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Recommendation for a

COUNCIL RECOMMENDATION

on the 2019 National Reform Programme of Latvia and delivering a Council opinion on the 2019 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 policies[1], and in particular Article 5(2) thereof,

Having regard to the recommendation of the European Commission,

Having regard to the resolutions of the European Parliament,

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 21 November 2018, the Commission adopted the Annual Growth Survey, marking the start of the 2019 European Semester for economic policy coordination. It took due account of the European Pillar of Social Rights, proclaimed by the European Parliament, the Council and the Commission on 17 November 2017. The priorities of the Annual Growth Survey were endorsed by the European Council on 21 March 2019. On 21 November 2018, on the basis of Regulation (EU) No 1176/2011, the Commission also adopted the Alert Mechanism Report, in which it did not identify Latvia as one of the Member States for which an in-depth review would be carried out. On the same date, the Commission also adopted a recommendation for a Council recommendation on the economic policy of the euro area, which was endorsed by the European Council on 21 March 2019. On 9 April 2019, the Council adopted the recommendation on the economic policy of the euro area ('Recommendation for the euro area').

(2) As a Member State whose currency is the euro and in view of the close interlinkages between the economies in the economic and monetary union, Latvia should ensure the

[1] OJ L 209, 2.8.1997, p. 1.

full and timely implementation of the Recommendation for the euro area, as reflected in recommendations (1) to (4) below. In particular, focusing economic policy related to investment in the specified areas and measures to improve skills will help address the first euro area recommendation as regards productivity improvements for euro area rebalancing and tax measures will help address the third euro area recommendation as regards the functioning of the labour market.

(3) The 2019 country report for Latvia[2] was published on 27 February 2019. It assessed Latvia's progress in addressing the country-specific recommendations adopted by the Council on 13 July 2018, the follow-up given to the recommendations adopted in previous years and Latvia's progress towards its national Europe 2020 targets.

(4) On 15 April 2019, Latvia submitted its 2019 National Reform Programme and, on 17 April 2019, its 2019 Stability Programme. In order to take account of their interlinkages, the two programmes have been assessed at the same time.

(5) Relevant country-specific recommendations have been addressed in the programming of the European Structural and Investment Funds ('ESI Funds') for the 2014-2020 period. As provided for in Article 23 of Regulation (EU) No 1303/2013 of the European Parliament and of the Council[3], where it is necessary to support the implementation of relevant Council recommendations, the Commission may request a Member State to review and propose amendments to its Partnership Agreement and relevant programmes. The Commission has provided further details on how it would make use of that provision in guidelines on the application of the measures linking the effectiveness of the ESI Funds to sound economic governance[4].

(6) Latvia is currently in the preventive arm of the Stability and Growth Pact. In its 2019 Stability Programme, the government plans an improvement of the headline balance from a deficit of 1.0% of GDP in 2018 to a deficit of 0.5% of GDP in 2019 and 0.4% of GDP in 2020 and 2021[5]. Based on the recalculated structural balance[6], the medium-term budgetary objective, set at a deficit of 1% of GDP in structural terms, is planned to be reached in 2019, taking into account the allowance linked to the implementation of the structural reforms for which a temporary deviation is granted. According to the 2019 Stability Programme, the general government debt-to-GDP ratio is expected to decrease to 33.1% of GDP by 2022. The 2019 Stability Programme's GDP growth projections appear to be plausible. Risks to the budgetary position are balanced.

(7) On 13 July 2018, the Council recommended that Latvia achieve its medium-term budgetary objective in 2019, taking into account the allowances linked to the implementation of the structural reforms for which a temporary deviation is granted. This is consistent with a maximum nominal growth rate of net primary government expenditure[7] of 4.8% in 2019, corresponding to an improvement in the structural

2 SWD(2019) 1013 final.

3 Regulation (EU) No 1303/2013 of the European Parliament and of the Council of 17 December 2013 laying down common provisions on the European Regional Development Fund, the European Social Fund, the Cohesion Fund, the European Agricultural Fund for Rural Development and the European Maritime and Fisheries Fund and laying down general provisions on the European Regional Development Fund, the European Social Fund, the Cohesion Fund and the European Maritime and Fisheries Fund and repealing Council Regulation (EC) No 1083/2006 (OJ L 347, 20.12.2013, p. 320).

4 COM(2014) 494 final.

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6 Cyclically-adjusted balance net of one-off and temporary measures, recalculated by the Commission using the commonly agreed methodology.

7 Net primary government expenditure comprises total government expenditure excluding interest expenditure, expenditure on Union programmes fully matched by Union funds revenue and non-

balance by 0.2% of GDP. Based on the Commission 2019 spring forecast, Latvia is expected to be close to its medium-term budgetary objective, taking into account the allowance linked to the implementation of the structural reforms for which a temporary deviation is granted. Thus, the current assessment indicates a risk of some deviation in 2019. At the same time, projected nominal growth rate of net primary government expenditure would currently point to a risk of a significant deviation from the requirement in 2019. If the structural balance is no longer projected to be close to the medium-term budgetary objective, taking into account the allowance linked to the implementation of the structural reforms for which a temporary deviation is granted, in future assessments an overall assessment would need to take into account a possible deviation from the requirement.

(8) In 2020, in view of Latvia's projected output gap of 1.3%, the nominal growth rate of net primary government expenditure should not exceed 3.5%, in line with the structural adjustment of 0.5% of GDP stemming from the commonly agreed adjustment matrix of requirements under the Stability and Growth Pact. Based on the Commission 2019 spring forecast under unchanged policies, Latvia is expected to be close to its medium-term budgetary objective. Thus, the current assessment indicates risk of some deviation in 2020. At the same time, the projected nominal growth rate of net primary government expenditure would currently point to a risk of a significant deviation from the requirement in 2020. If the structural balance is no longer projected to be close to the medium-term budgetary objective, in future assessments an overall assessment would need to take into account a possible deviation from the requirement. Overall, the Council is of the opinion that Latvia needs to stand ready to take further measures as of 2019 to comply with the provisions of the Stability and Growth Pact.

(9) The tax revenue as a share of the gross domestic product of Latvia is low compared with the Union average and limits to some extent the delivery of public services, in particular healthcare, and social inclusion. Capital and property are relatively undertaxed and the freezing of the values used to calculate land and property taxes will reduce their revenue further. At the same time, the tax burden on labour remains high for low-wage earners relative to the average of the European Union, despite having been reduced. The share of the shadow economy appears to have declined over the past years by different estimates. Nevertheless, the share of under-reported economic activity is higher in Latvia than in other Baltic States. In particular, underreporting of salaries (‘envelope wages’), particularly in the construction sector, accounts for a large share of the shadow economy.

(10) Following the closure of its third largest bank due to allegations of money laundering, Latvia tightened the regulation concerning non-resident clients. As a result, non-resident deposits, which are the main source of money laundering risk in Latvia, have significantly decreased since May 2018, but challenges regarding fighting money laundering remain. Moreover, Latvia has come up with a detailed action plan for improving its anti-money laundering/counter terrorist financing strategy. The main priorities listed in the action plan include enhancing risk-based supervision, ensuring the required human resources for the supervisory authorities, and ensuring effective information exchange and collaboration among the investigative authorities and with the private sector. Attention should be paid to the effective implementation of these

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discretionary changes in unemployment benefit expenditure. Nationally financed gross fixed capital formation is smoothed over a 4-year period. Discretionary revenue measures or revenue increases mandated by law are factored in. One-off measures on both the revenue and expenditure sides are netted out.

measures, once adopted. Finally, law enforcement and judicial authorities' capacity also need to be increased.

(11) Latvia faces challenges on delivering on several of social protection and inclusion principles of the European Pillar of Social Rights. Income inequality in Latvia is high, as the redistribution through the tax-benefit system is low. The adequacy of social benefits remains low and the impact of social transfers on poverty and inequality reduction is limited. The poverty risk among the elderly and the people with disabilities is relatively high and increasing due to benefits not keeping pace with wage growth. The at-risk-of-poverty or social exclusion rate for the elderly was 49.0% in 2018 (European Union average: 18.2% in 2017) and for the disabled people with disabilities 40.7% in 2017, (European Union average: 29.3% in 2017). The state social security benefit for people with disabilities and minimum old-age pensions, have not been revised since 2006. The minimum income level reform, announced in 2014, has not been implemented, which negatively affects the poorest households. Access to long-term care also remains weak. Investments are thus required to address social exclusion, including food and material aid for the most deprived. Moreover, investments, including infrastructure, are needed to improve access to childcare, long-term care, employment and other social services, and to enable integration of health and social services, including the transition from institutional to community-based care. The share of people facing severe housing deprivation is among the highest in Europe (15.2% vs 4.0% in average in 2017 in the European Union) and social housing is scarce. Investment is needed to improve the provision of affordable housing.

(12) While overall employment rates are high and increasing, headcount employment is negatively affected by the adverse demographic developments and emigration. In addition, employment varies between regions and skill levels. Older people with outdated skills encounter more difficulties. The low level of digital skills among the labour force limits the use of digital technologies by businesses and the potential for innovation. Adult participation in learning and the involvement of the unemployed in active labour market measures is lower than the average of the European Union.

(13) The education system faces a challenge to consolidate resources while improving quality and efficiency. While Latvia's education system performs well in terms of learning achievement, access to quality education remains dependent on the place of residence and type of school. Curriculum reform in vocational education and training aimed at aligning it with new skills requirements has progressed and the vocational school environment is significantly improved. However, attractiveness remains low with enrolment rates and the employment rate of recent graduates below the average of the European Union.

(14) Ensuring skills' supply is one of the main areas where demand for investment remains significant. Matching investment, including through infrastructure, is required to improve the quality, effectiveness and labour market relevance of education and training, and to promote lifelong learning, notably flexible upskilling and reskilling opportunities. Investment are also needed to improve access to employment, including to improve outreach and coverage of active labour market policies, enhance the workability of workforce, as well as sectoral and regional labour mobility. In a broader context, strengthening social partners' capacity is important in promoting the fair working conditions and delivering on the European Pillar of Social Rights.

(15) Low public spending for healthcare and unhealthy lifestyle choices are the main reasons for the population's poor health outcomes. The recently increased funding for

healthcare addresses some of the access restrictions linked to the annual service limits and long waiting times. However, public financing for healthcare remains well below the European Union average. Timely and equal access to healthcare is limited. This leads to high self-reported unmet needs for care due to high out-of-pocket payments, especially for vulnerable groups, as well as inequality of opportunities. Reforms to boost efficiency and quality in healthcare are progressing but are in an early phase and should be accelerated, including effective prevention measures, streamlining of the hospital sector, strengthening primary care and targeting quality management. In addition, Latvia faces health workforce shortages, especially of nurses, which hamper the delivery of public healthcare and pose risks to the success of the health reforms. If the division of health services into two baskets ("full" and "minimum") comes into effect, it risks further limiting equitable access to healthcare and leading to adverse health outcomes. Matching investments in healthcare, including infrastructure, are needed to increase the accessibility, affordability and quality of healthcare in order to improve the population’s health status and ensure healthier and longer working lives.

(16) Latvia invests little in research and development and its investment gap in innovation is important. In 2017, Latvia’s share of expenditure on research and development was among the lowest in the European Union and has been rather stable over the past decade. Moreover, research funding relies almost entirely on European Union Funds. As a result, Latvia is a moderate innovator with some strong points, such as its information, communications and technology infrastructure but its performance lags behind in human resources, in public-private sector cooperation and in investment in intellectual property.

(17) Important investment gaps also remain to address regional disparities. Significant economic differences persist between Riga and Latvia’s other regions. While Latvia as a whole is converging with the European Union, the gap in economic performance between the capital region and the other regions has not narrowed since Latvia’s accession to the European Union. The competitiveness and quality of public services differs considerably among the different Latvian regions, influencing their territorial attractiveness. Investment needs should therefore address significant regional differences in mobility and digital infrastructure, in particular the last mile connections. Gaps in connectivity in the Trans-European Transport Network and with peripheral and border regions are still extremely pronounced having a negative impact on Latvia’s economic activities and exports. Investments gaps also exist to complete the Rail Baltica project and the key electricity infrastructure projects that form part of the Baltic energy market interconnection plan. Additionally, investment in resource efficiency is also needed in order to speed up Latvia's energy transition. More efforts are needed to improve overall energy efficiency, in particular in the residential and transport sectors.

(18) The recent adoption of the whistleblower law marks a positive step and the country’s anti-corruption body has also gathered momentum recently thanks to it uncovering a number of high profile corruption cases. Nevertheless, government decision-making is still perceived to be influenced by favouritism and the procurement process as susceptible to corruption due to lack of transparency, in particular in municipalities and state-owned and municipal enterprises. Legislative amendments on conflict of interest regime may give rise to abuses. The recently adopted Code of Ethics does not cover politically appointed persons.

(19) Public services have not been adjusted to the declining and ageing population. The declining population and urbanisation leave infrastructure and public services

underused in the rural areas. Public administration, education, healthcare services require strategies to preserve access to quality services in scarcely populated and dwindling areas, while ensuring greater efficiency. A general administrative territorial reform to be implemented by December 2021 has been recently announced. A timely implementation of this reform could contribute to enhancing the accountability and efficiency of the public sector, all the more in light of the operational programme for European Union funds, which is to be approved by the year 2020.

(20) The programming of EU funds for the period 2021-2027 could help address some of the gaps identified in the recommendations, in particular in the areas covered by Annex D to the country report[8]. This would allow Latvia to make the best use of those funds in respect of the identified sectors, taking into account regional disparities. Strengthening the country's administrative capacity for the management of these funds is an important factor for the success of this investment.

(21) In the context of the 2019 European Semester, the Commission has carried out a comprehensive analysis of Latvia's economic policy and published it in the 2019 country report. It has also assessed the 2019 Stability Programme and the 2019 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 socioeconomic policy in Latvia, but also their compliance with Union rules and guidance, given the need to strengthen the Union's overall economic governance by providing Union-level input into future national decisions.

(22) In the light of this assessment, the Council has examined the 2019 Stability Programme and its opinion[9] is reflected in particular in recommendation (1) below.

HEREBY RECOMMENDS that Latvia take action in 2019 and 2020 to:

1. Ensure that the nominal growth rate of net primary government expenditure does not exceed 3.5% in 2020, corresponding to an annual structural adjustment of 0.5% of GDP. Reduce taxation for low-income earners by shifting it to other sources, particularly capital and property, and by improving tax compliance. Ensure effective supervision and the enforcement of the anti-money laundering framework.

2. Address social exclusion notably by improving the adequacy of minimum income benefits, minimum old-age pensions and income support for people with disabilities. Increase the quality and efficiency of education and training in particular of low-skilled workers and jobseekers, including by strengthening the participation in vocational education and training and adult learning. Increase the accessibility, quality and cost-effectiveness of the healthcare system.

3. Focus investment-related economic policy on innovation, provision of affordable housing, transport notably on its sustainability, resource efficiency and energy efficiency, energy interconnections and on digital infrastructure, taking into account regional disparities.

[8] SWD(2019) 1013 final.

[9] Under Article 5(2) of Council Regulation (EC) No 1466/97.

4. Strengthen the accountability and efficiency of the public sector, in particular with regard to local authorities and state-owned and municipal enterprises and the conflict of interest regime.

Done at Brussels,

For the Council
The President