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COMMISSION OPINION

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GENERAL CONSIDERATIONS

1. Regulation (EU) No 473/2013 sets out provisions for enhanced monitoring of budgetary policies in the euro area for ensuring that national budgets are consistent with the economic policy guidance issued in the context of the Stability and Growth Pact (SGP) and the European Semester for economic policy coordination.

2. Article 6 of Regulation (EU) No 473/2013 requires Member States to submit annually to the Commission and to the Eurogroup a Draft Budgetary Plan presenting by 15 October the main aspects of the budgetary situation of the general government and its subsectors for the forthcoming year.

CONSIDERATIONS CONCERNING LATVIA

3. A no-policy-change Draft Budgetary Plan was submitted by the outgoing Latvian government on 15 October 2014 in compliance with Regulation (EU) No 473/2013 on which the Commission issued an opinion on 28 November 2014[1].

4. On the basis of the updated Draft Budgetary Plan of Latvia for 2015 which was submitted on 22 November by the new government, which took office on 5 November after the general elections on 4 October, the Commission has adopted the following opinion in accordance with Article 7 of Regulation (EU) No 473/2013.

5. Latvia is subject to the preventive arm of the Stability and Growth Pact. On 8 July 2014 the Council recommended that Latvia should preserve a sound fiscal position in 2014 and strengthen the budgetary strategy for 2015, ensuring compliance with its medium-term budgetary objective (MTO), while allowing for the impact of the systemic pension reform.

6. The macroeconomic scenario underlying the updated Draft Budgetary Plan foresees a slowdown in economic growth from 4.2% in 2013 to 2.9% in 2014 and 2.8% in 2015. 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. The macroeconomic scenario underlying the updated Draft Budgetary Plan is broadly in line with the Commission ad hoc forecast, updating the Commission 2014 autumn forecast with the draft 2015 budget measures (hereafter the Commission forecast).

7. Regulation (EU) No 473/2013 requires the draft budget to be based on independently endorsed or produced macroeconomic forecasts. The Fiscal Discipline Council, Latvia's fiscal monitoring institution, has concluded on 5 December that the draft 2015 budget is consistent with the fiscal rules of the Fiscal Discipline Law. The Council has assessed the macroeconomic projections underlying the draft 2015

[1] http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/dbp/2014/lv_2014-11-28_co_en.pdf

budget as acceptable although perhaps slightly optimistic given the current economic climate.

8. The updated Draft Budgetary Plan estimates a headline deficit of 1.4% 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 mostly due to a one-off measure related to the support of one bank (0.4% of GDP). The fiscal deficit target for 2015 is 1% of GDP, as compared to the target of 0.8% of GDP in the Stability Programme. The worsening of the fiscal position in both 2014 and 2015 is related to lower tax revenue and higher social spending, both reflecting the softening of the economic activity.

9. Uncertainty about the general economic situation and a large pent-up demand for public services constitute a risk to the budgetary targets. The budgeted new expenditure measures of around 0.5% of GDP for 2015 have been selected out of total spending proposals of 2.2% of GDP put forward by the line ministries.

10. The updated Draft Budgetary Plan estimates gross public debt at 40% of GDP in 2014 and declining to 35% of GDP in 2015. The reduction in the gross debt ratio mostly reflects a large repayment of the EU financial support due in early 2015 from the accumulated cash reserves. The debt dynamics are similar in the Commission forecast, except for assuming a lower debt-reducing effect from the stock-flow adjustments in 2015.

11. The updated Draft Budgetary Plan announces new spending plans of around 0.5% of GDP, which are financed by revenue-increasing measures of the similar magnitude. Several smaller tax policy measures cover both rate changes and improvements in tax collection. The increase in the monthly minimum wage from EUR 320 to EUR 360 has both a positive tax revenue effect and higher expenditure on public sector wages. New spending initiatives are undertaken in the health, education, defence and agriculture sectors. The Commission ad hoc forecast includes the measures announced in the updated Draft Budgetary Plan.

12. Latvia is eligible for the systemic pension reform clause from 2013, which allows a deviation from the MTO (a structural deficit of 1% of GDP) of 0.5%, 0.5%, and 0.8% of GDP in 2013, 2014 and 2015, respectively. The recalculated structural deficit is 1.4% of GDP in 2014. A deviation of 0.4% of GDP from the MTO is within the allowed deviation by the pension reform clause. Compliance with the structural balance rule is also observed based on the Commission forecast of a structural deficit of 1.4% of GDP. Based on the Commission forecast, the growth rate of government expenditure, net of discretionary revenue measures, corrected for the pension reform clause, will exceed the reference medium-term rate of potential GDP growth of 1.4% by 0.1% of GDP. This permissible deviation is due to the 2014 measures reducing the tax burden on low-income earners. However, a significant deviation of the two-year average expenditure benchmark over 2013 and 2014 is projected based on the updated Draft Budgetary Plan. 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. The structural deficit subsequently increased to 1% in 2013, which corresponds to the Latvia's MTO, in spite of the pension reform starting in 2013 and the corresponding allowed deviation from the MTO of 0.5% of GDP. Based on an overall assessment, the adjustment

towards the MTO seems compliant with the requirement of the preventive arm of the Pact in 2014 considering effect of temporary measures and the available fiscal space.

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

13. The updated Draft Budgetary Plan includes measures that affect the tax wedge on labour. The measures to some extent address the Country Specific Recommendations, but the effort could be better targeted. A progressive differentiation of non-taxable minimum income used for individual personal income tax assessment is planned to be implemented in 2016.

14. Overall, the Commission is of the opinion that the updated Draft Budgetary Plan of Latvia for 2015, which is currently under the preventive arm, is compliant with the provisions of the Stability and Growth Pact. The Commission invites the authorities to rigorously implement the 2015 budget.

The Commission is also of the opinion that Latvia has made some progress with regard to the structural part of the fiscal recommendations issued by the Council in the context of the 2014 European Semester and invites the authorities to make further progress.

Done at Brussels, 15.12.2014

For the Commission
Pierre MOSCOVICI
Member of the Commission