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**COMMISSION STAFF WORKING DOCUMENT**

**Analysis of the draft budgetary plan of LATVIA**

***Accompanying the document***

**COMMISSION OPINION**

**on the draft budgetary plan of LATVIA**

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## 1. INTRODUCTION

Latvia has submitted its Draft Budgetary Plan for 2015 on 15 October in compliance with Regulation (EU) No 473/2013 of the Two-Pack. The Draft Budgetary Plan was submitted by the outgoing government on the basis of unchanged policies. Following the general elections on 4 October, the new government took the office on 5 November. The updated Draft Budgetary Plan including the 2015 budget proposal by the new government has been submitted on 22 November and will be assessed in due time. 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 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 Commission Forecast. 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 summarises the main conclusions of the present document.

## 2. MACROECONOMIC DEVELOPMENTS UNDERLYING THE DRAFT BUDGETARY PLAN

The macroeconomic scenario underlying the Draft Budgetary Plan foresees a slowdown in economic growth from 4.2% in 2013 to 2.9% in 2014 and 2.8% in 2015. This represents a significant revision from the latest Stability Programme where economic growth was forecast at 4% in 2014 and 2015. Inflation and employment are also revised downwards. Compared with the Commission 2014 autumn forecast, the projection for economic growth enshrined in the Draft Budgetary Plan is higher in 2014, but slightly lower in 2015. The cumulative growth rates for 2014-15 are however identical in the Commission and Latvia's forecasts, both in real and nominal terms. Overall, the macroeconomic scenario underlying the Draft Budgetary Plan is broadly in line with the Commission 2014 autumn forecast.

Uncertainties related to geopolitical tensions, in particular the conflict between Russia and Ukraine, 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.

**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 | 0.5 | 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 2014 autumn forecast (COM); Commission calculations.*

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

The macroeconomic forecast underpinning budgetary projections in the Draft Budgetary Plan has been prepared by the Ministry of Finance; it has not been formally endorsed by an independent body as defined in Regulation (EU) No 473/2013.

The Fiscal Discipline Council, Latvia's fiscal monitoring institution, will prepare a fiscal discipline monitoring report on the 2015 budget law that will be presented to the parliament. The report will provide the Council's opinion on the budget's compliance with the Fiscal Discipline Law, including an independent evaluation of the macroeconomic projections and the cyclical position of the economy.

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.

## 3. RECENT AND PLANNED FISCAL DEVELOPMENTS

### 3.1. Deficit developments

The Draft Budgetary Plan presents a headline deficit of 1.5% of GDP in 2014, as compared to the deficit target of 1% of GDP in the Stability Programme. The worsening of the fiscal position is largely due to weaker tax revenue (0.1% of GDP) and a one-off payment to the European Bank for Reconstruction and Development (EBRD) under the guarantee contract on the EBRD participation in the bad-bank Parex (0.4% of GDP). The weakness in tax revenue is related to the slowdown in the economic activity, but the negative effect is muted by a somewhat stronger wage growth than previously expected. The Commission 2014 autumn forecast, which projects a deficit of 1.1% of GDP, excludes the effect of the one-off measure, given limited information available at the time of the forecast, but the underlying fiscal developments are consistent with the authorities' estimates.

Based on unchanged policies, the Draft Budgetary Plan envisages a fiscal deficit of 1% of GDP in 2015, as compared to 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 Commission 2014 autumn forecast projects a deficit of 1.2% of GDP based on a no-policy-change assumption.

The structural deficit recalculated according to the commonly agreed methodology[1] has deteriorated by 0.1pp. of GDP in 2014 to 1.5% of GDP, but remains unchanged at 1.4% of GDP in 2015, as compared to the Stability Programme. The Commission 2014 autumn forecast presents a structural deficit of 1.5% of GDP in 2014 and 1.6% in 2015.

[1] 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 [3] | | | 2015 [3] | | | Change: 2013-2015 |
|---|---|---|---|---|---|---|---|---|
| | **COM** | **SP** | **DBP** | **COM** | **SP** | **DBP** | **COM** | **DBP** [3] |
| **Revenue** | **34.8** | **33.9** | ***34.7*** | **34.3** | **32.0** | ***33.0*** | **33.7** | **-1.8** |
| *of which:* | | | | | | | | |
| - Taxes on production and imports | 13.9 | 11.6 | *12.0* | 14.1 | 11.5 | *11.9* | 14.3 | -2.0 |
| - Current taxes on income, wealth, etc. | 7.6 | 7.6 | *7.6* | 7.5 | 7.3 | *7.3* | 7.3 | -0.3 |
| - 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* | 8.3 | 7.7 | *8.2* | 8.0 | -0.3 |
| - Other (residual) | 4.8 | 6.5 | *6.5* | 4.4 | 5.5 | *5.6* | 4.2 | 0.8 |
| **Expenditure** | **35.7** | **34.9** | **36.2** | **35.4** | **32.8** | **34.0** | **34.9** | **-1.7** |
| *of which:* | | | | | | | | |
| - Primary expenditure | 34.2 | 33.3 | 34.8 | 34.0 | 31.6 | 32.7 | 33.5 | -1.5 |
| *of which:* | | | | | | | | |
| Compensation of employees | 9.2 | 9.2 | 9.4 | 9.4 | 8.7 | 9.1 | 9.4 | -0.1 |
| Intermediate consumption | 6.1 | 6.5 | 6.5 | 6.2 | 6.2 | 6.2 | 6.1 | 0.1 |
| Social payments | 10.7 | 10.1 | 10.3 | 10.7 | 9.9 | 10.3 | 10.7 | -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 | 4.0 | 3.8 | 3.2 | 3.5 | 3.6 | -0.5 |
| Other (residual) | 3.7 | 3.3 | 4.0 | 3.3 | 3.0 | 3.0 | 3.2 | -0.7 |
| - Interest expenditure | 1.5 | 1.6 | 1.4 | 1.4 | 1.2 | 1.3 | 1.4 | -0.2 |
| **General government balance (GGB)** | **-0.9** | **-1.0** | **-1.5** | **-1.1** | **-0.8** | **-1.0** | **-1.2** | **-0.1** |
| **Primary balance** | **0.6** | **0.6** | **0.0** | **0.3** | **0.4** | **0.3** | **0.2** | **-0.3** |
| One-off and other temporary | 0.0 | 0.0 | -0.4 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| **GGB excl. one-offs** | **-0.9** | **-1.0** | **-1.1** | **-1.1** | **-0.8** | **-1.0** | **-1.2** | **-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 | -1.9 | -1.5 | -1.4 | -1.4 | -1.6 | -0.4 |
| **Structural balance (SB)** [2] | **-1.0** | **-1.4** | **-1.5** | **-1.5** | **-1.4** | **-1.4** | **-1.6** | **-0.4** |
| Structural primary balance [2] | 0.4 | 0.2 | -0.1 | 0.0 | -0.2 | -0.1 | -0.3 | -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.

[3] Direct comparison of different vintages of the forecasts (SP, DBP and COM) is complicated by the significant statistical revisions, including due to transition to the new ESA2010 methodology. This also affects calculated change between 2013 and 2015.

Source :

*Stability programme 2014 (SP); Draft Budgetary Plan 2015 (DBP); Commission 2014 autumn forecast (COM); Commission calculations.*

## 3.2. Debt developments

The Draft Budgetary Plan estimates gross public debt at around 40% of GDP in 2014 and declining to some 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 2014 autumn 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** | **39.7** | **40.3** | **32.9** | **34.6** | **36.3** |
| Change in the ratio | -2.7 | 0.7 | 1.5 | 2.0 | -5.9 | -5.1 | -3.9 |
| *Contributions[2]:* | | | | | | | |
| **1. Primary balance** | **-0.6** | **-0.6** | **0.0** | **-0.3** | **-0.4** | **-0.3** | **-0.2** |
| **2. "Snow-ball" effect** | **-0.6** | **-0.4** | **0.1** | **-0.1** | **-1.3** | **-0.6** | **-0.5** |
| *Of which:* | | | | | | | |
| Interest expenditure | 1.5 | 1.6 | 1.5 | 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** | **1.8** | **1.4** | **2.5** | **-4.2** | **-4.1** | **-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

Source:

*Stability programme 2014 (SP); Draft Budgetary Plan 2015 (DBP); Commission 2014 autumn forecast (COM); Commission calculations.*

### 3.3. Measures underpinning the draft budgetary plan

The Draft Budgetary Plan was submitted by the outgoing government on the basis of unchanged policies. Any new policy measures will be presented in the updated Draft Budgetary Plan to be submitted in due time by the new government including the 2015 budget proposal that will be sent to the national parliament.

## 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 eligible to 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[2].

The recalculated structural balance is within the limits of the allowed deviation from the MTO of a structural deficit of 1% of GDP, including in 2015 on a no-policy change basis. The structural balance rule is also observed based on the Commission 2014 autumn forecast.

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 and, on a no-policy change basis, also in 2015. A significant deviation from the

[2] 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.

expenditure benchmark over 2013 and 2014 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. Latvia was at its MTO in 2013. Based on the Commission 2014 autumn forecast, the assessment of compliance with the expenditure benchmark in 2014 is similar to that based on the Draft Budgetary Plan. However, in 2015, some deviation (0.2pp. of GDP) from the expenditure benchmark is projected on a no-policy-change basis, putting at risk compliance with the Stability and Growth Pact. Average expenditure growth over 2014 and 2015 is within the limit of the expenditure benchmark.

**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.

**Box 3. Addressing the tax wedge**

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 its commitment to effectively reduce the tax burden on labour. It will take stock of Member States' plans for reductions of the tax burden when discussing the draft budgetary plans.

In the context of the European Semester, Latvia was issued the recommendation 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."

The tax wedge in Latvia is well above the EU average, especially for low-income earners. The tax wedge in 2012 for a single person without children earning 50% of the average wage was 42.8% compared to an EU average of 34.1%, for 67% of the average wage it was 43.6% (EU average: 37.7%) and for the average wage it was 44.5% (EU average: 41.1%). While the overall employment rate is somewhat above the EU average, the unemployment rate of low-skilled workers is high (24.8% compared to an EU average of 19.1% in 2013)[3].

The Draft Budgetary Plan does not include a reform affecting the tax wedge on labour. However, the authorities have announced the Tax Policy Strategy for 2015-17, including plans to reduce tax burden on labour and improving tax compliance[4]. In particular, the strategy sets out the plans of increasing minimum wage by at least 10% every year and increasing untaxed minimum income, thus reducing tax burden on low-income earners.

[3] The arithmetic average is used to calculate the average tax wedge for the EU; recent data for Cyprus and Croatia are not available; data from 2012 were used for Bulgaria, Latvia, Lithuania, Malta and Romania. The unemployment rate is for the age group 20-64.

[4] http://www.fm.gov.lv/files/presesrelizes/Nodoklu%20politikas%20strategija%202015_2017.pdf

## Table 4 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 | -1.5 | | -1.6 | |
| 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 | -0.5 | -0.4 | 0.1 | -0.2 |
| *One-year deviation from the required adjustment after considering the relevant factors*[6] | 0.0 | 0.1 | 0.1 | 0.4 | 0.2 |
| Two-year average change in structural balance[5] | 0.2 | -0.6 | -0.6 | -0.2 | -0.3 |
| *Two-year average deviation from the required adjustment after considering the relevant factors*[6] | 0.6 | 0.3 | 0.3 | 0.2 | 0.1 |
| **Expenditure benchmark pillar** | | | | | |
| Applicable reference rate[7] | 1.2 | 1.4 | | 0.1 | |
| *One-year deviation*[8] | -1.4 | 0.5 | 0.3 | 0.9 | -0.2 |
| *Two-year average deviation*[8] | 0.0 | -0.6 | -0.6 | 0.7 | 0.0 |
| **Conclusion** | | | | | |
| Conclusion over one year | Overall assessment | Compliance | Compliance | Compliance | Overall assessment |
| 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. The indicator is corrected for the pension reform clause.

Source :

*Draft Budgetary Plan 2015 (DBP), Commission 2014 autumn forecast (COM), Commission calculations*

## 5. OVERALL CONCLUSION

The Draft Budgetary Plan, being based on a no-policy change scenario, is short on the specific information required by the Two Pack Code of Conduct.

Following an overall assessment of Latvia's Draft Budgetary Plan, with the structural balance as a reference, including an analysis of expenditure net of discretionary revenue measures, 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 in 2014, but there is a risk of some deviation from the preventive arm requirements in 2015. On the basis of this assessment, it also appears that Latvia is expected to broadly comply with the recommendation addressed to it by the Council on 8 July 2014.