



Brussels, 24.11.2021
C(2021) 9510 final

COMMISSION OPINION

of 24.11.2021

on the Draft Budgetary Plan of Latvia

{SWD(2021) 915 final}

(Only the Latvian text is authentic)

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GENERAL CONSIDERATIONS

1. Regulation (EU) No 473/2013 sets out provisions for enhanced monitoring of budgetary policies in the euro area, to ensure that national budgets are consistent with the economic policy guidance issued in the context of the Stability and Growth Pact and the European Semester for economic policy coordination.
2. Article 6 of Regulation (EU) No 473/2013 requires Member States to submit annually to the Commission and to the Eurogroup a Draft Budgetary Plan by 15 October, presenting the main aspects of the budgetary situation of the general government and its subsectors for the forthcoming year.
3. On 20 March 2020, the Commission adopted a Communication¹ on the activation of the general escape clause² of the Stability and Growth Pact. In that Communication, the Commission set out its view that, given the expected severe economic downturn resulting from the COVID-19 outbreak, the conditions to activate the general escape clause were met. On 23 March 2020, the Ministers of Finance of the Member States agreed with the assessment of the Commission.³
4. On 3 March 2021, the Commission adopted a Communication providing further policy orientations to facilitate the coordination of fiscal policies.⁴ In that Communication, the Commission set out its view that the decision on the deactivation or continued application of the general escape clause should be taken on the basis of an overall assessment of the state of the economy, with the level of economic activity in the EU or euro area compared to pre-crisis levels (end-2019) as a key quantitative criterion. On 2 June 2021, on the basis of the Commission's 2021 spring forecast, the Commission considered that the conditions to continue to apply the general escape clause in 2022 and to deactivate it as of 2023 were met.⁵ Country-specific situations will continue to be taken into account after the deactivation of the general escape clause.
5. Next Generation EU, including the Recovery and Resilience Facility, supports a sustainable, inclusive and fair recovery. Regulation (EU) 2021/241 established the

¹ Communication from the Commission to the Council on the activation of the general escape clause of the Stability and Growth Pact, Brussels, 20.3.2020, COM(2020) 123 final.

² 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.

³ <https://www.consilium.europa.eu/en/press/press-releases/2020/03/23/statement-of-eu-ministers-of-finance-on-the-stability-and-growth-pact-in-light-of-the-covid-19-crisis/>

⁴ Communication from the Commission to the Council on one year since the outbreak of COVID-19: fiscal policy response, Brussels, 3.3.2021, COM(2021) 105 final.

⁵ Communication from the Commission on economic policy coordination in 2021: overcoming COVID-19, supporting the recovery and modernising our economy, Brussels, 2.6.2021, COM(2021) 500 final.

Recovery and Resilience Facility⁶ which provides financing support for the implementation of reforms and investments, notably to promote the green and digital transitions, thereby strengthening the economies' resilience and potential growth. Part of this support is in the form of non-repayable financial support ("grants"), entailing a fiscal impulse financed by the EU budget. By contributing to economic recovery and to strengthening long-term growth, it supports public finances, growth and job creation in the medium and long term.

6. On 2 June 2021, the Commission emphasised in its communication that the coordination of national fiscal policies remains crucial to underpin the recovery. In this context, the Commission set out its view that the overall fiscal stance, taking into account national budgets and the Recovery and Resilience Facility, should remain supportive in 2021 and 2022. Fiscal policy should remain agile and adjust to the evolving situation as warranted, and a premature withdrawal of fiscal support should be avoided. Once health risks diminish, fiscal measures should gradually pivot to more targeted measures that promote a resilient and sustainable recovery. Finally, with economic activity gradually normalising in 2021, Member States' fiscal policies should become more differentiated in 2022, taking into account the state of the recovery, fiscal sustainability and the need to reduce economic, social and territorial divergences. All Member States should preserve nationally financed investment. As the recovery takes hold, fiscal policy should prioritise higher public and private investment, supporting the transition towards a green and digital economy.

In its recommendations on the 2021 Stability Programmes on 18 June 2021, the Council also recommended that, when economic conditions allow, Member States should pursue a fiscal policy aimed at achieving prudent medium-term fiscal positions and ensuring fiscal sustainability in the medium term. At the same time, investment should be enhanced to boost growth potential.

The Council, on 13 July 2021, further recommended to euro area Member States⁷ to take action, individually and collectively within the Eurogroup, in the period 2021–2022 to ensure a policy stance that supports the recovery from the COVID-19 crisis. When the epidemiological and economic conditions allow, emergency measures should be phased out while combatting the social and labour-market impact of the crisis. Recalling the need for prudent medium-term fiscal positions and debt sustainability, while enhancing investment, the Council also called for particular attention to the quality of budgetary measures.

The recovery of the European economy has been strengthening, thanks to the improved health situation and easing of pandemic control restrictions. The volume of output in the euro area is expected to return to its pre-pandemic level by the end of the year. However, bottlenecks in global supply and rising energy and commodity prices have been increasingly weighing on activity in the EU. This together with production bottlenecks, due to the shortage of some input components and raw materials, and capacity constraints vis-à-vis booming demand both in the EU and internationally have been putting upward pressure on consumer prices.

7. On 18 June 2021, in its recommendations on the 2021 Stability Programmes, the Council highlighted that the established indicators of fiscal adjustment set out in

⁶ OJ L57, 18.2.2021, p.17.

⁷ Council Recommendation of 13 July 2021 on the economic policy of the euro area, OJ C 283, 15.7.2021, p. 1

Regulation (EC) No 1466/97 need to be considered in the context of the current circumstances. Specifically, the assessment of the overall fiscal stance at the current juncture should take into account the transfers from the EU budget (such as those from the Recovery and Resilience Facility). Furthermore, the assessment also needs to take into account the phasing-out of crisis-related temporary emergency measures that were designed to support health systems and compensate workers and firms for the losses in income due to lockdowns and supply chain disruptions, while their withdrawal is accompanied by the easing of lockdown restrictions that will support growth.

Accordingly, the fiscal stance in 2021 and 2022 is measured by the change in primary expenditure (net of discretionary revenue measures), excluding crisis-related temporary emergency measures but including expenditure financed by grants under the Recovery and Resilience Facility and other EU funds, relative to medium-term potential growth.⁸ Going beyond the overall fiscal stance, in order to assess whether national fiscal policy is prudent and its composition is conducive to a sustainable recovery consistent with the green and digital transitions, attention is also paid to the evolution of nationally financed primary current expenditure (net of discretionary revenue measures and excluding crisis-related temporary emergency measures) and investment.

CONSIDERATIONS CONCERNING LATVIA

8. On 14 October 2021, Latvia submitted the Draft Budgetary Plan for 2022. On that basis, the Commission has adopted the following opinion in accordance with Article 7 of Regulation (EU) No 473/2013.
9. On 18 June 2021, the Council recommended that in 2022 Latvia⁹ maintain a supportive fiscal stance, including from the impulse provided by the Recovery and Resilience Facility, and preserves nationally financed investment. The Council also recommended Latvia to keep the growth of nationally financed current expenditure under control.

The Council also recommended to pay particular attention to the composition of public finances, on both the revenue and expenditure sides of the national budget, and to the quality of budgetary measures in order to ensure a sustainable and inclusive recovery; to prioritise sustainable and growth-enhancing investment, in particular investment supporting the green and digital transition; and to give priority to fiscal structural reforms that will help provide financing for public policy priorities and contribute to the long-term sustainability of public finances, including, where relevant, by strengthening the coverage, adequacy and sustainability of health and social protection systems for all.

On 2 June 2021, the Commission issued a report under Article 126(3) TFEU.¹⁰ This report discussed the budgetary situation of Latvia, as its general government deficit in 2020 exceeded the 3% of GDP Treaty reference value. The report concluded that the deficit criterion was not fulfilled.

⁸ The Commission's estimates of medium-term potential growth do not include the positive impact of reforms that are part of the Recovery and Resilience Plan and can boost Latvia's potential growth.

⁹ Council Recommendation of 18 June 2021 delivering a Council opinion on the 2021 Stability Programme of Latvia, OJ C 304, 29.7.2021, p. 63

¹⁰ Report from the Commission prepared in accordance with Article 126(3) of the Treaty on the Functioning of the European Union, Brussels, 2.6.2021, COM(2021) 529 final.

10. According to the Commission 2021 autumn forecast, the Latvian economy is expected to grow by 4.7% in 2021 and by 5.0% in 2022, while inflation is forecasted at 3.1% in 2021 and 3.6% in 2022. According to the macroeconomic scenario underlying the Draft Budgetary Plan, real GDP is projected to grow by 3.7% in 2021 and by 5.0% in 2022. The difference in the GDP growth forecasts for 2021 are due to the different timing of the forecast preparation: Latvia's scenario was prepared in June 2021, while the Commission forecast was prepared in October 2021, when the outcome of the very strong second quarter could already be taken into account. The Draft Budgetary plan expects inflation at 2.0% for 2021 and 2.4% for 2022, which is significantly lower than the Commission's forecast. The difference is explained by the recent acceleration in energy prices, which was not yet factored in the Plan's forecast. Overall, the macroeconomic assumptions underpinning the Draft Budgetary Plan are plausible for both 2021 and 2022.

Latvia complies with the requirement of Regulation (EU) No 473/2013 since the draft budget is based on independently endorsed macroeconomic forecasts.

11. Latvia submitted its Recovery and Resilience Plan on 30 April 2021. The Council approved the assessment of Latvia's Recovery and Resilience Plan on 13 July 2021. A pre-financing payment of Recovery and Resilience Facility grants of 0.8% of GDP was made to Latvia in September 2021. The Draft Budgetary Plan assumes that expenditure amounting to 0.7% of GDP in 2022 will be funded by non-repayable financial support (grants) from the Recovery and Resilience Facility. Expenditure financed by RRF grants will enable high-quality investment and productivity-enhancing reforms without a direct impact on the general government deficit and debt. The Commission 2021 autumn forecast includes a similar amount of expenditure financed by RRF grants in its budgetary projections. Simulations by the Commission services show that the Recovery and Resilience Plan, together with the rest of measures of the European Union Recovery Instrument, has the potential to increase the GDP of Latvia by 2 % by year 2026, not including the possible positive impact of structural reforms, which can be substantial¹¹.
12. In its 2022 Draft Budgetary Plan, Latvia's general government deficit is planned to decrease from 9.3% of GDP in 2021 to 4.8% of GDP in 2022, mainly due to the phasing out of the majority of the support measures related to the COVID-19 crisis. The general government debt ratio is planned to increase from 48.8% of GDP in 2021 to 51.7% of GDP in 2022, driven by the deficit and a stock-flow adjustment adding about 2% of GDP to the debt projection for 2022. The projections for the deficit and debt ratio for 2022 are higher than in the Commission 2021 autumn forecast (4.2% and 50.7% of GDP respectively) due to a lower nominal GDP forecast in the Draft Budgetary Plan . The outlook for public finances continues to be subject to the high uncertainty that surrounds the macroeconomic projections, including risks related to the evolution of the pandemic and possible scarring effects. There is a positive risk associated with the budget revenues for 2021 as the actual data up to September point to a significantly better outcome than projected in the Draft Budgetary plan. A better budget balance outcome in 2021 would have a positive carry-over effect on the 2022 balance, as well.

¹¹ These simulations reflect the overall impact of NGEU, which also includes funding for ReactEU, and increased funding for Horizon Europe, InvestEU, JTF, Rural Development and RescEU.

13. The Draft Budgetary Plan includes measures on both the revenue and expenditure side. The main measures on the revenue side for 2022 are an increase in the non-taxable income tax allowance as well as a discretionary increase in dividends from State Forests for 2022. Overall, the revenue measures are estimated to have a neutral effect on the budget balance. The Commission's estimate of the overall impact of revenue measures is deficit-increasing by 0.2% of GDP¹². Measures on the expenditure side for 2022 are estimated to have a deficit-increasing impact of 1.8% of GDP. The main expenditure measures are increases in public sector wages to healthcare and social workers as well as teachers, as well as an expansion of healthcare services. The plan also contains a sizeable investment package aimed at supporting the economic recovery (0.6% of GDP). On the expenditure side, the Commission takes account of the same measures in a similar amount. In addition, the Commission forecast for 2021 includes measures that were introduced to support the economy during the lockdown announced in October 2021 and that were approved after the submission of the Draft Budgetary Plan. These measures include working capital and wage subsidy support to businesses, wage top-ups to the healthcare sector and support to culture, sports, and tourism sectors, which are particularly affected by the newly introduced restrictions. Altogether, these measures amount to 0.7% of GDP. Based on the Commission's forecast, the crisis-related temporary emergency measures will increase from 0.9% of GDP in 2020 to 2.1% in 2021 and will be discontinued in 2022.

According to the Draft Budgetary Plan gross fixed capital formation is expected to increase from 5.5% of GDP in 2021 to 6.5% of GDP in 2022. The change is due to a pick-up in EU-funded investments (contribution of 0.3% of GDP) and a nationally financed investment package (contribution of 0.7% of GDP) consisting primarily of investments in roads and other regional infrastructure projects. These projections are lower than the Commission 2021 autumn forecast, mainly due to differences in actual investment levels in 2020, which rely on older data in the Draft Budgetary Plan.

Some of these measures, such as the green and digital investments included in Latvia's Recovery and Resilience plan are aimed at supporting the green and digital transition, as well as strengthening the coverage, adequacy, and sustainability of health and social protection systems, as recommended by the Council on 18 June 2021. A complete assessment of the fiscal-structural reforms implemented by Latvia will be done in the context of the assessment of the implementation of the Recovery and Resilience Plans and the 2022 Country Report.

14. The fiscal stance, which excludes crisis-related temporary emergency measures while including the impact on aggregate demand from investment financed by both the national and the EU budgets, notably the Recovery and Resilience Facility, is projected in the Commission 2021 autumn forecast at -2.5% of GDP in 2022¹³. Latvia is projected to use the Recovery and Resilience Facility in 2022 to finance additional investment in support of the recovery. The positive contribution to

¹² The difference in the estimates of the revenue measures is mainly due to a difference with the definition of a fiscal measure as used by the Commission, i.e. the Commission does not assume the second-round effects on revenues as part of the discretionary measures. However, they still enter the Commission's forecast via macroeconomic effects.

¹³ A negative sign of the indicator corresponds to an excess of primary expenditure growth compared with medium-term economic growth, indicating an expansionary fiscal policy.

economic activity of expenditure financed by Recovery and Resilience Facility grants and other EU funds is projected to increase by 1.0 percentage point of GDP in 2022 compared to 2021. Nationally financed investment is projected to provide an expansionary contribution to the fiscal stance of 0.6 percentage points in 2022.¹⁴ The growth in nationally financed primary current expenditure (net of new revenue measures) in 2022 is projected to provide an expansionary contribution of 0.8 percentage points to the overall fiscal stance.

15. The Draft Budgetary Plan does not include budgetary projections beyond 2022.
16. In 2022, based on the Commission's forecast and including the information incorporated in Latvia's Draft Budgetary Plan, the fiscal stance, including the impulse provided by the Recovery and Resilience Facility, is projected to be supportive, as recommended by the Council. Latvia plans to provide continued support to the recovery by making use of the Recovery and Resilience Facility to finance additional investment. As recommended by the Council, Latvia plans to preserve nationally financed investment. At the same time, Latvia does not sufficiently keep under control the growth of nationally financed current expenditure.

The Commission recalls the importance of the composition of public finances and the quality of budgetary measures, including through growth-enhancing investment, notably supporting the green and digital transition. The measures included in Latvia's Recovery and Resilience plan and which are part of the Draft Budgetary Plan are aimed at addressing the investment needs of the green and digital transitions.

Taking into account the strength of the recovery, Latvia is invited to regularly review the use, effectiveness and adequacy of the support measures and stand ready to adapt them as necessary to changing circumstances.

Done at Brussels, 24.11.2021

For the Commission
Paolo GENTILONI
Member of the Commission

¹⁴ Other nationally financed capital expenditure is projected to provide an expansionary contribution of 0.1 percentage point of GDP.