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REPORT ON THE OBSERVANCE OF STANDARDS AND CODES (ROSC)

Latvia

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I. Fiscal Transparency

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I. Fiscal Transparency

Prepared by the Fiscal Affairs Department

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Executive Summary

This report provides an assessment of fiscal transparency practices in the Republic of Latvia in relation to the requirements of the IMF *Code of Good Practices on Fiscal Transparency—Declaration on Principles* based on the authorities' response to the IMF fiscal transparency questionnaire and other documents provided by the authorities.

Latvia has achieved many of the basic requirements of fiscal transparency and has identified important steps for further improvement. Among the group of economies in transition, Latvia has been one of the leaders in adopting improved accounting and fiscal practices, and in providing financial markets with relevant information on fiscal activities.

Further efforts to improve transparency are underway, particularly with regard to the need to deepen the fiscal management system by implementing better definitions of government and a clear definition of medium- and long-term policies and plans. The staff also suggested improvements in public information, and the importance of consolidating current reforms, particularly with regard to improvements in the budgeting and accounting framework of public agencies.

Abbreviations and Acronyms

BOL	Bank of Latvia
BFI	Budget-financed institution

CPC	Corruption Prevention Council
CSB	Central Statistical Bureau
ESA	European System of Accounts
EU	European Union
GFS	Government Finance Statistics
LPA	Latvian Privatization Agency
MOF	Ministry of Finance
PSAL	Programmatic Structural Adjustment Loan (World Bank)
OECD	Organization for Economic Cooperation and Development
ROSC	Report on the Observance of Standards and Codes
SAO	State Audit Office
SDDS	Special Data Dissemination Standard
SNA	System of National Accounts
SRS	State Revenue Service

I. Introduction¹

1. This Report on the Observance of Standards and Codes (ROSC) module provides an assessment of fiscal transparency practices in Latvia against the requirements of the IMF *Code of Good Practices on Fiscal Transparency—Declaration on Principles*. The assessment has two parts. The first part is a description of practice, prepared by the IMF staff on the basis of a questionnaire response and additional information provided by the authorities. The second part is an IMF staff commentary on fiscal transparency in Latvia.

II. Description of Practice

A. Clarity of Roles and Responsibilities

2. **General government is defined according to international statistical principles, but some government functions and modalities need further clarification.** The role and responsibilities of government for fiscal activity are described in legislation including the Constitution of the Republic of Latvia.² Broadly, the concept of general government corresponds to international statistical definitions (e.g., GFS or SNA), but the boundaries between noncommercial, supportive activities of government and the operations of the market economy need clearer definition, in particular with respect to government agencies. Many government agencies have been created in recent years as a means of executing government policies. Such a separation of policy implementation from policy formulation can, in principle, lead to greater clarity and accountability. However, the proliferation of agencies in recent years in Latvia, without adequate criteria to define their functions or limit their operations,³ has had a contrary result in some instances and has made budgetary control more difficult. To address these issues, the government is preparing a stronger legal framework to govern agencies and to integrate them into the budgetary process. A law on public sector agencies, which defines the financial and accounting framework for agencies, is expected to be enacted in March 2001. Further work is required to establish detailed regulations to define the types of agency that can be created and the procedures for their creation, and there is a need to take strong administrative action to ensure that the cost of activities of all agencies are incorporated in the central and local budgets (see further discussion below).⁴

3. Privatization is now being carried out more transparently than in the past, but continued monitoring is needed to ensure transparency of procedures and use of privatization receipts. Most commercial and banking operations have been or are being privatized.⁵ The Latvian Privatization Agency (LPA) was created in 1994⁶ to improve accountability and focus of the government's privatization program, which had previously been carried out in a decentralized way by individual ministries. The LPA, while experiencing some difficulties, has been largely successful in achieving these objectives.⁷ During its six years of existence, more than 1,000 companies and properties have been privatized and public offerings of shares have been taken up for 85 formerly government-owned companies. The LPA has made considerable efforts to keep the general public, the legislature, and the government informed on how, to whom, and under what conditions state property is being sold. More recently, it has also reduced possibilities of political interference by relying on reputable financial advisors to help steer divestiture and by opening the process to independent scrutiny. It is highly desirable that this level of transparency be maintained until privatization is complete. However, the LPA's operations have been extended, mainly through decisions of the Cabinet of Ministers, beyond management of privatization. It carries out a significant social role in spending for social tax and salaries of laid-off workers and has extended support to enterprises that were under short-term financial difficulties, and was used to carry out spending outside the budget.⁸ There is a need to avoid recurrence of such activities, which reduce budget transparency and aggregate control.

4. Some off-budget and quasi-fiscal activities are identified and are being reduced, but these steps are not explicitly linked to the budget process or documents. As part of the program of reform leading to EU accession, Latvia has initiated measures to identify all forms of state aid⁹ to enterprises with a view to ensuring that state aid conforms to EU limits on such activities. The *Law On Control of the State and Local Government Aid to Entrepreneurial Activity* adopted on February 1998 establishes a framework for controlling state aid. This law is implemented by the State Aid Surveillance Commission, under the chairmanship of the Ministry of Finance (MOF), which has the authority to receive all necessary information from government institutions to identify state aid activities and ensure compatibility with the law. The current process does not, however, cover all forms of off-budget activity and the information that is available is not systematically linked to the budget. All activities that provide assistance to investment or regional development outside the budget process should be fully scrutinized and costs and potential costs to the budget estimated and reported with the budget presentation. The transparency of on-budget assistance to investment and regional development should receive similar attention.

5. The Bank of Latvia (BOL) is independent and generally does not carry out quasi-fiscal activities. The BOL (see <http://www.bank.lv>) is guaranteed independence by law¹⁰ and operates in practice independently of the government. It acts as the government's fiscal agent in sale of securities, but does not have the right to purchase government securities on the primary market. Its purchases of securities in practice have generally been confined to monetary purposes, but these practices may benefit from periodic review. Credit to financial institutions is provided on a strict market basis. Responses to banking crises have been largely addressed by enhancing bank supervision and bringing the prudential framework close to international standards (such as the Basle Core Principles).¹¹

6. Government regulation of the nonbank private sector has been complex, but measures to reduce discrimination and corruption are being taken. The regulatory system (for example, customs procedures, visa and work permit regulations, and issuance of construction permits) for private enterprise has been recognized as being in need of reform and steps are being taken toward this end under the public administration reform

program being supported by World Bank programmatic structural adjustment loans (PSALs).¹² Reform of the regulatory framework is complex and requires the development of systematic methods for evaluating existing regulations and new proposals.

7. Government equity holding is limited but not systematically reported. Government equity in the private sector consists mainly of residual holdings in privatized enterprises. As discussed below (paragraph 17), there is no systematic reporting of government financial assets.

8. Roles of the executive, legislative, and judicial branches are clear, but some aspects require further refinement. The basic roles of the different branches of government are well understood and established in the constitution. Some areas, such as the role of the Saeima in reviewing State Audit Office (SAO) reports, need to be strengthened (see further discussion of SAO below). The role of the judiciary is generally recognized as requiring strengthening to ensure its independence from political processes.

9. Mechanisms governing intergovernmental fiscal relationships have been established, but further development of fiscal responsibilities at local and regional levels is needed. Fiscal relationships between national and local governments¹³ are largely defined in the *Law on Local Government Budgets* of April 1995, the *Law on Equalization of Local Government Finances*, and the *Law on Budget and Financial Management* of March 1994 (or as subsequently amended in each case).¹⁴ However, there is continuing debate on the role of regional administration vis-à-vis the state, and the need to rationalize and strengthen local administration is recognized. Revenue and expenditure assignments to local authorities are specified under the self-government law. There is a substantial vertical imbalance (shared taxes and intergovernmental transfers accounted for 77 percent of local government revenue in 1998) and local sources of revenue are inadequate for the towns and pagasts with lower revenue-raising capacities to meet expenditure needs. The gap in local financing for less well-off municipalities is closed through an Equalization Fund that is financed through contributions from richer councils and the central government.¹⁵ The mechanism achieves its objectives and shows clearly the relative contributions to equalization, but the formula used is complex and it is recognized that the longer-term objectives for establishing local fiscal sustainability require further clarification. In this context, the authorities are exploring mechanisms to amalgamate smaller councils and/or to establish a regional administration based on a smaller number of regions.

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

11. The legal and administrative framework for fiscal management is clear in most respects, but its coverage requires further strengthening. The *Law on Budget and Financial Management* provides clear guidance on most aspects of budget management for

both levels of government consistent with the general principles of legal appropriation given in the constitution. It was originally constructed to include all formerly extrabudgetary operations within the budget framework as special funds. However, excessive creation of special funds and earmarking of revenues within this framework has reduced transparency of the budget and fungibility of resources—and hence fiscal policy flexibility, but measures are being taken to reduce special fund operations.¹⁶ Creation of agencies, as noted earlier, also gave rise to problems of coverage and control, but these problems are being addressed through the introduction of the law on public agencies. Implementation of this law will pose practical difficulties, but in principle, should allow a comprehensive and clear presentation of central government fiscal activity. It is essential, from this point of view, that action is taken to ensure that all agencies financed directly by the budget and included as budget-financed institutions (BFIs) comply with budget procedures and treasury monthly reporting requirements. Similar problems exist and are being addressed for local budgets. The practical problems of implementation are more intractable at the local level because of the large numbers of small units—many with limited administrative capacity. A sustained effort will, therefore, be required to achieve reliable coverage of general government.

12. Coordination of the budget with fiscal and economic policy needs improvement.

Greater clarity is required in defining the roles of the State Chancellery, the Public Administration Reform Bureau, the Ministry of Economy, and the MOF in coordinating government and legislative formulation of policies and budget planning. Separation of recurrent budget management (by the MOF) and investment budget planning by the Ministry of Economy, make it difficult to budget for recurrent costs of investments, particularly over the medium term. The role of the Ministry of Economy in recommending foreign investment projects that can claim tax breaks under the corporate income tax law or otherwise attracting investment funds through concessionary arrangements also needs to be clearly defined and coordinated with budget decision-making, given the fiscal implications of such decisions.¹⁷ Many of these issues can be addressed in the context of a medium-term budget-planning framework (see paragraph 22 below), and development of such a framework constitutes an important element of the public administration reforms being supported by the EU and the World Bank.

13. Tax laws and administration are being streamlined. As part of the anticorruption effort, tax laws¹⁸ are being streamlined and simplified to reduce exemptions and establish a more effective appeals mechanisms as part of the action plan to improve the business environment (see above), as well as to align with requirements for EU accession.¹⁹ For similar reasons, a tax administration manual is being developed to reduce discretion and regional variation in application of tax laws. The State Revenue Service (SRS) is taking steps to improve taxpayer's services and rights.²⁰ The appeal process has now been fully separated from the audit process and more effort is being made to improve publications and information available to taxpayers, with an emphasis on ensuring uniformity among regions. Internal audit is being strengthened through twinning arrangements with the EU. Observation of tax law is limited in part by a lack of capacity within the court system to adjudicate cases in a timely and effective manner.

14. Ethical standards are set for public officials, but implementation requires strengthening. Corruption has been recognized by the authorities as a serious problem arising from the transition process.²¹ The *Law on Prevention of Corruption* of September 1995 sets broad ethical standards for public officials, covering all elected officials, parliamentarians, statutory appointees, and civil servants, including, under specified conditions, relatives and former public officials. It prohibits activities that may generate conflict of interest and requires a declaration of income and assets. Recent

amendments to the law make illicit enrichment an offence. An interministerial Corruption Prevention Council (CPC), chaired by the Minister of Justice, is responsible for overseeing implementation of the program and its further elaboration.²² More work is needed, however, to implement these measures. An Anticorruption Unit, formed within the SRS to help implement the income and asset declaration process, has been set up. Because of its lack of investigative powers, the unit is not yet operating effectively with regard to verifying the legitimacy of public officials' income; in other respects the unit is helping to increase openness with regard to activities of public officials. Consideration is being given to creating an Anticorruption Bureau with executive powers under the Ministry of Justice, replacing the Executive Secretariat of the CPC and absorbing the SRS anticorruption unit.

B. Public Availability of Information

15. The budget documents provide a clear and detailed explanation of the state budget revenues and expenditure, but further strengthening is required on financing and general government data. State budget estimates are clear and detailed with satisfactory supporting documents to explain the annual estimates of expenditure and revenue.²³ The estimated outturn for the previous year and actual outturns for the two preceding years are provided. As discussed further below, estimates for future years are provided by ministries in the course of budget preparation, but, except for military spending,²⁴ the budget documents do not yet include estimates of spending beyond the budget year. A summary of the consolidated general government expenditure, revenue, and the overall balance is included in the *National Budget* summary document. Information and analysis of sources of financing the deficit/surplus, however, are not provided in the budget documents for either central or consolidated general government. Data on financing is provided in the treasury monthly reports, but these are not reconciled with the BOL data. As noted, fiscal activities carried out by agencies at central and local level are not yet fully covered. Given the expected delay in passage of the required legislation, administrative action to include these in future budgets and within-year reports would be highly desirable.

16. Some data are collected and reported on contingent liabilities, tax expenditures, and quasi-fiscal activities, but these are not yet systematically integrated with the budget or accounting reports. The annual budget sets an overall ceiling on government borrowing and guarantees and an annex giving these limits for central and local borrowing and issuance of guarantees is included in the annual budget. The state treasury includes aggregate data on government guarantees issued by central government and local government in its monthly treasury report. In addition to guarantees, this report should aim to disclose all forms of contingent liability arising from government transactions.²⁵ Data on state aid to enterprise, covering a range of guarantees, tax expenditures, and quasi-fiscal activities, is collected and published by the State Aid Surveillance Commission each year. The Commission produces an annual report to the European Commission that is available to the public. As yet, this process is not linked to the budget and it does not cover the full range of subsidies, tax expenditure, or quasi-fiscal activities carried out by the government. It has, however, established a process of analysis and reporting that could be developed and applied as part of the annual budget. The annual budget makes only a small provision for contingencies that may be called, giving rise to possible recourse to supplementary budgets during the year to meet such expenses.

17. Information on public debt is published regularly, but there is no systematic reporting on financial assets. The monthly report of the state treasury provides up-to-date data on public debt and guarantees issued. A summary of government securities issued to date is also provided in the MOF's monthly publication *Survey of the State Budget* (which is available in English). Both publications are available through the MOF's website

(<http://www.fm.gov.lv>). Debt data is also available from the BOL and the Central Statistical Bureau (CSB) of Latvia monthly publication *Monthly Bulletin of Latvian Statistics*. Latvia subscribes to the IMF Special Data Dissemination Standard (SDDS) and meets these requirements with respect to debt reporting.²⁶

18. Formal commitments for regular publication of fiscal data on general government operations are made by law and through subscription to the SDDS

(<http://dsbb.imf.org>). The *Law on Budget and Financial Management* prescribes clear times for auditing and publishing final accounts. SDDS requirements for a monthly report and an advance release date calendar are met.²⁷

C. Open Budget Preparation, Execution, and Reporting

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

20. Budget classification is consistent with current GFS principles. The broad principles of GFS 86 have been used for central government classification, but (quite appropriately) privatization receipts are shown as financing rather than as revenue in deriving the fiscal balance. The classification will be modified and aligned with the European System of Accounts (ESA 95) standards—which are very similar to the forthcoming revision of GFS.

21. Estimates of ongoing costs of government policies are distinguished in budget preparation, but are not presented separately in the budget documents. In preparing the annual budget, estimates of future year costs are provided by ministries to the MOF, but no forecasts of existing policy costs are projected in the budget documents. Annual budget estimates are on a cash-limit basis with no latitude for price changes during the year, and no price change assumptions are applied to the forward estimates of ministries.

22. Medium-term fiscal planning is at an early stage of development. Preparation of a medium-term macroeconomic framework and fiscal projections is underway as part of the requirements for EU accession.²⁸ It is recognized, however, that practical implementation of a medium-term framework will take some time and will require close cooperation among the central agencies of government as well as a disciplined process of policy review and priority setting by the government and the Saeima. Improvements are needed in improving transparency and accountability of fiscal policy goals,²⁹ establishing open processes of review and costing of existing and new policies, and establishing an open process for government priority setting. Some steps are being taken toward establishing a framework for these processes, but responsibilities for action among the key central agencies of government require further clarification.³⁰

23. Fiscal sustainability issues are not clearly examined or reported in the budget process. The budget documents include documentation of long-term liabilities, but this has

not been developed sufficiently to provide the basis for an effective assessment of the sustainability of current policies. Long-term liabilities of pension schemes are not shown in the budget and the implications for the long-term position of the special fund for social insurance of changes introduced each year are not indicated, despite the fact that these projections are produced by the Ministry of Welfare.

24. No formal analysis is undertaken of sensitivity of the estimates to changes in economic assumptions or of aggregate fiscal risks. The budget supporting documents provide an economic background and a discussion of major macroeconomic risks. The discussion, however, does not include analyses of the fiscal position relative to the economic cycle and fiscal risks arising from changes in key economic parameters (such as interest rate or rate of economic growth) on the fiscal outcome. The aggregate risk from contingent liabilities is not assessed, although risk assessment is carried out for individual guarantees issued by the central government.

25. Accounting reports are timely and reconciled effectively with bank accounts, but further action could be taken to extend reconciliation and make accounting practices and policies clear to the public. Monthly reports covering general government are published not later than 18 days after month-end. Year-end reports are submitted to the SAO by May 31 each year, as required by law. Reconciliation of treasury ledgers with the treasury single account at the BOL is undertaken daily and reconciliation details are prepared at period-end. Issues that have arisen regarding differing interpretations of government institutions have been resolved. A full reconciliation with the BOL sources of financing (covering both deposits and securities) is done, and highlighted in the report. Some improvements could be made in updating reports to show data revisions from previous months. For reasons outlined earlier, it will take longer to establish effective procedures for local governments. Accounting is on a cash basis, but consideration is being given to move toward accrual accounting. No statement is given of accounting policies in the budget or final accounts document.

26. Internal control procedures are in place and are being strengthened. Effective compliance controls over budget execution are in place for all transactions in the state budget. The state treasury ensures that all spending under its control is properly authorized and that funds are available. The budget department controls budget revision, and supplementary budgets are used infrequently.³¹ Internal control structures had been allowed to lapse in the early 1990s and are being reintroduced with an overall emphasis on systems management as well as compliance and regularity audit. Overall coordination is provided by the Internal Audit Department (8 persons) of the MOF and an Internal Audit Council, which is made up of professionals drawn from outside the government sector who are appointed for five-year terms by the cabinet on the recommendation of the MOF. Internal audit units have been set up for each ministry and subordinate institution. Heads of units are appointed by the state secretary of the ministry or institution head and the units report in the first instance to the state secretary. Reports and audit information compiled by the units are made available to the SAO and end-year reports are submitted to the council. The first such report is being compiled for FY 2000. Technical assistance for internal auditing is being provided by the EU.

27. Transparency and structure of civil service pay and employment practices are being improved. The current pay system relies heavily on ad hoc bonuses to supplement base pay and there are a variety of systems in use. A unified and broad-banded pay scale is being developed, along with standard job descriptions and performance evaluation procedures as part of the public administration reform supported by the World Bank PSAL.³²

28. Public procurement legislation and observation of regulations are being strengthened. A 1999 SAO audit observed many systematic breaches of procurement procedures. Legal requirements were not met in awarding contracts; unjustified advance payments were made for works, supplies; financial resources were not spent according to the approved cost estimate. A new law *On Public Procurement* has been prepared and is expected to be in place early in 2001. Support for strengthening the Public Procurement Department of the MOF is to be provided by the EU. This support will be important given the challenges associated with strengthening procurement practices for subnational governments to support the anticipated increase in funds flowing to these levels of government, particularly from the EU.

29. Defense expenditures are included in the budget. Military spending is shown in full in the budget. There are provisions in the budget management law to ensure that "secret spending" is scrutinized and audited under special procedures.

D. Independent Assurances of Integrity

30. The SAO has the legal authority to carry out independent audit of government activity, but issues of resource constraints and effectiveness of follow-up need to be addressed. The *Law on the State Audit Office* of October 1993 (as amended) is the basis for the present structure and operations of the SAO. Under the law, the Auditor-General (head of the SAO) is given independence from the government by being elected by the Saeima for a seven-year term and reporting directly to the Saeima. However, budgetary considerations are dealt with in the same way as government departments. The Auditor-General has the right to attend cabinet meetings in the capacity of an advisor and SAO officers may attend government meetings at which economic matters are discussed. A Council of the SAO, comprising six members appointed by the Saeima (also for a seven-year term) and the Auditor-General, reviews the work of the SAO and examines complaints. Decisions by the Council may be appealed to the Senate of the Supreme Court. The mandate of the SAO covers all state and local government institutions and permits broad value for money audit. The first priority, however, is to establish effective financial and regularity audit. Assistance has been given by OECD/SIGMA in this task and the work of the SAO was favorably reviewed by SIGMA experts. SAO reports have identified a wide range of systematic breaches of procedure (including some aspects of the LPA operations). These findings are made public, but an effective mechanism for follow-up has yet to be established. The capacity of the SAO to carry out its mandate with respect to agencies and 578 local councils also needs to be examined. The SAO will submit the draft law "*On the State Audit*" to parliament before July 1, 2001 to fully comply with the legal system of the EU.

31. Macroeconomic assumptions are described in summary, and the methodology is open to limited external scrutiny. Summaries of assumptions appear publicly in the budget documents, but there is neither systematic external scrutiny nor use of independent forecasts. Before the 2001 Budget, however, a meeting, attended by representatives from a range of public and financial institutions was arranged to discuss the macroeconomic scenario. The forecasts are discussed extensively internally. A draft macroeconomic scenario is prepared jointly by the MOF, the Ministry of Economy, and the BOL and submitted to the Cabinet of Ministers.

32. The national statistics office has legislative assurance of independence. The *Law on State Statistics of the Republic of Latvia* of November 1997 (as amended) provides legal authority to the CSB to determine statistical techniques and authority to collect required data. The CSB provides a wide array of economic and social statistics that are well publicized and readily available to the public (<http://www.csb.lv>). Fiscal statistics are drawn directly from treasury reports and are published with a relatively small time lag in the *Monthly Bulletin of Latvian Statistics* (in Latvian and English).

III. IMF Staff Commentary

33. Latvia has achieved many of the basic requirements of fiscal transparency and has identified important steps for further improvement. Among the economies in transition, Latvia has been one of the leaders in adopting improved accounting and fiscal management practices and in providing the financial markets with relevant information on fiscal activities. In particular, the state treasury has established an accounting and reporting system that is widely recognized as being effective and reliable and the budget process is open and soundly based on a macroeconomic framework and reliable estimates of expenditure and revenue. The authorities have recognized the limitations of the present budget and treasury coverage and the need to extend budget analysis beyond a single year, and are taking steps toward more comprehensive public administration reforms with EU, international financial institutions, and bilateral support. Participation in this fiscal ROSC has identified specific areas where improvements in fiscal transparency are needed.

34. The ROSC gives a benchmark for future assessments and should help in assigning priorities in the public administration reform process. Possible improvements can be considered in three broad areas: (i) consolidation of current reforms; (ii) immediate improvements in public information; and (iii) deepening of the fiscal management system by better definition of government tasks and a clear definition of medium- and long-term policies and plans. A considerable amount of information is already collected as part of the budget process, but is not used systematically and is not presented clearly to the public. Substantial improvements can thus be achieved in a number of aspects of fiscal transparency with relatively little additional effort. Efforts to deepen the system are already underway through the programs of public administration reform supported by several international or bilateral agencies. These will take some time to achieve their goals in full, but the objective of improving fiscal transparency can be used to help guide the overall effort and to monitor progress systematically.

35. An immediate priority is that public agency reforms be firmly consolidated and transparency of the privatization process be maintained. For the public agency law to be effective, immediate work is required to implement the accounting and budgeting framework for agencies and to establish regulations with clear criteria and disciplined procedures for establishing agencies within general government. The following activities should be given a high priority:

- requirements for all BFI to transfer accounts to the state treasury and comply with monthly reporting should be strictly enforced and put in place by mid-2001;
- regulations establishing clear criteria and disciplined procedures for creation of agencies operating as BFIs should be drafted and be available for operation as soon as the law on public agencies is in force; and
- continuing transparency of the privatization process until the program is completed should be firmly guaranteed by the government, whether under the LPA or an alternative arrangement.

36. A number of basic improvements can be made to the presentation of budget and accounts information. A number of weaknesses in the presentation of fiscal data have been noted. Many require only moderate changes to monthly fiscal reports and annual budget and accounts documents, and significant progress could be expected in all of the following areas for the FY 2002 Budget:

- Financing information should be provided in the budget documents together with an analysis of sources of financing. This presentation will provide a more complete picture of

- the fiscal position and provide a better basis for monthly reporting by the state treasury.
- Annexes covering contingent liabilities, tax expenditures, and quasi-fiscal activities should be provided as part of the budget documents. Data already collected by the State Aid Surveillance Commission from various sources, together with other data on tax expenditures and state treasury records of contingent liabilities, should be consolidated and made more comprehensive, used in budget decision-making, and presented in the budget documents.
 - Emphasis should be given immediately to reporting of potential budget and off-budget costs of measures currently being considered to encourage foreign investment.
 - A more comprehensive presentation of forecasting assumptions and fiscal risks (drawing from both macroeconomic analysis and a review of contingent liabilities) should be provided in the budget supporting documents. The methodology for forecasting should be developed to incorporate sensitivity analysis and fully explained in the budget documents. External scrutiny of forecasts should be encouraged.
 - All financial assets held by government and new acquisitions or dispositions should be compiled by the state treasury and reported at least in the final accounts of the state budget.
 - A statement of accounting policies should be included in the final accounts report of the state treasury.
 - The annex on long-term liabilities included in the budget document should be progressively developed to give comprehensive quantitative information. Specifically, information on pension liabilities and expected revenue flows should be included for information purposes.³³

37. Three aspects of transparency need emphasis in implementing longer-term public administration improvements: (i) defining the tasks of central agencies and government in developing a medium- and long-term fiscal framework; (ii) protecting data quality by strengthening internal and external control processes; and (iii) defining long-term fiscal goals for local government. The first of these is most critical to meeting immediate needs for EU accession; the other two need sustained attention over the longer term.

38. Defining central agencies' roles more clearly is essential for establishing a medium-term budget framework. A disciplined process for establishing medium-term priorities and plans is an essential basis for the Pre-Accession Economic Program, and the need for "horizontal" coordination among government agencies to achieve this objective has been recognized. The precise tasks of each agency and a mechanism for overall government coordination have yet to be defined clearly, however. The following is suggested as a basis for meeting these requirements:

- The MOF should take the technical lead in developing a medium-term macroeconomic framework for the development plan and a clear medium-term costing of the "existing funded policies of government"³⁴ (baseline forecast).
- The processes of "zero-base" and "fundamental" reviews of selected programs, being carried out under the leadership of the State Chancellery, should be integrated with the MOF baseline forecast.
- Ministries should be asked to make budget submissions on new policies—including unfunded policies under current legislation—and a **Budget Working Group** should be established by the key central agencies³⁵ to evaluate all new policies and make

recommendations to **cabinet**. It is essential that new policies should encompass both investment and recurrent spending and close coordination between the Ministry of Economy and the MOF will be required on this aspect. The MOF should give clear directions to ministries on likely resource availability for such policies.

- A **Budget Priorities Committee of the Cabinet of Ministers** should be established to review the Budget Working Group recommendations and present the medium-term budget to the full cabinet.
- All new laws introduced by the government should be accompanied by detailed costing of its budgetary implications³⁶ and other costs and should be subject to review by the MOF before being approved by cabinet. Actual funding for such legislation in the budget, however, can only occur through the budget process.
- New legislation with long-term implications, such as amendments to pension legislation, should be examined in the context of their expected impact on government balances over the long term. This information should be published with the budget.

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

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

40. Subnational government responsibilities and financing should be extensively reviewed and objectives for long-term fiscal viability of local government clearly defined. The future shape of subnational government is already under review. Transparency of this process would be significantly enhanced by clearly defining the government's aims to establish fiscal viability for subnational governments over the long term, covering the appropriate revenue base, expenditure responsibilities relative to that base, and possible rights to borrow directly from the market in the context of a strong mechanism to ensure continued aggregate control.

¹ The report was prepared by a mission headed by Mr. William Allan, Senior Economist, FAD, and incorporates comments from EU2, PDR, and FAD.

² The constitution gives only broad guidance, particularly Article 66, with more specific definition in the *Law on Budget and Financial Management* of 1994 (as amended).

³ In Latvia, there are currently three kinds of budget institution: (i) subordinate; (ii) supervised; and (iii) agencies under ministerial management. Only the first two are integrated into the budget and treasury accounts-steps are

underway to integrate the agencies with the budget (see below). The only legal framework for agencies at present is the private sector joint stock or limited liability company legislation-which leads to confusion between private and public sector operations. The Latvian model has some similarities to that practiced by Sweden for over a century and to modern management practices elsewhere; up until recently, however, its primary driving force has been a reaction against low civil service pay and centralized regulation.

⁴ A broader administrative framework law has been prepared and discussed by the Saeima (parliament), but further drafting and a broadening of the scope of this law is now underway.

⁵ Remaining majority-owned public enterprises slated for privatization include Latvenergo; Latvian Shipping Company; and Lattelekom. The government also intends to divest its remaining 43 percent stake in Ventspils Nafta oil terminal. An additional 50 organizations, which are presently regarded as mainly governmental, have been excluded from the privatization process. These include regional road maintenance units; agricultural units (research stations and laboratories); culturally oriented entities; strategic enterprise units (ports, postal service, railway company).

⁶ Procedures for privatization are regulated by the *Law On Privatization of State and Municipal Asset Units* of February 17, 1994.

⁷ Although some aspects of its operations have been subject to critical comment by the State Audit Office (SAO).

⁸ In 2000, the cabinet issued resolutions authorizing direct spending of LVL 20 million by the LPA on various activities. It subsequently, however, passed a resolution limiting direct spending by the LPA to legally defined administrative costs and reserve requirements, underlining the importance of a firm delineation of agency operations at the outset.

⁹ The term *state aid* covers any kind of financial assistance provided by state or municipal institutions directly or indirectly with an aim of increasing the competitiveness of an enterprise or group of enterprises. The concept covers a range of fiscal, tax expenditure and quasi-fiscal activities, including grants, preferential credits, credit guarantees, and tax exemptions. However, it includes only activities involving a transfer of state resources, conferring an economic advantage to enterprises, applied selectively, and with an appreciable effect on competition and trade.

¹⁰ The *Law on the Bank of Latvia* of May 1992, Article 13, states: "In fulfilling its tasks and performing supervision.... the Bank of Latvia shall not be subject to decisions or regulations adopted by the government in any way."

¹¹ In the wake of the Russian financial crisis, however, the BOL provided LVL 15 million as part of a rescue operation for Rigas Komerc Banka.

¹² Following a report on administrative barriers to investment prepared in 1999 by the Foreign Investment Advisory Service of the World Bank, problems were widely discussed and the government approved an action plan, which is being implemented under the supervision of the Latvian Development Agency. Project reports have recorded significant achievements in improving the business environment by streamlining regulations and removing discretionary powers of officials.

¹³ In Latvia's two-tier system, there are three forms of local self-government by elected councils: republican cities (7), towns (70), and pagasts (rural districts-of which there are 493). Prior to a 1997 amendment of the law, elected councils also operated in a middle tier of rayons (26). These continue to exist to coordinate activities of towns and pagasts but are formed from the elected chairmen of the constituent local self-governments.

¹⁴ Responsibilities of local governments are further defined in the *Law on Self-Governments* of May 1994 (as amended), the *Law on Administrative Territorial Reform* of 1997, and the *Law on Territorial Development Planning* of 1998.

¹⁵ According to World Bank analysis, in 1999, the horizontal contribution from richer councils was four times the vertical contribution from the central government. The 2000 Budget indicated a ratio of local to central contributions to the equalization fund of around 3.6.

¹⁶ In 1999, the share of special budgets in the central state budget was 55.9 percent. This was reduced to 51.6 percent in 2000 by abolition of some special budgets. It should be noted, however, that the special social security budget (covering social funds for pensions, employment, job injury, and handicapped) is a high proportion of special budgets (estimated as 69.5 percent of the total in the FY 2000 Budget).

¹⁷ The Saeima amended the corporate income tax law in November 2000 to provide a 40 percent tax break for 10 years for investments of more than LVL 10 million.

¹⁸ As well as laws covering each tax, the umbrella *Law on Taxes and Fees* of February 1995 (as amended) sets out broad principles for revenue collection. The *Law on State Revenue Service* of October 1993 (as amended) regulates the operations of the SRS.

¹⁹ Exemptions under the corporate tax law (see above) run somewhat counter to this trend, however.

²⁰ The SRS is initiating a modernization program, using consultants from Holland and Germany, which, among

other things, will set up special taxpayer service centres to speed up service to taxpayers and reduce opportunities for corruption.

²¹ Latvia has been characterized by the World Bank (in *Anticorruption in Transition*, World Bank, Washington, 2000) as having a medium level of administrative corruption, but a high level of "state capture," which refers to the actions of individuals or groups to influence formation of laws and policies of government to their own advantage by transfer of illicit benefits.

²² The fiscal ROSC is concerned with ethical standards for civil servants as an element of fiscal transparency. It should be made clear, however, that the Latvian Corruption Prevention Program is aimed at a broad range of activities to strengthen administrative and judicial institutions that go well beyond the scope of this report. These are being supported by the World Bank PSAL.

²³ Budget documents presented each year consist of the *Law on State Budget*, and *Explanations to the Law on State Budget* (in two parts: Part I - Macroeconomic Framework Analysis; and Part II - Details of the Budget-Structure and Expenditures of the Budget). A document detailing changes to other laws (e.g., tax laws) associated with the budget is also presented to the Saeima. After the budget law is approved, it is amended to reflect changes introduced by the Saeima and a summary is produced. All are publicly available. The summary document, *The National Budget* is also available in English.

²⁴ In line with the objective of increasing military spending to 2 percent of GDP, a three-year projection of military spending is shown.

²⁵ Contingent liabilities may also arise from legal action, contractual agreements associated with privatization, or use of derivatives or swap arrangements for financing. Risks and costs associated with all such arrangements should be clearly identified and any contingent liability or risk to the government budget reported.

²⁶ For other aspects of SDDS compliance, see <http://www.imf.org> (Standards & Codes/Data Dissemination).

²⁷ Implementation of the *Law on the Freedom of Information* is an important feature of the World Bank PSAL.

²⁸ Latvia will have to present its Pre-Accession Economic Programme, incorporating a rolling forward program, to the EU in May 2000. Selected components related to EU accession are included in the National Development Plan, a draft of which was approved by the Cabinet of Ministers in October 1999. Annual updates of the National Development Plan are prepared under the direction of the Minister for Cooperation with International Financial Institutions.

²⁹ A very broad statement of government goals is given in the *Declaration on the Intended Activities of the Cabinet of Ministers* (<http://www.mk.gov.lv/eng/cabinetofministers/default.htm>), which defines the tasks of government in each economic sector with the general objective of promoting a market economy. The State Chancellery has been strengthened and given the role of developing a strategy based on these principles and linking strategic plans to the budget in coordination with the MOF.

³⁰ The main bodies involved are the Macroeconomic Department and the Budget Department of the MOF; the Ministry of Economy; the Policy Planning and Coordination Department of the State Chancellery; and the Public Administration Reform Bureau.

³¹ Recently, except for the spending from the LPA receipts in 2000, expenditure has not exceeded authorized limits and supplementary budgets are used sparingly. In FY 1999, the budget authorization was reduced from the original budget in response to reduced revenue.

³² Some elements of the framework have been established under the *Law on State Civil Service* of September 2000, which became effective on January 1, 2001. Implementation of the new pay scale requires adoption of regulations by the cabinet of ministers.

³³ Such data would be provided in line with the government's "stewardship" obligations and would not constitute a legal or policy obligation. Governments providing full accrual balance sheets, such as New Zealand or the United States, also disclose a range of such information to supplement balance sheet information.

³⁴ That is, those policies for which some form of contractual obligation has been established. All other policies, even where laws have been passed, should be considered as unfunded policies. Financing of such policies over the medium-term should be established during the budget process each year.

³⁵ Consisting mainly of the agencies designated in paragraph 22, footnote 25.

³⁶ Cabinet regulations requiring cost estimates of new legislation are already in place (Cabinet Regulation 160 *Internal procedures and activities of the Cabinet of Ministers* of April 30, 1996). These need firmer application in the context of establishing medium-term plans.