

## ACQUISITION OF RESOURCES OF THE INSTRUMENT FOR REGIONAL DEVELOPMENT – THE COHESION FUND – IN LATVIA UNDER CONDITIONS OF GLOBAL ECONOMIC CRISIS

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### **Abstract**

The European Union Cohesion Fund provides funding for large scale infrastructure development activities (projects) to reach defined goals in the environmental and transport fields, to realize goals of European Union regional development policy, and to fulfil requirements of Directives. The aim of formation of Cohesion Fund – to level the economical and social differences between European Union member states' and their regions – comes into effect in Latvia. Total amount of European Union Cohesion Fund resources of period 2004 – 2006 is approximately 28 212 billion Euro; expressed in prices of year 2004. Resources of Cohesion Fund were allocated to Spain, Greece, Portugal, Ireland and all ten, in year 2004 affiliated states. Financial support of the instrument for regional development – European Union Cohesion Fund – in Latvia for the 2000 – 2006 Programming period amounts to EUR 710 million (including ISPA – Instrument for Structural Policies for Pre-accession resources). Still EUR 215 million of European Union Cohesion Fund resources should be used by 2010 (including). It means that Latvia must realize European Union Cohesion Fund projects for about EUR 345 million. These great resources shall be acquired in relatively short period of time and under conditions of global economic crisis. Choice of this theme was made by lack of scientific basis for 2007 – 2013 Programming period, since only small number of scientists is involved in researches for acquisition of European Union financial instruments.

The aim of this article is to analyze flexibility of instrument for regional development – acquirement of resources of European Union Cohesion Fund under conditions of global economic crisis in Latvia and to evaluate effectiveness of Cohesion Fund resource disposition under these new circumstances. Acquirement of resources of European Union Cohesion Fund has not been studied so much; therefore it may be scientifically interesting topic. To achieve this goal there are three tasks developed – analyzed European Union Cohesion Fund resource acquirement status and status of insecure projects whose unimplementation may cause losses to Latvia state budget; discussed about two actual problems regarding this acquirement under economic crisis conditions – the value added tax rate increase and blocked financial funds of contractors' as a result of in–advance–established guarantees; analyzed the balance of strategy of European Union Cohesion Fund aims and Latvian economic stabilization and growth renewal program. There are developed the scientifically valid suggestions for acquirement of European Union Cohesion Fund resources under crisis conditions. Most substantial conclusion has been made in connection with distribution of resources among Latvia regions. Most substantial suggestion has been made regarding to arrangement and simplification of public procurement legislation – this should boost acquirement process, since the reduction of thresholds of public procurement will shorten the time of concrete contract implementation.

This article consists of four chapters, the introduction and conclusions. Methods of analyzing and comparison were implemented to fulfil these tasks. For further investigation of European Union Cohesion Fund acquirement and its influence on development of Latvian regions, other researches should be performed.

### **Keywords:**

Cohesion Fund, Project implementation problems, acquisition of resources of Cohesion Fund, Stabilization of Latvia economy.

## Introduction

The aim of formation of Cohesion Fund (CF) – to level the economical and social differences between European Union (EU) member states' regions – comes into effect. The CF provides funding for large scale infrastructure development activities (projects) to reach defined goals in the environmental and transport fields, to realize goals of EU regional policy, and to fulfil requirements of Directives.

Resources of CF were allocated to Spain, Greece, Portugal, Ireland and all ten, in year 2004 affiliated states. Total amount of resources of period 2004 – 2006 is approximately 28 212 billion Euro; expressed in prices of year 2004. That time Latvia had accessible financing of 515 millions Euro.

Choice of this theme was made by lack of scientific basis for new planning period, since only small number of scientists is involved in researches for acquisition of EU financial instruments. However, some researches have been made regarding SAPARD – the resource acquisition instrument of pre-accession to the EU period (Čiulevičiene V., Čiulevičius J., Kripaitis R. 2004), as well as regarding Structural Fund (SF) support (Millere I., Medne L. 2006) and direct support (Pilvere I., Rukmanis A. 2006). Regarding CF there has been made a cascade of studies – first, the institutional and administrative system of CF (Āboliņa I. 2006, 2007); second – the Management and Control system of CF (Āboliņa I. 2008) and third – the socio-economic influence on development of Latvia (Āboliņa I. 2009).

At the time being there has been new circumstances emerged – the global economic crisis under which the economic situation has changed quickly almost everywhere in the world; not only in Latvia. Therefore it is important to perform investigation on:

- How to efficiently acquire CF resources during crisis and how it influences CF scope in Latvia.
- To analyse whether it is necessary re-estimate allocated resource distribution

- Possible price changes.
- How this resource acquisition is tied up with Latvian economic stabilization and growth renewal program of Latvian economy.

The **aim** of this Document is to analyse flexibility of CF resource acquisition under conditions of global economic crisis as well as to evaluate usefulness of these expenditures in new circumstances.

This aim highlighted following **tasks** for research:

- To analyse the status of CF acquisition.
- To discuss about topical problems on time of economic crisis.
- To analyse the balance of CF project aims and stabilization and growth recovery program implementation strategy of Latvian economy.

For research program realization and achievement of scope of work, the information has been taken from electronic databases, EU and National legislative acts and normative documentation as well as in scientific publications and other sources. The analysis and comparison methods have been used in this research.

### CF resource acquisition in Latvia

For programming period of 2000 – 2006 the CF financing in Latvia, accordingly EU Regulation 1164/1994, chapter 10, section 2 – “A suitable balance shall be struck between projects in the field of the environment and projects relating to transport infrastructure. This balance shall take account of Article 130s (5) of the Treaty” (European Commission 1999) – has been divided into equal parts for environmental and transport sectors as well as allocated to one technical support project for capacity increase of Managing Authority (CF Managing Authority in Latvia for programming period 2000 – 2006 is Ministry of Finance).

The distribution of CF co-financing for environmental and transport sectors, accessible to Latvia, is shown in Table 1 (including Instrument for Structural Policies for pre-Accession (ISPA) that after year 2004 are CF co-financed).

**Table1. CF financing for environmental and transport sectors (in millions Euros)**

Sector	Total CF financing	Financing for approved ISPA projects	Financing for CF projects
Transport	257'933'331	38'864'826	219'068'505
Environment	257'933'331	76'447'053	181'486'278

Source: Ministry of Finance of Latvia (Ministry of Finance 2007)

In the next table (Table 2) there are classified calculations on CF resource distribution over Latvian economic sectors. As I pointed above, in the programming period of 2000 – 2006 EU Regulation requires equivalent distribution of resources for both transport and environmental sectors, and this requirement has been followed (European Commission 1999). However, distribution over these sectors' branches may be named

“discussable”. For example, strong support is allocated for railway development, although passenger traffic does not develop, many passenger lines are being closed. Unfortunately this means that conveniences of Latvian people are not affected by those 22.5% of allocated CF co-financing for railway development in transport sector.

Certainly, one may say that this investment in railway infrastructure will return to Latvia as transit carriage of goods, although this does not give direct benefit to state inhabitants – it is advantageous for state-owned enterprise. The fundamental objective of CF, though, is to reduce socio-economic differences among EU NUTS1 and NUTS2 and NUTS3 regions (Central Statistical Bureau 2009); by giving that substantial contribution to railway infrastructure it should be attained that it is beneficial to regions' people, for instance by offering mentioned above new passenger traffic lines.

Regarding to environmental sector, this resource distribution is more accessible to Latvian people, since touches particular NUTS3 region, where projects and

level of development are being realized and give certain improvements.

Similarly, CF co-financing for different branches is very diverse. Besides technical support projects, the most CF co-financing amount 70.4% of project expenses is allocated to airport development (compare it with auto road projects).

Until the end of last year successfully realizing CF co-financed projects, Latvia has received 495.4 millions Euro, or 69.7% from approved financing of programming period 2004 – 2006. CF project contractors, in their turn, have received EUR 463.4 millions or 65.2%. Table 3 shows this progress more detailed.

**Table 2. Distribution of CF resources among Economic sectors of Latvia of period 2000 – 2006**

Sector	Number of projects	Total Eligible cost of project		Average Project Value, millions EUR	CF co-financing		
		Millions EUR	%		Millions EUR	Total, %	For sector, %
Roads	6	377.37	27.8	62.90	150.93	40.0	21.2
Railway	5	260.77	19.2	52.15	159.40	61.1	22.4
Roads in total	11	638.14	47.0	58.01	310.33	48.6	43.7
Airport	1	23.50	1.7	23.50	16.56	70.4	2.3
Ports	2	43.40	3.2	21.70	24.40	58.4	3.4
Transport sector in total	14	705.04	51.9	50.36	351.29	49.9	49.4
Waste management	10	98.81	7.3	9.88	55.33	56.0	7.8
Water services development	11	426.42	31.4	38.76	234.81	61.6	33.0
Development of Heating	1	81.21	6.0	81.21	34.61	42.6	4.9
Environmental sector in total	22	606.44	44.6	27.56	324.75	57.9	45.7
Technical assistance	10	46.69	3.4	4.67	34.76	76.6	4.9
In total	46	1 358.17	100	29.52	710.78	54.3	100

Source: Calculations by Author using Ministry of Finance data (Ministry of Finance 2009a).

**Table 3. CF resource acquisition of period 2004 – 2006 until 31.12.2008**

Ministry of:	Approved by EU projects (commitment)		Paid to beneficiaries		Payments submitted EC*		Received from the EC **	
	EUR	% of accessible financing	EUR	% of commitment	EUR	% of commitment	EUR	% of commitment
1	2	3	4	5=4/2*100	6	7=6/2*100	8	9=8/2*100
Environment	353'199'446	49.7%	231'585'040	65.6%	254'385'281	72.0%	234'891'481	66.5%
Transport	353'899'446	49.8%	230'270'728	65.1%	267'068'880	75.5%	258'339'369	73.0%
Finance	3'668'644	0.5%	1'605'372	43.8%	2'243'445	61.2%	2'243'445	61.2%
In total	710'767'536	100.0%	463'461'140	65.2%	523'697'605	73.7%	495'474'294	69.7%

\* Payments submitted EC + all prepayments.

\*\* Including prepayments.

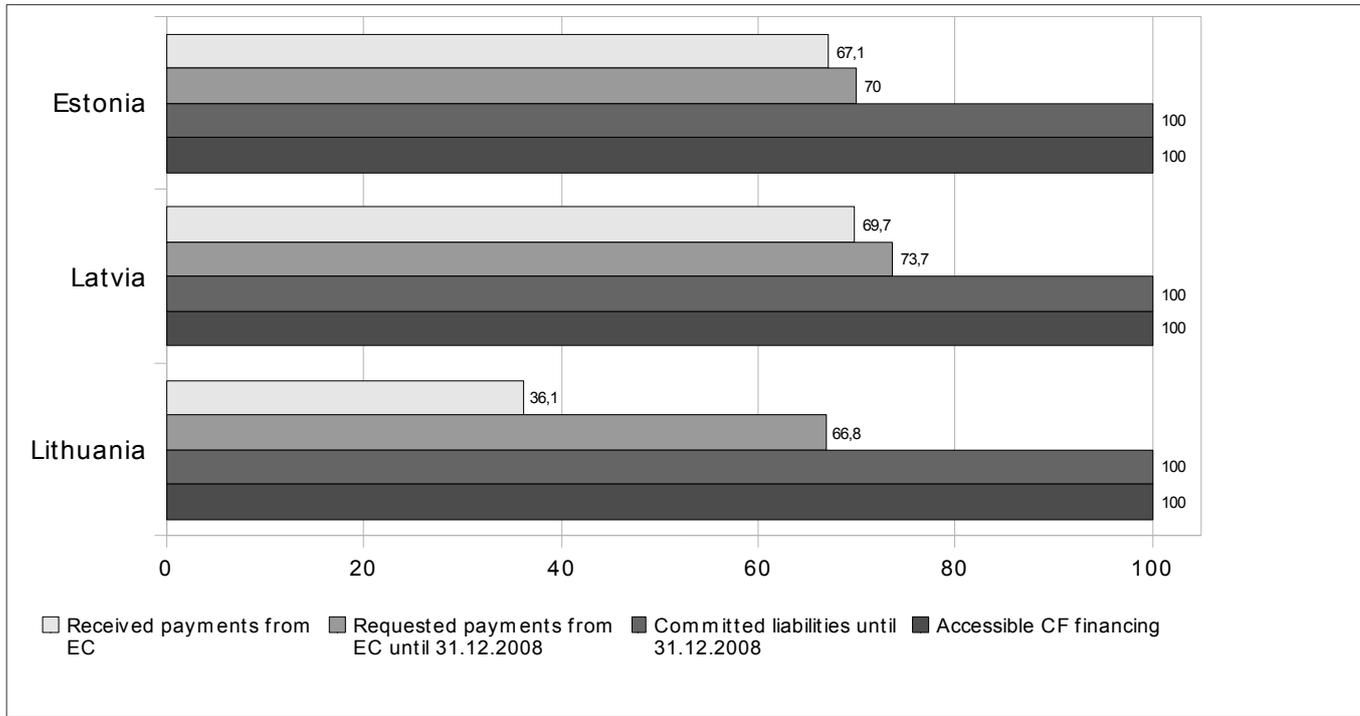
Source: Calculations by Author using Ministry of Finance data, (Ministry of Finance 2009a).

For example, comparing with our neighbour countries, such acquisition results are not bad at all – they as shown in Picture 1 are relatively high. However, it would be

necessary to consider that in absolute numbers the assignments for Baltic States are very different – for instance total assignment for Lithuania is nearly EUR

1.55 billions, which is twice the allocation for Latvia. But what concerns Estonia, this proportion is just opposite – Estonians have only a half of those of Latvia – “only”

EUR 431 millions. Consequently, it is obvious that in these indicators Lithuania overtakes us, as already today has retrieved EUR 560 millions from EC.



**Picture 1. Comparison of CF resource acquisition among Baltic States**

Source: Data summarized by Ministry of Finance, (Ministry of Finance 2009c)

### Problematic projects of CF

Until year 2010 in Latvia there are 24 CF projects waiting for finishing realization. Over the sectors they

spread as follows: 14 projects for environmental; 9 projects of transport and one project for Managing Authority. More detailed information on these unfinished projects is shown in the following Table 4.

**Table 4. Unfinished CF Projects in Latvia**

CF project	Total Eligible cost of project	CF co-financing	Payments made till 1.03.2009.	Still needs to be acquired
	EUR	EUR	EUR	EUR
Track turnouts	35'201'185.0	26'430'000.0	21'144'000.0	14'057'185.0
Signalling system	92'982'800.0	67'463'223.0	22'430'860.7	70'551'939.3
Hot box	15'342'000.0	11'342'910.0	9'074'328.0	6'267'672.0
Technical assistance for transport sector	1'535'000.0	1'304'750.0	929'878.8	605'121.3
Improvements of the TEN road network, Project 1	159'771'000.0	78'778'727.0	70'900'854.3	88'870'145.7
Track Renewal on The East - West Railway Corridor	85'997'092.6	46'499'997.0	33'091'243.8	52'905'848.7
Technical assistance to Ministry of Transport	278'000.0	374'000.0	195'373.9	82'626.1
Access roads to Ventspils Port terminal	36'405'005.0	15'901'397.0	9'330'346.9	27'074'658.1
Reconstruction of access roads to Liepaja Port	13'454'179.0	8'499'519.0	6'799'615.2	6'654'563.8
Transport sector in total	440'966'261.6	256'594'523.0	173'896'501.5	267'069'760.1
River Basins	104'958'115.3	44'616'000.0	35'692'800.0	69'265'315.3

Technical assistance for Environment sector	20'254'524.0	15'190'893.0	12'152'714.4	8'101'809.6
Technical assistance for Water services Development in Municipalities	8'915'496.0	7'310'707.0	5'848'565.6	3'066'930.4
Development of water services in Ventspils, Stage 2	30'538'307.9	18'516'077.0	14'812'861.6	15'725'446.3
Development of water services in Olaine and Jaunolaine	21'733'327.4	11'209'854.0	8'967'883.2	12'765'444.2
Development of water services in Liepāja, Stage 2	25'296'262.8	21'502'863.0	17'202'289.9	8'093'973.0
Development of water services in Daugavpils, Stage 2	33'523'422.0	16'420'991.0	13'136'792.8	20'386'629.2
Solid Waste Management in Zemgale	8'852'907.7	6'147'881.0	4'918'304.8	3'934'602.9
Solid Waste Management in Maliena	9'085'181.0	5'925'433.0	4'740'346.4	4'344'834.6
Hazardous waste management System in Latvia, Stage 1	8'115'000.0	6'492'000.0	5'193'600.0	2'921'400.0
Solid Waste Management in Piejura	23'778'144.0	15'951'632.0	10'605'503.8	13'172'640.2
Development of water services in Rīga, Stage 3	82'153'408.6	58'838'450.0	34'036'084.3	48'117'324.4
Development of the District Heating System of Ventspils City in Latvia	37'377'028.1	34'605'360.0	68'305.3	37'308'722.8
Technical assistance for development of Water service projects in Latvia	3'056'478.0	2'567'441.0	1'585'447.4	1'471'030.6
Environmental sector in total	417'637'602.8	265'295'582.0	168'961'499.4	248'676'103.4
Technical assistance for Managing Authority	3'534'100.0	2'968'644.0	1'584'913.0	1'949'187.0
<b>In total</b>	<b>862'137'964.4</b>	<b>524'858'749.0</b>	<b>344'442'913.9</b>	<b>517'695'050.5</b>

Source: Calculations by Author using Ministry of Finance data, (Ministry of Finance 2009b).

Today there is a number of CF projects that have some irregularities in project implementation plan with high implementation risk (Ministry of Finance 2009a):

*1. Project “Development of the District Heating System of Ventspils City in Latvia”*

The implementation progress is more than unsatisfactory, since project forecast time schedule significantly runs behind the EC defined deadline – 30 of November, 2009. As the enterprise representatives have informed the Monitoring committee (CF Monitoring comity 2008), construction jobs could be finished in 3. Quarter of 2011. This is substantially longer period and furthermore may cause money damage to Latvian state budget, if only EC will not prolong project realization deadline. At the moment there are announced procurement competitions on all activities provided in project framework. It is planned that all project contracts will be concluded in first quarter of 2009.

*2. Project “Modernization of train service supervision system”.*

Today from the CF co-financing total amount LVL 47.4 million, acquired are only 33% or LVL 15.8 million. Therefore all possible actions are being performed to ensure successful realization of this project. For example, Ministry of Transport and state joint-stock company „Latvijas dzelzceļš” have undertaken to ensure reinforced project implementation control. For this

reason it is planned to draw in an expert – engineer who will be responsible for work realization monitoring in defined time limit.

*3. Project “Development of water services in Ventspils, Stage 2”*

Despite of comparatively good financial and job progress (today acquired are LVL 13.0 millions or 80% of CF resources), unfortunately should be considered the remarkable increase of expenses, because of what it is not possible to finish the project in initially planned range. Unfortunately today it is not possible to find these lacking resources in state budget and therefore it is planned to ask for EC to agree/support the feasibility for reducing amount of required jobs in project.

**Discussion on problems and possible solutions under conditions of global economic crisis**

In my previous publication (Ābolaņa I. 2008.) I have raised a discussion regarding problems in CF project implementation and offered various possible solutions. I have seen over the two most substantial problems of that time (years 2007/2008) and now I propose discussion on how these problems are being solved and solved under crisis conditions.

The first problem is in connection with fast growth of construction sector, consequently many companies

re-profiled to act in private real estate business with much more earnings. At the time being this problem has been solved – in announced construction procurements now applies the considerable number of competitors. Furthermore prices are very competitive and lower (reduction starting from 30% as in 2007/2008).

There has been another problem arisen regarding realized construction procurements. In last years there were defined a specific guarantees for enterprises, who participate in large construction procurements (for instance, two years after object completion some amount of money should persist in the account for warranty repair works). Consequently, enterprises who are involved in CF projects have frozen resources. Unfortunately solution for this situation does not exist at the moment, as reducing these guarantees will violate Public Procurement law. Solution suggested by me is to inform EC about those particular cases and to recover EC support again by methodically clarifying why situation became so worse. This would also help to prevent potential financial correction.

The second problem regards to increase of payments. The fast economic growth facilitated development and this led to overall growth of prices. In that time the solutions were found by requesting additional resources from EC and/or Latvian budget. As another alternative was the reduction of amount of works in projects, as long this did not interfere with project goals. Today the situation has changed – for some projects there is an actual savings. However, one should understand how this problem had arisen – because of poor quality and robustness of project planning.

At the time being situation has been changed and most essential problem in various project realisation is related to value added tax (VAT) changes (increase) (Saeima 1995). Unfortunately decision was made without consideration of the sector specialist opinions. As a result, today implementation of EU funds projects is burdened. I would like to emphasize that this change affects every EU fund co-financed project. Consequently, these problems apply to all institutions who administer EU resources, as well as beneficiaries and contractors. Unfortunately responsible authorities until now did not give interpretations regarding possible solutions and rate application for diverse situations. For solving the situation the Managing Authority has prepared guidelines (Ministry of Finance 2009d) regarding VAT rate application for EU funds projects

Unfortunately, the principle of Legal certainty has not been taken into consideration (Kalniete M. 2005). Applying the new rate, no solutions for cost increase prevention are being offered. At the time being it is suggested to detect resources in budget framework of already approved project (using potential savings). However, not always such savings can take place. Another offered solution is to reduce amount of works in

project, although this is not always possible, since pretty often amount of works are reduced earlier – in previous years. By further reducing of these amounts the situation may arise, when goals defined by CF along with project implementation are not reached.

### **The balance of CF co-financed project goals and Latvian economic stabilization and growth renewal program**

Analysing the economic stabilization and growth renewal program (Cabinet of Ministers 2009) one may conclude that in its form and fact it's declarative and isn't scientifically grounded. Its defined goals are unclear.

Program says that it is necessary to simplify only EU fund implementation system of planning period 2007 – 2013, but there have to be acquired large amount of previous period resources – EUR 518 millions. To successfully and flexible realize these projects of previous period, it is necessary urgently to improve also this system, as I pointed out in my previous publications (Āboliņa I. 2008, 2009).

The EU fund re-plan provided in the renewal program is related only to planning period 2007 – 2013. Allocation of period 2000 – 2006 cannot be changed, since all resources are attached to EC approved projects.

If there will be implemented the provided enhancements for procurement legislation, it will benefit the realisation of not yet started contracts in CF projects. For instance, if the procurement contract price level will be raised, it will shorten procurement procedures of large contracts for about two months. Encouraged is the idea to define guarantee payment, if a compliant has been lodged regarding decision in time of procurement procedure. At the time being in the public procurement law (Saeima 2006) has been provided an option to complain in Procurement Monitoring Bureau (PMB) about all possible infringement. Any complaint regarding particular procurement procedure temporarily suspends conclusion of contract. Complaint review times in PMB are two months, and this seriously impacts terms of project realization. Regulation of presence of irresponsible and abuse complaints will be assured by defining that in cases of these unfounded complaints guarantee payment will not to be returned.

As positive aspect in this Program is the willingness to arrange (adjust) the public and private partnership sector in Latvia. Previously due to shortcomings in legislation, the implementation of projects that were financed from state, local municipalities, non-governmental organizations and private capital, wasn't possible (State Chancellery 2009). Realization of these projects should be encouraged, as this will facilitate financial load of all involved parties.

Also positively on previous period CF projects will allude the arrangement of guarantee legislation. Until now quantity of guarantees were defined in technical

specifications of announced procurement tenders. As I previously pointed out, today it is extremely sensitive to review the guaranteed quantity established in contracts. By substantially reducing guarantees for contractors at the moment the procurement procedure has not been violated. Arrangement of this sector will positively impact further, still not concluded contracts.

### Conclusion

The CF financial acquisition and progress of works are satisfactory, however there are some risky projects that may create a load to Latvian state budget if EC won't approve reconciliation measures.

CF projects in Latvia are huge, involving EUR 1.4 billions, however they do not facilitate socio-economic equalization, since great amount of them are invested in state owned enterprises that do not directly yield to society.

Great amount of allocated CF financing for transport infrastructure has been attached to state JSC "Latvijas Dzelzceļš"; smaller amount – for auto roads, although that would be direct contribution to society's standard of living.

In environmental area in both numbers of projects and their allocated money amounts prevails the water service development, but these invested resources give immediate benefit to people.

Exact planning prevents problems in project realisation under both normal and global economic crisis conditions.

Economic crisis in Latvia positively impact implementation of CF projects, since also contract costs reduces significantly (in some contracts even up to 30%).

Latvian economic stabilization and growth renewal program points towards resource re-planning of new period and simplification of EU fund implementation system. In practice this has small impact on period 2004 – 2006 CF project realisation.

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