2024

Stability Programme of Latvia 2024–2028

Finanšu ministrija

RIGA

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COMMONLY USED ABBREVIATIONS

Altum	JSC Development Finance Institution Altum
BoL	Bank of Latvia
Cabinet	Cabinet of Ministers
CFCA	Central Finance and Contracting Agency
CIT	Corporate income tax
CPI	Consumer Price Index
CSB	Central Statistical Bureau
DRM	Discretionary Revenue Measures
EC	European Commission
ECB	European Central Bank
EPC AWG	The Working Group on Ageing Populations and Sustainability (AWG) of the Economic Policy Committee (EPC)
ESA	European System of Accounts
ESI	Economic Sentiment Index
EU	European Union
FFA	Foreign Financial Assistance
FDL	Fiscal Discipline Law
FDC	Fiscal Discipline Council
FRD	Fiscal Risks Declaration
FSP	Fiscal Structural Plan
GDP	Gross Domestic Product
HICP	Harmonized Index of Consumer Prices
IMF	International Monetary Fund
LALRG	Latvian Association of Local and Regional Governments
LBFM	Law on Budget and Financial Management
MoD	Ministry of Defence
MoE	Ministry of Economics
MoF	Ministry of Finance
MoW	Ministry of Welfare
PIT	Personal Income Tax
PMI	Purchasing Managers' Index
RRF	Recovery and Resilience Facility
SRS	State Revenue Service
SSIA	State Social Insurance Agency
SURE	Support to mitigate Unemployment Risks in an Emergency
USA	United States of America
VAT	Value added tax

1. INTRODUCTION

Stability Programme of Latvia for 2024-2028 is based on the conditions and guidelines for the implementation of the Stability and Growth Pact and is prepared in accordance with the requirements of EU Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies.

This Stability Programme is the last one that Latvia is preparing and submitting to the European Commission (EC). The new EU fiscal policy framework, which no longer requires the preparation of a Stability Programme and a National Reform Programme, is expected to enter into force in May 2024. Instead, a Fiscal Structural Plan (FSP) will be prepared every four years. The first FSP will be prepared already this year and submitted to the EC on 15 October together with the Draft Budgetary Plan for 2025. This Stability Programme is therefore prepared in a transition period, when the current fiscal policy framework is in place and will change significantly in the near future.

So far, the Stability Programme has been prepared as a "snapshot" of current macroeconomic and fiscal projections, with deficit targets and fiscal space set under the current fiscal conditions. This time, the Stability Programme has been prepared to incorporate, as far as possible, the fiscal provisions of the new EU framework. First, it does so by extending the Stability Programme's projection period from three years to four years, thus aligning it with the period of the first FSP from 2025 to 2028. Second, it does so by calculating fiscal targets not only in line with the provisions of the Fiscal Discipline Law (FDL), but also in line with the new EU fiscal rules. Hence, this Stability Programme not only presents the macroeconomic and fiscal projections at no-policy change scenario, but also provides information on the main fiscal indicators of the FSP. The Stability Programme will also serve as a valuable reference material for the negotiations with the EC on Latvia's FSP for the period 2025-2028.

2024 is characterised by a return to growth, a sharp decline in inflation, stabilising energy prices, a resilient labour market and, overall, the resilience of the national economy to external economic shocks. Sustainability can be also talked about in the context of fiscal policy. Although the general government deficit is close to the 3% of gross domestic product (GDP) threshold, most of it is made up of one-off expenditure related to the country's internal and external security. The structural deficit is close to the 0.5% of GDP threshold, making public debt sustainable. Unfortunately, investment in internal and external security is necessary – both to ensure the security of the country's citizens and to create the necessary conditions for economic development.

According to the February 2024 forecast, Latvia's GDP will grow by 1.4% in 2024, with economic growth accelerating to 2.9% in 2025. The GDP growth forecast for 2024 has been revised down by 1.1 percentage points, while the forecast for 2025 is unchanged. Economic growth will slow slightly over the next three years, to 2.5% in 2026 and 2.3% by 2028.

With the sharp decline in global energy and other commodity prices having a stabilising effect on other commodity prices, as well as the European Central Bank's (ECB) tight policy of containing inflation, Latvia's inflation forecast for 2024 has been lowered to 1.6%. In the previous forecasts, prepared in June 2023, the Ministry of Finance (MoF) had projected a price increase of 2.2% for 2024. Over the medium term, inflation is projected to stabilise around 2.5% by 2028, in line with the rate of price inflation in a converging country.

After a period of rapid deficit reduction, when the general government deficit fell from 7.2% of GDP to 2.3% of GDP between 2021 and 2023, the deficit rises significantly to 2.9% of GDP in 2024, close to the Maastricht threshold of 3% of GDP. In the no-policy change scenario, the general government deficit is projected at 2.7% of GDP in 2025, 2.2% of GDP in

2026, 2.0% of GDP in 2027 and 1.7% of GDP in 2028. Weaker growth and inflation-driven revenue dynamics, public sector wage increases, rising health spending and the need for a rapid and substantial increase in spending on internal and external security have all had an impact on the deficit. It should be noted that the 2024 deficit level is not surprising as a deficit of 2.8% of GDP was already planned when the 2024 budget was prepared.

With the EU's general escape clause abrogated as of 2024 and the new fiscal Rules in place as of 2024, the high level of the deficit in 2024 and its relatively slow reduction in a no-policy change environment point to a strained public finances in the coming years.

2. Economic Situation

2.1. External Economic Environment

Global economic growth, after a strong recovery from the Covid-19 pandemic, slowed to 3.5% in 2022 and fell to 3.1% last year, according to the latest estimates by the International Monetary Fund (IMF) in January this year. The global economic situation since February 2022 has been shaped by Russia's war in Ukraine and the energy crisis it has triggered, pushing up energy prices and overall inflation and, together with rising interest rates, slowing economic growth significantly. Although inflation rates started to decline sharply in 2023, central bank interest rate cuts have not yet followed and economic growth will remain at historically low levels in 2024. According to IMF forecasts, the world economy is expected to grow by 3.1% this year, accelerating only slightly to 3.2% in 2025, still below the long-term average.

The situation is similar in the EU and the *euro* area, where economic growth has weakened even faster. In the EU-27, after a 3.4% increase in 2022, GDP grew by only 0.4% last year, with some EU economies experiencing a contraction, including Latvia and the other Baltic countries, as well as Latvia's important foreign trade partners Sweden, Germany and Finland (see Figure 2.1.).

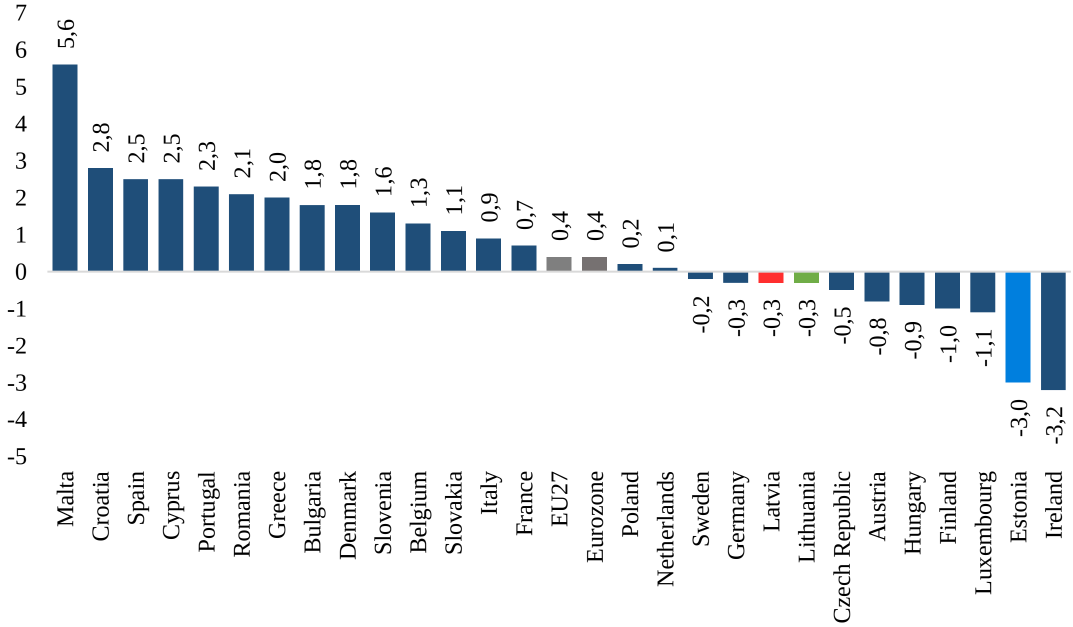


Figure 2.1. GDP change in EU countries in 2023, % compared to the previous year

EU economies will continue to grow weakly in 2024, rising to 0.9% according to the latest EC forecasts, but still below the long-term average. This growth is also 0.4 percentage points lower than the EC's previous forecast in November last year. The EU economy is also expected to grow at a significantly lower rate than in the US, where the IMF's latest forecasts suggest GDP growth of 2.1% this year. In 2025, the EU economy is projected to grow faster to 1.7% as interest rates are cut and inflation eases, and the US economy is projected to grow at the same rate.

The combined weighted average growth forecasts for 2024 of Latvia's ten main foreign trade partners – Lithuania, Estonia, Germany, Russia, Sweden, the UK, Denmark, Poland, Finland and the Netherlands - are slightly higher than for the EU as a whole at 1.2%, but down 0.3 percentage points compared to last autumn's forecast.

The leading business and consumer confidence indicators do not yet signal a return to strong economic growth in Europe. The EC's Economic Sentiment Index (ESI), which fell sharply in 2022 as a result of the war and the energy crisis, has started to stabilise since mid-2023, rising slightly in recent months. However, the dynamics of improvement are so far very subdued and business and consumer sentiment remain more negative than the long-term average.

The euro area Purchasing Managers' Index (PMI), a leading indicator of economic output, has also stabilised but remains below the 50 mark, indicating an economic decline. However, it shows the smallest drop since June 2023 and rose to 49.9 points in March 2024 compared to 49.2 points in February. Growth could therefore be expected to pick up in the coming months, ending a ten-month downturn.

The acceleration in economic growth and the improvement in confidence are largely linked to the fall in energy prices and the stabilisation of inflation, which also point to a decline in interest rates as central banks have completed their interest rate hiking cycle. The US Federal Reserve has already signalled three upcoming interest rate cuts this year, and the ECB is also planning rate cuts, which market participants expect to start in mid-2024. Inflation in the *euro* area, after peaking at 10.6% in October 2022, has declined to 2.6% in February 2024, but is still slightly above the ECB's target inflation rate of close to but just below 2%. For 2024 as a whole, the EC forecasts price inflation for the *euro* area at 2.7%, compared to 8.4% in 2022 and 5.4% in 2023.

2.2. Current Economic Development[1]

Up to 2022, the economy of Latvia had weathered both the Covid-19 pandemic and the Russian-led war better than initially forecast, but in 2023 the negative impact of the external environment became more pronounced, with Latvia's GDP contracting by 0.3% compared to the previous year as demand in external markets fell.

The economic slowdown in 2023 was mainly driven by low economic growth globally and in Latvia's main foreign trade partners, where growth was held back by Russia's war in Ukraine and rising energy prices, as well as interest rate increases as central banks sought to contain inflation. As a result, Latvia's exports of goods and services fell by 5.9% in 2023, particularly in the export-oriented manufacturing sector, which declined by 5.2%, and in the transport and storage sector (-7.8%), which was further affected by the loss of Russian cargo transit.

At the same time, domestic demand remained relatively strong, with investment and construction growing particularly strongly, by 8.2% and 18.6% respectively. Public consumption increased by 7.0%, driven by education and arts, entertainment and recreation, which grew by 7.8% and 11.7% respectively. The 1.3% decline in private consumption is also relatively moderate, given the sharply higher price level, which was offset by the savings built up during the Covid-19 pandemic, the government's energy support measures and faster pension indexation in the second half of 2022. The contributions of the expenditure side components, including exports, imports, investment and private and public consumption, to GDP growth are summarised in Figure 2.2.

[1] The description uses data from the CSB and other sources available until 25 March 2024.

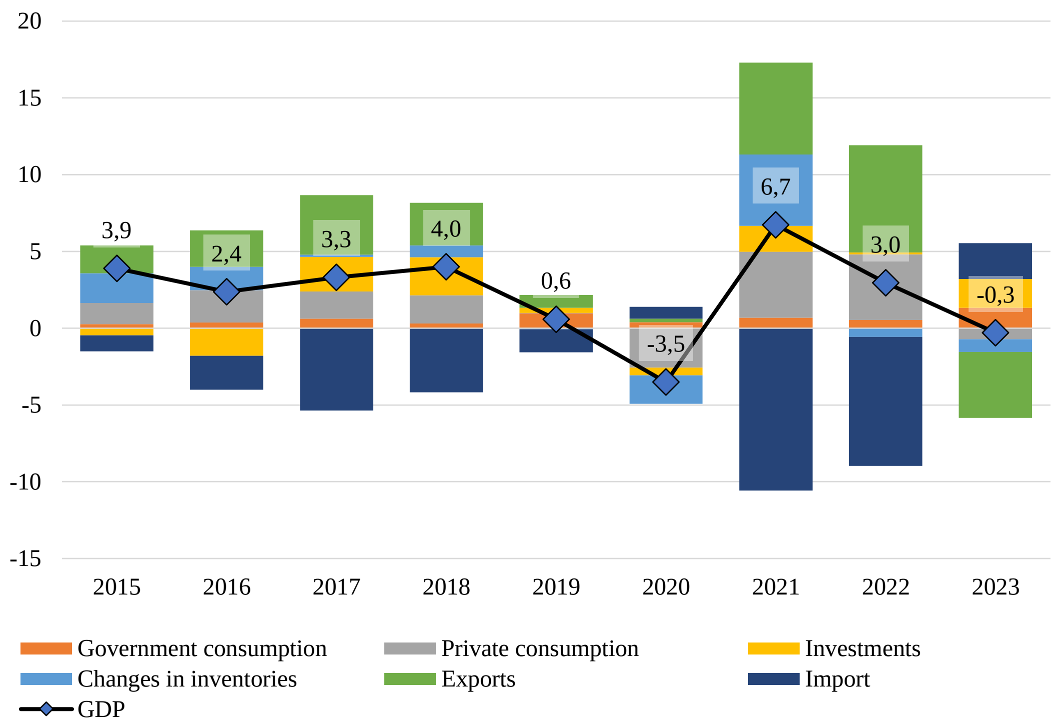


Figure 2.2. Contribution of expenditure-side components to GDP growth, percentage points

In 2024, Latvia's economic development will continue to be determined mainly by the situation in external markets, above all in the *euro* area, where economic growth is forecast to be stronger than last year, although still at historically low levels. Economic growth in the *euro* area is currently being held back by high interest rates, but interest rates are expected to come down in line with easing inflation, which will have a positive impact on *euro* area growth. As price inflation stalls, the purchasing power of the Latvian population will continue to recover, with wage growth already significantly outpacing price inflation and creating the conditions for private consumption to pick up. The implementation of large investment projects and the increase in EU funding will also play a key role.

At the same time, uncertainty and external risks remain very high, in particular with the geopolitical situation and the war in Ukraine, as well as with the development of the *euro* area economy and the global situation in general, which hinder investment decisions and undermine consumer confidence.

Sectoral development

In 2023, the value added **of the industrial sector** in constant prices has fallen by 4.6%, while the value added of manufacturing, which accounts for 81.5% of all industry, has fallen by 5.2%. Producer prices rose further in the first half of 2023 as energy prices fell, but were already lower in the second half than a year earlier. The most limiting factor for companies in the sector in 2023 was clearly insufficient demand for Latvian products, due to Europe's weak economic growth, as well as Latvia's still high production costs. A large part of Latvia's exports are destined for the European construction sector, but rising credit interest rates are weakening construction demand, causing residents and businesses in Latvia's main export partner countries to postpone construction projects until credit conditions become more favourable.

Both industrial and manufacturing output in 2023 is down 4.5% on 2022, the largest contraction since 2009. Production in 2023 was higher at the beginning and end of the year, with the summer months showing the biggest drop. The largest Latvian manufacturing sub-sector, the wood industry, was the most negatively affected, with a contraction of 7.8% in 2023.

Other large sectors such as non-metallic minerals and fabricated metal products also contracted, by 16.4% and 5.7% respectively. Printing and reproduction of records also declined by 28.3%, while furniture manufacturers also had a difficult time, with output falling by 20.2%. At the same time, the food sector (+4.5%), which grew by the most since 2017, prevented manufacturing from falling further. Also increasing were the manufacture of computers, electronic and optical equipment (+16.7%), the manufacture of electrical equipment (+13.1%), the manufacture of machinery and machine tools (+5.3%) and repair and installation of machinery and equipment (+27.1%). Technical products such as computers and electrical equipment are more often high value-added, providing more demand at a time when demand for low value-added goods has fallen.

The electricity and gas supply sector, which accounts for 15.7% of total industry, shrinked by 11.5% in 2022 due to rising electricity and gas prices. Although energy prices fell in 2023, consumption did not increase and the sector contracted by a further 0.8%. Meanwhile, mining, which accounts for only 2.8% of all industry, has also suffered from low demand, with production down 19% in 2023.

Future trends in manufacturing will depend on the economic growth rates in Latvia's major trading partners. Producers point to very low demand, which will start to recover as the economic situation in the EU countries improves.

The rapid growth of **the construction sector** in 2023 has also significantly improved the situation of the economy as a whole. After value added reductions in 2020-2022, the construction sector's value added has increased by 18.6% in 2023 in constant prices. The industry has come out of a period of soaring construction costs, which often led to the suspension of ongoing construction projects when the parties could not agree on changes to the terms of contracts. Construction volumes in 2023 have grown slightly more than value added compared to the previous year (+18.9%), and are roughly in line with the 2019-2020 average, when EU funds from the 2014-2020 cycle were most actively invested. Future construction volumes will also depend on the ability to successfully use the funds for the next funding cycle (2021-2027). At the same time, rapid absorption of EU funds could risk overheating the sector, which could manifest itself in labour shortages.

The **transport and storage sector** was one of the hardest hit by the pandemic and was also more severely affected than others by Russia's war in Ukraine and trade restrictions. In 2022, the transport sector grew by 3.0%, driven by a recovery in passenger traffic after the Covid-19 restrictions, but in 2023 the sector experienced a 7.8% decline, with passenger traffic growth no longer able to compensate for losses in freight transport, in particular the decline in Russian rail and port transit.

The number of passengers at Riga Airport in 2023 increased by 23.2% compared to the previous year and reached 6.6 million, however, it still fell short of the 2018-2019 level, when the number of passengers at the airport exceeded seven million. Land transport passenger numbers increased by 15.4% and seaports handled 1.4% more passengers than in 2022.

At the same time, port freight turnover fell by 19.6% and rail freight by 27.5%. The drop in freight volumes was mainly due to the loss of transit of Russian energy products, and at 38.7 million tonnes, port throughput was only half the level of 2012, when throughput was at its peak. Rail freight volume fell to 15.4 million tonnes, just a quarter of the 2012 level. In 2023, road freight transportation volume declined by 3.5%, with international traffic falling, while domestic freight transportation volume continued to grow.

The situation remains similar in early 2024, with passenger traffic continuing to recover and freight transit volumes declining. The industry as a whole will struggle to show significant growth in 2024, and this may be based solely on a pick-up in domestic demand. In January, the number of passengers at Riga Airport increased by 1.3% compared to January 2023, cargo turnover in ports was 14.9% lower in two months than a year ago, while rail freight dropped by 23.7%.

The **trade sector** in 2023 was negatively affected mainly by volume declines in wholesale trade, which in turn were driven by volume declines in the industrial sector, declining exports and a significant decline in trade with aggressor countries. On the other hand, the fall in retail sales also had an additional negative impact, as the increase in prices exceeded the increase in the income of the population. At the same time, the smaller auto/moto trade sector continued to show growth. Total value added in the trade sector in constant prices fell by a further 5.1% last year, after a 6.1% decline in 2022.

Wholesale volumes decreased by 11.3% in 2023, following a 9.8% decline in 2022, mainly due to the exclusion of large Russian partners from the Latvian market. In 2023, the further decline was driven by low economic growth in Europe and Latvia, with declining industrial volumes, imports and exports.

Retail sales declined by 1.9% in 2023, mainly due to a sharp increase in prices in the second half of 2022, which was not as strong in 2023, but wage growth lagged far behind price increases, so people cut back on both food and non-food (excluding fuel) purchases. In contrast, fuel trade volumes have increased, driven among other factors by falling oil prices. In addition, people's spending on goods was constrained by the rising cost of credit, and households' declining savings also signalled a deterioration in their financial situation in 2023.

Meanwhile, the trade sector was prevented from further declines, with auto/moto trade volumes growing by 12.5% in 2023, compared to a 9.8% increase in 2022. The share of auto/moto trade in 2022 was 12%, while wholesale and retail trade accounted for the bulk of the trade in roughly equal shares.

In 2024, wholesale growth may be boosted by industrial growth, while retail sales will be boosted by an increase in people's purchasing power in the second half of 2024, when housing bills fall, credit payments start to decline and wage growth has caught up with previously soaring prices.

The **accommodation and catering sector** has been hit hard in recent years by both pandemic restrictions and Russia's war in Ukraine, reducing the number of foreign tourists both from the sanctioned aggressor countries and from further west, as their travellers worry about increased security risks. In 2022, tourist arrivals started to recover after the pandemic and in 2023 growth continued, but at an increasingly slower pace and the sector has still not returned to pre-pandemic levels. The sector's value added increased by 7.4% in 2023 compared to the previous year, after having grown by 57.3% in 2022.

In 2023, a total of 4.4 million nights were spent by domestic and foreign guests in Latvian tourist accommodations, which was 12.6% more than in 2022. The number of nights spent by foreign guests increased by 22.0%, while the number of nights spent by domestic guests increased by 1.3%. At the same time, the number of nights spent by foreign visitors remained 33.1% lower than before the pandemic in 2019, while the number of nights spent by domestic visitors increased by 8.1% over the same period.

The **agricultural sector** experienced an 8.1% drop in value added in 2023, due to both frost and drought damage. Harvesting was hampered by rain and heavy storms, which had the biggest negative impact on small and medium-sized farms. The disruptive factors were also reflected in 2023 wheat and rye exports, (-13.9% vs. 2022) in volume terms, while planted area has not changed significantly since 2021, standing at 1 303 thousand hectares.

Investments

In a context of high inflation and falling external demand, public consumption and investment played an important role in boosting economic activity in 2023. It was investment that grew the most compared to the other components of GDP. Last year, investment in Latvia increased by 8.2% in constant prices and totalled EUR 7 112 million, contributing 1.8 percentage points to GDP growth, thus slightly mitigating the negative impact of the decline in private consumption and exports. Thanks to the strong growth, investment as a share of GDP rose by 2.1 percentage points to 24.1%. This level of investment in the economy is higher than both the EU average and the average share of Latvian GDP in recent years. This is positive, but it is important to maintain a high share of investment in the economy over the long term to boost competitiveness and productivity.

Analysing the change in investment by type of fixed asset, the increase in investment was driven by higher activity in the construction sector. Investment in other fixed assets, on the other hand, has declined, reflecting the uneven development of economic sectors over the past year.

In 2023, investment in the construction of dwellings and other buildings and structures, as well as in the renovation of existing buildings and structures, increased by 18.9% or EUR 495 million in constant prices, reversing the decline in investment in these fixed assets since 2019. Last year, investment in construction and renovation reached EUR 3 110 million, close to the 2018 level. The increase in investment in these fixed assets is closely linked to the activity of the construction sector, where output increased by 18.9% in 2023. Several factors contributed to the strong growth in construction investment and output last year. First, the low base in 2022 due to weak activity in previous years. Second, significantly more investment inflow from the EU Structural Funds and the European Recovery Fund. Third, private sector investment also increased significantly. According to the MoF's assessment, in 2023 the gross fixed capital formation or investment of the general government in current prices amounted to EUR 1 643 million, which was 8.5% more than in the previous year. By contrast, investment by the private sector and by non-general government enterprises owned by the state or a local government increased by 16.4%.

Investment in the construction of dwellings and other buildings and structures, as well as in the renovation of existing buildings and structures, is expected to continue to increase in 2024, but at a more moderate pace than in 2023. Several factors could limit the pace of investor activity in the construction of offices, housing, warehouses and other buildings, as well as in the renovation of existing buildings and structures this year. First, the still high construction costs. Producer and consumer price inflation have fallen substantially since the end of 2022, when inflation reached a very high level due to the sharp rise in commodity prices. Construction costs followed. In 2023, construction costs increased by 5.8%, compared to a 19.7% increase in 2022. Cost increases in 2023 were fixed for all resource types. Thus, workers' wages rose by 7.7%, the cost of maintaining and operating machinery and other equipment increased by 7.1% and the cost of construction materials rose by 4.6%, more than five times lower than in 2022. Looking at the January 2024 data, the overall rate of increase in construction costs continued to decline, while the construction materials component recorded deflation, which is positive. However, the level of construction costs remain high and, in a context of general economic slowdown, remain a barrier to investment projects. Second, it is high interest rates that keep the cost of servicing corporate loans high. All the conditions are now in place for the ECB to start cutting interest rates. However, even if this happens in the first half of 2024, the reduction in interest rates on the main refinancing operations will be moderate and gradual. Thus, 2024 can also be safely described as a year of high interest rates overall. Third, the potential slower-than-expected flow of EU Structural Funds investments in the new programming period 2021-2027.

Investment in machinery and equipment in 2023 amounted to EUR 3 286 million at constant prices, down 0.3% on the previous year. Information on the composition of investment in these fixed assets is limited and precise data are only available for transport equipment. Investment in transport equipment, which accounts for just under a third of total investment in this group, grew by 28.1% last year, a very sharp increase. On the basis of this information, it can be concluded that investment, or part thereof, in fixed assets such as information and communication equipment, weapon systems and other technological equipment, has declined significantly. According to foreign trade data, imports of cars, rail and aircraft and other motor vehicles also increased significantly in 2023, which generally explains the sharp rise in investment in transport equipment. Despite the fact that investment in construction projects has increased significantly and investment in machinery and equipment has fallen, investment in machinery and equipment still accounts for the largest share, 46.2% of total investment, while investment in buildings and structures accounts for 43.7%.

The most recent survey of manufacturing entrepreneurs shows that 33.1% of planned investments in 2024 will be aimed at expanding production. This is a significant figure, as it is the highest since such statistics started to be collected in 2004. In addition, it is important to note that for the first time in the 21-year period, investment earmarked specifically for business expansion accounts for the majority of planned investment. Until 2024, most of the investment was focused on replacing old equipment, accounting for almost 40% of all planned investment. This year, the share has fallen to 32%. On the positive side, the share of investments focused on rationalisation increased. Although the data show a positive trend, which could be indicative of the development of the manufacturing sector, such data should be interpreted with caution, as they only reflect the intention to invest, not the actual investment made. Efficiency and productivity are important issues in the context of investment. To boost productivity, investment in process efficiency needs to be further increased. In countries such as Germany and the Czech Republic, where GDP per capita is significantly higher than in Latvia, manufacturing companies spend more than a third of their investments on streamlining production processes.

Foreign trade

In 2023, a decline in foreign trade activity was observed worldwide, including in the EU, Latvia's main export market for goods and services. Weak economic growth in the EU, which was simultaneously negatively affected by high inflation, high interest rates and other economic and geopolitical factors, significantly reduced economic activity, resulting in lower external demand for Latvian exports in major EU markets. As a result, Latvia's exports of goods and services in 2023 have fallen for the first time since 2010. The **total value of exports** in 2023 was EUR 19 667 million in constant prices, down 5.9% on the previous year. This was one of the sharpest declines in exports among EU Member States. Only Estonia saw an even sharper fall in exports of goods and services last year – by 6.9%. Lithuania's export value fell by 4.8%. This shows that the Baltic countries felt the fall in external demand most acutely in 2023. In addition, GDP also decreased last year in all the Baltic countries, largely due to a fall in exports.

The value of Latvia's imports of goods and services also fell by 2.9% in 2023, driven by a fall in imports of intermediate consumption goods due to lower manufacturing activity. With exports of goods and services having fallen faster than imports, the external trade balance is set to deteriorate in 2023. The contribution of foreign trade to GDP growth was thus negative, at -2.1 percentage points, significantly higher than in 2022, when net exports contributed -0.9 percentage points. The fall in exports and imports last year was steeper than the contraction in GDP, so the role of foreign trade in the economy has declined. Exports as a share of nominal GDP fell by 8.8 percentage points to 64.1% in 2023. Imports accounted for 68.0% of the national economy last year, down 9.5 percentage points compared to 2022.

Assessing Latvia's export development in 2023 **by commodity group**, it can be concluded that a decline was recorded for most export groups. Overall, the value of goods exports in current prices fell by 10.9% last year. Mineral products, wood and wood products were the main commodities contributing to the decline in exports. The fall in exports of these groups of goods last year explains 88% of the total fall in exports. These commodity groups were among the main drivers of exports in 2022, boosted by high oil, gas and timber prices. In 2023, however, the prices of these goods have fallen substantially, reducing the value of their exports. Thus, the value of exports of mineral products in 2023 declined by 45% or EUR 1240 million, driven by a 42% (EUR 186 million) and 55% (EUR 655 million) decline in re-exports of oil products and gas, respectively, and a 55% (EUR 374 million) decline in exports of electricity. The largest declines in exports of these energy sources were recorded in export markets such as Lithuania, Estonia and Finland.

Exports of wood and wood products fell by 22% last year (EUR 806 million). Although the fall in exports of this group is smaller than for mineral products, its negative impact on the economy as a whole, and in particular on the manufacturing sector, is greater. This is also due to the fact that exports of wood and wood products are based on local production using local labour and raw material resources, while for mineral products, most of the raw materials re-exported are originally imported from other countries. On the negative side, the decline in exports of wood and wood products is widespread and recorded in all subgroups – processed and unprocessed wood, particle board, plywood and other products. In terms of export markets, the decline in exports of wood and wood products is also widespread, with declines recorded in all major markets, including exports to the United Kingdom, Estonia, Lithuania, Poland, the Netherlands, Germany, Sweden and Finland.

Exports of metals and articles thereof also declined significantly, with the value of exports in 2023 16% (EUR 227 million) lower than in 2022. In this commodity group, too, the decline in exports is widespread and is recorded for waste iron and steel as well as for articles of iron and steel.

Latvia's export structure is dominated by low value-added goods such as mineral products, wood and wood products, iron waste and scrap, and cereals, the prices of which can fluctuate significantly on world markets. This also exposes Latvia's total merchandise exports to the significant fluctuations observed in recent years.

Among the major export groups, exports of agricultural products and foodstuffs, as well as of mechanical and electrical machinery and equipment increased by 1.2% (53 million) and 1.2% (EUR 35 million) respectively, thus slightly mitigating the overall decline in exports.

Unlike exports of goods, **exports of services** continued to expand in 2023, albeit at a more moderate pace than in 2022. In 2023, the value of services exports in real prices was 3.8% or EUR 273 million higher than in 2022.

Of all services provided to foreigners, tourism services saw the fastest growth. Foreign tourist expenditure in Latvia in 2023 grew by 15.5%. This growth was driven by higher numbers of foreign tourists, which benefited from the World Ice Hockey Championships in Riga, the recovery of the tourism industry from the pandemic, and high inflation, which pushed up the prices of services. The number of foreign guests in Latvian hotels and other tourist accommodations reached almost 1.4 million last year, which was 22% more than in 2022. However, the number of foreign tourists is still about a third below its pre-pandemic level.

Exports of transport services also increased, by 2.1% overall. However, growth in this service group was also driven solely by tourism-oriented activities. Of all transport services provided to foreigners, only exports of air transport services increased, by 31.3% overall. Exports of maritime and rail transport services fell by 28.8% and 14.7% respectively. Exports of road transport services, the largest group in transport services exports by weight, fell by 7.1%. Among other services, exports of information and computer services rose by 2.3%, and exports of construction services by 8.5%. Exports of financial services fell by 13.5%.

When assessing Latvia's export prospects in 2024, several things should be noted. First, global commodity prices have stabilised, so this factor has had a transitory effect on Latvian exports. However, negative price effects on exports could be felt early this year due to base effects. Second, economic growth in Latvia's trading partners is an essential ingredient for the future development of exports. Weak economic growth in the EU is dampening external demand overall. The latest EC macroeconomic forecasts, updated in February this year, show that EU GDP will grow by 0.9% in 2024. The EU market accounts for three quarters of Latvia's total exports, so economic activity in the largest export market is an important indicator for assessing future export development. Economic growth in the EU in 2024 is projected to be higher than in the previous year, but at a lower rate than in previous EC projections. This shows that the effects of high inflation, as well as geopolitical shocks, continue to weigh on the European economy. The ECB is also expected to start cutting interest rates in the second half of the year, which could have a positive impact on household and business activity. Looking at the most recent EU economic confidence indicators, they remain at low levels. The EU Economic Sentiment Indicator has been below 100 points since July 2022. Businesses and consumers are pessimistic about economic activity in virtually all EU Member States and in all sectors, including industry and construction, which are the most important for Latvian exporters. Therefore, it can be concluded that Latvian exports of goods in the first quarter of this year will remain close to last year's level. From the second quarter onwards, exports are expected to pick up slightly, mainly due to the low base in 2023, but growth in exports of goods could accelerate in the second half of 2024.

An analysis of the dynamics of **imports of goods** in 2023 shows that they were similar to those of exports. While imports of goods were still on the rise at the beginning of 2023, imports of goods have been declining in annual terms since March 2023. Overall, imports of goods in current prices are set to fall by 12.3% in 2023. The most significant negative contribution to the fall in imports of goods was a 52.2% or EUR 2 899 million decrease in imports of mineral products, due to both lower energy prices and lower consumption of natural gas. Imports of metals and articles of metal products, as well as wood and wood products, also decreased significantly, by 18.5% or EUR 333 million and 36.8% or EUR 332 million respectively.

At the same time, the value of agricultural and food imports increased significantly in 2023, by a total of 10.2%, driven by growth in imports of alcoholic beverages, meat products, vegetables, cereals and other food products. Imports of transport goods, i.e. cars, tractors and trains, increased by 17.5%.

The value **of imports of services** increased by 8.6% in 2023, driven by almost all major types of services. The increase in imports of air and road transport services led to a 5.1% increase in the value of imports of transport services. Latvian residents' spending abroad increased by 18.6% or by EUR 179 million, which was the highest increase among all types of services. Significant import growth was recorded for construction and financial services, as well as telecommunication and computer services, by 30.4%, 13.4% and 7.7% respectively.

Current account

In 2023, the current account deficit of the balance of payments has narrowed compared to the previous year, but remains high. Last year, the current account deficit was EUR 1 617 million, or 4.0% of GDP, compared to 4.7% of GDP in 2022. The improvement in the current account balance was driven by an increase in the surplus on the secondary income account and a narrowing of the deficit on the goods account. The secondary income account surplus increased by EUR 380 million to EUR 885 million, thanks to higher income from abroad received by both businesses and households, as well as higher investment flows from EU structural funds. The value of both exports and imports of goods fell last year. However, the fall in imports of goods was slightly larger, which had a positive impact on the balance of this account, reducing the deficit by EUR 357 million to EUR 3 736 million. While this is positive, the deficit of the goods account remains significant, which also determines the large deficit of the current account. The goods account deficit in 2023 is EUR 1 billion higher than in 2021 and more than EUR 2 billion higher than in 2020. The goods account deficit in recent years has been driven by the high value of imports, caused by a sharp rise in prices, especially for energy, which Latvia mostly imports.

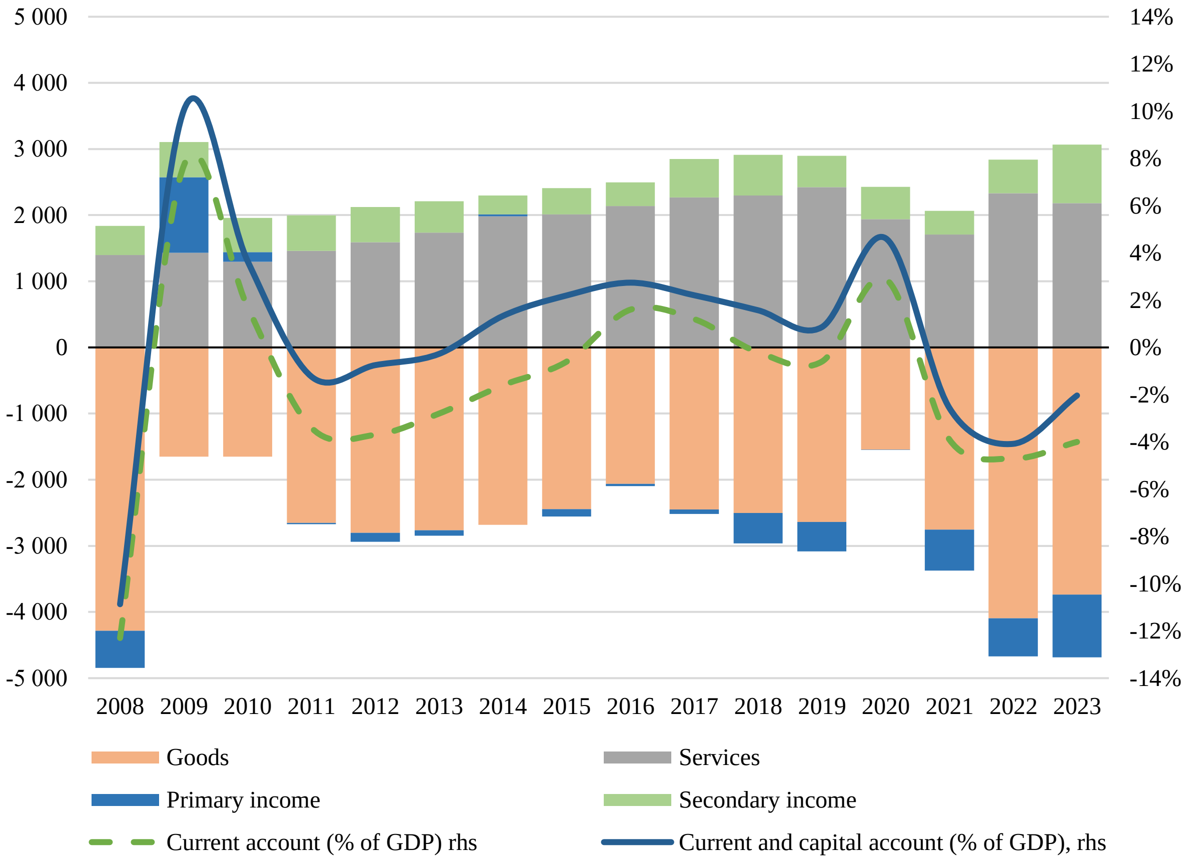


Figure 2.3. Current account components of Latvia's balance of payments (million EUR), current and capital accounts as a percentage of GDP

The services account and the primary income account has deteriorated in 2023. Despite continued growth in services exports in 2023, services imports have grown faster, reducing the account surplus by EUR 150 million to EUR 2 182 million. Looking at the total value of foreign trade, the overall balance of foreign trade in goods and services in 2023 is set to improve slightly, both in nominal terms and relative to GDP. The overall deficit on foreign trade in goods and services amounted to EUR 1 554 million, or 3.9% of GDP. The primary income account balance was negatively affected by higher dividends paid to foreign investors, as well as other payments abroad related to higher loan repayments. As a result, the deficit on this account widened by EUR 372 million to EUR 949 million.

Inflation

Inflation has been the focus of increased attention in Latvia and other countries around the world over the past year, as rapid consumer price inflation, which started in 2022, has had a significant impact on the global economy and reduced people's purchasing power.

In January and February 2023, Latvia was the only euro area country with annual inflation above 20%, well above the euro area average. However, 2023 was notable for the fact that inflation in both the euro area and Latvia has slowed down every month since the start of the year. As a result, the harmonised index of consumer prices (HICP) in Latvia fell from 21.4% in January to 0.9% in December. Meanwhile, average inflation in the euro area was 8.6% in January 2023 and 2.9% in December. This would bring average inflation (HICP) in Latvia to 9.1% in 2023, compared to 5.4% in the euro area. Overall, the deceleration of consumer price growth in Latvia at the end of 2023 was significantly faster than the euro area average, putting

Latvia in the group of countries with the lowest inflation. It should be noted that this sharp slowdown in inflation is largely due to base effects, as consumer price growth in Latvia was among the highest in the euro area at the end of 2022. The evolution of the HICP in the EU Member States is shown in Figure 2.4.

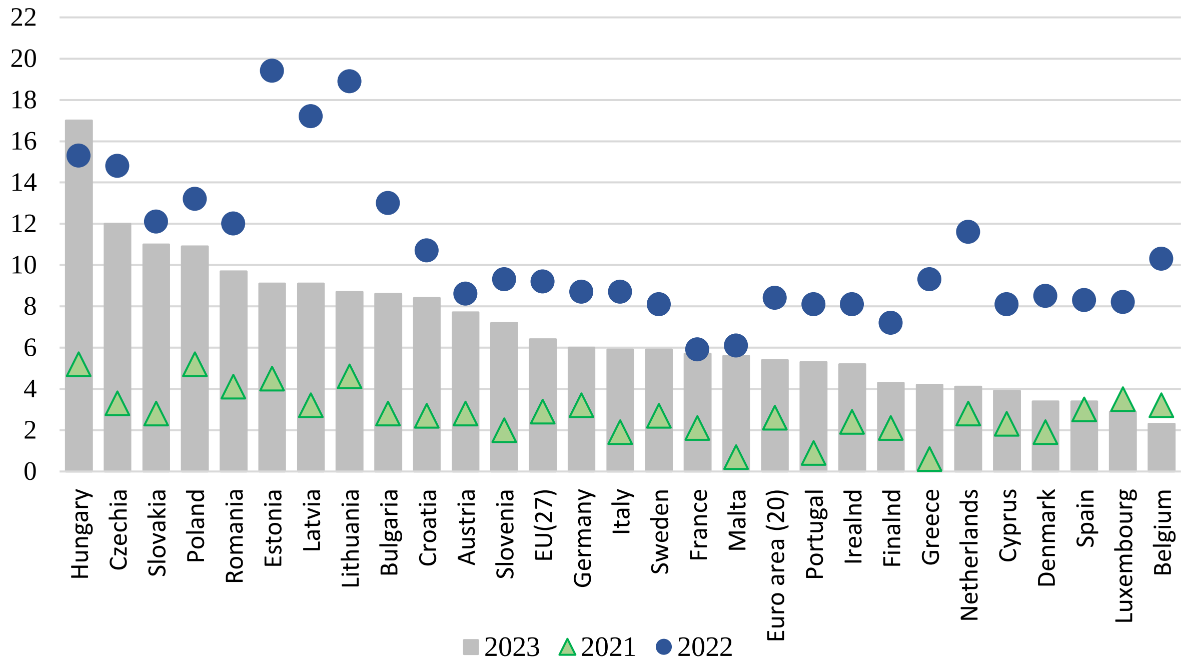


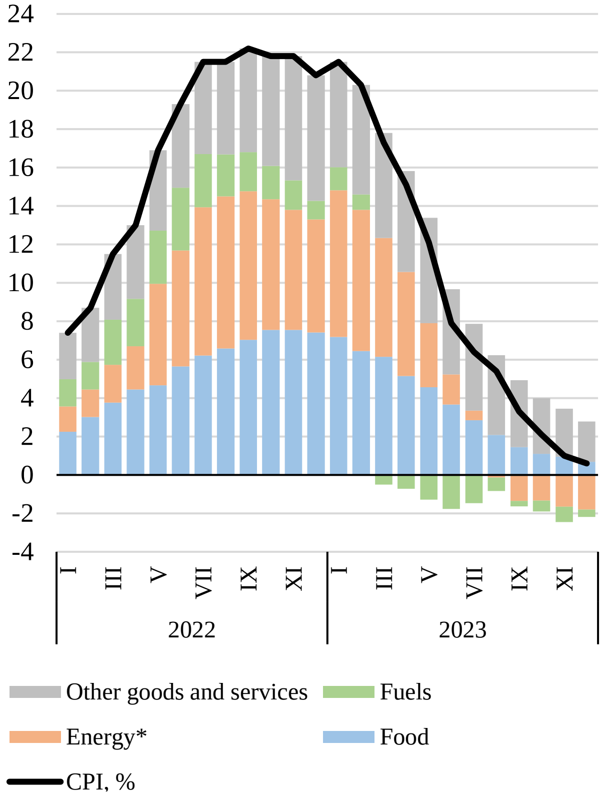
Figure 2.4. Changes in the harmonised index of consumer prices in 2021, 2022, 2023 on average in EU Member States, % (Data source: Eurostat, FM)

Looking at consumer price dynamics in 2023, according to the CSB, consumer prices in Latvia will increase by 8.9% in 2023, almost twice as much as in the previous year. In 2023, as in 2022, the main drivers of inflation were energy and food.

The biggest contributor to inflation in 2023 was a 13.2% increase in food and non-alcoholic beverages, accounting for more than a third of total inflation. Food prices have a significant impact on average inflation, accounting for the largest share of all goods and services in a household consumption basket – 26.2%. Food price inflation slowed during 2023, in line with average inflation, but food inflation was above average inflation throughout the year. This has put significant pressure on household spending, especially for low-income households.

In 2023, the prices of services related to housing management also increased. The price of heat increased by 19.6%. Electricity and gas rose by 12.5% and 2.7% respectively. While this is a sufficiently high increase for utilities, it is several times lower than in 2022. The increase in prices for these services was very high in the first half of last year, but in the second half of the year, as natural gas prices in Europe fell significantly, electricity, gas and heating tariffs in Latvia also fell. While in January 2023 the annual price increases for electricity, gas and heat were 89.8%, 65.7% and 69.6% respectively, in December 2023 the prices for these services decreased by 12.2%, 20.4% and 19.7% respectively on an annual basis. Thus moderating the overall price increase. The price of fuel also fell in 2023, by 9.2% overall. The average price of diesel in 2023 was EUR 1.589 per litre, 18.3 euro cents lower than in 2022. The price of 95-grade petrol, on the other hand, fell by 14.2 euro cents to EUR 1.637 per litre in 2023. The dynamics and contribution of the prices of these goods and services to average inflation can be seen clearly in Figure 2.5, energy group. Despite the escalation of the geopolitical situation in the Middle East in October 2023, in a region that plays a key role in the gas and oil markets, both gas and oil prices continued to decline at the end of last year.

Overall, the price of natural gas in Europe in 2023 has fallen 3.3 times to 40.2 EUR/MWh, which was even slightly lower than in 2021. The price of *Brent* crude oil in 2023 was 82.5 US dollars per barrel, which was 18.2% less than in 2022. Last year, a number of factors influenced the price dynamics of these raw materials, but one of the main ones was the slowdown in the global economy and the resulting lower consumption of oil and gas.



*Energy group includes electricity, gas, heat, solid fuels

Figure 2.5. Contribution to annual inflation by source (percentage points) and average change in consumer prices (CPI, %) (Data source: CSB, MoF)

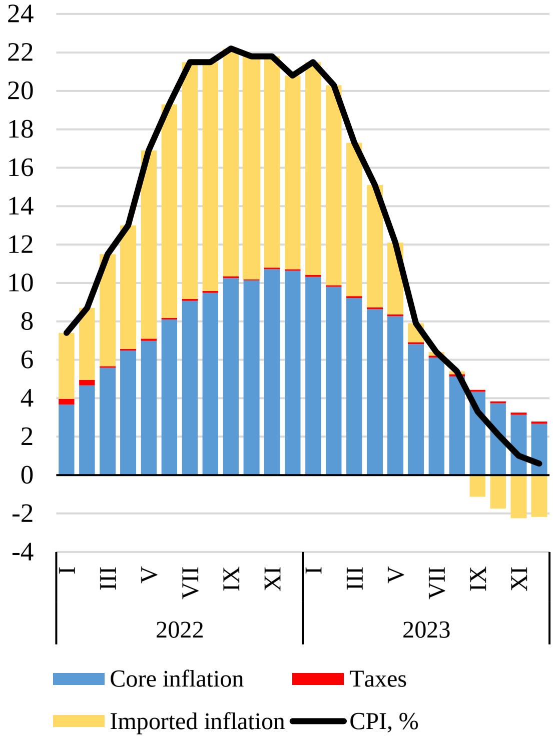


Figure 2.6. Contribution to annual inflation by source (percentage points) and average change in consumer prices (CPI, %) (Data source: CSB, MoF)

Imported inflation, which measures the impact of changes in energy and food prices, has fallen substantially in 2023, thanks to the fall in energy prices in the second half of the year. Core inflation, which measures the impact of domestic factors on price dynamics, was stable last year and declined only slightly. According to the MoF's assessment, core inflation was 9.4% in 2023, compared to 11.0% in 2022. High core inflation is driven by second-round effects from soaring energy and food prices, as well as labour market tightness and upward pressure on labour costs. The dynamics of core inflation and its contribution to headline inflation are shown in Figure 2.6.

Although inflation was significantly lower last year than in 2022, it can still be considered very high and a drag on economic growth. GDP data show that the Latvian economy slowdown contracted by 0.3% in 2023, largely due to the effects of high inflation, negatively affecting household purchasing power and the profitability of businesses both in Latvia and in Latvia's major trading partners. In 2023, real wage growth has resumed. Average gross monthly earnings growth was 11.9% last year, 3 percentage points higher than consumer price inflation. However, looking at the data for the last two years as a whole, purchasing power has still not recovered, which only confirms that consumer price growth in 2022-2023 has been very strong.

At the same time, as inflation stabilises at a relatively low level, people's purchasing power is becoming stronger. Looking at the most recent data for the fourth quarter of last year, the situation has improved considerably, with average wage growth of 11.6% compared to the fourth quarter of 2022 outpacing consumer price growth of 1.2% over the same period. In 2024, the purchasing power of the population is expected to improve further.

Inflation in Latvia has stabilised at a low level in early 2024. In January and February 2024, annual consumer price inflation was 0.9% and 0.4% respectively. As in previous months, food prices continue to weigh on inflation, with increases remaining above average inflation. In addition, consumer prices continue to be significantly affected by rising prices for healthcare services, recreational and cultural services, and food services, largely due to the tight labour market and rising labour costs.

Thanks to significantly lower gas prices on world markets, heat and gas tariffs in 2024 will be lower than last year. An assessment of the draft heat tariffs approved and submitted by municipalities shows that overall heat tariffs in Latvia this year will be lower than last year. Heat tariffs are decentralised, so the situation may vary from municipality to municipality, depending on both the raw material used to produce the heat and when the tariff comes into effect.

According to the updated macroeconomic projections, average inflation in Latvia will be 1.6% in 2024. This year, inflation-boosting factors will mainly be linked to internal economic processes, influenced by labour market developments, especially in services sectors. External factors are more likely to have a downward impact, driven by stabilising energy prices. Tax rate increases in 2024 will have a small inflation-enhancing effect. From 1 January 2024, the value added tax (VAT) on fresh fruit, vegetables and berries specific to Latvia will increase from 5% to 12%. Excise duties on alcoholic beverages, tobacco products, tobacco substitutes and electronic smoking devices will be raised from 1 March.

Labour market

With robust economic growth, Latvia's unemployment rate fell sharply in the period to 2019, with labour shortages already looming in some sectors and occupations. In 2020, this momentum was interrupted by the Covid-19 crisis, but its impact on the labour market proved to be very limited, including thanks to public support measures. The employment situation was not altered by Russia's war in Ukraine in February 2022, and unemployment continued to fall steadily and quite rapidly.

After a temporary increase to 8.1% in 2020, the LFS unemployment rate dropped to 7.6% in 2021 and fell to 6.9% in 2022. In 2023, despite a slowdown in economic growth and a drop in some quarters, the unemployment rate continued to decline, slipping 0.4 percentage points year-on-year to 6.5%.

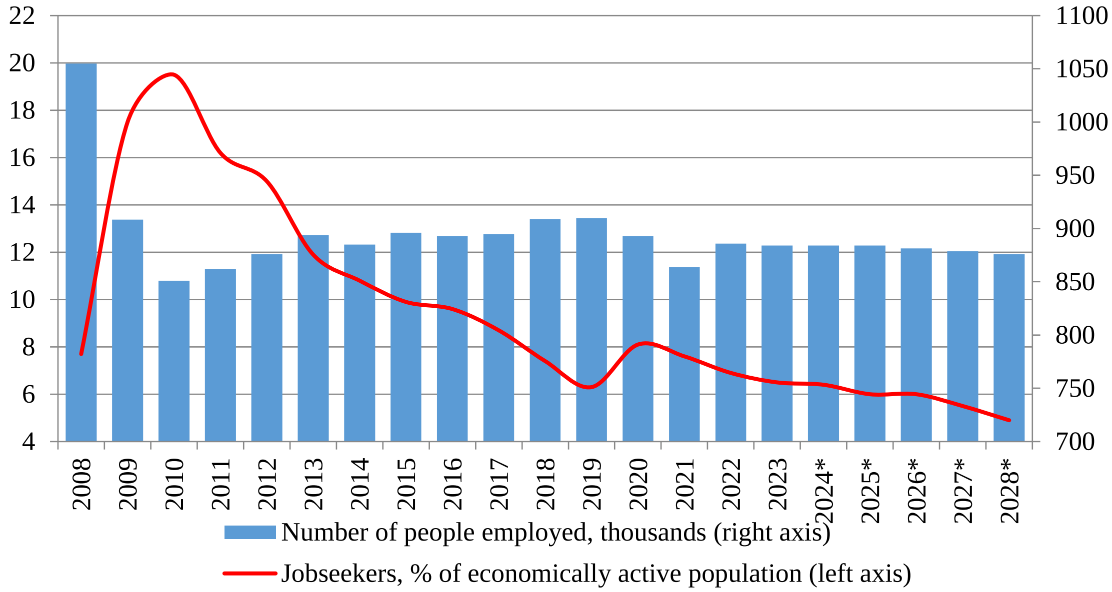
Alongside economic development, the demographic situation is also having a significant impact on the reduction of unemployment, as since 2015 the number of young people entering the labour market has been lower than the number of people in their sixties leaving the labour market and the total working-age population has been steadily decreasing, with the exception of 2022, when Latvia welcomed Ukrainian war refugees.

In the final months of 2023, however, the negative impact of the economic downturn has started to be felt in the labour market, albeit with a very long time lag and only very moderately. Unemployment increased to 6.8% of the economically active population in the fourth quarter of 2023, up from 6.5% in the third quarter. Part of this increase is due to the seasonal rise in unemployment during the winter months, but unemployment was also slightly (0.1 percentage point) higher in Q4 than in the same period a year earlier. The upward trend is also reflected in the more operative monthly data, the unemployment rate reached 7.1% in January 2024, already 0.7 percentage points higher than in the same month a year earlier.

A slight increase in unemployment at the end of 2023 and the beginning of 2024 is also shown by the data of registered unemployment. The number of unemployed people registered at the State Employment Agency has increased from a minimum of 47 thousand in October last year to 52 thousand at the beginning of March. However, this increase in the winter months is in line with regular seasonal fluctuations and, unlike the survey data, still shows a fall in unemployment compared to the same period of the previous year. In the following weeks of March, the data again show a decline in the number of unemployed, as in other years, with the end of the winter season, and in 2024 as a whole, although the fall in unemployment has temporarily slowed down, an increase is not foreseeable either.

The total number of people employed in the economy decreased by 0.2% or 2 thousand to 884.2 thousand last year. In the fourth quarter, the number of employed persons was up by 1.4% or 12.9 thousand. The fall in the number of employed people, together with the rise in unemployment at the end of the year, somewhat alleviates concerns about acute labour shortages caused by population decline. At the same time, business surveys also show that insufficient demand, rather than labour shortages, remains a more important factor in hampering business activity, especially in manufacturing, which continues to experience weak demand in external markets.

In 2024 and 2025, the number of people in employment is likely to remain at last year's level as economic growth picks up, while a slight decline in employment is expected in the following years, mainly driven by the decline in the working-age population as a result of demographic trends.



* MoF forecast

Figure 2.7. Employment and unemployment 2008-2028

Despite the worsening economic situation due to both the Covid-19 pandemic and the Russian-led war, incomes and wages have continued to grow strongly over the past years. Average monthly gross wages increased by 7.5% in 2022, accelerating further to 11.9% in 2023, with average monthly gross wages reaching EUR 1 537.

The sharp rise in wages in 2023 was driven by a substantial increase in the minimum wage from EUR 500 to EUR 620, an increase in public budget spending on public sector wages, energy subsidies provided by private companies to their employees and high inflation. Wage growth in 2023 was slightly faster in the public sector, where average gross monthly earnings increased by 13.1% to EUR 1 553, while in the private sector average earnings rose by 11.5% to EUR 1 533.

By sector, average wages have grown fastest in agriculture and forestry, where they increased by 18.2% in 2023, in energy by 17.5% and in transport and storage by 15.6%. The lowest increase was in the health and social work sector, where average monthly earnings rose by only 3.9%, driven by the abolition of Covid-19 allowances in health care. The highest wage levels remained in financial services at EUR 2 678 and information and communication services at EUR 2 549, while the lowest wage levels were in accommodation and food services at EUR 993 and education at EUR 1 247 per month (see Figure 2.8).

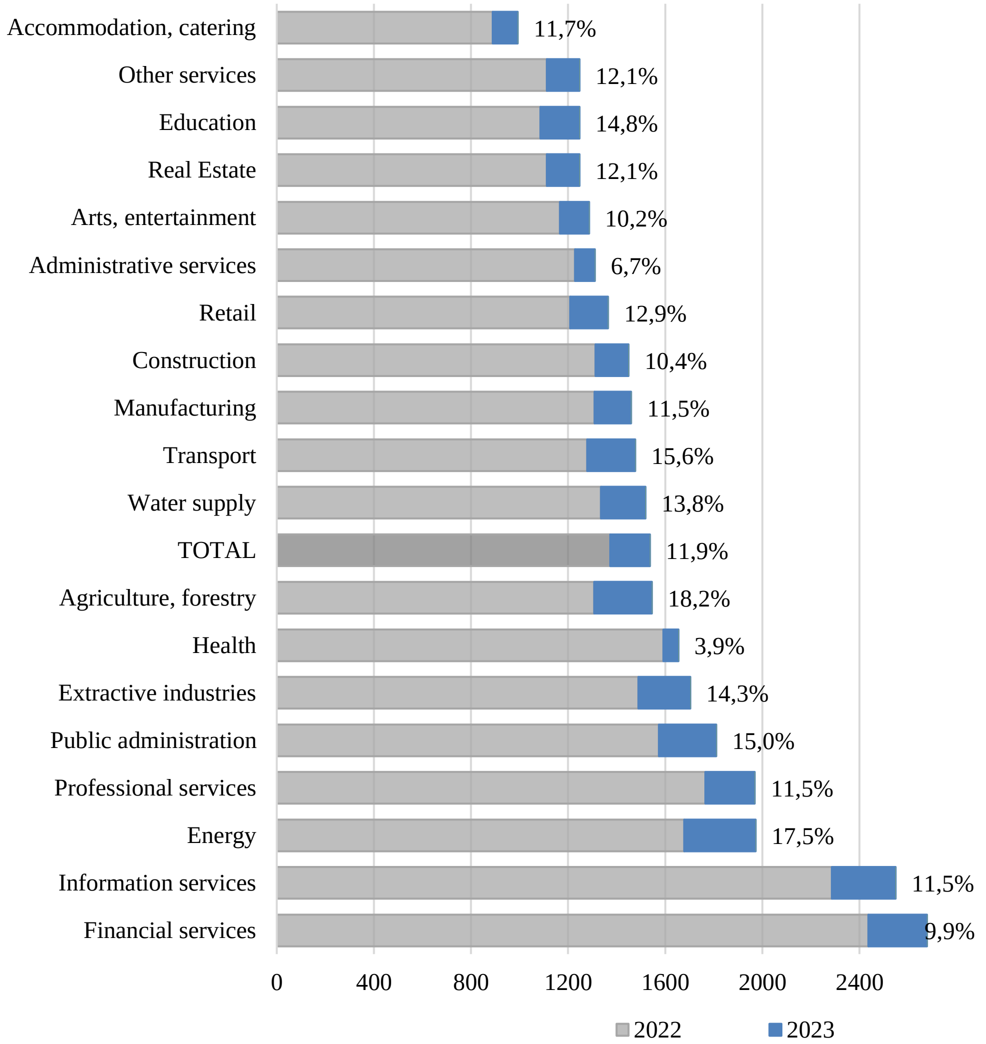


Figure 2.8. Average monthly gross wage by sector, EUR and changes in %

Workers' real net wages, which represent income net of inflation and more accurately reflect changes in workers' purchasing power, fell by 8.7% in 2022 due to high inflation, the first decline since the last financial crisis in 2009-2010. In 2023, as consumer price inflation moderated and wage growth accelerated, wage purchasing power gradually started to recover, with real net wages rising by 2.2% in the year as a whole. However, while workers' purchasing power has started to recover compared to the previous year, it will not yet return to the level it was at before the price spike this year, and could not fully recover until 2025.

Average monthly wages are expected to continue rising this year, driven by the increase in price level, in the minimum wage hike from EUR 620 to EUR 700 and the increase in government spending on public sector wages, including in the health, defence and education sectors, although the pace of wage growth is expected to slow significantly. The MoF forecasts that average monthly gross wages will increase by 7.5% this year to over EUR 1 650, but that wage growth will slow in the coming years, gradually catching up with productivity growth and stabilising at 5%.

2.3. Macroeconomic Development Scenario

The medium-term macroeconomic development scenario for the period 2024-2028 was developed in February 2024. It was based on the macroeconomic data available up to the end of 2023, incorporating the flash estimate of GDP for the Q4 2023. The most recent EC and IMF forecasts for winter 2024 serve as the foundation for the external economic environment assumptions used in projecting Latvia's export figures. In formulating its macroeconomic forecasts, the MoF has consulted experts from the Bank of Latvia (BoL) and the Ministry of Economics (MoE), as well as the EC and the IMF. he Fiscal Discipline Council has endorsed these forecasts, officially publishing its opinion on February 12, 2024.

Baseline scenario

According to the scenario from February 2024, Latvia's GDP is projected to increase by 1.4% in 2024, with the pace of economic growth accelerating to 2.9% in 2025. This represents a downward revision of 1.1 percentage points for the 2024 GDP growth forecast compared to earlier projections from the beginning of June 2023; however, the 2025 forecast remains unchanged. Looking further ahead, economic growth is expected to decelerate, reaching 2.5% in 2026 and gradually decreasing to 2.3% by 2028.

The reduced economic growth forecast for 2024 primarily reflects last year's dynamics, where GDP growth fell short of expectations. This shortfall was largely due to weakened external demand and elevated price levels, which constrained the growth of private consumption in Latvia. In 2023, the Latvian economy contracted by 0.3%, primarily as a result of declines in exports and private consumption, while both investment and public consumption registered positive growth contributions during the same period.

Concurrently, starting from the second half of 2024, as the European economy begins to experience faster growth and the adverse effects of recent sharp price increases on the purchasing power of the Latvian population diminish, Latvia's economic growth rate is expected to accelerate, reaching 2.9% in 2025. Additionally, the execution of major investment projects and an increase in EU funding will play crucial roles in this acceleration.

Investment (gross fixed capital formation) growth is projected to be approximately 4% in 2024 and 2025, which is 0.7 and 1.3 percentage points higher than the forecasts from June 2023, respectively. This increase is primarily attributed to the anticipated greater utilization of EU funds, spurred by the expected conclusion of the Recovery and Resilience Facility (RRF) in 2026. Over the subsequent years, investment growth is expected to stabilize at around 3%, contingent upon the continued stability of the investment environment, including price levels and business confidence.

Foreign trade in 2023 was negatively influenced by reduced trading activities with Russia and, more significantly, by a drop in energy prices. Looking ahead, the EU and the euro area are projected to experience growth rates in 2024 that exceed those of 2023, although these rates are still expected to be at historically low levels. High uncertainty persists, particularly concerning the ongoing Russian-led war in Ukraine and the ECB’s monetary policy, with expectations of potential interest rate cuts starting in 2024. Consequently, while export growth is anticipated to recover to 4% over the projection period as external demand stabilizes, although it is expected to decrease by 0.8% in 2024 due to base effects.

With the significant decline in global energy and other commodity prices contributing to the stabilization of prices overall, coupled with the ECB's stringent inflation control policy, the inflation forecast for Latvia in 2024 has been revised downward to 1.6%. This marks a decrease from the previous forecast of 2.2% made by the MoF in June 2023. Over the medium term, inflation is projected to stabilize at around 2.5% by 2028, aligning with the typical rate of price inflation for a converging economy.

Despite the recent slowdown and contraction in economic growth, there has been virtually no significant impact on unemployment or employment figures, which remain largely unchanged from previous forecasts. According to projections by the Ministry of Finance, the unemployment rate is expected to decrease slightly this year (by 0.1 percentage point compared to 2023) to 6.4%. It is then anticipated to gradually fall to 5% by 2028, driven by stronger economic growth and demographic factors. The total number of employed individuals is expected to remain stable at 884 thousand, though with a slight decreasing trend.

Average monthly wages are expected to continue rising in 2024, influenced by increases in the price level, a rise in the minimum wage from EUR 620 to EUR 700, and heightened public expenditure on public sector wages, particularly in the health, defense, and education sectors. The MoF forecasts a 7.5% increase in average monthly gross wages this year, reaching EUR 1,652. However, wage growth is anticipated to decelerate in subsequent years, aligning more closely with productivity growth, and is expected to stabilize at around 5%.

Table 2.1. Growth and related factors

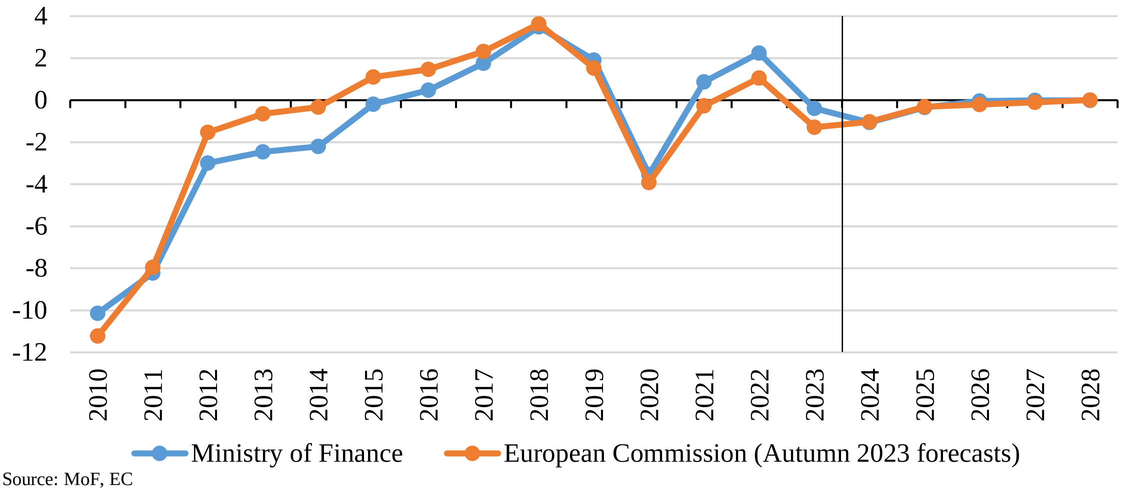
	ESA code	**2023***	**2023***	**2024**	**2025**	**2026**	**2027**	**2028**
		mln EUR	Growth %					
1.GDP in real prices	B1*g	40 348	5.1	4.1	6.0	5.3	5.1	5.1
2.GDP in 2015 prices	B1*g	28 739	-0.3	1.4	2.9	2.5	2.3	2.3
GDP by expenditure at 2015 prices								
3.Private consumption	P3	17 539	-1.3	1.9	2.5	2.7	2.5	2.5
4.Public consumption	P3	5 862	7.0	6.7	5.8	3.1	3.0	3.0
5.Gross fixed capital formation	P51	7 110	8.2	3.8	4.2	2.8	2.8	2.8
6.Changes in inventories and acquisition of valuables	P52+P53	1 428	-	-	-	-	-	-
7.Export	P6	19 665	-5.9	-0.8	3.3	4.1	4.0	4.0
8.Import	P7	22 865	-2.9	1.9	3.9	4.0	4.0	4.0
Contribution to GDP growth								
9.Total domestic demand	P3+P51		2.4	3.5	3.9	3.0	2.9	2.9
10.Changes in inventories and acquisition of valuables	P52+P53		-0.7	0.0	0.0	0.0	0.0	0.0
11.Export-import balance	B11		-2.0	-2.1	-0.9	-0.5	-0.6	-0.6

** 2023 data - CSB as of 25.03.2024.*

Cyclical development of the economy

Between 2011, the first year after the recession, and 2019, the economy of Latvia grew at an average annual rate of 3%, driven by both domestic and external demand, signaling an upturn in the economic cycle. However, as the EU funding cycle concluded, a cyclical slowdown commenced in 2019, and investment growth decelerated to 0.6%, down from an average of 3.7% during 2017-2018. The economic downturn was further exacerbated in 2020 by the Covid-19 pandemic, which affected all sectors and significantly impacted potential GDP growth, particularly in tourism-related sectors, erasing the positive output gap that had developed. Consequently, GDP declined by 3.5% in 2022, and the previously positive output gap, sustained since 2015, turned negative in 2020. With the phasing out of Covid-19 restrictions in 2021, the economy showed signs of recovery, but the onset of the Russian-led war in Ukraine further hindered potential GDP growth, plunging the economy back into recession.

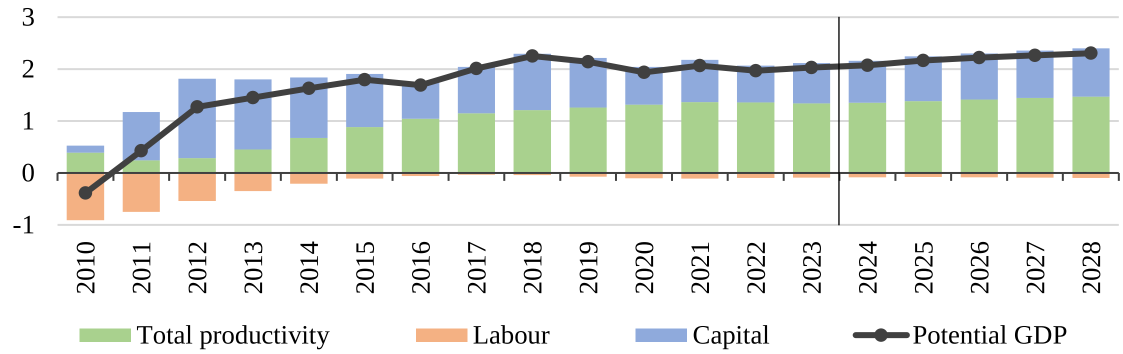
Under the February 2024 scenario, it is projected that the negative output gap will close within three years, allowing the economy to return to its potential growth rate and then continue to expand at just above 2% from 2026 onwards. This medium-term assessment of the output gap aligns closely with the EC's autumn 2023 forecasts.



Source: MoF, EC

Figure 2.9. Output gap, %

During the projection period, potential GDP growth will be primarily driven by an overall productivity increase of approximately 1.4 percentage points, a rate that was typical during the upturn leading up to 2019. The remaining growth in potential GDP will be attributed to capital contributions, which account for about 1 percentage point. Meanwhile, the contribution from labor is expected to be slightly negative, influenced by demographic trends but partially offset by higher productivity gains. According to the MoF, potential GDP growth is projected to be above 2% in the medium term.



Source: MoF

Figure 2.10. Potential GDP growth and contribution of components, %

3. GENERAL GOVERNMENT BUDGET BALANCE AND DEBT

3.1. Fiscal Policy Strategy and Medium-Term Targets

3.1.1. Fiscal Policy Strategy

The Stability Programme comes at a time of ongoing war in Europe and escalating geopolitics in the Middle East. Although the war in Ukraine has stabilised energy prices and the economy of Latvia has been able to adapt relatively well to the challenges, stable economic growth can only be expected in the medium term, provided that external demand picks up, inflation eases as expected and interest rates are lowered, which will have a positive impact not only on public finances, but also on the economy of Latvia as a whole. At the same time, uncertainty and external risks remain very high.

The year 2024 is significant in that, with the termination of the EU's general escape clause, on the one hand, the application of EU fiscal rules was renewed, which means the initiation of the excessive deficit procedure in the spring of 2024, based on the outcome of 2023 according to the current EU legislation, on the other hand, a preliminary political agreement was reached in the spring of 2024 on the reform package of the EU economic governance framework[2] (the new EU fiscal rules), which will tentatively enter into force in May of this year, i.e. shortly after the submission of this Stability Programme to the EC.

At the same time, the Council's EU country specific recommendations, which integrate a fiscal component, were endorsed on 14 July 2023. According to the recommendation[3], Latvia should ensure prudent fiscal policy in 2024 by limiting the nominal increase in government-financed net primary expenditure to an amount consistent with an annual improvement in the structural budget balance of at least 0.5% of GDP in 2024. The fiscal component of this recommendation is to some extent a transition to the application of the reformed EU fiscal rules, which involves setting a country-specific fiscal trajectory (for nationally financed net primary expenditure[4]) for four years in terms of changes in the structural primary balance. The fiscal or nationally financed net primary expenditure trajectory should be set in the FSP that EU Member States including Latvia should prepare until September 20 of 2024, but the EU Member States and the EC can agree on an extension of the deadline for submitting the plan[5]. Accordingly, the next draft law "On the State Budget for 2025 and the Budget Framework for 2025, 2026, and 2027" will need to be developed taking into account not only the FDL, but also the reform package of the EU economic governance framework that has entered into force, as well as the trajectory of nationally financed net primary expenditure.

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[2] Regulation of the European Parliament and of the Council on the effective coordination of economic policies and multilateral budgetary surveillance and repealing Council Regulation (EC) No 1466/97; Council Regulation amending Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure; Amendment to Council Directive amending Directive 2011/85/EU on requirements for budgetary frameworks of the Member States, available at: https://www.consilium.europa.eu/en/press/press-releases/2024/02/10/economic-governance-review-council-and-parliament-strike-deal-on-reform-of-fiscal-rules/

[3] Recommendation for a Council Recommendation on the 2023 National Reform Programme of Latvia and delivering a Council opinion on the Stability Programme of Latvia, available at: https://data.consilium.europa.eu/doc/document/ST-9839-2023-REV-1/lv/pdf

[4] General government expenditure, net of interest expenditure, DRM, expenditure on EU programmes fully matching EU funds revenue, government expenditure on co-financing EU-funded programmes, and cyclical elements of unemployment benefit expenditure. In line with the principles used by the EC to classify transactions as one-off and other temporary measures, these one-off and other temporary measures should also be deducted from government expenditure.

[5] Latvia plans to take advantage of the extension and submit the FSP to the EC on October 15, together with the Draft Budgetary Plan for 2025.

In view of the foreseen reintroduction of EU fiscal rules from 2024 onwards, the financing of measures considered as one-off under the Fiscal Policy Strategy[6] should be financed within the rules of fiscal discipline, i.e. at a level that avoids the general government deficit exceeding the 3% of GDP threshold. At the same time, the core principle of the above-mentioned Fiscal Policy Strategy that one-off measures are excluded from the national general government structural balance target is not abrogated.

The scope of the one-off measures is set out in Section 5 of the Law on the State Budget for 2024 and the Budget Framework for 2024, 2025, and 2026:

1) one-off expenditure related to mitigating the negative effects of the Covid-19 pandemic;
2) one-off expenditure to compensate for substantial increases in energy prices;
3) one-off expenditure on national defence and internal security
   a) for investments to ensure the continuity of the State limited liability company *Latvijas Televīzija* (*Latvian Television*) in the event of an external threat to the State;
   b) for building and strengthening the country's external border infrastructure and investing in strengthening national security institutions;
   c) for strengthening national defence capabilities;
   d) for the purchase of special fire-fighting and rescue vehicles;
   e) for the State Fire and Rescue Service depot - for the construction of disaster management centres;
   f) for providing the population with essential industrial goods in the event of a threat to the State;
   g) for strengthening cyber security;
   h) for providing the structural units of the State Police Riga Regional Administration with appropriate premises;
4) one-off expenditure in support of Ukrainian civilians in Latvia;
5) one-off expenditure in support of Ukraine;
6) 100% increase in base national defence spending compared to the previous year. 80% in the first year of increase, 60% in the second year of increase, 40% in the third year of increase and 20% in the fourth year of increase.

The preparation of this Stability Programme takes into account the fiscal impact of the one-off measures listed in Table 3.1.

Table 3.1. One-off measures, EUR million/ % of GDP

	2020	2021	2022	2023	2024	2025	2026	2027	2028
GDP, EUR million	**30 109**	**33 349**	**38 386**	**40 348**	**42 008**	**44 548**	**46 904**	**49 281**	**51 779**
	fact/estimation					forecast			
one-off and other temporary measures, million EUR, including	**-1 018.1**	**-2 054.7**	**-1 878.6**	**-819.2**	**-693.5**	**-704.0**	**-771.3**	**-729.0**	**-680.1**
Covid-19 pandemic mitigation measures	-960.8	-2 102.8	-796.4	-65.3	-8.9	-5.3	-5.3		
measures to mitigate energy price increases		-1.9	-1 001.2	-399.3	0.0				
defence and internal security funding				-218.2	-330.6	-380.4	-488.5	-435.3	-355.2
support for Ukrainian refugees			-81.0	-67.9	-70.0				
other/one-off expenditure on national defence and internal security	-57.3	49.9		-68.6	-284.0	-318.3	-277.6	-293.8	-324.9

[6] Approved at the Cabinet meeting of 12 April 2022 (Minutes of the Cabinet meeting No 20, § 45)

	2020	2021	2022	2023	2024	2025	2026	2027	2028
(18.pr + % payments on UA loan)									
	fact/estimation					forecast			
one-off and other temporary measures, % of GDP, including	**-3.4**	**-6.2**	**-4.9**	**-2.0**	**-1.7**	**-1.6**	**-1.6**	**-1.5**	**-1.3**
Covid-19 pandemic mitigation measures	-3.2	-6.3	-2.1	-0.2	0.0	0.0	0.0	0.0	0.0
measures to mitigate energy price increases		0.0	-2.6	-1.0	0.0				
defence and internal security funding				-0.5	-0.8	-0.9	-1.0	-0.9	-0.7
support for Ukrainian refugees			-0.2	-0.2	-0.2				
other/one-off expenditure on national defence and internal security (18.pr + % payments on UA loan)	-0.2	0.1		-0.2	-0.7	-0.7	-0.6	-0.6	-0.6

Differences of accrued balances

Section 11 of the FDL provides for an automatic ex-post adjustment mechanism, i.e. an adjustment of the minimum planned structural balance of the general government budget, to ensure that actual deviations from the balance rule (Section 10 of the FDL) in previous years do not affect budgetary balance. If, in the course of budgetary implementation, the cumulated deviation of actual structural balances from planned balances is found to be negative and amounts to at least 0.5% of GDP, the general government structural balance target is set 0.5% of GDP higher in the third year of the next medium-term budget. The cumulated balance gaps are shown in Table 3.2 and, given the cumulated value of the actual structural balance deviation of 4.5% of GDP, no adjustment to the structural balance of the general government budget is required.

Table 3.2. Differences of accrued balances

		2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
1	GDP (in nominal prices), mln EUR	22 749	23 626	24 572	25 371	26 984	29 154	30 573	30 109	33 349	38 386	40 348
2	Actual structural general government balance, % of GDP	-0.3	-0.8	-1.4	-0.4	-1.0	-2.1	-0.8	0.3	-1.3	-0.6	-0.1
3 (1×2)	Actual structural general government balance, mln EUR	-66.3	-185.2	-345.3	-95.8	-258.6	-604.2	-234.0	77.9	-449.6	-214.2	-40.6
4	Minimum planned structural general government balance, % of GDP	-1.3	-1.0	-1.0	-0.9	-1.0	-1.2	-0.6	-0.5	-1.6	-4.0	-0.5
5 (1×4)	Minimum planned structural general government balance, mln EUR	-295.7	-236.3	-245.7	-228.3	-269.8	-349.8	-173.2	-140.0	-537.2	-1 541.0	-201.7

		2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
6 (3-5)	Economic year balance difference, mln EUR	229.4	51.0	-99.6	132.6	11.3	-254.3	-60.8	217.8	87.6	1 326.8	161.1
7 ((6:1) ×100)	Economic year balance difference, % of GDP	1.0	0.2	-0.4	0.5	0.0	-0.9	-0.2	0.7	0.3	3.5	0.4
8 (Σ(6))	Sum of differences of accrued balances (cumulative), mln EUR	229.4	280.5	180.9	313.4	324.7	70.4	9.6	227.4	315.1	1 641.9	1 803.0
9 ((8/1) ×100)	Sum of differences of accrued balances, % of GDP	1.0	1.2	0.7	1.2	1.2	0.2	0.0	0.8	0.9	4.3	**4.5**
10	Rule of Section 11 of FDL, % of GDP	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5
11	To be adjusted if 9<10											No need to adjust

3.1.2. Compliance with Fiscal Rules in Medium-Term Fiscal Policy Planning

In general, the FDL requires a multi-stage approach to the definition of structural balance targets, which must simultaneously ensure compliance with the national fiscal rules (balance rule, expenditure growth rule and expenditure pass-through rule) and the Stability and Growth Pact rules. It should be noted that the FDL rule is to be respected in the preparation of the medium-term budgetary framework, but compliance is not legally binding in the preparation of the Stability Programme. Accordingly, in this context, the application of the specific fiscal provisions of the FDL should be seen in the context of the planned changes to the EU fiscal rules, including the extension of the planning/forecasting cycle by one year.

3.1.3. Structural Balance Targets of the General Government Budget for 2025, 2026, 2027 and 2028

The Stability Programme is prepared taking into account both the provisions of the FDL and the new EU fiscal rules that will enter into force this year. So, in effect, three fiscal rules are currently applied:

1. FDL structural balance rule;
2. EU structural primary balance rule and
3. Net primary expenditure rule for EU public spending.

Although each of the fiscal rule refers to a different fiscal indicator, in order to ensure comparability and to determine which of the fiscal rules is dominant, it is necessary to translate the different fiscal indicators into a single fiscal indicator. For this purpose, the FDL structural balance indicator is chosen.

1. FDL structural balance rule

In line with the Fiscal Policy Strategy, the structural balance target for 2025-2028 is based on the 2024 structural balance projection.

According to the updated medium-term (i.e. until 2028) general government budget projections, the general government deficit is estimated at 2.9% in 2024 under no-policy change scenario.

Taking into account the output gap and the size of one-off measures, the general government structural deficit in 2024 is projected at 0.8% of GDP (see Table 3.3). This is above the medium-term target of 0.5% of GDP set in Section 10 of the FDL. In the general case, according to the Fiscal Policy Strategy, the structural deficit should be reduced by 0.5% of GDP each year until it reaches the 0.5% of GDP value in 2025, then at the most recent projections it needs to be reduced so far as to reach and further maintain the general government structural deficit at the maximum allowable level set in Section 10 of the FDL.

Table 3.3. General government structural balance targets

		2024	2025	2026	2027	2028
GDP forecast, EUR million	(1)	42 008				
2024 general government budget balance, EUR million	(2)	-1 213				
2024 general government budget balance as % of GDP	(3)=(2)/(1)*100	-2.9				
output gap, % of potential GDP	(4)	-1.1				
cyclical component of the balance, % of GDP	(5)=0.378*(4)	-0.4				
one-off and other temporary measures, % of GDP, including	**(6)=(7)+(8)+(9) +(10)+(11)**	**-1.7**				
Covid-19 pandemic mitigation measures	(7)	-0.02				
measures to mitigate energy price increases	(8)	0.0				
defence and internal security funding	(9)	-0.8				
support for Ukrainian refugees	(10)	-0.2				
other/one-off expenditure on national defence and internal security	(11)	-0.7				
General government structural balance projections and targets, % of GDP	**(12)=(3)-(5)-(6)**	**-0.8**	**-0.5**	**-0.5**	**-0.5**	**-0.5**

Taking into account that the expenditure in Table 3.1 is excluded from the calculation of the structural balance according to the EU methodology, the 2024 structural balance of general government is -2.5% of GDP (according to the EU methodology).

2. EU structural primary balance rule

Regulation of the European Parliament and of the Council on the effective coordination of economic policies and multilateral budgetary surveillance and repealing Council Regulation (EC) No 1466/97[7] (hereafter "the Regulation") states that a country-specific fiscal path - nationally financed net primary expenditure[8] in terms of changes in the structural primary

[7] Proposal for a Regulation of the European Parliament and of the Council on the effective coordination of economic policies and multilateral budgetary surveillance and repealing Council Regulation (EC) No 1466/97, available at: https://www.consilium.europa.eu/media/70386/st06645-re01-en24.pdf

[8] General government expenditure, net of interest expenditure, DRM, expenditure on EU programmes fully matching EU funds revenue, government expenditure on co-financing EU-funded programmes, and cyclical elements of unemployment benefit expenditure. In line with the principles used by the EC to classify transactions as one-off and other temporary measures, these one-off and other temporary measures should also be deducted from government expenditure.

balance – should meet the requirements of achieving or maintaining a credible reduction in general government debt at a prudent level below 60% of GDP by the end of the adjustment period and of reducing and maintaining government deficits below 3% of GDP in the medium term.

This rule is calculated according to the common EU methodology and the assumptions used in the EU. This is based on a structural primary balance for 2024 of -1.4% of GDP, as projected by the SP. The structural primary balance is assumed to remain constant over the projection period, i.e. until 2038, under a no-policy change scenario.

The nominal balance is obtained by adding to the structural primary balance interest expenditure (% of GDP), the change in ageing expenditure (% of GDP) and the cyclical component of the balance (% of GDP). It should be noted that interest expenditure (% of GDP) is set to increase in the near term, as interest expenditure rises in a situation of higher interest rates, when debt that was borrowed at lower interest rates is refinanced. Although ageing expenditure for Latvia decreases over time, it does not compensate for the increase in interest expenditure, so that over the period to 2038, holding the structural primary balance constant, the initial 2024 nominal deficit of 2.9% of GDP increases and exceeds the 3% of GDP threshold, peaking at 3.3% of GDP in 2034.

To avoid a headline deficit overshoot over the entire projection period, Latvia needs to reduce its structural primary deficit from 1.4% of GDP in 2024 to 1.2% of GDP in 2029, or by 0.055 percentage points of GDP in 2025, 2026, 2027 and 2028, over a 4-year period starting in 2025 and ending in 2028. Under this fiscal rule, the allowed structural primary balance is shown in Table 3.4, row 1.

Table 3.4 also shows the conversion from the allowed structural primary balance to the structural FDL balance. According to this recalculation, the allowed structural deficit of the FDL is close to 1% of GDP in 2025, slightly lower in 2026 and then rising to 1.3% of GDP in 2028.

Table 3.4. General government structural balance targets based on the EU structural primary balance rule

		2024	2025	2026	2027	2028
1.	**structural primary balance target, % of GDP**	-1.441	-1.386	-1.331	-1.276	-1.221
2.	**general government interest expenditure, % of GDP**	1.04	1.20	1.28	1.35	1.42
3.	**one-off and other temporary measures, % of GDP**		-1.58	-1.64	-1.48	-1.31
4.	**General government structural balance projections and targets, % of GDP**		**-1.008**	**-0.971**	**-1.149**	**-1.328**

It should be noted that the new EU framework states that EU countries with debt below 60% of GDP and deficits below 3% of GDP in 2024 can choose whether or not to request technical information from the EC[9]. Article 9 of the Regulation stipulates that, if a country requests technical information, the allowable structural primary balance specified by the EC must also ensure compliance with the deficit resilience safeguard, which requires the structural primary deficit to be reduced by 0.4 percentage points of GDP each year until its value ensures that the structural deficit is no higher than 1.5% of GDP. In fact, this would impose on Latvia a rule 7 times stricter than the fiscal rule described above. The Regulation stipulates that in the

[9] "technical information" means the guidance provided by the EC to Member States on request, before they draw up their national medium-term FSP, on the structural primary balance needed to ensure that the headline deficit is kept below 3% of GDP without any additional policy measures in the medium and long term, and indicating whether this implies the need for a fiscal adjustment.

process of assessing the FSP, the EC will only assess compliance with the 3% of GDP deficit target over the entire forecast horizon, but not compliance with the deficit resilience safeguard. Moreover, the assessment does not depend on whether the country has requested the technical information or not. Given these conditions, if the EC forecasts a deficit below 3% of GDP for Latvia in 2024, Latvia will not request technical information and will not voluntarily opt to be subject to the deficit resilience safeguard.

3. EU nationally financed net primary expenditure rule

While conceptually the increase in net primary nationally financed expenditure is not considered a separate fiscal rule and is rather positioned as a technical recalculation of the structural primary balance, it is in fact a new EU fiscal rule.

Growth in general government primary expenditure is calculated under the assumption that, in the case of a constant primary balance, expenditure grows in line with growth in potential GDP and the GDP deflator, and growth is only adjusted by the necessary improvement in the structural primary balance. In practice, this means that general government revenue is assumed to grow “in line with the economy”, i.e. in line with real GDP growth and the GDP deflator, and the deviation is only by the amount of discretionary revenue. In the general case, however, revenue growth can vary and lead to different structural primary balances. The Stability Programme’s projections for general government revenue also diverge significantly from this simplified revenue growth model. Given these differences, Latvia’s fiscal strategy treats the increase in EU nationally financed net primary expenditure as a separate fiscal rule.

To ensure the improvement in the structural primary balance shown in Table 3.4, the increase in primary expenditure calculated according to the EU methodology is around 5%. See Table 3.5, row 1. Adjusting the increase in expenditure for discretionary revenue measures (DRM), which reduce revenue by EUR 238 million in 2025, the allowable increase in primary expenditure would be 3.7% in 2025, 5.6% in 2026 and around 5% thereafter. Recalculating this allowable increase in expenditure into the structural balance of the FDL results in a significantly higher level of structural deficit of the FDL than under the EU structural primary balance rule. Following the rule of EU nationally financed net primary expenditure, the nominal deficit would be well above the 3% threshold.

Table 3.5. General government structural balance target based on EU expenditure growth rule

		2024	2025	2026	2027	2028
1.	**Growth rate of nationally financed net primary expenditure (NFNPE), %**		**5.07792**	**5.10214**	**5.12265**	**5.13208**
2.	**NFNPE level, EUR million**	16 939	17 799	18 708	19 666	20 675
3.	**Discretionary Revenue Measures (DRM)**	354.30	-238.15	91.89	-0.36	0.00
4.	**NFNPE level (with DRM), EUR million**		17 561	18 799	19 665	20 675
5.	**NFNPE growth rate (with DRM), %**		**3.67**	**5.62**	**5.12**	**5.13**
6.	**General government interest expenditure, EUR million**		535	602	666	735
7.	**Cyclical components of unemployment benefit expenditure, EUR million**		10	21	15	5
8.	**Expenditure on EU programmes fully matching EU funds' revenue, EUR million**		984	897	644	506
9	**Expendinture on national co-financing for EU-funded programmes, EUR million**		404	307	204	198
10.	**Total general government expenditure, EUR million**		19 495	20 627	21 194	22 118
11.	**Total general government revenue, EUR million**		17 953	18 683	19 166	19 781

		2024	2025	2026	2027	2028
12.	**General government budget balance, EUR million**		-1 542.29	-1 943.46	-2 028.08	-2 337.67
13.	**General government budget balance, % of GDP**		**-3.462**	**-4.143**	**-4.115**	**-4.515**
14.	**Cyclical component of the balance, % of GDP**		-0.13	-0.02	0.0	0.0
15.	**General government structural balance projections and targets, % of GDP**		**-1.752**	**-2.481**	**-2.632**	**-3.198**

Structural balance targets

Taking into account Tables 3.3, 3.4 and 3.5 , **general government structural balance target that fulfils all three** rules is set for 2025-2028 at **-0.5% of GDP in 2025**, **-0.5% of GDP in 2026**, **-0.5% of GDP in 2027** and **-0.5% of GDP in 2028**.

It should be noted that the structural balance targets are set on the basis of the Stability Programme projections for the general government balance in 2024, which are 2.9% of GDP. Under the new EU fiscal framework, if the EC forecasts a deficit above 3% of GDP for Latvia in 2024 in its spring 2024 forecasts published in May this year, Latvia will be subject to stricter fiscal conditions and will have to respect the deficit resilience safeguard in addition to the structural primary balance rule. Such developments are outside the scope of this Stability Programme and the possible consequences will be taken into account in the autumn of 2024 when developing the FSP.

Potential changes in the regulatory framework of Latvian fiscal policy

As can be seen, in all years the dominant fiscal rule is the structural balance rule of the FDL. The EU's structural primary balance rule is next in order of stringency. Given that the new EU fiscal framework for countries with low debt and deficits is less stringent than the existing framework, there is a case for revising the fiscal rules under the FDL. The approach could be as in the new EU framework that is based on debt sustainability.

If we take the long-term average debt level of 40% of GDP set out in the government's declaration[10] as a basis, the calculation based on the EU methodology shows that this condition can be met if the country maintains a structural balance of around -1.2% of GDP. Given the significant size of the one-off measures, which remain at 1.6-1.3% of GDP in the coming years and also have an impact on debt, the structural deficit allowed by the FDL could be set slightly below 1.2% of GDP as long as the one-off measures persist. If set at 1% of GDP, the structural balance rule for the FDL in 2025 would almost coincide with the EU structural primary balance rule, indicating a correct calibration to avoid that the national framework sets significantly stricter rules. Raising the structural deficit from 0.5% of GDP to 1% of GDP should be accompanied by a move away from the concept of further one-off expenditure.

3.1.4. Discretionary Measures

Between the Stability Programme 2023-2026 and this Stability Programme, fiscal policy decisions have been taken. These include:

(i) measures contained in the Law on the State Budget for 2024 and the Budgetary Framework for 2024, 2025 and 2026, which are not presented separately in this Stability Programme and can be found in the Draft Budgetary Plan for 2024;

[10] Declaration on the intended activities of the Cabinet headed by Evika Siliņa, 15 September 2023. Paragraph 40, available at: https://www.mk.gov.lv/lv/media/16704/download?attachment

(ii) the proposals supported by the Saeima in the 2nd reading of the draft law "On the State Budget for 2024 and the Budgetary Framework for 2024, 2025 and 2026" (increasing the revenue from dividend payments of several JSCs, updating the revenue forecast from fines imposed by the State Police and the State Fire and Rescue Service, increasing excise duty rates for several items[11], applying the VAT rate of 12% to fruit and vegetables in 2024[12], revenue from the gambling levy on the issue of a gambling licence forecast for 2027), the estimated fiscal impact of the abolition of the personal income tax exemption on amounts paid as state or EU support for agriculture and rural development[13], new provisions under the Cabinet of Ministers (Cabinet) Regulation No 158 of 5 March 2024 on Provisions on agricultural and animal feed products prohibited for importation into Latvia[14], as well as amendments to the Consumer Rights Protection Law[15]. Their impact is shown in Table 3.6.

Table 3.6. Discretionary Revenue Measures

Detailed description*	**Type of tax**	**ESA code**	**Accounting principle**	**Adoption status**	**Budgetary impact**			
					2024	**2025**	**2026**	**2027**
					% of GDP			
Raising the rates (Amendments to the Law on Lotteries and Gambling Fee and Tax)	Lotteries and gambling tax	D2	Accruals	Approved by the Government	**0.01**	**-0.01**	**0.00**	
incl. State basic budget					0.01	-0.01	0.00	
incl. local government budget					0.00	0.00	0.00	
Abolition of personal income tax relief on sums received as state or EU aid for agriculture and rural development	PIT	D5	Accruals	Approved by the Government	**0.00**	**0.05**	**0.00**	
incl. State basic budget					0.00	0.01	0.00	
incl. local government budget					0.00	0.04	0.00	
Application of the reduced VAT rate of 12% on fresh fruit and vegetables in 2024 (for one year)	VAT	D2	Accruals	Approved by the Government	**-0.04**	**0.04**	**0.00**	
incl. State basic budget					-0.04	0.04	0.00	
incl. local government budget					0.00	0.00	0.00	
Raising excise duty rates	AN	D2	Accruals	Approved by the Government	0.00	0.00	0.00	

[11] Amendments to the Law on Excise Duties, available at: https://likumi.lv/ta/id/348551-grozijumi-likuma-par-akcizes-nodokli-

[12] Amendments to the Value Added Tax Law, available at: https://likumi.lv/ta/id/348559-grozijumi-pievienotas-vertibas-nodokla-likuma

[13] Amendments to the Law on Personal Income Tax, available at: https://likumi.lv/ta/id/348453-grozijumi-pateretaju-tiesibu-aizsardzibas-likuma

[14] Provisions on agricultural and feed products prohibited for import into Latvia, available at: https://likumi.lv/ta/id/350370

[15] Amendments to the Consumer Rights Protection Law, available at: https://likumi.lv/ta/id/348453-grozijumi-pateretaju-tiesibu-aizsardzibas-likuma

Detailed description*	Type of tax	ESA code	Accounting principle	Adoption status	Budgetary impact			
					2024	2025	2026	2027
					% of GDP			
incl. State basic budget					0.00	0.00	0.00	
incl. local government budget					0.00	0.00	0.00	
Increase in VAT revenue from higher excise duty rates	VAT	D2	Accruals	Approved by the Government	**0.02**	**0.00**	**0.00**	
incl. State basic budget					0.02	0.00	0.00	
incl. local government budget					0.00	0.00	0.00	
Provisions on agricultural and feed products prohibited for importation into Latvia	Non-tax	D2	Accruals	Approved by the Government	**-0.01**	**0.01**	**0.00**	
incl. State basic budget					-0.01	0.01	0.00	
incl. local government budget					0.00	0.00	0.00	
Improvement of the unified lottery and gambling monitoring information system: increase in revenue from the state fee collected from lottery organisers for the issuance of a special permit (licence)	Non-tax	P.11+ P.12+ P.131 +D.39 +D.7+ D.9	Accruals	Approved by the Government	**0.00**	**0.00**	**0.00**	**-0.001**
Increase in revenue from dividend payments, JSC *Latvia's State Forests*	Non-tax	D4	Accruals	Approved by the Government	**0.02**	**-0.02**	**0.00**	
	CIT	D5	Accruals	Approved by the Government	**0.01**	**0.00**	**0.00**	
Increase in revenue from dividend payments, JSC *Latvijas Loto*	Non-tax	D4	Accruals	Approved by the Government	**0.00**	**0.00**	**0.00**	
Increase in revenue from dividend payments, JSC *Latvian State Radio and Television Centre*	Non-tax	D4	Accruals	Approved by the Government	**0.01**	**0.00**	**0.00**	
Financial stability fee revenue update, in line with 2023 actual revenue trends, adjusted by credit institutions' asset change projections	Non-tax	P.11+ P.12+ P.131 +D.39 +D.7+ D.9	Accruals	Approved by the Government	**0.00**	**0.00**	**0.00**	
Increase in revenue from fines imposed by the National Police for road traffic offences recorded by means of technical means of merchants (Classification code 10152)	Non-tax	P.11+ P.12+ P.131 +D.39 +D.7+ D.9	Accruals	Approved by the Government	**0.00**	**0.00**	**0.00**	

Detailed description*	Type of tax	ESA code	Accounting principle	Adoption status	Budgetary impact			
					2024	2025	2026	2027
					% of GDP			
Increase in revenue from fines imposed by the State Fire and Rescue Service (code 10115)	Non-tax	P.11+ P.12+ P.131 +D.39 +D.7+ D.9	Accruals	Approved by the Government	**0.00**	**0.00**	**0.00**	
Borrowers' fee	Non-tax	P.11+ P.12+ P.131 +D.39 +D.7+ D.9	Accruals	Approved by the Government	**0.23**	**-0.22**	**0.00**	
Total					**0.24**	**-0.16**	**0.00**	**-0.001**

3.2. Current Fiscal Situation

According to the assessment of MoF, based on the European System of Accounts 2010 (ESA) methodology, the general government budget in 2023 had a deficit of EUR 921.1 million or 2.3% of GDP. Official statistical data on the preliminary general government budget deficit and debt for 2023 will be available at the end of April 2024, when the calculations of all general government sector transactions, including the performance of general government joint-stock companies, will be completed, and CSB together with the EU statistical office *Eurostat* will publish the results of the general government budget deficit and debt notification[16.]

The estimate of the MoF budget deficit for 2023 is 0.4 percentage points lower than projected at the end of last year. The improvement in the deficit was positively impacted by lower expenditure in line with the ESA methodology, such as the recognition of energy support expenditure in 2022 for 2023, the recognition of some government expenditure as advance payments, and lower expenditure on contributions to the EU budget and social security benefits. Higher non-tax revenue (mainly dividends from state-owned corporations and fees for the maintenance of petroleum product safety reserves) and fee-based services also contributed to the lower-than-expected deficit.

Compared to 2022, when the general government deficit was 4.6% of GDP, the balance improved by 2.3 percentage points in 2023, with a significant reduction in Covid-19 support and energy support. If the balance sheet impact of total support was negative at around EUR 1 billion or 3.2% of GDP in 2020, EUR 2.1 billion or 6.3% of GDP in 2021 and EUR 1.5 billion or 3.9% of GDP in 2022, the MoF estimates that total support in 2023 will be around EUR 0.6 billion or 1.5% of GDP, of which more than 70% is accounted for by energy support for heat and electricity consumers and the payment of energy-related social benefits.

With the central government bearing the bulk of the expenditure burden, the general government sub-sector ended 2023 with a deficit of EUR 1.1 billion, while the local government budget had a much smaller deficit (EUR 111 million) than the central government, thanks to a significant increase in tax revenues, and the social security fund remained in surplus (EUR 302.8 million) (see Figure 3.1.).

[16] The general government deficit and debt notification, as required by Regulation (EC) No 479/2009, is submitted to *Eurostat* twice a year, by 1 April and 1 October.

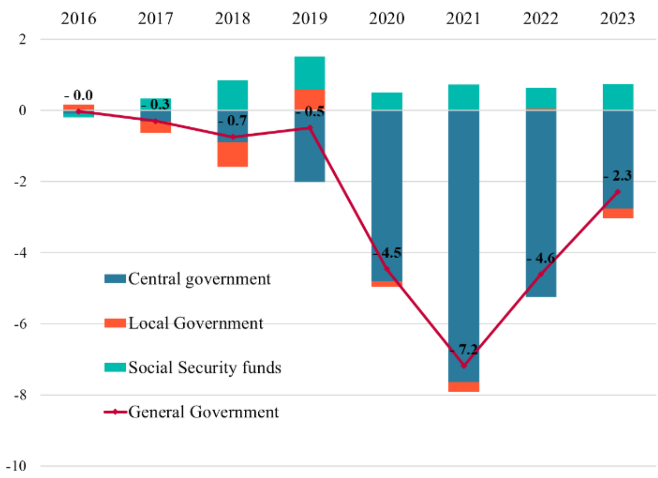

Figure 3.1. General government budget balance sheet by subsectors, % of GDP (Data source: Eurostat, MoF)

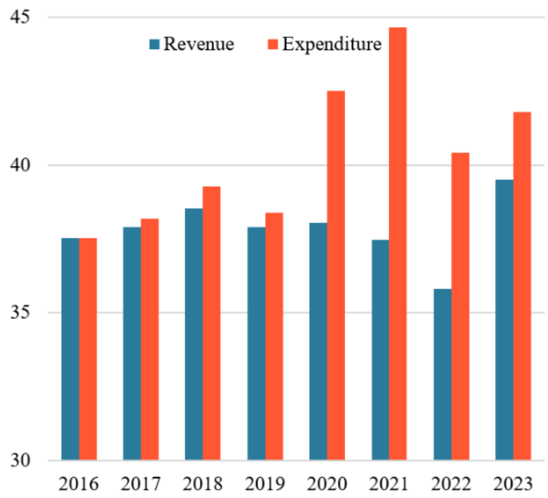

Figure 3.2. General government revenue and expenditure, % of GDP (Data source: Eurostat, MoF)

In 2023, compared to 2022, general government revenue increased by EUR 2,017 million or 14.5% to EUR 15.9 billion or 39.5% of GDP (see Figure 3.2). General government budget revenue as a share of GDP increased by 3.7 percentage points in 2023.

Tax revenue[17] accounts for the largest share of revenue, reaching 32.3% of GDP in 2023, representing 1.6 percentage points over the indicator of 2022. In nominal terms, tax revenue increased by EUR 1,093 million or 9.1%, of which taxes on production and imports (D.2) rose by EUR 232 million or 4.3%. VAT revenue accounted for almost EUR 3.9 billion, representing EUR 320.8 million or 9% over the indicator of 2022. The sharp rise in VAT revenue is to be related mainly to taxes paid in the trade sector, given last year's average inflation of 8.9%. High energy prices contributed to the increase in tax revenues in the electricity, gas and heating sectors in early 2023.

Current taxes on income and wealth (D.5) increased by EUR 417.3 million or 15.3% compared to 2022. As the amount of distributable profit increased, including in the largest SOEs, corporate income tax (CIT) increased by EUR 166.1 million or 43.8% in 2023. The largest contributions of this tax were observed in energy, forestry, trade and financial services sectors.

High growth rate was observed in labour tax revenues in 2023. Positive dynamics in the wage bill contributed to high growth rate of labour tax revenue throughout the year. Social contributions (D.61) thus amounted to EUR 4.2 billion last year, increasing by EUR 470.2 million or 12.5%. Personal income tax (PIT) revenue was EUR 2.5 billion, representing EUR 238.3 million or 10.5% over the indicator a year earlier.

Revenue from property income tax (D.4) has increased substantially amounting to EUR 557.9 million in 2023, representing increase by EUR 351.4 million and accounting for 1.4% of GDP. This was facilitated by dividend payments by the state's largest capital companies in the first half of 2023. In May 2023, the Joint-Stock Company *Latvenergo* disbursed EUR 134 million in dividends to the State, what is by EUR 63.8 million more than a year earlier. What also should be noted is the amount of EUR 18.5 million additionally paid by the Joint-stock Company *Latvenergo* into the budget in November 2023 to compensate for the reduction in electricity distribution tariffs. The Joint-stock Company *Latvijas valsts meži* also paid EUR 162.5 million in dividends in June 2023, representing EUR 91 million over the indicator of

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[17] Tax burden (D.2 (incl. EU share)+D.5+D.61+D91).

2022. In 2023, EUR 48.8 million was collected in state duties, representing 29% over the indicator a year ago, including the state duty for the maintenance of oil stocks was collected in the amount exceeding the indicator of 2022 by EUR 44.4 million. Whereas, interest income on deposits and account balances, on the other hand, increased by EUR 62.7 million in 2023, attributable to the ECB's monetary policy to contain inflation. This led to a series of interest rate hikes starting on 21 July 2022.

In the first two months of 2024, the consolidated general government budget revenue (according to the cash-flow methodology) was EUR 269.8 million or 10.2% higher than in the same period last year, amounting to EUR 2.9 billion. The increase in general government budget revenue was mainly due to the receipt of foreign financial assistance (FFA) revenue for the implemented EU fund projects, which was significantly higher this year (by EUR 155.1 million more) than a year ago. Increase in revenue was also driven by non-tax revenue, which in the first two months of 2024 was collected in the amount of EUR 154.6 million, i.e., increase of EUR 52.3 million or 51.1%, compared to the same period of previous year. The increase in revenue was mainly due to a special-purpose state duty of EUR 24.2 million paid by commercial banks in January 2024, which will be accounted as general government budget expenditure when disbursing compensations to support mortgage borrowers. However, total tax revenue, including the balance in the Single Tax Account, was only EUR 44.1 million or 2.1% higher in the first two months of this year compared to the same period in 2023, accounting for EUR 2.1 billion. It should be noted that, in the first two months of last year, tax revenue growth was much sharper, with VAT revenue rising significantly. While VAT revenue grew by 27.8% in the first two months of 2022 and by 25.9% in the first two months of 2023, this year's VAT collection rate is EUR 81.2 million or 11.8% less than last year, accounting for EUR 606.7 million. High inflation and energy prices contributed to a surge in tax revenues in the electricity, gas and heating sectors at the beginning of last year, which started to decline in the second half of the year and also affected this year's VAT revenue. VAT revenue in the wholesale sector fell significantly, with lower contributions from wholesalers of petroleum products and fuel, as well as agricultural goods. Whereas, the construction sector experienced high volume indices in the last quarter of 2023, which contributed to the fall in VAT revenue in January this year due to significantly higher refunds within the sector. On the contrary, the growth rate of labour tax revenue continues to increase. According to the SRS, the wage bill grew by 11.1% in the first two months of 2024. In the private sector increase in the wage bill was 7.5%, while in the public sector — 19.8%. Social contributions thus amounted to EUR 749.4 million in the first two months of 2024, an increase of EUR 73 million or 10.8%. Personal income tax (PIT) revenue was EUR 511.5 million, representing EUR 68.1 million or 15.3% over the indicator a year earlier. In January-February, personal income tax (PIT) revenue grew faster than social contributions, driven by the progressivity of the PIT rate and the graduated tax-free minimum, which decreases at higher wage levels, thus increasing the taxable income base.

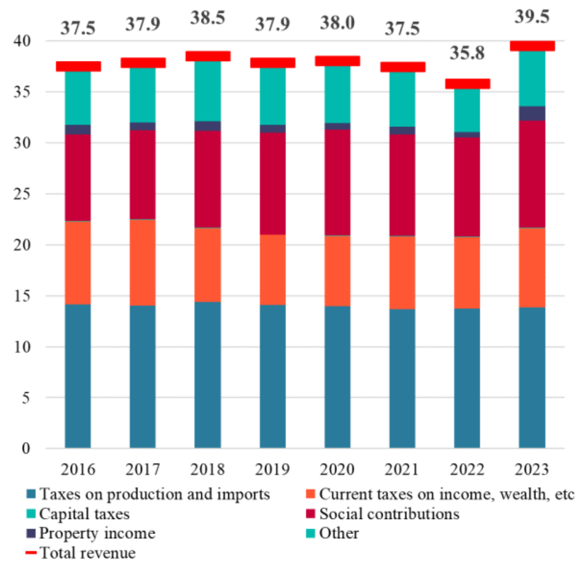


Figure 3.3. General government revenue structure, % of GDP (Data source: Eurostat, MoF)

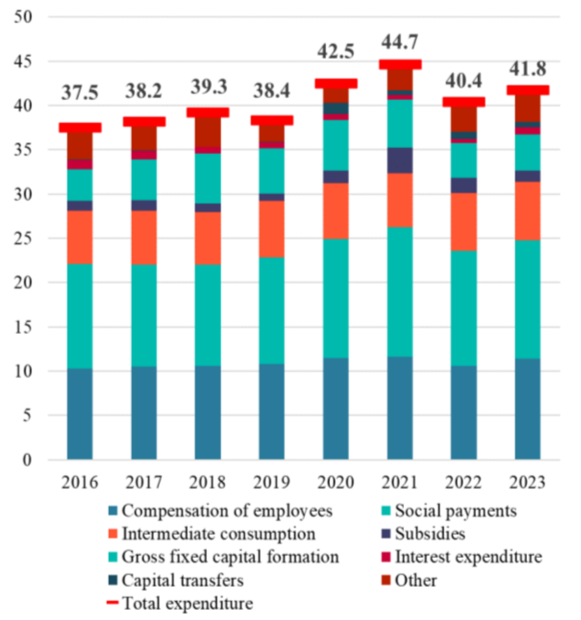


Figure 3.4. General government expenditure structure, % of GDP (Data source: Eurostat, MoF)

General government budget expenditure increased by EUR 1,148.7 million or 7.3% in 2023, amounting to EUR 16.9 billion or 41.8% of GDP (see Figure 3.4.). It should be noted that general government expenditure as a share of GDP increased by 1.4 percentage points in 2023. As spending continued to rise in both the social security fund and local government budgets, balances at these budget levels declined sharply. By contrast, the central government budget the year 2023 was closed with a significantly lower deficit than a year earlier. This can be mainly explained by the expenditure in 2022 to secure strategic gas reserves, as well as significantly lower government spending in 2023 to finance Covid-19 support measures. However, significantly higher use of the financing from EU funds in 2023 is reflected in an increase in subsidies and grants, as well as in capital expenditure.

Total expenditure on remuneration (D.1) increased by EUR 487.5 million or 11.8% in 2023. This was boosted by the increase in the minimum wage from EUR 500 to EUR 620 from January 1, 2023. The biggest increases can be observed in local government budget, including on teacher pay rises. Central government expenses on remuneration have also increased, mainly in defence, interior and justice structures.

Expenditure on social benefits (D.632 and D.62) increased by EUR 325.3 million or 6.4%. However, the situation varied by general government budget sub-sectors: while central government spending on social payments fell by EUR 160.1 million or 12.6%, the social security fund increased by EUR 359.2 million or 10%. The lower central government expenditure can be explained by a significantly higher expenditure base in 2022, when lump-sum allowances were paid to families and seniors to compensate for the negative effects of energy price increases. In contrast, the social security fund shows higher expenses on old-age and disability pensions, taking into account the very high indexation coefficient of pensions in 2023. It should be noted that spending on sickness benefits in 2023 was lower than a year ago. A positive aspect is the sharp drop of 31,6% in the number of sickness benefit recipients compared to 2022, which should be attributed to the wide spread of the omicron variant of Covid-19 a year earlier. Expenditure on social payments in local government budgets is also rising sharply. Expenditure increased on housing allowances, mainly due to the provision of assistance to the Ukraine civilians. There was also more spending on paying for care at home and for social care and rehabilitation services.

General government expenditure on gross fixed capital formation (P.51G) increased by EUR 128.2 million or 8.5% in 2023. More money was spent on the purchase of communication and computer equipment, reconstruction and construction projects in the defence sector and purchase of vehicles in the interior sector, as well as on implementation of the EU co-funded projects in the transport sector. Increase in gross fixed capital formation was limited by lower estimates of investment projects by enterprises classified in the general government sector, as well as the persistently high level of estimated amount of military equipment assistance.

Intermediate consumption expenditure (P.2) rose by EUR 120.1 million or 4.7% last year. The relatively modest increase in expenditure can be explained by the central government's one-off purchase of energy security reserves in autumn 2022. Whereas, increase in expenditure was driven by an increase in the estimate of expenditure on goods and services by non-classified traders due to price increases, as well as local government expenditure on heating, catering, real estate and road maintenance.

In the first two months of 2024, the consolidated general budget expenditure (according to cash-flow methodology) of EUR 2.7 billion was EUR 236.3 million or 9.5% higher than in the same period year earlier. The increase in expenditure was driven by higher FFA expenditure, due to the beginning of disbursements to farmers in January this year under the Latvia's new Common Agricultural Policy Strategic Plan 2023—2027. Payments of EUR 16 million have also been made to Recovery Fund projects and *Rail Baltica's* expenditure amounted to EUR 18 million in the state basic budget in the two months of 2024. Whereas, as previous programming period closes and projects gradually start in the new programming period, Cohesion Policy spending in the first two months of this year was EUR 74.3 million lower than last year and accounted for EUR 40.7 million. Similarly, increase in general government budget spending in two months of 2024 was driven by significantly higher general government budget spending on remuneration. The increase was driven by the increase in the minimum wage from EUR 620 to EUR 700 as of 1 January this year, as well as by salary increases for the employees of the defence, inerior and justice sectors, including the payment of retirement allowances to inerior and justice officials with special service ranks for every five years of continuous service. The local government budget also saw a significant increase in remuneration expenditure, largely due to higher expenditure on teachers' salaries.

Whereas, increase in capital expenditure of the general government budget is mainly due to higher expenditure on basic functions in the state basic budget, where EUR 145.3 million were spent on the purchase of equipment for the National Armed Forces, while capital expenditure in the local government budget was lower than last year. This year, rising wages and inflation, which affect the level of social benefits and pensions, also contributed to the increase in social payments in the general government budget. With the number of beneficiaries remaining at the same level as last year, but the average amount of pensions increased, expenditure on old-age and disability pensions in the state special budget has risen. Expenditure on sickness benefits has also rose, driven by increase in the average amount of sickness benefits (19.3% in the first two months of this year), while the number of beneficiaries fell compared to the first two months of 2023. Social payments are also rising in local government budgets, due to the increase in payments for social care services, including care at home.

3.3. Support Measures for Mitigating the Consequences of Crisis

Since 2020, Latvia, like other countries in the region, has faced necessity to allocate substantial but at the same time fixed-term funding to mitigate the effects of the Covid-19 pandemic in addition to regular expenditure, whereas, as of 2022 - to mitigate the impact of rising energy prices and support Ukrainian refugees.

Expenditure on support measures in 2023 was significantly lower than in the previous year, at just under EUR 600 million. Majority of this was energy assistance - EUR 454 million, mainly to compensate for increases in heat and electricity costs for businesses and households, EUR 77 million was spent for Covid-19 support payments and EUR 68 million - to provide support to Ukrainian civilian population. The overall impact of aid on the general government budget balance in 2023 was negative - 1.5% of GDP, of which 1.1% of GDP - for energy support, 0.2% of GDP - for Covid-19 and 0.2% of GDP - for support to the Ukrainian civilian population.

Table 3.7. Amount of support and its impact on the general government budget balance,
EUR million and % of GDP

	Amount of support					Impact on the budget balance				
	2020	**2021**	**2022**	**2023**	**2024**	**2020**	**2021**	**2022**	**2023**	**2024**
	Implementation				Plan	Implementation				Plan
Covid-19	1,282 4.3%	2,315 6.9%	966 2.5%	77 0.2%	29 0.1%	-961 -3.2%	-2,103 -6.3%	-796 -2.1%	-95 -0.2%	-37 -0.1%
Energy		2 0.0%	604 1.6%	454 1.1%	50 0.1%		-2 0.0%	-604 -1.6%	-436 -1.1%	0 0.0%
Ukraine			81 0.2%	68 0.2%	70 0.2%			-81 -0.2%	-68 -0.2%	-70 -0.2%
TOTAL support	**1,282**	**2,317**	**1,650**	**599**	**149**	**-961**	**-2,105**	**-1,481**	**-599**	**-107**
% of GDP	**4.3%**	**6.9%**	**4.3%**	**1.5%**	**0.4%**	**-3.2%**	**-6.3%**	**-3.9%**	**-1.5%**	**-0.3%**

It should be noted that Covid-19 support has already decreased significantly since 2022, and in 2023 expenditure was paid for certain ongoing investment projects only, for previously ordered Covid-19 vaccines and for the implementation of programmes of the financial institution, Joint-Stock Company *Development Finance Institution Altum* (Altum). In 2024, Covid-19 support is planned to be even smaller, with the effective closing of ongoing investment projects and, as in 2023, providing for funding for the purchase of Covid-19 vaccines previously ordered, as well as the continuation of the Altum programmes with impact up to 2027, as a result of the programmes' performance indicators.

Whereas, with regard to energy support, while in 2023 the compensation of households for the increase in district heating costs, the full reduction of the electricity system service charge for enterprises and support for seniors, persons with disabilities, persons who have lost their breadwinners and other support measures continued, in 2024, taking into account the decrease in energy prices, support of EUR 50 million is planned to mitigate the impact of the increase in electricity distribution tariffs on households. This budget expenditure is partly compensated by dividend income from the Joint-Stock Company *Latvenergo*.

Since 2022, Ukrainian residents who have migrated to Latvia because of Russian aggression have received social assistance and social services. There are currently just under 32,000 Ukrainian civilians registered in Latvia and receiving assistance from local governments[18]. In 2023, support to Ukrainian refugees amounted to EUR 68 million, of which EUR *28*.9 million was allocated to local governments for refugees accommodation, meals and education expenses for children, EUR 10 million for contributions to international organisations for humanitarian and military assistance to Ukraine and EUR 29 million for other expenses assigned by order of the Cabinet.

Whereas, in 2024, the amount planned to be spent on support of Ukraine accounts for EUR 70 million, including primary support for accommodation and meals, social assistance, financial support measures, access to education and healthcare, employment support measures, language training, cultural orientation and other integration measures. When planning the funding, it is assumed in the calculations that, in 2024, around 12,000 Ukrainian civilians could arrive in Latvia.

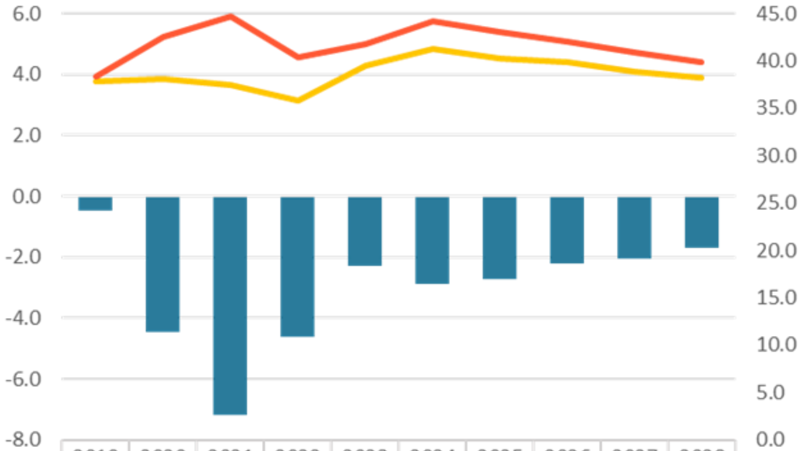
3.4. Fiscal Development Scenario

3.4.1. Fiscal Development Scenario at No-Policy Change Scenario

The medium-term general government budget projections at no-policy change scenario were based on the Law on the State Budget for 2024 and the Budgetary Framework for 2024, 2025 and 2026, approved by the Saeima on 9 December 2023, and, updating revenue and some expenditure projections in line with the updated macroeconomic development scenario and budget implementation trends in the first two months of 2024. The general government budget deficit in 2024 is projected to be 0.1 percentage point higher than budgeted, at 2.9% of GDP. In the no-policy-change scenario, the general government budget deficit is projected at 2.7% of GDP in 2025, 2.2% of GDP in 2026, 2.0% of GDP in 2027 and 1.7% of GDP in 2028 (see Figure 3.5).

According to the projections, general government revenue as a share of GDP projected to be higher in 2024 than in 2023, reaching 41.3% of GDP, before declining in subsequent years to 40.3% of GDP in 2025, 39.8% of GDP in 2026, 38.9% of GDP in 2027 and 38.2% of GDP in 2028, respectively. The high revenue share in 2024 will be driven by an increase in tax revenues and social contributions in relation to GDP, related to high growth in the wage bill and corporate income tax applied to the banking sector. Whereas, the projected amount of dividends received from public sector capital companies will affect the decline in the revenue-to-GDP ratio in the coming years. Similarly, a decrease in revenue from EU investment funding is expected from 2026, due to the end of the Recovery Fund implementation period.

[18] Data source: Ministry of the Interior, 08.04.2024



	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028
	Actual				Estimate		Forecast (unchanged policy)			
General Government Balance (Budget 2024-2026)	-0.5	-4.5	-7.2	-4.6	-2.7	-2.8	-2.4	-0.9		
General Government Balance (SP 2024-2028)	-0.5	-4.5	-7.2	-4.6	-2.3	-2.9	-2.7	-2.2	-2.0	-1.7
Revenue (right axis)	37.9	38.0	37.5	35.8	39.5	41.3	40.3	39.8	38.9	38.2
Expenditure (right axis)	38.4	42.5	44.7	40.4	41.8	44.2	43.0	42.0	40.9	39.9

Figure 3.5. General government revenue, expenditure and balance as % of GDP (Data source: Eurostat[19], MoF)

General government expenditure as a share of GDP is expected to grow significantly in 2024, with significant funding provided for to strengthen internal and external security, as well as raising wages for public sector employees (D.1), in particular in the force authorities and for teachers. According to the projections, general government expenditure as a share of GDP will be significantly higher in 2024 than in 2023, reaching 44.2% of GDP, before declining to 43% of GDP in 2025, 42% of GDP in 2026, 40.9% of GDP in 2027 and 39.9% of GDP in 2028. In 2025, the budget no longer includes support for residents to mitigate energy price increases, or support for Ukrainian civilians, on which no government decisions have been taken. In nominal terms, both total revenue and expenditure will grow every year.

Compensation expenditure (D.1) will grow by 14.4% overall to 12.5% of GDP in 2024, compared to 11.4% of GDP in 2023.

Intermediate consumption expenditure (P.2) is projected at 6.5% of GDP in 2024, roughly the same level as in previous years, driven by a persistently high level of expenditure on goods and services, largely due to rising spending on utilities and fuel. Although in nominal terms intermediate consumption expenditure is projected to increase year on year, however, as a percentage of GDP it will decline moderately to 6.4% of GDP in 2025 and fall to 6% of GDP by 2028.

Interest expenditure (D.41) as a share of GDP has been increasing since 2023 and is projected to show similar trend until 2028. High interest rates and the size of the nominal deficit increase the need to borrow, so the share of interest expenditure will rise from 0.8% of GDP in 2024 to 1.4% of GDP in 2028.

Investment expenditure (P.51g) in 2024-2026 is projected to be above the levels of previous years - 5.3% of GDP in 2024, 5.7% of GDP in 2025, respectively, driven by both investments in internal and external security and active implementation of EU fund projects and the *Rail Baltica* project.

[19] Actual data for 2019-2022 are according to *Eurostat* published (October 2023).
According to *Eurostat* (22.04.2024), the general government budget deficit in 2023 was 2.2% of GDP.

Table 3.8. Fiscal development scenario at nopolicy change scenario

		2023	2024	2025	2026	2027	2028
	ESA code	**% of GDP**					
Net loans (+) or borrowings (-) (B.9) by subsector							
General government	S.13	-2.3	-2.9	-2.7	-2.2	-2.0	-1.7
incl. traders[20]		-0.3	-0.3	-0.1	0.0	0.0	0.0
Central government	S.1311	-2.8	-3.5	-3.3	-2.7	-2.4	-2.1
incl. traders		-0.3	-0.3	-0.1	0.0	0.0	0.0
Local government	S.1313	-0.3	-0.1	-0.1	0.0	-0.1	0.0
incl. traders		0.0	0.0	0.0	0.0	0.0	0.0
Social security funds	S.1314	0.8	0.7	0.7	0.6	0.4	0.4
General government (S.13)							
Total revenue	TR	39.5	41.3	40.3	39.8	38.9	38.2
Total expenditure	TE	41.8	44.2	43.0	42.0	40.9	39.9
Interest expense	D.41	0.8	1.0	1.2	1.3	1.4	1.4
Cyclical development							
Cyclical component of the budget balance[21]		-0.1	-0.4	-0.1	0.0	0.0	0.0
One-off and other temporary measures		-2.0	-1.7	-1.6	-1.6	-1.5	-1.3
Cyclically-adjusted balance		-2.1	-2.5	-2.6	-2.2	-2.0	-1.7
Cyclically-adjusted primary balance		-1.3	-1.4	-1.4	-0.9	-0.7	-0.3
Structural balance		-0.1	-0.8	-1.0	-0.5	-0.6	-0.4

Central government budget

The central government budget projections an 11.4% increase in expenditure in 2024 compared to 2023, while revenue will increase by only 8.6%. Whereas, in the following years, expenditure is projected to remain stable under a no-policy-change assumption. The amount of revenue is projected to increase annually with higher tax revenues. Over the medium term, annual increases in all major taxes are broadly projected, driven by a growing wage bill and also by consumption growth. Thus, the share of tax revenue in 2024 and beyond will be well above the average share of tax revenue in GDP in previous years. In 2024-2026, high FFA revenues are also expected, which will also lead to a higher share of total central government revenue in GDP.

- Extensive energy support was not foreseen in the 2024 budget and the government has earmarked EUR 50 million to mitigate the impact of the increase in electricity distribution tariffs and EUR 70 million to support the Ukrainian civilians. This funding has been kept close to the level of expenditure in previous years.
- The 2024 budget prioritised internal and external security, as well as education and health. Defence expenditure by functional division will increase especially significantly: 2.9% of GDP in 2024-2025, 3.5% of GDP in 2026 and 3.7% of GDP in 2027-2028.

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[20] Commercial companies controlled and financed by state and local government bodies (result of the MoF sample survey). The full list of traders is available on the CSB website https://www.csb.gov.lv/lv/statistika/klasifikacijas/institucionalo-sektoru-klasifikacija/kodi.

[21] The cyclical component of the budget balance is calculated using a budget semi-elasticity of 0.378 (Data source: *G.Mourre ao. European Commission. The Semi-Elasticities Underlying the Cyclically-Adjusted Budget Balance: An Update & Further Analysis. May 2019).*

- Delivery of the new electric trains was started at the end of 2023 and continues in 2024. While it was initially planned to finance part of the 32 new electric trains from the state budget funds, it is now planned that the purchase of all the trains is financed from the EU Cohesion Fund with co-financing from the state budget. In line with the ESA methodology, expenditure in the general government budget will be accounted according to the actual delivery of trains.
- The projections also include the Latvia's largest rail freight operator, the State Joint-stock Company *Latvijas dzelzceļš*, which was reclassified to the general government sector during the April 2024 general government notification (EDP). The impact of this trader on the general government budget deficit (B.9) is estimated at negative 0.1% of GDP in 2023-2024 and projected below 0.1% of GDP in 2025.

Social Security Fund

- The Social Security Fund has been in surplus since 2017 and is expected to remain in surplus until 2028. Overall, social security revenue is projected to grow slightly more moderately than expenditures and the surplus is projected to decline from 0.7% of GDP in 2024 to 0.4% of GDP in 2028. Pension expenditure would rise even faster if the pension reform introduced in 2014 were not implemented, raising the retirement age to 65 by three months every year until 2025. As a result, the number of pension beneficiaries is declining and is currently projected to continue to decline until the end of the reform. Whereas, as of 2026, decline in the number of pension beneficiaries will stop, and, in the coming years, according to *Eurostat* demographic projections, the population 65+ is expected to increase, which will have a concomitant impact on expenditure growth, along with the increase in the average pension amount.
- Every year on October 1, (indexed) old-age, disability, retirement, survivors' pensions and insurance benefits are reviewed in Latvia, which is also taken into account in the projections until 2028. On October 1, 2023, the index calculated by the MoW was 1.064, and pensions not exceeding EUR 609 (50% of the national average wage subject to insurance contribution of the previous calendar year) were indexed, while pensions and insurance compensations exceeding EUR 609 were reviewed only for the part of EUR 609.
- According to the MoW projections, the average number of old-age pension beneficiaries per month will increase from 424.7 thousand in 2024 to 429.4 thousand in 2028. The average old-age pension will rise from EUR 598 in 2024 to EUR 773 in 2028.
- The number of unemployment benefit recipients in 2024 will be 1.0% higher than in 2023, but will decline annually thereafter. According to the MoW projections, the number of unemployment benefit recipients per month will reach 30.7 thousand on average in 2024, but will decrease to 29.1 thousand in 2025 and in 2028 it will decrease to 24.8 thousand. In the medium term, given the increase in the average benefit level, expenditure on unemployment benefits will increase, only decreasing slightly from 2027 onwards.
- Despite the projected decline in the number of sickness benefit recipients in the medium term, expenditure on sickness benefits is projected to increase in 2024 and throughout the medium term, driven by the increase in the average benefit level. The increase is

due to both the projected trend in wage subject to contributions and the projected increase in the number (duration) of sick days.

Local government budget

- In 2024, local government budget is expected to run a deficit of 0.1% of GDP, while in 2023 local government was running a deficit of 0.3% of GDP. Lower deficit is mainly due to a lower growth rate of expenditure (+4.7%) compared to 2023, while revenue is projected to grow by 6.5% this year. A small deficit is projected over the entire medium term, but it should be noted that FFA investment flows and the corresponding co-financing are important for the local government budget, affecting the year-on-year fluctuations in the balance.
- Expenditure on all kinds of goods and services is projected to decline slightly in 2024, driven by stabilising energy prices. Likewise, lower expenditures for social support also projected to be lower. Smaller expenditure is due to the fact that some energy support costs are not planned to be spent this year as last year, as well as lower expenditure, for example, on housing allowances for Ukrainian refugees. Whereas, increase in expenditure in 2024 will be driven by wage increases in local governments. Higher level of spending in the local government budget is determined by additionally assigned funding for teacher pay rises, minimum wage increases and assistant and companion service providers. Thus, local government expenditure for remuneration is expected to increase substantially in 2024 continuing to grow in the medium term, but at a more moderate pace under a no-policy change assumption.
- In 2024, capital expenditure in the local government budget is expected to decrease, driven by lower levels of expenditure on investment in basic functions, while investment in projects financed by foreign financial assistance is expected to increase year-on-year in the medium term. From 2025 onwards, a significant increase in investment is planned every year.

3.4.2. Fiscal Indicators and Fiscal Space Arising from the Fiscal Strategy

According to the fiscal strategy (see Section 3.1.2), targets of the general government structural budget balance **of -0.5% of GDP in 2025**, **-0.5% of GDP in 2026**, **-0.5% of GDP in 2027** and **-0.5% of GDP in 2028**.

The resulting nominal general government budget balance is calculated in Table 3.9.

Table 3.9. Nominal general government budget balance arising from the structural balance goal

		2025	2026	2027	2028
General government budget structural balance targets, % of GDP	**(1)**	**-0.5**	**-0.5**	**-0.5**	**-0.5**
Output difference, % of potential GDP	**(2)**	-0.3	0.0	0.0	0.0
Cyclical component of the balance, % of GDP	**(3)=0.378*(2)**	-0.1	0.0	0.0	0.0
One-off and other temporary measures, % of GDP, including	**(4)**	**-1.6**	**-1.6**	**-1.5**	**-1.3**
Covid-19 pandemic mitigation measures		-0.01	-0.01	0.00	0.00

		2025	2026	2027	2028
measures to mitigate energy price increases		0.0	0.0	0.0	0.0
defence and internal security funding		-0.9	-1.0	-0.9	-0.7
support for Ukrainian refugees		0.0	0.0	0.0	0.0
one-off expenditure on national defence and internal security		-0.7	-0.6	-0.6	-0.6
Nominal general government budget balance, % of GDP	**(5)=(1)+(3)+(4)**	**-2.2**	**-2.2**	**-2.0**	**-1.8**

Table 3.10. Fiscal space

		2025	2026	2027	2028
Projection of general government headline balance at no policy change, % of GDP	**(1)**	-2.7	-2.2	-2.0	-1.7
Output difference, % of potential GDP	**(2)**	-0.3	0.0	0.0	0.0
Cyclical component of the balance, % of GDP	**(3)=0.378*(2)**	-0.1	0.0	0.0	0.0
***One-off* and other temporary measures included in the no-policy-change scenario, % of GDP, including**	**(4)**	**-1.6**	**-1.6**	**-1.5**	**-1.3**
Covid-19 pandemic mitigation measures		0.0	0.0	0.0	0.0
measures to mitigate energy price increases		0.0	0.0	0.0	0.0
defence and internal security funding		-0.9	-1.0	-0.9	-0.7
support for Ukrainian refugees		0.0	0.0	0.0	0.0
one-off expenditure on national defence and internal security		-0.7	-0.6	-0.6	-0.6
General government structural balance projections at no policy change, % of GDP	(5)=(1)-(3)-(4)	**-1.0**	**-0.5**	**-0.6**	**-0.4**
General government budget structural balance goals, % of GDP	(6)	**-0.5**	**-0.5**	**-0.5**	**-0.5**
Fiscal security resetve, % of GDP	(7)	0.1	0.1	0.1	0.1
Fiscal space, % of GDP	**(8)=(5)-(6)-(7)**	**-0.6**	**-0.1**	**-0.2**	**0.02**
Fiscal space, million *EUR*		**-279.5**	**-67.8**	**-77.8**	**10.4**

The Stability Programme's fiscal development scenario projects a negative fiscal space of 0.6% of GDP or EUR 279.5 million in 2025, 0.1% of GDP or EUR 67.8 million in 2026, 0.2% of GDP or EUR 77.8 million in 2027 and a positive fiscal space of 0.02% of GDP or EUR 10.4 million in 2028, excluding possible additional financing for one-off expenditure, which in any case cannot exceed EUR 222.7 million in 2025.

If a decision is taken to increase the structural deficit limit under the FDL from 0.5% of GDP to 1% of GDP (see Section 3.1.3), fiscal space improves substantially. In 2025, it remains negative at EUR 56.8 million, but positive in the following years: EUR 153.0 million in 2026, EUR 168.6 million in 2027 and EUR 269.3 million in 2028. However, in this case, additional one-off measures cannot be financed.

There is no difference between the two options if the 2026 budget preparation process were to identify that geopolitical challenges require significant additional funding for national defence: in the first case, space is smaller, but this is financed outside fiscal space; whereas, in the second case, space is larger, but additional defence spending is financed within the framework of the fiscal space.

It should also be noted that in both cases the space in 2025 is negative, and additional sources of funding need to be sought for non-defence policy priorities.

Table 3.11. Medium-term fiscal development scenario, % of GDP

		2023	2024	2025	2026	2027	2028
	ESA code	**% of GDP**					
Net loans (+) or borrowings (-) (B.9) by subsector							
General government	S.13	-2.3	-2.9	-2.2	-2.2	-2.0	-1.8
Central government	S.1311	-2.8	-3.5	-2.8	-2.7	-2.3	-2.2
Local government	S.1313	-0.3	-0.1	-0.1	0.0	-0.1	0.0
Social security funds	S.1314	0.8	0.7	0.7	0.6	0.4	0.4
General government (S.13)							
Total revenue	TR	39.5	41.3	40.3	39.8	38.9	38.2
Total expenditure	TE	41.8	44.2	42.5	42.0	40.9	40.0
Interest expense	D.41	0.8	1.0	1.2	1.3	1.4	1.4
Cyclical development							
Cyclical component of the budget balance[22]		-0.1	-0.4	-0.1	0.0	0.0	0.0
One-off and other temporary measures[23]		-2.0	-1.7	-1.6	-1.6	-1.5	-1.3
Cyclically-adjusted balance		-2.1	-2.5	-2.1	-2.1	-2.0	-1.8
Cyclically-adjusted primary balance		-1.3	-1.4	-0.9	-0.9	-0.6	-0.4
Structural balance		-0.1	-0.8	-0.5	-0.5	-0.5	-0.5

The fiscal scenario assumes that the fiscal space in 2025, 2026, 2027 and 2028 is attributed to the central government. The fiscal buffer is assumed to be exhausted, i.e. fiscal risks of 0.1% of GDP occur. As decisions on the development section of the budget are taken during the budget-setting process and are currently unknown, changes in expenditure are made in proportion to the expenditure categories in the years concerned, based on the proportion of individual headings to total expenditure under a no-policy-change scenario. Interest expenditure is excluded from the calculation of the ratio of individual expenditure categories to total expenditure under a no-policy change scenario. This approach is used because it is assumed that the decisions of the development part of the budget do not affect this heading.

3.5. Medium-Term Development Trends of Government Debt

The basic principles and objectives of the central government debt management for the medium term are defined in the Central Government Debt and Cash Management Strategy, which is approved by the Minister of Finance. According to the Strategy, the objective of government debt and cash management is to ensure timely availability of financial resources to cover financing requirement at the lowest possible cost of servicing public debt, limiting financial risks, contributing to the development of the domestic financial market. A strategic approach to public borrowing and debt management is used to meet public debt and budget liabilities, while maintaining as much flexibility as possible in the selection of conditions (time of borrowing, instrument, amount, maturity) of borrowing from financial markets. It allows limiting of financial risks in the medium term and ensuring the resources to cover the total financing requirement under favourable conditions.

In 2022, Russia's invasion of Ukraine led to geopolitical tensions in the region, a global increase in energy prices and a sharp rise in inflation, which had a negative impact on the

[22] The cyclical component of the budget balance is calculated using a budget semi-elasticity of 0.378 (Data source: *G.Mourre ao. European Commission. The Semi-Elasticities Underlying the Cyclically-Adjusted Budget Balance: An Update & Further Analysis. May 2019*).

[23] See Table 3.1.

economy and public spending in 2022. In 2023, general government budget expenditure continued to rise, increasing by 7.9% compared to 2022. Increases were observed in expenditure in the transport and defence sectors. The use of EU funds in 2023 is reflected in an increase in subsidies and grants in the basic state budget, as well as in capital expenditure. As a result, the general budget deficit in 2023 reached EUR 1.4 billion, or 3.5% of GDP.

In 2023, EUR 3,649.9 million of financial market borrowing was used to cover the total financing requirement, including the financing of the general government deficit. *EUR* 2,100 million were raised in international financial markets through three Eurobond issues - EUR 750 million in January with a maturity of 5 years and a coupon rate of 3.5%, EUR 750 million in July with a maturity of 10 years and a coupon rate of 3.875%, and EUR 600 million in November with a maturity of 5.5 years and a coupon rate of 3.875%. In the domestic financial market, EUR 1,095.0 million was raised through additional issues of outstanding Eurobonds of different maturities, and EUR 254.9 million was raised from the Latvian residents through the issuance of savings bonds. In addition to borrowing on the financial markets, a 15-year loan of EUR 200 million from the European Investment Bank was received on financially favourable terms to co-finance projects under the planning period 2014-2020 of EU funds.

In 2023, the general government debt obligations were met in line with the debt repayment schedule, including repayment of Eurobonds issued in 2020 in the amount of EUR 1,000.0 million in April, repayment of 5-year domestic borrowing bonds in the amount of EUR 270.0 million in May, and repayment of 5-year domestic borrowing bonds in the amount of EUR 250.0 million in November, as well as early repayment of the EUR 500 million of the Covid-19 pandemic mitigation loan to the Nordic Investment Bank in April 2023.

As a result, general government debt at the end of 2023 was EUR 17.5 billion or 43.4% of GDP, according to the ESA methodology.

Despite an increase in general government debt according to the ESA methodology in recent years, Latvia's debt level remains among the lowest in the EU and euro zone.

The amount of borrowing and the level of government debt in the medium term are affected by the overall financing requirement, which mainly consist of the general government budget deficit, including various support measures, repayment of government debt and the issue of state loans (to local governments, local governments companies, state capital companies, ports and universities).

Taking into account the central government debt liabilities outstanding as of 31 March 2024, in accordance with the central government debt repayment schedule in the period between April 2024 till December 2028 the central government debt obligations should be refinanced in the amount of ~EUR 8.8 billion (see Figure 3.6). The majority of the debt to be refinanced during the aforementioned period consists of Eurobonds issued in international financial markets the maturity of which will become due.

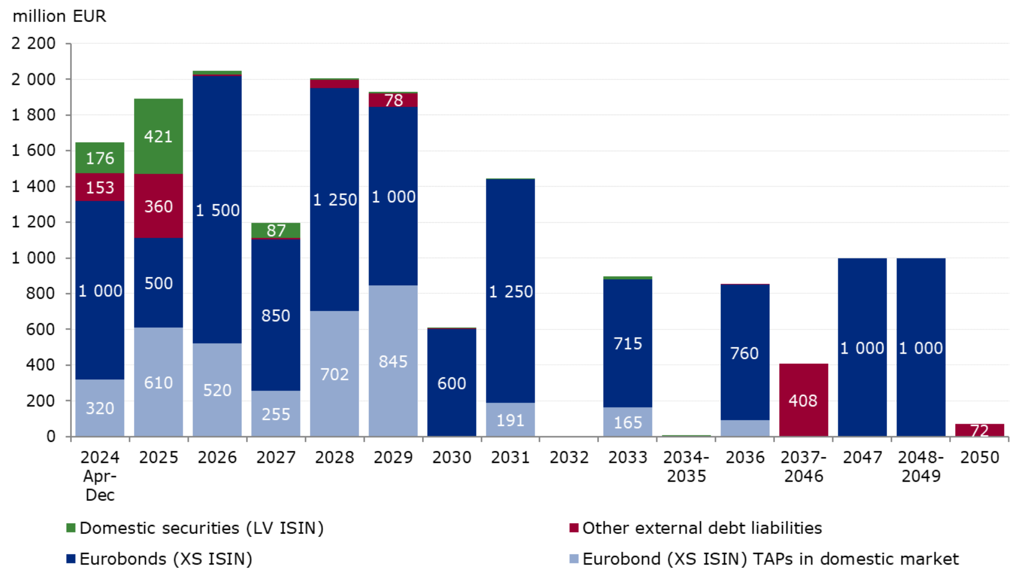


Figure 3.6. Repayment schedule of central government borrowing (liabilities outstanding as of 31 March 2024, nominal value, EUR million)

In the first quarter of 2024, additional issues of outstanding Eurobonds with maturities in 2027, 2028, 2029 and 2033 of EUR 520 million, as well as savings bonds of EUR 41.7 million were issued.

Until the end of 2024 and in 2025-2028, the total financing requirement will be covered by the resources available in the Treasury accounts and by borrowing measures in the financial markets, allowing also for the use of other borrowing instruments depending on the situation in the financial markets and interest rate trends. Borrowing on international financial markets is planned mainly through public issues of benchmark Eurobonds, while maintaining as much flexibility as possible in the parameters of the borrowing instruments. Raising financial resources in the domestic financial market is planned to be continued mainly through additional issues of outstanding Eurobonds and the issue of savings bonds, thus using the potential of the domestic financial market.

Medium-term trends of the general government debt are affected by a current forecast of the general government budget balance, including increased spending for strengthening national defence capacity and projects co-financed by EU funds, as well as updated projections of macroeconomic indicators for 2024-2028, which foresee lower economic growth rates. In addition to the factors mentioned above, the level of the general government debt in 2027 and 2028 will be determined by the need to ensure timely resources for the repayment of government debt scheduled for early 2028 and 2029.

According to current projections, the general government debt ratio as a percentage of GDP is expected to increase gradually from 45% of GDP in 2024 to 48% of GDP in 2028 over the medium term (see Figure 3.7.), but the debt condition set by the FDL (60% of GDP) will be met over the medium term. The General government debt will be maintained at a moderate, sustainable level over the long term, ensuring that debt liabilities are refinanced on optimal terms.

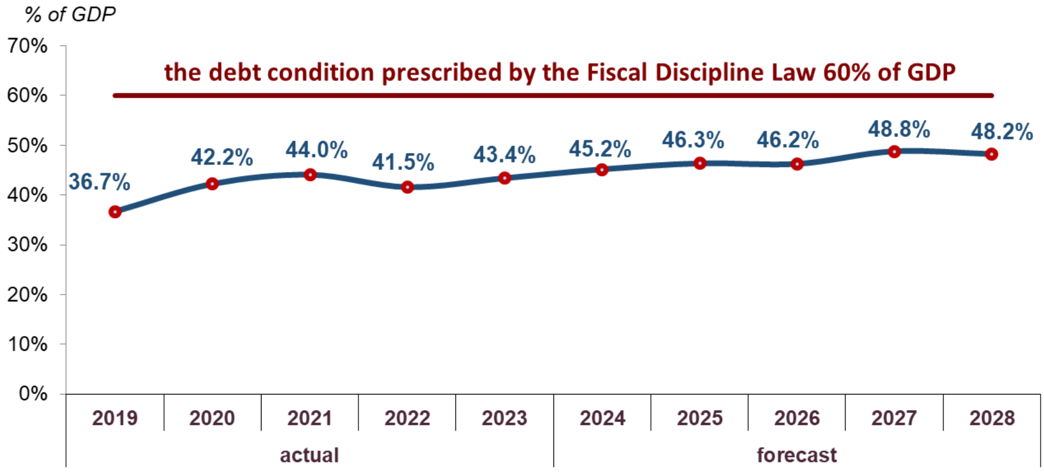


Figure 3.7. General government debt development trends

4. Sensitivity Analysis and Comparison

4.1. Macroeconomic Scenario Risks

The medium-term macroeconomic development scenarios are based on conservative assumptions about economic growth. Despite these prudent projections, the scenarios are framed within a context of substantial uncertainty. Concurrently, the potential upside and downside risks to these scenario projections are considered to be evenly balanced at present.

The primary risk for 2024 and 2025 is potential delays in the absorption of EU funds, which could constrain investment and impede the execution of major projects. Another significant risk is the possibility of weaker-than-expected economic growth in key trading partners, which may be influenced by subdued global economic conditions. Such developments could limit Latvia's export opportunities.

The deteriorating geopolitical situation is likely to undermine investor and consumer confidence, potentially driving up energy prices and domestic inflation. Additionally, the ECB's base rate might remain elevated or prove ineffective in curtailing it without a corresponding decrease in lending rates. This situation could fail to stimulate lending, resulting in persistently low lending levels.

Downside risks also encompass increasing tightness in the labor market, characterized by a declining working-age population and rising wages. These factors may potentially erode the competitiveness of firms.

Conversely, the upside risks are the direct opposites of the downside ones, notably a potential decrease in energy prices and geopolitical tensions. Additionally, business sentiment is expected to improve should the conflict between Russia and Ukraine de-escalate.

4.2. Sensitivity Analysis – Pessimistic Scenario

Economic impact

The pessimistic scenario anticipates that the downside risks will begin to materialize in the second half of 2024. This includes a reduction in the inflow of EU funds, particularly affecting the use of RRF and *Rail Baltica* funding, leading to a nominal decrease in investments. Furthermore, the economies of Latvia's key trading partners are projected to experience weaker growth during this period.

Under the pessimistic scenario, the economy of Latvia might face a more pronounced slowdown in growth rates compared to the baseline scenario. Consequently, real GDP growth in 2024 could drop by 1 percentage point to just 0.4% in constant prices. While real GDP growth is expected to recover to 2.2% in both 2025 and 2026, these rates would still be 0.7 and 0.3 percentage points slower, respectively, than in the baseline scenario.

Meanwhile, investment (gross fixed capital formation) growth would also decrease. In 2024, it is projected to be 2.4%, which is 1.5 percentage points lower than the baseline scenario. Due to increased geopolitical uncertainty reducing the region's attractiveness for investment, the growth rates for 2025 and 2026 are expected to be lower by 1 and 0.4 percentage points, respectively. Moreover, without an increase in EU funding, investment growth is anticipated to remain flat.

Geopolitical uncertainty and diminished external demand are expected to result in a 2.5% decline in Latvia's exports of goods and services in 2024. Although this downturn is anticipated to be temporary, export growth, starting from a low base, is projected to recover over the next two years. However, it would still lag behind the baseline scenario by 0.8 and 0.4 percentage points in 2025 and 2026, respectively.

Table 4.1. Pessimistic macroeconomic scenario

	Pessimistic scenario					Deviation from the baseline scenario				
	2024	**2025**	**2026**	**2027**	**2028**	**2024**	**2025**	**2026**	**2027**	**2028**
Nominal GDP growth, %	3.4	5.6	5.1	5.1	5.1	-0.7	-0.5	-0.2	0.0	0.0
Real GDP growth, %	0.4	2.2	2.2	2.3	2.3	-1.0	-0.7	-0.3	0.0	0.0
Consumer price index change, %	2.0	3.0	2.8	2.5	2.5	0.4	0.5	0.3	0.0	0.0
Private consumption, real growth, %	1.4	1.7	2.4	2.5	2.5	-0.5	-0.8	-0.3	0.0	0.0
Public consumption, real growth, %	6.7	5.8	3.1	3.0	3.0	0.0	0.0	0.0	0.0	0.0
Total fixed capital formation, real growth, %	2.4	3.2	2.4	2.4	2.4	-1.5	-1.0	-0.4	0.0	0.0
Exports of goods and services, real growth, %	-2.5	2.3	3.6	4.0	4.0	-1.7	-1.0	-0.5	0.0	0.0
Imports of goods and services, real growth, %	0.4	3.1	3.6	3.6	3.6	-1.5	-0.8	-0.4	0.0	0.0
Average monthly gross wage, nominal growth,, %	6.0	6.0	6.0	5.0	5.0	-1.5	-0.5	0.0	0.0	0.0
Number of persons employed, growth, %	-0.1	0.0	-0.3	-0.3	-0.3	-0.1	0.0	0.0	0.0	0.0
Unemployment rate, %	6.7	6.3	6.3	5.8	5.2	0.3	0.3	0.3	0.3	0.3

Under this scenario, energy prices are expected to remain relatively high, leading to a modest increase in consumer price inflation. However, the impact is anticipated to be minimal due to the ECB's restrictive monetary policy and decreasing global demand. Consequently, inflation rates are projected at 2%, 3%, and 2.8% for the years 2024 to 2026, respectively. These rates represent an average increase of 0.5 percentage points above the baseline scenario.

Despite the tight labor market conditions, no significant decline in employment is anticipated, with unemployment expected to rise by only 0.3 percentage points compared to the baseline scenario. However, the adverse economic conditions will affect wage growth. Companies are projected to increase wages at a slower pace than anticipated in the baseline scenario, with wages growing by 6%, which would be 1 percentage point lower than in the baseline scenario.

Impact on the general government budget

The pessimistic scenario would lead to lower tax revenues, higher benefit spending from 2026 and a deterioration in the general government budget balance. Compared to the baseline scenario, the general government deficit in 2024 would increase by EUR 146.8 million, or 0.4 percentage points of GDP in the pessimistic scenario. In 2025, 2026, 2027 and 2028, the general government balance would deteriorate by 0.6 percentage points of GDP annually compared to the baseline scenario, or by EUR 237.9 million, EUR 266.5 million, EUR 278.8 million and EUR 284.1 million, respectively. The general government deficit in the pessimistic scenario would increase to 3.3% of GDP in 2024, 3.3% of GDP in 2025, 2.8% of GDP in 2026, 2.6% of GDP in 2027 and 2.3% of GDP in 2028.

Table 4.2. Impact of the pessimistic scenario on the general government budget, EUR million

	Pessimistic scenario					Deviation from the baseline scenario				
	2024	**2025**	**2026**	**2027**	**2028**	**2024**	**2025**	**2026**	**2027**	**2028**
General government budget balance, % of GDP	**-3.3**	**-3.3**	**-2.8**	**-2.6**	**-2.3**	**-0.4**	**-0.6**	**-0.6**	**-0.6**	**-0.6**
General government budget balance	-1,359.8	-1,457.3	-1,301.8	-1,284.8	-1,162.7	-146.8	-237.9	-266.5	-278.8	-284.1
Tax revenue	13,480.6	14,257.8	15,010.4	15,686.6	16,380.9	-138.5	-224.8	-260.1	-281.5	-293.4

	Pessimistic scenario					Deviation from the baseline scenario				
	2024	**2025**	**2026**	**2027**	**2028**	**2024**	**2025**	**2026**	**2027**	**2028**
Personal income tax	2,677.6	2,846.4	3,037.8	3,195.4	3,366.6	-37.4	-58.6	-67.2	-74.6	-78.4
Corporate income tax	695.3	672.4	681.2	691.2	701.2	-4.7	-7.6	-8.8	-8.8	-8.8
VAT	3,963.4	4,233.3	4,419.2	4,628.3	4,847.3	-26.6	-47.7	-56.8	-58.6	-60.5
Mandatory state social insurance contributions[24]	4,372.2	4,643.6	4,921.5	5,164.9	5,418.7	-61.2	-95.9	-109.4	-121.3	-127.3
Excise duty	1,207.5	1,272.3	1,333.6	1,374.4	1,410.9	-8.2	-14.4	-17.1	-17.4	-17.5
Non-tax revenue	1,011.0	792.8	774.1	785.4	822.3	-2.7	-2.5	-2.6	-2.5	-2.5
Interest expenditure	757.0	757.0	757.0	757.0	757.0	0.0	4.9	13.0	21.9	31.3
Expenditure on social benefits	5,166.3	5,520.5	5,918.2	6,225.3	6,524.5	5.6	5.7	-9.2	-27.2	-43.1
General government debt, % of GDP	**45.8**	**47.8**	**48.3**	**51.3**	**51.2**	**0.7**	**1.4**	**2.0**	**2.5**	**3.0**

Under the most pessimistic scenario, a decline in tax revenues would increase the general government budget deficit, resulting in a higher overall financing requirement and, consequently, higher borrowing amount over the period in question compared to the baseline scenario. Additional borrowing would lead to higher interest expenses. In case of the pessimistic scenario, interest expenditure would be EUR 4.9 million higher in 2025, but by 2028 it would already be EUR 31.3 million higher than in the baseline scenario.

4.3. Sensitivity Analysis – Optimistic Scenario

Economic impact

The optimistic scenario assumes a substantial easing of geopolitical risks and a boost in confidence, leading to stronger investment growth, particularly fueled by an increase in EU fund inflows. This scenario anticipates a temporary surge in economic activity, resulting in the Latvian economy expanding more rapidly than in the baseline scenario. Consequently, real GDP growth is projected at 1.6% in 2024 and 3.5% in 2025, which are 0.2 and 0.6 percentage points higher, respectively, than the baseline scenario. In terms of inflation, there would be no change compared to the baseline, as global supply and demand are expected to progress at a similar pace.

An increase in household confidence is expected to boost private consumption growth by an average of 0.3 percentage points annually over the period from 2024 to 2026. However, the most significant contribution to economic growth is anticipated from investment, which is projected to rise by 5.6% in both 2024 and 2025, exceeding the baseline scenario by 0.3 and 1.4 percentage points, respectively. This robust investment growth will be driven by accelerated use of EU funds and RRF financing, the timely implementation of the *Rail Baltica* project, and the de-escalation of geopolitical risks, which in turn would strengthen business confidence.

Export growth is also expected to significantly support economic growth from 2024 to 2026, with exports rising gradually to 5.6% by 2026, primarily driven by increased external demand. However, as domestic demand strengthens, imports are anticipated to rise more quickly. Consequently, foreign trade, or net exports, is expected to contribute negatively to overall GDP growth during this period.

The scenario anticipates no change in inflation relative to the baseline scenario, as it foresees neither negative shocks that could escalate energy prices nor does it predict that increased economic activity will lead to lower prices. Additionally, while heightened economic activity is expected to increase labor demand, the dynamics of employment are projected to

[24] Less contributions to the state funded pension scheme and contributions to pension level 3

align with those of the baseline scenario. The tightness in the labor market will continue, with employment beginning to decline from 2026, mirroring the baseline scenario.

Table 4.3. The optimistic macroeconomic scenario

	Optimistic scenario					Deviation from the baseline scenario				
	2024	**2025**	**2026**	**2027**	**2028**	**2024**	**2025**	**2026**	**2027**	**2028**
Nominal GDP, growth, %	4.4	6.7	5.6	5.1	5.1	0.2	0.6	0.4	0.0	0.0
Real GDP, growth,, %	1.6	3.5	2.8	2.3	2.3	0.2	0.6	0.3	0.0	0.0
Consumer price index change, %	1.6	2.5	2.5	2.5	2.5	0.0	0.0	0.0	0.0	0.0
Private consumption, real growth, %	2.2	2.9	2.9	2.5	2.5	0.3	0.4	0.2	0.0	0.0
Public consumption, real growth%	6.7	5.8	3.1	3.0	3.0	0.0	0.0	0.0	0.0	0.0
Total fixed capital formation, real growth, %	4.2	5.6	2.9	2.9	2.9	0.3	1.4	0.1	0.0	0.0
Exports of goods and services, real growth, %	-0.6	4.4	4.8	4.0	4.0	0.1	1.1	0.7	0.0	0.0
Imports of goods and services, real growth, %	2.1	4.8	4.4	4.4	4.4	0.2	0.9	0.4	0.0	0.0
Average monthly gross wage, nominal growth, %	8.0	7.0	6.5	6.0	5.0	0.5	0.5	0.5	1.0	0.0
Number of persons employed, growth, %	0.0	0.0	-0.3	-0.3	-0.3	0.0	0.0	0.0	0.0	0.0
Unemployment rate, %	6.4	6.0	6.0	5.5	4.9	0.0	0.0	0.0	0.0	0.0

Impact on the general government budget

Under the optimistic scenario, in which tax and non-tax revenue increase, as does expenditure on benefits in the state special budget and the state basic budget, while interest expenditure to finance public debt decreases, the general government budget balance would improve. Compared to the baseline scenario, the general government deficit in 2024 would decrease by EUR 49.8 million, or 0.1 percentage point of GDP, in case of the optimistic scenario. Whereas, in 2025, 2026, 2027 and 2028, the general government balance would improve annually by 0.3 percentage points (EUR 129.2 million), 0.4 percentage points (EUR 191.6 million), 0.6 percentage points (EUR 269.5 million) and 0.5 percentage points (EUR 273.9 million), respectively compared to the baseline scenario.

Table 4.4. Impact of the optimistic scenario on the general government budget, EUR million

	Optimistic scenario					Deviation from the baseline scenario				
	2024	**2025**	**2026**	**2027**	**2028**	**2024**	**2025**	**2026**	**2027**	**2028**
General government budget balance, % of GDP	**-2.8**	**-2.4**	**-1.8**	**-1.5**	**-1.1**	**0.1**	**0.3**	**0.4**	**0.6**	**0.5**
General government budget balance	-1,163.3	-1,090.2	-843.6	-736.5	-604.7	49.8	129.2	191.6	269.5	273.9
Tax revenue	13,670.0	14,617.7	15,481.5	16,274.2	17,002.9	50.9	135.0	211.0	306.1	328.6
Personal income tax	2,729.0	2,936.7	3,156.4	3,356.4	3,538.7	14.0	31.7	51.4	86.4	93.7
Corporate income tax	701.6	685.5	697.9	708.1	718.3	1.6	5.5	7.9	8.1	8.3
VAT	3,999.3	4,315.8	4,527.4	4,741.1	4,965.1	9.3	34.8	51.4	54.2	57.3
Mandatory state social insurance contributions[25]	4,456.4	4,791.5	5,114.7	5,426.6	5,697.8	23.1	52.1	83.9	140.4	151.8
Excise duty	1,218.6	1,297.1	1,366.3	1,407.9	1,445.0	2.9	10.4	15.6	16.2	16.7

[25] Less contributions to the state funded pension scheme and contributions to pension level 3

	Optimistic scenario					Deviation from the baseline scenario				
	2024	2025	2026	2027	2028	2024	2025	2026	2027	2028
Non-tax revenue	1,014.6	797.2	779.0	790.3	827.2	0.9	1.9	2.3	2.4	2.4
Interest expenditure	379.7	458.8	557.8	624.9	706.9	0.0	-1.5	-5.4	-11.2	-18.9
Expenditure on social benefits	5,162.7	5,524.0	5,954.5	6,302.7	6,643.6	2.1	9.1	27.1	50.2	76.0
General government debt, % of GDP	**44.8**	**45.3**	**44.6**	**46.6**	**45.6**	**-0.4**	**-1.0**	**-1.6**	**-2.2**	**-2.6**

Should the optimistic scenario of the economic development materialise, tax revenue increases would improve the financial balance of the general government budget, leading to a reduction in the overall financing requirement and, consequently, in the amount of borrowing over the relevant period compared to the baseline scenario. Lower borrowings would lead to savings in interest expenditure. In case of the optimistic scenario, interest expenditure would be EUR 1.5 million lower in 2025 and, by 2028, they would already be EUR 18.9 million lower compared to the baseline scenario.

4.4. Comparison of General Government Budget Balance and Debt Projections to Latvia's Stability Programme for 2023-2026

According to the scenario developed in February this year, Latvia's GDP will grow by 1.4% in 2024, and economic growth is expected to accelerate to 2.9% in 2025. Compared to the Latvia’s Stability Programme 2023-2026 scenario, the GDP projection for 2024 has been revised down by 0.6 percentage points, while the projection for 2025 is unchanged. Economic growth will slow down slightly over the next three years, to 2.5% in 2026 and 2.3% by 2028. Lower economic growth projection for 2024 was largely driven by the dynamics in 2023, as GDP growth fell short of the previous projections. The reason for this was decreasing external demand and high price levels, hampering private consumption growth in Latvia.

Table 4.5. Comparison with projections of the 2023-2026 Stability Programme (no policy change scenario)

	ESA code	2023	2024	2025	2026	2027	2028
GDP growth (%)	B1g						
2023		0.0	2.0	2.9	2.8	-	-
2024		-0.3	1.4	2.9	2.5	2.3	2.3
Changes		-0.3	-0.6	0.0	-0.3	-	-
General government budget balance (% of GDP)	B.9						
2023		-4.0	-2.5	-2.2	-0.7	-	-
2024		-2.3	-2.9	-2.7	-2.2	-2.0	-1.7
Changes		1.7	-0.4	-0.6	-1.5	-	-
General government debt (% of GDP)							
2023		39.6	39.7	39.8	38.9	-	-
2024		43.4	45.2	46.3	46.2	48.8	48.2
Changes		3.8	5.5	6.5	7.3	-	-

According to the MoF's assessment, the general government budget deficit in 2023 was 2.3% of GDP, lower than projected in Latvia's Stability Programme for 2023-2026, when a general government budget deficit of 4.0% of GDP was budgeted, given the high uncertainty surrounding energy price increases. The deficit in 2023 was lower than expected due to lower expenditure on energy support measures. Whereas, for 2024 and beyond, the general government budget deficit is projected higher than before, because the decisions taken in autumn 2023 with regard to additional funding for raising salaries for teachers and for employed persons in the interior sector, as well as additional funding for healthcare have been taken into account and providing for additional funding for national defence in the base expenditure this spring, especially in 2026-2027, and the corresponding supplies being implemented accordingly. In addition, expansion of the deficit was also driven by revised tax revenue over the medium term in line with the updated macro scenario and an increase in current expenditure in the local government budget, given the high 2023 performance indicators.

The general government debt projection is revised upwards in 2024-2026 compared to the 2023-2026 Stability Programme projections. The changes were mainly determined by an updated projection of the general government budget balance, as well as updated projections of macroeconomic indicators for 2024-2028.

5. Quality of Public Finances

5.1. Efficiency of State Budget Resources and Expenditure Control

Procedures for the development, approval and implementation of the State budget and responsibilities within the budgeting process are determined by the LBFM.

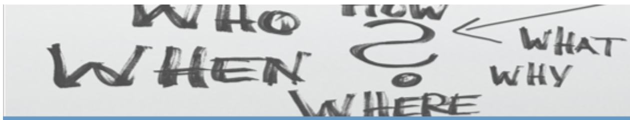
According to the LBFM, the Minister of Finance is responsible for the development of the Draft State Budget Law (package of the Drafts Budget Law) and the explanations to be attached thereto, as well as ensures the development of the Draft State Budget Law, based on budgetary requests. The Minister of Finance may, at any stage of examination of the draft State budget law until submission thereof to the Cabinet, request the necessary additional information, express his or her point of view, add necessary opinions, and also results of separate audits in order to evaluate its conformity with the purposes provided for and the results to be achieved. On the basis of the results of such evaluation and the provided information, the Minister of Finance shall take the decision to include the budgetary requests in the draft State budget law.

The Minister of Finance shall also be responsible for the organisation and management of the State budget implementation process, as well as the supervision of the operation of the Treasury in accordance with the requirements of the LBFM.

During the development of the Draft State Budget Law or amendments thereof the Minister of Finance shall inform the Budget and Finance (Tax) Committee of the Saeima on the course of the State budget planning, as well as no less than once in a quarter – on the course of implementation of the State budget.

According to the LBFM, heads of bodies financed from the budget, institutions non-financed from the budget and local governments, as well as of capital companies, in which a State or local government capital share has been invested, shall be responsible for the observance, implementation and control of the procedures and requirements prescribed by the above-mentioned law, as well as for the efficient and economic utilisation of budgetary funds in conformity with the intended purposes.

The LBFM includes a provision prescribing for the Cabinet to ensure constant and systematic review of the State budget expenditure, allowing for more efficient and economic implementation of the State policy, as well as optimising budget expenditure and evaluating the conformity thereof to the priorities and objectives set in the development planning documents. The Cabinet, on an annual basis, adopts the decision on the scope of the State budget spending review, concurrently with the approval of the schedule for preparation of the budget. The Minister of Finance, in turn, in accordance with the referred to schedule, submits the Cabinet the results of the State budget spending review revision and proposals for the use of these results in the process of developing of the Draft State Budget Law.



Implementation of performance based State budget programmes

In order to improve the linking of State budget expenditures with the objectives and results of sectoral policies, as well as to use the advantages of the performance indicator system in taking decisions related to the State budget in conformity with the possibilities, the Ministry of Finance, in cooperation with the line ministries, should start the implementation of performance based State budget programmes, including performing an analysis according to performance, costs and international comparisons (*benchmarking*).

Analysis of State budget expenditures

1. Line ministries to carry out a horizontal review of the State budget programmes, including review of the funding allocated to the priority measures, as well as an analysis of the implementation of performance indicators in 2023.
2. Line ministries to analyze the expenditures planned in the sector budget, provide proposals for the impact on the 2025 budget and the medium-term general government budget, and to prepare proposals for possible policy changes.

Figure 5.1. Scope of the spending review for 2024

In 2024, as part of the spending review, is planned to improve the linking of State budget expenditures with sectoral policy objectives and results, and start implementing performance-based State budget programmes, analysing them according to the performance, costs and international *comparisons (benchmarking)*, so that the advantages of the performance indicator system were used for decision-making in relation to the State budget. The spending review also provides for a review by line ministries of the funding allocated to priority measures, an analysis of the implementation of performance indicators in 2023, as well as an analysis of the expenditures planned in the sector budgetand proposals for possible policy changes (see Figure 5.1).

The State budget consists of budget programmes, the structure of which is determined by the operational (action) course defined in the institution’s operational strategy or functions defined in the regulation of the ministry or other central State institution. Thus, the budget development is linked to the policy planning, as one of the institution’s operational strategy objectives in the medium term is to ensure that budget programmes provide the achievement of objectives, planned results and performance indicators which are defined in the development planning documents. Each year, ministries and other central State institutions in their budget requests include operating results of the budget programmes which, whenever possible, are developed in accordance with the planned operating results and performance indicators of the development planning documents. By enhancing the content of the budget explanations aimed at providing information about the State budget as the policy implementation instrument and increasing the perceptibility of information contained in the budget explanations, the Policy and Resource Management Scorecards have been introduced, providing an in-depth insight to invested resources (financial and human resources) to achieve sectoral policy outcomes and on the benefits for society as a result of sectoral activity.

Such new budget format has provided for the possibility, in an interactive and demonstrative manner, to inform the population in Latvia about the fields where and the amount in which the taxpayers' money is being invested and what the expected outcomes are. Any interested person has access to the following on the MoF website:

- interactive budget infographics, which allows the user to get acquainted with nine budget investment areas (for example, health, education, social protection, etc.) and the allocated funding, as well as to find out detailed information on the investment directions in each area and funding sources. Additionally, information is provided on the results that can be expected from the investment of State budget funding into the relevant area;

- budgets of the ministries and other central State institutions are visualised both in summarised form and in more detail. The user can view the fields of operation of the ministries and other central State institutions and the financing allocated thereto, as well as get an insight regarding the benefits for society as a result of sectoral activity. It is reflected in the Policy and Resource Management Scorecards, which in summarised form provide possibly comprehensive and characteristic information on sectoral activity in the relevant field – the goal, inputs for the achievement thereof, expected operational outputs and the highest-level sectoral policy and quality outcomes to be achieved.

When preparing a report on the analysis of State budget execution, ministries and other central State institutions shall provide explanations about previously planned results and the performance indicators thereof, their implementation during the year, as well as explanations about the deviations in values of the achieved and planned performance indicators if they exceed 15 percent (both in positive and negative terms). The MoF aggregates, assesses, and ensures the accumulation of the outcomes specified in the Policy and Resource Management Scorecardsand the performance indicators thereof, as well as the operational outputs of the State budget programmes (sub-programmes) and their performance indicators.

The LBFM prescribes the following organisational aspects of State budget implementation:

- persons implementing the State budget may only make budget expenditure or assume short-term liabilities within the limits of the assignations determined by financing plans issued by the Treasury. In turn, the Treasury shall grant assignations for expenditures in accordance with the appropriation determined in the State budget law and ensure the implementation thereof according to the procedure determined by the Cabinet. Ministries and other central State authorities are responsible for the development of the system of control over the fulfilment of the appropriations determined in the State Budget Law and for the control over expenditure of the State budget funds transferred into the current accounts of the Treasury in accordance with the purposes intended;
- Budget institutions may assume the State budget long-term liabilities without exceeding the maximum permissible amounts of the State budget long-term liabilities determined in the State budget law for a financial year;
- For the receipt of assignations and for the making of expenditure from the State budget funds, State budget institutions and institutions non-financed from the budget shall open the State basic budget and State special budget accounts with the Treasury only. In turn, institutions financed by the budget, which are not State budget institutions and institutions non-financed by the budget, may open accounts in the Treasury for receiving State budget funds, making expenditure, as well as performing delegated State administration tasks, unless provided for otherwise in other laws and regulations;
- ministries and other central State budget institutions and local government according to the procedures stipulated by the Cabinet, shall prepare and submit the Treasury the quarterly statements; in turn, the Treasury shall arrange for the accounting of State budget finances; The Treasury shall prepare regular official and operative statements and provide information regarding State and local government budget execution, ensuring the informing of the MoF, other institutions, as well as the public regarding the process of budget execution.

In order to strengthen the possibilities to control the utilisation of resources, the LBFM provides that the Minister of Finance has the right to issue an order to the Treasury to delay or reduce assignations for a certain period if at least one of the following conditions exist:

- within the time period of three months the actual revenues from the State budget taxes and non-taxes in respect to the projected revenues in the relevant period decrease by more than 0.5 per cent from the forecast of GDP determined in the State budget law or the actual accumulated State budget financial deficit within the time period of three months exceeds the State budget financial deficit projected for the relevant time period by more than 0.5 per cent from the forecast of gross domestic product determined in the State budget law, or the amount of funds in the budgetary accounts of the Treasury is not sufficient to cover payment commitments planned for the next month;
- if the Minister of Finance has received a written notice on the setting in of the condition referred to in Clause 1 of this Paragraph.

The LBFM provides for the following main sanctions in the case of inappropriate utilisation of budget resources:

- for late or incomplete payment of the amounts to the State budget into Treasury budget accounts, the Treasury, unless this is under the competency of another State agency, shall recover the amount not paid into the revenue of the basic budget and may recover charges in the amount of 0.1% of the amount not paid in time for each late day of payment unless provided otherwise by regulatory enactments;
- in order to cover losses caused to the budget, the Treasury may include amounts in the basic budget revenue and withdraw or suspend assignations, if the reports on budget and financial management have not been submitted in time or are incomplete; the budgetary funds and transactions in such funds have not been registered in accordance with the procedures prescribed by law or notice has not been given regarding them; the accounting does not comply with the prescribed procedures and, thus, funds due to the budget are concealed; if a manager of a body financed from the budget has undertaken liabilities exceeding the assignation allocated by the Treasury;
- if bodies financed from the budget, institutions non-financed from the budget and local governments, as well as capital companies, in which a State or local government capital share has been invested, have violated the financial management provisions provided for in the LBFM, the Minister of Finance, the administrator of the Treasury or the heads of ministries and other central State institutions may in accordance with the competence withdraw for a period of time, an authorisation to assign or deal with budgetary revenue or expenditures; determine limitations on the use of accounts; withdraw or suspend the assignations in order that the illegally used funds be refunded or require the refunding of illegally used funds; submit a civil claim to a court or provide materials to competent officials for deciding on the issue of initiation of criminal proceedings; or withdraw or suspend payments;
- the Treasury, in accordance with the Law on Equalisation of Local Government Finances, is entitled, by uncontested procedure, to recover from local government budget funds the amount, which the relevant local government has not included in the local government finance equalisation fund in time or in full amount, by writing off such amounts from the budget of the relevant local government.

In order to maintain a general economic balance and to ensure a uniform State financial policy, the amounts of total increase in local government borrowings and guarantees shall be separately prescribed in the State Budget Law.

The Treasury has the right to withhold the sums from the amount, which is due to the local government from personal income tax, or from a grant of equalisation fund of local government finances in the following cases and amount:

- if the local government does not ensure the timely fulfilment of the liabilities specified in State loan agreements – in the amount of the sum not paid timely;
- if local government does not ensure the use of the State loan in compliance with the purpose specified in the loan agreement – according to the order of the Minister of Finance in the amount of the loan sum used in non-compliance with the purpose specified in the agreement.

5.2. Efficiency of the Revenue Structure and System

5.2.1. Tax Revenue Projections of the Baseline Scenario of the Stability Programme

Tax revenue projections are made on a constant tax policy basis, based on projections of macroeconomic indicators and taking into account actual tax compliance as well as previously adopted legislative changes. The tax revenue projections do not include undistributed tax revenue in the single tax account.

The most significant changes to tax policy adopted during the drafting of the Law on the State Budget for 2024 and the Budget Framework for 2024, 2025 and 2026 are:

- 20% corporate income tax surcharge for credit institutions and consumer credit providers;
- increase in excise duty rates for several product groups;
- in relation to the personal income tax, the amount of compensation for remote working has been increased; an increase in the threshold for health and accident insurance premiums; and the application of reliefs and non-taxable minimum also to micro-enterprise tax payers;
- raising gambling tax rates;
- application of a reduced rate of value added tax of 12% on fresh fruit and vegetables in 2024, determination of a registration threshold at EUR 50,000, determination of lost debt transaction threshold of at EUR 1,000, exemption for sports activities;
- changes to natural resource tax rates, new tax objects, abolition of the exemption and changes to the allocations between State and local government budgets;
- exemption from corporate income tax on operating expenses for the use of representation cars;
- setting a unified tax rate for royalty and micro-business tax regimes.

Compared to the Law on the State Budget for 2024 and the Budgetary Framework for 2024, 2025 and 2026, changes in the projections of economic growth rates lead to a reduction in the projections of tax revenue of the general budget by *EUR* -185.5 million (by cash-flow) in 2024, *EUR* -107.1 million in 2025 and *EUR* -183.8 million in 2026.

Table 5.1. Tax revenue in general government budget (S.13), EUR million

	Code (ESA)	2024	2025	2026	2027	2028
1 Taxes on production and imports	D.2	5,927.9	6,185.2	6,466.2	6,730.4	6,989.1
2 Current taxes on income and wealth	D.5	3,512.3	3,680.6	3,894.1	4,074.7	4,259.7
3 Capital taxes	D.91	17.0	17.3	17.3	17.3	17.3
4 Social contributions	D.61	4,625.3	4,941.5	5,232.0	5,485.0	5,744.9
Of which actual social contributions	*D.611 and D.613*	4,436.9	4,753.1	5,043.6	5,296.6	5,556.5

Total tax revenue shows a steady upward trend in the coming years, remaining at a stable level relative to GDP, which is projected at 33% on average.

Total tax revenue growth (2028 vs 2024) is projected at 21%, with labour taxes rising by 26%, consumption taxes by 21%, but capital taxes falling by 1%.

The share of the most important tax revenue categories in GDP is depicted in Figure 5.2.

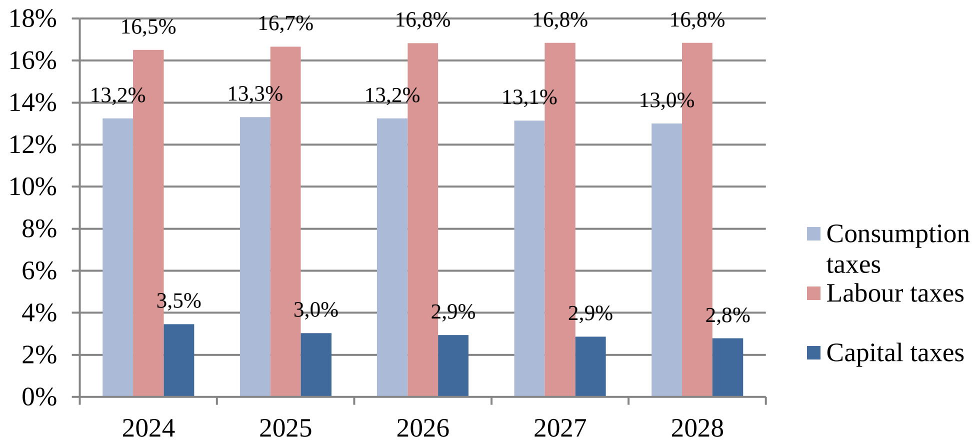


Figure 5.2. Tax revenue by economic function, % of GDP

It should be noted that, in 2024, the National Tax Policy Framework 2024-2027 will be developed in cooperation with the government's social and cooperation partners, defining tax policy priorities for the coming years. Clarity and stability in the strategic direction of tax policy is essential for effective planning of both business and public services and investment, linking it to the country's overall development objectives.

6. Sustainability of Public Finances

6.1. Long-Term Development Scenario for Public Finances

Every three years, the EC, in cooperation with Member States, develops long-term projections of age-related budgetary expenditure within the framework of the Ageing Working Group of the Economic Policy Committee (EPC AWG). The most up-to-date long-term expenditure projections developed by the Working Group in the second half of 2023 are published in the Ageing *Report* 2024.

The public expenditure projections up to 2070 took into account *Eurostat'* s *EUROPOP2023* demographic projections as well as the EC's long-term projections of macroeconomic indicators. The projection methodology, which is common to all Member States, has been discussed and approved by the AWG and published in the *Ageing Report 2024: Underlying Assumptions and Projection Methodologies.*

EUROPOP2023 projections have a base year of 2022, and population of Latvia was 1.88 million people at the beginning of 2022, representing a decrease of 245,000 compared to 2010, for example. According to *Eurostat* demographic projections, Latvia's population will continue to decline, and, in 2070, it will already be one-third smaller than in the base year (see Figure 6.1).

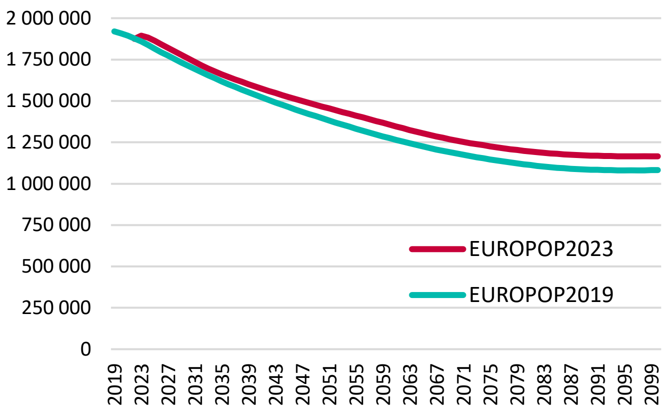


Figure 6.1. Population (Data source: Eurostat)

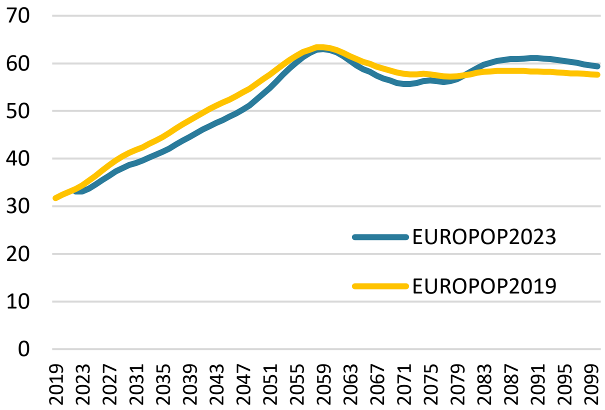


Figure 6.2. 65+ population to population 15-64 ratio, % (Data source: Eurostat)

When preparing the demographic projections, it was taken into account that:

- the total fertility rate will increase from 1.53 in 2022 to 1.72 in 2100;
- increase in natural population growth in Latvia will remain negative for a long time - until 2100. Current statistics show that, in 2023, the number of deaths was twice as high (or 13,345 higher) as the number of births, which has been the case since 2021. However, the number of births in Latvia continues to decline, for example, 14,121 children were born in 2023, representing 11.5% or 1,833 births below the indicator of 2022;
- Increase in ratio 65+ population to the working-age population (15-64) (*old-age dependency ratio*), peaking at 63% of the working-age population in 2059 (see Figure 6.2). In the long term, increase in the proportion of older people will be affected by the increase in life expectancy, which , according to *Eurostat* projections, will rise from an average of 71.4 years in 2022 to 87.5 years in 2100 for men and from an average of 80.6 years in 2022 to 92 years in 2100 for

women in Latvia. Similarly, the increase in the 65+ to 15-64 ratio will be affected in the long term by the decline in the working-age population, according to *Eurostat* projections.

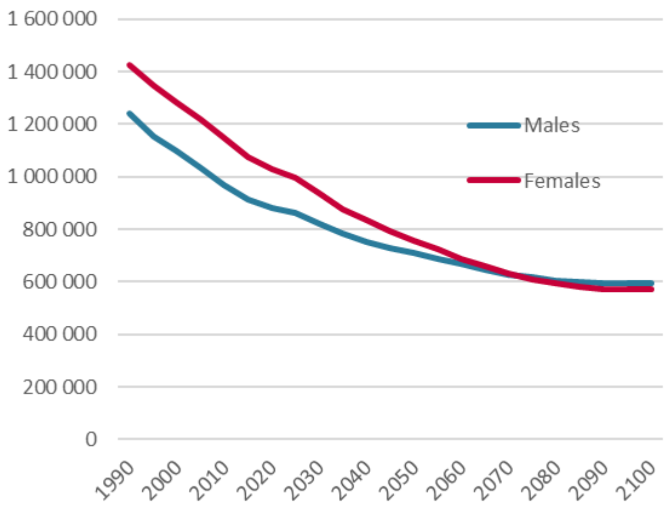


Figure 6.3. Population by sex (Data source: Eurostat, EUROPOP2023)

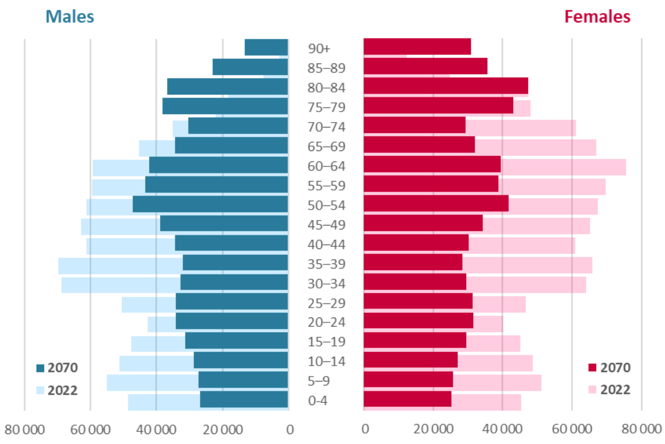


Figure 6.4. Population age pyramid in 2022 and 2070 (Data source: Eurostat, EUROPOP2023)

According to *Eurostat* projections, the number of men in Latvia, which has historically been lower than the number of women, will decline at a slower rate in the long term (see Figure 6.3). This will be driven by the fact that a larger number of boys have been born than girls over at least the last 15 years, and as mortality rates are projected to decrease at higher rate for men than for women, male life expectancy will rise faster - for example, in 2100 compared to 2022, male life expectancy will increase by 16.1 years or 22.5%, whereas, female life expectancy - by 11.4 years or 14.1%.

Alongside the decline in the total population, the age structure of the population is projected to change (see Figure 6.4), with an increase in the number of older residents between 2022 and 2070, especially in the number of women aged 80+.

In its long-term projections of macroeconomic indicators, using the assumptions endorsed by the AWG, the EC projections that the Latvia's real GDP growth to decline from 2.8% in 2022 to 0.9% in 2070. The economy is projected to see total hours worked decline by an average of 1.0% per year between 2022 and 2070, with the working-age population shrinking at a higher rate. The EC projections that Latvia's employment rate will fall from 71.4% to 70% between 2022 and 2034, before gradually rising to 71.9% in 2070. Despite the increase in employment, the overall employment rate is projected to fall in the long term in line with the working-age population.

Demographic and economic situation, in particular in the labour market, will have a long-term impact on the sustainability of public finances, with impact on both tax revenue and budgetary expenditure. The amount of taxes collected will depend to a large extent on long-term trends in employment, while the long-term growth in budgetary expenditure will also be affected by pre-existing commitments for pensions and benefits, debt-servicing expenditure, and increase in age related expenditure.

The EPC AWG Task Force has updated its projections for age-related expenditure up to 2070, taking into account the updated long-term demographic and macroeconomic projections. These will be published in Part Two of the Ageing Report 2024*: Economic & Budgetary Projections for the EU Member States (2022-2070*).

Under the baseline scenario, age-related public expenditure in 2070 will decrease by 1.8 percentage points compared to 2022 to 15.4% of GDP (see Figure 6.5). The overall downward trend in Latvia's budget expenditure over the long term remains similar to previous projections, mainly driven by *Eurostat* conservative demographic projections. It should be noted that the projections are made under a no-policychange scenario, i.e. taking into account those legislative changes that have been adopted by October 2023.

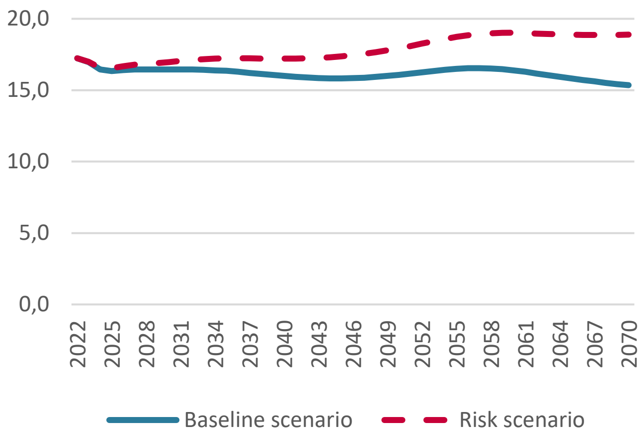


Figure 6.5. Age-related public expenditure in the baseline and risk scenarios, % of GDP (Data source: Ageing Report 2024)[26]

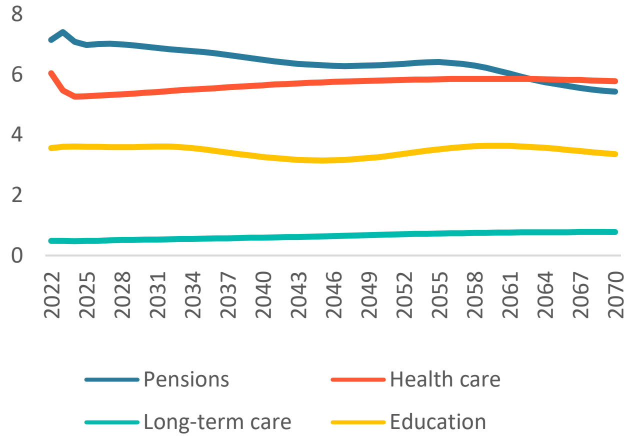


Figure 6.6. Age-related public expenditure by line item, % of GDP (Data source: Ageing Report 2024)

The projections for pension expenditure (see Figure 6.6.) are based on the projections made by the MoW, which provide for a decline in the share of pension expenditure in GDP from 7.2% of GDP in 2022 to 5.4% of GDP in 2070. The pension reform, raising the retirement age to 65, is contributing to the decline in expenditure as a share of GDP, in particular until 2025, resulting in fewer pension beneficiaries and a longer time in the labour market for pre-retirees. However, future projections of pension expenditure will be determined mainly by changes in the number of pensioners in line with demographic projections. Pension expenditure as a share of GDP will decline most sharply from around 2055-2060, as the number of new pension beneficiaries will decline significantly (those who were born in the 1990-ies). The projections for pension expenditure are made under a no-policy-change scenario, taking into account legislative changes that have been adopted by October 2023.

Health spending is projected to fall from 6.0% of GDP in 2022 to 5.8% of GDP in 2070. However, it should be noted that Covid-19 support measures were still included in 2022 expenditure, so, compared to 2024 (5.3% of GDP, for example), expenditure will increase in the long term. This will be driven by higher demand for health services as life expectancy increases and the population ages. Given the growing need for long-term care services, long-term care expenditure shows a similar trend, with a projected increase from 0.5% of GDP in 2022 to 0.8% of GDP in 2070.

In addition to the baseline scenario, a number of sensitivity tests and alternative scenarios were developed under different assumptions. In the risk scenario, public expenditure related to the aging population is projected to increase by 1.4 percentage points compared to 2022, reaching 18.9% of GDP in 2070. The risk scenario would mainly lead to increased spending on health care and long-term care, taking into account both potential cost increases due to technological developments and convergence of costs per one beneficiary with the EU average.

[26] The 2024 Ageing Report is scheduled for publication in April 2024

6.2. Government Guarantees

The Law on the State Budget for 2023 and the Budget Framework for 2023, 2024 and 2025 did not foresee new guarantees to be provided on behalf of the State, but stipulated that the State would be liable for guarantees issued by Altum in the amount of EUR 250.0 million in accordance with the Law on Agriculture and Rural Development and the Law on Development Finance Institutions.

The total balance of guarantees on behalf of the State at the end of 2023 was EUR 354.6 million, or just below 1% of GDP (see Figure 6.7), while the outstanding but still available amount of guarantees on behalf of the State was EUR 187.3 million.

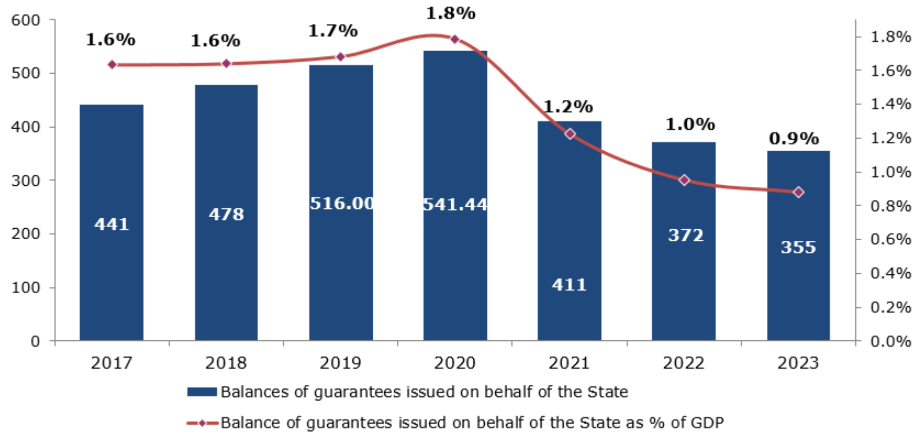


Figure 6.7. Balance of guarantees issued on behalf of the State at the end of the year (EUR million)

The largest part of the portfolio of guarantees issued on behalf of the State consists of guarantees for warrantees issued by Altum to credit institutions for loans to farmers (re-guarantees) and guarantees to the European Investment Bank for loans issued by Altum within the framework of the support programme for improving the competitiveness of enterprises and the development lending to Latvian small and medium-sized enterprises (total EUR 229.9 million) on the basis of the Law On Measures for the Prevention and Suppression of Threat to the State and Its Consequences Due to the Spread of Covid-19, guarantee to the EC for Latvia's participation in the EU support instrument EC SURE (EUR 57.1 million), guarantees for student and study loans (total EUR 38.4 million), as well as guarantees for the World Bank Group's International Bank for Reconstruction and Development within the framework of the "Strengthening Administrative Capacity for Public Expenditure in Ukraine" project and the EC in relation to the emergency macro-financial assistance to Ukraine (total EUR 18.1 million).

Despite the factors observed in previous years - the economic downturn triggered by Covid-19, the global energy price surge, Russia's full-scale invasion of Ukraine and the rise in lending interest rates – so far, they have not caused negative impact on the performance of guarantees issued on behalf of the State.

7. INSTITUTIONAL FEATURES OF PUBLIC FINANCES

7.1. Medium-Term Budgetary Planning

According to the LBFM, medium-term State budget planning is a process in which the resources accessible for the medium term are determined and the use of these resources is ensured in conformity with the priorities determined by the government. A “medium term” shall mean a three-year period formed by the financial year for which the State budget is planned and the subsequent two financial years.

Since 2007, the Medium-Term Macroeconomic Development and Fiscal Policy Framework (hereinafter the “Framework”) has been prepared in the State for the next three financial years, in which there is an analysis of the medium-term State macroeconomic situation presented, as well as objectives of the government fiscal policy for the medium term, forecasts on the State budget revenue and ceilings of the State budget total expenditure for each ministry and other central State institutions for the medium term. In view of the fact that the Framework did not have a legally binding nature and it only indicated the ceilings of the State budget total expenditure for the medium term, a need arose to strengthen the medium-term budget planning system. Therefore, corresponding amendments to the LBFM have been made, and since 1 January 2012 the Framework, which since 2007 had been approved by the Cabinet, is drafted as a Framework Law and approved by the Saeima. In turn, in 2022, amendments were introduced to the LBFM, which, starting from 2023, combine the Medium-Term Budget Framework Law and the Annual State Budget Law, reducing the administrative burden and simplifying the procedure for reviewing the law in the Saeima. Thus, information about the current year and the following two years is integrated into one law - the State Budget Law.

The State Budget Law is drawn up every year for the next three-year period, with the first year of the operating period being elaborated in detail. For the first and the second year of each following period of the State Budget Law, the indicators set in the previous State Budget Law are used, adjusted in accordance with the cases stated in the regulatory enactments, but the indicators planned for the third year are new. At the same time, the State Budget Law is associated with development planning documents ensuring the coherence of available resources with the priorities of the government policy in the medium term, and it complies with the fiscal rules prescribed by the FDL, providing for a transparent and responsible fiscal policy. Thus, the State Budget Law is the main tool to ensure compliance with the fiscal discipline.

The State Budget Law implements the fiscal policy principles determined by the FDL and specifies the priority development directions of the medium-term budget policy, the maximum permissible total amount of the State budget expenditure (also the maximum total amount for each budget sector), forecasts of the GDP, forecasts of the State budget revenue, the amount of the State budget financial balance (maximum deficit level or minimum surplus level). According to the provisions of the FDL, concurrently with the State Budget Law, the Fiscal Risk Declaration is developed, aiming to ensure the overall management of fiscal risks, as well as stability of fiscal indicators in the medium term.

Latvia as an EU Member State submits the Stability Programme to the EC. Latvia, as a euro area Member State, prepares the Draft General Government Budget Plan of Latvia, specifying the forecasts of the key indicators of the next year's budget - revenue, expenditure, deficit and government debt, including the State budget, local government budget, the budget of the partially State budget-funded derived public persons and the commercial companies included in the general government sector. The purpose of the above plan is to submit the EC information, which would allow it to assess the compliance of the planned budget fiscal the norms of law of the EU in the field of fiscal discipline. If the EC finds that the budget plan considerably violates the EU fiscal discipline rules, it may reject the budget plan and request the Member State to introduce changes and resubmit the plan. The EC may, in its opinion, provide a recommendation for improving the plan. The procedure prescribes that the national parliaments consider the opinion of the EC, when adopting the State budget in its final reading.

7.2. Budgetary Procedures, Including Public Finance Statistical Management

7.2.1. Budget Procedures

The Constitution of the Republic of Latvia prescribes that the Saeima annually, before the beginning of a financial year, shall decide on the State revenue and expenditure budget, the draft of which is submitted to the Saeima by the Cabinet. The State Budget Law for the current year and the Medium-Term Budget Framework (hereinafter referred to as the State Budget Law) is approved by the Saeima.

When planning the expenditure of the state budget, the base expenditure is calculated and agreed on first. The calculation of base expenditure and the principles of linking them to the medium-term budget framework are determined by the 17 January 2023 Cabinet Regulation No. 15 Procedures for determination of maximum permissible total amount of the State budget expenditures and the maximum permissible total amount of the State budget expenditures for each ministry and other central State institution in the medium term. Thus, the necessary amount of expenditure is determined in order to ensure the execution of the State functions at a constant level. Base expenditure shall be approved by the Cabinet.

Since 2016, a constant and systematic State budget spending review has been introduced as an integral part of the budgetary process, explained in more detail in Chapter 5.1. above.

The ministries and other central State institutions shall prepare proposals for the priority measures to be supported, if in the relevant following financial years funds are available for financing priority measures in conformity with the latest macroeconomic development forecasts. The proposals for priority measures shall be prepared on the basis of the priorities and objectives specified in the National Development Plan, the State Defence Concept, and other development planning documents. Thus, linking of the national priorities with the resources available within the State budget for the medium term is ensured.

When calculating ceilings of the total amount of the State budget expenditure, consisting of base expenditure of the State basic budget and the State special budget and of the expenditure for priority measures of the State basic budget and the State special budget, the MoF shall rely on the State Budget Law, forecasts of macroeconomic development, as well as observe fiscal conditions that are defined in the State. On the basis of the decisions approved by the Cabinet on the base expenditure and financing priority measures, the ministries and other central State institutions shall prepare and submit the budgetary requests to the MoF. The MoF shall prepare and submit the draft law on State Budget Law for the current year and the Medium-Term Budget Framework (hereinafter referred to as the draft State Budget Law) with explanations, fiscal risks declaration, fiscal discipline supervision report of the Fiscal Discipline Council for the review to the Cabinet.

In order to provide the society with a clear idea of the resources involved in the execution of State basic functions and implementation of activities of the EU and other foreign policy instruments, the budget shall be prepared according to the following sections:

- execution of State basic functions (except projects and activities financed or co-financed by EU policy instruments and other foreign financial aid);
- execution of projects and activities financed or co-financed by EU policy instruments and other foreign financial aid.

Within the process of preparation of the Draft State Budget Law, the following indicators shall be evaluated in an aggregated form and then presented in the State Budget Law:

- the State budget revenue by types of revenue;

- the State budget expenditure by budget units, programmes (sub-programmes) and the types of expenditure according to the economic nature;
- the financial balance of the State budget;
- the maximum permissible amount of the government debt at the end of a financial year;
- the amount of guarantees to be issued on behalf of the State;
- the total increase in State budget loans;
- the amount of State budget earmarked grants for local governments, as well as the amount of the State budget subsidy for the local government financial equalisation fund;
- the total increase in local government borrowings and total increase in the guarantees provided by local governments;
- other conditions, such as the contribution rate and contribution sum to the State-funded pension scheme.

Explanations to the Draft State Budget Law include a description of the macroeconomic development scenario, fiscal review, description of setting the medium-term structural balance targets, description about the priority development directions of the medium-term budget, analysis of revenue forecasts, the most significant elements of the state budget expenditure planning, explanations of tasks of the ministries, state budget expenditure divided by functional, administrative and economic categories, as well as information about the planned investment projects, information about the financial obligations of the State debt, loans and guarantees (summary) and information about the amendments made to the regulatory enactments within the package of draft budget laws. Ministries and other central State institutions in the budget explanations include the, the priority measures and the operational outputs and performance indicators as a result of their implementation, the optimisation measures, as well for each programme (sub-programme) of the basic budget or special budget indicate the objective, main activities and performers, operational outputs and performance indicators, financial indicators and total expenditure changes.

Independent institutions (courts, the State Audit Office, the Ombudsman's office and others) play a special role in the budget process. The LBFM stipulates that the Cabinet, when preparing the Draft State Budget Law, shall hear the view of independent institutions about the financing sections of corresponding institutions, justify the opinion of the Cabinet in the case of funding reduction, and inform the legislator about the results of the aforementioned negotiations in the form of a protocol attached to relevant draft laws.

During the process of development of the Draft State Budget Law, negotiations between the LALRG and the MoF are being held, as a result of which a Cabinet and LALRG Draft Protocol is being prepared, which is submitted for consideration at the Cabinet's session. In the Draft Protocol, there are questions included on the local governments' tax and non-tax revenue and other revenue forecasts, central government budget transfers to local governments, amount and conditions of the local governments' loans, guarantees and long-term obligations, local government financial equalisation, and other issues related to the operations and finances of local governments. The Protocol is attached to the Draft State Budget Law, when the Cabinet submits it to the Saeima.

If, at the beginning of the financial year, the State Budget Law has not into force, the Minister of Finance shall approve the State budget expenditure necessary for the operation of the State, as well as the loan and borrowing limits, provided that the expenditure does not exceed the volume of the maximum permissible total State budget expenditure set by the State Budget Law for the relevant year for each Ministry and other central State institution, by introducing the corrections laid down in the LBFM.

In compliance with the LBFM, local governments shall develop their budgets no later than within two months following the proclamation of the State Budget Law.

If, at the beginning of the financial year, the annual local government budget has not into force, the budget expenditure necessary for operation of the local government shall be approved in accordance with the procedures stipulated by the local government council, provided that:

1) the expenditures do not exceed the actual expenditures of the previous financial year of the local government by making the following adjustments:
    a) the services (payment orders) which have not been provided in the previous financial year are not paid for, and the investments which have not been realised in the previous financial year are not made;
    b) the financing of the measures commenced in the previous financial year is continued;
    c) the enforcement of the existing laws and regulations is ensured;
2) the implementation of budget policies and conditions determined in the local government budget law of the previous financial year is ensured at a constant level, except for fixed-term measures;
3) the implementation of projects co-financed by the European Union and other foreign financial assistance is ensured;
4) the State budget earmarked grants and grants approved for the financial year are taken into account;
5) the financing for the fulfilment of the liabilities undertaken by the local government is provided for;
6) new borrowing and guarantee liabilities are not undertaken, except for liabilities for the implementation of the projects referred to in Paragraph one, Clause 3 of this Section.

The Law on Local Government Budgets prescribes strict conditions for the local government in the field of budget planning and execution – the local government budget assignations may not exceed the amounts planned in the budget.

The Cabinet has the right to determine additional conditions for the planning and implementation of state and local government budgets in order to ensure measures for the reduction and prevention of impact of the increased fiscal, economic and social risks caused by macroeconomic processes and ensure implementation of the fiscal criteria determined in international commitments.

7.2.2. Management of Government Finance Statistics

The CSB compiles government financial statistics in accordance with the requirements of Regulation (EU) No. 549/2013 of the European Parliament and of the Council of 21 May 2013 on the European system of national and regional accounts in the EU (hereinafter referred to as - ESA 2010).

The framework of general government sector (S.13) in Latvia according to the ESA 2010 methodology consists of three subsectors: the central government subsector (S.1311), the local government subsector (S.1313) and the social security funds subsector (S.1314).

In accordance with Paragraph 6 of the Cabinet Regulation No. 1456 of 10 December 2013 "Regulations on the Classification of Institutional Sectors", the CSB prepares and maintains the list of the general government sector. In order to draw up the list and decide on the units to be included therein, the CSB follows the requirements of ESA 2010, as well as the principles defined in the *Eurostat Manual on Government Deficits and Debt,* which provide for referral of state and local government-controlled and financed capital companies to the general government sector.

In the general government sector, as of 31 December 2023, there were 540 independent budget institutions, 227 of which - in the central government subsector, 312 in the local government subsector and one institution in the social security funds subsector, in addition to 141 state and local government controlled and financed commercial companies, of which 56 state controlled and 85 local government controlled commercial companies.

The CSB calculates the following general government indicators on a quarterly basis - revenue, expenditure, deficit, debt - and produces quarterly general government financial accounts. The information is published on the CSB website and sent to *Eurostat* three months after the end of the reference period.

In addition, the CSB prepares and submits the general government deficit and debt notification (hereinafter referred to as - the Notification) to *Eurostat* by the set deadlines of 1 April (operational data) and 1 October (final data) every year.

The Notification is prepared in accordance with the requirements of the Cabinet Regulation No. 756 of 22 December 2015 "Procedures for Preparation of the General Government Deficit and Debt Notification". The CSB is the authority responsible for preparing and submitting the Notification to *Eurostat* and chairs regular meetings of the inter-institutional task force. The preparation of the Notification involves specialists from the MoF, Treasury, CFCA, MoD and SSIA. If needed, specialists from other institutions (MoE, MoW, Riga City Council, etc.) are involved.

The results of the Notifications are used for the assessment of the States on how the compliance of fiscal indicators with the conditions of the Stability and Growth Pact is ensured with the aim to implement sustainable public finances and coordination of among Member States.

Council Directive 2011/85/EU of 8 November 2011 on requirements for budgetary frameworks of the Member States lays down detailed rules for EU Member States to reinforce EU fiscal and economic governance and avoid excessive budget deficits. The MoF website[27] publishes the fiscal data covered by Directive 2011/85/EU. Furthermore, the website provides a detailed transition table for budget data from cash flow according to national classification to general government data according to ESA 2010 methodology. The following information is published on regular basis:

- fiscal data (monthly and quarterly data);
- general government sector guarantees (annual data);
- non-performing loans (annual data);
- outstanding liabilities related to off-balance public-private partnerships (annual data);
- liabilities of government-controlled corporations classified outside general government (annual data);
- participation of government in the capital of corporation (annual data).

[27] Available at: https://www.fm.gov.lv/en/fiscal-policy

ANNEXES

Table 1a. Macroeconomic prospects*

	ESA code	2023	2023	2024	2025	2026	2027	2028
		Levels, mln EUR	Rate of change, %					
1. Real GDP	B1*g	28 739	-0.3	1.4	2.9	2.5	2.3	2.3
2. Nominal GDP	B1*g	40 348	5.1	4.1	6.0	5.3	5.1	5.1
Components of real GDP								
3. Private consumption expenditure	P3	17 539	-1.3	1.9	2.5	2.7	2.5	2.5
4. Government consumption expenditure	P3	5 862	7.0	6.7	5.8	3.1	3.0	3.0
5. Gross fixed capital formation	P51	7 110	8.2	3.8	4.2	2.8	2.8	2.8
6. Changes in inventories and net acquisition of valuables (% of GDP)	P52+P53	1 428	-	-	-	-	-	-
7. Exports of goods and services	P6	19 665	-5.9	-0.8	3.3	4.1	4.0	4.0
8. Imports of goods and services	P7	22 865	-2.8	1.9	3.9	4.0	4.0	4.0
Contribution to real GDP growth								
9. Final domestic demand			1.7	3.5	3.8	3.0	2.8	2.9
10. Changes in inventories and net acquisition of valuables	P52+P53		-0.7	0.0	0.0	-0.1	-0.1	-0.1
11. External balance of goods and services	B11		-2.0	-2.1	-0.9	-0.5	-0.5	-0.5

* Forecasts: February 2024 scenario

Table 1b. Price developments*

	ESA code	2023	2023	2024	2025	2026	2027	2028
		Levels	Rate of change, %					
1. GDP deflator			5.4	2.7	3.0	2.7	2.7	2.7
2. Private consumption deflator			8.0	1.6	2.5	2.5	2.5	2.5
3. HICP			8.9	1.6	2.5	2.5	2.5	2.5
4. Public consumption deflator			0.6	1.5	2.0	1.2	0.5	0.5
5. Investment deflator			6.4	4.0	4.0	2.0	2.0	2.0
6. Export price deflator (goods and services)			-1.8	2.9	3.4	3.2	3.2	3.2
7. Import price deflator (goods and services)			-5.2	1.1	2.6	3.0	3.0	3.0

* Forecasts: February 2024 scenario

Table 1c. Labour market developments*

	ESA code	2023	2023	2024	2025	2026	2027	2028
		Levels	Rate of change, %					
1. Employment, persons		884	-0.2	0.0	0.0	-0.3	-0.3	-0.3
2. Employment, hours worked		1 862	-0.4	0.0	0.0	0.0	0.0	0.0
3. Unemployment rate (%)			6.5	6.4	6.0	6.0	5.5	4.9
4. Labour productivity, persons			-0.1	1.4	2.9	2.8	2.6	2.6
5. Labour productivity, hours worked			0.0	1.4	2.9	2.8	2.6	2.6
6. Compensation of employees	D.1	20 564	12.7	6.5	6.5	5.7	4.7	4.7
7. Compensation per employee		1 537	11.9	7.5	6.5	6.0	5.0	5.0

* Forecasts: February 2024 scenario

Table 1d. Sectoral balances* (policy change scenario)

% of GDP	ESA code	2023	2024	2025	2026	2027	2028
1. Net lending/borrowing vis-a-vis the rest of the world	B.9	-2.0	-2.6	-2.3	-2.2	-2.7	-3.3
of which:							
- Balance on goods and services		-3.9	-4.4	-4.3	-4.2	-4.1	-4.0
- Balance of primary incomes and transfers		-0.2	0.7	0.7	0.3	0.2	-0.8
- Capital account		2.0	1.1	1.4	1.6	1.2	1.5
2. Net lending/borrowing of the private sector	B.9	0.2	0.2	-0.1	0.0	-0.7	-1.5
3. Net lending/borrowing of general government	EDP B.9	-2.3	-2.9	-2.2	-2.2	-2.0	-1.8
4. Statistical discrepancy		0.0	0.0	0.0	0.0	0.0	0.0

* Forecasts: February 2024 scenario

Table 2a. General government budgetary prospects (policy change scenario)

	ESA code	2023	2023	2024	2025	2026	2027	2028
		mln EUR	% of GDP					
Net lending (+) or borrowing (–) (B.9) by sub-sector								
1. General government	S.13	-921.1	-2.3	-2.9	-2.2	-2.2	-2.0	-1.8
2. Central government	S.1311	-1 112.9	-2.8	-3.5	-2.8	-2.7	-2.3	-2.2
3. State government	S.1312							
4. Local government	S.1313	-111.0	-0.3	-0.1	-0.1	0.0	-0.1	0.0
5. Social security funds	S.1314	302.8	0.8	0.7	0.7	0.6	0.4	0.4
General government (S.13)								
6. Total revenue	TR	15 941.0	39.5	41.3	40.3	39.8	38.9	38.2
7. Total expenditure	TE	16 862.1	41.8	44.2	42.5	42.0	40.9	40.0
8. Net lending/borrowing	B.9	-921.1	-2.3	-2.9	-2.2	-2.2	-2.0	-1.8
9. Interest expenditure	D.41	340.1	0.8	1.0	1.2	1.3	1.4	1.4
10. Primary balance		-581.0	-1.4	-1.8	-1.0	-0.9	-0.6	-0.4
11. One-off and other temporary measures [28]		-820.8	-2.0	-1.7	-1.6	-1.6	-1.5	-1.3
Selected components of revenue								
12. Total taxes (12=12a+12b+12c)		8 740.3	21.7	22.5	22.2	22.1	22.0	21.8
12a. Taxes on production and imports	D.2	5 580.7	13.8	14.1	13.9	13.8	13.7	13.5
12b. Current taxes on income, wealth, etc.	D.5	3 141.3	7.8	8.4	8.3	8.3	8.3	8.2
12c. Capital taxes	D.91	18.3	0.0	0.0	0.0	0.0	0.0	0.0
13. Social contributions	D.61	4 245.9	10.5	11.0	11.1	11.2	11.1	11.1
14. Property income	D.4	557.9	1.4	1.3	0.7	0.7	0.6	0.6
15. Other revenue		2 396.9	5.9	6.4	6.3	5.9	5.2	4.7

[28] See Table 3.1.

	ESA code	2023	2023	2024	2025	2026	2027	2028
		mln EUR	% of GDP					
16. Total revenue	TR	15 941.0	39.5	41.3	40.3	39.8	38.9	38.2
Tax burden (D.2[29]+D.5+D.61+D.91-D.995)		13 052.0	32.3	33.7	33.4	33.4	33.2	33.0
Selected components of expenditure								
17. Compensation of employees and intermediate consumption	D.1+P.2	7 266.4	18.0	19.1	18.3	18.0	17.6	17.1
17a. Compensation of employees	D.1	4 603.0	11.4	12.5	12.0	11.8	11.3	11.1
17b. Intermediate consumption	P.2	2 663.4	6.6	6.5	6.3	6.3	6.3	6.0
18. Social payments (18=18a+18b)		5 384.5	13.3	13.6	13.1	13.5	13.5	13.5
of which Unemployment benefits		159.2	0.4	0.4	0.4	0.4	0.4	0.4
18a. Social transfers through market producers	D.6311, D.63121, D.63131	551.9	1.4	0.9	0.9	0.8	0.8	0.8
18b. Social transfers which are no transfers in kind	D.62	4 832.6	12.0	12.6	12.2	12.6	12.7	12.7
19.=9. Interest expenditure	D.41	340.1	0.8	1.0	1.2	1.3	1.4	1.4
20. Subsidies	D.3	525.7	1.3	0.8	0.8	0.7	0.7	0.7
21. Gross fixed capital formation	P.51	1 643.4	4.1	5.3	5.6	5.3	4.6	4.6
22. Capital transfers	D.9	228.8	0.6	0.3	0.3	0.3	0.3	0.0
23. Other		1 473.2	3.7	4.0	3.2	2.9	2.8	2.7
24.=7. Total expenditure	TE	16 862.1	41.8	44.2	42.5	42.0	40.9	40.0
Government consumption	P.3	7 710.5	19.1	20.5	20.5	19.8	18.9	18.4

Table 2b. No-policy change projections

	2023	2023	2024	2025	2026	2027	2028
	mln EUR	% of GDP					
1. Total revenue at unchanged policies	15 941.0	39.5	41.3	40.3	39.8	38.9	38.2
2. Total expenditure at unchanged policies	16 862.1	41.8	44.2	43.0	42.0	40.9	39.9

Table 2c. Amounts to be excluded from the expenditure benchmark

	2023	2023	2024	2025	2026	2027	2028
	mln EUR	% of GDP					
1. Expenditure on EU programmes fully matched by EU funds revenue	463	1.1	1.6	1.9	2.1	1.8	1.2
1.a Of which investment expenditure fully matched by EU funds revenue	228	0.6	0.9	1.2	1.1	0.8	0.6
2. Cyclical unemployment benefit expenditure	4.0	0.0	0.0	0.0	0.0	0.0	0.0
3. Effect of discretionary revenue measures	165.4	0.4	1.0	-0.7	0.2	0.0	0.0
4. Revenues increased mandated by law	0	0	0	0	0	0	0

[29] Including taxes collected by EU budget

Table 3. General government expenditure by function (policy change scenario)

% of GDP	COFOG code	2022*	2028
1. General public services	1	4.4	3.9
2. Defence	2	2.2	3.7
3. Public order and safety	3	2.0	1.8
4. Economic affairs	4	5.7	5.2
5. Environmental protection	5	0.5	0.4
6. Housing and community amenities	6	0.8	0.8
7. Health	7	5.1	4.1
8. Recreation, culture and religion	8	1.3	1.1
9. Education	9	5.3	5.3
10. Social protection	10	13.2	13.8
11. Total expenditure	TE	40.4	40.0

*EDP notification, October 2023

Table 4. General government debt developments

% of GDP	ESA code	2023	2024	2025	2026	2027	2028
1. Gross debt		43.4	45.2	46.3	46.2	48.8	48.2
2. Change in gross debt ratio		1.8	1.8	1.2	-0.1	2.5	-0.6
Contributions to change in gross debt							
3. Primary balance		-1.4	-1.8	-1.5	-0.9	-0.7	-0.3
4. Interest expenditure	EDP D.41	0.8	1.0	1.2	1.3	1.4	1.4
5. Stock-flow adjustment		1.6	0.6	1.0	0.0	2.7	0.1
Implicit interest rate on debt		2.1	2.5	2.8	2.9	3.1	3.1
Other relevant variables							
6. Liquid financial assets		9.2					
7. Net financial debt (7=1-6)		34.2					
8. Debt amortization (existing bonds) since the end of the previous year		3.8	3.1	3.4	4.3	2.4	3.8
9. Percentage of debt denominated in foreign currency		0.0	0.0	0.0	0.0	0.0	0.0
10. Average maturity		6.79 years					

Table 5. Cyclical development (policy change scenario)

% of GDP	ESA code	2023	2024	2025	2026	2027	2028
1. Real GDP growth (%)	B1g	-0.3	1.4	2.9	2.5	2.3	2.3
2. Net lending of general government	B.9	-2.3	-2.9	-2.2	-2.2	-2.0	-1.8
3. Interest expenditure	D.41	0.8	1.0	1.2	1.3	1.4	1.4
4. One-off and other temporary measures		-2.0	-1.7	-1.6	-1.6	-1.5	-1.3
5. Potential GDP growth (%)		2.4	2.1	2.2	2.2	2.3	2.3
contributions:							
- labour		-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
- capital		0.8	0.8	0.9	0.9	0.9	0.9
- total factor productivity		1.7	1.3	1.4	1.4	1.4	1.5
6. Output gap, % of potential GDP		-0.4	-1.1	-0.3	0.0	0.0	0.0
7. Cyclical budgetary component		-0.1	-0.4	-0.1	0.0	0.0	0.0
8. Cyclically-adjusted balance (2-7)		-2.1	-2.5	-2.1	-2.1	-2.0	-1.8
9. Cyclically-adjusted primary balance (8+3)		-1.3	-1.4	-0.9	-0.9	-0.6	-0.4
10. Structural balance (8-4)		-0.1	-0.8	-0.5	-0.5	-0.5	-0.5

Table 6. Comparison with forecasts of the Stability Programme 2023-2026 (policy change scenario)

	ESA code	2023	2024	2025	2026	2027	2028
Real GDP growth (%)	B1g						
2023		0.0	2.0	2.9	2.8	-	-
2024		-0.3	1.4	2.9	2.5	2.3	2.3
Changes		-0.3	-0.6	0.0	-0.3	-	-
General government net lending/borrowing (% of GDP)	B.9						
2023		-4.0	-2.5	-2.2	-0.7	-	-
2024		-2.3	-2.9	-2.2	-2.2	-2.0	-1.8
Changes		1.7	-0.4	0.0	-1.5	-	-
General government gross debt (% of GDP)							
2023		39.6	39.7	39.8	38.9	-	-
2024		43.4	45.2	46.3	46.2	48.8	48.2
Changes		3.8	5.5	6.5	7.3	-	-

Table 7. Long-term sustainability of public finances [30]

% of GDP	2022	2030	2040	2050	2060	2070
Age-related general government expenditure	17.3	16.4	16.0	16.1	16.4	15.4
(Public) pension expenditure	7.2	6.9	6.5	6.3	6.1	5.4
Old-age and early pensions	6.3	6.2	5.8	5.6	5.5	4.7
Other pensions (incl. disability, survivors)	0.9	0.7	0.7	0.7	0.6	0.7
Non-earnings related pensions (incl. minimum pension and minimum income guarantee)	0.01	0.01	0.01	0.02	0.02	0.02
Health care expenditure	6.0	5.4	5.6	5.8	5.9	5.8
Long-term care expenditure	0.5	0.5	0.6	0.7	0.8	0.8
Education expenditure	3.6	3.6	3.3	3.3	3.6	3.4
Social security contributions into the state pension budget (I pillar)	7.9	7.3	7.2	7.2	7.2	7.1
Systemic pension reforms						
Social security contributions into the state funded pension scheme (II pillar)	1.8	1.9	1.9	1.9	1.9	1.9
Pension expenditure from the state funded pension scheme	0.1	0.2	0.5	1.2	1.9	2.2
Assumptions						
Labour productivity growth, %	1.9	3.1	2.2	2.0	1.6	1.2
Real potential GDP growth, %	1.7	1.4	1.2	0.4	0.9	0.9
Participation rate, males (aged 20-64), %	85.6	86.0	86.2	86.0	87.1	86.3
Participation rate, females (aged 20-64), %	79.9	79.4	79.0	79.4	80.8	80.0
Total participation rate (aged 20-64), %	82.7	82.7	82.7	82.8	84.1	83.3
Unemployment rate (aged 20-64), %	6.9	6.8	6.9	6.5	6.4	6.5
Population aged 65+ over total population, %	22.8	10.8	11.0	11.1	9.8	11.1

Table 7a. Contingent liabilities

% of GDP	2023
State and local government guarantees	1.4

[30] Data source: *The 2024 Ageing Report*

Table 8. External environment basic assumptions*

	2023	2024	2025	2026	2027	2028
Short-term interest rate in Eurozone (annual average)	3.4	3.2	2.2	2.2	2.2	2.2
Long-term interest rate in Eurozone (annual average)	2.4	2.3	2.3	2.3	2.3	2.3
EUR/USD exchange rate (annual average)	1.08	1.09	1.09	1.09	1.09	1.09
Nominal effective exchange rate in the EU	5.8	1.5	0.0	0.0	0.0	0.0
World GDP, excluding EU, growth at constant prices, %	3.5	3.3	3.5	3.5	3.5	3.5
EU GDP growth at constant prices, %	0.5	0.9	1.7	1.7	1.7	1.7
World goods and services trade volumes changes on the EU export markets, excluding EU, %	-7.0	10.7	3.2	3.2	3.2	3.2
World goods and services import volumes changes, excluding EU, %	-8.4	11.5	4.3	4.3	4.3	4.3
Oil price (Brent, USD/barrel)	82.5	82	79	79	79	79

* Forecasts: February 2024 scenario

Table 9. RRF impact

Revenue from RRF grants (% of GDP)							
	2020	**2021**	**2022**	**2023**	**2024**	**2025**	**2026**
RRF GRANTS as included in the revenue projections	0.0	0.0	0.0	0.4	1.4	1.7	1.0
Cash disbursements of RRF GRANTS from EU	0.0	0.7	0.5	0.0	0.9	0.6	1.9

Expenditure financed by RRF grants (% of GDP)							
	2020	**2021**	**2022**	**2023**	**2024**	**2025**	**2026**
TOTAL CURRENT EXPENDITURE	0.0	0.0	0.003	0.1	0.6	0.6	0.3
Gross fixed capital formation P.51g	0.0	0.0	0.01	0.3	0.9	1.0	0.7
Capital transfers D.9							
TOTAL CAPITAL EXPENDITURE	0.0	0.0	0.01	0.3	0.9	1.0	0.7
Other costs financed by RRF grants (% of GDP)							
	2020	**2021**	**2022**	**2023**	**2024**	**2025**	**2026**
Reduction in tax revenue	-	-	-	-	-	-	-
Other costs with impact on revenue	-	-	-	-	-	-	-
Financial transactions	-	-	-	-	-	-	-

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