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**COMMISSION STAFF WORKING DOCUMENT**

**Analysis of the Draft Budgetary Plan of Latvia**

*Accompanying the document*

**COMMISSION OPINION**

**on the Draft Budgetary Plan of Latvia**

{C(2020) 8513 final}



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## EXECUTIVE SUMMARY

- The Draft Budgetary Plan expects Latvia's real GDP to decline by 7% in 2020 because of the COVID-19 pandemic. The economy is expected to recover in 2021 with GDP growth of 5.1%. The Commission economic forecast is more upbeat for 2020, as it includes more recent economic data, while real GDP growth for 2021 is similar.
- The government deficit is estimated at 7.6% of GDP in 2020 according to the Draft Budgetary Plan. The deficit target for 2021 is 3.9% of GDP. The Commission projects a slightly lower deficit in both 2020 and 2021, on back of its more positive economic projections.
- On 20 May 2020, the Commission issued a report under Article 126(3) TFEU, as Latvia's general government deficit in 2020 was planned to exceed the 3% of GDP Treaty reference value. The report concluded that, after the assessment of all relevant factors, the deficit criterion was not fulfilled. In light of the exceptional uncertainty created by the outbreak of COVID-19 and its extraordinary macroeconomic and fiscal impact, including for designing a credible path for fiscal policy, which will have to remain supportive in 2021, the Commission considered that a decision on whether to place Member States under the Excessive Deficit Procedure should not be taken.
- Temporary support measures for 2020 amount to 4.3% of GDP, including support for businesses and households. Only some of these measures will continue into 2021.
- The Draft Budgetary Plan presents several permanent measures that increase both revenue and expenditure by some 0.7% of GDP in 2021 and offset each other. The increases in minimum social benefits are well targeted towards the lowest income groups. However, the minimum social security contribution will affect low-wage and part-time workers, with possible negative effect on their labour market participation.
- The government debt is projected to peak at 47.5% of GDP in 2020, due to the large government borrowing and the drop in the nominal GDP. The debt ratio is set to decrease in 2021, in view of lower borrowing and the resumption in the economic growth, and given a reduction of large cash resources.
- Overall, the measures in the Draft Budgetary Plan of Latvia are supporting economic activity against the background of considerable uncertainty. The measures set out in the Draft Budgetary Plan are temporary in nature or permanent deficit-increasing measures that are offset by deficit-reducing revenue measures. At the same time, it would be useful to regularly review the use, effectiveness and adequacy of the support measures and stand ready to adapt them as necessary to changing circumstances.



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## 1. INTRODUCTION

This document assesses the economic and budgetary projections contained in the 2021 Draft Budgetary Plans of Latvia (hereafter called the Plan), which was submitted on 14 October 2020 in compliance with Regulation (EU) No 473/2013. The Plan was adopted by the government on 13 October together with the draft laws on the budget for 2021 and on the medium-term budgetary plan for 2021-2023. The parliament is reviewing the draft laws and the final reading is scheduled for 23 November 2020. Latvia is subject to the preventive arm of the Stability and Growth Pact.

On 20 March 2020, the Commission adopted a Communication on the activation of the general escape clause of the Stability and Growth Pact and on 23 March 2020 the Ministers of Finance of the EU Member States agreed with the Commission assessment. The clause facilitates the coordination of budgetary policies in times of severe economic downturn. As indicated in the Annual Sustainable Growth Strategy 2021[1] and as communicated in the letter of 19 September 2020 from the Commission to the EU Ministers of Finance[2], the activation of the general escape clause allows for a temporary departure from the adjustment path towards the medium-term budgetary objective of each Member State, which should continue to provide targeted and temporary fiscal support in 2021, provided that this does not endanger fiscal sustainability in the medium term. The general escape clause does not suspend the procedures of the Stability and Growth Pact. It allows Member States to depart from the budgetary requirements that would normally apply while enabling the Commission and the Council to undertake the necessary policy coordination measures within the framework of the Pact.

Public finances in 2021 are also expected to be influenced by the proposed establishment of the Recovery and Resilience Facility (RRF), alongside the proposal for the reinforced long-term budget of the EU for 2021-2027. RRF is envisaged to provide a total envelope of €672.5 billion in loans and non-repayable financial support (grants) to support the implementation of investments and reforms in the EU Member States. The 2021 Draft Budgetary Plan of Latvia does not take into account the implementation of the reforms and investments under the RRF, and their associated costs.

On 20 May 2020, the Commission issued a report under Article 126(3) TFEU, as Latvia’s general government deficit in 2020 was planned to exceed the 3% of GDP Treaty reference value. The report concluded that, after the assessment of all relevant factors, the deficit criterion was not fulfilled. In light of the exceptional uncertainty created by the outbreak of COVID-19 and its extraordinary macroeconomic and fiscal impact, including for designing a credible path for fiscal policy, which will have to remain supportive in 2021, the Commission considered that

[1] Communication from the Commission on Annual Sustainable Growth Strategy 2021, Brussels, 17.9.2020, COM(2020) 575 final.

[2] https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-economic-governance-monitoring-prevention-correction/stability-and-growth-pact/annual-draft-budgetary-plans-dbps-euro-area-countries/draft-budgetary-plans-2021_en



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a decision on whether to place Member States under the Excessive Deficit Procedure should not be taken.

## 2. MACROECONOMIC DEVELOPMENTS UNDERLYING THE DRAFT BUDGETARY PLAN

The macroeconomic scenario underlying Latvia's Draft Budgetary Plan forecasts real GDP declining by 7.0% in 2020 and recovering by 5.1% in 2021. The scenario assumes a sharp fall in GDP in Q2-2020 followed by a gradual recovery in the second half of the year. Actually, the economic contraction in Q2-2020 turned out to be less severe than expected when the scenario was prepared in June 2020. The economy is expected to regain around half of the lost ground by the end of 2020. Investment and exports are forecast to suffer the most from the COVID-19 containment measures at home and abroad, while rising government consumption provides some support to the economy in 2020.

In 2021, consumption and exports are expected to recover relatively quickly while investment will remain considerably below its 2019 level. Inflation is forecast to slow to near zero in 2020 before rising to 1.2% in 2021. The GDP deflator is expected to decline in 2020 (-0.5%), and turn positive again with 1.3% growth in 2021. Employment is projected to decline by 4.4% in 2020 and to only rise slowly by 0.6% in 2021. Correspondingly, the unemployment rate is set to increase to 10.5% in 2020 and decline somewhat to 9.8% in 2021. The macroeconomic and fiscal outlook continue to be affected by high uncertainty due to the COVID-19 pandemic.

Compared with the scenario underlying the Stability Programme, GDP growth for 2020 has remained unchanged, while for 2021 it has been revised up substantially from 1.0% to 5.1% primarily due to more clarity about the duration of containment measures at that time and because the economy already showed signs of turnaround at the time of preparation of the scenario underlying the Plan.

The Plan’s output gap, as recalculated by the Commission following the commonly agreed methodology, is estimated to fall from +3.6% of GDP in 2019 to -3.6% of GDP in 2020 and to almost close in 2021. Based on the Commission forecast, the output gap is estimated to fall from +3.6% of GDP in 2019 to -4.4% of GDP in 2020 and remain negative in 2021 at -1.9% of GDP. The differences between the two sets of estimates are mostly due to different forecast for investment, which decline by significantly less in the Commission forecast therefore having much smaller impact on the potential GDP.

Compared with the Commission forecast, the Plan is notably more pessimistic about real GDP growth in 2020 and conversely more optimistic for growth in 2021. According to the Plan scenario, GDP is 2.3% lower in 2021 than it was in 2019. This is worse than the Commission forecast where GDP remains only 1.0% below 2019 levels. From a demand components’ perspective, the investment performance accounts for the largest difference between the DBP and the Commission forecasts.

The Draft Budgetary Plan considers a possible second wave and following tightening of the containment measures as a negative risk to its scenario.

To conclude, the Plan’s macroeconomic assumptions are somewhat more pessimistic for 2020 than the Commission forecast and broadly the same for 2021.



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The macroeconomic forecast underlying the DBP was prepared by the Ministry of Finance and endorsed by the Fiscal Discipline Council on 15 June 2020.[3] In its endorsement of the forecasts, the Fiscal Discipline Council expressed concerns over structural changes of the economy in the aftermath of the crisis that would complicate the assessment of the cyclical position and the definition of an appropriate fiscal stance. The Fiscal Discipline Council also urged caution with regard to excessive deficit and debt growth in 2021 and coming years, while welcoming short-term government support measures.

**Table 1. Comparison of macroeconomic developments and forecasts**

| | 2019 | 2020 | | | 2021 | | |
|---|---|---|---|---|---|---|---|
| | COM | SP | DBP | COM | SP | DBP | COM |
| Real GDP (% change) | 2.1 | -7.0 | -7.0 | -5.6 | 1.0 | 5.1 | 4.9 |
| Private consumption (% change) | 2.2 | -6.0 | -7.5 | -11.4 | 1.0 | 5.8 | 8.5 |
| Gross fixed capital formation (% change) | 2.1 | -18.0 | -10.2 | -0.8 | 3.0 | 12.2 | 2.6 |
| Exports of goods and services (% change) | 2.1 | -9.0 | -14.8 | -7.5 | 1.0 | 7.7 | 4.2 |
| Imports of goods and services (% change) | 3.0 | -10.0 | -16.3 | -8.6 | 1.9 | 9.0 | 6.0 |
| *Contributions to real GDP growth:* | | | | | | | |
| - Final domestic demand | 2.2 | -8.4 | -6.3 | -6.4 | 3.0 | 5.0 | 5.9 |
| - Change in inventories | 0.4 | -0.5 | -2.0 | 0.0 | 0.0 | 0.5 | 0.0 |
| - Net exports | -0.5 | 1.0 | 1.3 | 0.7 | -0.6 | -0.4 | -1.0 |
| Output gap[1] | 3.6 | -3.5 | -3.8 | -4.4 | -3.5 | -0.3 | -1.9 |
| Employment (% change) | -0.1 | -5.0 | -4.4 | -3.2 | 1.2 | 0.6 | 0.4 |
| Unemployment rate (%) | 6.3 | 11.2 | 10.5 | 8.3 | 10.1 | 9.8 | 8.0 |
| Labour productivity (% change) | 2.1 | -2.1 | -2.7 | -2.5 | -0.2 | 4.5 | 4.5 |
| HICP inflation (%) | 2.7 | 0.4 | 0.0 | 0.3 | 1.7 | 1.2 | 1.3 |
| GDP deflator (% change) | 2.4 | -1.0 | -0.5 | 1.0 | 1.3 | 1.3 | 1.3 |
| Comp. of employees (per head, % change) | 8.8 | -3.0 | -1.0 | 3.1 | 3.0 | 3.0 | 3.7 |
| Net lending/borrowing vis-à-vis the rest of the world (% of GDP) | 0.8 | 2.2 | 1.5 | 3.3 | 1.5 | 0.9 | 2.7 |

Note:

[1]In percent of potential GDP, with potential GDP growth recalculated by Commission services on the basis of the programme scenario using the commonly agreed methodology.

*Source:*

*Stability Programme 2020 (SP); Draft Budgetary Plan for 2021 (DBP); Commission 2020 autumn forecast (COM); Commission calculations*

## 3. RECENT AND PLANNED FISCAL DEVELOPMENTS

On 20 July 2020 the Council addressed recommendations to Latvia in the context of the European Semester. In the area of public finances and in line with the general escape clause, the Council recommended Latvia to take all necessary measures to effectively address the pandemic, sustain the economy and support the ensuing recovery, when economic conditions allow, Latvia should pursue fiscal policies aimed at achieving prudent medium-term fiscal positions and ensuring debt sustainability, while enhancing investment.

[3] https://fiscalcouncil.lv/17062020-fdc-opinion-on-the-ministry-of-finances-macroeconomic-forecast-for-2020-and-2021-2023



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### 3.1. Deficit developments

The Draft Budgetary Plan estimates the government deficit at 7.6% of GDP in 2020, compared to a deficit of 0.6% of GDP in 2019. The sharp deterioration mostly reflects a decline in government revenue, which is linked to the drop in economic activity, and to the temporary support measures adopted in response to the COVID-19 crisis. The deficit estimate for 2020 has improved since that in the 2020 Stability Programme of 9.4% of GDP. Notably, the actual revenue performance was stronger, thanks to the observed economic recovery in Q3-2020. Moreover, an automatic increase in unemployment, sickness and other social benefits was less pronounced, because the unemployment rate peaked at a lower level than initially projected and because the spread of the virus in Latvia was relatively limited in the first half of 2020. At the same time, spending on the temporary support measures has increased from 3% of GDP at the time of the Stability Programme to 4.3% of GDP in the Plan. This reflects a number of new measures adopted since the Stability Programme, while the take-up for some earlier measures has been lower than expected.

The recalculated structural balance[4] is estimated to deteriorate by 4 percentage points of GDP between 2019 and 2020, reaching a structural deficit of 6½% of GDP in 2020. The structural deficit is estimated to narrow to 4% of GDP in 2021. However, a mechanical reading of traditional indicators is not well suited at the current juncture to assessing the fiscal stance. The introduction and subsequent withdrawal of sizeable temporary emergency measures distort the picture, as the corresponding changes in the level of public spending from one year to the next affect the indicators used to assess the fiscal stance Excluding the temporary emergency measures from the calculation of the fiscal stance indicators provides a more representative assessment of the underlying fiscal support to economic activity.

For 2021, the Draft Budgetary Plan targets a deficit of 3.9% of GDP, which is 1 percentage point smaller than that planned in the Stability Programme. This improvement is underpinned by higher government revenue, based on a stronger starting position in 2020. Some support measures launched in 2020 will extend into 2021, contributing to a higher expenditure growth. Moreover, new budgetary measures for 2021 increase both revenue and expenditure by some 0.7% of GDP and offset each other. The Draft Budgetary Plan does not include any revenue from or expenditure under the Recovery and Resilience Facility. All in all, the deficit reduction between 2020 and 2021 mostly reflects a discontinuation of the majority of support measures adopted in 2020.

The Commission autumn forecast expects a government deficit trajectory similar to that of the Draft Budgetary Plan, while being slightly more positive in both 2020 and 2021. This stems from a more upbeat expectation of economic growth in 2020, resulting in GDP level being almost 3% higher in 2020 and 2021 under the Commission autumn forecast. While nominal revenue and expenditure developments are similar between the Commission forecast and the Plan, their ratios to GDP appear lower, due to a higher denominator effect. Since the submission of the Recovery and Resilience Plans and their subsequent approval are expected to take

[4] Cyclically adjusted balance net of one-off and temporary measures, recalculated by the Commission using the commonly agreed methodology.



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place in 2021, the Commission forecast assumes in its budgetary projections for 2021 the 10% pre-financing of Recovery and Resilience Facility grants and treats it as a financial transaction with no impact on the budget balance, but with a public debt-reducing impact. In the case of Latvia, the 10% pre-financing of Recovery and Resilience Facility grants is equivalent to EUR 2020 million (0.6% of GDP) in 2021.[5] On the expenditure side, in line with its no-policy change assumption, the Commission forecast includes no expenditure related to the Recovery and Resilience Facility.

**Table 2. Composition of the budgetary adjustment**

| (% of GDP) | 2019 | | 2020 | | | 2021 | | | Change: 2019-2021 |
|---|---|---|---|---|---|---|---|---|---|
| | COM | DBP | SP | DBP | COM | SP | DBP | COM | DBP |
| **Revenue** | **37.8** | **37.8** | **37.4** | ***39.8*** | **38.1** | **38.9** | ***39.2*** | **38.2** | **1.4** |
| *of which:* | | | | | | | | | |
| - Taxes on production and imports | 14.0 | 14.0 | 14.0 | *14.7* | 14.1 | 14.9 | *14.9* | 14.7 | 0.9 |
| - Current taxes on income, wealth, | 7.0 | 7.0 | 6.3 | *7.0* | 7.2 | 7.1 | *7.2* | 7.2 | 0.2 |
| - Capital taxes | 0.0 | 0.0 | 0.0 | *0.0* | 0.0 | 0.0 | *0.0* | 0.0 | 0.0 |
| - Social contributions | 10.0 | 10.0 | 9.9 | *10.3* | 10.0 | 10.2 | *10.1* | 9.8 | 0.1 |
| - Other (residual) | 6.7 | 6.7 | 7.2 | *7.8* | 6.8 | 6.7 | *7.0* | 6.5 | 0.3 |
| **Expenditure** | **38.4** | **38.4** | **46.8** | **47.4** | **45.5** | **43.8** | **43.2** | **41.7** | **4.8** |
| *of which:* | | | | | | | | | |
| - Primary expenditure | 37.7 | 37.7 | 45.9 | 46.5 | 44.8 | 42.9 | 42.4 | 41.0 | 4.7 |
| *of which:* | | | | | | | | | |
| Compensation of employees | 10.9 | 10.9 | 12.4 | 12.1 | 11.8 | 12.3 | 11.8 | 11.8 | 0.9 |
| Intermediate consumption | 6.4 | 6.4 | 6.5 | 6.1 | 6.8 | 6.3 | 5.9 | 6.5 | -0.5 |
| Social payments | 12.1 | 12.1 | 15.3 | 14.5 | 13.9 | 14.2 | 14.0 | 13.7 | 1.9 |
| Subsidies | 1.0 | 1.0 | 1.6 | 1.5 | 1.2 | 1.5 | 1.3 | 1.3 | 0.3 |
| Gross fixed capital formation | 5.0 | 5.0 | 5.7 | 6.0 | 5.7 | 5.5 | 5.3 | 5.1 | 0.3 |
| Other (residual) | 2.4 | 2.4 | 4.4 | 6.3 | 5.3 | 3.1 | 4.1 | 2.6 | 1.7 |
| - Interest expenditure | 0.7 | 0.7 | 0.9 | 0.9 | 0.7 | 0.9 | 0.8 | 0.7 | 0.1 |
| **General government balance (GGB)** | **-0.6** | **-0.6** | **-9.4** | **-7.6** | **-7.4** | **-5.0** | **-3.9** | **-3.5** | **-3.3** |
| **Primary balance** | **0.1** | **0.1** | **-8.5** | **-6.7** | **-6.7** | **-4.1** | **-3.2** | **-2.8** | **-3.3** |
| One-off and other temporary measures | 0.2 | 0.2 | 0.0 | 0.2 | 0.0 | 0.0 | 0.1 | 0.0 | -0.1 |
| **GGB excl. one-offs** | **-0.8** | **-0.8** | **-9.4** | **-7.8** | **-7.4** | **-5.0** | **-4.0** | **-3.5** | **-3.2** |
| Output gap[1] | 3.6 | 4.2 | -3.5 | -3.8 | -4.4 | -3.5 | -0.3 | -1.9 | -4.5 |
| Cyclically-adjusted balance[1] | -1.9 | -2.2 | -8.1 | -6.2 | -5.7 | -3.7 | -3.8 | -2.8 | -1.6 |
| **Structural balance (SB)[2]** | **-2.1** | **-2.4** | **-8.1** | **-6.4** | **-5.7** | **-3.7** | **-3.9** | **-2.8** | **-1.5** |
| Structural primary balance[2] | -1.5 | -1.7 | -7.2 | -5.5 | -5.0 | -2.8 | -3.1 | -2.1 | -1.4 |

Notes:

[1] Output gap (in % of potential GDP) and cyclically-adjusted balance according to the DBP/Programme as recalculated by Commission on the basis of the DBP/Programme scenario using the commonly agreed methodology.

[2] Structural (primary) balance corresponds to cyclically-adjusted (primary) balance excluding one-off and other temporary measures.

*Source:*

*Stability Programme 2020 (SP); Draft Budgetary Plan for 2021 (DBP); Commission 2020 autumn forecast (COM); Commission calculations*

The main negative risk to the fiscal forecast comes from a new outbreak of COVID-19 and its adverse effect on economic activity. However, the 2020 deficit may turn out to be lower than planned, if the temporary support measures are underused. Moreover, the deficit for 2021 could turn out more favourable as a result of the higher

[5] The amount of pre-financing is based on the Council Presidency compromise proposal for the RRF Regulation (11538/20) of 7 October 2020, on which the Council Presidency obtained a mandate for conducting the negotiations with the European Parliament.



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growth from the implementation of measures financed by the Recovery and Resilience Facility.

The medium-term budgetary plan for 2021-2023 targets a structural deficit of 0.5% of GDP in 2023. This assumes the narrowing of a large negative output gap and the recovery in government revenue after the crisis. For 2022, the authorities argue against a contractionary fiscal policy in view of a large output gap, that suggest a need to lean against the cycle.

### 3.2. Debt developments

Government debt ratio is planned to increase from 37% of GDP in 2019 to 47% of GDP in 2020. Two thirds of the increase reflects government borrowing, while the rest is mostly due to the drop in nominal GDP. The debt ratio is set to decline marginally in 2021 to 46% of GDP, as GDP resumes and the government deficit shrink, and given a partial reduction in large cash resources, acquired in 2019 and 2020.

**Table 3. Debt developments**

| (% of GDP) | 2019 | 2020 | | | 2021 | | |
|---|---|---|---|---|---|---|---|
| | | SP | DBP | COM | SP | DBP | COM |
| **Gross debt ratio**[1] | **36.9** | **51.7** | **47.3** | **47.5** | **52.2** | **46.0** | **45.9** |
| Change in the ratio | -0.2 | 14.8 | 10.4 | 10.6 | 0.5 | -1.3 | -1.6 |
| Contributions[2]: | | | | | | | |
| **1. Primary balance** | **-0.1** | **8.5** | **6.7** | **6.7** | **4.1** | **3.2** | **2.8** |
| **2. "Snow-ball" effect** | **-0.9** | **4.1** | **3.9** | **2.5** | **-0.3** | **-2.2** | **-2.1** |
| *Of which:* | | | | | | | |
| Interest expenditure | 0.7 | 0.9 | 0.9 | 0.7 | 0.9 | 0.8 | 0.7 |
| Real growth effect | -0.7 | 2.8 | 2.8 | 2.2 | -0.5 | -2.3 | -2.2 |
| Inflation effect | -0.9 | 0.4 | 0.2 | -0.4 | -0.7 | -0.6 | -0.6 |
| **3. Stock-flow adjustment** | **0.8** | **2.2** | **-0.2** | **1.4** | **-3.3** | **-2.3** | **-2.3** |
| *Of which:* | | | | | | | |
| Cash/accruals difference | | | | | | | |
| Net accumulation of financial | | | | | | | |
| of which privatisation proceeds | | | | | | | |
| Valuation effect & residual | | | | | | | |

Notes:

[1] End of period.

[2] The snow-ball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator). The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other residual effects.

*Source:*

*Stability Programme 2020 (SP); Draft Budgetary Plan for 2021 (DBP); Commission 2020 autumn forecast (COM); Commission calculations*

## 4. MEASURES UNDERPINNING THE DRAFT BUDGETARY PLAN

The Draft Budgetary Plan focuses on the policy response undertaken in the context of the COVID-19 outbreak in 2020 and the measures planned to sustain the recovery



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in 2021. Supportive fiscal measures should be tailored to the specific situation of each Member State, but as a rule, they should be well targeted and temporary. Their use and effectiveness should be regularly reviewed by the national authorities. Depending on the development of the pandemic, emergency fiscal measures should be adjusted and combined with other measures that improve economic fundamentals, support the green and digital transition and have a positive impact on demand.

### 4.1. Measures in 2020

The Draft Budgetary Plan presents support measures for businesses and households totalling at 4.3% of GDP in 2020 (see Table 4.1a). Several new measures have been introduced since the 2020 Stability Programme, when the total package stood at 3.0% of GDP. Some of the previously adopted measures have been less used than planned reducing their fiscal impact. Temporary support for idle employees during the state of emergency in the first half of 2020 was restricted to full-time idle workers and benefits were smaller than planned, as those were linked to individual social insurance contributions, which turn out to be on average lower than planned. Temporary expansion of state-covered sick leave payments in case of COVID-19 is also estimated to be less costly, as infection rates in Latvia were relatively low in the first half of 2020. An option to deferred tax payment up to 3 years saw a lower take-up than planned and its impact in 2020 now reflects estimated unrecoverable revenue over the duration of the scheme. However, spending on medical purchases and investments has increased, as well as support for aviation industry. New support measures help tourism sector, exporting companies and passenger and freight carriers to cope with the crisis. Moreover, local authorities are allowed to proceed with implementation-ready investment projects.

Liquidity supporting measures in the form of supported loans and guarantee amount to around 1% of GDP. Contingent liabilities on the guarantees amount to 0.8% of GDP supporting restructuring of loans up to 2.5% of GDP. State guarantees of 0.1% of GDP have been used up until October 2020. Moreover, loan programmes with private sector participation are established by providing state funding of 0.5% of GDP. The Draft Budgetary Plan accounts for the expected losses from these measures as having a deficit-increasing effect of 0.7% of GDP in 2020, based on the past experience with similar instruments.

Most of the measures are effective only in 2020 and some have already ended on 10 June 2020 when the state of emergency was lifted. Few investment-related measures (0.4% of GDP) will be still implemented in 2021, but no budgetary impact is expected in 2022.

The Commission autumn forecast estimates of the measures as the Draft Budgetary Plan are in line with those presented in the Draft Budgetary Plan. Overall, the measures taken by Latvia in 2020 were in line with the guidelines of the Commission Communication of 13 March 2020 on a coordinated economic response to the COVID-19 outbreak.



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### Table 4.1.a. Main discretionary measures adopted with budgetary impact reported in the Draft Budgetary Plan

| Description | ESA Code (Expenditure / Revenue component) | Adoption Status | Budgetary impact (% of GDP - change from previous year - positive sign for deficit-increasing measures) | | |
|---|---|---|---|---|---|
| | | | | 2020 | 2021 |
| Tax deferral option up to 3 years | D.2, D.5, D.61 | Adopted | | 0.2 | -0.2 |
| Self-employed personal income tax advance payments deferred for 2020 | D.5 | Adopted | | 0.1 | -0.2 |
| Excess input VAT refunded within 30 days | D.2 | Adopted | | 0.2 | -0.2 |
| Support for employees (incl. self-employed) during downtime | D.7 | Adopted | | 0.2 | -0.2 |
| Subsidized jobs for the tourism sector and exporting companies | D.7 | Adopted | | 0.2 | -0.2 |
| Loss provision for guarantees and loans | D.7 | Adopted | | 0.7 | -0.7 |
| Financing increase for local capital projects | P.51 | Adopted | | 0.2 | 0.0 |
| Support to aviation through capital injections | D.9 | Adopted | | 1.1 | -1.1 |
| Medical purchases of protective gear, laboratory equipment, medical supplies, premium for medical personnel | P.2, D.1, P.51 | Adopted | | 0.5 | -0.3 |
| Support for agricultural producers | D.3 | Adopted | | 0.2 | -0.2 |
| Increase in road construction | P.51 | Adopted | | 0.3 | -0.3 |
| Support for passenger and freight carriers | D.3, D7, D.9 | Adopted | | 0.2 | -0.2 |
| Support for science, education and culture | D.7, P.2 | Adopted | | 0.2 | -0.2 |
| | | | **Total** | **4.3** | **-3.8** |

### Table 4.1.b. Guarantees adopted in response to COVID-19 outbreak

| Description | Adoption Status | Maximum amount of contingent liability* (% of GDP) | | Current take-up (actual contingent liability, % of GDP) |
|---|---|---|---|---|
| Guarantees for credit holidays and for new or existing loans | Adopted | | **0.8** | **0.1** |

* Any budgetary impact related to expected losses or actual calls should be provided in the standard table **5.1 Description of discretionary measures included in the draft budget** *(see Code of Conduct,* https://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/coc/2014-11-07_two_pack_coc_amended_en.pdf )

## 4.2. Measures in 2021

The Draft Budgetary Plan presents several permanent measures that increase both revenue and expenditure by some 0.7% of GDP and offset each other, leaving the fiscal deficit of 3.9% in 2021 unchanged, relative to the no-policy-change situation. Most of the measures are permanent and their overall impact on the government borrowing is planned to be limited in 2022 and 2023.

The Plan includes notable tax policy changes, which aim at improving competitiveness of Latvian businesses by permanently reducing tax wedge on employees and by restricting other labour tax regimes, which tend to be abused for



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tax avoidance. In particular, the security contribution rate is reduced by 1 percentage point (at the cost of 0.3% of GDP) and the application threshold for income tax allowance is increased (0.1% of GDP). A permanent revenue yield of 0.3% of GDP is expected from the introduction of minimum social contributions and raising the taxation of self-employed, microenterprise taxpayers and other alternative taxpayers to a level similar to that of regular employees. Moreover, the state-owned electricity producer and forest management company are expected to pay higher dividends than previously planned (0.3% of GDP). The Plan also accounts for a higher tax revenue linked to public sector wage increases (0.4% of GDP). The latter is included in the Commission forecast, but is not treated as a discretionary measure.

The main expenditure measures include wage increases for health workers (0.6% of GDP) and teachers (0.1% of GDP), and higher minimum social benefits following the constitutional court's decision on inadequate level of the benefits (0.2% of GDP). At the same time, government capital spending is reduced by some 0.4% of GDP by temporary lowering investments in roads and by permanently reducing revenue for local authorities, which is expected to affect their investments. However, the still undecided investments under the Recovery and Resilience Facility may offset the planned investment decline.

Household disposable income is expected to increase by around 1% in 2021, because of the tax and benefit measures presented in the Draft Budgetary Plan. However, the positive impact will decline to ½% by 2023, when self-employed are expected to pay full social security contribution from all their incomes. The poorest 10% of households are expected to gain the most from the policy changes, as minimum social benefit increases (guaranteed minimum income and housing benefits, minimum pensions, disability benefits) are targeted towards the most vulnerable groups (see Chart 1)[6]. Middle and higher income groups will gain most from the increase in the upper threshold of the income tax allowance and the reduction in social security contribution rate, as those groups have a higher share of work income and are set to gain most from the tax cuts. The minimum social security contribution and increasing contributions for self-employed are regressive measures, as they affect low-income groups more. As self-employed, low-paid and part-time workers are also members of middle and higher income households, the increase in social contribution will have an impact across most income groups. Inequality and poverty indicators improve little because of the measures, while poverty is somewhat reduced more among pensioners.

[6] Simulation results are indicative, as models and assumptions have certain limitation in representing real life situation. Notably, the effect of means-tested benefits (GMI and housing benefit) is overestimated, as in reality, some eligible persons do not apply for the benefits. The gaps to the minimum social security contributions for employees are planned to be paid by their employers, while the simulation assume that employees pay their share of the contributions (10.5% in 2021).



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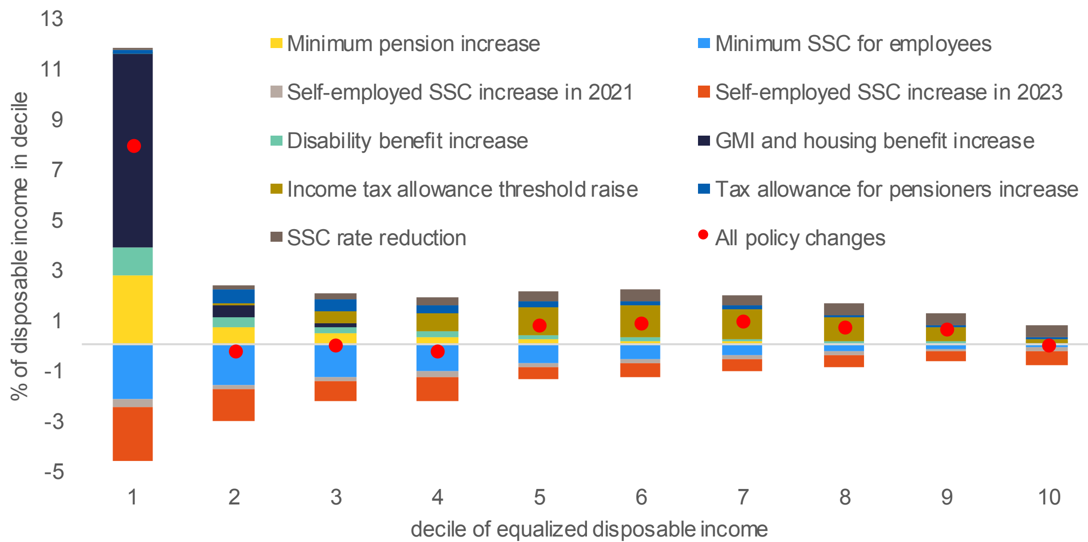
## Chart 1. Distributional impact of the main policy changes presented in the Draft Budgetary Plan




Note: The scenario with 'all policy changes' simulates all reforms together and reflects interactions between different policy changes. This is different from summing up the results for individual policy changes.

*Source: European Commission, Joint Research Centre, based on the EUROMOD model*

The tax wedge[7] for self-employed is set to increase from 2021 and to exceed the planned level for employees in 2023 (Chart 2). Self-employed earning below the minimum wage will face the sharpest tax increase from 5% in 2020 to 10% in 2021 and to a full social security contribution of 32.15% in 2023. Sudden jumps in the tax wedge reflects changes between different tax brackets. Both employees and self-employed earning less than the minimum wage (EUR 500 per month in 2021) are required to pay the minimum social security contribution irrespective of their actual income. As a result, their tax wedge is set to increase and exceed that of other income levels. The peak in the tax wedge depends on workers being eligible for social assistance (a threshold of EUR 272 per month for a single person household), which exempts the workers from the minimum social contribution. Overall, the higher tax on incomes below the minimum wage makes low-pay and part-time work unattractive, impeding labour market flexibility. This goes against the recommendation to Latvia on supporting the groups most affected by the crisis and providing flexible working arrangements.

Participation tax rates[8] stand at 100% for low-income earners, which indicates a strong disincentive to seek employment at low wage, as any net income from work reduces social assistance received (GMI and housing benefit). The planned increases in the guaranteed minimum income and housing benefit extends support to a wider range of incomes, as well as tax increases for self-employed contributes to a

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[7] Tax wedge is a difference between the amount of taxes paid and the total labour cost.

[8] The participation tax rate measures the proportion of gross earnings from work that is "taxed away" in the broad sense when a social assistance recipient takes up a job, both as a result of taxes and social contributions that are charged and as a result of benefits that are lost.



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higher participation tax rates. This can be addressed by a more gradual transition from benefits to work income, thus improving work incentives for low-wage earners[9].

**Chart 2. Impact of the policy changes on tax wedge and participation tax rate for single employees and self-employed**

*Source: European Commission*

Overall, based on the information presented in the Draft Budgetary Plan and taking into account the Commission 2020 autumn forecast, the measures planned by Latvia in 2021 are supporting economic activity against the background of considerable uncertainty.

At the same time, it would be useful to regularly review the use, effectiveness and adequacy of the support measures and stand ready to adapt them as necessary to changing circumstances.

It is anticipated that Latvia will submit its Recovery and Resilience Plan in 2021. The Regulation establishing a Recovery and Resilience Facility will set out how the Commission is to assess that the reforms and investments included in the Recovery and Resilience Plan are coherent with the policy priorities of the Union and the challenges identified in the context of the European Semester. This assessment by the Commission will inform the approval of the Plan by the Council and the information to the European Parliament.

[9] Ivaškaitė-Tamošiūnė et al. (2018). *The Effect of Taxes and Benefits Reforms on Poverty and Inequality in Latvia.* Directorate-General for Economic and Financial – Economic brief, 39. doi:10.2765/830917. Retrieved from: https://ec.europa.eu/info/sites/info/files/economy-finance/eb039_en_0.pdf



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## 5. Annex – Mandatory variables not included in the Draft Budgetary Plan

The Draft Budgetary Plans does not include mandatory variables for the expenditure benchmark calculations. However, this do not impede the Commission's ability to assess the Draft Budgetary Plan.



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