii) reducing income inequality by increasing the minimum wage and implementing the progressive personal income tax allowance and (iv) increasing the tax revenue ratio to 1/3 of GDP, primarily through better tax collection. However, only the defence spending increase and the progressive personal income tax allowance are specified and fully accounted for in the budgetary plans. The measures in other priority areas are not specified as such decisions are generally taken when setting the annual budgets, while respecting the fiscal discipline constraints. The authorities have commissioned the development on the tax policy strategy and a comprehensive expenditure review with a view to better define the medium-term budgetary strategy[4].

[4] The April 2016 Government's Action Plan shifts out the deadline for tax policy strategy to end-2017 with evaluation of the current policy expected by end-2016 – after the 2017 budget discussions. The

The government revenue and expenditure ratio is estimated to remain broadly stable over the period covered by the Stability Programme. However, the revenue and expenditure breakdown demonstrates fluctuations in some items. In particular, both the direct and indirect tax revenue ratio are estimated to increase by some ½% of GDP each in 2016 offsetting a drop in the other revenue ratio by 1% of GDP. The tax burden is estimated to increase from 28.8% of GDP in 2015 to 29.5% of GDP in 2016 with some further increase to 29.7% of GDP expected by 2018, before a small decrease in 2019 when the tax on subsidised electricity production is set to expire. The Stability Programme does not show how the policy objectives of reaching the tax revenue ratio of 1/3 of GDP and increasing the tax-ratio-to-GDP by 1% through better tax collection will be attained. On the expenditure side, an expected temporary dip in the capital spending in 2016 by 0.8% of GDP is mainly explained by the delays in rolling-out of EU funded projects[5]. The effect on total expenditure is largely mitigated by an increase in other expenditure.

The Commission 2016 spring forecast estimates the headline deficit at 1.0% of GDP in 2016 and 2017. The improvement from 2015 reflects the pick-up in economic growth and the effect of the revenue-increasing measures, while the strong growth in wages, social transfers and public purchases is projected to continue, based on unchanged policies for 2017. The structural deficit is estimated to improve from 1.9% of GDP in 2015 to around 1½% of GDP in 2016 and 2017. This improvement is driven by the decline in the headline deficit, while the positive output gap is estimated to remain stable at around 1¾% of GDP over 2015-2017.

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



Source: Commission 2016 spring forecast; Stability Programmes

comprehensive expenditure review is set to become an element of annual budget preparation and the first results of pilot cases will inform the 2017 budget.

[5] The transition between two EU budget programming periods has been affected by delays in preparation of the new national planning documents, providing legal basis for the EU-funded projects.

3.3. Measures underpinning the programme

The Stability Programme presents the measures adopted since the previous Stability Programme, notably in the 2016 budget package. New revenue-increasing measures have been introduced and some of the previously-legislated measures have been reversed or modified in order to accommodate the spending increase for defence, security and the health sector. The main measures, with an impact of at least 0.1% of GDP are listed below.

The Stability Programme assumes the implementation of the health sector reform over the period 2017-2019 and thus requests to benefit from the so-called "structural reform clause". Measures in the healthcare sector will be spelled out in the annual budgets based on the Health Strategy for 2014-2020 and possible new financing initiatives.

Risks to the expected impact of the measures are limited. Uncertainty is higher for taxation measures, but estimates for such measures appear prudent. The new solidarity tax can be avoided by some high-income earners by diverting their labour income to capital income streams, which are taxed at an overall lower tax rate. The expected yield of the measure assumes some behavioural response, but the extent of this is difficult to estimate. The new requirements for cash registers provide for easier-to-check electronic records of business transactions, reducing possibilities for tax evasion. This measure is part of a series of tax compliance measures, which have demonstrated their effectiveness in 2015 through better VAT revenue growth relative to the tax base.

Main budgetary measures

Revenue	**Expenditure**
2016	
• Introduction of solidary tax on high personal incomes (+0.2% of GDP) • Restriction of personal income tax allowance for working age dependants (+0.1% of GDP) • Systemic pension reform (-0.3% of GDP)	• Increasing defence capacity (+0.2% of GDP) • Wage increase for security officers (+0.1% of GDP) • Increased health spending (+0.1% of GDP)
2017	
• Introduction of minimum monthly social contribution (+0.3% of GDP) • Stronger requirements for cash machines (+0.1% of GDP)	• Increasing defence capacity (+0.2% of GDP)
2018	
• Full year effect of the minimum monthly social contribution (+0.1% of GDP)	• Increasing defence capacity (+0.2% of GDP)
2019	
• End of taxation on subsidised electricity production (-0.1% of GDP)	

Note: The budgetary impact in the table is 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

The government debt ratio amounted to 36% of GDP at the end of 2015. The Stability Programme projects an increase in the debt ratio to 40% of GDP at the end of 2016, considering an accumulation of cash reserves ahead of a large bond repayment in early 2017. Such debt dynamics were already projected in the previous Stability Programme and in the Draft Budgetary Plan. The debt ratio is expected to decline to 38% of GDP after the bond repayment from cash reserves in 2017 and to remain around that level thereafter. The debt level from 2017 appears to assume a higher cash balance than foreseen in the previous Stability Programme and the Commission forecast (see Figure 2).

Table 3: Debt developments

(% of GDP)	Average 2010-2014	2015	2016		2017		2018	2019
			COM	SP	COM	SP	SP	SP
Gross debt ratio[1]	**42.3**	**36.4**	**39.8**	**40.3**	**35.6**	**38.3**	**37.5**	**38.2**
Change in the ratio	0.8	-4.4	3.4	3.9	-4.2	-2.0	-0.8	0.7
1. Primary balance	**1.4**	**-0.1**	**-0.1**	**-0.2**	**0.0**	**0.0**	**0.0**	**-0.5**
2. “Snow-ball” effect	**-0.3**	**0.0**	**-0.2**	**-0.3**	**-1.0**	**-1.2**	**-1.2**	**-1.3**
Of which:								
Interest expenditure	1.6	1.3	1.1	1.2	1.0	1.0	1.0	1.0
Growth effect	-1.0	-1.1	-1.0	-1.0	-1.2	-1.3	-1.2	-1.2
Inflation effect	-0.9	-0.2	-0.4	-0.4	-0.8	-0.9	-1.0	-1.1
3. Stock-flow adjustment	**-0.2**	**-4.3**	**3.8**	**4.4**	**-3.1**	**-0.8**	**0.4**	**2.5**

Notes:

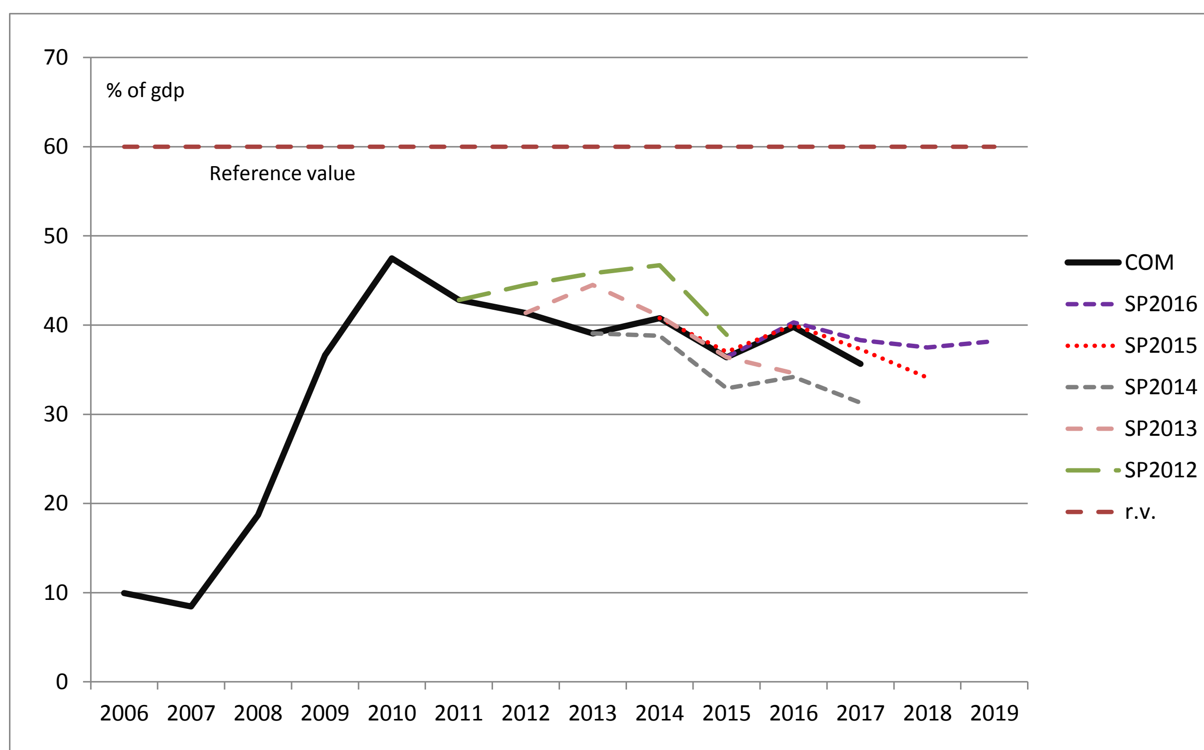
[1] End of period.

[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 2016 spring forecast (COM); Stability Programme (SP), Comission calculations.

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



Source: Commission 2016 spring forecast; Stability Programmes

3.5. Risk assessment

The economic growth and fiscal projections of the Stability Programme are broadly in line with the Commission spring forecast. However, risks to the deficit projections are skewed on the negative side. Social spending overruns remain a risk to the fiscal targets. The social spending has accounted for an increasing share of government expenditure and the number of recipients and contribution-based benefit rates have been occasionally underestimated for some benefits. The Fiscal Discipline Council has proposed to use the statutory fiscal security reserve as a safeguard against such risk.

The Stability Programme does not fully specify the budgetary plans over 2017-2019, but the track record of complying with the fiscal targets during the past four years gives confidence that appropriate measures will be taken for maintaining the fiscal discipline. At the same time, there are pressures from ministries for additional spending of around 2% of GDP in 2017. Even allowing for some prioritisation and possible expenditure savings in the order of 0.2% of GDP from the comprehensive expenditure review, new revenue-increasing measures for 2017 are likely to be needed to cover spending priorities. Moreover, the new tax strategy is not planned to be defined in time for the 2017 budget preparation, so that stop-gap revenue measures can be expected in 2017, which put at risks the predictability of the fiscal policy.

Over the past years, the government's capital injections in the national airline Air Baltic have been classified as the deficit-increasing capital transfers. These have been used to cover large prior losses. The capital injection of 0.3% of GDP in 2016, in addition to that of a private investor, will be examined by the statistical authorities. An impact on the 2016 deficit cannot be excluded at this point. On the other hand, the authorities try to recover their investment in the steel plant Liepajas Metalurgs (0.2% of GDP), which was already recorded in the 2013 deficit, and any recovery could have a positive effect on the government deficit.

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

Box 1. Council recommendations addressed to Latvia

On 14 July 2015, 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 Latvia to ensure that the deviation from the medium-term objective in 2015 and 2016 is limited to the allowance linked to the systemic pension reform.

4.1. Compliance with the MTO or the required adjustment path towards the MTO

Assessment of eligibility to the structural reform clause

In its Stability Programme, Latvia has requested a temporary deviation of 0.5 % of GDP from the required adjustment path towards the MTO in 2017 to take account of a major structural reform in the health sector. The details of the reform are specified in the Health Strategy for 2014-2020 and summarised in the Stability Programme. One of the key objectives is to increase public financing for the health sector to 4% of GDP by 2020, relative to 3% of GDP in 2015.

Several conditions have to be fulfilled for the structural reform to be taken into account. The reform should be major, with direct long-term positive budgetary effects, and implemented. Furthermore, the deviation – allowed under the clause – should not lead to a breach of the 3% of GDP deficit threshold and a safety margin to this threshold should be continuously preserved. Moreover, the structural balance in the year preceding the application of the clause should be within a maximum distance of 1.5% of GDP from the MTO.

The reform is being already implemented, including an increase in public financing in 2014-2016, but is lagging behind the original plans.

The low public financing and high out-of-pocket payment for health services have been highlighted as one of the major structural bottlenecks for Latvia in the Commission country report released on 26 February 2016 [6]. Moreover, the related country-specific recommendation for Latvia asks for action to improve accessibility, cost-effectiveness and quality of the healthcare system and link hospital financing to performance mechanisms.

The reform has been independently evaluated by the University of Latvia. It is estimated to reduce the large number of premature deaths due to health problems[7], thus increasing the working-age population and employment. The full implementation of the reform would increase employment by 0.6% and the GDP level by 2.2% by 2023. This in turn is estimated to have a positive impact on the sustainability of public finances in the long run. Moreover, the estimates does not account for other benefits from healthier population such as higher productivity, less absences for medical reasons, higher activity at pension age and indirect fiscal savings in social and health expenditure. Overall, the positive impact on growth and the long-term sustainability of public finances is assessed to be plausible.

Based on the Commission spring forecast, the general government deficit of Latvia is projected to be at 1% of GDP in 2017, well below the 3% of GDP Treaty reference value. The

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[6] http://ec.europa.eu/europe2020/pdf/csr2016/cr2016_latvia_en.pdf

[7] The indicator of potential years of life lost stood at 5,960 per 100,000 inhabitants in 2012, which is one of the worst performances among developed countries. The reform is estimated to reduce the indicator to 5,300 years of life lost by 2020.

structural deficit is estimated at 1.6% of GDP in 2017, below the minimum benchmark for Latvia of 1.7% of GDP, thus preserving the safety margin to the 3% of GDP reference value for the deficit. Finally, Latvia's structural balance is also expected to remain within a maximum distance of 1.5% of GDP from the MTO in 2016, which is currently fixed at -1.0% of GDP, as the structural balance is foreseen to be -1.6% of GDP.

Latvia can currently be assessed as qualifying for the requested temporary deviation in 2017, provided that it adequately implements the agreed reform, which will be monitored under the European Semester over the next years. The eligible budgetary costs of the healthcare reform amount to 0.5% of GDP per year over the period 2017-2019, subject to Latvia maintaining the safety margin to the 3% of GDP reference value of the Treaty (a structural deficit of 1.7% of GDP) which cannot be breached in any of the years of application of the clause. The existing allowance for the pension reform clause of 0.6% of GDP in 2017 and 0.3% of GDP in 2018 already uses some space between the MTO and the minimum benchmark of 0.7% of GDP in 2017 and 2018.

<u>Compliance with the MTO</u>

Latvia is currently in the preventive arm of the Stability and Growth Pact. Latvia is eligible to the systemic pension reform clause, which allows for a deviation from the adjustment path towards the MTO (i.e a structural deficit of 1% of GDP which is in line with the SGP requirements) of 0.8% of GDP in 2015, 0.6% of GDP in 2016 and 2017 and 0.3% of GDP in 2018. The additional allowed deviation of 0.1% of GDP in 2017, 0.4% in 2018 and 0.5% in 2019 comes from the structural reform clause for the healthcare reform, considering the constraint of the minimum benchmark.

In 2015, the structural balance is expected to have improved by 0.2% of GDP, while it was allowed to deteriorate by 0.4% of GDP by the pension reform clause, pointing to compliance both in 2015 and over the years of 2014 and 2015 taken together. Net expenditure growth is also forecast to have been in compliance with the benchmark both in 2015 and over 2014 and 2015 taken together. Therefore, the assessment suggests that the adjustment path towards the MTO in 2015 was respected.

In 2016, the structural balance is expected to improve by 0.3% of GDP in line with the recommended structural adjustment after taking into account the deviation allowed by the pension reform clause. However, the expenditure benchmark points to a risk of significant deviation (gap of -0.8% of GDP based on the Commission spring forecast and -1.1% of GDP based on the Stability Programme[8]). This calls for an overall assessment. The difference between the two indicators is largely driven by (i) the relatively tax-rich composition of GDP growth, (ii) use of lower interest expenditure gains and (ii) the fact that the medium-term rate used in the calculation of the expenditure benchmark is lower that the annual potential GDP growth rate. The former reflects the stronger performance of wages and nominal private consumption relative to nominal GDP growth, supporting both tax revenue and expenditure, which is not captured by the structural balance pillar. The interest savings are used for other current expenditure, which are monitored under the expenditure benchmark pillar. Both elements lead to an overestimation of the fiscal effort based on the structural balance. The benchmark rate used for the computation of the expenditure benchmark (1.5%, frozen based on Commission 2015 spring forecast) reflects the notable economic adjustment with negative

[8] A larger deviation based on the Stability Programme, relative the Commission spring forecast, is largely related to an assumption of no change in investment expenditure fully matched by EU funds revenue, as this information was not specified in the Stability Programme.

potential growth rates in 2010-2011 and therefore underestimates the potential growth rate used in the computation of the structural balance in 2016 (2.7%). As a consequence, correcting for the above-mentioned factors, both the structural balance and the expenditure benchmark suggest some deviation. Therefore, the overall assessment points to a risk of some deviation in 2016.

In 2017, based on the Stability Programme, both the recalculated structural balance and net expenditure growth is estimated to be in compliance with the required adjustment both in 2017 and over 2016 and 2017 taken together. Based on the Commission spring forecast, the expected change of the structural balance is in line with the structural adjustment as required by the matrix after taking into account the deviation allowed by the pension reform clause and the structural reform clause, pointing to compliance with the structural balance pillar. While the expenditure benchmark in 2017 is expected to be adhered to, it shows a deviation of 0.4% of GDP over the years of 2016 and 2017 taken together, based on the Commission spring forecast. This calls for an overall assessment. The two-year average indicator in 2017 is affected by the deviation observed in 2016. Therefore, under the assumption of unchanged policies, the overall assessment points to a risk of some deviation in 2016 and 2017 taken together.

Table 4: Compliance with the requirements under the preventive arm

(% of GDP)	2015	2016		2017	
Initial position[1]					
Medium-term objective (MTO)	-1.0	-1.0		-1.0	
Structural balance[2] (COM)	-1.9	-1.6		-1.6	
Structural balance based on freezing (COM)	-1.9	-1.6		-	
Position vis-a -vis the MTO[3]	Not at MTO	Not at MTO		Not at MTO	
(% of GDP)	**2015**	**2016**		**2017**	
	COM	**SP**	**COM**	**SP**	**COM**
Structural balance pillar					
Required adjustment[4]	0.4	0.8		0.6	
Required adjustment corrected[5]	-0.4	0.3		-0.1	
Change in structural balance[6]	-0.2	0.3	0.3	0.1	0.0
One-year deviation from the required adjustment[7]	0.1	0.0	0.0	0.2	0.1
Two-year average deviation from the required adjustment[7]	0.0	0.1	0.0	0.1	0.0
Expenditure benchmark pillar					
Applicable reference rate[8]	2.4	0.6		2.2	
One-year deviation[9]	0.4	-1.1	-0.8	1.2	0.1
Two-year average deviation[9]	0.1	-0.3	-0.2	0.1	-0.3
Conclusion					
Conclusion over one year	Compliance	Overall assessment	Overall assessment	Compliance	Compliance
Conclusion over two years	Compliance	Overall assessment	Overall assessment	Compliance	Overall assessment

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 2014) is carried out on the basis of Commission 2015 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 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 2016 spring forecast (COM); Commission calculations.

5. FISCAL SUSTAINABILITY

Latvia's public finances are assessed to have low sustainability risks both in the short and medium to long run (see Table 4). However, the fiscal sustainability can be eroded by policy changes addressing the low future pension adequacy, as discussed in the country report for Latvia published on 26 February 2016[9]. Based on Commission forecasts and a no-fiscal-policy-change scenario beyond forecasts, the medium-term sustainability gap indicator (S1) at -2.3% of GDP reflects a distance between the current government debt level and the benchmark ratio of 60% of GDP, as well as the projected decline in ageing costs until 2030. The full implementation of the Stability Programme would put the sustainability risk indicator S1 at -3.1 pps. of GDP, leading to even lower risk. Also in the long-run, Latvian public finances are assessed to be sustainable. The long-term sustainability indicator (S2) at 0.8 % of GDP shows the adjustment effort needed to ensure that the debt-to-GDP ratio is not on an ever-increasing path. Full implementation of the Stability Programme would nonetheless put the S2 indicator at -0.2 pps. of GDP, leading to a lower long-term risk.

Based on Commission forecasts and a no-fiscal-policy-change scenario beyond forecasts, the government debt is expected to decrease slightly from around 36% of GDP in 2015 to less than 32% in 2026, thus remaining well below the Treaty threshold of 60%. Over this horizon, the government debt is projected to peak at the end of 2016 at about 40% of GDP, due to temporary effects from debt management operations. The full implementation of the Stability Programme would also put debt on a decreasing path up to 2026.

[9] http://ec.europa.eu/europe2020/pdf/csr2016/cr2016_latvia_en.pdf

Table 5: Sustainability indicators

Time horizon			No-policy Change Scenario		Stability / Convergence Programme Scenario	
Short Term			**LOW risk**			
S0 indicator [1]			0.3			
	Fiscal subindex (2015)		0.1	LOW risk		
	Financial & competitiveness subindex (2015)		0.4	LOW risk		
Medium Term			**LOW risk**			
DSA [2]			LOW risk			
S1 indicator [3]			-2.3	LOW risk	-3.1	LOW risk
of which						
	IBP		-0.1		-1.1	
	Debt Requirement		-1.9		-1.9	
	CoA		-0.3		-0.1	
Long Term			**LOW risk**		**LOW risk**	
S2 indicator [4]			0.8		-0.2	
of which						
	IBP		1.2		0.0	
	CoA		-0.4		-0.2	
	of which					
		Pensions	-1.6		-1.2	
		HC	0.4		0.4	
		LTC	0.1		0.1	
		Other	0.6		0.5	

Source: Commission services; 2016 stability/convergence programme.

Note: the 'no-policy-change' scenario depicts the sustainability gap under the assumption that the structural primary balance position evolves according to the Commissions' spring 2016 forecast until 2017. 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 2015 Ageing Report.

[1] The S0 indicator reflects up to date evidence on the role played by fiscal and financial-competitiveness variables in creating potential fiscal risks. It should be stressed that the methodology for the S0 indicator is fundamentally different from the S1 and S2 indicators. S0 is not a quantification of the required fiscal adjustment effort like the S1 and S2 indicators, but a composite indicator which estimates the extent to which there might be a risk for fiscal stress in the short-term. The critical threshold for the overall S0 indicator is 0.43. For the fiscal and the financial-competitiveness sub-indexes, thresholds are respectively at 0.35 and 0.45.

[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. See Fiscal Sustainability Report 2015.

[3] The medium-term sustainability gap (S1) indicator shows the upfront adjustment effort required, in terms of a steady adjustment in the structural primary balance to be introduced over the five years after the forecast horizon, and then sustained, to bring debt ratios to 60% of GDP in 2030, including financing for any additional expenditure until the target date, arising from an ageing population. The following thresholds were used to assess the scale of the sustainability challenge: (i) if the S1 value is less than zero, the country is assigned low risk; (ii) if a structural adjustment in the primary balance of up to 0.5 p.p. of GDP per year for five years after the last year covered by the spring 2015 forecast (year 2017) is required (indicating an cumulated adjustment of 2.5 pp.), it is assigned medium risk; and, (iii) if it is greater than 2.5 (meaning a structural adjustment of more than 0.5 p.p. of GDP per year is necessary), it is assigned high risk.

[4] The long-term sustainability gap (S2) indicator shows the immediate and permanent adjustment required to satisfy an inter-temporal budgetary constraint, including the costs of ageing. The S2 indicator has two components: i) the initial budgetary position (IBP) which gives the gap to the debt stabilising primary balance; and ii) the additional adjustment required due to the costs of ageing. The main assumption used in the derivation of S2 is that in an infinite horizon, the growth in the debt ratio is bounded by the interest rate differential (i.e. the difference between the nominal interest and the real growth rates); thereby not necessarily implying that the debt ratio will fall below the EU Treaty 60% debt threshold. The following thresholds for the S2 indicator were used: (i) if the value of S2 is lower than 2, the country is assigned low risk; (ii) if it is between 2 and 6, it is assigned medium risk; and, (iii) if it is greater than 6, it is assigned high risk.

6. FISCAL FRAMEWORK

The centrepiece of the Latvian national fiscal framework is the Fiscal Discipline Law (FDL) adopted in 2013. The law establishes the structural balance rule, which requires that the annual structural budget balance target should not be lower than -0.5% of GDP and which is supplemented by the expenditure rule. In the multi-annual budgetary planning, the most stringent expenditure ceilings established on the basis of the applicable rules are applied. The ex-post deviations are corrected through the debt brake rule. In addition, the debt rule requires that the Maastricht debt does not exceed 60% of GDP.

The Stability Programme includes an estimate of the Ministry of Finance for the nominal general government deficit of 1.0% of GDP in 2015, which corresponds to a structural deficit of 0.7% according to the authorities' calculations. However, the final outcome validated by Eurostat shows a deficit of 1.3% of GDP in 2015. While this points to a structural deficit above that implied by the FDL, the deviation is attributable to the impact of the systemic pension reform. The latter is not explicitly envisaged in the FDL but the national Fiscal Council, which is an independent monitoring body established on the basis of the FDL, considers the pension reform a valid reason for departure from the target, given its direct positive impact on the long-term sustainability of public finances[10].

The 2016 budget was adopted on the basis of the structural balance target of -0.9% of GDP and the April 2016 Stability Programme provides targets of -1.1% of GDP in 2017, -1.2% in 2018 and -0.8% in 2019, accommodating the deviation due to the ongoing systemic pension reform and the deviation due to the planned healthcare reform. Since the national Fiscal Council does not consider the healthcare reform eligible for deviation in the meaning of the FDL, it has found that the fiscal path in the programme diverges somewhat from the requirements of the FDL and recommends that the targets are tightened by 0.1% of GDP in 2017, by 0.4% of GDP in 2018, and by 0.3% of GDP in 2019.

As regards other national fiscal rules, the public debt is projected to stay below 60% throughout the programme, while the monitoring of the expenditure rule and the debt brake rule require detailed data input and are done by the Fiscal Council.

Based on the information provided in the Stability Programme, the past and planned fiscal performance in Latvia appears to comply only partially with the requirements of the applicable national numerical fiscal rules. However, monitoring of the national rules requires considerably more detailed information than what is provided in the programme, and is done in a transparent and proactive manner by the national Fiscal Council.

The Stability Programme points out that the document also serves as a national medium-term fiscal plan in the meaning of the Regulation 473/2013. There is no explicit information on expected economic returns on non-defence public investment projects with significant budgetary impact presented in the Stability Programme and the national reform programme, while the national reform programme provides details on a number of projects involving public financing. The macroeconomic forecast underlying the Stability Programme has been endorsed by the Fiscal Council on 19 February 2016[11].

[10] See the Fiscal Discipline Monitoring Interim Report on Latvia's Stability Programme for 2016-2019, http://fiscalcouncil.lv/files/uploaded/FDP_1_08_591_20160411_Interim_report.pdf

[11] See http://fiscalcouncil.lv/files/uploaded/FDP_1_08_355_20160219_macroeconomic_forecasts_MoF.pdf

7. CONCLUSIONS

The Stability Programme targets a headline deficit of 1% of GDP over the period 2016-2018 and 0.5% of GDP in 2019. For 2015, the estimated structural adjustment is in line with the required adjustment path towards the MTO as the deviation is within the limit allowed by the systemic pension reform clause. For 2016, an improvement of the structural balance of 0.3% of GDP is in line with the required adjustment towards the MTO. However, the growth rate of government expenditure, net of discretionary revenue measures, is foreseen to exceed the applicable expenditure benchmark rate by 0.8% of GDP and 1.1% of GDP based on the Stability Programme. The overall assessment points to a risk of some deviation from the recommended adjustment path towards the MTO in 2016. For 2017, the planned structural adjustment is in line with the required adjustment path towards the MTO, but the average expenditure growth over 2016 and 2017 points to a risk of some deviation, following an overall assessment.

8. ANNEX

Table I. Macroeconomic indicators

	1998-2002	2003-2007	2008-2012	2013	2014	2015	2016	2017
Core indicators								
GDP growth rate	5.6	9.9	-2.3	3.0	2.4	2.7	2.8	3.1
Output gap [1]	-0.7	5.3	-5.4	0.4	1.2	1.7	1.8	1.7
HICP (annual % change)	2.7	6.5	4.8	0.0	0.7	0.2	0.2	2.0
Domestic demand (annual % change) [2]	6.1	12.7	-4.5	2.1	0.9	3.0	3.5	3.7
Unemployment rate (% of labour force) [3]	13.7	9.3	15.2	11.9	10.8	9.9	9.6	9.3
Gross fixed capital formation (% of GDP)	24.8	31.1	24.3	23.2	22.9	22.8	22.7	22.7
Gross national saving (% of GDP)	17.9	20.6	23.7	22.0	21.5	20.8	19.5	19.7
General Government (% of GDP)								
Net lending (+) or net borrowing (-)	**-2.1**	**-0.9**	**-5.2**	**-0.9**	**-1.6**	**-1.3**	**-1.0**	**-1.0**
Gross debt	**12.1**	**11.7**	**37.4**	**39.1**	**40.8**	**36.4**	**39.8**	**35.6**
Net financial assets	**n.a**	**4.4**	**-9.3**	**-13.8**	**-14.4**	**n.a**	**n.a**	**n.a**
Total revenue	35.1	33.7	35.3	36.1	35.9	35.9	35.8	36.4
Total expenditure	37.2	34.6	40.4	37.0	37.5	37.2	36.8	37.3
of which: Interest	0.8	0.5	1.4	1.5	1.4	1.3	1.1	1.0
Corporations (% of GDP)								
Net lending (+) or net borrowing (-)	**-3.2**	**-9.2**	**5.6**	**5.6**	**5.6**	**4.2**	**2.1**	**2.0**
Net financial assets; non-financial corporations	**n.a**	**-96.8**	**-126.2**	**-117.1**	**-121.0**	**n.a**	**n.a**	**n.a**
Net financial assets; financial corporations	**n.a**	**-2.1**	**6.2**	**0.8**	**-1.0**	**n.a**	**n.a**	**n.a**
Gross capital formation	21.8	26.0	16.9	17.2	16.7	14.8	15.3	14.6
Gross operating surplus	31.2	31.6	30.8	33.1	31.3	29.2	27.8	27.4
Households and NPISH (% of GDP)								
Net lending (+) or net borrowing (-)	**-2.5**	**-4.1**	**-0.2**	**-4.2**	**-2.8**	**-1.5**	**-1.2**	**-0.9**
Net financial assets	**n.a**	**30.3**	**36.1**	**50.1**	**72.0**	**n.a**	**n.a**	**n.a**
Gross wages and salaries	33.8	35.6	38.2	36.3	38.3	39.7	40.2	40.3
Net property income	10.9	8.9	4.8	4.7	4.0	3.6	2.8	3.4
Current transfers received	16.7	17.1	18.9	16.9	17.1	17.8	18.2	18.4
Gross saving	-0.2	1.4	3.6	-1.8	-0.5	1.4	2.0	2.3
Rest of the world (% of GDP)								
Net lending (+) or net borrowing (-)	**-7.8**	**-14.2**	**0.3**	**0.4**	**1.2**	**1.6**	**0.0**	**0.1**
Net financial assets	**n.a**	**64.2**	**93.2**	**80.0**	**64.1**	**n.a**	**n.a**	**n.a**
Net exports of goods and services	-10.1	-16.5	-5.1	-3.2	-2.2	-1.4	-2.0	-2.6
Net primary income from the rest of the world	0.0	-1.8	1.3	-0.2	-0.2	-0.3	-1.0	-0.5
Net capital transactions	0.3	1.2	2.2	2.5	3.2	2.8	2.6	2.6
Tradable sector	51.9	47.8	46.3	45.5	44.5	44.0	n.a	n.a
Non tradable sector	37.5	41.3	43.4	43.4	44.1	44.5	n.a	n.a
of which: Building and construction sector	5.8	6.7	6.3	5.8	6.0	5.8	n.a	n.a
Real effective exchange rate (index, 2000=100)	78.3	86.1	107.2	103.2	107.3	110.2	112.2	113.3
Terms of trade goods and services (index, 2000=100)	96.9	98.1	100.6	100.7	99.9	101.6	102.1	102.0
Market performance of exports (index, 2000=100)	76.4	86.9	100.4	104.2	103.8	101.3	98.6	96.7

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 2016 spring forecast