Latvia

FISCAL DISCIPLINE COUNCIL
OF THE REPUBLIC OF LATVIA

Country note, December 2018

Key messages:

- **Delays in securing support for a new coalition government in Latvia have resulted into no-policy change draft budget plan for 2019 to the EC for review. Latvia has the weakest structural balance in Baltics (Chart 1) for 2019.**
- **The Fiscal Council finds the tax reform adopted in 2017 resulting into fiscal stimulus for the economy, while it deteriorate tax revenue to GDP ratio and has limited impact on improving income equality.**
- **The Council agrees with the Government assessment in the draft budgetary plan for 2019 that the structural balance rule requirements have been met, while there are significant differences regarding the expenditure growth exceeding the potential growth in the budgetary plans.**

Macroeconomic outlook

Historically low unemployment has been reached in 2018 (Chart 2) resulting into upward wage pressures. Unemployment rate is forecasted to decrease further from 7.7% in 2018 to 6.8% by 2021. This indicates increasing hiring difficulties in certain industries, where increasing share of enterprises claim that shortage of staff is restricting business growth, particularly in manufacturing, construction, services, and retail.

Real GDP growth forecast for 2018 the has been revised upwards from 4.0% to 4.2%, while it is expected to moderate in the future closer to the economic potential growth, revising the growth rate for 2019 downwards from 3.4% to 3.0% (Table).

Short-term fiscal outlook

Tax reform adopted in 2017 has resulted into fiscal easing and thus adding stimulus to the economy growing above the economic potential. Latvian fiscal performance since 2017 lags behind Baltic neighbour countries in the effort of counter-cyclical policies as measured by structural balance outcomes and forecasts for 2018-2019 (Chart 1). Elevated expectations of increased remuneration in the public sector and the delays in forming a new government pose challenges for fiscal responsibility.

Medium-term fiscal outlook

Dealing with the challenges of tight labour market and ageing costs will determine fiscal policies in the medium-term. Weak tax revenues and unrealistic expectations of improving these without addressing low tax burden on wealthy causes additional problems, while tax revenue to GDP has been estimated declining (Chart 3) and is among the lowest in EU. Fiscal tightening is on agenda for 2020, when deviations from the medium term objective for supporting structural reforms expire.

Fiscal framework and national fiscal rules

EU flexibility clauses together with the fiscal rules have been used to the maximum extent, while developing and approving fiscal frameworks. Improved outcomes of 2016 have been mostly result of delays implementing projects with support by EU grants. Excessive focus on the structural balance rule has resulted into the expenditure growth exceeding the potential economic growth. The Council finds it necessary to meet the medium-term objective bringing the structural balance above -0.5% of GDP in the budget plans to return to sustainable fiscal policies despite current challenges.

Chart 1. Structural balance in Baltics

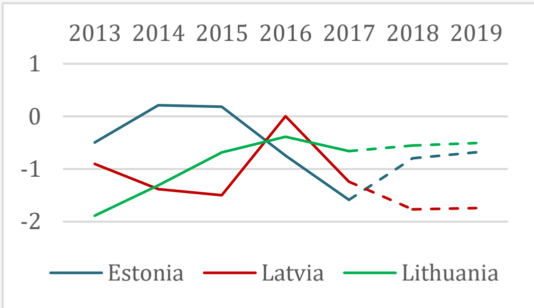


Chart 2. Unemployment rate

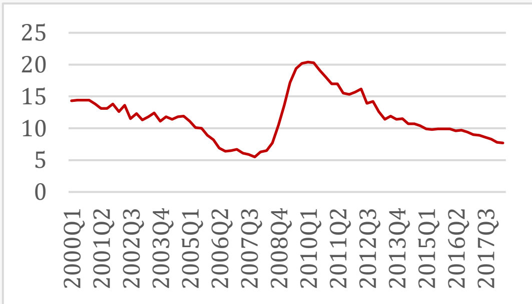
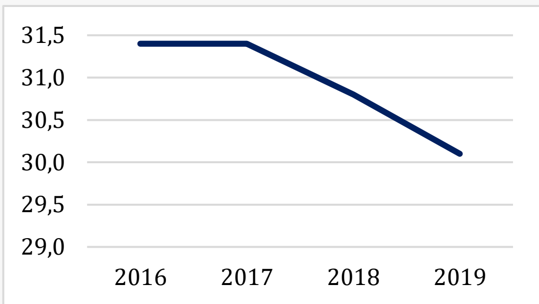


Chart 3. Tax revenues and social security contributions to GDP



Key indicator forecast

		2018 f	2019 f	2020 f	2021 f
Real GDP growth	[% y-to-y]	4.2	3.0	3.0	2.9
Nominal GDP growth	[% y-to-y]	7.4	6.2	5.8	5.5
Inflation	[%]	2.5	2.5	2.2	2.1
GDP deflator	[%]	3.1	3.1	2.7	2.5
Potential GDP growth	[% y-to-y]	3.4	3.4	3.3	3.2
Output gap	[% of GDP]	1.3	0.9	0.6	0.3

Source: Macroeconomic forecast endorsement. October 2018. Available: http://fiscalcouncil.lv/15102018-macroeconomic-forecast-endorsement.

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