



Latvia`s Experience with Fiscal Adjustment

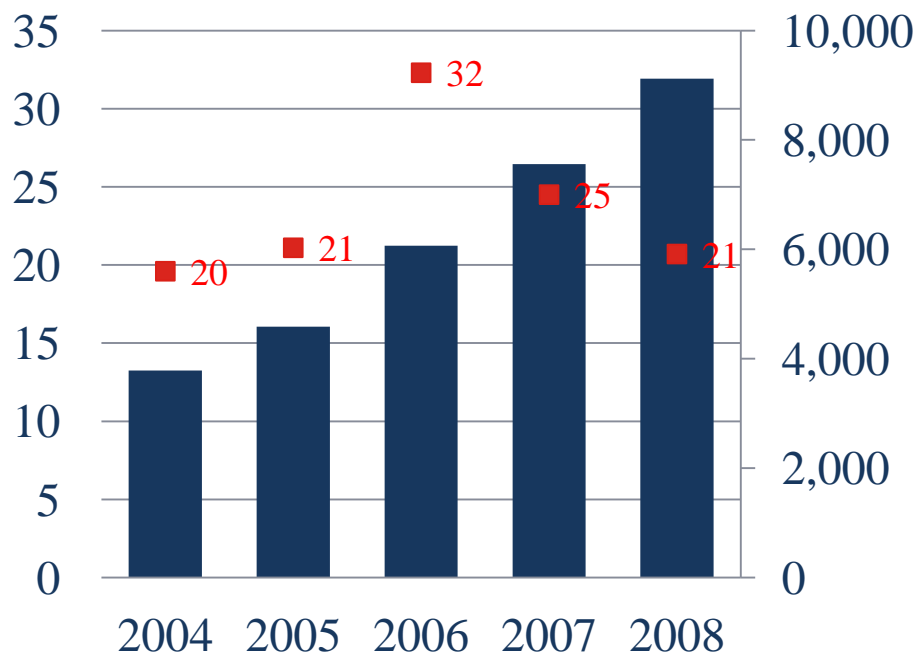
Baiba Traidase

Bank of Latvia

11.02.2014.

Budget expenditure over 2004-2008 increased by more than 100% – half of that due to salaries and social benefits

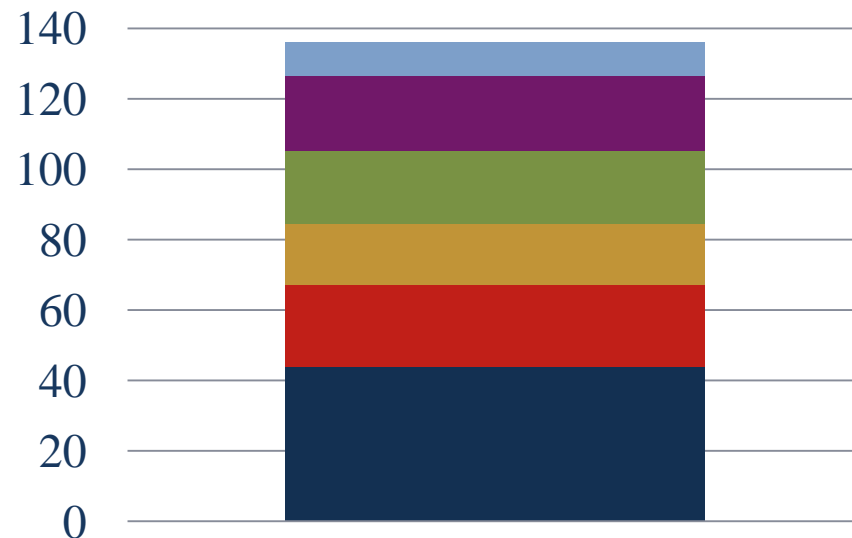
Expenditure growth, 2004-2008



■ Expenditure (milj. EUR) (RHS)

■ Expenditure growth (%)

Contribution of expenditure items to total expenditure growth, 2004 – 2008, %



■ Compensation of employees

■ Social benefits

■ Intermediate consumption

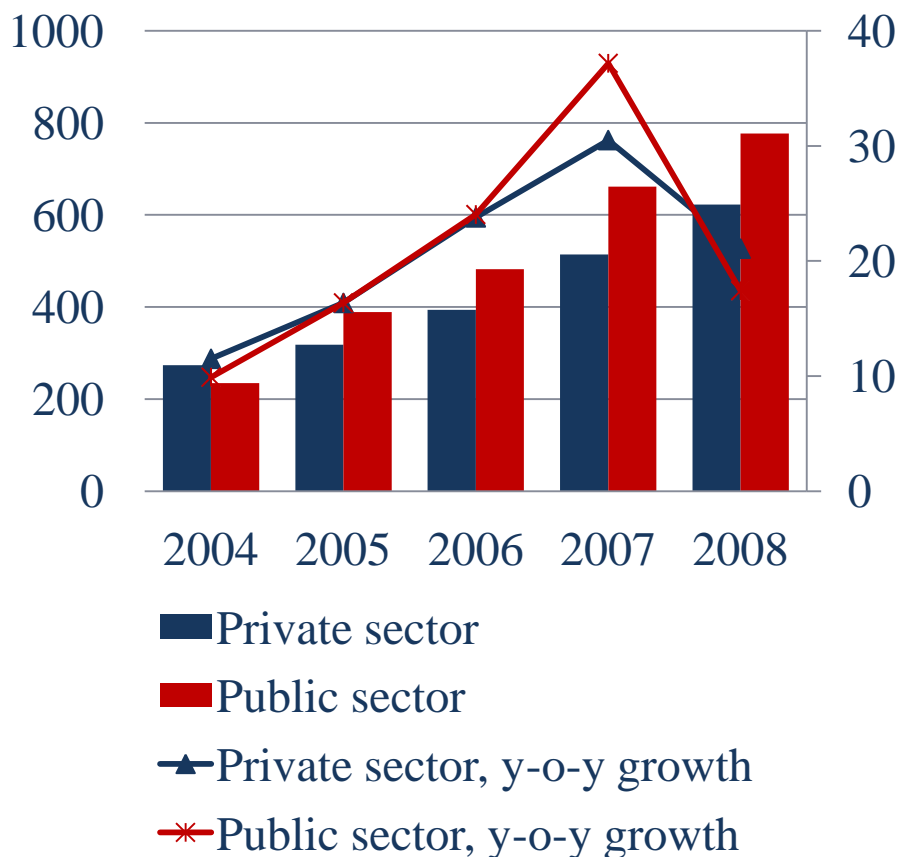
■ Capital expenditure

■ Other current transfers

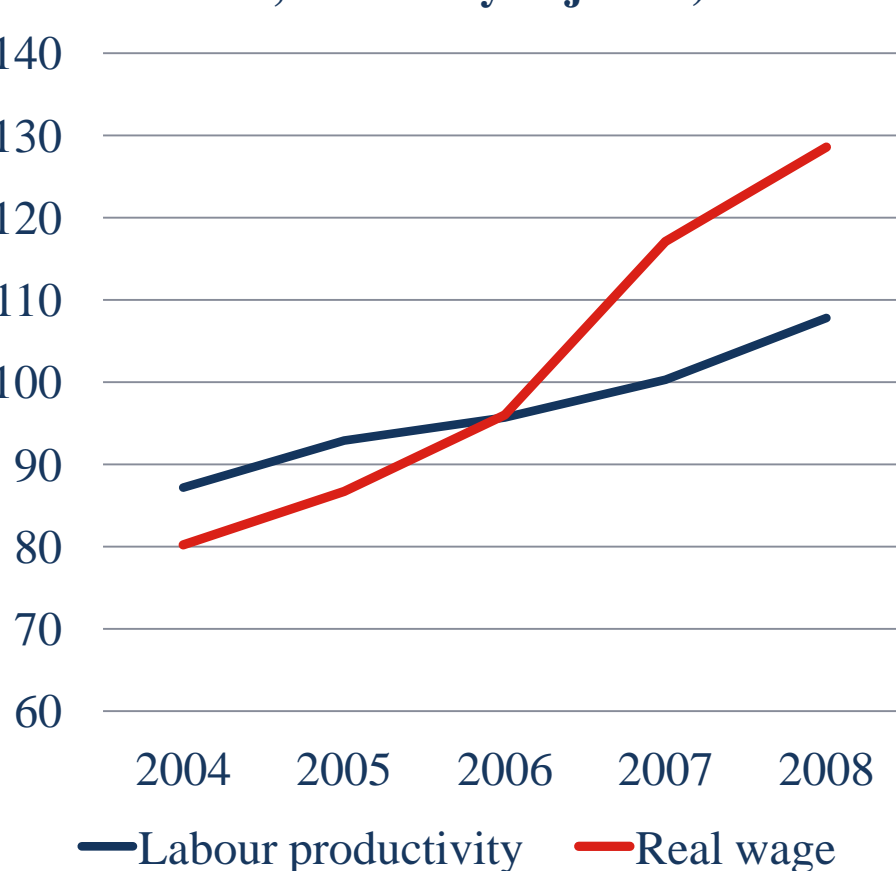
■ Other expenditure

Growth of the average salary of public sector employees was higher than in the private sector

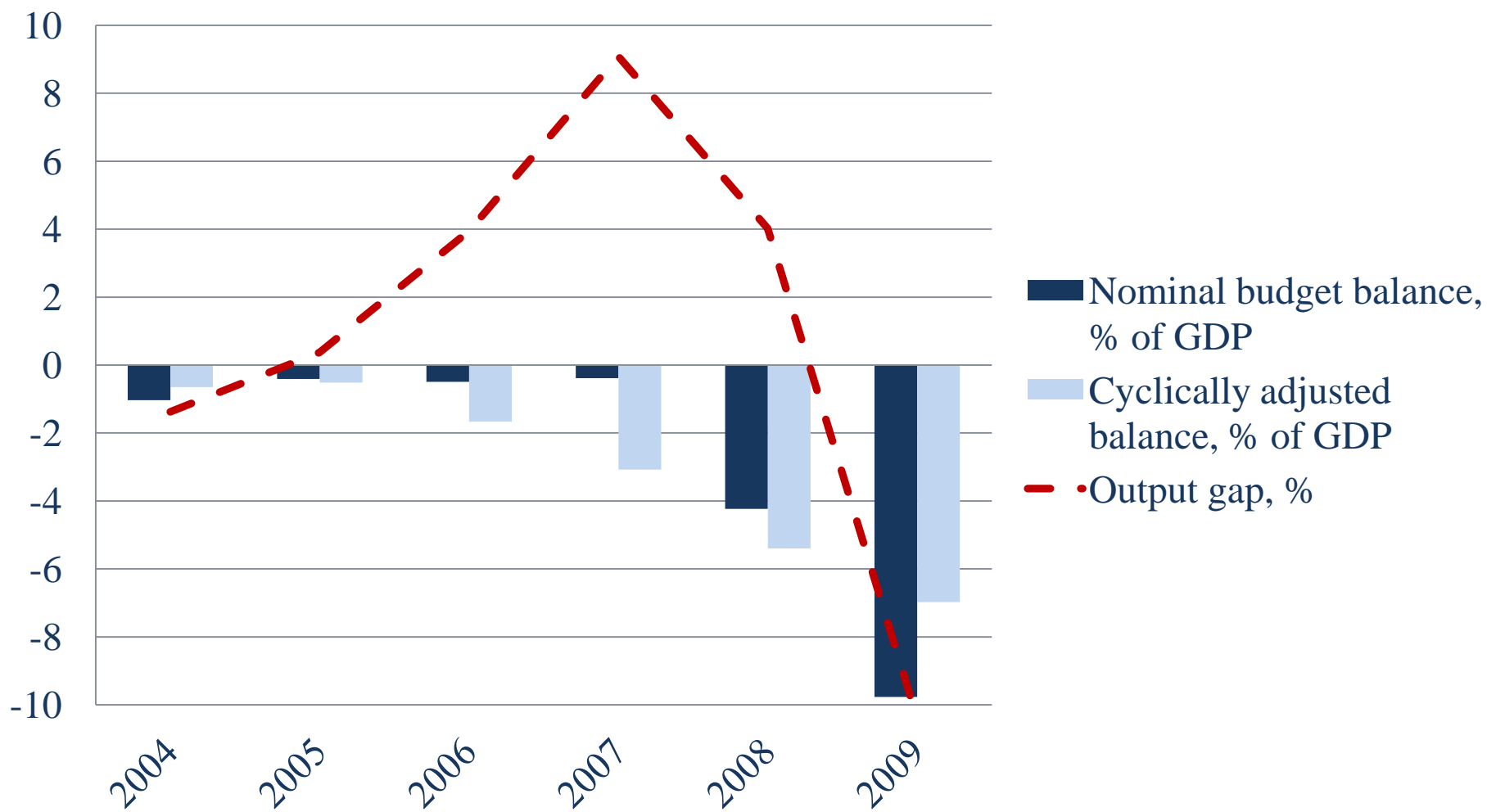
**Average salary (EUR, nominal)
and y-o-y growth (%)**



**Real hourly wage and labour
productivity per hour (2005 Q1 =
100, seasonally adjusted)**

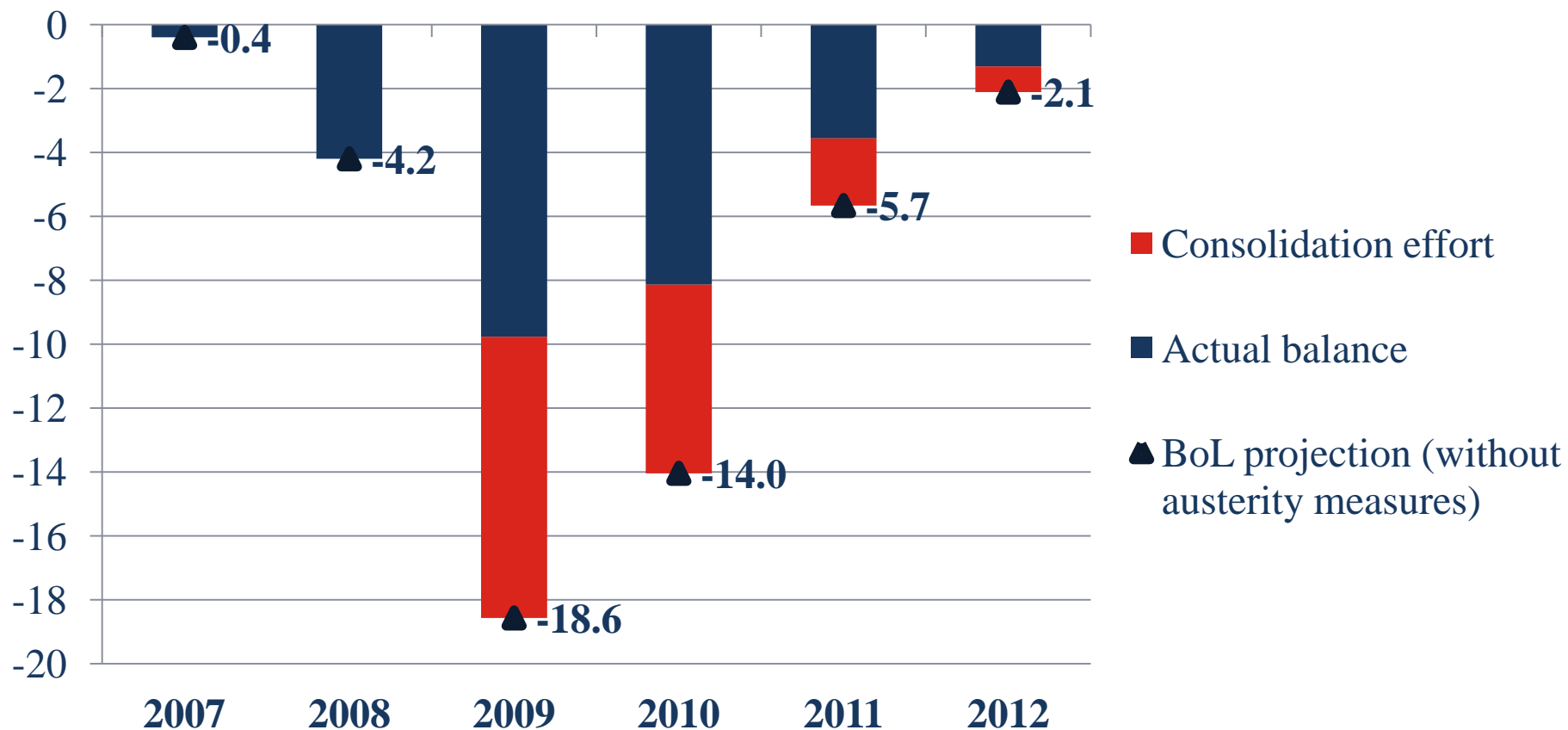


Output gap, nominal and CAB shrank dramatically



Without sizeable fiscal adjustment the budget balance would have reached almost 19% of GDP in 2009

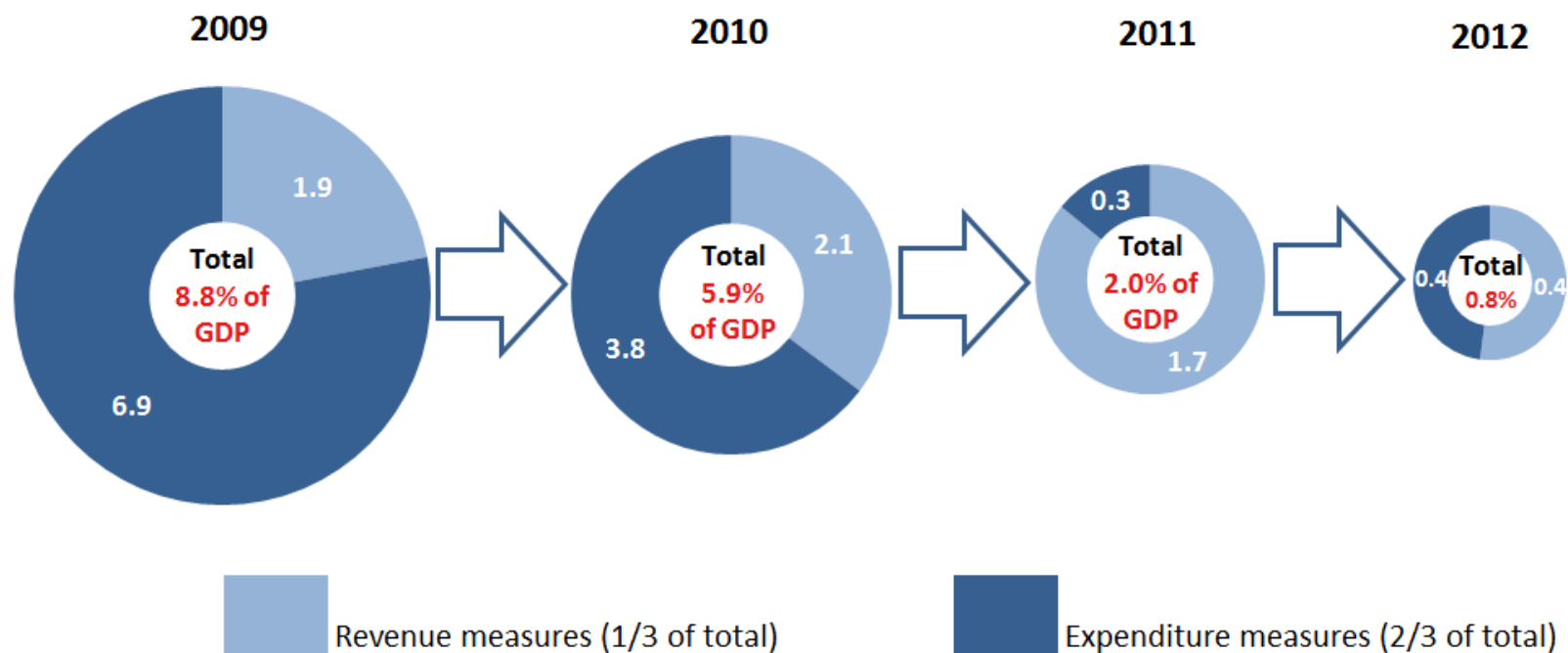
General Government balance, (ESA'95, % of GDP)





Four years of austerity

Fiscal adjustment concentrated in 2009-2010; a move from expenditure towards revenue measures




Compensation of employees was reduced by 5.0% of GDP, accounting for almost 45% of expenditure measures

Measures	2009	2010	2011	2012
Revision of VAT rates	0.9		0.6	
Revision of excise tax rates	0.2	0.1	0.1	0.2
Measures regarding Personal income tax	0.3	1.2		
Measures regarding SSC		0.3	0.5	
Measures regarding real estate tax		0.2	0.1	
An increase in dividends rate	0.6	0.1	0.1	
Other revenue measures		0.1	0.3	0.2
Compensation of employees	2.8	2.2		
Intermediate consumption	2.1	0.1		0.2
Subsidies	0.3	0.4		0.1
Social spending		0.4		
Investments	1.7	0.7		0.2
Other expenditure measures			0.3	

At the same time:

- ✓ additional spending on interest payments;
- ✓ bank capitalisation;
- ✓ support to the national aviation services;
- ✓ extensive use of EU funds

Fiscal adjustment was backed by structural reforms in the public sector

- **Public administration**
 - optimisation of governmental institutions and reduction of the number of employees; unified wage grid;
 - **Health care sector**
 - optimisation of in-patient institutions;
 - **Secondary education**
 - optimisation of schools` network, money follows pupil approach;
 - **Pension system**
 - an increase in the retirement age as from 2014;
 - **Higher education**
 - optimisation of programmes;
 - **Tax system**
 - introduction of capital income tax and imposition of real estate tax on dwellings
 - **Social safety net**
 - introduction of measures to support most vulnerable groups⁹
- 

Social Safety net

In 2010 compared to 2008 the average nominal wage in the economy dropped by 7%; in the public sector falling by 21%. The employment decreased by 19%; in the private sector falling by 27%



Increase of the importance and dependency on the welfare benefits (social expenditures growth by 20% (2008-o-2010));



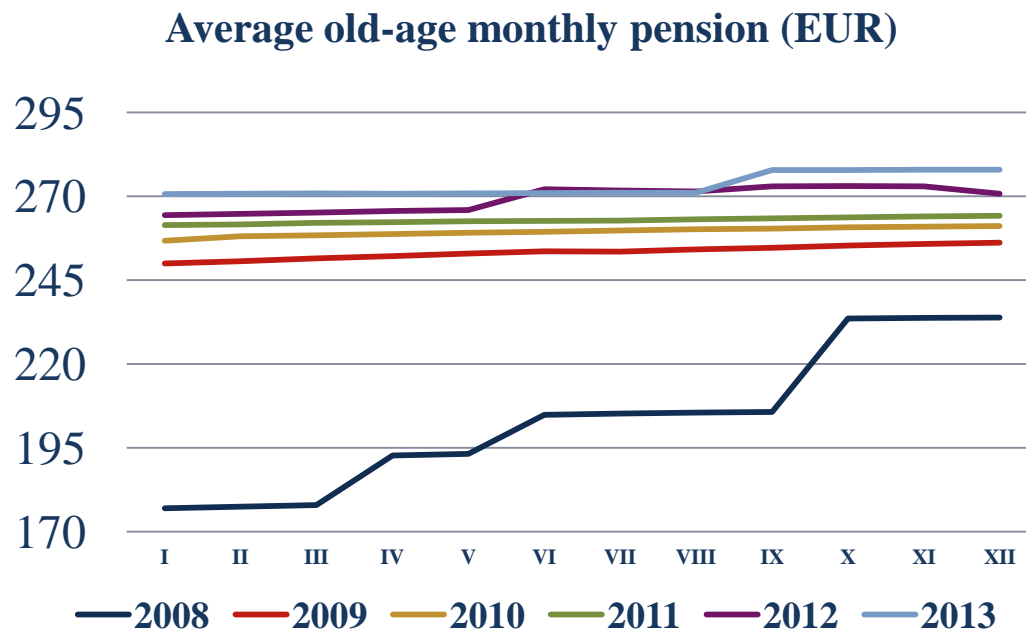
In September 2009 the Latvian government adopted **The social safety net strategy**



- support to low income households via assistance through municipalities:
 - guaranteed minimum level of income, housing benefits, basic health services, public transport services, ensuring access to education
 - providing temporary public works (WB and ESF)

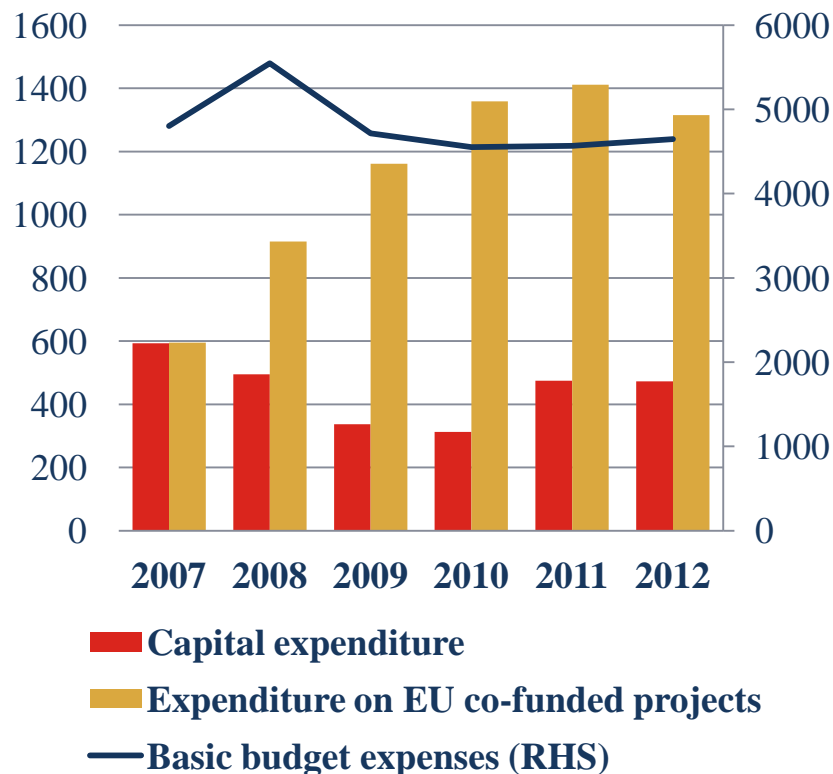
Pension system

- Pension indexation was interrupted during the crisis, however, serving as a regular, constant source of income (above or close to the full-time minimum wage).
 - Indexation restored in 2013
- An increase in the retirement age as from 2014

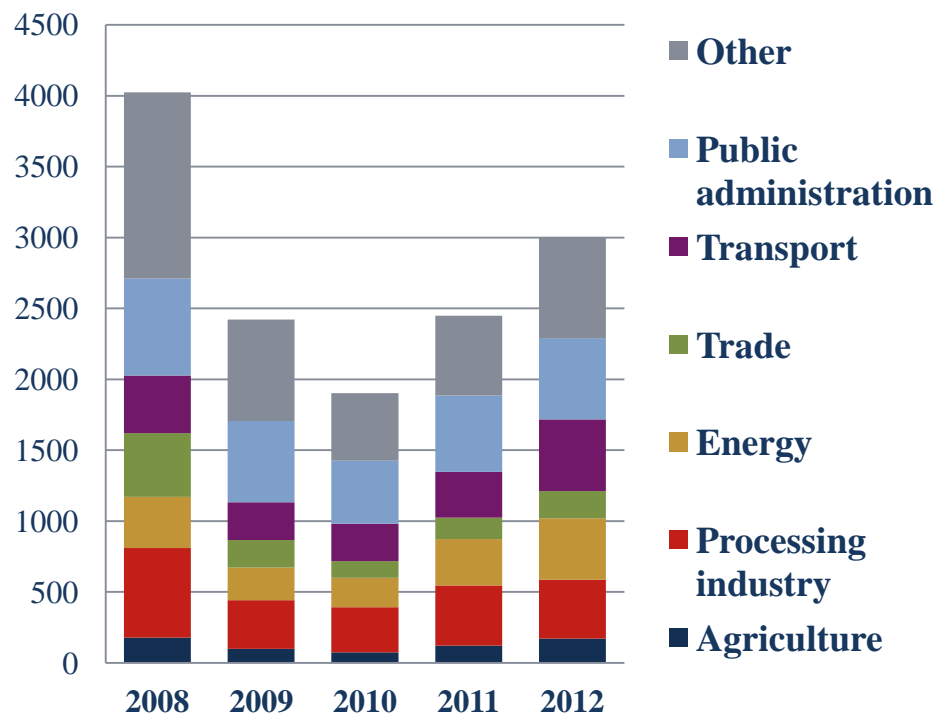


Budget investments shifted towards EU funds; Public administration positioned as the main non-financial investor of the crises

Budget expenses, capital expenditure and expenditure on EU policy instruments co-financed projects (million EUR)



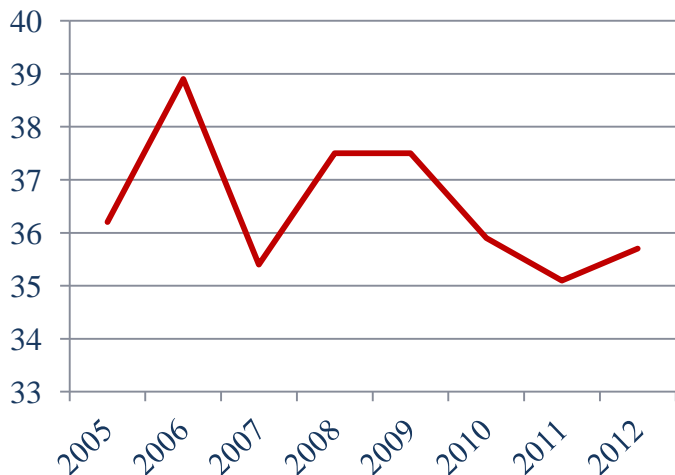
Non-financial investment volumes (million EUR)



Economic consequences: positive reaction of the private and external sectors (non-Keynesian effect)

- Income distribution measures affected the public support and success of consolidation;
- GINI index decreased;
- Latvia has quickly regained its cost competitiveness: wage-productivity gap has been closed

Dynamics of GINI coefficient

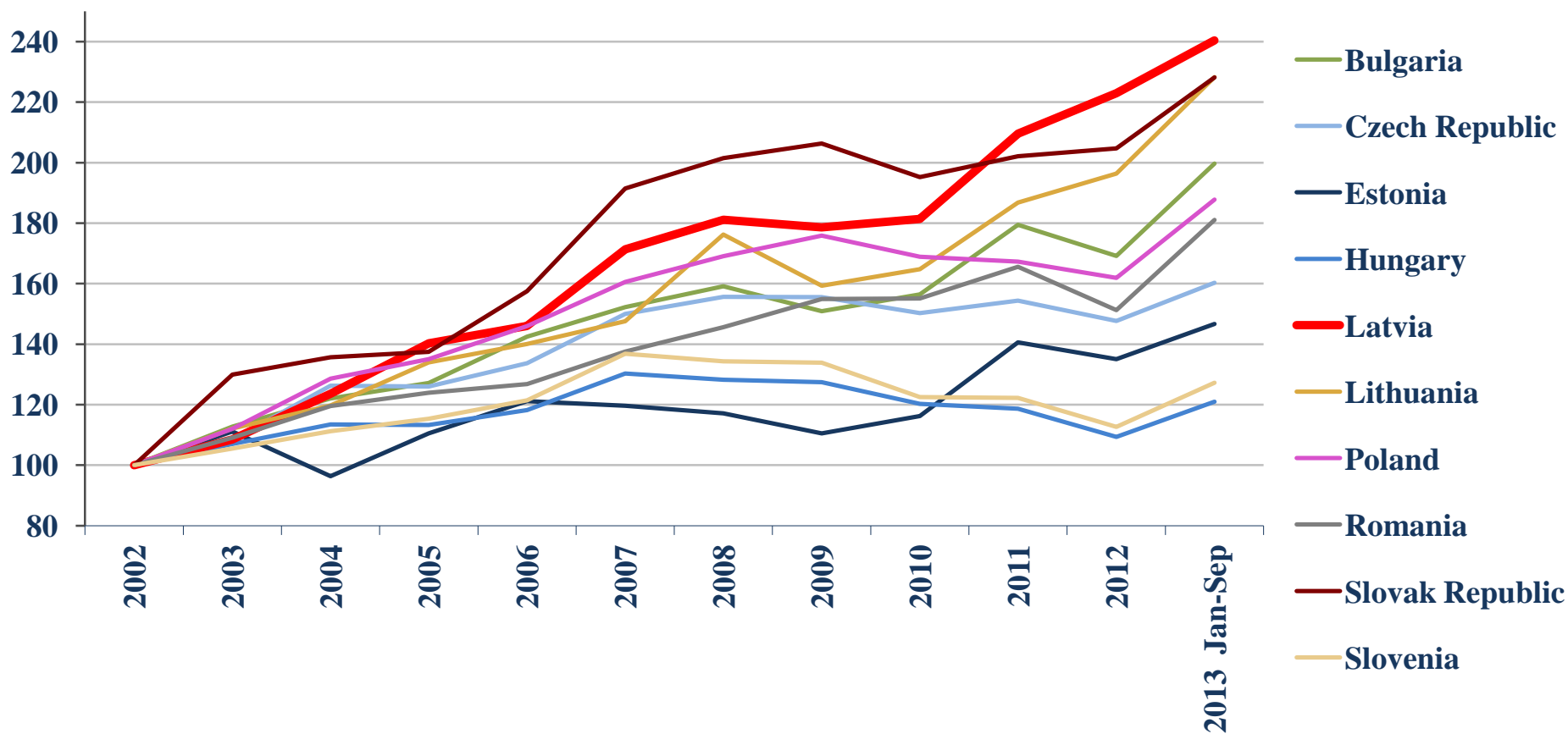


Real hourly wage and labour productivity per hour (2005 Q1 = 100, seasonally adjusted)



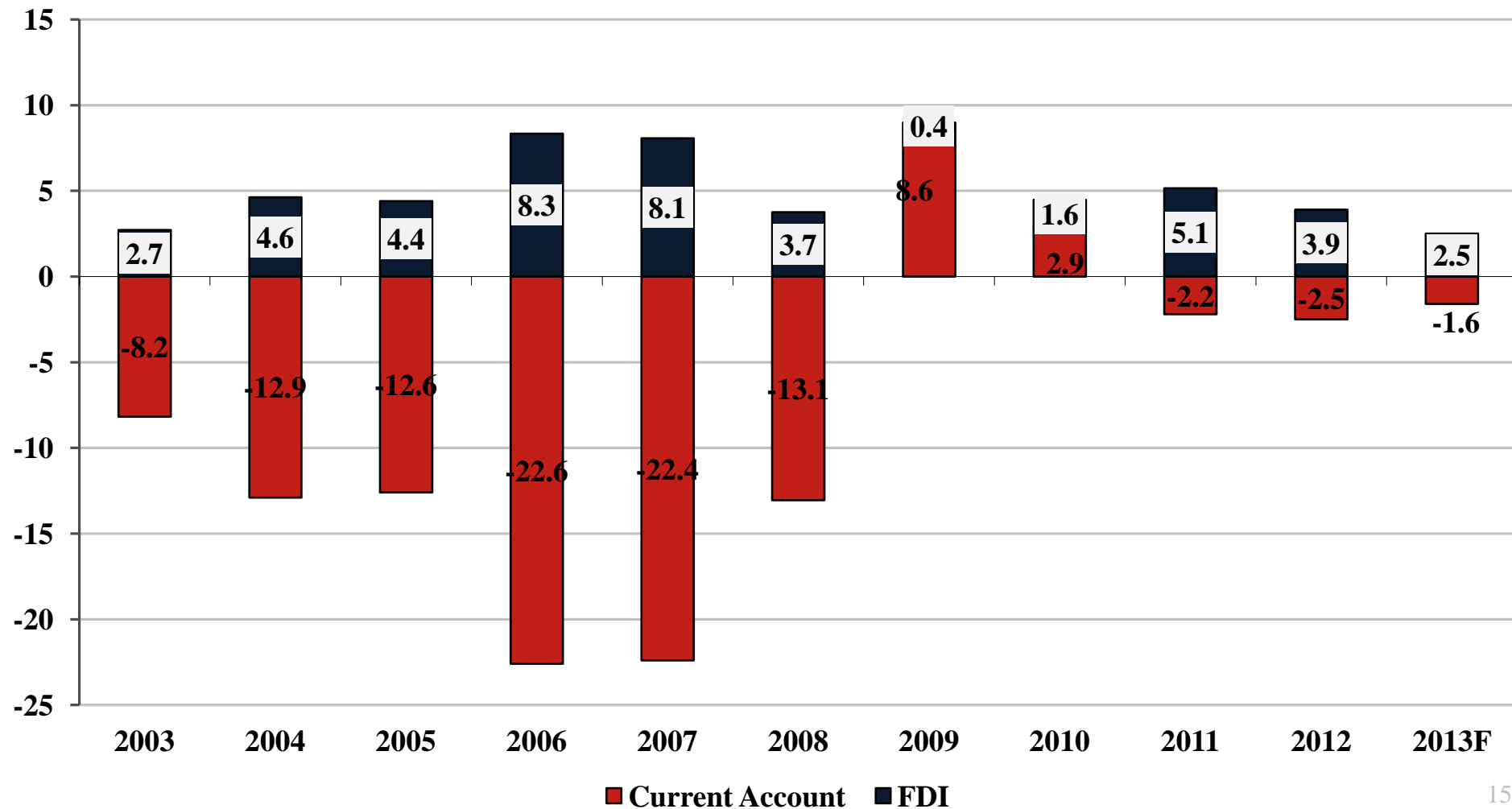
Improvement in cost competitiveness has been reflected in gains in the Latvian export market share...

Merchandise export shares in world import (2002=100)



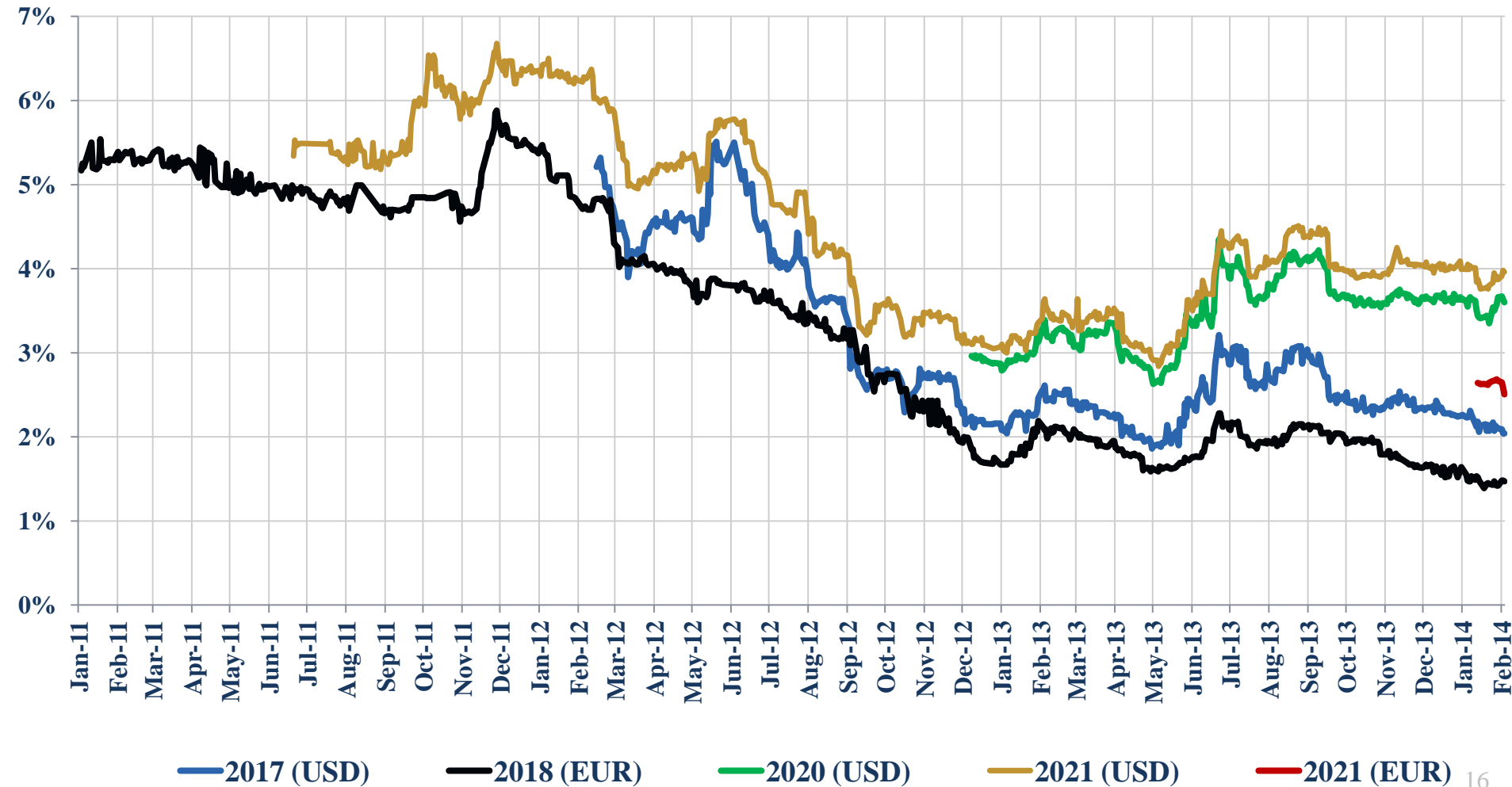
...external imbalances have been corrected quickly (serving by both, import and export): current account close to equilibrium and fully covered by FDI inflows

Current account and FDI in Latvia (% of GDP)



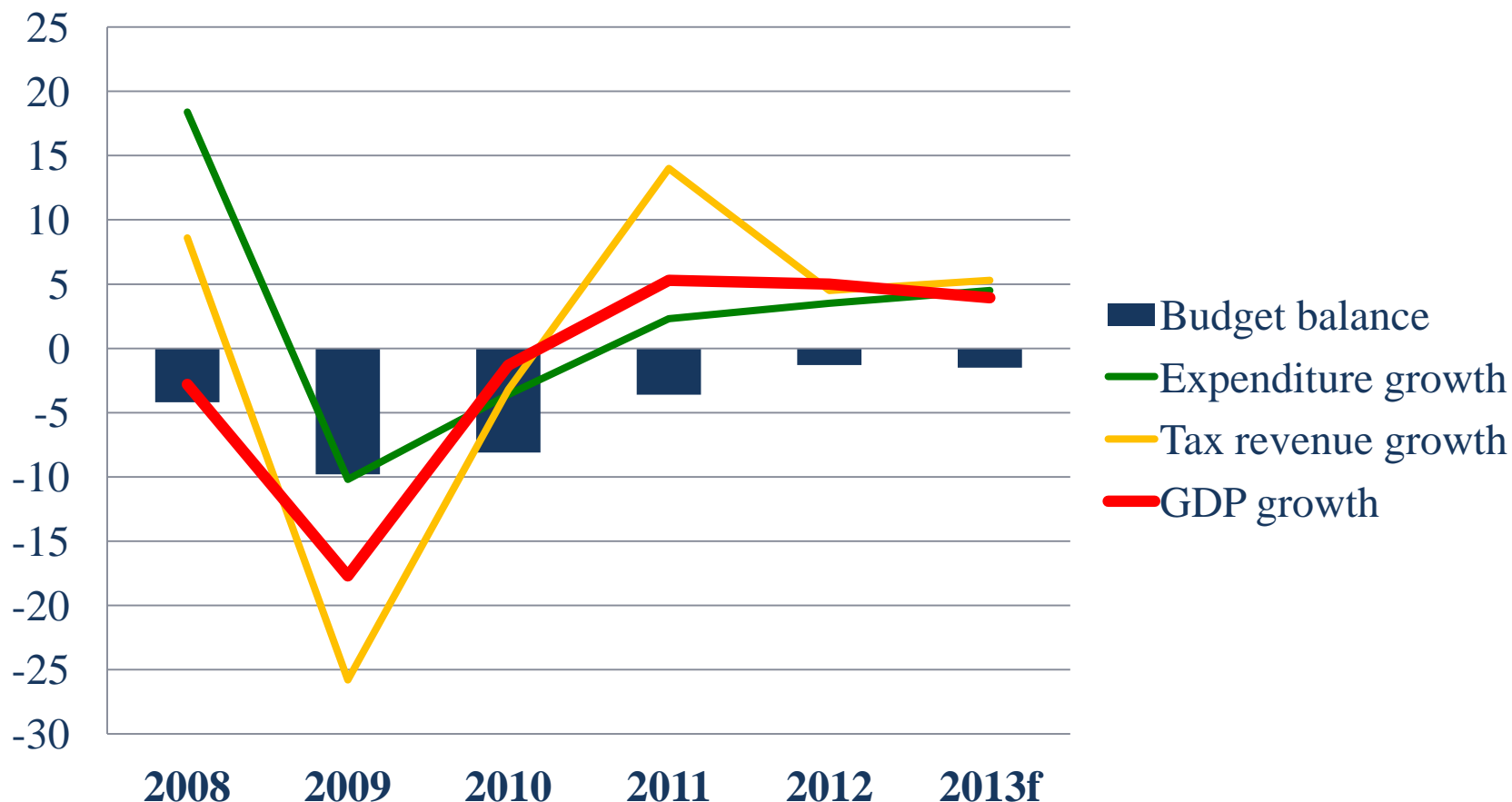
Regained confidence reflected in successfully issued bonds, attaining strong demand. The latest issue in Jan 2014 yielded 2.8%.

Yields of Latvian sovereign bonds in international markets



GDP and tax revenue growth recovered; Fiscal compact approved in March 2013

GDP, tax revenue and expenditure growth (% , y-o-y),

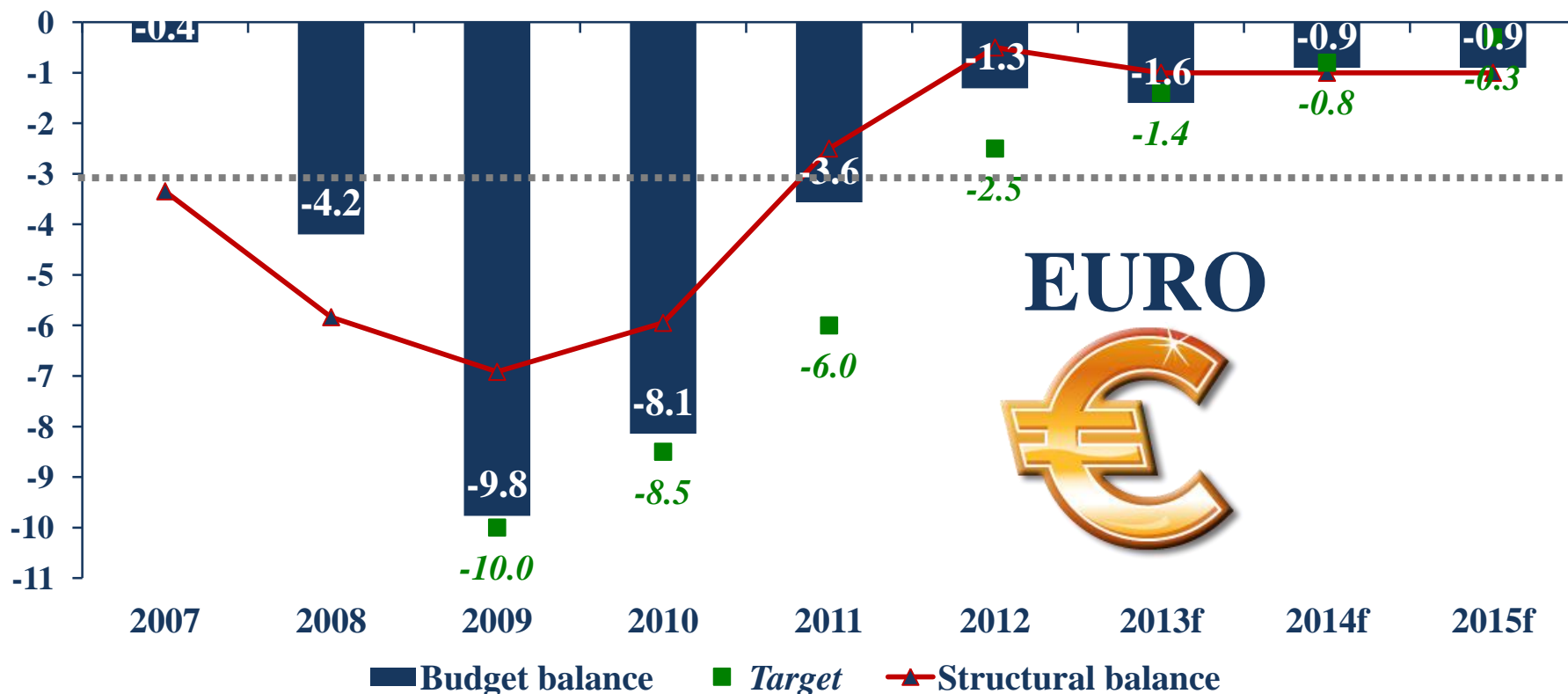




Future Challenges

Structural deficit reached MTO in 2012; fulfilling the budgetary criteria for euro adoption. Challenge: MTO

General Government budget balance (% of GDP)



Source: Central Statistical Bureau of Latvia; F-forecast according to the Convergence Programme 2013-2016;
Target – 2009-2012 according to the agreement within International assistance programme, 2013-2015 according to Convergence Programme 2012-2015

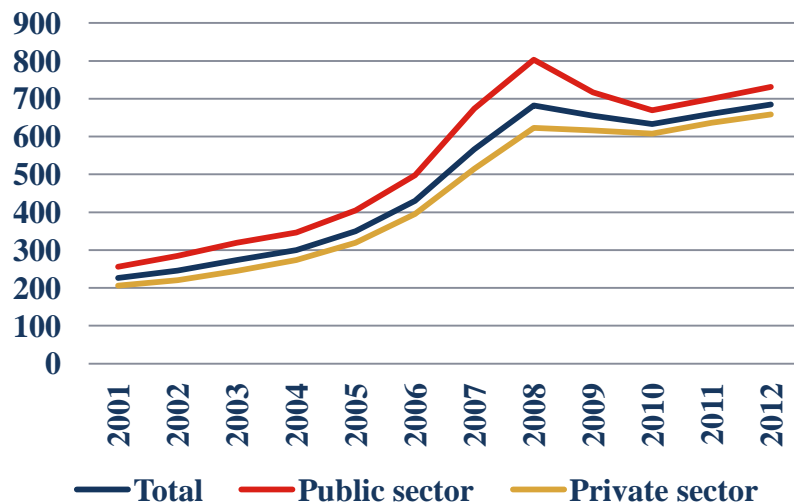


Annex to the Q-A session

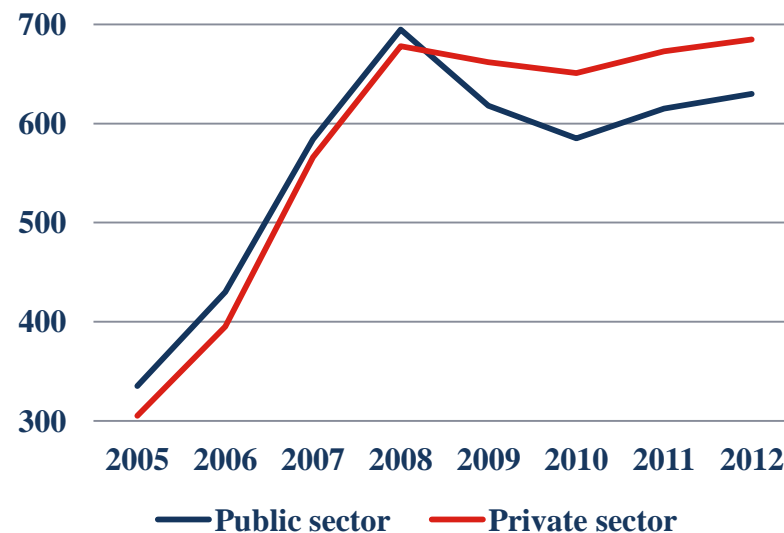
The potential wage-gap

- Latvia's labour market is flexible;
- Widely-spread "envelope wages" in the private sector (decreasing lately);
- **Wages after taxes in the public sector are not higher than for the same work in the private sector**, however, in most sectors the comparison is not feasible*.

Gross average monthly wages for full-time job (EUR)



Gross average monthly wage for full-time health care workers (EUR)



Source: Central Statistical Bureau, Bank of Latvia calculations

* <http://www.macroeconomics.lv/average-wages-latvia-how-big-how-credible-how-relevant-they-are>

Fiscal governance

According to the Fiscal Discipline Law (approved 31.01.2013, entered into force 6.03.2013.) there is developed a medium-term framework and following fiscal risks management rules applied:

- **The principle of sustainable fiscal policy**
 - Expenditure increase rule; Debt Rule
- **The principle of fiscal discipline**
 - Fiscal Discipline Council (6 members, for 3 and 6 years)
- **The principle of savings**
 - In case of revenue excess to expenditure, the Cabinet of Ministers decides on transferring of the excess to the Long-term Stabilization Reserve or to reduction the government debt.
 - Fiscal Safety Reserve for covering of expenditure provoked by fiscal risks (not less than 0.1% of GDP)
- **The principle of transparency**
 - Information on fiscal policy objectives, methods for their achievement and results is publicly available;
 - Information on budget performance of the local governments available since 2008 (on annual and monthly bases), for the central government available since 1998
- **The principle of consistency on forecasts**
 - Macroeconomic forecasts for medium-term inter alia growth rates of gross domestic product, deflator of gross domestic product and growth rates of potential gross domestic product are prepared by Ministry of Finance, and reconciled with the Bank of Latvia and Ministry of Economics.

Thank you for the attention!