

## MONITORING REPORT NO. 9

03.10.- 03.11.2020.

### SUMMARY

1. The Fiscal Discipline Council (FDP) generally approves the government's work in overcoming the first wave of the Covid-19 crisis. The public attitude towards the work of government institutions in the crisis (until September) is also relatively positive. The results of the public survey published in October within the State research program project "reCOVvery-LV"<sup>1</sup> show that 35% of respondents feel proud of the government's work during the crisis, but 50.5% believe that in an emergency the state is able to perform its functions as good or even better. Objective data also show the effectiveness of government action. Although Latvia's support program has been less ambitious compared to Lithuania and Estonia, especially in the area of downtime benefits, it has been more effective and will have less of an impact on government debt levels. At the same time, the survey revealed that the opinion of the population about state aid is not very positive.
2. The second wave of Covid-19 is intensifying all over the world and in Latvia. Restrictive measures are already in place in Europe, which will also limit economic activity. In Latvia, too, they look inevitable. On Friday, November 6, the government will decide whether to declare a state of emergency in Latvia. In its surveillance report<sup>2</sup>, the Council recommends that the government's fiscal policy should be flexible depending on the circumstances - additional fiscal stimulus may be needed if the economic situation deteriorates. Unfortunately, the epidemiological situation is deteriorating and additional fiscal stimulus appears to be needed. The relatively conservative draft budget for 2021 should be praised here, which could allow for an increase in fiscal stimulus without unduly jeopardizing the country's long-term fiscal sustainability.
3. On October 29, 2020, the Constitutional Court pronounced a judgment in case no. 2019-29-01, stipulating that the Law "On the State Budget for 2019", insofar as it does not provide for the annual increase in state funding specified in Section 78, Paragraph seven of the Law on Higher Education Institutions, complies with Articles 1 and 66 of the Satversme of the Republic of Latvia. This is a fiscally significant and responsible judgment that will contribute to the country's fiscal sustainability and stability. The Council warns that various legal acts (Law on Higher Education Institutions, Law on Scientific Activities, Law on Roads, Law on Health Care Financing, etc.) currently provide for "earmarked" budget funding (percentage of GDP, percentage of certain budget revenues, grant not less than a year in advance, increasing grant, etc.), which significantly exceeds the possibilities of the state budget of the programming year. The Council estimates that such spending exceeded € 700 million in 2020 and will continue to increase

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<sup>1</sup> Available: <https://www.bvef.lu.lv/petnieciba/petnieciba/zinatniskie-instituti/lu-domnica-lv-peak/>, accessed 03/11/20

<sup>2</sup> Available: <https://fiscalcouncil.lv/files/uploaded/UZ2020galavariantsENG.pdf>, accessed 03/11/20

in the coming years, ignoring the cyclical nature of the economy and the tensions caused by the pandemic. This systemic problem needs to be addressed by streamlining the legislative process.

4. The GDP results of the 1st and 2nd quarters of 2020, and the rapid GDP assessment of the 3rd quarter give hope that the GDP decline of -7% projected by the Ministry of Finance in 2020 will not come true. For this forecast to materialize, a decline of around 14% of GDP would have to occur in the fourth quarter, which is unrealistic. This confirms the Council's view that the June forecast of the MoF was conservative, which contributed to fiscal security in the context of the crisis.
5. In Latvia, economic sentiment is generally worse than in most trading partners, even despite their worse situation in the context of the second Covid-19 outbreak. This shows the caution of Latvian entrepreneurs and their uncertainty about what they might experience in the coming months.
6. In the third quarter, the capacity utilization of manufacturing enterprises returned to the indicators of the beginning of the year and this had a positive effect on the performance indicator of GDP in the third quarter. However, the recovery of capacity utilization in small businesses is still lagging behind, and they have been particularly hard hit by the first Covid-19 outbreak.
7. The increase in retail sales in the third quarter confirmed the assumption that consumers had used a wait-and-see tactic in the past, but that the effect of deferred consumption is now being observed. After a quick estimate of GDP in the third quarter, the services sector showed a decline of 4.8%. However, in the services sector, retail trade showed a positive result, increasing by 4.3%. This result can be explained by a change in the pattern of consumption, most likely temporary. At a time when purchases of services have decreased due to the difficulty of their availability because of Covid-19, consumers are more likely to purchase goods, including making purchases online.
8. General government debt is projected at 47.3% of GDP in 2020, which would be achievable given the conservative GDP forecast as well as the economic developments observed in previous quarters. However, the possible introduction of emergency and additional support measures in the first decade of November could increase this year's debt. The Treasury has projected a reduction in general government debt to 46% of GDP in 2021, and this is a welcome government commitment, but the challenges of the second wave of Covid-19 may lead to adjustments.
9. In October, there is still an increasing trend of tax collection: 13% more taxes were collected in the basic budget than in October 2019, but the collection of the Social security contribution (SSC) exceeded the previous year's level by 4%. This could be due to both the improvement of the economic situation and changes in the structure of consumption - after the Covid-19 period, expenditures on entertainment, restaurants, tourism have decreased, but purchases of goods and fuel consumption have increased.
10. Within the framework of the State research program project "reCOVVery-LV", a public survey assessed the impact of the Covid-19 pandemic on mutual solidarity and tax discipline: 68.4% of respondents believe that tax evasion is reprehensible and

54.2% believe that because of Covid-19 population is more willing to pay taxes. It is possible that the increase in motivation for some taxpayers to pay tax is one of the factors that influenced the positive dynamics of tax revenues. However, a relatively large share of respondents believe that in case of financial difficulties, temporary tax evasion should be allowed (51.4 percent). In our view, a large segment of 'envelope wages' is concentrated, especially in the services sector, which has been hit hard by the crisis, and therefore the correlation of tax revenues with the dynamics of the 'real' economy is weak. Given that the services sector has a higher share of the informal economy and a lower tax burden, while fuel is very tax-intensive, this also results in an increase in taxes collected.

## **DETAILED ANALYSIS**

### **1. Description of the overall situation**

The second wave of Covid-19 is taking effect both in Latvia and around the world. France and Germany, the major EU economies, as well as other EU countries, are introducing restrictions that will also affect economic activity and growth. In Latvia, too, they look inevitable. Although scientists believe the Covid-19 vaccine will be approved and will be in production by the end of this year, it will be several months before it is available to anyone who needs it. In Latvia on October 28, the Cabinet of Ministers decided that the working group for business and employee support in the Covid-19 crisis will be renewed. But, on Friday November 6, the government will decide whether to declare a state of emergency in Latvia. In its surveillance report, the Council recommends that the government's fiscal policy should be flexible depending on the circumstances - additional fiscal stimulus may be needed if the economic situation deteriorates. Unfortunately, the epidemiological situation is deteriorating and additional fiscal stimulus appears to be needed. The relatively conservative draft budget for 2021 should be praised here, which could allow for an increase in fiscal stimulus without unduly jeopardizing the country's long-term fiscal sustainability. At present, it is quite clear that the second wave of Covid-19 will have a negative impact on Latvia's economic growth and fiscal situation in the 4th quarter of 2020.

The political situation in the world is also very unstable. The US presidential election, the illegitimate presidential election in Belarus, the UK-EU trade talks, the Nagorno-Karabakh conflict, and the aggressive rhetoric of the Turkish president leading to terrorist acts in France - all have a potentially negative impact on the Latvian economy.

In its Regional Economic Review (Europe, October)<sup>3</sup>, the IMF forecasts that the European economy will shrink 7% in 2020, but grow 4.7% in 2021. Forecasts have improved slightly compared to June, when economic contraction of 8.5% and + 5.4% growth were forecast, respectively. Latvia's forecasts have also improved from -8.6% and 5.0% to -6.0% and 5.2%, respectively. The report acknowledges that its forecasts are extremely volatile. In addition, it should be noted that the updated forecasts were likely to have been made before the big second wave of Covid-19 exacerbated, and the IMF's latest GDP forecasts are more optimistic than the FM's assumptions for the 2021 government budget. The report emphasizes that the immediate challenge for policy

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<sup>3</sup> Available: <https://www.imf.org/en/Publications/REO/EU/Issues/2020/10/19/REO-EUR-1021>, accessed 30/10/20

makers will be to balance restrictive measures to reduce short-term social and economic costs. It is extremely important to continue to support the economy before it is fully recovered. There is a need to continue supporting businesses and sustainable jobs, including downtime support. Monetary policy must also be accommodative, especially given the low risk of inflation in the short run. Banking supervision must be flexible enough not to unnecessarily reduce credit growth.

As part of the first phase of the research project “reCOVvery-LV”<sup>4</sup>, a public opinion poll was conducted on the work of state institutions during an emergency. The results of the public survey show that the attitude towards the work of government institutions in a crisis situation (until September) is relatively positive, as 35% feel proud of the work of the government during the crisis, but 50.5% believe that in an emergency the state can perform functions good or even better. At the same time, the survey revealed that the opinion of the population about state aid is not very positive.

In Latvia, the Saeima has approved the 2021 state budget in the first reading. In its Surveillance report on Latvia's Medium-Term Budget Framework for 2021-2023<sup>5</sup>, the Council welcomes the fact that the priorities for the 2021 budget are socially oriented, with the potential to stimulate aggregate domestic demand, improve the capacity of the health care system and reduce social inequalities, while without jeopardizing the fiscal sustainability of the country. The Council notes that the country's fiscal policy in 2021 will be conservative, at the same time the Council recommends that the government's fiscal policy should be flexible depending on the circumstances - if the economic situation deteriorates, an additional fiscal stimulus may be needed. Unfortunately, the epidemiological situation is deteriorating and additional fiscal stimulus appears to be needed. Here, once again, the relatively conservative draft budget for 2021 should be praised, which could allow for an increase in fiscal stimulus without unduly jeopardizing the country's long-term fiscal sustainability.

On October 29, 2020, the Constitutional Court pronounced a judgment in case no. 2019-29-01<sup>6</sup>, stipulating that the Law “On the State Budget for 2019”, insofar as it does not provide for the annual increase in state funding specified in Section 78, Paragraph seven of the Law on Higher Education Institutions, complies with Articles 1 and 66 of the Satversme of the Republic of Latvia. The Constitutional Court indicates in the Judgment: “From the principle of a state under the rule of law arises the requirement that the actions of any state institution be true. The adoption of legal norms, which from the very beginning are only empty promises addressed to voters, which will not be fulfilled with the means entrusted to the people, is not in accordance with the principle of the rule of law. Such action endangers the very foundations of the democratic system of the state protected by the Satversme”. Considering that various legal norms (Law on Higher Education Institutions, Law on Scientific Activities, Law on Roads, etc.) currently provide for budget financing in connection with an economic or numerical indicator (percentage of GDP, percentage of certain budget revenues, grant not less than a year earlier, increasing grant, etc.), which significantly exceeds the possibilities of the state budget of the programming year and is therefore not allocated to different departments. A contrary ruling would have set a precedent and a series of other demands on the state budget. The Council therefore considers this judgment to be of

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<sup>4</sup> Available: <https://www.bvef.lu.lv/petnieciba/petnieciba/zinatniskie-instituti/lu-domnica-lv-peak/>, accessed 03/11/20

<sup>5</sup> Available: <https://fiscalcouncil.lv/files/uploaded/UZ2020galavariantsENG.pdf>, accessed 03/11/20

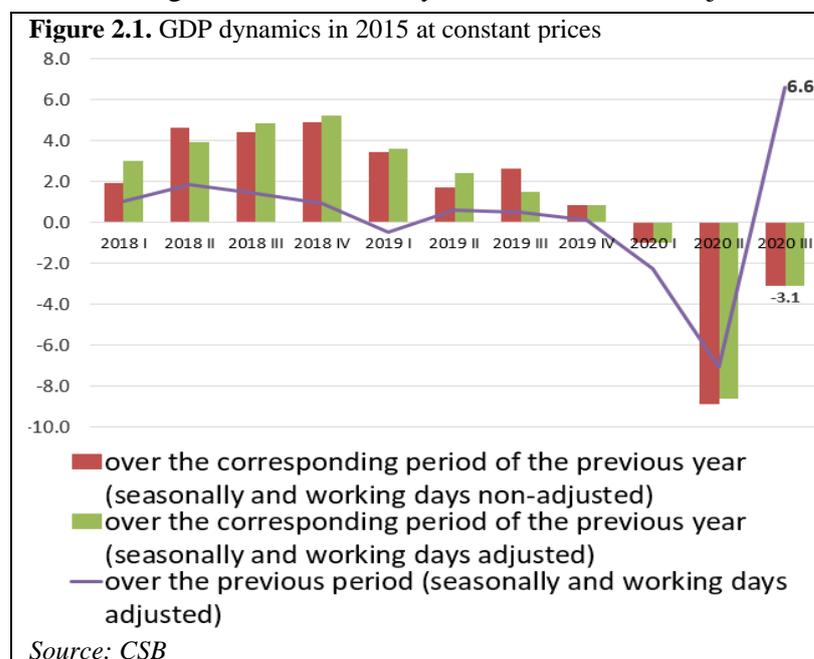
<sup>6</sup> Available: [https://www.satv.tiesa.gov.lv/wp-content/uploads/2019/11/2019-29-01\\_Spriedums-1.pdf](https://www.satv.tiesa.gov.lv/wp-content/uploads/2019/11/2019-29-01_Spriedums-1.pdf), accessed 31/10/20

fiscal significance and responsibility, which will contribute to the fiscal sustainability and stability of the country.

## 2. Macroeconomic situation analysis

### 2.1. GDP dynamic

According to the seasonally and calendar unadjusted data of the CSB rapid



assessment, GDP in the 3rd quarter of 2020 has decreased by 3.1% compared to the corresponding period of 2019.

According to preliminary estimates, the decline in GDP was mitigated by a 0.4% increase in manufacturing. The services sector showed a decrease of 4.8%.

In the services sector, retail trade showed a positive

result, increasing by 4.3%. Compared to the second quarter of 2020, according to seasonally and calendar adjusted data, GDP has increased by 6.6%. In June, the Fiscal Discipline Council approved a forecast of macroeconomic indicators, in which the GDP decline for 2020 was estimated at 7%. At present, thanks to the ability of manufacturing and retail companies to recover in the third quarter and the first quarter results, such an economic decline is not expected at this year, even in the second Covid-19 outbreak situation. This can only happen if the economy fall to approx. (-14%), that is significantly lower than during spring Covid-19 lockdown.

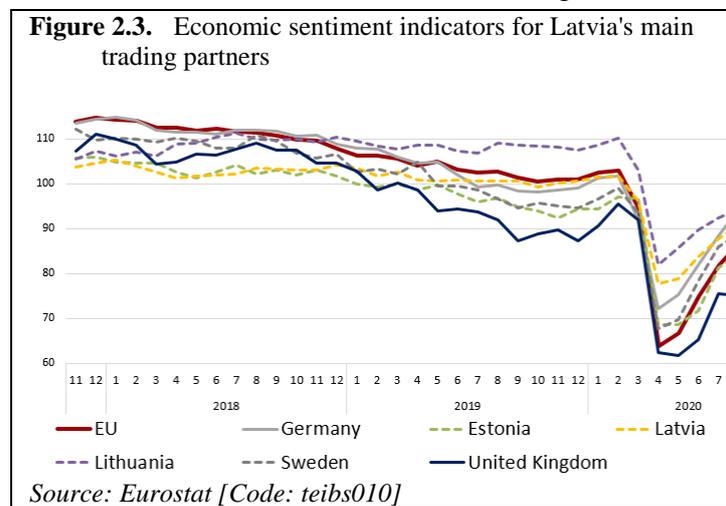
### 2.2. Economic sentiment indicators

Confidence indicators in Latvia had improved during the summer period, but for the most part, they did not grow to positive values. At present, the October data already shows the instability and decline of economic sentiment in the sectors. The confidence indicator has improved and reached positive values only in retail trade, which correlates with relatively good retail sales results in previous months, however, consumer confidence has been volatile in recent months, reaching (-13.4%) in October. In industry, confidence indicators improved compared to the situation in the second quarter of this year, when the average value of confidence balance was (-15.1%). In the third quarter the confidence indicator rose on average to (-5.9%), but in October it was (-5.7%). Entrepreneurial confidence in the construction sector is recovering most slowly, and in October it fell by a few percentage points and reached (-21.4%). Latvia's

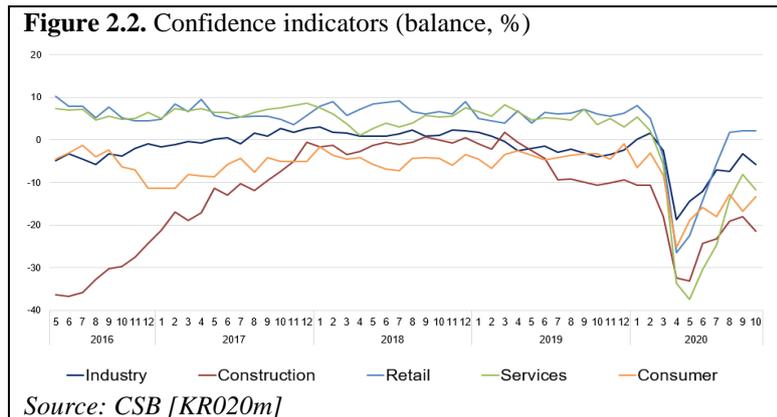
long-term average economic sentiment indicator has decreased by 2 percentage points compared to September, reaching 92.3% in October.

Contrary to the declining confidence indicator observed in Latvia, Eurostat data show that economic sentiment indicators for

Latvia's main trading partners continue to improve. Compared to September, the sentiment indicator in the EU has not changed and remains at the level of 90 points.

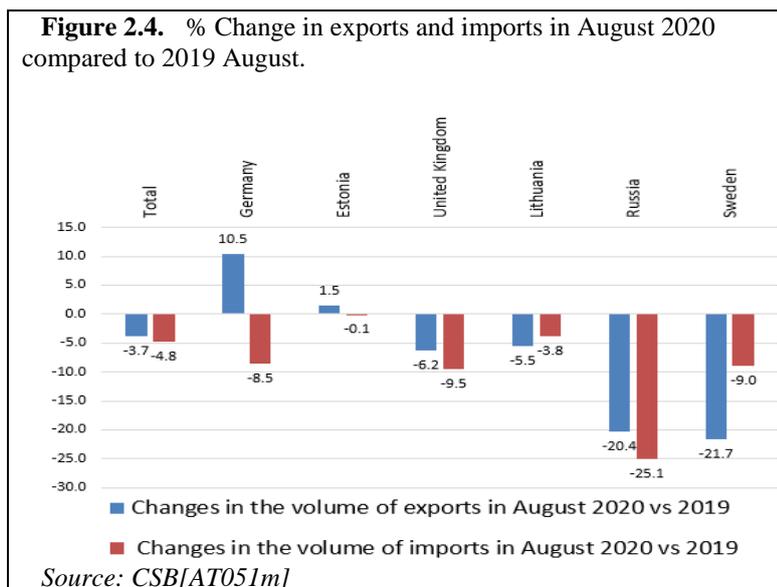


signal, but the latest published data for August show that exports from Latvia to Germany have increased by 10.5% and to Estonia by 1.5%, which does not correlate with the improvement in sentiment indicators of other trading partners.



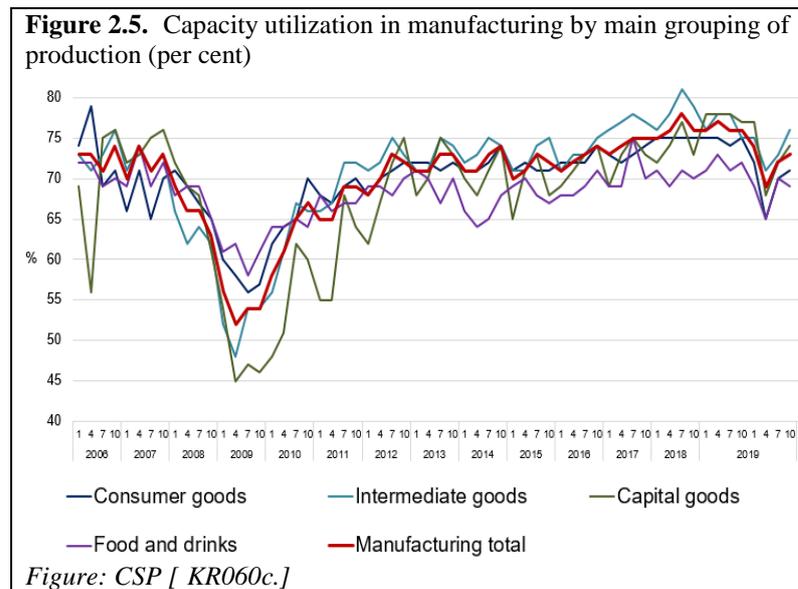
Special mention should be made of Estonia, where sentiment indicators improved by 3.5 percentage points compared to September, and Lithuania (+2.4% points), while other trading partners also showed minimal improvements in sentiment indicators. As Latvia's economic recovery also depends on the stabilization of foreign trade partners, this is a positive

signal, but the latest published data for August show that exports from Latvia to



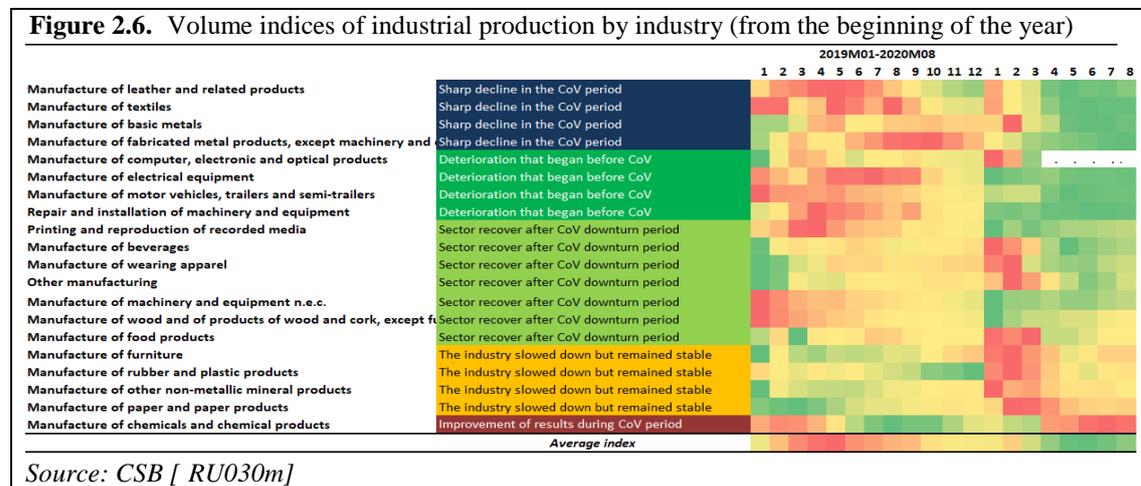
### 2.3. Manufacturing and capacity utilization

According to the CSB October data, capacity utilization in the manufacturing industry has started to return to this year January figures. Overall, manufacturing capacity utilization reached 73%, but in January it was 74%. The capacity utilization of small enterprises improved, but still lags behind the indicators of the beginning of the year. The capacity utilization of small enterprises was 67% in January and 59% in October. Looking at capacity utilization by product group, it can be concluded that the situation in the production of consumer goods, intermediate goods and food and drinks has improved, which is close or slightly higher than at the beginning of the year. Capacity utilization in investment (capital goods) production lags behind the beginning of the year by 3 percentage points and in October was at the level of 74%.



The dynamics of the industrial production volume index in the sectors from the beginning of the year allows to assess the sectors most affected by Covid-19, as well as to observe the recovery of activity in the sectors that had previously suffered from Covid-19 lockdown measures. At present, it can be concluded that the leather

industry, the textile industry, and the metals and metal products industry have experienced a downturn without further signs of recovery. Manufacturers of electrical equipment, car trailers and semi-trailers are in a difficult situation, although the decline in production in companies in these sectors had begun before the start of Covid-19, no improvement is yet to be seen. The decline in production volumes before the Covid-19 events was observed in the wood and wood products industry, however, at the third quarter activity started to recover.

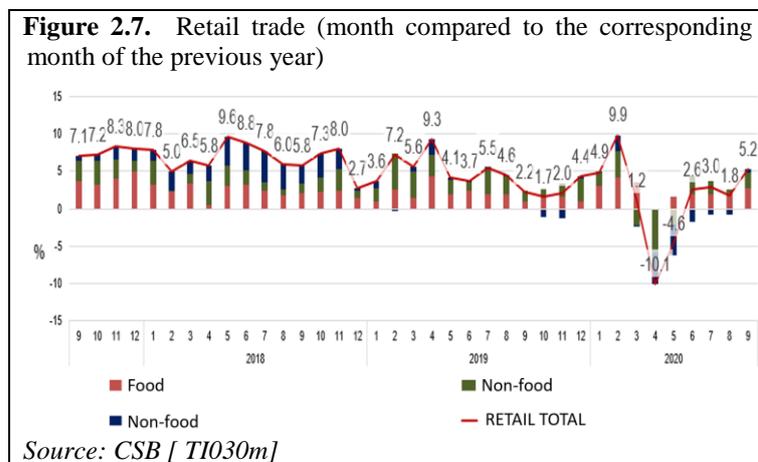


Cautious optimism is demonstrated by industries that are succeeding in gradually resuming production after slowing down during Covid-19 lockdown.

These sectors are printing and reproduction of recorded media, the manufacture of beverages and, in particular, the manufacture of wearing and manufacture of food products. It is also worth noting the sectors whose production decreased, but remain stable even after the Covid-19 lockdown, such as the manufacture of rubber and plastic products, the manufacture of non-metallic mineral products, and the manufacture of paper and paper products. The industry whose production increased immediately after the Covid-19 events is the production of chemicals and chemical products, which is associated with high demand for disinfectants and detergents.

## 2.4. Retail trade indicators

At the September, retail trade turnover increased by 5.2% year - on - year. This



improvement can be explained by the effect of postponed consumption. Overall, retail trade turnover grew by an average of 3.3% in the third quarter.

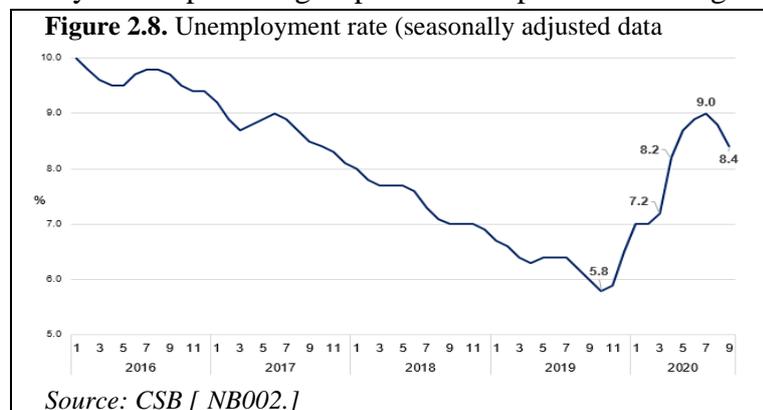
This was ensured by a steady increase in turnover in food and non-food retail trade, as well as a resumption of growth in motor fuel trade. This

result can be partly explained by lower availability of services, instead of which consumption shifted to the purchase of goods, including purchase of goods on the Internet. Such a change in the pattern of consumption is likely to be temporary.

## 2.5. Labour market

According to the CSB data, the seasonally adjusted unemployment rate in September was 8.4% and confirmed the previously observed signs of stabilization in the labour market and a turn towards a decrease of unemployment. According to the data of the State Employment Agency (SEA), the registered unemployment rate was 7.7% in September and decreased by 0.5 percentage points compared to August.

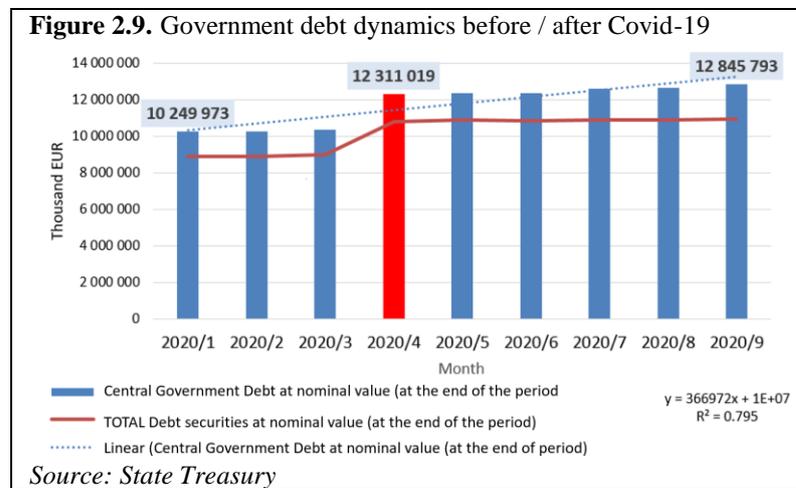
Unemployment fell in all regions of Latvia, but the best results were observed in the Kurzeme region, where unemployment decreased by 0.7% compared to August, and in Riga, where unemployment decreased by 0.6% compared to August.



## 2.6. Public debt

The operative data of the Treasury show that this year at the end of the third quarter, the total nominal value of central government and local government consolidated debt was 12.916 billion euros, but at the end of the second quarter, it was 12.485 billion euros. The fastest debt growth this year was observed in April

(+ 18.5%) compared to March. Since May, the debt has continued to grow minimally - in the period from May to September, the consolidated central and local government debt increased by 0.8% on average. It should be noted that the share of local government debt in the consolidated government debt is small and attention should be paid to the dynamics of government debt. In September, the national debt reached 12.845 billion euros. Thus, since the declaration of the state of emergency in March, the government debt has increased by more than 2 billion euros (more precisely - 2.483 billion euros).

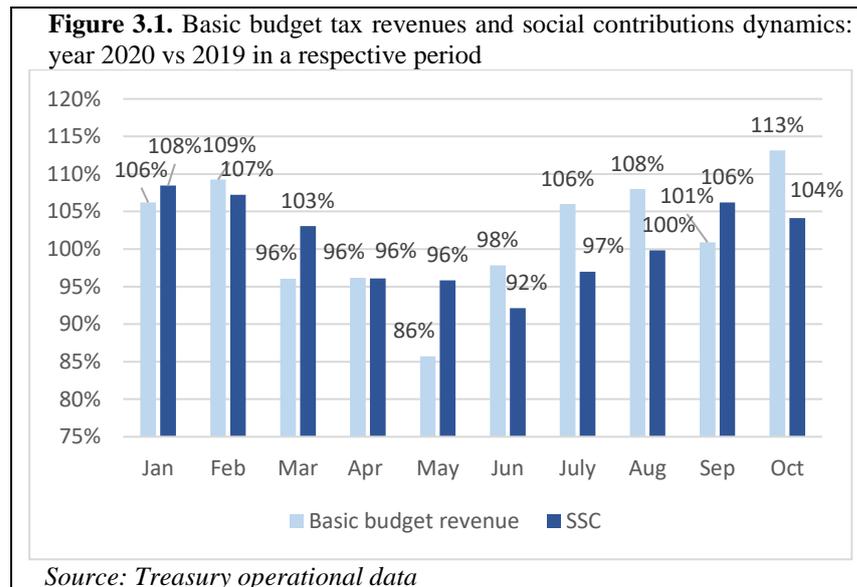


At the same time, there has been a significant stabilization of the economy in the third quarter and also a relatively stable situation in the first month of the fourth quarter. This means that the decline in GDP will not increase until the projected -7% decline by 2020, and

the Treasury's projected general government debt of 47.3% of GDP in 2020 is reachable in the context of currently available economic observations. It is already planned to reduce general government debt to 46% of GDP in 2021, but this plan will be highly dependent on the speed of the second Covid-19 outbreak and its economic consequences.

### 3. Budget balance and tax revenue

In October, the trend of improving tax collection is still observed: 13% more taxes were collected in the basic budget than in October 2019, but the collection of the State Social Contributions (SSC) exceeded the previous year's level by 4%. This confirms that the earlier forecast that the lowest tax collection point could be reached in May has proved accurate. Citizens, who have become more optimistic about their financial situation, are making deferred purchases at the beginning of the crisis, thus improving the collection of both consumption taxes and other taxes. However, value added tax is still below plan -

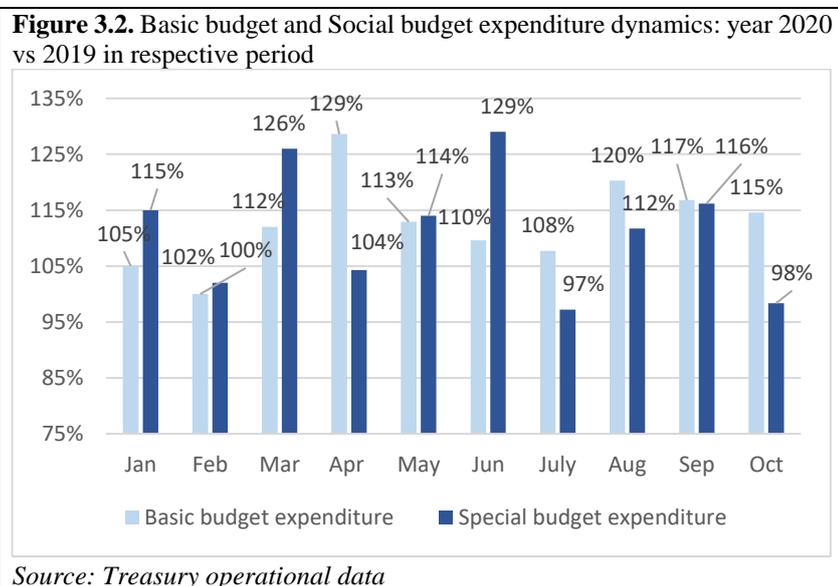


in October, only 87.1% of the planned amount was collected. The collection of other taxes is also below plan, except for the collection of PIT, which was 6.6% above the plan in October, according to the Treasury's operational data. In general, it can

be concluded that the tax collection plan will not be fulfilled in 2020 - according to the operative data of the Treasury, the amount of taxes collected at the end of October was only 73.5% of the annual plan, but the October plan was fulfilled by only 89%.

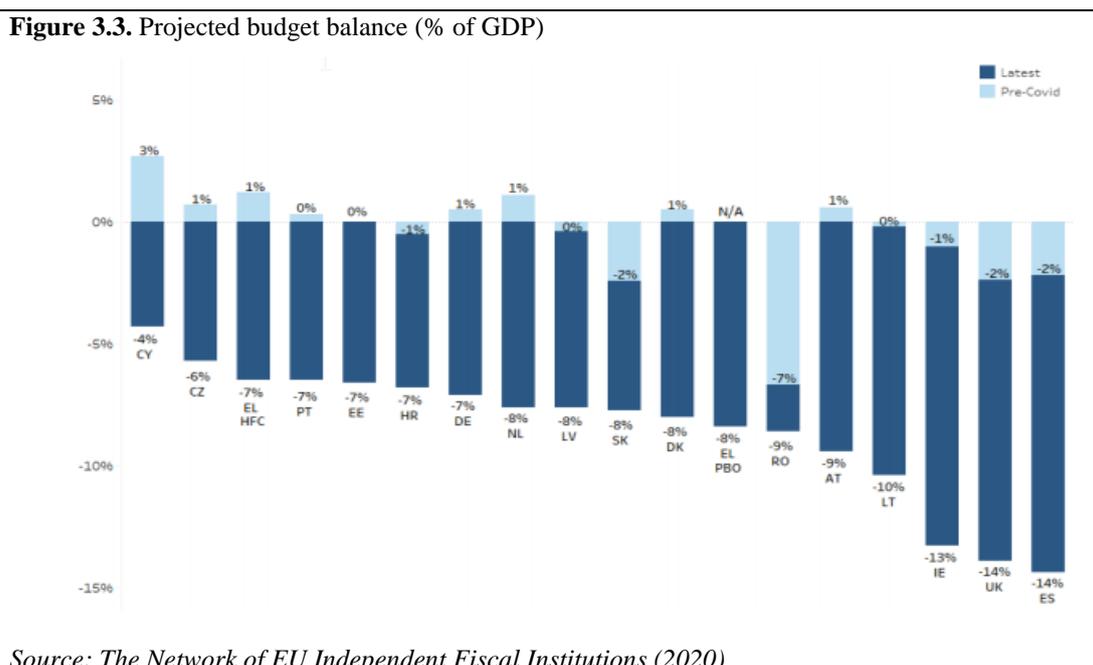
Relatively good tax

collection could be related to both the improvement of the economic situation and changes in the structure of consumption - after the COVID period, expenditures on entertainment, restaurants, tourism have decreased, but purchases of goods and fuel consumption have increased. As the services sector has a higher share of the informal economy and a lower tax burden while fuel is very tax-intensive, the amount of taxes collected increases.



In contrast to tax collection, where there has been a marked improvement, the dynamics of government expenditure is unclear. Although there has been an increase in expenditure due to state aid measures, the overall level of expenditure growth has been uneven over the month. This is so because the financing of support measures is not balanced.

In general, both the basic budget and special budget balances can be considered adequate for an emergency: according to the operational data of the Treasury, the central government basic budget balance was -265.6 million euros at the end of October (-87.3 million euros a year ago). The special budget balance at the end of October 2020 was 28.2 million euros, respectively at the end of October 2019 it was -9.6 million euros.



According to the calculations of the EU network of independent fiscal institutions, Latvia's planned budget balance is approximately -8%. Prior to the onset of the Covid-19 crisis, this figure was around 0%, and its decline happened due to state-organized measures to support a number of at-risk groups. Latvia's planned budget balance is comparable to other EU countries, where the measure is approximately at the same level, or even at the level of larger deficit. For example, if the one compares Latvia with other Baltic countries, it appears that the planned budget balance in Estonia fell from 0% to -7% after the start of Covid-19, while in Lithuania the decline was larger - from 0% to -10%.

Analyzing the growth factors of tax collection, the Governing Council considers that relatively good tax collection could occur due to both the improvement of the economic situation in the third quarter and changes in the consumption structure. After the period of Covid-19, spending on entertainment, restaurants, tourism and fuel consumption has increased.

Within the framework of the NRP (National Research Program) “reCOVery-LV” project, the public survey assessed the impact of the Covid-19 pandemic on mutual solidarity and tax discipline: 68.4% of respondents believe that tax evasion is reprehensible and 54.2% believe that due to Covid-19, people pay taxes more readily.

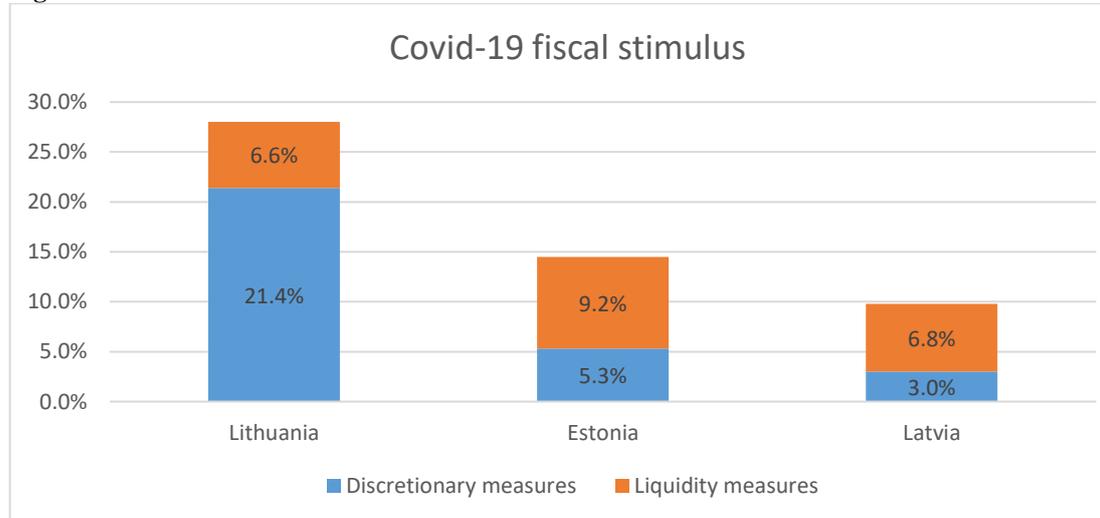
It is possible that the increase in motivation for some taxpayers is one of the factors that influenced the positive dynamics of tax revenues.

However, a relatively large share of respondents (51.4%) believe that in case of financial difficulties, the government should allow temporary tax evasion. In our view, a large segment of 'envelope wages' is concentrated, especially in the services sector hardly hit by the crisis, and therefore the correlation of tax revenues with the dynamics of the 'real' economy is weak. Given that the services sector has a higher share of the informal economy and a lower tax burden, while fuel is very tax-intensive, this also results in an increase in taxes collected.

#### 4. Analysis of state economic support from a fiscal point of view

Calculations of the EU network of independent fiscal institutions show that Latvia's stimulus policy during Covid-19 was the most moderate among the Baltic States. Latvia's discretionary measures related to the Covid-19 crisis were only 3% of GDP, while in Estonia and Lithuania they were 5.3% and 21.4%, respectively. It should be noted that Lithuania's discretionary package is so large because 13 percentage points of the measures are related to a five-year plan for a large investment, which was accelerated by the Covid-19 crisis and formally included as a discretionary measure. Latvia's expenditure on liquidity measures, which mainly consists of loans and guarantees, was 6.8%, Estonia and Lithuania 9.2% and 6.6%, respectively.

**Figure 4.1.** Amount of fiscal measures in the Baltic States



Source: *The Network of EU Independent Fiscal Institutions (2020)*

Overall, the Fiscal Discipline Council (FDC) welcomes the government's work in overcoming the Covid-19 crisis, although in previous monitoring reports the FDP has repeatedly called on the government to limit additional economic stimulus measures as they directly undermine the fiscal sustainability of the GGBB and the country. However, as the situation is changing, the government's fiscal policy may need to change. With the adoption of the second wave of Covid-19 infection, the need for restrictive measures is growing, which will also slow down economic activity and growth. The FDC calls on the government to monitor closely the spread of the epidemic and to respond appropriately with the constraints that call for fiscal stimulus measures.

Objective data also show the effectiveness of government action. Although Latvia's support program has been less ambitious compared to Lithuania and Estonia, especially in the area of downtime benefits, it has been more effective and will have a lower impact on government debt levels. The Bank of Latvia estimates that Estonia has spent 0.9% of its GDP on downtime benefits, Lithuania 0.8% and Latvia 0.2% of GDP. Despite Estonia's generous downtime benefits, unemployment rose by 3.2 percentage points in Estonia from March to July, while it rose only by 2 percentage points in Lithuania and by 1.7 percentage points in Latvia.

Chairwoman of the Fiscal Discipline Council

Inna Steinbuka