LATVIJAS REPUBLIKAS FISKĀLĀS DISCIPLĪNAS PADOME

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Minutes of the meeting of the Council No Nr. 2 (77)

Riga 14 March 2025

The meeting is chaired by:
Chairwoman of the Fiscal Discipline Council - I.Šteinbuka

Participants of the meeting:

Vice-Chairman of the Fiscal Discipline Council	J.Priede
Member of the Fiscal Discipline Council	A.Jakobsons
Member of the Fiscal Discipline Council	U.Kāsiks
Member of the Fiscal Discipline Council	I.Golsts

Secretariat –

Fiscal Discipline Council secretary	N.Malnačs
Fiscal Discipline Council macroeconomics expert	V.Zaremba
Fiscal Discipline Council fiscal risks expert	I.Verpakovska

Invited person for agenda question 1 and 2:

Head of MoF Fiscal policy department	N. Sakss

Taking minutes:
Fiscal Discipline Council macroeconomics expert V. Zaremba
The meeting starts at 14:00

I.Šteinbuka opens the meeting
The **Chairwoman** of the Fiscal Discipline Council (hereinafter – the Council), **I. Šteinbuka**, opens the meeting and announces the agenda.
The Council operates in a hybrid format, conducting discussions on the agenda items via the **MS Teams** online video conferencing platform.

1. On Amendments to the Fiscal Discipline Law

Reporter: N. Sakss
Considering the new EU fiscal framework, amendments to the Fiscal Discipline Law are necessary, particularly concerning expenditure regulation. The proposed changes include:

- Retaining the structural balance but replacing the current expenditure level with a new indicator—**net expenditure growth**. This indicator will align with the parameters outlined in the EU fiscal framework, specifying which elements should be included or excluded in its calculation.
- The fiscal discipline mechanisms will maintain their existing operational model but will be based on three key numerical fiscal rules: **(i)** net expenditure growth, **(ii)** primary structural balance, and **(iii)** structural balance. The primary objective of these calculations is to determine the optimal trajectory for net expenditure growth while ensuring compliance with these three numerical fiscal rules.

However, the extent of political willingness to adopt this approach remains uncertain. An alternative option would be to retain the existing system, with the possibility of allocating net expenditure growth across line ministries and general government sectors. For example, if net government expenditure were to grow by *x%* annually, this rate could serve as a benchmark for distributing expenditures among ministries. This would represent a sector-specific approach rather than a shift toward nationally significant priorities.

Implementing these reforms would bring substantial changes to fiscal policy. While the leadership of the Ministry of Finance is committed to advancing these reforms, some resistance remains. Ongoing calculations are assessing their feasibility, but due to time constraints, certain reforms may not be incorporated into the current reform cycle.

Regarding the role of the Fiscal Discipline Council, it is proposed that the Council remains responsible for developing two key documents currently included in the annual budget law. Additionally, a formal procedure would be established for approving macroeconomic forecasts, which have been applied informally until now. Furthermore, the Council would gain the authority to employ internal experts rather than relying on external specialists.

The next steps involve drafting detailed legislative amendments, though this process has yet to begin. Currently, a conceptual discussion is underway, with more concrete proposals to follow at a later stage.

I. Šteinbuka inquired about the timetable for the proposed amendments.

N. Saks responded that the draft law is expected to be prepared by the end of the summer to allow sufficient time for the approval process in parliament by year-end.

I. Šteinbuka also raised the question of excluding defence spending from fiscal discipline rules or setting a specific threshold, such as a percentage of GDP.

N. Saks explained that the Fiscal Discipline Law already includes an escape clause, though it is highly specific and must not contradict EU regulations. While there is a possibility to temporarily exclude defence spending from fiscal balance, such kind of exemption cannot become a permanent practice.

If defence spending were to rise to 5% of GDP and become the new standard, a long-term solution would be required. **One potential short-term measure could be to exclude this increase from structural balance calculations for a limited period (e.g., four years). However, such a temporary solution is not sustainable, and legal amendments would be needed. This is particularly important since the national escape clause is expected to expire in 2029.**

Long-Term Defence Financing Strategy

Three possible long-term financing solutions for defence spending are currently under discussion:

- Reducing other expenditures to allocate more funds for defence. However, this would be politically difficult and could pose economic risks.
- Introducing a special defence tax, such as a 1% VAT increase. However, this would require strong political backing.
- Increasing the structural budget deficit from 1% to 1.5%, with the additional 0.5% strictly allocated for defence.

Given the expectations of credit rating agencies and financial markets, a clear and credible long-term financing plan for defence is essential to ensure economic stability and investor confidence.

I. Šteinbuka inquires about the mandate and capacity of the Fiscal Discipline Council, noting that there is external demand for the Council to engage in more analytical work. However, due to limited staffing and resources, it is not feasible to expand its responsibilities without additional support.

N. Saks clarifies that, under current legislation, the Fiscal Discipline Council already has the authority to provide opinions on any fiscal policy matters. However, it is not designed to function as a broad economic analysis institution. He emphasizes that instead of expanding the Council's legal mandate, efforts should focus on enhancing its capacity to effectively carry out its existing functions. As such, while its mandate is considered sufficient, additional resources and staffing are necessary for the Council to fulfill its role more effectively.

I. Šteinbuka agrees, highlighting that the Council already produces analytical reports and collaborates with institutions such as the Bank of Latvia and the Productivity Council to strengthen fiscal policy oversight.
U. Kaasiks asks how Latvia's national fiscal discipline rules will be aligned with the EU framework, particularly in cases where they may diverge. He cites defense expenditure as an example where national rules may not reflect the same exceptions allowed under EU regulations.
N. Saks explains that the EU fiscal discipline framework sets a fixed medium-term expenditure trajectory over four years, whereas Latvia's fiscal planning is structured around an annual budget cycle. This results in regular *autumn* discussions on available funding and fiscal space. The Ministry of Finance calculates fiscal space annually, ensuring compliance with both EU expenditure limits and Latvia's structural balance rules. In practice, the strictest fiscal rule is always upheld.
He further notes that in order to enhance alignment between EU and Latvian fiscal rules, Latvia has already increased its structural balance deficit target from -0.5% to -1%. This adjustment allows for greater flexibility in applying EU rules while mitigating the need for significant expenditure cuts in the state budget.
U. Kaasiks points out that given Latvia's small economy and high cyclical fluctuations, a structural balance target of -1.5% could lead to frequent nominal budget deficits exceeding 3%.
N. Saks acknowledges this concern and explains that one key objective is to phase out "one-off measures", allowing for better fiscal predictability. If the structural deficit were increased to -1.5%, even during economic downturns, Latvia's nominal deficit would likely remain within 4–5%.
He also emphasizes that even if the budget deficit surpasses 3%, EU regulations provide exemptions for relevant factors, ensuring a degree of fiscal flexibility. Moreover, Latvia's Fiscal Discipline Law does not impose an absolute restriction on exceeding the 3% deficit threshold, placing the country in a relatively secure fiscal position.
However, N. Saks stresses that under EU fiscal regulations, Latvia can raise its structural balance target to -1.5%, but this would be the maximum allowable limit. Any further increase would not be feasible, meaning that if defense spending continues to rise, alternative funding sources will be required.
I. Golsts asks about the implementation timeline for the new Fiscal Discipline Law and its impact on next year's budget preparation.
N. Saks clarifies that the new law will take effect next year, but the next budget will still be drafted in accordance with the current fiscal framework. The core fiscal requirements will remain unchanged, including adherence to net expenditure growth limits and the 1% structural balance target.
The only significant modification will relate to additional deficit for defence spending, though overall fiscal rules will remain in place.
The new law could introduce expenditure ceilings, but their difference from the current ceilings would be minimal (approximately 0.1% of GDP). If Parliament's final decision on the law's content introduces substantial changes, transitional provisions could be applied to delay the implementation of certain new rules. The new net expenditure growth rules for sectoral ministries could take effect from 2028, aligning with the new fiscal structural plan. However, if there is political will, this deadline could be adjusted to match the parliamentary election cycle.
N. Malnačs informs that the European Commission has assessed the Fiscal Discipline Law's compliance with the new EU Directive 2024/1265. The analysis highlights several discrepancies, some of which are technical, while others may require broader policy discussions.
One of the Commission's key recommendations is to include a clear provision stating that the Fiscal Discipline Council operates independently and is not subject to any instructions from public or private entities. While this recommendation could be considered, it is not deemed critical.
The second major recommendation concerns the budgetary independence of the Fiscal Discipline Council. The Commission suggests ensuring greater financial autonomy, similar to that of the State Audit Office or the Chancellery of the President.

I. Šteinbuka argues that the current model is effective, as the Council is a small institution that relies on the support services of the Ministry of Finance. She warns that full budgetary autonomy could create administrative challenges without yielding significant benefits.
N. Saks points out that in the previous conformity assessment of the EU directive, the Commission had deemed the Latvian Fiscal Discipline Law compliant. He acknowledges that if the new directive necessitates changes, they will have to be implemented. However, he stresses the importance of carefully evaluating the interpretation of these requirements.
N. Malnačs notes that one of the proposals is to require the Fiscal Discipline Council to undergo periodic external independent assessments. While the OECD has already conducted a similar review, it was costly (approximately $130,000). The main issue remains who would finance these assessments and how frequently they should take place.
Another proposal under discussion is to expand the Fiscal Discipline Council's mandate to include broader fiscal risk management. N. Malnačs suggests that if the Council had played a greater role earlier, many fiscal risks could have been identified sooner.
Regarding the necessity of national fiscal rules, N. Malnačs questions whether they are still needed given the strict fiscal framework already established at the EU level.
N. Saks responds that national rules are legally required under the EU directive, which mandates the existence of a national fiscal framework. He acknowledges that EU regulations have become increasingly complex, particularly concerning the regulation of net expenditure growth. However, he emphasizes that national fiscal rules allow for adaptation to Latvia's specific economic needs, such as fiscal risk management, which is not directly covered by EU regulations.
N. Malnačs agrees that national fiscal rules should be designed in a way that serves national interests, rather than simply replicating EU regulations.
N. Malnačs also raises the issue of the term limits for Fiscal Discipline Council members. The possibility of extending the terms of office for the Chairman and members is under discussion. Currently, the Chairman can serve a maximum of two three-year terms (a total of six years).
N. Saks explains that this system was originally introduced to ensure rotation and prevent excessive dependence on a single leader. He notes that discussions with Parliament on this matter have produced varied opinions, and any potential changes would require political consensus.

Decided:
1.1. To take note of the information provided by N. Saks regarding possible amendments to the Fiscal Discipline Law.

I.Šteinbuka – votes for;
I.Golsts – votes for;
A.Jakobsons – votes for;
U.Kāsiks – votes for;
J.Priede - votes for.

2. Ministry of Finance Plans for the Fiscal Structural Plan Progress Report

N. Saks explains that the Fiscal Structural Plan Progress Report consists of two parts:
- The formal part, which presents data in accordance with European Commission requirements, including fiscal indicators and economic forecasts.
- The national part, which is similar to the previous Stability Programme and serves as a basis for internal policy discussions and budget planning.

The report plays a key role in parliamentary debates, and therefore, its current structure is maintained.
To take note of the explanation on the development of the **Fiscal Structural Plan Progress Report**.

Decided:
2.1. To take note of the explanation on the development of the Fiscal Structural Plan Progress Report.

I.Šteinbuka – votes for;
I.Golsts – votes for;
A.Jakobsons – votes for;
U.Kāsiks – votes for;
J.Priede – votes for.

The meeting concluded with an expression of appreciation to the participants. A follow-up discussion on the amendments to the law is scheduled to take place after the draft law is prepared in the summer.

The meeting on 13 March 2025 was closed at 16:00.

Chairwoman of the Council I. Šteinbuka

Meeting Secretary V. Zaremba

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