Latvia

FISCAL DISCIPLINE COUNCIL
OF THE REPUBLIC OF LATVIA

Country note, January 2018

Key messages:

- **The general government budget balance target was surpassed in 2016, and will be better than planned in 2017, even though the government went ahead with decisions that entail additional spending.**
- **The Saeima passed a comprehensive tax reform that will reduce the tax burden on low and medium income earners, but does not fully take into account future expenditure needs.**
- **The economy will grow above its potential from 2018 onwards, unless bold reform measures are implemented to boost potential output.**
- **The Council welcomes the decision to establish a fiscal security reserve for 2018 and 2020 at the minimum amount of 0.1% of GDP, but no reserve is planned for 2019.**

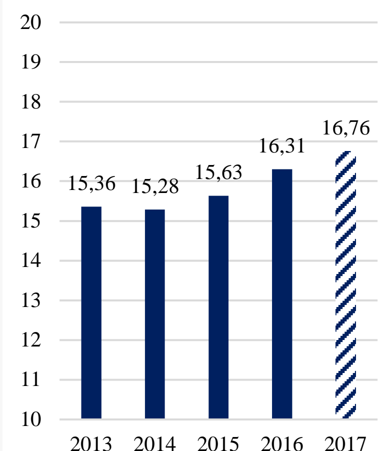
Macroeconomic outlook

In August 2017, the Council endorsed the macroeconomic forecast for 2017-2020, including the potential GDP growth forecast. The forecasted annual potential GDP growth rate for 2018-2020 is 3%, while real growth is projected to be higher than 3%. Consequently, from 2018 onwards the economy will grow above its potential, thus creating an output gap. Raising potential output requires bold reform measures that ensure a skilled and competitive labour force, boost productivity and strengthen long-term economic growth prospects in a sustainable manner.

Short-term fiscal outlook

While the budget outturn for 2017 is expected to surpass the target set in the MTBF 2017-2020, several decisions that entail additional expenditures were approved by the Cabinet of Ministers, thus absorbing some of the savings. Tax revenues remain resilient, and PIT revenues in particular will likely be higher than planned and continue growing as a share of GDP (Chart 1).

Chart 1: Labour tax revenues, PIT + SSC, (% of GDP). *Source: State revenue service & CSB*



Medium-term fiscal outlook

Despite favourable macroeconomic conditions, the government continues to use all available deviations from the budget balance target, and decided not to establish a fiscal safety buffer for 2019, citing a lack of fiscal space. While the tax reform will reduce the labour tax burden, other measures (e.g. 0% CIT rate on undistributed profits) will reduce tax revenues. Even though recent EU-wide methodological changes (Table 1) have resulted in a higher tax-to-GDP ratio, it is unlikely that the reform measures will ensure the achievement of the tax revenue target (1/3 of GDP), and their long-term impact is presently unclear. Furthermore, recent experience suggests that expenditure plans are continually revised upwards, but the commitment to refrain from changing the tax system in the medium term will constrain the ability to generate revenues. While there is a considerable tax gap and scope to reduce tax evasion, few concrete measures to combat the shadow economy have been outlined. Finally, the government has earmarked funds for health care to ensure the necessary financing after the permitted deviation from the MTO has expired.

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Tax-to-GDP (summer 2017)	28.3	28.0	27.5	28.0	27.9	28.7	28.7	29.1	29.3	
Tax-to-GDP (autumn 2017)	28.4	28.3	27.9	28.5	28.4	29.2	29.6	30.1	30.4	31.4
Difference	0.1	0.3	0.4	0.5	0.5	0.5	0.9	1.0	1.1	

Source: Eurostat.

Fiscal framework and national fiscal rules

There are several differences between the calculations done by the Council and the results provided by the Ministry of Finance. Regarding the structural balance rule, the Council does not agree to the use of deficit financing to implement health care reforms (0.1% of GDP in 2017, 0.4% of GDP in 2018 and 0.5% of GDP in 2019). Consequently, the Council has a more ambitious structural balance target. Regarding the expenditure rule, the Council's interpretation of the calculation methodology has led to a different approach to reflecting the impact of the tax reform in 2019 and 2020. In the Council's assessment, expenditure rule calculations should be adjusted by more than 1% of GDP in 2019 and 0.1% of GDP in 2020. Regarding the continuity rule, the Council used the budget plans approved on 24 November 2016 (budget law), whereas the Ministry of Finance used amended budget plans as the basis for their calculations, leading to different end results.

Key indicator forecast

		2017 f	2018 f	2019 f	2020 f
Real GDP growth	[% y-to-y]	3.7	3.4	3.2	3.2
Nominal GDP growth	[% y-to-y]	6.6	6.3	5.7	5.6
Inflation	[%]	2.8	2.8	2.4	2.1
GDP deflator	[%]	2.8	2.8	2.4	2.3
Potential GDP growth	[% y-to-y]	2.8	3.0	3.0	3.0
Output gap	[% of GDP]	0.0	0.3	0.5	0.8

Source: Fiscal discipline council surveillance report on Latvia's Medium Term Budget Framework Draft Law 2018-2020. October 2017. Available at: http://fiscalcouncil.lv/04-10-2017-surveillance-report.

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