Fiskālās disciplīnas padome

Fiscal sustainability interim report 2021-2041

Summary and main conclusions

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Fiscal sustainability assessment is one of the basic functions of independent fiscal institutions. Therefore, considering the current developments in the economy, the Fiscal Discipline Council has elaborated an interim report on the prospects of fiscal sustainability.

The previous sustainability report in the Council was made in 2017 and covers the period from 2017 to 2037. Currently, the Council has renewed the data of the previous report and conducted research on the future development of fiscal policy scenarios, considering the costs necessary to achieve the goals of the Green transition. The resulting interim report covers the period from 2021-2041. and it will be used as a basis for the joint project of the Fiscal Discipline Council and the European Commission creating a fiscal sustainability assessment model.

A significant research limitation in the creation of this interim report is the impact of statistical data from the previous two years, which includes the time of the Covid-19 pandemic crisis. This period saw a sharp increase in the deficit and debt, as well as a rise in health care and social protection spending, all against the backdrop of an economic downturn.

The main conclusions of the interim report:

1. In the reporting period from 2018 to 2022, Latvia's economy has experienced two significant shocks, the economic recession caused by the Covid-19 pandemic in 2020 (-2.2% of GDP) and the energy crisis currently occurring in 2022, which is characterized by an extremely rapid an increase in inflation that has exceeded the 20% and a predictable economic recession in 2023.
2. Considering both the consequences of climate change and the geopolitical escalation that took place in 2022, the need to invest in strengthening climate neutrality and energy independence throughout the EU is increasing. Therefore, the need for additional expenses to achieve these goals has increased.
3. Long-term macroeconomic forecasts allow us to conclude that negative demographic trends will be observed in Latvia in the coming years. Depopulation will be one of the main drags on economic potential in the long term. Eurostat forecasts show that the population in the age group from 15 to 64 will decrease by 27% in 2040 compared to 2019. In the review period, the period from 2035-2041 shows the most unfavourable in terms of population, this means that in 2025 the number of people in the age group from 15-64 will be 1.124 million, but in 2035 it will decrease to 969 thousands, while in 2040 it will decrease to 897 thousand. Consequently, the labour market forecasts subordinated to demographic forecasts are quite pessimistic.
4. The level of participation of the employed will remains increasing, because as the population decreases in general, greater involvement of the labour force will be required, as well as economic development will ensure the demand for labour.
5. Given the downward demographic projections, it is expected that the national tax revenue base as we know it today will be insufficient to finance the social protection system. Consequently, residents will not be able to afford early retirement. The proportion of economically active population in the total population (age group 15-64) will reach the level of about 82%-86% by 2041.

6. Productivity growth until 2041, based on the Council's assessment, could reach an average of 2.4% per year, while based on the EC Aging report, 2021 forecasts, its growth will be slower at an average of 1.7%. In both cases, the rate of productivity growth will decrease given the negative demographic projections.
7. Tax revenues in Latvia, in the period from 2017-2021. accounted for an average of 30.1% of GDP, which is about 10 percentage points less than in EU countries. Also compared to the closest neighbours Lithuania and Estonia in 2021, the ratio of taxes collected in Latvia was 3 percentage points lower than in Estonia and 1.6 percentage points lower than in Lithuania. In the last five years, the fastest increase in collected taxes among the Baltic States was in Lithuania, on average 9.5%, followed by Estonia at 7.8%, while in Latvia, the amount of tax revenue increased by 5.7% on average in five years. It should be noted that in all three countries the growth rate of tax revenues is ahead of the EU creators.
8. Despite the economic recession experienced during the Covid-19 period, tax revenues have continued to grow compared to each previous year, and they have also been collected more than the amount of tax revenues forecast for the year. However, the manifestations of the shadow economy, such as envelope wages, non-disclosure of income, etc., are still a significant problem that limits budget revenue.
9. Latvia's expenditure on social protection, when evaluated as a % of GDP, lags the Baltic neighbouring countries, while all Baltic countries lag behind the EU level in terms of social protection expenditure by almost half.
10. The amount of expenditure on social protection in the EU has averaged 27.5% of GDP over 10 years. Setting the goal of reaching at least 66% of the EU level in Latvia, it would be necessary to allocate 18.2% of GDP to this area. On the other hand, setting the goal of reaching 75% of the EU average level, Latvia should allocate around 20.6% of GDP to this area.
11. The amount of funding allocated to health care as a % of GDP lags the EU level by about half and has been the lowest in the Baltics for many years. However, it must be said that the amount of funding in Latvia has increased every year. Bringing the amount of health care funding closer to the EU average, which is 8% of GDP on average over 10 years, 5.3% to 6% of GDP should be allocated in Latvia to finance these areas.
12. Creating fiscal sustainability scenarios, it is essential to balance the part of budget revenues and expenditures in the long run. Assuming the existing amount of tax revenues as a % of GDP and that the amount of taxes collected will increase annually by 0.5%, moving towards the tax revenue target by 33% of GDP in 2041, while spending on social protection and health care will move towards 66% or 75% of the EU averages, the modelling results show that this amount of revenue cannot be balanced with the expenditure goals in social protection and health care. In such a scenario, the amount of debt exceeds the Maastricht criterion (60% of GDP) already in 2028 and continues to grow. On the other hand, assuming that the amount of tax revenues will move towards the EU average revenue indicators, i.e. 41.5% of GDP until 2041, fiscally sustainable are those scenarios that include the direction of spending in social protection and health care to 66% of the amount of EU spending.
13. Without changing the approach to raising budget revenues, healthcare and social protection spending goals may be a difficult task for future governments. Moreover, in addition to these goals, investments to Green transition targets are also in a table. Since Latvia's economy is not related to the production of large-scale GHG emissions by itself, investments to achieve the goals of the Green transition can be implemented without

risks of fiscal sustainability, however, in combination with spending goals in social protection and healthcare, they need to be evaluated separately.

14. The results of the modelling carried out in the development of this interim report show that fiscally sustainable progress towards the goals of the Green transition, for health care and social protection is possible subject to several conditions: (i) the movement of health care and social protection costs to the level of 66% of the EU level, (ii) the intensity of funding to achieve the goals of the Green transition is around 1% of GDP per year, (iii) the progress of tax and social security revenues to the EU level of 41.5% of GDP. If such conditions are met, the maximum amount of debt would be reached around 2033.-34. year and would be within the range of 50.4%-57.9% of GDP. In addition, in such a scenario, debt reduction is possible, because when a certain level of tax revenues is reached and expenses grow more slowly than revenues, a surplus in the budget balance is possible.

15. However, since social protection and bringing health care expenses closer to the EU level are recognized as social policy priorities, which is also repeatedly indicated in the EC Semester reports, work is needed on creating additional sources of income and increasing economic productivity.