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Analysis of the 2016 Draft Budgetary Plan of LATVIA

Accompanying the document

COMMISSION OPINION

on the Draft Budgetary Plan of LATVIA

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Analysis of the 2016 Draft Budgetary Plan of LATVIA

1. INTRODUCTION

Latvia submitted its Draft Budgetary Plan (DBP) for 2016 on 30 September 2015 in compliance with Regulation (EU) No 473/2013 of the Two-Pack. 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.

Section 2 of this document presents the macroeconomic outlook underlying the DBP and provides an assessment based on the Commission Forecast. The following section presents the recent and planned fiscal developments, according to the DBP, including an analysis of risks to their achievement based on the Commission 2015 autumn forecast. In particular, it also includes an assessment of the measures underpinning the DBP. Section 4 assesses the recent and planned fiscal developments in 2015-2016 (also taking into account the risks to their achievement) against the obligations stemming from the Stability and Growth Pact (SGP). Section 5 provides an analysis of implementation of reforms in the area of fiscal governance in response to the latest Country-specific Recommendations (CSRs) adopted by the Council on 14 July 2015, including those to reduce the tax wedge. Section 6 concludes.

2. MACROECONOMIC DEVELOPMENTS UNDERLYING THE DRAFT BUDGETARY PLAN

Latvia's economic growth has moderated after bouncing back from the financial and economic crisis. GDP grew by 2.4% in 2014 and is expected to grow by 2.1% in 2015, according to the DBP. In 2016, growth is forecast to reach 3.0%, supported by domestic demand and a weakening negative impact from the external sector. This scenario is unchanged with respect to the 2015 Stability Programme.

The Commission autumn forecast points to a slightly stronger real growth of 2.4% in 2015 with some more significant differences to the DBP across components, in particular investment and foreign trade. For 2016, both the Commission and the DBP forecast real GDP growth at 3.0%. Taking into account the most recent energy price decrease, the Commission consumer price inflation forecast of 0.2% in 2015 and 1.4% in 2016 is slightly lower than the DBP forecast.

Overall, the macroeconomic assumptions in the DBP appear plausible. However, both the forecast of the Commission and that of the DBP are subject to risks related to highly uncertain external environment that could affect both trade dynamics and business sentiment.

Box 1: The macro economic forecast underpinning the budget in Latvia

The macroeconomic forecasts underlying the DBPs were prepared by the Ministry of Finance. At the early stages of the 2016 budget preparation, the macroeconomic forecast was agreed with the Bank of Latvia and the macroeconomic working group of the Fiscal Discipline Council[1]. A more detailed assessment was provided in the Fiscal Discipline Council's fiscal discipline monitoring report published on 25 September[2]. In this report the Fiscal Discipline Council expressed no objections to the Ministry of Finance's macroeconomic forecast as a basis for the 2016 budget, but cautioned against lower-than-expected inflation and possible external shocks, which may lead to lower tax revenue. As a safeguard to the risks, the Fiscal Discipline Council has advised to develop contingency measures.

The Fiscal Discipline Council was established in January 2014 on the basis of the Fiscal Discipline Law as a functionally and financially independent body with the purpose of monitoring the compliance with that law.

1 The meeting of the working group of the Fiscal Discipline Council on 9 July with participation of the experts from the Bank of Latvia is documented at this link: http://fiscalcouncil.lv/files/uploaded/FDP_1_01_486_20150710_GDPWG_minutes2_draft.pdf

2 http://fiscalcouncil.lv/files/uploaded/FDP_1_01_691_20150925_Monitoring_report_with_Annexes.pdf

Table 1. Comparison of macroeconomic developments and forecasts

	2014	2015			2016		
	COM	SP	DBP	COM	SP	DBP	COM
Real GDP (% change)	2.8	2.1	2.1	2.4	3.0	3.0	3.0
Private consumption (% change)	2.6	2.4	2.6	3.1	3.1	3.5	3.7
Gross fixed capital formation (% change)	0.3	-1.5	-0.9	0.5	3.5	2.5	2.3
Exports of goods and services (% change)	3.1	0.8	2.5	1.3	4.0	4.5	2.6
Imports of goods and services (% change)	0.8	0.0	-0.4	1.4	4.2	4.7	2.8
Contributions to real GDP growth:							
- Final domestic demand	2.6	1.6	1.9	2.5	3.2	3.2	3.1
- Change in inventories	-1.1	0.0	-1.5	0.0	0.0	0.0	0.0
- Net exports	1.4	0.5	1.7	-0.1	-0.2	-0.2	-0.1
Output gap[1]	1.5	0.8	1.5	1.7	0.5	1.9	1.9
Employment (% change)	-1.4	0.0	0.1	0.2	0.2	0.2	0.4
Unemployment rate (%)	10.8	10.2	9.7	10.1	9.8	9.1	9.5
Labour productivity (% change)	4.2	2.1	2.1	2.3	2.8	2.8	2.6
HICP inflation (%)	0.7	0.4	0.8	0.2	1.9	2.0	1.4
GDP deflator (% change)	1.2	1.2	1.1	1.1	1.9	2.1	2.0
Comp. of employees (per head, % change)	9.1	4.5	5.5	5.2	5.0	5.0	5.2
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	1.2	0.5	1.2	1.2	0.3	0.8	0.8

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 2015 (SP); Draft Budgetary Plan for 2016 (DBP); Commission 2015 autumn forecast (COM); Commission calculations

3. RECENT AND PLANNED FISCAL DEVELOPMENTS

3.1. Deficit developments

The DBP estimates the headline deficit at 1.4% of GDP for 2015. The deficit estimate has declined from 1.5% of GDP in the April 2015 Stability Programme, due to minor adjustments, which have a rounding effect, as well as revenue and expenditure composition has somewhat changed. On the revenue side, the upward revision is related to solid labour and excise tax revenue performance, better than expected non-tax revenue outturn and higher EU receipts[3]. On the expenditure side, social benefit spending has been higher than budgeted, partly due to a strong demand for sickness benefits after removing the cap on the amount of

[3] A comparison of indirect tax and other revenue items between the Stability Programme and the Draft Budgetary Plan is affected by statistical revisions of VAT revenue accounting from recording separately fully assessed VAT liabilities and unpaid VAT to recording in a single line on net basis (time-adjusted cash method).

the benefit from 1 January 2015. Public sector wages and investment are also expected to be higher than assumed in the Stability Programme, but those are compensated by lower intermediate consumption and other expenditure.

The Commission autumn 2015 forecast estimates the government deficit at 1.5% of GDP in 2015. The forecast incorporates the latest downward revision to the GDP level[4], which has a marginal effect on the deficit ratio. The Commission's forecast assumes somewhat stronger revenue and expenditure growth with an overall limited impact on the fiscal balance.

The DBP targets a nominal deficit of 1% of GDP in 2016. The 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 DBP. Revenue-increasing measures amount to around 0.8% of GDP, and expenditure-reducing measures to 0.1% of GDP, while allowing for additional priority spending increases of 0.5% of GDP. Tax revenue as share of GDP is foreseen to increase through the effect of the measures, while higher public expenditure is related to wage increases, public purchases and investments. The revenue and expenditure projections also accommodate changes in the baseline, notably higher social spending and the limited revisions to the economic outlook.

The Commission's forecast of a deficit of 1.2% of GDP in 2016 assumes somewhat higher growth of public sector wages and social benefits than the DBP, considering the track record of expenditure overruns. The Commission's forecast is also slightly more cautious on the expected yield of the some revenue-increasing measures, relative to the authorities. In particular, the expected yield from the new solidarity tax may be compromised by tax optimisation options for some high-wage earners.

The Fiscal Discipline Council in its fiscal discipline monitoring report has assessed that the government's deficit targets and the expenditure ceilings for 2016-2018 are in line with the domestic fiscal rules. However, the draft budget omits the required provision for the fiscal security reserve of 0.1% of GDP for 2016, which is in breach of the Transitional Provisions of the Law and reduces a safety cushion against unforeseen circumstances. Moreover, there is a risk that the 2015 structural deficit outturn may exceed its target by 0.5% of GDP, which would trigger the automatic adjustment mechanism of the cumulative deviation.

The Fiscal Discipline Council also highlights the key economic and fiscal challenges and makes recommendations for addressing them. The Fiscal Discipline Council welcomes the announced tax revenue measures, but urges to make further steps in shifting the tax burden from labour to consumption and capital gains, as well as in improving tax compliance. The Fiscal Discipline Council recommends quantifying major fiscal risks, inter alia pointing to the expenditure overruns in the social welfare over the past years, and developing preventive measures to safeguard the budget. Insufficient progress in the implementation of structural reforms, the decreasing labour force, due to negative demographic trends, lagging investment and skill mismatch in the labour market imply, according to the Fiscal Discipline Council, that potential GDP growth would not exceed 3-3.5% in the medium term. This leads to the conclusion that with the current structure of the economy, Latvia's prospects of income convergence to the EU average remain limited.

[4] The Latvian statistical office has made further GDP revisions in relation to transition to the ESA2010 methodology. On 1 October 2016 GDP revisions up to 2014 were released, reducing the GDP level by 1.5% of GDP in 2014. Revised quarterly data up to Q2 2015 were published on 26 October.

The recalculated structural deficit[5] of the DBP is planned to decrease by 0.3 percentage points between 2015 and 2016. The improvement in the (recalculated) structural balance is lower than the nominal deficit improvement by 0.4 percentage points, due to a projected increase of the cyclical component. The Stability Programme assumed no improvement in the recalculated cyclically-adjusted balance and proposed to exclude additional defence spending of 0.3% of GDP as a one-off measures in 2016. The DBP accommodates the defence-related spending increase in the structural balance by revenue-increasing measures. The Commission's 2015 autumn forecast foresees a decline in the structural deficit by 0.2% between 2015 and 2016, which represents a somewhat smaller improvement than planned in the DBP.

[5] Cyclically-adjusted balance net of one-off and temporary measures, recalculated by the Commission on the basis of the information provided in the Draft Budgetary Plan, using the commonly agreed methodology.

Table 2. Composition of the budgetary adjustment

(% of GDP)	2014	2015			2016			Change: 2014-2016
	COM	SP	DBP	COM	SP	DBP	COM	DBP
Revenue	**35.6**	**34.2**	***34.8***	**34.9**	**32.7**	***34.3***	**34.6**	**-1.3**
of which:								
- Taxes on production and imports	12.5	14.5	*12.4*	12.7	14.3	*12.6*	12.9	0.1
- Current taxes on income, wealth, etc.	7.7	7.5	*7.6*	7.7	7.3	*7.9*	7.7	0.2
- Capital taxes	0.0	0.0	*0.0*	0.0	0.0	*0.0*	0.0	0.0
- Social contributions	8.6	8.4	*8.3*	8.4	8.2	*8.2*	8.2	-0.4
- Other (residual)	6.7	3.8	*6.5*	6.0	2.9	*5.6*	5.7	-1.1
Expenditure	**37.1**	**35.6**	**36.2**	**36.4**	**34.3**	**35.3**	**35.7**	**-1.8**
of which:								
- Primary expenditure	35.7	34.4	35.0	35.1	33.1	34.1	34.5	-1.6
of which:								
Compensation of employees	9.5	9.4	9.6	9.8	9.1	9.6	9.8	0.1
Intermediate consumption	6.1	6.5	6.4	6.3	6.3	6.2	6.2	0.1
Social payments	11.2	10.6	11.4	11.5	10.3	11.0	11.3	-0.2
Subsidies	0.7	0.6	0.6	0.6	0.6	0.6	0.7	-0.1
Gross fixed capital formation	4.4	4.0	4.2	4.3	3.4	3.6	3.7	-0.8
Other (residual)	3.7	3.3	2.8	2.6	3.4	3.1	2.9	-0.6
- Interest expenditure	1.4	1.2	1.2	1.3	1.2	1.2	1.2	-0.2
General government balance (GGB)	**-1.5**	**-1.5**	**-1.4**	**-1.5**	**-1.6**	**-1.0**	**-1.2**	**0.5**
Primary balance	**-0.1**	**-0.2**	**-0.2**	**-0.2**	**-0.4**	**0.2**	**0.0**	**0.3**
One-off and other temporary measures	-0.3	0.0	0.0	0.0	-0.3	0.0	0.0	0.3
GGB excl. one-offs	**-1.2**	**-1.5**	**-1.4**	**-1.5**	**-1.3**	**-1.0**	**-1.1**	**0.2**
Output gap[1]	1.5	0.8	1.5	1.7	0.5	1.9	1.9	0.2
Cyclically-adjusted balance[1]	-2.1	-1.8	-2.0	-2.1	-1.8	-1.7	-1.9	0.5
Structural balance (SB)[2]	**-1.8**	**-1.8**	**-2.0**	**-2.1**	**-1.5**	**-1.7**	**-1.9**	**0.1**
Structural primary balance[2]	-0.3	-0.6	-0.8	-0.8	-0.3	-0.5	-0.6	0.2

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 2015 (SP); Draft Budgetary Plan for 2016 (DBP); Commission 2015 autumn forecast (COM); Commission calculations

Box 2: Impact of the current low interest rate environment on compliance with the SGP

Identifying an interest rate windfall/shortfall for 2016

Sovereign bond yields have fallen sharply since end-2013 and reached historical lows in the first half of 2015, before increasing somewhat during the summer months. The latest 10-year bond issue in September 2015 was at the historically lowest yield of 1.4%, in contrast to 3% yield on the April 2014 10-year bond issue. The effect of low interest rates is expected to feed through to lower debt servicing costs, but it will take some time given the maturity profile of the debt (average maturity of around 5 years). Interest expenditure in Latvia is estimated to have fallen from 1.6% of GDP in 2012 to 1.2% in 2015, and is projected to decrease further to 1% of GDP by 2018, according to the medium-term expenditure plans. The decline in debt servicing costs is also driven by a downward trend in the debt-to-GDP ratio from some 43% at end-2011 to an estimated 35% by end-2018.

Prospects and vulnerability

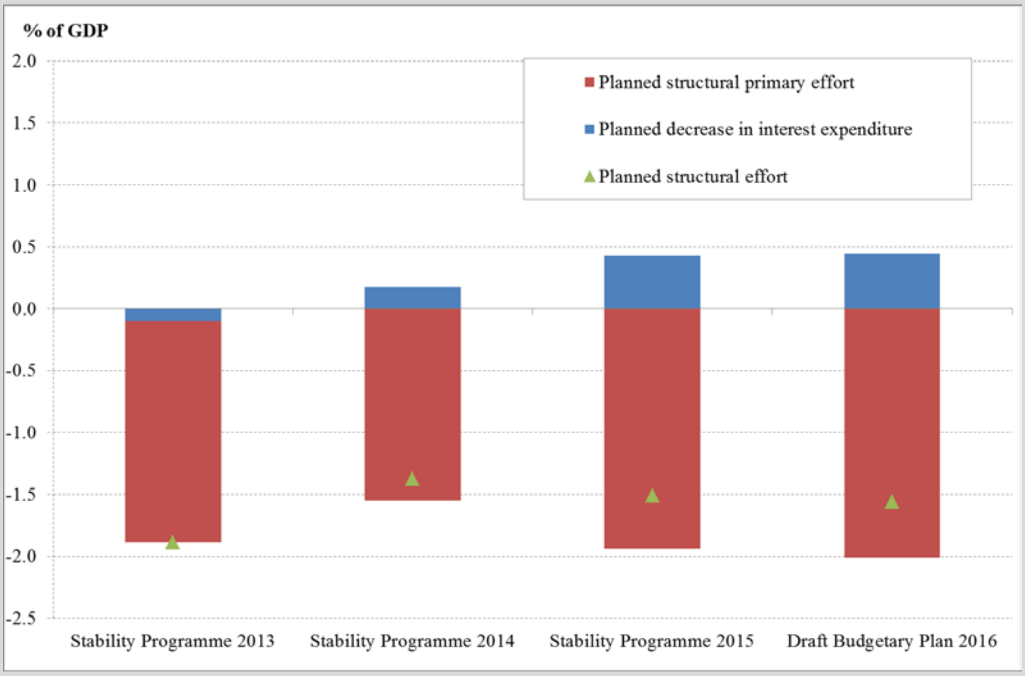
The current maturity profile includes bond redemptions in 2017 and 2018 amounting to 3.3% and 1.4% of GDP respectively. These bonds were issued at the yield of around 5.5%. Replacing these bonds at their maturity with debt instruments at a yield of 1.4% would produce fiscal savings of around 0.1% of GDP in 2017 and 0.2% of GDP cumulatively by 2018. However, implicit interest rate on the gross debt at 3.2% in 2015 is lower than that of the two above-mentioned bonds, suggesting on average smaller interest rate savings in the future.

Consequences for public finances

Comparing the interest expenditure projections across different vintages of Stability and Convergence Programmes and the DBP sheds some light on the interest windfall since the drop in interest rates[6]. Chart 4 indicates that interest rate savings have accumulated relative to the past vintages of the policy plans in the amount of around 0.5% of GDP between the 2013 Convergence Programme and the current DBP. However, interest rate developments cannot be viewed in isolation of inflation developments. The low inflation environment has taken a toll on public finances thus making it more difficult to achieve a primary structural fiscal effort. The inflation effect is more pronounced on government revenues (in particular, VAT revenue), while the effect on expenditure is lower and more under the control of the government. The accumulated HICP inflation differential between the 2013 Convergence Programme and the current DBP amounts to some 5 percentage points. This implies that a negative impact on primary balance broadly counterbalances the interest rate savings.

[6] Note that, while it is likely that revisions in the interest expenditure projections across different vintages primarily reflect changes in interest rates, other factors such as debt dynamics, the maturity profile of debt and statistical reclassifications (e.g. the switchover to the ESA 2010 standard of national accounts) may also have played a role.

Structural effort and decrease in interest expenditures between 2012 and 2016 based on government plans



Source: Stability programmes, Draft Budgetary Plan 2016 and AMECO

3.2. Debt developments

The DBP 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. In the medium term, the nominal GDP growth effect is foreseen to more than offset the government's net borrowing, leading to a projected decline of the debt ratio in 2017. The Commission forecast for the government debt follows as similar profile, while assuming 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.

Table 3. Debt developments

(% of GDP)	2014	2015			2016		
		SP	DBP	COM	SP	DBP	COM
Gross debt ratio[1]	**40.6**	**37.0**	**36.3**	**38.3**	**40.0**	**39.9**	**41.1**
Change in the ratio	1.6	-3.6	-4.3	-2.3	3.0	3.6	2.8
Contributions[2] :							
1. Primary balance	**0.1**	**0.2**	**-0.2**	**0.2**	**0.4**	**0.2**	**0.0**
2. "Snow-ball" effect	**-0.1**	**0.0**	**0.3**	**-0.1**	**-0.5**	**-1.0**	**-0.6**
Of which:							
Interest expenditure	1.4	1.3	1.6	1.3	1.2	0.8	1.2
Growth effect	-1.1	-0.8	-0.8	-1.0	-1.1	-1.0	-1.1
Inflation effect	-0.5	-0.5	-0.4	-0.4	-0.7	-0.7	-0.7
3. Stock-flow adjustment	**1.5**	**-3.8**	**-4.5**	**-2.4**	**3.2**	**4.4**	**3.5**

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

Source:

Stability Programme 2015 (SP); Draft Budgetary Plan for 2016 (DBP); Commission 2015 autumn forecast (COM); Commission calculations

3.3. Measures underpinning the Draft Budgetary Plan

The DBP presents measures with a net-deficit-reducing effect of 0.4% of GDP. The revenue measures yielding 0.8% of GDP include a cancellation of the planned personal income tax cut and a new solidarity tax for high-wage earners (together yielding 0.4% of GDP in 2016). A restriction of the personal income tax allowance for working-age dependants covers costs of an increase in the monthly basic allowance by EUR 10. Annul steps of a progressive differentiation of the basic allowance for the personal income tax are set until 2020, but the measure is designed to be broadly fiscally neutral as the tax burden is shifted from lower-wage earners to medium and higher-wage earners. An increased share of dividend payments from the state own enterprises and a postponed change in company car tax payment system will produce temporary fiscal gains (each yielding 0.1% of GDP in 2016). The pre-set shift of social security contributions to private pension schemes under the pension reform[7] will negatively impact government revenues (not included in Table 4). Expenditure increasing measures amount to 0.4% of GDP, including limited cuts of 0.1% of GDP. Most of the new expenditure increase is devoted to external and internal security and, to a lesser extent for health and education.

Some fiscal measures for 2016 respond to the country-specific recommendations for Latvia. The introduction of a progressive solidarity tax, the suspension of the planned across-the-board personal income tax cut (a regressive measure), the increase in the basic allowance and starting of a progressive differentiation of the basic allowance will make the tax system more

[7] Under the reform, a part of social security contributions is being diverted from the government to the private pension schemes, thus reducing the government's revenue.

progressive and will improve work-incentives for the lower-wage earners. However, there is little progress in terms of shifting the tax burden from labour to other tax sources, as revenue from excise tax increases are far lower than the yield from labour taxation measures. Specific elements of some tax measures represent a trade-off between a less complicated tax administration and an additional burden on tax payers. For example, the progressive differentiation of the basic allowance will be applied after submitting tax declarations for the previous year, which implies a risk that not all tax payers will submit tax declarations to benefit from a reimbursement of overpaid tax. Also, the solidarity tax is levied at the rate of social security contributions, while no benefit rights will be accrued for the high-wage earners.

Estimated effect of the measures is overall plausible, except for a risk of a lower yield from the solidarity tax, as some high-wage earners may try to shift some of their wage income to capital income streams, which are taxed at lower rate.

Table 4. Main discretionary measures reported in the DBP

A. Discretionary measures taken by General Government - revenue side

Components	Budgetary impact (% GDP) (as reported by the authorities)		
	2015	**2016**	**2017**
Taxes on production and	0.2	0.0	0.1
Current taxes on income,	0.5	-0.1	0.1
Capital taxes	n.a.	n.a.	n.a.
Social contributions	0.0	0.2	0.0
Property Income	0.1	0.2	0.2
Other	n.a.	n.a.	n.a.
Total	0.8	0.3	0.3

Note:

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

Source: Draft Budgetary Plan for 2016

B. Discretionary measures taken by general Government- expenditure side

Components	Budgetary impact (% GDP) (as reported by the authorities)		
	2016	**2017**	**2018**
Compensation of employees	0.1	0.0	0.2
Intermediate consumption	0.3	0.2	0.2
Social payments	n.a.	n.a.	n.a.
Interest Expenditure	n.a.	n.a.	n.a.
Subsidies	0.0	0.0	0.1
Gross fixed capital formation	n.a.	n.a.	n.a.
Capital transfers	0.0	0.0	0.1
Other	0.0	0.9	0.2
Total	0.4	1.1	0.8

Note:

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

Source: Draft Budgetary Plan for 2016

4. COMPLIANCE WITH THE PROVISIONS OF THE STABILITY AND GROWTH PACT

4.1. Adjustment towards the MTO

Latvia is subject to the preventive arm of the SGP and is eligible for the pension reform clause from 2013. The allowed deviation from the MTO in 2015 and 2016 is 0.8% of GDP and 0.6% of GDP, respectively. The allowed deviation from the MTO represents a sum of the costs incurred by the three consecutive reform steps with each step leading to a deviation lasting for three years.

In 2015, the DBP is assessed to be fully compliant with both the structural balance and the expenditure benchmark pillar (see Table 7). 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. The expenditure benchmark and indicators over 2014 and 2015 are observed as well.

For 2016, the recalculated structural balance is planned to improve by 0.3% of GDP which is consistent with the required adjustment for 2016, including the deviation allowed by the pension reform clause. At the same time, the DBP foresees net expenditure growth in 2016 to exceed the expenditure benchmark by 0.4% of GDP. Over 2015 and 2016 together, both the structural balance and expenditure benchmark pillar point to compliance based on the DBP. The medium term reference rate used in the calculation of the expenditure benchmark of 1.5% for 2016 is based on potential growth estimates over the period of a notable economic adjustment including a temporary drop in potential growth. However, the structural balance is calculated based on the potential growth of 2.7% in 2016, which is a more 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 DBP, suggests compliance with the preventive arm in 2016.

Table 5: Compliance with the requirements of the preventive arm

(% of GDP)	2014	2015		2016	
Initial position[1]					
Medium-term objective (MTO)	-1.0	-1.0		-1.0	
Structural balance[2] (COM)	-1.8	-2.1		-1.9	
Structural balance based on freezing (COM)	-1.4	-1.9		-	
Position vis-a -vis the MTO[3]	At or above the MTO	Not at MTO		Not at MTO	
(% of GDP)	**2014**	**2015**		**2016**	
	COM	**DBP**	**COM**	**DBP**	**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	0.2
One-year deviation from the required adjustment [7]	-0.1	0.2	0.0	0.0	-0.1
Two-year average deviation from the required adjustment [7]	0.2	0.1	0.0	0.1	0.0
Expenditure benchmark pillar					
Applicable reference rate[8]	3.0	2.4		0.5	
One-year deviation [9]	-0.3	0.4	0.2	-0.4	-0.9
Two-year average deviation [9]	-0.8	0.0	0.0	0.0	-0.3
Conclusion					
Conclusion over one year	Overall assessment	Compliance	Compliance	Overall assessment	Overall assessment
Conclusion over two years	Overall assessment	Compliance	Compliance	Compliance	Overall assessment

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

[2] Structural balance = 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, page 27.).

[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 2014) was carried out on the basis of Commission 2015 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 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.

Source :
Draft Budgetary Plan for 2016 (DBP); Commission 2015 autumn forecast (COM); Commission calculations.

Based on the Commission forecast, the structural balance is expected to improve by 0.2% of GDP in 2016 compared to the required structural adjustment of 0.3% of GDP. Therefore, the structural balance pillar points to a risk of some deviation (of 0.1% of GDP). In turn, the expenditure benchmark points to a risk of significant deviation (gap of -0.9% of GDP). Over 2015 and 2016 together, the structural balance pillar suggests compliance, while the expenditure benchmark points to a risk of significant deviation (of 0.3%). Considering the structural balance pillar as a more relevant indicator for 2016, the overall assessment points to a risk of some deviation from the adjustment path towards the MTO in 2016.

5. IMPLEMENTATION OF FISCAL-STRUCTURAL REFORMS

The DBP reports on implementation progress of the CSRs and the national targets under the Europe 2020 strategy. Performance across the reform areas is mixed. In some areas, concrete steps have been taken that will produce tangible results, while in other areas progress is slow with a limited impact on addressing the underlying challenges.

The commitment to prudent fiscal policy is reflected in the deficit target of 1% of GDP for 2016 by taking the necessary deficit-reducing measures, covering also crucial defence spending needs. The announced tax measures constitute a step in the right direction, while there is still room to shift the tax burden from labour to other sources. Reforms in vocational and higher education are progressing. Mixed performance is noted in reforming the judiciary system with steps taken to strengthen the role of the Judicial Council, but a postponement of changes to the insolvency framework. Limited progress is recorded regarding the social benefit system, as well as health care and public service reforms. A comprehensive assessment of progress with the reforms will be provided in the next Country Report.

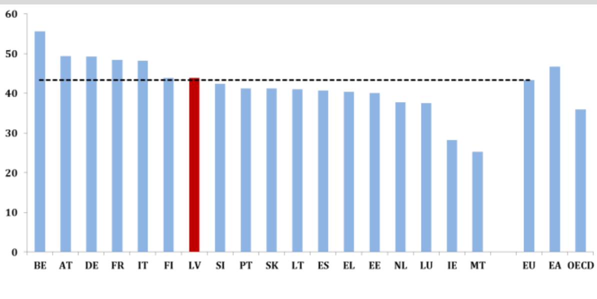
A comprehensive assessment of progress made with the implementation of the CSRs will be made in the 2016 Country Reports and in the context of the CSRs adopted by the Commission in May.

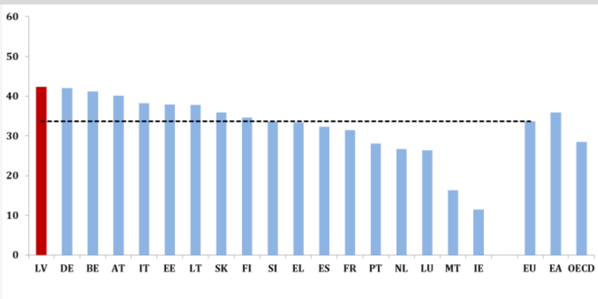
Box 4: Addressing the tax burden on labour in the euro area

The tax burden on labour in the euro area is relatively high, which weighs on economic activity and employment. Against this background, the Eurogroup has expressed a commitment to reduce the tax burden on labour. On 12 September 2015, the Eurogroup agreed to screen 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 these numbers to the OECD average for purposes of broader comparability. Furthermore, the Eurogroup expressed its intention to take stock of the state of play in the reduction of the tax burden on labour when discussing the DBPs of euro area Member States.

The tax wedge on labour measures the difference between the total labour costs to employ 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 (2014)





Notes: Data for Latvia, Lithuania and Malta is for 2013. No recent data is available for Cyprus. 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.

This screening 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.

In the context of the 2015 European Semester, Latvia was issued the recommendation to "(...) reduce the high tax wedge for low-wage earners by shifting tax burden to other sources less detrimental to growth (...)."

The DBP has responded with the following measures: increase in monthly basic allowance from EUR 75 to EUR 85 and the introduction of the progressive differentiation of basic allowance from 2016, reducing the tax wedge on low-wage earners, while the new solidarity tax for wages exceeding EUR 4050 per month increase the tax wedge for high-wage earners in line with that for other wage earners.

6. OVERALL CONCLUSION

The DBP targets a headline deficit of 1% of GDP in 2016, down from the estimated 1.4% of GDP for 2015. In 2015, the planned structural adjustment is in line with the required adjustment path towards the MTO as the deviation is within the limits allowed by the systemic pension reform clause. For 2016, following an overall assessment, the planned structural adjustment is in line with the required adjustment path towards the MTO based on data provided in the DBP.

Based on the Commission 2015 autumn forecast, the structural balance is expected to improve in line with the required adjustment in 2015. Regarding 2016, the Commission 2015 autumn forecast points to a risk of some deviation from the adjustment path towards the MTO following an overall assessment.