EUROPEAN
COMMISSION

Brussels, 22.11.2022
C(2022) 9515 final

COMMISSION OPINION

of 22.11.2022

on the Draft Budgetary Plan of Latvia

{SWD(2022) 950 final}

(Only the Latvian text is authentic)

COMMISSION OPINION

of 22.11.2022

on the Draft Budgetary Plan of Latvia

(Only the Latvian text is authentic)

GENERAL CONSIDERATIONS

1. Regulation (EU) No 473/2013 sets out provisions for enhanced monitoring of budgetary policies in the euro area, to ensure that national budgets are consistent with the economic policy guidance issued in the context of the Stability and Growth Pact and the European Semester for economic policy coordination.

2. Article 6 of Regulation (EU) No 473/2013 requires Member States to submit annually to the Commission and to the Eurogroup a Draft Budgetary Plan by 15 October, presenting the main aspects of the budgetary outlook of the general government and its subsectors for the forthcoming year.

3. The general escape clause of the Stability and Growth Pact has been active since March 2020[1]. On 23 May 2022, the Commission indicated, in its Communication on the European Semester,[2] that heightened uncertainty and strong downside risks to the economic outlook in the context of war in Europe, unprecedented energy price hikes and continued supply chain disturbances warrant the extension of the general escape clause of the Stability and Growth Pact through 2023 and it considered that the conditions to deactivate it as of 2024 were met. The continued activation of the general escape clause in 2023 will provide the space for national fiscal policy to react promptly when needed, while ensuring a smooth transition from the broad-based support to the economy during the pandemic times towards an increasing focus on temporary and targeted measures and fiscal prudence required to ensure medium-term sustainability.[3]

4. The Recovery and Resilience Facility, as established by Regulation (EU) 2021/241, provides financial support for the implementation of reforms and investment, notably to promote the green and digital transitions, thereby strengthening the economies' resilience and potential growth. Part of this support is in the form of non-repayable financial support ("grants"), entailing a fiscal impulse financed by the Union. Together with cohesion policy funds and the Just Transition Mechanism, the RRF is supporting a fair and inclusive recovery in the EU in line with the European Pillar of Social Rights. It also boosts growth and job creation in the medium and long term, and thereby strengthens sustainable public finances. According to the Commission

[1] Communication from the Commission to the Council on the activation of the general escape clause of the Stability and Growth Pact, COM(2020) 123 final of 20 March 2020.

[2] COM(2022) 600 final.

[3] On 17 June 2022, the Council agreed its recommendations on the 2022 National Reform Programmes and the opinions on the 2022 Stability and Convergence Programmes, which takes into account the continuation of the Stability and Growth Pact's general escape clause into 2023. (See: https://www.consilium.europa.eu/en/meetings/ecofin/2022/06/17/)

proposal of 18 May 2022,[4] the Facility should also aim at increasing the resilience of the Union energy system by reducing dependence on fossil fuels and diversifying energy supplies at Union level ('REPowerEU objectives').

5. On 12 July 2022, in the recommendations delivering Council opinions on the 2022 Stability Programmes,[5] the Council recalled that the overall fiscal stance is currently best measured as the change in primary expenditure (net of discretionary revenue measures and excluding temporary emergency measures related to the COVID-19 crisis), including expenditure financed by non-repayable support (grants) from the Recovery and Resilience Facility and other Union funds, relative to medium-term potential growth[6]. Going beyond the overall fiscal stance, in order to assess whether national fiscal policy is prudent and its composition is consistent with the green and digital transitions, energy security and ensuring social and economic resilience, attention is also paid to the evolution of nationally financed[7] primary current expenditure (net of discretionary revenue measures and excluding temporary emergency measures related to the COVID-19 crisis) and investment.

6. The shocks unleashed by the Russian invasion of Ukraine are impacting the EU economy both directly and indirectly, setting it on a path of lower growth and higher inflation. Intensifying and broadening inflationary pressures have been prompting faster normalisation of monetary policy in the euro area. Public spending on measures containing the social and economic impact of high energy costs, on security and defence and on humanitarian assistance to the displaced persons from Ukraine is weighing on public finances. The specific nature of the macroeconomic shock imparted by Russia's invasion of Ukraine, as well as its long-term implications for the EU's energy security needs, call for a careful design of fiscal policy in 2023. A broad-based fiscal impulse to the economy in 2023 does not appear warranted. The focus should instead be on protecting the vulnerable, allowing automatic stabilisers to operate and providing temporary and targeted measures to mitigate the impact of the energy crisis and to provide humanitarian assistance to people fleeing from Russia's invasion of Ukraine, while maintaining the agility to adjust, if needed. Fiscal policy should combine higher investment with controlling the growth in nationally financed primary current expenditure. Full and timely implementation of the Recovery and Resilience Plans is key to achieving higher levels of investment. Fiscal policies should aim at preserving debt sustainability as well as raising the growth potential in a sustainable manner, thus also facilitating the task of monetary policy to ensure the timely return of inflation to the ECB's 2% medium-term target. Fiscal plans for 2023 should be anchored by prudent medium-term adjustment paths reflecting fiscal sustainability challenges associated with high debt-to GDP levels that have increased further due to the pandemic as well as reforms and investment challenges associated with the twin transition, energy security and social and economic resilience.

7. Russia's war of aggression against Ukraine has resulted in substantial additional increases in and volatility of the prices of energy. The price shock in imported energy

---

4 COM(2022) 231 final.

5 Council Recommendation of 12 July 2022 on the National Reform Programme of Latvia and delivering a Council opinion on the 2022 Stability Programme of Latvia, OJ C 334, 1.9.2022, p. 112.

6 The estimates on the fiscal stance and its components in this Opinion are Commission estimates based on the assumptions underlying the Commission 2022 autumn forecast. The Commission's estimates of medium-term potential growth do not include the full positive impact of reforms that are part of the Recovery and Resilience Plan and that can boost potential growth.

7 Not financed by grants under the Recovery and Resilience Facility or other Union funds.

implies a substantial terms of trade loss to Member States' economies. In parallel, the exceptionally high temperatures in summer 2022 pushed up demand for electricity, while, at the same time, energy production from certain technologies has been significantly below historical levels due to technical and weather-dependant circumstances. All Member States have been negatively affected by the current energy crisis, albeit to a different extent, calling for a rapid and coordinated response.

8. Given that budgetary resources are limited and need to be used in the most efficient way, in order to manage a durable and equitable adjustment across society, the quality and design of the policy response is highly important. Therefore, also in line with the Council Regulation on an emergency intervention to address high energy prices adopted on 6 October 2022, measures should focus on providing temporary support, targeted to households and firms most vulnerable to energy price increases, while maintaining the right incentives to reduce energy demand and increase energy efficiency, in line with the European Green Deal[8]. Policies should also help reducing the energy consumption and develop the energy autonomy of the Union.

CONSIDERATIONS CONCERNING LATVIA

9. On 11 October 2022, Latvia submitted the Draft Budgetary Plan for 2023. On that basis, the Commission has adopted the following opinion in accordance with Article 7 of Regulation (EU) No 473/2013.

   The Draft Budgetary Plan was submitted by the outgoing government on the basis of unchanged policies; therefore, the figures shown for the 2023 government deficit and other fiscal variables do not represent policy targets.

10. On 12 July 2022, the Council recommended that Latvia[9] takes action to ensure in 2023 that the growth of nationally financed primary current expenditure is in line with an overall neutral policy stance[10], taking into account continued temporary and targeted support to households and firms most vulnerable to energy price hikes and to people fleeing Ukraine. Latvia should stand ready to adjust current spending to the evolving situation. Latvia was also recommended to expand public investment for the green and digital transitions, and for energy security taking into account the REPowerEU initiative, including by making use of the Recovery and Resilience Facility and other Union funds. For the period beyond 2023, Latvia should pursue a fiscal policy aimed at achieving prudent medium-term fiscal positions.

11. On 23 May 2022, the Commission issued a report under Article 126(3) of the Treaty[11]. That report assessed the budgetary situation of Latvia, as its general government deficit in 2021 exceeded the Treaty reference value of 3% of GDP. The report concluded that the deficit criterion was not fulfilled.

---

[8] Communication from the Commission, the European Green Deal, COM(2019) 640 final.

[9] Council Recommendation of 12 July 2022 on the National Reform Programme of Latvia and delivering a Council opinion on the 2022 Stability Programme of Latvia, OJ C 334, 1.9.2022, p. 112.

[10] Based on the Commission autumn 2022 forecast, the medium-term (10-year average) potential output growth of Latvia, that is used to measure the fiscal stance, is estimated at 8.5% in nominal terms. The Commission's estimates of medium-term potential growth do not include the full positive impact of reforms that are part of the Recovery and Resilience Plan and that can boost potential growth.

[11] Report from the Commission prepared in accordance with Article 126(3) of the Treaty on the Functioning of the European Union, Brussels, 23.5.2022, COM(2022) 630 final.

12. According to the Commission 2022 autumn forecast, Latvia's economy is expected to grow by 1.9% in 2022 and decline by 0.3% in 2023, while inflation is forecast at 16.9% in 2022 and 8.3% in 2023.

According to the Draft Budgetary Plan, Latvia's economy is expected to grow by 2.8% in 2022 and 1.0% in 2023, while inflation is projected at 16.5% in 2022 and 6.5% in 2023. In the Commission's forecast investments, exports and public consumption are projected to be the growth drivers, while private consumption is expected to decline. In turn, the Draft Budgetary Plan projects private consumption, investments and exports to be the growth drivers. These differences in the projections are mainly due to timing of their production – the Commission's forecast takes into account the flash estimate for the third quarter of 2022, which contrary to earlier expectations showed a year-on-year decline in GDP. The differences in forecast for private consumption are due to differing assumptions about household savings' capacity to cushion the decline in real disposable income, while both forecasts expect similar wage growth and inflation. Overall, the macroeconomic assumptions underpinning the Draft Budgetary Plan are markedly favourable in both 2022 and 2023.

Latvia complies with the requirement of Regulation (EU) No 473/2013 since the draft budget is based on independently endorsed macroeconomic forecasts.

13. The Draft Budgetary Plan assumes that expenditure amounting to 0.3% of GDP in 2022 and 0.9% in 2023 will be financed by non-repayable financial support (grants) from the Recovery and Resilience Facility. Expenditures financed by Recovery and Resilience Facility grants will enable high-quality investment and productivity-enhancing reforms without a direct impact on the general government deficit and debt of Latvia. The Commission 2022 autumn forecast includes a similar amount of expenditure financed by Recovery and Resilience Facility grants.

14. In its 2023 Draft Budgetary Plan, Latvia's general government deficit is planned to decrease from 7.0% of GDP in 2022 to 3.3% of GDP in 2023, thanks to decreased expenditures as a share of GDP while the tax revenues in all the main tax categories are projected to grow in line with the nominal GDP growth. Despite additional support measures to mitigate energy price hikes for households and companies, higher spending for social support, a spending increase in the local government budget, and additional spending on interior and justice sector employees' salaries, the total expenditure is planned to slightly decrease in nominal terms thanks to lower spending for COVID-19 support and the effect of 2022 lump-sum expenditure for the creation of national gas security which is not foreseen for 2023. The general government debt ratio is planned to increase from 42.0% of GDP in 2022 to 43.0% of GDP in 2023. These projections are in line with the Commission 2022 autumn forecast of a deficit of 7.1% of GDP in 2022 and of 3.4% in 2023 and general government debt-to-GDP ratio of 42.4% in 2022 and 44.0% in 2023, whereby the higher debt projections are due to a lower forecast of nominal GDP by the Commission.

The outlook for public finances continues to be subject to the high uncertainty that surrounds the macroeconomic projections, including macroeconomic risks related to the Russian invasion of Ukraine, energy price hikes and continued supply chain disturbances.

15. Although the Draft Budgetary Plan for 2023 was submitted on the basis of unchanged policies it does include discretionary measures for 2022 and 2023

entering into force after the adoption of the State Budget for 2022. Discretionary measures to counter the economic and social impact of the exceptional increases in energy prices and measures to provide temporary protection to displaced persons from Ukraine are described in detail in the following two paragraphs. Other discretionary measures for 2022 include expenditure for the creation of national gas security reserves, additional support for COVID-19 in the healthcare sector and capital injection in the national airline company. According to the Commission autumn 2022 forecast these measures are projected to amount to 1.7% of GDP in 2022. For 2023, the Draft Budgetary Plan includes additional expenditure for defence (which according to the Commission autumn 2022 forecast is projected at 0.3% of GDP in 2023) while it does not specifically mention other new discretionary measures.

The government deficit is impacted by the measures adopted to counter the economic and social impact of the exceptional increases in energy prices, which aggravated over the course of the summer[12]. The budgetary cost of these measures is projected in the Commission autumn 2022 forecast to amount to 2.0% of GDP in 2022 and 1.5% of GDP in 2023. They consist of measures increasing expenditure, such as price caps for centralised heating, natural gas and electricity tariffs for households, additional benefits to vulnerable households to mitigate for the energy price increase, suspension of the electricity system service tariff for companies, partial compensation on the electricity costs to all legal persons as well as grants to energy intensive manufacturers. These measures have been announced as temporary, expiring after the first half of 2023. Most of these measures do not appear targeted to vulnerable households or firms[13], and most of them do not fully preserve the price signal to reduce energy demand and increase energy efficiency[14]. As a result, the amount of temporary and targeted support to households and firms most vulnerable to energy price hikes, that can be taken into account in the assessment of compliance with the fiscal country-specific recommendation for 2023, is estimated in the Commission 2022 autumn forecast at 0.5% of GDP in 2022 and 0.1% of GDP in 2023.

The government deficit is also impacted by the costs to offer temporary protection to displaced persons from Ukraine, which in the Commission 2022 autumn forecast are projected at 0.2% of GDP in 2022 and 0.3% in 2023.

16. Based on the Commission 2022 autumn forecast and including the information incorporated in Latvia's 2023 Draft Budgetary Plan, gross fixed capital formation is expected to amount to 5.0% of GDP in 2022 and 5.3% of GDP in 2023, compared to 5.2% of GDP recorded in 2021. This includes investment for the green and digital transitions, such as greening the public transport systems, improving the energy efficiency of multi-apartment buildings and in business, modernisation of the electricity transmission and distribution networks, strengthening the response capacity of rescue services, centralising governance platforms and systems in the public sector, developing the digital skills and digitisation of processes in business,

12 Deficit developments in 2023 are also affected by the complete phasing out of COVID-19 emergency temporary measures, which are estimated in the Commission autumn 2022 forecast at 1.3% of GDP in 2022.

13 Targeted measures amount to 0.5% of GDP in 2022 and 0.1% of GDP in 2023, while untargeted measures amount to 1.5% of GDP in 2022 and 1.3% of GDP in 2023.

14 Income measures amount to 1.0% of GDP in 2022 and 0.3% of GDP in 2023, while price measures amount to 1.1% of GDP in 2022 and 1.2% of GDP in 2023.

broadband infrastructure development as well as foster digitalization in the education sector, which are funded by the Recovery and Resilience Facility and other EU funds.

17. In 2023, the fiscal stance is projected in the Commission 2022 autumn forecast to be contractionary (+ 2.3% of GDP[15]). This follows an expansionary fiscal stance in 2022 (- 2.9% of GDP).

The growth in nationally financed primary current expenditure (net of new revenue measures) in 2023 is projected to provide a contractionary contribution of 1.7 percentage points.[16] This includes the reduced impact from the support measures adopted to counter the economic and social impact of the exceptional increases in energy prices by 0.5% of GDP,[17] with temporary and targeted support measures to households and firms most vulnerable to energy price hikes accounting for 0.4 % of GDP of this reduction. This also includes higher costs to offer temporary protection to displaced persons from Ukraine (by 0.1 % of GDP).

The positive contribution to economic activity of expenditure financed by Recovery and Resilience Facility grants and other EU funds is projected to increase by 1.3 percentage points of GDP in 2023 compared to 2022. Nationally financed investment is projected to provide a contractionary contribution to the fiscal stance of 0.7 percentage points in 2023.[18]

18. The Draft Budgetary Plan does not include budgetary projections beyond 2023.

19. On 12 July 2022, the Council also recommended Latvia to broaden taxation, including of property and capital, and strengthen the adequacy of healthcare and social protection to reduce inequality. As the Draft Budgetary Plan was submitted by the outgoing government on the basis of unchanged policies it does not include new measures to address the fiscal-structural recommendation.

20. In 2023, based on the Commission's forecast and including the information incorporated in the Draft Budgetary Plan, the overall fiscal policy stance is estimated to be contractionary. This included a contractionary contribution to the overall fiscal stance from nationally-financed current expenditure. Overall, given the evolving situation, in particular the expansionary fiscal stance in 2022 and the high inflationary pressures, the growth of nationally financed primary current expenditure is in line with the recommendation of the Council. Latvia plans to finance additional investment through the RRF and other EU funds, while it does not preserve nationally financed investment. It plans to finance public investment for the green and digital transitions.

Overall, the Commission is of the opinion that the Draft Budgetary Plan for Latvia, which is based on a no-policy-change assumption, is in line with the fiscal guidance contained in the Council recommendation of 12 July 2022.

---

15 A negative (positive) sign of the indicator corresponds to an excess (shortfall) of primary expenditure growth compared with medium-term economic growth, indicating an expansionary (contractionary) fiscal policy. The fiscal stance includes the fiscal impulse funded by the Union.

16 This follows an expansionary contribution from this component of 2.0 percentage points in 2022.

17 The budgetary impact of targeted price and income measures is projected to decrease by 0.1% and by 0.2% of GDP respectively, while the budgetary impact of untargeted price and income measures is projected to increase by 0.3% and decrease by 0.5% of GDP respectively.

18 Other nationally financed capital expenditure is projected to provide a contractionary contribution of 1.2 percentage points of GDP as in 2022 Commission forecast includes the creation of national gas security reserves in 2022 but such measure is not envisaged to have any further budgetary impact in 2023.

While Latvia rapidly deployed energy measures as part of the emergency policy response to the exceptional energy price hikes, a prolongation of existing and/or an enactment of new support measures in response to high energy prices would contribute to higher growth in net nationally financed current expenditure and to an increase in the projected government deficit and debt in 2023. Therefore, it is important that Member States better focus such measures to the most vulnerable households and exposed firms, to preserve incentives to reduce energy demand, and to be withdrawn as energy price pressures diminish.

The Commission is also of the opinion that Latvia has made limited progress with regard to the structural part of the fiscal recommendations contained in the Council Recommendation of 12 July 2022 in the context of the European Semester and thus invites the authorities to accelerate progress. A comprehensive description of progress made with the implementation of the country-specific recommendations will be made in the 2023 Country Report and assessed in the context of the country-specific recommendations to be proposed by the Commission in spring 2023.

As soon as a new government takes office, and as a rule at least one month before the draft budget law is planned to be adopted by the national parliament, Latvia is invited to submit to the Commission and to the Eurogroup an updated Draft Budgetary Plan.

Done at Brussels, 22.11.2022

For the Commission
Paolo GENTILONI
Member of the Commission