Latvia

Country note, June 2017

FISCAL DISCIPLINE COUNCIL OF THE REPUBLIC OF LATVIA

Key messages:

- **Instead of headline deficit of 1 percent 2016 fiscal turned out balanced according to the ESA2010 with improvements in all subsectors of the general government except the social insurance.**
- **The tax reform and improved funding of health services are two new initiatives of the government both potentially brining negative fiscal impact in 2018 with the SGP flexibility measures maximized and bringing the fiscal balance position to increased deviation from the national MTO.**
- **The Government's tax strategy bets on economic stimulus and less tax evasion from the reform, while it is unlikely that the objective of tax revenue to GDP could reach 33 percent before 2021 as per the government manifestos.**

Macroeconomic outlook

Real GDP growth for 2016 at 2 percent was substantially lower than projected (at 2.5 percent during the adoption of the 2016 budget) largely resulting from decline in the construction sector 18.2% in current prices compared to 2015. Consequently the total investment declined mostly resulting from delays implementing EU supported projects. Similarly, a decrease in freight and cargo sector, especially railways and ports, contributed to slower GDP growth in 2016. Meanwhile improvements have been observed in exports, positive economic sentiment in the main export destination countries, as well as improved consumer confidence and lending has picked up during the past two quarters.

Short-term fiscal outlook

The budget outturn for 2016 was better than anticipated. Despite economic performance lagging the projections the revenue target has been exceeded, while expenditures performed at lower levels – mostly reflecting delays in launching investment projects with EU support. Thus the government has achieved both – the MTO of -1% according to the agreements under the SGP and -0.5% according to the Fiscal Discipline Law (FDL). Only the social insurance budget had much smaller surplus than planned due to higher outlays for unemployment and sickness benefits. Better economic conditions could allow achieving slightly better fiscal results compared to the approved budget for 2017, while extra deficit would come from the flexibility clauses, particularly the deviations from MTO for the pension reform and the health care reform, which together maximize the deficit level under SGP.

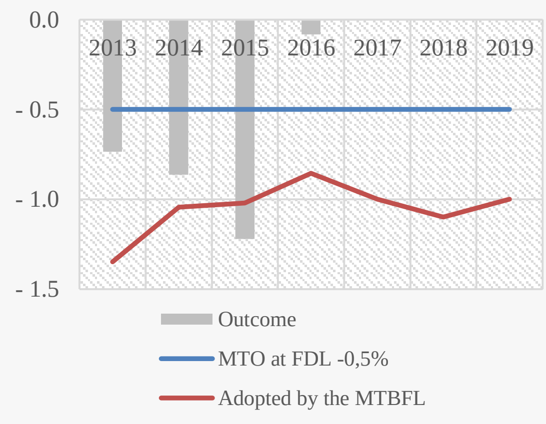
Medium-term fiscal outlook

The Government of Latvia has started applying a deviation from the MTO for structural reforms in health care in the amount of 0.1% of GDP in 2017, which will increase to 0.4% of GDP in 2018. The MoF has devised treating the proposed tax reform as one-off measure, which would reduce by further 0.7% of GDP to the government balance in 2018. The government balance has been projected to improve only starting from 2019 and 2020. Meanwhile, it is unlikely that the tax reform planning to reduce the personal income tax revenue and to shift to zero percent rate for the retained profits would allow steady reduction in tax evasion and to accelerate economic development so that the tax revenue to GDP ratio would reach 33 percent in line with the manifesto of this coalition government.

Fiscal framework and national fiscal rules

The Government has committed itself to follow the toughest fiscal rule – either under SGP or the national law – the Fiscal Discipline Law. Various deviations have actually maximized the deficit level under SGP. This has been worrying the Fiscal Council, which has been pointing at very loose interpretation of SGP flexibility clauses to the fiscal framework. In April 2017 the Fiscal Council has been opposing the deviation from the MTO for the implementation of the health reform that it would be counterproductive to engage deficit financing for recurrent expenditure on health. The shape of the health reform has been outlined only recently and still pending the approval by the Cabinet. The Fiscal Council has been also opposing the treatment of the proposed tax reform as a one-off measure.

Chart 1: Level of structural balance and MTO
% of GDP



Key indicator forecast

		2017f	2018f	2019f	2020f
Real GDP growth	[% y-to-y]	3.2	3.4	3.2	3.0
Nominal GDP growth	[% y-to-y]	5.2	5.2	6.0	5.7
Inflation	[% y-to-y]	2.3	2.0	2.0	2.0
GDP deflator	[% y-to-y]	1.9	1.8	2.6	2.6
Potential GDP growth	[% y-to-y]	2.5	2.9	2.8	2.9
Output gap	[%]	-0.2	0.3	0.7	0.7

Source: Fiscal discipline monitoring interim report on the Latvia Stability Programme 2017-2020. April 2017. Available at: http://fiscalcouncil.lv/13042017-interim-report-opinion

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