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**Assessment of the 2015 Stability Programme for
LATVIA**

(Note prepared by DG ECFIN staff)

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1. INTRODUCTION

This document assesses Latvia's April 2015 Stability Programme (hereafter called Stability Programme), which was submitted to the Commission on 15 April and covers the period 2014-2018.¹ The Stability Programme was approved by the government and the respective parliamentary committee.

Latvia is currently 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 objective.

This document complements the Country Report published on 26 February 2015 and updates it with the information included in the Stability programme. Section 2 presents the macroeconomic outlook underlying the Stability Programme and provides an assessment based on the Commission 2015 spring forecast. The following section presents the recent and planned budgetary developments, according to the Stability Programme. In particular, it includes an overview on the medium term budgetary plans, an assessment of the measures underpinning the Stability Programme and a risk analysis of the budgetary plans based on Commission forecast. Section 4 assesses compliance with the rules of the Stability and Growth Pact, including on the basis of the Commission forecast. Section 5 provides an overview on long term sustainability risks and Section 6 on recent developments and plans regarding the fiscal framework and the quality of public finances. Section 7 summarises the main conclusions.

2. MACROECONOMIC OUTLOOK

Latvia recorded a strong economic rebound in the aftermath of the economic crisis, with the real GDP growth rates exceeding 4 % in 2011-2013. Real growth decelerated in 2014 to 2.4% and is estimated at 2.1% in 2015, according to the Stability Programme. The slowdown is explained by the economic turbulence in Russia affecting Latvian investment confidence and certain export sectors. However, private consumption is expected to remain strong, boosted by strong growth in real incomes. Once the external risks subside, growth is projected by the Stability Programme to accelerate to 3.0% in 2016 and to 3.6% in 2017-18. This macroeconomic scenario is substantially weaker than that of the previous Stability Programme of April 2014, when GDP was projected to expand by 4% in each year over 2014-2017. It is also weaker compared with the more recent Draft Budgetary Plan of November 2014, which expected GDP to grow by 2.8% in 2015.

The output gap as recalculated by Commission based on the information in the programme, following the commonly agreed methodology, is estimated to be positive, but declining from 1.3% of GDP in 2014 to 0.5% in 2016, before increasing thereafter. The Commission, on the other hand, estimates the output gap to remain positive at around 1.5 % of GDP in 2014-2016. The difference is largely explained by a higher labour contribution to the recalculated potential growth and the lower real GDP growth assumptions of the Stability Programme.

¹ The English version of the stability programme was submitted on 12 May.

Table 1: Comparison of macroeconomic developments and forecasts

	2014		2015		2016		2017	2018
	COM	SP	COM	SP	COM	SP	SP	SP
Real GDP (% change)	2.4	2.4	2.3	2.1	3.2	3.0	3.6	3.6
Private consumption (% change)	2.3	2.3	3.3	2.4	3.9	3.1	3.8	3.8
Gross fixed capital formation (% change)	1.3	1.6	0.5	-1.5	4.4	3.5	4.1	4.5
Exports of goods and services (% change)	2.2	1.9	2.6	0.8	4.6	4.0	4.5	5.0
Imports of goods and services (% change)	1.6	1.5	2.9	0.0	5.4	4.2	4.6	5.3
<i>Contributions to real GDP growth:</i>								
- Final domestic demand	2.3	2.4	2.5	1.6	3.7	3.2	3.7	3.8
- Change in inventories	-0.3	-0.3	0.0	0.0	0.0	0.0	0.0	0.0
- Net exports	0.4	0.2	-0.3	0.5	-0.6	-0.2	-0.2	-0.3
Output gap ¹	1.4	1.3	1.4	0.8	1.6	0.5	1.0	1.2
Employment (% change)	-1.4	-1.0	0.2	0.0	0.5	0.2	0.4	0.4
Unemployment rate (%)	10.8	10.8	10.4	10.2	9.4	9.8	9.3	9.0
Labour productivity (% change)	3.8	3.4	2.0	2.1	2.6	2.8	3.2	3.2
HICP inflation (%)	0.7	0.6	0.7	0.4	2.2	1.9	2.5	2.5
GDP deflator (% change)	1.2	1.2	1.6	1.2	1.9	1.9	2.5	2.5
Comp. of employees (per head, %)	8.7	6.8	5.2	4.5	4.8	5.0	5.5	5.5
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	2.3	-0.6	2.5	0.5	1.6	0.3	0.2	-0.1
<u>Note:</u>								
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.								
<u>Source:</u>								
Commission 2015 spring forecast (COM); Stability Programme (SP).								

The Commission 2015 spring forecast projects marginally stronger (by 0.2 pp.) real GDP growth in 2015 and 2016 compared to the programme. Some notable differences exist in terms of the composition of growth, as the Stability Programme expects a weaker growth contribution from domestic demand, but compensated by stronger net exports. The programme also projects somewhat weaker inflation and a lower GDP deflator for 2015 than the Commission, while projections for 2016 are very close. The wage growth assumptions are similar between the two forecasts. External assumptions of the Stability Programme are based on the Commission winter 2015 forecast, which was available at the time of preparation. The spring forecast suggest a stronger external demand environment for Latvia, but in view of the downside risks to the Commission 2015 spring forecast, the macroeconomic scenario of the Stability Programme appears plausible for 2015 and 2016. However, the macroeconomic projections for 2017-2018 appear slightly favourable, relative to the potential growth estimates based on the common methodology.

The macro-economic scenario of the programme includes the estimated macroeconomic impact of structural reforms, specifically the healthcare reform, whose budgetary costs amounts to 0.2% of GDP in 2016. The reform is estimated by the programme to increase employment by 0.6% and GDP level by 2.2% by 2023. The impact on individual years is not quantified. Overall, the positive impact on growth and the long-term sustainability of public

finances is assessed by the Commission to be plausible. However, Latvia is not considered to be eligible to the structural reform clause in 2016 (see section 4).

3. RECENT AND PLANNED BUDGETARY DEVELOPMENTS

3.1. Deficit developments in 2014

The general government headline deficit stood at 1.4% of GDP in 2014, including a one-off payment to the European Bank for Reconstruction and Development for bank-restructuring-related expenses during the crisis (0.4 % of GDP). Despite headwinds, overall tax revenues were only slightly behind the estimates of the 2014 Stability Programme (by some 0.1% of GDP). In particular, a shortfall in corporate income tax was broadly compensated by an over-performance in personal income tax and VAT revenue. This good tax outturn was related to the higher-than-expected wage growth and suggests an improved tax collection linked to reduced share of the shadow economy. The overall expenditure level turned out largely as planned, apart from the impact of the one-off. However, there were some expenditure reallocations from intermediate consumption and interest expenditure to capital and social spending². The latter resulted from unforeseen compositional changes in contributions-based social benefits, in view of higher wage growth and somewhat higher unemployment than budgeted.

3.2. Target for 2015 and medium-term strategy

The target for 2015

According to the Stability Programme, the government headline deficit in 2015 is estimated at 1.5% of GDP, as compared to the 1% target in the 2015 budget. The deterioration is mostly due to a downward revision of the tax revenue projections, in view of the lower economic growth outlook and disappointing tax revenue outturn in the first quarter of 2015. The expenditure composition has been updated in view of the latest information on the local governments, showing somewhat higher capital spending and lower compensation of employees and intermediate consumption.

The recalculated structural balance based on the information provided in the Stability Programme in line with the commonly agreed methodology is estimated at 1.8% of GDP in 2015, as compared to the structural balance of 1.4% of GDP estimated at the time of the Draft Budgetary Plan. While most of the deterioration of the headline balance is due to the lower tax revenue projections in line with the weaker economic growth outlook, this is only partly captured in the structural balance estimate as potential growth estimates up to 2016 have been revised down as compared to the previous estimates.

The measures for 2015 presented in the Draft Budgetary Plan have been largely implemented. However, the Micro-Enterprise Tax pre-set move to two rates of 9% and 11% depending on the size of the turnover in 2015 was modified incurring fiscal costs of less than 0.1% of GDP. Also, some legislative proposals for combating the shadow economy have been delayed in the parliament.

² The reallocation of interest savings to higher social spending was considered in breach of the Fiscal Discipline Law by the Fiscal Discipline Council.

The Commission spring 2015 forecast estimates the government deficit at 1.4% of GDP in 2015. The lower deficit of 0.1pp. of GDP compared to the Stability Programme is largely due to somewhat higher tax revenue estimates in line with the more favourable macroeconomic projections. In terms of revenue and expenditure composition, the Commission forecast assumes a lower drop in other revenues and social payments remaining at the level similar to 2014.³

The medium-term strategy

The Stability Programme reconfirms the commitment to observe the structural balance rules of the national fiscal framework and those of the Stability and Growth Pact. Latvia's MTO of -1.0% of GDP is considered to respect the requirements of the SGP. The programme lays out the structural deficit targets until 2019 consistent with the MTO, the existing pension reform clause and the proposed application for structural reform clause for the health reform. Taking this into account, the Stability Programme foresees a maximum structural deficit at 1.8% of GDP in 2016, which is in line with the current minimum benchmark.

The Stability Programme treats the accelerated defence spending as a one-off measure, as a result of which it does not negatively impact the structural balance. The authorities had previously planned to increase the defence spending to the NATO target of 2% of GDP by 2020. However, due to the sharp deterioration of the external security situation, the 2%-target will be now reached in 2018. This implies additional financing needs over the period 2016-2019. The authorities argue that this additional increase should be treated as a one-off measure, given its temporary nature and the exceptional circumstances that cause it. In the Commission's view, the acceleration of the defence spending cannot be classified as a one-off measure (see section on measures below).

The programme's headline deficit targets are derived from the structural targets and also take into account the above-mentioned one-off measure. The headline deficit targets are thus set at 1.4% of GDP in 2016, 1.3% in 2017 and 1.7% in 2018.⁴

The Stability Programme also presents a no-policy-change projection according to which the headline deficit will be 1.6% of GDP in 2016. This implies that in order to achieve the target of 1.4% of GDP a fiscal adjustment of 0.2% of GDP is needed, based on the current projections. The measures to cover the gap will be only presented in the budget for 2016. The Commission forecast of the 2016 government deficit of 1.6% of GDP is similar to that of the Stability Programme, while the underlying growth assumptions are somewhat stronger.

For the later years the authorities estimate fiscal space of 1.1% of GDP in 2017 and 1.9% of GDP, which is technically distributed among the expenditure items before the specific spending decisions are made.

³ Regarding the composition of tax revenue it should be noted that the 2015 Stability Programme uses statistical recording of full assessed VAT liability (under “taxes on production and imports”), which is partly offset by assessed but unpaid VAT (with opposite sign under “other revenue”). However, the Latvian statistical authorities recently re-introduced the recording of VAT based on time-adjusted cash data, and this approach is already reflected in Commission’s projections. This implies higher indirect tax revenue and lower other revenue in the Stability Programme relative to the Commission forecast.

⁴ The government deficit targets in Table 2 shows a bottom-up no-policy-change forecast of 1.6% of GDP for 2016 and top-down deficit target from 2017 onwards. The top-down deficit target for 2016 is 1.4% of GDP.

Table 2: Composition of the budgetary adjustment

(% of GDP)	2014	2015		2016		2017	2018	Change: 2014-2018
	COM	COM	SP	COM	SP	SP	SP	SP
Revenue	35.5	34.7	34.2	34.0	32.7	32.7	32.3	-3.2
<i>of which:</i>								
- Taxes on production and imports	12.3	12.5	14.5	12.6	14.3	14.2	13.8	1.5
- Current taxes on income, wealth, etc.	7.6	7.5	7.5	7.3	7.3	7.4	7.4	-0.2
- Social contributions	8.5	8.2	8.4	7.9	8.2	8.2	8.2	-0.3
- Other (residual)	7.1	6.5	3.8	6.2	2.9	2.9	2.9	-4.2
Expenditure	36.9	36.1	35.6	35.6	34.3	34.0	34.0	-2.9
<i>of which:</i>								
- Primary expenditure	35.5	34.9	34.4	34.4	33.1	32.9	33.0	-2.5
<i>of which:</i>								
Compensation of employees	9.4	9.4	9.4	9.3	9.1	9.2	9.1	-0.3
Intermediate consumption	6.2	6.4	6.5	6.6	6.3	6.6	7.0	0.8
Social payments	11.1	11.1	10.6	10.8	10.3	10.3	10.2	-0.9
Subsidies	0.7	0.7	0.6	0.7	0.6	0.7	0.8	0.1
Gross fixed capital formation	4.3	4.0	4.0	3.7	3.4	3.2	3.1	-1.2
Other (residual)	3.9	3.4	3.3	3.3	3.3	3.0	2.7	-1.2
- Interest expenditure	1.4	1.2	1.2	1.2	1.2	1.1	1.0	-0.4
General government balance (GGB)	-1.4	-1.4	-1.5	-1.6	-1.6	-1.3	-1.7	-0.3
Primary balance	-0.1	-0.2	-0.2	-0.4	-0.4	-0.2	-0.7	-0.6
One-off and other temporary	-0.3	0.0	0.0	0.0	-0.3	-0.4	-0.5	-0.2
GGB excl. one-offs	-1.1	-1.4	-1.5	-1.6	-1.3	-0.9	-1.2	-0.1
Output gap ¹	1.4	1.4	0.8	1.6	0.5	1.0	1.2	-0.2
Cyclically-adjusted balance ¹	-2.0	-1.9	-1.8	-2.2	-1.8	-1.7	-2.2	-0.2
Structural balance (SB)²	-1.6	-1.9	-1.8	-2.2	-1.5	-1.3	-1.7	0.0
Structural primary balance ²	-0.3	-0.7	-0.6	-1.0	-0.3	-0.2	-0.7	-0.4
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 (SP); Commission 2015 spring forecasts (COM); Commission calculations.								

Measures underpinning the programme

The Stability Programme includes the fiscal measures presented in the 2015 budget. There are no new measures with the exception of the proposed one-off treatment of accelerated defence spending. Any policy change will be presented in the 2016 budget. In particular, the introduction of a progressive differentiation of the basic allowance for the personal income tax is announced for 2016, but without further details. The legislated reduction of the personal income tax from 23% to 22% in 2016 is retained as a measure in the Stability Programme and the Commission forecast. Under the systemic pension reform, part of social security contributions is being diverted from the government to private pension schemes, thus reducing the government's revenue. The amount of the diverted contributions increased from

4% to 5% of individual social contributions in 2015 and will further increase to 6% in 2016, with a fiscal cost of around 0.3% of GDP in each year.

Main budgetary measures

Revenue	Expenditure
2014	
<ul style="list-style-type: none"> • Reduction in social security contributions rate from 35.09% to 34.09% (-0.2% of GDP) • Increase in PIT non-taxable thresholds (0.2% of GDP) • Tax on subsidised electrical energy (tax on energy producers) (0.1% of GDP) • Higher tax revenue due to increase in minimum wage (0.1% of GDP) • Higher tax revenue due to raising efficiency of tax control and administration (0.2% of GDP) 	<ul style="list-style-type: none"> • Change in pension indexation formula (impact not specified)
2015	
<ul style="list-style-type: none"> • Systemic pension reform (-0.3% of GDP) • PIT rate cut from 24% to 23% (-0.2% of GDP) • Higher tax revenue due to increase in minimum wage (0.1% of GDP) • Higher tax revenue due to raising efficiency of tax control and administration (0.2% of GDP)* 	<ul style="list-style-type: none"> • Public sector wage increase (0.1% of GDP) • Increase for health, education, defence (0.2% of GDP) • Temporary payments to farmers (0.1% of GDP)
2016	
<ul style="list-style-type: none"> • Systemic pension reform (-0.3% of GDP) • PIT rate cut from 23% to 22% (-0.2% of GDP) 	<ul style="list-style-type: none"> • Additional defence spending (0.3% of GDP)
2017	
<ul style="list-style-type: none"> • n.a. 	<ul style="list-style-type: none"> • Additional defence spending (0.4% of GDP)
2018	
<ul style="list-style-type: none"> • n.a. 	<ul style="list-style-type: none"> • Additional defence spending (0.5% of GDP)
<p><u>Note:</u> The budgetary impact in the table is the impact reported in the programme, i.e. by the national authorities. A positive sign implies that revenue / expenditure increases as a consequence of this measure.</p> <p>* This includes a list of many smaller measures across different type of taxes and specific administrative/regulatory changes improving tax collection.</p>	

The measures presented in the Stability Programme are included in the Commission forecast at face value, based on the track record of prudent tax estimates compared with the outturn. However, the risks related to the achievement of the projected yields are higher for some measures than for others. In particular, the measure geared at improving tax collection can surprise both on the upside and the downside. For example, the good tax revenue outturn in 2014 relative to the economic developments can be partly attributed to the improved tax collection and declining share of the shadow economy. Tax returns in 2015 have surprised on the downside so far, which may suggest that reliance on the tax collection efficiency measures can be risky.

The authorities are currently considering increasing excise duties on alcohol and tobacco as from July 2015 and also legislating further increases in the following years. This measure is not included in the budgetary estimates of the Stability Programme and the Commission forecast.

The proposed one-off for military spending is not considered as a one-off measure by the Commission. As a rule, deficit-increasing measures should only be considered as one-offs in case they are considered triggered by exceptional events in the meaning of the SGP (e.g. linked to major natural catastrophes or other exceptional events outside the control of the government) and the associated amount should be limited to their short-term direct budgetary impact. A planned discretionary increase in military expenditure is considered to be well under control of the government regardless of any possible external commitment by the government (such as the NATO Member states' commitment to raise their defence spending to 2% of GDP). Furthermore, in this case, the temporariness of the one-off measures (generally understood as having an impact over one year) is not ensured.

3.3. Debt developments

The general government debt stood at 40% of GDP at the end of 2014, including accumulated cash reserves of around 6% of GDP for the large repayment of the EU funding in early-2015 (4.8% of GDP). Following this large repayment, the government debt is estimated at around 37% of GDP in 2015. However, the debt-to-GDP ratio is expected increase once again at the end of 2016 to 40% in preparation for a sizable repayment in early 2017. The underlying debt dynamics are set to improve over the forecast horizon due to an increasing primary balance, a pick-up in GDP growth, and declining interest expenditure. The Commission forecast for the government debt is close to that of the Stability Programme.

Table 3: Debt developments

(% of GDP)	Average 2009-2013	2014	2015		2016		2017	2018
			COM	SP	COM	SP	SP	SP
Gross debt ratio¹	41.0	40.0	37.3	37.0	40.4	40.0	37.3	34.1
Change in the ratio	3.9	1.8	-2.7	-3.0	3.1	3.0	-2.7	-3.2
<i>Contributions²:</i>								
1. Primary balance	2.8	0.1	0.2	0.2	0.4	0.4	0.2	0.7
2. “Snow-ball” effect	1.0	0.1	-0.2	0.0	-0.6	-0.5	-1.2	-1.1
<i>Of which:</i>								
Interest expenditure	1.6	1.4	1.2	1.3	1.2	1.2	1.1	1.0
Growth effect	-0.2	-0.9	-0.9	-0.8	-1.1	-1.1	-1.4	-1.3
Inflation effect	-0.4	-0.4	-0.6	-0.5	-0.7	-0.7	-0.9	-0.9
3. Stock-flow adjustment	0.2	1.7	-2.6	-3.3	3.3	3.2	-1.7	-2.7
<i>Of which:</i>								
Cash/accruals diff.								
Acc. financial assets								
Privatisation								
Val. effect & residual								

Notes:

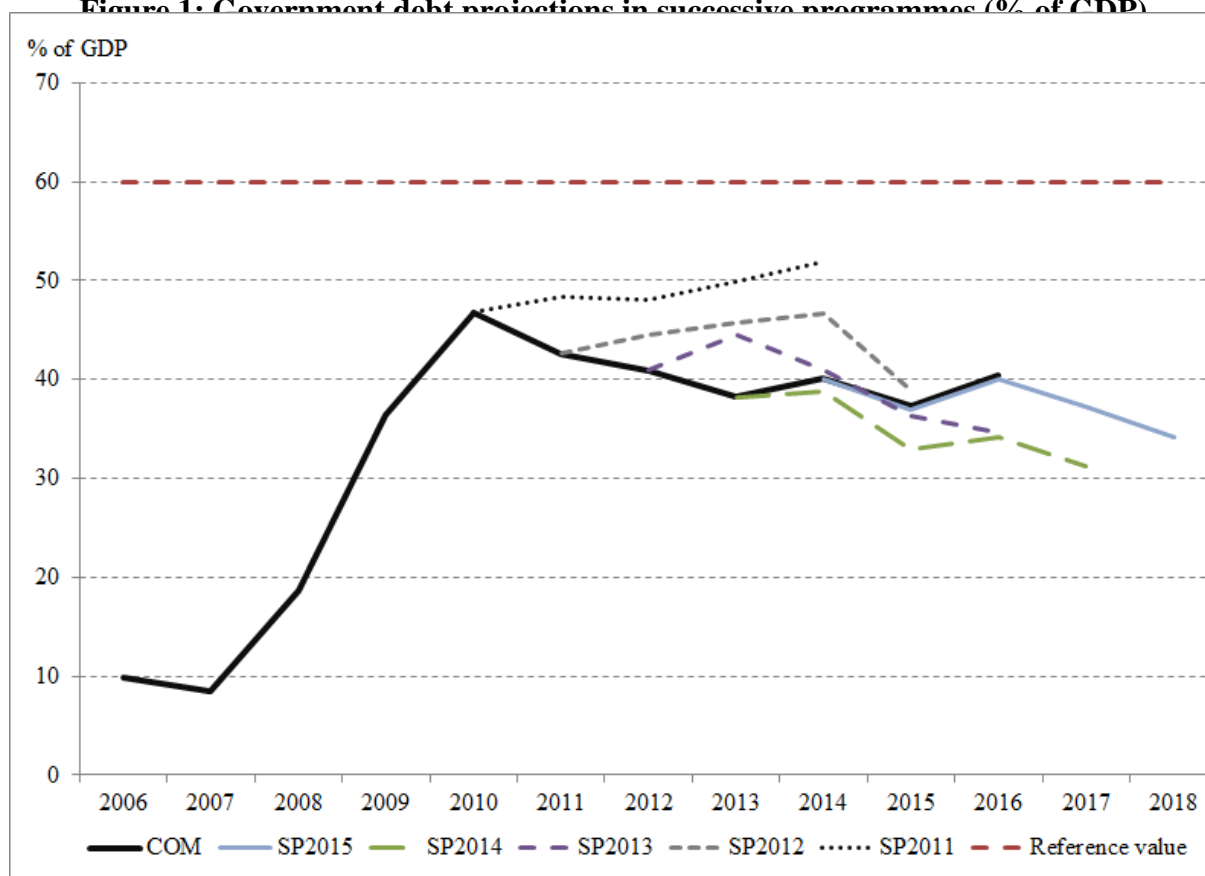
¹ End of period.

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:

Commission 2015 spring forecast (COM); Stability Programme (SP), Commission calculations.

Figure 1: Government debt projections in successive programmes (% of GDP)



Source: Commission 2015 spring forecast; Stability and Convergence Programmes

3.4. Risk assessment

Deficit developments

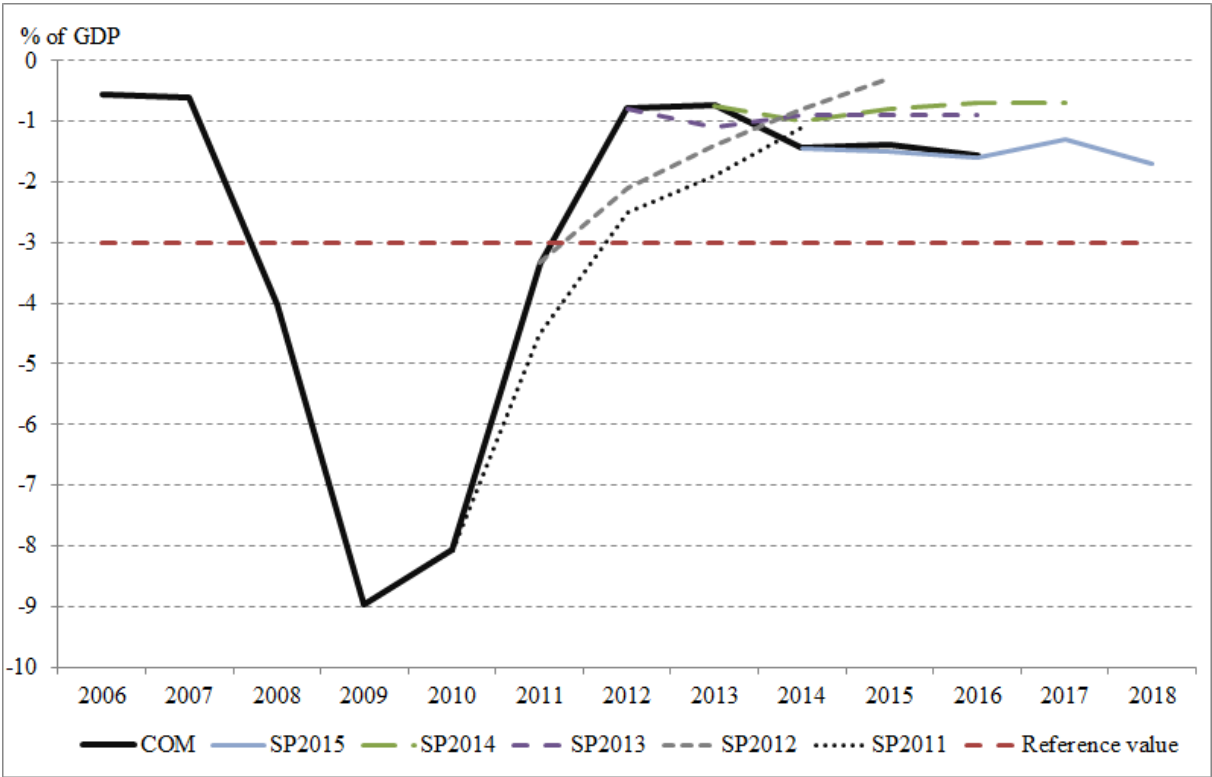
The main risk to the deficit targets is related to the uncertain economic outlook and the lack of specification of the adjustment effort of 0.2% of GDP needed to reach the structural deficit target in 2016, according to the Stability Programme. Moreover, the additional defence spending of 0.3% of GDP in 2016 needs to be compensated by other measures as it is not considered as one-off measure by the Commission and thus cannot be excluded from the structural deficit.

The macroeconomic scenario underpinning the budgetary projections of the Stability Programme is plausible. It has also been assessed to be realistic by the Fiscal Discipline Council (see section 6.1). However, the worsening of the budgetary situation due to lower tax revenue in line with the update growth outlook is not fully captured by the cyclical adjustment, leading to an increase in the structural deficit.

Compared with the Commission forecast, the no-policy-change budgetary estimates of the Stability Programme appear plausible. Both projections are subject to risks related to the preparation of the 2016 budget. In particular, the total size of the new policy initiatives represent a pressure for spending increases at the time of negative fiscal space. Considering some moderation in private sector wage growth and the low inflation environment, the wage pressures in the public sector could be lower than projected, but remaining nevertheless an important risk factor due to the relatively low public sector pay level. Moreover, reliance

on more efficient tax collection measures as a means to increase total tax revenue over the coming years is a risky strategy.

Figure 2: Government balance projections in successive programmes (% of GDP)



Source: Commission 2015 spring forecast; Stability and Convergence Programmes

Debt developments

Risks to the government debt projections are related to macroeconomic and fiscal risks. Latvia restarted debt emissions in the euro financial markets in 2014 after an interruption for a number of years during the crisis. Given the sound budgetary situation and the low interest rate environment in the EU, Latvia can currently borrow at historically low interest rates driving down the total debt servicing costs.

The general government debt includes loans by public hospitals from financial institutions for which the State Treasury has issued guarantees. There are some discussions of transferring these loans from the hospitals to the central government, but this will have no implications at the general government level as any flows between the government entities are consolidated.

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 clause⁵. The allowed deviation from the MTO represents a sum of costs incurred by the three consecutive reform steps with each step leading to a deviation lasting for three years. The allowed deviation amounts to 0.5% of GDP in 2014, 0.8% in 2015, 0.6% in 2016-17 and 0.3% in 2018.

Latvia has requested in its Stability Programme a temporary deviation from the medium-term objective in view of continued implementation of a major structural reform in the health sector with a positive impact on the long-term sustainability of public finances. The reform is summarised in the Stability Programme based on information provided in the national strategy for the public health sector for 2014-2020 approved by the Latvian government in October 2014 and its evaluation report by the University of Latvia. The fiscal costs of the health sector reform amount to 0.2% of GDP in 2016. The full implementation of the multi-annual reform is estimated to increase employment by 0.6% and the GDP level by 2.2% by 2023, considering increase in life expectancy of the labour force.

While the health sector reform is assessed to be a valid structural reform, based on the Commission forecast, a structural deficit of 2.2% of GDP is projected in 2016, which exceeds the appropriate safety margin with respect to the deficit reference value that is a requirement to be eligible for the structural reform clause. Therefore, Latvia does not fulfil the requirements to benefit from the requested temporary deviation in 2016. This implies that the allowed deviation from the MTO is limited to the existing pension reform clause and the maximum permissible structural deficit in 2016 amounts to 1.6% of GDP.

In 2014, the structural deficit is estimated at 1.6% of GDP. A deviation of 0.6 pp. of GDP from the MTO (a structural deficit of 1% of GDP) exceeds the deviation of 0.5% of GDP allowed by the pension reform clause by 0.1% of GDP.⁶ Net expenditure growth in 2014 exceeds the expenditure benchmark by 0.3% of GDP⁷. This deviation from the expenditure benchmark is explained by the one-off guarantee payment to the EBRD of 0.3% of GDP, which is not excluded from the expenditure benchmark calculations. Over the years 2013 and 2014 taken together, the structural balance pillar suggests compliance, but the expenditure benchmark points to a significant deviation. This reflects a more dynamic expenditure growth in 2013, largely due to capital injections in state-owned enterprises, 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% of GDP in 2012, well below the MTO for Latvia. Overall, Latvia is assessed to be compliant with the preventive arm in 2014 considering the effect of temporary measures, the available fiscal space and the potential growth revisions.

In 2015, the recalculated structural deficit increases by 0.2% of GDP to -1.8% of GDP. The pension reform clause allows a deviation of 0.8% of GDP from the MTO. The required adjustment of 0.4% of GDP in 2015 is based on the initial position in 2014 estimated at the

⁵ Eurostat has concluded that the introduction of second pillar in 2001 constitutes a systemic pension reform in the meaning of the Stability and Growth Pact.

<http://ec.europa.eu/eurostat/documents/1015035/3991223/Final-findings-EDP-Pre-euro-Accession-visit-LV-8-9-April.pdf>

⁶ This deviation of 0.1% of GDP is explained by the revision of the potential growth estimates since the winter forecast, while the nominal headline deficit has turned out to be better than estimated.

⁷ The expenditure benchmark is corrected for the pension reform clause through the convergence margin.

time of the 2014 spring forecast. The increase in the recalculated structural deficit of 0.2% of GDP is lower than the allowed increase of 0.4% of GDP based on the initial position in 2014 and the pension reform clause. The net expenditure contraction by 0.1% in 2015 is below the expenditure benchmark of 2.4% considering the allowed deviation from the MTO. Based on the Commission 2015 spring forecast, the change in structural deficit from 1.6% of GDP in 2014 to 1.9% of GDP in 2015 is lower than the allowed deterioration of 0.4% of GDP. The Commission forecast of the net expenditure growth is 1.5%, which is within the expenditure benchmark. Therefore, Latvia is assessed to be compliant with the preventive arm in 2015.

In 2016, the recalculated structural deficit is estimated to improve by 0.3% of GDP to 1.5% of GDP. The recalculated structural deficit of 1.5% of GDP is in line with the allowed deviation of 0.6% of GDP from the MTO based on the pension reform clause. However, based on the Commission forecast, the structural deficit is estimated to deteriorate to 2.2% of GDP in 2016, because the additional defence spending is counted as structural expenditure and the Commission 2015 spring forecast includes a more positive output gap estimate. The annual structural deterioration by 0.3% of GDP falls short of the required improvement of 0.3% of GDP⁸. This results in a significant deviation from the MTO of 0.6% of GDP based on the structural balance pillar, while allowing for the pension reform clause. The net expenditure contraction by 0.6% of GDP in 2016, based on the information provided in the Stability Programme, is below the reference growth rate of 0.5% of. However, the Commission forecasts net expenditure growth of 4.1% in 2016, suggesting a significant deviation by 1.1% of GDP from the expenditure benchmark.

Based on the Commission no-policy-change forecast for 2016, there is a risk of a significant deviation from the requirement, while taking into account the allowance under the pension reform clause.

Box 1. 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.

⁸ The required adjustment of 0.3% of GDP in 2016 is composed of the adjustment set by the matrix of 0.75% of GDP, the pension reform allowance of 0.6% of GDP and the 0.1% of GDP correction of the excess structural deficit level in 2015 (1.9% of GDP) above the allowed level (1.8% of GDP).

Table 4: Compliance with the requirements under the preventive arm

(% of GDP)	2014	2015		2016	
Initial position¹					
Medium-term objective (MTO)	-1.0	-1.0		-1.0	
Structural balance ² (COM)	-1.6	-1.9		-2.2	
Structural balance based on freezing (COM)	-1.4	-1.9		-	
Position vis-a -vis the MTO³	At or above the MTO	Not at MTO		Not at MTO	
(% of GDP)	2014	2015		2016	
	COM	SP	COM	SP	COM
Structural balance pillar					
Required adjustment ⁴	0.0	0.4		0.8	
Required adjustment corrected ⁵	-0.5	-0.4		0.3	
Change in structural balance ⁶	-0.6	-0.2	-0.3	0.3	-0.3
<i>One-year deviation from the required adjustment⁷</i>	-0.1	0.1	0.1	0.0	-0.6
<i>Two-year average deviation from the required adjustment⁷</i>	0.2	0.3	0.0	0.1	-0.3
Expenditure benchmark pillar					
Applicable reference rate ⁸	3.0	2.4		0.5	
<i>One-year deviation⁹</i>	-0.3	0.2	0.3	-0.8	-0.8
<i>Two-year average deviation⁹</i>	-0.8	0.0	0.0	-0.3	-0.2
Conclusion					
Conclusion over one year	Overall assessment	Compliance	Compliance	Overall assessment	Significant deviation
Conclusion over two years	Overall assessment	Compliance	Compliance	Overall assessment	Overall assessment
Notes					
<p>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.</p> <p>² Structural balance = cyclically-adjusted government balance excluding one-off measures.</p> <p>³ Based on the relevant structural balance at year t-1.</p> <p>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.).</p> <p>⁵ Required adjustment corrected for the clauses, the possible margin to the MTO and the allowed deviation in case of overachievers.</p> <p>⁶ Change in the structural balance compared to year t-1.</p> <p>⁷ The difference of the change in the structural balance and the required adjustment corrected.</p> <p>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 not at its MTO.</p> <p>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.</p>					
<i>Source :</i>					
<i>Stability Programme (SP); Commission 2015 spring forecasts (COM); Commission calculations.</i>					

5. LONG-TERM SUSTAINABILITY

The analysis in this section includes the new long-term budgetary projections of age-related expenditure (pension, health care, long-term care, education and unemployment benefits) from the 2015 Ageing Report⁹ published on 12 May. It therefore updates the assessment made in the Country Reports¹⁰ published on 26 February.

Government debt stood at 40% of GDP in 2014. However, the full implementation of the programme would reduce the debt to 34% by 2018, remaining at that level until 2025 (Figure 3). This is well below the 60% of GDP reference value.

Latvia appears to face low fiscal sustainability risks. Public finances are assessed to be sustainable in the medium-term. The medium-term sustainability gap indicator (S1) at -2% of GDP reflects a distance between the current government debt level and the benchmark ratio of 60% of GDP, as well as the projected decline in ageing costs until 2030. Also in the long-run, Latvian public finances are assessed to be sustainable. The long-term sustainability indicator (S2) at 0.1 % of DGP concludes that the structural primary deficit of 1% of GDP in 2015 is offset by the projected decline in ageing costs of 1% of GDP over the very long run. The long-term sustainability gap shows the adjustment effort needed to ensure that the debt-to-GDP ratio is not on an ever-increasing path, is at 0.1 % of GDP. However, the adequacy of future pensions is estimated to decline¹¹, thus representing a risk of current policies being reviewed, which could have an impact on future sustainability.

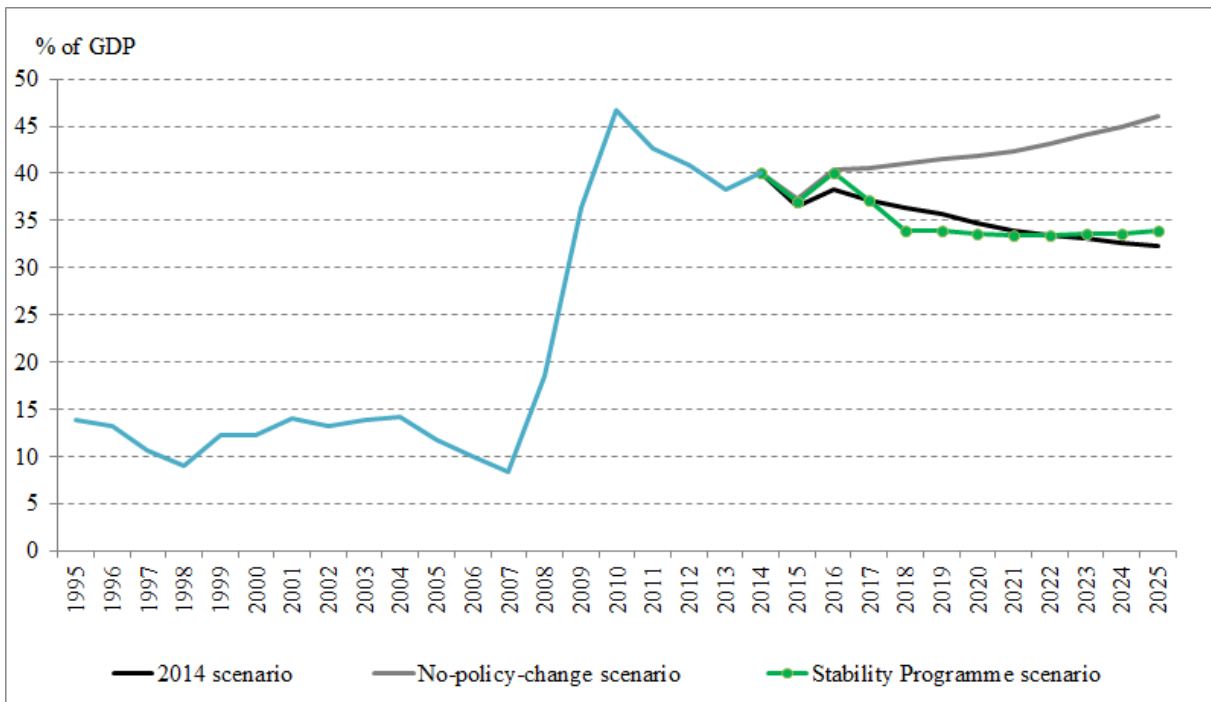
A systemic pension reform is being implemented in Latvia. Under the reform, part of social security contributions is being diverted from the government to private pension funds, thus reducing the government's revenue, but increasing the share of the private pension schemes in the pension system, thus reducing risks to future pension sustainability. The retirement age is increased by three months every year, going up from 62 years in 2014 to 65 years in 2025.

⁹ See http://ec.europa.eu/economy_finance/publications/european_economy/2015/ee3_en.htm

¹⁰ See http://ec.europa.eu/europe2020/making-it-happen/country-specific-recommendations/index_en.htm

¹¹ Net replacement rate at the average wage is estimated to decline from around 71.9% in 2013 to 51.2% in 2053.

Figure 3: Gross debt as % of GDP - Medium-term debt projections



Source: Commission 2015 spring forecast; Stability Programme; Commission calculations

Table 5: Sustainability indicators

	Latvia			European Union		
	2014 scenario	No-policy-change scenario	Stability Programme scenario	2014 scenario	No-policy-change scenario	Stability/Convergence Programme scenario
S2*	0.1	1.4	1.0	1.4	1.7	0.4
<i>of which:</i>						
Initial budgetary position (IBP)	1.0	1.8	1.4	0.4	0.5	-0.7
Long-term cost of ageing (CoA)	-1.0	-0.4	-0.4	1.0	1.1	1.1
<i>of which:</i>						
pensions	-2.2	-1.6	-1.5	0.0	0.1	0.1
healthcare	0.5	0.5	0.4	0.8	0.7	0.6
long-term care	0.1	0.1	0.1	0.7	0.7	0.6
others	0.6	0.6	0.5	-0.4	-0.3	-0.2
S1**	-2.0	-0.5	-2.1	1.4	1.8	0.5
<i>of which:</i>						
Initial budgetary position (IBP)	-0.1	1.1	0.3	-0.4	-0.3	-1.6
Debt requirement (DR)	-1.2	-1.3	-2.1	1.7	1.9	1.8
Long-term cost of ageing (CoA)	-0.8	-0.3	-0.3	0.1	0.3	0.4
S0 (risk for fiscal stress)***	0.28	:	:	:	:	:
<i>Fiscal subindex</i>	0.10	:	:	:	:	:
<i>Financial-competitiveness subindex</i>	0.35	:	:	:	:	:
Debt as % of GDP (2014)	40.0			88.6		
Age-related expenditure as % of GDP (2014)	15.5			25.6		

Source: Commission, 2015 Stability Programme
Note: the '2014' scenario depicts the sustainability gap under the assumption that the structural primary balance position remains at the 2014 position according to the Commission 2015 spring forecast; the 'no-policy-change' scenario depicts the sustainability gap under the assumption that the structural primary balance position evolves according to the Commission 2015 spring forecast until 2016. The 'stability programme' scenario depicts the sustainability gap under the assumption that the budgetary plans in the programme are fully implemented over the period covered by the programme. Age-related expenditure as given in the 2015 Ageing Report.

* The long-term sustainability gap (S2) indicator shows the immediate and permanent adjustment required to satisfy an inter-temporal budgetary constraint, including the costs of ageing. The S2 indicator has two components: i) the initial budgetary position (IBP) which gives the gap to the debt stabilising primary balance; and ii) the additional adjustment required due to the costs of ageing. The main assumption used in the derivation of S2 is that in an infinite horizon, the growth in the debt ratio is bounded by the interest rate differential (i.e. the difference between the nominal interest and the real growth rates); thereby not necessarily implying that the debt ratio will fall below the EU Treaty 60% debt threshold. The following thresholds for the S2 indicator were used: (i) if the value of S2 is lower than 2, the country is assigned low risk; (ii) if it is between 2 and 6, it is assigned medium risk; and, (iii) if it is greater than 6, it is assigned high risk.

** The medium-term sustainability gap (S1) indicator shows the upfront adjustment effort required, in terms of a steady adjustment in the structural primary balance to be introduced over the five years after the forecast horizon, and then sustained, to bring debt ratios to 60% of GDP in 2030, including financing for any additional expenditure until the target date, arising from an ageing population. The following thresholds were used to assess the scale of the sustainability challenge: (i) if the S1 value is less than zero, the country is assigned low risk; (ii) if a structural adjustment in the primary balance of up to 0.5 p.p. of GDP per year for five years after the last year covered by the spring 2015 forecast (year 2016) is required (indicating an cumulated adjustment of 2.5 pp.), it is assigned medium risk; and, (iii) if it is greater than 2.5 (meaning a structural adjustment of more than 0.5 p.p. of GDP per year is necessary), it is assigned high risk.

*** The S0 indicator reflects up to date evidence on the role played by fiscal and financial-competitiveness variables in creating potential fiscal risks. It should be stressed that the methodology for the S0 indicator is fundamentally different from the S1 and S2 indicators. S0 is not a quantification of the required fiscal adjustment effort like the S1 and S2 indicators, but a composite indicator which estimates the extent to which there might be a risk for fiscal stress in the short-term. The critical threshold for the overall S0 indicator is 0.43. For the fiscal and the financial-competitiveness sub-indices, thresholds are respectively at 0.35 and 0.45.

6. FISCAL FRAMEWORK AND QUALITY OF PUBLIC FINANCES¹²

6.1. Fiscal framework

As discussed in the Country Report for Latvia, the national fiscal framework is based on the Fiscal Discipline Law that came in force in 2013; the Medium Term Objective serves as fiscal policy anchor both in the national framework and under the SGP. The Fiscal Discipline Council was created on 1 January 2014 and is now fully operational.

The Stability Programme points out that the document also serves as the national medium-term fiscal plan in the meaning of the Regulation 473/2013. There is no explicit information on expected economic returns on non-defence public investment projects with significant

¹² This section complements the Country Report published on 26 February 2015 and updates it with the information included in the Stability Programme.

budgetary impact presented in the Stability Programme and the national reform programme, while the national reform programme provides details on number of projects involving public financing.

The macroeconomic projections underlying the Stability Programme were prepared in consultation with the experts from the Bank of Latvia, the Ministry of Economics and the commercial banks and have also been presented to the Fiscal Discipline Council. The authorities consider that consultation prior to finalising the projections with the Bank of Latvia, which is an independent institution, serves as an endorsement, while the formal agreement of the Bank of Latvia and its justification are not made public yet. Moreover, the assessment by the Fiscal Discipline Council includes an opinion on the plausibility of the macroeconomic projections.

The Fiscal Discipline Council has issued its assessment of on the 2015 Stability Programme. The macroeconomic scenario of the programme is assessed to be plausible, but the Council encourages the government to advance structural reforms that would improve the long-term potential of the Latvian economy. However, the Council suggests targeting the structural deficit of 1.1% of GDP in 2016, which implies fiscal adjustment of 0.4% of GDP, based on the Council's calculations. The Council considers that additional defence spending in 2016-2019 should be treated as any other government expenditure and the proposed allowance for the health reform is not provided for in the Fiscal Discipline Law. The Council also points out that no revenue measures were presented to attain the government's own target of bringing the tax-revenue-to-GDP ratio from 28% to around 33%. To this end, the Council suggests increasing consumption and property taxation, while the legislated personal income tax rate reduction in 2016 could be replaced by more cost effective tax measures targeted at low-income earners, e.g. an increase in the basic allowance.

6.2. Quality of public finances

Latvia was recommended under the 2014 European Semester to further shift the tax burden from low-income earners to more growth-friendly property and environmental taxation and improve tax compliance. The Stability Programme restates the measures implemented in 2014 and 2015 with a view to addressing the recommendation. In 2016, a progressive differentiation of the basic allowance from the personal income tax is planned, but no details are provided in the Stability Programme. However, the Stability Programme still includes the planned personal income tax cut from 23% in 2015 to 22% in 2016, but this measure appears to be regressive and poorly targeted at reducing the high tax wedge for the low-income single earners. Replacing the personal income tax cut with an increase in the basic allowance, possibly in the context of the progressive differentiation, could notably reduce tax burden for low-income earners, thus supporting formal employment.

The government's plans to increase the overall tax burden from around 28% of GDP to around one-third of GDP are not yet supported by specific measures. According to the authorities plans the comprehensive tax policy strategy will be developed only in 2016 and is expected to be presented in 2017. In the meantime, the authorities plan to achieve greater tax compliance by combating the shadow economy. Several initiatives are underway, but it is too early to judge their effectiveness.

7. CONCLUSIONS

In 2014, Latvia recorded the structural balance of 1.6% of GDP, which is just above the deviation from the MTO allowed by the systemic pension reform clause. The growth rate of government expenditure, net of discretionary revenue measures, exceeded the applicable expenditure benchmark rate by 0.3% of GDP. However, both excesses are attributed to potential growth revisions and the one-off measure, with overall assessment suggesting compliance with the preventive arm of SGP in 2014.

Latvia has requested in its Stability Programme a temporary deviation from the medium-term objective in view of continued implementation of a major structural reform in the health sector. While the health sector reform is assessed to be a valid structural reform, based on the Commission forecast, the projected structural deficit of 2.2% of GDP exceeds the appropriate safety margin with respect to the deficit reference value as a result of which Latvia does not fulfil the requirements to benefit from the requested temporary deviation in 2016. This implies that the allowed deviation from the MTO is limited to the existing pension reform clause and the maximum permissible structural deficit in 2016 amounts to 1.6% of GDP.

Latvia plans a deterioration of the structural balance by 0.2% of GDP in 2015, but a structural improvement in 2016 by 0.3% of GDP, while remaining within the allowed deviation from the MTO based on the pension reform clause.

However, while the structural effort appears to be in line with the preventive arm requirements in 2015, there is a risk of a significant deviation in 2016. According to the Commission 2015 spring forecast the structural balance deteriorates by 0.3% of GDP – also reflecting that the above-mentioned defence spending cannot be classified as a one-off – whereas it is required to improve by 0.3% of GDP taking into account the allowance for the pension reform.

ANNEX

Table I. Macroeconomic indicators

	1997-2001	2002-2006	2007-2011	2012	2013	2014	2015	2016
Core indicators								
GDP growth rate	5.9	9.3	-1.1	4.8	4.2	2.4	2.3	3.2
Output gap ¹	0.0	3.6	-2.9	-2.2	0.7	1.4	1.4	1.6
HICP (annual % change)	3.9	4.9	6.3	2.3	0.0	0.7	0.7	2.2
Domestic demand (annual % change) ²	6.0	11.4	-2.3	2.4	3.1	1.9	2.5	3.6
Unemployment rate (% of labour force) ³	14.2	10.6	13.4	15.0	11.9	10.8	10.4	9.4
Gross fixed capital formation (% of GDP)	23.6	28.7	26.4	25.2	23.3	23.0	22.5	22.8
Gross national saving (% of GDP)	15.7	20.2	22.4	22.5	21.8	21.3	21.3	20.8
General Government (% of GDP)								
Net lending (+) or net borrowing (-)	-1.4	-1.2	-5.0	-0.8	-0.7	-1.4	-1.4	-1.6
Gross debt	11.6	12.6	30.6	40.9	38.2	40.0	37.3	40.4
Net financial assets	9.7	6.6	-5.6	-11.6	n.a	n.a	n.a	n.a
Total revenue	36.0	33.5	34.4	35.7	35.3	35.5	34.7	34.0
Total expenditure	37.5	34.7	39.4	36.5	36.0	36.9	36.1	35.6
<i>of which: Interest</i>	0.8	0.6	1.2	1.6	1.5	1.4	1.2	1.2
Corporations (% of GDP)								
Net lending (+) or net borrowing (-)	-3.6	-7.4	3.5	7.1	6.5	6.0	7.3	6.4
Net financial assets; non-financial corporations	-58.7	-88.0	-91.8	-84.8	n.a	n.a	n.a	n.a
Net financial assets; financial corporations	-4.4	-0.9	5.9	3.2	n.a	n.a	n.a	n.a
Gross capital formation	19.8	24.8	18.0	17.7	18.0	16.8	16.5	16.8
Gross operating surplus	28.5	31.6	28.7	32.5	31.9	28.6	29.8	29.6
Households and NPISH (% of GDP)								
Net lending (+) or net borrowing (-)	-2.8	-3.1	-1.9	-6.8	-5.4	-4.7	-3.4	-3.2
Net financial assets	30.6	33.1	8.3	23.6	n.a	n.a	n.a	n.a
Gross wages and salaries	34.6	34.2	38.8	35.0	37.3	38.4	38.6	38.6
Net property income	10.8	10.2	5.1	3.9	4.4	3.0	2.7	2.8
Current transfers received	16.5	17.7	17.9	17.3	17.0	17.2	17.4	17.4
Gross saving	-0.5	1.3	2.7	-3.3	-2.4	-1.7	-0.2	0.1
Rest of the world (% of GDP)								
Net lending (+) or net borrowing (-)	-7.8	-11.7	-3.5	-0.5	0.5	2.3	2.5	1.6
Net financial assets	23.8	49.9	84.7	71.5	n.a	n.a	n.a	n.a
Net exports of goods and services	-9.9	-14.7	-8.0	-4.4	-2.9	-2.9	-2.4	-3.2
Net primary income from the rest of the world	0.1	-1.2	0.8	-0.7	-0.4	-0.8	-0.9	-1.0
Net capital transactions	0.3	0.8	1.9	3.0	2.5	5.2	4.8	4.7
Tradable sector	52.3	49.4	44.4	45.1	44.1	43.1	n.a	n.a
Non tradable sector	36.4	39.0	43.7	42.1	42.9	43.5	n.a	n.a
<i>of which: Building and construction sector</i>	5.1	5.7	6.5	5.3	5.5	5.8	n.a	n.a
Real effective exchange rate (index, 2000=100)	80.3	79.9	110.6	99.8	106.3	110.8	110.2	110.8
Terms of trade goods and services (index, 2000=100)	96.7	96.6	100.8	100.2	100.8	100.1	101.1	100.6
Market performance of exports (index, 2000=100)	77.4	83.8	97.6	107.2	105.3	103.3	101.6	100.4
Notes:								
¹ The output gap constitutes the gap between the actual and potential gross domestic product at 2005 market prices.								
² The indicator on domestic demand includes stocks.								
³ Unemployed persons are all persons who were not employed, had actively sought work and were ready to begin working immediately or within two weeks. The labour force is the total number of people employed and unemployed. The unemployment rate covers the age group 15-74.								
Source:								
AMECO data, Commission 2015 spring forecast.								