Latvia

FISCAL DISCIPLINE COUNCIL OF THE REPUBLIC OF LATVIA

Country note, July 2018

Key messages:

- **Latvia's Stability Program (SP) for 2018-2021 provides both nominal and structural balance improvements from 2019 as compared to previous plans.**
- **The tax reform in 2018 and 2019 does not strengthen the revenue side of the state budget and departs from the government's target of 1/3 of tax-to-GDP.**
- **The economic growth in 2017 has been faster than expected, though the tightening in labour market continued.**
- **The Council welcomes the Government's general government target of reducing general government debt to 36% of GDP in 2021 (Chart 1).**

Macroeconomic outlook

The rapid growth of the Latvian economy and the reform on labour taxation introduced by the Government, stimulates entering the labour market and the net wage increase especially for the low-income quartiles. However, the tightening in the labour market because of labour deficit and fiscal easing has already pushed up the wages in 2017 and resulted in slower productivity growth than the wage growth in recent years. In the long term, the problems of high structural unemployment and regional differences remain.

Short-term fiscal outlook

Tax reform generally has a negative impact on total tax revenues during the short-term planning period, although favorable economic conditions allow a gradual increase the total tax revenues. The tax reform impact on the government fiscal balance has been assessed as slightly positive, as strong economic performance has offset negative effects and provided higher headline revenue figures. Strong economic conditions confirm that correct timing has been chosen to implement changes in the Latvian tax system, while disregard to the increasing demands on the public funds should also be noted.

Medium-term fiscal outlook

The tax and social contributions income to GDP will not increase in the coming years, which is a critical issue, taking into account the impact of EU grant (current and capital transfers) revenues. When assessing this reduction in external revenue and the need to replace with the local tax revenues, in order to maintain at least the previous level of public services provided, the Government needs to develop an action plan to maintain a sustainable income level (Chart 2). The current level of debt may not represent an imminent threat to solvency, but it weakens Latvia's ability to withstand demand fluctuations in case of funding shocks. During good economic times the government can take advantage of revenue excess for deficit and debt reduction and build up fiscal buffers. The target for the structural balance in 2019 is -0.8% of GDP, in 2020 -0.4% of GDP and in 2021 -0.5% of GDP.

Fiscal framework and national fiscal rules

In view of trends in the world and available information in Latvia, demand for public-private partnerships (PPP), as a solution for funding important public investment, is expected to increase. It should be taken into account that the possibilities for co-financing from the European Union will decrease and there will be a desire to attract other financing. Against this background, the implementation of PPP projects is closely linked to the government's fiscal balance, which would require the implementation of specific identification and quantification of fiscal risks. Also, developments in the financial sector in the first half of 2018 show that this has prevented all risks from being eliminated. Increased capital and reserve requirements for banks, which mainly provide customer service to non-residents, protect the state budget and the Deposit Guarantee Fund from direct losses. However, refusals to access the international payment system and reputational risks might create real economic losses. Certainty in the risk identification, its numerical assessment and inclusion in the fiscal risks statement is an essential priority.

Chart 1: General government debt: forecasts and actual outcome, % of GDP. Source: *The Treasury.*

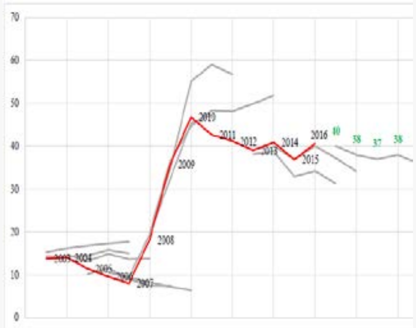

Chart 2: Tax revenues and social contributions to GDP, % of GDP. *Source: MoF.*

Key indicator forecast

		2018 f	2019 f	2020 f	2021 f
Real GDP growth	[% y-to-y]	4	3.4	3	2.9
Nominal GDP growth	[% y-to-y]	7.2	6.5	5.8	5.4
Inflation	[%]	2.8	2.4	2.1	2.1
GDP deflator	[%]	3.1	3	2.7	2.5
Potential GDP growth	[% y-to-y]	3.4	3.4	3.3	3.3
Output gap	[% of GDP]	1.1	1	0.7	0.3

Source: Fiscal discipline surveillance interim report on the Latvia Stability Programme 2018-2021. April 2018. Available: http://fiscalcouncil.lv/06042018-interim-report-opinion.