MINISTRY OF FINANCE
REPUBLIC OF LATVIA

CanCham FOCUS on Money

at the Grand Palace Hotel

April 5th, 18.30

with **Dana Reizniece-Ozola**
Minister of Finance

Real wage growth in 2017 mostly in line with productivity increase

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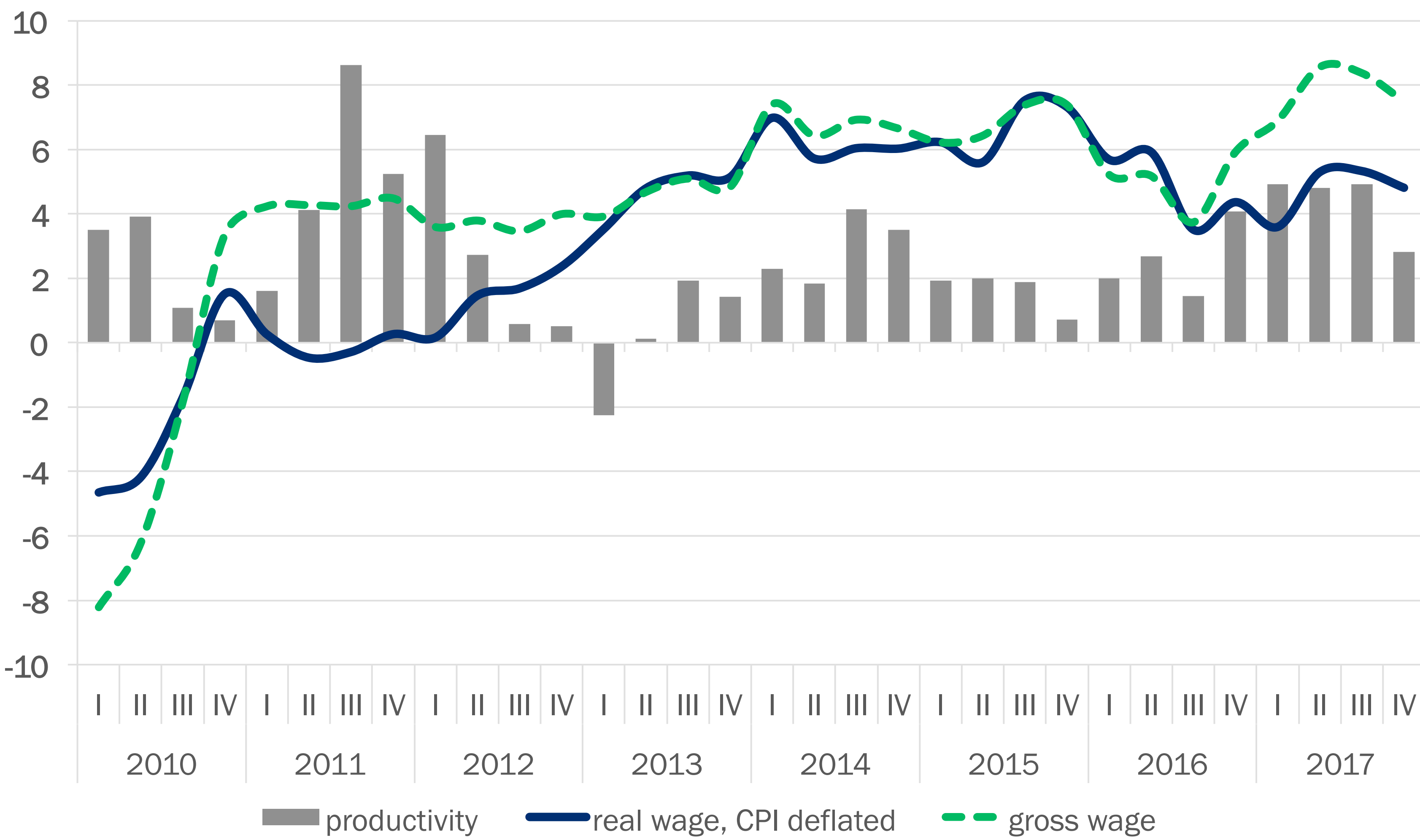
Real and gross wage growth, productivity growth y-o-y, %



Data: CSB, MoF calculations

Unemployment rate declined faster in 2017, number of employed persons increased since mid-year

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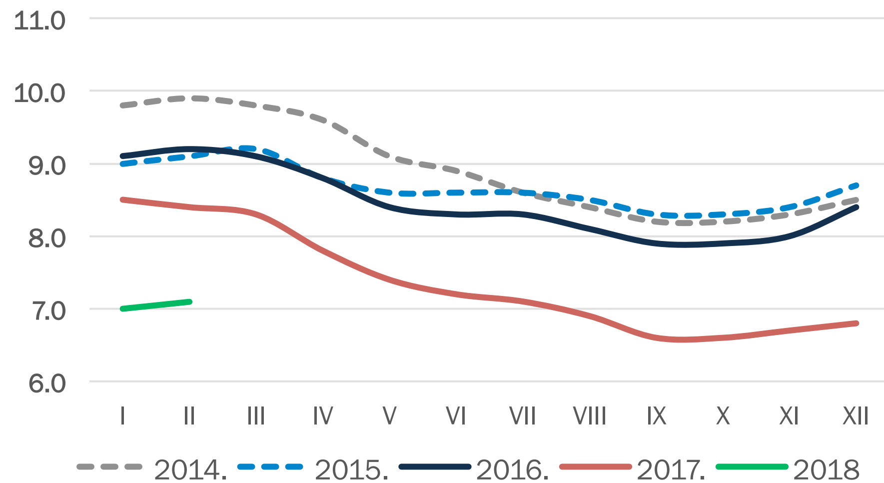
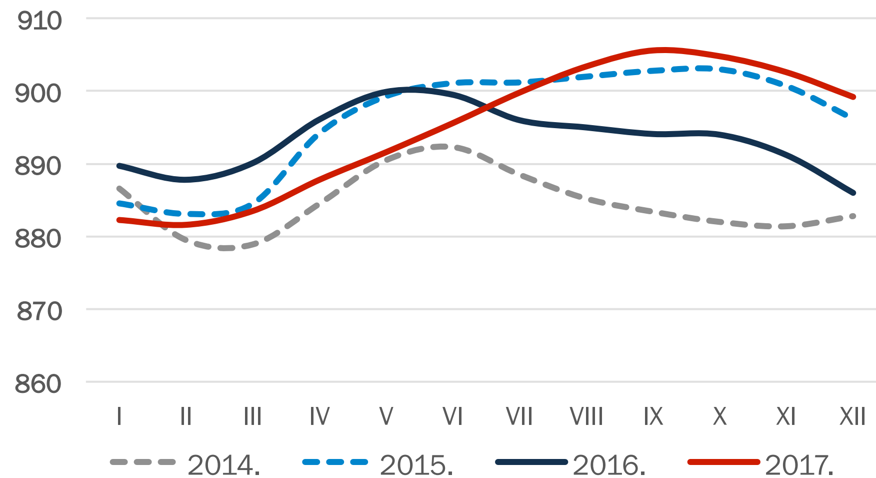
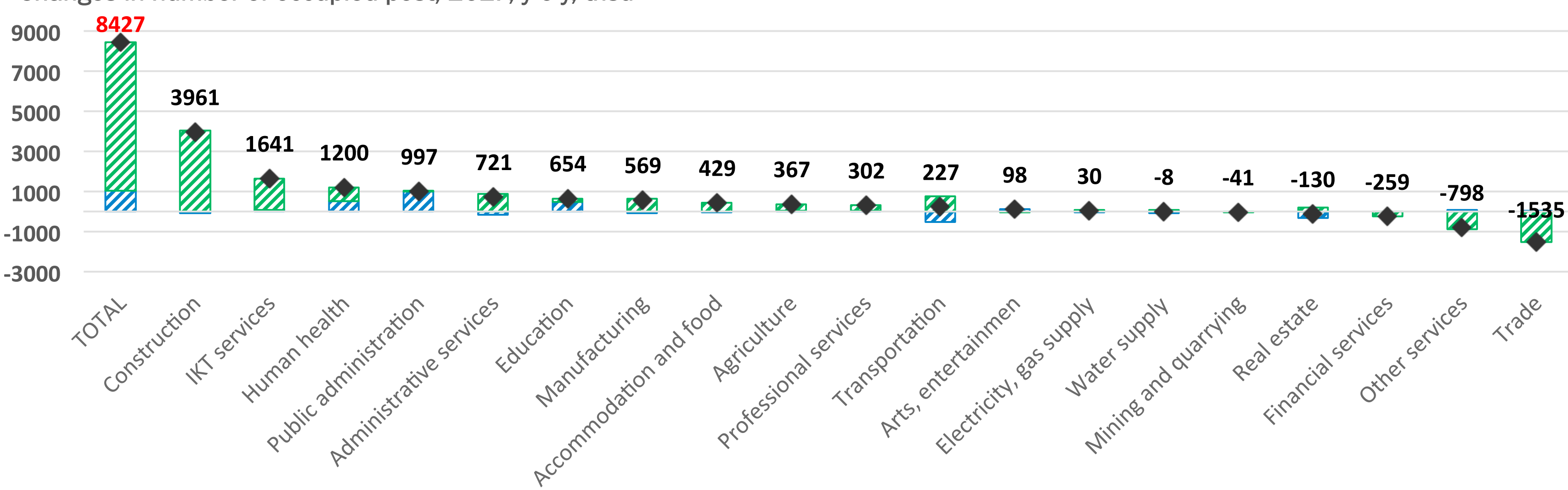
Registered unemployment level by months, %



Number of employed persons, CSB, thsd



Changes in number of occupied post, 2017, y-o-y, thsd



Data: CSB, SEA

Inflation rose to 2,9% in 2017 - the highest level in the last six years. In 2018, inflationary pressure diminishes

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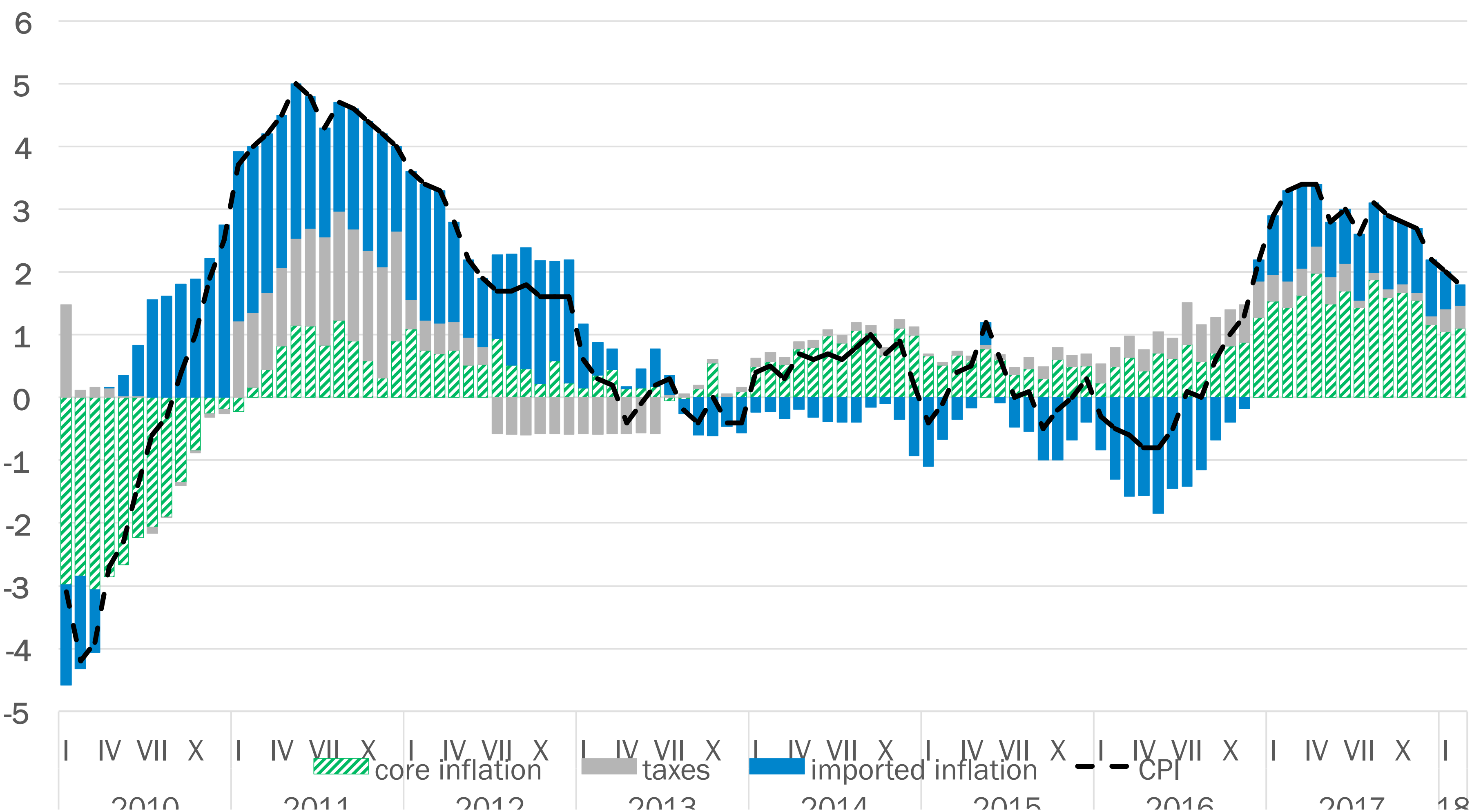
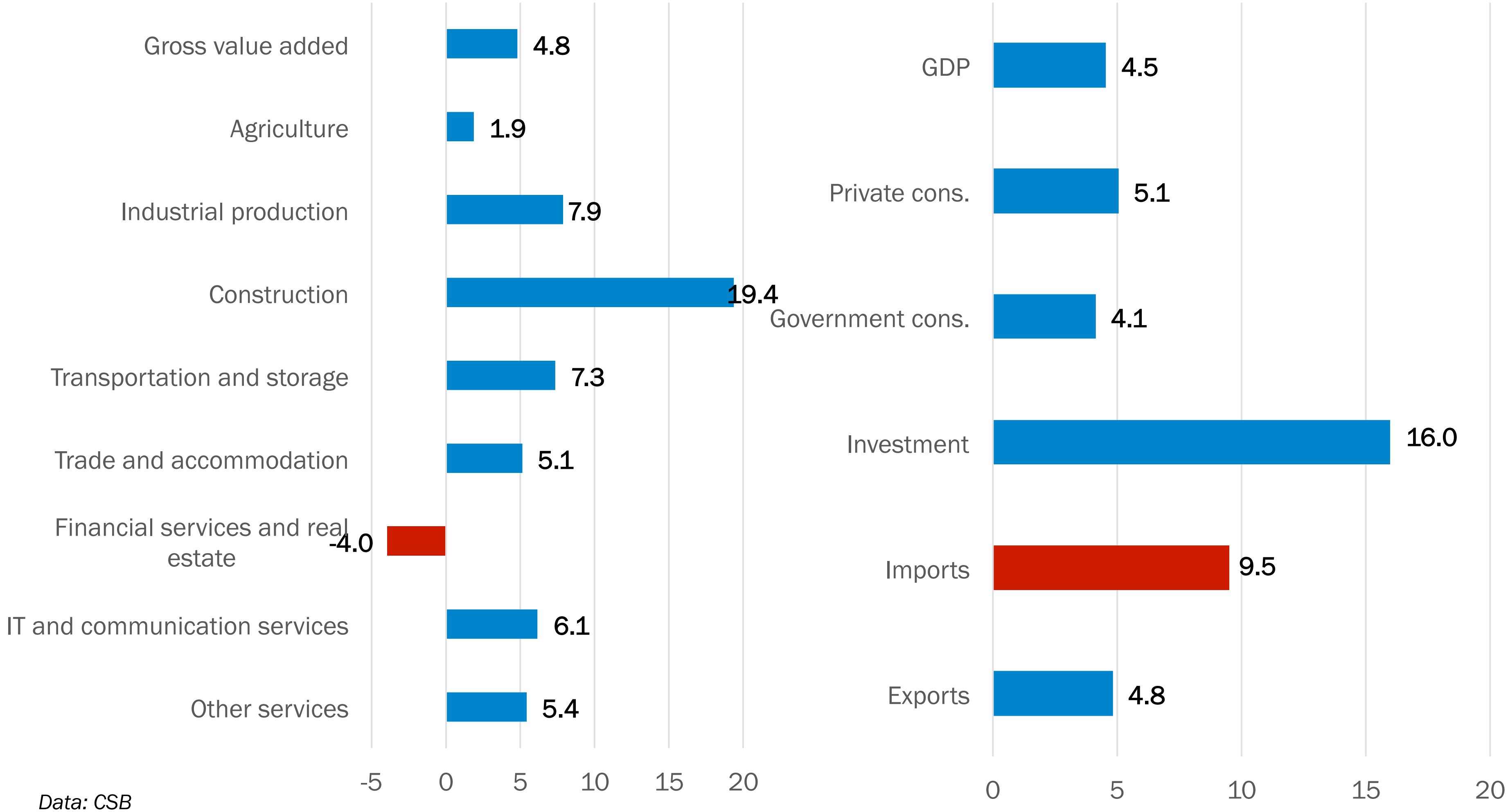
Consumer Price Index (CPI), y-o-y, contributions, %



Data: CSB, MoF

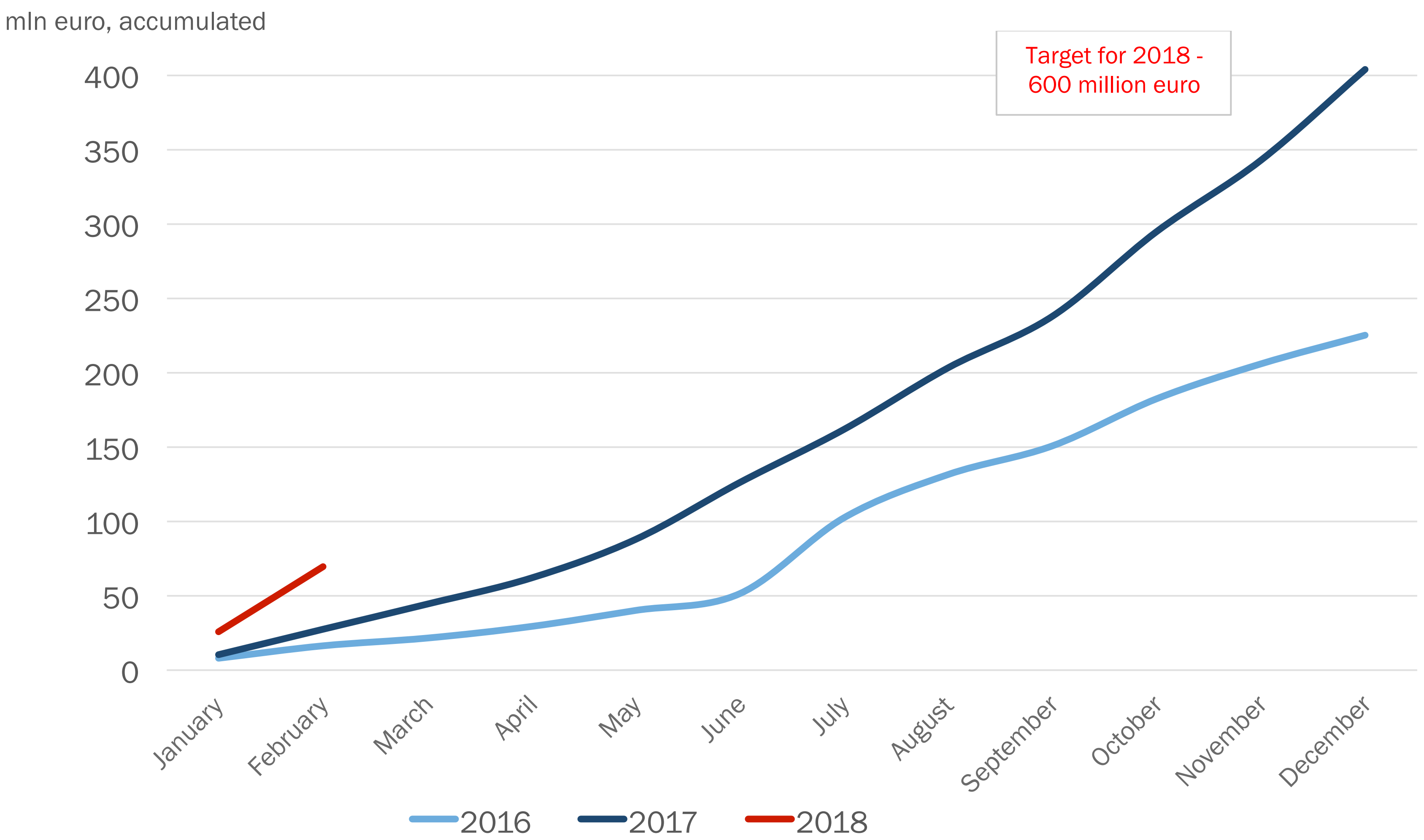
In 2017, GDP growth in Latvia was driven by strong external demand and revival of investment

Growth of GDP components in 2017, %



Data: CSB

EU funds budget expenditure substantially up in 2017 and at the beginning of 2018



Data: MoF

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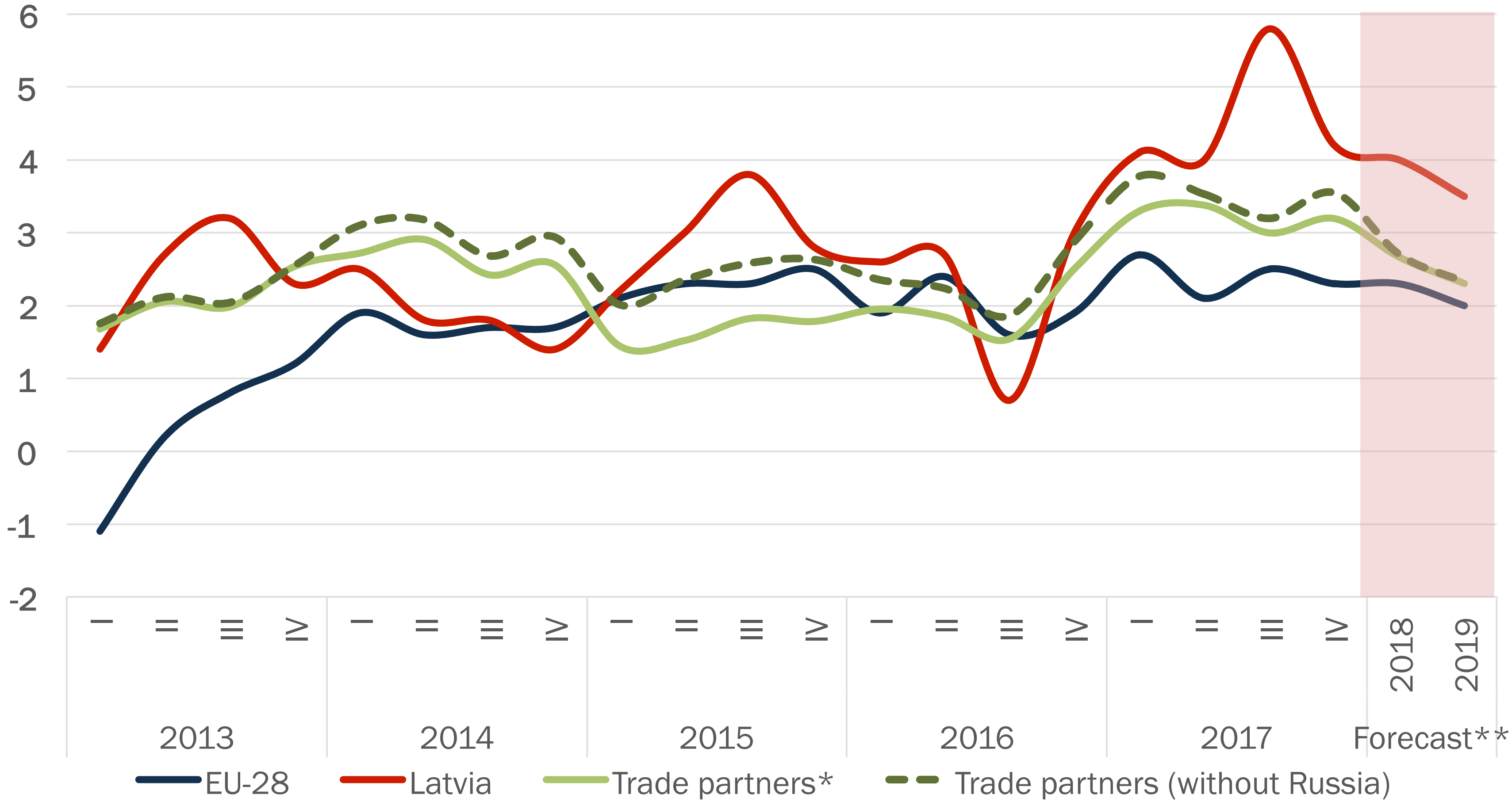
Latvia's main trade partners' growth remains above the EU average

Real GDP growth, y–o–y, %



Data: Eurostat, EC, MoF calculations

* *Average GDP growth rate of Latvia's top 7 trading partners, weighted by export share in 2017*

***EC Interim Economic Forecast, January, 2018, Latvia – MoF forecast*

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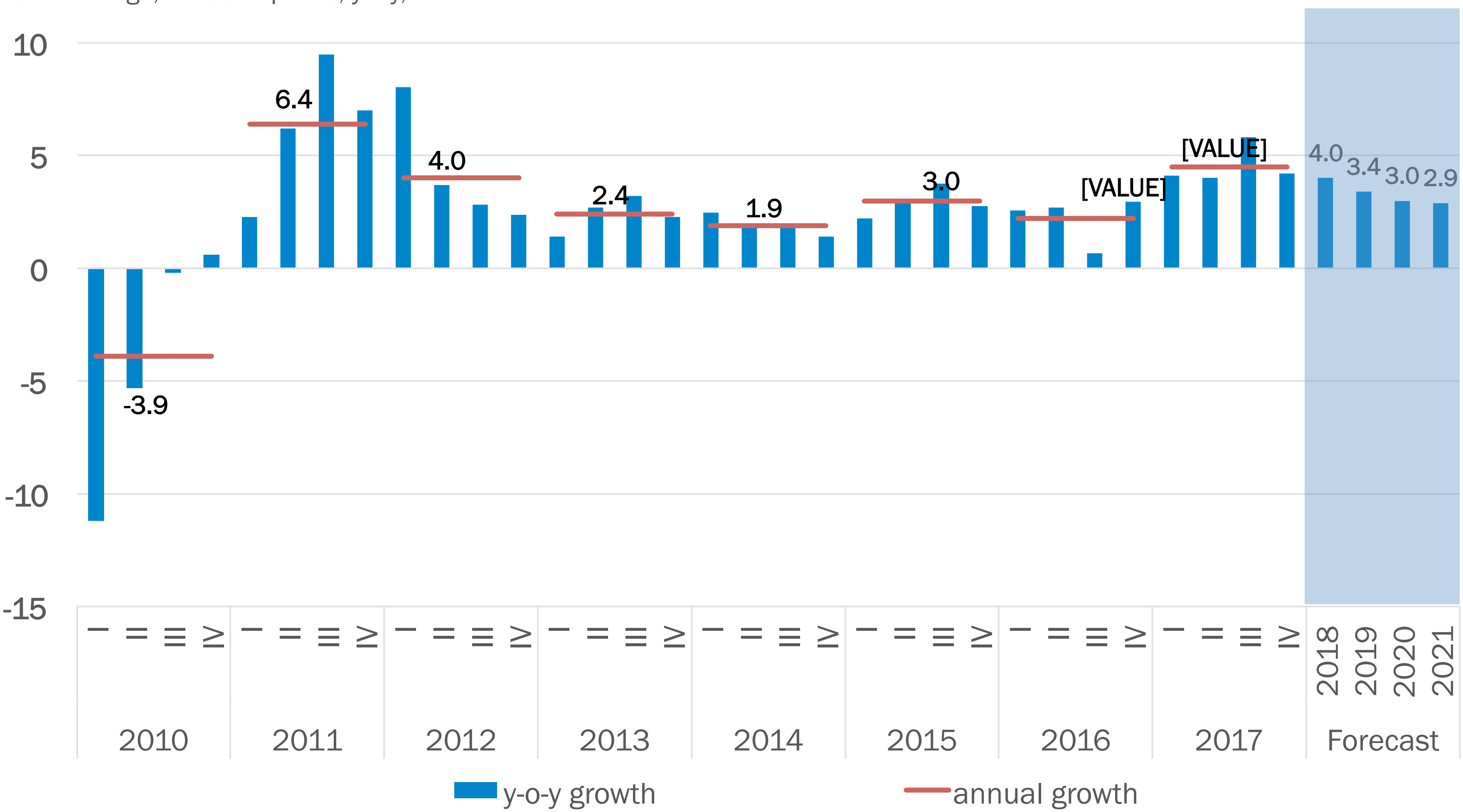
Latvia's economic growth accelerated in 2017, in the mid-term steady growth is expected to continue

GDP change, constant prices, y-o-y, %



Data: CSB, MoF

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Tax reform framework and principles

→ Increase in competitiveness and exportability, reduce of inequality and ensure revenue 1/3 of GDP

Strategy framework

- Tax structures and rates review
- Improving tax administration
- The fight against the shadow economy

Principles

- Predictability and a long-term vision
- Regional competitiveness, at least in the Baltic region
- Tax motivation for improvement
- A similar tax burden on similar types of revenue
- Lending and capitalization improvement
- Reducing the cost of tax administration

Positive impact on economy

- Raise of disposable income of employees inducing private consumption;
- More competitive entrepreneurs on regional and global scene as well as stimulation of own investment;
- Better capitalized businesses, more opportunities to raise additional funds for development;
- Increased prospects to raise production capacity of goods and services, more effective and efficient production process;
- More equality between different income groups and types of income;
- Higher tax revenue resulting from increased economic activity and less tax avoidance.

Reasons for Tax Reform

National Development Plan:
average annual GDP growth of at least 5%

In 2015, the Gini coefficient for Latvia was 35.4, which is one of the highest in the European Union
Government Action Plan:
to reduce income inequality for employees

Government Action Plan:
in 2018 the **total amount of taxes revenues approaching 30% of GDP**

Government Action Plan:
the efficiency of the SRS increases – costs for one collected euro in 2016 was 0.0157 euros, in 2018 will be 0.0130 euros

Government Action Plan:
reduce the size of the shadow economy : from 23.6% of GDP (2015) to 21% of GDP (2018)

Labour Tax reform

Progressive Personal Income Tax rate

Incomes, EUR per year	PIT basic rates	
	2017	2018
To 20,004	23%	20%
From 20,004 to 55,000		23%
To 55,000		31.4%

Differentiated non-taxable minimum

	2017	2018	2019	2020
NM_{max}	115	200	230	250
NM_{min}	60	0	0	0
AI_{max}	1100	1000	1100	1200
AI_{min}	400	440	440	440

Allowance for dependants

Year	Allowance, EUR per month
2017	175
2018	200
2019	230
2020	250

Non-taxable minimum for pensioners

Year	Allowance, EUR per month
2017	235
2018	250
2019	270
2020	300

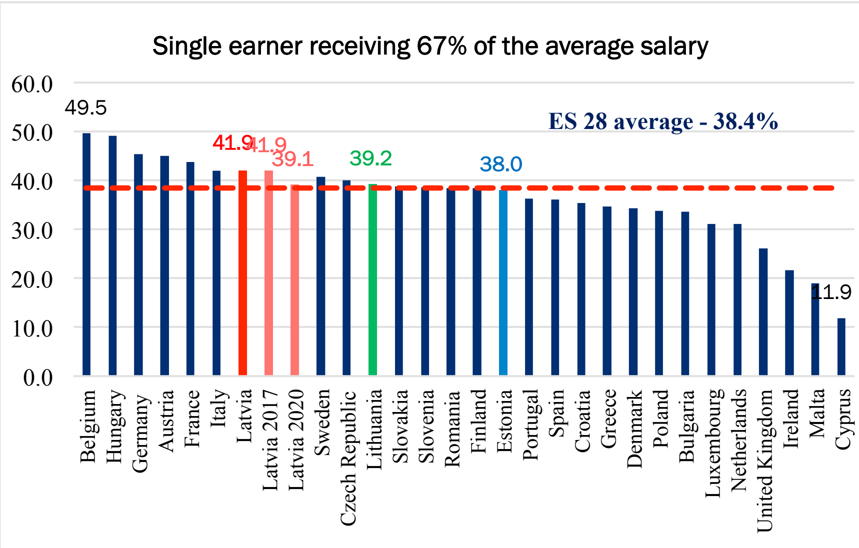
Minimum monthly salary

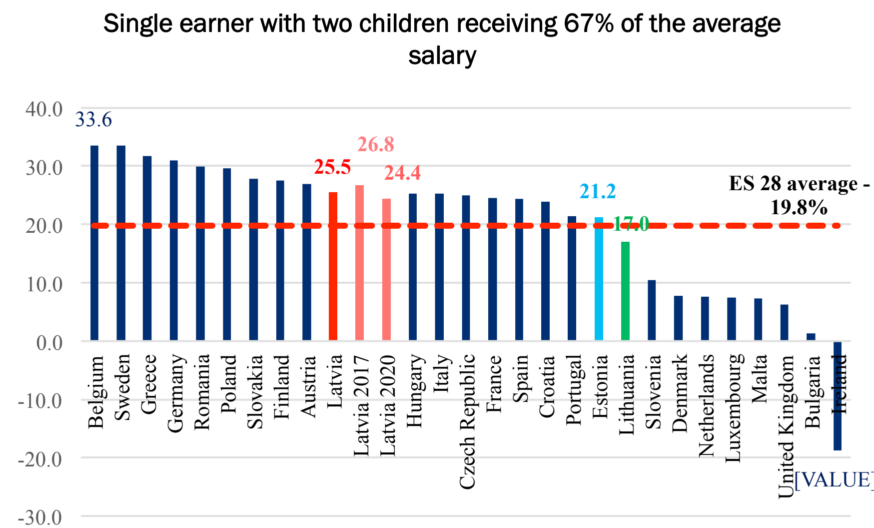
- from 380 to 430 euro

State social contribution rate

- Increase by 1% (0.5% for the employer and 0.5% for the employee) as a part of the health reform

As a result of Tax Reform, the Tax Wedge* will be reduced





* *Tax wedge is defined as the ratio between the amount of taxes paid by employee and the corresponding total labour cost for the employer. The average tax wedge measures the extent to which tax on labour income discourages employment. This indicator is measured in percentage of labour cost.*

Data source: Eurostat and Ministry of Finance calculations for Latvia 2017 and Latvia 2020

Corporate Income Tax (CIT)

General provisions

CIT is payable on distributed profits (including deemed profit distributions);

No CIT is payable on undistributed profits;

CIT is payable on net amount of expenditures not related to business activity;

CIT rate is 20% on the gross distributed amount or 20/80 on the net income; In case of dividends distributed to individuals no personal income tax (PIT) apply;

CIT taxable period is one month.

Special provisions

Flowing through dividends – the CIT is not applicable, if the income from which the dividends have been paid has already been subjected to CIT or withholding tax.

Holding regime - the exemption for income from alienation of shares has been maintained, in case if holding lasts for a period of at least 36 months.

Representation expenses - not subjet to CIT, provided they do not exceed 5% of the total gross wage calculated for the employees.

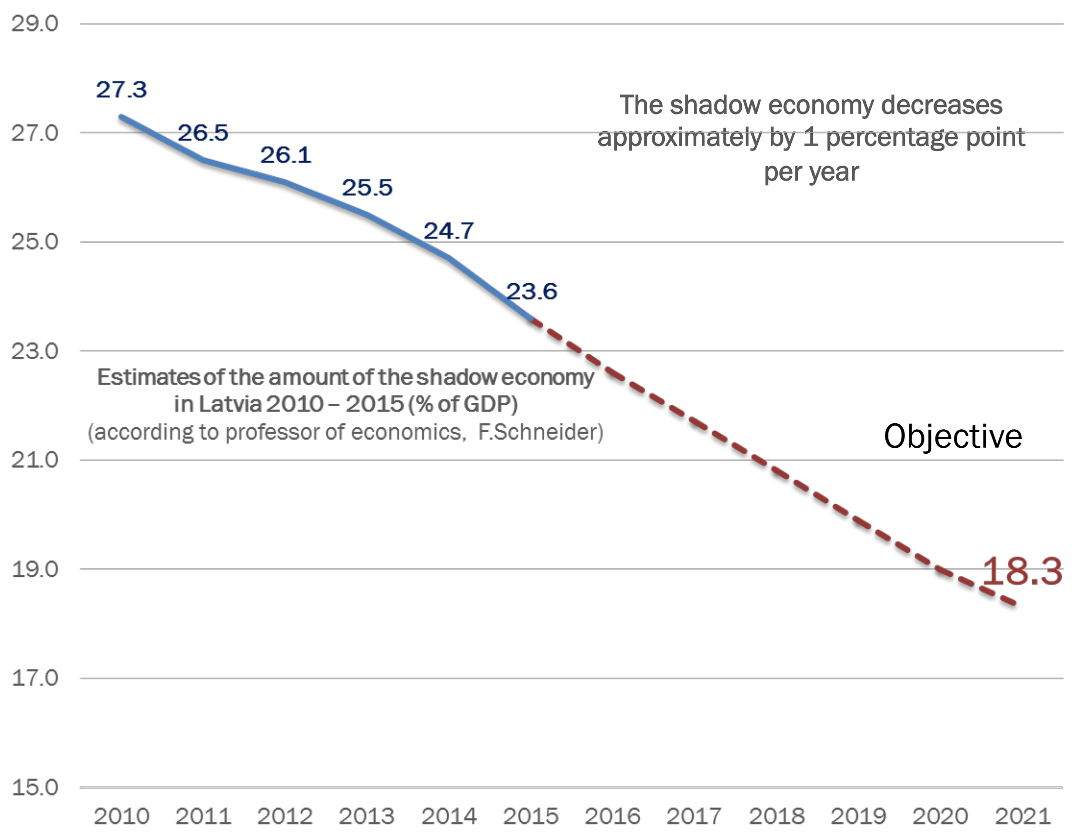
Transition period – profits made in the previous years (until 2018) are not subject to the new CIT at 20% rate, regardless when such profits are distributed. If distributions are made to individuals, the 10% PIT rate apply during the first two years, and the 20% PIT rate after such transitional period.

Compensatory Measures

- Increasing PIT rate from capital (10/15% => 20%)
- Increasing excise duties rates
- Increasing gambling tax rates (30% for gaming machines and tables; PIT for wins over EUR 3,000)
- Restriction of MET activity (turnover EUR 100,000 => EUR 40,000)
- Restricting PIT eligible expenses

Sustainable economic development and combating shadow economy has the greatest impact on the additional tax revenues

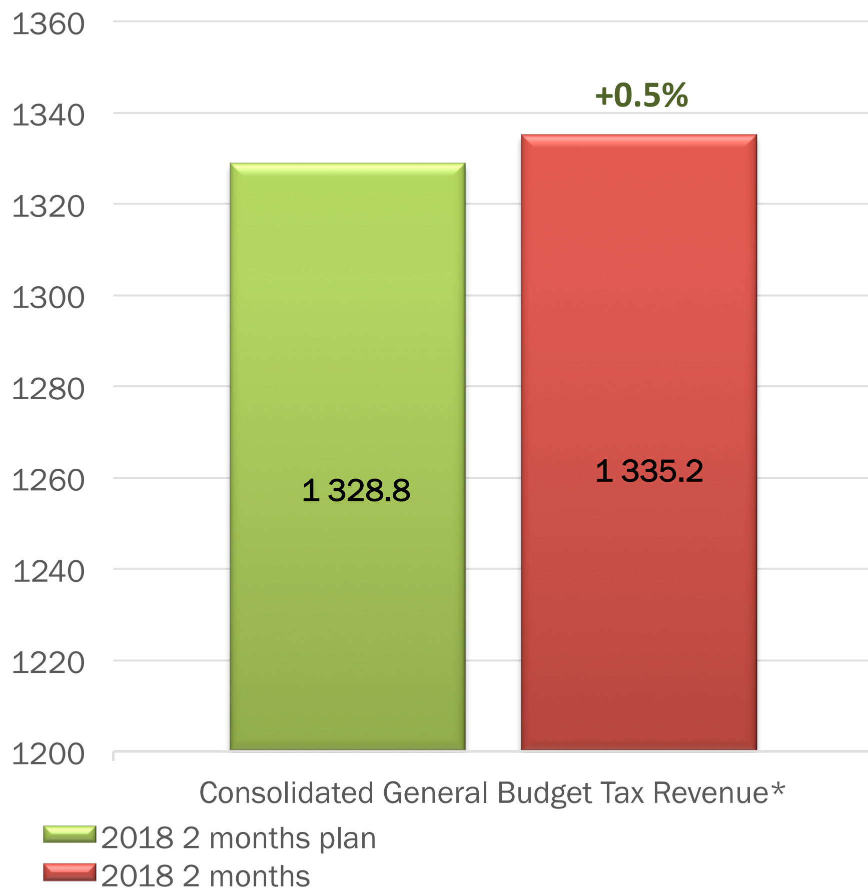
The shadow economy. Objective – 18.3% of GDP

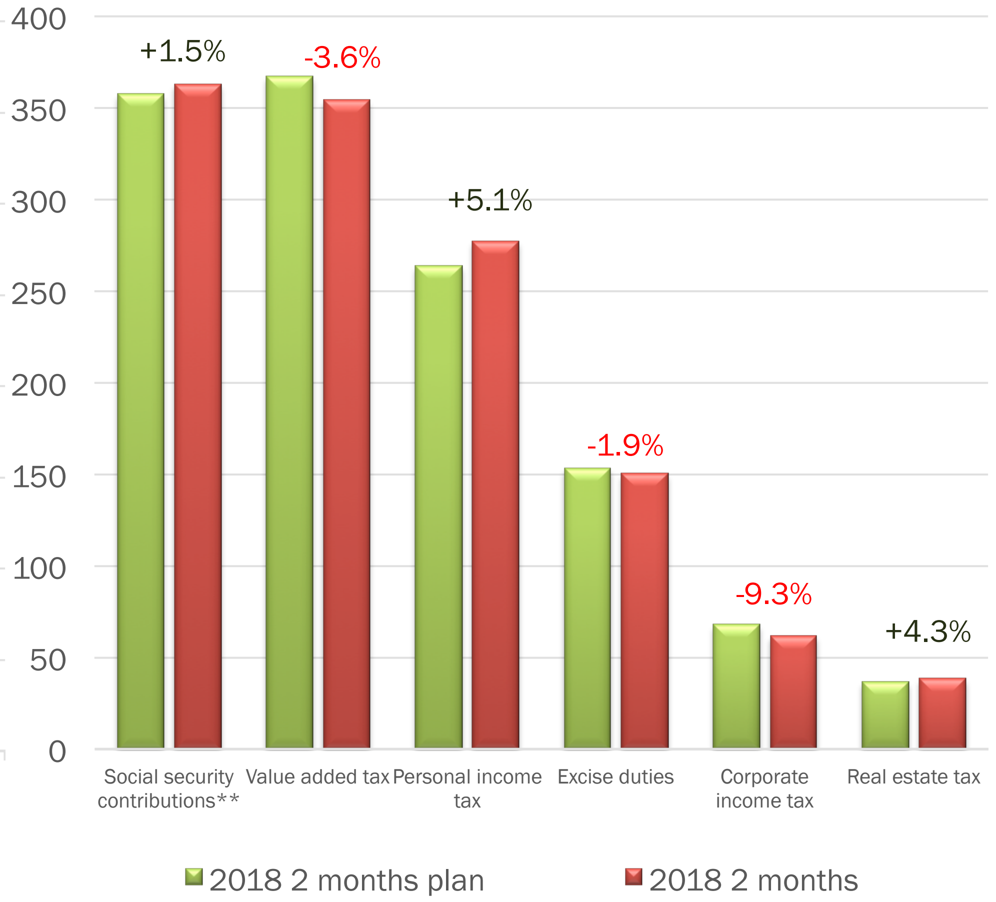


Measures planned to diminish the shadow economy:

- Broadening use of the VAT reverse charge
- Reduction of VAT transaction's decryption threshold in VAT returns
- Restriction of registration and business activities of fictitious, unfair subjects
- Broadening the exchange of information
- Availability of the information regarding tax offences
- Improvement of liability of the members of the board regarding tax compliance
- Development of the penalty policy (inevitability)
- Improvement of the investigation and the court proceedings
- Availability of new solutions for administration /tax payments

In 2018 2 months tax revenue* has overachieved the plan





*excluding contributions to the state funded pensions scheme and 3rd pillar
** central government special budget

Wage increase* – proof of successful introduction of the tax reform

Period	Total number of employees	Number of employees with wages>0	Average gross wage
2017/01	795 935	730 162	751,56
2018/01	807 021	744 361	816,84
Difference	11 086	14 199	65,28
Difference %	1.4%	1.9%	8.7%

- increase of number of employees by **1,9%**;
- increase of average gross wage by **8,7% receiving 816.84 EUR** (with part-time employees);
- **decrease by 22,7% of number of employees receiving wage less than 430 EUR** – strong evidence of positive return of combating shadow economy and improving tax compliance;
- increase of number of employees in wage groups over minimum;
- highest wages in air transport, financial service and computer programming sectors.

* gross wage

Labour tax revenue increase – proof of successful introduction of the tax reform

Period	Total income mil.EUR	SSC mil.EUR	PIT mil.EUR	SSC+PIT mil.EUR
2017/01	619.7	209.5	117.9	327.3
2018/01	693.5	240.7	127.2	367.9
Difference	73.8	31.2	9.3	40.5
Difference %	11.9%	14.9%	7.9%	12.4%

- Increase of labour tax revenue by **12,4% or 40,5 milj.EUR**;
- Major labour tax payers – state institutions and trade sector.

Annual Spending Reviews – Procedure Framework for Linking Budget with Policy Planning

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Legislation Driven Initiative

On 30 November 2015 amendments to **Law on Budget and Financial Management** approved by Parliament.
Entered into force as of **1 January 2016.**
Law supplemented with **new article 16.^{3} «State budget expenditure review»**

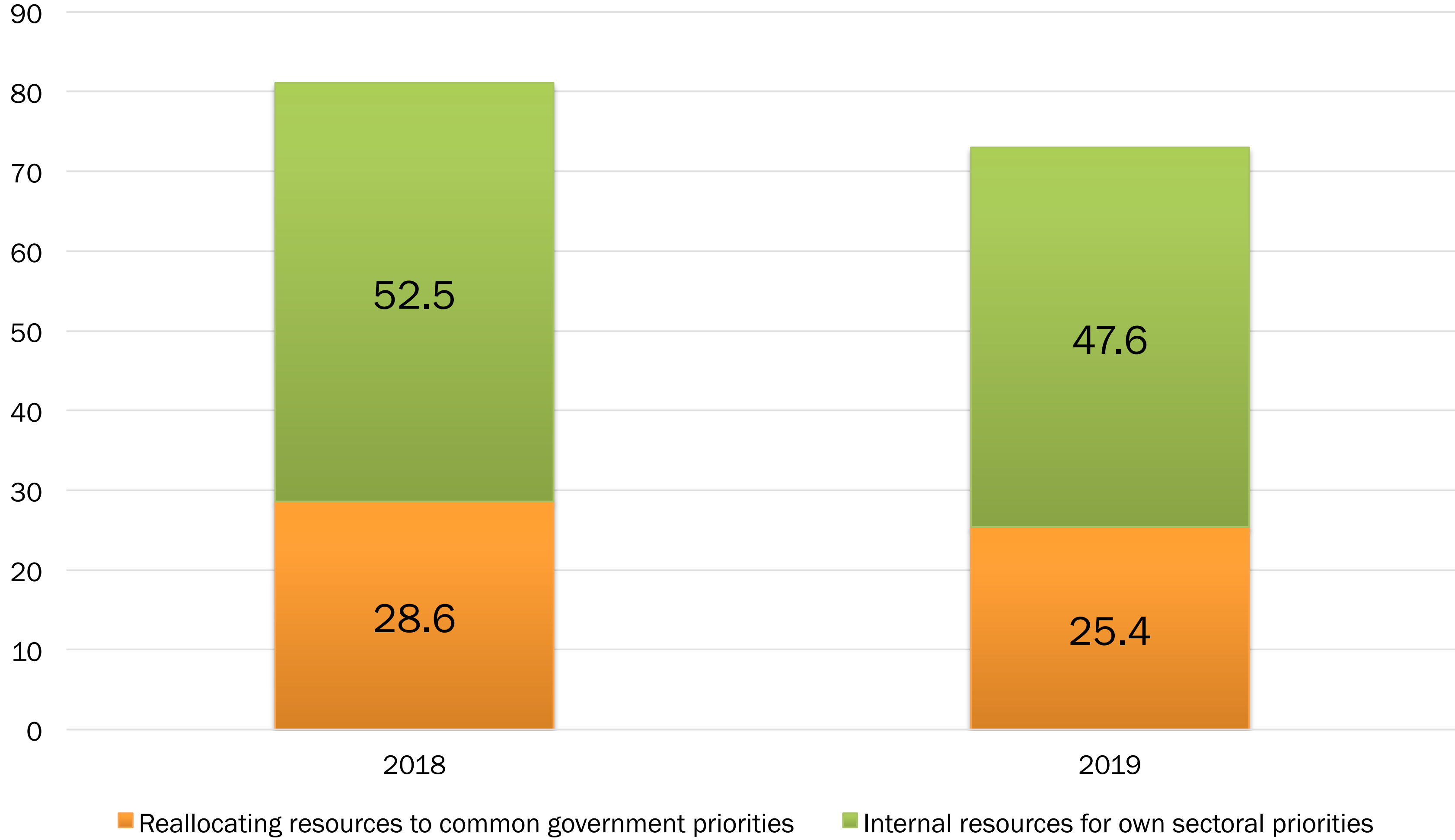
Objectives

Accountability for policy outcomes and outputs	**Better policy** outcome with **less inputs**	Regularly (annually) and systematically **reprioritize public spending**

Role of Government

Set **scope** and **priorities** of spending review	Process integrity is **in line with budget schedule**	**Finance ministers** submits to GOV **review results and implementation proposals**

2017 expenditure review results (EUR, million)



Sound, Well Capitalised and Liquid Banking Sector

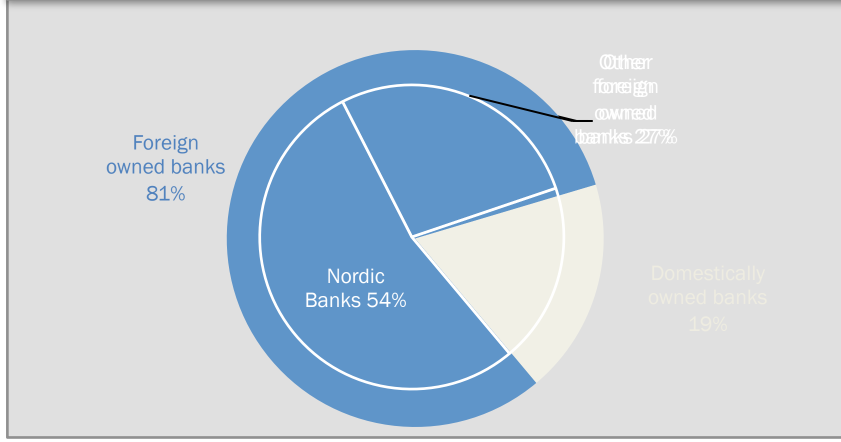
→ Foreign banks have shown commitment to their local subsidiaries and branches in Latvia, reducing contingent liability risk to the Government

Key Highlights

- The Latvian banking sector is dominated by subsidiaries and branches of banks from the European Economic Area, mostly Nordic countries[(1)] (54% of the banking sector capital, 51% of assets, 81% of domestic loans and 80% of domestic deposits).
- Capitalisation and liquidity ratios are well above minimum requirements. The banking sector's capital is mostly made of CET1 capital (in 4Q 2017 CET1 ratio was 19.0% (EU average 2Q 2017 – 14.7% [(2)]), in 4Q 2017 FCMC liquidity ratio amounted to 59% and LCR was 308%).
- As of November 2014 the three largest banks are directly supervised by the ECB. Since January 2016 four banks fall under the remit of the Single Resolution Mechanism.

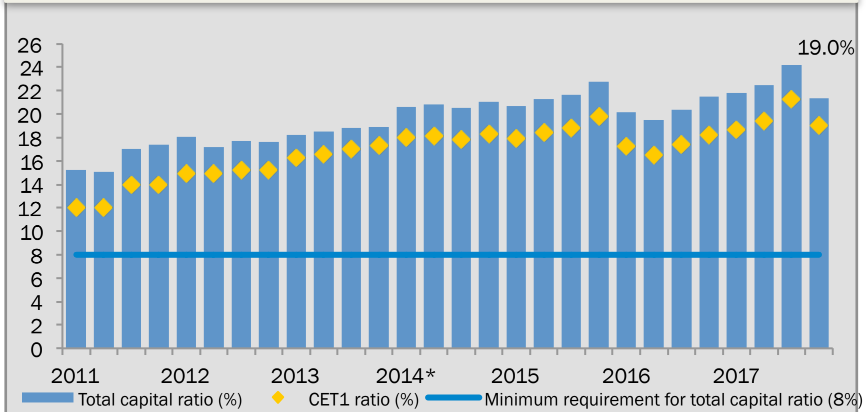
Source: (1) - Financial and Capital Markets Commission (2) – EBA risk dashboard

Capital Ownership of the Banking System (4Q 2017, %)



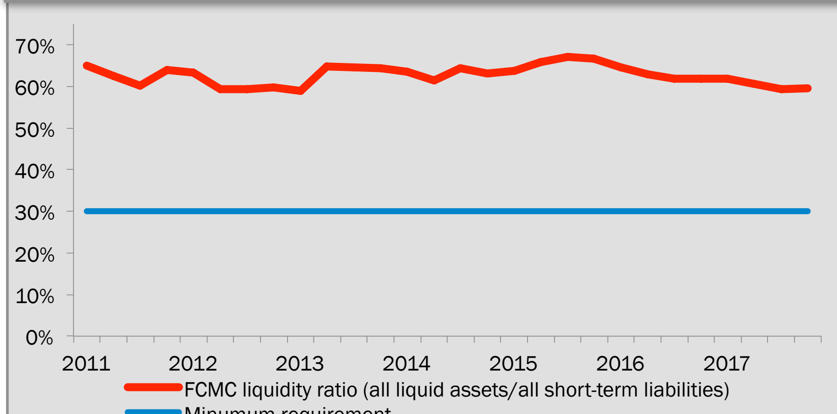
Source: Financial and Capital Market Commission

Capital Adequacy (%)



Source: Financial and Capital Markets Commission
Note: Data on 2Q2017
** As of Q1 2014 capital adequacy is calculated according to the CRDIV/CRR requirements and is not directly comparable with the data until Q1 2014 due to differences in methodology.*
Tier 1 ratio matches CET 1 ratio.
The regulatory minimum capital adequacy requirement is 8%. Since 28 May 2014 the FCMC also applies a 2.5% capital conservation buffer.

FCMC Liquidity Ratio (%)



Source: Financial and Capital Market Commission
Note: Data on 3Q2017

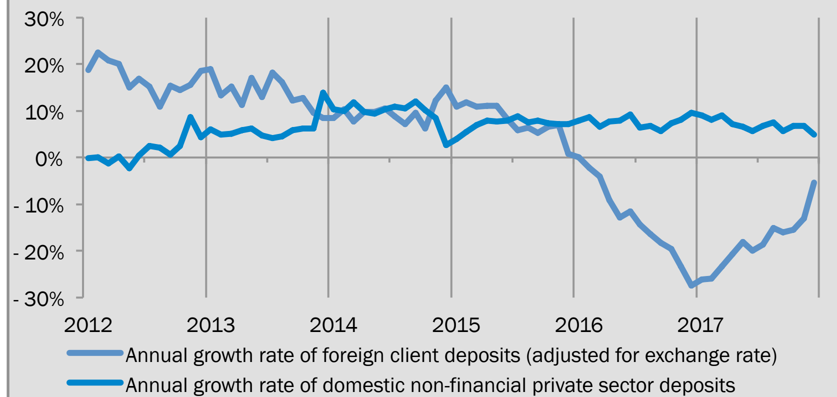
Banks servicing Foreign Clients Have a Negligible Role in the Domestic Financial Market and the Economy

→ **The FCMC requires banks mainly servicing foreign clients to hold an additional capital buffer up to 9.5% of risk-weighted assets and up to twice the minimum liquidity requirement**

Key Highlights

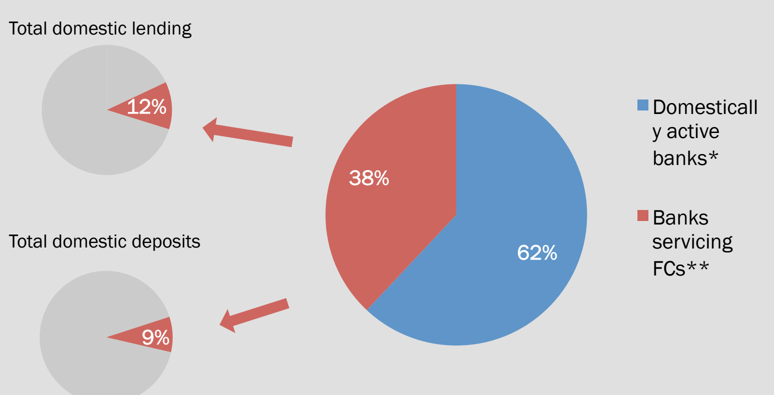
- Servicing foreign clients has been part of Latvia's banking sector since the early 1990s. However, the banks actively engaged in FC (foreign client) business have little domestic operations.
- FC deposit growth was relatively stable until end-2015, but then reversed in 2016 with continuously deteriorating CIS economies and enhanced enforcement of tougher AML/CFT requirements.
- Additional liquidity and capital requirements for banks servicing FCs hold significant liquidity and capital buffers to counter potential liquidity outflows and to withstand potential shocks.

Growth Rates of Domestic and Foreign Client Deposits (%)



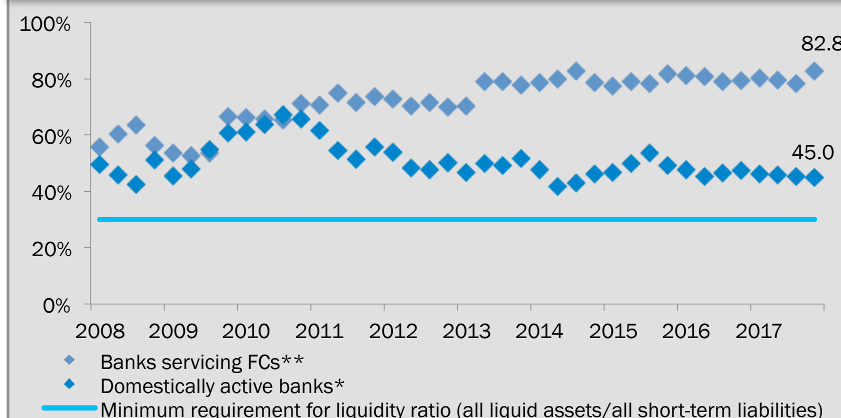
Source: Bank of Latvia

Banking Assets including Foreign Branches
(end of December 2017, %)



*Source: Bank of Latvia; Note: * Credit institutions which grant more than 50% of loans domestically and receive more than 50% of deposits from domestic clients ** Other banks*

FCMC Liquidity Ratio (%)



*Source: Bank of Latvia; Note: * Banks which grant more than 50% of loans domestically and receive more than 50% of deposits from domestic clients ** Other banks*

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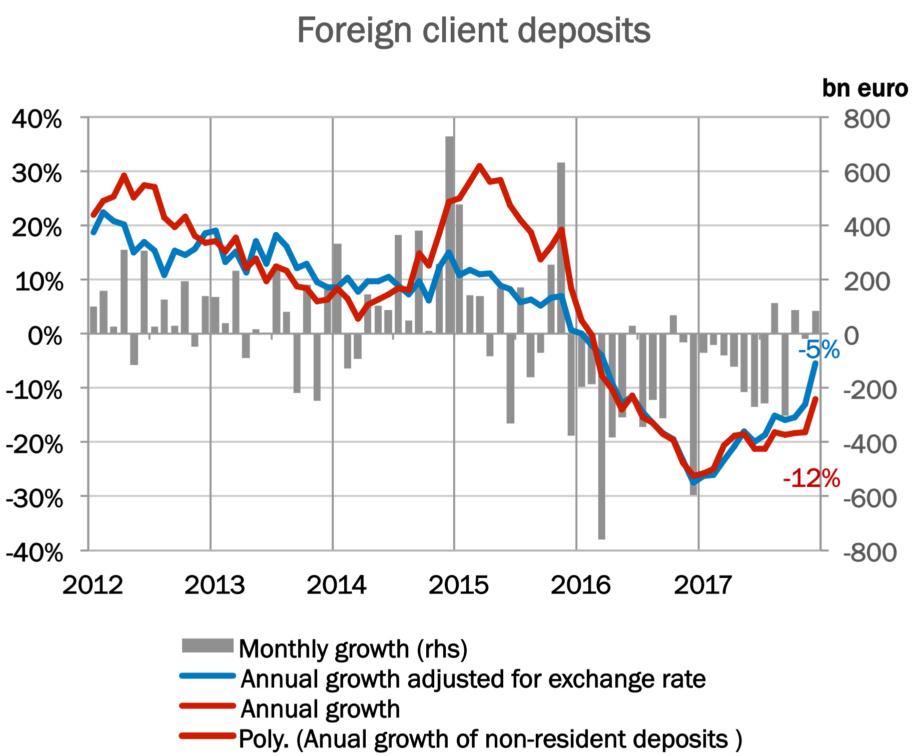
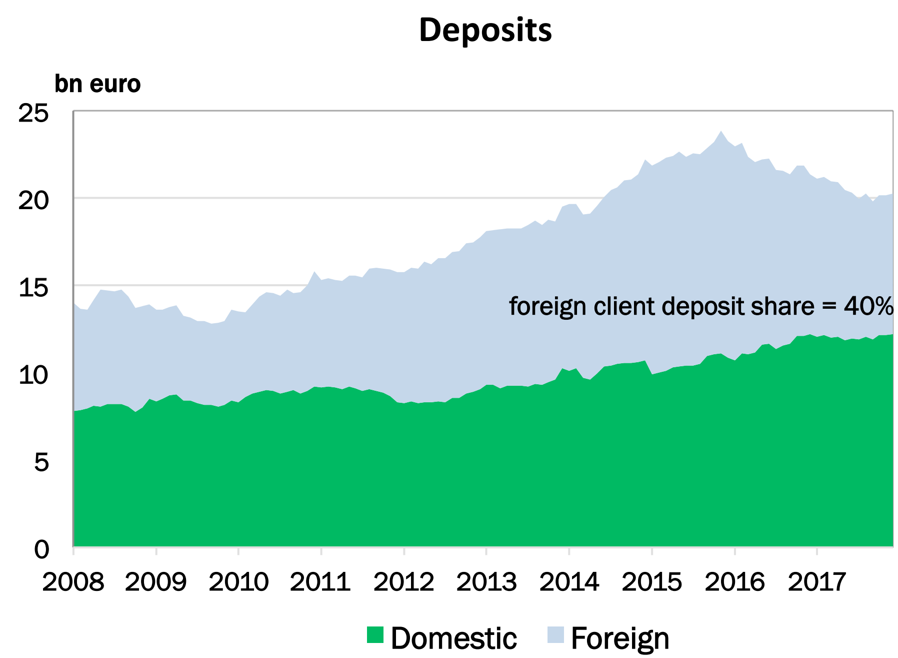
Stock of foreign client deposits fell considerably from its peak in 2015





Source: LB

Latvia Investment Highlights

Latvia recovered from the economic recession and managed to build-up an outstanding fiscal position, together with a sustained growth, based on an increased competitiveness, a robust domestic demand, and a flexible business sector able to adjust to external shocks

Flexible and Resilient Economy
→ Decreasing Unemployment

Sustainable Debt Levels and Prudent Fiscal Management
→ Investor attractiveness

Resilient towards external shocks
→ Proven track record in overcoming economic crisis in the past

Belongs to the Core of Europe
→ EZ membership
→ The member of all the important international organizations

Predictable public policies and outstanding track record of successful structural reforms
→ Long term growth reinforced

Well Capitalised Banking Sector
→ Credit Growth is being restored
→ Economic Development promoted

Credit rating gains
→ Investors confidence boosted due to reforms and sound macroeconomic fundamentals

Solid Export Growth
→ Balance of Payments improvement
→ Sustainable Current Account Balance