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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 submitted its Draft Budgetary Plan for 2020 on 11 October 2019 in compliance with Regulation (EU) No 473/2013. Latvia is subject to the preventive arm of the Pact and should ensure sufficient progress towards its medium-term budgetary objective, taking into account the allowance linked to the implementation of the structural reforms for which a temporary deviation is granted.

Section 2 of this document presents the macroeconomic outlook underlying the Draft Budgetary Plan and provides an assessment based on the Commission 2019 autumn 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 2019 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 2019-2020 (also taking into account the risks to their achievement) against the obligations stemming from the Stability and Growth Pact. Section 5 provides an analysis of implementation of fiscal-structural reforms in response to the latest country-specific recommendations in the context of the European Semester adopted by the Council in July 2019, including those to reduce the tax wedge. Section 6 summarises the main conclusions of the present document.

2. MACROECONOMIC DEVELOPMENTS UNDERLYING THE DRAFT BUDGETARY PLAN

The macroeconomic scenario underlying Latvia's Draft Budgetary Plan forecasts real GDP growth slowing down from 4.8% in 2018[1] to 3.2% in 2019, and then to 2.8% in 2020. A slowdown in both consumption and investment growth are the main drivers of the overall growth deceleration in 2019. In 2020, GDP growth is forecast to moderate, with investment growth projected to slow down further. For all other GDP components growth is expected to maintain the same pace as in 2019. Harmonised Index of Consumer Prices inflation is forecast to reach 2.8% in 2019 before abating to 2.5% in 2020, with the GDP deflator following a similar path – it is forecast to reach 3.1% in 2019 and 2.7% in 2020. Employment is projected to grow by 0.5% in 2019, before falling to 0.1% growth in 2020. The unemployment rate is set to continue decreasing due to a shrinking labour force. The tight labour market is set to keep wage growth high in both 2019 and 2020, although on a slowing trajectory.

[1] Statistics Latvia has since revised the GDP growth for 2018 from 4.8% to 4.6%.

Compared with the scenario underlying the Stability Programme, GDP growth for 2019 has remained unchanged, while for 2020 it has been revised down by 0.2 percentage points due to somewhat lower forecasted growth for all major components. Harmonised Index of Consumer Prices inflation has been revised slightly upwards from 2.2% in the Stability Programme to 2.5% in the Draft Budgetary Plan, while the GDP deflator has been revised down by 0.1 percentage point to 2.7%. The employment growth forecast has not changed and the wage growth forecast has been revised up somewhat from 5.5% in the Stability Programme to 6.0% in the Draft Budgetary Plan.

The positive output gap, as recalculated by the Commission following the commonly agreed methodology, is estimated to fall from 2.9% of GDP in 2018 to 2.8% of GDP in 2019 and further to 2.1% of GDP in 2020. Based on the Commission forecast, the positive output gap is estimated to fall from 2.2% of GDP in 2019 to 1.4% of GDP in 2020. The differences between the two sets of estimates are explained by differences in GDP forecasts for 2019 and 2020. More specifically, while the forecast underlying the potential GDP estimate are similar, higher actual forecast GDP growth in the Draft Budgetary Plan leads to a slower closing of the output gap compared with the Commission's forecast.

Compared with the Commission forecast, the Draft Budgetary Plan is notably more optimistic about real GDP growth in 2019 and somewhat more optimistic about the real GDP growth 2020. The Commission forecast a lower investment growth in 2019 and even lower in 2020. Slowing investment and export demand is expected to spill over to domestic consumption and to affect Latvia's exports more than assumed in the Draft Budgetary Plan.

The Draft Budgetary Plan sees the risks to the macroeconomic forecast as tilted to the downside. The major risks recognised by the Draft Budgetary Plan relate to weakening global growth and export demand in the event of the UK leaving the EU without a deal and a possible escalation of protectionist measures in global trade.

To conclude, the Draft Budgetary Plan's macroeconomic assumptions are markedly favourable for 2019 and favourable for 2020.

Box 1: The macroeconomic forecast underpinning the budget in Latvia

The macroeconomic forecast underlying the Draft Budgetary Plan was prepared by the Ministry of Finance and endorsed by the Fiscal Discipline Council (FDC) in June 2019. The endorsement report is published on the FDC's website[2] and acknowledged in the Draft Budgetary Plan. The FDC is an independent body established with the purpose of monitoring compliance with the Fiscal Discipline Law. It has also been charged with the task of endorsing the macroeconomic forecasts underlying the budgetary plans.

Along with the endorsement, the FDC made several comments, pointing out the risks to the forecast, mainly due to weakening external demand. It also noted inflation risks stemming from the tight labour market and agreed that the current investment cycle was winding down and that, therefore, Latvia should generally expect lower growth rates over the coming years compared to the growth rates it enjoyed in 2017 and 2018. Moreover, in the more recent Fiscal Discipline Surveillance Report from September 2019[3] the FDC noted that a number of

[2] https://fiscalcouncil.lv/27062019_macroeconomic_forecast_endorsement
[3] https://fiscalcouncil.lv/files/uploaded/Surveillance_report_2020_final_3.docx.pdf

short-term economic indicators had worsened since the adoption of the June opinion on the macroeconomic forecast.

Table 1. Comparison of macroeconomic developments and forecasts

	2018	2019			2020		
	COM	SP	DBP	COM	SP	DBP	COM
Real GDP (% change)	4.6	3.2	3.2	2.5	3.0	2.8	2.6
Private consumption (% change)	4.2	4.3	3.4	3.2	3.6	3.3	3.6
Gross fixed capital formation (% change)	15.8	7.7	8.2	4.5	6.0	5.0	1.3
Exports of goods and services (% change)	4.0	3.2	2.9	2.7	4.1	3.2	1.8
Imports of goods and services (% change)	6.4	5.7	0.9	4.2	5.2	2.8	2.2
Contributions to real GDP growth:							
- Final domestic demand	6.5	5.0	4.6	3.4	4.2	3.8	2.8
- Change in inventories	-0.4	0.0	-2.6	0.0	-0.2	-1.2	0.0
- Net exports	-1.5	-1.8	1.2	-0.9	-1.0	0.2	-0.3
Output gap[1]	3.1	2.1	2.8	2.2	0.9	2.1	1.4
Employment (% change)	1.6	0.5	0.5	-0.4	0.1	0.1	0.0
Unemployment rate (%)	7.4	7.0	7.0	6.6	6.5	6.6	6.4
Labour productivity (% change)	3.0	2.7	2.7	2.9	2.9	2.7	2.6
HICP inflation (%)	2.6	2.5	2.8	3.1	2.2	2.5	2.5
GDP deflator (% change)	4.0	3.1	3.1	3.1	2.8	2.7	2.3
Comp. of employees (per head, % change)	8.5	6.5	7.5	6.1	5.5	6.0	5.0
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	1.1	-0.7	2.5	1.3	-1.6	2.1	0.7

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 2019 (SP); Draft Budgetary Plan for 2020 (DBP); Commission 2019 autumn forecast (COM); Commission calculations

3. RECENT AND PLANNED FISCAL DEVELOPMENTS

3.1. Deficit developments

The Draft Budgetary Plan targets a government deficit of 0.5% of GDP in 2019, which is unchanged compared to the April 2019 Stability Programme. The revised revenue estimates reflect underperformance of corporate income tax in 2019, which are offset by better-than-planned labour tax revenue. The transition to the new corporate income tax regime, where only dividend withdrawals are taxed, has had a more negative effect on revenue than initially planned. A temporary shortfall in corporate income tax in 2019 is linked to larger-than-planned repayments of advance payments made under the previous tax regime, as well as companies paying out a lower share of new profits than earlier assumed, thus reducing government revenue in 2019 and over the coming years. Strong personal income tax and social contribution revenue growth is linked to buoyant wage growth. Expenditure plans have little changed, except for a higher public investment, financed from EU funds.

The Commission 2019 autumn forecast estimates a government deficit of 0.6% of GDP in 2019. The Commission forecast is more cautious on tax revenue projections, in line with the lower economic growth outlook. Moreover, corporate income tax revenue are assumed to be lower, as suggested by the tax returns in the first nine month of 2019. The overall expenditure

growth of the Commission forecast is similar to that of the Draft Budgetary Plan, but the assumptions on the expenditure breakdown by economic classification differ somewhat.

For 2020, the Draft Budgetary Plan targets a nominal deficit of 0.3% of GDP, as compared to the 0.4% deficit target of the Stability Programme. The difference is mostly due to a different treatment of the fiscal security reserve, which was assumed to be used under the Stability Programme but not used under the Draft Budgetary Plan. This has resulted in slightly lower projected expenditure in 2020. Revenue revisions for 2020 reflect the revenue updates for 2019 and the revised economic outlook, as well as the effect of revenue measures included in the budget. In particular, direct tax revenues are reduced by a sharper increase in personal income tax allowance and non-tax revenue benefits from higher-than-previously-planned dividend payments from the state-owned companies. Expenditure plans have changed as a result of forecast updates and expenditure reallocation, as decided for in the Draft Budgetary Plan. Interest expenditure and social spending is projected to be slightly lower than previously estimated, while public sector wage growth and subsidies are prioritised over other expenditure items. Public investment peaked in 2019 after a steep increase in 2017 and 2018, but is planned to shrink by 7% in 2020.

The Commission forecasts a deficit of 0.6% of GDP in 2020. As compared to the Draft Budgetary Plan, the Commission forecast is based on a weaker starting position in 2019 (0.1 percentage point of GDP) and assumes slower tax revenue growth, in line with the somewhat lower economic growth outlook (0.2 percentage points of GDP). Other elements of revenue and expenditure growth projections are similar between the Commission forecast and the Draft Budgetary Plan.

The recalculated structural deficit[4] presented in the Draft Budgetary Plan is estimated to decrease from 1.9% of GDP in 2018 to 1.1% of GDP in 2020. It reflects an improvement in the nominal government balance by 0.4 percentage points and a narrowing of the positive output gap. The Stability Programme estimated a recalculated structural deficit of 2.1% of GDP in 2018, as the initially notified nominal government deficit stood at 1.0% of GDP, as compared to the most recent estimate of a headline deficit of 0.7% of GDP for 2018. The recalculated structural deficit of the Stability Programme was projected to shrink to 0.9% of GDP by 2020, assuming a lower recalculated output gap. The Commission autumn 2019 forecast estimates the structural balance to decline to 1.1% of GDP in 2020. While the Commission forecast of the nominal deficit is higher for 2020, its output gap estimate is lower than that recalculated based on the information of the Draft Budgetary Plan, since higher forecast GDP growth in 2019 and 2020 in the Draft Budgetary Plan leads to slower closing of the output gap compared with the Commission's forecast. This results in similar estimate of the structural balance by the Commission and the Draft Budgetary Plan for 2020.

Euro area sovereign bond yields remain at historically low levels, with 10-year rates in Latvia currently standing at -0.11%[5]. As a consequence, total interest payments by the general government have continued to decrease as a share of GDP. Based on the information included in the Draft Budgetary Plan, interest expenditure in Latvia is expected to decrease from 0.8% of GDP in 2019 to 0.7% of GDP in 2020. It is well below the 1.7% recorded in 2012 at the

[4] Cyclically adjusted balance net of one-off and temporary measures, recalculated by the Commission using the commonly agreed methodology.
[5] 10-year bond yields in September on average, as estimated by Eurostat.

peak of the euro-area sovereign debt crisis. The Commission forecast of interest expenditure is 0.7% over the 2018-2020 period.

Table 2. Composition of the budgetary adjustment

(% of GDP)	2018	2019			2020			Change: 2018-2020
	COM	SP	DBP	COM	SP	DBP	COM	DBP
Revenue	**37.8**	**36.2**	***36.5***	**37.0**	**35.9**	***36.3***	**36.7**	**-1.5**
of which:								
- Taxes on production and imports	14.3	14.1	*14.1*	14.4	14.3	*14.2*	14.5	-0.1
- Current taxes on income, wealth,	7.4	6.5	*6.4*	6.5	6.6	*6.4*	6.5	-1.0
- Capital taxes	0.0	0.0	*0.0*	0.0	0.0	*0.0*	0.0	0.0
- Social contributions	9.5	9.4	*9.5*	9.7	9.4	*9.6*	9.8	0.1
- Other (residual)	6.6	6.2	*6.5*	6.3	5.6	*6.1*	5.8	-0.5
Expenditure	**38.5**	**36.7**	**37.1**	**37.6**	**36.4**	**36.6**	**37.2**	**-1.9**
of which:								
- Primary expenditure	37.8	36.0	36.3	36.9	35.6	35.9	36.5	-1.9
of which:								
Compensation of employees	10.3	10.3	10.1	10.6	9.9	10.1	10.6	-0.2
Intermediate consumption	5.6	5.5	5.4	5.2	5.2	5.1	4.9	-0.5
Social payments	11.6	11.6	11.5	11.6	11.8	11.7	12.0	0.1
Subsidies	1.0	1.6	1.6	0.9	1.5	1.6	0.9	0.6
Gross fixed capital formation	5.4	5.1	5.5	5.6	4.9	4.9	4.9	-0.5
Other (residual)	3.8	1.9	2.2	3.0	2.3	2.5	3.2	-1.3
- Interest expenditure	0.7	0.7	0.8	0.7	0.8	0.7	0.7	0.0
General government balance (GGB)	**-0.7**	**-0.5**	**-0.5**	**-0.6**	**-0.4**	**-0.3**	**-0.6**	**0.4**
Primary balance	**0.0**	**0.2**	**0.2**	**0.1**	**0.4**	**0.4**	**0.1**	**0.4**
One-off and other temporary measures	0.0	0.1	0.2	0.2	0.0	0.0	0.0	0.0
GGB excl. one-offs	**-0.7**	**-0.6**	**-0.7**	**-0.8**	**-0.4**	**-0.3**	**-0.6**	**0.4**
Output gap[1]	3.1	2.1	2.8	2.2	0.9	2.1	1.4	-0.8
Cyclically-adjusted balance[1]	-1.9	-1.3	-1.6	-1.5	-0.8	-1.1	-1.1	0.8
Structural balance (SB)[2]	**-1.9**	**-1.4**	**-1.8**	**-1.6**	**-0.8**	**-1.1**	**-1.1**	**0.8**
Structural primary balance[2]	-1.2	-0.7	-1.0	-0.9	0.0	-0.4	-0.4	0.7

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 corresponds to cyclically-adjusted (primary) balance excluding one-off and other temporary measures.

Source:

Stability Programme 2019 (SP); Draft Budgetary Plan for 2020 (DBP); Commission 2019 autumn forecast (COM); Commission calculations

3.2. Debt developments

The Draft Budgetary Plan plans for the government debt ratio to increase from 36.4% of GDP in 2018 to 37% of GDP in 2020. The increase in the gross debt ratio in 2019 and 2020 is underpinned by an accumulation of financial resources ahead of a large debt redemption in 2020 and 2021. The deference between nominal GDP growth and government borrowing leads to a reduction in the debt ratio over the forecast period.

Based on the Commission 2019 autumn forecast, the debt-to-GDP ratio is projected to decline to 35.2% of GDP by the end of 2020, which assumes a lower accumulation of cash reserves in 2019 and 2020 ahead of large debt redemptions.

Table 3. Debt developments

(% of GDP)	2018	2019			2020		
		SP	DBP	COM	SP	DBP	COM
Gross debt ratio[1]	**36.4**	**37.4**	**36.6**	**36.0**	**36.1**	**37.0**	**35.2**
Change in the ratio	-2.3	1.0	0.2	-0.4	-1.3	0.4	-0.7
Contributions[2]:							
1. Primary balance	**0.0**	**-0.2**	**-0.2**	**-0.1**	**-0.4**	**-0.4**	**-0.1**
2. "Snow-ball" effect	**-2.3**	**-1.5**	**-1.5**	**-1.2**	**-1.3**	**-1.2**	**-1.0**
Of which:							
Interest expenditure	0.7	0.7	0.8	0.7	0.8	0.7	0.7
Real growth effect	-1.6	-1.1	-1.1	-0.9	-1.1	-1.0	-0.9
Inflation effect	-1.4	-1.1	-1.1	-1.1	-1.0	-0.9	-0.8
3. Stock-flow adjustment	**0.1**	**2.7**	**1.9**	**1.0**	**0.4**	**2.0**	**0.4**
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 2019 (SP); Draft Budgetary Plan for 2020 (DBP); Commission 2019 autumn forecast (COM); Commission calculations

3.3. Measures underpinning the draft budgetary plan

The Draft Budgetary Plan incorporates net revenue-increasing measures of 0.1% of GDP and expenditure-increasing measures of 0.3% of GDP in 2020 (Table 4).

Only a few new revenue measures have been announced in view of the government's commitment of no major tax policy changes in 2020. A steeper increase in the income-differentiated basic allowance, which was already planned for 2020, is estimated to cost 0.1% of GDP. Larger than usual profits of the State Forest Company are linked to favourable market conditions in 2018, leading to a temporary higher dividend payment in 2020. Other smaller revenue-increasing measures amount to 0.1% of GDP. The Commission 2019 autumn forecast treats the policy changes, like the increase in the basic allowance, as discretionary revenue measures. However, fluctuations in dividend payments and second-round effects from the planned increase in the national minimum wage in 2021 are not recorded as discretionary measures, although they are included in the Commission forecast.

Increases in public spending mostly reflect an increase in wages for medical personnel, teachers and internal security forces (0.3% of GDP). Subsidies for farmers will be temporarily increased in 2020 (0.1% of GDP), extending the support received in the previous years. Capital spending plans are readjusted by switching projects and spreading their implementation over the following years, while available resource in 2020 are used for other spending needs. Interest expenditure savings relative to the previous plans are presented among the budgetary measures of the Draft Budgetary Plan, but are not treated as such by the Commission.

Table 4. Main discretionary measures reported in the Draft Budgetary Plan

A. Discretionary measures taken by General Government - revenue side

Components	Budgetary impact (% GDP) (as reported by the authorities)		
	2020	**2021**	**2022**
Taxes on production and imports	0.0	0.0	0.0
Current taxes on income, wealth, etc.	-0.1	0.0	0.0
Capital taxes			
Social contributions	0.0	0.1	0.0
Property Income	0.1	-0.1	0.0
Other	0.1	0.0	0.0
Total	**0.1**	**0.0**	**0.0**

Note:

The budgetary impact in the table is the aggregated impact of measures as reported by the national authorities. A positive sign implies that revenue increases as a consequence of this measure.

Source:

Draft Budgetary Plan for 2020

B. Discretionary measures taken by General Government- expenditure side

Components	Budgetary impact (% GDP) (as reported by the authorities)		
	2020	**2021**	**2022**
Compensation of employees	0.3	0.0	0.0
Intermediate consumption	0.0	0.0	0.0
Social payments	0.0	0.0	0.0
Interest Expenditure	-0.1	0.0	-0.1
Subsidies	0.1	-0.1	0.0
Gross fixed capital formation	-0.1	0.2	0.1
Capital transfers	0.0	0.0	0.0
Other	0.1	-0.1	0.0
Total	**0.3**	**0.0**	**0.1**

Note:

The budgetary impact in the table is the aggregated impact of measures as reported by the national authorities. A positive sign implies that expenditure increases as a consequence of this measure.

Source:

Draft Budgetary Plan for 2020

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 medium-term budgetary objective. Box 2 reports the latest country specific recommendations in the area of public finances.

Box 2. Council recommendations addressed to Latvia

On 9 July 2019, the Council addressed recommendations to Latvia in the context of the European Semester. In particular, in the area of public finances the Council recommended that the nominal growth rate of net primary government expenditure does not exceed 3.5% in 2020, corresponding to an annual structural adjustment of 0.5% of GDP.

Adjustment towards the medium-term budgetary objective

Latvia has been granted a temporary increase in its structural deficit to finance healthcare reform. The structural reform clause for the healthcare reform was granted in 2017 and allows for a deviation of 0.5% of GDP in 2019[6]. This allowance expires in 2020. Latvia is therefore expected to return to its medium-term budgetary objective of a structural deficit of 1% of GDP in 2020.

For 2019, the Draft Budgetary Plan suggests compliance with the expenditure benchmark and some deviation from the structural balance requirement (a gap of 0.1% of GDP over one year). However, over 2018 and 2019 on average both indicators point to a significant deviation, with gaps of 0.7 and 0.3% of GDP respectively. Overall, the Draft Budgetary Plan points to a risk of a significant deviation from the requirements in 2019.

Based on the Commission 2019 autumn forecast, Latvia's structural deficit of 1.6% of GDP in 2019 is expected to be close to the medium-term budgetary objective, taking into account the allowance linked to the healthcare reform (gap of 0.1% of GDP). At the same time, the Commission forecast points to a risk of some deviation from the expenditure benchmark in 2019 and to a risk of significant deviation in 2018-2019 taken together. Taking into account the limited distance to the medium-term budgetary objective, the current assessment points to a risk of some deviation in 2019. If the structural balance is no longer projected to be close to the medium-term budgetary objective, taking into account the allowance linked to healthcare reform, future assessment of compliance with the requirements of the preventive arm would consider a possible deviation from the requirement.

For 2020, the recalculated structural deficit of 1.1% of GDP in the Draft Budgetary Plan is expected to be close to the medium-term budgetary objective (gap of 0.1% of GDP). This implies an improvement of 0.7% of GDP in the structural balance indicator for 2020. At the same time, the expenditure benchmark points to a significant deviation of 1.1% of GDP. The different reading of the indicators is largely explained by different potential growth and investment assumptions. The 10-year average GDP growth rate used for the expenditure benchmark is lower than the estimate for 2020 used for the structural balance (gap of 0.2% of GDP). The 4-year average investment used for the expenditure benchmark is estimated to be still catching up with planned investment for 2020, which tightens the expenditure benchmark

[6] The structural reform clause for the healthcare sector reform of 0.5% of GDP was granted to Latvia as from 2017, but the existing allowance for the pension reform and the minimum benchmark of a structural deficit of 1.7% of GDP limited the deviation granted under the structural reform clause to 0.1% of GDP in 2017 and 0.4% in 2018. The allowed deviation of 0.5% of GDP can be used in full in 2019.

relative to the structural balance by 0.8 percentage points of GDP. Overall, given the closeness to the medium-term budgetary objective, the Draft Budgetary Plan points to a risk of some deviation in 2020. If compliance with the medium-term budgetary objective can no longer be established in future assessments, an overall assessment would need to take into account a possible deviation from the requirement.

Based on the Commission 2019 autumn forecast, Latvia's structural deficit of 1.1% of GDP in 2020 is expected to be close to the medium-term budgetary objective (gap of 0.1% of GDP). At the same time, Latvia has a requirement that the nominal growth rate of net primary government expenditure should not exceed 3.5% in 2020. The Commission forecast points to a risk of significant deviation from the expenditure benchmark in 2020 (gap of 1.4% of GDP). The expenditure benchmark is a more restrictive indicator due to a lower medium-term potential growth rate and a more demanding growth in the 4-year average investment than that projected for 2020. Taking into account the distance to the medium-term budgetary objective, the current assessment points to a risk of some deviation in 2020. If the structural balance is no longer projected to be close to the medium-term budgetary objective, future assessments would consider a possible deviation from the requirement.

Table 5: Compliance with the requirements of the preventive arm

(% of GDP)	2018	2019		2020	
Initial position[1]					
Medium-term budgetary objective (MTO)	-1.0	-1.0		-1.0	
Structural balance[2] (COM)	-1.9	-1.6		-1.1	
Structural balance based on freezing (COM)	-1.7	-1.6		-	
Position vis-a -vis the MTO[3]	At or above the MTO	Not at MTO		Not at MTO	
(% of GDP)	**2018 COM**	**2019 DBP**	**2019 COM**	**2020 DBP**	**2020 COM**
Structural balance pillar					
Required adjustment[4]	0.0	0.6		0.5	
Required adjustment corrected[5]	-0.5	0.2		0.5	
Change in structural balance[6]	-0.8	0.1	0.3	0.7	0.6
One-year deviation from the required adjustment[7]	-0.4	-0.1	0.0	0.2	0.1
adjustment[7]	0.0	-0.3	-0.2	0.0	0.1
Expenditure benchmark pillar					
Applicable reference rate[8]	6.6	4.8		3.5	
One-year deviation adjusted for one-offs[9]	-1.4	0.0	-0.3	-1.1	-1.4
Two-year average deviation adjusted for one-offs[9]	-0.8	-0.7	-0.8	-0.6	-0.9

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 is allowed in order to be evaluated as having reached the MTO.

[2] Structural balance corresponds to 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 ed. 2018, page 38.).

[5] Required adjustment corrected for the clauses, the possible margin to the MTO and the allowed deviation in case of overachievers.

[6] Change in the structural balance compared to year t-1. Ex post assessment (for 2018) was carried out on the basis of Commission 2019 spring forecast.

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

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

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

Source :

Draft Budgetary Plan for 2020 (DBP); Commission 2019 autumn forecast (COM); Commission calculations.

5. COMPOSITION OF PUBLIC FINANCES AND IMPLEMENTATION OF FISCAL STRUCTURAL REFORMS

The Draft Budgetary Plan plans a reduction of the government revenue share in GDP by around 1 percentage point between 2018 and 2020. This reflects the effect of tax-cutting measures included in the tax reform being implemented from 2018, as well as a lower growth of non-tax revenue, including those linked to the implementation of EU-funded projects. The contraction of the revenue ratio and the government's commitment to reduce government borrowing constrains public expenditure growth. The government expenditure ratio is planned to contract by 1½ percentage points of GDP over the period 2018-2020. Current expenditure is planned to decrease by 1 percentage point of GDP (mostly government purchases and transfers) and capital expenditure by 0.5 percentage points of GDP between 2018 and 2020. The public investment ratio peaked at 5.5% of GDP in 2019 after a sharp increase in 2017 and 2018, fuelled by the implementation of EU-funded projects. From 2020 on, capital spending is planned to remain broadly stable in nominal terms, which implies an expected decline in its ratio to GDP. Among government functions, health expenditure is set to shrink the most by around ½ percentage points of GDP to decrease to 3.5% of GDP by 2020. While an increase

in healthcare expenditure is presented as one of the largest policy measures of the Draft Budgetary Plan, this increase is measured against a nominally fixed starting position. The Commission country report for Latvia[7] and Latvia's 2019 expenditure review both recognise that the baseline budgetary plans for healthcare do not account for demographic and cost pressures. This puts healthcare at a disadvantage relative to other government sectors during budget discussions.

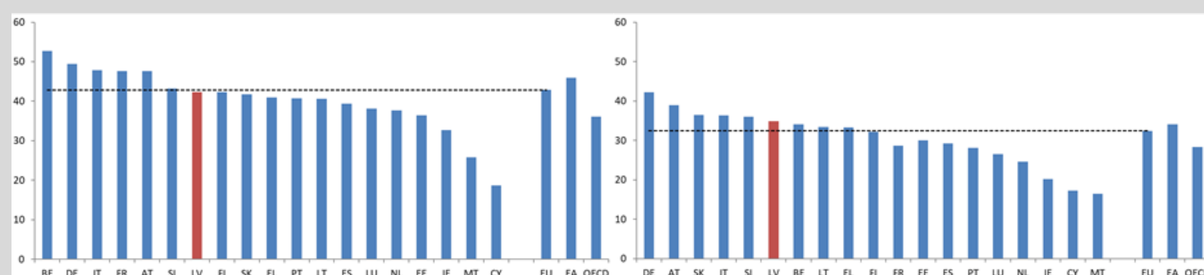
The 2019 expenditure review produced an efficiency analysis of the education and healthcare sectors, but was limited in terms of evaluating and adjusting government spending priorities. The major savings identified as part of the spending review were similar to other revisions in budgetary projections (interest savings and higher dividends from the State Forest Company) and decisions on their use could have been part of the regular budget process. In substance, the 2019 expenditure review appears to be less ambitious than in the previous years.

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 that background, the Eurogroup has expressed a commitment to reduce the tax burden on labour. On 12 September 2015, the Eurogroup agreed to benchmark euro area Member States' tax burden on labour against the GDP-weighted EU average, relying in the first instance on indicators measuring the tax wedge on labour for a single worker at average wage and a single worker at low wage. It also agreed to relate those numbers to the OECD average for purposes of broader comparability.

The tax wedge on labour measures the difference between the total labour costs of employing 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 (2018)



Notes: 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.

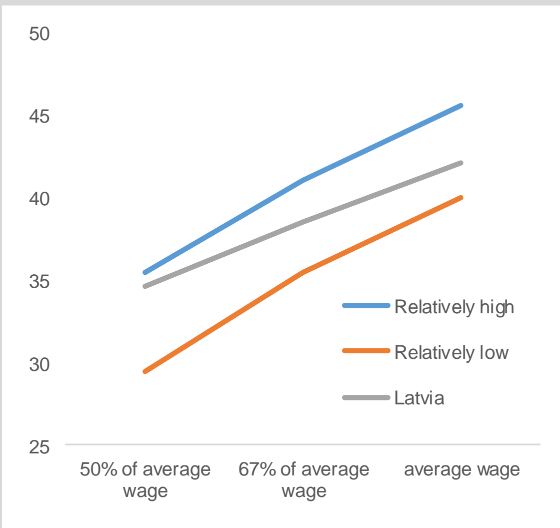
Benchmarking is only the first step in the process towards firm, country-specific policy conclusions. The tax burden on labour interacts with a wide variety of other policy elements such as the benefit system and the wage-setting system. A good employment performance indicates that the need to reduce 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.

[7] The 2019 country report for Latvia: https://ec.europa.eu/info/sites/info/files/file_import/2019-european-semester-country-report-latvia_en.pdf.

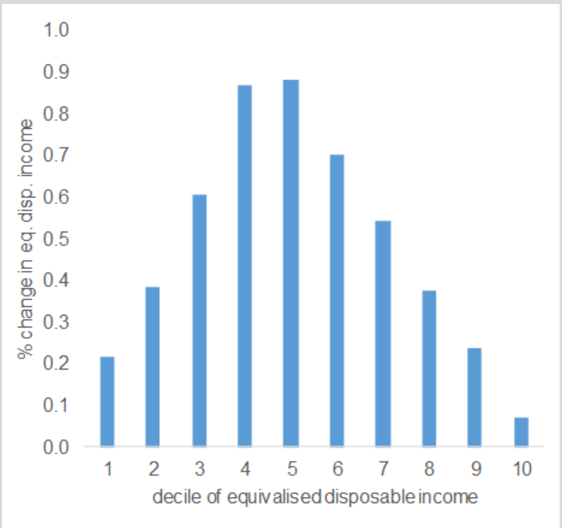
In the context of the 2017 European Semester, Latvia was issued the recommendation to "(..) Reduce the tax wedge for low-income earners by exploiting a growth-friendly tax shift towards environmental and property taxes and improving tax compliance".

Latvia's Draft Budgetary Plan contains measures that reduce the tax wedge on labour. In particular, the Draft Budgetary Plan increased the monthly income-differentiated basic allowance to EUR 300 and its minimum threshold to EUR 500. This goes further than the already-planned increase for 2020 adopted as part of the 2017 tax reform. The planned measure reduces the tax wedge for wages at 50% of average wage to 35%, which is below the relatively high threshold benchmarked against other Member States (Graph 1). In terms of the population-wide income distribution, the measures benefits more middle income groups (Graph 2). Despite its progressive design, the income-differentiated basic allowance does not reach lower income groups in a meaningful way, as they have lower labour market participation and their taxable incomes are already reduced by other allowances (for dependants and pensioners). As a result, the increase in the basic allowance delivers only a modest decline in income inequality.

Graph 1: Estimated tax wedge on labour in Latvia in 2020, compared to relatively high and relatively low levels in other EU countries.



Graph 2: Effect on income distribution of the increase in the basic allowance announced in the Draft Budgetary Plan.



Source: European Commission (Euromod)

6. OVERALL CONCLUSION

In 2019, Latvia based on the Draft Budgetary Plan is projected to be at a risk of a significant deviation from achieving medium term budgetary objective, taking into account the allowance linked to the implementation of the healthcare reform. Based on the Commission 2019 autumn forecast Latvia is projected to be close to its medium-term budgetary objective, taking into account the reform clause. However, the expenditure benchmark points to a risk of significant deviation from the adjustment requirement in 2018 and 2019 on average. Taking into account the distance to the medium-term budgetary objective, the current assessment points to a risk of some deviation in 2019. If the structural balance is no longer projected to be close to the medium-term budgetary objective, taking into account the allowance linked to

healthcare reform, future assessments would consider a possible deviation from the requirement.

In 2020, Latvia is projected to be close to its medium-term budgetary objective, based on the Draft Budgetary Plan and the Commission 2019 autumn forecast. However, the expenditure benchmark points to a risk of significant deviation from the requirement in 2020. Taking into account the distance to the medium-term budgetary objective, the current assessment points to a risk of some deviation in 2020. If the structural balance is no longer projected to be close to the medium-term budgetary objective, future assessments would consider a possible deviation from the requirement.