Brussels, 24.2.2023
C(2023) 1392 final

COMMISSION OPINION

of 24.2.2023

on the Draft Budgetary Plan of Latvia

{SWD(2023) 51 final}

(Only the Latvian text is authentic)

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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 euro area 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 economic growth and job creation in the medium and long term, and thereby strengthens sustainable public finances. According to the

[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/)

amendments to the RRF regulation as politically agreed by the co-legislators on 14 December 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 energy and commodity price shocks and Russia's invasion of Ukraine are impacting the economies of the EU Member States both directly and indirectly, with implications on economic growth and 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.

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[4] Further to the Commission proposal of 18 May 2022, 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 ad hoc 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.

7. The price shock in imported energy implies a substantial loss in terms of trade for Member States' economies. The outlook for energy prices has significantly improved since January 2023, with European wholesale gas spot prices falling back to well-below pre-war levels, albeit still higher than 2019 prices. Gas prices are expected to remain subject to exceptional volatility in 2023 and a reversal of recent downward pressure cannot be ruled out. Furthermore, the recent decrease in wholesale spot prices of electricity and gas is set to only gradually translate into lower retail prices. 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[8], 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[9]. 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 adopted by the outgoing government on the basis of unchanged policies. Therefore, the figures shown for the 2023 government deficit and other fiscal variables did not represent policy targets. The Commission adopted an opinion on that Draft Budgetary Plan on 22 November 2022 and invited Latvia to submit an updated Draft Budgetary Plan as soon as a new government took office.

10. On 8 February 2023, Latvia submitted an updated Draft Budgetary Plan for 2023 (hereafter, "Draft Budgetary Plan"). On that basis, the Commission has adopted the following opinion in accordance with Article 7 of Regulation (EU) No 473/2013.

11. On 12 July 2022, the Council recommended that Latvia[10] takes action to ensure in 2023 that the growth of nationally financed primary current expenditure is in line with an overall neutral policy stance[11], 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.

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[8] OJ L 261I , 7.10.2022, p. 1.

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

[10] 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.

[11] Based on the Commission ad hoc forecast, the medium-term (10-year average) potential output growth of Latvia, that is used to measure the fiscal stance, is estimated at 9.1% 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.

12. On 23 May 2022, the Commission issued a report under Article 126(3) of the Treaty[12]. 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.

13. According to the Commission ad hoc forecast[13], Latvia's economy is estimated to have grown by 1.8% in 2022 and is forecast to grow by 0.1% in 2023, while inflation for 2022 was recorded at 17.2% and is forecast at 7.9% in 2023.

According to the Draft Budgetary Plan, Latvia's real GDP is estimated to have grown by 1.6% in 2022 and is forecast to contract by 0.6% in 2023, while inflation is projected at 17.3% in 2022 and at 8.5% in 2023[14]. In both forecasts public consumption is projected to be the main growth driver in 2023. However, while the Commission projects weak growth in other components, the Draft Budgetary Plan forecast expects a notable decline in private consumption and a moderate drop in investments. These differences are due to different outlooks on price developments, which are more benign in the Commission's forecast due to recent price developments. The GDP deflator for 2023 is forecast at 6.8% in the Commission's forecast and at 8.7% in the Draft Budgetary Plan. The differences between the forecasts are mainly due to the timing of their production – the outlook for price growth in 2023 has materially improved between December 2022, when the macroeconomic scenario of the Draft Budgetary Plan was produced, and February 2023. More benign price developments, explain the differences between the two forecasts both in terms of the real GDP growth and inflation. Nominal GDP growth is expected at 8.0% in both forecasts. Overall, the macroeconomic assumptions underpinning the Draft Budgetary Plan are plausible for 2022 and cautious for 2023.

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

14. The Draft Budgetary Plan assumes that expenditure amounting to 0.03% of GDP in 2022 and 0.9% in 2023 is 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's ad hoc forecast includes similar amounts of expenditure financed by Recovery and Resilience Facility grants.

15. In its Draft Budgetary Plan, Latvia's general government deficit is planned to decrease from 4.7% of GDP in 2022 to 4.2% of GDP in 2023. Tax revenue in 2023 is forecast to grow in line with the nominal GDP, while both property income and other revenue are projected to increase above the nominal GDP growth rate, mainly due to

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[12] 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.

[13] In order to assess the updated Draft Budgetary Plan for 2023, the Commission produced an ad-hoc forecast based on its 2023 winter interim forecast, extended with fiscal variables and taking into account the information on the new fiscal policy measures contained in the Plan. All other information and forecast assumptions remained unchanged, in line with the Commission 2023 winter interim forecast and its cut-off date (1 February 2023). The ad hoc forecast is published in the accompanying Fiscal Statistical Tables.

[14] The macroeconomic scenario underlying the Draft Budgetary plan was produced in December 2022. Since then, Eurostat has published the outcome for 2022 inflation at 17.2% and flash estimate for the Q4 GDP growth, which implies annual real GDP growth in 2022 at 1.8%.

higher dividends from state-owned enterprises and an expected pick-up of EU funded investment, respectively. At the same time, support to mitigate the impact of high energy prices on households and companies is planned to be lower than in 2022 and spending for COVID-19 support is to decline further. The lump-sum expenditure in 2022 for the creation of a national gas reserve is not foreseen for 2023. The general government debt ratio is planned to increase from 40.9% of GDP in 2022 to 41.9% of GDP in 2023.

These projections are broadly in line with the Commission's ad hoc forecast of a deficit of 4.8% of GDP in 2022 and of 3.9% in 2023 and of a general government debt-to-GDP ratio of 41.2% in 2022 and 42.3% in 2023. In 2023, the Commission's lower budget deficit forecast reflects lower projected government expenditure, mainly through lower projected spending on energy support measures[15] and lower inflation affecting expenditure of general government units. Meanwhile, the Commission ad hoc forecast takes a more conservative approach regarding the growth of tax revenue and foresees lower intakes from property income.

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 prices and continued supply chain disturbances.

16. The Draft Budgetary Plan contains an extensive list of discretionary expenditure and revenue measures with a total reported deficit-increasing effect of 1.4% of GDP in 2023 (consisting of measures increasing revenue by 0.3% of GDP and measures increasing expenditure by 1.6% of GDP). The main revenue measures for 2023 are additional dividend payments from state joint-stock companies in the field of energy and forest management and secondary tax revenue impacts due to public wage increases[16]. On the expenditure side, the main measures are wage increases (in the central administration, administration units abroad, independent institutions financed from the state budget and medical personnel, with a fiscal impact of 0.3% of GDP in 2023), expenditure to increase the availability of healthcare services (0.1%), and financing for science, research and higher education (0.1%). The government also plans public investment spending totalling 0.7% of GDP, including the purchase of an air defence system, special fire-fighting and rescue vehicles, and the development of the public IT system. The Commission takes account of the same expenditure measures, with similar amounts.

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[17]. The budgetary cost of these measures is projected in

[15] The Commission ad hoc forecast takes into account that the actual spending on energy support measures in 2022 turned out to be lower than initially budgeted. The forecast assumes that also for 2023 spending on energy support will be below what was initially budgeted and their budgetary cost for 2023 has therefore been adjusted downwards.

[16] The Commission does not classify these items as discretionary fiscal measures. The second-round revenue impact is not a discretionary fiscal measure but does enter the Commission forecast via macroeconomic effects. Additional dividend payments from state joint-stock companies also enter the Commission's forecast but are not treated as discretionary fiscal measures as they do not involve the changes in "normal" dividend policy, e.g., adjustments to dividend pay-out ratio.

[17] Deficit developments in 2023 are also affected by significantly lower spending related to COVID-19, including the complete phasing out of COVID-19 emergency temporary measures, which are estimated in the Commission ad hoc forecast at 1.3% of GDP in 2022.

the Commission ad hoc forecast to have amounted to 1.4% of GDP in 2022 and to fall to 0.6% of GDP in 2023[18]. 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, 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[19], and most of them do not fully preserve the price signal to reduce energy demand and increase energy efficiency[20]. 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 ad hoc 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's ad hoc forecast are projected at 0.2% of GDP in 2022 and 0.3% in 2023.

17. Based on the Commission's ad hoc forecast and including the information incorporated in Latvia's Draft Budgetary Plan, gross fixed capital formation is expected to have amounted to 4.5% of GDP in 2022 and to increase to 5.7% of GDP in 2023, compared to 5.2% of GDP recorded in 2021. This includes investment for the green and digital transitions, such as the purchase of electric vehicles for public transport, improving the energy efficiency of multi-apartment buildings and business properties, modernising the electricity transmission and distribution networks, strengthening the response capacity of rescue services, centralising governance digital platforms and systems in the public sector, developing the digital skills and digitisation of processes in businesses, broadband infrastructure development as well as fostering digitalization in the education sector, which are largely funded by the Recovery and Resilience Facility and other EU funds.

18. In 2023, the fiscal stance is projected in the Commission's ad hoc forecast to be expansionary (- 0.6% of GDP[21]). This follows an expansionary fiscal stance in 2022 (- 0.4% of GDP).

The growth in nationally financed primary current expenditure (net of new revenue measures) in 2023 is projected to provide a broadly neutral contribution of -0.2

[18] The budgetary cost of these measures both for 2022 and 2023 have been updated compared to the Commission autumn 2022 forecast based on the availability of the actual outcome data for 2022. Due to a lower than expected uptake and smaller energy price effects, the budgetary cost for 2022 has proven to be lower than initially planned by 0.5% of GDP. The budgetary cost for 2023 has been adjusted downwards by 0.9% of GDP.

[19] Targeted measures amount to 0.5% of GDP in 2022 and 0.1% of GDP in 2023, while untargeted measures amount to 0.9% of GDP in 2022 and 0.5% of GDP in 2023.

[20] Income measures amount to 1.0% of GDP in 2022 and 0.2% of GDP in 2023, while price measures amount to 0.5% of GDP in 2022 and 0.4% of GDP in 2023.

[21] 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.

percentage points.[22] 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 0.8% of GDP,[23] with temporary and targeted support measures to households and firms most vulnerable to energy price hikes accounting for 0.4 percentage points of this reduction. This also includes higher costs to offer temporary protection to displaced persons from Ukraine (by 0.1 % of GDP). Therefore, the projected broadly neutral contribution of nationally financed primary current expenditure is due to the planned phasing-out of the temporary and targeted support to households and firms most vulnerable to energy price hikes. The main drivers of growth in nationally financed primary current expenditure (net of new revenue measures) are higher public sector wages and intermediate consumption as well as expenditure on healthcare.

The positive contribution to economic activity of expenditure financed by Recovery and Resilience Facility grants and other EU funds is projected to increase by 1.2 percentage points of GDP in 2023 compared to 2022. Nationally financed investment is projected to provide an expansionary contribution to the fiscal stance of 0.3 percentage points in 2023.[24]

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

20. 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. While the Draft Budgetary Plan does not include measures to address taxation policy issues, it does include some measures fostering the availability of healthcare services, such as additional financing for state-funded medicines and for medical testing and screening, including for the oncology patients. The Plan also envisages financing for the minimum income reform and for out-of-family care support services, including for children.

21. 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 expansionary in a situation of high inflation. This includes a broadly neutral contribution to the overall fiscal stance from nationally-financed current expenditure, assuming the planned phasing out of the measures in response to high energy prices, including temporary and targeted support to vulnerable households and firms. Therefore, the growth of nationally financed primary current expenditure is in line with the recommendation of the Council, but it would risk not being in line if Latvia adopted additional energy support or other deficit-increasing measures. Latvia plans to finance additional investment through the RRF and other EU funds, while it also preserves nationally financed investment. Indeed, higher investment (funded by the

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22 This follows a broadly neutral contribution from this component of -0.1 percentage points in 2022. A negative (positive) sign of the indicator corresponds to an excess (shortfall) of this expenditure growth compared with medium-term economic growth.

23 The budgetary impact of targeted price and income measures is projected to decrease by 0.1% and by 0.3% of GDP respectively, while the budgetary impact of untargeted price measures is projected to remain stable, whereas the budgetary impact of untargeted income measures is expected to decrease by 0.5% of GDP .

24 Other nationally financed capital expenditure is projected to provide a contractionary contribution of 1.1 percentage points of GDP, as the Commission ad hoc forecast includes the creation of national gas security reserves in 2022 whereas this initiative is not envisaged to have any further budgetary impact in 2023.

EU and nationally financed) is driving the expansionary fiscal policy stance. Latvia also 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 is in line with the fiscal guidance contained in the Council recommendation of 12 July 2022.

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 Latvia 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 some 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.

Done at Brussels, 24.2.2023

For the Commission
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