FISCAL DISCIPLINE COUNCIL OF THE REPUBLIC OF LATVIA

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Minutes of the extraordinary meeting of the Council No 5 (73)

Riga 28th of August 2024

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

Participants of the meeting:

Vice-Chairman of the Fiscal Discipline Council	M.Āboliņš
Member of the Fiscal Discipline Council	J.Priede
Member of the Fiscal Discipline Council	A.Jakobsons
Member of the Fiscal Discipline Council	U.Kāsiks
Secretariat –	
Fiscal Discipline Council secretary	N.Malnačs
Fiscal Discipline Council macroeconomics expert	V.Zaremba
Fiscal Discipline Council fiscal risk expert	I.Verpakovska
Fiscal Discipline Council lawyer	I.Jansone
Invited participants -	
Director of the Fiscal Policy Department of the Ministry of Finance	N.Sakss
Deputy Director of the Fiscal Policy Department of the Ministry of Finance, Head of the Fiscal Management Department	I.Blauberga
Senior expert of the Fiscal Management Division of the Fiscal Policy Department of the Ministry of Finance	E.Vītols
Deputy State Secretary of the Ministry of Transport	K.Malnača

Taking minutes:
Fiscal Discipline Council lawyer I.Jansone
28th of August 2024 meeting starts at 13:00

Opening of the meeting - I. Šteinbuka
The Chairman of the Fiscal Discipline Council (hereinafter - the Council) I. Šteinbuka opens the meeting and expresses gratitude to the Deputy State Secretary of the Ministry of Transport, Kristīne Malnača, for the opportunity to participate in the meeting of the Fiscal Discipline Council to discuss current information related to the Rail Baltica project and expresses gratitude to the Director of the Fiscal Policy Department of the Ministry of Finance, Nils Sakss, for participating in the meeting of the Fiscal Discipline Council in order to present to the Council the current news related to the new European Union economic and fiscal governance regulation.

The Council understands that the implementation of the Rail Baltica project is strategically important, but in the opinion of the Council, the implementation of the Rail Baltica project creates serious fiscal risks and the fiscal reserve for this risk is not created separately. There are also concerns about the amount of financial commitments and the sources of funding for the implementation of the project in the future. Therefore, the Council wants to obtain additional information regarding the mentioned project and asks the Deputy State Secretary of the Ministry of Transport, Kristīne Malnača, to talk about the current events in the implementation of the mentioned project.

1. Rail Baltica project implementation progress

K. Malnača provides basic information about the Rail Baltica project. The project is included in the core TEN-T core network and the TEN-T regulation requires the creation of a connection between the Baltic states. Currently, the Baltic states, including Latvia, have obligations to create a railway connection between all three Baltic states by 2030. This project cannot be seen as solely belonging to Latvia - it includes obligations for all three Baltic states and its implementation is anticipated by EU regulations. As a result of the project, a number of benefits are expected, the most important of which are:

- a new connection through all the Baltic states will connect them with European markets and stimulate exports;
- the time spent on the road will be reduced by two times, which will positively affect the flow of both cargo and passengers;
- the new connection will improve cargo logistics in the region;
- implementation of the project will strengthen the security of the Baltic region by improving military mobility.

The construction of the project includes complex engineering solutions - the construction of several bridges is planned, incl. bridges over Gauja, Daugava. It is planned to build two-level overpasses, two international passenger stations, sixteen regional stations, a train depot, and a cargo terminal.

In the cost-benefit analysis carried out by international consultants, the positive economic benefit of the project has been calculated - the direct net benefit of the project is measured in the amount of 6.6 billion euros over a period of 50 years. Indirect benefits are estimated at 15.5-23.5 billion euros. Also, the impact of the project on GDP growth is estimated at 0.5%. This project would also be a huge benefit in terms of military mobility and regional security.

I. Steinbuka wants to clarify who and when did the cost-benefit analysis?

M. Āboliņš adds to the question whether the analysis is publicly available?

K. Malnača comments that the latest analysis was carried out in 2023 by Boston Consulting Group and confirms that the performed cost-benefit analysis is publicly available on the official website of Rail Baltica. However, she notes that such calculated benefits are possible only if the full scope of the project is implemented.

In the continuation of the presentation, K. Malnača addresses the topic of project financing and explains that all construction contracts of the Rail Baltica project are framework contracts. This means that orders are given to the contractor only when funding is available.

The Council is interested in whether funding is linked to economic fluctuations? For example, when there is an economic recession, is there also a decrease in funding?

K. Malnača: No, the funding is not linked to fluctuations in the economic cycle. The project does not have a specific budget, as it depends on EU funding for each specific phase. In order to receive funding from the EU, an application is submitted for the necessary funding for specific planned activities within the project. And the EU accordingly approves what will be funded and what will not. Project financing and budget planning for each subsequent stage are difficult because it is not known in advance which project measures will be financed and which will not. This results in ineligible costs that have to be covered by the state budget. Until now, it was planned that the EU would finance 85%, while the state co-financing was required in the amount of 15%.

I. Šteinbuka is interested in whether co-financing is planned in the state budget?

M. Āboliņš adds to the question, is inflation included in these 85%?

K. Malnača explains that the first project application was submitted in 2014, based on inflation forecasts in 2014, but no one at that time could predict such a high level of inflation as it has been in recent years. In connection with that, in 2024, additional expenses amount to around 40 million euros. When submitting an application for EU funding, a reserve for cost indexation and unforeseen works is also planned as part of the eligible costs. Currently, a little less than half of the already available project funding of around 1 billion has been used for the project. And the relevant state co-financing is already planned in the budget. K. Malnača continues with the information that currently the EC has changed the conditions and announced that station buildings are no longer financed by the EU. Also, construction supervision and management of the project, which is absolutely necessary in the construction process, will not be financed. This means that in order to acquire the funding allocated by the EU in the 2023 call, it is necessary to plan additional expenses in the amount of 33.8 million euros from the state budget for the period from 2025 to 2028.

E. Vītols asks about the situation with the compliance period, and whether there is funding that is at risk of not being used due to project delays?

K. Malnača comments that at the moment it is five million in connection with the order of the construction project, and it is likely that it will be transferred to another activity of the project where there is a lack of funds.

K. Malnača continues on the challenges related to project financing and points out that the lack of financing is especially critical for 2025-2027. The model of 85% EU and 15% state co-financing will no longer work, EU funding no longer covers project monitoring and management, real estate expropriation, construction supervision and building construction. Therefore, the existing financing model of the project does not facilitate the implementation of the project, it is fragmented and incomplete. All financing options must be considered: EU funds, national budget, private financing, instruments of financial institutions.

At the moment, it has been concluded that the project is too expensive and extensive to be implemented until 2030. Therefore, for the time being, as a solution to the financial challenges, it is proposed to reduce the scope of the project and carry it out in several phases. Therefore, the construction works will be carried out in parts, according to the received funding. The first phase is planned to be implemented by 2030.

The Council, after hearing K. Malnačas's narrative about the progress of the Rail Baltica project, decided:
1.1. To take note of the information provided.

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

2. The impact of the new EU fiscal regulation on the budget process

Nils Sakss introduces the new approaches to the application of fiscal numerical conditions, in connection with the EU's new regulation of fiscal and economic management. In 2024, taking into account that the EU's general exception clause and the previously applied EU economic management regulation are no longer valid, all EU countries will develop multi-year financial planning documents based on the new regulation – Fiscal-Structural Plans. The autumn of this year is considered a transition period, as it is the first attempt to shape the fiscal policy of the member states, in accordance with the new regulation.

From now on, as a general procedure, fiscal-structural plans will be developed every four years in April, while every year in April each EU member state will submit a progress report to the EC on the existing fiscal-structural plan (FSP). For the fiscal-structural plan, the balance of the general government will be calculated by choosing the strictest of the following three fiscal numerical conditions: the structural balance condition stipulated in the national legislation, in this case - the Latvian Fiscal Discipline Law (FDL), the primary structural balance condition and the increase in net expenditures condition stipulated in the EU regulation.

It is expected that in Article 10 of the FDL, starting from 2025, amendments regarding the balance condition will enter into force. Thus, in the development of the Latvian Fiscal-Structural Plan for 2025-2028 and the Medium-term Budget Framework for 2025-2028, the limit value of the structural deficit will be changed from -0.5% to -1.0% of GDP in order to bring it closer to the limit value adopted by the EU (-1.5% of GDP). The next FSP 2028-2031 will be developed in 2027, it will be coordinated with the election cycle. Thus, the priorities of the new government and the coalition will be included in the four-year fiscal-structural plan.

Harmonization of fiscal conditions and control of expenditure growth is based on the conditions of the primary structural balance and net expenditure growth defined in the EU regulation. This is done to ensure comparability and integration of Member States with EU calculations, as well as to control the growth of Member States' expenditure. When we talk about the increase in spending, we are basically talking about the increase in nationally financed net primary expenditure (NFNPE). In order to calculate that - interest expenses, discretionary revenue measures (DRM), expenses for EU funds, which fully correspond to the revenues of Union funds, state expenses for co-financing of programs financed by the Union, cyclical elements of unemployment benefit expenses and one-off and other temporary measures are deducted from general government expenses.

Member States' expenditure must not exceed the multi-year net expenditure growth trajectory, even if their revenues grow faster. Thus, the fiscal space will be determined by the allowable amount of increase in expenditures, not revenues. Previously, for example, in 2023, when creating the 2024 budget, the fiscal space was expanded thanks to a series of one-time revenue measures - a bank tax and borrowers' fee were introduced, Latvenergo and "Latvia's State Forests" dividends were raised, etc. Consequently, the 2025 fiscal space, without policy changes, is smaller than the amount of discretionary revenue measures introduced in 2024. If a decision is made on the same volume of discretionary revenue measures for 2025 as well, it would expand the fiscal space, but the increase in expenses itself should be kept within the framework set by the EU regulation.

N. Sakss continues - for member states whose debt does not exceed 60% of GDP and whose budget deficit is below 3% of GDP, the EC will provide, upon request, technical information on the necessary amount of the structural balance to ensure that the deficit is maintained below 3% of GDP and public debt below 60% of GDP. Based on the above and EC calculation methodology, the increase in net expenses must not exceed the following limit values: 4.6% in 2025, 3.7% in 2026, 3.4% in 2027 and 3.4% in 2028. Nils Sakss notes that the increase in expenses calculated by the EC differs from the calculations by the MoF, because the EC calculates that revenues grow in line with GDP, but Latvia faces a situation where GDP grows more slowly than expenses. Both MoF and EC calculated values are based on complicated multi-step calculations and assumptions. They take into account Member States' macroeconomic forecasts, including forecasts of the deflator, output gap and potential GDP growth, as well as debt service interest rates and population aging forecasts.

M. Āboliņš: makes a comment that EU regulation foresees forecasts for a very long period, extending even to 2030. We currently have very low potential GDP and also low productivity, the burden of aging costs is also increasing over the years. Thus, it turns out that by accepting the forecast of low economic potential and slow economic growth, which objectively exists at the moment, we limit the growth of expenses and, thus, also limit the growth of the economic potential in the following years.

There is a discussion among those present about the possible challenges to the latest monitoring report of the Council, because the new fiscal regulation is quite complicated to explain to a wider circle of readers.

Taking into account all of the above, the present meeting participants conclude that special attention is needed on the use of terminology and explaining the nature of the new fiscal management to the wider public.

Decided:
1.1. To take note of the information provided.

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

The meeting closed at 15:00, 28th of August 2024.

Chairwoman of the Fiscal Discipline Council	I.Šteinbuka
Secretary of the meeting	I.Jansone
Fiscal Discipline Council secretary *visa*:	N.Malnačs

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