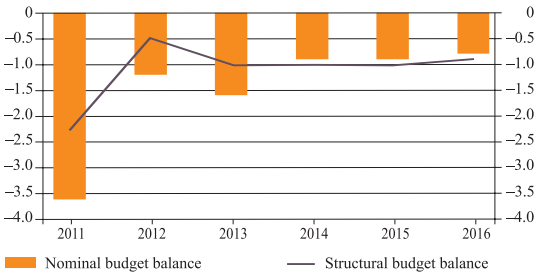
3. In Focus

Budget 2014 and Structural Balance Dynamics

Budget 2014 is the first budget drafted in accordance with the Fiscal Discipline Law adopted earlier in 2013. Integration of the fiscal discipline principles in the national law was assumed by the ratification of the Fiscal Compact. Apart from requiring embedding the fiscal rules of the Stability and Growth Pact (SGP) in the national legislation, the Fiscal Compact stipulates introduction of an automatic correction mechanism in case of deviations and independent monitoring of the compliance to the rules by an independent authority.

This budget, the first to be drafted in euro, was passed in the first reading at the Parliament on 17 October. The Fiscal Discipline Law set a number of requirements for budgets: most importantly, it had to be drafted with a medium-term framework in mind, i.e. setting the path of the budget deficit for the next three years and limiting the expenditure for the said horizon accordingly. The budget deficit itself, measured in structural terms, has to target an objective to be reached in the "medium term" following a convergence path. According to the Draft Law on the Medium-Term Budget Framework for 2014–2016, the nominal budget target is set at –0.9%, –0.9% and –0.8% of GDP respectively for the three consecutive years of the planning period. As the economy is expected to grow broadly in line with the growth of its potential in the next three years, the deficit expressed in structural terms, i.e. without the effect of the economic cycle, turns out very similar: –1%, –1% and –0.9% of GDP respectively.

Nominal and structural balance dynamics in Latvia
(% of GDP)



Sources: Latvia's Convergence Programme for 2013-2016; Draft Law on Medium-Term Budget Framework for 2014-2016

In the case of Latvia, the medium-term objective (MTO) deficit representing a "balanced budget" over the economic cycle is set at 0.5% of GDP. In 2012, this objective was reached: with –1.2% of GDP nominal budget deficit, the negative effect of the economic cycle was estimated at –0.3% of GDP and removed from the calculation of a cycle-neutral deficit accordingly. In addition, a capital injection of 0.5% of GDP to support the financial sector was made in 2012 and as such it was considered a "one-off" measure (unrelated to the normal course of the fiscal policy) and was excluded from the calculation of the structural deficit. Thus Latvia has already completed convergence to its medium-term structural balance objective and the task for the future is to maintain the achieved balanced level of the government revenue and expenditure. Current forecasts (e.g. Latvia's Convergence Programme for 2013–2016) indicate that in 2013 the structural balance could turn out around –1% of GDP. Moreover, as mentioned above, it is expected to remain at that level throughout the medium-term planning period. Although the calculated deficit lies below the MTO, an important point has to be made: according to the Stability and Growth Pact derogations are possible from the MTO in specific cases, for example, with regard to pension reforms. Latvia is in the process of increasing the contribution to the 2nd pillar of the pension system: in 2013, the contributions were increased from 2% to 4%, thereby reducing the social security revenue by 0.5% of GDP. Since it is permitted to deviate from the MTO by the amount of the fiscal impact of the pension reform, Latvia is still expected to fulfil the MTO requirement in 2013. With the pension reform ongoing and prudent budget targets set for the medium-term horizon, Latvia is determined to remain on a sound fiscal path in accordance with the SGP.