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Recommendation for a

COUNCIL RECOMMENDATION

on the 2015 National Reform Programme of Latvia

and delivering a Council opinion on the 2015 Stability Programme of Latvia

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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 policies¹, and in particular Article 5(2) thereof,

Having regard to the recommendation of the European Commission²,

Having regard to the resolutions of the European Parliament³,

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.

¹ OJ L 209, 2.8.1997, p. 1.

² COM(2015) 263

³ P8_TA(2015)0067, P8_TA(2015)0068, P8_TA(2015)0069

- (3) On 8 July 2014, the Council adopted a recommendation on Latvia's National Reform Programme for 2014 and delivered its opinion on Latvia's updated Stability Programme for 2014.
- (4) On 28 November 2014, the Commission adopted the Annual Growth Survey⁴, marking the start of the 2015 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 Report⁵, in which it did not identify Latvia as one of the Member States for which an in-depth review would be carried out.
- (5) On 18 December 2014, the European Council endorsed the priorities for boosting investment, accelerating structural reforms and pursuing responsible growth-friendly fiscal consolidation.
- (6) On 26 February 2015, the Commission published its 2015 country report for Latvia⁶. The country report assessed progress in addressing the country-specific recommendations adopted on 8 July 2014.
- (7) On 17 April 2015, Latvia submitted its 2015 National Reform Programme and its 2015 Stability Programme. In order to take account of their interlinkages, the two programmes have been assessed at the same time.
- (8) Latvia is currently in the preventive arm of the Stability and Growth Pact and benefits from the implementation of the systemic pension reform clause as confirmed by Eurostat. In its Stability Programme, Latvia has requested a temporary deviation from the required adjustment path towards the medium-term objective, because it continues to implement a major structural reform in the health sector. The budgetary costs of the health sector reform amount to 0.2% of GDP in 2016. The reform is estimated to increase employment by 0.6% and the GDP level by 2.2% by 2023. The positive impact on growth and the long-term sustainability of public finances is assessed to be plausible. However, based on the Commission's 2015 spring forecast, the projected structural deficit of 2.2% of GDP in 2016 exceeds the appropriate safety margin with respect to the 3% of GDP reference value of the Treaty which should be respected in order to be eligible for the structural reform clause. Therefore, and while recognising that the ongoing health sector reform is warranted, the Council is of the opinion that Latvia does not fulfil the requirements to benefit from the requested temporary deviation in 2016.
- (9) In its 2015 Stability Programme, the government plans a broadly stable headline deficit at 1.4% of GDP in 2016 and 1.3% in 2017, rising to 1.7% in 2018. To achieve these targets, the government intends to reach a structural deficit of 1.8% of GDP in 2016, and of 1.4% of GDP as from 2017. The path in the Stability Programme incorporates a deviation based on the structural reform clause for which Latvia does not appear to be eligible, and classifies planned additional defence spending over 2016-2019 as one-off operations. According to the Stability Programme, the government debt ratio is expected to decline from 37% of GDP in 2015 to 34% of GDP by 2018, with some annual fluctuations in between due to accumulation of liquid assets for debt management purposes. The macroeconomic scenario underpinning these budgetary projections is plausible. Measures for 2015 have

⁴ COM (2014) 902
⁵ COM(2014) 904
⁶ SWD(2015) 33 final

largely been implemented as budgeted. However, measures to support the planned deficit targets from 2016 onwards have not been sufficiently specified. Based on the Commission's 2015 spring forecast, Latvia complies with the requirement in 2015, taking into account the application of the pension reform clause. For 2016, there is a risk of a significant deviation. The structural balance is required to improve by 0.3% of GDP taking into account the allowance for the pension reform. Based on the Commission forecast, it deteriorates by 0.3% of GDP, which is also linked to the fact that the defence spending cannot be classified as one-off measures. Based on its assessment of the Stability Programme and taking into account the Commission's 2015 spring forecast, the Council is of the opinion that there is a risk that Latvia will not comply with the provisions of the Stability and Growth Pact.

- (10) A national independent accreditation agency is being set up and a new quality-targeting financing model is being developed for Latvia's higher education. Despite some progress in reforming the research and innovation system, in line with the Smart Specialisation Framework, inadequate public funding in a fragmented research and innovation system is leading to poor scientific outcomes. Latvia invested only around 0.6% of GDP in R&D in 2013 - the third lowest level in the EU. Public R&D intensity reached only 0.43% of GDP in 2013. Lack of innovation and private investment in higher value added and knowledge intensive sectors hampers competitiveness.
- (11) Notwithstanding the progress made to tackle unemployment, further action is needed to prevent youth unemployment and its negative long-term consequences, giving the shrinking labour force. Latvia has made some progress to reform the vocational education and training and its apprenticeship component; however, its attractiveness remains a challenge, due to the limited engagement of SMEs.
- (12) Even if a significant amount of analytical and planning work has been carried out, the social assistance reforms have not advanced and are not backed by sufficient budgetary plans. Low coverage and adequacy of unemployment and social assistance benefits prevents effective action on reducing poverty, social exclusion and the high degree of inequality. Under these conditions, social expenditure has little impact on poverty reduction. In 2014, around 32.7% of Latvia's population were at risk of poverty or social exclusion and income inequality remains among the highest in the EU. The financing and coverage of active labour market policies remains low in comparison with other EU countries. The high tax wedge for low- income earners remains a disincentive for formal employment and reduces demand for low-skilled workers; whereas environmental and effective property taxation have significant unexploited potential. Low public healthcare financing and high out-of-pocket payments, inadequate focus on performance incentives and efficiency, lack of care coordination result in reduced access of large proportion of the population. There is significant room to increase the cost-effectiveness and quality of the system and to link hospital financing to performance based mechanisms.
- (13) Latvia has made significant progress in reforming the judicial system. However, the rate of resolving civil and commercial cases remains low creating additional burden to business and the role of the Judicial Council and court chairpersons in implementing judicial reforms should be strengthened. Fight against tax evasion and appropriate tax collection is insufficient and the level of tax avoidance is still high. While the insolvency law has been adopted, challenges remain on proper insolvency policy and on an effective insolvency administrators' supervision system. The business climate and the quality of public services would benefit from stronger

measures against conflict of interest and corruption, especially in vulnerable sectors such as public procurement, construction and healthcare. There has been no progress on the Competition Council's proposals for amendments to the Competition Law to give it greater institutional and financial independence to take effective action against public bodies. The Public Service Law has not been adopted by the Parliament. It will be important that the local government will be included.

- (14) In the context of the European Semester, the Commission has carried out a comprehensive analysis of Latvia's economic policy and published it in the 2015 country report. It has also assessed the Stability Programme and the National Reform Programme and the follow-up given to the recommendations addressed to Latvia in previous years. 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. The recommendations under the European Semester are reflected in recommendations (1) to (4) below.
- (15) In the light of this assessment, the Council has examined Latvia's Stability Programme, and its opinion⁷ is reflected in particular in recommendation (1) below,

HEREBY RECOMMENDS that Latvia take action within the period 2015-2016 to:

1. Ensure that the deviation from the medium-term objective in 2015 and 2016 is limited to the allowance linked to the systemic pension reform.
2. Improve vocational education and training, speed up the curricula reform and increase the offer of apprenticeships. Ensure that the new financing model of the higher education system rewards quality. Better target research financing and incentivise private investment in innovation on the basis on of the Smart Specialisation Framework.
3. Take concrete steps to reform social assistance, ensuring adequacy of benefits, and take measures to increase employability. Reduce the high tax wedge for low-income earners by shifting tax burden to other sources less detrimental to growth. Take action to improve accessibility, cost-effectiveness and quality of the healthcare system and link hospital financing to performance mechanisms.
4. Improve efficiency of the judicial system, by increasing accountability of all parties (including insolvency administrators), by providing adequate means to fight tax evasion and by strengthening the role of the Judicial Council. Improve the public service legislation to strengthen the conflict of interest regime and link remuneration to responsibilities.

Done at Brussels,

For the Council
The President

⁷ Under Article 5(2) of Council Regulation (EC) No 1466/97.