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Budgeting in Latvia

by
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At the time of this review, fiscal policy in Latvia was in considerable turmoil as a consequence of the world-wide financial crisis. Thus, some of the usual budget rules and procedures were not followed during budget preparation 2009 and 2010 and budget execution 2009. This review examines the usual budget rules and procedures that were followed until 2008 and also the major institutional revisions that were discussed in 2009. The instability of fiscal policy is a major problem for Latvia and there is an urgent need to bring more stability to the budget process.

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Preface

This review of the budget procedure of the Republic of Latvia was carried out as part of the work programme of the OECD Working Party of Senior Budget Officials. In 2004, the Working Party established in 2004 the Network of Senior Budget Officials of Central, Eastern and South Eastern European (CESEE) countries. Budget reviews of CESEE countries serve as a basis for the examination of a country's budget institutions by the network in its annual meetings, and enable the participants to discuss the budget procedures of a country in depth.

A mission consisting of Dr. Dirk Kraan (Head, OECD), Dr. Joachim Wehner (London School of Economics), Mr. James Sheppard (OECD), Mrs. Valentina Kostyleva (OECD) and Dr. Barbara Duzler (German Technical Cooperation) visited Riga from 11 May to 14 May 2009 to prepare the review. During its visit, the mission met with Mrs. Ilonda Stepanova, Director of the Budget Department, Mrs. Daiga Gulbe, Head of Economic Analysis and Fiscal Policy, Mr. Artis Lapins, Head of the Procurement Monitoring Bureau, Mrs. Inguna Zvane, Director of the Internal Audit Department, and other officials of the Ministry of Finance; Mr. Martins Krievins, Head of the Policy Co-ordination Department, and other officials of the State Chancellery; Mrs. Gunta Medne, Deputy Treasurer of the Republic of Latvia, Mrs. Laila Ruskule, Under State Secretary in financial matters, and other officials of the Ministry of Health; Mr. Mareks Gruskevics, Secretary General, and other officials of the Ministry of Education; Mrs. Sanita Skiltere, Financial and Economic Advisor of the Latvian Association of Municipalities; Mrs. Karina Petersone, Deputy Speaker of the Parliament of the Republic of Latvia; Mr. Guntis Berzins, Chairman of the Budget Committee of the Parliament of the Republic of Latvia;, Mrs. Inguna Sudraba, Auditor General, and other officials of the State Audit Office of the Republic of Latvia; and Mrs. Madara Fridrihsone, financial journalist of *Dienas Bizness*.

The mission is grateful to all these officials and experts for the time they made available to explain to the mission the procedures and practices of the budget process in Latvia and for the informative and clear answers they gave to the questions posed by the members of the mission. OECD budget reviews can only serve their purpose if they are based on accurate information about the decision-making process and the incentives and constraints that determine its outcomes in each of its phases. This information is not always available in official documents. Oral information is then of essential importance. This is true in particular for the present review of Latvia which was drafted in a period of considerable budgetary turbulence. The mission feels that in spite of these somewhat difficult circumstances, it has acquired a fair picture of the Latvian budget process, thanks to the openness and frankness that characterised the discussions with the Latvian officials throughout the mission's visit. The mission expresses its sincere appreciation for the efforts of the Latvian authorities to provide the mission with the information it sought and for their helpful attitude during the meetings.

The mission would like to thank in particular Mrs. Ilonda Stepanova and Mrs. Liga Ozolina for the excellent organisation of the meetings, their help with the collection of documents, and their practical support during the mission's stay in Riga. The review was completed in June 2009.

1. Introduction

1.1. Contents of the review

During the preparation of this budget review, fiscal policy in Latvia was in great turmoil as a consequence of the world-wide financial crisis. The OECD Secretariat felt that this fact in itself was not a reason to abstain from conducting the review or to postpone it. Indeed, OECD budget reviews are not about fiscal policy, but about fiscal or budgetary institutions – that is, the rules, procedures and practices that govern the budget process. However, it cannot be denied that the present turmoil in Latvia has posed certain problems for the choice of contents of this review. First, the institutions that are the normal subject of OECD budget reviews have partly been overridden in Latvia for the formulation and execution stages of the 2009 budget and for the formulation stage of the 2010 budget. Second, it seems highly probable that the present events will have an impact on the rules, procedures and practices of budgeting in Latvia in the sense that these institutions will be revised as a consequence of these events.

Against this background, the approach followed in this review has been as follows. In the sections on budget formulation and budget execution, which are the most affected by the present crisis, the review distinguishes as far as possible between the regular process – which had prevailed in the years since independence until and including the budget year 2008 – and the exceptional course of affairs during the formulation and execution of the 2009 budget and the formulation of the 2010 budget, which broke with some of the institutional constraints that determined the regular process. Furthermore, the review addresses the revision of the rules and procedures that the present crisis will probably induce, and it gives some recommendations in this respect. Finally, the present section pays attention to the institutional arrangement that provides the basis for the fiscal packages agreed since the beginning of 2009.

Apart from the institutional revisions triggered by the present crisis, the contents of the review conform with the usual set-up of OECD budget reviews. Successively, attention is given to the processes of budget formulation, parliamentary budget approval, budget execution, accounting and auditing. A special feature is a separate section devoted to public administration and service delivery. The inclusion of this section was partly inspired by the special efforts that Latvia has made over the past decade to reorganise its central government. In addition, discussions of human resources, procurement and financing of local government find a logical place in that section.

1.2. General characteristics

The Republic of Latvia regained independence in 1991. Latvia is a parliamentary republic. The governance institutions are provided in the Constitution and in legislation. Latvia joined the European Union in 2004. There are two layers of government: the state (central government) and the municipalities (local government). Important organic laws are: the State Administrative Structures Law (2001), the Law on Local Government (1994) and the Law on Budget and Financial Management (1994). The budget process is governed by the Law on Budget and Financial Management both for central and local government.

Latvia is a relatively small European country, the size of Belgium or the Czech Republic. However, its population is only 2.27 million (in 2008). Consequently, like the Nordic and other Baltic countries, it is one of the least densely populated countries in Europe. As a result of emigration, the population has been shrinking (by 10 000 inhabitants in 2008) and this tendency is expected to continue in the coming years (Ministry of Finance, 2008).

In the medium term, the working-age population will decrease, mainly due to a major decrease in the age group 15-24 induced by the low birth rates in the 1990s. However, this will not lead to a decline of the labour supply because of the increase in the age group 25-27 with the high average participation rate of more than 80%. However, with the higher birth rates of the present century and the retirement of the "baby boom" generation, Latvia will experience a serious ageing problem in the longer term, like many European countries (Ministry of Finance, 2008).

The structure of the Latvian economy has been modernised rapidly since independence and is no longer significantly different from western European countries. The services sector accounts for 75% of Latvia's value added (24% financial and business services; 33% trade, transport and hotels; 14% public services; 4% other services). Industry accounts for 14% (mostly food, building materials, wood processing and textiles), construction for 8% and agriculture for 3% (Ministry of Finance, 2008).

Since independence, the economy has been growing at a very high rate. From 2000 to 2007, GDP increased at the annual average rate of 9%, the fastest growth of all EU countries. Rapid growth initially reflected the utilisation of excess capacity dating from before independence and productivity gains from successful reforms. Since EU accession in 2004, growth further accelerated due to the integration of capital and labour markets and EU funds (IMF, 2009a).

Since independence, cheap credit in international capital markets fostered investment. Strong multiplier effects induced steep increases in wages in the domestic labour market. Labour market integration after EU accession further contributed to the rise of wages. Domestic consumption was in turn strongly pushed up by increasing wages and cheap consumer credit. By mid 2006, the economy was overheating, with actual GDP exceeding substantially potential GDP:[1] credit grew at an annualised rate of more than 50%; the current account of the balance of payments increased rapidly (from 12.5% GDP in 2005 to 23.8% in 2007); and gross external debt, mostly of the private sector, rose above 130% of GDP, the highest foreign debt among EU countries (IMF, 2009a, and Ministry of Finance, 2008).

Macroeconomic policy in Latvia is anchored in the maintenance of the exchange rate peg that keeps the currency (the Latvian lat, LVL) at a fixed parity with the euro. This policy implies that volatility in the balance of payments will not be absorbed by exchange rate fluctuations but has to be accommodated by fluctuations of the domestic price level. In the years of strong growth, this induced high inflation in Latvia, increasing from 6.2% to 15.5% in 2008 (average head line[2] consumer prices). The Latvian authorities strongly endorse the maintenance of the peg, with the aim of Latvia entering the euro zone at the earliest possible occasion. Exchange rate stability is obviously an important requirement in this respect (IMF, 2009a).

Beginning in the last quarter of 2007 – well before the financial crisis in international capital markets – domestic demand started to decline, partly in reaction to high consumer debt levels and stagnating real estate prices. Private consumption (one of the main contributors to growth in previous years) started to shrink. Investment started to decline (in constant prices) beginning in 2008, due to business losing optimism and lending becoming more expensive because of rising interest rates in international capital markets (Ministry of Finance, 2008).

In the autumn of 2008, private sector bank deposits fell by 10%, starting with a run on one of the big commercial banks, Parex. Almost 60% of the banking system is owned by banks from Sweden and other Nordic countries, but 40% is domestically owned, Parex bank among them. Parex is the second largest bank in the country. After a first failed attempt to restore confidence by a partial takeover, the bank had to be nationalised almost entirely (85%) and the management had to be replaced. Capital flight led to sizeable interventions on the open money market by the central bank to defend the currency peg. From September to November 2008, official reserves fell by 20% to the dangerously low level of EUR 3.4 billion. Concerns over the sustainability of external debt and the maintenance of the currency peg increased and led to an agreement with the IMF and the EU aimed at financial assistance and implementation of a macroeconomic and fiscal reform programme to restore stability (IMF, 2009a).

The reform programme agreed in January 2009 with the IMF and the EU was designed to adjust the domestic economy to the international economic environment while maintaining the currency peg. Its expected effects include a slowdown of economic growth, a substantial reduction of inflation, an absolute decrease of the wage level, and a substantial reduction of the current account deficit of the balance of payments. According to the interim review of April 2009, these economic indicators had all started to move in the expected directions (IMF, 2009b).

Table 1 shows the development of GDP since 2004 in comparison with the former EU countries (EU15) and the present EU countries (EU27). The estimates for 2009 and 2010 include the effects of the reform programme agreed with the IMF and the EU. The table makes abundantly clear how economic growth in Latvia exceeded by far the EU averages (roughly by a factor of four) in the period up to 2007, whereas now it is shrinking much faster than those countries (by a factor of more than three in 2009).

Table 1. **Real economic growth of the gross domestic product (GDP) of Latvia**

% of GDP

	2004	2005	2006	2007	2008	2009 (forecast)	2010 (forecast)
EU27	2.5	2.0	3.1	2.9	0.9	–4.0	–0.1
EU15	2.3	1.8	2.9	2.7	0.7	–4.0	–0.1
EU12	2.1	1.7	2.9	2.6	0.8	–4.1	–0.2
Latvia	8.7	10.6	12.2	10.0	–4.6	–13.1	–3.2

Sources: Latvia data: Latvian authorities and IMF (2009), “Republic of Latvia: Request for Stand-By Arrangement – Staff Report”, January, International Monetary Fund, Washington DC. EU data: Eurostat.

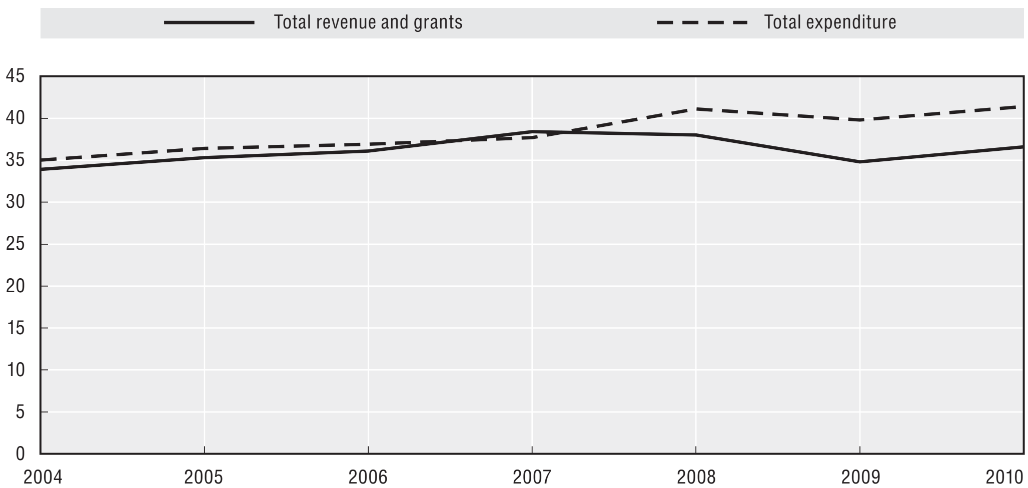
As a consequence of buoyant growth throughout the 1990s and the first half of the present decade, tax revenues strongly increased (at a slightly lower rate, reflecting pro-cyclical tax relief under the roughly unitarian income elasticity of tax proceeds). Since 2004, tax revenues and EU grants increased from 33.9% to 38.4% of GDP. For 2008, proceeds are estimated to decrease by 3.2 percentage points of GDP, whereas for 2010 they are supposed to slightly increase again, due to macroeconomic stabilisation and rising yields from revenue-enhancing measures (increases in VAT and excises) (IMF, 2009a).

In Latvia, general government expenditure has roughly kept pace with revenues throughout the years of high growth. Accordingly, the deficit could be maintained at a low level, easily satisfying the 3% Maastricht criterion. Unlike Estonia, which stored a substantial part of its exceptional growth proceeds in a stabilisation fund, Latvia spent its revenues. This applied not only to the additional revenues estimated in the annual budget, but also to the windfall proceeds accruing to the treasury from higher-than-expected growth, leading to annual supplementary budget laws laden with new spending initiatives. When growth faltered unexpectedly in 2008, there was a sudden jump of the deficit to 3% of GDP[3] (5.9% minus EU project grants[4]) despite attempts to cut appropriations in the last quarter of the year. During budget preparation for 2009, GDP growth was still estimated at 2.2% and the deficit at 1% of GDP. Towards the end of 2008, it became clear that maintenance of the spending plans included in the 2009 budget would lead to a double-digit deficit. This led to the enactment of a supplementary budget law for 2009 – even before the budget year had started – which included a large package of revenue-enhancing measures amounting to 2.5% of GDP and expenditure-saving measures amounting to 4.6% of GDP. In this way, the government hoped to maintain the deficit at 4.9% of GDP (IMF, 2009a). However, in the first half of 2009 it became clear that this target could not be achieved without further intervention. This led to the preparation of a new large package of saving measures, to be submitted to Parliament in a second supplementary budget law for 2009 in the spring of 2009. In this way, the government hopes to keep the deficit at 7% of GDP in 2009.

Figure 1 shows the development of revenues and expenditures since 2004. The forecasts for 2009 and 2010 are the official forecasts of end 2008 and do not yet take account of the worsening of the financial situation that has become apparent in the first half of 2009 nor of the additional fiscal package in the second supplementary law for 2009 that is now being prepared. Table 2 shows the development of the deficit under the same provisos.

Figure 1. **Expenditures and revenues of general government in Latvia**

% of GDP



Sources: Latvian authorities and IMF (2009), “Republic of Latvia: Request for Stand-By Arrangement – Staff Report”, January, International Monetary Fund, Washington DC.

Table 2. **General government balance in Latvia**

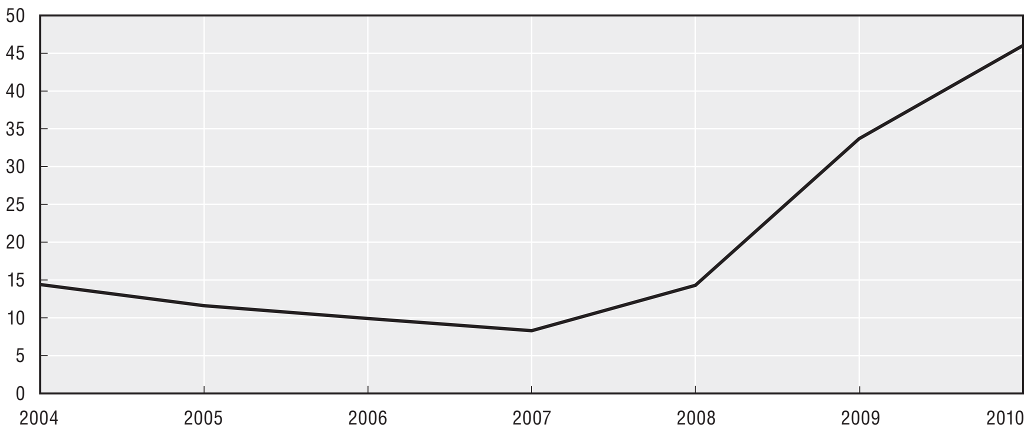
% of GDP

	2004	2005	2006	2007	2008	2009	2010
Fiscal balance	–1.0	–1.1	–0.9	0.7	–3.0	–4.9	–4.9
Adjusted basic fiscal balance	n.a.	n.a.	–3.2	–2.6	–5.9	–8.5	–9.5

Sources: Latvian authorities and IMF (2009), "Republic of Latvia: Request for Stand-By Arrangement – Staff Report", January, International Monetary Fund, Washington DC.

The level of public debt in Latvia has been low in comparison to other Baltic countries. However, in 2008 it started to rise due to the increasing deficit, and in 2009 and 2010 it is expected to rise even more as a consequence of still further rising deficits. Nevertheless, even if this happens debt will still remain under 50% of GDP, lower than in many other EU countries and comfortably within the Maastricht criterion for accession to the euro zone. Figure 2 shows the development of public debt since 2004.

Figure 2. **Gross general government public debt in Latvia (% of GDP)**



Sources: Latvian authorities and IMF (2009), "Republic of Latvia: Request for Stand-By Arrangement – Staff Report", January, International Monetary Fund, Washington DC.

1.3. Current institutional arrangements

The agreements concluded in December 2008 and January 2009 with the IMF and the EU included a package of financial assistance amounting to approximately EUR 7.5 billion, of which EUR 3.1 billion will be provided by the European Union, EUR 1.8 billion by the Nordic countries (Denmark, Finland, Norway and Sweden), EUR 0.4 billion by the Czech Republic, Estonia and Poland, EUR 0.4 billion by the World Bank, EUR 0.1 billion by the European Bank for Reconstruction and Development, and EUR 1.5 billion by the IMF. This assistance package has been provided on the basis of a far-reaching reform programme to which the Latvian government has committed itself. This programme assumes the maintenance of the exchange rate peg.

The reform programme has the following components (IMF, 2009a):

- **Financial sector reform,** including emergency legislation allowing bank takeovers, a targeted examination of the banking system focusing on domestic banks, commitments from foreign banks to maintain their presence, and improvement of supervision and intervention capacity of the central bank.

- **Private debt restructuring,** focusing on bank capacity to assist in debt restructuring and reform of the insolvency and bankruptcy laws.
- **Substantial and front-loaded fiscal tightening** to prevent the 2009 deficit from rising to double-digit figures.
- **Structural reform** focusing on the speedy implementation of the National Lisbon Programme aimed at innovation and modernisation of productive capacity as well as a strong incomes policy to reverse the stark wage growth of the boom years. For the latter purpose, the government hopes to work with the National Tripartite Council (government, employer associations and trade unions) to monitor wage-cutting measures in the public sector and to issue recommendations to bring private sector compensation back to a more competitive level.

The fiscal tightening component of the reform programme envisaged a second supplementary budget law for 2009 to be submitted to Parliament in the spring of 2009, designed to maintain the deficit at 4.9% as intended in the December supplementary law. Furthermore, it not only aimed at far-reaching structural consolidation measures but also at institutional changes, in particular:

- Emergency powers of the Ministry of Finance to prepare and implement the supplementary budget and increase access to timely, reliable fiscal data.
- Removal of rigidities in the budget so that line ministries can deliver the required spending reductions. Measures aim to provide more flexibility in carry-overs and in reallocations of resources between line items (except for expenditure from earmarked revenues) for some ministries with sound technical capacities.

During the implementation of the programme, the IMF proposed to ask the ministries to provide a menu of realistic options to achieve the programme's fiscal targets. Regarding the 2010 budget preparation, the IMF proposed to abolish the separation between decision making on the base lines and decision making on the new spending initiatives that have characterised the Latvian budget process in the past (see below in Section 2 of this review). Instead, the IMF proposed to move swiftly to discussions on ministries' proposals to reduce spending and global envelopes under an intangible and binding top-down constraint derived from the macroeconomic scenario (IMF, 2009c).

The IMF and the EU are aware of the considerable risks involved in the financial assistance agreement, particularly as far as the maintenance of the currency peg is concerned. Alternatives to the maintenance of the currency peg were extensively studied and discussed, but were finally rejected mainly because the Latvian authorities remained strongly committed to its maintenance and were willing to accept the reform programme, including drastic fiscal tightening and wage reduction in the public sector (20% on average, and up to 40% for certain groups of employees). It remains to be seen whether the agreement gains credibility in the international capital markets and whether the government will be able to deliver on its commitments. In addition, it is not clear that the stabilisation of the Latvian economy is served by a retrenchment as drastic as is now being prepared.

The paradoxical effect of the present approach to the Latvian financial crisis is that, in the short and medium term, it may accelerate the economic recession rather than counterbalance it. Whereas almost all western European country governments have maintained existing spending plans despite the recession to generate a stabilising effect, and whereas many western European countries have even increased expenditures above existing spending plans in an attempt to provide an additional "Keynesian" stimulus, Latvia has now embarked on a fiscal course of action that could further destabilise the economy. A more cautious approach aiming at a limited adjustment of the existing multi-annual expenditure framework based on a growth assumption of some 3-5% in the medium term would provide more automatic stabilisation but could lead to a large increase in the deficit in the short term, perhaps exceeding 10% of GDP. However, fluctuations of the deficit over the cycle around a medium-term target are generally much larger in Eastern European economies than in western European ones, which are characterised by other stabilising arrangements (more developed social security systems, second and third pillar pension systems, better developed financial markets, etc.).

The present review diagnoses the instability of the Latvian budget process and its lack of a medium-term perspective as its main weakness, next to various strong aspects such as a modern and efficient Treasury, accurate and timely financial reporting, and a very effective and well-organised State Audit Office. The main weaknesses existed long before the present financial crisis and led to annual supplementary budget laws full of new spending initiatives and a lack of consistency between multi-annual spending plans in successive budgets. The OECD Secretariat is aware that there is a certain tension between the emphasis in this review on more stability and the course of action upon which the Latvian authorities have embarked in the context of the financial assistance agreement with the IMF and the EU.[5] In essence, this tension means that either the implementation of some of the suggestions of this review will have to wait until the reform programme of the fiscal assistance agreement has expired, or some elements of the financial assistance agreement will have to be reconsidered in the 2010 budget preparation.

2. Budget formulation

2.1. Key characteristics

The budget process in Latvia is characterised by some key features that merit special attention:

- Continuous budgeting.
- The absence of a fiscal rule.
- Weak multi-annual fiscal planning.

2.1.1. Continuous budgeting

Budget formulation in Latvia can best be described as "continuous". During years of high economic growth, the approach to budgeting involved a pattern of in-year adjustments with at least one supplementary budget and additional expenditures each year. In contrast, a series of substantial expenditure cuts had to be made to the 2009 budget in order to adjust to the unfolding crisis and to maintain external financial support. In the process of fiscal adjustment, the regular budget formulation schedule has been suspended and budgeting has lost the character of an annual process. Although the budget formulation process was reformed in 2007, these changes had little time to be established before the country experienced a severe economic deterioration.

2.1.2. The absence of domestic fiscal rules

Many national governments in OECD countries have adopted numerical fiscal rules.[6] In Latvia, there are no domestic fiscal rules that impose a constraint on the annual budget process at the central government level (local authorities are subject to fiscal constraints that are discussed in Section 5 below). However, as a member of the EU, Latvia is obliged to comply with a set of four convergence criteria, known as the Maastricht criteria. In terms of fiscal policy, these require that the ratio of the annual government deficit to GDP does not exceed 3% and that the ratio of gross government debt to GDP does not exceed 60%.

In some countries with multi-party governments, coalition agreements play an important role in guiding fiscal policy (Hallerberg *et al.*, 2009). Latvia has a history of coalition governments since regaining independence in 1991. New governments produce a declaration with key commitments in varying detail. The five-party coalition government constituted in March 2009 made a public commitment to large-scale expenditure cuts in response to the economic crisis. However, these declarations do not play as important a role in budgeting as coalition agreements in some other countries, such as the Netherlands (Blöndal and Kristensen, 2002) or neighbouring Estonia (Kraan *et al.*, 2008). One reason for this is the instability of governments. Latvia has had 14 different governments since 1991. This instability undermines the potential for coalition agreements to function as multi-year fiscal contracts.

In the current economic crisis, external actors have gained strong influence over fiscal policy in Latvia and imposed aggregate fiscal constraints on the government. In December 2008 and January 2009, Latvia received a package of assistance of approximately EUR 7.5 billion from the IMF, the EU and other international institutions and European countries (see Section 1.3 above). The IMF has stipulated approval rights on all major decisions on fiscal policy as part of the agreement (IMF, 2009c).

In return for this assistance, the government of Latvia committed itself to a number of economic adjustment measures, including a general government deficit target of 4.9% of GDP. However, the achievement of this figure quickly became unlikely, and this precipitated renegotiations which settled on a deficit target of 7% of GDP. In the current crisis, these deficit targets constitute a *de facto* fiscal rule and have forced extensive budget cuts and structural reforms, which are further discussed below. To enforce the targets, the IMF has insisted that no Cabinet decision or any other decision with a fiscal impact, including decisions on social security or on any guarantee scheme, be taken and announced before discussions with the European Commission and the IMF.

The absence of a structural deficit target ("over the cycle") and of medium-term expenditure planning is not conducive to ensuring prudent public finances, and has led to a pro-cyclical fiscal policy. While the Maastricht deficit criterion establishes a minimum condition, it does not prevent overspending during high-growth periods nor the necessity to resort to highly contested saving measures as is the case in Latvia now. To enable more counter-cyclical fiscal policy requires firm medium-term expenditure plans that are adhered to regardless of what happens with revenues. While allowing deficit volatility, this would engender greater expenditure stability and contribute to automatic stabilisation.

The comprehensiveness of the Latvian budget would support a rules-based approach to fiscal management. In recent years, off-budget activities have been greatly reduced, and capital budgeting has been integrated into the annual budget procedure. Moreover, substantive legislative changes including social benefits and other entitlements are an integral part of the annual budget process, unlike in many OECD countries. However, what is lacking thus far is a stable multi-annual expenditure framework anchored in a medium-term target for the budget balance.

2.1.3. Weak multi-annual fiscal planning

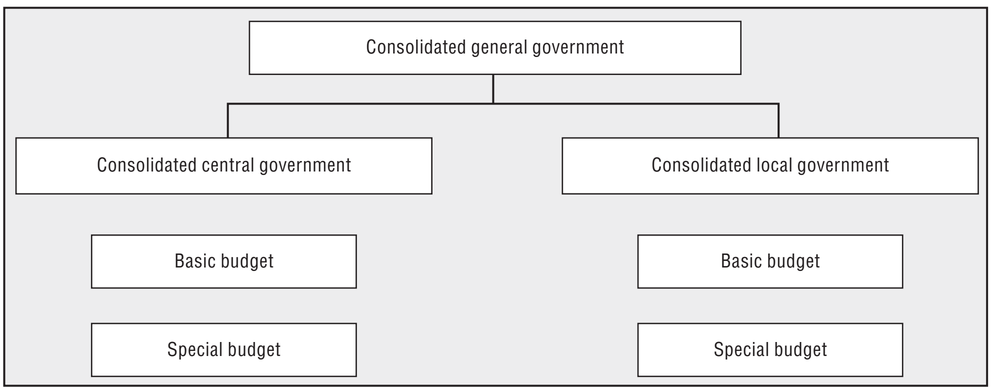
Many OECD countries use medium-term frameworks that are decided at the start of the annual budget cycle and serve as a top-down steering tool. This role of expenditure frameworks is only possible if line ministries provide multi-annual estimates at the line-item level, on the basis of either current law or current policy. Such multi-annual estimates are currently not produced in Latvia. Comparison between the ceilings of the expenditure framework and the (sum of the) line-item estimates makes clear whether there is room for new spending or whether savings in existing programmes are necessary. This is the essence of budgeting in a multi-annual perspective. Such a multi-annual perspective is necessary because important adjustments of existing programmes or the establishment of new programmes usually require more than a year to implement. In a budget process that looks only at the upcoming budget, as has been practised until now in Latvia, measures that start to produce savings only in the medium term will escape any budgetary constraint. The same applies to new programmes that appear small initially but require increasing resources in the medium term – a budgeting tactic Wildavksy described as the "camel's nose" (Wildavsky, 1984, p. 111).

Once decided, medium-term expenditure frameworks should be rigidly adhered to during budget preparation and execution. In many OECD countries, the ceilings of the multi-annual framework are the main tool for the enforcement of budgetary discipline. OECD countries that use multi-annual expenditure frameworks usually also try to maintain them from year to year. This provides stability to expenditure plans and stabilisation for the economy as a whole. However, practices differ: some countries allow adjustments from year to year in the light of new spending initiatives of line ministries or macroeconomic developments.[7]

2.2. Budget structure and format

The consolidated general government budget is summarised in Figure 3. The consolidated central government budget consists of two parts, *i.e.* the basic budget and the special budget. The basic budget is financed by general revenues, whereas expenditures in the special budget are financed by income from earmarked revenue sources (Sections 7 and 8 of the Law on Budget and Financial Management). The same distinction applies to the consolidated local government budget. The consolidated central government budget covers institutions of direct state administration and 11 high colleges of state.[8] It is financed via the annual budget law and accounted for three-quarters of the consolidated

Figure 3. **Latvia's budget structure**



general budget in 2008. The consolidated local government budget consists of the sum of annual budgets authorised by local authorities. It accounted for about one-quarter of consolidated general government expenditures in 2008. Until recently, there were two extrabudgetary funds. The Privatisation Fund is now closed, while the Long-Term Stabilisation Fund has been suspended until 2012. Extrabudgetary funds are discussed further in Section 4 on budget execution.

In August 2006, the Cabinet of Ministers approved a new programme-based budget format with a three-year perspective.[9] The basic principles of this reform were developed with technical assistance from the World Bank. The new budget format was first applied in 2007 during the preparation of the 2008 budget. The intention is to embed the annual budget process in a broader three-year framework. The new process entails the adoption of the annual budget law for a one-year period, as previously, but complements this with a two-year framework for out-years including ceilings by ministry and other central government institutions. The intention is to link the budget more closely to strategic plans prepared by line ministries for a three-year period. However, it is questionable whether this is a realistic and worthwhile objective. Sectoral strategic planning and evaluation are important tools of policy development, but they can best be practised at the programme level under the responsibility of the line minister. There is no need for uniformity across government, nor for uniform planning periods, nor for direct linkage with the budget process, apart from the need for regular updating of strategic plans in the light of budgetary decisions. However, a multi-annual expenditure framework, including ceilings for line ministries, is an essential tool for budgetary policy in itself – irrespective of any relationship with sectoral planning – because it provides a multi-annual perspective to the budget process.

The new programme format lists budgets by spending unit, programme and subprogramme. In 2009, the basic state budget contained 208 programmes and 304 subprogrammes. The average line ministry has about ten programmes, one of which is usually for central management functions. There are no programmes that cut across ministries. Most EU funds are associated with a separate programme. Total ministerial budgets, as well as each programme and subprogramme, are further broken down by economic classification, using on average nine main types of expenditures and four main types of resources for the coverage of expenditures: grants from general revenue, revenue from paid services and other own revenue, foreign financial assistance and transfers. An exception is the state special social insurance budget, where social insurance contributions are shown as revenues. The total number of line items amounts to several thousands, which makes it difficult to analyse strategic priorities on the basis of the budget documents.

Related to the new budget format, the Cabinet of Ministers also resolved to improve the availability of performance information. In June 2008, the Cabinet of Ministers adopted basic concepts for a system of performance measures. Among the changes is a requirement for line ministries to link their operational strategies to the programme structure of the budget by linking objectives to each programme and subprogramme, as well as performance measures and achieved and expected results (Ministry of Finance, 2008, p. 48). At the time of the review, this decision had not yet been implemented.

OECD countries have different practices concerning the inclusion of performance information in the budget. Some are reducing the amount of performance information because there is only room in the budget for summary indicators. In turn, this can lead to oversimplification and perverse incentives (the Netherlands, the United Kingdom). However, regardless of whether performance information should be included in the budget documents, it is important that this information is collected, provided to Parliament and published (in sectoral planning and evaluation documents) so that it can be the basis of informed debate on the effectiveness and efficiency of sectoral programmes.

2.3. Economic forecasting by the Ministry of Finance

In Latvia, macroeconomic and revenue forecasting functions are carried out by the Department of Economic Analysis and Fiscal Policy, which is part of the Ministry of Finance. As from mid 2009, the department reports directly to the Deputy State Secretary on Budget Issues in the Ministry of Finance. Previously, it reported directly to the State Secretary. The department has a staff of 20, distributed across the Macroeconomic Division (6), the Fiscal Analysis and Forecasting Division (6) and the Public Sector Wage Policy Division (8). The first two divisions are described further below, while public sector wages are discussed in a later section of this review.

The Macroeconomic Division forecasts a list of main macroeconomic indicators and provides a three-year outlook as a basis for fiscal policy formulation. The main indicators include GDP, consumer price inflation, wages and salaries, employment and unemployment, government debt, the trade balance, and the balance of payments. The Minister of Economics approves the list of indicators, but the Ministry of Finance is in charge of preparing the forecasts and submitting them to the government. In preparing the forecasts, the Department of Economic Analysis and Fiscal Policy collaborates with the Economics Ministry, the central bank, and large commercial banks. The involvement of the central bank is a new development. In the current conditions, the IMF and the European Commission are also consulted.

The Fiscal Analysis and Forecasting Division prepares short-term (monthly and quarterly) as well as three-year medium-term budget revenue forecasts for tax and non-tax revenues. The division focuses exclusively on revenues and has no role in forecasting expenditures. Revenue forecasts are provided twice a year, in the spring (March) and the autumn (August). The spring forecast is particularly important for budget formulation.

The division also participates in the Forecasting Working Group that monitors the differences between planned and actual expenditure and revenue in the central government budget on a monthly basis, and local government budgetary developments and their implications for the consolidated general government budget on a quarterly basis. This working group also includes the Budget Department and the Tax Policy Department, as well as the Treasury and the State Revenue Service. The work of this body is discussed further in Section 4 on budget execution.

The Fiscal Analysis and Forecasting Division also assesses the sustainability of public finances and prepares long-term fiscal projections (until 2050) using a methodology provided by the European Commission. Relevant other ministries are also involved in the process, notably the Ministries of Health, Welfare and Education. The Ministry of Welfare received assistance from the Swedish government to develop a long-term forecasting model for social security and pensions. The long-term fiscal projections are published in chapter six of the convergence programme together with a discussion of the impact of demographic developments on health, welfare and education expenditures.

Unrealistic economic assumptions are "the government's key fiscal risk" and can "de-rail" fiscal consolidation (Blöndal, 2003, p. 12). A number of OECD countries have increased disclosure and use sensitivity analysis to investigate what impact any changes in the assumptions would have on the budget. In Latvia, the macroeconomic scenario is discussed in the explanations accompanying the annual budget law, but this does not include any results from sensitivity analysis. In addition, some OECD countries such as Canada and the Netherlands use prudence margins and have moved the forecasting function to a body outside the Ministry of Finance. The option of strengthening the institutional independence of the forecasting function has been discussed in Latvia. However, with few exceptions officials feel that they generally carry out their forecasting work without pressure to deliver optimistic assessments. The department describes its forecasts in recent high-growth years as "cautious".

2.4. The annual budget process

The actors in the annual budget formulation process are the Cabinet of Ministers, the Ministry of Finance, the State Chancellery, the Ministry of Regional Development and Local Government, and line ministries. During the current economic crisis, external actors – in particular the IMF and the European Commission – also exert substantial influence on budgetary decisions (see Box 1).

The Ministry of Finance has about 400 staff. Within the Ministry of Finance, the key unit is the Budget Department, which has a staff of 56 and falls under the authority of the Deputy State Secretary on Budget Issues (see Figure 4). The nature of coalition politics in Latvia limits the potential for delegation to the Ministry of Finance. Most substantive issues are resolved at a political level by the Cabinet of Ministers.

The Latvian government followed a new budget process in 2007. This pre-crisis budget formulation process, as it applied in 2007 (for the 2008 budget) and to some degree in 2008 (for the 2009 budget), is summarised in Table 3. This schedule is referred to as the "regular" process, but the sequence of steps is currently in large part suspended due to the uncertainty of the economic crisis. After describing the regular process, the remainder of this section discusses the effect of the crisis on the budget formulation process.

The regular process starts at the beginning of the year, when the Ministry of Finance and the State Chancellery set medium-term objectives and priority areas, which are approved by the Cabinet of Ministers in March. This is in line with the amendments of 2008 to the Law on Budget and Financial Management (LBFM), which clearly state in Section 16 that the Minister of Finance shall submit to the Cabinet a draft schedule for the preparation and submission of the State Budget Law for the financial year (a package of draft budget laws), the medium-term macroeconomic development forecast and the fiscal framework.

Ministries and other central government institutions submit their new or updated operational strategies to the Cabinet of Ministers at the end of February. These include a "wish list" of new policy initiatives, ranked by order of priority. By the end of March, line ministries are requested to submit proposals for reducing line items, measured against the current budget law, on the basis of which the Ministry of Finance calculates a base budget for the upcoming three-year period. The subtraction of the base budget from the available resources in years n + 1 (the upcoming budget year), n + 2 and n + 3 yields the part of the budget that is available for development over the medium term.

Box 1. **Budgeting during economic crisis**

The 2009 budget as initially drafted and approved by Parliament in November 2008 had to be amended for the first time a month later to ensure access to external funding from the IMF and the EU. The amendments in December 2008 cut expenditures substantially. This package included a reduction in public employment. It also cut remuneration by 15%, expenditures for goods and services by 25% on average, and grants by 25% on average. At the same time, the value-added tax increased by 3 percentage points. Riots in Riga in January 2009 were followed by the fall of the government in February and the formation of a new coalition government in March. In April 2009, a review by the IMF under its stand-by arrangement cautioned that the agreed fiscal targets were likely to be missed and called for "significant additional measures and tighter spending controls" (IMF, 2009, p. 6).

To ensure continued access to external support, the new government had to embark on a second and unprecedented budget-cutting exercise during the months of April to June 2009 that effectively meant drafting a new budget for the second half of the 2009 fiscal year. Representatives of the IMF and the European Commission participated in this process. To target reductions, the government initially used a formula based on budgeted expenditures (for the second half of 2009) minus "irreducible" expenditures. The latter included items such as debt-servicing costs, contributions to international bodies, money set aside to meet EU co-financing requirements, and spending in protected areas such as pensions. In the "reducible" part of the budget, the government cut remuneration by 20%. Taking into account that additional payments and bonuses had already been cancelled in December 2008, these additional amendments amounted to a real wage decrease of 20%. The remaining "other reducible expenditures" were cut by 40%.

The second round of amendments relied heavily on line ministries to identify items suitable for reduction or elimination. The process was also used to take forward structural reforms in public administration, as well as in the education, social and health sectors. This resulted in a reduction of early retirement pension rates from 80% to 50%, a cut in old-age and long-term service pensions by 10%, and a decrease in old-age pensions for working pensioners by up to 30%. A major reform proposal in the education sector was the switch to a funding arrangement for schools based on the number of pupils rather than the number of teachers, with the aim of promoting consolidation. In the documents prepared by the line ministries, the required cuts were measured against the 2009 budget as amended in December 2008, and their budgetary effect was documented across the period 2009 to 2011. The Latvian Parliament passed the second round of emergency amendments in June 2009.

For the preparation of the 2010 state budget, a new operation has been launched which is aimed at scrutinising budget expenditures per function for necessity and efficiency.

Source: IMF (2009), "Republic of Latvia: Stand-By Arrangement – Interim Review Under the Emergency Financing Mechanism", April, International Monetary Fund, Washington DC.

In early April, the Ministry of Finance, the State Chancellery and the Ministry of Regional Development and Local Government participate in evaluating the new policy initiatives proposed by line ministries. The evaluation of new policy initiatives is the only formal role for the State Chancellery in the annual budget procedure, although it has informal roles, for instance in the discussion of the 2009 budget cuts (see Box 1 above). Based on the outcome of the evaluations of new policy initiatives, the Ministry of Finance drafts a list of new policy initiatives across all spending areas and central government institutions.

Figure 4. **The organisation of the Latvian Ministry of Finance**

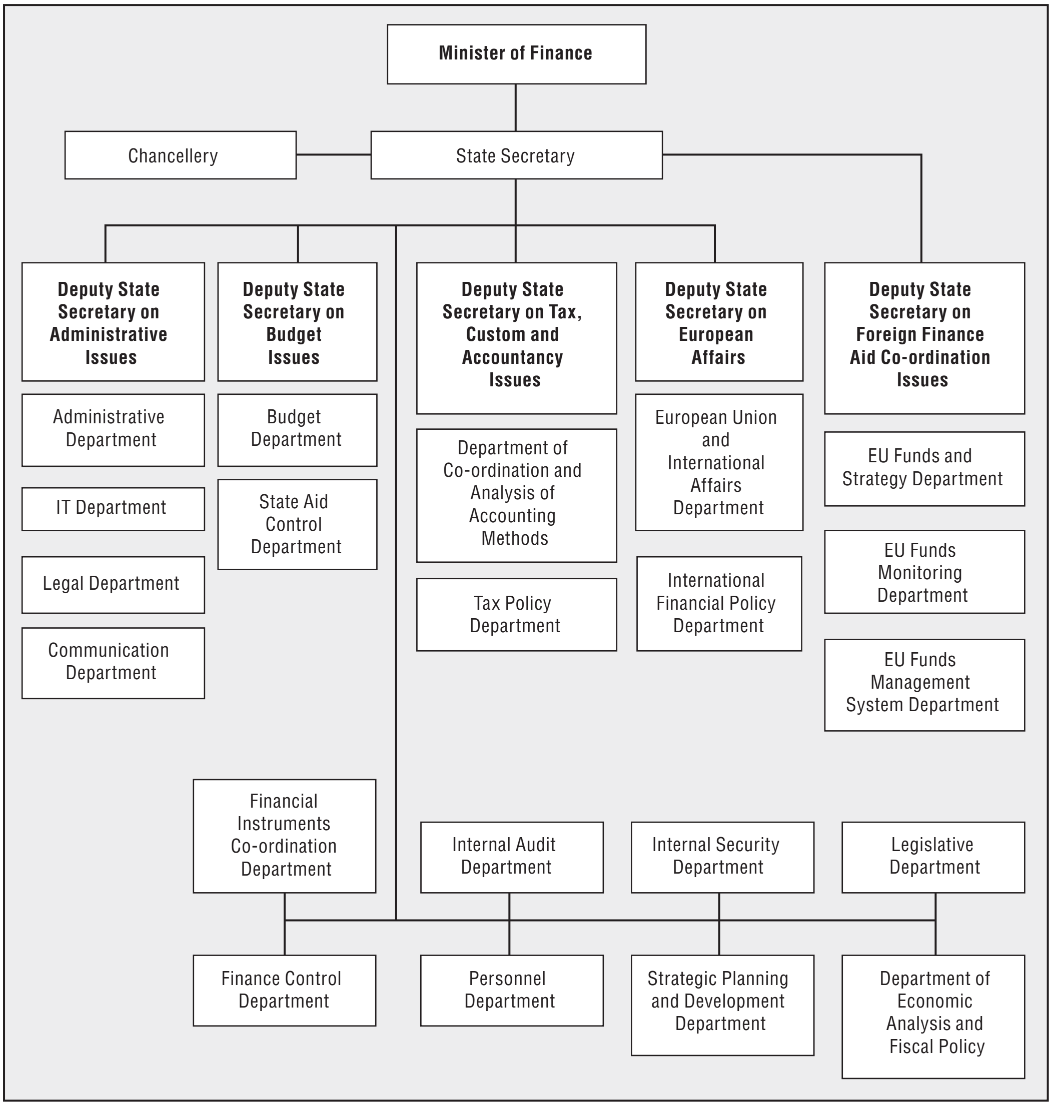


Table 3. **The calendar for budget formulation in 2007 and 2008**

End of February	The Ministry of Finance and the State Chancellery prepare medium-term budget goals and priorities for the next three years.
	Ministries submit new policy initiatives to the Cabinet of Ministers.
End of March	The Cabinet of Ministers adopts the medium-term budget goals and priorities.
	The Ministry of Finance and line ministries agree basic budget expenditures.
	The Ministry of Finance calculates development expenditures.
Early April	Evaluation of new policy initiatives by the Ministry of Finance, the State Chancellery and the Ministry of Regional Development and Local Government.
	The Ministry of Finance creates a prioritised intersectoral list of new policy initiatives.
Mid April	The Cabinet of Ministers discusses and adopts the medium-term framework, including the list of new policy initiatives that will be financed over the next three years.
Early May	The medium-term framework is sent to Parliament for information.[1]
May to July	Line ministries prepare detailed budget requests.
September	The draft annual budget is submitted to the Cabinet of Ministers.
Early October	The annual budget documents are submitted to Parliament.

1. This happened only in 2007 (for the 2008 budget) but not in 2008 (for the 2009 budget), since that medium-term framework had only been discussed but not approved by the Cabinet of Ministers.

The Ministry of Finance, in consultation with the Ministry of the Economy and the Bank of Latvia, prepares the medium-term macroeconomic development and fiscal policy framework for the next three financial years and submits it to the Cabinet of Ministers in mid April. The medium-term framework spells out the expected macroeconomic developments, fiscal policy goals, budget revenues, maximum expenditures, appropriation reserve, and spending limits for each ministry and other central government institutions over the medium term (Section 16 of the LBFM).

Together with the medium-term framework, the Ministry of Finance also submits the draft list of new policy initiatives to be financed over the next three years. The Cabinet of Ministers discusses the medium-term framework and the new policy initiatives and approves them at the beginning of May. In 2007, the Minister of Finance referred the approved medium-term framework to Parliament for information, which was the intended practice. However, this process was not repeated in 2008, since the Cabinet of Ministers only discussed the framework but did not formally approve it.

Based on instructions for drafting budget proposals issued after the approval of the medium-term framework and new policy initiatives, line ministries proceed to prepare budget proposals starting in May and submit them to the Ministry of Finance by July. This does not include multi-annual estimates at the line-item level, which are crucial for ensuring the congruence of current law or policy with the multi-annual ceilings. The budget proposals prepared by line ministries are reviewed and collated by the Budget Department of the Ministry of Finance. According to Section 19(2) of the LBFM, the Minister of Finance has the final say regarding the inclusion of a budgetary request in the draft State Budget Law submitted to the Cabinet of Ministers. The draft law on the central government budget and accompanying documentation are submitted to the Cabinet of Ministers in September.

The Cabinet of Ministers discusses and approves the budget documents. Section 20(2) of the LBFM requires the Minister of Finance to "seek to attain agreement" on their draft budgets with the heads of ministries and other central institutions. If agreement is not attained, the Minister of Finance must attach to the package of draft budget laws submitted to the Cabinet of Ministers a statement of his or her objections against proposals rejected during the evaluation of the draft budgets. In practice, the Cabinet of Ministers usually examines a number of unresolved issues. At this stage, such disputes are resolved by a majority vote of the Cabinet of Ministers. The approved documents include the annual draft law on the central government budget for the next financial year, a comprehensive list of any related proposals for amendments to other legislation, explanations of the draft law, and the medium-term macroeconomic development and fiscal policy framework. Once approved, the budget documents are submitted to Parliament at the beginning of October.

With the onset of the economic crisis, the budget procedure as explained above has effectively been suspended. For the development of the 2010 budget, all the steps involving new policy initiatives and medium-term planning are cancelled, so that the first step of the procedure will commence with the preparation of annual budget proposals, roughly in July. Medium-term planning is very difficult given the uncertainty of the economic outlook and the overriding importance of fiscal adjustment. Moreover, there is no need to prepare proposals for new policy initiatives, since there is no money to finance them for the foreseeable future. The disruption of the budget process is discussed more fully in Box 1 above.

2.5. Conclusions

The economic crisis has disrupted the regular budget formulation process and forced large-scale and *ad hoc* fiscal adjustments to the 2009 budget and has thus far (June 2009) suspended the regular budget formulation process for 2010. In the medium term, additional institutional reforms are important to further strengthen the resilience of the process. Regardless of whether the emergency measures of 2008 and 2009 will attain their main objectives of bringing down the deficit and curbing inflation, it is important that Latvia implements reforms that provide more stability to the budget process.

Adoption of a fiscal rule: Fiscal governance in the long run would benefit from the adoption of a fiscal rule that forces governments to set aside funds in good economic times while ensuring fiscal space during low-growth periods. This would be particularly beneficial in the Latvian political context with its frequently changing coalition governments. The most feasible fiscal rule for Latvia is an expenditure rule that would keep the total of expenditures as fixed as possible over the medium term. This could take the form of a medium-term expenditure framework that remains fixed during budget formulation and budget execution and that is maintained as much as possible from year to year.

Strengthening the medium-term perspective: Together with the consolidation of the programme structure, the level of medium-term information in the budget should be expanded to the same level of detail as the annual budget. Medium-term line-item estimates on the basis of current policy or current law are essential for the allocation of financial resources in the annual budget negotiation, and they would help to ensure the congruence of current law or policy with the multi-annual ceilings. Multi-annual estimates on the basis of current policy or current law ("baseline estimates") should not be produced and agreed between the line ministry and the Ministry of Finance annually, but at least quarterly. They are an essential tool for budgetary discipline not only during budget formulation, but also during budget execution (during execution they alert at an early stage to possible overspending, which may trigger correcting measures).

Consolidation of the programme format: The programme classification of the budget remains overly detailed. The number of (sub)programmes should be reduced further. To facilitate a more policy-based review, the budget documents should provide summary tables of ministerial budgets by programme.

An effective programme review mechanism: The budget process introduced in 2007 provides a mechanism to evaluate new policy initiatives put forward by line ministries. This incremental approach works during times of fiscal expansion, but it is irrelevant for prioritisation in a cutback environment. There is currently no regular mechanism for assessing the base of existing expenditures. A more comprehensive review mechanism within a reinforced medium-term framework would help to strengthen the allocative capacity of the budget process.

3. Parliamentary approval

3.1. The Latvian Parliament

Latvia has a unicameral Parliament called the Saeima (see Box 2).

According to the Latvian Constitution, the Saeima must adopt a budget for all state revenues and expenditures on an annual basis. Generally, laws in Latvia can be adopted in a national referendum if the President suspends the proclamation of a law and not less than one-tenth of the electorate requests that the law be put to a referendum. Referenda

Box 2. **Saeima, the Latvian Parliament**

The Saeima has 100 seats. Members are elected by popular vote under a system of proportional representation for a four-year period. Parties need at least 5% of the overall vote to gain representation in the Saeima. Apart from its role in law making, Parliament elects the President and may express no confidence in the Prime Minister. If the latter occurs, the entire Cabinet must resign. Judicial appointments are also to be confirmed by the Saeima. Parliament elects from among its members a Chairperson (Speaker), two Deputies and Secretaries who form the Presidium of the Saeima and direct its work in accordance with the Rules of Procedure.

Members of Parliament have the right to form factions (parliamentary groups). Parliamentary groups, like individual members as well as parliamentary committees, have the right to initiate draft legislation and amendments. The deputies of the current 9th Saeima elected in October 2006 have formed eight different factions: People's Party (21 seats), Greens and Farmers Union (17), Concord Centre (18), New Era (14), Latvia's First Party/Latvia's Way Party (10), For Fatherland and Freedom/LNNK (5), Civic Union (7), For Human Rights in a United Latvia (5). There is a Council of Parliamentary Groups to co-ordinate the activities and strategies of factions within the Saeima. Each parliamentary group or political bloc (a union of parliamentary groups) delegates one representative to the Council of Parliamentary Groups.

Source: Parliament of Latvia, Riga, *www.saeima.lv*.

on different matters take place once or twice per year. However, the budget law may not be submitted to a national referendum (Article 73 of the Constitution of the Republic of Latvia). Every year a draft budget is to be submitted to the Saeima by the Cabinet (Article 66 of the Constitution). On the basis of a proposal by the government, Parliament may also adopt a supplementary budget during the budget year. Parliament equally approves the annual account submitted by the Cabinet after the end of the budget year.

If the annual draft budget submitted by the Cabinet is rejected by the Saeima at the first or second reading, it is regarded as a vote of no confidence in the Cabinet (Article 30 of the Rules of Parliamentary Procedure). Since 1980, the government had to resign for this reason only once.

The Saeima is authorised to amend the draft budget proposed by the Cabinet. However, the Constitution restricts the amendment powers of Parliament by the following provision: "If the Saeima makes a decision that involves expenditures not included in the budget, then this decision must also allocate funds to cover such expenditures." The restriction is further elaborated in the Law on Budget and Financial Management (Section 10.1): "In the decisions of the Saeima, the adoption of which relates to expenditures not provided for by the budget, provision shall also be made for funds by which such expenditures shall be covered. In cases provided for by law, the Minister of Finance shall submit an opinion in regard to submitted draft laws not later than within a two-week period from the date of receipt of the relevant draft law." In practice, an amendment increasing expenditures is possible by either correcting the revenue estimation or changing a tax rate for certain taxes. Both are difficult to realise; thus, the total amendment power of Parliament remains limited. The budgetary impact of amendments in recent years has amounted to around 0.06% of GDP (0.1% of total budget expenditures). Amendments usually concern constituency issues or education. Over the last years, it became customary for the Cabinet to make available a pool of approximately

1.5 million lats (LVL) to be distributed by deputies. This amount allowed each parliamentary group to allocate approximately LVL 200 000 for its motions. However, this practice was suspended in 2009 due to the financial crisis.

The budget adopted by Parliament enters into force at the beginning of the budget year.[10] If an annual state budget has not come into force in due time, the Minister of Finance approves the state budgetary expenditures, provided that the monthly expenditures cannot exceed one-twelfth of the appropriations of the previous year.

The Saeima is financially independent. After its budget request has been examined by the committees and approved by the Presidium, it is submitted to the Minister of Finance who incorporates it without any amendments into the draft budget law. Issues related to the financial management of the Parliament are decided by the Presidium on the basis of the proposals of the Administrative Committee. Finances are managed by the Presidium or a parliamentary official appointed by the Presidium. Bookkeeping records, the legitimacy and usefulness of expenditures, and the annual report of the Parliament are audited by the Public Expenditure and Audit Committee (Chapter VII of the Rules of Parliamentary Procedure).

3.2. Parliamentary approval procedure

The constitutional provision for the submission of the draft budget law to Parliament is elaborated in the Law on Budget and Financial Management. It requires that the Cabinet submit the draft budget law to the Saeima not later than 1 October (Section 21 of the LBFM).[11] The deadline is usually respected, but delays have occurred in parliamentary election years.[12] The Law enumerates a set of documents that have to be submitted in conjunction with the annual budget bill: proposals for amendments to substantive laws so that they conform to the draft budget law (so-called "budget-related draft laws"), explanations of the draft budget law, and the medium-term macroeconomic development and fiscal policy framework. Usually the number of budget-related draft laws submitted together with the budget bill amounts to around 30, but for the 2009 supplementary budget there were more than 100. The fiscal policy framework contains information for the medium term: macroeconomic forecasts, fiscal policy goals, government budget revenue forecasts, maximum spending, appropriation reserve in the government budget, and spending limits for each ministry and other central government institutions.

The Saeima is given approximately two and a half months to scrutinise the budget bill. To ensure that the budget law comes into force prior to the start of the fiscal year, Parliament should pass the budget law by the middle of December. It thus allows the President to proclaim the budget law within a period stipulated by the Constitution, *i.e.* not earlier than the tenth day and not later than the twenty-first day after the law has been adopted (Article 69 of the Constitution). The time frame allocated to Parliament to examine the budget bill is in accordance with the "OECD Best Practices for Budget Transparency" (OECD, 2002), namely that the government's draft budget should be submitted to Parliament not less than three months prior to the start of the fiscal year.

Parliament considers the budget bill in two readings. The regular procedure for Latvian legislation consists of three readings, but the budget law is always considered as an urgent law for which a special, two-reading procedure is applied. Once submitted to Parliament, the draft budget law is forwarded by the Presidium to the Budget, Finance and Taxation Committee (BFTC), a standing committee of the Saeima responsible for budget-related issues. There are 13 members in the BFTC representing almost all parliamentary groups of the Saeima. There is no specialised parliamentary research service to assist Parliament with scrutinising the budget. However, the BFTC has some analytical support provided by five analysts attached to the committee.

In practice, Parliament receives the draft budget law at the end of September, ahead of the first reading debate. This allows time for members to get acquainted with its contents. The first reading of a draft law begins with a report by the rapporteur appointed by the BFTC. Debate on the provisions of the draft law begins after the report. At the first reading, only main conceptual principles are debated. When the debate is closed, Parliament decides on the adoption of the draft law at its first reading. The deadlines for submitting motions are set, and the assignment to sectoral committees proposed by the Presidium is adopted. If the draft law has not been adopted at the first reading, it is deemed to be rejected and may be resubmitted for consideration during the same session only at the request of at least 51 parliamentarians or if it has been revised by the government.

At the second and final reading, the draft budget law is scrutinised article by article and the bill is voted. The BFTC prepares the draft for the second reading (collecting and aggregating proposals), provides its opinion concerning the submitted proposals and, if necessary, adds its own proposals. Members, standing committees and factions may submit motions to amend the budget. Hundreds of amendments are proposed at this stage. Sectoral committees consider the relevant parts of the budget and hold hearings with the respective ministers. The government also gives its opinion on parliamentary amendment motions. The BFTC forwards any proposals for the draft budget law to the Cabinet at least five days before they are to be considered at a committee meeting, simultaneously informing the Cabinet about the date when the proposals will be considered by the committee. Predictably, opposition proposals are typically voted down, while proposals with Cabinet support are adopted. The second reading of the draft law begins with a report by the rapporteur. Consideration of the draft law, article by article, follows the report. During the second reading, only debate on a specific article or a part of it is permitted. After all the proposals have been considered, the person chairing the session puts the draft law to a vote in its entirety, together with the adopted proposals. The budget has always been approved in December.

3.3. Conclusions

The role of the Latvian Parliament in the budget process is limited, as is the case in many OECD countries. It has the right to amend the draft budget law submitted by the government, but amendments that increase the total expenditures need, first, compensation by additional revenue or reallocation from other budget articles and, second, the agreement of the Cabinet.

The time allocated for scrutinising the bill complies with the OECD best practices. The deliberation process is open to the public. The committee structure for deliberating the budget is also in line with OECD practices: a special budget committee scrutinises financial issues and co-ordinates the work between sectoral committees considering the budget in their respective areas.

A shortcoming of the present system is the lack of staff support regarding scrutiny of the budget bill. Moreover, the budget itself is a very detailed document which is hard to understand and analyse. The lack of a clear programme structure makes it difficult for parliamentarians to focus on strategic issues.

4. Budget execution

4.1. Organisation of budget execution

Budget execution in Latvia starts on 1 January, with the entering into force of the Annual State Budget Law. If the budget is not adopted before the beginning of the fiscal year, in virtue of Article 15 of the LBFM (Law on Budget and Financial Management, adopted by the Saeima on 24 March 1994, with amendments), the Ministry of Finance approves monthly expenditures to a maximum of one-twelfth of the previous year's appropriations.

The organisation responsible for budget execution is the State Treasury (*Valsts Kase*), since 1997 an independent agency[13] financed by the Ministry of Finance.[14] The Treasurer is appointed and dismissed by the Minister of Finance. Currently, the Treasury has about 200 employees. According to Article 23 of the LBFM and subsequent regulation (Regulation No. 677, Regulation of the Treasury, issued on 3 August 2004), the Treasury:

- assigns and effects payments from the state budget;
- manages the state accounts;
- manages the national debt;
- administers state-funded pensions; and
- is the paying and certifying authority for EU funds.

Latvia has a single treasury account (STA) that is held at the central bank, but this applies only to transactions in national currency. For the purpose of transactions in foreign currency, the Treasury holds several accounts with commercial banks. While budget holders in the central government are not allowed to open accounts in banks, but only with the Treasury, local governments are not required to use the STA, except for the use of resources which they receive from the state budget. They can choose to use the STA as far as the use of their own resources is concerned (proceeds from own taxes and non-tax non-grant revenues). About 90% of the 500 local governments opt to make payments through commercial banks for this purpose. Apparently, working through commercial banks has advantages for municipalities in terms of flexibility and compensation of interest that the STA does not offer. From the point of view of efficiency (and costs of interest), it could be useful for the Treasury to make the STA more attractive for municipalities.

The Treasury is currently undergoing a structural reform, which by the end of 2009 will have decreased the number of regional units from 22 to 5. Thus far, Treasury regional units effected foreign currency payment on behalf of budget holders of the central government. With the roll-out of the web-based communication system *eKase* between the budget holders and the Treasury, as well as with the inclusion of foreign currency transactions in the Internet banking system, the process is becoming significantly more centralised.

Responsibility for the execution of the budget, including management of accounts and reporting, rests ultimately with the heads of the approximately 7 000 spending units or budget holders (including public agencies, their local branches, prisons, schools and 640 budget holders of ministries and independent agencies, but not municipalities or hospitals). The state secretary of each line ministry is formally responsible for the sector budget and accounts, including the budget and accounts of the budget holders belonging to the ministry. Yet, as far as the accounts are concerned, the role of state secretaries is effectively dependent on information provided by the Treasury, since the Treasury makes the financial accounts for all ministries. This division of responsibilities is usual in many OECD countries.

The Treasury also participates in the Forecasting Working Group which, among other tasks, regularly compares the differences between fiscal planning as reflected in budget estimates and estimated outcomes (see Section 2.3 above). The Forecasting Working Group looks at the basic budget as well as the special budget at the level of both central and local government. If the Forecasting Working Group comes to the conclusion that a budget line item is likely to be exceeded, it can report its findings to the Fiscal Discipline Monitoring Committee, which is a committee established by the Minister of Finance. The Committee meets every week and considers the state budget implementation process by looking at areas and causes of possible overspending and areas and causes of arrears in debt payments. In addition, the Committee considers requests for reallocation of resources over line items and matters concerning cash limits (see Section 4.2 below) and non-tax revenues. Every week, the Committee submits recommendations and information to the Prime Minister, so that he can take measures or make proposals to the Cabinet of Ministers in order to ensure budgetary discipline during budget execution. The Fiscal Discipline Monitoring Committee was created to ensure that the fiscal component of the reform programme agreed with the IMF and the EU will be realised. In the longer run, the regular updating of the current policy and current law estimates by the line ministries, as recommended in Sections 2.1.3 and 2.5 above, is a more structural solution to the problem of lacking budgetary discipline. Such a solution requires strict rules – individually agreed by all ministers – about the compensation of overspending, and lenient reallocation and carry-over rules to facilitate compensation.

4.2. Cash and debt management

The budget is implemented after approval by Parliament on the basis of a resource and expenditure plan based on the budget that is drawn up centrally at the Ministry of Finance. The line ministries then decide, by means of a regulation, which programme will be executed by which budget holder, and what amount will be transferred to that budget holder. The budget holders in turn draw up financial plans – that is, quarterly cash-flow surveys broken down by week, which are consolidated at line ministry level, approved by the state secretary, and sent to the Treasury for approval. In 2009, due to tightened cash controls, financial plans were drawn up on a monthly basis.

All budget holders prepare their own financial plans for each of their programmes separately. For the Ministry of Health with its 17 budget holders alone, more than 100 financial plans need to be monitored and administered by the Treasury and staffed by the Ministry of Health. In total, there are 640 budget holders that report directly to the Treasury for which, in 2007, 3 086 accounts were opened (1 568 accounts less than in 2006).[15]

The Treasury conducts cash planning in the light of the cash plans as well as historical spending patterns. There are no incentives for budget holders to gradually improve spending plans. The Latvian Treasury could consider introducing moderate penalties in the form of interest rates on idle balances caused by inaccurate cash planning (inaccuracies exceeding certain thresholds), as exist in some OECD countries.

The Treasury acts like a bank for the spending units. After checking whether the submitted plans are in accordance with the line ministry budget, the Treasury opens an account per programme and allots resources through the state budget implementation IT system *eKase*. The budget holders subsequently send payment orders directly to the Treasury. The Treasury checks against the availability of appropriations approved by Parliament. The Treasury also checks the documents certifying the transaction and has the authority to block payments. Payments are made overnight by the regional units, but will be done entirely through *eKase* for national currency payments by the end of 2009. Overspending is technically impossible. As payments are made on the basis of payment orders checked against approved appropriations, the budget holder cannot overspend.

Cash management is generally accurate and efficient. It is supervised by the Liquidity Committee consisting of experts from the Treasury's Budget Execution and Forecasting Department, as well as from municipalities. The committee meets every morning for 10-15 minutes to analyse the cash-flow forecast. The debt manager, who also participates in the meeting, immediately executes borrowing decisions.

Due to the specific circumstances in 2009, cash limits were put in place to solve temporary liquidity problems. First, all spending ministries had to freeze 10% of their allocations in special reserve funds, one in each ministry. This allocation was left in the budget in case the situation improved and money could be disbursed. In the first quarter of 2009, the Treasury issued a regulation that, of the remaining 90%, only 21% of the yearly allocation could be spent in the first quarter. As this proved impossible for some line ministries with special spending patterns, certain line ministries have since then been exempted from this liquidity rationing. In fact, the cash limits have served as a delaying measure, anticipating the large savings package introduced in the supplementary budget of June 2009.

4.3. Budget flexibility and reallocation

Overall, the budget execution process seems well structured, and the Treasury is a committed and efficient implementing agency.[16] However, the system has two weak links that have become apparent in the present time of crisis: *i)* lack of commitment and arrears controls; and *ii)* inflexible reallocation procedures.

As to commitments and accumulation of cash arrears, there are currently neither *ex post* nor *ex ante* controls. Following discussions with the IMF, the Cabinet of Ministers introduced, from June 2009 onwards, an information-sharing system according to which budget holders have to report on existing commitments, the areas in which spending arrears occur, and the causes of the arrears. Currently, not all line ministries have a commitment and arrears control system within the ministry in place. Those that do not have one must now set up such a system.

The causes of arrears differ. Sometimes, arrears occur because of insufficient allocations due to inaccurate forecasting by budget holders. Sometimes, however, payment has to wait for reallocation. This issue leads to the second weak link in the budget execution system, the reallocation procedure.

The root of the problem lies in the fact that the budget classification is very detailed. This results in demands for reallocations that the Ministry of Finance collects for all line ministries and that the Cabinet of Ministers approves at least once per quarter. The result, at the end of the year, is that not only does the budget look quite different from what Parliament originally approved, but also line ministries are permanently engaged in a slow and cumbersome procedure for changing allocations from one line item to another.

Articles 9 and 26 of the LBFM, Regulation No. 584/2007 of the Cabinet of Ministers[17] and the Annual State Budget Law establish certain principles:

- reallocations cannot increase the total amount of expenditure approved by Parliament, or more than 5% of the annual appropriations to a (sub)programme;

- reallocations cannot be made from capital to current spending, or be used for increases of salaries, insofar as they increase future spending;
- similarly, such changes of appropriations that increase the long-term commitments authority of ministries are not allowed; and
- reallocations from EU funds to other expenditure programmes, from basic to special budgets, and from social security expenditure to current expenditures, and the establishment of new (sub)programmes, are prohibited.

The proposals of line ministries are reviewed by the Ministry of Finance within three weeks. Depending on the level of reallocation, permission is granted either by Parliament if it concerns residuals of self-earned revenues or additional self-earned revenues or foreign financial assistance, or by the Cabinet of Ministers if the reallocation request concerns shifts between (sub)programmes or economic spending items. With the amendment to the LBFM submitted with the supplementary budget of 1 June 2009, approval of the proposals will be by the Minister of Finance instead of the Cabinet of Ministers. Although this is a step in the right direction, it seems as if a more far-reaching reform could have been envisaged.

Latvia has recently introduced a very effective carry-over regime that avoids the risk of both unlimited carry-over and of "December fever". Unused appropriations are automatically cancelled at the end of the fiscal year, but payments for investment projects that have already started can be made from an appropriations reserve which is annually filled for that purpose. At the end of 2008, the fund comprised about LVL 10 million, of which only half was spent (added to the 2009 budget).

4.4. *Extrabudgetary funds*

There were two extrabudgetary funds in Latvia. The Long-Term Stabilisation Fund was created in 2008 (Article 8 of the LBFM). It aimed at ensuring the availability of resources in emergency situations. On 12 June 2009, the Saeima adopted a law to the effect that, in the period 2009-12, no resources will be added to the Fund and that, moreover, the resources held by the Fund will be used to decrease the deficit over 2009. This implies that the Long-Term Stabilisation Fund is suspended until 2012. Second, there is the older Privatisation Fund, which was established in the 1990s and used to finance additional expenditures. In the past, the proceeds accruing to the Privatisation Fund were only reported in the accounts of the Latvian Privatisation Agency, but the transfers made from the Agency to the state (only a part of the proceeds) were authorised in the budget. The IMF and the Ministry of Finance have agreed to abolish the Privatisation Fund, as its purposes were not clear. Future privatisation proceeds should be used to pay off public debt. The Privatisation Fund is now closed.

4.5. *Conclusions*

The budget execution process in Latvia is well structured, and the Treasury is a committed and efficient implementing agency. After the recent reorganisation, the Treasury has become significantly more centralised and even more efficient.

The use of the single treasury account for the municipalities is obligatory for financial resources which municipalities receive from the state budget, but optional for other resources (proceeds from own taxes and non-tax non-grant revenues). From the point of view of efficiency (and costs of interest), it could be useful for the Treasury to make the single treasury account more attractive for municipalities.

Cash management is generally accurate and efficient. There are no incentives for budget holders to gradually improve spending plans. The Latvian Treasury could consider introducing moderate penalties in the form of interest rates on idle balances caused by inaccurate cash planning (inaccuracies exceeding certain thresholds), as exist in some OECD countries.

Latvia has started to develop a system of commitment registration. This should be pursued with urgency, since the absence of commitment registration may lead to inaccurate cash planning and arrears.

Latvia has recently revised its reallocation procedure to allow for more flexibility. A more far-reaching reform could have been envisaged. Obviously, the need for flexibility in the reallocation regime is directly connected with the number of line items in the budget classification, but even after a classification reform, Latvia could benefit from a more flexible reallocation regime.

The Privatisation Fund was abolished, as its purpose was not clear and it was not filled during the period of large privatisation revenues. Future privatisation proceeds should not be used for additional expenditure but to pay off public debt.

5. Public administration and service delivery

5.1. Organisation of government

The Latvian government has pursued a policy of administrative reform since 1993, most recently articulated through a medium-term public administration strategy spanning 2008-13 (Government of Latvia, 2007). This section describes the key features of public administration and service delivery in Latvia.

According to the State Administrative Structure Law (2001), the state administration is divided into direct and indirect administration. This excludes the high colleges of state, *e.g.* the legislature, the supreme audit institution, the national ombudsman, and the national electoral commission.

- **Direct administration:** Institutions and officials of the Republic of Latvia (being the "initial public person"). Direct administration includes ministries that are responsible for policy development and regulation and their directly subordinated institutions. There are currently 14 ministries. For the central government, subordination can take the form of control or supervision. At present, there are around 185 institutions of direct state administration in control and in supervision. Control means the rights of higher institutions or officials to issue orders to lower institutions or officials, as well as to revoke decisions of lower institutions or officials. Supervision means the rights of higher institutions or officials to examine the lawfulness of decisions taken by lower institutions or officials and to revoke unlawful decisions, as well as to issue an order to take a decision in case of unlawful failure to act. Examples of institutions in supervision are: the Central Statistical Bureau, the Investment and Development Agency of Latvia, the Office of Citizenship and Migration Affairs, and the State Labour Inspectorate.
- **Indirect administration:** Institutions and officials of local government or other public persons established by law or on the basis of law (being "derived public persons"). To such a derived public person has been conferred its own autonomous competence by law, which includes establishing and approving its own budget. Such a person may have its own property. The form and content of the institutional subordination of derived public persons is determined by the law by which, or on the basis of which, the public

person was established. Unless otherwise prescribed by law, the derived public person is under the supervision of the Cabinet. Local governments – in performing the functions of state administration that, in accordance with law, are transferred to their autonomous competence – are under the supervision of the Cabinet in accordance with the procedures of and to the extent prescribed by the Law on Local Government.

The state government holds full and partial ownership in approximately 50 companies. Major state companies include Lattelecom (telecommunications) and Air Baltic (air transportation), both 51% government-owned. Others include Latvian State Forests with responsibility for forest management under the supervision of the Ministry of Agriculture, and the Latvian State Roads with responsibility to manage the state road network, to administer the State Road Fund and to procure road construction under the supervision of the Ministry of Transport.[18]

Table 4 provides a snapshot of central government employment in Latvia. It includes breakdowns for state administrative employment excluding individual and collective service delivery and state enterprises. The number for the central government includes all those working on policy development, support services, administrative policy execution, and regulatory services.

Table 4. **Central government employment in Latvia, 2009**

State administrative employment (ministries and subordinated agencies)	33 913[1]
of which:[1]	
Policy development	1 617
Support services	6 253
Administration of policy execution	2 221
Regulatory and supervisory services	5 382
(Not divided over tasks)	(PM)
State service delivery employment	48 587
of which:	
Health service delivery	3 400[2]
Education service delivery	7 500[2]
Police, firefighters, border guards	16 500[2]
Armed forces	6 000[2]
(Other service delivery)	(PM)
Total central government	**82 500**

1. Figure based on positions obtained, sorting by job families; the figure does not differentiate between filled and unfilled positions as of end February 2009 and includes the 10% reduction in staff numbers that occurred in December 2008.
2. Estimates of the Latvian Ministry of Finance.

Sources: Latvian Ministry of Finance; *Laborsta* Database of the International Labour Organization, *www.ilo.org*; authors' calculations.

The Cabinet of Ministers has set up guidelines regarding the establishment of state agencies. The relevant ministry should demonstrate that a proposed state agency's outputs can clearly be measured, that its operations necessitate substantial managerial flexibility, and that a private company is not a suitable alternative. In addition, the guidelines regulate a minimum size for state agencies (15 staff). State agencies are subsequently managed through a five-year performance agreement between the relevant minister and the director of the state agency. The performance agreements must include a medium-term strategy, a variety of performance indicators for each activity (output targets, cost-effectiveness targets, and quality indicators), an annual business plan and budget, stipulations regarding user charges that may be levied, and the conditions under which a performance agreement can be amended.

The legal framework for state agencies has sought to enhance flexibility in public administration and strengthen transparency and accountability. Previously, during the mid-1990s, a number of state institutions were converted into state joint-stock or limited liability companies regulated under private commercial law. Such arrangements, however, gave rise to a lack of oversight and guidance from parent ministries, overlapping functions and excessive discretion including with regard to user fees. In spite of the fact that they are separate from line ministries, however, state agencies do not receive flexible appropriations and are constrained by the input controls and cumbersome reallocation procedures faced by line ministries (see Section 4 above on budget execution). Some ministries have maintained joint-stock companies to ensure flexibility in service delivery.

A number of initiatives have been taken by the government to improve the accessibility and quality of public services. The government has proposed, among other things, conducting functional reviews of public authorities' activities, establishing a catalogue of public services and user fees, and instituting quality management systems in public administration. The government has established a number of targets for these activities in the current public administration reform strategy, for example:

- 10% of state administration must have undergone a functional audit by 2013;
- 100% of all services provided by state administration must be included in the electronic catalogue of public services by 2013; and
- 50% of state institution services must be subjected to regular quality assessments and client surveys by 2013.

While the first functional reviews have been conducted by the State Chancellery in 2008/09 focusing on the state archives, criminal investigations, agricultural vehicle registration and casino inspections, it is unclear what impact the current crisis will have on the government fulfilling its targets.

5.2. Service delivery in social security, health and education

Social security is financed by social security contributions which are collected by the State Revenue Service. Benefits are administered by the State Social Insurance Agency (VSAA) under the supervision of the Ministry of Welfare. This includes the state pension fund, unemployment benefits, the accident-at-work insurance fund, and the disability, maternity and sickness fund. The VSAA has 38 regional offices throughout Latvia to provide service to all socially insured persons, including 1 130 000 social insurance contribution accounts in 2005 (702 000 of which are under the state-funded pension scheme). The Ministry of Welfare and the Ministry of Health are responsible for the implementation of the state's social security programmes.

Health services are primarily managed by the Health Compulsory Insurance State Agency (VOAVA) under the Ministry of Health. In addition to the Ministry of Health, several other ministries are also involved in health-care service delivery. The Ministry of Justice provides health-care services to prisoners and refugees; the Ministry of Defence provides health-care services to the armed forces; and the Ministry of Internal Affairs operates its own outpatient clinic, although its employees mostly use the mainstream statutory system. Transfers to the VOAVA account for approximately 95% of health expenditures.

The remaining share is managed by the Ministry of Health for health sector management, medical education facilitates within clinical centres, monitoring and control activities, and cultural activities (*e.g.* libraries and museums).

The VOAVA contracts with a variety of service providers including state agencies, joint-stock companies, organisations owned by subnational governments and self-employed providers. Providers tend to be predominantly private for primary care (*i.e.* the level at which a patient has first contact with general practitioners), predominantly public for secondary care (*e.g.* diagnostic treatment and rehabilitation often following referral from primary health care), with ownership concentrated mainly at the subnational government level, and exclusively public in the case of tertiary care (*i.e.* highly specialised for high-risk treatments and rare diseases), with ownership concentrated at the state level.

The Ministry of Education and Science is the main education policy-making institution. It is responsible for issuing the necessary licences for education institutions, sets educational standards along with teacher training content, and is directly responsible for school inspection. Cities and regions are responsible for all public pre-primary, primary, and lower and upper secondary schools. Subnational governments (in liaison with the appropriate ministry) can establish, reorganise or close education institutions, while observing education legislation. Education institutions are relatively independent to organise their work, to establish internal regulations, to appoint teaching and technical staff, and to use their resources. The Ministries of the Interior, Welfare and Culture can also establish education and training institutions and finance and supervise their administration.

The Ministry of Education and Science is currently implementing reforms to rationalise education delivery within Latvia, much of which has been accelerated by the current financial crisis. Among the major changes to be introduced during the second half of 2009 are new funding mechanisms for schools based on the number of students rather than the number of teachers as done in the past. The previous system resulted in a very low student-to-teacher ratio in regional areas: 10:1 for basic education and 20:1 in general secondary education. It is also hoped that the new funding mechanism will help finance the teacher salary reform programme for 2006-10 approved by the Cabinet of Ministers in 2005.

5.3. Human resources management

There are two categories of public sector employees in Latvia: civil servants and public employees. The State Civil Service Law (2001) defines civil servants as employees of ministries and other subordinate institutions of direct and indirect administration; the definition of civil servants excludes local government employees. The responsibilities of a civil servant include policy planning, development strategy formulation, sector activity co-ordination, control of financial resources, and the formulation and observance of regulatory controls.

The civil service accounts for 13% of total central government employment (including public enterprises owned by the central government). Other public sector employees – accounting for 87% of total public employment – are covered by the Law on Labour Affairs. However, most public employees (including civil servants) are regulated under the Law on Prevention of Conflict of Interest in Activities of Public Officials.

Responsibility for public sector employment and pay policies is shared between the State Chancellery and the Ministry of Finance. The Policy Co-ordination Department of the State Chancellery is responsible for the development of human resource policies – including performance evaluation, co-ordination of job classification, career development, and disciplinary rules – and authorisation of establishment of civil servant positions. The Public Sector Wage Policy Division of the Ministry of Finance's Fiscal Policy Department is responsible for public sector remuneration and benefits, including maintaining a database of remuneration (wages and salaries) of civil servants and other state employees.[19] Previously, the Civil Service Administration had been responsible for these tasks but it was closed in 2008. The closing of the Civil Service Administration represents a cost-saving measure in light of the current financial crisis, and followed a gradual shift in responsibilities from the Civil Service Administration to the State Chancellery in recent years.[20]

Recruitment for direct and indirect administration is based on open competition. There is a uniform qualification criterion for entry into the civil service, in addition to position-specific criteria. The State Chancellery is currently working on developing a new methodology regarding the recruitment process. Once employed, state employees may be transferred by the head of the ministry or agency to another position within the same institution.

In December 2005, a new unified pay system for all public sector employees was adopted and implemented in a phased manner between January 2006 and July 2007. Previously, public sector pay was governed by 21 different laws and regulations. Under the new unified system, pay is separated into three components:

- The monthly salary is derived from a combination of (16) salary groups (basic salary) and (6) qualification levels (flexible part of the salary). The salary level of each group is based on a survey of comparable salary groups in the private sector.[21] The state government has established a target for state employees to be paid 80% of a selected private sector comparator. In practice, a broad salary range is established within which state employees may be paid. It gives state secretaries much discretion in setting pay.
- Bonuses according to work assessment (approximately 20% of annual salary but, under certain conditions, reaching 20% of monthly salary – for instance, in case of overwork). Bonuses are based on the outcome of the annual performance evaluation by the public employee's superior and the human resources manager. The objective of the performance appraisal is not confined to performance pay alone, but also to establish training needs and career development.
- In addition, civil servants receive various allowances (annual leave, birth of a child, injury/death of the civil servant and/or family members, dismissal) and supplements for additional duties (up to 40% of the salary per month) or for performance of duties under periods of increased work intensity (up to 20% of the salary per month). However, bonuses and allowances have been capped or stopped since the end of 2008 owing to the financial crisis.[22]

The financial crisis has also precipitated the elimination of a system of management contracts for senior public employees. Previously, management contracts had existed in parallel with the pay system since 1997 to attract and retain highly qualified senior civil servants. The contracts were often seen as an important instrument of political control, and gave the heads of direct and indirect administration complete discretion in salary determination. The introduction of the unified pay system has substantially reduced the use of management contracts; for example, in the State Chancellery the use of performance contracts declined from an estimated 60% to 20% of staff between 2006 and 2008. It is uncertain whether such contracts will be re-established following economic recovery in Latvia.

5.4. *Public procurement*

Public procurement is regulated under the Law on Procurement for State or Local Government Needs (2001) and the Law on Procurement for the Needs of Public Service Providers (2004). The Procurement Monitoring Bureau, an independent agency within the Ministry of Finance, was established in 2002 and charged with regulatory, administrative and monitoring tasks concerning public procurement. In particular, the Bureau provides guidelines, training and technical support to ministries/agencies, publishes full tender information via its Internet portal, and monitors compliance with public procurement laws and regulations. In addition, the Corruption Prevention and Combating Bureau, established in January 2003, may examine violations of procurement procedures after the awarding of a contract.

In recent years, the government has taken various initiatives to promote e-procurement. A Minister for Special Assignments for Electronic Government Affairs was appointed in 2004, and an Electronic Procurement State Agency was established within the Procurement Monitoring Bureau in 2006. As of 1 June 2009, the Agency was moved out of the Procurement Monitoring Bureau to the Ministry of Regional Development and Local Government so as to separate procurement policy making from procurement implementation. The decision to locate the Agency within the Ministry of Regional Development and Local Government reflects the large number of procurement notices issued by subnational governments. In 2008, 56% of all public procurement notices were issued by subnational governments.

The above-mentioned laws define the thresholds for procurement procedures. In addition to these thresholds and procedures, the EU directives on procurement also apply to Latvia. Under state procurement legislation (and the EU directives), there are no obligatory procurement procedures, aside from ensuring transparency, for any procurement estimated at below LVL 10 000 (EUR 14 000). Above this threshold, the minimum time for interested parties to submit bids is determined by the estimated cost of the services, supplies or works being procured. If below LVL 50 000 (EUR 72 000) for services/supplies or LVL 120 000 (EUR 206 000) for works, the procuring agent may invite three or more suppliers to provide a price quotation. Suppliers are to be given a minimum of 15 working days to submit their price quotation. If above LVL 50 000 for services/supplies or LVL 120 000 for works, the procuring agent may select one of four procurement methods (*i.e.* open competition, restricted competition, negotiated procedures, or design contest), each with different minimum time periods for suppliers to submit their bids (see Table 5).

The procuring agent is responsible for issuing its own procurement notice (or for contacting suppliers in the case of the price quotation method) and evaluating the bids received. The procuring agent is generally the unit within a ministry or state agency purchasing the supplies, services or works. In 2008, only 3% of all procurements were done by the central purchasing agent within a ministry/agency.

The Procurement Monitoring Bureau has also established a standard mechanism through which complaints can be made concerning the conduct of procuring agents and concerning possible violations of procurement procedures. Complaints regarding the completeness of the procurement notices and their supporting documents and/or perceived bias in the selection criteria can be submitted to the procuring agent before the closure of bid submissions. Complaints regarding the evaluation of individual bids can be made to the procuring agent up to 10 working days after the announcement of the awarding of the contract. If a complaint is received, the procuring agent must inform any

Table 5. **Procurement thresholds by estimated cost and procurement method**

Estimated cost	Procurement method	Minimum time limit under:	
		Domestic thresholds	EU thresholds
Services/supplies: LVL 10 000-50 000. Works: LVL 10 000-120 000.	Price quotation: purchasers are required to invite at least three suppliers to provide a quotation.	15 working days.	n.a.
For services/supplies, if the estimated cost is: ● LVL 50 000-92 755 (EUR 72 000-172 000), then domestic thresholds apply. ● LVL 92 755 (EUR 172 000) or more, then EU thresholds apply. For works, if the estimated cost is: ● LVL 120 000-3 591 633 (EUR 206 000-5 150 000), then domestic thresholds apply. ● LVL 3 591 633 (EUR 5 150 000) or more, then the EU thresholds apply.	Open competition: suppliers submit all relevant information at the same time in relation to selection and award criteria.	30 calendar days.	52 calendar days.
	Restricted competition: interested suppliers are invited to respond to a request to participate, but filtered to a limited group which is then requested to tender.	25 calendar days for submission of tenders, and 25 calendar days for receipt of tenders after the invitation to submit tenders has been sent to selected candidates.	37 calendar days for submission of tenders, and 40 calendar days for receipt of tenders after the invitation to submit tenders has been sent to selected candidates.
	Negotiated procedure: purchaser negotiates the contract conditions (such as financing, technical specification or documentation) with suppliers after receiving bids.	25 calendar days.	37 calendar days.
	Design contest: purchaser evaluates procurement based on plan/design from suppliers.	30 calendar days	52 calendar days

unsuccessful provider of the reasons why its bid was unsuccessful. If the procuring agent does not respond within two working days, then the complaint may be registered at the Procurement Monitoring Bureau.

Upon receiving a complaint, the Procurement Monitoring Bureau may suspend the procurement process until the complaint has been reviewed, typically within one month. The head of the Procurement Monitoring Bureau establishes a commission consisting of three of the Bureau's civil servants and one expert from outside of government. While the commissions are currently *ad hoc*, starting in 2009 a permanent commission will be established in line with EU directives. Each commission sends an invitation to all the parties involved in a complaint procedure to attend a public hearing in which the commission will ask questions and seek clarification. Following a process of internal deliberation by the commission, a signed verdict is issued by the commission's chair. In 2008, around half of the complaints examined by the Procurement Monitoring Bureau (310 out of 633) resulted in a decision to prohibit the conclusion of the contract.

Public-private partnerships have been identified in Latvia as a potential instrument to provide public services and infrastructure. A Law on Concessions was passed in November 2000, although it did not come into effect until April 2002 following the approval of the "Concept Paper on Promotion of Concessions" by the Cabinet of Ministers. The concept paper delegated responsibility for PPP policy to the Ministry of the Economy. Then in February 2003, the Latvian Investment and Development Agency (LIAA) was established as a dedicated public-private partnership unit under the Ministry of the Economy.[23] Its main tasks are to formulate PPP policy, to provide technical support to ministries regarding project finance mechanisms and project evaluations, and to promote PPPs.

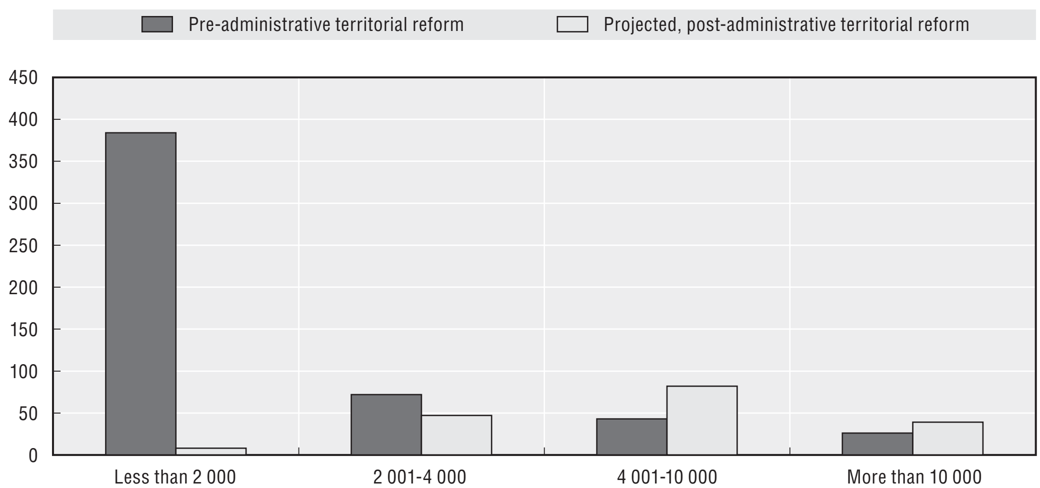
In 2005, a "Policy Framework for Promotion of Public-Private Partnerships" identified a number of constraints faced by the government. These included: the inadequacy of the legal framework (and incompliance with EU standards); a lack of institutional co-ordination; a disconnect between PPPs and public investment planning; and the lack of tools available to ministries to support PPP evaluation.[24] To promote the use of PPPs, the government has established an interministerial action plan and working group chaired by the Ministry of the Economy. It includes representation from the Ministry of Finance, the Ministry of Regional Development and Local Government, the LIAA, and local governments. The policy framework established a target of 30% annual growth of procured PPP projects between 2006 and 2009.

Given the limitations of the current legal framework for PPPs, it is not known for certain how many PPPs exist in Latvia. The Procurement Monitoring Bureau believes that a number of PPPs have been established as regular procurement projects under the public procurement law of 2004.[25] However, a new PPP bill is currently being discussed in the Saeima to replace the 2000 Law on Concessions and address the concerns raised over that law. The new bill includes new procedures for public-private partnerships and for the transfer of the dedicated PPP unit to the Ministry of Finance.

5.5. *Local government*

Latvia is a unitary state with a two-tier governmental structure: the central government level and the local level. Until recently, the subnational governments were divided into regions and municipalities (cities, towns, parishes and amalgamated municipalities). There are a total of 548 local governments (522 municipalities and 26 regional governments). From July 2009, the number of municipalities will be reduced to 118 (9 republican cities and 109 territorial local governments) and the division by tiers will be abolished. Due to this territorial reform, approximately 95% of all municipalities will be amalgamated. Figure 5 shows the projected reduction in the number of municipalities with less than 4 000 residents and the increase in those with 4 001 or more residents.

Figure 5. **Inhabitants in municipalities, pre-and (projected) post-administrative reform**



Latvia is a fairly decentralised country. The list of municipalities' spending mandates is set out in the Law on Local Government. These functions include providing utilities, maintaining and developing public services and facilities (streets, roads, public squares, parks; control of collection and removal of waste, etc.), regulating the utilisation of public forests and waters, providing residents with education (primary and secondary education; extracurricular training and educational institutions), ensuring access to health and social care, providing assistance regarding housing, facilitating economic activities and issuing permits and licences for commercial activity, determining land utilisation, performing civil status document registrations, organising public transport services, etc. Some additional tasks are assigned for the city of Riga. The Law on Local Government stipulates that additional obligations may only be transferred from the central government to local governments if adequate resources for the performance of such tasks are provided. Of all assigned functions, the area of education requires particularly large expenditures. As an example, local budget expenditures in 2008 were distributed by functional area as follows:

- Education: 43% of the total expenditures.
- General public services: 19%.
- Housing and utilities: 12%.
- Economic activity: 11%.
- Recreation, culture, religion: 9%.
- Other functions: 6%.

There are two main sources of municipal revenue: tax sharing and grants from the central government. Depending on the municipality, either grants or tax shares constitute the largest part of revenues. Local taxes constitute a less significant part of the local budget, while non-tax revenues (fees, fines, charges for the use of municipal property) are the smallest part. For example, in 2008 local basic[26] budget tax revenues amounted to 59%, grants to 31%, non-tax and other revenues to 10%.[27]

Local tax revenue comes from the municipal share of the personal income tax (PIT) and from three local taxes (real estate tax, gambling tax and natural resources tax). Of all tax revenue collected in Latvia in 2008, 81% went to central government and 19% to local government.[28]

The local share of the PIT is the most important part of municipal tax revenues (more than 80%). Both the PIT rate and the municipal share in the proceeds are defined by the central government. Since 2005, the central government has annually increased the municipal share of the PIT revenue from 73% in 2005 to 83% in 2009. At the same time, the tax rate has been reduced from 25% in 2005 to 23% in 2009.

The shares of central and local governments are calculated from estimated PIT revenue and not the revenue actually received. For this purpose, the Ministry of Finance annually fixes an estimated total PIT revenue for the following budget year and calculates a PIT ratio for each local government. The estimation basis is the actual tax performance of local governments in the year prior to the budget preparation year (*e.g.* for the budget year 2009, PIT total and ratio data of budget year 2007 were used). The central government set up a compensation system to provide local governments that collect lower-than-estimated PIT revenue with a refund from the central government budget. The refund bridged a gap between real and forecasted proceeds. This system provided a certain predictability to the budget planning process at the local level, though the estimates fixed at the central government level were rather pessimistic (due to high growth and increasing PIT revenues up to 2008). However, the compensation system was abolished in 2009 because the central government was not able to guarantee refund payments to the local level in the difficult circumstances of the financial crisis. At the same time, the PIT proceeds are expected to drop by 15% in 2009 according to the latest forecasts of the Ministry of Finance; therefore, the current financial situation of the local governments is very precarious.

Almost all grants transferred from the central government to the local level are earmarked. They concern teachers' and trainers' remuneration, salaries of medical staff, any increase in the minimum wage, investment projects, road maintenance and construction, etc. The only non-earmarked grant is the equalisation transfer. The equalisation system is implemented to balance substantially different tax and service capacities of municipalities in Latvia. The present demographic situation particularly contributes to creating a gap between poor and rich local governments (about one-third of the population live in Riga and another one-third live in rural areas).

The main equalisation instrument is the Equalisation Fund. The Fund is financed by, first, local government payments (56 local governments contribute to the Fund) and, second, a contribution from the central budget (LVL 7 153 million). In fact, 8% of the total in the Equalisation Fund for 2009 is provided by the state and the rest by the municipalities. The city of Riga pays 63% of the Fund's total. In contrast to the present situation, in 1995 the central government's contribution to the Equalisation Fund amounted to 81%. Since then the central government share has been shrinking compared to local contributions. The amount of the state contribution (LVL 7 153 million) remained fixed over recent years despite inflation and the greater functional decentralisation of local governments. The sources of the Equalisation Fund are distributed between municipalities on the basis of needs determined according to criteria established by law. In 2009, 427 local governments were entitled to equalisation grants. There are also 65 "neutral" municipalities which neither make contributions to the Fund nor receive equalisation grants.

Starting with the administrative reform of 2004, Latvia has implemented a policy aiming to strengthen local fiscal autonomy and independence. One of the objectives of this policy is the reduction of the central government grants in local revenues without increasing local tax bases and local shares in the central government taxes. The reform aims to promote stricter fiscal discipline at the local level. The Latvian administrative reform has not yet reached its goals and, at present, municipal financing remains deficient. The Latvian Association of Local and Regional Governments keeps drawing attention to the weaknesses in the municipal financing system and emphasizes that the gap between real disposable local revenue and the necessary revenue for providing the services prescribed by law has been growing over the last years. The situation became particularly perilous in 2009, when the central government had to make important budget cuts. The drop in local revenues in 2009 is expected to reach 30% compared to 2008.

In the longer term, the Latvian authorities may consider incorporating more financial incentives – for instance, by moving away from earmarked grants (that stimulate both federal and regional authorities to shift spending patterns in the direction of subsidised services) towards non-earmarked grants – and providing larger tax bases or tax shares to municipalities in order to restore the balance between local spending mandates and local resources.

The fiscal rule for local governments focuses on the right of municipalities to borrow and issue guarantees. Debts and guarantees are limited by the annual budget law (Section 45 of the LBFM). Annual borrowing cannot exceed 20% of the current budget revenues of a municipality, excluding earmarked grants and contributions to the Equalisation Fund. The Treasury is the main lender for local governments. The accounts of the municipalities are monitored by the Council on Control and Surveillances. If local governments do not comply with their debt repaying obligations, the Treasury is entitled to apply sanctions to the local government budgets, *e.g.* retrieve funds. In case of financial problems, local governments are placed under supervision. A financial supervisor is appointed by the Ministry of Finance to help a municipality to prepare a stabilisation plan, to decide on loans from the central government, to amend the budget, etc. At present, 19 local governments are under financial supervision.

5.6. Conclusions

The Latvian government has continued to undertake reforms to service delivery and state administration over the last decade, both in the lead up to and in the aftermath of its accession to the EU. The current crisis represents not only an opportunity but also a threat to these reforms. It has accelerated a number of administrative rationalisations and supports the government's commitment to reform. However, it also tends to delay reforms that do not immediately lead to savings and that may be equally important. In the medium term, the government should not lose sight of reform objectives.

The government has moved to amend limitations in the current legal framework and procedures for PPPs. A number of PPPs may have been established as regular procurement projects. The Procurement Monitoring Bureau should ensure that PPPs are not established as a means of circumventing budget cuts during the crisis. Moreover, it should identify whether PPPs have been established and their associated project and fiscal risks.

Partly under the impact of the recent savings packages, the financing of local government has become highly volatile. Not only have grants to local governments been cut at extraordinarily high rates, but also the stabilising tool (the PIT compensation) has been suspended. This makes it virtually impossible for local governments to develop medium-term fiscal planning. It is important that stability is restored as soon as possible in Latvian local public finances.

In the longer term, the Latvian authorities may consider incorporating more financial incentives and providing larger tax bases or tax shares to municipalities in order to restore the balance between local spending mandates and local resources.

6. Accounting and auditing

6.1. Financial reporting

The financial accounts are a responsibility of the Treasury. Its Reports Department ensures the registration of central government budget execution and the aggregation of local government budget execution, and draws up operative and official reports of the Treasury. The Department also ensures a unified methodology for the registration of the central government and local governmental budget execution and releases regulations concerning accounting practices.

Accounting data established by accounting units of line ministries at the central government level are introduced into a centralised electronic system (VBPBP system) and can be downloaded by the Treasury. Local accounting units also provide their accounts to the Treasury. Some local governments use the VBPBP system to send their accounting data to the Treasury, but the majority of municipalities use other means to provide the Treasury with their data.[29] On the basis of the collected accounts, the Treasury compiles three kinds of financial reports: monthly, quarterly and annual.[30]

Monthly reports are cash-based and cover both the central government and the local levels. Reports are publically available and are disseminated on the Treasury's website 15 days after the reporting month. The Treasury also issues monthly reports on debt and guarantees, also available on the Treasury's website.

Quarterly reports prepared by the Reports Department of the Treasury are available only for professional users: the Ministry of Finance, the central bank, the State Audit Office (SAO), and the Central Statistical Bureau. Since 2005 – *i.e.* after Latvian accession to the EU – the quarterly reports have been on a full accrual accounting basis. However, the revenue part of the report remains cash-based.

The annual consolidated report uses Treasury data which are checked and reconciled with the budget holders' accounts by the Treasury and its branches.[31] Ministries and local governments are to submit annual accounts to the Treasury by 1 May of the financial year following the reporting year. The annual report is regulated in Article 30 of the LBFM. The report is fully accruals-based but includes additional information on cash-based execution data. An opinion of the SAO (for local governments, of a sworn auditor) regarding the correctness of the annual accounts must be attached. The Ministry of Finance uses the accounts to prepare a consolidated report. The consolidated report is thereafter submitted to the SAO, and by 1 September the SAO provides its opinion on the report. The Treasury reports to the Cabinet in the middle of September and the Cabinet submits the report to the Saeima by the middle of October. Therefore, the annual consolidated report can be published in October, *i.e.* ten months after the end of the reporting year. The annual reports provide both accrual and cash information and are available on the Treasury's website. The annual report includes:

- A balance sheet of all payments compared with the balance sheets of the preceding year.
- A report on revenues and expenditures compared with the appropriations and revenue authorisations of the state budget and the revenues and expenditures of the preceding year.
- A report on expenditures in connection with unforeseen events within the year.
- A report regarding guarantees issued in the name of the state.
- An account of the investments made by the Minister of Finance.
- A summary of the implementation of local government budgets and a report of the implementation of the consolidated general budget, etc.

Financial reporting in Latvia is accurate and timely and in accordance with international accounting and transparency standards. All important data are released on the website of the Treasury after only a short delay.

6.2. Internal audit

Internal audit procedures in Latvia were introduced in 1999. According to the Law on Internal Audit (of 23 February 2006) and the regulation on internal audit of the Cabinet of Ministers,[32] state secretaries and heads of independent public agencies are responsible for the establishment of a comprehensive and efficient internal control system, as well as for its permanent improvement and supervision. The Ministry of Finance is responsible for overall co-ordination. The Cabinet has specified procedures for the certification of internal auditors,[33] approved the methodology for internal audits,[34] and determined procedures for a peer review.[35]

The state secretaries and heads of agencies have thus established the structure of their internal control systems, in particular the coverage of the subordinate units. In 2008, there were 78 internal audit units in the central government with 300 auditors, 70 of them certified. For 2010, a reduction of 20% (60 auditors) is envisaged. Many of these units are very small (2-4 persons) which hampers operational efficiency. Theoretically, they should audit all systems[36] within the ministries over a five-year period, but not all of them are able to do so. The number of internal auditors (300) is quite large for a small country such as Latvia. For instance, in Scandinavian countries there are generally less than 100 internal auditors (in Denmark, there are less than 50).

The role of the Ministry of Finance includes the development of methodology, the co-ordination of training and professional development, consultative assistance and peer reviews every two years, as well as the preparation of an annual report which is submitted to the Cabinet of Ministers and the State Audit Office on 1 June. In spite of these co-ordination efforts, the quality of internal audit in the ministries varies, depending on whether the units have experienced and qualified staff. The instrument of peer review is very helpful. It entails that the Internal Audit Department of the Ministry of Finance assesses the degree of independence, the application of legal acts and methodology, and the quality of reports, and recommends measures for improvement to the state secretaries. However, given the capacity constraints of the Internal Audit Department, it is planned to extend the period during which all units are reviewed from two years to five years, except for those that need special attention.

Another instrument to promote the introduction and development of a common policy and methodology in ministries and institutions is the Internal Audit Council. It is a consultative forum with five members of high professional standing and expertise that has an important role in the drafting of the annual report. The ministries must submit their contributions for the annual report to the Ministry of Finance by 30 January. The Council reviews and comments on all ministerial contributions and gives written opinions and recommendations. The Internal Audit Department consolidates the comments and sends the annual report to the State Audit Office and the Cabinet of Ministers by 1 June.

The internal audit units are directly subordinated to the state secretaries, to whom they report and who appoint the auditors. The units produce strategic audit plans before the beginning of the budget year. The Internal Audit Department receives the strategic plans at the beginning of the year but cannot change them. The Department similarly receives the compilation of the main audit results in the annual reports of the units, but not the detailed recommendations. This makes it hard for the Internal Audit Department to judge the effectiveness of the internal audits as regards relevance of findings and recommendations. The Internal Audit Department observes the largest problems in the area of performance indicators that are poorly developed, and the multiplicity of different IT systems in use that often cannot communicate with each other. There are monthly meetings between the Internal Audit Department and the heads of the internal audit units at ministry level to share views on these and related issues.

The Law on Internal Audit applies only to the central government. Local governments are regulated by the Law on Local Government which only requires external audit but not internal audit. On a voluntary basis, the largest municipalities use the methodology of the Ministry of Finance and also participate in training.

6.3. External audit

External audit in Latvia is performed by the State Audit Office (SAO) which is, in virtue of the Constitution, Latvia's independent and collegial supreme audit institution. The Auditor General and the seven members of the SAO Council are elected by Parliament pursuant to the same procedure as judges. As the Law on the State Audit Office specifies, its tasks are to:[37]

- Perform financial and performance audits in conformity with international audit standards.
- Ensure the lawful, correct, economical and effective utilisation of public funds – that is, central and local resources (revenues, expenditures, property) as well as EU funds.
- Assist in developing a fair and transparent decision-making process.

The Auditor General has the authority to determine the internal structure of the SAO, to approve procedures and instructions, and to maintain relations with the Parliament, in particular the Public Expenditure and Audit Committee. There are six departments within the SAO: one concerned with methods, and five sectoral departments (Ministry of Finance, President, Cabinet, Foreign Affairs; Defence and Justice; Welfare; Economic; Local Governments), the heads of which are members of the Council. The most important responsibilities of the Council lie in approving the annual audit plans and strategic plans, the report on the annual accounts, and the budget request of the SAO. In a response to the financial crisis, staff was reduced from 193 to 162 by 1 May 2009.

There is currently a discussion on strengthening the budgetary independence of the SAO. The SAO is financed from the state budget, and its budget request cannot be amended by the Ministry of Finance. However, it can be amended by the Cabinet of Ministers. For four other institutions (the Parliament, the Constitutional Court, the Supreme Court, and the President), the Constitution foresees a different procedure – that is, only Parliament can amend the budget request. As the Cabinet of Ministers is subject to audit by the SAO, this could be seen as a potential conflict of interest. The accounts of the SAO are audited by a sworn auditor appointed by Parliament.

The SAO conducts 60 audits a year, half of which are financial audits and half of which are performance audits. Both types of audit are, in their quality and scope, in accordance with international standards.[38] Financial audits aim to establish an opinion on behalf of Parliament whether the annual accounts of ministries and other central state institutions constitute a true and fair representation of the financial facts, are in accordance with the legislation, and are managed efficiently. The SAO also reviews revenues, debt management, and local government annual accounts in co-operation with sworn auditors. The opinion on behalf of Parliament is on both the consolidated accounts and on the annual accounts of the ministries. In 2005, 2006 and 2007, the SAO opinion on the consolidated accounts was qualified due to presentational mistakes, an incomplete list of assets, and poor consolidation of accounts. In addition, out of the 30 financial audits in 2008, about ten were reported to law enforcement institutions (for instance, because the prohibition to pay bonuses was circumvented by using different economic classifications). The SAO keeps records of these cases and follows up on how these violations are being rectified.

The audit cycle starts on 1 July, when the Minister of Finance submits the consolidated annual accounts to the SAO. By 15 September, the SAO reviews the accounts and provides an opinion to Parliament, which votes on it before 15 October. So far, Parliament has never rejected the SAO opinion.

From spring to September, the SAO focuses on performance audits – that is, systemic audits that aim at assessing whether systems are lawful and whether government programmes are efficient and effective and promote accountability, good governance, and good management practice. In the absence of good performance indicators in programmes, however, the SAO finds it difficult to evaluate programme performance.

All auditors perform both types of audits, as the SAO removed the separation of functions taking into account that financial audits serve as the basis for performance audits. Yet, given the different requirements in terms of information and methodology, this approach is now being reconsidered.

The SAO decides completely independently upon its work plan by first determining audit priorities such as public services, investment, use of state property, or collection of revenues. The departments then develop the concrete work plan based on findings from financial audits, press reports, or citizen complaints. In a last step, the audit teams are selected and concrete questions are proposed, together with a costed time plan, and approved by the SAO Council.

The co-operation between the SAO and Parliament is very intense and fruitful for both sides. The Public Expenditure and Audit Committee of Parliament meets once a week for approximately one hour, with the Auditor General always participating.

As to co-operation on internal audits, with a view to the SAO's main task of providing assurance on the annual accounts, the SAO receives the annual reports and discusses the results with the internal audit units at the end of May. The SAO also receives the audit plans and strategic plans and can request access to the internal audit reports – for instance, if it intends to audit a special area. The SAO will discuss the report and assess to what extent the conclusions are useful for its own work. In many instances, however, the reports are not relevant for the issues which the SAO intends to review.

6.4. Parliamentary audit process

The Saeima actively co-operates with the State Audit Office (SAO), ensuring an ongoing engagement with the findings produced by the SAO and thus encouraging executive accountability regarding the budget. Different committees participate in this co-operation, but the central and co-ordinating role is given to the Public Expenditure and Audit Committee, established in 2002 and responsible for examining the SAO reports and opinions. Joint meetings of 1-1.5 hours between the Committee and the Auditor General take place almost every week, during which parliamentarians examine audit reports, interview the minister (or state secretary) responsible for the audited field, monitor the implementation of audit recommendations, consider the SAO annual plan, listen to the SAO opinion on government actions regarding stabilisation, etc. There are joint public hearings with other relevant committees which are invited according to the SAO semi-annual (session) work plan. The SAO is very satisfied with the legislative follow-up on its reports (approximately 80% of the SAO recommendations are implemented).

6.5. Conclusions

Financial accounts in Latvia are a responsibility of the Treasury. The accounts are accurate, timely and in accordance with international accounting standards. Reports are easily available on the website of the Treasury.

The Latvian internal audit system is well structured and in accordance with international standards. Its effectiveness in the prevention of irregularities or inefficiencies cannot be established because the Internal Audit Department of the Ministry of Finance has no insight in the details of the recommendations of internal audit units and the follow-up that is given to them by ministers. It would be useful if the Internal Audit Department could collect more information on the effectiveness and follow-up of the recommendations, preferably not from the internal audit units themselves but from their clients (the ministers). The number of internal auditors (300) is quite large for a small country such as Latvia.

The State Audit Office in Latvia is a well-organised and very efficient institution. It works in accordance with international standards, and annually produces a large number of financial and performance audits of high quality. Its reports are appreciated by Parliament. The SAO recommendations are generally followed up. The SAO also plays an important role in law enforcement. The parliamentary audit process is effective.

Notes

1. Potential GDP: maximal GDP in view of the domestic labour force, capital stock and productivity development.
2. Including food and energy.
3. In the 2008 budget, the government had originally planned a surplus of 1% of GDP.
4. Adjusted fiscal balance in Table 2.
5. Obviously, there are also many components of the financial assistance agreement that are fully in line with the approach and the recommendations of the present review.
6. Numerical fiscal rules can be applied to various fiscal aggregates, such as measures of expenditure, revenue, the budget balance or debt. See also Anderson and Minarik (2006).
7. Countries that try to avoid annual adjustments, such as the Netherlands and Sweden, do reallocate from year to year between sectoral ceilings in the light of new spending initiatives or macroeconomic circumstances. Furthermore, for 2009 and 2010 these countries have adjusted their multi-annual frameworks in reaction to the financial crisis.
8. Direct administration includes: the State Chancellery; the Ministry of Agriculture; the Ministry of Culture; the Ministry of Defence; the Ministry of the Economy; the Ministry of Education and Science; the Ministry of the Environment; the Ministry of Finance; the Ministry of Foreign Affairs; the Ministry of Health; the Ministry of the Interior; the Ministry of Justice; the Ministry of Regional Development and Local Government; the Ministry of Transport; and the Ministry of Welfare. High colleges of state include: the Saeima (Parliament); the State Audit Office; the Supreme Court; the Constitutional Court; the Prosecutors Office; the Central Election Commission; the Central Land Commission; the Radio and TV Board; the Corruption Prevention and Combating Bureau; the Information Analysis Service; and the Office of the Ombudsman. See Section 5 for a discussion of the organisation of government.
9. A programme-based classification groups expenditures according to their objectives. Refer to Kraan (2007) and Robinson (2007).
10. The budget year coincides with the calendar year.
11. It does not apply to the 2009 budget year when the procedure was completely changed because of the financial crisis.
12. It is worth mentioning that 1 October is the only deadline left in the Law on Budget and Financial Management after the amendments of 2008. Other binding deadlines for the budget procedure were removed from the Law to make the budget preparation process more flexible.
13. In the Latvian terminology: an institution of direct administration, see Section 5 below.

14. The legal basis is, apart from Article 23 of the Law on Budget and Financial Management, the Cabinet of Ministers Regulation No. 677, 3 August 2004, "Regulation of the Treasury approved by the Cabinet of Ministers", with amendments, and the Regulation on the Treasury's Reports, 7 February 2007, approved by the Minister of Finance.
15. These are the budget holders of the ministries and independent public agencies mentioned in Section 4.1 above.
16. The Treasury maintains its management system in accordance with the requirements of the ISO 9001:2000 Quality Management System, and implements specified policies and goals.
17. Cabinet of Ministers Regulation No. 584, 28 August 2007, "The order how ministries and other central state institutions work out and the Ministry of Finance evaluates requests on reallocation of appropriation among programmes, subprogrammes and economic expenditure codes".
18. Latvian State Forests was established in 1999 following the closure of the Forestry Fund special budget. It obtains its income from stump taxes and is not included in the budget, but is required to make a payment to the state budget. Latvian State Roads is the legal successor of the former Latvian Road Administration and now fulfils the same road administration and management functions.
19. Two databases are maintained by the Ministry of Finance. One covers civil servants (approximately 16 000), the other covers central government employees (approximately 54 000). The necessary information for the database is provided by state budget institutions and analysed after collection.
20. Since the administrative reforms of 2004-09, a proposal has been put forward to establish a new government human resources agency. While this proposal has not been altogether eliminated, it is uncertain whether this will now happen because of organisational arrangements precipitated by the current financial crisis.
21. The Ministry of Finance purchases private sector market comparator information from the private sector. It does not use the data of the Central Statistical Bureau.
22. Bonuses according to work assessment and annual leave allowances were cut altogether in 2009 as part of the fiscal consolidation programme. Allowances for the birth of a child have been limited to two children, instead of six children before the crisis, and capped at LVL 1 000. The allowance following the death of a family member has been capped at LVL 1 000. Finally, supplements for additional duties have been capped at 20% of a civil servant's salary, and are not to exceed two months' salary.
23. The unit was first set up in September 2003 as the Concessions Division within the Ministry of the Economy, taking over the functions of the Privatisation Agency, and only became the Latvian Investment and Development Agency (LIAA) in February 2004.
24. Lacking tools are, for instance, value-for-money assessments, project risk management, project finance management, project legal frameworks, and an evaluation framework.
25. The Procurement Monitoring Bureau cannot differentiate between traditional public procurement and PPPs, but estimates that around 20 PPPs have been established based on estimates from the Registry of Companies.
26. Each local government budget, like the central government budget, is divided into a basic and a special budget. The special budget's share in the consolidated local government budget is very small (less than 10%). The revenues of the special budget, formed by the resources of the State Roads Fund, the natural resources tax and privatisation, are earmarked for special purposes and expenditures established by law.
27. *Source:* Ministry of Finance of the Republic of Latvia, *www.fm.gov.lv*.
28. *Source:* Ministry of Finance of the Republic of Latvia, *www.fm.gov.lv*.
29. The Treasury envisages making the use of the VBPBP system mandatory for all local governments.
30. The Treasury also prepares operative cash-flow execution reports on a daily basis. These are available only to the Cabinet and the line ministry concerned.
31. Together with the reduction of the number of municipalities in July 2009, the number of Treasury branches will reduce to five (at present, there are around 25).
32. Cabinet Regulation No. 306, adopted 10 June 2003, "Procedures for the Performance of the Internal Audit in an Institution".

33. Cabinet Regulation No. 307, adopted 10 June 2003, "Procedures for the Certification of Internal Auditors".
34. Instruction No. 8, 24 April 2007, "Internal Audit Methodology, Issued in compliance with Internal Audit Law Section 13, Part 6".
35. Cabinet Regulation No. 55, adopted 16 January 2007, "Procedures for the Performance of the Peer Review of the Work of Internal Audit Units".
36. The regulation on audit methodology defines eight systems: common administration and management of the ministry or institution; financial management; personnel management; provision of the ministry's or institution's performance; document flow; information technologies; public procurement; and EU programmes.
37. The Law on the State Audit Office, adopted on 9 May 2002, with amendments in 2004 which removed the authority to make decisions on penalties, and reduced the term of the Auditor General from 7 years, non-renewable, to 4 years, renewable once. Further amendments were made in 2005 (audit of local governments) and in 2008 (removal of election of managers).
38. See, for instance, the report on unprofessionalism of Latvia's higher education system, *www.lrvk.gov.lv/index.php?id=2022&newsid=1022*.

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