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INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

PROGRAM DOCUMENT FOR THE FIRST SPECIAL DEVELOPMENT POLICY LOAN

IN THE AMOUNT OF EURO 100 MILLION
(US$143,900,000 MILLION EQUIVALENT)

AS PART OF A PROPOSED LENDING PROGRAM OF TWO LOANS

TO THE

REPUBLIC OF LATVIA

TO SUPPORT A

SAFETY NET AND SOCIAL SECTOR REFORM PROGRAM

February 12, 2010

Human Development Sector Management Unit
Central Europe and the Baltic Countries Department
Europe and Central Asia Regional Office

LATVIA

CURRENCY EQUIVALENTS
(Exchange Rate Effective December 31, 2009)

EUR 1:00 : US$ 1.439 : LVL 0.708

ABBREVIATIONS, ACRONYMS & TERMS

AAA	Analytic and Advisory Activities
ALMP	Active Labor Market Programs
BoL	Bank of Latvia
CEE	Central and Eastern Europe
CoM	Cabinet of Ministers
CSB	Central Bureau of Statistics
DC	Defined Contribution pension plan, in Latvia, funded and privately managed
DG ECFIN	EC Directorate-General for Economic and Financial Affairs
DG EMPLOYMENT	European Commission Directorate for Employment
EC	European Commission
ECA	Europe and Central Asia Region
ECB	European Central Bank
ERM2	Exchange Rate Mechanism (2nd phase)
ESA	European System of Accounts
ESF	European Social Fund
ESSNS	Emergency Social Safety Net Strategy
EU	European Union
FDI	Foreign Direct Investments
GDP	Gross Domestic Product
GMI	Guaranteed Minimum Income means tested social assistance benefit
GNI	Gross National Income
GP/PHC	General Practitioner/Primary Health Care
HBS	Household Budget Survey
IBRD	International Bank for Reconstruction and Development
IMF	International Monetary Fund
LFS	Labor Force Survey
LVL	Latvian Lats
MoE	Ministry of Economy
MoES	Ministry of Education and Science
MoF	Ministry of Finance
MoH	Ministry of Health
MoW	Ministry of Welfare
MoRDLG	Ministry of Regional Development and Local Government
NDC	Notional Defined Contribution, pay-as-you-go pension plan
NUTS	Nomenclature of Territorial Units for Statistics (EU geo-code identification)
OECD	Organization for Economic Cooperation and Development
PER	Public Expenditure Review
PFM	Public Finance Management
PHC	Primary Health Care
PISA	Program for International Student Assessment
PIT	Personal Income Tax
PPP	Public Private Partnerships
SEA	State Employment Agency
SOE	State Owned Enterprises
UI	Unemployment Insurance
VAT	Value Added Tax
EU SILC	Survey of Incomes and Living Conditions

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REPUBLIC OF LATVIA
SAFETY NET AND SOCIAL SECTOR REFORM PROGRAM

SPECIAL DEVELOPMENT POLICY LOAN (SDPL)
FIRST IN A PROPOSED PROGRAM OF TWO SDPLS

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This loan, the first in a proposed program of two, was prepared by an IBRD team consisting of Charles Griffin (Sr. Advisor, ECAVP), Mohammed Ihsan Ajwad (Sr. Economist, ECSHD), Michael Mertaugh (Consultant Lead Education Economist, ECSHD), Asta Zviniene (Sr. Social Protection Specialist, HDNSP), Kathy Lalazarian (Sr. Public Sector Specialist, ECSPS), Paulina Holda (Country Economist for the Baltic Countries, ECSPE), Emilia Skrok (Country Economist, ECSPE), Stanislav Polak (Country Economist, ECSPE), and Truman G. Packard (Task Team Leader, Lead Economist, ECSHD). Mehtabul Azam (Economist, ECSHD); Mihails Hazans (Consultant, University of Latvia) and Inga Vilka (Consultant, University of Latvia) provided key analytical input to the lending program. Regina Nesiama (Program Assistant, ECSHD), Katerzyna Popielarska (Sr. Executive Assistant, ECCPL) and Malgorzata Michnowska (Program Assistant, ECCPL) provided essential support to the task team.

LOAN AND PROGRAM SUMMARY

REPUBLIC OF LATVIA

SAFETY NET AND SOCIAL SECTOR REFORM PROGRAM

FIRST SPECIAL DEVELOPMENT POLICY LOAN

Borrower	REPUBLIC OF LATVIA
Implementation Agency	MINISTRY OF FINANCE
Amount	EUR 100 Million (US$143,900,000 equivalent)
Financing	IBRD Special Development Policy Loan (SDPL), with a front end fee of 100 basis points; 8 year average maturity; 10 year final maturity; 5 year grace period; and interest rate equal to Libor + 200 basis points.
Tranching	Single tranche (part of a proposed program of two single tranche SDPLs)
Description	This is the first of a proposed program of two loans focused on Safety Net Support and medium term social sector expenditure reform. The objectives of the proposed program are: (i) to protect vulnerable groups with emergency safety net support during the economic contraction; (ii) to mitigate the social costs of fiscal consolidation; (iii) to ensure structural reforms lay a foundation for medium term improvements in the social sectors. The first operation will focus mainly on the first and second objectives. The second operation will expand this focus to the third objective. The proposed program of World Bank support will focus on measures designed to mitigate the social impact of fiscal consolidation, and the implementation of the Government's cross sector Emergency Social Safety Net Strategy (ESSNS). With technical input from the World Bank, the Government has developed and approved the ESSNS to finance essential services and benefits delivered by national agencies, and locally by municipal governments. The ESSNS came into legal effect on October 1, 2009. The ESSNS finances and coordinates the efforts of national and local government agencies to: (1) maintain pre-primary education and child development programs for 5 and 6 year old children; (2) cover the costs of transporting students from communities where schools have closed to their new places of instruction; (3) exempt needy households from health service co-payments; and (4) subsidize their pharmaceutical costs; (5) sustain and improve general practitioner (GP) and primary health care (PHC) services and access; (6) increase the coverage and pay-out period of unemployment insurance; and (7) increase the coverage and amount of targeted social assistance benefits administered by local governments. For the growing number of unemployed who are not covered by unemployment insurance or other social support, the Government has (8) fortified the safety net by rapidly deploying a labor-intensive emergency public-works programs.
Benefits	The proposed operation will help to protect vulnerable groups with emergency safety net support during the economic contraction, and mitigate the social costs of an ambitious program of fiscal consolidation while supporting important structural reforms in social sector expenditure programs.
Risks	**Risks to the proposed program of lending are high.** Risks arise mainly from an ongoing and sharp economic contraction and the size of the needed fiscal

	adjustment Latvia has committed itself to make. **Further, unexpected economic contraction could reduce tax revenues, which would require further fiscal adjustment.** The IMF and EC led program was based on assumptions that the economy would only contract by 5 percent in 2009 but GDP is estimated to have contracted by 18 percent. Although the fiscal outlook has become more stable, considerable uncertainty remains. **The program faces considerable macroeconomic risks that lower the likelihood of a quick recovery**. The Government is undertaking a very ambitious economic adjustment program based on a macroeconomic strategy that includes severe fiscal consolidation measures and wage cuts under the fixed exchange rate regime. The severity of the measures may make them difficult to implement. Also, the much higher government deficits will make it harder to meet the Maastricht criteria and may delay the program's exit strategy of Euro adoption. Deflation may be even deeper than currently projected, which could also jeopardize Euro adoption. However, the economy may also recover faster than expected if global growth resumes faster. These risks are mitigated by the size of the multilateral financial package, equivalent to 35 percent of GDP, in support of the Government's program. In addition, the support of Latvia's international partners, particularly the EU, represents a key safeguard to the program. The EU's commitment of €3.1 billion under the international support package has provided space for implementation of the programmed reforms. *In a July 27 press statement announcing their disbursement of €1.2 billion, the EU affirmed that it will continue to work closely with the Latvian authorities and the IMF to ensure Latvia implements successfully its economic reform program and repays in a timely manner all loans associated with the international program to support Latvia. Thus, while the risks are significant, continued current account surpluses, Latvia's strong commitment to the program, expected improvements in global financing conditions, and EU support provide safeguards.* **The ESSNS may not be sufficient to address the social costs inflicted by the speed of fiscal adjustment and structural reforms.** The fiscal adjustment Latvia undertook in the second half of 2009 and is committed to undertake in 2010 and 2011 is substantial and would be difficult even in a non-recession environment. The sheer size and speed of the adjustment raises the risks of adverse impact on households. Of particular concern is the structure of means tested minimum income assistance – the most decentralized in the ECA region. Decentralized provision of social assistance, particularly in the context of the extraordinary economic contraction, can lead to gaps in the safety net across municipalities of different wealth. *A key part of the Government's ESSNS is to provide contingent financing for the GMI, as well as to raise the income threshold for households to qualify for assistance. These measures, as well as the deployment of the new Workplaces with Stipend public works program, can help to contain social costs. In dialogue with the Bank team the Government agreed to expand the ESSNS package to include strengthening GP/PHC services with public health nurses. Implementation and adequacy of ESSNS measures is being monitored on regular basis. Should the ESSNS allocations in the 2010 budget prove inadequate, the Government could consider a further temporary extension of unemployment insurance; a larger deployment of emergency public works; and increasing the co-financing of GMI. Program partners have agreed to provide leeway in fiscal adjustment targets to accommodate additional safety net measures.*

	The difficulty of structural reforms during a period of severe and prolonged economic recession could trigger a backlash or reversion to past practices. The Government will need to continue explaining why structural reforms are necessary and how these measures will lead to improvements in the medium term. This has proven to be a difficult task in 2008 and 2009 as conditions continued to worsen. Even early in the IMF-led program, there were violent protests against the first changes to the 2009 budget. Although the bottoming out of Latvia's economic decline has lowered resistance and there is widespread acceptance of the measures the Government is taking, more can be done to increase information and public awareness. *The Bank team supports a proactive effort by the Government to explain the need for fiscal adjustment and the rationale for reform, having participated in several instances, in key discussions with social partners. The Bank team has engaged local communications experts to help clarify the role of the institution in the overall international assistance effort. The Bank encouraged and assisted in the development of the emergency social safety net to mitigate some of the negative impacts of the fiscal consolidation and economic crisis, and supported the Government's strategy to be widely publicized.* **Budget reductions of this speed and breadth are unprecedented in most countries, and the success of structural reforms depends on the quality of implementation in a very difficult political climate.** Success requires difficult decisions to be made at the local level, as general elections grow nearer. *The Bank will remain engaged through this two-loan program to monitor how structural reforms are being implemented in the education and health sectors, to inform the ongoing process of rationalization, and to adjust the content of the proposed lending program as implementation issues arise.*
Operation ID Number	P115732

IBRD PROGRAM DOCUMENT FOR THE

FIRST SPECIAL DEVELOPMENT POLICY LOAN IN A PROGRAM OF TWO LOANS

TO THE

REPUBLIC OF LATVIA

TO SUPPORT A

SAFETY NET AND SOCIAL SECTOR REFORM PROGRAM

I. INTRODUCTION

1. **The Republic of Latvia has requested Special Development Policy Lending (SDPL) support from the World Bank as part of the package of emergency assistance agreed between the Government, the International Monetary Fund (IMF), the European Commission (EC), Nordic and other European countries, to limit and contain the damage of a financial crisis and rapid economic contraction.** The package of EUR7.5 billion (balance-of-payments and budget assistance) which was approved on December 23, 2008 supports a program of financial sector, fiscal consolidation and structural reforms extending through March 2011. The package is designed to address severe macroeconomic and fiscal imbalances and financial vulnerabilities that have grown worse in the wake of the global economic and financial crisis.

2. **The SDPL assistance from the World Bank is being delivered in two parallel programs, one supporting reforms to strengthen the financial sector, and the other providing support for an emergency safety net and social sector reform.** The two program teams have worked in parallel to ensure the Bank can react to the demands of the Government and international partners with speed and flexibility, in a fluid macroeconomic and political environment. The World Bank's Financial Sector Development Policy Loan of EUR 200 million to support financial sector strengthening, was approved by the Board on September 22, 2009, and was fully disbursed on November 4, 2009.

3. **This is the first of a proposed program of two loans focused on Safety Net Support and Social Sector Reform.** The objectives of the proposed program are: (i) to protect vulnerable groups with emergency safety net support during the economic contraction; (ii) to mitigate the social costs of fiscal consolidation; and (iii) to ensure structural reforms lay a foundation for medium term improvements in the social sectors. Given the deep impact Latvia has suffered in the wake of the global crisis, and due to the emergency nature of this proposed program, the first operation will focus mainly on the first and second objectives. The second operation will expand this focus to the third objective.

4. **The financial crisis hit Latvia at a time when the country was particularly vulnerable, and its impact has been felt more deeply than elsewhere in the region - the economy is estimated to have declined by 18 percent in 2009 and to further contract by 4**

percent in 2010. In the years following its accession to the EU, Latvia ran up a large current account deficit, high external debt, and a very high loan to deposit ratio in the financial sector. Concerns among non-resident and foreign banks about their overexposure resulted in a sharp slowdown in credit and have led to a significant downturn in domestic economic activity. In 2009, domestic demand contracted more sharply than expected. Given that the Government intends to continue with efforts to contain the budget deficit, fiscal cuts are expected to lower GDP further in 2010 (minus 4 percent). GDP growth is likely to resume in the last two quarters of 2010 and in 2011, when output is projected to grow again by 2.7 percent.

5. **Having decided to pursue a strategy of internal adjustment by retaining its exchange rate peg to the Euro, the Government undertook a severe and rapid fiscal consolidation in 2009, which has been met with stoic resolve by the public.** Sharp cuts in spending along with increased taxes and direct efforts to lower public sector wages have been deployed to lower real wages and aggregate demand. In a small, open economy that was already contracting in the wake of the global financial and economic crisis, these adjustment measures have wrought heavy social costs measured in higher unemployment, poverty and inequality. Despite this, the political environment has remained stable. After street protests in January and February, the resignation of the Godmanis Administration on February 26, 2009, and the instatement of a new Dombrovskis Government, the public have been, at least on the surface, resigned to the measures taken. Migration of Latvians abroad, which accelerated after accession to the EU in 2004, may have released some of the social tension from widespread job losses but raises concern for the loss of skilled labor.[1] The fast growth of the economy, with real gains in GDP of just under 10 percent per year from 2004 to 2007, means that even with the sudden contraction of 2008 and 2009, real GDP is just back to the level of 2006. The Government's attempts to guide the process of fiscal consolidation with needed structural reforms and to provide emergency safety net support may also have helped to sustain a social compact of support for the adjustment strategy it has chosen. Finally, local elections in June 2009 and national elections planned for October 2010 have and will provide opportunities for the electorate to assess and weigh in on the situation. For example, in the June 6, 2009 election, more than half of Riga City Council's 60 incumbents failed to win re-election. The previous mayor's party failed to win any seats, and power shifted to a center-left coalition that vowed to reduce the size of the public administration to maintain spending on services. Although social stability is far from assured, these factors plus the apparent bottoming out of several economic indicators in the autumn of 2009 and the implementation of the emergency social safety net beginning on October 1, give rise to hope that the calm in 2009 may continue.

6. **The Government is committed to structural reforms that will help achieve fiscal consolidation targets agreed as part of the program with the IMF, EC, Nordic and other European countries.** The most important social sector and public administration measures being taken are: in the education sector, the introduction of *"funds follow the student"* financing in the 2009 academic year; and in the health sector, a reduction in the number of hospital beds, more effective use of copayments to control demand for services, and reductions of excessive costs by shifting health care toward out-patient and hospital day-care procedures. Additionally, reforms have been passed that will increase the efficiency of social protection by eliminating overlapping benefits and improving the long-term financial sustainability of old-age pensions and other forms

[1] Greater details of the changing profile of international migration are given in section 2.3.

of social insurance. Moreover, measures are planned to consolidate and professionalize the public administration by improving human resource management and increasing transparency in the management of state owned enterprises (SOEs). This package of measures implemented by the Ministry of Education and Science (MoES), the Ministry of Health (MoH), the Ministry of Welfare (MoW), the Ministry of Regional Development and Local Government (MoRDLG), and the State Chancellery and their subordinate agencies, will deliver fiscal savings required as part of the program agreed with international partners, as well as contribute to greater efficiency and efficacy of social services and public administration in the medium and long term.

7. **The proposed program of World Bank support will focus on measures designed to mitigate the social impact of fiscal consolidation, and on the implementation of the Government's cross sector Emergency Social Safety Net Strategy.** As structural reforms are implemented, the Government is committed to alleviating the social costs of the transition to new financing and service delivery models in the education and health sectors, in order to ensure an adequate level of service provision is maintained across the country. Moreover, in the context of the current economic contraction and high levels of unemployment, this commitment extends to strengthening the safety net to respond to the immediate needs of vulnerable households. With technical input from the World Bank, the Government has developed and approved an Emergency Social Safety Net Strategy (ESSNS) to finance essential services and benefits delivered by national agencies, and locally by municipal governments. The ESSNS came into legal effect on October 1, 2009.

8. **The Emergency Social Safety Net Strategy underpins fiscal consolidation and structural reforms by deploying supplementary support to ensure basic social services are maintained.** The strategy finances and coordinates the efforts of national and local government agencies to: (1) maintain pre-primary education and child development programs for 5 and 6 year old children; (2) cover the costs of transporting students from communities where schools have closed to their new places of instruction; (3) exempt needy households from health service co-payments; and (4) subsidize their pharmaceutical costs; (5) sustain and improve general practitioner (GP) and primary health care (PHC) services and access; (6) increase the coverage and pay-out period of unemployment insurance; and (7) increase the coverage and amount of targeted social assistance benefits administered by local governments. For the growing number of unemployed who are not covered by unemployment insurance or other social support, the Government has (8) fortified the Emergency Social Safety Net by re-allocating financing from the European Social Fund (ESF) to expand and rapidly deploy labor-intensive emergency public-works programs.

9. **To increase transparency and accountability, the Emergency Social Safety Net Strategy includes procedures for and adequate financing to closely monitor its implementation and rigorously evaluate its impact.** The World Bank team would coordinate the timing of its assessment of performance under the first loan in the program with the Republic of Latvia State Audit Office's (SAO) possible audit of the Government's performance in meeting its targets for the first year of implementation of the ESSNS. If the government's performance is audited, we will use its findings to discuss how to improve performance during the second year of program implementation. This is an important innovation of the proposed lending program that complements the Bank's normal program supervision and strengthens Latvia's existing institutions for greater governance and accountability.

II. COUNTRY CONTEXT

2.1. RECENT ECONOMIC DEVELOPMENTS IN LATVIA

2.1(a) Growing macro imbalances and buildup of vulnerability

10. **Following its accession into the European Union (EU) in 2004 until 2007, the Latvian economy experienced rapid economic growth averaging over 10 percent per year (see Table 1).** High economic growth was driven almost entirely by domestic demand, encouraged by rapid credit growth and large real wage increases. With expectations of a rapid catching-up with EU living standards, the country also experienced a consumption and real estate boom.

Table 1: Selected Economic Indicators

	Actual					Projected		
	2004	2005	2006	2007	2008	2009	2010	2011
Output	*(Annual growth rate, in percent, unless otherwise stated)*							
Real GDP (annual growth rate, in percent)	8.7	10.6	12.2	10.0	-4.6	-18.0	-4.0	2.7
Private consumption	9.8	11.2	21.2	14.8	-5.5	-22.0	-10.0	1.0
Government consumption	2.1	2.7	4.9	3.7	1.5	-9.0	-9.0	-4.0
Gross fixed investment	23.8	23.6	16.4	7.5	-15.6	-34.0	-10.0	6.0
Exports of goods and services	9.4	20.2	6.5	10.0	-1.3	-17.5	1.5	5.0
Imports of goods and services	16.6	14.8	19.4	14.7	-13.6	-35.0	-9.9	2.4
Nominal GDP (in billions of euros)	11.1	12.9	15.9	21.0	23.1	18.6	17.0	17.0
Prices and employment								
HICP (average, in percent)	6.2	6.9	6.6	10.1	15.3	3.3	-3.7	-2.5
Unemployment rate (LFS, average, in %)	10.4	8.7	6.8	6.2	7.8	17.5	20.0	18.8
Avg. monthly wage (lats)	210.9	245.8	302.4	397.6	479.3	455.0	410.7	409.8
Percent change	9.6	16.5	23.0	31.5	20.5	-5.1	-9.7	-0.2
Consolidated general government 1/	*(In percent of GDP)*							
Revenue	33.9	35.3	36.1	36.2	35.2	36.7	39.6	38.1
Expenditure and net lending	35	36.4	36.9	35.6	38.5	44.8	48.2	44.6
Fiscal balance 2/	-1	-1.1	-0.9	0.6	-3.3	-8.1	-8.6	-6.5
Balance of Payments								
Gross official reserves (in billions of euros)	1.6	2	3.4	4.0	3.7	4.5	5.0	5.3
	(In percent of GDP , unless otherwise stated)							
Current account balance	-12.8	-12.5	-22.5	-22.3	-13.0	*7.7*	*8.4*	*8.8*
Trade balance	-20.2	-19	-25.6	-23.9	-17.6	*-6.7*	*-3.4*	*-2.8*
Capital and financial account				26.5	8.7	*-17.0*	*-21.4*	*-15.6*
Gross External Debt	93.3	99.4	114.0	127.6	127.9	159.9	180.1	182.8

1/ National definition - includes economy-wide EU grants in revenue and expenditure
2/ Fiscal balance excluding bank restructuring costs.
Source: Latvian authorities

11. **Pro-cyclical fiscal policy further fueled the domestic boom.** Public expenditure grew by 80 percent (in real terms) between 2003 and 2007 as the authorities spent cyclically strong tax revenues. The fiscal balance remained in deficit in most years (except in 2007 when the budget saw a small surplus of 0.7 percent of GDP). Large wage increases in the public sector contributed both to maintaining a premium over average wages in the private sector, and to

crowding out fiscal space for productive spending in human and physical capital. Pension benefits linked to wage growth rose in parallel.

12. **Excessive domestic demand translated into large and widening macroeconomic imbalances and a build-up of vulnerabilities (Table 2).** Consumer inflation rose from 6.2 percent in 2004 to over 10 percent in 2007. Rapid wage dynamics outstripped productivity growth undermining Latvia's international competitiveness. The current account deficit widened from 13 percent of GDP in 2004 to almost 23 percent of GDP in 2007.

13. **The expansion of credit was largely financed by short-term external borrowing from private banks, resulting in the highest loan to deposit ratio of the banking sector in the region (248 percent in 2007)**. For foreign owned banks, which accounted for 77 percent of banking assets at the end of 2007, their parent institutions (mainly Swedish banks) were the main source of financing—and much of it was extended short-term in that year. By contrast, domestically owned banks relied substantially on short-term syndicated loans as well as non-resident deposits. As a result of these developments, Latvia's external debt to GDP rose from 90 percent of GDP in 2004 to 128 percent by 2007, with short term debt rising to over 55 percent of GDP in 2007.

14. **The growth in domestic credit resulted in rising household and corporate indebtedness.** The indebtedness of corporate entities and households more than tripled between 2004 and 2007, exceeding 80 percent of GDP. The share of loans to households in total bank assets rose to 28 percent by end 2007 (equivalent to 40 percent of GDP, up from 18 percent of GDP in 2004). The amount of outstanding mortgage loans almost doubled each year until mid-2007.

Table 2: Vulnerability Indicators

	2002-2004	2005	2006	2007	2008
Fiscal indicators					
Balance of general government /GDP, ESA 95	-1.6	-0.4	-0.5	-0.4	-4.0
Balance of general government /GDP, GFS (IMF)	-1.6	-1.1	-0.9	0.7	-3.3
Primary Balance of the Public Sector /GDP, ESA95	-0.9	0.2	0.0	0.1	-3.1
Primary Balance of the Public Sector /GDP, GFS (IMF)	-0.8	-0.5	-0.4	1.1	-2.9
Gross debt of general government /GDP, ESA95	14.3	12.4	10.7	9.0	19.5
Gross debt of general government /GDP, GFS (IMF)	13.6	11.6	9.9	7.8	17.0
Foreign Currency to Central Government Debt in (in %)	55.9	56.0	58.1	61.5	47.7
External indicators					
Current Account Balance /GDP	-9.2	-12.5	-22.5	-22.5	-12.6
Net Direct Investment /GDP	2.9	3.6	7.5	6.7	3.3
Gross external debt/GDP*	81.8	99.4	114.0	127.6	128.2
Net external debt /GDP*	24.9	35.6	44.0	49.3	56.5
Gross external debt (% of exports)*	284.1	296.9	371.2	447.4	457.5
Net external debt (% of exports)*	86.1	106.3	143.2	173.0	201.8
Short-term External Debt/Total External Debt	59.0	49.3	44.1	43.2	33.5
Gross Reserves/Short-Term External Debt (in %)		29.8	41.6	33.0	35.7
Financial indicators					
Foreign currency deposits/Total deposits (%)	38.3	40.6	41.2	48.2	48.6
Foreign currency loans/Total loans (%)	60.6	69.8	76.8	86.3	88.3
Domestic credit to private sector (yoy change %)	47.0	64.3	58.4	34.2	11.7
Loan to deposit ratio (%)	168.1	192.0	215.6	247.6	287.8
Sovereign Credit Default Swap (ave)	--	--	8.1	12.3	133.8
Sovereign Credit Default Swap (eop)	--	--	12.3	133.8	819.0
Sovereign Debt Ratings: Standard and Poor's (eop)	A-	A-	A-	BBB+	BBB-
Eurobond Secondary Market Spread (in basis points)		16	19	58	446

Sources: Latvian statistical office, Central Bank, Ministry of Finance, Eurostat, WB staff.

15. **By 2008 the need for a macroeconomic correction was increasingly evident.** Domestic credit slowed down sharply as banks became more aware of rising risks, and growth slowed down sharply. Unfortunately, wages and fiscal policy failed to adjust in time to the rapidly deteriorating environment, taking their toll on the competitiveness and fiscal position. In fact, public spending increased further in 2008 despite the accumulating evidence of economic over-heating and worrisome indications of increased external and financial vulnerability.

16. **Against the background of the re-pricing of risk in emerging markets, the currency peg came under pressure in September 2008.** By November 2008, the Bank of Latvia's foreign exchange reserves had fallen by 20 percent to euro 3.4 billion. Latvia was soon after downgraded by rating agencies and its Eurobond spread increased to around 600 basis points, while the 5-year Credit Default Swap (CDS) spread jumped to around 1,000 basis points in November 2008.

17. **The global financial crisis thus hit Latvia at a time when the country was highly vulnerable** (Table 2). While the banking sector had entered the crisis with relatively favorable

financial stability indicators,[2] and while the introduction of financial support schemes by the home authorities of foreign owned banks had helped stabilize the deposit base of their subsidiaries, locally owned banks (reliant as they were on more fragile forms of finance, as noted above) came under considerable pressures given the worsened global liquidity conditions in late 2008. Non-resident deposits were particularly affected, with Parex Bank—the largest domestic bank and the second largest bank in Latvia—losing one quarter of its deposits between end August and November 2008. By late 2008, it also became increasingly clear that syndicated lenders would experience growing difficulties in refinancing their loans.

2.1(b) The Stabilization Program

18. **It is against this rapidly deteriorating background that, in December 2008, the Latvian authorities called on international support and agreed to a stabilization program.** The program was supported by the EC, the IMF, EBRD, and the World Bank, and was complemented by bilateral financial support from Nordic and Central European countries[3]. The authorities chose to maintain the exchange rate peg after taking into consideration the balance sheet effect of a potential devaluation, and the severe corporate, banking and social risks that its removal would entail. In addition, there were fears of contagion to neighboring countries (Latvian devaluation would put pressure on the other Central and Eastern European countries currency boards, and could trigger severe exchange rates instability in the larger region). Maintaining the peg was also considered as the best way to facilitate the adoption of euro in the medium term—a natural exit strategy to the existing exchange rate peg. The stabilization package totaling €7.5 billion (or more than 35 percent of GDP) thus relied mostly on financial sector stabilization and strong domestic adjustment policies to achieve internal devaluation and restore the country's competitiveness—but at the cost of a sharp, and likely protracted, output contraction.

19. **An immediate priority was to stabilize the banking sector.** Financial sector measures aimed at stemming the loss of the bank deposit, particularly in the domestically-owned Parex Bank and to restore confidence in the banking system in the medium term. The government took over the bank and negotiated a rescheduling of its syndicated loans. In order to reduce deposit outflows, the authorities also put limits on deposit withdrawals at this bank. In May 2009, the Privatization Agency made an investment of about LVL 141 million, on behalf of the state, into Parex Bank's capital and issued a subordinated loan in the amount of LVL50 million, bringing its capital adequacy to about 11 percent. EBRD has also made an investment in Parex Bank—effective September 2009 acquiring 25 percent plus one share. While these measures have stabilized the bank, a final resolution is awaiting the conclusion of a dispute on state aid issues with the European Commission's (EC) DG on competition policies.

20. **Macroeconomic stabilization, however, proved initially more difficult to achieve as the economy went into a tailspin.** Real GDP fell by more than 18 percent in the first half of 2009 compared with the 2008 program projection of a 5 percent decline for the whole 2009. The main causes were the bursting of credit and real estate bubbles and a collapse in domestic

[2] At the end of 2007, the capital adequacy ratio stood at 11 percent, the liquidity ratio (liquid assets as a proportion of liabilities maturing in 30 days) at more than 55 percent (above the regulatory minimum of 30 percent), the Return on Assets (ROA) at 2 percent, and the Return on Equity (ROE) at 24 percent.

[3] The overall international financial support provides €7.5 billion, of which the EC committed €3.1 billion, the IMF €1.7 billion, Nordic countries €1.8 billion, WB €400 million, the EBRD €0.1 billion and the Czech Republic, Poland and Estonia €0.4 billion.

demand. Moreover, the deeper-than-projected downturn was also due to the worse than anticipated external environment. Instead of increasing by 1½ percent (as envisaged when the IMF-supported program was approved in late 2008), output growth among Latvia's main trading partners was revised to a projected decline of 5 percent in 2009. With the sharp economic downturn, unemployment rose significantly and reached 16.7 percent in the second quarter of 2009 up from 6.3 percent year ago. Much of the poverty and social impacts of the economic contraction can be traced to these adverse developments in the labor markets (see Section 2.3).

21. **Therefore, the need for a stronger fiscal correction than initially programmed was inevitable**. The initial spending cut measures, unevenly implemented for most of the first half of 2009, proved insufficient in curbing past spending trends in light of more severe economic conditions. With revenues plummeting as a result of the output contraction, the fiscal deficit initially widened well into double digits (as a percent of GDP).

22. **It is only with the supplemental budget of June 2009 that the authorities managed to get the fiscal accounts under control.** The latter involved additional measures of LVL500 million aimed at reducing the fiscal deficit to 13 percent of GDP. On the revenue side, measures amounting to 0.6 percent of GDP were introduced and included higher excise tax rates, lowering the threshold of tax-exempt income, and increases in state revenue from dividends. On the expenditure side, the spending reductions amounting to 5.5 percent of GDP came from a lower wage bill (reflecting a nominal wage reduction and a fall in public sector employment) and lower social transfers (including a 10 percent nominal pension cut and a 70 percent reduction of pensions for working pension recipients).[4]

23. **Given the government's successful implementation of the supplemental budget, it the fiscal outturn for 2009 is now estimated to have been better than had been programmed (at the time of the supplemental budget) and that the general government deficit may fall to 8 percent of GDP (see Table 3)**. On the revenue side, tax revenues have been higher than program projections. The higher than programmed revenues partly reflect the accounting effect of the diversion of second pillar pension fund contributions to the first pillar as a revenue item (contribution rates will be reverted to the private pillar in phases, but not fully, by January 2011).[5] In addition, revenues from EU transfers have been higher than projected (0.5 percent of GDP). On the spending side, lower spending on capital and untargeted social benefits have brought down the primary deficit and lower financing costs have reduced interest rate expenditures in the budget. Also, fiscal space for emergency social safety net spending provided under the program (1 percent of GDP) was underutilized (LVL 14 million or 0.1 percent of GDP).

[4] On December 21, 2009, the Constitutional Court ruled that the government's decision to reduce pensions was unconstitutional. The ruling requires the government to (i) refund the withheld pensions (LVL 73.7 million) by 2015, and (ii) start to pay pensions in full from February 1 (LVL 110.9 million in 2010).

[5] From 2009 to 2010, the contribution rate to the private pillar was reduced from 8 percent of a worker's salary to 2 percent. In January 2010, the contribution will be raised to 4 percentage points, and in January 2011 to 6 points. After 2011, contributions to the private pillar remain at 6 percent. Prior to the amendment, the contribution was to rise to 10 percent in 2011. The Government believes this temporary infusion is necessary to (i) avoid deeper cuts cutting pensions in payment; and (ii) to eliminate the need for transfers to the social insurance budget from general revenues to make up for the fall in contribution revenue as unemployment rises.

Table 3: Selected Categories of General Government Operations
(million of lats)

	2005	2006	2007	2008	Jun-09	2009	2010
	act.	act.	act.	act.	June proj. EBS/09/122	current est.	proj.
Total revenue and grants	**3,199**	**4,029**	**5,354**	**5,727**	**4,589**	**4,796**	**4,717**
Tax revenue	2,545	3,299	4,367	4,737	3,352	3,490	3,308
Direct taxes	1,501	1,936	2,627	3,005	1,991	2,138	2,098
Indirect taxes	1,043	1,363	1,741	1,733	1,361	1,351	1,209
Total expenditure	**3,298**	**4,128**	**5,255**	**6,255**	**6,279**	**5,849**	**5,559**
Of which: Wages and salaries	633	789	1,060	1,267	1,036	1,063	903
Goods and services	..	..	754	934	696	725	652
Subsidies and grants	1,537	1,849	2,101	2,693	3,097	2,955	2,931
Subsidies to companies and institutions	622	733	933	1,296	1,208	1,284	1,141
Social support	755	898	1,087	1,385	1,875	1,657	1,775
Pensions	553	661	754	954	1,055	1,055	1,230
Other	202	237	334	430	820	602	546
Interest	53	63	52	64	222	157	267
Capital expenditure	390	533	760	748	544	430	409
Fiscal balance (basic)	**-99**	**-99**	**99**	**-539**	**-1,528**	**-1,053**	**-1,026**
Fiscal balance (basic) as percent of GDP	**-1.1**	**-0.9**	**0.6**	**-3.3**	**-11.8**	**-8.1**	**-8.6**

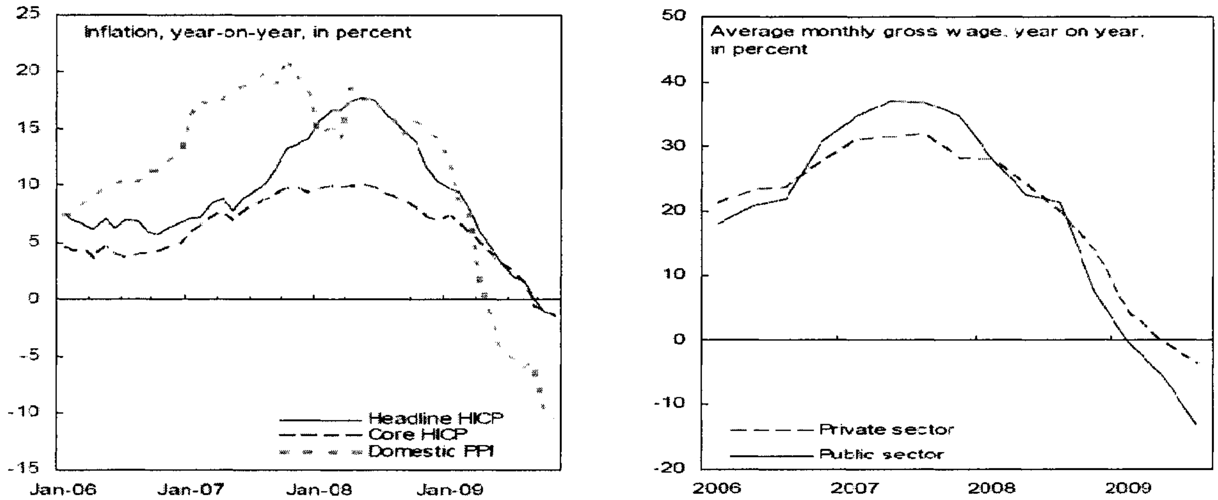
Source: Ministry of Finance

24. **In 2009, the supplemental budget adjustment of fiscal expenditures has been achieved mainly through administrative cuts and less through structural measures.** Administrative cuts were across ministries, including a reduction in the public sector wage bill. The central government reduced the public sector wage bill significantly by cutting 6,000 workers in the third quarter and applying a 20 percent average cut to the remainder of its work force. Administrative spending has also been reduced by merging some institutions. Among positive structural measures there have been those launched in health and education such as optimizing the number of hospitals, schools and teachers.

25. **A necessary price and wage correction is now underway, with inflation falling rapidly from double digits in 2008 into deflation at the end of 2009; nominal wages are following suit.** Month-on-month consumer prices have been falling since this past spring. In November 2009, CPI inflation was down to minus 1 ¼ percent year-on-year. Gross wages were down by 6.4 percent year on year in the third quarter with public sector wages falling faster (13 percent) than those of the private sector (3.7 percent). As a result of internal deflation, the real effective exchange rate (deflated by CPI)[6] has depreciated by 5 percent since its record level in March 2009.

[6] Preliminary data suggest that producer price and unit labor cost deflated real effective exchange rate have also depreciated by around 7 and 11 percent from their peaks, respectively.

Figure 1: Inflation and wages



Source: IMF

26. **The sharp decline in economic activity has masked the better than projected contribution of net exports to growth (13 percentage points in 2009).** Indeed, the external current account swung into surplus. In the first nine months of 2009, the current account surplus reached 7.2 percent of GDP (annualized) compared to a deficit of 13 percent a year earlier. This turnaround reflects an improving income balance due to foreign banks' provisioning for non-performing loans, but there is no real capital inflow. However, significant contribution of the surplus comes from decreasing foreign trade deficit and the stable positive balance of services, both of which have led to a surplus of the balance of goods and services (last recorded in 1994). After excluding the above mentioned provisioning, the current account is to remain in surplus of around 3 percent of GDP in 2009.

27. **On the financing side, private capital outflows have been less severe than feared, reflecting in part the confidence impact of recent disbursements by the international lenders**. While rollover rates by Nordic banks have been within program parameters, corporate borrowing has continued to be higher than projected. Furthermore, after dropping by more than LVL1 billion since beginning of 2008, non-resident deposits have been quite stable since late May 2009. Sizable external official support further shored up the balance of payments. This support came essentially in two waves: first, in early 2009 upon the approval of the stabilization package and, then, following the supplementary budget of mid-2009 when the international lenders approved their next tranches of financial support. On June 26, 2009, the EC approved the disbursement of its second tranche of €1.2 billion. Subsequently, on August 27, the IMF concluded its First Review and disbursed the second tranche of about €200 million. The World Bank's Financial Sector Development Policy Loan of €200 million was approved on September 22, 2009 and disbursed fully on November 4, 2009.

28. **The stabilization efforts of the authorities under the Program have so far helped stabilize financial markets** as evidenced by very low domestic interest rates, halved CDS spread, and limited foreign exchange interventions since summer 2009. The State Treasury has also succeeded in extending maturities of all one-month T-bills to 6- and 12-month in the domestic debt market.

2.2. MACROECONOMIC OUTLOOK AND DEBT SUSTAINABILITY

29. **The coordinated efforts of the Government of Latvia appear to be bearing positive results in stabilizing the economy, but significant macroeconomic adjustment challenges still lie ahead.** Continued fiscal consolidation remains essential given the adjustment strategy chosen by the Latvian authorities. Key to the success of internal devaluation is continuous price and wage correction in order to regain an effective degree of competitiveness. Further stabilization of the domestic banking sector is critical to restoring its soundness and renewing access to international capital markets. In order to complete the stabilization program, substantial official financing is expected to be provided by international and bilateral lenders.

30. **The 2010 deficit is programmed to be 8.6 percent of GDP.** On December 1, 2009, the Parliament (Saeima) approved the 2010 budget which is designed to lower Latvia's 2010 general government deficit by LVL500 million (4.2 percent of GDP) as agreed within the revised stabilization program in June 2009. The budget includes measures on broadening the revenues base (2.3 percent of GDP) and cuts in expenditure (1.9 percent of GDP). Following on measures introduced in 2009 to protect the poor, the 2010 deficit target allows for an additional maximum ½ percent of GDP of social safety net spending if the authorities deem it appropriate to ease social hardship if more severe than expected.[7] In addition, the 2010 deficit accommodates the Constitutional Court ruling of December 21, 2009 that the June pension cuts were unconstitutional. After consulting the EC and IMF, the government will resume payment of pensions in full in February 2010 (around LVL110 million, 1 percent of GDP) and will refund the 2009 withheld pensions as a lump sum in April 2010 (around ½ percent of GDP). It will also introduce new budgetary measures for 2011 and beyond to claw back the increased pension spending arising from the court ruling.

31. **Despite enormous fiscal consolidation in 2009-10, Latvia's fiscal policy continues to face unprecedented challenges due to still high fiscal imbalances compared to the authorities' fiscal target of meeting the Maastricht fiscal criterion in 2012.** A sizeable fiscal adjustment of around LVL800-900 million[8] will need to be spread over 2011 and 2012 in order to achieve programmed fiscal deficits of 6.5 percent and 3.6 percent of GDP, respectively. The authorities have committed to identifying necessary measures to deliver the above mentioned targets. It was also agreed that the authorities will work with the EC and World Bank on a new public expenditure review in order to identify areas for expenditure savings that will be sustainable over the medium term. The objective is to design a menu of available options for the next government.

[7] The need, scope and design of the social safety net measures will be explored in more details during the next review.

[8] The amount includes the authorities' commitment to compensate for the increased pension spending arising from the December 2009 Constitutional Court ruling.

32. **The authorities have requested to extend the program till end 2011 and re-phase its disbursement schedule (see below).** This extension, made possible by better than expected financing conditions in 2009[9], is recognition that sustainable macroeconomic adjustment will take longer than initially programmed. Continued involvement of the international lenders beyond the elections in October 2010 should provide assurances to financial markets that the authorities will continue with consistent and sustainable policies over the medium term. Access under the Stand-By Arrangement with the IMF will remain unchanged.

33. **The extension of the program will help the medium-term fiscal adjustment and use the 2009 good performance in support of upcoming government elections in October 2010.** This extension will allow for a continuous focus on medium-term tasks such as designing sustainable structural fiscal measures, developing a medium-term fiscal framework, etc. It will also cover the preparation of the 2012 budget which is key to bringing the deficit within 3 percent of GDP as required by the Maastricht criterion.

34. **With continued fiscal retrenchment, positive GDP growth is unlikely to resume quickly.** The 2010 fiscal adjustment will continue to restrain domestic demand. Expected further job and wage cuts will lower disposable incomes of households and limited bank lending (due to over-indebtedness) will keep consumer spending suppressed. Real GDP is projected to fall by 4 percent in 2010, with domestic demand decreasing by 9 percent (see Table 4).

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[9] The NIR target for 2009 will likely be exceeded by a very substantial margin and further accumulation of reserves is anticipated in 2010. Therefore, there is room for shifting some portion of the financing access into 2011.

Table 4: Macroeconomic Framework
(percentage change, unless otherwise indicated)

	2007	2008	2009	2010	2011	2012	2013	2014
			Projections					
Output and demand								
Real GDP	10.0	-4.6	-18.0	-4.0	2.7	3.8	4.0	4.0
Consumption	12.8	-4.4	-19.8	-9.8	0.0	2.3	3.0	3.1
Private consumption	14.8	-5.5	-22.0	-10.0	1.0	3.1	3.3	3.3
Public consumption	3.7	1.5	-9.0	-9.0	-4.0	-1.0	2.0	2.0
Gross fixed capital formation	7.5	-15.6	-34.0	-10.0	6.0	7.5	8.0	8.0
Exports of goods and services	10.0	-1.3	-17.5	1.5	5.0	5.6	5.5	5.5
Imports of goods and services	14.7	-13.6	-35.0	-9.9	2.4	5.6	7.0	7.0
Contributions to growth								
Domestic demand	15.1	-13.0	-31.4	-9.4	1.5	3.7	4.4	4.4
Net exports	-5.1	8.5	13.3	5.3	1.2	0.2	-0.5	-0.5
			(In percent of GDP)					
HIPC inflation								
Period average (in percent)	10.1	15.3	3.3	-3.7	-2.5	0.0	0.2	0.7
End-period (in percent)	14.0	10.4	-1.4	-3.3	-0.5	0.4	0.2	0.9
Labor market								
Unemployment (period average in percent)	6.2	7.8	17.5	20.0	18.8	17.5	15.9	14.9
Employment (period average, percent change)	2.7	0.1	-10.8	-4.7	-0.7	0.5	0.6	0.6
Real gross wages	19.7	4.4	-8.0	-6.3	2.3	1.8	1.5	1.6
Fiscal sector								
General government revenues	36.2	35.2	36.7	39.6	38.1	36.8	35.6	35.7
General government expenditure	35.6	38.5	44.8	48.2	44.6	40.4	37.6	37.4
Basic Balance	0.6	-3.3	-8.1	-8.6	-6.5	-3.6	-2.0	-1.7
Balance (including bank restructuring costs)	0.6	-7.5	-9.4	-16.4	-14.9	-3.6	-2.0	-1.7
General government gross debt	7.8	17.0	34.9	58.9	69.3	69.0	66.9	6.8
External Sector								
Current account balance	-22.3	-13.0	7.7	8.4	8.8	8.2	6.3	4.8
Net IIP	-74.4	- 78.2	-91.8	-89.1	-76.6	-62.4	-50.3	-40.1
External debt								
Gross	127.6	127.9	159.9	180.1	182.8	182.8	175.0	167.3
Net	49.3	56.4	58.2	44.1	23.5	14.5	0.0	-12.4

Source: Latvian authorities

35. **However, recent gains in competitiveness[10] and a more favorable global economic outlook in 2010 are expected to invigorate the tradable sector**. Exports are likely to increase by 1.5 percent in 2010 and imports are anticipated to decline by 10 percent in 2010 given the continued contraction in domestic demand. As a result, net exports are projected to mitigate the impact of falling domestic demand, with a positive contribution (5 percentage points) to real GDP in 2010.

36. **Over the medium term, recovery to higher and sustainable growth will require a continued structural adjustment of the economy towards the tradable sectors**. Pre-crisis growth was heavily dependent on unsustainable developments in non-tradables, particularly in real estate. Future growth should come more from the tradable sectors. The adjustment of

[10] Since March 2009, the real exchange rate has depreciated by 5 percent, about one-quarter of which is due to nominal appreciation of trading partners. Also, producer price and unit labor cost deflated real effective exchange rate have depreciated by 7 and 11 percent from their peaks, respectively.

domestic costs required by the stabilization program should not only put the economy on a stronger footing and strengthen export-based recovery, but should stimulate new investment in export-oriented industries. Such an adjustment is likely to remain gradual. The current projection of the program expects real GDP to grow around 4 percent annually in 2012-14.

37. **The labor market will continue to bear the brunt of the adjustment as economic activity remains depressed.** The unemployment rate is expected to be at about 20 percent in 2010, up from 17.5 percent in 2009. In 2010, the average gross monthly wage is expected to decline by 10 percent. Such wage correction is an inevitable part of the overall stabilization program. However, it is associated with risks of social tensions and political instability. The latter in turn may undermine efforts of the authorities and international community if it is not accompanied by a well coordinated and an improved social safety net.

38. **Internal price adjustment will continue.** Annual average deflation is expected to reach a rate of minus 3.7 percent in 2010 given the continuing negative output gap, falling wages and contracting domestic demand. The falling prices will provide additional real income to households, but this is unlikely to be enough to offset the large fall in wages and social benefits coming from program adjustments.

39. **Latvia's external imbalances are set to narrow.** The subdued domestic and improving foreign demands, as well as ongoing adjustment of domestic costs should facilitate export-based recovery. The current account surplus of 3 percent of GDP in 2009 (excluding provisioning by foreign banks of their non-performing loans)[11] is projected to improve further to around 8.4 and 8.8 percent of GDP in 2010 and 2011, respectively, before narrowing later on as recovery intensifies and growth takes over.

40. **Although Latvia's external vulnerability is expected to be reduced by the projected current account surpluses, the balance of payments will still face contingent risks.** Capital flows remains uncertain. Both foreign-owned and domestically-owned banks will need to repay to their parents or their maturing syndicated loans, respectively. Non-resident deposits have stabilized due to continuing restrictions on deposits at Parex Bank, but after their removal, non-resident deposits will likely decline over time to find their new steady state. Size and speed of capital flows will depend on restoring confidence in the banking sector and investment opportunities, particularly in the tradable sector.

41. **Further consolidation of the banking sector remains therefore key for the success of the program.** Following an unprecedented expansion in the pre-crisis period, the banking sector has been affected by reduction of output and rising unemployment, and remains under pressure from increasing overdue loans, liquidity and funding risks.[12] Therefore, the authorities have been working with the international partners on improving financial system conditions (e.g., by streamlining insolvency procedures and preparing guidelines for out-of-court mortgage

[11] 7.7 percent of GDP for 2009 reflected in Table 1 and 4 includes provisioning by foreign banks of their non-performing loans which improves the income balance, but there is no real inflow.

[12] In October 2009, the non-performing loan ratio reached nearly 15 percent and the provisioning losses totaled 5 percent of GDP. In an effort to maintain the system-wide capital adequacy ratio at 13 percent, the banks reduced the level of lending. The stock of credit to both households and corporate has fallen by five percent since the beginning of 2009.

workouts), as well as mitigating the impact of any future crisis through completing work on contingency planning, remedial action guidelines, and improved supervision and monitoring.

42. **The completion of restructuring of two state-owned banks, namely Mortgage and Land Bank ("MLB") and Parex Bank is essential to restore financial stability of the banking system.** MLB has sustained large losses and required two capital injections in 2009 (the second still to be approved by EC). The intention is to refocus MLB's activities to development lending, (SMEs, business start-ups, infrastructure, etc.) and separate non-performing assets into an independent asset management company. As for Parex Bank, the Latvian government cannot reorganize or recapitalize it again until the EC's DG Competition completes the review of the first capital injection—as noted earlier. Also, the government[13] in cooperation with EBRD intends to prepare a comprehensive plan to handle non-performing and non-core assets and will submit the plan to the EC by end March 2010.

43. **There is strong regional support from the large Nordic banks to ensure adequate capital and liquidity in their Latvian branches.** The 2009 September's coordination meeting in Stockholm confirmed this support conditional on how nominal GDP evolves and availability of sound business opportunities. The willingness of these banks to make bilateral commitments in the next stage of the process remains; however increased lending will likely be affected by global deleveraging. Nevertheless, the international lenders and the authorities will continue to seek more detailed and timely commitments from the key Nordic banks. The FCMC/BOL will monitor these banks' exposure and share information with foreign supervisors and central banks.

44. **With this, the projected external financing requirements of euro 8.9 billion in 2010 and 2011 (see Table 5) are expected to be fully covered and no additional official funds would be needed beyond what is envisaged in the program.** Two main developments that have contributed to lowering the pressure on the external sector as compared to earlier projections have been larger than anticipated surpluses in the current account and less severe capital outflows. The later has been mostly due to lower roll-over rates in the financial sector, moderated nonresident outflows, as well as larger, but less than anticipated resident accumulation of foreign assets.

45. **The financing from the IMF and other partners will be re-phased till end 2011 (Table 5).** The IMF supports the extension based on the substantial margin of the Net International Reserves target for 2009 and further accumulation of reserves expected in 2010. Also, Nordic disbursements in the first and third quarters in 2010 are retained, but in smaller amounts, while the remaining commitments are postponed for the first and third quarters of 2011. Official bilateral and multilateral resources represent about 47 percent (euro 4.2 billion) of the total financing needs in 2010-11 and as such are a key component of the funding sources. To date, 43 percent (euro 3.3 billion) of the official financial support have already been disbursed. The EU has affirmed that it will continue to work closely with the Latvian authorities and the Fund to ensure that Latvia implements successfully its economic reform program and its timely repayment of all loans associated with the international program to support Latvia.

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[13] The authorities have established a high-level working group, chaired by Governor Rimsevics, to prepare the restructuring of Parex Bank.

Table 5: External Financing 2010-11
(millions of euro)

	2010 Projection				2011 Projection				2010 to 2011
	Mar	Jun.	Sept.	Dec.	Mar	Jun.	Sept.	Dec.	Proj.
Total financing requirements	**1,497**	**1,101**	**1,038**	**1,361**	**1,071**	**1,088**	**878**	**844**	**8,878**
Amortizing debt	388	153	381	290	397	165	165	165	2,104
Short term liabilities	186	175	110	105	76	74	-	-	726
Banks credit from MFIs and	32	32	31	31	22	15	7	-	170
trade credit (net)	-19	74	-39	-27	12	52	-42	-2	9
Resident fx accumulation	910	667	555	962	564	783	748	682	5,871
Total financing sources	**102**	**1,003**	**-60**	**1,263**	**373**	**990**	**379**	**647**	**4,697**
Current account	328	344	367	384	352	368	386	402	2,931
Direct investment (net)	235	240	245	250	250	250	250	250	1,970
Portfolio investment and financial derivatives	415	52	50	47	200	-	200	-	964
o/w government eurobond	360	-	-	-	-	-	-	-	360
Capital account	135	135	135	135	135	135	135	135	1,080
Others	-179	-179	-179	-179	-179	-179	-179	-179	-1,432
Change in gross reserves (increase -)	-832	410	-679	625	-385	415	-413	38	-821
Financing gap	**1,394**	**98**	**1,098**	**98**	**698**	**98**	**498**	**197**	**4,180**
Official financing	1,394	98	1,098	98	698	98	498	197	4,180
IMF	194	98	98	98	98	98	98	97	880
EU	500	-	200	-	100	-	100	-	900
Nordics (incl. Estonia)	500	-	500	-	500	-	400	-	1,900
Other (WB, EBRD, CR, PO)	200	-	300	-	-	-	-	-	500

Source: Latvian authorities, IMF

46. **In such improved circumstances, the public debt is projected to increase less than expected at the time of the first Financial Sector DPL approved in September 2009 (see Table 6).** Gross public debt is now projected to peak at 69 percent of GDP in 2011 compared to 90 percent in 2013 estimated at the First Review of the SBA in August 2009.[14] While exceeding the Maastricht threshold, the criterion can still be met if the debt is on a downward path.[15] Even with sharper fiscal consolidation assumptions, public debt would only enter a gradual decline at the beginning of the next decade.[16]

47. **Although gross external debt is projected to remain high at around 180 percent of GDP in 2010,** net external debt should reach its peak 58 percent of GDP in 2009. Expected successive current account surpluses will result in its steady decrease. The main source of medium-term risk will be the banking sector, which will remain a large external debtor with gross debt estimated at 67 percent of GDP in 2014 of which 39 percent is short-term debt.

[14] The difference between the Financial Sector DPL estimates and the ones projected during the Second Review of the SBA is due to: (i) lower primary fiscal deficits, (ii) lower bank restructuring costs, (iii) lower interest payments, and (iii) updated assumptions about deposit build-ups in the BoL.

[15] The projection includes sizeable government deposits at the BoL. Excluding these deposits, public debt would be below 60 percent of GDP.

[16] Figures are based on sharp fiscal consolidation. Specifically, their path towards the Maastricht criterion involves sharp fiscal consolidation in 2010 and 2011 with the intent of meeting the 3 percent target (ESA terms) by 2012. The authorities' proposed fiscal consolidation path could put additional pressure on output but, if a faster-than-expected recovery were to materialize and the fiscal adjusts more rapidly, then lower level of debt—close to the debt Maastricht criterion—could be achievable by 2012.

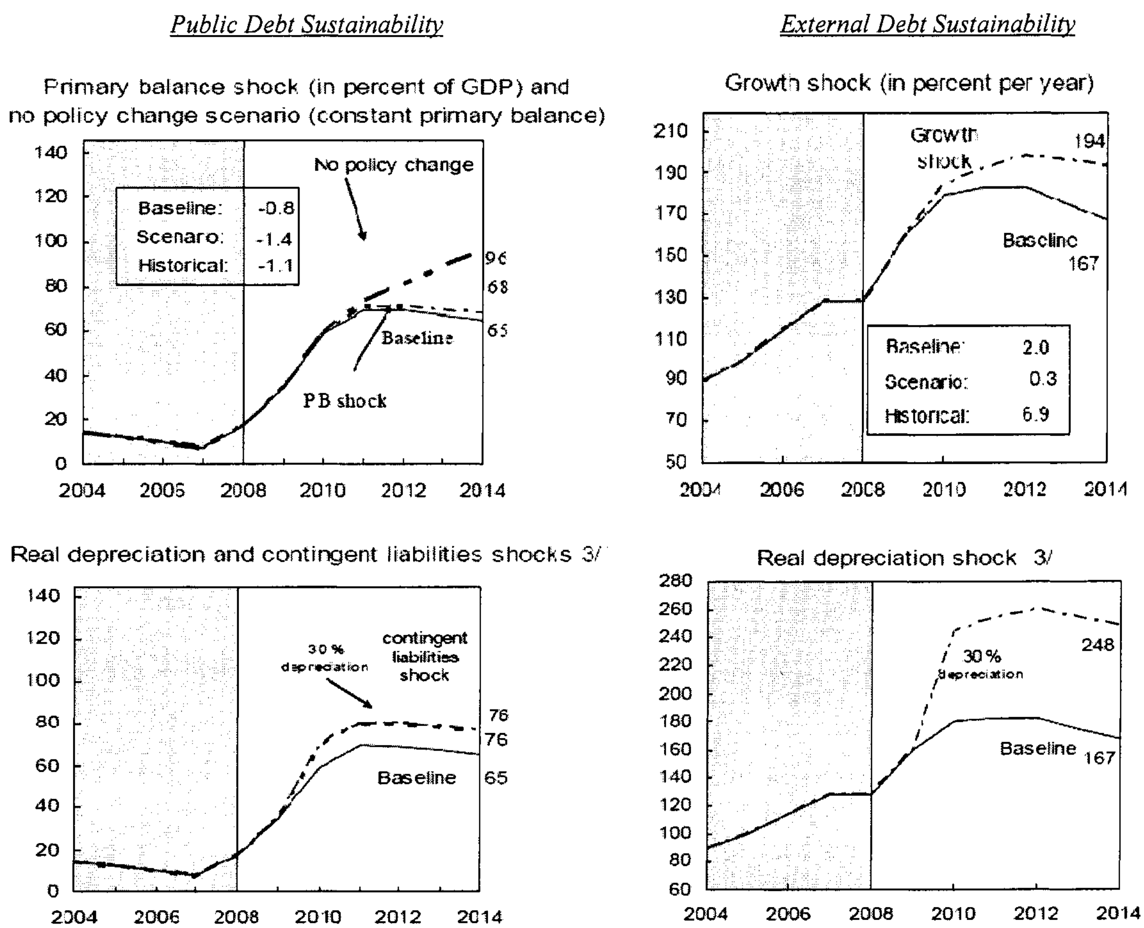
Table 6: Public and External Debt Sustainability
(Percent of GDP)

	2007	2008	2009p	2010p	2011p	2012p	2013p	2014p
Public sector debt								
Baseline public sector debt	**7.8**	**17.0**	**34.9**	**58.9**	**69.3**	**69.0**	**66.9**	**64.8**
o/w foreign currency denominated	4.4	9.8	26.6	47.1	55.0	54.3	50.4	44.1
Change in public sector debt (A)	-2.1	9.2	17.9	24.0	10.4	-0.4	-2.1	-2.0
Identified debt creating flows (B)	-3.5	6.3	13.5	19.8	14.6	0.8	-1.0	-1.4
Primary deficit	-1.0	2.9	6.9	6.4	3.0	-0.6	-2.3	-2.6
Revenue and grants	36.2	35.2	36.7	39.6	38.1	36.8	35.6	35.7
Primary (non interest) expenditure	35.2	38.1	43.6	46.0	41.1	36.2	33.4	33.1
Automatic debt dynamics	-2.4	-0.6	5.4	5.6	3.2	1.4	1.2	1.2
Other identified debt creating flows	-0.1	4.0	1.3	7.8	8.4	0.0	0.0	0.0
Residual including asset changes (A-B)	1.4	2.9	4.3	4.2	-4.2	-1.2	-1.2	-0.7
Public sector debt to revenue ratio (in percent)	**21.4**	**48.3**	**95.0**	**148.8**	**182.0**	**187.7**	**187.7**	**181.9**
External debt								
Baseline external debt	**127.7**	**128.0**	**159.9**	**180.1**	**182.8**	**182.8**	**175.0**	**167.3**
Change in external debt (C)	13.5	0.3	31.9	20.2	2.6	0.1	-7.9	-7.7
Identified debt creating flows (D)	-11.3	0.4	22.0	-5.4	-17.9	-18.9	-17.0	-15.2
Current account deficit excl. interest payments	18.3	7.6	-7.5	-14.9	-15.9	-16.0	-14.3	-12.8
Net non debt creating capital inflows (negative)	-5.7	-0.9	-3.9	-4.1	-4.2	-4.0	-3.9	-3.9
Automatic debt dynamics	-23.8	-6.4	33.4	13.5	2.2	1.1	1.2	1.5
of which from nom. interest rate	4.1	5.4	4.7	6.5	7.0	7.8	8.0	8.0
of which from real GDP growth	-8.6	5.3	28.7	7.0	-4.8	-6.7	-6.8	-6.5
Residual, including changes in gross foreign assets (C-D)	24.8	0.0	9.8	25.6	20.5	18.9	9.1	7.5
External debt to exports ratio (in percent)	**308.6**	**308.1**	**384.3**	**388.6**	**370.1**	**358.0**	**332.6**	**309.5**

Source: IMF calculation and projection

48. **Stress tests highlight the high degree of sensitivity of the debt sustainability.** Slower deficit reduction (for example, due to reform fatigue) would result in government debt ratios approaching 100 percent of GDP. Also, more rapid and sustained deflation than envisaged under the program would lead to higher government debt ratios (although smaller than during the last review). Overall, the sustainability of the public debt is most dependent on the size of the primary deficit, and the sustainability of the external debt would be most affected by real depreciation (see Figure 2). Public debt simulations are relatively less sensitive to a devaluation and contingent liability or interest rate shock. The external debt is less sensitive to shocks originating in lower growth, higher interest rates, or a non interest rate current account shock.

Figure 2: Public and External Debt Sustainability
(selected shocks)



Source: IMF simulations

3/One-time real depreciation of 30 percent occurs in 2009

49. **Overall, the current macroeconomic framework is adequate for the Bank to proceed with finalizing the proposed SDPL.** Indeed, the macroeconomic outlook has improved noticeably since the previous Bank loan was approved. The second review of the SBA by the Fund's Board is scheduled on February 12, 2010. However, the proposed lending program still remains subject to significant economic and political risks. Indeed, achieving real exchange rate depreciation without nominal exchange rate depreciation will depend critically on continuing strong domestic adjustment involving sustained wage correction and permanent fiscal consolidation. Moreover, the current coalition remains fragile.. Parliamentary elections are expected in early October 2010, which will increase centrifugal pressures on the coalition government. The current SDPL would also contribute to mitigating these risks as it would support the authorities finance safety net measures that should facilitate the medium-term structural budgetary reforms. Supporting actions have been designed to increase transparency and to hold the authorities accountable for implementation of the package of measures supported by the proposed operation.

2.3. SOCIAL IMPACT OF THE CRISIS AND ECONOMIC CONTRACTION[17]

50. **The social impact of the contraction has and will continue to be deep and widespread.** Bank staff simulations show Latvia is likely to experience a sharp increase in poverty, widening of the poverty gap, and a rise in income inequality as a result of the financial crisis and economic contraction. Bank staff simulations show that the percentage of people in poverty will have increased from 14.4 in December 2008 to 20.2 a year later.[18] In absolute terms, there will be more than 130,000 additional poor people in Latvia than in 2008, taking the total number of poor people to more than 453,000. The poverty gap, which measures the poverty deficit of the entire population, will also increase from 5.9 to 8.3 percent. Finally, income inequality – among the highest in the region prior to the crisis - will likely rise, with the Gini coefficient increasing from 39.3 to 41.3 percent.

51. **Much of the expected social impact of the economic contraction can be traced to the contraction of the labor market.** With an 18 percent contraction of GDP in 2009, the sectors most severely affected have been construction, manufacturing, retail trade, and the hotels and restaurants sector. This has led to a loss of more than 126,000 formal jobs, or 11.2 percent of the workforce. The large contraction in overall employment reflects employment contractions of 19 percent in trade hotels and restaurants, 16 percent in construction, and 14 percent in manufacturing. The largest increase in poverty is observed in the poor region of Latgale where the majority of employed people are likely to have been working in precarious, low wage jobs even prior to the crisis. The impact of the crisis is also felt more sharply in households where a man is the primary income earner, which to a large extent is explained by the contraction in the mostly-male-employing construction sector. Households in which economically active members have few skills (education levels of high school or less) suffer relatively more. Finally, households with children also suffer a greater impact.

52. **Having decided to pursue a strategy of internal adjustment by retaining its exchange rate peg to the Euro, the Government undertook a severe and rapid fiscal consolidation in 2009, which has been met with stoic resolve by the public.** Sharp cuts in spending along with increased taxes and direct efforts to lower public sector wages have been deployed to lower real wages and aggregate demand. In a small, open economy that was already contracting in the wake of the global financial and economic crisis, these adjustment measures have wrought heavy social costs measured in higher unemployment, poverty and inequality. Despite this, the political environment has remained remarkably stable. After street protests in January and February, the resignation of the Godmanis Administration on February 26, 2009, and the instatement of a new Dombrovskis Government, the public has been at least on the surface resigned to the measures taken. Migration of Latvians abroad, which accelerated after accession to the EU in 2004, may have released some of the social tension from widespread job losses but raises concern for the loss of skilled labor.[19] The fast growth of the economy, with

[17] Ajwad, M.I., F. Haimovich and M. Azam (2009) "The Employment and Welfare Impact of the Financial Crisis in Latvia", Mimeo, ECSHD, The World Bank, Washington, DC.

[18] A household is in poverty if its total household income is below LVL 90 per capita, or approximately US$6 per person per day. In Latvia, this line is known as the "needy" line.

[19] Migration of Latvians abroad has become a topic that is being increasingly discussed in the media as the rate of unemployment rises. Anecdotal evidence shows that the composition of migrants is changing, from single, working-age people, to families with children. This is being interpreted in the public discourse as a likely shift in the nature of migration toward longer stays or even permanent movement abroad. Although no official data exist to

real gains in GDP of just under 10 percent per year from 2004 to 2007, means that even with the sudden contraction of 2008 and 2009, real GDP is just back to the level of 2006. The Government's attempts to guide the process of fiscal consolidation with needed structural reforms and to provide emergency safety net support may also have helped to sustain a social compact of stoic support for the adjustment strategy it has chosen. Finally, local elections in June 2009 and national elections planned for October 2010 have and will provide opportunities for the electorate to assess and weigh in on the situation. For example, in the June 6, 2009 election, more than half of Riga City Council's 60 incumbents failed to win re-election. The previous mayor's party failed to win any seats, and power shifted to a center-left coalition that vowed to reduce the size of the public administration to maintain spending on services. Although social stability is far from assured, these factors plus the apparent bottoming out of several economic indicators in the autumn of 2009 and the implementation of the emergency social safety net beginning on October 1, give rise to hope that the calm in 2009 may continue.

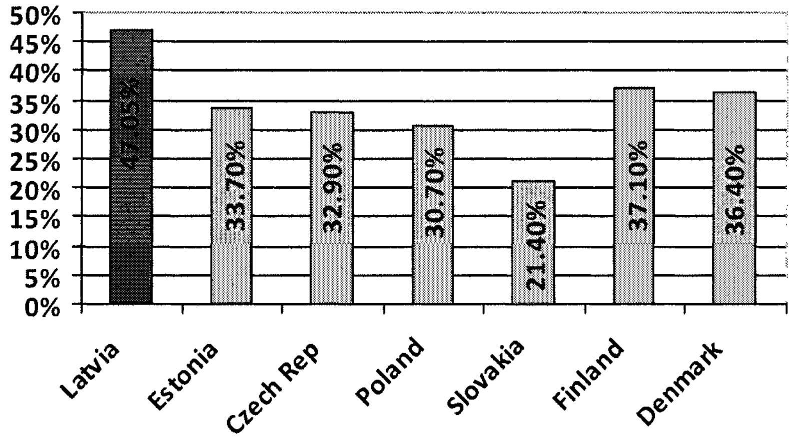
2.4. SOCIAL SECTOR POLICY ISSUES

2.4(a) Health

53. **The structure of healthcare financing and provision raises costs, with little impact on health outcomes that remain among the worst in the region.** Compared to other Central and Eastern European countries in 2007, Latvia had fallen behind in implementing its health sector modernization plans. As a result, the Latvian health sector produced a relatively poor level of health outcomes at a significantly higher cost. Compared to more efficient health sectors, Latvia has a greater number of hospitals and hospitals beds; a high number of outpatient clinics; misallocation of staff across facilities; and an overstaffed MoH and subordinated agencies. Furthermore, the structure of health financing creates incentives for provider-induced demand for specialist and hospital care; and consequently, Latvia has high inpatient admission rates and long average lengths of hospital stays.

record international migration, data from the Embassy of Latvia in the United Kingdom are indicative of a hypothesized sharp increase in migration as a result of the economic contraction. The United Kingdom and Ireland are two destinations within the EU where Latvian nationals can freely move and legally take up employment. From 2004 to 2008, 76,000 Latvians were issued with social insurance registration numbers in Ireland and UK; almost 4 thousand per year have been registered as migrants in other countries of European Economic Area. After peaking in 2005, the outflow from the Latvian labor force slowed down in 2006-2007, but intensified again with the onset of economic crisis in mid-2008 and especially in 2009. In the first half of 2009 the number of Latvians migrating to the UK rose by 46.7 percent on the previous year. The number of adult Latvian nationals registered in UK in the first quarter of 2009 (4.4 thous.) was much higher than in any of the previous quarters since start of registration in 2002. In 2009, the number of Latvian nationals in the UK grew faster than the number registered in the UK's Worker Registration Scheme, suggesting that the proportion of migrant workers moving from Latvia with dependent family members is growing (M. Hazans . 2009. "*Adjustment to the Crisis in the Latvian Labor Market*" University of Latvia, Department of Economics and Management, mimeo prepared for this program).

Figure 3. Inpatient expenditures are higher in Latvia
(Percentage of Total Health Expenditures)



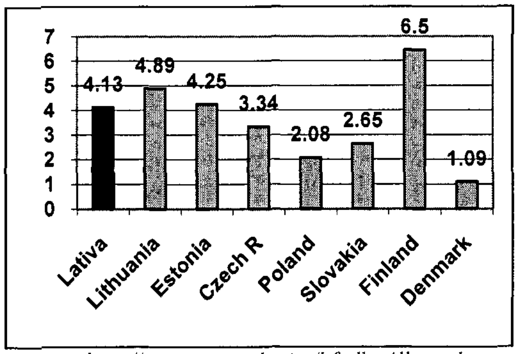
Source: WHO Health for All data: http://www.euro.who.int/hfadb. All numbers 2007 except Estonia 2006.

54. **A widespread and inefficient hospital network has led to Latvia spending more on inpatient care than other countries**. As recent as 2008, 65 percent of financing from the National Health Fund was allocated for inpatient and emergency care. High spending on services has crowded out spending for capital and maintenance cost. Investments in high cost medical technology and multiple and decentralized procurement of pharmaceuticals are major cost drivers in the system.

55. **The current provider payment structure creates adverse incentives that have delayed the implementation of the health sector rationalization plan**. Capitation to private health care providers coupled with a reimbursement system for specialist and inpatient care that is for all practical purposes fee-for-service based, create incentives for general practitioners (GPs) to refer patients to specialists and hospitals where they are kept longer. This situation is further exacerbated by calculating tariffs based on capacities instead of unit costs of the most efficient providers. Even for households required to pay co-payments, the exemption of emergency care encourages patients to use costly emergency services to leapfrog their GPs and gain direct access to hospitals and specialist care.

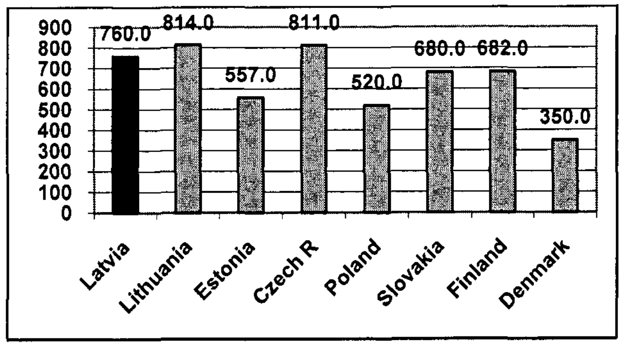
56. **Despite its extensive hospital network and Primary Health Care (PHC), relatively poor health outcomes point to inefficient treatment.** Latvia reports a relatively high tuberculosis incidence and HIV/AIDS prevalence, a small proportion of malignant tumors (0.8 percent) identified during preventive care examination indicating substandard quality, and a burden of diseases dominated by preventable and life style diseases related to smoking, alcohol and high blood pressure. Despite overcapacity in maternal and tuberculosis care, infant mortality and tuberculosis incidence in Latvia are the highest in the region. These health outcomes point to quality and efficiency issues in treatment patterns in prevention and PHC settings.

Figure 4. Hospitals per 100,000 Population



Source: http://www.euro.who.int/hfadb. All numbers 2007 except Poland 2006 and Denmark 2005.

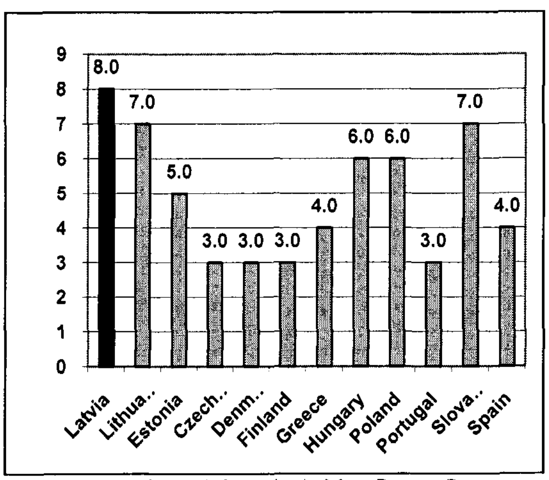
Figure 5. Hospital Beds per 100,000 Population



Source: http://www.euro.who.int/hfadb. All numbers 2007 except Poland 2006.

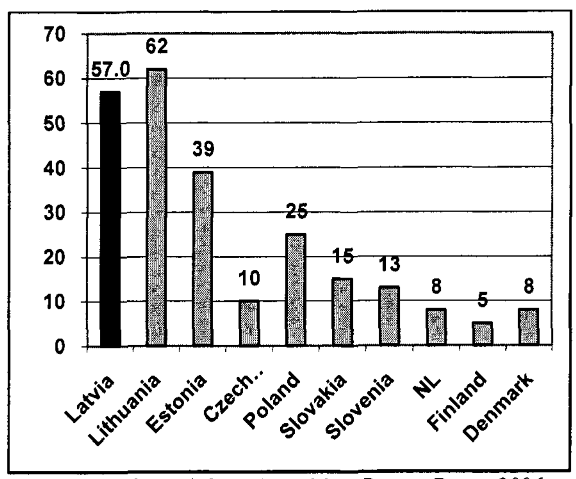
57. **To improve efficiency and quality in the health sector, the Government could play a stronger stewardship role.** A key to reform is to advance the implementation of the sector rationalization plan and reduce the number of hospitals, departments and beds to a level comparable with other small countries and consistent with Latvia's changing population. Further, analysis of the productivity of staff working in health facilities and a functional review of the MoH identified needs for downsizing numbers. Greater efficiency and improved performance can be achieved by supporting rationalization of hospital and beds with changes in the provider payment and exemption policies, and selective contracting by the health insurance fund.

Figure 6. Infant Mortality Rate



Source: www.who.int/whosis/en/. Most Recent Data - 2006.

Figure 7. Tuberculosis Incidence



Source: www.who.int/whosis/en/. Most Recent Data - 2006.

2.4(b) Education

58. **Latvia's education system is characterized by high coverage but low efficiency.** Demographic change since the start of the transition continues to lower efficiency. At the same time, decentralization and diversification of financing have led to greater inequality in learning achievement across municipalities and schools. Competition in the global economy has changed skill requirements in ways that make many education programs less relevant to today's labor-market needs.

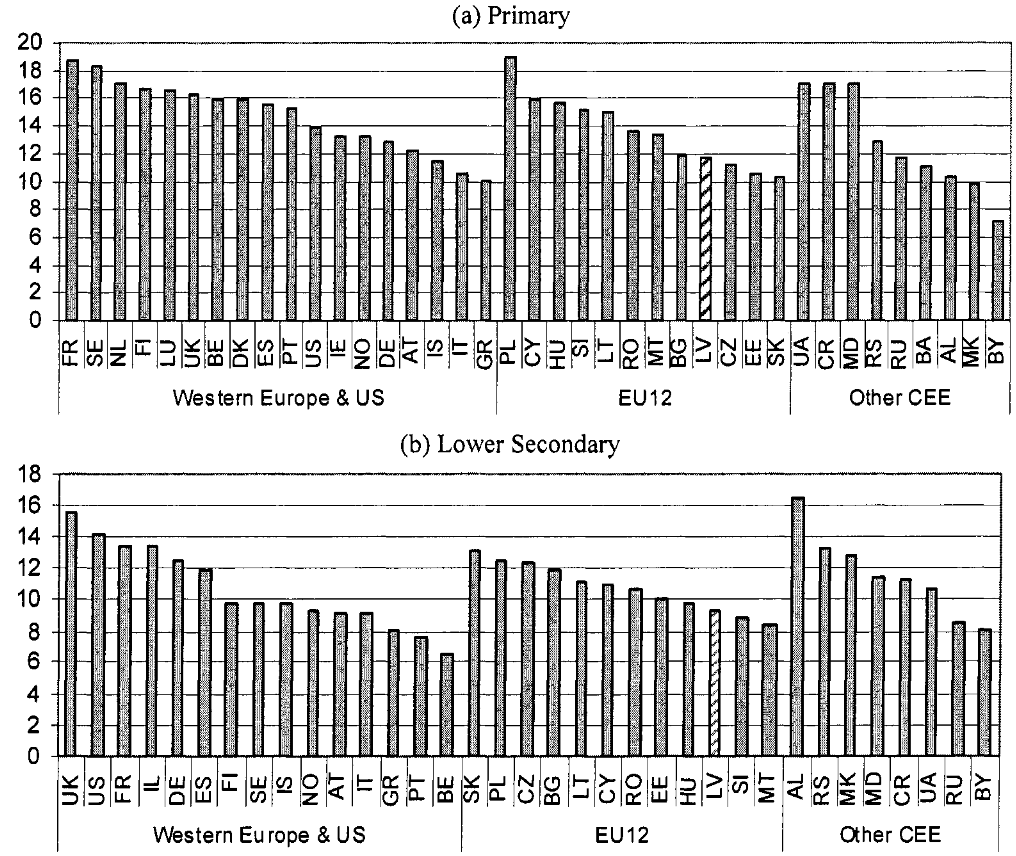
59. **The main driver of inefficient spending in the education system is the cost of teaching and non-teaching staff.** Until reductions in 2009, education accounted for a relatively high share of government spending and GDP in Latvia because staffing/output ratios for both teaching and non-teaching staff were among the highest in the region. This inefficiency is a legacy of changes that occurred early in the transition. In Latvia, as in most of the other transition countries, GDP and public revenues fell sharply early in the 1990s. The Government made a particular effort to protect education programs by allocating a greater share of public expenditures to the education sector. This preferential treatment persisted even after the fiscal crises of the 1990s passed. The overall education budget as a share of total government expenditures remained high by comparison to the OECD countries. The 2007 PER concluded that education spending would continue to grow and education expenditures would remain high unless budget financing for education was shifted from financing inputs (teachers) to financing outputs (students).

60. **Changing the basis for education finance would yield major fiscal advantages, allowing the education budget to adjust in proportion to the rapid decline in enrolments.** Between 1989 and 2004, the school-age population in Latvia fell by 28.6 percent.[20] As a result of this demographic contraction, enrolments in preschool, primary, and secondary education fell by over 25 percent between 1990 and 2006. In the 2008/2009 academic year, the pupil-teacher ratio was low and falling: 7.3 on average, down from 9.5 five years previously. At every level of the education system (primary, lower secondary, and upper secondary) the Latvian ratio is among the four lowest among the 12 new EU member states.[21] But education budgets did not fall as the school-age population declined: education budgets financed teachers rather than students, so the decline in enrolments did not trigger automatic reductions in staff. Indeed, there were (and remain) strong pressures on the part of communities and teacher unions to maintain teaching positions even as enrolments fall.

[20] United Nations Population Division database.

[21] These national averages conceal significant variation across Latvia. Pupil-teacher ratio is somewhat lower in Riga (8.2) than in other big cities (8.9), but this is consistent with higher proportion of secondary pupils in Riga. Riga aside, the pupil-teacher ratios in statistical regions (Pieriga, Kurzeme, Zemgale, Latgale and Vidzeme) range from 7.7 in Pieriga (where just one out of six pupils attends upper secondary school) to 7.2-7.4 in Zemgale and Kurzeme (about 20% of pupils are upper secondary ones) to 6.6 in Latgale and 6.2 in Vidzeme (about 22% pupils are upper secondary).

Figure 8. Pupil/Teacher Ratio, Latvia and Other Countries, 2007



Source: UNESCO Institute for Statistics database, in M. Hazan (2009) for this program[22]

61. **Spending on an inefficiently high number of teaching staff reduces fiscal space to raise the wages of Latvia's underpaid teachers**. Latvia's human resource inefficiencies in the education sector stem from too many teachers being paid too little. Latvian teachers are substantially underpaid, compared to their colleagues in other countries and with other professionals in Latvia. Underpayment of teachers was a problem even prior to the cuts required this year. Statutory wages for teachers amounted to only 59 percent of GDP per capita in 2008. Even though nominal statutory wages doubled since 2005, as a portion of per capita GDP, they varied only slightly between 54 and 59 percent. By way of comparison, only five countries in the EU and OECD pay their teachers significantly less than 100 percent of GDP per capita: Hungary, Ireland and Norway (where teachers are paid between 66 and 80 percent of per capita GDP). Only Estonia pays teachers less than Latvia. Survey data capturing the total income received by teachers – including income from overtime – raise the earnings indicator to 82 percent of GDP in 2008. This is still very low when compared to what professionals with similar characteristics and qualifications are earning, particularly in the national public administration, where salaries for comparable workers can be almost double that for teachers. This makes it difficult to attract the best people to teaching.

[22] Mihails Hazans. 2009. *"Are Latvian teachers, doctors, and nurses underpaid? An earnings functions approach"* University of Latvia Department of Economics and Management, mimeo prepared for this program.

62. **Further efficiency can be achieved by integrating and consolidating management of vocational schools at the municipal level.** The management and financing of primary education, secondary general education and secondary vocational education (including the secondary vocational programs currently managed by the MoES and other line ministries) could be consolidated at the regional level. Currently, municipalities rightly consider vocational schools outside their responsibility. Vocational schools could be seen as a community resource subject to the same value for-money scrutiny as general education schools and other activities managed by municipalities. If vocational schools are not providing the skills required by local employers, municipalities could be free to close them or convert them to other uses. Secondary vocational education programs have higher unit costs than secondary general education, but they do not necessarily confer better prospects in the labor market. The decision about whether to finance continuation of existing vocational programs or whether to convert them to other uses (including general education or vocational training in other areas) could be taken at the regional level as part of the ongoing reflection about how to maximize the efficiency of the general education network.

63. **The shift to "funds follow the student" financing, and loosening of centrally imposed guidelines for how budget allocations to education can be used, could create strong incentives for local governments to downsize the teacher workforce and retain the best teachers.** Municipalities will be free to reduce teacher needs by merging classes to create larger classes, by increasing teaching loads, by combining grades into multi-grade classes, and by bussing teachers to achieve fuller utilization. Schools could be combined in order to reduce teacher needs and improve quality. Costs could also be reduced and relevance of education to local skill needs improved by changing the specializations offered in vocational schools and providing stronger general education training to the students. To reduce differences in education quality, the Government would need to strengthen centrally managed actions to monitor student learning achievement in order to identify schools whose learning achievement falls below national standards and to carry out educational interventions to bring schools with lagging performance up to national standards. In its recent performance audit of the education system[23] the SAO expressed concerns about the quality of education and was critical of MoES for not establishing suitable mechanisms for monitoring the quality of general education.

64. **At the university level, students are selected for budget-financed places purely on the basis of performance.** Many students who qualify for budget-financed university places would pursue the same courses even without a budget subsidy. At the same time, many low-income students who do not qualify for budget-financed places are likely to be deterred by high fees from pursuing higher education, despite the availability of student loans. This raises concerns about the potentially regressive outcome of university subsidies.

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[23] State Audit Office, Republic of Latvia, "Implementation of General Education System in Compliance with the Set Objectives," Audit Report No.5.1-2-59/2006, November 16, 2007.

2.4(c) Social Protection[24]

Latvia's social welfare system provides cash benefits categorized into three groups: Social Insurance; State Social Benefits; and income-tested municipal Social Assistance[25] (Table 7). *State social insurance* guarantees people who make contributions compensation for the loss of income (income smoothing) in certain situations - such as when a person reaches the retirement age, becomes unemployed or disabled, loses their main income provider, becomes sick, has an occupational accident or disease cannot, or takes off from work during the pre-natal and post-natal (maternity) periods. People covered by social insurance (by virtue of paying contributions from their earnings) are entitled to the pensions, benefits and compensations to ensure they can sustain their consumption when they are unable to receive an income due to the circumstances discussed above. Social insurance in Latvia is based on two fundamental principles: (i) the amount of the social insurance payments are directly related to the earned-income on which the covered individual's social insurance contribution is calculated; (ii) financing is on a pay-as-you-go (PAYG) basis by which the current social insurance benefits are financed from the contributions of working people. *State social benefits* complement the state social insurance system and provide state support in the form of cash payments to certain population groups in vulnerable situations, due to reduction or loss of income, such as: (i) people who are not covered by social insurance or whose insurance contribution record is not sufficient to receive social insurance benefits (state social maintenance benefit); and (ii) in statutory cases when additional expenditure is needed but the state social insurance system does not envisage any protection (e.g., the state family benefit, the child care benefit and the child birth benefit). The right to receive the state social benefits does not depend on the social insurance contributions paid. The state social benefit system comprises both, benefits paid on a regular basis and lump-sum payments.

65. **In contrast, most forms of municipally administered *social assistance* is designed to target the poorest families, and awarded according to the results of an income test.** Housing benefits and the Guaranteed Minimum Income (GMI) transfers are the principal, mandatory targeted social assistance benefits administered and financed by municipalities. Local authorities also pay other social assistance benefits on a voluntary basis, as well as one-off, lump sum emergency benefits to residents who have suffered shocks. Many of these voluntary benefits and the emergency benefits are not income tested.

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[24] The social protection section of the 2007 review drew from: Palmer, E., S. Stabina, I. Svensson, and I Vanovska (2006) "NDC Strategy in Latvia: Implementation and Prospects for the Future" in R. Holzmann and E. Palmer (2006) Pension Reform: Issues and Prospects for Non-Financial Defined Contribution Schemes, World Bank. World Bank (2007a) "Social Assistance in Central Europe and the Baltic States", Policy Report, Washington DC, February; World Bank (2007b) "Latvia: Sharing the High Growth Dividend: A Living Standards Assessment", Policy Report No. 38437 LV, Washington DC, March

[25] This section does not cover in-kind and institutional forms of social assistance, such as long-term care for the elderly. These programs have been protected under the Government's fiscal consolidation program.

Table 7. Most Important Cash Benefits Paid by Latvia's Social Welfare System

Benefit type	**Type of coverage**	**Who are eligible?**	**Responsible administrative agency**	**Source of finance**
Social insurance	Old age Disability Survivors Unemployment Sick-leave Maternity/Paternity Parental	Contributing employees, employers and self employed	Ministry of Welfare's State Social Insurance Agency	Special Social Insurance Budget (individual and employer contributions & transfers from the general budget)
State social benefits	State social maintenance benefit (covering all contingencies above, except unemployment; sick – leave, maternity/paternity; parental) Family allowances Disability allowances	Individuals ineligible for SI benefits. All families with children. Disabled persons	Ministry of Welfare's State Social Insurance Agency	State base budget (transfers from the general budget to the Ministry of Welfare)
Social assistance	Guaranteed minimum income (GMI) Lump-sum emergency benefit Housing benefit	Means tested to households below a per-person eligibility threshold based on income.	Municipal governments	Municipal budgets (locally levied taxes and transfers from national budget)

66. **By EU standards, Latvia spends a modest sum on social protection**. In 2007 Latvia spent about 8.4 percent of GDP on social protection. This is well below Hungary, the Czech Republic, Slovakia and Slovenia, Romania and even Estonia. Spending on social insurance pensions makes up the largest share of social welfare spending in Latvia as in all EU8 countries – a product of rapid ageing of the population. Spending on non-contributory transfers in Latvia has been comparable to that of its neighbors. However, spending on the targeted guaranteed minimum income (GMI) benefit program – Latvia's "last resort" poverty benefit - is about 0.2 percent of GDP and has remained the lowest among the countries in Central Europe.

67. **Latvia was the first country in Central and Eastern Europe to restructure its public pay-as-you-go (PAYGO) pension regime**, from a purely defined benefit (DB) structure, to a non-financial (notional) defined contribution (NDC) plan. The new public plan was implemented in January 1996. Also as part of the structural reform a separate pillar of private mandatory individual retirement savings accounts was introduced, and began operating in July 2001.

68. **Although Latvia's pension reform was broadly considered a success, the pension system remains vulnerable to even small changes in parameters**. The retirement age which reached 62 for men in 2003 and reached the same age for women in 2008, is still very low by international standards. In 2002, Latvian men could expect to live 13 more years and women to live 20 more years on average after retirement. Since 1996, the unisex life expectancy factor tended to reduce the level of benefits from the plan. The Government was concerned that rapid changes in longevity as well as continued economic growth could lower the average pension benefit relative to average wages. This concern motivated changes in indexing benefits to include wage growth. From 2002 "Small pensions" (those equal to or less than 3 times the state social maintenance benefit) have been adjusted by 50 percent of wage growth in addition to the CPI

adjustment. Benefits are adjusted to changes in inflation twice a year, and on the second adjustment, 50 percent of growth in wages is added. The generous indexation mechanism put in jeopardy the fiscal stability brought by the 1996 reform, motivating the Government's move early in 2009 to shift to full inflation indexing. Pension indexation was frozen in 2009 and 2010. Future pensions will be indexed only by inflation once a year.

69. **With economic decline, revenues to the social insurance special budget have fallen, and the Government has introduced a temporary diversion of contributions from the privately managed funded pillar, to sustain pensions paid from the public pillar.** An amendment to the law "On State Pensions" passed by Parliament on April 23, 2009 introduced a time-bound diversion of contributions from Latvia's private pension funds, to the NDC pillar. From January 1, 2009, the contribution rate to the private pillar was reduced from 8 percent of a worker's salary to 2 percent. After 2011, contributions to the private pillar remain at 6 percent. Prior to the amendment, the contribution was to rise to 10 percent in 2011. The Government believes this temporary infusion is necessary to (i) avoid deeper cuts to pensions in payment; and (ii) eliminate the need for transfers to the social insurance budget from general revenues to make up for the fall in contribution revenue as unemployment rises. The diversion enjoys political support, however, it could be seen in future as a violation of private property rights and will weaken other financial contracts.

70. **Although not a policy supported by the World Bank, the circumstances and nature of the diversion of contributions from the funded pillar to the NDC pillar lower the danger of reversal of the 1996 pension reform.** The IMF and EC take account of the infusion of funds to the social insurance special budget from the diversion of contributions from the funded pillar, but do not recognize it as a revenue or savings measure in their assessment of the Government's fiscal performance. The diversion is treated as "financing" (in that it increases future pension liabilities), and is shown as a separate line item in reports of fiscal performance. The diversion is not a measure that any of the program partners would have advised. In its current form, however, the diversion has several features that limit its negative impact: (i) the diversion of contributions is *partial* and *temporary* (which is clearly spelled out in the amendment to the pension law), and thus is not a reversal of the 1996 structural pension reform; (ii) the diversion is a measure taken *within the parameters* of the multi-pillar model (not a break with that model); (iii) an affiliate's additional contribution to the public pillar is *recognized* as such in the NDC formula, retaining the "individualized" recognition of contributions; and (iv) the amendment includes a clear *"exit strategy"* reverting contributions to the funded pillar, although not to their originally envisioned level. Furthermore, the diversion has to be considered in the context of several other difficult pension reforms that the World Bank has long been arguing for to increase fiscal sustainability, which the Government took at about the same time, including most importantly, the repeal of wage-indexation of pensions. In the second half of the proposed program, the Bank team will continue to work with the Government on further reforms to public pensions, and monitor implementation of plans to restore contributions to the funded pillar.

71. **Latvia's unemployment insurance plan has been the subject of critical scrutiny for very low coverage and incentive problems.** While the parameters by which the benefit is calculated, and the maximum period over which it is paid, are similar to unemployment insurance schemes in other countries of the EU10 (although on the more generous side of this comparative scale given that benefits are calculated as a declining share of average earnings in

the job lost, as opposed to a declining percentage over the unemployment period of a flat amount), estimates made during the recent high-growth period show that the marginal effective tax on re-employment is much higher in Latvia, creating an unemployment trap. However, the more pressing concern given the current dramatic contraction in the economy and sharp rise in unemployment is the low share of newly unemployed at any given period that is eligible for benefits. In 2008 about half of applicants for unemployment would be turned away because they did not meet eligibility criteria.

72. **Turning to another branch of social insurance, there has been a worrying increase in the number of recipients of sickness benefits in recent years**. Since 1997, the social insurance budget finances benefits paid in the event of sickness, maternity and paternity. Since 2001, the number of social insurance benefits paid to cover sickness has been growing rapidly. From 2003 to 2005 the number of recipients of sickness benefits grew by 32 percent, and was accompanied by an increase in the average duration of benefits. The rapid growth of sickness benefits is a cause of concern for the MOW, and may be indicative of fraudulent gaming of the system. Across the region and elsewhere, sickness benefits are notoriously subject to moral hazard and third-party-payer problems.

73. **Social insurance and state social benefits reach a majority of the population.** Coverage and targeting performance indicators are presented in Annex 6, alongside comparative spending and performance indicators from other countries in the region. Although spending on social welfare cash benefits has been comparable to spending in Estonia and Lithuania and low relative to spending in other EU8 and EU15 countries, social insurance and state social benefits reach a large share of the population (81.5%) and almost all of the population in the poorest quintile (99.1%). Not surprisingly, most of the population receiving benefits in Latvia is paid state social benefits (mainly family state benefit). In contrast, social assistance paid by municipal governments covers only 6.1 percent of the population and 6.2 percent of the poorest quintile.

74. **For Latvia's broad array of non-contributory state social benefits, universal access poses the main risk to fiscal sustainability**. Latvia like many countries in the region provides universal state social benefits, and in particular family allowances. Family state benefits are by far the largest of the state social benefits, and are roughly evenly distributed across the households of different means (see Annex 6). Keeping family benefits universal is a social choice with explicit fiscal implications.[26]

[26] The Government is considering how to reform the state social benefit system to distribute spending on social assistance more progressively. As part of its dialogue with the World Bank, the MoW is considering reforming the largest of its state social benefits, the Family State Benefit (FSB). It is important, however, that reform is not initiated during the current economic contraction. The Bank team's simulations show that if the FSB is withdrawn, the post-crisis poverty rate would jump from 20.4 percent to 22.8 percent in 2009. Survey evidence shows that about LVL 83 million is transferred to households in the form of FSBs. Based on this, the Bank's simulations show that if the FSB is replaced by a top up cash transfer, all households with incomes below LVL 50 per capita per month will qualify. Given that the "needy" poverty line is LVL 90 per capita per month, replacing the FSBs with a targeted income transfer that only tops up incomes to LVL 50 per capita per month will have no impact on the poverty rate. However, the post-crisis poverty gap will decrease substantially from 8.3 to 6.9 percent. This post-crisis poverty gap is still marginally above the pre-crisis poverty of 5.9 percent, but represents a very positive impact on the welfare of the poorest households. Discussion of how to reform the FSB will continue during discussion of the second proposed SDPL.

75. **Means-tested social assistance, financed and administered by municipal governments, is meager.** Among the constellation of non-contributory benefits offered by the social welfare system, when compared to its neighbors, Latvia has the smallest share of transfers explicitly designed to target the poorest households. The meager spending on income-targeted benefits is apparent in the low coverage indicators (Annex 6), where the main benefit targeted to the poor, the GMI, has to be grouped with other municipal benefits in order to be captured in representative household surveys. In 2007 the GMI program was so scant that coverage and targeting performance cannot be evaluated with survey data. The relatively small volume of last-resort social assistance reaching poor households could reflect the highly decentralized character of Latvia's social assistance programs, which are not only administered but also financed by municipal governments. This may explain the low incidence of GMI if poorer municipalities are less able to provide benefits. If benefits designed to be targeted to the poor are reaching only 17 percent of households in the poorest quintile, this suggests that these particular programs may either be under-funded by municipalities, and/or that there is substantial leakage to non-poor groups. Regional experience has demonstrated definite gains in targeting accuracy from giving local governments certain roles and responsibilities in social assistance programs. However where there has been greatest success, central governments retain responsibility for financing minimum income guarantees, setting and enforcing targeting criteria, and conducting a quality assurance role to verify and enforce both standards and efficiency.

76. **Latvia's active employment assistance (active labor market programs, ALMPs) are organized and administered by the State Employment Agency (SEA), a subordinate body of the Ministry of Welfare.** All legal residents of Latvia are eligible for active employment assistance, as long as they are previously registered as unemployed with SEA. A broad range of ALMPs are provided, including vocational training, requalification and qualification improvement; paid temporary work; activities targeted to the specific groups, such as youth, disabled people, older workers and mothers reentering the labor market after maternity leave; programs to help business start-ups and self-employment; and apprenticeships.[27] Employment provided through Latvia's ALMPs usually has to conform to labor legislation and pay at least the legal minimum wage. The Government's budget allocations to ALMPs administered by the SEA are boosted with financial support from the EU's European Social Fund (ESF). In the 2007 – 2013 EC budget planning period, LVL 154 million (EUR 219.7 million) was allocated to activities in the social welfare sector (that is, under the domain of the MoW), and 92 percent of this came from the ESF specifically. The majority of ESF financing – LVL 129.5 million (81.5 percent) – is allocated to ALMPs. The largest ALMP, by budget allocation, is "promotion of employment in the regions" (LVL 34 million), which financed public works administered by local authorities. This is followed closely in budget size by training programs for job seekers (LVL 33.6 million), administered by local offices of the SEA.

[27] Information in more detail on the involvement of the unemployed and job seekers in the active employment measures and preventive measures for decreasing unemployment is available on the home page of the State Employment Agency: www.nva.gov.lv.

2.5. POLICY ISSUES IN PUBLIC ADMINISTRATION

77. **Public administration in Latvia is widely considered too costly and lacking in transparency.** Latvia's public administration has been criticized for unnecessarily high staffing levels, salaries and unjustified expenditures on the one hand, and for deficient establishment control over business activities and low quality on the other. Compensation of state employees as a percentage of GDP has risen from 10 percent in 2000 to 12 percent in 2008 (i.e. from LVL 503 million in 2000 to LVL 1,947 million in 2008).[28] There are also governance problems, such as opaque hiring and appointment processes for the management boards of SOEs.

78. **These features undermine the public's confidence in the State.** A well-functioning human resource system is imperative to a state-of-the art public administration. In the current economic environment, however, with declining budgets, tighter fiscal space and staffing cuts, it is particularly crucial to maintain incentives and accountability within the civil service. A further decline in the quality of human resources in the civil service in Latvia will make it especially difficult to establish a depoliticized and professional public administration in years to come.

79. **The executive government system is an overly complicated structure of ministries, agencies, administrative entities, inspections units, and services.** The current system of civil service management is more centralized than international practice would advise. A large number of executive bodies have sprung up during a recent period of rapid growth. While the economy was rapidly growing and the state budget increased proportionally, the public administration lost track of cost efficiency. In the years of economic boom public sector agencies and SOEs paid little attention to the efficiency of resource management.

80. **The current legal framework for management and governance of SOEs could result in added opportunities for corruption**. The law still allows SOEs to create subsidiary companies which are not subjected to the restrictions and supervision procedures that the capital companies themselves have to comply with. As a result, in individual state capital companies there is a complex and opaque network of subsidiaries which create opportunities for the use of state resources in private interests and for evading public procurement. Another serious issue is the opaque selection of SOEs management boards. This issue has been partly addressed by the *Saeima* which imposed certain restrictions on the boards of small and medium sized SOEs. However, the members of many SOE boards are still selected and remunerated in a non-transparent manner. The current economic situation provides natural incentives to increase the level of accountability in the operations of SOEs in order to reduce opportunities for corruption.

III. THE GOVERNMENT'S REFORM PROGRAM

3.1. FISCAL CONSOLIDATION

81. **The Government has passed budget consolidation measures that bring the deficit to the IMF/EC program targets.** On the 4th of June 2009, Latvia's Parliament passed a second supplementary budget for 2009. The Government's program yielded total savings in 2009 of

[28] EUROSTAT Government Finance Statistics, Summary Table 2/2009.

LVL 500 million, or 4 percent of GDP. Additional revenue and spending measures in the 2010 budget are expected to yield a further LVL 500 million savings. Because, measures included in the rapid fiscal consolidation would have had a regressive impact, the Government prepared at the same time a set of mitigating measures in an Emergency Social Safety Net (see section 3.4).

82. **Despite the severity and speed of adjustment, the Government is trying to navigate the process of fiscal consolidation with specific structural reform objectives.** The Cabinet of Ministers is committed to implementing fiscal consolidation through sound, structural reforms. In the social sectors, the most important measures are: in education, the introduction of *"funds follow the student"* per-capita financing in the 2009 academic year (which began in September 2009), and the consolidation of vocational schools under the management of municipal governments; and in the health sector, a reduction in the number of hospital beds, more effective use of copayments to control demand for services, and reductions in excessive costs by shifting health care toward out-patient and hospital day-care procedures. Additionally, reforms have been passed that will increase the efficiency of social protection by eliminating overlapping non-contributory benefits, improving the long-term financial sustainability of old-age pensions and other forms of social insurance, and increasing spending on targeted social assistance. Moreover, measures are planned to consolidate and professionalize public administration, by reducing the number of central government ministries, improving human resource management, and increasing transparency in the management of state owned enterprises (SOEs). This package of measures will deliver fiscal savings required as part of the program agreed with international partners, as well as contribute to greater efficiency and efficacy of social services and public administration in the medium term.

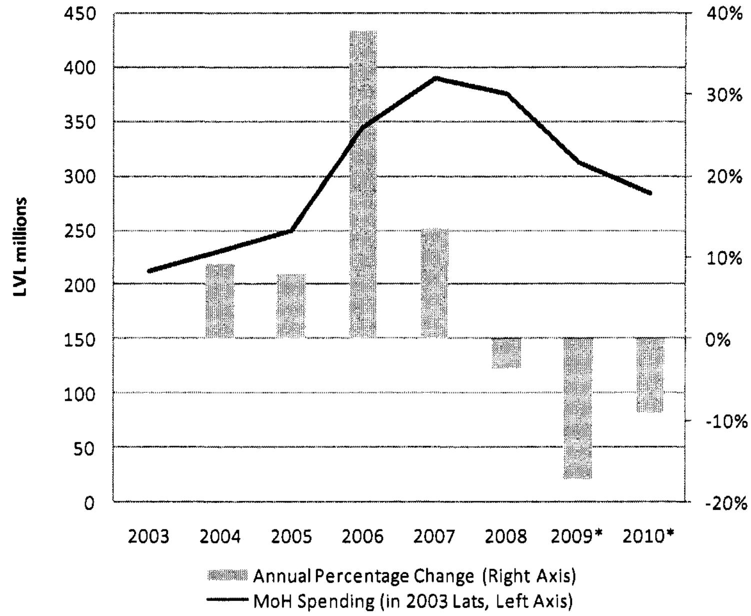
3.2. CRISIS-INDUCED EXPENDITURE CUTS AND STRUCTURAL REFORMS IN THE SOCIAL SECTORS

3.2(a) Health

83. **In the health sector, structural reforms delivering fiscal adjustment aim to improve administrative capacity and transparency, and to rationalize the provision of care.** Public expenditure on health rose from 3.0 percent of GDP in 2000 to a high of 3.8 percent of GDP in 2007. It fell to 3.6 percent in 2008 – corresponding to LVL 576 million. The 2010 budget is predicated on a contribution equal to 3.6 percent of GDP, or LVL 432 million, and is expected to remain at 3.4 percent of GDP through 2011.[29] The 25 percent cut from 2008 to 2010 has put the health budget back to where it was in approximately 2006 in real terms. The cuts took place precipitously during 2009 as the MoH attempted to cope with the economic situation. The Ministry's objective in trying to manage within this spending cap is to restructure health services fundamentally, in order to change the cost structure so that its lower level of funding contributes more effectively to improved population-based health outcomes.

[29] The draft budget for 2010 has a figure of LVL398 million for health; the exact amount is subject to change.

Figure 9. State Budget Expenditure in the Health Sector, 2003 – 2010



Source: Latvian Ministry of Health

Note: Prior to 2003, health sector spending appeared under Ministry of Welfare's budget. For 2009 and 2010 data are budgeted amounts

84. **The MoH is protecting primary care, services for children and pregnant mothers, emergency hospital services, subsidies for covered pharmaceuticals, and medical education.** To support these priorities it has cut financing for inpatient care, specialist services, high-cost tests, and elective surgery. It is trying to substitute for inpatient services to the extent possible through increased use of outpatient surgery and alternatives to overnight hospital stays. It has raised patient copayments substantially. By the mid-2009, the MoH was working with 56 percent of its original 2009 budget. It maintained GP/PHC services at approximately 83 percent of the original allocation, only by cutting hospital and specialist services to about 43 percent of the original amount. It will continue at these much reduced levels in 2010 and 2011. The key features of the Government's structural reforms are:

- ***Streamlined MoH***: The Government has substantially reorganized the Ministry and its affiliated agencies. Overall, there were 5,462 employees in the MoH and its agencies in January 2009. By September 15, 2009 employment had been cut at the Ministry and its agencies from 1,038 to 570 employees (at the ministry alone – from 155 to 93 emploees).[30]
- ***Reductions in infrastructure:*** Within the budget envelope for 2010, public financing of medical services will be LVL 366 million, down from LVL 385 million in the supplemental budget of June 2009.[31] Key actions taken to maintain funding for its priorities include the following:

[30] Overall spending on administration for the MoH and its agencies will fall from LVL32.1 million in 2009 based on the June supplemental budget to LVL7.88 million in 2010, based on the current budget proposal, a decline of 53 percent.

[31] In 2008 medical services were financed at LVL514 million; the total in 2010 is 30 percent lower.

- *Hospitals:* Elimination of 1,862 hospital beds by January 1, 2010. Based on a stock of 17,200 beds on January 1, 2009, this is an 11 percent reduction. The MoH plans to close another 1,335 hospital beds in 2010 and 3,231 beds in 2011. If it succeeds, it will have closed 37 percent of its beds by the end of 2011, leaving 10,777 beds, or about 475 per 100,000 people (down from 757 in 2007). Latvia had originally planned to meet this goal in 2015 although with little prospect of success given the political support for small municipal hospitals; the crisis has increased the probability of success and allowed the ministry to attempt to reach the goal four years earlier than originally proposed.[32] [33] Success in reducing hospital infrastructure will allow Latvia to reallocate funds to primary care, specialist outpatient services, pharmaceuticals, and public health activities.
- *Emergency Services:* Maintain full coverage of emergency medical services but eliminate redundancies by creating a unified service out of the 39 municipality-based institutions that exist today. Merging these services will be completed by July 1, 2010; it includes careful reductions in the number of hospitals providing 24-hour emergency services to minimize increased travel time.[34]

- ***Better use of copayments:***[35] There is a cap of LVL400 per year on the total copayments by a patient for all services, but this is not automatic – the patient must apply for it. From the standpoint of the public budget, the main benefit from increased copayments is a reduction in use – which means the cost goes to zero for the insurer – but of course it also benefits marginally by shifting more of the cost to the patient when a service is used. Effective February 1, 2009, with the first wave of budget cuts, copayments were substantially increased across the board. The last increase in copayments had been in 2005. By the end of the first month, there were immediate decreases in use of all services.[36]

- ***Reducing costs to the insurance agency:*** In May 2009 there was a second round of cuts required to achieve LVL500 million in savings for the whole government in the 2009 supplemental budget. The total amount to be cut from the health budget was about

[32] When the reduction is complete, Latvia will have about the same bed coverage as Poland, but still about a third more beds per capita than the United Kingdom.

[33] Many of the closed beds would be programmed for different purposes, such as long term care or day surgery, but would not be used for inpatient care. About 59 percent of medical care spending in 2008 went to inpatient services and 35 percent to general and specialist outpatient services. By 2011 the MoH goal is to equalize inpatient and outpatient spending at about 46 percent each, which would still leave inpatient spending well above the OECD average of about 34 percent. In other words, while the closure of hospitals and reduction in beds is severe, there is such a large excess supply today that there will still be a need for further adjustments after the crisis ends.

[34] There is considerable room for rationalization, as Latvia has triple the number of hospitals per capita rendering emergency services as do Hungary and Slovenia, for example, and five times the coverage in the Netherlands.

[35] Copayments are collected by the provider and retained at the point of service. Tariffs paid to providers for their services are unchanged by copayments; they simply offset subsidies from the insurance fund.

[36] *Outpatients:* The copayment for an outpatient visit to a family doctor was doubled to LVL1. Specialist copayments rose from LVL2 to LVL5. Charges for diagnostic tests were raised as well, with the final cost ranging from LVL2 for a simple X-ray to LVL25 for an MRI (magnetic resonance imaging).

Inpatients: For inpatient visits, the cost to the patient more than doubled. Each day in the hospital now costs LVL12. Up to LVL30 can be charged for surgery. There is a cap of LVL250 per event.

Other: Other reductions included specific changes that affected outlays by the insurance system, such as new rules on financing consultations in hospitals, the maximum amount the insurance system would pay for endoprosthetic devices (such as hip replacements), elimination of inpatient payments for psychiatric patients who could be managed in social care facilities, shifting cases to day beds, and so on.

LVL84 million for the second half of 2009 and about LVL169 for the full years of 2010 and 2011. For a brief period in June, it appeared that these cuts would be halved, but when the supplemental budget appeared, the original cuts were reinstated.

- *Exemptions:* The MoH eliminated the long copayment exemption list (ranging from pregnant women to politically repressed persons to Chernobyl victims to TB patients, and so on) and replacing it with an exemption for children under 18 and for households certified as needy (see discussion of ESSNS).
- *Negative List:* Latvia does not have a "positive list" benefits package; rather, it has a negative list of services not financed by the insurance system. A number of services were put on the negative list in the second round of cuts to reduce or eliminate the State subsidy.[37] Some "direct access specialists"[38] are still covered, and emergency services remain free to everyone.
- *Change in medical practice to less expensive approaches.* These changes include the use of less expensive antiretroviral drugs to treat AIDS patients, shifting second stage rehabilitation to outpatient care, shifting radiation therapy and cardiology services to a few central hospitals, and shifting chemotherapy and other inpatient services to day services, as appropriate.

- ***Reducing volume:*** By far the largest single contributor to cost savings is a reduction in the volume to be financed through contracts between the insurance agency and providers. A total of LVL103 million is to be saved in each of 2010 and 2011.[39]

3.2(b) Education

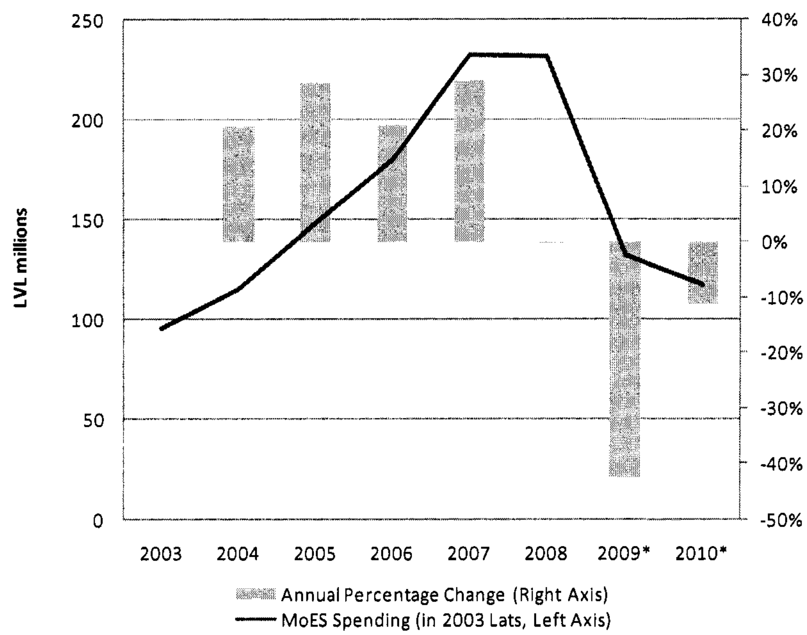
85. **In the education sector, structural reforms guiding the fiscal consolidation are designed to achieve greater administrative efficiency.** Expenditure reductions in the 2009 supplemental budget and sustained in 2010 and 2011, through reduced spending and increased teaching loads, reductions in teaching and non-teaching staff, consolidation of institutions and reduced outlays for materials, equipment and services.

[37] These include high-cost, low-use services such as elective endoprosthetic devices (a further limitation beyond that in the section on copayments above), positron emission tomography, and advanced diagnostics such as magnetic resonance imaging (for which the copayment increased to 50 percent of the cost). Specialist outpatient consultations were moved to the negative list and into the private market. If the exempt have a prescription from a GP they would still be covered. Everyone else pays 100 percent of the market price.

[38] Patients have direct access to specialists (without a prescription from their GP) for mental illness, TB, STIs, diabetes, cancer, gynecology, child dentists, and for emergencies.

[39] For institutions, the volume reductions translate into reduced employment, capacity utilization, and so on. It also creates the opportunity to consolidate services, leading to the reductions in beds and excess capacity discussed above. The negative result for patients is that the public sector now finances only primary care and outpatient services, subsidized pharmaceuticals, medical and dental services for those under 18, and emergency/acute inpatient care. People who are sick (or get sick), with either physical or mental problems that can put them in a hospital, continue to get care. However, all elective inpatient services have been stopped and specialist services for the average Latvian must be paid for directly.

Figure 10. State Budget Expenditure in the Education Sector, 2003 - 2010



Source: Latvian Ministry of Education and Science
Note: For 2009 and 2010 data are budgeted amounts

86. **The cornerstone of the Government's reforms in the sector is the shift away from financing inputs, toward a "*funds follow the student*", per-capita financing model** at the primary and secondary education levels, which is complemented with the transfer of greater responsibility over the allocation of education budgets to local authorities. The key features of the Government's education sector reforms are:

- ***Introduction of per-student financing for primary and secondary schools***, started in the 2009 academic year (from September 2009), is achieving the objectives of budget savings, more efficient deployment of teaching staff, and rationalization of the school network. Latvia's education system has excess capacity of school places and, especially, teachers. The problem of overcapacity is getting worse as the school-age population continues to shrink. The flexibility that comes through the per-student financing formula and lifting class-size and other constraints as part of the reform provides an opportunity for municipalities to better manage their schools. However, flexibility under the new policy also poses a risk. Some municipalities may avoid the hard choices of right-sizing and maintain existing schools and teachers, causing a sharp fall in teachers' earnings. Sustained declines in teacher earnings could threaten education outcomes by loss of the most competent teachers, failure to attract competent teachers in the future, and reducing the motivation of teachers who remain in the profession. There has been a major reduction in the total budget for teacher salaries in 2009 and 2010. In the first round of implementation prior to the start of the 2009 school year, municipalities have moved aggressively under the new policy to reduce the number of teachers and consolidate classes and schools. These measures absorb much of the excess capacity that characterized the system prior to the reform. In some cases, they may have gone too far,

imposing strains on education delivery that could threaten education quality: Some urban governments report excessive class sizes and classroom crowding – especially, at the secondary level; some small localities – especially, those with minority-language instruction – report that they have few options for school and class consolidation and thus are finding it difficult to maintain programs with the resources that they receive under the new financing formula.

- *Reduced Teacher Numbers:* The number of full-time teacher positions in primary and general secondary schools was reduced by 35 percent at the start of the 2009/2010 school year, from 38,309 in the prior school year to 24,858. This very sharp cutback led to a more-than 50 percent increase in the gross student/teacher ratio[40] -- from 6.2 in 2008/2009 to 9.5 in 2009/2010.
- *Rationalization of the school network:* Compared with the start of the 2008 school year, by September 1 2009, municipalities had closed 54 of the 948 primary and general secondary schools in the country and consolidated a much larger percentage of classes in primary and general secondary schools;[41] eliminated 13,451 budget teacher positions; dismissed 6,871 teachers; and reduced payments for overtime teaching.[42]
- *Teacher earnings:* Teacher earnings fell sharply in September, 2009 due to the reduction of the basic salary for a 21-hour workload from LVL 345 to LVL 255, the reduced number of paid overtime hours for teaching, and the suspension of payments for extra teaching-related work. These led to a 49 percent decline in average teacher earnings - from LVL 552 per month to LVL 281 per month.[43]
- *Sustainability and mitigation measures:* The sharp decline in teacher earnings raises questions of sustainability. For the immediate future, the MoES has proposed and the Cabinet of Ministers has agreed to mitigate risks to sustainability by raising the value of the transfer to municipalities for salaries by 37 percent starting January 1, 2010.[44] Under the new financing system, municipalities can choose how to allocate these funds. This action restores funding available for teachers' salaries to its level at the start of the 2008/2009 school year. In the medium term, MoES would like to further increase teachers' base salary in the context of a new full-time concept of teaching in which teacher compensation would be based on teaching outcomes (including student learning

[40] This figure is based on full-time teachers, and includes teachers who are working at schools in non-teaching functions.
[41] Statistics on the exact number of consolidated classes are currently being compiled from information provided by local governments.
[42] Prior to the reform, teachers were paid on average 36 percent more than their base salary for overtime teaching beyond the 21 lessons per week which comprise a standard teaching load. As of September, 2009, average payments for overtime teaching have been reduced to less than 10 percent of base salary. Reducing the number of hours of paid overtime teaching helped reduce the need for dismissing teachers.
[43] These figures reflect the decline in payments to teachers from the state budget. Some local governments in urban areas were able to reduce the impact of this reduction by using local revenues to supplement teacher salaries and to continue some payments for teaching-related work.
[44] Under the new policy of decentralized school management with per-student financing, this will take the form of a 37 percent increase in the per-student transfer to local governments for provision of primary and general secondary schooling.

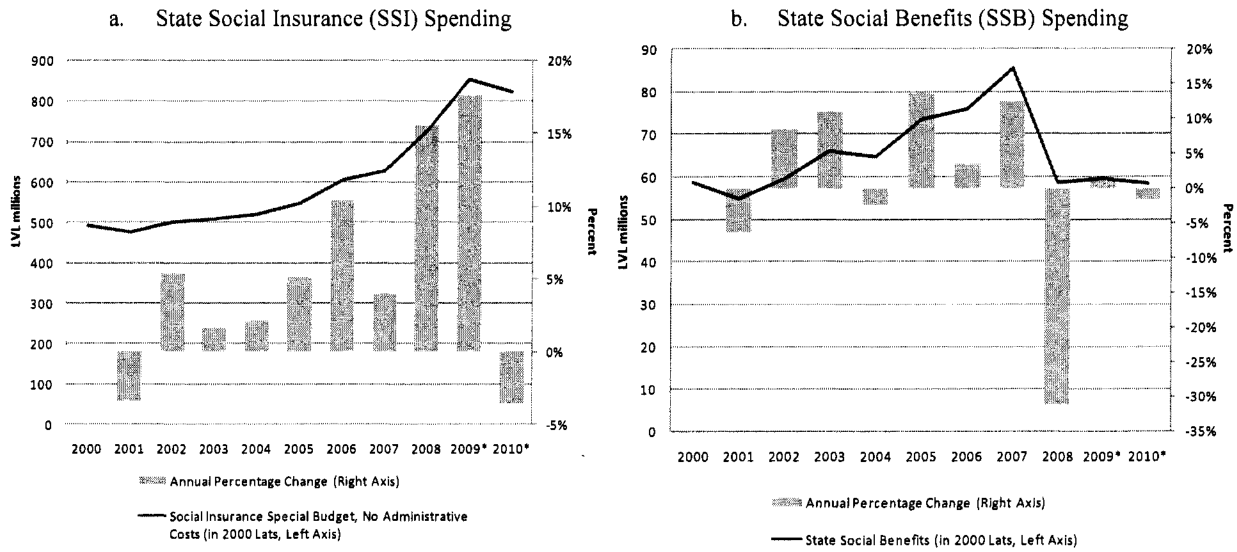
achievement) rather than teaching inputs (hours spent on teaching and various teaching-related tasks. The analytical and advisory assistance which is to be provided under the Program will help develop this new, output-based concept of the teaching profession.

- ***Reorganization of vocational secondary schools***. The Government is implementing a new policy of scaling down vocational education while strengthening the schools that remain in operation. It is moving towards consolidating management of vocational secondary and general secondary education which aims to bring vocational secondary education under the same financing and management process under which municipalities plan and deliver general secondary education. This change could help ensure that decisions affecting the use of vocational schools are subject to the same value-for-money assessment that is meant to guide municipalities' decisions in managing general education schools.
    - MoES has reorganized 9 vocational secondary schools, and reduced the level of financing per student. The Ministry is planning further changes which are designed to improve the efficiency and job relevance of vocational education. Among these is the conversion of 14 vocational secondary schools into multi-purpose regional competence centers. However, more fundamental changes in the process for financing and managing vocational schools are needed in order to achieve longer-term improvements in cost-effectiveness and labor-market relevance of vocational education programs.
- ***More extensive use of means-testing in allocating university student financing***. Budget outlays on higher education have been reduced by 50% -- from an actual budget allocation of LVL 81 million in 2008 and planned allocation of LVL 83.9 million in 2009 to LVL 42.3 million for 2010. These savings have been achieved mainly through a sharp reduction in financing per student university places – from LVL 3,124 in 2008 to LVL 1,866 in 2009. The allocation per student will decline further in the 2010 budget, to approximately LVL 1,500. As explained previously, many students who qualify for budget-financed university places would pursue the same courses even without a budget subsidy. At the same time, many low-income students who do not qualify for budget-financed places are deterred by high fees from pursuing higher education. MoES is improving the equity of spending on higher education by including household income among the criteria for budget financed places and strengthening targeting of scholarships to low-income applicants.
    - The budget reductions to date have led to increased teaching loads, larger class sizes, and consolidated management across and within higher education institutions and higher education programs.
    - To improve equity of access to higher education, budget-financed places are now being awarded on the basis of social need as well as student achievement. Means-based targeting of scholarships is being strengthened: 88% of scholarships in Rezekne University and 50% of scholarships in Daugavpils University this year were awarded on the basis of low household income and other social criteria rather than performance.

3.2(c) Social Protection

87. **In social protection, the Government's structural reforms are designed to help restore the long term financial solvency of social insurance and state social benefit programs.** Building on the achievement of Latvia's structural pension reform in 1996, and consolidating overlapping social insurance and state social benefits, reforms will help reverse the rapid growth of spending in recent years; and stabilize and reorient expenditure to prepare the safety net to meet the increasing needs of households in the wake of the economic contraction.

Figure 11. State Expenditure on Social Insurance and State Social Benefits, 2000 - 2010



Source: Latvian Ministry of Welfare

Notes: 1. For 2009 and 2010 data are budgeted amounts, rather than actual expenditure. 2. The large drop in State Social Benefit (SSB) spending in 2008 also reflects the transfer of a benefit category to the State Social Insurance (SSI) budget – "parental benefits" paid to households making national insurance contributions were paid from the SSI budget starting in 2008. The same benefit category paid to households who do not make contributions, is still paid from the SSB budget.

88. To achieve the fiscal consolidation targets, the Government's key social protection reforms are:

- ***Reduction of early retirement pensions*** from 80 to 50 percent of the normal retirement pension benefit, effective 1 July 2009.
- ***Suspension of pension indexing in 2009 and 2010, and elimination of future wage-indexing of pension benefits.*** In 2009, pensions were not indexed at all. In 2010 indexation is also frozen. After 2010 retirement benefits will be indexed to inflation only. MoW estimates reforming pension indexing saved LVL 13.5 million in 2009 and will generate considerable savings over a 20 year horizon.[45]
- ***Pension cuts.*** The 2009 supplemental budget cut old age and service pensions by 10 percent and those of working recipients by 70 percent. The pension benefit cuts are temporary, effective 1 July 2009 until 31 December 2012 and subject to review every 6

[45] MoW projections show indexation reform yields annual savings of 0.2% of GDP in 2010 and 2011, which gradually increase to 0.4% of GDP in 2018 and to 0.7% of GDP in 2030.

months. In December 2009, however, Latvia's Constitutional Court declared these cuts "unconstitutional". The Government is planning to restore full payment of pensions from 1 February 2010.[46] [47]

- ***Temporary diversion of contributions from the funded pension pillar.*** From 2009 to 2010, the contribution rate to the funded pension pillar was reduced from 8 percent of a worker's salary to 2 percent. In January 2011, the contribution will be raised to 4 percent, and in January 2012 to 6 percent. After 2011, contributions to the private pillar remain at 6 percent. Prior to the amendment, the contribution was to rise to 10 percentage points in 2011. The Government believes this temporary infusion is necessary to (i) avoid cuts to pensions in payment; and (ii) to eliminate the need for transfers to the social insurance budget from general revenues to make up for the fall in contribution revenue as unemployment rises (see section 2.4(c)).
- ***Reduction in sickness and work injury benefits.*** The maximum period of sickness and work injury benefit has been reduced from 52 to 26 weeks. MoW estimates the reduction in sickness benefits saved LVL 3.9 million in 2009 (with projected annual savings of 0.1% of GDP to 2030) and that reduced work injury benefits saved LVL 0.04 million (with negligible further projected annual savings).
- ***Reduction in parental benefits of working parents by 50 percent in 2009*** and elimination of these benefits for working parents for children born May 3, 2010 (from this date, benefits will be limited to children unemployed parents). This measure effectively eliminates overlapping benefits paid as state social insurance and State Social Benefits (i.e. the same need covered by both parts of the system), and has led to savings of LVL 2.85 million in 2009.
- ***Proposed increase of the retirement age, from the current 62, to 65***, in annual increases of 6 months, starting in January 2016. The MoW expects this increase to save 0.1 percent of GDP in 2016, for the savings to rise to 1.3 percent of GDP in 2022, and then to stabilize at 0.5 percent of GDP in 2030.[48]

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[46] Prior to the court's ruling, Bank staff advised against the differentiated treatment of pensions of retired and working people. The deeper cut in the pensions of working recipients was unlikely to have the expected fiscal impact. There is no good *a priori* rationale for treating the pensions of working people differently from those of people who are economically inactive. Indeed, given the rate at which Latvia's population is aging, and the importance of encouraging longer working lives, the measure would have imposed an economic cost. In the short run, the differentiated cut in pensions creates strong incentives for older people to withdraw from the labor market that could substantially reduce the savings expected from this measure. Experience from other countries suggests that the labor market participation of older workers is precarious: once they withdraw they are slow to return. Many could simply switch from formal to informal employment, reducing contribution revenue to the system. Discouraging older people from working will be detrimental and raise the cost of labor unnecessarily, particularly as the economy starts to recover. Treating working pensioners differently is also more likely to create a political constituency to challenge the constitutionality of the measure.

[47] The Bank team's simulations showed that this cut would have raised the post-crisis poverty rate from 20.2 to 21.4 percent of the population. It also would have lead to a small increase in the poverty gap and the Gini coefficient. However, a crucial assumption of the simulation is that active pension beneficiaries do not leave the labor force. Given the large cut in the pensions of working pensioners, the more likely outcome would have been that recipients would leave the labor force to receive their full pension, albeit 10 percent less than before the policy change.

[48] The Bank team and its program partners are discussing with MoW whether the starting date for the phased retirement age increase can be brought forward. During preparation of the first loan in the proposed program, the

3.3. FISCAL CONSOLIDATION AND THE PUBLIC ADMINISTRATION REFORM PROGRAM

89. **The Government's reform of public administration focuses on strengthening information management, streamlining core activities, and improving the operational efficiency and transparency of SOEs.** The Government's objective is to consolidate functions in order to arrive at a leaner public sector - possibly up to 30 percent smaller than today - as well as to move toward a professional, de-politicized, motivated and integrated civil service. In the past year, the Government has attempted to address high staffing, and by January 1, 2010, aims to have a total number of personnel in central government bodies less than or equal to the corresponding numbers in central government offices of Estonia and Lithuania. From the start of 2010 the number of staff employed in central offices of government ministries will be reduced by 30.37 percent as compared to July 1, 2008.

90. The reforms so far however are mostly linked to the consolidation of personnel management, internal audit and accounting functions and tasks in the central offices. This has led to a reduction of expenditures (i.e. improving the coherence of programs), the reduction of the use of different IT platforms, and reduction of redundant and duplicative activities. The key features of the Government's reforms are:

- ***Civil service wage decreases.*** A first round of wage reductions took place in January 2009. Wages were reduced using a sliding scale: salaries below LVL 300 a month were cut 15 percent, and the reductions increased in percentage terms for higher paid staff corresponding to staff grades and levels.[49] A second round was passed with the 2009 supplemental budget in the summer of 2009. Since August 2009 there has been a 34 percent decrease in public sector remuneration and a 33 percent decrease in wages and salaries.
- ***Reduction in government agencies.*** The Government is also eliminating and redistributing administrative functions. Since the start of 2009, there has been a 50 percent reduction in the number of agencies and a 30 percent reduction of staff.[50] To help inform the consolidation of government agencies, a functional classification of all administrative functions of the budget has been developed, which lists the financial burden for each function in all budget institutions. The functions are also rated by state institutions, unions and social partners and civil society on their relevance.[51] During

World Bank's Pension Reform Options Simulation Toolkit has been calibrated to compare simulations with the MoW model. This discussion will be central in preparation of the second loan, although the authorities have pointed out the difficulty of legislating a retirement age increase close to general elections in October 2010.

[49] Regulation 955 on remuneration will be amended to reflect this change. This second round of public sector salary cuts differs from the first round effective in January 2009, which was an overall decrease of 15 percent that budget institutions received for wages. Which staff received those cuts and at what levels was left to the discretion of management of those institutions.

[50] Structural changes include abolishing ministries' daily management of particular entities (e.g. museums, schools, sport facilities, libraries) while delegating daily management functions to local governments or other public bodies (e.g. universities). Other structural measures include consolidating support functions by creating specialized service centers for accounting, budget planning, internal audit, information and document management (as in Estonia), as well as redistributing functions among ministries, reducing duplications and concentrating similar functions under one ministry.

[51] The methodology is based on the United Nations classification system COFOG.

meetings of the Cabinet of Ministers the Government is now able to review these functions and take informed decisions on where cuts can be made.[52]

- ***Strengthening management of the civil service database linked to pay-roll and planning functions***. MoF has taken measures to instill basic discipline in the budget regarding information availability and accessibility of establishment control data (civil service numbers and statistics) and wages and remuneration.[53] The MoF is now collecting this critical information on a monthly basis from state budget institutions, where previously the data were only collected once every six months. The Ministry manages both the civil service database as well as its own database on remuneration, and inputs information as it is sent by budget institutions. A draft law (pending Cabinet of Ministers approval)[54] will mandate that the two databases administered by MoF be merged, and will require state budget institutions to input the information themselves on: (i) number of employees; (ii) remuneration; and (iii) wages directly into the system which can be monitored by MoF.
- ***Curtailing discretionary salary arrangements.*** The Government has taken measures in the past year to address flexible salary allocations which were determined in a discretionary manner. So called "management contracts" which were salary awards based on performance were initially introduced to retain qualified civil servants in the system, but ultimately were used on a discretionary basis and awarded by the head of the institution, in many cases not linked at all to performance. Following a long-standing recommendation by international organizations the Government abolished these management contracts.
- ***Increasing the efficiency and transparency of state owned enterprises.*** The Governments efforts include establishing criteria for the maximum remuneration for SOE management; establishing procedures to determine turnover, the balance and number of SOE staff; establishing professional criteria and selection procedures for SOE board members, and initiating a review of current board members against these criteria.

3.4. THE EMERGENCY SOCIAL SAFETY STRATEGY

91. **Underpinning structural reforms, the Government has passed an Emergency Social Safety Net Strategy.** This will ensure critical social services are maintained and the impact of the economic contraction on households is cushioned as structural reforms are carried out. The strategy finances and coordinates the efforts of national and local government agencies to: (1) maintain pre-primary education and child development programs for 5 and 6 year old children; (2) cover the costs of transporting students from communities where schools have closed to their new places of instruction; (3) exempt needy households from health service co-payments; and

[52] The intention of this approach is, to the extent possible, to depoliticize the process of consolidation by providing as much objective information and international benchmarking as possible. As an example of the outcomes of this process, the Ministry of Foreign Affairs considerably reduced its expenditures as it closed down several of its embassies..
[53] Total remuneration for public administration workers includes monthly base wages/salaries, supplements and bonuses according to the budget expenditure classification. Remuneration also includes employer taxes, state mandated social insurance contributions, allowances, as well as compensation for health, life and accident insurance.
[54] "Database for Remuneration on State Budget Institutions," (*Noteikumi par no valsts budžeta finansējamo institūciju darbinieku darba samaksas un ierēdņu amatu vienotās uzskaites sistēmu*)

(4) subsidize their pharmaceutical costs; (5) sustain and improve general practitioner (GP) and primary health care (PHC) services and access; (6) increase the coverage and pay-out period of unemployment insurance; and (7) increase the coverage and amount of targeted social assistance benefits administered by local governments. For the growing number of unemployed who are not covered by unemployment insurance or other social support, the Government has (8) fortified the Emergency Social Safety Net by expanding and rapidly deploying labor-intensive emergency public-works programs.

3.5. GOVERNMENT'S CONSULTATION

92. **The Government has made significant efforts to consult with stakeholders affected by the fiscal consolidation, but more could be done to improve the public's understanding of the need for reform.** Each line minister has held discussions with stakeholder groups. According to Latvian law, reform proposals have been published in draft online, and social partners have been invited to participate in policy debates. Discussions between the teachers unions and the Ministry of Education and Science have been particularly heated, with unions calling repeatedly for the resignation of the Minister. The Prime Minister has required all ministries to publish budget amendments on their web pages. The Bank team has accompanied government consultations with non-government organizations representing constituents affected by the fiscal consolidation and structural reforms. In addition to the teacher unions, the Government has consulted with the Union of Medical Professionals, the Hospital Owners Association, and the Local Government Association.

93. **Consultation discussions have been difficult but frank, given the extraordinary macroeconomic context in which social sector and public administration reforms are taking place.** There is broad understanding of the circumstances that lead to Latvia's economic contraction. However, there is still widespread misinformation about the rationale behind and objectives of reforms. Each group is insistent on minimizing the burden of the fiscal consolidation and structural reforms on their particular constituency. The Government and the Bank team have explained the rationale behind and expected medium term benefits that will arise from reforms. At the same time, the team has drawn valuable input on how best to target safety net support to cushion the impact of structural reforms on vulnerable households.

94. **To increase public information and transparency, the proposed operations include key actions to publicize the activities and performance of the Government.** For the first operation in the program, a critical prior action is that the Government publishes its Emergency Social Safety Net Strategy on the internet and in the local media. This action is key to help increase the level of public awareness of the measures the Government is taking to lower the social costs of fiscal consolidation and the economic crisis. For the proposed second operation, the Bank task team is partnering with the State Audit Office of the Republic of Latvia to conduct an audit of implementation of structural reforms and the Emergency Social Safety Net Strategy, as a complement to the Bank's own program supervision responsibilities. As with all of SAO's reports, the audit report will also be published on the internet.

IV. BANK SUPPORT TO THE GOVERNMENT'S PROGRAM

95. **This is the first of a proposed program of two SDPLs focused on Safety Net Support and Social Sector Reform.** The Bank program is an integral part of the international rescue package of the IMF, EC, EBRD, Nordic countries, and other lenders. The total rescue package amounts to €7.5 billion, of which the Bank's share is €400 million. The Financial Sector loan was for €200 million. The proposed first SDPL operation in the Safety Net Support and Social Sector Reform program represents €100 million. The second SDPL would be for the last €100 million of World Bank support. The IMF operation was approved on December 23, 2008 and the EC operation on January 20, 2009. The Bank team has collaborated very closely with the Fund and EC teams, and discussed complementarities and mutually supportive measures.

4.1. LINK TO COUNTRY PARTNERSHIP STRATEGY

96. **Latvia joined the World Bank in 1992, and graduated from Bank financing in 2007.** As a borrowing member, it received analytical and advisory support and loans totaling US$416 million for 19 operations that have supported Government actions to implement structural reforms, improve public finance management, modernize the welfare system and the health, education, and infrastructure sectors, and reduce pollution in the Baltic Sea. The last Country Assistance Strategy for 2002-2005 was launched during the period when Latvia's overriding objective was to prepare for accession to the European Union—a goal which was achieved in May 2004. The Government of Latvia requested the Bank to support priority areas which were not covered by the EU's *acquis communautaire*. As a result, the CAS focused on assisting Latvia's efforts to improve productivity growth, public sector reform, development outside the capital, and social sector reform. The six lending projects under this CAS closed with satisfactory outcomes. Upon graduating from Bank financing, Latvia became a donor to the International Development Agency (IDA) of the World Bank Group during the 15th replenishment of IDA.

97. **Since graduation from the World Bank, Latvia has made full use of the limited free technical assistance and entered into a technical cooperation agreement on a fee-for-service basis in the area of climate change**. The Bank provided technical assistance to the Government to help promote development in lagging rural regions, manage public finances strategically through medium-term budgeting, and develop a public-private partnership framework. At the request of the MoF, a Public Expenditure Review (PER) was conducted jointly with the IMF in 2007. The recommendations from this review are informing the social sector reforms being undertaken by the government today, and technical assistance is being provided to update the PER to inform possible further measures in the second part of the lending program. Finally, under the fee for service agreement on climate change, the Bank supported the Ministry of Environment's efforts to implement a pilot greening program financed by revenues from international emissions trading.

98. **The global financial crisis led to an exceptional request by the Government of Latvia for renewed access to World Bank lending resources**. The proposed program of operations is consistent with the Bank's Articles of Agreement. Pursuant to Article III, Section 4 (ii), the Bank may make loans to any member country, subject to Board approval, if "[it] *is satisfied that in the prevailing market conditions the borrower would be unable otherwise to*

obtain the loan under conditions which in the opinion of the Bank are reasonable for the borrower." In this case, the Bank is satisfied that, in the prevailing market conditions, Latvia would have been unable to otherwise borrow under reasonable terms, as confirmed by the very high prevailing CDS rates for Latvia since the beginning of the crisis. The crisis has exposed underlying macro-vulnerabilities, and the deep economic contraction that followed left Latvia with significant borrowing needs and constrained access to external financing on reasonable terms.

4.2. RELATIONSHIP TO OTHER BANK OPERATIONS

99. **Prior to graduating from World Bank borrowing, the Government of Latvia maintained an active series of projects with the Bank.** The proposed program draws heavily from the Bank's earlier portfolio of investment, technical assistance, and adjustment operations as well as AAA. Structural reforms to social protection in the 1990s were supported with resources from the Latvia Welfare Reform Project, which closed with a highly satisfactory rating in 2003. The objective of the project was to support the development of a more efficient and effective social welfare system. The Latvia Health Reform Project - approved in 1998 and which closed in 2001 with a satisfactory outcome - supported Government implementation of a health services restructuring strategy. The Education Improvement Project helped to increase capacity within the Latvian education sector for continuous improvement of education outcomes by strengthening the management of both resource and inputs and the learning process. The project was approved in 1999 and closed in 2004 with a satisfactory rating. Finally, an ongoing process of public sector modernization and improvements in service delivery in Latvia has been supported with World Bank adjustment operations. In 2000 the first Programmatic Structural Adjustment Loan and in 2002 the Second Programmatic Structural Adjustment Loan, supported reforms in the areas of public sector management, human resources management, and privatization and regulation of public utilities, and private business, respectively.

100. **However, the investments made during this period failed to be fully exploited after Latvia acceded to EU membership, leaving a legacy of pending reforms that has been taken up in the proposed program.** With World Bank assistance the Government invested heavily in the design of technically difficult reforms in the social sectors, the development of strategies for rationalizing service provision, and achieving greater efficiency in public administration. In several cases, however, these plans were set aside during Latvia's years of high growth, as the fiscal constraint required to create a political consensus in favor of their implementation was loosened. A lesson that could be drawn from this experience is that continued engagement is important to sustain the Government's reform efforts, even when the relationship between Latvia and the World Bank has moved beyond borrowing.

101. **As part of the current international program of support for Latvia the Bank approved a Financial Sector Development Policy Loan on September 22, 2009.** The Financial Sector DPL, which disbursed on November 4, 2009, supports a comprehensive financial sector reform program, including: short term measures aimed to contain the financial sector crisis, and long term structural reforms aimed to enhance the resilience of the system to future potential shocks. The short term crisis management measures include measures to strengthen the banking sector's solvency and liquidity, as well as measures to facilitate the renegotiations of corporate and mortgage debts with the objective to avoid the closure of viable

firms and the foreclosure of residential properties wherever possible. The long term structural reforms include strengthening critical banking sector regulations, including asset quality and capital adequacy regulation, strengthening prudential supervision, especially through the adoption of a Prompt Remedial Action Plan by the supervisory authority, and conducting a consumer protection review.

4.3. ANALYTICAL UNDERPINNINGS

102. **As rapidly growing macroeconomic imbalances began to become apparent, the Government asked the IMF and World Bank to conduct a public expenditure review (PER) in the summer of 2007, which has served as the analytical foundations of the Government's program.** The review examined public investment and outcomes in the social sectors and public administration, and identified a number of critical structural reforms. The sector analytical background presented in this document draws heavily from the 2007 PER. The report was discussed extensively in the Government during 2008. The MoF and the line ministries have for the most part modeled their structural reforms on the recommendations of the 2007 PER.

V. THE PROPOSED SPECIAL DEVELOPMENT POLICY LOAN

5.1. PROGRAM OBJECTIVES

103. **The Safety Net Support and Social Sector Reform Program focuses on measures to mitigate the social cost of fiscal consolidation, ensure a robust safety net for households affected by the crisis, and opportunities to improve public administration.** This is the first of a proposed program of two loans focused on Safety Net Support and medium term social sector expenditure reform. The objectives of the proposed program are: (i) to protect vulnerable groups with emergency safety net support during the economic contraction; (ii) to mitigate the social costs of fiscal consolidation; and (iii) to ensure structural reforms lay a foundation for medium term improvements in the social sectors. Given the deep impact Latvia has suffered in the wake of the global crisis, and due to the emergency nature of this proposed program, the first operation will focus mainly on the first and second objectives. The second operation will expand this focus to the third objective.

104. **The proposed operation will focus on measures designed to mitigate the social impact of fiscal consolidation, and the implementation of the Government's cross sector Emergency Social Safety Net Strategy.** As structural reforms are implemented, the Government is also committed to alleviating the social costs of the transition to new financing and service delivery models in the education and health sectors, in order to ensure an adequate level of service provision is maintained across the country. Moreover, in the context of the current economic contraction and high levels of unemployment, this commitment extends to strengthening the safety net to respond to the immediate needs of vulnerable households. The Government has developed and approved an Emergency Social Safety Net Strategy (ESSNS) to finance essential services and benefits delivered by national agencies, and locally by municipal governments. The ESSNS came into legal effect on October 1, 2009.

105. **The Emergency Social Safety Net Strategy underpins fiscal consolidation and structural reforms by deploying supplementary support to ensure basic social services are maintained.** The strategy finances and coordinates the efforts of national and local government agencies to: (1) maintain pre-primary education and child development programs for 5 and 6 year old children; (2) cover the costs of transporting students from communities where schools have closed to their new places of instruction; (3) exempt needy households from health service co-payments; and (4) subsidize their pharmaceutical costs; (5) sustain and improve general practitioner (GP) and primary health care (PHC) services and access; (6) increase the coverage and pay-out period of unemployment insurance; and (7) increase the coverage and amount of targeted social assistance benefits administered by local governments. For the growing number of unemployed who are not covered by unemployment insurance or other social support, the Government has (8) fortified the safety net by re-allocating financing from the European Social Fund (ESF) to expand and rapidly deploy labor-intensive, emergency public-works programs.[55]

5.2. MEASURES SUPPORTED BY THE FIRST SDPL & INDICATIVE TRIGGERS FOR THE SECOND (see Annex 2: Policy Matrix)

106. **The Bank's program supports deployment of emergency safety net measures and critical reforms to strengthen Latvia's social sectors.** The first loan in the program is designed to ensure adequate emergency safety net financing for education and health services, and social protection programs to mitigate the impact on households of fiscal adjustment and the economic contraction. The Government has taken specific actions to monitor the performance of national and local agencies as they implement the ESSNS to ensure the strategy is responding to household needs. Furthermore, the program is designed to increase public awareness, transparency and accountability of Government measures in the social sectors.

Prior actions for Loan 1	Indicative Triggers for Loan 2
• **The Borrower's Cabinet of Ministers approved an Emergency Social Safety Net Strategy for the period from October 1, 2009 through December 31, 2011 on September 8, 2009 (Protocol No. 56, 78§).** • **The Borrower has published the Emergency Social Safety Net Strategy on the internet, and in local media on December 21, 2009.** • The Borrower has provided adequate resources for and put in place a performance monitoring and impact evaluation plan, making use of existing monitoring mechanisms, administrative data, and surveys	• National and local government agencies are satisfactorily implementing Emergency Social Safety Net Strategy (according to details in each section below), maintaining adequate financing in 2010 and 2011. • The Borrower has submitted regular performance monitoring reports to the Cabinet of Ministers and published them on the web page of the Ministry of Regional Development and Local Government. • An independent audit of the Government's performance in implementing the Emergency Social Safety Net Strategy is being conducted

107. **In the health sector, the Government will strengthen GP and PHC services, provide supplementary financial protection, and maintain services for needy households.** The 30 percent reduction in spending for health services accomplished in one year and now expected to persist for at least two more years allows Latvia to make needed structural changes in its

[55] Being an ESF financed program, the new emergency public works must comply with certain legal requirements - it needs to be implemented, monitored, audited and evaluated within the legal framework of the Structural Funds management - in accordance with Council Regulation No 1083/2006, Council Regulation No 1081/2006 and the Commission Implementing Regulation No 1828/2006.

spending. But the policy response to this precipitous decline in public funding has put households at greater risk financially and – with access to care more problematic – at greater risk to health as well. Latvia already in 2005 had the highest out-of-pocket spending in the EU, with 39 percent of health spending coming directly from households. In developing its safety net program, the MoH sought to attenuate both types of risk for the most vulnerable while at the same time using the safety net program to support needed medium term structural changes in its budget. For the MoH, these programs add back approximately LVL24 million (out of LVL150 cut from 2008 spending) focused primarily on needy households. The key prior actions for the first loan, and triggers for the second loan are:

Prior actions for Loan 1	Indicative Triggers for Loan 2
• **The Borrower provided for an additional public health nurse for approximately half of the general practitioners and primary health care providers in the emergency social safety net and financed it fully in the 2010 budget pursuant to the Cabinet of Ministers Regulation No. 1630 dated December 22, 2009.** • **The Borrower allocated in the 2010 budget funds for households with per-capita income less than half the minimum wage, at adequate levels, to finance: (a) an exemption from co-payments for general practitioner, outpatient, specialist, and inpatient services; (b) an exemption from pharmaceutical charges above LVL 50 per year per person; and (c) an exemption from the cost of overnight hotel stays in hospitals, home care for those with serious diseases and day-care centers for those with mental diseases.**	• The Borrower has incorporated improvements to the program suggested by its evaluation and has prepared a plan for further strengthening GP/PHC services in the 2011 budget. • The Borrower has incorporated improvements to the exemption program, informed by an evaluation of its performance since October 2009 and fully funded the revised program for 2011.

108. **In the education sector, the operation will support measures to sustain critical services as the new per-capita financing model is implemented.** The main elements of the ESSNS in the sector are the safeguarding of financing for pre-primary programs for 5 and 6 year old children. International evidence consistently shows that pre-school education performs a vital role in improving the learning opportunities for children at risk. The Government's decision in 2005 to make preschool education free and mandatory for five-and-six-year-old children was a positive development in terms of long-term learning outcomes. The mandatory pre-primary program has strong effect in equalizing preschool attendance across income groups. Analysis suggests that the subsidy of pre-school provision has had a strong impact across the country and across income groups that could otherwise be at risk. Further, the proposed lending operation supports the provision of transportation subsidies for students who need to travel to a new place of instruction due to the consolidation of the school network, and protection for means-based aid to university students. The key prior actions for the first loan, and triggers for the second loan are:

Prior Actions for Loan 1	Indicative Triggers for Loan 2
• **The Borrower allocated funds in the 2010 budget for pre-primary education/child development programs for children starting 5 years of age** • **The Borrower allocated in the 2010 budget funds to cover the cost of transportation of students whose schools have closed to replacement schools** • **The Borrower added into the Regulation of the Cabinet of Ministers No. 740, dated August 24, 2004 social considerations, in addition to merit, to the awarding of state support to students in higher education by issuing a Regulation of the Cabinet of Ministers No.511 dated June 2, 2009.**[56]	• In 2011 budget, the Borrower has allocated adequate financing for pre-primary education/child development programs for children from the age of 5 years old. • In the 2011 budget, the Borrower has allocated adequate financing to cover the cost of transporting students whose schools have closed to replacement schools.

109. **In social protection, the operation will support reforms to increase coverage of social assistance, and better target spending to the most vulnerable households.** Early in 2009, the Government extended the pay-out period of unemployment insurance benefits, and adjusted eligibility criteria to ensure that a larger portion of workers at risk of losing jobs were covered by the social insurance system. For the unemployed not covered by unemployment insurance, the Government has reallocated ESF financing to support emergency public works programs, designed to be self targeting (see box on the Workplaces with Stipend public works program). Furthermore, the Government increased the level of the GMI, raising the size of benefits paid and the number of vulnerable households who can receive benefits. To ensure that local governments have sufficient resources to cover the rising demand for targeted social assistance benefits, the Government put in place financing guarantees to supplement municipal spending on GMI. In the second phase of the operation, most of the measures supported in the social protection sector, will ensure that the needs of poorer households continue to be met, and that resources are available to deploy additional assistance for people suffering losses from the economic contraction. Further measures are planned to strengthen contributory and non-contributory social protection in the longer term.. Key prior actions for each phase of the Bank's support are:

Prior Actions for Loan 1	Indicative Triggers for Loan 2
• **The Borrower enacted an amendment to the Law "On Insurance in Case of Unemployment" effective as of July 1, 2009, which extends the pay-out period of unemployment benefits to 9 months, effective until December 31, 2011, which, inter alia, provides for a decrease in the eligibility requirement for unemployment benefits to 9 months of contributions in the previous 12 months.** • **The Borrower: (a) enacted an amendment to the Regulations of the Cabinet Ministers No. 1070 dated October 1, 2009 and No. 1489 dated December 1, 2009 to increase the Guaranteed Minimum Income (GMI) benefit amount to LVL 40 per adult and LVL 45 per child in a household; and (b) allocated financing in the 2010 budget of, at least, 50 percent of the cost of the GMI from state funds, with local governments funding the other 50 percent.**	• The contribution rate to the funded pension pillar has been raised to is 6 percent of a worker's salary starting from January 1, 2012. • In the 2011 budget, the Borrower has financed at least 50 percent of the cost of the Guaranteed Minimum Income from State funds, with local governments funding the other 50 percent. • The Borrower has prepared an evaluation of how uniform standards of coverage, targeting, benefits, and financing of municipally administered, mandatory social assistance programs are implemented across local governments, based in part on an evaluation of the experience under the Emergency Social Safety Net Strategy.

[56] Social considerations include low family income, disability or handicap, large number of siblings, etc.). For potential students of equal academic merit, social considerations will prevail.

Prior Actions for Loan 1	Indicative Triggers for Loan 2
• **The Borrower introduced amendments to the Cabinet of Ministers Regulation No. 166, dated July 14, 2009 to provide temporary employment for the unemployed not covered by unemployment insurance effective as of August 8, 2009**	

Box 1. Latvia's New Workplaces with Stipend (WWS) Emergency Public Works Program

The design and roll-out of the new *Workplaces with Stipend* (WWS) public works program has been impressive. The design meets or exceeds international best practice for income support programs with a work requirement. Individuals who have lost their job but are not covered by unemployment insurance are eligible to apply. Each of Latvia's regions is assigned a specific number of program places according to the number of likely unemployed not covered by unemployment insurance in that region.

Participants have to work full time, are employed in labor-intensive tasks, and receive a monthly stipend of LVL 100, 55 percent of the legal minimum wage. A low benefit rate has been shown internationally to achieve the goal of "self targeting", i.e. attracting low skilled unemployed people, which makes the programs more effective at reaching those who need support the most and are able to work. Further, by requiring daily, full-time commitment to work, the program keeps participants active without impinging their incentives to continue looking for employment. Finally, market employers respond positively to the discipline and responsibility demonstrated by an individual's past participation in this sort of program.

At the start of November 2009, there were more than 16,000 work places registered in the SEAs and almost 14,000 people were participating in the WWS. The target of 17,000 WWS participants for 2009 is very likely to be reached. Furthermore, municipalities expect the number of work places to increase in the spring, summer and autumn of 2010. Although not a firm estimate, it is expected that a further 10,000 work places can be created by municipalities under the existing guidelines of the program in 2010 bringing the total number of work places to 27,000, which would mean spending all the resources currently allocated to the program from the ESF. Notably, about 10 percent of those who entered the program have already left for other job placements. About 2400 unemployed people who sought to join the program turned down the opportunity to participate. This could be evidence that the "self targeting" features of the program are working.

The program has been over-subscribed. About 26,000 people are waiting for workplaces. But as time passes and both the national and local authorities get practice at implementing the program, the cues will diminish. Local governments have been sharing experiences of the type of work they have managed to create that fits within the rules of the current design, particularly as the onset of winter limits the type of labor intensive work that can be created.

However, controversies continue over allowing municipal-owned agencies and businesses to take advantage of the free labor supplied by this program. Allowing state and municipal-owned enterprises to take in WWS participants would create strong budget incentives for these employers to dismiss workers to whom they pay the minimum wage. If the program automatically wilts as economic conditions improve – both because workers abandon it for better jobs and because no constituency has been built up to try to keep the free labor – this will be a mark of success. If hospitals or municipalities lobby to keep the program because they need the work done, then they will have failed in designing the program only to complete one-off activities that are not needed for everyday operation of an existing program. This program is adequately funded for 2010 in the ESSNS.

For the longer term, the Government is carrying out an important reform of ALMPs by increasing competition among training providers and the quality of training received by introducing vouchers into the employment training program.

5.1. ANALYTICAL AND ADVISORY ASSISTANCE

110. **The proposed lending program is accompanied with technical assistance to the Government in social sector and public administration reform.** The Bank has limited technical assistance resources, which are being deployed according to the following strategic priorities (in order): to provide the technical input needed (i) to design and implement their ESSNS; (ii) to monitor and (where appropriate) evaluate the impact of ESSNS measures; and (iii) to evaluate the state of the public expenditure program in 2010 in light of the extraordinary adjustments that have taken place in 2009 and to assist the Government in making strategic decisions as further adjustments will be required in 2010 and 2011.

111. **Consistent with the strategic priorities above, a program of analytical work will be conducted by the World Bank team that could identify further structural reforms.** Technical assistance during the preparation of the proposed first SDPL has focused on design and implementation of the ESSNS. In the interim between the two lending operations, the Bank task team will continue to provide technical assistance to help the Government monitor and evaluate its safety net response, and to update the 2007 PER of the social sector and public administration. This investment of technical assistance could identify further structural measures to improve efficiency and efficacy for possible inclusion in the second policy loan.

TA Activity Area	Deliverable
1. Poverty and social impact of Latvia's economic contraction: Simulation analysis of selected macroeconomic and social policy scenarios, taking into account government responses and household coping strategies using the crisis response survey module added into the quarterly Labor Force Survey[57]	PSIA for SDPLs 1 and 2; Technical note
2. Labor market adjustment to the contraction in Latvia: Who is impacted the most, and how?	PSIA for SDPLs 1 and 2;
3. Social sector spending at the local level, and a review of Latvia's municipal revenue equalization structures, covering municipal spending on wages and social service delivery	Technical note
4. International best practice for design, roll out and monitoring of emergency safety net programs to ensure essential social services during crises (all social sectors)[58]	Technical note
5. Earnings of teachers and medical workers: European and international comparative analysis	Technical paper
6. PER update education sector: Education sector review of budget reductions; assessment of local government school network rationalization decisions under new financing model; development of new career concept, performance standards, and compensation scheme for the teaching profession consistent with "output-based" financing model; support for developing a more modern results-based approach for vocational education; greater progressivity in distribution of university student financing.	PER-style and format technical note
7. PER update health sector: Health sector review of budget reductions; assessment of implementation of hospital bed/network consolidation and other health sector structural reforms to treatment incentives.	PER-style and format technical note
8. PER update, social protection: Social insurance and social assistance review of budget reductions; PROST simulations of pension reforms to date, and likely further measures (specifically, retirement age increase) and restoration of contributions to the funded pillar of individual accounts; spending, distribution and administration of universal social assistance benefits and income-tested social assistance benefit's since increase safety net reforms (updated survey analysis); assessment of targeting errors (type 1 and 2) and administrative issues in municipally administered social assistance.	PER-style and format technical note
9. PER update, public administration: Review/assessment of public sector wage reductions and dismissals; consolidation of administrative functions; likely impact of establishment control and civil service compensation reform measures.	PER-style and format technical note

[57] Staff initiated contact with Central Bureau of Statistics (CBS) to request adding a Crisis Response Survey module to the continuous Labor Force Survey, based on other Crisis Response Surveys ECSHD has led in other crisis-affected countries.

[58] Bank staff have continued to provide technical assistance to the Government on specific aspects of the Emergency Social Safety Net Strategy, and how to ensure that monitoring and impact evaluation plans are thought through and in place. One option is for the Government to add crisis/emergency safety net module to the continuous Labor Force Survey. The TA also includes sharing of international best practice in extension of GP and primary health care services, including costing of several proposals.

VI. OPERATION IMPLEMENTATION

6.1. POVERTY AND SOCIAL IMPACT

6.1(a) Impact of the economic contraction

112. **Latvia will experience a sharp increase in poverty, widening of the poverty gap, and a rise in income inequality as a result of the financial crisis and economic contraction.** In order to motivate urgent formulation of an Emergency Social Safety Net Strategy, the Bank team conducted simulation analysis of the likely increase in unemployment and poverty in the wake of the economic contraction.[59] Starting from the expected 18 percent contraction in GDP (affecting mainly trade, hotels and restaurants, construction and manufacturing) and 11.2 percent contraction of employment (concentrated in the same sectors) the percentage of people in poverty will increase from 14.4 to 20.2.[60] [61] In absolute terms, there will be more than 130,000 additional poor people in Latvia than in 2008, taking the total number of poor people to more than 453,000. The poverty gap, which measures the poverty deficit of the entire population, will also increase from 5.9 to 8.3 percent. Finally, income inequality – among the highest in the region prior to the crisis - will rise, with the Gini coefficient increasing from 39.3 to 41.3 percent.

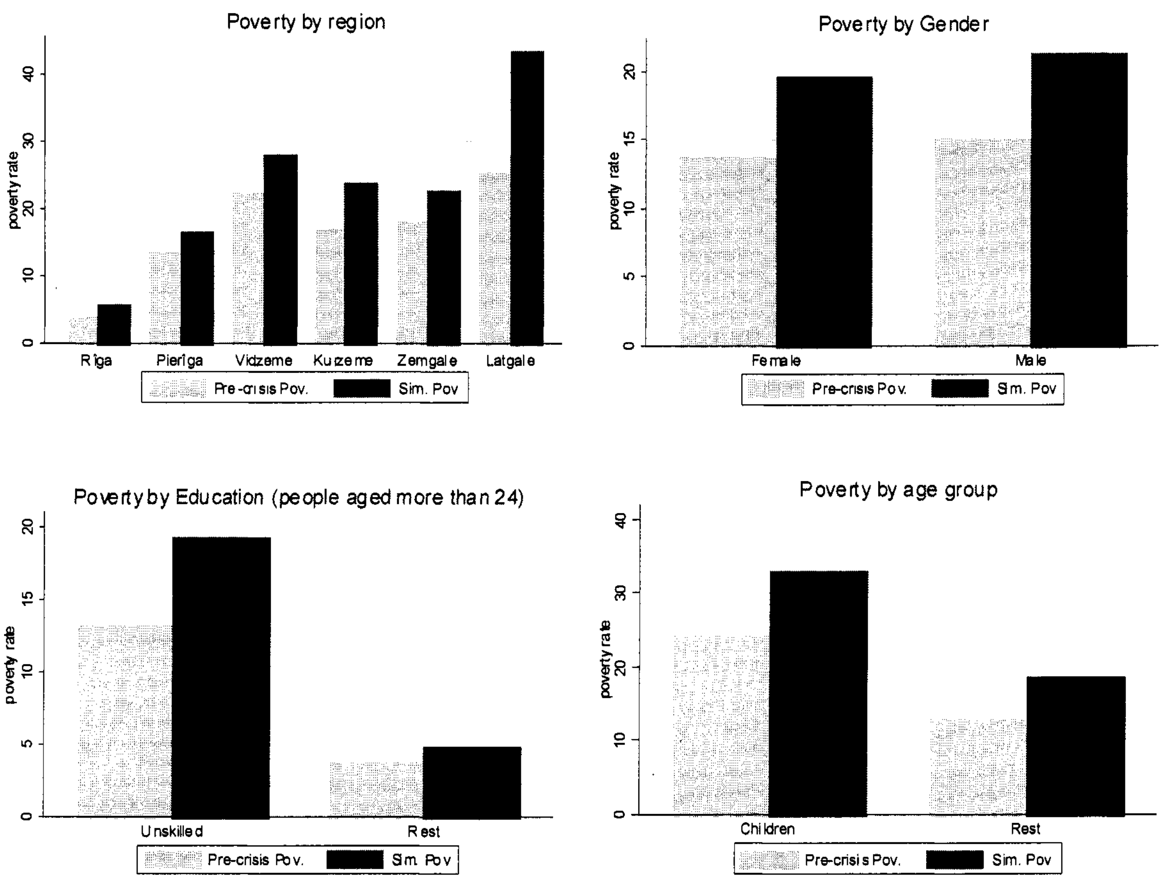
113. **There are substantial differences in the impact of the contraction across regions and specific population groups.** Bank staff simulations show that the largest increase in poverty is observed in the poor region of Latgale where the majority of employed people are likely to have been working in precarious, low wage jobs even prior to the crisis. The impact of the crisis is also felt more sharply in households where a man is the primary income earner, which to a large extent is explained by the contraction in the mostly-male-employing construction sector. Households in which economically active members have few skills (education levels of high school or less) suffer relatively more. Finally, households with children also suffer a greater impact.

[59] Analysis of the distributional impact of the economic crisis on households in Latvia was based on household survey data (Latvian EU-SILC 2006 database) and focused on the impact of the growth slowdown through labor markets. The impacts quantified are direct short-run impacts, and hence they do not take into account the general equilibrium effects.

[60] A household is in poverty if its total household income is below LVL 90 per capita, or approximately US$6 per person per day. In Latvia, this line is known as the "needy" line.

[61] Since the mid 1990s, Latvia has not used an absolute poverty line, and since accession to the EU, use of the Leaken measure of poverty (households at or below 60% of median income) has become widespread. However, only two income thresholds have policy consequences: the "needy" threshold, used in the simulation, entitles households in some municipalities to supplementary social assistance and – since passage of the Government's ESSNS – total exemption from health copayments; the guaranteed minimum income line entitles households across the country to the Guaranteed Minimum Income supplement and more recently to housing benefits.

Figure 12. Simulated Poverty and Social Impact of Latvia's Economic Contraction[62]



Source: Ajwad, M.I., F. Haimovich and M. Azam (2009)

6.2(b) Poverty and social impacts of ESSNS measures

114. **Bank staff simulations indicate that the measures supported by the proposed SDPL will mitigate the worsening effects from the global economic crisis on poor and vulnerable people.** Despite the adverse external factors surrounding this operation, the policies supported by the proposed SSDPL have been designed to protect the funding of basic needs and services for low income segments of the population and to boost expenditure on programs targeted to people affected by the crisis. Bank staff concludes that the components of the ESSNS will mitigate the impacts of the crisis for poor and vulnerable people and that no adverse distributional impacts are likely. The simulations for poverty and social impacts these measures are summarized below.[63]

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[62] For greater detail, see Ajwad, M.I., F. Haimovich and M. Azam (2009) "The Employment and Welfare Impact of the Financial Crisis in Latvia", Mimeo, ECSHD, The World Bank, Washington, DC.

[63] The details are available in Ajwad, M.I., F. Haimovich and M. Azam (2009) "The Employment and Welfare Impact of the Financial Crisis in Latvia", Mimeo, ECSHD, World Bank, Washington, DC.

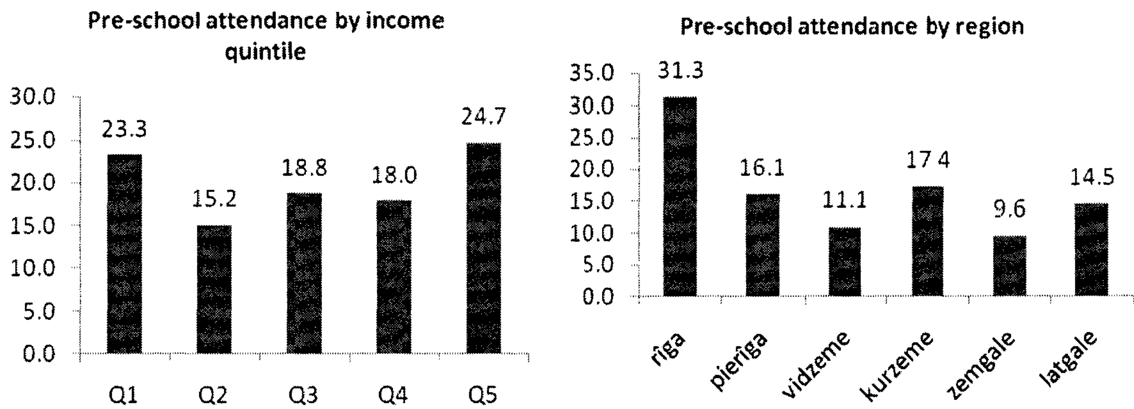
115. ***Simulation 1: Increasing the eligibility threshold at which GMI is provided.*** This reform has two impacts. First, it will lead to higher coverage and second it will lead to higher transfer to poor households and in doing so, lower the poverty gap. At the end of 2007, the GMI threshold was LVL 28 per person per month. However, at the beginning on 2008, the threshold was increased to LVL 37 per person per month and then in October, 2009 the threshold was increased again to LVL 40. If targeting were perfect, then the increase in the threshold will lead to 21,000 new GMI beneficiaries. Because the GMI eligibility threshold is still below the "needy" poverty line the team has used for these simulations (90 LVL per capita per month, approximately equivalent to the Leaken measure), there will be no change in the poverty rate. However, with the decrease in the poverty gap there is a reduction in household deprivation.

116. ***Simulation 2: Increasing household incomes of unemployed people either through augmented unemployment benefits or the provision of public works.*** Unemployed people are disproportionately represented among the poor in Latvia. Improving their welfare without affecting incentives to seek regular work is crucial. In this regard, the Government has taken 2 steps. First, the Government increased the duration during which unemployment benefits are paid to 9 months, where a payment of 45 LVL (a quarter of the minimum wage) is made for either 3 or 6 months depending on whether the unemployed person receives unemployment insurance benefits for 6 or 3 months respectively. Second, the Government began a public works program that pays 100 LVL per month (the minimum wage is 180 LVL per month) to participants. Both of these measures increase the incomes of households. In the aftermath of the crisis, if no unemployment benefits are paid, poverty rises dramatically to 23.1 percent. Under the 2008 rules of the unemployment insurance plan, the typical newly unemployed person received a benefit of about 28 percent of his/her pre-layoff income. With no changes to the plan, the expected poverty in the wake of the contraction is 20.2 as reported above. However, if that amount of the average post job-loss benefit were to increase to 40 or 50 percent (either through the more generous parameters passed early in 2009, or with the stipend from public works), then aggregate poverty in the wake of the contraction is reduced to 19.1 or 18.1 percent, respectively. Neither of the measures is likely to have a significant impact on incentives to rejoin the formal labor force when the labor market starts to recover, because the unemployment benefit top-up is low and because the public works stipend is lower than the minimum wage.

117. **Measures included in the ESSNS, supported by the proposed SDPL, are likely to have longer term, positive social impact, particularly the protection of financing for pre-primary education for 5 and 6 year old children.** International evidence consistently shows that pre-school education performs a vital role in improving learning opportunities for children from low-income and poor households. The Government's decision in 2005 to make preschool education free and mandatory for five-and-six-year-old children was a positive development in terms of long-term learning outcomes. Evidence suggests that the implicit subsidy of Government provided, mandatory pre-primary programs has had a strong impact across the country and across income groups. In the figure below the left panel shows that the program has had a fairly strong effect in equalizing preschool attendance across income groups. The poorest fifth (Q1) approximately matches the richest fifth (Q5) in attendance. The right panel shows that attendance is distributed across the country, with Riga barely matching its share of the population with preschool attendance. These data suggest that the program of public subsidies is raising preschool attendance. The economic literature suggests that these programs have a strong impact on the later success of children in school. In the absence of today's earmarked subsidy

for this program, some municipalities – the richer ones – will certainly be able to continue financing it, but poorer children and poorer localities will have great difficulty maintaining participation.

Figure 13. Distribution of Preschool Attendance in Latvia in 2007



Source: Community Statistics on Income and Living Conditions (EU-SILC) 2007 survey for Latvia analyzed by Mehtabul Azam, World Bank, July 2009

118. **The health sector measures included in the ESSNS will substantially lower household financial vulnerability to the cost of treatment, and encourage wider-spread access to health care.** The closure of hospital beds and medical facilities increases health risks and the burden on primary care services, which will be under pressure by patients to solve more problems for households. In addition, with more people in poverty and losing employment, medical care will become less accessible financially. However, each person in Latvia has a family doctor, and funding has been protected for this service. By adding funding in the ESSNS package for an additional public health nurse (with specific responsibility to lengthen operating hours and ensure that all patients receive preventive care and screenings and see their GP at least once during the year) the Government will ameliorate the stress that will be put on health outcomes and demonstrate a commitment to the part of the health system that people will use regularly. This short-term investment through the ESSNS puts the MOH in the position over the longer term to continue strengthening primary care by absorbing these costs in its regular budget when the economy begins to expand again.

119. **Needy households are exempt from copayments, which will lower the burden of out of pocket payments substantially.** Beginning October 1, 2009, this exemption was put into effect. Instead of having to pay first, and then apply for a partial refund from the municipal social assistance office, anyone in Latvia certified as needy can now go to her family doctor and receive care free of charge, with the insurance system paying the copayment. With referrals from their GP, other services are treated in the same way. In addition, pharmaceutical charges for covered drugs will be financed fully once the patient has paid LVL12.5 each quarter (or LVL50 for the year, whichever happens first). This measure is a complement to the previous one – trying to get the needy households in particular to use their GPs – and will shift its exemption policy ultimately to a means-testing approach in place of the current "social group" approach.

The measure is likely to eliminate variations across localities in assistance and creates an incentive for the poor to seek care - exactly what is needed if the health system is to contribute to better outcomes.

120. **Needy households will continue to receive the care they need in health facilities, free of charge.** The chronic poor in modern economies is a group heavily populated by those who suffer physical or mental disabilities that put them in need of long-term care and support of the state. An effort to manage the care of these patients outside an institutionalized setting, as Latvia plans to do through this policy shift, thus directly benefits one of the poorest segments of the population. However, a sudden shift away from inpatient services for these patients creates risks that they will be prematurely removed from institutions; that alternative services will not be developed in a timely manner; and that the public and the medical establishment will oppose new approaches because they are introduced recklessly. Shifts to home and day care must happen now, though, because the funding is simply not available to follow existing antiquated and uneconomic inpatient-based practices. This element of the ESSNS allows the MoH to target new services to needy clients and to assure that the severely constrained resources for inpatient care are available for people who really need to be treated on an inpatient basis. This is a first step in a long-term plan to de-institutionalize people who, because of the historical legacy, continue to be in residential care when they would be better off more integrated into normal social settings.

6.3. ENVIRONMENTAL ASPECTS

121. **The specific policies supported by the proposed development policy loan are not likely to have significant effects on Latvia's environment, forests, and other natural resources**. Unanticipated and unintended risks of adverse effects to the environment and natural resources are likely to be minor. Latvia has adequate environmental controls in place. Latvia's environmental legislation and regulation is reinforced by EU environmental directives, including the EU's guidelines on adoption of environmental assessments at the planning and programming level (June 2001) and the EU's Environmental Liabilities Directive setting out liability for damage to properties and natural resources (April 2007).

6.4. IMPLEMENTATION MONITORING AND EVALUATION

122. **The Bank will work closely with the MoF and sector Ministries to monitor and assess reform progress and impacts during the course of the program.** Monitoring of implementation and evaluation where possible will be supported by the various Ministries as well as budgetary, legislative and economic data provided by the authorities and verified in official disclosures, directives and regulations. The Ministry of Regional Development and Local Government (MoRDLG) has formal responsibility for monitoring implementation of the ESSNS, and for submitting regular reports to the Cabinet of Ministers on progress. Baseline and updated data are provided by the respective specialized agencies for the pertinent functions and tracked according to the indicators and outcome measures as shown in the Monitoring and Results Framework (see Annex 3).

123. **The State Audit Office of the Republic of Latvia (SAO) may choose to evaluate the government's performance in implementing the emergency social safety net supported by the proposed loan.** The State Audit Office reports independently to Parliament and is a key

institution for public sector accountability. Given the complex nature of structural reforms and emergency assistance supported by the proposed program of development policy lending, the Bank team has continuously shared information with the State Audit Office to encourage an interest by it in monitoring the Government's performance. If it decides to audit this program, its findings will be included the Bank's dialogue with the Government.

6.5. FIDUCIARY ASPECTS

6.5(a) Public Financial Management System and Budgetary Resources

124. **The most recent World Bank diagnostic work was conducted in 2007 and focused on selected sectors of public expenditure.** Latvia joined the European Union in 2004 and graduated from World Bank financial assistance in 2007. As such, the most recent diagnosis was the 2007 PER. This analytical work was complemented for the purpose of this development policy loan with ongoing monitoring by the World Bank of Public Financial Management (PFM) reforms and previous diagnostic work conducted by other external organizations.

125. **Overall, the Latvian PFM system is supported by a well established legal and institutional framework.** Over the recent years Latvia has introduced a series of PFM reforms and enhancements. The most significant reforms were the phased introduction of program and performance based budgeting, a medium term expenditure framework, capacity building at the State Audit Office, and implementation of the web based IT system supporting budget planning and execution. These reforms have resulted in a stronger PFM system characterized by centralized cash management within a single treasury account structure, a web-based on line reporting system updated twice per month, timely preparation and audit of government financial statements and strong audit capacity at the State Audit Office (supported by private sector sworn auditors) involved in auditing the Bank of Latvia and local governments.

126. **In spite of these major accomplishments, there are a few areas where further improvement is needed.** These include: the budgetary framework exposed to economic downturn due to lack of clear procedures on budget cuts, insufficient implementation of medium-term planning and performance budgeting (in practice performance indicators focus on outputs rather than outcomes, budget execution is still monitored on the basis of budget appropriations, there is tendency to use incremental budgeting), inadequate budgetary expenditures monitoring and enforcement especially at the local government level, deficiencies in accounting at the ministerial and local government level resulting in negative audit opinions, fragmentation of the budget into "base" and "special" (earmarked for special purposes) budgets, insufficient accountability framework of the sector ministries related to the overall performance of the sector (including also quality of the delivery of the services by the local governments).

127. **Based on the above status of PFM in Latvia, the fiduciary risk associated with the proposed program of operations is low.**

6.5(b) Foreign Exchange Environment

128. **The Bank of Latvia (BoL) is a member of the European System of Central Banks, and its legal independence is granted by the Law on the Bank of Latvia.** The main objective

of the Bank of Latvia is maintaining price stability in Latvia and the primary tasks include management of foreign currency and gold reserves. The BoL acts also as advisor to the Parliament and the Government with regard to the monetary policy, following ECB practice. The BoL does not engage in any commercial activity, and its operations related to the execution of its tasks are mainly financed from income from the management of foreign currency and gold reserves. The Parliament has supervisory role over the BoL.

129. **The IMF completed a Safeguards Assessment of the BoL in July 2009 and the World Bank reviewed external audit reports of the central bank.** The BoL financial management and operations are transparently disclosed and presented on its website. The BoL annual financial statements are regularly audited by the audit commission, whose members are approved by the Auditor General of the Republic of Latvia, and the most recent audit reports, for 2006-08 have unqualified audit opinions.

6.6. DISBURSEMENT, AUDITING AND PROCUREMENT

130. **The proposed lending program will follow the World Bank's disbursement procedures for development policy lending.** Loan proceeds from the first operation in the proposed program will be disbursed in one tranche to the foreign currency account at the BoL. Disbursement will be made upon Borrower meeting prior actions and declaration of loan effectiveness and submission of a withdrawal application to the IBRD. At the request of the MoF, the IBRD will deposit the proceeds of the loan into the deposit account at the BoL which forms part of the country's official foreign exchange reserves. The Borrower shall ensure that upon the deposit of the Loan into said account, an equivalent amount is credited in local currency[64] to the Single Treasury Account also kept in the BoL and that is available to finance budgeted expenditures. Disbursements will not be linked to specific purchases, thus no procurement requirements will be necessary. The Government shall maintain accounts and records with respect to the deposit of loan proceeds in the BoL. If the loan proceeds are used for ineligible purposes as defined in the loan agreement, IBRD will require the Borrower to refund the amount directly to IBRD

131. **No additional fiduciary arrangements will be required.** The Bank will not require an audit of the deposit account, but will require the Government to provide a confirmation to the Bank in the form of an official letter from the Ministry of Finance on the amounts deposited in the foreign currency account and credited to the budget management system (Single Treasury Account) within 30 days of receiving the funds.

VII. RISKS AND RISK MITIGATION

132. **Risks to the proposed program of lending are high.** Risks arise mainly from an ongoing and sharp economic contraction and the size of the needed fiscal adjustment Latvia has committed itself to make.

[64]The Bank can also agree that the proceeds of the loan will remain in loan currency (EUR), which should be reflected in the final version of the project document.

133. **Further, unexpected economic contraction could reduce tax revenues, requiring further fiscal adjustment.** The IMF and EC led program was based on assumptions that the economy would only contract by 5 percent in 2009 but GDP is estimated to have contracted by 18 percent. Although the fiscal outlook has become more stable, considerable uncertainty remains.

134. **The program faces considerable macroeconomic risks that lower the likelihood of a quick recovery**. The Government is undertaking a very ambitious economic adjustment program based on a macroeconomic strategy that includes severe fiscal consolidation measures and wage cuts under the fixed exchange rate regime. The severity of the measures may make them difficult to implement. Also, the much higher government deficits will make it harder to meet the Maastricht criteria and may delay the program's exit strategy of Euro adoption. Deflation may be even deeper than currently projected, which could also jeopardize Euro adoption. However, the economy may also recover faster than expected if global growth resumes faster. These risks are mitigated by the size of the multilateral financial package, equivalent to 35 percent of GDP, in support of the Government's program. In addition, the support of Latvia's international partners, particularly the EU, represents a key safeguard to the program. The EU's commitment of €3.1 billion under the international support package has provided space for implementation of the programmed reforms. *In a July 27 press statement announcing their disbursement of €1.2 billion, the EU affirmed that it will continue to work closely with the Latvian authorities and the IMF to ensure Latvia implements successfully its economic reform program and repays in a timely manner all loans associated with the international program to support Latvia. Thus, while the risks are significant, continued current account surpluses, Latvia's strong commitment to the program, expected improvements in global financing conditions, and EU support provide safeguards.*

135. **The ESSNS may not be sufficient to address the social costs inflicted by the speed of fiscal adjustment and structural reforms.** The fiscal adjustment Latvia undertook in the second half of 2009 and is committed to undertake in 2010 and 2011 is substantial and would be difficult even in a non-recession environment. The sheer size and speed of the adjustment raises the risks of adverse impact on households. Of particular concern is the structure of means tested minimum income assistance – the most decentralized in the ECA region. Decentralized provision of social assistance, particularly in the context of the extraordinary economic contraction, can lead to gaps in the safety net across municipalities of different wealth. *A key part of the Government's ESSNS is to provide contingent financing for the GMI, as well as to raise the income threshold for households to qualify for assistance. These measures, as well as the deployment of the new Workplaces with Stipend public works program, can help to contain social costs. In dialogue with the Bank team the Government agreed to expand the ESSNS package to include strengthening GP/PHC services with public health nurses. Implementation and adequacy of ESSNS measures is being monitored on regular basis. Should the ESSNS allocations in the 2010 budget prove inadequate, the Government could consider a further temporary extension of unemployment insurance; a larger deployment of emergency public works; and increasing the co-financing of GMI. Program partners have agreed to provide leeway in fiscal adjustment targets to accommodate additional safety net measures.*

136. **The difficulty of structural reforms during a period of severe and prolonged economic recession could trigger a backlash or reversion to past practices.** The Government

will need to continue explaining why structural reforms are necessary and how these measures will lead to improvements in the medium term. This has proven to be a difficult task in 2008 and 2009 as conditions continued to worsen. Even early in the IMF-led program, there were violent protests against the first changes to the 2009 budget. Although the bottoming out of Latvia's economic decline has lowered resistance and there is widespread stoic acceptance of the measures the Government is taking, more can be done to increase information and public awareness. *The Bank team supports a proactive effort by the Government to explain the need for fiscal adjustment and the rationale for reform, having participated in several instances, in key discussions with social partners. The Bank team has engaged local communications experts to help clarify the role of the institutions in the overall international assistance effort. The Bank encouraged and assisted in the development of the emergency social safety net to mitigate some of the negative impacts of the fiscal consolidation and economic crisis, and supported the Government's strategy to be widely publicized.*

137. Budget reductions of this speed and breadth are unprecedented in most countries, and the success of structural reforms depends on the quality of implementation in a very difficult political climate. Success requires difficult decisions to be made at the local level, as general elections grow nearer. *The Bank will remain engaged through this two-loan program to monitor how structural reforms are being implemented in the education and health sectors, to inform the ongoing process of rationalization, and to adjust the content of the proposed lending program as implementation issues arise.*

ANNEX 1: GOVERNMENT'S LETTER OF DEVELOPMENT POLICY (LDP)

LATVIJAS REPUBLIKAS FINANŠU MINISTRIJA
MINISTRY OF FINANCE OF THE REPUBLIC OF LATVIA

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Mr. Robert Zoellick
President
The World Bank
1818 H Street N.W.
Washington, DC 20433 U.S.A.

Riga, January 28, 2010
Our ref. No. 29-04/691

Subject: Letter of Development Policy

Dear Mr. Zoellick,

During 2000-2007 the economy of the Republic of Latvia experienced one of the fastest rates of growth in Europe, which led to a sharp improvement in living standards, but has been accompanied by rising imbalances. Growth, which averaged 9 percent between 2000-2007, was mainly driven by private consumption and investment in real estate and other non-tradable sectors. Rapid public expenditure growth added to demand and overheating during this period, while wage growth above productivity improvements exerted upward pressure on consumer price inflation and eroded the national competitiveness. The international financial crisis has further affected the stability of the national economy. The availability of external finance has fallen sharply, due to global developments and downgrades to the sovereign credit rating of the Republic of Latvia. In response the Government of the Republic of Latvia developed a comprehensive strategy to counter financing pressures in the near term, and put the economy on a sustainable footing in the long term. International partners such as the European Commission, the International Monetary Fund, the World Bank, and a number of bilateral partners have been involved to embark on a comprehensive crisis resolution reform program. For the aforementioned reasons, and to assure a smooth implementation of the

reform program described in this letter, the Government of the Republic of Latvia is requesting financial assistance from the World Bank as a part of multilateral financial assistance package agreed by the international and bilateral lenders.

In this letter the Government of the Republic of Latvia is kindly requesting financial support for "Safety Net and Social Sector Reform Loan" as laid out below.

Activities for strengthening of the social safety net

To deal with the rising unemployment and the social situation that is becoming more difficult, the Government of the Republic of Latvia in its meeting on September 8, 2009 has approved a Social Safety Net Strategy (hereinafter – the Strategy). The Strategy outlines activities to be carried out to strengthen the existing social safety net. The purpose of the Strategy is to develop a batch of safety net measures implementation of which would ensure decrease of adverse social effect resulting from: (1) financial and economic crisis in the world and Latvia, and (2) structural reforms performed. Duration of the Strategy is from October 1, 2009 till December 31, 2011, but can be extended if: (1) the consequences of the financial and economic crisis are not eliminated and situation in the social sphere continues to worsen by the end of 2011, or (2) assumptions forming the basis of this Strategy and affecting implementation of the Strategy change considerably.

We are committed to implementing the social safety net activities outlined below. The activities can be sub-divided into four categories: welfare, education, health, and transportation. Our commitments are elaborated below for each of the category.

Social safety net activities in the welfare domain

It is necessary to implement activities to give possibility for families to survive in the situation of unemployment, because poverty growth is envisaged till the end of 2010. According to statistics data of the Ministry of Welfare, in 2008, on the basis of inadequately low guaranteed minimum income (hereinafter – GMI) level (LVL 27 per person per month) 120 314 persons (5.3 % of population) complied with the status of needy person, however only 27 422 persons (1.2 % of population or 22.8 % of needy persons) received the GMI benefit. In 2008, 108 690 persons or 4.8 % of population received the housing

benefit. Therefore the GMI level should be increased to ensure that broader scope of recognized needy families could classify for the GMI benefit.

On the basis of the GMI level LVL 37 per person per months in the 1st half of 2009 the number of GMI benefit receivers increased rapidly reaching in average 16 047 persons per month or approximately 32.3 % of recognized needy persons. In the 1st half of 2009, the ratio of resources spent for the GMI benefit increased to approximately 12% and for housing benefit to approximately 30% of total resources spent for social benefits.

It is forecasted that, in 2009, the number of needy persons could reach 144 376 persons (6.4 % of population), but the number of GMI benefit receivers – 57 750 persons (2.5% of population) per year. According to the approximate estimates, in 2010, 200 000 persons could be recognized as needy persons (8.8% of population) and 100 000 persons (4.4 % of population) per year could receive the GMI benefit. However, almost all recognized needy persons are potential housing benefit receivers. In 2008, 20 950 persons or 14.1 % of population received municipal social benefits.

Considerable decrease in the local government revenue could be an obstacle for adequate provision of social assistance – payments of GMI and housing benefit to needy and low-income[1] citizens. Besides, the society could be unable to absorb and sustain significant cuts of wages and the number of work places that is taking place in the national economy at the moment. It can result in rapid increase in the number of persons subject to poverty risk (poverty risk index in Latvia in 2007 – 21%). At the same time, uncertainty about the future and inability to solve problems arising from the crisis and faced by particular groups of citizens could cause deeper stress, as well the lack of crisis management abilities could arise which can result in worsening of psychological health condition.

In 2008, 9 062 persons able to work, but not participating in the labour market, received municipal social assistance. Conditions for granting the GMI benefit envisage that the benefit recipient has to sign the agreement on cooperation with the social work specialist, which is a good instrument for motivating people able to work to integrate into the labour market because a person able to work has to register with the Latvian Public Employment Service (State Employment Agency - SEA) and make her/ his efforts to find a

[1] According to Article 14 Clause 6 of the Law on Assistance in Solving Apartment Matters a person shall be recognised as a low-income person if his or her income and material conditions do not exceed the level specified by the relevant local government council, which may not be less than the level of income and material conditions of a needy person, which the Cabinet has specified on the basis of the Law On Social Services and Social Assistance. Person recognised as a low-income person shall be issued a statement certifying such status.

new job (this includes taking part in active labour market measures organized by the SEA – one of those is the Workplaces with Stipend programme (co-financed by the European Social Fund)) in order to be eligible to the GMI benefit. The Workplaces with Stipend programme is being managed by the SEA and implemented by municipalities that are responsible for creating the workplaces. The stipend in the Workplaces with Stipend programme amounts to LVL 100 per month.

As a solution to the situation a differentiated increase in the GMI level has been in force as of October 1, 2009, setting the level at LVL 40 for adults and LVL 45 for children. To ensure payment of the GMI level in conditions of reduced municipal financing, the state from 2009 till 2011 participates with 50% co-financing of municipal resources spent for the GMI benefits; however, local governments should finance from their resources the remaining 50% of the GMI benefit. In 2009, the housing benefit has been co-financed by the state budget to all municipalities at the amount of 20% of expenditure paid-out for housing benefit. The Cabinet of Ministers prescribes the procedure for allocation of resources. Moreover, to help the local governments with fulfilling their obligation to pay out housing benefit, a 20% of the total housing benefit support has been earmarked in the state budget for financing of the housing benefit in 2010 and 2011.

Social safety net activities in the education domain

As of September 1, 2009, state budget resources were not available to ensure education of 5 and 6 years old children. Local governments could not be able to ensure pre-school education from their own resources, therefore 5 and 6 years old children would not acquire knowledge, skills, and competencies in the early age and they would not be ready for the primary school, also parents could have less possibility to have paid work because otherwise the child would be left without care during the working hours.

Seeking for solution to the issue on education of 5 and 6 years old children, it is proposed to make the system more effective thus putting lighter burden on the state budget comparing to previous years.

On September 1, 2009, a possibility to acquire knowledge, skills and competencies has to be given to all 5 and 6 years old children. The education offer should be provided with joint mastering of the education programme in the social, cognition, self-expression, and physical field. In the school year 2010/ 2011, it is planned to start pilot project for evaluating possibility to attend the 1st grade of primary education at the age of 6 years. The financing is

provided for teacher wages and improvement of the curriculum for pupils of age five to ten years.

Education system reform has led to school network optimization. According to situation report[2] of the Ministry of Education and Science as of November 25, 2009, 58 schools are confirmed to be closed (most of them have already been closed) and 84 more reorganized.

Social safety net activities in the health domain

Prior to October 1, 2009 patients who had been granted the needy person status (certification issued by the local government) paid 50% of patient payment for health care. Therefore, needy persons had limited access to health care services due to financial reasons. Introduction of patient payment compensation mechanisms made it possible for persons who have been granted the needy person status to receive necessary health care. Within the scope of expanded social safety net, needy persons are exempted from patient co-payment.

Prior to October 1, 2009 patients that had the needy person status paid for medicine, which was included in the list of compensated medicine, 25% or 50% copayment. As these patients had low income they could not receive necessary medication in the state medicine compensation system, because they could not cover the copayment. Patients are able to continue treatment at the outpatient level within the framework of the established compensation system. If the patient is granted the needy person status, then the patient will be compensated for essential medicine if the annual limit of purchased compensated medicine has reached LVL 50.

If mostly out-patient health care services are provided, patients living outside the big cities have to go long way to the treating institution. Within one treating process patients sometimes need to undergo several investigations, manipulations etc. Hence, they need to spend much time on their way as well as the treatment institution. The patients need to go home after the treatment, which is not always possible due to the fact that public transportation might not be available in late afternoon. Hence, the availability of health care to needy persons that cannot afford to stay overnight in a hotel is hindered. Therefore, within the framework of the compensation system it will be possible to cover expenses for hotel-type beds in hospitals and the patient will not need to take a long way to the treating institution and solve other problems related to

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[2] Source: Ministry of Education and Science http://izm.izm.gov.lv/nozares-politika/izglitiba/vispareja-izglitiba/aktualitates/3902.html

transportation. Thus out-patient, rather than inpatient treatment provided for the state budget resources will be more readily available to patients.

Home care service ensures the care of chronically ill patients at their place of living, thus decreasing the need for in-patient treatment services and the need for the emergency medical services. Provision of home care services is a part of the healthcare system reform, which foresees moving from in-patient care to out-patient care where possible. Within the scope of increased social safety net, home care services will be provided for needy chronically ill patients free of charge.

The development of care in day centres will ensure establishment of mental health care service based in society. Mental health care services will be available on equal terms for all citizens in Latvia increasing the role of family doctors and making it possible for patients to receive mental health care services of maximum proximity, as well as integrating patients in the society. In Latvia, the ratio of hospital beds is big comparing to other ES countries, including in the field of psychiatric care. Developing day centres could decrease the number of in-patient cases, make the use of resources more effective and take care of patients with mental disability as close to their living place as possible thus ensuring integration of these patients in the society and decreasing stigmatization of patients.

To alleviate the work-load of general practitioners as a result of shift from in-patient to out-patient medical care, the issue of hiring additional nurse for approximately half of the general practitioners and primary health care providers has been handled within the scope of the social safety net.

Social safety net activities in the transportation domain

There are two main issues in the transportation domain.

Firstly, to mitigate education network reform effect in terms of decrease of the number of schools, each local government has evaluated possibilities and costs of school children transportation between place of residence and school according to its budget, availability of public transport, intensity of public transport, and other specific factors of the local government. The school children transportation issues are being dealt with in four ways: (1) purchasing busses for school children transportation, (2) compensating expenditure for tickets in public transport, (3) compensating expenditure for local governments transport, or (4) buying transportation services from transportation service providers. To ensure purchase of busses for school children transportation in regions, Swiss financial assistance as well as state and municipal budget funds

will be used for solving of the children transportation issue. At the same time, the purchase of busses for school children transportation is foreseen also in the Strategy taking into account that the transportation issue using Swiss financial assistance will be solved partly. It should be noted that allocated financing within the Strategy could be re-distributed from purchase of busses to covering of subsidies for transportation or ticket compensation in cases subsidies for transportation are more advantageous than the purchase of busses.

Secondly, regulation of Cabinet of Ministers foresees groups of people for whom the state has undertaken to provide public transport services on preferential conditions – to use public transport in regional intercity routes and regional routes of local significance with 100% discount. The said categories of persons are: (a) children of preschool age, (b) orphans and children that are left without care from parents, (c) persons with group 1 and 2 disabilities, children with disabilities and persons who accompany persons with group 1 disabilities or disabled children, (d) politically repressed persons and members of National resistance movement. The passenger categories that are foreseen in the regulation do not pay for tickets in the public transport and they can utilise the said benefit by presenting special identity cards. The providers of the public transportation in accordance with the normative acts that regulate public transport services are entitled to claim the incurred losses from providing the aforementioned service from the state budget. Compensation of the said losses is foreseen as one of the activities of the strengthened social safety net for 2010 to foster free movement of the said socially vulnerable groups of people.

Monitoring and implementation of the social safety net activities

To ensure adequate monitoring of the Strategy implementation, the institution responsible for monitoring of the Strategy implementation shall submit to the Cabinet of Ministers till February 5, 2010 an informative report on the Strategy implementation progress in 2009. From 2010 till the end of the Strategy duration term the responsible institution shall on the quarterly basis submit to the Cabinet of Ministers informative reports on the Strategy implementation progress. The informative report shall be submitted to the Cabinet of Ministers till 5th date of the second month following the quarter (except for the fourth quarter of the year), as well as till February 5 – on the previous year. The Government of the Republic of Latvia has designated the Ministry of Regional Development and Local Governments as the institution responsible for monitoring of the Strategy implementation.

The Government of the Republic of Latvia expresses its full commitment to the implementation of the Strategy and corresponding social safety measures as outlined above. We highly appreciate the help and support the World Bank has consistently shown in our efforts to tackle the challenges that we have been facing in the social sector. Hence, we kindly request the World Bank to provide Development Policy Loan of EUR 100 million with a subsequent loan of another EUR 100 million to assist the Republic of Latvia as we pursue strengthening of the social safety net.

Sincerely yours,

Einars Repše
Minister of Finance

ANNEX 2: ASSESSMENT FROM INTERNATIONAL MONETARY FUND

The IMF's Board meeting for the Second Review and Financing Assurances Review Under the Stand-By Arrangement for the Republic of Latvia is scheduled for Wednesday, February 17, 2010. The PIN from the Fund's Board discussion will be circulated to Executive Directors prior to the March 4, 2010 World Bank Board discussion.

ANNEX 3: POLICY MATRIX

(Proposed Program of two Special Development Policy Loans)

Objective	Loan 1	Loan 2	Outcome
	Prior Actions (bold) & Supporting Measures	Indicative Triggers	
Ensure adequate emergency safety net financing for education and health services, and social protection programs to mitigate the impact of fiscal adjustment and the economic contraction on households.	**The Borrower's Cabinet of Ministers approved an Emergency Social Safety Net Strategy for the period from October 1, 2009 through December 31, 2011 on September 8, 2009 (Protocol No. 56, 78§).**	National and local government agencies are satisfactorily implementing Emergency Social Safety Net Strategy (according to details in each section below), maintaining adequate financing in 2010 and 2011.	Emergency safety net measures are deployed and remain in place through 2011.
Monitor performance of national and local government agencies in implementing ESSNS & increase public awareness, transparency and accountability of Government measures in the social sectors.	**The Borrower has published the Emergency Social Safety Net Strategy on the internet, and in local media on December 21, 2009.** The Borrower has provided adequate resources for and put in place a performance monitoring and impact evaluation plan, making use of existing monitoring mechanisms, administrative data, and surveys.[65] [66]	The Borrower has submitted regular performance monitoring reports to the Cabinet of Ministers and published them on the web page of the Ministry of Regional Development and Local Government.[67] An independent audit of the Government's performance in implementing the Emergency Social Safety Net Strategy is being conducted.[68]	Information on Government's implementation of ESSNS and structural reforms is independently assessed and publicly available.

Health			
Objective	Loan 1	Loan 2	Outcome
	Prior Actions (bold) & Supporting Measures	Indicative Triggers	
H1. Reduce the risks associated with fiscal consolidation in the health sector by strengthening General Practitioner/Primary	**The Borrower provided for an additional public health nurse for approximately half of the general practitioners and primary health care providers in the emergency social safety net and financed it fully in the 2010 budget pursuant to the Cabinet of Ministers Regulation No. 1630 dated December 22, 2009.**	The Borrower has incorporated improvements to the program suggested by its evaluation and has prepared a plan for further strengthening GP/PHC services in the 2011 budget.	Increased hours and outreach services at the Primary Health Care level to compensate in part for

[65] The Government (each agency and level of government responsible for implementing ESSNS actions) will establish baseline of implementation performance indicators that will be regularly monitored by a working group established for this purpose and convened by the Ministry of Regional Development and Local Government.

[66] The Government will add a specially designed module to its ongoing Labor Force Survey (LFS) for the duration of the ESSNS.

[67] Initially monthly (in 2009) and then quarterly (in 2010 and 2011) reports containing monitoring statistics for each element of the program along with an assessment of beneficial impacts, costs, and issues to be addressed during implementation will be submitted to the Cabinet of Ministers . A report prepared for September 30, 2010, would take a critical look at each element of the program for the previous eight months (through August) and recommend how to strengthen or adjust it in the following year. A report prepared for September 30, 2011, would take a critical look at each element of the program for the previous eight months (through August) and recommend how to strengthen or adjust it in the following year, if the ESSNS is still required. The second report should be accompanied by an impact evaluation, if possible.

[68] The independent audit report should be published on the internet and discussed publicly. Problems identified in the audit should be addressed with proposed actions in 2011 budget.

Health			
Objective	Loan 1 Prior Actions (bold) & Supporting Measures	Loan 2 Indicative Triggers	Outcome
Health Care to partially substitute for reduced access to specialist and hospital-based care.			reduced financing of specialist and hospital care.
H2. Augment financial protection from the cost of health care, and maintain critical health services for needy households.	**The Borrower allocated in the 2010 budget funds for households with per-capita income less than half the minimum wage, at adequate levels, to finance: (a) an exemption from co-payments for general practitioner, outpatient, specialist, and inpatient services; (b) an exemption from pharmaceutical charges above LVL 50 per year per person; and (c) an exemption from the cost of overnight hotel stays in hospitals, home care for those with serious diseases and day-care centers for those with mental diseases.**	The Borrower has incorporated improvements to the exemption program, informed by an evaluation of its performance since October 2009 and fully funded the revised program for 2011. The Borrower has prepared a plan for shifting all medical care subsidies from a list of social exemptions to a means-tested system of exemptions.	People from households certified as needy are exempt from health service copayments; are receiving subsidized prescriptions; and retain access to critical health care services.

Education			
Objective	Loan 1 Prior Actions & Supporting Measures	Loan 2 Indicative Triggers	Outcome
E1. Ensure access to pre-primary education and child development programs is maintained	**The Borrower allocated funds in the 2010 budget for pre-primary education/child development programs for children starting 5 years of age .**	In 2011 budget, the Borrower has allocated adequate financing for pre-primary education/child development programs for children from the age of 5 years old.	Enrollment of 5 and 6 year old children in free pre-primary programs is maintained at least at 89% for 5 y.o., and 98% for 6 y.o., respectively.
E2. Ensure access of primary and secondary school-aged children to education facilities is maintained during implementation of the per-student financing model	**The Borrower allocated in the 2010 budget funds to cover the cost of transportation of students whose schools have closed to replacement schools .**	In the 2011 budget, the Borrower has allocated adequate financing to cover the cost of transporting students whose schools have closed to replacement schools.	The time students spend travelling to and from primary and secondary school is kept within 60 minutes (one way).
E3. Improve equity of subsidies for higher education	**The Borrower added into the Regulation of the Cabinet of Ministers No. 740, dated August 24, 2004 social considerations, in addition to merit, to the awarding of state support to students in higher education by issuing a Regulation of the Cabinet of Ministers No.511 dated June 2, 2009.**[69]		Not less than 39% of state subsidies to cover the stipends of students in higher education are awarded to academically eligible students on the basis of poverty and social considerations in addition to merit.

[69] Social considerations include low family income, disability or handicap, large number of siblings, etc.). For potential students of equal academic merit, social considerations will prevail.

Social Protection			
Objective	Loan 1 Prior Actions (bold) & Supporting Measures	Loan 2 Indicative Triggers	Outcome
W1. Ensure social insurance system is responsive to households needs	**The Borrower enacted an amendment to the Law "On Insurance in Case of Unemployment" effective as of July 1, 2009, which extends the pay-out period of unemployment benefits to 9 months, effective until December 31, 2011, which, inter alia, provides for a decrease in the eligibility requirement for unemployment benefits to 9 months of contributions in the previous 12 months.**	The contribution rate to the funded pension pillar has been raised to is 6 percent of a worker's salary starting from January 1, 2012..	Percentage of unemployment benefit recipients whose benefits are extended by the reform – 22%. Individual contributions to the funded pension pillar have risen from 2% in 2009 to 6% from January 1, 2012.
W2. Strengthen mandatory, municipally administered, mean-tested social assistance to mitigate the impact of the crisis on the poorest households.	**The Borrower: (a) enacted an amendment to the Regulations of the Cabinet Ministers No. 1070 dated October 1, 2009 and No. 1489 dated December 1, 2009 to increase the Guaranteed Minimum Income (GMI) benefit amount to LVL 40 per adult and LVL 45 per child in a household; and (b) allocated financing in the 2010 budget of, at least, 50 percent of the cost of the GMI from state funds, with local governments funding the other 50 percent**	In the 2011 budget, the Borrower has financed at least 50 percent of the cost of the Guaranteed Minimum Income from State funds, with local governments funding the other 50 percent. The Borrower has prepared an evaluation of how uniform standards of coverage, targeting, benefits, and financing of municipally administered, mandatory social assistance programs are implemented across local governments, based in part on an evaluation of the experience under the Emergency Social Safety Net Strategy.	Municipalities have sufficient financial resources to make timely payment of GMI benefit to all eligible individuals.
W3. Strengthen active employment measures to respond to increased demand for assistance from unemployed people who do get unemployment insurance	**The Borrower introduced amendments to the Cabinet of Ministers Regulation No. 166, dated July 14, 2009 to provide temporary employment for the unemployed not covered by unemployment insurance effective as of August 8, 2009**		In 2010 Q4 34,309 workplaces have been created under the emergency public works program.

ANNEX 4: MONITORING AND RESULTS FRAMEWORK

MONITORING AND RESULTS FRAMEWORK

	Action	Monitoring Indicator	Baseline	2010 Q1	2010 Q2	2010 Q3	2010 Q4	2011 Q1	2011 Q2	2011 Q3	2011 Q4
1.	Identify target groups for Emergency Social Safety Net assistance	• Percentage of persons in the population whose household per capita income (measured by the HBS survey) is equal to or less than half the minimum wage	13.9% (data source: HBS 2008)	-	-	-	[HBS on 2009]	-	-	-	[HBS on 2010]
		• Percentage of persons living in households whose reported income qualify as needy, that have been certified as needy[70] (data estimated by Ministry of Welfare based on HBS indicator and administrative data, with a year lag)	38.6% (data on 2008)[71]	-	-	-	50% (data on 2009)[72]	-	-	-	50% (data on 2010)[73]
2.	Improve General Practitioner (GP) and other Primary Health Care (PHC) services by adding a Public Health Nurse to engage with and visit patients; ensure preventive examinations for	• Number of (rural) GPs with an extra public health nurse. There are 668 rural GPs in January 2010.	0				300[74] (est.)			-	500[75] (est.)

[70] The category "needy" is defined in the Regulation of Cabinet of Ministers No. 214, "Procedures by which a Family or Person Living Separately Shall be Recognized as Needy" (adopted on 3 March, 2009, in force from 18, March 2009), and refers to A family (person) shall be recognized as needy, if the income per each family member during the last three months does not exceed 50% of the minimum wage in force in the State on 1 January of the relevant year and if: (1) it does not own monetary accumulations in credit institutions; (2) it does not have debt obligations and it has not issued a loan; (3) it does not own property that could be used for the gaining of income; (4) it has not entered into a maintenance contract; (5) it is not on full support of the State or local government.

[71] In 2008 according to HBS survey 13.9% of the population lived in household whose per capita income (measured by the HBS survey) is equal to or less than half the minimum wage. It is approximately 311.4 thousand people. According to statistics of municipalities in 2008 120.3 thousand people were certified as needy or 5.3% of population. (120.3 :311.4 x100%)

[72] Agreed with the World Bank staff.

[73] Agreed with the World Bank staff.

[74] In compliance with Regulations of Cabinet of Ministers No.1046 one half or 668 General Practitioners' practices are allowed to employ the second nurse. As it takes time to study, to train and to sign an agreement with the nurses who are interested to engage in primary care it is planned that in 2010 one half of General Practitioners' practices will employ the second nurse.

[75] The ratio of 2010 is increased by 60% on average, taking into account the number of medical persons who will retrain and the time for retraining.

MONITORING AND RESULTS FRAMEWORK

	Action	Monitoring Indicator	Baseline	2010 Q1	2010 Q2	2010 Q3	2010 Q4	2011 Q1	2011 Q2	2011 Q3	2011 Q4
	clients; alert patient and GP/PHC provider to emerging health issues; and extend clinic hours.	• Percentage of needy patients who are registered at GPs with an extra nurse that have had at least one preventive contact with a Public Health Nurse or GP for cancer screening, physical exams, vaccinations and related health services.	65%[76] (est.)				75%[77] (est.)			-	85%[78] (est.)
3.	In 2010 and 2011 budgets, financing for full exemption from co-payments for GP, outpatient, specialist, and inpatient services for needy households (i.e. with per-capita income less than half the minimum wage).	• Number of subsidized out-patient visits.	October-December 2009 under ESSN 27 909		-		184 199[79] (est.)			-	202 620[80] (est.)
		• Number of subsidized in-patient admissions.	October-December 2009 under ESSN 2 140		-		14 380[81] (est.)			-	15 818[82] (est.)

[76] The average coverage ratio of patients registered with GP.
[77] The average coverage ratio of patients registered with GP increased by 10% is used for estimates, as it is planned that the second nurse will engage in the care of needy persons.
[78] The ratio of 2010 is increased by 10%, because after engaging the second nurse in the primary care network the coverage of patients will increase.
[79] Calculations are made based on fourth- quarter 2009 data, relating quarter to the year and taking into account the projected increase in the number of needy persons.
[80] The ratio of 2010 is increased by 10%, because the overall coverage of patients it planned to increase for 10%.
[81] Calculations are made based on fourth- quarter 2009 data, relating quarter to the year and taking into account the projected increase in the number of needy persons
[82] The ratio of 2010 is increased for 10%, because it planned to increase the overall coverage of patients.

MONITORING AND RESULTS FRAMEWORK

	Action	Monitoring Indicator	Baseline	2010 Q1	2010 Q2	2010 Q3	2010 Q4	2011 Q1	2011 Q2	2011 Q3	2011 Q4
4.	In 2010 and 2011 budgets, financing for full exemption from pharmaceutical charges above LVL 50 per year per person (LVL 12.5 each quarter), for needy households (i.e. with per-capita income less than half the minimum wage).	• Number of patients receiving 100% reimbursement of medicinal products or medicines charges under the emergency social safety net.	October-December 2009 under ESSN 99		-		34 080 (est.) [83]			-	37 488 (est.)[84]
5.	In 2010 and 2011 budgets, financing sufficient to maintain overnight hotel stays in hospitals for patients from needy households (i.e. with per-capita income less than half the minimum wage).	• Number of hospitals' hotel patients receiving a subsidy under the emergency social safety net.	October-December 2009 under ESSN 551		-		27 200 (est.) [85]			-	29 920 (est.) [86]
6.	In 2010 and 2011 budget, financing sufficient to offer home care to patients with serious diseases from households with per-capita income less than half the minimum	• Number of subsidized home care visits under the emergency social safety net for needy persons with serious diseases.	October-December 2009 under ESSN 115		-		200 000[87] (est.)			-	220 000 [88] (est.)

[83] New action (launched on October 2009), therefore the fourth- quarter 2009 data were not used for calculations. The probable number of needy persons to whom the expenses for the medicinal products will be reimbursed in the amount of 100%, was estimated taking into account the total number of patients received reimbursements for medicinal products and the projected increase in the number of needy persons. The rates will be revised, when the first-quarter 2010 data will be available

[84] The ratio of 2010 is increased for 10%, because it planned to increase the overall coverage of patients

[85] New action (launched on October 2009), therefore the fourth- quarter 2009 data were not used for calculations. The estimates are based on the assumption that 50% of patients who received health care services in the reorganised hospitals, will use only out-patient services, thereby the overnight hotel stays in hospitals should to be reimbursed. The rates will be revised, when the first-quarter 2010 data will be available.

[86] The ratio of 2010 is increased for 10%, because it planned to increase the overall coverage of patients.

[87] New action (launched on October,2009), therefore the fourth- quarter 2009 data were not used for calculations. The estimates are based on the assumption that after decreasing the number of hospitalisations and the average length of stay, the certain number of home care services need to be provided. The rates will be revised, when the first-quarter 2010 data will be available.

[88] The ratio of 2010 is increased for 10%, as it is planned to increase the overall coverage of patients.

MONITORING AND RESULTS FRAMEWORK

	Action	Monitoring Indicator	Baseline	2010 Q1	2010 Q2	2010 Q3	2010 Q4	2011 Q1	2011 Q2	2011 Q3	2011 Q4
	wage.										
7.	In 2010 and 2011 budget, financing required for day-care centers for patients with mental diseases from households with per-capita income less than half the minimum wage.	• Number of established day care centers.	2				4[89]				6[90]
		• Number of needy patients receiving care in mental day care centers.	October-December 2009 under ESSN 21		-		400 (est.) [91]			-	600 (est.) [92]
8.	In 2010 and 2011 budgets, maintain financing for pre-primary education/child development programs for 5 and 6 year olds.	• Percentage of 5 year old children attending pre-primary child development.	89% (17707 of 19896)		90% (18799 of 20888)		93% (19425 of 20888)			93% (19013 of 20444)	93% (19013 of 20444)
		• Percentage of 6 years old children in pre-primary/starting primary (from September 2010).	98% (19008 of 19396)		98% (19473 of 19870)		98% (19473 of 19870)			98% (20470 of 20888)	98% (20470 of 20888)
9.	Financing in the 2010 and 2011 budgets adequate to cover costs of transporting students to replacement schools	• Percentage of students receiving assistance for school transportation in municipalities where schools have closed.	October-December 2009 under ESSN 70% (1870 of 2680)		70% (1870 of 2680)		72% (2160 of 2980)			75% (2240 of 2980)	77% (2400 of 3130)
		• Percentage of students required to travel more than 60 minutes (one way) to get to school, in municipalities where schools have closed.	October-December 2009 under ESSN 1.5% (28 of 2680)		1,5% (28 of 2680)		1,2% (25 of 2980)			1,0% (22 of 2980)	0,8% (20 of 3130)

[89] The planned decrease of the number of inpatient psychiatric beds is possible by developing mental health care centres. Two community-based mental health care centres can serve not over 10% of patients with mental disorders, thereof in addition to the current centres (2) and along with the reorganisation or decrease of the number of inpatient psychiatric beds it is necessary to develop at least 2 community-based mental health care centres in 2010 and two in 2010. The policy planning document of mental health care development states the development of 6 community-based mental health care centres.

[90] See the previous (91) reference.

[91] New action (launched on October, 2009), therefore the fourth- quarter 2009 data were not used for calculations. Estimates are made based on the number of patients receiving care in mental day- care centres.

[92] The ratio of 2010 is increased, considering that the number of mental day care centres will increase.

MONITORING AND RESULTS FRAMEWORK

	Action	Monitoring Indicator	Baseline	2010 Q1	2010 Q2	2010 Q3	2010 Q4	2011 Q1	2011 Q2	2011 Q3	2011 Q4
10.	Implement program to add social considerations (low family income, disability, etc) to the award of state support for higher education.	• Percentage of students qualifying for state financial support university based on social considerations/ criteria (proportion of persons of total received state education grants).	39% (1379 of 3549)		39% (1379 of 3549)		45% (1620 of 3600)			45% (1620 of 3600)	50% (1850 of 3700)
11.	Temporary extension of pay-out period of unemployment insurance benefits to 9 months, until January 1 2012, and reduction in the months of contribution to become eligible for coverage (from 12 in the previous 18, to 9 in the previous 12)	• Percentage of newly registered unemployed eligible for unemployment insurance benefit (administrative data of the Ministry of Welfare).[93]	74% (data from 2009 Q1)	60%	60%	60%	60%	60%	60%	60%	60%
		• Percentage of unemployment benefit receivers whose benefits are extended by the reform measure.[94]	0[95]	22%	22%	22%	22%	22%	22%	22%	22%
12.	Raise coverage and increase the payment period of GMI, while establishing financial compensation to help local governments meet greater demand for the benefit.	• Percentage of population receiving GMI (administrative data of the Ministry of Welfare and Central Statistical Bureau of Latvia)	1.2% (data for 2008; the indicator will be updated by situation on year 2009 at April of 2010)[96]	2.3%[97]	2.3%	3.5%	4.4%[98]	4.4%	4.4%	4.4%	4.4%

93 It is agreed with the WB that there is no need to show the assumptions for this indicator.

94 It is agreed with the WB that there is no need to show the assumptions for this indicator.

95 Percentage of unemployment benefit receivers whose benefits are extended by the reform was 22% in 2009 Q4

96 According to the statistics of municipalities 27.4 thousand people received GMI benefit or 1.2% of the population of the previous year

97 The assumption is that there will be 54.0 thousand GMI recipients or 2.3% of the population (assuming that the number of population is not changed).

98 In 2010 Q4 and the next quarters the assumption is that there will be 100.0 thousand GMI recipients or 4.4% of the population (assuming that the number of population is not changed).

MONITORING AND RESULTS FRAMEWORK

Action	Monitoring Indicator	Baseline	2010 Q1	2010 Q2	2010 Q3	2010 Q4	2011 Q1	2011 Q2	2011 Q3	2011 Q4
	• Percentage of needy persons receiving GMI benefit (administrative data of the Ministry of Welfare)	22.8% (data on 2008; the indicator will be updated by situation on year 2009 at April of 2010)[99]	30%[100]	50%[101]	50%	50%	50%	50%	50%	50%
	• Average length of pay-out/period of receipt of GMI benefits, in months (estimated data of the Ministry of Welfare)	4.05 months (in 2008)[102]	-	-	-	7.00 months[103]	-	-	-	6.00 months
	• Share of spending on GMI financed through ESSNS co-financing mechanism, % (administrative data of the Ministry of Welfare).[104]	0[105]	50%	50%	50%	50%	50%	50%	50%	50%

99 According to statistics of municipalities in 2008 120.3 thousand people were certified as needy, and 27.4 thousand people received the GMI benefit. (27,4 :120,3 x100%= 22.8%).

100 The assumption is that 180.0 thousand people will be certified as needy and GMI benefit receivers will be *54.0* thousand people (180.0 / 54.0 x100%=30%).

101 Assumption is that 200.0 thousand people will be certified as needy and GMI benefit receivers will be 100.0 thousand people (100.0 :200.0 x100%=50%).

102 According to the statistics of municipalities the average pay-out/period of GMI benefits is **4.05 month in 2008**. It is calculated as (number of persons x months) / number of persons.

103 As from the October 2008 the restriction to receive the benefit only 9 month is canceled. The assumption is that taking into account the economical decline, the average length of benefit pay-out period will increase, but when economy starts to recover the average pay-out period will decrease. 2010 Q4 - 7.00 months, 2011 Q4 - 6.00 months.

104 The indicator is defined as in the legislation.

105 Data on Q4 2009 will be provided in first week of February of 2010

MONITORING AND RESULTS FRAMEWORK

	Action	Monitoring Indicator	Baseline	2010 Q1	2010 Q2	2010 Q3	2010 Q4	2011 Q1	2011 Q2	2011 Q3	2011 Q4
13.	Increase the absorptive capacity of active employment measures in the face of increased demand from unemployed people without coverage of UI.	• Percentage of registered unemployed ineligible for UI, who are participating in Workplaces with Stipend program (at any given point during the quarter) – data from the Ministry of Welfare.	0[106] The indicator is calculated comparing the No. of persons which are involved in the measure against the No. of unemployed who are not receiving unemployment benefit	25 No. of participants in the measure during the period – 30000/ No. of unemployed who are not receiving unemployment benefit 120000	30 No. of participants in the measure during the period – 37500/ No. of unemployed who are not receiving unemployment benefit 125000	25 No. of participants in the measure during the period – 32000/ No. of unemployed who are not receiving unemployment benefit 128000	20 No. of participants in the measure during the period – 26400/ No. of unemployed who are not receiving unemployment benefit 132000	10 No. of participants in the measure during the period – 13000/ No. of unemployed who are not receiving unemployment benefit 130000	10 No. of participants in the measure during the period – 13000/ No. of unemployed who are not receiving unemployment benefit 130000	5	0
		• Total duration of participation in "person months" in Workplaces with Stipend program (cumulative data as of first participant starting to participate in the measure) [107]	0[108]	85 000 The number of days (total duration of participation) 2550000 / 30	130 000 The number of days (total duration of participation) 3900000 / 30	170 000 The number of days (total duration of participation) 5100000 / 30	200 000 The number of days (total duration of participation) 6000000 / 30	224 000 The number of days (total duration of participation) 6720000 / 30	245 000 The number of days (total duration of participation) 7350000 / 30	245 000 The number of days (total duration of participation) 7350000 / 30	245 000 The number of days (total duration of participation) 7350000 / 30
		• Number of created workplaces in Workplaces with Stipend program (data of the Ministry of Welfare) – (cumulative data as of first participant starting to participate in the measure)	0[109]	22 183	34 309	34 309	34 309	42 398	42 398	42 398	42 398

[106] Percentage of registered unemployed ineligible for UI participating in Workplaces with Stipend program was 21,2% in 2009 Q4. Calculation for 4th quarter 2009 - 19130 - unemployed participating in the program in the 4th Q 2009 (at any time and of any duration of participation during the 4th quarter) 90124 - average number of unemployed not receiving UB in the 4th Q 2009 (October - 81450, Nov - 90390, Dec - 98531).

[107] The database of the SEA captures the starting and the finishing date of the period that a person participates in the WWS program. The period includes days that are free (like week-ends), days when a person is counted as a participant in the program but does not earn the stipend (e.g. because of unjustifiable absence) or if they have a justifiable paid or non-paid absence (according to the rules of the program). Therefore, to calculate the indicator - person months - the number of days (total duration of participation) is divided by 30 (the average number of days per month in a year including weekends etc.). Result: Starting from the first day of participation till the 31st December, the total duration of participation was 1363997 days (including weekends etc.), if divided by 30 the result is 45467)

[108] The duration of participation in person months in Workplaces with Stipend program at the end of 2009 was 45467

[109] Number of created workplaces in Workplaces with Stipend program at the end of 2009 was 16830

ANNEX 5: LATVIA'S MULTI-PILLAR RETIREMENT SECURITY SYSTEM

1. **Latvia was the first country in Central and Eastern Europe to restructure its public pay-as-you-go (PAYGO) pension regime**, from a purely defined benefit (DB) structure, to a non-financial (notional) defined contribution (NDC) plan. The new public plan was implemented in January 1996. Although not funded, the benefits paid under a non-financial NDC retirement savings plan are calculated based on an affiliated worker's accumulation of "notional" capital (the individually accounted accumulation of contributions to the plan) and a notional rate of return, which in Latvia's case is tied to the contribution wage bill.[110] Simultaneously, a phased increase in the minimum retirement age for men and women was introduced, which converged at 62 in 2008. One of the merits of an NDC structure – like a funded defined contribution plan – is that by tying benefits to contributions, it provides workers with an incentive to work longer, since their benefits are linked to how much they "accumulate" and the returns earned on their notional capital. Thus workers are able, and indeed encouraged, to work and contribute past the minimum retirement age as upon retiring, a worker's notional annuity is calculated by dividing his notional capital by his remaining life expectancy.

2. **Also as part of the structural reform of social insurance for old age, disability and survivor coverage in the 1990s, a separate pillar of private mandatory individual retirement savings accounts was introduced, and began operating in July 2001**. The new funded accounts were made mandatory for any worker under 30 at that time, and all new entrants to the formal labor force. Since 2001 a small share of workers' social insurance contributions to the NDC plan (about 2 percentage points) has been diverted to the individual retirement accounts. This share has been increasing slowly (in 2008, it was equal to 8 percentage points).

3. **Latvia's structural pension reform was considered a success from the perspective of an affiliated individual and his household**. Estimates of gross replacement rates (Table A.5.1) and net replacement rates (Table A.5.2)[111] indicate that a Latvian worker of average earnings who participates in the system could expect a higher retirement benefit than a similar worker in Estonia and Lithuania, and even in Poland. The expected benefit from the Latvian system was actually higher than the regional average. And unlike other mixed-plan systems in the region and elsewhere in the world, in Latvia, a worker can choose to add his financial savings to his notional savings upon retiring in order to increase his benefit from the NDC plan, or purchase a private annuity.

[110] Thus, the rate of return earned during the accumulation period (when a worker is paying into the plan) reflects (a) growth in productivity and the wage rate; (b) changes in fertility; (c) the net migration of working age individuals; and (d) the gradual formalization of the economy.

[111] Net replacement rates take into account the taxes and social security contributions that individuals have to pay while working but also in retirement.

Table A.5.1. Gross Replacement Rates by Earnings Level, Mandatory Pension Plans, and Percentage of pre-retirement gross earnings.

	Individual earnings, multiple of average					
	0.5	*0.75*	*1*	*1.5*	*2*	*2.5*
Bulgaria	49.7	49.7	49.7	49.7	40.0	33.5
Croatia	47.3	41.3	38.4	35.4	33.9	33.0
Czech Republic	70.5	53.3	44.4	31.7	25.4	21.6
Estonia	58.4	53.9	51.6	49.4	48.2	47.5
Hungary	75.4	75.4	75.4	75.4	75.4	66.3
Latvia	63.6	58.2	58.2	58.2	58.2	58.2
Lithuania	69.9	58.9	53.4	47.8	45.1	43.4
Poland	56.9	56.9	56.9	56.9	56.9	55.8
Slovak Republic	48.6	48.6	48.6	48.6	48.6	48.6
Turkey	96.2	90.2	87.2	84.1	71.9	57.5
Average	**63.7**	**58.6**	**56.4**	**53.7**	**50.4**	**46.5**

Source: Whitehouse (2007)

Table A.5.2 Net Replacement Rates by Earnings Level, Mandatory Pension Plans, Men, Percentage of pre-retirement net earnings.

	Individual earnings, multiple of average					
	0.5	*0.75*	*1*	*1.5*	*2*	*2.5*
Bulgaria	67.1	73.8	75.2	74.0	61.8	52.9
Croatia	66.7	63.1	61.6	59.7	59.6	58.9
Czech Republic	88.3	68.3	58.2	42.9	35.3	31.0
Estonia	59.9	60.6	60.9	61.3	61.5	61.7
Hungary	86.6	90.9	90.5	99.1	92.6	81.8
Latvia	89.2	83.7	81.8	76.7	74.1	72.5
Lithuania	81.7	75.1	71.3	67.2	64.9	63.5
Poland	69.6	69.7	69.7	69.8	70.5	71.0
Slovak Republic	58.2	59.4	60.2	63.1	65.7	67.8
Turkey	113.2	106.7	103.3	99.9	84.3	66.8
Average	**78.1**	**75.1**	**73.3**	**71.4**	**67.0**	**62.8**

Source: Whitehouse (2007)

4. **Although Latvia's pension reform was broadly considered a success, the pension system remains vulnerable to even small changes in parameters**. Latvia's pension reform brought long term financial stability to the old age, survivor and disability programs of the social insurance system (Palmer, et al, 2006). However, this financial stability was fragile and vulnerable to even small changes in the parameters of the plan (such as the contribution rate, indexation mechanism, and the minimum age of retirement) and how contributions to and rights acquired under the pre-reform plan are recognized.[112]

[112] The method of calculation of a worker's notional annuity has two important fiscal policy implications. Upon retiring, a worker's notional annuity is calculated by dividing his notional capital by his remaining life expectancy. There are two important points to note with this estimation, which both have potential fiscal consequences. First, a unisex estimate is made which overestimates the remaining expected years of life for men and underestimates the remaining lifespan of women. Second, the life expectancy estimate is made annually for each cohort of retirees from the plan, and as such captures the longevity gains reflected in population ageing.

5. **Due to rising unisex life expectancy factor used to calculate NDC annuity and the resulting gradual reduction of benefits there was a move toward indexing benefits to wage growth**. The retirement age which reached 62 for men in 2003 and reached the same age for women in 2008, but is still very low by international standards. In 2002, Latvian men could expect to live 13 more years and women to live 20 more years on average after retirement. Since 1996, the unisex life expectancy factor used to calculate the NDC annuity has increased from 18.25 years to 19.17 years in 2004, which tended to reduce the level of benefits from the plan. The Government was concerned that rapid changes in longevity as well as continued economic growth could lower the average pension benefit relative to average wages. This concern motivated changes in indexing benefits to include wage growth. Until 2002, indexation of benefits was based solely on the consumer price index (CPI). From 2002 "Small pensions" (those equal to or less than 3 times the state social benefit) have been adjusted by 50 percent of wage growth in addition to the CPI adjustment. Benefits are adjusted to changes in inflation twice a year, and on the second adjustment, 50% of growth in wages is added. The Government planned to extend this wage adjustment in addition to the CPI to all pension benefits (old age, survivor and disability benefits) in 2015.[113] According to the new policies indexation of pensions has frozen in 2009 and **2010** and further pensions will be indexed by pure CPI.

6. **The generous indexation mechanism put in jeopardy the fiscal stability brought by the 1996 reform**. During the period of high wage growth from 2004 – 2007 the mixed indexing regime put at risk the fiscal stability brought by the 1996 reform, particularly given the growing share of funds going to private individual accounts. The 2007 PER concluded that significant medium and long-term savings for the social insurance special budget would arise from abandoning the policy of adjusting benefits to wage growth.

7. **With economic decline, revenues to the social insurance special budget have fallen, and the Government has introduced a temporary diversion of contributions from the privately managed funded pillar, to sustain pensions paid from the public pillar.** In the first half of 2009, as the economy contracted, revenue to the social insurance special budget declined sharply. An amendment to the law "On State Pensions" passed by Parliament on April 23, 2009 introduced a time- bound diversion of contributions from Latvia's private pension funds, to the NDC pillar. From 2009 to 2010, the contribution rate to the private pillar was reduced from 8 percent of a worker's salary to 2 percent. In January 2011, the contribution will be raised to 4 percentage points, and in January 2012 to 6 percent. After 2011, contributions to the private pillar remain at 6 percent. Prior to the amendment, the contribution was to rise to 10 percentage points in 2011. The Government believes this temporary infusion is necessary to (i) avoid cutting pensions in payment; and (ii) to eliminate the need for transfers to the social insurance

[113] The Government sought to avoid a sharp decline in pension benefits relative to the wages of the working population during sustained period of high economic growth, to prevent pensions from looking meager relative to wages, thereby avoiding a political back-lash and lead to calls for even more populous measures. However, from a purely economic perspective, the mixed indexation is excessive. The adjustment to a contributor's notional capital during working life is sufficient to help him smooth consumption (the first function of any old-age income security system), and adequately captures his contribution to the economy and whatever externalities that arise from that contribution. Further underpinning this growth in notional capital, is the security of the safety net benefit to keep him out of poverty (the second function), and the diversified returns earned from the private investment of savings in a worker's funded individual account. In most PAYGO pension plans like Latvia's NDC, although the salary base from which the annuity is calculated is indexed to wage growth, once an affiliate retires, benefits are usually only indexed to inflation, or to a combination of inflation and wage growth.

budget from general revenues to make up for the fall in contribution revenue as unemployment rises. The diversion enjoys political support. However, it could be seen in future as a violation of private property rights and will weaken other financial contracts.

8. **Although extreme, the Government's action is a change within the parameters of the multi-pillar pension model, and with the right measures, the damage to the system can be mitigated.** In assessing the amendment, it is important to note the NDC structure of Latvia's pay-as-you-go pillar. Strictly speaking, these additional contributions to the public pillar will add to participants' "notional capital" accumulation and translate into higher pensions when currently working affiliates retire. The amendment requires that the NDC rules be applied to the diverted contributions. Assuming that public administration is as good a custodial service as private administration, then the loss to the affiliate at the time they retire, is the difference between the NDC notional rate of return (which is currently negative) and the financial rate of return had these savings been invested in securities (which is also negative). From an affiliated workers' perspective, the difference depends on the extent to which the risk to the rights acquired by workers under the NDC rules of the public pillar are greater/less than the property rights of holding financial assets (mostly publicly issued debt). However, the infusion from this measure relies on the same source of revenues – worker contributions – and so is also vulnerable to increasing unemployment. It also increases the future liabilities of the social insurance special budget, raising the risk to the financial sustainability of public pension provision.

9. **An additional weakness of the NDC plan which threatened the long-term financial stability of publicly financed pensions even before the crisis is the lack of a pension reserve fund**. Outside observers have been calling for such a fund to safeguard the PAYGO structure of the NDC plan since its inception. While pensions are financed out of a special social insurance budget that accounts for workers' contributions (as well as the government's responsibilities to pensioners under the pre-reform regime), any surpluses are simply deposited in a special account at the Treasury, and are not earning as high nor as diversified a return as they would if they were invested on the international capital market. This is a problem, as prior to the crisis Latvia was enjoying a demographic yield from a surge in childbirth in the 1980s, and the annual surpluses from additional worker contributions were not being used optimally to help underpin the NDC plan's long term finances. Without a reserve fund, the risks of the financial stability of the public pension scheme were growing even before the downturn.

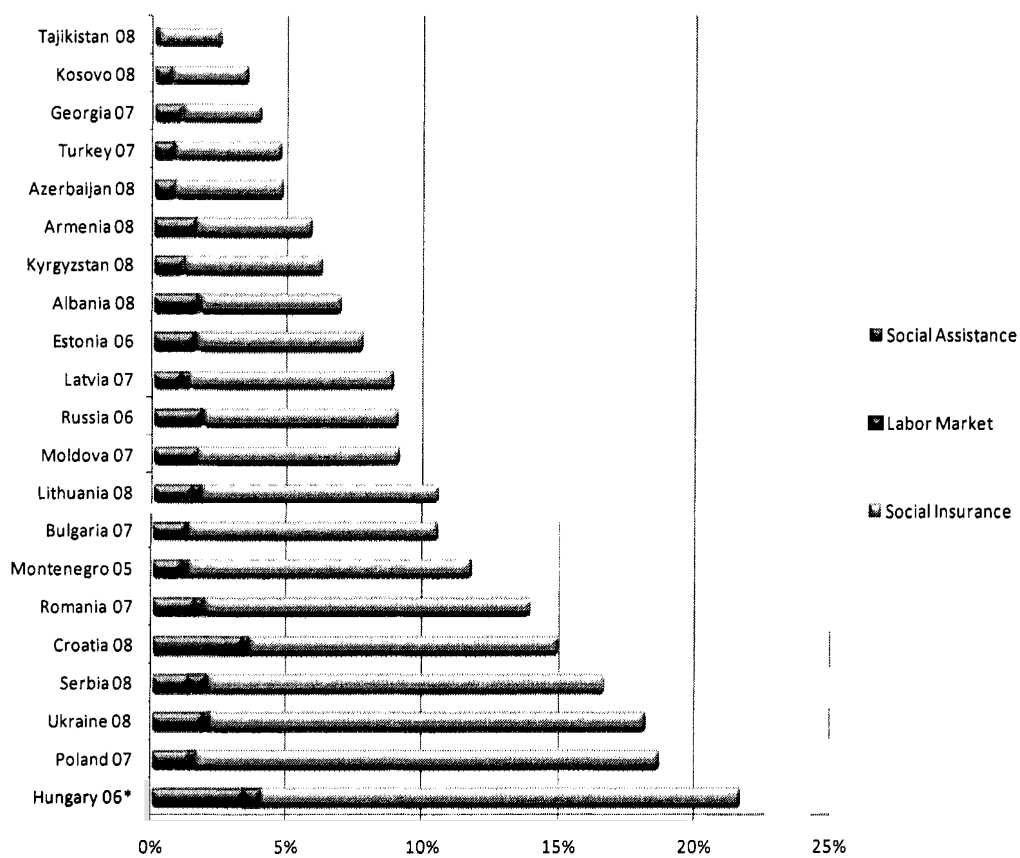
ANNEX 6: SPENDING, COVERAGE AND DISTRIBUTION OF LATVIA'S SOCIAL PROTECTION PROGRAMS AND BENEFITS

Table A.6.1. Spending on Social Protection
(Percentage of GDP)

	2002	2003	2004	2005	2006	2007
Hungary	15.4	15.9	16	17	17.6	17.3
Poland	18.3	18.8	17.6	17	16.9	15.7
Slovenia	17	17	17.4	17.3	16.9	15.5
Bulgaria	14.4	13.5	11.3	11.1	12.2	13.1
Czech Republic	14.6	14.4	13	12.8	12.7	12.9
Lithuania	10.8	10.3	10.2	9.9	9.9	11.1
Slovakia	14.9	16.3	12.1	13.2	12.4	10.6
Romania	10.4	9.3	9.6	9.8	9.7	9.9
Estonia	10	9.9	10.2	9.9	9.6	9.8
Latvia	11.5	10.7	10.4	9.8	9.8	8.4

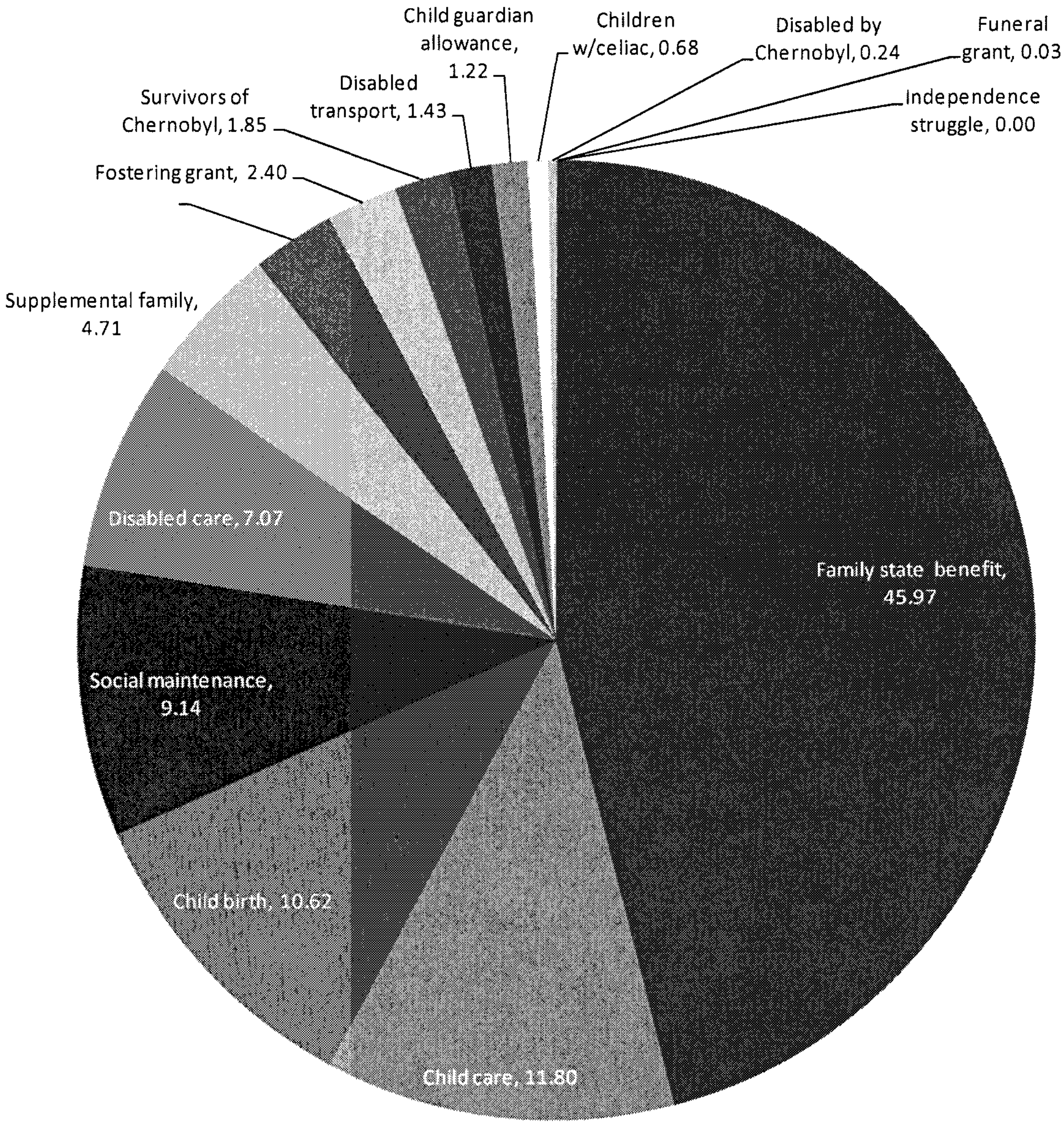
Source: EUROSTAT

Figure A.6.1. Spending on Social Protection, Latvia and other Europe and Central Asia Countries
(Percentage of GDP – Year Indicated)



Source: ECSHD Social Protection Unit

Figure A.6.2. Latvia's State Social Benefits (National Government General Revenue Financed), by Spending Allocation in 2008
(Percentage of Total Spending on State Social Benefits)



Source: Ministry of Welfare

Figure A.6.3. Municipal Social Assistance Benefits, by Spending Allocation in 2007

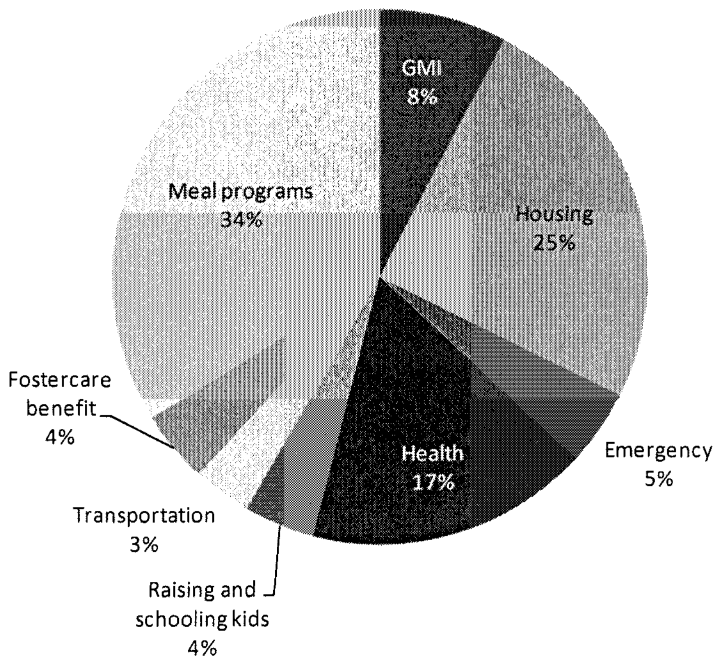
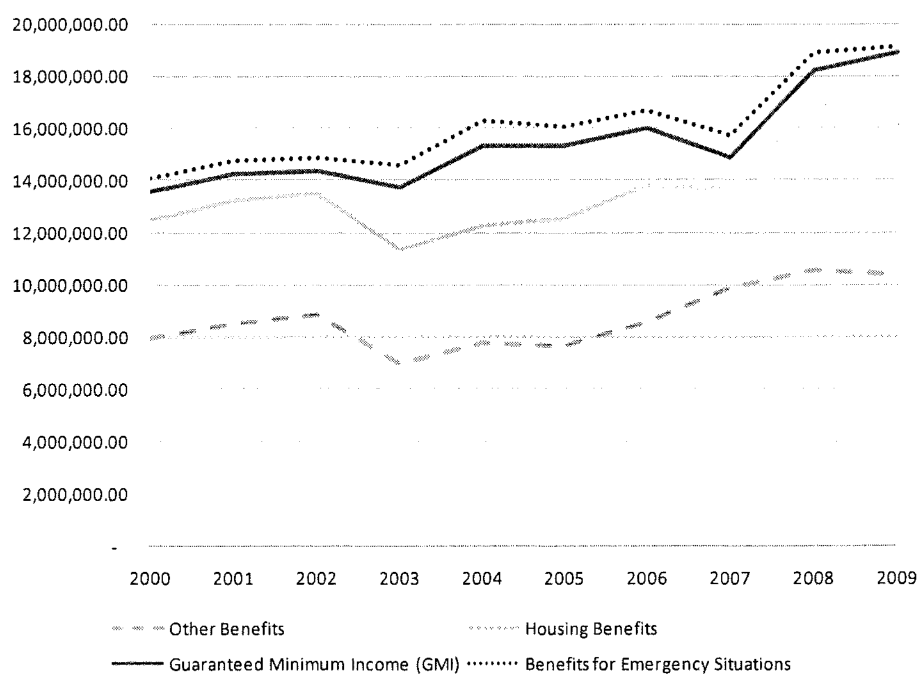


Figure A.6.4. Municipal Spending on Social Assistance Benefits, 2000 - 2009



Source: Ministry of Welfare

Table A.6.2. Coverage of Latvia's Social Protection Programs, 2007
(By Quintiles of Household Consumption)

	Total	Q1	Q2	Q3	Q4	Q5
All social protection	81.5	99.1	90.1	85.1	72.7	60.6
All social insurance	44.8	90.7	53.4	35.7	25.0	19.1
Old-age pension	35.8	84.5	41.8	24.1	18.1	10.8
Disability pension	6.7	17.2	6.2	4.1	3.3	3.1
Survivor's pension	1.6	1.9	2.4	1.6	1.2	0.7
Service and special pension	1.2	3.1	1.1	0.7	0.3	0.9
Sickness and other benefits (social insurance)	1.4	1.0	1.3	2.4	1.1	1.3
Maternity/Paternity benefit	2.5	2.5	0.9	2.8	5.2	1.3
All labor market programs	2.1	2.0	3.7	2.0	1.4	1.5
Unemployment benefit	2.1	2.0	3.7	2.0	1.4	1.5
All social assistance	55.9	61.0	61.7	57.1	54.5	45.1
Child care benefit	8.0	10.0	9.0	10.8	5.9	4.4
Family state benefit (including also supplement for disabled child)	48.4	49.4	52.5	48.5	49.8	41.7
Guardian benefits + State social maintenance benefit	0.9	2.6	0.9	0.9	0.0	0.1
Birth Allowance	4.5	4.7	2.5	5.3	6.4	3.5
Funeral Allowance	0.9	1.0	0.8	0.0	0.9	1.6
Other state target allowances + transport expense for disabled	0.4	0.8	0.3	0.4	0.6	0.0
GMI + Dwelling + Care + Other local gov. target allowance	6.1	6.2	5.5	7.3	6.6	4.9
Paid housing expenses (local government - includes actual rentals, electrici	1.4	3.4	2.2	0.8	0.6	0.1
Paid health services (local government) - includes vaccination, medication,	2.0	3.3	3.4	2.1	0.9	0.2
Other in-kind local government allowances	0.6	1.6	0.5	0.8	0.1	0.2
Scholarship for students and pupils	3.9	5.4	3.7	3.1	5.4	2.1

Notes:

1. Quintiles constructed by consumption ability pre-receipt of transfer
2. Program coverage is the portion of population in each group that receives the transfer.
3. Specifically, coverage is: (Number of individuals in the group who live in a household where at least one member receives the transfer)/(Number of individuals in the group).
4. Program coverage is calculated setting as expansion factor the household expansion factor multiplied by the household size.

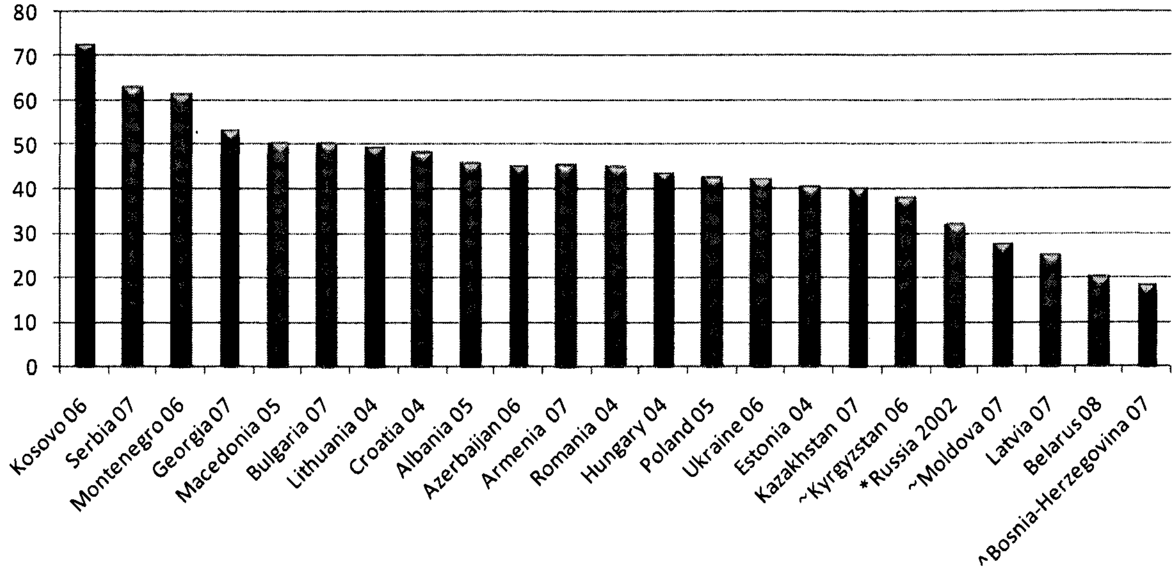
Table A.6.3. Distribution of Benefits
(Percentage of Benefits Received by Households in Each Consumption Quintile)

	Total	Q1	Q2	Q3	Q4	Q5
All social protection	100.0	49.3	20.2	13.3	9.5	7.7
All social insurance	100.0	56.9	19.0	10.1	7.5	6.6
Old-age pension	100.0	60.9	17.3	8.9	7.3	5.6
Disability pension	100.0	57.4	15.6	11.0	7.9	8.1
Survivor's pension	100.0	29.9	27.1	18.1	16.0	9.0
Service and special pension	100.0	50.8	17.8	9.0	3.9	18.6
Sickness and other benefits (social insurance)	100.0	65.0	9.1	12.3	6.1	7.6
Maternity/Paternity benefit	100.0	12.8	14.1	16.4	39.6	17.1
All labor market programs	100.0	24.2	19.6	12.2	9.8	34.2
Unemployment benefit	100.0	24.2	19.6	12.2	9.8	34.2
All social assistance	100.0	25.0	22.3	23.4	16.9	12.5
Child care benefit	100.0	18.6	23.4	33.7	13.1	11.1
Family state benefit (including also supplement for disabled child)	100.0	24.3	22.1	19.3	18.6	15.7
Guardian benefits + State social maintenance benefit	100.0	61.8	18.8	16.5	0.0	2.9
Birth Allowance	100.0	18.9	10.4	23.7	28.5	18.5
Funeral Allowance	100.0	19.1	15.2	2.9	19.6	43.2
Other state target allowances + transport expense for disabled	100.0	55.0	19.4	4.3	21.3	0.0
GMI + Dwelling + Care + Other local gov. target allowance	100.0	22.7	14.8	22.5	24.7	15.4
Paid housing expenses (local government - includes actual rentals, electrici	100.0	31.2	38.3	13.9	10.8	5.8
Paid health services (local government) - includes vaccination, medication,	100.0	33.8	37.9	18.7	8.3	1.4
Other in-kind local government allowances	100.0	56.4	16.5	20.2	3.6	3.4
Scholarship for students and pupils	100.0	20.5	14.6	8.8	41.1	15.1

Notes:

1. Quintiles of per-capita consumption are net of SP benefits
2. Benefits' incidence is the transfer amount received by the group as a percent of total transfers received by the population
3. Specifically, benefits' incidence is: (Sum of all transfers received by all individuals in the group)/(Sum of all transfers received by all individuals in the population).
4. Aggregated transfer amounts are estimated using household size-weighted expansion factors.

Figure A.6.5. Percentage of Non-Contributory Benefits Received by the Poorest Quintile in Latvia and other Countries in Eastern Europe and Central Asia
(all social assistance, universal and means-tested)

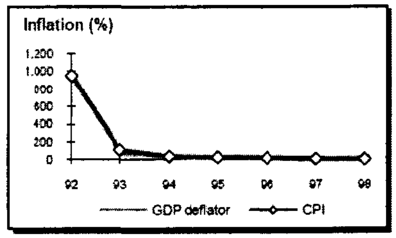


Source: ECSHD Social Protection Unit

ANNEX 7: LATVIA AT A GLANCE

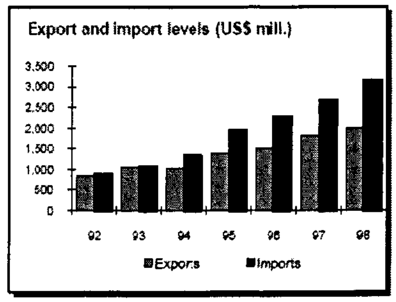
PRICES and GOVERNMENT FINANCE

	1978	1988	1997	1998
Domestic prices				
(% change)				
Consumer prices	..	..	8.4	4.7
Implicit GDP deflator	0.8	0.1	6.6	11.3
Government finance				
(% of GDP, includes current grants)				
Current revenue	..	..	41.3	40.6
Current budget balance	..	..	3.6	5.2
Overall surplus/deficit	..	..	0.3	-0.8



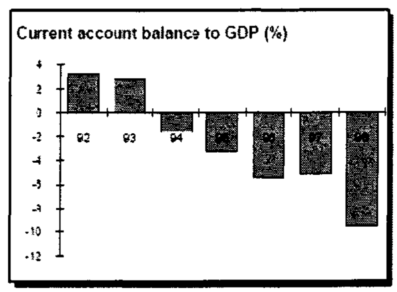
TRADE

	1978	1988	1997	1998
(US$ millions)				
Total exports (fob)	..	..	1,030	2,011
Commodity 1	..	..	..	..
Commodity 2	..	..	..	..
Manufactures	..	..	1,548	1,627
Total imports (cif)	..	..	2,686	3,141
Food	..	..	273	301
Fuel and energy	..	..	145	116
Capital goods	..	..	476	609
Export price index *(1995=100)*	..	..	108	108
Import price index *(1995=100)*	..	..	..	..
Terms of trade *(1995=100)*	..	..	..	..



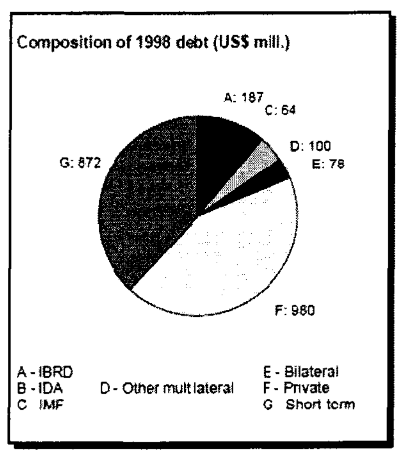
BALANCE of PAYMENTS

	1978	1988	1997	1998
(US$ millions)				
Exports of goods and services	..	..	2,929	3,156
Imports of goods and services	..	..	3,348	3,902
Resource balance	..	..	-420	-746
Net income	..	..	55	54
Net current transfers	..	..	77	84
Current account balance	..	..	-288	-608
Financing items (net)	..	..	390	671
Changes in net reserves	..	..	-102	-63
Memo:				
Reserves including gold *(US$ millions)*	..	..	953	1,012
Conversion rate *(DEC, local/US$)*	..	..	0.6	0.6



EXTERNAL DEBT and RESOURCE FLOWS

	1978	1988	1997	1998
(US$ millions)				
Total debt outstanding and disbursed	0	0	1,825	2,230
IBRD	0	0	120	137
IDA	0	0	0	0
Total debt service	0	0	232	204
IBRD	0	0	6	12
IDA	0	0	0	0
Composition of net resource flows				
Official grants	..	..	48	..
Official creditors	0	0	63	95
Private creditors	0	0	12	5
Foreign direct investment	..	..	..	..
Portfolio equity	..	..	26	..
World Bank program				
Commitments	0	0	38	31
Disbursements	0	0	53	82
Principal repayments	0	0	0	4
Net flows	0	0	53	78
Interest payments	0	0	6	8
Net transfers	0	0	47	70



MAP SECTION

JANUARY 2005

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