





Weekly Briefing

Latvia economy briefing:
Latvia: the main prospects and challenges of 2021
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Latvia: the main prospects and challenges of 2021

Introduction

Last year 2020 the world has faced a severe challenge that hit every country. It was not possible to forecast such a widespread Covid-19 and all the consequences it brought as it is never possible to predict something uncontrollable by its nature. However, Latvia is fighting the virus as the whole world does, and it is needed to make a prognosis regarding the future of the country's economy in the nearest future. 2021 is going to be a year of recovery after Covid-19 crisis. However, the first half of the year is going to be under restrictive measures, so the improvement of the economic situation is more likely to happen in the second half of 2021.

In general, the Latvian economy suffered less other European countries as measures taken by the government were less strict and friendlier for the maintenance of the economy. Nonetheless, as a result of the pandemic, several significant issues need to be fixed in 2021: vaccination schedule, export recovery, reduction of unemployment, an increase of the consumption among the population, decrement of the government deficit and as a result debt ratio. Besides, the introduction of the mandatory minimum state social insurance contribution rate may negatively impact Latvian economy in 2021.

There is great hope for 2021 not only from the economic point of view but regarding every aspect of the life of society.

Tax reform and its consequences

In December 2020, the Parliament approved the changes in the state budget and taxes for 2021, which put Latvian entrepreneurs in the weak position. In general, local entrepreneurs will practically be forced to cope with the challenges posed by the government in the conditions of the crisis caused by Covid-19.ⁱ According to the changes, the mandatory minimum state social insurance contribution rate (SSICR) was introduced and it was determined that ensuring its amount is the duty of the employer. The minimum amount of the SSICR will be EUR 170, while the minimum wage in the country will be EUR 500.

The law does not provide an opportunity for the contributor to plan its activities in relation to the minimum overall SSICR burden on the company, nor does it offer to introduce the

minimum SSICR gradually, both in terms of the effective date and the expected amount of contributions. The consequences of the introduction of mandatory social insurance will be significant and, unfortunately, negative for the economy of Latvia in 2021.

The law approved by the Parliament does not offer a solution for the participation in the social insurance system also of those persons who are of working age and to whom none of the categories of exceptions provided by law would apply. This will encourage undeclared work and the shadow economy, leaving current envelope wage earners in the shadows and not participating in taxes and social budgeting. New companies in the market are rarely able to generate income in the first years of work, therefore, it will be a huge pressure for entrepreneurs to pay a monthly insurance. Moreover, a lot of entrepreneurs, who have a transparent business will go bankrupt as for many micro enterprises and small businesses the amount of the minimum social contribution is too expensive.

In addition, the Parliament has taken a step closer to increasing the competitiveness of Latvian companies, at least in the Baltic region - by reducing the SSICR rate by 1%. However, the proposed reduction is insufficient to ensure Latvia's international competitiveness, therefore the government's plan to further reduce the labor tax burden by 1 June 2021 plays a crucial role.

Savings rate in Latvia

In 2021, consumer spending might significantly grow. The reason for it not only the elimination of the restrictions but also because people saved more money in 2020 and will be ready to spend more this year. In comparison with September 2019 Latvians saved approximately 4% more in September 2020 (20,76% and 24,63% respectively).ⁱⁱ Besides, the investment market should benefit from the strengthening of the private sector and the construction of *Rail Baltica* (greenfield rail transport infrastructure project to integrate the Baltic States in the European rail network)ⁱⁱⁱ. Export recovery is likely to take longer as Latvia's main export markets are expected to recover more slowly and exports of travel services will not reach pre-Covid levels in the forecast horizon. Overall, according to the European Economic Forecast, GDP is projected to grow by almost 5% in 2021, which should return the economy almost to the level that it was at the end of 2019.^{iv}

State spending and deficit

The general government deficit is forecasted to increase from 0.6% of GDP in 2019 to 7.5% of GDP in 2020. The intense decline was due to the economic plunge and temporary incentive measures, especially in the field of health care and business support. The drop in tax revenues indicates a lower consumption rate and job losses.

State spending is still growing on measures taken in response to Covid-19 pandemics and increasing unemployment expenses. The influence of the measures is predicted at approximately 4% of GDP. Deferred taxes, which are questionable to be collected in 2021, and past tax reliefs are around 0.5% of GDP. Social and employment support measures equal around 0.5% of GDP. Besides, support for various sectors and the provision of loan guarantees are estimated at 3% of GDP. All in all, these expenditures accounted for 8% of Latvian GDP.

In 2021 the government budget deficit is estimated to decline to 3.5% of GDP, because of the elimination of the majority of the Covid-19 restrictive measures. The 2021 budget introduces new measures to enhance revenues and expenditures, which usually have a neutral influence on government balance. The social security contribution rate reduced by 1% in 2020 (-0.3% of GDP) and the income tax exemption threshold raised (-0.1% of GDP).^v On the contrary, the establishment of a minimum mandatory social contribution and an increase in micro-enterprise tax are projected to add approximately 0.3% to GDP. The government-owned energy company is expected to return a higher dividend of 0.3% of GDP. Salaries and wages increase as well as minimum social benefits for health care workers account for most of the rise in spending.

According to the CEIC data, Latvian debt to GDP ratio was 42.9% in June 2020 (the latest available data), which is 5.4% more than in the corresponding period of 2019 (37.5%).^{vi} The main reason for such an increase is the GDP drop and government deficit. However, it is estimated that debt ratio will be reduced in 2021 and 2022, mainly because of the recovery of the economy (decline of the governmental debt, a partial reduction in the large monetary resources accumulated in 2019 and 2020).

Summary

2021 have to be an intense, precise, and fruitful year to improve Latvian economy, which is still influenced by the Covid-19 pandemic. The main priority for the first half of the year is to complete the vaccination. After that, it would be possible to eliminate restrictive measures and recovery of the country's economy.

The big challenge for Latvian economy is the introduction of the mandatory minimum state social insurance contribution rate, which may have a significant negative impact on the micro-enterprises and small businesses in Latvia. Due to this change, a plethora of enterprises are at the risk of bankruptcy in 2021 or will be forced to switch their activity to the shadow economy. Both options will make a negative influence of the economy of Latvia in general.

Latvians had more saving last year, because of the crisis situation. It is predicted that this year consumption of the population will increase and, therefore, stimulate economic growth. However, export recovery is not going to be a fast process as many countries, trade partners of Latvia, faced much more severe consequences of the Covid-19 crisis. Even with these difficulties, the GDP rate of Latvia is projected to grow by 5% in 2021, which is almost the pre-Covid level.

State deficit has significantly increased in 2020, so there is a necessity to reduce it in 2021. For this reason, the Latvian government will take serious measures to eliminate unemployment rate, enhance revenues and expenditures, cancel restrictive measures, and debt ration of the country.

ⁱ Latvijas Tirdzniecības un rūpniecības kamera. (02.12.2020). Nodokļu reforma bez uzņēmēju atbalsta. Available at: <https://www.chamber.lv/lv/content/jaunumi/4902>

ⁱⁱ CEIC DATA. (2021). Latvia Gross Savings Rate. Available at: <https://www.ceicdata.com/en/indicator/latvia/gross-savings-rate>

ⁱⁱⁱ Rail Baltica official website. Rail Baltica – Project of the Century. Available at:

<https://www.railbaltica.org/about-rail-baltica/>

^{iv} European Commission. (November 2020). European Economic Forecast. Available at:

https://ec.europa.eu/info/sites/info/files/economy-finance/ip136_en_2.pdf

^v The Baltic Course. (27.11.2020). Social security contributions in Latvia to be cut by 1 pp in 2021. Available at: <http://www.baltic-course.com/eng/legislation/?doc=161033>

^{vi} CEIC DATA. (2021). Latvia Government Debt: % of GDP. Available at: <https://www.ceicdata.com/en/indicator/latvia/government-debt--of-nominal-gdp>