Council of the European Union

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| From: | General Secretariat of the Council |
| To: | Permanent Representatives Committee/Council |
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| Subject: | Recommendation for a COUNCIL RECOMMENDATION on the 2018 National Reform Programme of Latvia and delivering a Council opinion on the 2018 Stability Programme of Latvia |

Delegations will find attached the above mentioned draft Council Recommendation, as revised and agreed by various Council committees, based on the Commission Proposal COM(2018) 413 final.

**COUNCIL RECOMMENDATION**

**of…**

**on the 2018 National Reform Programme of Latvia**

**and delivering a Council opinion on the 2018 Stability Programme of Latvia**

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,

1 OJ L 209, 2.8.1997, p. 1.

Whereas:

(1) On 22 November 2017, the Commission adopted the Annual Growth Survey, marking the start of the 2018 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 22 March 2018. On 22 November 2017, on the basis of Regulation (EU) No 1176/2011 of the European Parliament and of the Council[2], 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 22 March 2018. On 14 May 2018, the Council adopted the Recommendation on the economic policy of the euro area[3] ('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 full and timely implementation of the Recommendation for the euro area, as reflected in recommendations below, in particular recommendations (1) and (2).

(3) The 2018 country report for Latvia was published on 7 March 2018. It assessed Latvia's progress in addressing the country-specific recommendations adopted by the Council on 11 July 2017[4], the follow-up given to the country-specific recommendations adopted in previous years and Latvia's progress towards its national Europe 2020 targets.

(4) Latvia submitted its 2018 National Reform Programme on 11 April 2018 and its 2018 Stability Programme on 16 April 2018. In order to take account of their interlinkages, the two programmes have been assessed at the same time.

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2 Regulation (EU) No 1176/2011 of the European Parliament and of the Council of 16 November 2011 on the prevention and correction of macroeconomic imbalances (OJ L 306, 23.11.2011, p. 25).

3 OJ C 179, 25.5.2018, p. 1.

4 OJ C 261, 9.8.2017, p. 1.

(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[5], 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.

(6) Latvia is currently in the preventive arm of the Stability and Growth Pact. In its 2018 Stability Programme, the Government plans a deterioration of the headline balance from a deficit of 0,5 % of GDP in 2017 to a deficit of 0,9 % of GDP in both 2018 and 2019 before improving to 0,4 % of GDP in 2020 and 2021. This path is expected to be consistent with the medium-term budgetary objective of a structural deficit of 1 % of GDP and the allowed deviations based on the pension reform and the structural reform clause for the healthcare sector. The recalculated[6] structural balance deficit is estimated to increase from -1,2 % of GDP in 2017 to -1,7 % of GDP in 2018 and then decrease to -1,5 % of GDP in 2019. According to the 2018 Stability Programme, the general government debt-to-GDP ratio is expected to decrease from 40,1 % of GDP in 2017 to 36 % of GDP by 2021. The 2018 Stability Programme’s GDP growth projections appear to be markedly favourable for 2018 and plausible for 2019, as compared to the Commission forecast. Risks to the budgetary position are tilted to the downside linked to the optimistic forecast of the yield of tax compliance-improving measures.

[5] 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).

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

(7) On 11 July 2017, the Council recommended that Latvia achieve its medium-term budgetary objective in 2018, taking into account the allowances linked to the implementation of the systemic pension reform and 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 6,0 % in 2018, corresponding to an allowed deterioration in the structural balance by 0,3 % of GDP. Based on the Commission 2018 spring forecast, there is a risk of a significant deviation from the medium-term budgetary objective in 2018. However, as a result of the better-than-expected outcome for 2017, such risk may be lower in 2018. At the same time, the plausibility tool based on the Commission 2018 spring forecast indicates a high degree of uncertainty surrounding the estimate of output gap for Latvia based on the common methodology. If confirmed, these factors will be considered in the ex-post assessment for 2018 in spring 2019.

(8) In 2019, Latvia should achieve its medium-term budgetary objective, taking into account the temporary allowance related to the implementation of the structural reform in the healthcare sector granted for 2017-2019. This is consistent with a maximum nominal growth rate of net primary government expenditure of 4,3 % in 2019, which corresponds to a required improvement in the structural balance of 0,4 % of GDP. Based on the Commission 2018 spring forecast, there is a risk of a significant deviation from that requirement in 2019 and over 2018 and 2019 taken together. Overall, the Council is of the opinion that the necessary measures should be taken as of 2018 to comply with the provisions of the Stability and Growth Pact.

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[7] Net primary government expenditure comprises total government expenditure excluding interest expenditure, expenditure on Union programmes fully matched by Union funds revenue and non-discretionary changes in unemployment benefit expenditure. Nationally financed gross fixed capital formation is smoothed over a four-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.

(9) Income inequality in Latvia is high. The ratio of incomes of the richest 20 % of households to that of the poorest 20 % stood at 6.3 in 2017, among the highest in the Union, as the redistribution through the tax-benefit system is lower. Latvia's tax system has been overhauled and personal income tax progressivity increased; however, the tax wedge on low-wage earners remains relatively high and discourages formal employment. The tax reform is limited in terms of shifting taxation to sources less detrimental to growth and achieving the stated policy objective of increasing the tax revenue share in GDP. The low share of tax revenue in GDP limits the resources for sustainable delivery of public services and social inclusion. The revenue potential of property and capital taxation is underused relative to other Union countries. Despite some progress in fighting tax evasion, tax compliance remains a serious challenge.

(10) Weaknesses in the social safety net are reflected in the high proportion of people at risk of poverty or social exclusion and indicate challenges on minimum income, pensions and the inclusion of people with disabilities. Poverty rates among people with disabilities and the elderly have been increasing in recent years and are among the highest in the Union. The minimum income level reform, announced in 2014, has not been implemented which negatively affects the poorest households. The adequacy of social assistance benefits increased only slightly and remains low. Minimum old-age pensions have not been increased since 2006. The share of people facing severe housing deprivation is among the highest in the Union and social housing is scarce.

(11) The labour market is tightening due to adverse demographic developments and emigration. While employment growth is becoming constrained by falling labour supply, employment opportunities vary between regions and skill levels. Curriculum reform in vocational education and training aimed at aligning education with contemporary skills requirements has progressed. However, further efforts are needed to fully implement the reform and increase participation in both initial and continuous vocational education and training. The implementation of the new work-based learning approach has started, with the involvement of social partners and companies. However, few students are enrolled in the scheme. Adult participation in learning has increased only slightly and the involvement of the unemployed in active labour market measures is lower than in most other Member States. This is of concern in the context of a high unemployment rate among the low-skilled. In a broader context, strengthening social partners' capacity is important to foster their engagement.

(12) Reforms have been taking place in the health system. The increased funding for healthcare is expected to address some access restrictions linked to the annual service limits and long waiting times. However, public financing for healthcare remains well below the Union average and efficiency-increasing measures are still to be implemented, including effective prevention measures, streamlining of the hospital sector, strengthening primary care and targeting quality management. Health outcomes are relatively poor and timely access to affordable healthcare for everyone remains a concern. The high out-of-pocket payments and the division of health services into two baskets ("full" and "minimum") risks lowering access for some groups and leading to adverse health outcomes.

(13) Weaknesses in regulatory quality and low public administration efficiency and effectiveness are detrimental to the business environment. In 2017, the Government adopted an ambitious reform plan for a leaner and more professional public sector, aiming to improve efficiency through reductions in staff and centralisation of support functions, while strengthening performance-based payment and increasing transparency. This plan is however limited to the central administration, despite the fact that significant efficiency gains could also be achieved at municipality level. State-owned enterprises, which account for a sizeable share of the economy, are coordinated at government level. While companies owned by central government are subject to a centralised corporate governance framework, ports and enterprises owned by municipalities remain outside this mechanism.

(14) Corruption continues to hamper Latvia's business environment, and the prevention of conflicts of interest remains rigid and formalistic. The delay in legislating on whistle-blower protection is detrimental to the accountability and efficiency of public administration. Regulation of the insolvency process has been significantly strengthened over the recent years, limiting the opportunities for abuses. However, the Council for the Judiciary encouraged investigating accusations of past abuses in the insolvency system by reviewing certain cases. It has recommended improving the judges' qualifications assessment and reviewing the available disciplinary measures.

(15) Latvian banks serving non-resident clients are exposed to a high risk of involvement in money laundering. This creates challenges for the integrity , and can damage the reputation, of the financial system of Latvia and negatively affect investment and economic growth. The anti-money laundering framework has recently been strengthened; continuous efforts would be needed to achieve sustainable improvement. Latvia has recently adopted a law aimed at significantly limiting the exposure of the Latvian financial sector to money-laundering risks. Key elements are enhancing the exchange of information between financial institutions and law enforcement agencies and curbing transactions with shell companies. The consequences of the law and its effectiveness will need to be monitored.

(16) In the context of the 2018 European Semester, the Commission has carried out a comprehensive analysis of Latvia's economic policy and published it in the 2018 country report. It has also assessed the 2018 Stability Programme, the 2018 National Reform Programme and the follow-up given to the recommendations addressed to Latvia in previous years. The Commission has taken into account not only their relevance for sustainable fiscal and socioeconomic policy in Latvia but also the extent to which they comply 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.

(17) In the light of this assessment, the Council has examined the 2018 Stability Programme and its opinion[8] is reflected in particular in recommendation (1).

HEREBY RECOMMENDS that Latvia take action in 2018 and 2019 to:

1. Achieve the 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. Reduce taxation for low-income earners by shifting it to other sources, particularly capital and property, and by improving tax compliance.

2. Improve the adequacy of minimum income benefits, minimum old-age pensions and income support for people with disabilities. Increase the labour market relevance of vocational education and training, and foster upskilling of low-skilled workers and jobseekers. Increase the accessibility, quality and cost-effectiveness of the healthcare system.

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

3. Strengthen the efficiency of the public sector, in particular with regard to local authorities and state-owned enterprises. Strengthen the accountability of public administration by protecting whistle-blowers, preventing conflicts of interest and following-up on the results of the ongoing assessment of past insolvency proceedings.

Done at Brussels,

*For the Council*

*The President*