Fiskālās disciplīnas padome

Surveillance report on the Fiscal Structural Plan of Latvia 2025–2028: 2025 Progress Report

Adopted at the meeting of the Fiscal Discipline Council

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Summary

1. In January of this year, the Council of the European Union approved Latvia's Fiscal-Structural Plan (FSP) for 2025–2028[1]. Within this framework, Latvia is now preparing its first annual progress report, which replaces the former Stability Programme. This report is developed in line with the new Regulation (EU) 2024/1263[2] and serves as a key instrument for monitoring compliance with fiscal and structural commitments. In addition, it offers an updated assessment of macroeconomic and fiscal developments, as well as insights into the fiscal resources likely to be available during the autumn budget cycle. As such, the report plays a central role in shaping medium-term fiscal policy and setting budgetary priorities. The Council's opinion on this report will reflect its assessment of both the implementation of the FSP and the trajectory of Latvia's fiscal development.

2. **We are currently living through a period of heightened geopolitical uncertainty, which is already impacting global economic and fiscal trends — and is expected to exert even greater influence in the near future.** While Latvia has maintained a generally prudent fiscal policy in recent years and benefits from membership in the Eurozone, it remains a small, open economy that is particularly sensitive to external shocks. Trade disputes, rising debt levels in other countries, domestic political instability, and assertive foreign policies all pose risks to Latvia's economic and fiscal stability. In this context, maintaining a responsible and adaptable fiscal policy is essential to ensure that the country can respond swiftly and effectively in times of crisis. Budgetary savings must be actively pursued, especially given the growing need for increased defence spending. Nevertheless, the Progress Report already projects a negative fiscal space in the coming years, underscoring the urgency of careful fiscal planning.

3. **On 12 February of this year, the Council approved Latvia's macroeconomic forecasts for 2025–2028[3]. GDP growth is projected at 1.2% for 2025, rising to 2.1% in 2026 and stabilizing at 2.2% in both 2027 and 2028.** This translates to an average annual growth rate of 1.9% over the forecast period. The Ministry of Finance (MoF) has identified weak external demand and the risk of external shocks as key downside factors. As of now, the Bank of Latvia has not updated its forecasts since December[4], and the European Commission's projections date back to November 2024.

[1] National medium-term fiscal-structural plans
[2] Regulation (EU) 2024/1263 of the European Parliament and of the Council of 29 April 2024 on the effective coordination of economic policies and on multilateral budgetary surveillance and repealing Council Regulation (EC) No 1466/97
[3] Macroeconomics projections for MTBF 2024-2028| Fiscal Discipline Council
[4] Macroeconomic forecasts | December 2024 | Bank of Latvia

According to the latest available data, the Bank of Latvia expects GDP growth of 2.1% in 2025, followed by 3.0% in 2026 and 3.3% in 2027. However, these figures are expected to be revised downward in light of recent economic data. When issuing its forecasts in November 2024, the European Commission[5] took a more cautious stance than both the Bank of Latvia and the MoF, projecting GDP growth of just 1.0% for 2025. Its 2026 forecast of 2.1% is consistent with that of the Ministry of Finance.

4. **In 2024, Latvia's economy entered a mild recession, posting one of the weakest performances in the European Union — real GDP declined by 0.4%.** Among the Baltic States, Latvia recorded the poorest result: Estonia experienced a slightly smaller contraction (–0.3%), while Lithuania posted strong growth (+2.7%). There was a modest positive contribution to real growth from household consumption (+0.2%) and government consumption (+1.6%), but these were insufficient to offset the decline in investment (–1.6%) and a weakening of exports (–1.1%). This downward trend persisted in the fourth quarter of 2024, with real GDP falling again by 0.4%. During that quarter, household consumption rose by 0.4% and government consumption by 1.4%, while investment continued to drag growth with a decline of 2.1%. Due to inflation, GDP at current prices still grew by 2.1%.

5. **Although Latvia experienced negative economic growth in 2024, early signs of recovery began to emerge at the start of 2025.** The industrial sector contracted last year, with total output falling by 2.2%, including a 2.6% drop in manufacturing. However, data from January 2025 indicate a cautious rebound: industrial output rose by 0.6%, driven by a 1.8% increase in manufacturing and positive dynamics in the mining sector. Growth also returned to the wood processing industry and continued in the food sector. In the retail sector, moderate expansion persisted through January and February 2025 (+0.3%), primarily supported by the non-food segment. Meanwhile, the tourism industry saw a strong revival in January 2025, with a 15.6% increase in the number of guests and an 18.4% rise in overnight stays.

6. **In the first two months of this year, inflation has risen noticeably — reaching 3.0% in January and accelerating to 3.7% in February.** The sharpest increases were observed in food prices (+5.7% in February) and alcoholic beverages (+8.4%). A significant disparity between goods and services inflation also persists: goods prices rose by 2.9%, while services prices increased by 6.0% in February. This rise in inflation, particularly in the services and food segments, may temporarily boost tax revenues, including VAT and labour taxes. However, sustained inflation could suppress household consumption over time. The Ministry of Finance currently forecasts an annual inflation rate of 2.5% for 2025 — a projection that does not yet factor in the potential impact of the United States' new tariff policy. In its December forecast, the Bank of Latvia projected a lower inflation rate of 1.4% for 2025.

7. **Alongside inflationary pressures, other economic challenges persist — particularly in foreign trade, where exports continue to weaken.** In 2024, goods exports declined by 1.9% (–€365.4 million), primarily due to subdued external demand. In January 2025, foreign trade turnover at current prices rose by 7.2% year-on-year, reaching €3.52 billion. However, this growth was driven almost entirely by a sharp

[5] Economic forecast for Latvia - European Commission

increase in imports (+16.8%), while exports continued to fall (–2.1%). This points to a growing asymmetry in external demand, which may affect trade balance and economic stability.

8. **The labour market continues to face an imbalance between wage growth and productivity.** In 2024, the average gross wage increased by 9.7% — with rises of 8.7% in the private sector, 12.2% in the public sector, and 12.4% in the general government. However, productivity growth lagged significantly behind. According to the Ministry of Finance, productivity grew by only 1.3% in 2024 and is expected to average just 2.1% in the medium term. This disparity poses long-term risks to both competitiveness and fiscal sustainability. The think tank PEAK[6] at the University of Latvia continues to emphasize this issue in its productivity reports, noting that productivity growth is essential for achieving economic transformation and improving societal well-being. However, such progress depends on targeted investments, innovation, and the strengthening of human capital. The Council has positively assessed recent government initiatives aimed at reducing bureaucracy and reviewing public expenditures, viewing them as important steps toward fiscal improvement and productivity enhancement.

9. According to the law On the State Budget 2025 and the Budgetary Framework for 2025, 2026, and 2027, **the general government budget balance (GGBB) for 2025 was initially planned at –2.9% of GDP, or approximately –€1.3 billion.** Targets for 2026 and 2027 were set at –2.6% and –2.4% of GDP, respectively. The corresponding structural balance targets are –0.8% of GDP in 2025, –0.7% in 2026, and –0.8% in 2027. **However, the Ministry of Finance's updated forecasts — included in the 2025 Progress Report of the Fiscal-Structural Plan 2025–2028 — now project a higher general government deficit of 3.1% of GDP for 2025[7]. Under a no-policy-change scenario, deficits are expected to reach 3.0% in 2026, 3.2% in 2027, and 2.8% in 2028.** The upward revision is mainly attributed to a downgraded tax revenue forecast and a lower nominal GDP forecast, which has increased the deficit in relative terms. The structural balance is expected to remain at –0.8% of GDP in 2025, while estimates for subsequent years have been revised to –0.9% in 2026, and –1.0% in both 2027 and 2028.

10. **According to the 2025 Budget Law, consolidated general budget tax revenue is planned at €14.6 billion[8]. However, in the 2025 Progress Report of the Fiscal-Structural Plan[9], this forecast has been revised downward by 1.1% — or €153.6 million — due to updated macroeconomic projections[10].** These revisions reflect a downward adjustment of GDP growth by 1.7 percentage points and a slight upward revision of inflation by 0.3 percentage points. **The Fiscal Discipline Council (FDC) has issued a similar forecast of €14.4 billion in tax revenue for 2025, which is just 0.1% or €9.6 million below the Ministry of Finance's revised estimate — a statistically insignificant difference. Overall, the FDC's forecast is broadly aligned with that of the Ministry,** and the Ministry's updated projection can be considered both conservative and realistic. Tax revenue collection in 2025 may be supported by growth in private consumption, economic recovery in key export markets,

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[6] University of Latvia's think tank PEAK Latvia's Productivity Report
[7] The Ministry of Finance's forecasts in the 2025 Progress Report of Fiscal Structural Plan of Latvia for 2025-2028
[8] Law "On the State Budget 2025 and the Budgetary Framework for 2025, 2026, and 2027". Explanatory Notes, Section I , p. 95
[9] The Ministry of Finance's forecasts in the 2025 Progress Report of Fiscal Structural Plan of Latvia for 2025-2028
[10] Macroeconomics projections for MTBF 2024-2028| Fiscal Discipline Council

and a significant inflow of EU funding. Notably, 2025 is expected to mark the highest level of EU fund expenditure to date.

11. Nonetheless, achieving the fiscal targets for 2025 may prove challenging due to several downside risks:

i) escalation of geopolitical tensions;

ii) weaker-than-expected economic growth or lower inflation;

iii) subdued external demand;

iv) delays in the absorption of EU funds;

v) persistently high public sector wage costs, which strain public finances and harm competitiveness;

vi) fiscal risks associated with state-owned enterprises (e.g., Air Baltic, Latvian Railways) and large infrastructure projects such as Rail Baltica.

12. In 2024, Latvia's economic environment was shaped by several adverse factors — geopolitical uncertainty, slowing economic activity in export partner countries, weak private consumption, and a decline in domestic investment. Despite these challenges, the actual budget deficit turned out to be lower than projected**. While the 2024 Budget Law anticipated a deficit of 2.8% of GDP, the current estimate places it at 2.1% of GDP, or €849.6 million.** This more favourable outcome is largely attributed to higher-than-expected non-tax revenues and increased corporate income tax (CIT) revenues recorded in January 2025, which, under the European System of Accounts (ESA) methodology, are attributed to the 2024 fiscal year. Additionally, the lower deficit was supported by slower-than-anticipated absorption of EU funds and reduced spending on core public functions. However, the delayed use of EU funds also had a clear dampening effect on economic growth.

13. The 2024 Budget Law projected consolidated general budget tax revenues at €13.8[11] billion. In practice, €13.6 billion was collected — €247 million, or 1.8%, below the target[12]**. Nonetheless, tax collection performance can be considered relatively strong, especially given that nominal GDP growth in 2024 was just 2.1%, while tax revenue grew by 7.8%, outpacing economic expansion.**

14. In 2024, consolidated general budget expenditures were €1 billion, or 5.4%, lower than planned in the Budget Law, which contributed significantly to the more favourable deficit outcome of 2.1%. One key reason for the lower spending was the slower implementation of EU-funded projects. **During periods of subdued growth, EU funding plays a vital role as a source of investment and economic stimulus. Therefore, timely and effective absorption of EU funds is essential to maximize the benefits of available financing. In particular, the efficient execution of Recovery and Resilience Facility (RRF) projects is critical, as the EU has set a firm deadline for utilizing RRF funds by the end of August 2026.**

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[11] Law "On the State Budget 2025 and the Budgetary Framework for 2025, 2026, and 2027". Explanatory Notes, Section I , p. 92
[12] On an accrual basis (excluding the undistributed balance in the single tax account).

15. **Overall, the Council positively evaluates the government's efforts in recent years to pursue a balanced, counter-cyclical, and socially responsible fiscal policy.** This approach is reflected in Latvia's relatively strong standing with independent international credit rating agencies, as well as in the moderate level of general government debt. For example, in January of this year, Moody's Ratings reaffirmed Latvia's credit rating at A3 with a stable outlook — a favourable assessment, particularly given the challenging geopolitical context and subdued economic growth indicators.

16. **In response to the deteriorating geopolitical environment, the President of the European Commission, following consultations with EU and partner country leaders, has announced the ReArm Europe initiative[13].** This ambitious plan aims to significantly increase defence spending among EU member states and expand the bloc's military production capacity. It is estimated that by raising defence expenditure by an average of 1.5% of GDP, additional defence-related outlays could amount to approximately €650 billion over four years. The initiative also includes the creation of a new financial instrument that would provide €150 billion in loans to member states for the development of defence capabilities. In total, ReArm Europe could mobilize up to €800 billion — around 4.7% of the EU's GDP — ensuring long-term investment in European security and defence. However, the plan has met resistance from several high-debt southern member states — notably France, Italy, and Spain — who oppose further national borrowing[14]. Instead, they propose joint EU borrowing, with funds disbursed as grants to prevent increases in individual national debts. Conversely, fiscally conservative Northern European countries, particularly Germany and the Netherlands, are strongly opposed to such a joint-debt approach. These divergent views are expected to create significant challenges in implementing the initiative. **Should the plan proceed, it would likely raise national debt levels and increase debt servicing costs.** Discussions on the structure and details of the financing instrument are ongoing, and its potential macroeconomic and fiscal impact has yet to be fully assessed.

17. While a general government budget deficit exceeding 3% of GDP is projected for 2025 and the following years, this figure alone is no longer considered decisive under the European Union's revised fiscal framework. If the established expenditure path — specifically, the growth trajectory of net primary government-financed expenditure — is maintained, exceeding the deficit threshold does not automatically constitute a breach of fiscal discipline. Furthermore, the new EU economic governance rules allow for greater flexibility regarding defence spending. Under specific conditions, increased public investment in defence may be deemed justified, and in such cases, the Excessive Deficit Procedure (EDP) may not be triggered.

18. **In its most recent Debt Sustainability Monitor[15], the European Commission assessed Latvia as facing low short-term fiscal sustainability risks, despite relatively high government financing needs and a notable current account deficit.** However, medium-term risks are more pronounced. Without further policy action, government debt could rise to 65% of GDP by 2035, primarily driven by a structural primary deficit and moderate ageing-related costs. In the long term, fiscal risks are considered low — assuming geopolitical conditions remain stable — due to a

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[13] Press statement by the President on the defence package
[14] Southern Europe rebuffs von der Leyen's debt-based defense plan
[15] Debt Sustainability Monitor 2024

projected decline in ageing-related expenditures and debt levels remaining below 60% of GDP. Although Latvia's external debt exposure and the share of non-performing loans may present additional vulnerabilities, these are mitigated by several factors, including the euro-denomination of government debt and the limited proportion of short-term liabilities within the overall debt portfolio.

19. **Russia's ongoing aggression against Ukraine remains the primary source of economic instability and fiscal risk in the region. Both the European Union and Latvia continue to provide military assistance to Ukraine, as well as support for Ukrainian refugees residing in Latvia. In the 2025 state budget, Latvia has allocated €115 million for this purpose — €50 million for military support and €65 million for civilian aid[16].** The proximity of the conflict directly affects Latvia's fiscal capacity, investment levels, and both business and consumer confidence, all of which have a negative impact on economic growth and fiscal performance. Additionally, a shift in U.S. foreign policy under the new administration, marked by increased isolationism, is expected to influence global economic dynamics with potential fiscal consequences.

20. **Several companies under the supervision of the Ministry of Transport currently pose significant fiscal risks.** These include Air Baltic and Latvian Railways. In 2024, Air Baltic posted losses of €118.2[17]. million. Latvian Railways is also experiencing financial strain due to a continued decline in east–west freight transit, which has necessitated increased state support. Meanwhile, fiscal risks associated with the Rail Baltica project are escalating. Rising costs and the unsustainability of the current financing model have raised concerns. Furthermore, uncertainty about the availability of EU funding in the 2026–2028 period may require increased national co-financing, exacerbating the project's fiscal burden.

21. **During the preparation of the Fiscal-Structural Plan (FSP) for 2025–2028, the Ministry of Finance and the European Commission agreed—through technical dialogue—to base 2024 projections on the Ministry's macroeconomic forecasts, and to apply the European Commission's Spring 2024 forecasts for the subsequent years. This approach was also endorsed by the Fiscal Discipline Council**. Based on the Ministry's 2024 estimates, Latvia was assigned a net nationally financed primary expenditure (NNFPI) growth rate of +5.9% for 2025. For 2026 through 2028, the NNFPI growth rates based on the European Commission's forecasts are +3.6%, +3.4%, and +3.3%, respectively.

22. **Stronger-than-expected budget performance in 2024 enabled Latvia to accumulate a surplus in the control account.** While drafting the 2025 FSP Progress Report, the Ministry of Finance noted that although the European Commission initially set the permissible NNFPI growth rate at 5.9% for 2025, updated data suggests actual growth will be 5.7%. In accordance with Article 22 of EU Regulation 2024/1263, the European Commission monitors deviations from the expenditure path approved by the Council. Due to a cautious fiscal approach, Latvia accumulated a surplus of €830.1 million in 2024, and a further €27.6 million is projected for 2025 — resulting in a total cumulative surplus of €857.7 million. **While these funds cannot be used to finance**

[16] Law "On the State Budget 2025 and the Budgetary Framework for 2025, 2026, and 2027". Explanatory Notes, Section I , p. 82
[17] airBaltic Group Annual results 2024

new policy measures, they signal sound fiscal management and may be considered if expenditure limits are exceeded in the medium term.

23. **EU fiscal rules (Article 5 of Directive 2024/1265) allow Member States to apply both European and national fiscal frameworks, provided they are not in conflict.** In autumn 2024, while preparing the FSP 2025–2028, the Ministry of Finance applied three fiscal conditions, translating them into structural balance terms: (1) Structural balance condition – under the Fiscal Discipline Law, it must not be lower than –1% of GDP; (2) Structural primary balance (SPB) condition – set targets ranging from –0.8% to –1.5% of GDP for 2025–2028; (3) EU expenditure growth (NNFPI) condition – defined structural balance targets between –0.7% and –1.3% of GDP for the same period.

    Each year, the strictest of these three criteria was applied to determine the fiscal target, resulting in structural balance targets of –0.8% in 2025, –0.7% in 2026, –0.8% in 2027, and –0.9% in 2028.

24. **The Council underscores the importance of adhering to the fiscal conditions set out in EU and national regulations.** The EU's Stability and Growth Pact stipulates that the general government deficit should not exceed 3% of GDP. In spring 2025, while preparing the FSP 2025–2028 Progress Report, the Ministry of Finance's updated projections indicated that the nominal deficit would exceed this threshold in 2027, and that the structural balance would surpass the –1% limit set by the Fiscal Discipline Law throughout 2027–2029. To address this, the Ministry introduced an additional metric — the so-called "nominal deficit condition" — within the fiscal framework. Under this condition, the nominal deficit for 2026 is projected at exactly 3% of GDP, with a structural balance of –0.9%. For 2027–2029, the nominal deficit is expected to decline from 2.9% to 1.6% of GDP, while the structural balance remains within the –1% limit. However, the Council notes that this "nominal deficit condition" is not currently recognized in either Latvian or EU legal frameworks. As such, the Ministry's approach will require adjustments to the regulatory basis to ensure legal compliance. The Council stresses that fiscal policy must be grounded in clearly defined, legally established numerical rules.

25. **Latvia's general government debt is estimated at 47.1% of GDP in 2024 and is projected to rise to 49% in 2025.** It is expected to continue increasing, reaching 49.5% in 2026 and 52.8% in 2027, before stabilizing slightly at 52.2% in 2028 and 51.3% in 2029. Although the 60% debt ceiling has not been breached, surpassing the 50% threshold signals growing fiscal pressure. **Notably, these projections do not account for the potential fiscal impact of the ReArm Europe initiative.** Debt servicing costs are also projected to rise steadily, both in nominal terms and as a share of GDP. Interest payments are expected to total €555.2 million (1.3% of GDP) in 2025, increasing to €640.4 million (1.5%) in 2026. From 2027 to 2029, interest expenditures are forecast at 1.6% of GDP annually, rising in nominal terms to €722 million in 2027, €762 million in 2028, and €831 million in 2029. This trend reflects the growing burden of debt servicing amid increasing overall debt levels.