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COMMISSION STAFF WORKING DOCUMENT

Analysis of the updated Draft Budgetary Plan of Latvia

Accompanying the document

COMMISSION OPINION

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1. INTRODUCTION

Due to the general election on 6 October 2018, on 15 October 2018 the outgoing government submitted a no-policy-change Draft Budgetary Plan in compliance with Regulation (EU) No 473/2013. The new government took office on 23 January 2019 and on 19 February 2019 it submitted an updated Draft Budgetary Plan for 2019. Latvia is subject to the preventive arm of the Stability and Growth Pact and should achieve 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 updated Draft Budgetary Plan and provides an assessment based on Commission ad hoc forecast[1] prepared for this assessment. The following section presents the recent and planned fiscal developments, according to the updated Draft Budgetary Plan, including an analysis of risks to their achievement based on the Commission ad hoc 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 UPDATED DRAFT BUDGETARY PLAN

With the exception of 2018 GDP growth, which is based on the flash estimate for fourth quarter of 2018, the macroeconomic scenario underlying Latvia's updated Draft Budgetary Plan has remained unchanged from the one underlying the no-policy change plans submitted in Autumn 2018. The scenario forecasts real GDP growth to have reached 4.8% in 2018 and expects it to slow to 3.0% in 2019, as investment growth moderates from the high growth rates of the past two years. Moreover, weakening external demand is expected to weigh on export growth in 2019. However, solid private consumption growth will ensure that GDP growth remains relatively high. HICP inflation is forecast at 2.5% in both 2018 and 2019

[1] The Commission published its winter 2019 forecast (interim) on 7 February 2019. It only includes projections for GDP growth and inflation. In order to assess the updated Draft Budgetary Plan, the Commission complemented its winter 2019 forecast for Latvia by a fully-fledged “ad-hoc” forecast, including in particular projections for the general government balance and the structural balance.

down from 2.9% in 2017, while the GDP deflator is forecast at 3.1% in both 2018 and 2019. Employment growth for 2018 is projected at 1.2% and 0.1% for 2019. The unemployment rate is set to continue decreasing in 2019 to 7.4% compared with 7.7% in 2018. Annual wage growth is forecast at 8.3% in 2018 and is set to slow down in 2019 to 6.0%.

Compared with the scenario underlying the Stability Programme, GDP growth for 2018 is 0.8 percentage points higher, primarily due to better investment performance. Exports have also been revised upwards, but private consumption is slightly lower. 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 3.2% in 2018 and to diminish to 2.5% in 2019. Based on the Commission ad hoc forecast, the positive output gap is estimated to peak at 2.8% in 2018 before receding to 2.1% in 2019. The differences between the two sets of estimates are explained by the different forecasts for unemployment rate and wage growth. The Commission's ad hoc forecast takes into account the actually reported unemployment rate for 2018, which was 7.4% according to Eurostat.

Compared with the Commission ad hoc forecast, the updated Draft Budgetary Plan is slightly more optimistic about real GDP growth in 2018 and slightly more cautious about the real GDP growth 2019.

The updated 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. According to the Commission ad hoc forecast, the risks are tilted to the downside as positive risks for 2019 related to EU fund inflows are limited because they have already materialised in 2018. Whereas on the negative side, the slowing European economy may weigh on domestic sentiment and hence domestic demand in addition to negatively affecting export growth.

To conclude, the updated Draft Budgetary Plan is based on plausible assumptions for both years.

Box 1: The macro economic forecast underpinning the budget in Latvia

The macroeconomic forecast underlying the updated 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[2]. 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.

[2] http://fiscalcouncil.lv/15102018-macroeconomic-forecast-endorsement

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. Finally, the Fiscal Discipline Council called for strengthening of the risk analysis part of the macroeconomic projections.

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	4.8	4.7	3.4	3.0	3.1
Private consumption (% change)	4.1	6.1	4.2	4.6	3.5	4.2	4.2
Gross fixed capital formation (% change)	13.1	11.2	14.1	15.3	9.0	6.3	2.5
Exports of goods and services (% change)	6.2	4.0	5.0	2.7	3.9	4.1	2.4
Imports of goods and services (% change)	8.9	7.6	5.7	6.4	4.7	5.5	2.6
Contributions to real GDP growth:							
- Final domestic demand	5.8	6.6	4.8	6.7	4.6	4.1	3.3
- Change in inventories	0.3	-0.1	-1.4	0.3	-0.5	-0.6	0.0
- Net exports	-1.5	-2.5	-0.6	-2.3	-0.8	-1.1	-0.2
Output gap[1]	1.8	2.2	3.2	2.8	1.6	2.5	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	7.4	7.7	7.4	7.1
Labour productivity (% change)	4.7	3.9	3.0	3.2	3.4	2.9	2.8
HICP inflation (%)	2.9	2.8	2.5	2.6	2.4	2.5	2.7
GDP deflator (% change)	3.2	3.1	3.1	3.2	3.0	3.1	2.7
Comp. of employees (per head, % change)	8.0	8.0	8.3	7.8	6.0	6.0	6.2
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	1.5	-1.6	2.7	0.9	-2.3	2.1	1.2

Note:

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

Source:

Stability Programme 2018 (SP); Draft Budgetary Plan for 2019 (DBP); Commission ad hoc forecast (COM); Commission calculations

3. Recent and planned fiscal developments

3.1. Deficit developments

The updated Draft Budgetary Plan estimates a headline deficit of 0.7% of GDP in 2018, compared to the deficit target of 0.9% of GDP in the Stability Programme (Table 2) and the deficit estimate of 0.8% of GDP of the no-policy change Draft Budgetary Plan. The improvement since the Stability Programme is mostly on the revenue side. Notably, corporate income tax revenue surprised on the back of better-than-expected company profits in the previous year and the government received more in dividends than planned as well. On the expenditure side, social spending is estimated to be lower than planned in the Stability Programme, but public investment is expected to exceed the plans[3]. The estimated increase in investment by 1 percentage point of GDP between 2017 and 2018 surpasses the earlier plans and is strongly linked to a higher implementation of EU-financed projects. Those projects that are implemented by government entities are reflected in both government revenue and expenditure, but an increase in the government deficit is limited to the co-financing part.

The Commission ad hoc forecast of the government deficit of 0.7% of GDP corresponds to that of the updated Draft Budgetary Plan. Revenue and expenditure estimates for 2018 also correspond to those of the updated Draft Budgetary Plan, except for different expenditure recording among subsidies, investment and other expenditure, while their total amount is broadly similar. The Commission estimate of the general government nominal budget balance in 2018 is in line with the general government data for the first three quarters of 2018 and the government cash data for the full year.

The updated Draft Budgetary Plan plans a nominal government deficit of 0.5% of GDP for 2019, as compared with the target of 0.9% of GDP in the Stability Programme. The current target is also better than the 0.7% of GDP deficit envisaged in the no-policy-change Draft Budgetary Plan. The revenue (as a share of GDP) is planned to contract by 1 percentage point and the expenditure by 1.1 percentage point as compared with the previous year. However, the contraction is ¾ percentage points less pronounced than under the no-policy-change scenario. This difference is due to the announced expenditure-increasing measures of 0.6% of GDP, revenue-increasing measures of 0.35% of GDP and other upward revenue revisions amounting to 0.4% of GDP. The latter includes multiple minor revenue revisions and exceptional revenues from an unusually large amount of CO_2 emission sales in 2018, which are recorded in 2019 on an accrual basis and amount to 0.2% of GDP[4]. Due to increase in wages to medical personnel and other public sector employees, the public expenditure for compensation of employees is planned to increase by 0.3 percentage points of GDP, while purchases of goods and services are planned to contract by 0.6 percentage points of GDP. The government investment-to-GDP ratio is set to moderate in 2019 after a notable increase in 2018, but its level is higher than expected in the Stability Programme and the no-policy-change Draft Budgetary Plan. On the revenue side, the outlook remains broadly unchanged for taxes that are set to develop in line with the macroeconomic projections, except for somewhat higher labour taxes linked to the planned public sector wage increase. Changes in other revenue demonstrate the effect of the exceptional revenues related to income from the CO_2 emission sales and an updated profile of the EU-financed investments, which are reflected in both government revenue and expenditure.

[3] In Table 2, numbers for the Stability Programme are not directly comparable to those of the updated Draft Budgetary Plan, as data for 2017, which is used as starting position for estimates for 2018 and 2019, changed, due to statistical revisions.

[4] The statistical treatment of the measure follows the statistical accounting principles used so far by the Latvian statistical office. It may change in case of a new guidance from Eurostat.

Table 2. Composition of the budgetary adjustment

(% of GDP)	2017	2018			2019			Change: 2017-2019
	COM	SP	DBP	COM	SP	DBP	COM	DBP
Revenue	**37.2**	**36.8**	***37.4***	**37.6**	**36.1**	***36.4***	**36.9**	**-0.8**
of which:								
- Taxes on production and imports	13.9	14.3	*14.0*	14.0	14.4	*14.1*	14.2	0.2
- Current taxes on income, wealth, etc.	8.5	7.1	*7.4*	7.5	6.5	*6.6*	6.9	-1.9
- 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*	9.4	9.4	*9.5*	9.4	0.8
- Other (residual)	6.1	5.9	*6.6*	6.7	5.8	*6.2*	6.4	0.1
Expenditure	**37.8**	**37.8**	**38.0**	**38.3**	**37.1**	**36.9**	**37.5**	**-0.9**
of which:								
- Primary expenditure	36.9	37.0	37.2	37.5	36.2	36.1	36.7	-0.8
of which:								
Compensation of employees	10.2	10.5	10.2	10.2	10.1	10.5	10.5	0.3
Intermediate consumption	5.7	6.4	6.0	5.9	6.2	5.4	5.4	-0.3
Social payments	11.7	11.7	11.6	11.6	11.7	11.7	11.7	0.0
Subsidies	1.3	1.6	1.7	1.2	1.5	1.6	1.1	0.3
Gross fixed capital formation	4.4	4.8	5.4	5.1	4.7	5.3	5.0	0.9
Other (residual)	3.6	2.0	2.3	3.5	2.0	1.6	3.0	-2.0
- Interest expenditure	0.9	0.8	0.8	0.8	0.9	0.8	0.8	-0.1
General government balance (GGB)	**-0.6**	**-0.9**	**-0.7**	**-0.7**	**-0.9**	**-0.5**	**-0.6**	**0.1**
Primary balance	**0.3**	**-0.1**	**0.1**	**0.1**	**0.0**	**0.2**	**0.2**	**-0.1**
One-off and other temporary measures	0.0	0.0	0.0	0.0	0.0	0.1	0.2	0.1
GGB excl. one-offs	**-0.6**	**-0.9**	**-0.7**	**-0.7**	**-0.9**	**-0.6**	**-0.8**	**0.0**
Output gap[1]	1.8	2.2	3.2	2.8	1.6	2.5	2.1	0.7
Cyclically-adjusted balance[1]	-1.3	-1.7	-1.9	-1.7	-1.5	-1.5	-1.4	-0.2
Structural balance (SB)[2]	**-1.3**	**-1.7**	**-1.9**	**-1.7**	**-1.5**	**-1.6**	**-1.6**	**-0.3**
Structural primary balance[2]	-0.3	-0.9	-1.1	-0.9	-0.6	-0.8	-0.8	-0.4

Notes*:*

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

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

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

The Commission ad hoc forecast projects a government deficit of 0.6% of GDP in 2019. The government revenue and expenditure (as a share to GDP) are forecast to contract by 0.7 and 0.8 percentage points, respectively. That forecast is slightly more positive on tax revenue and expenditure developments in 2019 than the updated Draft Budgetary Plan (by 0.3% of GDP for total revenue and expenditure). Tax revenue growth is in line with the projected wage and nominal private consumption developments, which are slightly more positive under the Commission ad hoc forecast than in the updated Draft Budgetary Plan. For expenditure developments, the Commission forecasts a less steep decline in other expenditure than the updated Draft Budgetary Plan. Moreover, the different expenditure distribution between subsidies, investment and other expenditure in the estimates for 2018 are projected to persist in 2019.

The recalculated structural deficit[5] is estimated to decrease from 1.9% of GDP in 2018 to 1.6% of GDP in 2019. It reflects an improvement in the nominal government balance by 0.2 percentage points and a narrowing of the positive output gap. The Stability Programme projected a similar decline in the recalculated structural deficit by 0.2 percentage points of GDP entirely on the back of a smaller positive output gap.

The Commission ad hoc forecast estimates the structural balance at 1.7% of GDP in 2018 and 1.6% of GDP in 2019. This demonstrates an improvement in the nominal balance by 0.1 percentage points of GDP and a less positive output gap in 2019. The structural balance in 2019 excludes a one-off revenue related to income from the CO_2 emission sales, which amounts to 0.1% of GDP according to the updated Draft Budgetary Plan and 0.2% of GDP based on the Commission estimates.

Euro-area sovereign bond yields remain at historically low levels, with 10-year rates in Latvia currently standing at 0.8%[6]. 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 updated 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. It is well below the 1.7% recorded in 2012 at the peak of the euro-area sovereign debt crisis. The Commission ad hoc forecast of interest expenditure in 2019 at 0.8% of GDP is in line with updated Draft Budgetary Plan projections.

The headline deficit target of the updated Draft Budgetary Plan of 0.5% of GDP for 2019 includes the fiscal security reserve of 0.1% of GDP.

Latvia's Fiscal Discipline council plans to publish its assessment of the updated Draft Budgetary Plans in early March 2019.

3.2. Debt developments

The updated Draft Budgetary Plan estimates the government debt ratio to increase in 2019 by almost 1 percentage point to 38.1% of GDP. The increase in the gross debt ratio is underpinned by an expected accumulation of financial resources ahead of a large debt redemption in early 2020.

Based on the Commission ad hoc forecast the debt-to-GDP ratio is projected to decline to 35.7% of GDP by the end of 2019, which assumes a reduction of the previously accumulated cash reserves in 2018 and 2019.

[5] Cyclically adjusted balance net of one-off and temporary measures, recalculated by the Commission using the commonly agreed methodology.
[6] 10-year bond yields as of 7 February 2019. Source: Bloomberg.

Table 3. Debt developments

(% of GDP)	2017	2018			2019		
		SP	DBP	COM	SP	DBP	COM
Gross debt ratio[1]	**40.0**	**38.4**	**37.2**	**37.4**	**37.4**	**38.1**	**35.7**
Change in the ratio	-0.3	-1.6	-2.8	-2.5	-1.0	0.9	-1.7
Contributions [2] :							
1. Primary balance	**-0.3**	**0.1**	**-0.1**	**-0.1**	**0.0**	**-0.2**	**-0.2**
2. "Snow-ball" effect	**-2.0**	**-1.8**	**-2.1**	**-2.1**	**-1.4**	**-1.4**	**-1.3**
Of which:							
Interest expenditure	0.9	0.8	0.8	0.8	0.9	0.8	0.8
Growth effect	-1.7	-1.5	-1.8	-1.7	-1.2	-1.1	-1.1
Inflation effect	-1.2	-1.1	-1.1	-1.2	-1.1	-1.1	-1.0
3. Stock-flow adjustment	**2.1**	**0.2**	**-0.5**	**-0.2**	**0.4**	**2.6**	**-0.2**
Of which:							
Cash/accruals difference							
Net accumulation of financial							
of which privatisation proceeds							
Valuation effect & residual							

Notes:

[1] End of period.

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

Source:

Stability Programme 2018 (SP); Draft Budgetary Plan for 2019 (DBP); Commission ad hoc forecast (COM); Commission calculations

3.3. Measures underpinning the updated draft budgetary plan

The updated Draft Budgetary Plan presents revenue-increasing measures of 0.35% of GDP and expenditure-increasing measures of 0.6% of GDP. Those measures have been announced by the new government since the no-policy change Draft Budgetary Plan.

The spending measures mostly reflect a 20% wage increase for medical personnel (amounting to 0.3% of GDP) and wage increases for judges and prosecutors, and providing special pensions for employees under the Ministry for interior affairs (0.1% of GDP). Other expenditure increases are mostly adjustments to the budgetary projection — lowering the social spending forecast (0.1% of GDP), while increasing spending for some other government functions. This also reflects the results of the 2018 spending review, which identified some 0.2% of GDP in spending to be reallocated for other spending priorities.

The revenue-increasing measures include an increase in dividends from the State forest management company (0.1% of GDP) and several tax compliance measures targeting unlicensed online gambling and the underreporting of wages in the construction sector. Moreover, the updated Draft Budgetary Plan counts the positive effect of wage increases on labour tax revenue of more than 0.1% of GDP as a separate discretionary measure. It is not treated as a separate revenue measure under the Commission ad hoc forecast, but the effect of the higher gross wage growth is reflected in tax revenue projections. The Commission ad hoc forecast is also cautious on the yield of tax compliance measures, while the size of the measures and difference in assessment relative to the updated Draft Budgetary Plan are small.

Table 4. Main discretionary measures reported in the updated DBP

A. Discretionary measures taken by General Government - revenue side

Components	Budgetary impact (% GDP) (as reported by the authorities)		
	2019	**2020**	**2021**
Taxes on production and	0,0	0,0	0,0
Current taxes on income,	0,1	-0,05	0,0
Capital taxes	0,0	0,0	0,0
Social contributions	0,1	0,04	0,1
Property Income	0,1	-0,1	0,0
Other	0,0	0,0	0,0
Total	0,3	-0,11	0,0

Note:
The budgetary impact in the table is the aggregated impact of measures as reported in the DBP, i.e. by the national authorities. A positive sign implies that revenue increases as a consequence of this measure.
Source: Draft Budgetary Plan for 2019

B. Discretionary measures taken by general Government- expenditure side

Components	Budgetary impact (% GDP) (as reported by the authorities)		
	2019	**2020**	**2021**
Compensation of employees	0.3	0.0	0.0
Intermediate consumption	0.0	0.0	0.0
Social payments	0.0	0.0	0.0
Interest Expenditure	0.0	0.0	0.0
Subsidies	0.0	0.0	0.0
Gross fixed capital formation	0.0	0.0	0.0
Capital transfers	0.0	0.0	0.0
Other	0.3	-0.2	0.1
Total	0.6	-0.2	0.1

Note:
The budgetary impact in the table is the aggregated impact of measures as reported in the DBP, i.e. by the national authorities. A positive sign implies that expenditure increases as a consequence of this measure.
Source: Draft Budgetary Plan for 2019

The updated Draft Budgetary Plan details adjustments to revenue projections amounting to 0.4% of GDP. That figure includes higher self-earned revenue and higher EU funding-related revenue. In particular, revenue from an unusually high amount of CO_2 emission allowances sold in 2018 is recorded as one-off revenue in 2019 on an accrual basis. That allowance was awarded to Latvia from the previous emission-trading period of 2008-2012, following a judgment of the Court of Justice. The sale of the emission allowances created exceptional revenue for the government and therefore is considered to be one-off in the Commission ad hoc forecast. The updated Draft Budgetary Plan estimates the one-off effect at 0.1% of GDP and this estimate excludes the effect of market price increase of the allowances relative to the past years. However, the Commission ad hoc forecast considers the entire revenue derived from the sale of the allowance to be one-off, therefore amounting to 0.2% of GDP.

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

Latvia is subject to the preventive arm of the Pact and achieve its medium-term budgetary objective. Box 2 reports the latest country-specific recommendations in the area of public finances.

Box 2. Council recommendations addressed to Latvia

On 13 July 2018, 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.

According to the Commission ad hoc forecast Latvia is expected to meet its MTO in 2018, taking into account the allowances linked to the implementation of the systemic pension reform and of the structural reforms, and in line with the arrangements in place for updating the fiscal requirements contained in the country-specific recommendations[7], the nominal growth rate of net primary government expenditure should not exceed 4.8%, which corresponds to an improvement in the structural balance by 0.2% of GDP.

Adjustment towards the MTO

Latvia has been granted a temporary increase in its structural deficit 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 2019[8]. The combination of those 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 updated Draft Budgetary Plan indicates a breach of the expenditure benchmark by 0.4% of GDP and a gap from the structural adjustment 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, which is 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 on the basis of the data then

[7] Those arrangements, known as the ‘unfreezing’ principle, are referred to in the Opinion of the Economic and Financial Committee of the Council on “Improving the predictability and transparency of the SGP: A stronger focus on the expenditure benchmark in the preventive arm”, of 29 November 2016, and have been specified further in the subsequent discussions with the Member States.

[8] 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.

available. Overall, the updated Draft Budgetary Plan indicates a risk of some deviation from the requirements of the preventive arm of the SGP in 2018.

For 2019, the updated Draft Budgetary Plan suggests compliance with both the expenditure benchmark (a positive gap of 0.3% of GDP over one year) and the structural balance (a positive gap of 0.1% of GDP over one year) requirements. Some deviation from structural balance requirement over 2018 and 2019 on average (negative gap of 0.1% of GDP) is driven by the estimated deviation in 2018. Overall, the updated Draft Budgetary Plan points to some deviation from the requirements in 2019.

Based on the Commission ad hoc forecast, Latvia is expected to have met its MTO in 2018 and to be close to the MTO in 2019 (gap of 0.1% of GDP), when taking into account the allowances linked to the implementation of the systemic pension reform and of the structural reforms. Thus, the current assessment points to compliance in 2018 and broad compliance in 2019.

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 4.8% in 2019, corresponding to a maximum deterioration of the structural balance by 0.3% in 2018 and an adjustment of 0.2% of GDP in 2019. Based on the Commission ad hoc forecast, the expenditure benchmark would currently point to a risk of a significant deviation from those requirements in 2018 and over two years 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 particular the possible ex-post unfreezing of the requirements and the different potential growth estimates underlying the structural balance and the expenditure benchmark.

Table 5: Compliance with the requirements of the preventive arm

(% of GDP)	2017	2018		2019	
Initial position[1]					
Medium-term objective (MTO)	-1.0	-1.0		-1.0	
Structural balance[2] (COM)	-1.3	-1.7		-1.6	
Structural balance based on freezing (COM)	-1.4	-1.7		-	
Position vis-a -vis the MTO[3]	At or above the MTO	Not at MTO		Not at MTO	
(% of GDP)	**2017**	**2018**		**2019**	
	COM	**DBP**	**COM**	**DBP**	**COM**
Structural balance pillar					
Required adjustment[4]	0.0	0.4		0.6	
Required adjustment corrected[5]	-1.4	-0.3		0.2	
Change in structural balance[6]	-1.0	-0.6	-0.5	0.4	0.1
One-year deviation from the required adjustment [7]	0.5	-0.4	-0.2	0.1	-0.1
Two-year average deviation from the required adjustment [7]	0.7	0.0	0.1	-0.1	-0.1
Expenditure benchmark pillar					
Applicable reference rate[8]	6.0	6.0		4.8	
One-year deviation adjusted for one-offs [9]	-0.2	-0.4	-0.9	0.3	-0.3
Two-year average deviation adjusted for one-offs [9]	-0.2	-0.3	-0.6	0.0	-0.6

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 20XX-1) was carried out on the basis of Commission 20XX spring forecast.

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

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

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

Source :
Draft Budgetary Plan for 2019 (DBP); Commission ad hoc forecast (COM); Commission calculations.

5. Composition of public finances and implementation of fiscal structural reforms

According to the updated Draft Budgetary Plan, the government revenue (as a share of GDP) is planned to fall by around 1 percentage point in 2019 as compared to the level in 2017 and 2018. That reduction broadly corresponds to a decline in the overall tax burden, which is linked to the costs of the tax reform announced in 2017 and implemented over the period of 2018-2020.

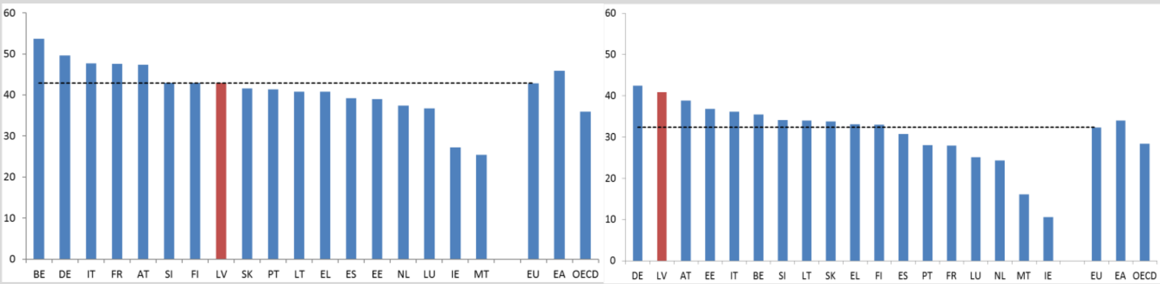
Latvia has not responded with any new measures to the fiscal-structural recommendation to shift tax burden from low-income earners to capital and property and to improve tax compliance, as no policy changes are presented at this stage. The updated Draft Budgetary Plan demonstrates continued implementation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

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

The tax burden on labour in the euro area is relatively high, which weighs on economic activity and employment. Against that 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 those 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, the Council recommended to Latvia to "(..) Reduce taxation for low-income earners by shifting it to other sources, particularly capital and property, and by improving tax compliance."

Latvia's updated 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, which is still high relative to other Member States.

6. OVERALL CONCLUSION

The information contained in the updated Draft Budgetary Plan indicates a risk of some deviation from the requirements of the preventive arm of the SGP in 2018 and 2019. According to the Commission ad hoc forecast, the structural balance is expected to be at the medium-term objective in 2018 and marginally below it in 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 at or 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.