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Public Expenditure Review

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GOVERNMENT FISCAL YEAR
January 1 to December 31

WEIGHTS AND MEASURES
Metric System

ACRONYMS AND ABBREVIATIONS

CAS	Country Assistance Strategy
CG	Central Government
CIS	Commonwealth of Independent States
CPAR	Country Procurement Assessment Review
CPC	Corruption Prevention Council
CPI	Consumer Price Index
CPP	Corruption Prevention Program
EU	European Union
EUR	Euro
FDI	Foreign Direct Investment
FSAP	Financial Sector Adjustment Program
FSU	Former Soviet Union
FY	Fiscal Year
GDP	Gross Domestic Product
GFS	Government Financial Statistics
GMI	Guaranteed Minimum Income
GoL	Government of Latvia
IMF	International Monetary Fund
IFOs	International Financial Organizations
LASCO	Latvian Shipping Company
LBFM	Law on Budget & Financial Management
LPA	Latvian Privatization Agency
LVL	Latvia LAT
LVM	Latvia State Forests
MoAg.	Ministry of Agriculture
MoE	Ministry of Economy
MoEnv.	Ministry of Environment
MoF	Ministry of Finance
MoT	Ministry of Transport
MOU	Memorandum of Understanding
MoW	Ministry of Welfare
MTEF	Medium-Term Expenditure Framework
NATO	North Atlantic Treaty Organization
OECD	Organization for Economic Cooperation and Development
PAC	Public Accounts Committee
PEM	Public Expenditure Management
PER	Public Expenditure Review
PHRD	Policy & Human Resources Development Fund
Prog.	Program
PSAL	Programmatic Structural Adjustment Loan
PUMA's	Public Management Programme
ROSC	Report on the Observance of Standards & Codes
RSFs	Regional Sickness Funds
SAO	State Audit Office
SAPARD	Special Accession Programme for Agriculture & Rural Development
SBA	Stand-by Arrangement
SCHIA	State Compulsory Health Insurance Agency
SC	State Clearance Agency
Supp.	Supplement
VAT	Value Added Tax
WHO	World Health Organization
WTO	World Trade Organization

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TABLE OF CONTENTS

List of Tables

List of Boxes

List of Figures

Map

Acknowledgements

This report is based upon findings of several missions that visited the Republic of Latvia between July 2000 and February 2002. The work on this study began under the direction of Jos Verbeek and Pascale Kervyn, and was completed by Célestin Monga. The World Bank team was composed of Serif Sayin, (public expenditure management), Nancy Van Dycke (education), Loraine Hawkins (health), Emily Andrews (social protection), Andrejs Jakobsons (statistics and projections). Contributions were also made by Hilmar Thor Hilmarsson and Normunds Malnacs. Pascale Kervyn prepared an earlier draft that was revised and completed by Célestin Monga. Valuable comments and suggestions were received from Inguna Dobraja, Louise Fox, Helen Sutch, Helga Muller and Bernard Funck. The peer reviewers were Louise Fox, Malcolm Holmes, M. Helen Sutch and Allister Moon. This study was carried out under the direction of Michael Carter, Country Director, ECC09; Pradeep Mitra, Sector Director, ECSPE; and Kyle Peters, Sector Manager, ECSPE. The manuscript was edited by the World Bank's English Translation Team, Translation and Interpretation Unit (GSDTI), and typed and formatted by Alison Panton.

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Executive Summary

1. The Latvian authorities have improved their budgeting and expenditure practices over recent years. Traditionally, Latvia's budget process had been an incremental one, focused on determining how to adjust existing budgets to fit within next year's available resources. As a result, the budget process was driven by historical spending patterns, with little opportunity for meaningful discussion at Cabinet (Council of Ministers) level on how the budget is currently spent, and on planning how it should be spent in future. Moreover, the process of determining budgets was disconnected from the policy process. In the framework of the law "On the State budget for the year 2001," the Latvian authorities adopted and began to implement an ambitious medium-term action plan aimed at improving the performance of the entire public sector. A policy paper stating the Government's macroeconomic and fiscal policy for 2002-2006 was also approved. The objective is to build public institutions that are responsive to the citizenry and reasonably efficient in the delivery of public services.

2. This report summarizes the findings of a participatory process of expenditure review, which extended over a period of 12 months, and involved the Government (including Government-financed consultants), the European Commission in Latvia, and IMF and World Bank staff. This process resulted in several reports already discussed with the Government. In brief, this public expenditure review summarizes the findings of previous reports, and focuses on the intermediate steps that the Government now needs to undertake to stay on track with respect to its intention to move towards a Medium-Term Expenditure Framework (MTEF).[1]

3. A successful MTEF is a series of budget management processes and systems embedded in the medium term, and rests on a few key principles of good public expenditure management. The Government has recognized that an MTEF would go a long way to improving public sector management in Latvia and meeting EU standards. As a result, the Government has already initiated a reform program which includes several important elements of an MTEF, such as a medium-term fiscal policy statement, a budget priorities statement, and the development of guidelines for line ministries to design their own strategic plans. These important steps will constitute necessary building blocks of the medium-term expenditure framework.

4. While an MTEF is most likely the best-known public expenditure management system, its success depends critically on a clear understanding of all incentives at play. In many countries where an MTEF did not bring the desired results, a major cause was the absence of true commitment from all parties to the obligations embedded in the MTEF's explicit "contract." Certainly in the case of Latvia, the MTEF would involve a different balance of power between line ministries, the Ministry of Finance, and the Chancellery. Similarly, the Cabinet would need to take a more active role in setting priorities and determining the budget process.

[1] The Annex gives a detailed description of the building blocks of a Medium-Term Expenditure Framework for Latvia.

5. Drawing on recent analytical work[2] carried out by the Policy Coordination Unit (PCU) in the State Chancellery, with participation from the Prime Minister's Office, the Ministry of Finance, the Ministry of Economy, the Secretariat of the Minister with Special Responsibility for Cooperation with International Financial Agencies, the European Integration Bureau, the International Monetary Fund, and the World Bank, this report discusses Latvia's performance in public sector reform and governance, highlights progress made by the authorities over recent years, and identifies areas for further improvement.

Recent Progress in Public Sector Reform and Governance

6. **Latvia's fiscal discipline has generally been good, contributing to the country's macroeconomic stability**. The fiscal balance went from a deficit of 3.7 percent of GDP in 1995 to 0.8 percent in 1998, before slipping back up to 3.9 percent in 1999 (mainly due to the impact of the Russian crisis) and to 3.3 percent in 2000. It appears that the especially disappointing performance of 2000 has been reversed in 2001 with a preliminary estimated deficit of 1.7 percent of GDP. This performance can be ascribed to a strong Ministry of Finance backed by political consensus on fiscal discipline, good revenue estimates, and a well-developed Treasury.

7. **Latvia has achieved many of the basic requirements of fiscal transparency and has identified important steps for further improvement**. Among the economies in transition, Latvia has been one of the leaders in adopting improved accounting and fiscal management practices and in providing the financial markets with relevant information on fiscal activities. In particular, the State Treasury has established an accounting and reporting system that is widely recognized as being effective and reliable, and the budget process is soundly based on a macroeconomic framework and reliable estimates of expenditure and revenue.

8. **The budget process is open, with an emphasis on financial compliance, and also provides for development of performance budgeting and medium-term planning**. The *Law on Budget and Financial Management* gives a clear mandate to the Minister of Finance to exercise control over fiscal management, and this will be strengthened with enactment of the *Public Agency Law*. The nature of the budget process is clearly explained in the Law. It specifies basic requirements for budget preparation, reporting, and auditing of accounts that are observed in practice. The Law requires planning for long-term obligations. Under recent amendments, estimates are required for current expenditures for two years, and for investment for four years beyond the budget year, and outcome indicators have to be specified. Implementation of the Public Agency Law also requires development of performance budgeting techniques. Considerable further work is required, however, to put these elements of the Law into effective practice, and it will be difficult to apply these procedures to local budgets.

9. **Medium-term fiscal planning is at an early stage of development.** Preparation of a medium-term macroeconomic framework and fiscal projections is underway as part of the requirements for EU accession. It is recognized, however, that practical implementation of a

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[2] This include sectoral reports of the PER (World Bank), the Fiscal Module of the Report on Observance of Standards and Codes (IMF), the Government's Pre-Accession Economic Programme, and the EU's regular reports on Latvia's progress towards accession.

medium-term framework will take some time and will require close cooperation among the central agencies of government as well as a disciplined process of policy review and priority setting by the Government and the Saeima. Further work is needed to improve transparency and accountability of fiscal policy goals, to establish open processes of review and costing of existing and new policies, and to establish an open process for government priority setting. Some steps are being taken toward establishing a framework for these processes, but responsibilities for action among the key central agencies of government require further clarification.

10. **Public procurement legislation and observation of regulations are being strengthened.** A new *Law on Public Procurement* was prepared and adopted by the Parliament on July 5, 2001. The new law has been in force since January 1, 2002.

11. **Internal control procedures are in place and are being strengthened.** Effective compliance controls over budget execution are in place for all transactions in the State Budget. The State Treasury ensures that all spending under its control is properly authorized and that funds are available. The Budget Department controls budget revision, and supplementary budgets are used infrequently.

Areas for Further Improvement

12. **The lack of clearly defined policy priorities has often led to an increase in unfunded mandates and ineffectiveness of the budget formulation process.** Over the medium term, a primary task facing Latvia in the fiscal area is rationalizing public expenditure and reforming the civil service. Given the country's goals of accession to the EU, which will require increased spending in a number of areas, limiting unproductive spending becomes all the more important. The Government's objectives in this area include eliminating the duplication of activities across ministries and agencies, devolving certain activities to the private sector, and providing competitive and transparent wages. The absence of a forum where alternative policy proposals compete, poor policy formulation in some sectors, a budget process based on incremental budgeting, and ad hoc commitments to unfunded policy proposals during budget preparation or execution, all tend to lead to over-commitments and unpredictability of resources, and thus limit incentives, and indeed performance of programs. Placing policies at the center of budget decisions is further hampered by structural rigidities in the budget (limited fungibility), notably earmarking in special budgets (about 45 percent of Latvia's revenues are earmarked), the existence of own revenue and the proliferation of autonomous agencies (208 agencies in 2000). Similarly, fairly rigid rules on financing and allocations limit the scope for true policy decisions.

13. **Fiscal discipline has been achieved and maintained at a cost**, as it has often required expenditure adjustments during the year. Relatively strong input controls have given line ministries incentives to move tasks and their resources to special budgets or to semi- autonomous agencies, resulting in a smaller basic budget under the control of the budgetary authorities. In addition, cash rationing has induced some line ministries to resort to arrears rather than face tough choices imposed by expenditure restrictions. At the end of 1999, outstanding payables and general tax arrears stood at 13 percent of the budget, while in 2000 accounts payable to suppliers and others in the health sector stood at 12 percent of the health budget.

14. **The costs of EU accession and other upcoming liabilities will add further pressures** as the Government is also committed to a balanced budget. These costs have not yet been fully quantified. If the Government is to stay within the constraints of a balanced budget objective, savings will need to be generated in other parts of the Government to increase funding for priority programs. More fundamentally, the key challenge for the Government is first to develop and use a (proper) methodology to make appropriate choices among policy priorities, and second to allocate its resources to those priority areas in a manner conducive to sustainable, cost-effective results.

15. **The economic composition of the budget is unbalanced but a new pay system for public wages is in preparation.** Investment remains below the regional average, while subsidies and transfers (mainly entitlements) - at over 60 percent of central government expenditure for 2001 - are significantly higher than the average for comparative countries. But from 1997 to 2000, the share of the wage bill in the budget decreased from 12.4 percent to 11.4 percent. The Ministry of Finance is elaborating a new, unified pay system for civil servants.

16. **Inter-sectoral allocations also are out of line with European standards**, reflecting in part overfunding and underfunding of sectors, as well as misalignment of allocations with stated priorities. Similar imbalances also appear in the intra-sectoral composition of expenditure, as shown by an excessive hospital network in health care, an excessive number of schools and teachers in general education, while in agriculture under-funding of investments is matched with high employment and a large, but inefficient, subsidy program.

17. **The internal and external fiscal control framework needs sustained support, in line with EU accession requirements (Chapter 28 of the *Acquis communautaire*).** At the execution stage, weak accountability mechanisms have allowed a system combining tight fiscal control with wide management discretion. As the arrears situation illustrates, expenditure commitment control is incomplete. In addition, external and internal control are developing, but from a very low basis. Internal audit was set up in 1999, and in 1998 external audit covered an estimated 10 percent of mandated annual coverage. There is no formal role yet for Parliament in the audit cycle, and effective follow-up of audit reports has not yet been observed.

18. **The internal and external fiscal control framework needs sustained support.** Sound structures have been established for both internal and external audit and, in principle, these together should provide an assurance of continuing high fiscal data quality. In both cases, further capacity development is required, and there is a need to ensure that adequate mechanisms are in place to follow up audit findings. The following are suggested as priorities:

- Follow-up reports should be issued for both internal (MoF) and external (SAO) audits, listing actions taken on previous audit recommendations. Both reports should be available to the public.
- Adequacy of funding for internal and external audit should be subject to periodic independent review, which should be made publicly available. The possibility of direct budgetary support for the SAO by the Saeima should be considered. Immediate attention should be given to strengthening the capacity of the SAO to fulfill its mandates for audit of agencies and local governments.

19. Setting up a Public Accounts Committee of the Saeima to review SAO reports should be given a high priority.

20. The Latvian authorities have recognized the limitations of the present budget and Treasury coverage and the need to extend budget analysis beyond a single year, and are taking steps toward more comprehensive public administration reforms with support from the EU, international financial institutions, and bilateral organizations. To carry out its commitment towards a Medium-Term Expenditure Framework (MTEF), the Government needs to establish the right sequencing of reforms. While the principles of good public expenditure management are all important, some cannot be applied in the absence of others. In the case of Latvia, several issues should be addressed as priorities:

- The Government should put high priority on the proposed reforms, not in the least because of mounting pressure on the budget due to EU commitments and pension reforms;
- The Government should develop meaningful policy and program trade-offs and increase fungibility of the budget (e.g., earmarking should be reviewed);
- The Cabinet should adopt "funded only" policies and then only during the budget preparation process;
- The Government should immediately tackle the issue of arrears and develop measures to prevent further arrears;
- The Government should secure increased commitment to accountability through increased coverage of audit activities and follow-up by the Executive.

21. The Latvian authorities have recognized the limitations of the present budget and Treasury coverage and the need to extend budget analysis beyond a single year, and are taking steps toward more comprehensive public administration reforms with support from the EU, international financial institutions, and bilateral organizations. To carry out its commitment towards a Medium-Term Expenditure Framework (MTEF), the Government needs to establish the right sequencing of reforms. While the principles of good public expenditure management are all important, some cannot be applied in the absence of others. In the case of Latvia, several issues should be addressed as priorities:

1. INTRODUCTION

1.1 The Government of Latvia (GoL) has in recent years undertaken an ambitious reform program in the area of public sector management. The program is being designed and implemented with the support of the donor community, to help Latvia accelerate economic growth, improve the role and service delivery of the State, and meet EU standards in public sector management. The reforms pertain to the main following areas: (i) macro management; (ii) public expenditure (budget) management; (iii) human resource management, including pay reform; (iv) administrative and organizational reforms in the ministries; and (v) re-delineation of the role of the State.

1.2 The focus of this public expenditure review (PER) is limited to assessing the reforms underway in the area of public expenditure management. The report does not address issues related to human resource management[3] or local government finances,[4] even though these areas overlap significantly with public expenditure management. The PER aims to help the GoL strengthen its capacity to manage public expenditure more effectively.

1.3 Specifically, the purpose of the PER is:

- To present an overall diagnosis of public expenditure management, which the GoL (and particularly the line ministries, the Ministry of Finance (MoF) and the Chancellery) can use in their policy reviews and budget oversight and management.
- To present a path for reforms in the short and medium term that will help the authorities set a track toward meeting some of the key long-term objectives already endorsed by the GoL.

1.4 The coverage of the issues and sectors in this PER is selective. The report draws on several documents prepared by the Government, the World Bank, the International Monetary Fund (IMF), and Sigma. Specifically: sector analyses, the PSAL preparation documentation, the IMF's ROSC and SBA documents, the Sigma assessment on public expenditure management (1999), and reports by PHRD-financed consultants[5] on the development of a Medium-Term Expenditure Framework (MTEF). The report aims at summarizing the findings of the various public expenditure analysis reports, and related documents. The objective is to draw from findings in the sector analyses to substantiate and illustrate issues related to overall public expenditure management in Latvia.

1.5 The main report is composed of seven chapters.

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[3] See the PSAL documentation for in-depth analysis of these issues.

[4] See "Strengthening Fiscal Decentralization and Balanced Development: Current Situation and Policy Options for Reform", World Bank, 2000.

[5] Anne Evans and Graham Scott, FTI/PDP.

1.6 Chapter 2 assesses recent macroeconomic developments and structural reforms in Latvia. The focus is on the dynamics of growth, the fiscal stance and the external accounts.

1.7 Chapter 3 examines fiscal performance within an aggregate budget constraint. It shows that, in principle, Latvia has had an excellent record in fiscal restraint, as measured by the progressive reduction in the fiscal deficit since 1994. However, this achievement has required expenditure adjustments during the year, which has produced adverse effects on expenditure management.

1.8 Chapter 4 reviews the budget process, highlighting weak planning, poor policy formulation, incremental budgeting and commitments, and unfunded policy proposals that all lead to over-commitments and limit performance of programs.

1.9 Chapter 5 assesses public expenditure performance based on available evidence and examples from the sector analysis. Generic causes underlying performance are identified. Output and outcome indicators drawn from various sectors show uneven performance relative to other transition and OECD countries. Factors underlying this performance are discussed.

1.10 Chapter 6 examines the rules for improving transparency and accountability. The Government's public sector reform and anti-corruption program is analyzed beyond the traditional focus on technical, supply-side budget rules, to include demand-side incentives that would foster ownership and promote sustainable changes.

1.11 Chapter 7 summarizes the findings and recommendations of the report.

Box 1.1: Note on the Budget

The budget in Latvia is comprised in four parts:

1. The Central Government Basic Budget
2. The Central Government Special Budgets
3. The Local Government Basic Budget
4. The Local Government Special Budgets

The term "consolidated budget" designates all four budgets.
The term "central government budget" designates the central government basic and special budgets.

Special budgets are financed from: (i) block grants from the basic budgets; (ii) earmarked revenues; (iii) own revenues; (iv) foreign financing; and (v) net borrowing from the basic budget.

The budget structure is explained in Chapter 4.

2. RECENT MACROECONOMIC DEVELOPMENTS AND STRUCTURAL REFORMS

A. ECONOMIC PERFORMANCE IN 1995-2000

2.1 **Background.** Latvia is a small country of 2.5 million inhabitants located at a crossroads between East and West. It is situated on the eastern coast of the Baltic Sea, bounded by Estonia to the north, Lithuania to the south, and Russia and Belarus to the east. Latvia has an area of about 25,000 square miles and a little less than half the country is arable. It has very few natural resources and imports all of its natural gas and oil products, and half of its electricity needs. After independence from the former Soviet Union in 1990, Latvia experienced high inflation and severe declines in incomes and social indicators. But since 1996 the economy has stabilized and it is now growing at a fast pace. GDP per capita (at current prices) amounted to US$3,013 in 2000.

2.2 Topping Latvia's political and economic agenda, EU accession is one of the driving forces behind the country's adjustment and reform efforts. The European Commission has determined that Latvia largely meets the general, so-called Copenhagen criteria for EU membership. During its first decade as an independent country, Latvia needed to retain established economic links to its eastern neighbors as well as to develop trade with new western partners. Its shift to western markets was slow initially, but the sharp depreciation of the ruble in 1998 and default on Russia's sovereign debt (the so-called Russian crisis) sparked a process of adjustment, leading to a jump in the share of exports to the EU from 49 percent in 1997 to 65 percent in 2000. The biggest importers of Latvian goods are Germany, the United Kingdom, Sweden and Denmark), and the biggest exporters to Latvia are Germany, Russia, Finland, and Lithuania.

2.3 **Macroeconomic Performance**. Between 1995 and 2000, real GDP grew on average by 4.7 percent annually despite the adverse impact of higher oil prices and the depreciated Euro over the recent period. Growth has been broad based, with especially strong gains in trade, in the transportation, storage and communications sector, and in manufacturing and business services. Monetary policy has been consistent and remains relatively tight as the Central Bank continues to concentrate on maintaining price stability in the country. Since its inception in 1994 Latvia's fixed exchange rate regime, tied to the SDR through a currency board arrangement, has served the country well. After inflation reached 109 percent in 1993, the rise in the consumer price index (CPI) has been held to single digit levels since 1997; in 2000 the CPI grew by a mere 2.6 percent and its average rate was estimated to be 2.5 percent in 2001 (year-to-year). Interest rates have come down significantly since the 1998 Russian crisis that affected the banking system. The annualized yield on a 3-month Treasury bill, which was 7.4 percent at the beginning of January 1999, was 4.8 percent at the end of December 2001. Fiscal policy has been conservative from the outset of the transition process, with a few notable exceptions caused by internal or external shocks. As a consequence of the fiscal discipline at the macro level, Latvia has low

levels of overall public debt. The country's credit ratings have gradually improved, giving Latvia easier and less expensive access to international capital markets.

2.4 Government revenue increased rapidly in the mid-nineties before dropping from 41.3 percent of GDP (1997) to 37.5 percent of GDP (2000). Total expenditure remained broadly stable (from 40.7 percent of GDP to 40.9 percent during the same period). After deteriorating from 0.3 percent of GDP in 1997 to almost 4 percent of GDP in 1999, the fiscal deficit improved to –3.3 percent in 2000. A more prudent fiscal policy stance in the medium term is a condition for maintaining macroeconomic stability. Following several years of small external current account deficits that were entirely financed by foreign direct investment (FDI), Latvia's current account deficit (including official transfers) rose from 6.1 percent of GDP in 1997 to 10.6 percent in 1999, with only half financed by FDI—a deterioration largely initiated by the Russian crisis. But there have been some improvements over the past two years and the current account deficit was brought to about 7 percent of GDP in 2000, despite an appreciation of the Lats (national currency) against the Euro and the sharp rise in oil prices during the period. Further, the share of this deficit financed by FDI rose noticeably from just over half in 1999 to 80 percent in 2000.

Table 2.1: Selected Economic Indicators, 1994-2000

	1994	1995	1996	1997	1998	1999	2000
GDP, % Growth	0.6	-0.8			3.9	1.1	6.6
Industrial Production, % Growth	-9.5	-6.3		6.1	2.0	-8.8	3.2
Inflation, % Growth, End-Year	26.3	23.1	13.1	7.0	2.8	3.2	1.8
General Government Budget Balance, % GDP	-4.0	-3.4	-1.4	0.2	-0.9	-4.2	-2.8
Gross Wage, USD, Period Average	128	170	179	207	226	241	244
Unemployment, % (2nd Quarter, LFS Data)			22.2	15.9	14.7	14.0	14.4
Exports, USD Million	1020	1367	1488	1838	2011	1889	2058
Imports, USD Million	1321	1947	2286	2686	3141	2916	3116
Current Account, % GDP	5.5	-0.4	-5.5	-6.1	-10.6	-9.7	-6.9

Source: Central Statistical Bureau of Latvia, Bank of Latvia, EBRD, IMF

2.5 Generally good progress was made in implementing structural reforms in 1997-2000. The restructuring and privatization process for state enterprises has basically been completed with the notable exceptions of several large companies—Latvenergo (power), Lattelekom (communications), Ventspils Nafta (oil pipeline company), Latvia Shipping, and a 3 percent stake in Latvijas Gaze (gas). Progress in privatization of these large companies has been much slower than planned due to continuing discussions and lack of consensus within the Government over the timing and modalities of privatization. Restructuring, commercialization and eventual privatization of municipal enterprises (district heating, water and sewerage, solid waste management, and housing maintenance) are in very initial stages. In March 2000, the Cabinet approved a plan for restructuring and privatizing parts of Latvenergo, and the *Law on Corporations* - needed for effective restructuring—has recently been passed by Parliament. Progress has also been made in reinforcing the regulatory structure for utilities, improving the business climate, enhancing the legal and judicial system, and strengthening the efficiency and transparency of the public sector. Parliament has also adopted legislation to implement the second, fully funded, tier of the pension system beginning July 1, 2001. Apartment privatization moved ahead, property rights were strengthened, and the business climate was improved. Progress also continued in trade policy and in February 1999 Latvia formally joined the World Trade Organization (WTO), which influenced policymaking because the conditions associated

with membership provided targets that helped policymakers reach consensus on launching and sustaining politically difficult reforms to liberalize the economy and trade.

2.6 Macroeconomic conditions have created an environment favorable to sustained financial sector development. Following the Russian crisis, several Latvian banks came under significant pressure. Two small banks were closed, and the operations of two other banks, including Rígas Komercbanka (RKB), the country's fifth largest bank, were suspended in early 1999. The Government and the Bank of Latvia responded to the banking sector difficulties with a three-pronged approach. First, temporary liquidity support was provided to the banking system. Second, banking supervision and the prudential regime continued to be enhanced and came to full compliance with the Basle Core Principles of Effective Bank Supervision (BCP) and the relevant EU directives. Third, RKB was recapitalized, and the bank was reopened in October 1999. Foreign investment has strengthened the banking sector, and banks are now well capitalized, liquid, and profitable, although the financial system nonetheless is susceptible to an array of shocks. The recent Financial Sector Assessment Program (FSAP) confirmed the soundness of the financial system. The FSAP identified no major sources of vulnerability in the short run, but stressed the need for vigilance in various areas (rapid credit expansion, rising short-term interest rates, significant non-resident deposits).

2.7 **Dynamics and Sources of Growth.** The services sector was the main source of growth, contributing about 70 percent of GDP in 2000 (compared to 59.9 percent in 1996). The importance of agriculture and fishing has declined considerably over the course of the previous CAS period (from 8.7 percent of GDP in 1996 to 4.1 percent in 2000), following a general trend since independence. The contribution of the manufacturing sector to GDP also decreased from 21 percent of GDP in 1996 to 15 percent in 2000.

2.8 The key factors in building the growth momentum during the 1997-2000 period were the acceleration of domestic private and public demand, and the growing demand for Latvia's exports in both the traditional CIS and new EU markets. Domestic consumer and investment demand were supported by growing real incomes and tax revenues, and reinforced by improving consumer and investor confidence, and projections of rising real income in the medium term. Low capital intensive and fast maturing foreign direct investments contributed to increased productive capacity and competitiveness of Latvia's manufacturing base. The economic expansion was easily financed with relatively cheap domestic credit provided by foreign direct portfolio investment inflows, and a very competitive financial system.

2.9 However, the concurrence of strong external demand, positive domestic factors, and availability of financing, did not last. Starting in mid-1998, a sharp contraction in external demand from the CIS could not be fully compensated by an already declining rate of growth of exports to the EU. As a result of weaker external demand, a number of companies had to lay off workers, and this in turn led to lower consumer confidence and spending. On the public side, lower tax revenues starting in 1999 constrained public demand. And the very high credit expansion of 1997-98 resulted in increasing proportion of non-performing loans in 1999-2000. A less liquid banking system led to the tightening of credit and to higher demand for more secure assets, such as Government bonds.

2.10 Among the Central and Eastern European countries, Latvia is one of the leaders in attracting foreign direct investment (about US$170 per capita in 2000; more than 60 percent of the cumulative FDI went to the services sector, followed by industrial production at 22 percent of the total). The inflow of investment should continue as the country becomes increasingly engaged in European Union projects. By anchoring its economic, political, and institutional structures to those of advanced European nations, Latvia is likely to continue to be perceived as a secure place for doing business. Such a perception should help reduce the risk premiums associated with the Baltic countries and foster further investment and stronger trade flows.

2.11 **Growth, Unemployment, and Poverty Linkages.** The benefits of growth have not been shared equally among the population of Latvia. A Poverty Assessment undertaken in 2000 indicated that the poverty headcount index in 2000 was 19 percent. While Latvia's ranking on the Human Development Index climbed from 72nd in 1997 to 63rd in 2000, and negative trends in life expectancy and mortality have stopped, significant problems still need resolution. Notwithstanding Latvia's impressive growth performance in 1997-2000, unemployment—an important correlate of poverty and to some extent mirroring regional variations in the latter—stands at 13 percent (down from 14.4 percent at the height of the Russian crisis), which raises questions about the ability of the labor market to generate the appropriate matching between jobs and skills requirements. Throughout the first decade of transition, inflows of foreign direct investment have been concentrated mainly in urban areas, especially Riga. The differences between income levels in various regions are striking and pose the threat that the long-term unemployed may become less and less capable of meeting the requirements of the current or future labor market due to their outdated skills and limited access to education services. In the last few years unemployment has been the largest source of poverty in young and middle-age groups; while among pensioners lack of income is another major source. Unemployment is especially significant in rural areas, and marked disparities in regional unemployment rates have not changed despite the overall 25 percent increase in real economic output during the past five years.

2.12 The UN Common Country Assessment 2000 for Latvia notes that, even though Latvia has reasonably good gender indicators in terms of education, life expectancy, and labor force participation, there is a need for increased awareness of the gender dimension of development, especially on issues related to poverty and women's position in the labor market. Wage and employment prospects determine whether a person is at risk of entering poverty or of successfully moving through the transition. Women are frequently discriminated against while job seeking—surveys of small- and medium-size entrepreneurs done by the Ministry of Economy verified that these employers prefer to hire men over women, although the reasons given (viz., need for certain skills) do not match the educational profiles of the two genders, as women are in fact better educated than men. Once in the labor market, on average women are paid 24.8 percent less than men (Poverty Assessment, 2000) and are clustered in professions with low wages, such as teaching, health care, and social care. The Poverty Assessment data revealed that, with increasing numbers of children, poverty rates are higher in female-headed households. The highest poverty rates (51 percent) are found in the households where the female head is between 15 and 34 years old. The Household Budget Survey data also indicated a sharp increase in the poverty risk among elderly women (>70 years), most probably associated with women living longer than their partners.

B. LATVIA'S MEDIUM-TERM PROSPECTS AND CHALLENGES (2002-2005)

2.13 **Macroeconomic Framework and Growth Prospects**. It is expected that the Latvian economy will continue to grow strongly and sustainably, at a rate of about 6 percent annually, over the next five years. On the demand side, growth will be driven by exports and investment by both the private and the public sectors in the run-up to EU accession. On the supply side, continued efficiency gains are expected in line with progress made on the structural front. The inflation is expected to remain low (about 3 percent per annum). The 2002 Budget Law envisages an increase in the fiscal deficit to 2.5 percent of GDP, however it is expected to decrease in the following years.

2.14 Recent empirical studies focusing on the evolution of the real exchange rate indicate that Latvia may have lost some of its external competitiveness. Latvia's wages have been converging to their equilibrium level but there is still scope for further appreciation. However, the country is still in a strong competitive position, as evidenced by its ability to increase its export market share, in particular in the EU. In the medium term, competitiveness will be dependent on Latvia's ability to continue to attract foreign direct investment, which in turn will be determined by progress in public sector reform and governance, structural reforms, and maintenance of macroeconomic stability.

2.15 **External Environment and the Need for Fiscal Adjustment**. Between 2001 and 2003 Latvia's gross external financing needs are estimated at about US$2.0 billion. These resources will be needed to finance US$1.5 billion in current account deficits, about US$200 million in increases in international reserves, and the remainder to fulfill debt repayment obligations. Direct foreign investment is expected to finance about 57 percent of these needs, driven by privatization of the remaining large enterprises to strategic foreign investors, improvement of the investment climate through business deregulation, and a stable regulatory framework. Official resources will finance 17 percent of these financial needs. The remainder will have to come from portfolio investment and loans directed toward the private sector in Latvia.

2.16 The large investments needed in the medium term to sustain economic growth, coupled with a catch-up in private sector consumption, will, however, necessitate a leveling off in the improvement of the external current account deficit, as imports will continue to grow strongly and FDI-related profit remittances are expected to rise. On the other hand, a continued strengthening of Latvian exports to the EU, together with a diversification in the export base resulting from broad-based FDI, is projected to materialize during the period 2002-2005. As FDI is projected to remain buoyant—because of the forthcoming privatization of large public enterprises like Ventspils Nafta and Latvian Shipping, and the sale of new telecommunications licenses—the external account is expected to be almost fully covered by non-debt creating flows, thereby containing Latvia's already favorable debt indicators.

2.17 Sensitivity analysis suggests that Latvia's medium-term external outlook would remain sustainable in the face of moderate shocks or weaker export performance—provided that fiscal consolidation remains a priority. It is estimated, for example, that a 4 percent reduction in export growth—consistent with a 7 percent decline in timber prices—would imply a widening of the current account deficit by 1 percent point of GDP and a rise of 2 percent points in the debt-to-

GDP ratio over the medium term, maintaining the debt burden at a moderate level. A permanently lower growth rate in exports, down by 2 percent points, would raise the medium-term current account deficit by 1.25 percent points of GDP and increase debt by 3.5 percent points. However, a failure to undertake fiscal adjustment, maintaining the expenditure-to-GDP ratio at its 2000 level, would have more significant effects: the current account deficit would rise to about 8 percent of GDP, while external debt would increase from 63 percent to 77 percent of GDP in order to keep external reserves at adequate levels. This highlights the risk of failing to successfully reform public expenditure policy and management in the face of considerable medium-term spending pressure.

C. THE GOVERNMENT'S MEDIUM-TERM OBJECTIVES AND STRATEGY

2.18 As Latvia proceeds further into the third millennium, it is poised to become a member of the EU. Since the Helsinki summit (December 1999) approved its candidacy for membership, detailed negotiations have been underway for its entry. EU accession has served as the country's primary political and economic goal, and as the "anchor" for domestic policies. But the Latvian authorities recognize that it will take decades to close the income gap between Latvia and the rest of the European Union. They have identified three key issues facing their country: (i) how and when the income gap between Latvia and the EU can be closed; (ii) how to stay on track to achieve fiscal and monetary convergence; and (iii) how to accelerate structural convergence and create a more competitive market economy. Against this background, the Government has articulated medium-term policy objectives that can be summarized as follows:

- to raise GDP by 5-7 percent annually;
- to maintain low inflation (2-4 percent per annum);
- to maintain a stable exchange rate;
- to reduce the unemployment rate to 8 percent.

2.19 To meet these objectives, a three-pronged strategy has been articulated in several recent policy documents (including the National Development Plan approved by the Government in December, 2001, the 2000 Poverty Reduction Strategy, and the Public Administration Reform Strategy): (i) maintaining macroeconomic stability through prudent fiscal policy; (ii) reforming the public sector and improving governance; and (iii) accelerating structural and sectoral reforms to improve productivity.

(i) Maintaining Macroeconomic Stability through Prudent Fiscal Policy

2.20 From a macroeconomic perspective, given the exchange rate regime, fiscal policy represents the main instrument at the disposal of the authorities to reduce the still large current account deficit, mandating the pursuit of a tight fiscal stance over the medium term and completion of the structural reform program. The challenges facing the Latvian authorities in this regard are formidable, as they need to reconcile selected tax rate cuts to remain an attractive place for investors with higher spending in certain policy areas to comply with EU accession requirements.

2.21 Given its current high pace, private saving is expected to level off over the medium term; this means that strong public savings will have to be available to help finance the large private-sector investments needed to sustain growth, plus the Government's investments to comply with the EU *acquis communautaire* (which could amount to 2 to 5 percent of GDP annually). Transfers from the EU to finance such spending are expected to reach 1 percent of GDP in 2001 but at best rise moderately over the medium term, implying a significant domestic cofinancing share. Furthermore, in its quest for rapid NATO membership, Latvia has announced its intention to raise military expenditure from 1.1 percent of GDP in 2001 to 2 percent in 2003.

2.22 Latvia's relatively high tax burden precludes reliance on rate increases to strengthen the revenue base. On the contrary, Latvia aims to lower its taxes, especially on labor income. The social tax was reduced by 1 percent point, to 35 percent, effective January 1, 2001, and a further reduction by 2 percent points is planned in 2003. But further such efforts would be needed, especially with regard to the corporate income tax rate. Latvia's standard rate of 25 percent was detrimental to attracting foreign investors if compared to neighboring Estonia, where such tax on retained profits was abolished in 2000. In accordance with recent amendments to the *Law on Corporate Income Tax* in force since January 1, 2002, the rate of corporate income tax will be reduced from 25 percent to 22 percent in 2002, 19 percent in 2003, and 15 percent in 2004. In addition, Latvia will need to continue to improve its tax administration and broaden its tax base, including by limiting tax exemptions. The combined effects of the EU- and NATO-related spending pressures and the implementation of selective tax rate cuts stress the need for further rationalization and curtailment of current spending. This would keep expenditure slightly below the current level of about 40 percent of GDP over the medium term, which is still high by international standards.

(ii) Reforming the Public Sector and Improving Governance

2.23 The brunt of the fiscal adjustment envisaged in the medium term will need to be on the expenditure side. The expenditure-to-GDP ratio is projected to decline from 41 percent of GDP in 2000 to less than 39 percent in 2002 and onwards. Key elements of this strategy are a temporary freeze in civil service wages, coupled with implementation of civil service reform beginning in 2002; restraint in non-priority current spending; and moderate pension increases in line with inflation. Notwithstanding the decline in overall spending, capital expenditure is projected to increase in 2001 and 2002, reflecting both an improvement of Latvia's institutional capacity and expenditures related to EU accession.

2.24 The expected reduction in the expenditure-to-GDP ratio hinges on the Government's commitment to rationalize and better prioritize expenditure. The Government has started the implementation of a wide array of reforms in this area, which is the focus of World Bank assistance to Latvia. The objectives are to improve budgeting, expenditure management and procurement practices; contain the proliferation of public sector agencies and increase their accountability; enhance the transparency of public sector operations; review and modify as appropriate the functions, structure, and expenditure of sectoral ministries; implement a far-reaching civil service reform; and reduce the number of local governments.

2.25 Latvia also needs to address governance issues. State capture[6] is significant, the economy is highly concentrated, political parties are closely aligned with business interests, and the country's geographic position on east-west trade and energy transit routes exposes it to strong corruption pressures. The balance of interests in the succession of generally short-lived coalition governments relies on rewards available through the distribution of ministries and appointments to agencies and SOE boards. The Government's medium-term program to fight corruption and improve governance will have to be implemented.

(iii) Accelerating Structural and Sectoral Reforms to Improve Productivity

2.26 With EU accession as a catalyst, substantial progress will be needed with structural reforms. Despite the upcoming elections and the setbacks in 2001, the authorities hope to reinvigorate large-scale privatization in 2002. In January 2002, the Board of Directors of the Latvian Shipping Company (LASCO) adopted a privatization strategy which provides a public offer of 32 percent of the company's shares for privatization vouchers, starting in February 2002; a second phase involving an international public offer through the Riga Stock Exchange is also envisaged. The Latvian authorities will also seek to sell their minority share in Ventspils Nafta in the second half of 2002. The arbitration process resulting from the accelerated elimination of Lattelekom's monopoly rights in 2003 continues, with the divestiture of the state share in Lattelekom hinging on its conclusion. The State's remaining holdings in Latvijas Gaze and Krajbanka are to be sold by mid-2002.

2.27 The Latvian authorities continue to implement the **Action Plan to Improve the Business Environment**, in consultation with foreign investors. A key step was parliamentary approval of transitional provisions to allow the entry into force of the new Commercial Law in January 2002. In other key areas, the Corruption Prevention Bureau (CPB) will be established by May 2002 under the Ministry of Justice to consolidate resources and responsibilities and end agency fragmentation. Another positive development in the fight against corruption has been the involvement of Transparency International in monitoring the LASCO privatization.

2.28 In the infrastructure sector, the Government's objective is to establish a transparent and stable regulatory framework for infrastructure utilities to protect the public interest, encourage competition and increase efficiency of regulated sectors in line with the requirements of EU directives. *The Law on Public Utility Regulators* has been passed and the basic legal framework is already in place. The regulatory reform is being implemented at the central and municipal levels through the introduction of multi-sectoral regulatory institutions. The central Public Utility Commission has already started to operate. At the local level, the structure of the regulatory framework is linked to regional and municipal reform and is still unclear. Political interference in the decision-making process, the power of infrastructure monopolies, lack of experience and inadequately trained staff in regulatory institutions can easily lead to "regulatory capture," where regulatory decisions reflect more the interests of utilities than those of the

[6] The Bank's study *Anticorruption in Transition* ranked Latvia among the countries with the highest level of state capture. State capture is defined as the actions of individuals, groups, or firms both in public and private sectors to influence the formation of laws, decrees and other government policies to their own advantage as a result of the illicit and non-transparent provision of private benefits to public officials (source: *Anticorruption in Transition: A Contribution to the Policy Debate*, September 2000)

general public. Latvia is establishing, by October 2002, separate legal entities for electricity generation, transmission, and distribution, and intends to complete the restructuring plan for Latvenergo by end-2002. The Public Utilities Commission is developing, by April 2002, a strategy paper and detailed work program for its regulation of the energy and telecommunications sectors over the medium term.

2.29 Increasing the efficiency and quality of social service delivery is an important factor to ensure that every member of society benefits from growth. In Latvia, several factors complicate the efficient delivery of social services: (i) the over-decentralized municipal structure; (ii) the unfavorable demographic situation, with a declining and aging population putting pressure on health and social insurance costs; and (iii) an over-capacity of health and education infrastructure. Significant disparities exist between urban and rural areas (especially between Riga and other regions) in terms of economy, quality of life, and educational opportunities. Relative to other countries in the Baltic region and around the world, Latvia has relatively poor adult health status and relatively high infant mortality rates. The most serious problem in the Latvian public health system is the inefficiency in health care provision – especially in the hospital sector – and the lack of transparency and accountability of health services. There has been some progress since the beginning of the transition in rationalizing excess hospital capacity (down from 14.1 to 9.5 beds per 1000 population since 1990) and improving some indicators of efficiency such as average length of stay (down from 17.3 to 12.5 days since 1990), but the pace of progress has been slow relative to more efficient EU and OECD countries. Latvia has a strong education base, with the adult literacy rate of 98 percent. In the last ten years Latvia has been implementing a series of important reforms in this sector. The present Government has identified education as one of its priorities and has recognized the need to develop an education system that is responsive to the changing requirements of the labor markets. The continuation of the reform is critical to Latvia's socio-economic success. Improving efficiency in allocation and utilization of resources, strengthening management, and raising the quality and relevance of general education (primary and secondary) and higher education, are the three major challenges that should orient the future implementation of the reform.

3. FISCAL PERFORMANCE

3.1 This chapter will discuss Latvia's performance in living within an aggregate budget constraint. It will show that, in principle, Latvia has had an excellent record in fiscal restraint, as measured by the progressive reduction in the fiscal deficit since 1994. However, this achievement has required in-year expenditure adjustments, with adverse effects on expenditure management. Moreover, revenue shortfalls in the past two years have led to a build-up of arrears, which the system is powerless to control.

Table 3.1: Fiscal Performance, 1994-2000

	1994	1995	1995	1996	1996	1997	1997	1998	1998	1999	1999	1999	2000	2000	2000	2001
	Act.	Budget [3]	Act.	Budget [4]	Act.	Budget [5]	Act.	Budget	Act.	Budget	Rev. budget	Act.	Budget	Act.	Supp budget	Budget
(In millions of lats)																
Revenue[1]	738	928	880	1020	1057	1314	1352	1496	1529	1647	1595	1561	1661	1620	1632	1761
Expenditure	780	968	952	1094	1104	1330	1332	1572	1554	1755	1736	1707	1695	1764	1754	1827
Financial Balance	-42.1	-40.0	-71.6	-74.0	-46.7	-16.0	20.0	-75.6	-24.8	-108.1	-141.0	-146.3	-34.5	-143.6	-121.5	-66.9
Net Lending (+)	48.0	15.0	15.0	20.0	5.0	14.0	10.0	16.5	2.6	52.0	19.0	6.9	16.0	-0.2	14.6	12.4
Fiscal Balance	-90.1	-55.0	-86.6	-94.0	-51.7	-30.0	10.0	-92.1	-27.4	-160.1	-160.0	-153.2	-50.5	-143.4	-136.0	-79.3
(as % of GDP)																
Revenue[1 2]	36.1	37.6	37.5	34.3	37.4	39.9	41.3	39.7	42.6	41.7	40.4	40.0	39.8	37.5	37.8	40.7
Expenditure	38.2	39.2	40.5	36.7	39.0	40.4	40.7	41.7	43.3	44.4	44.0	43.8	40.6	40.9	40.6	42.2
Net Lending (+)	2.3	0.6	0.6	0.7	0.2	0.4	0.3	0.4	0.1	1.3	0.5	0.2	0.4	0.0	0.3	0.3
Fiscal Balance	-4.4	-2.2	-3.7	-3.1	-1.8	-0.9	0.3	-2.4	-0.8	-4.1	-4.1	-3.9	-1.2	-3.3	-3.2	-1.8

1/ Revenues exclude receipts from privatization.

2/ Before 2000, the receipts and expenditure related to EU accession were not part of the budget.

3/ Prog. EBS/95/53.

4/ Adj. Budget.

5/ Revised Budget prepared during Stand-By negotiations.

Source: IMF.

3.2 **Unlike some other transition economies, Latvia's revenue performance has increased steadily since independence**, from 36.1 percent of GDP in 1994 to 42.6 percent in 1998. As a result, the fiscal deficit was reduced from 4.4 percent of GDP in 1994 to 0.8 percent in 1998. In 1999, however, the economy was hard hit by the Russian crisis, and the deficit widened to 3.9 percent of GDP. In 2000, the deficit declined slightly to 3.3 percent of GDP, an improvement of 0.6 percent points with respect to 1999.

3.3 In 1999, in the face of revenue shortfalls, the Government was somewhat successful in reining in expenditure and net lending (by a total of 0.4 percent of GDP). However, in 2000, expenditure controls were relaxed, particularly as the Government spent some privatization revenue off-budget. However, as a percentage of GDP, expenditure went down from 43.8 percent in 1999 to 40.9 percent in 2000. Nevertheless, the Government missed the performance criteria for the general government deficit under the first SBA program for end-September and

end-December 2000. The 2000 performance also reflects in part a shortfall in tax revenues caused by difficulties in collecting excise taxes and unexpected corporate income tax repayments stemming from the economic downturn of 1999, as well as increased spending.

3.4 Following the fiscal slippage in 2000, the general government deficit in the first nine months of 2001 was 1.4 percent of GDP. This was achieved mainly by restraining expenditures and net lending. Continuing administrative problems with excise taxes and a one-time shortfall early in the year in VAT revenues (reflecting changes to meet EU requirements) were largely offset by otherwise strong VAT collections and buoyant customs and property tax revenues.

A. How To Explain Latvia's Fiscal Performance?

3.5 **Serious application of fiscal restraint proved a very successful ingredient in macroeconomic performance.** With the exception of periods characterized by revenue shortfalls (1995, 1999 and 2000), the financial deficit has been consistently lower than budgeted. Within the last several years, Latvia has instituted a top-down budgeting system, where the Cabinet collectively decides on aggregate fiscal targets and expenditure ceilings for each ministry at the beginning of the budget formulation process.[7]

3.6 In addition, there is a political consensus on the need for fiscal discipline by the Cabinet and Parliament, which have supported the deficit objectives. Fiscal responsibility is considered a collective responsibility by all political parties, not only by those represented in the Cabinet but also by the opposition. Therefore, although governments change often and generally consist of coalitions of many parties, fiscal discipline has been carefully preserved (except in 2000). The Budget Commission of the Parliament is also firm in maintaining fiscal discipline and moderates the pressures coming from sector commissions competently.

3.7 Overall, management of fiscal unpredictability has been supported by a conservative approach to revenue forecasting, debt and fiscal contingency management. Data indicate that, from 1995 to 1998, revenue consistently exceeded forecasts, and this can be explained by a strong commitment by the MoF to meet unpredictable shocks. However, as mentioned above, the 1999 and 2000 revenue shortfalls suggest that the authorities are still grappling with fiscal risks. The budget supporting documents provide a clear economic background and a discussion of major macroeconomic risks. Up to 2000, the discussion, however, did not include analyses of the fiscal position relative to the economic cycle and fiscal risks arising from changes in key economic parameters (such as interest rates or rate of economic growth). The aggregate risk from contingent liabilities was not assessed, although risk assessment was carried out for individual guarantees issued by the central government. Major progress was achieved for the 2002 budget, as three different macroeconomic scenarios with fiscal risk implications were elaborated.

3.8 Development of Treasury operations has allowed the Ministry of Finance to control cash outlays. The Treasury has to approve all expenditures ex ante and has the authority to block them. There is no flow of funds through the individual ministries, as this flow is centralized through the Treasury. Individual payment requests are aggregated within each line ministry to

[7] See also Chapter 4.

support the periodic transfer of funds from the Treasury to the bank accounts held by individual line ministries with the Treasury. All disbursements are paid from these Treasury accounts and spending during the year is monitored against monthly budget spending profiles. There is a facility for incorporating commitments in accounting and budget reports and all line ministries have detailed charts of accounts.

Table 3.2: Actuals as a Percentage of Budget

	1995	1996	1997	1998	1999	2000
Revenue	94.9	103.6	102.9	102.2	94.8	97.9
Expenditure	98.3	100.9	100.1	98.8	97.3	96.7
Financial Balance	179.0	63.1	-125.0	32.8	135.3	82.2
Net Lending (+)	100.0	25.0	71.4	15.8	13.3	-5.9
Fiscal Balance	157.5	55.0	-33.3	29.8	95.7	75.5

Source: IMF.

3.9 **Expenditure cuts (except in 2000) have secured containment of the deficit when needed (1995, 1998, 1999).** Expenditure cuts may originate in one of two situations. First, during budget preparation, the authorities have sometimes overestimated some expenditure categories in the budget, for example by budgeting vacant positions[8] (hence bloating the wage bill). Second, some line ministries have been unable to review their program budgets during the course of the year and save or reallocate financial resources when necessary.

Strengths and Weaknesses of Fiscal Performance in Latvia

3.10 **The Government exercises tight control on debt management.** First, the Law on Budget and Financial Management gives the Ministry of Finance exclusive power to borrow funds on behalf of the Government. While this framework implies strict discipline, it also has its drawbacks for local governments.[9] The budget also contains a ceiling for central and local borrowing and issuance of guarantees. The Treasury provides up-to-date data on public debt and guarantees issued. Data are collected and reported on contingent liabilities, tax expenditure and quasi-fiscal activities, although these are not systematically integrated with the budget or accounting reports.

3.11 However, comprehensiveness of the Budget continues to be hampered by the large number of agencies with own revenues outside the control of the MoF. Off-budget and quasi-fiscal activities (mainly aid to enterprises) have been clarified and reduced after 1998. However, *further improvements are needed, notably to improve coverage of other forms of off-budget* activities and link these activities with the budget. Additional transparency is needed in the use of the funds related to these activities, e.g., subsidies.

3.12 The main problem hampering the comprehensiveness of the budget has been the multiplication of agencies, giving rise to problems of coverage and control. But this problem is being addressed through the Law on Agencies passed by Parliament in April 2001. One aspect

[8] Parts of these allocations are later distributed as bonuses or incentives, which need to be rationalized.

[9] An improved framework for local government borrowing autonomy will have to be defined over time, eventually allowing viable municipalities to establish their own market credentials while retaining a strong framework of aggregate control.

of the implementation of this law particularly pertinent to fiscal discipline is a more comprehensive and clearer presentation of government fiscal activities. In particular, it is important that all budget-financed institutions (BFIs) be included in the Budget and comply with budget procedures and Treasury reporting requirements.[10] This measure implies that the proceeds from the BFIs will be brought back into the Treasury and will become part of the (fungible) budget. During the past year, the Government brought back the accounts of around 100 of these 208 supervised entities under the Treasury and ensured that the others provide regular financial reports to the Treasury.

3.13 **Other off-budget spending, if not controlled, can threaten fiscal discipline.** As future privatizations are expected in Latvia, the Government should exercise restraint in the use of these proceeds to maintain the deficit target. It is encouraging to note that in 2000, privatization proceeds were used as a source of deficit financing.

3.14 **Transparency in the presentation of budget and accounts information needs improvements.** Up to 1999, several studies on budget management had identified a number of weaknesses in the presentation of fiscal data. These include:

- Financing information was not provided in the budget documents together with an analysis of sources of financing.
- Annexes covering contingent liabilities, tax expenditures, and quasi-fiscal activities were not provided as part of the budget documents.
- Not all financial assets held by government and new acquisitions or dispositions were compiled by the State Treasury and reported.
- A formal reconciliation summary was missing from Treasury reports.
- A statement of accounting policies should be included in the final accounts report of the State Treasury.

3.15 Progress was made recently on the first two points, as the analysis of sources of financing and the annexes covering contingent liabilities, tax expenditures and quasi-fiscal activities were included in the documentation of the 2002 budget. Also, all financial assets held by the Government were included in the budget annual report and in monthly reports on budget execution prepared by the Treasury (since 2001, these monthly reports are provided with a formal reconciliation summary.)

3.16 **Commitment control is incomplete.** Within each ministry, the Chief Accountant is responsible for checking commitments and payments (i.e., verifying that funds are available) before signing off, but there is in general no systematic, *ex ante* control of commitments, payments and proposals. Every spending request must be signed by two people, with each ministry being given discretion to decide who these should be. Definitions of procedures, roles and responsibilities have been specified in a note released by the MoF in June 2001. As noted above, the proliferation of organizations that receive budget expenditure but whose financial dealings are not subject to direct oversight by central budget agencies has also contributed to reduced control of liabilities. There is no simple answer on how to deal with this issue. Latvia has opted for a model where line ministries are responsible for ensuring that (a) expenditure

[10] This measure was a structural benchmark of the 2001 SBA as well as a Bank-supported PSAL measure.

commitments conform with the budget; (b) sufficient resources are available under the budget (monthly financial plans prepared by the line ministries are the basis for determining the amounts to be committed). However, as Chapter 6 will show, the legal framework for financial control needs improvement. Furthermore, a number of agencies and budget entities are outside the Treasury's control. These issues will be addressed under the recommendations.

B. THE MEDIUM-TERM FISCAL FRAMEWORK

3.17 Latvia's main fiscal policy objectives for the medium term are to:[11]

- Ensure a stable tax system;
- Reduce the budget fiscal deficit; and
- Develop a balanced national budget over the long term.

3.18 To ensure a stable tax system, the Government needs to lower the tax burden on entrepreneurs, which will improve the business environment in Latvia. The property tax rate is being gradually reduced (from 1.5 percent of the value of balance or inventory in 2002 to 1 percent of cadastral value in 2004). Current legislation envisages certain corporate income tax allowances (e.g., for large-scale projects; for enterprises that produce high-technology products and software; for enterprises that operate in special economic zones; for small enterprises; and others). A reduced value-added tax (VAT) rate of 9 percent will be introduced in 2003 for various categories of goods and services. The guidelines for implementation of this fiscal policy will be formulated in 2002.

Table 3.3: Fiscal Balance of the General Government Consolidated Budget (% of GDP)

	2000	2001	2002	2003	2004	2005
	Actual	*Plan*		Target Forecast		
Fiscal Deficit, % of GDP	2.8	1.8	2.5	2.0	1.7	1.5

Source: The World Bank

3.19 **There are several reasons why Latvia should further focus on lowering the fiscal deficit in the coming years**: (i) in the case of a fixed currency exchange rate regime, reduction of the fiscal deficit is the only tool available for lowering the current account deficit; (ii) debt service expenditures are high, especially taking into account the size of the national budget. Further growth in expenditures of this kind may significantly reduce the funds available for realization of other budget programs. (iii) limited fiscal deficits act as a signal for investors and international financial institutions, indicating that the country's fiscal policy is a sustainable one.

3.20 No significant growth in budget revenues permitting increased expenditure on certain government priorities is expected for the year 2002. Consequently, in order to reduce the budget deficit, it will be necessary to keep the focus on rationalization of budget expenditures.

3.21 **Latvia's stock of public debt is low**: at the end of the 3rd quarter of 2001 it amounted to 636 million lats, accounting for about 13 percent of GDP. Public debt as a percentage of GDP peaked in 1995, when it accounted for 16.1 percent of GDP, but then it gradually declined as the

[11] See Ministry of Finance of the Republic of Latvia, *Pre-Accession Economic Program*, Riga, 2001.

fiscal situation improved and in 1998 it amounted to 10.4 percent of GDP. The most recent sizable increase in the public debt occurred in 1999, due to the negative impact of the Russian crisis on the Latvian state budget.

3.22 The *Law on Budget and Financial Management* assigns institutional responsibility for public debt management in Latvia as follows: the Minister of Finance is authorized, for and on behalf of the State, to take out loans in the amount defined in the annual laws on the state budget in order to finance the budget deficit, refinance the public debt, and for such other purposes as are defined in the annual laws on the state budget. In addition, the Minister is authorized to issue government guarantees in the amount defined in the annual laws on the state budget, which guarantees create indirect liabilities for the budget. With the authorization of the Minister of Finance, the State Treasury manages the public debt, performing financial risk analyses, carrying out financial market research, developing public debt management strategies for the medium term, and drawing up financing plans for each fiscal year. Based on these studies, the State Treasury prepares loan contracts, ensures safekeeping of the originals of the contracts, carries out public debt servicing, as well as maintaining records of government loans, credits and guarantees. The State Treasury reports to the Minister of Finance.

Table 3.4: Public Debt Dynamics (Mln Lats)

	1996	1997	1998	1999	2000
Total public debt	**408.2**	**391.8**	**372.6**	**510.7**	**570.9**
% of GDP	14%	12%	10%	13%	13%
Internal Debt	180.8	173.4	141.0	151.7	222.9
External Debt	227.4	218.4	231.6	359.0	348.0

Source: The World Bank

3.23 On December 31, 2000 the average maturity of the public debt was 3.71 years. Fixed-interest debt represented 57 percent of the total public debt portfolio. The distribution of foreign currencies in the public external debt is determined by the exchange rate policy implemented by the Bank of Latvia, which pegs the lat to the SDR basket. The currency risk is greatly reduced by denominating the external debt in SDRs or in basket currencies in the relevant proportions.

Table 3.5: Public External Debt by Currencies and Interest Rates, December 31 2000 (Mln Lats)

	CHF	DKK	XDR	JPY	SEK	USD	EUR	Total	% of Total
Interest-Free	0.00	0.02	0.00	0.00	0.00	6.37	0.00	6.45	1.8%
Fixed Rate	0.00	0.00	0.00	24.07	0.00	6.05	162.14	192.32	55.4%
Floating Rate	0.53	0.86	21.34	0.00	0.22	118.98	6.47	148.46	42.8%
External Debt	0.53	0.87	21.34	24.07	0.22	131.40	168.61	347.27	100%
% of Total	0.2%	0.3%	6.1%	6.9%	0.1%	37.9%	48.6%	100%	

Source: The World Bank

3.24 In 2000 debt service payments totaled 39.3 million lats, of which expenditures on internal debt servicing amounted to 19.6 million lats and on external debt servicing to 19.5 million lats. Other debt service payments amounted to 0.2 million lats. Overall, expenditures on public debt servicing accounted for 0.9 percent of GDP. In line with the general thrust of fiscal policy, which is aimed at attaining a balanced budget over the medium term, growth of the public debt will be at or below that of GDP as of the year 2002. As a result, the public debt/GDP ratio will gradually decrease.

Table 3.6: Public Debt Forecast (Mln Lats)

	2001	2002	2003	2004	2005
Total Public Debt	**712.7**	**860.5**	**975.5**	**110.5**	**1229.5**
% of GDP	14.9	16.6	17.4	18.0	18.4
Internal debt	256.0	315.0	382.8	457.0	521.3
External debt	456.7	545.5	592.7	643.5	708.2

Source: The World Bank

3.25 Public debt management policy envisages an increase in the share of debt repayable in the national currency. This is to be accomplished by developing a longer-term financial resource base in order to avoid possible losses caused by the currency risk. As regards the composition of the external debt, its link to the SDR will be maintained. However, as Latvia joins the European Union, the Lat will be pegged to the Euro; for this reason, some deviations from the standard currency composition in favor of the Euro could take place. In order to ensure stability in public debt service expenditures, the public debt management policy envisages fixing the interest rates for at least 60 percent of the state debt.

3.26 Every year, the State Treasury develops a financing plan that determines the overall level of financing required, financial markets and liquidity risks, and the most appropriate financial instruments for financing the deficit. This plan also determines the appropriate mix of internal debt financial instruments. For 2001, it was determined that the deficit would be financed mainly through the emission of short-term T-bills (3-month, 6- month, and 1-year) and medium-term obligations (3-year and 5-year).

Fiscal Risks Ahead

3.27 One significant fiscal risk in the medium term would be lower than forecast government revenues resulting from a slowdown in economic growth, which could adversely affect the Government's fiscal stance. Tax revenues are closely related to the economic context. This was observed in 1999 and 2000, when tax revenues were relatively low due to the negative impact of the Russian crisis and the worsening of the business environment. Tax revenues are also influenced by oil prices—with high oil prices causing a fall in consumption of oil products and a resulting decline in tax revenues.

3.28 The fiscal module of the IMF 2001 ROSC noted several other important issues that need urgent attention: first, the legal and administrative framework for fiscal management is clear in most respects, but its coverage requires further strengthening. The *Law on Budget and Financial Management* provides clear guidance on most aspects of budget management for both levels of government consistent with the general principles of legal appropriation given in the Constitution. It was originally constructed to include all formerly extra-budgetary operations within the budget framework as special funds. However, excessive creation of special funds and earmarking of revenues within this framework has reduced transparency of the budget and fungibility of resources—and hence fiscal policy flexibility—but measures are being taken to reduce special fund operations. Creation of agencies, as noted earlier, also gave rise to problems of coverage and control, but these problems are being addressed through the introduction of the Law on Public Agencies. Implementation of this law will present practical difficulties, but in principle it should allow a comprehensive and clear presentation of central government fiscal

activity. It is essential, from this point of view, that action is taken to ensure that all agencies financed directly by the budget and included as budget-financed institutions (BFIs) comply with budget procedures and the Treasury's monthly reporting requirements. Similar problems exist and are being addressed for local budgets. The practical problems of implementation are more intractable at the local level because of the large numbers of small units involved—many with limited administrative capacity. A sustained effort will, therefore, be required to achieve reliable coverage of general government.

3.29 Second, some off-budget and quasi-fiscal activities are identified and are being reduced, but these steps are not explicitly linked to the budget process or documents. As part of the program of reform leading to EU accession, Latvia has initiated measures to identify all forms of state aid to enterprises with a view to ensuring that state aid conforms to EU limits on such activities. The *Law on Monitoring of State and Local Government Aid to Entrepreneurial Activity* adopted on February 1998 establishes a framework for monitoring state aid. This law is being implemented by the State Aid Surveillance Commission, under the chairmanship of the Ministry of Finance (MoF), which has the authority to receive all necessary information from government institutions to identify state aid activities and ensure compatibility with the law. The current process does not, however, cover all forms of off-budget activity and the information that is available is not systematically linked to the budget. All activities that provide assistance to investment or regional development outside the budget process should be fully scrutinized and costs and potential costs to the budget estimated and reported with the budget presentation. The transparency of on-budget assistance to investment and regional development should receive similar attention.

3.30 Third, mechanisms governing intergovernmental fiscal relationships have been established, but further development of fiscal responsibilities at local and regional levels is needed. Fiscal relationships between national and local governments are largely defined in the *Law on Local Government Budgets* of April 1995, the *Law on Equalization of Local Government Finances* of March 1998, and the *Law on Budget and Financial Management* of March 1994 (or as subsequently amended in each case). However, there is continuing debate on the role of regional administration vis-à-vis the state, and the need to rationalize and strengthen local administration is recognized. Revenue and expenditure assignments to local authorities are specified under the self-government law. There is a substantial vertical imbalance (shared taxes and intergovernmental transfers accounted for 77 percent of local government revenue in 1998) and local sources of revenue are inadequate for the towns and pagasts with lower revenue-raising capacities to meet expenditure needs. The gap in local financing for less well-off municipalities is closed through an Equalization Fund that is financed through contributions from richer councils and the central government. The mechanism achieves its objectives and shows clearly the relative contributions to equalization, but the formula used is complex and it is recognized that the longer-term objectives for establishing local fiscal sustainability require further clarification. In this context, the authorities are exploring mechanisms to amalgamate smaller councils and/or to establish a regional administration based on a smaller number of regions.

3.31 Fourth, **the framework for local borrowing requires further definition of objectives.** Local capacity constraints and aggregate control concerns have led to stricter controls being applied to local borrowing in recent years. The *Law on Local Government Budgets* gives local councils the right to borrow and issue municipal bonds. In February 1997, however, a regulation

was introduced taking away the authority of local governments to undertake either domestic or international borrowing without the approval and, in the case of external loans, guarantee of the national government. Total local borrowing is overseen by an interministerial Council for Loans and Guarantees. Local governments now borrow from the Treasury, which adds 50 basis points to market borrowings for on-lending to local authorities. The *Local Government Financial Stabilization Act* of May 1998 applies a financial stabilization process to councils that are unable to meet their obligations. In the longer term, the framework needs to be reviewed to meet broader objectives, eventually allowing viable municipalities to establish their own market credentials while retaining a strong framework of aggregate control.

C. Expenditure Pressures Ahead

3.32 **EU and NATO accession aspirations put pressure on the budget**. These programs require significant resources. While data on all costs of EU accession are not yet available,[12] national contributions to the three main programs (SAPARD, ISAP, EU-PHARE) are estimated at about 4 percent of the budget[13] for 2001. NATO accession budgets are usually thought to be around 2 percent of GDP. It is beyond the scope of this PER to review how well these requirements are addressed in the budget so far, but the scant evidence tends to suggest that EU accession policies are not all funded (see also next chapter).

3.33 Other pressures will arise, with continued pressure on entitlement programs, and particularly on the pension scheme, due to aging of the population. Two measures that the Government adopted in the second half of 1998 have severely impacted the financial sustainability of the system: (i) the Government provided a one-off pension increase that permanently raised all pensions by approximately 10 percent, and (ii) the Government allowed a recalculation of pensions for those pensioners who continued to work that was regressive and unfair as it more than doubled pensions for a select group of pensioners.

3.34 The new Government which took office in the fall of 1999 proposed a set of emergency measures to restore financial viability to the pension system. Unfortunately, the amendments did not get the full support of the Saeima and a weaker set of measures was approved. As a consequence, the pension system has not been able to return to a much-needed surplus and still has incentive mechanisms in place which are unfair and economically inefficient.

3.35 The Government's reform program, supported by the World Bank, is geared toward completing the pension reform agenda and achieving an equitable and financially sound system which is less likely to contribute to macro imbalances when the economy is affected by an adverse shock. To that effect, with Bank support, the Saeima has adopted a package of measures with opposite fiscal effects: (a) the amendments to the Pension Law that remove all prohibitions on working while drawing a pension will increase the pension fund's liabilities; (b) curbing early retirement and regulating future indexation will reduce the fund's deficit over time. Another costly measure in the short term is the implementation of the second tier and development of regulations to permit private pension funds to operate. In the next two years, the Government will have all three tiers of the pension system in place and will closely monitor the financial

[12] A report on fiscal costs of EU requirements, prepared by the GoL, is pending.
[13] Exchange rate LAT/EUR: 1.36.

viability of the pension system. Overall, the costs of the pension reform package will burden the budget in the short term and will need to be addressed, while the sustainability of the pension fund will have to be strengthened.

D. CONCLUSION

3.36 The costs of EU accession and other upcoming liabilities will have to be accommodated under a tight fiscal constraint as the Government is also committed to a balanced budget.

3.37 The Government will be looking for savings over the next few years in order to increase funding for priority programs. Previous work (sector analyses and IMF) and the above section have shown that allocations can be redressed in some sectors (e.g., health and education), as well as in the economic composition of expenditure (e.g., the wage bill) with the view of finding short- to medium-term savings. Recommendations on how to proceed in the very short term will be discussed in the final chapter.

3.38 More fundamentally, however, the key challenge is for the Government to address allocations in a manner conducive to sustainable, cost-effective results without disruptions to service delivery. There is an urgent need to bring policy decisions and priorities into line with resources available. The Government has taken steps toward reviewing its main program in the context of 2002 budget preparations (while, in parallel, the fiscal costs of EU accession are being assessed). This is a step in the right direction. These measures will require strengthening of the Government's allocative process, i.e., a shift to a policy-based discussion on expenditure trade-offs.

3.39 However, the significance of real trade-offs is somewhat dampened by the worrying build-up of arrears in Latvia. The effects of arrears can disrupt honest efforts at public expenditure management reforms and should be addressed as a priority. These issues are discussed in the next chapter.

4. STRATEGIC ALLOCATIONS AND OPERATIONAL EFFICIENCY

4.1 The previous chapter discussed Latvia's remarkable fiscal performance. However, this performance hides weaknesses in the system which have led, inter alia, to the build-up of arrears and, to a lesser extent, to budget cuts. This chapter will review the budget process. Weak planning in particular, from poor policy formulation to incremental budgeting and commitments to unfunded policy proposals, tends to lead to over-commitments and to limit performance of programs. These weaknesses are compounded by the structural rigidities in the budget (limited fungibility), notably earmarking and the proliferation of autonomous agencies. In the face of these weaknesses, budget execution cannot be effectively monitored, leading to cash rationing and unpredictability of resources for line ministries. In turn, cash rationing induces line ministries to resort to arrears and to seek ways to avoid central control of their budget.

A. FROM POLICIES TO BUDGETING

4.2 Several factors stand in the way of strong links between policies and resource management: first, fiscal discipline objectives force the Government into cutting expenditure during the year—whether the cause of the fiscal pressure is exogenous (mainly revenue shortfalls caused by external shocks) or a decision to fund new priorities. As a result, some policy priorities are under-funded, as was shown in the discussion on inter- and intra-sectoral allocations, and line ministries are subject to unpredictability of resources, with perverse effects on their incentives.

4.3 Priority setting lies at the heart of the policy process. A government's policies are defined by what government does, not simply by what government says. Approving policies without providing the necessary resources for implementation results in an unreliable government. A good priority-setting process recognizes that resources are limited. It provides a mechanism for the government to identify those policies it considers most important, and ensures that adequate resources are allocated to these priorities.

4.4 An effective priority-setting process also lies at the heart of the budget process. After all, the purpose of a budget is to fund government programs. But, over time, some of the existing programs can become outdated, unnecessary, or lose their effectiveness. In addition, new issues can emerge, or governments with different policy agendas can be elected, both of which can result in the need for new programs. The annual decision process through which the budget is allocated needs to take into account these changing priorities so that the right programs are funded. By integrating the budget and priority-setting processes, a government's ability to deliver on its commitments can be increased significantly.

4.5 The rest of the section will examine the following questions: where does policy formulation stand in Latvia? How is priority-setting determined? And how does the budget process allow for linking policies with resources?

B. POLICIES

4.6 **In some sectors, policy formulation remains weak.** The current planning and budgeting frameworks do not place much emphasis upon the elaboration of sectoral priorities that are broadly congruent with a medium-term planning framework. The current objectives of ministries that are contained in the relevant regulations outline the sectoral role of the particular ministry. For example, the closest to a policy document outlining priorities in agriculture is the Concept Document on Agriculture which notes that "the main purpose of state agricultural policy is to establish agriculture as a sector capable of integration to the European market and producing marketable products capable of competing in terms of quality and production costs." It is then stated that this will be achieved through modernization of production, quality control, and market promotion. There then follows a detailed analysis of problems in fourteen branches of agriculture (from grain farming to forestry) in which possible measures to resolve problems (usually subsidies) and possible targets are proposed. In most cases, the measures tend to prescribe inputs as a means to raise output and quality rather than considering what measures might be taken to bring about the desired results. In addition, the document does not attempt to prioritize these activities or relate them to the resources available.

4.7 **....or implementation is proving difficult.** In the Health sector, for example, the reform agenda is good, but implementation of the harder parts of the agenda (hospital downsizing) is slow; and institutional commitment to give "bite" to the harder parts of the agenda is limited or lacking—e.g., development of an audit function for municipal health care institutions; development of legal and institutional bases for enforcing contracts. More attention to the incentives for policy implementation is needed (e.g., create incentives to downsize hospitals by allowing institutions to retain the proceeds of disposal of surplus assets).

Priority Setting at Cabinet Level

4.8 The Government of Latvia occasionally adopts new measures and policies during the year without proper discussion on the trade-offs involved. For example, the late-1998 Government's decision to increase pension benefits was funded through significant reallocation of expenditures to meet the fiscal target. As discussed in the previous chapter, significant EU and NATO commitments remain unfunded. The result of these measures is either reallocation of expenditures (and, as shown in the above section, little reallocation can take place without disruption of policies and delivery); or the GoL commits to new policies it cannot fund. This practice has been facilitated by uneven respect of Regulation Number 160, specifying that new policies need to be costed out before presentation to the Cabinet. In Latvia, policy commitments are made in a number of different ways. First of all, the Government's Declaration is its formal statement of priorities. This document contains a long list of initiatives covering all areas of government activity, but with no estimate of the cost of implementation. In addition to the Declaration, the Government approves new policy programs throughout the year, but, again, generally without any provision of funding or even an estimate of the cost. In addition to these government commitments, Parliament can also introduce and approve legislation that requires funding, but it is up to the Government to decide whether there is funding available within the budget for these new programs. The commitments made through these various processes far exceed the funding that may be available each year through the budget process. As a result, many remain as unfunded commitments, and have not been implemented.

4.9 **Provision of funding for priorities occurs too late in the budget process.** In the current budget process, the base budget for existing programs is approved before provision is made for new priorities. As a result, priorities only receive funding if there is anything "left over." The base budget includes allocations which allow the Government to implement its expenditure program and carry out its functions as provided by the budget bill. Base expenditures for each year are planned according to the unified principles and it is impossible to reallocate financial resources according to priorities. However, if priorities were to be discussed early in the budget process, during the discussion of the fiscal plan, an allocation for priorities could be set aside before the base is determined. Such a revised order of procedures would force an examination of the base for savings if needed to fund the approved priorities.

4.10 While some effort is being made in this direction (see Box 4.2 on budgeting for social protection), assessment and review of existing programs needs strengthening. There is no unified approach to policy planning. Since 1993, there have been more than 450 conceptual documents approved by the Government the status of which is not clear due to the underdeveloped system of policy revision, replacement, and cancellation. The existing *Cabinet Rules and Procedures* do not provide a precise definition of types of policy planning documents and the intended use of

Box 4.1: The Budget Process Viewed from the Health Sector

Although the budget process in practice determines aggregate Health expenditure, it fails to achieve the potential benefits of a budget-financed health system; it also fails to achieve the benefits of an earmarked-financed health system. Although aggregate public expenditure on health has been maintained at a relatively low level, the budget constraint on health care institutions lacks credibility, and this is now reflected in off-budget forms of spending (accumulation of arrears, soft loans). Aggregate public health expenditure is exposed to the delays and revisions that are part and parcel of the budget process, which is typically determined late and subject to in-year revisions. This engenders a lack of predictability of revenue for health care institutions and associated weakening of accountability. Budget preparation is not based on or consistent with the policy decisions and reform strategies for the health sector. The presentation of the budget and the debate between the Ministries of Welfare and Finance on the budget are taken up with the arbitrary and misleading distinctions between different revenue sources. There is a lack of capacity in the MoF and MoW, and a lack of commitment to ensure that policies and resource allocations in the budget are consistent. Little meaningful information on resource allocation choices or sector performance is presented or considered in the budget preparation process. In fact, there is a system of output-based resource allocation within the health sector which is undergoing progressive refinement. There is also a contracting system which has the potential to provide a basis for performance monitoring and accountability. But these positive features are not reflected or used in the budget process.

The resource allocation systems in the health care sector are complex, reflecting the inherent institutional complexity of the sector. This complexity is increased in Latvia by decentralization. As a result, it will be a very demanding task for the MoF and MoW to develop the capacity to play such an active role in health resource allocation through the state budget processes. Some aspects of health resource allocation may be legally or institutionally too complex for the budget-financed model to be effective in the Latvian context.

those documents at various stages of the policy-making process. At the same time, policy planning within various sectors develops differently (for example, policy planning is better developed in areas that receive EU financing, with the result that policy revision does take place there). The link between policy planning and the State Budget is not well developed. Often policy planning does not take financial constraints into account, leading to unrealistic programs and inefficient use of resources. Policy and legal initiatives can be adopted without providing

adequate resources. The implementation of the sectoral expenditure programs by line ministries should be consistent with the Government's overall program and goals presented in the budget law and adopted by Parliament.

4.11 **There is a lack of reliable information on existing programs.** Although Latvia has formally adopted a program budget structure, there are often no linkages between policy programs that deliver products or services and budget programs that are more input based. Furthermore, in several line ministries, these program budgets do not include performance indicators. As a result, it is difficult to provide reliable information on the cost of delivering government services, on the outputs that are achieved, and on the impact that those services have in meeting government priorities. In the absence of this type of information, it is very difficult to assess the value of existing programs in order to identify savings.

4.12 **Priority setting needs a forum for trade-offs.** There is no opportunity for political discussion and trade-off between priorities. At no time during the year is Cabinet provided with an overview and assessment of all commitments made to date. This type of analysis, set in the context of the economic and fiscal outlook, allows a government to make choices about what should be its immediate priorities.

C. THE BUDGET PROCESS

4.13 **There are few analytical links between recurrent and investment programs.** This is due in part to the absence of a medium-term expenditure framework defining programs, and the administrative responsibility for sharing budgets. According to the law, the Ministry of Finance is responsible for the preparation of the draft budget bill, including external financing from foreign sources. But, in practice, the capital investment budget is prepared by the Ministry of Economy, the basic budget of current expenditures and the special budgets by the Ministry of Finance, and the budget for projects financed with external aid by the Minister with Special Responsibility for Cooperation with International Financial Institutions. The Ministry of Finance aims in the future to present a plan of long-term expenditure commitments to be approved by the *Saeima* along with the State budget. Among other commitments, line ministries will be required to identify and include in their budget programs all contractual obligations connected with international programs, including cofinancing of EU projects. However, the present division of responsibilities between the Ministry of Finance and the Ministry of Economy runs contrary to good practice and represents a potential threat to the efficient use of scarce resources.

4.14 While the budget preparation process itself has improved,[14] and the MoF is successful in implementing a top-down approach to budgeting, the line ministries tend to place emphasis on incremental budgeting. This involves an over-emphasis on recent budget allocations, which are adjusted at the margin. This approach tends to neglect the emerging medium-term priorities and the Government's current sectoral priorities. Indeed, incremental budgeting tends to flourish in circumstances where little or no emphasis is placed upon a medium-term planning framework and there is an absence of clearly enunciated sectoral priorities that are congruent with the medium-term planning framework. In the absence of this kind of planning and priority setting,

[14] See Annex for the budget process in 2001.

the reference point becomes last year's budget and its associated programs, with the focus being on incremental change to last year's budget allocations.

4.15 The use of incremental budgeting reflects a failure to address linkages between the various functions of budgeting. Use of incremental budgeting is likely to give rise to the following weaknesses in budget processes, which are found to occur in some sectors in Latvia (see Box 4.1 on Health):

- Almost exclusive focus on inputs, with performance judged largely in terms of spending no more and no less than appropriated in the budget;
- The input focus takes a short-term approach to budget decision-making, resulting in failure to adequately consider longer-term costs (potential and real), and biases in the choice of policy instruments (e.g., between capital and current spending, and between spending, doing and regulating) because of the short-term focus of the time horizon;
- The Cabinet and/or central agencies become extensively involved in micro decision-making on all aspects of funding for ongoing policy, with a consequent loss of "ownership" and associated accountability by the relevant sectoral agency/line ministry;
- Weak decision-making and last-minute, across-the-board cuts to budgets, including cuts during budget execution;
- Existing policy and legal obligations (as opposed to funding) are subject to very little scrutiny from one year to the next, which—coupled with the previous point—reflects the worst dimension of incremental budgeting;
- There are poor linkages between policy goals and resources at the center, between the center and line ministries, and within line ministries because of incremental budgeting;
- Given the poor linkages, there is a lack of clarity as to the purpose (goals/objectives) and task and this tends to result in poor information on the performance of policies, programs and services, and their attendant costs;
- Overall, incremental budgeting provides few incentives to improve the performance of resources provided.

All these weaknesses are due to the lack of a political agreement on a clear set of priorities at the government level, and the inability of line ministries to review program (and subprogram) budgets during the implementation phase in order to save or reallocate financial resources.

4.16 Incremental budgeting reflects the lack of consensus on policy priorities at the government level, and the inability of line ministries to save resources during the implementation phase of the budget. Furthermore, in the framework of the preparation for EU accession and NATO integration, Parliament has adopted a series of spending programs, the implementation of which requires additional financial resources. For instance, the *Law on State Defense Financing* provides for an increase in the Defense budget to 1.75 percent in 2002 and 2 percent in 2003.

4.17 Allocations to expenditure programs are largely determined by a combination of historical inertia and severe resource constraints. Line ministries lead the process, as they are

now required to set clear objectives for their programs, and develop performance indicators so that action plans can be revised should it become necessary. However, the current approach to budget management appears to give too much importance to micro-management of inputs. This approach can be explained by a context where:

- A medium-term planning framework and associated priorities are absent;
- Sectoral priorities are not currently developed by line ministries in a manner congruent with the medium-term framework;
- The program framework is heavily focussed on inputs rather than outputs;
- There is a lack of clearly-defined performance measures and indicators;
- Staff knowledge and capacity to operate these facets of a program budgeting framework is weak.

4.18 In addition, transfer of funds between programs and subprograms during budget execution does not always occur when needed (through amendments of the annual budget law), which limits flexibility to switch funding between programs and subprograms.

Box 4.2: Budgeting for Social Protection

In recent years about 94 percent of all social protection expenditures have been non-discretionary. While budgetary processes are similar for discretionary and non-discretionary programs, negotiations with the Ministry of Finance on the latter are more likely to be driven by assumptions related to beneficiary growth and economic indicators, rather than the prioritization of program requirements. Consequently, while Ministry of Finance budget analysts scrutinize Ministry of Welfare, SIA, and Social Assistance Fund social spending, the ministries have had no choice but to take into account legal expenditure requirements. Similarly, the Ministry of Welfare has little latitude to request funding for initiatives above and beyond relatively fixed program resources. In areas in which entitlement is based on administrative procedures, such as the award of disability pensions, the process used to make the determination is sufficiently complex to necessitate the creation of a task force to develop administrative or regulatory modifications. The situation in Latvia is similar to that of other European countries in this regard.

In Latvia, more than in many other transition economies, program outcomes are internally evaluated and program reforms are developed through inter-ministerial task forces. In particular, such an interagency task force was instrumental in the development of the pension reform and another is now working on the proposed GMI initiative. In addition, considerable staff time and energy go into the preparation of the annual budget. While there are still analytical gaps in program analysis and the need for greater cross-program coordination, the Ministry of Welfare has been unusually successful in developing and administering reforms in the area of social protection which mitigate the social risks of a market economy.

4.19 This focus on micromanaging budgets centrally results in:

- Central agencies devoting their major efforts to monitoring budget expenditures rather than on the connection between goals, priorities, programs, and funding, and monitoring related performance;
- A tendency for line agencies to lack ownership and a sense of responsibility for the development of sectoral priorities, structures and programs and resultant performance.

D. THE BUDGET STRUCTURE

4.20 **As shown above, the budget process in Latvia is not conducive to strategic allocations.** Further compounding the Government's inability to reallocate is the limited pool of fungible resources at its disposal.

4.21 In fact, the fragmented budget structure puts pressure on overall fiscal discipline, leads to misallocations, reduces flexibility and transparency of allocations, and pre-empts any real policy discussions.[15] As summarized by the IMF,[16] the legal and administrative framework for fiscal management is clear in most respects but its coverage requires further strengthening. The *Law on Budget and Financial Management* provides clear guidance on most aspects of budget management for both levels of government consistent with the general principles of legal appropriation set forth in the Constitution. It was originally constructed to include all formerly extra-budgetary operations within the framework as special funds. However, excessive creation of special funds and earmarking of revenue within this framework has reduced transparency of the budget and fungibility of resources—and hence fiscal policy flexibility.

Table 4.1: Revenue Allocations by Budget on a Net Basis[5] (Percent)

	1999	1999	2000	2000	2001
	Budget	Actuals	Budget	Actuals	Budget
Basic Budget[1]	39	40	44	42	44
Special Budgets[2]	43	40	38	38	37
Local Government Basic Budget[3]	15	17	16	17	16
Local Government Special Budget[4]	2	3	2	3	2
TOTAL	100	100	100	100	100

1/ Excluding transfers from special budgets.
2/ Excluding transfers from central budget.
3/ Excluding payments received from other budgets.
4/ Gross basis.
5/ Total exceeds consolidated figures, probably because of double counting from local government special budget.
Source: IMF.

Table 4.2: Revenue of Main Special Budgets (Gross)

	1999	1999	2000	2000	2001
	Budget	Actuals	Budget	Actuals	Budget
Total	737,019	683,985	691,520	673,162	724,592
Earmarked Taxes/Excises/Duties	648,476	604,116	618,382	604,138	662,305
Subsidy from CG (block Grant)	66,316	62,171	61,168	62,339	57,151
Own Revenue and Other	22,227	17,698	8,599	5,903	3,458
Foreign Grants	0	0	3,371	1,099	1,678
Earmarked Taxes/Excises/Duties (Percent)	88	88	89	90	91
Subsidy from CG (Percent)	9	9	9	9	8
Own Revenue and Other (Percent)	3	3	1	1	0.5
Foreign Grants (Percent)	0.0	0.0	0.5	0.2	0.2

Source: IMF.

[15] Comprehensiveness of the budget is equally important with regard to capacity and willingness to reallocate. Issues concerning budget comprehensiveness have been discussed in Chapter 3 in relation to fiscal discipline.
[16] Source: ROSC, IMF, March 2001.

4.22 The Central Government budget in Latvia consists of two parts, the basic budget and the special budgets. The basic budget consists of all central government revenues and expenditures not included in the special budgets. The local government budgets present the same division. Revenue of the basic budget is less than 50 percent of total revenue, as shown in the Table 4.1.

4.23 During the decade of transition, there has been a marked increase in the portion of state revenues that is earmarked for particular purposes. Latvia's interest in budgetary enclaves is partly a reaction to the over-centralized state apparatus built up during the Soviet era.

4.24 The most important of the special budgets are the funds for social security (under the aegis of the Ministry of Welfare) and a road fund under the Ministry of Transportation (MoT). Other sources of income for special budgets are transfers from the central budget, fees and grants. A breakdown of revenue of the main special budgets[17] is presented below. While the special budgets' share of revenue has been declining overall since 1999, they still account for about 40 percent of total revenue, and around 50 percent of central government revenue, on average over the past 3 years.

Box 4.3: Agriculture: The State Forest Service

In agriculture, the effort to reduce earmarking has posed a different problem for the financing of forests. The Forestry Fund special budget of 1999 was liquidated and replaced by (i) the State Forest Service (in the basic budget) responsible for the supervision and inspection of forests, and (ii) a (public) joint stock company "VAS Latvijas Valsts Meži" (Latvia's State Forests) (LVM) dealing with forest management and development issues. LVM obtains its income from stump taxes and covers its expenditure in this way, since it is no longer included in the budget. LVM is required to make a special payment into the budget of 7.9 million lats. This payment is then used to finance the State Forest Service (although apparently, if for any reason the payment is not made, the State Forest Service will receive its grant from general fiscal revenues). The net direct fiscal effect of the reorganization is thus zero, since both the company's expenditures and its revenues are removed from the budget. The resources available to the Ministry of Agriculture are not reduced despite the apparent reduction in expenditure on forests. The change in the management of forests represents a step away from fiscal transparency. It is somewhat anomalous that LVM's gross accounts are not available for budgetary purposes, since it is a public enterprise exploiting a public resource. The requirement that LVM make a lump-sum payment to the budget presents two risks. The first is that at some point in the future it may be unable to make these payments due to commitments which the company has incurred in the past, and that this situation would not become apparent until too late, due to the absence of gross accounts. The second risk is that, unless carefully regulated, future earnings above those required for the payment to the budget will not necessarily be directed to the highest priorities of the Ministry of Agriculture.

4.25 **This implies that 45 percent of central government revenue is earmarked in Latvia.** In 1999, the State took steps to reduce earmarking. However, in agriculture the abolition of the Forestry Fund did not lead to improved transparency and fungibility.

4.26 **Earmarking is quite extensive in OECD countries and, particularly in transition economies with large budgets allocated to social transfers, the consequences are rigidities in the expenditure structure, and vulnerability to shocks, with resultant pressures on fiscal**

[17] These are: Social Insurance (MoW); Health (MoW); Environment (MoEnv); Radio (Skrunda RLS); Road Fund (MoT); Ports (MoT); Forestry Fund (MoAg) liquidated at the end of 1999; Sports (MoE); Culture (MoE); Fisheries Fund (MoAg); Radio and TV Board. The Privatization Agency has been excluded from these calculations as its revenue is transferred to other budgets and funds.

discipline. This can be seen on an aggregate basis from the tables above. In 1999 and 2000 revenue shortfalls have affected special budgets significantly.

4.27 **Another symptom of the fragmentation of the budget is the flexibility for ministries to levy and retain their own fees** (e.g., Ministry of Justice, Transportation, Education, etc.). These fees can represent in some cases a significant portion of the ministry's budget (see Table 4.3 for the 1999 budget). This power has been vested in particular agencies that have a monopoly on particular services, leaving citizens with no recourse but to pay the fees imposed on them. In effect, the Government has surrendered a portion of its taxing power to certain entities. The combination of institutional independence, self-generated revenue, and earmarked funds is an invitation to trouble. Government is weakened, fiscal discipline is undermined, and public accountability is placed at risk. Most importantly, the policy basis for government expenditure management cannot be secured.

Box 4.4: Earmarking in Latvia

Latvia has made wide use of the practice of earmarking certain budgetary revenues for specific expenditure purposes. It would therefore be useful to understand the main drawbacks and benefits of this practice. The theoretical dispute on whether earmarking is a practice that should be used in allocating budgetary resources has lasted for many years. Some of the latest findings are described below.

Key arguments against earmarking[18] are the following: 1) earmarking leads to a misallocation of resources, usually providing too much funding for the earmarked activities; 2) it hampers effective budgetary control; 3) it infringes on the powers and discretion of the government; and 4) it reduces flexibility in budgets. These factors seem to outweigh most of the positive aspects of earmarking—application of the benefit principle of taxation, providing greater stability in funding, and creating a linkage between taxation and spending, as these benefits are normally not automatic. In general, it has been noted that the principles of earmarking would work better at the level of local governments, as some of the benefits listed above would be more obvious; in Latvia, however, this type of earmarking is basically missing.

Some important aspects of earmarking are related to the way the earmarking mechanism is set up. In general, the use of earmarking is more justifiable in cases where the linkage between the earmarked revenues and expenditures is strong and where the "benefit" rationale is clearly identifiable.

In the case of Latvia, various types of earmarking are used. Unfortunately, only some of these activities are in line with the better practices of earmarking discussed above. A major portion of the special budget revenues (69.5 percent of total special budget revenues in 2000) are social security payments, followed by the special health care budget (19.2 percent). Although, revenue earmarking is frequently used in social security systems, the rest of the areas where earmarking is used in Latvia seem to lack a tight revenue-expenditure linkage, thus rendering the use of earmarking in these areas questionable.

4.28 On the expenditure side, non-flexible[19] expenditures include the wage bill, interest payments, subsidies and transfers. Subsidies are mainly agriculture subsidies, and transfers are

[18] Summarized by William McCleary in his article "The Earmarking of Government Revenue: A Review of Some World Bank Experience".

[19] The non-flexible part of the budget is an estimate, and it refers to budget components that are either non-discretionary (the Government is committed by contracts and obligations) or not adjustable within the span of a few months. The wage bill qualifies under the latter heading. Non-flexible expenditure could also include the portion of the capital budget covering counterpart funds for donor-financed projects. Similarly, a portion of the wage bill could be considered flexible as it includes short-term contractual labor. Also, non-flexible expenditure may be

primarily to households (social protection) and grants for health. What can be seen from the table above is that the non-flexible part of the budget has increased slightly over the years. This portion of the budget compares well with other countries and is actually lower than in some other countries such as Macedonia where flexible expenditures are around 14 percent of the budget. Increases in non-flexible expenditure can best be explained by the overall increase of entitlements, particularly pensions, in the budget. The State has an obligation to compensate for the funds' financial shortfalls. Similarly, the State usually ensures that wages are paid.

Table 4.3: Own Revenue of Ministries (Percent of Total Revenue)

Ministry	Revenue Basic Budget			Revenue Special Budgets			Total
2001 Budget[1]	Allocated through the Budget Process [2]	Own Revenue	Special Grants and Foreign Financial Assistance	Own Revenue	Earmarked	Foreign Financial Assistance	
Defense	95.4	4.6	0.0	0.0	0.0	0.0	100.0
Foreign Affairs	98.2	1.8	0.0	0.0	0.0	0.0	100.0
Economy	44.9	4.2	23.5	0.0	27.4	0.0	100.0
Finance	89.4	4.2	2.9	0.0	3.5	0.0	100.0
Interior	87.5	8.8	3.7	0.0	0.0	0.0	100.0
Education & Science	69.5	22.7	4.4	0.0	3.3	0.0	100.0
Agriculture	70.2	8.7	20.4	0.0	0.7	0.0	100.0
Transportation	12.1	0.1	9.8	0.1	75.9	2.0	100.0
Welfare	19.2	0.7	0.4	0.4	79.4	0.0	100.0
Justice	90.2	4.9	5.0	0.0	0.0	0.0	100.0
Envir. Protection & Regional Development	32.6	5.4	21.3	0.3	40.4	0.0	100.0
Culture	77.1	11.4	1.2	0.0	10.4	0.0	100.0
Special Task for Co-operation with IFOs	19.3	0.0	77.7	3.0	0.0	0.0	100.0
TOTAL	40.0	3.7	3.5	0.3	52.4	0.1	100.0

1/ Data have not been netted out for transfers from special budgets to the central budget.
2/ Allocated through the budget process.
Source: GoL budget.

4.29 While these obligations are natural, they do, however, limit the Government's margin for maneuver in the event of exogenous shocks or a decision to fund new policies. As has been discussed above, expenditure cuts are disruptive, but all the more so when they are borne by the limited and shrinking discretionary portion of the budget. This point has been made before but is worth repeating: as the Government commits to EU accession, the budget's non-discretionary portion will continue to increase. Unless action is taken to review sector policies in the direction of increased cost-effectiveness, pressure on the overall fiscal stance will be felt.

4.30 **In some sectors like agriculture, there is a complicated formula-based allocative system that does not promote policy review.** The volume of subsidies to agriculture is determined by the provisions of the *Law on Agriculture* which requires that agricultural subsidies

slightly overestimated as: (i) these figures include local governments, which have more autonomy in the use of social protection expenditure than central government does; (ii) discretionary grants for health are included in transfers.

be no less than 3 percent of basic budget expenditure. This essentially takes the volume of direct subsidies outside the budgetary process, but it also entrenches the idea that it is unnecessary to examine the purpose and time horizons of subsidies. In fact, a closer examination of the subsidy program shows that the program does not meet its objectives, but rather lacks focus and coherence in its policy approach.

Table 4.4: Flexible and Non-Flexible Expenditure in Latvia's Budget (Percentage)

Consolidated	1994	1995	1996	1997	1998	1999	2000	2001 Budget
Expenditure	100	100	100	100	100	100	100	100
Wages & Salaries	17	22	24	22	23	23	22	23
Goods & Services	20	23	24	24	20	18	17	17
Interest	1	3	4	2	2	1	3	2
Subsidies & Transfers	43	42	43	45	45	48	46	49
Other Expenditure	17	8	0	0	1	0	1	0
Capital Expenditure	3	2	5	6	9	10	10	9
Flexible	39	33	30	30	30	28	28	26
Non-Flexible	61	67	70	70	70	72	72	74

Source: IMF.

4.31 **Pressure to compensate for shortfalls in earmarked resources can result in breaking down of agreements and unpredictability**. In the case of Health, expenditure is financed from two major sources: an earmarked percentage (28.4 percent) of the personal income tax collected (which largely replaces former municipal finance for health care), and variable transfers from the state budget. An agreement was reached in 1998 to prepare a multi-year budget with monitorable indicators, and set a target for maintaining real health expenditure over the period 1999-2001, by earmarking 10 percent of the state budget while maintaining earmarking of 28.4 percent of personal income tax revenues for health. This agreement broke down in FY2000, so that, in practice, the state budget process determines aggregate public health expenditure and can offset movements in the earmarked portion of income tax. Recent budget processes have resulted in unpredictable, short-notice adjustments to health financing.

4.32 In the health care sector, the reforms in health finance are consolidating (and recentralizing) the formerly fragmented municipal/state financing flows at state level into a national social health insurance system, though presentation of public health expenditure continues to reflect the historic split between the special budget (formerly municipal revenue) and the state basic budget (formerly state budget revenue). The special budget (now around 85 percent of public health finance) goes to a State Compulsory Health Insurance Agency (SCHIA), which allocates most of the money among the eight Regional Health Funds (RHFs) for reimbursement of service providers. Prior to reform, the basic budget was allocated entirely to the Ministry of Welfare to directly reimburse a range of specialized public sector health institutions, as well as to finance public health programs and regulatory functions. With the consolidation of responsibility for paying for health care in SCHIA and the RHFs, most of the basic budget has now been transferred to the special budget, with the result that the distinction between the basic budget and the special budget is of little meaning but decreases transparency.

4.33 In the case of the pension fund, reduced revenues and increased expenditures (resulting from exogenous changes, including increased unemployment and unanticipated Parliamentary decisions) required inter-fund transfers and state budgetary loans. As a result, the funding and budgeting of these programs is becoming considerably more complex.

4.34 **Rigid allocative and financing rules also lead to distortions in allocations.** This issue is best exemplified with the financing of the investment budget. An "informal" rule establishes that all investment allocated to the basic budget has to be financed from the Government's own revenue while investment in special budgets can be financed through borrowing. In light of the budget composition, this rule has limited investment in the basic budget without any consideration for policy issues or investment needs.[20]

4.35 **Efficient use of resources is limited**. Capital investment in the health sector is almost entirely dependent on very limited public investment programs. Rationing of capital finance is an obstacle to improved operational efficiency as well as to increased quality. The mechanisms for financing capital do not encourage rational investment. If a particular proposal is approved, it is funded by the public investment program, free of charge to the provider. Moreover, no provision is made for facing public providers with the cost of existing capital, placing private providers at a disadvantage. As a result, the investment costs (including depreciation and opportunity cost of capital) are neither reflected in the price for services nor in the treatment or management decisions of providers. On the other hand, health care providers generally do not retain the proceeds of disposing of surplus assets, though they would face costs and also regulatory barriers if they were to do so. To address these problems, the Ministry of Welfare has begun to develop policy proposals for improving resource allocation for health sector investment, which would introduce incentives for public providers to consider the cost of capital, put public sector providers on a level playing field with private sector providers, link capital spending to service reconfiguration plans, and introduce financial appraisal of investment. This should be done within the limits of the financial envelope allocated to the health sector so that there is no issue of incremental budgeting during the course of the fiscal year. The MoF and MoE need to engage with this work program, as critical stakeholders in this area of policy.

4.36 Line ministries have sought to escape control and rigidities through the proliferation of agencies. During recent years Latvia has followed the example of many other countries and delegated the execution of policies to semi-autonomous public sector agencies. In 2000, there were some 208 of these agencies in Latvia. In light of the above discussion, a number of factors contributed to the rationale for establishing autonomous agencies:

- As discussed above, there was a pull away from over-centralization, which was associated in peoples' minds with the previous regime, and perceived as incompatible with Latvia's endorsement of market reforms.
- There was a perception that public sector performance could not improve under tight controls and rules that were viewed as too rigid. In particular, the line

[20] Note, however, that investment expenditure remains higher in the basic budget than the special budgets. For example, investments in the basic budget were respectively 6 percent, 6 percent and 4 percent of (gross) basic budget expenditure in 1998, 1999 and 2000 respectively, while investments stood at 3 percent, 4 percent and 3 percent respectively of special budget expenditure for the same years.

ministries were anxious to get away from the Ministry of Finance's overbearing control, notably on line item budgeting.

- Line ministries were also anxious to free themselves from the fiscal constraint on wage increases. In particular, as seen above, the compression of the wage scale could not be resolved under the tight fiscal constraint and managers were anxious to improve their own incomes.
- Loopholes in the financial accountability structure allowed agencies to be created without accountability.

4.37 This was done in an ad hoc manner and without having a clearly defined institutional framework of public administration or legislative framework for operations of the agencies, especially financial management, in place. The result is that agencies were given significant autonomy and flexibility while accountability decreased markedly. In fact, the fundamental compact under which agencies are created elsewhere in the world, i.e, on the basis of a *quid pro quo*—more freedom in exchange for more accountability—was lost sight of in the case of Latvia. Predictably, case studies showed that some agencies did indeed improve public sector management, while others engaged in doubtful activities.

4.38 To correct for this shortfall in Latvian legislation, the *Law on the Institutional Framework of Public Administration* and the *Law on Public Sector Agencies* were drafted and submitted to the Saeima for enactment. In the meantime, the Cabinet adopted a moratorium on the creation of public sector agencies until the Saeima had adopted *the Law on Public Sector Agencies*. The *Law on Public Sector Agencies* was enacted in March 2001. The Government has also prepared an implementation plan for the Agency Law.

4.39 The transition arrangements contained in the Agency Law require all 208 (or so) supervised entities to undergo a review process before they are transformed into a recognized agency or privatized, or returned to the regulatory framework for budget-funded entities. The Government is currently preparing the secondary legislation, including the criteria for becoming a recognized agency.[21]

E. Some Consequences of these Weaknesses

Program Budgeting Needs Further Strengthening

4.40 **Program budgets have been adopted by line ministries but further work is needed to improve their effectiveness.** Formally, the Latvian budget uses a program and subprogram structure. This programmatic structure was introduced for all ministries in 1996. A study of the program and subprogram items for the Ministries of Justice and Agriculture indicates that, while the budget appears to be programmatic in format, many of the program categories are simply input category items. The tendency for program and subprogram categories to reflect inputs is compounded by, and partly the result of, the lack of clearly enunciated sectoral goals described

[21] The agency reform efforts have been agreed with and are being monitored by the World Bank in the context of the structural adjustment program. Progress to date has been quite satisfactory. The Government is receiving further technical assistance from PHARE 2000.

in the previous section. In part, this reflects the input nature of program and subprogram items and also, in part, a lack of knowledge and understanding of the nature and use of performance and outcome measures. Since the programs and subprograms are not always designed around objectives, it is difficult to develop meaningful performance measures and indicators (this is discussed in following section). This lack of a true program and subprogram framework negates the principal purpose of such a system, which is to link policy priorities (programs) and targets (planned performance) with budget allocations (to programs) and the measurement of performance (performance measures and indicators).

4.41 Program budgets are not used as part of the budget discussions (see Box 4.5 on Health). As a result, performance measures and indicators are of no use in reviewing program efficiency and effectiveness. The absence of a true program and subprogram framework has significant consequences for the development of performance measures and indicators. An examination of the performance indicators produced for Agriculture and Justice reveals inconsistencies with the performance measures and indicators associated with program budgeting. The indicators simply reflect the quantity of items.

Cash Rationing is Prevalent and Arrears are Developing

4.42 As shown above, inadequate planning, including adoption of new policies during the budget year, combined with budget rigidities and lack of budget comprehensiveness, explain ad hoc budget execution. Additionally, as discussed in the previous chapter, commitment control is not complete. As a result, ministries are faced with unpredictability of resources, while at the same time they have an opportunity to escape from the Ministry of Finance's control by allowing arrears to build up. Both arrears and cash rationing are disruptive of good public expenditure management.

4.43 Overall, arrears have a negative effect on the Government's credibility with suppliers, tend to induce unpredictability in resource funding, and limit incentives for cost effectiveness in management of resources. The process of building up liabilities is not one which can continue indefinitely and is likely to result in some resource pressure on ministries once they can no longer postpone payments. Rolling over expenditure at the level of an individual ministry implies that activities for the current year are partly unfunded, with implications for the Government's ability to manage programs and provide adequate services. Arrears (to suppliers) typically translate into higher premiums and favor corruption in procurement.

4.44 Incentives for managers to pursue cost effectiveness are eroded through the possibility of carrying over liabilities. As shown in the Health PER, cash accounting and inadequate commitment control have given health care providers considerable scope to accumulate debts to suppliers and tax authorities. As long as health care providers have this latitude, incentives to rationalize programs in the health care system remain limited. In fact, it can be argued that the financial situation offers little incentive for decision makers to focus the policy debates on the most important issues (for instance, whether the level of public spending on health should be adjusted. or what kinds of activities should be publicly financed) or to draw upon analysis of the implications of alternative budget choices (choices about what to spend or cut at the margin).

4.45 **To some extent, expenditure reallocations take place during the budget year, even without revenue shortfalls.** Overall, the numbers show that reallocations are relatively contained. The overall burden of revenue shortfalls has been borne by O&M and payment of interest, less so by capital expenditure in 1999 and 2000. However, the numbers also show that even when there was no revenue shortfall (1997 and 1998), the budget was being reallocated between economic categories as well as ministries (basic budget). Given that the overall budget framework is fairly predictable, one of the main explanations for this phenomenon is that the Government considers and approves new policy programs throughout the year, which will be discussed in the next section.

4.46 In Latvia, as in any other country, cuts throughout the year and revised budgets tend to have the following effects on ministries' performance:

- They induce line ministries to inflate the costs and estimates of needs during budget preparation.
- They hamper managers' sense of ownership and accountability for results, particularly if the budget process does not allow for consultations on cuts.

4.47 For many categories of expenditure, the lead times for implementing a change in resource allocation—whether increases or cuts—are a year or more; there are very few expenditure decisions that can be made and realized within a six-month period, and most of these are damaging from a policy perspective. For example, in the health sector, the menu of actions to be taken at short notice without causing other inefficiencies tend to require urgent explicit policy decisions at Cabinet level on such items as: deferring implementation of health sector pay increases without backdating; deferring the start of new capital expenditure projects; deferring the start of any new policy implementation; cutting entitlements to reimbursement, e.g., for prescription drugs; and increasing the levels of existing user fees. The last three items may require changes in legislation in some circumstances—if so, they cannot easily be done inside a six-month time frame.

Box 4.5: Accountability and Incentives: Examples from the Health Sector

In the health sector, late and uncertain budgets undermine the ability to hold health care institutions accountable for living within their annual revenue limits. The response of health institutions to budget constraints in this environment is to defer expenditure in the hope of budget increases later in the fiscal year; and when no increase is forthcoming, health care institutions are able to finance overspending by accumulating debts to tax agencies and suppliers. The MoW and the State Compulsory Health Insurance Agency do not have fully effective mechanisms for holding health care institutions accountable for accommodating budget constraints through efficiency gains, rather than through arrears, output reductions, or shifting the financial burden of care to patients. The institutional foundations for accountability are in place—notably the recent development of audit systems. But the system needs more development, and stronger and more unified commitment from all spending agencies and central ministries. And enforcement mechanisms need to be developed—ultimately the ability to replace the management of public health care institutions. Sizable efficiency gains will require politically difficult decisions to close and downsize hospitals and shed staff.

When budget cuts occur, they are perceived to be determined in an arbitrary way, without explicit analysis or decisions on what outputs will be foregone, or where efficiency gains will be made. Earmarked revenue for health is set on a basis which explicitly does not cover some elements of health care costs, but in the absence of any decision about how these costs will be financed, or any accountability, costs are shifted to consumers in an ad hoc way or financed by arrears.

F. CONCLUSIONS

4.48 This chapter has shown that Latvia's capacity and willingness to reallocate is hampered by certain weaknesses in budget processes as well as in budget structure. The past two years have been marked by the development of arrears, reflecting the Government's difficulty in controlling its resources. Furthermore, the Government's adoption of unfunded policies and proposals tends to increase aggregate spending.

4.49 In all countries, a budget system—good or bad—can endure as long as key actors benefit from it. In Latvia, there has been a proliferation of agencies and the Government has made efforts to rein them in. This shows that when the transparency and accountability mechanisms in place are not fully effective, public resource management may be open to abuse. Fortunately, the Latvian authorities have decided to strengthen checks and balances as a key part of the Government's reforms. The next chapter will discuss the status of checks and balances in Latvia.

5. PERFORMANCE OF PUBLIC EXPENDITURE MANAGEMENT

5.1 When assessing how well the budget system and overall resource management operate in any given country, it is useful to examine outputs or outcome indicators, in order to draw some comparisons between countries and assess their relative performance. This approach does not, however, provide a diagnosis of the reasons why a budget system performs better or worse than average. Thus it is also necessary to analyze the budget system itself in order to understand the issues. This chapter compares Latvia's budgetary performance to that of other countries on a number of sectoral or economic indicators. Indicators drawn from various sectors show uneven performance relative to other transition countries, and to OECD. Factors underlying this varying performance are discussed next.

A. INDICATORS SHOW THAT LATVIA IS PERFORMING BELOW ITS POTENTIAL

5.2 **There is evidence that some sectors[22] are performing below their potential relative to the resources put into them.** Performance measures vary by sector but overall they capture achievements in the sector linked with budget management, notably: (i) cost-efficiency of programs; (ii) effectiveness of programs, including targeting of programs; and (iii) selected program outcomes or outputs.[23]

5.3 **Health.** Health expenditure in Latvia as a percentage of GDP is below that of the EU but compares with the average in Eastern Europe. Between 1996 and 1999, health expenditure grew from about 3.9 percent of GDP to above 4 percent of GDP. However, per capita expenditure is higher than in comparable countries while performance of the health sector trails behind that of the region (except Russia), as shown in Table 5.1.

5.4 The recent World Health Report 2000 (WHO) ranked Latvia 121st out of 187 countries for overall level of health and 105th out of 187 for health system performance.[24] WHO also ranks Latvia very poorly in relation to fairness in financial contributions to health expenditure.

5.5 Health outcomes also compare unfavorably to other countries. Latvia has relatively poor adult health status and relatively high inequality in child survival, both in international comparisons and in comparison with the other Baltic States.[25] Life expectancy fell in the early years of transition, though improvement resumed in 1996. There are indicators which show that Latvia has relatively poor outcomes in areas which can be addressed by allocating resources more effectively within the health system or by other policy interventions. Cardiovascular

[22] Based on the sector analyses prepared by the World Bank and FTI for Health, Social Welfare, Education, Agriculture and Justice.

[23] The links between some outcome indicators and public expenditure management are in some cases tenuous (e.g., in health, outcome indicators such as life expectancy also depend on exogenous factors, such as lifestyle).

[24] For a methodology of performance measurement in the Health sector, see WHO report methodology.

[25] *World Health Report 2000,* World Health Organization.

disease accounts for 56 percent of adult mortality, and could be mitigated by increases in tobacco tax, reduction in production subsidies for foodstuffs high in saturated fat, and better detection and treatment of high blood pressure in primary care. Tuberculosis rates have increased 50 percent since 1987 and, at 60.3 cases per 100,000, Latvia has one of the highest prevalence rates in the region. As of 1987, only 30 percent of those infected were cured and the rate of antibiotic resistance remains very high.

Table 5.1: Performance in the Health Sector (1999)[26]

(Rankings out of 187 WHO Member Countries)	Health Public Expenditure per Capita in Current Dollars	Performance on Level of Health	Overall Health System Performance
Latvia	77	121	105
Estonia	60	115	77
Lithuania	71	93	73
Russian Federation	75	127	130
Belarus	74	116	72

Source: World Health Organization (WHO), World Health Report 2000.

5.6 **Education.** In the Education sector, expenditure is well above comparable countries and has grown as a percentage of GDP[27] (Figure 5.1) while it seems that education sector performance remains well below potential.

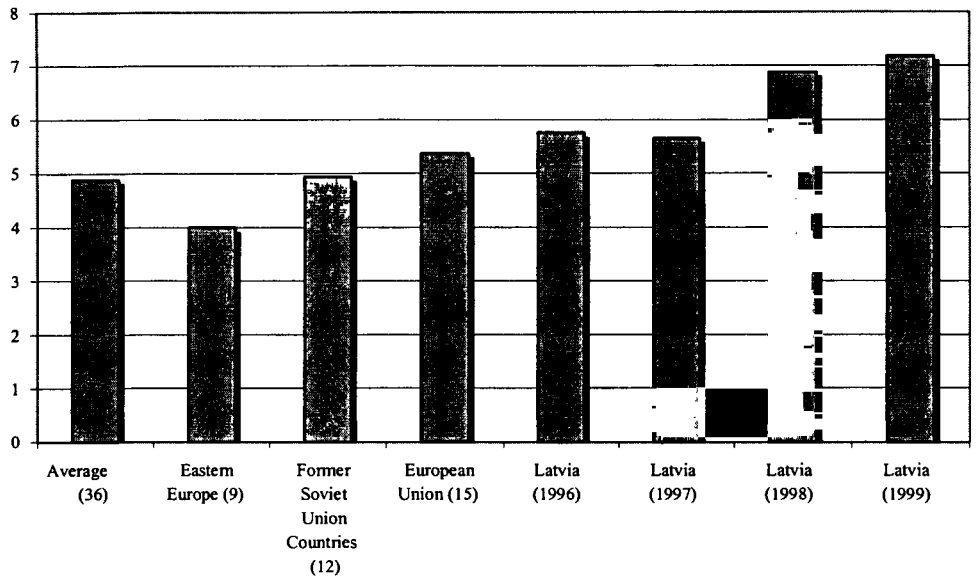
5.7 Time series data on outcomes of the education system, such as student performance, access to and market relevance of education, are not readily available. Scattered evidence, however, suggests that the Latvian education system does not adequately meet its goals.[28] While it also appears that the subsidization of education (while not disaggregated by education level) is only mildly or not at all pro-poor, it is clear that state funding of higher education does not target students in need. Finally, evidence suggests that vocational education poorly prepares students for employment in a modern economy. The 1998 Labor Force Survey shows that 37 percent (14.4 percent vocational, 12.5 percent technical secondary, and 9.3 percent secondary specialized) of job seekers had a technically oriented education degree. A year after, the share of job seekers with vocational education had increased by 2.1 percent points (and 1.2 for technical secondary, and 0.3 for secondary specialized).

[26] This measure is based on an index which reports how efficiently health systems translate expenditure into health as measured by disability-adjusted life expenditure. Performance on this measure is defined as the ratio between achieved levels of health and the levels of health that could be achieved by the most efficient health system. This index is only one imperfect attempt to measure this relationship. But it is borne out by other performance indicators which, although less comprehensive, are easier to measure and interpret. Indicators of low technical efficiency in the hospital system, and a slower rate of improvement in technical efficiency in Latvian hospitals compared to Estonia (which faced a similar legacy) appear in the Appendix of the health analysis.

[27] Including user fees collected by higher institutions.

[28] These goals can be broadly defined as: (a) ensuring universal access to general education; (b) providing state support for the poor; and (c) securing a market-relevant education.

Figure 5.1: Public Education Spending as a Share of GDP



Source: Organization for Economic Co-operation and Development; IMF country database; and Fund staff estimates.

Note: Number of countries or year in parentheses. Data for Eastern Europe and FSU countries refer to 1998; data for European Union refer to 1996.

5.8 **Agriculture.** In the Agriculture sector, there is prime facie evidence that objectives for the sector are not being fully met. The main purpose of the Government's agricultural policy is to establish agriculture "as a sector capable of integration to the European market and producing marketable products capable of competing in terms of quality and production costs." The policy states that this will be achieved through modernization of production, quality control and market promotion. The policy provides detailed analysis of problems in fourteen branches of agriculture (from grain farming to forestry) in which possible measures to resolve problems (usually subsidies) and possible targets are proposed. In most cases the measures tend to prescribe inputs as a means to raise output and quality rather than considering what measures might be taken to generate an environment in which endogenous processes would bring about the desired results.

5.9 One key objective of the Ministry of Agriculture is to contribute to raising productivity in the sector and ensure the transformation of the productive structures through a subsidy program. Evidence points to declining rates of return in the use of public funds, as the share of agriculture in GDP declined dramatically, from 10.8 percent of GDP in 1995 to 4.5 percent in 2000, while the budget has been increasing slightly, from 1.5 percent of GDP in 1997 to 1.9 percent in 2000. Furthermore, as Table 5.2 shows, Latvia and Estonia allocate relatively large portions of the budget to the sector compared with the sector's share in the economy. In agriculture, it would appear that a major reason underlying poor performance in the sector lay with policy design. While policy design cannot be used as a performance indicator, it could be useful to review the main policy components in agriculture and review them against similar programs in OECD countries (e.g., subsidies).

Table 5.2: Comparative Data: Expenditure on Agriculture[1] and Agriculture as Percent of GDP (2000)

	Latvia	Estonia	Lithuania	Poland	Hungary
Exp as % Total Exp.	4.5	2.6	5.9	1.5	2.6
Agriculture as Percent of GDP	4.1	6.3	7.7	3.4	4.1

1/ Including fisheries, forestry, fishing and hunting.
Source: GFS.

5.10 **Justice.** In the Justice sector, evidence shows that the court system is hampered by significant inefficiencies. In particular, there is a large backlog of cases waiting to get into the courts, with the system in Riga particularly overloaded. The average duration of cases brought to court is also inordinately long, with cases in the "first instance" courts outside Riga lasting 2-3 months on average. The main reason for this state of affairs cited by the Ministry of Justice is a lack of judges and other court staff as well as premises.[29] Table 5.3 shows the growing number of outstanding cases, pointing to increasing inefficiencies.

Table 5.3: Workload, County Courts, Number of Cases, 1997-99

Riga	New			Finished			Outstanding		
	1997	1998	1999	1997	1998	1999	1997	1998	1999
Criminal	503	432	608	355	330	327	394	496	777
Criminal	414	538	550	329	392	422	256	402	530
Civil	1536	1122	1031	1409	1233	927	1282	1171	1275
Civil	1601	2263	2784	1340	2080	2324	986	1169	1629
Non-Riga	New			Finished			Outstanding		
	1997	1998	1999	1997	1998	1999	1997	1998	1999
Criminal	539	513	478	535	485	490	93	121	109
Criminal	810	816	782	841	951	788	264	129	123
Civil	1673	1066	834	1377	1136	973	916	846	707
Civil	1002	967	998	1003	1286	1097	643	324	225
Total	New			Finished			Outstanding		
	1997	1998	1999	1997	1998	1999	1997	1998	1999
Criminal	1042	945	1086	890	815	817	487	617	886
Criminal	1224	1354	1332	1170	1343	1210	520	531	653
Civil	3209	2188	1865	2786	2369	1900	2198	2017	1982
Civil	2603	3230	3782	2343	3366	3421	1629	1493	1854

[29] Another reason cited for court delays is the problem of no-shows by witnesses, causing frequent postponements in hearings. The Ministry of Justice claims a major factor contributing to this problem is a shortage of funds for registered postage to summon witnesses to court proceedings. Since there is no proof of receipt of the summons there can be no sanction for non-appearance. However, it should be noted that this argument is somewhat spurious since there is no specific budgetary limit on postage and that in this case a reallocation of resources within operating expenses to postage, by the ministry itself, would have significant multiplier effects in terms of savings in the court system. This example is significant in that it suggests that there little incentive for the line ministries to be creative in finding efficiency savings.

B. IMBALANCED ALLOCATIONS REFLECT SECTOR PERFORMANCE

Inter-Sectoral Composition of Expenditure

5.11 It appears that inter-sectoral allocations are not in line with international comparisons, or, more importantly, with expected outputs in the sector. While the inter-sectoral allocations reflect for the most part the Government's implicit or explicit priorities, they point to over- and under-financing of sectors. For example, Agriculture, as noted above, receives a relatively large share of GDP (and the budget), while the Justice sector seems to be underfunded, at least relative to the required outputs. Table 5.4 also shows the large share of social security and welfare expenditure in Latvia relative to other countries. Numbers for Education may be surprising at first. However, these numbers exclude spending by local governments and user fees collected by higher institutions. Once these are taken into account, Education rises to 7.2 percent of GDP in 1999 and 15.4 percent of total government spending.[30]

5.12 Further analysis of the composition of expenditure will support these preliminary conclusions. While these imbalances alone cannot explain inefficiencies, they may contribute to the low productivity of government programs and raise the question of how the Government should reallocate its resources. In turn, this question raises the issue of allocation mechanisms within the Government and incentives at the sector level for cost efficiency.

Table 5.4: Central Government Expenditures by Function in Central Europe, 2000 (percent of total spending)

	Latvia	Czech Republic	Hungary	Poland	Estonia	Lithuania	Average
Defense	**2.7**	5.0	1.7	4	5.1	4.7	3.9
Education	**5.6**	9.4	6.3	4.7	10.2	5.8	7.0
Health	**10.7**	17.1	4.4	1.5	16.5	15.7	11.0
Social Security/Welfare	**42.1**	37.2	21.9	50.4	31.4	36.8	36.6
Recreational/Culture	**2.1**	1.1	1.3	0.5	4.0	1.9	1.8
Agriculture	**4.5**	2.6	2.6	1.5	2.6	5.9	3.3
Transport/Communication	**5.7**	4.6	3.0	1.4	6.4	5.8	4.5
Other	**26.6**	23.0	58.8	36.0	23.8	23.4	31.9
	100	**100**	**100**	**100**	**100**	**100**	**100**

Source: IMF (GFS).

Economic Composition of Expenditure

5.13 The economic composition of expenditure in Latvia has already shown a very high share of transfers for social security. This is confirmed by Table 5.5 for central government expenditure. Two other issues stand out: the relatively low share of investment expenditure in Latvia and the below-average share of goods and services. Investment-related issues are discussed in the sector PERs and will be discussed in a generic fashion in the rest of the report. While the table points to a central government wage bill in line with comparable countries, the total government wage bill stood in 1998 at 23 percent of expenditure, higher than the regional average. This will be discussed below.

[30] Supported by the Education analysis.

Table 5.5: Economic Composition of Central Government Expenditure, 2000

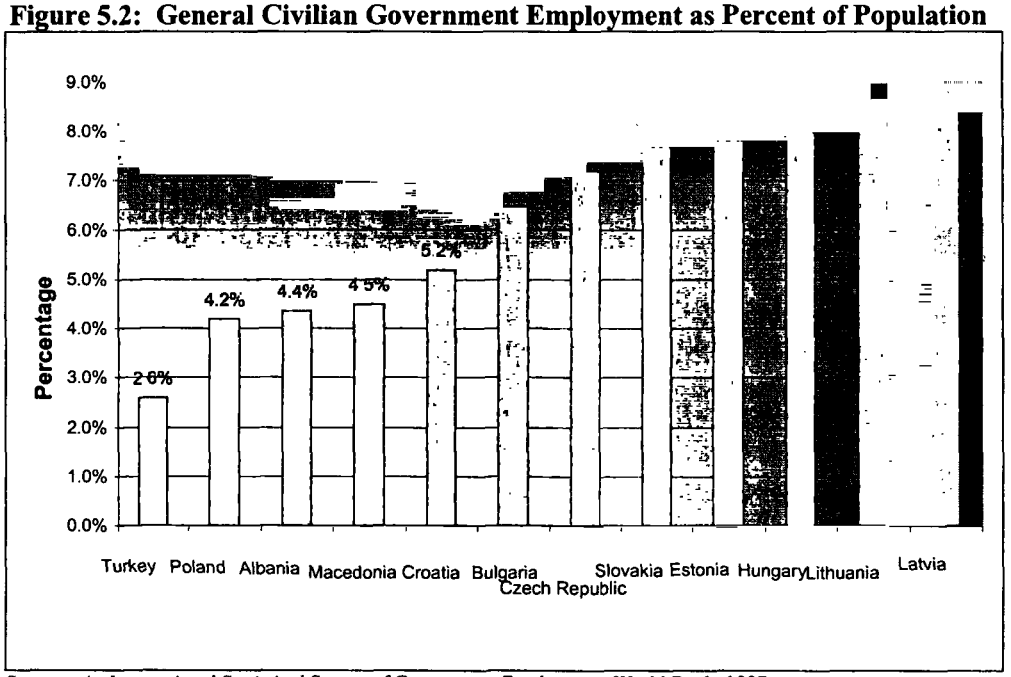
	Latvia	Estonia	Lithuania	Poland	Average
Wages & Salaries	**11.7**	13.6	17.2	8.3	12.7
Goods & Services	**12.7**	32.4	31.4	8.9	21.4
Interest	**3.3**	0.6	6.6	8.5	4.8
Subsidies & Transfers	**64.6**	50.2	43.2	81.2	59.8
Capital Expenditure	**6.9**	6.2	7.8	4.6	6.4
Lending Minus Repayments	**0.9**	-2.9	-6.2	-11.5	-4.9
Total	**100**	100	100	100	100

Source: GFS.

The Wage Bill

5.14 **The level of employment in the budget sector is still relatively high.** In 1997 and 1998, this sector had 84 and 90 employees per 1,000 population respectively,[31] a ratio comparable with other countries in the region, but higher than most other countries, regardless of their degree of development.[32]

Figure 5.2: General Civilian Government Employment as Percent of Population



Source: An International Statistical Survey of Government Employment, World Bank, 1997.

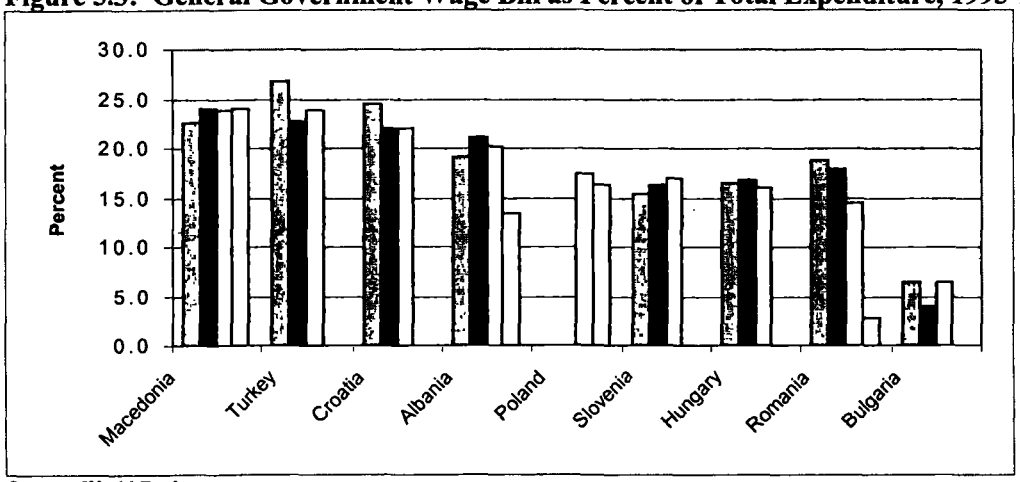
5.15 Currently, the central government has more than 45,000 employees in the ministries, civil service institutions, and central state institutions. For example, Ministry of Agriculture 2000 budget data show almost 11,000 persons employed directly or indirectly by the Ministry. From a strategic viewpoint concerning the fundamental role of government in the economy, this level of public sector employment in this sector seems high.

[31] Employment in public administration, defense and mandatory social security, education, and health services is used to approximate public employment in the budget sector.

[32] For instance, budget-sector employment in the OECD area averages less than 7 percent of the population.

5.16 The wage bill has remained relatively stable as a percentage of total expenditure since 1995. However, at an average of almost 23 percent of total expenditure between 1995 and 1998, the wage bill is on the high side compared to other countries.

Figure 5.3: General Government Wage Bill as Percent of Total Expenditure, 1995-98



Source: World Bank.

5.17 **As a percentage of GDP, Latvia's wage bill is also on the high side and rising.** The wage bill in 1999, at 9.9 percent of GDP gross of social tax obligations, is comparable to OECD countries but higher than in most low- and middle-income countries.[33] Moreover, the share in GDP of the budget-sector wage bill has been gradually increasing in recent years from 8.9 percent of GDP in 1996.

Table 5.6: Consolidated Government Wage Bill

	1994	1995	1996	1997	1998	1999	2000	2001 Budget
As Total Exp (Gross) Percent	17.2	22.0	24.1	22.3	22.9	22.6	22.5	22.8
As Percent of GDP (Net)		7.3	7.0	7.0	7.8	7.8	7.3	7.6
As Percent of GDP (Gross)		9.3	8.9	8.9	9.9	9.9	9.3	9.7

5.18 According to the IMF,[34] average wages (including supplements and bonuses) in public administration, defense, and mandatory social security grew more rapidly during the last five years than wages in the private sector, and in 1999 they were 45 percent higher than the average wage in the private sector.[35] This is shown in Table 5.7. Wages that exceed their free market equilibrium level will lead to inefficient allocation of labor and a potential oversupply of high-quality staff in public service. Conversely, wages that are too low will make it difficult to hire and retain needed staff, contribute to underutilization of other employees, and result in suboptimal provision of public services to society. Latvia's ongoing pay reform effort is

[33] It is important to note that the actual share of the government wage bill in GDP may have been somewhat lower due to likely undervaluation of Latvia's GDP. Likely significant undervaluations of GDP in the transition economies make direct comparisons of various fiscal indicators with OECD countries difficult.

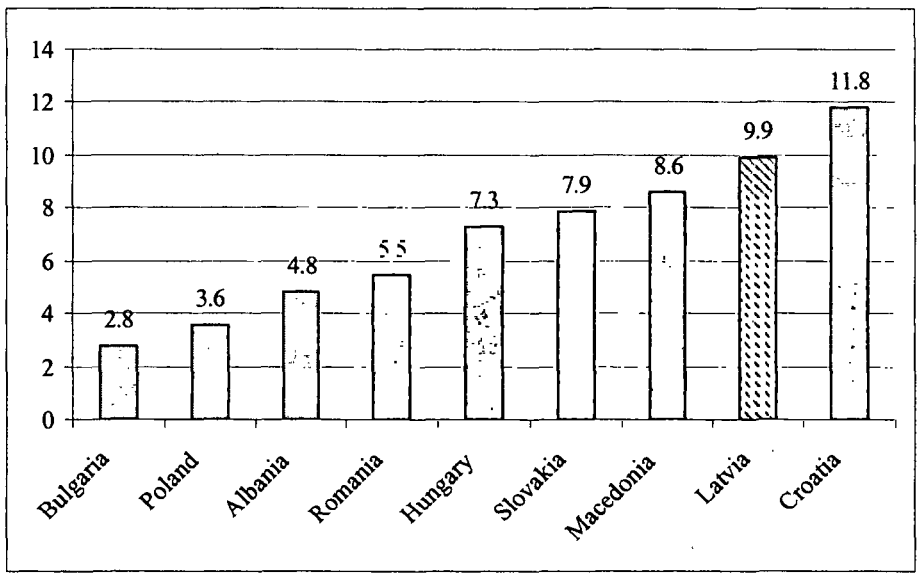
[34] Options for Public Expenditure Management (IMF-FAD), 2000.

[35] Wages in the private sector may be underestimated in the survey, reducing the wage differential. It is less likely, however, that any underestimation can explain the trend.

supposed to address this issue. However, it will be difficult to implement this reform if the wage bill is already large and relative wages are high, particularly in view of the other demands on the budget.

5.19 While in theory the wage scale is compressed, the system of bonuses and promotion has led to fragmentation of the pay scale, which is detrimental to the performance of the state administration as a whole. Government remuneration is based on a graded classification system. The basic salary for each category is expressed as an interval (salary range), and civil servants who have passed civil service examinations are awarded a 25 percent increase over their base pay. However, each institution currently has wide discretion over which positions are included in the civil service.[36] In 2000, the highest base wage was about 3.4 times the lowest base wage.[37]

Figure 5.4 : Wages and Salaries as Percent of GDP, 1998



Source: World Bank, IMF.

5.20 International experience suggests that if the ratio of the highest to the lowest wage is less than 10, then the wage scale is compressed and may therefore not provide sufficient incentives in the system for higher levels of productivity. In addition to basic wages, workers receive supplements for factors such as length of service and efficiency, and can also receive a bonus. A more accurate analysis of compression rates should be based on actual pay (including bonuses) rather than the official wage scale. Findings from surveys of pay[38] indicate indeed that compression is far less significant if based on actual pay.

5.21 These adjustments can lead to an actual compensation that is a multiple of the basic wage. Bonuses and efficiency adjustments are made on the basis of the eligibility of the

[36] According to the Ministry's senior manager, in the Ministry of Finance only directors of departments and their supervisors are included in the civil service. In the Treasury, however, all employees are part of the civil service.
[37] This ratio increases to 4.3 if the highest paid civil servant has passed the civil service examination.
[38] Prepared with the support of the World Bank, 2000

employee as well as the availability of a bonus fund within the ministry or government department.[39] But the capacity to offer bonus and efficiency payments varies among government

Table 5.7: Average Monthly Salary by Type of Activity, 2000 (In lats)

Type of Activity	2000	Percent Change from 1999
Total	149.53	6.1
Public Sector	169.03	7.9
Private Sector	134.86	4.4
Agriculture	114.58	16.4
Fishery	85.85	-18.7
Industry	151.26	3.2
Quarries	152.69	-3.0
Processing Industry	140.53	2.6
Electricity, Power, Gas and Water	235.89	9.6
Construction	133.08	-3.2
Wholesale and Retail Trading	108.20	6.3
Hotels and Restaurants	85.15	4.5
Transportation, Warehouses, and Communications	193.06	3.3
Financial Sector	382.50	14.0
Real Estate	170.51	7.7
Public Administration and Defense	197.85	5.3
Education	135.13	12.7
Health and Social Assistance	124.32	5.0
Recreation, Cultural and Sports	122.93	4.6

Source: Latvian Central Statistics Bureau.

institutions. This can result in differences between the salaries of two equally graded, equally productive employees, thus violating the principle of equal pay for equal work performed under similar conditions. For example, in Agriculture, unexplained wage differentials exist between headquarters and regional posts. Similarly, salaries in the education sector of the agriculture ministry are less than 25 percent of those in headquarters, raising some questions on the quality and value of the education being provided by staff with average wages of less than 100 lats per month.

5.22 **The current pay reform will address wage bill decompression aimed at considerably improving the transparency of the pay structure and linking it with incentives.** The Cabinet has adopted a public sector pay concept that supports the introduction of a broad-banded transparent uniform pay scale, with performance evaluation mechanisms. However, it finds it difficult to grapple with the details of implementation, phasing, and change management. The MoF, which is responsible for drafting the implementing regulations, has asked for assistance from the Bank in order to ensure that these regulations are in line with the concept adopted and will indeed improve the ability of the public sector to retain and improve the motivation of high-quality staff within a career civil service. To be able to analyze the budgetary consequences of the proposed new pay system, the Ministry of Finance carried out a survey of the existing pay structure.

[39] All wages, including bonuses and efficiency adjustments, are taxed. Various privileges received by different categories of staff, such as free transportation, are not subject to taxes.

5.23 This methodology was used during 2000 to collect detailed information on the existing pay structure to serve as a basis for calculating various implementation options. The Ministry of Finance is responsible for working out the implementation regulations by September 2001. It has made significant progress towards finalizing the detailed implementation regulations as it has developed a limited number of options for attaching monetary values to the broad bands and steps, developed options for phasing in the pay scale, and developed an implementation timetable.

5.24 **However, unaddressed by the fiscally neutral pay reform, is the need to scale down the wage bill to make room for other demands on the budget.** The reforms undertaken by the Government to improve prioritization of resource allocations should assist in tackling the wage bill issue as part of each sector dialogue. Diagnoses in the sector analyses (particularly Agriculture, Health, and Education) point to overstaffing, while it would appear prima facie that ministries like the Ministry of Justice lack technical staff (see also below). A process for implementing the sector recommendations is presented in the last chapter of this report.

Intra-Sectoral Allocations of Expenditure

5.25 **Most of the sector PERs show that the intra-sectoral allocations between programs and** categories **of expenditure are unbalanced**. As shown above, wage discrepancies exist within the sector or across sectors for similar functions, capital expenditures seem to be on the low side, and recurrent costs (including maintenance of infrastructure) are underfunded.

5.26 **In Education, allocation of resources is inefficient across levels of education and between economic categories**.

- **Excess number of schools and teachers for general education.** The Latvian education system includes a large number of very small rural schools. In 1999, two-thirds of rural schools enrolled fewer than 75 students. The substantial decrease in enrollment rates in rural areas has further exacerbated the underutilization of facilities and staff.
- **Excessive number of general education teachers, relative to international standards.** The student/teacher ratio in both rural and urban areas is low by international standards. The student/teacher ratio in general education is 12:1 in urban areas and 10:1 in rural areas, compared to 15:1 in OECD countries. Both rural and urban areas have an excessive number of teachers relative to OECD standards. In rural areas, 27 percent of schools have fewer than 9 students per teacher, and 67 percent have between 10 and 12 students per teacher. In urban areas, the student/teacher ratio is low as well, albeit to a lower degree: 15 percent of the schools have 10 to 12 students per teacher and 72 percent of schools have 13 students per teacher.
- **Misallocation of public resources across levels of education.** The education sector commands a large share of the economy's resources but allocates them inefficiently. Spending per student is relatively high and increasing in pre-schools and comprehensive schools, which are administered at the local level, compared to vocational, special and higher-education institutions, which are administered by line

ministries. As can be calculated from Table 5.8, the ratio between lower levels and higher levels increased from 55 percent to 69 percent. This ratio is high compared to other countries (ratios typically vary between 5 percent and 20 percent), but not unusual for transition economies. In the case of Latvia, it can be partly ascribed to the excess personnel noted above.

- Within spending administered at the local level, **the spending on preschools appears to be excessive** with respect to relative needs. Public spending per pupil per year at preschools has increased from 291 lats in 1997 to 508 lats in 1999. Education of children aged 3 to 7 has potentially high social returns, as it can improve performance in subsequent levels of education. However, some preschools are simply day-care centers, accepting children as young as one year of age.

Table 5.8: Public Spending on Education, by School Year

	School Year			
	96-97	**97-98**	**98-99**	**99-00**
	(in millions of lats)			
Public spending	162.6	184.9	246.5	262.7
Total Preschool and Comprehensive Schools	75.4	128.4	172.5	184.2
Preschool	...	19.9	29.6	33.1
Comprehensive Schools	...	108.5	142.9	151.1
Total Vocational, Special, and Higher Education	87.2	56.5	74.0	78.6
	(in lats per year)			
Spending per Student	312	347	455	476
Total Preschool and Comprehensive Schools	177	300	403	432
Preschool	...	291	448	508
Comprehensive Schools	...	301	395	418
Total Vocational, Special, and Higher Education[1]	922	543	648	624

1/ Excludes students of private higher-education institutions.
Source: 1999 Statistical Yearbook of Latvia, Education Institutions in Latvia 1999/2000, Ministry of Finance, and IMF staff estimates.

5.27 In the Health sector, the hospital network is excessive (as measured by beds per population) and there is an oversupply of specialized medical personnel. There has been some progress since transition in rationalizing excess hospital capacity (down from 14.1 to 9.5 beds per 1000 population since 1990), but the pace of progress has been too slow when viewed against the considerable gap between Latvian hospital sector performance and that of the more efficient EU and OECD countries. See Table 5.9.

Table 5.9: Hospital Sector: Allocative Efficiency Indicators

Country	HOSPITAL BEDS PER 1000 POPULATION	AVERAGE LENGTH OF STAY (DAYS)	ADMISSIONS PER 100 POPULATION
Latvia	**9.5**	**12.5**	**21.0**
Lithuania	9.6	11.8	23.9
Estonia	6.0	8.8	17.9
Norway	3.3	6.5	14.7
Sweden	3.1	8.5	16.0
Finland	2.4	4.7	20.5
Denmark	3.6	5.6	18.8

Source: WHO/Europe, Medical Statistics Agencies in Baltic Countries.

5.28 In response to recent fiscal constraints, public hospitals have tended to take short-term measures to defer cash expenditure, rather than long-term measures to increase efficiency. Debts of public hospitals to suppliers rose by 84 percent from 1998 to 1999, and amounted to 4.4 percent of revenue in 1999. There are indications that hospital debts were increasing further in 2000.

5.29 Other data on allocative efficiency are very limited. However, some inputs to health care account for a very low share of expenditure relative to OECD averages, notably capital expenditure and salaries (the latter reflecting in part general labor market conditions, but also relatively low public sector remuneration). As shown in the Health analysis, pharmaceutical expenditure accounts for a relatively high share of public and total health expenditure. Steps are being taken to shift resources to services which are likely to be relatively cost-effective. For example, the State Compulsory Health Insurance Agency's (SCHIA's) contracts with the Regional Health Funds (RHFs) specify a minimum share of resources that must be allocated to primary care (30 percent in 2000, and this percentage has gradually increased by 2-3 percent points in the past two years), and an upper limit on resources which are allocated to secondary and tertiary care.

5.30 In the Agriculture sector, imbalances appear in the ratio between recurrent and capital expenditure (see Table 5.10).

- The recurrent proportion, ranging from 94.4 to 93.3 percent, seems unduly high, particularly in view of forthcoming EU requirements.
- The capital component, ranging from 5.6 to 6.7 percent, appears small, especially when the investment component of capital is only between 2.1 and 3.2 percent.
- The investment component of capital expenditure (38 percent in 2000) is extremely low at present levels, given the declared need to rebuild agricultural infrastructure.

Table 5.10: Recurrent/Capital Mix from 1997 to 2001 (Current Lats)

	1997		1998		1999		2000		2001 Budget	
	Th. Lats	%	Th. Lats	%	Th. Lats	%	Th. Lats	%	Th. Lats	%
Recurrent	47,693	94	65,663	94	65,499	92	67,419	93	71,048	94
Salaries & Wages	20,893	41	22,693	32	24,191	34	19,697	27	16,561	22
Operating Costs	16,515	32	22,141	32	21,966	31	29,774	41	17,418	23
Subsidies	10,285	20	20,830	30	19,341	27	17,948	2	37,069	49
Capital	2,840	5.6	3,632	5.2	5,070	7.2	4,813	6.7	4,437	5.9
Investment	1,079	2.1	1,583	2.3	2,278	3.2	1,825	2.5	1,622	2.1
Other	1,761	3.5	2,049	3.0	2,793	4.0	2,988	4.1	2,815	3.7
Total	50,534	100	69,295	100	70,569	100	72,232	100	75,485	100

Note: Figures refer to actual expenditures in 1997-2000 and budget for 2001.
Source: GoL.

C. FROM ALLOCATIONS TO PUBLIC EXPENDITURE MANAGEMENT ISSUES

5.31 As mentioned above, misallocations are to a large extent a symptom of weaknesses in a public expenditure management system. They constitute the end result of a process beset with multiple shortcomings and can result in performance below potential. In Latvia, these can be narrowed down to the following main issues:

- Well-articulated sector policies with clear objectives, programs, and related fiscal costs are largely absent. As a result, few analytical links between policies and resources exist, and unfunded policies or programs are adopted (e.g., pension measures in 1998). This practice has been favored by the absence of a strong coordinator at the center of government, weaknesses in the line ministries, and fragmentation of administrative responsibilities for budget management. The absence of a medium-term perspective in expenditure management also undermines the link between policies and expenditure and limits incentives for cost efficiency.
- Rigidities in budget structure (earmarking of resources), notably as a large portion of the budget comprises entitlements. This often results from decisions made at the Government level and validated by Parliament. In consequence, budget fungibility to accommodate strategic choices is limited.
- Protracted budget process and little incentive for performance: late and uncertain budgets undermine the ability to hold institutions accountable for living within their annual revenue limits; the response to budget constraints in this environment is to defer expenditure in the hope of budget increases later in the fiscal year.
- Accountability is undermined by imperfect mechanisms for holding institutions accountable for accommodating budget constraints through efficiency gains, rather than through arrears. While institutional foundations for accountability (internal and external audit) are in place, the system needs more development, and stronger and more unified commitment from all of the parties involved to generate effective performance improvements. Enforcement mechanisms also need to be developed.

5.32 Performance of a PEM system can be analyzed by the degree to which it accomplishes these objectives:

- Ensure fiscal discipline;
- Allocate public resources to strategic priorities;
- Ensure operational efficiency; and
- Report accurately and be open to audit scrutiny.

5.33 Fiscal discipline refers to the Government's capacity and willingness to live within an overall budget constraint. Fiscal discipline is enhanced by a strong Ministry of Finance commitment to spending restraint. However, the Ministry of Finance alone is not sufficient to guarantee the outcome. Budget comprehensiveness, adequate control mechanisms, and relatively predictable budget forecasts are important to support fiscal discipline. Equally important is the transparency of the budget and its management.

5.34 Allocation of resources to strategic priorities refers to the Government's willingness and capacity to reallocate its programs. The willingness builds on sound priority-setting mechanisms where programs can truly compete. These mechanisms are to be found at the center of government (usually the Chancellery), and are based on review of policies and programs leading to collective decisions on reallocations. Capacity depends largely on budget comprehensiveness, fungibility and transparency.

5.35 Operational performance refers to the Government's ability to implement programs effectively and efficiently. It relies on adequate incentive structures for the line ministries and

personnel, and it places heavy emphasis on transparency and accountability structures for management of financial and human resources (checks and balances). Equally important, operational performance depends on the Government's capacity and willingness to evaluate program performance.

5.36 The rest of the report will examine the underlying public expenditure management issues in Latvia, which explain the overall performance of the sectors.

6. A BROADER APPROACH TO ACCOUNTABILITY AND TRANSPARENCY

6.1 The Latvian authorities have adopted and begun to implement a medium-term action plan aimed at improving the performance of the entire public sector. The objective is to build public institutions that are responsive to the citizenry and reasonably efficient in the delivery of public services. New rules have been adopted to make their decision-making processes and resultant decisions both more transparent and more predictable. Oversight mechanisms (both internal to the budget system like the Internal Audit Department of the MoF, and independent like the State Audit Office or the Parliament) are being strengthened to guard against arbitrariness and to ensure accountability in the use of public resources. In March 2001, a fiscal module was prepared as part of an IMF Report on the Observance of Standards and Codes (ROSC). The report concluded that "Latvia has achieved many of the basic requirements of fiscal transparency and has identified important steps for further improvement. Among the group of economies in transition, Latvia has been one of the leaders in adopting improved accounting and fiscal practices, and in providing financial markets with relevant information on fiscal activities."

6.2 The public sector reform and anti-corruption program goes beyond the traditional focus on technical, supply-side budget rules, to include demand-side incentives that would foster ownership and promote sustainable changes.[40] Action plans outlined in Latvia's Pre-Accession Economic Program and developed in the Government's sectoral strategies aim at: (i) improving budget management rules, including procurement; (ii) strengthening participation in public affairs to improve the transparency of public decision-making and limit opportunities for discretionary action by government officials; and (iii) broadening the number of providers and eliminating unnecessary regulations and licenses to promote some competition in service delivery. Along with these three dimensions, this section of the report[41] assesses progress made in addressing the issues, shortcomings in the current approach to accountability and transparency, and outlines the remaining agenda.

A. BUDGET MANAGEMENT RULES

6.3 For historical reasons, devolution of financial management responsibilities within the Government preceded development of proper internal controls and financial accountability mechanisms at lower levels. Ministries and their departments have been responsible for all financial management functions between the allotment and payment stages. Moreover, agencies are responsible for managing their own accounts in commercial banks. This system requires an evolved system of internal controls and accountability, which has not been in place for a long time.

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[40] We follow here the approach recommended in *Reforming Public Institutions and Strengthening Governance: A World Bank Strategy*, PREM, November 2000.

[41] This chapter draws from findings of recent World Bank studies on public administration reform and corruption, as well as from the recent IMF report on the fiscal module of the ROSC.

6.4 According to the 2001 fiscal module of the IMF ROSC, **general government is defined according to international statistical principles, but some government functions and modalities need further clarification.** The role and responsibilities of government for fiscal activity are described in legislation including the Constitution of the Republic of Latvia. However, the boundaries between noncommercial, supportive activities of government and the operations of the market economy need clearer definition, in particular with respect to government agencies. In order to improve the implementation of public policies, many government agencies have been created in recent years. These new entities were supposed to lead to greater clarity and accountability. Instead, and in the absence of adequate criteria to define their functions or limit their operations, they have in some instances made budgetary control more difficult. The Latvian authorities are addressing these issues—a stronger legal framework to govern agencies and to integrate them into the budgetary process is under preparation. A *Law on Public Sector Agencies*, which defines the financial and accounting framework for agencies, was enacted in March 2001. Further work is required to establish detailed regulations, to define the types of agency that can be created and the procedures for their creation, and there is a need to take strong administrative action to ensure that the costs of activities performed by all public sector agencies are incorporated in the central and local budgets.

6.5 **Measures to identify off-budget and quasi-fiscal activities are being implemented.** As part of the program of reform leading to EU accession, Latvia has initiated measures to identify all forms of state aid to enterprises with a view to ensuring that state aid conforms to EU limits on such activities. The *Law on Control of State and Local Government Aid* to Entrepreneurial Activity adopted on February 1998 establishes a framework for monitoring state aid. This law is implemented by the State Aid Surveillance Commission, under the chairmanship of the Ministry of Finance (MoF), which has the authority to receive all necessary information from government institutions to identify state aid activities and ensure compatibility with the law. However, as pointed out in the 2001 ROSC, the current process does not cover all forms of off-budget activity and the information that is available is not systematically linked to the budget. All activities that provide assistance to investment or regional development outside the budget process should be fully scrutinized and costs and potential costs to the budget estimated and reported with the budget presentation. The transparency of on-budget assistance to investment and regional development should receive similar attention.

6.6 **The roles of the various branches of government are clearly defined, but some aspects require further refinement.** The roles of the different branches of government (executive, legislative, and judicial) are well established in the Latvian Constitution. In practice however, the distribution of responsibilities is not always optimal. Some areas, such as the role of the Saeima in reviewing State Audit Office (SAO) reports, need to be strengthened so that members of Parliament can assess more effectively the use of public resources. The role of the judiciary is generally recognized as requiring strengthening to ensure its independence from political processes.

6.7 **The legal and administrative framework for fiscal management is satisfactory, but its coverage should be improved.** The IMF ROSC noted that "the *Law on Budget and Financial Management* provides clear guidance on most aspects of budget management for both levels of government consistent with the general principles of legal appropriation given in the

Constitution. It was originally constructed to include all formerly extrabudgetary operations within the budget framework as special funds. However, excessive creation of special funds and earmarking of revenues within this framework has reduced transparency of the budget and fungibility of resources—and hence fiscal policy flexibility—but measures are being taken to reduce special fund operations." The creation of large numbers of government agencies, as noted above (paragraph 6.4), also gave rise to problems of coverage and control, but these problems are being addressed through the introduction of the *Law on Public Agencies*. The authorities agree that action should be taken to ensure that all agencies financed directly by the budget and included as budget-financed institutions (BFIs) comply with budget procedures and Treasury monthly reporting requirements. Similar problems exist and are being addressed for local budgets. The practical problems of implementation are more intractable at the local level because of the large numbers of small units—many with limited administrative capacity.

6.8 **The legal framework for financial control needs improvement**: In 1999, the basic laws and regulations for financial control were the *Law on Budget and Finance Management* (1994, with latest amendment in 1998), the 1992 *Law on Accounting, and Cabinet Regulation* 339 (1996). These acts, mainly developed to regulate other areas, do not together or individually today define a comprehensive and coherent statutory base for financial control.

6.9 The *Organic Budget Law* states that the State Audit Office (SAO) shall give its comments on the annual financial report but defines the control requirements only in very general terms. The *Law on Accounting* established a sound basis for accounting but does not define control requirements. Regulation 339 requires Audit Units to be established in all ministries and, where appropriate, subordinated units. But the main focus of these audit units is to carry out performance type reviews and there is little emphasis on financial control. Procedures for recruitment and dismissal of controllers are not regulated by law.

6.10 The 1992 *Law on Accounting* is the basis for both public and private sector accounting, while the 1994 *Law on Budget and Finance Management* establishes the right of the Ministry of Finance or the Treasury to issue ministerial orders on accounting procedures for budget institutions. In each ministry, the Chief Accountant is responsible for checking commitments and payments (e.g., verifying that funds are available) before signing off, but ex ante control of commitments, payments and proposals is not always systematic. Every spending request must be signed by two people, with each ministry being given discretion to decide who these should be. The Ministry of Finance, via the Treasury, has authority over the accounting procedures to be used in both central and local government and has issued a manual for accounting operations. The accounting system permits a reasonably satisfactory follow-up of projects that are cofinanced with foreign donors. But it does not provide systematic information on the costs of public services.

6.11 Besides monthly reports produced by accounting units in line ministries for the Ministry of Finance, quarterly reports are generated for use by line ministries and the Cabinet. The *Organic Budget Law* prescribes that an annual report for the financial year be produced by May 31 for the State Audit Office (SAO) to analyze. The SAO is required to deliver an opinion to Parliament on this report. The opinion of the SAO, however, does not provide Parliament with an "attestation audit" of the type defined in the INTOSAI Auditing Standards/EU Guidelines,

i.e., a statement of assurance as to the reliability of the accounts and the legality and regularity of the underlying transactions.

6.12 Reviewing the **accounting reports**, the IMF ROSC concluded that they **are reconciled in a timely and effective manner with bank accounts, but recommended further action to extend reconciliation and make accounting practices and policies clear to the public.** Monthly reports covering general government are published no later than 18 days after the end of the month. Year-end reports are submitted to the SAO each year, as required by law. Reconciliation of Treasury ledgers with the Treasury single account at the BoL is undertaken daily and reconciliation details are prepared at the end of each period. Issues that have arisen regarding differing interpretations of government instructions have been resolved. A full reconciliation with BoL sources of financing (covering both deposits and securities) is done, and highlighted in the report. Some improvements could be made in updating reports to show data revisions from previous months. Because of the large numbers of small units at the local level, it will take longer to establish effective procedures for local governments. Accounting is on a cash basis, but consideration is being given to moving toward accrual accounting.

6.13 **Internal Audit is developing from a very low base.** In 1999, the audit function's **control** requirements were fairly general (Organic Budget Law and Regulation 339). There were no independent bodies responsible for carrying out internal audits or inspections. Inspections, which were not primarily financial, were carried out by the Inspection Units in line ministries but their responsibilities were not clearly defined and they were not systematically audited by the state audit authority. As a result, the scope of their work varied across ministries. In 1999, an Internal Audit Department was established in the Ministry of Finance with responsibility for developing and coordinating internal audits in line ministries, and regulations on internal audit were approved by the Cabinet later that year. Over a period of two years, the Government undertook to formalize internal audit procedures based on the coordinating role assigned to the Ministry of Finance, and adopted an Audit Council whose role would be, inter alia, to receive and evaluate internal audits. In 2001, the internal audit at the MoF was fully operational. In a little over two years, the Government also started to develop a modern internal audit system covering all ministries and large departments.

Box 6.1: Internal Control Procedures are in Place and are Being Strengthened

"Internal control structures had been allowed to lapse in the early 1990s and are being reintroduced with an overall emphasis on systems management as well as compliance and regularity audit. Overall coordination is provided by the Internal Audit Department (8 persons) of the MoF and an Internal Audit Council, which is made up of professionals drawn from outside the government sector who are appointed for five-year terms by the Cabinet on the recommendation of the MoF. Internal audit units have been set up for each ministry and subordinate institution. Heads of units are appointed by the state secretary of the ministry or by the institution head and the units report in the first instance to the state secretary. Reports and audit information compiled by the units are made available to the SAO and end-year reports are submitted to the Council. The first such report is being compiled for FY 2000. Technical assistance for internal auditing is being provided by the EU."

Excerpts from the IMF ROSC Report (2001).

6.14 **The Government is tackling procurement reforms.** A 1999 SAO audit observed many systematic breaches of procurement procedures. Legal requirements were not met in awarding contracts; unjustified advance payments were made for works and supplies; financial resources were not spent according to the approved cost estimate. In 2000, the World Bank prepared a

Country Procurement Assessment Report (CPAR) and provided comments to a new procurement law that was being discussed in the parliament. On the base of the CPAR recommendations the Government has initiated a procurement reform program, which is currently being implemented. In 2001 the Parliament passed the new *Public Procurement Law* that incorporates many of the CPAR recommendations and streamlines Latvian procurement procedures in line with EU requirements. The new law has been in force since January 1, 2002. The law also provided for the creation of an autonomous Procurement Supervision Bureau, which has been in operation since January 1 and is being strengthened as suggested in the CPAR. The new bureau is being supported by the EU under twinning arrangements. This support will be important given the challenges associated with strengthening procurement practices for subnational governments to support the anticipated increase in funds flowing to these levels of government, particularly from the EU.

6.15 **External audit needs further strengthening.** The State Audit Office (SAO)—the Valsts Kontrole—is a national judicial public audit body. The *Law on the State Audit Office* of October 1993 (as amended) is the basis for the present structure and operations of the SAO. Under the Law, the Auditor General (head of the SAO) is given independence from the Government by being elected by the Saeima for a seven-year term and reporting directly to the Saeima. Whilst the SAO is subject to some budgetary control by the Government, it is free to decide questions of audit approach and choice of enquiry and to report without restriction or interference from the Government or other bodies it is charged by law to audit. The SAO is organized both as a collegiate decision-making audit body and as an audit office carrying out the audit work and supporting activities. The SAO consists of the Auditor General, the Council of the SAO, the auditing departments, and the Secretariat. The Auditor General has the right to attend Cabinet meetings in an advisory capacity, and SAO officers may attend government meetings at which economic matters are discussed. The Council of the SAO, comprising six members appointed by the Saeima (also for a seven-year term) plus the Auditor General, reviews the work of the SAO and examines complaints. Decisions by the Council may be appealed to the Senate of the Supreme Court. The mandate of the SAO covers all state and local government institutions and permits broad value for money audit. The SAO has a staff of about 200. The SAO's mandate is extremely wide and covers almost all public bodies. The SAO is allowed to examine effectiveness issues, although this aspect of its work is not well developed.

6.16 The independence of the SAO is protected by appropriate constitutional and statutory references,[42] and the arrangements for the appointment, tenure, removal from office and remuneration of the head of the SAO and staff are adequate to provide independence. The SAO is free to decide what work it will carry out, and the work and activities of the SAO are clearly not subject to the interference, direction or control of any other person or authority. The SAO is free to decide the timing and content of its work. The SAO has the power to appoint its own staff and has adequate arrangements for determining their remuneration. Levels of pay are higher than in the rest of the public sector. The SAO does appear to have reasonably adequate means to carry out its functions as presently defined. Budgetary considerations are dealt with in the same way as in government departments. The SAO has a generally competent staff with

[42] The SAO submitted the draft "Law on the State Audit" to Parliament in 2001 to fully comply with the legal system of the EU.

good levels of education and professional experience. However, the SAO does not present its budget proposals directly to Parliament and is not subject to any external audit arrangements.

6.17 The SAO has good access to all the records, persons, assets, premises and data that it requires for the effective performance of its functions and has powers to enforce these legal rights. The SAO carries out several joint audits with private sector auditors of various important state bodies, including the National Bank. However, the scope of the SAO's audits has traditionally been quite narrow and currently confined to mostly a legal approach. In 1998, about 20 percent of public accounts were audited and no follow-up of audits was reported. The SAO's first priority is to establish effective financial and regularity audits. Assistance has been given by OECD/SIGMA in this task and the work of the SAO was favorably reviewed by SIGMA experts. SAO reports have identified a wide range of systematic breaches of procedure (including some aspects of the LPA operations). These findings are made public, but an effective mechanism for follow-up has yet to be established.

6.18 While the SAO has the legal mandate to carry out the full range of audit types set out in the INTOSAI Standards, it does not yet carry out an adequate range of external audit work. In particular the SAO's audit does not cover such matters as: the attestation of financial accountability of accountable entities, involving examination and evaluation of financial records and expression of opinions on financial statements; the audit and review of financial and internal control systems and transactions; or the audit of economy, efficiency and effectiveness issues. The SAO does carry out some minor activities concerning questions of administrative procedure from the public that would perhaps be better for an Ombudsman type body to carry out. However, this is not on a significant scale and is not assessed here as significant. The capacity of the SAO to carry out its mandate with respect to the multiple public agencies and 578 local councils also needs to be examined. The SAO is keen to develop itself as a properly functioning SAI operating to best EU standards. It has demonstrated a clear commitment to change by agreeing to undergo a detailed organizational review by senior experts from member state SAIs, accepting fully the recommendations produced, and demonstrating a willingness, if not yet the capacity, to implement a strategic development plan. It recently set up good and practical mechanisms to introduce priority improvements on a small scale. However, it still needs to build experience, resources and knowledge to undertake significant institution building and process re-engineering. For example, it was reported that the 1998 report was deemed unsatisfactory by the Budget Commission in Parliament (significant progress was noted in 1999, however).

6.19 As a means to develop the SAO's role and scope of activities, the SAO has agreed (in the context of the PSAL) to the following main actions:

- The audit plan for 2001 encompasses an estimated minimum 20 percent of basic and special budgets.
- SAO undertakes to audit the accounting/reporting standards of the Central Budget institutions under SAO's purview.
- Implementation of an action plan to strengthen state audit functions on financial management.

6.20 In addition, the SAO has substantially increased audits of local governments in 2001 and intends to focus its audits more on special budgets, starting with health and pensions.

6.21 **While the SAO is being strengthened, issues of effectiveness in follow-up need to be addressed.** Parliament does not exercise its role in reviewing audits and calling on the Executive. There is no Parliamentary (Audit) Committee that is specifically responsible for considering in detail the reports of the SAO. In principle, any parliamentary committee may take an interest in the SAO's reports and there has been a lot of interest in some of their work. However, there are no formal arrangements for reporting and follow-up of the work by Parliament and the Government. Whilst it is evident that Parliament is very interested in the work and reports of the SAO, there is little, if any, organized follow-up and review of actions taken by the Government. Nor does the SAO have rigorous follow-up on whether its recommendations and those of Parliament are implemented by the Government. If there is any follow-up it is during the next audit work in the particular area. The SAO does not produce specific guidelines or advice on best practices following its work but it does publish a quarterly magazine giving details on what it has been doing.

Box 6.2: Functions of the Public Accounts Committee

Examine the accounts of Government receipts and expenditures including the financial statements given to the Auditor General:

a) Examine the financial affairs of Government authorities;
b) Examine all reports of the Auditor General (including reports on the results of performance audits) that are submitted to Parliament;
c) Report to Parliament, with such comments as it thinks fit, on any items or matters in those accounts, statements and reports, or any circumstances connected with them, that the Committee thinks should be drawn to the attention of Parliament;
d) Report to Parliament any changes which the Committee thinks desirable in: the form of the public accounts or in the method of keeping them; or the mode of receipt, control, issue or payment of public monies;
e) Inquire into any question connected with the public accounts which is referred to the Committee by Parliament, and report to Parliament upon that question;
f) Consider: the operations of the Audit Office; the resources of the Audit Office, including funding, staff, and information technology; and reports of the Independent Auditor on operations of the Audit Office;
g) Report to Parliament on any matter arising out of the Committee's consideration of the matters listed in paragraph (g), or on any other matter relating to the Auditor General's functions and powers, that the Committee considers should be drawn to the attention of Parliament;
h) Report to Parliament on the performance of the Audit Office at any time;
i) Consider draft estimates for the Audit Office;
j) Consider the level of fees determined by the Auditor General;
k) Make recommendations to Parliament on draft estimates referred to in paragraph (i) ;
l) Determine the audit priorities of Parliament and advise the Auditor General of those priorities; and
m) Determine the audit priorities of Parliament for audits of the Audit Office and advise the Auditor General of those priorities.

6.22 Box 6.2 represents the functions of PAC as agreed two years ago. The necessity of establishing a Public Accounts Committee (PAC) in Parliament was agreed by the Parliamentary Budget Commission, the Auditor General and the Government during structural adjustment program discussions two years ago. There has been no progress in this area over the last two years. In fact, forming a Public Accounts Committee has dropped from Parliament's agenda. A simple way of introducing the PAC could be to add it to the tasks and statutes of the Budget Commission, which would require only a few changes to Parliament's rules of procedure. This could be done at the same time as the State Audit Office submits the changes to its law and discussed as part of the 2002 budget package.

6.23 In some sectors (e.g., health), where performance-based contracts form the basis for budgeting, weak accountability poses serious problems. In health, financial and other data are collected about health care providers by the MoH, SCHIA, RHFs, municipalities and other supervisory agencies, but the data are not integrated into a consistent, reliable database, nor are they analyzed to assess provider performance or used to ensure accountability. Fragmentation of hospital ownership makes implementation difficult. The internal audit system in SCHIA is still in a developmental phase. Adequate staffing and resourcing of this function should be given priority. There are gaps in implementation of audit requirements at the municipality level for the majority of hospitals which are municipally owned.

6.24 **There is a need for better coordination of the budget with fiscal and economic policy.** The Latvian authorities acknowledge that greater clarity is required in defining the roles of the State Chancellery, the Public Administration Reform Bureau, the Ministry of Economy, and the MoF in coordinating government and legislative formulation of policies and budget planning. The IMF has pointed out that separation of recurrent budget management (by the MoF) and investment budget planning by the Ministry of Economy makes it difficult to budget for recurrent costs of investments, particularly over the medium term. The role of the Ministry

Box 6.3: Accountability and Governance for Public Hospitals

Latvia's hospitals are autonomous public sector agencies at either state or municipal level. Many EU countries have a long tradition of autonomous hospitals, with diversity of hospital ownership (commonly including municipal ownership, ownership by religious and other non-profit organizations, and ownership by universities). These countries frequently use regulatory mechanisms and/or a state investment program to exercise control over capacity and configuration of the health system. A small number of OECD countries have introduced hospital autonomy or corporatized hospitals which were formally state owned—as Latvia has—including the United Kingdom, parts of Australia, New Zealand, Singapore and Hong Kong. These "Anglo" countries have generally placed greater emphasis than Latvia has on public accountability mechanisms, including monitoring and performance management systems for the autonomous hospitals, and on developing appropriate financial incentives and financing mechanisms for capital investment. Latvia has a number of separate mechanisms for collecting data from providers, for reporting, monitoring and regulation purposes. In fact, the multiplicity of such mechanisms may reduce their effectiveness as well as duplicating scarce resources. Clarification of lines of accountability for health care providers, and consolidation of monitoring and analysis of performance could well improve the capacity of the system to improve provider performance.

of Economy in recommending foreign investment projects that can claim tax breaks under the Corporate Income Tax Law or otherwise attracting investment funds through concessionary arrangements also needs to be clearly defined and coordinated with budget decision-making, given the fiscal implications of such decisions. These issues should be addressed in the context of a medium-term budget planning framework, and development of such a framework constitutes an important element of the public administration reforms being supported by the World Bank PSAL agenda and the EU.

B. Participation in Public Affairs to Improve Transparency

6.25 **Information on public finance management is made available to the public.** The budget documents provide a detailed explanation of state budget revenues and expenditures, but further strengthening is required on financing and general government data. State budget estimates are available, with satisfactory supporting documents to explain the annual estimates of

expenditure and revenue. The estimated outturn for the previous year and actual outturns for the two preceding years are provided. Estimates for future years are provided by ministries in the course of budget preparation, but the budget documents do not yet include estimates of spending beyond the budget year. A summary of the consolidated general government expenditure, revenue, and the overall balance is included in the National Budget summary document. Up to 2001, information and analysis of sources of financing for the deficit/surplus, however, were not provided in the budget documents for either central or consolidated general government. Data on financing were provided in the Treasury monthly reports, but these were not reconciled with the Bank of Latvia (BoL) data. As already noted, fiscal activities carried out by agencies at central and local level are not yet fully covered. Given the expected delay in passage of the required legislation, administrative action to include these in future budgets and within-year reports would be highly desirable.

6.26 **Data on contingent liabilities, tax expenditures, and quasi-fiscal activities are reported, but not yet fully integrated with the budget or accounting reports.** According to the 2001 fiscal module of the IMF ROSC, "the annual budget sets an overall ceiling on government borrowing and guarantees, and an annex giving these limits for central and local borrowing and issuance of guarantees is included in the annual budget. The State Treasury includes aggregate data on government guarantees issued by central government and local government in its monthly Treasury report. In addition to guarantees, this report should aim to disclose all forms of contingent liability arising from government transactions. Data on state aid to enterprises, covering the range of guarantees, tax expenditures, and quasi-fiscal activities, are collected and published by the State Aid Surveillance Commission each year. The Commission produces an annual report to the European Commission that is available to the public. As yet, this process is not linked to the budget and it does not cover the full range of subsidies, tax expenditure, or quasi-fiscal activities carried out by the Government. It has, however, established a process of analysis and reporting that could be developed and applied as part of the annual budget. The annual budget makes only a small provision for contingencies that may be called, giving rise to possible recourse to supplementary budgets during the year to meet such expenses."

6.27 **Information on public debt is available.** The monthly report of the State Treasury provides up-to-date data on public debt and guarantees issued. A summary of government securities issued to date is also provided in the MoF's monthly publication Survey of the State Budget. Both publications are available through the MoF's website. Debt data are also available from the BoL and the Central Statistical Bureau of Latvia's monthly publication Monthly Bulletin of Latvian Statistics. According to the 2001 fiscal module of the IMF ROSC, Latvia subscribes to the IMF Special Data Dissemination Standard and meets these requirements with respect to debt reporting.

6.28 The legal framework governing intergovernmental fiscal relationships has been established, but further development of fiscal responsibilities at the local and regional levels is needed. Fiscal relationships between national and local governments are largely defined in the *Law on Local Government Budgets* of April 1995, the Law on Equalization of Local Government Finances, and the *Law on Budget and Financial Management* of March 1994 (or as subsequently amended in each case). However, there is continuing debate on the role of regional administration vis-à-vis the State, and the need to rationalize and strengthen local administration

is recognized. Revenue and expenditure assignments to local authorities are specified under the self-government law. There is a substantial vertical imbalance (shared taxes and intergovernmental transfers accounted for 77 percent of local government revenue in 1998), and local sources of revenue are inadequate for the towns and pagasts with lower revenue-raising capacities to meet expenditure needs. The gap in local financing for less well-off municipalities is closed through an Equalization Fund that is financed through contributions from richer councils and the central government. The mechanism achieves its objectives and shows clearly the relative contributions to equalization, but the formula used is complex and it is recognized that the longer-term objectives for establishing local fiscal sustainability require further clarification. In this context, the authorities are exploring mechanisms to amalgamate smaller councils and/or to establish a regional administration based on a smaller number of regions.

6.29 **The framework for local borrowing requires further definition of objectives.** Local capacity constraints and aggregate control concerns have led to stricter controls being applied to local borrowing in recent years. *The Law on Local Government Budgets* gives local councils the right to borrow and issue municipal bonds. In February 1997, however, a regulation was introduced taking away the authority of local governments to undertake either domestic or international borrowing without the approval and, in the case of external loans, guarantee of the national government. Total local borrowing is overseen by an interministerial Council for Loans and Guarantees. Local governments now borrow from the Treasury, which adds 50 basis points to market borrowings for on-lending to local authorities. The Local Government Financial Stabilization Act of May 1998 applies a financial stabilization process to councils that are unable to meet their obligations. In the longer term, the framework needs to be reviewed to meet broader objectives, eventually allowing viable municipalities to establish their own market credentials while retaining a strong framework of aggregate control.

C. Competitive Pressure and Regulations

6.30 According to Latvia's Pre-Accession Economic Program, "the goal of the competition policy is to prevent such a level of market concentration that may be critical for the consumer due to dominating enterprises and a market structure that does not provide sufficiently efficient competition." The backbone of the competition policy in Latvia is formed by the legal basis, which is similar to legal norms of competition applicable in the European Union and other OECD countries. Among the major provisions are:

- prohibited agreements—including, but not limited to, agreements between enterprises, coordinated activities, and decisions of enterprise associations with the object or consequence of limiting or hindering competition or distorting the market—are deemed automatically null and void. At the same time, the Law stipulates that such prohibition may not apply if the agreement provides significant benefits for production, trade, or economic progress or for consumers and does not completely preclude competition in the market;
- prohibition of abuse of an enterprise's dominant position in the market. No exceptions have been envisaged for application of this prohibition;
- procedure for monitoring business mergers, determination of what types of activities are deemed to constitute mergers, criteria according to which enterprises should

report a planned merger to the supervising institution, and criteria the supervising institution should follow in permitting or prohibiting a merger.

6.31 The legal basis envisages transparency of the competition supervision system, obliging the supervising institution to hold hearings on the suspected offender, to receive opinions from other market participants, and to publish decisions. The cornerstone of the competition policy is efficient application of the law, safeguarding the rights of any market participant to conduct business under conditions of free and equal competition. The supervision functions are performed by the Competition Council; under the law this Council has the rights and obligations of a state administrative institution as well as responsibilities in the sphere of competition supervision.

6.32 Latvia has made progress in the implementation of competition policy—the legal basis has been established and the supervising institution is in operation. But progress can only be fully assessed in the long term, by analyzing the efficiency with which the law is applied in terms of the number of violations detected, the results of litigation, and by analyzing the introduction of competition and observing results in sectors of the economy where high market concentration persists as a result of various administrative and other constraints. Legislation in the sphere of competition protection will further be based on norms similar to those existing in the European Union and other OECD countries which are implementing an active competition protection policy. The main principles, which will be further embodied in the legislation, will include:

- prohibition of abuse of a dominant position by market participants;
- prohibition of agreements among market participants with the aim or consequence of hindering, limiting or distorting competition;
- limiting of market concentration by controlling mergers and acquisitions among market participants;
- prohibition of unfair competition.

6.33 In Latvia, the authorities have determined that it is economically reasonable to have limited competition with regulation in individual economic sectors where sophisticated infrastructure is necessary for producing goods and delivering services. These sectors are: energy, telecommunications, postal services, railway transportation, water supply and sewerage services, and waste management. Regulation involves licensing of monopolies providing public services, in the interest of the public, by specifying requirements for quality of services (goods), safety, stability, and impact on the environment and on humans.

6.34 **The regulatory system in Latvia needs improvement**. The Cabinet adopted the Public Services Regulatory Outline in 1999. The object was to achieve efficient operation of the independent regulators before privatization of the aforementioned sector monopolies—the providers of public services. The *Law on Regulators of Public Services* was approved by Parliament on October 19, 2000 and took effect on June 1, 2001. Separate provisions of the law dealing with the appointment of officials to the Public Services Regulatory Commission (state regulator) took effect on March 1, 2001. The aim of the *Law on Regulators of Public Services* is to ensure that users of public services receive safe and high-quality public services with tariffs (prices) corresponding to economically justifiable costs, as well as to promote economically

justifiable competition and development in the regulated sectors. An independent Regulator has been appointed and her main tasks are as follows:

- To protect consumers' rights so that high-quality services are provided at justifiable tariffs and disputes between the monopolies and the consumers are settled as necessary;
- To protect investors from economically unjustifiable (socially oriented) government decisions;
- To encourage efficiency in the aforementioned sectors as well as to promote inter-sectoral cooperation and coordination.

6.35 The Law envisages establishment of a two-tier regulatory system, separating **state-regulated sectors** (where the types of regulated public services will be determined by the Cabinet):

- Energy, except heat supply where no electricity is produced in the production process;
- Telecommunications;
- Postal services;
- Ports;
- Railway transportation (including passenger carriage by rail);

and **municipality-regulated sectors** (where the types of regulated public services will be determined by the municipalities in question):

- Household waste management except for household waste processing;
- Water supply and sewerage services;
- Heat supply where no electricity is produced in the production process.

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6.36 **To ensure strong implementation of the regulatory framework, ethical standards have been set for public officials, but there are implementation issues.** The *Law on Prevention of Corruption* of September 1995 sets broad ethical standards for public officials, covering all elected officials, parliamentarians, statutory appointees, and civil servants, including, under specified conditions, relatives and former public officials. It prohibits activities that may generate conflict of interest and requires a declaration of income and assets. Recent amendments to the Law make illicit enrichment an offense. An interministerial Corruption Prevention Council (CPC), chaired by the Minister of Justice, is responsible for overseeing implementation of the program and its further elaboration. More work is needed, however, to implement these measures. An Anti-Corruption Unit, formed within the State Revenue Service to help implement the income and asset declaration process, has been set up. Because of its lack of investigative powers, the unit is not yet operating effectively with regard to verifying the legitimacy of public officials' income; in other respects the unit is helping to increase openness with regard to activities of public officials. Consideration is being given to creating an Anti-Corruption Bureau with executive powers under the Ministry of Justice, replacing the Executive Secretariat of the CPC and absorbing the SRS anti-corruption unit.

Box 6.4. Combating Corruption in Latvia

An effective fight against corruption remains a leading priority of the Latvian authorities. In its recent report on corruption in transition countries, the World Bank assessed the level of administrative corruption in Latvia as the second lowest among the countries surveyed. The USA Helsinki Commission recognizes that Latvia openly discusses the corruption issue and actively involves international organizations and NGOs in corruption prevention and promotion of transparency. Transparency International has also acknowledged that corruption in Latvia is not out of proportion.

The system for preventing and fighting corruption has been significantly improved: the anti-corruption policy framework is in place, institutions are already established and are being further strengthened, legislation continues to be improved, and society is being actively involved in prevention efforts. On May 15, 2001, the Government adopted the renewed **Corruption Prevention Program**. With a view to streamlining anti-corruption policy, it provides for the implementation of measures such as protection of whistleblowers, improvement of criminal procedure in conformity with anti-corruption requirements, improvement of internal audit, and improvement of the system for the financing of political parties. The institutional set-up for the fight against corruption has been in place since 1997. The *Law on Corruption Prevention* has regulated corruption prevention in the public sector since 1995. To complete the overall legal and institutional framework, the implementation of new initiatives is being enforced.

Latvia has also started to implement new initiatives in the areas of party financing, the institutional set-up for the fight against corruption, and drafting amendments to the *Anti-Corruption Law* according to the Draft Paper on Corruption Prevention (adopted on August 8, 2000 and supplementing the CPP). The Government is committed to further improving the legal framework and its implementation. At present, the *Draft Law on the Financing of Political Parties* has been submitted by the Government. It provides for direct State financing and establishes a control mechanism to oversee the financial activities of political parties. The *Draft Law on the Anti-Corruption Bureau* is being prepared for submission to the Government. It foresees the establishment of a central institutional responsible for fighting corruption in the country. The new *Law on the Prevention of Conflicts* of Interest in Public Institutions has been drafted in order to improve the oversight of public officials. It will replace the existing *Law on Corruption Prevention*. Furthermore, the principles of initial fixation of property and legal presumption have been elaborated. Latvia is committed to continuing alignment with international anti-corruption instruments. The Council of Europe Criminal Law Convention was ratified on December 7, 2000. The amendments to the Criminal Law necessary for the implementation of the Convention have been adopted by Parliament at the second reading. The amendments are also in conformity with the OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions and other international instruments. The OECD Convention will be signed as soon as the OECD Working Group on Bribery finishes examination of the Latvian anti-corruption legislation.

Concrete results have been achieved in the implementation of anti-corruption policy. Amendments to the *Law on Public Procurement* provide for the publication of public procurement offers on the Internet. Amendments to the Law on Managing State Shares in Enterprises provide that state proxies must be nominated in an open competition. The Strategy for Fighting Corruption among Public Officials has been elaborated to raise the efficacy of anti-corruption measures. Proper and efficient functioning of public administration and prevention of corruption are being promoted by ensuring internal audit within the ministries.

Surveys of public perception of corruption indicate that the most corruption-prone sectors are the Customs and the Highway Police. In reaction to public opinion, special anti-corruption action plans are being implemented within the State Revenue Service and the State Police. Since October 2000, the State Police has been recording all violations in a joint database, while fines for traffic violations are payable by money transfer. The rotation principle among customs officials has been enforced. Unified technological schemes have been developed for all customs points providing a clear division of competencies among the institutions involved. Video-monitoring systems are in place at the airport and at major customs points. During the year 2000, 16 internal audits were carried out in different regional units of the SRS. A special expert in corruption prevention matters in SRS will be appointed before the end of 2001. The Institute of Foreign Affairs of Latvia, in its recent report, recognizes that corruption in the court system is insignificant.

Box 6.4. Combating Corruption in Latvia (continued)

Over the last year, five individuals were sentenced for passive bribery, six for active bribery and thirteen for abuse of official status. In 2000, 4.8 percent (instead of the obligatory 2 percent) of public officials' financial declarations were reviewed in accordance with the *Corruption Prevention Law*, resulting in administrative sanctions for 287 public officials. The Security Police, a special squad dealing with corruption in law enforcement institutions that was established in April 2000, initiated nine criminal cases during the year 2000 and three additional cases as of mid-2001. The non-governmental organization Delna takes an active role in promoting transparency in public bodies. Since January 2001, Delna has been monitoring the privatization process in the Latvian Shipping Company. The new *Law on Procurement for Government and Municipal Needs* has been elaborated following Delna's recommendations. The Government is pursuing an active seminar policy in cooperation with international donors to raise public awareness and involvement in corruption prevention. In the framework of the PHARE project Program for Anti-Corruption Legislation, Education and Information, the educational project Together against Corruption has been launched in schools across Latvia. A number of seminars concerning the investigation of corruption cases have been held for judges, prosecutors, police officers and representatives of the mass media.

6.37 **The privatization process has become more transparent but continued monitoring of the use of the receipts is needed.** The Latvian Privatization Agency (LPA) was set up in 1994 to improve accountability and focus of the Government's privatization program, which had previously been carried out in a decentralized way by individual ministries. The LPA, while experiencing some difficulties, has been largely successful in achieving these objectives. During its six years of existence, more than 1,000 companies and properties have been privatized and public offerings of shares have been taken up for 85 formerly government-owned companies. The LPA has made efforts to keep the general public, the legislature, and the government informed on how, to whom, and under what conditions state property is being sold. More recently, it has also reduced possibilities of political interference by relying on reputable financial advisors to help steer divestiture and by opening the process to independent scrutiny. It is highly desirable that this level of transparency be maintained. However, the LPA's operations have been expanded, mainly through decisions of the Cabinet, beyond management of privatization. It now plays an important social role in spending for social tax and salaries of laid-off workers and has extended support to enterprises facing short-term financial difficulties, and has been used to carry out spending outside the budget. It is important to avoid recurrence of such activities, which reduce budget transparency and aggregate control.

7. CONCLUSIONS AND RECOMMENDATIONS

7.1 Latvia's public expenditure management system presents an interesting contrast as it seems to oscillate between too little control and too much.

7.2 On the one hand, Latvia's fiscal performance has been in many respects remarkable when measured in terms of deficit reduction. But this achievement has come at a cost. Cash rationing has led to unpredictability of resources for the line ministries, leading them to resort to arrears, which has in turn strongly discouraged performance. Similarly, fairly rigid rules on financing and allocations have constrained real policy decisions, while forcing cuts on a limited number of expenditure items when shocks occur or decisions to reallocate take place.

7.3 On the other hand, the fragmentation of the budget—with the existence of several budgets, off-budget funds, earmarking and own revenue—has led to a fragmentation of policy decisions, a disjointed budget process, and limited fungibility of resources, providing a further disincentive to place policies at the center of budget decisions.

7.4 These weaknesses reveal the nature of relations between the Ministry of Finance and the line ministries. The Ministry of Finance is de facto placed in an oversight position when it requires that past expenditure and additional funds be justified. When government revenues are expected to be below projections, the Ministry of Finance proposes amendments to the national budget, which are discussed and adopted at the level of a Cabinet meeting. The line ministries, however, have been able to escape control: over the span of just a few years, the creation of some 208 agencies with almost complete autonomy and limited accountability has provided line ministries with plenty of hiding places from Ministry of Finance oversight. Lack of transparency in wage-setting rules has allowed a fair amount of discretion, and limited enforcement of accountability mechanisms has allowed line ministries to avoid difficult choices, notably by building arrears in some sectors.

7.5 These developments have been allowed to occur in the absence of a clear two-way relationship between the Ministry of Finance and the line ministries. As a result, the budget process has been voided of content, with policies and performance remaining outside the realm of the negotiations. The other facets of the fragmented system have also been allowed to endure, including the absence of a real forum for policy review and discussion (the Cabinet), resulting for example in the adoption of unfunded policies and programs.

7.6 While it can be readily seen that such a system would lead to unsatisfactory outcomes, it should also be stressed that it could jeopardize even Latvia's best achievement so far: fiscal discipline. Indeed, the disjointed decision-making system (unfunded commitments) has generated pressure on the budget, while arrears are allowed to develop and threaten the Government's credibility. As was seen in 2000, in the absence of a satisfactory process for policy negotiations and resource trade-offs within the Government, the political commitment to stick to fiscal discipline may weaken in the face of mounting pressures on the budget.

7.7 The Government has already started on an ambitious public sector reform agenda. Additional support for this program comes from the Government's commitment toward EU accession and the realization that public sector management needs to be brought into line with EU standards.

7.8 The PER provides some background to reforms already undertaken or agreed for the medium term. There should be no surprise, therefore, to find below some recommendations already adopted by the Government. Recommendations will be focused on the short term (2001-2002). Medium-term recommendations can be found in the Annex and in other reports prepared by PHRD-financed consultants and the IMF ROSC.

7.9 Two objectives underlie the recommendations. First, they seek to address immediate pressures on the budget, as well as the issue of arrears. Second, they aim to lay the foundations for the MTEF through sequencing of actions. Detailed recommendations for the medium term on: (i) priority setting; (ii) the budget process, and (iii) strategic prioritization can be found in the Annex, where a longer-term version of achievements under the MTEF is presented.

A. Addressing Budget Pressures

7.10 Chapter 5 has shown that fiscal discipline in Latvia will, in the short term, come under mounting pressure due to the sizable commitments the Government has undertaken toward EU (and perhaps NATO) accession as well as pension reforms. At the same time, the Government is committed to an overall balanced budget. Unless the reform agenda is implemented quickly, the Government will be confronted with the difficulties of prioritization discussed in the PER, and fiscal pressure will increase substantially.

B. Quantify main policy commitments

7.11 The GoL has started to estimate the fiscal requirements for EU accession over the medium term. This exercise is very important to determine the size of the fiscal needs, and therefore the trade-offs faced.[43] Similarly, the Government has adopted a package of measures related to pension reforms, including the introduction of a second and third pillar, curbing early retirement and regulating future indexation as well as introducing pension benefits for working pensioners who continue to work. All these commitments should be quantified before the end of the 2003 budget process. In all likelihood, the Government will find that funding these commitments will require some expenditure trade-offs without changes in the overall fiscal constraint. It is suggested that the Government proceed immediately to explore possibilities for cutting expenditure programs and/or accelerating reforms toward cost effectiveness in selected sectors. As mentioned above (and discussed in more detail in the sector PERs), the primary targets are:

- the wage bill, which is relatively high
- excess staffing in health (hospitals) and general education
- agriculture programs which could be streamlined.

[43] The GoL may also have developed some estimates of the fiscal needs for NATO accession.

7.12 While Latvia's 2002 budget process is already underway,[44] the Government can and, in fact, is proceeding with the development of its medium-term priorities for Cabinet consideration. Despite the fact that key spending decisions have already been made, particularly in terms of the base budget for 2002, **it is strongly recommended that the Cabinet also consider at this time reserving some additional allocation for priority initiatives. These should be included in the budget priority statement.** It is still early enough in the process to allocate savings targets to ministries. By doing so, the Government would be able to demonstrate that it is taking concrete action in the 2002 budget to address its priorities, as a first step toward implementing more comprehensive planning reforms for 2003. The 2003 process will also benefit from the experience gained. The more concrete actions are taken now, the sooner the reforms will become institutionalized.

7.13 Even if the Cabinet chooses not to set aside an allocation for new priority initiatives at this time, once these priorities are approved, the Chancellery, along with the Ministry of Finance, should proceed as quickly as possible to review all the priority initiatives submitted by ministries against a set of criteria based on the list provided earlier in this chapter. Only very limited analysis will be possible, as ministries were not required to submit much in the way of detail. But at a minimum, it should be possible to develop a short list of initiatives that directly support the approved priorities. If an allocation has already been put aside, the Cabinet will be able to approve some of these initiatives. If no allocation has been made, the Cabinet may still want to consider one or more of the following options:

- Approve a limited number of initiatives, and direct ministries to fund them from within their base budget;
- Approve a limited number of initiatives, and fund them by applying a savings target to all ministries;
- Select initiatives that warrant further development for inclusion in the 2003 priority-setting process.

7.14 This would be a short-term measure aimed at ensuring that the GoL will accelerate reforms toward meeting its commitments while minimizing the adverse effects on the budget process, programs and service delivery. Recommendations for improving the budget process in 2002-2003 are summarized below (details are given in the Annex).

- **Three-year planning horizon:** In 2001, the GoL should have adopted a three-year planning horizon for purposes of fiscal strategy (see below) and strategic planning in pilot line ministries (see below). In 2002, detailed budget forecasting by pilot line

[44] The Cabinet's decisions regarding the fiscal plan have largely been made (a few tax issues are still under discussion). One of these decisions has been to approve only minor reductions to the base, leaving very little room for new initiatives beyond some minimal funding for EU accession requirements, NATO commitments, and some salary adjustments for teachers. In addition, some months ago, the Ministry of Finance requested ministries to submit a list of their priorities, as part of the regular budget request, but without any instruction in terms of the Government's overall priorities or funding limitations. This information has been submitted, but no decisions have been made.

ministries should be reviewed and strengthened. The Ministry of Finance should review costing and assist in improving the forecasting of pilot line ministries.

- **Continue to adopt cautious assumptions in developing the multi-year revenue forecast.**.
- **Establish a multi-year "no-policy-change" expenditure forecast** as the baseline against which expenditure cuts and new initiatives are applied. For many budget decision-making processes, the starting point for developing future-year expenditure budgets is the "forward" or future estimate of the current budget. The operating definition refers to "the future cost of existing and approved programs." By definition, expenditure adjustments that require decisions by the Cabinet should be outside this no-policy-change forecast—either (1) adding new programs or expanding existing programs (new funding for priority initiatives); or (2) eliminating or reducing existing programs (expenditure savings). In practical terms, following this principle means creating a forward-looking expenditure forecast that starts with the current year budget and then adjusting it in a number of ways (see the Annex for details).
- In setting the fiscal plan at the beginning of the budget process, **overall levels should be established for revenues, expenditures and the deficit.** The expenditure limit should include specific amounts for:
    - a "no-policy-change" expenditure budget, plus
    - new initiatives in support of government priorities, plus
    - public investment program, minus
    - required expenditure cuts from the base budget.

7.15 The expenditure target or limit should be determined by adding the deficit target to the revenue forecast (adjusted for tax changes). To achieve this expenditure target, specific adjustments need to be made to the no-policy-change expenditure outlook. An amount for new initiatives in support of government priorities needs to be added, as does an amount for new initiatives under the public investment program. The difference between this new total and the expenditure target is the amount of expenditure cuts required from current programs.

7.16 The amount for new initiatives will be informed by the process coordinated by the Chancellery that will have taken place prior to this point in the budget process. The amount of new funding for public investment projects could be estimated by similar analysis, or an envelope could be determined. The Cabinet should then be provided with some sense of the impact of the resulting level of cuts. With this collective information, the Cabinet needs to agree to a balance between these competing actions that is reasonable and affordable.

7.17 Once these amounts have been established, the ministries can follow up with more detailed work on specific initiatives and the development of expenditure reduction strategies.

- **Set ministry expenditure ceilings as part of the planning phase of the budget process**—before ministries are asked to prepare their budget requests. Once the overall expenditure results have been determined, the Ministry of Finance needs to recommend an expenditure ceiling for each ministry. These ceilings will include: amounts for new priority initiatives, new public investment projects, and a savings target to be achieved by reducing or eliminating current programs. It is only at this

point in the budget process that ministries should proceed to develop their strategic plans and their budget requests, so that they can reflect and incorporate the broader fiscal planning decisions.

- **Reforms to the process of approving the public investment program**

  (a) Shift coordination of the public investment program to the Ministry of Finance.

  The public investment program needs to be fully coordinated with the budget process by shifting responsibility for its coordination to the Ministry of Finance. This will allow:

  - expenditure ceilings for the public investment program to be set within the context of the fiscal plan;
  - the timing of decisions to coincide with decisions on priority initiatives;
  - the inclusion of public investment projects into ministry strategic plans;
  - ongoing operating costs to be built into ministry multiyear budgets.

  The Ministry of Economy should continue to have a role in assessing the quality of the public investment program and its contribution to economic development.

  (b) When the public investment program is presented to the Cabinet, a comprehensive picture should be provided, showing proposed new projects, status of committed projects, and the total multiyear costs of committed and new projects.

  Currently, public investment projects already approved or underway are included in the MoF's base budget calculations. Only new investment projects are presented separately to the Cabinet. In addition, there are capital expenditures in all ministries for internal purposes. Given the nature of public investment projects and capital spending generally, it would be very useful to provide the Cabinet with an overview of all public investment and capital spending.

  - At the end of the budget process, but before ministry budget requests and strategic plans have received final approval, **the Cabinet should review the fiscal plan once more,** in case some further adjustment in overall spending levels is required.

  - **Special budgets should be better integrated into the budget process:**

    1. Where warranted, funding should come from general revenues, not specific earmarked revenue sources (see above recommendations).
    2. Special budgets should be included in all program reviews and other expenditure reduction exercises.

- **All program review exercises, including fundamental or functional reviews, should be conducted within the context of the overall fiscal plan, to ensure that the results of these reviews meet fiscal planning objectives**

  Just as program or ministry functional reviews need to be done within the context of the Government's policy objectives, reviews also need to be conducted within an affordable fiscal framework. Estimates of the volume of savings required are needed when determining which functions to drop or reduce. Moreover, as developing concrete recommendations on improved efficiencies and ranking priorities are very difficult processes, expenditure targets add a strong incentive to make the tough choices.

7.18 Ministry program structures should be reviewed to ensure that policy programs are aligned with budget programs, so that every program has an output orientation (delivers a service or a product) and has an identifiable budget that includes all staff and other resources required to deliver the program.

7.19 In order to effectively review the existing expenditure base as part of the reallocation process, it is essential that the Government have good information on how it spends its money. This means that policy programs should be directly linked to budget programs. In other words, programs should be defined by the services or outputs they deliver, and each program should have a budget that covers all the staffing and other resources required to deliver that program. In addition, ministries should track performance measures for each program that describe program outputs, and ideally, program outcomes. This type of quantifiable financial and policy impact information is critical if the Cabinet is to assess priorities and make budget choices. In addition, this type of program information improves budget transparency for Parliament and the public.

Eliminate Existing Arrears and Prevent the Creation of New Arrears

7.20 The Government should take stock of the arrears situation and discuss a plan for purging them over the next few years with the line ministries. It would be desirable for the arrears payments to appear as a separate budget line, so as to enable the Treasury to monitor the regular payment of arrears. This discussion between the line ministries and the MoF should be part of the 2002 budget process (see above).

7.21 To prevent creation of new arrears, the Treasury should receive a regular update of expenditure commitments made by line ministries. These could be done on a trimester basis or a monthly basis depending on the Treasury's capacity. Above and beyond information sharing, there is a need for the Government to examine closely the existing financial control model. The model relies on discipline by line ministries, which can only be enforced through accountability for any over-commitments. Unless the Government wishes to revisit the current model (and, for example, institute a "French" type of control on commitments where the Ministry of Finance is the only ministry legally entitled to commit an expenditure), it would be advisable for the Government to institute sanctions on over-commitments. In smoothly running budget systems, most of this function is delegated to the Audit Office. In Latvia, the audit function has yet to be developed to ensure adequate ex post control of expenditure. Thus the Ministry of Finance should be able to act, and apply sanctions, upon the information received by line ministries on

commitments. This is likely to require changes in the legislation. It would be advisable to ensure that sanctions are accompanied by incentives for keeping in line with commitments in order to avoid under-reporting by ministries.

7.22 In addition, the Government should amend the legislation to: (i) set government- wide standards on accounting; (ii) institute systematic, ex ante controls for commitments and payments; (iii) issue standard regulations regarding responsibility for the use of budget allocations.

C. Laying the Foundations of the MTEF

Strengthen Commitment to Fiscal Discipline

7.23 **First building block of a Medium-Term Expenditure Framework: Develop a medium-term fiscal strategy.** While still in the early stages, medium-term fiscal planning is making progress. In 2001, the MoF will prepare a medium-term (five years) fiscal policy statement and provide three-year-forward estimates of current government programs and obligations.[45] This is a mighty step. It will take at least three or four budget cycles to imbed a medium-term perspective into the fiscal planning process and to link the additional information to the decision processes.

7.24 Public announcement of the medium-term fiscal policy statement would strengthen the political commitment to fiscal targets even further. Hence, a future step (2003) could be to submit this statement to Parliament prior to the detailed budget and to receive its approval on fiscal targets. This move will also split the parliamentary discussion on macro-fiscal issues from sector policy and allocation issues and put the correct sequence of decisions in place in the Legislature. Moreover, it would increase the power of the Budget Commission over sector commissions with respect to fiscal discipline and allow the Budget Commission to share responsibility with the Cabinet in setting fiscal targets. Many OECD countries do this, Sweden being a good example.[46]

7.25 **Better Predictability: Improve revenue forecasting and honesty of budget estimates.** The Government should resume its prudent approach to revenue forecasting (2003). Inherent in forecasting is a degree of risk that can result in more "optimistic" as well as more "pessimistic" scenarios. While it is important to draw on technical expertise to develop a most likely forecast in light of these risks, the Government also has some choice about how cautious it should be in the economic assumptions used in developing the revenue forecast. Over the past few years, many governments have adopted as standard practice the use of conservative economic assumptions for fiscal planning purposes. This practice forces tougher decisions during the budget process but, when given time to plan, ministries are in a much better position to minimize the impact on services. And of course a conservative approach to planning reduces the risk of missing deficit targets.

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[45] The FTI report on the Medium-Term Fiscal Policy Statement explains how the MTFPS will be integrated into the current budget formulation process.

[46] The process between the Parliament and the Cabinet is explained in detail by OECD PUMA's "Budgeting in Sweden" document.

7.26 The Government's conservatism should, however, be accompanied by "honesty" in the projections. Indeed, to facilitate expenditure trade-offs if or when needed, the Government should refrain from building "fat" into the budget (i.e., deliberately bloating some expenditure items). Instead, if the Government feels it is warranted to build reserves, it should do so explicitly by showing a budget item to that effect. The amount set aside should either be used for true emergencies (e.g., floods, foot and mouth outbreaks, etc.) or should be allocated based on true competition among claimants during the year.

Increase the Pool of Fungible Resources at the Government's Disposal

7.27 The following recommendations could be implemented immediately (as part of the 2002 budget preparation, to be effective in 2002).

- The creation of new special budgets should immediately be banned.
- Furthermore, as part of the review of programs the Government is undertaking for the 2002 budget, a review of the rationale for special budgets should be conducted. In cases where the rationale for special budgets is not strong enough,[47] special budgets should be abolished (e.g., the Health budget).
- New earmarking practices should be stopped. In addition, a review of earmarking should be undertaken against criteria set out in the PER (see Box 4 on Earmarking) and, wherever warranted, earmarking should be abandoned.
- Review of key rules on financing and allocations (e.g., basic budget investment may be financed through own revenue only; 3 percent of budget must be allocated to agriculture subsidies) with a view to eliminating them.
- Revenue earned by administrative agencies should be returned to the Treasury and deposited in the general fund unless the Cabinet or Ministers and/or Parliament have authorized the establishment of a special fund. The MoF and the line ministries should develop **fair, incentive-based rules for allocations and carry-over of own revenue** (see Box 4.1 on Health).

7.28 Implementation of the Agency Law should be strictly enforced. Furthermore, the Government should undertake a review of agencies and determine which ones should be privatized, divested, or brought back into the budget.[48]

Refrain from Adopting Unfunded Policy Programs

7.29 To prevent further commitments to unfunded policies by the Government and Parliament, the following actions should be implemented or strengthened immediately:

7.30 **Program Costing**. Revised Cabinet Regulation #160 should be adopted by the Cabinet, requiring that all new proposals be costed out for the medium term and that this costing be

[47] Criteria in favor of special budgets include, among others: the need for earmarking of resources, the distribution effect of allocation of resources, the need for separate administration, the strength of transparency and accountability in the special budgets, simple transfer mechanisms, and equal budget rules.

[48] Criteria for the review are defined in Allan Shick's report on agencies (1999). Additional material can be provided by the Bank.

approved by the MoF. Implementation and monitoring of Regulation #160 (by the Chancellery) should be strictly enforced.

7.31 **Exclusive Use of the Budget Preparation Process for Funding New Policies**. The budget process should be used as the process where almost all matters with fiscal implications are dealt with in one annual process, rather than allowing many ad hoc proposals throughout the year. This would require the Prime Minister and other ministers to agree to this, and to back it up with rules of Cabinet. The budget law could also back this up with a provision that all expenditure must be in accordance with the annual budget law and a prohibition on any expenditure by government bodies that is not in accordance with the annual budget law.

7.32 **Preventing Unfunded Laws by Parliament** in the future. In order to prevent a continuation of Parliament passing unfunded laws in the future, several options can be considered. Many countries have laws to prevent Parliament passing unfunded laws and some embed these in the Constitution.

7.33 The rules of Parliament (called "Standing Orders" in Commonwealth countries) could be amended to say that Parliament will not pass laws for which funding has not been provided.

7.34 Another option is to change the Constitution or budget law to state that Parliament may not pass laws for which no funding has been provided. An example of a law that has this effect is Thailand's Constitution which prevents anyone but the Prime Minister introducing money bills. The Thai Constitution also requires Parliament to make changes to the budget only within the total amount of the budget introduced by the Government. It can reallocate but not increase the total size of the budget.

7.35 Many countries balance the restriction on Parliament passing unfunded laws with a power to end the life of the Government, if a majority refuses to pass the Government's budget. By convention in many countries, this is a matter of confidence and the Government is forced to resign.

Increase Transparency in the Budget[49]

7.36 Many of the noted weaknesses require only moderate changes to monthly fiscal reports and annual budget and accounts documents and should be fully in place by the FY 2002 budget. These include:

7.37 Expenditure financing information should be provided in the budget documents together with an analysis of sources of financing. This presentation will provide a more complete picture of the fiscal position and provide a better basis for monthly reporting by the State Treasury.

7.38 Annexes covering contingent liabilities, tax expenditures, and quasi-fiscal activities should be provided systematically as part of the budget documents. Data already collected by the State Aid Surveillance Commission from various sources, together with other data on tax expenditures and State Treasury records of contingent liabilities, should be consolidated and

[49] These are recommendations of the ROSC (IMF, 2001).

made more comprehensive, used in budget decision-making, and presented in annexes to the budget. The annex on long-term liabilities included in the budget document should be progressively developed to give comprehensive quantitative information. Specifically, information on pension liabilities and expected revenue flows should be included for information purposes.[50]

- Immediate emphasis should be placed on reporting potential budget and off-budget costs of measures currently being considered to encourage foreign investment.
- A more comprehensive presentation of forecasting assumptions and fiscal risks (drawing from both macroeconomic analysis and a review of contingent liabilities) should be provided in the budget supporting documents. External scrutiny of forecasts should be encouraged.
- A statement of accounting policies should be included in the final accounts report of the State Treasury.

Strengthen Accountability

7.39 External audit should be strengthened considerably. The GoL recognizes that financial accountability is limited, and that the Government lacks a proper forum within the Saeima to discuss fiscal accountability issues. First, the State Audit Office (SAO) and the Saeima should make a major push to strengthen accountability for the use of resources by setting up a Public Accounts Committee (PAC). A PAC in Parliament could greatly improve the Saeima's internal controls. Second, to strengthen the external audit function, the SAO has prepared and adopted an action plan to strengthen its own operations, as part of its goal to provide the Saeima with a full attestation audit. Based on the plan, the SAO should extend its coverage of audits. Equally importantly, audit activity should be followed up by the GoL and evidence should be provided that recommendations have been addressed.

7.40 Third, to improve each line ministry's accountability for the use of resources, the internal audit procedures at the Ministry of Finance will have to be further strengthened. For this purpose a three-year strategic plan as well as a supporting action plan already developed should be implemented. There will be a need for adequate staffing and enhanced staff training in line ministries.

Priority-Setting Process [51]

7.41 The development of priority setting is critically important in Latvia over the medium term. The process will involve strengthening institutions and budget processes, in particular: establishing medium-term priorities, linking annual priority initiatives to the fiscal plan, defining criteria for selecting initiatives, reconfiguring the roles of the ministries and the Chancellery, and allocating funding in the fiscal plan. The details appear in the Annex

[50] Such data would be provided in line with the Government's "stewardship" obligations and would not constitute a legal or policy obligation. Governments providing full accrual balance sheets, such as New Zealand or the United States, also disclose a range of such information to supplement balance sheet information.
[51] See main recommendations on the budget process for 2003 in the Annex.

- The Government has already adopted the methodology for medium-term budget planning. It is suggested that the schedule be as follows:

  - Quantify main commitments to EU and pension reforms (2001 and beyond) as described above;
  - Identify other GoL main priorities for the medium term and start costing them out (2002);
  - Develop a priority-setting process as described in Annex.
  - Develop a budget process consistent with priority setting (budget 2003 and beyond), as described in the Annex;
  - Publish a budget priorities statement (2003).

Develop Pilot Ministries' Strategic Planning Process

7.42 Ministry strategic plans are a critical part of a government's planning and priority-setting process. The ministry plan is the key document that brings together the budget and the strategic planning process within each ministry, in the context of the Government's priorities.

7.43 In order to complement the priority-setting process at the Cabinet level, the Government has decided to initiate a strategic planning process at the ministry level. The Policy Coordination Unit is also being given the responsibility for coordinating this government-wide initiative. The Government has adopted a strategy for this initiative. First, the respective roles and functions of the Chancellery, the MoF and the top management of the line ministries will be identified in the context of a high-level model of strategic planning. Then the Chancellery and the MoF will prepare draft regulations for the strategic planning procedure and the way it links with the budget process. Next, a pilot ministry will undertake a strategic planning exercise; central agencies will learn from this experience and adjust their regulations before strategic planning is further expanded. The Ministry of Agriculture has been identified as the pilot ministry. In 2001, the Government approved a medium-term budget planning process which is set out in a document titled "Methodology Guidelines for Medium-Term Budget Planning."

7.44 The purpose of strategic planning, the process of strategic planning, processes to develop the core of the strategic plan and its content, roles and responsibilities in relation to strategic planning,[52] documentation and application to the methodology for medium-term budget planning, are all explained in the Annex.

7.45 In addition, the Government has decided to regularize Public Expenditure Reviews (which are to become fundamental reviews combining administrative and budget management). As mentioned above, it is important that the Government use the PERs already done in 2000 to review programs and bring the budget discussion to the level of policies. To this end, it is recommended that the PERs be used as a basis to assist line ministries in preparing their budget submissions. It is also recommended that the Chancellery prepare a broad overview of the sector

[52] A Memorandum of Understanding has been prepared, detailing the expectations and mutual responsibilities among key actors in the context of the ministry strategic planning process.

PERs for the Cabinet to assist it in determining savings and priorities in the 2002 budget preparation process.

7.46 The Government has already initiated strategic planning. In 2001, the GoL will issue the MoU and guidelines, and pilot ministries are expected to start in 2001-2002. If the experience is conclusive—and it should be reviewed after one year—the Government should envisage initiating a second group of pilot ministries between 2003-2005, and later formalizing the process by issuing regulations for all ministries.

D. Summary of Main Recommendations

7.47 It should be emphasized that, while the concept of an MTEF is a very attractive one, it usually takes a long time before all mechanisms and institutions are fully in place and have been tested in practice.

7.48 There are strong benefits to Latvia in adopting the MTEF. However, for this policy to be effective, Latvia also needs to be cognizant of the particular circumstances and challenges facing the government and the bureaucracy. These challenges include:

- A bureaucracy that has to develop a performance culture;
- Lack of in-depth knowledge at the center of government of line ministry program details;
- A budget structure that expends over half its resources on special budgets protected from the normal allocation process by legislated earmarking of revenues;
- The administration's capacity to develop well formulated policies, review and evaluate programs, and secure adequate control over resources;
- Need for greater transparency and other accountability mechanisms.

7.49 While the Government has already engaged in these reforms in a meaningful way, it is suggested that unless key milestones are reached, the effort may yield limited results, which would prove to the skeptics that program budgeting cannot succeed in Latvia.

7.50 The main issues the Government should address in a meaningful way before consolidating the MTEF pertain to:

- Increasing the fungibility of resources;
- Strengthening accountability in public institutions, including strict implementation of the Agency Law and follow-up by the Government on audit findings;
- Using the sector analyses in line ministries as well as at the Cabinet level to inform the 2002 budget process as discussed above;
- Developing a broad-based communication campaign for the reforms across government.

Table 7.1: Timetable

Measures	Timing for Taking Action	Responsible Central Agency	Suggested Implementation Timetable
Quantify main Policy Commitments	2002	GoL	• Quantify main EU fiscal requirements and pension reform costs • Prepare 2003 budget based on process described • Use sector analyses to inform the process.
Eliminate Arrears	2002	MoF	• Prepare budget with plan to eliminate arrears for 2003 • Change legislation to prevent new arrears
Strengthen Fiscal Discipline	2002 2002 +	MoF	• Develop fiscal strategy for 3-year period • Improve scope and content
	2002	MoF	• Increase transparency of the budget
Increase the Pool of Fungible Resources	2003 +	GoL	• Ban on new earmarking and new special budgets • Review financing rules and special budget • Increase fungibility of own revenue (amend LBFM if necessary)
Refrain from Adopting Unfunded Policy Programs	2002	GoL	• Adopt and implement Regulation #160 • Limit new policy commitments to the budget preparation process
Strengthen Accountability	2002 +	SAO-GoL	• Extend coverage of SAO and internal audit • Provide evidence that recommendations have been addressed
Priority Setting	2002 +	Chancellery and MoF	• Quantify main commitments to EU and pension reforms (2002 and beyond) • Identify other GoL priorities for the medium term and start costing them out (2002) • Develop priority-setting as described in the Annex (2002-2003 and beyond). • Develop a budget process consistent with priority-setting as described in The Annex (2002-2003 and beyond) • Prepare a budget priorities statement (2002), improve its scope and content (2003+) and submit a budget priorities statement to Parliament before budget documents (2003)
Ministry Strategic Planning	2002	Chancellery and MoF	• Issue the MoU and guidelines in 2002 • Start in pilot ministries in 2002-2003 • Review first-year implementation and address outstanding problems (2003-4)

ANNEX

STEPS TOWARDS A MEDIUM-TERM EXPENDITURE FRAMEWORK

A. CONCEPTUAL FRAMEWORK

1. The public sector is managed by a series of authority delegations. In a democracy, the ultimate authority belongs to the citizen. The citizenry entrusts its authority to Parliament, Parliament entrusts its authority to the Cabinet, the Cabinet to individual ministers, and ministers to departments. Each delegation of authority rests on a contract that specifies the conditions on which the authority is delegated. For each contact, there is a specific set of rules that regulate the making of that contract. For example, constitution and election laws regulate the delegation from citizen to Parliament; laws on government formation, budget law, and other laws regulate the delegation from Parliament to Cabinet, and public administration law and internal regulations regulate the delegation within the executive branch.

2. There is an inherent problem in authority delegation: those who receive authority – agents – know more about how they use the authority than those who delegate it –principals. This information advantage allows agents to use the authority for their own benefit instead of the objectives specified in the contract with the principal. Therefore, agents' use of authority is restricted with further rules and regulations and they are subject to controls. Moreover, principals are supported by a group of specialist organizations whose job is to design, implement and enforce these controls.

3. All these rules, regulations, controls and controllers help in lessening the information asymmetry between principals and agents, but they can never eliminate it – there is no perfect system. Keeping this in mind, we could comfortably say that the better the rules and regulations are, the more competent specialist organizations become, and the richer the information content of the contracts are, the better are the results of the public sector. The search for better contracts, reporting requirements, management techniques, rules and regulations for dealing with information asymmetry over the centuries has resulted in good practices, generally accepted principles and standards that are now applied internationally. The building blocks of a good system continue to evolve every day.

4. The public expenditure management (PEM) system is a collection of processes, rules, regulations and supporting organizations that govern the delegation of authority for allocating and using public resources from Parliament at the top to a ministry department at the bottom.

5. The PEM system as a whole aims at reducing information asymmetries. It can be analyzed in terms of five main processes: planning, budgeting, financial management, audit, and evaluation. Planning and budgeting processes are crucial in preparing the contracts between principals and agents prior to delegation of the authority for using public resources. Processes that govern financial management are those rules, regulations and controls that restrict agents to use public resources as authorized by principals. Audit and evaluation are ex-post controls to find out whether resources are actually used as authorized and whether intended results in contracts are achieved.

6. This cycle repeats every year between multiple layers of principals and agents: Parliament, Cabinet, ministries and departments. Primarily, a supreme audit institution assists Parliament, and a ministry of finance assists the Cabinet in their functions and decisions around this cycle.

7. Historically, the PEM system evolved first to limit the totals of public expenditure to a level that would not distort macroeconomic stability. That is nowadays called fiscal discipline or

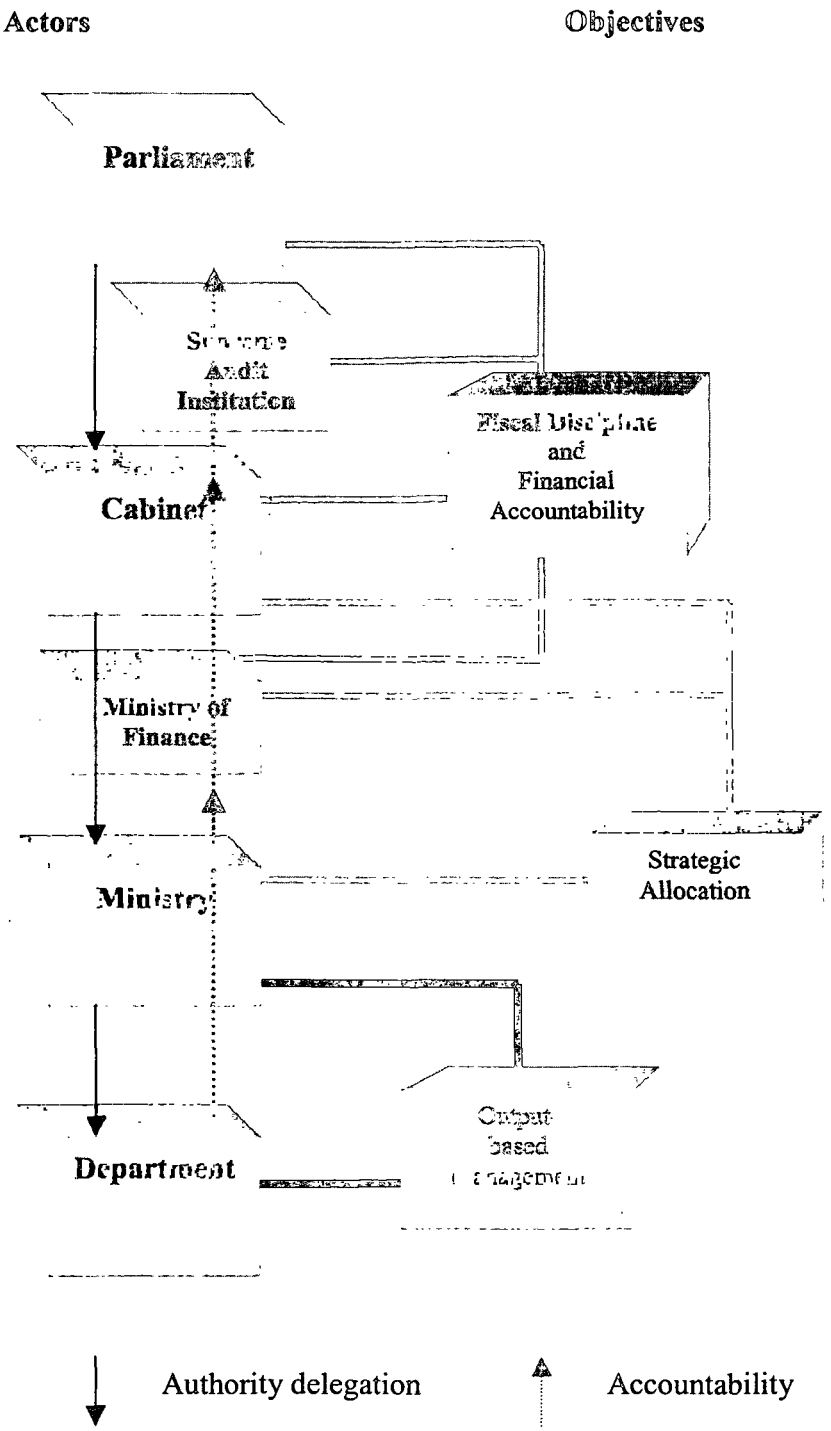
purposes, the system is primarily confined to a Parliament-Cabinet interplay and requires only financial and fiscal information.

8. Later, after the systems performance matured around these two initial objectives, it embraced a policy orientation and brought in sector ministries. This development gave rise to attempts to integrate policy-making, planning and budgeting processes at ministry level. Such an integration requires information on social outcomes and classification of financial information in terms of these outcomes. This development enriched the information content of contracts by linking inputs to outcomes and gave rise to the programmatic approach.

9. After decades of disappointment with the results of the programmatic approach, it was realized that a programmatic approach could only be effective in the context of larger management reforms. Ministerial departments were brought in and provided with incentives to implement an output-based management system. It was also understood that inputs could only be linked to outcomes through outputs, and that this requires classification of financial information in terms of outputs.

10. As the PEM system evolved, it became more complex. New objectives required more information, further rules, regulations, controls and management techniques and more competent support organizations. A sequence in system design also became apparent: unless the system performed well first in fiscal discipline and financial accountability, it would not be able to evolve further to embrace a policy orientation and to support management reforms in ministries and departments.

Annex-Figure 1: The Actors and Objectives of a Public Expenditure Management System



11. This Annex will focus on the pillars for establishing an MTEF. These are: (i) medium-term fiscal framework (discussed in the main report and below); (ii) a new budget process to support medium-term budgeting; (iii) new priority-setting mechanisms at the Cabinet level; and (iv) strategic planning in line ministries. In addition, this report presents an output-based budget management model and a list of reporting requirements under the new system. The proposals below are clearly intended for a progressive medium-term approach to the MTEF.

B. THE BUDGET PLANNING PROCESS

Multi-Year Planning Horizon

12. Before moving to the specific steps in the budget process, it is useful to spend some moments on the concept of multi-year planning.

13. Multi-year budget planning means that in each budget process the fiscal outlook is projected forward through the medium term (usually three but as many as five years). In many countries, the government only submits one year of allocations for approval by Parliament, but endorses a planning figure for future years. In some countries, Parliament actually approves multi-year allocations, but this is generally not practical for governments that are facing uncertain economic trends or are in a process of transition.

14. In either case, the multi-year plan is a 'rolling' plan that is updated every year, with a new year being added on every twelve months. This ongoing process of review results in a planning process that can respond to new economic circumstances. It also can be modified to respond to new political realities.

15. More specifically, multi-year planning allows governments to:

- Identify future problems and make adjustments now (e.g., if the deficit is currently low, but is projected to grow each year at a significant pace, corrective action can be taken before the problem becomes significant).
- Introduce program restructuring that will take more than one year to implement (e.g., planning the multi-year implications of EU accession).
- Take into account future implications of decisions taken in the current budget year (e.g., a new program may cost only a small amount this year, but may grow substantially in future years).

16. Multi-year planning does not mean establishing an expenditure plan for a fixed period of years, which is then completed before a new plan is developed for the next period (e.g., the first plan covers years 1 to 3, the second plan covers years 4 to 6, etc.) This situation would result in:

- Operating within an increasingly out-of-date budget framework in later years and an inability to respond to changing circumstances;
- Greatly reduced flexibility to accommodate the priorities of a new government.

17. In Latvia, elements of multi-year planning do take place. Following EU requirements, a five-year economic and revenue forecast is prepared, and there are multi-year deficit and expenditure targets. Ministries provide multi-year budget details to the Ministry of Finance.

One of the key elements missing is projecting the future cost of existing programs, taking into account such factors as population and other growth pressures. Without this information, government will not have a good understanding of the impact on program delivery of meeting predetermined deficit targets.

18. Having said this, implementing multi-year planning is not simple, and it will take considerable effort to develop a reasonable expenditure forecasting capability. The Ministry of Finance should be placing a high priority on addressing this issue as part of its capacity-building agenda. The Ministry should also be realistic in choosing the planning timeframe. At the programmatic level, planning should be limited to a three-year horizon. Beyond that, uncertainties inherent in forecasting will in all likelihood outweigh the benefits.

Establishing the Fiscal Policy Planning Framework

19. Establishing the fiscal policy planning framework is the critical first stage in the budget process, and sets the direction for the more detailed level work. It is based on a top-down planning approach in which the government looks at what it can afford (spending limits derived from the economic and revenue forecast coupled with a deficit target), identifies what it wants to do (priority setting), and develops a strategy for setting the budget that meets these twin objectives (allocation for priorities combined with a savings target designed to keep overall spending within established limits). Once it has been established, ministries can develop their budgets within this planning framework.

Cautious Economic Outlook and Revenue Forecast

20. The first step in developing the fiscal policy planning framework is preparing the economic and revenue forecast. Economic forecasting is a well-developed, technical skill, and the government should draw upon the collective expertise available to it within the government and from external sources to the extent possible. However, inherent in forecasting is a degree of risk that can result in more 'optimistic' as well as more 'pessimistic' scenarios. While it is important to draw on technical expertise to develop a 'most likely' forecast in light of these risks, the government also has some choice about how cautious it should be in the economic assumptions used in developing the revenue forecast.

21. Taking an optimistic approach eases the need for cuts during the budget process, but if the economy slows down and revenues fall below forecast, ministries will be forced to make in-year cuts. Not only does this practice cause significant disruption to service delivery, it can dramatically undermine ministry planning efforts.

22. Over the past few years, many governments have adopted as standard practice the use of conservative economic assumptions for fiscal planning purposes, either by reflecting a more pessimistic forecast, or explicitly building caution into the 'most likely' forecast by reducing GDP growth and increasing interest rates. This practice forces tougher decisions during the budget process but, when given time to plan, ministries are in a much better position to minimize the impact on services. And, of course, a conservative approach to planning reduces the risk of missing deficit targets.

Setting the Fiscal Deficit and Expenditure Limits

23. The most important fiscal target to be set is the deficit level. In Latvia's case, medium-term deficit targets have been established through a process of negotiation with the IMF. Although the Cabinet has an opportunity during the fiscal policy discussions to alter these targets, it must be mindful of the implications of doing so.

24. With the medium-term deficit targets established, the expenditure limit can readily be calculated. The challenge then becomes determining how much of this expenditure limit should be allocated to current programs, and how much should be reallocated to priority initiatives. The method of determining the new priority initiative envelope is discussed in the next chapter. The critical point to be made here is that this amount should be established before the 'base' expenditures are approved. The size of the priority initiatives envelope will determine the size of the base budget, and by extension, the level of savings required – not the reverse.

25. The concept of reallocation that underlies these budget planning reforms is significantly complicated by the prevalence of special budgets in Latvia. About 50 per cent of the expenditure budget is protected from reallocation by the use of special budgets, which essentially earmark specific revenues to particular programs. As a result, the impact of any savings target required to meet fiscal planning objectives must be borne by only a fraction of government programming. In fact, there is no reason why the programs currently protected by special budgets should not be subject to the same tests of policy relevance and fiscal stewardship.

Ministry Ceilings and Policy Direction

26. The final step in establishing the fiscal planning framework is to establish hard ministry expenditure ceilings, taking into account an allocation for new priority initiatives, the ministry's base budget, and a savings target. Once this ceiling is established, the detailed, ministry-level work begins.

Ministry Strategic Plans and Budget Submissions

27. Ministries can only begin their planning processes once they have an established expenditure ceiling that reflects the fiscal policy planning framework. With this information, including government direction on priority initiatives, ministries can plan how to allocate the limited funds available. Assuming some cuts are built into the ceiling, ministries will need to determine which programs should be affected, what the impact will be, and what implementation strategies can be employed to minimize this impact. The results of this planning process will be reflected in the ministry's detailed budget submission, which should be prepared at the same time.

28. Ministry strategic plans are discussed below in more detail.

Final Review and Approval by Cabinet

29. The third stage in the budget decision-making process begins when ministry strategic plans and detailed budget submissions are submitted to the Policy Coordination Unit and the Ministry of Finance. These central agencies should review these submissions and assess the impacts. The results and recommendations are presented to Cabinet, including an overview of the combined impact of the ministry plans. At the same time, Cabinet should review an update

of the economic and revenue outlook, and make adjustments to the fiscal plan, as well as ministry strategic plans, if necessary.

30. Once the plans and ministry budgets are approved, the decision process, as far as Cabinet is concerned, is over, and the draft budget law and other documents are submitted to Parliament.

Communicating the Plan and Reporting Results

31. In addition to the actual decision process discussed above, government has a responsibility to present its plan to Parliament, and report on whether the plan was achieved. Currently, Latvia's Parliament receives little information beyond the actual draft budget law containing the specific spending allocations. With the introduction of an integrated priority-setting and budgeting process, there is an opportunity to provide Parliament with planning documents that support and explain the draft budget law.

32. In particular, it is recommended that government prepare a Budget Priorities Statement that would precede or accompany the draft budget law. This statement would explain the economic and fiscal outlook, identify the government's priorities, describe the key strategies and initiatives to be funded through the budget in support of these priorities, and outline the government's reallocation strategy. This Budget Priorities Statement is discussed below.

33. In addition, some governments choose to publish a fiscal policy document earlier in the budget process, usually at the time that the fiscal policy planning framework is determined. The purpose of this document is to inform Parliament and the public about the fiscal challenges facing the government and the general strategy it intends to follow in making specific budget decisions. The inclusion of ministry ceilings in this document can serve to strengthen the government's resolve to enforce these ceilings by making a public commitment.

34. It is equally important to publish the ministry strategic plans. These plans provide an opportunity to explain what each ministry does, what services it expects to deliver, and what performance targets it commits itself to meet.

35. Once the planning cycle has been introduced, government will also be expected to report on results achieved – i.e., did government actually deliver on the plan? The Budget Priorities Statement, the Fiscal Policy Document and the ministry strategic plans should all include reporting on results as a standard element.

Critical Success Factors

36. Although much still needs to be done, Latvia has made progress towards reforming its budget process and integrating it with priority setting and policy planning. Cabinet has recently approved a reform framework. But as the process details are developed, it is essential that the issues discussed in this chapter be addressed. A number of specific recommendations with regard to the budget process are presented below. However, there are a small number of critical success factors that require focused attention. In particular, the government needs to:

- Establish the fiscal policy framework at the beginning of the budget process, including an allocation for priorities, savings targets and hard ministry expenditure ceilings.
- Strengthen analytical capacity at the center of government:

    - Both the PCU and the Ministry of Finance require an in-depth knowledge of ministry programs in order to effectively challenge and review ministry plans;
    - They also need to work as a team to ensure that policy and budget decisions are integrated.
- Improve the program information base:
    - ensure policy and budget programs are integrated;
    - develop program performance measures that focus on services and outputs.
- Strengthen political will by engaging Cabinet in meaningful decision-making:
    - improve the quality of decision documents by including options and impact analysis.

C. SPECIFIC BUDGET PROCESS RECOMMENDATIONS

37. Adopt a three-year planning horizon for purposes of strategic planning and detailed budget preparation

38. In keeping with requirements for EU integration, the Government of Latvia has adopted a five-year time horizon as part of its methodology guidelines for planning the medium-tem budget. This timeframe may be reasonable for reviewing the macroeconomic outlook and fiscal outlook at an aggregate level, in order to identify trend and medium-term risks. At the same time, however, the accuracy of these forecasts falls significantly the further out the projections go.

39. Moreover, planning five years into the future is unrealistic for most government programs. For many governments who have worked through these reforms, the experience has been that although ministries generate the numbers, real planning is only done for one year, and future-year estimates are little more that prorated projections.

40. Multi-year planning only becomes meaningful when ministries begin to implement change strategies that achieve results in the future. And this can only happen when ministries can accurately forecast the future-year cost of current programs, and identify undesirable trends, such as unaffordable program growth. It is strongly recommended that ministries develop this forecasting capability (see also the recommendation below), and limit the expenditure budget planning horizon to a more practical three-year timeframe.

41. Adopt cautious assumptions in developing the multi-year revenue forecast development of the fiscal plan begins with a multi-year economic, revenue and expenditure outlook. The economic outlook is usually based on the most likely expectations on growth, employment, inflation and so on using expert advice. But this economic outlook will have both positive and negative risks associated with it. If these risks are realized, they could affect the level of revenues (and to some degree expenditures as well). Adopting a cautious set of assumptions builds a cushion into the revenue forecast and reduces the likelihood that reduced revenues will require expenditure cuts during the year. As a result, ministries can have greater confidence that they will receive their full budget, and this provides a more stable environment for planning.

42. Establish a multi-year 'no-policy-change' expenditure forecast as the baseline against which expenditure cuts and new initiatives are applied for many budget decision-making processes, the starting point for developing future-year expenditure budgets is the 'forward' or future estimate of the current budget. The operating definition refers to 'the future cost of

existing and approved programs.' By definition, expenditure adjustments that require decisions by Cabinet should be outside this no-policy-change forecast: either (1) adding new programs or expanding existing programs (new funding for priority initiatives); or (2) eliminating or reducing existing programs (expenditure savings).

43. In practical terms, following this principle means creating a forward-looking expenditure forecast that starts with the current-year budget and then adjusting it in a number of ways:

- Many programs will require adjustment according to general parameter changes:
    - Some transfer expenditures (pension, unemployment benefit) grow with population;
    - Demand for public services alters with economic growth, population growth and shifts in demographic patterns;
    - Generally investment expenditure is sensitive to changes in exchange rate;
    - Public sector wages may alter with labor market conditions;
    - Interest payments alter with the level of debt, country credit rating and international market conditions.
- In addition, projecting the no-policy-change expenditure forecast requires adjustments to account for start-up of **approved** new programs (legal commitments), and **approved** termination of existing programs. Also, most investment programs will have uneven cash flows.
- Finally, it is also reasonable to adjust the forecast downward by some percentage to account for a reasonable annual improvement in efficiency.

44. The purpose of defining a no-policy-change expenditure forecast is to ensure that Cabinet understands the full implications of budget decisions that will follow. **It does not mean that this outlook is an acceptable level of spending**. But it serves to inform Cabinet of the implications of determining an acceptable level of spending.

45. When a no-policy-change expenditure forecast is combined with a cautious revenue forecast, a no-policy-change deficit outlook can be calculated. The difference between this no-policy-change deficit outlook and the target deficit the government would like to achieve is the net value of decisions that is required to achieve the deficit target.

46. In setting the fiscal plan at the beginning of the budget process, overall levels should be established for revenues, expenditures, and the deficit. The expenditure limit should include specific amounts for:

- a 'no-policy-change' expenditure budget, plus;
- new initiatives in support of government priorities, plus;
- public investment program, minus;
- required expenditure cuts from the base budget.

47. Typically, the expenditure target or limit is determined by adding the deficit target to the revenue forecast (adjusted for tax changes). To achieve this expenditure target, specific adjustments need to be made to the no-policy-change expenditure outlook. An amount for new initiatives in support of government priorities needs to be added, as does an amount for new initiatives under the public investment program. The difference between this new total and the expenditure target is the amount of expenditure cuts required from current programs.

48. The amount for new initiatives will be informed by the process coordinated by the Chancellery that will have taken place prior to this point in the budget process. The amount of new funding for public investment projects could be estimated by a similar process of analysis, or an envelope could be determined. Cabinet should then be provided with some sense of the likely impact of the resulting level of cuts. With this collective information, Cabinet needs to agree to a balance between these competing actions that is reasonable and affordable.

49. Having established these amounts, more detailed work by ministries can follow on specific initiatives, and the development of expenditure reduction strategies.

50. Set ministry expenditure ceilings as part of the planning phase of the budget process – before ministries are asked to prepare their budget requests and their strategic plans.

51. Once the overall expenditure results have been determined (as described under Recommendation 3), the Ministry of Finance needs to recommend expenditure ceilings for each ministry. These ceilings will include amounts for new priority initiatives, new public investment projects, and a savings target to be achieved by reducing or eliminating current programs.

52. It is only at this point in the budget process that ministries should proceed to develop their strategic plans and their budget requests, so that they can reflect and incorporate the broader fiscal planning decisions.

53. Reforms to the process of approving the Public Investment Program

(a) Shift the coordination of the Public Investment Program to the Ministry of Finance. The public investment program needs to be fully coordinated with the budget process by shifting the responsibility for coordination to the Ministry of Finance. This will allow:

- expenditure ceilings for the public investment program to be set within the context of the fiscal plan;
- the timing of decisions to coincide with decisions on priority initiatives;
- the inclusion of public investment projects into ministry strategic plans;
- ongoing operating costs to be built into ministry multi-year budgets.

The Ministry of Economy should continue to have a role in assessing the quality of the public investment program and its contribution to economic development.

(b) In presenting the public investment program to Cabinet, a comprehensive picture should be provided, showing proposed new projects, status of committed projects, and the total multi-year costs of committed and new projects.

Currently, public investment projects already approved or underway are included in the Ministry of Finance's base budget calculations. Only new investment projects are presented separately to Cabinet. In addition, there are capital expenditures in all ministries for internal purposes. Given the nature of public investment projects and capital spending generally, it would be very useful to provide Cabinet with an overview of all public investment and capital spending.

54. At the end of the budget process, but before ministry budget requests and strategic plans have received final approval, Cabinet should review the fiscal plan once more, in case some further adjustment in overall spending levels is required.

55. Between the time that the fiscal plan is first established in the spring, and the point at which the budget is finalized for submission to Parliament, considerable time will have elapsed, and there will be new economic data, and more up–to-date information on actual revenues and expenditures, all of which can result in a revised fiscal outlook. To ensure that the plan is still achievable, adjustments may be needed in ministry expenditure ceilings.

56. It is important that these adjustments are done as soon as possible, despite the timing. If no adjustments are made, there will be a much greater risk of having to adjust ministry budgets during the year, with greater disruptions, or of missing the fiscal targets.

57. In fact, as the capability to generate forecasts improves, and more frequent revisions to the fiscal outlook are possible, providing Cabinet with regular updates to the fiscal plan will improve the government's ability to respond to changes.

58. Special budgets should be better integrated into the budget process:

- funding should come from general revenues, not specifically earmarked revenue sources;
- special budgets should be included in all program reviews and other expenditure reduction exercises.

59. In Latvia, more than 50 percent of expenditures is represented by special budgets. Special budgets are budgets that are funded by specific sources of revenues, or have an allocation fixed by formula. As such, their levels of expenditures are determined not by need or requirements, but by the amount of revenue generated. In the case of social welfare, expenditures have been exceeding revenues recently, and the difference has been funded by borrowing from the general budget. Special budgets have also been excluded from any review process.

60. This protection from normal budget review and scrutiny significantly reduces the government's ability to set priorities and reallocate funding. It also reduces government's ability to impose a consistent discipline in terms of effectiveness and efficiency.

61. It is recommended that special budgets be integrated into the general budget, and that the programs funded from special budgets receive all funding directly from the general budget. **Integrating special budgets into the general budget does not mean that the programs will end.** But it will mean that they will be subject to the same scrutiny and priority-setting processes as all other programs.

62. All program review exercises, including fundamental or functional reviews, should be conducted within the context of the overall fiscal plan, to ensure that the results of these reviews meet fiscal planning objectives

63. Just as program or ministry functional reviews need to be done within the context of the government's policy objectives, reviews also need to be done within an affordable fiscal framework. One cannot completely answer the question of what functions to drop or reduce

without knowing how much savings are needed. Moreover, since developing concrete recommendations on improved efficiencies and ranking priorities are very difficult exercises in practice, expenditure targets add a strong incentive to make the tough choices.

64. New policy programs should be approved by Cabinet only if financing is made available and built into the budget. If ministries are unable to reallocate resources to fund a new initiative, then approval of the initiative should be deferred until it can be considered in the context of the government's process to develop priority initiatives

65. Currently in Latvia, new policy programs are approved throughout the year without any information on program costs. These programs are only implemented if and when funding is identified in the budget. As a result, there are a significant number of policy commitments that remain unfunded. In addition, it is these 'one-off' policy decisions that drive the decision on how to allocate any excess funding during the budget process.

66. The priority-setting process that is discussed in the next section is intended to address this issue, by providing a mechanism to discuss the relative merits of competing priorities, and to approve initiatives **only** if funding is available. It is critical that this principle also be applied to policy programs that come forward outside the normal budget process.

67. To the extent possible, the preferred approach should be to only consider new policies during the annual priority-setting process. Recognizing that this is not always practical, government should consider reviewing new policies in groups at a limited number (2 or 3) of Cabinet meetings during the year. In each case, an analysis of the cost of new programs should be provided to Cabinet, and the Ministry of Finance should provide advice on the budget impact of funding these programs. The source of funding should be a part of all new policy program approvals.

68. Ministry program structures should be reviewed to ensure that policy programs are aligned with budget programs, so that every program has an output orientation (delivers service or product) and has an identifiable budget that includes all staff and other resources that are required to deliver the program

69. In order to effectively review the existing expenditure base as part of the reallocation process, it is essential that government have good information on how it spends its money. This means that policy programs should be directly linked to budget programs. In other words, programs should be defined by the services or outputs that are delivered, and each program should have a budget that covers all the staffing and other resources required to deliver that program. In addition, ministries should track performance measures for each program that describes program outputs, and ideally, program outcomes. This type of quantifiable financial and policy impact information is critical if Cabinet is to assess priorities and make budget choices. In addition, this type of program information improves budget transparency for Parliament and the public.

D. PRIORITY SETTING PROCESS AT THE CABINET LEVEL

70. The recommendations propose a priority-setting process that is integrated with the budget process. The basic elements of the process are described in general terms in the Methodology Guidelines for Planning the Medium-Term Budget paper, and are developed in more detail here. This new process is also consistent with, and builds on, the recommendations made by Sir Robin

Mountfield in his report on Public Administration Reform, prepared in February 2000, which outlined a priority-setting framework that featured:

- a limited number of government priorities;
- ministry strategic plans that support government's priorities;
- a mechanism for horizontal linkages among ministries; and
- leadership for the process based in the State Chancellery.

What are Government Priorities?

71. To begin with, it is important to consider briefly what government priorities are. The priorities that are identified through the government's priority-setting process represent major changes that a government or a ministry wishes to make to the existing system. These changes may result in the creation of new programs, the elimination of existing programs or the strengthening or restructuring of existing programs. Since priorities represent change, they will always have an impact on one or more programs. In most cases, these changes will have resource implications.

72. Although government identifies new priorities each year, this does not mean that the previous year's priorities are no longer important. In some cases, where extensive change is required, the priority may be repeated over several years. In other cases, where implementation is proceeding as planned, the priority will not be repeated. However, government should expect the responsible ministry to assign a high priority to the program(s) within which implementation is taking place as part of the preparation of its strategic plan and budget submission.

How Should Strategic Priorities Be Expressed?

73. There are numerous ways that government can express its strategic priorities. Common approaches include:

- Vision: This is very high level and is usually supplemented with other types of strategic priorities expressed below. The vision is always long term and describes a future where significant improvements have been made. While extremely important in themselves, visions that are not accompanied by concrete strategies that begin the change process are criticized as being utopian and unrealistic.
- Values/behaviors: Values and behaviors (e.g., freedom, equality, rule of law, innovation) can have strong resonance with the public but, like an overall vision, are very abstract unless supplemented by concrete strategies.
- Themes: Themes are commonly used to indicate the key areas in which the government wishes to focus its efforts (e.g., improved health care; safe and secure communities; smaller, more efficient government). Themes are more operational than values. Where themes have been identified as strategic priorities, the government should expect to see these reinforced through specific initiatives in the annual budget process and legislative program.
- Results/targets: Sometimes governments commit to specific, quantitative results or targets. These might include economic growth of x percent, increase literacy rate by x percent, create x jobs, reduce size of government by x percent. In other instances,

the targets may be more qualitative; e.g., the best economy or education system in the Baltics. These targets become more compelling if time frames are attached to them. However, it is extremely important to prepare a preliminary analysis as to what would be involved and how much it might cost before making this commitment. In practice, any ministry that is responsible for delivering the target should develop a multi-year strategy that would be reflected in its annual strategic management plan.

- Impacts on groups: When the government wishes to appeal to a specific group (e.g., small business, women, children, farmers, etc.), it may wish to state its strategic priorities in terms of an impact on that group. Although such commitments are often effective in terms of generating strong political support from that group, there will need to be a strong follow-up, as the affected groups will be carefully monitoring whether the government delivers its commitments to them. Preliminary analysis on potential cost is critical.

74. Key initiatives: Perhaps the most common approach to priority setting is to identify those major initiatives (e.g., specific laws, investment projects) being contemplated to deliver the government's vision and national goals. The Government Declaration contains numerous initiatives. The danger of simply listing initiatives is that the sum result may be neither strategic nor financially feasible. From a strategic perspective, major initiatives are the means to deliver the government's priorities rather than priorities in themselves.

75. Which of these methods is best for expressing government's priorities depends to some degree on political preferences, but it also depends on the approach to planning and the degree of sophistication.

Recommended Approach

76. The priority-setting process that is recommended for implementation in Latvia is based on the collaborative efforts of the consultant and the staff of the Policy Coordination Unit (PCU) of the State Chancellery. It includes the following key features that are fundamental to any good priority-setting process:

- Substantive political discussion and involvement in decision-making;
- Government priorities that are set within a strategic planning and fiscal framework;
- Ministry expenditure ceilings that incorporate an allocation for government priorities;
- Ministry budgets that reflect a reallocation of resources from lower priorities to fund higher priorities;
- Ministry-level priorities and strategic plans that are set within the government's strategic planning and fiscal framework.

The new priority-setting process should involve two main stages of decision-making.

Establishing Medium-Term Priorities

77. The first stage focuses on establishing a limited number (4 to 6) of medium-term priorities that are broadly defined themes with some indication of expected results. These medium-term priorities should be drawn from established policy documents such as the Government's Declaration, international agreements, and emerging economic and social issues

facing the government. These medium-term priorities would be established and reviewed each year before the budget process begins.

78. There is no hard and fast rule for the exact number of priorities. A range of 4 to 6 is recommended here as a guide. The objective should be to have a very limited number, so that each priority is achievable financially, and can be implemented effectively. With too many priorities the government stretches the capacity of government to deliver on its commitments, and reduces the range of 'non-priority' areas from which to achieve savings.

79. The choice of priorities is essentially a political decision. However, this discussion should be supported and guided by an analysis and assessment of options prepared by the PCU, with input from the Prime Minister's Office, the Ministry of Finance, and other government ministries as necessary. To further support this first stage in the priority-setting process, Latvia's Cabinet has appointed a group of external advisors who will work with the PCU in developing options. Some of the key considerations that should guide this analysis include:

- Is the priority achievable within a medium-term timeframe?
- Can government make a concrete and substantive contribution toward achieving the priority?
- Is the government the sole means or most important means of achieving the priority?
- Is the priority described in a way that points to concrete and measurable results?

80. The product of this work would be summarized in a Medium-Term Priorities decision document, to be presented to Cabinet for discussion. With the use of this document, Cabinet will choose its priorities. Usually this choice can be very difficult, as tradeoffs must be made between different political objectives. Cabinet should be encouraged to devote significant time to this discussion, and could consider convening a separate meeting away from the government offices, to allow for a more candid debate.

Linking Annual Priority Initiatives to the Fiscal Plan

81. Once the medium-term priorities are agreed to by government, the second stage of the process begins with the development of more detailed strategies and specific priority initiatives. As this second stage focuses more directly on specific action plans, the issue of affordability becomes critical, and the relationship with the budget decision-making process has to be established. In particular, the question that needs to be addressed is, 'How much funding should be provided to priority initiatives, given the overall expenditure ceiling established through the fiscal planning process?' The dilemma is that it is difficult to determine how much to set aside without a sense of how much the priorities are likely to cost, but it is also hard to determine which priorities to fund without a sense of how much is potentially available, knowing that new priority initiatives will likely be funded by cutting existing programs.

82. There are two basic options for dealing with this question.

(a) Establish a Priority Initiatives envelope from which initiatives will be funded. In this approach, an amount of funding for new priority initiatives is set aside during the fiscal planning discussions at Cabinet. The amount is essentially arbitrary, in that it is not related to the actual cost of achieving the priorities, but is the maximum

affordable within the fiscal plan, taking into account a reasonable amount of savings to be achieved from the base. Having established this envelope, ministries are requested to develop proposals for funding that will achieve the priorities, and submit these proposals as part of their budget request. Once Cabinet reviews the ministry proposals and approves a selection, ministries can then incorporate these initiatives into their ministry plans.

The advantage of this approach is that it simplifies the fiscal planning discussions and shortens up the budget planning process. It also ensures that proposals are developed within a fixed amount of spending. However, there is a risk that ministries will fail to develop good proposals, or that the overall funding will be inadequate to achieve the intended results.

(b) Develop and determine the cost of priority initiatives before establishing an allocation for priorities from within the expenditure limit. In this approach, the medium-term priorities are set much earlier in the budget cycle. Ministries are then instructed to develop specific initiatives that will achieve the priorities. This process is completed prior to Cabinet's discussion of the fiscal plan, and as a result Cabinet can set aside an appropriate amount knowing the estimated cost of these initiatives. Ministries can then proceed to develop their strategic plans building on the government's priority initiatives.

This approach provides for more rational planning of new priority initiatives, and provides greater opportunity to develop effective strategies. However, it lengthens considerably the overall budget process, and results in greater separation of decisions that ultimately should involve trade-offs between new priorities and savings options.

83. Either of these approaches is doable, and the choice should reflect the government's particular decision processes, timeframe, quality of available data, and so on. In Latvia's case, these two approaches were considered in the course of developing the medium-term budget process methodology, and the approved methodology reflects the second approach described above. Since the 2002 budget process is already well underway, however, full implementation will only be possible for the 2003 budget process. For 2002, a modified version of the first approach can be used, and is discussed in more detail at the end of this chapter.

Criteria for Selecting Initiatives

84. Regardless of the approach chosen, the specific initiatives that are developed to meet the medium-term priorities should be carefully analyzed in order to advise Cabinet on which initiatives should be funded. Ideally, a set of criteria should be established at the outset of the process to assist staff in the line ministries who will be developing proposals. These criteria could encompass the following principles:

(a) Contribution to Government Priorities. The initiative should demonstrate a clear, direct and measurable contribution to one or more medium-term priorities of government. It should represent a substantive improvement over current government activity in this area. Suggested questions:

- How does the initiative relate directly to the medium-term priorities of government?
    - Which priorities? How many priorities?
    - Does it conflict with any priorities?

- Are the specific objectives of the initiative clearly identified?
- What are the expected results? Are the expected results concrete and measurable? How soon will the results be achieved? Who are the prime beneficiaries or target groups? How many people or businesses will be affected?
- Has the initiative already received policy approval (without funding) by the current government or by a previous government? Has legislation already been passed?

(b) Impact Assessment. The initiative should have minimal negative social and economic impacts, and where possible should contribute positively to other government objectives. Suggested questions:

- Will there be a positive or negative impact on (for example): economic growth; employment; households?
- Can these impacts be quantified?
- Will there be a specific regional impact?

(c) Fiscal and administrative implications. The initiative should minimize the amount of new funding required, and where possible should use existing funding. The costs associated with government administration should be minimal. No new special budgets should be created by the initiative. Suggested questions:

- What is the total cost of the initiative? How much new funding is required? Is the ministry providing any funding for the initiative from its base? What percentage of the total cost will be taken up by administration?

- Is the ministry proposing that a new special budget be created, or an existing budget expanded?
- Are there staffing implications? Is there a need to hire more staff?
- Does this initiative have revenue implications? Is there a direct or indirect impact on tax revenues? Does the initiative involve an increase or decrease in fees?

(d) Opportunity for reallocation. The initiative should form part of a broader strategy of reallocation and improved effectiveness for program funding within a common policy area. Suggested questions:

- What other programs (within the ministry or in other ministries) have similar objectives? Does this initiative consolidate or replace these existing programs?

(e) Level of detail. The initiative should be well thought out, including an accurate estimate of costs. Suggested questions:

- Are the details of the initiative well developed?

    - Is there a detailed, multi-year estimate of cost?
    - Is there a detailed design for the initiative?
    - Is there a plan for implementation?
- Is there a communications plan?

Priority Working Groups and the Role of Ministries

85. The development of these priority initiatives should be done by line ministries with direct responsibility for these policy areas. However, in some cases government priorities will affect the programs of more than one ministry. In addition, it may well require a number of different initiatives to achieve a priority.

86. To ensure good coordination and responsiveness to political objectives, the development of individual initiatives should also be guided by a working group for each priority area, led by staff from the PCU with participation from the Prime Minister's Office, the Ministry of Finance, and appropriate line ministries. It may also be useful to include representation from the external advisory group on priority setting. The responsibility of each of these working groups would be to develop a strategy or action plan for achieving each priority, and identifying specific initiatives that could be developed.

Allocating Funding in the Fiscal Plan

87. Once the strategies for achieving the medium-term priorities have been developed, along with specific priority initiatives, the PCU would prepare an Annual Priority Initiatives Decision Document, containing a summary of the analysis and a set of recommendations. This document would be presented to Cabinet at the same time that it is making decisions on the fiscal plan. Cabinet would approve in principle a set of priority initiatives, identify an amount of funding to be allocated to these priority initiatives, and would concurrently identify the level of savings required to remain within overall spending limits of the fiscal plan.

88. Once the allocation for priorities has been set, along with a savings target, ministry expenditure ceilings can be set and ministries can proceed to develop their strategic plans and detailed budget submissions.

Budget Priorities Statement

89. As a final step prior to the budget in Parliament, the government should prepare a Budget Priorities Statement presenting the results of the priority-setting and budget processes, including the government's rationale for pursuing its medium-term priorities, the specific strategies and initiatives that have been including in the budget in order to achieve these priorities, as well as a discussion of the government's reallocation strategy through which it has reduced the cost of current programs.[53]

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[53] In response to some of these recommendations, Cabinet recently approved a framework for an integrated medium-term planning and budgeting process. This framework was prepared by a working group led by the Policy Coordination Unit (PCU) in the State Chancellery, with participation from the Prime Minister's Office, the Ministry of Finance, the Ministry of Economy, the European Integration Bureau, and the Secretariat of the Minister with Special Responsibility for Cooperation with International Financial Agencies.

E. STRATEGIC PLANNING IN MINISTRIES

90. Ministry strategic plans are a critical part of government's planning and priority-setting process. The ministry plan is the key document that brings together the budget and the strategic planning process within each ministry, in the context of government priorities.

91. In order to complement the priority setting process at the Cabinet level, the Government has decided to initiate a strategic planning process at ministry level. The Policy Coordination Unit is also given the responsibility to coordinate this government-wide initiative. The Government has adopted a well-measured strategy for this initiative. First, the respective roles and functions of the Chancellery, the Ministry of Finance and top management of line ministries will be identified in the context of a high-level model of strategic planning. Then, the Chancellery and the Ministry of Finance will prepare draft regulations for the strategic planning procedure and the way it links with the budget process. Next, a pilot ministry will undertake a strategic planning exercise; central agencies will learn from this experience and adjust their regulations before they initiate strategic planning across the government. The Ministry of Agriculture has been identified as the pilot ministry.

92. The rest of this section sets out a possible high-level model for strategic planning in ministries. This model fits with the methodology for medium-term budget planning which the Government has recently approved. It is also compatible with the budget process described above permitting the strategic planning model to be implemented in harmony with changes to that process.

Purpose of Strategic Planning

Integration and Alignment

93. Strategic planning is a process designed to integrate policy, planning, budgeting and management:

- within a ministry;
- between a ministry and its associated agencies, state-owned enterprises and other bodies;
- between ministries, particularly those with closely related functions; and
- with the higher-level policy planning, budgeting and reporting activities of the government.

94. The strategic plan of a ministry sets out what will be delivered for what costs in the coming year, taking into account medium-term requirements and funding forecasts. It does this in a way that can be measured, monitored and reported on. It is a way to link the work of the ministry to the government's requirements and to the budget of the ministry. If strategic planning is done well in the ministries, it increases the ability of the government to ensure that its policy intentions become a reality and that scarce resources are allocated to priorities and used more effectively.

95. The strategic plan provides a framework for developing plans for agencies, state enterprises and other bodies closely associated with the work of the ministry. This helps ensure

alignment of the plans of related agencies and organizations with the ministry's obligations and requirements.

Accountability and Flexibility

96. The strategic plans can provide a basis for greater accountability which can be matched to increased flexibility for ministries to manage resources. The greater accountability comes through integrating policy-making, planning and budgeting. It also comes through improving the information available on planned performance and results, which can be used by the ministry itself, related agencies, other ministries, central agencies, the Government, Parliament and the public. Better accountability can be matched with greater flexibility over the use of inputs, as confidence is developed that resources are being well managed and monitored. The use of strategic plans in agencies could have an important role in developing a good balance between accountability and flexibility for these agencies.

Engagement of Staff and Stakeholders

97. The strategic planning process can be a way of engaging staff and stakeholders,[54] resulting in higher-quality planning work, greater staff commitment, and services which are more responsive to the legitimate expectations of the people receiving them.

Potential Gains from Strategic Planning in Ministries

98. The potential gains from strategic planning include the following:

- Greater ability to set and deliver on priorities through better information and the alignment of priorities, programs and the budget at all levels in government. This includes the alignment of the work of ministries and subordinate agencies.
- Improved decision-making on the allocation of resources in the budget process due to better information, including medium-term impacts.
- Greater management effectiveness in ministries through formally prioritizing resources, planning the use of resources, and monitoring performance.
- More efficient budget process through the provision of higher-quality budget bids linked to financial limits.
- Potential for better fiscal management, as current and future commitments would be better identified.
- Eventual elimination of commitments to undertake work without the funding to do so.
- Better accountability through the information provided in the strategic plans and the performance reports against those plans.
- More effective reviews of strategy and operations as the strategic plans will provide a better context for these.
- Greater commitment to delivering results, in response to the participatory nature of the strategic planning work.

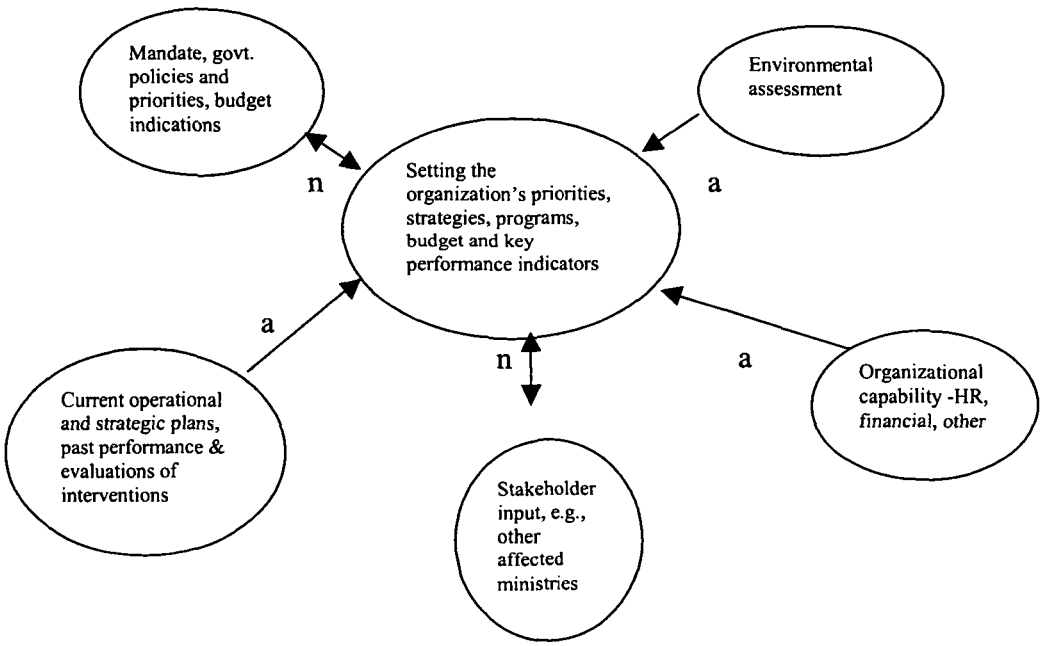
[54] Stakeholders may be other ministries affected significantly by the decisions of the ministry and recipients of the services, for example, recipients of rural health services.

Process of Strategic Planning

99. This section sets out the key parts of a strategic planning process which ministries could use to develop their plans. The State Chancellery, in consultation with the Ministry of Finance, the Prime Minister's Office, line ministries, and others, will create guidelines for ministries to assist them to develop high-quality strategic planning processes. The guidelines will cover matters such as consultation, timing and budget parameters (set by the Ministry of Finance). While certain planning parameters must be set out in the guidelines, the guidelines will not be overly prescriptive in areas where there will be benefits from ministries having flexibility. Ministries will need some scope to develop aspects of the strategic planning process to meet their unique requirements. The following description of a strategic planning process is provided as an example of what can be considered in developing the guidelines.

Processes to Develop the Core of the Strategic Plan

100. The core of a strategic plan is the development of the ministry's priorities, the strategies to deliver on these, the determination of the services to be provided and the resources to be applied. This involves the following processes of analysis (a) and negotiation (n) as described in the diagram below.



Annex-Table 1: Description of Process

1. Determining the Mandate, Government Policies and Priorities, and Budget Indications.	The organization's mandate may be set out in legislation and/or government policy documents such as Cabinet decisions. The priority areas at a high level should take into account the government's goals. Assumptions should be made about the likely funding level, based on planning parameters advised to the ministry by the State Chancellery and the Ministry of Finance. The planning parameters would include an indicative budget. Ministers and/or State Secretaries may wish to set other planning parameters for the organization. All this material sets the boundaries for planning. Some of it can be negotiated, e.g., the government may change its priorities in response to information from the ministry.
2. Environmental Assessment	The organization considers external factors which affect its mandate, policy settings, priorities, external demands, costs and other factors related to its role and ability to perform. These may include: new policy directions suggested by government but not yet confirmed, changes in legitimate requirements of people receiving services, economic forecasts and the effect on costs, technology changes, changes in society and cultural factors, changes in the law, changes in the labor market, etc.
3. Organizational Capability	This needs to be assessed against the current and future demands. A gap analysis and strategies to close any gaps need to be developed. This must be done within the planning parameters which include the indicative budget. Sometimes the strategies will need to be modified because the ministry cannot develop the capabilities required.
4. Stakeholder Input Including the Minister	The ministers have a valuable role in getting involved at a high level early on in the strategic planning process. This gives the ministry an opportunity to understand priorities and can help ministers understand capabilities better, e.g., the timeframes and resources required to support major policy changes. The useful engagement of the minister should help the organization to produce a draft plan which is acceptable to the minister. Other stakeholders can include major customer groups if these exist, interest groups, and other government agencies. Their involvement will help the ministry focus on developing effective plans to meet legitimate expectations within a process which considers resources and priorities. Cross-ministry work should be facilitated by joint planning prior to the commitment of resources. The ministry can use the process to "negotiate" with stakeholders and modify their expectations where necessary. The effective engagement of stakeholders should help develop good relationships.
5. Current Operational and Strategic Plans, Assessment of Past Performance and Evaluations of Interventions.	This information should help the organization set its priorities and strategies and may feed into advice to the minister to seek an alteration to policies and laws. An example would be advice to a minister about seeking changes to unfunded laws which cannot be met within existing resources without seriously damaging the provision of essential services.
6. Setting the Organization's Objectives, Priorities, Strategies, and Key Performance Indicators.	This process takes in information from the work set out above. It is an assessment and prioritization process which links the planned work to the ministry's ability to carry it out. The capability assessment, financial projections, and risk assessments are critical parts of this work.

Contents of Strategic Plans

101. The planning guidelines developed by the State Chancellery, in consultation with others, will set out expectations on contents.

102. Without predetermining those guidelines, a fully developed strategic plan could be expected to cover at least the areas below. As it takes time to develop the processes underpinning the plan and time to collect and analyze information, initial strategic plans may not cover all the areas below, or may not cover them in depth. An example of possible contents for a strategic plan for a ministry has been set out below.

103. A description of the setting for the ministry in terms of its mandate, its functions, the government's policies and the government's priorities. The mandate may come from legislation and/or formal government policy such as decisions by ministers. This section can include the ministry's response to this in terms of its mission statement and statement of values. The purpose of this section is to make the ministry's operating parameters very clear. The strategic plan must cover matters inside these parameters. The inclusion of value statements can provide clarity to staff and others about the way the ministry is expected to operate. They should reflect the values for the civil service.

104. Key points from the assessment of critical environmental factors and stakeholder requirements. This involves considering things which are likely to have significant impacts on how the ministry will do its work in the future. These include matters such as the impact on agricultural production of world trade policies and changing EU requirements for access of products to markets. The inclusion of this material means that the ministry has gone through a process of considering important external factors in determining its direction and allows people to see what these factors are.

105. The ministry's priorities with reference to why these have been selected, including their relationship to the Government Declaration, the government's medium-term priorities, and the work of the State Chancellery in strategic policy analysis and priority setting. The inclusion of this material indicates that the ministry has gone through some sort of priority-setting process and has a rationale for the direction chosen. Stakeholders and others can assess these and provide feedback in the draft stages. This section, along with the strategy section and the key performance indicators, would be what the ministry and external agencies use for driving the reporting, evaluation and monitoring systems.

106. Key strategies associated with the priorities. This informs staff and others of how the priorities will be met.

107. Key performance indicators. The indicators should be a selection of indicators that allow the ministry and its monitors to assess how well it is achieving its objectives and how well it is positioned to operate in the future. The indicators should also inform external monitors about performance.

108. Information on risks and plans to manage these. The risks should be ones which need to be actively managed and monitored by staff, such as impending legal actions or impacts from loss of key personnel near retirement age, or potential failures in an overextended IT system.

109. Financial projections. The financial projections would be well integrated into the operational plans (workplans) and risk management plan. They would be in a form that is compatible with the government budget.

110. Annexes with material required to support the plan, such as:

- key assumptions made in the plan;
- description of programs and costs;
- evaluation and monitoring approach;
- information to be reported.
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111. The strategic plans should have a medium-term focus with more detail for the coming year. They are rolling plans, revised each year to reflect changes in government requirements, other factors in the environment, and capability.

Roles and Responsibilities in Relation to Strategic Planning

112. The roles and responsibilities in relation to strategic planning have been set out below.

Parliament

113. Parliament creates certain legal obligations on ministries, including matters affecting the mandates of some ministries, the laws they must implement, and the annual budget they must operate within (annual budget law). This is reflected in the strategic plan through the expression of the purpose of the ministry with reference to its mandate, the programs it will deliver and the funds associated with those programs.

114. Parliament receives the annual report of performance against the strategic plan and examines these through its parliamentary committees.

Government

115. The government sets the mandates for some ministries. It sets out their requirements in the form of the Government Declaration and the related document setting out the medium-term aims and objectives. These are taken into account by the ministries in developing their priorities and strategies, the services to be delivered within the programs, the resources to be used, and their planning for the development of future capability. This is reflected in the strategic plan.

116. A sound process is needed for the development of the Government Declaration and the medium-term priorities. This might be done in a Cabinet 'retreat.' Ministers would determine a small number of top priorities and the outline of plans to achieve them in addition to discussing their agendas of more specific political commitments. The State Chancellery could arrange for papers to be available on a few key strategic policy issues that run across the mandates of the individual line ministries.

117. The government determines the budget to be presented to Parliament, what programs will be delivered for what cost, and ensures implementation after the budget has been passed by Parliament.

Ministers

118. Each minister responsible for a ministry approves the ministry's draft strategic plan for submission into the budget process, at the time the budget bids are made. The Ministry of Finance will determine the information required for the budget bid and may include a requirement to provide the draft strategic plan in addition to other information.

119. Following the passing of the budget law, the ministry will revise the draft strategic plan to ensure that it reflects the budget law. Each minister will approve the final version of the strategic plan following its revision in response to the budget law and will sign the plan, provide it to government and submit it to Parliament.

120. The minister then monitors the implementation of the plan and approves the quarterly reports on progress to the Cabinet and the annual report on the plan, which is provided to government and submitted to Parliament.

121. Ministers who have responsibility for agencies under the new Agency Law will need to ensure that the management agreements set out roles and responsibilities in relation to strategic planning which are aligned with the roles and responsibilities of the related ministry.

Minister of Finance

122. The Minister of Finance, on behalf of the government, sets the financial parameters for the next budget year to be used in developing the strategic plans of ministries. The Minister of Finance oversees the government's budget process, represents the government's interests in the efficient and effective use of resources, and manages fiscal risk across the government.

Ministry of Finance

123. The Ministry of Finance manages the budget process and undertakes the analytical and advisory functions associated with this. This ministry will set the initial financial parameters for the draft strategic plans. The Ministry of Finance's work includes analyzing the strategic plans and the associated budget bids.

124. The role of the Ministry of Finance includes involvement in the reviews of ministries and programs aimed at raising allocative efficiency, technical efficiency and effectiveness. The Ministry of Finance has the primary responsibility to initiate program reviews. This may be on its own initiative or in response to requests from the State Chancellery, the ministry or some other organization. The Ministry of Finance will be involved in other types of reviews having significant financial impacts as appropriate.

125. The Ministry of Finance's role includes the monitoring of financial performance, including performance against the budget as reflected in the strategic plans of the ministries.

State Secretary of the State Chancellery

126. The role of the State Secretary of the State Chancellery involves oversight of strategic planning and performance in the ministries. This includes setting expectations for the process, timing and quality of the strategic plans. The State Secretary also facilitates the coordination of strategically significant work which spans ministries, if problems of coordination are likely to emerge or have emerged.

State Chancellery

127. The State Chancellery set standards and timing for strategic planning by issuing planning guidelines and assessing the quality of strategic plans. With respect to the financial parameters of the guidelines, these are set by the Ministry of Finance in accordance with government requirements which are determined after taking into account advice from the State Chancellery, ministries and other organizations.

128. The State Chancellery advises the Prime Minister on the adequacy and acceptability of draft strategic plans with respect to their responsiveness to government objectives and priorities. Acting on behalf of the Prime Minister, the State Chancellery can work with ministries to seek improvements to the responsiveness to government objectives and priorities and, if necessary, advise the Prime Minister that a ministry should amend, add, remove or otherwise modify its strategic plan.

129. The State Chancellery assesses draft strategic plans for policy coordination, coherence and impact across the government. This includes assessing the legislative changes proposed by or associated with the draft strategic plans, to ensure that the government has a realistic agenda for legislative change which can be financed and implemented. While it is the principal responsibility of ministries to include the impact of proposed policy and legal changes and to include the costs in their strategic plans, the State Chancellery will consider and advise Cabinet on the overall fiscal and other impacts of the proposed policy and legal changes.

130. The State Chancellery advises ministers and Cabinet on the adequacy and acceptability of the performance indicators proposed by ministries in their draft strategic plans. Acting on behalf of ministers and the Cabinet, the State Chancellery can work with ministries to improve indicators and, if necessary, advise Cabinet that the ministry should amend, add, remove or otherwise modify performance indicators.

131. The State Chancellery monitors delivery by ministries against the performance indicators in the strategic plans.

132. The State Chancellery also facilitates the coordination of strategically significant work which spans ministries, where facilitation is required to achieve a coherent and coordinated approach between ministries.

State Secretaries of Other Ministries

133. The State Secretaries of ministries are responsible for producing feasible strategic plans which are aligned to the budget and responsive to government objectives and priorities.

134. The State Secretaries are responsible for ensuring that the planning and management arrangements in the departments within their ministry and in all agencies reporting to them are aligned to the ministry's strategic plan.

135. The State Secretaries are responsible for implementing management arrangements within their ministry to deliver on the strategic plan and to produce services to fulfil the strategic plan. The State Secretaries are responsible for monitoring delivery by agencies against their strategic plans.

136. State Secretaries who have supervisory responsibility for agencies will need to provide advice on the management agreement to ensure alignment between the agency and the ministry

of strategic planning roles and responsibilities. The law requires the ministry to assess the strategic plan of the agency and to monitor performance against the management agreement.

Heads of Departments in Ministries

137. Heads of departments have the role of managing their operations efficiently and effectively. They are responsible for producing operating plans aligned to the ministry's strategic plan, for implementing those plans, and for reporting on delivery against the plans.

Heads of Subordinate Bodies, Agencies Linked to Ministries

138. The heads of these organizations have the role of managing the organization efficiently and effectively. They are responsible for producing strategic plans aligned to the ministry's strategic plan, for implementing those plans, and for reporting on delivery against the plans.

139. Agencies operating under the Agency Law will be under the supervision of the ministry and will operate in accordance with a management agreement signed with the minister. The management agreements will need to set out roles and responsibilities in relation to planning and budgeting.

Local Government

140. When local government provides services funded through a ministry or very closely associated with the work of a ministry, processes will need to be developed to ensure the alignment of the plans and work between the ministry and local government. The impact this has on the roles and responsibilities of local government and ministries and local government in relation to strategic planning will need to be considered further as this model is refined.

State Audit

141. The State Audit Office is responsible for auditing the financial and service performance of ministries and agencies and reporting to Parliament on this.

How the Ministry's Strategic Planning Fits with the Whole of the Government-Level Work

Linkages

142. The strategic planning process within ministries and other government organizations must be linked into the policy-making, planning and budgeting process at the level of the whole government.

This involves:

- Government setting its priorities.
- Ministries and government agencies developing their draft strategic plans in response to the priorities.
- The ministries making their budget bids based on the strategic plans.
- The budget bids analyzed and processes undertaken to result in the proposed budget and annual budget law.
- Annual budget law and budget scrutinized and budget passed.

- Ministries finalize their strategic plans to reflect the budget.
- Periodic reporting of achievement by ministries and other government agencies.
- Periodic reporting by government to Parliament on the achievements by ministries and other government agencies and on government's overall performance.
- Reviews by monitoring agencies including Ministry of Finance and scrutiny by standing committees of Parliament on the audited annual reports.
- Feedback on performance taken into account in revising the strategic plan for the next budget bid.

Stability

143. The process of strategic planning proposed in this model has the potential to help create a stable environment where the annual budget covers the expenditure required for the vast majority of activities for the financial year, without the need for ad hoc expenditure demands being made through the year. To achieve this, the government would need to commit to putting expenditure demands through the annual budget, and apply discipline to requests for further expenditure within the year. The strategic planning within ministries would support this system, as the plans would consider expenditure for the year, as well as medium-term forecasts.

Reporting and Monitoring

144. The strategic plan would form the basis for the reporting and monitoring systems for the various monitoring agencies. To ensure that it is suitable for this purpose, the strategic plan sets out what will be achieved in the financial year and what resources will be used. It also has forecasts for the following two years, to ensure that the annual work is placed in a medium-term context. This model of strategic planning does not involve a separate action plan, rather it integrates this with the strategic plan. This reduces the risks of disparities developing between the medium-term and annual intentions

145. The State Chancellery and the Ministry of Finance, in consultation with State Audit, will jointly develop guidelines and formats for reporting. In developing these guidelines, the State Chancellery and the Ministry of Finance will take into account the information required to permit Parliament to hold the Government to account for delivery by the ministry on its strategic plan. The Ministry of Finance and the State Chancellery will also consider ways to build on current reporting, and how to achieve gains in an efficient and effective way when altering reporting requirements. They will also consider how the reporting on the Government Declaration relates to reporting on strategic plans and the potential for aligning these.

Documents

146. The documents produced from the strategic planning process are:

- A draft strategic plan used as part of the budget bid (this would be a revision to the strategic plan used for the current year). The draft strategic plan would be made available to the State Chancellery and the Ministry of Finance during the preparation of the budget.

- A final strategic plan approved by the relevant minister, reflecting the budget law. This would set out what would be provided in the coming year for what resources, and would have forecasts for the next two years. The final strategic plan would be a public document, submitted to Parliament.
- The operational plans for units within a ministry, underpinning the strategic plan. These would be internal management documents for the ministry.
- Agreements with other agencies and ministries. These may be informal but, in the case of an agency, the law requires a formal agreement between a minister and the agency specifying the subject which a ministry will be involved in advising on.
- Reports on progress against key performance indicators. These reports could be quarterly and made available to the Government. An annual audited performance report would be signed by the State Secretary and the minister, and would be publicly available and submitted to Parliament.
- Performance expectations from managers in the ministry for their staff, reflecting the requirements on the ministry. These would be internal ministry documents.
- Individual work plans for staff members. These would also be internal ministry documents.

Application to the Methodology for Medium-Term Budget Planning

147. In 2001, the Government approved a medium-term budget planning process which is set out in a document titled "Methodology Guidelines for Medium-Term Budget Planning."

Fiscal Policy

148. The strategic plans of the ministries and their performance reports against those plans provide information on fiscal performance and risks which is incorporated into the macroeconomic development scenario and fiscal policy in the Ministry of Finance.

149. As the strategic plans and annual reports become increasingly more sophisticated, the quality of the information they provide for developing the macroeconomic development scenario and fiscal accountability should increase, leading to better forecasting and more robust fiscal policy.

Policy Planning

150. The strategic plans and annual reports of the ministries and agencies can be taken into account by the experts preparing the proposals for the medium-term aims and objectives. This should provide a rich source of information on priorities, strategies, capability, programs being delivered, results and costs of programs. This would provide a context for assessing the Government's medium-term aims and objectives, leading to more informed advice, linked to what is currently happening and the costs.

151. When ministries elaborate the proposals for responding to the Cabinet's advice on medium-term aims and objectives, they can do so within the context of their strategic planning process. This would involve considering what they are currently doing, for what results and costs, their capability, and the options for improving services in response to priorities, within the indicative budget parameters.

152. After the Cabinet has set firm ceilings and advised ministries of their decisions on new priorities and associated financing requirements, such as reallocations within the base and/or additional spending, then ministries will refine their draft strategic plans and provide these, along with their budget bid information, to the Ministry of Finance.

153. After the budget law has been passed, the ministries will finalize their strategic plans to reflect the budget law and have them approved by their minister. The strategic plans will be submitted to Parliament and made available to the public.

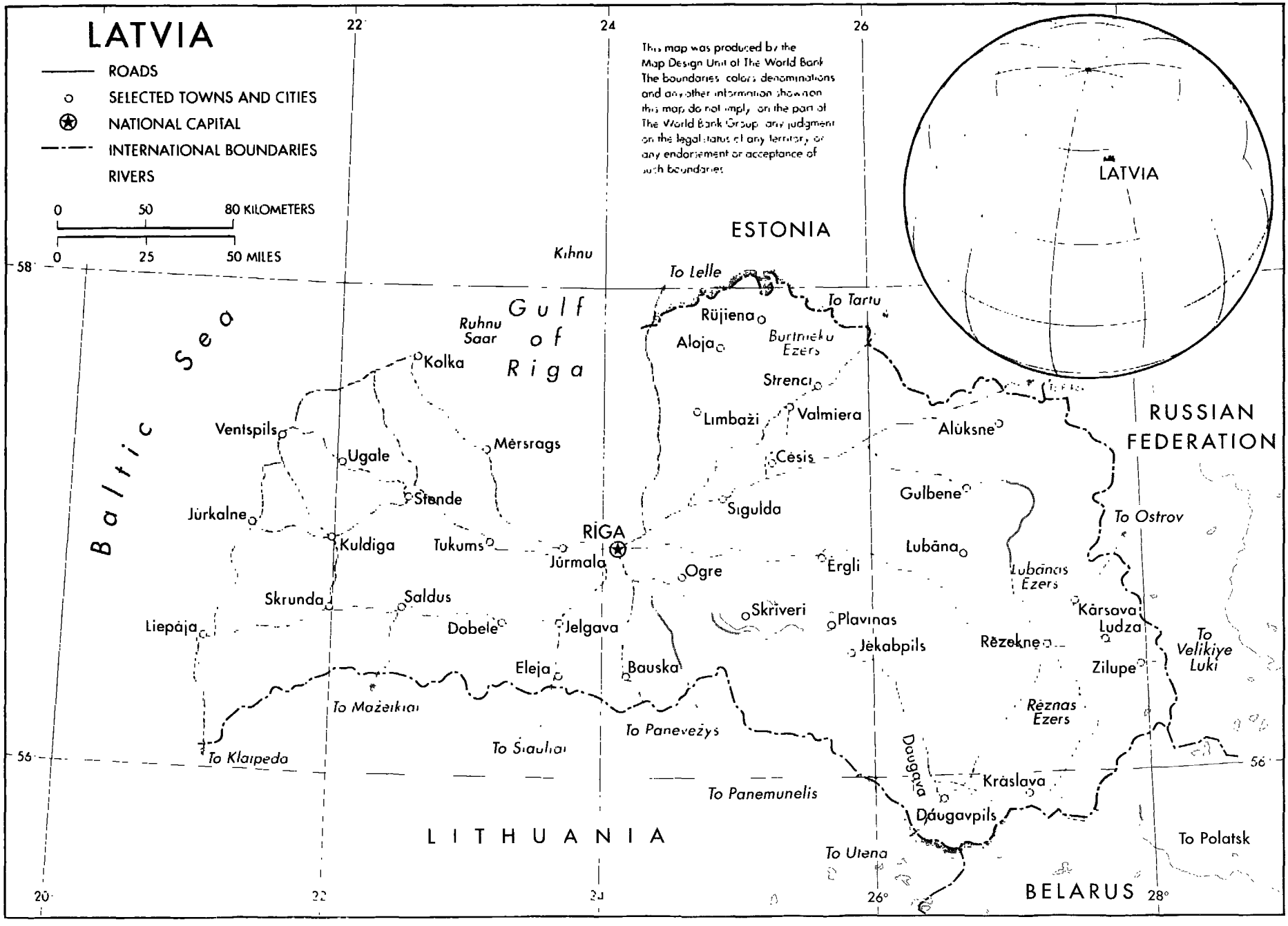
Expenditure Planning

154. The ministries would engage in an analysis of budget programs within the context of their strategic planning process. This may include a review with the Ministry of Finance of programs or a fundamental review of broader scope. Fundamental reviews are expected to take into consideration the ministry's overall purpose and strategic priorities, and then to consider what roles, functions, systems, processes, structure, staffing, and relationships are needed for that organization to deliver its strategic priorities efficiently and effectively. They can take a horizontal perspective across more than one ministry.

155. The budget bids and draft strategic plans supporting those bids would be provided to the Ministry of Finance as part of the budget process.

Delivery and Performance Reporting

156. The ministries would monitor their performance against their strategic plans and report on this quarterly to their minister, the Ministry of Finance, and the State Chancellery. The State Chancellery would report significant achievements and issues to the Cabinet on a quarterly basis three times each year, and annually after the conclusion of the financial year. In addition, the audited annual reports of ministries would be submitted to Parliament and made available to the public.



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