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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 elections on 4 October, a no-policy-change Draft Budgetary Plan was submitted by the outgoing government on 15 October in compliance with Regulation (EU) No 473/2013 of the Two-Pack. The new government took office on 5 November and submitted on 22 November an updated Draft Budgetary Plan for 2015. Latvia is subject to the preventive arm of the Stability and Growth Pact and should preserve a sound fiscal position which ensures compliance with the medium-term budgetary objective (MTO), while allowing for the impact of the systemic pension reform.

Section 2 of this document presents the macroeconomic outlook underlying the updated Draft Budgetary Plan and provides an updated assessment based on an ad-hoc Commission forecast updating the Commission 2014 autumn forecast with the draft 2015 budget measures[1]. 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 Commission 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 2014-2015 (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 on 8 July 2014. Section 6 summarises the main conclusions of the present document.

2. MACROECONOMIC DEVELOPMENTS UNDERLYING THE DRAFT BUDGETARY PLAN

The macroeconomic scenario underlying the updated Draft Budgetary Plan foresees a slowdown in economic growth from 4.2% in 2013 to 2.9% in 2014 and 2.8% in 2015. The economic growth forecast has not changed compared to the no-policy-change Draft Budgetary Plan. The current forecast, therefore, still represents a significant downward revision from the latest Stability Programme where economic growth was forecast at 4% in 2014 and 2015. Inflation rate and employment growth rate have also been reduced since the Stability Programme. The ad hoc Commission forecast includes the new fiscal measures for 2015, but economic growth projections have remained unchanged. As compared to the Commission forecast, the Draft Budgetary Plan assumes somewhat higher real GDP growth in 2014 and slightly lower growth in 2015. The cumulative growth rates for 2014-15 are however very close in the Commission and Latvia's forecasts, both in real and nominal terms. Overall, the

[1] Hereafter referred to as the Commission forecast.

macroeconomic scenario underlying the Draft Budgetary Plan is broadly in line with the Commission forecast.

Uncertainties related to geopolitical tensions pose downside risks to the macroeconomic scenario. This is partly counterbalanced by positive risks related to possible resumption of production at the country's largest steel maker.

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

The macroeconomic forecast underpinning budgetary projections in the updated Draft Budgetary Plan has been prepared by the Ministry of Finance. The main macroeconomic indicators have been agreed with the Bank of Latvia, which is an independent institution. However, the agreement and the underlying justifications are not public. Other experts from the Ministry of Economics, commercial banks and international organisations have also been consulted on the forecast.

The Fiscal Discipline Council, Latvia's fiscal monitoring institution, in its first fiscal discipline monitoring report has concluded on 5 December that the draft 2015 budget is consistent with the fiscal rules of the Fiscal Discipline Law.[2] The Fiscal Discipline Council has assessed the macroeconomic projections underlying the draft 2015 budget as acceptable although perhaps slightly optimistic given the current economic climate, in particular (i) a slow growth in Europe coupled with geopolitical uncertainty and continuing sanctions vis-à-vis Russia and counter-sanctions; (ii) real GDP growth of 2.5% in the first three quarters of 2015 against for the 2015 budget forecast of 2.9% and (iii) likely lower inflation than forecasted in view of the declining oil prices. In order to insure against the downside risks to the forecast, the Fiscal Discipline Council invites the government to prepare contingency measures. Moreover, the fiscal monitoring report includes several recommendations to the government, in particular in area of taxation.

The Fiscal Discipline Council was established in January 2014 on the basis of the Fiscal Discipline Law and with the purpose of monitoring the compliance with that law. The Council is designed to be functionally and financially independent. In the course of performing its duties, the Council has the rights to request all necessary information from the government institutions and to involve experts. The Council prepares regular reports on the draft budget laws and, when necessary, irregularity reports, which are made public. The Council's six members held their first meeting in February 2014. From the start of its operations, the Council has already issued two irregularity reports pointing at decisions by the government and the parliament that appear to breach the Fiscal Discipline Law.

[2] The fiscal monitoring report, published on 5 December, is available on a webpage of the Fiscal Discipline Council: http://fiscalcouncil.lv

Table 1. Comparison of macroeconomic developments and forecasts

	2013	2014			2015		
	COM	SP	DBP	COM	SP	DBP	COM
Real GDP (% change)	4.2	4.0	2.9	2.6	4.0	2.8	2.9
Private consumption (% change)	6.2	5.1	3.1	3.6	4.6	3.2	4.0
Gross fixed capital formation (% change)	-5.2	3.8	1.6	0.5	5.0	0.6	1.9
Exports of goods and services (% change)	1.5	4.0	0.6	1.5	4.6	1.0	3.3
Imports of goods and services (% change)	0.3	4.5	0.2	1.4	5.1	0.7	3.5
Contributions to real GDP growth:							
- Final domestic demand	1.7	4.4	2.7	2.5	4.4	2.6	3.1
- Change in inventories	1.8	0.0	-0.1	0.0	0.0	0.0	0.0
- Net exports	0.7	-0.4	0.2	0.1	-0.4	0.2	-0.2
Output gap[1]	0.4	1.2	1.0	1.0	1.8	1.1	1.2
Employment (% change)	2.3	1.2	0.3	0.3	0.8	0.2	0.5
Unemployment rate (%)	11.9	10.5	10.8	11.0	9.7	10.1	10.2
Labour productivity (% change)	1.9	3.1	2.6	2.3	3.5	2.5	2.3
HICP inflation (%)	0.0	1.1	0.8	0.8	3.0	2.4	1.8
GDP deflator (% change)	1.1	1.6	0.9	1.6	2.8	2.4	2.2
Comp. of employees (per head, % change)	9.4	5.6	7.0	6.2	5.3	4.5	4.6
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	0.2	1.2	0.6	0.3	1.1	0.7	0.1

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 2014 (SP); Draft Budgetary Plan 2015 (DBP); Commission ad hoc forecast (COM); Commission calculations.

3. RECENT AND PLANNED FISCAL DEVELOPMENTS

3.1. Deficit developments

The Draft Budgetary Plan estimates the government deficit at 1.4% of GDP in 2014, including a one-off payment to the European Bank for Reconstruction and Development (EBRD) under the guarantee contract on the EBRD participation in solving the Parex bank restructuring during the crisis (0.4% of GDP). This one-off measure largely explains an increase from a fiscal deficit of 1% of GDP estimated in the Stability Programme. The underlying fiscal position has also weakened by some 0.1% of GDP relative to the Stability Programme, but its effect on the headline balance is compensated by statistical revisions for the previous years. Tax revenue performance in 2014 relative to intra-year targets shows mixed results as effects of lower economic growth are partly offset by somewhat stronger wage growth than previously expected. Expenditure adjustments across economic categories since the Stability Programme reflect both spending reallocations and data revisions. Notably, capital and social spending have increased at the expense of intermediate consumption. The Commission forecast is similar to that of the authorities with an estimated fiscal deficit of 1.4% of GDP in 2014, including the one-off guarantee call payment. However, the Commission forecast has a somewhat different revenue and expenditure composition, in view of the trends in the first three quarters of 2014. Also, Commission forecast includes a recent separation in statistical accounts of assessed VAT and unpaid VAT revenue, not yet reflected in the forecast of the updated Draft Budgetary Plan.

The updated Draft Budgetary Plan targets a nominal government deficit of 1% of GDP for 2015, as compared with the target of 0.8% of GDP in the Stability Programme. The worsening of the fiscal position is related to lower tax revenue and higher social spending, both reflecting the softening of the economic activity. The new spending priorities for 2015 of around 0.5% of GDP are largely financed from new revenue measures.

The Commission forecast of the government deficit is 1% of GDP in 2015. This is consistent with the authorities target for 2015. The new spending measures of 0.6% of GDP (Table 4.b) address some of the public service needs in priority areas, but many new spending initiatives (2.2% of GDP for 2015), of which a large part are based on the National Development Plan (a long-term strategic planning document), are not catered for in the Draft Budgetary Plan. Therefore, several sectors remain tightly constrained under the current medium-term expenditure plans and spending demands may arise during the budget implementation. For example, a demand for increasing teacher wages was only partly satisfied during the 2015 budget negotiations, in view of a need for a comprehensive reform of the sector. Fiscal projections are sensitive to the risks to the macroeconomic scenario, in particular in view of possible external shocks. These risks apply to the Commission forecast, but are not quantified in the central scenario.

The structural deficit recalculated according to the commonly agreed methodology[3] at 1.4% of GDP in both 2014 and 2015 has remained unchanged since the Stability Programme. The Commission forecast estimates a structural deficit at 1.4% of GDP in 2014 and 1.5% in 2015.

[3] Cyclically adjusted balance net of one-off and temporary measures, recalculated by the Commission services on the basis of the information provided in the Draft Budgetary Plan, using the commonly agreed methodology.

Table 2. Composition of the budgetary adjustment

(% of GDP)	2013	2014			2015			Change: 2013-2015
	COM	SP	DBP	COM	SP	DBP	COM	DBP
Revenue	**34.8**	**33.9**	***35.1***	**34.3**	**32.0**	***33.6***	**33.8**	**-1.2**
of which:								
- Taxes on production and imports	13.9	11.6	*12.0*	14.1	11.5	*12.2*	14.1	-1.7
- Current taxes on income, wealth, etc.	7.6	7.6	*7.6*	7.5	7.3	*7.4*	7.5	-0.2
- Capital taxes	0.0	0.0	*0.0*	0.0	0.0	*0.0*	0.0	0.0
- Social contributions	8.5	8.2	*8.6*	8.5	7.7	*8.3*	8.5	-0.2
- Other (residual)	4.8	6.5	*6.9*	4.2	5.5	*5.7*	3.7	0.9
Expenditure	**35.7**	**34.9**	**36.5**	**35.7**	**32.8**	**34.6**	**34.8**	**-1.1**
of which:								
- Primary expenditure	34.2	33.3	35.1	34.3	31.6	33.3	33.5	-0.9
of which:								
Compensation of employees	9.2	9.2	9.4	9.4	8.7	9.4	9.4	0.2
Intermediate consumption	6.1	6.5	6.1	6.2	6.2	6.2	6.2	0.1
Social payments	10.7	10.1	10.4	10.6	9.9	10.3	10.5	-0.4
Subsidies	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.0
Gross fixed capital formation	4.0	3.6	4.2	3.8	3.2	3.7	3.6	-0.3
Other (residual)	3.7	3.3	4.4	3.7	3.0	3.1	3.3	-0.6
- Interest expenditure	1.5	1.6	1.4	1.4	1.2	1.3	1.3	-0.2
General government balance (GGB)	**-0.9**	**-1.0**	**-1.4**	**-1.4**	**-0.8**	**-1.0**	**-1.0**	**-0.1**
Primary balance	**0.6**	**0.6**	**0.0**	**0.0**	**0.4**	**0.3**	**0.3**	**-0.3**
One-off and other temporary	0.0	0.0	-0.4	-0.4	0.0	0.0	0.0	0.0
GGB excl. one-offs	**-0.9**	**-1.0**	**-1.0**	**-1.0**	**-0.8**	**-1.0**	**-1.0**	**-0.1**
Output gap[1]	0.4	1.2	1.0	1.0	1.8	1.1	1.2	0.7
Cyclically-adjusted balance[1]	-1.0	-1.4	-1.8	-1.8	-1.4	-1.4	-1.5	-0.4
Structural balance (SB)[2]	**-1.0**	**-1.4**	**-1.4**	**-1.4**	**-1.4**	**-1.4**	**-1.5**	**-0.4**
Structural primary balance[2]	0.4	0.2	0.0	0.0	-0.2	-0.1	-0.2	-0.5

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 2014 (SP); Draft Budgetary Plan 2015 (DBP); Commission ad hoc forecast (COM); Commission calculations.

3.2. Debt developments

The updated Draft Budgetary Plan estimates gross public debt at 40% of GDP in 2014 and declining to 35% of GDP in 2015. The reduction in the gross debt ratio reflects a large repayment of the EU financial support due in early 2015 from the accumulated cash reserves, as well as a small primary surplus in 2015 and a positive GDP growth – interest expenditure differential. The debt dynamics are consistent with the Commission forecast, except for assuming a somewhat high debt-reducing effect from the stock-flow adjustments in 2015.

Table 3. Debt developments

(% of GDP)	2013	2014			2015		
		SP	DBP	COM	SP	DBP	COM
Gross debt ratio[1]	**38.2**	**38.8**	**40.0**	**40.2**	**32.9**	**35.0**	**36.1**
Change in the ratio	-2.7	0.6	1.8	2.0	-5.9	-5.0	-3.9
Contributions [2] :							
1. Primary balance	**-0.6**	**-0.6**	**0.0**	**0.0**	**-0.4**	**-0.3**	**-0.3**
2. "Snow-ball" effect	**-0.6**	**-0.4**	**0.0**	**-0.1**	**-1.3**	**-0.7**	**-0.5**
Of which:							
Interest expenditure	1.5	1.6	1.4	1.4	1.2	1.3	1.4
Growth effect	-1.6	-1.4	-1.1	-1.0	-1.5	-1.1	-1.1
Inflation effect	-0.4	-0.6	-0.3	-0.6	-1.0	-0.9	-0.8
3. Stock-flow adjustment	**-1.4**	**1.6**	**1.8**	**2.1**	**-4.2**	**-4.0**	**-3.1**
Of which:							
Cash/accruals difference		n.a.	n.a.		n.a.	n.a.	
Net accumulation of financial		n.a.	n.a.		n.a.	n.a.	
of which privatisation proceeds		n.a.	n.a.		n.a	n.a.	
Valuation effect & residual		n.a.	n.a.		n.a.	n.a.	

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 2014 (SP); Draft Budgetary Plan 2015 (DBP); Commission ad hoc forecast (COM); Commission calculations.

3.3. Measures underpinning the draft budgetary plan

The updated Draft Budgetary Plan presents revenue-increasing measures rounding to 0.5% of GDP and expenditure-increasing measures rounding to 0.6% of GDP. The measures have been approved by the government and have been presented to the Parliament on [10 December].

The revenue-increasing measures include tax policy changes, improvements in tax administration and some upward revisions to previous revenue projections. The main thrust of the measures is concentrated on combating the shadow economy and improving tax compliance. These measures rely on a better information exchange between the State Revenue Service, other government bodies and financial service providers; using new and existing registers that allow early identification of fraudulent behaviour; extending responsibility for tax debts to board members of the companies and addressing some rigidities in excise taxation. These measures are expected to impact on several taxation categories as summarised in Table 4. While it is difficult to assess plausibility of the estimated yields from the improvements in the tax administration, granularity and large number of measures gives confidence that the plans will be met. In view of this, the Commission forecast incorporates the announced measures. Moreover, the authorities account for the positive revenue effect of the increase in the minimum wage from EUR 320 to EUR 360 from January 2015 and have decided to maintain the requirement for commercial state-owned enterprises to pay 90% of their dividends to the government in 2015. The second round effect of the minimum wage increase on tax revenue in not treated as a discretionary revenue measure by the Commission services, nevertheless the positive revenue effect is reflected in the Commission forecast. Regarding the dividend payments from the state-owned enterprises, the track record shows that in certain cases the enterprises are allowed by the ad hoc government decisions to retain their dividend payments for investment purposes (in 2013 some 70% out of planned 90% of dividends were actually paid to the government). Without prejudging the government's decisions, any risk to revenue targets is weighted against the authorities' commitment to adhere to the fiscal targets and allowing for a possible room for manoeuvre during the budget implementation.

The main spending increases, as compared to the exiting multi-annual expenditure plans, are foreseen in the health, education, defence and agriculture sectors. The increase in the minimum wage implies wage increases for low-paid state employees, leading to a wage compression for employees earning wages close to or at minimum wage despite different levels of responsibility. An increase in compensation of employee is also related to plans to reduce remuneration differences among equivalent positions in different government entities over the coming years, as well as increasing the capacity of the State Revenue Service. An increase in public purchases of goods and services is concentrated in the health sector, increasing availability for health services and reducing patient co-payments. Other expenditure measures in 2015 include temporary payments to farmers allowing for smooth transition between the two EU budgetary frameworks. The planned measures have been incorporated in detailed budget allocation presented to the Parliament and their implementation will be well under control of the government, therefore these measures are included in the Commission forecast at face value.

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)		
	2014	**2015**	**2016**
Taxes on production and	0	0.3	0
Current taxes on income,	0	0.1	0
Capital taxes	n.a.	n.a.	n.a.
Social contributions	0	0.1	0
Property Income	0	0	0.2
Other	0	0	0
Total	0	0.5	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 revenue increases as a consequence of this measure.

Source: Draft Budgetary Plan 2015

B. Discretionary measures taken by general Government- expenditure side

Components	Budgetary impact (% GDP) (as reported by the authorities)		
	2014	**2015**	**2016**
Compensation of employees	0	0.1	0
Intermediate consumption	0	0.1	0
Social payments	0	0	0
Interest Expenditure	n.a.	n.a.	n.a.
Subsidies	0	0	0
Gross fixed capital formation	n.a.	n.a.	n.a.
Capital transfers	n.a.	n.a.	n.a.
Other	0	0.4	0
Total	0	0.6	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 expenditure increases as a consequence of this measure.
Source: Draft Budgetary Plan 2015

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

Latvia is subject to the preventive arm of the Stability and Growth Pact. Latvia is also eligible for the systemic pension reform clause from 2013, which allows a deviation from the MTO of 0.5%, 0.5%, and 0.8% of GDP in 2013, 2014 and 2015, respectively[4].

The recalculated structural deficit is 1.4% of GDP in 2014. A deviation of 0.4 pp. of GDP from the MTO of a structural deficit of 1% of GDP is within the deviation of 0.5% of GDP allowed by the pension reform clause. The Commission forecast of a structural deficit of 1.4% of GDP in 2014 is also in compliance with the structural balance rule.

According to the information provided in the Draft Budgetary Plan, the growth rate of government expenditure, net of discretionary revenue measures corrected for the pension reform clause will not exceed the reference medium-term rate of potential GDP growth of 1.4% in 2014. A significant deviation from the expenditure benchmark over 2013 and 2014, based on the information provided in the updated Draft Budgetary Plan, is related to dynamic expenditure growth in 2013, including capital injections in state owned enterprises (0.4% of GDP), which were of a temporary nature. The underlying expenditure growth in 2013 is also explained by the available fiscal space based on the initial budgetary position of a structural deficit of 0.1 in 2012, well below the MTO for Latvia. The structural deficit subsequently increased to 1% in 2013, which corresponds the Latvia's MTO, in spite of the pension reform starting in 2013 and the corresponding allowed deviation from the MTO of 0.5%. A two-year average significant deviation over 2013-14 of 0.7% of GDP is identified also based on the Commission forecast. This deviation is explained by the same factors mentioned for the

[4] Under the reform, part of social security contributions is being diverted from the government to private pension funds, thus reducing the government's revenue. The amount of the diverted contributions increased from 2% to 4% in 2013, with a fiscal cost of 0.5% of GDP, and will further increase to 5% in 2015, with an additional cost of 0.3% of GDP.

updated Draft Budgetary Plan. Overall, compliance with the expenditure benchmark over 2013-14 is ensured considering effect of temporary measures and the available fiscal space, while obsering the strucural balance rule.

Based on the Commission forecast, a deviation from the expenditure benchmark in 2014 of 0.1% of GDP is foreseen, within a range of a permissible deviation. The deviation can be explained by tax-revenue-reducing measures being implemented without compensatory measures in 2014 (social security contribution cut; increase in non-taxable minimum and allowances for dependants for the personal income tax), as well as relatively strong real GDP growth (2.6% based on the Commission forecast) as compared to the reference rate of 1.4%, which makes the expenditure benchmark more binding than the MTO. Moreover, the implemented tax-reducing measures aim at addressing the Country Specific Recommendation on reducing the tax burden on low-income earners. The structural balance rule, on the other hand, is observed for 2014 when taking into account the allowed deviation for the pension reform clause.

For 2015, the recalculated structural deficit is estimated at 1.4% of GDP. The Commission forecast of a structural deficit is 1.5% of GDP. The distance to the MTO for both indicators is within the 0.8% of GDP allowed deviation due to the pension reform clause. The expenditure benchmark requirement is projected to be respected based both on the Commission forecast and the updated Draft Budgetary Plan.

Following an overall assessment of the updated Draft Budgetary Plan, with the structural balance as a reference, including an analysis of expenditure net of discretionary revenue measures Latvia is expected to be in line with the requirements of the preventive arm of the Pact in both 2014 and 2015. On the basis of this assessment, it also appears that Latvia is expected to comply with the recommendations addressed to it by the Council on 8 July 2014.

Table 5 Compliance with the preventive arm of the Stability and Growth Pact

(% of GDP)	2013	2014		2015	
Initial position[1]					
Medium-term objective (MTO)	-1.0	-1.0		-1.0	
Structural balance[2] (COM)	-1.0	-1.4		-1.5	
Structural balance based on freezing (COM)	-1.0	-1.4		-	
Position vis-a -vis the MTO[3]	At or above the MTO	At or above the MTO		Not at MTO	
(% of GDP)	**2013**	**2014**		**2015**	
	COM	**DBP**	**COM**	**DBP**	**COM**
Structural balance pillar					
Required adjustment[4]	0.0	0.0		0.4	
Change in structural balance[5]	-0.8	-0.4	-0.4	0.0	-0.1
One-year deviation from the required adjustment after considering the relevant factors [6]	0.5	0.2	0.2	0.3	0.3
Two-year average change in structural balance[5]	0.1	-0.6	-0.6	-0.2	-0.2
Two-year average deviation from the required adjustment after considering the relevant factors [6]	0.8	0.3	0.3	0.2	0.2
Expenditure benchmark pillar					
Applicable reference rate[7]	1.2	1.4		0.1	
One-year deviation [8]	-1.4	0.4	-0.1	0.2	0.5
Two-year average deviation [8]	0.0	-0.6	-0.7	0.8	0.2
Conclusion					
Conclusion over one year	Overall assessment	Compliance	Overall assessment	Compliance	Compliance
Conclusion over two years	Compliance	Overall assessment	Overall assessment	Compliance	Compliance

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 28.).

[5] Change in the structural balance compared to year t-1. Ex post assessment (for 2013) is carried out on the basis of Commission 2014 spring forecast.

[6] The difference of the change in the structural balance and the required adjustment corrected for the clauses, the possible margin to the MTO and the allowed deviation in case of overachievers.

[7] 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 lower rate applies as long as the country is adjusting towards its MTO, including in year t. The reference rates applicable to 2014 onwards have been updated in 2013.

[8] 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 2015 (DBP), Commission ad hoc forecast (COM), Commission calculations

Box 2. Council recommendations addressed to Latvia

On 8 July 2014, 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 preserve a sound fiscal position in 2014 and strengthen the budgetary strategy as of 2015, ensuring that the deviation from the medium-term budgetary objective remains limited to the impact of the systemic pension reform, and to pursue efforts to further reduce the tax burden on low-income earners in the context of a shift towards more growth-friendly property and environmental taxes and by improving tax compliance and collection.

5. IMPLEMENTATION OF FISCAL-STRUCTURAL REFORMS

Latvia is recommended to further shift the tax burden from low-income earners to more growth-friendly property and environmental taxation and improve tax compliance. The updated Draft Budgetary Plan mentions the taxation measures effective from 1 January 2014, the continuation of the already legislated personal income tax reduction from 24% in 2014 to 23% in 2015 and 22% in 2016, and the increase in minimum wage from EUR 320 to EUR 360 in 2015. For 2016, an introduction of a progressive differentiation of non-taxable minimum income used for individual personal income tax assessment is planned, increasing non-taxable minimum income for low wage earners, calibrating it for middle-income earners and removing it for high-income earners. Moreover, the authorities have announced a high level Tax Policy Strategy aiming at reducing labour taxation and increasing the overall tax burden to 30% of GDP mainly through increasing tax compliance.

The existing and new policy measures go in the direction of the Country Specific Recommendation, but the effort could be better targeted and implementation could be accelerated. Specifically, the personal income tax rate reduction benefits mostly middle and high income earners, while for low-income earners, a relatively high share of their income is not subject to the income tax (covered by the non-taxable minimum income and other deductions). The increase in the minimum wage supports income of low-earners, in some cases allowing utilising all eligible deduction from taxable income, but may reduce the number of low-skilled jobs, which may not be sustained at the increased minimum wage. The plans to implement the progressive non-taxable minimum income are well targeted at supporting the low-income earners, but its implementation is postponed to 2016, as the specifics of the measure and its practical implementation are yet to be developed.

In terms of improving tax compliance, the authorities pay a sufficient attention to the existing problems. Several measures are already being implemented and are reflected in the draft 2015 budget calculations, as well as new measures are in preparation. The authorities are working on a renewed action plan on combating the shadow economy. In this context, adequate resourcing and training of the professionals in tax administration and judiciary would further strengthen their capacity to solve complex financial crimes.

6. OVERALL CONCLUSION

Both in 2014 and 2015, the deviation from the MTO is within the limits allowed by the systemic pension reform clause of the preventive arm of the Stability and Growth Pact. Also the overall assessment over 2013-14 concludes that there is no deviation from the requirements considering the effect of temporary measures and available fiscal space.

The updated Draft Budgetary Plan includes measures addressing the Country Specific Recommendations on the fiscal structural reforms, but the effort could be better targeted. A progressive differentiation of non-taxable minimum income used for individual personal income tax assessment is planned to be implemented in 2016.