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Latvia
From Exuberance to Prudence
A Public Expenditure Review of Government Administration and the Social Sectors

(In Two Volumes) Volume I: Overview and Summary

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Abbreviations, Acronyms & Terms

BoL	Bank of Latvia
CEE	Central and Eastern Europe
CDS	Credit Default Swap
CoM	Cabinet of Ministers
CIT	Corporate Income Tax
CSB	Central Statistics Bureau
DC	Defined Contribution pension plan
EC	European Commission
EU SILC	Survey of Incomes and Living Conditions
EBRD	European Bank for Reconstruction and Development
ECB	European Central Bank
ESA	European System of Accounts
ESF	European Social Fund
ESSNS	Emergency Social Safety Net Strategy
ESSNS	Emergency Social Safety Net Strategy
EU	European Union
FDI	Foreign Direct Investments
GDP	Gross Domestic Product
GMI	Guaranteed Minimum Income means tested social assistance benefit
GP/PHC	General Practitioner/Primary Health Care
HBS	Household Budget Survey
IMF	International Monetary Fund
LFS	Labor Force Survey
LVL	Latvian Lats
MoES	Ministry of Education and Science
MoF	Ministry of Finance
MoH	Ministry of Health
MoW	Ministry of Welfare
MoRDLG	Ministry of Regional Development and Local Government
NDC	Notional Defined Contribution, pay-as-you-go pension plan
OECD	Organization for Economic Cooperation and Development
PER	Public Expenditure Review
PFM	Public Finance Management
PHC	Primary Health Care
PISA	Program for International Student Assessment
PIT	Personal Income Tax
PPP	Public Private Partnerships
SEA	State Employment Agency
SOE	State Owned Enterprises

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The data/information used for this review is collected during the first 2 quarters of 2010. This document represents the opinion of the World Bank. (This document has not been approved by the Government. The Cabinet of Ministers only took note of the informative note prepared on the basis of this PER.)

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Volume 1 Overview and Summary of the PER

I. Objectives, Scope, and Summary of the 2010 Public Expenditure Review

A Public Expenditure Review for Latvia's Post-Crisis Objectives

1. This Public Expenditure Review (PER) was conducted at the request of the Ministry of Finance (MoF) on behalf of the Government of the Republic of Latvia. The objective of the PER is to identify potential areas of further budget savings in public administration and the social sectors that could help restore fiscal balance, speed Latvia's recovery from the current crisis, and help it to meet the Maastricht Criteria by 2012 so it can adopt the Euro in 2014. In this way, the PER responds directly to the Government's request to international agencies, including the World Bank, to help it meet its goals for fiscal consolidation. Perhaps more importantly than opportunities for further fiscal consolidation in 2011 and 2012, the measures recommended in this review could lead to improved performance and greater economic and social returns on Latvia's investment of public resources. One important aspect in future sectors are their equity impact -- prior to the crisis, the impact of public spending on income equality in Latvia was among the lowest in the European Union.

2. Pushed by the devastating consequences of the global financial crisis of 2008 and Great Recession of 2009, Latvia has achieved years worth of difficult structural reforms in the short space of just a few months, and for its efforts in the face of the most adverse circumstances, deserves praise. However, more can be done not only for the country to achieve the goal it has set for itself of entry to the Euro, but also to improve the public services that Latvians depend on. This PER offers a menu of policy options from which the Government -in close consultation with stakeholders- can consider and choose the measures it thinks are not only appropriate but also timely. It is not a prescription.

3. Implementation of any of the options identified in this review will require broad consensus around difficult political choices. Most of the suggestions can help the Government achieve further reductions in the state budget in the immediate term. But for the most part, the options identified in this review are desirable in their own right in order to provide a more efficient and effective public administration, and better incentives for sustainable and responsive social sector programs. Here, as with many of the structural reforms already implemented in 2009 and 2010, the current economic crisis and the need for fiscal consolidation that it brings, offers an opportunity to adjust public spending with a clear rationale that will increase the likelihood of improved performance in the future.

Main Messages for Policy Makers

4. **There is little, if any, room for further reductions in the budgets for health and education.** The PER concludes that the health sector and the education sector have borne the brunt of fiscal adjustment in the 2009 and 2010 budgets. With very few exceptions, further cuts in the budget allocations to these sectors could put in jeopardy the progress achieved so far. Indeed, the speed of reductions in the in-patient care budget have surpassed the ability of the authorities to close hospital beds and decommission hospital buildings, and supplemental financing in 2010 to sustain an orderly, and de-politicized process of hospital closures phased over the next three years will be required.

5. **Structural reforms of health and education are on track and are showing measurable improvements, but they need to be continued with care and commensurate financing.** On the whole, the structural reforms in the health and education sectors initiated in 2009, although rapidly put in place, took the form of fundamental changes in incentives that need time to "take root" before they can fully deliver expected gains. Yet already there is clear evidence of a shift in health spending which favors more intensive use of preventive and day-care procedures, and which is likely to better address the health problems Latvians suffer. The heavy burden on the budget of over-capacity of schools and teachers has been lightened significantly and financing for primary and general secondary education has been fundamentally altered to better adapt to demographic trends and increase efficiency. However, there is still much to be done in the health and education sectors to make them perform to the high-standards of an EU member state, and the sections of this review on both sectors are rich with suggestions for how to accelerate convergence. But while these suggestions can indeed speed improvements in performance, they are *not* likely to deliver the savings the Government seeks in 2011 and 2012.

6. **The opportunities for the savings in 2011 and 2012 that Latvia seeks to meet its Maastricht objectives, lie in reducing spending on social insurance pensions and efficiency gains from further public administration reform.** In contrast to the review of the health and education sectors, the PER finds that bolder action could be taken by the Government to capture substantial budget savings from further structural reform of public administration, reductions in subsidies, and reform of the social welfare sector. The most immediate fiscal savings could be had from well targeted measures to recover at least part of the windfall gains made by the recipients of social insurance pensions, while protecting the lowest pensions. The actions proposed in this review would be starkly different in substance and in form from the Government's flat, across the board pension cut in 2009, which regressively penalized all pensioners regardless of their income or their age, and inadvertently punished pensioners who preferred to keep working. Despite some consolidation in 2009, the public administration could be further streamlined at the national and municipal levels of government, although to ensure it retains skilled and motivated civil servants, the PER warns against further reductions in public sector salaries at the national government level. As was the case with the structural reforms to education and health in 2009 and 2010, the PER's recommendations in these areas are made to guide the process of fiscal adjustment with a clear rationale that will increase the changes of improved performance.

7. The three main messages of this review, stated above, are the most important conclusions policy makers should take away from this review. These messages summarize the findings of an intensive period of work by the World Bank team with Government counterparts. The three main messages are complemented with important points summarized in the sections that follow, as well as in the longer chapters of the technical Volume 2 of the PER.

8. However, readers should note that the PER is only a partial analysis of government expenditure. It is important to consider the options identified in this review in the broader fiscal context. This review focuses only on the three social sectors and the Government's efforts to improve public administration. There may be opportunities for immediate expenditure savings in other sectors that impact less directly on household welfare. Furthermore, the PER does not cover issues of public financial management and the budget process, which are critical to prudent and sustainable public finances, and are being

examined in depth through a program of technical assistance provided by the IMF. A broad view should be taken when looking for savings particularly in a period of economic contraction and high unemployment. Changes in how the Government uses revenue instruments -being discussed between the Government and other international partner agencies- will be critically important to achieving the goals of fiscal consolidation, and are only summarized briefly in this report.

9. As the conclusions of the social welfare sections of this review make clear, Latvia does not have a particularly generous social welfare system when compared with its partners in the EU. For this reason, and especially until there are signs of recovery in the labor market, this review suggests ways in which the modest amount that Latvia spends on state social benefits and municipal social assistance could be redistributed to much better effect. By taking these suggestions, the Government can confront the high cost of social insurance pensions with greater confidence that it does so in a way that protects vulnerable households. A similar emerging policy approach can be seen in the health sector: more parsimonious and targeted use of co-payment exemptions, and strategic deployment of public health measures, allows the authorities to confront the difficult process of rationalizing the hospital network with greater confidence. The Government has set a strong precedent in this regard, with the rapid design and deployment of the cross-sector Emergency Social Safety Net Strategy (ESSNS), which it continues to monitor closely, and plans to sustain throughout 2011. There are lessons from the design and deployment of the safety net that could inform more permanent reforms to welfare, health, and education policy.

Noteworthy Items from the PER's Menu of Policy Options

10. In this section, the three main messages of the PER are further substantiated with more specific policy suggestions selected by the PER team for particular attention and consideration by the Government. Two criteria have been used by the team to make this selection. These are the measures that (i) are most likely to deliver the savings that Latvia seeks in 2011 and 2012, and/or (ii) are critical to improving equity as well as efficiency.

Public Administration and Subsidies

11. **Remuneration structures in the public sector could be further improved and more effective establishment control could be put in place, but further reductions in salaries in 2010 and 2011 would pose a risk to the quality of the civil service.** The PER suggests further amendments to the new remuneration grid that was introduced in 2009, that would eliminate salary bands and reduce the number of public service job families. The remuneration grid remains overly complex and contains many inconsistencies that reduce predictability in managing the wage bill, and undermine the principle of 'equal pay for work of equal value'. Short-term savings can be achieved through a reduction of the maximum salary levels to bring them closer to the current average salaries paid by ministries and agencies. This would force agencies that pay salaries on the higher end of the bands (e.g., Ministry of Health, Ministry of Regional Development, Ministry of Welfare) to reduce their wage bill. The benefits from a more simple grid would be greatly enhanced with the establishment of a centralized personnel and payroll system and introduction of central controls for the establishment of new posts. Stronger establishment control would ensure consistency in human resource management and remuneration policies and result in further savings in administrative costs through reduction of HRM staff. In the

period 2010-2011, further reductions in salary levels does not seem feasible or advisable, as they could lower morale and would carry a very high risk of qualified staff leaving the civil service.

12. **Further staff reductions to pre-2007 levels, particularly in agencies subordinated to ministries and local government bodies, are possible and, if implemented carefully, would not risk the quality of public services.** Overall, public sector employment in Latvia remains higher than in some comparator countries, and staffing levels remain higher than 4-5 years ago. The wage bill as a share of GDP is also on the high side of a range of comparator countries. Thus there may be some room for adjustment to pre-2007 staffing levels without a negative impact on policy functions and service delivery. It is important to note that the central government has borne the brunt of staff reductions thus far. For the reason, the most substantial budget savings from this option in 2011 and 2012 would come from reducing staff at the level of local government.

13. **Significant savings can be found from phasing out direct subsidies to loss-making enterprises at both the central and municipal levels.** Currently, subsidies are not targeted to supporting access to services for low-income citizens, but come in the form of 'compensation for losses' to providers, without adequate cost-control mechanisms. As a result, subsidized enterprises have an incentive to provide unnecessary services, to understate revenues, and to inflate operational costs. Reduction of central budget subsidies –e.g., for passenger transport – could be achieved by targeting the subsidy to low-income persons or for rural routes only. The risks of this option could be substantially lowered by accompanying the reduction in subsidies with a compensation strategy, along the lines of current ESSNS support for disabled passengers. User fees (e.g., passenger transport prices) could be allowed to increase. This would allow subsidies to be targeted to protect low-income beneficiaries, instead of protecting firms from losses. Services considered socially essential, but which would not be commercially viable even if providers were able to charge market prices, could be specifically identified and prioritized based on cost-benefit analysis. As it reviews the merit and justification for subsidies, the Government could also scrutinize subsidies for SOEs in the areas of culture, broadcasting, and sport. Many advanced countries subsidize these activities. The policy question for consideration is whether set against the objectives of further fiscal consolidation and other priorities for support (such as social services for vulnerable groups) these subsidies are affordable. This question can only be answered by the Government in consultation with stakeholders.

Social Welfare

14. **The Government could lower the amount of pension income exempt from taxation**. The unprecedented economic growth until 2007 translated into a rapid growth in wages and consequently of the wage bill covered by the social insurance system. This boom was reflected in the notional interest rate applied to pension benefits from the public pension pillar. Between 2005 and 2009 the average pension for new retirees grew 69 percent. The cohorts that retired prior to 2010 have benefited from a windfall from the pre-2007 bubble that the Government could recover, applying the principle of burden sharing. A broader "taxation based" measure is probably justified (over, for example, a measure targeting only recent retirees) as the increase in revenue to the state social insurance special budget motivated other costly pension policies during the high-growth, such as the indexation of pensions to wage growth. It is important to note that this suggestion is a far more equitable and incentive compatible policy option, and different in both form and substance to the flat cut in pensions in mid-

2009. The 2009 pension cut was both regressive and penalized working pensioners, and was overturned by a Constitutional Court decision of December 21, 2009. However, the recommended measure is far more progressive, affecting lower-income pensioners relatively less, and it does not distort work incentives. The Constitutional Court's decision indicates how the measure might be more appropriately implemented by the Government: with (i) careful presentation of alternative options, and why they are less effective; and (ii) sufficient prior notice between passage of the measure and when it takes effect to allow households dependent on pension income to prepare for the change.

15. **The pre-1996 service pension supplement could be used more effectively to support the poorest pensioners.** This option is the measure that holds the greatest potential for fiscal savings among the all the options presented in the PER. The pension supplement pays LVL 0.7 (70 centimes) for each year of service an affiliated worker had accrued before 1996, and on average amounts to 14 percent of the overall pension spending. The supplement was originally introduced as a measure directed at pensioners with the lowest benefits. However, in the general exuberance that gripped fiscal policy prior to the crisis was extended to all pensioners in 2008. Extending the supplement to all pensioners was an unsustainable policy. The Government could save a substantial amount of resources from repealing the extension of supplements to all pensioners, and still continue to supplement the pensions of the 10 percent of retirees with lowest incomes.

16. **The age of retirement could be increased starting in January 2015, but will only bring savings in the medium term.** An increase in the statutory and effective retirement ages is essential to the long-run financial sustainability of the social insurance special budget, and to help raise replacement rates. Among the cohorts turning 62 in 2012 and 2013, around 70 percent will already be receiving old age or disability benefits. This defeats the purpose of trying to increase retirement ages before 2014. Furthermore, the cohort turning 62 in 2014 will already experience a significant increase in the effective retirement age, so it is not equitable to increase their burden further. Thus, the most logical time to start increasing retirement age is 2015. An increase in the retirement age earlier than January 2015 will probably precipitate a faster "rush to retire" that could destabilize the state social insurance budget. It is frequently argued that raising the retirement age, particularly in a recessionary period (or when the labor market is very slack) exposes older workers to greater risk of unemployment. However, this concern seems misplaced. Workers, who would be affected by an increase in the retirement age, are also more likely to have coverage of unemployment insurance, as well as relatively greater job security (than younger cohorts). Indeed, in the current contraction, younger workers have suffered unemployment at relatively higher rates than older workers.

17. **Also critical to the sustainability of retirement income security in the medium and long term, are effective and viable means of diversifying risks, such as a strong funded pension pillar.** Chapter 4 in Volume 2 explains why Latvians will have to rely on the funded pillar of their multi-pillar pension system for a greater share of their income security in old age. To ensure it could keep paying pensions during the unprecedented economic contraction – which play an essential safety net function for most Latvian families - in 2009, the Government diverted a portion of contributions to individual accounts in the funded pillar of Latvia's pension system to shore up the finances of the pay-as-you-go, NDC pillar. While regrettable, this decision is understandable in the circumstances. The measure is also temporary, and passed with a clear "exit strategy" that envisions a phased restoration of contributions to the

funded pillar. The funded pillar was "small" relative to the NDC pillar even when the contribution rate was 8 percent of workers' salaries. So it was struggling to function as a viable risk-diversification instrument even before the diversion in 2009. Now at 2 percent of workers' salaries it is even smaller. It is difficult for fund managers to keep administering such a small trickle of contribution capital without a firm expectation of when that flow will be restored to the volume they expected to be managing. A negative outcome could be -without the certainty of a clear time-table for restoration of contributions- a withdrawal of market participant that would increase the concentration of the industry and limit the benefits to affiliates of competition between fund managers. A more immediate fiscal danger could arise from how any departure from (or delay in) the planned restoration of contributions to the funded pillar would be interpreted by markets. A loss of market confidence could put in jeopardy the hard-won gains that the Government has made in navigating the financial crisis.

18. **To improve the equity impact of the welfare system, the Government could replace the earnings-related Parental Benefit with an augmented flat Childcare Benefit of LVL 100 paid from State basic budget.** The relatively recently created Parental Benefit was shifted into the social insurance special budget in 2008. The Parental Benefit is earnings-related, and paid only to those with a history of contributions to the social insurance. However, when it was introduced, no increase in contribution revenue to the state social insurance budget was made. The benefit is, for all intents and purposes, a *non-contributory* benefit. For this reason, the recent shift of the Parental Benefit spending to the social insurance budget is inappropriate. Furthermore, as with all other “non contributory” benefits, linking the benefit amount with the recipients’ earnings, introduces regressive redistribution to people with higher incomes. A flat Childcare Benefit is already granted from the State basic budget for the same social welfare objective. The coexistence of the earnings-related Parental Benefit alongside the flat Childcare Benefit augments inequality, and imposes a high fiscal cost. The progressive flat benefit could be raised to its 2005 level, LVL 100.

19. **Family State Benefits (FSB) could be targeted to poorer households with children, to improve their impact and reduce waste.** Family State Benefits constitute about 37 percent of state social benefits. FSBs are monthly payments of LVL 8 to all families with a child between the ages of 1 up to 18 years of age. The Government could achieve a higher social return from its social welfare spending, by reducing coverage of FSB for non-poor households, but maintain assistance for poor households. Means-testing all state social benefits (i.e., those financed from the national basic budget for the Welfare sector) would be advisable – with the exception of benefits related to disability. FSB could be the best benefit to start with, given its currently wide coverage; large volume (and thus potential savings); and that the public is “sensitized” to reform of this benefit (earlier public discussion of possible reform. FSBs have a small impact on non-poor households and are more symbolic than welfare enhancing: households in quintiles 4 and 5 spent about 2,300 and 4,200 LVL per person per year in 2008, and hence, the added 72 LVL per child per year has little impact on household welfare. Given how little Latvia spends on social assistance, savings from targeting FSB could be re-distributed to strengthen targeted social assistance programs.

20. **To strengthen the safety net for the poorest households, the Government could increase co-financing from the State budget for GMI and Housing benefit.** GMI and Housing benefits are increasing in importance as safety-net instruments, and appear to be reasonably well targeted to the lowest

income groups. Both benefits are mandatory for local governments to pay to eligible households, but are financed from municipal budgets. The mismatch between a national mandate and local financing causes perverse incentives at the local level, and disparities in provision of these mandatory benefits across wealthy and poor municipalities. For this reason, few EU and OECD countries retain decentralized financing of mandatory targeted benefits. Raising co-financing and eventually recentralizing financing for mandatory targeted benefits from the State budget, will ensure a robust, uniform safety net for the lowest-income, needy households wherever they happen to live. The co-financing introduced in the ESSNS (50 percent of spending on GMI and 20 percent of spending on housing benefit) helps mitigate the problem of perverse incentives, particularly in the face of higher demand for benefits from the crisis. Savings from targeting FSBs could be used to increase the share of co-financing of mandatory benefits from the State budget, and still leave room for overall fiscal savings.

Education

21. **In order to retain and attract good teachers, the Government could maintain the level of salaries of general primary and secondary teachers, and the parity of teacher remuneration with workers with similar qualifications in the public sector.** The formula financing reform in primary and general secondary education is on-track, and already delivering efficiency gains. A critical part of ensuring the reform continues to deliver benefits is adequate and competitive teacher remuneration. Teachers in Latvia were substantially underpaid even before the reductions in the education budget in 2009. During the first year of implementation of the education financing reform, steps have been taken to bring greater equivalence between teachers' pay and the pay of similar positions elsewhere in the public sector. A salary increase in January 2010 brought average teacher earnings (including overtime) to parity with employees of state budget institutions. Maintaining teacher salaries at a comparable level with employees of state budget institutions will help attract and retain competent teachers. The Government could monitor this parity closely, as a reversion to former low salaries for teachers would endanger education quality by dissuading the most competent teachers. Competitive pay levels would be easier to monitor and maintain if the system of teacher remuneration were shifted towards full-time concept of teachers' profession, based on learning outcomes rather than time inputs. This shift would require strengthening of assessment instruments.

22. **Finance vocational education places more adequately, but ensure a "level playing field" between vocational and general secondary education, so households make better informed choices about their investment in education**. There is a legitimate policy question about the appropriate scale of vocational education relative to general secondary education. Streaming students into vocational education at early ages could risk locking them into lower-lifelong earnings, and close off other opportunities. This risk can be mitigated by ensuring a "level playing field" between vocational and general secondary, and keeping opportunities open for movement from one stream to the other. The level of per-student expenditures by government on vocational secondary education in Latvia is below those of international comparators with high-quality vocational education programs. To the extent that vocational education is justified by skill needs in the labor market, it should be funded adequately to provide high-quality and relevant skill training. A key step towards ensuring a "level playing field" would be to ensure that students in general secondary and vocational secondary are equally eligible for the same welfare benefits, so that decisions about what sort of secondary education households chose are

not influenced by considerations other than the quality of instruction and likely future earnings. With major EU support, all secondary vocational schools are preparing and implementing restructuring plans. All of the restructured vocational schools are scheduled to be transferred to local governments by 2015. Local management and financing of vocational schools would help ensure that vocational programs are cost-effective (in comparison to general secondary education), and provide good value in terms of improved job prospects for graduates.

23. **The Government could reduce budget-financed student places in higher education, financing these at a more adequate level, and prioritizing them for the poorest applicants** (including those interested in part-time courses that allow them to work during their study). Government expenditure on higher education is very low in Latvia by comparison to most countries. Budget-financed places are rationed, solely on the basis of student performance and not on need. Half of full-time students pay full cost-recovery fees, which vary by specialization. The other half of students pay no fees: their places are financed by the budget. The number of budget-financed places in higher education increased over the past three years, despite large overall budget reductions in higher education – implying a deterioration of teaching and learning conditions. As currently used, budget financing of higher education is inequitable because it disproportionately benefits students from higher-income families. Greater reliance on fee financing and targeting budget assistance to the neediest students of otherwise equal academic merit, would improve equity and fiscal sustainability of higher education, and promote quality by encouraging competition based upon relevance to changing skill needs in the labor market as reflected by changing patterns of earnings. Current university students have acquired rights to continued financing under the arrangements that were in place when they entered higher education. Thus, this shift in policy would need to be introduced gradually, applying to newly registered students.

Health and Long Term Care

24. **The most important opportunities for structural reforms created by the economic crisis have already been seized by the Ministry of Health: prioritizing the right services and creating a means tested safety net that did not exist for Latvian households previously.** However, the path ahead demands a much stronger effort to rationalize the hospital sector, to improve the prevention of the health conditions that contribute the most to mortality in Latvia, to reform the reimbursement system to improve incentives for secondary outpatient services and hospitals, and to make the health sector a more dynamic contributor to Latvia's economy.

25. **The Government will need to prepare and implement a technical plan for closure of hospital beds and to decommission hospital buildings.** As a result of budget cuts and priorities set in 2009, Latvia now prioritizes adequate funding of general practitioners, emergency care, health services for mothers and children, dental services for children, covered prescriptions, referred secondary outpatient services, a safety net for needy families, and unplanned hospitalizations. Hospitals have become a residual in the budget, which provides funding for continued catastrophic protection at that level. However, the hospital infrastructure has – not surprisingly – not adjusted in one year to substantially lower funding. Therefore funds for hospitals in 2010 would need to be restored, if the funding is available, but only with the proviso of an agreed technical plan for closure of hospital beds and buildings – a plan that would ideally be implemented from 2010 through 2013. The Government could consider a 5,000 bed reduction that takes place at a measured pace from 31 October 2010 to 31 December 2013.

By 2013, the goal would be to achieve an overall ratio of 350 beds per 100,000 population. Although there would be some additional spending required over this period, by 2013, the goal would be to realize spending for inpatient hospital services at 35 percent or less of total medical care expenditure. Hospitals need to be closed or they will come back on the budget in the future, and as long as buildings are kept open, much of the expected savings will not materialize.

26. **To support rationalization and improve health outcomes, the Government could further reduce average length of stay in hospitals.** There has long been a structural bias in Latvia's health sector toward provision of relatively costly inpatient care. The Government has reduced this bias. Challenges remain. Latvia's average hospital length of stay has been stuck at a high level for many years; cutting it is essential if fewer hospital beds are to be adequate. In 2009 the average length of stay dropped from 9.5 to 8.7 days. The Government could set itself the target of reducing average length of stay by 1.2 days in 2010 (to 7.5), 0.5 days in 2011 (to 7.0), and 0.5 days in 2012 (to 6.5). The high length of stay may reflect reimbursement policies and could be tackled with conversion of secondary outpatient services and inpatient care reimbursed based on diagnostically related groups. But it will take time to change reimbursement policies and for providers to adjust; in the meantime, direct action will have to be taken to reduce lengths of stay. It is unclear that the global budget system – a first attempt at prospective payments- put in place in 2010, will be sufficient to change current incentives for hospitals to keep patients in beds. In addition, to reduce incentives for costly behavior by providers, prospective payment methods should replace fee-for-service payments to the degree possible for hospital and secondary outpatient services, as soon as is feasible.

27. **The Government could further improve financial protection from the cost of health care, with more equitable and targeted use of subsidies and copayment exemptions.** Copayments are a variable that the health sector authorities have control over. Copayment policies can be adjusted further so that those who can pay pay more, while the poor are better protected. Close attention needs to be paid to annual data on the percent of income devoted to health care by quintile in the household consumption survey data. In particular, pharmaceutical reimbursement policies should be adjusted as needed to reduce the burden of these expenses on the poor and chronically ill. A reasonable goal is to maintain in the household consumption of health care as a flat or increasing function of expenditure per capita, so the poorer quintiles are devoting a smaller proportion of their expenditures to health care than are the wealthy. This outcome is more likely if the Government were to shift how it targets exemptions from social groups to completely means testing.

28. **To increase the efficiency and equity of health finance, the Government could clearly codify the State-financed benefit package of health coverage and the "rules of the game" for non-government providers for coverage of additional health risks.** There is no compelling argument for structural reform of health finance in Latvia at this juncture, such as a shift to a social insurance model, mandatory private insurance, or a mix of public and private insurance beyond what exists today. Latvia has a "single-payer" health finance system with very low administrative costs. However, to encourage public debate about the future of health finance in Latvia, the PER provides analysis of one of many possible options for development of the insurance market. The PER argues for the development of competitive contracting, which would allow the State, as it gains experience, to extend this to the

competitive contracting[1] of insurers if so desired. However, in making these arguments, the PER is not advocating this policy. A clearer definition of what is the core level of services the State will finance (and limits on providers' ability to game multiple payers) would encourage the development of a more robust private supplementary insurance system that would open possibilities for the future.

29. **As Latvia's elderly population continues grows, the Government could contain the cost of long term care by improving discharge management in hospitals and eliminating biases in current financing model that encourage medical in-patient treatment for the elderly over long term care.** Due to the overcapacity in the hospital sector it is conceivable that a large part of long term care (LTC) is currently provided in hospitals, but in the guise of in-patient services. This is both expensive and to the determent of the wellbeing older people. A more cost-efficient solution would be to discharge the patient when medical treatment is no longer necessary, and to provide the social support through community-based LTC services. Many countries in Europe have converted redundant hospitals into residential LTC institutions. However, this introduces a costly bias towards expensive institutional care. The final chapter of the PER proposes a new "Community Centers" LTC model which could be at the center of care coordination for patients. Community centers could house daycare facilities for elderly and disabled people (or even childcare), but also outpatient services like physical therapy. They could also be the hosting facilities for home-based services like care assistants or community nurses who support dependent people in their homes. The authorities could convert redundant municipal hospitals into LTC Community Centers—privately or publicly owned—that could provide a whole range of LTC and rehabilitative services, and thus avoid the costly model of institutional care.

Structure of the PER

30. The remainder of this volume is structured in the following way. Section II recounts the events and circumstances that set the Government's fiscal stance in the years prior to the crisis. Section III summarizes the principal emergency measures the Government took to cope during 2008 and 2009 as the crisis broke and led to Latvia's severe economic contraction. The purpose of these sections - which draw liberally from material prepared by the financial authorities, the IMF and the EC - is to make the case for further fiscal adjustment plain. The report then summarizes the main messages and highlights the most important suggestions made in each of the longer, more detailed chapters of Volume 2 of the review. Each section is followed by a matrix of the options presented for the Government to take into consideration. Given the important role that municipalities and republican cities play in the delivery of social services, the Chapter 3 of Volume 2 provides an in depth examination of local government finances and spending. Local authorities (municipalities and republican cities) play such a prominent role in the delivery of public services – particularly social services – that a close look at the character of their spending is critical.

31. The matrices included in this volume present the World Bank team's best estimate of what the savings from the particular measures suggested are likely to be. However, these estimates are in some

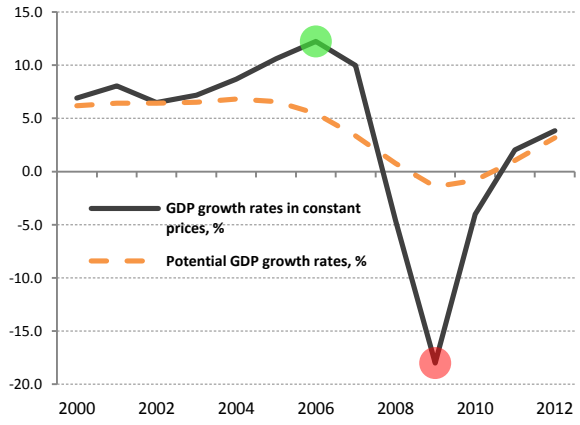
[1] The health sections of the PER suggest that the Ministry of Health pilot competitive contracting, which could help to develop several instruments that are currently missing in the system: public competitive procurement of medical services based on tenders transparently defining the services to be provided; tenders encouraging providers to cooperate to integrate care and compete for patients on that basis; contracts exceeding a year; much clearer rules of the game for providers and other insurers on what the government will cover, on service levels, quality of care, and so on.

cases based on secondary sources, such as household survey data, or vulnerable to even small changes in assumptions. This is particularly the case in trying to calculate the budget savings from changes in support to state-owned enterprises (SOEs) and subsidies to transportation. For these reasons, the World Bank team's estimates are undoubtedly second best. Ideally, the estimates of likely immediate and longer term savings will be verified and further refined with better informed estimation by counterparts in each line ministry and in the Ministry of Finance, who have superior knowledge of Latvia's programs and a far better command of administrative data sets.

II. Latvia's Economic Boom and the Fiscal Consequences of High Growth

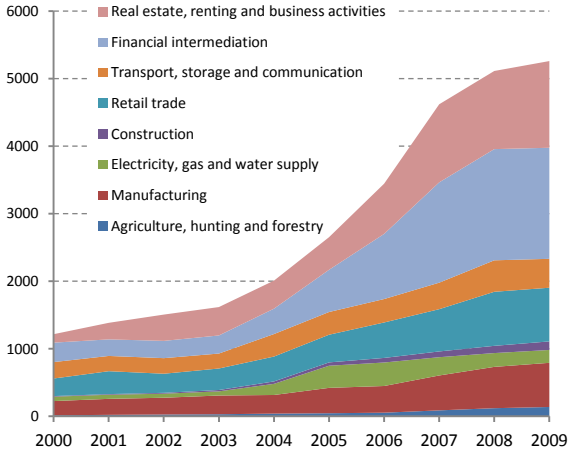
32. In the years leading up to the global financial crisis, Latvia's economic growth significantly outpaced potential growth rates. Following Latvia's accession into the European Union in 2004, the annual average rate of growth – which was already high at 7 percent from 2000 to 2003 - accelerated to more than 10 percent through 2007. In contrast to actual GDP growth, potential output (which grew on average by around 6 percent at the beginning of the decade) began to decline after 2004. In 2009, potential GDP growth was estimated to be negative 1.4 percent due to low gross fixed capital formation and the decline of employment as a result of the economic contraction. Real GDP growth reached its peak of 12.2 percent in 2006 (Figure 1.1) while the output gap culminated in 2007 (at around 18 percent).

Figure 1.1: GDP and Potential Output Growth



Source: Ministry of Finance

Figure 1.2: Composition of FDI



Source: Bank of Latvia

33. Double digit growth after Latvia's EU accession stemmed from a vigorous financial integration with the EU15 countries which lowered the price of borrowing and encouraged an unprecedented increase in private debt. The expansion of credit was largely financed by short-term external borrowing from foreign private banks, resulting in the highest loan to deposit ratio of any banking sector in the region (248 percent in 2007).[2] Fast credit growth led to a consumption and real estate boom, and eventually to a bubble. The largest increase in foreign direct investment during 2004-2008 was observed in the financial intermediation, real estate, and retail trade sectors (Figure 1.2).

34. Accelerated economic growth, driven almost entirely by excessive domestic demand, translated into large macroeconomic imbalances. Consumer inflation rose from 6.2 percent in 2004 to over 10 percent in 2007. Rapid wage increases outstripped productivity growth undermining Latvia's external competitiveness. The current account deficit widened from 13 percent of GDP in 2004 to almost 23 percent of GDP in 2007. By 2008, the need for a macroeconomic correction was increasingly evident. Against this backdrop, in September 2008, the re-pricing of risk in emerging markets with the onset of the global financial crisis put Latvia's currency peg under pressure.[3]

35. To correct this rapidly deteriorating financial situation, the Latvian authorities agreed to a stabilization program in December 2008. The program package of €7.5 billion - more than 35 percent of GDP - was supported by the EC, the IMF, EBRD, the World Bank, and bilateral support from Nordic and Central European countries, and is conditioned on strong fiscal adjustment to achieve internal devaluation and restore the country's competitiveness under the fixed exchange rate arrangement. Given the extent of overheating of Latvia's economy, the macroeconomic adjustment strategy was implemented at the cost of a sharp contraction of output.[4]

36. Latvia's post accession boom fueled excessive public expenditures (Figure 1.3). Growth above potential during the period 2004-2007 generated buoyant tax revenues. A pro-cyclical fiscal stance turned these windfalls into rapidly increasing government spending which further fuelled the domestic boom. The fiscal deficits were small (not exceeding 2.5 percent of GDP) from the beginning of the current decade and reached a small surplus (0.6 percent of GDP) in 2007, which was partly responsible for disguising the problem. The extent of the fiscal expansion became apparent with the economic downturn when the financing of public expenditure became unsustainable in the face of much lower revenues.

[2] Latvia experienced rapid credit growth, due to broadly held expectations of fast convergence with EU living standards, and a strict peg to the Euro which eliminated exchange rate risk.

[3] By November 2008, the Bank of Latvia's foreign exchange reserves had fallen by 20 percent to euro 3.4 billion. Latvia was soon after downgraded by rating agencies and its Eurobond spread increased to around 600 basis points, while the 5-year Credit Default Swap (CDS) spread jumped to around 1000 basis points in November 2008.

[4] The sharp output contraction is expected to lead to a large negative output gap of almost 10 percent in 2010.

Figure 1.3: General Government Total Revenue and Expenditure (LVL millions)

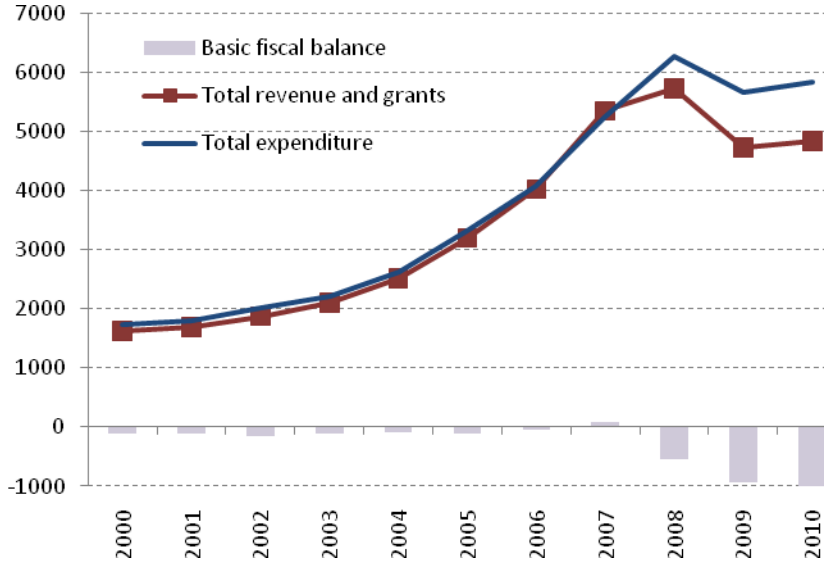
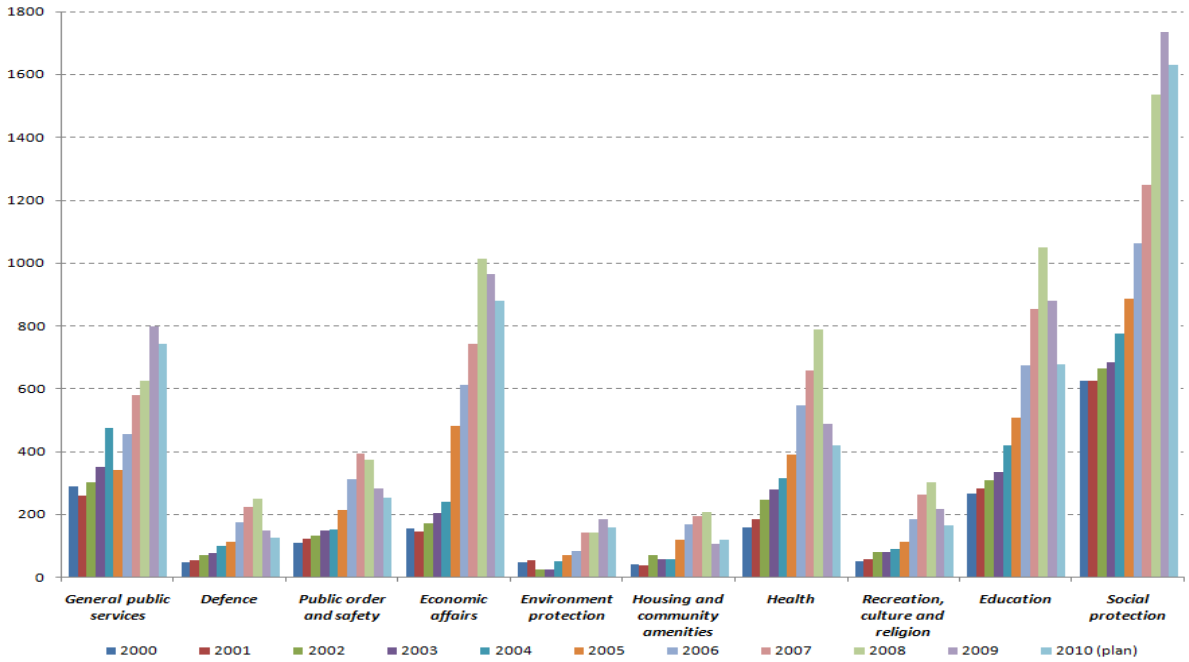


Figure 1.4: General Government Expenditure by Function (COFOG, LVL millions)



Source: Ministry of Finance

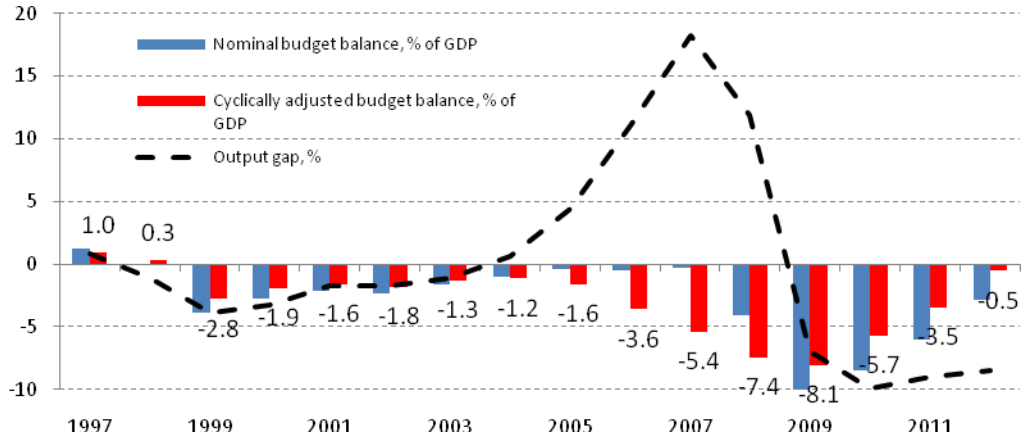
37. All sectors of the general government (using the international COFOG functional classification) benefited from the pro-cyclical orientation of fiscal policy (Figure 1.4). Expenditures in all governmental functions at least doubled between 2004 and their peaks in 2008. Moreover, expenditures for social protection and general public services increased further in 2009 when nominal GDP fell by 20 percent. Fiscal consolidation in 2009 and the planned adjustment in 2010 are most apparent in health, education and defense, bringing nominal expenditures to or below the 2007 levels. Comparing Latvia's COFOG expenditures with EU10 and EU27 over 2004 and 2008 suggests that Latvia's expenditures as percent of

GDP were below the averages of these groups in all sectors, except for education and economic affairs. In this context, Latvia's expansion was largely in line with its European peers. However, given its growth rate being one of the highest in the region and driven entirely by domestic demand, it should have been targeted and partly channeled towards savings.

38. This budget expansion led to large structural fiscal imbalances (Figure 1.5). During the period 2000-2008, general government expenditure grew on average, in real terms by 6.5 percent annually (deflated by GDP deflator). The structural (cyclically adjusted) fiscal deficit reached negative 7.4 percent of GDP in 2008 and minus 8 percent of GDP in 2009. The recent sharp recession represents a permanent shock to revenues. As such, permanent expenditure cuts and/or sustainable increase of revenues are required to correct the structural fiscal imbalances.

39. The Government's main objective is to eliminate structural deficits and to return the economy to a prudent and sustainable fiscal path. The Government's Stabilization and Convergence programs aim at designing both revenue and expenditure policies to reduce the cyclically-adjusted structural general government budget deficit to below 1 percent of GDP after 2012. This would enable automatic stabilizers to smooth cyclical swings caused by factors outside the control of the government. [5]

Figure 1.5: Output Gap, Nominal and Cyclically Adjusted Budget Deficits



Source: Ministry of Finance

40. In the years ahead, the negative output gap is expected to close gradually and both actual as well as potential growths are expected reach 4 percent in 2012. This expectation rests on the current macroeconomic outlook and the successful implementation of structural reforms agreed to in the stabilization program. The current program, aimed at the adjustment of domestic costs through fiscal consolidation and structural reforms, should stimulate new investment in export-oriented industries. However, this adjustment is likely to come about only gradually.

[5] A Fiscal Responsibility Law that would allow counter-cyclical fiscal policy is currently being discussed by the authorities. One of its four rules permits a deficit of 0.4 times deviation of growth from its potential and has been supported by the IMF. This rule is a pragmatic approach to a cyclically adjusted budget balance aiming at balanced public finances during "normal" growth of real GDP.

III. Emergency Measures and the Need for Permanent Fiscal Adjustment

41. *Fiscal adjustment has been a key macroeconomic tool for stabilizing the economy and putting it* on sound footing. With a fixed exchange rate, there are few options for macroeconomic management other than through fiscal consolidation. The authorities chose to maintain the exchange rate peg after taking into account the balance sheet effect of a potential devaluation, severe corporate, banking and social implications, as well as fear of contagion beyond Latvia's borders. Most importantly, maintaining the exchange rate peg has been considered a natural exit strategy of the stabilization program and the best way to prepare the country for the adoption of the euro.

42. The 2009-2010 fiscal correction came about primarily from "emergency" measures on both the expenditure and revenue sides. Tax revenues started declining significantly in the autumn of 2008. The fiscal consolidation launched in 2009 and continued in 2010 aimed at correcting the fiscal position mainly with immediate emergency measures. A comparison of baseline and projected fiscal balances (Table 1.1) shows that fiscal measures amounting to 13.3 percent of GDP have been implemented, of which 2.2 percent result from tax policy changes (some of them simply reversing previous tax cuts, i.e., the VAT reduction in 2009).[6] Expenditure cuts over a wide range of institutions and functional areas made up the remaining 10.4 percent of GDP suggesting that the bulk of adjustments have already taken place on the expenditure side.

Table 1.1: General Government Operations 2008-2010 (Percent of GDP)

	2008	2010		
		Baseline	Projection	Measures
Total revenue and grants	**35.2**	**36.8**	**39.6**	**2.8**
Tax revenue	29.1	25.1	27.3	2.2
Direct taxes	*18.5*	*16.0*	*16.7*	*0.7*
Indirect taxes	*10.6*	*9.1*	*10.6*	*1.5*
Non-tax	3.4	4.2	4.9	0.7
Total expenditure	**38.5**	**58.2**	**47.8**	**10.4**
Current expenditure	33.5	49.6	42.2	7.4
Remuneration	*10.3*	*13.7*	*9.7*	*4.1*
Goods and Services	*5.7*	*7.6*	*5.6*	*2.0*
Subsidies and transfers	*16.5*	*27.0*	*24.8*	*2.2*
Capital expenditure	4.6	6.9	3.9	3.0
Fiscal balance	**-3.3**	**-21.4**	**-8.1**	**13.3**

Source: Latvian authorities and the IMF Staff estimates

43. After the supplemental budget was passed in June 2009, which introduced measures totaling LVL 500 million, the authorities managed to get the fiscal accounts under control. The initial spending cuts, which were unevenly implemented for most of the first half of 2009, proved insufficient in curbing past spending trends in light of more severe economic conditions. The supplementary budget introduced revenue measures, which amounted to 0.6 percent of GDP (higher excise tax rates, a lower threshold on income exempt from taxes, and increases in state revenue from dividends) and expenditure cuts, which reduced spending by 5.5 percent of GDP. These expenditure cuts came mainly from a lower wage bill (reflecting a nominal wage reduction and a fall in public sector employment) and

[6] Baseline scenario provides estimates of the budget without incorporating fiscal measures needed to achieve programmed fiscal targets.

lower social transfers (including a 10 percent nominal pension cut and a 70 percent reduction of pensions for working pension recipients, which have since been reversed[7]), but less through structural adjustments.

44. On December 1, 2009, Latvia's Parliament (Saeima) approved the 2010 budget with a programmed deficit of 8.5 percent of GDP. The budget is designed to lower Latvia's 2010 general government deficit by LVL 500 million (4.2 percent of GDP) as agreed in the revisions to the stabilization program in June 2009. The 2010 budget includes measures to broaden the revenue base (2.3 percent of GDP) and further cuts in expenditure (1.9 percent of GDP). Following on measures introduced in 2009 to protect the poor, the 2010 deficit target allows for an additional maximum ½ percent of GDP of social safety net spending if the authorities deem it appropriate to ease social hardship if the contraction is more severe than expected. In addition, the 2010 deficit accommodates the Constitutional Court ruling of December 21, 2009 that the pension cuts of June 2009 were unconstitutional.[8]

45. Implementation of the 2010 budget indicates that the approved adjustment of 8.5 percent of GDP is largely on track. Weak personal income taxes have been offset by strong indirect, corporate and nontax revenues. Since the government has been in minority since March 2010, several unexpected decisions have also been taken, including lowering hotel VAT from 21 to 10 percent, extending low VAT rates to books and the print media, exempting gifts for medicine and education from personal income tax and exempting unused infrastructure from real estate taxation. These measures will increase the deficit by 0.3 percent of GDP in 2010. However, the government intends to compensate for these slippages by cutting central government net lending.

46. Despite the substantial fiscal consolidation achieved in 2009-2010, Latvia's fiscal policy continues to be challenged by fiscal imbalances that are high compared to the authorities' fiscal targets of meeting the Maastricht criterion in 2012. Under the current macroeconomic framework, the required fiscal adjustment is estimated at LVL 800 million, or 6 percent of GDP. Of this amount, about LVL 420 million or 3.3 percent of GDP needs to be achieved in 2011. This is a formidable adjustment given the programmed deficit for 2010 is 8½ percent of GDP. In addition, revenues to the budget will be reduced by the reversal of pension contributions from the social insurance special budget back to the funded pension pillar (1.2 percent of GDP), declining non-tax revenues (0.6 percent of GDP), and increases in interest payments (1 percent of GDP).[9]

47. The new fiscal measures have to be prepared with more time giving consideration to their quality and sustainability. The authorities agreed to work with the World Bank to identify areas for expenditure savings that will be sustainable over the medium term. Given that 2010 is an election year, the objective is to design a menu of available options for the next government and possibly, to determine more savings than are actually needed so that the new government can select the options that are the most politically palatable.

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[7] On December 21, 2009, the Constitutional Court ruled that the government's decision to reduce pensions was unconstitutional. The ruling requires the government to (i) refund the withheld pensions (more than LVL 74 million) by 2015, and (ii) start to pay pensions in full from March 1 (LVL 111 million).

[8] The Government resumed payment of pensions in full in February 2010 (at a cost of around LVL110 million, or 1 percent of GDP) and refunded pensioners for the reduction with a lump sum in April 2010 (around ½ percent of GDP).

[9] These estimates are subject to change depending on uncertainties related to economic growth, restructuring costs, domestic short term interest rates, etc.

48. The authorities extended the Stabilization Program with international lenders until the end of 2011. This extension, made possible by better than expected financing conditions in 2009,[10] is a recognition that sustainable fiscal adjustment will take longer than initially programmed. The extension will cover the period of the 2012 budget preparation which is key to bringing the deficit within 3 percent of GDP, as required by the Maastricht criterion. Continued involvement of international lenders beyond the elections in October 2010 should also provide assurances to financial markets that the authorities will continue with consistent and sustainable policies over the medium term.

49. While the consensus view is that most of the fiscal adjustment should come from the expenditure side, revenue measures will also still be required given the nature of fiscal imbalances and the significant size of the adjustment needed to fulfill fiscal deficit criterion for euro adoption in 2014. The Ministry of Finance and the IMF are working to identify scope for further revenue measures, which may include: (i) an increase in residential real estate tax combined with mechanisms to protect the poor; (ii) an alignment of reduced VAT rates with standard VAT rate on heating, natural gas, medicines, electricity and press; (iii) a review of the generous taxation of pension and insurance funds; and (iv) higher taxation on capital income and cars. These measures are intended to improve the quality and composition of the overall tax system as well as to increase incentives for households and firms to pay taxes. They could complement fiscal savings that will need to come from further reductions in spending to eliminate structural deficits and to improve efficiency of the public sector.

IV. The Structure of Taxation in Latvia

50. This section summarizes the current policy discussion on the revenue side of Latvia's fiscal consolidation, and places this discussion in a regional context. Revenue policy is being covered by technical assistance from other international agencies. However, a brief preview of the scope and structure of tax amendments is warranted, given the discussion of structural expenditure cuts to help fulfill the Maastricht fiscal criterion by 2012.

51. The tax system in Latvia is characterized by a relatively low tax burden and a reasonably wide tax base. In 2007, the tax burden as a percentage of GDP placed Latvia in the fourth lowest position in the EU. In 2009, the tax base was expanded with changes to the real estate tax rate. Despite the tax increases in 2009-10, the tax burden has still decreased due to structural changes such as a sharp fall in consumption, anemic exports, an increase of undeclared "shadow economy", as well as the decline of wages and corporate profits. In the next three years, when tax revenue to GDP is likely to rise slightly, the share of the tax burden will probably still remain below 29 percent.

52. The economic downturn led to changes in both tax structure and revenue, prompting the Government to consider future efforts in improving the composition of taxes. Until 2008, the share of direct taxes (the largest in total tax revenues) continued increasing. In 2009, due to personal income tax (PIT) rate reductions, an increase of non-taxable minimums, and higher VAT and excise rates, the overall tax burden shifted towards indirect taxes. The bulk of total tax revenues in Latvia is comprised of labor taxes, which rose steadily until 2008 (from 48.5 percent in 2005 to 49.8 percent in 2008). In tandem, the share of consumption taxes in total tax revenues has decreased (from 42 percent in 2005 to 36.4

[10] The NIR target for 2009 will likely be exceeded by a very substantial margin and further accumulation of reserves is anticipated in 2010. Therefore, there is room for shifting some portion of the financing access into 2011.

percent in 2008), suggesting this as an area of revenue for future improvement. Especially under conditions of diminishing employment and increasing public debt, increasing and shifting the tax burden towards property and consumption taxation would be appropriate given that these taxes pose less of a harmful distortion to economic activity and less vulnerable to evasion.

53. The undeclared shadow economy poses a formidable challenge to any effort by the Government to increase tax revenue. Measuring the shadow economy is difficult, by the very nature of the phenomenon. The estimates of shadow economy from the Central Statistical Bureau and State Revenue Service range from 12-16 percent, while other estimates are as high as 40 percent of GDP. As proxies for undeclared economic activity, according to labor force and other expert surveys, 11 percent of the employed population between 15-74 years old work without an employment contract, while another 12.7 percent receive additional "wages in envelopes".

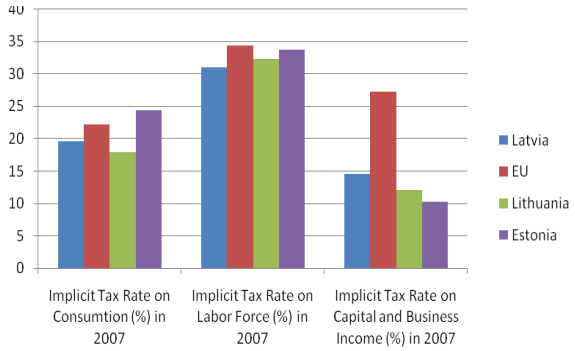
Table 1.2: Tax Revenue in General Budget (% of total tax revenue)

	2004	2005	2006	2007	2008	2009*
Direct taxes	**62.66**	**59.49**	**59.20**	**61.21**	**65.37**	**63.34**
Personal income tax	21.28	19.77	19.67	19.84	20.57	19.82
Social insurance contributions	32.37	30.31	29.94	30.78	33.33	36.16
Corporate income tax	6.25	7.02	7.60	8.93	10.06	5.36
Real estate tax	2.77	2.39	1.99	1.66	1.41	1.98
Indirect taxes	**36.43**	**39.60**	**39.85**	**37.90**	**33.88**	**35.9**
Value added tax	23.78	26.29	27.85	26.88	22.33	21.7
Excise duty	11.46	12.19	10.96	10.01	10.81	13.7
Tax on cars and motorcycles	0.36	0.37	0.41	0.37	0.19	0.07
Electricity tax	-	-	-	0.01	0.02	0.02
Customs duty	0.84	0.75	0.62	0.62	0.53	0.41
Other taxes	**0.90**	**0.91**	**0.96**	**0.90**	**0.75**	**0.76**
Tax on natural resources	0.40	0.40	0.33	0.23	0.18	0.2
Lottery and gambling tax	0.50	0.51	0.63	0.66	0.57	0.56

Source: Ministry of Finance

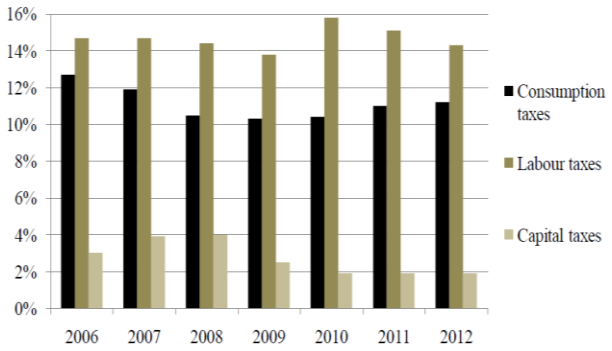
54. A comparison of the implicit tax rates by consumption, labor and capital with Latvia's neighbors and other EU countries shows both potential for and constraints to further tax reform. Official data as of 2007 show that the implicit tax rates in Latvia were about the EU average on consumption and labor, however significantly below the average on capital and business corporate income. Increases of VAT, excise and PIT rates in 2009 have contributed to Latvia's changed relative position in the consumption and labor category. In addition, the broadening of the personal income tax base to include capital income, which came into effect on January 1, 2010, will increase the implicit tax rate on capital. This will be the only category of income where there is still some room for further improvement. However, the Government is deliberating any change with close attention to tax policy in neighboring countries since huge swings can contribute to capital flight and other unintended consequences. With the changes introduced in 2009-2010, room for extensive tax reform is limited.

Figure 1.6: Comparison of Implicit Tax Rate



Source: Eurostat

Figure 1.7: Tax Revenue by Economic Function



Source: Convergence Program 2009-2012

55. A more detailed comparison of Latvia's selected taxes with the EU, Lithuania and Estonia (Table 1.3) shows that considerable changes have been already made in the various tax categories but further amendments could be warranted. It also reveals that there are few taxes that have room for additional adjustment in the short-term. Among the few options that can result in short term savings are gradual increase of personal taxable minimums, elimination of the CIT tax reliefs (since they do not represent a significant share of business expenditure), elimination or increase of VAT reduced rates, or increase of the tax rate for expensive cars. In addition to these measures, longer-term impact on revenue could be achieved by expanding the RET rate on residential property -without due care not to overburden low-income citizens- and further increases in excise taxes.

Table 1.3: Comparison of Selected Taxes

Direct taxes	Latvia	Lithuania	Estonia	Comparison to EU and Other Comments
Personal income tax (PIT)	Min/Max 2009-23percent; 2010-26 percent	Max/Min 21 percent;	Max/Min 21 percent;	EU maximum tax rate is higher than in Latvia while the minimum tax rate is lower. Latvia has introduced a number of reliefs, the most significant being non-taxable minimum and allowance for dependents. The changes made in 2009/2010 have increased this tax burden and made the tax regressive. Currently, the non-taxable minimum is three times lower than in Estonia/Lithuania. Although the tax burden is not so great compared to EU, given the low purchasing power of Latvian citizens, wage decline, increasing unemployment and shadow economy, it would not be useful to further increase the tax burden from PIT. However, a gradual increase of the taxable minimum may be considered.
Corporate income tax (CIT)	Reduced from 25 percent in 1995 to 15 percent	15 percent	21 percent	EU CIT rate is higher than in Latvia. In addition to a very low CIT rate, Latvia has many tax relief incentives. This combination makes Latvia one of the most favorable countries within the EU. Usefulness of CIT tax relief is being

Direct taxes	Latvia	Lithuania	Estonia	Comparison to EU and Other Comments
				considered since it does not represent a significant decrease in business expenditure.
Real estate tax (RET)	As of Jan. 2010, RET on land and buildings for economic activity increased from 1 to 1.5 percent; tax base was widened by including engineering construction (1.5 percent) and residential buildings (0.1-0.3 percent).	RET imposed on land (at about 1.5 percent) and buildings for economic activity (municipality may set rate between 0.3 to 1 percent)	RET is applied only on land and the municipality may fix a rate between 1.1-2.5 percent	Despite the 2010 significant RET rate increase and base expansion, the RET burden is not excessive, especially for residential areas. Further medium-term solutions are expected to be developed while not burdening low-income citizens.
Indirect taxes				
Value added tax (VAT)	Standard rate 21 percent; reduced rate 10 percent	Standard rate 21 percent; reduced rate 5/9 percent	Standard rate 20 percent ; reduced rate 5 percent	The weighted average VAT rate in Latvia has been reduced from 17.28 percent in 2004 to 15.51 percent in 2008, suggesting that the tax burden is substantially lower than the standard rate due to exceptions and reduced rates. While the standard rate is among the highest in the EU (increased by 3 percent in 2009), it was unable to fully offset the tax revenue loss associated with decrease in demand. Since VAT affects consumer prices/ consumption, it would not be advisable to increase the VAT rate during economic downturn. A better solution would be eliminating or increasing the reduced rate or exceptions.
Excise duty – as of 1.07.2009	Fuel (on unlead petrol 379 Euro per 100 Litre, on diesel 330 Euro), alcohol (ethyl alchohol 1255 Euro per 100 Litre, intermediate products 98.7 Euro, wine 56.4 Euro), tobacco (67.7 Euro per 1000 cigarettes) are harmonized among the EU. In 2009, Latvia reached EU minimum for unlead petrol and diesel. In addition, Latvia charges	Fuel – on unlead petrol 434 Euro per 100 Litre, on diesel 330 Euro Tobacco 49.6 Euro per 1000 cigarettes. Excise on ethyl alcohol 1278 Euro per 100 Litre, on intermediate products 88Euro, on wine 57.3 Euro	Fuel – on unlead petrol 398 Euro per 100 Litre, on diesel 369.9 Euro Tobacco 63.8 Euro per 1,000 cigarettes. Excise on ethyl alcohol 1291 Euro per 100Litre, on intermediate products 142 Euro, on wine 66.5 Euro	Main focus of excise tax policy in Latvia has been harmonization with EU requirements on energy, alcohol, and tobacco (Latvia only reached minimum levels in 2009). Oil and tobacco rates increased substantially contributing to high excise revenue growth. However, increase on all excises in 2009 was affected by sharp drop in trade volumes. Further increases would contribute to higher share of illegality in the market. Such increases could be considered at a later time in a wider EU context and when economic conditions improve.

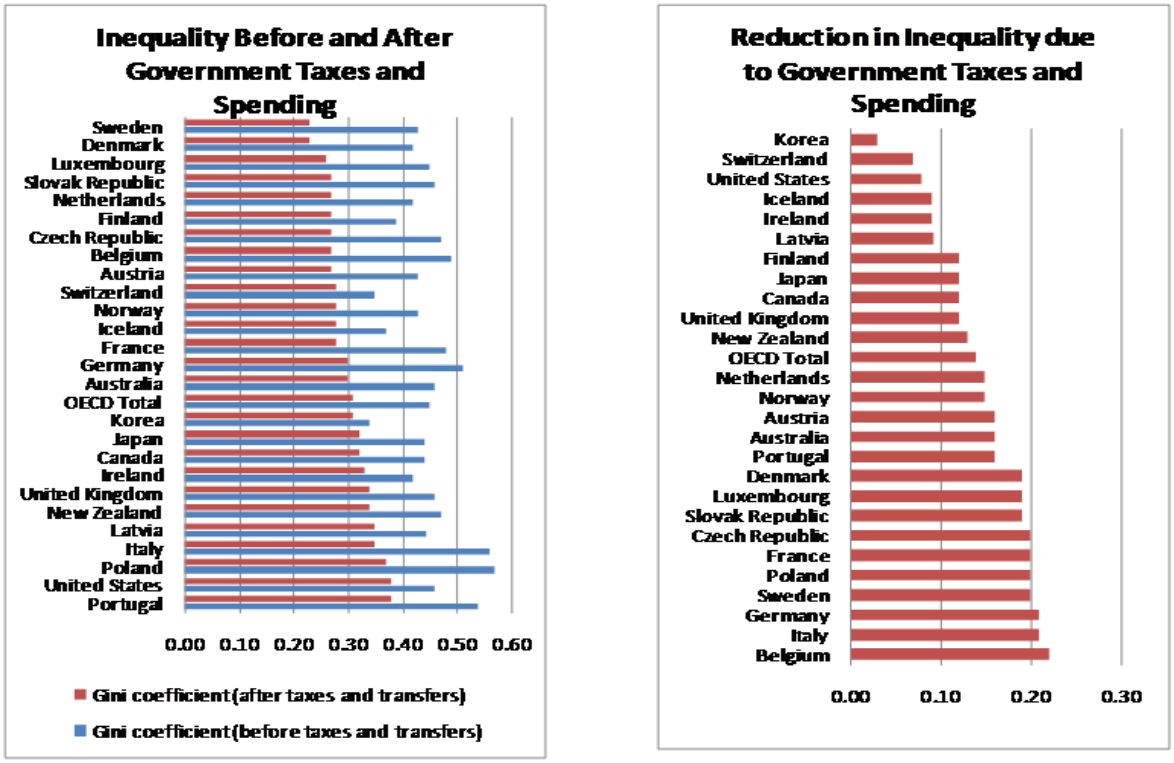
Direct taxes	Latvia	Lithuania	Estonia	Comparison to EU and Other Comments
	excise tax for coffee and non-alcoholic beverages.			
Tax on cars and motorcycles	As of January 2010, tax on unregistered cars or registered abroad was introduced based on CO2 emissions ranging from 0.3 to 5 lats per each gram per kilometer.	There is no such duty	There is no such duty	Some other EU states do not have such tax, although Latvia's tax burden in this category is relatively low. Given the drop in the car market, unless the tax burden is increased on exclusive/expensive cars, it would not be good to raise this tax for other car categories.

Source: Ministry of Finance

V. Public Administration, Subsidies, and State Owned Enterprise

56. This section of the report summarizes the longer chapters on each of the sectors in Volume 2. The intent of this section is to provide just enough details for readers to understand the background and motivation behind the suggestions included in each of the matrices. As stated in the introduction of this report, the suggestions included in the matrices meet at least one of two criteria: (i) they are likely to deliver the savings the Latvia seeks in 2011 and 2012, and/or (ii) are critical to improving equity as well as efficiency. The second of these criteria is arguably more important. Prior to the crisis in 2007, Latvia had one of the lowest reductions in inequality due to government taxes and spending when compared to high-income OECD countries. The Gini coefficient for household income was 0.44 before and 0.35 after government taxes and transfers. The options suggested to the Government are intended to help improve this performance.

Figure 1.8: Impact of Taxation and Expenditure on Income Equality in European and OECD Countries



Source: Staff estimates using data from EUROSTAT and OECD

57. The second chapter of Volume 2 covers public administration, including subsidies and spending on state owned enterprises. Latvia's spending on these categories is compared with other countries in Central and Eastern Europe (CEE) and elsewhere in the European Union (EU) based on available data. This section examines the Government's response to the crisis and economic contraction, by reviewing the distribution of the spending cuts in the 2009 and 2010 budgets. The PER provides options that the Government may wish to consider as a means of achieving further budget savings and increasing revenues to meet its fiscal targets for the years 2011 and 2012. The savings that may be available in the next two years involve implementing further consolidation and elimination of ministries, agencies, and functions; greater simplification and consistency in the application of uniform salary and human resource rules; the reduction and even elimination of subsidies to loss making enterprises; and measures to strengthen public financial management.

58. Public employment in Latvia expanded during the boom years that preceded the crisis to levels exceeded only by neighboring Estonia and Lithuania. Though data on the size of public employment in Latvia for the years before 2008 is scant, estimates by the State Chancellery suggest that general government employment grew from 7.5 percent of the population in 2005 to 8 percent in 2008, declining to 7.4 percent in 2009 after staff cuts that were implemented in response to the crisis. According to staff estimates for this PER based on data from the State Chancellery and the Ministry of Finance, in the last quarter of 2009 government employees at the central and the local levels

represented 7.4 of the population or 14.3 percent of the labor force. This level of public employment is higher than in most Central and Eastern European countries, but lower than in neighboring Estonia and Lithuania, even allowing for the fact that in Latvia healthcare personnel are not considered public employees. It is worth noting, however, that public employment levels in many Central and Eastern European countries are above the OECD and EU averages. Moreover, Latvia has a considerable segment of employment in state-owned enterprises (SOEs). If staff in SOEs are included, public employment in Latvia reaches 10 percent of the population or 19.5 percent of the total labor force.

Figure 1.9: Wage Bill as Percentage of GDP

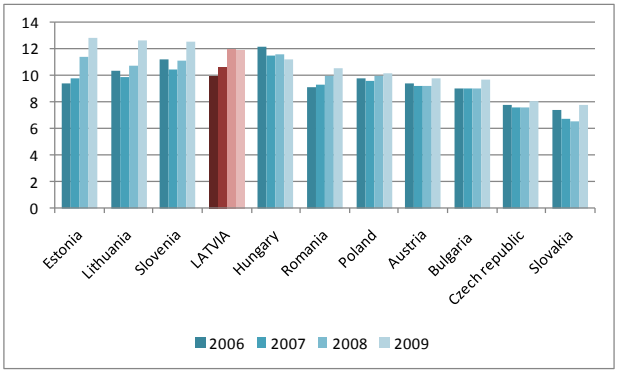
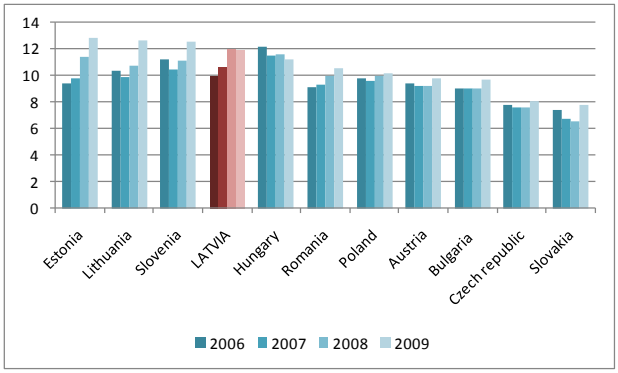


Figure 1.10: Wage Bill as Percentage of Primary Expenditure



Source: EUROSTAT, GFS 2010 edition

59. Like in other countries in the region, even before the crisis the salaries of government employees were higher than the average salary in the Latvian economy. According to data from Latvia's Central Statistics Bureau, in 2008 the average salary in the government was 14 percent higher than the average salary in the economy. However, as in other countries in the region, salary levels in the private sector may be under-estimated in official data due to the allegedly widespread practice by firms of under-reporting employee salaries to reduce payroll tax liabilities.

60. Starting in the second half of 2008, the Government took decisive actions to cut the wage bill. This was done by reducing remuneration levels and by reducing staff numbers by 14.8 percent between the first quarter of 2008 and the fourth quarter of 2009. Base salaries of central government employees were cut by 30 percent on average. These salary cuts were differentiated so that salaries above LVL 300 per month were reduced by 32 percent, while those below LVL 300 were reduced by 28 percent. The wage bill was also reduced by freezing the payment of performance-related bonuses (from November 2008) and most other allowances such as holiday pay through 2011. This measure has meant that many civil servants, especially those in senior positions in central government bodies for whom performance-related bonuses accounted for a significant share of remuneration, have suffered a steep decline in their earnings. At the same time, the freeze on bonuses and allowances has produced substantial savings, as bonuses and allowances declined from 11 percent of the total wage bill in 2007 to 3.7 percent in 2009. The analysis shows how as a result of the Government's actions, in 2009 the wage bill declined by 26.2 percent compared to 2008 and is projected to decline by a further 23.4 percent in 2010. The ratio between the average salary in the economy and the average government salary declined from 1:1.14 in 2008 to 1: 1.02 in 2009. As a share of GPD, the wage bill declined from 10.3 percent in 2008 to 9.3 percent in 2009 or according to EUROSTAT data from 12 percent in 2008 to 11.9 percent in 2009.

61. The PER charts how the crisis propelled efforts to expand the coverage of the unified remuneration principles, which were first introduced in the National Government in 2007 to reduce pay differentials between staff in different government bodies and improve wage bill management. Key legislative steps toward this objective were taken and came into force in 2009 and 2010. A new salary "grid" has narrowed previous divergences in pay levels among ministries and agencies, but significant disparities remain. For example, the average salary in the headquarters of the highest-paying ministry (the Ministry of Welfare) is 25 percent higher than that in the lowest-paying ministries (Ministry of Education and Science and Ministry of Culture). Payroll data suggest that indeed different ministries continue to pay different salaries for employees of the same grade and salary step -within the permissible bands for each step- and that they use the grading system, particularly the horizontal qualifications grades, inconsistently. Municipalities remain largely beyond the scope of efforts to harmonize remuneration policy, and although SOEs and commercial entities funded primarily from the state budget have not avoided staff cuts, they appear to have largely escaped salary reductions.

62. Local governments' wage bill has declined far less sharply than that of the National Government. Reflecting this, there was an increase in local governments' share of the total wage bill. Treasury data show that local government spending on employees' remuneration declined by only 16 percent in 2008-2009, compared to 35.2 percent decline in remuneration for employees of the national government. As a result, local governments' share of the total wage bill exceeded the national government wage bill in 2009 for the first time, growing to 53 percent from 46.6 percent in 2008.

63. At the level of National Government, staff reductions have so far been achieved largely by merging administrative bodies and consolidating support functions, and do not appear to have had a tangible impact on core policy and service delivery functions. The Government took steps to reduce the number of administrative bodies, primarily by merging bodies with related functions. As a result of this consolidation, by January 2010 the number of central government bodies and subordinated agencies was reduced to 136[11], from 229 a year earlier. The Government also consolidated some support functions such as human resource management, accounting, and audit among ministries' departments and subordinated institutions. This reflects an effort to minimize disruption to core government functions and the delivery of public services. However, in the absence of a central personnel database, the Government lacks detailed information on staff composition in different administrative bodies, which makes it difficult to identify areas where further staff reductions could be undertaken without a significant impact on core functions or public services. To address this information gap, the Government has conducted targeted functional reviews focused on areas of apparent duplication of functions (e.g. support functions, vehicle registration, forensic services) to assess the scope for further efficiency gains and identify options for reform. Such options for achieving permanent savings include combinations of delegating, outsourcing, or eliminating certain non-core functions – to be decided on a case-by-case basis

64. Further across-the-board reductions in salary levels at the level of National Government are not recommended, as they may erode staff motivation and risk the loss of highly qualified staff as the labor market starts to recover. Due to the continuing economic contraction and the depressed labor market, so far these sharp pay cuts do not seem to have led to a significant out-flux of staff from the public

[11] This includes 39 central government bodies and 97 subordinated institutions.

sector. However, they may have negatively affected staff motivation and productivity – an impact that the Government may wish to investigate through a survey and/or focus groups of public employees. As the Latvian economy and those of other EU countries gradually recover, the competitiveness of remuneration in the public administration may lag behind and staff may leave the public administration for other opportunities. The Government may therefore wish to closely monitor salary trends in the private sector and, once the fiscal space is available, review salary levels to ensure the public administration's capacity to attract and retain qualified staff.

65. However, pay levels in 'outlier' budget-supported entities that appear to be paying disproportionally high salaries could be further adjusted by reducing the ceilings of the salary bands, thereby narrowing pay differentials. Adjusting pay levels in some of the high-paying ministries (e.g. Ministry of Agriculture, Health, Welfare, Regional Development) and some agencies (e.g. the Social Integration Foundation, State Education Development Agency, National Film Center), where average pay levels outstrip those of other ministries, could yield minor but significant savings (approximately LVL 1.5 million). At the same time, this step could pave the way for further reform of remuneration aimed at equalizing salary levels across the public administration (for example, by eliminating the salary bands).

66. At the national government level, further staff reductions appear feasible among certain categories of public employees that seem comparatively generously staffed. For example, although police staffing has been reduced considerably in recent years a further reduction of some 5 percent could be considered to bring staffing levels closer to those of leaner forces in countries with comparable crime rates (e.g. Lithuania and Estonia). The tax administration (State Revenue Service) appears overstaffed but underpaid, with 4,500 staff and an average salary of LVL 329. Considerable scope remains for further consolidation of administrative bodies, which could help reduce duplication of functions, though the savings may be relatively modest after the consolidation achieved in 2009. Some further efficiency gains could be achieved by merging institutions, including ministries. Compared with other small countries in Europe, Latvia does not have a particularly large number of ministries, though it does have a high number of subordinated agencies, which offer wider scope for consolidation.

67. The analysis shows how in the short term, the cost savings from such mergers is likely to be modest, especially as many support functions have already been consolidated. Further savings would come primarily from the reduction in administrative departments and managerial posts as well as reduction in office space. So far cost savings from non-salary administrative costs (e.g. rental of premises) have been modest following the mergers of administrative bodies in 2009, which indicates that there may be scope for additional savings. However, in the medium term, potentially substantial permanent savings could be achieved with the elimination of unnecessary functions. Such reforms would require substantial preparatory work, which should ideally be guided by a clear concept of the appropriate role of the State in Latvia's economy and society. This could provide a basis for determining which functions lie at the core of the Government's mission and which ones can be considered of secondary importance or unnecessary. In the absence of adequate preparatory work, the abolition of functions could lead to unintended consequences.

68. Given that most of the cost savings have so far disproportionately affected the national government, there may be further scope for efficiency savings in public administration at the municipal level. The constitutional division of responsibilities and functions between national and sub-national

authorities, as well as Latvia's carefully negotiated revenue sharing arrangements between the national government and municipalities will shape exactly how these efficiencies could be achieved. The authorities might consider creating incentives for these gains by reducing earmarked transfers from the central budget (with the exception of teachers' salaries which are now governed by the per-student financing formula) or by reducing municipalities' share of tax revenues.

69. As a result of the reform of territorial administration that was introduced based on the Law 'On Administrative Territories and Settlements' of December 2008, following the local elections of June 2009, the number of local government units was reduced from 548 to 118 municipalities and republican cities. The reform and the consolidation that ensued appears to have coincided with the acceleration of staff cuts at the local government level. Municipal government staffing declined by 8.5 in the second half of 2009, compared to 5.2 percent in the first half of 2009 (compared to a reduction of only 0.06 percent in 2008). However, the consolidation of local government administration has not yet reached its full potential in terms of achieving efficiency gains. 'General government services' continue to represent a relatively high 18.3 percent of expenditures (compared to 18.4 percent in 2009) in municipal budgets, suggesting room for further savings in this area. According to State Chancellery data, by the end of 2009 municipalities employed about 87,000 staff, of whom 37 percent worked in education. In the absence of a personnel database that can provide information on staffing composition at the municipal level, a functional review of selected municipalities could help identify areas in which staffing could be reduced without a significant impact on service delivery.

Box 1.1: Latvia's Administrative Territorial Reform

Latvia is a unitary state with a single-level local government system. Municipal governments are key providers of social services in Latvia, being responsible for delivering about 70 percent of the overall education budget and for substantial supplementary social assistance programs and housing benefits, particularly for the poor. While health does not feature as a large expenditure under local government budgets as health services are largely funded through regional health funds, local governments have an important role to play in health care management as employers and operators of medical facilities. Thus, this review includes a chapter that focuses specifically on municipal spending and intergovernmental fiscal structures, the role of local authorities is touched on in almost all chapters of the report.

Prior to June 2009, sub-national governments in Latvia were organized along two levels. The first level (closest to citizens) consisted of republican cities, towns, and municipalities. The second level (county level) was formed by 26 districts and republican cities. Seven republican cities were included under both local government levels as they provided both first-level local government and district government functions. First level local governments were not subordinated to district governments. Following the implementation of local government reforms in 2009, there is a single level sub-national government system in Latvia consisting of republican cities and municipalities. The district level of government has been abolished.

Before the reform, the total number of local governments was 548, including 26 districts (rajons), 7 republican cities (republikas pilsēta), 50 towns (pilsēta), 424 rural municipalities (pagasts) and 41 reformed municipalities (novads). The average population at the first-level of local government before the reform was 4,260 thousand, but the number of residents in the smallest municipality (Kalncempju pagasts) was 251. The population stood at fewer than one thousand in more than one third of local administrative units. After the reform, the number of local government units declined to 118 comprising 9 republican cities and 109 municipalities (novads).

Despite the reform, there are significant disparities in population size between local governments, ranging from the capital city Riga with almost one third of the country's population (709,145) to the municipality of Baltinavas with 1,365 residents. Thirty-seven municipalities have a population of less than five thousand residents. There is some evidence that further municipal mergers may be warranted in order to create municipalities of a sustainable size. Further mergers may lead to budget savings with regard to administrative functions. Preliminary evidence points to possible inefficiencies due to the small scale of many municipalities. There is a tendency for per capita administrative costs to decline the higher the population size serviced by local government in Latvia. Out of the 13 municipalities with an administrative budget share of total spending of over 20 percent (compared to an average of 12 percent), 10 have a population of less than 10,000.[1] It should be noted that international evidence is not conclusive as to the optimal size of local governments to achieve economies of scale. Some studies have suggested that there is a U-shaped relationship between population size and administrative costs and others have found that amalgamation do not lead to a reduction in administrative costs.

Beyond the weight of administrative expenses, there may be strong arguments for amalgamation related to increasing the quality of municipal service provision. Administrative capacity is likely to be constrained for local governments that cover very low populations. This was the main motivation for the recent reform of municipalities in Denmark. Denmark restructured its municipalities in 2005 by merging 270 municipalities into 98 units (enforced in 2007). Now there are few municipalities with less than 20,000 in population. The objective of this reform was chiefly to ensure municipalities have adequate administrative capacity for service delivery. Using the Danish population threshold, even following the reform Latvia still has 94 municipalities out of the total 109 with under 20,000 in population. Even if the current number of municipalities (novads) is to be maintained, semi-amalgamation models could be considered. Novads may be too small for some of their functions, i.e., organizing public transport services, managing roads funding, operating secondary schools with wide curricula, operating orphanages and homes for the disabled or retirees. A semi-amalgamation model whereby small municipalities are combined into large units for service delivery would be an option for taking on these functions (perhaps using the five planning regions).

Source: PER Volume 2, Chapter 3.

70. For the medium and long term, the Government would greatly benefit from a more coherent and fiscally sustainable system of staffing and remunerations, which should ideally be anchored in a clear human resource management policy aimed at attracting and motivating staff with the appropriate skills for the needs of the public administration. Latvia has committed to establishing a central body with a strong mandate to formulate and monitor the consistent application of human resource management policy across the public administration by the end of 2010. This commitment need not imply a full reversal of the current decentralized model of human resource management in Latvia's public administration (e.g. recruitment may remain decentralized). However, there could be benefits from coordinated staff planning and coherent policies on career development and staff incentives, including for fiscal planning. The body responsible for human resource management policy would also have a key role in designing and managing the pay system reform and would therefore need to be established before further reform of the pay system. A fiscally sustainable remuneration policy would need to be supported by firm establishment and fiscal controls to avoid a new uncontrolled expansion of public employment and the wage bill. This may require the Government to develop longer-term fiscal targets for the size of the wage bill and principles for containing its growth, once the crisis has passed.

71. The analysis in the second chapter of Volume 2 extends beyond public administration, to State support to enterprises. The Government could review spending on subsidies to enterprises with a view to phasing some of this spending out. Subsidies to enterprises tend to be an inefficient form of public expenditure, especially when they displace public procurement processes or are intended to cover operational losses. When used selectively, subsidies can be a useful policy instrument to address demonstrable market failures and to support the provision of public goods (e.g. introduction of new, environmentally friendly technologies; or the provision of postal services in rural areas), which the private sector could not otherwise provide profitably. In the interests of social equity, governments may also wish to subsidize the access of the poor to some goods (e.g. medicines) and/or services (e.g. public transport), which are considered essential to ensure an adequate quality of life or income generation opportunities. However, Latvia currently provides subsidies to enterprises that do not fully correspond to these principles. In particular, the Government continues to substantially subsidize the cost of public transport to keep fares low for all passengers, irrespective of their ability to pay higher fares that would ensure cost recovery for transport providers. Such subsidies are not targeted to benefit the poor nor do they seem necessary to maintain the provision of services (with the possible exception of rural routes).

72. The PER suggests that the Government could review the composition of spending on subsidies with a view to substantially reduce or eliminate subsidies intended to cover enterprises' operational losses and maintaining consumer prices below cost recovery level. These subsidies create perverse incentives for enterprises to provide unnecessary services, and tend to keep their operational costs high. The Government could further reduce the amount of the passenger transport subsidies, not by cutting services, but by liberalizing passenger fares for most passengers, and continuing to subsidize of low-income persons (and possibly other beneficiaries such as school children or the disabled). For example, targeting the subsidy to the 40 percent of the lowest-income persons would result in annual savings of LVL 33 million below the planned subsidy for 2010. A targeted subsidy could be administered by issuing beneficiaries with cards proving their eligibility to discounted fares. Indeed, the beneficiaries of the

activities included in the Government's recently implemented Emergency Social Safety Net package are already issued with identification cards confirming their low income and needy status.

73. The analysis uses data from the most recent HBS to show that rates of public transport usage do not differ significantly across income groups, which suggests that most transport users have the capacity to pay higher fares. At the same time, households' expenditure on public transport as a share of household consumption does vary from 3.6 percent for the lowest-income quintile (Q1) to 0.7 percent for the highest-income quintile (Q5), with rural households spending more than urban households. This suggests that there may be considerable efficiency gains from targeting the subsidies to low-income groups and rural routes. However, it may be necessary for the Government to continue subsidizing some rural routes, where passenger numbers would not be sufficient to ensure cost recovery for carriers. These routes need to be identified based on an analysis of passenger flows and surveys to assess passengers' ability to pay higher fares.

74. The analysis of subsidies is followed with a close look at state owned enterprises (SOEs). Typically, governments tend to maintain (majority or minority) stakes in enterprises for reasons of national security (e.g. in the defense industry), the provision of public goods in sectors of market failure (e.g. healthcare), or in sectors that represent 'natural' monopolies (e.g. water sector utilities, and railways). Yet many of the 60 SOEs owned by the Government of Latvia would not easily fit in these categories. The Government's recent initiative to review the status of SOEs and define key policy principles to inform the Government's exercise of its ownership function could result in reforms that would not only have a positive fiscal impact in the short term, but also improve the competitiveness of the economy in the longer term. A key task of this review led by the Ministry of Economy has been to compile an inventory of SOEs. So far the Government has exercised its function as an owner of SOEs in a decentralized manner, whereby sector ministries have supervised SOEs subordinated to them without reference to a common policy framework or set of guidelines.

75. The ongoing review would allow the Government to differentiate among SOEs with different functions and identify options for reform, including privatization, change of legal status, or closure. In doing so, the review will need to define some parameters of an overall policy of SOE ownership, most notably the appropriate purposes of the Government's ownership of SOEs. Privatization could be an appropriate option for those SOEs that are not 'natural monopolies', but operate in an actually or potentially competitive market environment (e.g. banking; electricity distribution). The privatization of these SOEs, including through the possible reduction of the state's ownership in them, could be a significant source of additional revenues, which could be estimated on the basis of each SOEs' financial performance and assets, including stakes in subsidiary companies.

76. Alternatively, the Government might consider integrating those SOEs that exercise government functions into the public administration. Examples of traditionally public administration functions currently performed by SOEs include market regulation (e.g. the Standardization, Accreditation, and Metrology Center), administration of public funds (e.g. the Road Transport Administration) or public procurement (e.g. Latvia State Roads). A possible option for transforming the status of these SOEs could be to close them as commercial entities and re-establish them as government bodies –either as agencies or departments within a ministry. The argument that these functions require highly specialized skills that the public administration cannot attract due to the salary ceilings is not convincing, given that many

government agencies in Latvia are already successfully attracting staff with these skills to perform similar functions.

77. Finally, the Government might consider developing a coherent policy that defines the objectives for the Government's ownership of enterprises as well as specific guidelines to ensure high standards of corporate governance in SOEs. The centralization of the Government's ownership function in a single agency with high standards of transparency and accountability could be an option for achieving coherence in the Government's exercise of its ownership function and its separation from regulatory and public procurement functions.

Matrix 1.1 Options for the Government to Consider in Public Administration Reform, Subsidies and SOEs						
Options for policy action	**Savings 2011 (LVL million)**	**Savings 2012 (LVL million)**	**Background**	**Rationale**	**Risk**	**Longer-Term Benefit**
Public Sector Remuneration						
Further amendment of a new remuneration system (elimination of salary bands & reduction in the number of public services job families) Short-term savings can be achieved through a reduction of the maximum salary levels to bring them closer to the current average salaries paid by ministries and agencies. This would force agencies that pay salaries on the higher end of the bands (e.g. Ministry of Health, Ministry of Regional Development, Ministry of Welfare) to reduce their wage bill.	**1.5**[12] The consistent application of the salary grid (use of salary steps or 'qualifications grades') could potentially save up to LVL 0.5 million.	**1.5 - 2**	As of January 2010, the reduced remuneration levels have been reflected in a new remuneration grid, which attempts to bring more coherence across civil service and the public sector more broadly.	The remuneration grid remains relatively complex and contains many inconsistencies that reduce predictability in managing the wage bill, as well as undermine the principle of 'equal pay for work of equal value' (especially salary bands and remaining differences in average pay levels in different ministries and agencies).	It may be difficult to only cut the salaries of those ministries/ agencies that pay higher than the national government average (currently LVL 756 per month), and to resist pressures to increase the salaries in those ministries and agencies that pay less than the average. In the medium term, equalizing salary levels across ministries and agencies could lead to an increase in the overall wage bill.	Increased consistency (e.g. elimination of salary bands and transition to a pure salary grid system) and transparency (e.g. reduction in the number of allowances; increasing base salary as a share of total remuneration from 67% to e.g. 80%).
Establishment of a centralized personnel and payroll system (Human Resource Management Information System, HRMIS) and introduction of central controls fo the establishment of new posts	The launch of a HRMIS linked to payroll will incur **a start-up cost** (up to LVL 0.5-1 million)		MoU with the European Commission requires the Government to develop a strategy for unifying the human resource management (HRM) function across public administration institutions.	This will ensure consistency in human resource management and remuneration policies. The current situation lowers the likelihood that ministries, agencies, and local governments accurately report payroll and personnel data (but		The consolidation of the HRM function would also result in further savings in administrative costs (through reduction of HRM staff).

[12] This amount is calculated by assuming that average salary levels in ministries and agencies that currently pay above the average salary (LVL 756 per month) is reduced to this average. However, a more precise calculation could be made by estimating the number of staff whose pay levels are above the average *within* each monthly salary group and qualification grade. This information (number of staff within each monthly salary group and qualifications grad in each ministry/ agency) is not currently available to the World Bank team.

Matrix 1.1 Options for the Government to Consider in Public Administration Reform, Subsidies and SOEs						
Options for policy action	**Savings 2011 (LVL million)**	**Savings 2012 (LVL million)**	**Background**	**Rationale**	**Risk**	**Longer-Term Benefit**
				continuing to hire staff not included in the payroll database). The introduction of a mandatory personnel ID number should increase the accuracy of payroll and personnel data.		
Further staff reductions, particularly in agencies subordinated to ministries and local government bodies (e.g. police, revenue administration)	**4** [13] at the central level **30** through a 5% reduction in municipal staffing[14]	**5** at the central level **37.5**	In the period 2010-2011 a further reduction in salary levels does not seem feasible or advisable, as it would carry a very high risk of qualified staff leaving the civil service and/or losing motivation.	Overall, public sector employment remains higher than some comparator countries and staffing levels remain higher than 4-5 years ago. The wage bill as a share of GPD is also on the high side of a range of comparator countries, especially if one considers that healthcare staff are not included in Latvia's public sector wage bill (which they are in most countries). This suggests that there may be some room for adjustment to pre-2007 staffing levels without a negative impact on policy functions and service delivery. Specific	There is a risk that quality of public services may suffer if staffing levels are cut further. A review of functions and appropriate staffing levels within each agency would seem appropriate. Otherwise, short-term savings may have to be reversed later to restore an acceptable quality of services. The tax administration seems clearly overstaffed, but salary levels also appear too low. It is therefore recommended to consider cutting staff while increasing salaries.[15] A transition to a leaner tax	Optimization of the scope, network and productivity of public administration institutions.

[13] An estimated LVL 2 million would be saved in 2011, if staffing levels in the police, prison administration, and court personnel were cut by 5 percent. These savings are estimated by assuming that the redundant staff are currently earning the average salary paid by their service and will receive severance pay equal to 3 months' salary. These savings would increase to LVL 2.5 million in 2012, as severance pay would not have to be paid. The higher figure can be reached by sharper staff cuts in these services (up to 10 percent) and/or by staff cuts in additional agencies.

[14] Again, this amount is based on a 5 percent reduction of the municipal wage bill achieved through redundancies. The savings are expected to increase in 2012, as severance pay to employees laid off in 2011 would not have to be paid.

[15] For illustration purposes, Cutting staff by 2/3, while doubling salaries (to LVL 660 per month) would lead to a saving of LVL 3 million in the first year of the reform, even taking into account severance pay of LVL 2.9 million. In the second year of the reform, the savings would reach LVL 5 million. However, the reform of the revenue administration should be carefully designed to ensure that staff reductions are accompanied by efficiency gains and do not result in reduced compliance rates and revenue collection.

Matrix 1.1 Options for the Government to Consider in Public Administration Reform, Subsidies and SOEs						
Options for policy action	**Savings 2011 (LVL million)**	**Savings 2012 (LVL million)**	**Background**	**Rationale**	**Risk**	**Longer-Term Benefit**
				services (e.g. police, prison administration) seem overstaffed.	administration however would be a medium-term reform.	
Consolidation of the Public Administration						
Further elimination/consolidation of functions, through mergers of ministries and agencies.	**3.5 – 5** from staff cuts depending on the number of agencies to be consolidated and the degree to which support services may have already been consolidated[16]		Latvia continues to have what appears to be too many agencies, which in many countries either do not exist or are consolidated. Some entities subordinated to ministries could be amalgamated (e.g. various inspectorates)	Optimizing the scope of service to the size of the economy and available fiscal resources. The abolition of SOEs, which compete with market operators may also be expected to increase competition in the domestic market, thus improving the investment climate and resulting in potential further savings for the budget (through increased competitiveness in public procurement).	--	Improved public perception of the public administration and increased quality of public goods and services.
Reducing non-salary administrative costs (including by raising revenue from the rental of vacant state-owned premises), e.g. consolidate police stations, tax offices, and other regional branches of central institutions	**6** at central government level[17]		Mergers of institutions/ reduction in staffing should result in savings in rental of premises; state-owned premises could be offered for lease		--	Greater efficiency
Introduce salary caps for monopolies and SOEs that	Savings would be achieved		SOEs, including those in receipt of subsidies,	Control of administrative costs and performance	--	Greater efficiency

[16] The Bank mission has not received expenditure data broken down by subordinated institutions to more accurately estimate the potential amount from the abolition or merger of such agencies; approximate estimates are based on salary level and employment data from the State Chancellery. In principle, mergers of institutions (e.g. consolidation of inspectorates in Croatia) may result in savings of up to 20 percent of operating costs, however lower savings are estimated here in view of efforts already undertaken to cut costs in 2009.

[17] This is based on a 5 percent reduction in rent, lease, and non-capital maintenance costs (total cost in 2009: LVL 122 million for central government), which should be feasible through a more efficient use of premises.

Matrix 1.1 Options for the Government to Consider in Public Administration Reform, Subsidies and SOEs						
Options for policy action	**Savings 2011 (LVL million)**	**Savings 2012 (LVL million)**	**Background**	**Rationale**	**Risk**	**Longer-Term Benefit**
receive subsidies from the budget.	through a reduction in subsidies (to be estimated, and can be complemented with an increase in dividends)		have cut staffing and salaries less sharply than in the rest of the public sector.	targets should be developed for all monopolies and firms receiving subsidies.		
Support to Enterprises						
Phase out direct subsidies to loss-making enterprises at both the central and municipal levels. Reduction of central budget subsidies for **passenger transport** by targeting the subsidy to low-income persons or to rural routes only (a compensation strategy can be developed before elimination of subsidies, along the lines of current ESSNS for disabled passengers). Reduction in subsidies for SOEs in the areas of **culture, broadcasting, and sport**	**25- 33**[18] **up to10**[19]		Currently, subsidies are not targeted to supporting access to services for low-income citizens, but come in the form of 'compensation for losses' to providers, without adequate cost-control mechanisms. As a result, subsidized enterprises have an incentive to provide unnecessary services, to understate revenues, and to inflate operational costs.	Contracts should be closely monitored to ensure cost control. User fees (e.g. passenger transport prices) could be allowed to increase. This would allow subsidies to be targeted to protect low-income beneficiaries, instead of protecting firms from losses. Services that are considered essential from a social perspective (e.g. transport routes to rural communities) but would not be commercially viable, even if providers were able to charge market prices,	Impact on the poor of a rise in transportation costs (this risk can be minimized by developing a compensation strategy prior to cutting subsidies). Allowing prices for passenger transport to increase may reduce passenger numbers, which may reduce transport operators' overall revenues and thus reduce savings. Transition to market (unsubsidized) ticket prices could be piloted in a few routes to measure the impact on passenger	Efficiency gains by allowing prices to rise to cost recovery levels, and targeting subsidies to low-income users of the services concerned (e.g. railway and bus transport). Increased budget revenue and equal treatment by nature of the institution.

[18] Data from the most recent household survey indicate that public transport users are fairly evenly spread among income groups, which a slightly higher rate of usage among rural residents. The higher figure is based on the assumption that the current level of user subsidization (approximately 50 percent of the ticket price for bus services; 60 percent for railways) would be maintained only for the two poorest quintiles of the population (i.e., 40 percent of transport users), leading to a 60 percent reduction in subsidy. The lower figure is based on maintaining the current level of subsidy for rural routes (LVL 13 million in 2010).

[19] The estimate is based on a one third reduction from 2009 subsidy levels. There is no dispute that the State has a role to play in supporting culture, broadcasting and sport. The policy question that needs to be considered is whether the current level of subsidies to these activities is affordable, given the severity of fiscal constraints and what Latvia wants to achieve. This is only something the Government can decide. Based on Treasury data on expenditure by functional classification, it appears that subsidies to "recreation, culture, and religion" were LVL 9.8 million in 2008 and LVL 8.3 million in 2009.

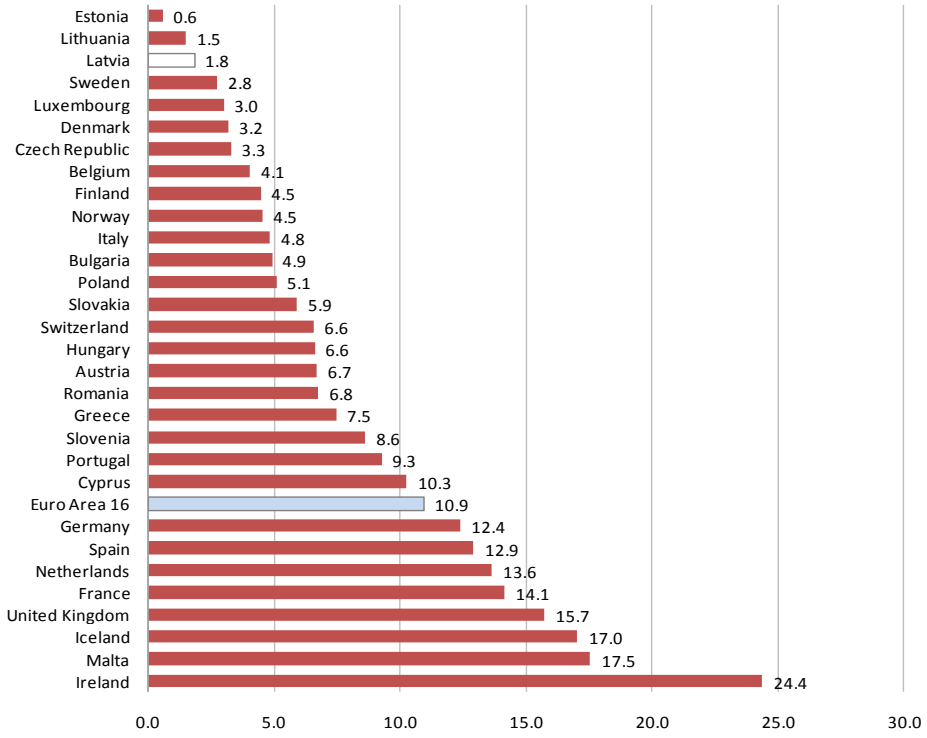
Matrix 1.1 Options for the Government to Consider in Public Administration Reform, Subsidies and SOEs						
Options for policy action	**Savings 2011 (LVL million)**	**Savings 2012 (LVL million)**	**Background**	**Rationale**	**Risk**	**Longer-Term Benefit**
				could be specifically identified and prioritized based on cost-benefit analysis.	flows and operators' revenues. Another risk concerns the identification of low-income transport users who could continue to benefit from the subsidy. Access to subsidized (discounted) transportation could be granted to persons who are eligible for other types of social assistance (e.g. free medical care; housing benefit; GMI) who are already issued with a document proving their status. The impact of removing subsidies for the non-poor in rural routes could be assessed by a survey of public transport users in a sample of these routes.	
Tightening public financial management (PFM) controls in SOEs and agencies	Savings depend on level of under-executed/ misappropriated funds in 2010.		Concerns about the management of subsidies to SOEs under Ministries of Education, Culture, and Transport revealed by the State Audit Office (SAO) in 2008.	Ensure recovery of misappropriated or unspent funds, including subsidies (e.g. LOC).	--	Improved transparency and efficiency of PFM, including improved budget execution.
Revenue Raising from SOEs (and other state assets)						
Extend to SOE subsidiaries the requirement to *increase the minimum dividend paid by*	--	--	A positive step was taken with legislation adopted in 2009 that	It would be expedient to tighten the legislation to ensure that these SOEs'	--	Increase in revenue to the state budget. Consistency in rules applying to SOEs

Matrix 1.1 Options for the Government to Consider in Public Administration Reform, Subsidies and SOEs						
Options for policy action	**Savings 2011 (LVL million)**	**Savings 2012 (LVL million)**	**Background**	**Rationale**	**Risk**	**Longer-Term Benefit**
profit-making SOEs to the state budget to 80 percent.			increased the minimum dividend paid by profit-making SOEs to the state budget to 80 percent. Extending this requirement to SOE subsidiaries would increase revenue to the state budget.	subsidiaries are also included in the measure.		and SOE subsidiaries.
Privatize SOEs that are not providing essential public services. Prepare an inventory of real property owned by the state and identify assets suitable for privatization (those not used for public functions).	Savings depend on valuation of assets to be privatized	--	The private sector accounts for 70 percent of GPD; this level could be raised to 75 percent (e.g. as in Lithuania, Poland) or even 80 percent (e.g. as in Estonia, Hungary). A Government Working Group has been formed to review the expediency of state ownership of SOEs on a case-by-case basis.	Examine whether some SOEs could generate more budget revenue by being privatized.	Valuation of assets could be affected by current contraction, continued recession and weak recovery in the world economy.	Competition in Latvia's internal market would be strengthened. Savings to the budget could also accrue through increased competition in public procurement.

VI. Social Welfare

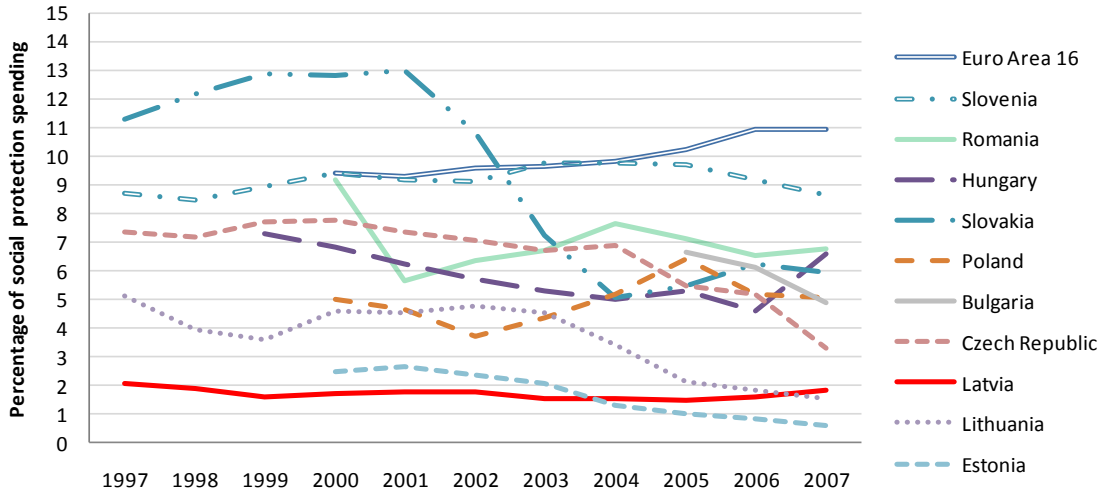
78. By EU standards, Latvia spends a very modest sum on social welfare (protection), although this amount has risen rapidly in the last three years. Total spending in 2007 was well below spending levels in Hungary, the Czech Republic, Slovakia and Slovenia, Romania and even Estonia. Spending on social insurance pensions makes up the largest share of social welfare spending in Latvia as in other countries – a product of rapid ageing of the population. Spending on non-contributory transfers in Latvia has been comparable to that of its immediate neighbors. However, spending on targeted "exclusion" benefits is – along with Estonia - the lowest among the new member states and indeed in the entire EU.

Figure 1.11: Spending on Income-Tested Programs, as a Percentage of Total Social Welfare Spending in EU Member States, 2007



Source: EUROSTAT ESSPROS

Figure 1.12: Trends in Spending on Means Tested Programs in Central and Eastern European Members States of the EU, 1997 – 2007

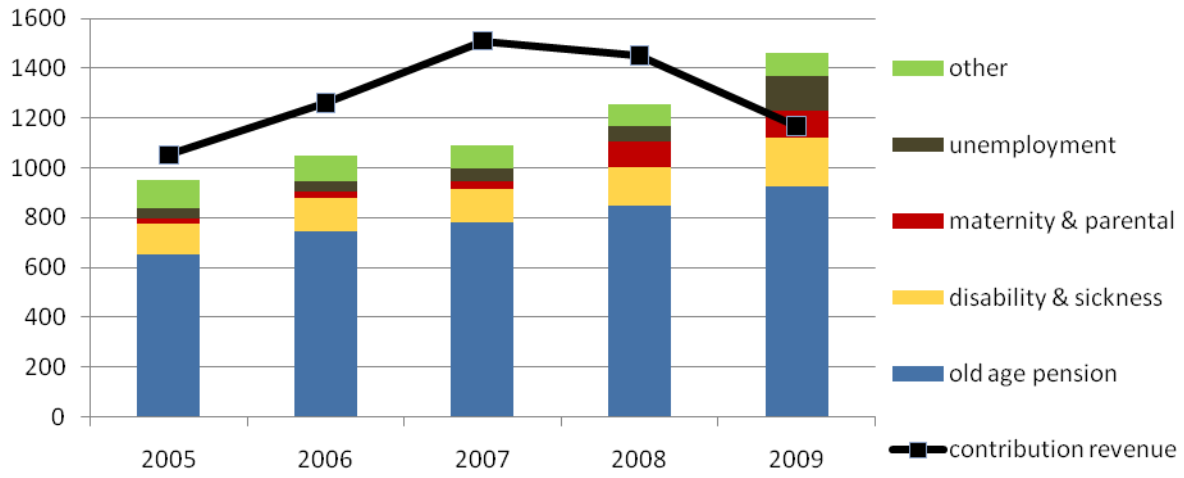


Source: EUROSTAT ESSPROS

79. All forms of social welfare play a critical role in smoothing household consumption, particularly during periods of economic crisis. For this reason, the reluctance during the current contraction to make quick cuts in social welfare spending without careful deliberation is reasonable. However, Latvia is faced with having to make difficult fiscal choices if it wants to achieve its objective of Euro entry. And in this context, there are clear opportunities for fiscal savings in the social welfare sector, mainly from a package of measures to recover at least some of the windfall spending on old age pensions.

80. Social insurance accounts for about 83 percent of social welfare spending, and is the part of public expenditure where the Government is most likely to find options for immediate savings and longer-term fiscal sustainability. Due to a lagged impact of the high-growth period, the level of old-age pensions paid to those who recently retired is considerably higher than amounts paid to retirees from previous years. To illustrate, the purchasing power of a pensioner who retired in 2009 was 69 percent higher than that of a person who retired in 2005. By way of comparison and to put this increase in context, the cumulative reported real wage growth during this period was only 28 percent. Furthermore, amidst the fiscal exuberance of the high-growth years, two important changes in pension policy encouraged a rapid and unsustainable rise in benefit spending: the expansion to all retirees of what was originally a targeted supplement to top up low pensions; and the introduction of generous benefit indexation to the growth of salaries as well as to price increases.

Figure 1.13: Social Insurance Special Budget, Contribution Revenues and Expenditures in 2005-2009, in 2009 LVL



Source: Staff estimates using data from MOW

81. Through a combination of proposed measures designed to protect the households receiving the lowest pensions the Government could save as much as LVL 205 million immediately.

82. The Government could tax pensions more progressively, and by doing so recover much of the recent windfall to pensioners. Given the accelerated increases in pensions that resulted from the booming economy prior to 2008 (driven by (a) partial wage indexation of pensions, (b) the introduction and then extension of new supplementary benefit for pre-1996 contribution years, and (c) the abnormally high notional interest rates), it is reasonable to attempt to recover some of this spending. This is viable especially if it is done in a targeted manner, aimed mostly at the most recently retired pensioners who gained disproportionately from the pre-2008 boom, many of whom are still capable of working Currently the first LVL 165 of monthly pension benefits is exempt from income tax. This exemption is much higher than the exemption on income from labor, and gathers LVL 34 m in annual revenues. Moving this threshold to any point lower, but above LVL 80 -the level of the minimum pension guarantee- can generate substantial additional revenue.

83. The Government could return to a policy of targeting the pension supplement for years of service prior to 1996. A non-contributory supplement to pensions was introduced in 2006 for low income pensioners and extended to all pensioners in 2008. The benefit pays LVL 0.7 for each year of accrued service before 1996, even though actual records of contribution prior to this year are partial, at best. On average the supplement amounts to 14 percent of overall pension spending. This measure could be implemented progressively by eliminating the supplement for all retirees except the 10 percent of pensioners with the lowest benefits. Eliminating the supplement on pensions at or above LVL 140 per month would protect the incomes of the poorest pensioners, and save up to LVL 120 m annually.

84. Having eliminated indexation of pension benefits to wage growth in 2009, the Government could index pension benefits to deflation. By definition, this protects the purchasing power of pensioners. Given that purchasing power of contributors has decreased on average by 13 percent in 2009 it is appropriate that the purchasing power of pensioners is at least constrained from rising. The

current pension law indicates that pensions should be indexed to prices but *cannot be reduced in nominal terms*. This provision could be interpreted in two ways. Under a lenient interpretation of the law pensions should be frozen in times of deflation and indexed positively when the CPI is positive. Under a more stringent interpretation the downward adjustment of the pension is not allowed but upward adjustment only starts when purchasing power of the pension starts to fall behind its original level. Whether the more stringent application of the law is possible would have to be investigated by the authorities. However, the legality of stringent interpretation clearly runs a political risk of being challenged when inflation returns. There is also a risk that deflation could be prolonged, which would not allow the Government to recover accumulated deflation for a long time.

85. A gradual increase of the statutory retirement age is another critical step the Government could consider to put the social insurance special budget on a more financially sustainable path. This measure would not only increase medium and long term fiscal sustainability of social insurance, but also augment the level of pension for future retirees. The statutory retirement age could be safely increased by 6 month increments every year, starting in January 2015. There are several reasons to wait until then. The current early retirement option expires in 2011. Given the recent rush to early retirement and disability, this could mean very few new old age benefits are awarded in 2012-2013.[20] This means that an increase of the retirement age before 2014 would not generate any significant savings, and could be counterproductive in the recessionary environment. Furthermore, the cohort turning 62 in 2014 will already have experienced a significant increase in the effective retirement age (70 percent of previous cohort will have retired early, while most representatives of this cohort will have to wait until 62), so it would be inequitable to increase their burden further. Strong commitment to this reform, even if implementation does not begin until 2015, could offer immediate benefits in the form of greater confidence in Latvia's fiscal position.

86. The Government could improve retirement income security for households by ensuring the viability of structures designed to help manage risks to pension income, such as the funded pension pillar. The reduction of contributions to the funded pillar from 6 percent to 2 percent between 2009 and 2012 has reduced the fee base for the private pension fund managers. While most of these companies can survive such temporary changes, an extended period of diverted contributions could cause some fund managers to start leaving the market. This could reduce competition in fund management services, and would very likely increase account administration fees. For this reason, it is important for the authorities to adhere to the planned path for restoring contributions to the funded pillar. A more immediate fiscal danger could arise from how any departure from (or delay in) the planed restoration of contributions to the funded pillar would be interpreted by markets. A loss of market confidence could put in jeopardy the hard-won gains that the Government has made in navigating the financial crisis.

87. In a period of constrained fiscal circumstances which are likely to become tighter, when considering state social benefits – the categorical, non-contributory programs administered by the national government - Latvia could achieve more progress in supporting its most vulnerable households by using resources more parsimoniously. The recommendation being made here is for re-distribution rather than reduction of what Latvia is spending on non-contributory benefits. This could be achieved

[20] It is expected that among the cohorts turning 62 in 2012 and 2013, around 70 percent will already be receiving either an old age or disability benefit.

with a wider use of means-testing, particularly of family benefits. New members of the EU such as Poland and the Czech Republic have followed this approach. Older members seeking to use resources for social welfare more optimally, such as the United Kingdom, are seriously considering following their example. Taking the largest state social benefit – the family state benefit - as an example, if eligibility were set at a relatively generous threshold such as the 40 percent of least well-off households about LVL 17.3 m could be saved. This estimate is based on the amount of family state benefits received by households in the 2008 Household Budget Survey. The Government can arrive at a more precise figure by cross checking administrative data on payment of sate social benefits with reported income held at the Ministry of Welfare. It is important to emphasize, that any savings from means-testing the family state benefit would be best used to fortify the targeted programs in Latvia's social welfare system, given how meager these program are relative to the rest of the EU.

88. Furthermore, to improve equity impact of the welfare system, the Government could replace the earnings-related Parental Benefit with an augmented flat Childcare Benefit of LVL 100 paid from State basic budget. The relatively recently created Parental Benefit was shifted into the social insurance special budget in 2008. The Parental Benefit is earnings-related, and paid only to those with a history of contributions to the social insurance. However, when it was introduced, no increase in contribution revenue to the state social insurance budget was made. The benefit is, for all intents and purposes, a *non-contributory* benefit. For this reason, the recent shift of the Parental Benefit spending to the social insurance budget is inappropriate. Furthermore, as with all other "non contributory" benefits, linking the benefit amount with the recipients' earnings, introduces regressive redistribution to people with higher incomes. A flat Childcare Benefit is already granted from the State basic budget for the same social welfare objective. The coexistence of the earnings-related Parental Benefit alongside the flat Childcare Benefit augments inequality, and imposes a high fiscal cost. The progressive flat benefit could be raised to its 2005 level, LVL 100.

89. The remaining suggestions in the social welfare sections of the report are intended primarily to improve the performance of the social welfare system, although they may deliver some fiscal savings at the margin. In the branch of the social welfare system that provides employment assistance, for example, the Government has already initiated steps to increase the relevance and flexibility of its support to job-seekers. The most important is a gradual shift away from direct provision and augmenting the supply of training programs, toward augmenting individual demand with vouchers. This shift is encouraging, as it will not only introduce further market discipline to improve the quality of the training, but also align incentives so that people who need this form of assistance have greater choice and pursue training that is more likely to give them marketable skills and increase their employment opportunities.

90. The highly decentralized nature of social assistance in Latvia – particularly of its main targeted programs for the poorest households - may be unnecessarily impairing performance. The PER motivates a careful policy discussion of the optimal role for local governments in the delivery of social assistance, particularly of programs mandated by the State, such as the GMI and the housing benefit (see Box 1.2). With devolved responsibility from the national government, local governments have a strong incentive to look for savings and to be more efficient. This can, of course, be a force for improving performance. In other parts of the region, however, this incentive has sometimes led to compromised standards and

uneven delivery of entitlements to the poorest households across municipalities of different incomes. From the experience in other countries, the devolution of financial responsibility for social assistance could create strong incentives for sub-national governments to cut back or ration benefits, particularly during economic downturns. This is a concern national authorities should keep in mind while monitoring the performance and standards maintained by local authorities in the current economic contraction.

91. Finally, some of the features of the social welfare system in Latvia could be modernized to deliver much needed performance gains. Firstly, the Government could consider a shift to monetization of the large share of social assistance benefits granted to household in-kind. Curiously, the share of welfare spending on in-kind benefits in Latvia has risen over the past decade while remaining flat in the other EU New Member States and in the Euro area. Secondly, there are likely to be gains from introducing systematic cross checks of administrative information already held by the authorities. Although the Ministry of Welfare has strengthened its capacity to manage administrative data, different categories of cash benefits paid by the social welfare system are administered with separate databases with no regular cross-check for inconsistencies and incompatible benefits. These databases all contain a common unique identifying code (like the social security number in the United States and the national insurance number in the United Kingdom). Although income checks are conducted as part of each beneficiary's application process in the Latvian system, the databases have never been systematically cross checked for inconsistencies and incompatible benefits. A more ambitious approach would be to cross check welfare data with administrative data held by tax authorities, the register of persons, as well as property registries maintained by local and national governments. The benefits of this cross-checking exercise often prove to be substantial even in the best administered systems, and accrue not only in the form of savings to the national budget, but also in political support for and popular confidence in the social welfare system.

Box 1.2: Financing Mandatory Social Assistance: Best Practice Guidance

Experts agree on the advantages of central-government financing social assistance entitlements. Several arguments are presented to support this emerging consensus.

First, from a legal standpoint, the national government is it is the only level of authority that can guarantee that as citizens of a country, every individual will be treated equally and have access to the protection no matter where they happen to live.

Second, to act as an effective "safety net" this guarantee has to function effectively as a citizen's entitlement which implies the need for nationally uniform eligibility criteria, benefit amounts and quality guidelines, all of which determine costs and therefore are best established through nationally representative institutions.

Third, from and economic perspective, the national governments is best positioned to engage in counter-cyclical spending – to redistribute resources from times of economic growth to when the economy is faltering - while in many countries local authorities are forbidden from doing so, or where they are allowed, do so far less effectively.

Fourth, not only can the national government more effectively redistribute spending to counteract the economic cycle, but it is also uniquely placed economically and politically to redistribute resources from prosperous places to poor parts of a country.

Fifth, financing safety net benefits and other welfare entitlements from the national budget allows people to be more mobile, and to move to improve their economic prospects, neither worrying about the entitlements they have to leave behind, nor choosing their destination according to the generosity of benefits.

Sixth, taking into account the nature of risk management, the much larger risk pools offered by financing from the national budget can increase the responsiveness and efficiency of safety nets and other welfare entitlements, significantly reducing administration costs.

Most countries in the EU and OECD are moving toward national financing of at least minimum entitlements. This has been the direction that welfare policy has been taking over a long period of history. Although, social welfare assistance started in many places as the responsibility of local authorities, decentralized financing has been typically put under severe strain by shocks, such as national economic crises. National governments have to move quickly in the wake of a crisis to take up financial responsibility for social welfare when constrained local authorities simply do not have the resource base to do so.

Source: Musgrave, (1959), Oates, (1972), Grosch, et al. (2008)[1]

Matrix 1.2. Options for the Government to Consider in the Social Welfare Sector						
Options for policy action	**Savings 2011 (LVL million)**	**Savings 2012 (LVL million)**	**Background**	**Rationale**	**Risk**	**Longer-Term Benefit**
Social Insurance (State Special Budget for Social Insurance)						
Lower the amount of pension income exempt from taxation to a point between the current level of LVL 165 and LVL 80 per month.	**85** if exempt amount is lowered to 80 LVL. **24** if exempt amount is lowered to LVL 140		The unprecedented growth in revenues until 2007 translated into a rapid growth in wages and consequently of the covered wage bill. This boom was reflected in the notional interest rate applied to pension benefits from the NDC pillar. The cohorts that retired prior to 2010 have benefited from a windfall from the pre-2007 bubble. Between 2005 and 2009 the average pension for new retirees grew 69%.	Given very high pension increases that resulted from fiscally profligate policies during the boom before 2008 (wage indexation, new benefit for pre-1996 contribution years and windfall gains for younger pensioners associated with abnormally high real notional interest rates) it is reasonable to recover some of the recent unsustainable increases . A broader "taxation based" measure may be further justified (over a measure targeting only recent retirees) as the increase in revenue to the state social insurance special budget motivated other "high-cost" pension policies, during the high-growth, such as the indexation of pensions to wage growth. As the Government seeks further savings, the principle of "burden sharing" should apply. Pensions have been relatively unaffected by budget cuts up to now; the adjustment and contraction has been bourn primarily by people	The flat cut in pensions in mid-2009, that was both regressive and penalized working pensioners, makes any measure that reduced pensions risky, particularly in the wake of the Constitutional Court decision of December 21, 2009. However, the recommended measure is different from the 2009 cuts both in form and in substance: • The measure is progressive, affecting lower-income pensioners relatively less. • The measure does not distort work incentives.	Immediate short term gains that will help put the social insurance special budget on long-run financial sustainable path, as well as lead to a more progressive distribution of welfare spending.

Matrix 1.2. Options for the Government to Consider in the Social Welfare Sector						
Options for policy action	**Savings 2011 (LVL million)**	**Savings 2012 (LVL million)**	**Background**	**Rationale**	**Risk**	**Longer-Term Benefit**
				of working age. Pensioner households are also more likely to own their homes and to have fewer current expenditures (on child-rearing, schooling, etc).		
Targeted elimination of the pre-1996 service supplement for pensions above LVL 140 per month	**120**	--	A non-contributory supplement was introduced in 2006 for low income pensioners. This was extended to all pensioners in 2008. The benefit pays LVL 0.7 (70 centimes) for each year of service accrued before 1996 and on average amounts to 14% of the overall pension spending.	Extending the supplement to all pensioners was an unsustainable policy. The Government could save from repealing the expansion of the benefit to all pensioners, and still continue to supplement the pensions of the 10% of retirees with lowest incomes which would place the benefit elimination threshold at or above LVL 140.	Although the extension of the supplement to all pensioners with a work-history prior to 1996 is recent (2008), a sense of "acquired right" may already have solidified among retirees receiving this benefit. As this is a specific "constituency", the group is likely to be more able to organize resistance to the measure.	Immediate short term gains that will help put the social insurance special budget on long-run financial sustainable path, as well as lead to a more progressive distribution of welfare spending.
Fully index pensions to changes in the CPI, both positive and negative.	**31** (Alternatives discussed in the PER would deliver savings only in 2017)	**61** thereon	In 2009 and 2010 pension benefits are "frozen" (i.e., not adjusted). However, in 2011, benefits will be indexed to the CPI. The current law indicates that pensions should be indexed to prices but cannot be reduced in nominal terms. The savings shown here assume automatic indexation to the CPI whether positive or negative and would require	Alternatives exists for savings without changes in the law, however, these alternatives would only deliver savings when the deflationary period ends. Under a lenient interpretation the indexation law, adjustment could be 0 in times of deflation and positive when CPI is positive. Under the more stringent interpretation the downward adjustment of the pension is not allowed but upward adjustment only starts when the	There is political risk of the measure being reversed when positive inflation returns as well as a risk of prolonged deflation which would not allow recovery of resources accumulated deflation for a long time.	Combined with other measures, CPI indexing pensions will help put the state social insurance budget on a long term financially sustainable path.

Matrix 1.2. Options for the Government to Consider in the Social Welfare Sector						
Options for policy action	**Savings 2011 (LVL million)**	**Savings 2012 (LVL million)**	**Background**	**Rationale**	**Risk**	**Longer-Term Benefit**
			additional legislative action.	purchasing power of the pension starts to fall behind its original purchasing power. Whether the more stringent application of the current law is possible would have to be investigated further.		
Application of true "G values", without any change in the current law	**2**	**4** [6 million in 2013]	At the point of retiring, an affiliated workers accumulated "notional capital" is divided by an estimate of life-expectancy. In the NDC formula, the life expectancy parameter is referred to as the "G value".	New retirees are expected to be hit by negative notional interest in 2010 and 2011 of -4% and -10% respectively. This is why this year regular increase in G values amounting to 2% decrease in pensions was not applied. This is being done at the discretion of the authorities, and is not reflecting the automatic application of the NDC parameters as intended.	Application of the G values will lower benefits awarded in 2010 and 2011.	For long term financial sustainability, the automatic parameters of the NDC formula should be allowed to function.
Retirement age increase starting in January 2015	--	-- (Savings in the medium term expected.)	The early retirement option is expiring in 2011 – which given extremely high "pre-retirement rates" through early retirement and disability programs, would translate into very few old age benefit applications in 2012-2013.	Among the cohorts turning 62 in 2012 and 2013, around 70% will already be receiving old age or disability benefits. This defeats the purpose of trying to increase retirement ages before 2014. Furthermore, the cohort turning 62 in 2014 will already experience a significant increase in the	It is frequently argued that raising the retirement age, particularly in a recessionary period (or when the labor market is very slack) exposes older workers to greater risk of unemployment. However, this concern seems misplaced. Workers with retirement	An increase in the statutory and effective retirement ages is essential to the long-run financial sustainability of the system, and help raise replacement rates, as, all else equal, affiliates' notional capital will be larger and is spread over fewer years in retirement.

Matrix 1.2. Options for the Government to Consider in the Social Welfare Sector						
Options for policy action	**Savings 2011 (LVL million)**	**Savings 2012 (LVL million)**	**Background**	**Rationale**	**Risk**	**Longer-Term Benefit**
			An increase in the retirement age earlier than January 2015 will probably precipitate a faster "rush to retire" that could destabilize the state social insurance budget.	effective retirement age (70% of previous cohort retired early, while this cohort will have to wait until 62), so it is not equitable to increase their burden further. Thus, the most logical time to start increasing retirement age is 2015. The MoW presents a proposal to begin this increase in 2016, based on expected unemployment until then and a desire for parity with increases in the retirement age in Estonia.	coverage who would be affected by an increase in the retirement age, are also more likely to have coverage of Unemployment Insurance, as well as relatively greater job security (than younger cohorts). In the current contraction, younger workers have suffered unemployment at relatively higher rates than older workers.	
Replace the earnings-related parental benefit with an augmented flat Childcare benefit of LVL 100 (paid from State basic budget: see social assistance section of this matrix)	-- The law requires 306 day transition period from the date of passage of any measure that changes benefits related to child bearing.	**65** (Assumes Childcare state social benefit is raised to LVL 100)	New parental benefit was shifted into the social insurance special budget in 2008. The parental benefit is earnings-related, and paid to those with a history of contributions. However, when it was introduced, no increase in contribution revenue to the state social insurance budget was made. The benefit is, for all intents and purposes, a *non-contributory* benefit, reflecting the fiscal profligacy of the boom period.	Given that no additional social insurance contributions were levied in 2008, the recent shift of the parental benefit spending to the social insurance budget is inappropriate. Furthermore, as with all other "non contributory" benefits, it should not be linked with the recipients earnings, which otherwise introduces regressive redistribution to people with higher incomes. A flat Childcare benefit is already granted from the State basic budget for the same social welfare objective. As part of this measure,	Arguments have been presented that this measure will deter higher-income households from having children. However, it is not clear from international evidence that social welfare benefits are successful in inducing families to have children. Nor is it clear why the State should subsidize childbearing of wealthier households at a relatively more generous rate than it does to poorer households that are not covered by the state social insurance special	Immediate short term gains that will help put the social insurance special budget on long-run financial sustainable path. Eliminates duplication of benefits, and leads to a more progressive distribution of social welfare spending.

Matrix 1.2. Options for the Government to Consider in the Social Welfare Sector						
Options for policy action	**Savings 2011 (LVL million)**	**Savings 2012 (LVL million)**	**Background**	**Rationale**	**Risk**	**Longer-Term Benefit**
				the flat benefit could be raised to its 2005 level, LVL 100.	budget.	
Increase flexibility of maternity benefit, allowing expecting mothers to decide to postpone the commencement of the 4 month benefit period by a few weeks or even up to the time of birth.	**2** [21]	**2**	Contributory earnings related maternity benefits are paid for the duration of 4 months starting with the 7th month of pregnancy with average benefit of LVL 1,234. Subsequently, an earnings-related parental benefit (discussed above) is paid for those covered by social insurance.	The Government could consider introducing greater flexibility to the maternity benefit. Rather than requiring women to exit the labor force at 7 months of pregnancy, a woman could be allowed to decide to postpone the commencement of the 4 month benefit period by a few weeks or even up to the time of birth. International practice suggests that many women would prefer this flexibility and choose to remain active, although individual decisions would depend on doctor's opinion, the type of employment, and particular economic circumstances of the family.	--	The current structure of the maternal benefit could be made more flexible to offer additional choices, and produce savings for the Government in the first year of implementation by adding additional taxpayers which would increase social insurance and general tax revenues.
State Social Benefits						
Target Family State Benefits (FSB) to poorer households with children. The	-- Not clear if the	-- Given how	Family state benefits constitute about 37 percent of state social	FSBs have a small impact on non-poor households and are more symbolic	Some political resistance is to be expected. However, anecdote	A stronger, more robust and responsive safety net for the poorest

[21] This estimate is based on a conservative assumption that women will decide to shift the date of benefit commencement by an average of 2 weeks. Under that scenario, the savings for the social insurance budget in the first year of implementation would amount to LVL 1.4 million. In addition, increasing the flexibility of the maternal benefit would add additional taxpayers which would increase social insurance and general tax revenues, adding another 0.6million in combined revenue raising total savings to LVL 2 million.

Matrix 1.2. Options for the Government to Consider in the Social Welfare Sector						
Options for policy action	**Savings 2011 (LVL million)**	**Savings 2012 (LVL million)**	**Background**	**Rationale**	**Risk**	**Longer-Term Benefit**
Government could achieve a higher social return from its social welfare spending, by reducing coverage of FSB for non-poor households, but maintain assistance for poor households. Means-testing all state social benefits (i.e., those financed from the national basic budget for the Welfare sector) would be advisable – with the exception of benefits related to disability. FSB could be the best benefit to start with, given its currently wide coverage; large volume (and thus potential savings); and that the public is "sensitized" to reform of this benefit (earlier public discussion of possible reform).	306-day fair notice requirement which applies to benefits related to child birth, is relevant – this requires consultation with legal counsel.)	little Latvia spends on social assistance, any, and all potential savings from restricting FSB– which 17.3 million[22] – should be re-distributed to strengthen targeted social assistance programs.	benefits. FSBs are monthly payments of LVL 8 to all families with a child between the ages of 1 up to 18 years of age.	than welfare enhancing. For example, households in quintiles 4 and 5 spent about 2,300 and 4,200 LVL per person per year in 2008 and hence the added 72 LVL per child per year has little impact on household welfare. In quintile 3, whose yearly per capita household consumption is almost LVL 2,000. However, the fiscal implications of the program are significant.	suggests a many households in the wealthier segments of society do not bother to collect the FSB they are entitled to.	households, particularly those with children. Keeping family benefits universal is a social choice with explicit fiscal implications. The current transfer amount has a minimal impact on non-poor households The government needs to weigh the benefits of universality, with the fiscal implications of providing a benefit to households whose welfare is hardly improved by the transfer.
Restore Childcare Benefit to a flat amount of LVL 100 (see above recommendation on Parental Benefit)	--	-- (see Parental Benefit segment on State Social Insurance)	Currently the coexistence of the earnings-related Parental Benefit alongside the flat Childcare Benefit augments household income and welfare	The Parental Benefit is essentially non-contributory. Once it is transferred to the State basic budget, it is inequitable and unjust to maintain an earnings-related benefit in parallel	No anticipated risks of raising Child benefit, if Parental Benefit is eliminated. Political resistance to be anticipated from households covered by social insurance, as the	Reverting to a single, flat Childcare benefit will lead considerable fiscal savings, and a more progressive distribution of social welfare spending.

[22] This estimate is made by estimating the amount of FSB being received by 60 percent wealthiest households (consumptions quintiles 3-5) in the 2008 HBS. The SILC survey may provide a more accurate estimate of the benefits received by households. However, any survey is only a reported "reflection" of what is actually being paid. The Government can arrive at a far more precise figure by cross checking administrative data on payment of FSB with reported income held at the Ministry of Welfare, or even at the State Revenue Service.

Matrix 1.2. Options for the Government to Consider in the Social Welfare Sector						
Options for policy action	**Savings 2011 (LVL million)**	**Savings 2012 (LVL million)**	**Background**	**Rationale**	**Risk**	**Longer-Term Benefit**
			inequality, and imposes a high fiscal cost.	to a flat benefit that have the same social welfare objective.	earnings related Parental Benefit is considerably higher than the flat Child benefit, even with an increase to 100 LVL.	
Municipal Social Assistance						
Increase co-financing of GMI and Housing benefit: Keeping the amounts of mandatory targeted assistance benefits constant, increase co-financing share from State budget for GMI and Housing benefit to 75%.	--	-- [14 million increase, based on anticipated spending in 2010, financed from targeting FSB, as above]	GMI and Housing benefits are increasing in importance as safety-net instruments, and appear to be reasonably well targeted to the lowest income groups. However, there are still improvements in targeting accuracy that could be achieved. The mismatch between a national mandate and local financing causes perverse incentives at the local level, and disparities in provision of these mandatory benefits across wealthy and poor municipalities. For this reason few EU and OECD countries retain decentralized financing of mandatory targeted benefits.	The co-financing introduced in the ESSNS (50% of spending on GMI and 20% of spending on housing benefit) helps mitigate the problem of perverse incentives, particularly in the face of higher demand for benefits from the crisis. Savings from targeting Family State Benefits to households in quintiles 1 and 2 (as above) could be used to increase the share of co-financing of mandatory benefits from the State budget, and still leave room for overall fiscal savings. As the Latvian Welfare system does not yet have the information management tools to monitor targeting performance of municipalities, less-than-full State financing may still be appropriate.	The budget "reprieve" on municipalities from greater financing of mandatory benefits from national budget, could also lead to perverse outcomes: (i) moral hazard (municipalities awarding GMI and housing benefit with less care for means testing); (ii) diverting social assistance spending to benefits that don't benefit the poorest households. These risks can be mitigated by instituting more rigorous monitoring of municipal compliance with GMI and housing benefit mandates; targeting; and quality requirements (something that the MoW is planning to do anyway).	Raising co-financing and eventually recentralizing financing for mandatory targeted benefits from the State budget, will ensure a robust, uniform safety net for the lowest-income, needy households wherever they happen to live.

Matrix 1.2. Options for the Government to Consider in the Social Welfare Sector						
Options for policy action	**Savings 2011 (LVL million)**	**Savings 2012 (LVL million)**	**Background**	**Rationale**	**Risk**	**Longer-Term Benefit**
Employment Assistance						
Shift training to a demand-based model. The Government could continue its shift away from the current supply-driven system of job retraining for the unemployed, toward a more demand-driven process by expanding voucher use by program participants.	-- Efficiency gains at the margin.	-- Efficiency gains at the margin.	There are three main inefficiencies of the current training program: (i) Administrative requirements on the State Employment Agency (SEA) to procure training services is high; (ii) Failure to give freedom to participants to choose their training courses can lead to sub-optimal personal choices; (iii) Competition among training providers is stifled because firms have no incentive to improve performance after they become accredited.	Vouchers devolve to the individual the choice of training programs and location of training, and create an incentive for beneficiaries to choose the type of training that best prepares them for productive employment. It allows participants to choose the training discipline, the firm to provide the training, the location of the training institution, etc. Minimal restrictions can be placed, such as: (i) requiring participants to choose from a positive (and regularly updated) list of licensed (by MoES) training providers; (ii) requiring minimal educational qualifications for certain training opportunities. However, the strength of vouchers is flexibility and hence, restrictions on participants should be minimized.	Lack of competition between providers, and lack of information among voucher recipients can reduce the benefits of this shift. This risk can be mitigated by measures to improve competitions among providers and information of those seeking training.	Vouchers will have several benefits over the status quo: (i) Administrative requirements stemming from procurement of training services for each course by the SEA can be greatly simplified. (ii) Market forces could weed out low quality licensed training providers through low demand for their services. This is important because under the current regulations, the SEA is not able exclude low quality training providers who have been licensed by MoES even if additional quality criteria are set during the procurement process. (iii) Greater competition among training providers could be fostered if the SEA publishes evaluation results of all training providers. This publication can also give potential participants the information base needed to make career choices.
Allow vouchers to be used for	--	--	MoES managed	It is not cost-effective for	--	Besides reducing unused

Matrix 1.2. Options for the Government to Consider in the Social Welfare Sector						
Options for policy action	**Savings 2011 (LVL million)**	**Savings 2012 (LVL million)**	**Background**	**Rationale**	**Risk**	**Longer-Term Benefit**
all training options. Training vouchers should also be usable in special, short-duration retraining programs offered by existing secondary vocational schools, including those managed by MoES.	Efficiency gains at the margin	Efficiency gains at the margin	vocational training institutes do not participate in the request for proposals from PESs. The main reason is that MoES providers are not able to perform the required quarterly financial planning forecasts.	the Government to finance new, tailored programs for the unemployed when there is significant unused capacity in some existing state-financed programs in secondary vocational education and higher education programs that are explicitly or implicitly ignored. Although the recent financing reforms reduced excess capacity, considerable excess capacity remains.		capacity in MoES managed vocational training institutions, including these institutions will lead to increased competition among service providers and hence increase training quality and relevance.
Eventually reduce stipends paid to training recipients. Although appropriate during the current contraction, government should consider reducing the stipend paid to training participants to reduce take up by those who want a safety net rather than a human capital investment.	-- Efficiency gains and budget savings	-- Efficiency gains and budget savings	Income support provided to those who participate in training programs may lead people to request the program for the financial rather than the human capital accumulation motive.	Lowering the stipend could ensure that training program participants are motivated by human capital accumulation objectives rather than the safety net objective of training programs. The Government might consider providing more than 1 stipend level to program participants when participants have to travel to receive training.	Withdrawing stipends too soon (before the labor market starts to recover) could increase the number of needy job-seekers waiting for limited WWS workplaces.	Lowering the stipend amount will lead to a reduction in the waiting list for training programs and will lead to more take up of training programs by people interested in the courses rather than people taking the course with the least transaction costs associated with the LVL 70 stipend.
Maintain Workplace With Stipends (WWS) until labor market recovers. The Government could begin preparations for a phased	--	--	The WWS program formed a crucial part of the emergency social safety net to mitigate the impact of the crisis	If labor market conditions begin to improve in mid-2011 as forecasted, it would be reasonable to begin withdrawing the	Withdrawing the WWS too soon (before the labor market starts to recover) will increase the number of people seeking	Phasing out the WWS program will be important to minimize economic distortions and increase the potential for private

Matrix 1.2. Options for the Government to Consider in the Social Welfare Sector						
Options for policy action	**Savings 2011 (LVL million)**	**Savings 2012 (LVL million)**	**Background**	**Rationale**	**Risk**	**Longer-Term Benefit**
withdrawal of the WWS program when labor market conditions improve.			on households. The design features of the program meet best-practice conditions for public works programs around the world. The program was rolled out in record time and targeted individuals who do not receive unemployment insurance benefits. In 2009, LVL 8 million were allocated to the WWS program. Continuing soaring unemployment numbers have forced the government to allocate LVL 26.7 m to the WWS program in 2010.	WWS program in the third quarter of 2011. A credible exit strategy for the government can be through stipend reduction (to around LVL 80 per person per month for full time participants). This move will reduce the relative attractiveness of the program for unemployed people who would be faced with the option of choosing the program with the reduced stipend or intensifying their job search.	GMI and other forms of minimal social assistance.	sector led growth. In addition, the expected reallocation of ESF money away from WWS into longer-term priorities will result in fiscal pressures that might be avoided by minimizing the size of the WWS program.
Restrict entry of early retirees in Workplace With Stipends (WWS). The Government could exclude early retirees who are receiving a pension from the WWS program.	--	--	The program currently rewards early retirees, who receive a pension, by providing them with a supplementary income. However, the intension of the program was to give people a "last resort" safety net, not a supplementary income.	Early retirees have made a choice to retire and should not have access (and thereby crowd out people with no safety net) to the WWS program. Given the length of the waiting list for the program, this move will help redirect resources to more deserving participants.		In addition to the benefits of reallocating resources away from people who are already receiving pension to people with no safety net, eliminating eligibility of early retirees will help reduce the incidence of early retirement.

VII. Education

92. In the years prior to the economic crisis, budget expenditures for education programs grew rapidly. A spending review conducted by the World Bank in 2007 concluded that there was overstaffing in Latvia's schools, and recommended a number of fundamental reforms to help contain budget expenditures and improve the efficiency of education provision. The review suggested that the Government create the *means* for improved efficiency in school management, by relaxing central norms on class size and by allowing school directors and local education authorities more flexibility in managing education resources. Further, the review suggested the Government could create the *incentive* for improved efficiency (and improved quality) by revising the basis of budget financing of primary and general secondary education to finance outputs (students) rather than inputs (teachers and schools). Finally, the review suggested the Government could – through the adoption of similar reforms (per-student financing and flexible management) – improve efficiency and responsiveness of vocational secondary education and higher education to changing skill needs in the labor market.

93. The crisis and ensuing economic contraction in 2009 created a fiscal imperative to reduce budget costs in the education sector. Responding to this imperative, the Government moved decisively to implement the key measures that had been recommended in the 2007 review. A plan for per-student financing of primary and general secondary schools was developed in 2008 and early 2009, and put into effect at the start of the 2009-2010 school year. Implementation of per-student financing is being managed by the 118 new units of local government that were established in July 2009.[23]

94. The reductions of the MOES budget in 2009 and 2010 occurred in stages. The 2009 total plan budget for the Ministry was 25 percent lower than the prior year's amended budget. This budget was itself amended later in the year to a level 40 percent below the amended 2008 budget. The 2010 plan budget made further reductions, bringing the total MOES basic budget to a level 45 percent below the amended 2008 MOES basic total. Some education subsectors experienced even greater reductions – particularly in higher education, where the amended 2009 budget was 58 percent below the amended 2008 budget, and the 2010 budget fell even further to just one-third of the amended 2008 budget. The contraction of government expenditures for education in 2009 further lowered the share of education spending in total government expenditure in Latvia by comparison to other countries: Government spending on education as a percentage of total government spending was 10.2 percent in 2009, versus a mean of 12.2 percent for the EU-19 for the most recently available year and 13.3 percent for the OECD.

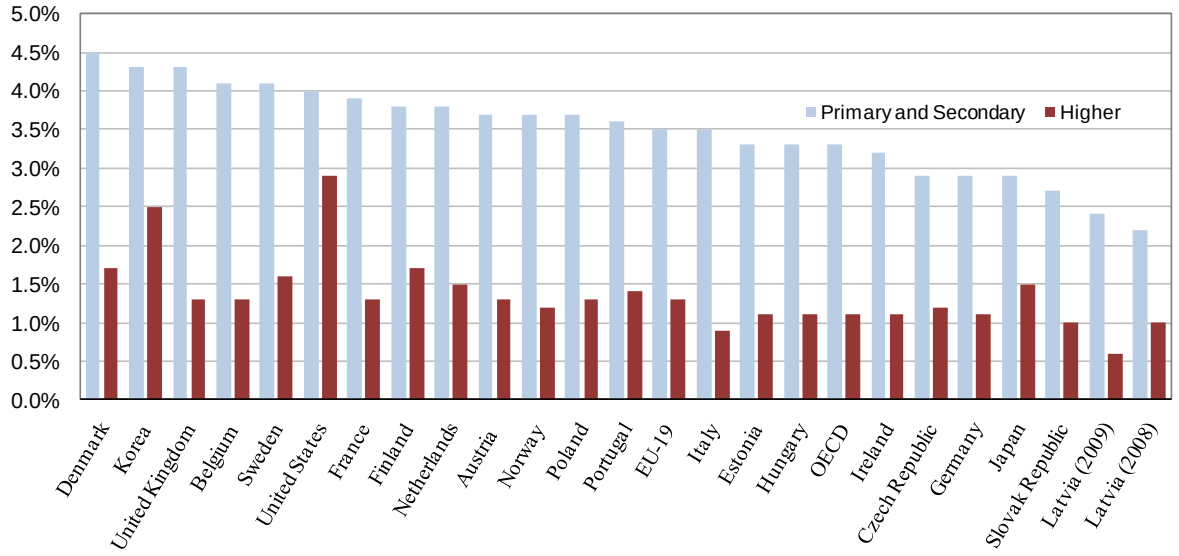
95. These are major accomplishments achieved in a remarkably short period of time, and under the most difficult economic, fiscal and political circumstances imaginable. Yet by guiding budget consolidation with structural reforms, the authorities have already improved efficiency in the management of education resources. As the structural reforms unfold, they will yield further efficiency gains in the medium and long term.

96. In light of the progress in implementing structural reforms to the education system, and the enormous fiscal adjustment these achieved, the PER concludes that there are very limited options for further immediate budget savings. Continued budget financing is a logical necessity for compulsory

[23] Local government under the administrative reorganization of July 1, 2009 comprises 9 republican cities and 109 municipalities (*novads*).

education at the preschool and basic education levels. Further budget savings in primary and general secondary education are possible, but these can come *only gradually* as local authorities become more adept at applying the new financing measures in primary and general secondary education and as they eventually take over responsibility for managing secondary vocational schools.

Figure 1.14: Government Expenditure on Primary-Secondary and Higher Education, as a Percentage of GDP, Latvia and Comparator Countries



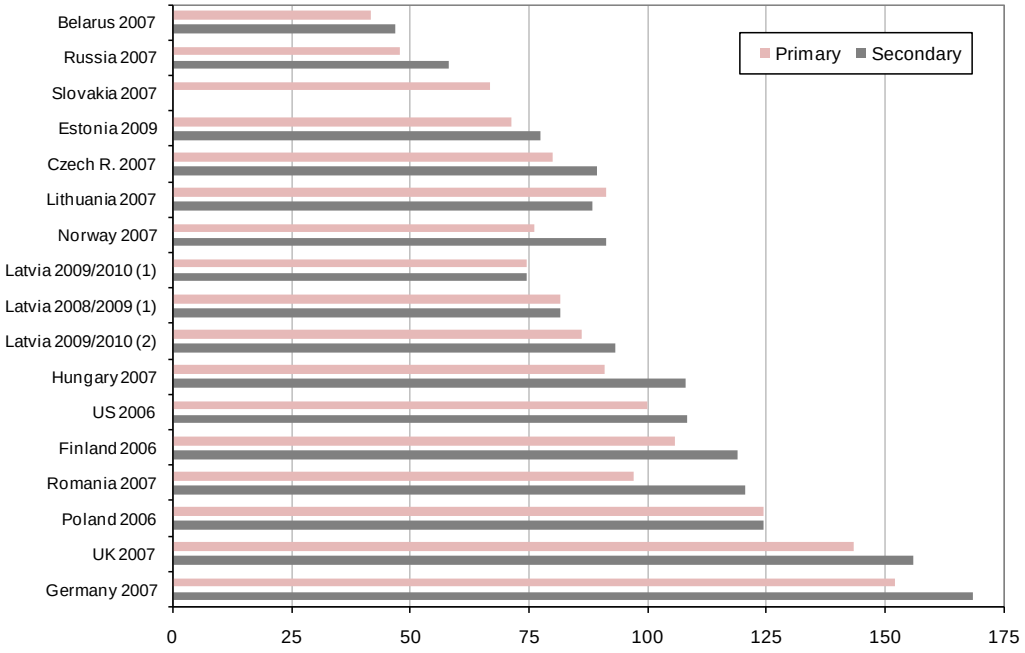
Note: Secondary education figures include secondary vocational education. Reference years for Latvia as shown; for comparator countries, 2006.
Source: Latvia figures from Table 5.7, above. Figures for other countries from Table B2.3 *Education at a Glance, 2009,* OECD.

97. However, there are some further reforms that would help full implementation of the structural reforms initiated in 2009, and in doing so, deliver minor but significant budget savings in 2011 and 2012. The Government could continue further its progress in implementing the new financing model by providing more guidance to municipal authorities and to school administrators on options for application of per-student financing, based on the lessons of implementation during the first year of the new financing scheme. Many novads still are not aware of all the options available to them to achieve better efficiency – such as transporting teachers (rather than students) between schools. With more guidance from MOES (and knowledge-sharing between municipalities organized by the Ministry) local authorities are likely to be able to exploit more fully the flexibility availability under per-student financing.

98. The per-capita formula itself is coming under the scrutiny of academic specialists and experts interested in seeing further efficiency improvements. Even after just one year of implementation, already the data are available for researchers to evaluate the impact of the structural reform of education financing, to identify problems and simulate changes to the parameters of the formula. This is a welcome development. As in other upper middle- and high-income countries with plenty of local expertise, the Government of Latvia could benefit from encouraging a continuous transparent discussion of how the formula can be improved.

99. To support the further implementation of the new per-capita financing model, it is important to underscore that although low teacher salaries have been a threat to education quality in the past, teacher earnings are now at a level that is generally comparable to earnings in other sectors of public service, although this important balance needs to be closely monitored. Historically, teachers in Latvia have earned less than workers with equivalent qualifications in other occupations, raising concerns for the quality of teachers that can be retained at relatively low earnings. The gap between reported average earnings in the education sector and comparator sectors narrowed in 2009, reflecting the combined effect of salary increases adopted in 2008 and the first of the salary reductions initiated in 2009. As a consequence of the major reduction in the earmarked transfer for primary and general secondary education, there were cuts in all components of teachers' earnings during the last half of the 2008/2009 school year and the beginning of the 2009/2010 school year. Out of concern that the speed and depth of these cuts could further threaten the quality of teachers, in January, 2010, central budget transfers to local governments for teacher salaries were increased by 37 percent, with no additional teaching requirement. This increase was intended to finance the restoration of payments to teachers for teaching-related tasks such as class preparation and follow-up and correction of exams. As of February, 2010, average monthly earnings of employees of state budget institutions were LVL 500 and falling, whereas in April, 2010 average monthly earnings of teachers were LVL 476 and rising.

Figure 1.15: Annual average gross teacher earnings in public schools, per cent of GDP per capita), by level of education, in Latvia, selected countries



Notes: Entries 'Latvia 2008/2009 (1)' and 'Latvia 2009/2010 (1)' refer to all classroom teachers, while 'Latvia 2009/2010, (2)' and other countries' data refer only to teachers with full-time workload.
Source: Prepared by Professor Mihails Hazans, Consultant to World Bank team. Calculated with teacher earnings data (Latvia – administrative data; Estonia – LFS data, other countries - ILO LABORSTA data), GDP (in national currency, current prices) and population data of Statistics Latvia, Statistics Estonia and UNESCO Institute of Statistics.

100. In order to preserve a positive incentive to enter the teaching profession, the Government could maintain the January, 2010 salary increase for primary and general secondary education. This would help maintain the recently attained balance in earnings between teachers in primary and general secondary schools and people with similar qualifications who are working in other sectors. The Government would have to closely monitor teacher earnings to maintain general equivalence with other professionals working in the public sector, which is a task made very difficult by the antiquated "piece work" model of teacher remuneration still in place. If further salary increases for teachers in the immediate future are being considered, moderating these increases to maintain this earnings comparability across sectors could yield significant savings.

101. Eventually, MOES could move toward a more modern, full-time concept of remuneration in the teaching profession based on learning outcomes rather than time inputs for specific tasks. In such a model teaching responsibilities would be defined to include a broad array of teaching-related tasks that support student learning, including lesson preparation and follow up, correction of exams, collegial support, and meeting with students and parents. This approach would be more consistent with the output-oriented financing reforms, and would provide more explicit incentives for teachers to focus on learning outcomes. Adoption of a new, full-time concept of the teaching profession based on learning outcomes will require preparation of the methodology and further strengthening of assessment instruments. It would be easier to apply this concept once the economic recovery has allowed the restoration of more adequate financing for base salaries and other school inputs for effective teaching and learning.

102. Turning to a large area of education spending, the cost-effectiveness of special needs education could be scrutinized, in order to take advantage of beneficial opportunities for "mainstreaming" students with special needs. An expenditure item in the MOES budget which appears particularly large in relation to other programs is the earmarked transfer to local governments "for educational activities." This allocation – amounting to LVL 48.6 million in the 2010 plan budget, larger than the entire budget for higher education– is provided for the support of the special education institutions which are managed by local governments for special-needs students. Preliminary evidence suggests that some local authorities are claiming "special needs" financing when it is actually not warranted. However, it is possible that other approaches to education provision for some of these special-needs students – including mainstreaming in general education schools- could lead to more cost-effective education provision. In cases of severe disability, which is not the comparative advantage of the Ministry of Education, the Government could consider transferring principal financing and management responsibility to the Welfare sector. For students with lesser disabilities, the Government could consider financing under a more comprehensive, per-student financing approach which provides an incentive for local governments to seek more efficient models for educating special-needs students, including moving students to mainstream schools where feasible. Mainstreaming special-needs students whose conditions are mild and whose needs can be met in mainstream schools can improve their opportunities, as well as sensitize other students to the challenges faced by students with learning disabilities.

103. Beyond primary and general secondary, the network of vocational secondary schools is being substantially upgraded in quality and capacity with resources from the EU's European Social Fund so it

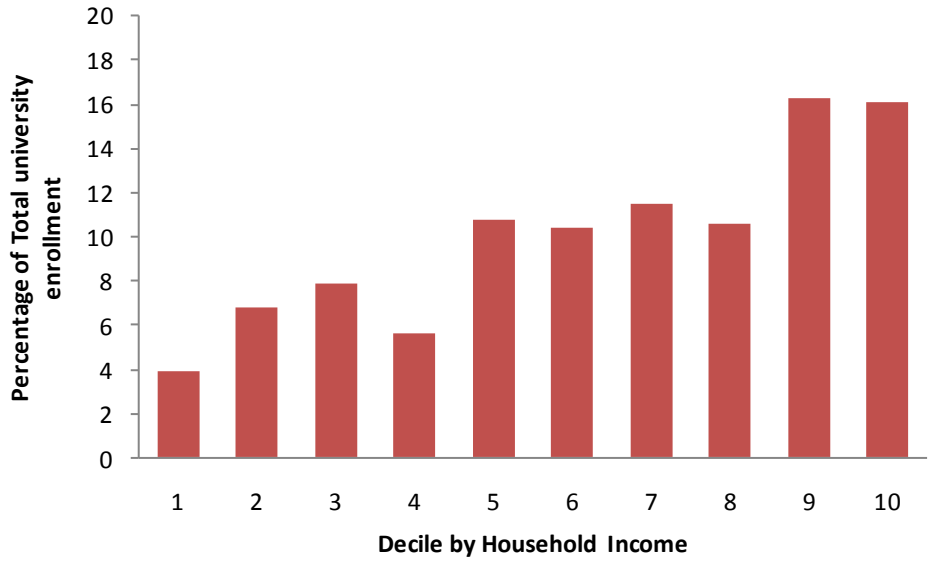
can play a part in meeting the future skills needs of Latvia's economy. There is a legitimate question about the appropriate scale of vocational education (in terms of percentage of secondary students enrolled in vocational programs). Streaming students into vocational education at early ages could risk locking them into lower-lifelong earnings, and close off other opportunities. This risk could be mitigated by ensuring a "level playing field" between vocational and general secondary, and keeping opportunities open for movement from one stream to the other. To the extent that vocational education is justified by skill needs in the labor market, it should be funded adequately to provide high-quality and relevant skill training.

104. Yet there are legacies from the old model of vocational education that could limit the contribution of vocational training, and could be consigned to the past. To prepare for the eventual transfer of vocational schools to local authorities, the Government could eliminate remaining differences in the treatment of students from households who choose vocational schools and those that choose general secondary education for their children. The Government could consider financing vocational education places more adequately as vocational schools are upgraded and transferred to local government management. Per-student expenditures on vocational secondary education in Latvia are below international comparators with high-quality vocational education programs. More adequate recurrent financing of the upgraded vocational schools would help exploit the important potential benefits of this investment.

105. Part of ensuring a level playing field between vocational and general secondary education is ensuring equal treatment under the state social benefit system, and the elimination of stipends and scholarships that may unduly influence how households – particularly low income households - decide to invest in the human capital of their children. In the same spirit, vocational schools could be given a fair opportunity to compete for contracts to provide training and retraining services to unemployed people participating in Latvia's programs of employment assistance.

106. As with other parts of the education sector, there are very few opportunities for further immediate budget savings in higher education. Latvia allocates a very small portion of total education spending to universities compared to its neighbors and OECD countries. The network of university institutions suffered sharp cuts in 2009, to which it needs to adjust if the reported deterioration of conditions and the quality of instructions is to be reversed. To counter this decline, the Government's medium term objective could be to increase private financing of higher education. As currently used, budget financing of higher education is inequitable because it disproportionately benefits students from higher-income families. Figure ## shows that in 2007, 65 percent of students enrolled in university came from the wealthiest 50 percent of households. As currently structured, budget-financed places are rationed solely on the basis of student performance. Half of full-time students pay full cost-recovery fees, which vary by specialization. The other half of students pay no fees as their places are financed by the budget.

Figure 1.16: Distribution of Total University Student Enrollment, by Household Income Decile, 2007



Source: Staff estimates, using Latvia SILC 2007

107. Yet many prospective entrants to university can and would pay for a degree. The individual returns to and investment in higher education in Latvia are among the highest in the EU. Budget financing of higher education, with no regard for household means, is *inefficient* because it contaminates students' choices about how much higher education to seek. In contrast, fee financing encourages efficient and disciplined decisions about higher education, such that students will pursue a degree only to the extent that it increases expected future earnings more than it costs.

108. In the immediate term, given how little of total budget financing to the education sector is directed to higher education relative to EU and OECD countries, progress toward meeting this objective will need to be slow. The Government could gradually replace budget financing with fee financing, without having to worry too much about equity of access, since student loans to meet tuition and living expenses are available to all students in Latvia. Greater reliance on fee financing would improve equity and fiscal sustainability of higher education, and promote quality by encouraging competition based upon relevance to changing skill needs in the labor market as reflected by changing patterns of earnings.

109. There is, however, an important social role for the state in supporting the aspirations of high-achieving students from low income households who genuinely cannot afford or cannot receive loans to finance university. But this role implies a far more parsimonious use of state-budget support than has been observed in Latvia. A short term option to consider is to reduce the number of budget-financed student places, financing these at a more adequate level, and prioritizing them for the poorest applicants (including those interested in a part-time course that would allow them to retain employment during their study), while keeping the total "envelope" of public financing for higher-education constant in the next two years.

110. The PER makes a similar argument for gradually suspending stipends for students in higher education. Currently, 3,379 higher education students receive stipends of LVL 70 per month. These were formerly granted to reward high performance. To make them more equitable, targeting criteria

were introduced in 2009, and slightly over half of scholarships are now awarded on the basis of need as well as performance. Student stipends can be *inefficient* because high performance reaps its own lifelong rewards through higher earnings and professional mobility. Indeed, the returns to higher education in Latvia are among the highest in the EU. Although improved since 2009 with the introduction of some means testing, student stipends remain *inequitable* because they are only awarded to budget-financed students, who tend to be from higher-income families.

111. For more immediate savings to the state budget, the Government could also consider suspending interest subsidies for student loans. The Government currently pays accrued interest on student loans during the duration of studies and for one year after completion of a degree. The Government also guarantees repayment and pays any excess of borrowing costs above 5 percent. This arrangement is unnecessarily generous to students and entails serious contingent liabilities. Due to falling interest rates, interest payments on student loans in 2010 are likely to be about LVL 1.6 million below the amount the Government has budgeted for this subsidy. As is the case with budget support and stipends, interest subsidies on student loans contaminate students' choices about how much higher education to seek. The current practice under which the Government negotiates interest margins and guarantees repayment (in addition to individual guarantees) offers attractive borrowing costs to students. Actual interest rate subsidies beyond this are unnecessary and potentially costly, introducing unnecessary uncertainty about the potential future costs of this policy.

112. Finally, the PER suggests that the Government could move far more aggressively to competitive financing of science and research by reducing budget shifting budget support to a the more competitive, international peer-reviewed allocation structure, in which public and private universities, as well as public research institutes, can participate. The largest element of budget financing for science and research (amounting to slightly over LVL 7 million) finances inputs in the form of salaries and facilities for state science and research institutions. More competitive financing would encourage higher productivity, greater relevance and fuller participation by universities.

Matrix 1.3 Options for the Government to Consider in the Education Sector						
Options for policy action	**Savings 2011 (LVL million)**	**Savings 2012 (LVL million)**	**Background**	**Rationale**	**Risk**	**Longer-Term Benefit**
Education, Preschool, Primary and General Secondary						
Maintain budget financing preschool for 5 and 6 year old children in preschool education.	--	--	Budget financing for 5 and 6 year old children in preschool education was restored under the World Bank Special Development Policy Loan.	Budget financing of preschool education is consistent with the compulsory nature of preschool education and the demonstrated benefits for subsequent school performance.	--	--
Maintain salaries of general primary and secondary teachers. Maintain January, 2010 salary increase for primary and general secondary education.	--	--	The January, 2010 salary increase brought average teacher earnings (including overtime) to parity with employees of state budget institutions.	Maintaining teacher salaries at a comparable level with employees of state budget institutions will help attract and retain competent teachers.	Reversion to former low salaries for teachers would endanger education quality by encouraging departure of the most competent teachers.	--
Maintain implementation of "funds follow the student" financing model --Exploit more fully the flexibility availability under per-student financing: --MOES to provide more guidance to novads and schools on options for application of per-student financing --Move towards full-time concept of teachers' profession, based on learning outcomes rather than time inputs.	--	--	Many novads are not yet getting the full potential benefit of per-student financing – in terms of either efficiency or quality.	Many novads still do not understand the options available to them to achieve better efficiency – such as transporting teachers (rather than students) between schools. The determination of teachers' earnings under per-student financing is still based on the old, *input-based* approach of hours spent on reimbursable tasks, rather than on what their students are learning.	--	Adoption of a new, *full-time concept* of the teaching profession, based on learning results, would require preparation of the methodology and further strengthening of assessment instruments. It would be easier to apply this concept once the economic recovery has allowed the restoration of more adequate financing for teacher salaries and other school inputs for effective teaching and learning.

Matrix 1.3 Options for the Government to Consider in the Education Sector						
Options for policy action	**Savings 2011 (LVL million)**	**Savings 2012 (LVL million)**	**Background**	**Rationale**	**Risk**	**Longer-Term Benefit**
Review cost-effectiveness of budget for special education.[24] In cases of severe disability, transfer principal financing and management responsibility to the Welfare sector. For students with lesser disabilities, consider financing under a more comprehensive, per-student financing approach which provides an incentive for local governments to seek more efficient models for educating special-needs students, including transferring students, where appropriate, to mainstream schools.	--	--	Central financing of each institution provides no incentive for local governments to seek more efficient service delivery models.	The approach of sequestering special-needs students in separate institutions is inconsistent with the global trend towards mainstreaming special-needs students. Many students in special needs facilities could function well in mainstream schools, to their benefit, as well as that of classmates.	Care needs to be taken to preserve special education facilities for those students with severe conditions.	Mainstreaming special needs students whose conditions are mild and whose needs can be met in mainstream schools, can improve their opportunities, as well as sensitize other students to the challenges faced by students with learning disabilities.
Vocational Secondary Education						
Finance vocational education places more adequately as schools are upgraded and transferred to local government management.	--	--	The level of per-student expenditures by government on vocational secondary education in Latvia is below those of international comparators with high-quality vocational education programs.	With major support from the EU, Latvia is in the process of upgrading and restructuring secondary vocational schools and transferring the improved schools to local government management. Mor adequate recurrent financing of the upgraded vocational schools would help exploit the important potential benefits of this investment for the growth of the economy.	There is a legitimate question about the appropriate scale of vocational education (in terms of percentage of secondary students enrolled in vocational programs). Streaming students into vocational education at early ages could risk locking them into lower-lifelong earnings, and close off other opportunities. This risk can be mitigated by	To the extent that vocational education is justified by skill needs in the labor market, it should be funded adequately to provide high-quality and relevant skill training.

[24] An expenditure item in the MOES budget which appears particularly large (in relation to other programs) is the earmarked transfer to local governments "for educational activities." This allocation – amounting to LVL 48.6 million in the 2010 plan budget– is provided for the support of the special education institutions which are managed by local governments for special-needs students. This amount appears to be possibly larger than necessary – even larger than the budget for all of higher education.

Matrix 1.3 Options for the Government to Consider in the Education Sector						
Options for policy action	**Savings 2011 (LVL million)**	**Savings 2012 (LVL million)**	**Background**	**Rationale**	**Risk**	**Longer-Term Benefit**
					ensuring a "level playing field" between vocational and general secondary, and keeping opportunities open for movement from one stream to the other.	
Suspend financing of stipends for students in vocational education and training (VET), beginning with incoming students in September, 2010. Family State Benefits should be paid to parents of children in vocational schools under the same regime as applies to parents of children in general secondary..	**1.2** [25]	**2.3** [26]	All vocational secondary students receive stipends of between 1 and 70 LVL per month. A small part of this amount is designed to offset the child allowances paid to parents whose children attend general secondary schools. During the current (2009/2010) school year, the budget-financed portion of the stipend amounted to LVL 3.1 million for the 32,296 students in MOES VET institutions and c. 0.4 million for the 4,364 students in VET programs under other ministries – an average of LVL 96 per student per year. The remaining portion of the VET stipend is paid	Stipends for vocational-school students are often presented as necessary to attract students to attend vocational schools. But if vocational education provides valuable skills for young people, students should not need to be paid as an inducement to attend vocational schools, particularly, for the enhanced VET programs which are being developed with EU financing. The state budget already finances free room and board for boarding students in vocational schools. Stipends could act as an unnecessary inducement for households to stream their children into VET, particularly for lower income households.	To the extent lower income households are more likely to have children enrolled in vocational schools, immediate repeal of stipends could impact negatively on their welfare. Measures recommended to strengthen the social welfare system could help mitigate this impact in the short term.	Suspension of student stipends in vocational education would help to emphasize to parents, students, and teachers that vocational education is an investment that should be fully justified by increased lifetime earnings.

[25] This is estimated at 96 LVL per student per year (equal to current average budget-financed stipend for students in MOES VET schools), times the number of incoming VET students in September, 2010 (estimated as one-third of current total VET enrollments of 36,660). *This savings estimate does not include the cost of replacing VET student stipends with targeted family allowances.*

[26] This is estimated through same procedure, applied to incoming class and 2nd-year class of September, 2012, estimated as 12,220 for each class. *This savings estimate does not include the cost of replacing VET student stipends with targeted family allowances.*

Matrix 1.3 Options for the Government to Consider in the Education Sector						
Options for policy action	**Savings 2011 (LVL million)**	**Savings 2012 (LVL million)**	**Background**	**Rationale**	**Risk**	**Longer-Term Benefit**
			by the EU structural funds. Parents of students in VET are not paid Family State Benefit (FSB).			
Enable VET school to compete for adult retraining. Revise budget regulations to allow vocational schools to participate in MoW-financed retraining projects, administered by the State Employment Agency (SEA).	--	--	Most secondary vocational schools have the expertise and capacity to offer adult retraining. Vocational schools report that they cannot participate in competitive tenders for adult retraining because current regulations for budget institutions require them to plan and get prior approval for all expenditures, whereas the income from competitive tenders is uncertain and thus cannot be planned with any certainty.	Most of the budget-financed retraining which is provided under the MOW's employment assistance program is contracted with private providers. Allowing VET schools to compete to offer this training, would help finance some of the schools' fixed costs, and thus yield budget savings.	Allowing public VET schools to compete with private training providers could introduce political obstacles to full competition. This risk could be mitigated through close monitoring and adherence to competitive procurement procedures.	In the medium and long term, adult education programs in public vocational schools should be fully self-financed through fees, as they are now. But under the current crisis, public vocational schools should be able to compete for contracts to deliver adult retraining.
Accelerate transfer of vocational schools to novads.	--	--	With major EU support, all secondary vocational schools are preparing and implementing restructuring plans. All of the restructured vocational schools are scheduled to be transferred to local governments by 2015.	Local management and financing of vocational schools would help ensure that vocational programs are cost-effective (in comparison to general secondary education), and provide good value in terms of improved job prospects for graduates.	In the short run, poorer municipalities could struggle with the additional burden of vocational schools.	Financing and managing secondary vocational education under the same process which is used for general secondary schools would increase the likelihood of unbiased decisions about the appropriate scale and content of general secondary and vocational secondary education.
Higher Education & Science						

Matrix 1.3 Options for the Government to Consider in the Education Sector						
Options for policy action	**Savings 2011 (LVL million)**	**Savings 2012 (LVL million)**	**Background**	**Rationale**	**Risk**	**Longer-Term Benefit**
Finance higher education places more adequately, even if it requires reducing the number of budget-financed places. To reduce the number of budget-financed places, the Government could target budget financing to students from households with insufficient means to attend university. The Government could reduce budget-financed student places, financing these at a more adequate level, and prioritizing them for the poorest applicants (including those interested in a part-time course that would allow them to retain employment during their study), while keeping the total "envelope" of public financing for higher-education constant in the next two years.	--	--	Government expenditure on higher education is very low in Latvia by comparison to most countries. Budget-financed places are rationed, solely on the basis of student performance. Half of full-time students pay full cost-recovery fees, which vary by specialization. The other half pay no fees; their places are financed by the budget. The number of budget-financed places in higher education increased over the past three years, despite large budget reductions in higher education – implying a deterioration of teaching and learning conditions. Maintaining the number of budget-financed places in higher education under progressively reduced financing will erode and eventually destroy the quality and credibility of higher education for new graduates and could even undermine public perception of the qualifications of earlier graduates.	As currently used, budget financing of higher education is inequitable because it disproportionately benefits students from higher-income families. Greater reliance on fee financing would help to shift the public perception of higher education, to view it as an individual human capital investment decision rather than a universal entitlement. It would improve equity and fiscal sustainability of higher education, and promote quality by encouraging competition based upon relevance to changing skill needs in the labor market as reflected by changing patterns of earnings.	Current students may have acquired rights to continued financing under the arrangements that were in place when they entered higher education. Thus, this measure might need to be introduced gradually, by applying it to newly registered students in September, 2010 and September, 2011.	In the medium term, it is desirable to provide a higher level of budget support for higher education at a level comparable to other European countries.

Matrix 1.3 Options for the Government to Consider in the Education Sector						
Options for policy action	**Savings 2011 (LVL million)**	**Savings 2012 (LVL million)**	**Background**	**Rationale**	**Risk**	**Longer-Term Benefit**
Suspend higher education student stipends	**0.6** [27]	**1.2** [28]	Currently, 3,379 higher education students receive stipends of LVL 70 per month. These are granted to reward high performance. To make them more equitable, targeting criteria were introduced under the SDPL, and slightly over half of stipends are now awarded on the basis of need as well as performance.	Student stipends are inefficient because high performance reaps its own lifelong rewards through higher earnings and professional mobility. The returns to higher education in Latvia are among the highest in the EU. Student stipends are inequitable (despite the SDPL-supported targeting action) because they are only awarded to budget-financed students, who tend to be from higher-income families.	Abrupt suspension of student stipends could adversely impact the personal finances of students already enrolled. The "acquired right" principle may also need to be applied, with gradual implementation of this measure.	Suspension of student stipends would help to shift the public perception of higher education, to view it as an individual human capital investment decision rather than a universal entitlement.
Discontinue budget subsidies for interest on student loans.	**0.03** [29]	**0.03** [30]	The Government currently pays accrued interest on student loans for the duration of studies and for one year after completion. It also guarantees repayment and pays any excess of borrowing costs above 5%. This arrangement is unnecessarily generous to students and entails	Interest subsidies on student loans contaminate students' choices about how much higher education to seek. The current practice under which the Government negotiates interest margins and guarantees repayment (in addition to individual guarantees) offers sufficiently attractive borrowing costs to students. Actual interest	In the short term, some students could be dissuaded from taking up university studies by repeal of the subsidy. However, the high rates of return from investment in higher education should eventually prevail on individual decisions.	Individuals will make decisions about how much higher education to invest in, based on earnings prospects.

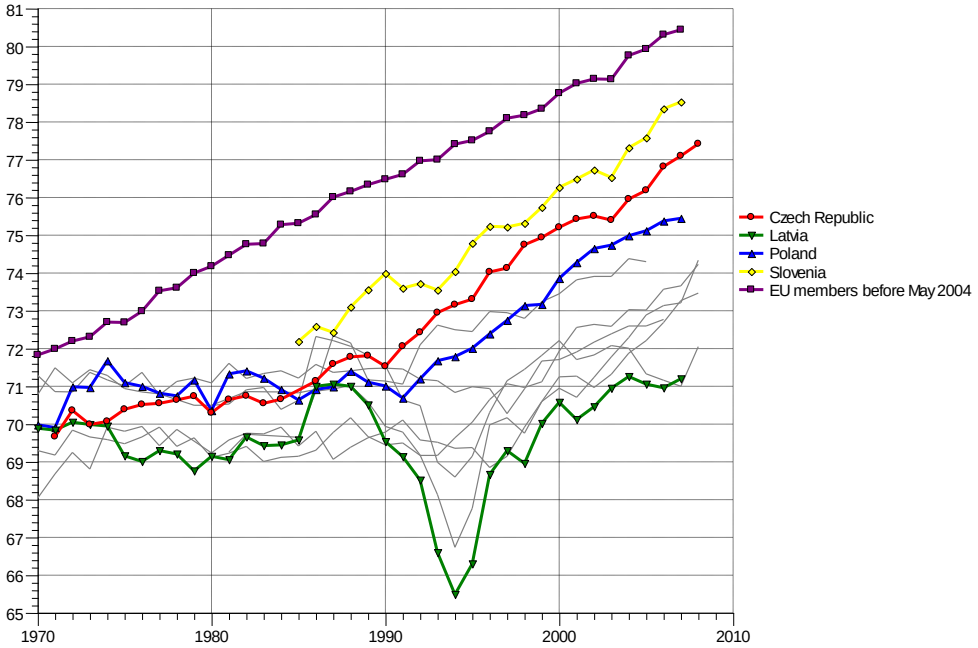
[27] This is estimated as LVL 700 per student, applied to new students in September, 2010 (estimated as one-quarter of current enrollments).
[28] This is estimated on the same basis (footnote above), but applied to the incoming classes on 2010 and 2011.
[29] This is an estimate based on current interest rates, or LVL 0.1 million at 5 percent interest rate, as calculated by the MOES, based on the number of students currently receiving interest subsidies on student loans. This amount could increase significantly if the loan uptake rate or loan default rate were to increase significantly.
[30] As above, based on current interest rates, or 0.1 at 5 percent interest rate LVL 0.03 million at current interest rates, or 0.1 at 5 percent interest rate. This amount could increase significantly if the loan uptake rate or loan default rate were to increase significantly.

Matrix 1.3 Options for the Government to Consider in the Education Sector						
Options for policy action	**Savings 2011 (LVL million)**	**Savings 2012 (LVL million)**	**Background**	**Rationale**	**Risk**	**Longer-Term Benefit**
			potentially serious contingent liabilities for the Treasury. Due to falling interest rates in CY 2010, interest payments on student loans in CY 2010 are likely to be about 1.6 million Lats below the budgeted amount.	rate subsidies beyond that are neither necessary nor desirable. Maintaining interest subsidies risks inducing students who do not need loans to borrow money in order to earn interest on the funds during the duration of their studies. This risk would rise sharply with higher interest rates.		
Place greater emphasis on competitive financing of research and development. The Government could promote improved quality of R&D by moving towards a heavier reliance on competitive financing of research outputs rather than financing inputs. Shift some of the financing of salaries and facilities of public R&D institutes to competitive, international peer-reviewed programs, in which public and private universities, as well as public research institutes, can participate.	--	--	The largest element of budget financing for science and research (amounting to slightly over LVL 7 million) finances inputs in the form of salaries and facilities for state science and research institutions.	More competitive financing would encourage higher productivity and fuller participation by universities.	--	Likely to increase performance and quality of budget supported research and development.

VIII. Health and Long Term Care

113. The health of Latvians, especially of men, is well below where it could be. From the evidence presented in this review, despite rapidly increasing spending on health care after 2004 until the economic crisis hit, it appears that inadequate attention and resources were given to reverse this situation through better primary care and prevention. Instead, resources were spent to improve acute care upon occurrence of a health event. Without a national focus on the crisis in health, with all of its resources aligned behind overcoming the problem in a cost-effective way, Latvia has little prospect of converging on health with the original EU States within the foreseeable future.

Figure 1.17: Life Expectancy at Birth in Latvia and the EU member States before 2004, and the Other EU Accession Countries



Source: WHO/Europe Health for All Database January 2010

114. However, more can be done. The health data available point to obvious interventions at the general practitioner (GP) and secondary specialist levels and in general public health interventions for the conditions that contribute the most to mortality, such as heart attack, stroke, and external causes. The PER suggests holding the health system and health care providers more accountable for health outcomes. This can be accomplished by adjusting GP and secondary specialist compensation to require improved monitoring, prevention, treatment, and coordinated care related to cardiovascular health. It also means redoubling efforts to reduce deaths due to external causes. These changes could be part of a commitment by the MoH to the Cabinet of Ministers to use all of its instruments to achieve goals in these areas, which would help Latvia converge with EU health outcomes.[31]

[31] Toward this end, the MOH could more intensively use population based monitoring data. The FINBALT survey provides important evidence of health outcomes and behavior that is an essential complement to the claims-based data that the government generally uses to monitor the health system. The PER recommends making the survey a more robust tool to

115. Reductions in the health budget in 2009 and 2010 were substantial. However, as a consequence, the 2010 budget cannot finance the inpatient care infrastructure that still exists. Nor is that infrastructure needed. The overall health budget in 2010 is 24 percent below 2008 in real terms, but the inpatient care budget is 51 percent lower. While aggressive steps to reduce hospital beds have been made *cutting them from about 17,000 in 2008 to 13,000 in 2010) this 24 percent reduction does not begin to keep up with the cut in the budget. For this reason Latvia still has difficult choices to make on the 2010, 2011, and 2012 health budgets: either to raise inpatient spending to keep the hospitals running or reduce hospital beds in line with the available budget. This PER estimates that to keep the same level of spending per bed as in 2009 (which was 18 percent below 2008) would require an increase of about LVL 36 million in the inpatient care budget in 2010. If, on the other hand, Latvia chooses to keep the total inpatient budget at its current level and force the physical resources (hospital beds and buildings) to adjust, the PER estimates it would need to have cut approximately 3,000 more beds by January 1, 2010, and of course more beds the later in the year that the decision is made.[32] The fact that so much inpatient volume could be cut in 2009 and that there was such rapid uptake of day services in their first year shows that the system can adjust rapidly while still providing the needed care. For this reason, the PER suggests shrinking the hospital infrastructure to fit within the budget rather than the other way around, but recognizes this cannot be done overnight.

116. The Government could consider a 5,000 bed reduction that takes place at a measured pace from 31 October 2010 to 31 December 2013. That would leave Latvia with about 350 beds per 100,000, at about the level of Denmark in 2007.[33] The additional beds cut in 2010 would not fully solve this year's problem, and it is quite likely that half or more of the shortfall of LVL 36 million would need to be restored to the inpatient care budget – an addition to the budget deficit. The PER proposes a system (see Volume 2, Chapter 6, Box 6.1) that the Government can use to right-size the hospital sector for Latvia's budget today and its needs over the ensuing decade.

117. Along with a reduction in the capacity of the inpatient sector, there is a need to shift hospital compensation toward prospective payment mechanisms such as diagnosis-related groups (DRGs). In addition, DRGs for secondary ambulatory services could help to integrate compensation of secondary outpatient services and hospitals to improve incentives for efficiency and continuity of care.[34] Inefficiencies abound in hospitals. First there is too much capital in the form of buildings, beds, and accompanying equipment. Second, it is used inefficiently. Between 2005 and 2009, spending on inpatient care rose 31 percent while the number of unique patient admissions in 2009 fell 17 percent from the 2005 level, and total bed days dropped 24 percent. Nevertheless, Latvia's long average length of stay hardly changed. During the same period, expenditures for secondary outpatient services

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measure Latvians' health and health-related behaviors, as part of the health convergence campaign and as part of health policy-making.

[32] Such a cut in many countries would not be feasible, but in Latvia, at least nominally, it is a matter of dropping or reducing inpatient contracts with selected hospitals. However the fact that the contract is changed does not physically eliminate the beds, and they may come roaring back onto the budget in the future if hospitals succeed in exerting political pressure to be reinstated.

[33] We mix acute and long-term stay beds because Latvia has too many of both. The Denmark number is acute care beds only.

[34] Latvia currently uses a mix of prospective payment and fee-for-service in hospitals, paid within a global budget. Specialists are compensated on a fee-for-service basis.

increased 72 percent in real terms on a 16 percent increase in the volume of patients.[35] General practitioners (GPs), who are paid almost entirely on a capitation basis, saw a spending increase of 50 percent with a 16 percent increase in patient visits. The rise in costs for lower production in hospitals and no improvement in productivity among secondary outpatient services relative to GPs is likely a result of the weight given to fee-for-service payments for hospitals and secondary outpatient services and an expansion of technology for diagnosis and treatment of acute cases. It also suggests scope for improving productivity in these two areas with a change in how they are compensated. This would complement efforts to reduce hospital over-capacity.

118. In 2010, the Ministry of Health reformed how it pays hospitals to a global budget system, although within that "black box" they still account for their volume on a fee-for-service basis. Within the current health finance system, there is a need to move away from fee-for-service payments as soon as possible and shift to DRGs for care at the specialist and inpatient levels. More radical changes to encourage greater competition (and in fact a greater level of control over results for the MoH while reducing its direct role in contracting) would be to shift to competitive procurement for providers (almost certainly with longer term contracts than is the practice today). Other more radical options can also be considered. The Government could lay the groundwork for a more flexible system in the future that would allow limits to be defined on what it can finance and encourage greater provider accountability for performance of the system.

- One option is to make changes only to the payment system for inpatient and specialist care. In this scenario, Latvia would adopt a DRG payment system as soon as possible and start piloting it as a parallel system in its major cost centers no later than 2012. If the results of this pilot were promising, full implementation could begin in 2013 and 2014.

- A second option, complementary to the first, is to begin contracting competitively for services. The current system of annual contracts could be replaced incrementally with competitive contracts to deliver a specified mix of services to a defined population. Latvia could thus begin defining the quantity, continuity, and quality of care it would like to purchase and encourage providers to collaborate to deliver those services – and most importantly to begin bidding competitively to provide them. It could also put in place rules that providers – such as specialists – who are parties to these bids provide 100 percent of their efforts to government-financed patients and meet performance targets for quality, results, and satisfaction. The current system exposes patients to efforts to switch them to private practices and encourages specialists to work in multiple full time jobs simultaneously.

- A third option -that would be much more costly and difficult to implement, with uncertain results- would be to begin offering a voucher for individuals to purchase insurance on the open market that would provide the same level of coverage that exists today: catastrophic protection for emergency and inpatient care, general practitioner services, coverage of essential drugs, dental care for children, and specialist referrals. The voucher could be fully

[35] Although secondary outpatient services include tests and other services, the number of secondary outpatients is a reasonable measure of the quantity of services provided because all of the tests and other activities are presumably for these patients.

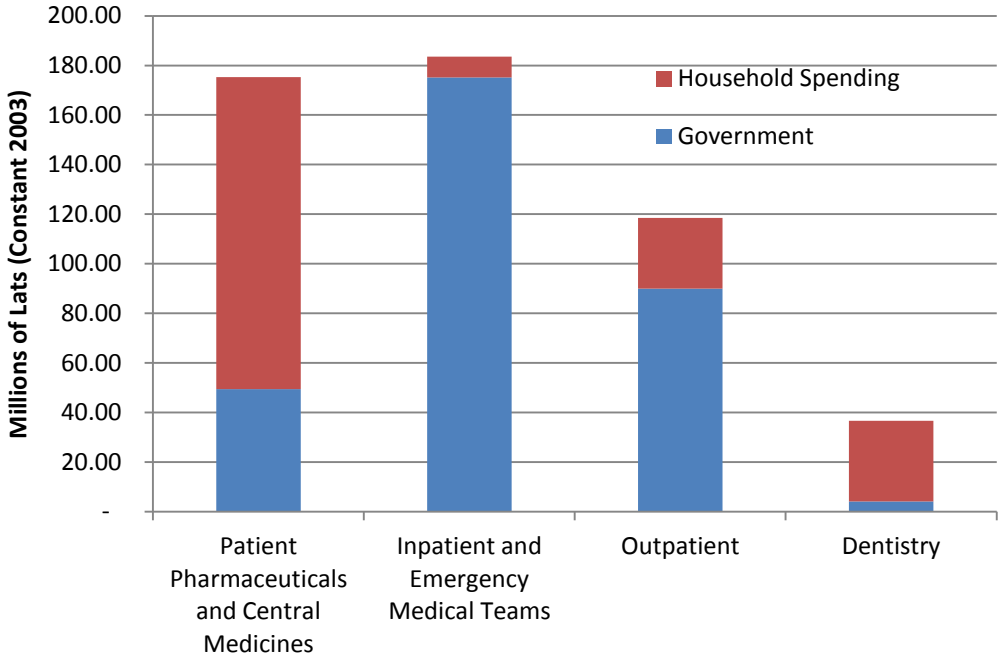
subsidized for the needy and perhaps require a contribution on a sliding scale from those in higher income groups. Coverage beyond this basic level would be allowed, but at an extra out-of-pocket cost. This change would be a complex undertaking and would require careful design, but it would allow the government to open the market for care, define the rules of competition, define a basic benefit package, set performance standards, and encourage payers to achieve greater continuity of care. It would be a revolutionary change from the current approach. It is not recommended by us but is certainly an option.

119. Further efficiency gains could be made in health sector administration by shifting the service delivery activities that remain within the MoH budget, to the contracting system managed by the Payments Center. The care-giving organizations providing these services could then be compensated according to DRGs or capitation, as appropriate. Once the EMT consolidation is completed, it could follow the same path back to the purchaser-provider split managed by the Payments Center.

120. Turning to protection from the cost of health care - which for many can be impoverishing or create a barrier to necessary care - there is much to be learned for health policy from the Emergency Social Safety Net. The ministry's design of the health activities of the emergency social safety net deserves plaudits on many fronts. The health portion of the emergency package provides an incentive to local authorities to identify beneficiaries correctly and make sure they receive benefits; it treats everyone equally, no matter where in Latvia they reside; the payment mechanism is administratively simple and creates no burden on the client; and revisions in early 2010 removed the 100 percent tax on health benefits that originally occurred at the "needy" line. The safety net protects the needy from copayments and encourages providers to deliver traditional inpatient services on a day or outpatient basis. The PER argues that the Government could provide more effective financial protection – particularly for the poorest households in Latvia – if it adopted the same approach while keeping the payment caps that are in place to provide the whole population with financial protection.

121. In the interest of greater efficiency of health finance as a whole, many people in Latvia advocate additional insurance coverage for the population that would supplement that which is provided through the public budget. This could allow Latvia to mobilize additional resources for health outside of the tax system. After reviewing government and household expenditures, the PER concludes that Latvia already has a reasonable system to protect its population against catastrophic financial risks in health. It also has a functioning secondary private market for insurance that fills in gaps in public coverage for just over ten percent of the population. Given the above, the PER finds no compelling reason for structural reform of health financing to introduce a social insurance model or mandatory private insurance.

Figure1.18: Combined Government and Household Spending on Health 2008 (in Constant 2003 Lats)



Source: Staff Estimates based Latvia's Household Consumption Survey and Health Compulsory Insurance State Agency News

122. However, neither does the PER find reasons to slow or stop the development of private insurance, which is likely to continue to evolve as a gap-filling mechanism - and the gaps are growing as public budgets decline. The secondary market would benefit from a stable, clear definition of what the public budget will finance: a clearly defined, state-financed health benefit package. The current system of a negative list that excludes few services but rations care through waiting lists, does not create clear rules of the game that would allow private insurers to better define their offerings. If Latvia would like to eventually move to a model in which households choose their insurer as they choose their family doctor today, then specification of the benefit package financed by the government will be essential. Under any reforms, insurance would need to maintain the principle of 100 percent coverage of the population, financial protection for everyone, subsidies for the poor to reduce further barriers to use which they face, and a long list of highly probable benefits relative to the current approach that could offset the considerable risks that radical reforms would create.

123. The Government could accelerate progress toward better health system performance by increasing the degree to which health care is provided as a business. Although it is not directly addressed in the PER, only limited elements of the health system have been privatized, namely General Practitioners, Specialists in private practice, and pharmacies. However, for the most part, even these elements of the system are on contract to the State. Capital-intensive hospitals and most of the infrastructure are owned by the State and by local governments. They are run – to a limited extent and in varying degrees – like businesses but also have political overseers and protectors. If providers have contracts with the Payments Center, most of their revenue comes from the State. European Structural

Funds support investment in infrastructure, even though much of it is not economically viable and may not be suitable for its purpose.

124. The Government could consider moving the delivery of medical care into the market to a greater degree. The public sector can continue to have a primary role in the financing of care, but the market will only develop fully if the delivery of care has a greater element of private participation than is currently the case. Poland, for example, is advancing a program to "corporatize" its hospitals by shifting them from government-owned limited liability companies to joint stock companies that would face bankruptcy if they cannot pay their bills. Shares at first could be owned by the same governments that own the hospitals today, but if they become economically viable they could be sold. They will be governed by the same laws as private businesses, and there will be a more distant relationship with government. Another alternative is to turn hospitals into nonprofit companies owned by foundations that are managed by independent boards but have no connection to a government. This is an item on the economic development agenda as much as on the health agenda because the purpose would be to spur greater efficiency and entrepreneurial activity in the health sector.

125. To conclude, the most pressing issue for better health in Latvia is the one highlighted by MoH decisions to prioritize GPs, maintain emergency services, build a safety net for the poor, maintain services for mothers and children, and maintain access to medicines. These decisions have made inpatient care the residual category in the current budget environment. In the short term – 2010 through 2012 – shrinking inpatient capacity in line with available resources is the fundamental policy challenge. There is so much hospital overcapacity and so many preferred alternatives to inpatient care that further hospital downsizing is unlikely to affect health results negatively and may in the longer term contribute to improvements. The public resources freed up to fund the government's priorities may contribute to better health, although it would take years to adequately assess the results. The MoH made many smart choices in 2009 as it adjusted to the economic crisis. It probably has helped the health system transform into one that is more appropriate to Latvia's needs. The longer term challenge is how to marshal the resources at hand to boost the health and life expectancy of the Latvian people.

Long Term Care for the Elderly

126. The PER looks briefly at long term care (LTC), particularly of Latvia's elderly population. LTC is a crucial policy area, with important fiscal implications in the medium and long-term. It is important that Latvia improves its data collection and recording practices on LTC services in order to develop good and fiscally sustainable policies in this area. The OECD standard health accounts (SHA) methodology gives good guidance on how to record public (and private) expenditures, and it is important that Latvia strengthens its efforts along these lines, also at the level of local government.

127. What can be said with certainty at this point is that Latvia spends relatively little on LTC and that increased investments in LTC services could lead to important efficiency gains in the health sector. Due to the overcapacities in the hospital sector it is conceivable that a large part of LTC is currently provided in hospitals, but in the guise of in-patient services. This is both expensive and to the determent of the wellbeing older people, who receive the wrong type of care and are exposed to infection risks in hospitals.

128. The relatively high average length of stay in hospitals suggests that improved patient discharge management could decrease inpatient expenditures. As discussed at length in the previous section, patient discharge management aims at reducing length of stay in hospitals by passing on patients to more cost-efficient outpatient services like post-surgical treatments and rehabilitation. The fact that Latvia currently spends only 0.8 percent of total health expenditures on rehabilitation hints at a lack of rehabilitative services. In contrast, for those countries where such data are available, expenditures on rehabilitative services as a share of total health expenditures is around 2.9 percent (including many EU10 countries).

129. In the case of older patients, patient discharge management also involves social workers who can help organizing temporary (or permanent) assistance with ADLs after discharge. For older patients who live on their own and lack family support, even a minor injury—like a broken leg—can leave them temporarily dependent on outside support. Given the overcapacities in hospital beds, hospital management might currently be more than happy to keep such patients hospitalized until they are fully recovered, although such patients are not in need of medical, but social welfare services. A more cost-efficient solution would be to discharge the patient when no more medical treatment is necessary and provide the social support through community-based LTC services. This could either happen through temporary home-based or even residential LTC services. The city of Riga has already successfully implemented this approach. A careful evaluation of the experience in Riga could form the basis of a countrywide rollout of discharge management.

130. Any publicly funded investments in building up more LTC (and also rehabilitative) service facilities, though, would need to be to be carefully evaluated against other policy objectives. Various potential policy objectives come to mind. First, reforms should be cost-effective and have the wellbeing of patients in mind, which implies a focus on community-based services like home care and daycare. Institutional care is also an important component of any LTC system, but it results in higher-intensity care, is therefore more expensive, and is not the preferred form of care by patients. Second, cost shifting between the health and the social welfare sector should be avoided as much as possible. This implies that coordination of care services has to focus on the needs of patients rather than cost implication for either the health or the social welfare sector. The current LTC needs assessment in Latvia involves both a social worker and a general practitioner, which is an excellent starting point from which to build a patient-focused care coordination system. Third, provider payment rules and capital investments have to ensure a leveled playing field between the public and the private sector. If public providers are subsidized—either directly from budget through staff salaries or through capital investment subsidies—private sector providers are unfairly disadvantaged and discourage the interest of the private sector in providing LTC services.

131. The conversion of small municipal hospitals into institutional LTC facilities is an example of how LTC reform can run counter to some of these policy objectives. International experience shows that many countries at some point in their history have converted redundant municipal hospitals into LTC institutions. The risk that is created by such reforms is that it introduces a bias towards expensive institutional care in a country's LTC system. Poland provides an example of how this shift can become costly. Some years ago, Poland started to convert small hospitals into medical nursing homes, run and financed by the health sector, that were intended to provide post-surgical treatment at lower costs than

in regular hospitals. The unintended consequences were that—given the general shortage of LTC services in Poland—patients and their families continued to use the medical sector as a substitute for social LTC services, at a much higher price than this could be done in the social welfare sector. The medical nursing homes were largely financed from the health insurance fund and came at a much lower price for patients than private or social welfare sector LTC services. The private sector was discouraged from entering the market because for-profit and even non-profit organizations could not compete with the lower user fees in medical nursing homes. Municipalities, who finance most of the social LTC services, also found it cheaper to shift patients to the health sector than provide their own social services.

132. A better approach could be to convert redundant municipal hospitals into community centers—privately or publicly owned—that provide a whole range of LTC and rehabilitative services. Such community centers could be at the center of care coordination for patients. They could house daycare centers for elderly and disabled people (or even childcare), but also outpatient services like physical therapy. They could also be the hosting facilities for home-based services like care assistants or community nurses who support dependent people in their homes. To the extent necessary, they could of course also provide limited facilities for residential care, in particular for limited periods of time and respite care. The exact setup of such community centers would depend on local needs and circumstances and also have to be balanced against transportation costs in sparsely populated areas in rural Latvia. High transportation costs could in fact justify more residential care facilities with low levels of care intensity.

Matrix 1.4. Options for the Government to Consider in the Health Sector						
Options for policy action	**Savings 2011 (LVL million)**	**Savings 2012 (LVL million)**	**Background**	**Rationale**	**Risk**	**Longer-Term Benefit**
Inpatient						
Prepare and implement a technical plan for closure of hospital beds and buildings. The Government should consider a 5,000 bed cut that takes place at a measured pace from 1 October 2010 to 31 December 2013. By 2013 the goal would be to achieve an overall ratio of 350 beds per 100,000 population.	**10** [An additional 25 to 36 million is likely to be needed in 2010, which could then be recovered from savings to in spending from bed/hospital closures in 2011 and 2012 budgets.]	**10 -15** [10 -15 million 2013]	In 2010, Latvia has achieved about 575 beds per 100,000, just above the average for Poland, Estonia, and Europe as a whole in 2007. This number includes psychiatric beds, which Latvia has in abundance relative to its neighbors and Europe. By cutting 3,000 beds, Latvia would reach about 440 beds per 100,000; a 5,000 bed cut would allow it to reach 350 beds per 100,000. Both beds and hospitals need to be closed, not just beds eliminated while the buildings are maintained. The larger decrease would put Latvia at about the same density of beds as Denmark in 2007.	The MoH has cut planned inpatient spending to LVL 106 million, plus an additional LVL 8 million for day surgery. As a result, while the overall health budget in 2010 is 24 percent below 2008 in real terms, the inpatient care (plus day surgery) budget is 51 percent lower. While aggressive steps to reduce contracted hospital beds have been made, cutting them from about 17,000 in 2008 to 13,000 in 2010, this 24 percent reduction does not begin to keep up with the planned cut in spending. And the cuts in beds have not actually eliminated the hospitals, which for the most part were converted to another type of care institution. Consequently, in 2010, we estimate that the budget for inpatient care is LVL 25-36 million below the likely cost of maintaining the current infrastructure and expected utilization. But it is dangerous to	The MoH's priorities have been to maintain expenditures for primary care, for medicines, for emergency care, for mothers and children, and for the safety net. These are sound priorities from population health and equity standpoints. These core expenditures mean that inpatient care is funded by the residual that is left. While the expenditure priorities are sensible from a population standpoint, the resulting limitation on inpatient care poses risks to individuals if they fall ill or if they must delay planned procedures. This risk can be reduced by moving deliberately rather than precipitously to further cut hospitals; they should be reduced but in a measured and transparent way. Latvia could benefit from further cuts in hospitals, but the Government	De-hospitalization of health care for a more effective and efficient system. Hospitals would need to be closed and permanently removed from the health system for this strategy to succeed. Otherwise they may return in the future as a cost. Some sort of privatization program or bankruptcy program would be appropriate to remove them as wards of municipal governments seeking support from the State. If given the power and political support to do so, the MoH could rapidly develop and begin executing a strategic plan to reduce the hospital sector so that it consumes no more than 35 percent of acute care expenditures - about average for the OECD.

Matrix 1.4. Options for the Government to Consider in the Health Sector						
Options for policy action	Savings 2011 (LVL million)	Savings 2012 (LVL million)	Background	Rationale	Risk	Longer-Term Benefit
				suddenly shrink inpatient care to fit the budget. The Government could instead implement a strategic reduction beginning in 2010 but with the major reductions coming in 2011, 2012, and 2013, with the MoH given an objective of achieving LVL 30 million in permanent annual savings on inpatient care by 2013, with agreed benchmarks on reductions in infrastructure to reach that point.	would need to carefully manage the risks that go with it for individual patients during the transition.	
Reduce average length of stay by 1.2 days in 2010 (to 7.5), 0.5 days in 2011 (to 7.5), and 0.5 days in 2012 (to 7.0)	-- [Savings would be part of the reductions for inpatient care included above]	-- [Savings would be part of the reductions for inpatient care included above]	This would accelerate the improvement in 2009, when average length of stay dropped from 9.5 to 8.7 days, and would take advantage of changes encouraged by MoH to use day surgery and home care. If Latvia moves to 350 beds per 100,000, average length of stay must fall to use the remaining beds more efficiently. Elimination of long term care beds for psychiatry is included in this estimate.	Greater use of modern outpatient-based medicine, management of diseases through the primary care system, day surgery, home care. Shifting to a prospective payment system for hospital services, such as DRGs, would create incentives for hospitals to reduce length of stay. Currently, the combination of case-based plus fee-for-service payment both for specialists and hospitals provide incentives to increase the cost per patient. It is unclear that the global budget system	Very little risk if doctors are given incentives to manage patient stays better and if safe alternatives are available for psychiatric patients. Much safer to handle through incentives to doctors and hospitals rather than through edicts from the central administration.	De-hospitalization of health care. See above.

Matrix 1.4. Options for the Government to Consider in the Health Sector						
Options for policy action	Savings 2011 (LVL million)	Savings 2012 (LVL million)	Background	Rationale	Risk	Longer-Term Benefit
			Because those stays are extremely long, they distort the totals.	put in place in 2010 will change current incentives for hospitals to keep patients in beds.		
Reduce MoH specialized health care provision through marginal improvements in productivity.	**2.5** [36]	**2.5**	This area of the MoH budget includes communicable diseases, sports medicine, blood supply, emergency medical assistance, disaster medicine, and forensic labs.	Request the MoH to manage a 5 percent cut in this area through increases in efficiency in each fiscal year. The logic is simply that small additional cuts even in areas of high importance may be possible without resulting in major losses of output.	If part of the savings is due to deflation in the economy, this change can be risk free. As these are service providers, it also makes sense to put them in the same *"arm's length"* bargaining position (i.e., contracts with the Health Payment Center) as other service providers are today with the Payments Center.	Unification of the financing of care-giving medical institutions.
Pilot competitive contracting	--	--	MoH could begin piloting requests for proposals to provide services to supplement or replace the current system of renewing contracts and negotiating with providers on quantities and costs. This would make the system more transparent and give the MoH another tool to manage costs,	DRGs or prospective payment systems will take time to develop. The current system seems locked into a high level of unit costs that increased rapidly between 2005 and 2008. There are clear signals that the quality of care would benefit from greater integration of services. Competitive contracting would also give the MoH	Minimal for a piloting exercise. Risks would manifest during the pilot and Government would learn how to manage these if decision to go for a full roll-out of the policy is taken.	We are suggesting only that this be started or experimented with. All the benefits would be longer term if it becomes a practical way to do business. Competitive contracting is not a panacea but provides another instrument to manage services financed by the State. It is a logical extension of Latvia's purchaser-provider split.

[36] To arrive at possible savings, we assume that part of the reduction will be due to deflation and part will be actual savings. These services are currently funded directly by the MoH, and we further assume that they will be put on contract like other service providers.

Matrix 1.4. Options for the Government to Consider in the Health Sector						
Options for policy action	Savings 2011 (LVL million)	Savings 2012 (LVL million)	Background	Rationale	Risk	Longer-Term Benefit
			quality, and the integration of care.	another tool to reduce hospitals and beds. Competitive contracting would add another instrument to allow the MoH to influence behavior and encourage providers to improve their business acumen. In addition, with competitive contracting, the MoH could require participants to exclusively serve State financed services, reducing the "gaming" that currently is possible for providers under the current mixed system.		
Copayments and Targeted Exemptions from Health Charges						
Review copayments. Copayments are a variable that the MoH has control over. Copayment policies can be adjusted further so that those who can pay pay more, while the poor are better protected.	-- [Variable impact]	-- [Variable impact]	Copayments were raised in 2009 for the first time in five years, and then reduced in 2010.	We are not arguing that copayments be changed. We include the option in this table because it is a way to manage demand while also reducing the amount of subsidy that is necessary. It is a tool to use if additional revenue is needed.	Latvia does not maintain sufficient household survey data to understand the impact of copayment policies and does not undertake sufficient analysis to understand how best to manage copayments.	Fine-tuning co-payments can improve the distribution of government subsidies in health and help manage demand.
Fully means test exemptions. Shift targeting of exemptions from social groups to	1	1	The Emergency Social Safety Net is already a step in this direction.	Consistent with other suggestions (for the Welfare and Education		The shift to means testing exemptions would improve the transparency

Matrix 1.4. Options for the Government to Consider in the Health Sector						
Options for policy action	**Savings 2011 (LVL million)**	**Savings 2012 (LVL million)**	**Background**	**Rationale**	**Risk**	**Longer-Term Benefit**
completely means testing.				sector), targeting can improve the fairness and impact of public subsidies. In this case they are unlikely to save a substantial amount but would be consistent with a government-wide switch to targeting based on means. Using means-testing to target subsidies would also allow the Government to take efficiency measures with greater confidence that the impact of these measures on low-income groups is mitigated.		and consistency of public subsidies in health as well as contribute better to a national safety net. The change is also consistent with fundamental principles of public economics. The measure saves money and improves the equity impact of public subsidies.
Health Finance						
Clarify the guaranteed package of health coverage. There is no compelling argument for structural reform of health finance at this juncture, such as a shift to a social insurance model, private insurance, or a mix of public and private insurance.	--	--	Latvia has a mix of public insurance taking the first level of risks and private insurance filling in gaps (provided by employers as a benefit to their employees). A first priority is to clarify exactly what the public sector will pay for under current conditions and budgetary restrictions. This has become evident in the MoH's budgetary priorities.	Attract additional sources of finance to the health sector, where demand seems to surpass the ability of the State to finance services. Coupled with independent hospitals run as businesses, insurance could contribute to a more dynamic health sector, which is now to a large degree a ward of the State.	Latvia today has a health system with very low administrative costs because of its single payer model. A private insurance market exists at the margin.	"Zero sum game". In the end, Latvia will have to decide how much to spend on health care no matter what the source of funding. It can be on budget or off budget (i.e., via private premiums or earmarked payroll taxes), but households will still be financing it. It is possible to affect the mix of payments: increase administrative costs, decrease payments to providers, and change copayments depending on

Matrix 1.4. Options for the Government to Consider in the Health Sector						
Options for policy action	Savings 2011 (LVL million)	Savings 2012 (LVL million)	Background	Rationale	Risk	Longer-Term Benefit
			But the rules may not yet be clear to providers, clients, and insurers so that they may adjust to the new reality. If the *"rules of the game"* were set out publicly and pursued consistently, the current public/private provision of insurance would work much better. Private insurance can provide the State the ability to cap public spending for a core package of services for everyone plus subsidies to the needy for additional services. Beyond this set of State-financed benefits, additional insurance would be shifted to individuals (either via premiums or payroll taxes)			the approach followed, but it is unlikely that the total cost to society will change very much in the next 5 years.
Long Term Care						
Improve discharge management, especially of the elderly, and eliminate biases in current financing model that encourage practitioners and households to prescribe	--	--	Due to the overcapacities in the hospital sector it is conceivable that a large part of LTC is currently provided in hospitals, but in the	Patient discharge management aims at reducing length of stay in hospitals by passing on patients to more cost-efficient outpatient services like post-surgical		A more cost-efficient solution would be to discharge the patient when no more medical treatment is necessary and provide the social support through community-based

Matrix 1.4. Options for the Government to Consider in the Health Sector						
Options for policy action	Savings 2011 (LVL million)	Savings 2012 (LVL million)	Background	Rationale	Risk	Longer-Term Benefit
medical in-patient rather than long term care.			guise of in-patient services. This is both expensive and to the determent of the wellbeing older people, who receive the wrong type of care and are exposed to infection risks in hospitals.	treatments and rehabilitation. The fact that Latvia currently spends only 0.8 percent of total health expenditures on rehabilitation hints at a lack of rehabilitative services. In contrast, for those countries where such data are available, expenditures on rehabilitative services as a share of total health expenditures is around 2.9 percent (including many EU10 countries).		LTC services.
Convert redundant municipal hospitals into LTC Community Centers—privately or publicly owned—that provide a whole range of LTC and rehabilitative services.	--	--	Many countries have converted redundant municipal hospitals into residential LTC institutions. This introduces a costly bias towards expensive institutional care in a country's LTC system	Sustainable LTC requires models that change the bias to community and home care, while still providing specialist and some residential care when it is truly necessary.	The exact setup of such community centers would depend on local needs and circumstances and also have to be balanced against transportation costs in sparsely populated areas in rural Latvia. High transportation costs could in fact justify more residential care facilities with low levels of care intensity.	A new "Community centers" LTC model could be at the center of care coordination for patients. They could house daycare centers for elderly and disabled people (or even childcare), but also outpatient services like physical therapy. They could also be the hosting facilities for home-based services like care assistants or community nurses who support dependent people in their homes.

IX. Municipal Spending and Intergovernmental Fiscal Structures

133. Local governments differ not only by size, but also by the demographic and socio-economic situation of the population. At the beginning of 2010, among municipalities the unemployment level varied from 7.8 percent (Ādažu novads, Garklanes novads) to 28.3 percent (Viļānu novads). Average unemployment in the republic cities at 10.7 percent was lower than that of municipalities, where the mean was 13.4 percent in 2010. There is also a large difference in the increase in unemployment that occurred in local government territories from January 1, 2009 to January 1, 2010. The rise in unemployment ranged from 4.3 to 13.5 percentage points. Among those municipalities that had to cope with the greatest increases in unemployment are those with small and largely rural populations. Dependency ratios vary across local government areas in Latvia, with differences in the share of under- and over-working age of the population. Such differences highlight the varied needs for service delivery of local government territories in Latvia.

134. The economic recession and rising unemployment led to an increase in the demand for social benefits for the poor. This showed the procyclical social protection spending pressures that arise at a local level in bad times. In first half of 2009 the expenditures for social benefits was lower than in the same period of previous year, but since August 2009 those expenditures outgrew those of the same period in the in previous year. The impact of the crisis also is reflected in the increase in spending on the GMI. In 2008, the GMI equaled 3.4 percent of all social benefits; in 2009 it had increased to 8.9 percent. In the first three months of 2010, GMI benefits had risen to comprise a 16 percent share of overall social benefits given by local governments.

135. Individual local governments face very different conditions with regard to social protection spending. For the group of republican cities social benefits per capita varied from LVL 16 (Jūrmala) to LVL 38 (Liepāja) in 2009. For municipalities, it differed from LVL 7 (Rojas novads) to LVL 42 (Aizkraukles novads). This data and the different underlying social economic conditions (unemployment level, personal income tax revenue) show that local governments have very different needs for social assistance and also often different local social assistance policies. A significant proportion of local governments have problems in maintaining adequate social services. This situation was exacerbated in the aftermath of the recent crisis. As most household revenues have decreased, so have local government revenues, but the necessity for social support has been increasing.

136. Up until 2008, local budget revenues rose each year as did the share of local government revenues in overall general consolidated budget revenues. Local government revenues were 2.5 times higher in nominal terms in 2008 than in 2004 and their share of overall revenues had increased to 29.3 percent. The fall in government revenues in 2009 led to a nominal contraction of 20.7 percent in local government revenues. The share of local government consolidated budget in general budget revenues also decreased somewhat to 28.2 percent in 2009.

137. Local governments do not have the legal authority to impose taxes in Latvia. Only the national-level government has the power to set taxes. The local government shares revenues from state taxes. Tax revenues and transfers made up almost equal shares of local government revenues in 2009, combining to account for over 90 percent of total local government revenues. The majority of tax revenues came from personal income taxes (PIT) (40 percent of total local government revenues). Real

estate taxes contributed under 5 percent to total local government revenues. Of state budget transfers, earmarked grants are the most significant, contributing 18 percent to total revenues. Inter-local government transfers account for 11 percent of overall basic budget revenues. Transfers here included the substantial transfer for teachers salaries recorded as a local government transfer as it went to municipalities through district government (but it went directly to republican cities). The Local Government Finance Equalization Fund (LGFEF) makes up a 5 percent share of total revenues. The main contributors to the LGFEF are local governments themselves. Own revenues remain relatively low at a 7 percent share of overall revenues.

138. The Government sets the PIT base and rate. Although Latvia allocates a large share of PIT to local governments, this is because there is a relatively low yield from the PIT, which has a low, flat rate. Administration, except in the cases of the republican cities of Riga and Ventspils, is carried out by the State Revenue Service. The local government share of PIT constantly increased from 2005 until 2009, going from 71.6 percent before 2005 to 73 percent in 2005, 75 percent in 2006, 79 percent in 2007, and 80 percent in 2008 to 83 percent in 2009, but in 2010 it decreased to 80 percent. As between local governments there is a big difference in the growth of PIT revenues in periods when revenues are expanding, with the increase in the PIT local government tax share during good times, the difference between local governments' financial capacity increased. Rich municipalities benefitted from the increase in the PIT tax share, whereas for poor municipalities there was almost no impact.

139. Chapter 3 of the Volume 2 of the PER suggests that giving the ability to local governments to set and raise their own tax revenues could be considered. Tax pressure in general is relatively low in Latvia; and Latvia together with Malta is one of only two countries in the EU-27 without local government taxes.[37] A challenge is that such a tax would need to be a stable revenue component if local governments were to rely on it. The tax would need to provide an adequate revenue base, and not be overly procyclical. More cyclical taxes, such as corporate taxes, would possibly promote procyclical revenues. A local sales tax is not allowed under EU regulations. A local income tax or real estate tax is a possibility. Taxes on immovable property are most appropriate for the financing local government. In the medium-term such a development is likely not to occur, as the national government may need to rely on any increase in real estate taxes rather than devolving them to lower levels government in the current tightly constrained fiscal environment. An additional possibility is to consider giving local governments more rights to charge local service fees.

140. The amount of central government funding that goes to the Local Government Finance Equalization Fund has remained unchanged at LVL 7.2 million since 2001. Therefore, the system relies mostly on the revenues received from personal income tax (with a smaller share coming from the real estate tax). Given that the benefits of the equalization structure are likely to be of greatest value to households during economic downturns, the building up of buffer resources to be used to fund transfers to needy local governments in bad times (to finance social spending requirements) could be a valuable countercyclical tool. Currently, when local governments' tax share amounts decrease, so does the amount available for redistribution.

[37] Source: *Sub-national governments in the European Union: Organization, responsibilities and finance.* Dexia, July 2008, page 97.

141. Small municipalities rely considerably on the equalization fund for revenues as their revenue share from PIT is low. A new law to alter the equalization system is due to be submitted to parliament next year (January 1, 2011). The ministry responsible has appointed a committee to examine the issue. One idea being discussed is that the mechanism may be deepened through additional resources from the State.

142. As the discussion of how to improve equalization takes place, it would be useful to clarify the objective and definition of terms used in the equalization framework, and the role of the equalization grant, given that other budget mechanisms (such as several of the earmarked grants) also contribute to vertical equalization. A clarification of the methodology and the order in which calculations are to be made is also merited. The current system is complicated and not understood by many local governments. To sustain the effectiveness of the equalization mechanism, the indicators used for the equalization formula could be regularly updated, at least every 4 to 5 years.

143. The mechanism for redistributing revenues across local governments would also benefit from a system of monitoring and evaluation. For example, there is no regular analysis of how the mechanism has performed. The criteria used to determine each unit of local government's spending needs are connected with providing basic local services to the population (education, social services, etc.). It would be useful to examine whether the redistributed funds result in an equal provision of such services across local governments. In addition, the performance of the revenue forecasts used to calculate the equalization needs are not compared with the actual situation that evolves.

144. There may be some room for redesigning the equalization mechanism to increase the incentives for local governments to raise revenues. Under the current system, a government that benefits from the equalization grant has little motivation to increase tax and other revenues if increased revenue effort would result in them losing the equalization grant. One method that could be used to increase the returns to collecting revenues is to reward local governments for increased revenue effort by setting aside a portion of revenues raised and not subjecting it to the equalization calculation.

145. Under the current system, revenue transfers to local governments in Latvia are procyclical since they are mostly based on tax revenue sharing and transfers funded by current government revenues. In good times, the central government then shares its booming revenues with local governments, and does not set resources aside to be used to fund local government spending in bad times. In bad times, the result is a fall in revenues often partially compensated by reducing capital spending. Such a cycle is apparent in looking at the recent crisis, which is much deeper, but repeats the pattern seen in the 1998 downturn.

146. Since local government expenditure has a substantial social sector element, it could be argued that it should be more protected than other forms of expenditure during economic downturns and perhaps even increased. After all, the activities financed from social sector budgets are in most cases, those that benefit households most directly. Indeed, many countries with countercyclical fiscal packages during the recent economic crisis increased social sector spending to protect the most vulnerable households. Therefore, any fiscal framework with a structural target should outline the preferred path for social sector spending, and hence local government spending, across the cycle (while

keeping such targets in the budget and flexible rather than enshrined in law). Box 1 proposes using fiscal rules for social policy, rather than having the objective of smoothing government consumption across economic cycles, Engel, Nielsen, and Valdés (2010) suggest targeting the inter-temporal consumption path of the poor.

Box 1.3: Fiscal Rules as Social Policy

Engel, Nielsen, and Valdés (2010) examine the role of fiscal policy across the cycle when there are exogenously driven and volatile fiscal revenues. They present a theoretical model in which there is a substantial welfare gain associated with running a countercyclical fiscal policy that targets increased spending to the poor. Their model is motivated by fiscal savings in Chile during the recent copper revenue boom that enabled the government to put in place a substantial and well-targeted fiscal package beginning in 2008. As part of the fiscal stimulus, the Chilean government made one-off transfers to the poorest 40 percent in March and August 2009. For the poorest decile, these transfers equaled about two months of income.

Households have incomes that fluctuate across the economic cycle. The government planner in the model is focused on managing fiscal transfers so as to maximize household utility over time. Because of revenue uncertainly, precautionary savings are made in good times to finance transfers to households in bad times. Inequality in household income is critical. Equal incomes means that there is a representative agent that receives average income, whereas inequity introduces a poorer population with less stable marginal utility over time.

Incorporating heterogeneity in household income introduces an important role for targeting in the context of fiscal policy. With no targeting, an optimal policy rule would be more expensive in bad times because spending would need to be higher to receive the same level of welfare compared to a situation where transfers can be targeted to the needy. Conversely, the greater the possibility to target the poor in bad times, then the lower the amount of government spending that is required. The larger and more volatile the fiscal revenues, the higher are the welfare gains associated with adopting an optimal "social needs" rule over a balanced budget (BB) expenditure. Welfare gains are greater the better is targeting in bad times, but they are smaller when there is no heterogeneity between household income levels.

A calibration of the model for Chile suggests that the government should spend 100 percent of revenues in very low revenue states, but less that 100 percent even in slightly below-the-mean states (due to the precautionary saving motives). Around 80 percent should be saved in the most favorable states.

Source: Engel, Nielsen, and Valdés 2010.

147. Sub-national savings mechanism could be used to put away resources during good times so that procyclical spending cuts could be avoided in economic downturns. Local governments could consider setting up "Rainy Day" Funds such as those that many States have put in place in the United States. These types of funds are, however, more likely to be suitable for larger sub-national governments such as republican cities or planning regions, rather than municipalities. Local governments have the advantage that—unlike line ministries that must return unused funds—they are permitted to keep budget underruns.

148. There is some evidence that the intergovernmental financial system in Latvia could improve incentives for rationing services. For example, (as discussed in Chapter 5 of Volume 2 on education) there is a lack of incentives to close under-enrolled classrooms or schools. Administrative cost data also points to a large variance in its share of overall spending across local governments. Data on individual

salaries in the public sector for 2009 was leaked in 2010 and showed that salaries in local government were often higher than those in the private sector and that there existed considerable differences in salaries between local governments as well as within individual local governments.

149. How can efficiency be protected? Over the past decades, numerous methods have been tried. These range from using performance data to inform budgetary decisions, and setting service standards, to adopting innovative ways to deliver services in small-scale service delivery mechanisms. Latvia is moving to further increase transparency, and accountability for the use of local budgets and local public resources. One step in this direction is the intention to publish salaries and wages of local government employees. A restriction on the holding of multiple local government salaried posts could also be considered.

150. There is no tradition in Latvia of analyzing local government budgets, to compare and explain local government budget indicators. Negotiations, discussions on local government finance issues usually are based on fragmentary budget information, not on a more complete analysis. Therefore, it would be useful to have regular monitoring and analysis of the budget performance of local governments, including designing input, intermediate and output performance indicators for budget programs and making such indicators publically available. Such a benchmarking process may be a useful tool for increasing innovation and peer learning among republican cities and municipalities with regard to service provision.

151. The Ontario Municipal Benchmarking Initiative (OMBI) is one such benchmarking exercise that resulted from a voluntary imitative established by the Ontario Ministry of Municipal Affairs and Housing (Canada), regional chief administrative officers from across the province and 15 municipalities in 2000. The aim of the initiative was for municipalities to work together to share performance information and identify operational good practice. This involved developing, collecting and making publicly available data on input and output indicators by municipality. In Box 2 below, one example of benchmarks is given for social assistance from the OMBI. The aim of this benchmarking was to assist municipalities to assess their relative performance; identify areas where service improvements or costs savings could be made; assess improvements over time; and share ideas on new processes and solutions to better use available resources. As such, the OMBI benchmarking was not designed to be a punitive process to be used to penalize low-performing municipalities, but rather one to encourage collaboration and peer learning. The idea was that this data would be a foundation for more detailed analysis of service delivery and lead to the identification of good practices that would be applicable across municipalities (OMBI, 2008).

152. The 2008 report by OMBI identifies a number of benefits that have resulted from the benchmarking process, including improvements in service performance that came following the setting of targets, the shift of focus to results and the increased accountability that municipal reporting brought, as well as the identification and study of numerous best practices in Ontario municipalities in different service areas. Of course, there are costs attached to benchmarking. The collecting and collating of data and participation in benchmarking activities across municipalities involves financial investment and staff time. This staff effort typically involves service experts, an overstretched and scarce resource for many municipalities. The strong media interest in the benchmarking results that has developed makes the process politically difficult to manage for low performers. Some participants in OMBI have viewed it as of limited use as it fosters an environment where the only factor of a service that counts is cost. The

concern is that this spurs on a "race to the bottom" in cost terms, with little focus on service quality (Graham 2007). There have been some examples where information generated by the process is only used when it is negative (Graham 2007).

Box 1.4: Ontario Municipal Benchmarking Initiative 2008: Benchmarking Social Assistance Services

In measuring budget input and outputs, the process takes into account that each municipality's results are influenced to varying degrees by a number of factors, including:

- Participant readiness for work, literacy level, language skills, and lack of Canadian work experience can impact the ability to find work;
- Health barriers to employment may vary across client profiles;
- Client access to programs can vary due to geographical, technological, cultural or other limitations;
- Differing local labor market conditions; and
- Family size and caseload mix.

Social Assistance Benchmarks Compared Across Municipalities

1. How long does it take to determine client eligibility?
   How long it takes -on average- to determine if someone is eligible for assistance after receiving their request for help, in days. These figures show whether the response time for municipalities has been improving.

2. How many households are receiving social assistance?
   The number of cases is one indicator of the level of service required in a municipality. It also provides an indication of the economic and social well-being of a community. Caseloads directly influence the overall cost of service delivery.

3. What percentage of clients received assistance for less than 12 months?
   Of course, clients with more complex needs (i.e., severe health conditions) may require social assistance for a longer period.

4. What is the average length of time that clients receive social assistance?

5. How much does it cost to provide social assistance services?
   Cost measured as:
   (a) Monthly Social Assistance Administration Cost per Case. Administration cost represents the average cost to deliver and administer the social assistance programs and services. Administration cost per case can be influenced by the caseload size and demographics, services provided and local labor costs.
   (b) Monthly Social Assistance Benefit Cost per Case. The benefits cost represents the average cost of benefits paid to a social assistance client. The benefit cost per case can vary based on the caseload mix (single or family) and the types of benefits required.
   (c) Monthly Social Assistance Total Cost per Case.
   The trend over time is of interest here.

Source: http://www.ombi.ca/charter.asp

153. The chapter on municipal finance in Volume 2 of the PER makes several suggestions for improving the efficiency, equity and predictability of the municipal revenue and spending. The discussion and suggestions are general in character, and require refinement to take account of the political complexities of Latvia's administrative structure. However, the discussion in the PER is of core importance to any attempts to sustainably improve the performance social policy in Latvia, as discussed in the other chapters of this review. Local government expenditure has a substantial social sector element, and the activities financed from social sector budgets are in most cases, those that benefit households most directly.