

Summary and main conclusions

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The Council has reviewed the information provided by the Ministry of Finance and expresses its opinion on the preparation of the 2026 budget and the Medium-Term Budgetary Framework for 2026–2028 — the EU and national fiscal rules are met, in accordance with the national escape clause. However, the easiest path has been chosen — the additional required funding for defense has been found mainly through an increase in debt rather than by reducing budget expenditures. The Council calls on the government to set more ambitious targets for reducing budget expenditures. A structural and sustainable solution for financing defense expenditures must be found in a timely manner, one that is not based on further increases in public debt.

- 1. In setting the structural balance target for the Medium-Term Budgetary Framework (MTBF) for 2026–2028, both the restrictions set out in the Fiscal Discipline Law and the additional expenditures permitted under the national exception clause were taken into account. As a result, the strictest structural balance target was chosen, which simultaneously complies with both Latvia's and the European Union's fiscal rules.** When incorporating the planned revenue and expenditure measures for 2026–2028 into the MTBF, the Fiscal Discipline Law's structural balance condition is recognized as the strictest numerical constraint for all years. Accordingly, the structural balance target is set at (-1.48%) of GDP for 2026, (-2.10%) of GDP for 2027, and (-2.00%) of GDP for 2028.

The Ministry of Finance forecasts the following general government budget balances under a policy-change scenario (without a fiscal safety reserve): (-3.3%) of GDP in 2026, (-3.9%) of GDP in 2027, and (-3.6%) of GDP in 2028. Increases in the general government budget deficit during this period are made in accordance with the provisions of the national exception clause. Adjustments for creditors and debtors under the European System of National and Regional Accounts (ESA) — particularly related to military equipment deliveries — have the potential to either improve or worsen the deficit parameters. In the general government budget for 2026, revenues are planned to increase by 6.5% compared to the projected revenues for 2025, while expenditures are planned to increase by 6.2%. According to the COFOG classification and ESA methodology, defense expenditures will amount to 4.2% of GDP in 2026, 5.2% of GDP in 2027, and 5.1% of GDP in 2028.

- 2. The Council draws attention to the increasing burden of debt and interest payments. If there is no rapid economic growth in the future, the government may face challenges in meeting all fiscal conditions, especially after 2029, while maintaining both defense spending at the current level and the existing budget expenditure structure. The planned volume of commitments aimed at strengthening national defense capabilities calls for a more thorough**

assessment of risks related to debt sustainability and debt servicing costs. In Latvia, the general government debt is projected to reach 49% of GDP in 2025, while in the medium term — assuming unchanged economic growth and no additional policy measures — it is expected to rise to 51% of GDP in 2026 and to 55% of GDP in 2027 and 2028. Forecasts of interest payments indicate that debt servicing costs will increase significantly, limiting the fiscal space available for financing other nationally important initiatives. Although Latvia currently complies with the 60% of GDP debt threshold, the fiscal burden will continue to grow, requiring a stricter approach to reducing expenditures and increasing revenues by improving tax collection. Interest payments on debt will increase both in absolute terms and relative to GDP: if in 2025 they amount to €519 million or 1.2% of GDP, then in 2026 they will reach €617 million or 1.4% of GDP. From 2027 to 2028, general government interest expenditures will account for 1.5% of GDP; however, in nominal terms they will continue to rise — to €700 million in 2027 and €736 million in 2028. If the favorable economic development scenario developed by the Ministry of Economics and approved by the government materializes, the debt-to-GDP ratio may be lower. However, given the slow economic growth observed in recent years, it is safer to adhere to the cautious forecast prepared by the Ministry of Finance and endorsed by the Council.

At present, Latvia continues to maintain the reputation of a fiscally responsible country. Latvia's credit ratings remain at a stable level despite geopolitical and economic challenges. International credit rating agencies assign Latvia high ratings: Moody's A3, S&P Global A, Fitch A-, and R&I A — all with a stable outlook.

3. **The development of the medium-term budget framework for 2026–2028 is based on macroeconomic forecasts approved by the Fiscal Discipline Council on June 9, 2025.** According to the forecasts, the economy will grow by 1.1% this year and by 2.1% next year; nominal GDP is expected to increase by 4.4% this year and 4.7% next year. Inflation is projected to be higher than the ECB's target—3.5% in 2025, decreasing to 2.3% in 2026. The economy will operate below its potential this year and in the coming years, with a negative output gap. On September 30, the Central Statistical Bureau (CSB) published revised national account time series data starting from 2022. The Ministry of Finance (MoF), in preparing the medium-term budget framework, did not include the CSB revision results in its calculations. **The Fiscal Discipline Council urges CSB to align the publication of account revisions with the budget development schedule to avoid releasing corrections during the final stages of budget preparation.**
4. **Based on the latest CSB data, Latvia's economic growth in the first half of 2025 was 1.2%, suggesting that the MoF's forecast of 1.1% for the year could be achieved if there is no significant deterioration in the macroeconomic environment. The 2.1% GDP growth forecast for 2026 also remains realistic.** The labor market remains active—unemployment fell to 6.7% in Q2 2025, and the average wage increased by more than 8% compared to the same period last year. However, this wage growth has not led to stronger household consumption due to persistently negative consumer sentiment, exacerbated by inflationary pressures. At the same time, household bank deposits grew by 9.4% in the first half of 2025, and with improving consumer confidence, this will support household consumption growth. Bank of Latvia data shows that the outstanding loan balance in Q2 exceeded €11.8 billion—9.2% more than a year ago, driven by ECB rate cuts and relaxed banking standards, improving the investment environment. Thus, while domestic consumption still slows

growth, external and investment factors provide sufficient support for economic expansion. Industrial growth slowed in July to 1.5% after a 2.2% increase in the first half of the year. Manufacturing growth in July was only 1.4%, compared to 3.6% in the first half. Goods exports are recovering from a downturn but growing slowly—3.9% in the first half—while services exports outpaced them, growing by 7.7%. In summary, it can be concluded that, despite some positive trends in the economy, the growth rate will most likely remain moderate and will depend on the stability of the external environment.

5. **Inflation in Latvia rose to 4.1% in August 2025, mainly driven by persistent service price increases and food price hikes. Goods prices rose more moderately—by 3.6%, while service prices remained high, increasing by 5.7%. Prices for food and non-alcoholic beverages rose the fastest—by 7.5%, continuing to be a significant driver of inflation. In budget planning, the coalition agreed to implement a pilot project reducing VAT on certain food products—bread, milk, eggs, and fresh poultry—from July 1, 2026, to June 30, 2027.** Fiscally, this measure will reduce total budget revenues—by €14.95 million in 2026 and €16.4 million in 2027. The revenue shortfall will be offset by other savings or additional revenues, but balancing the budget will remain a significant challenge. This measure may have two major side effects: first, the removal of reduced VAT rates in mid-2027 could be highly unpopular, shifting political responsibility to the next parliamentary term; second, ending the VAT reduction after the pilot could trigger a renewed inflation spike in the affected product group. Moreover, there is still no clear control mechanism to ensure that the VAT reduction benefits reach consumers rather than increasing retailer profits. This creates a risk that, under reduced administrative burden, the initiative may not be sufficiently effective.
6. **The 2025 budget was developed based on a projected GDP growth of 2.9%, but the Ministry of Finance's current forecast now anticipates only 1.1% growth.** Although tax revenues this year are slightly below plan and economic growth is slower, the budget deficit is expected to remain at a similar level as originally planned in the budget law (2.9%). This will be ensured by higher forecasts for other revenues, which will compensate for the shortfall in tax revenues, as well as lower projected expenditures for subsidies, grants, and interest payments. **Comparing nominal GDP growth in the first half of 2025 (4.4%) with the increase in tax revenues (5.8%), a positive trend is observed—tax revenues are growing faster than nominal GDP.**
7. **During the 2025 state budget expenditure review process, financial resources amounting to €190.5 million were identified for the 2026 budget.** Of this, €171.1 million in expenditures were reduced within the framework of public sector efficiency improvements and general government expenditure cuts. A significant portion of the reduction—€58.7 million—comes from the revised compensation for the impact of the tax reform on municipalities. The Council does not consider this revised compensation a true expenditure reduction, as it is not a structural reduction of expenditure. Therefore, the actual expenditure reduction for 2026 is €112.4 million (or €131.8 million within the expenditure review framework). It should also be emphasized that the cumulative savings of €479.0 million mainly reflect savings identified in 2026 that are carried over to subsequent years and do not constitute new additional savings. **Given the limited fiscal space in the coming years, the Council urges the government to set more ambitious targets for reducing budget expenditures. At the same**

time, the Council encourages broader implementation and improvement of performance-based budgeting in the review process.

8. This year, decision-making regarding supported priority measures in the budget bill is challenging due to the need to balance extensive needs with limited budgetary resources. **Overall, priorities are planned to be funded in the amount of: €693.5 million in 2026, €724.8 million in 2027, €935.9 million in 2028. Most of the funding is intended for defense and internal security measures: 65% in 2026, 70% in 2027, 77% in 2028.** In 2026, the following allocations are planned: €94.8 million for demographic measures, €59.3 million for farmer support, €45.0 million for implementing the "Program at School" financing model, €15.0 million for VAT reduction on certain food products, €31.2 million for regulatory compliance and other measures.
9. **Consolidated general government tax revenues for 2026 are planned at 15,219.8 million euros, which is 5.4% or 779.0 million euros more than the forecast for 2025.** The Fiscal Discipline Council (FDC) projects tax revenues for 2026 at 15,236.6 million euros, which is 0.1% or 16.7 million euros higher than the Ministry of Finance (MoF) forecast. Overall, the MoF's tax revenue forecasts are assessed as realistic and similar to those of the FDC. Tax revenues in 2026 could be improved by growth in private consumption, the economic expansion of Latvia's export partner countries, and the inflow of EU funds into the economy. Furthermore, stabilization of the geopolitical situation and improvement in the global environment would positively affect the external trade climate and, consequently, tax revenues.
10. **Latvia has fiscal flexibility available for strengthening defense capabilities, provided by the national exception clause. This clause temporarily eases fiscal constraints but will impact both the general government budget balance and national debt dynamics from 2026 to 2028. After 2028, deviations from fiscal constraints will only apply to military supply contracts signed between 2025 and 2028. The Ministry of Finance has calculated the impact of the exception clause without exceeding the ceilings set in recommendations. For the period 2026–2028, exception clause funding is currently estimated at €971.5 million, applicable only to the SAFE instrument. However, total funding may be increased through appropriation reallocations.** The use of SAFE funding is also planned beyond the MTBF 2026–2028 period. Current Ministry of Finance calculations indicate that in 2029, expected funding under the SAFE instrument will be €720 million, which will continue to burden the budget deficit and debt. To ensure Latvia can maintain defense spending at 5% of GDP even after the exception clause ends, the Cabinet of Ministers has reviewed amendments to the Fiscal Discipline Law (FDL) regarding Article 10 on allowable structural deficit. It is proposed to increase the limit from 1% of GDP to 1.5%, with 0.5% allocated to the budget program "National Defense and Security Fund." This arrangement would take effect on January 1, 2028, and be applied in the preparation of the draft law "On the State Budget for 2029 and the Budget Framework for 2029, 2030, 2031, and 2032."
11. **The Medium-Term Budget Framework (MTBF) for 2026–2028 is being prepared during a time of increasing geopolitical tension in the region. During this period, expenditures for national security and defense have become an absolute priority. In July 2025, the EU Council activated the Stability and Growth Pact's national exception clause for member states, including Latvia.** This clause allows deviation from the European Commission Council's set maximum growth rates for nationally financed net primary expenditure (NFPNE) up to 1.5% of

GDP for the period from 2025 to 2028, specifically regarding defense spending increases. This flexibility can be used provided it does not jeopardize the country's fiscal stability in the medium term. The funds needed to finance the increase in defense spending will be sourced from savings identified through expenditure reviews, the SAFE financial instrument, and by increasing the general government budget deficit under the national exception clause. Latvia's maximum available SAFE funding is €5.7 billion. The SAFE loan offers potentially better terms than Treasury borrowings—repayment up to 45 years and the possibility to defer principal payments for 10 years. Part of these funds would be invested in local procurements and investments to strengthen Latvia's defense industry and stimulate the economy, especially in construction and manufacturing sectors. The final decision on the loan amount will be made after the European Commission evaluates the official applications and defense industry investment plans submitted by member states, which must be submitted by November 30 of this year.

12. The Council of the European Commission¹ recommends that Latvia, within its fiscal policy framework, increase defense expenditures, comply with the maximum growth rates of the nationally financed net primary expenditure (NPNPE) set by the EC Council, and at the same time make use of the deviation allowed under the national escape clause to increase defense spending. **The European Commission² also notes that fiscal gains could be achieved by improving the approach to public expenditure reviews and by gradually introducing performance-based budgeting.**
13. In its annual report³ on Latvia, the **International Monetary Fund (IMF)** positively assesses Latvia's fiscal discipline while also pointing out risks that could increase the budget deficit — higher defense spending due to rising costs, potential liabilities of state-owned enterprises that may exceed the fiscal buffer reserve, and increased capital expenditures for implementing major infrastructure projects. **The IMF recommends: (i) mobilizing additional revenues by strengthening tax discipline, reducing exemptions, broadening the tax base, curbing the shadow economy, and updating cadastral values to reflect market prices; (ii) improving expenditure management efficiency and accelerating structural fiscal reforms, including enhancements to public investment and state-owned enterprise governance; (iii) continuing to strengthen the pension system to ensure adequate income; (iv) reviewing the solidarity contributions applied to banks.**
14. The Cabinet of Ministers has approved the fiscal buffer reserve proposed in the Fiscal Risk Declaration at 0.1% of GDP for 2026, 2027, and 2028. **The Fiscal Discipline Council approves the fiscal buffer reserve at 0.1% of GDP for 2026.**
15. Currently, Latvia faces several significant risks that could impact economic growth and fiscal indicators in the medium term:
 - Russia's aggression against Ukraine and ongoing geopolitical tensions remain the main sources of economic instability and fiscal risk;
 - Changes in U.S. trade policy and new customs tariffs could indirectly affect Latvia's exports through its key trading partners;

¹ Recommendation for a COUNCIL RECOMMENDATION on the economic, social, employment, structural and budgetary policies of Latvia

² COMMISSION STAFF WORKING DOCUMENT 2025 Country Report - Latvia Accompanying the document Recommendation for a COUNCIL RECOMMENDATION on the economic, social, employment, structural and budgetary policies of Latvia

³ Republic of Latvia: 2025 Article IV Consultation-Press Release; Staff Report; and Statement by the Executive Director for the Republic of Latvia

- Fiscal risk arising from the operations of state-owned enterprises (such as AS *airBaltic* and others);
- Fiscal risk stemming from the implementation of the Rail Baltica project;
- A rapid increase in public debt servicing costs in the coming years;
- The reluctance of certain Eurozone countries to return to responsible fiscal policies poses a risk to Eurozone fiscal stability;
- U.S. fiscal instability and a decline in the value of the dollar increase fiscal risks for Latvia as well, affecting the country's reserves.