Latvia World Bank Policy Lending & Technical Assistance Program

2010 Public Expenditure Review

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Aide Memoir

A World Bank team[1] visited Riga to continue work on a Public Expenditure Review (PER). The Bank team is grateful once again for the Government's efforts during the mission to make our time in Riga productive.

This Aide Memoir presents team's initial ideas, based on our discussions with counterparts in the last two weeks and during earlier visits, and a very preliminary look at budget and survey data. All of the recommendations herein will be subject to further analysis and will very likely be revised. Therefore, this Aide Memoir should be read as the first part of an ongoing exchange of ideas that will take fuller form – and be substantiated - in an informal Team Draft of the PER which we aim to deliver the first week of May. A full review by our peers and management at the World Bank will take place in late May, which would allow us to deliver a formal First Draft soon thereafter. Until that point, the observations and proposals in this Aide Memoir are purely those of team members, and should not be taken as the assessment or recommendations of the World Bank.

The following recommendations are offered in response to a specific request from the Ministry of Finance (MoF) to identify potential areas of short-term budget savings in public administration and the social sectors that could help restore fiscal balance, speed Latvia's recovery from the current crisis, and help to meet the Maastricht Criteria by 2014.

Implementation of any of these measures would require difficult political choices and inevitably incur public resistance. But in the team's view, the longer-term benefits to the economy would more than compensate for these short-term hardships. A few of the budget-reduction measures proposed here are desirable only for their short-term fiscal savings, and should be maintained only as long as they are necessary to support the economic recovery. But for the most part, the proposed actions are desirable in their own right in order to provide a more efficient and effective public administration, and healthier incentives for sustainable and responsive social-sector programs. Here, as with many of the reforms already implemented, the current crisis and the need for fiscal consolidation that it brings, offers an opportunity to adjust public spending with a clear rationale that will increase the likelihood of improved performance in the future.

Generally, the team's view is that the health sector and the education sector have already borne the brunt of fiscal adjustment in the 2009 and 2010 budgets. With very few exceptions, further cuts in the absolute allocation to these sectors could put in jeopardy the real and quantifiable progress achieved so far. The structural reforms in the health and education sectors initiated in

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2009 took the form of fundamental changes in incentives that need time to "take root" before they can fully deliver expected efficiency gains. For this reason the Bank team's additional recommended measures for these sectors might accelerate improvements in performance, but are not likely to deliver fiscal savings in 2011 and 2012.

Our recommended measures in the area of public administration reform and social welfare – specifically, changes to the programs financed from the Social Insurance special budget – are farther reaching. At this early stage in preparing the PER, we think actions in these areas are more likely to deliver the substantial savings in spending that the Government is seeking. As was the case with the structural reforms to education and health in 2009 and 2010, these recommendations are made to guide the process of fiscal adjustment with a clear rationale.

This said, it is important to consider these recommendations in the broader context. We have only examined the three social sectors and broader efforts to improve public administration. There may be opportunities for immediate expenditure savings in other sectors that impact less directly on household welfare. We encourage the Government to take a broad view when looking for savings particularly during the current period of economic contraction and high unemployment. Critical to sound and sustainable fiscal adjustment, is for the Government to make use of efficient and progressively designed revenue measures. Our partners in the IMF are providing technical assistance to the Government toward this end. We will make every effort to ensure our recommendations are consistent with those made by the Fund.