2022

Stability Programme of Latvia 2022–2025

Finanšu ministrija

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COMMONLY USED ABBREVIATIONS

USA	United States of America
CSB	Central Statistical Bureau
DNM	Differentiated non-taxable minimum
EC	European Commission
ESA	European system of national and regional accounts
MoE	Ministry of Economics
EU	European Union
ESF	European Social Fund
FDL	Fiscal Discipline Law
MoF	Ministry of Finance
MoI	Ministry of the Interior
PIT	Personal income tax
GDP	Gross domestic product
IT	Information technologies
MoES	Ministry of Education and Science
CF	Cohesion Fund
LBFM	Law on Budgetary and Financial Management
MoW	Ministry of Welfare
LALRG	Latvian Association of Local and Regional Governments
Cabinet	Cabinet of Ministers
NGOs	Non-governmental organisations
OECD	Organisation for Economic Cooperation and Development
MPC	Mandatory procurement component
VAT	Value added tax
LLC	Limited Liability Company
CIT	Corporate income tax
MEPRD	Ministry of Environmental Protection and Regional Development
SJSC	State joint-stock company
SRS	State Revenue Service
Treasury	The Treasury
SSIA	State Social Insurance Agency
MSSSC	Mandatory State social security contributions
SLLC	State limited liability company
MoA	Ministry of Agriculture

1. OVERALL ECONOMIC POLICY GUIDELINES AND OBJECTIVES

The Stability Programme of Latvia 2022—2025 has been developed following the conditions and guidelines of the Stability and Growth Pact implementation 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.

The spring of 2022, when the present Stability Programme is prepared, is characterised by weakening of the COVID-19 pandemic and lifting of the related restrictions, which gave a positive view to the future and expectations that the autumn might not come with repeated restrictions on economics. Russia's invasion in Ukraine on 24 February 2022 was a turning point in the usual global order and created high uncertainty about the future developments and their impact on the economy. Although the preparation of the Stability Programme started before the war and a macro-economic development scenario (February scenario) was developed, it became clear that it is also necessary to develop an alternative macro-economic scenario which would take into account the initial impact assessment of the Russian-Ukrainian war (March scenario). The March scenario is to be considered as a base scenario in the preparation of this Programme.

After falling by 3.8% in 2020 due to the COVID-19 crisis, in 2021, the economy of Latvia strongly recovered, and the GDP has grown by 4.8% as compared to the previous year. State support to reduce the consequences of COVID-19 in 2020 amounted to EUR 1.3 billion or 4.3% of GDP, while in 2021, the amount of the support reached EUR 2.3 billion or 6.9% of GDP thus ensuring substantial support both for businesses and workers. Thanks to the State support and due to businesses adapting more and more successfully to operation during the crisis, in Q2 of 2021 the economy of Latvia returned to its pre-crisis level as it was in Q4 of 2019.

According to the March scenario, this year, the GDP will grow by 2.1% with economic growth accelerating to 2.5% in 2023, which is respectively 1.9 and 1.4 ppt less than in the February scenario. In 2024 and 2025, the GDP growth is expected to reach 3.3% and 3.4% accordingly. In the March scenario it is expected that the consumer price increase in 2022 will reach 8.5%, which will mainly be influenced by an increase in energy resource and food prices. The pressure on consumer prices will also be seen in other product and service groups. However, Russia's aggression in Ukraine and the potential escalation of the war, as well as the imposition of sanctions on Russia, especially in the field of energy, could result in even more increases of consumer prices in both Europe and Latvia.

According to the MoF's estimate, the general government budget deficit in 2021 is 7.2% of GDP, which is 2.1 per cent less than was forecast in autumn of 2021. This year, with no changes to the policy, it will drop to 6.5% of GDP, while in the coming years it will drop sharply and will be 2.4%, 1.8% and 0.9% of GDP in 2023-2025 respectively.

The Fiscal Strategy of the Stability Programme predicts a gradual annual decrease of the structural deficit of the general government by 0.5-1% of GDP. COVID-19 mitigation measures, energy price rise compensation measures and the growth of internal security investments are seen in the Fiscal Strategy as one-off measures and are excluded from the structural balance-sheet of the general government's budget.

The general government's structural budget deficit arising from the Fiscal Strategy during 2023-2025 is forecast to reach 2.8%, 2.3% and 1.7% of GDP, and the fiscal space is projected to reach 0.4% of GDP, not including one-off measures.

Increase of defence financing to 2.5% of GDP in 2025 is included in the Stability Programme's no policy change scenario.

2. Economic Situation

2.1. External Economic Environment

According to the International Monetary Fund data, with the spread and impact of COVID-19 on the economy weakening, the global economy last year achieved growth of 5.9% after a drop by 3.1% in 2020. A similar situation also existed in the EU and the Latvia's main foreign trade countries where after a drop by 5.9% in 2020 the EU economy grew by 5.3% in 2021.

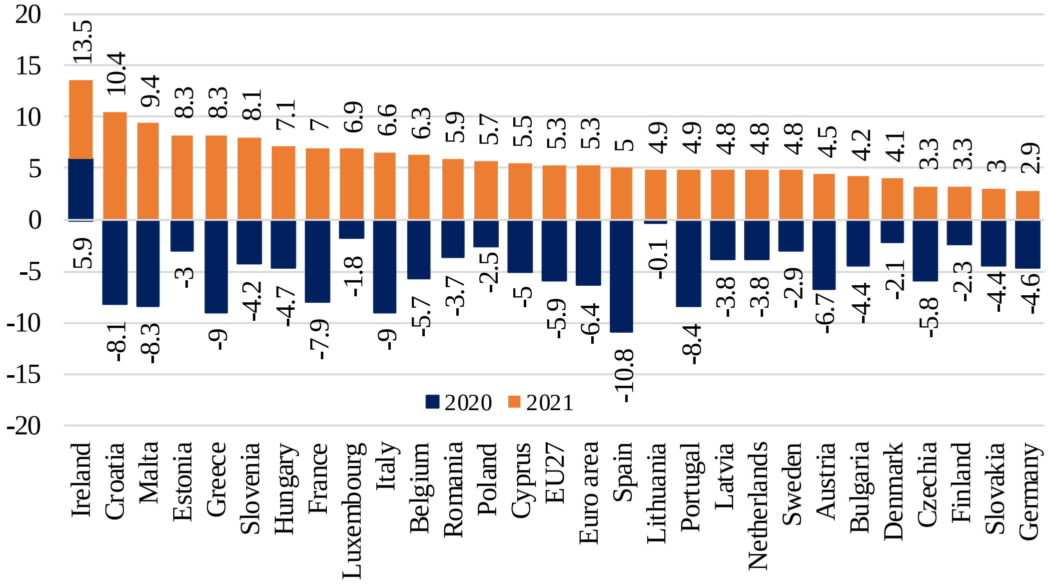

Figure 2.1. GDP changes in EU countries, % against the previous year

This year, before Russia's invasion of Ukraine, both the global and EU economy was projected to grow slower than 2021 – by 4.4% and 4.0% respectively. The reduction in the growth rate was attributed both to the increasing spread of the COVID-19 omicron variant at the beginning of the year and the restrictions imposed in many countries, the sharply rising resource prices and supply disturbances, and the most notable reduction in forecasts affected the US and developing countries. Now, after the onset of the war, growth forecasts have decreased even more, with the previously incurred price rise and delivery disturbance problems even exacerbated, and with new global trade limitations and burdens arising.

The largest reduction in growth now affects EU countries where economic forecasts have been lowered several times. In mid-March, *Fitch Ratings* lowered the global economic growth forecast for this year by 0.7 ppt to 3.5%, while the forecast for the Eurozone was lowered by 1.5 ppt to 3.0%. On 23 March, the German Economic Institute, IFO, lowered the German economic growth forecast from 3.7% to 2.2-3.1%, while on 25 March, the Institute of International Finance (IIF) reported a lowering of the Eurozone growth forecast for this year from the previous 3% to 1%.

The expected drop in growth in Europe was already signalled by the leading indicators. The EU Flash Consumer Confidence Index shows that in March, consumer sentiment has worsened almost as rapidly as in 2020 at the very onset of the COVID-19 pandemic. Compared to February, the Index has dropped by 9.4 points and currently only slightly exceeds the level in April 2020. Also, March indicators of the Purchasing Managers Index in the Eurozone show a reduction, with the business forecasts regarding the expected outputs in the services sector being at the lowest level since November 2020, while in the manufacturing sector – since April 2020.

According to the latest forecasts of the EC, published on 10 February, inflation in the Eurozone this year is expected to increase to 3.5% as compared to 2.6% last year. However, the recent rises in oil, natural gas, metal, fertiliser and other resource prices after Russia's invasion of Ukraine show that this year, the rise in prices could be even sharper. Already after the onset of the war, on 10 March, the European Central Bank increased this year's inflation forecast from the previous 3.2% to 5.1%. On 8 March, the *Brent* crude oil price reached USD 128 per barrel, which is the highest level since July 2008 and the highest ever when converted to euros, and also in the second half of March the oil price remained at USD 110-120 per barrel. The natural gas price in the European market at the beginning of March exceeded EUR 220 per megawatt hour as compared to the average level in 2021, when it was EUR 47 per megawatt hour.

2.2. Current Economic Development[1]

After a drop by 3.8% in 2020 due to the COVID-19 crisis, in 2021, the economy of Latvia strongly recovered, and the GDP has grown by 4.8% as compared to the previous year.

Already in 2020, the economic slump was not as sharp as was assumed at the very beginning of the COVID-19 crisis, as the Latvian producing sector turned out to be more resilient to the shock of the pandemic, and the services sector recovered more rapidly than expected. Similarly, in 2021, the economic growth was more rapid than was expected, which was ensured by the favourable situation in external markets and the sizeable economy support measures, thus allowing one to maintain business operations and jobs in the sectors directly affected by the crisis, as well as providing support to socially more-vulnerable population groups.

State support to reduce the consequences of COVID-19 in 2020 amounted to EUR 1.3 billion or 4.3% of GDP, while in 2021, the amount of the support reached EUR 2.3 billion or 6.9% of GDP, thus ensuring substantial support both for businesses and workers. Thanks to the State support and due to businesses adapting more and more successfully to operation during the crisis, in Q2 of 2021 the economy of Latvia returned to its pre-crisis level as it was in Q4 of 2019.

In 2021, the largest contribution to economic growth was provided by the trade, health and manufacturing sectors which grew by 8.9%, 24.8% and 7.4% respectively. At the same time, a downturn was observed in the agricultural and construction sectors, by 6.8% and 6.1% respectively. The accommodation and food services sector that was most hit by the COVID-19 restrictions, decreased by 5.2%, while the arts, entertainment and recreation sector decreased by 3.3%.

From the expenditure side, economic growth last year was facilitated most by an increase in private consumption by 4.8%, which was ensured by the gradual lifting of COVID-19 restrictions, as well as the State support to businesses and households. Public consumption increased strongly, by 4.4% as compared to 2020, and the investment in fixed capital increased by 3.0%. With exports (+6.2%) growing slightly slower than imports (+13.5%), the net export contribution to economic growth was negative.

Similarly in 2020 and 2021, when the development of the Latvian economy was affected most by the COVID-19 pandemic and the State support measures for its mitigation, in

[1] The description uses data from the CSB and other sources that was available until 24 March 2022.

2022, economic development is already driven by Russia's war in Ukraine, the resulting geopolitical crisis and the suspension of economic cooperation with Russia and its ally, Belarus.

Sectoral Development

The transportation and storage sector, which was one the sectors hit by COVID-19 the hardest, after a drop in 2020 by 14.6%, increased last year by 5.9%, with air transport volumes starting to recover and freight transport by road increasing. At the same time, the development of this sector continued to be negatively affected by the reduction of Russian cargo transit through the ports of Latvia, and passenger road transport within the territory of Latvia also decreased.

The number of passengers in Riga Airport in 2021, as compared to the previous year, increased by 17.0% and reached 2.3 million passengers, while still being 3.3 times lower than before the COVID-19 pandemic in 2019. Cargo turnover in road transport increased last year by 10.2% thereby contributing significantly to the overall growth of the transport sector, while the number of passengers in road transport decreased by 16.6% due to COVID-19. With Russian cargo transit continuing to decrease, last year, the cargo volume transshipped in ports dropped by 7.0%, including a reduction in coal cargo by 48.9% and oil product cargo by 25.9%. The volume of cargo transported by rail in 2021 was 9.5% less than a year before.

This year, the development of the transport sector will be affected significantly by the war in Ukraine and the suspension of transport connections with Russia and Belarus. Last year, the proportion of oil product cargo directly related to Russian transit in Latvian ports was 19.5%, while that of coal cargo had dropped to 4.2%. Until the war in Ukraine, the cargo volumes in ports and rail transport this year had been slightly stabilised, with the cargo turnover in ports in the first two months of 2022 increasing by 6.6% and in rail increasing by 5.1% as compared to the first two months of the previous year. The number of passengers serviced in Riga Airport in January and February exceeded the level of the first two months of 2021 by 6.4 times, but was still 47.3% lower than before the crisis, in the first two months of 2019. According to 2020 data, the proportion of Russian passengers in Riga Airport was 8.3%.

Although the pandemic situation in 2021 was complicated, the **trade** sector was already better adapted to the situation, and the impact of COVID-19 on the sector was much less than in 2020. The sector's value added in 2021 increased by 8.9%, which is the sharpest rise in value since 2007. This was driven by the increase in sales volumes in wholesales, as well as strong growth in car and motorcycle sales.

At the same time, for retail sales the year 2021 was very challenging. As in 2020, in 2021 the sector was also impacted by COVID-19 restrictions; however, both traders and consumers had gained experience from the situation in 2020, so the negative impact on retail sales became weaker with each wave of lockdown, with companies and the population adapting to the situation. The year 2021 started with severe restrictions or a lockdown followed by strong growth of the sector mid-year; however, in the second half of the year the pandemic situation worsened again resulting in the second lockdown during the year in October and December. However, despite the two pandemic outbreaks, the retail sales sector in 2021 grew by 2.5% thanks to high sales activity during the summer months.

Lockdowns or severe restrictions affect non-food product sales more, with non-food stores temporarily stopping their business or switching their business model to online sales. However, when restrictions are mitigated, non-food sales also provide the largest contribution to the overall retail sales growth with non-food product sales in 2021 reaching a growth of 3% in total. Although fuel prices increased sharply in 2021, fuel sales increase by 6.3% provided a positive effect to the overall growth of the retail sales sector. Meanwhile, food sales retained output volumes of 2020 (+0.1%).

The population's financial savings also continue to grow. In January this year, as compared to January 2021, household deposits attracted by commercial banks in Latvia grew by 13.9%, achieving 9.63 billion euros, which was determined by the increase in the balance of the population's financial funds held in bank accounts. This means that the population has funds at their disposal that may be diverted to consumption in trade, service sectors, etc.

In retail sales, the year 2022 has started with strong growth determined both by the low base of the previous year and the population's high consumption of non-food products. Significant growth of the sector is expected in Q1 of 2022, while the future development is unclear.

The **accommodation and food service activities sector**, which was hit by the COVID-19 crisis the most, after a fall by 42.0% in 2020, shrank by another 5.2% last year. The recovery of the sector, as opposed to most of the other sectors, was hampered in 2021 by the still high spread of COVID-19 and the restrictions imposed to reduce the disease rates, which, as opposed to 2020, were also maintained during the most active tourism season in the summer months.

In 2021 in total, local and foreign visitors stayed in tourist accommodation in Latvia for 2.4 million nights, which was 17.6% less than in 2020. Among this, the number of nights stayed by foreign visitors was 42.6% less than a year before, while the number of nights stayed by local visitors increased by 9.5%, still not being able to compensate the fall in the number of stays of foreign visitors. As opposed to Latvia, in its neighbouring countries, Lithuania and Estonia, where COVID-19 restrictions last year were less stringent, the accommodation sector already started to recover from the COVID-19 crisis and the total number of nights stayed by visitors grew by 12.4% and 8.8% respectively.

Another sector which has suffered more during the COVID-19 crisis, the **arts, entertainment and recreation sector**, after a fall by 22.6% in 2020 suffered another fall by 7.0% in 2021, with restrictions on organising and visiting entertainment and cultural events being maintained.

The **industry sector** was only severely impacted by the pandemic at its very onset in April and May 2020. In 2021, the COVID-19 disease impacted industry volumes by increasing the number of workers who fell ill, but overall, the year 2021 was very successful for Latvian industrialists. The sector's value added increased by 6.3%, which is the sharpest rise in value since 2015. Among this, the processing sector's value added, which makes up 81% of the whole industry, has grown by 7.4%. Still, the average processing industry growth of the EU Member States in 2021 was even higher, which was determined by the sharpest fall experienced in the previous year.

In 2021, there was growth in almost all processing industry commodity groups. Good results were seen in the largest sub-sector of the manufacturing industry, the timber industry, where production volumes grew by 3.7%, which was determined by the high prices and high level of demand. Meanwhile, in furniture production growth reached 24.3%. Textile and clothing production volumes increased by 8.5% and 15.5% respectively. Printing and publishing and record reproduction output increased by 15.9%. During the pandemic period there was a high demand for disinfectants, thus the production of chemical substances and products increased by 24.9%. The production of rubber and plastic products also increased by 10.7%. The manufacture of fabricated metal products, which is important for the industry of Latvia, increased by 10%. At the same time, the produced volumes of cars and trailers increased by 34.5%. Meanwhile, output reductions have been recorded in product groups such as production of metal (-37.6%), manufacture of leather and related products (-10.9%), as well as repair and installation of machinery and equipment (-8.6%). A slight reduction was also observed in the sizeable food production (-0.5%).

Meanwhile, this year has started for the processing industry with an increase by 9.3% in January, which was driven by high production volumes of construction materials and fabricated metal products. At the same time, in timber production a decrease of 1.4% was observed.

In the other sub-sectors of the industry, namely, the mining industry and electricity and gas supply, the increase in 2021 was 4.7% and 2.9% respectively. The produced energy output was impacted positively by the increasing volumes of electricity produced by hydropower plants. Whereas the year 2022 has started with a reduction in electricity and gas production by 10.8%, mainly due to lower volumes of electricity produced by cogeneration plants than in January last year. At the same time, in the mining industry the year has started with 9.4% growth.

The future development of the Latvian industry will be affected negatively by the war initiated by Russia in Ukraine. Industrialists will have to find alternatives to imported goods, as well as new outlets for their products. This is a very time-consuming process, thus a reduction in companies' production volumes and terminations are expected until the situation stabilises.

Whereas the **construction sector** in 2021 experienced a value added reduction of 6.1%. This sector remained practically unaffected by COVID-19 and the related restrictions; however, a negative impact was caused by a sharp rise in construction costs. In building construction, there was a decrease of 10.5% last year, with construction of such non-residential buildings as hotels, wholesale and agricultural buildings decreasing. Civil engineering construction volumes decreased by 5.1%, with also road and rail, as well as urban infrastructure construction decreasing, while specialised construction works fell by 2.7%. In the future, the construction sector will benefit from EU fund investments and the continuation of the construction of Rail Baltica. However, a negative impact will be caused by Russia's invasion of Ukraine, which may cause a deficit of certain construction materials, as well as a rise in the prices of construction projects with the prices of materials and energy resources increasing.

In **agriculture** the value added also decreased by 6.8% last year. Last year's cereal yield was 14.4% lower than in 2020 when the cereal yield was the highest ever in the history of Latvia. The reduction in yield was caused by prolonged drought and heat during the summer months. Meanwhile, the sowing areas in Latvia have been increasing since 2018 and in 2021 increased by 3% as compared to 2020. Due to the reduction in yield, cereal export also decreased in 2021. In the spring of this year, concerns about the development of this sector arise due to the rapid increase in fertiliser costs caused by Russia's invasion of Ukraine.

Investments

In 2021, the amount of investments increased by 3.0% and totalled EUR 6.774 million. As compared to the other GDP components, such as private and public consumption, as well as export, the investment performance has been weaker. Thus, the share of investments in the GDP lowered slightly, from 24.7% in 2020 to 24.3% in 2021. At the same time, it should be noted that just in 2020, when private consumption and export fell, the investment amount was resilient to the negative effect of the COVID-19 pandemic and stayed at the level of 2019. The overall resilience of investments in 2020 was facilitated by an increase in the general government's investments.

The investment activity in 2021, especially in the second half of the year, was impacted negatively by the sharp price rise. The prices of timber, metal, energy resources, rubber and other raw materials and resources, which are important in the construction process, rose significantly. The total construction costs in 2021 increased on average by 6.7% as compared to the previous year, with the construction materials component growing the most (+9.1%), while the remuneration component and costs of maintenance and operation of machinery increased by 4.1%. However, while in the first half of the year the rise in construction costs was only 2.9%, in the second half of the year it already reached 10.3%. It was the fall in investment activity in the construction sector that hindered the overall investment dynamics. In the context of price impact, it is important to note that the investment deflator in 2021 was 4.4%, which means that in actual prices the amount of investments in agriculture last year increased by 7.5%. This investment deflator was the highest since 2013.

Investments in equipment and machinery had a decisive role in the increase of total investments in 2021. The amount of these investments increased by 13.7% and made up 46.7% of the total investments. Thus, the amount of investments in these fixed assets was larger than investments in construction. The sharp increase has also been reflected in import data, as the import value of capital goods which reflects investments in equipment and machinery also increased sharply during the period, i.e., by 24.9% in actual prices. Despite the relatively rapid growth of investments in equipment and machinery, data from surveys of merchants operating in the processing industry regarding the factors influencing investments in 2021 show that 59% of the investments made in the processing industry were directed towards replacing old equipment and optimising production processes. As compared to the previous year, the share of these investments increased by 2 ppt. Meanwhile, only 28% of investments made were directed towards the expansion of production. Most probably, due to the pandemic companies are still cautious as regards the implementation of new projects and therefore allocate less than a third of planned investments to the expansion of production. Based on the most recent survey data, a similar situation will also exist in 2022.

In 2021, investments in the construction of offices, housing, warehouses and other buildings, as well as in the renovation of existing buildings and structures shrank by 6.5% and totalled EUR 3.063 million. Thus, the share of this type of investments in the total investments decreased by 4.6 ppt to 45.2%. The drop in investments was driven by less activity in the construction sector. In Q1 of 2021, the drop in construction production by 12.4% as compared to the respective period of the previous year was mainly caused by the adverse weather conditions for construction works. In Q2 and Q3 of last year, investments in structures and buildings stabilised. Whereas in Q4, in terms of the year the drop was 11.0%. The reduction in investment activity was driven by an increase in raw material prices and the limited labour force, which induced the increase of wages thereby putting pressure on construction costs. Considering the fact that the building construction process can last for more than a year, while the implementation of large infrastructure objects takes several years, a rapid and significant rise in raw material prices required a review of development projects.

Another factor which negatively affected construction investments is related to the pandemic. Due to the COVID-19 crisis, turnover has decreased, and profit indices deteriorated significantly in sectors such as accommodation, catering, entertainment and culture, as well as transport. Most probably, these sectors are considering new credit and investment possibilities in the medium term. Whereas, the change in work organisation habits and mass remote working practice reduced the demand for offices.

Russia’s invasion of Ukraine and the high level of raw material prices will negatively affect investment activity in 2022, especially in the construction sector. Although the credit rating of Latvia, which also reflects investment risks, is still at a high level, the physical border with Russia, an aggressor state, could lead to reconsidering the foreign investors’ behaviour as regards the implementation of new projects in Latvia. Whereas, the high raw material prices will negatively affect local business, as it will be harder to predict the total costs of investment projects. In these 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 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 2022 will be weak. According to the MoF's updated forecasts, the amount of investments will increase this year by 1.9%.

Foreign trade

In 2021, **foreign trade turnover of Latvia's goods and services** at constant prices increased by 10.0%, representing the best performance since 2012. The global economic recovery and increase of foreign exports to the main export outlets, such as the EU and the UK, as well as the substantial growth of export to countries such as the USA, Turkey, Japan, Nigeria and Norway, ensured last year's rise in exports of Latvian goods and services of 6.2%. Whereas, the increase in Latvia's internal consumption and investments in equipment and technological machinery facilitated growth of the total goods and services imports of 13.5%. Considering the fact that imports rose more sharply than exports, the foreign trade balance in 2021 has deteriorated significantly. In 2021, the foreign trade deficit increased by EUR 2 635 million as opposed to EUR 1 225 million in 2020. The growth in exports and imports was faster than the growth in gross domestic product 4.8%, hence, the significance of foreign trade in the economy has increased. The share of exports in the GDP in 2021 increased by 3.5 ppt and reached 64.0% Whereas, the share of imports in the national economy last year amounted to 66.0% by increasing by 6.7 ppt as compared to 2020.

Despite the pandemic and restrictions imposed to mitigate the spread of coronavirus hampering the development of certain sectors, as well as logistics disturbances and deficit of certain raw materials, in 2021, the Latvian **commodity export** growth in actual prices was the strongest in a decade. Last year, the goods export value increased on average by 23.9%, reaching EUR 16.5 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, and there was growth in all commodity groups, which means that the improvement of external demand is felt by all sub-sectors of the processing industry.

A sharp rise in commodity exports was observed not only in Latvia but also in all Member States of the EU; however, Latvia ranks among the countries with the sharpest rise in commodity exports. The average rise in exports in the EU in 2021 in actual prices amounted to 7.8%. Whereas in 2020, the decline in commodity exports in Latvia was one of the smallest among EU Member States, which proves the steady competitiveness of Latvian commodity export. Export growth both in Latvia and in the EU last year was driven in general by a favourable external environment and a stronger than expected global economic growth since the onset of the pandemic.

Another factor that contributed to the growth of commodity exports last year in nominal terms was the rise in raw material prices. It was affected by both the rapid recovery of the global economy and the imposed restrictions to reduce the spread of coronavirus, thereby negatively affecting production capacities and speed of delivery. Thus, supply recovers slower than demand, thereby creating price pressure in certain sectors. In 2021, in global stock exchanges, oil, gas, electricity, timber, metal and other raw material prices increased sharply. This was also reflected in export unit prices of Latvian producers. In 2021, as compared to the previous year, the goods export unit-value index rose by 13.9%, which is a very sharp increase.

The main driver of goods export in 2021 was the timber and timber products group, the export value of which increased by 44.4% or EUR 972 million, which explains almost one third of the total growth of the goods export value. This group of goods was the largest and amounted to 19.2% of the total export value of goods. An increase in timber and timber product export was observed in practically all the largest outlets — in Germany, Denmark, Lithuania, Sweden and the Netherlands. However, the decisive role was played by the growth in exports to the UK where the value of timber and timber products in 2021 doubled and reached almost EUR 1 billion, thereby providing more than a half of the total timber product export. This increase in exports to the UK was mainly facilitated by the increase in exports of timber sawn lengthwise and wood pellets. It has to be noted that there was a sharp increase in timber exports not only to traditional markets; it also increased noticeably in new markets, such as Belgium, France, Ireland, Italy, Japan, China and the USA. While geographically wide the exports of timber products was, in terms of types of goods the diversification is not so large. In 2021, exports of timber sawn lengthwise amounted to 38.5% of the total value of exports of timber, while exports of wood in the rough and particleboard amounted to 5.9% and 9.0% respectively. Meanwhile, the share of goods with the largest value added, such as plywood and wood pellets, in the total timber exports, was 8.1% and 11.0% respectively.

Apart from timber, a substantial contribution to the overall growth of goods last year was also provided by exports of metal and metal products, as well as mineral products. The export value of metal and metal products increased by 50.5% or EUR 555 million, which was also facilitated by the increase in exports of ferrous waste and scrap to Turkey and Estonia, as well as exports of iron and steel flat-rolled products and iron structures to EU countries. The export value of mineral products increased by 87.5% or EUR 473 million, thanks to a larger exports of petroleum oils, natural gas, peat and electricity to EU Member States. The export value in this group was increased both by the rise of reexports value and the rise in energy resource prices. A significant increase in exports was noted for chemical industry products, which was facilitated by the increase in export value of pharmaceutical products and biodiesel. A notable increase in exports was also seen for machinery and electrical equipment. Exports also increased in other product groups; however, more slowly than in the above-mentioned product groups.

One can conclude that the export of Latvian goods has coped successfully with the negative impacts of the pandemic, while **services export** still feels them. In 2021, the Latvian services export value increased by 10.0%. The services export value was influenced positively by the rise in export of telecommunications, information and computer services, air and road transport services, as well as financial services. Meanwhile, expenditure of foreign tourists decreased by 35.7%. A decrease in exports was also recorded for construction, as well as rail and sea transport services.

In January 2022, the trends observed in the previous year continued along with a strong growth in **export of goods**. As compared to January 2021, the export value of goods increased by 29.6%. At the beginning of this year the growth in export of goods was facilitated by a favourable external environment, which was driven by the development of the global economy and foreign trade, as well as a sharp rise in prices of goods. Although the beginning of the year turned out to be good for the development of exports of goods, starting from Q2, growth rates will decrease. First, it is related to the high base last year. Secondly, a deficit of certain parts and components is still felt in the global market in general, while Russia's invasion in Ukraine hampered the availability and supply of certain parts. Thirdly, to suppress Russia's aggression in Ukraine, the USA, EU, as well as several other countries of the world imposed economic sanctions on Russia. The economic situation in Russia has worsened significantly during the last weeks, while the value of the Rouble to the Euro decreased by half. In addition, sanctions in the finance sector will encumber mutual settlements by negatively affecting foreign trade. In 2021 in general, exports of Latvian goods to Russia amounted to EUR 1 196 million or 7.3%. Although since 2014, when Russia annexed the Crimean peninsula, followed by US and EU sanctions against Russia and an embargo on Russian food products, the Latvian export value to Russia has virtually not changed, and its share in the total export has decreased significantly.

In 2021, Russia was the fifth largest export market of Latvia, while in 2013 — the third largest with 11.6% share of the total exports. The most negative effect due to the rapid devaluation of the Rouble will be seen in the machinery, pharmaceutical, clothing and textiles, as well as alcoholic beverage production sectors where exports to Russia have been significant until now. It is expected that exports to Belarus and Ukraine will also decrease. Thus, the deterioration of the geopolitical situation in Europe, as well as the high energy prices could negatively affect the competitiveness of exporting companies of Latvia. However, the Latvian goods export structure is rather well diversified both in terms of countries and commodity groups, hence, it is expected that exports of goods will continue to increase, while the growth rates will be lower. A negative effect is also expected in exports of services, as Russia's share in the total exports of services amounts to 5.3%, while together with Belarus and Ukraine it reaches 6.7%. This effect will mainly be reflected in the tourism sector with the number of incoming tourists decreasing, and will cause a decrease in transport services.

In 2021, as compared to the previous year, the value of **import of goods** in current prices increased by 28.4%. The sharp rise in imports was facilitated by growth of both private consumption and investments in Latvia. This is also evidenced by the growth of consumer and capital goods imports by 5.0% and 24.9% respectively. A certain part of imported goods is also used during the production process, and immediate consumption goods were the ones that had the sharpest growth of imports — by 42.9%. Similarly to exports of goods, the growth of imports was also steady throughout the year and was recorded for all commodity groups.

The largest contribution to imports of goods was provided in general by the growth of imports of mineral products by 87.3% or EUR 874 million, thereby providing one fifth of the total growth of imports of goods. Rapid growth in imports in this commodity group was facilitated by petroleum oil, natural gas and electricity imports. The same strong contribution was provided by the growth in imports of vehicles by 52.5% or EUR 721 million as compared to 2020. The growth in imports in this commodity group was recorded for all vehicles, while the most notable contribution was provided by imports of cars, tractors, trailers, as well as aircraft. Imports in metal and metal products increased by 56.0% or EUR 665 million. The growth in imports in this commodity group was rather large and was recorded for iron scrap, rolled iron and steel products, iron rods, iron pipes and other metal products. A significant growth in import value was also noted for machinery and electrical equipment, chemical industry products, as well as timber and timber products.

The **import value of services** in 2021 increased by 20.5%, which was driven by the rise in imports of transport services, as well as information and computer services. Transport services imports grew in all transport modes, thus, the import value of these services increased by 24.5%. Meanwhile, imports of information and computer services grew by 24.0%. At the same time, expenditure of the Latvian population abroad decreased by 9.4% as compared to 2020.

Current account

In 2021, a deficit was recorded in the current account in the amount of EUR 940 million in contrast to a surplus of EUR 845 million in 2020. All sub-account balances of the current account deteriorated; however, the decisive role in increasing the deficit was played by foreign trade accounts, as well as the primary income account (see Figure 2.2). With the import of goods growing sharper than the export of goods, the goods account deficit increased by EUR 949 million to EUR 2 438 million. The situation was similar as regards the services account — import of services grew sharper than export, thus, the surplus of the services account decreased by EUR 79 million to EUR 1 756 million. Thus, the surplus of the services account only partially covers the deficit of the goods account.

The primary income account deficit increased by EUR 631 million to EUR 639 million, which was affected by a larger amount of dividends paid to foreign investors. Whereas, the surplus of the secondary income account has decreased by EUR 125 million to EUR 382 million, which was negatively influenced by higher contributions of Latvia to the EU budget, as well as a higher amount of capital transfers by households and companies to abroad.

The current account deficit against the GDP in 2021 increased by 2.9%. It is important to note that the current account deficit is to be assessed in conjunction with the capital account surplus, which is made up basically by incoming EU structural fund investments, as well as fisheries fund investments. In such terms, the deficit in the previous year would only be 1.4% of GDP. Although a deficit was recorded in the current account, overall, the balance-sheet structure and dynamics of the current account is to be assessed as balanced.

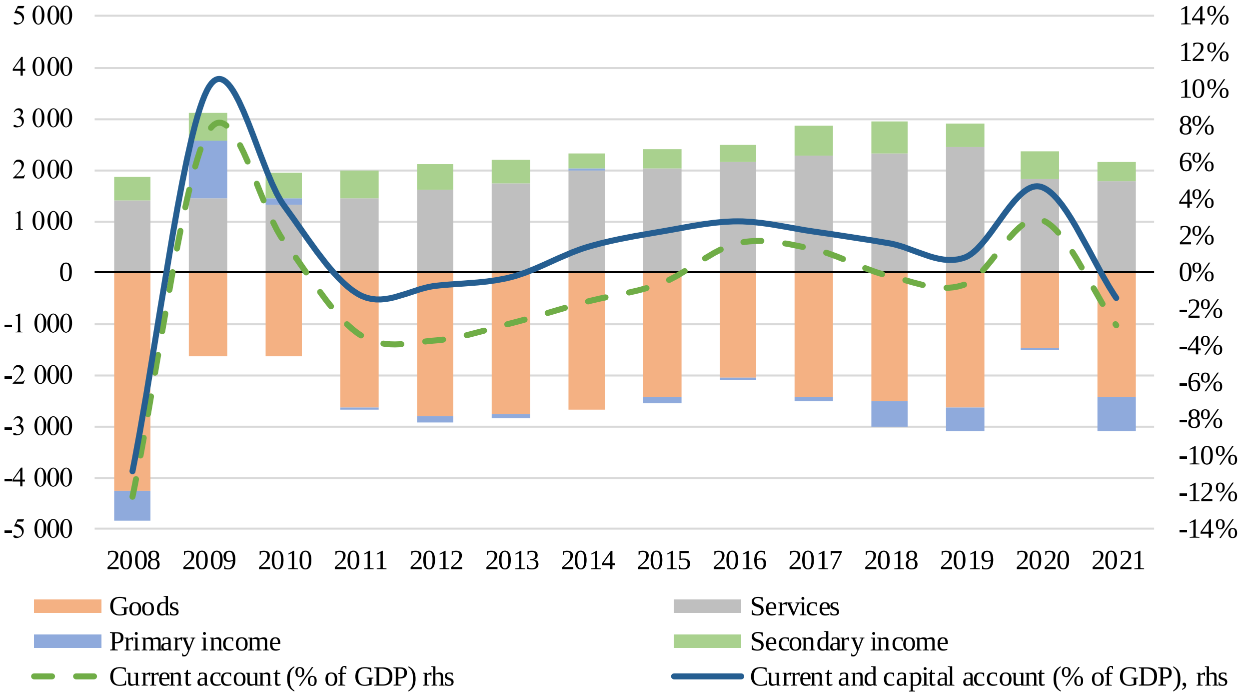

Figure 2.2. Components of the current account of Latvia's balance of payments (MEUR) and current and capital accounts as a percentage of GDP[2]

Inflation

In 2021, as compared to the previous year, consumer prices in Latvia grew by 3.3%, which was the sharpest rise in prices since 2012. Although the average rise in prices in 2021 was stronger than in the previous years, the inflation has, in general, returned to the pre-pandemic level when inflation in 2017 and 2018 was 2.9% and 2.5% respectively. At the same time, it is important to note that the average increase of consumer prices in 2021 does not reflect the current situation as regards price changes of goods and services, since the monthly inflation dynamics was heterogeneous last year. In January and February 2021, deflation was recorded in Latvia at 0.5% and 0.2% respectively. Whereas, starting from March, consumer prices have been rising steadily, with the annual growth rate increasing by 0.3% in March to 7.9% in December. Hence, the consumer price rise recorded in December last year was the sharpest in the last 12 years. More details regarding consumer price changes in 2021 by months and goods and services groups can be found in Table 2.1 and Figure 2.3.

[2] Data source: Bank of Latvia

Groups and sub-groups	2021	Jan 2022	Feb 2022
Average inflation	3.3	7.4	8.7
Food and non-alcoholic beverages	2.2	8.8	11.8
Housing rent	1.6	2.1	3.1
Electricity	8.1	17.9	17.9
Gas	16.8	65.3	65.5
Heat	3.5	25.2	26.7
Fuel	17.4	26.3	26.6
Transport services	-0.5	1.4	0.2
Healthcare	2.8	3.7	4.2
Leisure and culture	2.3	3.5	4.0
Restaurants and hotels	2.1	5.3	6.2
Various goods and services	1.0	4.7	4.3

Table 2.1. Annual inflation by groups in 2021 on average and in January and February 2022, %

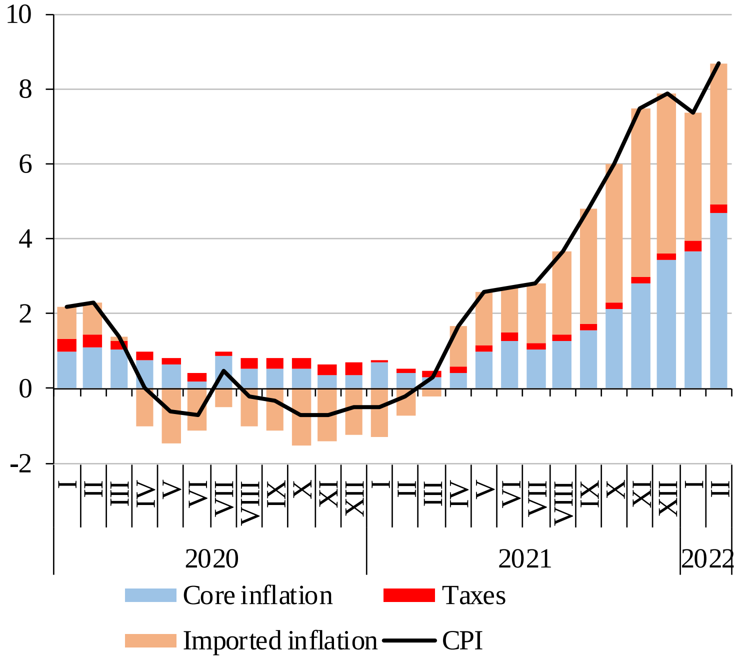

Figure 2.3. Input into annual inflation by the source of origin, percentage points and CPI, %[3]

A sharp rise in consumer prices can be seen not only in Latvia but also globally. The harmonised index of consumer prices in the Eurozone in 2021 increased by 2.6% on average. Whereas, in December of the previous year, the consumer price level in the Eurozone increased by 5.0%, which is the strongest increase in prices since the establishment of the Euro area, or 1999. The average inflation in the USA in 2021 was 4.7%, while the annual inflation in December reached 7.0%, which is the strongest price rise since 1982. Since Latvia is a small and open economy, which is strongly integrated in the global economy by importing many raw materials and capital goods, the global price rise also affects consumer prices in Latvia.

The factors facilitating inflation globally in 2021 can be categorised in three groups. First, the increase in global economic activity supported by favourable fiscal and monetary stimuli. It is important to note that the global economy's recovery from the COVID-19 pandemic was stronger than expected. Thus, the total demand exceeds the total supply by creating a pressure on production and delivery capacities, which were influenced substantially in 2020. In autumn of 2020, the International Monetary Fund projected that in 2021, global GDP would increase by 5.2%, while the actual growth reached 5.9%. Secondly, the increase in prices of raw materials, especially oil, gas, timber and metal, which is related to the strong increase in demand for these commodities. Thirdly, the lack of raw materials and supply chain disruptions. In this case, not natural resources, but rather other intermediate goods are concerned, such as semiconductors or microchips used in the production of vehicles, electrical equipment and household appliances. Whereas, the increase in fuel prices and supply disruptions negatively affect the costs of logistics. According to the most recent assessment by the International Monetary Fund, the global inflation will stabilise in mid-2022. This means

[3] Data source: CSB, MoF calculations

that the price increase will continue to speed up during the first half of this year. Whereas, in the second half of 2022, global inflation will stabilise, while the price level in itself will remain high.

The largest contribution to the consumer price rise in 2021 in general was driven by the rise in energy prices, especially fuel. Last year, fuel prices increased by 17.4%, largely due to the oil price rise in global stock exchanges. Thus, the fuel price rise alone accounts for one third of the total rise in consumer prices. The rise in fuel prices recorded last year was the sharpest since 2011, when the price of fuel rose by 17.5% during the year. On the one hand, such a rise could be seen as very sharp; however, the average price of diesel fuel in Latvia last year was EUR 1.24 per litre, which generally corresponds to the average price before the pandemic, since in 2019, the average price of diesel fuel was EUR 1.20 per litre. The rise in fuel prices was driven by the rise in oil prices where Brent crude oil price in 2021 reached USD 70.8 per barrel on average as opposed to USD 43.4 per barrel a year before. Last year, oil price forecasts were continually revised upwards, which is mainly related to the oil deficit with the demand rising alongside global economic development. Whereas, the supply of oil was limited by the rather slow increase of OPEC+ oil production amounts.

The price of fuel already started to rise from March last year, while a rapid rise in prices of other energy resources was only recorded in the autumn, which was caused by the energy crisis in Europe. The cold winter during the last heating season in Europe led to an increase in demand for gas, while the hot summer last year stimulated the consumption of electricity. At the same time, a low water level in hydropower plants and weak production of energy from alternative sources (wind and solar) reduced the supply of electricity. In addition, energy prices were also affected by the upward trends in the emission allowance market in the EU, technical works in nuclear power plants in Scandinavia, increase in gas consumption in Asia, as well as logistics disturbances. Combined with the growing economy, this led to a scarcity of energy resources and hence also substantially affected the price. In 2021, the prices of gas, electricity and heat energy in Latvia increased by 16.8%, 8.1% and 3.5% respectively. These goods together with fuel will also continue to impact the increase in average consumer prices in 2022.

Food and non-alcoholic beverages was another commodity group which influenced the average inflation substantially last year, with the sharpest increase observed at the end of the year. Food prices in 2021 globally reached the highest level in a decade; however, in Latvia this global increase of food prices only started to show in the last months of the year. This could be related to the strong competitiveness in this segment, especially in retail food sales. In addition, the food price dynamics were also affected by the spread of COVID-19, with hotels not operating and cafes operating only partially, so the demand for food products was lower. Thus, the food prices in 2021 in general were 2.2% higher than in the previous year. However, in December last year, annual food inflation already reached 7.2%, and in 2022 the pressure of the food price increase will rise even more.

At the beginning of 2022, the high inflation trend observed at the end of the previous year continued, which continued to determine the high energy and food prices. In January and February, consumer prices increased by 7.4% and 8.7% respectively. The consumer price rise in the last months is similar to the 2007-2008 period when there were signs of pronounced overheating of the economy of Latvia. However, it is important to stress that the current causes of inflation are mainly related to external factors, not with non-balanced development of the economy.

The government introduced several support measures to reduce the sharp increase in energy prices. As from 1 January this year, several support instruments are available to households, which are directed towards the reduction of electricity, gas and heat energy tariffs. In addition, support is provided to pensioners and large families to compensate for energy costs.

The support measures will be in force until the end of April this year, and, when the support period ends, the rate of price increase for the above-mentioned goods may accelerate again. The future price dynamics of electricity, gas and heat will depend on energy price fluctuations in global stock-exchanges. Due to the worsening of the geopolitical situation in Europe as a result of Russia's invasion in Ukraine, oil and gas prices increased. Thus, fuel prices will be high in Latvia for at least the whole first half of this year. As regards gas tariffs, one can say for sure that in the second half of the year they will be revised upwards, and heat energy tariffs will also remain high in the next heating season. It is also important to note that the rise in energy prices has not yet been reflected fully in the prices of other goods and services. Since energy resources are a substantial component of production and logistics costs, which influence the final price of goods and services, their secondary effects will still be felt on consumer price changes.

According to the MoF's macroeconomic scenario of the beginning of March, it is expected that the consumer price increase in 2022 will reach 8.5%, which will be mainly influenced by an increase in energy and food prices. The pressure on consumer prices will also be seen in other product and service groups. However, Russia's aggression in Ukraine and the potential escalation of the war, as well as the imposition of sanctions on Russia, especially in the field of energy, could result in even more increases of consumer prices in both Europe and Latvia.

Labour market

The labour market situation in 2021, just like in the previous year, was determined by the COVID-19 pandemic, restrictions imposed to reduce the spread of the disease, the gradual reduction of the sickness rate and the public support to the sectors and population hit by the pandemic and restrictions the most.

After an increase of up to 8.1% in 2020, the first year of the pandemic, the unemployment rate, according to the labour force survey, decreased last year to 7.6% of the economically active population. Both in 2020 and in 2021, the influence of COVID-19 in the Latvian labour market was rather limited, mainly thanks to the public support measures, including idle time allowances and wage subsidies. As a result, the increase of unemployment during the pandemic was significantly lower than during the 2008-2009 financial crisis and also more moderate than was expected at the start of the COVID-19 crisis.

The total COVID-19 support in 2021 reached EUR 2.3 billion (6.9% of GDP) by increasing from EUR 1.3 billion (4.3% of GDP) in 2020, while the direct support to employment in the form of idle time allowances and wage subsidies last year increased to EUR 168.6 million (0.5% of GDP) as compared to EUR 107.8 million (0.4% of GDP) in 2020.

Throughout 2021, the unemployment rate decreased gradually, by falling from 8.1% in Q1 to 7.1% in Q4 when employment was already 0.8 ppt lower than in the respective quarter of the previous year. The decrease in unemployment in 2021 could have been even stronger; however, in the last months of the year the outbreak of the pandemic and working restrictions on the non-vaccinated population started to negatively affect the unemployment and employment rates again. As a result, the unemployment rate recorded by the State Employment Agency in Q4 showed a slightly faster increase in unemployment than usual during the winter season.

At the same time, the available data for the first months of 2022 point towards the stabilisation of registered unemployment rates, and in February, the number of the registered unemployed had practically not increased, while in March it already started to decrease. In the coming months, unemployment rates might be reduced by the lifting of vaccination certificate requirements for workers; however, the economic activity will be negatively affected with Latvian companies stopping their cooperation with Russia and Belarus and seeking to find new sales and raw material markets. Accordingly, in the middle of the year a temporary increase in the unemployment rate is possible, and in 2022 in general, unemployment might remain at the 2021 level, but later on, with the negative impact decreasing, in 2023 it could decline to 6.7% of the active population.

Last year, the number of the population employed in the economy sector, according to the labour survey data, was 3.2% lower than in 2020 and amounted to 864 thousand. The decline in the number of employed was determined by the restrictions imposed to reduce the COVID-19 disease rates, when people temporarily became inactive and received idle time allowances. With the restrictions being reduced, the number of employed started to gradually increase during 2021, until in Q4 it was brought down again by the COVID-19 outbreak, as well as working limitations on the non-vaccinated population. In Q4 of 2021, the number of employed was 864.2 thousand, which is 2.4% less than the respective quarter of 2020. At the beginning of 2022, with the COVID-19 disease rates and restrictions declining, the population who were temporarily inactive started to return to the labour market. In February, the number of employed was already higher than in the respective month of the previous year, reaching 858 thousand and exceeding the level of February 2021 by 0.9%.

At the beginning of 2022, the employment rates could be affected positively by the possibility to return to the labour market for the non-vaccinated population, as well as Ukrainian war refugees admitted to Latvia. On the other hand, the demand for workers could be reduced by the decline in economic activity related to Russia. However, for the year in general an increase in employment is expected, with the number of workers increasing by 1.3% as compared to 2021, but still lagging behind the pre-crisis level in 2019.

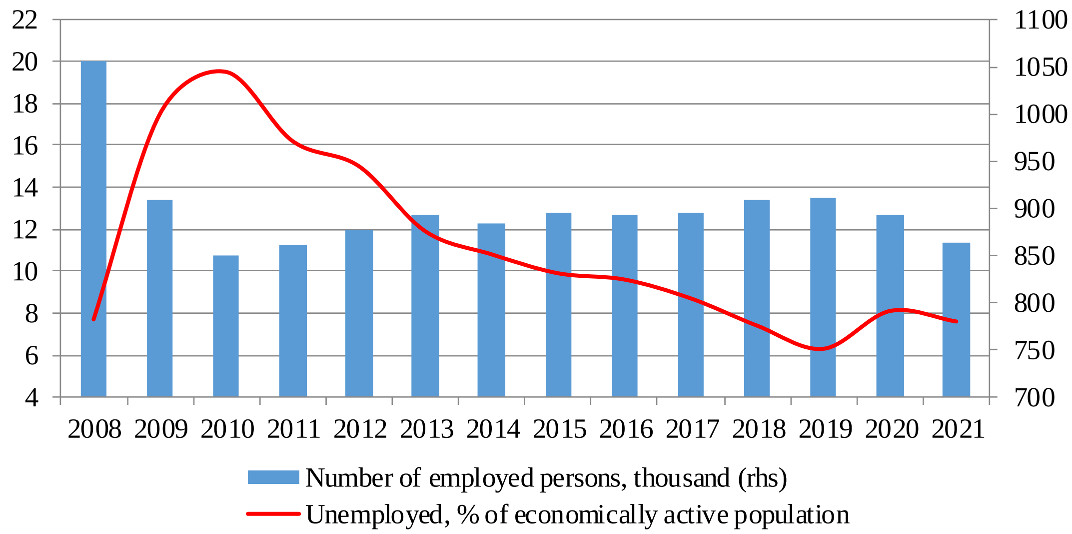

Figure 2.4. Employment and unemployment in 2008-2021

Despite the COVID-19 crisis, the growth in wages in 2020 only decelerated slightly, with the average monthly gross wage increasing by 6.2% as compared to the previous year. In 2021, with the minimum wage increased to EUR 500, remuneration in the healthcare sector increasing sharply, and low wage earners temporarily leaving the labour market in such sectors as accommodation and food service activities, the price increase accelerated even more. The average monthly gross wage in 2021 has increased by 11.8%, reaching EUR 1 277. Last year, wage growth rates in the private and public sectors were similar — 11.9% and 11.8% respectively; however, in the public sector there was a slightly higher level of remuneration — EUR 1 293, while in the private sector the average wage was EUR 1 273.

Changes in the average wage last year were significantly affected not only by changes in the wages of the employees, but also by structural changes in the labour market, *inter alia*, enterprises commencing and terminating operation over the year and the changes in the number of employees and workloads, also including under the influence of the COVID-19 pandemic. In 2021, there were also significant changes in the field of labour taxation, when from 1 July mandatory State social security contributions were introduced and the transition period ended, after which for all employees of microenterprise tax payers, labour taxes should be paid according to the general procedure, which also affected the level of average monthly remuneration.

From the sectoral perspective, the average wage increased most rapidly during the year in the healthcare sector — by 28.2%, the professional services sector — by 18.2%, and in the arts, entertainment and recreation sector — by 13.9%. The highest monthly gross wage was recorded in the financial services sector where it was EUR 2 282, and in the information and communication services sector, where it was EUR 2 088. Whereas, the lowest wage was in the accommodation and food service activities — EUR 795, and the difference in wage levels in higher and lower paid sectors in 2021 only increased.

In 2022, the increase in remuneration will decelerate, which will be determined by the high base of the previous year, the slower increase in wages in the public sector, the maintaining of the average wage at the 2021 level, as well as breaking of economic links with the war-initiating Russia. Similarly, the wage pressure already in place this year will be reduced by the growing labour supply, including the possibility for the non-vaccinated population to return to the labour market and the reception of Ukrainian war refugees.

In general, it is expected that lower economic growth in the labour market this year will be reflected more in the slower increase of wages, less in declining employment and increasing unemployment rates. It is expected that the rincrease in the average gross wage in 2022 will fall to 6.0%, in 2023 it will fall to 5.7%, and thereafter will stabilise close to the productivity growth rate.

2.3. Macroeconomic Development Scenario

This year, two medium-term macroeconomic development scenarios were developed. The first scenario was drafted at the beginning of February 2022; however, at the end of February, the Russia's military aggression against Ukraine made it obsolete, considering the sanctions imposed by the EU and other countries and the refusal of private companies to make business in Russia due to negative reputation risks. Thus, at the beginning of March a new scenario was drafted, which will form the basis for the preparation of the Stability Programme 2022-2025.

Both scenarios were developed in consultation with experts from the Bank of Latvia and the Ministry of Economy; the February's scenario – also in consultation with EC and International Monetary Fund experts, while the March scenario – with commercial bank experts. Both macroeconomic development scenarios were approved by the Fiscal Discipline Council by publishing its opinions on 14 February and 9 March of 2022 respectively.

The initial or February scenario

The February's scenario was developed under the circumstances of high uncertainty: the economy was continuing to be affected by COVID-19 restrictions and uncertainty regarding the development of the pandemic. Besides, the increasing geopolitical pressure substantially increased energy prices at the end of 2021 by increasing the costs and growing inflation.

The scenario provides that the infection rate with COVID-19 will decrease in spring of 2022 and the strict restrictions imposed at the end of last year will be gradually lifted, and, starting with Q2 of this year, the economy will start to operate without limitations. Considering the fact that the immunity of the population to COVID-19 has increased substantially, the scenario does not envisage that in the future to introduce economy-restricting measures to reduce the disease rates would not be necessary.

According to this scenario, the Latvian GDP in 2022 would increase by 4.0%, while in 2023, the economic growth would amount to 3.9%. As compared to the previous forecast of June 2021, the expected growth in gross domestic product for 2022 has been reduced by 1 ppt, while for 2023 GDP growth is projected to be 0.4 ppt higher than in June last year. In the next two years, 2024 and 2025, the economic growth is projected to be close to the potential economic growth rate at 3.4%.

Table 2.2. GDP growth and related factors

	ESA code	2021*	2021*	2022	2023	2024	2025
		MEUR	Growth, %				
1. GDP at current prices	B1*y	32 917	11.8	10.8	7.6	6.3	5.8
2. GDP at 2015 prices	B1*y	27 904	4.8	4.0	3.9	3.4	3.4
GDP by expenditure at 2015 prices							
3. Private consumption	P3	15 601	4.8	5.4	6.2	4.0	4.0
4. Public consumption	P3	5 377	4.4	5.2	0.6	0.5	0.5
5. Gross fixed capital formation	P51	6 774	3.0	2.5	5.0	5.0	3.0
6. Changes in inventories and acquisition of valuables	P52+P53	2 788	-	-	-	-	-
7. Export	P6	18 138	6.2	5.1	4.0	4.1	5.0
8. Import	P7	20 773	13.5	6.4	4.7	3.8	3.9
Contribution to GDP growth							
9. Total domestic demand	P3+P51		4.3	4.6	4.8	3.6	3.2
10. Changes in inventories and acquisition of valuables	P52+P53		5.8	0.8	0.0	0.0	0.0
11. Export-import balance	B11		-5.3	-1.5	-0.9	-0.2	0.3

* 2021 statistics are from the CSB as at 28.02.2022.

In 2021, the growth of the Latvian economy would reach 4.8%, and recovery of the economy from the COVID-19 crisis would markedly stronger and started earlier than was projected in June last year. This has also determined the lower GDP growth rates expected in 2022, which were also reduced slightly by the restrictions still in place in Q1 on the operation of certain services sectors.

With the emergency situation coming to an end and a full economic recovery in 2022, a strong increase of the private consumption by 5.4% would be expected, which would still be slightly limited by the sharp decrease in the population's purchasing power as a result of the strong increase in prices. In 2023, the private consumption would grow even more, which would be ensured both by wage increase and lifting of restrictions on travelling, as well as savings made during the pandemic.

The February's scenario assumes for considerable EU investments for the 2021-2027 programming period, in light of the expected planned funding of the EU structural funds and the Recovery and Resilience Facility. Meanwhile, their actual contribution (or contribution in constant prices) would decrease due to the growing construction costs, which are affected among others by the rising energy prices. Hence, investments would only grow by 2.5% this year. Whereas, starting from 2023, the investments would increase more strongly and could reach growth of 5% with the construction prices stabilising.

Meanwhile, the increase in exports in 2022 would be slightly slower than last year amounting to 5.1%, while in 2023 it would increase by 4%, which corresponds to the development of the external economic environment and the main external trade partner countries of Latvia. The latter was based on the latest EC forecasts at that time and the International Monetary Fund's winter 2022 forecasts, which showed that the economic growth in the world and the main foreign trade partner countries of Latvia has recovered stronger than expected, by determining accordingly slower development rates in 2023. This year, growth would also be slowed down by the spread of the new COVID-19 omicron variant, supply chain disturbances and the rising energy and food prices.

In 2022, the average annual inflation would reach 6.2%, increasing from 3.3% last year. The high inflation rate this year, like in the second half of 2021, would be determined by the sharply rising energy prices, which would start to reflect more in prices of other goods and services. In the first half of the year, inflation would remain high at 7-8%, while in the second half of the year, with energy prices stabilising, the overall consumer price increase would slow down and inflation in 2023 would drop to 3.1%. In the next two years, inflation would continue to decrease and would stabilise at 2% by 2025.

After the sharp rise by 11.8% in 2021, the monthly average wage this year would continue to rise rather sharply, which would be determined by the limited labour supply and the rising prices. At the same time, with the increase of public spending decelerating, the increase in wages in the public sector would become slower, and the overall the average wage would increase by 7.5%. In the next years, the wage growth rate would continue to moderate, by coming close to the productivity growth rate during the period until 2025 and stabilising at 5%. The unemployment rate would continue to decrease to 6.9% in 2022 and further down to 6.5% in 2023, while the number of population employed in the economy sector would recover slightly slower than expected in June last year, with the population's involvement in the labour market reducing as a consequence of the pandemic and with the number of the active population decreasing more strongly.

Cyclical development of the economy according to the February's scenario

Since 2011, the first post-2007-recession year, the Latvian economy has been growing on average by 3.4% annually due to stable growth of external demand and investment flows, especially in 2017 and 2018 due to the new cycle of the EU funds. In 2019, due to cyclical slowdown of the economy investment growth rates declined from 11.6% on average in 2017-2018 to 6.9% in 2019. As a result, the GDP growth slowed down to 2.5% in 2019. Whereas, in 2020, the economic cycle turned to recession due to the COVID-19 pandemic, affecting the development of all economic sectors and, in some sectors related to tourism, leaving long-term consequences on the potential GDP growth rate. As a result, the output gap that had been positive since 2015, became strongly negative in 2020. Under the February's scenario, the negative output gap would disappear within three years until the economy returns to the potential development level, and, from 2024, would continue with growth with 3.4%. Overall, a similar medium-term output gap estimate was in the EC's autumn of 2021forecasts.

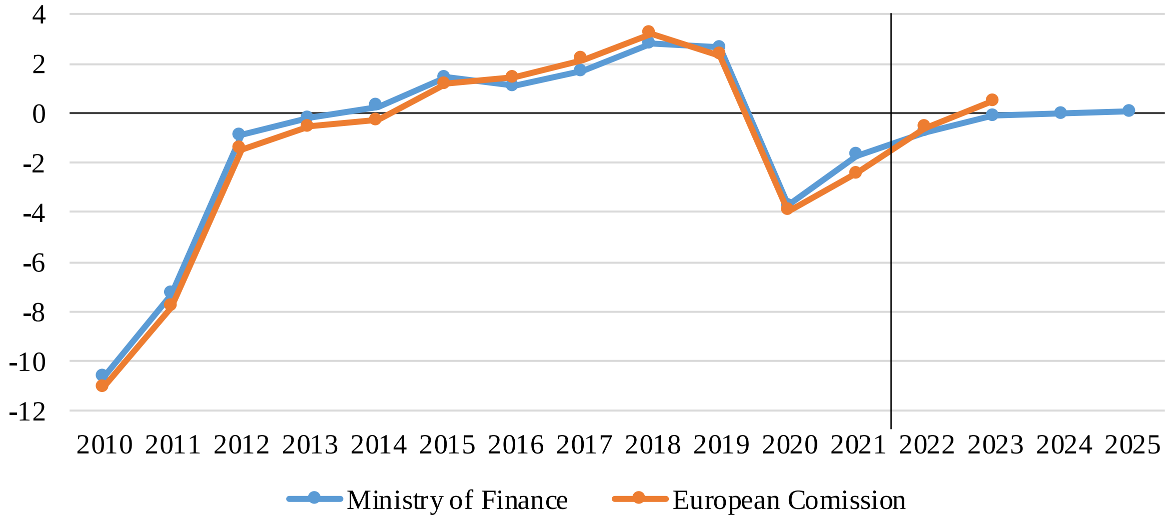

Figure 2.5. Output gap, %

The potential GDP growth during the forecast period will be pre-dominantly determined by the total productivity growth, the input of which from the low 1.6ppt in 2019 during the post-pandemic period will increase to 2.3ppt, thereby characterising the economic recovery stage. The rest of the growth of the gross domestic product would be ensured by capital input, constituting approximately one percentage point, while the labour force input would become negative due to the negative demographic situation. According to the MoF's estimates, the medium-term potential gross domestic product growth would be 3.0-3.3%.

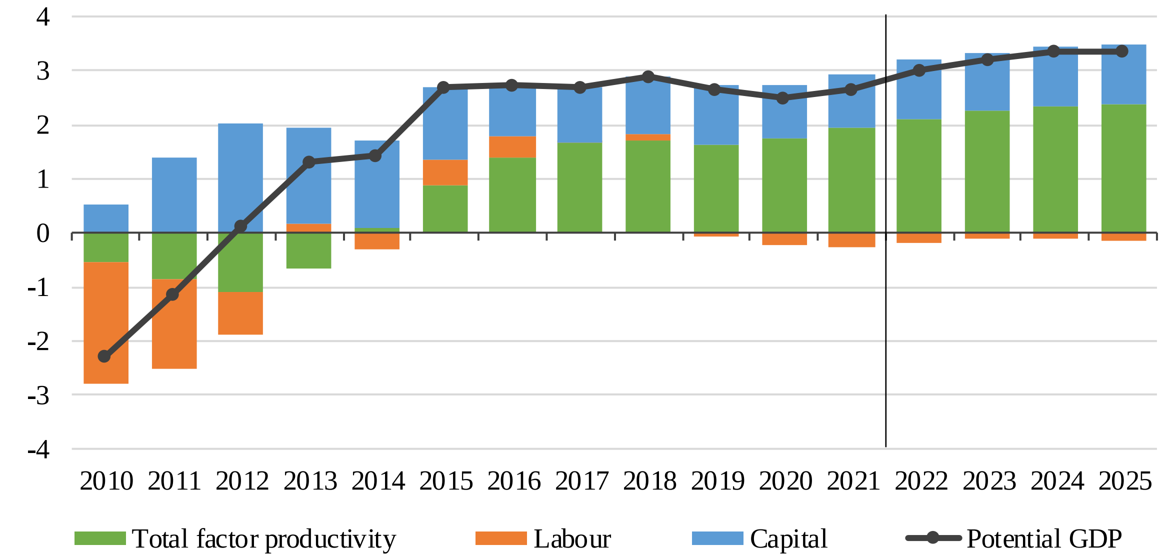

Figure 2.6. Potential gross domestic product growth and input of components, %

Renewed or March scenario

Russia's invasion in Ukraine on 24 February this year made sharp decline in economic cooperation with Russia and its ally Belarus. Thus the scenario developed at the beginning of February became obsolete. At the beginning of March, the MoF renewed the macroeconomic development scenario taking the new geopolitical reality into account.

Table 2.3. GDP growth and related factors

	ESA code	2021*	2021*	2022	2023	2024	2025
		MEUR	Growth, %				
1. GDP at current prices	B1*y	32 917	11.8	10.9	6.8	6.1	5.8
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3. Private consumption	P3	15 601	4.8	3.7	4.4	4.0	4.0
4. Public consumption	P3	5 377	4.4	0.8	0.6	0.5	0.5
5. Gross fixed capital formation	P51	6 774	3.0	1.9	4.7	4.8	3.0
6. Changes in inventories and acquisition of valuables	P52+P53	2 788	-	-	-	-	-
7. Export	P6	18 138	6.2	-3.0	-0.1	4.0	5.0
8. Import	P7	20 773	13.5	-2.0	1.7	3.7	4.0
Contribution to GDP growth							
9. Total domestic demand	P3+P51		4.3	2.7	3.7	3.6	3.2
10. Changes in inventories and acquisition of valuables	P52+P53		5.8	-0.1	0.0	0.0	0.0
11. Export-import balance	B11		-5.3	-0.5	-1.3	-0.2	0.2

* 2021 statistics are from the CSB as at 28.02.2022.

According to the updated scenario, the GDP would grow by 2.1% in 2022 then accelerating to 2.5% in 2023 and returning to the previously forecast growth rates in the medium term. These forecasts for 2022 and 2023 are respectively 1.9 and 1.4 ppt lower than in the February's macroeconomic development scenario.

The economic growth this year and the next year will be influenced mostly by the foreign trade channel – all developed countries imposed trade sanctions on Russia, and many private companies refused to cooperate, taking care of their reputation. Hence, a significant fall in the turnover of goods and services is expected in this important for Latvia direction of trade. The forecasts also assume that the limitations on trade with Russia and Belarus would be maintained in 2023, but at the same time, there is no further strong escalation of the situation.

Last year, exports of Latvian goods to Russia amounted to 7.3% of the total exports, while the share of Belarus and Ukraine in the goods export of Latvia was 1.1% and 1.4% respectively. Services export's share to Russia is 5.3%, considering the rapid shrinking of Russian cargo transit though Latvian ports during the last years and Latvia's refusal to service non-residents in the banking sector. The scenario assumes lower export and import volumes, while Latvian companies will shift the goods and services export from the aggressor countries to new markets. As a result, the Latvian exports of goods and services in 2022 will decrease by 3.0%, which is 8.1 ppt less than in the initial scenario. Over the next years, the growth of exports will be at the level projected in the February scenario. However, it should be noted that the value of exports will be lower than in the February's scenario.

In addition, the economic situation will also continue to be negatively affected by the sharp rise in prices due to rising energy and food prices as a consequence of the war, sanctions and supply chain disruptions, as well as by the declining in business and households confidence. Thus, the private consumption will grow by 3.7% this year and by 4.4%, or by 1.8% ppt slower than in the February's scenario, the next year. Likewise, the growth of investments will be hampered by the rising costs, especially on the private investment side; hence, the gross fixed capital formation would only by 1.9% this year, and, with the situation normalising, by 4.7% in 2023.

At the same time, the increase in public spending in form of increasing financing for defence, as well as for social support of the Latvian population and Ukrainian refugees, will help to maintain the growth. This year, a significant increase in national and EU fund investments is also expected, which will exceed the 2021 level by one third.

A lower economic growth in the labour market this year mostly will manifest in a slower wage growth, while the negative impact on employment and unemployment rates will be smaller. Expected average gross wage growth will decelerate to 6.0% in 2022, and to 5.7% in 2023, and thereafter will stabilise close to the productivity growth rate. In the middle of the 2022, the unemployment rate may temporarily increase as workers of individual companies related to Russian and Belarusian markets may lose jobs; however, in 2022 in general, unemployment rate would remain at the 2021 level at 7.6%, and as the negative effect decrease would decline to 6.7% in 2023.

3. GENERAL GOVERNMENT BUDGET BALANCE AND DEBT

3.1. Fiscal Policy Strategy and Medium-Term Objectives

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 also 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 specifies that according to the forecasts at that time it is necessary to also continue applying the general escape clause 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 adopted. 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 terminated starting from 2023. On 2 March 2022, the EC published Fiscal Policy Guidance 2023. These guidelines indicate that, on the basis of the EC’s 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’s 2022 spring forecast (May of this year).

The existence of the general escape clause has also changed the scope of application of fiscal discipline norms. The principles of application of the FDL numerical fiscal conditions in preparation of the Draft Law on the Medium Term Budget Framework are defined in

Section 33, Paragraph two of the Law on the Suppression of Consequences of the Spread of COVID-19 Infection:

Section 33 of the Law on the Suppression of Consequences of the Spread of COVID-19 Infection: "(2) Upon developing the draft law On the Medium Term Budget Framework for 2022, 2023, and 2024 and the draft law On the State Budget for 2022 and upon enforcing the abovementioned laws, the conditions of Section 7, Paragraph three and Sections 9, 10, and 13 of the Fiscal Discipline Law are not applied, but the conditions of the opinion issued in accordance with Article 5(2) of 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 are applied."

Taking into account the forecast consistently expressed by the EC to the effect that the general escape clause would be cancelled in 2023, the preparation of the Stability Programme is based on a presumption that this clause is cancelled from 2023 and, accordingly, the FDL norms are in effect. If, however, the general escape clause is maintained in 2023, when developing a Medium Term Budget Framework, the Fiscal Policy Strategy will be adjusted accordingly.

Transitional Period and Activation of Section 12, Paragraph One, Clause 1 of the FDL

Section 12 of the FDL provides for the possibilities to deviate from the 0.5% deficit target in exceptional cases, including during a severe economic downturn. A severe economic downturn in the EU served as a basis for the implementation of the general escape clause. It should be noted that the FDL norms have been drafted on a presumption that additional expenditure or reduction of revenues caused by exceptional circumstances is temporary in nature, and, with the exceptional circumstances coming to an end, the general government structural deficit automatically returns to the pre-crisis level. The FDL has not provided for a fiscal policy that would, during a crisis period, deliberately increase the structural deficit above the level that is necessary to cover the additional costs/reduction in revenue objectively caused by the crisis. However, the general escape clause introduced by the EC and the related fiscal recommendations not only invited to cover additional crisis costs at the expense of the increase of deficit, but also to finance economy warming measures. This led to a situation where the structural deficit has grown more than the additional expenses caused by the crisis, and the structural deficit does not return to its pre-crisis level after the crisis. By excluding COVID-19 support measures, including economy warming investment projects, as well as by excluding energy price rise compensation measures, the structural deficit in 2021 and 2022 has increased against the 2019 level and, in the case of no policy change, does not return to the pre-crisis level.

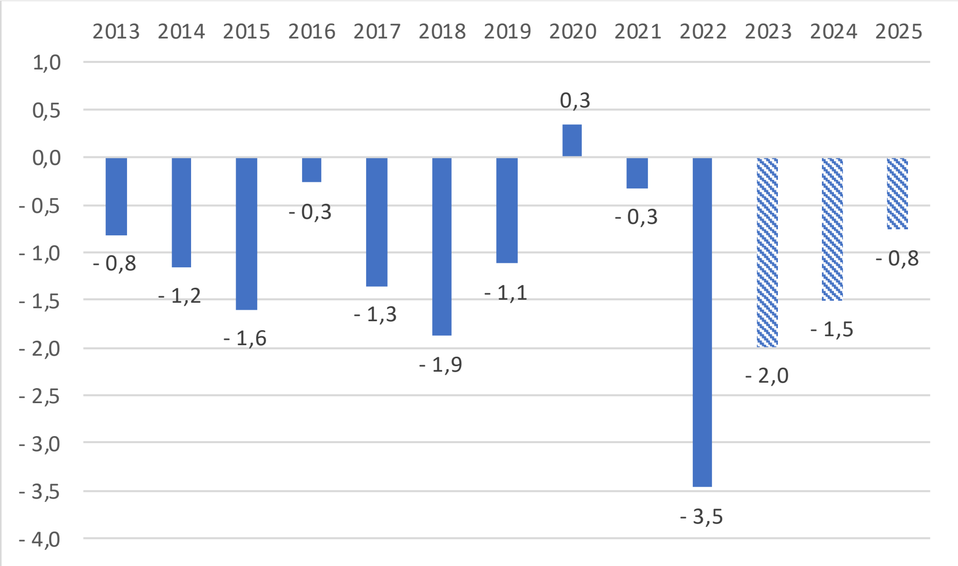

Figure 3.1. General government budget structural balance, from the 2023 forecast with no policy change (March scenario)

In accordance with the requirements of the FDL, the structural deficit in 2023 may not exceed 0.5% of GDP; however, with no policy change, it is already 2.0% of GDP, which leads to the need for consolidation of 1.5% of GDP. Such consolidation would not only be hard to implement in practice, but would also lead to a severely restrictive fiscal policy which would negatively affect the economy.

The COVID-19 pandemic corresponds not only to the case of Section 12, Paragraph one, Clause 3 of the FDL, which was the basis for the introduction of the general escape clause, but also to the case of Section 12, Paragraph one, Clause 1 of the FDL, which states that "measures for the rectification of material damages caused by natural disasters, accidents and other nature or social processes are to be implemented, the forecast costs of which in one financial year exceed 0.1 per cent of the gross domestic product of the relevant year". The COVID-19 pandemic is a natural process, which has caused damages to the public interests and the economy. Mitigation measures of the pandemic, including measures to reduce the economic downturn, are to be regarded as being "damages" within the meaning of the FDL. Even if the COVID-19 pandemic ends, its consequences continue to affect the society and economy, e.g., in the form of an increase in the general government's structural deficit. The increase in the general government's structural deficit is a direct consequence of the COVID-19 pandemic; therefore, if the structural deficit would be reduced gradually, deviations from 0.5% of GDP level would we considered as "damages" caused by the COVID-19 pandemic within the meaning of the FDL. If such "damages" or deviation from 0.5% of GDP were not implemented, and consolidation which is inappropriate to the economic situation was carried out, the State would implement an inadequate policy for exiting the COVID-19 crisis. Hence, with the COVID-19 pandemic coming to an end, the negative effect caused by it does not end but continues to exist for some time. In the present period, the State implements a policy to mitigate the negative effect, and the negative fiscal effect of this policy is to be regarded as being "damages" within the meaning of the FDL, and Section 12, Paragraph one, Clause 1 is applicable during this period.

The Fiscal Policy Strategy 2023-2025 provides for a gradual reduction of the general government's structural deficit by activating Section 12, paragraph one, Clause 1 of the FDL.

Deviations of Accrued Balances

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. If, during 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, in the third year of the next medium-term budget law the target structural balance of the general government budget shall be determined greater than 0.5% of GDP. Differences of accrued balances are shown in table 3.1.

Table 3.1. Deviations of Accrued Balances

		2013	2014	2015	2016	2017	2018	2019	2020
1	GDP, at current prices, MEUR	22 749	23 626	24 572	25 360	26 984	29 154	30 647	29 433
2	Actual structural balance of the general government budget, % of GDP	**-0.8**	**-1.2**	**-1.6**	**-0.3**	**-1.3**	**-1.9**	**-1.1**	**0.3**
3(1×2)	Actual structural balance of the general government budget, MEUR	-184.7	-272.4	-392.7	-68.7	-363.5	-546.1	-342.5	100.0
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**
5(1×4)	Minimum planned structural balance of the general government budget, MEUR	-296.2	-236.2	-243.2	-225.3	-270.3	-354.3	-173.6	-136.8
6(3-5)	Financial year balance deviation, MEUR	111.5	-36.2	-149.5	156.6	-93.2	-191.8	-168.9	236.9
7((6:1)×100)	Financial year balance deviation, % of GDP	**0.5**	**-0.2**	**-0.6**	**0.6**	**-0.3**	**-0.7**	**-0.6**	**0.8**
8(Σ(6))	Amount of accrued balance deviations (cumulatively), MEUR	111.5	75.3	-74.1	82.4	-10.8	-202.6	-371.5	-134.6
9((8/1)×100)	Amount of accrued balance deviations, % of GDP	**0.5**	**0.3**	**-0.3**	**0.3**	**0.0**	**-0.7**	**-1.2**	**-0.5**
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**
11	To be adjusted if 9<10								**To be adjusted**

Considering the fact that in 2023, the output gap is 0% of GDP and is positive during the next years, adjustment of the minimum planned structural balance of the general government budget is to be applied during this period where, in accordance with Section 11, Paragraph five of the FDL, the structural deficit is reduced by 0.5% of GDP more as a reduction without adjustment.

Deficit Reduction Path

In 2023, with the general escape clause being cancelled, provisions of the Stability and Growth Pact and of the FDL are to be observed. In this case, provisions should be applied which establish the deficit reduction path if the structural deficit of the general government budget exceeds the medium-term budgetary objective.

Article 5 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 states that: "The Council and the Commission, when assessing the adjustment path towards the medium-term budgetary objective, shall examine if the Member State concerned pursues an appropriate annual improvement of its cyclically-adjusted budget balance, net of one-off and other temporary measures, required to meet its medium-term budgetary objective, with 0.5 % of GDP as a benchmark." Hence, annual reduction by 0.5 of GDP is a benchmark for the reduction of structural deficit.

Section 11 of the FDL stipulates adjustment of the minimum planned structural balance of the general government budget if the actual structural deficit in previous years has exceeded target values and the cumulative excess is at least 0.5% of GDP. As set out in the previous section, this condition is met.

In accordance with Section 11, Paragraph five of the FDL, in such cases the structural deficit shall be determined as lower for 0.5 per cent of GDP than in the standard case. Since for the 2023-2025 period the medium-term objective is not met, but there is a convergence to it, adjustment of 0.5% of GDP should be applied to the structural deficit reduction rate.

With compensation of the cumulative excess in 2023 by the structural deficit reduction by an additional 0.5% of GDP, in the next years' adjustment is not necessary since the cumulative excess after the compensation is less than 0.5% of GDP.

It arises from EU and Latvian fiscal policy law that in 2023, the structural deficit of the general government budget is to be reduced by 1% of GDP (0.5 (standard reduction) + 0.5 (adjustment of deviations accumulated in the previous years)), while in the next years of the Stability Programme the structural deficit of the general government budget is to be reduced by 0.5% of GDP annually.

One-off Measures

For the calculation of the structural balance of the general government budget it is important to establish which measures are to be regarded as one-off measures and are excluded from calculation of the structural balance. When the general escape clause was in force, the issue of one-off measures was not relevant since there were no limitations on the amount of the structural balance and change path. With the cancellation of the general escape clause FDL provisions are in force, and hence, the issue of one-off measures arises as it directly affects the determination of value of the structural balance. It should be noted that the question on which measures should be regarded as one-off measures is up to each EU Member State as regards the application of national fiscal conditions; however, this does not alter the need to ensure conformity to EU law where the classification of measures as one-off measures may differ. Since the structural balance indicator is not regarded by the EC as the main indicator anymore, and instead in fiscal policy recommendations, the EC uses an expenditure growth rule which has been borrowed from the Stability and Growth Pact and modified, it is essential to ensure that one-off measures established on a national level do not lead to a contradiction with the expenditure growth rule used by the EU.

COVID-19

The Fiscal Policy Strategy recognises all COVID-19-related expenditure and revenue measures as one-off measures. This has a strong basis, since these measures have been specifically developed for COVID-19 support, and, with the pandemic ending, they cease to exist. They have no structural impact on expenditure and revenue of future years. It has to be noted that the EC, when evaluating the fulfilment of the expenditure growth rule, also excludes COVID-19-related expenditure from the expenditure growth rule. It is expected that such measures will practically cease to exist in 2023; hence, they will affect the structural deficit level in 2022 but will not provide the possibility to carry out additional expenditure in 2023, unless a new outbreak of pandemic occurs.

Energy

The Fiscal Policy Strategy recognises measures mitigating the energy price increase at the end of 2021 as one-off measures. The notable rise in energy prices that was observed before Russia's invasion in Ukraine, will, most probably, remain longer than planned. It cannot be excluded that the impact of sanctions will increase energy prices even more, and in such circumstances, the State will have to carry out support measures to mitigate the negative impact on the economy. Currently, it is not known if the EC would adopt a decision regarding the exclusion of such expenditure from the expenditure growth rule. If such decision will not be adopted and this expenditure will be included in the expenditure growth rule, the potential support in 2023 will not be allowed to exceed the amount that ensures fulfilment of the expenditure growth rule. It is expected that in Q3 of 2022 there will be more information available regarding energy prices and the necessity for EU States to carry out support measures. Based on this information, the Fiscal Policy Strategy may be adjusted before drawing up the State budget for 2023 and the medium-term budgetary framework law.

Investments in Defence and Internal Security

Russia's invasion in Ukraine highlighted the necessity for EU States to substantially increase defence expenditure. Since no decision is currently adopted regarding the exclusion of defence expenditure from deficit restrictions, the potential increase in defence expenditure is to be viewed within the framework of the national and EU fiscal regulation in force, including the EC's fiscal recommendation of 2nd of March of this year.

It arises from the above-mentioned regulation that current defence expenditure and its potential increase is to be implemented in accordance with the general procedure within the framework of the available fiscal space by prioritising it among other expenditure policy measures.

The EC's fiscal recommendations of 2nd of March of this year allow low-debt States to expand public investments in 2023. Although the respective recommendation in this context refers to green and digital investments, this does not exclude other investments:

> ***All Member States should protect overall investment and, where justified, expand nationally financed investment, in particular for the green, digital and resilient transition.*** *Emphasis should be put on the high quality of investment, in line with the investment financed from the RRF. Fiscal policies should be reorientated to support the twin transition in order to achieve sustained and sustainable growth. Where necessary, for example in response to declining RRF contributions, Member States should expand nationally-financed investment, in particular for the twin transitions.*
>
> ***Low/medium debt Member States should prioritise investment for the twin transition.*** *Member States with low/medium debt are generally characterised by sound budgetary positions. Expanding public investment for the twin transitions should be prioritised, where necessary (for example, in response to declining RRF contributions) by nationally financed investment growing faster than medium-term potential output. The development in current expenditure should be in line with preserving an overall neutral policy stance, hence not delivering a fiscal adjustment in 2023, unless signs of excess demand would call for agile fiscal policies to control its growth, or conversely, a deteriorated economic outlook would necessitate additional spending. This will contribute to preserving an appropriate policy stance for the euro area as whole, as spillovers from a premature fiscal retrenchment in low/medium debt, Member States could unduly reduce the aggregate demand in the euro area and make it more difficult for high-debt Member States to implement fiscal adjustment.*

Taking the above into account, investments in defence for the period 2023-2025 which exceed the 2022 level are recognised by the Fiscal Policy Strategy as one-off measures with the following amortisation in the fiscal space:

$$\Delta_t = AI_t - AI_{t-1}$$

Where: AI_t is the amount of investments during the year t in % of GDP; Δ_t is the increase in defence investments during the year t as against the previous year, the increase being measured in % of GDP.

Increase of the defence budget is recognised as a one-off measure in the amount which reduces with time linearly to zero on the 5th year after the increase (amortisation in the fiscal space) according to the following algorithm:

Table 3.2. Investment amortisation in the fiscal space

Year	Expenditure to be recognised as one-off	Expenditure to be financed within the framework of the fiscal space
Year t when the increase was made Δ_t	100% of Δ_t	0% Δ_t
t+1	80% of Δ_t	20% Δ_t
t+2	60% of Δ_t	40% Δ_t
t+3	40% of Δ_t	60% Δ_t
t+4	20% of Δ_t	80% Δ_t
t+5	0% of Δ_t	100% Δ_t

Such Fiscal Policy Strategy provides the possibility to sharply increase the amount of investments and to gradually amortise this increase in fiscal conditions thereby preventing the public finance sustainability risk. If the increase of defence financing takes place in several stages, each individual step of increase is amortised in accordance with the above algorithm.

The above-referred amortisation in the fiscal space refers to amount of defence investments in % of GDP, which is increased and remain at an increased level. In addition to the above, if a decision is taken regarding one-off defence or internal security investments which temporarily exceed the level mentioned above, such investments are recognised as one-off measures, however, amortisation in the fiscal space does not apply to such a case.

Table 3.3. One-off measures, MEUR

	2020	2021	2022	2023	2024	2025
One-off and other temporary measures, incl.	-1014.08	-2057.44	-1016.56	-150.23	-140.75	-114.16
COVID-19 mitigation measures	-958.8	-2104.4	-659.75	-92.26	-38.04	
measures to reduce energy price increase		-3.0	-356.81			
defence investments			0.00	-57.97	-102.71	-114.16

other	-55.30	49.94	0.00			

Effect of EC Communication of 2nd of March 2022 on the fiscal strategy of the Stability Programme

In the EC Communication of 2nd of March 2022 "Fiscal Policy Guidance 2023", five key policy principles are set out:

(1) **On an EU level, the transition from a supportive fiscal stance which was implemented during the 2020-2022 period to a neutral common fiscal stance in 2023 should be achieved**;
(2) In 2023, it is justified to start **gradual fiscal adjustment** in order to reduce the high public debt level;
(3) Publicly-financed high quality investments should be promoted and protected in medium-term fiscal plans;
(4) To promote fiscal strategies consistent with **medium-term approach** to ensuring the fiscal adjustment;
(5) It is necessary to establish different fiscal strategies depending on the country's specific fiscal policy challenges. For high-debt countries, it is necessary to ensure from 2023 that nationally financed current expenditures grow more slowly than the medium-term potential GDP growth, while low-debt countries should ensure that nationally financed current expenditures grow at a pace that, with the support of EU funds, ensures a neutral fiscal stance.

It should be noted that the Guidance defines general fiscal policy paths appropriate for 2023, while it does not define a numerical fiscal condition to such a detail that it could be used for the calculation of the fiscal space.

Hence, the Latvian fiscal policy strategy is based on the above-described general government's structural balance reduction path in the context of one-off measures. The effect of this strategy on the increase in nationally financed expenditure growth will be assessed in accordance with the EC Fiscal Guidance to establish if a gross error exists.

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), and the rules of the Stability and Growth Pact. Hence, it would also be justified to use this approach in the preparation of the Stability Programme.

However, taking into account the general escape clause in 2022 and EC Communication on the Fiscal Policy in 2023, the application of other (except for structural balance according to the national methodology) numerical fiscal conditions in 2023 is encumbered.

Application of the structural balance rule by using the EU methodology is not applicable since the EC has not come forward with a structural deficit reduction rule for 2023.

The expenditure growth rule to be calculated according to the EU methodology is not applicable since the expenditure growth rule of the Stability and Growth Pact is not applied and, instead, there is a partly qualitative nationally financed current expenditure growth rule.

The expenditure growth rule calculated in accordance with Section 13 of the FDL is not applicable since this Section refers to EU-compliant legal provisions as regards the expenditure rule, which are not applied in 2023.

The expenditure inheritance rule set out in Section 5 of the FDL is actually not applicable as the adjusted maximum permissible State budgetary expenditure in the Medium-Term Budgetary Framework Law 2022-2024 is determined according to another fiscal policy strategy, and therefore, it can be reliably predicted that the inherited adjusted maximum permissible State budgetary expenditure will differ by more than 0.1% of GDP from the maximum permissible State budgetary expenditure calculated in accordance with the balance rule. In any case, the application or non-application of the inheritance rule may lead to a structural balance target difference by not more than 0.1% of GDP, which at present, given the uncertainty of the economic development, is a rather small difference. Therefore, in the preparation of the Stability Programme, the inheritance rule is not applied.

3.1.3. General government budget structural balance targets of the for 2023, 2024 and 2025

In accordance with the Fiscal Policy Strategy, the structural balance target for 2023 has been determined by taking the 2022 structural balance forecast as the basis and increasing it by 1% of GDP. For each subsequent year, the structural balance target is established to be 0.5% of GDP higher than the previous year's structural balance target. The calculation takes into account the recognition of certain expenditures as one-off expenditure as set out above.

Table 3.4. Structural balance targets of the general government budget (February scenario)

		2022	2023	2024	2025
GDP forecast	(1)	36484			
General government budget balance 2022, MEUR	(2)	-2159.9			
General government budget balance 2022, % of GDP	(3)=(2)/(1)*100	-5.9			
Output gap, % of the potential GDP	(4)	-0.628			
Cyclical balance component, % of GDP	(5)=0.378*(4)	-0.237			
One-off and other temporary measures, % of GDP, incl.	(6)	-2.79			
COVID-19 mitigation measures		-1.808			
measures to reduce energy price increase		-0.98			
general government budget structural balance forecast and targets	**(7)=(3)-(5)-(6)**	**-2.90**	**-1.90**	**-1.40**	**-0.90**

Table 3.5. General government budget structural balance targets (March scenario)

		2022	2023	2024	2025
GDP forecast	(1)	36520			
General government budget balance 2022, MEUR	(2)	-2369.54			
General government budget balance 2022, % of GDP	(3)=(2)/(1)*100	-6.49			
Output gap, % of the potential GDP	(4)	-0.628			
Cyclical balance component, % of GDP	(5)=0.378*(4)	-0.237			
One-off and other temporary measures, % of GDP, incl.	(6)	-2.78			
COVID-19 mitigation measures		-1.81			
measures to reduce energy price increase		-0.98			
general government budget structural balance forecast and targets	**(7)=(3)-(5)-(6)**	**-3.47**	**-2.47**	**-1.97**	**-1.47**

3.1.4. Discretionary measures

In between the Stability Programme 2021-2024 and this Stability Programme, fiscal policy decisions have been adopted. They include:

(i) measures included in the Medium-Term Budgetary Framework Law for 2022, 2023 and 2024 and the Annual State Budget Law for 2022, as well as

(ii) support measures for mitigation of the COVID-19 crisis approved (incl. conceptually) by the government and the Saeima until 20 March of this year, and support measures to compensate for the energy price rise approved (incl. conceptually) by the government and the Saeima until 28 January of this year[4].

The first set of measures is not separately described in this Stability Programme and can be consulted in the Draft General Government Budget Plan of Latvia for 2022. Whereas, the second set of measures is described in detail in Chapter 3.3 of the Stability Programme.

3.2. Current Fiscal Situation

According to the MoF assessment, there was a deficit of EUR 2 378.4 million or 7.2% of GDP in the general government budget in 2021, which is significantly higher than in the Law of State Budget for 2021 but lower than the general government budget deficit of 9.3% of GDP forecasted in the Stability Programme 2021-2024. At the end of 2020, when the State Budget Law was prepared, there was high uncertainty regarding the impact of the COVID-19 pandemic on both economic development and the general government budget deficit, which is reflected in the difference between the estimate of the general government budget deficit for 2021 and what was planned in the State Budget Law.

Official data on the general government budget deficit for 2021 will be available at the end of April this year, when the calculations on all transactions of the general government sector are completed, including the performance of the general government reclassified enterprises, as well as *Eurostat* will have completed the process of clarification of the government budget deficit and debt notification.

The general government budget deficit last year was affected by decisions adopted by the government to support the national economy during the COVID-19 pandemic. Overall, according to estimates of the MoF, the government decisions in 2021 ensured support to the national economy in the amount of 6.9% of GDP, while the impact of these measures on the general government budget deficit was negative – 6.4% of GDP. Support to national economy was provided in the following directions – support in the field of taxes, benefits, loans and guarantees, support to sectors, as well as EU funding support. See a more detailed description of the support provided by the government during the COVID-19 pandemic in Chapter 3.3 of this Stability Programme.

The analysis of the contribution of the general government sub-sectors to the overall fiscal balance (see Figure 3.2) allows to conclude that the largest deficit was mainly formed in the central government, amounting to 7.4% of GDP in 2021, which was mainly due to the government's decisions to support the national economy. In the local government budget deficit of 0.3% of GDP also formed, where expenditure for remuneration, incl. for teachers, provided the sharpest increase in expenditure. Whereas, the social security fund, despite the increase in sickness and unemployment benefits, preserved a budget surplus in the amount of 0.5% of GDP.

[4] https://likumi.lv/ta/id/329532-energoresursu-cenu-arkarteja-pieauguma-samazinajuma-pasakumu-likums

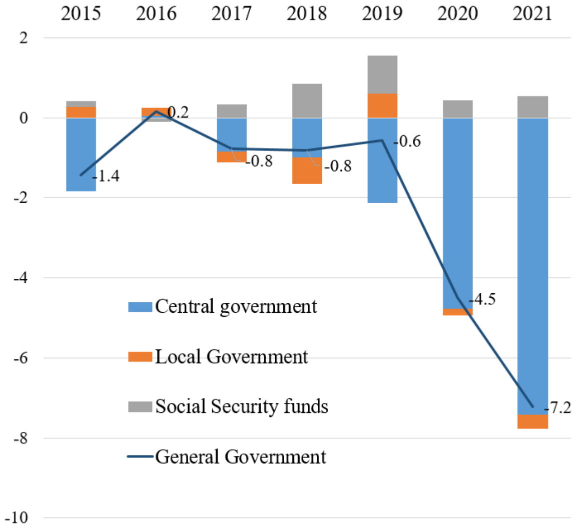

Figure 3.2. Budgetary balance of the general government by sub-sectors, % of GDP (Data source: Eurostat, MoF)

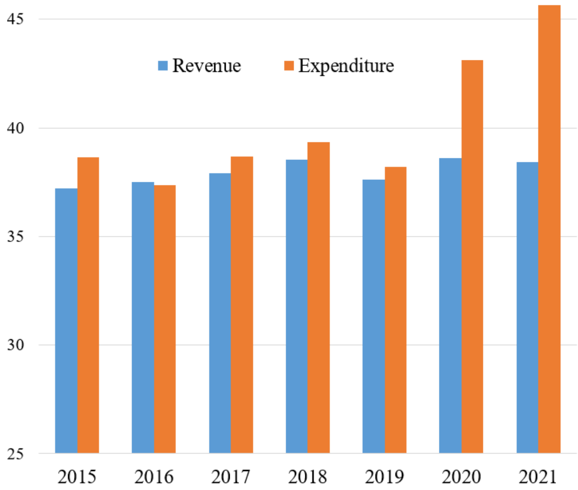

Figure 3.3. General government revenue and expenditure, % of GDP (Data source: Eurostat, MoF)

In 2021, as compared to 2020, general government budget revenue has grown by EUR 1 246.1 million or 10.9%, reaching EUR 12.6 billion or 38.4% of GDP (see Figure 3.3). The share of the general government budget revenue to gross domestic product in 2021 decreased by 0.2 ppt. While in nominal terms, general government budget revenue increased, its share to GDP decreased, which can be explained by a higher GDP growth rate in current prices than the growth rate for general government budget revenue.

Tax revenue[5] comprises the largest part of revenue and, in 2021, reached 31.1% of GDP, which is 0.8 ppt lower than in 2020, considering the strong increase in GDP. In nominal terms, tax revenue increased by EUR 819.1 million or 8.7%. Taxes on production and imports (D.2) increased by EUR 306.7 million or 7.4%. Value added tax (VAT) revenue, with the population's economic activity increasing, amounted to EUR 2.8 billion, which was EUR 210.4 million or 8.3% more than in 2020. The increase in VAT revenue formed in Q2 of 2021, when the revenue, q-o-q, increased by EUR 178.7 million. This was mainly ensured by higher VAT payments in the trade sector.

Excise duty revenue increased by EUR 70.3 million or 6.6% reaching EUR 1.1 billion, which was driven by the increase in revenue for oil products by EUR 18.2 million and tobacco products by EUR 17.7 million.

Current taxes on income and wealth (D.5) increased by EUR 289.8 million or 13.8%, as compared to 2020. Corporate income tax (CIT) in 2021 grew by EUR 73.7 million or 35.5%. The strong CIT increase rate is related to the implementation of the 2018 tax reform as a result of which both the CIT rate and payment procedure were revised substantially. 2019 is to be considered as a transitional period, during which the CIT revenue in the State budget only comprised the amount of EUR 44.8 million, while in 2020, CIT revenue grew by EUR 162.7 million reaching EUR 207.5 million.

With the improvement in economic situation in 2021, the average gross wage of the employed continued to grow and reached EUR 1 277, and, with unemployment decreasing to 7.6% of the active population, PIT revenue increased by EUR 169.3 million or 9.5%. The

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

positive trends in the labour market also affected social contribution revenues (D.61) which, as compared to 2020, grew by EUR 223.8 million or 1.2% despite the reduction of the social security contribution rate by 1 ppt.

According to State Revenue Service data, the largest growth in tax revenue, as compared to 2020, was observed in the wholesale and retail sales sectors, as well as in the health sector, processing industry and information and communication service sectors. While in the sectors hit by the crisis the hardest – accommodation and catering services, arts, entertainment and recreation – tax revenues last year were generally lower than in 2020 and substantially lag behind the pre-pandemic levels.

Additional revenue growth was also ensured by property income (D.4) which reached 0.8% of GDP, which is 0.1 ppt higher than in 2020, and other revenue, which, in 2020, reached 6.7% of GDP, which is 0.6 ppt higher than in 2020 (see Figure 3.3). Property income growth was ensured by dividends received in the State budget, while the growth in other revenue was ensured by higher foreign financial assistance revenues and higher revenue from the business activity of general government reclassified enterprises.

During the first two months of this year, the consolidated general budget revenue (on a cash flow basis) was EUR 320.8 million or 15.5% higher than in the respective period of last year, amounting to EUR 2.4 billion. The increase in the consolidated general budget revenue is mainly related to higher tax and non-tax revenues. Tax revenues to the consolidated general budget in January-February of this year amounted to EUR 1.8 billion, which is EUR 294.8 million or 19.4% more than in the first two months of the previous year. During the first two months of the previous year, economic activity was severely hindered as a result of COVID-19 epidemiological restrictions, while, since Q2 of the previous year, with COVID-19 restrictions being mitigated, a significant increase in tax revenues can be observed, which also continues this year. Revenues both from labour taxes and consumer taxes to the consolidated general budget have increased substantially.

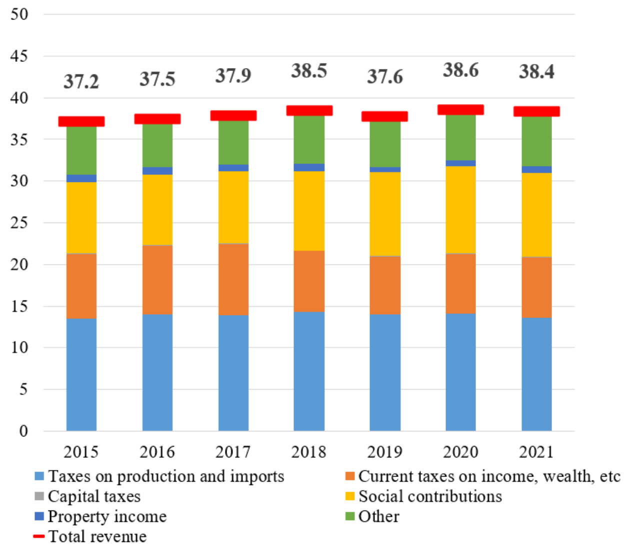


Figure 3.4. General government revenue structure, % of GDP (Data source: Eurostat, MoF)

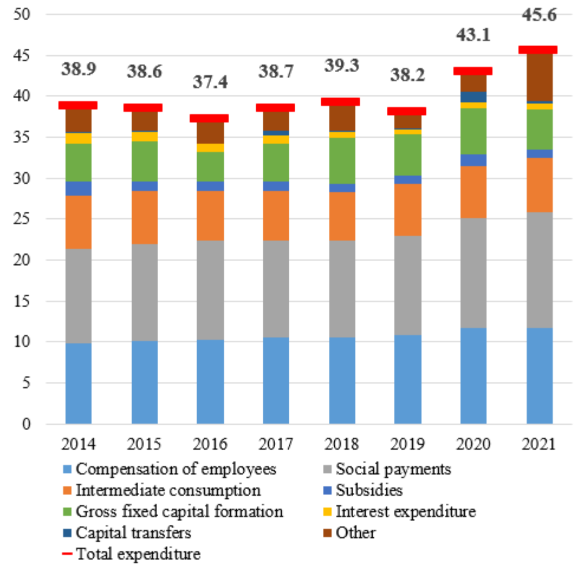


Figure 3.5. General government expenditure structure, % of GDP (Data source: Eurostat, MoF)

The general government budget expenditure grew by EUR 2 296.5 million or 18.0%, reaching EUR 15 billion or 45.6% of GDP (see Figure 3.4). The largest increase was ensured by other expenditure that has grown by EUR 1 291.9 million or 166.8%. The increase in this item was mainly ensured by financing awarded for the mitigation of consequences of the COVID-19 pandemic, incl. EUR 101.3 million that was awarded to ensure that COVID-19 testing targets are met. In accordance with ESA Methodological Guidelines, grants for current assets, downtime benefits and wage subsidies which amounted in total to EUR 681.7 million, as well as other support granted for the mitigation of COVID-19 impact, were also accounted as other expenditure. An additional increase by EUR 85.6 million was provided by an increase in contributions to the EU budget and international cooperation. The rest of the increase of other expenditure is attributable to foreign financial assistance expenditure and general government reclassified enterprises expenditure.

Total compensation of employees (D.1) in 2021 grew by EUR 409.7 million or 11.8%, determined by the increase in remuneration for those working in the health sector, who receive premiums for working during the pandemic, as well as those working in the defence sector, and teachers.

Expenditure for social payments (D.632 and D.62) increased by EUR 662.4 million or 16.7%, determined by the payment of one-off benefits in the amount of EUR 297.9 million to families with children, pensioners and disabled persons as part of mitigation of the consequences of the COVID-19 pandemic. In the special budget, expenditure for pensions and sickness benefits increased. Expenditure growth for pensions by EUR 120.3 million was affected by indexation, by applying higher indices in October 2020 and 2021, while the increase in sickness benefits by EUR 70 million is to be related to the increase in the average insurance contributions wage and impact of COVID-19.

The general government budget expenditure for gross fixed capital formation (P.51G) decreased by EUR 44.2 million or 2.6%. The formation of the gross fixed capital was affected by the delays in implementation of the investment projects by the general government reclassified enterprises due to high uncertainty, as well as by the delay in delivery of public transport units. It should be noted that last year, a slowdown was observed in the implementation of EU fund investments, which was largely related to the restructuring of EU funds in favour of investments targeted specifically to mitigating COVID-19 impact and promoting economic recovery, as a result of which the projects were commenced later.

Intermediate consumption expenditure (P.2) grew by EUR 329.6 million or 17.5%, which was mainly determined by expenditure for the mitigation of the consequences of the COVID-19 pandemic, including to increase the capacity and resilience of the healthcare sector, procure vaccines and provide the necessary logistics services.

Capital transfers (D.9) expenditure in 2021 decreased by EUR 263.8 million or 73.4%. In 2020, the government provided support to JSC "*Air Baltic Corporation*" in the amount of EUR 250 million, while in 2021 this support reached EUR 45 million. In 2020, support was also provided to other merchants, for example, JSC "*Latvijas dzelzceļš*" received support in the amount of EUR 32.4 million.

3.3. Support Measures for Mitigating the Consequences of Crisis

For the last two years, the national economy of Latvia has not only faced the consequences of the COVID-19 pandemic but also a substantial rise in prices of strategically important resources and economic implications of the war initiated by Russia in Ukraine. Acquisition of energy from new suppliers, a general rise in prices and reorientation of the export market will be significant challenges in the next years. At the same time, the government is looking for instruments to support the vulnerable part of the population and stimulate business activity.

COVID-19 Support

To ensure support to the population and businesses in the COVID-19 crisis, the government has approved and since 2020, implements a substantial support package. Until 20 March of this year, the total approved amount of support for the national economy (see Figure 3.5), in accordance with the MoF estimate and taking into account information provided by the State Revenue Service, ALTUM and other bodies, reached EUR 5.4 billion, of which EUR 1.3 billion or 4.3% of GDP was the actual support in 2020, EUR 2.3 billion or 6.9% of GDP is support provided in 2021, while in 2022, until now (considering the government's decisions until 20 March), it is planned to reach EUR 1.4 billion or 3.7% of GDP. The planned financing for 2023 is EUR 0.3 billion or 0.8% of GDP, for 2024 – EUR 0.1 billion or 0.3% of GDP. When updating the general government budget balance for the medium-term, the impact of support approved by 20 March this year on the budgetary balance was considered (see Figure 3.6).

Figure 3.6. COVID-19 support, MEUR and % of GDP

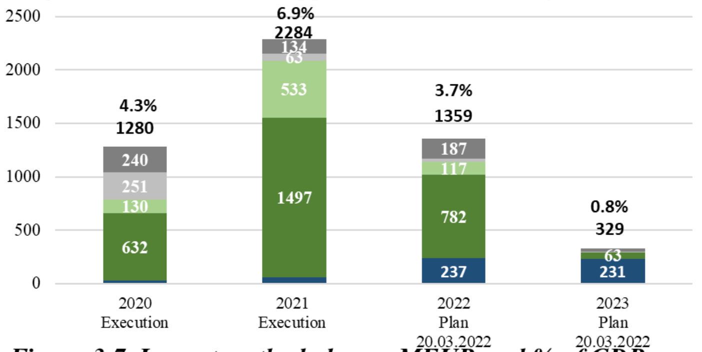
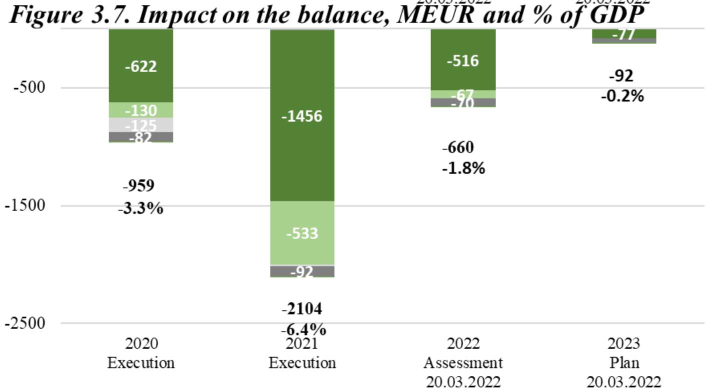
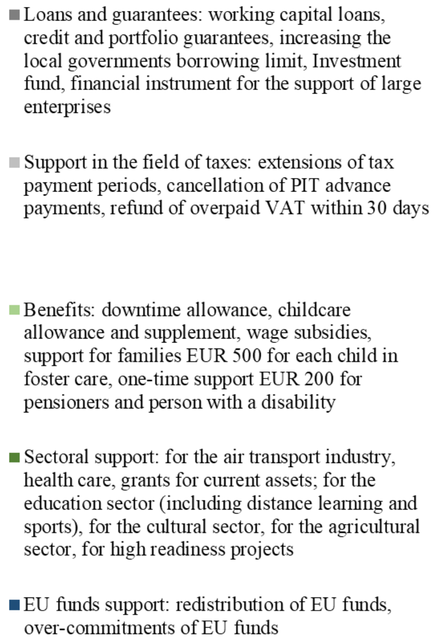


Figure 3.7. Impact on the balance, MEUR and % of GDP





The amount of support measures makes a significant impact on the general government budget deficit, with an adverse effect in 2021 in the amount of EUR 2.1 billion or 6.4% of GDP, while in 2022 the impact is expected to be EUR 0.7 billion or 1.8% of GDP. For 2023 and 2024, the impact on the general government budget balance is assessed to a considerably lower extent – 0.2% and 0.1% of GDP respectively, mainly, through continuing to implement high-readiness investment projects, which were commenced in 2021.

Measures to overcome the COVID-19 crisis may be classified into five categories – support in the field of taxes, support in the field of benefits, support in the field of loans and guarantees, support to sectors, as well as EU funding support.

In the Law on the Suppression of Consequences of the Spread of COVID-19 Infection, several **tax support measures** have been defined, in order to mitigate the consequences of the crisis for entrepreneurs and the population. In 2022, the support in the field of taxes includes measures such as extensions of tax payment deadlines and repeal of PIT advance payments.

In 2020, regulatory enactments were adopted, defining additional support to the population **for the disbursement of benefits**, thereby mitigating the consequences of the crisis caused by COVID-19. In 2021, EUR 32.7 million was paid out in wage subsidies, while EUR 135.9 million was paid out in downtime benefits. According to information from the SRS, the largest part of downtime benefits has been paid out to representatives of sectors such as trade, accommodation and catering. The support provided to the population in 2021 exceeds four times the one provided in 2020, considering the fact that, in addition to employment support programmes, one-off benefits to families with children were also paid out (EUR 500 per child), as well as EUR 200 to pensioners and disabled persons, which, in total, amounted to EUR 298 million from the budget. In order to facilitate the vaccination of older persons, since December 2021, vaccinated older persons aged 60 and above are paid a monthly allowance of EUR 20 for the period from 1 November of this year to 31 March of the next year – for five months.

Support measures in the field of loans and guarantees are mainly ensured through the institution ALTUM, and the type of support is mainly intended for improving the liquidity of enterprises in order to overcome the COVID-19 crisis. Part of ALTUM programmes concluded in 2021. The plan for 2022 includes measures such as loans for current assets (EUR 30 million), a capital fund for large merchants (EUR 18 million), loans with capital discount for investment projects for merchants to facilitate competitiveness, financing for support to large merchants (EUR 70 million). This group of support measures also entails increasing of the limit of borrowing of local governments, which in 2022 is planned to be used in the amount EUR 50.2 million.

Support to sectors is provided for reducing the financial difficulties of the sectors, as well as the provision of medicinal aids, equipment, vaccines and ensuring the remote learning process. Sectors with the largest amount of support include the health sector, transport sector and support for current assets in the form of grants. Support to sectors makes up nearly half of the total amount of support; however, when compared to 2021 (EUR 1.5 billion), the planned amount in 2022 is half as much (EUR 782 million), as the sectors have already been able to demonstrate adaptation to the new circumstances. At the conclusion of Q1 of 2022, it can be seen daily that the spread of the infection is reducing, also thanks to the high vaccination coverage. From 1 April, the majority of restrictions have been lifted, and this will increase the activity of the population, which will be felt by the tourism and culture, trade and healthcare sectors.

EU funding support has the purpose to ensure the possibility to react more easily and quickly when mitigating the consequences caused by COVID-19 for the most affected territories of the Member States and their population, allowing for amendments to the EU funds operating programmes of the Member States. It also provides for allocating support in the form of over-commitments of the State budget for increasing the investments of the EU fund projects in the medium term and additional over-commitments for the support of the crop-growing agricultural sector, allowing one to assume over-commitments for project implementation, *inter alia*, by ensuring investment of the total financing of EU funds. The projects are basically concerned with the renovation or expansion of education and medical establishments. Data on implementation in 2021 are specified, considering the actual payments.

Table 3.6. Scope of support approved by the government for mitigating the consequences of COVID-19, MEUR

Measures	2020		2021		2022			2023	
	Execution		Execution		Plan 20.03.2022	Assessment 20.03.2022	Execution until 20.03.2022	Plan	
	Total support	impact on balance	Total support	Impact on balance	Total support	Impact on balance	Total support	Total support	Impact on balance
TOTAL SUPPORT	1 280	-959	2 284	-2 104	1 359	-660	164	329	-92
% of GDP	4.3%	-3.3%	6.9%	-6.4%	3.7%	-1.8%	0.4%	0.8%	-0.2%
I Support to the field of taxation	251	-125	63	-15	36	0	1	6	26
Extension or division of the term for payment of taxes into terms of up to 3 years	162.0	-36.1	62.6	-14.8	0.0	0.6	1.1	0.0	1.3
Possibility not to pay PIT advance payments	29.0	-29.0	0.0	0.0	30.0	5.0	0.0	0.0	30.0
II Aid in the field of benefits, ***including:***	129.6	-129.6	533.5	-533.5	117.5	-67.4	44.5	0.0	0.0
Downtime benefits for company employees, patent payers, self-employed	60.5	-60.5	135.9	-135.9	0.0	0.0	0.0	0.0	0.0
Wage subsidies for part-time workers	47.3	-47.3	32.7	-32.7	57.0	-7.0	6.8	0.0	0.0
Sickness benefit for childcare	0.1	-0.1	2.9	-2.9	0.3	-0.3	0.1	0.0	0.0
Unemployment assistance allowance	5.2	-5.2	10.8	-10.8	0.0	0.0	0.0	0.0	0.0
Payment of Covid sickness benefits from the 1st day	2.9	-2.9	32.7	-32.7	13.3	-13.3	13.3	0.0	0.0
Allowance (500 EUR) for families with children	0.0	0.0	187.9	-187.9	0.0	0.0	0.0	0.0	0.0
Benefit (200 EUR) for pensioners and persons with disabilities	0.0	0.0	110.0	-110.0	0.0	0.0	0.0	0.0	0.0
Benefit for vaccinated seniors aged over 60	0.0	0.0	15.0	0.0	30.1	-30.1	23.5	0.0	0.0
III Aid in the field of loans and guarantees, ***including:***	240.0	-81.7	133.7	-91.7	187.1	-70.1	3.9	29.6	-37.7
Credit guarantees	91.8	-17.7	14.8	-2.9	5.0	-1.0	0.0	0.0	0.0
Portfolio guarantees	3.0	-0.5	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Working capital loans	92.5	-13.1	13.3	-1.9	30.0	-4.3	1.3	0.0	0.0
Capital fund for large merchants	0.0	0.0	16.1	0.0	18.9	0.0	0.0	0.0	0.0
Loans with a capital discount for investment projects for entrepreneurs to promote competitiveness	0.0	0.0	0.0	0.0	70.0	-10.8	0.0	29.6	-37.7
Increase of the local governments borrowing limit	50.1	-50.1	83.7	-83.7	50.2	-50.2	2.6	0.0	0.0
IV Sectoral support, ***including:***	631.8	-622.4	1 497.1	-1 455.8	782.3	-515.5	110.3	63.4	-77.2
Health sector	133.1	-123.6	578.4	-537.8	430.1	-326.5	26.1	63.4	-63.7
Transport sector (incl. aviation)	408.4	-408.4	227.9	-227.9	23.8	-23.8	0.0	0.0	0.0
Grant for current assets	0.1	-0.1	513.1	-513.1	160.0	-60.0	56.4	0.0	0.0
Agriculture sector	37.5	-37.5	24.1	-24.1	0.1	-0.1	0.0	0.0	0.0
Culture sector	21.1	-21.1	19.8	-19.8	1.8	-1.8	1.0	0.0	0.0
Education and science (incl. sports and distance learning)	22.1	-22.1	36.9	-36.9	16.1	-7.3	2.5	0.0	0.0
High readiness projects submitted by ministries related to overcoming the Covid-19 crisis and economic recovery	0.0	0.0	52.4	-51.7	93.1	-80.3	16.4	0.0	-13.5
V Support related to EU funds	27.3	0.0	57.2	-8.6	236.5	-6.9	3.8	230.8	-3.1

Support for Reducing the Energy Price Rise

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. During a period of four months – from 1 January to 30 April 2022 – various forms of support measures are 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, incl.

- the State will cover 100% of the MPC payment for electricity;
- the State will cover 100% of electricity system service costs;
- for district heating customers who face an extreme increase in prices, the State will cover 100% of the difference up to the tariff approved by the Public Utilities Commission, which is EUR 68 per megawatt hour;

- for households who use natural gas for heating, the State will cover costs above EUR 34/MWh;
- families are paid EUR 50 per child each month, while all elder persons, as well as persons with a disability are paid EUR 20 a month;
- reduction of the MPC by 85 for energy-intensive companies, as a one-off payment;
- for low-income households, for the time period from 1 January to 31 December 2022, 50% co-financing is provided to municipalities for housing support.

The energy support package for 2021-2023 amounts to EUR 432.1 million (see Table 3.7), of which EUR 407.5 million is planned to be used in 2022; however, if measures related to the mitigation of COVID-19 consequences, as already listed under COVID support (allowance to vaccinated elder persons and expenditure for housing allowance) are not taken into account, the energy support in 2022 amounts to EUR 342.6 million in total.

Table 3.7. Approved financing for energy support measures, MEUR

Measures	2021 Plan	2022 Actual plan	2023 Plan	TOTAL Plan
TOTAL	**21.5**	**407.5**	**3.1**	**432.1**
A cost-cutting measures for end-users	**3.0**	**232.9**		**235.9**
Electricity system service fee compensation in full for all end users from December 1, 2021 to April 30, 2022		141.4		**141.4**
Increase of support for protected users by 10 EUR in the period from 1 November 2021 to 31 December 2022	3.0	17.5		**20.5**
Reduction of the mandatory procurement component in 2022 to 7.55 EUR per megawatt hour[1]		18.4		**18.4**
Compensation of district heating service fee from January 1, 2022 to April 30, 2022		7.0		**7.0**
Compensation of natural gas trade service fee from January 1, 2022 to April 30, 2022		27.4		**27.4**
Compensation of the mandatory procurement component fee for the period from January 1, 2022 to April 30, 2022		21.2		**21.2**
Payments of social benefits	**18.5**	**174.5**	**3.1**	**196**
Payment of a benefit of 20 EUR per month for seniors in the period from 1 November 2021 to 31 March 2022 in order to promote vaccination of persons against Covid-19 during the spread of Covid-19 in the country and to compensate for the increase in expenses related to higher energy prices[2]	18.5	30.1		**48.6**
State budget grant to local governments for the provision of housing benefit - in the amount of 50 per cent of the actual expenses for housing benefit incurred in the period from 1 January 2022 to 31 December 2022[3]		20.6	3.1	**23.7**
Payment of support 20 EUR per month for seniors and persons with disabilities in the period from 1 January 2022 to 30 April 2022		44.3		**44.3**
Payment of support 50 EUR per month for families with children in the period from 1 January 2022 to 30 April 2022		79.6		**79.6**
Payment of support 20 EUR per month to recipients of a long-service pension of the Ministry of Defense who have not reached the age required for granting an old-age pension and who have been diagnosed with a disability in the period from 1 January 2022 to 30 April 2022		0.0		**0.0**

[1] *The specified financing is intended to impact the general government budget deficit*
[2] *The financing is intended as COVID-19 mitigation support*
[3] *The financing of EUR 16.7 million in 2022 is also intended as COVID-19 mitigation support*

Support to Ukrainian Civilians

On 24 February this year, the military forces of the Russian Federation started the invasion of Ukraine, as a result of which millions of Ukrainians were forced to leave their homes and emigrate to other countries. According to information of the Ministry of the Interior, since the start of the war, 11 254 Ukrainian civilians have already been issued residence documents with the right to employment. The Ukrainians who have travelled to Latvia are provided with social support and social services. On 12 March this year, the government adopted a regulation concerning the provision of accommodation and catering services to Ukrainian refugees. Initially, it was estimated that in total, it was planned to accommodate up to 10 000 persons for a period of three months; however, the current situation as at the end of March shows that the planned number persons have already entered Latvia, and the MoI is working on a new plan which provides for the admission of another 30 000 refuges in the nearest months. The indicative necessary financing could reach EUR 27 million. Taking into account the fact that currently, no precise number of Ukrainian civilians to be supported and the duration of the support is known, for the time present, in accordance with the set procedure, funds have been requested in the amount of 50% of the total planned financing, or EUR 13.5 million. Contributions to international organisations are also made. Latvia has paid EUR 1.2 million to the European Peace Facility by helping to provide arms and equipment to the Ukrainian armed forces. An additional EUR 1.2 million has been granted for the provision of operational support to Ukraine thereby responding to Ukrainian government's requests for help. This amount will be used so that Latvia can immediately decide on contributions to international organisations for the provision of humanitarian aid to Ukraine, provide rehabilitation to Ukrainian soldiers and their families in Latvia, help representatives of Ukrainian institutions who have found themselves in an emergency situation, provide the necessary support to Ukraine's independent media and journalists. Finally, EUR five million was 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.

Table 3.8. Approved financing for support to Ukrainian civilians, MEUR

Plan 2022*	
Contributions to international organisations	6.7
To municipalities for accommodation and catering of refugees	13.5
Other measures	0.8
Total	21.0

* Financing approved by the Cabinet until 12 March of this year

3.4. Fiscal Development Scenarios

3.4.1. Initial or February Scenario With No Policy Change

Initially, the general government budget forecasts with no policy change for the medium term were prepared by taking into account the macroeconomic development scenario which was prepared in February 2022 and approved by the Fiscal Discipline Council before Russia's invasion in Ukraine. The February macro-scenario provides for a real GDP growth of 4.0% in 2022 and of 3.9% in 2023. The forecasts included the revenue based on the February macroeconomic development scenario, the approved State basic budget base expenses for 2023–2024 and the projection for 2025, as well as the expected development in the local government budget and social security funds, in light of the current trends. Balances include the expected impact from the government's support for the mitigation of COVID-19 consequences (with approved decisions until 20 March of this year) and the support for mitigating the energy price rise. COVID-19 support measures substantially influenced the budget expenditure of 2020 and 2021 and also continue to a lesser extent. In addition, the government has approved support to the population in order to mitigate the energy price rise, for which a significant fiscal impact on the general government budget is foreseen in 2022 as well.

In 2022, taking into account the wide support programmes, the general government budget deficit has been estimated at 5.9% of GDP. While, in the medium term, with the support programmes concluding and the economic growth continuing, which will increase tax revenues, it is estimated that the general government budget deficit will decrease and will amount to 1.6% of GDP in 2023, 1.2% of GDP in 2024 and 0.4% of GDP in 2025.

According to forecasts, the share of the general government revenue in GDP will be 36.4% of GDP in 2022, which is 2.1 ppt less than in 2021. Although a moderate reduction of the share of revenue in GDP is expected in all revenue groups, in nominal terms, tax revenue will continue to grow in the medium term, while non-tax revenue will decrease. This can be explained by the fact that the expected dividend payments by individual State capital companies are not yet planned in the budgets for 2023-2025. While the increase in tax revenue is expected to be at a lower pace than for the economy as a whole. Reduction in the share of revenue is also expected in the medium term. On 1 January 2022, the PIT non-taxable minimum for pensioners was raised from EUR 330 to EUR 350, while from 1 July 2022 it will be raised to EUR 500, thus reducing the PIT taxable base for receivers of income and pensions.

According to the February scenario, the share of general government expenditure in GDP, after reaching the high level in 2021 when wide government support to the national economy to mitigate the consequences of COVID-19 was provided, in the medium term, will decline each year. The reduction in the share of expenditure over the medium term can be explained, to a large extent, by the fact that the scenario was developed on a no policy change assumption and that decisions on additional expenditure initiatives will be adopted, as the current annual budget approval is approaching. It should be noted that in the initial scenario, the general government budget expenditure took account of additional financing for defence in accordance with the government's decision of 22 March, by gradually increasing it to 2.5% of GDP in 2025.

3.4.2. Renewed or March Scenario With No Policy Change

After Russia's invasion in Ukraine and the imposition of sanctions on Russia, the macroeconomic development scenario was updated, which forms the basis for the renewed general government budget scenario, or March scenario. In accordance with the March scenario, which provides for an increase in real GDP by 2.1% in 2022 and by 2.5% in 2023, tax and non-tax revenue was updated, State special budget expenditure was updated by taking into account changes in remuneration, employment and inflation rates, as well as interest expenditure was increased, taking into account a larger need for financing and higher interest rates. The renewed scenario takes account support for Ukrainian civilians.

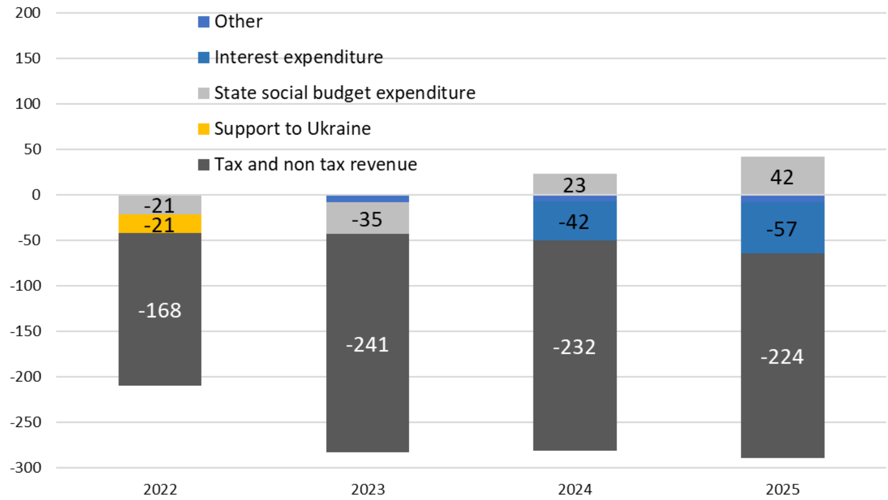
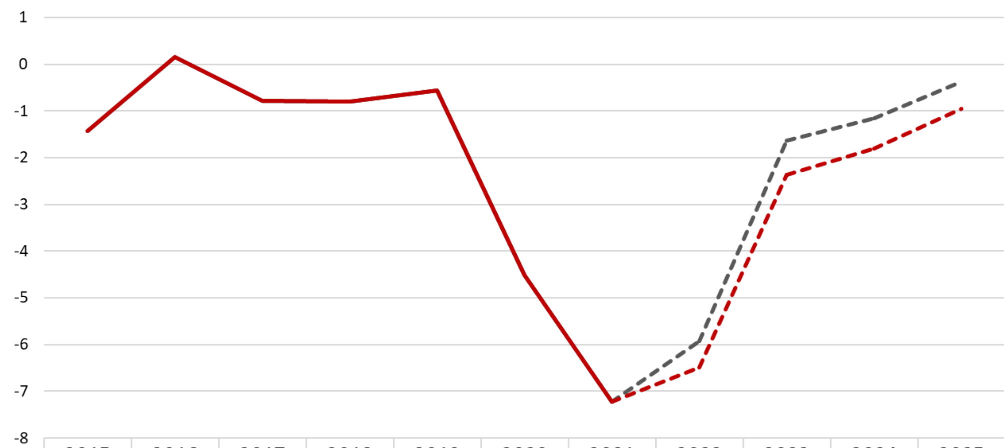


Figure 3.8. Impact of the renewed (March) scenario on the general government budget balance as compared to the initial (February) scenario, MEUR (Data source: MoF)

The impact of changes on the general government budget balance, when comparing the renewed (March) scenario with the initial (February) scenario, amounts to EUR 209.7 million in 2022, EUR 283.3 million in 2023, EUR 258.3 million in 2024 and EUR 247.2 million in 2025; it is shown in Figure 3.8. The renewed scenario, as compared to the initial scenario, forecasts that the general government budget deficit with no policy change would increase – from 5.9% to 6.5% of GDP in 2022, from 1.6% to 2.4% of GDP in 2023, from 1.2% to 1.8% of GDP in 2024 and from 0.4% to 0.9% of GDP in 2025 (see Figure 3.9).



	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
	Fact						Estimate		Forecast		
Budget 2022-2024								-4.8	-2.1	-1.3	
February scenario	-1.4	0.2	-0.8	-0.8	-0.6	-4.5	-7.2	-5.9	-1.6	-1.2	-0.4
March scenario	-1.4	0.2	-0.8	-0.8	-0.6	-4.5	-7.2	-6.5	-2.4	-1.8	-0.9

Figure 3.9. General government budget balance in the February and March scenarios, % of GDP
(Data source: Eurostat, MoF)

The renewed (March) scenario expects that on all budget levels, tax revenue will be lower than in the initial (February) scenario, while the higher expenditure level will generally be determined by the higher indexation of pensions (in 2022 and 2023) and interest expenditure for servicing the public debt (in 2024 and 2025). In the same way as the initial scenario, the March scenario also provides for a gradual increase in expenditure for the defence sector by reaching 2.5% of GDP in 2025.

Table 3.9. Renewed (March) Fiscal Development Scenario with no policy change

		2021	2022	2023	2024	2025
	ESA code	% of GDP				
Net lending (+) or borrowings (-) (B.9) by sub-sectors						
General government	S.13	-7.2	-6.5	-2.4	-1.8	-0.9
incl. reclassified enterprises[6]		-0.1	-0.5	-0.1	0.0	0.0
Central government	S.1311	-7.4	-6.1	-1.9	-1.5	-0.5
incl. reclassified enterprises		0.0	-0.4	-0.1	0.0	-0.1
Local government	S.1313	-0.3	-0.5	-0.3	-0.3	-0.4
incl. reclassified enterprises		-0.1	-0.1	0.0	0.1	0.0
Social security funds	S.1314	0.5	0.2	-0.1	0.0	0.0
General government (S.13)						
Total revenue	TR	38.4	35.9	36.0	35.1	34.4
Total expenditure	TE	45.6	42.4	38.3	36.9	35.4
Interest expenditure	D.41	0.6	0.6	0.6	0.6	0.6
Cyclical development						
Cyclical component of the budget balance[7]		-0.7	-0.2	0.0	0.0	0.1
One-off measures[8]		-6.3	-2.8	-0.4	-0.3	-0.3
Cyclically adjusted balance		-6.6	-6.3	-2.4	-1.8	-1.0
Cyclically adjusted primary balance		-6.0	-5.7	-1.8	-1.2	-0.4
Structural balance		-0.3	-3.5	-2.0	-1.5	-0.8

Central government budget

- In 2022, the support for the national economy for mitigating the consequences of COVID-19 continues, which results in the high deficit level being maintained. The government has also approved significant support for the period till 30 April 2022 in connection with the rising energy prices (see Section 3.3), and support for Ukrainian civilians is awarded from the funds for unforeseen events, from which local governments' expenditure for accommodation and catering is also covered.
- In the central government budget, it is planned that the share of expenditure will decrease from 29.9% of GDP in 2022 to 27.2% of GDP in 2023 and will be even lower, i.e., 23.3%, in 2024, which can be explained by both the high expenditure level in 2022 for mitigating the consequences of COVID-19 and by the fact that currently, no decisions have been taken on granting additional resources in the medium term. With the higher tax revenue and rise in foreign financial assistance investments, the amount of revenue will increase each year. Still, in 2022, a lower level of revenue is expected, when expressed in GDP (21.1% of GDP), than in 2021, taking into account the reduction of non-tax revenue. In 2023, the amount of revenue to GDP will be 21.4% of GDP and will decrease in the

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

[7] 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).

[8] For 2021-2022, the implemented support for reducing the COVID-19 pandemic has been included as a one-off (continues as one-off until 2024), as well as expenditure for measures reducing the increase of energy prices. For 2023-2025, investment expenditure for the defence sector has been included as a one-off, taking into account the government's decision of 22 March of this year on theto increase ofthe financing to 2.5% of GDP until 2025.

medium term in the next years. This will be determined by a reduction of property income (D.4) due to lower planned dividend payments and also by a reduction of the current transfers (D.7). In the medium term, an annual increase in all larger taxes is expected, which will be facilitated by the growing consumption and the growing salary fund.

- Compensation of employees (D.1), after an increase in 2022, is expected to be at a slightly lower level in the coming years, which will be determined by lower expenditure for remuneration by the general government reclassified enterprises. In 2022, increasing of wages for those employed in the healthcare sector (for medical personnel, residents), carers in social care institutions, education sector (teachers, pre-school teachers), in the interior sector and cultural field were a priority. Expenditure for intermediate consumption (P.2) is planned to increase moderately with each year.
- The share of interest expenditure (D.41) to GDP has been decreasing annually for a longer period of time – from 1.5% of GDP in the central government budget in 2012 to 0.6% of GDP in 2021. In 2022, it is projected that this trend will continue, since borrowing conditions have been very favourable, with the share reaching 0.5% of GDP. Whereas, in the medium term, this share will grow to 0.6% of GDP, since both the need to borrow will increase and interest rates are expected to increase.
- Social payments (D.62, D.632) in 2021 and 2022 was remarkably higher than in the previous years due to the awarding of additional support; however, already from 2023, the amount thereof will decrease noticeably, since support programmes implemented until now will have been completed. It should be noted that from 1 January 2022, the State family benefit has been increased, which will drive the increase in expenditure in the medium term. The benefit for one dependent child aged 1 to 20 years amounts to EUR 25 a month, for two children – EUR 100 (EUR 50 per each child), and for three children – EUR 225 (EUR 75 per child). For four and more children up to the age of 20 the benefit amounts to EUR 100 a month per child.
- With EU fund investment flows increasing, gross fixed capital formation (P.51g) will increase substantially in 2022 and reach an even higher level in 2024-2025, since the implementation of projects for the 2014-2020 programming period will have been concluded and both the implementation of projects of the 2021-2027 programming period, Recovery and Resilience Facility projects, as well as the Rail Baltica project will be in their active phase.

Social security fund

- Already since 2017, there has been an annual surplus in the social security fund, and also in 2022 a moderate (0.2% of GDP) surplus is expected. It is projected that in 2023, revenue in the social security fund will grow by 4.8%, while expenditure will grow by 8.1%, amounting to a small deficit of 0.1% of GDP accordingly. Considering the high expected inflation rate in 2022, pensions will be indexed with higher indices in October 2022 and 2023, thus, pension expenditure in 2023 is expected to grow by 10.7% as compared to 2022, thereby determining the formation of a deficit. With further economic recovery, in 2024 and 2025, a well-balanced budget is forecasted in the social security fund.
- In 2022, an increase in pension expenditure is expected, in light of both the rise in the average contribution wage and larger indices because of the price increase. On 1 October each year, indexation of pensions is carried out, which mainly determines the average amount and increase of pensions in the next years' expenditure for old pensions. On 1 October 2021, old-age, disability, service, survivor's pensions and insurance allowances granted (recalculated) up to 30 September 2021 and the amount of which does not exceed EUR 470, have been revised (indexed), while as regards pensions and insurance allowances, the amount of which exceeds EUR 470, only a part thereof, amounting to EUR 470, is indexed. Expenditure for pensions would grow even sharper, if the reform of

retirement age would not be implemented. According to the pension reform, introduced in 2014, the retirement age increases by three months annually, until reaching the age of 65 in 2025, as a result the number of pension recipients decreases, and it is currently forecasted that it will also continue to decrease in the medium term. In 2022, persons who have reached the age of 64 and 3 months will be entitled to receive the State old-age pension. Persons, the insurance period of whom is at least 30 years are eligible to retire earlier – two years before reaching the general retirement age, thus, in 2022, persons who have reached the age of 62 years and 3 months are entitled to retire prematurely.

- In general, the labour market situation is to be assessed as satisfactory and stable, and the wage increase ensures a high rate of tax revenue growth. However, the deterioration of the Social security budget balance, as compared to 2021, will be determined by a sharper increase in unemployment benefit expenditure considering both the increase in the average amount by 18% (from EUR 318 to EUR 375) and the increase in the number of recipients by 15.2% (from 31.7 thousand to 36.5 thousand on average a month). In the medium term, the reduction in expenditure will be determined by a reduction in the number of recipients to 28.8 thousand in 2025.
- A significant increase due to the influence of the COVID-19 pandemic is also expected in 2022 as regards the expenditure for sickness benefits (+9.8%), inter alia, by taking into account changes to legislation to the effect that in the case of falling ill with COVID-19, the State already pays the sickness benefit from the first day of illness. From 1 April 2022, the period for which the employer pays sickness benefits from its own funds is reduced by one day. The changes provide that, starting from the 10th day of incapacity for work (until the end of 2021 – from the 11th day) until the day of regaining the capacity for work, a person is entitled to receive the sickness benefit, which is granted and paid by the State Social Insurance Agency. In 2023, the expenditure will remain at the level of 2022, as the number of recipients is planned to be 6% lower, which, in 2022, is still determined, to a large extent, by the spread of COVID-19.

Local government budget

- In 2022, the local government budget deficit will be higher than in 2021 reaching 0.5% of GDP. Larger budget deficit is mainly explained by a lower growth rate of the PIT revenue (+1.5%) as compared to 2021, taking into account the renewed macro-scenario which foresees lower growth of employment and wages as compared to 2021, and the increase in the non-taxable minimum. It is forecasted that, in 2023-2024, the deficit in the local government budget would decrease to 0.3% of GDP, projecting an annual increase in PIT revenue. In 2025, the amount of deficit will grow to 0.4% of GDP, which will be determined by slower growth of revenue.
- Meanwhile, the increase in expenditure in 2022 will be driven by an increase in wages in local government and the energy price rise thereby increasing expenditure for goods and services. Thus, as regards the local government budget expenditure, in 2022, an increase for both compensation of employees (D.1) and intermediate consumption (P.2) is expected. The forecasts also take into account the social support to Ukrainian civilians.
- Regarding the capital expenditure or gross fixed capital formation (P.51g), it is projected that this year it will grow compared to 2021, due to the increase in capital expenditure in basic functions, which is caused by implementation of COVID-19 investment projects, inter alia, by using additional local government borrowing. In accordance with the Law on State Budget for 2022, the total increase in local government borrowing has been set at EUR 188 million, of which EUR 70 million may be used for the implementation of local government investment projects, including in education establishments, and mitigation of the effect of COVID-19. In the medium term, expenditure for gross fixed capital formation will be largely determined by the cycles of the EU fund investments.

3.4.3. Fiscal indicators arising from the Fiscal Strategy, and the fiscal space in the March scenario

In accordance with the Fiscal Strategy, the general government budget structural balance targets are -2.47% of GDP in 2023, -1.97% of GDP in 2024 and -1.47% of GDP in 2025. 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

		2023	**2024**	**2025**
general government structural balance targets	(1)	-2.47	-1.97	-1.47
Output gap, % of the potential GDP	(2)	0.03	0.12	0.19
Cyclical balance component, % of GDP	(3)=0.378*(2)	0.01	0.05	0.07
One-off and other temporary measures, % of GDP, incl.	(4)	-0.39	-0.34	-0.26
COVID-19 mitigation measures		-0.24	-0.09	0.00
measures to reduce energy price increase		0.00		
defence investments		-0.15	-0.25	-0.26
other				
general government balance	**(5)=(1)+(3)+(4)**	**-2.84**	**-2.26**	**-1.66**

Table 3.11. Fiscal space

		2023	**2024**	**2025**
general government nominal balance forecast with no policy change	(1)	-2.36	-1.80	-0.95
Output gap, % of the potential GDP	(2)	0.03	0.12	0.19
Cyclical balance component, % of GDP	(3)=0.378*(2)	0.01	0.05	0.07
One-off and other temporary measures included in the no policy change scenario, % of GDP, incl.	(4)	-0.39	-0.34	-0.26
COVID-19 mitigation measures		-0.24	-0.09	0.00
measures to reduce energy price increase		0.00		
defence investments		-0.15	-0.25	-0.26
other				
general government budget structural balance forecasts in a no policy change scenario	(5)=(1)-(3)-(4)	-1.99	-1.50	-0.76
general government budget structural balance targets	(6)	-2.47	-1.97	-1.47
fiscal reserve	(7)	0.10	0.10	0.10
fiscal space	**(8)=(5)-(6)-(7)**	**0.38**	**0.37**	**0.61**

The March Fiscal Development Scenario of the Stability Programme projects a positive fiscal space at 0.38% of GDP in 2023, 0.37% of GDP in 2024 and 0.61% of GDP in 2025, not including the potential additional financing for one-off measure expenditures.

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

		2021	2022	2023	2024	2025
	ESA code	**% of GDP**				
Net lending (+) or borrowings (-) (B.9) by sub-sectors						
General government	S.13	-7.2	-6.5	-2.8	-2.3	-1.7
Central government	S.1311	-7.4	-6.1	-2.4	-2.0	-1.3
Local government	S.1313	-0.3	-0.5	-0.3	-0.3	-0.4
Social security funds	S.1314	0.5	0.2	-0.2	0.0	0.1
General government (S.13)						
Total revenue	TR	38.4	35.9	36.0	35.1	34.4
Total expenditure	TE	45.6	42.4	38.8	37.3	36.1
Interest expenditure	D.41	0.6	0.6	0.6	0.6	0.6
Cyclical development						
Cyclical component of the budget balance[9]		-0.7	-0.2	0.0	0.0	0.1
One-off measures[10]		-6.3	-2.8	-0.4	-0.3	-0.3
Cyclically adjusted balance		-6.6	-6.3	-2.9	-2.3	-1.7
Cyclically adjusted primary balance		-6.0	-5.7	-2.2	-1.7	-1.1
Structural balance		-0.3	-3.5	-2.5	-2.0	-1.5

The Fiscal Development Scenario assumes that the fiscal space of 2023, 2024 and 2025 is distributed proportionately between the central government and the social security fund in addition to expenditure for new policy priorities. It is assumed that the fiscal margin is used, i.e., fiscal risks occur at amount of 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 approach is used because it is assumed that the decisions on the budget development section do not affect on 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, in a timely manner, the availability of cash for financing requirement at the lowest possible debt servicing costs while hedging financial risks and at the same time contributing to the development of the domestic financial market. For meeting the central government debt obligations and fulfilling budget liabilities, a strategic approach to ensuring 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 financing requirement at as favourable and attractive conditions as possible.

[9] 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).

[10] For 2021-2022, the implemented support for reducing the COVID-19 pandemic has been included as a one-off (continues as one-off until 2024), as well as expenditure for measures reducing the increase of energy prices. For 2023-2025, investment expenditure for the defence sector has been included as a one-off, taking into account the government's decision of 22 March of this year on the increase of financing to 2.5% of GDP until 2025.

COVID-19 outbreak has 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[11]), resulting in considerable growth of the general government debt. According to operational data, at the end of 2021, the general government debt, according to the ESA methodology, reached EUR 14.7 billion or 45% of GDP.

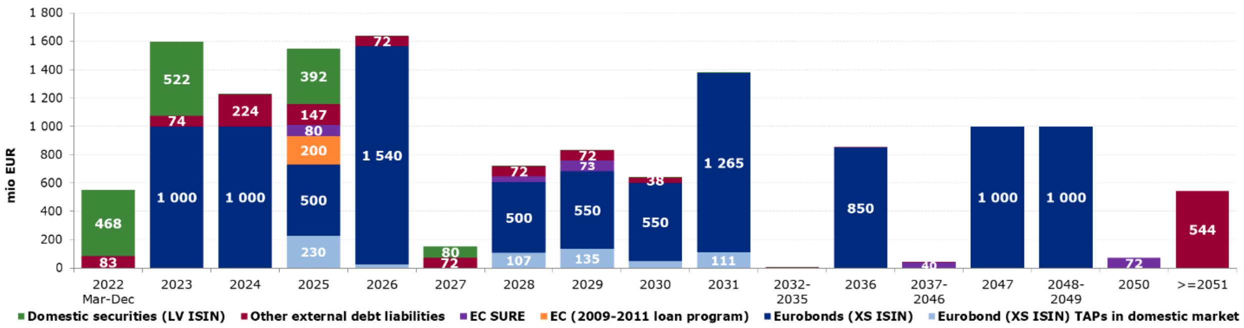
In 2021, necessary financing for covering the total financing need, incl. for the mitigation of the COVID-19 outbreak and support to the economy in the state of emergency, was ensured by borrowing in the amount of EUR 2.972 billion in the domestic and international financial markets.

In international financial markets, in 2021 resources in the amount of EUR 2.350 billion were attracted by issuing a new 10-year Eurobond in the amount of EUR 1.250 billion and a new 7-year Eurobond in the amount of EUR 0.5 billion. In both emissions, a coupon rate of 0.000% a year was fixed, which is the historically lowest level of security coupons of such a tenor ever reached in international markets in Latvian debt securities issues. In December 2021, for the first time in Latvian history, the Treasury issued State sustainability bonds in the amount of EUR 600 million with a maturity of eight years and fixing a coupon rate of 0.250%. The bonds were issued for support of the sustainable development of Latvia and attraction of financing for measures and priorities directed towards mitigating the negative effect of climate change, transition to climate neutrality and raising of welfare. Latvia is first among the Baltic and Scandinavian countries to issue sustainable bonds.

In the domestic financial market, in 2021, outstanding Eurobonds were tapped in the amount of EUR 622.25 million with maturity in 2025, 2026, 2028, 2029 and 2031, by fixing in security auctions low, incl. negative, yield from -0.422% to 0.243% (depending on the tenor).

In addition to borrowings in financial markets in 2021 on financially favourable conditions, borrowings from international financial institutions were made within the framework of existing contracts: from the Nordic Investment Bank in the amount of EUR 250 million and the EC financing instrument SURE in the amount of EUR 185 million.

Taking into account the central government debt obligations outstanding as of 28 February 2022, in accordance with the central government debt repayment schedule in the period between March 2022–December 2025 the central government debt obligations should be refinanced in the amount of ca. EUR 4.9 billion (see Figure 1). The majority of the amount of debt to be refinanced within the referred to period consists of Eurobonds issued in international financial markets, the total liquidity of which has been increased with regular tapping of Eurobonds in the domestic financial market and the maturity of which will become due (see Figure 3.10).



* *does not include sectors S130130, S130140, S130330, S130340, as well as on-demand and short-term deposits; according to ECB FX rates of 25 February 2022*

Figure 3.10. Central government borrowing repayment schedule (liabilities outstanding as of 28 February 2022, nominal value)

[11] SURE – *The temporary Support to mitigate Unemployment Risks in an Emergency.*

3.5.1. General Government Debt Forecasts in the Medium Term in the February Scenario

The February scenario for 2022-2025 stipulates that funds for covering the total financing requirement will mainly be provided by using borrowing possibilities in the domestic and international financial markets. Attraction of funds in the domestic financial market will be ensured 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 most financially beneficial borrowing instruments.

The February scenario stipulates that the need to ensure financial resources for State support measures in connection with the spread of COVID-19 and the sharp increase in energy prices will lead to an increase in general government debt in 2022 to 46% of GDP (see Figure 3.11). After the repayment of the government debt obligations planned in 2023-2024, as well as with the impact of the COVID-19 outbreak on the government budget fiscal indicators decreasing, starting from 2023, the proportion of general government debt to GDP is expected to slightly decrease and become stable (see Figure 3.11).

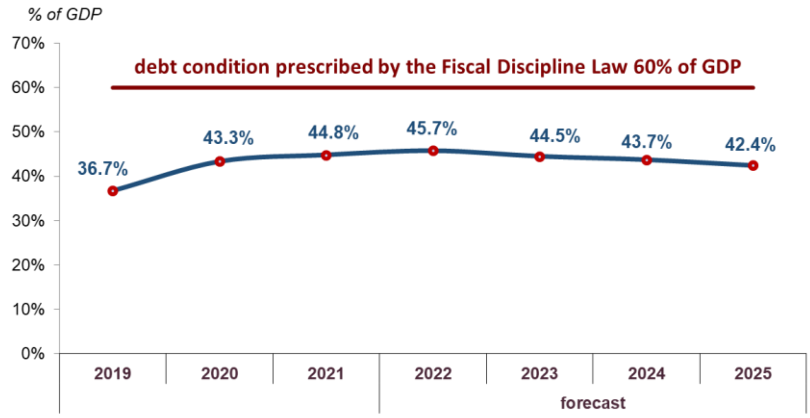


Figure 3.11. General government debt development trends in the February scenario

Despite the increase in the level of the general government debt, which has mainly been affected by the need to finance measures related to restricting the effect of the COVID-19 pandemic, it is expected that, in the medium and long term, the debt condition prescribed by the FDL would be met, thereby ensuring sustainability of the general government debt.

3.5.2. General Government Debt Forecast in the Medium Term in the March Scenario

Negative development of the geopolitical situation, Russia's invasion in Ukraine and a sharp decline in economic cooperation with Russia and its ally, Belarus, due to the influence of sanctions, as well as the sharp price increase will substantially worsen the economic situation, and there is a high probability to expect a sharp rise in demand for government support measures, increase in defence expenditure, which will increase the burden on fiscal indicators; however, the extent and duration of this impact cannot be reliably estimated for the time being, and it is also not possible to precisely forecast the full fiscal impact in 2022 and in the medium term.

Thanks to the borrowings made in 2021 in international financial markets at financially favourable conditions, the State already has available financing in a considerable amount for reducing the impact of the sanctions and for support of the economy.

Considering Russia's military aggression in Ukraine, for Latvia, just like for other EU states, borrowing possibilities in international financial markets are currently limited, hence, at present, borrowing measures are carried out in the internal financial market (in Q1 of 2022, outstanding Eurobonds have been tapped in the amount of EUR 490 million in the domestic financial market, the maturity of which will become due in 2024, 2025, 2029 and 2031). As soon as the situation in the financial markets stabilises, the attraction of funds will continue for covering the financing requirement, incl., for the fulfilment of the planned government debt obligations, funding of increasing government budget deficit and issuance of budget loans, also with other security maturities, amounts and placement methods. In parallel to borrowings in the domestic and international financial markets, possibilities to also borrow from international financial institutions, as well as possibilities to attract resources in other financial markets are maintained.

Considering the increase in the amount of borrowing, influenced by the negative effect of the sanctions imposed on Russia and Belarus, coupled with the sharp rise in energy prices, on the government budget deficit, according to the current forecast which was prepared in highly uncertain circumstances, it is indicatively expected that the general government debt level could increase to 46% of GDP in 2022 (see Figure 3.12). General government debt forecasts were prepared by taking into account the updated MoF's government budget deficit and GDP forecasts in the March scenario, and they do not take into account the possible additional State support measures that could be potentially implemented in order to reduce the negative economic effect of Russia's military aggression in Ukraine on the solvency of the Latvian population and businesses.

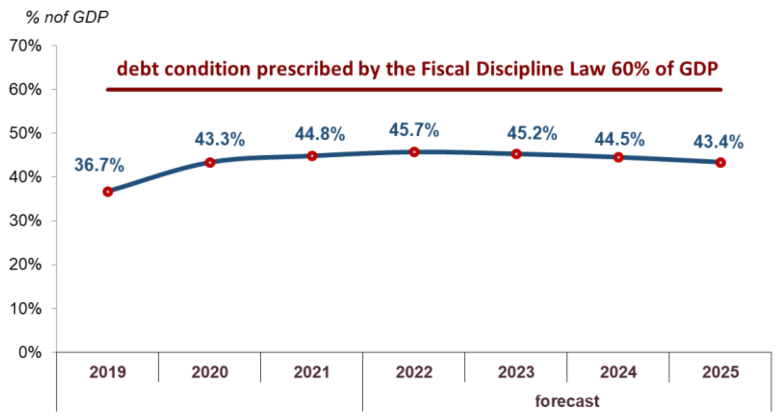


Figure 3.12. General government debt development trends in the March scenario

Despite the projected debt increase in the medium term, it is expected that, similarly to the February scenario, the debt condition prescribed by the FDL will be met as well ensuring sustainability of the general government debt.

4. SENSITIVITY ANALYSIS AND COMPARISON

4.1. Macroeconomic Scenario Risks

As a general rule, the medium-term macroeconomic development scenario is based on conservative assumptions regarding economic development in the medium term and the scenario risks are well-balanced. However, it should be noted that this year, macroeconomic forecasts have been developed in circumstances of very high uncertainty and are based on the situation as at the first week of March 2022, as well as on a assumption that there would be no further strong escalation of the situation in Russia-West relations.

As a result, the forecast risks of the renewed March scenario currently are downward biased and the negative risks are high related to an even wider discontinuation of trade and business connections, including the discontinuation of imports of Russian energy resources, as well as wider supply disturbances, which may cause a deficit of energy resources and other essential goods and substantially increase the prices thereof. Under the a sharper price rise, the economic growth rates may be significantly lower as the private consumption and private investment levels decline. In addition, the households and business confidence can be undermined by further worsening of the geopolitical situation and expansion of the war activities. This will force refraining from investments in the region. The negative risks also include the difficulty for exporting companies to reorientate business from Russian to Western markets, which may lead to a some of bankruptcies and dismissals thereby increasing the unemployment rate and creating social tension.

At the same time, there are also positive risks, which may provide stimulus for economic growth, inter alia, the increase of defence expenditure can provide for stronger development of the manufacturing and construction sectors, and additional business activity may come from the admission of Ukrainian refugees, incl. in the accommodation and catering sector that suffered severely from the COVID-19 crisis. Helping Ukraine and its population may also facilitate a stronger increase in private consumption, and the consumers expenditure may be affected by the decline in previously accumulated savings due to the lowering security risks. In turn, waiving of the vaccination certificate requirement (concurrently with the admission of Ukrainians) may reduce the tension in the labour market, where labour shortage was recorded in some sectors and professions over the last six months, and more steadily increase employment.

4.2. Sensitivity Analysis – Pessimistic Scenario

Impact on Economy

According to the pessimistic scenario, the economic growth of Latvia might decelerate more than in the renewed March scenario. As a result, the GDP real growth would be 0% in 2022 and could only by 0.5% in 2023. In both years, the growth would be around 2 ppt lower than in the March scenario.

Such an outcome would be a consequence of a complete disruption in the flow of goods and services, incl. as regards Russian energy resources, which would mean a reduction of exports by 4.7% in 2022 for Latvia. This shock would also be felt in 2023 when exports could decrease by another 2.7%.

The reduction of energy supply would facilitate an increase in business costs and inflation. The scenario assumes that energy prices would be at the March level, which is slightly higher than provided in the March scenario. Consumer price inflation could reach 11% in 2022, which is by 2.5 ppt more than in the March scenario. In the medium term, inflation will gradually converge to the price stability target at 2%.

Table 4.1. Pessimistic macroeconomic scenario

	Pessimistic scenario				Difference from the March scenario			
	2022	2023	2024	2025	2022	2023	2024	2025
GDP growth at current prices, %	11.2	5.6	6.8	5.8	0.3	-1.2	0.7	0.0
GDP growth at constant prices, %	0.0	0.5	3.3	3.4	-2.1	-2.0	0.0	0.0
Private consumption, growth at constant prices, %	1.0	1.6	4.0	4.0	-2.7	-2.8	0.0	0.0
Public consumption, growth at constant prices, %	0.8	2.0	0.5	0.5	0.0	1.4	0.0	0.0
Gross fixed capital formation, growth at constant prices, %	-3.1	1.0	4.8	3.0	-5.0	-3.7	0.0	0.0
Export of goods and services, growth at constant prices, %	-4.7	-2.7	4.0	5.0	-1.7	-2.6	0.0	0.0
Import of goods and services, growth at constant prices, %	-4.2	-0.9	3.7	4.0	-2.2	-2.6	0.0	0.0
Average wage in national economy growth at current prices, %	5.0	4.0	5.3	5.0	-1.0	-1.7	0.0	0.0
Employment growth, %	1.0	0.0	0.0	0.0	-0.3	-0.4	0.0	0.0
Unemployment rate, %	7.9	7.8	6.4	5.9	0.3	0.1	0.2	0.0

In such circumstances, the private consumption growth would be largely determined by inflation. The consumption real growth would only 1.0% in 2022 and 1.6% in 2023 as inflation stabilise.

Meanwhile investments will decrease by 3.1% in 2022 and 2.7% in 2023. This would also a consequence of rising prices, termination of State projects concluded previously from the contractors' side, in addition the geopolitical uncertainty will reduce investments' attractiveness of the region.

Considering the downward forecast risks after the start of the war in Ukraine, the February's scenario (see. Section 2.3) is to be taken as the optimistic scenario of macroeconomic development.

Impact on the general government budget

If the pessimistic scenario were to occur, tax revenue would decrease significantly, and the general government budget balance would deteriorate. As compared to the renewed (March) scenario, in the case of the optimistic scenario the general government deficit in 2022 would increase by EUR 154.4 million or 0.4 ppt of GDP. Whereas, in 2023, the balance would deteriorate by EUR 210.2 million or 0.6 ppt of GDP, while in 2024 and 2025 – by EUR 157.4 million and EUR 163.3 million respectively, as compared to the March scenario, or 0.4 ppt of GDP. In the pessimistic scenario, the general government deficit in 2022 would grow to 6.9% of GDP, in 2023 – to 2.9% of GDP, in 2024 – to 2.2% of GDP, but in 2025 – to 1.3% of GDP.

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

	Pessimistic scenario				Deviation from the March scenario			
	2022	**2023**	**2024**	**2025**	**2022**	**2023**	**2024**	**2025**
General government budget balance, % of GDP	**-6.9**	**-2.9**	**-2.2**	**-1.3**	**-0.4**	**-0.6**	**-0.4**	**-0.4**
General government budget balance	-2 523.9	-1 132.6	-901.2	-577.9	-154.4	-210.2	-157.4	-163.3
Tax revenue	10 356.6	10 810.3	11 392.6	11 993.5	-151.9	-206.1	-149.3	-148.6
Personal income tax	1 936.0	1 984.0	2 070.0	2 192.0	-27.0	-42.0	-44.0	-46.0
Corporate income tax	320.0	325.0	350.0	390.0	-10.0	-15.0	-15.0	-10.0
VAT	3 096.4	3 289.8	3 525.2	3 726.4	-53.4	-53.3	0.0	0.0
Mandatory State social security contributions[12]	3 371.2	3 526.4	3 692.7	3 874.4	-32.5	-64.0	-69.6	-73.3
Excise duty	1 120.9	1 149.0	1 197.0	1 233.6	-17.1	-15.8	-6.7	-6.5
Non-tax revenue	668.6	567.0	536.6	546.5	-2.5	-4.1	-5.9	-4.6
Interest expenditure	200.1	232.2	277.5	295.7	0.0	0.0	2.2	10.0
General government debt, % of GDP	**45.6**	**45.9**	**45.1**	**44.4**	**-0.1**	**0.7**	**0.6**	**1.1**

Upon the implementation of the pessimistic scenario of economic development, under the influence of the tax revenue decrease the State budget deficit would grow, as a result of which the overall funding needs would increase in the next years and, accordingly, the borrowing for the respective period would increase, as compared to the renewed March scenario. Additional borrowing would generate the interest expenditure growth. In the case of the pessimistic scenario, interest expenditure in 2022 and 2023 would remain unchanged, but in 2024 it would increase by EUR 2.2 million and, in 2025, by EUR 10 million as compared to the March scenario.

4.3. Comparison of the General Government Budget Balance and Debt Forecasts with the Latvia's Stability Programme 2021–2024

According to the assessment of the MoF, general government budget deficit in 2021 amounted to 7.2% of GDP, which is lower than forecasted in Latvia's Stability Programme 2021-2024, when, given the high uncertainty due to COVID-19 pandemic, the deficit for 2021 had been forecasted to reach 9.3% of GDP.

With the steady spread of COVID-19, the sharp rise in energy prices and war in Ukraine continuing, a larger than expected impact in 2022 is caused by wide support measures, as a result of which the general government budget deficit in 2022 in the renewed March scenario is projected to be higher, i.e., 6.5% of GDP instead of the previously forecast 2.7% of GDP. Whereas, in the medium term, with the conclusion of support programmes and the economic growth continuing, which will increase tax revenues, it is projected that the general government deficit would decrease; however, considering the decisions adopted in the autumn of 2021 regarding additional expenditure for remuneration and investments, as well as the government's recent decision on increasing the defence financing, the deficit with no policy change is forecasted to be higher than earmarked in the previous Stability Programme of Latvia.

The general government debt forecasted in the March scenario has been decreased in 2022-2024, as compared to the forecasts of the COVID-19 impact scenario of the Stability Programme for 2021-2024 (see Table 4.3).

The changes were mainly driven by stronger than expected economic growth in 2021, which has resulted in a higher GDP nominal value, which, in turn, reduced the general government debt level to GDP. Also in the next years, despite the forecasted increase in borrowings, updated

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

GDP forecasts provide lower debt levels to GDP, as compared to the forecasts of the COVID-19 impact scenario of the Stability Programme for 2021-2024.

The medium-term general government debt forecast has been prepared in circumstances of still high uncertainty, considering the expected impact of the sanctions imposed on Russia and Belarus and the sharp energy price rise on the macroeconomic and government budget fiscal indicators in accordance with the MoF assessment. General government debt forecasts do not take into account the possible additional State support measures that could be potentially implemented in order to reduce the negative economic effect of Russia's military aggression in Ukraine on the solvency of the Latvian population and businesses.

Table 4.3. Comparison of the renewed March scenario with forecasts of the Stability Programme for 2021-2024

	ESA code	2021	2022	2023	2024	2025
GDP growth (%)	B1y					
2021		3.0	4.5	3.2	2.8	-
2022		4.8	2.1	2.5	3.3	3.4
Changes		1.8	-2.4	-0.7	0.5	-
Actual budget balance (% of GDP)	B.9					
2021		-9.3	-2.7	-1.3	-0.3	-
2022		-7.2	-6.5	-2.4	-1.8	-0.9
Changes		2.1	-3.8	-1.0	-1.4	-
General government debt (% of GDP)						
2021		48.9	50.3	48.8	48.5	-
2022		44.8	45.7	45.2	44.5	43.4
Changes		-4.1	-4.6	-3.6	-4.0	-

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 shall ensure the development of the Draft Annual State Budget Law, on the basis of the Framework Law and budgetary requests. The Minister of Finance shall evaluate the conformity of the budgetary requests with the budgetary purposes and priority courses of development prescribed by the Framework Law, as well as with the principles of economy and efficiency and, if necessary, shall request necessary additional information. Based on the evaluation and the provided information, the Minister of Finance, till the submission of the Draft Annual State Budget Law to the Cabinet, shall take a decision regarding the inclusion of the budgetary requests in the Draft Annual State Budget Law. The Minister of Finance may, at any stage of the examination of the Draft Annual State Budget Law, express their point of view, add the necessary opinions, as well as the results of separate audits.

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.

The Minister of Finance during the development of the Draft Annual State Budget Law or amendments thereof 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 and proposals for the use of these results in the process of developing of the Draft Framework Law and the Draft Annual State Budget Law.

In 2022, 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 the financing policies under the supervision of line ministries, horizontal measures for the resource allocation to the current priorities, and improvement of financial management system and processes.

Within the framework of the medium-term spending review of the State budget, it is planned to ensure the processing and analysis of information and data in order to perform research on the policies and fields which are under the supervision of individual line ministries, in order to increase the effectiveness of expenditure related to the lease and maintenance of real estate, taking into account the increasing use of remote working possibilities in public administration, as well as to carry out analysis of financial management in local governments in order to improve the financial equalisation and provide similar possibilities for local governments for the fulfilment of their statutory functions (see Figure 5.1).

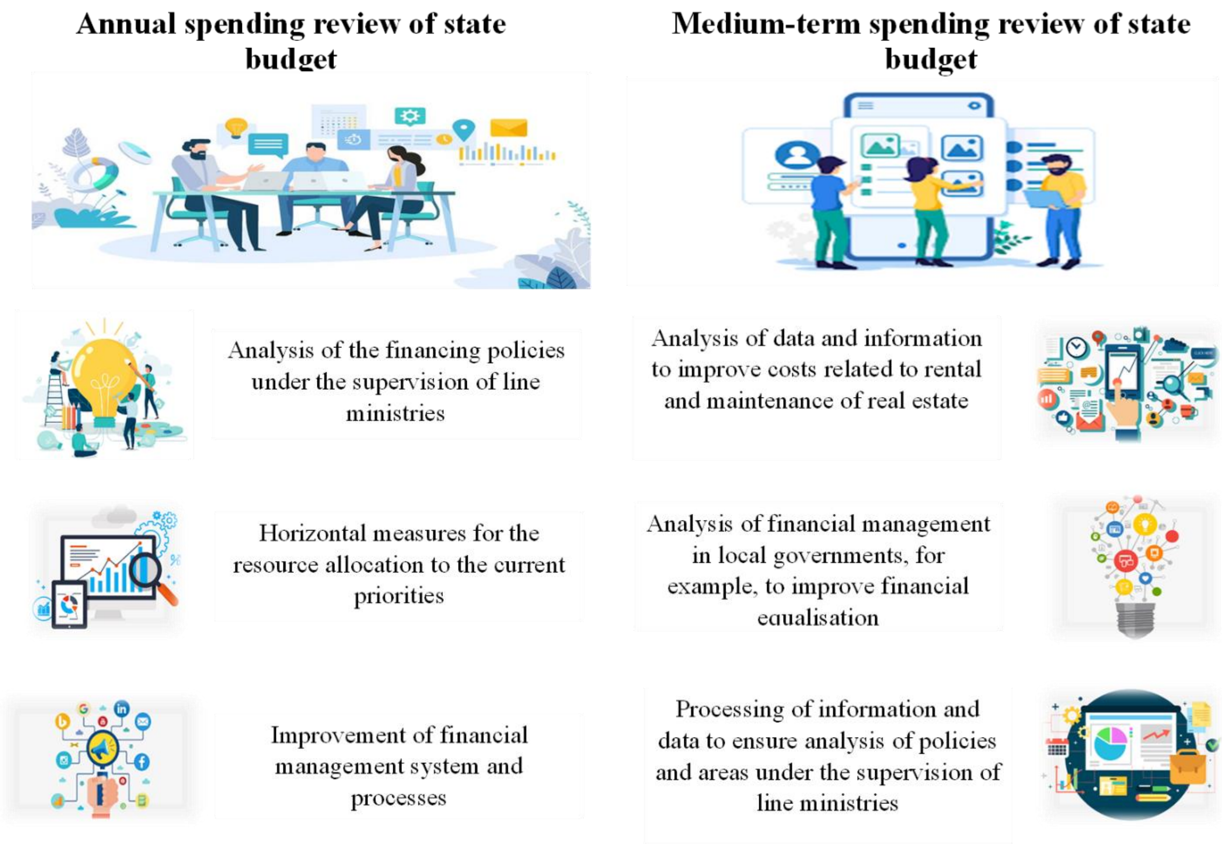


Figure 5.1. Scope of spending review for 2022

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.

In addition, the enhanced budget format has provided 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 the 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 annual 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 Annual 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.;
- State budget institutions for the receipt of assignations and for the making of expenditures from the State budget funds shall open the State basic budget and State special budget accounts only with the Treasury. Accounts for funds deposited by the State budget institution shall be opened only with the Treasury. Institutions non-financed from the budget shall open current accounts only with the Treasury. Bodies financed from the budget, except for the State budget institutions, for the receipt of the State budget funds and for the making of expenditures financed therefrom shall open current accounts only with the Treasury, unless provided for otherwise in other regulatory enactments. Local governments, derived public entities financed partly from the State budget, and capital companies in which a State or local government capital share has been invested, may open current accounts with the Treasury for the funds not received from the State budget;
- 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 the State budget finances; The Treasury shall prepare regular official and operative statements and provide information regarding the 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:

- if 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 annual 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 annual 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 provided for in accordance with this Law on budget and financial management have not been submitted in good 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 Treasurer 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 Annual 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 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 February Scenario of the Stability Programme

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. Also, their link to the general development aims of the State is important. Thus, the most important tax measures are also directed so as to improve, by means of the tax policy, the competitiveness of labour force taxes and to reduce the income inequality for the working population.

Tax revenue forecasts have been prepared on the basis of macroeconomic indicator forecasts, as well as by taking into account the actual implementation in 2021, previous changes to legislation and tax support measures adopted during the COVID-19 crisis.

The most important tax policy changes adopted during the preparation of the Draft Law on State Budget for 2022:

- increasing of the DNM and pensioners' non-taxable minimum as from 1 January 2022, from EUR 300 to EUR 350 a month and from EUR 330 to EUR 350 a month respectively, and increasing of both non-taxable minimums as from 1 July 2022 to EUR 500 a month;
- reducing the VAT rate from 12% to 5% on book supplies and supplies and subscription fees for press and other mass media editions or publications; reducing the VAT rate on e-books, newspapers and e-periodicals and media content in a digital format from 21% to 5%;
- increasing of the MSSSC maximum object from EUR 62 800 to EUR 78 100.

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

	Code (ESA)	2022	2023	2024	2025
Tax revenue					
1. Production and import taxes	D.2	4 760.2	5 126.1	5 382.8	5 632.2
2. Current income and wealth taxes	D.5	2 409.8	2 540.4	2 666.2	2 819.4
3. Capital taxes	D.91	18.3	18.6	18.9	19.1
4. Social contributions	D.61	3 552.8	3 768.5	3 961.2	4 152.2
Of which actual social contributions	*D.611 and D.613*	3 425.2	3 641.0	3 833.7	4 024.7

It is projected that the share of labour force taxes will decrease from 47.0% in 2022 to 46.8% in 2025; therefore, the share of revenue from consumption and capital taxes in total tax revenue will gradually increase from 53.0% in 2022 to 53.2% in 2025.

The share of labour tax revenue in GDP in 2025, as compared to 2022, will decrease by 0.4 ppt, while consumption and capital tax revenue from GDP will increase by 0.4 ppt.

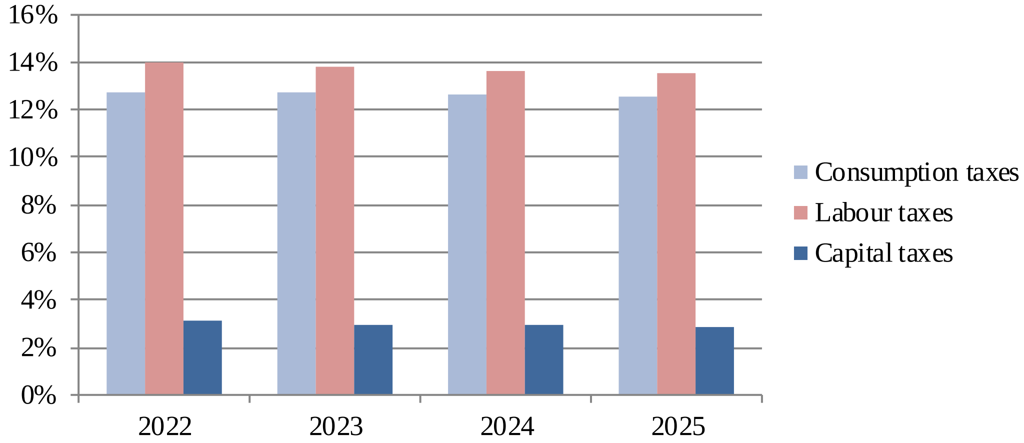


Figure 5.1. Tax revenue according to economic functions, % of GDP

As the crisis caused by the COVID-19 infection also continues in 2022, the following support measures and measures restricting economic activity, which have been incorporated in the Law on the Suppression of Consequences of the Spread of COVID-19 Infection, will continue:

- a taxpayer who, from 11 October 2021, cannot carry out economic activity, which is his/her primary activity, as a result of prohibitions imposed due to the emergency situation announced in the State, may apply for an extension of the tax payment period, by dividing it into periods or postponing it until 30 June 2023, counting from the day of application;
- cancellation of PIT advance payments in 2022;
- prohibition to organise gambling and lotteries (except for interactive gambling, numerical lotteries, and instant lotteries) and suspension of licences to organise gambling during the period of the announced emergency situation, and a prohibition to organise gambling in gambling organisation places. Tax is calculated in proportion to those calendar days of the month, when it is allowed to organise gambling.

Value added tax

In the February scenario, the dynamics of the VAT revenue reflects the projected economic development of the country, to be promoted by the recovery of Latvia's and the global economy from COVID-19 and implementation of the European Recovery and Resilience Facility.

VAT revenue in 2022 will be affected by the amendments to the Value Added Tax Law adopted in 2021: as from 1 January 2022, the reduced VAT rate of 5% has been introduced for books and periodicals both in printed and all electronic forms – data carriers, downloads and online regime (also for e-books, e-publications of periodicals, news portals and publications thereof). Also, as from 2022, a reduced VAT rate of 5% is applied to subscription fees. Besides, in accordance with the judgment of 22 March of 2021 of the Senate of the Republic of Latvia, the VAT application norm has been specified for the supply of medical devices (incl. components, spare parts and accessories thereof). As a result, most of the above-referred goods are now subject to the VAT standard rate, not the reduced VAT rate.

In addition to the above mentioned changes, VAT revenue is also influenced by other measures which are not directly related to the changes to the Value Added Tax Law, but which will affect the amount of revenue (see Table 5.2 showing all the tax policy measures affecting the VAT revenue).

Table 5.2. Impact of tax policy changes on [13]VAT revenue, MEUR

	2022	2023	2024	2025
Introduction of the reduced VAT rate of 5% for books and periodicals both in printed and all electronic forms – data carriers, downloads and online regime (also for e-books, e-publications of periodicals, news portals and publications thereof), as well as for the subscription thereof.	-6.2			
In accordance with the judgment of 22 March 2021 of the Senate of the Republic of Latvia, the norm for the supply of medicinal devices has been specified.	10.4			
Increasing of the DNM and pensioners' non-taxable minimum as from 1 January 2022, from EUR 300 to EUR 350 a month and from EUR 330 to EUR 350 a month respectively, and increasing of both non-taxable minimums as from 1 July 2022 to EUR 500 a month.	+12.4	+7.8	+0.1	
The extensions of terms under Covid-19 granted during the period from 11 October 2021.	-0.02			
Total impact of changes:	**+16.5**	**+7.8**	**+0.1**	

Corporate Income Tax

As of 2018, a conceptually new CIT payment regime has been introduced. The referred to model envisages postponing the moment of payment of tax till the time, when the profit is allocated or otherwise expended for such expenditure, which do not ensure further development of the company.

In the medium term, CIT revenue will be influenced by tax support measures approved during the COVID-19 crisis in the Law on the Suppression of Consequences of the Spread of COVID-19 Infection.

Table 5.3. Impact of tax policy changes on CIT revenue, MEUR

	2022	2023	2024	2025
Exclusion of interest payments from the CIT taxable base in 2021 and 2022	-5.5		+5.5	
Total impact of changes:	**-5.5**		**+5.5**	

Excise duty

Excise duty revenue in 2022 will be influenced by previous years' amendments to the Law on Excise Duties, mainly increasing of rates for tobacco products.

From January 2021 till the end of 2025, excise duty rate for natural gas used as a fuel has been reduced, which will not have a substantial negative effect on public budget revenue.

According to the amendments to the law On Excise Duties adopted by the Saeima on 24 November 2020, in 2022 changes in excise duty rates for tobacco products have also been provided for. Table 5.4 summarises the excise duty rates for tobacco products.

[13]Here and in the subsequent table showing the impact of tax policy changes, the annual impact of introduction is presented.

Table 5.4. Excise duty rates for tobacco products in 2021-2023

Type of tobacco product	Effective date of the rate		
Cigarettes	**01.03.2021**	**01.01.2022**	**01.01.2023**
Tax rate per 1 000 cigarettes, EUR	92.50	98.00	104.00
Minimum level of tax per 1 000 cigarettes, EUR	121.40	128.40	135.90
Ad Valorem, %	15.0	15.0	15.0
Cigars, cigarillos	**01.01.2021**	**01.01.2022**	**01.01.2023**
Tax rate per 1 000 pieces, EUR	104.7	115.20	126.70
Smoking tobacco, tobacco leaves	**01.01.2021**	**01.01.2022**	**01.01.2023**
Tax rate per 1 000 g, EUR	80.25	85.90	91.90
Heated tobacco	**01.01.2021**	**01.01.2022**	**01.01.2023**
Tax rate per 1 000 g, EUR	160.00	207.00	218.00

These amendments provide for changes in other excise goods rates as from 1 January 2022:

- excise duty rate for fluids used in electronic cigarettes and components of preparation thereof is EUR 0.16 per 1 ml of fluid, as from 1 January 2023 – EUR 0.20 per 1 ml of fluid;
- excise duty rate for tobacco substitute products is EUR 100.00 per 1000 grams, as from 1 January 2023 – EUR 120.00 per 1000 grams.

In accordance with the amendments in the Law on Excise Duties, adopted by the Saeima on 6 February 2020, it is planned to apply an increased excise duty rate for non-alcoholic beverages with sugar content from 8 grams per 100 millilitres – EUR 14.00 per 100 litres, as from 1 January 2022.

In addition to the above changes in excise duty rates, as from 1 January 2022, an excise duty is applied on food supplements which contain ethyl alcohol, if a unit of packaging exceeds 150 millilitres.

From 1 July 2022, reduced excise duty rates are provided for wine, fermented drinks and intermediates, if these products are manufactured by a medium wine, medium fermented drinks or permanent medium intermediate product manufacturer. In addition, reductions of excise duty rates are applied for small alcoholic drink breweries.

Personal income tax

PIT revenue is mainly influenced by the amount of the population employed in the national economy, income of the employed, the amount of non-taxable minimum and exemptions of the PIT, minimum wage, as well as legislative changes introduced.

Adopted changes to regulatory enactments influencing PIT revenue:

- increasing of the MSSSC maximum object from EUR 62 800 to EUR 78 100;
- increasing of the employer's health service limit;
- increasing of the DNM and pensioners' non-taxable minimum as from 1 January 2022, from EUR 300 to EUR 350 a month and from EUR 330 to EUR 350 a month respectively, and increasing of both non-taxable minimums as from 1 July 2022 to EUR 500 a month.

In addition to the above, PIT revenue in the medium term will be influenced by legislative changes approved previously, tax support measures approved during the COVID-19 crisis, as well as the judgment of 7 January of 2022 of the Constitutional Court on the abolition of restrictions on operating expenses in the amount of 80 per cent.

Table 5.5. Impact of changes in tax policy on PIT revenue, MEUR

	2022	2023	2024	2025
Maintaining of PIT exemption for support amounts until 2023				+2.2
Increasing of the DNM and pensioners' non-taxable minimum as from 1 January 2022, from EUR 300 to EUR 350 a month and from EUR 330 to EUR 350 a month respectively, and increasing of both non-taxable minimums as from 1 July 2022 to EUR 500 a month	106.2	66.9		
Abolition of advance payments for economic operators in the 2022 taxation year	-30.0	+60.0	-30.0	
Increasing of the employer's health service limit	-0.5			
Increasing of the MSSSC maximum object from EUR 62 800 to EUR 78 100	-6.8			
Decision of the Constitutional Court on the abolition of restrictions on operating expenses in the amount of 80 per cent		-3.6		
The extensions of terms under Covid-19 granted during the period from 11 October 2021	-0.1			
Total impact of changes:	**-143.5**	**-10.5**	**-30.0**	**+2.2**

Social Security Contributions[14]

The medium-term dynamics of revenue from social security contributions will be determined not only by the forecast increase in the wage fund, but also by changes in the legal framework.

As of 1 January 2022, amendments are in force which provide that solidarity tax rate shall be applied on income exceeding EUR 78 100 per year. The procedure of payment and order of distribution of the solidarity tax have not been changed. Tax distribution order by prioritising solidarity-related components:

- in the amount of 1 ppt for funding health care services;
- in the amount of 14 ppt into the State pension special budget (as from 2021, such will be transferred to the State pension special budget in a non-personalised manner);
- in the amount of 10 ppt into the personal income tax account.

The rate of contributions into the State-funded pension scheme remains unchanged, comprising 6 ppt of the total rate of mandatory State social security contributions.[15]

The adopted changes in the legal framework affecting the revenue from social security contributions in 2022:

- increasing of the MSSSC maximum object from EUR 62 800 to EUR 78 100;
- increasing of the employer's health service limit.

In addition to the above, contributions in the medium term will be affected by tax support measures approved previously during the COVID-19 crisis.

Table 5.6. Impact of changes in tax policy on the revenue from social security contributions[16], MEUR

	2022	2023	2024	2025
Increasing of the employer's health service limit	-0.8			
Increasing of the MSSSC maximum object from EUR 62 800 to EUR 78 100	+9.6			
The extensions of terms under Covid-19 granted during the period from 11 October 2021	-0.1			
Total impact of changes:	**+8.7**			

[14] Excluding contributions to the State-funded pension scheme.

[15] According to the methodology of the ESA, social security contributions that are being transferred to the State-funded pension scheme, are not being accounted as the general government budget revenue.

[16] Except for contributions into State funded pension scheme and payment into the basic budget for funding healthcare

Measures adopted previously also influence the State social security contributions into the basic budget for health funding.

Table 5.7. Impact of changes in tax policy on the State social security contributions into the basic budget for health funding, MEUR

	2022	2023	2024	2025
Increasing of the employer's health service limit	-0.03			
Increasing of the MSSSC maximum object from EUR 62 800 to EUR 78 100	+0.1			
The extensions of terms under Covid-19 granted during the period from 11 October 2021	-0.01	+0.01		
Total impact of changes:	**+0.01**	**+0.01**		

5.2.2. Tax Revenue Forecasts in the March Scenario

When preparing revenue forecasts in the March scenario, the updated macroeconomic forecasts, which include sanctions imposed on Russia and Belarus, were taken into account. This scenario contains no additional measures listed in Chapter 5.2.1. It is forecast that, in 2022, GDP, as compared to the year before, will increase by 10.9% (the growth forecast in the medium-term budget framework was +10.8%). As a result, the total budget tax revenue after cash flow is projected to be EUR 317.9 million larger as compared to the medium-term budget framework forecast for 2022, while, as compared to the February scenario of the Stability Programme, a reduction by EUR 147.2 million is forecasted.

Table 5.11. Tax revenue in general government budget (S.13), MEUR

	Code (ESA)	2022	2023	2024	2025
Tax revenue					
1. Production and import taxes	D.2	4 710.7	5 028.3	5 282.4	5 532.9
2. Current income and wealth taxes	D.5	2 362.7	2 484.1	2 610.1	2 772.9
3. Capital taxes	D.91	18.3	18.6	18.9	19.1
4. Social contributions	D.61	3 498.0	3 703.9	3 894.6	4 082.2
Of which actual social contributions	*D.611 and D.613*	3 370.5	3 576.4	3 767.1	3 954.7

In the March scenario, it is projected that the share of labour force taxes will decrease from 47.0% in 2022 to 46.9% in 2025, while the share of revenue from consumption and capital taxes in total tax revenue will gradually increase from 53.0% in 2022 to 53.1% in 2025.

The share of labour tax revenue in GDP in 2025, as compared to 2022, will decrease by 0.3 ppt, while consumption and capital tax revenue from GDP will increase by 0.3 ppt.

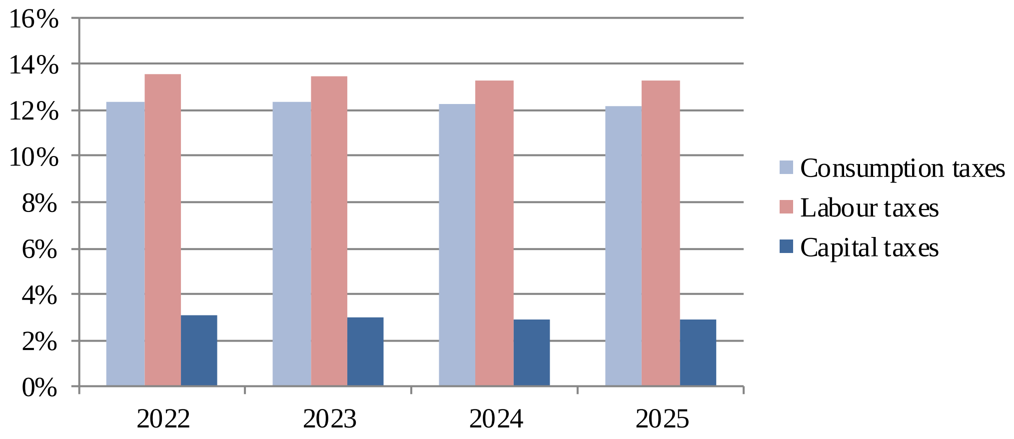


Figure 5.2. Tax revenue according to economic functions, % of GDP

Value added tax

VAT forecasts take into account the updated macroeconomic forecasts which provide that, starting from Q2 of 2022, the national economy of Latvia will start to feel the negative effects of sanctions imposed on Russia even more. The real growth of the economy for this year has been reduced by 1.9 ppt (from the 4.0% forecast previously to 2.1%), which will negatively affect the VAT revenue. In turn, the price factor which will increase as a result of the sanctions, will ensure a stronger nominal growth of the national economy of Latvia than was forecast previously and hence will benefit VAT revenue: it is estimated that the consumer price index in 2022 will increase on average by 8.5% (the price increase forecast was increased by 2.3 ppt).

Customs Duty

Customs duty forecasts provide for a substantial reduction in connection with the imposition of various import sanctions on Russia and Belarus. In the near future it will be necessary to restructure the import market, and it is likely that part of the goods will be imported from EU States where no import duty is applied.

Excise duty

Excise duty forecasts take into account a reduction in revenue from oil products in connection with the sharp rise in fuel prices, which will result in a reduction of fuel consumption. Due to the sanctions, excise duty revenue from natural gas could decrease, as there is uncertainty regarding the supplies of natural gas from Russia and natural gas supply alternatives. It also takes account of the assumption that due to the increase in natural gas price, the population could increasingly consider other heating solutions. It is predicted that the consumption of other excise goods will decrease, such as coffee and non-alcoholic beverages. Instead, more essential supplies will be purchased.

Social Security Contributions[17] and Personal Income Tax

The forecasts of social security contributions and PIT took into account the updated macroeconomic forecasts which provide that wage bill indicators, as compared to the ones planned in the Medium Term Budgetary Framework for 2022-2024, would decrease by 1.9 ppt in 2022 and by 1.8 ppt in 2023; in 2024, the growth rate will be as planned.

Corporate Income Tax

CIT forecasts provide for lower growth in the amount of distributed profits, as the companies' profit will be influenced by potential supply chain disruptions (especially for those which cooperated with companies connected with Russia), and, with energy prices rising, the cost price of products will also increase (part of the price increase will be compensated from the profit to maintain the competitiveness).

Lotteries and Gambling Tax

Lotteries and gambling tax forecasts in relation to the increase of inflation and the potential reduction of the revenue of the population provide for a smaller number of slot machines in gambling halls in 2022 and 2023.

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[17] Excluding contributions to the State-funded pension scheme.

Table 5.12. Changes of tax revenue forecasts of the March scenario by cash flow, as compared to the February scenario forecasts, %

	March scenario forecast / February scenario forecasts, %			
	2022	**2023**	**2024**	**2025**
Value added tax	*-0.62%*	*-1.95%*	*-2.25%*	*-2.30%*
Corporate Income Tax	*-4.62%*	*-6.08%*	*-5.19%*	*-2.44%*
Personal income tax	*-1.46%*	*-1.65%*	*-1.67%*	*-1.63%*
Social security contributions to the State special budget	*-1.45%*	*-1.75%*	*-1.74%*	*-1.74%*
State social security contributions to the basic budget for health funding	*-1.41%*	*-1.71%*	*-1.71%*	*-1.72%*
Customs Duty	*-15.00%*	*-10.00%*	*-7.00%*	*-5.00%*
Excise duty	*-1.60%*	*-2.34%*	*-1.41%*	*-0.76%*
Vehicle operation tax	*0.00%*	*0.00%*	*0.00%*	*0.00%*
Company vehicles tax	*0.00%*	*0.00%*	*0.00%*	*0.00%*
Electricity tax	*0.00%*	*0.00%*	*0.00%*	*0.00%*
Natural resources tax	*0.00%*	*0.00%*	*0.00%*	*0.00%*
Lotteries and Gambling Tax	*-5.41%*	*-2.77%*	*0.00%*	*0.00%*
Real estate tax	*0.00%*	*0.00%*	*0.00%*	*0.00%*
Total budget	***-1.38%***	***-1.99%***	***-1.93%***	***-1.77%***

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 budgetary expenditure forecasts, developed by the Working Group in the second half of 2020, were published in *Ageing Report 2021*.

When updating the public expenditure forecasts till 2070, EUROPOP2019 demographic forecasts prepared by the Eurostat, as well as the forecasts of the macroeconomic indicators for the long term prepared by the European Commission, have been considered. The forecasting methodology, being uniform for all Member States, has been discussed and approved by the AWG, 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 population comprised 1.92 million people, which is, for example, 200 thousand less than in 2010. The current statistics show that at the beginning of 2021, the population in Latvia was 1.89 million people. According to the baseline scenario of demographic forecasts, it is being forecasted that the population in Latvia will reduce to 1.26 million in 2060 and further on to 1.08 million people in 2100.

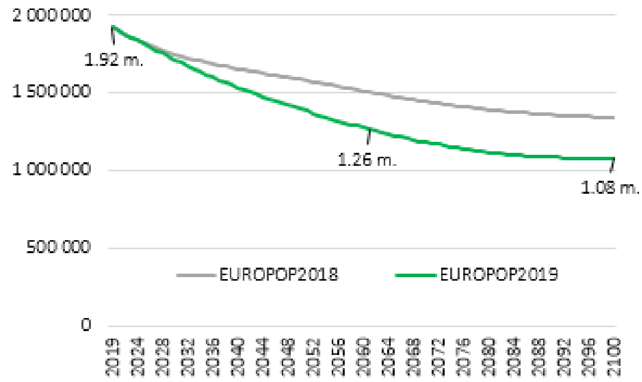

Figure 6.1. Number of population (Data source: Eurostat)

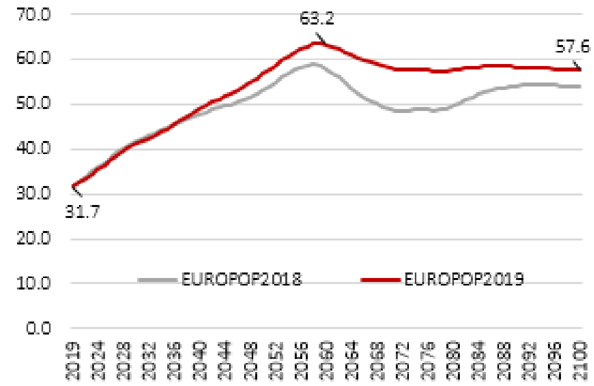

Figure 6.2. Share of population aged 65+, in the number of population aged 15-64, % (Data source: Eurostat)

It should be noted that, as compared to the previous forecasts (see Figure 6.1), the updated forecasts of the population is more pessimistic, and it is attributable to:

- A lower birth rate than forecasted before. Even though the forecasted total birth rate is lower, in the long run, it will nevertheless grow from 1.58 in 2019 to 1.73 in 2100. The current statistics show that in 2021, the birth rate was one of the lowest during the last 100 years: 17.1 thousand newborns, which is 437 or 2.5% less than in 2020.
- Even though the forecasted death rate is slightly lower than before, *Eurostat* forecasts that the natural growth in Latvia will protractedly remain negative – up to 2100. The current statistics show that in 2020, when the COVID-19 pandemic started, the number of the deceased increased slightly – as compared to 2019, it increased by 1.1 thousand or 4%. In turn, in 2021 the situation changed, and the number of the deceased was the largest during the last 20 years: as compared to 2020, it increased by 5.4 thousand or

19%. According to *Eurostat* forecasts, the impact of COVID-19 on death rate will have a short-term (1-2 years) effect.

- Larger 65+ population share in the number of working age population (15-64) (see Figure 6.2) than forecasted before, reaching the highest share – 63.2% of the working age population in 2060. In the long term, the increase in the elderly population share in the population aged 15-64 will be influenced by the increase of the lifespan, which, according to *Eurostat* forecasts, will grow from 70.6 years, on average, in 2019 to 87.6 years in 2100 for men, while for women it will grow from, on average, 80.2 years in 2019 to 92.1 year in 2100. Likewise, the proportion of population aged 65+ to population aged 15-64 population in the long term will also be influenced by a decline in the number of working age population according to *Eurostat* forecasts.
- Changes in migration model. By applying new methodology to migration, all Member States are having a more negative migration balance than forecast before. 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 AWG, the EC forecasts that Latvia's gross domestic product will continue growing, on average, by 1.2% during the time period from 2019 to 2070. As compared to previous forecasts, growth is forecasted at a slightly slower rate (see Figure 6.3), mainly, considering the impact of economic crisis caused by COVID-19, as well as the reduction of the forecasted total number of hours worked in economy, on average, by 1.1% in 2019-2070, along with a steeper decline in the number of working age population than forecast before. It should be noted that the EC forecasts that the employment rate during the time period from 2019 to 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 in 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).

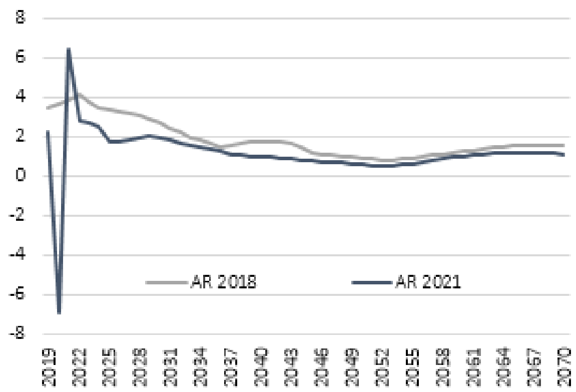

Figure 6.3. Real GDP growth, %
(Data source: Ageing Report 2021)

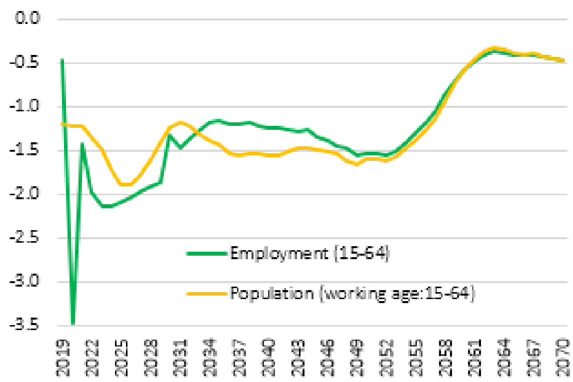

Figure 6.4. Increase of the working population and employment, %
(Data source: Ageing Report 2021)

Demographic and economic, especially, the labour market situation will have a long-term influence on the sustainability of public finances, causing an 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 already assumed 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.

According to the reference scenario, ageing-related public expenditure in 2070, as compared to 2019, will decrease by 0.6 ppt and will amount 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 in a no policy change scenario, namely, considering the legislative changes adopted until October 2020.

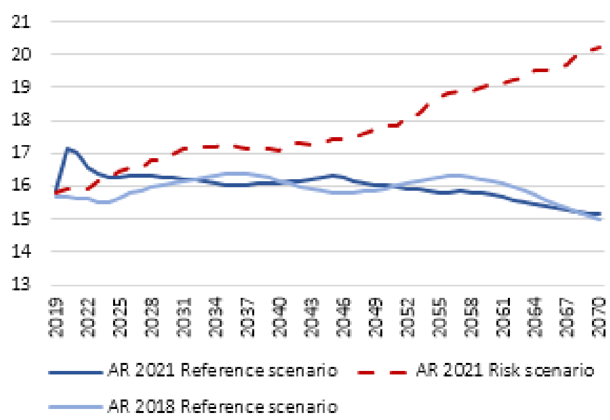

Figure 6.5. Ageing-related public expenditure in the baseline and risk scenario, % of GDP (Data source: Ageing Report 2021)

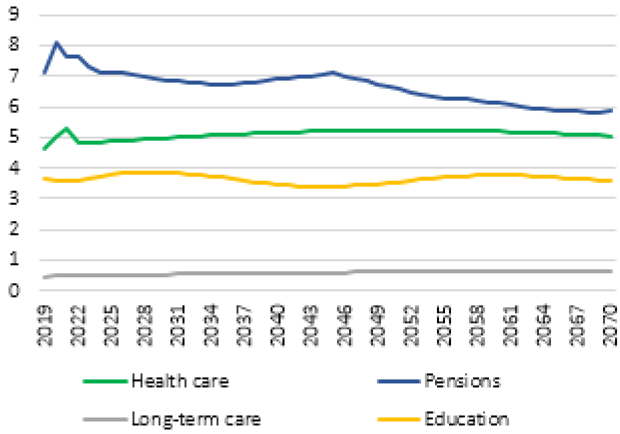

Figure 6.6. Ageing-related public expenditure by items, % of GDP (Data source: Ageing Report 2021)

Forecasts of expenditure for pensions are based upon (see Figure 6.6) the forecasts prepared by the Ministry of Welfare, implying 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 the increase of the retirement age, resulting in a decline in the number of recipients of pensions and the pre-retirement aged population staying longer in the labour market.

It should be noted that the long-term reduction of the share of pension expenditure in GDP will, most likely, improve fiscal sustainability assessment, which the EC will prepare in the second half of this year; however, at the same time, the issue on the sufficiency of pensions remains open.

When preparing the forecasts, the following legislative changes were mainly considered:

- Starting from 2014, the retirement age is being gradually increased – by three months annually, until the age of 65 years will be reached in 2025. Persons whose insurance period is at least 30 years are eligible to retire earlier – two years before reaching the general retirement age.
- From 2018, when the persons, whose insurance period is less than 15 years and who are not eligible for the State old-age pension, in accordance with the Law on State Social Allowances, reach retirement age, they shall be granted the State social security allowance (benefit) disbursed from the State basic budget funds. The necessary insurance period as of 2025 – 20 years.
- From 1 October 2019, the actual consumer price index and 80% (previously – 70%) of the real growth percentage of the sum of wages of security (insurance) contributions will be applied in the pension indexation for the old-age pensions calculated for 45 and more years of the insurance period.

- From 1 October 2019, the amount of supplement per each year of insurance period accrued up to 31 December 1995 (EUR 1.50 for pensions granted up to 1996 and EUR 1 for pensions granted from 1997), is revised, considering the actual consumer price index and 50% of the real growth percentage of the sum of wages of security (insurance) contributions.
- Starting from 2020, it is possible to leave the State-funded pension capital as inheritance or to add it to the pension capital of the designated person, in the case if a person dies before retirement age.
- On 1 October 2020, pensions and remuneration or the amount of the parts thereof not exceeding EUR 454 per month were indexed. Old-age, disability, service and survivor's pensions and remuneration granted or recalculated until 30 September 2020 are subject to indexation.

It is forecast 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 reference scenario, the Working Group has also developed several alternative scenarios by different assumptions, and, in the risk scenario, it is forecast that the public expenditure related to ageing of the population, contrary to the reference scenario, as compared to 2019, might increase by 4.4 ppt, and reach 20.2% of GDP in 2070. In the risk scenarios, 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.

6.2 State-Issued Guarantees

The Law On the State Budget for 2021 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 "Development Financial Institution Altum".

Also, in order to ensure the possibility for population to keep their workplaces and the employers to keep professionals on the job in the state of emergency caused by COVID-19, on the basis of the Law On Measures for the Prevention and Suppression of Threat to the State and Its Consequences Due to the Spread of COVID-19, a guarantee was issued on behalf of the Republic of Latvia to the EC regarding participation in the EU support mechanism "For mitigation of unemployment risks in an emergency (SURE)" in the amount of EUR 57.1 million.

The total amount of the State guaranteed loans at the end of 2021 was EUR 578.9 million, which consisted of the paid out, but not yet repaid, part of the State guaranteed loans in the amount of EUR 411.1 million, and the non-paid, but still available, part of the State guaranteed loans issued on behalf of the State amounting to EUR 167.8 million.

The total balance of the State guaranteed loans as at the end of 2021 was EUR 411.1 million or 1.2% of GDP (see Figure 6.7), which is EUR 130.0 million less than at the end of 2020 and can be explained by the complete fulfilment of the guarantees taken over by medical institutions and issued on behalf of the State in the amount of EUR 128.7 million.

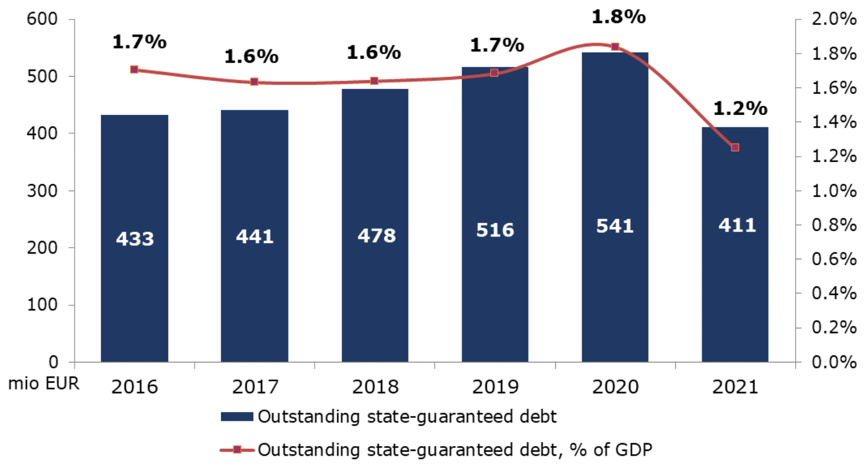

Figure 6.7. State-guaranteed loans outstanding at the end of the respective year (MEUR)

In the State-guaranteed loan portfolio, the largest part is made up by guarantees to JSC "Development Financial Institution Altum" regarding the guarantees issued by the JSC " Development Financial Institution Altum" to credit institutions for farmers' borrowings (over-guarantees), guarantees to the European Investment Bank for borrowings issued by the JSC "Development Financial Institution 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 280.4 million), guarantees for students and study crediting (EUR 57.7 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 State guaranteed loans portfolio will consist of the support to small and medium enterprises and implementation of the support programmes of other countries.

Notwithstanding the economic downturn caused by COVID-19, up to now, it has not caused a considerable impact on the fulfilment of the obligations of the State guarantees. However, for the time being, it is impossible to estimate the impact on the guarantees issued on behalf of the State which will be caused by potential COVID-19 outbreaks, the global energy price rise and Russia's invasion of Ukraine.

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. Therefore, the achievable financial indicators, included in the Framework Law, have legally binding force and the drafting of the Annual State Budget Law, as well as drafting of further Framework Laws, shall be based on these indicators.

The Framework Law is developed every year for the next three-year period. For the first and the second year of each following period of the Framework Law, the indicators set in the previous Framework 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 Framework 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 Framework Law is the main tool to ensure compliance with the fiscal discipline.

The first year of the Framework Law operating period is elaborated in detail in the Annual State Budget Law. For each year of the Framework Law period, the medium-term budget objectives and priority development directions determined in the National Development Plan are specified, formulation of the fiscal policy objectives of the government, 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 Framework Law for 2015-2017, the Fiscal Risk Declaration was developed for the first time, aiming to ensure the overall management of fiscal risks, as well as stability of fiscal indicators in the medium term. Even though the LBFM states that the Framework Law is to be developed in spring and submitted to the Saeima by 15 May of the relevant year, in fact, in accordance with the Transitional Provisions, the Framework Law is prepared in autumn and submitted to the Saeima concurrently with the State Budget Law by October 15 of the relevant year.

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 Annual State Budget Law shall be approved by the Saeima.

When planning the expenditure of the State budget, the February expenditure is calculated and agreed on first. Calculation of the February expenditure and the principles of its coherence with the Framework Law is determined by the 11 December 2012 Cabinet Regulation No. 867 Procedure for establishing ceilings on the total amount of the State budget expenditure and on the total amount of the State budget expenditure for each ministry and other central State institutions for the medium term. Thus, the necessary amount of expenditure is determined in order to ensure the execution of the State functions at a constant level. Base expenditure shall be approved by the Cabinet.

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

The ministries and other central State institutions shall prepare proposals for the priority measures to be supported, if in the relevant following financial years funds are available for financing of 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 Framework 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 Framework Law (with explanations, fiscal risks declaration, fiscal discipline supervision report of the Fiscal Discipline Council) and Draft Annual State Budget Law (with explanations) 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 Annual 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 Annual State Budget Law include a description of the macroeconomic development scenario, fiscal review, 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 State financial obligations (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 expenditures 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 Framework Law and the Draft Annual 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 annual Draft State Budget Law and Draft Framework Law, negotiations between the LALRG and the MoF are being held, as a result of which a Cabinet and LALRG Draft Protocol is 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 annual Draft Annual State Budget Law and Draft Framework Law, when the Cabinet submits it to the Saeima.

If, at the beginning of the financial year, the Annual 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 for the relevant year by Framework Law 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 Annual 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 planning and implementation of the 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. Public Finance Statistical Management

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 of 21 May 2013 on the European system of national and regional accounts in the European Union (hereinafter the “ESA 2010”).

The framework of the 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 Clause 6 of the 10 December 2013 Cabinet Regulation No. 1456 “Regulation Regarding Classification of Institutional Sectors”, the CSB prepares and maintains the list of the general government sector. In order to prepare the list and resolve upon the entities to be included therein, the CSB takes into account the ESA 2010 requirements, as well as the principles defined in the EU Statistical Office (hereinafter “Eurostat”) Handbook on Government Deficit and State Debt, which prescribe to refer the capital companies controlled and mainly financed by the State and local governments to the general government sector.

As at 31 December 2021, in the general government sector there were 780 independent budgetary institutions, of which 225 institutions were in the central government subsector; 554 institutions – in the local government subsector and one institution – in the social security fund subsector; moreover, there were 144 capital companies controlled and financed by the State and local governments, of which 56 capital companies were controlled by the State, 88 capital companies – controlled by local governments.

The CSB, on a quarterly basis, calculates the following general government sector indicators: revenue, expenditure, deficit, debt, and prepares the general government quarterly financial accounts. Information is posted on the CSB website and sent to Eurostat three months after the expiry of the reporting period.

Moreover, the CSB each year within the set terms, by 1 April (provisional data) and by 1 October (final data) prepares and submits Eurostat the general government budget deficit and debt notification (hereinafter the “Notification”).

The Notification is prepared in accordance with the requirements of the 22 December 2015 Cabinet Regulation No. 756 “Procedure by Which the Notification of the General Government Budget Deficit and Debt Shall be Prepared”. Institution responsible for the preparation of the Notification and submission thereof to Eurostat is the CSB, which carries out regular inter-institution working group meetings. Specialists from the MoF, the Treasury, Central Finance and Contracting Agency of the Republic of Latvia, the Ministry of Defence and the State Social Security Agency are involved in the preparation of the Notification. If necessary, 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 the national evaluation of how the conformity of the fiscal indicators to the provisions of the Stability and Growth pact is ensured, with the aim of implementing sustainable public finances and the coordination of fiscal policy between Member States.

Council Directive 2011/85/EU of 8 November 2011 on the requirements of budgetary frameworks of the Member States sets out detailed rules for the EU member States, in order to strengthen the EU fiscal and economic governance, and not to form an excessive budget deficit. The fiscal data considered within the framework of Directive 2011/85/EU are published on the MoF website. Besides, a detailed transition table is available on the MoF website regarding budget data from the cash flow according to national classification to the general government sector data according to the ESA 2010 methodology. The following information is made public on a regular basis:

- fiscal data (monthly and quarterly data);
- general government sector guarantees (annual data);
- non-performing loans of the general government sector (annual data);
- adjusted value of the off-balance sheet public and private partnerships (annual data);
- liabilities of public capital companies (annual data);
- the value of the general government sector shareholding in the capital of the capital company (annual data).

ANNEXES

Table 1a. Growth and related factors‡

	ESA code	2021†	2021†	2022	2023	2024	2025
		MEUR	Growth, %				
1. GDP at 2015 prices	B1*y	27 904	4.8	2.1	2.5	3.3	3.4
2. GDP at current prices	B1*y	32 917	11.8	10.9	6.8	6.1	5.8
GDP by expenditure at 2015 prices							
3. Private consumption	P3	15 601	4.8	3.7	4.4	4.0	4.0
4. Public consumption	P3	5 377	4.4	0.8	0.6	0.5	0.5
5. Gross fixed capital formation	P51	6 774	3.0	1.9	4.7	4.8	3.0
6. Changes in inventories and acquisition of valuables	P52+P53	2 788	-	-	-	-	-
7 Exports	P6	18 138	6.2	-3.0	-0.1	4.0	5.0
8. Imports	P7	20 773	13.5	-2.0	1.7	3.7	4.0
Contribution to GDP growth							
9. Final domestic demand			4.3	2.7	3.7	3.6	3.2
10. Changes in inventories and acquisition of valuables	P52+P53		5.8	-0.1	0.0	0.0	0.0
11. Export-import balance	B11		-5.3	-0.5	-1.3	-0.2	0.2

† 2021 statistics are from the CSB as at 28.02.2022
‡ Scenario of March 2022 of the forecast

Table 1b. Price changes‡

	ESA code	2021	2021†	2022	2023	2024	2025
		level	Growth, %				
1. GDP deflator			6.7	8.7	4.2	2.7	2.3
2. Private consumption deflator			3.4	8.5	3.5	2.5	2.0
3. HICP changes (year to year)			3.3	8.5	3.5	2.5	2.0
4. Public consumption deflator			3.2	-2.8	1.3	1.5	1.5
5. Investment deflator			4.4	7.8	4.4	3.5	3.0
6. Export (goods and services) deflator			11.4	15.1	5.0	3.0	3.0
7 Import (goods and services) deflator			9.7	13.0	4.0	4.0	3.5

† 2021 statistics are from the CSB as at 28.02.2022
‡ Scenario of March 2022 of the forecast

Table 1c. Labour market development‡

	ESA code	2021	2021	2022	2023	2024	2025
		level	Growth, %				
1. Employment, persons, thousand		864	-3.2	1.3	0.4	0.0	0.0
2. Employment, work hours per employed		1 473	5.1	0.0	0.0	0.0	0.0
3. Unemployment rate (%)			7.6	7.6	6.7	6.2	5.9
4. Labour productivity, per capita			8.3	0.8	2.1	3.3	3.4
5. Labour productivity, per working hour			3.0	0.8	2.1	3.3	3.4
6. Remuneration of employees, MEUR, at current prices	D.1	15 330	1.5	5.2	6.1	5.3	5.0
7 Gross wage, EUR		1 277	11.7	6.0	5.7	5.3	5.0

‡ Scenario of March 2022 of the forecast

Table 1d. Sectoral balances‡

% of GDP	ESA code	2021†	2022	2023	2024	2025
1. Current and capital account	B.9	-1.4	1.2	1.0	0.6	0.6
of which:						
- Balance of goods and services		-2.1	-1.6	-2.0	-2.5	-2.3
- Balance of income and transfers		-0.8	1.1	1.0	1.0	1.6
- Capital account		1.5	1.7	2.1	2.0	1.3
2. Net lending / borrowing in the private sector	B.9	5.9	7.7	3.4	2.4	1.6
3. Net lending / borrowing in the general government sector	EDP B.9	-7.2	-6.5	-2.4	-1.8	-0.9
4. Statistical discrepancy		*0*	*0*	*0*	*0*	*0*

† 2021 statistics are from the CSB as at 28.02.2022

‡ Scenario of March 2022 of the forecast

Table 2a. General government budget development at no policy change (forecasts of March 2022)

	ESA code	2021	2021	2022	2023	2024	2025
		MEUR	% of GDP				
Net lending (+) or borrowings (-) (B.9) by sub-sectors							
1. General government	**S.13**	**2 378.4**	**-7.2**	**-6.5**	**-2.8**	**-2.3**	**-1.7**
2. Central government	S.1311	-2 443.4	-7.4	-6.1	-2.4	-2.0	-1.3
3. State government	S.1312						
4. Local government	S.1313	-113.8	-0.3	-0.5	-0.3	-0.3	-0.4
5. Social security funds	S.1314	178.7	0.5	0.2	-0.2	0.0	0.1
General government (S.13)							
6. Total revenue	**TR**	**12 644.5**	**38.4**	**35.9**	**36.0**	**35.1**	**34.4**
7 Total expenditure	TE	15 023.0	45.6	42.4	38.8	37.3	36.1
8. Budget balance	B.9	-2 378.4	-7.2	-6.5	-2.8	-2.3	-1.7
9. Interest expenditure	D.41	201.9	0.6	0.6	0.6	0.6	0.6
10. Primary balance		-2 176.6	-6.6	-5.9	-2.2	-1.6	-1.1
11. One-off and other temporary measures[18]		- 2 057.4	-6.3	-2.8	-0.4	-0.3	-0.3
Components of revenue							
12. Total taxes (12=12a+12b+12c)		**6 876.6**	**20.9**	**19.4**	**19.3**	**19.1**	**19.0**
12a. Production and import taxes	D.2	4 476.8	13.6	12.9	12.9	12.8	12.6
12b. Current income and wealth taxes	D.5	2 396.6	7.3	6.5	6.4	6.3	6.3
12c. Capital taxes	D.91	3.2	0.0	0.1	0.0	0.0	0.0
13. Social contributions	D.61	3 312.5	10.1	9.6	9.5	9.4	9.3
14. Property income	D.4	265.9	0.8	0.6	0.4	0.2	0.2
15. Other revenue		2 189.5	6.7	6.3	6.8	6.3	5.9
16. Total revenue	TR	12 644.5	38.4	35.9	36.0	35.1	34.4
Tax burden (D.2[19]+D.5+D.61+D.91-D.995)		10 252.2	31.1	29.2	29.0	28.7	28.5
Components of expenditure							
17. Remuneration for employees and intermediate consumption	**D.1+P.2**	**6 084.8**	**18.5**	**16.9**	**15.9**	**15.1**	**14.6**
17a. Remuneration for employees	D.1	3 869.5	11.8	10.9	10.1	9.7	9.3
17b. Intermediate consumption	P.2	2 215.3	6.7	6.0	5.8	5.4	5.3
18. Social payments (18=18a+18b)		4 621.4	14.0	12.9	12.4	12.0	11.8
of which unemployment benefits		120.9	0.4	0.4	0.4	0.4	0.3
18a. Social transfers through market producers	D.6311, D.63121, D.63131	554.6	1.7	0.7	0.7	0.6	0.6
18b. Social transfers, other than transfers in kind	D.62	4 066.8	12.4	12.2	11.7	11.4	11.2
19.=9 Interest expenditure	D.41	201.9	0.6	0.6	0.6	0.6	0.6
20. Subsidies	D.3	314.1	1.0	0.8	0.8	0.7	0.7
21. Gross total fixed capital formation	P.51	1 638.7	5.0	5.9	5.5	5.7	5.6
22. Capital expenditure transfers	D.9	95.6	0.3	0.1	0.1	0.1	0.1
23. Other expenditure		2 066.5	6.3	5.2	3.6	3.1	2.8
24.=7. Total expenditure	TE	15 023.0	45.6	42.4	38.8	37.3	36.1
Government consumption	P.3	6 638.3	20.2	18.0	16.8	16.0	15.2

[18] In 2021: 0.15% of GDP: revenue from seizure of proceeds of crime; -6.4% of GDP: support for mitigating the consequences of COVID-19; -0.01% of GDP: measures for mitigation of energy price rise.
In 2022: -1.8% of GDP: support for mitigating the consequences of COVID-19; -1.0% of GDP: measures for mitigation of the energy price rise.
In 2023: -0.2% of GDP: support for mitigating the consequences of COVID-19; -0.1% of GDP: investments in defence.
In 2024: -0.1% of GDP: support for mitigating the consequences of COVID-19; -0.2% of GDP: investments in defence.
In 2025: -0.3% of GDP: investments for defence.

[19] Including share of taxes collected by the EU budget.

Table 2b. Forecasts with no policy change

	2021	2021	2022	2023	2024	2025
	MEUR	% of GDP				
1. Total revenue with no policy change	12 644.5	38.4	35.9	36.0	35.1	34.4
2. Total expenditure with no policy change	15 023.0	45.6	42.4	38.3	36.9	35.4

Table 2c. Expenditure excluded from the expenditure benchmark

	2021	2021	2022	2023	2024	2025
	MEUR	% of GDP				
1. Expenditure for foreign financial aid projects consistent with the received foreign financial aid revenue	680.1	2.1	2.4	3.1	2.9	2.6
1.a of which capital expenditure (gross fixed capital formation) which corresponds to the received foreign financial assistance revenue	234.8	0.7	1.4	1.5	1.5	1.3
2. Cyclical expenditure for unemployment benefits	9.4	0.0	0.0	0.0	0.0	0.0
3. Discretionary revenue measures	232.0	0.7	0.1	-0.2	-0.3	0.0
4. Revenue increase mandated by law						

Table 3. General government expenditure by function at no policy change

% of GDP	COFOG code	2020	2025
1. General public services	1	4.0	3.3
2. Defence	2	2.5	2.5
3. Public order and safety	3	2.3	1.9
4. Economic affairs	4	7.0	6.6
5. Environmental protection	5	0.6	0.2
6. Housing and community amenities	6	1.2	0.6
7 Health	7	4.8	3.7
8. Recreation, culture and religion	8	1.4	0.9
9. Education	9	5.9	4.4
10. Social protection	10	13.5	11.9
11. Total expenditure	**TE**	**43.1**	**36.1**

4. Table. General government debt developments and contribution to changes in the debt in 2021-2025

March scenario						
% of GDP	ESA code	**2021**	**2022**	**2023**	**2024**	**2025**
1. Gross debt		**44.8%**	**45.7%**	**45.2%**	**44.5%**	**43.4%**
2. Changes in gross debt		**6.0%**	**5.3%**	**2.5%**	**1.9%**	**1.3%**
Contribution to changes in gross debt						
3. Primary balance		**-6.6%**	**-5.9%**	**-1.8%**	**-1.2%**	**-0.4%**
4. Interest payments	**EDP D.41**	**0.6%**	**0.6%**	**0.6%**	**0.6%**	**0.6%**
5. Stock-flow adjustments		**-1.2%**	**-1.2%**	**0.1%**	**0.1%**	**0.4%**
Implicit interest rate on government debt		**1.6%**	**1.4%**	**1.4%**	**1.5%**	**1.4%**
Other variables						
6. Liquid financial assets		11.1%				
7 Net financial debt (7=1-6)		33.7%				
8. Debt amortisation		4.3%	1.7%	3.9%	2.4%	2.6%
9. Share of debt denominated in foreign currency		0.0%	0.0%	0.0%	0.0%	0.0%
10. Average maturity		8.49 years				

5. Table. Cyclical development at no policy change

% of GDP	ESA code	2021	2022	2023	2024	2025
1. GDP growth at constant prices (%)	**B1y**	**4.8**	**2.1**	**2.5**	**3.3**	**3.4**
2. Actual budget balance	B.9	-7.2	-6.5	-2.8	-2.3	-1.7
3. Interest expenditure	D.41	0.6	0.6	0.6	0.6	0.6
4. One-off and other temporary measures[20]		-6.3	-2.8	-0.4	-0.3	-0.3
5. Potential GDP growth (%)		2.7	3.0	3.2	3.3	3.3
input:						
- of employment		-0.3	-0.2	-0.1	-0.1	-0.1
- of capital		1.0	1.1	1.1	1.1	1.1
- of total manufacturing factors' productivity		1.9	2.1	2.2	2.3	2.4
6. Gap between actual and potential GDP (% of the potential GDP)		-1.7	-0.6	0.0	0.1	0.2
7 Cyclical component of the budgetary balance		-0.7	-0.2	0.0	0.0	0.1
8. Cyclically adjusted balance (2-7)		-6.6	-6.3	-2.9	-2.3	-1.7
9. Cyclically adjusted primary balance (8+3)		-6.0	-5.7	-2.2	-1.7	-1.1
10. Structural balance (8-4)		-0.3	-3.5	-2.5	-2.0	-1.5

[20] In 2021: 0.15% of GDP: revenue from seizure of proceeds of crime; -6.4% of GDP: support for mitigating the consequences of COVID-19; -0.01% of GDP: measures for mitigation of energy price rise.
In 2022: -1.8% of GDP: support for mitigating the consequences of COVID-19; -1.0% of GDP: measures for mitigation of the energy price rise.
In 2023: -0.2% of GDP: support for mitigating the consequences of COVID-19; -0.1% of GDP: investments in defence.
In 2024: -0.1% of GDP: support for mitigating the consequences of COVID-19; -0.2% of GDP: investments in defence.
In 2025: -0.3% of GDP: investments for defence.

Table 6. Comparison with forecasts of the Stability Programme 2021-2024 (forecasts of March 2022 with no policy change)

	ESA code	2021	2022	2023	2024	2025
GDP growth (%)	B1y					
2021		3.0	4.5	3.2	2.8	-
2022		4.8	2.1	2.5	3.3	3.4
Changes		1.8	-2.4	-0.7	0.5	-
Actual budget balance (% of GDP)	B.9					
2021		-9.3	-2.7	-1.3	-0.3	-
2022		-7.2	-6.5	-2.8	-2.3	-1.7
Changes		2.1	-3.8	-1.5	-2.0	-
Total general government debt (% of GDP)						
2021		48.9	50.3	48.8	48.5	-
2022		44.8	45.7	45.2	44.5	43.4
Changes		-4.1	-4.6	-3.6	-4.0	-

Table 7. Sustainability of Public Finances[21]

% 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

[21] Data source: *2021 Ageing Report*

7.a. Contingent Liabilities

% of GDP	2021
State and local government guarantees	**2.0%**

Table 8. External environment basic assumptions‡

	2021	2022	2023	2024	2025
Short-term interest rate in Eurozone (annual average)	-0.5	-0.4	0.0	0.0	0.0
Long-term interest rate in Eurozone (annual average)	-0.4	0.0	0.1	0.1	0.1
EUR/USD exchange rate (annual average)	1.18	1.13	1.13	1.13	1.13
Nominal effective exchange rate in the EU	1.6	-1.2	0.0	0.0	0.0
World GDP, excluding EU, growth at constant prices, %	5.7	4.2	3.8	3.4	3.4
EU GDP growth at constant prices, %	5.3	4.0	2.8	2.0	2.0
World goods and services trade volumes changes on the EU export markets, excluding EU, %	9.4	4.8	4.6	4.0	4.0
World goods and services import volumes changes, excluding EU, %	9.3	5.5	4.6	4.0	4.0
Oil price (Brent, USD/barrel)	70.8	98.6	91.5	84.4	84.4

‡ Scenario of March 2022 of the forecast

Table 9. Amount of guarantees

Measure		Date of approval	Maximum amount of indirect guarantees (% of GDP)[22]	Actual amount (% of GDP)
COVID-19	**Loan guarantees**	**24.03.2020**	**0.25**	**0.24**
	Portfolio guarantees	24.03.2020	0.01	0.01
	Guarantees for performers of economic activity	16.06.2020	0.04	0.01
		Total	0.30	0.26
Other				
		Total		
Total			**0.30**	**0.26**

[22] GDP of 2022 used.

Table 10. RRF impact

Revenue from RRF transfers (% of GDP)							
	2020	**2021**	**2022**	**2023**	**2024**	**2025**	**2026**
RRF revenue included in the general government forecasts	**0.0**	**0.0**	**0.4**	**1.0**	**1.2**	**1.0**	**0.7**
RRF reimbursement (cash flow) from the EU	0.0	0.7	0.6	1.3	1.0	0.7	0.3

Expenditure financed from RRF transfers (% of GDP)							
	2020	2021	2022	2023	2024	2025	2026
CURRENT EXPENDITURE	**0.0**	**0.00**	**0.1**	**0.4**	**0.4**	**0.4**	**0.2**
Gross fixed capital formation P.51g	0.0	0.00	0.2	0.7	0.8	0.7	0.5
Capital transfer D.9							
CAPITAL EXPENDITURE	0.0	0.0	0.2	0.7	0.8	0.7	0.5
Other costs financed from RRF transfers (% of GDP)							
	2020	2021	2022	2023	2024	2025	2026
Tax revenue reduction							
Other costs affecting revenue							
Financial transactions							

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