Fiskālās disciplīnas padome

Adopted at the meeting of the Fiscal Discipline Council No. 6(74) 2024 Minutes No. §1.1.

Surveillance Report on the 2025-2027 Medium-Term Budgetary Framework, the 2025 Budget, and the 2025-2028 Fiscal Structural Plan

2024

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Executive summary

1. The Council has a broadly positive assessment of the draft Budget 2025 and the Medium-Term Budgetary Framework for 2025–2027. Both EU and national fiscal requirements have been met. However, high geopolitical uncertainty and sluggish economic growth present significant fiscal risks and challenges. Due to various constraints, the budget has been prepared within a very short timeframe, which has required the Council to base its review on preliminary budget documents. A more comprehensive analysis will be provided in the Council's interim monitoring report in spring 2025.

2. The development of the draft Medium-Term Budgetary Framework for 2025–2027 is based on macroeconomic projections approved by the Council on 10 June 2024[1]. These projections foresee real GDP growth of 1.4% this year, 2.9% in 2025, 2.8% in 2026, 2.6% in 2027, and 2.3% in 2028. On 30 September, the CSB published comprehensive national accounts audits for the period 1995-2023, reducing GDP in real prices over this period, changing the base year for constant prices from 2015 to 2020, and making minimal changes to growth rates. This audit may impact past assessments of the structural balance and general government deficit, potentially worsening them. The CSB audit results have not been included in the Medium-Term Budgetary Framework by the MoF.

3. Latvia, like other EU Member States, is experiencing 'post-crisis syndrome,' with recovery trajectories varying by country. Latvia’s economic performance in the first half of the year was weaker than initially expected. In response to recent economic data, commercial banks revised their forecasts more pessimistically in August, predicting growth of 0.8-0.9% for the year. On 8 October, the Bank of Latvia significantly lowered its GDP forecast for this year from 1.8% growth in June to 0.6%. Projections for subsequent years have also been revised downwards, with 2.6% growth now projected for 2025 instead of 3.3%, and 3% for 2026 instead of 3.8%[2]. Given the slower growth context, it is essential to monitor economic developments closely and prepare for necessary adjustments to public finances.

4. The MoF's pessimistic scenario[3] forecasts GDP growth of only 0.4% this year and 1.8% next year. Based on this scenario, the MoF estimates a general government budget deficit of 2.8% of GDP in 2024, 3.4% in 2025, 3.1% in 2026, 2.9% in 2027, and 2.6% in 2028. The Bank of Latvia’s even more pessimistic projection[4] suggests that the deficit could exceed 3% of GDP from this year onward: potentially 3.1% in 2024, 3.3% in 2025, and 3.2% in 2026. This is not the 'worst case' but rather the baseline scenario in the BoL’s projections. In light of these risks, the Council advocates for savings during budget execution, rather than reallocations, to achieve budgetary targets, particularly considering slippages in tax collection.

5. The ECB has begun gradually easing monetary policy in response to falling euro area inflation. In September, the ECB cut key interest rates by 25 basis points in response to inflation expectations and underlying inflation trends. The ECB now projects that

[1] FDC's view on the MoF's macroeconomic forecasts for the MTBI 2024-2028 download (fdp.gov.lv)
[2] Macroeconomic projections | October 2024 | Bank of Latvia
[3] Explanatory draft of the draft Law on the State Budget for 2025 and the Budgetary Framework for 2025, 2026 and 2027
[4] Macroeconomic projections | October 2024 | Bank of Latvia

inflation in the euro area will gradually decline to 2.5% in 2024, 2.2% in 2025, and 1.9% in 2026. Inflation is expected to rise slightly towards year-end due to base effects in price statistics following extreme movements in energy prices. These effects should dissipate by mid-2025, allowing inflation to fall once more.

6. Inflation in Latvia is below the EU and euro area average, with consumer prices rising by just 0.7% in August compared to a year earlier. However, Eurostat flash estimates suggest that it may have risen to 1.6% in Latvia in September. Goods and services price inflation in Latvia and the euro area show a rise in services inflation and a fall in goods prices, but the dynamics are different. In Latvia, prices of goods fell by 0.8% in August, while prices of services rose by 5.4%, faster than the euro area average.

7. The labour market is quite active despite the stagnating economy. The actual unemployment rate in recent months has been around 6.9%-7%, while registered unemployment is around 5%. Thus, the high demand for workers and the need for employers to adapt to wage pressures may become increasingly challenging for private entrepreneurs.

8. Wage growth averaged 10.3% in the first half of the year but slowed slightly to 9% in the second quarter, bringing the rate of wage growth below double digits. During this period, public sector wages rose by 12.4%, while private sector wages increased by a more modest 8.3%. The misalignment between wage growth and productivity has been repeatedly highlighted in productivity reports by the PEAK think tank of the University of Latvia[5]. Additionally, an in-depth IMF[6] study concluded that Latvia's income convergence trails behind that of other Baltic countries, with relatively low labour productivity, especially in manufacturing. This productivity gap is attributed to weak investment flows, a high share of low-productivity firms, and limited innovation.

9. Both wage growth and the ECB's monetary policy easing positively impacted the increase in retail deposits in commercial bank accounts. According to the Bank of Latvia, retail deposits rose by 5.8% in August. However, card transaction data indicate that people have become more cautious in their spending and are increasingly inclined to save.

10. Industrial production in Latvia declined by 2% in the first seven months of the year, with manufacturing experiencing a notable 4.4% drop. Conversely, the mining and quarrying industries, along with electricity and gas supply, grew by 12.8% and 6.8%, respectively. Manufacturing results varied, with food production increasing by 1% while industries such as wood processing (-2.2%) and metal products (-10%) faced declines. However, the latest data from August show a recovery in overall industrial output, which increased by 2.1%, driven primarily by growth in the mining and electricity sectors, while manufacturing continued to decline by 0.9%.

11. Lending activity in Latvia lags significantly behind that in Lithuania and Estonia in both the household and corporate sectors. Eurostat data indicate that household loan liabilities amount to 35% of GDP in Estonia, 22% in Lithuania, and only 17% in Latvia. Lending to households in Latvia has begun to recover this year following prolonged stagnation, supported by the ECB's signals of interest rate cuts. In the first eight

[5] Latvian Productivity Report (lu.lv)
[6] Republic of Latvia: Selected Issues (imf.org)

months of the year, housing loans increased by 11%, consumer loans by 14%, and other household loans by 47%. However, corporate lending remains stagnant, with new loans to non-financial corporations decreasing by 1% over the same period.

12. In the first half of the year, export values declined by 6% compared to the same period in 2023. The most recent monthly export data available for July shows a 6.5% increase compared to July of the previous year. This rebound is particularly notable following a prolonged downturn, as similar export increases were last observed in early 2023.

13. From a fiscal perspective, 2023 was a relatively successful year, with an improvement in the government's fiscal position. The deficit decreased from 4.4% to 2.2% of GDP, amounting to 893.1 million euros, compared to the budgeted deficit of 4.2%. This resulted in a structural balance of 0.2% of GDP, despite the fiscal strategy targeting a structural deficit of 0.5% of GDP. This improvement was supported by nominal GDP growth and higher tax revenues driven by inflation, alongside a gradual reduction in COVID-19 and energy support measures.

14. The 2024 budget was based on projected GDP growth of 2.5% and inflation of 2.2%. However, the MoF's June projections adjusted expectations to slower GDP growth of 1.4% and lower inflation of 1.2%. Consequently, general budget tax collection for the first eight months met 98.2% of the target. Non-tax revenue collection has also exceeded expectations, while spending on subsidies and grants has been reduced by €1.1 billion due to slower implementation of EU-funded projects and reallocations. As a result, the GGB deficit is now projected at 2.6% of GDP, with a structural GGB deficit of 0.2% of GDP.

15. This spring, the EU's new economic governance framework was introduced, aiming to gradually and sustainably reduce the EU's rising deficit and debt levels. While several Member States consider the framework complex and challenging to apply, it emphasizes economic growth while directing some of the additional budget revenue toward deficit reduction. Under this framework, EU Member States must prepare a medium-term Fiscal Structural Plan (FSP), which replaces the annual Stability Programme and National Reform Programme. This fiscal path sets a cap on the growth rate of government-financed net primary expenditure. Consequently, the draft law "On the State Budget 2025 and the Budgetary Framework 2025, 2026, and 2027" must align with both the FDL's structural balance condition, whose deficit tolerance has been increased to 1%, and the new EU fiscal guidelines.

16. The fiscal conditions for the 2025 State Budget and the Medium-Term Budgetary Framework (MTBF) for 2025–2027 have been calculated according to the new EU economic framework, using three methods: (1) the structural balance condition, mandated by national legislation and EU Regulation 2024/1263; (2) the structural primary balance condition; and (3) the EU expenditure growth condition. According to these calculations, the general government structural balance target meeting all three conditions for 2025–2028 is as follows: -0.817% of GDP in 2025, -0.749% in 2026, -0.792% in 2027, and -0.932% in 2028. The Council notes that the improved GGBB target for 2025 relies significantly on EAS adjustments, highlighting limited fiscal space in upcoming years: -€13.0 million in 2025, €32.2 million in 2026, €43.5 million in 2027, and €1.4 million in 2028.

17. The Fiscal Discipline Council recognizes that the fiscal path calculated by the MoF aligns with the provisions of Regulation 2024/1263 (EC technical information). The Council also appreciates the use of more current national data in the 2024 fiscal projections and the alignment of the 2025 budget preparation with the FSP fiscal path. In developing the draft General Government Budget Plan for 2025, the net increase in state-financed primary expenditure is projected, according to the MoF's calculations, to be 4.4% (excluding the fiscal buffer), which remains below the ceiling set by the FSP.

18. The tax reform approved by the government, set to take effect in 2025, aims to achieve several key improvements: reducing the labour tax burden for low- and middle-income earners, simplifying the tax system, and promoting income equality. To maintain fiscal neutrality, a temporary shift of 1% from the second to the first pillar of the pension system is proposed, which may increase government pension liabilities in future years. Nevertheless, the pension system remains stable. The reform also provides additional benefits, including enhanced business competitiveness, reduced labour costs, and increased investment opportunities.

19. The Fiscal Risk Declaration, prepared by the MoF and approved by the Cabinet, proposes a fiscal reserve in amount of 0.1% of GDP for 2025, 2026, and 2027. The Fiscal Discipline Council supports this fiscal reserve in amount of 0.1% of GDP for 2025.

20. Latvia faces several significant risks to economic growth and fiscal performance in the medium term:

- Geopolitical tensions and proximity to Russia and Belarus deter investors and tourists,
- Weak demand in key export markets poses a potential risk to export performance,
- Continued weakness in the manufacturing sector limits economic growth,
- Fiscal risks associated with the implementation of the Rail Baltica project,
- Fiscal risks related to the operations of state-owned enterprises, including AS AirBaltic and others,
- A sharp increase in public debt servicing costs anticipated in the coming years,
- Public sector wage increases that may expand the budgetary base, impact the labour market, and weaken national competitiveness.

21. According to the Ministry of Finance (MoF), government debt servicing costs under the MTBF for 2025–2027 are projected to be 1.1% of GDP this year, increasing to 1.2% in 2025 and rising by approximately one percentage point each year to reach 1.5% of GDP in 2028. High interest rates add to the debt servicing burden, limiting the capacity for public spending.

22. The Fiscal-Structural Plan projects gross government debt levels at 45.8% of GDP this year, increasing to 47.5% in 2025, 48.5% in 2026, 49.7% in 2027, and 50.8% in 2028. The Bank of Latvia's estimates are more conservative, anticipating government debt at 47% of GDP this year, 48.4% in 2025, and 49% in 2026. The approach of the 50% debt threshold underscores the need for fiscal discipline, as government debt typically spikes during crises. Although Latvia currently faces no imminent crisis, the volatile geopolitical climate suggests a prudent approach is warranted.

23. Latvia's government debt remains below the Maastricht criteria threshold of 60% of GDP, which supports its reputation as a fiscally responsible country. Rating agencies have acknowledged this, although Latvia's long-term rating has been downgraded in recent years due to regional geopolitical instability. On July 26, Moody's reaffirmed Latvia's A3 credit rating with a stable outlook[7]. Similarly, Fitch Ratings maintained Latvia's A- rating on July 12, highlighting the low cost of government debt and effective debt management policies, supported by EU and euro area membership[8].

[7] Moody's Ratings declares Latvia's credit rating at current A3 with stable future outlook | Moody's Ratings declares Latvia's credit rating at current A3 with stable future outlook | The Treasury

[8] Fitch Ratings affirms Latvia's credit rating at the current A- level with a positive future outlook | Fitch Ratings affirms Latvia's credit rating at the current A- level with a positive future outlook | The Treasury

Abbreviations

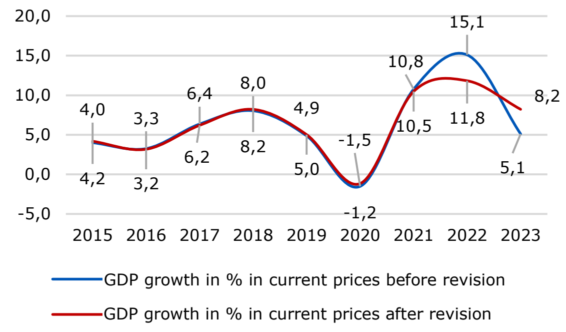
ED	Excise duty
JSC	Joint stock company
DBP	Draft budget plan
CSB	Central Statistical Bureau
ECB	European Central Bank
EC	European Commission
EAS	European national and regional accounts system
EBRD	European Bank for Reconstruction and Development
EU	European Union
OECD	Organisation for Economic Co-operation and Development
FDL	Fiscal Discipline Law
FDC	Fiscal Discipline Council
MoF	The Ministry of Finance
FSR	Fiscal security reserve
FRD	Fiscal risks declaration
FSP	Fiscal Structural Plan
PIT	Personal income tax
GDP	Gross domestic product
BoL	Bank of Latvia
LBFM	Law on Budget and Financial Management
Cabinet	Cabinet of Ministers
RET	Real estate tax
Council	Fiscal Discipline Council
VAT	Value added tax
SGP	Stability and Growth Pact
SP	Stability programme of Latvia
SPBS	Stability Programme baseline scenario
IMF	International Monetary Fund
CIT	Corporate income tax
Surveillance Report	Fiscal Discipline Surveillance Report
SRS	State Revenue Service
TT	The Treasury
SCC	State Capital Companies
MSSIC	Mandatory State social insurance contributions
MTBF	Medium-term Budgetary Framework
LMTBF	Law on Medium-Term Budgetary Framework
MTO	Medium-term objective
GG	General government
GGB	General government budget
GGBB	General government budget balance

1. Assessment of the macroeconomic environment

The factors shaping growth prospects in Europe remain the Russian aggression in Ukraine, the weakness of consumption and external demand, and the impact of the ECB's restrictive monetary policy. The growth outlook for Latvia and Latvia's trading partners is slower than expected at the beginning of the year. This chapter will look at the main changes in the Latvian economy since the approval of the MoF's macroeconomic forecasts in June this year.

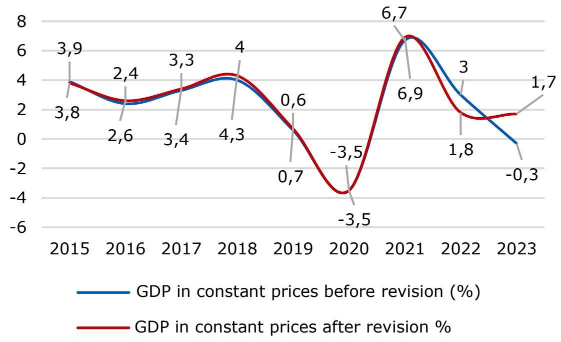
1. **On September 30 this year, the CSB published the results of a comprehensive national accounts revision[9] for the period 1995-2023.** Taking all revisions into account, GDP in current prices fell for all years from 1995 onwards. Between 1995 and 2009, GDP has been reduced by a maximum of (-5.3%) or EUR 905.2 million and a minimum of (-2.1%) or EUR 153.2 million. Between 2010 and 2021, the GDP outturn declined by a maximum of (-3.7%) or EUR 820.1 million and a minimum of (-2.0%) or EUR 368.3 million. GDP in current prices for 2022 is revised downwards by (-5.9%) or EUR 2.283 million and is estimated to grow by 11.8% instead of the previous 15.1%. GDP in current prices in 2023 is also revised down by 3.2% or EUR 1.276 million, but it is estimated to grow faster (+8.2%) than before (+5.1%) because the growth rate is calculated on a lower base than before.

1.1. Figure. CSB data audit in current GDP prices



Source: CSB

Figure 1.2. CSB data audit for GDP at constant prices



Source: CSB

2. GDP growth in constant prices also changed for all years. As for GDP at constant prices, unlike GDP at current prices, changes are measured in percentage points rather than percentages. Overall, the revisions made between 1996 and 2009 range from (-1.8 pp) to (+0.9 pp). For the period 2010-2021, the adjustment ranges from (-0.1 pp) to (+0.8 pp). For 2022, growth in constant prices has been revised down by (1.1 pp) and the new growth estimate is 1.8% instead of 3%. For 2023, GDP in constant prices has been revised upwards by 2 percentage points, so instead of a 0.3% downfall, the revised data show real GDP growth of 1.7%.
3. It is also important to note the change in the base year for calculating GDP at constant prices. As a result of the audit, the base year, previously 2015, has now been changed to 2020. Changing the base year does not affect GDP growth rates; however, it alters the base period against which price time series are compared and conditionally adjusts

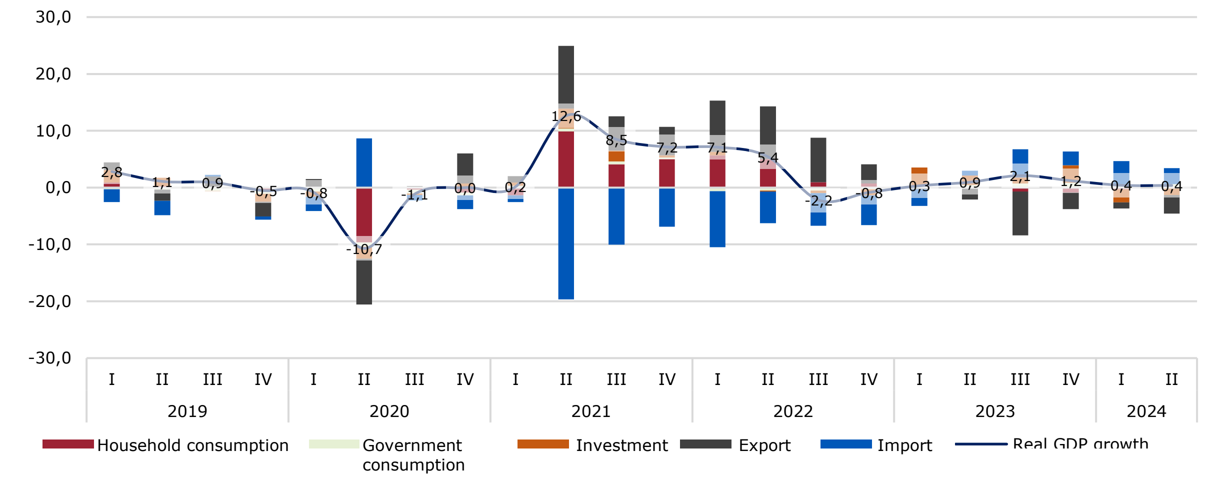
[9] Gross Domestic Product Audit 2024[IKP_2024_gada_revizija_30092024.pdf (stat.gov.lv)]

the levels (numerical values) of the time series. Consequently, following the revision, all chained GDP indicators are expressed in 2020 prices.

Gross domestic product

4. Assessing GDP from the expenditure perspective, it is evident that in the second quarter, GDP increased by 0.4%. Government spending contributed 0.6% to GDP growth, while other components contributed negatively – household consumption (-0.1%), investment (-1.2%) and exports of goods and services (-3.3%).

Figure 1.3. Contribution to real GDP growth (year-on-year), %



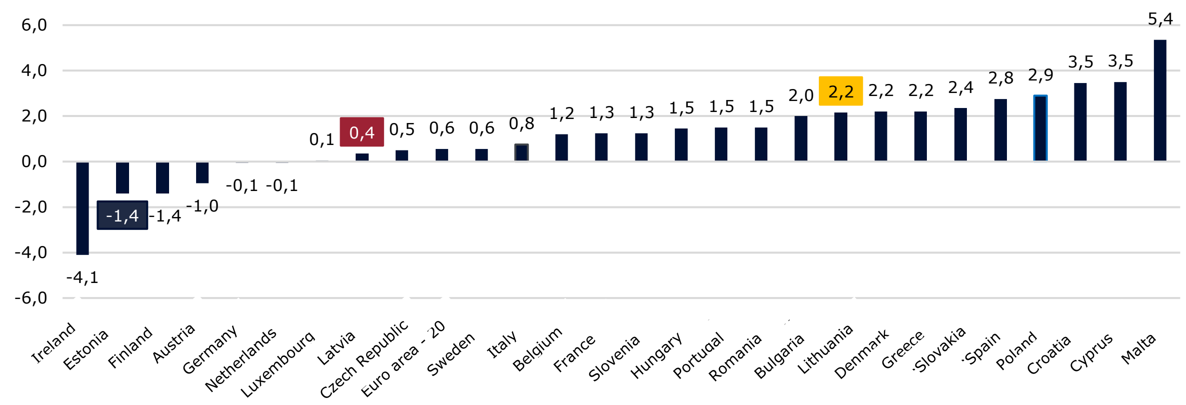
Source: CSB

5. Overall, GDP also grew by 0.4% in the first half of the year. Government consumption (0.6%) was the main contributor to GDP growth, while investment (-1.8%), exports (-2.2%) and household consumption (-0.2%) were the other GDP-decreasing contributors.

6. Eurostat data on first-half GDP dynamics in EU countries show significant differences in economic development, but overall, the economies of Latvia's main trading partners are showing signs of improvement, contributing to a more favourable macroeconomic environment for Latvian exports.

7. Eurostat data on GDP dynamics in EU countries in the first half of this year show that they varied widely, from a 4.1% GDP decline in Ireland to a 5.4% GDP growth in Malta. The dispersion among the Baltic countries is also quite significant – Estonia contracted by 1.4% in the first half of the year, Latvia grew by a very marginal 0.4%, and Lithuania led the way with 2.2% growth, three times faster than in the euro area. In the euro area, GDP growth has been rather weak at just 0.6%. In the EU, out of 27 countries, six are in recession, five are growing at less than 1% and the remaining 16 are growing between 1.2% and 5.4%.

Figure 1.4. GDP growth in EU countries in H1 2024, %



Source: Eurostat

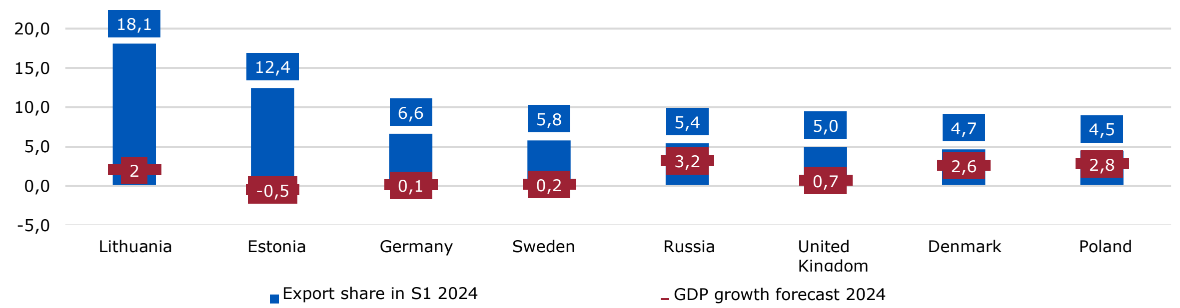
8. In the first half of the year, the GDP of Latvia's major EU trading partners grew by 1.1% on average, half as fast as that of the euro area, suggesting that the macroeconomic environment in economies important for Latvia's exports is gradually improving.

External environment

9. The European Commission's spring forecasts[10], for GDP growth in Latvia's main export partners, point to uneven growth this year. However, growth forecasts for Latvia's trading partners exceed those for the European Union.

10. In May this year, the European Commission's forecast for 2024 GDP growth in Latvia's main export countries pointed to a rather uneven development. Figure 1.5 shows the share of Latvian exports in the first half of this year and GDP growth forecasts for this year. Lithuania, which accounted for 18% of Latvia's total exports in the first half of the year, is forecast by the EC to grow by 2%. For Estonia, which accounts for 12% of Latvia's exports, the EC forecasts a contraction of 0.5%.

Figure 1.5. Latvia's export share (%) by main trading partner countries and GDP growth forecasts (%) for 2024



Source: CSB [ATD040m], EC forecast[11], IMF forecast[12] (Russia and UK)

[10] Spring 2024 Economic Forecast: A gradual expansion amid high geopolitical risks - European Commission (europa.eu)
[11] Economic forecast for Latvia - European Commission (europa.eu)
[12] World Economic Outlook Databases (imf.org)

11. On average, Latvia's export partners' GDP forecast for 2024 is 1.3% (1.1% excluding Russia), which is above the 1% growth forecast by the EC for the European Union[13] and the 0.9% growth forecast by the IMF[14] . It should be noted that the IMF has forecast global economic growth at 3.2%, well ahead of the forecast for the European Union.

12. The latest EC Business and Consumer Sentiment Survey, published on 27 September at[15] , shows that economic sentiment in the EU and the euro area is broadly stable, while employment expectations improved in September after having fallen in previous months. The economic sentiment indicator in Latvia has been improving since June, also improving by 1.1 percentage points to 98.4% in September, but is below the long-term average (100%). This gives hope for only a marginal pick-up in economic growth in the second half of the year. Lithuania's sentiment indicator has been slightly above its long-term average since August, at 101.4% in September and up 0.3 pp since August. In contrast, Estonia has the lowest sentiment indicator in the Baltics – 85.4% in September, but an increase of 0.8 pp compared to August.

13. In Germany and Sweden, the economic sentiment indicator fell by 1.2 percentage points to 89.3% and 94.4% respectively, reflecting a rather cautious assessment of the future. However, sentiment indicators in other countries important for Latvian exports, such as Poland and Denmark, have been improving in recent months. Polish sentiment was 102.1% in September, up by 2 pp since August, and Danish sentiment was 104.8%, up the fastest by 4.2 pp.

14. Overall, these data indicate that the Latvian economy is experiencing a mixed outlook – while sentiment indicators are improving for some trading partners, they are sliding downwards for Germany and Sweden. This suggests that the coming months could be marked by very minimal export gains for the Latvian economy and that external factors could continue to limit export opportunities.

15. Fluctuations in employment expectations among Latvia and its major trading partners point to uneven labour market developments, with positive trends in Poland and Denmark, but small or even negative developments in most other countries, including Latvia.

16. Employment expectations fluctuate both in Latvia and among its major trading partners. In September, Latvia recorded a slight increase in employment expectations of 0.4 percentage points, which is more likely due to seasonal factors.

17. Meanwhile, employment expectations deteriorated in Lithuania (-0.7 pp), Estonia (-0.9 pp), Germany (-1.7 pp) and Sweden (-0.2 pp). In Denmark and Poland, the opposite is true, with employment expectations rising by 1.3 pp in Poland and by 2.6 pp in Denmark, in addition to an overall improvement in economic sentiment.

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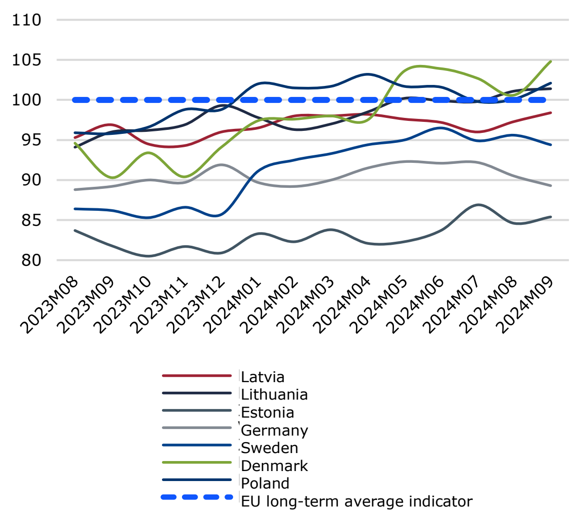
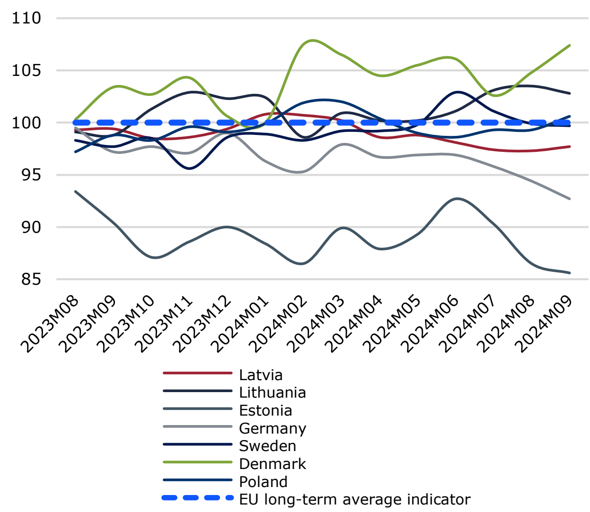
[13] Spring 2024 Economic Forecast: A gradual expansion amid high geopolitical risks - European Commission (europa.eu)
[14] World Economic Outlook Update, July 2024: The Global Economy in a Sticky Spot (imf.org)
[15] Business and consumer survey results for September 2024 – Statistical Annex (27. September, 2024)0125244c-12c9-4085-8985-9018cd316cc6_en (europa.eu)

Figure 1.6. Economic sentiment indicator for Latvia and its trading partners in the EU



Source: Eurostat

Figure 1.7. Employment expectations indicator for Latvia and its trading partners in the EU



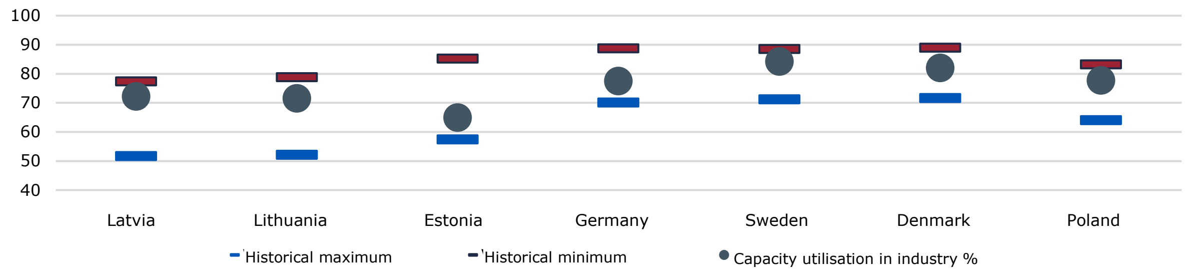
Source: Eurostat

18. **The EC survey data on industrial capacity utilisation, published in July[16], covers three quarters of this year. They show that in Latvia and its main export partners, industrial capacity utilisation is in most cases closer to historical peaks than to troughs, although there are some notable differences.** In Latvia, industrial capacity utilisation reached 72.1% in the third quarter, between the historical low (51.6%) and the historical high (77.3%), closer to the latter. The situation is similar in Lithuania, where third-quarter capacity utilisation was 71.5% – slightly below the Latvian figure and also below its historical peak (78.7%). In the third quarter, the industrial capacity utilization in Germany and Estonia significantly lagged historical highs. In Germany, industrial capacity utilisation was 77.4%, close to its historical low (70%) and well below its historical high (88.7%). In Estonia, capacity utilisation in July was 64.9%, which is also closer to the historical minimum and 20.2 percentage points away from the historical maximum.

19. Both Estonia and Germany are important export markets for Latvia. The limited economic activity of these countries has a negative impact on Latvia's export volumes and economic growth prospects. In Sweden, industrial capacity utilisation reached 84.2% in the third quarter, very close to its historical peak of 88.4%. This suggests a gradual recovery of the industrial sector.

[16] Business and consumer survey results for July 2024 – Statistical Annex (30 July 2024) [bcs_2024_07_statistical_annex_en.pdf (europa.eu)]

Figure 1.8. Capacity utilisation in industry in Latvia and its main trading partners in the EU in Q3 this year, %



Source: Eurostat

20. Overall, industrial capacity utilisation indicators point to positive, but in some places slightly more moderate, economic activity in Latvia's export partner countries. The Latvian economy can expect that part of the export demand could come from countries with higher capacity utilisation, such as Sweden and Lithuania.

21. ***Components of the Latvian sentiment indicator for September.*** The sentiment indicator was positive for service providers in September (2.9%), improving compared to January but still declining compared to August. Retailers had the same rating (2.9%) in September, but sentiment in this segment improved, both compared to the beginning of the year and compared to August.

22. Consumer sentiment is negative at -8.2% in September, but at the same time showing the sharpest improvement, both compared to the beginning of the year (+5 pp) and compared to August (+1.1 pp).

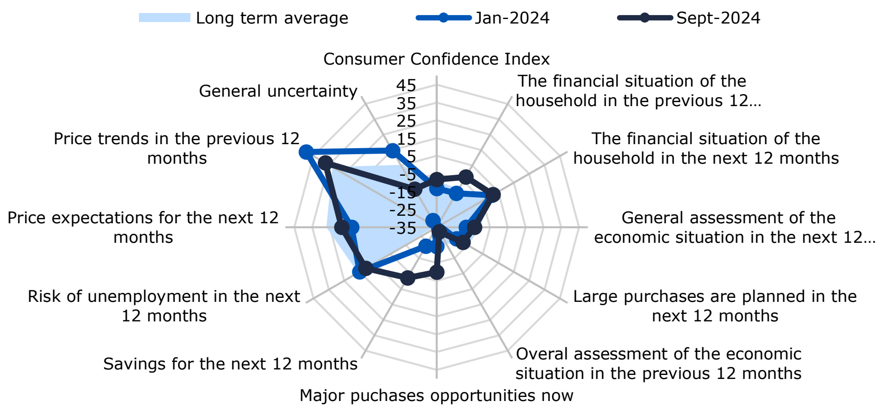
23. The lowest sentiment scores are in manufacturing and construction, at (-7.5%) and (-12.7%) respectively in September. However, there was a marginal improvement in sentiment in manufacturing, both compared to January (+0.6 pp) and compared to August (+0.7 pp). In construction, sentiment worsened by 1 pp compared to January, but improved by 2.8 pp compared to August.

24. ***Manufacturers*** sentiment in Latvia is low (negative) for the whole year, reaching -7.5% in September, which is (0.7-0.8 pp) better than in August or January. Overall, the score is half the long-term average and points to protracted difficulties in the sector. The valuation of order books is below its long-term average, consistently hovering between -29% and -31% since January. It also deteriorated marginally by 0.4 pp in September compared to August. The assessment of manufacturing managers on finished inventories is gradually improving and shows that manufacturers have adapted to the current market situation and do not have significant overstocks. The September sentiment survey shows a volatile but still unfavourable situation regarding industry trends, export orders, employment expectations.

25. Sentiment in ***service*** sector was 2.9% in September compared to August. This indicator has deteriorated by 0.7 pp year-o-year but improved by 1.1 pp since the beginning of the year. In September, all three components of this indicator deteriorated compared to August: demand expectations (-1.1 pp), assessment of the previous business situation (-0.2 pp) and assessment of demand in the previous period (-0.8 pp).

26. ***Consumer*** sentiment in September was -8.2%, quite close to the long-term average (-8.7%), while consumer sentiment has gradually improved since the beginning of the year, as illustrated in Figure 1.9. The components of the consumer sentiment indicator point to a significant improvement since the beginning of the year, suggesting that consumption could recover towards the end of this year and early next year and have a positive impact on GDP. Consumers' views on their household finances have improved by 10.5 pp since the beginning of the year, while their assessment of their expected financial situation has improved by 0.8 pp over the past 12 months and is slightly above the long-term average. Expectations for the overall economic situation over the next 12 months have also turned more optimistic (up 4.7 pp). Households have started to look more confidently at the possibility of making larger purchases, both now and in the next 12 months. The rating on the ability to make major purchases now has improved by 14.4 pp compared to the beginning of the year, while the rating on plans to make major purchases in the next 12 months has improved by 4.1 pp, both above the long-term average.

Figure 1.9 Consumer sentiment indicator and its components



Source: Eurostat

27. Households' perceptions of price trends have changed markedly since the start of the year and are consistent with a slowdown in inflation. At the same time, households' sentiment about savings for the next 12 months has improved significantly. While in January the score was -22.8%, in September it improved to -2.2%, an improvement of 20.6 pp. However, households' concerns about overall uncertainty have intensified, with a 25 pp deterioration.

28. **Overall, the mood of Latvian consumers in September suggests that consumers have started to feel more confident about saving and making larger purchases, while the factors that keep uncertainty high have not disappeared.**

29. ***The retail sentiment indicator*** has been volatile since the beginning of the year, but has been improving again since July, reaching 2.9% in September. Retailers' assessments of the situation in the sector over the past three months improved both compared to the beginning of the year and compared to August. However, the future business situation is better assessed in September than in August or January (5.6% vs. a long-term average of 9.8%).

30. ***The construction sentiment indicator*** has been stable throughout the year, but the assessment is negative, also in September (-12.7%). This is a slight improvement compared to the summer months. On the downside, but still improving, is the indicator related to the volume of orders (-25.3%); construction employment expectations improved to -0.1% from -1.6% in January and are above the long-term average (-2.9%).

Industry

31. Industrial output in the first seven months of the year fell by 2% year-on-year, including a 4.4% decrease in manufacturing output and a 12.8% increase in mining and quarrying. Electricity and gas supply companies also saw a 6.8% increase in output. The first seven months of the year have been challenging in manufacturing, with a very mixed performance by sub-sectors. The manufacturing sub-sectors with the largest impact on GDP mostly posted output declines – apart from food production, which grew by 1% over the seven months, and metals production, which increased by 7.2%. Output fell in large industries such as wood processing (-2.2%), non-metallic mineral products (construction materials) (-1.3%), rubber and plastic products (-2.1%) and fabricated metal products (-10%). Overall, out of 20 manufacturing sub-sectors, 14 sub-sectors saw a decrease in output by 7.9% on average in the first seven months of the year, while six sub-sectors saw an increase in output by 7% on average. The strongest performance over the seven-month period was observed in metal production, which rose by 17.2%, while the largest decline was in other manufacturing, which fell by 17.7%. In July, industrial production increased by 1.4% compared to the same month last year, including a 6.1% rise in mining, a 6.4% decline in manufacturing, and a notable 66% increase in electricity and gas supply, driven by a substantial rise in hydroelectric power production during the month.

Transport

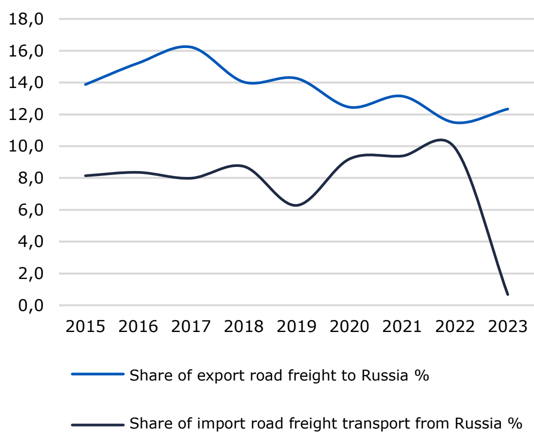
32. Cargo turnover in Latvian ports decreased by more than 11% in the first and second quarters of this year, with the overall decline reaching 11.4% in the first half of the year. Although the decline in port freight turnover has been ongoing since the first quarter of 2023, it has slowed down. The overall situation reflects the continuing problems in the freight sector.

33. Looking at the largest Latvian ports, the biggest drop in turnover in the first half of the year was in the Port of Ventspils, where the drop reached 31.7%. The volume of shipped cargo decreased by 23.4%, which also reflects the decline in exports, while the volume of cargo received at the Port of Ventspils decreased by 42.1%. The Port of Riga also saw a 7.8% drop in cargo turnover in the first half of the year, mainly due to a 40% drop in the volume of cargo received. However, the volume of cargo shipped increased by 10.2%. In the first half of the year, cargo turnover in the Port of Liepaja and small ports increased by 2.6% and 13.6%, respectively. The Port of Liepaja shipped 6.5% more cargo but received 10.1% less than in the first half of the previous year. Small ports, on the other hand, shipped 21.3% more cargo, while the volume of cargo received dropped by 46%.

34. Data on land transport for the first half of this year show a 2% decrease. However, the situation varies by sub-sector, with rail transport down by 4.3% and road transport registered in Latvia up by 2.3%.

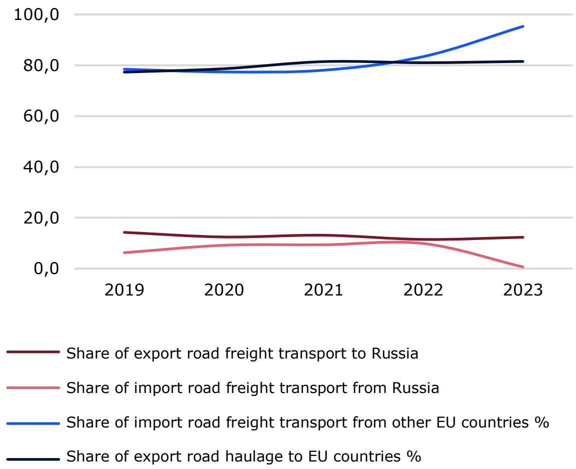
35. The dynamics of geopolitical relations have had a direct impact on freight transport to and from Russia. The share of Latvian road transport to Russia for export cargo has slowly decreased since 2019 and is currently around 11%-12%. By contrast, the share of road transport imports from Russia fell sharply to 0.7% in 2023.

Figure 1.10. Share of international road freight transport to/from Russia in export and import shipments



Source: CSB

Figure 1.11. Share of international road freight transport to/from Russia and EU countries* in export and import traffic



Source: CSB
**Austria, Belgium, France, Estonia, Italy, Lithuania, the Netherlands, Poland, Finland, Spain, Germany, Sweden*

36. In recent years, Latvian exports have started to shift towards EU markets. The share of road transport to EU countries is significantly higher than that to Russia. It stood at 81.5% in 2023 and has been rising moderately since 2015. Therefore, the potential for reorientation towards the EU is still high and should be exploited when export flows from Latvia resume.

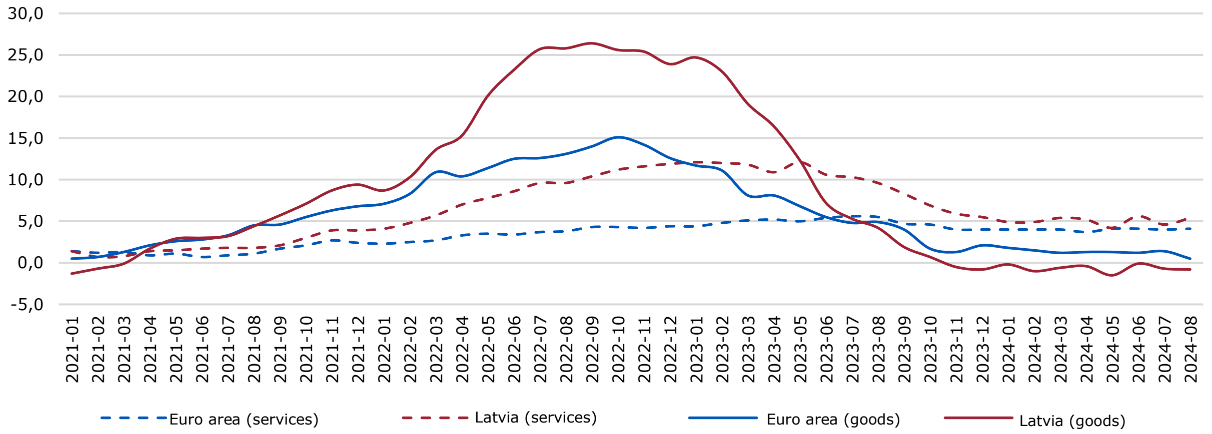
Inflation

37. **Since September 2023, Latvia has had a lower inflation rate than the EU and euro area average. According to the Central Statistical Bureau, consumer prices in Latvia increased by only 0.7% in August compared to August of the previous year. Compared to July, consumer prices in Latvia decreased by 0.5%.**

38. Preliminary data from Eurostat show that inflation in Latvia may have risen to 1.6% in September, while in the euro area it fell from 2.2% in August to 1.8% in September. Preliminary data also show that the lowest inflation rate in the Baltics in September could be 0.4% in Lithuania, while in Estonia it has been around 3% since April, with the September estimate at 3.2%. The highest inflation in the euro area since the start of the year is in Belgium, where consumer price inflation was also estimated at 4.5% in September.

39. The internal processes of inflation in Latvia and the euro area show that **price inflation in services is almost half the rate of overall consumer price inflation, while price inflation in goods is minimal or, in Latvia's case, negative.** This is now a common feature of the euro area. Eurostat data by goods and services are now available for August and show that in the euro area, goods prices rose by 0.5% and services by 4.1%. In Latvia, prices of goods fell by 0.8% in August, while prices of services rose by 5.4%, faster than in the euro area. Inflation data for Latvia compiled by the CSB are also available for August and are in line with the trend in services and goods prices recorded in Eurostat data.

Figure 1.12. Changes in consumer prices (HICP) in Latvia and the Euro area in services and goods segments % year-on-year

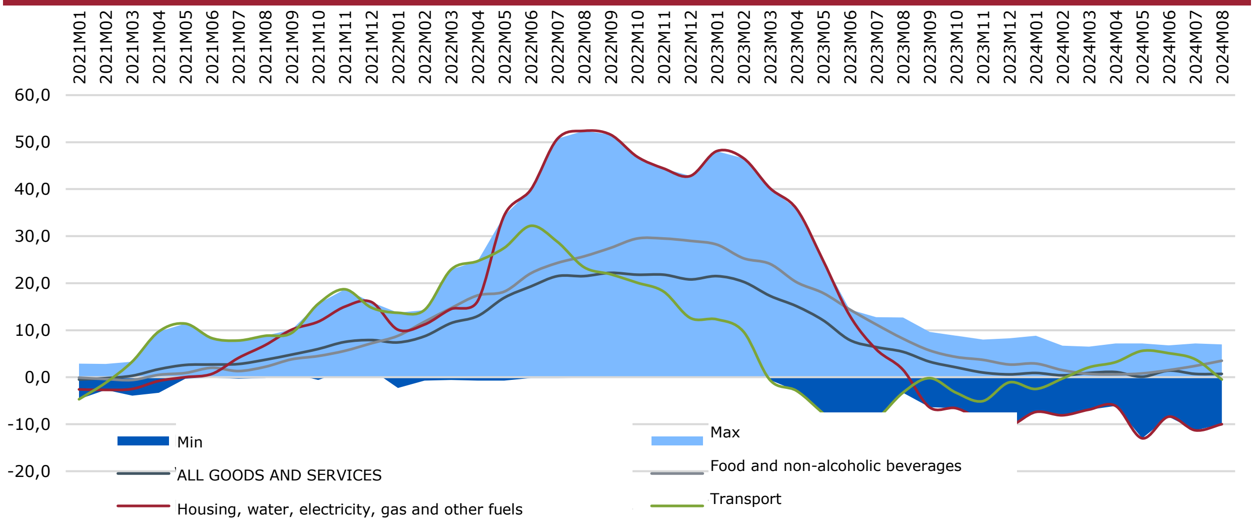


Source: Eurostat

40. Despite a general stabilisation of inflation, there are still segments in Latvia where prices continue to rise several times faster than annual headline inflation. In August, prices for healthcare services increased by 5.6% overall, especially for dental care and laboratory tests, where prices rose by 9.8%. Prices for telecommunication services increased by 4% overall, while prices for bundled telecommunication services increased by 11.7% within this group of services. Prices of education services rose by 6.6% in August, especially for pre-primary education and paid courses, by 9.6% and 6.6% respectively.

41. In the goods segment, consumer prices of alcoholic beverages and tobacco products increased significantly (+7%) in August and in the previous months, due to the increase in excise tax. Food prices also rose, but not as sharply (+3.5%), but it should be noted that this increase is important for the consumption basket. Clothing and footwear prices rose by 3%. At the same time, the largest price decreases in August and in the previous months were for housing costs (-10%), including electricity (-28.6%) and heating (-13.1%), which helped to stabilise the overall level of consumer prices.

Figure 1.13. Consumer price changes by groups and subgroups % year-on-year



Source: CSB

42. **In September of this year, the European Central Bank (ECB) decided to lower key interest rates for the second time since September 2023. Key interest rates cut by 25 basis points or 0.25 percentage points[17].** This decision was taken because the ECB's inflation forecasts and the dynamics of core inflation, as well as an assessment of the strength of the monetary policy transmission, signalled the need to reduce restrictive monetary policy.

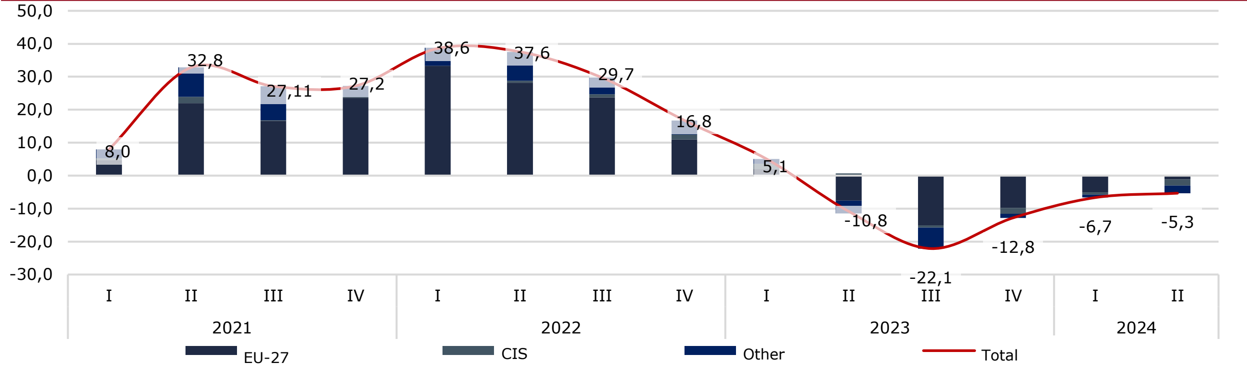
43. ECB experts forecast headline inflation in the euro area at 2.5% in 2024, 2.2% in 2025 and 1.9% in 2026. Inflation will pick up slightly towards the end of this year, as base effects related to energy price volatility in previous years have dissipated but should fall again in the second half of next year. The ECB has increased its core inflation projections for 2024 and 2025, due to higher-than-expected services prices. The ECB expects core inflation to fall sharply, from 2.9% in 2024 to 2.3% in 2025 and 2% in 2026.

<u>Exports.</u>

44. In the second quarter of this year, Latvia's exports of goods fell by 5.3% compared to the second quarter of 2023. Exports to the EU countries fell by 1.2%, to the CIS countries by 1.8% and to other countries by 2.3%. Latvia's export slowdown persists for five consecutive quarters but slows down from the last quarter of 2023.

[17] Decision of 12 September 2024 Monetary policy decisions (europa.eu)

Figure 1.14. Dynamics of Latvian goods exports by region, % year-on-year

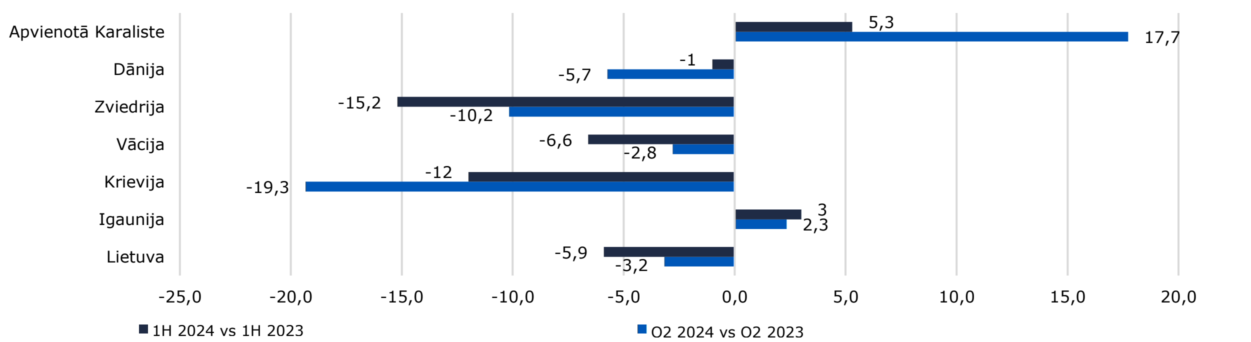


Source: CSB

45. In the first half of the year, the overall value of exports is down 6% compared to the first half of 2023. In the first half of the year, exports of goods to trading partners increased only in trade with Estonia by 3% and with the United Kingdom by 5.3%. Exports to Lithuania (-5.9%), Germany (-6.6%), Sweden (-15.2%) and Denmark (-1%) declined in the first half of the year, while exports to Russia fell by 12%.

46. Comparing the second quarter of this year to the second quarter of last year, the situation is similar, with a few exceptions. Exports to trading partners have improved to Estonia (+2.3%) and increased sharply to the UK (+17.7%). Trade with Lithuania (-3.2%), Germany (-2.8%) and Sweden (-10.2%) is slowing down. Trade with Denmark (-5.7%) and Russia (-19.3%) deteriorated in the second quarter.

Figure 1.15. Export growth by main trading partner in total for Semester (S) 1 2024 and quarter (Q) 2 2024, %



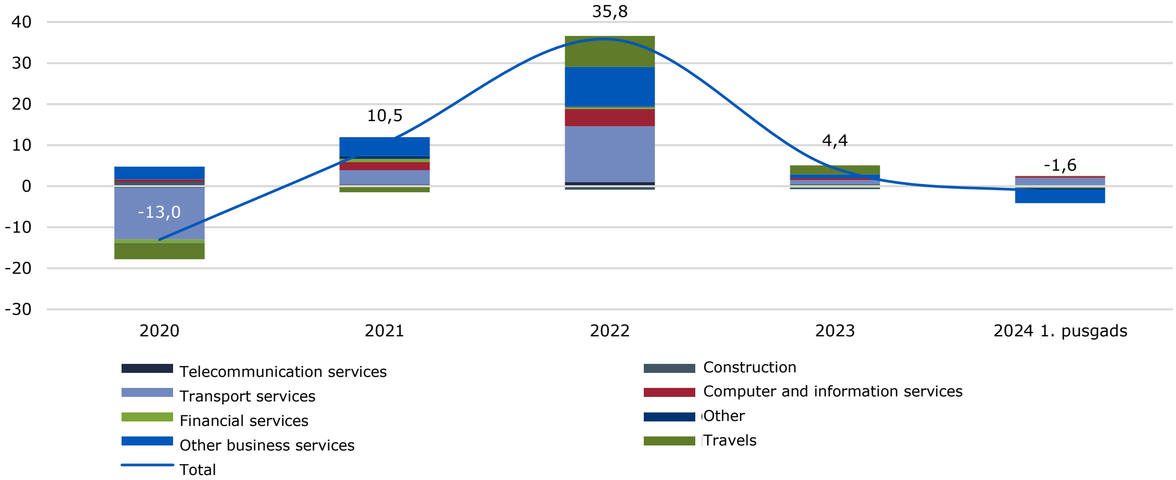
Source CSB

47. **The latest CSB data on export dynamics, available at the time of this report writing, are for July and show a 6.5% increase in exports compared to July last year. This result is also remarkable as similar results were previously observed in the first months of 2023.**

48. The Bank of Latvia's data on services exports by month show a decline in this area from September 2023. The results for the first half of this year also show a contraction of 1.6% in services exports, but the situation is starting to level off and the downturn is not as sharp.

49. In the first half of the year, compared to the first half of the previous year, there was a slight increase in exports of transport services (+2%), an increase of 0.4% in exports of IT services, and an even smaller increase in exports of travel services (+0.1%). Most exported services declined – financial services (-0.1%), telecommunication services (-0.3%), other business services (-3.2%).

Figure 1.16. Dynamics of Latvian services exports % year-on-year



Source: Bank of Latvia

<u>Labour market</u>

50. The actual unemployment rate was 7% in August, according to the CSB. From November 2023, the rate ranges between 6.9% and 7% (seasonally adjusted data). The number of unemployed is around 65,000-66,000. Overall, the labour market situation could be described as stable, despite stagnation in the overall economy and a slowdown in some sectors. According to the SEA, 46.8 thousand people were unemployed at the end of August and the registered unemployment rate was 5.3% in August, up 0.1 pp since July. All regions recorded an increase of 1 pp in the unemployment rate in August. Unemployment in Riga is traditionally the lowest, at 4.1% in August. In Kurzeme, Vidzeme and Zemgale regions the unemployment rate is 5.1%, 5.4% and 5% respectively. However, Latgale has the highest unemployment rate in a long time, at 10.5% in August.

51. Unemployment profile. An in-depth analysis by the SEA[18] shows that the average duration of unemployment is 136 days, 4 days shorter than a year earlier. The majority of the unemployed, or 63%, had been unemployed for up to 6 months and the number of unemployed in this group increased by 0.8% during the month. The most unemployed were retail salespeople, project managers and skilled craftspeople (tailors, builders, etc.).

Age structure: The majority of the registered unemployed at the end of June 2024 were aged between 50 and 59, accounting for 25.4% of the total unemployed. This high share indicates that older jobseekers are at higher risk of long-term unemployment. In addition, people aged 60 and over make up a significant 15.2% of the total number of

[18] <u>REPORT ON NATIONAL LABOUR MARKET (JUNE OF 2024) (nva.gov.lv)</u>

unemployed, which could point to difficulties for older people in finding new job opportunities.

Impact of education level: The unemployed with vocational training accounted for the largest share of the registered unemployed (31.9%), but their share has fallen by 0.3 percentage points over the year. At the same time, the number of unemployed with higher education has increased by 0.7 pp. This shows that labour market challenges affect not only people with lower levels of education, but also higher-skilled professionals, pointing to increased competition and skills mismatch problems.

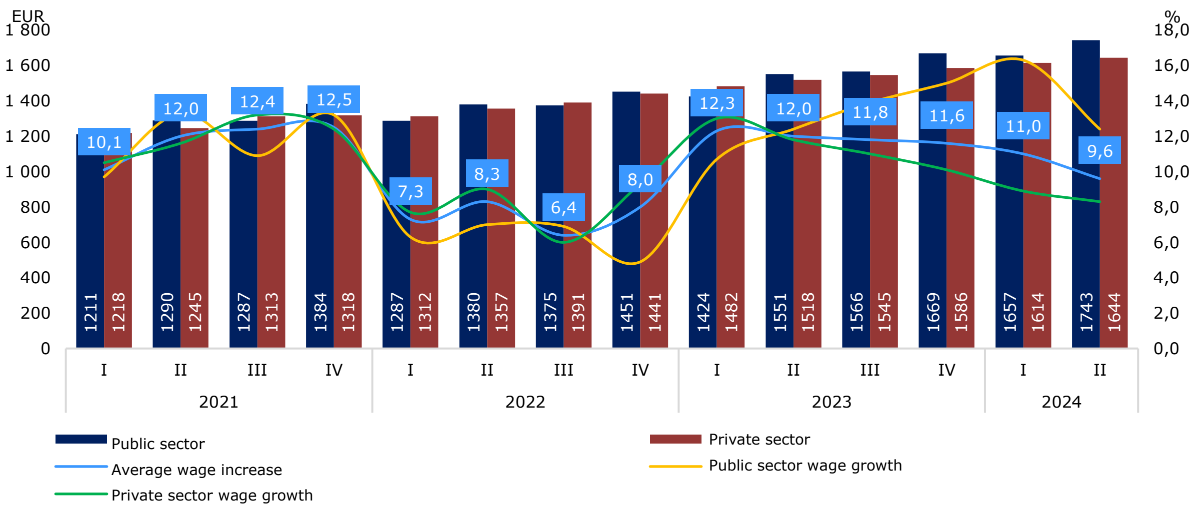
52. **Long-term unemployment.** The number of such unemployed people registered with the SEA for more than one year accounted for 16.3% of the total number of unemployed at the end of June 2024. Of these, more than 60% were aged 50 and over. Although the number of long-term unemployed is on a downward trend, the most difficult people to find a job are the elderly, the pre-retired unemployed and people with disabilities.

<u>Wages and consumption</u>

53. **Gross wage growth** slowed slightly compared to previous quarters and is no longer in double digits, but it was still quite strong in the second quarter of this year, at 9%. Public sector wages grew by 12.4%, while private sector wages grew by a much slower 8.3%. Overall, the national average gross wage was EUR 1,671, EUR 1,743 in the public sector and EUR 99 less in the private sector, or EUR 1,644, indicating a significant gap between public and private sector wages.

54. **The misalignment between wages and productivity growth has been repeatedly pointed out in the productivity reports of the PEAK think-tank[19]. The IMF[20] has also carried out an in-depth study, concluding that Latvia's income convergence lags behind the other Baltic countries, while labour productivity, especially in manufacturing, is relatively low, driven by weak investment flows and a high share of low-productivity and innovation-poor firms in the economy.**

Figure 1.17. Wage dynamics in euro and % – quarter on quarter, y-o-y

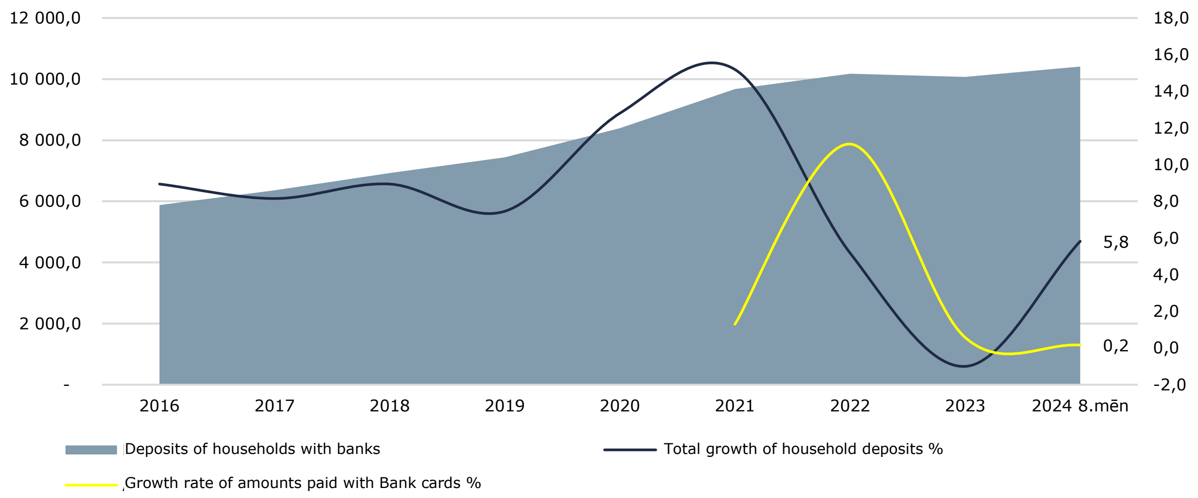


Source CSB

[19] Latvian Productivity Report (lu.lv)
[20] Republic of Latvia: Selected Issues (imf.org)

55. **Both wage growth and the ECB's monetary easing have had a positive impact on the increase in the amount of households' deposits in commercial bank accounts.** Bank of Latvia data show that households' deposits increased by 5.8% in August. However, data on the amounts paid by people using their bank cards show that people are more cautious in their spending and more inclined to save.

Figure 1.18. Amount of deposits of Latvian households in bank accounts (euro, right axis) and % growth compared to the previous year (%, left axis), growth rate of bank card payments (%, left axis)



Source: CSB

56. The analysis of the Bank of Latvia data also reveals a tendency to shop abroad more than to make payments in Latvia. The volume of card payments has increased by 12% for payments abroad, while the volume of payments made in Latvia has even decreased.

Lending

57. **Latvia is significantly behind Lithuania and Estonia in lending activity in both the household and corporate segments. Eurostat data[21], available for 2022, show that household loan liabilities in Estonia amounted to 38% of GDP, in Lithuania 26% and in Latvia 19.4% of GDP. The Financial Industry Association, citing Eurostat, publishes similar data[22], that household loan commitments in Estonia amount to 35% of GDP, in Lithuania to 22% and in Latvia to 17% of GDP.** Citadele Bank's data for the first eight months of this year show that the average consumer loan borrowing has increased in Lithuania and Estonia, while it has fallen in Latvia. Estonia has the largest amount of consumer credit among the Baltic States. The level of income of the borrowers plays an important role in the loan process, and there are differences. In Latvia, the share of customers with a salary above EUR 1,200 after tax applying for a personal loan is 24% of all applications, compared to 32% in Lithuania and 39% in Estonia.

58. **This year, lending in the household and mortgage segments in Latvia has recovered somewhat after the first signals from the ECB on interest rate cuts.**

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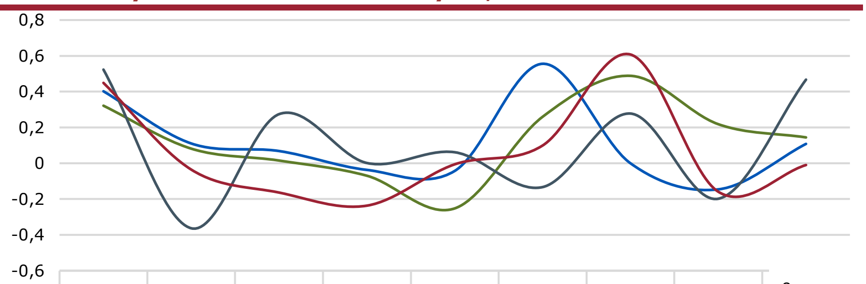
[21] Eurostat Financial balance sheets - annual data [nasa_10_f_bs]
[22] Lending to companies – how does Latvia compare to the Baltics? Finance Latvia

According to the Bank of Latvia, in the first eight months of this year loans to households for the purchase of housing increased by 11% compared to the same period last year. This is the first increase after two years of stagnation and decline in this lending segment. Over the same period, consumer credit to households increased by 14% and other credit to households by 47%. However, new lending to businesses (non-financial corporations) was by 1% lower than in the first eight months of last year.

59. Looking at year-on-year comparisons, data on lending to Latvian companies show that only every few years is there a significant increase in lending, followed by a prolonged period of contraction.

Figure 1.19. Dynamics of new lending to Latvian households and businesses year-on-year and in 8 months of this year vs. 8 months of last year, %



	2016	2017	2018	2019	2020	2021	2022	2023	8 mon 2024
New loans to households for house purchase	40,2%	11,1%	6,8%	-3,7%	-4%	56%	0%	-15%	11%
New consumer loans to households	32,2%	8,2%	1,5%	-7,0%	-25%	26%	49%	22%	14%
New other loans to households	52,3%	-36,3%	27,4%	0,2%	6%	-13%	28%	-20%	47%
New loans to non-financial corporations	44,9%	-3,5%	-16,3%	-23,7%	-1%	10%	61%	-16%	-1%

Source: Bank of Latvia

60. The problem of credit is largely linked to the investment deficit in the Latvian economy. Although the bulk of investment in Latvia is co-financed by EU funds, limited credit is reducing the ability of Latvian entrepreneurs to invest themselves and to co-finance EU projects.

61. Investment contributed negatively to GDP growth in the first half of this year. After a very strong investment growth of 10.2% in 2023, the gross fixed capital formation declined by 7.1% in the first half of this year. Moreover, declines are seen in all asset classes, with the largest falls in investment in housing -12.1% and investment in machinery and equipment -11.6%. Investment in intellectual property products fell by 7.4% and investment in transport equipment fell by the same amount.

Forecasts

62. In June this year, the Ministry of Finance presented the Council with macroeconomic forecasts, which foresaw GDP growth of 1.4% this year. The Council endorsed the projections, considering them to be cautious and in line with the actual economic situation[23]. The projections are made for the Medium-Term Budgetary Framework 2025-2027 and are also used for the development of the Fiscal Structural Plan 2025-2028.

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[23] FDC's view on the MoF's macroeconomic projections for MTBF 2024/28 [download (fdp.gov.lv)]

63. Since the confirmation of the forecasts, economic development has begun to deviate even from the very cautious scenario developed by the Ministry of Finance. Already in August and September, based on the latest available data, bank forecasters revised their projections in a more pessimistic direction, including Swedbank and SEB Bank, as well as the European Bank for Reconstruction and Development, which now forecasts economic growth below 1% for this year. On October 8, the Bank of Latvia significantly lowered its GDP forecast for this year—from a projected 1.8% growth in June to 0.6%. Forecasts for the following years have also been reduced: growth for 2025 is now projected at 2.6%, down from 3.3%, and for 2026, at 3%, down from the previous 3.8%. Given the slower growth, it is important to closely monitor economic developments and be prepared for necessary adjustments in public finances.

64. The Ministry of Finance did not revise its forecasts following the budgeting timetable, so it should be noted that the budget is based on forecasts that do not yet include data on actual economic developments for the current year, nor do they include audits of the CSB national accounts data.

Table 1.1. Real GDP growth forecasts for different forecasters

	2024	2025	2026	2027	2028
Ministry of Finance (June)	1.4%	2.9%	2.8%	2.6%	2.3%
Swedbank (August)	0.9%	2.6%	2.9%		-
SEB bank (August)	0.8%	2.2%	2.5%	0.8%	-
EBRD (September)	0.9%	2.4%			-
IMF (September)	1.7%	2.4%	2.5%	2.5%	2.5%
EC (May)	1.7%	2.6%	-	-	-
Bank of Latvia (October)	0.6%	2.6%	3.0%	-	-

Source: MoF[24], Swedbanka[25], SEB banka[26], EBRD[27], IMF[28], EC[29], BoL[30]

65. High uncertainty continues to challenge macroeconomic forecasting. Given these differences in the estimates of different forecasters for this and future years, and the fact that the current MTBF 2025-2027 and FSP 2025-2028 do not yet incorporate the latest audited data from the CSB, it is important to continue to monitor economic developments closely and remain ready to make the necessary adjustments if the economy deviates significantly from the baseline scenario.

66. The MoF, in its work on the MTBF 2025-2027[31], has analysed the pessimistic scenario in terms of macroeconomic and fiscal indicators and highlighted that high geopolitical uncertainty could be one of the reasons for the increase in energy prices. It would also worsen investor and consumer sentiment, further hampering economic growth and tax revenues. The MoF's pessimistic scenario foresees GDP growth of only 0.4% for this year and 1.8% for next year. Given the pessimistic macroeconomic scenario, the MoF has assessed its impact on the general government deficit: It could be 2.8% of GDP in 2024, 3.4% of GDP in 2025, 3.1% of GDP in 2026, 2.9% of GDP in 2027 and 2.6% of GDP in 2028. The Bank of Latvia has published an even more pessimistic forecast[32], expecting the deficit to exceed 3% of GDP already this year – in 2024 the deficit could

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[24] Macroeconomic projections for the medium-term budgetary framework 2024-2028 | Fiscal Discipline Council (fdp.gov.lv)
[25] Swedbank Economic Review – Aug 2024 (swedbank-research.com)
[26] Analytics | SEB
[27] The EBRD's Regional Economic Prospects
[28] Republic of Latvia: 2024 Article IV Consultation-Press Release; and Staff Report (imf.org)
[29] Economic forecast for Latvia - European Commission (europa.eu)
[30] Macroeconomic projections | October 2024 | Bank of Latvia
[31] Explanatory draft of the draft Law on the State Budget for 2025 and the Budgetary Framework for 2025, 2026 and 2027
[32] Macroeconomic projections | October 2024 | Bank of Latvia

be 3.1% of GDP, in 2025 – 3.3%, and in 2026 – 3.2%. Moreover, in the BoL projections this is not the pessimistic scenario, but the baseline scenario.

2. Fiscal policy developments

2.1. Retrospective of recent years and 2024 outlook

67. Global events in the recent years have destabilised the economic situation worldwide. As a result, Latvia's fiscal position deteriorated, with the GGBB deficit reaching 7.2% of GDP in 2021 due to the COVID-19 pandemic. Also in 2022, the economy was further impacted by the Ukraine war and the energy crisis, which resulted in a deficit of 4.6% of GDP at the end of the year. **The government's fiscal position improved in 2023, with the deficit falling to 2.2% of GDP, or -893.1 million EUR (the budget law had planned a deficit of 4.2%). Respectively, the structural balance was 0.2% of GDP.** This budgetary improvement was driven by nominal GDP growth and higher tax revenues due to high inflation, alongside a gradual reduction in COVID-19 and energy support measures. In 2023, the general escape clause of the EU Stability and Growth Pact (SGP), triggered in 2020, was still in force, allowing an increase in the general government deficit, but the fiscal rules of the FDL were already in place in 2023, and the fiscal strategy targeted a structural deficit of 0.5% of GDP, which was achieved. Table 2.1 shows that the State's special budget and the budgets of derived public persons ended 2023 with a positive balance. Although the State basic budget balance was negative, the deficit was lower than projected in the 2023 budget law and lower than a year ago. However, local governments ended the year with a higher-than-expected deficit.

Table 2.1. GG budget balance projection for 2023 and outturn in 2023 and 2022, € million.

Balance	2023			2022
	Budget	Outturn	% of GDP	Outturn
General government budget balance	**-1,772.4**	**-893.1**	**-2.2%**	**-1,778.8**
ESA2010[33] corrections	226.7	529.8	1.3%	-355.0
Consolidated general budget	**-1,999.0**	**-1,330.0**	**-3.3%**	**-1,423.9**
State basic budget	-2,065.1	-1,438.1	-3.6%	-1,862.5
State special budget	113.7	251.4	0.6%	343.5
Local government budget	-41.7	-155.9	-0.4%	62.9
Derived public persons budget	-6.0	12.6	0.0%	32.2

***Source: The Ministry of Finance*[34]**

68. **Expenditure in the consolidated general budget in 2023 increased by 7.9% relative to 2022, slightly below the average annual inflation rate of 8.9%[35].** A year earlier, the corresponding figure was 9.2%. The increase in expenditure in 2022 was driven by a significant 48.5% increase in spending on goods and services. In 2023, expenditure on remuneration increased by 15.4%, interest expenditure by 16.5%, capital expenditure by 13.8%, social benefits by 6.8%, and subsidies and grants by 5.1%. Expenditure on goods and services grew by just 0.2%. This small increase was due to a high base effect, with a significant increase in spending on goods and services in 2022. However, contributions to the EU budget decreased by 1.8%.

[33] Under the SGP and the FDL, the fiscal outcome is assessed on the basis of the European System of Accounts 2010 (ESA2010) methodology, which is based on the accrual method. Meanwhile, in Latvia, the state budget is traditionally approved and assessed on the basis of the cash-flow method.
[34] FM Bilance_04102024.xlsx file
[35] CSB PCI020

69. **In 2023, the revenue of the consolidated general budget increased by 9.3% compared to 2022.** A year earlier, the corresponding figure was 13.9%. The budget for 2023 projected 6.5% more tax revenue than was collected in 2022. In fact, 9.5% more tax revenue was collected in 2023 than in 2022. Better tax collection was driven by a 43.8% increase in CIT revenue compared to 2022. As well as better collection of personal income tax, social security contributions, and VAT. The best result was achieved in CIT revenue, where the plan was exceeded by 35.5%. There were also over-runs in personal income tax, VAT, social security contributions, and real estate tax. The plan was not met for ED and other tax revenue. However, overall, this underperformance was offset by overperformance in other tax types, and 2023 closed with the budget's tax revenue target achieved, exceeding the plan by 2.9% (see Table 2.2).

Table 2.2 Tax revenue dynamics, plans and execution of the consolidated general budget 2022-2023, %

	2023 budget/ 2022 fact	2023 fact / 2022 fact	2023 fact / 2023 budget
Tax revenue*	**6.5%**	**9.5%**	**2.9%**
MSSIC**	9.0%	9.7%	0.7%
VAT	6.6%	9.0%	2.3%
PIT	4.2%	10.5%	6.1%
ED	5.0%	2.1%	-2.8%
CIT	6.1%	43.8%	35.5%
RET	0.0%	2.6%	2.5%
Other taxes	2.0%	-3.9%	-5.8%

Source: The Ministry of Finance and the Council calculations

MSSIC – mandatory state social insurance contributions; **VAT** – value added tax; **PIT** – personal income tax; **ED** – excise duty**; CIT** – corporate income tax; **RET** – real estate tax.

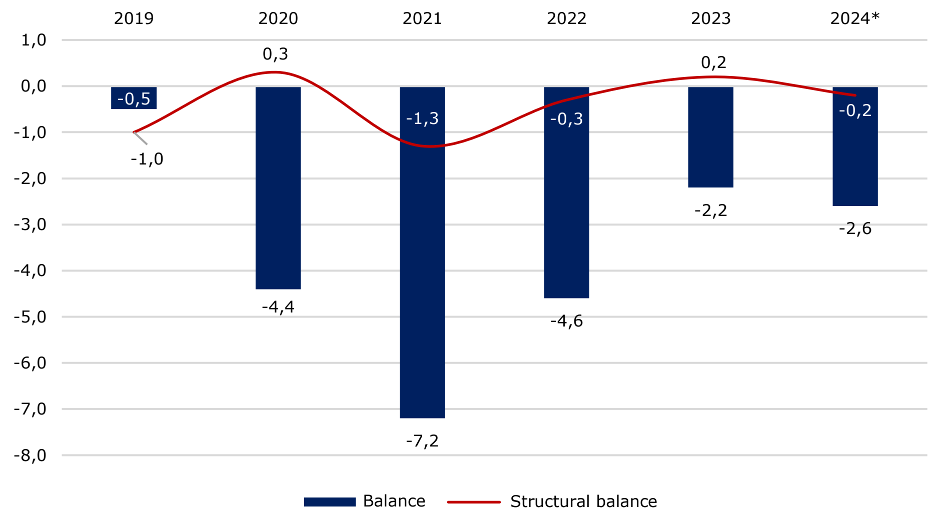
**Total tax revenue on an accrual basis (excludes the undistributed balance in the Single Tax Account).*
*** Excluding contributions to the state funded pension scheme.*

70. **The Law on the State Budget for 2024 and the Budgetary Framework for 2024, 2025 and 2026[36] projected economic growth of 2.5% in 2024 and a deficit of EUR 1.3 billion, or 2.8% of GDP, for the GGBB.** The Stability Programme 2024-2028[37] revised the GDP growth forecast to 1.4% and projected an increase in the GGBB deficit to 2.9% of GDP. Currently, the latest MoF projections show that the GGBB deficit will reach EUR 1.1 billion, or 2.6% of GDP, in 2024[38] (see Figure 2.1). Despite lower-than-expected tax collections this year, lower inflation, and lower GDP, the deficit is now projected to be lower than planned in the budget law. This is due to higher non-tax revenue and a decrease in expenditure. Some expenditure lines, such as remuneration, goods and services, have been increased, but spending on subsidies and grants has been reduced by EUR 1.1 billion. The reduction in expenditure on subsidies and grants is due to the slower implementation of projects financed by the EU Fund and redeployments from the budget unit "74. Funding to be Re-distributed in the Process of Implementation of the Annual State Budget". Overall, spending is cut by 477.5 million. This year, the general escape clause of the EU's Stability and Growth Pact (SGP),

[36] Explanatory notes to the Law on the State Budget for 2024 and the Budgetary Framework for 2024, 2025 and 2026 I. BUDGETARY FRAMEWORK 2024, 2025 AND 2026.
[37] Stability Programme of Latvia 2024-2028, available at: https://www.fm.gov.lv/lv/latvijas-stabilitates-programma
[38] Information Report on projections of macroeconomic indicators, revenue and general government budget balance in 2025, 2026, 2027 and 2028, available at: https://tapportals.mk.gov.lv/legal_acts/38f8bbd5-6811-4034-b5dc-dd56b744a009

activated in 2020, which allows general government deficits to be increased, is no longer in force. **The Council therefore calls for savings to be made during the remaining budgetary implementation period, rather than being reallocated, to meet the budgetary targets, especially in view of the sluggish tax collection this year.**

2.1. figure. GG budget balance and structural balance 2019-2024* (% of GDP)



*Source: The Ministry of Finance, *evaluation*

71. **Consolidated general budget expenditure for the 8 months of this year has increased by 8.6% compared to the same period in 2023.** A year earlier, the corresponding figure was 12.2%. The biggest increase in expenditure was in remuneration, where spending rose by EUR 387.6 million, or 17.3%, year-on-year. Inflation, the new 2022 public sector wage framework, which allowed for salary increases within the existing budget, the quinquennial bonuses paid in the home affairs sector, as well as the generally tight labour market, all contributed to this increase. As a result of the ECB's restrictive monetary policy and interest rate hikes, servicing public debt has become more expensive, with interest expenses rising by EUR 134.0 million, or 79.7%. Expenditure on social benefits has so far increased by EUR 200.6 million, or 6.2% during this period. In the same period of the previous year, growth was 10.7%. Expenditure on subsidies and grants increased by 2.8% (68.6 million), contributions to the EU budget by 6.3% (14.8 million) and capital expenditure by 11.6% (84.2 million). Spending on goods and services, on the other hand, fell by EUR 22.7 million or 1.8%.

72. **Revenue from the consolidated general budget in the 8 months of this year has increased by 14.1% compared to the same period in 2023** (see Table 2.3). A year earlier, the corresponding figure was 12.8%. This year, tax revenue is projected to be 9.2% more than was collected in 2023. In the first 8 months of this year, tax revenue is up 6.6% compared to the same period in 2023. This year, tax revenues are not growing as fast as in previous years. In the relevant period of 2023, the 11.8% increase in tax revenue and the 16.4% increase in 2022 were driven by high inflation.

Table 2.3. Consolidated general budget tax revenue projections for 2024 and execution in the first 8 months of the year, %

	2024 Budget/ 2023 fact	2024 budget/ 2023 budget	2024 8 months fact/ 2023 8 months fact	2024 8 months fact / 2024 8 months budget
Tax revenue*	**9.2%**	**12.4%**	**6.6%**	**-1.8%**
MSSIC**	13.0%	13.7%	11.0%	-0.8%
VAT	5.6%	8.0%	-3.8%	-6.8%
PIT	5.4%	11.7%	12.9%	7.3%
ED	8.7%	5.7%	2.0%	-4.4%
CIT	28.1%	73.6%	33.1%	-6.6%
RET	0.4%	2.9%	0.3%	1.7%
Other taxes	12.9%	6.3%	5.3%	-4.5%

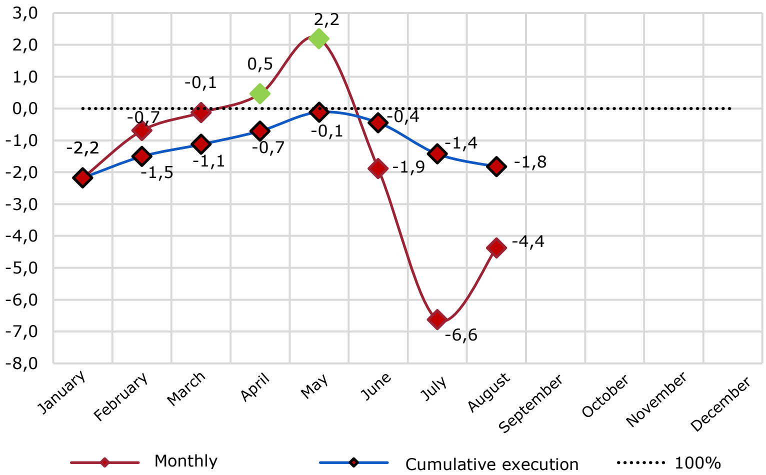
Source: The Ministry of Finance and the Council calculations

**Total tax revenue on an accrual basis (excludes the undistributed balance in the Single Tax Account).*

*** Excluding contributions to the state funded pension scheme.*

73. Labour taxes, PIT and MSSIC, have performed well this year, rising by 12.9% and 11.0% respectively. These have been relatively well collected, due to the strong wage growth of 10.3% in the first half of the year[39]and the increase in the minimum wage. This is why the PIT revenue is also 7.3% above plan. MSSIC revenue is slightly behind (-0.8%) the planned level. In relation to CIT, on the one hand, tax revenue is up by 33.1% compared to last year. On the other hand, there is a 6.6% shortfall from the planned target. This year's weak private consumption has a significant impact on VAT collection. VAT collection was 3.8% below the same period last year and 6.8% behind the plan. ED is also showing a 2.0% increase in revenue this year but is 4.4% behind the plan. At present, the overall tax revenue plan is 1.8% or EUR 166.5 million behind (Figure 2.2). The Treasury's operational data for September shows an improving situation. The plan for the month of September has been met for PIT, CIT and VAT. However, it should be noted that the plan has not been met in the areas of MSSIC and ED revenues. Note that this year's budget foresaw a higher increase in tax revenue. Overall, tax collection is not bad this year, but the pace of tax growth has slowed.

2.2. figure. Dynamics of monthly and cumulative execution of the general budget tax revenue plan, %



Source: The Treasury, the FDC calculations

[39] CSB DSV020c.

74. **The 2024 State Budget Law projected a total tax revenue of EUR 13.8 billion. The MoF has now reduced the tax revenue forecast to EUR 13.7 billion - by EUR 100.9 million or 0.7% less than projected in the budget law.** The largest decrease of 2.7% in the tax revenue forecast is in VAT revenue. The downward revision was to be expected, as VAT collections are currently weaker than last year and are the most behind the plan. The forecasts for the other taxes that are currently behind plan – ED and MSSIC – have also been reduced. Although the CIT is behind the plan so far, the forecast for this year has been slightly increased. However, due to the positive trends in personal income tax collection, the tax forecast has been increased by 5.2%. The FDC's new tax revenue projections have also been revised downwards. Currently, the FDC model forecasts 0.3% lower tax revenues than the MoF. Economic uncertainty can have a significant impact on tax collection and, of course, on forecasting itself. Overall, however, it looks like the General government budget this year is likely to collect less tax than planned in the annual budget. The main projections by tax group are summarised in Table 2.4.

Table 2.4. Consolidated general budget tax revenue plans, forecasts for 2024 (EUR million) and changes in forecasts (%)

	2024 budget	New MoF forecasts for 2024	FDC forecasts (30.10.2023)	New FDC forecasts	New FDC/MoF forecasts	Nominal difference between the new forecasts of the FDC and the MoF
Tax revenue	**13,804.6**	**-0.7%**	**13,827.4**	**-1.2%**	**-0.3%**	**-37.2**
MSSIC*	4,544.7	-1.6%	4,382.0	2.0%	0.0%	-0.8
VAT	4,096.7	-2.7%	4,209.3	-6.0%	-0.7%	-28.2
PIT	2,634.7	5.2%	2,844.4	-2.1%	0.5%	13.2
ED	1,255.0	-3.8%	1,194.9	-0.2%	-1.2%	-14.9
CIT	697.8	0.3%	597.4	17.1%	-0.1%	-0.4
RET	237.4	0.6%	230.8	2.5%	-1.0%	-2.3

Source: The Ministry of Finance and the Council estimates

** Excluding contributions to the state funded pension scheme.*

2.2. Fiscal position for 2025-2028

75. **The EC's general escape clause is no longer in force in 2024, while the FDL rules have been in force since the beginning of 2023.** The government's fiscal strategy for the budget 2025 and the following years was defined in Latvia's Stability Programme for 2024-2028[40]. This includes the application of the renewed EU fiscal rules and the transition arrangements for the implementation of the new economic framework. The strategy is endorsed in the Informative Report "On the projections of macroeconomic indicators, revenue and general government budget balance in 2025, 2026 and 2027"[41], approved by the Cabinet of Ministers this year, August 20.

76. This spring, the new EU economic governance framework came into force[42]. The new fiscal rules are designed to gradually and sustainably reduce the increased deficit and debt levels of EU countries. Under this framework, EU Member States must prepare a medium-term Fiscal Structural Plan every four or five years in April, replacing the annual Stability Programme and National Reform Programme, setting out the fiscal path. The fiscal path sets a limit on the allowable growth rate of nationally financed net primary expenditure[43]. **Accordingly, the draft law on the State Budget 2025 and the Budgetary Framework for 2025, 2026 and 2027 must comply not only with the structural balance condition of the FDL, but also with the new EU fiscal rules.**

77. **On September 24, this year, the government approved amendments to the Fiscal Discipline Law, which increase the structural deficit ceiling from 0.5% to 1.0% of GDP[44].** Historically, since the adoption of the Fiscal Discipline Law in 2013, a budget balanced over the economic cycle has been pursued, with a general government structural deficit of no more than -0.5% of GDP. In the light of these amendments, which will enter into force on 1 January 2025, the structural deficit ceiling does not provide for the recognition of new expenditure measures as one-off (in addition to those already approved[45]). The one-off measures previously approved will amount to -1.7% of GDP or -773.9 million EUR in 2025, -1.8% of GDP or -831.8 million EUR in 2026 and -1.7% of GDP or -820.3 million EUR in 2027. This one-off expenditure is intended to strengthen defence and internal security, and a small part is earmarked for mitigating the effects of the COVID-19 pandemic. It should be noted that the new EU economic governance framework includes more flexible conditions for defence spending: under certain conditions, an increase in government investment in defence could be justified and, in this context, the excessive deficit procedure may not be triggered.

78. **Latvia's fiscal policy framework is also currently influenced by recommendations from EU institutions.** The Council of the European Union's 2024

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[40] Available at: https://tapportals.mk.gov.lv/legal_acts/b75ce8f5-2802-4b1d-b2a6-5da803f49442
[41] Available at: https://tapportals.mk.gov.lv/legal_acts/38f8bbd5-6811-4034-b5dc-dd56b744a009
[42] It consists of two Regulations and one Directive:
1. Regulation (EU) 2024/1263 of the European Parliament and of the Council of 29 April 2024 on the effective coordination of economic policies and on multilateral budgetary surveillance and repealing Council Regulation (EC) No 1466/97;
2. Council Regulation (EU) 2024/1264 of 29 April 2024 amending Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure
3. Council Directive (EU) 2024/1265 of 29 April 2024 amending Directive 2011/85/EU on requirements for budgetary frameworks of the Member States

[43] Expenditure excluding several items: interest expenditure, discretionary revenue measures (government-approved changes in taxes, non-taxes, charges for services and other own revenues), expenditure on EU funds programmes and public co-financing of EU funds programmes, as well as cyclical elements of unemployment benefit expenditure.
[44] Available at: https://tapportals.mk.gov.lv/legal_acts/4aa5676b-953b-4490-8e90-55a972d3f0d6
[45] Within the framework of Section 5 of the Laws "On the State Budget for 2023 and the Budget Framework for 2023, 2024 and 2025" and "On the State Budget for 2024 and the Budget Framework for 2024, 2025 and 2026".

recommendations for Latvia, endorsed last July[46], included a recommendation to ensure prudent fiscal policy by limiting the nominal increase of nationally financed net primary expenditure to an amount consistent with an annual improvement in the structural budget balance of at least 0.5% of GDP. The European Commission's 2024 report on Latvia[47] notes that Latvia's tax revenue as a share of GDP remains well below the EU average, which constrains the financing of public services, especially health and social protection. In June this year, the Council of the European Union published its recommendations on structural and budgetary policies for 2024 and 2025[48]. The Council recommends:

> *"Present a medium-term Fiscal Structural Plan on time. In line with the requirements of the reformed Stability and Growth Pact, limit the increase in net expenditure[49] in 2025 to a level that ensures that the general government deficit remains below the 3% of GDP Treaty reference value over the medium term and that general government debt is kept at a prudent level.*
>
> *Broaden taxation, including on property and capital, and strengthen the adequacy of health and social protection."*

79. In its annual report on Latvia[50], the IMF forecasts economic growth to pick up, but points to downside risks: rising geopolitical tensions and geo-economic fragmentation, credit risks from variable interest rate lending and weaker-than-expected external demand. **In view of the improved outlook, the IMF recommends a less expansionary, neutral fiscal stance in 2024 and a tighter fiscal stance in 2025.** The fiscal stance should be strengthened in 2025 to build up reserves for future spending needs, including to find the necessary space for higher public investment in infrastructure and R&D. This could be achieved by (i) broadening the corporate income tax (CIT) and personal income tax (PIT) bases, including by reducing the informal economy; (ii) broadening the property tax base; (iii) reducing tax exemptions and fossil fuel subsidies; (iv) rationalising spending on goods and services. The IMF also points out that fiscal policy should be flexible to adapt if risks materialise.

80. The review of public spending is part of the budget process that the MoF carries out each year in cooperation with line ministries. **The revision of the State Budget's expenditure in 2024 found an internal resource of EUR 138.1 million in the 2025 budget**, EUR 120.8 million in the 2026 budget, EUR 155.9 million in the 2027 budget and EUR 153.2 million in the 2028 budget[51]. Of the potential resources identified for 2025 of EUR 138.1 million, EUR 138.0 million represents potential internal resources available to sector ministries, while **EUR 0.1 million, or only 0.1%, is earmarked for improving the overall fiscal space.** Figure 2.3 shows the dynamics of the internal resource identified by the expenditure review, with a very small share being allocated

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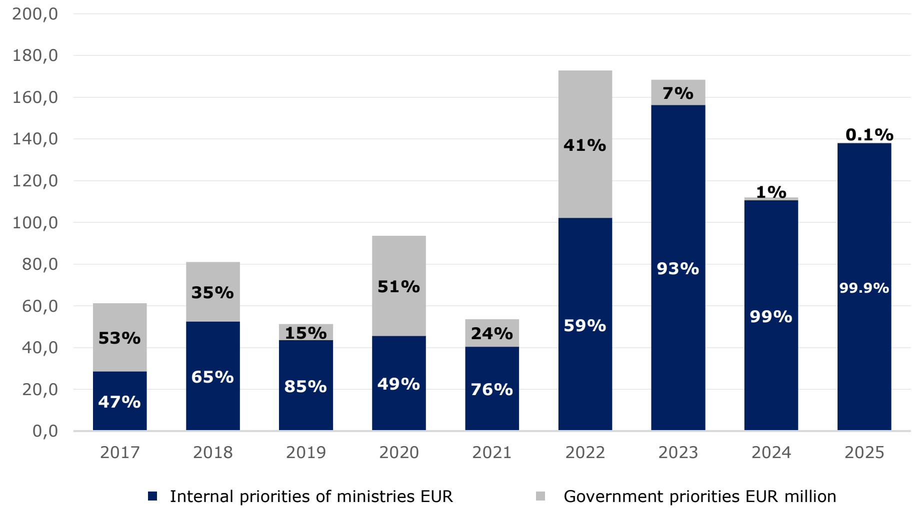
[46] Available at: https://commission.europa.eu/document/download/77207bce-9f86-43b5-9c0e-e104aef27972_lv?filename=COM_2023_614_1_LV.PDF
[47] Available at: https://economy-finance.ec.europa.eu/document/download/3fd8135b-da2d-455f-97c8-842378c6f2b9_en?filename=SWD_2024_614_1_EN_Latvia.pdf
[48] COUNCIL RECOMMENDATION on economic, social, employment, structural and budgetary policies in Latvia, available at: https://eur-lex.europa.eu/legal-content/LV/ALL/?uri=CELEX:52024DC0614
[49] According to Article 2(2) of Regulation (EU) 2024/1263, 'net expenditure' means all government expenditure net of interest expenditure, discretionary revenue measures, expenditure on Union programmes fully matching Union funds' revenue, national expenditure on co-financing Union-financed programmes, cyclical elements of unemployment benefit expenditure and one-off and other temporary measures.
[50] Available at: https://www.imf.org/en/Publications/CR/Issues/2024/09/05/Republic-of-Latvia-2024-Article-IV-Consultation-Press-Release-and-Staff-Report-554553
[51] Available at: Information Report (On the base of the State's basic and special budgets and the results of the expenditure reviews for 2025, 2026, 2027 and 2028)

to fiscal space in recent years. The years 2017 and 2020 are positively assessed, as half of the available resources were directed towards increasing general fiscal space. In 2022, 41% was also earmarked for fiscal space, with the highest amount so far – 70.6 million. **The FDC calls for more of the savings to be allocated to expanding fiscal space and for the spending review process to be made more efficient.**

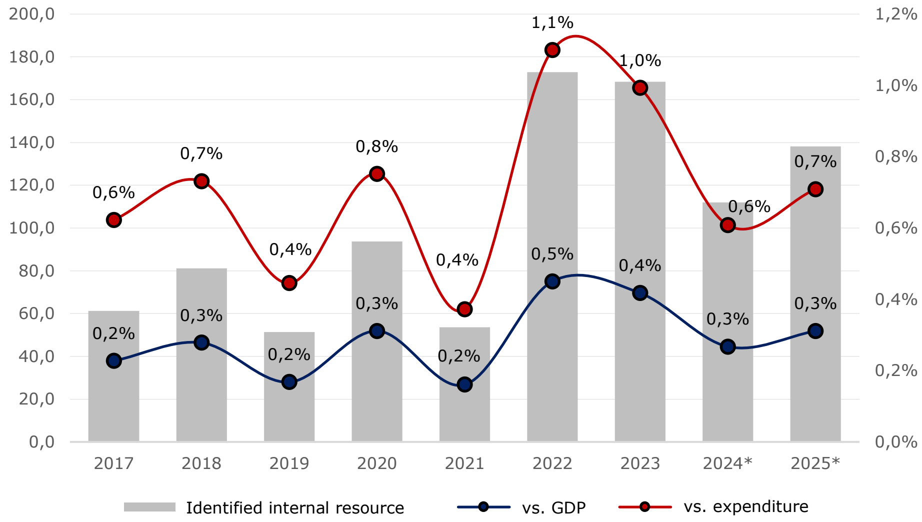
2.3. figure. Dynamics of the internal resource identified by the expenditure review 2017-2025 (EUR million; left axis) and its allocation to priorities (%)



Source: MoF data, FDC calculation

81. **Looking at the internal resources identified because of the expenditure review in relation to GDP, the expenditure review results in savings of 0.3% of GDP on average** (Figure 2.4). While the internal resources identified in 2022 and 2023 amounted to 0.5% and 0.4% of GDP, respectively, there is no clear indication of a long-term trend toward identifying and saving more resources. In relation to expenditure, on average 0.7% of the internal resource is found as a result of expenditure revisions. There is also no upward trend in savings against expenditure. **Therefore, the Council notes that the full potential of the expenditure review is not being fully utilized** and that increasingly larger savings against expenditure or GDP are not being achieved year on year. As well, in recent years there has been a trend where primarily the ministries are reallocating the savings to other priorities within the ministries, and very little being directed towards fiscal space. Although the MoF has calculated a negative fiscal space for 2025 (-13 million EUR), it has been allocated the smallest amount ever of the resources generated by the expenditure review.

2.4. figure. Dynamics of the internal resource identified by the expenditure review 2017-2025 (EUR million; left axis) vs. GDP and expenditure (%; right axis)



Source: MoF data, FDC calculation

82. This year, deciding on the measures to be supported in the draft budget law is a major challenge, as negative fiscal space (-13 million) is estimated for 2025. **Total planned funding for priorities: 392.4[52] million EUR for 2025, 389.9[53] million EUR for 2026, 398.8 million EUR for 2027 and 334.8 million EUR for 2028. The bulk of the funding – 57% - is earmarked for priority actions related to national security.** The rest is earmarked for measures related to tax policy changes, enforcement of the Constitutional Court ruling and laws, and independent institutions. In addition to fiscal space, several offsetting measures are foreseen to reduce expenditure and increase revenue in order to provide the necessary financing for priority measures. The main expenditure reduction measures[54] in 2025 are: changes in municipal budgets after tax revisions, horizontal cuts in spending by ministries and other central authorities, revisions in general and special budget spending, reductions in contributions to the European Union budget and reassessment of the impact of reclassified corporations. Also, in view of the rapid growth of renumeration expenditure in the private sector, the compensation fund cap of 6% has been reduced to 2.6% in 2025. The following measures are planned to increase revenue: a solidarity contribution to banks, the fiscal space effect of tax policy changes in line with ESA adjustments, the rebound effect of changes in remuneration policy and an increase in dividends to public corporations from 64% to 70%. **The Council welcomes the decision to reduce horizontally the expenditure of ministries and other central government bodies from the general revenue grant. This will lead to a reduction in base spending for all ministries, which will improve the general government budget balance.**

83. The general government budget balance, which is derived from the general budget and to which the ESA adjustment has been applied, is also numerically consistent with the GGBB as a % of GDP calculated according to the European System of Accounts methodology.

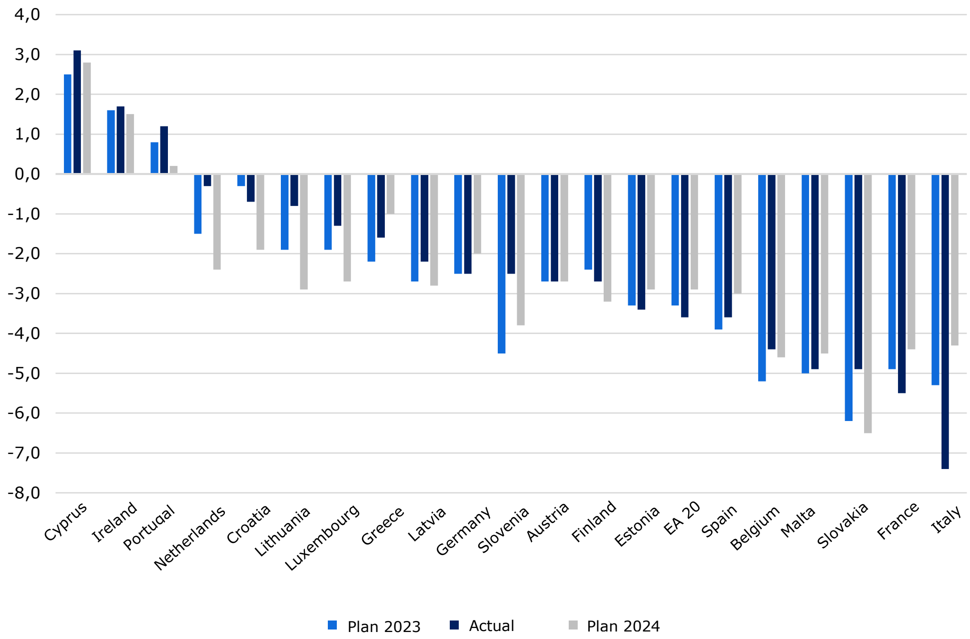
[52] DRAFT GENERAL GOVERNMENT BUDGET PLAN FOR LATVIA 2025
[53] Latvia's Fiscal and Structural Plan 2025 – 2028
[54] Information Report on Priority Measures to be included in the Draft State Budget Law for 2025, 2026, 2027 and 2028, available at: https://tapportals.mk.gov.lv/legal_acts/4b64813a-3464-47ab-b910-33b059e7f284

The MoF forecasts the following GGBB under unchanged policies: -2.9% of GDP in 2025, -2.6% of GDP in 2026 and -2.4% of GDP in 2027. It should be noted that the 2025 GGBB result is achieved with a significant ESA adjustments of EUR 701.1 million or 1.6% of GDP, so the deficit on a cash-flow basis would be significantly higher. The bulk of ESA adjustments is made up of correction on EU funds' revenue of EUR 593.8 million, and with a significant net other accounts receivable and payable correction of EUR 210.8 million. The positive adjustment to net other accounts receivable and payable is mainly due to planned advances for the purchase of fixed assets and services in the defence sector. The general government budget plans revenue of EUR 17.9 billion and expenditure of EUR 19.8 billion in 2025, revenue of EUR 19.0 billion and expenditure of EUR 20.1 billion in 2026 and revenue of EUR 18.8 billion and expenditure of EUR 20.0 billion in 2027.

84. The permissible general government budgetary position includes a set of balance components – the structural balance, the cyclical component of the balance, one-off measures and a fiscal risk buffer. **The MoF projects the following permissible GGBB -2.9% of GDP in 2025, -2.6% of GDP in 2026 and -2.4% of GDP in 2027.** The structural GGBB target is -0.8% of GDP in 2025, -0.7% of GDP in 2026 and -0.8% of GDP in 2027. The above-mentioned permissible GGBB would ensure the achievement of the structural balance target in future years, in line with the new FDL amendment on the structural deficit ceiling. **The Council broadly supports the fiscal strategy and fiscal targets proposed by the MoF but notes the limited fiscal space in the coming years: -€13.0 million in 2025, €32.2 million in 2026, €43.5 million in 2027, and €1.4 million in 2028.**

85. Latvia is a small and open economy, exposed to external economic and political factors. Unfortunately, many EU countries are pursuing risky fiscal policies that could trigger a serious crisis in the euro area's fiscal space, which would also affect Latvia. Figure 2.5 shows the projected and actual GGBB of euro area countries in 2023, as well as the projections for 2024. The reluctance of some countries – Italy, France, Belgium – to return to responsible fiscal policy despite rising interest rates and high sovereign debt is worrying. Latvia's GGBB score ranks relatively well compared to other euro area countries. That is why Latvia needs to pursue a responsible fiscal policy.

2.5. figure. Euro area countries planned and actual GGBB in 2023 and planned for 2024 (% of GDP)



Source: Eurostat, Budget plans submitted by EU Member States[55]

86. **In July, the Council of the EU opened excessive deficit procedures against 7 Member States** - Belgium (4.4% deficit in 2023), France (5.5%), Italy (7.4%), Hungary (6.7%), Malta (4.9%), Poland (5.1%) and Slovakia (4.9%). Romania (6.6%) is also the subject of an excessive deficit procedure since 2020 and has not taken the necessary measures to correct its deficit. Now, at the end of the year, the Council of the EU will adopt individual recommendations for each country, most likely including a corrective spending plan with clear deadlines for implementation. However, EU law also allows for fines and the freezing of EU structural funds if a country fails to comply with fiscal rules. **Latvia should avoid being included in this group of countries.**

87. **Total tax revenue for the 2025 budget is projected at EUR 14.6 billion, which is by EUR 849.1 million or 6.2% more than the forecast for this year.** The MoF tax revenue projections are reasonable and similar to the FDC tax model forecasts, which are slightly lower in total (by 0.8%) than the MoF. For the time being, the FDC expects weaker VAT collections due to current trends in VAT collections and private consumption, but an improvement in private consumption is expected to lead to a corresponding improvement in VAT receipts and hence in overall tax revenues. Due to the transfer of 1 percentage point from Pillar 2 to Pillar 1 of pensions, in 2025 tax revenues for the state funded pension scheme will decrease by 11.1% and for the state special budget will increase by 2.6% compared to the MTBF 2025-2027 baseline projections. It should be noted that the MoF's tax revenue forecasting has been conservative in recent years and actual tax revenues have been higher than planned in the budget law, except for the COVID-19 affected year 2020. However, it looks like tax revenues will be lower than budgeted this year, as both the MoF and the FDC have

[55] Available at: https://economy-finance.ec.europa.eu/document/download/8a8414a2-8284-49af-8a9e-82c6b904afab_en?filename=com_2023_900_en.pdf

lowered their forecasts. Table 2.5 shows the tax collection forecasts of the MoF and the FDC by tax type.

Table 2.5 MoF Total Budget Tax Collection Plan and FDC forecasts for 2025 (EUR million) and comparison of forecasts (%)

	MoF Plan	FDC forecasts	FDC/MoF
Tax revenue	**14,552.7**	**14,429.6**	**-0.8%**
MSSIC*	4,862.9	4,899.0	0.7%
VAT	4,245.5	4,138.4	-2.5%
PIT	2,735.9	2,728.7	-0.3%
ED	1,314.0	1,285.9	-2.1%
CIT	690.7	677.3	-1.9%
RET	241.2	236.7	-1.8%
Other taxes	462.5	463.6	0.2%

Source: The Ministry of Finance and the FDC forecasts
*** Excluding contributions to the state funded pension scheme.*

88. Tax revenue is the most important source of revenue in the State's consolidated general budget, accounting for 81.5% of total revenue next year. Non-tax revenue will represent 5.6% of revenue, EU funding 10.0% and own revenue 2.9%.

2.3. Tax reform

89. **The Cabinet has approved the information report "The review of the state budget revenue and tax policy in 2025-2027"[56], which foresees significant changes in tax policy from 2025 onwards. Despite the reform's many challenges, which are sometimes mutually exclusive, it has achieved five key objectives:**

- easing the labour tax burden on small and medium-sized wages (95% of all wages)
- simplifying the tax system,
- ensuring that the tax system is fiscally neutral for the next four years[57],
- reducing income inequality, including for pensioners,
- improving the competitiveness of Latvia's tax system compared to other Baltic countries.

90. One of the main compensatory measures is a fixed-term, 4-year transfer of 1% from the funded pension scheme (second tier) to the first tier. According to the MoF's calculations, the reverse transfer of funds from the first to the second tier would reduce the fiscal space of the 2029 budget by EUR 179 million. In addition, higher contributions in the first tier will increase future governments' pension liabilities, which could be burdensome given Latvia's demographic trends. However, the public pension system is fiscally sustainable. Figure 2.6 below shows that, since 2014, the social security budget has been in a positive financial position, resulting in a steady increase in the special budget's cash balance, which is projected at EUR 2.44 billion at the end of this year. About 74% of this amount comes from the special budget for state pensions. Note that fiscal sustainability does not imply social sustainability: if in 2022 the old-age pension (tiers 1 and 2 combined) rate of relief from net pay was 60.2%, in 2062 it is projected at 46.4%[58]. In summary, we believe that, although the transfer of pension contributions from the second to the first tier is generally not a good practice, it does not have a significant impact on the sustainability of the pension system or the level of individual pensions over the next four years[59]. Although practice shows (reduced VAT on fruit) that fixed-term tax reductions are likely to be long-lasting, the Council welcomes the fixed-term solution.

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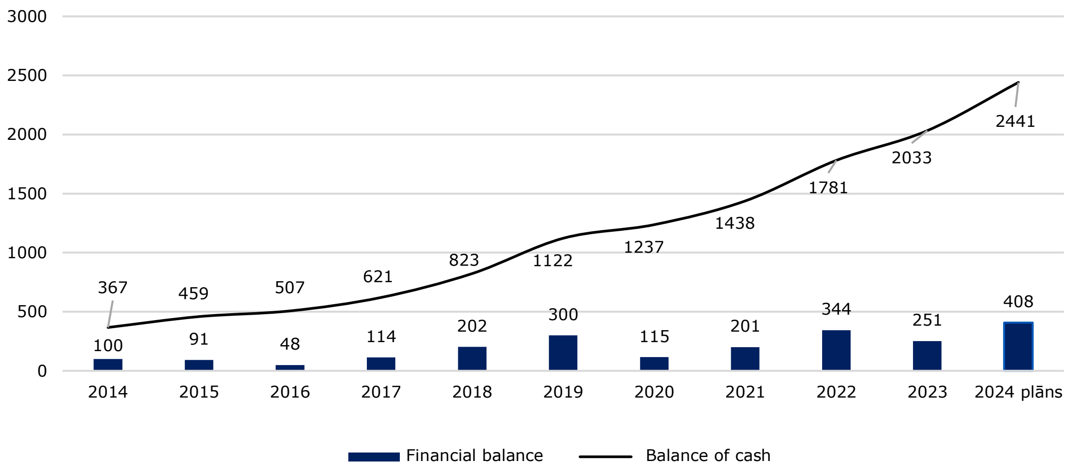
[56] https://tapportals.mk.gov.lv/legal_acts/efd239f3-9bcd-4b5c-ae73-60750ace3d9d

[57] According to the MoF's calculations, the fiscal impact on the general state budget as a result of the overall changes is as follows: -7.7 million EUR in 2025; +23.6 million EUR in 2026; -13 million EUR in 2027; -14.2 million EUR in 2028.

[58] Theoretical pension relief level – newly granted pension as % of final salary (for a person with 40 years of uninterrupted service at the statutory retirement age). Source: European Commission forecast 2024 Pension Adequacy report, https://op.europa.eu/en/publication-detail/-/publication/8df7f3c0-2eb5-11ef-a61b-01aa75ed71a1/language-en

[59] See Annex No. 1

Figure 2.6. Annual financial position and end-of-period cash balance of the special budget for social security, EUR million



Source: Ministry of Welfare and FDC calculations

91. Given the government's limited fiscal space, the tax reform is broadly favourable for business. The reduced labour tax burden, depending on labour demand and supply elasticities, will reduce labour costs for businesses, albeit slightly. This increases potential profits, the international competitiveness of export products and leaves more funds for investment. Accountants have an easier job calculating payroll. 95% of employees will see an increase in their net salary, which they can put towards their pension savings if they are concerned about the potential impact of the reform on their pension capital. A gradual increase in the minimum wage will contribute to narrowing the inequality gap. Compensatory excise duty measures will contribute to achieving the Green Deal objectives and healthier food consumption.

92. In its June recommendations on Latvia's economic, social, employment, structural and budgetary policies[60] , the Council of the EU recommends: "Extend taxation, including on property and capital". This recommendation is partly being implemented because the new higher personal income tax will also apply to income from capital gains. The Council of the EU's recommendations also underline that Latvia's tax revenue share fell to 30.3% of GDP in 2022, the lowest level in 3 years (40.2% of GDP EU-wide). According to the Stability Programme 2024-2028 forecasts[61], the tax burden will rise to 33.7% this year, still well below the EU average.

93. While the Council generally recognises the positive aspects of tax reform, it does not believe that changes to the tax system will radically improve the country's competitiveness, economic growth and prosperity. The weakest links in economic development are low productivity, labour shortages and low levels of investment and innovation. International studies have rated Latvia's tax system relatively highly in

[60] https://eur-lex.europa.eu/legal-content/LV/ALL/?uri=CELEX:52024DC0614
[61] https://www.fm.gov.lv/lv/media/17745/download?attachment

recent years[62], but the improvements proposed by the tax reform could further increase the attractiveness of the tax system.

[62] Tax foundation report available at: https://taxfoundation.org/research/all/global/2023-international-tax-competitiveness-index/

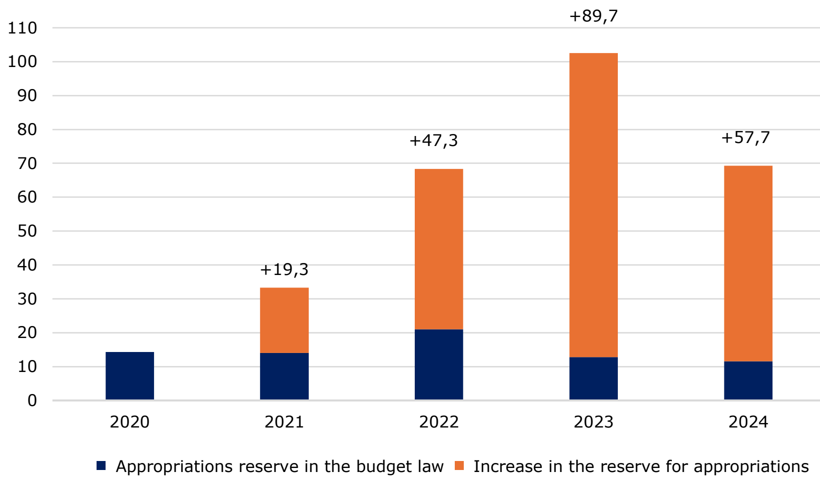
3 Fiscal risks and other issues

94. In recent years, Latvia's economy and fiscal position have been severely affected by macroeconomic shocks, caused by both the COVID-19 pandemic and Russia's military aggression against Ukraine. Such unusual events are almost impossible to predict, but their consequences have had a serious impact on Latvia's economic situation, leading to soaring energy prices, commodity shortages, supply chain disruptions, high inflation and rising debt servicing costs. International military conflicts and tensions exacerbate forward-looking projections and contribute to macroeconomic and fiscal instability and are now a major source of fiscal risks. **However, according to the FDL, the fiscal risk buffer is only built up for potential events that occur in standard situations and that could lead to significant deviations from the planned budgetary targets.** The FDC agrees with the MoF's position that the Fiscal Risk Management Mechanism does not cover such comprehensive and large macroeconomic shocks and contingencies. Despite the fact that the FDL interprets fiscal risk in a relatively narrow sense, the Fiscal Risk Declaration and the Council's comments also include fiscal risks in a broader sense.

95. Despite the entry into force of the new EU economic and fiscal governance reform framework, fiscal risk management and FRD remain in Latvian law. **Compared to last year's Fiscal Risk Declaration, the MoF has expanded it slightly.** A new section on "Green Budget" has been introduced as an interim solution, pending the development of a separate Climate Declaration from 2026. The section "Climate change impacts" has also been updated with an indicative assessment of the additional investment required to implement the measures described in the NECP Plan by 2030. The Council calls for this chapter to be further developed and expanded, as climate change has a very significant potential impact on national economies and finances.

96. **Amendments to Section 9[1] of the Law on Budget and Financial Management allow ministries and central public authorities to request the allocation not used in the previous year in the current year from the budget programme "Appropriation Reserve". The Minister of Finance, on the other hand, has the power to increase the appropriation for this programme, which has a direct negative impact on the GGBB and represents an increasing fiscal risk.** Since the amendment to the law was introduced, the increase in appropriations from the budget programme "Appropriation Reserve" has increased significantly: EUR 19.3 million in 2021, EUR 47.3 million in 2022, EUR 89.7 million in 2023 and EUR 57.7 million this year (Figure 3.1). This year shows a positive trend, with a smaller increase in the margin than last year. Overall, from a financial management point of view, carrying forward unspent budget allocations to the next financial year can improve the efficiency of budget execution and reduce the risk of increased spending at the end of the year. However, this reserve can have a negative impact on the budget deficit in the year in which the reserve is actively used. The Council recognises the positive aspects of the new arrangements – more rational, flexible and unhurried use of budget resources – but they undermine budget management capacity and reduce deficit control. **The Council therefore considers that the level of the 'Appropriation Reserve' programme should be at least equal to the increase of the previous year's appropriation.** The FRD has not established a fiscal reserve for this risk, but the FDC calls for monitoring developments on this issue and, if necessary, changing the legislation by setting a ceiling for the carry-over of unused appropriations to the following year or establishing an appropriate fiscal reserve.

3.1. figure. Programme "Appropriation Reserve" 2020-2024 (EUR million)



Source: TAP portal[63]

97. The activities of certain state capital companies (SCC) have a significant potential to worsen the country's fiscal position. The historical performance of the SCCs indicates that they are one of the biggest sources of fiscal risks. This applies to both general government and non-general government SCCs. No fiscal buffer for the activities of public corporations is created in this year's FDR. The Council notes that the section on state and local government corporations in the FRD is incomplete. More detailed information on the major state and municipal corporations that have the potential to influence the GGBB would be welcome. **The Council calls for a renewed focus on this risk and for a fiscal buffer against the potential negative impact of the activities of state capital companies on the GGBB.** Air Baltic's first half-year results in a loss of 88.7 million[64], therefore the Council recalls that Air Baltic remains a significant fiscal risk and that the MoF should closely monitor its activities.

98. **The Council has previously drawn attention to the operation of the Maintenance Guarantee Fund, which has become a significant fiscal burden on the budget.** It points out that the total amount owed to the Fund by maintenance defaulters continues to rise each year. The total debt to the State currently stands at EUR 560 million (EUR 430 million principal and EUR 130 million legal interest)[65]. The Fund also requires a substantial budget – EUR 54.7 million in 2024. Although the Fund's financial performance has improved slightly this year, the policy continues to cost the public budget a significant amount of budgetary resources. Also, from 2025, the amount of maintenance payable will be increased by EUR 17.50 for children up to 7 years and by EUR 21.00 for persons up to 21 years. Consequently, unless radical structural reforms are made, spending on these policies is expected to rise even further in the future. While the Council agrees with the MoF that the operation of the Fund is not a

[63] https://tapportals.mk.gov.lv/legal_acts?search%5Bquery%5D=Apropri%C4%81cijas+rezerve&quicksearch=
[64] https://assets.airbaltic.com/f/236210/x/a21d3eba4c/h1_2024-airbaltic-group-interim-unaudited-financial
[65] https://lvportals.lv/viedokli/363767-mekle-risinajumus-samilzusajai-uzturlidzeklu-paradu-problemai-2024

fiscal risk in the classical sense, it considers that the MGF costs are significantly higher than in Estonia and Lithuania and are probably the result of a fiscal risk not identified in time, which has become a costly policy. It would therefore be appropriate to include an in-depth analysis of the Fund's performance in the FRD.

99. The Baltic States, within the Rail Baltica project, have a commitment to establish a rail link between all three Baltic States by 2030 (in line with the TEN-T Regulation[66]). The fiscal risks of the Rail Baltica project are not only related to the increase in construction costs and overall project costs, but also to the project financing model. Until now, 85% of the funding has come from EU programmes (Connecting Europe Facility – CEF) and 15% from the national budget. However, this model will no longer work as the EC has prioritised support for construction works and in the last CEF call did not support works supervision and contract management, real estate disposals and building construction. Project financing and budgeting for each subsequent phase is complicated by the fact that it is not known in advance which project activities will be financially supported and which will not. The project is only funded through the CEF calls, where the period between submission of the project application and funding is at least nine months[67]. It is important to note that the project application submitted is in competition with applications submitted by other EU Member States, which means that approval of the project application or individual activities is not guaranteed. There is also the possibility that activities applied for may be approved at a lower level and with less funding than applied for, or not supported at all. This increases the time and cost of project implementation. This results in ineligible costs that have to be borne by the national budget. Consequently, the project's current funding model is not conducive to successful implementation, it is fragmented and incomplete. Funding uncertainties are also created by the expected gap in EU funding in 2026-2028, which may require a larger contribution from the Baltic States. The high investment costs raise concerns about the future sources of financing for the project, which will most likely require third-party funding.

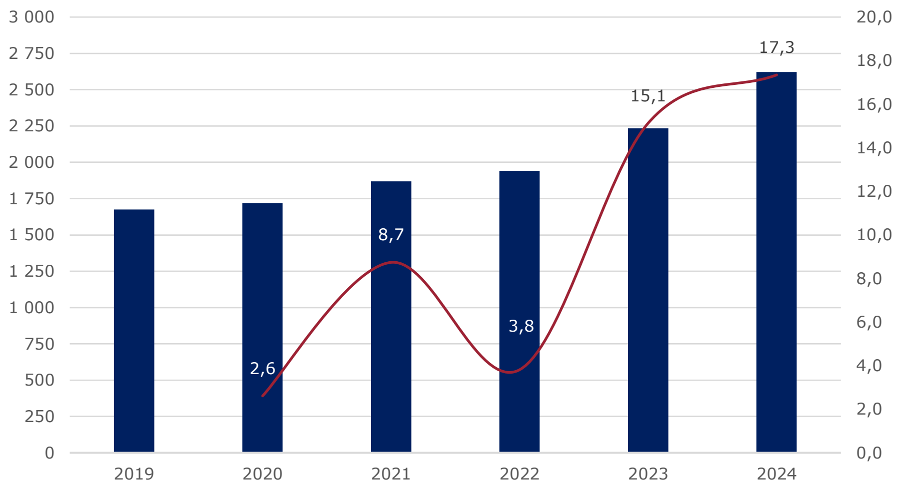
100. It has now been concluded that the project is too large to be fully implemented by 2030. Therefore, for the time being, a reduction in the scope of the project and a phased approach is proposed as a solution to the financial challenges. The project could therefore be built in phases, subject to available funding. The first phase is planned to be implemented by 2030. **The Council recognises that the implementation of the Rail Baltica project is strategically important, but that the implementation of the project poses serious fiscal risks that require enhanced monitoring and involvement of the Ministry of Finance.**

101. The FDC has been drawing attention to the sharp rise in public sector pay since the spring. In the first 8 months of this year, the total budget spent EUR 2.6 billion on compensation, 17.3% more than in the same period last year (Figure 3.2). The 2024 Budget Law projected a 9.7% increase in remuneration expenditure compared to 2023. The first 8 months of 2023 also saw a 15.1% increase in remuneration expenditure. The new 2022 public sector wage framework, which allowed for wage increases within the existing budget, the tight labour supply situation, the effects of the high inflation of previous years, as well as the five-yearly bonuses paid in the home affairs sector could

[66] REGULATION (EU) 2024/1679 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 13 June 2024 on Union guidelines for the development of the trans-European transport network and amending Regulations (EU) 2021/1153 and (EU) No 913/2010 and repealing Regulation (EU) No 1315/2013
[67] https://www.sam.gov.lv/lv/media/12396/download?attachment

have contributed to the increase in compensation expenditure. The government has also now identified the sharp rise in public sector pay and is planning measures to curb it.[68] **Analysis is needed on the extent to which remuneration expenditure is carried forward to the base of future years' budgets.**

3.2. figure. Remuneration expenditure in the first 8 months 2019-2024 (EUR million; left axis) and growth rate of renumeration expenditure (%; right axis)



Source: The Treasury

102. The COVID-19 crisis has introduced a hybrid working regime into society – where employees spend part of their working hours at home and part in the office. While such arrangements can increase productivity and reduce time and financial costs, they also create uncertainties in accounting for working time and holidays due to a lack of control mechanisms. This results in unjustified payments for untaken leave, which are most often charged to the Contingency Fund. The cost of untaken leave is not an unforeseen event but the result of inadequate financial management. The Council recommends that a framework should be developed to regulate the use of leave when working in hybrid mode.

103. The FDC draws attention to the allocation of financial resources from the state budget programme 02.00.00 "Contingency funds". While contingency funds are earmarked for emergencies, the programme allocates significant sums to sporting events - which were known in advance and for which the need for funding should have been assessed as part of the budgetary process. Also, funds are allocated for teachers' salaries[69], which cannot really be classified as a contingency. The legal basis for the use of Contingency Funds may need to be clarified to ensure that the budget programme is not misused.

104. Climate change is one of the biggest global challenges today. In December 2019, the EC launched the "European Green Deal", which aims to develop and implement comprehensive policy initiatives at European level to achieve climate neutrality in the EU by 2050. While this is not considered a fiscal risk under the FDL, it is important to

[68] https://www.lsm.lv/raksts/zinas/ekonomika/27.08.2024-budzets-2025-valdiba-plano-taupibu-valsts-sektora-griestus-algam-un-nodarbinato-skaitam.a566511/
[69] https://tapportals.mk.gov.lv/legal_acts/a4bc8049-38ab-44f1-a588-f0a07f033a61

assess the impact of climate change mitigation and adaptation to climate neutrality on public finances, as climate change has a significant potential to affect a country's economy and finances. The indicative additional requirement to achieve the climate neutrality targets by 2030 is EUR 13.1 billion, of which EUR 3.8 billion or 29.1% is currently earmarked[70]. The climate neutrality targets are to be achieved through state and local budget funding, EU funding, private capital and other sources of finance. **Delivering on the "European Green Deal" will require additional investment in the coming years, including from the national budget. The Council therefore calls for the future development of the climate change chapter in the FRD to assess potential investment needs and fiscal implications, as well as the risks of not meeting these targets.**

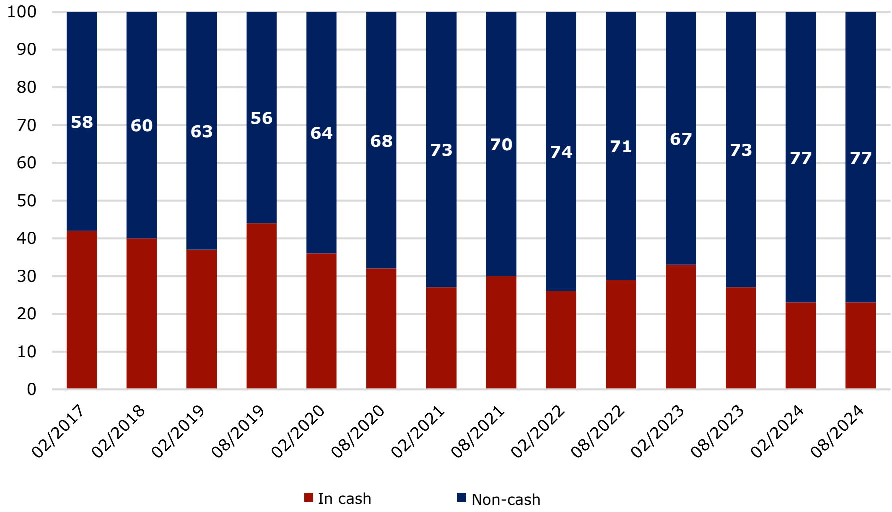
105. According to Section 61 of the Law "On the State Budget for 2024 and Budgetary Framework for 2024, 2025 and 2026"[71] , the Cabinet may decide to increase the appropriation for co-financing **the organisation of grand events** if these events are considered fiscally neutral – they generate tax revenues that exceed the amount of state aid granted and do not have a negative impact on the general government budget balance. Fiscal risks arise when the funding allocated to a major event exceeds the revenue generated by the event. **The Council doubts that it is possible to calculate objectively and accurately the fiscal impact of such events and considers that the funds for such events should be allocated within the existing budget.**

106. In February 2025, the Baltic electricity grids are scheduled to be de-synchronised from the common grid of Russia and Belarus and synchronised with the electricity grids of continental Europe. In the event of adverse circumstances, this measure could also significantly increase the price of electricity, which in turn could affect economic development and the country's fiscal position.

107. The shadow economy is a major constraint on economic growth and the development of a better business environment. The shadow economy also significantly reduces tax revenues, which in turn reduces budgetary space and fiscal space. Latvia collects relatively less taxes relative to GDP than other EU countries – in 2022, Latvia collected 30.8% of GDP, compared to an EU average of 41.0%[72]. As there is no method of calculating the size of the informal economy that can be assumed to be unambiguously correct and accurate, the share of the informal economy in Latvia in 2022 has been estimated by various methods at between 19.9-26.5%[73] of GDP. Another indicator that indirectly describes the size of the shadow economy is the share of cash payments. Since 2017, the Bank of Latvia has been monitoring non-cash and cash payments with the Payment Radar. In this year, 23% of payments were made in cash and 77% in non-cash payments (Figure 3.3). Since 2017, there has been a decline in cash payments, driven by the restrictions on face-to-face sales during the COVID-19 pandemic. A further decline in the share of cash payments could be a further sign of a shrinking shadow economy.

[70] MoF estimates for FRD 2024
[71] https://likumi.lv/ta/id/348569-par-valsts-budzetu-2024-gadam-un-budzeta-ietvaru-2024-2025-un-2026-gadam
[72] Eurostat data https://ec.europa.eu/eurostat/databrowser/view/gov_10a_taxag/default/table?lang=en
[73] Plan to curb the shadow economy 2024-2027 https://likumi.lv/ta/id/349352-enu-ekonomikas-ierobezosanas-plans-2024-2027-gadam

3.3. Figure. Dynamics of the share of cash and non-cash payments 2017-2024 (%)



Source: Bank of Latvia[74]

108. The Shadow Economy Reduction Plan 2024-2027[75] sets out measures to reduce the risk of the shadow economy in specific sectors and to reduce the circulation of cash. In parallel, measures are planned to improve sectoral policies and the regulatory framework to curb the shadow economy, clean up the business environment and promote voluntary tax compliance. The realistic scenario for reducing the shadow economy is to reduce the shadow economy by 1.0 percentage points to 18.9% of GDP by 2027, which would provide additional resources of EUR 120 million to the national budget by 2027. **The Council considers that reducing the informal economy is an essential step towards increasing the ratio of tax revenue to GDP and therefore calls on the government to implement concrete and effective measures to curb the informal economy.**

109. The Fiscal Risk Declaration prepared by the MoF and approved by the Cabinet[76] proposes a fiscal buffer of 0.1% of GDP in 2025, 2026 and 2027. **The Fiscal Discipline Council approves a fiscal buffer of 0.1% of GDP for 2025.** In the current situation, there are still too many legal, macroeconomic and fiscal unknowns, which is why the FDC is currently postponing an opinion on the required size of the fiscal backstop for 2026 and 2027.

110. In general, fiscal risk management comprises a set of measures that can be divided into 3 groups: (i) identification and analysis of fiscal risks, (ii) mitigation and management of potential impacts, and (iii) reporting and availability of information. The Council considers that (i) and (iii) work well in Latvia's fiscal risk management framework, but that there is room for improvement in mitigating and managing the impact of potential fiscal risks. The new EU economic framework makes it necessary to draw up a new FDL or amend the existing FDL. The new national framework could focus more on the

[74] Payment radar https://www.bank.lv/aktualitates-banklv/publikacijas/maksajumu-radars-p
[75] Plan to curb the shadow economy 2024-2027 https://likumi.lv/ta/id/349352-enu-ekonomikas-ierobezosanas-plans-2024-2027-gadam
[76] Information Report "Fiscal Risk Declaration " https://tapportals.mk.gov.lv/legal_acts/b83539ff-70f1-49b8-99ba-ce3119f14b23

mitigation and management of fiscal risks, including in the broader sense of fiscal risks. It is possible that with more effective and timely identification of fiscal risks (in the broad sense) – MGF, Air Baltic, Rail Baltica - the impact on the state budget would be smaller. Greater responsibility for fiscal risk management should also be considered for the FDC, which has the status of an independent body and can contribute to this function.

4 Fiscal numerical rules

4.1. Fiscal structural plan and calculations of eligible expenditure

111. Development of Budget 2025 and Budgetary Framework for 2025 – 2027, for several reasons, is taking place within a very short timeframe, which makes detailed and comprehensive analysis difficult due to changing information. The Council has not received the FSP and other necessary information and calculations in time to assess the fiscal conditions. For this reason, the Council will analyse the fiscal and structural framework in more detail in its Spring 2025 Interim Surveillance Report.

112. The new European Union framework for fiscal and economic governance comes into force from 2024. This includes two Regulations[77],[78] and one Directive[79]. Under the new framework, EU Member States must produce a medium-term Fiscal Structural Plan (FSP) every four or five years in April, replacing the annual Stability Programme and National Reform Programme. This plan should set out the fiscal path in terms of the limits to the growth of net primary public expenditure[80] . The fiscal path is designed to keep the general government deficit below 3% of GDP and debt below 60% of GDP over the plan period and 10 years thereafter.

113. The fiscal trajectory must be adhered to in the preparation of the draft law 'On the State Budget for 2025 and the Budget Framework for 2025, 2026, and 2027.' When evaluating Latvia's submitted General Government Budget Plan draft for 2025, the European Commission will assess the compliance of fiscal indicators with the constraints of the Fiscal Structural Plan. Given that 2028 plays a critical role in the new EU economic governance model—since the fiscal numerical rules for 2025, 2026, and 2027 are calculated based on the target indicators for 2028—this chapter also includes fiscal indicators for 2028 for informational purposes.

114. In accordance with the new EU regulation, amendments were made to Article 10 of the Latvian Fiscal Discipline Law, setting the maximum allowable structural deficit at 0.5% of GDP. Starting in 2025, the structural deficit is set at 1% of GDP.[81].

115. Resuming the application of EU fiscal rules, the Cabinet decided not to introduce new one-off measures in budgetary planning[82], but to continue with the one-off measures started earlier - to mitigate the effects of COVID-19 and to finance internal and external security, which were already in place and approved in the Budget Laws. The MoF is committed to financing one-off measures within the framework of fiscal discipline to avoid exceeding the 3% of GDP general government deficit threshold and to respect the fiscal trajectory set by the FSP.

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[77] Council Regulation 2024/1263 – Preventive Mechanism – on effective coordination of economic policies and multilateral surveillance of budgetary developments and repealing Council Regulation (EC) No 1466/97 (in force from 29.04.2024).
[78] Council Regulation 2024/1264 – Correction Mechanism – amending Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure (in force from 29.04.2024).
[79] Council Directive 2024/1265 – amending Directive 2011/85/EU on requirements for budgetary frameworks of the Member States (effective from 29.04.2024).
[80] Expenditure excluding several items: interest expenditure, discretionary revenue measures (government-approved changes in taxes, non-taxes, charges for services and other own revenues), expenditure on EU funds programmes and public co-financing of EU funds programmes, as well as cyclical elements of unemployment benefit expenditure.
[81] Cabinet Minutes 24.09.2024 No. 39/§31: Draft Law (amendments) (mk.gov.lv)
[82] Minutes of the Cabinet meeting of 30.04.2024, No.18; § 53

Table 4.1 One-off measures EUR million and % of GDP

	2025	2026	2027	2028
Expenditure on internal and external security	-768.6	-826.5	-815.0	-663.9
COVID-19 mitigation expenditure	-5.3	-5.3	-5.3	-5.3
One-off measures % of GDP	-1.7	-1.8	-1.7	-1.3

Source: Ministry of Finance

116. Considering these significant regulatory changes, the fiscal numerical conditions, starting with the preparation of the 2025 budget and the budget framework for 2025-2027 and beyond, will be calculated according to three methods: (1) the Structural Balance rule, derived from national legislation and (2) Structural Primary Balance (SPB) rule derived from EU Regulation 2024/1263, the, and (3) the EU expenditure growth rule. Each of these fiscal rules applies to a different fiscal indicator; however, to ensure their comparability and to determine which fiscal condition is strongest and decisive, the fiscal indicators are recalculated into a single indicator. For this purpose, the Ministry of Finance selected the FDL structural balance indicator.

A set of numerical fiscal conditions stemming from national and EU frameworks

LV SGP Structural balance condition

(Allowable structural deficit increased from 0.5% to 1%)

EU Structural primary balance condition

EU condition on net primary expenditure growth

117. These indicators are also used in the FSP to determine the fiscal trajectory – the maximum growth in net state-financed primary expenditure – that Latvia has included in the draft FSP, which, according to the MoF's calculations, is as follows:

	2025	2026	2027	2028
Net government-financed primary expenditures (EC)	5.9%	3.6%	3.4%	3.3%

118. According to the MoF's calculations at[83], after expanding the fiscal space and filling it with new policy measures, a general government structural budget balance target that meets all three numerical fiscal rules would be reached by 2025. - 2028 is set at: -0.789% of GDP in 2025, -0.749% of GDP in 2026, -0.792% of GDP in 2027, and -0.954% of GDP in 2028. In all four years, the strongest fiscal rule is the EU expenditure growth rule.

119. Latvia's fiscal projections for 2024 imply a structural primary balance of -0.789% of GDP, better than in the (EC) spring 2024 forecast of -1.362%. However, to ensure process stability, the 2025 EU Structural Primary Balance target remains at -1.342%.

[83] Explanatory draft of the draft Law on the State Budget for 2025 and the Budgetary Framework for 2025, 2026 and 2027

This allows spending growth to increase from 4.5% to 5.9% in 2025. The difference between the EC and Latvian forecasts also applies to government debt – Latvia forecasts 45.8% of GDP, while the EC forecasts 44.5%, resulting in higher interest expenditure. The EU's structural primary balance target for 2028 has been slightly revised from -1.282% to -1.257%, to keep the deficit below 3% of GDP in 2028. Following a technical dialogue with the EC, it was agreed that an integrated forecasting framework would be used to set the fiscal path, with Latvia's macroeconomic and fiscal forecasts used for 2024 and the EC's spring 2024 forecasts and common assumptions and methodology used from 2025 onwards. After these adjustments, the EU structural primary balance rule becomes the strongest and prevailing fiscal rule in 2025.

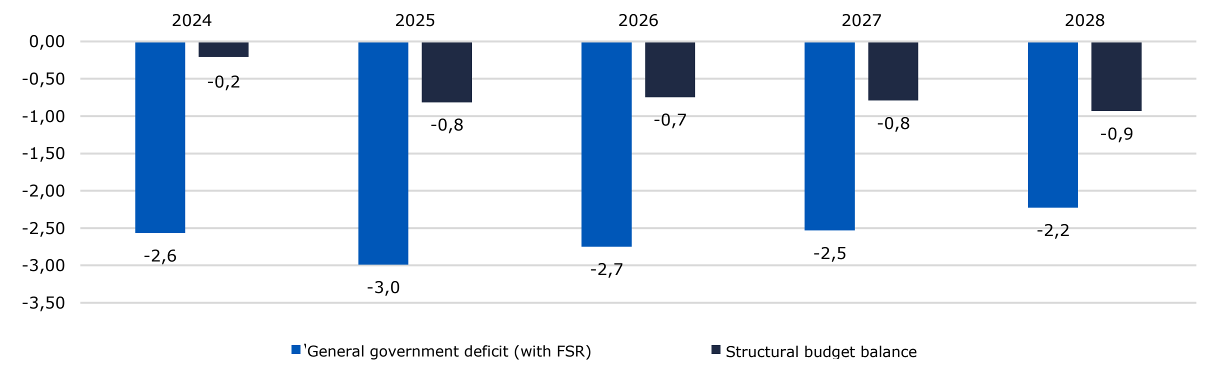
Table 4.2. EC technical information requirements for SPB improvement and SPB according to Latvia's up-to-date information (after technical dialogue)

	2024	2025	2026	2027	2028
structural primary balance, % of GDP According to ***EC technical information requirements for improving SPB***	-1.362	-1.342	-1.322	-1.302	-1.282
structural primary balance, % of GDP ***In line with the EC technical information requirements for improving the structural primary balance*, Latvia's most up-to-date data (projections)**	-0.789	-1.342	-1.322	-1.302	-1.257

Source: Ministry of Finance

120. Hence, the final general government structural balance targets, which fulfil all three rules, for 2025 – 2028 sets the following: -0.817% of GDP in 2025, -0.749% of GDP in 2026, -0.792% of GDP in 2027, and 0.932% of GDP in 2028.

Figure 4.1. Structural budget balance with all fiscal conditions and corresponding general government deficit (with FSR)



Source: Ministry of Finance

121. In the preparation of the draft General Government Budget Plan for 2025, the net increase in state-financed primary expenditure is estimated and, according

to the MoF's calculations, it is projected at 4.4% (excluding Fiscal Security Reserve), which is below the ceiling set by the FSP.

122. The Fiscal Discipline Council acknowledges that the fiscal path calculated by the MoF is consistent with the provisions of Regulation 2024/1263 (EC technical information). The Council also welcomes the use of more up-to-date national data in the 2024 fiscal projections and the preparation of the 2025 budget following the FSP fiscal path.

4.2. General government debt

123. In Latvia, the general government debt projections for this year do not exceed 47% of GDP. The Ministry of Finance projects debt at 45.8% of GDP for this year. The forecasts published by the MoF, the European Commission and the Bank of Latvia are summarised in Table 4.3.

Table 4.3. General government debt forecasts in Latvia

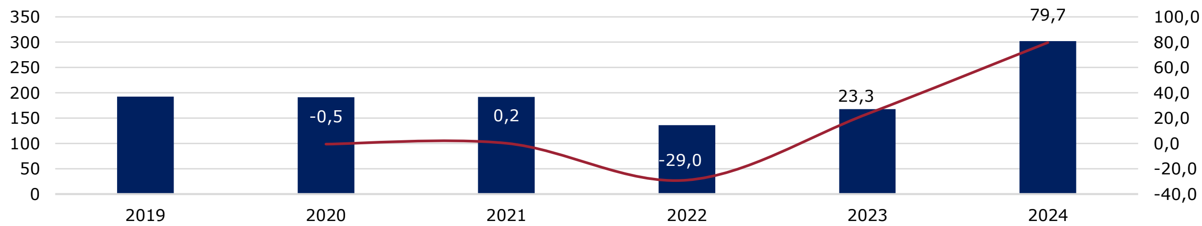
	2024	2025	2026	2027	2028
MoF (gross debt)	45.8	47.5	48.5	49.7	50.8
Bank of Latvia (GGD)	47.0	48.4	49.0	-	-
European Commission (GGD)	44.5	46.3	-	-	-

Source: EC[84], BoL[85], *MoF (FSP) [86]

124. Overall, there are no indications of a sharp increase in Latvia's debt this year or next year. This year it could remain in the range of 44.5%-47%, but next year it might rise to 46.3%-48.4% next year. However, forecast for 2026-2027 show debt rapidly approaching the 50% of GDP threshold and reaching it in 2027. This is a strong signal for consistent fiscal discipline, as government debt tends to rise sharply in times of crisis. Although there are currently no indications of a crisis scenario in Latvia, such a scenario cannot be ruled out given the highly volatile geopolitical situation.

125. Servicing government debt is currently a major burden on public finances. In the context of the ECB's restrictive monetary policy, interest expenditure is set to increase the fastest this year, with interest expenditure 79.7% higher in the first eight months of 2024 than in the same period of 2023 (Figure 4.2).

Figure 4.2. Interest expenditure in the first 8 months 2019-2024 (EUR million; left axis) and growth rate of interest expenditure (%; right axis)



Source: The Treasury

126. According to the MoF's calculations, for the years 2025-2027 and 2025-2028, government debt servicing expenditures will amount to 1.1% of GDP this year,

[84] COMMISSION STAFF WORKING DOCUMENT Fiscal Statistical Tables providing background data relevant for the assessment of the budgetary policies of the Member States Accompanying the document Recommendations for COUNCIL RECOMMENDATIONS on the 2024 economic, social, employment, structural and budgetary policies of Belgium, Bulgaria, Czechia, Denmark, Germany, Estonia, Ireland, Greece, Spain, France, Croatia, Italy, Cyprus, Latvia, Lithuania, Luxembourg, Hungary, Malta, the Netherlands, Austria, Poland, Portugal, Romania, Slovenia, Slovakia, Finland and Sweden - Publications Office of the EU (europa.eu)
[85] Macroeconomic projections | October 2024 | Bank of Latvia
[86] Latvia's Fiscal and Structural Plan 2025 - 2028 (Table 1b and Table 4)

rising to 1.2% of GDP in 2025, 1.3% in 2026, 1.4% in 2027 and 1.5% of GDP in 2028. High interest rates add to the burden of servicing public debt and reduce the scope for public spending.

Table 4.4 Debt servicing cost forecasts

	2024	2025	2026	2027	2028
Debt servicing (interest payments) EUR million	457	541	645	721	772
Debt servicing as % of GDP (D. 41)	1.1	1.2	1.3	1.4	1.5

Source: Ministry of Finance

127. Given the ECB's restrictive monetary policy, debt servicing costs are already high. They will tend to rise, and new borrowing rates will also be burden for the public budget. Such challenges remain on the agenda, despite the high credit rating agencies' assessment of the Latvian economy.

128. Moody's Ratings[87] announced on July 26 that it is maintaining Latvia's credit rating at A3 and that its outlook is stable. The assessment reflects the country's strong financial position and sound institutional governance, which enable it to cope successfully with external challenges, including geopolitical risks. The Agency underlines that Latvia's economy is small but resilient and continues to grow steadily. Moody's also assesses Latvia's moderate level of government debt, but points to a significant share of state companies' leverage.

129. Fitch Ratings[88] affirmed Latvia's credit rating at A- on July 12, highlighting the low cost of government debt and debt servicing, as well as credible policies supported by EU and euro area membership. The outlook for the Latvian economy is positive. The Agency's positive assessment is based on Latvia's resilience to external shocks, such as the COVID-19 pandemic and Russia's war in Ukraine. Fitch points to the Latvian economy's declining dependence on Russian energy imports and expects economic growth to continue, although the budget deficit will widen in the short term due to higher spending on defence and social needs.

130. On May 31, S&P Global Ratings[89] downgraded Latvia's credit rating from A+ to A, while maintaining a stable outlook. The decision is based on concerns about the long-term impact of the Russia-Ukraine war on Latvia's fiscal performance and slow economic growth. Although the Latvian economy has been resilient so far, the increase in security spending could delay the reduction of the budget deficit. The stable forward-looking assessment reflects the projected economic recovery and the Latvian government's commitment to a tight fiscal stance.

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[87] Moody's Ratings declares Latvia's credit rating at current A3 with stable future outlook | Moody's Ratings declares Latvia's credit rating at current A3 with stable future outlook | The Treasury

[88] Fitch Ratings affirms Latvia's credit rating at the current A- level with a positive future outlook | Fitch Ratings affirms Latvia's credit rating at the current A- level with a positive future outlook | The Treasury

[89] S&P Global rates Latvia's credit rating at A with stable outlook | S&P Global rates Latvia's credit rating at A with stable outlook | The Treasury

Annex No. 1

Annual pension tier 1 capital update indices and tier 2 average return index dynamics

Year	T1 equity index*	T2 average growth index**	CSSIC rates %p in T2 pension	PCI per year
1997	1.0300	-	-	
1998	1.1200	-	-	1.047
1999	1.1170	-	-	1.024
2000	1.0690	-	-	1.026
2001	1.0835		2% *(July 1)*	1.025
2002	1.0453		2%	1.019
2003	1.1645	1.037	2%	1.029
2004	1.1754	1.053	2%	1.062
2005	1.1712	1.079	2%	1.067
2006	1.2333	1.035	2%	1.065
2007	1.3593	1.035	4%	1.101
2008	1.3106	0.902	8%	1.154
2009	1.0000	1.133	2% *(May 1)*	1.035
2010	1.0000	1.083	2%	0.989
2011	1.0000	0.977	2%	1.044
2012	1.0000	1.089	2%	1.023
2013	1.0000	1.023	4%	1
2014	1.0000	1.053	4%	1.006
2015	1.0000	1.019	5%	1.002
2016	1.0614	1.020	6%	1.001
2017	1.0786	1.031	6%	1.029
2018	1.1064	0.961	6%	1.025
2019	1.1029	1.108	6%	1.028
2020	1.0445	1.021	6%	1.002
2021	1.0632	1.091	6%	1.033
2022	1.1357	0.859	6%	1.173

2023	1.1329	1.125	6%	1.089

Source: Ministry of Welfare

*the procedure for updating the old-age pension capital is laid down in the Cabinet Regulation No. 205 of 27 March 2007 "Procedures for Calculation of the Wage Index of Insurance Contributions and Updating the Old-age Pension Capital".

** weighted average return on the net asset value of investment plans in the relevant category. Using data on the value of the investment plan's share, returns are calculated for different periods, expressed as an annual percentage. The return on plan investments is calculated as the ratio of the change in the value of a plan unit during the reference period to its value at the beginning of the period, expressed as an annual percentage (assuming 365 days in a year). According to the SSIA reports on the operation of the state funded pension scheme. The values in the table are expressed in indices of change. It is specified as from 2023, as the management of the State funded pension scheme funds was entrusted to private fund managers as from 1 January 2003.

Tier 2 pensions are allowed to invest in higher-risk equity markets from 2018.