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COMMISSION OPINION

of 22.11.2017

on the Draft Budgetary Plan of Latvia

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GENERAL CONSIDERATIONS

1. Regulation (EU) No 473/2013 sets out provisions for enhanced monitoring of budgetary policies in the euro area for ensuring that national budgets are consistent with the economic policy guidance issued in the context of the Stability and Growth Pact (SGP) and the European Semester for economic policy coordination.

2. Article 6 of Regulation (EU) No 473/2013 requires Member States to submit annually to the Commission and to the Eurogroup a Draft Budgetary Plan presenting by 15 October the main aspects of the budgetary situation of the general government and its subsectors for the forthcoming year.

CONSIDERATIONS CONCERNING LATVIA

3. On the basis of the Draft Budgetary Plan for 2018 submitted on 11 October 2017 by Latvia, the Commission has adopted the following opinion in accordance with Article 7 of Regulation (EU) No 473/2013.

4. Latvia is subject to the preventive arm of the Pact and should preserve a sound fiscal position which ensures compliance with its medium term budgetary objective (MTO) of -1.0% of GDP 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.

5. The real GDP growth forecast appears to be cautious in 2017 and plausible in 2018, as compared to the Commission 2017 autumn forecast. The macroeconomic scenario underlying Latvia's Draft Budgetary Plan forecasts GDP growth to increase from 2.0% in 2016 to 3.7% in 2017, and to slow down to 3.4% in 2018, reflecting a recovery in the EU fund-driven investment cycle in 2017 and normalisation in 2018. The nominal GDP growth projections are in line with the Commission forecast.

6. Latvia complies with the requirement of Regulation EU No 473/2013 that the draft budget has to be based on independently endorsed or produced macroeconomic forecasts. The macroeconomic forecasts underlying the Draft Budgetary Plan have been endorsed by the Fiscal Discipline Council.

7. The Draft Budgetary Plan estimates the government deficit at 0.9% of GDP in 2017, as compared to 0.8% of GDP in the April 2017 Stability Programme. The fiscal position is estimated to have improved by 0.4% of GDP due to better-than-projected revenues, but the decision to early settle some support for electricity production increases the deficit by 0.5% of GDP in 2017. The deficit target for 2018 of 1.0% of GDP demonstrates a notable improvement from the planned deficit of 1.6% of GDP in the Stability Programme. This largely stems from the changes to the tax reform, delaying the revenue-decreasing effect of the corporate tax changes, lowering the costs of the personal income tax changes and specifying additional revenue-increasing measures.

8. The Draft Budgetary Plan presents the measures announced at the time of the budget preparation and the tax reform measures adopted in July 2017. The reduction of the standard rate of personal income tax from 23% to 20% has a negative impact of 0.8% of GDP while the changes in corporate income tax reduce revenues by 0.3% of GDP. This is partly compensated by the increase in excise duties, tightening VAT administration and aligning taxes on both wage and capital income at a 20% rate. Moreover, the social contributions rate is increased by 1.0 percentage point, which is ear-marked for financing an increase in healthcare spending of 0.7% of GDP. Other spending increases amount to 0.5% of GDP, including for family benefits and road infrastructure. The spending measures are financed from revised revenue projections and through the expenditure review process.

9. The Commission forecast projects a government deficit of 0.9% of GDP in 2017 and of 1.0% of GDP in 2018, which corresponds to the targets of the Draft Budgetary Plan. Risks to the budgetary targets are mostly related to uncertainty over the revenue impact of the tax policy changes, notably given the reliance on higher tax compliance measures. These risks are balanced by the provision of a fiscal security reserve of 0.1% of GDP and possible delays in the implementation of the investment plans.

10. In 2017, the real growth rate of net primary government expenditure is estimated to be well below the applicable expenditure benchmark rate of 5%, with a gap of 1.9% of GDP. However, the recalculated structural balance[1] is expected to fall short of the requirement by 0.1% of GDP. The structural balance is affected by temporary investment fluctuations and a revenue shortfall. Considering these factors, the overall assessment points to compliance in 2017. Following the same reasoning, the Commission autumn forecast confirms compliance with the requirements of the preventive arm.

    In 2018, the nominal growth rate of net primary government expenditure is estimated to exceed the applicable expenditure benchmark rate of 6%[2], leading to a deviation of 0.4% of GDP, despite the benchmark rate being higher than in 2017. At the same time, the recalculated structural balance suggests compliance with the fiscal requirement. The medium-term growth rate of potential output underlying the expenditure benchmark is affected by the years of the post-crisis fiscal adjustments up to 2014 and a number of shocks hitting external demand and investment until 2016. Considering this, the expenditure benchmark is still projected to be missed by 0.1% of GDP. This points to some deviation based on the Draft Budgetary Plan. However, based on the Commission forecast, the gap on the basis of the expenditure benchmark is somewhat smaller and actually points to compliance with the requirements of the preventive arm after taking into account the above-mentioned elements affecting the underlying estimate of potential growth.

11. The Draft Budgetary Plan presents measures that respond to the Council Recommendation of 11 July 2017[3] to reduce taxation for low-income earners by shifting it to other sources that are less detrimental to growth and by improving tax

[1] Cyclically adjusted balance net of one-off and temporary measures, recalculated by the Commission using the commonly agreed methodology.

[2] As part of the agreement on the EFC Opinion on "Improving the predictability and transparency the SGP: a stronger focus on the expenditure benchmark in the preventive arm", which was adopted by the EFC on 29 November 2016, the expenditure benchmark, that is the maximum allowable growth rate of expenditure net of discretionary revenue measures, is expressed in nominal terms as from 2018.

[3] OJ C 261, 9.8.2017

compliance. The measures do not sufficiently reduce the high tax wedge on low income earners, which remains relatively high compared with the EU average. Among the measures, the increase in the basic allowance for personal income tax is the most effective at reducing the high tax wedge on low income earners, but it represents only a fraction of the total cost of the reform. Tax policy changes are overall regressive, as the medium and high income groups benefit more than the low income groups. The target of a tax revenue share of one third of GDP is not reached, which limits the government's capacity to deliver public services for a sustainable economic development.

The past fiscal adjustment between 2011 and 2017 relied on an increase in revenue share in GDP. The Draft Budgetary Plan foresees an increase in both the revenue and the expenditure ratio to GDP, in contrast with the Commission forecast. An expansion of public wage bill has driven an increase in expenditure share in GDP in 2011-2017. The Draft Budgetary Plan foresees a reduction in the wage share in GDP in 2018, while the Commission forecast and the policy measures point in the opposite direction.

12. Overall, the Commission is of the opinion that the Draft Budgetary Plan of Latvia, which is currently under the preventive arm, is compliant with the provisions of the Stability and Growth Pact. The Commission invites the authorities to implement the 2018 budget.

The Commission is also of the opinion that Latvia has made some progress with regard to the structural part of the fiscal recommendations contained in the Council Recommendation of 11 July 2017 in the context of the 2017 European Semester and invites the authorities to make further progress. A comprehensive assessment of progress made with the implementation of the country-specific recommendations will be made in the 2018 Country Reports and in the context of the country-specific recommendations to be proposed by the Commission in May 2018.

Done at Brussels, 22.11.2017

For the Commission
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Member of the Commission