Unclassified

23LV15 Strengthening of medium-term expenditure framework and budget outcomes in Latvia: Final Report

This Report presents the progress of Latvia in implementing public financial management reforms, the results achieved to date and the recommended follow-up actions.

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Brian Finn Brian.finn@oecd.org

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Executive Summary

1. Latvia established a medium-term perspective for the budget with the enactment of the Fiscal Discipline Law (FDL) in 2013, which provided the legislative basis for a top-down approach to allocating government expenditures and a sustainable medium-term budgetary framework that would ensure more efficient management of public resources while supporting the implementation of prudent fiscal policies and respecting the preventive arm of the EU Stability and Growth Pact. Despite this, however, the practice of incrementally increasing budget allocations remains. There are challenges that need to be addressed, such as the methodology for estimating multi-annual expenditure baselines, creating efficiencies in budget execution and improving performance budgeting. The initial building block to delivering these reforms is the establishment of a multi-annual approach to budgeting that is aligned with the Government's policy vision over the medium-term. Ambitious plans to create a more strategic approach with better spending outcomes will fail in the absence of a medium-term budget framework to which all stakeholders are committed.

2. The Project was tasked with developing proposals that would help to deliver (i) a stronger medium-term expenditure framework underpinned by a cross-government methodology that provides robust estimates and ensures compliance with fiscal constraints; and (ii) the establishment of budget planning and treasury execution procedures that underpin the annual budget being anchored by a medium-term expenditure framework.

3. In this regard, the OECD drafted four analytical reports with recommendations for reforms that would:

- strengthen the medium-term approach to public spending in Latvia
- improve the efficiency of in-year budget execution by introducing an in-year re-allocation process that will allow line ministries in Latvia more flexibility for the re-allocation of resources
- provide line institutions with greater autonomy and accountability for delivering policy objectives within a framework that still respects fiscal discipline by enhancing performance budgeting
- propose a framework incorporating government commitments on assets (e.g., state owned enterprises) and liabilities (e.g., occupational pensions and climate risks), which can be integrated into the fiscal risk management framework.

4. The Budget Policy Development Department of the Ministry of Finance (MoF) has accepted these recommendations and actively supported and participated in their presentation to senior civil servants from both the MoF and line ministries at two days of workshops in March 2025. Furthermore, the MoF plans to introduce amending legislation to the Law on Budget and Financial Management (LBFM) that will see the budget being approved at programme level from 2027 onwards. This will be a significant development, which lays a foundation for strengthening the medium-term approach, creating a basis for giving line ministries more flexibility in managing budgets, as well as providing the framework for enhancing performance budgeting.

5. Fiscal risk management is already quite strong with a Fiscal Risks Statement (FRS) that already already complies with good practice in several ways (e.g. risks coverage, quantitative assessment, impacts on the main fiscal aggregates, discussions on mitigation measures). The Fiscal Policy Department of the MoF has expressed strong interest in improving the FRS and has welcomed the proposals for fiscal risk management.

Introduction

6. The OECD has drafted this report as part of the support that Latvia requested from the European Commission, under the TSI Regulation, to reform the country's public financial management process, with the purpose of strengthening the medium-term expenditure framework and budget outcomes under the conditions set in the Contribution Agreement REFORM/IM2023/004.

7. Latvia requested further support from the European Commission under the TSI Regulation to build on the 2022 Budget Review by the OECD and develop a multi-annual approach to budgeting that would address these challenges and develop a framework for strengthening fiscal discipline and sustainability, as well as enhancing accountability. This would help Latvia with the implementation of the Recovery and Resilience Programme and comply with recommendations in the EU Economic Governance Review, the EU 2022 Country Specific Recommendations for Latvia and the Commission's Fiscal Policy Guidelines 2023.

8. The specific objectives of this Project are:

- to support Latvia to design, develop, and implement reforms
- to support Latvia to prepare amend, implement and revise its national recovery and resilience plan in accordance with Regulation (EU) 2021/241.

The achievement of these objectives will depend on the follow-up actions undertaken by Latvia.

9. Although Latvia established a medium-term perspective for the budget in 2013, the practice of incrementally increasing budget allocations remains. There is no standard and reliable methodology for calculating multi-annual, no policy change baseline estimates. Therefore, line ministries use a variety of ways to estimate the additional funds required for the increase in operational expenses. This makes the budget process less structured and clear. The 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. The current procedure also fails to mitigate the inevitable increase of operational expenses, and the practice is that line ministries must try to offset these increases through efficiency gains. As a result, line ministries are competing for incremental resources where overall demands far exceed fiscal constraints. To address this challenge, this Project aims to support the authorities to

- Develop a stronger medium-term expenditure framework underpinned by a cross-government methodology that provides robust estimates and ensures compliance with fiscal constraints.
- Establish budget planning and treasury execution procedures that underpin the annual budget being anchored by a medium-term expenditure framework.

10. The agreed Project envisages several outputs that will guide and assist the authorities to adopt an approach to budgeting that looks beyond the annual incremental changes towards a multi-annual process that links budget and strategic planning. In this regard, the OECD has drafted four substantive guidance notes with recommendations that can provide a basis for the Latvian authorities to implement the reforms necessary to achieve the desired impact of an improved budget implementation process that will contribute towards strengthening public financial management through increased fiscal discipline and expenditure control. The four documents provide:

- recommendations for strengthening the medium-term approach to public spending in Latvia. The note emphasises the importance of formulating budget plans while respecting top-down expenditure ceilings and prioritising planned expenditure so that it is aligned with policy goals
- recommendations for improving the efficiency of in-year budget execution by introducing an in-year re-allocation process that will allow line ministries in Latvia more flexibility for the re-allocation

of resources. The overarching objective is to encourage an approach that promotes management and accountability regarding public finances as opposed to the existing approach where budget institutions engage in a cumbersome process for making changes at line-item level

- recommendations for budget planning and budget execution procedures, aiming to reduce technical work and ensure compliance with policy goals and fiscal constraints, while increasing the role of line ministries. It recognises the important responsibility of both the MoF and the line ministries in using performance budgeting so that the impact will be one of improved accountability and funds being allocated in a more efficient manner
- recommendations for a proposed framework that incorporates government commitments on assets (e.g., state owned enterprises) and liabilities (e.g., occupational pensions and climate risks), which can be integrated into the fiscal risk management framework. The note recognises that the existing fiscal risks statement is already quite comprehensive, where the main risks are covered and detailed analysis (including a quantitative approach) provided.

11. The project also recognises that if the proposed reforms are to be implemented successfully, it may be necessary to revise the Latvian organic budget law, Law on Budget and Finance Management (LBFM), which sets the legal basis for budget planning and execution. Accordingly, the OECD has drafted recommendations for improving the legal framework so that it underpins and supports the reforms that the Latvian authorities wish to implement to facilitate enhanced fiscal discipline and expenditure control.

Background

12. The Latvian budget preparation process traditionally was characterised by continuous budgeting involving regular in-year adjustments to expenditure and limited emphasis on multi-annual fiscal planning despite the existence of a formal medium-term fiscal framework.

13. However, the enactment of the Fiscal Discipline Law (FDL) in 2013 strengthened the legal framework for managing public finances by ensuring a balanced budget over the course of the economic cycle. 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, article 9 of the FDL requires that the adoption of laws and regulations that will weaken the structural balance must be offset fully by compensatory measures.

14. 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.

15. There are no specific 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. There is a provision in the LBFM that the draft MTBF will be submitted to the Saeima by 15 May. The MoF considers that this is important because it facilitates a strongly informed public debate in the Saeima on the economic framework underpinning the Budget every Spring rather than

in Autumn, which could put upward pressure on expenditures owing to more buoyant revenues than foreseen in the Spring.

16. The LBFM has been amended to ensure consistency with the requirements of the FDL. Article 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 secondary legislation in the form of Cabinet Regulations that regulate specific financial operations.

Guidance report for implementing a multi-annual approach

17. The basic elements are in place for a multi-annual approach but there are several reforms that could help to deliver such an approach and move away from the annual focus. These include more accurate baseline estimates, setting clear and realistic ministerial ceilings, improving financial oversight and control mechanisms, and adopting a more strategic and long-term perspective in budget planning. These reforms would help align budget priorities with policy goals and promote more efficient and effective use of public resources.

18. The initial building block in delivering these reforms is the establishment of a multi-annual approach to budgeting that is aligned with the Government’s policy vision over the medium-term. Ambitious plans to create a more strategic approach with better spending outcomes will fail in the absence of a medium-term budget framework to which all stakeholders are committed.

19. Latvia’s commitment to fiscal discipline is proven but it relies on a budgetary governance model that is centrally driven by the Ministry of Finance (MoF) ensuring that annual increases in total expenditure are kept within an overall top-down ceiling. While the MoF ensures that appropriations are agreed within the framework of the ceiling, there is significant scope for a more collaborative approach between the MoF and the line ministries with the objective of ensuring that the latter spend within their agreed envelopes, and in a manner that is linked to planning policies over the medium-term period.

20. In this context, the guidance report considers the planning of the medium-term budgetary framework under several aspects. These are:

- **Background**, which sets out the general context including the Latvian commitment to fiscal discipline.
- **Medium-term budget framework**, which identifies issues that need to be addressed.
- **Preparing the MTEF and the annual budget**, which sets out the calendar and the preparation process, including an examination of Cabinet Regulation No. 15/2023 that establishes the rules and procedures for preparing the budget.
- **Multi-annual expenditure baselines**, which examines baseline estimates in Latvia compared to OECD standards and identifies changes that could be made.
- **Top-down expenditure ceilings**, which examines the use of top-down ceilings in Latvia compared to OECD standards and recommends making greater use of bottom-up estimates in formulating those ceilings.
- **Linking baseline estimates to the previous year’s outturn**, which examines how the baseline estimates can be made more accurate in particular by not relying on one MTEF that is only updated once a year.

- **Spending reviews**, which describes the already successful spending review process in Latvia and identifies how the introduction of a pre-defined saving target can create greater fiscal space for new policies.
- **Link between policies and budget planning**, which considers how the links between budgeting and the strategic planning process can be strengthened.
- **Incentivising line ministries**, which identifies steps that could incentivise line ministries to buy into a process which is more focused on the medium-term from a planning perspective.
- **Recommendations for implementing a multi-annual approach**, which sets out the recommendations for the reforms required to develop a more multi-annual approach
- **Suggested timelines for implementing key steps**, which sets out the key steps along with suggested timelines for making these changes.

The recommendations are key to enhancing the multi-annual approach. Taken together these measures can help achieve the objective of more effective spending and sustainable finances. They are set out below.

- The existing guidelines are generally clear. However, the authorities could modify several possible areas in Regulation No. 15/2023 and the procedures that it underpins. These are:
    1. The assignment of responsibility to line ministries so that they provide more accurate estimates for proposed new policies
    2. Requiring line ministries to provide more details in their proposals for new policies
    3. Encouraging line ministries to make a shorter number of proposals so that the MoF can give greater consideration to those proposals that are made
    4. Encouraging greater cooperation between the MoF and line ministries
    5. Ensuring that the instructions to line ministries are clearly understood
- The MoF should work with line ministries to improve the credibility of baseline estimates. Baseline estimates play a crucial role in the budgeting process as they serve as the starting point for budget formulation. In Latvia, the weak methodology can result in poor planning that leads to overspending in some areas and underspending in others, requiring in-year adjustments that can be cumbersome to implement. To address this issue, the standard methodology in Regulation No. 15/2023 should be followed by all budget institutions. The MoF needs to carefully review these estimates to ensure they are credible. The MoF should regularly update the medium-term budget framework in response to policy changes during the execution of the budget so that the evolution of expenditure can be tracked against the planned budget and changes incorporated into the baseline figures.
- The baselines should be linked to the previous year's outturn rather than the budget allocation. Line ministries should
    1. submit baselines that are clearly derived from the previous year's most readily available outturn data
    2. explain and quantify each of the factors that underpin the difference between the previous year's outturn and the estimates in each year of the medium-term period
    3. submit the baselines at the programme level rather than the line-item level so that the MoF can more easily monitor the calculations.
- The line ministries should develop their budget proposals within a framework that respects the top-down ceiling. While top-down ceilings are considered binding for each year of the medium-term budget framework, line ministries do not formulate their proposals for funding new policies in this

context. To implement this recommendation, it is important to engage all budget institutions in the budget formulation process and encourage them to work within the set ceilings. This will require strong communication and coordination between the MoF and line ministries. It is also essential to have a mechanism in place to monitor adherence to these ceilings and address any potential issues that may arise.

- The MoF should ensure it has adequate institutional capacity for driving the reforms. The effective implementation of a medium-term fiscal framework requires strong institutional capacity within the MoF. This not only requires the ability to analyse and forecast spending trends accurately but the time and resources to carry out this task. The MoF may struggle to allocate these resources due to budget constraints or competing priorities. Changing institutional procedures to create time for this kind of work is a challenge that needs to be met.
- The MoF should work with the line ministries to develop adequate institutional capacity at line ministry level. Some line ministries may not have the necessary capacity or expertise to prepare baseline estimates and place ceilings at the heart of their budget formulation. The MoF should help budget institutions in building the necessary capacity. This includes providing training and resources for budget officers to effectively plan and manage their expenditures over the medium-term.
- The Government should introduce a pre-agreed fiscal constraint into its spending reviews, by including a requirement that a minimum level of savings – a savings target – must be identified when conducting the spending review. Line ministries could be incentivised to cooperate by being allowed to keep a certain proportion of savings for priority areas.
- The Government, the MoF and the line ministries should develop a more strategic approach. The emphasis on the annual budget can lead to a lack of strategic thinking and long-term perspective in decision making. As a result, policy goals and priorities may not be adequately addressed, and the budget may not be aligned with the Government’s long-term objectives.
- Line ministries should be willing (incentivized) to prioritise activities and programmes to deliver results within the overall ceiling that applies to them. The implementation of a medium-term expenditure framework on a programme basis requires line ministries to prioritize programmes and projects according to the government's overall budgetary constraints. This may require reallocation of funds among different programmes and projects, which could face resistance from ministries whose budgets are being cut unless it is clearly communicated that the Government expects this reprioritization to be a key element of budget formulation.
- The MoF should work with line ministries to strengthen performance budgeting and move from a presentational approach to a performance informed approach. Performance budgeting exists in Latvia, where performance information is presented as part of the budget. The approach is more presentational where performance information is presented with budgeting documents and is included as background information for the purposes of accountability and dialogue with legislators and citizens on public policy issues and government direction. Performance information does not play a significant role in decision-making on allocations.
- It may also be necessary to invest in technological infrastructure to support accurate and timely budget data analysis. 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.

- The MoF needs to incentivize line ministries to manage their budgets and accept accountability for doing so. Line ministries lack incentives to adhere to the medium-term expenditure framework. In some cases, they are more focused on short-term results rather than long-term fiscal sustainability. One incentive could be to reward line ministries that meet their targets by allowing them more flexibility in managing their budgets. Conversely, penalties involving far closer monitoring and reporting could be imposed for line ministries that consistently fail to comply with the reforms.
- The MoF needs to coordinate with line ministries. As the MoF is responsible for overall budget planning and management, it should collaborate and coordinate with line ministries responsible for implementing various policies and programmes. Effective implementation of a medium-term fiscal framework requires close coordination and communication between line ministries and the MoF. However, line ministries may not have a clear understanding of the framework or its implications, resulting in a lack of cooperation and coordination.

Guidance report for improving the efficiency of in-year budget execution

21. The Project is expected to help Latvia in developing a framework for strengthening fiscal discipline and sustainability, as well as enhancing accountability. One of the key outputs is a guidance report that focuses on improving the efficiency of in-year budget execution by introducing an in-year re-allocation process that will provide line ministries with more responsibility and greater flexibility for the re-allocation of resources. Providing line ministries with more flexibility in managing their budgets is not merely about reducing the workload associated with reallocations; it is driven by the need to manage expenditures more effectively, enhance accountability and to focus on results. This will shift the focus at the line ministries from rigid line-item budget adjustments to a more flexible management-oriented approach that emphasizes accountability in public finances.

22. In making the recommendations, the analysis recognises the important responsibility of line ministries in planning and managing their own budgets by addressing the lack of incentives that the existing system provides to line ministries for carrying out internal budgetary reallocations, reviewing existing functions and processes, and proposing policy changes.

23. The report considers the development of procedures that give greater flexibility to line ministries in managing their budgets by examining several aspects. These are:

- **Overview of the challenges to be addressed**, which sets out the objectives of the Project in general and this note in particular.
- **Existing procedures for re-allocations in Latvia**, which sets out the general context including key issues that need to be addressed if the workload surrounding reallocations is to be reduced and line ministries be provided with more autonomy to carry these out.
- **In-year reallocations in OECD countries**, which examines the characteristics and principles in a number of OECD countries regarding in-year reallocations.
- **Enhancing autonomy through a more flexible approach to executing the budget**, which provides examples of the key principles that allow for line ministries to have more autonomy but at the same time respecting the role of Parliament and the role of the MoF in guarding the public purse.
- **Changing culture and accountability**, which describes how reducing the workload is not a key consideration in isolation but that it is part of a process that can deliver greater accountability of line ministry managers for their budgets and that the MoF should support and incentivise line ministry managers to implement the changes.

- **Amending legislation in Latvia**, which highlights the key sections of the LBFM that need to be amended in the event of a new procedure being adopted, as well as those which must remain to ensure the role of the Saeima. Two sections from Cabinet Regulation No. 421/2018 are also highlighted as allowing for the adoption of a more flexible approach.
- **Recommendations for implementing a more flexible approach**, which sets out the recommendations that would allow for a more flexible approach.

24. To encourage an approach that promotes management and accountability as opposed to the existing approach where budget institutions engage in a cumbersome process for making changes at line-item level, the OECD made a number of recommendations. They are set out below.

- As already recommended in the guidance report for implementing a multi-annual approach, the MoF should work with line ministries to improve the credibility of baseline estimates. Baseline estimates illuminate the multi-year implications of spending decisions, and act as an early warning of emerging expenditure trends. If baselines are not robust, however, they result in poor planning that leads to overspending in some areas and underspending in others, requiring in-year adjustments that can be cumbersome to implement. To address this issue, the recommendation in output 3 should be implemented as it will not only improve budget estimates but will lead to a reduction in the need for reallocations.
- Reconsider the number of programmes and sub-programmes to address the problem of the excessively detailed programme and sub-programme classification restricting the extent to which funds can be re-allocated between programmes. In this regard, deciding that reallocations can take place between programmes without the need for Saeima approval would introduce a greater degree of flexibility even if the number of programmes was not reduced. On the other hand, however, a more concise number of programmes plus the right to reallocate across the reduced number would enhance flexibiilty even more. To do this, the MoF should work with line ministries to identify programmes that are duplicative or where one programme can include the objectives of another.
- 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. Virement should be implemented on the basis that the Saeima appropriates money to each budget user at the overall level and not at a lower programme, sub-programme or line-item level. This approach may be easier to implement than reducing the number of programme and sub-programmes, which may also facilitate greater flexibility but may not be so easy to implement.
- Any decision to provide more autonomy to line ministries should safeguard the role of the MoF in protecting the public purse. The approval of the MoF would be required for virement subject to several conditions in order to respect Parliamentary authority and fiscal constraints. A list of factors to consider is included in the guidance report.
- The MoF needs to incentivize line ministries to manage their budgets and accept accountability for doing so because the flexible approach requires line ministries to accept responsibility for making the changes without the comfort of using extra checks that apply currently where the agreement of the MoF and ultimately the Saeima is required. Line ministries lack incentives to adhere to the medium-term expenditure framework. In some cases, they are more focused on short-term results rather than long-term fiscal sustainability. One incentive could be to reward line ministries that meet their targets by allowing them more flexibility in managing their budgets. Conversely, penalties involving far closer monitoring and reporting could be imposed for line ministries that consistently fail to comply with the reforms.

- The MoF needs to work with line ministries to ensure that policy units clearly understand what the more flexible approach entails. The MoF should work with the finance functions in line ministries to develop training materials that can be delivered in workshops organised jointly by the MoF and the various line ministry finance functions. This will ensure that the policy units have the technical capacity to adopt the new more flexible approach that also requires more responsibility at the line management level.
- Carry out an examination of the LBFM with a view to making those amendments that are required to introduce a more flexible process for reallocating appropriations. Any decision to amend the process for approving reallocations can only be put into effect after a detailed examination of the LBFM.
- Ensure that those articles of the LBFM which safeguard the roles of the MoF and, in particular, the Saeima remain in place. It should be clearly understood that virement for line ministries does not give them unlimited scope for reallocations. There must also be a framework of rules to ensure that public financial management principles are respected.

Proposed outline for ensuring compliance with policy goals and fiscal constraints

25. In Latvia, performance information is used for spending reviews and budget reallocations. The MoF consolidates performance information into a database which makes it possible to track results. Beginning in 2025, line ministries must submit to the relevant Parliamentary Commissions reports on the objectives and results of their activities, the implementation of the previous year's budget, the resources used relative to the results achieved, and the benefits to society and the impact on the future financing of sectoral policies in the medium term. The MoF plans to introduce amending legislation to the LBFM that will see the budget being approved at programme level from 2027 onwards.

26. However, although the performance information framework enters budget negotiations via spending reviews, this framework is complex and detailed. Furthermore, while the programme objectives are transparent, the key performance indicators are often not robust. Within this context, the OECD prepared a report that describes the key factors which facilitate the use of performance budgeting so that budget decision making is better informed. It identifies steps that facilitate a shift from focusing on inputs (“how much funding will I receive?”) towards measurable results (“what can be achieved with the funding I received?”). The report makes use of examples from OECD countries. The key factors and steps are set out as follows:

- **Budget Planning and Execution in Latvia**, which highlights the key features of the budget process, including the roles of the key institutions, budget planning and budget execution.
- **Use of Performance information in Latvia**, which describes the existing situation regarding performance budgeting with emphasis on some of the weaknesses and an explanation of the planned reforms to the Centralised Financial Management Information System (CFMIS).
- **Performance budgeting**, which defines what performance budgeting is about and how the various elements (inputs, activities, outputs and outcomes) relate to each other.
- **Improving the quality of performance information**, which explains the importance of quality information so that it is meaningful and can be useful in decision-making. It explains the importance of ensuring performance objectives are output and outcome oriented.
- **Presenting performance information in budget documentation**, which explains how to integrate performance information within the budget to enhance decision-making. It also explains how effective use of the information requires a structured, standardized presentation tailored to

various stakeholders that ensures clarity, consistency, and effective assessment of budgetary performance.

- **Strengthening reporting practices to increase accountability**, which describes examples from several OECD countries and explains that while OECD countries vary in their performance reporting methods, most publish year-end reports that may include either standalone performance data or a combination with financial information.
- **Improving IT systems to support the implementation of performance budgeting**, which considers how a well-designed IT system is crucial for public financial management reforms, as it reduces paperwork and errors, facilitates the systematic collection of performance information, and enhances communication through user-friendly dashboards and visual tools that engage stakeholders and improve transparency.
- **Recommendations for implementing enhanced performance budgeting in Latvia**, which sets out the recommendations that can improve the performance budgeting framework in Latvia.

27. Implementing the recommendations will improve the performance budgeting framework. They provide a basis for changing the existing scenario whereby information is available but not central to the budgeting system to one where it is placed at the heart of the public finance management process. The detailed list of recommendations are as follows:

- 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 should include:
  - Reducing the currently used 2,000 key performance indicators (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.
- Prepare and implement an action plan on a redesigned PBB system, which would involve:
  - Initiating a dialogue between the MoF, budget entities and other stakeholders with a view to redesigning the PBB system.
  - Implementing the action plan with analytical tools and skills, extensive training and capacity building, and reengineered IT systems on a phased basis.
- Improve the existing performance budgeting framework by
  - Improving the outcome orientation of performance information developed by line ministries.
  - Improving linkages between performance objectives and performance indicators.
  - Progressively incorporating performance information within medium-term planning.
  - Improving the transparency over the achievement of targets.
  - Gradually integrating performance information within the IT systems.
- Take account of the 2024 OECD report “Building Capacity for Evidence-Informed Policymaking in Latvia” which recommended that analytical skills inside the public administration should be strengthened “by mapping analytical skills, performing upskilling and attracting new analytical skills”. If analytical capacity can be strengthened, this will increase the likelihood of information being used more effectively within line ministries.

Improving assets and liabilities management in the fiscal risk management framework

28. In developing recommendations for a proposed framework incorporating government commitments on assets (e.g., state owned enterprises) and liabilities (e.g., occupational pensions and climate risks), which can be integrated into the fiscal risk management framework, the OECD analysed the current Latvian fiscal risk statement (FRS), with a focus on fiscal risks related to State-Owned Enterprises (SOE), on fiscal risks related to pensions, and on fiscal risks related to climate change.

29. The key factors and steps are set out as follows:

- **Introduction**, which describes how the development of a strong fiscal risks management framework is crucial to the success of planned PFM reforms and how this applies to Latvia
- **Overview of the Current Fiscal Risks Statement**, which includes a general assessment compared to international standards, the strengths of the current FRS and identifying areas for improvement with reference to examples in other countries
- **Fiscal Risks related to state owned enterprises**, which focuses on the treatment of fiscal risk associated with SOEs in Latvia and provides examples of practices in other countries
- **Fiscal Risks related to pensions**, which focuses on the fiscal risks associated with Latvia's three-pillar pension system (the pay-as-you-go public pension scheme, state mandatory funded defined contribution pension scheme, and voluntary private pension funds) and provides examples of practices in other countries
- **Fiscal Risks related to climate change**, which focuses on the treatment of fiscal risks associated with climate change, including how it can affect the main drivers of economic growth by causing both supply and demand side vulnerabilities, and provides examples of practices in other countries
- **Recommendations and Roadmap**, which sets out a series of recommendations for each of the three areas considered and presents them as short-term or medium-term recommendations.

30. The report found that the current FRS is already consistent with international best practice in several key dimensions, such as risks coverage, quantitative assessment, impacts on the main fiscal aggregates and explanations of mitigation measures. The fiscal risk management framework and the related FRS are designed to identify fiscal risks that occur in standard situations. The new EU economic governance framework does not change the fiscal risk management mechanism and, accordingly, the content and purpose of the Latvian FRS. Rather, it confirms the approach to identify, assess, and manage fiscal risks.

31. However, the analysis found that the FRS could be strengthened to have a greater impact on Public Financial Management improvements in Latvia. Currently, it is a technical document with a detailed approach, which can obscure the main messages both for an internal audience and for the wider public. In this regard, therefore, the report provided the following list of recommendations:

Short-term recommendations

- Make the Fiscal Risk Statement more impactful by
  - Providing a clear executive summary of the document, with a strong narrative regarding the evolution of the fiscal risks in Latvia over the past year
  - Providing a synthetic view of the fiscal risks and their evolution to highlight the main changes (e.g., new risks, changes in terms of probability and / or impacts, etc.)

    - Consolidating the identified fiscal risks in a synthetic fiscal risk register (like the one presented in the UK FRS)

- Strengthen the presentation of the main transmission channels by risks (beyond consolidation in General Government, e.g., PPP-related fiscal risks) and assess the opportunity to strengthen some quantitative approaches
- Assess the opportunity to present a short discussion on macroeconomic fiscal risks (referring to relevant documents for further analysis)
- Provide a brief overview of the SOE portfolio in the narrative, highlighting the main specificities of the portfolio and its main sensitivities (e.g., concentration issues, sensitivity to some macroeconomic assumptions such as energy prices, etc.)
- Provide an overview of the financial transfers between the Government and the Public Corporations, and, if possible, of past deviations against budget (forecasts versus actuals)
- Identify and validate criteria (e.g., size, existing guarantees) to prioritize the monitoring of the portfolio of SOEs, with strong monitoring and assessment of the fiscal risks for the selected SOEs
- Start building a long-term fiscal risks chapter, building on current existing analysis (e.g., debt management, climate change, etc.)
    - This chapter should aim to assess the sensitivity of long-term outputs to identified fiscal risks
    - Development of this chapter should be progressive
- Include analysis of Pensions in the long-term view, with the description of the main schemes, and their potential fiscal impacts

Short-term recommendations

- Develop stronger quantitative approaches (e.g., probabilistic / stochastic, fiscal stress-test) on selected fiscal risks
- Progressively expand the long-term risks section, showing the impacts of those long-term risks on the main fiscal aggregates
- Develop a dedicated approach on fiscal risks related to climate change, with a progressive identification of the transmission channels, as well as an assessment of short-term and long-term fiscal risks
- Strengthen quantitative analysis through review of the financial conditions of selected SOEs (e.g., performance assessment through ratio analysis, scorecards)
- Assess the opportunity to discuss Quasi-Fiscal Activities and their impacts in the Fiscal Risks Statement
- Detail sensitivity of the Pension schemes to selected key assumptions (e.g., building on existing actuarial analysis).

Legislative Amendments

32. The LBFM establishes the basic legal framework for public financial management. 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.

33. The LBFM is consistent with the requirements of the FDL. Article 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 the LBFM and the FDL, there is secondary legislation in the form of Cabinet Regulations that regulate specific financial operations.

34. There are no specific provisions in the LBFM 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. There also are plans to amend the LBFM so that the budget will be approved at programme (policy area) level from 2027 onwards. This is a significant development in that it will provide a basis for moving to a more flexible management-oriented approach that enables line ministries to manage within programmes, as well as emphasizing accountability in public finances. It also provides a sounder basis for implementing efforts to place a greater emphasis on results with performance budgeting techniques.

35. In considering the legislative amendments that could be needed to underpin the recommendations for reform, the OECD found that:

- Implementing an enhanced multiannual approach requires amendments to the LBFM although the number of amendments is not extensive. The proposed amendment to approve the budget on a programme basis will develop a stronger multiannual approach as programmes should be managed on a period beyond the annual. The review also suggested some amendments The Cabinet of Ministers Regulation No. 15/2023 *Procedures for determining the maximum allowable total amount of state budget expenditure and the total amount of expenditure planned for each ministry and other central state institutions for the medium term* which establishes the rules and procedures for estimating the budget ceilings for the three-year medium-term period.
- For improving the efficiency of in-year execution of the budget, the analysis highlighted several articles in the LBFM that need to be amended in the event of a new procedure being adopted, as well as those which must remain to ensure the role of the Saeima. The Cabinet of Ministers Regulation No. 421/2018 *Procedures for Making Changes to the Appropriations Specified in the Annual State Budget Law* which prescribes the details of the procedures under which public bodies may request reallocations during the year was examined and appears to present no impediment to a more flexible approach; two sections allow for this approach.
- For developing a more results-oriented approach linking policies to budgets, the OECD proposed that the Saeima adopt the budget on the total allocation to each line ministry or at least on a programme basis. From 2027, the authorities intend to adopt the budget on a programme basis. The only other legislative amendment would be to amend the provision that requires line managers to execute the budget on a compliance basis so that they are required to focus on performance and results.
- For improving fiscal risk management, neither the FDL nor the Cabinet Regulation No. 229/2014 *Regulations on the general management of fiscal risks and on the methodology for determining the amount of fiscal security reserve* need to be amended to support the implementation of the recommendations.