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Assessment of the 2020 Stability Programme for

Latvia

(Note prepared by DG ECFIN staff)

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EXECUTIVE SUMMARY

- On 6 April 2020, the Commission provided guidelines to the Economic and Financial Committee on how the format and content of the 2020 Stability and Convergence Programmes can be streamlined in light of the exceptional circumstances related to the Covid-19 pandemic. This assessment takes into account the severe constraints that Member States faced in providing the information usually required in their Programmes. The assessment focuses on the near term in light of the high uncertainty attached to the projections.
- The Latvian economy is expected to shrink by 7% in 2020, because of the COVID-19 pandemic. The recovery in 2021 is expected to be gradual according to the Stability Programme, but more rapid based on the Commission spring forecast.
- The government deficit is planned to increase from 0.2% of GDP in 2019 to 9.4% of GDP in 2020, according to the Stability Programme. It is set to decline to 5% in 2021 under unchanged policies. The Commission estimates a government deficit of 7.3% of GDP in 2020 and 4.5% in 2021.
- The policy response to the pandemic amounts to some 3% of GDP in discretionary fiscal measures and an additional 3% of GDP in liquidity support. While support measures were quickly adopted, support is restricted to viable businesses and orderly taxpayers, limiting its take up. While assistance has been extended to employees with lower social insurance coverage, it remains somewhat limited. Most of the measures are planned to end in 2021.
- The macroeconomic and fiscal outlook is affected by high uncertainty due to the outbreak of the COVID-19 pandemic.

1. INTRODUCTION

This document assesses the economic and budgetary projections contained in the 2020 Stability Programme[1] of Latvia covering the period 2020-2023 (hereafter called the Programme), which was submitted on 30 April 2020[2]. It also assesses Latvia's compliance with the preventive arm of the Stability and Growth Pact in 2019. The government approved the Programme on 30 April and it was reviewed in the respective Parliamentary Committee on 29 April.

On 20 March 2020, the Commission adopted a Communication on the activation of the general escape clause of the Stability and Growth Pact. The clause, as set out in Articles 5(1), 6(3), 9(1) and 10(3) of Regulation (EC) 1466/97 and Articles 3(5) and 5(2) of Regulation (EC) 1467/97, facilitates the coordination of budgetary policies in times of severe economic downturn. In its Communication, the Commission shared with the Council its view that, given the expected severe economic downturn resulting from the COVID-19 outbreak, the current conditions permit the activation of the clause. On 23 March 2020, the Ministers of Finance of the Member States agreed with the assessment of the Commission. The activation of the general escape clause allows for a temporary departure from the adjustment path towards the medium-term budgetary objective, provided that this does not endanger fiscal sustainability in the medium term. For the corrective arm, the Council may also decide, on a recommendation from the Commission, to adopt a revised fiscal trajectory. 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.

Latvia is among those Member States that have invoked national escape clauses to suspend budgetary constraints set by their national fiscal rules, as part of the effort to accommodate the budgetary implications of the outbreak.

2. MACROECONOMIC DEVELOPMENTS

Latvia's real GDP grew by 2.2% in 2019, driven by solid private consumption but curbed by slowing investment and export growth. The Stability Programme projects a drop in GDP of 7% in 2020. This assumes containment of the COVID-19 pandemic in the first half of 2020, while the worst affected sectors (transport, accommodation and catering, the arts, entertainment) are expected to experience very low activity throughout 2020. Investments and exports are expected to suffer the most amid border closures and declining foreign demand. A recovery in real GDP growth is projected to be gradual with 1% growth in 2021 and reaching 3.5% in 2022. Employment is projected to decline by 5% in 2020 and to recover only partly by 2023. Unemployment is projected to reach 11.2% in 2020 after 6.3% in 2019, and to

[1] The Stability Programme of Latvia does not indicate that it also constitutes the national medium-term fiscal plan required under Article 4(1) of Regulation 473/2013.

[2] The Stability Programme is in line with the guidelines for a streamlined format of the 2020 Stability and Convergence Programmes in light of the COVID-19 outbreak, provided by the Commission services on 6 April 2020.

decline to below 9% by 2023. Inflation is expected to decelerate to 0.4% in 2020, mainly as a result of a drop in energy prices, and to return to around 2% thereafter.

The Fiscal Discipline Council was consulted on the updated macroeconomic scenario of the Stability Programme on 3 April. In their monitoring report on the Stability Programme[3], the Fiscal Discipline Council stressed the high uncertainty regarding the duration of the pandemic and its impact on the economy, suggesting to be more cautious and to utilise alternative macroeconomic scenarios.

The Commission 2020 spring forecast (hereafter Commission forecast) projects a similar decline of 7% in GDP in 2020. However, the economic recovery in 2021 is expected to be stronger reaching a real GDP growth of 6.4%. This rests on the assumption that once the peak containment measures are lifted, the economy can bounce back quickly. Nevertheless, travel and tourism related services, as well as cultural and sports activities are expected to continue operating substantially below capacity for an extended period of time.

Table 1: Comparison of macroeconomic developments and forecasts

	2019		2020		2021		2022	2023
	COM	SP	COM	SP	COM	SP	SP	SP
Real GDP (% change)	2.2	2.2	-7.0	-7.0	6.4	1.0	3.5	2.4
Private consumption (% change)	2.9	2.9	-6.1	-6.0	7.0	1.0	3.9	3.0
Gross fixed capital formation (% change)	3.1	3.1	-12.0	-18.0	9.2	3.0	4.9	2.0
Exports of goods and services (% change)	2.0	2.0	-10.3	-9.0	7.8	1.0	4.0	3.3
Imports of goods and services (% change)	2.3	2.3	-8.3	-10.0	8.0	1.9	4.5	3.7
Contributions to real GDP growth:								
- Final domestic demand	2.9	2.9	-5.8	-8.4	6.5	3.0	6.1	4.7
- Change in inventories	-0.5	-0.5	0.0	-0.5	0.0	0.0	0.0	0.0
- Net exports	-0.2	-0.3	-1.2	1.0	-0.1	-0.6	-0.5	-0.4
Output gap[1]	3.5	4.3	-5.7	-3.5	-1.8	-3.5	-0.9	0.7
Employment (% change)	-0.1	0.1	-2.6	-5.0	0.9	1.2	1.0	-0.1
Unemployment rate (%)	6.3	6.3	8.6	11.2	8.3	10.1	9.0	8.6
Labour productivity (% change)	2.3	2.1	-4.4	-2.1	5.5	-0.2	2.5	2.5
HICP inflation (%)	2.7	2.7	0.2	0.4	1.9	1.7	2.0	2.0
GDP deflator (% change)	2.6	2.6	1.4	-1.0	2.3	1.3	2.0	1.9
Comp. of employees (per head, % change)	8.8	7.2	0.3	-3.0	3.9	3.0	5.0	5.0
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	2.8	1.4	2.6	2.2	3.4	1.5	1.0	0.4

Note:

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

Source :

Commission 2020 spring forecast (COM); Stability Programme (SP).

[3] https://fiscalcouncil.lv/news/fiscal-discipline-surveillance-interim-report

3. RECENT AND PLANNED BUDGETARY DEVELOPMENTS

3.1. DEFICIT AND DEBT DEVELOPMENTS AND MEDIUM-TERM STRATEGY AND TARGETS[4]

The government deficit was 0.2% of GDP in 2019, somewhat better than the planned deficit of 0.5% of GDP in the 2019 Stability Programme and the Draft Budgetary Plan for 2020. The improvement was mostly driven by higher revenue from taxes on labour and non-tax revenues, while taxes on consumption underperformed. The expenditure breakdown showed higher current transfers and purchases, but lower capital investment than planned. The growth of primary government expenditure, net of discretionary revenue measures and one-offs, exceeded the recommended benchmark of 4.8%.

The Stability Programme projects the government deficit to increase to 9.4% in 2020 including the impact of automatic stabilsers. In particular, government tax and non-tax revenue is estimated to decline by some 5% of GDP, which is linked to the drop in the economic activity. A pickup in unemployment numbers and a higher demand for sick leave and social assistance benefits is expected to cost around 1% of GDP. Moreover, support measures for businesses and households are estimated to increase the government deficit by 3% of GDP in 2020.

The Stability Programme plans a reduction of the government deficit to 5.0% in 2021 and to 2.7% of GDP by 2023, under the assumption of unchanged policy. The bulk of the improvement in 2021 will come from the ending of the 2020 emergency measures. The tax revenue to GDP ratio is assumed to recover and surpass the 2019 level, while the expenditure share of GDP is planned to decline across all the main expenditure items. Notably, social spending is projected to recede in 2021 after the strong increase in 2020.

Based on the Commission forecast, the government deficit is projected to reach 7% of GDP in 2020 and to improve to 4.5% in 2021. This includes the impact of automatic stabilisers and assumes a similar effect of the stimulus measures as in the Stability Programme, but the drop in employment is projected to be lower. Automatic stabilisers on the expenditure side are also assumed to be lower in 2020. For 2021, the Commission forecast is more upbeat on the economic recovery, but assumes a more stable tax revenue share in GDP.

General government gross debt stood at 36.9% of GDP in 2019. The Stability Programme plans the debt ratio to peak at around 53% of GDP in 2022. Liquid assets accumulated in 2019 and 2020 are expected to be reduced in 2021, thus flattening the peak in the gross debt ratio. Based on the Commission forecast, the debt ratio will increase to some 44% of GDP in 2021.

[4] In light of the activation of the general escape clause, the measures taken in response to the coronavirus outbreak in 2020 are not treated as one-off and are thus not excluded from the estimation of the structural budget balance.

Table 2: General government budgetary position

(% of GDP)	2019	2020		2021		2022	2023	Change: 2019-2023
	COM	COM	SP	COM	SP	SP	SP	SP
Revenue	**38.7**	**37.8**	**37.4**	**37.0**	**38.9**	**38.9**	**38.8**	**0.1**
of which:								
- Taxes on production and imports	14.2	13.5	14.0	13.6	14.9	14.9	14.9	**0.7**
- Current taxes on income, wealth, etc.	7.0	6.7	6.3	6.7	7.1	7.2	7.3	**0.3**
- Social contributions	10.0	10.0	9.9	9.6	10.2	10.3	10.4	**0.4**
- Other (residual)	7.5	7.5	7.2	7.0	6.7	6.5	6.2	**-1.3**
Expenditure	**38.9**	**45.1**	**46.8**	**41.5**	**43.8**	**42.8**	**41.4**	**2.5**
of which:								
- Primary expenditure	38.2	44.4	45.9	40.7	42.9	41.9	40.5	**2.3**
of which:								
Compensation of employees+Intermediate consumption	17.2	19.2	18.9	18.3	18.6	18.0	17.2	**0.0**
Compensation of employees	10.9	12.1	12.4	11.5	12.3	11.9	11.5	**0.6**
Intermediate consumption	6.4	7.1	6.5	6.7	6.3	6.1	5.7	**-0.7**
Social payments	11.9	14.2	15.3	13.4	14.2	13.8	13.9	**2.0**
Subsidies	1.0	1.2	1.6	1.0	1.5	1.3	1.2	**0.2**
Gross fixed capital formation	4.9	5.2	5.7	4.9	5.5	5.8	5.4	**0.5**
Other (residual)	3.2	4.6	4.4	3.2	3.1	3.0	2.8	**-0.4**
- Interest expenditure	0.7	0.8	0.9	0.7	0.9	0.9	0.9	**0.2**
General government balance (GGB)	**-0.2**	**-7.3**	**-9.4**	**-4.5**	**-5.0**	**-3.9**	**-2.7**	**-2.5**
Primary balance	**0.5**	**-6.6**	**-8.5**	**-3.8**	**-4.1**	**-3.0**	**-1.7**	**-2.2**
One-off and other temporary measures	0.2	0.0	0.0	0.0	0.0	0.0	0.0	**-0.2**
GGB excl. one-offs	**-0.4**	**-7.3**	**-9.4**	**-4.5**	**-5.0**	**-3.9**	**-2.7**	**-2.3**
Output gap[1]	3.5	-5.7	-3.5	-1.8	-3.5	-0.9	0.7	**-3.6**
Cyclically-adjusted balance[1]	-1.5	-5.2	-8.1	-3.8	-3.7	-3.5	-3.0	**-1.1**
Structural balance[2]	**-1.7**	**-5.2**	**-8.1**	**-3.8**	**-3.7**	**-3.5**	**-3.0**	**-0.9**
Structural primary balance[2]	-1.0	-4.4	-7.2	-3.1	-2.8	-2.6	-2.1	**-0.7**
Gross debt ratio	**36.9**	**43.1**	**51.7**	**43.7**	**52.2**	**53.3**	**53.1**	**16.2**

Notes:

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

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

Source :

Stability Programme (SP); Commission 2020 spring forecasts (COM); Commission calculations.

3.2. MEASURES UNDERPINNING THE PROGRAMME

The Stability Programme presents tax measures, income support, liquidity and sectoral measures, which have been adopted within a week of declaration of state of emergency (see Table 3). Most of the measures are set to be temporary for the duration of the state of emergency or until the end of 2020. The total deficit-increasing impact is estimated at 3% of GDP. The Commission forecast broadly shares the cost estimates of the measures. Overall, the measures taken by Latvia are in line with the guidelines set out in the Commission Communication on a coordinated economic response to the COVID-19 outbreak[5]. The measures appear timely, temporary and targeted at cushioning the shock induced by COVID-19. The full implementation of those measures, followed by a refocusing of fiscal policies towards achieving prudent medium term fiscal positions when economic conditions allow, will contribute to preserving fiscal sustainability in the medium term.

Different tax measures would cost around 1.2% of GDP in 2020, but some two thirds of deferred tax payments are expected to be recovered in the following years. Tax deferrals of 0.3% of GDP were granted by the end of April 2020 and more are expected to be granted for businesses.

Income support measures amount to 0.5% of GDP, including an expanding coverage of the state-paid sick leave from the second day of sick leave, downtime payments for idle workers and additional support for children and the unemployed with limited unemployment insurance. Furthermore, an unemployment assistance payment extending the period of support for the unemployed was adopted after the cut-off dates of both the Stability Programme and the Commission forecast (costs 0.1% of GDP in 2020). The use of the downtime payments has been lower than planned due to a high rate of rejections for unpaid tax debts and the low social insurance coverage of the applicants. The payout trend until the end of April corresponds to a total cost estimate of 0.1% of GDP in the Stability Programme, as compared to the initially planned support of 0.5% of GDP. The effectiveness of this measure is limited by supporting only full idle time rather than allowing for partly reduced work intensity.

The support for aviation, agriculture and healthcare sectors is estimated to cost 1% of GDP in 2020. Liquidity support through loans and state guarantees of 3.2% of GDP (see Table 4) is assessed to have a deficit-increasing effect of 0.4% of GDP, based on the experience with the standardised guarantees. Loan guarantees of 2.5% of GDP are managed by commercial banks. Loans from the national development bank Altum amount to 0.7% of GDP. The pick-up rate of the guarantees has been limited, partly because the banks have managed to restructure the majority of loans without the help of state guarantees and partly because the financial situation of the credit-worthy companies is relatively good with low leverage levels and sizeable cash reserves. Activity has been higher in the loans scheme, where EUR 40 out of the total 200 million have already been granted. However, close to half of applications are being turned down due to the weak financial position of the applicants before the crisis or due to tax discipline or credit history issues.

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[5] https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52020DC0112.

Table 3: Discretionary measures adopted/announced in response to COVID-19 outbreak

Description	ESA Code (Expenditure / Revenue component)	Adoption Status	Budgetary impact (% of GDP - change from previous year)		
				2020	2021
Tax deferral option up to 3 years	D.2, D.5, D.61	Adopted		-0.8	0.9
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
Sick leave payments from the 2nd day of leave are covered by state	D.632, D.62	Adopted		-0.3	0.3
Salary subsidies for employees (incl. self-employed) during downtime	D.7	Adopted		-0.1	0.1
Loss provision for guarantees and loans	D.7	Adopted		-0.4	0.4
Support to aviation through capital injections	D.9	Adopted		-0.6	0.5
Medical purchases of protective gear, laboratory equipment, medical supplies, premium for medical personnel	P.2, D.1	Adopted		-0.3	0.3
Support for agricultural producers	D.3	Adopted		-0.2	0.2
			Total	**-3.0**	**3.0**

Source: Stability Programme

Table 4: Guarantees adopted/announced in response to COVID-19 outbreak

Description	Adoption Status	Maximum amount of contingent liability (% of GDP)	
Working capital loans up to EUR 1 million up to 3 years	Adopted		0.7
Credit holiday guarantee for SMEs and large companies, guarantee up to 50% for loans up to EUR 5 million	Adopted		1.4
Portfolio guarantees for SMEs, guarantee up to 50% for loans up to EU 0.5 million	Adopted		1.1
		Total	**3.2**

Source: Stability Programme

3.3. RISK ASSESSMENT

The macroeconomic and fiscal outlook is affected by high uncertainty due to the outbreak of the COVID-19 pandemic. The pandemic could become more severe and last longer than assumed, requiring more stringent and longer lasting containment measures. This would result in worse economic and fiscal outcomes. It could also require further fiscal policy measures. That would result in worse fiscal outcomes but help to mitigate the economic impact. An additional risk stems from the considerable size of public guarantees issued in response to the crisis.

However, country-specific risks to Latvia are balanced. There are no supply-side restrictions to manufacturing and construction. As a result, these sectors may prove more resilient than currently assumed should demand return. Still, there is a sizable

risk that the external demand recovery will not be as robust as currently assumed and will therefore result in a more protracted recovery in Latvia.

The use of the support measures might turn out to be lower than planned, considering their limited take-up and administrative restrictions. This would reduce fiscal costs of the measures, but their macroeconomic stabilisation effect would be lower as well, possibly affecting public finances indirectly.

4. COMPLIANCE WITH THE PROVISIONS OF THE STABILITY AND GROWTH PACT

4.1. COMPLIANCE WITH THE DEFICIT CRITERION

According to the Stability Programme, Latvia's general government deficit is expected to reach 9.4% of GDP in 2020, thereby exceeding the Treaty reference value of 3% of GDP. This provides *prima facie* evidence of the existence of an excessive deficit in Latvia for the purposes of the Treaty and the Stability and Growth Pact. The Commission has therefore prepared a report under Article 126(3) TFEU, which analyses Latvia's compliance with the deficit criterion of the Treaty. Overall, the analysis suggests that the deficit criterion as defined in the Treaty and in Regulation (EC) No 1467/1997 is not fulfilled.

4.2. COMPLIANCE WITH THE MTO OR THE REQUIRED ADJUSTMENT PATH TOWARDS THE MTO IN 2019[6]

Assessment of requests for deviating from SGP requirements

Latvia has been granted a temporary deviation from its MTO to finance a healthcare reform. The structural reform clause for the healthcare reform was granted in 2017 and allows for a deviation of 0.5% of GDP in 2019[7]. This allowance expires in 2020.

The Stability Programme reports on the implementation of the structural reform in 2019. The implementation broadly follows the announced plans. The measures launched from 2017 were continued and new measures were added in 2019: supporting health service network reform and improving the provision of rehabilitation and mental health services. There were some financing reallocations during 2019 from less-used measures to more-demanded ones. The measures are assessed to have decreased waiting lines for specialists and improved access to outpatient treatment and rehabilitation services. In particular, the high demand for cancer examinations have increased the number of timely diagnosed cases and more successful treatments. The Stability Programme reconfirms a positive effect of the

[6] The possible retroactive impact on output gap estimates as a result of the recession induced by the COVID-19 outbreak and the possibility of abnormal responses of government revenues to major swings in economic activity underline that compared to the structural balance the expenditure benchmark is likely to provide a more reliable and predictable indicator in times of severe economic downturn.

[7] The structural reform clause for the healthcare sector reform of 0.5% of GDP was granted to Latvia as from 2017, but the existing allowance for the pension reform and the minimum benchmark of 1.7% of GDP limited the deviation granted under the structural reform clause to 0.1% of GDP in 2017 and 0.4% in 2018. The allowed deviation of 0.5% of GDP was used in full in 2019.

reform measures on economic growth, employment and public finances in the long run, which appears plausible.

Adjustment towards the MTO

In 2019, based on the outturn data and the Commission forecast, Latvia's structural deficit of 1.7% of GDP was close to the MTO of -1.0% of GDP, taking into account the allowance linked to the healthcare reform of 0.5% of GDP in 2019. The overall assessment points to compliance with the requirements of the Stability and Growth Pact in 2019 as Latvia's structural balance is assessed to be close to the MTO, taking into account the allowance linked to structural reforms.

Table 5: Compliance with the requirements under the preventive arm

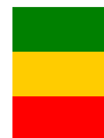
	(% of GDP)	2019	2020		2021	
	Background budgetary indicators[1]					
(1)	Medium-term objective (MTO)	-1.0	-1.0		-1.0	
(2)	Structural balance[2] (COM)	-1.7	-5.2		-3.8	
	Setting the required adjustment to the MTO					
(3)	Structural balance based on freezing (COM)	-1.6				
(4) = (1) - (3)	Position vis-a -vis the MTO[3]	Not at MTO				
(5)	Required adjustment[4]	0.6				
(6)	Required adjustment corrected[5]	0.2				
(8)	Corresponding expenditure benchmark[6]	4.8				
	Compliance with the required adjustment to the MTO					
		COM	COM	SP	COM	SP
	Structural balance pillar					
(8) = Δ (2)	Change in structural balance[7]	0.6				
(9) = (8) - (6)	*One-year deviation from the required adjustment*[8]	0.4				
	Two-year average deviation from the required adjustment[8]	0.0				
	Expenditure benchmark pillar					
(10)	Net public expenditure annual growth corrected for one-offs[9]	7.7				
(11) = (10) - (8)	One-year deviation adjusted for one-offs[10]	-1.0				
	Two-year deviation adjusted for one-offs[10]	-1.2				
	Finding of the overall assessment	**Compliance**				

Legend

'*Compliance*' - the recommended structural adjustment or a higher adjustment is being observed.

'*Some deviation*' - a deviation from the recommended structural adjustment is being observed, but it is below the threshold for a significant deviation.

'*Significant deviation*' - a deviation which has reached or breached the threshold for a significant deviation (i.e. 0.5% of GDP over one year, 0.25% of GDP over two years on average).



Notes

[1] The most favourable level of the structural balance, measured as a percentage of GDP reached at the end of year t-1, between spring forecast (t-1) and the latest forecast, determines whether there is a need to adjust towards the MTO or not in year t. A margin of 0.25 percentage points (p.p.) is allowed in order to be evaluated as having reached the MTO.

[2] Structural balance = cyclically-adjusted government balance excluding one-off measures.

[3] Based on the relevant structural balance at year t-1.

[4] Based on the position vis-à-vis the MTO, the cyclical position and the debt level (See European Commission: Vade mecum on the Stability and Growth Pact, page 38.).

[5] Required adjustment corrected for the clauses, the possible margin to the MTO and the allowed deviation in case of overachievers.

[6] Reference medium-term rate of potential GDP growth. The (standard) reference rate applies from year t+1, if the country has reached its MTO in year t. A corrected rate applies as long as the country is adjusting towards its MTO, including in year t.

[7] Change in the structural balance compared to year t-1. Ex post assessment (for 2019) is carried out on the basis of Commission 2020 spring forecast.

[8] The difference of the change in the structural balance and the corrected required adjustment.

[9] Net public expenditure annual growth (in %) corrected for discretionary revenue measures, revenue measures mandated by law and one-offs (nominal)

[10] Deviation of the growth rate of public expenditure net of discretionary revenue measures, revenue increases mandated by law and one-offs from the applicable reference rate in terms of the effect on the structural balance. The expenditure aggregate used for the expenditure benchmark is obtained following the commonly agreed methodology. A negative sign implies that expenditure growth exceeds the applicable reference rate.

Source :

Stability Programme (SP); Commission 2020 spring forecast (COM); Commission calculations.