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COMMISSION STAFF WORKING DOCUMENT

Analysis of the draft budgetary plans of Latvia

Accompanying the document

COMMISSION OPINION

on the draft budgetary plan of Latvia

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COMMISSION STAFF WORKING DOCUMENT

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COMMISSION OPINION

on the draft budgetary plan of Latvia

1. INTRODUCTION

Latvia has submitted its Draft Budgetary Plan for 2017 on 14 October in compliance with Regulation (EU) No 473/2013 of the Two-Pack. Latvia is subject to the preventive arm of the Pact and should ensure sufficient progress towards its medium-term budgetary objective (MTO).

Section 2 of this document presents the macroeconomic outlook underlying the Draft Budgetary Plan and provides an assessment based on the Commission Forecast. The following section presents the recent and planned fiscal developments, according to the Draft Budgetary Plan, including an analysis of risks to their achievement based on the Commission 2016 autumn forecast. In particular, it also includes an assessment of the measures underpinning the Draft Budgetary Plan. Section 4 assesses the recent and planned fiscal developments in 2016-2017 (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 adopted by the Council in the spring of 2016, including those to reduce the tax wedge. Section 6 summarises the main conclusions of the present document.

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2. MACROECONOMIC DEVELOPMENTS UNDERLYING THE DRAFT BUDGETARY PLAN

Latvia's economy grew by 2.7% in 2015, supported by strong domestic demand and despite a significant drop in trade with Russia. The growth rate in the DBP is projected at 2.5% in 2016 as compared to 3.0% in the 2016 Stability Programme. The downward revision reflects weaker exports and a substantially lower investment growth due to delays in the use of EU funds under the new programme period. The negative impact on GDP is estimated to be mitigated by a large accumulation of inventories. With the assumed rebound in EU funding and a recovering external sector, growth is projected to reach 3.5% in 2017 as compared to 3.3% in the Stability Programme. Inflation is projected to pick up from 0% in 2016 to 1.6% in 2017 in the DBP, slightly below the projections of the 2016 Stability Programme.

The Commission autumn forecast points to weaker economic growth rates of 1.9% in 2016 and 2.8% in 2017. While the Commission assumes similar fluctuations in investment to those of the DBP, the fall in investment in 2016 is expected to be smaller than in the DBP. This is also the case for the contribution of net exports. The main explanation for the lower GDP growth in the Commission forecast is the more cautious approach towards the build-up of inventories. For 2017, the Commission forecast of GDP growth is lower than that of the DBP as a higher private consumption growth is more than offset by a slower rebound in investment. HICP is broadly similar in 2016, but somewhat higher in the Commission forecast for 2017 at 1.8%.

The risks to the DBP forecast are mainly linked to possible further delays in the absorption of EU funds that could have a significant effect on the pace of recovery of investments. This risk is partly mitigated by recent reports on construction works in progress and the number of new building contracts. The uncertain external environment is also posing risks, as the government forecast assumes a substantial export rebound in 2017.

Overall, the GDP growth assumptions in the DBP appear somewhat optimistic. The main downside risks refer to less tax-intensive components such as investments and exports, while the DBP appears cautious on the outlook for private consumption.

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

The macroeconomic forecast underlying the DBP as prepared by the Ministry of Finance was endorsed by the Fiscal Discipline Council on 16 June 2016[1]. The Fiscal Discipline Council's monitoring report of 8 October[2] considers the macroeconomic forecast for the horizon period as realistic, while calling for maintaining vigilance with regard to real GDP growth and inflation.

The Fiscal Discipline Council was established in January 2014 as a functionally and financially independent body with the purpose of monitoring the compliance with the Fiscal Discipline Law. The function of endorsement of the macroeconomic forecasts by the Fiscal Discipline Council was formally agreed upon in the Memorandum of Understanding signed with the Ministry of Finance on 8 February 2016.

[1] A letter to the Ministry of Finance, published on the websites of the Fiscal Discipline Council and the Ministry of Finance: http://fiscalcouncil.lv/files/uploaded/FDP_1_08_898_20160616_makroekonomikas_prognozes_FM_EN.pdf

[2] http://fiscalcouncil.lv/files/uploaded/FDP_1_08_1186_20161005_FCSR.pdf

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The Fiscal Discipline Council in its monitoring report assesses that the government broadly complied with the principles of fiscal discipline in 2014 and 2015, while an assessment of the accumulated deviation from fiscal targets in 2015 and 2016 will be done at a later stage. However, the Council recommends that the DBP's deficit target for 2017 is tightened by 0.1% of GDP, based on the Council's interpretation of the prevailing fiscal rule, and finds that the healthcare reform should not lead to an increase in the deficit. Moreover, the Fiscal Discipline Council recommends setting a clear plan for reaching the tax revenue target of 1/3 of GDP and quantifying tax revenue risk and expenditure containment options under the sensitivity analysis.

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Table 1. Comparison of macroeconomic developments and forecasts

	2015	2016			2017		
	COM	SP	DBP	COM	SP	DBP	COM
Real GDP (% change)	2.7	3.0	2.5	1.9	3.3	3.5	2.8
Private consumption (% change)	3.5	3.4	4.0	3.8	3.3	3.4	3.9
Gross fixed capital formation (% change)	2.8	4.6	-11.8	-6.5	7.0	9.5	5.5
Exports of goods and services (% change)	2.6	3.0	-0.6	2.0	4.1	3.9	2.6
Imports of goods and services (% change)	2.1	3.8	5.1	3.1	5.3	5.1	4.1
Contributions to real GDP growth:							
- Final domestic demand	3.3	3.6	0.5	1.3	4.2	4.5	4.0
- Change in inventories	-0.8	-0.1	5.5	1.2	0.0	0.0	-0.3
- Net exports	0.3	-0.6	-3.5	-0.7	-0.9	-1.0	-0.9
Output gap[1]	1.5	1.8	1.6	1.4	1.4	2.0	1.3
Employment (% change)	1.4	0.2	0.2	0.3	0.2	0.2	0.5
Unemployment rate (%)	9.9	8.9	9.8	9.6	8.4	9.4	9.2
Labour productivity (% change)	1.4	2.8	2.3	1.5	3.1	3.3	2.3
HICP inflation (%)	0.2	0.4	0.0	-0.1	2.0	1.6	1.8
GDP deflator (% change)	0.4	1.3	0.3	0.8	2.4	1.7	1.8
Comp. of employees (per head, % change)	6.9	5.5	5.5	5.1	5.5	5.5	5.5
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	2.0	-0.4	3.3	2.0	-0.2	1.2	1.0

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 2016 (SP); Draft Budgetary Plan for 2017 (DBP); Commission 2016 autumn forecast (COM); Commission calculations

3. Recent and Planned Fiscal Developments

3.1. Deficit developments

The DBP estimates the headline deficit at 0.9% of GDP in 2016, as compared to 1.0% of GDP in the April 2016 Stability Programme. The improvement is attributed to savings on interest expenditure, contributions to the EU budget and capital expenditure, which are more than offsetting social expenditure overruns. The tax revenue performance is supported by firm consumption and wage growth, and demonstrates signs of improved tax collection. The Commission autumn 2016 forecast estimates a fiscal deficit of 0.8% of GDP in 2016, including a one-off receipt of confiscated illicit money (0.2% of GDP), which is not accounted for in the DBP.

For 2017, the DBP targets a headline deficit of 1.1% of GDP, relative to the 1.0% of GDP in the Stability Programme. The DBP announces net revenue-increasing measures of 0.4% of

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GDP and net expenditure-increasing measures of 0.6% of GDP. Revenue-increasing measures are concentrated on indirect taxes (0.3% of GDP) and non-tax revenues (0.1% of GDP) with limited revision across other revenue items. The main expenditure changes are related to wage-increasing measures (0.3% of GDP) and the upward revision of social expenditure in 2016 (0.2% of GDP).

The Commission forecast of the 2017 headline deficit is 1.1% of GDP, which corresponds to the DBP deficit target. While the Commission's GDP forecast is lower than that underlying the DBP, tax-intensive private consumption and wage dynamics are similar. The Commission forecast also assesses the most recent revenue and expenditure trends and measures in a similar way to the DBP.

Risks to the DBP are lessened by the fact that the headline deficit target for the first time includes a fiscal security reserve of 0.1% of GDP. This reserve is intended to directly offset possible fiscal risks such as risks stemming from the state loans and guarantees (less than 0.1% of GDP) and risks related the winding-down of the "bad bank" Reverta in 2017.

Additional risks to the fiscal targets are related to the balance of the local authorities and implementation of investment plans and revenue measures. The local authorities are estimated to have contributed to the improvement in the general government balance in 2016, including by lower capital spending. A negative surprise in 2017 cannot be excluded, considering local elections in June and uncertainty over investment costs, as an increased demand for construction in 2017 from EU-funded projects may push up construction costs in case of supply constraints. Furthermore, some measures improving revenue collection face opposition on the grounds of their quality and impact on the business environment. One such measure – the application of a tax payment risk assessment during registration of enterprises – has not been implemented for the past three years. Moreover, the one-off receipt of confiscated illicit money in 2017 (0.1% of GDP) depends on the related court proceedings, the outcome of which remains uncertain.

Euro area sovereign bond yields remain at historically low levels. Latvia issued 10-year bonds at the historically low yield of 0.5% on 30 September 2016. This has contributed to a decrease of the interest expenditure to GDP ratio from 1.3% in 2015 to 1.1% in 2016. The DBP plans a further reduction in the interest expenditure ratio to 1% of GDP in 2017, well below the 1.6% recorded back in 2012 at the peak of the euro area sovereign debt crisis. The picture stemming from the DBP is broadly confirmed by the Commission forecast.

The fiscal targets of the DBP are set in line with the national numerical fiscal rules, as estimated by the authorities in the Medium-Term Budgetary Framework for 2017-2019 with the structural deficit target for 2017 being derived from the expenditure continuity rule[3]. However, this assessment of compliance is contested by the Fiscal Discipline Council, which considers that the balance rule should be used as a basis for the 2017 deficit target, implying that the 2017 deficit target of the DBP should be tightened by 0.1% of GDP.

[3] A numerical fiscal rule provided by the Fiscal Discipline Law (Artilce11).

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The recalculated structural deficit[4] is estimated at 1.5% of GDP in 2016 and 1.8% of GDP in 2017. As compared to the Stability Programme, the recalculated structural deficit has improved in 2016 and deteriorated in 2017, due to changes in both the headline deficit and output gap estimates. The Commission estimates of the structural balance are close to those of the DBP: different projections of one-off measures and the size of the positive output gap mainly explain the difference.

Table 2. Composition of the budgetary adjustment

(% of GDP)	2015	2016			2017			Change: 2015-2017
	COM	**SP**	**DBP**	**COM**	**SP**	**DBP**	**COM**	**DBP**
Revenue	**35.8**	**35.1**	***36.1***	**35.8**	**35.3**	***36.6***	**36.4**	**0.8**
of which:								
- Taxes on production and imports	12.8	13.0	*13.1*	13.3	13.0	*13.4*	13.7	0.6
- Current taxes on income, wealth, etc.	7.9	8.2	*8.3*	8.3	8.1	*8.4*	8.2	0.5
- Capital taxes	0.0	0.0	*0.0*	0.0	0.0	*0.0*	0.0	0.0
- Social contributions	8.7	8.4	*8.5*	8.5	8.7	*8.8*	8.8	0.1
- Other (residual)	6.5	5.5	*6.2*	5.8	5.5	*6.0*	5.7	-0.5
Expenditure	**37.1**	**36.1**	**37.0**	**36.6**	**36.3**	**37.7**	**37.5**	**0.6**
of which:								
- Primary expenditure	35.7	34.9	35.9	35.5	35.3	36.7	36.5	1.0
of which:								
Compensation of employees	9.9	10.0	10.2	10.2	10.0	10.4	10.4	0.5
Intermediate consumption	6.2	6.1	6.4	6.2	6.2	6.6	6.2	0.4
Social payments	11.2	11.5	11.8	11.4	11.4	11.8	11.6	0.6
Subsidies	0.2	0.6	0.6	0.2	0.6	0.6	0.3	0.4
Gross fixed capital formation	4.6	3.7	4.1	3.5	4.5	4.4	3.9	-0.2
Other (residual)	3.6	3.0	2.8	3.9	2.6	2.9	4.0	-0.7
- Interest expenditure	1.3	1.2	1.1	1.1	1.0	1.0	1.0	-0.3
General government balance (GGB)	**-1.3**	**-1.0**	**-0.9**	**-0.8**	**-1.0**	**-1.1**	**-1.1**	**0.2**
Primary balance	**0.1**	**0.2**	**0.3**	**0.3**	**0.0**	**0.0**	**0.0**	**-0.1**
One-off and other temporary measures	0.0	0.0	0.0	0.1	0.0	0.0	0.1	0.0
GGB excl. one-offs	**-1.3**	**-1.0**	**-0.9**	**-0.9**	**-1.0**	**-1.1**	**-1.2**	**0.2**
Output gap[1]	1.5	1.8	1.6	1.4	1.4	2.0	1.3	1.0
Cyclically-adjusted balance[1]	-1.8	-1.7	-1.5	-1.3	-1.5	-1.8	-1.6	-0.2
Structural balance (SB)[2]	**-1.8**	**-1.7**	**-1.5**	**-1.5**	**-1.5**	**-1.8**	**-1.7**	**-0.2**
Structural primary balance[2]	-0.5	-0.5	-0.4	-0.3	-0.5	-0.8	-0.6	-0.5

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 2016 (SP); Draft Budgetary Plan for 2017 (DBP); Commission 2016 autumn forecast (COM); Commission calculations

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

3.2. Debt developments

Government debt stood at 36.3% of GDP in 2015. It is estimated to have increased to 40.1% of GDP in 2016, largely due to pre-financing of a large debt redemption in February 2017. The DBP assumes a reduction in the debt level in 2017 to 39.1% of GDP, on the back of an improved primary balance and stronger nominal GDP growth. The Commission forecast of the headline debt level of 37.2% of GDP in 2017 assumes a lower level of precautionary cash balances.

Table 3. Debt developments

(% of GDP)	2015	2016			2017		
		SP	**DBP**	**COM**	**SP**	**DBP**	**COM**
Gross debt ratio[1]	**36.3**	**40.3**	**40.1**	**40.0**	**38.3**	**39.1**	**37.2**
Change in the ratio	-4.4	4.0	3.8	3.7	-2.0	-1.0	-2.8
Contributions[2] *:*							
1. Primary balance	**-0.1**	**-0.2**	**-0.3**	**-0.3**	**0.0**	**0.0**	**0.0**
2. “Snow-ball” effect	**0.1**	**-0.3**	**0.2**	**0.2**	**-1.2**	**-0.9**	**-0.7**
Of which:							
Interest expenditure	1.3	1.2	1.2	1.1	1.0	1.1	1.0
Growth effect	-1.1	-1.0	-0.9	-0.7	-1.3	-1.3	-1.1
Inflation effect	-0.2	-0.4	-0.1	-0.3	-0.9	-0.7	-0.7
3. Stock-flow adjustment	**-4.4**	**4.5**	**3.9**	**3.8**	**-0.8**	**-0.1**	**-2.1**
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 2016 (SP); Draft Budgetary Plan for 2017 (DBP); Commission 2016 autumn forecast (COM); Commission calculations

3.3. Measures underpinning the draft budgetary plan

The DBP presents net revenue-increasing measures of 0.4% of GDP and net expenditure-increasing measures of 0.6% of GDP (see Table 4). The main revenue measures include a postponed change in the tax payment date for vehicles from 2017 to 2019 (0.1% of GDP) and

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a one-off receipt of confiscated illicit money in 2017 (0.1% of GDP)[5]. An increased share of dividend payments from state owned enterprises in 2017-2019 is expected to yield up to 0.1% of GDP in 2019. The remaining revenue measures consist of small tax increases and collection improvements. The expenditure measures are concentrated on the compensation of employees and purchases of goods and services. The former largely follows from an introduction of new pay systems for internal security officers and teachers, as well as from an increase in the national minimum wage. The latter includes the allocation of funds for the health sector reform (0.1% of GDP), for which specific measures are still to be defined. Changes to capital spending in 2017-2019 are largely related to revised construction plans for a new prison.

[5] This one-off receipt is additional to the similar one-off receipt in 2016.

Table 4. Main discretionary measures reported in the DBP

A. Discretionary measures taken by General Government - revenue side

Components	Budgetary impact (% GDP) (as reported by the authorities)		
	2017	**2018**	**2019**
Taxes on production and	0.2	0.0	-0.2
Current taxes on income,	0.1	0.0	0.0
Capital taxes			
Social contributions	0.0	0.0	0.0
Property Income	0.0	0.0	0.1
Other	0.1	-0.1	0.0
Total	0.4	-0.1	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 2017

B. Discretionary measures taken by general Government- expenditure side

Components	Budgetary impact (% GDP) (as reported by the authorities)		
	2017	**2018**	**2019**
Compensation of employees	0.2	0.0	0.0
Intermediate consumption	0.2	-0.1	0.0
Social payments	0.0	0.0	0.0
Interest Expenditure	0.0	0.0	0.0
Subsidies	0.1	0.0	0.0
Gross fixed capital formation	-0.1	0.1	0.1
Capital transfers			
Other	0.1	0.0	0.1
Total	0.6	0.0	0.2

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 2017

The estimated effect of the measures is overall plausible. The second round effect of the increase in the national minimum wage on tax revenue is not considered as a discretionary revenue measure by the Commission, but its impact is reflected in the Commission forecast.

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

Latvia is subject to the preventive arm of the Pact and should ensure sufficient progress towards its MTO. Box 2 reports the latest country specific recommendations in the area of public finances.

Box 2: Council recommendations addressed to Latvia

On 18 May, 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 adjustment path towards the medium-term budgetary objective in 2016 and 2017 is limited to the allowance linked to the systemic pension reform and the major structural reform in the healthcare sector.

Box 3: Implementation of the "constrained judgement" approach and its impact in the context of the fiscal surveillance

The April 2016 Amsterdam Informal ECOFIN Council requested that improvements be made to the commonly agreed methodology for the estimation of potential growth and the output gap. In response to this mandate from the Council, two concrete decisions were taken in agreement with the Member States in October 2016. First, it was agreed that a revised methodology for the estimation of the non-accelerating wage rate of unemployment (NAWRU) would be introduced in the commonly agreed methodology. This change has already been implemented in the Commission 2016 autumn forecast. Second, in line with the renewed mandate provided by the ECOFIN Council on 11 October, the Economic Policy Committee – Output Gap Working Group has worked on a "constrained judgement" approach for cases where the common method is shown to produce counterintuitive output gap results for individual Member States.

The objective of the "constrained judgement" approach is to have a transparent and economically grounded tool to statistically test the plausibility of the output gaps for individual Member States estimated on the basis of the common method. To this end, the Commission developed in cooperation with the Member States an objective screening tool to assess if the common methodology produces plausible output gap estimates for all Member States. If this "plausibility" tool identifies counter-intuitive results, the Commission has carried out an "in depth" analysis.

For Latvia, the plausibility tool indicates a small negative output gap estimate of -0.3% of GDP in 2016. The standard output gap estimate, based on the Commission autumn 2016 forecast and using the common methodology, returns a positive output gap of 1.4% of GDP in 2016. The discrepancy between the two estimates illustrates an uncertainty over potential growth estimates for Latvia. This can be related to the large structural changes during the boom-bust cycle. Under the common methodology, potential GDP level is estimated to have decreased by some 5% during the economic crisis between 2008 and 2011 and the most recent potential GDP estimates appear to be still affected by the past volatility. Latvia's economic adjustment process was a relatively short as compared to other Member States. After a cumulative drop by around 20% in 2008-2010, real GDP recovered by around 5% annual growth in 2011 and 2012 and in the range of 2-3% annual growth in 2013-2015. Actual GDP growth in 2016 is considered to be at or just below the potential growth by the Latvia's Fiscal Discipline Council and the authorities.

In the light of the uncertainty surrounding the estimation of the level of the output gap for Latvia, the Commission does not see sufficient ground to deviate from the output gap estimated on the basis of the commonly agreed methodology.

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4.1. Adjustment towards the MTO

As from 2013 Latvia is benefiting from the pension reform clause, which allows for a deviation from the adjustment path towards the MTO (which is a structural deficit of 1% of GDP) of 0.6% of GDP in 2016 and 2017. Latvia is also eligible to an additional deviation of 0.1% of GDP in 2017, 0.4% in 2018 under the structural reform clause for the healthcare reform, which is limited by the constraint of the minimum benchmark[6].

In 2016, the recalculated structural balance based on the DBP is estimated to improve from -1.6% of GDP in 2015 to -1.5% of GDP in 2016, falling slightly short of the required improvement of 0.2% of GDP. The expenditure benchmark is estimated to be complied with in 2016. This calls for an overall assessment. The headline deficit improved by 0.4 percentage point between 2015 and 2016, but an increase in the positive output gap from 1% to 1.6% of GDP results in the structural improvement of only 0.1 percentage point of GDP. The recalculated output gap has a distinctly different dynamic compared to that based on the Commission forecast, which shows a gradual reduction of the positive output gap from 1.5% of GDP in 2015 to 1.3% of GDP in 2017. The overall assessment based on the information provided in the DBP suggests compliance in 2016, considering uncertainty over output gap estimates (see also Box 3).

Based on the Commission forecast, the structural balance is expected to improve by 0.4% of GDP in 2016 exceeding the 0.2% of GDP required structural improvement, thus pointing to compliance. In turn, the expenditure benchmark points to a risk of some deviation (gap of -0.3% of GDP). This calls for an overall assessment. The gap between the structural balance and expenditure benchmark indicator readings amounts to 0.5% of GDP. This is largely explained by (i) the use of interest expenditure savings for other current expenditure (0.2% of GDP) and (ii) a temporary drop in government capital expenditure net of EU-funded capital expenditure (0.3% of GDP), both of which accentuate the improvement in the structural balance. Therefore, the expenditure benchmark should be seen as the better indicator for the fiscal situation. Taking into account these factors, the overall assessment points to a risk of some deviation from the adjustment path towards the MTO in 2016.

In 2017, the recalculated structural balance is planned to deteriorate by 0.3% of GDP, exceeding the allowed deterioration by 0.2% of GDP, while the expenditure benchmark is estimated to be complied with. This calls for an overall assessment. The headline deficit is expected to increase by 0.2 percentage point of GDP and expansion of the positive output gap accounts for 0.1% of GDP of the structural deterioration. The recalculated output gap dynamics are not consistent with the estimates based on the Commission forecast, which show a reduction of the positive output gap, as described for 2016. Also, the deviation from the structural balance pillar of 0.1% of GDP over 2016-2017 on average stems from the divergent recalculated output gap estimates. Therefore, considering the uncertainty over output gap estimates, the overall assessment points to compliance in 2017.

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[6] The health sector reform clause of 0.5% of GDP was granted to Latvia as from 2017, but the existing allowance for the pension reform and the minimum benchmark ceiling of a structural deficit of 1.7% of GDP for Latvia constrains the application of the healthcare reform to 0.1% of GDP in 2017, 0.4% in 2018 and the full 0.5% of GDP in 2019.

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Based on the Commission forecast, the change of the structural balance in 2017 is in line with the structural adjustment as required by the matrix after taking into account the deviation allowed by the pension reform and the structural reform clauses. The expenditure benchmark is also expected to be met. However, the expenditure benchmark over 2016-2017 taken together is exceeded by 0.1% of GDP. This calls for an overall assessment. The deviation measured over 2016 and 2017 taken together is exclusively the result of the deviation observed in 2016, but the factors leading to the excess of net expenditure growth in 2016 are not fully compensated for in 2017. While the share of capital expenditure in total expenditure is projected to increase in 2017, interest expenditure gains in 2016 remain used for other current expenditure in 2017. As the excess in the two year average net expenditure growth relates to dynamics in 2016 which are partly corrected in 2017, the overall assessment points to compliance in 2017, but to a small deviation over 2016 and 2017 together.

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Table 5: Compliance with the requirements of 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)	-1.8	-1.5		-1.7	
Structural balance based on freezing (COM)	-1.8	-1.5		-	
Position vis-a -vis the MTO[3]	Not at MTO	Not at MTO		Not at MTO	
(% of GDP)	**2015**	**2016**		**2017**	
	COM	**DBP**	**COM**	**DBP**	**COM**
Structural balance pillar					
Required adjustment[4]	0.4	0.8		0.5	
Required adjustment corrected[5]	-0.4	0.2		-0.2	
Change in structural balance[6]	-0.2	0.1	0.4	-0.3	-0.2
One-year deviation from the required adjustment[7]	0.1	-0.1	0.2	-0.1	0.0
Two-year average deviation from the required adjustment[7]	0.0	0.0	0.1	-0.1	0.1
Expenditure benchmark pillar					
Applicable reference rate[8]	2.4	0.8		2.6	
One-year deviation[9]	0.4	0.1	-0.3	0.1	0.1
Two-year average deviation[9]	0.1	0.3	0.0	0.1	-0.1
Conclusion					
Conclusion over one year	Compliance	Overall assessment	Overall assessment	Overall assessment	Compliance
Conclusion over two years	Compliance	Compliance	Compliance	Overall assessment	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 27.).

[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) was 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 :

Draft Budgetary Plan for 2017 (DBP); Commission 2016 autumn forecast (COM); Commission calculations.

5. IMPLEMENTATION OF FISCAL STRUCTURAL REFORMS

The DBP reports on progress of implementing the country-specific recommendations and the national targets under the Europe 2020 strategy. Limited steps have been taken across the policy areas, but decisive measures have been postponed or still need to be developed. Notably, a major social safety net reform planned to be introduced in 2017 has been postponed to 2019, as the fiscal costs were not duly provided for in the earlier budgetary plans. Large changes to the tax policy have been ruled out for the 2017 budget, while a presumably comprehensive Tax Strategy is expected in early 2017. For the Tax Strategy, the authorities have gathered input from the World Bank and the OECD of the best way forward with the tax policy, which will be considered in the national debate.

The DBP responds to the country-specific recommendations for Latvia by increasing the natural resource tax rates, including on land fill municipal waste, and pursuing the health care reform. Moreover, the vehicle taxation system is changed by replacing the vehicle registration tax with an increase in the annual vehicle taxation based on CO_2 emissions, in a budgetary neutral way. Even more, the previously scheduled increases in excise duties on tobacco and alcohol will continue, as well as the phased implementation of the income-differentiated basic allowance by 2020. An introduction of the minimum mandatory social security contribution was legislated in 2016, but will only come into effect in 2017, yielding 0.3% of GDP in revenue. However, this measure represents a trade-off between the minimum social security coverage of the low-income earners and flexibility of employers to employ part-time workers who are marginally attached to the labour market and have limited job opportunity elsewhere. In terms of improving tax compliance, the DBP among other things extends the use of the risk registers in the Enterprise Register, makes the general contractors in construction liable for tax payments by subcontractors and provides a direct exchange of information between financial institutions and the State Revenue Service for recovering tax debts. Furthermore, the authorities have announced to replace the Micro Enterprise Tax regime, increasingly used as a labour tax optimisation tool, with a dedicated support measures to the star-up companies with limited-time eligibility.

Box 4: Addressing the tax burden on labour in the euro area

The tax burden on labour in the euro area is relatively high, which weighs on economic activity and employment. Against this background, the Eurogroup has expressed a commitment to reduce the tax burden on labour. On 12 September 2015, the Eurogroup agreed to benchmark euro area Member States' tax burden on labour against the GDP-weighted EU average, relying in the first instance on indicators measuring the tax wedge on labour for a single worker at average wage and a single worker at low wage. It also agreed to relate these numbers to the OECD average for purposes of broader comparability.

The tax wedge on labour measures the difference between the total labour costs to employ a worker and the worker’s net earnings. It is made up of personal income taxes and employer and employee social security contributions. The higher the tax wedge, the higher the disincentives to take up work or hire new staff. The graphs below show the tax wedge in Latvia for a single worker earning respectively the average wage and a low wage (50% of the average) compared to the EU average.

The tax burden on labour in Latvia at the average wage and a low wage (2014)

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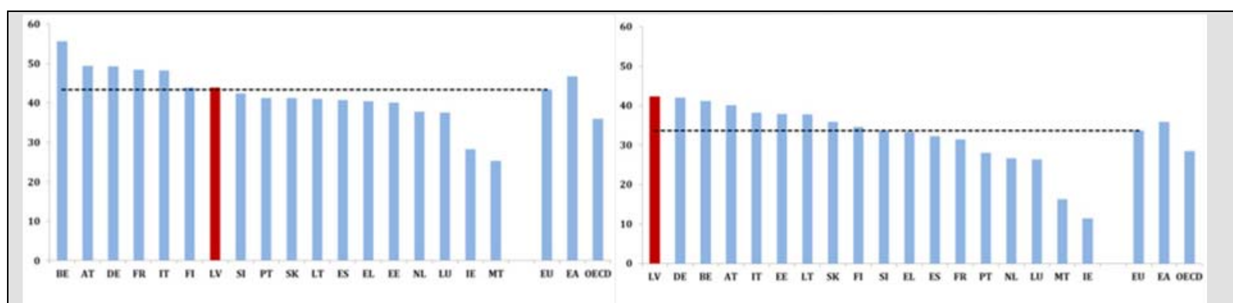

Notes: Data for Latvia, Lithuania and Malta is for 2013. No recent data is available for Cyprus. EU and EA averages are GDP-weighted. The OECD average is not weighted.

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 2016 European Semester, Latvia was issued the recommendation to "(..) Reduce the tax wedge for low-income earners by exploiting a growth-friendly tax shift towards environmental and property taxes and improving tax compliance".

Latvia's DBP contains few measures with limited effect on the tax wedge on labour – the base of personal income tax will exclude (i) costs of catering provided by employer and (ii) scholarships at the level of net national minimum wage paid under the work-based learning.

6. OVERALL CONCLUSION

Following an overall assessment of the DBP, the planned structural adjustment is in line with the required adjustment path towards the MTO both in 2016 and 2017. However, following an overall assessment based on the Commission 2016 autumn forecast there is a risk of some deviation from the adjustment path towards the MTO in 2016. While the adjustment path seems to be appropriate in 2017, the deviation currently projected for 2016 leads to a risk of a small deviation over 2016 and 2017 together.

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