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Abbreviations and Acronyms

COFOG	Classification of the Functions of Government
EC	European Commission
EU	European Union
FAD	Fiscal Affairs Department
GDP	Gross Domestic Product
IMF	International Monetary Fund
LBFM	Law on Budget and Financial Management
LOI	Letter of Intent
MTEF	Medium-Term Expenditure Framework
MoF	Ministry of Finance
PC	Performance Criterion under the IMF's Stand-By Arrangement
PFM	Public Financial Management
PPP	Public-Private Partnership
SAO	State Audit Office
TSA	Treasury Single Account

PREFACE

This aide-mémoire summarizes the key recommendations of the technical assistance provided by experts from the Fiscal Affairs Department (FAD) of the International Monetary Fund and from the Directorate-General for Economic and Financial Affairs of the European Commission (EC) in Riga during March 24–30, 2009.

This aide-mémoire recommends a number of immediate measures in support of the supplementary budget. It also provides broad orientations for further reforms that will need to be refined, in particular during the technical assistance mission tentatively scheduled for the first half of May.

Technical assistance was provided by Mr. François Michel (FAD), Ms. Anita Angelovska-Bezoska, Mr. Benoit Chevauchez (both FAD panel experts), and Messrs. Gatis Eglitis and Julien Rousselon (both from the EC). The experts held discussions with Mr. Dombrovskis, Prime Minister; Mr. Repše, Finance Minister; Mr. Leiškalns, Head of the Saeima Budget Commission; Mrs. Sudraba, State Audit Office General Auditor; Mr. Bičevskis, Finance State Secretary; Mrs. Bāne and Mr. Taurins, Finance Deputy State Secretaries; Mr. Abolins, Head of Treasury; Mrs. Stepanova, Budget Director; Mrs. Medne, Deputy Treasurer; Mrs. Petersone, Deputy Director of the State Chancellery; Mr. Gruškevics, Ministry of Education and Science State Secretary; Mr. Straujuma, Ministry of Regional Development and Local Government State Secretary; Mr. Freivalds, Ministry of Transport State Secretary; Mr. Snore, Ministry of Agriculture Deputy State Secretary; Mr. Mucinš, Ministry of Health Deputy State Secretary.

The experts presented their recommendations to the Minister of Finance on March 27 and, at his request, organized a government seminar on March 30.

The experts would like to express their gratitude to the Latvian authorities, and in particular to Mmes. Bāne, Stepanova, and Bajāre, for the excellent assistance and cooperation provided by all the officials who attended the meetings.

EXECUTIVE SUMMARY

While presenting certain strengths, Latvia's public financial management (PFM) system needs immediate and fundamental adjustments to prepare the upcoming supplementary budget and to prevent fiscal slippages. The report focuses on providing emergency powers to the Ministry of Finance to prepare and implement a realistic supplementary budget and exert effective control over spending, consistent with program targets, within the next two months.

This aide-mémoire focuses on immediate issues that need to be resolved to prepare the upcoming supplementary budget law between April and May 2009, but puts them in the perspective of longer-term reforms, for which general orientations are provided. Most of the changes relate to the budget system and practices and to the coordination of the work between the Ministry of Finance (MoF) and line ministries. Further technical assistance will be essential to help implement the short-term recommendations and design a more comprehensive plan for long-term reforms.

Immediate and practical actions for April-May 2009 are recommended in order to

- **Prepare a supplementary budget for 2009, buttressed with spending reductions and backed by appropriate structural reforms,** that deliver **sustainable** cuts to meet the government's fiscal consolidation objectives of 4.9 percent of the general government deficit in 2009 and 2010 (cash basis), as set out in the Letter of Intent (LOI) to the IMF and the Memorandum of Understanding with the European Commission;

- **Strengthen the powers of the Minister of Finance** to control the preparation and execution of the budget, and increase his access to timely, reliable fiscal data;

- **Remove unnecessary rigidities in the budget so that line ministries can deliver the required spending reductions.** If appropriate safeguards are put in place, more flexibility could be allowed for carryovers and reallocating appropriations between line items (except for ring-fenced expenditure) for some ministries with sound technical capacities.

Measures to mitigate the risks of fiscal slippages will be critical, including strengthening transparency, controls, and accountability regimes, but also ownership of the fiscal consolidation program by all members of the government. The MoF should be empowered to take all appropriate measures to meet the fiscal targets, while line ministers and their staff should be politically and administratively accountable for delivering the spending reductions within their budget.

Recommendations for immediate actions are identified through the text with a diamond sign (♦). The most important ones are identified with a double diamond sign (♦♦), and are summarized in Box 1. The suggested timeline for preparing the supplementary budget is presented in Appendix I.

Box 1. Key Recommendations for Immediate Action

Design a More Strategic Budget

- Adopt the general government deficit target (4.9 percent in 2009 and 2010 on a cash basis) and an indicative target on local governments' aggregate balance in the supplementary budget
- Update the local governments' budget within two months after the supplementary budget
- Decide on all measures with a fiscal impact during the budget cycle and reflect them in the budget; in particular, appropriate guarantees
- Organize discussions on options for spending reductions in the next few weeks by requesting ministries to provide a menu of realistic options to achieve the program's fiscal targets
- Put appropriations for 2009 and indicative targets for 2010 in the supplementary budget
- Describe the nature, the sequencing and the fiscal (and financial) impact of all spending reductions decided for each ministry for 2009 and 2010 in the supplementary budget
- Starting from July 2009, report on a monthly basis to cabinet on the overall progress being made on structural reforms along with implementing the budget cuts

Strengthen the Powers of the Minister of Finance

- Grant emergency powers to the MoF to enforce fiscal discipline (including effective veto powers on decisions with fiscal impact and related communications)
- Assess outstanding and planned commitments, including for public-private partnership (PPP) projects, by ministry; and start the process of introducing an *ex ante* system to control commitments in the budget execution
- Begin the process of centralizing and rationalizing the system for setting wages in the administration, under the MoF's control
- Strengthen and streamlined the work of the Fiscal Discipline Monitoring Committee in line with the LOI
- Improve the monitoring and projections of local government finances
- Close the remaining extrabudgetary funds
- Increase the MoF's capacities by 20-50 employees qualified to perform data analyses

Ensure the Coherence of the Budget to Deliver Sustainable Cuts

- Ensure government's solidarity over the spenmding reductions required to consolidate the budget
- Ensure that no cabinet decisions with a fiscal impact are taken or a fortiori announced before discussions with the EC and the IMF
- Remove unnecessary rigidities in the budget classification to improve spending flexibility
- Establish a MoF commission to review the financial management in the line ministries and institutions
- Ensure the cooperation between Parliament (Budget Commission and Controls Commission) and the State Audit Office
- Develop an accountability regime for ministers and the senior budget and treasury officials

I. INTRODUCTION: FOCUSING ON THE SUPPLEMENTARY BUDGET

1. **This aide-mémoire contains immediate recommendations to strengthen Latvia's PFM system in the context of the preparation of the upcoming supplementary budget law.** Under the *Economic Stabilization Program* adopted in November 2008 and supported by the international community, Latvia needs to prepare a full-fledged supplementary budget for 2009, buttressed with major spending reductions, to supplement the across-the-board cuts introduced in December 2008.

2. **Significant fiscal slippages since the beginning of the program and a worsened economic situation imposes even further cuts to meet the 4.9 percent deficit target (for the general government; on a cash basis) to which the government is committed with the EC, the IMF and other program partners**. A number of measures planned in the program were not implemented and, at the current pace of spending, the deficit could reach 12½ percent this year. In this context, this document's scope is limited and focuses primarily on a limited set of **emergency measures** for the period April–May 2009. The aide-mémoire also contains orientations for longer-term reforms that will need further analysis and require additional technical assistance from program partners. However, further work will be necessary to design the main changes in the Latvian fiscal framework.

3. **Latvia's PFM system presents a number of strengths that will help address the challenges ahead,** including inter alia a dedicated staff in the MoF and in the line ministries that have been able to implement a number of reforms in recent months, attesting to the administration's capacity to reform; a relative awareness of the country' financial situation in the senior administration; a quite sound legal basis (which will need to be improved, but not overhauled); a clear vision to anchor the budget against the medium term, in line with international best practices; a number of projects to develop the IT financial systems, in particular in the Treasury; and a relatively strong State Audit Office (SAO).

4. **On the other hand, the system presents four major shortfalls that will need to be addressed to ensure a successful fiscal consolidation.** (i) although improved in recent weeks, the quality of fiscal data reported to the government and program partners appears largely insufficient; (ii) the current budget preparation process, even as revised in 2007, provides limited systematic, comprehensive and structured information to the Cabinet and none to Parliament on policy priorities before the expenditure ceilings are set and appears inadequate to prepare a realistic budget under a heavy top-down constraint (which should be approved by the Cabinet and should not be revised once set); (iii) the powers of the Minister of Finance are insufficient to enforce fiscal discipline, and the ministry's analytical capacities need to be immediately strengthened; and (iv) on the whole, line ministries' budgets appear overly fragmented and do not always provide the flexibility required to carry out difficult and substantial spending reductions. The remainder of this report addresses these issues in turn.

II. DESIGN A MORE STRATEGIC BUDGET A. Articulate the Budget with the *General Government* Fiscal Policy

5 **Latvia's PFM system should be designed to minimize fiscal risks and support Latvia's macrofiscal policy.** This macrofiscal policy is currently determined by the *Economic Stabilization Program* and Latvia's European commitments under the Stability and Growth Pact. The pact includes three key concepts that should shape Latvia's PFM system (Box 2).

6 **The budget should be clearly articulated against the government's macrofiscal objectives.** The general government deficit target (4.9 percent in 2009 and 2010 on a cash basis) should, thus, be adopted in the supplementary budget law in the context of the specified macroeconomic assumptions (♦♦).

7 **An indicative target on local governments' aggregate balance should be set in the budget**. It should be consistent with the general government deficit target (♦♦).

Box 2. The Stability and Growth Pact and the Public Financial Management System

The **Stability and Growth Pact** contributes to achieving macroeconomic stability in the EU and safeguarding the sustainability of public finances. The Pact includes three key concepts that should shape Latvia's PFM system: (i) the design of macrofiscal policy at the general government level; (ii) medium-term anchors; and (iii) the importance of spending reductions delivered through targetted structural reforms.

The Pact's two nominal anchors—the 3 percent of GDP reference value for the deficit ratio and the 60 percent of GDP reference value for the debt ratio—and **the medium-term budgetary objectives (MTO)** are the centrepiece of multilateral surveillance. **They apply to the whole general government sector**. The MTO is defined in cyclically adjusted terms, **net of one-off and other temporary measures.**

In order to enhance the growth-oriented nature of the Pact, **structural reforms** will be taken into account when defining the adjustment path to the MTO for countries that have not yet reached this objective and in allowing a temporary deviation from this objective for countries that have already reached it.

The MTOs are differentiated for individual Member States to take into account the diversity of economic and budgetary positions and developments as well as fiscal risk to the sustainability of public finances, including because of demographic changes.

Member States outside the Euro area have to submit **annual convergence programmes, showing how they intend to achieve or safeguard sound fiscal positions in the medium term**. The information provided must recap the preceding and current years and present a **medium-term plan for at least three years out**. These programmes have to be updated yearly. The Commission makes an assessment of these programmes, on the basis of which the Council of Ministers gives an opinion and policy guidance to the Member State.

Source: European Commission

8 **Local governments' budgets should be revised within two months after the supplementary budget, and more appropriate sanction mechanisms should be implemented if local budgets prove unrealistic** The current legal provisions oblige local governments to adopt their budget within two months after the annual budget law is passed, but it is unclear whether this rule applies to supplementary budgets. This should be the case, which could require a change in the law. The supplementary budget will include a significant downward revision to the personal income tax revenue, which should be reflected in local budgets (as opposed to previous years, no guarantees on the level of Personal Income Tax revenues should be extended in the current context) (♦♦). Finally, the MoF appears to have limited control powers over local governments whose budgets prove unrealistic, between the simple injunction to revise their budget and the extreme case of passing a special law to remove the municipality's elected officials. An intermediate sanction mechanism should be introduced (♦).

9 **The budget should also reflect all measures with a fiscal impact**, particularly those dealing with taxes or guarantees. Where appropriate, guarantees should be adequately covered by budget appropriations. These measures should therefore be adopted at the same time as the budget (♦♦).

10 **The information provided in the budget and the budget coverage will also need to be improved over the medium term**. The budget should include, among other items, information on the finances of State-Owned Enterprises and on the Treasury's debt to the Social Security Fund. Starting with the supplementary budget, it should also include information on the nature and the fiscal impact of the spending reductions decided for each ministry (cf. infra).

B. Anchor the Budget against the Medium Term

11 **The budget needs to be anchored against a medium-term outlook.** The Medium-Term Expenditure Framework (MTEF) introduced in 2007 will need to be improved once the PFM reaches sufficient maturity. In the interim, and starting with the preparation of the 2010 budget, the MTEF should focus on a limited set of expenditure targets (about 5 targets for each year) consistent with the macroeconomic program, allowing for the determination of top-down constraint and spending priorities at the beginning of the budget procedure.

12 **The supplementary budget should cover the 18 or 19-month period from June/July 2009 to December 2010.** Including projections for 2011 might be attempted for a few ministries but should not be applied universally in light of time constraints in preparing the supplementary budget. In practice, (i) budget discussions should focus on the 2009 and 2010 budget targets and associated structural measures (♦♦), and (ii) *indicative, preliminary* 2010 ceilings for ministries and programs should be included as supporting information to

the supplementary budget (♦). These indicative ceilings for fiscal year 2010 will be replaced by updated figures in the 2010 budget.

13 **Carryovers should be selectively allowed for about 3-5 percent of capital expenditure from 2009 through 2010 for the basic state budget (central government except social security fund).** This should (i) limit the "spending rush" at the end of the fiscal year and (ii) allow for the allocation of scarce resources where most needed (e.g. investment). The Law on Budget and Financial Management (LBFM) allows carryovers under the form of the appropriation reserve (Section 9-4). This implies that carryovers need to be fully offset by a share of the budget's contingency reserve, which ensures that they do not result in fiscal slippages. However, such carryovers have been infrequently used in the past. The MoF should keep allowing carryovers on a case-by-case basis, while making this more flexible in practice in order to provide line ministries with some latitude in the timing of the structural reforms. This should be indicated in the supplementary budget (♦).

C. Design Effective Measures to Reduce Spending

14 **The current budget provides little margin for further cuts under constant policy assumptions.** In addition to the identified issues in the design of the initial budget and of detailed allocations of appropriations, the across-the-board cuts taken on transfers and current expenditure in the December budget are sizeable and have distorted budget execution and resulted in the buildup of arrears (a breach of a continuous Performance Criterion (PC) for the IMF-supported program). The safeguards included in the initial program have partially addressed these issues but further across-the-board cuts would not deliver the intended savings.

15 **Designing good quality measures to reduce spending will be key** By contrast with across-the-board cuts, such measures—typically decisions to consolidate, merge, reorganize services, or discontinue less effective programs—yield **realistic, long-lasting savings** in the short-term and improve public sector productivity over the long-term. Fiscal consolidations are only successful when they rely on such reforms. Latvia's decisions to reform the education system (reforming the system for allocating budgets by schools to support their consolidation) or to reduce the number of municipalities provide good examples of structural reforms that should generate large-scale savings.

16 **The budget cycle will need to be changed for the preparation of the 2010 budget** The current focus on the distinction between the baseline and new policy initiatives encourages fiscal expansion. It would be better to move swiftly to zero-based discussions on the ministries' proposals to reduce spending and global budget envelopes, under an intangible and binding top-down constraint derived from the macroeconomic scenario. Cabinet decisions on ministries' ceilings should not be revised once set.

17 **Without a clear macroeconomic scenario, including fiscal targets, available for preparing the supplementary budget, discussions on spending reductions should be based on constraints expressed as a percentage of 2009 budget appropriations** (♦♦). In practice, the MoF should request line ministries to prepare immediate proposals for spending reductions, allowing savings amounting to an agreed overall percentage of their current budget to be delivered **The upper percentage should be set by the Ministry of finance for 2009 and 2010 at a higher level than the overall cut targeted in the budget to meet the program's objectives (a general government deficit of 4.9 percent in 2009 and 2010)**, so as to produce a **menu of spending options**. The MoF's Tax department should be requested to prepare a similar plan as any other line ministry. One unit in the MoF should be assigned to consolidate information on guarantees. Constitutional and specific institutions should be associated with the exercise with simpler deliverables. In parallel, the MoF should prepare scenarios for potential cuts in each line ministry. The options should then be compared and discussed first (i) between technical services and thereafter, based on short, focused notes summarizing the discussions and comparing the options prepared by the budget department, (ii) between each line minister and the Minister of Finance; and finally, (iii) by the full Cabinet. The suggested timetable for preparing the structural reforms and associated spending reductions, and organizing these discussions is provided in Appendix I.

18 **Ministry ceilings will be determined in a second phase, based on the menu of spending reductions that allows the government to meet the fiscal targets derived from the macroframework and agreed with the EC and the IMF.** While all line ministries should be expected to contribute to the fiscal adjustment, their respective budgets should then be cut in varying proportion, depending on the nature of the measures proposed. Line ministries that commit to the most difficult reforms should be rewarded by relatively more budgetary margins, to the extent permitted by the overall budget constraint. This should be clearly indicated at the start of the budget process.

19 **The supplementary budget should describe the nature, the sequencing and the fiscal (and financial) impact of all spending reductions decided for each ministry for 2009 and 2010 (and possibly 2011 for selected ministries)** (♦♦).

20 **The preparation of the 2010 budget will need to start immediately after the supplementary budget is adopted.** As the 2009 budget is prepared with limited time and as further measures will be implemented, the 2010 budget will be complex to design.

21 **A permanent committee in charge of supporting the design, implementation and monitoring of structural reform, and accociated spending reductions, should be put in place within the MoF.** This could be the Fiscal Discipline Monitoring Committee. This committee should liaise with the Parliamentary joint committee set for a similar purpose (cf infra). Starting from July 2009, the Minister of Finance should report on a monthly basis to the Cabinet on the overall progress being made on structural reforms and spending cuts,

based on information provided by line ministries (♦♦). This meeting could take place every two months once the situation improves.

III. Strengthen the Powers of the Minister of Finance

22 **The Minister of Finance is in charge of organizing the budget preparation and controlling the budget execution in order to deliver the government's macrofiscal targets**. This should be reflected in the various tools at his disposal.

A. On Budget Preparation and Fiscal Policy

23 **The Minister of Finance should be granted emergency powers to enforce fiscal discipline** (♦♦). The following measures could be enforced immediately through Cabinet decisions, without prejudice to possible necessary legal changes:

- **The MoF should have full control on all ministerial decisions with a fiscal impact (expenditure increase, extension of guarantees, or revenue decrease) and government communications on fiscal matters** Two measures should be taken in the short run: (i) make fully effective any provision that already exists in that regard over any formal decision (draft law, decree, regulation, contract etc); (ii) enlarge this executive power to any draft public announcement made by a line Minister. Ensuring the consistency of government's communication on fiscal measures and spending reductions included in the supplementary budget is particularly important in the runup to the June 2009 elections.

- **The MoF should have full control over new tax measures.** (i) Barring exceptional cases, no tax changes (including changes in tax regimes, rates, bases for the central and local governments, and the social security system) should be made outside of a budget law; (ii) any proposal by another minister for a change in tax regulations should require the prior approval by the Minister of Finance.

24 **Stronger cooperation between the MoF and Parliament over budget issues should be pursued along the following lines**:

- **Parliament should be provided with better information and deepen its involvement in the administrative phase of the budget preparation** There are multiple options for this. The following procedure could be considered starting with the 2010 budget: *(i) one or two months before submitting the budget law, the Cabinet, based on a MoF proposal, would submit to Parliament a report on its fiscal strategy, its major expenditure priorities, as well as its major tax options, for the upcoming year; (ii) this report would be presented, debated and adopted through a binding* *vote; then (iii) any proposed changes to this framework in the Cabinet's subsequent submission of the budget would have to be fully justified.* In the short term, Parliament should be consulted on the main orientations of the next supplementary budget law at least 15 days before the submission of the draft law. This consultation could take place in a closed session (♦).

- **Parliament should be invited to raise its ex post control** of the budget (i) As a general rule, budget execution laws (currently a formal accounting exercise with little effects) should allow members of Parliament a real opportunity to assess the implementation of public policies by respective ministries; sufficient time should be allocated to this exercise both by the Saeima committees and the ministries. (ii) The legal powers of the relevant Saeima committees, should be strengthened to allow them to request any information, data, or documentation detained by any public body; and the committees should be entitled to hear any civil servant. (iii) A stronger cooperation between the Saeima committees and the SAO should be organized, while respecting their mutual autonomy. These should jointly define a follow-up procedure designed to prompt ministries to take into account the findings and proposals of their reports. In addition, the options for better integrating the Finances and Control Committee of the Saeima should be explored. The Saeima committees could be invited to establish a temporary joint committee dedicated to controlling the proper implementation of the supplementary budget. These options should be discussed with Parliamentary committees over the course of 2009 (♦).

B. On Budget Execution

25. **In order to prevent the buildup of arrears, a comprehensive system of commitment controls should be introduced on a step-by-step basis.** The commitment represents the critical stage of the spending process on which the budget (preparation and execution) should largely rely (although the budget should keep a cash component). Appropriation now represents "authorization granted by a budget law in a fixed amount which allows the Treasury to assign and make payments," and no harmonized commitment control exists, which puts fiscal sustainability at risk. In the medium term, the appropriation regime could be reformed so that appropriations represent hard ceilings on both the authorization to pay and the authorization to commit (except for capital outlays, for which commitment and payment appropriations should be distinguished). Full implementation of a modern commitment control system will require time to upgrade the treasure software and prepare regulations/instructions for the new procedures.

26 **For the preparation of the supplementary budget, the MoF should concentrate on assessing outstanding and planned commitments**, including for PPP projects, by ministry. In addition, a procedure should be introduced that requires budget institutions to submit requests for approval of new commitments on a weekly basis to the MoF. This should

apply to commitments above a certain threshold. (♦♦). The Treasury should also provide information on commitments reported by line ministries and institutions to the Budget Department and the Fiscal Discipline Monitoring Committee of the MoF (♦♦).

27 **The current reporting system on arrears should also be improved** Arrears may not yet be a massive problem (though breach of a PC) but could become one. As of end-February, arrears of general government amounted to about 0.15 percent of GDP (as opposed to 0.07 percent a month earlier). Starting this year, the Treasury collects data on a monthly basis on liabilities and arrears of all line ministries and institutions, including the local governments. It should also collect and report information on the age of arrears (using the following thresholds: less than one month; one to three months; and more than three months) **(♦).**

28 **Cash controls should be strengthened to avoid paying companies or individuals with tax arrears against the central or local governments** Spending is currently controlled by the Treasury against monthly financial plans with a level of detail corresponding with that of budget allocations approved by Parliament. In addition, the Treasury controls: (i) whether the payment request is signed by an authorized person; and (ii) whether there is any discrepancy between the expenditure code and purpose of the payment. Such a reform will require both additional human capacity and a software upgrade in the Treasury, and should be considered for the medium term.

29 **A start should be made on upgrading the present system for controlling civil service staff numbers and the government payroll.** This could be achieved through the following steps:

- **A cap put on the number of authorized positions in each ministry.** There is currently no aggregate control by the MoF over the number of public employees in the Central Government. The annual budget law should establish a global ceiling in terms of number of employees. Each line ministry should disaggregate this global ceiling across its agencies and establish internal control arrangements to monitor it; compliance to these ceilings should also be checked, for each institution, by the Treasury at the occasion of monthly compensation payments (this will require including additional statutory information in the centralized payroll ledger). A simple and consistent methodology for calculating staff ceilings should be set by the MoF, in consultation with line ministries and the EC and the IMF, in the upcoming weeks. It will need to be refined over time (e.g., to move from headcounts to full-time-employees as the basic control unit). On this basis and as a first step, hard headcount ceilings should be introduced in the supplementary budget law (♦).

- **Controls on government payroll**: (i) The system for setting wages in the administration (including agencies) needs to be urgently **centralized** and

rationalized; in particular, the wage grid established by the Chancellery service, and processes for its regular updating **must be put under the MoF's control** (♦♦); (ii) the MoF needs to have better knowledge of and stronger analysis capacity on the wage levels, distribution, and evolution; (iii) the Treasury should design and maintain a global payroll ledger detailing and organizing information by types of employees, level and composition of wage; (iv) a methodology for forecasting the evolution of the wage bill should be established; and (v) detailed data on the wage bill (for each ministry as well as for each spending agency, the average salary level by type of position, and their changes over time) should be published online on a regular basis by the Treasury. These reforms, essential to meeting the *Economic Stabilization Program's* medium-term objectives, should be launched as quickly as possible.

30 **The work of the Fiscal Discipline Monitoring Committee of the MoF should be strengthened and streamlined in line with the LOI** (♦♦):

- **The Committee should focus on commitments as well as cash** The Committee meets on a weekly basis to discuss budget execution, weekly cash projections, monthly financial plans, arrears and requests for use of the contingency reserve. However, as indicated in the LOI, "a consolidated report should be submitted to the Prime Minister who will decide on the level of the new *commitments* to be authorized in the following week." The MoF should thus establish a procedure whereby budget institutions submit proposals for new commitments (above a certain threshold; cf. supra), which should be reviewed by the Committee.

- **The weekly spending plans submitted by the line ministries and institutions to the MoF and reviewed by the Committee should be simplified** The requirement for providing detailed weekly spending plans (with line items) creates substantial work for budget institutions, as well as for the Treasury staff. Such detailed plans do not appear to be needed. In practice, the Treasury is not setting weekly spending limits, using them only for information purposes. The MoF should continue to receive more aggregate projections (for three major expenditure categories, including wages) on the total spending (and commitments) of each budget institution on a weekly basis.

- **In this connection, the rule for setting the quarterly spending targets should be adjusted.** According to the Cabinet of Ministers' regulation on fiscal discipline (adopted in December 2008) the financial plans for each ministry and institution for the first quarter were set in a very rigid manner, by opening 21 percent of their annual budget appropriations. This rule does not seem appropriate as the pattern of spending differs between institutions and ministries. While complying with the quarterly fiscal targets of the program, the financial plans should be decided in a more flexible manner (i.e., allowing various percentages per quarter to various ministries). This will minimize the pressure on the contingency reserve.

- **The Committee should also make recommendations to the Minister of Finance on further budget freezes, as necessary to meet fiscal targets, in particular where the pace of spending can be realistically reduced before the supplementary budget.** This is indicated in the LOI as revenues fall short of projections.

31 **The monitoring and projections of local governments' finances should be improved (♦♦).** Starting in 2009, all local governments submit reports on a biweekly basis to the Treasury on budget execution, liabilities, arrears and revenue, and expenditure projections. In the short-term, further improvement could be achieved by: (i) providing information on commitments and more detailed information on arrears (age), and (ii) assigning a person in the Treasury to closely analyze, monitor, and project local governments' budget execution (not only their aggregate balance).

32 **The coverage of the treasury single account (TSA) should be expanded to the local governments' accounts and the two extrabudgetary funds should be closed (Privatization Fund and Long-Term Stabilization Reserve**):

- **In line with the LOI, both extrabudgetary funds (in addition to any other that may remain) should be closed**. Their resources should be transferred to the TSA and used in accordance with budget appropriations. This requires amending the laws that established the funds (♦♦).

- **Including all local government accounts into the TSA would improve the monitoring and oversight of local governments' spending** This would require amending the LBFM as this law currently only allows local governments to open accounts with the Treasury. This second reform should only be considered over the medium term.

C. Strengthen the Ministry's Capacities

33 **The MoF's capacities should be strengthened by technical assistance over the next few weeks as well as in the medium term (cf. Section V)**. This could include large involvement of EC and IMF technical assistance teams and the installation of long-term experts in the MoF, in particular in the Budget and Tax Policy Departments.

34 **In addition, the MoF's analytical capacities should be immediately strengthened. This is essential to secure the quality of information reported to the government** The current shortage in analytical staff working for the MoF puts the program at considerable risk. All options to increase the MoF's capacities by 20-50 employees qualified to perform data analyses should be explored in the next few days (e.g. secondments, for instance from the SAO or central bank staff, or agreements with universities) (♦♦). Similarly, line ministries should plan to staff their budget departments appropriately to respond to the current situation.

35. **Communications and cooperation between the MoF and the line ministries should be enhanced**. As a general rule, all technical documents and tables regarding each ministry's area should be systematically and rapidly shared between both ministries.

IV. ENSURE THE COHERENCE OF THE BUDGET TO DELIVER SUSTAINABLE CUTS A.

Ensure Government Solidarity over the Budget

36 **The budget is the Cabinet's budget, and the budget procedure is the Cabinet's as well**. It is the government's collective responsibility—MoF and line ministries as well, all under the control of the Prime Minister—to deliver the spending cuts required by the fiscal consolidation package (♦♦). Decisions on fiscal policy, priorities and procedure should be collegially discussed and supported by all ministries at any point in time and in particular at the start of the budget cycle (first half of April). The rules—e.g., to allow ministries more or less flexibility in their budget (cf. infra), or the sequence of the work on structural reforms, or the new control powers necessary for the MoF—should be discussed openly and supported by the full Cabinet.

37 **At this juncture, no Cabinet decision or any other decision with a fiscal impact, including on social security or on any guarantee scheme, should be taken and a fortiori announced before discussions with the EC and the IMF**, so that a consistent plan, based on all structural measures, can be designed to meet the program's fiscal targets. **Any such decisions that could have been made should be immediately withdrawn** (♦♦).

38 **Ministries' responsibilities should be clearly spelled out as follows:**

- **With a view to delivering the macrofiscal targets set in the government's economic policy**, the Minister of Finance should propose the practical *rules* for designing the budget and the spending reductions, and have full powers to monitor and control their execution.

- **Line ministers should primarily be assessed on their ability to deliver the spending reductions needed for the fiscal consolidation, absolutely respect their budget constraints (without creating arrears)** and support the Cabinet's collegial decisions. In order to deliver these spending reductions, their budget should be made the most flexible that their technical capacities allows, while preserving the MoF's necessary controls over the budget execution (cf. Section III).

B. Remove Unnecessary Rigidities in the Budget

39 **Line ministries' budgets should be made more flexible in certain cases, taking account of capacity constraints, to support the MoF's overarching responsibility to control budget execution**. Any measures allowing more flexibility should be associated with strong safeguards (e.g. immediately implementable withdrawal clauses) and control systems. Three measures are recommended:

- **Allowing some flexibility for reallocating budget appropriations during the budget execution**. The budget appears extremely fragmented: there are probably a few *thousands* of different appropriations, while a few *hundreds* might be sufficient and compatible with the preservation of rich information. Over the medium term, the budget classification should be revised in order to ensure a better articulation between the different levels of classifications, and to reduce its size. The practical arrangements recommended for achieving more flexibility in the short term (♦♦) without revising the budget classification are presented in Box 3.

- **The rules for carryover should be carefully loosened between 2009 and 2010**, as described in Section II.B**.**

- **Raising self-earned revenue should be encouraged, under the control of the Minister of Finance, to the extent that this does not distort markets and remains consistent with the government's social policy** (in particular to protect social safety nets). A comprehensive audit of the self earned revenues received by the central government should be prepared on time for the preparation of the 2010 budget.

C. Improve Transparency and Accounting, Controls, and Accountability

40. As a counterpart to the flexibilities mentioned above, and to improve public confidence in the budget process and the accountability of government, it is important to consolidate and extend recent improvements in transparency and the associated institutional mechanisms that ensure integrity. A number of measures were discussed in the context of the recent fiscal Reports on Standards and Codes (ROSC) mission. Enhancements not previously mentioned in this aide-mémoire include

- **Accounting:** The main accounting principles set by the LBFM conform to international standards. Line ministries and institutions are responsible for their accounting which is based on the rules and regulations prescribed by the Cabinet of Ministers (including the chart of accounts). The same accounting rules apply at the level of central and local governments. All line ministries and institutions need to submit to the Treasury information on some of the components of the balance sheet (claims and liabilities) on a monthly basis. For the purposes of the annual budget

Box 3. Removing Unnecessary Rigidities in the Budget Classification

Under appropriate controls and safeguards clauses, line ministries' budgets could be made more flexible by loosening or removing the constraint for reallocation appropriations between line items within a given program (under the authority of a single given ministry), except for certain ring-fenced appropriations; and possibly between programs. Three levels of flexibility could be considered:

(i) Keeping the current budget constraints. This must be the case for the special budget (social security);

(ii) Allowing the free reallocation by line ministries, during budget execution, of appropriations between line items within a given program under the authority of a single given ministry, except for certain categories of ring-fenced expenditure. Ring-fenced expenditure must include wages and other expenditure protected under the program (such as EU-related and social spending);

(iii) In addition to (ii), for ministries committed to large-scale spending reductions involving the merger of multiple agencies, allowing more flexible reallocation of appropriations between programs.

This flexibility is fully permitted by and consistent with the spirit of the LBFM. According to the law (Section 9-7), the Cabinet of Ministers can reallocate budget appropriations among programs, sub-programs and economic expenditure codes. However, these provisions are currently limited by Cabinet regulations. These will need to be updated with the supplementary budget. The new regulations should also include the following:

(i) Wages and salaries need to be ring-fenced and de facto pooled under the authority of each ministry (appropriations for wages and salaries should be globalized under in each ministry). Each Minister should be fully responsible for not accumulating arrears, including on wages and for all agencies under his ministry's control;

(ii) The Fiscal Discipline Monitoring Committee should decide, under the authority of the Minister of Finance and on the basis of the line ministries' capacities (informed, in particular, by the reports from the SAO), the size and content of their spending reductions, of the ministries whose budgets can be made more flexible.

(iii) Regardless of the sanction regime described in Section IV-C, the Committee should have the right to withdraw any flexibility to the budget at any point in time to control budget execution and prevent fiscal slippages. All the arrangements above should be designed and technically implemented as fully and immediately reversible.

account, they also need to submit balance sheets and cash flows to the MoF. The MoF is then responsible for the preparation and submission of the consolidated annual budget account. More work is needed to assess Latvia's accounting framework and to address its weaknesses.

- **Internal controls**: Each ministry has an internal audit department but their cooperation with the MoF appears to be limited. The reports prepared by the internal audit departments are sent to internal audit department of the MoF, but are not effectively reviewed by the Budget Department and Treasury. In the short term, the MoF should closely look at these reports and establish a closer cooperation with the internal audit departments of the line ministries (♦).

- **External controls (♦♦)**: The Minister of Finance should effectively exercise the powers given by section 46 of the LBFM that authorizes him to establish a commission to review the financial management in the line ministries and institutions (with full access to all financial data) and take appropriate measures in case of infringement of the regulations. The external control systems can be strengthened by further enhancing the cooperation between Parliament (Budget Commission and Controls Commission) and the SAO.

- **Accountability regimes (♦♦)**:

  - A strong regime of sanctions should be put in place for managers of public money (in particular for State Secretaries and Heads of Institutions) before the supplementary budget enters into force. The sanction regime should be enforced, as needed, in a fair, transparent, but very rapid manner.

  - The Cabinet should agree *ex ante* on the political sanctions against line ministers that would misuse the greater flexibility that could be allowed for executing their budget.

V. NEXT STEPS

41. **Further technical assistance will be essential to prepare the supplementary budget.** The upcoming technical assistance mission(s) before end-May should concentrate on helping the MoF to (i) finalize the implementation of the emergency provisions and immediate recommendations contained in this aide-mémoire; and (ii) review, from a methodological point of view, the line ministries' plans for spending reductions after the discussions between them and the MoF. This should ensure that all materials are ready to support the discussion of fiscal options (e.g., the balance between revenue and expenditure measures, specific spending reductions, ministerial expenditure ceilings) during the program review mission.

42. **Once the supplementary budget is passed, a consistent PFM reform action plan covering 2009–13 should be prepared.** It should include longer-term reforms of budget preparation, execution and controls systems, with a particular focus on fiscal risks, as well as measures to strengthen fiscal decentralization arrangements and ensure the sustainability of the social security system.

APPENDIX I. TIMETABLE FOR APRIL AND MAY 2009

March 31–April 7	The MoF organizes the procedure and sets the calendar for preparing the supplementary budget. In particular, it designs the deliverables and sets the percentages of budget cuts in 2009 and 2010 for each scenario expected from line ministries. A Cabinet decision launches the budget procedure on April 7.
April 8–April 21	Line ministries prepare proposals for structural reforms and related spending reductions. The MoF implements the recommendations contained in this report, monitors the preparation of discussions, and prepares proposals for cuts, in cooperation with the EC and the IMF. On April 21 at the latest, all line ministries submit plans for structural savings to the MoF. These should be fully quantified and summarized in short notes of 5–10 pages each. The compilation of the notes should be translated and communicated to the EC and the IMF on April 21. The MoF prepares a schedule for technical and political discussions on structural reforms and associated spending cuts with each line ministry.
April 22–May 5	Discussions on proposed structural reforms between the line ministries and the MoF. For each ministry, the discussions should be summarized in a short note, communicated to the EC and IMF, identifying the points of agreement and the *few* items remaining for the arbitrage of the Prime Minister.
April 29–May 10 (tentative)	IMF and EC technical assistance (tentative).
May 22	Time target for finishing the preparation of the supplementary budget.

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