3. In Focus

Progress with Fiscal Consolidation in Latvia

Curbing the budget deficit – from the planned 8.5% of GDP last year to below 6.0% and 3.0% of GDP in 2011 and 2012 respectively – is supposed to spell a gradual return to fiscal sustainability and restore the overall credibility of Latvian economy. The deficit adjustment measures already implemented in 2009–2010 amount to 14.0% of GDP: 10.0% of GDP come from cuts in the general government budget expenditure and 4.0% of GDP from revenue increasing measures. On the revenue side, both direct and indirect taxes have been raised. On the expenditure side, austerity measures have been largely backed by structural reforms in public administration, education and health care. At the same time, a social security net has been introduced to cope with the social consequences of the economic downturn and to protect the most vulnerable groups.

At the end of 2010, Latvia held general elections and the most urgent task of the new government was approving the budget for 2011 before the end of the year, thus under a very tough timetable. In order for the budget deficit to be in line with the target of 6% of GDP in 2011, a consolidation effort of 400 million lats was estimated to be needed, but due to improving macroeconomic conditions this estimate was revised downwards to 280 million lats (2.2% of GDP) of quality measures.

The structure of the consolidation plan adopted by the new government is not the same as the one promised by Latvian politicians before the elections (1/3 – tax increases, 2/3 – expenditure cuts), since there was not enough time for designing credible expenditure cuts. Instead, only 0.7% of GDP of deficit adjustment has resulted from spending cuts while the rest (1.5% of GDP) has been achieved by revenue measures, inter alia a VAT rate increase by 1 pp to 22%. Nevertheless, Latvia's government is expected to look for additional opportunities for spending cuts during the course of 2011 which would bring the deficit ratio from the projected 5.6% of GDP to even less, i.e. well below the target.

Furthermore, Latvia's government has established a working group to prepare a credible strategy for structural reforms underpinning 2012 budgetary consolidation. The working group is expected to focus on structural reform options in both the education and social security sectors as well as potential reforms concerning local governments, while not much could be saved at the expense of the health care sector. Latvia's government has already ruled out further tax raises, which would have a negative effect on the business environment and exert inflationary pressures.

In the meantime, Latvia's government has drafted a Fiscal Discipline Law to ensure counter-cyclical fiscal policy over medium-term and put public finance on a sustainable footing permanently. The law defines the basic principles of Latvia's fiscal policy, sets numerical budget balance and public debt rules and provides fiscal policy planning instruments. The medium-term budget framework law is required to contain binding expenditure ceilings for the following two years, based on the deficit target (as consistent with the balance rule) and budget revenue projections.

While some euro area countries are struggling to implement austerity measures on the background of stagnating economies, Latvia has accomplished the largest part of its homework and is currently well on track to reach the budgetary target necessary for the euro adoption already in 2014 as an exit from the current international support program.