Organisation for Economic Co-operation and Development

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IMPROVING THE FUNCTIONING OF PUBLIC FINANCIAL MANAGEMENT IN LATVIA – BUDGET PREPARATION AND IMPLEMENTATION

Technical Note

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List of acronyms

CBA	Cost-Benefit Analysis
CFMIS	Centralized Financial Management Information System
CoM	Cabinet of Ministers
CSCC	Cross-Sectoral Coordination Centre
CSO	Civil Society Organisation
EU	European Union
FDC	Fiscal Discipline Council
FDL	Fiscal Discipline Law
GFC	Global Financial Crisis
GDP	Gross Domestic Product
IA	Internal Audit
IFRS	International Financial Reporting Standard
IMF	International Monetary Fund
IPSAS	International Public Sector Accounting Standard
KPI	Key Performance Indicator
LALRG	Latvian Association of Local and Regional Governments
LBFM	Law on Budget and Financial Management
MEPRD	Ministry of Environmental Protection and Regional Development
MoF	Ministry of Finance
MTBF	Medium-Term Budget Framework
MTEF	Medium-Term Expenditure Framework
MTO	Medium-Term Objective
OECD	Organisation for Economic Cooperation and Development

PEAC	Public Expenditure and Audit Committee
PFM	Public Financial Management
PIM	Public Investment Management
PPP	Public Private Partnership
SAO	State Audit Office
SBPEIS	State Budget Planning and Execution Information Systems
SGP	Stability and Growth Pact
SOE	State-Owned Enterprise
TSA	Treasury Single Account
VSAA	State Social Insurance Agency

Executive Summary

Following strong institutional reforms introduced in 2013-2014 in the wake of the 2008 crisis, the Latvian budget system has generally remained stable. During the last decade, significant progress has been achieved in many of the areas covered by the *Recommendation of the Council on Budgetary Governance*. The most significant reform has been the establishment of a sustainable medium-term budgetary framework, underpinned by a set of strong fiscal rules. These rules were adopted to ensure that Latvia would achieve full compliance with the new rules of the European Union's (EU) economic and fiscal surveillance, which were strengthened following the 2008 crisis. They have been important in helping to deliver enhanced fiscal discipline in recent years.

Fiscal rules help ensure fiscal discipline, but they are not sufficient in themselves, and tools and processes must be put in place to ensure that the rules are respected. In response to the strong deterioration of public finances in the wake of the global financial crisis, it was decided that the budget framework needed to be changed significantly, with a far greater emphasis on a medium-term approach underpinned by fiscal rules – to be applied by central and local authorities – that would provide the overarching framework within which the budget would be formulated.

In Latvia, the Fiscal Discipline Law (FDL) of 2013 was drafted with the purpose of achieving this objective. Its enactment was intended to achieve a sustainable and predictable medium-term budgetary framework that would ensure more efficient allocation and management of public resources while supporting the implementation of prudent fiscal policies and respecting the preventive arm of the Stability and Growth Pact. As such, it provides an overarching framework of fiscal sustainability within which the budget process must be implemented. The Law on Budget and Financial Management (LBFM) of 1994, which has been revised accordingly, sets out the budget procedures.

With regards to independent fiscal institutions, the establishment of the Fiscal Discipline Council (FDC) in 2014 is another important recent initiative. The FDC was established by the FDL. The Council has become an effective fiscal monitoring body that, among other responsibilities, monitors the government's compliance with fiscal rules, endorse the macroeconomic forecasts that are used to prepare the budget, assess the adequacy of the Fiscal Security Reserve and assess the sustainability of national fiscal policy.

The FDL also established a strong fiscal risks management framework by requiring the regular identification and disclosure fiscal risks. This is done through a Declaration on Fiscal Risks is annexed to the Medium-Term Budget Framework Law published every year. The Declaration also presents how the budget and government policies mitigate the identified fiscal risks. This include a Fiscal Safety Reserve of at least 0.1% of GDP, prescribed by the FDL, which provides a pocket of financial resources that can be tapped if fiscal risks materialise.

The FDL has also made improvements in setting a medium-term perspective in the budget anchored by the EU Stability and Growth Pact. Latvia adopted a top-down approach to determine the aggregate volume of funds available every year for government expenditures (fiscal space), with three-year projections updated on a rolling basis. In practice however, the expenditure ceilings are not enforced: they have little bearing on the budget.

Latvia has also made strong efforts in improving its tools and processes for resource prioritisation and allocative efficiency. For example, it started an annual spending review process in 2016 with the aim of increasing policy effectiveness and to aligning expenditure to government priorities**.** Spending reviews are one of the areas in which Latvia has made impressive progress in adopting good international practice of budgetary governance.

While Latvia has made impressive progress in adopting good international practice with regard to budgetary governance, more can be done to prepare Latvia to deal with the fiscal challenges on the next decades, including:

- Improving the methodology for estimating of expenditure baselines to create more incentive for realistic budget planning
- Addressing the inefficiency of in-year budget execution and the rigidity of the current system in allowing for budget reallocations;
- Improving performance budgeting with a view to enhancing accountability;
- Building the capacity within the MoF for central management and oversight of public investments;
- Improving the quality and timeliness of financial and non-financial information from the proposed new CFMIS;
- Establishing an independent review of the current arrangements for managing public service payroll costs;
- Introducing a fiscal constraint into the spending reviews; and
- Introducing amending legislation where this is required to underpin key reforms.

Latvia’s recent record on the sustainability of the public finances provides a strong basis for the successful implementation of these remaining challenges. Delivering such improvement will be key in successfully implementing investment and reform measures identified in Latvia's recovery and resilience plan, such as the green transition and improvements in the educational, health and social services sectors.

The main recommendations for reform are summarised below:

- Strengthen the MTEF by improving baseline estimates.
- Improve the efficiency of in-year budget execution, by introducing a structured in-year reallocation (virement) regime, based on a supplementary budget towards the end of the year rather than the existing practice of bi-weekly reallocations.
- Improve Latvia’s performance-based budgeting system to enhance accountability.
- Build the capacity of the MoF to undertake a central role in the management and oversight of public investment.
- Improve the quality and timeliness of financial and non-financial information from the proposed new CFMIS.
- Undertake an independent review of the current arrangements for managing public service payroll and determining salary increases in Latvia and implement measures to enhance the role of the MoF.
- The Government should consider how to introduce a pre-agreed fiscal constraint into its spending reviews, by including a requirement in the TORs that a minimum level of savings – a savings target – must be identified when conducting the spending review.
- The LBFM should be amended so that it strengthens the medium-term budgeting approach and underpins the recommended reforms identified above.

More detailed recommendations are provided in the section Recommendations for Reform.

Recommendations for reform

Main Recommendations

Strengthen the MTEF by improving baseline estimates (2022-2025).

- Develop a framework to estimate baseline expenditures based on OECD good practice. The framework should take account of the issues highlighted in Box 2 of this report.
- Prepare an action plan to implement the new framework across line ministries and budget entities, and include building analytical tools, skills and capacity in these ministries and the MoF.
- The action plan should include a phased approach with an initial focus on capacity building in the MoF and selected ministries.

Improve the efficiency of in-year budget execution, by introducing a structured in-year reallocation (virement) regime, based on a supplementary budget towards the end of the year rather than the existing practice of bi-weekly reallocations (2023-24).

- A process with greater flexibility should have specific regard for the authority of the Saeima when approving the Budget. The process should take into account the issues in Box 6 of this report.
- The MoF should consider the implications of introducing such a process, including amendments to the LBFM.

Improve Latvia's performance-based budgeting system to enhance accountability (2022-2025).

- Undertake a review of the existing PBB system to make it more effective in allocating budgets to priority areas of government policy, and monitoring the impact of government programmes and projects on public services.
- The review could include the following elements:
    - An assessment of the design of the Latvian PBB system, its scope, and objectives.
    - The extent to which PBB has been used in practice in Latvia, and has resulted in improved performance in delivering public services.
    - A comparison of the Latvian PBB system against OECD standards of good practice.
    - A redesign of the current system of 2,000 KPIs to a manageable number, distinguishing between indicators that are used for strategic purposes (e.g. in setting overall spending priorities and monitoring performance) or for the detailed management of spending by line ministries.
    - An examination of the budget structure for PBB purposes, possibly by amending the basis on which the Saeima approves the budget and to ensure that policy objectives are aligned with the administrative responsibilities of the entities responsible for executing budget programmes.
    - How the system can be used by officials for different purposes in different organisations (e.g. by line ministries in managing large expenditure programmes and projects, by the MoF in deciding on the allocation of budget resources, by parliamentarians in holding the government to account for its budget or investment decisions).
- Prepare and implement an action plan on a redesigned PBB system, which would involve:
    - Initiate a dialogue between the MoF, budget entities and other stakeholders with a view to redesigning the PBB system.

    - Implement the action plan with analytical tools and skills, extensive training and capacity building, and reengineered IT systems on a phased basis.

Build the capacity of the MoF to undertake a central role in the management and oversight of public investment (2022-2025). This recommendation would require consultations across government ministries and would need to be implemented over a period of years. It could include the following stages:

- Conduct a comprehensive review of public investment management (PIM) policies and practices in Latvia. This should focus on the three main aspects: (i) the planning of sustainable investment across the public sector; (ii) the section of investments to the right sectors; and (iii) the implementation of projects to deliver productive and durable public assets.
- Based on this review, consider the options for improving PIM across the public sector, and specifically the MoF's role, which could include:
    - Effective oversight of PIM and PPPs by the MoF.
    - Increasing the capacity of the MoF to take a central role in overseeing the PIM of budgetary entities and other public bodies, either by reviewing the mandate of the Budget Department or establishing a separate unit in the MoF.
    - Preparing and publishing guidelines on the appraisal and selection of investment projects, with a focus on major projects.
    - Ensuring that the processes for evaluating, selecting, and monitoring PPPs are integrated fully into the government's PIM strategy.
    - Establishing a framework for monitoring the implementation of major investment projects to ensure they deliver value for money.
    - Improving the forecasting of public investment expenditures, which will enhance capital budgeting in the medium term expenditure framework
    - Considering the development of a centralised public investment databank that tracks projects from initiation to completion, and includes a register of public assets.
- Build capacity within the MoF should recognise the responsibility of the line ministries for managing investment projects efficiently and effectively. The MoF should scrutinise management of PIM and engage with line ministries on the budget implementation of PIM.

Improve the quality and timeliness of financial and non-financial information from the proposed new CFMIS (2023-24).

- In developing the new system, the separate needs of line ministries as well as the MoF should be carefully assessed so that the system that is selected can provide the essential information for all users.
- The new system should be designed to ensure value-for-money for taxpayers. The estimated expense of a new system should be based on its whole-life costs, which will include operating costs and maintenance, as well as depreciation. The MoF should be closely involved in the decision on the new system in defining the requirements of the new system, and as guardian of the public purse.
- The new system should be implemented to allow for ongoing reform of the organisation of the government's accounting services across ministries, to achieve efficiencies and allow key budgeting and financial management functions to be decentralised to line ministries.

Undertake an independent review of the current arrangements for managing public service payroll and determining salary increases in Latvia and implement measures to enhance the role of the MoF (2023-2024).

- The review would evaluate the role of the MoF in determining payroll structures and salary increases in Latvia, how its mandate compares with the role of finance ministries in other OECD countries, and how the role could support the MoF's responsibilities for managing fiscal policy and the budget process.

The Government should consider how to introduce a pre-agreed fiscal constraint into its spending reviews, by including a requirement in the TORs that a minimum level of savings – a savings target – must be identified when conducting the spending review (2023-24).

- The MoF could build on the excellent framework in place and at the same time take on a similar approach to other OECD countries which have highlighted areas to strengthen – and scale up – spending review practices to ensure they are as effective a tool as possible for reallocating fiscal resources.
- In order to introduce such a change, a comprehensive review of the spending reviews process may be necessary with reference to other OECD countries where spending reviews have been in operation for a longer time.
- Even with the pre-agreed savings targets, line ministries could still be incentivised to cooperate in the spending review process by allowing them to keep a proportion of the identified savings for priority areas.

The LBFM should be amended so that it strengthens the medium-term budgeting approach and underpins the recommended reforms identified above (2023).

Supporting Recommendations

Broaden the coverage of its Declaration of Fiscal Risks to include risks such as climate change and the environment (2022-2023).

- Build the skills and analytical tools of the MoF to broaden the scope of risks monitored, disclosed and managed to include climate and environmental issues (e.g. physical and transition risks).

Publish every 3-5 years a report on the long-term fiscal sustainability of public finances (2023).

- The FDC should consider preparing similar reports or commenting on the MoF's analysis of long-term fiscal sustainability, consistent with OECD good practice (e.g. the OECD Best Practices for Budget Transparency).

Implement the recommendations of the OECD's 2021 report to strengthen the Council's analytical capacity, which includes preparing monthly reports, increasing the accessibility of these reports, and engaging with the Saeima (2022-24).

- Amend the FDL to enable these improvements to the FDC's operations and outputs.

Increase the incentives for budget holders to improve annual financing plans, by introducing penalties in the form of interest rates on idle balances caused by inaccurate cash planning, as exist in some OECD countries (2023).

- In parallel to these cash management reforms, the Treasury should consider digitalising the middle office functions of its debt management unit with the aim of reducing the manual transactions and improving data analyses and decision-making processes

To facilitate debate in the Saeima and by CSOs and the public, improve the presentation of the budget documents in line with the recommendations of the SAO's 2018 Report and OECD good practice (2024).

- Essential information would include improved analysis of and information on the performance of the government in delivering public services (see Recommendation 4.2).
- Provide the Saeima with the resources to examine effectively any budget or fiscal report that it deems necessary.

Internal audit functions should be rolled out across the municipalities, and be provided with more staff resources, improved analytical capabilities and a dedicated IT system (2023-24).

Economic Background and State of Public Finances

Recovering from the Global Financial Crisis (GFC)

Latvia was hit severely by the 2008 global financial crisis and even more so than other Baltic countries. This external shock coincided with the bursting of the debt-financed domestic demand bubble. Latvian Gross Domestic Product (GDP) contracted by about 25%. The unemployment rate jumped from 8% in 2008 to around 20% in 2010. The budget deficit widened from 0.6% of GDP in 2007 to 9.7% in 2009 (and 8.6% in 2010). Consequently, public debt increased from 9% of GDP at the end of 2007 to 44.5% of GDP at the end of 2010.

The country asked for international financial assistance from the European Union (EU), the International Monetary Fund (IMF) and regional partners. The support reached EUR 7.5 bn (30% of GDP), of which EUR 4.5 bn was used. In return for this assistance but also in response to calls from domestic stakeholders, the country implemented a harsh fiscal adjustment of about 25% of GDP within five years to achieve fiscal sustainability. Public sector wages, for example, were cut by 20%. Latvia also implemented wide-ranging reforms to strengthen its fiscal framework and to meet European requirements for joining the Eurozone, of which Latvia became an official member in 2014.

Latvia's recovery and economic adjustment from the crisis was generally lauded as impressive. The government addressed prior economic imbalances. Internal devaluation contributed to raising external competitiveness and supported the recovery. In 2013, Latvia was the fastest growing economy in the European Union, with GDP growth reaching just above 4%. Unemployment was brought down to 10% in 2015. The country nevertheless still faced long-term structural issues such as unemployment, emigration and public finance challenges.

The state of the economy and public finances prior to the COVID-19 pandemic

In 2019, the budget deficit decreased to pre-GFC levels as it reached 0.6% of GDP. Between 2016 and 2018, Latvian economic growth averaged around 3.2% on the back of strong investment and a supportive external environment. [1] Both factors, however, faded and in 2019, economic growth was 2.5%.[2]

In 2019, the IMF and the Organisation for Economic Cooperation and Development (OECD) regarded the country's fiscal stance to be broadly neutral over the medium term.[3,4] The IMF saw no immediate risks of fiscal imbalances, though it considered that the precise costs of wage increases, territorial reform and tax adjustments had to be assessed. It expected Latvia's public debt to GDP ratio and borrowing needs to decline. It also considered that Latvia had sufficient fiscal space to react to exogenous shocks (the fiscal stance and public debt level should remain resilient in the case of an expansionary fiscal policy to respond to a shock).

Consequences of the COVID-19 crisis

In 2020, the Latvian economy contracted by 3.6%, which was less severe than the 6.6% average contraction across the Eurozone. Large and active fiscal policy intervention, however, limited the damage to the economy. Owing to available fiscal space and the suspension of the Stability and Growth Pact, the cumulative fiscal support since the start of the pandemic has reached around 12% of GDP (see Figure 1

[1] Real GDP forecast, Total, Annual growth rate (%), 2016 – 2022 (oecd.org)

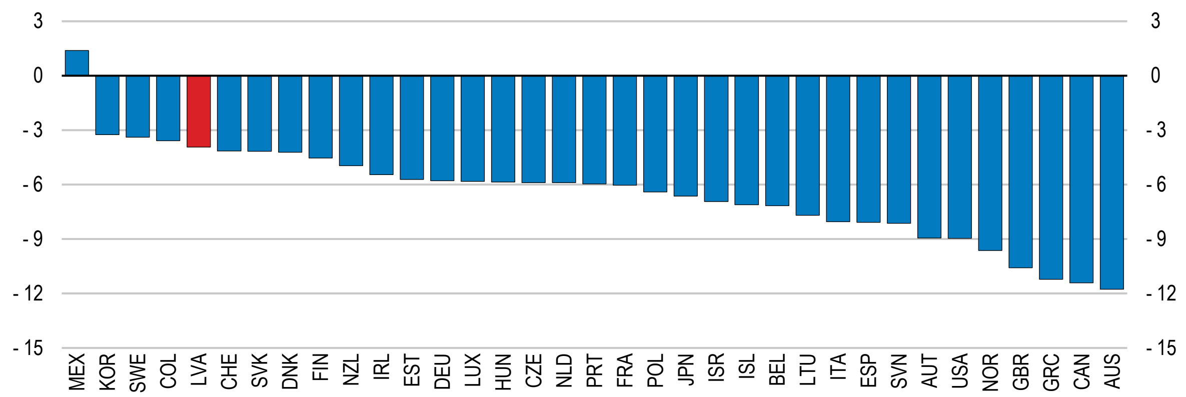
[2] c0113448-en.pdf (oecd-ilibrary.org)

[3] Republic of Latvia: 2019 Article IV Consultation-Press Release; and Staff Report (imf.org)

[4] f8c2f493-en.pdf (oecd-ilibrary.org)

for 2020). In 2022, output growth is expected to reach between 3.6% (OECD) and 5.2% (IMF). The IMF also projects limited scarring of the economy in the medium-term: by 2025, real GDP levels should be lower than its pre-crisis trend by 1.3%.[5]

Figure 1. General government financial balance (% of GDP), change between 2019 and 2020, % pts



Source: OECD Economic Outlook 110 database

As a result of this large fiscal support, Latvia's budget balance was -7.2%[6] in 2021, and is projected to be -1.4% in 2022 and -2% in 2023[7]. Latvian public debt, while still well-below the Euro average, increased from under 37% in 2019 to about 49% of GDP in 2021 due to both nominator (higher debt) and denominator (lower GDP) effects. The outlook of course remains subject to the evolution of the pandemic. While the European Commission 2021 Spring Forecast expected the debt-to-GDP ratio to decline in the wake of a lower fiscal deficit and a rebound in GDP, Latvia's latest Draft Budgetary Plans foresees general government debt to reach 51% in 2022[8]. This does not take account, however, of the impact of the Russian invasion of Ukraine.

Recovering from the crisis

The pandemic has raised the importance of a higher level and a better quality of sustainable and growth-enhancing investments. In this context, Latvia will receive approximately 6.7% of 2020 GDP in grants from Next Generation EU[9]. These EU-funded investments are expected to take over from the initial fiscal response to support the economic recovery and accelerate the green and digital transition[10].

[5] https://www.imf.org/en/Publications/CR/Issues/2021/08/31/Republic-of-Latvia-2021-Article-IV-Consultation-Press-Release-Staff-Report-and-Statement-by-465002

[6] Ministry of Finance.

[7] https://ec.europa.eu/info/sites/default/files/economy-finance/ip160_en_0.pdf

[8] https://en.upbilancio.it/focus-paper-no-3-23-december-2021/

[9] https://www.oecd-ilibrary.org/sites/66c5ac2c-en/1/3/2/29/index.html?itemId=/content/publication/66c5ac2c-en&_csp_=9b4ecb1aafc11518f34da944ee244a5b&itemIGO=oecd&itemContentType=book

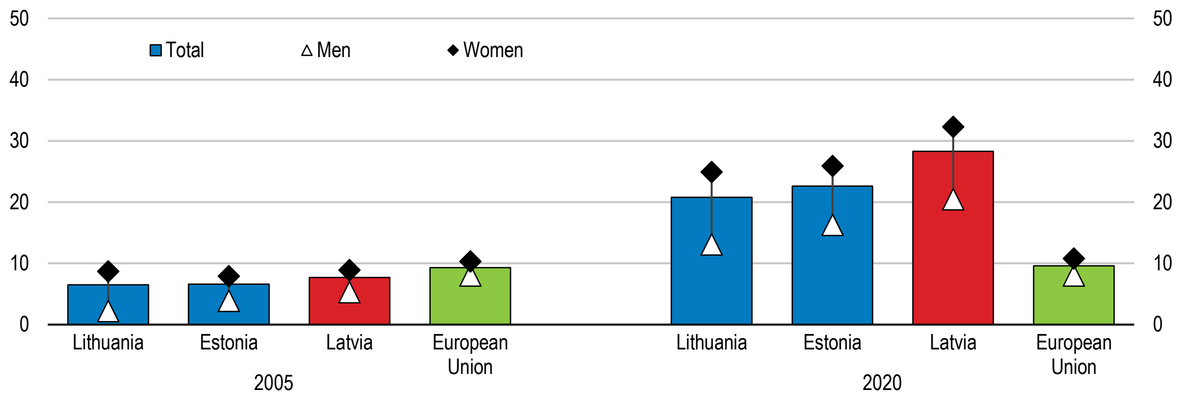
[10] https://ec.europa.eu/info/sites/default/files/economy-finance/com-2021-514-1_en_act_part1_v3.pdf

Once the economic recovery is well established, Latvia will likely have to rebuild its fiscal space[11]. A strong medium-term budgeting framework (MTBF) is essential to make the country resilient to future shocks and allow for targeted fiscal policy support where needed (e.g., improvements in the coverage and adequacy of the social protection system). A strong public financial management (PFM) framework is essential to control the growth of current expenditures[12]. Such a framework is also crucial to sustaining growth-enhancing public investments, especially in the event of a reduction of EU funding for structural programmes.

Besides the green and digital transition, Latvia will have to face specific economic challenges, which include:

- *In the short-term*: Wage growth has been steady in Latvia. While the minimum wage was raised by 13% in 2018, it was still below that of its Baltic neighbours in 2020. Wages grew by 8% in 2019 and 6% in 2020. Public sector wage and higher minimum wage increases contributed to wage growth in 2021. A sustained increase in wages, decoupled from productivity growth, could put pressure on the economy and impede competitiveness. The government is making efforts to restructure the public service wage bill to reduce bonuses and overall costs.
- In the long-term: Ageing and emigration have contributed to a strong decline in the working age population of 20% since 2000 and to the rapid increase in the old-age dependency ratio (Figure 2). A large share of emigrants is skilled, increasing the pressure on wage growth through skills shortages. The OECD does not forecast age-related spending to increase substantially in the long-term. However, the lack of social protection associated with the large informal sector and the structure of the pension system have caused high poverty levels among the elderly. A reduction in old age poverty and the maintenance of replacement rates would require additional spending on age-related spending.

Figure 2. Old-age poverty rate



Note: Population over 65, threshold is set at 50% of median disposable income.
Source: OECD Latvia Economic Survey 2022

[11] IMF 2021.

[12] https://ec.europa.eu/info/sites/default/files/economy-finance/com-2021-514-1_en_act_part1_v3.pdf

Conclusions

Latvia has managed a strong turnaround in its public finances following the global financial crisis. From 2014 to 2020, Latvian fiscal performance has been robust. It has provided Latvian with the ability to respond to large shocks such as the COVID-19 pandemic. The strong fiscal response to the pandemic did not hamper the fiscal sustainability of the country. Still, structural challenges remain, especially related to public service wages, ageing and emigration. Improvements in PFM, including better management of public investment and medium-term budget planning would also be useful to make the Latvian economy more resilient and support the digital and green transition.

Institutional and Legislative Framework

Institutional organisation

Administrative organisation

Latvia is a parliamentary republic with a unitary system of government comprising three branches, legislative (the Parliament or *Saeima*), executive (the Cabinet) and judicial (the Courts). The functions and responsibilities of each are outlined in the Constitution and in legislation.

Important organic laws are the State Administration Structure Law (2002), the Law on Local Government (1994), the Fiscal Discipline Law (FDL) (2013), the Law on Budget and Financial Management (LBFM) (1994) and the Law on Local Government Budgets (1995). The FDL underpins overall fiscal discipline while the LBFM governs the budget process, both for central and local government. The Law on Local Government Budgets prescribes the local government budget process in greater detail and is consistent with the LBFM.

The State Administrative Structure Law provides that state administration will be divided into direct and indirect administration. Direct administration includes ministries and their directly subordinated institutions, such as the Central Statistical Bureau, which is subordinated to the Ministry of Economics. The Law also provides that institutions of direct administration be under the supervision of the Cabinet of Ministers (CoM). Indirect administration includes local government institutions and other public entities that operate autonomously, which includes establishing and approving their own budgets.

There are two layers of government: the state (central government) and the municipalities (local government). The central administration consists of the CoM, the State Chancellery and 13 Ministries, 167 institutions directly subordinated to a ministry, as well as institutions of direct administration not financed from the Budget and institutions partially financed from the Budget, such as universities. Local government consists of 36 municipalities and 7 state cities, following a substantial reduction in the number of local authorities, introduced in 2021.

Municipalities are the basic administrative territorial units of self-governance. They are legal entities and possess their own budgets, but rely significantly on transfers from the State Budget. Executive power at municipal level is exerted by the Chairperson of the Council, who is elected by his or her fellow Council members.

There are technically no extra-budgetary entities or funds in Latvia[13]. However, social security benefits are administered by the State Social Insurance Agency (VSAA), which operates under the direct supervision of the Ministry of Welfare. Social security is financed by social security contributions collected by the State Revenue Service. There are four separate funds: the state pension fund, the unemployment benefit fund, the accident at work insurance fund and the disability, maternity, and sickness fund. Although the VSAA may borrow from the Treasury to meet shortfalls in revenues, this has not been necessary in recent years as the social insurance fund is strongly in surplus. There is also the National Health Service under the Ministry of Health, which holds primary responsibility for administering health services. The National Health Service is funded mainly from the State Budget but it also allocated one percentage point of the social security contributions annually.

[13] Defined as a set of accounts or a government entity that engaged in “financial transactions, often with separate banking and institutional arrangements, that are not included in the annual state budget law” (Allen and Radev, 2006).

The Constitution[14] provides that the Saeima must approve the annual budget before the year commences. It also provides that Cabinet must submit an annual account of budget expenditures to the Saeima for its approval. The LBFM provides that the deadline for this is 15 October.

Main participants in the budgetary process and budgetary organisation

The main players in the budget process are the CoM, the Saeima, the Ministry of Finance (MoF), as well as the line ministries and other central State institutions. Lower-level spending units are engaged in the budget system through the higher-level central State institution to which they report.

The MoF is the central budget authority. However, core budgetary functions are spread across several departments within the Ministry and are not centralised under a single Deputy State Secretary. The structure of the ministry is shown in Figure . The core functions are allocated as follows:

- The Budget Department (under the Deputy State Secretary on Budget Issues) is responsible for the preparation of the draft annual budget law, monitoring budget expenditures during the year, organising re-allocations of budgetary appropriations during the year, assessing the financial impact of new policies and/or new legal acts on the budget and monitoring performance with regard to key performance indicators;
- The Budget Policy Development Department (under the Deputy State Secretary on Budget Issues) prepares budgetary legislation, engages with budget institutions regarding the interpretation of this legislation, provides solutions to non-routine issues that may arise, organises the procedures for implementing priority measures, conducts spending reviews, and focuses on improving the results and performance of public spending;
- The Local Government Financial Supervision and Financing Department (under the Deputy State Secretary on Budget Issues) is responsible for the oversight of the sub-national finances by reviewing the finances of municipalities, organising loans to be granted to municipalities, regulating the Municipality Equalisation Fund and dealing with other issues regarding the budgetary relationships between State and local budgets;
- The Economic Analysis Department (under the Deputy State Secretary on Financial Policy Issues) is responsible for preparing macroeconomic and fiscal forecasts. The Department is composed of two divisions: the Macroeconomic Analysis Division and the Fiscal Analysis Division. It prepares medium-term forecasts twice a year – at end-February for the Stability Programme and in early June in preparation for the annual budget;
- The Fiscal Policy Department (under the Deputy State Secretary on Financial Policy Issues) is responsible for drafting the Medium-term Budget Framework Law, updated annually, that establishes the fiscal framework within which the annual budget is formulated. The Department is also responsible for preparing the Stability Programme, monitoring compliance with fiscal rules, and monitoring the long-term impact of PPPs on the State budget and debt position. In addition, this department is responsible for monitoring the financial position of state-owned enterprises that are classified as part of general government under the European System of National Accounts.

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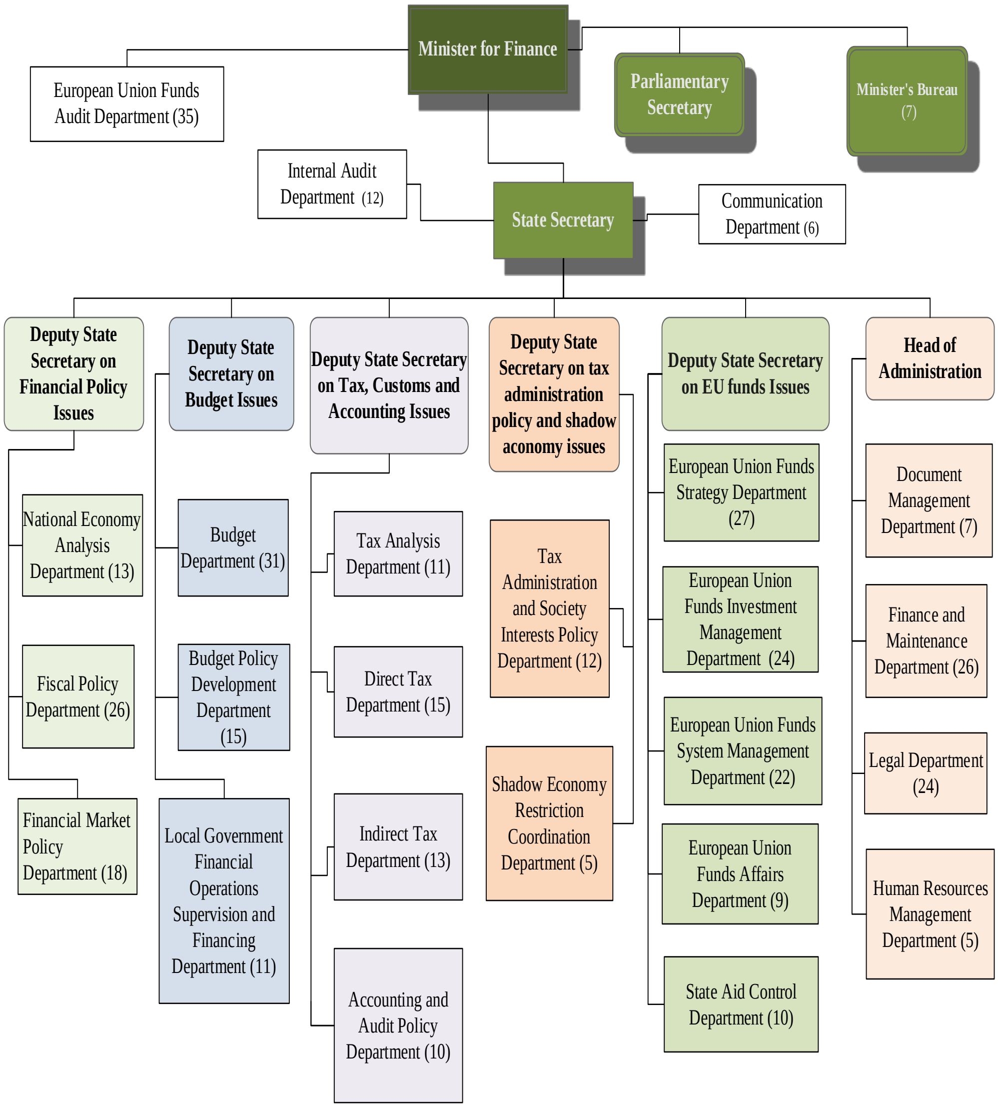
[14] Article 66 of the Constitution.

Figure 3. Structure of the Ministry of Finance



Source: Ministry of Finance

- Treasury functions are carried out at arms'-length to the MoF. The Treasury is responsible for the financial transactions underlying the budget execution and accounting functions of the government, as well as managing the national debt. The head of the Treasury, the Treasurer, is appointed and dismissed by the Minister for Finance. The Treasury coordinates its activities with the Deputy State Secretary on Budget Issues but it enjoys significant autonomy;
- Three departments under the Deputy State Secretary on EU Funds Issues manage the selection, contracting, and certification of the legality and compliance of European Union funded projects. While the regulatory framework governing EU-funded projects is strong, line ministries have a key role in the selection of projects;
- These funds are included in the State Budget and before projects are selected, the appropriate line ministry must receive agreement from the MoF Budget Department that domestic co-funding is available for the project.

As stated above, the State administration consists of institutions of direct administration and institutions of indirect administration. For budgetary purposes, however, public bodies consist of bodies financed from the budget and agencies non-financed from the budget. The LBFM defines bodies financed from the budget as budget institutions, derived public entities partially financed from the State budget, all economic operators, associations or foundations financed fully or partially directly from the State budget. Budget institutions comprise State or local government institutions, State or local government agencies are fully financed from the State or local government budgets while derived public entities like universities are partially financed from the State budget. The agencies not financed from the budget are seven institutions of direct State administration subordinated to a member of the Cabinet whose activities are financed fully from own revenues or, in the case of the VSAA, from the special budget. The LBFM therefore covers every type of public institution and provides that each may be funded from the budget. Even the agencies non-financed from the Budget may avail of the provision to borrow from the Treasury to meet a shortfall in revenue.

The initial discussions for the State Budget are primarily between the MoF and the line ministries. This is the case even for bodies subordinated to the ministries. However, the negotiation process is heavily politicised. Either the Prime Minister or the Minister for Finance conducts negotiations, involving other ministers and other members of the political community as required. The roles of the MoF and line ministries are to provide any detailed information that may be requested.

For the local government budgets, the Latvian Association of Local and Regional Governments (LALRG) negotiates with the Municipal Financial Supervision and Financing Department of the MoF. These negotiations are to agree on local government's share of the consolidated general budget and the allocations to individual municipalities through the equalisation process. The proposed allocations are sent to the Saeima with the draft State budget. The Ministry of Environmental Protection and Regional Development (MEPRD), which discusses with the municipalities their strategic goals, performance, compliance with legislation etc., has no direct role in negotiating their budgets. Nevertheless, before 1 August each year, the LALRG negotiates with each line ministry, including the MEPRD, on the funding of local governments. The results of these negotiations are sent to the Ministry of Justice to ensure that the agreements are in line with existing legislation and to the MoF to ensure that they can be funded from the State Budget. Therefore, the MEPRD is indirectly involved in the process of local government budget determination to a significant extent.

The LBFM provides that the heads of institutions "financed from the budget, institutions non-financed from the budget and local governments, as well as of capital companies, in which a State or local government capital share has been invested, shall be responsible for the observance, implementation and control of the procedures and requirements laid down in this Law, as well as for the efficient and economic utilisation of budgetary funds in conformity with purposes intended"[15]. The focus of this process is on compliance rather than performance. Although line ministries and agencies report annually with reference to key performance indicators, and at end-June and end-September prepare budget execution reports on what has been achieved and how it will affect key performance indicators, a substantive discussion of these matters is neither required under the Law nor occurs in practice.

Consolidated General Budget

The LBFM provides that the consolidated general budget, which is "the sum of the State budget, the local government budgets, the budgets of derived public entities partially financed from the State budget and the budgets of the institutions non-financed from the budget from which transfers have been deducted[16]",

[15] Article 46.1.

[16] Law on Budget and Financial Management, Part I Terms Used in This Law.

will be made for information purposes. It also classifies social insurance as a special budget that is part of the State budget. The consolidated general budget aggregates the following:

- The State budget, comprising the Presidency, the CoM, ministries, executive bodies and budgetary organisations on the central level, and social insurance, as well as the budgets of the Saeima and the courts. The State budget accounted for 78.5% of the consolidated general budget in 2021;
- Local government budgets, which accounted for 18.5% of the consolidated general budget in 2021;
- Budgets of entities partially financed and/or non-financed from the State budget, which accounted for 3.0% of the consolidated general budget in 2021.

The LBFM provides that both the State budget and local government budgets consist of a basic budget, donations and gifts. While only the State budget is approved by the Saeima, there are safeguards to ensure that the budgets of local governments and other entities are monitored. The LBFM Art. 25.5 allows the Minister for Finance to examine institutions' budgets, including local governments, with regard to planning, accounting and reporting. In addition, local governments are required to send regular reports to both the MoF and the Treasury on budget execution as well as loans and guarantees. Within this framework, local governments have access to significant resources. They receive 75 per cent of total receipts from personal income tax and also have the power to raise revenues by applying a real estate tax rate of between 0.2 per cent and 3.0 per cent. Most local governments choose to apply the lowest real estate tax rate and any shortfall of personal income tax is guaranteed from the State budget. With regard to the budgets of the Saeima and of the judiciary, although these are presented as part of the State budget, the Government may not amend the original requested budget without it having been agreed with the institutions themselves.

Budget legislation

The LBFM establishes the basic legal framework for public financial management. This law was enacted in 1994 and has been amended on over 40 occasions since then, including every year since 2002. The LBFM provides for many of the essential principles associated with sound budgeting, such as top-down budgeting, a multi-year budgeting framework, comprehensive budget accounting, provision for unforeseen expenditures arising from fiscal risks, alignment between the budget and medium-term strategy, comprehensiveness, quality and transparency, and independent oversight through the State Audit Office (SAO).

The LBFM is amended annually but at a technical level (e.g., changes in terminology) in consultation with the Saiema. The MoF considers that these amendments take up little time and do not detract significantly from resources that could be used for deeper analysis of data. There is a provision in the LBFM that the draft MTBF will be submitted to the Saeima by 15 May, rather than the existing deadline of 15 October. The MoF considers that it is better to have a strongly informed public debate in the Saeima on the economic framework underpinning the Budget every Spring than create the scope for extensive debates on expenditure in both the Spring and Autumn, which could put upward pressure on expenditures.

However, there are no specific provisions for capital budgeting in the Law other than to state that an explanation of capital expenditure shall be included in the annual budget documentation presented to the Saeima. Neither does the Law contain provisions to ensure that performance, evaluation and value for money are central to the Budget process although it should be noted that there are Cabinet guidelines on the use of performance indicators. Furthermore, although the Law places the MoF at the centre of the budget preparation process, the available fiscal space each year is allocated by the Cabinet without technical guidance from the MoF to ensure that it is allocated most effectively.

The 2009 OECD Budget Review noted that the Latvian budget preparation process was characterised by some features that required attention. These were:

- Continuous budgeting whereby there were regular in-year adjustments to increase expenditure in years of high economic growth and downward adjustments in years of weak economic growth.
- The absence of a domestic fiscal rule that would impose a constraint on central government spending (although Latvia of course has complied with the Maastricht criteria regarding the 3% limit on the annual general government budget deficit as a percentage of GDP and the 60% limit on the debt to GDP ratio).
- Ineffective multi-annual fiscal planning despite the existence of a formal medium-term fiscal framework.

These weaknesses have been addressed to some extent. The enactment of the FDL in 2013 strengthened the legal framework for managing public finances by ensuring a balanced budget over the course of the economic cycle. Although there is no domestic fiscal rule, the Law complies with EU Council Directive 2011/85/EU of 8 November 2011 on requirements for budgetary frameworks of the Member States. This Directive regulates the scope, structure and content of the medium-term budget framework and integrates into the national legislative framework the obligations under the EU Directive, which mandated, in particular, the implementation of new fiscal rules. In this regard, the provisions for an enhanced medium-term fiscal outlook, a structural budget balance over the medium-term, an expenditure ceiling rule, enhanced fiscal risk management, the rule that general government real expenditure growth does not exceed average potential GDP growth, and the establishment of the Fiscal Discipline Council (FDC) ensure that fiscal discipline is stronger because of this legislation. To guard against the weakness of 'continuous' budgeting, section 9 of the Law requires that the adoption of laws and regulations that will weaken the structural balance must be offset fully by compensatory measures. Fiscal rules and the sustainability of the public finances are discussed in more detail in the next section of this report.

The LBFM has been amended to ensure consistency with the requirements of the FDL. Section 9 of the LBFM states that "financial management shall be implemented in conformity with the fiscal policy principles laid down in the Fiscal Discipline Law". Together, these two laws provide the present legal framework for the budget process. The FDL establishes the fiscal rules and framework while the LBFM sets out the budget procedures.

In addition to these laws, there is legislation to regulate specific financial operations, e.g.:

- The annual Medium-Term Budget Framework Law (the package of draft framework laws), the annual State Budget Law (the package of draft budget laws) and the annual Protocol (agreements and disagreements) between the Cabinet and the Association of Local and Regional Governments of Latvia, all of which are presented to the Saeima in October each year;
- The Law on Local Government Budgets, which establishes the procedures for local government budgeting and is consistent with the LBFM;
- The Internal Audit Law, which determines the legal regulations for the establishment, operation and co-ordination of the internal audit system in ministries and other public institutions;
- The Law on Public Private Partnerships (PPPs) which regulates the agreement and transparent operation of PPPs in accordance with EU Directives;
- There are also several Cabinet Regulations that provide for: (i) the classification of revenues and expenditures in the budget documentation, (ii) preparing and submitting budget requests, (iii) amending budget appropriations, and (iv) the performance of internal audit, and other matters.

There is no specific legislation for the management of public debt but the LBFM provides that the Treasury manages it in accordance with the Central Government Debt and Cash Management Strategy approved by the Minister for Finance. Although the public debt to GDP ratio has been rising in recent years and, as stated above, is projected to reach 51% at the end of 2022, the impact of Covid-19 has been a significant factor in this rise. Prior to Covid-19, the ratio had actually fallen from 47.7% at end-2010 to 36.7% at end-2019[17]. Furthermore, the ratio has remained below the 60% debt to GDP Maastricht threshold. On this basis, one can say that debt management is not a weakness in Latvia. However, it could be an advantage to have a clearly defined debt management strategy underpinned by appropriate legislation in case an economic crisis accompanied by higher interest rates should emerge. Further, the SAO has expressed concern that there is no policy regarding the optimum level of debt that Latvia can incur before it becomes difficult to fund, especially considering pessimistic demographic forecasts[18].

Overall, following the adoption of the FDL, the Latvian legal framework for budgeting appears comprehensive albeit without specific provisions for capital budgeting and performance budgeting. There is full compliance with EU Directive 85/2011 although it is not clear what should be the follow-up actions in the event of any deviation from the fiscal rules. The law also provides a legal and operational framework that facilitates broad compliance with the OECD Principles of Budgetary Governance. It must be noted, however, that the SAO has criticised the LBFM for a number of shortcomings. In a recent report, the SAO observes that the Law's objectives and the range of procedures it covers are not clear; the terminology is not correct or consistent; explanations of key terms are lacking; and it does not always regulate some of the more recent practices adopted in the process. The Office has also criticised the number of amendments that have been made to the Law over the years[19].

Conclusions

The institutional and legislative framework for the budget and PFM in Latvia is generally of a sound standard, as would be expected of an OECD member country. The roles and responsibilities of the key institutions are well defined in legislation and in practice. The legislative framework, especially since the enactment of the FDL in 2013, provides a strong basis for ensuring that budgetary policy is framed within the overarching principle of fiscal discipline. The legislation also provides for a medium-term approach to fiscal policy and budgeting.

However, the dominant role of the Cabinet in making most decisions on priority activities and the timelines in the budgetary cycle suggest that budget formulation is still focused primarily on the annual budget, a view that was confirmed in discussion with officials. Furthermore, the existing legislation fails to provide for a structured and unified approach to the management of capital budgets. Nor does it contain provisions to ensure that performance, evaluation and value for money are central to the Budget process. In the following sections of this report, we make a number of recommendations that would strengthen the role of the MoF, strengthen medium-term budgeting, improve capital budgeting and place greater emphasis on performance budgeting. Should these recommendations be adopted and implemented, the LBFM should be amended to underpin the reforms.

[17] https://ec.europa.eu/eurostat/databrowser/view/SDG_17_40__custom_2154677/default/table?lang=en

[18] Presentation from SAO to OECD Team during meeting.

[19] Budget Planning in Latvia: Is the Current Approach Effective? SAO, 2018.

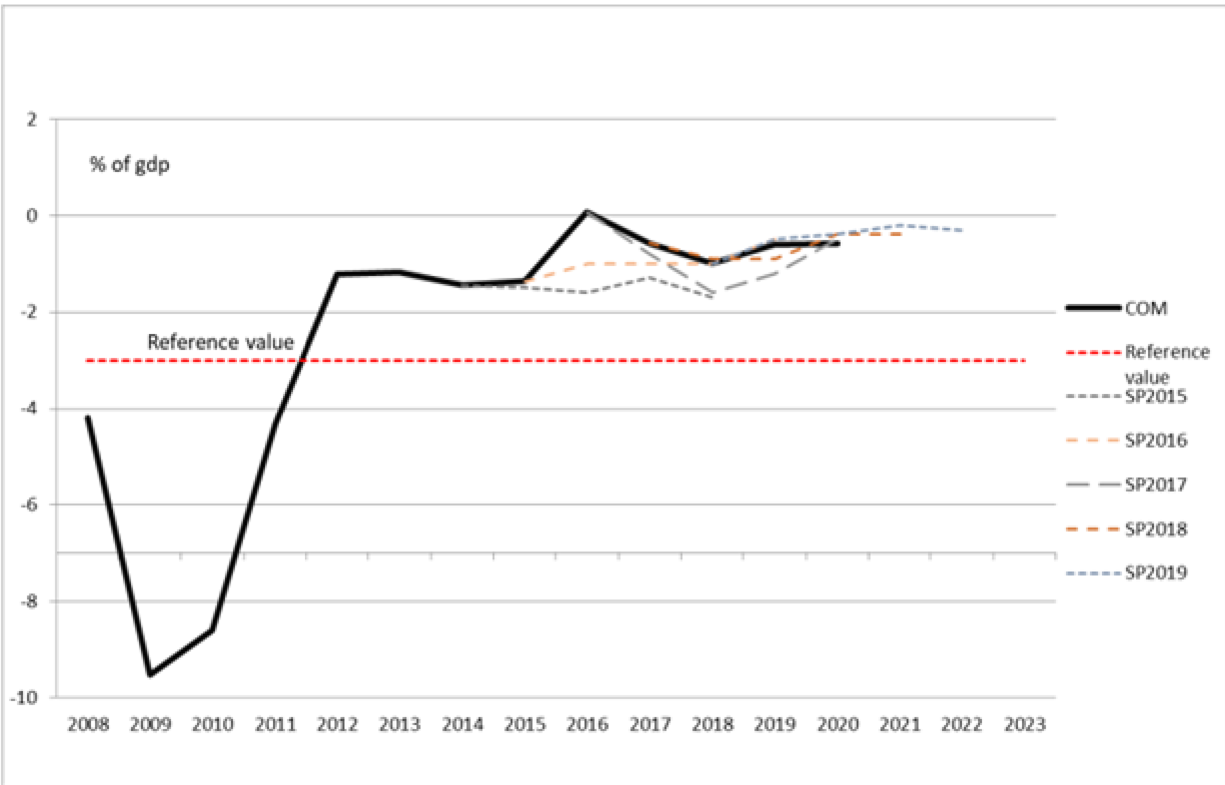
Fiscal rules, risks management and sustainability of public finances

Fiscal rules

Four of Latvia's fiscal rules are fixed by the EU fiscal framework. The preventive arm of the European Stability and Growth Pact (SGP) uses two budget indicators: the structural balance and the expenditure benchmark. The first of these indicators stipulates that the structural budget deficit should be no greater than 0.5% of GDP. The expenditure benchmark limits the growth of net expenditure to the growth in medium-term potential GDP. In assessing progress towards the Medium-Term Objective (MTO) under the preventive arm of the SGP, the European Commission makes an analysis based on both of these budget indicators. At the end of 2016, the European Council agreed to give more prominence to the expenditure benchmark in checking compliance with the MTO. Following the Council agreement, the European Commission shifted its focus from the structural balance to the expenditure benchmark under both the preventive and the corrective arms of the SGP. The two other EU fiscal rules are the Maastricht criteria on the nominal budget deficit being above 3% of GDP and the government debt-to-GDP ratio being below 60% of GDP (or at least moving towards it). In 2020, the European Fiscal Board activated the general escape clause to suspend the Stability and Growth Pact. The rules remain deactivated in 2022. These rules are fixed in the domestic fiscal framework through primary legislation. The FDL and the Medium-Term Budget Framework Law operationalise these fiscal rules by providing for three-year expenditure ceilings to be used as the framework for drawing up the annual Budget Law. Compliance with Latvia's fiscal rules is monitored by the FDC, the country's independent fiscal institution (discussed in the section on transparency and openness in budgeting).

In recent years, Latvia's (legal) compliance with EU fiscal rules has been very strong (Figure 4). On the debt rule, Latvia's public debt-to-GDP ratio has always been below 60%. While Latvia deviated from the deficit rule from 2009 until 2014, it is to be noted that this deviation decreased in a linear fashion (i.e., every year, Latvia's nominal budget deficit declined or stabilised). This period coincides with the consequences of the global financial crisis and Latvia's turnaround of its fiscal framework. In addition, Latvia's structural balance was making constant progress towards its Medium-Term Objective (MTO) of a structural balance of about 1% of GDP.

Figure 4. Government budget balance projections in successive stability programmes



Source: Commission 2019 spring forecast; Stability Programmes

Fiscal risks and sustainability

Overview of the fiscal risks management framework

The objective of Latvia's fiscal risks management framework is to minimize deviations from the forecasted fiscal variables over the medium-term. These indicators are the structural general government budget balance, the nominal general government balance, government revenue and adjusted ceilings of government expenditures.

The various elements of the country's fiscal risks framework have a strong legal basis. They are grounded in both primary and secondary legislation. The 2014 FDL requires regular identification, disclosure and mitigation of fiscal risks. A Declaration on Fiscal Risks is annexed to the Medium-Term Budget Framework Law published every year. The Law also sets a Fiscal Safety Reserve of at least 0.1% of GDP, which provides a pocket of financial resources that can be tapped if fiscal risks materialise. Government regulation No. 229 governs the management of fiscal risks by the public administration and the methodology to determine the size of the Fiscal Safety Reserve.

Overall, Latvia's fiscal risks management framework is well integrated into the processes for managing fiscal policy and the budget. The identification and measurement of fiscal risks are disclosed in the budget. The measurement of fiscal risks helps determining the size of the main mitigation tool, the Fiscal Safety Reserve. Fiscal risks are monitored and managed by a well-specified and devolved management system. The FDC also carries out an external control function.

Identification and measurement of fiscal risks

Latvia has developed a sophisticated methodology to identify and measure fiscal risks. It first classifies the sources of fiscal risks according to a modified version of the matrix developed by the World Bank (Figure). Fiscal risks are defined by the nature of a government obligation (implicit or explicit) and the influence of the government on the materialisation of the risks. This complies with Principle 9 of the OECD Recommendation on Budgetary Governance of "clearly identifying, classifying by type, explaining and, as far as possible, quantifying fiscal risks, including contingent liabilities, so as to inform consideration and debate about the appropriate fiscal policy course adopted in the budget".

Figure 5. Government Fiscal Risks Matrix

Sources of obligations	*Direct liabilities (obligation in any event)*	*Contingent liabilities (obligation if a particular event occurs)*	
Explicit Government liability as recognized by a law or contract	• Sovereign debt (loans contracted and securities issued by central government) • Expenditure composition (nondiscretionary spending) • Expenditures legally binding in the long term (civil service salaries and pensions)	• State guarantees for non-sovereign borrowing by and other obligations of sub-national governments and public and private sector entities (development banks) • Umbrella state guarantees for various types of loans (mortgage loans, student loans, agriculture loans, small business loans)	• Trade and exchange rate guarantees issued by the state • State guarantees on private investments • State insurance schemes (deposit insurance, income from private pension funds, crop insurance, flood insurance, war-risk insurance)
Implicit A moral obligation of government that reflects public and interest group pressures	• Future public pensions (as opposed to civil service pensions)[a] • Social security schemes[a] • Future health care financing[a] • Future recurrent costs of public investment projects	• Default of a subnational government or public/private entity on nonguaranteed debt/obligations • Banking failure (support beyond government insurance, if any) • Cleanup of liabilities of entities being privatized • Failure of a nonguaranteed pension fund, employment fund, or social security fund (protection of small investors)	• Possibly negative net worth and/or default of central bank on its obligations (foreign exchange contracts, currency defense, balance of payments) • Other calls for bailouts (for example, following a reversal in private capital flows) • Environmental recovery, disaster relief, military financing

09.03.2022

Source: Adapted from World Bank, 2002

Latvia defines two types of fiscal risks: quantifiable and non-quantifiable. A quantified fiscal risk is one where the probability of occurrence and the impact on the budget balance are assessed. Latvia's Declaration of Fiscal Risks identifies and discusses both types of fiscal risk. Their measurement is then used to determine the Fiscal Safety Reserve.

Cabinet Regulation No.229 presents the methodology to determine the impact and probability of fiscal risk materialisation. Fiscal risks are measured both quantitatively and qualitatively. The impact on the general government balance is measured qualitatively on a three-point scale: the impact may be considered as significant (>0.5% of GDP), medium (between 0.01% and 0.5% of GDP) or low (below or equal to 0.01% of GDP). Where possible, the impact is also measured quantitatively. The probability of a fiscal risk materialising is assessed on a 5-point scale. Existing mitigation measures are taken into account in assessing this probability.

The Declaration on Fiscal Risks presents an assessment of the accuracy of past fiscal forecasts. Sources of deviations from past forecasts are examined from both the perspective of the structural balance and the nominal balance at the general government level.

In recent years, Latvia has made continuous improvements in the identification and measurement of fiscal risks. Table 1 below shows how the government has performed over a 5-year period compared to its objectives.

Table 1. Latvia Fiscal Risk management between 2016 and 2020

Areas of possible improvements identified in 2016	2016 Declaration of Fiscal Risks	2020 Declaration of Fiscal Risks
Compliance of fiscal risk against principle of symmetry	Little to no coverage	Discussed
Evaluation of macroeconomic risks	Little to no coverage	Examined as (1) non-quantifiable risks and (2) in the Chapter on the transmission channels of economic shocks to the national fiscal indicators
Improved quality control over SOEs	Little to no coverage	Examined as (1) quantifiable risks and as part of (2) Chapter on the transmission channels of economic shocks to the national fiscal indicators
Political unwillingness to create fiscal security reserve	N/A	N/A

Source: OECD Secretariat

Key policies for the prevention or mitigation of fiscal risks

A well-developed monitoring and management system

Latvia's fiscal risks management framework is also operationalised by a devolved three-tiered management system. The Fiscal Policy Department in the MoF handles the general management of fiscal risks. The Department maintains a register of fiscal risks and liaises with individual ministries and agencies to update it. It is in charge of drafting the Declaration of Fiscal Risks. In this capacity, it assesses the fiscal impact and probability of occurrence of fiscal risks that are used, in turn, to determine the size of the Fiscal Safety Reserve. The Department also provides methodological assistance to central administration institutions on a case-by-case basis.

Central administration institutions such as line ministries are responsible for fiscal risks that are more specific to their functions. They are in charge of the monitoring, prevention and mitigation of such risks. They coordinate with the MoF to keep the register up to date. They also elaborate their own fiscal risk management reports that are submitted to the MoF every year.

In addition to quantifiable and non-quantifiable risks, Latvia distinguishes a third level of fiscal risk management: individual fiscal risks. Individual fiscal risks are those related to the execution of projects and policy. One such example is fiscal risks stemming from a state-owned enterprise (SOE) or a specific Public Private Partnership (PPP) project. Responsibility for these risks is devolved to the entity that directly supervises the corporation or policy.

Declaration of Fiscal Risks

Every year, the Declaration of Fiscal Risks that is annexed to the Medium-Term Budget Framework Law contains several elements. These are a descriptive summary of the Latvian management framework of fiscal risks, their classification, the methodology to assess how likely they are to occur and their budget impact, a presentation of each quantifiable fiscal risk and non-quantifiable fiscal risk, and the calculation of the Fiscal Safety Reserve.

As argued by the OECD Review of the FDC, the Declaration of Fiscal Risks is a comprehensive and detailed analysis of the fiscal risks in Latvia and their management. The 2020 Declaration identifies quantifiable fiscal risks as risks from the materialisation of state and municipal guarantees, state loans and risks related to state and local corporations. PPPs are identified as non-quantifiable risks, as are risks emanating from the financial sector and cyclical deviations from the macroeconomic forecasts. The 2020 Declaration also includes a chapter on the transmission channels of economic shocks to the national fiscal indicators, especially the structural balance. The channels identified in the Declaration are: general government sector guarantees, debt management risks and state-owned companies not classified as part as the general government. It should be noted that environmental issues such as climate change are not considered as a fiscal risk.

Fiscal Security Reserve

As stated previously, the FDL establishes a Fiscal Security Reserve of at least 0.1% of GDP. This Reserve ensures there is fiscal capacity to provide financial resources in case these fiscal risks materialise. It is implemented by allowing an upward adjustment to the expenditures of individual budget institutions as planned in the annual budget law. The combined total of the Reserve and the individual expenditures cannot exceed the expenditure ceiling under the MTEF. The amount of the Reserve is calculated every year based on quantifiable fiscal risks included in the Declaration of Fiscal Risks.

The sophisticated calculation of the Reserve is set by Cabinet Regulation No. 229. It is derived from a risk-weighted formula. Broadly, the values of the fiscal impact are multiplied by the probability of the risks materialising. Fiscal risks that have a probability of occurrence of 5 (the highest on the scale; close to 100%) are excluded from the Reserve and included as part of the regular expenditures. Fiscal risks that have a probability of occurrence of 1 (the lowest on the scale; close to 0%) are excluded. As such, only quantifiable risks with a probability of occurrence of 2, 3 and 4 are included.

Latvia’s Fiscal Safety Reserve is consistent with Principle 9 of the OECD Recommendation on Budgetary Governance to apply “mechanisms to promote the resilience of budgetary plans and to mitigate the potential impact of fiscal risks, and thereby promoting a stable development of public finances”.

Budget Programme “Reserve for Unforeseen Events”

The Latvian annual budget also includes a one-line item programme dedicated to a "Reserve for Unforeseen Events". This fund is available to finance policies or measures considered as strategic for the government, unforeseen expenditures for the state regular budget appropriations, compensation and prevention measures of natural disasters, and other unforeseen expenditures. Ministries allocate funds from this reserve according to the relevant economic classification within their budgets. There is no specific formula for determining the amount of the reserve. It is determined based on the situation in each budget year and the experience from previous years. The average size of this programme over the past three years amounted to 0.08% of GDP.

The procedure to draw down from this fund is quite strict and set by Cabinet Regulation No.421. Line ministries are required to first explore resources within its own budget before requesting funds from the Reserve. The ministry presents a justification to the MoF, which is submitted to the CoM, which then has to approve such additional funding. Based on information prepared by the Budget Department, the Minister for Finance authorises disbursements from the Reserve.

Fiscal sustainability

The MoF does not publish reports on the long-term sustainability of the public finances, as recommended under Principle 9 of the OECD Recommendation on Budgetary Governance. The FDC does not publish such reports either. This is the subject of a recommendation of the OECD FDC Review: The FDC should aim at publishing a long-term fiscal sustainability report every three years (see **Error! Reference source not found.**).

The FDC retains an important role in the analysis of Latvian fiscal sustainability. It is an explicit part of its mandate. It published in 2017 a report on the long-term macroeconomic and fiscal trends up until 2037. The FDC argued that government debt could rapidly increase if Latvia's health care and social protection system was brought in line with the EU average. In addition to this report, the FDC regularly uses an audit approach to scrutinise the effect of new policy measures on fiscal sustainability. This involves requesting the MoF's analyses of such measures and assessing the prudency of its assumptions.

Fiscal Discipline Council

The FDC was established in January 2014 in accordance with the FDL. The Law prescribes that the FDC monitor fiscal discipline and compliance with the principles set in the law. The adoption of the Law was partly driven by the requirements of the EU fiscal governance framework which Latvia had to fulfil prior to join the euro in 2014. EU countries reformed the EU fiscal framework in 2011 by putting in place a set of rules (the "six-pack" reform) to reduce macroeconomic imbalances and improve the viability of public finances of member states. The "two-pack" reform, introduced in 2013, builds upon the "six-pack" and adds a new budget coordination and surveillance process to the SGP. According to Chapter III Article 4 of Regulation (EU) No 473/2013, a Member State can choose between having either an independent fiscal institutions endorse its macroeconomic forecast or produce its own macroeconomic forecast. Like most Member States, Latvia has chosen the former route.

The mandate of the Council is broad and includes:

- Verifying whether Latvia's fiscal rules have been properly applied, including an independent assessment of the structural balance calculation and of the assumptions for potential GDP and nominal GDP;
- Monitoring whether the implementation of the annual state budget law conforms to the planned budget, including the consolidated budget of local governments and budgets of 'derived public entities', which are public entities not under the direct administration of the central government);
- Preparing an opinion on whether conditions to suspend the budget balance target have been met during a severe economic downturn;
- Preparing an opinion on whether the Fiscal Stability Reserve is set at an appropriate level to counter fiscal risks;
- Preparing a surveillance report on fiscal discipline and, if necessary, a non-conformity report that identifies departures from the FDL;
- Endorsing the MoF's macroeconomic forecasts twice a year – once for preparing the Stability Programme, and once for preparing the annual state budget and the medium-term budget framework;
- Preparing an interim report (opinion) on the Stability Programme; and
- Assessing and analysing the sustainability of fiscal policy.

In order to properly carry out its mandate, the FDC signed a Memorandum of Understanding with the MoF to clarify their interactions (e.g. exchange of information). The FDC also established two working groups to support it in carrying out its mandate. One working group is dedicated to assessing nominal and potential

GDP and one working group is tasked with evaluating the adequacy of the Fiscal Safety Reserve (as already explained). These working groups each meet twice a year.

The FDC plays an important role in the monitoring of fiscal risks. The Secretariat of the FDC includes a fiscal risks expert. The FDC also has a working group whose purpose is to assess the adequacy of the Fiscal Safety Reserve. According to the OECD FDC Review[20], "the working group's discussion consists mostly of qualitative observations of the comprehensiveness of the MoF's declaration of fiscal risks, along with recommendations to the Ministry to expand its analysis and quantify risks it has not considered." The group meets regularly throughout the year to produce a chapter on fiscal risks in the FDC's Surveillance Report.

The FDC is a small institution with limited resources and analytical capacity. The Council is composed of six members. Three of them are nominated by Parliament and three others are jointly nominated by the Central Bank and the Ministry of the Finance. The Secretariat is composed of the Secretary, two economists and one administrative official. The FDC's financial resources and staff are comparably lower than its peers with a similar mandate. The FDC does not produce its own macroeconomic and fiscal projects. Rather, it uses an auditing and external benchmarking approach to assess the MoF's forecasts for unreasonable assumptions compared to forecasts of other institutions such as the Bank of Latvia, the European Commission, the OECD and the IMF.

Box 1. Recommendations of the OECD's Review of the FDC

As part of its review of Independent Fiscal Institutions in many countries, the OECD reviewed the Latvia's FDC

in 2021. The basis of these reviews is the OECD Recommendation of the Council on Principles for Independent Institutions.

The main recommendations of the Review are the following:

- The FDC should build its capacity to support Council opinions with a clear and consistent analytical base that endures beyond the tenure of any specific Chair or Council members
- The FDC should commit to a regular schedule for publishing long-term fiscal sustainability analysis, with the goal of releasing an updated report within the next two years, when the economy and public finances have stabilised. The sustainability report should be made a regular publication every three years.
- As the immediate pandemic crisis subsides, the FDC should reduce the frequency of monitoring reports, for example to quarterly or twice annually. This will free staff resources to support a greater focus on strategic medium- and long-term fiscal issues and the development of the analytical underpinning of Council opinions.
- The FDC should strengthen engagement with parliament, specifically with the Budget and Finance (Taxation) Committee and the European Affairs Committee.
- The *Fiscal Discipline Law* should be amended at the next opportunity to explicitly authorise the FDC to be supported by "a Secretary and staff" instead of only a Secretary. The legislation should specify a minimum baseline level of funding for secretariat staff that provides greater flexibility to increase staff numbers toward the average analytical staff levels of EU IFIs with similar mandates.
- The FDC should strive to increase the engagement of non-technical stakeholders through short summaries in plain language, infographics, and visuals with a distinct and consistent branding across reports and on social media.

[20] OECD Review of Latvia's Fiscal Discipline Council, Page 33 https://www.oecd.org/gov/budgeting/review-of-latvia-fiscal-discipline-council.pdf

Source: OECD Review of Latvia's Fiscal Discipline Council, 2021

Conclusions

Latvia's reformed fiscal framework has allowed stronger compliance with EU fiscal rules in recent years. The country's fiscal risks management framework is well integrated into the processes for managing fiscal policy and the budget. The measurement of fiscal risks helps determine the size of the main mitigation tool, the Fiscal Safety Reserve. Fiscal risks are monitored and managed by a well-specified and devolved management system. The FDC also carries out an external control function with regards to fiscal risks. The identification and measurement of fiscal risks are disclosed in the budget, though Latvia could give greater considerations to the fiscal risks posed by climate change. The inclusion of environmental risk would be an improvement to the fiscal risks management framework.

The recommendations made in the OECD Review of the FDC remain valid (Box 1). A stronger FDC would reinforce the role of the MoF in fiscal policymaking.

Annual Budget Preparation and the MTBF

Annual Budget Preparation Process

There are two stages to the budget calendar. The first stage is concerned with developing the medium term budget framework (MTBF) that establishes the Government's fiscal plan for the period and within which the annual budget must be framed. The second stage is concerned with the preparation of the annual budget, which takes place during the second half of the year. The cycle is aligned with the European Union's Semester and "Two Pack", which requires Euro area countries to publish their Stability Programmes (medium-term macroeconomic and fiscal plans) by the end of April each year, to publish their draft annual budgets for the upcoming year by the 15 October in the current year, and that the approved Budget will take account of the opinion of the European Commission.

The budget process is guided by a calendar that varies from year to year and is not defined in law. The calendar also includes a wide range of events related to fiscal planning, fiscal risk management as well as the budget approval process itself. The key steps in the calendar are as follows:

- The CoM approves by 1 March each year a budget process time schedule, covering reporting requirements and allocation of responsibilities, as well as the timelines;
- In mid-April the MoF submits the Latvian Stability Programme, setting out macroeconomic projections, medium-term budget forecasts on a general government basis and the overall fiscal policy objectives, to the European Commission;
- By the end of June, line ministries submit their proposals for priority measures to the MoF and the Cross Sectoral Coordination Centre (CSCC);
- In early September, the Cabinet, having been informed of the results of annual spending reviews conducted by the MoF with the line ministries, makes its decision on basic medium-term expenditure and priority measures within the top-down constraints of pre-determined fiscal targets;
- Within a week of the Cabinet decision, the MoF calculates the overall expenditure limits for the medium-term and informs the line ministries that their expenditure requests must be framed within these limits;
- Within 10 days, the line ministries submit their medium-term budget requests to the MoF;
- In mid-October, the draft Medium-Term Budget Framework Law, the draft Annual Budget Law and the Protocol between the Cabinet and the Association of Local and Regional Governments of Latvia are submitted to the Saeima and to the European Commission;
- The Saeima then debates the draft laws and approves the Medium-Term Budget Framework Law and draft Annual Budget Law by the end of the year, which takes account of the opinion of the European Commission.

The budget schedule for each year is established by a Cabinet Order. Table 2 shows selected elements of the calendar for 2022.

Table 2. Budget Calendar, 2022 (selected items)

Measure	Deadline
Submission of Stability Programme 2021-2024 to EC	April 13
Submission by ministries to MoF of information on draft budget base for 2022-2024	May 14
Submission by ministries of priority measures and necessary funding to MoF and ICC	June 30
Examination by CoM of MTBF and annual state Budget Laws	August 24
Submission to CoM of draft MTBF and annual budget laws	September 9
Approval by CoM of draft MTBF and annual budget laws	October 12

Submission to Saeima of draft MTBF law, annual budget law, fiscal risk statement, and other budget documents	October 14

Source: Latvia, Cabinet Order No 207, 25 March 2021

The outlines of the budget process can be summarized as follows. The MoF, 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. The Ministry does this twice: the first occasion is for the Stability Programme in the Spring and the second time is for the actual budget process. This framework spells out the expected macroeconomic developments, fiscal policy goals, budget revenues, maximum expenditures, the appropriation reserve, and spending limits for each ministry and other central government institutions over the budget year and the three following years. Based on instructions for drafting budget proposals and new policy initiatives issued by the CoM in accordance with Cabinet Regulation Number 867, line ministries proceed to prepare budget proposals starting in May and submit them to the MoF by the end of June. In August the MoF submits to the Cabinet, the no policy change estimates, spending review results and the draft list of new policy initiatives to be financed over the next three years. The priorities to be accepted are decided by the Cabinet in early September. Based on the Cabinet decision, the line ministries submit their proposals for the upcoming budget. There is no annual budget circular to provide a standard methodology to line ministries for calculating expenditure for the upcoming fiscal year. Line ministry initial requests far exceed what is available within the fiscal framework agreed by the Cabinet, which suggests that this part of the process is not taken seriously. It also results in the MoF having to focus its efforts on separating existing policy and the previously agreed priority measures (Regulation 867) from new policy requests that can only be funded from available fiscal space.

The draft law on the annual State budget and accompanying documentation, as well as a draft MTBF law, are submitted to the CoM in September. The Cabinet discusses and approves the budget documents in mid-October. In accordance with Article 20(4) of the LBFM, the CoM usually discusses several unresolved issues which it resolves by a majority vote. Furthermore, Article 20(4^1) requires the Cabinet to review the opinions of constitutional bodies which may ask the Cabinet to resolve unsettled issues regarding their budgets. Once approved, the budget documents are submitted to the Saeima in mid-October.

The time available for finalising expenditure requests is compressed. The emphasis in the second half of the year is very much on the annual budget. In practice, the budget negotiations are a largely political process in which the line ministries fight for their share of the available fiscal space defined in the medium-term fiscal framework. Each line ministry and constitutional entity puts forward its own demands for new priorities and competes with the other entities regarding next budget year's additional allocations. Except on technical issues (e.g., related to the verification of line ministries' calculations and that ministries' demands have the requisite legal authority), the MoF's role in this dialogue is limited. This political process is fuelled by demands from lobbyists representing trade unions, sector interest groups, NGOs and other groups. The result is a hurried process in which last minute spending reallocations are common. In addition to the discussions in the CoM, the Government Coalition Working Group, representing the political interests of the coalition partners, may input their own proposals that have not been discussed or agreed by the respective line ministries. This practice is arguably inconsistent with budgetary law which requires a due process to be carried out.

In its 2018 Report, the SAO criticised certain aspects of the Budget formulation process. The SAO considered that Cabinet decisions on new policy initiatives (priority activities) were decided outside the budget process as defined in legislation and that there were no transparent criteria on which decisions were based[21]. Political circumstances may have led to this being considered the most practical option for reaching agreement on new policies. Furthermore, steps have been taken to address this issue by

[21] Budget Planning in Latvia: Is the Current Approach Effective? SAO, 2018.

providing the public with greater access to information on these CoM decisions. Nevertheless, providing for an inclusive, participative and realistic debate on budgetary choices and ensuring that budget documents are open, transparent and accessible are key principles of the *OECD Recommendation of the Council on Budgetary Governance*. Consideration should be given to ensuring that all aspects of the process conform to these principles.

The budget formulation process contains elements of top-down budgeting. Paragraph 5 of Regulation No. 867 states "the maximum allowable total expenditure shall be calculated by the MoF on the basis of the medium-term budget framework law, forecasts of macroeconomic development, as well as in compliance with national fiscal conditions, if such are adopted in regulatory enactments in the field of medium-term budget planning or fiscal discipline". Furthermore, the line ministries are required to formulate their budget requests within the constraints of an overall expenditure ceiling. However, line ministries tend not to respect the ceiling in their budget requests and the final allocations are based on political decisions at the Cabinet table. There is not a standard methodology for calculating multi-year no policy change baseline estimates.

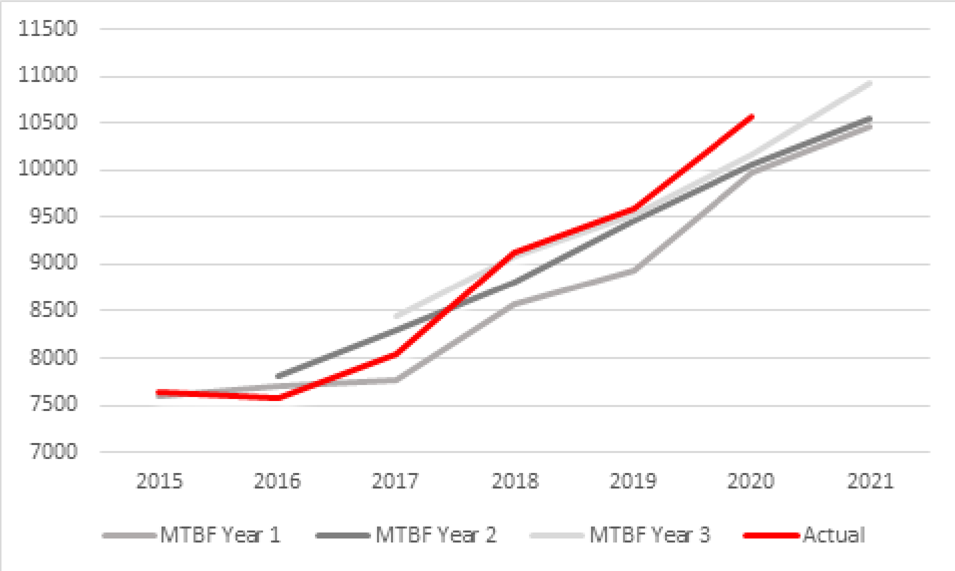
MTBF and Baseline Estimation

Since the enactment of the FDL in 2013, the Latvian budget cycle is characterised by a top-down approach to determining the aggregate envelope that is available each year for financing budgetary spending (fiscal space), anchored by a medium-term fiscal policy framework that respects the fiscal rules and Latvia's medium-term budgetary objectives under the preventative arm of the Stability and Growth Pact.

A draft Medium-Term Budget Framework Law is prepared in parallel to the Annual Budget Law and submitted first to the CoM and then to the Saeima for approval. The projections are for three years (n+1, n+2, n+3) beyond the current fiscal year, and the framework is rolled forward by one year every year, with a new third year being added. The projections for ministries and spending entities are formally described as ceilings, though in practice they are changed substantially from year to year. In reality, the ceilings for the second and third years taken as the baseline expenditures for the following year's MTEF. The calculation of ceilings is largely a mechanical exercise with no real impact on the allocation of resources over the medium term. The annual budget law contains an annex showing medium-term and long-term liabilities that ministries have undertaken, including funding approved by the CoM for substantial investment projects. However, the MoF has no means of tracking individual commitments that have been made by line ministries. The institutional coverage of the MTBF is close to the coverage of the annual budget law, namely it includes social security spending and most parts of the central government financed by the state as well as transfers to municipalities and universities. Payments to hospitals and subsidies to state-owned corporations are treated as transfers via their respective line ministry and are outside the budget framework. The MTBF projections are presented on an accrual basis, with adjustments from the cash basis on which the annual budget is prepared. This is because the MTBF is published on a general government basis (ESA2010) in accordance with the requirements of the Stability and Growth Pact whereas the budgets for line ministries are established on a cash basis.

Figure 3 shows the deviations between spending projections and outturns for successive vintages of the MTBF over the period 2015-2021. These deviations are larger for the out-years of the MTBF than for the coming budget year. The credibility of the MTBF projections also worsens as one moves through successive vintages. This demonstrates that historically MTBF projections in Latvia have been a poor guide to actual developments in public spending.

Figure 3. Aggregate Expenditure Outturns vs. MTBF Projections, 2015-2021



Source: Ministry of Finance

To improve the credibility of the projections in their MTBFs, some countries have invested in modern techniques for preparing estimates of their medium-term spending baselines (sometimes called "forward estimates") for both recurrent and capital expenditure. Baselines are defined broadly as spending projections that assume no changes in existing policies. Reliable methods are therefore required to estimate the future cost not only of the baselines but also the cost of new policies. Many countries have transitioned from a centralized approach in which baselines are prepared by the MoF ("top-down") to a decentralized ("bottom-up") approach in which the line ministries undertake the technical analysis, but with clear guidelines and rules set by the MoF. Some complex issues are involved (see **Error! Reference source not found.**). In Latvia, most ministries (the Ministry of Welfare seems to be an exception) do not currently have the skills and capacity to prepare reliable forward estimates. They could develop this capacity but they have little incentive to do so because the emphasis is on the annual budget for which resources are planned on a top-down basis. A common feature of the OECD team's discussions with officials was that it was difficult to plan past the upcoming budget year because there was no certainty of funding beyond that year.

Box 2. Methodology for Estimating Medium-Term Expenditure Baselines

Key issues

- Calculate baselines for both recurrent and capital spending.
- Choose the level of disaggregation - should it be programmes or sub-programmes?
- Choose the right base – should it be the current year's budget or actual spending in the previous year?
- What are the main cost drivers – what adjustments to make for one-off events such as elections, census collections, or cyclical influences, e.g., a severe recession, the Covid-19 pandemic?
- What adjustments to make on policies implemented over several years, e.g., an increase in the retirement age that temporarily reduces pension costs, a restructuring of public service pay schemes?
- How to adjust for cyclical or temporary influences, e.g., a severe recession, the impact of the

Covid-19 pandemic?
- How should interest payments be calculated – the policy may be to finance the deficit over the medium term in which case is the baseline a forecast of interest rates?
- How to calculate the cost of co-payments linked to EU funding?

Capital expenditure
- Capital baselines are often overestimated – tensions between ambitious plans for investment and reality.
- Capital baselines can be calculated by an analysis of spending commitments (e.g., in France "commitment appropriations").
- This requires a robust system of recording spending commitments and a strong challenge role for the MoF's central budget office who must have a close knowledge of ministries' capital plans.

Role of MoF's Central Budget Office
- To provide guidelines, key assumptions such as growth, inflation, interest rate
- To ensure that line ministries calculate baselines according to agreed methodology, provide training.

Source: Authors

The extent to which the spending ceilings from the MTBF are used for the allocation of budgetary resources could be strengthened. Despite the fact that Cabinet Regulation No. 867 specifies the procedures for calculating expenditure ceilings for the state budget and for each central state institution for the medium term, proposals from the spending institutions normally exceed the ceiling by a significant amount. The latter years of the MTBF are less about expenditure ceilings than about providing a starting point for the following year's budget.

Performance budgeting

Key performance indicators (KPIs) on policy outcomes and outputs are aimed at achieving important goals for society and motivate the responsible institutions to execute polices, programmes and projects to achieve these goals. Each line ministry and agency sets its own performance targets following a methodology set out in a Cabinet Instruction. The budget submitted to the Saeima includes a set of programmes, with budget explanations containing information about programme objectives and performance indicators. As performance information is used in formulating the budget, Latvia's budgeting system is considered to be performance-informed although the Saeima does not formally vote on performance indicators and targets. Furthermore, KPIs are included in the national development plan and the strategic policy plans of various sectors and ministries (education, health, transport, etc.) as well as in budget explanations (policy and resource management "scorecards"). While all budgetary expenditures are linked to policy and resource management scorecards, there is an excessive number (around 2,000) of performance indicators. There seems to be a lack of higher level "strategic" performance indicators that can be used by top management in the line ministries and agencies and by the MoF to monitor and evaluate performance at a high level.

While performance information cannot be regarded as a core element in the budget process, it is nevertheless used in spending reviews and when budget reallocations are examined. The MoF consolidates performance information into a database where it is possible to track all changes. This allows the Ministry to regularly monitor performance (via so-called "execution analysis" exercises) though there may be some lags in the data. In addition, budget execution reports to Parliament include performance information and a narrative explaining the reasons for under or over-performance. Finally, the Parliamentary Commission on Public Expenditures and Audit, which works in liaison with the SAO, can use performance information when examining budget programmes. The transparency resulting from publication of performance information and reporting on it to the Saeima is designed to encourage accountability in line ministries and agencies for achieving their performance targets.

However, although the policy objectives of each programme are stated clearly and transparently, the key performance indicators are often not robust. They are often vague and there are multiple indicators in some programmes. For example, in a programme "General Education" under the Ministry of Education, the policy objective "to increase the quality of the general education environment by improving the content" has the performance indicator "number of teachers involved in professional development activities". There is a relationship between the two but it is not clear what the development activities are and it is not clear if the teachers were able to apply the newly acquired knowledge in their day-to-day roles. Under the Ministry of Transport's Roads programme, the key performance indicator is "the country's main roads are in very good or good condition compared to 2012" but it is not clear how this better condition is to be defined or by which independent body. For the Ministry of Health "Healthcare" programme, there are 11 KPIs for one policy objective. Other programmes also have multiple KPIs. This must be very difficult to monitor and to evaluate performance effectively.

Though the performance information framework enters budget negotiations via spending reviews, it is excessively complex and detailed. There are further steps to be taken before it can to become a useful tool of budgetary management both for the MoF and line ministries. Some of the key factors for effective performance budgeting are set out in Box 3.

Box 3. Good Practice for Performance Budgeting

Information overload is a common problem in performance budgeting. OECD countries with the most experience of performance budgeting have steadily reduced the number of programmes and indicators over time. This has been a response to both the administrative burden of reporting and the limited time senior managers have available to monitor performance. The selected indicators should be linked to the objectives of each ministry and illuminate the quality of service delivery. Although it can be relevant to have a large set of indicators and targets on a more detailed level for internal management purposes, indicators and targets to be published as budget information should focus on the objectives of the policy.

The OECD Recommendation on Budgetary Governance highlights the importance of high-quality (i.e. relevant, consistent, comprehensive and comparable) performance and evaluation information to facilitate an evidence-based review and it defines good indicators as:

- limited to a small number for each policy programme or area;
- clear and easily understood;
- allow for tracking of results against targets and for comparison with international and other benchmarks;
- make clear the link with government-wide strategic objectives.

It can be useful to use a cascade or pyramid approach with the selection of indicators. At the level on which the Parliament approves the Budget, just one or two indicators tightly linked to the policy objective should be selected. A good practice is to ensure that the indicators and targets included in the performance budget are linked to internal KPIs for the managers resulting from internal objectives and/or from overarching national objectives. So the objectives of individuals, units and directorates would be linked upwards to the Vote level objectives. In turn, the objectives and indicators at the Vote level would be linked upwards to the Government's objectives. If the performance budget is an additional information tool separated from other management tools, it may turn out to be a merely formal exercise and the impact on actual performance could be minimal.

Experience has shown that it can be difficult to get parliamentarians to engage with performance information and to hold line ministries to account using non-financial information. One of the impediments can be the level at which the Parliament votes the appropriations in the Budget. If the vote is at the overall level of the line ministry or agency, or at a line item level, parliamentarians may not focus at the programme level. Ideally the Parliament should vote the appropriations at programme level, which can be combined to provide more information at a detailed level in the budget.

The selection of good quality indicators and relevant targets involves an iterative process, balancing input from both line ministries and the MoF. The line ministries have detailed sector knowledge, while the MoF needs to ensure that performance indicators are SMART and target values represent stretch goals.

Just as it is important to have a certain stability of the programme structure, it is important to have a certain stability of the indicators (and targets). Frequent changes to indicators can make it more difficult to track performance over time and hold the responsible manager accountable or provide the manager the opportunity to learn from the evolution of the indicators. On the other hand, it should be possible to change some indicators and targets when other and more relevant indicators can be used.

The performance budgeting methodology needs to have the flexibility to deal with the varied nature of government funded activities, and the different relationships that exist between financial resources and performance in different programmes.

Source: Authors

Spending reviews

The main objectives of spending reviews in Latvia are to improve policy effectiveness and to align expenditure to government priorities. Spending reviews do not aim at reducing the overall level of expenditures. In recent years, around 40% of identified savings have been taken back into the general budget as additional fiscal space to fund “New Policy Priorities” and the remaining 60% has been used internally by the individual Ministries. Overall, the process has generated efficiency gains that have freed resources for other expenditure priorities[22].

The scope of spending reviews has progressively evolved since their start in 2016. Every year, the CoM approve the scope of year’s spending reviews. There are currently three types of spending reviews in Latvia: horizontal review of the state budget programme, review of the sectoral policy funding, and review of process and systems.

This process is led by an inter-institutional working group. This group is composed of members of the relevant line ministry, the Bank of Latvia, the State Chancellery, the MoF, the SAO, the CSCC and an external expert when possible. Line ministries participate in the analysis of measures, and may make proposals and comment on the final report. The working group benefits from strong technical input from the Budget Policy Development Department of the MoF. The Parliamentary Secretary of the MoF chairs the working group. This indicates strong political support for the spending review process and ensure its viability and sustainability.

Civil servants carry out spending reviews with a clear allocation of roles between line ministries and the MoF and the Bank of Latvia. Line ministries carry out an analysis of possible policy changes/development of processes, analyse the implementation of the development part (whether the measures are

[22] Over the past six years, a total of EUR 550.5m of savings were identified. In 2021 alone, savings from spending reviews amounted to EUR 172.8m.

implemented according to the original objective and the planned amount), and prepares proposals. Together with the Bank of Latvia, the Ministry analyses available/requested data, carries out comparative studies with other countries, and prepares calculations/proposals.

From October to February, the inter-institutional working group decides on the scope of the spending reviews for the year. The CoM then approves the scope. From March to July, working group meetings take place to carry out analyses and proposals. This includes discussing the achievement of performance targets. In August, the MoF prepares an information report that presents the findings and recommendations of the spending review. The line ministry and the inter-institutional report can make final comments on the report. The MoF then submits the report to the CoM for review and approval. As previously explained, around 40% of identified savings fall back in the general budget to be used as additional fiscal space to fund "New Policy Priorities" which are approved in August.

The MoF's website presents the annual results of spending reviews. However, guidance materials are not publicly available. Every year, the spending review process incorporates the implementation of the recommendations formulated in the previous year for each ministry. The MoF requires line ministries to report on implemented changes identified in the latest Spending Review, thus highlighting a link between budget planning and the Spending Review.

The process is an important step forward in budget management, and has generated useful spending savings[23]. However, to enhance the process further, it could benefit from exposure to spending reviews in other countries such as Denmark and France which have a long experience of conducting such exercises.

Box 4. Strengthening Spending Reviews

Spending reviews play a critical role in assisting governments address challenges to their public finances over the medium and long run and identifying fiscal space for emerging spending priorities in areas such as climate change, healthcare and defence. As governments work to address many of the spending pressures over the medium and long-term, spending decisions will require active consideration for fiscal consolidation and reallocation.

The growth and use of spending review practices in OECD countries since the global financial crisis place governments in a better position to consider these challenges. Spending reviews provide opportunity to maintain public trust by ensuring challenging policy decisions are taken in a systematic and thoughtful matter with careful consideration of the policy impact on society and citizens. A strengthened spending review practice can only help to strengthen the capability of governments to make these difficult decisions. Observations in OECD countries have highlighted areas to strengthen – and scale up – spending review practices to ensure they become an integral part of the budgetary process and a meaningful tool for reallocating fiscal resources.

Spending reviews rely on foundational budget practices to help improve quality and impact over the medium and long-term. Strong medium-term frameworks help to provide longer-time horizons for implementing spending review decisions whilst a strong performance budgeting framework can help provide additional evidence to inform decisions. For example, a strong medium-term expenditure framework (MTEF) allows a country to plan the impact of savings measures over multiple years than over a single annual budget cycle. In Denmark, spending reviews have been undertaken for more than 20 years and are led by the Economic Co-ordination Committee of the Cabinet, with the government setting a 2% target for productivity gains on operating expenditure as a means to find ways to streamline processes and increase efficiency. The spending reviews inform decisions on multi-annual budget agreements, for expenditure in sectors such as defence and justice.

Performance budgeting can help to establish a baseline understanding of the performance of budgetary programmes that contribute to the identification of the budget. Spending reviews benefit from a strong base of evidence and information from evaluations, performance audits, and performance frameworks. In this manner, countries have been building the capacity for evaluation by introducing evaluation from a whole of government perspective. In the Netherlands, the Netherland's Strategic Evaluation Agenda aims to promote a coordinate approach to evaluation across ministries, improve the role evaluations can have in learning and ensuring evaluations are timely to feed into policy consideration.

Traditionally, spending reviews have included targets for the proportion of public expenditure that is to be reallocated, sometimes referred to as a 'savings target', as illustrated below. The practice of a savings target was prominent following the global financial crisis to help return public expenditure to pre-crisis levels. Since then, the range of objectives pursued through spending reviews has broadened, but in the context of fiscal challenges facing many countries following the COVID-19 health crisis, it is important to reconsider savings targets as an integral part of the spending review process.

Examples of countries with spending review targets

OECD country	Illustrative savings targets
Canada	To target savings of CAD 1.5 billion from 2020-21
Denmark	2% savings for productivity gains
France	Real 10% savings over 3 years (General Review of public policies)
United Kingdom	Real 3% savings per annum for departmental expenditure (2007)

Source: Authors

provides some information on the practices for strengthening spending reviews.

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Source: Authors

Public Investment Management

Responsibilities for public investment management (PIM) are largely decentralized to spending ministries, with little financial oversight by the MoF. Ministries are responsible for planning their public investment projects, conducting feasibility studies and cost-benefit analysis (CBA), managing the procurement process, and implementing the projects. There is no central guidance on public investment management equivalent, for example, to that published by HM Treasury in the UK (the British finance ministry).[24] The Ministry of Transport appears to conduct CBA but this may not be true of other ministries. The LBFM includes no requirements on public investment management and it is unclear if there are any statutory requirements for ministries to follow modern methods in appraising and selecting projects.

[24] See the UK Government's Green Book on "Appraisal and Evaluation in the Central Government", updated in March 2022, and the Magenta Book that provides more detailed guidance on evaluation.

Ministries include investment projects in their strategic development plans which in turn are integrated into Latvia's National Development Plan (the latest version covering the period 2021-2027 which coincides with the period of the EU's new fiscal framework). When line ministries put forward their budget proposals to the MoF, the proposals for capital investment are not rigorously scrutinised by the Budget Department. Instead, the projects are mainly discussed by the CoM, and decisions on which projects to select are largely based on political horse-trading, not technical issues such as whether the project is expected to generate an acceptable economic and social rate of return. The CSCC in the Prime Minister's Office (23 staff) is responsible for coordinating the preparation of Latvia's national development plans which also includes a role in reviewing and prioritizing proposals for new capital investment projects.

Some other European countries have established central PIM units in the MoF that have responsibility for providing financial oversight of PIM across government, setting guidelines for conducting feasibility studies and CBA, and ensuring that line ministries follow these guidelines on the appraisal and selection of projects. **Error! Reference source not found.** cites the example of the Slovak Republic.

Box 5. Public Investment Management in the Slovak Republic

In the Slovak Republic, the Ministry Finance has established a new Investment Authority with about 30 staff in the ministry's Value-For-Money Directorate. Modelled on the Infrastructure and Projects Authority in the UK, and similar arrangements in Ireland, the main aim of the Investment Authority is to increase the quality of investment projects and to streamline project preparation. Methodologies for preparing feasibility studies and conducting cost-benefit analysis have been published and are required by law for all projects above EUR 40 million (and above EUR 10 million for Information Technology projects). During 2021 alone, the Slovakian Investment Authority evaluated more than 250 projects with a total cost of EUR 6.3 billion and identified potential savings of over EUR 800 million on these projects.

Source: Authors

Some countries (e.g., Ireland and the UK) have also developed a comprehensive public investment databank that records information on all projects (or all major projects above a defined value threshold) at all stages of their development from initiation, through appraisal, through procurement, through implementation and completion. Such banks include information of projects being implemented by central government contracting entities as well as local governments and (in some cases) state enterprises. They would record the total value of the projects, the allocation of these costs between the budget year and future years, procurement data, and which projects are incurring cost overruns or are delayed for technical or political reasons. Many countries publish information from these data bases (at least for major projects) with the budget documents.

It is important that policy on PIM be linked to the development of new public-private partnerships (PPPs) which pass through similar stages of development as projects that go through a regular procurement process. There are, however, important differences between PPPs and conventional infrastructure projects, notably that PPPs must demonstrate that (because of the additional fiscal risks) they will achieve a higher rate of return than conventionally procured investment projects. In Latvia a significant number of PPPs have been conducted or are in the pipeline, for example in the transport, education, and health sectors. There is no separate PPP unit in the MoF; instead, policy on PPPs is managed through the MoF Procurement Monitoring Bureau.

To conclude, the PIM framework in Latvia puts too much authority into the hands of the line ministries with no real financial oversight by the MoF. Line ministries need to be responsible for taking projects through the main stages of their development (planning, appraisal, procurement, implementation, and monitoring and evaluation) but with guidelines and limits established and closely monitored by the MoF.

Budgeting for Public Service Salaries

Unlike in most EU Member States, budgeting for salaries in Latvia is largely outside the control of the MoF, even though pay accounts for around 27 per cent of the annual general government budget. The State Chancellery is responsible for policy on most public service salaries (except for institutions partly financed from the State Budget which are responsible for setting their own pay levels subject to approval by the CoM), under the Law on State Administration and other laws/regulations. There are two important exceptions, however. Teachers' salaries are determined by the Ministry of Education under a separate law, and the salaries of most health workers (except some administrative staff) are similarly determined by the Ministry of Health. The MoF has little involvement in policy issues on public service pay, nor in the negotiations with line ministries that lead to the annual round of salary increases that are reflected in the budget. The State Chancellery plays the main role in advising the CoM on these matters.

The actual link between the budget and agreements on wage increases and/or additional recruitment is weak. The general approach is that the State Chancellery can make a pay agreement with a union or with a ministry that puts upward pressure on expenditure but that the additional cost is not automatically included in the budget. On wage increases, it may fall to a line ministry to find all or some of the additional cost from within its budget allocation. On numbers, the State Chancellery may approve an increase but the additional costs must still be approved by the MoF under the provisions of CoM regulation No. 867. Even if it is approved, the affected ministry or authority may need to fund this from within its existing administrative budget.

The current salary structure for public servants is unbalanced, bonuses taking a disproportionately large share, and there are significant differences between pay levels in different ministries for employees with comparable functions and tasks. To help address these issues, the State Chancellery has been advocating policies aimed at reducing the share of bonuses in total pay (to a maximum of 30 percent) and moving toward the greater equalization of pay levels across different ministries and agencies by 2024. Currently the total costs of bonus payments can reach 60 per cent of an institution's pay bill but the new Law on Salaries provides that this be reduced to 30 per cent.

The bonus system is considered necessary in order to retain quality staff who otherwise could leave. In recent years there has been a high turnover of staff in certain institutions and abolishing the bonus system completely could lead to further instability regarding turnover of staff. The new law, therefore, recognises that certain positions are highly skilled specialist roles. To accommodate this, it provides for a basic salary plus an allowance of up to 50 per cent based on a market co-efficient for a similar role in the commercial sector. This will have to be monitored carefully to ensure that it is not being abused.

Between 2016 and 2021 there was a policy to decrease the number of civil servants by 5 per cent over the five year period. This was a strategy but was not a legal requirement. Between 2020 and 2022, there was also a 6 per cent reduction in staff (not including defence, health or education). Overall, numbers may not be excessive compared to other countries. For example, Public Employment Data in the OECD's *Government at A Glance* publication shows public sector employment in Latvia as a percentage of total employment, at about 19%. This is above OECD average but below the Scandinavian countries, Finland and the other two Baltic countries. It also seems to have been relatively stable between 2007 and 2019. However, it seems that the policy on recruitment pay are quite decentralised and are not linked to the budget costs. It is noted that the institutions must bear a significant proportion of the additional costs from within their allocated budget but there is a danger that this will incentivise the institutions to increase their pay bill at the expense of non-pay expenditure, which could impact on service delivery.

Conclusions

Latvia should continue the steps to enhance the transparency around the budget formulation process. The SAO considers that Cabinet decisions on new policy initiatives (priority activities) are not in compliance with OECD Principles of Budgetary Governance and that the decisions are lacking transparency.

The authorities should strengthen the MTEF by developing a methodological framework for estimating baseline expenditures and ensuring that it is consistently updated following policy changes or the introduction of new policy initiatives. Capacity development in line ministries will be required, supported by clear rules/guidance from the MoF on the complex technical issues. Furthermore, if changes are to be tracked adequately, it is important that this data can be inputted to the State Budget Planning and Execution Information Systems (SBPEIS), which can then in turn provide analytical information to the MoF. Some of the key factors to consider are described in Box 2.

Latvia should conduct a fundamental review of its perfomance management system to align it with interrnational good practice. It should be reviewed if it is to become a useful tool of budgetary management both for the MoF and line ministries. Some of the key factors to consider are described in Box 3. A more strategic approach to monitoring and managing performance is required. The MoF and top managers of line ministries have different needs (strategic) compared to operational staff in the ministries. Ultimately it is the line ministries and agencies which are responsible for achieving their objectives and for answering questions about performance and results. They should be prepared to answer questions at the level of parliamentary committees and to be accountable for results.

Latvia should build on its existing strong spending review system and introduce a requirement that SRs should be set a target for delivering savings that could either be used by ministries to expand their fiscal space, or could be budgetised (a softer or harder version). In order to introduce such a change, a comprehensive review of the spending reviews process may be necessary with reference to other OECD countries where spending reviews have been in operation for a longer time.

The MoF should build its capacity to undertake a central role in the management and oversight of public investment. This recommendation would require extensive consultations across government ministries and would need to be implemented over a period of years.

The authorities should implement a detailed review of the present pay system to analyse the strengths and weaknesses. Latvia’s approach to public sector pay costs is unusual. The pay negotiation process is decentralised and the responsibility lies not with the MoF but with the State Chancellery and the Ministries of Education and Health. Normally, the ministry charged with managing the public finances plays a central role in discussions on salary increases before they are finalised so that it can inform the Cabinet as to the budgetary implications of any increase to the wage bill. Moreover, there is significant use of bonuses as a means of retaining staff but this leads to significant differences between pay levels in different ministries for employees with comparable functions and tasks. The area is clearly complex and requires more in depth specialist analysis before recommendations for change could be considered.

Budget execution

The annual budget execution process

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, Article 15 of the LBFM provides for the Minister for Finance to approve the State Budget expenditures subject to several conditions including that the expenditure for each ministry may not exceed the limit provided for in the Medium Term Budget Framework Law. The organisation responsible for budget execution is the State Treasury which, since 1997, has been an independent agency financed by the MoF. The Treasurer is appointed and dismissed by the Minister for Finance. Currently, the Treasury has about 200 employees.

According to Article 23 of the LBFM and subsequent regulations, the Treasury is responsible for:

- making payments from the state budget;
- managing the state accounts;
- managing the national debt; and
- acting as the paying and certifying authority for EU funds.

Latvia has a treasury single account (TSA) that is held at the central bank but applies only to transactions in Euros. For transactions in foreign currency, the Treasury holds several accounts with commercial banks which are thoroughly evaluated under a strict internal risk frame. While budget holders in the central government are not allowed to open accounts in banks, but only with the Treasury, municipalities are not required to use the TSA, except for the use of the substantial resources which they receive from the state budget (mainly 75 percent of revenues from the personal income tax, amounting to about 60 percent of municipalities' total revenues). They can choose to use the TSA as far as the use of their own resources is concerned (mainly revenue from local property taxes and fees and charges).

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. The state secretary of each line ministry is formally responsible for the ministry's budget and accounts, including the accounts of the budget holders belonging to the ministry. The role of state secretaries is effectively dependent on information provided by the Treasury since the Treasury prepares the financial accounts for all ministries.

Despite the large number of in-year adjustments to the budget, deviations between total planned spending and the outturns have been relatively small (less than 5 percent each year) since 2015, except for 2021 (because of the unforeseen impact of Covid-19 related expenditure on the budget).

Cash and Debt Management

The government's annual Debt and Cash Management Strategy is approved by the Minister for Finance. It prescribes the goals, principles, tasks, and functions of the Treasury to ensure that liquidity is available for the management of the state's financial assets and liabilities, to limit financial risks in cash management, and to ensure the safe and efficient investment of cash resources.

The budget is implemented after approval by the Saeima by means of a resource and expenditure plan based on the approved budget. 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 annual financial plans – that is, cash-flow projections, which are consolidated at line ministry level, approved by the state secretary, and sent to the Treasury for approval. Budget holders prepare plans for each of their programmes. For example, in 2020 there were 2230 financial plans of 170 budget institutions. The Treasury conducts cash planning in the light of the cash plans as well as historical spending patterns. In addition, at the beginning of the year, line ministries provide an estimate to the MoF of their planned expenditures on a quarterly basis and at the end of the second quarter they must explain variations between planned and actual expenditures. In this way potential deviations are monitored not just by the Treasury but by the MoF.

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 for each programme and allocates resources through the state budget IT system. The Treasury checks against the availability of appropriations approved by the Saeima. It also is authorised to check the documents certifying the transaction and has the authority to block payments. As payments are made based on payment orders checked against approved appropriations, overspending is technically impossible, and there are currently no recorded payment arrears, the system of commitment control having been substantially tightened in the early 2010s.

Cash management appears to be generally accurate and efficient. It is supervised by a Liquidity Management Committee consisting of representatives from the front, middle and back offices of the Treasury's debt management unit. The Committee takes operational decisions on cash flow and liquidity management, and the investment of free cash compliant with the Debt and Cash Management Strategy. It meets every morning and, based on the cash flow forecast and other information, takes liquidity management decisions to ensure timely and full availability of resources in the Treasury`s accounts for performing budget execution and meeting the financial liabilities of the state.

Ceilings set by appropriation cannot be exceeded. If a ministry runs short of money, it can re-evaluate expenditure intensity among its other budget programmes and request a reallocation. In the case of unforeseen events such as the Covid-19 pandemic or a natural disaster, a ministry can request the CoM for resources from the budget contingency reserve (the "reserve for unforeseen events") which is a separate budgetary programme.

There are certain restrictions defined in law and regulations on the use of reallocations:

- reallocations cannot increase the total amount of expenditure approved by the Saeima, or more than 5 percent of the annual appropriations to a sub-programme;
- reallocations cannot be made from capital to current spending, or be used to increase salaries;
- 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.

Approvals for in-year reallocations may be granted by the Minister for Finance or, in certain cases (e.g., foreign financial assistance), by the Saeima. End-year carryovers of unspent resources are permitted but limited. Unused appropriations are automatically cancelled at the end of the fiscal year, but there are exceptions to this rule. For example, unspent revenues from foreign financial assistance may be carried over, as well as revenues for services provided. Furthermore, the Minister for Finance may allow a carry-over of payments for investment projects, goods and services and salaries subject to certain conditions.

A challenge for effective budget execution is the large number of spending reallocations that occur during the budget year (around 200 per year typically, but more than 370 in 2021 because of the Covid-19 pandemic). The root of the problem lies in the fact that the Saeima approves the budget at the most detailed line item level. There are approximately 1,100 line items. As a result, too many line item changes need parliamentary approval. This means that line ministries and the Budget Department of the MoF are permanently engaged in a slow and cumbersome procedure for changing allocations from one line item to another. It is desirable that a greater level of flexibility be introduced within a framework that ensures fiscal discipline and budgetary aggregates are respected. A more structured in-year reallocation regime, based on a supplementary budget towards the end of the year rather than the cumbersome practice of bi-weekly reallocations, would allow for greater efficiency and effectiveness in managing budget execution.

One option would be to rely more on a system of virement to provide this flexibility. Virement applies where a line ministry or agency uses savings on one or more line items from within its overall budget allocation to meet an expenditure overrun on another line item during the course of the year. It does not require specific approval from the Parliament. For it to be applied in Latvia the basis for the approval of the Saeima would have to change to a higher level, from the existing line item basis. This is common in EU and OECD countries and Box 6 highlights aspects of the system in Ireland and France. In selecting a higher level to vote appropriations, Latvia could choose either the overall level of the individual institutions or a programme total level. To maintain consistency with the recommendation on more selective use of indicators to encourage greater focus on performance, especially on the part of the Saeima, it may be more useful to approve the Budget at the programme total level. Regardless of the higher level chosen, it would lead to greater flexibility and freeing up resources for more analytical work.

The budget execution process in Latvia is well structured, and the Treasury is a committed and efficient implementing agency. The Treasury is considering options for digitalizing the middle office functions of its debt management unit with the aim of reducing the volume of manual transactions and improving data analysis and decision-making processes[25]. Cash management is generally accurate and efficient. However, there are no incentives for budget holders to gradually improve their financing plans. To address this issue, the 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 EU countries.

Box 6. In-year budget reallocations in Ireland and France

Ireland

The Parliament appropriates money to each budget user at the overall level and legislation does not give effect to parliamentary approval at a lower programme or line item level. The approval of the MoF is sufficient for virement subject to several conditions in order to respect Parliamentary authority:

- The Minister of Finance has legal authority to vary the allocation for each budget user between its constituent line items.
- The prior approval of the Minister of Finance is required for virement.
- The application of savings on a line item to offset an excess in another line item would not be approved unless the Minister of Finance is satisfied that the savings are real and not merely the postponement of expenditure to a subsequent year.
- The Minister of Finance could decline approval where there is doubt as to whether an excess spend requires parliamentary approval.
- Virement is not permissible to fund excess spending on staffing and administrative costs such as salaries or allowances.
- Virement cannot be implemented between budget users since the Parliament votes to appropriate moneys at the level of each budget user; therefore, an excess for any user would have to receive parliamentary approval.
- Virement would not allow for additional own revenues of the budget users to be used to offset overruns on a line item.

[25] This project is supported by the Commission's DG Reform using KPMG as a technical advisor.

- The exercise of its discretionary power of virement by the MoF is subject to the normal scrutiny of the Comptroller and Auditor General.

France

France recognises that some programmes may require more than anticipated while others may require less. France therefore allows several procedures for the reallocation of funds.

- The organic law on finance laws (the LOLF) authorises reallocations
    - within a ministry within a 2% limit of the credits opened by the initial finance law for each programme
    - between ministries provided that the reallocation relates to actions of the same nature
    - under 'decrees of advance' where in the case of emergency, an additional credit may be opened for a programme, within the limit of 1% of the initial credits provided and on condition that an offsetting reduction will be applied to another programme
    - where appropriations (excluding staff expenditure) not used during a financial year on a programme may be 'carried over' to the following financial year up to a limit of 3% of the initial appropriation voted for this programme.
- Transfers may be made by decree on the authority of the Minister of Finance and after informing the relevant committees of the Parliament. No transfers are possible to staff expenditure. The ratification of transfers by decree must be proposed by the Government to the Parliament in the next finance bill. The Court of Audit submits a report to Parliament on these movements.
- Supplementary budget and finance laws can also be adopted for larger scale reallocations, to take account of new revenue forecasts and, possibly, to modify the forecast budget balance, for example during the Covid crisis.
- There is a supplementary finance law at the end of the year which allows the final redeployment of appropriations on the basis of the latest execution forecasts of the MoF.

Source: Authors

Public Procurement

The Procurement Monitoring Bureau located in the MoF acts as Latvia's central authority for procurement policy, which is based on a framework of EU-derived law. Its role is similar to that of procurement authorities in other EU Member State. The Bureau monitors the activities and operations of the more than 2000 contracting entities in Latvia, both in the central government and municipalities. It is responsible for ensuring that ministries and agencies comply with the procurement law (which in turn is based on EU procurement directives); providing methodological guidelines for ministries and agencies in conducting their procurement operations; maintaining a register of procurement contracts and publishing information on these contracts and tenders; making judgments, through an independent tribunal, on complaints received from suppliers that contract awards were not made fairly and consistently with the law; and providing training to procurement officers through Latvia's School of Public Administration.

The procurement process in Latvia appears to be well managed but there is room for improvement. In taking forward its work, the Bureau has emphasized that priority will be given to: (i) developing a professional certification process for procurement officers; (ii) the digitalization of procurement information systems using open-source data; and (iii) developing a "red flags" system for alerting the Bureau to areas of high vulnerability and fiscal risk. Such a system would be helpful to internal auditors and well as the SAO in conducting audits of infrastructure projects where irregularities may have been identified in procurement.

Budget documentation and accounts

The LBFM requires the Cabinet to submit to the Saeima each year a package of draft framework laws, which relates to the draft medium term budget framework law, and a package of draft budget laws, which relates to the draft annual State budget law, as well as explanations of the draft annual State budget law. The explanatory material is comprehensive. Section 21.2 of the LBFM provides that the draft annual State budget law (the packages of draft budget laws) shall contain a wide range of information including explanatory information about the projections underlying the State budget, the impact of tax reliefs, information on the major planned investment directions in the current financial year; information about local government finances and the consolidated budget, and information about national debt.

The annual Budget law itself is very detailed. Appendix 4 of the Law contains appropriations for revenue and expenditure for all ministries and other central state institutions, which comprise approximately 30 entities. The expenditure is divided into about 400 budget programmes and sub-programmes. Each programme/sub-programme consists of budget line items (classification codes), which show expenditure at a detailed level. The line items themselves are sub-divided into four different levels and there are about 1,100 items at the lowest and most detailed level.

Once the Annual budget Law is approved, the state budget institutions prepare the financial plans for the budget programmes. Each programme has one or more financial plans. In 2020, there were about 2 230 such plans for about 170 budget institutions. The financial plans are the basis by which the Treasury facilitates and controls expenditure by the budget institutions but they are not published.

Accounting and Reporting

The Treasury produces standard monthly, quarterly and annual financial reports on the execution of the budget. Monthly reports are on a cash basis and cover both central and local government. The Treasury also publishes monthly reports on debt and guarantees.

The annual consolidated financial report uses data that are checked and reconciled with the budget institutions' accounts. The Minister for Finance submits the annual report to the SAO for its opinion by 1 July, after which the report is submitted to the Saeima by 15 September. The Saeima votes on the accounts by 15 October.

The annual report and the financial reports of the state budget institutions are prepared on an accrual basis according to international public sector accounting (IPSAS) standards. The MoF regularly updates the Cabinet regulation on the preparation of financial statements with reference to any changes in IPSAS. There are no plans to change the chart of accounts.

The State budget is planned and executed on a cash basis. This has the advantage of allowing the public and the Saeima to see how the approved budget has been executed. While the annual report is fully accruals-based, it includes additional information on cash-based execution transactions, which facilitates transparency and understanding of the budget transactions.

The 2009 OECD Budgetary Governance Report on Latvia found that financial reporting in the country "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"[26]. On the evidence presented to us, this conclusion remains valid. Internally, higher level information is available on a next day basis with line item information being available on the fifth day of each month, and more detailed classification codes being available on the seventh day. On the 15th day of each month, the Treasury

[26] https://www.oecd.org/latvia/46051679.pdf

produces a consolidated report including local government. There are however two potential weaknesses, which officials explained to us:

- While the financial reports of state budget institutions and at the general government level are prepared in accordance with IPSAS, the accounts of state owned enterprises are prepared on an International Financial Reporting Standards (IFRS) basis. These accounts are finalised too late for proper consolidation with the general government sector and must be estimated initially.
- Despite the annual report facilitating some comparison between cash based execution and accrual information, it can be difficult to reconcile between cash-based execution by spending units and the budget planning that they undertake on an accrual basis.

Centralized Financial Management Information System (CFMIS)

A project has been established to replace Latvia's existing SBPEIS with a new Centralized Financial Management Information System (CFMIS), based on an enterprise resource planning approach. The project, which is being led by the State Chancellery and the Treasury with technical support from PWC is currently in the design phase. The objective would be to operate the system through a centre established either in the Treasury or the MoF. The project is scheduled to reach the procurement phase in 2023 and be implemented by 2026. Its overall design is strongly influenced by the similar IT systems established in Estonia, though less ambitious in scope. The project is currently focused on Latvia's 167 budgetary institutions in the central government but could eventually be rolled out to the municipalities.

The new system would cover financial accounting and reporting, management accounting and HR management. Improved information sharing and transparency are key objectives. It is intended that the system will include performance information. Currently, this is recorded using an excel spreadsheet and the plan is to migrate it into the CFMIS. It will be inputted by the budget users themselves as the system will be interactive. It is intended that the new system will provide management information to line managers within the budget users so that individual managers will have up to date information on the evolution of their own budgets and performance relative to expenditure.

The new system could also address the ongoing weakness of access to detailed information of financial accounts. For example, up to 2013, some line ministries provided a detailed breakdown of accounts receivable and accounts payable even though this was not mandatory. In January 2013, however, the methodology for accounting procedures in budget institutions was changed. This included a standard definition of materiality for all institutions. On the one hand, this created a standard definition; on the other hand, it meant that detailed information that had been available previously was no longer available because transactions were below the materiality threshold. Now there is an automated reporting system which does not easily facilitate tracking. Furthermore, the system requires an explanation for variation against target but the explanation is little more than a statement that variance has occurred.

The project is linked to other digitalization initiatives being considered by the government. It could potentially generate budgetary savings through economies of scale and more efficient transmission of data, and through linkages to other IT platforms (interoperability). Identification of a source of funding, possibly the European Commission, will be required to finance the implementation of the project.

This project is an important new venture for Latvia that could generate substantial benefits for the efficient management of financial information, linked to other digitalization initiatives. In particular the Budget Policy Department of the MoF should be fully involved in the new system when it becomes operational.

The introduction of the new CFMIS is an opportunity to upgrade the quality and timeliness of both financial and non-financial information. However, it is important that the users' requirements are clearly articulated before a system is selected. The separate needs of line ministries as well as the MoF must be clearly understood.

Furthermore, the new system must provide value for money. While it may not necessarily be the best option to select the cheapest system, it would be particularly ill-advised to purchase an expensive system that requires regular and expensive high maintenance if the identified needs justified a less expensive system. In this regard, the MoF will need to be involved in its role as guardian of the public purse.

The provision of information at the level of the line manager is an important factor to get right. To achieve 'sound financial management', operational objectives and performance standards need to be defined and linked to the policy and budgetary objectives a manager is expected to achieve. The line manager needs to be able to allocate costs over different cost centres (such as each regional office, prison, police unit or operating theatre etc.). The manager will also need to know the performance of each cost centre and be able to identify which cost centres are operating more efficiently than others. Only then will the manager be able to take any necessary corrective action. To make such a detailed allocation of costs possible, more elaborate coding of costs and more detailed information about performance will be required.

The selected system must go beyond financial information and to able to provide users with performance management information. It should be able to differentiate between the different levels of indicators. For instance, the indicators selected for publication as budget information would be at one level while detailed indicators that are of use mainly to line managers would be at another level. It is important that the CFMIS recognise this hierarchy of indicators so that line managers could easily access what they need.

Conclusions

A key weakness is the number of budget amendments that must be approved by the Saeima every year. The efficiency of in-year budget execution would improve if it were based on a structured in-year reallocation (virement) regime, with a supplementary budget towards the end of the year should this prove necessary. A process that facilitates greater flexibility could be designed so that the authority of the Saeima would still be respected. The process should take account of the issues in Box 6 of this report.

In developing the new CFMIS, the separate needs of line ministries as well as the MoF should be carefully assessed so that the system that is selected can provide the essential information for all users. The new system should be designed to ensure value-for-money for taxpayers. It should be implemented to allow for ongoing reform of the organisation of the government's accounting services across ministries, to achieve efficiencies and allow key budgeting and financial management functions to be decentralised to line ministries.

While cash management appears to be generally accurate and efficient, consideration should be given to increasing the incentives for budget holders to improve annual financing plans. This could be achieved by introducing penalties in the form of interest rates on idle balances caused by inaccurate cash planning, as exist in some OECD countries. In parallel to these cash management reforms, the Treasury should consider digitalising the middle office functions of its debt management unit with the aim of reducing the manual transactions and improving data analyses and decision-making processes.

Transparency and Openness in Budgeting

Accessibility and legibility

The LBFM states that information regarding the State budget shall be published regularly in a format that is both fully comprehensive and understandable to the public. Accordingly, the MoF makes sure that as much information as possible, including all the main reports on the State budget, is publicly available. This is usually published on line on the websites of the MoF, the Treasury and the line ministries. This is very comprehensive.

The Treasury publishes monthly and quarterly reports on every expenditure programme, and makes the reports publicly available on its website[27]. The monthly reports show actual expenditure compared to the budget estimates by ministry or agency, programmes and expenditure line items. The quarterly reports also show actual expenditure compared to planned expenditure on a four-digit classification code basis. They are published on the 21st day of the following month (or the next business day if the 21st is not a business day). The quarterly reports are also available on the MoF website[28].

The MoF also publishes annual results data using qualitative and quantitative performance indicators of budget programmes[29]. These are published in an Excel format and show the performance indicators included in the State Budget Law package, the planned targets for the year and the extent to which they were fulfilled. The report also explains the reasons, including external factors, behind the achievement or non-achievement of objectives, as well as the actions taken to achieve the objectives.

Furthermore, once the State Budget Law is approved, ministries must prepare detailed estimates of their budget programmes/sub-programmes for the upcoming year to four levels of classification codes. This information is also accessible to the public via access to an on-line database.

Citizen engagement and consultation

The MoF publishes some information on its website that is easily accessible and understandable. The aim is to inform citizens about how their taxes are spent and how actual results compare to expected results. There are two main sources of information. The first is a presentation of key budget data in an interactive infographics format that allows the user to mine down through a series of charts to find the level of detail that they need[30]. The second source is a structured presentation of individual ministerial budgets in a relatively simple format[31]. This open data portal enables the user to see financial and non-financial performance information at programme level for individual ministries. The information provides a user with links between resources used and policy goals, but suffers from the weaknesses in performance information discussed earlier.

Citizens or civil society organisations (CSOs) have the right to be consulted in the development of the draft budget although it is not clear how strong their influence is. In the first instance, civil society and citizens have the right to comment on all draft legal acts that are in progress, including any with an impact on the budget. Furthermore, specifically for the budget process, the CoM engages with both the Council for the Implementation of the Memorandum of Cooperation between Non-Governmental Organisations and the

[27] https://www.kase.gov.lv/parskati/kopbudzeta-izpildes-parskati

[28] https://www.fm.gov.lv/lv/budzets2020#analize-un-izpilde

[29] https://data.gov.lv/dati/eng/dataset/ministriju-un-citu-centralo-valsts-iestazu-rezultatu-un-to-rezultativo-raditaju-izpilde

[30] https://www.fm.gov.lv/lv/interaktivais-budzets2021

[31] https://www.fm.gov.lv/lv/2021-gada-valsts-budzeta-strukturetie-paskaidrojumi

Cabinet, and with the National Tri-Partial Cooperation Board, which comprises the Chamber of Commerce and Industry, the Employers' Confederation, and the Free Trade Union Association. These are formal meetings for which minutes are kept. Finally, CSOs may attend and express their opinions in sittings of the CoM, and in sittings of the Parliamentary Budget Committee.

There are also procedures to enhance the general understanding of the budget and the budgetary procedures. Soon after the election of a new Parliament, the MoF makes a detailed presentation about the budget process to enhance members' understanding of the process. In addition, MoF officials may participate in educational programmes of the State Administration School and/or may work as lecturers in State Universities. This gives them the opportunity to provide comprehensive information about the budget to course participants.

Not surprisingly for a country with a strong tradition of open government, Latvia has a good commitment to budget transparency and accessibility, which includes active budget communication and a range of both financial and non-financial information that ordinary citizens can use. The weakness is in the quality of the information provided and in there being an excess of non-financial information that may be difficult to understand. Furthermore, while not strictly a matter of budget documentation, there are elements of opaqueness in the Budget formulation process. The SAO has been critical of the fact that the provision for new policy initiatives are agreed at Cabinet level and that there are no records available as to how these decisions have been taken.

Role of the Parliament in the Budget

As shown previously, the Constitution states that the Saeima must approve the Budget and the LBFM provides that the budget package submitted to the Saeima is comprehensive. The detailed procedures for voting on the budget is prescribed in the Rules of Procedure of the Saeima. The Saeima has relatively broad powers to review and approve the budget, which the Government has submitted. It not only debates but also approves the medium term budgetary framework, which is not the case in many OECD countries. The Saeima can propose changes to the draft budget submitted by the CoM. However, as in many countries, the powers are limited. If the Saeima proposes an initiative not provided for in the draft budget, the proposal must also provide the means by which the additional expense is to be offset so that the overall budget is not affected.

The Saeima approves the Budget in two stages or readings. The debate in the first reading covers the entire draft budget law package. The package is submitted to all parliamentary commissions but the Budget and Finance (Tax) Commission is responsible for coordinating all proposals to be considered in the first reading. Individual politicians, political parties, ministries and private organizations may submit proposals, which the Budget Commission reviews and votes on. After the first reading, the Commission compiles the proposals that is has accepted and submits them to the Government for consideration. In recent years, between 400 and 700 amending proposals have been submitted regarding the draft Budget Law. At the second reading, the proposals, now reflecting the Government's response, are debated again. After debating all the proposals, the Saeima votes on the draft Budget Law as a whole.

The Budget and Finance (Tax) Commission is also involved in post-Budget decisions (i) to increase appropriations that would change the budget balance or (ii) to make inter-ministerial transfers or (iii) the transfer of appropriations within a ministry. Parliamentary approval is required for all such decisions except for transfers within a ministry where the amount is not more than 5% of the appropriation for the relevant programme or sub-programme and is not more than EUR 100 000. In such a case, the Commission is informed of the change but its approval is not required. Furthermore, the Commission reviews the Treasury reports on the operational data of the state budget execution and it consults regularly with the MoF and line ministries on budgetary issues. The Budget and Finance (Tax) Commission and the Public Expenditure and Audit Commission may request the MoF to prepare a presentation on the budget execution process.

During the year, the Saeima may propose amendments to the budget. As with proposals for the draft Budget, however, they may not affect the budget balance. Accordingly, the resource for this is the budget programme “Reserve for Unforeseen Events”, which is included in the Budget to provide for these kind of proposals. Other parliamentary committees can hold public hearings on the budget. The relevant ministries are invited to participate, as are relevant other parties. CSOs regularly use these meetings as opportunities to make their own proposals.

The Saeima plays a central role in both the formulation and execution of the Budget. However, its ability to perform the role has two significant weaknesses. Firstly, the Budget Commission does not have sufficient analytical resources available to it. Secondly, the period for consideration and approval of the draft Budget is very compressed, which inevitably weakens the ability of deputies to contribute effectively to the debate.

The Saeima as a whole has an analytical service to carry out research on its behalf. This service provides technical support to the legislature in the decision-making process, improvement of the regulatory framework and dealings with the executive. In 2021, it carried out detailed research about Budget Procedures in the Parliaments of other countries and in Latvia. This report pointed out that while the provision of information and analytical support to a budget committee during the examination of the draft budget is important, such support is lacking in Latvia[32]. This is a major weakness since it leaves members relying on their own resources to carry out analyses without specialist technical support.

The report also highlighted that the time provided for debating the Budget is too short. The draft Budget Law is submitted to the Saeima by 15 October and it is usually approved by early December. Yet, the average size of the draft State budget Law has been 584 pages since 2011, which is extremely high. The situation is even more challenging when one considers that the legislature also must make annual amendments to the draft laws accompanying the draft state budget law, which can also be considerable. In addition to this, the Rules of Procedure of the Saeima provide for only a five-day interval between the first reading of the Budget and the submission of amendment proposals to the Budget Commission for its consideration. Given that the number of such proposals submitted by deputies can be very high, reaching 666 in 2017, this is a very short timeframe for any consideration by the Commission. The reality must be that it merely compiles most of the proposals and passes them onto the Government for its own considerations. Furthermore, the Saeima report states that in recent years the trend has been towards an even shorter timeframe for approving the Budget.

In addition to the Saeima’s own report, the SAO has also expressed concerns that “the Saeima has difficulties in exercising its exclusive right to decide on the budget, owing to the large volume of information of the Draft Framework Law and the Draft Annual State Budget Law, its fragmentation and incompleteness, as well as the limited time for budget examination”[33]. It also stated that the budget documentation did not facilitate a clear determination as to whether expenditure was effective because clear information about goals and activities was lacking. The SAO opinion was that these factors reduced the quality of debate and also the opportunity for the legislature to engage meaningfully with both public and non-governmental organisations.

The OECD’s Best Practices on Budget Transparency[34] states, “The government’s draft budget should be submitted to Parliament far enough in advance to allow Parliament to review it properly. In no case should this be less than three months prior to the start of the fiscal year”. It also states, “Parliament should have

[32] Report on Parliamentary Budget Procedures, Saeima, 2021

[33] Budget Planning in Latvia: Is The Current Approach Effective?, State Audit Office, 2018

[34] https://www.oecd.org/governance/budgeting/Best%20Practices%20Budget%20Transparency%20-%20complete%20with%20cover%20page.pdf

the opportunity and the resources to effectively examine any fiscal report that it deems necessary". This seems not be the case in Latvia.

Internal Audit

There is a well-developed and quite efficient system of internal audit (IA), which has adopted international (IIA[35]) standards, including a risk-based approach to audit. The system covers central government entities, institutions partly financed from the State Budget and (on a voluntary basis until 2021) municipalities. The 2021 amendments to the Law on Local Government, which reduced their number from 119 to 43, requires them to establish IA units. There are currently 21 IA units spread across the central government employing a total of 81 staff. SOEs have their own arrangements for IA (audit committees) based on company law requirements. Some audits have been carried out of horizontal issues, e.g., IT systems, the use of consultants. The IA function does not currently benefit from a dedicated information management system.

The government has established an IA Council to oversee IA functions and operations. The Council comprises five members including representatives of CSOs, the Bank of Latvia and the SAO. A small IA policy unit (four staff) acts as a secretariat, supports the IA Council on issues related to IA policy, and exercises quality control of the operations of IA units in the line ministries. The Council prepares a medium-term strategic plan and publishes an annual report. The IA unit has periodically carried out some quality reviews of the IA function in Latvia which have used external advisors (KPMG, Deloitte) and found that IA functions are not applied uniformly and systematically across all government entities. However, both reports were broadly positive and found that IA policy in Latvia was broadly in line with international professional standards. This is not surprising since Latvia has participated in twinning projects with the Netherlands and Croatia to improve IA skills and capacity in EU Accession and Neighbourhood countries. Historically, a high proportion (around 85 percent) of the recommendations of IA reports have been implemented by the audited entities. There is good cooperation between IA units and the SAO, which includes a process for sharing audit reports.

IA is a well-established function in Latvia and its operations are effective. IA functions should be rolled out across the municipalities, and would benefit from more staff resources, improved analytical capabilities and a dedicated IT system.

State Audit Office

The OECD Budgetary Governance Review of 2009 found that the SAO was "very effective and well-organised". Since then it has continued to perform effectively. It carries out its functions within a sound operational framework whereby its organisational and financial independence is guaranteed under Article 87 of the Constitution and the State Audit Office Law establishes the legal mandate and procedures under which it operates. These allow it to operate in accordance with the INTOSAI and other international standards. The Office has its own strategy which is a medium-term policy document, which sets out the strategic objectives, priorities, and planned results of the SAO on a rolling four-year basis[36].

Since 2009, the SAO's financial independence has been strengthened further. The Office is financed from the State Budget but its proposed budget cannot be amended by the MoF. LBFM articles $16^2(8)$ and 19(5) provide that the CoM may amend the SAO's budget proposal without the consent of the latter but, in such a case, it must inform the Saeima of its opinion and the SAO's response.

The SAO's power to audit extends to revenues, expenditure and property of (i) State and local government institutions (except for the Saeima), (ii) public and private companies where the State or local government

[35] Institute of Internal Auditors, a professional and standard-setting body based in Florida, USA.

[36] The current strategy document is the State Audit Office Strategy 2022-2025

own shares and (iii) European Union funds and funds of other international organisations, which are included in State or local government budgets. It conducts financial, compliance and performance audits. It is required to carry out financial audits in respect of ministers and other central government institutions but makes its own decisions as regards where to carry out compliance and performance audits. Currently, the number of performance audits is low but it also carries out 'combined' audits that have elements of compliance and performance combined. Furthermore, the SAO Strategy 2022-2025 aims to increase the percentage of resources devoted to performance auditing to 50% by 2024.

The SAO also publishes non-audit reports. In 2018, it published *Budget Planning in Latvia: Is The Current Approach Effective?*, where it attempted to benchmark Latvia against eight of the ten OECD Principles of Budgetary Governance. The report concluded that none of the eight principles were applied in full for two main reasons: firstly because there was poor cooperation and coordination among the various stakeholders so that there was no team approach and secondly because there was very little focus on planning beyond the annual cycle. The report was also critical of budget transparency, stating that the CoM agreements on priority activities without explanation are outside the normal budget procedures and that they diminish transparency.

The SAO Law provides that the SAO reports to the Saeima, which is responsible for appointing the Auditor General and Audit Council Members. The relationship between the Saeima and the SAO is strong, with there usually being one or two meetings per week. In 2020, there were 60 meetings to discuss audit reports, the implementation of audit recommendations, non-audit reports, legislative proposals, initiatives of Parliamentary Committees, as well as strategic and organisational issues of the Office itself. Most of these meetings were held with the Public Expenditure and Audit Committee (PEAC) of the Saeima. The Committee sets deadlines for (i) audited entities to report on implementation of the SAO recommendations (and may add its own recommendations for implementation by the entities); and (ii) the SAO to report about the extent to which the audited entities are implementing the recommendations. The SAO and the PEAC jointly monitor the progress on recommendations being implemented, which means they can cooperate closely to achieve the same goal.

The SAO is an effective organisation that has a wide mandate, can operate independently, and enjoys the support of the Saeima. It is highly professional and its 2018 report, *Budget Planning in Latvia: Is The Current Approach Effective?*, which benchmarked Latvia against eight of the ten OECD Principles of Governance, is a sound analysis. With particular regard to budget transparency, the SAO is of the opinion that it is difficult for the Saeima to exercise its right to decide on the Budget because of the large volume of information that it must consider and the short timeframe provided. The report contains several recommendations to the MoF and to the CoM to improve not just transparency but also the quality and effectiveness of the State Budget. Consideration should therefore be given to implementing the recommendations in the report.

Conclusions

A key weakness is the number of budget amendments that must be approved by the Saeima every year. The efficiency of in-year budget execution would improve if it were based on a structured in-year reallocation (virement) regime, with a supplementary budget towards the end of the year should this prove necessary. A process that facilitates greater flexibility could be designed so that the authority of the Saeima would still be respected. The process should take account of the issues in Box 6 of this report.

In developing the new CFMIS, the separate needs of line ministries as well as the MoF should be carefully assessed so that the system that is selected can provide the essential information for all users. The new system should be designed to ensure value-for-money for taxpayers. It should be implemented to allow for ongoing reform of the organisation of the government's accounting services across ministries, to achieve efficiencies and allow key budgeting and financial management functions to be decentralised to line ministries.

While cash management appears to be generally accurate and efficient, consideration should be given to increasing the incentives for budget holders to improve annual financing plans. This could be achieved by introducing penalties in the form of interest rates on idle balances caused by inaccurate cash planning, as exist in some OECD countries. In parallel to these cash management reforms, the Treasury should consider digitalising the middle office functions of its debt management unit with the aim of reducing the manual transactions and improving data analyses and decision-making processes.