Improving the Business Environment in Latvia

The Impact of FIAS Assistance

Sanda Liepina
Jacqueline Coolidge
Lars Grava

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ABOUT FIAS

For 20 years, FIAS has advised more than 130 member country governments on how to improve their investment climate for both foreign and domestic investors and maximize its impact on poverty reduction. FIAS is a joint service of the International Finance Corporation, the Multilateral Investment Guarantee Agency, and the World Bank. FIAS receives funding from these institutions and through contributions from donors and clients.

FIAS also receives core funding from:

- Australia
- Canada
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CONTENTS

Preface vii
Acknowledgments vii
Acronyms viii
Executive Summary 1

IMPROVING THE BUSINESS ENVIRONMENT IN LATVIA: THE IMPACT OF FIAS ASSISTANCE 5
Rationale for the Case Study 5
The Study 5
FIAS Follow-Up Assistance to and Collaboration with the Government of Latvia 7
Did the Business Environment Improve? 8
From Improvements in the Business Environment to Greater Welfare 16
Did FIAS Succeed in Measuring Economic Improvements? 24

Chronology of FIAS Work in Latvia since 1998 28

APPENDIX 2: DETAILED DESCRIPTION OF FIAS’ LATVIA PROGRAM 31
Project Inputs and Activities 31
Project Outputs and Outcomes 32
Inspections 33
Customs Administration, Border-Crossing, and Import/Export Procedures 40
Tax Administration 48
Expatriate Immigration 53
Procedures for Land Acquisition and Construction Permits 56
Structured Dialogue between the Government and the Business Community 61

APPENDIX 3: INTERMEDIATE IMPACT ON THE INVESTMENT CLIMATE IN LATVIA 65
Defining the Investment Climate 65
Scope of FIAS’ Administrative Barrier Work and the Investment Climate 66
Customs, Border-Crossings, and Import/Export Procedures 67
Regulatory Barriers to Business 68
Corruption 74

APPENDIX 4: FINAL IMPACT: INVESTMENT, GROWTH, AND POVERTY ALLEVIATION 77
Private Sector Investment 77
Trade Openness 79
Economic Growth 80
Formalization and Tax Revenues 80
Employment and Living Standards 84
Poverty and Human Development 85
APPENDIX 5: METHODOLOGY NOTE ON COST-BENEFIT CALCULATIONS OF THE FIAS LATVIA ADMINISTRATIVE BARRIERS PROJECT

Assumptions 89
Qualification of Calculations 89

REFERENCES 91

BOXES
Box 1. Inspections Reform: More Professional Inspections, More Accountability in the Inspection Process 14

FIGURES
Figure 1. FIAS Monitoring and Evaluation Framework 5
Figure 2. Cycle of Reforms 6
Figure 3. Areas of Regulation Considered by Businesses to Impede Their Operation and Growth, 2001, 2003, and 2005 10
Figure 4. Business Registration in EU Accession Countries, 2004 and 2005 13
Figure 1B.1. Average Duration of Inspections, 2001 and 2003 15
Figure 1B.2. Changes in Quality of Inspection Work between 2001 and 2003 16
Figure 5. Annual FDI in Latvia, 1996 through September 2005 21
Figure 6. Rates of Unemployment and Job Seekers, 1999–2004 22
Figure 7. Comparison of Average Wage and the Cost of Minimum Subsistence, 1997–2005 23
Figure 8. GDP Per Capita, PPS, 1999 and 2005 24
Figure 9. Change in GDP Per Capita, PPS, 1999–2005 25
Figure 10. Poverty Trends in Latvia, 1998–2004 25
Figure 2A.1. Average Duration of Inspections, 2001 and 2003 36
Figure 2A.2. Changes in Quality of Inspection Work between 2001 and 2003 42
Figure 2A.3. Business Opinions on Customs Services Obstacles to Operation and Growth, 2003 47
Figure 2A.4. Customs Control Work, 1998–2003 48
Figure 2A.5. Number of Customs Declarations (Import, Export, Transit), 1998–2003, and Amount of Calculated Tax, 2000–03 49
Figure 2A.6. Time Required for Tax Preparation, 2001 and 2003 54
Figure 2A.7. Building Permits Issued Nationally for Houses, Nonresidential Buildings, and Engineering Structures, 1999–2003 59
Figure 2A.8. Building Permits Issued in Riga, 1998–2003 59
Figure 2A.9. Length of Real Estate and Construction Procedures, 2001, 2003, and 2005 60
Figure 3A.1. Business Registration in EU Accession Countries, 2004 and 2005 70
Figure 3A.2. Property Registration
Figure 4A.1. Gross Fixed Capital Formation as a Share of GDP, 1999–2005
Figure 4A.2. Per Capita Net FDI Inflows in EU Accession Countries, 1994–2005
Figure 4A.3. Growth in GDP Per Capita and Per Capita Real GDP
Figure 4A.4. Minimum Wage in Eastern Europe, 2004
Figure 4A.5. Wages and Subsistence
Figure 4A.6. Poverty Trends in Latvia, 1998–2004

TABLES

Table 1. Changes in Obstacles to Doing Business between 2002 and 2005
Table 2. Summary of the Quantifiable Impact of Reform
Table 3. Key Indicators of Economic Development, 1999–2005
Table 4. Key Poverty and Inequality Statistics, 1998–2004
Table 1A.1. Logical Framework for Removal of Administrative Barriers to Investment
Table 2A.1. Inspections: Recommended Reforms and Their Outcomes
Table 2A.2. Average Number of Annual Inspections per Company Inspected
Table 2A.3. Changes in Selected Performance Indicators of the State Labor Inspectorate
Table 2A.4. Selected Performance Indicators of the Fire and Rescue Service and the State Labor Inspectorate
Table 2A.5. Government Information Available to Enterprises
Table 2A.6. Evaluation of Inspectorate Web Sites, August 2004
Table 2A.7. Customs Administration, Border-Crossing, and Import/Export Procedures: Reform Recommendations and Their Outcomes
Table 2A.8. Tax Administration: Recommended Reforms and Their Outcomes
Table 2A.9. Work Permits: Recommended Reforms and Their Outcomes
Table 2A.10. Land and Construction Procedures: Recommended Reforms and Their Outcomes
Table 2A.11. Structured Dialogue with the Business Community: Recommendations and Their Outcomes
Table 3A.2. Changes in Customs Services between 2001 and 2003
Table 3A.3. Business Regulation Ratings
Table 3A.4. Corruption Ratings
Table 4A.1. Trade Openness, 1995–2005
Table 4A.2. Number of Taxpayers by Type of Employment, 1999 and 2005
Table 4A.3. Tax Revenues, 1995–2004
Table 4A.4. Employment, 1996 to September 2005
Table 4A.5. Wages and Cost of Minimum Subsistence, 1997–2005
Table 4A.6. Key Poverty and Inequality Statistics, 1998–2004
Table 4A.7. Human Development in EU Accession Countries, Selected Years, 1995–2003
PREFACE

This paper tracks the process through which FIAS, the investment climate advisory service of the World Bank Group advised the government of Latvia from 1998 to 2004 on ways to improve the business environment, achieve higher rates of economic growth, and thereby alleviate poverty.

The case study was developed on the basis of interviews with many of the stakeholders involved in the reform process; surveys of the business environment in Latvia in 2001, 2003, and 2005 (including independent econometric findings prepared by a researcher in 2004 and 2006, which the authors used in their conclusions); legal research; and materials generated by governmental institutions, including the Business Environment Improvement Unit at the Latvian Investment and Development Agency and the Ministry of Economy.

The first draft of this case study was prepared in August 2004. It was updated after a series of discussions and comments during the first half of 2006.

The executive summary presents a concise account of the findings and the arguments used in the case study. The main report contains a detailed analysis of the key elements of the reform program in Latvia and the reasoning behind the conclusions.

The appendixes contain an overview of the FIAS program in Latvia (appendix 1) and details of the reforms enacted (appendix 2). The outcome of reforms as experienced by businesses are discussed at length in appendix 3, and the higher level impact of these reforms and improvements in the business climate is assessed in appendix 4. Details of the methodology of the analysis are described in appendix 5.

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# ACRONYMS

<table>
<thead>
<tr>
<th>Acronym</th>
<th>Description</th>
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<tbody>
<tr>
<td>ARCS</td>
<td>Administrative and Regulatory Cost Survey</td>
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<tr>
<td>BEEPS</td>
<td>Business Environment and Enterprise Performance Survey</td>
</tr>
<tr>
<td>CC-BEST</td>
<td>Candidate Country–Business Environment Simplification Task Force</td>
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<tr>
<td>CM</td>
<td>Cabinet of Ministers</td>
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<td>CMIB</td>
<td>Citizenship and Migration Issues Board</td>
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<td>CPI</td>
<td>Corruption Perceptions Index</td>
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<td>EBRD</td>
<td>European Bank for Reconstruction and Development</td>
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<td>EU</td>
<td>European Union</td>
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<td>FDI</td>
<td>foreign direct investment</td>
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<td>FIAS</td>
<td>Foreign Investment Advisory Service</td>
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<td>FICIL</td>
<td>Foreign Investors’ Council in Latvia</td>
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<td>GCR</td>
<td>Global Competitiveness Report</td>
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<td>GDP</td>
<td>gross domestic product</td>
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<td>HDI</td>
<td>Human Development Index</td>
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<tr>
<td>LDA</td>
<td>Latvian Development Agency</td>
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<td>LIDA</td>
<td>Latvian Investment and Development Agency</td>
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<td>LVL</td>
<td>Latvian lats</td>
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<tr>
<td>NGO</td>
<td>Nongovernmental Organization</td>
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<tr>
<td>PCR</td>
<td>Project Completion Report</td>
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<tr>
<td>PIMS</td>
<td>Project Implementation Monitoring System</td>
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<tr>
<td>PPP</td>
<td>purchasing power parity</td>
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<td>PPS</td>
<td>purchasing power standards</td>
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<td>SES</td>
<td>State Employment Service</td>
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<td>SME</td>
<td>small and medium enterprise</td>
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<td>SRS</td>
<td>State Revenue Service</td>
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<td>UNDP</td>
<td>United Nations Development Programme</td>
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<td>VAT</td>
<td>value-added tax</td>
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EXECUTIVE SUMMARY

The primary mission of the World Bank Group is reducing poverty. FIAS, the multidonor investment climate advisory service of the World Bank Group, supports this mission by advising developing country governments on how to improve their investment climate through private sector development. Poverty-reducing economic growth is most sustainable where the private sector is flourishing; where there are efficient, competitive, and dynamic markets; and where the government intervenes only when needed to correct market failures and to improve opportunities for the poor—and then does so in the most efficient manner.

There is now an increasing demand in the development community to verify the relationships between advisory assistance on reforms to improve the business environment and the actual enactment of such reforms; and beyond that, to verify whether such reforms are indeed associated with higher rates of investment, economic growth, job creation, and poverty reduction. This paper attempts to track the practical connection between FIAS projects and poverty alleviation, focusing on FIAS assistance to the Government of Latvia and the government’s reforms to improve the business environment and remove administrative barriers to investment from 1998 to 2004.

The most significant reforms between 1999 and 2004 were achieved in the following areas:

- **Enterprise registration:** Procedures were streamlined and simplified, company and tax registration procedures were combined, and the time for basic business registration processes was reduced to three days.
- **Tax administration:** An appeals body was established in the State Revenue Service; and tax legislation was drafted and posted on the Internet for comment, which helped resolve tax problems that businesses identified by amending relevant tax laws and by consolidating methodological guidelines and manuals.
- **Inspections:** The rights and responsibilities of government inspectors relative to those being inspected were specified, greater information about the inspection process was made available to businesses, compulsory annual performance reports were established, and training programs for inspectors were devised to improve their relationships with clients.
- **Customs and border crossing:** Responsibilities of the border guard and customs service were better defined.

1. Although FIAS conducted a study of administrative barriers to investment in 1998, the reform program to implement recommendations from that study began in 1999.
and delineated, customs procedures were simplified, manuals were prepared and made available to businesses, a Consultation Department was established, and simplified clearance procedures for regular importers/exporters were set up.

- **Construction and real estate:** Information on cadastral valuations for determining the real estate tax was improved; a state duty of 2 percent of the transaction value or real estate cadastral value to register title transfer was capped; a uniform set of fees and duties for construction were introduced; and the construction permit process was simplified, streamlined, and made more transparent.

- **Expatriate residency:** Procedures for issuing work and residence permits were simplified and new service centers for foreigners were established by the Citizenship and Migration Issues Board.

Reform dynamics resulted in the simultaneous institutionalizing of

- the public/private dialogue (i.e., government officials are more willing and able to engage the business community in constructive dialogue to identify problems and solutions, government agencies more actively seek private sector comments on draft legislation, and information on various business-related procedures has become more accessible)

- **action plan updates** (i.e., regular government review and updating of mechanisms/instruments to address issues of concern to the business community)

- a **monitoring system** to track the views and experiences of the business community (i.e., the government is funding a regular independent and representative business survey to assess the scale of administrative burdens and to identify problem areas).

According to the results of surveys conducted between 2001 and 2005, businesses operating in Latvia have seen improvements in the overall business environment and in specific regulatory areas and administrative procedures.

Several key international indicators of the investment climate have shown clear signs of improvement (although not all indicators did).

Although FIAS cannot claim direct credit for the impact of its recommendations, improvements to the investment climate in the broader economy clearly have yielded improvements in private investment. For example, whereas gross fixed capital formation in the private sector in 1997 was 16 percent of gross domestic product (GDP), by 2004 it had increased to 27.5 percent of GDP; and the number of active taxpaying firms

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Many reforms were initiated in the period 1999 through 2002, and the Administrative and Regulatory Cost Survey carried out in Latvia in late-2001 and again in late-2003 and 2005 showed many signs of continuing improvement:

- a steady reduction in the share of businesses that regard regulations as an obstacle to their operation and growth
- improved access to information and updates regarding tax issues
- reduced frequency and duration of inspections
- declines in the incidence and severity of fines imposed on businesses
- There have been reductions in the time and money costs of administrative procedures, such as time spent registering a company and registering title transfer in Land Books.
increased by 31 percent between 1997 and 2004 (from 35,259 to 51,440 active companies, respectively).

After a period of high economic growth in the mid-1990s (GDP growth averaged 6 percent), the Latvian economy suffered a downturn in mid-1998 as a result of the Russian currency crisis and a slowdown in reforms. The new wave of reforms—not the least of which were efforts to improve the business environment—along with favorable external conditions resulted in a recovery that began in early 2000 with industrial output and investment growing and business confidence improving. GDP growth reached 10.2 percent in 2005 with continued strong domestic demand, and the July 2006 forecast was that strong investment would continue to maintain GDP growth at 8 percent in 2006.

Beyond these figures, Latvia achieved substantial progress in poverty reduction. The effect of high GDP growth has been to lift an estimated 325,000 people out of poverty (World Bank 2006, p. vii). The labor market provided the primary channel through which more people are now living above the poverty line.

The quantifiable benefits of business environment improvements accruing to businesses were at least US$170 million between 2001 and 2005, discounted to 1998 dollars (for details, see the main text and appendixes). It is worth noting that these are very conservative estimates of the benefits from only a few reforms undertaken between 1999 and 2004 for which we have measurable results. Some important reforms took place in 2000 and 2001, but our baseline survey took place only in 2001, so some improvements were entirely missed in the benefits calculation. Also, given the range of reforms that have been implemented (including some for which quantifiable data are not readily available), it is likely that the effect of the business environment improvement program is much more substantial.

Most important is the likelihood that the dismantling of barriers to investment and reduction in regulatory risk (for example, the risk of severe bureaucratic delays or spurious fines imposed by government inspectors) did indeed help stimulate more private investment than would have taken place without the reforms, the value of which has not been quantified for this analysis. Along with the growth in investment came a growth in the overall number of firms in the Latvian economy—an indication of increased competition as a result of lower barriers to entry.

It must be noted that the analysis is more “after vs. before” rather than the more accurate “with reform vs. without reform,” for which we lack a counterfactual. As a control, Estonia and Lithuania might be reasonable comparators. Latvia has enjoyed the highest growth rates of the three countries over the period 1998–2005, with an average annual GDP growth rate of 7.1 percent, compared with 6.3 percent in Estonia and 6.0 percent in Lithuania (http://ddp.worldbank.org/ddp/home.do). Whereas these are impressive figures, it is not possible to prove conclusively that Latvia’s growth advantage during this period is attributable to its reform program.

FIAS, along with many other stakeholders,3 reasonably can claim some credit for assisting the Government of

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2. See appendix 4 for a full discussion of economic growth, employment, and living standards.
3. Other stakeholders include, for example, a World Bank project in support of public administration reform following the FIAS recommendations, and various projects sponsored by the European Union.
Cost-Benefit Ratios

FIAS and the Government of Latvia inputs: $1 million; World Bank loan: $45 million; quantifiable benefits: $170 million

By way of comparison, it is appropriate to examine the cost of the design and implementation of the program. The FIAS interventions were relatively inexpensive: between 1998 and 2005, FIAS carried out six projects at a total cost less than $500,000. The Government of Latvia also provided major in-kind contributions of staff time to oversee the reforms, and it covered most of the costs of the second and third business surveys. Its contribution may have been roughly another $500,000 over the period 1998 to 2005, putting the total cost of the work at roughly $1 million. Many of the FIAS recommendations also were supported by a World Bank loan of about $45 million for public administration reform (including tax and customs reform).

The investment climate reforms, which clearly improved efficiency and lowered costs for businesses, were carried out without any discernible harm to broader welfare in Latvia. For example, there is no evidence that a reduction in inspections of businesses has been associated with any increase in the rates of industrial fires, workplace accidents, and so forth. To the degree that the reforms promoted growth in investment and new company formation, however, the increased workload for public servants might have held back improvements in the time required to complete various administrative procedures (such as the Doing Business indicator for the time required to start a business, which suffered during the period covered here because of a one-off requirement for re-registration of companies and which created a significant backlog in 2005).

This case study shows that it is reasonable to describe how assistance by FIAS led to an improved business environment. The role that FIAS advice played may be discerned at the level of benefits accruing to the target population (i.e., the amount of resources freed up by lower costs associated with administrative procedures). Whether these benefits accruing to the business community translated into higher rates of investment and productivity, and thus to higher economic growth and reduced poverty, is a function of the entire political, social, and economic structure in Latvia. It is evident that there are many links in the chain of causation, and that the direct attribution FIAS can claim diminishes at every step downstream from its activities. Credit for success must be shared with the Government of Latvia and its immediate stakeholders (i.e., the businesses and their associations), the European Union accession process, the input of many other complementary projects, market forces, and fortuitous timing.

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4. Latvia ranked among the best countries in the Doing Business 2004 report for ease of starting a new business, but its ranking was slightly lower in the Doing Business 2005 report because of this backlog.
IMPROVING THE BUSINESS ENVIRONMENT IN LATVIA: THE IMPACT OF FIAS ASSISTANCE

RATIONALE FOR THE CASE STUDY

The overriding mission of the World Bank Group is poverty alleviation, a goal that is shared by FIAS, the multidonor investment climate advisory service of the World Bank Group, and all its donors. For more than 20 years, FIAS has advised more than 130 member country governments on ways to improve the investment climate for foreign and domestic investors alike, and in the process, to reduce poverty.

The FIAS mandate: Advise developing country governments on how to improve the investment climate for both foreign and domestic investors and maximize its impact on poverty reduction.

The purpose of this case study is to measure the effects of FIAS recommendations (i.e., through project activities) on outcomes (such as newly enacted legislation leading to an improved investment climate), and to assess their impact (i.e., investment flows, economic growth and employment, and poverty alleviation [figure 1]). The study attempts to track how FIAS’ work has led to poverty alleviation by focusing on its efforts in Latvia from 1998 to 2004. (For a chronology of projects, see appendix 1.)

THE STUDY

Latvia, one of the three Baltic States, covers an area of 64,589 km². As of 2006, its population was 2.27 million. Latvia’s desire to integrate into the economic and security structures of Western Europe after regaining independence in 1991 created a broad consensus for reform. Its economic policy was based on the tenets of a liberal market economy: creating the necessary institutional structures while maintaining a consistent macroeconomic policy. Some progress had already been achieved by 1998 when Latvia joined the World Trade Organization. Despite legislative reforms, the investment climate was characterized by recurring problems in the day-to-day realities of conducting business—a typical situation in many other post-Communist transition countries. Until 1998, the effects of administrative procedures were not consistently addressed in Latvia.

As a result, complaints from foreign investors and local entrepreneurs alike concerned recurring problems associated with conducting business (for example, unclear immigration procedures for foreign citizens, delays in transferring property rights, burdensome and unmotivated visits by government inspectors, and an unnecessarily large number of permits required for construction approval).

5. Latvia is a unitary state and a parliamentary democracy with a proportional electoral system. The prime minister presides over a coalition government, typically formed by three to five parties that compose a majority in the parliament.
To address these issues, in 1998 the Ministry of Finance and the Latvian Investment and Development Agency (LIDA) requested FIAS’ assistance. FIAS believed it was appropriate to work with Latvia because it was a transition country that strongly aspired to join the European Union (EU), but it was not considered part of the likely first wave of countries that would receive accession approval; rather, it was expected that Latvia would join the EU at a later time, along with Romania, for example. There was a consensus among almost all political parties that Latvia should join the EU at the earliest possible date.

Thus, at the request of the Government of Latvia, in late 1998 FIAS began to advise the government on ways to dismantle administrative barriers to investment. FIAS provided assistance to implement various administrative reforms from 1999 to 2002, and conducted an impact analysis in 2003–05. The initial study evaluated many problems related to company registration, licensing, inspections, expatriate work permits, taxation and customs procedures, real estate and construction procedures, and other issues of importance to entrepreneurs. The study then offered detailed recommendations for removing those barriers.

To initiate an open discussion about the problems identified in the FIAS study, the LIDA invited business representatives and government officials to the presentation of the draft report. The prime minister established a steering group to seek solutions to the issues identified in the 1998 study. The steering group was created by a decree of the prime minister and, using both the recommendations from FIAS and suggestions from subcommittees, it developed the first “Action Plan to Improve the Business Environment in Latvia.”

The action plan was the government’s key reform instrument. It was first adopted by the Cabinet of Ministers on May 11, 1999, and subsequently revised on the basis of new problems and suggestions (the latest version was adopted in early 2006). The plan was an interministerial planning document that summarized the problems, listed the specific tasks to be undertaken to solve the problems, designated the institutions with the responsibility for doing so, imposed implementation deadlines, and identified performance indicators. The action plan followed the “cycle of reforms” depicted in figure 2. The plan called for amendments

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6. The steering group was composed of leading civil servants in the ministries of economy, finance, justice, and regional development, and heads of government agencies responsible for implementing the Reform Program to Improve the Business Environment in Latvia. It also included representatives of the Foreign Investors Council in Latvia (which includes the foreign chambers of commerce), the Latvian Chamber of Commerce and Industry, and other business associations. The steering group has since been formalized and meets regularly to monitor the progress of reform implementation.

7. Four technical subcommittees were created to examine (1) inspections problems; (2) expatriate residency and work permit issues; (3) registration, tax, and customs matters; and (4) land acquisition and construction issues.

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FIGURE 2: CYCLE OF REFORMS

1. Identifying problems
2. Agreeing on reform priorities and action plan
3. Enacting and implementing actions
4. Monitoring the impact of reforms implemented

Source: Authors’ illustration.
to legal acts, revision and simplification of procedures, improvement of coordination among different institutions, preparation and publication of information, and training for officials.

LIDA’s Business Environment Improvement Unit was assigned the tasks of supervising the implementation of the action plan and institutionalizing the dialogue between the investment community and the government. Revisions to the action plan are guided by the results of regular monitoring of the business environment via business focus groups, consultations, and company surveys (three successive, representative surveys of businesses were undertaken in 2001, 2003, and 2005) and by detailed studies of specific issues and analyses performed by various government entities.

The most significant results between 1999 and 2004 were achieved in enterprise registration, tax administration, inspections, customs and border-crossing procedures, construction permit and real estate procedures, and expatriate residency. Significant achievements were made in institutionalizing the public/private dialogue, updating the action plan, and monitoring. According to the progress reports on implementing the action plan, 91 of 106 tasks included in the action plan had been implemented successfully by December 31, 2003, Appendix 2 describes these specific reforms and their outcomes in detail, starting with the recommendations provided by FIAS, formulation of the reform measures included in the action plan, reforms enacted by the government, and improvements in Latvia’s investment climate as evidenced by various indicators.

**FIAS FOLLOW-UP ASSISTANCE TO AND COLLABORATION WITH THE GOVERNMENT OF LATVIA**

The initial study that FIAS conducted in 1998 was well received and led the Government of Latvia to request FIAS assistance to implement reforms in inspections and construction approval issues, and to provide further guidance to establish the public/private dialogue and improve the business environment monitoring system. In addition to substantive advice, an important component of FIAS assistance was the transfer of methodological knowledge on the management and monitoring of investment climate reforms and as-needed collaboration to prepare the initial and subsequent action plans.

By 2000, the LIDA Business Environment Improvement Unit had developed Latvia’s approach to investment climate reform and the initial results of this reform program were becoming evident. While FIAS was continuing its assistance to the Government of Latvia, primarily in the form of as-needed substantive advice on specific issues and reform options, it simultaneously engaged in deeper collaboration with the LIDA to design a set of standardized instruments for assessing the business environment that could be repeated over time in Latvia and replicated in other client countries.

FIAS then also helped the Government of Latvia carry out its own self-assessment update of administrative barriers in 2001–02, which provided a new set of insights.
into the problems and options for reform. FIAS assistance was twofold: (1) to provide best-practice information and overall quality assurance of the recommendations included in the final self-assessment report, and (2) to design and implement a representative Administrative and Regulatory Cost Survey (ARCS) to establish a monitoring system to track the experiences of business representatives with specific administrative requirements and changes in their perceptions about the overall business environment.8

In 2003 and 2005, the Government of Latvia financed the second and third ARCSs of businesses and, in 2005, produced an updated assessment of the business environment (i.e., a policy report). In the latest survey, FIAS involvement was designed to be limited to providing minor quality supervision of the company that conducted the survey and to assist in developing an oversight function, independent of the government, to oversee such efforts in the future. It reasonably can be expected that this type of monitoring by the government is now institutionalized and will continue in the future without the need for FIAS assistance. In this regard, the Latvian experience constitutes a best practice of mainstreaming governance and regulatory survey work and its use in monitoring and advancing a reform agenda.

In addition to FIAS projects, there were other World Bank Group projects in Latvia and extensive assistance from the EU PHARE9 program and from many bilateral donors. Most important, the Government of Latvia maintained steady progress in implementing reforms (even through many changes in government)—steady progress that may be considered the outcome of all these projects.

The assistance provided by FIAS (i.e., the inputs at the front end of the chain of causation) is described in detail in the first section of appendix 2, including the key resources and activities of the relevant projects.

DID THE BUSINESS ENVIRONMENT IMPROVE?

Investment climate is a broad concept; essentially, it is a key determinant of whether an economy is able to respond dynamically to the opportunities offered by globalization. The investment climate is affected by a number of factors:

- macroeconomic stability
- bureaucratic harassment, especially in the administration of regulations and taxes
- strength of financial institutions
- rule of law (including law enforcement), corruption, and crime
- quality of infrastructure (including power and telecommunications)
- government effectiveness in providing sound regulatory structures for the private sector (including promotion of competition and regulation of natural monopolies)
- effective provision of public services or the framework for such services
- quality of the labor force (Batra and Mody 2003). Thus, investment climate is multidimensional, and a great deal of overlap and correlation exists between its various elements.

8. LIDA also was making use of support from the EU PHARE program and the Swedish International Development Agency to cofinance some of this work.
9. The acronym PHARE originally stood for “Poland and Hungary: Assistance for Restructuring Their Economies.” The PHARE program later was expanded to provide assistance to other countries seeking EU accession.
The core objective of the Government of Latvia’s Reform Program to Improve the Business Environment from 1999 to 2004 was predominantly to reduce administrative barriers to investment. Over time, other elements were added to the government’s program (such as addressing labor skills and access to finance). However, assistance by FIAS primarily concerned the removal of regulatory barriers to business. Given the aim of this case study to track the effect of FIAS’ work, we focus on indicators that concern regulatory procedures to illustrate the improvements in the business environment.

Although many reforms had already been initiated in 1999 and 2000 and again in 2001 and 2002, an evaluation of the results of these reforms and those of the ARCSs carried out in Latvia in late 2001, late 2003, and 2005 showed many signs of continuing improvement (figure 3). For example, there was a steady reduction in the share of businesses that saw various regulations as obstacles to operating and expanding.

The following changes in the administrative culture in Latvia occurred:

- Government officials were more willing and able to engage the business community in constructive dialogue and to identify problems and solutions.
- Government agencies were more active in seeking private sector comments on draft legislation.
- The capacity of business associations gradually increased to meet the challenge of engaging the government in dialogue.
- Accessibility of information on various business-related procedures improved.

The following improvements to specific procedures were achieved, directly as a result of specific advice provided by FIAS advisers from 1999 to 2004.

### Tax administration and enterprise registration:
- An appeals body in the State Revenue Service was established.
- Draft tax legislation was posted on the Internet for comment.
- Tax and enterprise registration were combined.
- The time required to register a company at the Enterprise Register was reduced from approximately 20 days in 1998 to 3 days in 2005.\(^{10}\)
- The process of electronic submission and acceptance of tax declarations has commenced.
- Various specific tax-related problems identified by businesses were resolved via amendments to separate tax laws (i.e., the Law on VAT [value-added tax], the Law on Social Insurance Contributions, and the Law on Corporate Income Tax).
- Access to information and updates regarding tax issues has improved.

### Customs:
- Only incoming traffic was controlled at many inter-Baltic border checkpoints (until EU accession in 2004, when inter-EU customs controls were abolished).
- The responsibilities of the border guard and customs services were better defined and delineated.
- Customs procedures were simplified, and manuals were prepared and made available to businesses.
- Since September 1, 2001, the Consultations Department of the Legal Division of the National Customs Board has been providing information and consultations to clients of the customs authorities.

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10. Three days are required for the core registration procedure. The figure of 18 days cited in Doing Business 2006 includes additional procedures required for starting a new business. Discrepancies between FIAS ARCS data for Latvia and the Doing Business indicators are further accounted for by the fact that Doing Business indicators are based on a narrowly defined “case,” whereas the ARCS data are based on actual experiences of a representative sample of companies in Latvia.
**FIGURE 3: AREAS OF REGULATION CONSIDERED BY BUSINESSES TO IMPede THEIR OPERATION AND GROWTH: 2001, 2003, AND 2005**

- **Expatriate employment and residency:**
  - Procedures for issuing work and residence permits have been simplified.
  - New service centers for foreigners were established by the Citizenship and Migration Issues Board.

- **Government inspections:**
  - An Inspectorate Coordination Council functioned between 1998 and 2002 to coordinate the work of the various inspectorates, to serve as a forum to exchange information and experiences, and to design and implement common training programs.
  - The rights and responsibilities of inspectors and those being inspected were standardized. Each inspection agency and its controlling institution prepared internal regulations on the basis of guidelines provided in an Instruction of the Cabinet of Ministers, which was adopted on January 18, 2000. A requirement that inspections would be accompanied by written inspection reports was introduced.
  - Greater information was made available to businesses about the inspection process in general and about each specific inspection. Annual meetings between inspectorates and client groups for selected inspectorates were held in the regions.
  - Performance indicators in several key inspectorates were developed, and compulsory annual performance reports were made publicly available, thereby helping to track the progress of internal management changes in the inspectorates.
  - Inspectors received training to improve their strategic focus and to develop a client orientation in their work.
  - These reforms resulted in a reduction in the frequency and duration of inspections while maintaining the quality of supervision for consumers and the public at large (see appendix 2).
  - Greater compliance and a shift in approaches to enforcement by the inspectorates led to a reduction in the incidence and severity of fines imposed on businesses.

- **Real estate and construction procedures:**
  - Information on cadastral valuation for determining the real estate tax was clarified.
  - A state duty in the amount of 2 percent of the transaction value or real estate cadastral value for the registration of title transfer was capped at 30,000 Latvian lats (LVL).
  - The time and cost of several administrative procedures (such as title transfer in the land books) decreased.
  - A uniform set of fees and duties for construction permits and procedures was introduced, making the construction process less bureaucratic and more transparent. The construction preparation and the state expertise procedures were simplified and streamlined by adopting amendments to the General Construction Regulations.


An examination of the figures in table 1 shows that businesses operating in Latvia have seen improvements in the business environment and in specific regulatory areas and administrative procedures.

In addition, other key international indicators of the investment climate show clear signs of improvement. The Fraser Institute’s *Index of Economic Freedom* showed improvements in regulatory trade barriers. The Heritage Foundation indexes showed significant improvements in “administrative conditions for new businesses.” The
World Bank’s regulatory quality index and government effectiveness indexes both showed that ratings for Latvia have improved (Kaufmann, Kraay, and Mastruzzi 2003). In its Corruption Perceptions Index (CPI), Transparency International placed Latvia on par with Pakistan in 2003 (with CPI scores of 2.7, both countries were tied for 71st place out of 113 countries surveyed) and on par with Jamaica in 2003 (each country having a CPI score of 3.8), with further improvements over the following years (the 2006 survey tied Latvia and the Slovak Republic for 49th place among 163 countries surveyed—each with a CPI score of 4.7) (TI various years).

Both the European Commission and the EBRD’s Transition Reports noted steady improvements, with the EU Progress Reports (prepared until 2004) consistently praising the “serious efforts of Latvia to improve the business climate.”

In 2006, the Doing Business indicators ranked Latvia 24th among 175 countries for overall “ease of doing business,” placing it in the top quintile of countries, just behind the Republic of Korea (World Bank 2007, p. 6). In 2004, the Doing Business indicators showed that the regulatory environment in Latvia was one of the best among the EU accession countries in terms of business registration (see figure 4).

For a more detailed example of the types of reforms undertaken, see box 1 about the reform of Latvia’s inspectorates.

<table>
<thead>
<tr>
<th>Obstacle</th>
<th>Latvia</th>
<th>Czech Republic</th>
<th>Estonia</th>
<th>Hungary</th>
<th>Lithuania</th>
<th>Poland</th>
<th>Slovak Republic</th>
<th>Slovenia</th>
</tr>
</thead>
<tbody>
<tr>
<td>Business regulation</td>
<td>−5</td>
<td>8</td>
<td>−6</td>
<td>6</td>
<td>4</td>
<td>−7</td>
<td>−16</td>
<td>1</td>
</tr>
<tr>
<td>Institutions and property rights</td>
<td>−4</td>
<td>16</td>
<td>−2</td>
<td>1</td>
<td>−5</td>
<td>−9</td>
<td>−19</td>
<td>−2</td>
</tr>
<tr>
<td>Macroeconomic instability</td>
<td>8</td>
<td>5</td>
<td>−23</td>
<td>14</td>
<td>−18</td>
<td>−18</td>
<td>−44</td>
<td>−9</td>
</tr>
<tr>
<td>Taxation</td>
<td>−7</td>
<td>26</td>
<td>−20</td>
<td>14</td>
<td>−10</td>
<td>−5</td>
<td>−26</td>
<td>17</td>
</tr>
<tr>
<td>Infrastructure</td>
<td>2</td>
<td>14</td>
<td>−4</td>
<td>2</td>
<td>2</td>
<td>−3</td>
<td>−8</td>
<td>2</td>
</tr>
<tr>
<td>Skills and labor regulations</td>
<td>5</td>
<td>17</td>
<td>2</td>
<td>3</td>
<td>15</td>
<td>−4</td>
<td>−12</td>
<td>7</td>
</tr>
<tr>
<td>Access to and cost of financing</td>
<td>−8</td>
<td>7</td>
<td>−9</td>
<td>11</td>
<td>−2</td>
<td>−5</td>
<td>−29</td>
<td>−2</td>
</tr>
</tbody>
</table>

Note: Positive values indicate deterioration (a higher percentage of firms seeing particular regulations as an obstacle to doing business); negative values indicate improvement.
Figure 4: Business Registration in EU Accession Countries, 2004 and 2005

a. Number of procedures to start a business

- Latvia
- Estonia
- Hungary
- Lithuania
- Slovak Republic
- Slovenia
- Czech Republic
- Poland

Year 2004
Year 2005

b. Time to start a business

- Latvia
- Slovak Republic
- Lithuania
- Poland
- Estonia
- Hungary
- Czech Republic
- Slovenia

Year 2004
Year 2005

c. Minimum capital to start a business

- Slovenia
- Latvia
- Czech Republic
- Slovak Republic
- Estonia
- Lithuania
- Hungary
- Poland

The 1998 FIAS report on removing administrative barriers to investment cited complaints about intimidating behavior and aggressive and suspicious attitudes of inspectors, and about a lack of transparency in inspecting procedures. Entrepreneurs generally were unaware of the objectives of inspections, the legal framework in which they occurred, the rights and authority of the inspectors, and the rights of the inspected. Multiple public institutions frequently handled similar or overlapping areas, with little cooperation or coordination among them. To address a grievance, an entrepreneur had the unpleasant choice of approaching the institution’s management or following an expensive formal court procedure.

FIAS made several recommendations to improve the inspections regime, which resulted in numerous reforms. Here are some of those recommendations:

**Recommendation:** Give inspectors basic marketing training and customer service training.

**Outcomes:**
- The heads of inspections services and inspectors were offered tailored training in strategic planning, performance management, customer service skills, and administrative law.
- Inspectorates have demonstrated a meaningful change in attitude; inspectorate heads have acknowledged that their actions directly affect the business environment in Latvia.

**Recommendation:** Ensure that written reports are prepared and issued on the spot. The right of the person being inspected to see the inspection report should be well publicized.

**Outcomes:**
- Inspectorates prepared internal rules with standardized information on the rights and duties of inspectors and those being inspected, appeals mechanisms, and payment methods; these rules make the work of each inspectorate more transparent and understandable.
- A number of inspections introduced carbon-copy forms for their administrative protocols and decisions, and checklists of items to be inspected.

**Recommendation:** Improve the ways that information concerning the legal framework and the rights and obligations of the inspected are disseminated.

**Outcome:**
- Guidelines prepared by inspectorates were published as brochures and publicly distributed via the Internet and official gazettes.

**Recommendation:** Clarify appeals procedures and improve the handling of appeals.

**Outcome:**
- Appeals were partially addressed in guidelines, internal regulations, and revised forms for administrative acts to be used by individual inspectorates. This issue was later addressed through parallel initiatives such as the Administrative Procedure Law. a
**Recommendation:** Either merge the Riga Municipal Language Inspectorate and the State Language Inspectorate into a single unit, or define their specializations.

**Outcome:**
- In early 2001, following establishment and enforcement of a new language law, municipalities had no ability to enforce the old language law. The Riga Municipal Language Inspectorate was eliminated, and some of its functions were transferred to the Riga City Language Service.

The business surveys carried out in 2001 and 2003 indicate that entrepreneurs enjoyed significant savings as a result of the reforms (see figures 1B.1 and 1B.2). By 2003:
- The average inspected firm was subject to three fewer inspections for a time savings of almost 40 hours for each firm.
- The Labor Inspectorate had 17 percent more firms under its supervision, but the number actually inspected increased just 5 percent. An increase of only 2 percent to the team of inspectors was enough to handle the larger caseload.
- A firm’s probability of paying a fine for labor, sanitation, or fire safety infractions fell by more than 80 percent.
- Businesses indicated that “the inspectorates are no longer penalizing us for little mistakes, they are just writing or telling [us] that these problems have to be averted.”

**FIGURE 1B.1: AVERAGE DURATION OF INSPECTIONS, 2001 AND 2003**

*Source: ARCS 2001 and 2003.*

(continued)
We have determined that the business environment in Latvia did improve. But what interests the development community most is whether those improvements led to any benefits accruing to the target population (i.e., businesses), to the broader economy, or to both.

Logic would dictate that if the reforms led to a reduction in time and costs for administrative procedures, then the beneficiaries should enjoy cost savings—essentially
resources freed up for more productive uses, such as new investment. More generally, there is evidence that by eliminating unnecessary procedures and streamlining regulations, governments can encourage new investment, and thereby improve economic growth and employment opportunities and alleviate poverty. According to the 2005 Doing Business report, reducing key barriers to entry can result in a 0.25 percent increase in the annual income growth of a developing country (World Bank 2005). Similarly, trade openness leads to an approximate 0.7 percent increase in per capita income growth in well-regulated countries (Bolaky and Freund 2004).

Benefits Accruing to Businesses

We attempted to calculate a quantitative estimate of the effect on Latvian businesses of at least some of the reforms that were undertaken since 1998. The surveys of businesses in 2001 and 2003 confirmed that the average repetition and duration for the five most common inspections (state revenue, fire safety, labor, sanitary, and municipal police inspections) fell between 2001 and 2003, resulting in a time saving of more than 38 hours per year for an average Latvian enterprise. If we assume each firm needed to assign one staff member to accompany a government inspector for the entire duration of the inspection (at an average hourly wage of about US$2.2 in 2003), this represents a savings of US$85 per year for each active enterprise operating in Latvia. According to Ministry of Economy data, there were 40,668 economically active firms in 2001 and 45,300 in 2003. The change in the way inspections were conducted enabled businesses to free up more than US$3.8 million in 2003 alone. This is a conservative estimate of the benefits from just a subset of reforms supported by the FIAS projects in only one year.

Because the absolute number of inspected businesses did not decrease, the cost savings represent improved efficiency in the way inspections were conducted (i.e., inspections became shorter and led to fewer repeat inspections of the same business). More important, the reduction in the inspection burden on business did not lead to any worsening of outcomes for broader human health and safety (such as workplace accidents and fires).

We performed similar calculations of reform effects for licensing, company registration, access to real estate, and tax administration. Table 2 summarizes the results, amounting to about US$3,760 per enterprise. Thus the quantifiable benefits from implementing improvements in the business environment accruing to businesses in Latvia were in the range of US$170 million (the majority of the benefits were associated with reforms to improve tax administration). These are conservative estimates of benefits from only a few reforms undertaken between 1999 and 2004 (see the methodology note, appendix 5). The decision to select these reforms for analysis was driven by the data available from the business surveys and other sources. Given the range of reforms that were implemented, the impact of FIAS assistance to the Government of Latvia through

11. This excludes many other inspections (such as construction and environmental inspections) that affect significantly fewer firms.
12. This benefit does not include other aspects of the reforms that reduced the incidence of arbitrary and severe fines, and improved transparency and accountability in government inspections.
13. Data from 2005 suggest that improvements in the burden of inspections leveled off, as is to be expected. Inspections cannot be reduced to zero, but there has been no significant backtracking or erosion of the reforms.
**TABLE 2: SUMMARY OF THE QUANTIFIABLE IMPACT OF REFORMS**

<table>
<thead>
<tr>
<th>Reform area</th>
<th>Quantifiable effect of improvements</th>
<th>Explanation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inspection reforms</td>
<td>$3,011,839</td>
<td>Resources freed up for the entire economy from improvements in inspection procedures (2001 vs. 2003)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>The cost savings primarily represent improved efficiency (i.e., inspections became shorter and led to fewer repeat inspections of the same business). Total savings are calculated as a reduction in the cost of labor hours that need to be spent on inspections. Reduction in inspection hours is calculated as a reduction in both the duration and frequency of inspections. Total time savings are multiplied further by average salary and number of active enterprises in the economy. The probability of not being inspected also is taken into account.</td>
</tr>
<tr>
<td>Licensing</td>
<td>$4,275,459</td>
<td>Decrease in official payments for obtaining licenses for business operations (2001 vs. 2003)</td>
</tr>
<tr>
<td></td>
<td>$7,956,766</td>
<td>Decrease in official payments for obtaining licenses for business operations (2003 vs. 2005)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>The cost savings primarily represent lower payments to institutions for obtaining licenses and fewer licenses required to maintain business operations. The result is derived by considering a reduction in the average number of licenses necessary to operate and a reduction in official fees when obtaining a license. Savings per enterprise are generalized further by multiplying by the total number of economically active enterprises.</td>
</tr>
<tr>
<td></td>
<td>$322,264</td>
<td>Decrease in payments to intermediaries for obtaining licenses for business operations (2001 vs. 2003)</td>
</tr>
<tr>
<td></td>
<td>$143,487</td>
<td>Decrease in payments to intermediaries for obtaining licenses for business operations (2003 vs. 2005)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>The cost savings primarily represent the use of fewer intermediaries and lower payments to those used for obtaining licenses because of improved application processes. The result is derived by considering a reduction in the percentage of cases when intermediaries are used and a reduction in payments to intermediaries when obtaining licenses. Savings per enterprise are generalized further by multiplying the result by the total number of economically active enterprises.</td>
</tr>
<tr>
<td></td>
<td>7.3 Days</td>
<td>Increase in average time per enterprise to obtain all necessary licenses for business operations (2001 vs. 2003)</td>
</tr>
<tr>
<td></td>
<td>4.3 Days</td>
<td>Decrease in average time per enterprise to obtain all necessary licenses for business operations (2003 vs. 2005)</td>
</tr>
</tbody>
</table>
|                   |                                     | Although a favorable decrease in the amount of time needed to obtain all necessary licenses for business operations can be noticed for 2005 vs. 2003, the opposite was true for 2003 vs. 2001. The total effect in efficiency improvement expressed as the time to obtain all licenses is slightly negative. This reasonably may be explained by a rapidly growing number of active enterprises and consequent increase in the number of applications for licenses. Although the time required to obtain licenses has increased by 16 percent, the total number of active enterprises has grown by 33 percent, indicating that the time to obtain licenses is increasing. (

(continued)
but at a slower rate than the number of enterprises. Also, in 2005 vs. 2001, the average enterprise needed more licenses (1.14 vs. 0.96), showing that the number of license applications has increased even more than the number of active enterprises. Thus, in 2005, more licenses could be obtained at lower cost, but the duration of obtaining a license was longer.

**TABLE 2: SUMMARY OF THE QUANTIFIABLE IMPACT OF REFORMS (CONTINUED)**

<table>
<thead>
<tr>
<th>Reform area</th>
<th>Quantifiable effect of improvements</th>
<th>Explanation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Company registration</td>
<td>3.7 days</td>
<td>Decrease in duration of business registration process in the Enterprise Register (calendar days, 26 in 2000–01 vs. 22 in 2004–05)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>The decrease in the business registration process primarily represents improved efficiency in the procedure. Duration is decreasing despite an increasing number of applications. The decrease is derived from the average duration of the registration process as reported by survey respondents and by considering the year of registration.</td>
</tr>
<tr>
<td></td>
<td>$317,797</td>
<td>Total decrease in costs of using an intermediary for business registration (2000–01 vs. 2002–03)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Improvements represented by a decrease in the costs of using an intermediary are twofold. First, the procedure is less complex and fewer intermediaries are needed. Second, even if intermediaries are used, business registration has become cheaper. The lower monetary result is derived by considering the reduction in the percentage of cases when intermediaries are used and a reduction in payments to intermediaries when obtaining licenses. Savings per enterprise are generalized further by multiplying the result by the total number of economically active enterprises.</td>
</tr>
<tr>
<td></td>
<td>$59,147</td>
<td>Total decrease in official fee payments (2000–01 vs. 2002–03)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>A decrease in official fee payments represents a reduction in another type of cost when registering a business. The lower monetary result is derived by considering the reduction in official payments to intermediaries when registering a business. Savings per enterprise are generalized further by multiplying the result by the total number of enterprises registering in the Enterprise Register in 2003.</td>
</tr>
<tr>
<td>Real estate</td>
<td>11 days</td>
<td>Decrease in the duration of real estate registration procedures for an average enterprise (agency days, 2003 vs. 2005)</td>
</tr>
<tr>
<td></td>
<td>31 days</td>
<td>Decrease in the duration of real estate registration procedures for an average enterprise (calendar days, 2001 vs. 2005)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>This decrease is almost entirely attributable to the decreased probability of having to perform individual procedures between the particular two years. The number of agency days necessary for each procedure increased between 2003 and 2005. This would be a negative development for the Doing Business report; in our analysis, however, we multiplied the number of days by the probability of going through the procedure, and the final result implies a positive development.</td>
</tr>
<tr>
<td></td>
<td>–$616,146</td>
<td>Added cost for businesses due to increase in official fees for all enterprises undergoing any registration procedure in 2005 vs. 2001</td>
</tr>
</tbody>
</table>

(continued)
### TABLE 2: SUMMARY OF THE QUANTIFIABLE IMPACT OF REFORMS (CONTINUED)

<table>
<thead>
<tr>
<th>Reform area</th>
<th>Quantifiable effect of improvements</th>
<th>Explanation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax administration</td>
<td>$156,072,400</td>
<td>Savings on preparation of declarations (2001 vs. 2003). Savings represent improved procedures, easier preparation, and consequently lower duration and labor costs for preparing tax declarations. Total savings are calculated as a reduction in the cost of labor days needed to complete declarations. The reduction in days is calculated as a reduction in the duration of declaration procedures. Total time savings are multiplied further by an average salary and the number of active enterprises in the economy. The portion of companies not filling the specific declarations also is taken into account.</td>
</tr>
<tr>
<td>Total</td>
<td>$171,543,014</td>
<td>Total quantifiable effect from the above-cited factors</td>
</tr>
</tbody>
</table>

**Quantifiable monetary benefits accruing annually per average enterprise**

<table>
<thead>
<tr>
<th>Reform area</th>
<th>Monetary benefit</th>
<th>Explanation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inspections reforms</td>
<td>$66.49</td>
<td>The amount of resources freed up by improvements in inspection procedures (2001 vs. 2003)</td>
</tr>
<tr>
<td>Licensing</td>
<td>$94.38</td>
<td>Decrease in official payments to obtain licenses for business operations (2001 vs. 2003)</td>
</tr>
<tr>
<td></td>
<td>$147.19</td>
<td>Decrease in official payments to obtain licenses for business operations (2003 vs. 2005)</td>
</tr>
<tr>
<td></td>
<td>$7.11</td>
<td>Decrease in payments to intermediaries to obtain licenses for business operations (2001 vs. 2003)</td>
</tr>
<tr>
<td></td>
<td>$2.65</td>
<td>Decrease in payments to intermediaries to obtain licenses for business operations (2003 vs. 2005)</td>
</tr>
<tr>
<td>Company registration</td>
<td>$7.01</td>
<td>Total decrease in costs for using intermediaries in business registration (2000–01 vs. 2002–03)</td>
</tr>
<tr>
<td></td>
<td>$1.31</td>
<td>Total decrease in official fee payments (2000–01 vs. 2002–03)</td>
</tr>
<tr>
<td>Real estate</td>
<td>$11.40</td>
<td>Added cost for businesses due to increase in official fees undergoing any registration procedure (2001 vs. 2005)</td>
</tr>
<tr>
<td>Tax administration</td>
<td>$3,445.31</td>
<td>Savings in preparation of declarations (2003 vs. 2001)</td>
</tr>
<tr>
<td>Total</td>
<td>$3,760.06</td>
<td>Total quantifiable effect per enterprise from the above-cited factors</td>
</tr>
</tbody>
</table>

*Source:* Authors’ calculations.

*Note:* All figures are discounted to 1998 U.S. dollars.

a. Agency days are the number of days an agency takes to process documents that have been submitted.

b. Calendar days are the total number of days a procedure requires from start to finish.
the business environment improvement program is likely to be much more substantial.

FIAS interventions were relatively inexpensive. Between 1998 and 2005, FIAS carried out six projects for a total cost of less than US$500,000. The Government of Latvia also provided major in-kind contributions of staff time and assistance with translation and interpretation, and it paid for most of the second and third business surveys. Those expenses were an additional US$500,000 over the period 1998 to 2005, placing the total cost of the work at approximately US$1 million.

Such high cost–benefit ratios are well documented globally. For example, the Copenhagen Consensus in 2004 determined that reforms to reduce barriers to business are among the top 10 most cost-effective interventions to improve the “greatest global challenges” (http://www.copenhagenconsensus.com/Default.aspx?ID=699).

**Economywide Impact**

Improvements in the investment climate have yielded improvements in private investment. In 1997, gross fixed capital formation in the private sector was 16 percent of GDP; by 2004, it had increased to 27.5 percent of GDP. The number of active, taxpaying firms also increased by 31 percent between 1997 and 2004 (from 35,259 to 51,440 active companies).\(^\text{14}\)

Trends in foreign direct investment (FDI) are even more striking (figure 5).\(^\text{15}\) In 1994, FDI per capita was less than US$100; in 2004, it was more than US$280. At the

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**FIGURE 5: ANNUAL FDI IN LATVIA, 1996 THROUGH SEPTEMBER 2005**

![Graph showing annual FDI in Latvia from 1996 to 2005.](source: Ministry of Economy 2005.)

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14. Data are available at the Web site of Latvia’s Central Statistical Bureau (www.csb.lv).

15. As noted in *FDI and Poverty* (Klein, Aaron, and Hadjimichael 2001): “FDI is a key ingredient for successful economic growth in developing countries. This is because the very essence of economic development is the rapid and efficient transfer and adoption of ‘best practice’ across borders. FDI is particularly well suited to affect this and translate it into broad-based growth, not least by upgrading human capital. As growth is the single-most important factor affecting poverty reduction, FDI is central to achieving that goal…. However we may look at it—among the tools available—FDI remains among the most effective ones in the fight against poverty” (p. 2).

The increase in investment and number of active companies had its payoff in economic growth. Whereas growth in GDP per capita was under 5.0 percent in 1995 and 1996, the average annual growth of GDP between 2000 and 2004 was 7.7 percent. In 2004, it was 8.5 percent, and it reached 10.2 percent in 2005. New investment also created new employment opportunities: unemployment dropped from 9.7 percent of the labor force in 1999 to 8.0 percent in 2004 (table 3). That in turn implies approximately 19,000 fewer registered unemployed people in 2004 than in 1999. The rate of job seekers also improved, from 14.3 percent to 10.3 percent in the period 1999–2004 (figure 6). Real income in the period 2000–04 increased by 24 percent; and the average net monthly wage increased from US$179 in 1999, to US$284 in 2004, and to US$317 in 2005, outpacing a more moderate increase in the cost of living (figures 7–9).

### TABLE 3: KEY INDICATORS OF ECONOMIC DEVELOPMENT, 1999–2005

<table>
<thead>
<tr>
<th>Indicator</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP (growth against the preceding year, %)</td>
<td>3.3</td>
<td>8.4</td>
<td>8.0</td>
<td>6.5</td>
<td>7.2</td>
<td>8.6</td>
<td>10.2</td>
</tr>
<tr>
<td>Unemployment rate (% of economically active population)</td>
<td>9.7</td>
<td>8.5</td>
<td>8.3</td>
<td>8.0</td>
<td>8.0</td>
<td>8.0</td>
<td>—</td>
</tr>
<tr>
<td>FDI (net inflows, % of GDP)</td>
<td>4.5</td>
<td>5.0</td>
<td>2.0</td>
<td>4.0</td>
<td>2.9</td>
<td>3.8</td>
<td>3.9</td>
</tr>
<tr>
<td>FDI (growth against the preceding year, %)</td>
<td>9.2</td>
<td>21.1</td>
<td>–57.6</td>
<td>120.0</td>
<td>–12.3</td>
<td>64.0</td>
<td>15.6</td>
</tr>
<tr>
<td>Total active enterprises</td>
<td>37,628</td>
<td>41,992</td>
<td>40,668</td>
<td>42,549</td>
<td>45,300</td>
<td>51,440</td>
<td>n.a.</td>
</tr>
</tbody>
</table>

*Sources: Central Statistical Bureau of Latvia, June 2006; EBRD 2005.*

*Note: — = not available; FDI = foreign direct investment; GDP = gross domestic product; n.a. = not applicable.*

The increase in investment and number of active companies had its payoff in economic growth. Whereas growth in GDP per capita was under 5.0 percent in 1995 and 1996, the average annual growth of GDP between 2000 and 2004 was 7.7 percent. In 2004, it was 8.5 percent, and it reached 10.2 percent in 2005. New investment also created new employment opportunities: unemployment dropped from 9.7 percent of the labor force in 1999 to 8.0 percent in 2004 (table 3). That in turn implies approximately 19,000 fewer registered unemployed people in 2004 than in 1999. The rate of job seekers also improved, from 14.3 percent to 10.3 percent in the period 1999–2004 (figure 6). Real income in the period 2000–04 increased by 24 percent; and the average net monthly wage increased from US$179 in 1999, to US$284 in 2004, and to US$317 in 2005, outpacing a more moderate increase in the cost of living (figures 7–9).
Overall, these economic indicators show that the reforms carried out in the previous decade have strengthened the private sector, and that the business environment is improving. Investments continued to grow rapidly, encouraging modernization of production and the introduction of new, more productive technologies. Clearly, membership in the EU has had a positive effect on the development of the Latvian economy, but the reforms and the improved business environment have enabled the economy to outpace that of Poland, for example, which made excellent progress with structural reforms in the early years of transition but then failed to implement robust improvements in other aspects of the investment climate.

The broad-based economic growth in Latvia has helped alleviate poverty. A recent study conducted by the World Bank (2006) concluded that, between 1998 and 2004, Latvia achieved substantial progress in poverty reduction, with an estimated 325,000 people moving out of poverty over the period. Using household budget survey data from the period 1998–2004 and an absolute poverty line, the World Bank report published in June 2006 for the first time identified trends in poverty for this extended period on the basis of a consistent definition of poverty (p. vii). The poverty head count rate fell significantly, from 19.4 percent of the total population in 1998 to less than 6.0 percent in 2004 (figure 10). The distribution in income inequality has improved since 2000, and the poverty gap declined substantially from 5.5 percent to 1.2 percent (table 4).

The population was able to share widely in the expanded labor market. Along with higher employment rates came greater labor productivity, which spurred higher real wages, incomes, and living standards. Simultaneously, maintenance of a broad-based system of social transfers ensured that vulnerable groups, such as pensioners and the poorest people, were protected even as targeted local government benefits were improving (World Bank 2006, p. vii).

16. This paper uses the same poverty line as that used in the World Bank’s earlier living standards assessment for Latvia; namely, LVL 28 per person monthly in 1998 prices. It is adjusted for inflation to hold constant the real value of the poverty line over time.
“FIAS came in as a neutral third party....Well it’s definitely a great improvement. Five years and actually 10 years ago, foreign investors would have a very difficult time in areas such as tax compliance, understanding the environment. Now, the government welcomes foreign investors. The government is putting in place structures that encourage foreign investment.” (J. C. Cole, real estate developer and former chair, American Chamber of Commerce in Latvia; interviews conducted in Latvia for FIAS video, Riga, Latvia, September)

DID FIAS SUCCEED IN MEASURING ECONOMIC IMPROVEMENTS?

The role of FIAS advice may be discerned through the benefits accruing to businesses in Latvia (i.e., resources freed up by lower costs for administrative procedures). Whether these benefits translate into higher rates of investment and productivity and into greater economic growth and less poverty depends on the entire political, social, and economic structure in Latvia. There are many links in the chain of causation, and the direct attribution that FIAS can claim diminishes at every link farther away from FIAS activities. Credit for success must be shared with the Government of Latvia and with the businesses and their associations, the EU accession process, the input of many other complementary projects, market forces, and fortuitous timing.

Outlook for Latvia

Investment climate is a key determinant of whether an economy is able to respond dynamically to opportunities offered by globalization. The dynamic growth of the Latvian economy over the past few years indicates...
that the quality of the investment climate is quite good. On one hand, Latvia compares well with other countries in the region on the processes associated with starting and closing a business and on the burdens of obtaining licenses and permits, registering property, and enforcing contracts. On the other hand, Latvia has rigid labor markets and inefficient procedures for construction project approval. However, sustaining relatively high output growth rates in Latvia in the face of increasing competition from other new EU-member countries will require continued strong reform momentum and monitoring.

The government views continued monitoring of the business environment and ongoing dialogue as important instruments for assessing business regulation. A structured dialogue has continued with private sector organizations, and problems have continued to be incorporated into the Action Plan to Improve the Business Environment (the latest version of which was adopted in early 2006). Now that this mechanism has entered

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**FIGURE 9: CHANGE IN GDP PER CAPITA, PPS, 1999–2005**

![Graph showing change in GDP per capita](image)

*Source:* World Bank staff calculations based on Eurostat data; World Bank 2006.

*Note:* GDP = gross domestic product; PPS = purchasing power standards. Data for 2005 are estimates. Change for country $i$ equals $[Y_i(2005)/Y_i(1999)] / [Y_{eu}(2005)/Y_{eu}(1999)] 	imes 100 – 1000$, where $eu$ stands for EU24 and $Y$ stands for GDP in PPS.

**FIGURE 10: POVERTY TRENDS IN LATVIA, 1998–2004**

![Graph showing poverty trends](image)


**TABLE 4: KEY POVERTY AND INEQUALITY STATISTICS, 1998–2004**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Poverty head-count rate (%)</td>
<td>19.4</td>
<td>14.0</td>
<td>7.5</td>
<td>5.9</td>
</tr>
<tr>
<td>Poverty gap (P1) measure</td>
<td>5.5</td>
<td>4.1</td>
<td>2.0</td>
<td>1.2</td>
</tr>
<tr>
<td>Poverty line (% of mean consumption)</td>
<td>50</td>
<td>41</td>
<td>34</td>
<td>30</td>
</tr>
<tr>
<td>Gini coefficient</td>
<td>33.5</td>
<td>37.3</td>
<td>35.1</td>
<td>33.5</td>
</tr>
</tbody>
</table>

its fifth year, there are signs that it needs to be revitalized and better integrated with the wider initiative to reform regulations being promoted within the EU.

Business demands on the quality of the public service and the regulatory environment are growing constantly, as made evident by the business survey results. Attention to the means of public service delivery and communication, and further enhancement of the flexibility of labor markets, land markets, and the legal/regulatory environment for businesses, must be key priorities.

This case study attempts to describe and quantify the following key elements of FIAS assistance to the Government of Latvia from 1998 to 2004:

- project inputs (budget, human resources, government inputs, and so forth);
- project outputs (primarily FIAS recommendations), as well as advice and guidance provided in “implementation assistance” projects;
- project outcomes (primarily reforms enacted in response to FIAS recommendations, but also FIAS methodologies adopted by the Government of Latvia in the course of its own institutional development);
- improvements in Latvia’s investment climate, using various indicators;
- improvements in Latvian investment/business growth, based on foreign direct investment data, gross domestic private investment data, numbers of new businesses registered in Latvia, and the like;
- improvements in Latvian economic growth (for example, in GDP per capita and private sector employment); and
- improvements in Latvia’s poverty reduction, using various indicators.

This appendix assesses seven areas of reform in Latvia, all of which have relatively long track records in that they were covered in the initial administrative barriers study in 1999, were included in the first action plan, saw at least some reforms enacted (including, in some cases, FIAS implementation assistance), and have some survey results to show impact (except for immigration). Here are the key areas and some comments about them:

1. **Inspections.** FIAS learned that inspections were one of the complaint topics most often mentioned in Latvia. Investors complained about a lack of information regarding the reasons for inspections and the regulations they were intended to enforce, a lack of consistency in interpretation and enforcement of the relevant regulations, a lack of coordination between inspections, unreasonable fines, and the lack of recourse.

2. **Customs administration.** Because trade is vitally important in Latvia, competitiveness requires efficient procedures for import, export, and transit of goods and services. Although only a minority of firms in Latvia are involved in international trade, their complaints about confusion, delays, and corruption had to be treated as a high priority.

3. **Procedures for land acquisition.** Relatively few businesses need land (many small firms only need to rent premises within buildings owned by others). For firms trying to expand, however, administrative procedures for access to land were often severe obstacles, involving long delays and considerable uncertainty. Claims frequently were disputed. Potential buyers needed a cadastral survey to register in both the cadastre and the “Land Book,” and sometimes they needed to request a change in land use designation.

4. **Construction permits.** Once investors had secured land, they usually needed to obtain a long list of permissions to legally begin construction. Although there had been some effort at coordinating some of the key permits in Riga City, the process was complex, lengthy, and prone to corruption.

5. **Tax administration.** Almost all business representatives complained about tax administration. Their concerns included legislation and regulations that were unclear and often changed, frequent and onerous inspections, heavy fines often levied on the basis of minor technical infractions, and the lack of appeals mechanisms.

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17. In all cases, the paper makes note of other identifiable “influences” (for example, other projects), but it does not attempt to quantify them.
6. **Expatriate immigration.** Many foreign investors (and some domestic investors who tried to hire expatriate specialists) complained that the Immigration Service was known to deport people summarily on the basis of minor technical infractions of the law. Although that did not happen often, the stories were well known and created a climate of fear that undermined Latvia’s efforts to attract FDI. More common problems included unclear regulations and lengthy delays.

7. **General Recommendations.** In addition to recommending that specific administrative barriers to investment be dismantled, FIAS made many cross-cutting recommendations, including:
   - improving access to information about administrative procedures
   - improving the service orientation component of administrative procedures
   - introducing a regular, structured public/private dialogue
   - developing a specific action plan for reform and a system for updating it regularly.

We discuss these areas of reform on the basis of the logical framework matrix (table 1A.1). Appendix 2 examines the issues presented in the framework and the indicators of project achievement in each of the seven areas of reform.

The links between project inputs/activities and project outputs and outcomes can be described with a reasonable degree of confidence. However, the links to effects on investment rate and beyond are more tenuous. In all cases, a FIAS project was only one input among many, and it is not possible to state conclusively that FIAS was responsible for improved investment rates. Nevertheless, we can offer qualitative descriptions of the logic that may link the results of the project to the ultimate poverty alleviation goals of the World Bank Group and FIAS donors.

**CHRONOLOGY OF FIAS WORK IN LATVIA SINCE 1998**

FIAS began its consultation work in Latvia in autumn 1998, with a letter of request from the Minister of Finance asking for FIAS assistance in removing administrative barriers to foreign and domestic investment. The chronology of events was as follows:

- **October 1998:** FIAS mission to Latvia
- **December 1998:** draft report delivered to the Government of Latvia
- **January 1999:** seminar to present draft report
- **April 1999:** final administrative barriers report
- **May 1999:** government action plan established on the basis of FIAS recommendations (subsequently updated six to eight times)
- **Summer 1999:** letter of request from the Government of Latvia for implementation assistance, especially with inspections reform, construction permits, and monitoring
- **December 1999:** FIAS seminars on inspections reform and construction permit reform
- **2000:** Development of monitoring instruments
- **2001:** Request to collaborate with FIAS on “self-assessment” as a pilot
- **December 2001:** First ARCS
- **2002:** “Templates” exercise as part of self-assessment study to gather information from government institutions
- **January 2003:** Latvia “self-assessment” update report finalized, with fresh recommendations (which were made part of an updated action plan)
<table>
<thead>
<tr>
<th>General objective/ultimate impact</th>
<th>Intervention logic</th>
<th>Objectively verifiable indicators</th>
<th>Sources of verification</th>
<th>Assumptions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Increased investment, formalization, productivity growth, economic growth, employment, and alleviation of poverty</td>
<td>Statistics on FDI, gross domestic private investment, GDP growth, incidence of poverty, and others</td>
<td>Data from reports by Ministry of Economy, SRS, Enterprise Register, and others; IMF, IFS, World Bank, UNDP</td>
<td>Higher levels of investment and productivity lead to higher levels of growth, which, in turn, create more employment opportunities and better-paying jobs.</td>
<td></td>
</tr>
</tbody>
</table>

Direct objective/ultimate outcome

| Improvement of the investment climate through removal of administrative barriers to investment | Various indicators of investment climate | EBRD Transition Report, BEEPS, Heritage Foundation, Transparency International, and others | Removal of administrative barriers to investment contributes (among other things) to an improved investment climate, and thus leads to higher levels of investment. |

Outputs and immediate outcomes

| Specific recommendations to remove administrative barriers in • inspections • customs administration • construction permits • acquisition of land • tax administration • expatriate immigration • improved transparency, public/private dialog, and others | Reduced burden of government procedures and regulations in terms of reduced time/cost, reduced incidence of bribery, fewer fines/sanctions, improved quality of procedures, and the like | Doing Business database, ARCS, focus groups, data from government agencies, and others | Recommendations are enacted by government and supported through the implementation level (for example, training for civil servants, improved transparency and accountability in support of basic legislative reforms). |

(continued)
### TABLE 1A.1: LOGICAL FRAMEWORK FOR REMOVAL OF ADMINISTRATIVE BARRIERS TO INVESTMENT (CONTINUED)

<table>
<thead>
<tr>
<th>Activities</th>
<th>Intervention logic</th>
<th>Objectively verifiable indicators</th>
<th>Sources of verification</th>
<th>Assumptions</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>• Study of administrative barriers to investment, including input from both public and private sectors and other relevant stakeholders</td>
<td>FIAS reports, survey reports (some available on Internet)</td>
<td>FIAS PCRs and PIMS, government project status reports</td>
<td>Project research and dialogue lead to sound recommendations.</td>
</tr>
<tr>
<td></td>
<td>• Development of recommendations</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Input from international experts in specific areas (for example, inspections reform)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Assistance in initiating public/private dialogue</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Monitoring of impact</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Resource inputs</td>
<td>• Initial administrative barriers study: $152,000 (plus government resources of staff time and materials)</td>
<td>FIAS PCRs and PIMS, government project status reports</td>
<td>FIAS PCRs and PIMS, government project status reports</td>
<td>Resources allocated are adequate for the job.</td>
</tr>
<tr>
<td></td>
<td>• Implementation assistance: $98,300 (plus government resources)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Self-assessment update: $139,000 (plus government resources)</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: FIAS.

Note: ARCS = Administrative and Regulatory Cost Survey; BEEPS = Business Environment and Enterprise Performance Survey; EBRD = European Bank for Reconstruction and Development; FDI = foreign direct investment; GDP = gross domestic product; IMF IFS = International Monetary Fund International Financial Statistics; PCR = Project Completion Report; PIMS = Project Implementation Monitoring System; SRS = Latvia State Revenue Service; UNDP = United Nations Development Programme.

- **December 2003**: second ARCS, funded by the Government of Latvia, with methodological assistance from FIAS
- **Spring 2004**: case study of the impact of inspections reform in Latvia
- **September 2005–May 2006**: third ARCS, funded by the Government of Latvia, with methodological assistance from FIAS and quality review of the policy report prepared by the LIDA.
APPENDIX 2: DETAILED DESCRIPTION OF FIAS’ LATVIA PROGRAM

PROJECT INPUTS AND ACTIVITIES

The first FIAS study of administrative barriers to investment in Latvia began in autumn 1998. The study team consisted of one FIAS task manager and two international experts working with three to four counterparts from the Latvian Development Agency (LDA), which later became the Latvian Investment and Development Agency. The project cost approximately US$152,000 and took less than six months. The study included a field mission of three weeks in October 1998, the direct assistance of an LDA counterpart in writing the draft paper, delivery of the draft paper at the end of December 1998, a workshop in late January 1999, feedback on the draft paper, and delivery of the final paper in April 1999.

Meanwhile, the Government of Latvia began communicating with the business community on the development of an action plan to implement the reforms to be recommended in the administrative barriers study. The government agreed to implement the recommendations that were considered to be the highest priority, and they formed four technical subcommittees to examine (1) problems with inspections; (2) expatriate residency and work permit issues; (3) registration, tax, and customs matters; and (4) land acquisition and construction issues.

Each working group comprised six to eight individuals, including relatively equal numbers of technocrats (from the relevant government agencies) and representatives from the private sector. The resulting action plan was approved by the prime minister and the Cabinet of Ministers in May 1998, and implementation began immediately. Many of the elements of the action plan were combined with related, ongoing projects (for example, customs and tax reform) usually supported by other donors (such as the EU PHARE program; see footnote 10 in the main text).

The Government of Latvia specifically requested that the key recommendations for reforms to inspections and construction permit processes be included in a World Bank structural adjustment loan conditionality matrix. The government made a specific request to FIAS for follow-up assistance in those two areas, along with assistance in institutionalizing the public/private dialogue, improving the appeals system for key administrative procedures, and developing a system for monitoring the reforms.

Thus, the second FIAS administrative barriers project in Latvia was an implementation assistance project. This project began in autumn 1999; cost about US$98,000 (plus additional resources supplied by the Government of Latvia); and occupied a FIAS task manager, two international consultants, and two local consultants.

The project involved two workshops (one each on reform of inspections and construction permit processes), a number of field missions by an international expert on appeals systems, and several missions by the FIAS task manager. The project produced several reports with recommendations that were included in the government’s regular updates to its action plan. The monitoring system included a simple business survey questionnaire that was completed by members of several business associations.

The third FIAS project in the series was a self-assessment update of the original administrative barriers study. This project enabled Latvia to serve as the pilot country for new FIAS self-assessment tools (primarily a standard business survey and templates of the views of government agency officials of administrative procedures). It began in autumn 2001 and was mostly completed in 2002. The project cost approximately US$140,000 on budget (plus additional expenditures by the Government of Latvia, off the FIAS budget). Project staffing included a FIAS task
manager, one other FIAS staff person (for one workshop), one international survey consultant, two local consultants, and a local survey company that administered and analyzed the business survey.

The fourth and fifth FIAS projects in the series were devoted primarily to documenting the effects of reforms. The fourth project focused on reforms to the inspections system, and it cost about US$37,000 (including a repeat of the business survey); the fifth project (of which this paper is the main output) was intended to document the effects of all the key FIAS administrative barriers work in Latvia, and its estimated cost is approximately US$41,000.

In 2005, the Government of Latvia decided to carry out a third survey, and it requested help from FIAS only to supervise the survey and train a group of independent observers to supervise such surveys in the future. The FIAS work for that small project was about US$15,000.

PROJECT OUTPUTS AND OUTCOMES

This section describes the main project outputs (i.e., key FIAS recommendations for reform) and the immediate outcomes (such as changes in government policy, laws, and regulations)\(^ {18}\) in these areas of reform: inspections; customs administration, border-crossing, and import/export procedures; tax administration; expatriate immigration; construction permits; and procedures for acquisition of land. This section also identifies the ultimate outcomes—i.e., the performance indicators for relevant government institutions, results of the business focus groups, other sources of evaluation including various reports, and the results from the FIAS ARCS regarding changes in the time and cost demands of specific procedures and changes in perception by businesses. The results of the latest ARCS corroborate the trend revealed by the results of the 2003 ARCS.

The key challenge in identifying, collecting, and presenting these outcomes was that very few—if any—statistical indicators were collected nor were quantitative evaluations performed prior to 1999—the year when the reforms discussed here began. Therefore, there is no rigid baseline to use in assessing the objective reductions in time and relative cost of each procedure; however, the best available data are used to approximate the changes in quantifiable terms to calculate the impact of reforms where possible. In addition, although they are crucial for simplifying the procedures, many other legal changes implemented as a result of the FIAS recommendations might not be directly measurable in clear quantitative terms. For that reason, the discussion relies greatly on expert assessments of actual changes as presented in various studies and as experienced by businesses. Where possible, the most pertinent of the quantitative indicators are used in this section, whereas more information on applicable investment climate indicators can be found in the last section of this appendix.

Each of the following substantive areas of reform is presented in a separate section:

- inspections
- customs administration, border-crossing, and import/export procedures
- tax administration
- expatriate immigration
- construction permits
- procedures for acquisition of land.

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18. This information was largely compiled from the FIAS study finalized in 1999, the first action plan adopted by the government in May 1999, subsequent reports to the Cabinet of Ministers on the status of action plan implementation, reports and status notes prepared by the LDA, the FIAS assessment of progress, and reports prepared by the LDA as part of the PHARE project that supported the business environment improvement effort at the LDA.
In addition, a cross-cutting area of reform—structured dialogue between the government and the business community—is presented separately.

Each section follows the same format. First, a summary of the 1998 FIAS findings and recommendations is presented with a summary of activities undertaken by the government in response to those recommendations and in response to its discussion of the problems identified with the business community. After identifying outcomes achieved by the government, we examine the available indicators to assess the immediate impact of reforms.

INSPECTIONS

One of the cross-cutting deficiencies identified in the 1999 FIAS study was inconsistent implementation and interpretation of laws and regulations, particularly for government inspections. This deficiency was caused largely by an apparent lack of formalization in administrative procedures and interactions between government inspectors and businesses. The 1999 recommendations (presented in the “Findings and Recommendations” column of table 2A.1) were aimed specifically at these problems. The government recognized the issues and embarked on a coherent reform initiative to improve the legal and procedural conduct of inspections, the communication skills of inspectors, and the provision of information.19

Outcome of Reform

Most of the key legal and procedural reforms were planned and enacted during 1999 and 2000 through the assistance of the FIAS implementation project. The bulk of initial training took place during 2001 and early 2002 as part of the Inspectorate Improvement Program. The formulation of that program started as one component of the effort to reduce administrative barriers to investment (which later was renamed the Reform Program to Improve the Business Environment, although the focus continued to be on administrative barriers). The foreign chambers of commerce and business associations (such as the Foreign Investors Council established in Latvia in summer 1999) also played a role in the initial stages of formulating the problems and suggesting solutions. Certain aspects of inspections reform were included in the government’s action plan to reduce administrative barriers in 1999, based on the FIAS administrative barriers report. When an opportunity arose to strengthen these efforts and find them appropriate institutional support, however, the inspectorate improvement tasks were incorporated in the World Bank’s programmatic structural adjustment loan and a Policy and Human Resources Development grant was used to retain the required specialized expertise and leverage the activities of the FIAS implementation project. Overall, these activities resulted in the following reforms:

- reduced inspection burden on businesses (including incidence of inspections from labor, sanitary, construction, and municipal police, and a shorter average duration of inspections at one enterprise);
- development and implementation of a compliance-oriented approach in the inspectorates (at least to some extent) so that the imposition of sanctions would no longer be seen as an end in itself, but as one of the means for achieving compliance with and enforcement of safety regulations;
- improved provision of legal, procedural, and technical information to businesses by the inspectorates via brochures, Web sites, and training seminars; and
- greater quality and professionalism of inspectors in their relationships with those they were inspecting.

TABLE 2A.1: INSPECTIONS: RECOMMENDED REFORMS AND THEIR OUTCOMES

<table>
<thead>
<tr>
<th>FIAS Findings and Recommendations</th>
<th>Project Outcomes from Reforms Enacted</th>
</tr>
</thead>
<tbody>
<tr>
<td>Finding: There is an absence of a cooperation and coordination mechanism among various public institutions dealing with similar or overlapping competence.</td>
<td>The coordination and cooperation of various inspectorates improved as a result of the establishment of the Inspectorate Coordination Council in April 2000. The council was responsible for implementing the inspections improvement program.</td>
</tr>
<tr>
<td>Recommendation: Inspectors should receive basic marketing training and customer service skills.</td>
<td>Tailored training was offered to the heads of inspectorates and to inspectors, including strategic planning, performance management, customer service skills, administrative law, and so forth.</td>
</tr>
<tr>
<td></td>
<td>The inspectorates have demonstrated a meaningful change of attitude. The heads of the inspectorates have acknowledged that their actions directly affect the business environment in Latvia, and that they share certain problems that could be addressed most effectively by joint action.</td>
</tr>
<tr>
<td>Finding: Inconsistent attitude by inspectors when inspecting enterprises. Administrative statements are not always issued on the spot in writing. When administrative statements are not written (particularly after a positive inspection), inspectors in many institutions are not obliged to prepare a description of the inspection so that it is accessible to the investor. Such weaknesses give rise to business’ concerns about the transparency of inspectors’ operation and the reporting mechanisms.</td>
<td>On January 18, 2000, the Cabinet of Ministers issued an Instruction on the Procedures for Drafting Internal Rules Governing the Work of Inspectorates, based on the recommendations in the FIAS report and activity of the LDA in close cooperation with the Bureau for Public Administration Reform, the inspectorates, and the private sector.</td>
</tr>
<tr>
<td>Recommendation: Ensure mandatory preparation of a written report (administrative statement) and its immediate issuance. The right of the person being inspected to see the inspection report should be well publicized.</td>
<td>By September 1, 2000, the inspectorates prepared internal rules that contain standardized information on the rights and duties of inspectors and those being inspected, appeals mechanisms, payment methods, and other information that makes the work of each inspectorate more transparent and understandable to those being inspected.</td>
</tr>
<tr>
<td>Finding: Entrepreneurs often lack information about inspections, their objectives, legal framework, inspectors’ rights and authority, and rights of the inspected.</td>
<td>A number of inspections introduced carbon-copy forms for their administrative protocols and decisions, as well as checklists of items to be inspected.</td>
</tr>
<tr>
<td>Recommendation: Improve the dissemination of information on the legal framework, rights, and obligations of the inspected.</td>
<td>Pilot projects for reform were initiated in the State Labor Inspectorate and the State Education Inspectorate. These projects introduced risk assessment methodology and performance measurement systems in the pilot inspectorates.</td>
</tr>
<tr>
<td></td>
<td>On the basis of internal rules described above, guidelines in the form of brochures were published by inspectorates and publicly distributed via the Internet and official gazettes.</td>
</tr>
</tbody>
</table>

(continued)
Although some significant improvements occurred in most national-level inspectorates, the municipal police force, which also was empowered to inspect businesses, still seemed to exert its strong discretionary power in 2003—more prominently in Riga than elsewhere in the country. Businesses continued to complain about the work of the municipal police, which was not included in the original reform efforts. This serves as a good illustration of—and contrasts with—the success of the national inspectorate reform effort.

One can conclude that the inspectorate reform program was largely successful in maintaining and improving the government’s goals of safeguarding public health, safety, and the environment while reducing the associated costs and risks imposed on businesses. These reforms are noteworthy because many transition and developing countries have found it difficult to implement a coordinated reform program of this nature across a range of different agencies. The sections below provide some more detail on the key immediate impact of reforms.

### Changes in Inspection Burden

The intent of the ARCS is to examine objective and measurable indicators of administrative procedures that can provide information on changes occurring over time. For inspections, these changes included the number of on-site inspections that a business incurs in a year, the duration of these inspections, and the number of inspectors at one on-site inspection.20

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20. Because the reforms were enacted between 1999 and 2001, it is reasonable to expect that any meaningful impact of the reforms could be discerned at the earliest in 2002 and more realistically in 2003 and beyond. It is in this context that the results of the 2001 and 2003 ARCSs presented here should be viewed (that is, although the 2001 survey was not carried out in a strict prereform setting, the measures that were discussed could have only partially [if at all] affected the on-the-ground reality).
The survey data indicate that although the average frequency of inspections did not change substantially for the labor and fire inspectorates between 2001 and 2003 (table 2A.2), the average duration of on-site inspections decreased substantially for all major inspections (figure 2A.1). The business surveys confirmed that the average frequency and duration of inspections for the five most burdensome inspections (fire safety, labor, construction, environmental, and sanitary) fell between 2001 and 2003, resulting in a time saving of around 39 hours per year for an average firm.21 If we further assume that each firm needed to assign one staff member to accompany a government inspector, and the average wage was about US$2.2 per hour, saving that time alone represented a cost saving of US$85 per year for an average firm.22

What is more, according to the data from Latvia’s Central Statistical Bureau, there were about 45,300 active enterprises in Latvia in 2003. Thus, an average US$85 savings

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**TABLE 2A.2: AVERAGE NUMBER OF ANNUAL INSPECTIONS PER COMPANY INSPECTED**

<table>
<thead>
<tr>
<th>Inspecting Agency</th>
<th>2001</th>
<th>2003</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sanitary Inspectorate</td>
<td>4.3</td>
<td>2.6</td>
<td>2.10</td>
</tr>
<tr>
<td>Municipal Police</td>
<td>2.9</td>
<td>3.1</td>
<td>3.40</td>
</tr>
<tr>
<td>Construction Inspectorate</td>
<td>2.7</td>
<td>1.7</td>
<td>1.55</td>
</tr>
<tr>
<td>Environmental Inspectorate</td>
<td>2.3</td>
<td>2.1</td>
<td>1.60</td>
</tr>
<tr>
<td>State Revenue Service</td>
<td>2.2</td>
<td>1.9</td>
<td>1.90</td>
</tr>
<tr>
<td>Fire and Rescue Service</td>
<td>1.6</td>
<td>1.5</td>
<td>1.20</td>
</tr>
<tr>
<td>Labor Inspectorate</td>
<td>1.4</td>
<td>1.4</td>
<td>1.50</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>17.3</strong></td>
<td><strong>14.3</strong></td>
<td><strong>13.30</strong></td>
</tr>
</tbody>
</table>


21. This excludes many other inspections such as construction and environmental inspections that each affect a smaller number of firms.
22. This benefit does not include other aspects of the reforms, which improved transparency and accountability in government inspections.
per firm multiplied by 45,300 firms equals roughly US$3.8 million saved in labor costs for a single year. Note that this benefit calculation is very conservative; it is only for a subset of inspections that were subject to reform. It assumes that a worker with an average wage accompanied the inspector (rather than a manager with a higher opportunity cost). It excludes any other benefit resulting from the reforms (such as a decrease in fines or bribes).

A comparison of this information with statistics provided by the inspectorates shows both a reduction in the relative number of inspected entities and greater targeting of inspections. For example, data from the Labor Inspectorate (see table 2A.3) indicate that although the number of enterprises under its supervision in 2003 increased by 17 percent over 2001, the number of inspected entities in the same period increased by only 5 percent. This finding is consistent with the survey findings discussed above. It is also noteworthy that, at the same time, the number of inspectors increased by only 2 percent (from 96 to 98 inspectors). The number of repeat inspections is also fairly small—at 6.7 percent for 2002, a decrease of 3 percent compared with 2001.

In interviews, the heads of inspectorates indicated their belief that implementing better risk targeting methods accounts for these changes. There is also a general understanding that overall public health and workplace safety have not deteriorated because of changes in the frequency and duration of on-site inspections.

Another factor that accounts for these measurable changes was a qualitative improvement in the professionalism and competence of inspectors. In addition to the information provided by inspectorates indicating that training of inspectors has been given much more attention than previously was true, this assertion was confirmed in business focus group discussions held in March 2004. One business representative noted, “The length of the inspection depends on the qualifications of inspectors—if they know where to look and what to look for, the inspection is shorter. The inspectors have become more professional and they do not look just for anything but have developed their routines and standard procedures.”

### Changes in Administrative Sanctions and Penalties

The practice and procedures for imposing fines was one focus of the reform efforts. One aspect of that focus was the development and implementation of a compliance-oriented approach in the inspectorates to the extent that the imposition of sanctions was no longer seen as an end in itself, but as one of the means for achieving compliance with and enforcement of safety regulations (and, crucially, one not to be applied without considering alternatives). Another aspect was the improvement of

| TABLE 2A.3: CHANGES IN SELECTED PERFORMANCE INDICATORS OF THE STATE LABOR INSPECTORATE |
|-------------------------------------------------|-------------------------------|
| Indicator                                       | % Change, 2001 vs. 2003       |
| Number of inspectors                            | +2                            |
| Number of identified organizations and enterprises under supervision | +17                          |
| Number of employees in the supervised organizations and enterprises | +25                          |
| Number of inspected organizations and enterprises | +5                           |
| Number of organizations and enterprises inspected more than once a year* | –3                           |

operational procedures for handling applications of fines so they are properly registered and recorded.

As shown by the results of business surveys, the probability of inspectorates imposing fines was reduced by the following amounts between 2001 and 2003:

- Labor Inspectorate, 84 percent
- Sanitary Inspectorate, 82 percent
- Fire and Rescue Service, 87 percent
- Municipal police, 73 percent.

Focus group discussions provided more detail on these figures. One business representative indicated that “the inspectorates are no longer penalizing for little mistakes, they are just writing or telling [us] that these problems have to be averted.” Those conclusions are also supported by the performance data of the State Labor Inspectorate (table 2A.4), which reveal that the number of administrative penalties imposed decreased by 23 percent from 2001 to 2003. Similarly, the number of warnings issued for suspension of activities decreased by 22 percent, as did the number of cases of suspended equipment (44 percent). The number of administrative penalties and warnings issued by the Fire and Rescue Service followed a similar pattern.

**Changes in Provision of Information**

Another critical objective of reform was to improve the type and amount of information that businesses were given regarding the legal and procedural aspects of inspections, including substantive requirements and explanations. Although no information materials were available in 1998, the situation has improved considerably since then.

The self-assessment templates of 2002 asked the responding inspectorates to identify the methods they use to communicate information on the requirements to enterprises. The responses are presented in table 2A.5.

In addition to more traditional forms of knowledge dissemination, the Internet has been one of the most effective tools for distributing detailed information on laws, requirements, and guidance for achieving

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**TABLE 2A.4: SELECTED PERFORMANCE INDICATORS OF FIRE AND RESCUE SERVICE AND STATE LABOR INSPECTORATE, 1999–2003**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Administrative penalties imposed</td>
<td>−12</td>
<td>−23</td>
</tr>
<tr>
<td>Administrative penalties</td>
<td>3</td>
<td>−7</td>
</tr>
<tr>
<td>Warnings issued for suspension of activities/equipment</td>
<td>−52</td>
<td>−22</td>
</tr>
<tr>
<td>Suspended equipment</td>
<td>n.a.</td>
<td>−44</td>
</tr>
</tbody>
</table>

Source: Performance data provided to FIAS and LIDA by the relevant inspectorates.

---

23. For a summary of data analysis, see Coolidge, Grava, and Putnina (2004), annex D.
compliance. Web sites for Latvia’s inspection agencies were practically nonexistent in 1998–99. Most inspectorates doubted the utility of such a vehicle and they argued about the lack of funding. Although no specific funding had been earmarked for these purposes, the Latvian inspectorates found resources to invest in providing information via the Internet and developing Web resources. By now, all inspectorates have embraced dissemination of information as a core function and regard it as an effective tool for reaching a wider audience and promoting compliance. A snapshot of the status of the Web sites of key inspections appears in table 2A.6. This snapshot indicates that some institutions (such as the Fire and Rescue Service and the Language Inspectorate) still have room for improvement, whereas others can boast informative and useful Web sites.

### Evaluation of Services

Complaints about intimidating behavior, such as aggressive and unpleasant attitudes by inspectors during on-site inspections, and about lack of transparency in inspecting procedures were major concerns described in the 1998 FIAS report. There are, however, clear indications that the quality and professionalism of inspectors have improved (see figure 2A.2), as have internal operating procedures.

### Table 2A.5: Government Information Available to Enterprises

<table>
<thead>
<tr>
<th>Inspectorate</th>
<th>No additional information disseminated; relevant laws and regulations are sufficient</th>
<th>Printed leaflets and brochures</th>
<th>Seminars and training sessions</th>
<th>Information posted on Internet home page</th>
<th>Individual inquiries answered by phone, with letters, in person, and so forth</th>
</tr>
</thead>
<tbody>
<tr>
<td>Labor</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Sanitary&lt;sup&gt;a&lt;/sup&gt;</td>
<td></td>
<td>X</td>
<td>X</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Firefighting and Rescue Service</td>
<td></td>
<td>X</td>
<td>X</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Construction</td>
<td></td>
<td>X</td>
<td>X</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Environmental</td>
<td></td>
<td>X</td>
<td>X</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>State Revenue Service</td>
<td></td>
<td>X</td>
<td></td>
<td>X</td>
<td></td>
</tr>
</tbody>
</table>

Source: FIAS 2003b.

<sup>a</sup> The Sanitary Inspectorate also uses mass media to inform businesses about requirements.
Focus group discussions held in early 2004 confirmed the survey findings, and added that

- participants found the professional standards of most inspectorates had increased over the previous five years
- cash bribes associated with inspections had decreased (although, in some cases, bribes may have been replaced with more sophisticated forms such as pressure to take on a business partner or to hire someone recommended by an inspector).

CUSTOMS ADMINISTRATION, BORDER-CROSSING, AND IMPORT/EXPORT PROCEDURES

When the FIAS administrative barriers study was released in early 1999, Latvia was in the process of aligning its customs legislation with that of the EU Customs and Implementation Codex.24 The Government of Latvia received significant support from the EU for this process in the form of PHARE-financed projects aimed at improving and strengthening different aspects

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24. This section covers the reforms adopted before May 1, 2004, when Latvia became an EU member and the Customs Administration ceased control of intracommunity trade, which had constituted two-thirds of international trade. After May 1, 2004, customs matters were governed by the EU Customs and Implementation Codex, which means that national laws can be adopted only to govern issues not covered by EU regulations. The legislation discussed in this section became void as of May 1, 2004.
of customs administration. With this in mind, the FIAS analysis in 1999 was limited to those issues that were deemed prevalent problems and, from the perspective of businesses, had not been addressed adequately within large-scale, ongoing projects. Thus the critical role for FIAS was to highlight the immediate and short-term concerns of businesses that were overlooked by the customs administration, which had been more attuned to long-term and political goals.

A new Customs Law had been in force since July 1997; however, a significant portion of the secondary legislation had not been adopted. That delay in adoption allowed broad interpretation and inconsistent application of the law, and inhibited the daily operations of businesses. Although Latvia had positioned itself as a strategic transit route between west and east, these weaknesses had a negative effect on the investment climate.

**FIAS Recommendations and the Government’s Response**

Table 2A.7 summarizes the findings and recommendations that FIAS developed, and the reforms enacted by the government.

Businesses’ key practical and immediate complaints in 1998 were related to inconsistent treatment and poor availability of information on basic procedures and requirements. These were the issues that the FIAS implementation project focused on in the dialogue it facilitated between businesses, the Customs Administration (as part of the State Revenue Service [SRS]) and the Ministry of Finance (which oversees customs legislation and policy).
The first Action Plan for Removal of Administrative Barriers, adopted by the Cabinet of Ministers in May 1999, contained a series of measures aimed at increasing the legal certainty of customs procedures. The timing of the action plan formulation process in early 1999 coincided with the start of practical activities of the SRS Modernization Project. That project was financed through a loan from the World Bank, and was implemented from 1998 to 2002. The customs problems that FIAS identified and detailed in the implementation project found their way into activities funded under the Modernization Project, where they received higher priority, and they were further incorporated into the customs service strategic business plan for subsequent years.

The activities the government undertook in response to the FIAS project findings and recommendations resulted in the following improvements:

- Speedier adoption of the missing Cabinet of Ministers’ implementing regulations during 1999 and 2000. Publicly and continuously highlighting the detrimental effect of the lack of clear normative acts in the new Customs Law played a substantial role in moving this higher up the agenda of the Ministry of Finance. The FIAS implementation project actively solicited businesses’ opinions on draft regulations and facilitated more open approaches to discussing the draft normative acts.

- Improved coordination among customs agents and border guards. A key contribution of the FIAS implementation project was the initiation of open discussions between the SRS and the National Border Guard Service about the deficiencies in their organizational management of border checkpoints and overlapping control functions. These discussions led to practical delineation of duties between border guards and customs officials in cargo control, and to elaboration of site-specific technological schemes for the border checkpoints. Traders say this has produced significant improvements.

Another aspect of improved coordination was the joint implementation and analysis of the Border Control Point Survey by the National Customs Board, border guards, the Sanitary Border Inspectorate, and the LDA. This survey, conducted at the five largest border crossing points during one week in June 2001, covered a random sample of 500 truckers crossing these five points, and it was implemented by a professional survey company. The idea for such a survey emerged in discussions between the FIAS implementation team and the director of the customs service. The FIAS implementation project then proposed that the border guards and the Sanitary Border Inspectorate present at border crossing points also participate in such an exercise, and they agreed to do so.

(continued on p. 45)
TABLE 2A.7: CUSTOMS ADMINISTRATION, BORDER-CROSSING, AND IMPORT/EXPORT PROCEDURES: REFORM RECOMMENDATIONS AND THEIR OUTCOMES

<table>
<thead>
<tr>
<th>FIAS Findings and Recommendations</th>
<th>Project Outcomes from Reforms Enacteda</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Finding:</strong> Major upgrading of national customs legislation was in process as part of harmonizing legislation with that of the EU</td>
<td>• The Cabinet adopted the following regulations regarding application of the Customs Law during 1999–2001: Procedure for Declaring Goods, Procedure for Completing Customs Pre-clearance, Procedure for Completing Customs Procedure—Export, and Procedure for Completing Customs Procedure—Import. Entrepreneurs eagerly awaited these new regulations so that many discrepancies in the application of the Customs Law could be resolved.</td>
</tr>
<tr>
<td><strong>Recommendation:</strong> Speed improvement and adopt import- and export-related legislation.</td>
<td>• Following the suggestion of a number of business associations that it is necessary to separate liability for technical errors from liability for deliberate infringements, amendments to the Administrative Violations Code were adopted by the Saeima (parliament) on June 14, 2001, and came into force on July 16, 2001.</td>
</tr>
<tr>
<td>• Transit companies transporting goods through Latvia complained of inconsistent procedures at border posts and even among work shifts at the same border post. More generally, there were perceptions of a lack of coordination and lack of a central authority channeling the same information about regulations and their interpretation to the different customs posts.</td>
<td>• An exchange rate calculation methodology for customs payments has been included in the Customs Law in accordance with the EU Customs Code, and came into force in July 2002.</td>
</tr>
<tr>
<td><strong>Recommendation:</strong> The inconsistency of border post procedures for import and export of goods should be addressed as a matter of urgency. This inconsistency can lead to delays in shipping and creates opportunities for corruption. The customs service should develop and publish clear guidelines and manuals for its employees and for businesses.</td>
<td>• Regular discussions with business tackled issues to be clarified and developed in secondary legislation; for example, procedures for granting deferment of customs payments, procedures for implementing the simplified customs declaration procedures, and clarifying the application of natural resources tax.</td>
</tr>
<tr>
<td>• A precise delineation of the duties and authority relating to decisions by customs officials was implemented. A resolution of the SRS was adopted on July 7, 2000.</td>
<td>• The SRS home Web page is regularly updated and amended with legal acts regulating customs (see <a href="http://www.vid.gov.lv">www.vid.gov.lv</a>).</td>
</tr>
</tbody>
</table>

(continued)
### TABLE 2A.7: CUSTOMS ADMINISTRATION, BORDER-CROSSING, AND IMPORT/EXPORT PROCEDURES: REFORM RECOMMENDATIONS AND THEIR OUTCOMES (CONTINUED)

<table>
<thead>
<tr>
<th>FIAS Findings and Recommendations</th>
<th>Project Outcomes from Reforms Enacted&lt;sup&gt;a&lt;/sup&gt;</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Finding: Investors maintain that border guards create obstacles for investors to declare goods imported to Latvia, saying that border guards engage in unnecessary vehicle inspections. • Recommendation: Eliminate duplicate customs and border guard functions related to controlling goods and conventionally prohibited articles, thus accelerating border crossing.</td>
<td>• Since September 1, 2001, the Consultations Department of the Legal Division of the National Customs Board has provided information and consultations to customs clients concerning any customs issues. • The coordination between border guards and customs officials improved at both the institutional and practical levels. • A new cooperation methodology was introduced at major border-crossing checkpoints, ensuring that the functions of the border guards and customs officials did not overlap. The process of formulating the government’s Action Plan for Removal of Administrative Barriers served as the impetus for preparing this technological scheme, which was signed on December 21, 1999. • FIAS contributed to prioritizing the introduction of incoming-traffic border controls. In 2000, one-way border checks were instituted at all road crossings on the Estonia–Latvia border, on the Lithuania–Latvia border at Grenctâle, and at all pedestrian border-crossing points.</td>
</tr>
<tr>
<td>• Recommendation: Accelerate the introduction of a customs declaration processing system.</td>
<td>• The system for processing customs declarations, ASYCUDA++, was introduced at the major customs points. A simplified declaration system was introduced incrementally in 2000. • The SRS issued orders on procedures for issuing electronic declaration permits and procedures for document preparation. Issuance of permits for electronic declaration began December 18, 2000.</td>
</tr>
<tr>
<td>• Recommendation: Customs should create a fast-track system for receiving and acting on complaints and appeals.</td>
<td>• The Customs Board initiated a regular survey of those crossing the border to obtain their opinions of customs and the attitude of customs officers, and to identify existing problems and major reasons for dissatisfaction. Customs officials found the 1999 LDA survey to be useful, and they wanted to ascertain more information on client satisfaction. • A feedback questionnaire on the effectiveness of border-crossing and clearance procedures at border checkpoints was designed and implemented jointly by the SRS Customs Board, Border Guards, Sanitary Border Inspection, and the LDA in 2001. (More than 500 truckers filled out the questionnaire.) The results were used by each institution to develop its institutional improvement plans.</td>
</tr>
</tbody>
</table>

<sup>a</sup> Primarily reforms enacted in response to FIAS recommendations; also FIAS methodologies adopted by the government in the course of its institutional development.

Source: FIAS 1999; follow-up research by FIAS.

Note: EU = European Union; SRS = State Revenue Service.
The four institutions involved shared the cost of the survey; conducted joint preparations, analysis, and discussion of the results; and followed up on the measures to which they had agreed.

This was a very successful demonstration of the benefits of an improved and rigorous feedback and monitoring mechanism that enabled the institutions to jointly assess the functioning of specific border crossing points; identify the shortcomings in physical infrastructure, organizational management, and border-crossing procedures; and benchmark the effectiveness and quality of their representatives’ work at five different border crossing points. The FIAS implementation project initiated this and provided the much needed expertise and skills in designing, implementing, analyzing, presenting, and applying the results of such a monitoring exercise.

- **Improved access to information on procedures, requirements, and targeted consultations.** After procedural aspects in Cabinet regulations had been prescribed, consistent SRS methodological guidelines and implementation explanations had to be delineated in procedures manuals. The government agreed to improve regular processes to update the SRS Web site, to consolidate guidance letters into procedure-specific methodological guidelines, to prepare manuals and post them on the Internet, and to establish a customs consultation unit.

  The customs consultation unit seems to have served an especially important function in alleviating concerns and answering questions about legislation and procedures. It is part of the Legal Division of the SRS National Customs Board, and was established on September 1, 2001, as part of the Action Plan for Removal of Administrative Barriers. Its employees provide consultations on general customs problems by telephone, in writing, and by e-mail. One of its key responsibilities is to inform others about applicable normative acts and their interpretation. The success of the unit is best evidenced by the demand for its expertise. The number of consultations provided has increased tremendously since it was established:

<table>
<thead>
<tr>
<th>Year/period</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>31, 2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of consultations</td>
<td>1,506</td>
<td>6,971</td>
<td>12,083</td>
<td>7,318</td>
</tr>
</tbody>
</table>

The ability of customs authorities to effectively communicate upcoming changes in customs procedures was tested to capacity as the EU accession date of May 1, 2004, approached. The customs service could have performed better but, to be fair, confusion over customs functions after that date were fairly common across the new EU member-states for a few months before and after accession.

- **Change in speed of clearance and introduction of simplified clearance.** The speed of clearance was not among the most critical issues identified in the 1998 FIAS study. However, improvements introduced in 2000 to coordinate the work of border guards and customs officials, the introduction of one-way checks, and clarification of customs officials’ decision-making authority have led to improvements in the speed of clearance.

  The FIAS study released in the beginning of 1999 reported that the SRS’ claim of a one-hour clearance time was accurate, in the view of companies, and there were some complaints about delays stretching up to five hours at key Latvian-Lithuanian border posts. The best comparison of these figures can be found in the results of the June 2001 survey.
conducted at the five largest border crossing points. Those findings revealed actual clearance times. The survey indicated that more than 50 percent of shipments were cleared within 30 minutes, and a little more than 80 percent were cleared within one hour. This was also true for the border crossing point on the Latvian-Lithuanian border that was singled out in the 1998 FIAS study.

Another important point promoted by the FIAS implementation project and embraced by the National Customs Board was to speed up inland clearances by introducing simplified declarations and local clearances. Legislation permitting these was introduced in 2002. Gradual implementation started in 2002 and 2003. Statistics provided by the National Customs Board as of August 17, 2004, indicate that the following techniques have been introduced successfully:

- Licenses for simplified declaration had been issued to 78 companies.
- Licenses for local customs clearance had been issued to 41 companies.
- Agreements to use simplified customs clearance procedures were concluded with two companies.

Changes in the Perception of Customs Obstacles

Businesses engaged in clearance processes and those that responded to the 2003 ARCS were asked to evaluate whether customs administrative procedures presented an obstacle to their work (figure 2A.3). Although this was a question of perception, and it was not possible to make a direct comparison of 2003 results with those of the 2001 ARCS, the ranking of these obstacles and a discussion of the results in a focus group in April 2004 shed some light on the positive changes that occurred between 1999 and 2003. Most important, the availability of information on customs regulations/procedures and on customs authorities’ treatment of firms has improved (now, nearly 70 percent of businesses do not view these as obstacles). This is a remarkable change from the level of dissatisfaction found on these two issues in 1998.

Changes in Approaches to Control

Although trade facilitation is an important component of customs services, it is also the responsibility of the customs service to collect taxes from international trade transactions and to ensure that legitimate traders are protected via the curbing of illegal trade and smuggling. Therefore, the customs service must implement effective controls, such as post-clearance audits that ideally have minimum interference with commercial activity.

Strengthening the customs control function and improving its ability to effectively identify illegal trade were at the pinnacle of the European Commission’s attention in the process of Latvia’s negotiations to join the EU, not least because the Latvian customs service would assume responsibilities for admitting third-country goods to the EU market after accession. The local business community, however, was often more concerned with the practical and immediate implications of any strengthening of control on the flow of goods and the comparative attractiveness of Latvia as a transit and distribution route. The customs service always has had to balance these two objectives and find ways to achieve both.

In this respect it is interesting to ascertain the impact of amendments to the Administrative Violations Code that came into force in July 2001. The amendments were discussed in the framework of the dialogue between the

25. Another similar category—availability of information on changes in customs procedures—ranked as the most important obstacle in a survey conducted in autumn 2003, in anticipation of EU membership occurring on May 1, 2004. Subsequent focus group discussions confirmed that this temporary phenomenon was captured in responses to this category of obstacles.
government and the business community, which was facilitated by the FIAS implementation project, and they were made a part of the action plan. Reasons for complaints included increased aggressiveness by the customs service in identifying technical errors and imposing administrative fines. This trend can be observed until 2001 in figure 2A.4.

The amendment that was adopted stipulated that administrative liability was not to be applied for technical errors—thus separating liability for technical errors from liability for deliberate infringements, which had been the problem that businesses raised. The statistics provided by the National Customs Board indicate a slight decrease in the incidence of Administrative Violation Protocols (drawn up by customs officials) in the total volume of clearances performed in 2002 and 2003, and a relative reduction in fines imposed. We can only infer whether the cause of this decline was the enactment of these specific legal changes or some other factors, but it definitely has brought the issue to the attention of officials and changed (at least a little) their approach to penalizing offenders. The statistics also draw more attention to post-clearance audits, which is consistent with best-practice guidelines for modern customs administrations.

**Changes in the Volume of Customs Declarations**

The quality of customs administration is an important consideration for existing and potential investors, and for domestic enterprises that became increasingly engaged in international trade at the end of the 1990s. The primary task of an efficient customs administration is to collect duties and taxes while ensuring prompt clearance of goods. Therefore, modern customs
Procedures are designed to implement effective controls while facilitating international trade. Customs administrations ideally should have minimum interference with commercial activity. The same is true for other institutions involved in the clearance of goods.

One objective measure of the quality of customs work is the number of customs declarations processed and the amount of tax revenues that a customs service levies. In Latvia, the number of customs declarations has increased from around 850,000 in 1998 to nearly 1.2 million in 2003, while the amount of tax calculated on these transactions has increased approximately 1.6 times (figure 2A.5).

The results of the ARCS conducted at the end of 2003 indicated that clearances had also increased—i.e., businesses that were engaged in international trade were more active (as shown by more customs declarations being cleared than before).

**TAX ADMINISTRATION**

High tax rates and burdensome tax administration are at the top of the list of complaints for businesses in most countries. This can be reasonably expected, and governments must understand that the level of complaints is in itself not indicative of the severity of problems that entrepreneurs face. Although some complaints are
grounded, some are based on the fact that people simply do not like paying taxes and will avoid doing so, or will even evade paying to the extent they think they can get away with it.\footnote{Tax avoidance is defined as using legal measures to reduce taxes, usually involving changes in business activities that would not have been made in the absence of specific features in the business tax regime (for example, using “transfer pricing” to shift profits into a jurisdiction or activity that is relatively lightly taxed). Tax evasion is defined as an illegal measure, such as underreporting revenues.}

FIAS heard complaints about high tax rates in 1998 and again in 2005. The flat corporate tax rate was 25 percent in 1998 and 15 percent in 2004; and the tax base had not changed substantially during that period, except in the direction of a broader definition of deductibles. The social security contribution rate also decreased from 37 percent in 1998 to 33 percent in 2004. Other tax rates have remained stable. Complaints about high tax rates and poor tax administration might be partly the result of the distortions caused by underreporting for tax purposes, whereby some companies pay more and some pay less. The following was
noted in the “Latvia Self-Assessment Report” (FIAS 2003a):

On the basis of the self-assessment (including the business survey) and comparison with other emerging market economies, FIAS’ assessment of the current priorities needing attention in Latvia include the following:

■ Numerous complaints and difficulties in the area of tax administration […]
■ The persisting perception of an un-level playing field between those enterprises that operate lawfully and those functioning wholly or partially in the shadow economy, or with benefit of “good connections” with government officials (p. viii).

The work of the SRS undoubtedly improved (as evidenced from various outside assessments and from discussions and focus groups with business representatives). However, the expectations and demands of taxpayers also have grown, especially as the Latvian economy has expanded.

FIAS Recommendations and the Government’s Reforms

Table 2A.8 presents a summary of FIAS recommendations and the government’s response to tax administration.

Ultimate Outcome of Reform

The primary complaints of businesses in 1998 were inconsistent treatment and poor availability of information on basic procedures and requirements in tax administration, overlapping registration requirements, aggressive enforcement approaches, and lack of reliable appeals.

The first Action Plan for Removal of Administrative Barriers adopted by the Cabinet of Ministers in May 1999 contained a series of specific measures that were designed to improve the provision of information through the development and dissemination of implementing guidelines and the development of a targeted appeals division. The work that FIAS did to address the tax administration problems helped ensure their adequate incorporation in the SRS Modernization Project.27

With the commencement of EU accession talks in 1999, the European Commission and individual EU member-states devoted substantial attention to the functioning of the Latvian SRS. The legal, administrative, and organizational harmonization problems became the focus of the following:

■ PHARE 1999 and 2001 projects to address tax policy and tax administration
■ A bilateral cooperation program between Denmark and Latvia
■ Activities organized by the International Organization of Tax Administrations, the Organisation for Economic Co-operation and Development, the European Commission Technical Assistance Information Exchange Office, and others to address the tax administrations of countries seeking EU accession.

The critical contribution of the FIAS implementation project was in opening and maintaining channels of communication among the Ministry of Finance, the SRS,

27. The timing of the action plan formulation process in early 1999 coincided with the commencement of practical activities of this SRS Modernization Project, which was financed through a loan from the World Bank and was implemented from 1998 to 2002.
<table>
<thead>
<tr>
<th>FIAS Findings and Recommendations</th>
<th>Project Outcomes from Reforms Enacted&lt;sup&gt;a&lt;/sup&gt;</th>
</tr>
</thead>
</table>
| **Finding:** Many countries automatically register a company to pay taxes when it enters the Enterprise Register, which eases the company establishment process.  
**Recommendation:** The Enterprise Register and the SRS should continue to work to find technological solutions to end the duplicative registration process. | **Finding:** Tax and enterprise registration were combined into a single procedure in 2001.  
**Finding:** Conflicts arise between taxpayers and the SRS because of unclear interpretation of legislation and inconsistent application of regulations.  
**Recommendation:**  
- The Ministry of Finance, in particular, should make a concerted effort to provide advance rulings to taxpayers who request them, and publicize those rulings.  
- Other guidelines for SRS inspectors should be publicized as they are developed.  
- Opinions should be strengthened so that they are more reliable and improve the consistency of implementation.  
**Finding:** Investors are concerned about the ability of the SRS to inhibit a company’s operations and about its willingness to exercise such authority, including imposing significant fines and other measures. Investors are concerned about possibilities of recourse.  
**Recommendation:** The government should investigate measures to mitigate the power of the SRS over legitimate business enterprises, including  
- establishing a tax appeal tribunal to accelerate and improve the review of appeals  
- limiting the enforcement powers of the SRS by stipulating that it should not be allowed to seize the bank accounts of a firm without a court order  
- abolishing or reducing the need for a business to produce a tax clearance certificate for importation, real estate transactions, and employment of expatriate labor.  
**Finding:** Tax and enterprise registration were combined into a single procedure in 2001.  
**Finding:** Ongoing progress has been achieved in revising SRS methodological guidelines on application of legislation, taking into account discrepancies and problems indicated by taxpayers.  
**Finding:** The Internet home page of the SRS is regularly updated with new legislative amendments and SRS methodological guidelines. A hotline-type service has been established and is operating on the Internet (see http://www.vid.gov.lv).  
**Finding:** SRS officials no longer receive a 20 percent bonus for penalizing taxpayers.  
**Finding:** The Appeal of Decisions Department in the SRS was set up and began operating on January 17, 2000. Further appeals divisions were established in regional offices.  
**Finding:** Amendments to the Law on Taxes and Duties authorizing the SRS to reduce penalties (once every three years) were adopted (effective May 17, 2002).  
**Finding:** Amendments to the Law on Taxes and Duties (effective May 17, 2002) strengthened the legal procedure for the SRS to execute its enforcement powers and clarified the rights and responsibilities of both the SRS and delinquent taxpayers.  
**Finding:** The requirement to produce a tax clearance certificate has been eliminated for residence and work permits and for importation.  

<sup>a</sup> Primarily reforms enacted in response to FIAS recommendations; also FIAS methodologies adopted by the government in the course of its own institutional development.
and the business community on the issues of tax policy and tax administration. The large-scale PHARE project to improve tax administration, which commenced in 1999, and the SRS Modernization Project, which commenced in 1998, focused on rapidly upgrading legislation and improving the tax organizational and control methods. The views of business associations were often neglected and few discussions and consultations occurred. The emergence of a neutral moderator or broker (the LDA Business Environment Improvement Unit, supported by the FIAS implementation project) was instrumental in initiating the discussions.

In addition to the PHARE and SRS modernization projects, the government’s response to FIAS recommendations resulted in the following improvements to tax administration:

- **A practical combination of tax and enterprise registration into a single process.** The need to consolidate enterprise registration with SRS registration had been voiced by businesses before, but it took the intervention of an international organization to combine these processes. In an interview in autumn 2004, the head of the Enterprise Register noted

  As a result of discussions, as a result of conversations, as a result of the influence of FIAS, this situation was changed and the reform as such was undertaken. I think that if there hadn’t been FIAS experts [and] FIAS recommendations, the situation would still be the same today.

  When this change was implemented in 2001, registration formalities were reduced to five calendar days.\(^{28}\) Reforms to the Commercial Law occurred in 2003 and 2004, requiring re-registration. The resulting increase in the volume of applications expanded processing times to two to three weeks, which was captured in the results of the 2003 ARCS. As of January 2005, as part of the Commercial Law reform, the Enterprise Register performed the registration process within three working days.

- **Improved administrative appeals process for SRS decisions.** FIAS recommended that an independent appeal tribunal staffed with private sector professionals and representatives of the Ministry of Finance and the accounting profession be established, and the government implemented a dedicated appeals review division within the SRS.

- The establishment of the dedicated Appeals Division was envisaged under the SRS Modernization Project. The FIAS recommendation of establishing an open process of discussing these issues at a public/private forum, and resulting pressure from the business community, helped move this issue up the list of reform priorities.

- Following a gradual update in 2000, the SRS Appeals Division received more pre-court appeals after 2001 (Putnina and Russell-Einhorn 2004, table D-8.). The number of submitted appeals more than doubled between 2001 and 2003, with close to 30 percent of decisions being either fully or partly revised in favor of taxpayers. The doubling of appeals is a good indication of the success of this administrative appeals mechanism; and it demonstrates that, although it is part of the tax administration, the mechanism is capable of subjecting SRS decisions to scrutiny. Although businesses note significant improvement, they also indicate that the independence of the appeals division could be further strengthened.

- **Improved information distribution via published methodological guidelines.** The SRS invested heavily in preparing and distributing methodological guidelines and information brochures. The aim was to correct the deficient system that existed in 1998, whereby

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28. Results of the 2001 ARCS, average number of calendar days = 4.93; outliers removed.
instructions were issued in the form of letters from the director of the SRS. The letters accumulated at the SRS, and they became conflicting and difficult to follow. The need to switch to a consolidated, methodical system of guideline distribution for each type of tax was one of the key issues pressed by the FIAS implementation project. This requirement was included in the action plan adopted in May 1999.

It is difficult to directly measure the effect this method of SRS instruction consolidation has had on the accounting methods of different taxes. Nevertheless, we believe that one of the most precise measures is the time it takes a business to prepare its tax declarations. This was measured by the ARCSs in 2001 and 2003 (see figure 2A.6).29 The results indicate that the average time decreased for all tax declarations, which leads us to conclude that the new information distribution process was effective.

The ARCS survey data confirm that most declarations require substantially less time to prepare than they did before reforms were implemented. According to the survey, on average, it took 10.1 days less to prepare VAT declarations in 2003 than in 2001. If 91 percent of survey respondents prepared VAT declarations, this implies that 41,223 enterprises (91 percent of 45,300 active enterprises in 2003) were affected by the reform at a savings of 416,000 labor-days per month (legislation requires that VAT declarations be prepared once per month). In monetary terms, an eight-hour labor-day multiplied by US$2.2 per hour implies that one labor-day costs US$17.6, resulting in an annual saving in labor cost of over US$87 for the entire economy (i.e., total labor-days per month multiplied by average cost of labor-day multiplied by 12 months). If all other declarations are studied by applying the same logic, the total effect of tax administration reform is more than US$199 million in labor cost savings (in current U.S. dollars).

Clearly, the calculated cost savings for the Latvian economy are substantial. Still, the credibility of some of these results may be questioned because of the way the question was formulated in the surveys. In 2001, respondents were asked how frequently they prepared tax declarations and how many labor-days they spent doing so. Although the original intention of the question was to learn the amount of labor-days per every single inspection, the formulation leaves uncertain whether some of the respondents by accident had not provided the person-days per year rather than per inspection. Also, social insurance contributions and income tax declarations were separated in 2001, leaving uncertain whether some of the respondents had not considered these declarations together and had written the total number of labor-days twice.

EXPATRIATE IMMIGRATION

During the FIAS study in 1998, the foreign business community noted that procedures for obtaining residence and work permits were complicated and lengthy, and they had to be repeated yearly. The LDA took these issues seriously, and it actively embarked on changing the procedures. It was FIAS that identified the issue, raised its prominence, and assisted the government with advice to design more efficient procedures.

29. Because the reforms were enacted from 1999 to 2001, it is reasonable to expect that any meaningful impact of the reforms could be discerned at the earliest in 2002 and more realistically in 2003 and beyond. It is in this context that the results of the 2001 and 2003 ARCSs presented in this section should be viewed (that is, although the 2001 survey was not carried out in a strict pre-reform setting, the measures that were discussed could have affected the actual system only partially). This question was not included in the 2005 ARCS.
FIAS Recommendations and the Government’s Response

Table 2A.9 summarizes the key FIAS findings and the reforms enacted by the government.

Ultimate Outcome of Reform

The first Action Plan for Removal of Administrative Barriers adopted by the Cabinet of Ministers in May 1999 contained detailed and wide-ranging measures aimed at streamlining the procedures for issuing residence and work permits, especially for management positions. The measures were elaborated with direct assistance of FIAS experts who contributed best-practice advice early in the work and reviewed the proposed measures. The FIAS implementation project engaged in lengthy, complex, and detailed debates with the State Employment Service (SES) and the Citizenship and Migration Issues Board (CMIB) to convince them of the need for the very substantial changes being proposed. The best-practice information and details on how these procedures were handled elsewhere helped in convincing the officials that changes were needed. The changes as agreed were implemented by early 2000.

Overall, the activities undertaken by the government in response to the FIAS project findings and recommendations resulted in the following improvements:

- Residence and work permit procedures simplified. The legal changes in early 2000 introduced a combined issuance process, fewer documentary requirements,
### TABLE 2A.9: WORK PERMITS: RECOMMENDED REFORMS AND THEIR OUTCOMES

<table>
<thead>
<tr>
<th>FIAS Findings and Recommendations</th>
<th>Project Outcomes from Reforms Enacted(^a)</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Finding:</td>
<td>• The procedures for obtaining a work permit have been simplified via new regulations (Procedure for the Employment of Foreigners and Stateless Persons in Latvia), which were adopted on March 28, 2000, and those for obtaining a residence permit were simplified by amendments to the relevant regulations. More specifically,</td>
</tr>
<tr>
<td>• Obtaining work permits is a complicated and time-consuming process.</td>
<td>• the work permit is issued together with the residence permit, thus eliminating three additional visits to the SES</td>
</tr>
<tr>
<td>• Excessive documentation is required.</td>
<td>• coordination between the SES and the CMIB has greatly improved, due in large part to the requirement of the action plan that they cooperate in preparing informational materials</td>
</tr>
<tr>
<td>• Inadequate cooperation exists between the CMIB and the SES, and procedures are inconsistent. Investors complain about being sent from one department to another.</td>
<td>• the processing time for obtaining work and residence permits was reduced from 50–60 days at the end of 1998 to a maximum of 35 days in mid-2000.</td>
</tr>
<tr>
<td>• CMIB and SES formalities are doubled.</td>
<td>• Recommendation: An investor (i.e., the principal owner/director of a company or subsidiary) normally should not be subject to a work permit. If the government feels that a work permit adds value, then the process of authorizing the work permit and authorization of the letter of invitation for employment should be combined into a single process.</td>
</tr>
<tr>
<td>• Recommendation: The work permit, authorization of letter of invitation, and residence permit should be combined into a single work permit that would be approved by both the SES and the CMIB.</td>
<td>• The documentary requirements for work and residence permits have been eased for executives of companies.</td>
</tr>
<tr>
<td>• Recommendation: An investor (i.e., the principal owner/director of a company or subsidiary) normally should not be subject to a work permit. If the government feels that a work permit adds value, then the process of authorizing the work permit and authorization of the letter of invitation for employment should be combined into a single process.</td>
<td>• Supervisory and executive board members are not required to obtain authorization for employment from the SES. The residence and work permit are issued by the CMIB together as part of one interaction.</td>
</tr>
<tr>
<td>• Recommendation: Work permits should be issued for a minimum of two years (or less, if the term of the contract is less than two years).</td>
<td>• Company executives obtain their work permits for free.</td>
</tr>
<tr>
<td>• Finding: Entrepreneurs find information available on procedures for obtaining residence and work permits to be inadequate.</td>
<td>• The revised cabinet regulations on residence permits and work permits envisage issuance of residence permits and work permits for the duration of a contract, but not longer than four years.</td>
</tr>
<tr>
<td>• Recommendation: Develop and publish clear guidelines and manuals for employees and businesses on the residence and work permit processes.</td>
<td>• Coordination between the SES and the CMIB has improved considerably, due in large part to the requirement of the action plan that they cooperate in preparing informational materials.</td>
</tr>
<tr>
<td>• Recommendation: The work permit, authorization of letter of invitation, and residence permit should be combined into a single work permit that would be approved by both the SES and the CMIB.</td>
<td>• Informational materials are being publicly distributed at the institutions via the Internet and a brochure that was published in 2000 (10,000 copies of the English version were published).</td>
</tr>
<tr>
<td>• Recommendation: An investor (i.e., the principal owner/director of a company or subsidiary) normally should not be subject to a work permit. If the government feels that a work permit adds value, then the process of authorizing the work permit and authorization of the letter of invitation for employment should be combined into a single process.</td>
<td>• Relevant laws and regulations, as well as explanations, guidance, and process flowcharts are available on the CMIB (<a href="http://www.pmlp.gov.lv">http://www.pmlp.gov.lv</a>) and SES (<a href="http://www.nvd.gov.lv">http://www.nvd.gov.lv</a>) Web sites. Most of the materials are available in Latvian, English, and Russian.</td>
</tr>
</tbody>
</table>

(continued)
and lower fees. Work also started to establish the Foreigners’ Service Center to improve the quality of services delivered to applicants. The number of foreigners who have been served at the new Foreigners’ Service Center since its foundation reached an impressive 98,011 by August 16, 2004.

Less time needed to receive work and residence permits. The assessment conducted in mid-2000 indicated that after the reforms it took a maximum of 35 days to obtain residence and work permits, whereas it took approximately 50–60 days at the end of 1998.30

Cooperation and information sharing enhanced. There was virtually no coordination between the CMIB and the SES before these reform efforts. An open dialogue drew the two institutions into the reform process and led them to acknowledge that ongoing cooperation would be beneficial. A practical expression of this sense of cooperation was best evidenced when CMIB and SES officials collaborated in preparing information materials on residence and work permit procedures. The brochures were published and jointly distributed by the CMIB and the SES.

The Business Environment Improvement Unit, with the support of FIAS, brought the two parties to the table, initiated the dialogue between them and businesses, helped reengineer the immigration procedures, and provided advice on the initial design of information materials.

Excesses by the Immigration Police curbed. No cases of expulsion were reported by investors and government authorities from the second half of 1999 through 2000. Subsequent expulsions have been applied in extreme cases.

### TABLE 2A.9: WORK PERMITS: RECOMMENDED REFORMS AND THEIR OUTCOMES (CONTINUED)

<table>
<thead>
<tr>
<th>FIAS Findings and Recommendations</th>
<th>Project Outcomes from Reforms Enacteda</th>
</tr>
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<tbody>
<tr>
<td>• Finding: The Immigration Police have authority to detain investors and expel them from the country on the grounds of minor technical breaches of immigration rules.</td>
<td>• No cases of expulsion have been reported by investors and government authorities from the second half of 1999 through 2000. Subsequent expulsions have been applied in extreme cases.</td>
</tr>
<tr>
<td>• Recommendation: As a matter of urgency, Immigration Police should issue warnings and fines rather than resort to detention and expulsion.</td>
<td></td>
</tr>
</tbody>
</table>

**Sources:** FIAS 1999; follow-up research by FIAS.

**Note:** CMIB = Citizenship and Migration Issues Board; SES = State Employment Service.

a. Primarily reforms enacted in response to FIAS recommendations; also FIAS methodologies adopted by the government in the course of its institutional development.

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### PROCEDURES FOR LAND ACQUISITION AND CONSTRUCTION PERMITS

Procedures associated with registering title to real estate and obtaining construction permits were among those receiving the worst ratings in 1998.
complaints included overlapping coordination requirements and agency mandates, unclear fee schedules, and lengthy processing times. For construction, the need for the bulk of procedures to be carried out with local municipalities complicated the central government’s attempts to streamline administrative procedures. It is in this area that the limits of reforms through changes in laws were put to the greatest test.

The construction approval processes remained one of the least transparent. Although some streamlining was achieved, this had minimal effect on the speed of procedures, primarily because the volume of construction-related applications increased tremendously. Few reforms were associated with land procedures because it remained a politically charged topic.

**FIAS Recommendations and the Government’s Response**

Table 2A.10 summarizes the key findings of the FIAS 1999 study and the changes the government has implemented.

**Ultimate Outcome of Reform**

At the initiative of the Ministry of Economy, measures to simplify the construction process were included as conditions of the World Bank’s programmatic structural adjustment loan, which FIAS supported and facilitated. Introducing these conditions as part of the loan was intended to spur changes within the government and municipalities. With hindsight, however, the measures at the disposal of the central government were insufficient to impose significant changes on municipalities, the demand by municipalities to improve these services was not strong, and the political leadership of the municipalities had little to lose (and probably more to gain) by doing nothing. Nevertheless, the reform process under the Action Plan for Removal of Administrative Barriers resulted in the following improvements:

- *A dedicated working group with participation by the government, municipalities, investors, architects, and builders was set up by the prime minister to discuss the problems and come up with viable solutions.*
- *Legislation was changed and legal barriers to streamlining the procedures were minimized.* According to the recommendations of the working group, amendments to the construction law and the Cabinet’s General Construction Regulations were passed, which streamlined some aspects of the procedures, more clearly defined the liability of the designers, and introduced transparent fee schedules for municipalities and other institutions that issue technical specifications for designs.
- *A regular (albeit fairly low-yield) dialogue was established with the Riga City Council.* If measured by the feeling of success in 2000, this was a significant achievement mainly because previously there had been no forum for candidly discussing these construction approval procedures and the problems surrounding them.

With a gradual increase in residential construction, more individuals face the awkward coordination process themselves, and the pressure for change is mounting. By now, some municipalities—especially the Riga municipality—have taken steps to improve their procedures, but significant reforms remain to ensure smooth processing of construction approval applications31 (see figures 2A.7 and 2A.8 for volume of applications).

Although the number of construction permits being issued is growing steadily, so has the application processing time (figure 2A.9). The construction approval procedures have not kept up with the increased demand.

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31. For a more detailed analysis, see FIAS (2003a).
### TABLE 2A.10: LAND AND CONSTRUCTION PROCEDURES: RECOMMENDED REFORMS AND THEIR OUTCOMES

<table>
<thead>
<tr>
<th>FIAS Findings and Recommendations</th>
<th>Project Outcomes from Reforms Enacted&lt;sup&gt;a&lt;/sup&gt;</th>
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<tbody>
<tr>
<td><strong>Land procedures</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Finding:</strong> The evaluation required to register real estate ownership rights is valid for only six months. Issuance of a repeated evaluation takes one to three months even if the real estate has not changed physically. <strong>Recommendation:</strong> Review the period of validity of the evaluation report.</td>
<td><strong>Documents relating to the valuation of real estate now remain effective for an unlimited period of time (they do not expire), provided the cadastral value of the property has not changed (which must be certified with a reference obtained from the State Land Service). Legislation now allows that such certification can be done electronically, but steps still need to be taken to ensure that this can occur on a practical basis.</strong></td>
</tr>
<tr>
<td><strong>Finding:</strong> Registration of real estate operations with the Land Registry is comparatively long at 30 days. Legislation does not explicitly define whether accelerated registration is possible. <strong>Recommendation:</strong> Clarify the expedited service in applicable legislation.</td>
<td><strong>The relevant legislation was amended. It is now possible to register real estate within three working days.</strong></td>
</tr>
<tr>
<td><strong>Finding:</strong> The 2 percent state duty to register a real estate transfer via sale acts as a deterrent to declaring the actual transfer price, especially for large deals. The government loses valid market data for further reevaluations of real estate for tax purposes. <strong>Recommendation:</strong> Review the application of the 2 percent state duty and consider capping it.</td>
<td><strong>A state duty in the amount of 2 percent of the transaction value or real estate cadastral value for the registration of title transfer was capped at LVL 30,000.</strong></td>
</tr>
<tr>
<td><strong>Construction procedures</strong></td>
<td></td>
</tr>
</tbody>
</table>
| **Finding:** Obtaining a construction permit for a commercial project takes 1.0 to 1.5 years. **Recommendations:**  
  - Undertake process reengineering techniques to find ways to speed up the approval process, including eliminating unnecessary or duplicative procedures to ensure efficient approvals.  
  - Prepare and publish regulations with guidelines for municipal officials on the maximum approval times associated with each stage of the construction approval process. | **A dedicated working group was set up by the prime minister to address construction approval problems.**  
  **The construction preparation process and the state expertise procedure were simplified and streamlined by adopting amendments to the general construction regulations.**  
  **An information service has been opened in the Architectural Department of the Riga City Council.** |
| **Finding:** There is no uniform system of fees (i.e., every service that issues technical specifications charges a fee that is regulated by internal normative documents). **Recommendation:** Create a consolidated fee structure to help finance the need for increased resources. | **A uniform set of fees and duties related to construction was introduced, making the construction process less bureaucratic and more transparent by adopting amendments to the general construction regulations.**  
  **A register of municipal duties was instituted at the Municipal Affairs Board, where information concerning all the municipal duties and their rates imposed by local governments is available.** |

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<sup>a</sup> Primarily reforms enacted in response to FIAS recommendations; also FIAS methodologies adopted by the government in the course of its institutional development.

**Sources:** FIAS 1999; follow-up research by FIAS.
**FIGURE 2A.7: BUILDING PERMITS ISSUED NATIONALLY FOR HOUSES, NONRESIDENTIAL BUILDINGS, AND ENGINEERING STRUCTURES, 1999–2003**


**FIGURE 2A.8: BUILDING PERMITS ISSUED IN RIGA, 1998–2003**

Source: Riga City Construction Board.

- Change classification of usage (n1=59; n2=37; n3=16)
- Rezone land (n1=17; n2=22; n3=8)
- Obtain approval of design (n1=56; n2=69; n3=33)
- Coordinate design (n1=65; n2=72; n3=44)
- Have a public hearing (n1=9; n2=27; n3=11)
- Obtain final acceptance of the building (n1=45; n2=61; n3=29)
- Acquire architectural and planning task (n1=57; n2=62; n3=34)
- Obtain municipal right of first refusal (n1=37; n2=62; n3=26)
- Gather the technical regulations (2001, n1=48; 2003, n2=68; 2005, n3=40)
- Obtain Land Book title registration (n1=95; n2=107; n3=65)
- Obtain a construction permit (n1=57; n2=68; n3=46)


Note: Base = respondents who performed the respective procedures before using the premises.

a. Number of respondents is too small (n < 40) to generalize the acquired results.
According to the database that serves as the basis of the *Doing Business* reports, transfer of title in Riga takes nine steps, an average of 54 days, and about 2 percent of the property value. This ranks Latvia 89th among 155 countries, one of the lowest scores for the country and a significant drag on its ranking for overall ease of doing business. The *Doing Business* data for construction permits are somewhat better (relative to other countries): it takes 21 steps, 160 days, and costs about 44 percent of per capita income. This ranks Latvia 47th among 155 countries, but it is nevertheless a continuing source of complaints by investors (http://www.doingbusiness.org/ExploreEconomies/Default.aspx?economyid=108).

**STRUCTURED DIALOGUE BETWEEN THE GOVERNMENT AND THE BUSINESS COMMUNITY**

One of Latvia’s most noteworthy achievements since the 1999 administrative barriers report was the establishment of structured dialogue between representatives of the public and private sectors to identify problems and discuss solutions, prepare an action plan to improve the business environment, and subsequently to review progress made in implementing reforms. FIAS has introduced other transition countries to this model, and the European Commission Enterprise Directorate-General has cited this process in Latvia as a “CC-BEST” practice that could usefully be shared with other EU candidate-countries.32

**FIAS Recommendations and the Government’s Response**

Table 2A.11 summarizes the key recommendations of the FIAS 1999 study and the measures the government has taken in response.

**Ultimate Outcome of Reform**

It is this dialogue and action plan process that played a substantial role in ensuring that many of the recommendations and changes discussed in the preceding section were implemented in a coherent and coordinated fashion. The FIAS implementation project assisted the LDA in setting up the Business Environment Improvement Unit to serve as a coordinator of the action plan and facilitator of the dialogue process. These activities received support from the EU PHARE program, FIAS, the Swedish International Development Agency, and other international donors from 1998 to 2002.

To summarize, the following key developments have taken place since 1999:

- Enterprise and tax registration, immigration, and customs procedures were simplified, with fewer steps taking less time.
- Government institutions increased their level of cooperation to improve efficiency in areas such as border crossing and customs, immigration, and inspections.
- More and better information on procedures for enterprise registration, inspections, customs, and valuation of real estate was made available to the public.
- Administrative or petty corruption seems to have receded (although there are indications that other, more sophisticated forms of corruption are still problematic).
- There has been improved dialogue between the government and the business community about many areas of concern to the business community, and there is better understanding and use of consultations when policy documents and normative acts are drafted.

32. CC-BEST is the acronym for Candidate Country—Business Environment Simplification Task Force.
### TABLE 2A.11: STRUCTURED DIALOGUE WITH THE BUSINESS COMMUNITY: RECOMMENDATIONS AND THEIR OUTCOMES

<table>
<thead>
<tr>
<th>FIAS Recommendations</th>
<th>Project Outcomes and Reforms Enacted&lt;sup&gt;a&lt;/sup&gt;</th>
</tr>
</thead>
<tbody>
<tr>
<td>• <strong>Recommendation:</strong> Discuss the findings of the report at a public workshop with both government and private sector participation to design a reform program and prioritize the issues to be addressed.</td>
<td>• To openly discuss the issues identified in the FIAS report, the LDA invited the business community and government ministers to a presentation of the draft report by FIAS in January 1999. The prime minister established a working group to address the issues raised in the report. The working group was composed of members of the Latvian, American, British, German, and Swedish chambers of commerce, as well as civil servants.</td>
</tr>
<tr>
<td>• <strong>Recommendation:</strong> Set up an ongoing public/private dialogue to monitor the business environment and identify best possible corrective measures.</td>
<td>• By applying the recommendations of both the FIAS report and the working group’s subgroups on specific issues, the working group came up with an action plan containing more than 30 proposed actions and designating the government institution responsible for implementing each action. The proposed actions included items such as improving the quality of information on the functions of the government institutions, combining enterprise registration and tax registration into a single process, easing immigration requirements for expatriate workers, amending customs procedures, and establishing a special working group to deal solely with complex construction issues. On May 11, 1999, the CM accepted the action plan in its entirety. The LDA is monitoring its implementation, and the CM is regularly updating the plan. (The last one was adopted in early 2006.)</td>
</tr>
<tr>
<td></td>
<td>• The FICIL, composed of the CEOs of foreign companies representing a cross-section of sectors and countries doing business in Latvia, was set up in 1999. It holds a semianual meeting between the CEOs and other top executives of major international investors and the highest government officials, including the prime minister, minister of economy, minister of foreign affairs, minister of finance, and other government officials. Ten council meetings have been held since June 1999. Issues discussed have included tax policy, tax administration and appeals, higher and continuing education and development of a qualified workforce, customs and border crossing, EU accession, the accessibility of long-term financing in the local currency, the fight against corruption, valuation of land and buildings for determining the real estate...</td>
</tr>
</tbody>
</table>
**TABLE 2A.11: STRUCTURED DIALOGUE WITH THE BUSINESS COMMUNITY: RECOMMENDATIONS AND THEIR OUTCOMES (CONTINUED)**

<table>
<thead>
<tr>
<th>FIAS Recommendations</th>
<th>Project Outcomes and Reforms Enacted&lt;sup&gt;a&lt;/sup&gt;</th>
</tr>
</thead>
</table>
| • Recommendation: Because policy makers at the ministerial level work on the development of detailed implementing regulations, guidelines, procedures, and forms, they should regularly solicit input and suggestions from stakeholders. | • With more information posted on the Internet, with business associations gaining strength, and as civil servants gain greater understanding of the need to improve open consultations and dialogue, more decentralized consultations at various stages of policy making are taking place.  
• Since 2000, all the draft normative acts prepared by the ministries are available on the CM Web site when they are released. At that point, any NGO, including business associations, can freely access those drafts and submit their comments during the coordination process (which typically takes two to three months or more).  
• The government has introduced regulations mandating that government institutions that prepare draft normative acts carry out consultations with the private sector and NGOs, and conduct an assessment of the level of administrative burden imposed by new regulations. The requirement for such a regulatory impact assessment was introduced in 2001, and it has helped institutionalize these aspects of analysis in the public administration.  
• In addition to structured discussions with foreign investors, the government has committed to ongoing broad dialogue with the National Economy Council (a consultative council of businesspeople and representatives of governmental organizations and NGOs) on the concept of developing a national economy, state budget, and other key economic policy documents. The council also reviews drafts of key normative acts. Thirty-five meetings of the council took place between June 18, 1999, and August 10, 2004.<sup>c</sup> |

tax, and the new Commercial Law. Between the semiannual sessions of the council, ad hoc groups of business and government representatives discuss and evaluate issues of concern to foreign investors.<sup>b</sup> Their recommendations are incorporated into the action plan.

<sup>a</sup> Primarily reforms enacted in response to FIAS recommendations; also FIAS methodologies adopted by the government in the course of its institutional development.

<sup>b</sup> The LDA estimates that about 40 meetings of the FICIL working groups and meetings with government institutions occur during a year.

<sup>c</sup> Number of meetings of the National Economy Council: 1999, 6; 2001, 9; 2002, 7; 2003, 8; 2004, 5 (information provided by the Secretariat of the National Economy Council).

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**Sources:** FIAS 1999; follow-up research by FIAS.

**Note:** CEO = chief executive officer; CM = Cabinet of Ministers; EU = European Union; FICIL = Foreign Investors’ Council in Latvia; LDA = Latvian Development Agency; NGO = nongovernmental organization.

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<sup>a</sup> Primarily reforms enacted in response to FIAS recommendations; also FIAS methodologies adopted by the government in the course of its institutional development.

<sup>b</sup> The LDA estimates that about 40 meetings of the FICIL working groups and meetings with government institutions occur during a year.

<sup>c</sup> Number of meetings of the National Economy Council: 1999, 6; 2001, 9; 2002, 7; 2003, 8; 2004, 5 (information provided by the Secretariat of the National Economy Council).
Early on, the LDA Business Environment Unit, with the support of FIAS, started working on institutionalizing an economic and administrative burden analysis of the draft normative acts. In 2000 and 2001, the LDA unit worked with the State Chancellery to design the annotations that would be required for draft acts and to include consultation requirements into the annotations. The first version of the annotations was piloted in 2001, and a revised version was adopted in 2002 along with an instruction for its completion. The LDA Business Environment Improvement Unit helped draft the instruction and trained civil servants at the School of Public Administration on how best to apply the regulatory impact assessment required in the annotations.

Currently, all the legal acts reviewed by the Cabinet of Ministers need to be accompanied by an annotation. The annotation asks for an assessment of the impact of different aspects of the proposed regulation—such as impact on the legal system, state budget, international commitments, administrative simplicity, human rights, and so on.

For the purposes of this study, a two-year period (May 21, 2002, to June 30, 2004) was analyzed to identify trends in annotations and consultations with business associations. According to information from the State Chancellery, a total of 1,294 annotations were submitted during this time period:

<table>
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<tr>
<th></th>
<th>May–December</th>
<th>January–July 1, 2004</th>
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<tbody>
<tr>
<td>Number of annotations submitted</td>
<td>347</td>
<td>749</td>
</tr>
<tr>
<td>Number of legal acts adopted in the CM</td>
<td>198</td>
<td>198</td>
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</table>

An analysis of the annotations from the first half of 2004 indicates that the consultations were carried out most commonly with the largest nongovernmental organizations—Latvian Union of Municipalities, Latvian Confederation of Employers, Latvian Association of Free Trade Unions, Latvian Traders Association, Nature Fund of Latvia, Environmental Protection Club, Council for Cooperation of Farmers’ Organizations, Convent of Farmers, and Save the Children.

A review of the 198 submitted annotations reveals that the effect on the business environment and simplification of administrative procedures was assessed in 21 percent of draft legal acts. Thus, a significant number of legal acts were subjected to a test of reasonable regulatory policies and minimum necessary administrative requirements. The key achievement is that this activity is now institutionalized, and the LIDA and the State Chancellery can work to improve the quality of assessments.
APPENDIX 3: INTERMEDIATE IMPACT ON THE INVESTMENT CLIMATE IN LATVIA

DEFINING THE INVESTMENT CLIMATE

*Investment climate* is a broad concept. Stern (2001) defined the term as domestic policies and institutions that are necessary to realize the benefits of globalization and essential to minimize risks that may arise from such an integration process. Hence, as Batra and Mody (2003) pointed out, a country's investment climate is affected by a number of factors:

- macroeconomic stability
- bureaucratic harassment (especially in the administration of regulations and taxes)
- strength of financial institutions
- rule of law (including law enforcement), corruption, and crime
- quality of infrastructure (including power and telecommunications)
- government effectiveness (in providing sound regulatory structure for the private sector)
- government effectiveness in providing public services
- quality of the labor force.

Thus, investment climate is multidimensional, and a great deal of overlap and correlation exists between the various factors affecting the investment climate. To make the concept of investment climate operational, Batra and Mody (2003) categorized factors that influence investment climate into six groups or dimensions, with each group having several subgroups (see appendix table A.2 in Batra and Mody [2003]). Their factor groups and subgroups are these:

1. **Macroenvironment**
   - growth
   - inflation
   - monetary policy indicators (inflation rate, exchange rate constraints)

2. **Risk**
   - overall country risk rating
   - political risk/political instability
   - economic risk/economic uncertainty

3. **Policy and institutions**
   - trade
   - openness
   - access to bank finance
   - credit availability
   - access to capital markets
   - stock market development
   - tax rate
   - tax administration
   - crime
   - corruption
   - legal structure
   - court quality
   - confidence in courts
   - environmental protection
   - government attitude to business
   - government effectiveness
   - customs

4. **Competition policy and regulation**
   - degrees of competition
   - entry barrier
   - level of regulation
   - enforceability and predictability of laws and regulations
   - firms' compliance with international standards

5. **Infrastructure**
   - utilities
   - communication technology
   - road and rail
   - quality of infrastructure
6. **Human and technological development**

- human development
- technological development
- productivity.

**SCOPE OF FIAS’ ADMINISTRATIVE BARRIER WORK AND THE INVESTMENT CLIMATE**

The FIAS study of administrative barriers to investment focused primarily on the regulatory barriers to starting up, locating, and operating a business:

- **Start-up procedures** (immigration; business and tax registration procedures; and means of obtaining various business licenses, permits, and clearances)
- **Locating procedures** (land allocation and registration, site development, building permits, utility connections, inspections, and occupancy permits)
- **Operating procedures and reporting requirements** (import/export and foreign exchange procedures, product certification, labor regulations, government inspections, means of dealing with tax administration).

Thus, many of the indicators that proxy for policy and institutions as well as competition policy and regulation, and the productivity dimensions of investment climate (as defined by Batra and Mody [2003])—such as the following—are the areas in which FIAS consultants focus their assessment of administrative barriers:

- tax administration
- corruption
- government attitude toward business
- government effectiveness
- customs
- entry barriers
- regulation
- enforceability and predictability of laws and regulations.

Enhancements in those areas have, in turn, a positive effect on the macroeconomy and economic growth, and hence they can improve a country’s risk ratings. Similarly, improvements in labor regulations can contribute to job creation and productivity growth through a well-functioning and dynamic labor market. This, in turn, tends to improve the human development dimension of the investment climate.

Once a diagnosis of administrative barriers has been performed, FIAS communicates extensively with the government and the business community and helps facilitate government/private sector dialogue to develop an action plan. The action plan prioritizes the areas that require reforms; contains recommendations specific to each area of focus; and defines what reforms will be undertaken, who will be responsible for implementing them, when they should be completed, and how they should be assessed.

The areas of focus of the action plan in Latvia were business inspections, customs procedures (including border-crossing and import/export procedures), construction permits, land acquisitions, tax administration, expatriate employment and residency, enterprise registration, business regulation, structured dialogue between the government and the business community, appeal mechanisms, access to information, better service by government officials, activities of business associations and consultations on draft legal acts, and corruption.

Hence, to assess the effect of the work that FIAS conducted on examining administrative barriers in Latvia, FIAS considered various indicators from international sources, along with the ARCS data, which are related logically to the action plan. For each indicator, we report the data over the period 1995–2004 (or for whatever years during this period the data are available for the corresponding indicator) to assess the magnitude

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33. Definitions of key indicators are available on request.
and direction of change between the eras before and after administrative barriers were assessed (see table 3A.1). The following section further analyzes how the broader dimensions of Latvia’s investment climate have changed over the period 1995–2004 through economic growth, foreign and domestic investment, the private sector, trade openness, employment and living standards, and poverty and human development.

### CUSTOMS, BORDER-CROSSING, AND IMPORT/EXPORT PROCEDURES

We use the Heritage Foundation trade policy subindex and a number of subindexes from the Fraser Institute’s Index of Economic Freedom, which are related to freedom to perform international trade to serve as a proxy for the institutional and policy dimensions of the

#### TABLE 3A.1: TRADE POLICY RATINGS IN LATVIA, 1995–2006

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<tbody>
<tr>
<td>Heritage Foundation Index of Economic Freedom, subindex Trade Freedom (in %, based on 2007 revisions to methodology)</td>
<td>—</td>
<td>70</td>
<td>60</td>
<td>76</td>
<td>76</td>
<td>76</td>
<td>75</td>
<td>75</td>
<td>73.6</td>
<td>74.8</td>
<td>75</td>
<td>77.4</td>
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<tr>
<td>Fraser Institute indexes (0 = least free, 10 = most free)</td>
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<tr>
<td>Freedom to trade internationally</td>
<td>8.0</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>7.2</td>
<td>7.6</td>
<td>7.6</td>
<td>7.6</td>
<td>—</td>
<td>—</td>
<td>—</td>
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<tr>
<td>Taxes on international trade/tariffs</td>
<td>9.5</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>8.3</td>
<td>8.7</td>
<td>8.7</td>
<td>8.7</td>
<td>—</td>
<td>—</td>
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</tr>
<tr>
<td>i. Revenue from taxes on international trade as a % of exports plus imports</td>
<td>9.5</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>9.8</td>
<td>9.8</td>
<td>9.8</td>
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<tr>
<td>ii. Mean tariff rate</td>
<td>—</td>
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<td>—</td>
<td>—</td>
<td>—</td>
<td>8.9</td>
<td>9.2</td>
<td>9.2</td>
<td>9.3</td>
<td>—</td>
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<tr>
<td>iii. Standard deviation of tariff rates</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>6.3</td>
<td>7.0</td>
<td>7.0</td>
<td>7.0</td>
<td>—</td>
<td>—</td>
<td>—</td>
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<tr>
<td>Regulatory trade barriers</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>5.3</td>
<td>7.0</td>
<td>7.0</td>
<td>7.1</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>i. Hidden import barriers: no barriers other than published tariffs and quotas (GCR)</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>5.3</td>
<td>5.6</td>
<td>6.2</td>
<td>5.8</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>ii. Costs of importing: the combined effect of import tariffs, license fees, bank fees, and the time required for administrative red tape raises costs of importing equipment by (GCR)</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>8.5</td>
<td>7.8</td>
<td>8.3</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
</tbody>
</table>

**Sources:** Heritage Foundation Index of Economic Freedom, 1996–2006; Fraser Institute indexes for years indicated.

**Note:** — = not available; GCR = Global Competitiveness Report.
investment climate. These indexes tend to be based on tariffs, quotas, licensing requirements, corruption of customs officials, and other hidden barriers to trade. FIAS, however, does not provide advice on tariff rates or quotas; rather, it focuses on customs procedures, licensing requirements, and corruption in customs administration. Thus, changes in these latter areas are likely to be logically linked with the FIAS administrative barriers work and recommendations.

The Heritage Foundation trade policy index is based on a country’s tariff rate (the higher the rate, the lower the index score); nontariff barriers such as import quotas, licensing requirements, and so on; and corruption within the customs service. Administrative barriers and corruption in the customs service—as argued by the Heritage Foundation, FIAS, and others—are important barriers to trade because even though countries may publish official low tariff rates and no official nontariff barriers, their customs officials can create a cost or barrier to trade through bribe seeking or stealing. The index is based on a percent value, reflecting a change in methodology in 2007. According to the Heritage Foundation Trade Freedom subindex, Latvia’s position improved noticeably from a score of 60 percent in 1997 to a score of 77.4 percent in 2006, with some fluctuation in the meantime (see table 3A.1).

The Fraser Institute subindex of international freedom to trade also includes components to measure a wide variety of restraints to international trade: tariffs, quotas, hidden administrative restraints, exchange rates, and capital controls. The scale of this index is 0 to 10, with 0 considered least free to trade and 10 considered most free to trade. Table 3A.1 reports both the aggregate freedom to trade index and its subcomponents, which are particularly relevant from the point of view of the action plan and the study of administrative barriers in Latvia. The aggregate index of trade deteriorated slightly from 8.0 to 7.2 between 1995 and 2000, but it improved from 7.2 in 2000 to 7.6 in 2002. In 2003, the Fraser Institute index of freedom to trade maintained its 2002 level.

Although a score for the late 1990s does not exist, we see improvement in the scores for regulatory trade barriers, including hidden import barriers to trade. Such improvement was a key focus of FIAS work over the period 2000–03. Similarly, although we cannot compare the index value of the cost of importing in 2001 and 2002 with the preadministrative barrier reform period (i.e., 1995–97), the index value of the cost (which includes license fees and the time involved to deal with administrative red tape) had a very good score of 8.5 (out of 10) in 2001. In 2002, the score deteriorated slightly to 7.8, but it improved to 8.3 in 2003.

The ARCSs of 2001 and 2003 indicated that around 30 percent of firms viewed customs regulation as a major or severe problem. About 40 percent of the firms rated the services they received from the customs service as “good” or “very good.” Fifty percent of firms rated the services for cargo and road transport license as “good” or “very good” in 2001, whereas 70 percent of firms gave these ratings in 2003. Thus, available data and indicators imply some improvements in customs administration in Latvia (table 3A.2).

**REGULATORY BARRIERS TO BUSINESS**

The core objective of the administrative barriers work of FIAS is to remove regulatory barriers to business. Overwhelming regulations deter domestic investment, raise the cost of doing business, divert FDI, inspire corruption and black market activities (which, in turn, dampen a country’s revenue base), and encourage
capital flight. Although some regulations could be legitimate and necessary, many are not. Poor countries tend to regulate more than rich countries, despite the low bureaucratic quality and often poorly functioning institutions of the former. Not surprisingly, many regulations turn out to be rather inefficient and opaque. Furthermore, as the World Bank’s Doing Business reports indicate, complicated regulations rarely get enforced consistently; rather, beneath their shadow the games of corruption and rent seeking continue. Scarcely resources are misallocated from productive to unproductive purposes to deal with bureaucratic red tape. FIAS studies of administrative barriers in different countries have demonstrated that senior management in enterprises waste significant time addressing unnecessary government regulations, and they often must pay significant sums as bribes to get things done. Failure to comply with vague administrative procedures or the whim of a government officer could result in long delays, unpredictable sanctions, and disruptions in day-to-day business activities. Poverty also affects small and medium-size firms—generally the major employers of the poor (and whose owners also are likely to be comparatively poorer than the owners of large firms)—in that they bear a disproportionately larger share of the regulatory burden because they have neither the money to satisfy rent-seekers nor the political power to tame predators.

There is evidence that, by eliminating unnecessary procedures and streamlining regulations, governments can encourage new investment, and thereby improve growth and alleviate poverty. Reducing key barriers to business can result in a 0.25 percent increase in a developing country’s annual income growth (World Bank 2005). Similarly, trade openness leads to about a 0.7 percent increase in per capita income growth in well-regulated countries (Bolaky and Freund 2004).

The Doing Business indicators show that Latvia has some of the least complicated registration procedures of all the new EU member-countries (figure 3A.1). For example, Latvia requires only five procedures to start a business, whereas Estonia and Hungary require six. It takes only about 16 days to start a business in Latvia, whereas the

<table>
<thead>
<tr>
<th>TABLE 3A.2: CHANGES IN CUSTOMS SERVICES BETWEEN 2001 AND 2003</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Category of assessment</strong></td>
</tr>
<tr>
<td>----------------------------</td>
</tr>
<tr>
<td>Degree of problems with customs regulations</td>
</tr>
<tr>
<td>Services received during the process of receiving transportation of cargo by road transport licenses</td>
</tr>
<tr>
<td>Services received from customs service</td>
</tr>
</tbody>
</table>

*Source: ARCS 2001 and 2003.*

*Note: Data for 2005 are not included because, after Latvia’s entry into the EU (May 1, 2004), intra-EU trade no longer required customs clearance; thus, data are not comparable.*
FIGURE 3A.1: BUSINESS REGISTRATION IN EU ACCESSION COUNTRIES, 2004 AND 2005

a. Number of procedures to start a business

b. Time to start a business

c. Minimum capital to start a business

same procedures require about 72 and 52 days in Estonia and Hungary, respectively. These figures imply that the business registration system in Latvia functions well. Latvia also has minimal capital requirements to start a business, although it is relatively expensive to do so.

In 2005, it took about 54 days to register property in Latvia, whereas the process took only 3 days in Lithuania (figure 3A.2). There have been recent claims that real estate registration can now be expedited in three days in Latvia. Real estate registration requires 10 procedures in Latvia, whereas Lithuania requires only 3. The cost of registration is about 2.1 percent of the property value in Latvia, whereas in Estonia and Lithuania the costs are, respectively, about 0.5 percent and 0.9 percent of the property value.

In addition to Doing Business indicators, FIAS used the Heritage Foundation’s regulation subindex, a number of indicators from the Fraser Institute, and the regulatory quality index from Kaufmann, Kraay, and Mastruzzi (2003) to assess improvements in the regulatory environment in Latvia before and after the administrative barriers study was conducted. The Heritage Foundation’s regulation subindex is based on licensing requirements to operate a business; ease of obtaining a business license; corruption within the bureaucracy; labor, environmental, consumer safety, and worker health regulations; and regulations that impose a burden on business. Another consideration is whether a country has a state planning agency that sets production limits and quotas. The index is based on a percent value, reflecting a change in methodology in 2007. According to the Heritage Foundation Business Freedom subindex (see table 3A.3), starting from 1998 until 2005, the value for Latvia has been 50 percent, with an increase to 90.4 percent in 2006.

The Fraser Institute’s business regulation subindex is designed to identify the extent to which regulatory restraints and bureaucratic procedures limit competition and market operation. The scores for the indexes range from 0 to 10, with 0 being the worst and 10 being the best. A high score indicates that a country allows markets to determine prices, refrains from regulatory activities that retard entry and increase the cost of production, and refrains from using power to extract financial payments and reward some business at the expense of others. The business regulation index score for Latvia was around 5 on a scale of 0 to 10 over the period 2000–02. Latvia’s score for ease of business start-up rose from 5 in 2000 to 6 in 2002, whereas the score for administrative obstacles to starting a new business deteriorated from 7.5 in 2000 to 4.5 in 2002. The index of senior management’s time spent addressing government bureaucracy remained at about 4.

The results for the Fraser Institute’s subindexes on administrative obstacles from its Economic Freedom Index are directly in contrast with the Doing Business indicators on business registration in Latvia. This contrast might be due to expert opinions that contribute to the Fraser Institute’s subindexes. The reliability of expert opinions depends greatly on the ability of small groups of experts to provide objective and accurate assessments of a situation, but this same reliability can be prone to ideological biases as well.34

For the period 1996–2002, there has been a continuous improvement in the regulatory quality index developed by Kaufmann, Kraay, and Mastruzzi (2003) for Latvia. The index is calculated using an unobserved component analysis framework and it aims to more accurately assess regulation from a wide range of sources, including those used in the Heritage Foundation and Fraser Institute.

34. For a discussion on the advantages and disadvantages of polls of experts in surveys of market participants, see Kaufman, Kraay, and Zoido-Lobatón (1999) and Kaufmann and Kraay (2002).
FIGURE 3A.2: PROPERTY REGISTRATION

a. Number of procedures to register property

b. Time to register property

c. Cost of property registration

### TABLE 3A.3: BUSINESS REGULATION RATINGS

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<tbody>
<tr>
<td><strong>Heritage Foundation Index of Economic Freedom, subindex</strong></td>
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<td>Business Freedom (in %, based on 2007 revisions to methodology)</td>
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<tr>
<td><strong>Fraser Institute indexes (0 = least free, 10 = most free)</strong></td>
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<tr>
<td>Business regulation</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>5.8</td>
<td>4.7</td>
<td>5.4</td>
<td>6.2</td>
<td>—</td>
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<tr>
<td>i. Price controls: extent to which businesses are free to set their own prices</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>6.0</td>
<td>6.0</td>
<td>6.0</td>
<td>6.0</td>
<td>—</td>
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<td>—</td>
</tr>
<tr>
<td>ii. Administrative conditions and new businesses: administrative procedures are an important obstacle to starting a new business (GCR)</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>7.2</td>
<td>3.3</td>
<td>4.5</td>
<td>3.3</td>
<td>—</td>
<td>—</td>
<td>—</td>
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<tr>
<td>iii. Time with government bureaucracy: senior management spends a substantial amount of time dealing with government bureaucracy (GCR)</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>4.7</td>
<td>4.0</td>
<td>4.5</td>
<td>5.8</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>iv. Starting a new business: how easy is it to start a new business (GCR)?</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>5.0</td>
<td>4.6</td>
<td>6.0</td>
<td>5.3</td>
<td>—</td>
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</tbody>
</table>

| Regulatory quality (Kaufmann, Kraay, and Mastruzzi 2007) | | | | | | | | | | | |
| Estimate (−2.5 to + 2.5) | 0.53 | — | 0.72 | — | 0.53 | — | 0.92 | — | 1.02 | — | — |
| Percentile rank (0–100)\(^a\) | 0.73 | — | 0.74 | — | 0.73 | — | 0.77 | — | 0.83 | — | — |

**Sources:** Heritage Foundation Index of Economic Freedom, 1996–2006; Fraser Institute indexes for years indicated.

**Note:** — = not available; GCR = Global Competitiveness Report.

\(^a\) Author’s calculations.
indexes (table 3A.3). While the point estimate of the index increased from 0.53 (on a scale of –2.50 to +2.50) in 1996 to 1.02 in 2004, the corresponding percentile rank for Latvia also increased from 73 to about 83. The regulatory quality index focuses on policies and includes measures of the incidence of market-unfriendly policies, such as price controls or inadequate bank supervision, as well as perceptions of the burdens imposed by excessive regulation in areas such as foreign trade and business development.

Access to Information and Government Service Provision
Lack of transparency and access to information about government regulations, legislation, and policies can pose a serious problem for business. FIAS used the “government effectiveness” index developed by Kaufmann, Kraay, and Mastruzzi (2003) for this purpose. This index combines responses on the quality of public services, the quality of the bureaucracy, the competence of civil servants, the independence of the civil service from political pressures, and the credibility of the government’s commitment to policies. Although the index tends to serve as a proxy for a variety of governance issues, the most relevant issues for the purpose of assessing the business environment in Latvia are those concerning the quality of public services and the government’s commitment to its policies. The main focus of this index is inputs required for the government to produce and implement good policies and deliver public goods. There has been a significant improvement in this index for Latvia since 1996. The point estimate of the index (on a scale of –2.50 to +2.50) increased from 0.04 in 1996 to 0.60 in 2004, and the corresponding percentile ranking for Latvia similarly increased from 63 to 71. To the extent this index captures the quality of public service provision and the government’s commitment to its policies, one can infer that significant improvements have occurred in these dimensions since the late 1990s:

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</tr>
</thead>
<tbody>
<tr>
<td>Estimate (–2.5 to + 2.5)</td>
<td>0.04</td>
<td>0.19</td>
<td>0.36</td>
<td>0.70</td>
<td>0.60</td>
</tr>
<tr>
<td>Percentile rank (0–100)</td>
<td>63</td>
<td>67</td>
<td>68</td>
<td>75</td>
<td>71</td>
</tr>
</tbody>
</table>

CORRUPTION
The detrimental effect of corruption on business, and thus on domestic and foreign investment, growth, and poverty, is well known and well documented in the literature. Many of the indexes discussed earlier also attempt to account for corruption in the bureaucracy and in customs administration.

One of the most widely used indicators of corruption is the Transparency International Corruption Perceptions Index, which ranges from 0 to 10, with 0 indicating most corrupt and 10 indicating least corrupt. The index gave Latvia a very low score of 2.70 in 1998; but that score has improved continuously, reaching 4.20 in 2004. The overall score is still low, however, implying the need for further improvements in Latvia.

Corruption in Latvia is also reflected in the “control of corruption” index developed by Kaufmann, Kraay, and Mastruzzi (2003), which measures perceptions of corruption, conventionally defined as the exercise of public power for private gain. It captures different aspects of corruption, ranging from the frequency of “additional payments to get things done” to the effects of corruption on the business environment, grand
corruption in the political arena, and state capture. The score for Latvia increased from –0.56 in 1996 to 0.23 in 2004 (on a scale of –2.5 to +2.5), and its corresponding percentile ranking improved from 32 in 1996 to 63 in 2004.

Although FIAS was not able to obtain data from the late 1990s for two other indicators (table 3A.4), the Fraser Institute’s subindex of irregular payments (which tracks irregular, additional payments connected with import and export permits, business licenses, exchange controls, tax assessments, police protection, or loan applications) shows that scores for Latvia improved marginally from 5.8 (out of 10.0) in 2000 to 6.0 in 2003.

The Freedom House Corruption Index (http://www.transparency.org/publications/gcr/download_gcr/download_gcr_2003#download) remained at 3.5 (on a scale of 1.0–7.0, with 1 indicating least corrupt and 7 indicating most corrupt) from 1999 until 2004 (in 2002 the score dropped slightly to 3.75 but it returned to 3.50 in 2003). The major

### TABLE 3A.4: CORRUPTION RATINGS

<table>
<thead>
<tr>
<th>Index</th>
<th>1996</th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fraser Institute’s Index of Economic Freedom, subsection Business regulation, subsection Irregular Payments: irregular, additional payments connected with import and export permits, business licenses, exchange controls, tax assessments, police protection, or loan applications (GCR) (0 = worst, 10 = best)</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>5.8</td>
<td>5.4</td>
<td>6.0</td>
<td>6.0</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Control of corruption (Kaufmann, Kraay, and Mastruzzi 2007)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Estimate (−2.5 to +2.5)</td>
<td>−0.56</td>
<td>−0.10</td>
<td>0.04</td>
<td>—</td>
<td>0.09</td>
<td>—</td>
<td>0.23</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Percentile rank (0–100)</td>
<td>0.32</td>
<td>0.62</td>
<td>0.60</td>
<td>—</td>
<td>0.59</td>
<td>—</td>
<td>0.63</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Freedom House Corruption Index (1 = least corrupt, 7 = most corrupt)</td>
<td>—</td>
<td>—</td>
<td>3.50</td>
<td>—</td>
<td>3.50</td>
<td>3.75</td>
<td>3.50</td>
<td>3.50</td>
<td>2.50</td>
</tr>
<tr>
<td>Transparency International Corruption Perceptions Index (0 = most corrupt, 10 = least corrupt)</td>
<td>—</td>
<td>2.7</td>
<td>3.4</td>
<td>3.4</td>
<td>3.4</td>
<td>3.7</td>
<td>3.8</td>
<td>4.2</td>
<td>4.2</td>
</tr>
</tbody>
</table>

Sources: Fraser Institute indexes for years indicated; Kaufmann, Kraay, and Mastruzzi 2003; Freedom House Corruption Indexes, various years; Transparency International Corruption Perceptions Index, various years.

Note: — = not available.
improvement, however, appeared in 2005 when the score improved to 2.5.

On the basis of a wide range of data and information, there have been significant improvements in the investment climate in Latvia—namely, in customs and trade, the regulatory environment, access to information and government service provision, and corruption. However, the property registration procedures were more complicated in Latvia than in the other countries then seeking EU accession.
APPENDIX 4: FINAL IMPACT: INVESTMENT, GROWTH, AND POVERTY ALLEVIATION

PRIVATE SECTOR INVESTMENT

Gross fixed capital formation has been high and has increased over the period 1999–2005 (figure 4A.1). The private sector has been the key contributor to growth and development in Latvia, which further reinforces the link between removing administrative barriers to business and economic growth. Throughout the period 1995–2003, on average, 87 percent of total investment in Latvia came from the private sector. The private sector also held the dominant share of GDP, and that share improved from 55 percent in 1995 to 70 percent in 2002.36

Small and Medium Enterprises

The burden of regulations often falls disproportionately on small and medium enterprises (SMEs) because they lack both the resources and the political influence of larger firms. Indeed, the administrative and regulatory cost surveys that FIAS has conducted reveal significant evidence that small firms in Latvia tend to benefit more from inspection reforms than do medium and large firms. SMEs constitute the major part of the Latvian economy and play a significant role in employment and growth. There were about 45,300 economically active enterprises in Latvia in 2003, of which more than 99 percent (i.e., 45,014) were considered SMEs. Among those, the largest proportion

FIGURE 4A.1: GROSS FIXED CAPITAL FORMATION AS A SHARE OF GDP, 1999–2005

Sources: Data from Eurostat; Ministry of Economy 2005.
Note: GDP = gross domestic product.

36. The private sector share of GDP is calculated using available statistics from both official (government) and unofficial sources. The share includes income generated from the formal activities of registered private companies, as well as informal activities for which reliable information is available. The term private company refers to all enterprises in which private individuals or entities own the majority of shares (EBRD 2003).
comprises micro- and small enterprises (76 percent micro-, 20 percent small, and 4 percent medium enterprises). Seventy percent of private sector employees are employed in SMEs and create 63 percent of the GDP (Ministry of Economy 2004).

**Foreign Direct Investment**

Net FDI inflows appear to be volatile in all transition economies (figure 4A.2). In the last decade, the Czech Republic has attracted the largest share of per capita net FDI inflow (US$832 in 2005). In Latvia, per capita net FDI inflows improved in the period 1994–97 and reached their highest levels in 1997 at US$210 per capita. A noticeable temporary decline followed in 1998, but a continuous improvement in FDI inflows occurred again in later years (except 2001, when net per capita FDI inflows declined to US$72). The largest increases occurred in 2004 and 2005 (net per capita FDI inflows of US$270 in 2005), and the figure for 2005 was roughly double that of 2003. Although there seems to be an increase in FDI inflows into Latvia in recent years, the results are volatile, and it is difficult to surmise how removing administrative barriers has contributed to attracting FDI to Latvia.

Although Latvia has one of the least regulated business environments among EU accession countries,38 this is not reflected in the Heritage Foundation (http://www.heritage.org/index/) and Freedom House (http://www.freetheworld.com/) indexes, which are

**FIGURE 4A.2: PER CAPITA NET FDI INFLOWS IN EU ACCESSION COUNTRIES, 1994–2005**


Note: EU = European Union; FDI = foreign direct investment.

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37. FIAS has been active in advising these and other EU accession countries, in addition to Latvia.

38. Latvia ranked among the best countries in the Doing Business 2004 report for ease of starting a new business. Its ranking was slightly worse in the Doing Business 2005 report because of a temporary deadline for re-registration, which created a backlog.
largely based on perceptions of foreign investors. One possible explanation for this is that it takes time to change the perception of foreign investors ("a first impression is the last impression"). A large portion of FDI is initial investment, and subsequent inflows follow the initial investment. This, in turn, implies that Latvia has great potential to attract FDI in the future as a result of reforming administrative barriers.

**TRADE OPENNESS**

Benefits of trade openness are manifold. Openness tends to increase economic growth, foreign investment, and efficiency of domestic investment through increasing competitive pressure; and ideas, knowledge, innovation, and technology tend to flow with trade, which enables a country to operate as a leading technology frontier in producing goods and services. Recent evidence suggests that trade openness complements and often acts as a catalyst to reforms in other areas, such as the labor market and utilities.

Latvia has a high degree of openness (measured in terms of trade share in GDP), although the degree of openness was higher in the period 1996–98 and has declined marginally in recent years. Although imports (both of goods and services and of manufacturing) as a share of GDP increased from 1995 to 2005, exports remained steady over the same period (table 4A.1). Reforms in customs administration and the removal of administrative barriers in other areas have led to a growth in exports, underscoring the evidence that trade liberalization leads to higher economic growth in a well-regulated environment.39

### TABLE 4A.1: TRADE OPENNESS, 1995–2005

<table>
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</tr>
</thead>
<tbody>
<tr>
<td>Trade (% of GDP)</td>
<td>87.5</td>
<td>101.1</td>
<td>101.5</td>
<td>106.8</td>
<td>90.0</td>
<td>90.3</td>
<td>92.7</td>
<td>91.5</td>
<td>96.7</td>
<td>103.7</td>
<td>110.5</td>
</tr>
<tr>
<td>Exports of goods and services (% of GDP)</td>
<td>42.7</td>
<td>46.8</td>
<td>46.8</td>
<td>47.2</td>
<td>40.4</td>
<td>41.6</td>
<td>41.6</td>
<td>40.9</td>
<td>42.1</td>
<td>44.0</td>
<td>48.1</td>
</tr>
<tr>
<td>Exports of goods and services (annual % growth)</td>
<td>—</td>
<td>20.2</td>
<td>13.1</td>
<td>4.9</td>
<td>−6.0</td>
<td>11.3</td>
<td>7.5</td>
<td>5.4</td>
<td>5.2</td>
<td>9.4</td>
<td>20.7</td>
</tr>
<tr>
<td>Imports of goods and services (% of GDP)</td>
<td>44.9</td>
<td>54.3</td>
<td>54.7</td>
<td>59.6</td>
<td>49.6</td>
<td>48.7</td>
<td>51.1</td>
<td>50.6</td>
<td>54.6</td>
<td>59.7</td>
<td>62.4</td>
</tr>
<tr>
<td>Imports of goods and services (annual % growth)</td>
<td>—</td>
<td>28.5</td>
<td>6.8</td>
<td>19.0</td>
<td>−5.5</td>
<td>3.1</td>
<td>14.3</td>
<td>4.7</td>
<td>13.1</td>
<td>16.6</td>
<td>13.5</td>
</tr>
</tbody>
</table>


*Note:* — = not available; GDP = gross domestic product.

39. Trade liberalization leads to a 0.7 percent increase in economic growth in well-regulated countries (Bolaky and Freund 2004).
ECONOMIC GROWTH

A reduction in regulatory barriers tends to increase economic growth (see World Bank 2004, 2005), and reforms to administrative barriers along with other policy reforms have led to economic growth in Latvia. When Latvia began to realize the detrimental effect of regulatory burdens on business and initiated its action plan to reform administrative barriers in May 1999, the average annual growth rate during the period 1995–99 was about 3.8 percent. The growth rate has improved to an average annual rate of 8.2 percent over the period 2000–04 when many of the reforms were implemented. Consequently, the well-being of the average Latvian measured in terms of GDP per capita (purchasing power parity [PPP], constant 2000 prices) has increased steadily from about US$2,670 in 1995 to US$5,495 in 2005 (figure 4A.3).

FORMALIZATION AND TAX REVENUES

Improvements in the investment climate have led to higher investment levels and productivity, and to greater business formalization and higher tax revenues. The data in table 4A.2 show the growth in the number of taxpayers by type of employment (i.e., natural persons engaged in business and legal entities) between 1999 and 2005. These data reflect a combination of new businesses and the formalization of firms that previously may have been operating in the gray economy. According to the database used to compile the Doing Business reports, Latvia’s informal economy constitutes about 40 percent of its gross national product.

FIGURE 4A.3: GROWTH IN GDP PER CAPITA AND PER CAPITA REAL GDP

Note: GDP = gross domestic product.
In addition, prevalence and amount of minimum wage, if considered together, may serve as a relative indicator of the gray economy (figure 4A.4). A large portion of workers employed at minimum wage may indicate that the wage is too high; however, if the wage is low relative to average in the country and a substantial portion of employees work for minimum wage, it also may illustrate a substantial informal labor market.

In 2002, a high proportion of employees (15.4 percent) in Latvia worked for minimum wage, and the minimum wage was set at 32.5 percent of the country’s average wage. In 2004, the minimum wage in Latvia increased and the proportion of employees working for minimum wage decreased. This also is reflected in a tax increase of LVL 1.2 billion during those two years (table 4A.3).

![FIGURE 4A.4: MINIMUM WAGERS IN EASTERN EUROPE, 2004](image)

Source: Based on data from Eurostat, 2006.

**TABLE 4A.2: NUMBER OF TAXPAYERS BY TYPE OF EMPLOYMENT, 1999 AND 2005**

<table>
<thead>
<tr>
<th>Years and calculations</th>
<th>Legal entities (n)</th>
<th>Self-employed individuals (n)</th>
<th>Total (n)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1999</td>
<td>99,233</td>
<td>18,861</td>
<td>118,094</td>
</tr>
<tr>
<td>2005</td>
<td>130,772</td>
<td>27,205</td>
<td>157,977</td>
</tr>
<tr>
<td>Difference 2005 vs. 1999</td>
<td>31,539</td>
<td>8,344</td>
<td>39,883</td>
</tr>
<tr>
<td>% change 2005 vs. 1999</td>
<td>24</td>
<td>31</td>
<td>25</td>
</tr>
</tbody>
</table>


40. A billion is 1,000 millions.
### TABLE 4A.3: TAX REVENUES, 1995–2004

**US$ MILLIONS**

<table>
<thead>
<tr>
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</tr>
</thead>
<tbody>
<tr>
<td><strong>Total tax revenue</strong></td>
<td>1,425</td>
<td>(―)</td>
<td>1,597</td>
<td>(―)</td>
<td>1,886</td>
<td>(23.7)</td>
<td>2,249</td>
<td>(20.6)</td>
<td>2,318</td>
<td>(2.3)</td>
</tr>
<tr>
<td><strong>Corporate income tax</strong></td>
<td>87</td>
<td>(―)</td>
<td>105</td>
<td>(20.5)</td>
<td>137</td>
<td>(37.3)</td>
<td>159</td>
<td>(17.5)</td>
<td>160</td>
<td>(―0.2)</td>
</tr>
<tr>
<td><strong>Property tax</strong></td>
<td>28</td>
<td>(―)</td>
<td>33</td>
<td>(21.9)</td>
<td>35</td>
<td>(11.1)</td>
<td>47</td>
<td>(35.1)</td>
<td>42</td>
<td>(―10.6)</td>
</tr>
<tr>
<td><strong>Personal income tax</strong></td>
<td>245</td>
<td>(―)</td>
<td>280</td>
<td>(14.9)</td>
<td>320</td>
<td>(19.9)</td>
<td>379</td>
<td>(19.7)</td>
<td>416</td>
<td>(9.2)</td>
</tr>
<tr>
<td><strong>Value-added tax</strong></td>
<td>405</td>
<td>(―)</td>
<td>489</td>
<td>(21.7)</td>
<td>503</td>
<td>(7.8)</td>
<td>545</td>
<td>(9.6)</td>
<td>549</td>
<td>(0)</td>
</tr>
<tr>
<td><strong>Excise tax</strong></td>
<td>65</td>
<td>(―)</td>
<td>160</td>
<td>(148.7)</td>
<td>209</td>
<td>(36.7)</td>
<td>292</td>
<td>(41.2)</td>
<td>269</td>
<td>(―8.4)</td>
</tr>
<tr>
<td><strong>Customs duties</strong></td>
<td>34</td>
<td>(―)</td>
<td>34</td>
<td>(2.0)</td>
<td>38</td>
<td>(17.9)</td>
<td>34</td>
<td>(―10.2)</td>
<td>28</td>
<td>(―18.6)</td>
</tr>
</tbody>
</table>


Note: — = not available. Percent increase relative to previous year shown in parentheses.
**TABLE 4A.4: EMPLOYMENT, 1996–SEPTEMBER, 2005**

<table>
<thead>
<tr>
<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td>Population aged 15–64 years (thousands)</td>
<td>1,642.4</td>
<td>1,623.7</td>
<td>1,611.4</td>
<td>1,601.6</td>
<td>1,599.6</td>
<td>1,595.0</td>
<td>1,594.2</td>
<td>1,591.4</td>
<td>1,589.3</td>
<td>1,587.3</td>
<td>1,583.8</td>
</tr>
<tr>
<td>Economically active persons (thousands)</td>
<td>—</td>
<td>1,196</td>
<td>1,167</td>
<td>1,149</td>
<td>1,130</td>
<td>1,100</td>
<td>1,107</td>
<td>1,123</td>
<td>1,126</td>
<td>1,136</td>
<td>1,102</td>
</tr>
<tr>
<td>Employed persons (thousands)</td>
<td>—</td>
<td>949</td>
<td>990</td>
<td>986</td>
<td>968</td>
<td>941</td>
<td>962</td>
<td>989</td>
<td>1,007</td>
<td>1,018</td>
<td>999</td>
</tr>
<tr>
<td>Rate of economically active population (%)</td>
<td>—</td>
<td>60.9</td>
<td>59.7</td>
<td>58.9</td>
<td>57.9</td>
<td>56.3</td>
<td>56.6</td>
<td>61.8</td>
<td>62.0</td>
<td>62.6</td>
<td>69.6</td>
</tr>
<tr>
<td>Rate of employed population (%)</td>
<td>—</td>
<td>48.3</td>
<td>50.6</td>
<td>50.5</td>
<td>49.6</td>
<td>48.2</td>
<td>49.2</td>
<td>54.4</td>
<td>55.4</td>
<td>56.1</td>
<td>63.1</td>
</tr>
<tr>
<td>Unemployment rate (%)</td>
<td>6.6</td>
<td>7.2</td>
<td>7.0</td>
<td>9.2</td>
<td>9.1</td>
<td>7.8</td>
<td>7.7</td>
<td>8.5</td>
<td>8.6</td>
<td>8.5</td>
<td>8.2</td>
</tr>
<tr>
<td>Rate of job seekers (%)</td>
<td>—</td>
<td>20.6</td>
<td>15.1</td>
<td>14.1</td>
<td>14.3</td>
<td>14.4</td>
<td>13.1</td>
<td>12.0</td>
<td>10.6</td>
<td>10.4</td>
<td>—</td>
</tr>
<tr>
<td>Employment in the manufacturing sector (thousands)</td>
<td>—</td>
<td>183</td>
<td>183</td>
<td>183</td>
<td>170</td>
<td>170</td>
<td>156</td>
<td>167</td>
<td>174</td>
<td>163</td>
<td>156</td>
</tr>
<tr>
<td>Manufacturing employment as a share of total employment (%)</td>
<td>—</td>
<td>19.3</td>
<td>18.5</td>
<td>18.6</td>
<td>17.6</td>
<td>18.1</td>
<td>16.2</td>
<td>16.9</td>
<td>17.3</td>
<td>16.0</td>
<td>15.6</td>
</tr>
<tr>
<td>Employment in the construction sector (thousands)</td>
<td>—</td>
<td>51</td>
<td>51</td>
<td>54</td>
<td>58</td>
<td>56</td>
<td>68</td>
<td>60</td>
<td>74</td>
<td>87</td>
<td>92</td>
</tr>
<tr>
<td>Construction employment as a share of total employment (%)</td>
<td>—</td>
<td>5.4</td>
<td>5.2</td>
<td>5.5</td>
<td>6.0</td>
<td>6.0</td>
<td>7.1</td>
<td>6.1</td>
<td>7.3</td>
<td>8.5</td>
<td>9.2</td>
</tr>
</tbody>
</table>


*Note:* — = not available.

*2. Data as of September 2005 (Ministry of Economy 2005).*
EMPLOYMENT AND LIVING STANDARDS

Reforms to administrative barriers tend to have a positive impact on growth and investment, which, in turn, leads to job creation and a reduction in poverty. Employment figures in Latvia show a decent improvement over the period 1996–2004. Over that period, the rate of both the economically active population and those employed increased from 60.9 percent and 48.3 percent in 1996 to about 62.6 percent and 56.1 percent in 2004, respectively. The rate of job seekers dropped from 20.6 percent of the working-age population in 1996 to 10.4 percent in 2004 (table 4A.4). Most people work in the manufacturing sector (17.4 percent in 2003); followed by wholesale and retail trade and services (15.3 percent); and agriculture, forestry, and hunting (13.0 percent). In 2002–03, the highest growth (about 23.3 percent) in employment occurred in the construction sector. Employment in that sector as a share of total employment also increased from about 5.45 percent in 1996 to approximately 7.50 percent in 2003.

A benefit of reform to administrative barriers (and related reforms) is job creation. In 2003, the highest rate of employment was found in Riga, which may be logically linked with the FIAS findings that, on average, the burden of administrative barriers is less for firms in Riga than elsewhere. This, in turn, implies that other regions in Latvia might benefit from greater employment and productivity growth through the removal of administrative barriers.

Average nominal and real wages also increased in the period 1996–2004, implying an increase in both labor productivity and the average living standard in Latvia (figure 4A.5 and table 4A.5). The average standard of living (as represented by the net monthly average wage) has improved in absolute terms, and it has diverged from the poverty level. While the average monthly wage was only US$15 higher than the cost of goods and services to meet the minimum subsistence level in 1997, in 2005 the net average monthly wage increased to US$317 (compared with the cost of meeting the minimum subsistence level of US$189). For the average employee in Latvia, reforms to administrative barriers and other economic reforms have led to greater opportunities for employment, greater productivity, and a higher standard of living.

41. It also may be due to the result of a greater degree of sophistication in Riga than elsewhere in the country.

The economic indicators cited in this appendix show that the reforms carried out in the previous decade have strengthened the private sector, and that the business environment is improving. Investments continue to grow rapidly, which is encouraging the modernization of production and introducing new and more productive technologies. Clearly, accession to the EU has had a positive effect on the development of the Latvian economy, but the reforms and the improved business environment have enabled Latvia to reap enormous benefits. We can positively assert that the broad-based economic growth in Latvia has helped alleviate poverty. A study conducted by the World Bank and released in June 2006 concluded that, between 1998 and 2004, Latvia achieved substantial progress in poverty reduction, with an estimated 325,000 people moving out of poverty over the period. Using household budget survey data from 1998 to 2004 and an absolute poverty line, the World Bank report identifies—for the first time—trends in poverty for this extended period on the basis of a consistent definition of poverty. The poverty headcount rate fell significantly, from 19.4 percent in 1998 to less than 6.0 percent in 2004 (figure 4A.6 and table 4A.6). Inequality in the distribution of income also has improved since 2000. The poverty gap index, which measures the extent of poverty (i.e., how far below the poverty line poor people live), has declined substantially since 2000—from 5.5 percent to 1.2 percent.

### TABLE 4A.5: WAGES AND COST OF MINIMUM SUBSISTENCE, 1997–2005

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</thead>
<tbody>
<tr>
<td>Average monthly wage</td>
<td></td>
<td></td>
<td>209</td>
<td>229</td>
<td>245</td>
<td>251</td>
<td>254</td>
<td>281</td>
<td>339</td>
<td>399</td>
<td>443</td>
</tr>
<tr>
<td>Gross</td>
<td></td>
<td></td>
<td>153</td>
<td>167</td>
<td>179</td>
<td>182</td>
<td>184</td>
<td>201</td>
<td>244</td>
<td>284</td>
<td>317</td>
</tr>
<tr>
<td>Net</td>
<td></td>
<td></td>
<td>118</td>
<td>135</td>
<td>138</td>
<td>141</td>
<td>144</td>
<td>141</td>
<td>139</td>
<td>145</td>
<td>166</td>
</tr>
</tbody>
</table>

**Source:** Central Statistical Bureau of Latvia, June 2006.

**Note:** = not available.

42. This paper uses the same poverty line as that used in the World Bank’s earlier living standards assessment for Latvia: namely, 28 lats per person per month in 1998 prices. It is adjusted for inflation to hold constant the real value of the poverty line over time.
The labor market provided the primary channel through which the benefits of rapid economic growth were shared widely across the population. Along with higher employment rates, labor productivity rose appreciably—and that spurred higher real wages, incomes, and living standards. At the same time, maintenance of a broad-based system of social transfers has ensured that vulnerable groups, such as pensioners and the poorest people, are protected even as the targeted effectiveness of local government benefits has improved (World Bank 2006, p. vii).

Poverty is complex and, although income is a significant component in determining quality of life, there are other aspects to quality of life as well. To address the multidimensionality of quality of life, the United Nations Development Programme constructed the Human Development Index (HDI) using life expectancy at birth, level of education, and real GDP per capita in PPP units.

According to the HDI, Latvia ranked 50th in 2003 (its rank was 63rd in 2000 and 53rd in 2002). Although, in absolute terms, human development in Latvia has improved from an index of 0.76 in 1995 to 0.82 (on a scale of 0 to 1) in 2002, it still ranks last among EU accession countries (table 4A.7). Although Latvia’s GDP per capita improved greatly between 1995 and 2003, it still ranks last among new EU member-countries. In 1995, Latvia’s GDP per capita was about 29 percent of the EU average; in 2003, the corresponding share had increased to approximately 42 percent. These figures reflect Latvia’s having achieved noticeable improvements in its average level of well-being; but relative to its comparators, the figures also reveal that much room remains for development, particularly given Latvia’s commitment to reform and development.

### FIGURE 4A.6: POVERTY TRENDS IN LATVIA, 1998–2004

![Poverty Trends in Latvia](source: World Bank 2006)

### TABLE 4A.6: KEY POVERTY AND INEQUALITY STATISTICS, 1998–2004

<table>
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<tr>
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</thead>
<tbody>
<tr>
<td>Poverty head-count rate (%)</td>
<td>19.4</td>
<td>14.0</td>
<td>7.5</td>
<td>5.9</td>
</tr>
<tr>
<td>Poverty gap (P1) measure</td>
<td>5.5</td>
<td>4.1</td>
<td>2.0</td>
<td>1.2</td>
</tr>
<tr>
<td>Poverty line (% of mean consumption)</td>
<td>50</td>
<td>41</td>
<td>34</td>
<td>30</td>
</tr>
<tr>
<td>Gini coefficient</td>
<td>33.5</td>
<td>37.3</td>
<td>35.1</td>
<td>33.5</td>
</tr>
</tbody>
</table>

### TABLE 4A.7: HUMAN DEVELOPMENT IN EU ACCESSION COUNTRIES, SELECTED YEARS, 1995–2003

<table>
<thead>
<tr>
<th>HDI Rank</th>
<th>Country</th>
<th>GDP per capita, 2003 (PPP US$)</th>
<th>Life expectancy index</th>
<th>Education index</th>
<th>GDP index</th>
<th>HDI, 2002</th>
</tr>
</thead>
<tbody>
<tr>
<td>26</td>
<td>Slovenia</td>
<td>19,150</td>
<td>0.86</td>
<td>0.98</td>
<td>0.88</td>
<td>0.895</td>
</tr>
<tr>
<td>31</td>
<td>Czech Republic</td>
<td>16,357</td>
<td>0.84</td>
<td>0.93</td>
<td>0.85</td>
<td>0.868</td>
</tr>
<tr>
<td>35</td>
<td>Hungary</td>
<td>14,584</td>
<td>0.80</td>
<td>0.96</td>
<td>0.80</td>
<td>0.848</td>
</tr>
<tr>
<td>36</td>
<td>Poland</td>
<td>11,379</td>
<td>0.82</td>
<td>0.96</td>
<td>0.79</td>
<td>0.850</td>
</tr>
<tr>
<td>38</td>
<td>Estonia</td>
<td>13,539</td>
<td>0.77</td>
<td>0.97</td>
<td>0.82</td>
<td>0.853</td>
</tr>
<tr>
<td>39</td>
<td>Lithuania</td>
<td>11,702</td>
<td>0.79</td>
<td>0.97</td>
<td>0.79</td>
<td>0.842</td>
</tr>
<tr>
<td>42</td>
<td>Slovak Republic</td>
<td>13,494</td>
<td>0.82</td>
<td>0.91</td>
<td>0.82</td>
<td>0.842</td>
</tr>
<tr>
<td>48</td>
<td>Latvia</td>
<td>10,270</td>
<td>0.78</td>
<td>0.96</td>
<td>0.77</td>
<td>0.823</td>
</tr>
</tbody>
</table>

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<tr>
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</thead>
<tbody>
<tr>
<td>Slovenia</td>
<td>0.852</td>
<td>0.883</td>
<td>0.895</td>
<td>0.904</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>0.843</td>
<td>0.856</td>
<td>0.868</td>
<td>0.874</td>
</tr>
<tr>
<td>Hungary</td>
<td>0.810</td>
<td>0.837</td>
<td>0.848</td>
<td>0.862</td>
</tr>
<tr>
<td>Poland</td>
<td>0.816</td>
<td>0.843</td>
<td>0.85</td>
<td>0.858</td>
</tr>
<tr>
<td>Estonia</td>
<td>0.796</td>
<td>0.839</td>
<td>0.853</td>
<td>0.853</td>
</tr>
<tr>
<td>Lithuania</td>
<td>0.789</td>
<td>0.829</td>
<td>0.842</td>
<td>0.852</td>
</tr>
<tr>
<td>Slovak Republic</td>
<td>–</td>
<td>–</td>
<td>0.842</td>
<td>0.849</td>
</tr>
<tr>
<td>Latvia</td>
<td>0.765</td>
<td>0.808</td>
<td>0.823</td>
<td>0.836</td>
</tr>
</tbody>
</table>

Source: UNDP, various years.

Note: – = negligible; EU = European Union; HDI = Human Development Index; PPP = purchasing power parity.
At the end of the day, it is extremely difficult to attribute improvements in the standard of living or a reduction in poverty to any particular reform or project. FIAS reasonably can claim some credit for assisting the Government of Latvia in its efforts to improve the investment climate, alongside many other stakeholders. FIAS recommendations for reforming the processes of government inspections and customs and tax administration have been shown to have yielded tangible benefits to businesses in the form of lower costs. Beyond that, it may be reasonable to describe linkages between lower costs for businesses and higher rates of investment, productivity, and business formalization. These factors, in turn, logically contribute to higher rates of economic growth, higher tax revenues, more employment opportunities, higher wages, and lower rates of poverty.

A great deal of research supports the proposition that reforms to improve the investment climate have very high cost-benefit ratios and can make significant contributions to poverty reduction. In 2004, for example, the Copenhagen Consensus determined that reforms to reduce barriers to business are among the top 10 most cost-effective interventions to improve the “greatest global challenges” (http://www.copenhagen-consensus.com/Default.aspx?ID=699). The study that led to the 2004 Consensus performed a large body of cost-benefit research across a range of projects to improve governance, combat corruption, and reduce red tape. It concluded that the monetary costs of such projects are quite low; and that documented benefits, if meaningful reforms are enacted, usually are very high (Rose-Ackerman 2004). We are confident that the FIAS projects in Latvia were good investments from both the investment climate perspective and the human welfare point of view.
APPENDIX 5: METHODOLOGY NOTE ON COST-BENEFIT CALCULATIONS OF THE FIAS LATVIA ADMINISTRATIVE BARRIERS PROJECT

ASSUMPTIONS

The absence of annual survey data on benefits, or cost savings, resulting from reforms of the Latvian business environment does not enable us to construct a traditional cost-benefit analysis based on a flow or stream of project costs and cost savings over time. As a result, we have decided to calculate benefits based on the difference of survey-to-survey results. Most of FIAS’ programmatic interventions in streamlining the administrative barriers to doing business occurred between the late 1990s and 2004 at the latest. As a result, we determined that the two available survey years most appropriate for the analysis were 2001 and 2005. By using 2003 data, we might be committing an error of taking the data that represent some time in the middle of the reforms because most of the FIAS reforms were implemented and updated until 2004. What is more, the effects of the reforms usually are noticed with some lag (for example, reforms begun in 2002 and/or implemented in 2003 may be reflected only in the 2005 survey, when more of the respondents have been affected by the particular reform). However, in instances where 2005 data are not available, we will treat the 2001 data as the baseline and calculate the benefits (mostly cost savings) by comparing them to the 2003 data. As a result, all benefits and cost savings are calculated in the following underlying context: For the period of 12 months preceding the 2005 survey, in comparison to the data collected through the 2001 survey, the private sector in Latvia realized the following benefits/cost savings.

All monetized values are discounted (using the standard 5 percent annual discount rate) to 1998 U.S. dollars to obtain a consistent measure—the net present value—of costs and benefits across different time periods.

The analysis assumes that the project costs of US$1 million all were incurred at the outset of the program in 1998 and, therefore, are not discounted. For a more accurate calculation, we could obtain more detailed data on costs borne by FIAS and the Government of Latvia—particularly in the years in which various contributions were made—to be able to discount these costs and calculate their net present value in 1998.

QUALIFICATION OF CALCULATIONS

Why might we be underestimating?

- First and foremost, we are evaluating the benefits only at one point in time—in the year 2005 (or 2003, where 2005 data are not available) when our survey was conducted. However, benefits and cost savings to businesses occur every year.
- For the registration procedures, time savings have been estimated, but have not been converted to monetary output because of the complexities related to estimating the corresponding opportunity cost. Any time savings on registration procedures can be thought of as reduced costs in the form of forgone revenues (for example, in 2005, the business can be registered within four fewer days than in 2001; this reduction represents time that can be used to generate additional profits from business operations).
- Our analysis of benefits (in terms of cost savings) is based only on five areas of doing business (company registration, licensing, inspections, property registration, and tax administration). However, the scope of the FIAS program in Latvia also addressed other areas for reform (for example, customs procedures, hiring workers, and so forth). By choosing to quantify only a part of the overall benefits on the business community, we are providing a very conservative cost-benefit ratio.
We multiplied by the average salary to quantify cost savings. If we had disaggregated figures for the salary in the private sector, our calculated benefits might be even higher—provided that private sector salaries are higher than public sector salaries—so the current overall figure is probably an underestimate.

**Why might we be overestimating?**

- We are quantifying only the benefits to firms in the form of cost savings. However, there could be potential drawbacks to having shorter or less frequent inspections. One potential negative effect of less frequent and shorter inspections may be decreased quality control. In the case of fire safety inspections, it may imply higher probability of fire; in the case of sanitary inspections, it may imply more sanitary violations; and so on. Still, we are not in a position to evaluate these potential negative developments, and there is no clear reason to believe that the quality of control has been affected negatively so far.
REFERENCES


Stern, Nicholas. 2001. “Globalization, the Investment Climate, and Poverty Reduction.” New Delhi, India, March 27.


ECO-AUDIT

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- 2 trees
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- 462 lbs. of CO₂ equivalent greenhouse gases
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