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Recommendation for a

**COUNCIL RECOMMENDATION**

**on Latvia's 2014 national reform programme**

**and delivering a Council opinion on Latvia's 2014 stability programme**

{SWD(2014) 415 final}

Recommendation for a

## **COUNCIL RECOMMENDATION**

**on Latvia's 2014 national reform programme**

**and delivering a Council opinion on Latvia's 2014 stability programme**

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty on the Functioning of the European Union, and in particular Articles 121(2) and 148(4) thereof,

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies<sup>1</sup>, and in particular Article 5(2) thereof,

Having regard to the recommendation of the European Commission<sup>2</sup>,

Having regard to the resolutions of the European Parliament<sup>3</sup>,

Having regard to the conclusions of the European Council,

Having regard to the opinion of the Employment Committee,

Having regard to the opinion of the Economic and Financial Committee,

Having regard to the opinion of the Social Protection Committee,

Having regard to the opinion of the Economic Policy Committee,

Whereas:

- (1) On 26 March 2010, the European Council agreed to the Commission's proposal to launch a new strategy for growth and jobs, Europe 2020, based on enhanced coordination of economic policies, which will focus on the key areas where action is needed to boost Europe's potential for sustainable growth and competitiveness.
- (2) On 13 July 2010, the Council, on the basis of the Commission's proposals, adopted a recommendation on the broad guidelines for the economic policies of the Member States and the Union (2010 to 2014) and, on 21 October 2010, adopted a decision on guidelines for the employment policies of the Member States, which together form the 'integrated guidelines'. Member States were invited to take the integrated guidelines into account in their national economic and employment policies.
- (3) On 29 June 2012, the Heads of State or Government decided on a Compact for Growth and Jobs, providing a coherent framework for action at national, EU and euro area levels using all possible levers, instruments and policies. They decided on action to be taken at the level of the Member States, in particular expressing full

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<sup>1</sup> OJ L 209, 2.8.1997, p. 1.

<sup>2</sup> COM(2014) 415 final.

<sup>3</sup> P7\_TA(2014)0128 and P7\_TA(2014)0129.

commitment to achieving the objectives of the Europe 2020 Strategy and to implementing the country-specific recommendations.

- (4) On 9 July 2013, the Council adopted a recommendation on Latvia's national reform programme for 2013 and delivered its opinion on Latvia's updated convergence programme for 2012-2016.
- (5) On 13 November 2013, the Commission adopted the Annual Growth Survey<sup>4</sup>, marking the start of the 2014 European Semester of economic policy coordination. On the same day on the basis of Regulation (EU) No 1176/2011, the Commission adopted the Alert Mechanism Report<sup>5</sup>, in which it did not identify Latvia as one of the Member States for which an in-depth review would be carried out.
- (6) On 20 December 2013, the European Council endorsed the priorities for ensuring financial stability, fiscal consolidation and action to foster growth. It underscored the need to pursue differentiated, growth-friendly fiscal consolidation, to restore normal lending conditions to the economy, to promote growth and competitiveness, to tackle unemployment and the social consequences of the crisis, and to modernise public administration.
- (7) On 29 April 2014, Latvia submitted its 2014 national reform programme and on 30 April 2014 its 2014 stability programme. In order to take account of their interlinkages, the two programmes have been assessed at the same time.
- (8) The objective of the budgetary strategy outlined in the 2014 Stability Programme is to gradually reduce the headline deficit and to maintain a structural balance which is consistent with the medium-term objective when taking into account the allowed temporary deviation from the medium-term objective due to the impact of the systemic pension reform. The programme has changed the medium-term objective from -0.5% to -1.0%; the new medium-term objective reflects the objectives of the Stability and Growth Pact. The planned path of the headline balance in Latvia's programme implies a gradual deterioration of the (recalculated) structural balance, although still within the margin allowed by the implementation of the pension reform. Taking into account the allowed deviation from the medium-term objective, the planned structural deficit is in line with the requirement of the Pact until 2016. However, the planned increase in the recalculated structural deficit in 2017 leads to a deviation from the required adjustment path towards the medium-term objective. Overall, the budgetary strategy outlined in the programme is mostly in line with the requirements of the Stability and Growth Pact. Government debt is set to remain well below 60% of GDP over the whole programme period, declining to 31% of GDP by 2017. The macroeconomic scenario underpinning the budgetary projections in the programme, which has not been formally endorsed by an independent institution, is plausible. Economic growth is expected to remain around 4% per year over the programme period, and projected price increases are moderate. The programme's budgetary scenario envisages a steep decline in the share of government's revenue and expenditure in GDP, reflecting several revenue-reducing measures against targeted expenditure restraint. Increasing spending demands in several policy fields represent a risk to the projected expenditure reductions in the programme. The Commission 2014 spring forecast shows that while fiscal policy in 2014 is in line with the requirement of the Pact, there is a risk of a deviation in 2015. Based on its assessment of the programme and the Commission Forecast, pursuant to Council

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<sup>4</sup> COM(2013) 800 final.

<sup>5</sup> COM(2013) 790 final.

Regulation (EC) No 1466/97, the Council is of the opinion that in 2014 the deviation of the structural deficit from the medium-term objective reflects the impact of the systemic pension reform, while as of 2015 there is a risk of a deviation from the required adjustment path.

- (9) Latvia has taken steps to lower the tax burden for low-income earners and families with dependants and to strengthen property and environmental taxation, but the level and design of these taxes does not sufficiently affect the behaviour of economic operators, and some environmentally harmful subsidies remain in place. While the authorities have made some progress in improving tax compliance and reducing the proportion of undeclared economic activity, notably by improving risk assessment and tightening sanctions against fraudulent behaviour, challenges in the fight against tax fraud and evasion remain. In particular, despite representing a significant proportion of total taxation, revenue from consumption taxes has ample potential for further increase if tax compliance is improved.
- (10) Despite an originally ambitious plan to reform higher education, Latvia has made no progress in setting up an internationally approved accreditation system, plans to introduce a new financing model are uncertain, consolidation of higher education institutes has been weakened and restrictions on the use of foreign languages remain unchanged. This is despite the fact that there is significant room for reforming the higher education system, which is too large in view of the declining population, offers too many distinct study programmes and has a limited attraction for foreign students and teaching staff. The results of the first independent assessment of research institutions shows that only 10% of those evaluated can be considered as high-level international research centres. Moreover, Latvia had an R&D intensity of only 0.66% of GDP in 2012 and is not on track to achieve its Europe 2020 objective of devoting 1.5% of GDP to R&D.
- (11) Latvia has made progress in tackling unemployment, which has fallen considerably. However, youth unemployment is still relatively high and there is a need for outreach measures to non-registered inactive youth. Although Latvia has taken measures to address skills mismatches and the quality of vocational education, these still require attention, notably in improving the quality of apprenticeships and in developing comprehensive career guidance. Active labour market policies are still limited in scope and over rely on public works.
- (12) Working age poverty remains very high in Latvia. Latvia has taken some steps to reform social assistance and has completed a large-scale assessment of the social security system providing a solid basis for an evidence-based reform. It has significantly increased various child-related benefits, and raised the non-taxable thresholds in personal income tax for dependants. However, the effectiveness of social protection in terms of poverty reduction remains poor and designing an effective social safety net remains a challenge. Overall, a high proportion of population is at risk of poverty or social exclusion, and such proportion is even higher for children. Families with children, the unemployed, people with disabilities and people living in rural areas are at a particularly high risk of poverty and social exclusion. Latvia's spending on social protection as a percentage of GDP is the lowest in the EU. Access to healthcare is hampered by costs, including high out-of-pocket payments and prevalent informal payments, leaving a high proportion of the population with unmet health-care needs. There is significant room to enhance the efficiency of the system, ensure cost-effective financing and promote disease-prevention activities.

- (13) Latvia has made some progress in opening its electricity market to competition and this will be extended to the household sector in early 2015. Latvia joined the regional Scandinavian-Baltic Nord Pool Spot market for electricity contracting in June 2013. Further reinforcement of interconnections with the EU energy market is needed, as Latvia is currently import-dependent and the cross-border electricity connection with Estonia is mostly congested. Development of infrastructure is therefore essential and Latvia faces considerable challenges in closing infrastructure gaps. Some progress was also achieved in the natural gas sector as the Parliament approved amendments to the Energy law, defining gradual opening up of the gas market from April 2014; however, the full market opening was postponed until 2017. Latvia has put forward a balanced mix of policy measures addressing energy savings for the main sectors of the economy and in coming years more than 70% of energy savings will be generated in the buildings sector. However, efficiency in transport, buildings and heating systems still needs to be improved.
- (14) Latvia has taken significant action to improve capacities in the judiciary to reduce the backlog and length of proceedings. However, the high judicial backlog still poses a threat to business and reforms to improve the efficiency and quality of the judiciary need to be completed, including as regards insolvency, mediation and arbitration. Latvia has proposed ambitious public administration reforms; however their implementation is slow and not applied to local governments and the reform of state-owned enterprises has been significantly delayed. Amendments to the Competition Law are needed to give the Competition Council greater institutional and financial independence to intervene effectively against actions of public and private bodies restricting competition.
- (15) In the context of the European Semester, the Commission has carried out a comprehensive analysis of Latvia's economic policy. It has assessed the stability programme and the national reform programme. It has taken into account not only their relevance for sustainable fiscal and socio-economic policy in Latvia but also their compliance with EU rules and guidance, given the need to reinforce the overall economic governance of the European Union by providing EU-level input into future national decisions. Its recommendations under the European Semester are reflected in recommendations (1) to (5) below.
- (16) In the light of this assessment, the Council has examined Latvia's stability programme, and its opinion<sup>6</sup> is reflected in particular in recommendation (1) below.
- (17) In the context of the European Semester the Commission has also carried out an analysis of the economic policy of the euro area as a whole. On the basis of this analysis the Council has issued specific recommendations for the Member States whose currency is the euro. Latvia should also ensure the full and timely implementation of these recommendations.

HEREBY RECOMMENDS that Latvia take action within the period 2014-2015 to:

1. Preserve a sound fiscal position in 2014 and strengthen the budgetary strategy as of 2015, ensuring that the deviation from the medium-term objective remains limited to the impact of the systemic pension reform. Pursue efforts to further reduce the tax burden on low-income earners in the context of a shift towards more growth-friendly property and environmental taxes and by improving tax compliance and collection.

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<sup>6</sup> Under Article 5(2) of Council Regulation (EC) No 1466/97.

2. Step up implementation of the higher education reform, in particular through the establishment of an independent accreditation agency and a financing model that rewards quality. Provide career guidance at all education levels, improve the quality of vocational education and training, including by strengthening apprenticeship, and make progress in employability of young people including by putting in place outreach measures for non-registered youth not in employment education or training. Take steps for a more integrated and comprehensive research system also by concentrating financing towards internationally competitive research institutions.
3. Reform social assistance and its financing further to ensure better coverage, adequacy of benefits, strengthened activation and targeted social services. Increase coverage of active labour market policies. Improve the cost-effectiveness, quality and accessibility of the health care system.
4. Accelerate the development of gas and electricity interconnections to neighbouring Member States to diversify energy sources and promote competition through improved integration of the Baltic energy markets. Pursue efforts to further increase energy efficiency in transport, buildings and heating systems.
5. Complete judicial reforms including the pending reforms of insolvency, arbitration and mediation frameworks to ensure a more business- and consumer- friendly legal environment. Step up public administration reforms, including by implementing state-owned enterprise management reform and increasing institutional and financial independence of the Competition Council.

Done at Brussels,

*For the Council  
The President*