2023

Stability programme of Latvia 2023–2026

Finanšu ministrija

RIGA

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COMMONLY USED ABBREVIATIONS

Cabinet	Cabinet of Ministers
CSB	Central Statistical Bureau
EC	European Commission
ECB	European Central Bank
EPC AWG	Working Group on Ageing Populations of the Economic Policy Committee
ESA	European System of National and Regional Accounts
EU	European Union
FDL	Fiscal Discipline Law
GDP	Gross Domestic Product
IMF	International Monetary Fund
IT	Information Technologies
LALRG	Latvian Association of Local and Regional Governments
LBFM	Law on Budgetary and Financial Management
MoES	Ministry of Education and Science
MoF	Ministry of Finance
MoI	Ministry of the Interior
OECD	Organisation for Economic Cooperation and Development
PIT	Personal Income Tax
PMI	Purchasing Managers' Index
RRF	Recovery and Resilience Facility
SRS	State Revenue Service
SURE	Support to Mitigate Unemployment Risks in an Emergency
Treasury	The Treasury
USA	United States of America
VAT	Value Added Tax

1. Overall Economic Policy Guidelines and Objectives

The Stability Programme of Latvia 2023-2026 has been developed following the rules and guidelines for implementation of the Stability and Growth Pact and prepared in accordance with the requirements of EU Council Regulation (EC) No. 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies.

This Stability Programme is being prepared shortly after the law On the State Budget for 2023 and Budgetary Framework for 2023, 2024 and 2025 was drafted and adopted on 9 March of this year, which was prepared based on the macroeconomic forecasts of December 2022. In this relatively short period of time, the forecasts of the global and Latvian economic development have become slightly more optimistic. The decrease in energy prices, the volume of gas reserves stock in Europe, economic transformation towards energy independence marks the factors making the future prospects slightly more optimistic. Better economic development, in turn, has a less negative impact on inflation deceleration, core inflation has become a significant factor in the overall inflation contribution. In 2023, these factors have led to a slight increase in both growth and inflation in Latvia. According to the forecast of February of this year, the forecast GDP growth for 2023 has been increased by 0.6 percentage points, while for 2024 it is forecast to be 2.0%, which is one percentage point less GDP growth than last December. For the next two years - 2025 and 2026 - economic growth is forecasted by 2.9% and 2.8%, respectively. In 2023, the average annual inflation is forecasted at the level of 10%, which is 1.5 percentage points more than previously forecast. This increase was determined by the increased heat, electricity and gas tariffs at the end of the year, as well as stronger second-round effects of inflation. In 2024, inflation will continue to slow down, with prices rising by 2.2% and then stabilising at 2.5%. It should be noted that these forecasts are in accordance with the baseline scenario of economic development.

Better economic forecasts and higher inflation also mean higher State budget revenue. In 2023, it is forecasted to be EUR 160 million more, in 2024 and 2025, EUR 295 million and EUR 330 million more, respectively. Expenditure has also increased, especially the State special budget expenditure, interest expenditure and contributions to the EU budget, expenditure for core functions of local governments and adverse effects from the balance sheets of classified enterprises. Consequently, the impact on the balance of the general government budget is much smaller than it would have been if the only variation had been the growth in revenue. In 2023, the general government budget balance has only improved by EUR 19 million. In 2024, the overall changes have deteriorated the general government budget balance by EUR 76 million, while in 2025 they improved it by EUR 122 million.

After the Covid-19 pandemic, the operation of the Fiscal Discipline Law (FDL) has been fully restored in 2023, but from 2024 the general escape clause has been cancelled and the European fiscal discipline rules are in force. This Stability Programme has been prepared in accordance with the fiscal strategy approved by the Cabinet and fiscal discipline legal framework. Structural deficit targets remain unchanged for 2024 and 2025, in the amount of 0.5% of GDP as established by the law On the State Budget for 2023 and Budgetary Framework Law for 2023, 2024 and 2025. For 2026, the structural deficit target currently amounts to 0% of GDP and this is related to the need to adjust the negative deviations from the planned structural deficit targets of previous years, as well as the fact that a positive output gap is currently planned in 2026. The general government budget deficit of 2023 is forecasted in the amount of 4.0% of GDP, while the structural deficit - in the amount of 0.5% of GDP. The general government budget deficit arising from the structural deficit targets is forecasted 2.5% of GDP in 2024, and 2.2% and 0.7% of GDP in 2025 and 2026 respectively.

1. ECONOMIC SITUATION

2.1. External Economic Environment

In 2022, the global economy and the economy of EU countries continued to recover from the crisis caused by Covid-19, but since February of last year, the situation was already completely determined by the war started by Russia in Ukraine and the energy crisis triggered thereby, significantly increasing the prices of energy resources, raising the overall inflation rate and significantly slowing down economic development. To limit inflation, the central banks of the countries of the world started a cycle of interest rate increase in 2022, which also had a decelerating effect on economic growth.

According to the estimates of the International Monetary Fund (IMF), the global economy has grown by 3.4% last year, with the growth decelerating from 6.2% reached in 2021. Similarly, overall growth in the EU countries dropped to 3.5%, while in 2021 the EU economy had grown by 5.4%. A slowdown in growth in 2022 was already predicted before Russia's invasion of Ukraine, but the commenced war significantly adjusted the economic prospects downwards. However, the overall situation did not turn out to be as pessimistic as estimated in the first half of the year, and already from the middle of the year, growth forecasts for both the global and EU economy are being gradually adjusted upwards.

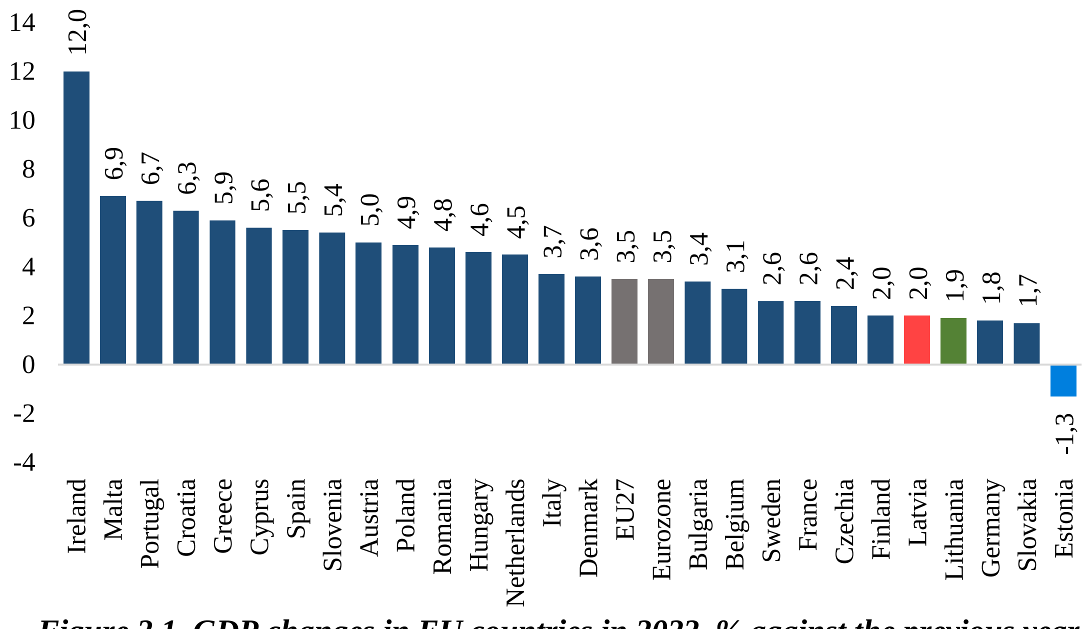


Figure 2.1. GDP changes in EU countries in 2022, % against the previous year

In 2023, the growth of both the global and European economy is projected to be slightly slower - 2.9% for the global economy according to the IMF forecasts and 0.8% for the economy of the EU countries according to the forecasts of the European Commission (EC), nevertheless the forecasts of this year have also been constantly increased over the period of recent months. After sharp drops in the summer of last year, in the last few months, the business and consumer confidence indicators have started to stabilise and improve as well. The Economic Sentiment Index for EU countries created by the EC showed the highest level in six months in February, though not yet reaching the long-term average.

The Purchasing Managers' Index (PMI) of *the Eurozone*, demonstrating forward-looking economic output volumes, reached the highest level in the last eight months in February this year, for the second month in a row, exceeding the mark of 50 separating economic growth from recession. The index of the services sector has improved especially rapidly, and the PMI indicator in manufacturing also signals the stabilisation of output, ending the eight-month long decline.

The improvement of the economic situation and confidence is largely related to the warm winter, the drop in prices of energy resources recorded in recent months and the decrease in the overall inflation level, where the annual inflation in the Eurozone after the 10.6% record reached in October 2022 has decreased to 8.5% over the following months till March. However, the decline in inflation in recent months has also been somewhat slower than expected by the analysts, signalling that the second-round effects of inflation could turn out to be stronger than initially projected. In its forecasts at the beginning of February of this year, the EC projected that inflation in the Eurozone, after the average of 8.4% reached in 2022, will decrease to 5.6% this year, and to 2.5% in 2024, starting to approach the desirable level of inflation set by the European Central Bank (ECB), being close to but slightly below 2%.

In response to high inflation, on 16 March 2022, the US Federal Reserve raised the reference interest rate by 0.25 percentage points from 0.25% - 0.5% for the first time since December 2018. After several subsequent interest rate increases, the rate reached 4.50% - 4.75% in February 2023. On 21 July 2022, the ECB carried out the interest rate increase for the first time in 11 years, raising the main reference interest rate by 0.5 percentage points to 0.5%, and subsequently, after five more rate increases, the main reference interest rate reached 3.5% in March this year. Up to now all central banks have signalled plans to raise rates even further, but they may be limited by the instability in the financial sector at the beginning of March this year, marked by the insolvency of the US bank *Silicon Valley Bank*. Interest rate increase and instability in the financial sector can also impair the global economic growth prospects and increase recession risks, especially in developing countries with high debt levels.

2.2. Current Economic Development[1]

After growth of 4.1% in 2021, as Latvia's economy recovered from the Covid-19 crisis, in 2022, as Russia launched a full-scale war in Ukraine, Latvia's GDP growth decreased to 2.0%.

The slowdown in growth has, nevertheless, been smaller than forecast at the outbreak of the war, and the adverse effects, contrary to the forecast, were less felt in foreign trade data and disruptions in supply chains, but more manifested in the rise of inflation and production costs, as the prices of energy resources grew sharply in the global markets. At the same time, the warm winter and state support measures have mitigated the adverse effects of this price increase on the economy.

In 2022, with the economy recovering from Covid-19 restrictions, rapid growth was recorded in almost all service sectors, and the largest contribution to GDP growth was provided by a 15.7% increase in the commercial service sectors. A significant role was also played by the 57.5% increase in the accommodation and food service activities' sector and the 26.6% increase in the arts, entertainment and recreation sector. The information and communication services sector developed very successfully last year, showing a 14.0% increase, which is a highly commendable result, taking into account the fact that, unlike other services sectors, information and communication services were previously much less adversely affected by the restrictions imposed to contain the pandemic. Manufacturing has also worked successfully in

[1]The description uses data from the CSB and other sources that was available until 13 March 2023.

2022, which, despite the decrease in volumes in the two largest sub-sectors – wood processing and food production – managed to achieve a 2.7% increase.

In general, last year's data show that the adverse effects of the war launched by Russia in 2022 were mainly reflected in the drop in volumes of the wholesale trade sector by 18.7% compared to 2021. At the same time, negative dynamics also remained in the construction sector, which after a drop of 9.8% in 2021, decreased by another 11.3% last year, due to the rapid increase in construction costs and delays in re-entering the contracts.

From the consumption side, economic growth last year was facilitated most by an increase in private consumption by 8.1%, which was ensured by the lifting of Covid-19 restrictions, as well as the State energy support measures, mitigating the adverse effects of the rise in prices of energy resources. Household savings in commercial banks, which significantly increased during the pandemic, also helped to ensure consumption. The growth of public consumption was more moderate last year, increasing by 2.8%, while the growth of investments (+0.7%) was hindered by both the rapid increase in construction costs and growing risk of war in the nearby region. Sharp increases last year were recorded both in exports (+9.1%) and imports (+11.6%), but, with exports growing slightly slower than imports, the net export contribution to economic growth was negative.

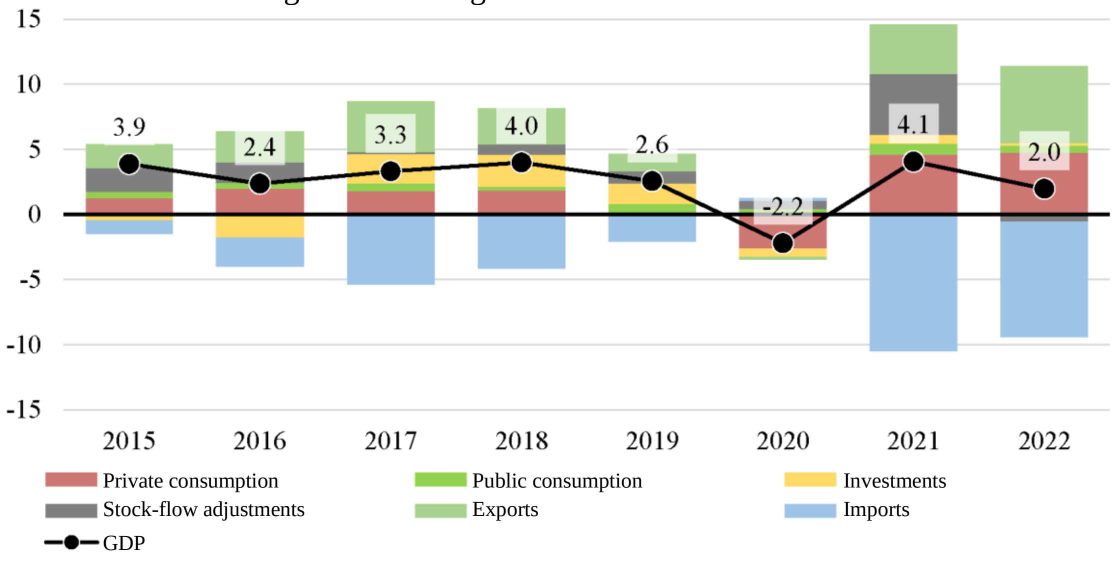


Figure 2.2. Contribution of consumption-side components to GDP growth, % points

Similar to last year, the economic development in 2023 is still being determined by a rapid rise in prices as a result of the war launched by Russia, and the inflation control measures of the central banks of the world, weakening the economic growth, but both Latvian and global economies have managed to avoid a more severe recession so far. Economic growth forecasts are being gradually elevated for several months already, and Latvia's GDP, unlike the forecast at the beginning of December last year, might not experience a drop this year, but remain at the level of 2022.

Sectoral Development

The added value of the **industry** sector decreased by 0.1% in 2022, which was mainly determined by the increase in production prices by 30.7%, including in the manufacturing industry (80.7% of the entire industry) by 19.1%, while electricity and gas supply (15.8% of the entire industry) costs increased by 94.4%. Despite the high costs, the manufacturing industry output increased by 2.6% last year, while the overall growth of the entire industry sector was only 0.8%, which was determined by the 11.5% decrease in the volumes of electricity and gas supply. The relatively small mining industry, in turn, has shrunk by 0.7% in 2022.

In terms of growth, the year 2022 has been similar to the pre-pandemic year (2019), when the industry sector also grew by 0.8%, including the manufacturing industry by 2.0%. It should be assessed positively that last year the situation in the manufacturing industry was much more complicated than in 2019, but the growth is similar. This was followed by 2020 with volume reductions in the shadow of the pandemic, but in 2021 the growth was the fastest in the last five years.

In the manufacturing industry, last year started with stable growth, but in the second half of the year, the volumes started to decrease compared to the same period of 2021 due to the high prices of energy resources and raw materials. The wood industry, which is the largest subsector of the manufacturing industry, decreased by 1.2% year-on-year, while the volumes produced in the second largest subsector – food production – decreased by 1.7%. A decrease is also recorded in the manufacture of machinery and equipment (-12.3%), manufacture of paper and paper products (-9.0%), as well as manufacture of chemicals and chemical products (-5.0%). At the same time, growth of the manufacturing industry was ensured by the manufacture of beverages, which grew by 18.8%, manufacture of electrical equipment, where the growth was 8.5%, manufacture of motor vehicles, trailers and semi-trailers grew by 13.4%, repair and installation of machinery and equipment increased by 8.3%, but wearing apparel was manufactured 5.9% more than in 2021.

The 11.5% decrease in electricity and gas supply can be explained by high electricity and gas prices, giving rise to austerity measures among both households and entrepreneurs, thus reducing demand. At the end of 2022, gas prices in the world have decreased, but consumers in Latvia do not feel it yet.

The year 2023 in the manufacturing industry has started with a decrease in volumes year on year, and it is likely that in the first half of the year it will be difficult for the manufacturing industry to reach the same production volumes as in the first half of 2022.

Similar to 2020 and 2021, the added value **of the construction sector** in Latvia continues to decrease in 2022 (-11.3%). The construction volume index also decreased by 11.3% in 2022, with a similar decrease present in all three sub-items - building construction, engineering construction and specialised construction works. Meanwhile, construction at current prices has increased by 6.4%, driven by inflation and rising construction costs. The low activity in construction can be partly explained by the transition period between the EU Funds investment cycles 2014-2020 and 2021-2027. The EU Funds resources are henceforth stipulated in larger-then-ever volumes, but there are concerns about the capacity of the sector. At the same time, the scope of construction works of *Rail Baltica* is also increasing. It should be mentioned that an important negative factor in the sector is the shadow economy, which affects competition in the sector, as well as tax revenue.

The transport and storage sector, which was one of the sectors that suffered more during the pandemic, increased by another 2.3% last year after a rise of 9.0% in 2021, as air and land passenger transport volumes continued to recover, while freight rail transport was reduced by export restrictions on Russian energy products, and freight transport by road also decreased slightly.

The number of passengers in Riga Airport in 2022, as compared to the previous year, increased by 2.3 times and reached 5.4 million passengers, however it is still below the level of 2018-2019, when the number of passengers in the airport exceeded seven million. The number of passengers in road transport increased by 28.0% and seaports served 49.8% more passengers than in 2021. Cargo turnover in the ports increased by 15.2% last year, while the railway already began to feel the decline in the export of Russian energy products, and the volumes transported by rail decreased by 5.3%. Cargo turnover in road transport decreased by 3.5% in 2022, due to a decrease in the volume of international transport, while inland cargo transport continued to grow.

The situation stays the same at the beginning of 2023, when passenger transport continues to recover, but cargo transit volumes by rail are falling, and the reduction of cargo this year could also affect the operation of ports, as the sector as a whole does not show growth. In January of this year, the number of passengers in Riga Airport, as compared to January of 2022, increased by 68.2%, cargo turnover in ports in two months was 2.7% higher than a year ago, while cargo transport by rail fell by 34.4 %.

The trade sector in 2022 was greatly affected by the hostilities in Ukraine, as a result of which the wholesale trade volumes with partners in Russia and Belarus decreased. It has also determined the drop in the added value of the entire trade sector by 6.3% at constant prices. At the same time, retail trade as well as trade volumes of cars and motorcycles continued to grow.

The wholesale trade sector accounted for 46% of the total trade sector in 2022, and traded volumes decreased by 9.3% over the year. Last year started with an increase in wholesale trade volumes in Q1, but along with Russia's invasion of Ukraine, the volumes decreased sharply and the remaining three quarters were in the red. The decrease was determined both by the sanctions imposed on Russia and by the unwillingness of Latvian entrepreneurs themselves to continue cooperation. At the same time, there are enough entrepreneurs who continue their business activities in Russia.

The retail trade sector (43% of all trade), in turn, showed a growth of 4.2% last year. However, the growth has developed against a low base, as the restrictions of the pandemic affected the retail trade volumes at the beginning of 2021 and in the last months of the year. Covid-19 certificates were still required for visiting points of sale up to 1st of March 2022. Along with the lifting of this restriction, trade in non-food products increased strongly in March. But the sector was already in front of the next challenges. In July last year, inflation exceeded the mark of 20% mark for the first time and remained at that level for the rest of the year, reducing the purchasing power of the population and raising concerns about the decline in private consumption. However, in 2022, reductions in retail trade volumes over the year were only recorded in certain months and they have not been significant.

The volumes of household financial deposits also continues to grow, but the rate of growth is decreasing every month. In 2022, the volumes of deposits grew by an average of 8.4%, reaching EUR 10.17 billion, but in 2021 – by 16.2%. Last year, inflation grew faster than deposits, thus the value of deposits has decreased. Households use the accrued deposits to compensate for the rising cost of living, as well as to avoid depreciation.

In the first half of 2023, no significant growth is expected in both the wholesale and retail sectors, which will be affected by the high base in 2022, but in the second half, as inflation decreases, growth in retail trade is expected, while the situation in wholesale trade will depend on finding new trade partners.

The accommodation and catering sector, which was hit by the Covid-19 crisis the most, after a severe fall in both 2020 and 2021, achieved a 57.5% increase last year, however, the volumes of the sector are still significantly behind the pre-pandemic level of 2019. This gap is determined both by the Covid-19 restrictions that existed in certain months of last year, and by the war started by Russia in Ukraine, reducing the number of foreign tourists both from the sanctioned aggressor countries and from further western countries, with travellers being concerned of the increasing safety risks.

In 2022 in total, local and foreign visitors stayed in tourist accommodation in Latvia for 3.9 million nights, which was 63.2% more than in 2021. Among this, the number of nights stayed by foreign visitors was 2.4 times larger than a year before, while the number of nights stayed by local visitors increased by 16.7%. At the same time, the number of nights spent by foreign guests was still 45.1% less than before the pandemic in 2019, while the number of nights spent by local guests increased by 6.7% during this time.

Another sector which suffered more during the Covid-19 crisis**, arts, entertainment and recreation,** after a fall by 3.4% in 2021, grew by 26.6% in 2022 as the restrictions were lifted.

In **agriculture**, after the decrease of the added value in 2021, the added value has increased again by 7.0% in 2022. In crop production, last summer, in terms of weather, has been more favourable than the summer of 2021; farmers also point to larger volumes of yield. The wheat and rye export volumes also increased last year, but the sowing areas did not increase last year.

Investments

In 2022, the amount of investments in Latvia increased by 0.7% at constant prices and totalled EUR 6.630 million. As compared to the other GDP components, such as private and public consumption, as well as export, the investment performance has been weakest, ensuring merely 0.2 percentage points in GDP growth. Thus, the share of investments in GDP has reduced to 23.0%, which is 0.3 percentage points less than in 2021. It should be noted that the investment deflator in 2022 was 12.4%. This means that at current prices, the volume of investments in the national economy increased by 13.2%, confirming that inflation had material adverse effects on investment activity as well.

The investment amount in Q1 of 2022 was 2.1% higher than in the respective period of the previous year. Such an increase was similar to 2021, when the investment amount increased by 2.9% on average. However, in the following quarters of 2022, the investment activity slowed down significantly, to 0.9%, 0.3% and 0.2%, correspondingly, compared to the respective quarter in 2021. Even though the overall investment dynamics were weak, investment changes by asset type were very heterogeneous. Investment growth in 2022 was driven by higher investments in equipment and machinery, as well as in intellectual property. At the same time, investments in buildings and structures were significantly lower than in 2021.

Last year, investments in equipment and machinery had a decisive role in the increase of total investments. The amount of these investments increased by 9.0% compared to 2021, making up 52.2% of the total investments, or EUR 3.458 million. Investments in technological equipment and machinery have already been continuously increasing since 2016, thus approaching the historically highest level in 2007, when the amount of investment in these fixed assets amounted to almost EUR 4 billion. Until 2020, investments in buildings and structures accounted for the most of total investments, but in the last two years, investments in equipment and machinery became the main object of investment, which might be indicative of the wish of enterprises to promote productivity. However, the most recent survey data of entrepreneurs engaged in the manufacturing sector show that 20% of the planned investments in 2023 will be aimed at optimising manufacturing processes, which corresponds to the dynamics of recent years. In order to rapidly raise productivity, the investment amount intended for raising the efficiency of the manufacturing process must be larger. Survey data also show that 38% of the planned investments this year are intended for the replacement of obsolete equipment, while entrepreneurs plan to direct only 29% of the planned investments towards the expansion of production. Based on these data, it should be concluded that there is no reason to expect significant development of the manufacturing sector this year.

In 2022, a rapid increase in investment was recorded in intellectual property products. These fixed assets include investments into research and development, software and licences. In total, last year the amount of investments in these fixed assets amounted to EUR 737 million, which was 21.2% more than a year ago. Even though Latvian enterprises have managed to double the amount of investments in intellectual property products over the past six years, which is to be assessed positively, the current level still lags behind Estonia and Lithuania, who invested EUR 1 033 million and EUR 1 086 million in intellectual property products last year, respectively.

The total amount of investments last year was reduced by lower activity in the construction sector. In 2022, investments in the construction of offices, housing, warehouses and other buildings, as well as in the renovation of existing buildings and structures shrank by 11.0% and totalled EUR 2 499 million. Thus, investments in these fixed assets have decreased for the third year in a row, or since the beginning of the pandemic. Along with this decline, the share of construction investments in total investments in 2022 decreased to 37.7%, while before the pandemic, construction investments accounted for half of the investments made in the national economy. Investments in these assets vividly characterise the decrease in the volume of construction production, which reached 11.3% in 2022.

The weak investment activity in construction in recent years is influenced by several factors. First, changes in work organisation habits and mass remote working practices due to the pandemic have a negative impact on the demand for offices, at least while the risks of the spread of the Covid-19 virus persist. Secondly, in sectors such as accommodation, catering, entertainment and culture, as well as transport - the sectors most affected by the pandemic, turnover has significantly decreased and profit indicators have worsened, due to a sharp decrease in demand for these services. Although it is currently seen that the demand in these sectors has increased rapidly, it has not been able to fully recover after the Covid-19 crisis and the sectors are suffering from a lack of labour force and rising costs of energy resources.

Thirdly, the rise in the prices of construction materials and energy resources significantly increased construction costs. This factor has a significant impact on investors' decisions regarding the construction of new infrastructure objects. Construction costs in 2022 increased by 19.7% compared to 2021. Although such an increase generally corresponds to the average inflation in the economy, taking into account the fact that the implementation of construction or infrastructure projects requires large capital investments, such an increase is to be assessed as very rapid. An increase in costs can be observed in all items, but the decisive role was played by the increase in the price of construction materials (+26.3%), which is negatively affected by the high prices of gas and electricity. The costs for maintenance and operation of equipment and machinery, in turn, increased by 16.7%. High costs will also continue to adversely affect construction activity in the first half of 2023, because inflation will still remain high in the first half of this year.

Another factor that had a negative impact on the implementation of new construction projects at the end of last year and will continue to adversely affect it this year as well, is the increase in interest rates. At the beginning of 2023, the 6-month EURIBOR rate exceeded 3%, while it was negative until the middle of last year. Such interest rate dynamics increase both the cost of servicing current credit obligations for entrepreneurs and households and reduce the demand for new loans.

Confidence in the construction sector reached pre-pandemic levels at the end of 2021. However, due to the energy crisis and the deterioration of the geopolitical situation, business sentiment has worsened since the beginning of 2022. Although the credit rating of Latvia, which also reflects investment risks, is still at a high level, the physical border with the aggressor state Russia could lead to foreign investors reconsidering plans as regards the implementation of new projects in Latvia. Whereas, the high raw material prices and interest rate growth negatively affects local business, as it is harder to predict the total costs of investment projects. In such circumstances, the role of government investments is increasing. Although the amount of government’s investments does not even reach one fourth of the total investments in the economy, these investments provide a significant multiplier for private investments. EU fund investments in the new programming period, the Recovery and Resilience Facility's (RRF) funds, as well as investments in the implementation of the *Rail Baltica* project will help mitigate the impact of negative factors. Still, the overall investment activity in 2023 will be weak. According to the MoF's updated forecasts, the total amount of investments will increase this year by 1.0%.

Foreign Trade

In 2022, the **foreign trade turnover of Latvia's goods and services** at constant prices increased by 10.4%, which was equivalent to the growth of the previous year. The global economic development and increase of foreign exports to the main export outlets, such as the EU, as well as the substantial growth of export to countries such as the USA, Ukraine, Saudi Arabia, Norway, Kazakhstan, China, ensured last year's rise in exports of Latvian goods and services of 9.1%. Whereas the increase in Latvia's internal consumption and investments in equipment and technological machinery facilitated the growth of the total goods and services imports of 11.6%. Considering the fact that imports rose more sharply than exports, the foreign trade balance in 2022 has deteriorated. Last year, the foreign trade deficit at constant prices increased by EUR 831 million, reaching EUR 3 959 million. Thus, the foreign trade contribution to GDP growth was negative, or -2.9 percentage points, which was significantly less than in 2021, when the net export contribution was -6.7 percentage points. The growth in exports and imports in 2022 was faster than the GDP growth, hence, the significance of foreign trade in the economy has increased. The share of exports in the GDP in 2022 increased by 4.5 ppt and reached 69.9% Whereas the share of imports in the national economy last year amounted to 83.6% by increasing by 7.2 ppt as compared to 2021.

In 2022, the Latvian commodity export growth at current prices was the fastest in a decade, despite the energy crisis in Europe and the geopolitical crisis caused by Russia's military invasion of Ukraine. Last year, the goods export value increased by 29.7%, reaching EUR 21.3 billion — the highest export value since the compilation of foreign trade statistics. It should be noted that a sharp rise in exports was observed throughout the year. The export growth was recorded in all commodity groups, except for metals and their products, which means that the improvement of external demand was felt by practically all sub-sectors of the manufacturing industry. The total export of goods was also boosted by the increase in re-exports, with the sharp increase in the export of mineral products, as well as certain mechanical and electrical equipment goods.

One of the main reasons for such rapid and stable growth in the export of goods was the rise in prices. The export unit value index in 2022 has increased by 19.7% compared to the previous year. This means that in real terms, excluding price effects, the value of goods exports would increase by 10.0% on average in 2022, instead of by 29.7%. Thus, approximately two-thirds of the increase in goods exports was ensured by the increase in commodity prices, while external demand accounted for one-third of the total goods export growth. The price increase was observed for practically all raw materials, namely energy resources, food, metals, as well as wood. Rising raw material prices, coupled with disruptions in logistics driven by growing global demand and high fuel prices, pushed up the price of end goods. However, even with such a price increase in the current geopolitical situation, the export growth last year can be assessed as very good.

A sharp rise in commodity exports was observed not only in Latvia but practically in all Member States of the EU; however, Latvia ranked among the countries with the sharpest rise in commodity exports, which is indicative of the steady competitiveness of exports of Latvian goods. Data for 2022 show that the increase in the value of export of goods in the EU was on average 19.7% in actual at current prices, compared to a 29.7% increase in Latvia. A higher increase was only recorded in Bulgaria, Greece, Croatia and Lithuania. The increase in exports both in Latvia and throughout the EU as a whole was determined by the growing global economy. According to the IMF data the global gross domestic product increased by 3.4% in 2022. However, the war started by Russia in Ukraine significantly worsened the global economic situation, because at the beginning of 2022, the IMF predicted that the growth of the global economy in 2022 could reach 4.4%.

The biggest contribution to export growth in 2022 was provided by the increase in the export of mineral products by more than 2.5 times. The increase in the export of these commodity groups was facilitated by the re-export of gas and refined petroleum products to the rest of the Baltic states, Finland and Ukraine, as well as the increase in the export of electricity to Lithuania. The export value of mineral products increased by EUR 1.7 billion to EUR 2.8 billion last year. Thus, the share of this commodity group in the total export of goods doubled over the year, reaching 12.9%.

The increase in the value of the total export of goods was also facilitated by the increase in the export of agricultural and food products by 41.2%, with a significant increase in the export of cereals, dairy products, alcoholic beverages, and oil. The group of agricultural and food products with a share of 19.9% in the total export of goods was the largest export group of Latvian goods last year.

In the first half of 2022, the main driver of the increase in the export of goods was the group of timber and timber products, with an average increase of 36.9% compared to the respective period of the previous year. However, in the second half of the year, the average growth of timber exports decreased to 1.0%. Overall, the export value of timber and timber products increased by 16.4% last year. The export of timber and timber products is quite well diversified both in terms of outlets and exported goods. The increase was recorded in practically all the largest outlets – Germany, Lithuania, Sweden, the Netherlands, Estonia. A significant increase in exports was also recorded to countries such as the USA, Poland and Italy, which could be considered new markets. The export of timber to the largest export market, the United Kingdom, in turn, decreased by 16.3%, being the direct factor that determined the slowdown in the growth of the total export of timber in the second half of last year. With a 23% share in the total export volume of this group, the United Kingdom is significantly ahead of other export markets. Timber exports to Sweden, Germany, Estonia and Lithuania account for 10%, 8%, 7% and 6% of the total value of timber exports, respectively.

Goods with low added value still prevail in the structure of timber exports, namely, raw timber, sawn or chipped timber, as well as wood chips and pellets. The share of the above-mentioned goods in the export of timber and timber products is 60%. Exactly these groups were the ones to provide the largest contribution to the growth of wood exports in 2022. However, the export of veneer sheets, plywood, wooden crates and carpentry products also increased significantly last year.

The increase in exports last year was also recorded in the other commodity groups, but it was significantly lower than the increase in the export of mineral products, food and timber. The only commodity group whose export value decreased in 2022 was metals and metal products. The exports of this commodity group were by 10.7% lower than in 2021, which was determined by the decrease in the export of iron waste and scrap to Turkey, as well as the decrease in the export of iron and non-alloy steel to EU countries.

Last year, the growth of **services export** was even faster than the growth of export of goods. In 2022, the total export of services at current prices increased by 34.8% compared to the previous year and amounted to EUR 6 999 million. Positive dynamics of services export has been recorded already in 2021, but in 2022 the growth accelerated even further. Unlike the export of goods, which continued to increase also in 2020 when the pandemic began, the export of services only exceeded the pre-pandemic level in 2022.

The export value of services increased in all service groups, except for construction services. Of all the services provided to foreigners, the fastest growth was in tourism services. Expenditure of foreign tourists in Latvia in 2022 increased by 62.5% compared to the previous year. Such a rapid growth was determined both by a higher number of foreign tourists and also by a very low base in the previous year. Along with the outbreak of the pandemic and introduction of strict restrictions on assembly and movement of people, the number of tourists decreased significantly in practically all EU countries. Thus, in 2020, the number of foreign tourists served in Latvian hotels dropped by 64%. In 2021, the decline continued, and the number of foreign tourists decreased by another 38%. Thus, the number of foreign tourists served in Latvian hotels decreased almost 4.5 times over the course of two years. In the first half of 2022, when most of the restrictions were lifted both in Latvia and the other EU countries, the tourism industry revived. Last year, the number of foreign guests served in Latvia increased 2.6 times. However, pre-pandemic levels have not yet been reached. In 2019, Latvia welcomed almost 2 million foreign visitors, and in 2022, the number of foreign tourists served was 1.1 million people.

The largest contribution to the growth of services export in 2022 was provided by the increase in the export of transport services by 42.4%. Exports of transport services were promoted by all types of transport services. However, the largest contribution to this development of the services export group was provided by the growth of air and road transport services abroad. The increase in the export of air transport services by 2.6 times compared to 2021 was favourably influenced by a higher flow of tourists. In turn, the increase of road transport services by 28.3% was determined by the larger volume of cargo. It should be noted that such rapid growth was mostly influenced by the increase in prices and not by the increase in the physical cargo volume.

Among other types of services, the export of information and computer services can be pointed out, which shows a steady increase from year to year. The export of these services in 2022 increased by 30.0%, thus accounting for 12.4% of the total value of services exports. It is the third largest group of services, coming close to foreign tourist expenditure in Latvia in terms of volume. It can be positively assessed that there was an increase in both information services in EU countries and outside the EU.

It is expected that the export of goods and services at current prices will continue to increase in 2023, but the growth rate will decrease significantly. The most recent data on the confidence of entrepreneurs and households confirm the concern about the deceleration of the economic development rates. The value of the EU economic sentiment indicator has been below 100 points since July 2022, which is the lowest level since the beginning of 2021. Economic activity assessment by entrepreneurs and consumers is pessimistic in practically all the Member States of the EU, as well as in all areas, including industry and construction, which are more important exactly for Latvian exporters. In February this year, the EC published updated economic forecasts. Even though compared to the forecasts of autumn last year the EU GDP growth forecast for 2023 was increased from 0.3% to 0.8%, it is still significantly lower compared to the 3.5% economic growth in 2022. According to the MoF forecasts, the export of goods and services in 2023 in real terms will be at last year's level, but the increase at current prices will amount to 9.0%.

Import of goods and services at constant prices in 2022 was 11.6% higher than the year before. A sharp increase in imports was recorded for both goods and services. The main drivers of Latvian economic development last year were domestic consumption and exports. Thus, as household consumption increased, driven by growing income and lifted Covid-19 restrictions, and re-exports grew as well, imports also increased rapidly.

Analysing the data of import of goods at current prices, it should be concluded that the value of import of goods increased by 35.8% or EUR 6.98 billion in 2022. More than half of the increase in imports is explained by the increase in the import of mineral products by 195% or EUR 3.7 billion. The physical import volume of mineral products increased by only 23% in 2022. The decisive role in such a rapid increase in the import of mineral products was played by the increase in prices, especially for gas, crude oil, petroleum products and electricity. Thus, the value of gas imports increased almost 5 times, electricity imports increased 3 times, and the value of imports of refined petroleum products increased almost 1.9 times. Thus, the share of mineral products in the total imports of goods increased from 9.7% in 2021 to 20.9% in 2022. A significant increase in the import of goods was also recorded for agricultural and food products, machinery and electrical equipment, as well as chemical industry products.

The import value of services in 2022 increased by 34.2%, which was driven by all types of services. With the simultaneous increase in the import of air, rail, sea and road transport services, the value of the import of transport services increased by 36.2% compared to 2021. Expenditure of the Latvian population abroad increased by 52.8%. Among other types of services, a significant increase in imports was recorded for information and computer services, with the import value increasing by 18.7%, as well as telecommunication services - by 25.0%.

Current Account

In 2022, the current account deficit of the balance of payments continued to increase, reaching EUR 2.495 million or 6.4% of GDP. The amount of the deficit reached the highest level since 2009. A larger current account deficit was only recorded in the period from 2005 to 2008, when there were pronounced indications of economic overheating, rising even to 20.8% of GDP. In the period before the financial crisis, the current account deficit was largely driven by rapidly growing imports of goods, stimulated by internal consumption. Though the current account deficit last year is to be assessed as high and the growth of import of goods played a decisive role, just like before the financial crisis, the current situation is not showing signs of imbalances in economic development. When evaluating last year's foreign trade in goods, it is important to note that the increase in the import of goods was faster than the increase in exports, thus worsening the balance of foreign trade in goods. The goods account deficit reached EUR 4 476 million last year, which was EUR 1 702 million more than in 2021, and, as already noted, the rapid increase in imports of goods was largely determined by the increase in prices, especially for energy resources, and not by the increase in internal consumption. In 2022, the import of mineral products increased by EUR 3 662 million, amounting to more than half of the total increase in import of goods. Taking into account the fact that Latvia does not produce gas and petroleum products, and cannot influence global stock exchange prices, the import of energy resources in 2022 significantly worsened the foreign trade balance. In 2022, the current account was also adversely affected by the decision of foreign investors to pay higher dividends than in previous years. This was exactly the reason why the primary income account deficit has increased to EUR 665 million.

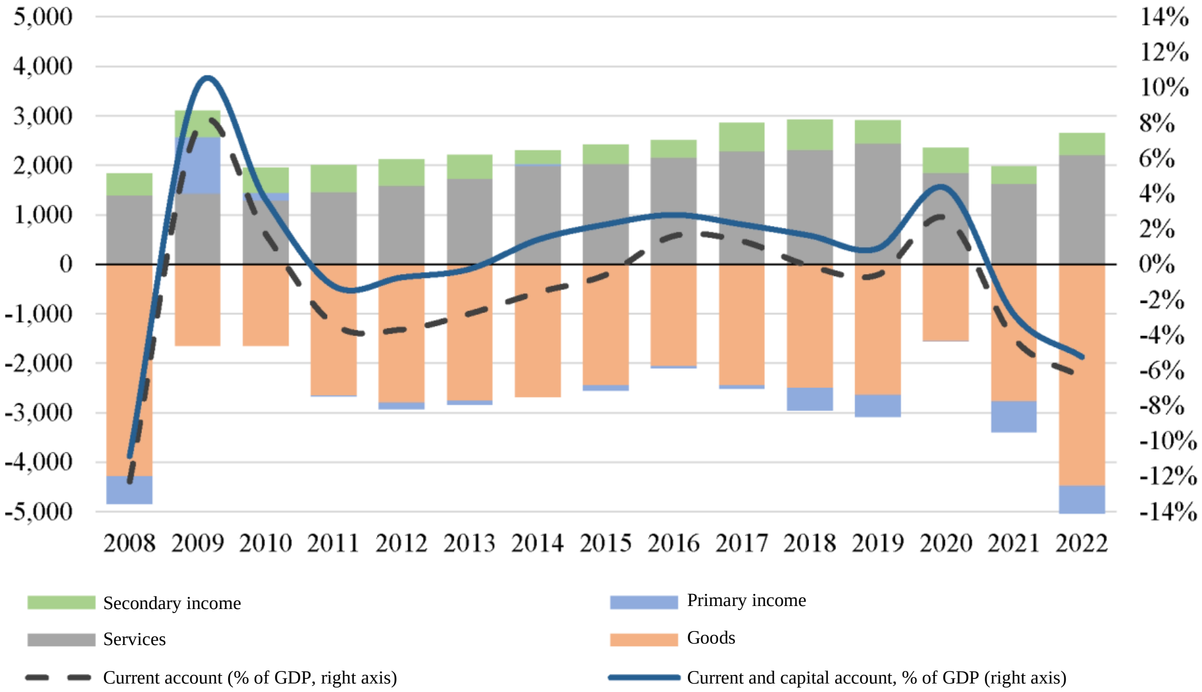


Figure 2.3. Components of the current account of Latvia's balance of payments (MEUR), current and capital account as a percentage of GDP[2]

The current account deficit of the balance of payments was slightly reduced by surpluses in the service and secondary income account. The surplus of the services account was supported by a higher growth of export of services, whereas the secondary income account was favourably affected by a higher inflow of EU funds. If one evaluated the current account together with the capital account, which in the case of Latvia mainly consists of incoming EU structural fund investments, as well as Fisheries Fund investments, the deficit in 2022 would be 5.3% of GDP.

Inflation

In 2022, the level of consumer prices was on average 17.3% higher than the previous year. The rise in consumer prices was comprehensive, as a price increase was recorded for all goods and services that are consumed on a daily basis. As recently as January 2022, annual inflation was 7.4%, but price growth continued to increase every month until September, with annual inflation reaching 22.2%. Since July last year, inflation in Latvia has been fluctuating between 20.3% and 22.2%. Inflation in 2022 can be assessed as very high, and an even faster price increase in Latvia was only observed in the middle of the nineties of the last century. High inflation is also evidenced by the fact that consumer prices increased last year practically as much as in the previous 12 years combined. Similar to 2021, the increase in consumer prices in 2022 was mainly determined by the increase in the prices of energy resources and food. This means that the prices of goods grew faster and their contribution to average inflation was significantly higher than that of the services. In 2022, the prices of goods increased by 20.6% on average, while service prices grew on average by 8.1%.

The largest contribution to the increase in consumer prices in 2022 was determined by the increase in the price of housing-related services by 35.1%, which was influenced by the increase in the prices of electricity, gas, thermal energy, solid fuel, as well as water supply and waste collection services. The main reason for the increase in the price of this group of goods

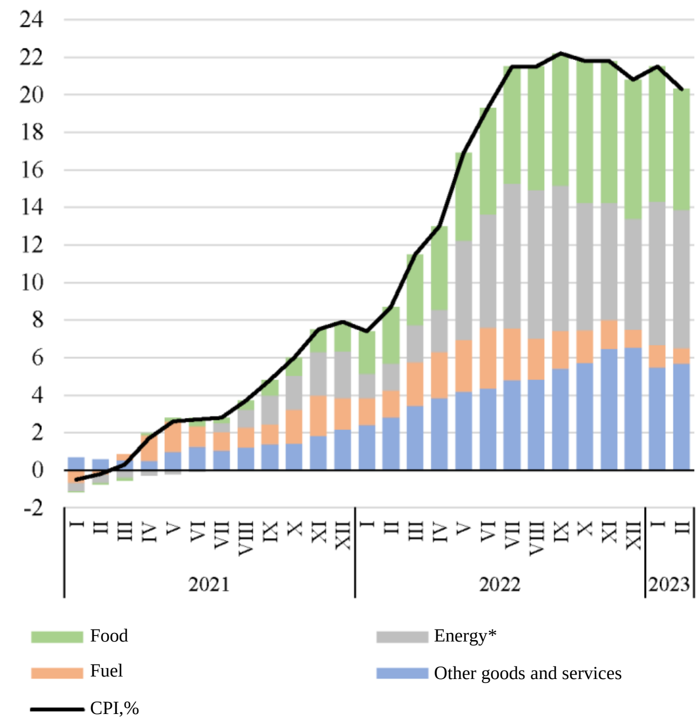
[2] Data source: Latvijas Banka, CSB

and services is the high price of gas in global markets, considering the fact that gas is used in the production of electricity and thermal energy, directly affecting the rise in the prices of these goods. Gas futures prices on the European market started to increase as early as autumn of 2021, driven by higher demand for gas in Asia as economic activity increased after the pandemic. In turn, Russia's invasion of Ukraine destabilised the gas market even further.

The price of gas on the European market at the end of summer of 2022 reached the historically highest level of EUR 345/ MWh, while before the pandemic the average gas price in Europe did not exceed EUR 20/MWh. Since autumn last year, the price of gas has been gradually decreasing, reaching EUR 80/MWh at the end of December. In general, in 2022, the average price of gas on the *Spot* market in Europe was EUR 134/MWh, as opposed to EUR 46/MWh in 2021. It should be noted that gas prices also rose rapidly in other regions of the world. Latvian households paid 99.2% more for gas last year than in 2021. In turn, electricity and thermal energy were respectively 36.2% and 52.9% more expensive. Differences in price changes between the above-mentioned energy resources are determined by different tariff calculation methodology, as well as different government support instruments for each type of energy resources. The sharp increase in gas prices contributed to the increase in demand for pellets and wood chips as alternative fuel, which also led to a 76.2% increase in solid fuel prices.

A significant contribution to the increase in consumer prices in 2022 was ensured by a 21.6% increase in the prices of food and non-alcoholic beverages, although the increase in food prices is comprehensive, as prices increased for all food. Compared to 2021, the price of oil increased by 30.4%, dairy products - by 28.3%, bread - by 25.9%, fish - by 19.4%, meat - by 16.8%. Vegetables and fruits rose in price by 17.4% and 13.7%, respectively. Food and non-alcoholic beverages make up a quarter of the total household consumption basket, so price increases for this group of goods have a significant impact on expenditure and purchasing power of population. Last year, the contribution of the group of food products and non-alcoholic beverages to annual inflation amounted to 5.5 ppt. Though the prices of unprocessed foods in the world have been showing downward dynamics since last April, they were on average by 14.3% higher than in 2021. In addition, the high processing and logistics costs due to the increase in energy prices do not allow reduction in the final price of food, confirming that the increase in energy prices has a significant impact on the prices of other goods as well.

The prices of energy resources have a negative impact on production and logistics costs, thereby raising the prices of other goods and services. In addition to this, rising wages are also putting pressure on costs of enterprises, forcing entrepreneurs to review their prices, as evidenced by the growth of core inflation. In 2022, core inflation reached 10.9%, compared to 1.9% in the previous year. More details regarding consumer price changes in 2022 and 2023 by months can be found in Figure 2.4.



*The energy group includes electricity, gas, thermal energy, solid fuel

Figure 2.4. Contribution to annual inflation by the source of origin (percentage points) and average consumer price variation (CPV, %)3

Groups and sub-groups	2022	Jan 2023	Feb 2023
Average inflation	17.3	21.5	20.3
Food and non-alcoholic beverages	21.6	28.2	25.3
Housing rent	2.9	-0.2	-1.2
Electricity	-36.2	89.8	90.2
Gas	99.2	65.7	65.6
Heat	52.9	-69.6	66.4
Fuel	38.2	17.8	12.0
Transport services	2.5	3.7	6.2
Healthcare	6.9	10.3	10.1
Leisure and culture	6.3	11.1	11.5
Restaurants and hotels	13.4	18.6	18.2
Various goods and services	11.8	17.4	+17.2

Table 2.1. Annual inflation by groups in 2022 on average and in January and February 2023, %

In 2022, the increase in consumer prices in Latvia was the third highest among EU Member States and significantly higher compared to the average price increase in the Eurozone of 8.4%. The differences from the average inflation indicators of the Eurozone can be explained by several factors. First of all, it is determined by a different structure of the consumer basket. In 2022, the expenditure on food and energy products in Latvia reached a total of 42% of the total consumption expenditure, while in the Eurozone they only accounted for 27% on average. If Latvia's consumption structure were the same as in the Eurozone, inflation in 2022 would have been 12.9% - 4.3 ppt lower than actual inflation. Just as a low-income society spends most of its income on essential needs such as food, electricity, heating, in countries with a relatively lower income level, food and energy resources make up the majority of their consumption. The sharpest price increases in 2022 were recorded exactly for food and energy resources.

Secondly, countries used different strategies to combat high inflation. In separate Eurozone countries, taxes were directly used to lower food and energy prices by applying a reduced VAT or excise tax rate for a certain period of time. Consumption taxes in Latvia have slightly increased in recent years. For example, the excise tax rate for tobacco products has been increased for several years in a row. In 2022, the excise duty has also been increased for certain alcohol products and non-alcoholic beverages. In recent years, the natural resource tax rate for waste removal has been increased on an annual basis. At the same time, in Latvia, in order to reduce the rapid increase in utility tariffs, support measures were developed to reduce the prices of energy resources. As a result, average inflation in 2022 was 1.2 ppt lower - without the State support measures, average inflation in Latvia would have reached 18.5% last year.

Thirdly, wages in Latvia have grown faster than in the Eurozone. This both strengthens demand and creates additional costs for manufacturers, who can then further include them in

[3] Data source: CSB, MoF calculations.

product prices. Hence, it has an impact on core inflation. In 2021, wages in Latvia increased by an average of 11.8%. In turn, in 2022, the average wage increased by 7.5%. There are also other factors that determine the difference in inflation between countries, such as the ability of enterprises to absorb the pressure of imported inflation on account of their profit, as well as the activities of regulatory authorities as regards reviewing and approving utility tariffs.

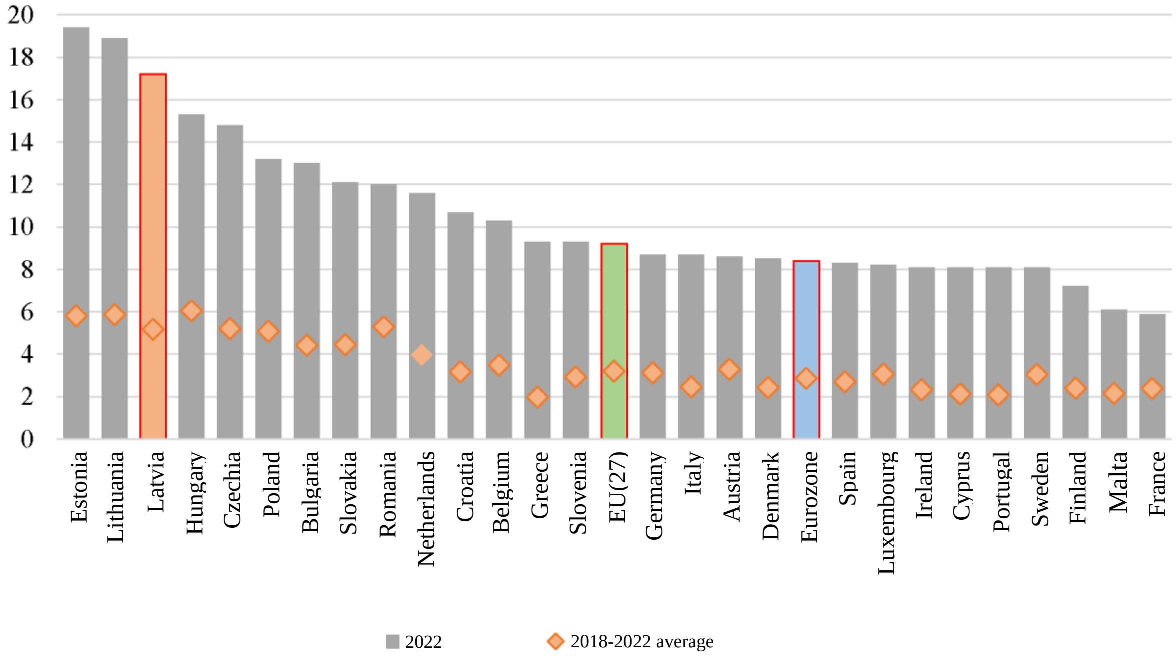


Figure 2.5. Harmonised consumer price index changes in 2022 and 5-year average growth for the period of 2018-2022 EU Member States, EU and the Eurozone on average, %[4]

Inflation continued to exceed the 20% mark in January and February 2023, affected by persistently high prices of food and utilities. However, already in March, annual inflation will be below 20%, continuing to also decrease in the coming months. It is expected that annual inflation will decrease to 10% in the middle of this year, but will fluctuate at the level of 3%-4% at the end of the year. Such dynamics of consumer prices will be determined by last year's high base, the decisions made by the government regarding the reduction of thermal energy, gas and electricity tariffs, which are valid until April 2023, as well as the reduction of gas prices. The price of gas in Europe reached the pre-war level at the beginning of March 2023, fluctuating around EUR 50/MWh, however, the positive effect of the reduction in gas prices will only be felt in the second half of this year. Regarding oil prices, when developing the macroeconomic development scenario, it was assumed that the average price of *Brent* crude oil in 2023 will be USD 90 per barrel, which is 10% less than the previous year. Thus, it is expected that the price of fuel in 2023 will be lower on average than in 2022. At the beginning of this year, downward dynamics are also demonstrated by the prices of unprocessed food in the world. In February this year, prices of unprocessed food were 8.1% lower compared to the corresponding month of the previous year, which was determined by the decrease in the prices of oil and dairy products. This, together with lower production costs (due to cheaper energy resources), will reduce the level of food prices in Latvian stores as well. However, this effect could also be expected closer to the middle of the year.

According to the MoF forecasts, consumer price growth will continue in 2023, with average inflation reaching 10.0%, while core inflation will be 7.2%. In 2024, it is expected that

[4] Data source: Eurostat, MoF calculations.

electricity, gas and heat could have a large deflation, which will lower the average inflation, however, the tense situation in the labour market will keep core inflation high. Thus, in 2024, average inflation will be 2.2%, and core inflation will reach 4.5%.

Labour Market

Although economic growth decelerated from 4.1% to 2.0% last year due to the war launched by Russia and rising energy prices, the negative impact on the labour market was practically not felt, and the unemployment rate fell from 7.6% in 2021 with the lifting of pandemic restrictions to 6.9% in 2022 as a whole. The negative impact of Covid-19 at the beginning of last year was further mitigated by the State support measures, but during the year, according to the labour force survey, the unemployment rate decreased from 7.3% in Q1 to 6.7% in Q4.

According to the data of the State Employment Agency on registered unemployment, the number of registered unemployed started to increase again in the last months of 2022, but this increase was fully consistent with the seasonal fluctuations of the labour market; the number of unemployed stabilised in January and February of this year, but in the first weeks of March it started to decrease again. Also, in 2023 as a whole, as economic growth continues to decrease, no significant increase compared to 2022 is predicted and the unemployment rate could be only 0.2 ppt higher than last year.

Last year, the number of population employed in the national economy, according to the data of the labour survey, increased by 2.6%, reaching 886.2 thousand, which was ensured by the full return to the labour market of employees who received unemployment benefits during the pandemic, and was additionally facilitated by the admission of Ukrainian citizens, of whom according to the data of the State Revenue Service, at the end of 2022, 7.8 thousand were employed, while in total, more than 11 thousand Ukrainians started to work during the year. At the same time, it should be pointed out that, despite the significant increase in 2022, the number of employed is still 2.6% or 23.6 thousand less than in 2019 before the Covid-19 pandemic, and this reduction was also affected by the decrease in the number of the working age population, and the fact that the volumes of certain sectors (such as transport, accommodation and catering) have still not returned to their previous levels.

In 2023, the total number of employed could remain at the level of last year, but a slight decrease in the number of the employed is expected in the coming years, which will be determined by both slightly lower economic growth and a decrease in the working age population as a result of demographic trends.

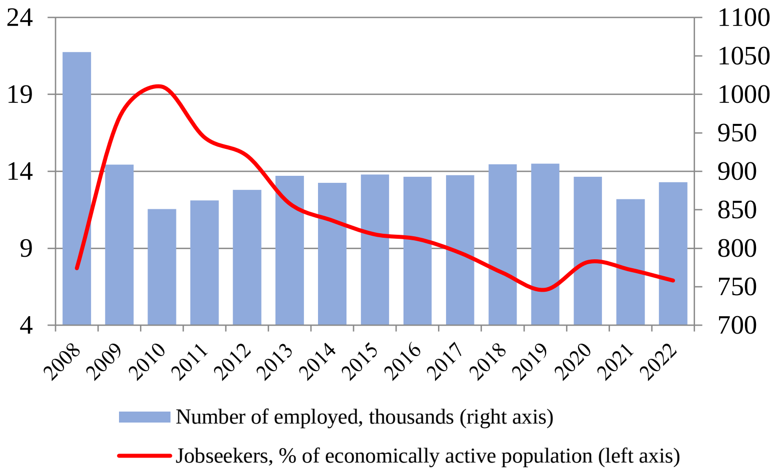


Figure 2.6. Employment and unemployment in 2008-2022

After a very rapid increase of 11.8% in 2021, the growth of the average monthly gross wage slowed down a bit in 2022, with the wage increase amounting to 7.5% and the average wage reaching EUR 1 373. Slower growth was determined by both lower wage increases in the public sector, primarily health and education, where wages had grown very rapidly in previous years, as well as a wider return to the labour market of the employees of lower paid sectors, including accommodation and catering. Wage growth rate was also reduced by the fact that, unlike the previous year, the minimum wage was not increased.

In the private sector, wage growth was slightly faster in 2022, with the average monthly gross wage increasing by 8.0% to EUR 1 375, while in the public sector, the wage grew by 6.2% to EUR 1 373. Due to this faster increase, last year the wage in the private sector exceeded the average wage in the public sector for the first time.

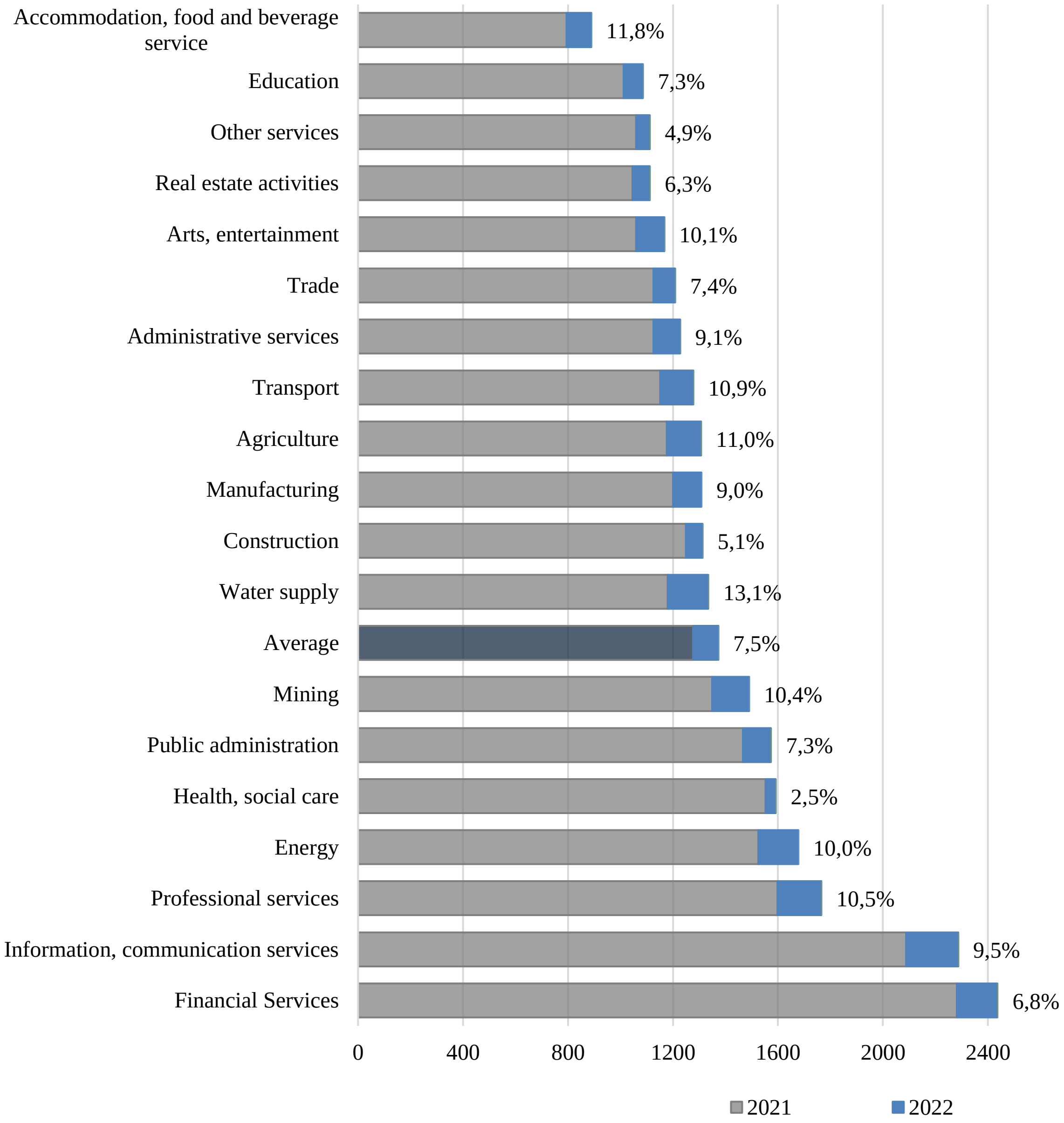


Figure 2.7. Average monthly gross wage by sector, euro and changes in %

From the sectoral perspective, the work remuneration increased most rapidly during the year in the water supply, wastewater and waste management and rehabilitation sector - by 13.1%, in the accommodation and catering services sector - by 11.8%, as well as in the agriculture, forestry, fisheries, transport and storage sector - by 11.0%. The lowest growth was observed in the health and social care sector - by 2.5%, in the other services sector - by 4.9% and in construction - by 5.2%.

The highest monthly gross wage was still recorded in the financial services sector where it was EUR 2 437, and in the information and communication services sector, where it was EUR 2 287, whereas, the lowest wage was in the accommodation and catering sector - EUR 889.

It is expected that in 2023 the wage growth rate will accelerate to 8.5%, which will be determined both by the considerable increase of the minimum wage from EUR 500 to EUR 620, the increase in funding for public sector, and the still high level of inflation, which will force the private sector enterprises to carry out wage increases. In the coming years, the annual gross wage growth rate will slow down, stabilising close to the productivity growth rate in the medium term.

2.3. Macroeconomic Development Scenario

The medium-term macroeconomic development scenario for 2023-2026 was drafted in February 2023, based on the available macroeconomic information for the period until the end of 2022, including the GDP flash estimates for Q4 of 2022. In turn, the latest EC and IMF 2023 winter forecasts were used as a basis for the external environment underlying Latvia's export forecasts. When drafting the forecasts of macroeconomic indicators, the MoF has consulted the experts of Latvijas Banka and the MoE, as well as the experts of the EC and the IMF. Forecasts of the macroeconomic indicators have been approved by the Fiscal Discipline Council, by publishing its opinion on 10 February 2023.

Baseline Scenario

According to the scenario developed in February of this year, Latvia's GDP will remain at the level of 2022 this year, while in 2024 economic growth of 2.0% is projected. Compared to the previous forecasts developed at the beginning of December of 2022, the forecast GDP growth for 2023 has been increased by 0.6 percentage points, while for 2024 GDP growth is forecast to be one percentage point lower than in December last year. For the next two years - 2025 and 2026 - economic growth is forecast of 2.9% and 2.8%, respectively.

The high level of energy resource prices will continue to affect economic development, slowing down private consumption, which after a rapid increase in 2022 as a result of the lifting of Covid-19 restrictions, will decrease by 0.9% this year. However, this is 2 percentage points higher than the December 2022 forecast, as this winter turned out to be warmer than expected. As prices stabilise and inflation declines to pre-war levels, private consumption growth will recover to 2.1% in 2024, and private consumption will grow by 4% and 3.5% in the next two years, respectively.

Foreign trade will also be a significant factor affecting economic development, but in the forecast period, such a large increase in external demand as it was in 2022 is not expected. It is to be forecast that, with the stabilisation of external demand, the volume of exports at constant prices will remain unchanged or increase by 0%. This will also be partially determined by the fact that trade volumes with Russia and Belarus will remain at a low level and the situation will not change dramatically. However, in the following years, an increase in exports of 4-5% is predicted, similar to that which was predicted in December 2022.

Investment (gross fixed capital formation) growth in 2023 is forecast at 1%, which is approximately 2 percentage points more than forecast in December 2022. The increase will be determined by the expected faster use of EU funds. In turn, in the coming years, investment growth will be below 5%, assuming that the investment environment, including price stability and business confidence, will be more favourable than this and last year.

The number of population employed in the national economy in 2023 is predicted to be at last year's level, because the economic growth is slowing down, however, a fall in GDP is not predicted either. In the coming years, a slight decrease in the number of the employed is predicted, which is mainly related to the decrease in the number of working age population. A slight increase of 0.2 percentage points is predicted for the unemployment rate in 2023. In the following years, faster economic growth and demographic trends will determine a slow decline in the unemployment rate to 6.4% in 2025.

In 2023, the average monthly gross wage growth rate will accelerate to 8.5%, which will be determined both by the considerable increase of the minimum wage from EUR 500 to EUR 620, the increase in funding for public sector, and the still high level of inflation, which will force the private sector enterprises to carry out wage increases. In the coming years, the annual gross wage growth rate will gradually slow down, stabilising close to the productivity growth rate in the medium term.

The average annual inflation in 2023 is forecast at the level of 10%, which is a significantly lower price increase than in 2022. However, compared to the forecast at the beginning of December 2022, the inflation forecast has been raised by 1.5 percentage points. This increase was determined by the increased heat, electricity and gas tariffs at the end of the year, as well as stronger second-round effects of inflation. In 2024, inflation will continue to slow down, with prices rising by 2.2% and then stabilising at 2.5%.

Table 2.2. Growth and related factors

	ESA code	2022*	2022*	2023	2024	2, 025	2026
		MEUR	Growth %				
1. GDP at current prices	B1*y	39 081	16.4	11.7	5.5	5.7	5.5
2. GDP at 2015 prices	B1*y	28 768	2.0	0.0	2.0	2.9	2.8
GDP by expenditure at 2015 prices							
3. Private consumption	P3	17 970	8.1	-0.9	2.1	4.0	3.5
4. Public consumption	P3	5 545	2.8	1.2	0.8	0.1	0.5
5. Gross fixed capital formation	P51	6 630	0.7	1.0	4.8	5.0	5.0
6. Changes in inventories and acquisition of valuables	P52+P53	2 582	-	-	-	-	-
7. Export	P6	20 103	9.1	0.0	4.3	4.6	5.0
8. Import	P7	24 063	11.6	0.5	3.9	4.7	5.0
Contribution to GDP growth							
9. Total domestic demand	P3+P51		5.5	-0.1	2.6	3.7	3.5
10. Changes in inventories and acquisition of valuables	P52+P53		-0.5	0.5	-0.3	0.0	0.0
11. Export-import balance	B11		-2.9	-0.4	-0.3	-0.8	-0.7

** 2022 data – CSB as at 28.02.2023*

Cyclical Development of the Economy

Thanks to internal and external demand, Latvia's economy grew by an average of 3.2% per year between 2011 (the first post-recession year) and 2019, marking the rising phase of the economic cycle. Upon completion of the EU Funds cycle, in 2019, the cyclical slowdown of the economy started to emerge and investment growth rates declined from 11.6% on average in 2017-2018 to 6.9% in 2019. As a result, the growth in GDP in 2019 slowed down to 2.5%. Whereas, already in 2020, the slowdown of the economic cycle was reinforced by the Covid-19 pandemic, affecting the development of all economic sectors and, in some sectors related to tourism, leaving considerable effects on the potential GDP growth and sharply decreasing the established positive output gap. As a result, the output gap that had been positive since 2015, became negative in 2020. After the gradual lifting of the Covid-19 restrictions, the economy had a chance to return to the growth phase, but the war initiated by Russia in Ukraine again slowed down the potential GDP development and the economy went into recession again.

According to the scenario of February this year, the negative output gap would disappear within three years until the economy returns to the potential growth level, and, from 2026, would continue to increase by about 2% growth. Overall, a similar medium-term output gap estimate is also included in the EC forecasts of autumn of 2023.

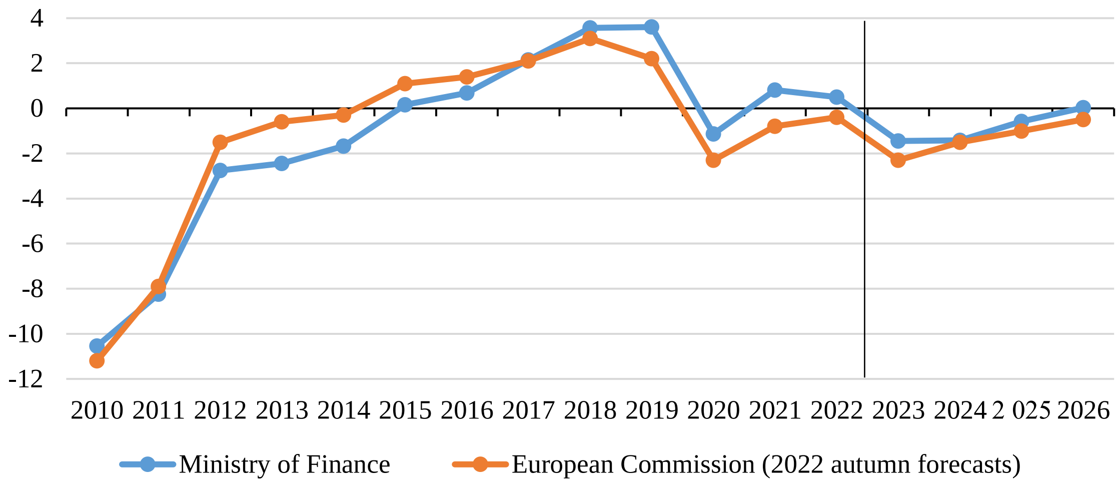


Figure 2.8. Output gap, %

The potential GDP growth of GDP during the forecast period will be basically determined by the total productivity growth, the input of which comprises around 1.3 percentage points in the period until 2024, which was characteristic during the period of economic rise. The rest of the potential GDP growth will be ensured by the capital input, constituting approximately one percentage point, while the labour force input will become negative due to demographic situation, especially from 2025, which will be compensated by steeper productivity growth. According to the MoF calculations, the potential GDP growth will be around 2% in the medium term.

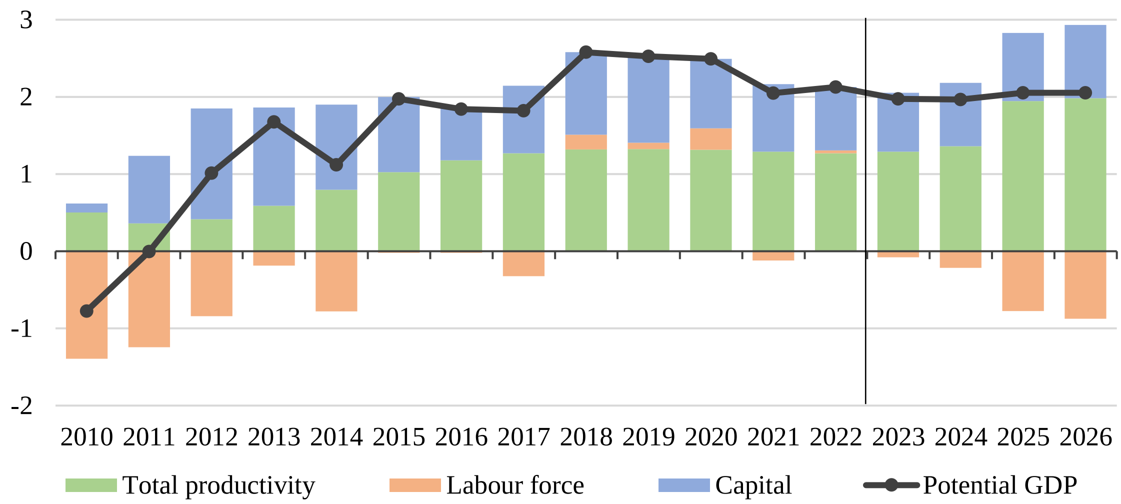


Figure 2.9. Potential GDP growth and input of components, %

3. General Government Budget Balance and Debt

3.1. Fiscal Policy Strategy and Medium-Term Targets

3.1.1 Fiscal Policy Strategy

The Covid-19 pandemic has triggered significant changes in the previously implemented fiscal policy, which is based on the compliance with the structural deficit objective - 0.5% of GDP.

In 2020, the general escape clause of the Stability and Growth Pact was activated in the EU by allowing the EU Member States to increase the general government budget deficit in 2020 to such an extent as is necessary to mitigate the economic harm caused by the Covid-19 pandemic. In its Annual Sustainable Growth Strategy 2021, the EC announced that the general escape clause will also remain in force in 2021, emphasising that the Member States are obliged to provide targeted and temporary fiscal support to their economies in 2021, by ensuring fiscal sustainability in the medium term at the same time. Whereas, in its Communication of 3 March 2021, providing general guidance to the Member States regarding the implementation of fiscal policy in the next period, the EC specified that according to the that time forecasts it is necessary to continue applying the general escape clause also in 2022 and to deactivate it starting from 2023. It was planned to adopt the final decision on the basis of forecasts of spring 2021, in the first half of May 2021. However, the final decision was not taken. In the 2021 Spring package communication, the EC confirmed that the general escape clause of the Stability and Growth Pact would be maintained in 2022; however, as regards 2023, it did not adopt a final decision but maintained its earlier position that it is expected that the clause would be deactivated starting from 2023. On 2 March 2022, the EC published Fiscal Policy Guidance for 2023. These guidelines indicate that, on the basis of the EC forecasts of winter 2022, it is expected that the clause will be deactivated from 2023; however, given the high uncertainty, this will be reassessed on the basis of the EC 2023 Spring forecast. On 8 March of this year, the EC published Fiscal Policy Guidance for 2024 and invites to take them into account when preparing the Stability Programmes this year. It states that the EU economy has recovered from the Covid-19 crisis and, despite the persisting great uncertainty regarding the development and consequences of Russia's invasion of Ukraine, the general escape clause is being cancelled from 2024 onwards. Later in the spring (provisionally, in May 2023), country-specific fiscal recommendations will be prepared to be followed when preparing the General Government Draft Budgetary Plans for 2024. Fiscal recommendations will be based on the targets set by the Stability Programme.

Latvia's Fiscal Policy Strategy 2022-2025 was approved during the preparation of the previous Stability Programme[5] and was aimed to set the policy to return to fiscal rules according to the FDL.

If in 2020, 2021 and 2022 both the fiscal provisions of the Stability and Growth Pact and the FDL deficit restricting rules were suspended, in 2023 the FDL rules are applied in full, but from 2024 onwards with the cancellation of the general escape clause, the rules of the Stability and Growth Pact are in force.

The Fiscal Policy Strategy is based on two basic principles:

[5] Adjustments were made by Minutes of the Cabinet Meeting No. 52 § 4 and Minutes of the Cabinet Meeting of 22 December 2022 No. 67, § 1.

1. The general government structural deficit is reduced by 0.5% of GDP every year until it reaches the level of 0.5% of GDP. Henceforth, it is maintained at the said level;
2. The expenditures related to Covid-19 and the war in Ukraine are recognised as one-off expenditures and are excluded from the structural balance target.

Accordingly, the Fiscal Policy Strategy distinguishes between "peacetime" expenditures, which are financed within the framework of fiscal conditions starting from 2023, and "crisis time" expenditures, which are financed outside the structural deficit target.

The Fiscal Policy Strategy defines the following categories of "crisis time" expenditures approved by the Cabinet:

1. expenditure related to mitigating the negative consequences of the Covid-19 pandemic;
2. expenditure related to increases in defence and internal security funding above the level of 2022;
3. expenditure related to compensatory measures for the significant increase in energy prices in 2021 and 2022 are considered as one-off measures in the calculation of the general government budget structural balance, within the meaning of Section 5, Paragraph three, Clause 3 of the FDL. In the following years, these expenditures are recognised as one-off measures, if the increase in energy prices in accordance with Article 5(1) of Regulation (EU) No. 1175/2011 of the European Parliament and of the Council of 16 November 2011 amending Council Regulation (EC) No. 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies is considered to be "unusual events outside the control of the Member State concerned which has a major impact on the financial position of the general government";
4. expenditure related to support measures for people fleeing Ukraine due to the Russian invasion.

It should be noted that such division is carried out within the framework of Latvia's fiscal strategy. The legal framework of the Stability and Growth Pact does not provide for such a division and all expenditures are included in the calculation of the structural balance. Therefore, the general government budget structural deficit is calculated differently – to comply with the FDL rules, the nationally determined structural deficit is used (excluding "crisis time" expenditures) and – to comply with the Stability and Growth Pact rules, the structural deficit determined according to the EU methodology is used (including also "crisis time" expenditures).

This circumstance creates differences in determining the amount of "crisis time" expenditures in 2023 and in subsequent years. In 2023, there were no restrictions on the volume, because the FDL rules are in force this year, but the EU fiscal rules for limiting the structural deficit have been suspended. In turn, in 2024, both the FDL rules and the rules of the Stability and Growth Pact are in force, stipulating that the structural deficit is reduced by 0.5% of GDP per year until it reaches the medium-term objective, which is -1% of GDP for Latvia. This circumstance imposes a limit on the amount of "crisis time" expenditure in 2024 and in subsequent years.

It should also be noted that the amount of "crisis time" expenditures and actual expenditures to be included in this category are set by the current the State Budget Law and the Medium-Term Budgetary Framework Law. By the law On the State Budget for 2023 and Budgetary Framework for 2023, 2024 and 2025 it was determined that the following "crisis time” expenditures (one-off measures) shall be excluded from the general government budget structural balance target:

1) one-off expenditure related to mitigating the negative consequences of the Covid-19 pandemic;

2) one-off expenditure for national defence and internal security:

a) for investments to ensure the continuity of the State limited liability company “Latvijas Televīzija” (*Latvian Television*) in the event of an external threat to the State;
b) for the creation of state border infrastructure and investments in strengthening the State security institutions;
c) for strengthening the national defence capabilities;
d) for the purchase of special firefighting and rescue vehicles;
e) for the State Fire and Rescue Service depot - for the construction of disaster management centres;
f) for providing the population with essential industrial goods in the event of a threat to the State;
g) for strengthening cyber security;
h) for providing the structural units of the State Police Riga Region Board with appropriate premises;

3) one-off expenditure for compensation of the significant increase in energy prices;

4) one-off expenditure for the support of Ukrainian civilians in Latvia;

5) one-off expenditure for the support of Ukraine;

6) an increase of 100% of the base expenditure of national defence compared to the previous year. In the first year after an increase - in the of amount of 80%, in the second year after an increase - 60%, in the third year after an increase - 40% and in the fourth year after an increase - 20%.

The fiscal impact of the one-off measures specified in Table 3.1 has been taken into account in preparing this Stability Programme.

Table 3.1. One-off measures, MEUR

	2020	2021	2022	2023	2024	2025	2026
GDP (MEUR)	30 294	33 588	39 081	43 637	46 017	48 642	51 329
	fact/estimate			forecast			
One-off and other temporary measures (MEUR), incl.	**-1 018.7**	**-2 054.7**	**-1 878.6**	**-1 307.1**	**-687.1**	**-709.4**	**-348.1**
COVID-19 pandemic mitigation measures	-960.8	-2 102.8	-796.4	-102.7	0.1	0.0	0.0
measures to reduce energy price increase		-1.9	-1 001.2	-606.8			
defence and internal security funding				-194.7	-302.7	-358.8	-348.1
support for refugees from Ukraine			-81.0	-102.0			
other	-57.9	49.9		-300.8	-384.5	-350.6	
	fact/estimate			forecast			
One-off and other temporary measures, % of GDP, incl.	**-3.4**	**-6.1**	**-4.8**	**-3.0**	**-1.5**	**-1.5**	**-0.7**
COVID-19 pandemic mitigation measures	-3.2	-6.3	-2.0	-0.2	0.0	0.0	0.0
measures to reduce energy price increase		0.0	-2.6	-1.4			

defence and internal security funding				-0.4	-0.7	-0.7	-0.7
support for refugees from Ukraine			-0.2	-0.2			
other	-0.2	0.1		-0.7	-0.8	-0.7	

Accrued Balance Deviations

Section 11 of the FDL provides for an automatic *ex-post* correction mechanism, i.e., adjustment of the minimum planned structural balance of the general government budget, in order to ensure that actual deviations of previous years from the balance rule (Section 10 of the FDL) do not impact the balanced position of the budget. Accrued balance deviations are shown in Table 3.2.

Table 3.2. Accrued balance deviations

		2013	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**
1	GDP (at current prices), MEUR	22 749	23 626	24 572	25 371	26 984	29 154	30 679	30 294	33 588
2	Actual structural balance of the general government budget, % of GDP	**-0.3**	**-0.9**	**-1.5**	**-0.4**	**-1.6**	**-2.2**	**-1.5**	**-0.5**	**-1.2**
3. (1.×2.)	Actual structural balance of the general government budget, MEUR	-68.2	-224.0	-365.1	-103.8	-427.3	-640.2	-455.2	-166.0	-399.6
4	Minimum planned structural balance of the general government budget, % of GDP	**-1.3**	**-1.0**	**-1.0**	**-0.9**	**-1.0**	**-1.2**	**-0.6**	**-0.5**	**-2.1**
5. (1.×4.)	Minimum planned structural balance of the general government budget, MEUR	-295.7	-236.3	-245.7	-228.3	-269.8	-349.8	-173.8	-140.8	-705.3
6. (3.-5.)	Financial year balance deviation, MEUR	227.5	12.3	-119.3	124.5	-157.5	-290.4	-281.4	-25.1	305.7
7. ((6.:1.) ×100)	Financial year balance deviation, % of GDP	**1.0**	**0.1**	**-0.5**	**0.5**	**-0.6**	**-1.0**	**-0.9**	**-0.1**	**0.9**
8. (Σ(6.))	Amount of accrued balance deviations (cumulatively), MEUR	227.5	239.8	120.5	245.0	87.6	-202.8	-484.2	-509.4	-203.7
9. ((8./1.) ×100)	Amount of accrued balance deviations, % of GDP	**1.0**	**1.0**	**0.5**	**1.0**	**0.3**	**-0.7**	**-1.6**	**-1.7**	**-0.6**
10	Rule of Section 11 of the FDL, % of GDP	**-0.5**	**-0.5**	**-0.5**	**-0.5**	**-0.5**	**-0.5**	**-0.5**	**-0.5**	**-0.5**
11	To be adjusted if 9<10									**To be adjusted**

If, during the execution of the budget, it is established that the accrued deviation of the actual structural balances from the amount of the planned balances is negative and reaches at least 0.5% of GDP, it must be adjusted. Accordingly, considering the fact that in 2021 the accrued deviation of the actual structural balances from the amount of the planned balances is negative and reaches the value of 0.6, according to Section 11 Paragraph five of the FDL, in the third year of the next medium-term budget framework the target of the of the general government budget structural balance shall be determined greater by 0.5% of GDP.

3.1.2 Observance of Fiscal Rules in Planning Medium-term Fiscal Policy

In a general case, the FDL provides that, when defining objectives of structural balance, a multi-stage method is being applied and it should concurrently provide for the compliance with the national level fiscal rules (balance rule, expenditure growth rule and expenditure inheritance rule), as well as the rules of the Stability and Growth Pact. It should be noted that the FDL conditions must be observed in the preparation of the medium-term budget framework, but the observance of these conditions is not legally binding during the preparation stage of the Stability Programme. The degree of detail in complying with these conditions depends on how significantly they affect the final result and in this context the degree of detail must be balanced against the goal of simplification.

Taking into account the fact that on 8 March of this year, the EC published the Fiscal Policy Guidance for 2024, which defines a flexible approach to the application of the terms of the Stability and Growth Pact, providing that the main indicator of the compliance of the fiscal conditions will be compliance with the fiscal trajectory of the Stability Programme, in this Stability Programme it is possible to carry out a simpler calculation of the structural balance target, renouncing the requirement to simultaneously also ensure the expenditure growth rule. Also, at this moment, it is not necessary to check the expenditure inheritance rule, because the maximum difference from the non-application of this rule does not exceed 0.1% of GDP, which is an acceptable deviation at this stage of fiscal forecasting.

3.1.3. Structural Balance Targets of the General Government Budget for 2024, 2025 and 2026 and Fiscal Trajectory of the Stability Programme

Structural Balance Targets

In accordance with the Fiscal Policy Strategy, the structural balance target for 2024-2026 has been determined by taking the structural balance forecast of 2023 as the basis.

According to the updated general government budget forecasts for the medium term with no policy change, the general government budget deficit is estimated at 4.0% in 2023.

Considering the output gap and the amount of one-off measures, it can be established that the general government structural deficit is -0.5% of GDP in 2023 (see Table 3.3). In 2023, the structural deficit with no policy change is forecast to be -0.4% of GDP. Thus, it is lower than the medium-term objective set by the FDL, which is -0.5% of GDP. If, in the general case, according to the Fiscal Policy Strategy, the structural deficit would have to be reduced by 0.5% of GDP annually until it reaches the value of 0.5% of GDP in 2025, then according to the most current forecasts, reducing the structural deficit is not necessary, it can even be increased and henceforth maintain the FDL at the maximum permissible level specified in Section 10 of the FDL.

In accordance with the above and taking into account the excess of the minimum limit value of the accrued deviations of actual structural balances and the need to adjust it in 2026, the general government budget structural balance target for 2024-2026 is set: -0.5% of GDP for 2024; -0, 5% for 2025 and 0% for 2026.

Table 3.3. General government structural balance targets

		2023	2024	2025	2026
GDP forecast, MEUR	(1)	**43637**			
General government budget balance 2023, MEUR	(2)	**-1753.3**			
General government budget balance 2023, % of GDP	(3)=(2)/(1)*100	**-4.0**			

		2023	2024	2025	2026
Output gap, % of the potential GDP	(4)	**-1.5**			
Cyclical balance component, % of GDP	(5)=0.378*(4)	**-0.5**			
One-off and other temporary measures, % of GDP, incl.	**(6)=(7)+(8)+(9) +(10)+(11)**	**-3.0**			
COVID-19 pandemic mitigation measures	(7)	-0.2			
measures to reduce energy price increase	(8)	-1.4			
defence and internal security funding	(9)	-0.4			
support for refugees from Ukraine	(10)	-0.2			
one-off expenditure for national defence and internal security	(11)	-0.7			
general government structural balance forecast and targets, % of GDP	**(12)=(3)-(5)-(6)**	**-0.5**	**-0.5**	**-0.5**	**0.0**

<u>Fiscal Trajectory of the Stability Programme</u>

Considering the fact that the expenditure specified in Table 3.1 according to the EU methodology are not excluded from the calculation of the structural balance, the general government structural balance of 2023 is -3.5% of GDP (according to the EU methodology).

Table 3.4. Structural balance targets of the general government (the EU methodology)

		2023	2024	2025	2026
GDP forecast, MEUR	(1)	**43637**			
General government budget balance 2023, MEUR	(2)	**-1753.3**			
General government budget balance 2023, % of GDP	(3)=(2)/(1)*100	**-4.0**			
Output gap, % of the potential GDP	(4)	**-1.5**			
Cyclical balance component, % of GDP	(5)=0.378*(4)	**-0.5**			
One-off and other temporary measures, % of GDP, incl.	**(6)=(7)+(8)+(9) +(10)+(11)**	**0.0**			
COVID-19 pandemic mitigation measures	(7)	0.0			
measures to reduce energy price increase	(8)	0.0			
defence and internal security funding	(9)	0.0			
support for refugees from Ukraine	(10)	0.0			
one-off expenditure for national defence and internal security	(11)	0.0			
general government structural balance forecast and targets, % of GDP	**(12)=(3)-(5)-(6)**	**-3.5**	**-3.0**	**-2.5**	**-2.0**

The maximum permissible level of one-off measures is limited so that the structural deficit of the general government budget determined according to the EU methodology would decrease by at least 0.5% of GDP annually until it reaches the medium-term objective, which is -1% of GDP for Latvia according to the EU methodology.

Considering the fact that the Fiscal Policy Guidance for 2024 published by the EC on 8 March of this year provides that the fiscal recommendations for the countries will be determined in accordance with the fiscal trajectory of the Stability Programme, for the purposes of this objective, the fiscal trajectory calculated in such a way so as to ensure the decrease of the structural deficit of the general government by 0.5% of GDP annually until it reaches the level of 1% of GDP is to be used.

3.1.4. Discretionary Measures

In between the Stability Programme 2022-2025 and this Stability Programme, fiscal policy decisions have been adopted. They include:

(i) measures included in the State Budget Law for 2023 and the Budgetary Framework Law for 2023, 2024 and 2025, which are not presented separately in this Stability Programme and are available in the General Government Draft Budgetary Plan of Latvia for 2023;

(ii) amendments to the law On Personal Income Tax, providing for abolition of the obligation to make advance PIT payments from economic activity. Their impact is specified in Table 3.5.

Table 3.5. Discretionary revenue measures

Detailed description*	Type of tax	ESA code	Accounting principle	Adoption status	Impact on the budget		
					2023	2024	2025
					% of GDP		
Cancellation of advance PIT payments (constant rule), total	PIT	D.5	Accruals	Partially adopted	-0.07	0.07	0,00
incl., State basic budget					-0.02	0.02	0.00
incl., local government budget					-0.05	0.05	0.00

3.2. Current Fiscal Situation

According to assessment of the MoF in the general government budget there was a deficit of EUR 1 838.8 million or 4.7% of GDP in 2022. Official data will be available at the end of April 2023, when *Eurostat* publishes general government budget deficit and debt data for 2022.

Compared to 2021, there is an improvement in the balance, but it is still significantly higher than before the pandemic and in the first year of the pandemic, i.e., 2020. The rapid deterioration of the balance in 2020 and 2021 can be explained by significant support measures for mitigating the consequences of the Covid-19 pandemic, while in 2022, as this support decreased, new support measures to reduce the increase in energy resource prices and support to Ukrainian refugee emerged. If the total impact of support measures on the deficit in 2020 was about EUR 1 billion or 3.2% of GDP and in 2021 it increased to EUR 2.1 billion or 6.3% of GDP, then in 2022, according to the MoF assessment, the total support increased the general government budget deficit by EUR 1.5 billion or 3.8% of GDP, with almost half of it being comprised of energy support and support to Ukrainian civilians. It should be noted that in the autumn of 2022, EUR 430 million or 1.1% of GDP from the State budget was used to purchase natural gas reserves, which along with the support measures can be considered as one-off expenditure. See a detailed description of the support provided by the government for mitigating the consequences of crisis in Chapter 3.3 of this Stability Programme.

With the biggest burden of expenditure falling on the central government, the year 2022 in this sub-sector of the general government ended in EUR 2.2 billion or 5.5% of GDP deficit, while thanks to a significant increase in tax revenue, the local government budget generated a surplus of 0.1% of GDP and the social security fund maintained a budget surplus of 0.7% of GDP (see Figure 3.1).

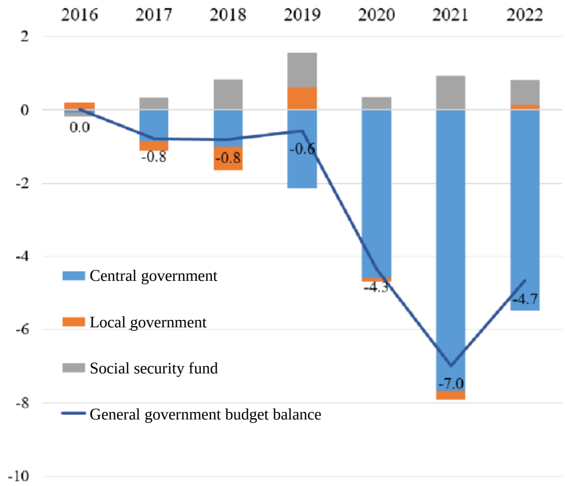


Figure 3.1. Budgetary balance of the general government by sub-sectors, % of GDP (Data source: Eurostat, MoF)

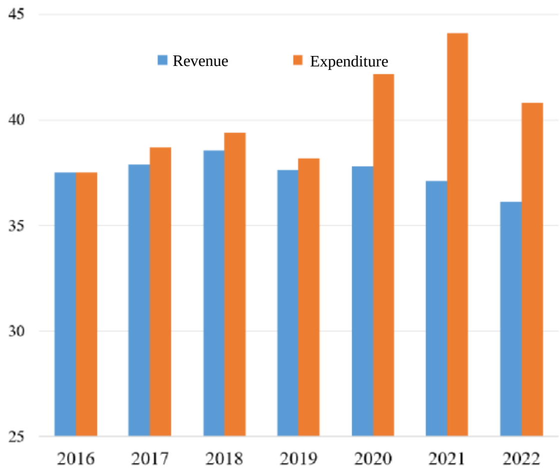


Figure 3.2. General government revenue and expenditure, % of GDP (Data source: Eurostat, MoF)

In 2022, as compared to 2021, general government budget revenue has grown by EUR 1 654.6 million or 13.3%, reaching EUR 14.1 billion or 36.1% of GDP (see Figure 3.2). The share of the general government budget revenue to GDP in 2022 decreased by 1 ppt. While in nominal terms, general government revenue grew, its share to GDP decreased, which can be explained by a stronger GDP increase rate at current prices than an increase in general government budget revenue. Higher revenues last year were significantly influenced by economic activity growth at the beginning of the year, as well as by the sharp increase in prices for all types of goods and services.

Tax revenue[6] comprises the largest part of revenue and, in 2022, it reached 30.3% of GDP, which is by 0.6 ppt lower than in 2021, considering the rapid GDP growth at current prices. In nominal terms, tax revenue increased by EUR 1 471.8 million or 14.2%, of which production and import taxes (D.2) increased by EUR 705.3 million or 15.6%. Value added tax (VAT) revenue amounted to EUR 3.6 billion, which was by EUR 796.2 million or 28.8% more than in 2021. The steep increase in VAT revenue in 2022 is basically related to the taxes paid in the trade sector, considering both the increase in internal demand and the sharp rise in consumer prices, when inflation in average increased by 17.3% during the last year. The rapid increase in the prices of energy resources contributed to higher taxes paid in the electricity, gas and heat supply sectors.

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

Current taxes on income (D.5) increased by EUR 347.9 million or 14.7%, as compared to 2021. Corporate income tax in 2022, due to the increase in the amount of distributable profit, grew by EUR 97.7 million or 34.7%, reaching EUR 378.8 million.

The average gross wage of the population employed in the national economy in 2022 grew by 7.5% and reached EUR 1 373, and unemployment decreased to 6.9% of the economically active population, ensuring PIT revenue growth of EUR 335.2 million or 17.4%. The positive situation in the labour market trends also influenced the social contributions revenue (D.61), which, as compared to 2021, increased by EUR 387.4 million or 11.4%.

Revenue from property income (D.4) in the amount of 0.7% of GDP remained at the level of 2021, while other revenue was 5.3% of GDP in 2022, which is 0.4 percentage points lower than in 2021 (see Figure 3.3). Property revenue was ensured by the dividends received in the State budget, while the decrease in other revenue can be explained by lower investment grants, including from the implementation of foreign financial assistance programmes.

During the first two months of 2023, the consolidated general budget revenue (according to the cash flow methodology) was EUR 246 million or 10.3% higher than in the respective period of last year, amounting to EUR 2.6 billion. The increase in general budget revenue is mainly related to higher tax revenue, which in January-February of this year in the amount of EUR 2 billion was EUR 248.1 million or 13.7% more than in the first two months last year. Revenues both from labour taxes and consumer taxes to the general budget have increased substantially. As the growth trends in the wage fund of the previous year continue, high increases can be observed in labour tax revenue. The sharp increase in VAT revenue, in its turn, is basically related to the taxes paid in the trade sector, taking into account the sharp increase in consumer prices, with the annual average inflation reaching 20.3% in February. The rapid increase in the prices of energy resources contributed to higher taxes paid in the electricity, gas and heat supply sectors.

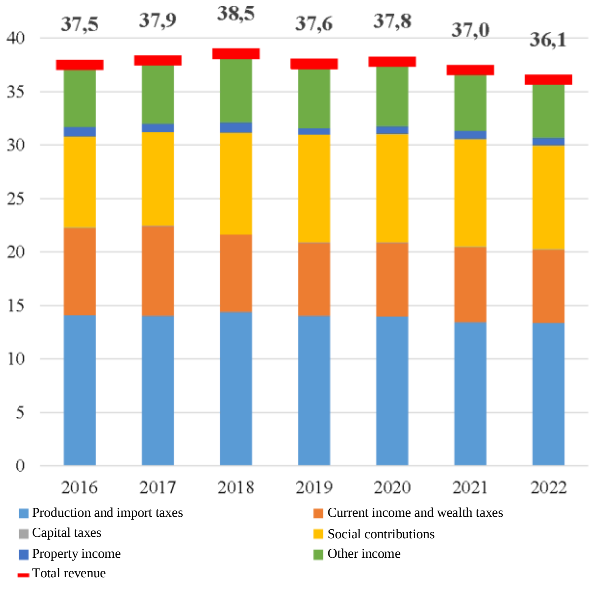


Figure 3.3. General government revenue structure, % of GDP (Data source: Eurostat, MoF)

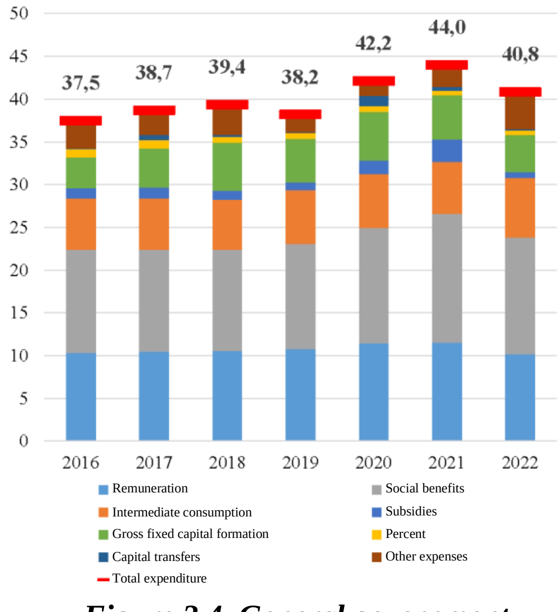


Figure 3.4. General government expenditure structure, % of GDP (Data source: Eurostat, MoF)

General government budget expenditure grew by EUR 1 142.8 million or 7.7%, reaching EUR 15.9 billion or 40.8% of GDP *(see Figure 3.4)*. The largest increase was ensured by the increase of other current transfers, which was by EUR 734.1 million or 78.2% higher than in 2021, considering the increase in subsidies for the health sector and the transport sector, as well as with the growing funding for the internal affairs sector and economic development. It should be noted that the share of general government budget expenditure in GDP decreased by 3.3 ppt in 2022, which was affected by lower expenditure for support measures due to the end of large-scale Covid-19 support programmes.

Total compensation of employees (D.1) in 2022 grew by EUR 100.2 million or 2.6%. The largest increase is observed in the local government budget, including the increase of remuneration for teachers. Central government expenditure for remuneration has also increased, mainly in defence and internal affairs entities.

Expenditure for social payments (D.632 and D.62) increased by EUR 271.3 million or 5.4%. However, the situation was different by the sub-sectors of the general government budget - while the central government expenditure for the payments of social nature decreased by EUR 150.9 million or 8.8%, the special budget shows an increase in expenditure by EUR 366.4 million or 11.5%. Lower central government expenditure can be explained by a significantly higher expenditure base in the corresponding period of 2021, as the downtime allowances, one-off allowances for seniors and families with children were disbursed due to Covid-19. By contrast, in the special budget, taking into account the very high pension indexation coefficient in 2022, higher expenditure for old-age pensions can be observed. Also, at the beginning of the year, the rapidly increasing number of disease cases due to the omicron variant of the Covid-19 virus contributed to the increase in expenditure for sickness benefits.

The general government budget expenditure for gross fixed capital formation (P.51G) in 2022 decreased by EUR 40.8 million or 2.3%. The amounts of the gross fixed capital formation were affected by lower estimates of the general government classified merchants' investment projects.

Intermediate consumption expenditure (P.2) last year increased by EUR 691.9 million or 34%, which can be primarily explained by the purchase of natural gas reserves last autumn, as well as the rising prices of energy resources, thus increasing expenses for utilities.

During the first two months of 2023, the consolidated general budget expenditure (according to the cash flow methodology) in the amount of EUR 2.5 billion was EUR 308.9 million or 14.1% higher than the year before. A rapid increase in expenditure can be observed for subsidies and grants, which in the amount of EUR 662 million was by EUR 127.9 million or 24% higher than the year before, attributable to the expenditure for support measures to reduce the increase in energy resource prices, which were paid out in a smaller amount at the beginning of last year, as well as by higher expenditure for the implementation of EU Funds' projects. In the two months of 2023, the expenditures for remuneration in the total budget were EUR 52.2 million or 13.8% larger than the year before. The growth is attributable to a significant increase in the minimum wage in the country, amounting to EUR 620 per month from 1 January 2023, as well as an increase in the State budget expenditure for wages of public sector employees, including in the defence and education sectors. Expenditures for goods and services were also higher than in January-February 2022, where due to the price increase, more was spent on heat energy, electricity, fuel, and road maintenance. Expenditures for the payments of social nature in the total budget in the two months of 2023 were EUR 46.9 million or 5.9% larger than in January-February 2022. However, the situation was different by the levels of budget - while in the State basic budget the expenditure for the payments of social nature decreased by EUR 104.5 million or 51.5%, the State special budget shows an increase in expenditure by EUR 137.1 million or 24.3%. Smaller expenditure in the basic budget can be explained by a significantly higher expenditure base in the corresponding period of 2022, due to the disbursement of a one-off benefit in the amount of EUR 50 to families with children and in the amount of EUR 20 to seniors to compensate for the negative effect from the increase in energy prices. By contrast, the special budget, taking into account the very high pension indexation coefficient, demonstrates EUR 115.7 million or 30.4% larger expenditure for old-age pensions.

3.3. Support Measures for Mitigating the Consequences of Crisis

In recent years, in Latvia, similar to the other countries of the region, there has been a need to allocate funding in addition to regular expenditure for mitigating the consequences of the Covid-19 pandemic, and since 2022 also for mitigating the impact of energy resource price increases and supporting Ukrainian refugees. As the rapid increase in prices continues in 2023, it is necessary to continue implementing measures to support the low-income population in order to reduce the impact of high energy resource prices. Support for refugees from the Ukrainian war will also be continued this year.

Covid-19 Support

In 2023, Covid-19 support funding is planned to be significantly smaller than in previous years (see Table 3.6), actually continuing only some of the commenced investment projects and providing funding for the purchase of Covid-19 vaccines that have been ordered in advance, as well as continuing the implementation of the programmes of the financial institution *ALTUM* with an impact until 2026, which results from the programme implementation indicators.

Table 3.6. Impact of government-approved support for mitigating Covid-19 consequences on the general government budget balance, MEUR

	2020	2021	2022	2023	2024	2025	2026
	Execution			Forecast			
Support in the field of taxes	-127.1	-12.8	-5.7	-4.9	0.1	-	-
Support in the field of benefits	-129.6	-533.5	-87.1	-	-	-	-
Support in the field of loans and guarantees	-81.7	-91.7	-72.8	-30.5	-11.3	-8.7	-7.0
Support to sectors	-622.4	-1 456.3	-624.0	-97.3	-	-	-
Support from EU fund allocation	-	-8.6	-6.9	-	-	-	-
TOTAL	**-960.8**	**-2 102.8**	**-796.4**	**-132.7**	**-11.2**	**-8.7**	**-7.0**
% of GDP	**-3.2**	**-6.3**	**-2.0**	**-0.3**	**-0.0**	**-0.0**	**-0.0**

Energy Support

State support in the circumstances of the energy price rise provides for a set of measures, which has been included in the Law on Measures to Reduce the Extraordinary Energy Price Rise. Since December 2021 various forms of support measures are being provided to legal and natural persons in order to partially compensate for the rising energy costs. The purpose of the support measures is to mitigate the negative socio-economic impact on the population's welfare and development of the national economy related to an unprecedented sharp rise in energy prices. The planned support (see Table 3.7) is expected until 30 April of this year, and the government is yet to decide on the need for support in the next heating season, prioritising the ensuring of more targeted support. Therefore, currently the funding for energy support in the amount of EUR 622 million is only provided for in the budget of 2023.

Table 3.7. Planned and expended funding for energy support measures, MEUR

	2021	2022		2023	
	Execution	Plan	Execution	Plan	Execution[7]
Compensatory measures to reduce price increases	**1.9**	**571.1**	**339.6**	**547.0**	**177.4**
Compensation of the electricity system service fee in the amount of 50% (in December 2021) and in full for all end users from 1 January 2022 till 30 April 2022	-	141.4	134.7	-	-
Increase of support for protected users by EUR 10 for the period from 1 November 2021 to 31 December 2022	1.9	17.5	12.7	-	-
Reduction of the mandatory procurement component in 2022 (up to EUR 7.55/MWh)[8]	-	18.4	14.3	-	-
Compensation of the centralised heat supply service fee from 1 January 2022 till 30 April 2022	-	7.0	8.7	-	-
Compensation of the natural gas trading service fee from 1 January 2022 till 30 April 2022	-	27.4	27.0	-	-
Compensation of the mandatory procurement component fee for the period from 1 January 2022 till 30 April 2022	-	21.2	18.0	-	-
Compensation for the increase in electricity costs from October 2022 till April 2023 for households using electricity for heating (if more than 500 KWh is consumed per month, 50% above EUR 0.16 per KWh, max. EUR 0.1 per KWh)	-	15.2	0.03	37.9	0.1
Compensation for the increase in natural gas costs for households from 1 July 2022 till 30 April 2023 (reimbursable part of the natural gas price - EUR 30/MWh)	-	26.1	6.1	17.4	4.8
Compensation for the increase in the costs of centralised heat energy supply for households (50% above EUR 68/MWh) from 1 October 2022 till 30 April 2023.	-	72.0	26.4	96.0	29.4
Compensation for the increase in firewood purchase costs for households (with a receipt) with purchases from 1 May 2022 till 30 April 2023, (if the costs exceed EUR 40 per bulk cubic metre), but no more than EUR 15 per bulk cubic metre	-	21.8	0.1	21.8	0.04
Firewood for which a receipt has not been saved - a one-off benefit for households in the amount of EUR 60 (with purchases having been carried out till 31 August 2022)	-	4.8	12.9	-	0.1
Compensation for the increase in briquette purchase costs for households with purchases from 1 May 2022 till 30 April 2023 (in the amount of 50% (if the costs exceed EUR 300 per tonne), but no more than EUR 100 per tonne)	-	2.0	0.1	2.0	0.04
Compensation for the increase in pellet purchase costs for households with purchases from 1 May 2022 till 30 April 2023 (in the amount of 50% (if the costs exceed EUR 300 per tonne), but no more than EUR 100 per tonne)	-	10.5	1.1	11.9	0.4

[7] Execution data until 28.02.2023 (social benefits data until 26.02.2023). Data source: Construction State Control Office, Ministry of Welfare, State Treasury.

[8] The specified financing is intended to impact the general government budget deficit The actual performance data may be adjusted, taking into account the information received from the MoE.

	2021	2022		2023	
	Execution	Plan	Execution	Plan	Execution[7]
Compensation for the increase in the cost of liquefied petroleum gas in the amount of 50%, if the cost exceeds EUR 0.91 per kilogram, but no more than EUR 1.29 per kilogram till 30 April 2023	-	-	-	-	0.01
Compensation for the increase in the cost of diesel fuel in the amount of 50%, if the cost exceeds EUR 0.69 per litre, but no more than EUR 2.01 per litre till 30 April 2023	-	-	-	-	0.04
Full reduction of electricity system service fees for enterprises from 1 October 2022 till 30 April 2023	-	53.0	31.0	70.6	35.1
Compensation of the difference between the regulated tariff and the market price for natural gas for households (determine the market price of natural gas for households identical to the price of regulated natural gas: EUR 108.7 per MWh from 1 October 2022 till 30 April 2023)	-	3.1	1.7	7.8	0.7
Compensation of the difference for the consumed natural gas at a price above EUR 0.07875 per 1 kWh from 1 December 2022 till 30 April 2023 - fee reduction in invoices	-	-	-	-	18.2
Compensation of the electricity price difference between the market price and the expected price ceiling for households (for all households, the price of the first 100 kWh of electricity consumption at a fixed fee of EUR 160 per MWh from 1 October 2022 till 30 April 2023)	-	19.2	5.1	47.9	7.0
Compensation of the costs of centralised heat supply for households (in the amount of an additional 90% for a tariff increase above EUR 150 per MWh) till 30 April 2023	-	24.9	15.1	62.2	32.8
Electricity compensation for legal entity users (to compensate all legal entity users for an increase in electricity costs in the amount of 50% above the electricity price of EUR 160 per MWh for the period from 1 October 2022 till 31 March 2023)	-	85.7	24.4	171.4	28.6
Social benefits	**-**	**214.9**	**240.4**	**74.6**	**22.1**
State budget earmarked grant to local governments for providing housing allowance - in the amount of 50 percent of the actual expenses for housing allowance incurred in the period from 1 January 2022 till 31 December 2023	-	14.1	5.5	14.7	3.4
Disbursement of support in the amount of EUR 20 per month for seniors and disabled persons for the period from 1 January 2022 till 30 April 2022	-	44.3	43.8	-	-
Disbursement of support in the amount of EUR 50 per month for families with children for the period from 1 January 2022 till 30 April 2022	-	81.1	81.0	-	-
Faster indexation of old-age pensions (in August 2022)	-	52.1	91.4	-	-
Support for seniors, disabled persons, survivor's support (from 1 November 2022 till 30 May 2023, EUR 10, 20 or 30 will be paid per month, depending on the amount of the recipient's pension income)	-	23.1	18.3	59.9	18.6
Support for energy efficient companies	**-**	**50.0**	**23.5**	**-**	**-**
TOTAL	**1.9**	**836.1**	**603.5**	**621.6**	**199.5**
% of GDP	**0.0**	**2.1**	**1.4**	**1.4**	**0.5**

Support to Ukrainian Civilians

According to the information of the Ministry of Internal Affairs, temporary protection status in Latvia has been granted to 38,437 persons in 2022 and 2 175 persons in 2023[9]. The Ukrainians who have travelled to Latvia are provided with social support and social services. Catering and accommodation expenses are covered, local governments pay a one-off allowance in a crisis situation of EUR 272 to an adult and EUR 190 for each child, the State provides a one-off allowance for starting a job. Like in 2022, contributions in the amount of EUR 7.7 million have been made to international organisations for the provision of humanitarian and military aid to Ukraine, out of which EUR 5 million has been paid to the World Bank's Support Facility for Ukraine where the collected funds will be available to Ukraine for covering urgent government budget needs, *inter alia*, to pay pensions, wages to doctors and teachers, as well as to cover any other urgent costs. Funding was granted for ensuring a preschool education service for children of refugees, as well as funds for Latvian language courses. In 2022, the total amount of expenditure from the State budget was EUR 81 million, and EUR 102 million is intended for 2023 according to that which was decided by the government (see Table 3.8). In addition to the State support, Latvian residents provide everyday assistance to Ukrainians on site in Latvia, as well as donate funds for ensuring humanitarian and military assistance.

Table 3.8. Planned and expended financing for support to Ukrainian civilians, MEUR

	ESA code	2022	2023	
		Execution	Plan	Execution[10]
Contributions to international organisations	D.7	7.7	-	-
To municipalities for accommodation and catering of refugees, education expenditure for children	D.62	56.8	-	5.8
Other funding granted by order of the Cabinet		16.5	-	5.9
TOTAL		**81.0**	**102.0**	**11.6**
% of GDP		**0.2**	**0.2**	**0.6**

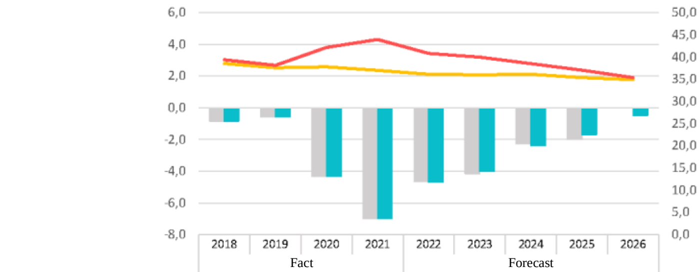
3.4. Fiscal Development Scenario

3.4.1. Fiscal Development Baseline Scenario with no Policy Change

The general government budget forecasts with no policy change for the medium term were prepared based on the law On the State Budget Law for 2023 and Budgetary Framework for 2023, 2024 and 2025 approved by the Saeima on 9 March 2023, and updating revenue and separate expenditure forecasts according to the renewed macroeconomic development scenario and budget execution trends in December 2022 and the first two months of 2023. In the scenario with no change policy, the general government budget deficit is forecast in the amount of 2.4% of GDP in 2024, 1.7% of GDP in 2025 and 0.5% of GDP in 2026 (see Figure 3.5). It is expected that in 2023 the general government budget deficit, will comprise 4.0% of GDP, being 0.2 percentage points lower than forecast, when preparing the budget for 2023.

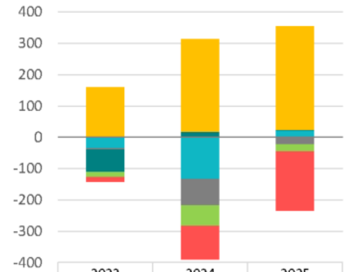
Changes in the general government budget balance and the impact of factors on the balance compared to the approved budget are reflected in Figure 3.6.

[9] Date as at 21.03.2023.
[10] Execution data up to 28.02.2023. Data source: Treasury, MoF calculations.



	2018	2019	2020	2021	2022	2023	2024	2025	2026
General government balance (Budget'2023)	-0,8	-0,6	-4,3	-7,0	-4,7	-4,2	-2,3	-2,0	
General government balance (SP 2023-2026)	-0,8	-0,6	-4,3	-7,0	-4,7	-4,0	-2,4	-1,7	-0,5
Central government	-1,0	-2,1	-4,6	-7,7	-5,5	-4,2	-2,7	-1,8	-0,5
Local government	-0,7	0,6	-0,1	-0,2	0,1	-0,1	0,0	0,0	0,1
Social security funds	0,8	0,9	0,3	0,9	0,7	0,3	0,3	0,1	-0,1
Revenue (right axis)	38,5	37,6	37,8	37,0	36,1	36,0	36,1	35,4	34,9
Expenditure (right axis)	39,4	38,2	42,2	44,0	40,8	40,0	38,5	37,1	35,4

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



	2023	2024	2025
General government balance changes total	19	-76	122
Revenues (tax, non-tax, own revenue)	160	295	330
State special budget expenditure for social benefits	-14	-106	-188
Interest expenditure and contributions to the EU budget	-16	-65	-23
Expenditure for basic functions of local governments	-71	18	2
Changes in the balance sheet of classified merchants	-4	-86	-22
Impact of other changes	-35	-133	22

Figure 3.6. Impact on the general government balance compared to the approved budget for 2023-2025, MEUR (Data source: Eurostat, MoF)

According to the forecasts the share of the general government revenue in GDP in 2023 will comprise 36.0% of GDP, increasing to 36.1% of GDP in 2024, whereas in 2025 and 2026 the share will reduce, correspondingly, to 35.4% and 34.9% of GDP. Reduction of the revenue share will be affected by a slight decrease in forecast revenue in EU investments funding, attributable to the closing stage of the 2014-2020 programming period. Similarly, in 2024-2026 the amount of dividends received from public sector capital companies planned in the budget will decrease.

It is expected that the share of the general government expenditure in GDP, similar to revenue in the medium term, will reduce on an annual basis, besides with a steeper reduction rate than that of revenue. Especially in 2024, as compared to 2023, when the budget no longer foresees support for mitigating the increase in energy resource prices, as well as support to Ukrainian civilians. Covid-19 support measures had a significant impact on the budget expenditures of 2020, 2021 and 2022, but in 2023 the impact of support on the balance sheet is only -0.3% of GDP, mostly providing financing for the purchase of vaccines and completing certain investment projects, to which funding has been granted before.

In nominal terms, the total amount of both revenue and expenditure will increase annually.

Table 3.9. Fiscal Development Baseline Scenario with no Policy Change

		2022	2023	2024	2025	2026
	ESA code	**% of GDP**				
Net lending (+) or borrowings (-) (B.9) by sub-sectors						
General government	S.13	-4.7	-4.0	-2.4	-1.7	-0.5
incl. merchants[11]		-0.1	-0.6	-0.2	-0.1	-0.1
Central government	S.1311	-5.5	-4.2	-2.7	-1.8	-0.5
incl. merchants		-0.1	-0.5	-0.2	-0.1	-0.1
Local government	S.1313	0.1	-0.1	0.0	0.0	0.1
incl. merchants		-0.1	-0.1	0.0	0.0	0.0
Social security funds	S.1314	0.7	0.3	0.3	0.1	-0.1
General government (S.13)						
Total revenue	TR	36.1	36.0	36.1	35.4	34.9
Total expenditure	TE	40.8	40.0	38.5	37.1	35.4
Interest expenditure	D.41	0.5	0.6	0.8	1.0	1.1

[11] Commercial companies controlled and financed by the State and local government entities (MoF sample survey result). Full list of merchants is available on the CSB website https://www.csb.gov.lv/lv/statistika/klasifikacijas/institucionalo-sektoru-klasifikacija/kodi.

		2022	2023	2024	2025	2026
	ESA code	% of GDP				
Cyclical development						
Cyclical component of the budget balance[12]		0.2	-0.5	-0.5	-0.2	0.0
One-off and other temporary measures[13]		-4.8	-3.0	-1.5	-1.5	-0.7
Cyclically adjusted balance		-4.9	-3.5	-1.9	-1.5	-0.5
Cyclically adjusted primary balance		-4.4	-2.9	-1.0	-0.5	0.6
Structural balance		-0.1	-0.5	-0.4	0.0	0.2

Central Government Budget

- The nominal amount of the government budget revenue will increase annually along with the higher tax revenue. In the medium term, an annual increase in all larger taxes is expected, which will be facilitated by the rise in consumption and the growing salary fund. Also, high revenue from foreign financial aid is expected in 2023 and is forecast at a high level up to 2026. On the other hand, the share of revenue in GDP will decrease in 2023 compared to 2022, taking into account the reduction in production and import taxes. A further decrease in the share of revenue in GDP is predicted in the medium term, which will be determined by a decrease in property revenues (D.4) due to lower planned dividend payments, as well as no increase in current transfers (D.7).
- In the central government budget in 2023, similar to previous years, a high level of expenditure will be determined by government-approved support measures for mitigating crises. In 2023, the funding for Covid-19 support is already expected to be much smaller, at the same time the government has planned funding for the reduction of energy resource prices in the amount of EUR 622 million and to Ukrainian civilians in the amount of EUR 102 million (see Section 3.3 on support measures).
- The national defence expenditure approved in the 2023 budget was updated according to the renewed macroeconomic scenario, thus defence expenditure broken down by functions will reach 2.7% of GDP in 2023.
- Expenditure for remuneration (D.1) in the central government budget, after an increase of 15.8% in 2023, is forecast with no stable growth trend in the next years, which will be determined by lower expenditure for remuneration by classified companies.
- Intermediate consumption expenditure (P.2) after a significant increase in 2022, when the purchase of natural gas reserves was made and the expenditure on goods and services increased significantly, are planned with a moderate increase annually.
- The share of interest expenditure (D.41) to GDP in the central government budget has been decreasing for a longer period of time to 0.4% of GDP in 2021. With increasing interest rates, in 2022 the share reached 0.5% of GDP. Whereas, in the medium term, the interest expenditure will grow annually till it reaches 1.1.% of GDP in 2026, since both borrowing is forecast and interest rates are expected to increase.
- Social benefits expenditure (D.62, D.632) in 2021 and 2022 due to the awarding of additional support in the central government budget was respectively 5.1% and 4.0% of GDP, but as of 2023 their amount will decrease to 3.2% of GDP and will also decrease

[12]In the calculation of the cyclical component of the budget balance, budgetary semi-elasticity of 0.378 was used (Data source: G. Mourre ao. European Commission. The Semi-Elasticities Underlying the Cyclically-Adjusted Budget Balance: An Update & Further Analysis. May 2019).
[13]See Table 3.1.

moderately in the medium term. In 2023, the increase of the minimum income level was set as a priority, henceforth linking it to socio-economic indicators. In determining the minimum income thresholds in Latvia, there will be a transition from the numerical value of the minimum income threshold in euro to the percentage value (20%) of the median of the minimum income. The new minimum income thresholds will be higher than before and will come into effect on 1 July 2023. Starting from 2024, they are planned to be reviewed in January each year. Currently, the minimum income is EUR 109, from July it will increase to EUR 125.

- Expenditure for fixed asset formation (P.51g), along with increasing flows of the EU funds' investments, will grow considerably in 2023. Considerably higher expenditure for the implementation of projects co-financed by foreign financial aid is also predicted in the following years compared to previous years. This will be facilitated by the funding for the implementation of the projects of the EU funds 2021-2027 programming period, as well as the funding for the projects of the Recovery Facility projects and the implementation of *Rail Baltica*, and the investment cycle of 2014-2020 programming period must be completed by 2024, as well.
- In 2023 and 2024, the delivery of 32 new electric trains is expected in Latvia, negatively affecting the balance of merchants in the general government budget. Although a large part of the train purchase transaction is financed from the EU Cohesion Fund resources, the State budget co-financing is also provided for the purchase of trains, and (according to the ESA methodology) expenditure is accounted for according to the actual delivery of trains.

Social security fund

- Already since 2017, there has been an annual surplus in the social security fund. Forecasts show that the surplus is also expected in the future, up to 2025. It is projected that in 2023, revenue in the social security fund will grow more moderately than expenditure and the amount of surplus will be 0.3% of GDP. It is planned to remain the same in 2024, but in 2025 it will decrease to 0.1% of GDP, while in 2026 a deficit of 0.1% of GDP is already forecast. Taking into account the high level of inflation in 2022, pensions were indexed with higher indices in October 2022, and in 2023 the indexation coefficients will also be higher than before. In general, this affects a steeper increase in expenditure than changes in revenue.
- In 2022, pensions were revised not on 1 October as usual, but two months earlier on 1 August, due to the steep increase rise in price levels. The old-age, disability, service, survivor's pensions and insurance allowances granted (recalculated) up to 31 July 2022 in the amount not exceeding EUR 534, have been reviewed (indexed), while as regards pensions and insurance allowances, the amount of which exceeds EUR 534, only a part thereof, amounting to EUR 534, is indexed. It is to be concluded that expenditure for pensions would grow even sharper, if the reform of retirement age would not be implemented, introduced in 2014 and providing for the increase of the retirement age by three months annually, until reaching the age of 65 in 2025, as a result of which the number of pension recipients decreases, and it is currently forecast that it will continue decreasing till the completion of the reform. Whereas, as early as 2026, the decrease in the number of pensioners will stop and in the following years, according to *Eurostat* demographic forecasts, an increase in the number of the population in the age group 65+ is expected, which, at the same time as the increase in the average pension amount, will contribute to a faster increase in expenditure.

- Unemployment benefit expenditure will increase annually in 2023 and in the medium term. The increase in unemployment benefit expenditure in 2023 by EUR 25.3 million or EUR 17.8 million will be basically determined by the changes in the number of benefit recipients, projecting that in 2023 compared to 2022 the number will increase by 4.6% (from 32.1 thousand to 33.6 thousand on average per month), as well as taking into account the increase in the average benefit amount compared to 2022 of 12.6%. In the medium term, the expenditure increase will mainly be determined by a further increase in the average benefit amount, as the number of unemployment benefit recipients is expected to decrease in the medium term.
- In 2023, expenditure for sickness benefits will increase by EUR 16.5 million or 4.8% compared to 2022, which is related to the increase of the average benefit amount by 12.6%. In the medium term, expenditure for sickness benefits will increase annually, despite the projected decline in the number of beneficiaries, as the average benefit amount is projected to increase.

Local Government Budget

- In 2023, a deficit is expected in the local government budget, reaching 0.1% of GDP, while in 2022, local governments managed with a slight surplus. The larger budget deficit is mainly attributable to a lower revenue growth rate (+1.7% compared to 2022) and a 4.7% increase in expenditure. A small deficit in the local government budget is also predicted in 2024 and 2025, but in 2026 a surplus of 0.1% of GDP is already predicted. Investment flows of foreign financial aid are significant in the budget of the local government, which affects the fluctuations of the balance over the years.
- It is projected that in 2023, expenditure for the acquisition of all types of goods and services will continue to increase, determined by the high prices of energy resources and inflation, as well as an increase in the State funding for school meals from Grade 1 to Grade 4 (from EUR 2.15 to EUR 3.09). Also, high expenditure for social support is forecast, citing the increase in the costs of energy support, support to Ukrainian refugees and the increase of benefits in connection with raising the minimum income level. The increase in expenditure in 2023 will also be facilitated by the increase in wages in local governments. A higher level of expenditure in the local government budget is also determined by the additional funding allocated to assistant and companion service providers, for raising teachers' wages, as well as for raising the minimum wage in 2023 and 2024. Thus, as regards the local government budget expenditure, in 2023, an increase for both remuneration (D.1) and intermediate consumption (P.2) is expected. The expenditure of these items will grow moderately in the medium term as well.

With the closure of implementation of the Covid-19 high-readiness investment projects and decrease in the total growth of local government borrowings, a decrease in capital expenditure (P.51g) in the local government budget is expected in 2023, which will be affected by a lower level of expenditure for basic functions for investments, while the investments of projects financed by foreign financial assistance in the medium term will increase year to year. Starting from 2024 onwards, a significant increase in investment is planned every year.

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

In accordance with the Fiscal Strategy, the general government budget structural balance targets are -0.5% of GDP in 2024, -0.5% of GDP in 2025 and -0.0% of GDP in 2026. The general government nominal balance arising from these targets is calculated in Table 3.10.

Table 3.10. Nominal balance of the general government budget arising from the structural balance target

		2024	2025	2026
General government structural balance targets, % of GDP	**(1)**	**-0.5**	**-0.5**	**0.0**
Output gap, % of the potential GDP	**(2)**	**-1.4**	**-0.6**	**0.0**
Cyclical balance component, % of GDP	**(3)=0.378*(2)**	**-0.5**	**-0.2**	**0.0**
One-off and other temporary measures, % of GDP, incl.	**(4)**	**-1.5**	**-1.5**	**-0.7**
COVID-19 pandemic mitigation measures		0.0	0.0	0.0
measures to reduce energy price increase		0.0	0.0	0.0
defence and internal security funding		-0.7	-0.7	-0.7
support for refugees from Ukraine		0.0	0.0	0.0
one-off expenditure for national defence and internal security		-0.8	-0.7	0.0
General government balance, % of GDP	**(5)=(1)+(3)+(4)**	**-2.5**	**-2.2**	**-0.7**

Table 3.11. Fiscal space

		2024	2025	2026
General government nominal balance forecast with no policy change, % of GDP	**(1)**	**-2.4**	**-1.7**	**-0.5**
Output gap, % of the potential GDP	**(2)**	**-1.4**	**-0.6**	**0.0**
Cyclical balance component, % of GDP	**(3)=0.378*(2)**	**-0.5**	**-0.2**	**0.0**
One-off and other temporary measures included in the no-policy change scenario, % of GDP, incl.	**(4)**	**-1.5**	**-1.5**	**-0.7**
COVID-19 pandemic mitigation measures		0.0	0.0	0.0
measures to reduce energy price increase		0.0	0.0	0.0
defence and internal security funding		-0.7	-0.7	-0.7
support for refugees from Ukraine		0.0	0.0	0.0
one-off expenditure for national defence and internal security		-0.8	-0.7	0.0
General government budget structural balance forecasts in a no-policy change scenario, % of GDP	(5)=(1)-(3)-(4)	-0.4	0.0	0.2
General government budget structural balance targets, % of GDP	(6)	-0.5	-0.5	0.0
Fiscal reserve, % of GDP	(7)	0.10	0.10	0.10
Fiscal space, % of GDP	**(8)=(5)-(6)-(7)**	**0.04**	**0.40**	**0.08**

The Fiscal Development Scenario of the Stability Programme projects a positive fiscal space at 0.04% of GDP in 2024, 0.40% of GDP in 2025 and 0.08% of GDP in 2026, not including the potential additional financing for one-off measure expenditures.

Table 3.12. Medium-term Fiscal Development Scenario, % of GDP

		2022	2022	2023	2025	2026
	ESA code	**% of GDP**				
Net lending (+) or borrowings (-) (B.9) by sub-sectors						
General government	S.13	-4.7	-4.0	-2.5	-2.2	-0.7
Central government	S.1311	-5.5	-4.2	-2.9	-2.3	-0.6
Local government	S.1313	0.1	-0.1	0.0	0.0	0.1
Social security funds	S.1314	0.7	0.3	0.3	0.2	-0.1
General government (S.13)						
Total revenue	TR	36.1	36.0	36.1	35.4	34.9
Total expenditure	TE	40.8	40.0	38.6	37.6	35.6
Interest expenditure	D.41	0.5	0.6	0.8	1.0	1.1
Cyclical development						

Cyclical component of the budget balance[14]		0.2	-0.5	-0.5	-0.2	0.0
One-off and other temporary measures[15]		-4.8	-3.0	-1.5	-1.5	-0.7
Cyclically adjusted balance		-4.9	-3.5	-2.0	-2.0	-0.7
Cyclically adjusted primary balance		-4.4	-2.9	-1.2	-1.0	0.4
Structural balance		-0.1	-0.5	-0.5	-0.5	0.0

The Fiscal Development Scenario assumes that the fiscal space of 2024, 2025 and 2026 is distributed proportionately between the central government and the social security fund for additional expenditure of new policy priorities. It is assumed that the fiscal margin is used, i.e., fiscal risks amount to 0.1% of GDP. As decisions on the budget development section are adopted during the process of budget formation and are not known for the time being, the increase in expenditure is carried out proportionally by expenditure categories in the respective years, assuming the share of separate expenditure categories to the total expenditure in the no policy change scenario as the basis. When calculating the share of individual expenditure categories to the total expenditure in the no policy change scenario, interest expenditure is excluded from the calculation. Such an approach is used because it is assumed that the decisions of the budget development section do not affect this category of expenditure.

3.5. Development Trends of Government Debt in the Medium Term

The key principles and medium-term objectives of the central government debt management are defined in the Central Government Debt and Cash Management Strategy approved by the Minister of Finance. In accordance with the Strategy, the purpose of government debt and cash management is to ensure the timely availability of financial resources to cover financing requirement with low public servicing costs, limiting financial risks and, at the same time, contributing to the development of the internal financial market. For meeting the central government debt obligations and fulfilling budget liabilities, a strategic approach to ensuring State borrowing and the debt management process is applied, maintaining the greatest possible flexibility in the choice of borrowing conditions on financial markets (time of borrowing, instrument, amount, maturity). It allows limiting of financial risks in the medium term, as well as ensuring the resources necessary to cover the total funding requirement under favourable conditions.

Covid-19 outbreak brought about the need to ensure funding in a considerable amount in 2020-2021 for mitigating the impact of the outbreak and for support to the economy in the state of emergency, by implementing borrowing both in financial markets, from the Nordic Investment Bank and the EC (SURE[16]) resulting in a considerable increase in general government debt. If at the end of 2019, before the outbreak of Covid-19, the general government debt amounted to 36.5% of GDP (or EUR 11.2 billion), then at the end of 2021 its level comprised 43.7% of GDP (or EUR 14.7 billion). At the end of 2022, according to flash estimates of the Treasury, the general government debt, according to the ESA methodology, reached EUR 15.9 billion or 40.8% of GDP.

In 2022, Russia's invasion of Ukraine caused geopolitical tension in the region, a global increase in energy prices and a rapid increase in inflation, adversely affecting the economic situation and the State budget expenditure in 2022. In 2022, resources to cover the total financing requirement, incl. support measures for population and companies to compensate for high energy prices, as well as expenditure for strengthening the national defence capacity, were provided by borrowings in the domestic and international financial markets in the amount of EUR 2 045 million. In the domestic financial market in 2022, additional issues of outstanding

[14]In the calculation of the cyclical component of the budget balance, budgetary semi-elasticity of 0.378 was used (Data source: G. Mourre ao. European Commission. The Semi-Elasticities Underlying the Cyclically-Adjusted Budget Balance: An Update & Further Analysis. May 2019).

[15]See Table 3.1.

[16] Support to mitigate Unemployment Risks in an Emergency after the outbreak of Covid-19.

Eurobonds in the amount of EUR 1 195 million were made. In 2022, resources of EUR 850 million have been raised in the international financial markets, by issuing Eurobonds with maturity in March 2027, coupon (fixed interest rate) of 3.875% per annum and yield of 4.198%. In addition to the borrowings in the financial markets, a loan of EUR 167 million was received in 2022 under financially favourable conditions within the framework of the EC financing instrument SURE with a repayment term of 15 years and a fixed interest rate of 2.75% per year.

The volume of borrowings and the level of the government debt in the medium term are affected by the total financing requirement, which is mainly made up of the State budget deficit, *inter alia,* various support measures, repayment of the central government debt, issuance of the State loans (to municipalities, State capital companies, ports and universities), as well as maintenance of cash buffer in the Treasury accounts for the management of various risks in conditions of increased uncertainty.

Taking into account the central government debt liabilities outstanding as of 28 February 2023, in accordance with the central government debt repayment schedule in the period between March 2023 – December 2026 the central government debt obligations should be refinanced in the amount of ~EUR 7.3 billion (see Figure 3.7). The majority of the amount of debt to be refinanced within the referred to period consists of Eurobonds issued in international financial markets, the maturity of which will become due.

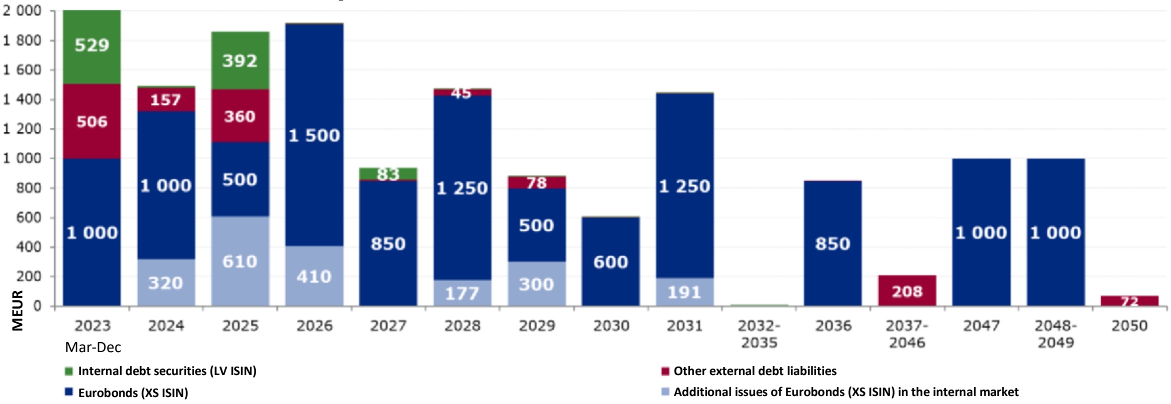
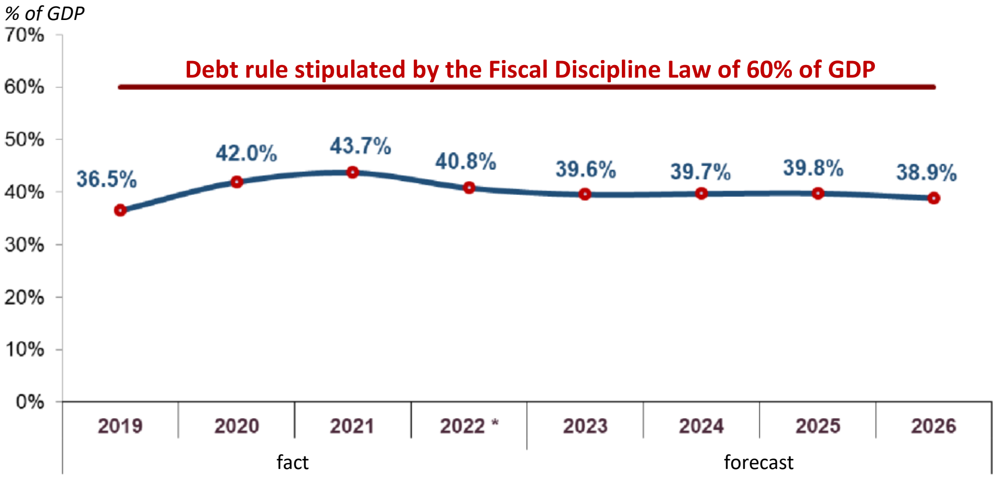


Figure 3.7. Central government borrowing repayment schedule
(liabilities outstanding as of 28 February 2023, nominal value, MEUR)

In 2023-2025, the resources available in the Treasury accounts and borrowing measures mainly in financial markets will be used to cover the total financing requirement, allowing the use of other borrowing instruments depending on the situation in the financial markets and interest rate trends. It is planned to carry out the attraction of funds in the domestic financial market by tapping of outstanding Eurobonds by using the domestic financial market potential. It is planned to ensure borrowing in international financial markets by public long-term benchmark Eurobond issues, preserving maximum flexible options for choosing the parameters of the most financially beneficial borrowing instruments.

In Q1 of 2023, new 5-year Eurobonds in the amount of EUR 750 million were issued in the international financial markets, with a yield of 3.693% and fixing the coupon rate at 3.500%, while in the domestic financial market, tapping of outstanding Eurobonds with maturity in 2026, 2028, 2029 and 2031 in the amount of EUR 385 million.

The implementation of support measures to compensate for the increase in energy resource prices, as well as additional expenditure for strengthening the national defence capacity, will continue to affect the trends of the general government debt in the medium term (see Figure 3.8).



** flash estimates*

Figure 3.8. General government debt development trends

It is expected that in the medium term, the debt rule set by the FDL of 60% of GDP will be respected and the general government debt of Latvia will stabilise at a level below 40% of GDP.

4. SENSITIVITY ANALYSIS AND COMPARISON

4.1. Macroeconomic Scenario Risks

Medium-term macroeconomic development scenarios are based on conservative assumptions regarding economic development in the medium term and the macroeconomic development scenario is still developed in circumstances of high uncertainty. At the same time, the upward and downward risks of scenario forecasts are currently well-balanced. The further development of the economy will be greatly affected by the efficiency of energy supply channels after the suspension of Russian energy imports, and the risks are related to possible wider supply disruptions, which may lead to a decrease in the supply of energy resources and other goods and significantly increase their prices, especially at the beginning of the new heating season.

Under the influence of a sharper price rise, the economic growth rates may turn out to be significantly lower, with the private consumption and private investment amounts declining. In addition, the confidence of consumers and entrepreneurs can be undermined by further escalation of the geopolitical situation and expansion of the war, by forcing refraining from investments in the region.

Negative risks also include gradually increasing tensions in the labour market as the working-age population declines and wages rise, which may reduce the competitiveness of companies.

On the other hand, the positive risks are in essence opposite to the negative ones, that is, the prices of energy resources and geopolitical risks will decrease. As the conflict between Russia and Ukraine subsides, the business sentiment will also improve.

4.2. Sensitivity Analysis – Pessimistic Scenario

Impact on Economy

The pessimistic scenario projects that the energy crisis in Europe will escalate again in the second half of the year, caused by the increase in demand in China and the inability of supply chains to meet the demand for gas and oil. Further escalation of the geopolitical situation cannot be ruled out, which would further reduce confidence in the region. In such case, energy prices would return to the heights they were at the end of last year, affecting inflation and decelerating private consumption. In addition to this, the inflow of the EU funds would also decrease, thus investments would also decrease in nominal terms.

According to the pessimistic scenario, the economy of Latvia might face a sharper decrease in growth rates than in the baseline scenario. As a result, in 2023, GDP at constant prices could decrease by 1.2% and in 2024 increase only marginally by 0.5%, with more stable growth only resuming in 2025. In these years, growth would be 0.9-1.5 percentage points slower than in the baseline scenario.

Table 4.1. Pessimistic macroeconomic scenario

	Pessimistic scenario				Deviation from the baseline scenario			
	2023	2024	2025	2026	2023	2024	2025	2026
GDP growth at current prices, %	11.9	4.5	5.2	5.5	0.2	-1.0	-0.5	0.0
GDP growth at constant prices, %	-1.2	0.5	2.0	2.7	-1.2	-1.5	-0.9	0.0
Changes of consumer prices index, %	11.0	5.5	3.5	2.5	1.0	3.3	1.0	0.0
Private consumption, growth at constant prices, %	-0.8	-0.8	3.1	3.5	0.1	-2.9	-0.9	0.0
Public consumption, growth at constant prices, %	1.4	1.3	0.0	0.5	0.2	0.4	0.0	0.0

	Pessimistic scenario				Deviation from the baseline scenario			
Gross fixed capital formation, growth at constant prices, %	-0.1	3.2	5.6	5.0	-1.1	-1.7	0.6	0.0
Export of goods and services, growth at constant prices, %	-0.4	3.7	4.6	5.0	-0.4	-0.6	0.0	0.0
Import of goods and services, growth at constant prices, %	0.7	3.1	5.3	5.0	0.2	-0.8	0.6	0.0
Average wage in national economy growth at current prices, %	7.0	5.5	4.0	4.0	-1.5	-1.0	-1.0	0.0
Employment growth, %	-0.3	-0.9	-0.3	0.0	-0.3	-0.7	0.0	0.6
Unemployment rate, %	7.5	7.8	7.4	6.8	0.4	1.0	1.0	0.5

The escalation of the geopolitical situation would also encumber the foreign trade of goods and services, which would mean a 0.3% decrease in exports for Latvia in 2023. Such a shock would be short-term, though, because Russia's share in foreign trade would drop to a minimum. In 2024, the export volume would increase by 3.7%, but would still be 0.6 percentage points lower than in the baseline scenario.

The reduction of energy supply would facilitate an increase in costs and inflation. Energy prices would return to the same heights as at the end of last year, affecting inflation and raising it to 11% or by 1 percentage point in 2023. Inflation would not reduce as sharply as in the baseline scenario in the following years either - it would be higher, namely 5.5% and 3.5% in 2024 and 2025, respectively. In the medium term, inflation will gradually converge to the price stability target above 2%.

High inflation would slow down private consumption, which would decrease by 0.8% in both 2023 and 2024. Although the wage increase would remain high - 7% in 2023 and 5.5% in 2024, the increase would be 1.5 and 1 percentage point lower than in the baseline scenario, respectively. Due to high inflation, the real purchasing power of wages would decrease. The demand for labour would also decrease – employment would decrease by 0.3%, 0.9% and 0.3% in 2023, 2024 and 2025, respectively, but the unemployment rate would be approximately 1 percentage point higher.

Meanwhile, in such uncertain conditions, investments would also decrease by 3.1% in 2022 and 2.7% in 2023. This would also be affected by the rising prices, termination of State projects concluded previously from the contractors' side, as well as the geopolitical uncertainty, reducing the attractiveness of the region to investments.

Impact on the General Government Budget

Upon the implementation of the pessimistic scenario, tax revenue would decrease significantly, expenditure for benefits would grow and the general government budget balance would deteriorate. As compared to the baseline scenario, in the case of the pessimistic scenario the general government budget deficit in 2023 would increase by EUR 79.3 million or 0.2 ppt of GDP. By contrast, in 2024, 2025 and 2026 the general government budget balance would deteriorate, correspondingly, by 0.6 (EUR 260.3 million), 0.7 (EUR 322.1 million) and 0.5 (EUR 236.2 million) ppt of GDP as compared to the baseline scenario. In the pessimistic scenario, the general government budget deficit in 2023 would grow to 4.2% of GDP, in 2024 – to 3.0% of GDP, in 2025 – to 2.4% of GDP, but in 2026 – to 1.0% of GDP.

Table 4.2. ***Impact of the pessimistic scenario on the general government budget, MEUR***

	Pessimistic scenario				**Deviation from the baseline scenario**			
	2023	**2024**	**2025**	**2026**	**2023**	**2024**	**2025**	**2026**
General government budget balance, % of GDP	**-4.2**	**-3.0**	**-2.4**	**-1.0**	**-0.2**	**-0.6**	**-0.7**	**-0.5**
General government budget balance	-1 832.6	-1 360.9	-1 139.6	-483.6	-79.3	-260.3	-322.1	-236.2

	Pessimistic scenario				Deviation from the baseline scenario			
Tax revenue	12 404.0	13 030.4	13 700.9	14 400.4	-66.2	-197.8	-241.8	-240.1
Personal income tax	2 330.9	2 457.6	2 555.9	2 691.6	-37.1	-83.4	-116.1	-108.4
Corporate income tax	402.7	418.9	441.5	488.0	0.7	-3.1	-5.5	-6.3
VAT	3 928.8	4 128.8	4 384.2	4 625.5	34.0	41.9	49.4	51.8
Mandatory State social security contributions[17]	4 017.2	4 255.2	4 500.3	4 718.1	-64.0	-144.4	-154.5	-161.2
Excise duty	1 187.9	1 221.4	1 257.4	1 300.4	0.0	-8.3	-14.2	-15.1
Non-tax revenue	861.8	718.9	728.8	647.1	0.0	-4.8	-8.0	-7.2
Interest expenditure	232.9	369.1	454.8	549.5	0.0	2.4	10.4	19.6
Expenditure for social benefits	4 884.4	5 264.1	5 621.0	5 863.4	13.1	55.4	61.9	-30.7
General government debt, % of GDP	**39.7**	**40.8**	**41.7**	**41.2**	**0.1**	**1.0**	**1.9**	**2.3**

Upon implementation of the pessimistic scenario of the economic development, under the influence of the tax revenue decrease the State budget deficit would grow, as a result whereof the overall funding need would increase and, correspondingly, also the lending volume for the respective period, as compared to the baseline scenario. Additional borrowing would generate the interest expenditure growth. In the case of the pessimistic scenario, the interest expenditure in 2023 would remain unchanged, but in 2024 they would be EUR 2.4 million larger, in 2025 - EUR 10.4 million larger and in 2026, correspondingly, by EUR 19.6 million larger than in the baseline scenario.

4.3. Sensitivity Analysis – Optimistic Scenario

Impact on Economy

The optimistic scenario includes a significant reduction of geopolitical risks, a reduction in energy resource prices and certainty, therewith also an increase in investments. Also, the inflow of EU funds in the optimistic scenario would be faster than in the baseline scenario, causing a temporary acceleration of economic activity. According to the optimistic scenario, Latvia's economy would achieve faster growth rates than expected in the baseline scenario. As a result, GDP could increase by 1% in 2023 at constant prices and by 3.3% in 2024, which is more than 1 percentage point more than in the baseline scenario.

The biggest contribution to growth (1.4 ppt) would be ensured exactly by the investment growth, which would reach 6.1% in 2023 and 6% in 2024 and would be 5 and 1.1 percentage points higher, respectively, than in the baseline scenario. Investment growth would be facilitated by decrease in inflation, the de-escalation of geopolitical risks, higher business confidence, as well as faster use of the EU funds and the RRF funding and the implementation of *Rail Baltica* project in accordance with the planned scope.

A decrease in inflation and an increase in household confidence would also contribute to an increase in private consumption by 0.3% in 2023, or 1.2 percentage points more than expected in the baseline scenario, and by 2.4% in 2024, but in the following years private consumption would grow as in the baseline scenario.

A noticeable positive impact on economic growth in 2023 and 2024 would also be left by increase in exports, which could reach 3.2% and 6.9%, respectively, with exports being promoted by the growing external demand. However, along with the growing domestic demand, imports would also grow faster. Therefore, foreign trade or net exports would generally have a negative contribution to GDP growth.

[17] Deducting contributions into the State funded pension scheme and contributions into the 3rd pension pillar

Assuming that the prices of energy resources will decrease, inflation would decrease to 7.5% in 2023 or by 2.5 ppt lower than in the baseline scenario. Inflation will be mainly maintained by secondary factors of price formation, with entrepreneurs trying to compensate for the rapid inflation growth in 2022. In turn, in 2024, a drop in prices is also possible in certain months, thus the annual average inflation would be 1% or by 1.2 ppt lower than in the baseline scenario.

As a result of larger economic activity, the demand for labour would also increase - employment would increase by 0.1% in 2023, however, in the following years, with the demographic pressure increasing, employment would decrease, although the decrease would be 0.1 ppt less than in the baseline scenario. Consequently, the unemployment rate would decrease more rapidly - from 6.8% in 2023 to 5.5% in 2026.

Table 4.3. Optimistic macroeconomic scenario

	Optimistic Scenario				Deviation from the baseline scenario			
	2023	2024	2025	2026	2023	2024	2025	2026
GDP growth at current prices, %	11.2	6.1	5.4	5.6	-0.5	0.7	-0.3	0.1
GDP growth at constant prices, %	1.0	3.3	2.9	2.8	1.0	1.3	0.0	0.0
Changes of consumer prices index, %	7.5	1.0	2.0	2.5	-2.5	-1.2	-0.5	0.0
Private consumption, growth at constant prices, %	0.3	2.4	4.0	3.5	1.2	0.3	0.0	0.0
Public consumption, growth at constant prices, %	1.2	0.8	0.1	0.5	0.0	0.0	0.0	0.0
Gross fixed capital formation, growth at constant prices, %	6.1	6.0	5.0	5.0	5.0	1.1	0.0	0.0
Export of goods and services, growth at constant prices, %	3.2	6.9	5.2	5.0	3.2	2.5	0.6	0.0
Import of goods and services, growth at constant prices, %	3.6	5.5	5.3	5.0	3.1	1.6	0.6	0.0
Average wage in national economy growth at current prices, %	9.0	7.0	4.5	4.0	0.5	0.5	-0.5	0.0
Employment growth, %	0.1	-0.1	-0.2	-0.2	0.1	0.1	0.1	0.4
Unemployment rate, %	6.8	6.7	6.1	5.7	-0.4	-0.2	-0.3	-0.6

Impact on the General Government Budget

If the optimistic scenario were to occur, in which tax and non-tax revenue increases, as well as benefit expenditure in the State special budget and the State basic budget and interest expenditure for financing the central government debt decrease, the general government budget balance would improve. As compared to the baseline scenario, in the case of the optimistic scenario the general government budget deficit in 2023 would decrease by EUR 97.8 million or 0.2 ppt of GDP. By contrast, in 2024, 2025 and 2026 the general government budget balance would improve each year by 0.5 ppt of GDP as compared to the baseline scenario or, respectively, by EUR 251.1 million, EUR 251.8 million and EUR 276.5 million.

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

	Optimistic Scenario				**Deviation from the baseline scenario**			
	2023	**2024**	**2025**	**2026**	**2023**	**2024**	**2025**	**2026**
General government budget balance, % of GDP	**-3.8**	**-1.8**	**-1.2**	**0.1**	**0.2**	**0.5**	**0.5**	**0.5**
General government budget balance	-1 655.5	-849.5	-565.7	29.1	97.8	251.1	251.8	276.5
Tax revenue	12 543.1	13 365.9	14 068.9	14 789.6	72.9	137.7	126.2	149.2
Personal income tax	2 383.3	2 576.4	2 703.5	2 845.7	15.3	35.4	31.5	45.7
Corporate income tax	400.4	422.9	446.8	494.3	-1.6	0.9	-0.2	0.05
VAT	3 929.9	4 125.7	4 365.8	4 608.7	35.2	38.8	31.0	35.1

	Optimistic Scenario				Deviation from the baseline scenario			
Mandatory State social security contributions[18]	4 107.6	4 460.9	4 719.2	4 947.6	26.4	61.3	64.4	68.4
Excise duty	1 185.9	1 230.8	1 271.1	1 315.5	-2.0	1.1	-0.5	0.0
Non-tax revenue	858.7	725.1	736.5	654.4	-3.1	1.4	-0.3	0.1
Interest expenditure	232.9	363.1	432.0	508.7	0.0	-3.6	-12.4	-21.2
Expenditure for social benefits	4 843.3	5 100.4	5 445.7	5 788.1	-28.1	-108.4	-113.4	-106.1
General government debt, % of GDP	**39.5**	**38.9**	**38.6**	**37.2**	**-0.1**	**-0.8**	**-1.2**	**-1.7**

Upon the implementation of the optimistic scenario of the economic development, under the influence of the tax revenue increase the State budget financial balance would improve, as a result whereof the overall funding need would reduce and, correspondingly, also the lending volume for the respective period, as compared to the baseline scenario. Smaller borrowings would generate savings in the interest expenditure. In the case of the optimistic scenario, the interest expenditure in 2023 would remain unchanged, but in 2024 it would be EUR 3.6 million smaller, in 2025 - EUR 12.4 million smaller and in 2026, correspondingly, EUR 21.2 million smaller than in the baseline scenario.

4.4. Comparison of the General Government Budget Balance and Debt Forecasts with Latvia's Stability Programme 2022-2025

Compared to Latvia's Stability Programme 2022-2025, the GDP forecast for 2023 was reduced by 2.5 ppt, which is related to military operations in Ukraine launched by Russia and, as a result, increased prices of energy resources, creating the need to change energy supply channels. Such structural changes reduced economic growth forecasts for the medium term as well - by 1.3 ppt in 2024 and by 0.5 ppt in 2025, respectively.

Table 4.5. Comparison with the forecasts of the Stability Programme 2022–2025 (with no policy change)

	ESA code	2022	2023	2024	2025	2026
GDP growth (%)	B1y					
2022		2.1	2.5	3.3	3.4	-
2023		2.0	0.0	2.0	2.9	2.8
Changes		-0.1	-2.5	-1.3	-0.5	-
Actual budget balance (% of GDP)	B.9					
2022		-6.5	-2.4	-1.8	-0.9	-
2023		-4.7	-4.0	-2.4	-1.7	-0.5
Changes		1.8	-1.7	-0.6	-0.7	-
General government debt (% of GDP)						
2022		45.7	45.2	44.5	43.4	-
2023		40.8	39.6	39.7	39.8	38.9
Changes		-4.9	-5.6	-4.8	-3.6	-

According to the assessment of the MoF, general government budget deficit in 2022 amounted to 7.4% of GDP, which is lower than forecast in Latvia's Stability Programme 2022-2025, when, given the high uncertainty with respect to the warfare launched by Russia in Ukraine, the impact on economy and tax revenue is being forecast to be more negative. With inflation

[18] Net of contributions to the State funded pension scheme and contributions to the 3rd pension pillar

remaining high and hostilities in Ukraine continuing, great uncertainty still remains. Also in the first months of 2023, support approved by the government is being provided to reduce the impact of the increase in energy resource prices on society, and significant additional funding has also been earmarked for increasing the national safety and defence capabilities, setting a higher deficit level in the medium term than planned last year in the Stability Programme. In 2024 and beyond, as the economy develops and tax revenue grows, it is predicted that the general government budget deficit will decrease; however, as defence expenditure continues to increase, it is still predicted to be higher than in the previous Stability Programme of Latvia with no policy change.

General government debt forecast has been decreased in 2023-2025, as compared to the forecasts of the Stability Programme 2022-2025. The changes were mainly determined by the updated GDP forecasts, according to which the nominal GDP (MEUR) in the medium term is higher compared to the previous forecast. The updated GDP forecasts ensure lower debt-to-GDP levels.

5. QUALITY OF PUBLIC FINANCES

5.1. Efficiency of State Budget Resources and Expenditure Control

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

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

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

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

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

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

In 2023, the spending review is structured in **two directions** – annual spending review of the State budget and medium-term spending review of the State budget.

Within the framework of the annual spending **review of the State budget,** three key blocks are envisaged - analysis of financing policies under the supervision of the line ministries, within the framework of which the evaluation of the health and education sector will be carried out, analysis of the field of information and communication technologies under the supervision of the Ministry of Environmental Protection and Regional Development, as well as the analysis of the interest-related education and vocationally oriented education, horizontal measures for the reallocation of financial resources in favour of the current priorities, revision of base expenditure of the line ministries, evaluation of the costs of mobile applications, translation services and other issues, as well as improvement of processes and systems.

Within the framework of the medium-term spending review of the State budget, further analysis of data and information is intended to increase the effectiveness of expenditure related to the rental and maintenance of real estate, focusing on office premises located in the regions (see Figure 5.1).

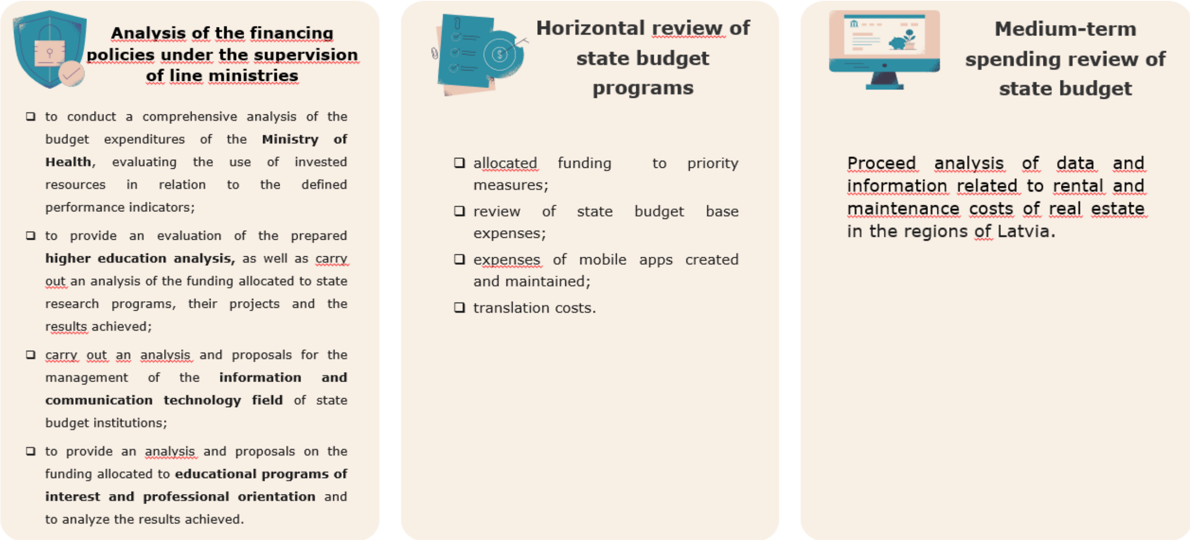


Figure 5.1. Scope of the spending review for 2023

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

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

- interactive budget infographics, which allows the user to get acquainted with nine budget investment areas (for example, health, education, social protection, etc.) and the allocated funding, as well as to find out detailed information on the investment directions in each area and funding sources. Additionally, information is provided on the results that can be expected from the investment of State budget funding into the relevant area;
- budgets of the ministries and other central State institutions are visualised both in summarised form and in more detail. The user can view the fields of operation of the ministries and other central State institutions and the financing allocated thereto, as well as get an insight regarding the benefits for society as a result of sectoral activity. It is reflected in the Policy and Resource Management Scorecards, which in summarised form provide possibly comprehensive and characteristic information on sectoral activity in the relevant field – the goal, inputs for the achievement thereof, expected operational outputs and the highest-level sectoral policy and quality outcomes to be achieved.

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

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

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

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

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

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

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

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

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

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

5.2. Efficiency of Revenue Structure and System

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

Tax revenue forecasts have been prepared for a constant tax policy scenario, on the basis of macroeconomic indicator forecasts, as well as taking into account the actual tax enforcement, previous changes to legislation and tax support measures adopted during the Covid-19 crisis. Tax revenue forecasts do not include the retained tax revenue in the single account.

The most significant tax policy changes adopted during the development of the Draft Annual State Budget Law for 2023 and Budget Framework for 2023, 2024 and 2025 are the increase of the minimum monthly wage and the increase of the object of the minimum State social security contributions, taking into account the changes in the minimum monthly wage (in 2023 it is increased from EUR 500 to EUR 620 and in 2024 from EUR 620 to EUR 700).

Also, on 23 March 2023, the Saeima supported the amendments to the law On Personal Income tax, by which the obligation of economic operators to make advance payments of personal income tax is abolished, thus making it a permanent norm.

Compared to *The Budget Framework for 2023-2025* the higher forecasted economic growth makes it possible to increase the total budget tax revenue forecasts (by cash flow) by EUR 183.6 million in 2023, by EUR 268.1 million in 2024 and by EUR 306.2 million in 2025.

Table 5.1. Tax Revenue in General Government Budget (S.13), *MEUR*

	Code (ESA)	2023	2024	2025	2026
1. Production and import taxes	D.2	5 591.5	5 914.3	6 215.7	6 514.9
2. Current income and wealth taxes	D.5	2 858.5	3 050.0	3 209.0	3 386.3
3. Capital taxes	D.91	18.3	18.7	19.0	19.0
4. Social contributions	D.61	4 208.9	4 553.4	4 807.5	5 024.9
Of which actual social contributions	*D.611 and D.613*	*4 071.3*	*4 415.7*	*4 669.8*	*4 887.2*

Total tax revenue shows a stable growth trend in the coming years, maintaining a steady level in relation to GDP, which is projected at an average of 29%.

Total tax revenue growth (2026 compared to 2023) is projected at 18%, with labour taxes increasing by 19%, consumption taxes - by 17% and capital taxes - by 4%.

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

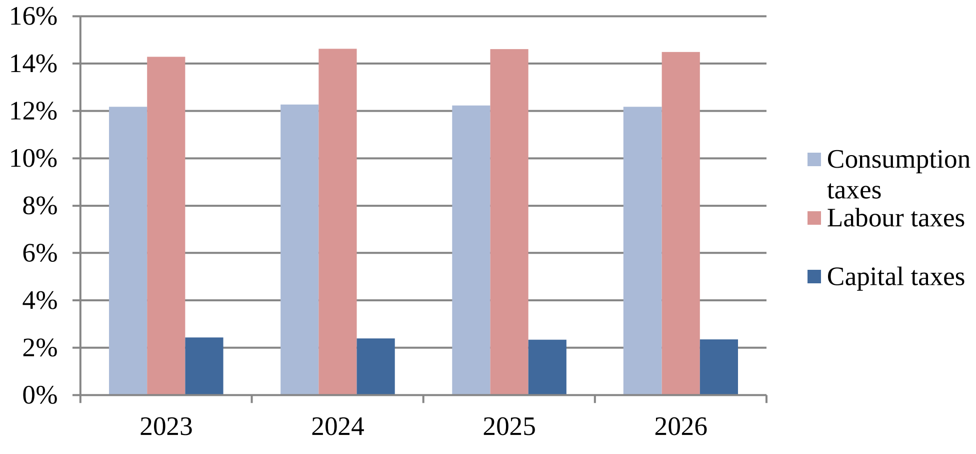


Figure 5.2. Tax revenue according to economic functions, % of GDP

It should be noted that in 2023, in cooperation with the government's social and cooperation partners, the National Tax Policy Guidelines for 2024-2027 will be developed, defining the tax policy priorities for the following years. They are aimed at implementing a stable, flexible and understandable tax policy for taxpayers, which promotes the well-being of population and the regional competitiveness of the country, simultaneously ensuring the achievement of the country's fiscal needs and strategic development goals. The clarity and stability of the strategic directions of the tax policy is essential for the effective planning of both business and public services and investments, linking it to the general development goals of the country.

6. Sustainability of Public Finances

6.1. Long-Term Development Scenario of Public Finances

Once every three years, the EC, in cooperation with Member State, within the scope of the Working Group on Ageing Populations of the Economic Policy Committee (EPC AWG), develops long-term ageing-related budgetary expenditure forecasts. The latest sustainable budgetary expenditure forecasts, developed by the Working Group in the second half of 2020, were published in *Ageing Report 2021*. Currently, the EPC AWG working group has started to work on improving the projection methodology and updating the long-term macroeconomic and budget forecasts, which will be included in Ageing Report 2024.

When updating the public expenditure forecasts till 2070 for the previous Ageing Report, EUROPOP2019 demographic forecasts prepared by the Eurostat, as well as the forecasts of the macroeconomic indicators for the long term prepared by the EC, has been considered. Forecasting methodology, being uniform for all Member States, has been discussed and approved by the AWG working group, as well as published in *Ageing Report 2021: Underlying Assumptions and Projection Methodologies.*

The base year in EUROPOP2019 forecasts is 2019, and in Latvia, at the beginning of 2019, the number of population comprised 1.92 million people, which is, for example, by 200 thousand less than in 2010. The current statistics show that at the beginning of 2022, the number of population in Latvia was 1.88 million people. Compared to 2021, the population decreased by 17.5 thousand or 0.9%, mainly due to a decrease in the birth rate.

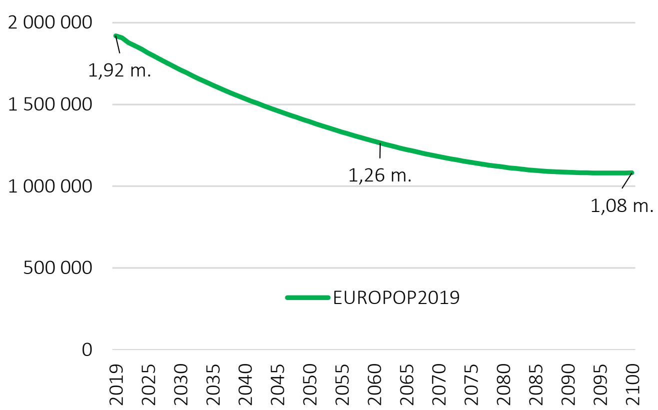


Figure 6.1. Number of population (Data source: Eurostat)

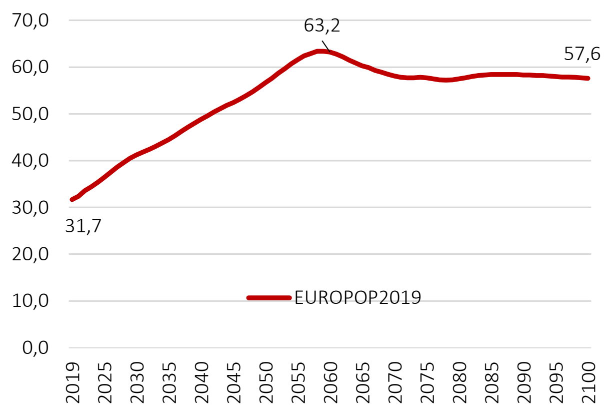


Figure 6.2. Share of population aged 65+, in the number of population aged 15-64, % (Data source: Eurostat)

According to *Eurostat* it is being forecasted that the number of population in Latvia will reduce to 1.26 million in 2060 and further on to 1.08 million people in 2100. When preparing demographic forecasts for Latvia, it was taken into account that:

- the aggregated birth rate will increase from 1.58 in 2019 to 1.73 in 2100. The current statistics show that the number of people born in Latvia continues to decrease, for example, in 2022, the birth rate was one of the lowest during the last 100 years: 15.5 thousand newborns, which is 1 885 or 10.8% less than in 2021;
- the natural growth in Latvia will protractedly remain negative - until 2100. The current statistics show that before the pandemic, from 2012 to 2019, the annual number of deaths tended to decrease, while in 2020, compared to the previous year, the number of deaths due to the Covid-19 pandemic increased by 1 135 or 4.1%, but in 2021 - by 5 746 or 19.9%. In 2022, compared to 2021, the number of deaths

reduced by 4 252 or 12.3% and was 30.3 thousand, which is almost twice as high as the number of births;

- The increase of 65+ population proportion to the number of working age population (see Figure 6.2), reaching the highest proportion - 63.2% of the working age population in 2060. In the long term, increase in the proportion of an elderly population share in the number of population will be influenced by the increase of the lifespan, which according to *Eurostat* forecasts will grow on average from 70.6 years in 2019 to 87.6 years in 2100 for men, while for women it will grow on average from 80.2 years in 2019 to 92.1 years in 2100. Likewise, also the proportion of population aged 65+ to population aged 15-64 in the long term will also be influenced by decline in the number of working age population according to *Eurostat* forecasts;

- For Latvia, till 2065, *Eurostat* forecasts that more of the population will leave the country than enter it, however, during the period from 2065 till 2100 the forecast migration balance is positive.

When preparing the long-term forecasts of macroeconomic indicators and using the assumptions approved by the Working Group of Economic Policy Committee, the European Commission forecasts that Latvia's GDP will continue growing, on average, by 1.2% during the time period from 2019 to 2070. The forecasts consider the impact of the economic crisis caused by Covid-19, as well as the reduction of the forecasted total number of hours worked in the economy, on average, by 1.1% in 2019-2070, along with a steeper decline in the number of working age population. It should be noted that the EC forecasts that the employment rate in Latvia during the time period from 2019 till 2032 will decrease from 72.5% to 68.2%, but will, nevertheless, gradually grow afterwards, until it reaches 71.3% in 2070. Notwithstanding the growth of employment rate, it is forecasted that, in total, the number of employed will decrease in the long term, along with the decline in the number of working age population (see Figure 6.4).

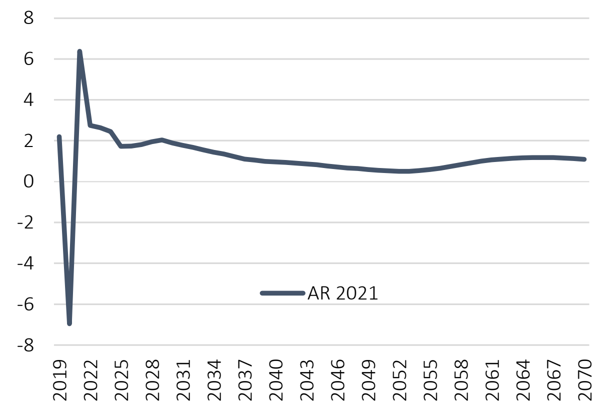


Figure 6.3. Real GDP growth, %
(Data source: Ageing Report 2021)

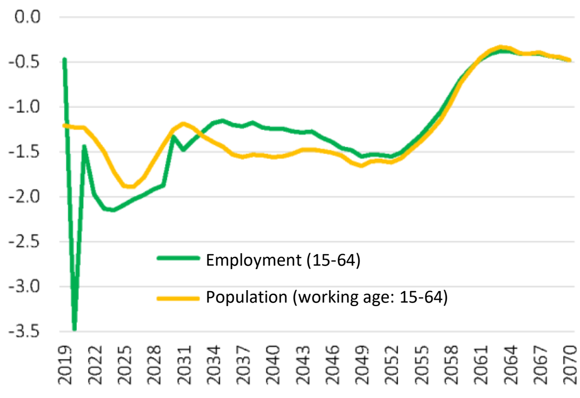


Figure 6.4. Increase of the working population and employment, %
(Data source: Ageing Report 2021)

The demographic and economic, especially, labour market situation will have a long-term influence on the sustainability of public finances, creating impact on both the tax revenue and the budget expenditure. The amount of collected taxes will depend on the long-term trends in the number of the employed, and the long-term growth of budget expenditure will also be affected by the obligations assumed already before for the disbursement of pensions and benefits, debt service expenses, as well as the growth in expenditure related to ageing of the population.

The EPC AWG, considering the updated long-term demographic and macroeconomic forecasts, has updated the forecasts of expenditure related to ageing of population up to 2070. They have been published in the Second Part of *Ageing Report 2021: Economic & Budgetary Projections for the EU Member States (2019-2070)).*

According to the baseline scenario, ageing-related public expenditure in 2070, as compared to 2019, will decrease by 0.6 ppt and will comprise to 15.2% of GDP (see Figure 6.5). The tendency of long-term reduction of expenditure, in total, remains similar to that of the previous forecasts. It should be noted that the forecasts have been prepared at a constant policy scenario, namely, considering the legislative changes adopted until October 2020.

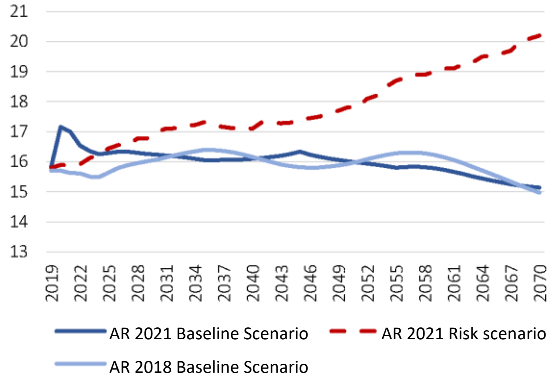


Figure 6.5. Ageing-related public expenditure in the baseline and risk scenario, % of GDP (Data source: Ageing Report 2021)

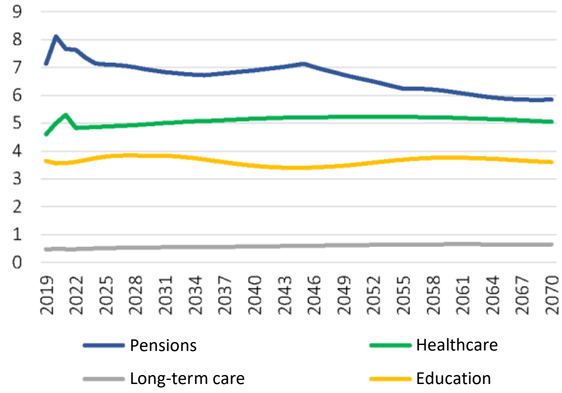


Figure 6.6. Ageing-related public expenditure by items, %of GDP (Data source: Ageing Report 2021)

Forecasts of expenditure for pensions are based upon (see Figure 6.6) the forecasts prepared by the Ministry of Welfare, providing for a reduction in the pension expenditure share in GDP from 7.1% of GDP in 2019 to 5.8% of GDP in 2070. Reduction of expenditure, especially until 2025, is driven by increase of the retirement age to 65 years, resulting in a decline in the number of recipients of pensions and the pre-retirement aged population staying longer in the labour market. Forecasts of expenditure for pensions have been prepared in a constant policy scenario, considering the legislative changes adopted until October 2020.

It is forecasted that expenditure for health care will increase in the long term from 4.6% of GDP in 2019 to 5.1% of GDP in 2070, mainly, considering the ageing of population, with the lifespan and the need for health care services growing. In 2020-2021, the health expenditure share in gross domestic product, considering both the fall in gross domestic product and additional funding for combatting Covid-19 (medicinal equipment, personal protection equipment, infrastructure improvement) will temporarily grow to 5.0-5.3% of GDP.

In addition to the baseline scenario, the Working Group has also developed several alternative scenarios by different assumptions. In the risk scenario, it is forecasted that the public expenditure related to ageing of population, contrary to the baseline scenario, as compared to 2019, might increase by 4.4 ppt, and reach 20.2% of GDP in 2070. In the risk scenario, expenditure would mainly increase for health care and long-term care, considering both the possible rise in costs, along with the development of technologies, and with the costs per 1 recipient converging with the average indicators of the EU.

In April 2022 the European Commission published the Fiscal Sustainability Report 2021. In this report a potentially low fiscal sustainability risk is identified for Latvia in all three risk categories (short-term, medium-term and long-term). The low risk of fiscal sustainability is determined by a relatively low level of central government debt, which will generally remain stable, as well as low long-term ageing-related expenditure.

6.2 State-Issued Guarantees

The Law On the State Budget for 2022 did not provide for any new guarantees provided on behalf of the State, but it, nevertheless, prescribed that in accordance with the Law On Agriculture and Rural Development and the Development Financial Institution Law, the State shall be liable in the amount of EUR 270.0 million for the guarantees issued by the JSC "Attīstības finanšu institūcija Altum".

In accordance with the provisions of Section 8.[2] of the Law on Assistance to Ukrainian Civilians, the Minister of Finance signed two guarantee agreements on behalf of the Republic of Latvia:

- on 11 July 2022, a guarantee agreement was signed with the International Bank for Reconstruction and Development of the World Bank Group on a loan to Ukraine of EUR 10.0 million and loan interest in the amount of EUR 3.78 million, within the framework of the project "Public Expenditures for Administrative Capacity Endurance in Ukraine". The final term for repayment of the loan is planned to be 15 August 2040. Ukraine's creditworthiness has been assessed as poor and due to the high risk of failure to repay the loan of the International Bank for Reconstruction and Development, this risk has been included in the calculation of the fiscal security reserve and provisions have been made for the State budget guarantee and guarantee interest payments;

- on 1 December 2022, a guarantee agreement was signed with the EC based on Decision (EU) 2022/1201 of the European Parliament and of the Council of 12 July 2022 and Decision (EU) 2022/1628 of the European Parliament and of the Council of 20 September 2022 providing exceptional macro-financial assistance to Ukraine. The agreement stipulates that till 31 December 2058 the Republic of Latvia will guarantee the payments of the principal amount of the loan in the amount of EUR 8.1 million and from 2028 to 2058 - the payment of the principal amount and interest payments of the loan. This risk is included in the calculation of the fiscal security reserve and, after receiving official information from the EC, provisions will be made in the State budget.

The amount of the guarantees provided on behalf of the State at the end of 2022 was EUR 578.2 million, which consisted of the paid out, but not yet repaid, part of the guarantee provided on behalf of the State in the amount of EUR 371.8 million, and the non-paid, but still available, part of the guarantee issued on behalf of the State amounting to EUR 206.4 million.

The total balance of guarantees issued on behalf of the State at the end of 2022 was EUR 371.8 million or 1% of GDP (see Figure 6.7).

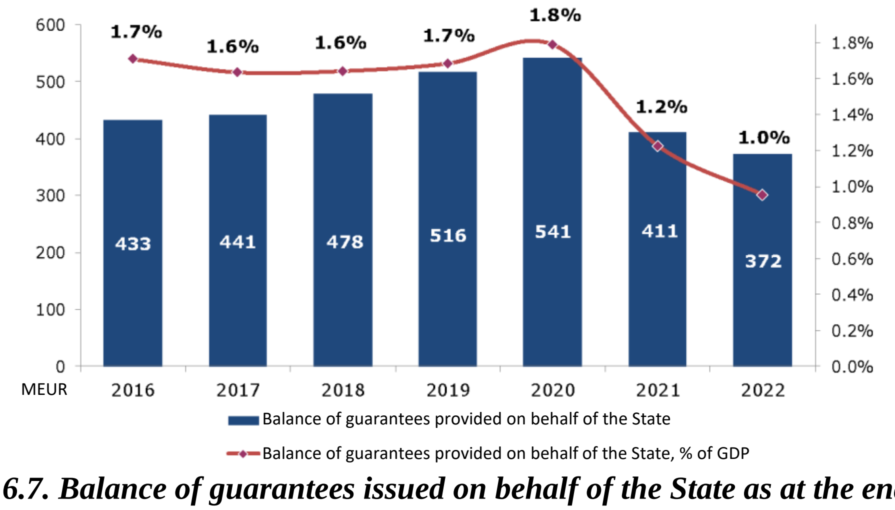


Figure 6.7. Balance of guarantees issued on behalf of the State as at the end of the respective year (MEUR)

In the portfolio of the guarantees issued on behalf of the State, the largest part is made up of guarantees to JSC “Attīstības finanšu institūcija Altum” regarding the guarantees issued by the JSC “Attīstības finanšu institūcija Altum” to credit institutions for farmers’ borrowings (over-guarantees), guarantees to the European Investment Bank for borrowings issued by the JSC “Attīstības finanšu institūcija Altum” within the framework of the programme for improving the companies’ competitiveness and within the framework of crediting the development of the small and medium enterprises of Latvia (EUR 242.6 million), guarantees for students and study crediting (EUR 48.3 million), as well as, based on the Law On Measures for the Prevention and Suppression of Threat to the State and Its Consequences Due to the Spread of Covid-19, a guarantee to the EC in the amount of EUR 57.1 million for Latvia’s participation in the EU support instrument EC SURE. In the future, it is expected that an increasingly larger share in the portfolio of guarantees issued on behalf of the State will consist of the support to small and medium enterprises and for the implementation of other state support programs.

Notwithstanding the economic downturn caused by Covid-19, the global increase of the prices of energy resources and Russia’s invasion of Ukraine, up to now, it has not caused a considerable impact on the fulfilment of the guarantees issued on behalf of the State. However, for the time being, it is impossible to assess the impact of the war started by Russia and its consequences on the guarantees issued on behalf of the State.

7. INSTITUTIONAL FEATURES OF PUBLIC FINANCES

7.1 Medium-Term Budget Planning

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

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

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

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

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

7.2. Budget Procedures, Including Public Finance Statistical Management

7.2.1. Budget Procedures

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

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

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

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

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

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

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

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

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

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

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

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

If, at the beginning of the financial year, the State Budget Law has not into force, the Minister of Finance shall approve the State budget expenditure necessary for the operation of the State, as well as the loan and borrowing limits, provided that the expenditure does not exceed the volume of the maximum permissible total State budget expenditure set by the State

Budget Law for the relevant year for each Ministry and other central State institution, by introducing the corrections laid down in the LBFM.

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

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

1) the expenditures do not exceed the actual expenditures of the previous financial year of the local government by making the following adjustments:

a) the services (payment orders) which have not been provided in the previous financial year are not paid for, and the investments which have not been realised in the previous financial year are not made;

b) the financing of the measures commenced in the previous financial year is continued;

c) the enforcement of the existing laws and regulations is ensured;

2) the implementation of budget policies and conditions determined in the local government budget law of the previous financial year is ensured at a constant level, except for fixed-term measures;

3) the implementation of projects co-financed by the European Union and other foreign financial assistance is ensured;

4) the State budget earmarked grants and grants approved for the financial year are taken into account;

5) the financing for the fulfilment of the liabilities undertaken by the local government is provided for;

6) new borrowing and guarantee liabilities are not undertaken, except for liabilities for the implementation of the projects referred to in Paragraph one, Clause 3 of this Section.

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

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

7.2.2. Management of Government Finance Statistics

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

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

In accordance with Paragraph 6 of Cabinet Regulation No. 1456 of 10 December 2013 "Regulation regarding the Classification of Institutional Sectors", the CSB shall prepare and maintain a list of the general government sector. To prepare the list and decide on the units to be included, the CSB ensures compliance with ESA 2010 requirements, as well as the principles defined in *Eurostat* (Statistical Office of the European Union) *Manual on Government Deficit* *and Debt*, which foresee that the capital corporations that are controlled and mostly financed by central and local governments belong to the general government sector.

As of 31 December 2021, the general government sector included 555 independent budgetary institutions, of which 228 institutions belonged to the central government sub-sector; 326 institutions belonged to the local government sub-sector, and 1 institution – to the social security fund sub-sector. Moreover, there were 142 capital corporations controlled and financed by the central and local governments, of which 56 capital corporations were controlled by the central, and 86 – by local governments.

Each quarter the CSB prepares detailed information about the following general government sector indicators: revenue, expenditure, deficit, debt, and compiles quarterly financial accounts of general governments. The information is published on the CSB home page, as well as sent to *Eurostat* three months after the end of the reporting period.

In addition, the CSB each year within the set deadlines – by 1 April (provisional data) and by 1 October (final data) – prepares the general government budget deficit and debt notification (hereinafter – Notification) and submits it to *Eurostat.*

The Notification is drafted in accordance with the provisions of Cabinet Regulation No. 756 of 22 December 2015 "Procedure by Which the Notification of General Government Deficit and Debt Shall Be Prepared". The CSB is the authority responsible for the preparation and submission of the Notification to *Eurostat*; it also conducts regular inter-institutional working group meetings. The following institutions are involved in the process of preparation of the Notification: the Ministry of Finance, the Treasury, the Central Finance and Contracting Agency, the Ministry of Defence and the State Social Insurance Agency. If needed, specialists from other institutions (the Ministry of Economy, the Ministry of Welfare, Riga City Council, etc.) are involved.

The results of the Notification are used for assessing how the countries observe the compliance of the fiscal indicators with respect to the requirements of the Stability and Growth Pact with an aim to pursue sound public finances and coordinate fiscal policies of the Member States.

Council Directive 2011/85/EU (8 November 2011) on requirements for budgetary frameworks of the Member States lays down the detailed requirements for the EU Member States to strengthen the EU fiscal and economic surveillance, and to avoid an excessive budget deficit. The fiscal data as envisaged within the Directive 2011/85/EU are published on the MoF website. In addition, the website offers a detailed transition table for budget data from the cash flow data according to the national classification to general government data according to the ESA 2010 methodology. The following information is published on a regular basis:

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

ANNEXES

Table 1a. Macroeconomic prospects*

	ESA Code	2022	2022	2023	2024	2025	2026
		Levels, M, euro	Rate of change %				
1. Real GDP	B1g	28 768	2.0	0.0	2.0	2.9	2.8
2. Nominal GDP	B1g	39 081	16.4	11.7	5.5	5.7	5.5
Components of real GDP							
3. Private consumption expenditure	P3	17 970	8.1	-0.9	2.1	4.0	3.5
4. Government consumption expenditure	P3	5 545	2.8	1.2	0.8	0.1	0.5
5. Gross fixed capital formation	P51	6 630	0.7	1.0	4.8	5.0	5.0
6. Changes in inventories and net acquisition of valuables (% of GDP)	P52+P53	2 582	-	-	-	-	-
7. Exports of goods and services	P6	20 103	9.1	0.0	4.3	4.6	5.0
8. Imports of goods and services	P7	24 063	11.6	0.5	3.9	4.7	5.0
Contribution to real GDP growth							
9. Final domestic demand			5.5	-0.1	2.6	3.7	3.5
10. Changes in inventories and net acquisition of valuables	P52+P53		-0.5	0.5	-0.3	0.0	0.0
11. External balance of goods and services	B11		-2.9	-0.4	-0.3	-0.8	-0.7

* Forecasts: March 2023 scenario

Table 1b. Price developments*

	ESA Code	2022	2022	2023	2024	2025	2026
		Levels	Rate of change, %				
1. GDP deflator			14.1	11.7	3.4	2.7	2.7
2. Private consumption deflator			14.2	10.0	2.2	2.5	2.2
3. HICP			17.3	10.0	2.2	2.5	2.5
4. Public consumption deflator			3.4	12.5	2.8	2.1	1.5
5. Investment deflator			12.4	10.0	4.0	3.6	3.2
6. Export price deflator (goods and services)			17.7	9.0	5.0	4.0	3.0
7. Import price deflator (goods and services)			18.2	7.0	4.0	3.0	2.9

* Forecasts: March 2023 scenario

Table 1c. Labour market developments*

	ESA Code	2022	2022	2023	2024	2025	2026
		Levels	Rate of change, %				
1. Employment, persons		886	2.6	0.0	-0.2	-0.3	-0.6
2. Employment, hours worked		1 498	1.8	0.0	0.0	0.0	0.0
3. Unemployment rate (%)			6.9	7.1	6.8	6.4	6.4
4. Labour productivity, persons			-0.6	0.0	2.2	3.2	3.4
5. Labour productivity, hours worked			-2.3	0.0	2.2	3.2	3.4
6. Compensation of employees	D.1	18 239	11.5	8.5	6.3	4.7	3.4
7. Compensation per employee		1 373	7.5	8.5	6.5	5.0	4.0

* Forecasts: March 2023 scenario

Table 1d. Sectoral balances*

% of GDP	ESA Code	2022	2023	2024	2025	2026
1. Net lending/borrowing vis-a-vis the rest of the world	B.9	-5.3	-1.9	-1.3	-1.0	-1.1
of which:						
- Balance on goods and services		-5.9	-4.7	-3.9	-3.3	-3.3
- Balance of primary incomes and transfers		-0.6	1.1	0.5	0.9	0.7
- Capital account		1.1	1.6	2.1	1.4	1.5
2. Net lending/borrowing of the private sector	B.9	-0.6	2.1	1.2	1.2	-0.4
3. Net lending/borrowing of general government	EDP B.9	-4.7	-4.0	-2.5	-2.2	-0.7
4. Statistical discrepancy		0.0	0.0	0.0	0.0	0.0

* Forecasts: March 2023 scenario

Table 2a. General government budgetary prospects

	ESA Code	2022	2022	2023	2024	2025	2026
		M, euro	% of GDP				
Net lending (EDP B.9) by sub-sector							
1. General government	S.13	-1 838.8	-4.7	-4.0	-2.5	-2.2	-0.7
2. Central government	S.1311	-2 157.8	-5.5	-4.2	-2.9	-2.3	-0.6
3. State government	S.1312						
4. Local government	S.1313	50.9	0.1	-0.1	0.0	0.0	0.1
5. Social security funds	S.1314	268.1	0.7	0.3	0.3	0.2	-0.1
General government (S13)							
6. Total revenue	TR	14 118.2	36.1	36.0	36.1	35.4	34.9
7. Total expenditure	TE	15 957.0	40.8	40.0	38.6	37.6	35.6
8. Net lending/borrowing	EDP B.9	-1 838.8	-4.7	-4.0	-2.5	-2.2	-0.7
9. Interest expenditure	EDP D.41	208.8	0.5	0.6	0.8	1.0	1.1
10. Primary balance		-1 630.0	-4.2	-3.4	-1.7	-1.2	0.4
11. One-off and other temporary measures[19]		-1 880.5	-4.8	-3.0	-1.5	-1.5	-0.7
Selected components of revenue							
12. Total taxes (12=12a+12b+12c)		7 957.2	20.4	19.4	19.5	19.4	19.3
12a. Taxes on production and imports	D.2	5 224.5	13.4	12.8	12.9	12.8	12.7
12b. Current taxes on income, wealth, etc	D.5	2 711.7	6.9	6.6	6.6	6.6	6.6
12c. Capital taxes	D.91	21.0	0.1	0.0	0.0	0.0	0.0
13. Social contributions	D.61	3 786.4	9.7	9.6	9.9	9.9	9.8
14. Property income	D.4	284.2	0.7	1.0	0.7	0.5	0.4
15. Other		2 090.3	5.3	5.9	6.0	5.5	5.4
16=6. Total revenue	TR	14 118.2	36.1	36.0	36.1	35.4	34.9
P.M. : Tax burden (D.2[20]+D.5+D.61 +D.91-D.995)		11 837.0	30.3	29.2	29.6	29.5	29.3
Selected components of expenditure							
17. Compensation of employees + intermediate consumption	D.1+P.2	6 715.2	17.2	16.2	15.7	15.2	14.4
17a. Compensation of employees	D.1	3 985.8	10.2	10.3	10.0	9.6	9.1
17b. Intermediate consumption	P.2	2 729.5	7.0	5.9	5.7	5.6	5.3
18. Social payments (18=18a+18b)		5 311.1	13.6	13.0	13.1	13.2	13.1
of which Unemployment benefits		150.6	0.4	0.4	0.4	0.4	0.4

[19] See Table 3.1.
[20] Including the share of taxes collected in the EU budget.

18a. Social transfers in kind supplied via market producers	D.6311, D.63121, D.63131	787.5	2.0	1.8	1.7	1.6	1.5
18b. Social transfers other than in kind	D.62	4 523.6	11.6	11.2	11.4	11.6	11.5
19=9. Interest expenditure	EDP D.41	208.8	0.5	0.6	0.8	1.0	1.1
20. Subsidies	D.3	266.1	0.7	0.7	0.6	0.6	0.6
21. Gross fixed capital formation	P.51	1 705.4	4.4	5.1	5.9	5.7	4.8
22. Capital transfers	D.9	76.4	0.2	0.1	0.1	0.1	0.0
23. Other		1 674.0	4.3	4.4	2.4	1.8	1.6
24=7. Total expenditure	TE	15 957.0	40.8	40.0	38.6	37.6	35.6
P.M. : Government consumption (nominal)	P.3	7 518.9	19.2	19.0	19.1	18.3	17.0

Table 2b. No-policy change projections

	2022	2022	2023	2024	2025	2026
	M, euro	**% of GDP**				
1. Total revenue at unchanged policies	14 118.2	36.1	36.0	36.1	35.4	34.9
2. Total expenditure at unchanged policies	15 957.0	40.8	40.0	38.5	37.1	35.4

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

	2022	2022	2023	2024	2025	2026
	M, euro	**% of GDP**				
1. Expenditure on EU programmes fully matched by EU funds revenue	450.0	1.2	2.2	2.6	2.2	2.2
1.a *Of which* investment expenditure fully matched by EU funds revenue	222.4	0.6	0.9	1.3	1.1	1.1
2. Cyclical unemployment benefit expenditure	-5.69	0.0	0.0	0.0	-0.1	-0.1
3. Effect of discretionary revenue measures	36.7	0.1	0.4	-0.4	0.0	0.0
4. Revenues increased mandated by law	-	-	-	-	-	-

Table 3. General government expenditure by function

% of GDP	COFOG Code	2022	2026
1. General public services	1	3.2	3.2
2. Defence	2	2.2	2.6
3. Public order and safety	3	2.1	1.7
4. Economic affairs	4	7.1	5.3
5. Environmental protection	5	0.7	0.4
6. Housing and community amenities	6	1.0	0.8
7. Health	7	5.6	3.6
8. Recreation, culture and religion	8	1.3	1.0
9. Education	9	5.1	4.7
10. Social protection	10	12.6	12.4
11. Total expenditure (= item 7=24 in Table 2a)	**TE**	**40.8**	**35.6**

Table 4. General government debt developments

% of GDP	ESA Code	2022	2023	2024	2025	2026
1. Gross debt		**40.8**	**39.6**	**39.7**	**39.8**	**38.9**
2. Change in gross debt ratio		-3.1	-1.2	0.2	0.1	-0.9
Contributions to changes in gross debt						
3. Primary balance		-4.2	-3.4	-1.6	-0.7	0.6
4. Interest expenditure	EDP D.41	0.5	0.6	0.8	1.0	1.1

% of GDP	ESA Code	2022	2023	2024	2025	2026
5. Stock-flow adjustment		-1.6	-1.0	-0.2	0.6	0.7
Implicit interest rate on government debt		1.4	1.7	2.2	2.7	2.8
Other relevant variables						
6. Liquid financial assets		9.3				
7. Net financial debt (7=1-6)		31.5				
8. Debt amortization (existing bonds) since the end of the previous year		1.6	3.5	2.9	3.1	3.7
9. Percentage of debt denominated in foreign currency		0.0	0.0	0.0	0.0	0.0
10. Average maturity		6.58 years				

Table 5. Cyclical developments

% of GDP	ESA Code	2022	2023	2024	2025	2026
1. GDP growth at constant prices (%)	B1g	2.0	0.0	2.0	2.9	2.8
2. Actual budget balance	B.9	-4.7	-4.0	-2.5	-2.2	-0.7
3. Interest expenditure	D.41	0.5	0.6	0.8	1.0	1.1
4. One-off and other temporary measures[21]		-4.8	-3.0	-1.5	-1.5	-0.7
5. Potential GDP growth (%)		2.1	2.0	2.0	2.1	2.1
input:						
- of employment		0.0	-0.1	-0.2	-0.8	-0.9
- of capital		0.8	0.8	0.8	0.9	0.9
- of total manufacturing factors' productivity		1.3	1.3	1.4	1.9	2.1
6. Gap between actual and potential GDP (% of the potential GDP)		0.5	-1.5	-1.4	-0.6	0.0
7. Cyclical component of the budgetary balance		0.2	-0.5	-0.5	-0.2	0.0
8. Cyclically adjusted balance (2-7)		-4.9	-3.5	-2.0	-2.0	-0.7
9. Cyclically adjusted primary balance (8+3)		-4.4	-2.9	-1.2	-1.0	0.4
10. Structural balance (8-4)		-0.1	-0.5	-0.5	-0.5	0.0

Table 6. Comparison with forecasts of the Stability Programme 2022-2025

	ESA Code	2022	2023	2024	2025	2026
GDP growth (%)	B1g					
2022		2.1	2.5	3.3	3.4	-
2023		2.0	0.0	2.0	2.9	2.8
Changes		-0.1	-2.5	-1.3	-0.5	-
Actual budget balance (% of GDP)	B.9					
2022		-6.5	-2.4	-1.8	-0.9	-
2023		-4.7	-4.0	-2.5	-2.2	-0.7
Changes		1.8	-1.7	-0.7	-1.2	-
Total general government debt (% of GDP)						
2022		45.7	45.2	44.5	43.4	-
2023		40.8	39.6	39.7	39.8	38.9
Changes		-4.9	-5.6	-4.8	-3.6	-

[21] See Table 3.1.

Table 7. Long-term sustainability of public finances [22]

% of GDP	2019	2030	2040	2050	2060	2070
Old age-related general government budget expenditure	**15.8**	**16.3**	**15.8**	**15.7**	**15.8**	**15.2**
Pension expenditure (for State-funded pensions)	7.1	6.9	6.6	6.3	6.2	5.9
Old-age and premature pensions – contributions-based	6.4	6.3	6.0	5.8	5.7	5.3
Other pensions (incl., disability, survivor's pension)	0.7	0.6	0.6	0.5	0.5	0.6
Non-social security pensions (incl., ensuring minimum pensions and minimum income)	0.0	0.0	0.0	0.0	0.0	0.0
Healthcare expenditure	4.6	4.2	4.4	4.5	4.4	4.3
Long-term care expenditure	0.5	0.5	0.6	0.6	0.7	0.6
Education expenditure	3.6	3.8	3.5	3.5	3.8	3.6
Social security contributions to the State-funded pensions special budget	8.4	7.3	7.0	6.7	6.6	6.8
Systemic pension reforms						
Social security contributions to the State-funded pension scheme	1.9	1.8	1.8	1.8	1.8	1.8
Pension expenditure from the State-funded pension scheme	-	0.2	0.4	1	1.7	2.2
Assumptions						
Growth of labour productivity (per hour), %	3.3	3.1	2.2	2.0	1.8	1.5
Potential GDP growth at constant prices (%)	2.7	1.9	1.0	0.6	1.0	1.1
Participation rate, males (aged 20-64)	85.6	84.3	84.2	84.0	85.1	84.7
Participation rate, females (aged 20-64)	80.4	79.7	79.8	80.3	81.9	81.2
Total participation rate (aged 20-64)	82.9	82.0	82.0	82.2	83.6	83.0
Unemployment rate (aged 20-64)	6.4	8.9	7.9	6.9	6.8	6.8
Population (aged 65+), % of total population	20.7	13.8	13.7	13.7	12.5	13.6

Table 7a. Contingent liabilities

% of GDP	2022
State and local government guarantees	1.9

Table 8. External environment basic assumptions*

	2022	2023	2024	2025	2026
Short-term interest rate in Eurozone (annual average)	0.3	3.1	2.8	2.8	2.8
Long-term interest rate in Eurozone (annual average)	1.1	2.1	2.1	2.1	2.1
EUR/USD exchange rate (annual average)	1.04	1.08	1.09	1.09	1.09
Nominal effective exchange rate in the EU	-4.0	3.3	0.0	0.0	0.0
World GDP, excluding EU, growth at constant prices, %	3.1	3.0	3.3	3.3	3.3
EU GDP growth at constant prices, %	3.5	0.8	1.6	2.0	2.0
World goods and services trade volumes changes on the EU export markets, excluding EU, %	4.2	2.9	3.6	3.6	3.6
World goods and services import volumes changes, excluding EU, %	4.4	2.4	3.6	3.6	3.6
Oil price (Brent, USD/barrel)	100.7	90.0	80.0	75.0	75.0

* Forecasts: March 2023 scenario

[22] Data source: *The 2021 Ageing Report*

Table 9. RRF impact

Revenue from RRF transfers (% of GDP)							
	2020	**2021**	**2022**	**2023**	**2024**	**2025**	**2026**
RRF grants as included in the revenue projections	0.0	0.0	0.0	0.7	1.2	1.2	0.7
Cash disbursements of RRF grants from EU	0.0	0.7	0.5	0.0	1.7	0.5	0.6
Expenditure financed from RRF transfers (% of GDP)							
	2020	**2021**	**2022**	**2023**	**2024**	**2025**	**2026**
TOTAL CURRENT EXPENDITURE	0.0	0.0	0.003	0.3	0.5	0.4	0.3
Gross fixed capital formation P.51g	0.0	0.0	0.01	0.4	0.8	0.7	0.4
Capital transfer D.9	-	-	-	-	-	-	-
CAPITAL EXPENDITURE	0.0	0.0	0.01	0.4	0.8	0.7	0.4
Other costs financed from RRF transfers (% of GDP)							
	2020	**2021**	**2022**	**2023**	**2024**	**2025**	**2026**
Reduction in tax revenue	-	-	-	-	-	-	-
Other costs with impact on revenue	-	-	-	-	-	-	-
Financial transactions	-	-	-	-	-	-	-

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