Fiskālās disciplīnas padome

# Surveillance report on the Stability Programme 2024-2028

**Adopted at the meeting of the Fiscal Discipline Council**

**Protocol No. 2(70) of 2024 No. §1.1**

## Summary


1. In the world, the EU, and Latvia, a period of high uncertainty continues, which complicates the preparation and assessment of the Stability Program (SP) 2024/2028. Russia's aggression in Ukraine continues, the tension in the Middle East may turn into a war, because of which the prices of oil and energy resources could rise significantly. The US presidential elections in the autumn of this year can significantly increase the already existing orientation of the US economic policy towards protectionism, which can negatively affect EU and Latvian foreign trade and the perspective of economic development. Also, China's aggressive subsidy policy continues to have a negative impact on the competitiveness of EU companies, which reduces the pace of economic development. The Council believes that it is necessary to be prepared for unfavourable geopolitical scenarios, which can further slowdown the fragile growth predicted in the SP 2024/2028 base scenario and worsen the fiscal position of Latvia.
2. Price growth in the Eurozone has significantly decreased, with inflation reaching 2.4% and core inflation 2.9% in March of this year. The ECB still maintains a tight monetary policy and has not cut interest rates since September 2023[1], but the ECB is now close to cutting interest rates unless global turmoil alters the trajectory of Eurozone inflation. In Latvia, inflation has been falling rapidly for ten months in a row, and consumer prices rose by only 0.9% in March.
3. The fiscal indicators of the Stability program are based on Macroeconomic forecasts approved at the Council meeting on February 12[2]. The indicators have worsened because of economic stagnation in 2023. The forecasted GDP growth for this year is 1.4%, 2.9% for 2025, 2.5% for 2026, and 2.3% for 2027 and 2028. In general, such a growth scenario could not only not reduce, but might even further increase Latvia's lagging behind neighbouring countries.
4. The Bank of Latvia and the European Commission are also cautious in their forecasts - lowering them. Compared to previous estimates, the Bank of Latvia predicts[3] that the growth of the Latvian economy will be 1.8% in 2024, 3.6% in 2025 and 3.8% in 2026. The European Commission predicts[4] that GDP will grow by 1.7% in 2024, and by 2.7% in 2025. Both MoF, BoL and EC emphasize weak private consumption and exports as the main constraints to growth, the negative effects of which can be mitigated by investment and government consumption.
5. Investments, related with the EU funds, are an essential pillar of economic growth. Currently, it is the most active period of inflow of EU funds into the Latvian economy, and Latvia is generally successfully implementing the projects. On April 10 this year,


[1] Key ECB interest rates (europa.eu)
[2] Pieejamas: Makroekonomikas prognozes Stabilitātes programmai 2024.-2028. gadam | Fiskālās disciplīnas padome (fdp.gov.lv) skatīts 18/04/2024
[3] Prognozes | Latvijas Banka
[4] Economic forecast for Latvia - European Commission (europa.eu)

the European Commission approved a positive initial assessment of Latvia's second payment request in the amount of EUR 335.7 million, under the Recovery and Resilience Mechanism[5]. Although the introduction of EU funds is associated with increased financial flow control measures and a high demand for labour in the construction sector, the project implementation and management mechanisms allow to effectively redirect the flow of money to the stages of high readiness projects.

6. In Latvia, investments from the private sector are still delayed. The Council of Foreign Investors[6], the Latvia University think-thank PEAK[7] and the Bank of Latvia[8] have reached similar conclusions in various studies about the problems that limit the entry of private investments into the Latvian economy. Among them are structural problems, including restrictions on the availability of labour, low quality of education and mismatch of skills with the demand of the labour market, as well as the burden of bureaucratic procedures in construction and other industries. Within the current economic cycle, the unemployment rate, reaching 7.2% in February this year, indicate a reserve of labour, although it does not prevent the competition of Latvian entrepreneurs for employees. In general, when economic growth resumes, the limited availability of labour will be a significant factor limiting growth.
7. The Council points out that investments in competitive innovative projects and human capital are vitally necessary to ensure labour migration from low-productivity sectors to sectors with high added value, increase productivity, promote growth and increase of budget revenues.
8. Exports, which, along with investments, are critically important for the Latvian economy, have still not resumed growth. Latvia's foreign trade turnover in February decreased by 3.8% compared to February of the previous year. The value of exports of goods fell by 5.3%, while the value of imports decreased by 2.4%. In February industry sector, which is closely related to export capacity, the volume continued to decrease by (-0.3%), compared to February of the previous year. But the volume of industrial production increased by 2.8% and in manufacturing by 1,2% when compared to January of this year.
9. This year's budget law envisages a budget deficit of 2.8% and a structural deficit of 0.5% of GDP - these indicators will not be easy to achieve, considering the reduced inflation and low economic growth - both of these indicators were predicted to be higher at the time of drawing up the budget (GDP 2.5% vs 1.4% and inflation 2.2% vs 1.6%). The tax collection plan for the first two months of the general budget was not fulfilled by 8.2%, even though operational Treasury data show that the plan was already exceeded by 14% in March. However, MoF has reduced this year's general budget tax revenue forecasts by 185.5 million euros. The planned expenses for the implementation of EU funds have also been reduced by almost 400 million euros, which are postponed to the following years. However, the structural balance estimate for this year is currently - 0.8%. **The Council calls on the government, in the event of a deterioration of the base scenario, during the execution of the budget, to save the saved funds as much as possible to achieve the set goals of the budget balances.**
10. Remuneration increase in the public sector is one of the areas where increased expenditure control is required, especially in the context of the budget execution for this

[5] Komisijas novērtējums par Latvijas otro maksājuma pieprasījumu 336 miljonu eiro apmērā (ANM) (europa.eu)
[6] Ārvalstu investori Latvijas investīciju piesaisti novērtē ar līdz šim zemāko atzīmi (ficil.lv)
[7] "Latvijas produktivitātes ziņojumā 2023" 2023_LPZ.pdf (lu.lv)
[8] Ekspertu saruna "Kā panākt NOTURĪGU Latvijas tautsaimniecības izaugsmi?" Ekspertu saruna "Kā panākt NOTURĪGU Latvijas tautsaimniecības izaugsmi?" | Ekspertu sarunas | Makroekonomika

year. In the first two months of this year, 547.5 million euros were spent on compensation in the General budget, which is 27.1% more than in the corresponding period a year ago, even though the 2024 budget law provided for an increase in compensation expenses by 9.7%, compared to the year before. The MoF explains that the high growth rates for the salary will not be maintained, as bonuses have been paid in the internal affairs sector, which are paid once in five years. However, the dynamics of salary costs must be closely monitored. Although salary increases in the public sector contribute to better involvement of civil servants in state and local government administration and increase private consumption, excessive salary increases also have a negative effect: i) "takes away" labor from the private sector, ii) promotes salary growth in the private sector, which in turn iii) reduces international competitiveness, iv) negatively affects the country's fiscal position, v) contributes to inflation.

11. The Council generally welcomes the state fiscal policy in 2023, as the goals of the budget balance were achieved despite the unfavourable geopolitical conditions. The GGB deficit is estimated at 921.1 million euros or 2.3% of GDP. The structural budget balance is minimally negative (-0.1%) of GDP. The general budget balance has improved: by collecting 447.7 million euros more in revenue and reducing expenses by 128.4 euros, compared to the 2023 budget plan, a balance improvement of 1.9% of GDP was achieved. Traditionally, the state's special budget has been executed with a positive balance. On the other hand, municipal budgets have worsened GGB balance. The general budget tax plan was fulfilled by 102.9%.
12. The planned impact of state aid measures (Covid-19, Energy Support, Ukrainian refugees) on this year's budget has significantly decreased. In fact, only support for Ukrainian refugees is maintained in the amount of 70 million euros, which is 0.2% of GDP. In 2023, the amount of support measures was more significant, reaching 599 million euros or 1.5% of GDP, and an important role was played by compensations for energy resource price increases (1.1% of GDP).
13. In accordance with the government's priorities and considering geopolitical threats, a significant increase in defence spending is expected this year and in the following years as well. Without questioning the importance of strengthening the defence, the Council is critical of the interpretation of such expenditures. The MoF considers the increases in defence expenses (this year and in the following years around 1.5% of GDP) to be one-offs, which do not affect the structural balance. The Council repeatedly emphasized and maintains the opinion that one-off measures for the internal and external security of the country cannot be recognized as such[9,10,11].
14. The government has resumed work on tax policy guidelines. It is planned that the tax reform will be introduced starting from 2025 or 2026. The Ministry of Finance is aware that any reduction in tax revenues would be offset by other tax revenues. In addition, relatively little is collected in taxes in Latvia, relative to GDP, compared to other EU countries (30.8% of GDP in 2022, 41.2% on average in the EU), but the need for additional funding is considerable. The Council reminds that international studies[12] rate Latvia's tax system relatively highly. The Council respects the task of improving the tax system set out in the government's declaration but believes that changes in the tax system will not radically improve the competitiveness of companies, economic growth or the state's financial position. The weakest points of economic development are low

[9] https://www.fdp.gov.lv/lv/media/4557/download?attachment
[10] https://www.fdp.gov.lv/lv/media/4258/download?attachment
[11] https://www.fdp.gov.lv/lv/media/4167/download?attachment
[12] Tax foundation ziņojums pieejams: https://taxfoundation.org/research/all/global/2023-international-tax-competitiveness-index/

productivity, lack of labour and low level of investment. In the field of taxes, it is necessary to strengthen measures to reduce the shadow economy, as well as to simplify the tax system and its administration, thus improving the business environment and encouraging the tax compliance.

15. SP 2024-2028 is being developed and evaluated at a time when there are changes in the EU economic and fiscal governance regulation. It is predicted that this year in May, the set of regulatory acts of the Stability and Growth Pact will be reformed by introducing a new regulation that has not yet been adopted at the time of drafting this surveillance report[13]. At the same time, the regulation of the national Fiscal Discipline Law is in force, although it is likely that the Latvian Fiscal Discipline Law will be changed, as the national legislation will have to be harmonized with the reformed EU fiscal legislation. Thus, the assessed SP 2024-2028 will soon be subject to a new regulatory framework, which could require adaptation of the fiscal strategy of the SP.
16. The MoF, regarding the period 2025-2028, has proposed three approaches to determining the structural balance targets - the SB target based on FDL, the SB target based on the rule of the structural primary balance of the EU and the SB target based on the reformed expenditure growth rule of the EU. Comparing the three approaches, from the calculated SB targets, the strictest is chosen, which is the FDL structural balance target (-0.5% of GDP). The Council supports the MoF's approach to creating the budget for 2025 and the budget framework for 2025-2028. for the year, choosing as the goal of the structural balance the national legislation (-0.5%) of GDP. Achieving this goal would ensure the recommendations[14] approved by the EU Council in July 2023 for Latvia to ensure a prudent policy in the fiscal field, in particular limiting the nominal growth of state-financed net primary expenditures.
17. Based on the set of numerical fiscal rules of the transition period, the MoF predicts the general government budget balance in 2024 in the amount of -2.9% of GDP in 2025, with unchanged policy, -2.7% of GDP, -2.2% of GDP in 2026, -2.0% of GDP in 2027 and -1.7% of GDP in 2028. According to current calculations, the fiscal space is predicted to be negative in the following years. Currently, the indicative calculations of the fiscal space are as follows: in 2025 -0.6% of GDP, in 2026 -0.1% of GDP, in 2027 -0.2% of GDP.
18. Latvia still has one of the lowest debt levels in the EU. In the period of 2022 - 2023, due to high inflation, the ratio of the debt to GDP improved. However, although in the fall of 2023, the Treasury predicted that the year would end with the debt level at 39.9% of GDP, the actual growth of nominal GDP in 2023 was significantly lower than the forecasted (5.1% against 11%) and the debt-to-GDP ratio deteriorated to 43.4%. Even now, inflation is slowing down and GDP in nominal terms is lower, so the debt to GDP is predicted to increase. For the period from 2024 to 2028, the Treasury forecasts the following ratio of debt to GDP: 2024 (45.2%), 2025 (46.3%), 2026 (46.2%), 2027 (48.8%) and 2028 (48.2%). Compared to debt forecasts in October 2023, when developing MTBF 2024-2026, the amount of forecasted debt has increased by 4.2 pp. for 2024, 5.2 pp. for 2025 and by 5.2 pp. for the year 2026. **The debt development trend, according to the 2023 MTBF 2024-2026 scenario, was moderately downward, but in the current base scenario SP 2024-2028, the debt has an upward dynamic, besides, the amount of interest payments is also growing**

***[13]Pēc šī starpziņojuma sagatavošanas (19.04.2024), Eiropas Parlamenta deputāti apstiprināja jaunos ES fiskālos noteikumus 23.04.2024: New EU fiscal rules approved by MEPs | News | European Parliament (europa.eu)**

[14] https://data.consilium.europa.eu/doc/document/ST-9839-2023-REV-1/lv/pdf

**quite rapidly - from 0.8% of GDP in 2023 per year to 1.4% of GDP in 2027 and 2028. Thus, especially in the following years, it is necessary to avoid increasing the amount of additional debt.**

19. A moderate level of debt has allowed Latvia to maintain a high credit rating for many years and Latvia is a country with free access to financial markets. In international assessments, Latvia has a relatively high credit rating, which was obtained, including thanks to a responsible fiscal policy. However, geopolitical tension has negatively affected S&P's future rating for Latvia. Moody's credit rating for Latvia is A3 and future rating stable, S&P rating A+, future rating negative, Fitch rating A-, future rating positive, R&I rating A, future rating stable[15]. Taking into account the negative geopolitical background in the region, there is a risk that future assessments for Latvia may be lowered, which, in combination with increased interest rates, may make the future servicing of the national debt more expensive.
20. The Council, aware of the set of challenges related to geopolitical tension, slow development of the Latvian economy and the transition period in the regulation of economic and fiscal government, points out a series of risks in the implementation of SP 2024-2028:
    - In the conditions of high geopolitical tension and the still restrictive monetary policy of the ECB - a rapid recovery of the economy is not expected and, therefore, the growth of budget revenues will be slower;
    - The new fiscal regulation foresees fairly strict restrictions on the fiscal independence of the member states in cases where the member state does not comply with the public debt and/or budget deficit thresholds. In accordance with the recommendation of the Council of the EU to "ensure prudent fiscal policy", Latvia should exercise caution when planning expenditure growth. As inflation falls and economic growth slows, fiscal space will be limited or even negative, requiring a critical assessment of spending growth;
    - In the SP base scenario, growth will be slow, the fiscal space will be narrow, and the needs for budget financing will be large;
    - Special attention should be paid to the refinancing and privatization of Air Baltic Corporation bonds, as well as the development of the Rail Baltica project.

[15] Kredītreitings | Kredītreitings | Valsts kase