BUDGETING UNDER STRESS: THE CASE OF LATVIA

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In this brief historical review the impact of the Great Recession of 2007–2009 on Latvia is explored. Within a year, the economy changed from a boom to one of the weakest in the EU. Examined are the efforts of a weak and distrusted Latvian government to have a large, suspended bailout loan reinstated. These processes changed from the 2008–2009 crash programs to make large cuts, to a more orderly budget adjustments to meet lender demands in 2010 and 2011. At the core of this study is the Latvian government's struggle with an accumulating deficit, conflicting interests of coalition partners and the professional bureaucracy, and a distrustful general population.[1]

Introduction

In March 2010, Latvian Prime Minister Valdis Dombrovskis and Finance Minister Repše concluded a year of historical calamity and crisis management. It was a rough, even chaotic, period of budget cuts and extremely difficult negotiations to have a large, suspended bailout loan extended. A euro 7.5 billion (about 10 billion USD) financing plan was reinstated by the European Commission (EC) and the International Monetary Fund (IMF). Dombrovskis and Repše managed to prevent the collapse of the Latvian financial system. A brutally cut 2009 budget was passed by the *Saeima* (parliament) on 12 December 2008. A managerially more acceptable, austere and unpopular 2010 budget was voted in on 21 November 2009. Moreover, they also succeeded in maintaining essential government operations.

The 2011 budget was finalized in December of 2010, after the parliamentary elections in October. A new cabinet was organized by Dombovskis with the bank economist Andris Vilks as the Finance Minister. The agreements with the EC and the IMF mandated that deficits be reduced to 6% in 2011, and 3% in 2012. Joining the euro zone in 2014 remained the agreed rationale for the bailout loan.

When the American bubble burst in 2007, Latvia still enjoyed the benefits of a credit binge financed by Swedish banks and Russian deposits. However, in just little over a year the Latvian economy had lost over a quarter of its GDP. By 2008, the Latvian

[1] Budžeta konsolidācijas rezultāti ir precizēti latviešu valodā Valsts kancelejas 2011. gada izdotajā pārskatā "Mīti un patiesība par valsts pārvaldē nodarbinātajiem, atalgojumu un strukturālām reformām".

economy was what was later described in *Foreign Policy* (Greenhalgh 2010) "the most imperiled in Europe". Another drop was expected, making the probable loss of 30% relatively larger than what the United States suffered during the Great Depression of 1929–1933 (Andersen 2009).

In this study we examine the crisis management of Latvian government, its mistakes and remedial actions during this traumatic two-year period. We evaluate various short and long-term influences that made the fiscal deficits and related budget cuts uncommonly difficult. We believe that this study will be helpful to fiscal managers when faced with emergency budgeting.

Plan of the study

Following a brief review of literature, we describe our research methodology and our plan of analysis. We concentrate on the assessment of the key economic and political policies and events in two different years, 2009 and 2010. Seen in a wider context, these political developments were aggravated by the unfortunate timing of the unexpected fiscal problems that coincided with the repercussions of the Great Recession in America.

Our principal purpose is to track the Latvian progress in meeting the twin goals of deficit reduction and managerial improvements. As perceived by John Micklethwait, editor-in-chief of *The Economist,* the saving of money should not be the sole motivation of fiscal reforms. Otherwise, it would waste an unusual opportunity to "make the state work better" (Micklethwait 2010). We see our study as an opportunity to provide budget planning in Latvia and in countries in similar circumstances with a review of the achievements, inadequacies and outright mistakes made. Broadly characterized, ours is a historical review of public management from 2008 through 2010 in what is an unusual and complex context (McNabb 2008).

The unifying thesis of our study is that weak governments tend to take short term actions. In unexpected crisis situations, the actions and reactions tend to be chaotic and conflicting in their nature. They serve the highest priority of the day. Other managerial improvements, even though accelerated, take longer.

In the period under review, the Latvian government made major budget cuts at the insistence of the last resort lenders, the EC, the IMF, including the World Bank (WB). These lenders provided dominant guidance for immediate actions. The speed and scope of the emergency budget cuts would make other reforms secondary.

Academic literature on public budgeting is available to identify policies and trends in the practice of crisis management in a tight financial situation. This literature review leads to several conclusions. The principal one is that Latvia's inability to meet economic, legal and social obligations cannot be resolved independently. Progress requires external support and influences, in this case, the EC and the IMF. Recent suggestions urge great caution and consensus building in planning budget cuts (Levine 1979, 1980).

Because fiscal policies are heavily influenced by well-established personal values that shape intellectual limits and norms (Lewis and Hildreth 2011), the policy priorities vary substantially. Still, important sources of information and insights for direct or modified adoption of principles for reform are desirable. In Latvia, the values held and priorities expressed maintained an unusual mix of political and economic policies. They represent the demands of bailout lenders, the objectives of the budget makers, and the priorities expressed by the constituencies affected. Several sources of information show ongoing explorations for a joint understanding and the formulation of a consensus on actions. They include choices on priorities, as well as methods and techniques tested elsewhere.

Others have noted that changes in budgets tend to sharpen policy conflicts. These conflicts are increased by economic difficulties, on the one hand, and serious political disagreements, on the other. Indeed, conflicts make public budgeting captive to power politics (Lewis and Hildreth 2011). Unique situations, tied to shifting constellations of power, emerge. Reflected in the academic literature, they also give important perspectives on the past, intellectual resources for the present, and a guide for the future. (Caiden 2010, McNabb 2010, OECD 2009, Schick 2002). New demands for more goods and services (Campbell 1993) go hand in hand with deficits (Arestis and Sawyer 2003). These departures from the traditional practices generate the most difficult changes in public budgeting.

Early American reformers (Premchand 1983, Starlings 1999, Starling 2005, Forester 1982, Jones 1996) suggested what appear to be comparatively more orderly and rational approaches to budgeting than the processes observed in Latvia today. Fundamental guides were available for improved management practice, or suggested limited entitlements and deficits, ceilings on discretionary spending, the avoidance of index budgeting and other across the board adjustments. Given more demands and less resources to meet them, more systematic approaches have been promoted by Rivlin (1971), Kirchheimer (1989) and Rubin (1990).

Globally, reformers are being urged to concentrate on tighter, more restricted budgets. Even as governments have more resources, they have less flexibility (OECD 2009; Caiden 2010). Cutback budgeting emerges as an important approach (Levine 1979, 1980; Caiden 1984; Behn 1985). Budget planners are urged to be more cautious, to begin making plans and priorities earlier, to expect extended interchanges with all major interested parties. Under these circumstances, the negotiation process is likely to involve shifts of political power (Lewis and Hildreth 2011) for a complex building of consensus on sources and uses of funds, as well as on agreed performance criteria (Modell and Gronlund 2007).

To us, the integrated private and public programs advocated by Stephen Goldsmith of the Kennedy School of Government at Harvard (Goldsmith 2010) were premature for Latvia. Clearly, such changes would require not only more time, but also a different planning environment (Levine 1980). To minimize problems of hasty actions, planners are urged to take more time for setting short and long term goals and to make related changes.

The clearest messages for future planners and decision makers are the cautious conclusions on the evolution of budgeting under new conditions (OECD 2009, Caiden 2010, Goldsmith 2010). An uneasy balance of change and stability can be expected. Due to the political upheavals in 2011, this balance is likely to be unstable. The parliament elected a new President, the unpopular financist Andris Bērziņš. The angry electorate dismissed the parliament with 94 percent favorable vote, and expected new elections in September of 2011.

The next stage of reforms is likely to include more interpersonal relations in the transformation of government work. This is a process that has to address major economic and social changes, as well as applications of new technologies (Abramson et al. 2006). To repeat Allen Schick, "there are no permanent solutions in budgeting" (OECD 2009).

According to Professor Edvīns Vanags, Director of the Public Administration Program at the University of Latvia, the first reforms are likely to be effected along the lines advocated in America in the 1970s (Vanags 2010). Such guidelines would be adopted by the professional bureaucracy first. Personal values of the leaders, political exigencies and shortages of funds were likely to preclude an early use of approaches suggested by budget cutters and conservers in the United States. Political exigencies and cash shortages were likely to limit the use of approaches advocated by Behn, Caiden, Levine and Schick. A comprehensive transformation of government work (Robertson 1999) will have to wait for years to come. This kind of progress would be difficult, if not impossible without major transformations in the leadership characteristics shown by Latvian leaders in the past.

Methodology

Our empirical study is based upon field research in Latvia prior to and during the budget years 2009 and 2010. The quantitative aspects are derived from the surveys of *Latvijas Barometrs.* Our information is supplemented with insights gained from academic literature, published reviews, and discussions with Latvian colleagues. We also had access to tentative plans for the maintenance of fiscal stability.

Technically, our study corresponds to the explanatory approach to case methods described by McNabb (2004). The phenomena studied are not isolated from their context. They are of interest precisely because of their relation to the situational context (Hartley 1994). Much of the information gathered represents a shifting and partially obscured scene of fiscal demands, political pressures, and occasional decisions under conditions of uncertainty.

The field data and observations gathered by us include several tours in Latvia as resident observers, as researchers on Baltic issues, as visiting faculty at local higher universities, and as recent Fulbright specialists in Latvia. Other data were also secured during informal discussions in the Ministry of Finance and the Latvian State Chancellery. The data collection methods included first hand observations, discussions and interviews with prominent state officials, and selected, well informed academic colleagues. Public documents and reports in the press in Latvian and English published during the period were also examined. For reporting purposes, the empirical information available in the Latvian language was summarized below.

The most reliable additional sources of quantitative information used in this study were the *DnBNord* bank's public opinion reports, entitled *Latvijas Barometrs.* These surveys were conducted by the highly respected social research center *SKDS*. In this year of crisis, samples of at least 1,000 persons are surveyed every month. The accuracy of these reports was indicated to be in the ± 3 percent range (*Latvijas Barometrs* Nr. 18, October 2009). These reports were consistent with trends observed by a panel of evaluators that included the senior author.

To frame our study of an initially chaotic and gradually changing situation later, we elected to examine several related issues. Together, they permit us to assess the progress made in Latvia to meet the two objectives of cutting deficits and the improvement of the government. The issues studied were at the core of Latvian negotiations with the EC and the IMF. *A priori,* these issues appeared to shape the principal Latvian budget cutting and related changes.

We review the slide of the Latvian economy toward bankruptcy and detail the manifestations of leaders' resistance to change. We also examine the austerity measures proposed by the EC and the IMF, consider the important role of distrust in the government's relationships with the public, and track the progress to improved public management.

The larger context

Several factors form the context for this study. Widely recognized in the last two decades, they are: the established organizational arrangements; deeply rooted Russian hierarchical traditions; recent policies and practices; and the slow adoption of modern public resource management (King et al. 2000). With the challenging demographic aspects, the complex environment made the functioning of government difficult at best. Among these policy-shaping factors are the following:

Faute de mieux, Latvia is a parliamentary democracy. It retains many of the bureaucratic and administrative practices of Imperial Russia and the Soviet Union (King *et al.* 2004). Managerial power is exercised arbitrarily, *ultra vires,* often for the personal benefits. The large Russian minority remains oriented to Russia, which is seen as an unstable political and economic factor (King and McNabb 2009). After the municipal elections of 2009, this political philosophy appears to dominate the important City Council of Riga. The ethnic Latvian element in the country is 60 percent.

The Latvian government is accustomed to budget deficits. At first reasonable, the deficits of 116 million LVL (lats) in 2007 show an internally unsustainable increase to 426 million LVL (about 1 billion US$) in 2008. The lack of the political will to enact necessary reforms is a widely perceived factor in the chronic delay of system changes (King et al. 2004).

Frequent changes lead the autonomous coalition leaders to expand favorite programs. These political officers, used to personal preferences and command structures, are generally unqualified for such modern leadership as is advocated internationally (Kouzes and Pozner 2007). Except for 2004–2008, prime ministers of an unstable government seldom serve longer than one year. Also, Latvia's Civil Service, weakened by patronage, was in need of extensive reform.

However, there was little time available for changes and reforms. The drafts of budgets, such as those for 2010 and 2011, were subject to uncertainties about the economic recovery. The declining and aging population of 2.2 million, low birth rates and extensive emigration, required reforms of education and the public health systems.

Together, these various influences and the rapidly changing economic conditions render the reform aspects of public management largely ineffective and chaotic. Below we present the five interrelated problems associated with the planning and budgeting processes through 2011.

The slide to national bankruptcy

In early 2008, Latvian financial planners, regulators and government leaders were caught in a cycle of borrowing and spending on an unprecedented scale. The problem was aggravated by a largely uncontrolled inflation and a conviction that double digit economic growth rates would last forever. Saddled with large government worker salary increases and staff expansion, the government faced large deficits in 2007 and 2008.

Prior to the 2007–2008, economic meltdown elsewhere, huge profits were still being made in Latvian real estate. Consumer expenditures were also rising in expectations of a rapid progress to European Union (EU) standards of living. Due to the small domestic markets in Latvia and the late entry in the EU markets, little was being invested in industry. Even with EC support grants, the development of exports to EU markets was slow.

Latvia's economy, much like that of the United States, was first hit by a collapse of the housing market. This was quickly followed by banking difficulties and a decline of employment and retail sales. The most traumatic fiscal effect was the widely anticipated inability of the government to meet current obligations. The government was no longer able to sell bonds in either local or international markets.

With the economy on a precipitous decline, the government sought bailout funds from lenders of the last resort, the EC and the IMF. Earlier, the lenders and their supporters included several EU countries, including Sweden. However, Sweden was the main source of support for Swedish banks in Latvia.

An attempt in 2008 by Latvian leaders to finesse the approval of bailout loans failed. On the brink of bankruptcy, Finance Minister Atis Slakteris rather famously described the fiscal situation as “nothing special.” The loan was suspended. The formation of the first Dombrovskis government followed.

Latvian leaders were not well prepared to make quick major transformations. Informed observers felt that the political leadership in Latvia did not have the will, the strength and the competence to manage itself out of the recession. To do it, it needed external direction and help.

Even as the public dissatisfaction of the government reached new heights, the weak five-party coalition led by Dombrovskis was unable to strengthen the social safety net for a large part of the population with no significant savings.

In this situation Latvian leaders had to again seek help from the lenders of last resort, the EC and the IMF (IMF 2009). These cautious lenders became dominant leaders in the negotiation processes. They subordinated budget cuts to the Latvian goal of joining the euro system in 2014. The lenders sought to balance Keynesian and Schumpeterian innovations. In 2009, this approach combined fiscal austerity with improvements in budgeting processes. Essentially, 2009 became a year of emergency budget cuts. Comparative analysis of functions did not become important until 2010.

Resistance to fiscal change and budgeting improvements

Initially, the year 2009 was marked by a strong intragovernmental resistance to the needed budget cuts. As most ministries continued to manage the affairs delegated to them with little or no change, Dombrovskis and Repše found themselves in a relatively weak position. The old hands resisted giving up their established prerogatives. They slowed down the proposed budget cuts in many ways. Their arguments to maintain salaries and personnel on a high level were essentially Keynesian. On a practical level, the resistance helped to protect relatives, business friends and political associates in comfortable positions.

By any measure, the Latvian economy was in a deep crisis. The GDP declined by about one fifth in 2009; unemployment was variously estimated at about 20% by *Eurostat* (based on statistics taken from the Latvian Statistical Bureau), and at 14% by the Latvian employment office. On the other hand, substantial numbers of the officially unemployed were actually engaged in the informal, grey economy. They thus continued to avoid paying taxes.

Budget planners and agency heads were especially slow in making staff reductions. Across the board cuts were actively resisted everywhere. The duplication of functions performed in various autonomous ministries could not be readily analyzed and eliminated. However, it was also argued that personnel reductions would result in more unemployment and increase the social burdens. Such actions would make unemployment the main internal problem.

In this context, serious pressures remained within the coalition to preserve the patronage system. Indeed, in late 2008 and early 2009 sabotage of the budget reduction was evident. As some salaries were cut by a third, other salaries were maintained or raised by reclassification and promotions. Released workers became consultants. Reforms were also slowed down by the lack of a uniform personnel classification. Extreme administrative autonomy made external evaluation of operations very difficult. Moreover, the state audit agency had no authority to order changes; it could make only recommendations to the fiscal managers audited.

After the summer of 2009, work on the budget was given the highest priority. The work was better organized and performance improvements were related to the most obvious and simplest changes. They included reductions of personnel as well as reduced salaries (*Delfi* 1 October 2009). In the schools, there was a shortage of students due to very low birth rates in the first years of recovered independence. Therefore, thousands of teachers were released and comparatively small schools were closed.

Still, budget reductions were handicapped by the lack of a unified system of accounting and salary administration; shortcomings of centralized purchasing; and little integration of government services. Needed were the long overdue reforms of systemic nature that had been blocked by the patronage system.

The opponents did not expect the ruling coalition to accomplish much. The strongest opposition was from the People's Party, the previous leaders of the coalition. Eventually, it quit the coalition and left Dombrovskis in charge of a shaken minority government.

Indeed, the coalition's interests appeared to be more personal than administrative. For example, the parliamentary majority passed special legislation that would give special separation payments to deputies who would not return to parliament after the 2010 elections.

There was a prevailing orientation toward meeting short term needs. Tatjana Volkova, the president of a Latvian banking college, felt that the decisions of the coalition were perceived as political, without adequate long-term economic analysis (*Delfi* 25 October 2009). Even positive actions were not easily believed by the polity.

Austerity steps proposed by the EC and the IMF

The EC viewed Latvia's situation more in the large context of the European Union. In fact, the then EC Commissioner of Economic and Monetary Affairs, Joaquin Almunia, approved the first payment of the reinstated bailout loan *(Diena* 26 June 2009*).* Relationships with the IMF, on the other hand, evolved more slowly. The IMF first urged that the Latvian currency be devalued. This was strongly opposed by many in Latvia, especially by the Bank of Latvia. The opponents viewed devaluation as politically risky and unnecessary as reduced salaries would informally achieve internal devaluation. The prominent economist Anders Aslund of the Peterson Institute also argued at the Bank of Latvia that formal devaluation was not necessary (Aslund and Dombrovskis 2011).

When the lenders suspended bailout payments in 2008, they stressed the serious nature of the fiscal emergency. They demanded the Latvian government stick to the terms previously agreed. The Latvians were able to reduce the 2008 expenditures by only 0.5%, or 83 million LVL.

Mark Griffiths, the IMF team leader of experts, made it clear that there could be only one principal purpose of the bailout loan: a financial stabilization plan that would permit Latvia to join the euro zone in 2014. Although the IMF team expressed concerns about the Latvian social safety net, the essence of the plan was the fiscal rebalancing of the budget for 2009. Within the Latvian government, the measures taken by the IMF were considered brutal.

The lenders assumed a comprehensive role of actively guiding Latvian budget processes. This included a crash program to make immediate budgets cuts. The actual expenditures were cut by 6.7%, or almost a billion LVL in the 2009 budget year.

The authorized *tranches* of the loan were tied to the stabilization of the Latvian financial systems. This including a clear goal of getting the country ready to apply for admission to the euro zone in 2014. In a sense, the lenders negotiated immediate, short term and longer term programs for budget planning in Latvia.

The lenders wanted to reduce the default risks. To this end, they secured formal commitments from all coalition parties to honor all agreements. (Dombrovskis 2009). Moreover, the lenders provided professional advice and technical assistance to Latvian budget planners.

Initially, Latvian commitments to these imposed standards were in doubt. Frequent past changes in coalition membership undermined government credibility and led to negative public perceptions. As a result, the confidence the lenders had in the government was eroded in the interactions of the Latvian leaders. There were pressures from the lenders to firm up the negotiated agreements and to reduce default risks. Given the changes in the economy, the fiscal performance of Latvia was followed very closely. Appropriate adjustments were made as more information became available. The actions by the lenders indicated that monetary and fiscal stability was the country's paramount priority.

The biggest change was the new government itself. Dombrovskis took office on 12 March 2009. Previously a finance minister under Einārs Repše and a former senior economist of the Bank of Latvia, Dombrovskis was a physicist with a supplementary economics degree. He was technically well qualified to conduct the negotiations with the lenders. His graduate work in Germany and in the United States and his association with the Christian Democrats in the European Parliament, gave him the strong background needed for international work.

He saw two tasks requiring immediate attention. His first task involved negotiating a resolution of pending issues with bailout lenders. The second one was to stabilize the country's financial systems. Dombrovskis stated additional internal policy intentions in a letter of commitments to the IMF, co-signed by political party leaders of the coalition (Dombrovskis 2009). The leaders were successful in revising the centralized budget, and in making public administration less costly. The managerial improvements were mostly related to the consolidation and elimination of the most obvious duplicate functions.

Moreover, Dombrovskis planned to assist the private sector to renew economic development, and to build better international relationships. He was additionally concerned with the budget situation and the continuation of the bailout payments, strengthening the Baltic region, full use of the European Union grants, and early administrative reforms. These were all related to the budgets.

Despite Latvian fiscal policy improvements, lenders remained concerned about Latvia's commitments to meet the negotiated bailout conditions (Stuttaford 2009). The EC repeated that the deficit limit of 500 million LVL established for 2010 was an absolute, not a negotiable condition for EU financial support. Similar warnings were seconded by Anders Borg, the finance minister of Sweden (*Delfi* 6 October 2009).

While such warnings may have increased Latvian commitments to achieve economic targets, they also had external repercussions. Prompted by Latvian inability to float bond issues, some Western banks were planning to take advantage of what they perceived as an eventual unavoidable devaluation of the Latvian currency. The continuing decline of the Latvian economy increased country risk and discouraged potential foreign investments. Even the most careful *bona fide* and promising economic forecasts were considered risky and unreliable.

The EC and IMF lenders were particularly concerned about the initially mild reduction of government salaries in 2009, the inadequacies of the social safety net, and the government's reluctance to raising new taxes. Various revenue proposals were discussed in parliament, although most of the ideas were left to budget planners and parliamentary committees.

The group of lenders anticipated making payments over several years as the Latvian economy recovery progressed. The general plans called for a deficit decline to 10% in 2009, 8.5% in 2010, 6% in 2011, and 3% percent in 2012 (*Delfi* 9 July 2009). It was agreed that this progress would help Latvia to apply for admission to the euro zone in 2014. In essence, the bailout was structured to help out the Latvian treasury to stabilize the financial system and in the short term to maintain a functioning government. It was also a facilitating factor to build a full partnership with the EU, and a stronger, more export-oriented private sector.

Distrust and the lack of public support

Extreme distrust in the government was a serious problem in Latvia (McNabb et al. 2010). The forever shifting leadership and unreliability of the government was a factor of apprehension in both the general population and among potential foreign investors. Under the circumstances the negotiations with the lenders of last resort concluded the adoption of their strong suggestions.

Results of a public opinion survey published in the October 2009 *Latvijas Barometrs* Nr. 18 revealed little confidence in the Latvian government and a strong public desire by 85% of respondents for a radical change of fiscal policies. Given that the government has been unable to effect long term changes as quickly as needed, the public's support for unity on budget issues was simply not there. Three quarters of the population felt that the economic situation was continuing to deteriorate, and only a minority (10%) expected future improvement. Subsequent *Latvijas Barometrs* Nr. 23 showed more optimism.

Latvijas Barometrs Nr. 18 focused on government's budgeting processes, with responses characterizing them as chaotic. Respondents stressed that social concerns were not adequately considered and that economic conditions were too dependent on international lenders. They also suggested that the needs of the population should be more important than those of political parties. They felt that the budget should be planned by professional economists and other experts, not the party leaders. The foremost concern of the sample was fear of the inability to pay for health care. Other high priorities were the economy in general, education, and welfare.

Among the many possible causes of the country's problems, respondents claimed "theft of the state" [assets] (59%), incompetent state administration (50%), waste of public funds and the saving of the *Parex* bank (48%), and domestic corruption (48%). Suggested solutions included: increasing exports and support for private sector entrepreneurs (47%), the elimination of corruption and favoritism (44%) and tax reductions (41%).

On the whole, the survey indicated that the population was gradually and unevenly evaluating available options more and more rationally. Still, the public expectations were characteristic of a wish list. Compared to findings of international leadership research (Kouzes and Pozner 2007), the Latvian rulers lacked honesty and other ethical values, long term commitments, competence, and empathy for their constituents.

Sharing common purposes

In addition to the euro zone goal, both the 2009 and the 2010 budgets served several common purposes. They included the financing of established government functions, as well as indirect support of the ruling coalition parties and their major and minor leaders. Relatively new to the government was a growing public concern over the recovery from crisis and slowdown in economic development. In practice, the principal focus in both years was the maintenance of monetary stability and an operational fiscal system. This stability was viewed as essential.

The government, mistrusted, weak and querulous, was reluctant to make changes. Especially in 2009, the government tended to make decisions from one day or one week to another as it sought to maintain itself and respond to the demands of the EC and the IMF. They made very substantial budget cuts, and they soon exhausted the few opportunities for quick improvements. To be fair, the desperate situation also changed rapidly. Many budget revisions were made when their need became urgent to Dombrovskis and Repše and the lenders. Given a number of conflicts and different perceptions of the situational gravity, the interactions of the government leaders and the lenders were increasingly important. In a year of change, the lenders changed from what was perceived as a simple textbook approach to a thorough understanding of the complexities of the Latvian political and economic situation. With this understanding and its own obligation to have a performing borrower, the IMF strengthened the Latvian government and guided it to an increasingly realistic multi-year plan of fiscal management. It was these pressures that led to the very difficult and yet rewarding process of improvements that had escaped the Latvians before.

Actually, Dombrovskis and Repše earned a measure of public respect as they cut excess employment and services. Their work was made worse by the relentless internal competition for funding by all coalition partners. As funding and financial management had been allocated to specific ministries, their political leaders worked hard to improve their patronage base to gain political support. In the aggregate, these activities still maintained indefensible staffing. Political interference also led to misallocation and waste of very scarce resources.

Slow progress on the road to fiscal and political reforms

In many ways, Latvian budget changes started from elementary levels that really did not include more than the most obvious, convenient and overdue actions. With the difficult cuts remaining to be made, the 2009 budget revisions were necessarily subordinated to the conditions imposed by the lenders. Pressures of time led the budget planners to use the simplest methods, such as across the board cuts, budget reduction methods. The planners also included long desired improvements to advance Latvia's qualifications to join the euro system. At worst, the revision processes were still characterized by poor internal discipline. As noted earlier (Jones 1996), such budgets elsewhere represented various compromises, strategies of negotiators, as well as the power of self-interested actors performing highly stylized roles. Changes in Latvia were often perceived as zero-sum games.

Functional analyses for the streamlining of government operations were at the core of substantive improvements in 2010. The budgeting for 2010 included functional assessments of Latvian public management from a professional perspective. Many of the early cuts negotiated with the ministries led the way to additional formal explorations of structural changes and adjustments. At the direction of Dombrovskis, the State Chancellery conducted functional audits in search of savings, reduced duplication of services, and improved performance.

The efforts made by the compromise budgets negotiated in Latvia over the past few years still did not reflect any common, comprehensive theoretical foundation for economically more rational budgets. Once adopted, the budgets were not easily changed to correct errors or to adjust government operations to new conditions.

The budgeting process for 2010 was more orderly than in previous years. The Latvian government's commitment to 40 specific performance improvements was summarized in a commitment letter to the IMF (Dombrovskis 2009). Planned cuts in expenditures accounted for about two-thirds of the deficit reduction in 2010. The remaining one-third was to be financed by new tax increases; Latvian tax burden of about 30% were low by EU standards.

In seeking new sources of revenues, four major fiscal changes were introduced. The first was the introduction of a progressive feature in the income tax; the second was a comprehensive capital gains tax; the third was an added property (occupancy) tax. Fourth, some popular nuisance taxes, such as a use tax on the few employer provided automobiles and similar benefits.

The proposal for a progressive income tax that had been supported by opposition parties (*Delfi* 5 November 2009), was set aside temporarily. Latvians, accustomed to low income and property taxes, tended to favor value added taxes (VAT) and other sales taxes. An alternative considered by the coalition was a more general increase of the income tax. To have a real fiscal impact, explained Dombrovskis, it would have to have low threshold levels (*Apollo* 3 November 2009; *Delfi* 3 November 2009). The progressive tax was opposed most by most coalition leaders.

A new capital gains tax of 10% was expected to be a comprehensive application. It was to be levied on profits gained in real estate transactions, the sale of securities, the sales of art, coin collections, and other personal valuables. This left an impression that the planners were scraping the bottom of the revenue barrel to impress the critics of the coalition leadership. Various major and minor permanent new sources of revenue, such added taxes on alcohol, dividends and interest received, were proposed, considered, adopted, modified or rejected. The tendency was to impose tolerable taxes that could be readily collected.

The maximum allowed deficit for 2010 was 500 million LVL specified in agreements with the lenders (*Delfi* 3 November 2009). The *Saeima* passed the first reading of the budget with a 64% affirmative vote. It was, according to Dombrovskis, intensely disliked by everyone. Expenditures adopted in the 2010 budget were aimed to restore the lower 2007 level. About 70 proposed changes were to be reviewed later by the parliament.

Unexpected internal and external changes also dominated the uncertain workings of Latvian government. These changes caused administrators to make frequent budget revisions. In addition to the previously accepted changes, there was constant pressure from the lenders for additional budget cuts and the adoption of new taxes (*Diena* 16 November 2009). Cuts were proposed in all budgets of ministries. Least affected (but still cut) were to be allocations for the high-priority programs of health, education, welfare and public safety. Approximately one-third of the budget expenditures would be earmarked for social programs.

The GDP was forecast for a further 4% drop in 2010 (*Delfi* 3 November 2009), and a recovery in 2011. No other funding could be provided for anything without additional sources of revenue (*Latvijas Vēstnesis* 4 November 2009). Despite the budget cuts, a Swedish bank analysis intimated that the 2010 budget lacked any real structural changes. Without the changes, the journey to an efficient public sector would be longer and more difficult than first expected (*Swedbank Analysis* 30 October 2009).

The 2011 budget

Fiscal policy and guidelines for 2011 were published on 1 July 2010. Prepared after detailed discussions with the IMF team, the guidelines were closely related to the economic news (Dombrovskis 2010). The guidelines were optimistic, counting on continued economic recovery in 2010 and 2011. However, the IMF, influenced by bank problems in the euro zone, was also concerned about 2012 and 2013. It urged further deficit reductions in 2011.

The proposed budget for 2011 was approved by the *Saeima* on 20 December 2010 with 54 votes in favor. As measured by EC standards, a deficit of 5.5% of GDP, was planned well below the 6% maximum. Revenues were estimated at 5.l billion LVL, expenditures were planned to be 5.7 billion LVL. The optimistic forecasts of economic growth were 3.3% for 2011, 4.0% for 2012, and 3.9% for 2013.

Unemployment in the summer of 2010 was down to 15%, with 10% in Riga and 20% in eastern Latvia. Shortages of qualified workers were reported in Riga. In the assessments of monetary policy, the Bank of Latvia was very pleased with the recovery progress reflected in the macroeconomic indicators in the first two quarters of 2010 (Bank of Latvia 2010).

The optimistic expectations depended on four major developments: the continuation of the worldwide economic recovery; the steady improvement of Latvian exports (primarily to EU, currently about 70% of the total); the gradual increase of public confidence in Dombrovskis and his associates suggested that the electorate accepted the austerity programs; the increased efficiency of the government, including improved tax collections from business.

Short term fiscal policy adjustments and related actions were to keep deficits down to the agreed levels in 2011 and 2012. Government subsidies in 2011 would be reduced, as would be the incidence of the grey economy. Most of the budget reduction would come from savings, the rest would come from increased revenues. User taxes would increase, income taxes would gradually become more progressive. For the longer term, the policy would favor countercyclical measures. It would limit government borrowing even for programs for a balanced economic development. Total pressure for deficit reduction was lessened by favorable economic developments that included a very welcome 29% annual increase of exports in the third quarter of 2010.

Uncertainties persisted with respect to external developments. There was concern about the slow economic recovery in the United States, and the financial difficulties in the euro zone. The dissatisfaction with the government decreased in a year's time from one half to one third of the respondents (*Latvijas Barometrs* Nr. 28). The emergency measures taken in a deep major recession were significant achievements. Still, they did not reflect suggestions found in American literature on public budgeting reforms.

Bailout reviews were still linked to Latvian plans to join the euro zone in 2014. The IMF and the WB representatives were pleased to note progress in the reduction of prospective deficits. They were progressively more flexible, they took seriously well prepared arguments, and made requests of their own in search of mutually acceptable solutions. Much of the Latvian planning for 2011 was done in the summer before the 2 October 2010 elections. This was internal work, dependent on further analysis of functions. Late in 2010, the lenders, less sure of the future, urged that the lenders' position be strengthened with additional tax revenues, as well as reduced government employment and further cuts. These suggestions, if effected in 2011, would not help improve the employment, nor would they reduce the number of destitutes.

All internal proposals for savings were subject to political negotiations. The top potential of budget reduction with structural reforms was estimated at 350 million LVL by Gunta Veismane, the Director of the State Chancellery. Veismane, in charge of functional analyses, expected a saving of 80 million LVL after internal-negotiations. Sceptics reduced this figure to 40 million LVL. However, any major structural changes would, according to Veismane, take three to five years of very hard team work (*Diena* 23 October 2010).

Still, much of this short term planning of tighter budgets was compromised by inefficient, quasi-feudal government structures and political conflicts. Practices of excessive staffing that included incompetents and political favorites, still exist. The open disregard of laws and regulations is a common occurrence. Time, staff, and financial resources to conduct overdue reforms are either not available or are delayed, thus reducing the scope of proposed changes. Indeed, they could not be effected without implementation of the overdue uniform accounting and personnel compensation systems recommended elsewhere (Abramson *et al.* 2006).

Demographic changes did not augur well for the quick reforms. Latvia is one of the most rapidly ageing countries in Europe. This change alone places new burdens on social security. Although it calls for several policy changes, as yet there is no evidence of early departures from the outdated Soviet-era minimal age for pensions and other entitlements.

Truly major reforms required substantial transformation of government work. Above all, the material and political progress of the Latvian society depended on the adoption of values suitable for a democratic society. To these purposes, a whole array of American public budgeting policies and practices were available to government leaders and budget planners for review and adoption. Such transformation was the challenge to the new government formed on 2 November 2010.

Even for short term planning, this process would not include two major reformers. Repše was replaced a bank economist, Andris Vilks, in the Finance Ministry. Veismane, the Director of the State Chancellery elected not to be reappointed to her position. Elita Dreimane, a lawyer and a formerly a Chancellery department head, replaced Veismane on 1 January 2011.

Further improvements were reflected in much more carefully made plans for 2011 (Dombrovskis 2010). Prepared after the People's Party left the coalition, the plans were far more realistic than the sweeping and comprehensive, proposals for immediate action advocated by the Latvian Chamber of Trade and Industry. The plans of the Prime Minister were built around a more realistic longer term. As scheduled, a four-year forecast and a fiscal plan, prepared by the Ministry of Finance were presented to the *Saeima* on 1 July 2010 (Bičevskis 2010). These plans were consistent with the lessons learned by analysts of the EC (Deroose et al. 2010).

Conclusions

Even though the optimistic, reduced 2011 budget was approved by a smaller than expected majority on 20 December 2010, Dombrovskis and Vilks had good reasons to be pleased. Indeed, Dombrovskis was praised highly for his economic performance and his political survival by Edward Lucas of *The Economist* on 16 December 2010. Latvian survival policies were later noted by a popular American economic columnist (Samuelson, 2011).

In retrospect, Dombrovskis and his minority coalition met the demands of lenders, and maintained government functions in a grave fiscal emergency. His administration managed the most demanding emergency in the first year. It cut the most obvious waste of excessive staffing and initiated the beginnings of comparative functional analysis that permitted some early, politically difficult, structural changes in the second year. These elementary analyses of performance established the essential core of preconditions for major structural reforms in 2011 and following years.

Our study confirms our thesis, expressed in the views of Andrew Heywood of Croydon College (Heywood 2007), that weak governments make short-term decisions. In a sense, Dombrovskis had no other choice than to start with brutal budget cuts that met the immediate demands of the lenders. In 2009, he quickly effected the most obvious improvements of fiscal and operational management.

With the help of economic recovery, Dombrovskis met the difficult deficit reduction targets. The situation in 2008 and 2009 was serious enough for the lenders to become dominant in Latvia fiscal affairs. The lenders had prescribed the stop of the hemorrhage at the treasury. Tied to the goal of joining the euro zone in 2014, the lenders limited the rescue to the repair of the financial system. This approach also prevented an unsustainable growth of deficits.

The achievements in 2009 led to closer bilateral relationships with the lenders. In 2010, the lenders gradually placed more policy weight to economic development and social issues. Actually, the EC unit head Gabriele Giudice urged Dombrovskis to start several projects to improve the quality of government in 2011. The lenders also insisted on immediate renegotiation of the funding for 2011 to reduce the risk of nonperformance in 2012. In a sense, the relationships with the lenders were broadened, and also mutually respectful cooperation for long-term developments. Although the exact nature of the EC proposals was not public, it was expected that the proposals would suggest rules and institutions to curb excessive spending, and to begin to formulate actions to raise retirement ages and overhauling pensions.

This progress was viewed critically by forces opposed to the current coalition, but the success of the relationship increased the credibility of Dombrovskis with the electorate. Public trust, weak as it was, increased somewhat, but it was not the strong glue to hold the government and the electorate together. It helped Dombrovskis in the 2010 elections, and strengthened his hand in internal negotiations. Still, the prevailing mode of political making of decisions did not foster professional management or a strong Civil Service. In such prevailing crisis management there is a pervasive reliance on established systems to preserve vested personal and party patronage. In particular, these coalitions dislike changes in the *status quo,* and they show little commitment to strategic goals. As the Latvian experience indicates, positions taken by coalition partners may change from day to day. The partners are especially weak in anticipating emergency situations. In practice, they perform best with the guidance and help of external forces. Latvia is fortunate to be assisted by forceful and dominant lenders of last resort, the EU and the IMF. Even with the lender support, long term planning in Latvia is in a very early stage.

In the absence of a substantial economic growth in Europe, the Latvian budgets through 2014 would still call for sharp budget reductions. It was increasingly doubtful that new taxes would be a significant source of revenues, but better collection of taxes would be important. The predicted GDP increase in the two years 2010 and 2011 was negligible (Bank of Latvia 2010).

The main target of budget reforms would be reduced expenditures, the toughest issue faced by Dombrovskis. With the opportunities for simple emergency cuts reduced, it was time to put more emphasis on more rational and fundamentally sound budgeting practices.

In this context of uncertainties, it was important to the lenders to maintain the careful and detailed monitoring of external economic developments and Latvian performance. As the paramount goal of joining the euro zone in 2014 was repeatedly confirmed, the guidance and technical assistance by the IMF was essential for the next few years. Due to the lack of knowledge, only a few of the improvements suggested in the literature review above would be generated locally. The financing of proposed new training programs was widely perceived to be a waste of time and money.

In retrospect, Dombrovskis and his colleagues did well enough under very demanding circumstances. The government did get the bailout funding restored and achieved other important goals. The immediate prospects (Dombrovskis 2010) were positive. Planning for both saving money and improving state operations was under way for 2011 and 2012**.** The application for joining the euro zone was still set for 2014.

In practical terms, however, the period under review, was, above all, characterized by bailout issues and major budget changes to keep Latvian government operational. However, substantial reforms to improve government performance were a task beyond the immediate horizon. The government was still very vulnerable to unexpected economic difficulties. These factors, together with the arbitrary use of power for personal or party benefits, as well as the lack of funding for long term reforms, limit the further fiscal management success. The financing plan for the bailout loans assured the Latvian Treasury of adequate cash flow as well as borrowing reserves. The Treasury reported on 31 August 2011 that of the planned 7.5 billion euro financing only 4.4 billion euro were received. This left 3.1 billion euro available for agreed purposes.

The plans were tentative at best. EU assistance grants and any other income will be increasingly helpful for development. More important will be a greater recognition of Latvian dependence on foreign investments (other than in real estate), in the private sector. To achieve this progress, it was essential to increase Latvian capabilities for longterm management. To accomplish this fundamental change, the further improvement in mutual trust was essential. A restoration of prewar values could ignite a popular engagement in major reforms. Yet such support was likely a major factor in planning the repayment of the bailout loans.

Finally, we would like to make a note about the wider applicability of our lessons learned. Although we firmly believe that every case is in some way unique, there are suggestions for political leaders and budget planners in other distressed countries today.

We find the managerial roles and contributions of the IMF most professional and useful in shaping the fiscal actions observed. We are sympathetic to the initial actions taken in the first yeas to effect very substantial budget cuts. We applaud the gradual evolution of long term management and fiscal reforms. Last, but not least, we note that substantially greater progress requires the restoration or adoption of traditional values, an increase of mutual trust, and the introduction of new decision processes.

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BUDŽETA VEIDOŠANA SPRIEDZES APSTĀKĻOS: LATVIJAS SITUĀCIJA

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Kopsavilkums

Atslēgas vārdi: *Baltijas valstis, budžeta samazinājumi, neatliekami finansiāli pasākumi, Starptautiskais valūtas fonds, recesija, reformas*

Pētījumā apskatīta 2007.–2009. gada Lielā recesija Latvijā. Gada laikā valsts kļuva no uzplaukstošas par vienu no vājākajām Eiropas Savienībā. Apskatīti vājās un uzticību neguvušās Latvijas valdības centieni panākt atlikta liela ārkārtējā aizņēmuma atjaunošanu. Šie procesi mainījās — no 2008.–2009. gada graujošajām programmām budžeta samazinājumu veikšanā uz pienācīgākiem budžeta koriģējumiem 2010.–2011. gadā, apmierinot aizdevēju prasības. Šī pētījuma pamatā ir Latvijas valdības cīņa ar pieaugošo deficītu, koalīcijas partneru konfliktējošām interesēm un profesionālo birokrātiju, un ar neuzticīgo pamatiedzīvotāju masu.

Profesors *emeritus* Deivids E. Maknabs bijis viesprofesors Rīgas Stokholmas Ekonomikas augstskolā kopš 90. gadu sākuma, un ir Biznesa vadības fakultātes mācībspēks Pasifika Luterāņu universitātē kopš 1979. gada. Viņam ir humanitāro zinātņu maģistra grāds komunikāciju zinātnē Vašingtonas universitātē un filozofijas zinātņu doktora grāds vadībā Oregonas valsts universitātē. D.E. Maknabs ir septiņu grāmatu, vairāk nekā 90 žurnāla rakstu un konferenču materiālu autors, šobrīd — vecākais konsultants un vecākais politikas analītiķis kādā ASV valdības aģentūrā. E pasts: *mcnabbde@plu.edu.*

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