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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. On the basis of the Draft Budgetary Plan for 2016 submitted on 30 September 2015 by Latvia, the Commission has adopted the following opinion in accordance with Article 7 of Regulation (EU) No 473/2013.
4. Latvia is subject to the preventive arm of the Pact and should ensure that the deviation from the medium-term budgetary objective (MTO), or the required adjustment towards it, in 2015 and 2016 is limited to the allowance linked to the systemic pension reform.
5. The macroeconomic projections of the Draft Budgetary Plan assume an acceleration in real GDP growth from 2.1% in 2015 to 3.0% in 2016, supported by domestic demand and a weakening negative impact from the external environment. The projections appear plausible in comparison to the Commission 2015 autumn forecast of real GDP growth of 2.4% in 2015 and 3.0% in 2016. Taking into account the most recent energy price decrease, the Commission inflation forecast of 0.2% in 2015 and 1.4% in 2016 is slightly lower than foreseen in the Draft Budgetary Plan.
6. Regulation (EU) No 473/2013 requires the draft budget to be based on independently endorsed or produced macroeconomic forecasts. The macroeconomic forecasts underlying the Draft Budgetary Plan have been agreed with the Central Bank of Latvia and the macroeconomic working group of the Fiscal Discipline Council, both of which are independent institutions. Subsequently, the Fiscal Discipline Council, in its fiscal monitoring report, expressed no objections to the macroeconomic forecast as a basis of the 2016 budget, but cautioned against lower-than-expected inflation and possible external shocks. As a safeguard for these risks, the Fiscal Discipline Council has advised to develop contingency measures.
7. The Draft Budgetary Plan targets a headline deficit of 1% of GDP in 2016, down from the estimated 1.4% of GDP for 2015. The deficit estimate for 2015 has changed from 1.5% of GDP in the Stability Programme, due to minor adjustments, which have a rounding effect. In 2016, a notable improvement relative to the no-policy-change deficit estimate of 1.6% of GDP in the Stability Programme reflects an effect of deficit-reducing measures announced in the Draft Budgetary Plan.

The low interest rate environment has created some budgetary savings of 0.5% of GDP over 2012-2016, but these savings have been broadly counterbalanced by budgetary losses from lower than expected inflation. Overall, Latvia has not benefited from interest windfalls in recent years.

8. Based on the Commission 2015 autumn forecast, the headline deficit is projected to decline from 1.5% of GDP in 2015 to 1.2% of GDP in 2016, slightly above the deficits planned in the Draft Budgetary Plan as the Commission forecast assumes a somewhat higher growth of public sector wages and social benefits, considering the track record of expenditure overruns.

9. The Draft Budgetary Plan expects the general government debt to increase from 36.3% of GDP at end-2015 to 39.9% of GDP by end-2016. This increase is mostly linked to a planned accumulation of financial assets ahead of a large bond repayment early in 2017. The Commission forecasts a similar debt profile, but at somewhat higher debt-to-GDP ratios of 38.3% in 2015 and 41.1% in 2016, mostly due to an assumption of higher cash balances at the end of each year.

10. The Draft Budgetary Plan presents measures with a net deficit-reducing effect of 0.4% of GDP. The revenue measures yield 0.8% of GDP, which includes a cancellation of the planned personal income tax cut and a new solidarity tax for high-wage earners. Expenditure-increasing measures amount to 0.4% of GDP, including limited cuts in expenditure of 0.1% of GDP. Most of the new financing is devoted to external and internal security and to a lesser extent health care and education. The Commission forecast is more conservative regarding the expected yield from the solidarity tax, considering tax optimisation options for some high-wage earners.

11. In 2015, the Draft Budgetary Plan is assessed to be compliant with the requirements based on both the structural balance and the expenditure benchmark pillar. The compliance is also confirmed based on the Commission 2015 autumn forecast, as the structural deterioration by 0.3% of GDP is within the allowed deterioration by 0.4% of GDP accounting for the pension reform clause. For 2016, the improvement in the recalculated structural balance by 0.3% of GDP based on the Draft Budgetary Plan is in line with the required adjustment of 0.3% of GDP, which allows for the pension reform clause. Some deviation from the expenditure benchmark pillar is planned based on the (recalculated) information provided in the Draft Budgetary Plan. The expenditure benchmark is based on potential growth estimates over the period of a notable economic adjustment including a temporary drop in potential growth and is therefore underestimating the relevant growth rate at the current juncture. Therefore, the structural balance pillar is considered to be a more relevant indicator for Latvia's fiscal effort in 2016. The overall assessment, based on the Draft Budgetary Plan, suggests compliance with the preventive arm in 2016. Based on the Commission 2015 autumn forecast, some deviation from the structural balance pillar and a significant deviation from the expenditure benchmark pillar are projected. Considering the structural balance pillar as a more relevant indicator, the overall assessment points to a risk of some deviation from the adjustment path towards the MTO in 2016.

12. The Draft Budgetary Plan has responded to the country-specific recommendations regarding the tax burden on labour with the following measures: (i) an increase in monthly basic allowance from EUR 75 to EUR 85 and (ii) the introduction of the progressive differentiation of basic allowance from 2016, reducing the tax wedge on low-wage earners, while (iii) the new solidarity tax for wages exceeding EUR 4050

per month increases the tax wedge for high-wage earners in line with that for other wage earners. However, shifting the tax burden from labour to other tax sources has seen little progress, as the indirect tax changes yield a small share of total revenue effort. Performance across other reform areas is mixed. Some progress in education and judiciary reforms and limited progress in social, healthcare and public service reform areas.

13. Overall, the Commission is of the opinion that the Draft Budgetary Plan of Latvia, which is currently under the preventive arm, is broadly compliant with the provisions of the Stability and Growth Pact. In particular, according to the Commission 2015 autumn forecast, there is a risk of some deviation from the required adjustment towards the MTO. The Commission therefore invites the authorities to take the necessary measures within the national budgetary process to ensure that the 2016 budget will be compliant with the SGP. A comprehensive assessment of progress made with the implementation of the CSRs will be made in the 2016 Country Reports and in the context of the Country Specific Recommendations adopted by the Commission in May.

Done at Brussels, 16.11.2015

For the Commission
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Member of the Commission