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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 2017 submitted on 14 October by Latvia, the Commission has adopted the following opinion in accordance with Article 7 of Regulation (EU) No 473/2013.
4. The Commission opinion is to be seen in light of the latest economic and budgetary data. In this context, as indicated in the Commission recommendation for a Council Recommendation on the economic policy of the euro area as well as in the Commission Communication 'Towards a positive fiscal stance for the euro area', it is important that the aggregate fiscal stance of the euro area is positive and supports the ongoing recovery, while ensuring the long-term sustainability of national public finances.
5. Latvia is subject to the preventive arm of the Pact and should ensure sufficient progress towards its medium-term budgetary objective (MTO) of a structural deficit of 1% of GDP. To this end, it should ensure that the deviation from the adjustment path towards the medium-term budgetary objective in 2016 and 2017 is limited to the allowance linked to the systemic pension reform and the structural reform in the healthcare sector.
6. The macroeconomic scenario underlying the Draft Budgetary Plan appears somewhat optimistic. The Draft Budgetary Plan projects an increase in real GDP growth from 2.5% in 2016 to 3.5% in 2017, assuming a rebound in EU funding and a recovering external sector. The growth outlook has been revised down as compared to the latest Stability Programme. The Commission 2016 autumn forecast points to weaker economic growth rates of 1.9% in 2016 and 2.8% in 2017.
7. Latvia complies with the requirement of Regulation (EU) No 473/2013 that the draft budget has to be based on independently endorsed or produced macroeconomic forecasts. The macroeconomic forecasts underlying the Draft Budgetary Plan have been endorsed by the Fiscal Discipline Council. The Fiscal Discipline Council was established in January 2014 as a functionally and financially independent body with the purpose of monitoring the compliance with the Fiscal Discipline Law. The function of endorsement of the macroeconomic forecasts by the Fiscal Discipline

Council was formally agreed upon in the Memorandum of Understanding signed with the Ministry of Finance on 8 February 2016.

8. The Draft Budgetary Plan targets a headline deficit of 0.9% of GDP in 2016 and 1.1% of GDP in 2017. The latest Stability Programme estimated a fiscal deficit of 1% of GDP in both 2016 and 2017. The improvement in the Draft Budgetary Plan compared to the Stability Programme is attributed to savings on interest expenditure, contributions to the EU budget and capital expenditure, which more than offset social expenditure overruns. The higher deficit in 2017 follows from a slightly expansionary effect of the new budgetary measures, which include expenditures to healthcare, education, and internal security. The recalculated structural deficit stands at 1.5% of GDP in 2016 and 1.8% of GDP in 2017, reflecting both the higher nominal deficit and an increase in the positive output gap. Government debt is estimated to peak at 40% of GDP in 2016, largely due to pre-financing of a large debt redemption in early 2017, before declining thereafter.

Euro area sovereign bond yields remain at historically low levels. Latvia issued 10-year bonds at the historically low yield of 0.5% on 30 September 2016. The currently low interest rate environment has contributed to a decrease of the interest expenditure to GDP ratio from 1.3% in 2015 to 1.1% in 2016, and a further reduction to 1% of GDP is projected in 2017.

9. The Draft Budgetary Plan presents net revenue-increasing measures of 0.4% of GDP and net expenditure-increasing measures of 0.6% of GDP. The main revenue measures include a postponed change in the tax payment date for vehicles from 2017 to 2019 (0.1% of GDP) and a planned one-off receipt of confiscated illicit money in 2017 (0.1% of GDP). The expenditure measures are concentrated on the compensation of employees and purchases of goods and services. An allocation for the health sector reform is provided (0.1% of GDP), but specific measures are still to be defined.
10. The Commission 2016 autumn forecast estimates a fiscal deficit of 0.8% of GDP in 2016, including an already-received one-off receipt of confiscated illicit funds (0.2% of GDP), which is not accounted for in the Draft Budgetary Plan. For 2017, the headline deficit projection at 1.1% of GDP corresponds to the deficit target of the Draft Budgetary Plan, as tax-intensive private consumption and wage dynamics are similar. Risks to the 2017 deficit target are related to the possible fiscal costs in the wind-down of the "bad bank" Reverta, a control of fiscal position of local authorities in the election year, an uncertainty over investment costs and in implementation of revenue measures.
11. As from 2013 Latvia has been benefiting from the pension reform clause, which allows for a temporary deviation from the adjustment path towards the MTO (which is a structural deficit of 1% of GDP) of 0.6% of GDP in 2016 and in 2017. As of 2017, Latvia is also eligible for an additional deviation under the structural reform clause for the healthcare reform. In 2017, this deviation is limited at 0.1% of GDP by the constraint of the minimum benchmark.

In 2016, an improvement in the (recalculated) structural balance of 0.1% of GDP falls slightly short of the required improvement of 0.2% of GDP, while the expenditure benchmark is met. The dynamics of the recalculated structural deficit is influenced by output gap estimates, which differ from those based on the Commission forecast. Taking into account the uncertainty over the output gap estimates, the overall assessment points to compliance in 2016, based on the Draft

Budgetary Plan. Based on the Commission forecast, the structural balance is expected to improve by 0.4% of GDP in 2016 exceeding the 0.2% of GDP required structural improvement. In turn, the expenditure benchmark points to a risk of some deviation (gap of -0.3% of GDP). This is largely attributed to (i) the use of interest expenditure savings for other current expenditure (0.2% of GDP) and (ii) a temporary drop in government capital expenditure net of EU-funded capital expenditure (0.3% of GDP), both of which accentuate the improvement in the structural balance. Therefore, the expenditure benchmark should be seen as the better indicator of the underlying budgetary situation. Taking into account these factors, the overall assessment points to a risk of some deviation from the adjustment path towards the MTO in 2016.

In 2017, the recalculated structural balance is set to deteriorate by 0.3% of GDP (to 1.8% of GDP), exceeding the allowed 0.2% of GDP temporary deterioration, while the expenditure benchmark is estimated to be complied with. The deviation corresponds to the divergence in the recalculated output gap estimates as compared to those based on the Commission forecast. The overall assessment points to compliance in 2017, taking into the uncertainty over the output gap estimates. Based on the Commission forecast, the change of the structural balance in 2017 is in line with the required adjustment and the expenditure benchmark is also expected to be met. However, as the deviation projected for 2016 is not fully compensated for in 2017, the expenditure benchmark over 2016 and 2017 together is exceeded by 0.1% of GDP. Therefore, while pointing to compliance in 2017, the overall assessment sees a risk of a small deviation over 2016 and 2017 together.

12. The Draft Budgetary Plan contains few measures with limited effect on the tax wedge on labour by expending tax expenditure for personal income tax. In terms of progress of implementing the country-specific recommendations, small steps have been taken across the policy areas, but decisive measures have been postponed or still need to be developed. Notably, a major social safety net reform planned to be introduced in 2017 has been postponed to 2019 and a comprehensive tax strategy remains to be defined.
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. According to the Commission 2016 autumn forecast, a small deviation is projected over 2016 and 2017 together as the deviation in 2016 is forecast not to be fully compensated for in 2017. In line with the Commission Communication 'Towards a positive fiscal stance for the euro area', the Commission invites the authorities to take the necessary measures within the national budgetary process to ensure that the 2017 budget will be compliant with the SGP.

The Commission is also of the opinion that Latvia has made limited progress with regard to the structural part of the fiscal country-specific recommendations issued by the Council in the context of the 2016 European Semester and thus invites the authorities to accelerate progress. A comprehensive assessment of progress made with the implementation of the country-specific recommendations will be made in the 2017 Country Reports and in the context of the country-specific recommendations to be adopted by the Council in 2017.

Done at Brussels, 16.11.2016

For the Commission
Pierre MOSCOVICI
Member of the Commission