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CONTENTS

Executive summary 3

1. Economic situation and outlook 7

2. Progress with country-specific recommendations 14

3. Reform priorities 18

3.1. Public finances and taxation 18
3.2. Financial sector 23
3.3. Labour market, education, and social policies 27
3.4. Competitiveness reforms and investment 38

Annex A: Overview table 55

Annex B: Commission Debt Sustainability Analysis and fiscal risks 59

Annex C: Standard Tables 60

Annex D: Investment Guidance on Cohesion Policy Funding 2021-2027 for Latvia 66

References 72

LIST OF TABLES

Table 1.1: Key economic, financial and social indicators 13
Table 2.1: Summary table of 2018 CSR assessment 15
Table 3.2.1: Financial soundness indicators 23
Table C.1: Financial market indicators 60
Table C.2: Headline Social Scoreboard indicators 61
Table C.3: Labour market and education indicators 62
Table C.4: Social inclusion and health indicators 63
Table C.5: Product market performance and policy indicators 64
Table C.6: Green growth 65

LIST OF GRAPHS

Graph 1.1: GDP growth and components' contributions 7
Graph 1.2: Investment growth and contributions, % 8

Graph 1.3: HICP inflation and contributions, % y-o-y change 8
Graph 1.4: Selected labour market indicators 9
Graph 1.5: Population change and its drivers, % 10
Graph 1.6: Selected social inclusion indicators 10
Graph 1.7: Current account and its components, % of GDP 12
Graph 2.1: Multiannual implementation of 2012-2018 country-specific recommendations to date 14
Graph 3.1.1: The fiscal stance and the economic cycle 18
Graph 3.1.2: Expenditure growth and the discretionary fiscal effort 18
Graph 3.1.3: Government primary expenditure by function 19
Graph 3.1.4: Tax revenue and implicit tax rates (2016) 20
Graph 3.1.5: Property tax revenue and cadastral values in 2012 and 2018 21
Graph 3.1.6: Estimates of Latvia's shadow of economy 21
Graph 3.2.1: Credit growth, y-o-y % change 24
Graph 3.2.2: Price to income ratio, index 2010=100 26
Graph 3.2.3: Newly constructed dwelling space, m2 per 1000 people 26
Graph 3.3.1: Job vacancies and labour shortage indicators 27
Graph 3.3.2: At-risk-of-poverty or social exclusion rate by age groups 31
Graph 3.4.1: Productivity annual change, % 38
Graph 3.4.2: Average annual growth 2010 - 2017, % 39
Graph 3.4.3: Real investment, index 2010=100 39
Graph 3.4.4: Real investment by asset type, million EUR in 2010 prices 40
Graph 3.4.5: Wage growth compared to wage benchmarks, % change 40
Graph 3.4.6: Productivity and unit labour costs, annual rate of change % 41
Graph 3.4.7: Export market shares, index 2010=100 41
Graph 3.4.8: Research and development expenditure, % of GDP 42
Graph 4.4.1: Europe's Digital progress report (EDPR), 2018 48
Map 3.4.4.1: GDP per head in Latvian regions, index EU=100 49
Map 3.4.4.2: Population change in Latvian regions, 2010-2016, % 49

LIST OF BOXES

Box 2.1: EU funds and programmes contribute to addressing structural challenges and to fostering growth and competitiveness in in Latvia 16
Box 3.3.1: Monitoring performance in light of the European Pillar of Social Rights 28
Box 3.4.1: Investment challenges and reforms in Latvia 54

EXECUTIVE SUMMARY

Latvia remains among the countries whose economy is catching up fastest with the EU average, but addressing population decline and ensuring that economic growth benefits all of society continue to be important challenges. Latvia's economic and labour market performance has been solid in recent years and government borrowing has remained broadly sound. However, growth has not been fully inclusive, as inequality has remained high and growth in peripheral regions has lagged behind the Riga region. Latvia's main challenge over the coming decades will be to ensure that its economy continues to catch up with the EU average while coping with a falling population. Therefore it will need to invest in innovation, regional development and human capital to improve its social, health and public governance policies ([1]).

A strong rise in investment and solid consumer spending carried economic growth to 4.7 % in 2018. Consumer optimism and the inflow of EU funds have fuelled domestic demand for the past 2 years and are expected to support GDP growth. However, economic growth is set to slow down in 2019 and 2020 as investment gradually loses its dynamism. Moreover, weakening external demand is expected to weigh on Latvia's export performance. At the same time, consumer optimism remains high thanks to strong wage increases, which are expected to continue feeding consumer spending in 2019 and 2020.

Strong economic growth helped increase employment for the first time in 3 years. The unemployment rate fell to 7.4 % in 2018 as employment growth is forecast to have reached 1.5 %. The strong economy drew more people into the labour market and therefore helped temporarily to offset the continuous decline in the working-age population. However, demographic trends will make it increasingly difficult to increase the number of people employed. Wages are growing rapidly in Latvia, (by nearly 9% in 2017, 7 % in 2018 according to Commission forecast) driven by the tightening of the labour market.

Latvia's population is projected to shrink on average by nearly 1 % annually over the next 20 years. That is roughly the same pace as what has been observed since the early 1990s. However, whereas until now emigration has been the primary driver of population decline, in the future natural population change will take the lead role. Moreover, the rate of decline in the working-age population is set to accelerate over the next 20 years compared with the previous two decades. This will mean that the ratio of non-working population to working population is set to increase at a faster pace than before, which puts an increasing burden on pension policy. Furthermore, a declining population tends to make the economy less efficient as the cost of infrastructure is borne by fewer people.

Growth in the cost of labour in Latvia has been among the fastest in the EU over the past few years. Due to the increasing shortage of workers, real wage growth (i.e. taking inflation into account) has exceeded productivity growth for a number of years already. This has not had a significant impact on Latvia's export performance so far, but if the current wage and productivity trend continues, the competitiveness of Latvia's exports could suffer in the longer term. On the other hand, inflation remains broadly in check, the economy's current account is in surplus and credit growth is low, thus significantly reducing the likelihood of the economy overheating.

Inequality remains high due to low redistribution through the tax and benefit system. The 2017 tax reform made income taxation slightly more favourable to those on lower incomes, but overall the tax cuts were only partly targeted at this group. Moreover, the overall tax cut has meant less funding is available for social benefits. Public spending on social protection and healthcare remains low and is less effective at reducing poverty and inequality than in other EU countries. Social dialogue between employers and trade unions in the private sector also remains limited.

Latvia is catching up fast with average EU living standards, but with great disparities

([1]) This report assesses Latvia's economy in light of the European Commission's Annual Growth Survey published on 21 November 2018. In the survey, the Commission calls on EU Member States to implement reforms to make the European economy more productive, resilient and inclusive. In so doing, Member States should focus their efforts on the three elements of the virtuous triangle of economic policy — delivering high-quality investment, focusing reforms efforts on productivity growth, inclusiveness and institutional quality and ensuring macroeconomic stability and sound public finance.

across its regions. Riga and its vicinity account for more than half of Latvia's GDP and are the country's economic engine. Regions further away from Riga are both poorer and have had slower growth. The average wage is 40 % higher in Riga than in Latvia's poorest region, Latgale. The most pronounced differences, however, lie in employment opportunities. In the greater Riga area, employment has increased by 12 % since 2010, while in the rest of the country it has declined by 2 %. These disparities have also had an impact on emigration; the population decline in Riga and its vicinity has been significantly smaller than in the rest of the country.

The budget deficit is set to increase slightly in 2019 and 2020 as a result of the tax reform. The 2018 budget balance was better than expected due to strong economic growth. However, the 2019 budget balance is expected to deteriorate somewhat due to the high growth in public wages, and the tax reform still weighing on government revenue.

Latvia's performance on the indicators of the Social Scoreboard supporting the European Pillar of Social Rights is mixed. There are notable improvements in Latvia's labour market: the employment rate is high for both men and women, unemployment is decreasing and there are fewer young people not in employment, education or training. However, not everyone is benefiting from the improved economic situation, and high income inequality remains a challenge. The proportion of people at risk of poverty is decreasing but remains high, especially among vulnerable groups. Moreover, the impact of social benefits on reducing poverty is relatively limited. Access to healthcare remains a significant concern, given the high number of cases where people, especially in the lowest income group, are unable to receive necessary health services.

Latvia can boost its long-term growth potential by focusing private and public investments on innovation, human capital and regional development. Latvia remains a catching-up economy and its main national development focus is on increasing its GDP per capita. As evidenced by falling productivity growth rates, the easy gains of the early catch-up stage have been exhausted. This means that productivity growth will have to increasingly rely on knowledge-intensive activities. Latvia's weakest point has been innovation, which requires investments in research and development, in developing people's knowledge and skills, and in other intangible assets. Latvia would also benefit from boosting the economic potential of its peripheral regions - increasing their accessibility, and promoting energy efficiency, employment and investment opportunities. Finally, investments in social inclusion and healthcare are needed in order to tackle high inequality and uneven access to employment and public services. Additionally, investment in resource efficiency is also needed in order to speed up Latvia's energy transition. Annex D identifies key priorities for support by the European Regional Development Fund, the European Social Fund Plus and the Cohesion Fund for the 2021-2027 period in Latvia, building on the analysis of investment needs and challenges outlined in this report.

Latvia has made limited progress in addressing the 2018 country-specific recommendations.

There has been some progress in the following areas:

- Improving governance: this has been achieved notably by passing the whistleblower protection law and by following up on recommendations by the country's Judicial Council to improve the insolvency process.

- Improving accessibility, quality and cost-effectiveness of the health system.

- Making vocational education and training more relevant to labour market; reforms have picked up pace in this area and work based learning is being rolled-out. Plans to develop a comprehensive skills strategy are ongoing.

There has been limited progress in the following areas:

- Improving the accountability and the efficiency of public administration.

- Improving taxation: some efforts have been made to improve tax compliance, but the tax burden on labour remains relatively high.

There has been no progress in the following areas:

- Improving the adequacy of minimum income benefits: plans to improve minimum income in 2019 have been proposed but funding has yet to be allocated for them.

Regarding progress towards its national targets under the Europe 2020 strategy, Latvia has attained its employment rate target. It already met its targets on preventing early school leaving, tertiary education attainment and on reducing poverty in 2016, and is performing well on renewable energy, energy efficiency and reducing greenhouse gas emissions. However, it is far from its public research and development investment target, which it is unlikely to meet by 2020.

The main findings of the analysis in this report, and the related policy challenges, are as follows:

- **The share of capital taxation is set to decline, while the tax burden on low wages remains high after the tax reform.** The cuts in taxes on capital and on labour income have been costly, with significant benefits going to the richest households while limiting resources for redistributive policies. The tax burden on labour has been reduced overall, but remains high for low-wage earners relative to the EU average. Moreover, the freezing of the values used to calculate land and property taxes will reduce the revenue share of recurrent property taxation in GDP over time.

- **Despite a sharp reduction in bank deposits by non-residents, improvements in Latvia's anti-money laundering strategy are warranted, to control the remaining banking risks.** In the wake of the closure of Latvia's third largest bank ABLV due to allegations of money laundering, Latvia banned its banks from servicing 'shell companies' and asked them to come up with new business models that would considerably reduce the exposure to money laundering risk. While the non-resident banking sector has now shed more than 60 % of non-resident deposits, Latvia's anti-money laundering framework still needs substantial improvements. An international expert report highlighted the need to strengthen the quality and capacity of Latvia's supervisory, control and law enforcement bodies and its international cooperation.

- **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. In addition, a disproportionate share of resources is used for the maintenance of the large school network rather than for teaching and learning. The higher education system is fragmented and while tertiary education attainment rates are high, the proportion of science, technology, engineering and mathematics graduates is low. Vocational education and training is being modernised, but the share of students in this type of education and their employability are below the EU average, as is participation in adult learning. The low level of digital skills among the labour force limits the use of digital technologies by businesses and the potential for innovation.

- **Latvia's labour market performance is positive overall but employment conditions differ across regions and skill levels.** Unemployment is significantly higher in regions furthest away from the capital, and moving for work remains a challenge. Older people with outdated skills also encounter more difficulties. Participation and spending in schemes which help the unemployed find work are still lagging behind. Efforts have been made to reach vulnerable groups outside the labour market, but this remains a complex task.

- **The adequacy of social benefits remains low.** Benefits rose only marginally and do not contribute a lot to alleviating the high levels of poverty and inequality. Ambitious government plans to raise the minimum income level have been shelved due to a lack of funding. The large share of low-wage earners and widespread under-reporting of wages mean that a sizeable part of the population has only minimal social coverage. Despite some increases in the lowest pensions, ensuring their adequacy remains a challenge, while the proportion of the elderly at risk of poverty and

social exclusion are increasing. Moreover, the social protection of people with disabilities remains weak. Social housing is scarce and not always fit for living.

- **Low public spending for healthcare, and unhealthy lifestyle choices, are the main reasons for the population's poor health.** Additional public financing has resulted in tangible improvements in the availability of health services and reduced waiting times in some areas. However, public spending plans for 2020 remain well below the EU average. Reforms to boost efficiency and quality in healthcare are progressing but are in an early phase. If the new health insurance system comes into effect, it risks reducing access to care for those who cannot afford to make voluntary health contributions.

- **Latvia invests very little in research and development.** In 2017, the share of expenditure on research and development was 0.51 % of GDP (against 2.1 % in the EU average). This level was among the lowest in the EU and rather stable over the last decade. Moreover, research funding relies almost entirely on EU funds. Latvia is a moderate innovator with some strong points like its information, communications and technology infrastructure, but its performance is lagging behind in human resources, in public-private sector cooperation, and in investment in intellectual property. Latvia's innovation performance could benefit from the more active involvement of its largest state-owned companies, which have the resources to afford substantive investment capacity.

- **Better internal labour mobility is crucial to economic growth outside Riga.** Moving for work to places outside the capital region is made difficult by a lack of rental housing. This has often led people who cannot find work where they live to move abroad rather than to move within Latvia. Despite the lack of adequate and affordable housing, investment in housing in places outside Riga has been low due to the population's low purchasing power and the lack of long-term financing. Investment in housing has also been hampered by lengthy construction processes and poor protection of landlords' interests in the case of rental housing.

- **Latvia is close to meeting its renewable energy target for 2020, but more efforts are needed to improve energy efficiency.** A comprehensive programme for improving the energy efficiency of dwellings has helped but energy consumption trend in the residential and transport sectors is growing. Latvia is also on track to achieve its 2020 target for the share of energy produced from renewable sources, although the support scheme has proved expensive.

- **Latvia's recycling rate is low and there is little progress in recent years**. Latvia still landfills most of its municipal waste. Poor coordination of policies and lack of financial incentives are the main reasons behind its struggle to increase the share of recycling.

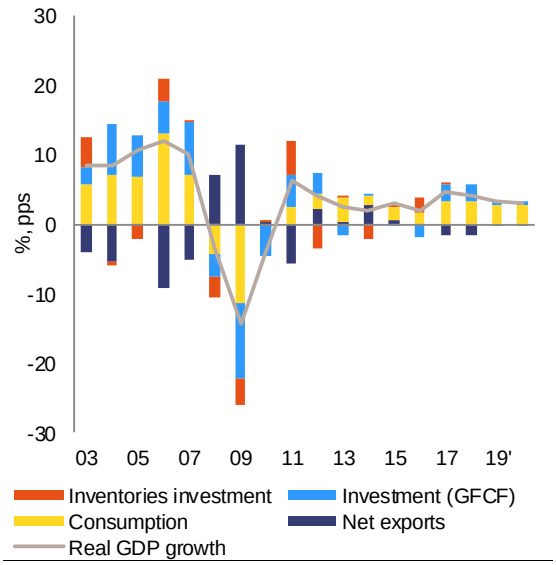
- **Latvia has slightly improved its score on the corruption perception index, but corruption remains a concern.** The recent adoption of the whistleblower law marks a positive step. The country's anti-corruption body has also gathered momentum recently thanks to it uncovering a number of high profile corruption cases. Nevertheless, government decision-making is still perceived to be influenced by favouritism and the procurement process as susceptible to corruption. Delays in the implementation of the anti-corruption strategy and the lack of verification of the officials' assets declarations still raise concerns.

1. ECONOMIC SITUATION AND OUTLOOK

GDP growth

Strong GDP growth continued in 2018 as investments and private consumption pushed it above 4% for the second year in a row. Consumer optimism and EU fund inflows have determined the growth conditions for the past 2 years and are expected to positively influence GDP growth going forward. Exports performed relatively well, considering the expected slowdown from financial services and transit services. Government consumption increased at a solid pace too and employment growth picked up in 2018 after several years of stagnation supported by strong growth in construction activity. At 2.6% growth, inflation remained about the same as the year before.

Graph 1.1: **GDP growth and components' contributions**



Source: European Commission

The Commission's Winter Forecast projects growth to slow down to 3.1% in 2019 and to 2.6% in 2020. The core growth drivers – above average consumer optimism and the favourable investment dynamic – are expected to remain present over the forecast horizon. However a number of other factors will mean that growth will slow compared with 2017 and 2018. Most important among them, investment growth is expected to slow to single-digit pace as the EU fund inflows peak. Furthermore, less dynamic external demand and limited fiscal space are set to slow exports and government consumption relative to the previous 2 years.

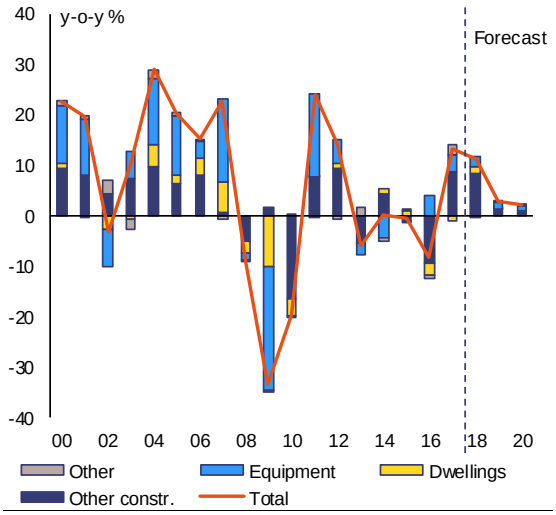
Consumption

Solid private consumption is set to remain the core of economic growth over the forecast horizon. In 2018, household consumption is forecast to have grown by 4.5%, surpassing the previous year's growth as it received a boost from strong employment growth. Consumption was further aided by rapid investment growth which led to a steady increase in durable goods consumption. Optimism remains well above the long-term average and is expected to carry private consumption growth at a healthy pace going forward. However, weak employment growth will slow it down somewhat.

Investment

The inflow of EU funds and office space construction are driving investment growth in Latvia. In 2018, investment is forecast to have grown by 11.2%, slightly down from 13.1% the year before. Office space and EU-funded non-residential construction were the biggest contributors to investment growth. At the same time, investment in intellectual property was stagnant in 2018. As inflows of EU-funds peak, infrastructure investment is set to slow but pent-up demand for office space and housing should ensure investment growth of around 2-3% over the forecast horizon (Graph 1.2).

Graph 1.2: **Investment growth and contributions, %**



Source: European Commission

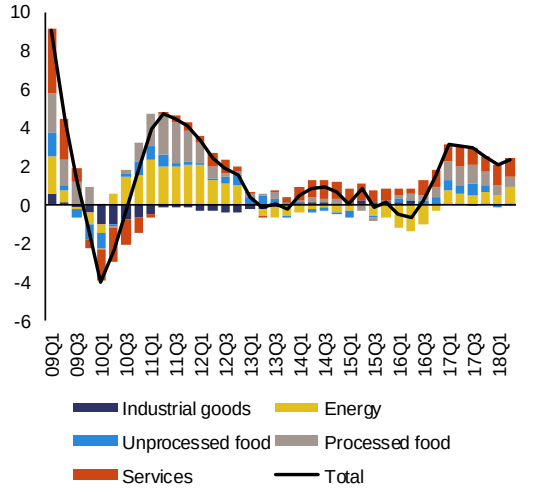
Trade

Export performed strongly in 2018, but weakening foreign demand and a structural decline in some of Latvia's services exports suggest a slowdown. Exports is forecast to have grown by 3.6% in 2018, delivering a positive surprise given that the decline in exports of financial services and transport services was expected to weigh heavily on Latvia's overall export performance. Financial service exports which amounted to around 1% of GDP in 2017 are expected to have declined significantly following the government's decision to drastically reduce the banking sector's exposure to non-EU clients by banning banks from serving shell companies. Transport exports, are in a long term structural decline due to Russia's decision to divert most of its cargo to its own ports. Besides these developments, the exports are forecast to perform well despite expected slowdown in external demand.

Inflation

Energy and services prices are expected to dominate the inflation dynamics over 2019 and 2020. The 2018 inflation figures of 2.6% was driven by increases in energy and services prices. This is slightly less than 2.9% in 2017 when substantial one-off increase in food prices created up-tick in inflation. Wage growth in Latvia has been among the fastest in the EU – it increased by 7.9% in 2017 and continued growing at around the same pace in the first half of 2018. The rapid wage growth has gradually pushed the services price inflation up, but otherwise it has been slow to translate into wider inflation. In 2019, energy price increases, recovering food price growth and a continued push from services prices are expected to lift inflation to 2.7%, before slowing down in 2020 as the energy price increase halts.

Graph 1.3: **HICP inflation and contributions, % y-o-y change**



Source: European Commission

Productivity and unit labour costs

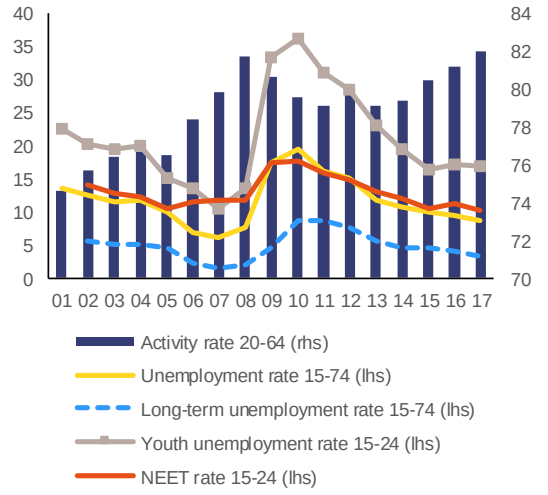
Over the past couple of years Latvia's productivity growth has accelerated, which dampened the high unit labour cost growth. Productivity growth reached 4.7% in 2017, putting Latvia among the countries with the highest productivity growth in the EU. This is also up from the 2.4% average growth of the preceding 3 years. The productivity growth is broad-based across all main economic activities like industry, trade and the public sector. As a result, the unit labour cost growth slowed to 3.2% in 2017, compared with an average growth of around 5% since 2012. However, over 3 years its growth rate of 14.7% remains among the highest in the EU. Looking forward, productivity growth is set to slow along with overall GDP growth, but is expected to remain robust. The unit labour cost growth is not expected to abate significantly over the forecast horizon as the falling labour supply is set to remain a permanent factor. But the cooling off of the

investment growth may ease the labour demand pressure somewhat.

Labour market

Latvia's economy raised the labour market activity rate and employment but a further decline of the labour force seems inevitable. In 2018, the rapid growth in construction and trade drove an increase in employment. At the same time, the labour force continued to decline, albeit at a slower pace than in previous years as the strong economy helped increased the activity rate among 20-64-year-olds, which stood at 83.5 % in 3rd quarter of 2018, exceeding its previous peak in 2008. The unemployment rate continued to fall and was 7.1% in 3rd quarter of 2018, well below its historical average, but slightly above the EU average. As a result of the tight labour market, wage growth continued at a rapid pace spurred in part by a significant increase in the minimum wage. Looking forward, wage growth is expected to remain elevated although it should ease somewhat as the pressure from the construction sector eases.

Graph 1.4: **Selected labour market indicators**



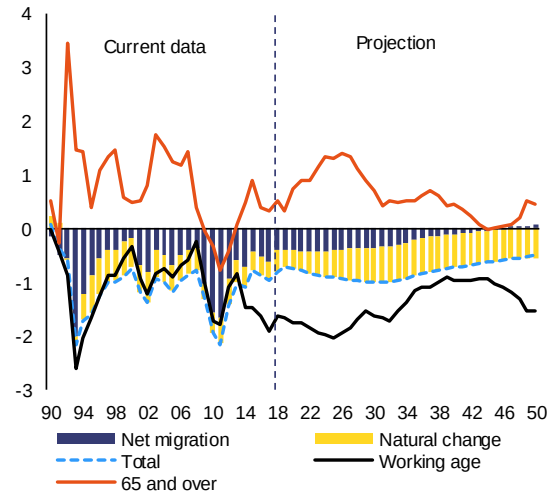
Source: European Commission

Since 2010, there has been a steady improvement in most labour market indicators. The long-term unemployed rate continued its downward path in 2018 and stood at 3.0 % in 3rd quarter of 2018, close to the EU average. Young people also benefit from the improvement in the labour market, with this group's unemployment rate falling to 9.8 % in 2nd quarter of 2018 (below the EU average of 15.2 %), down from 36.2 % in 2010. The share of young people not in employment, education or training (NEET) also decreased by 0.9 pp (year-on-year) to 10.3 % in 2017 (close to the EU average level of 10.9 %)

Demographic developments

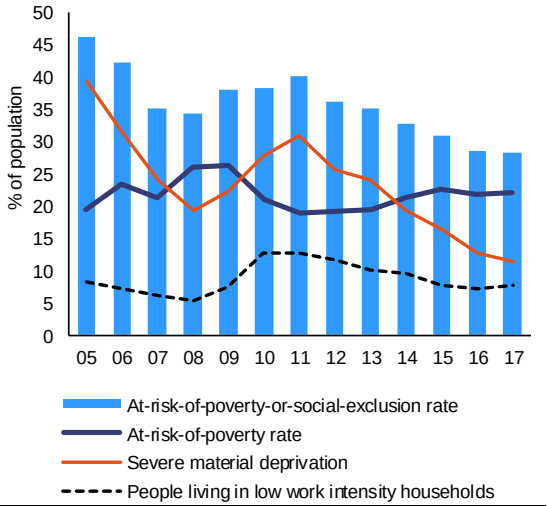
Latvia's population is projected to continue declining by around 1% annually, but the decline in the working age population is set to intensify. Latvia's population has been declining since 1991 at an average rate of slightly above 1% annually. Emigration has accounted for roughly two thirds of the depopulation, while natural change has accounted for the remaining third. The average pace of the population decline over the next 20 years is expected to be about the same as it has been over the past three decades – just above 1% annually. However, migration is projected to gradually balance, while natural change is expected to worsen. Also, the decline in working age population is set to intensify. Whereas since 1990, the working age population has decreased on average at the same rate as the total population, the rate of decline is set to increase. Over the next 20 years the average annual pace of working age population decline is projected at 1.6%, while the average total population decline is projected at 0.9% annually. The decreasing share of the working age population means the old-age dependency ratio is set to increase faster than before. The ratio of over 65 year olds to those between ages 20 and 64 was about 0.2 in 1990, is 0.33 now and is projected to increase to about 0.57 by 2040. The population decline and increasing dependency ratio bring important policy challenges in a number of areas: fiscal sustainability (*see Section 3.1.4)*, labour supply (*see Section 3.3.1)*, healthcare (*see Section 3.3.3)*, education (*see Section 3.3.4)*, productivity, energy and public administration (see European Commission, 2018h).

Graph 1.5: **Population change and its drivers, %**



Source: European Commission

Graph 1.6: **Selected social inclusion indicators**



Source: European Commission

Social developments

Overall poverty and social exclusion have decreased to pre-crisis levels, but vulnerable groups are being left behind. In line with the gradual improvement in the labour market, the share of people living in very low-work intensity households has been falling since 2010 and reached 7.6 % in 2018, down from the peak of 12.6 % recorded in 2010-2011([2]). Moreover, severe material deprivation has been steadily decreasing since 2011 and has fallen below pre-crisis levels (9.5 % in 2018 as compared to 24 % in 2007). However, the at-risk-of-poverty rate, a measure of relative poverty, is still above pre-crisis levels (23.3 % in 2018 as compared to 21.2 % in 2007). More broadly, the risk of poverty or social exclusion has decreased steadily since 2012 and was at historically low of 28.4% in 2018. However, the risk of poverty or social exclusion has been increasing for the elderly, the unemployed and persons with disabilities (Section 3.3.2). The at-risk-of-poverty rate is higher in rural areas, and in 2017 the median income of rural dwellers was only 76% that of urban dwellers, against an EU average of 84%.

Income inequality remains well above the EU average. In 2018, the income of the richest 20 % of the Latvian population was 6.8 times higher than that of the poorest 20 %; a significantly more uneven distribution than in the EU as a whole (5.1 times in 2017). The redistribution through taxes and social transfers in Latvia has a lower impact on income inequality than in other Member States, due to the limited adequacy of social protection system and the limited progressivity of tax system (Section 3.1.3. on taxation and Section 3.3.2 on social policies).

Wealth inequality in Latvia is among the highest in the EU. With a Gini coefficient for distribution of wealth ([3]) of 78.5, the wealth inequality in Latvia is among the highest of Member States. Around half of the wealth reflects ownership of the main residence and a quarter reflects ownership of other real estate, which is similar to the EU average. Share of wealth as financial assets is somewhat lower in Latvia, but it is mostly owned by the richest households, as in the rest of the EU. The high wealth inequality in Latvia persists despite low levels of housing-related debt and a high rate of home ownership in the general population (81.5 %), including among the population who are at-risk-of-poverty (74.2%).

([2]) Income data from EU-SILC refer to the previous year for all Member States except from IE and UK.

([3]) The Gini coefficient is an indicator that ranges between 0 and 100. Lower values indicate higher equality. In other words, a value equal to 0 indicates that everyone has the same net wealth, a value equal to 100 indicates that one person owns the whole wealth.

Unequal opportunities persist in access to education and healthcare. Income poverty between children of low-skilled parents and those of high-skilled parents has been gradually narrowing since 2009: in 2018, it stood at 52.1 pps, below the EU average of 53.9 pps in 2017. Likewise, the difference in 2015 students' performance in science in the OECD Programme for International Student Assessment that could be explained by students' socio-economic status was among the lowest in the EU. However, when looking at how affordable education is for the different income groups, Latvia fares worse than the EU average, with Latvians reporting more difficulty overall in affording education ([4]). In addition, there is a clear gap in labour market participation between ethnic minorities and ethnic Latvians. Moreover, access to healthcare is unequal among income groups — the low income groups report a much higher level of unmet needs for medical services than the high income groups (Section 3.3.3).

Regional perspective

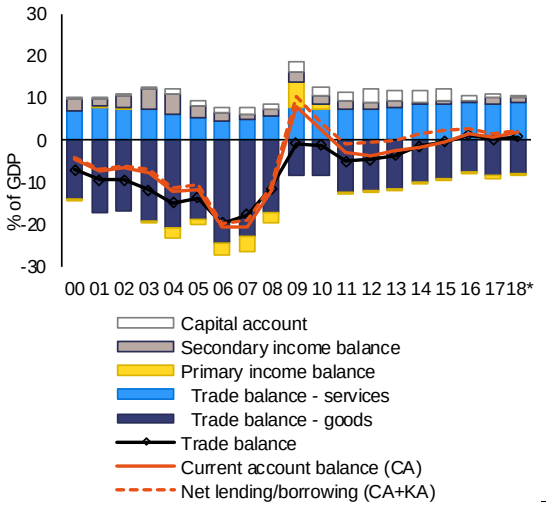
Economic development and employment opportunities differ considerably among Latvian regions. In 2015, GDP per capita in Riga stood at 167% of the national average, while in the other regions it was below the national average with the poorest region – Latgale – producing only 56% of the national average. However, the GDP per capita figures are influenced by the large amount of commuters coming to Riga and by the fact that all of the largest state-owned enterprises are registered in Riga, while producing economic output all over Latvia. Therefore, the differences in wages arguably provide a fairer view of regional disparities. Workers in Riga earn 113% of national average, while workers in Latgale receive 69% of the national average. Furthermore, the difference in GDP per capita and wages with Riga has narrowed for most regions, the exception being Latvia's western region – Kurzeme – where the growth of GDP per capita and the wages has been slowest in Latvia over the past 15 years or so. However, whereas wages and GDP per capita have risen in all regions (albeit much faster in Riga), employment opportunities have diverged – the Riga metropolitan region's share of total employment has increased from 52% in 2008 to 55% in 2017. Latgale and Kurzeme have fared the worst. Contrary to the rest of the country employment in these regions has shrunk compared to 2010, the year the economy hit its lowest point during the crisis.

External position

The current account has remained balanced despite accelerating GDP growth. In 2018, the current account is forecast to have been balanced, slightly lower than the 0.7% of GDP surplus in 2017. The current account has remained roughly balanced since 2014, largely due to a better trade balance. From the investment-savings perspective, higher households' net savings rate has been the main contributor to balancing the current account compared to 2010 – 2014. As a result, the net international investment position (NIIP) also continued to improve and stood at minus 50% of GDP at the end of 2018. While still relatively high, the associated economic risks are limited, because the NIIP is mostly composed of foreign direct investment, while the investment position excluding equity was close to balance at the end of 2018.

([4]) From the EU-SILC module on Access to Services (2016), in 2016, persons paying for formal education in Latvia reported much greater difficulty in affording it compared to the EU. In Latvia, 8 % reported great difficulty, 26.1 % moderate difficulty, and 33.1 % some difficulty in paying for formal education, whereas these figures for EU-28 stood at: 6.8 % (great difficulty), 12 % (moderate difficulty) and 22.3 % (some difficulty).

Graph 1.7: **Current account and its components, % of GDP**



Source: European Commission

Public finances

The general government balance remains negative despite strong GDP growth. The general government recorded a deficit of 0.7% of GDP in 2018 as a sizeable tax cut and increase in defence and healthcare spending drove the slight surplus of 2016 back into deficit. The government balance is set to deteriorate further in 2019 before improving somewhat in 2020. The Commission estimated that the output gap remains substantially positive, making the current deficits contribute to pro-cyclical fiscal policy stance.

Table 1.1: **Key economic, financial and social indicators**

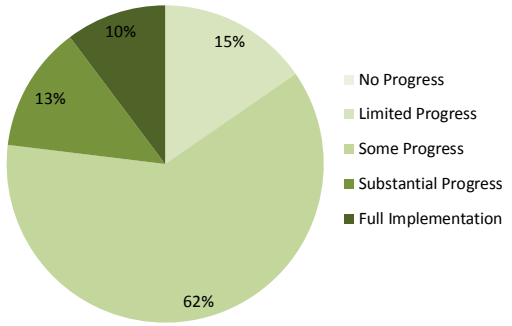
	2004-07	2008-12	2013-15	2016	2017	forecast 2018	forecast 2019	forecast 2020
Real GDP (y-o-y)	10,2	-2,6	2,4	2,1	4,6	4,7	3,1	2,6
Potential growth (y-o-y)	7,4	0,0	1,5	2,3	3,0	3,4	3,6	3,7
Private consumption (y-o-y)	12,5	-3,3	3,0	1,4	4,1	.	.	.
Public consumption (y-o-y)	4,0	-2,8	1,8	3,9	4,1	.	.	.
Gross fixed capital formation (y-o-y)	21,6	-7,2	-2,2	-8,4	13,1	.	.	.
Exports of goods and services (y-o-y)	14,5	4,5	3,4	4,4	6,2	.	.	.
Imports of goods and services (y-o-y)	19,1	-2,5	1,2	4,4	8,9	.	.	.
Contribution to GDP growth:								
Domestic demand (y-o-y)	14,9	-4,9	1,6	-0,3	5,8	.	.	.
Inventories (y-o-y)	0,1	-1,1	-0,5	2,4	0,3	.	.	.
Net exports (y-o-y)	-4,9	2,9	1,3	0,0	-1,5	.	.	.
Contribution to potential GDP growth:								
Total Labour (hours) (y-o-y)	0,3	-1,1	-0,6	0,0	0,2	0,5	0,6	0,7
Capital accumulation (y-o-y)	3,8	1,4	0,8	0,4	0,8	1,1	1,1	1,0
Total factor productivity (y-o-y)	3,4	-0,2	1,2	1,9	2,0	1,8	2,0	2,0
Output gap	6,3	-5,6	-0,2	0,2	1,8	2,4	2,1	1,3
Unemployment rate	8,7	15,2	10,9	9,6	8,7	7,3	6,7	6,5
GDP deflator (y-o-y)	12,5	2,0	1,1	0,9	3,2	3,7	2,1	2,7
Harmonised index of consumer prices (HICP, y-o-y)	7,4	4,6	0,3	0,1	2,9	2,6	2,7	2,1
Nominal compensation per employee (y-o-y)	24,4	1,5	7,3	7,3	8,0	7,1	5,8	5,8
Labour productivity (real, person employed, y-o-y)	7,4	1,4	1,6	2,4	4,7	.	.	.
Unit labour costs (ULC, whole economy, y-o-y)	15,9	0,1	5,5	4,8	3,1	4,4	2,8	2,9
Real unit labour costs (y-o-y)	3,0	-1,9	4,4	3,9	0,0	0,7	0,7	0,2
Real effective exchange rate (ULC, y-o-y)	11,2	-2,1	4,3	3,9	2,6	3,6	0,2	0,4
Real effective exchange rate (HICP, y-o-y)	2,0	1,1	0,8	1,3	-0,2	3,7	0,1	-0,1
Savings rate of households (net saving as percentage of net disposable income)	-9,1	-4,5	-12,0	-4,0	-5,8	.	.	.
Private credit flow, consolidated (% of GDP)	27,3	-0,2	-3,4	0,3	0,3	.	.	.
Private sector debt, consolidated (% of GDP)	86,3	115,4	92,6	88,0	83,5	.	.	.
of which household debt, consolidated (% of GDP)	32,5	43,3	26,9	23,6	22,2	.	.	.
of which non-financial corporate debt, consolidated (% of GDP)	53,8	72,1	65,7	64,4	61,3	.	.	.
Gross non-performing debt (% of total debt instruments and total loans and advances) (2)	.	9,9	6,1	5,2	4,7	.	.	.
Corporations, net lending (+) or net borrowing (-) (% of GDP)	-9,5	6,1	6,5	2,4	3,4	2,9	2,6	2,1
Corporations, gross operating surplus (% of GDP)	30,8	29,9	30,2	26,4	26,6	26,1	24,8	24,5
Households, net lending (+) or net borrowing (-) (% of GDP)	-5,6	-0,3	-3,9	0,1	-1,3	-0,2	0,1	0,6
Deflated house price index (y-o-y)	16,9	-11,3	4,2	4,7	5,5	.	.	.
Residential investment (% of GDP)	4,5	2,8	2,4	2,1	1,9	.	.	.
Current account balance (% of GDP), balance of payments	-16,4	-1,9	-1,6	1,6	0,7	-0,2	-0,6	-0,6
Trade balance (% of GDP), balance of payments	-16,6	-4,7	-1,9	1,2	0,1	.	.	.
Terms of trade of goods and services (y-o-y)	1,4	-0,3	0,0	2,8	0,7	1,4	-1,1	0,3
Capital account balance (% of GDP)	1,3	2,2	2,8	1,0	0,8	.	.	.
Net international investment position (% of GDP)	-60,0	-76,1	-65,4	-58,4	-56,3	.	.	.
NIIP excluding non-defaultable instruments (% of GDP) (1)	-30,2	-37,8	-17,2	-9,8	-7,6	.	.	.
IIP liabilities excluding non-defaultable instruments (% of GDP) (1)	93,8	132,4	127,0	134,5	128,2	.	.	.
Export performance vs. advanced countries (% change over 5 years)	105,1	50,6	15,2	6,2	2,9	.	.	.
Export market share, goods and services (y-o-y)	.	.	0,5	3,9	2,3	.	.	.
Net FDI flows (% of GDP)	-5,1	-2,6	-1,7	-0,1	-1,9	.	.	.
General government balance (% of GDP)	-0,6	-5,5	-1,3	0,1	-0,6	-0,8	-1,0	-0,7
Structural budget balance (% of GDP)	.	.	-1,3	0,0	-1,2	-1,8	-1,7	-1,2
General government gross debt (% of GDP)	10,8	36,9	38,9	40,3	40,0	37,1	35,5	35,7
Tax-to-GDP ratio (%) (3)	28,4	28,6	30,0	31,4	31,4	30,8	30,6	30,8
Tax rate for a single person earning the average wage (%)	29,0	29,7	29,6	29,1	.	.	.	.
Tax rate for a single person earning 50% of the average wage (%)	26,3	27,3	27,4	27,0	.	.	.	.

(1) NIIP excluding direct investment and portfolio equity shares
(2) Domestic banking groups and stand-alone banks, EU and non-EU foreign-controlled subsidiaries and EU and non-EU foreign-controlled branches.
(3) The tax-to-GDP indicator includes imputed social contributions and hence differs from the tax-to-GDP indicator used in the section on taxation
Source: Eurostat and ECB as of 31-1-2019, where available; European Commission for forecast figures (Winter forecast 2019 for real GDP and HICP, Autumn forecast 2018 otherwise)

2. PROGRESS WITH COUNTRY-SPECIFIC RECOMMENDATIONS

Since the start of the European Semester in 2011, 85% of all country-specific recommendations addressed to Latvia have recorded at least 'some progress'. Looking at how Latvia has implemented its CSRs in the years since they first began to be issued, 84% of all the recommendations addressed to Latvia have recorded at least 'some progress' (Graph 2.1). Latvia has achieved substantial progress and full implementation by maintaining fiscal discipline, adopting the domestic fiscal framework and by improving macro-prudential supervision of the banking sector.

Graph 2.1: **Multiannual implementation of 2012-2018 country-specific recommendations to date**



Notes: The multiannual CSR assessment looks at the implementation since the CSRs were first adopted until the 2019 Country Report.
The assessment excludes an assessment of compliance with the Stability and Growth Pact.
Source: European Commission

Latvia maintains fiscal discipline and has somewhat reduced tax burden on low wages. Fiscal targets are set with a tight margin to the rules-based requirements. A fiscal framework has been set up and implemented. The recommendation since 2012 to shift taxation from low wages to other sources less detrimental to growth was partly addressed by the 2017 tax reform. While the tax wedge on low wages has been reduced, it is still high in Latvia. Moreover, the tax-cutting measures were only partly targeted towards low income groups, while the reform costs limit resources for public services, including for distributional policies. Tax compliance has improved over time as a result of the tax administration's efforts, but remains a challenge.

Social policy reforms have not advanced much, mostly due to their costs. Minimum social benefits remain very low and only a marginal increase has been adopted. Far-reaching minimum income reform has not been introduced, primarily due to its cost. Public expenditure of and participation in activation measures for the unemployed remain limited, while outdated skills and insufficient knowledge of the Latvian language remain obstacles to employment. Updating vocational education and training curricular has been accelerated and work-based learning is introduced. Participation in adult learning although increasing, remains low. Financing for public healthcare is increasing in 2018-2019, but its level is still low relative to other countries and service needs.

The public administration reform plan adopted in November 2017 is being slowly rolled out, aiming for streamlining of central government as well as greater efficiency and quality of services, but no such plans have been presented for the local authorities. Streamlining of central government has been launched, aiming for greater efficiency and quality of services, but no such plans have been presented for the local authorities. The fight against corruption has been ramped up under the new leadership of The Corruption Prevention and Combatting Bureau, with investigations launched in several large corruption cases. However, verification of asset declarations of the public officials still raises concerns. The recent adoption of the Whistleblower Protection Law provides an opportunity to increase transparency and the efficiency of the public administration.

Overall, Latvia has made limited progress ([5]) in addressing the 2018 country-specific recommendations. It made some progress on strengthening the accountability of public administration, notably by passing the Whistleblower Protection Law, by following up on recommendations from its Judicial Council to improve the insolvency process, by increasing the provision of public healthcare services, and by

([5]) Information on the level of progress and actions taken to address the policy advice in each respective subpart of a CSR is presented in the overview table in the Annex. This overall assessment does not include an assessment of compliance with the Stability and Growth Pact.

proceeding with the reforms in the vocational education. Only limited progress was made on reducing the tax wedge on low-income earners, on improving the efficiency of public administration. No progress was made on improving the adequacy of minimum social benefits, as the planned increase in minimum income benefits has not been funded.

Table 2.1: **Summary table of 2018 CSR assessment**

Latvia	**Overall assessment of progress with 2017 CSRs: Limited**
CSR 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.*	**Limited progress (1)** • Limited progress in shifting the tax burden away from low wages to other sources • Some progress in improving tax compliance.
CSR 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.*	**Limited progress** • No progress in improving the minimum income benefits, minimum old-age pension and income support for people with disabilities • Some progress in improving the labour market relevance of vocational education and training • Some progress in improving the accessibility, quality and cost-effectiveness of the healthcare system.
CSR 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.*	**Some progress** • Substantial progress in protecting whistleblowers • Some progress in following-up on the results of the assessment of past insolvency proceedings • Limited progress on increasing the accountability of public administration. • Limited progress in increasing the efficiency of local authorities and state-owned enterprises.

(1) The assessment of CSR1 does not include an assessment of compliance with the Stability and Growth Pact.
Source: European Commission

Box 2.1: EU funds and programmes contribute to addressing structural challenges and to fostering growth and competitiveness in in Latvia

Latvia is one of the countries benefiting most from EU support. The financial allocation from the European Structural and Investment Funds (ESIF) to support Latvia in facing development challenges amounts to EUR 5.63 billion under the current multiannual financial Framework. This is equivalent to around 3% of the country's GDP annually. As of the end of 2018, some EUR 4.27 billion (around 76% of the total) had already been allocated to specific projects. In addition, Latvia benefits from other EU programmes such as: (i) the Connecting Europe Facility, which allocated EUR 269.4 million to specific strategic transport network projects; and (ii) Horizon 2020, under which 290 participants have received funding of EUR 53 million (including 47 SMEs, accounting for funding of about EUR 10 million).

EU funding has helped to address policy challenges identified in the 2018 country-specific recommendations. The European Social Fund is being used to upskill and reskill the labour force— as a result, so far more than 50 000 unemployed people and almost 9 000 employed people have improved their qualifications and skills. The quality of vocational education and training (VET) has improved as VET school network optimisation is completed, curricula reform is ongoing and over 1 000 students have enrolled in work-based learning. The implementation of Latvia's health reforms is ongoing and ESIFs are contributing to improving the accessibility, quality and cost-effectiveness of the healthcare system. For example, to address regional disparities in access to healthcare, 133 medical practitioners have already been attracted to rural areas and to cities outside Riga.

EU funding is contributing to major developments in the Latvian economy by promoting growth and employment via investments in areas such as research, technological development and innovation, business competitiveness, sustainable transport, employment and labour mobility. By 2018, investments driven by the ESIF had already led to the building or modernisation of more than 300 km of roads, both at regional level and in connection with the TEN-T network. Over 40 supported research project supported by the European Regional Development Fund (ERDF) have been commercialised, and support has already been approved for 3 111 businesses, including 382 start-ups, generating 665 new jobs. ESIFs have also contributed to a reduction of greenhouse gas emissions by 8 570 tonnes of CO_2.

In addition, the Commission can provide tailor-made technical support upon a Member State's request via the Structural Reform Support Programme to help Member States implement growth-sustaining reforms to address challenges identified in the European Semester process or other national reforms. Latvia, for example, is receiving support to improve its tax administration, assess and improve the overall performance of its health and develop its capital markets. The Commission is also assisting the authorities in their efforts to fight money laundering through the implementation of a training programme. In addition, in 2018, work has started on improving the efficiency of the public sector, in the Ministry of Interior in particular. Furthermore, support is being provided to strengthen the coordination and monitoring framework of state-owned enterprises.

EU funding contributes to the mobilisation of private investment. ERDF alone mobilises additional private capital by allocating about EUR 130 million in the form of loans, guarantees and equity. This is expected to leverage additional private investment amounting to EUR 440 million. Altogether, 2.85% of the ESIFs allocation was paid in the form of financial instruments.

In addition, the overall volume of approved operations by the European Investment Bank with backing from the European Fund for Strategic Investments (EFSI) amounts to EUR 229 million, which is set to trigger a total of EUR 966 million in additional private and public investments (February 2019). Latvia ranks 8th as to the overall volume of approved operations as a share of GDP. 9 projects involving Latvia have so far been approved under the infrastructure and innovation window of EFSI. They amount to EUR 207 million in total financing, which should, in turn, generate EUR 567 million in investments. Under the SME component, 8 agreements with intermediary banks have been approved for a total of EUR 22 million, which should mobilise around EUR 399 million of total investment. 7 298 SMEs and mid-cap companies are expected to benefit from this support.

EU action strengthens national, regional and local authorities and the civil society. EUR 101 million have been allocated to strengthen the capacity of public administration at different levels and to enhance cooperation with stakeholders.

More information at: https://cohesiondata.ec.europa.eu/countries/LV

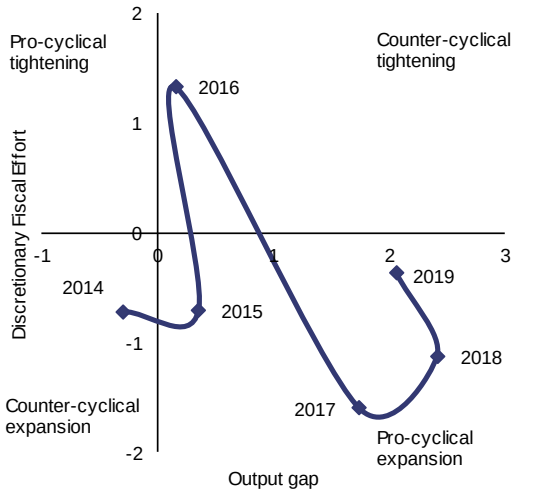
3. REFORM PRIORITIES

3.1. PUBLIC FINANCES AND TAXATION

3.1.1. FISCAL POLICY

The government's fiscal policy has been expansive at the time of cyclical upturn in the economy. The fiscal policy stance appears to have amplified volatility of the economy by the fiscal tightening in 2016, when the economy was temporarily affected by a drop in investment, and by the pro-cyclical expansion in 2017 and 2018 (Graph 3.1.1). Moreover, the fiscal stimuli in 2017 and 2018 added to wage and inflation pressures in the economy, and reduced fiscal capacity to counteract, when the cycle turns.

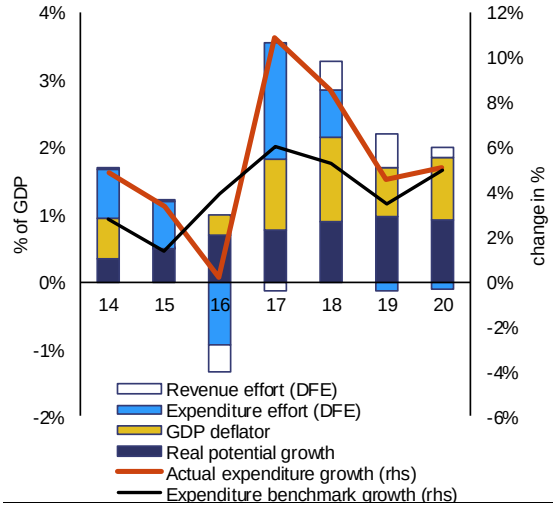
Graph 3.1.1: **The fiscal stance and the economic cycle**



Source: European Commission – Autumn 2018 forecast

Government spending has been volatile and has deviated from a prudent expenditure path. As a result of positive revenue surprises and underspending, Latvia achieved a fiscal surplus in 2016 compared to a planned deficit of 1% of GDP. However, rather than safeguarding the improved starting base, the budgets in 2017 and 2018 were marked by strong expenditure growth and the introduction of tax cuts, which exhausted the fiscal space. Government expenditure growth went from 0.2% in 2016 to 10.9% in 2017 and 8.6% in 2018 (Graph 3.1.2), exceeding a prudent expenditure path based on smoothed potential growth over 10 years and actual inflation. In 2019 and 2020, expenditure growth is projected to moderate to around 5%, while the expansionary effect of the adopted tax measures calls for a lower expenditure growth.

Graph 3.1.2: **Expenditure growth and the discretionary fiscal effort**

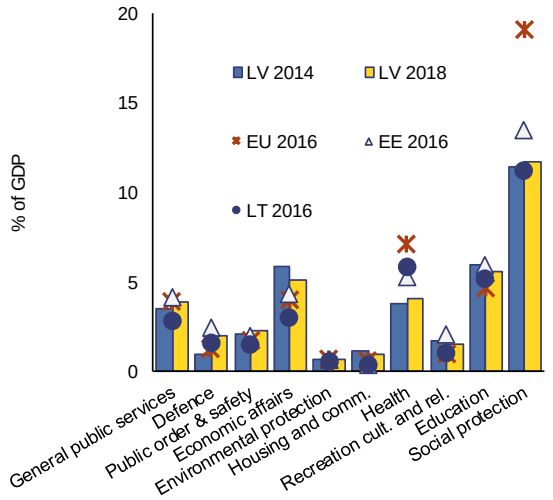


(1) Discretionary fiscal effort (DFE) consists of revenue and expenditure effort. (1)=(2)+(3)
(2) Revenue effort represents discretionary revenue measures. In this graph, positive revenue effort means expansionary fiscal stance (deficit-increasing).
(3) Expenditure effort shows the gap between the growth of public spending and smoothed potential growth over 10 years.
(4) Expenditure benchmark growth follows the notion of the expenditure benchmark in the EU fiscal framework (nominal smoothed potential growth adjusted for discretionary revenue effort).
For further details on the methodology see Carnot, N. and F. de Castro (2015). 'The Discretionary Fiscal Effort: an Assessment of Fiscal Policy and its Output Effect'. European Commission, Economic Papers 543, February.
Source: European Commission – Autumn 2018 forecast

Latvia spends less on health and social protection than other Member States on average. The government expenditure structure has changed very little between 2014 and 2018, except for an increase in defence spending and lower expenditure on economic affairs (Graph 3.1.3). The national defence spending increased due to the commitment regarding the North Atlantic Treaty Organization to attain the target of 2% of GDP. This is partly offset by a recent decline in the level of subsidies for the energy sector, although these are still higher than in other Member States (see Section 3.4.2 on mandatory procurement of electricity). Public spending on social protection and health services in Latvia has slightly increased, but remains

among the lowest in the EU. Such expenditure is a channel for redistributive policies, for which Latvia scores low. Section 3.3 covers social and health expenditure in greater detail.

Graph 3.1.3: **Government primary expenditure by function**



Source: European Commission, 2019 Draft Budgetary Plan

3.1.2. FISCAL FRAMEWORK AND EXPENDITURE REVIEW

The fiscal framework is broadly followed, but expenditure limits are occasionally disregarded in budget implementation. The budgetary planning is based on the fiscal rules set by the fiscal discipline law and takes into account the allowed deviations for implementing structural reforms. However, applying the national budgetary rules is problematic in two areas. Firstly, the Latvian authorities treat the transitional costs of the tax reform as one-off measures, while they are not recognised as such by the Commission because the adopted measures are deliberate policy actions. Secondly, authorities tend to reallocate expenditure from budgetary positions the fiscal discipline law allows to fluctuate, to expenditure positions fixed through pre-determined limits. The apparent breaches of the fiscal discipline law requirements are flagged by the independent Fiscal Discipline Council ([6]), but this has not yet led to policy change. Disregarding the expenditure limits has contributed to the recent rapid expenditure growth and undermines principles of fiscal prudence.

([6]) http://fiscalcouncil.lv/council

The 2018 annual expenditure review has delivered some savings, but it not yet used for the broader public sector reform. The review identified expenditure savings of 0.2% of GDP to be used for re-allocations of other spending priorities for 2019. Notable examples include more cost-efficient management of state-owned real estate and consolidation of information technology (IT) infrastructure which will bring further gains in the medium term. Completion of the pilot project for 'zero-based' budgeting for state libraries launched in 2017 has been further postponed to 2019, highlighting difficulties in applying the method across public services. The expenditure review process has not yet fed into public sector reform, intended to streamline public administration and readjust policy priorities. The State Chancellery is expected to lead the process, with administrative support from the Ministry of Finance and other ministries.

3.1.3. TAXATION

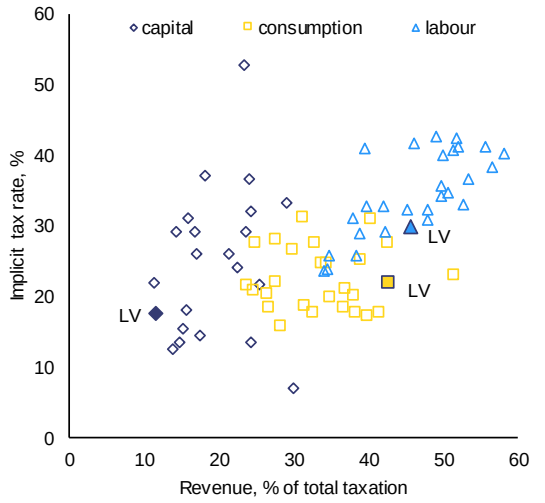
Latvia relies on labour and consumption tax revenue, while capital is less taxed. Latvia's tax revenue share in GDP is lower than the EU average. Labour and consumption taxes are the main revenue sources, but taxes on capital represent a low share of total revenue, even compared to other Member States (Graph 3.1.4). While cross-border effects are often used as an argument in favour of setting low tax rates, only in few cases lower implicit tax rates ([7]) on capital have gained disproportionately larger revenue. For most countries, including Latvia, the relationship between level of tax rates and tax revenue broadly holds. Moreover, a lower tax burden on capital has regressive distributional effects, considering that (i) high-income households hold a larger share of financial and property wealth and earn more income from capital; and (ii) lower capital tax revenue reduces public resources for redistributive policies supporting more low-income households.

A growth-friendly and revenue-neutral tax shift would have positive employment and GDP growth effects. Latvia stands out in terms of its high tax wedge on low wages; it is recommended

([7]) The implicit tax rates measure the actual or effective average tax burden levied on different types of economic income or activities.

that it shifts this tax burden to capital and property (Section 2). A model simulation shows that a revenue-neutral tax shift from low wages to property would increase employment and GDP growth, while also reducing income inequality (European Commission, 2017). Moreover, as property tax evasion is more difficult than labour tax evasion, it could also benefit tax compliance.

Graph 3.1.4: **Tax revenue and implicit tax rates (2016)**



Source: European Commission — Taxation trends in the European Union

The tax measures adopted in 2017 are costly, while the tax wedge, while smaller, remains high on low wage. Personal income taxation has become more progressive, but also lower on average. The tax wedge on low income has been reduced as a result, but for a single person earning 50% of the average wage in 2020 it is estimated at 36%, which is still high relative to the EU average of 32.5% in 2017 (European Commission, 2018h). The net costs of the tax cutting and revenue-increasing measures are estimated at a total of 1.1% of GDP over 2018-2020. The richest households and capital owners seem to be the main beneficiaries of the reforms. Notably, reducing the standard personal income tax rate from 23% to 20% costs 0.8% of GDP, of which 60% goes to the richest 30% of tax payers (Ivaškaitė-Tamošiūnė et al., 2018). Transforming the corporate income taxation regime is estimated to cost 0.7% of GDP by 2020. While some of the cost will be transitional, the cut in the effective corporate tax on profits and dividends benefits the richest households (who own most of the financial wealth) (Section 1). Moreover, lower public revenues limit resources for public services on which vulnerable groups rely.

The labour tax measures do not significantly reduce income inequality and poverty. The 2017 tax reform only partly targets low-income earners, as the adopted measures are not well suited for reaching the lowest income households, which tend to be unemployed, inactive or include pensioners with low pensions. For low-income earners with dependent children, a large share of their taxable income was already covered by tax-free allowances before the reform; they gain little from the personal income tax reduction and the increases in allowances. One third of pensioners had lower pensions than the allowance for pensioners before the reform, which means they do not benefit from an increase in the allowance. Such pensioners are concentrated in the poorest 20% of households. Therefore, social transfers seem better suited to reaching the poorest households (Section 3.3.2). At a similar cost as the adopted tax reform, increasing minimum social benefits has a potential to significantly reduce poverty and inequality in Latvia (Ivaškaitė-Tamošiūnė et al., 2018).

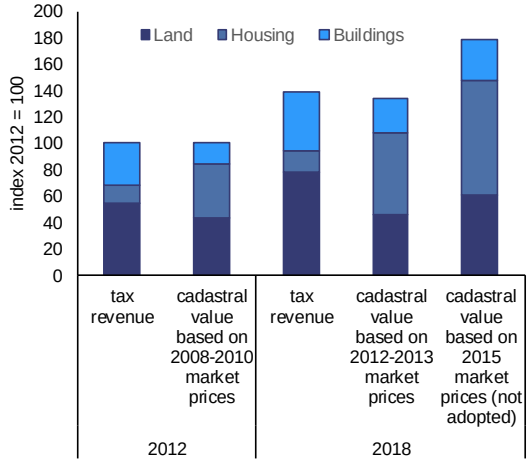
The share of capital taxation is set to decline under the current policies. Revenue from taxes on capital is estimated to decline from 3.6% of GDP in 2017 to around 3% of GDP by 2020. This mostly reflects the costs of the corporate income tax reform, which is somewhat offset by increasing tax rate on interest and capital gains. The share of recurrent property tax revenue is also projected to decline; this is connected to hesitation in updating property values used for taxation to bring them into line with market values.

Property taxation is based on outdated values. Recurrent property tax accounts for 0.8% of GDP in 2018, below the EU average of 1.6% of GDP in 2017. Around 60% of property tax revenue comes from land, 10% from housing and 30% from other buildings (Graph 3.1.5). The real estate cadastral values used as a basis for taxation are set to follow the market values. However, updating of cadastral values has been postponed for several years and taxation still reflects market values of 2012/2013. The proposed, but not adopted, update of cadastral values for 2018 based on 2015 market values would have increased total cadastral values by

34%, corresponding to some 0.3% of GDP in property tax revenue. The largest differences between cadastral values and market values are for agricultural land and newly built apartments.

Distortions in property taxation lead to unequal treatment of taxpayers. Similar properties can have notably different property tax liabilities. This is linked to freezing of the cadastral values and special tax treatment by some local authorities which set different tax rates ranging from 0.2% to 1.5% and grant tax rebates up to 90%. More affluent municipalities tend to grant more tax rebates and use them as tool for attracting residents, thus gaining their income tax revenue. Property tax expenditure accounted for 0.1% of GDP in 2016 (Ministry of Finance, 2017). While some 40% are socially motivated, a notable share of revenue is foregone for a blanket rebate for residents in the sea-side resort of Jurmala and dedicated rebates for companies in the special economic zones and municipal companies in Riga. Various distortions hinder the uniform application of property tax and equal treatment of all Latvian taxpayers irrespective of their place of residence. Cadastral value freezes and blanket rebates have regressive distributional impacts, as property wealth is concentrated in higher income households.

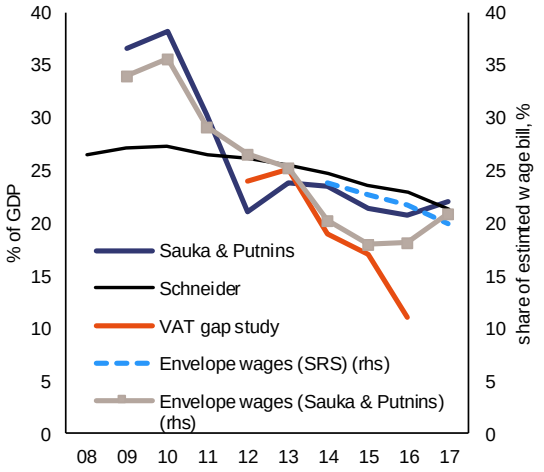
Graph 3.1.5: **Property tax revenue and cadastral values in 2012 and 2018**



Source: State Land Service of Latvia, Ministry of Finance

Tax evasion has declined, but remains relatively high. The share of the shadow economy appears to have declined over the past years by different estimates (Graph 3.1.6). However, estimates also show a large measurement uncertainty, even pointing in different directions at some points. 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. Under-reported work could be reduced as a result of: (i) a sectoral wage agreement in the construction sector setting a minimum wage higher than the national minimum (Section 3.3.1); and (ii) electronic registration of working hours on large construction sites.

Graph 3.1.6: **Estimates of Latvia's shadow of economy**



Source: Sauka & Putnins (2018), Schneider (2017), Study and Reports on the VAT Gap in the EU-28 Member States (2018), State Revenue Service (SRS) (2018)

Fighting tax crimes remains a priority for the authorities. Several measures to combat the shadow economy came into force in 2018, such as: (i) disclosure of information on employers paying average salaries that are lower than the state minimum wage; and (ii) disclosure of information on employers penalised for paying 'envelope wages' and taxpayers not submitting tax returns on time. By the order of the Prosecutor General, chief prosecutors are requested to intensify the prosecution of financial and economic crimes and the previously lenient approach to penalties has been stiffened. However, implementation of some measures faces difficulties, as new ways of tax evasion are being uncovered, e.g. updating cash registers takes more time than planned, as new

problems are discovered in already certified cash registers.

The tax administration has been strengthened to work more efficient and on more complex cases. The World Bank has launched, with the support of the European Commission, a technical assistance project on tax audit, VAT control and fraud risk assessment, and to review the legal framework for VAT compliance. Specifically, Latvia is advised to: (i) legislate joint and several liability in the case of fraudulent transaction chains; (ii) create a large taxpayers' unit within the State Revenue Service; and (iii) investigate VAT taxpayers not submitting tax returns instead of applying automatic deregistration ([8]).

The micro-enterprise tax regime has become more restricted, but is still abused as a tax optimisation tool. The maximum annual turnover for the micro-enterprise tax regime has decreased from EUR 100 000 to EUR 40 000. A higher tax rate is applied for turnover exceeding this amount, but the overall tax wedge remains still more attractive than that under the general labour tax regime. The micro-enterprise tax regime dominates in sectors with a high share of labour input, like taxi drivers, arts and sporting activities. The number of micro-enterprise taxpayers decreased in 2017-2018, but still accounts for some 8% of employees. These taxpayers have lower social contributions and social protection as a result.

3.1.4. DEBT SUSTAINABILITY ANALYSIS AND FISCAL RISKS

Under current policies, Latvia faces low fiscal sustainability risks in the medium and long run. The manageable initial debt level and the limited sensitivity to possible macro-fiscal shocks underpin the assessment of low fiscal sustainability risks (Annex B). Under the 2018 Ageing Report's (European Commission, 2018d) baseline scenario, total ageing-related expenditure is not projected to increase between 2018 and 2070 as a projected fall in pension spending more than offsets increases for other items.

If welfare pressures are considered, risks to fiscal sustainability appear higher. Healthcare and long-term care spending is projected to increase by some 3% of GDP by 2070 due to non-demographic cost drivers pushing up costs, under a more adverse scenario in the 2018 Ageing Report. This reflects on the currently low public spending on healthcare (Section 3.3.3) and the expected increase in demand for health services as living standards rise. Moreover, the currently very low pension adequacy is projected to worsen in the long run, which may not be socially and politically sustainable (Section 3.3.2). The average total pension (including both public and private pension income from the mandatory individual schemes) stood at 24% of the average wage in Latvia in 2016, below the EU average ratio of 43.5% ([9]). The 2018 Ageing Report projects that the ratio for Latvia will decline to 18.6% by 2070, indicating that income from mandatory individual schemes would not suffice to compensate for lower public pension benefits. The structural fiscal costs involved in maintaining the benefit ratio at its current level would amount to around 2% of GDP. Increasing it to the EU average would entail a cost of 10% of GDP.

([8]) Technical Assistance: Supporting the Implementation of the Mid-Term Tax Strategy of the Government of Latvia, World Bank Group.

([9]) The EU average benefit ratio is for public pensions only.

3.2. FINANCIAL SECTOR

Financial stability

The Latvian banking sector remains sound despite the challenges over non-resident banks. The total capital ratio is over 22% - in line with the euro area average and well above the 10% that banks are required to keep in order to withstand an adverse shock. The Latvian banking sector's profitability has until recently been considerably above the euro area average. However, the winding down of the non-resident banking sector activities coupled with more stringent requirements for loan loss provisions has reduced the non-resident banking sector's profitability. This is, however, expected to be temporary and does not pose a risk to the sector's stability. Finally, the share of non-performing loans (NPLs) at above 5% is somewhat higher than the euro area average. The NPL share dropped quickly after peaking during the financial crisis in 2010. However, unlike in the other Baltic countries, the figures have stopped improving and have remained broadly unchanged for the past 4 years. This is partly due to negative credit growth during most of that time, but primarily it is due to deteriorating quality of foreign customers' loan portfolio. While the quality of the domestic loan portfolio has continued to improve with loans past due 90 days standing at around 3.0% in 2018, the quality of the loan portfolio of foreign customers has rapidly deteriorated since 2015, landing at around 12% in 2018 (Bank of Latvia, 2018). The increase in NPLs of foreign customers is linked to the depreciation of the Russian rouble.

Table 3.2.1: **Financial soundness indicators**

(%)	2013	2014	2015	2016	2017	2018Q2
Non-performing debt	5,6	7,7	5,1	5,2	4,7	5,3
Non-performing loans	-	9,7	6,5	6,3	5,6	5,9
Non-performing loans NFC	-	12,0	11,1	11,1	10,4	10,7
Non-performing loans HH	-	12,3	10,4	7,9	5,9	5,6
Coverage ratio	79,3	39,9	37,7	35,3	35,9	32,2
Loan to deposit ratio*	132,3	119,4	109,3	107,8	102,6	104,1
Tier 1 ratio	16,5	17,5	19,0	17,3	18,4	20,1
Capital adequacy ratio	18,0	20,2	21,8	20,4	20,6	22,4
Return on equity**	8,8	10,2	10,7	14,3	7,6	-
Return on assets**	0,9	1,0	1,2	1,5	0,9	-

*ECB aggregated balance sheet: loans excl to gov and MFI / deposits excl from gov and MFI
**For comparability only annual values are presented
Source: European Central bank

A highly integrated and concentrated Nordic-Baltic banking system warrants close collaboration among financial supervisors. Most large Latvian banks belong to Nordic banking groups, with Swedish lenders SEB and Swedbank the two leading names in Latvia. The creation of Luminor Bank AS ([10]) in 2017 put in place Latvia's second largest credit institution, with a market share of 15 % in deposits and 25 % in lending. Given the Nordic economies' financial openness and the relatively large size of their banking system, potential spill-overs from shocks originating in those countries could be significant. Risks mainly relate to the Nordic housing markets and — with the exception of Finland — to the high indebtedness of their households. Risks may materialise in the form of constrained lending activity, short-term deposit volatility and higher financing costs for Latvian banks given the relatively heavy dependence of some Nordic countries on wholesale funding. In this regard, cross-border supervisory cooperation is warranted, to maximise the effectiveness of national macro-prudential policy instruments, ensure a level playing field for all credit institutions and reduce the risk of regulatory arbitrage.

Credit growth

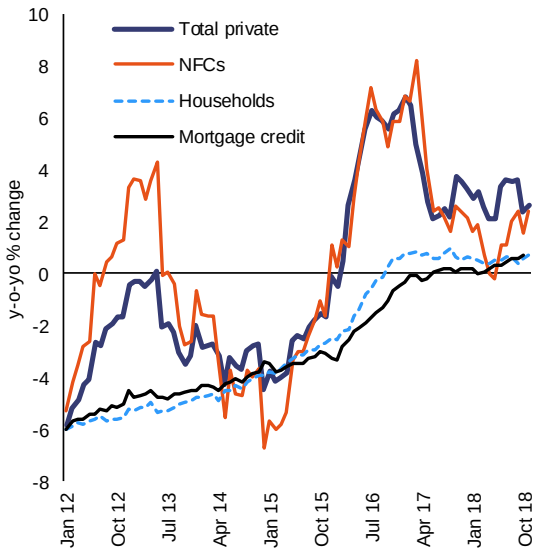
Credit growth is improving but remains below that of the other Baltic countries. Following the 2009-2010 economic crisis, credit growth to households was negative until 2017. Since then, the annual credit growth has hovered barely above zero, while in the other Baltic countries it had been around 6-8 % over the past 2 years. Credit growth (adjusted for sales and securitisation) to non-financial corporations has been on average 1.4 % over 2018. Since 2010, private sector credit growth rates on average have remained below nominal GDP growth and as a consequence private debt has declined from above 130 % of GDP in 2010 to just above 80 % in 2017.

The slow credit recovery is due to both demand and supply factors. High credit risk (bad track records, weak borrower collateral and equity), shortcomings in the legal framework (lengthy insolvency procedures, reluctance over income and asset disclosure) and the shadow economy are considered the most important supply side

([10]) Nordea Bank (Sweden) and DNB ASA (Norway) merged their cross-border operations in the Baltic states into Luminor, but subsequently cut back their presence in the Baltics in September 2018 by selling a 60 % stake to Blackstone, one of the world's largest private equity investment funds,.

constraints to corporate lending, especially to SMEs, keeping banks' lending standards tight. At the same time, credit demand from non-financial corporations is volatile due to the demand for large amounts, as smaller investments are often financed with internal resources. Subdued credit demand among households is linked to the shrinking of the population, the high incidence of undeclared incomes and to the large share of the population that has a bad credit score, a legacy of the financial crisis.

Graph 3.2.1: **Credit growth, y-o-y % change**



Source: European Central bank

Domestic non-bank lending is much more buoyant than bank lending. Although banks are the main providers of funding to the Latvian economy, the role of non-bank players such as leasing companies (e.g. for the purchase of vehicles) in domestic lending is growing. Latvian non-financial corporations, particularly start-ups, also use risk capital as an alternative source of funding. Crowdfunding services, mainly attracting foreign investors and foreign borrowers, are also increasing at a rapid pace.

Anti-money laundering supervision

In the wake of the downfall of its third largest bank Latvia has taken swift action to minimise money laundering risks. In early 2018, the United States financial crime enforcement network (FinCen) implicated Latvia's then third biggest bank ABLV to conducting large scale money laundering. Due to the gravity of FinCen's implications, the European Central bank revoked its licence and the ABLV bank went into self-liquidation. Its case reinvigorated international concern about the money laundering risks inherent to the Latvian non-resident banking sector ([11]). In March 2018, the European Commission requested the European Banking Authority (EBA) to investigate whether breaches of EU law were committed by Latvia in relation to the above case. Latvian authorities are cooperating well with the EBA in this enquiry, although there has been some delay in providing the EBA with the requested information. In the aftermath of the ABLV case, the government expressed its firm commitment to significantly reduce the risk of money laundering in the Latvian banking sector. In May 2018 it adopted a regulation banning servicing certain types of shell companies and required the remaining non-resident banks to change their business models away from providing transactions to risky non-resident clients.

Due to the ban on shell company servicing and banks' business model change, non-resident deposits fell significantly in 2018. In 2018 the non-resident deposits in Latvian banks declined by 60% from 8.2 billion euros (40 % of all deposits) in February to 3.1 billion euros (20% of all deposits) by the end of 2018 ([12]). The decline was due to non-resident banks ceasing relationship with the riskiest clients. The remaining deposits are split broadly equally between EU and non-EU clients. Although foreign deposits have declined substantially, they remain above the government's initial target of 5% of all deposits. Moreover, they have stabilised since August and Latvia's bank supervisor ([13]) believes that they are unlikely to fall further.

The money laundering case concerning the ABLV Bank showed that weaknesses in the supervision remain. Although, since 2015, the

([11]) Latvia's banking sector can nominally be divided in two parts – traditional domestic market-serving banks and banks that focus on providing primarily transaction services to non-residents

([12]) The share of foreign deposits had already been shrinking since 2015 when they peaked at over 12 billion euros or 53% of all deposits

([13]) Finance and Capital Market Commission or FCMC

Finance and Capital Market Commission (FCMC) had carried out several inspections at the ABLV Bank, in the course of which various sanctions and corrective measures had been imposed, apparently these did not ensure the expected results. Moreover, the 2018 Mutual Evaluation Report on Latvia's AML system by Moneyval ([14])found that while all the key risk assessment and control elements were in place, their scope and quality were inadequate relative to the volume of financial flows going through Latvia's non-resident banks (Council of Europe, 2018). The report was critical of Latvia's law enforcement's success in uncovering and prosecuting money laundering-related crime and it pointed out that the sanctions applied to convicted individuals did not appear to be dissuasive. Law enforcement bodies recognize deficiencies and are committed to putting in more effort into fighting the money laundering crime. Finally, the Moneyval's report called for a more holistic approach and for better international cooperation to fight money laundering-related crime.

In response to the Moneyval's report, Latvia has expressed commitment to review its anti-money laundering strategy. To address the weaknesses identified by the Moneyval's report, 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 and introducing preventive measures, ensuring the required human resources for the supervisory authorities, effective information exchange among the investigative authorities and IT solutions for timely and efficient data management, among others. The National Risk Assessment of Latvia is also under review. The government plans to strengthen the dialogue between the public and private sectors in order to ensure the necessary information sharing and collaboration.

While supervision and control bodies have been strengthened, law enforcement authorities' capacity also needs to be increased. FCMC's powers have been recently broadened to issuing regulations on risk assessment in national and international sanctions and its staff was increased. Financial Intelligence Unit's ([15]) staff was also increased to help them oversee the ABLV liquidation and implement Moneyval's recommendations. However, the law enforcement authorities' capacity to handle anti-money laundering cases remains low. Police investigators and prosecutors qualified in anti-money laundering are missing, which is one of the causes of the low number of money laundering prosecutions and convictions. Finally, despite improvements, first instance court cases concerning money laundering offences remain lengthy (2019 EU Justice Scoreboard (forthcoming).

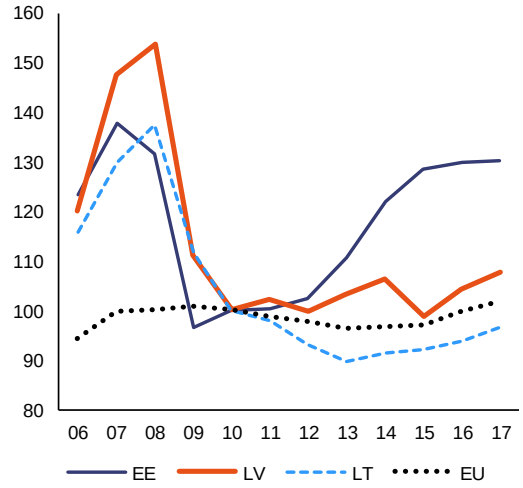
Housing market

House price growth has picked up over the past two years. The house price growth exceeded 8% in 2017 and continued at the same pace in the first half of 2018. By comparison, the average house price growth from 2010 to 2016 was 5.5%. Despite the rapid pace, house price growth has remained broadly in line with income growth. The price to income ratio is now only slightly higher than it was in 2010 and significantly lower than it was at the height of the real estate bubble in 2008 (Graph 3.2.2). The demand for housing has been boosted by a state guarantee programme helping families and young professionals to get a mortgage against lower down payment than banks would normally require. This has also helped the mortgage credit growth turn positive in 2017. The construction of dwellings has also increased slightly, but over a longer time frame it has been anaemic. In stark contrast with the other Baltic countries, the amount of newly constructed dwelling space in Latvia has not increased much since 2010 (Graph 3.2.3).

([14]) The report was based on an assessment carried out in Autumn 2017, i.e. before the closure of ABLV bank and the subsequent regulatory and operational changes

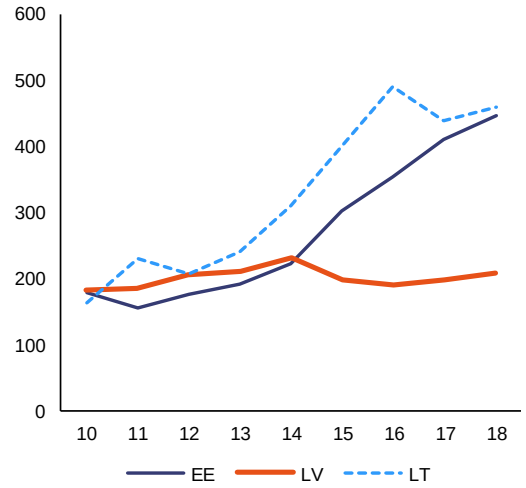
([15]) The Office for the Prevention of Laundering of Proceeds Derived from Criminal Activity

Graph 3.2.2: **Price to income ratio, index 2010=100**



Source: European Commission

Graph 3.2.3: **Newly constructed dwelling space, m2 per 1000 people**



Source: Statistics Estonia, Central Statistical bureau of Latvia, Statistics Lithuania, European Commission calculations

Undeclared wages, cumbersome construction regulations and weak protection of landlords hold back investment in housing. Since the financial crisis of 2009, banks in Latvia are taking a much more prudent approach to granting credit against undeclared incomes and they currently identify this as one of the main obstacles to higher mortgage credit growth. Furthermore, investors point to lengthy and cumbersome construction regulations making the process costly and leaving investors less agile to respond to growing demand. Finally, weak protection of landlords discourages more investment into rental housing (European Commission 2018a). The government has prepared a draft rental law that would significantly strengthen the protection of landlords' interests. However, there are concerns that the proposal would shift the balance of protection too much in favour of landlords.

Investment in housing is crucial to facilitating better internal mobility and access to quality jobs in the peripheral regions. A large share of owner-occupied buildings means there are few options for people who would like to move for jobs outside of the Riga metro area. Moreover, the population's low purchasing power makes commercial residential development not viable. This in turn hinders regional growth and encourages emigration. The experience of the city of Valmiera ([16]) shows that there is a high demand for affordable rental housing and that it can be a powerful policy tool to attract people to the municipality, providing employees to local businesses. However, it also suggests that residential development is only viable if cheap long-term financing is available. Inspired by Valmiera's example, the Ministry of the Economy has put forward a state support programme aimed at helping municipalities finance rental housing projects. However, this has yet to be approved by the government.

([16]) In 2018 Municipality of Valmiera built 150 flats on its own land without involving a real estate developer, thus making the flats cheaper than they otherwise would be. Within a couple of months 90% of the flats had been rented out. The city cites lack of long-term financing as the primary obstacle to building more apartments.

3.3. LABOUR MARKET, EDUCATION, AND SOCIAL POLICIES

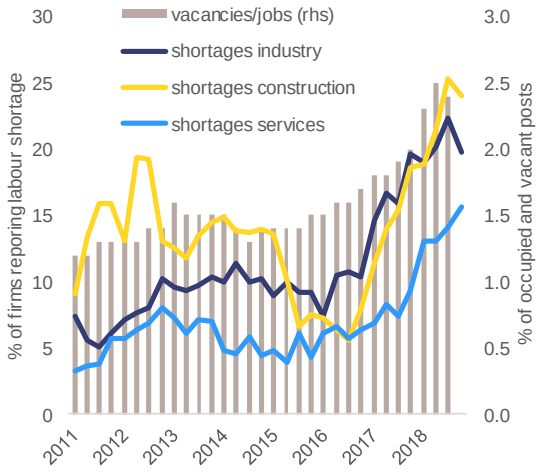
3.3.1. LABOUR MARKET

In line with the favourable macroeconomic environment, the labour market performance is overall positive. The employment rate increased on the back of declining unemployment and growing activity rate. The long-term unemployed and young people continue to benefit from the steady improvement in the labour market (Section 1). However, the shrinking pool of the working age population is contributing to increasing labour shortages, in particular in Riga. Population projections suggest a further decrease in the working age population and an increase in the share of the elderly in the population in the medium and long term (Ministry of Economics, 2018). In addition, structural gaps in employment based on skills level, ethnicity and regions persist. Ensuring skills' supply is one of the main areas where demand for investment remains significant.

Emigration is motivated by working and living conditions, and it contributes to skill shortages. Between 2009 and 2016, the outflow of skilled labour (those with at least a medium level of education) amounted to 120 000 people. More than a half of emigrants had tertiary education, equivalent to 17.4% of the high-educated segment (ECE, 2018b). Although the outflows have decreased in recent years, still about half of the country's population decline is due net emigration (Section 1). Emigration of skilled labour contributes to skills shortages (OECD 2017Z). Emigration is motivated by low wages and financial difficulties in Latvia, as well as dissatisfaction with quality of life and social safety nets (Hazans, 2015). The rapid wage growth (Section 1) in Latvia could discourage emigration and incentivise return migration. The Ministry of Economics (2018) assumes that the steady economic growth and increase of qualitative and well-paid jobs should reverse the net emigration by 2023.

Labour shortages are reported across various sectors. Most shortages are in sectors related to science, technology, engineering, and mathematics (STEM fields), including ICT, as well as in the healthcare sector (see Section 3.3.3 on healthcare and Section 3.3.4 on education) (European Commission, 2018a). Labour shortages are also becoming more pronounced in the construction sector following its recent stronger growth (Ministry of Economics, 2018). In 2018, vacancies registered at public employment services doubled, reaching pre-crisis levels, of which nearly 80% in the Riga region. Since February 2018, incentives are provided to employers to recruit highly skilled workers from non-EU countries in occupations where a significant shortage of labour is projected. The education and skills governance systems are also being reformed (Section 3.3.4)

Graph 3.3.1: **Job vacancies and labour shortage indicators**



Source: European Commission (Eurostat, Economic Sentiment Indicator)

Box 3.3.1: **Monitoring performance in light of the European Pillar of Social Rights**

The European Pillar of Social Rights is designed as a compass for a renewed process of upward convergence towards better working and living conditions in the European Union([1]). It sets out 20 essential principles and rights in the areas of equal opportunities and access to the labour market; fair working conditions; and social protection and inclusion. The analysis in this report has been carried out in light of the Pillar's principles.

SOCIAL SCOREBOARD FOR LATVIA		
Equal opportunities and access to the labour market	Early leavers from education and training (% of population aged 18-24)	Better than average
	Gender employment gap	Good but to monitor
	Income quintile ratio (S80/S20)	Critical situation
	At risk of poverty or social exclusion (in %)	To watch
	Youth NEET (% of total population aged 15-24)	On average
Dynamic labour markets and fair working conditions	Employment rate (% population aged 20-64)	On average
	Unemployment rate (% population aged 15-74)	On average
	Long-term unemployment	On average
	GDHI per capita growth	On average
	Net earnings of a full-time single worker earning AW	Weak but improving
Social protection and inclusion	Impact of social transfers (other than pensions) on poverty reduction	Critical situation
	Children aged less than 3 years in formal childcare	On average
	Self-reported unmet need for medical care	Critical situation
	Individuals' level of digital skills	To watch

Members States are classified according to a statistical methodology agreed with the EMCO and SPC Committees. The methodology looks jointly at levels and changes of the indicators in comparison with the respective EU averages and classifies Member States in seven categories (from "best performers" to "critical situation"). For instance, a country can be flagged as "better than average" if the level of the indicator is close to EU average, but it is improving fast. For methodological details, please consult the draft Joint Employment Report 2019, COM (2018)761 final. Data update of 29 January 2019.
NEET: neither in employment nor in education and training; GDHI: gross disposable household income.

Latvia faces challenges on a number of indicators of the Social Scoreboard supporting the European Pillar of Social Rights. Despite the improvements in the labour market, challenges remain on equal opportunities, labour market access, and social protection and inclusion. Disparities in employment across regions and skills levels persist, while participation in adult learning and active labour market policies is lower than in other EU countries. Wages are increasing at a rapid pace and the minimum wage was raised in 2018. However, income inequality remains high, in part due to the low redistributive power of the tax and benefits system. Although the risk of poverty or social exclusion has been decreasing, it remains elevated for people with disabilities, the elderly and the unemployed.

Access to affordable healthcare is a challenge. Although self-reported unmet needs for medical care are decreasing, they remain high. In 2017, people in the lowest income quintile reported a much higher level of unmet needs for medical and dental care due to cost (9.9% and 25.5% respectively) than people in the highest income quintile (0.9% and 3.3% respectively).

The Youth Guarantee is effectively supporting young people in the labour market. Implementation of the Youth Guarantee in Latvia started in 2014, targeting young people not in employment, education or training aged 15-29 years. The employment offers provided under the scheme are mostly subsidised employment in the regular labour market. The education offers emphasise several vocational tracks, and also include 'Youth workshops' which provide training to help young people with their career choices. The Youth Guarantee is implemented using national funds, the European Social Fund and the Youth Employment Initiative. It has helped significantly reduce the rate of young people not in employment, education or training, which in 2017 fell to 10.3%, below the EU average of 10.9%.

([1]) The European Pillar of Social Rights was proclaimed on 17 November 2017 by the European Parliament, the Council and the European Commission. https://ec.europa.eu/commission/priorities/deeper-and-fairer-economic-and-monetary-union/european-pillar-social-rights/european-pillar-social-rights-20-principles_en

Employment conditions differ across regions and internal mobility remains a challenge. Uneven regional distribution of jobs and vacancies is one of the key challenges the country is facing (Ministry of Economics, 2018). The employment rate in Riga is higher (73.4%) than in other regions, in particular Latgale (62.2%). This encourages residents of Vidzeme and Zemgale to take advantage of those region's proximity to the capital region, with the result that 10% and 15% respectively of their employed residents work in Riga. The regional mobility support programme

provides commuting or relocation support, but the uptake remains low, as the amount of support (cumulatively EUR 400 for first 4 months) does not sufficiently compensate for relocation expenses and the support is temporary. Lack of affordable and quality rental housing is the key bottleneck for internal mobility in the country (Section 3.2).

Gaps in employment based on skills level and ethnicity persist. The employment gap of 15.8 pps between people with high- and medium-educational attainment in Latvia is among the highest in the EU. This is linked to the relatively low employment rate of medium-educated men. More than 35% of registered unemployed have vocational education and training background and half of them are over 50 years old, thus indicating outdated skills. The employment gap between Latvians and citizens from ethnic minorities has narrowed to 3.3 pps, but the ethnic employment gap remains at 6.5 pps and is wider for the older generations. More than 40% of ethnic minorities over 55 year old have no knowledge of the Latvian language or their proficiency is low (Mieriņa et al., 2017). In addition, participation in adult learning for the 55-64 age group is only 3.5% (2017). Further investment in upskilling the older generations and in the Latvian language training could support the labour supply against the backdrop of the negative demographic trends.

The spending on and coverage of active labour market policies remains low, limiting the activation of those furthest away from the labour market. Latvia has made progress on integrating the long-term unemployed into the labour market with long-term unemployment rates at the EU average. However, participation in active labour market policies remains low at 5.8 per 100 persons wanting to work. Low public expenditure on active labour market policies, at only 0.6% of GDP (2016) contributes to this situation ([17]). Employment services can also be difficult to access, especially for more disadvantaged workers in rural areas, as the low adequacy of social assistance benefits hampers regular contact between jobseekers and employment offices (OECD, 2016a). Information exchange and coordination between public employment services, social services and educational institutions is insufficient, which results in poor monitoring of school-to-work transitions and success on the labour market. A coordinated approach aimed at long-term activation of people furthest away from the labour market could be improved. The coverage of the active labour market policies and the capacity of the public employment service are linked to funding, therefore the demand for investment will remain significant.

The prevalence of occupational diseases is increasing and the fatal accident rate is high. The rapid rise in victims of an occupational disease results in partial or full workability loss and contributes to the increasing rate of persons with disabilities. While the fatal accident rate is among the highest in the EU, the very low rate of non-fatal incidents is explained by the poor accident reporting culture. High prevalence of underreported work contributes to the under-reporting of accidents at work and heightens occupational risks (Section 3.1.3). The State Labour Inspectorate carries out preventive measures, but has limited capacity and high staff turnover. To pursue the Social Pillar principle on a healthy and safe work environment, further investments may contribute to ensure healthier and longer working lives.

A sectoral wage agreement in the construction sector is a novelty in Latvia, but it requires a more flexible legal framework. The agreement was reached in 2018, setting a minimum wage for the sector of EUR 780 (higher than the national minimum of EUR 430) and reducing a surcharge for overtime work to 50%. The current legal requirement for a surcharge is 100% of contractual wage. Amendments to the Labour Law allowing for a smaller surcharge for overtime if the minimum wage in a sector is substantially increased were adopted by the Parliament, but were rejected by the President, thus putting on hold the sectoral agreement. This agreement would be a novelty for the Latvian industrial relations system, as so far there have been no collective agreements at sector level in the private sector. Four additional agreements in transportation, wood processing, pharmaceuticals and telecommunications will be facilitated through an EU-funded project, thus strengthening social dialogue at sectoral level.

([17]) Almost 70 % of ALMP spending is financed by the European Social Fund so the national contribution is even smaller.

The institutional set-up for social dialogue is well established, but the capacity of social partners is limited. In 2016, membership of trade unions continued to decrease, falling to just 10.7%, while the density of employers' organisation has been increasing in recent years, reaching a figure of 44% (Eurofound, 2018). The institutional set-up for national level social dialogue is well developed and social partner involvement in policymaking has improved. However, social partners lack financial and human resources and their capacity to participate in the legislative process remains a challenge. In this context, investment in capacity building of social partners is important to ensure the effectiveness of social dialogue.

3.3.2. SOCIAL POLICIES

Income inequality and poverty remain high and spending on social protection is low. According to the Social Scoreboard (Box 3.3.1), Latvia faces challenges on equal opportunities, social protection and inclusion. In 2016, Latvia spent only 12 % of GDP on social protection, well below the EU average of 19.1 %. Given the low spending on social protection, the impact of social transfers is limited. In 2018, social transfers (excluding pensions) reduced the risk of poverty rate by 19.1% in Latvia vs. 33.2% on average in 2017 in the EU. Likewise, the impact of social transfers on inequality was only 19.3%, among the lowest in the EU and well below the average (of 40.4%). In order to accelerate progress towards inclusive growth, significant investments would be required to foster active inclusion and social integration of people at risk of poverty or social exclusion, including access to integrated social services, food and material aid for the most deprived.

The adequacy of social assistance benefits remains low and they contribute little to alleviating high poverty and inequality. From January 2018, the guaranteed minimum income tops up income to EUR 53 (some municipalities voluntarily provide higher benefits). The average housing benefit is less than EUR 15 per person per month, while the calculated poverty threshold for 2017 was EUR 367. The adequacy of the minimum income benefits is below the EU average ([18]). According to the national data, out of the first (lowest) income quintile, 68.3% report difficulties making ends meet; however, only 16.2% have received the status of 'poor person' giving them access to social assistance and only 6.7% receive guaranteed minimum income. People from quasi-jobless households at risk of poverty face more difficulty accessing certain services in Latvia compared to other EU Member States ([19]). The concept paper adopted in 2014 envisaging a significant increase in benefit adequacy has not been implemented and the plan to improve the minimum income support system has not been adopted, although revised and resubmitted to the government multiple times (latest version submitted in May 2018).

The minimum income level reform could bring inequality and poverty in Latvia more in line with the EU average. The reform targets low income households and can notably address poverty and inequality concerns. However, simply making benefits more generous could negatively affect the beneficiaries' incentives to work. The current withdrawal of means-tested benefits at the same rate as work income increases impacts on incentives to take up work. This can be mitigated by a more gradual withdrawal of the means-tested benefits. At a similar cost as the 2017 tax reform, the reform of the minimum income level, with more gradual transition from means-tested benefits to labour income, has the potential to close the gap to the EU average in terms of poverty and inequality while improving incentives to work (Ivaškaitė-Tamošiūnė et al., 2018).

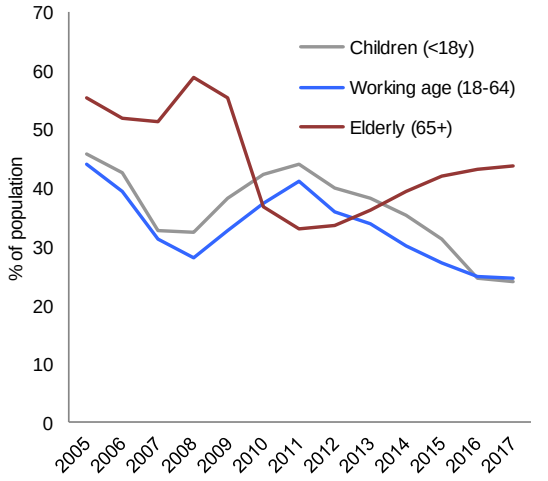
A relatively high and increasing share of the elderly are at risk poverty and social exclusion. The at-risk-of-poverty or social exclusion rate for the elderly continued to deteriorate and at 49.0% (2018) was significantly above the EU average of 18.2% (2017). From 2013 to 2018 the rate of poverty and social exclusion among women of 65

([18]) According to the Benchmarking Framework on Minimum Incomes conducted within the SPC Committee. For details, see the draft Joint Employment Report 2019, COM(2018) 761 final. The figures relate to single person households.

([19]) Information relates to gaps in self-reported unmet needs for medical examination, housing cost overburden rate, and non-participation in training related to professional activity between individuals (18-59) at risk of poverty from quasi-jobless households and the rest of the population aged 18-59 (The draft Joint Employment Report 2019, COM(2018) 761 final).

years of age and older has increased by 13.6 pps. Mostly, these are pensioners who retired before 1996 under the previous pension law, which produced very low benefit amounts that were further devalued by low indexation. Moreover, the poverty gap, which measures the intensity of poverty (i.e. how poor the poor are), is among the highest in Europe. This is mainly because pensions lag behind the growth in labour incomes while there are no adequate safety nets for the elderly.

Graph 3.3.2: **At-risk-of-poverty or social exclusion rate by age groups**



Source: European Commission (Eurostat

The adequacy of pensions is low and is projected to remain low in the long run. In 2018, Latvia took some steps to improve situation for pensioners by: (i) increasing pensions for older pensioners; (ii) raising income tax allowances; (iii) making indexation rules more favourable for pensioners with longer service records; and (iv) introducing a time-limited survivor's pension. In addition, a right to inherit state-funded pension capital if the deceased has not reached pension age will be effective as of 2020. However, the generosity and coverage of the measures are limited. The minimum pension and state social security old-age allowance have not been increased. The minimum pension remains at the 2006 level in a range from EUR 70.43 to EUR 108.85 per month, depending on the length of contributions. The pension adequacy is projected to remain one of the lowest in the EU in the long run (European Commission, 2018c).

The unemployed are at high risk of poverty, in particular if the duration of unemployment increases. Unemployment benefits are paid for the first 9 months of unemployment and are gradually reduced in the meantime. Both the replacement rate and the duration of unemployment benefit (for a year-long work record) correspond to the EU average ([20]). However, the at-risk of poverty rate of unemployed persons is high at 59.6% and increasing. The low social insurance contributions of employees often result in low unemployment benefits. Moreover, the low social assistance benefits, which support unemployed people experiencing long unemployment spells, contribute to high poverty among the unemployed.

The social security system does not cover all people in employment, and the self-employed contribute little to their pensions. Some 8% of Latvian workers are self-employed without employees, as compared to the EU average of 10%. They are not covered by unemployment benefits scheme or insured against accident and occupational injuries. Almost all (90%) self-employed pay social insurance contributions from income that are equal to the minimum wage. The low social contributions will result in very low old-age pensions (European Commission, 2018c). In addition, casual workers are not covered by sickness benefits and seasonal workers are not insured against the majority of social risks.

Social protection for persons with disabilities is weak. The share of persons with disabilities at risk of poverty or social exclusion in Latvia is 42.5%, one of the highest in the EU (EU average 30.1%). Latvia has one of the highest gaps in the EU between the at-risk-of poverty rate and social exclusion rate for persons with and without disabilities (20.8 pps vs. the EU average of 9.2 pps). Disability pensions are low and 43% of persons with disabilities receive pensions below EUR 120 per month. The state social security benefit, which serves as a base for calculating the invalidity pension, has not been revised since 2006 and currently stands at EUR 64.03 per month, or

([20]) According to the benchmarking exercise on unemployment benefits and active labour market policies conducted within the EMCO Committee. See the draft Joint Employment Report 2019 for details.

EUR 106.72 per month for people who have been living with disabilities since childhood.

The transition from institutional to community-based care has started. Institutions for children in out-of-family care and adults with special care needs are costly and have poor social outcomes. Those are set to be replaced by community-based services at local level and family-like care. In 2018, financial support for foster families was increased and a communication campaign to overcome prejudices about adults with mental disabilities was launched. The policy is supported by the EU funds, however, only a part of overall needs for community-based care services is covered and further investment would be needed. In addition, the implementation of EU-funded projects has been delayed for almost 2 years, putting at risk its planned completion by 2023 (State Audit Office, 2018).

Access to long-term care is improving but remains weak. Despite progress in the delivery of home care services, unmet needs for homecare services due to financial reasons was 37.9% of households in need in 2016, above the EU average of 32.2%. The municipalities are responsible for services, which are mostly delivered in institutional care centres. Low remuneration of social workers and low population density is a challenge for quality care services in rural regions (ESPN, 2018).

Access to childcare facilities is low in the countries' main centres of economic activity. Availability of affordable (mainly public) kindergartens is a challenge in Riga and other larger cities, where young people tend to migrate (Eurofound, 2018). In 2017, 28.4% of all 0-3 year olds were enrolled in formal childcare, which is below the Barcelona targets of 33% and below the EU average of 34.2% (EU-SILC). Compensation for inability to provide a place in municipal kindergarten does not cover the costs of private child-minding services, which can cause people to choose not to work over accepting low-wage employment.

Poor prestige, low remuneration and heavy workload result in high staff rotation and recruitment problems at social service providers. Currently, 38.7% of municipal social services do not comply with the minimum requirement set by law to provide one social work specialist per 1 000 inhabitants. National social care centres face a large staff turnover, especially in jobs directly related to customer care (caregivers, social caregivers, social rehabilitators and social workers). One fifth of carers receive the minimum statutory wage, and many other employees are paid only slightly higher than that.

Access to adequate housing, particularly for low-income groups, is a challenge. 15.2% of the population experiences severe housing deprivation, significantly above the EU average of 4.5%. Half of those below the poverty risk threshold live in poor housing conditions ([21]). Inhabitants of rural areas, in particular in the Latgale region, live in worse housing conditions than the urban population. While the housing cost overburden rate in Latvia has been declining, still almost one-third (32.9 %) of households report that housing costs impose a heavy burden (CSB 2018a).

Social housing is scarce and often not fit for living. In 2016, social housing constituted only 0.4% of social housing stock compared to the EU average of 8%. This is insufficient to respond to demand and currently there are 7 000 people waiting for a home. Local governments, with few exceptions, invest little to improve the technical condition of social housing and as a result, one third of vacant premises are not fit for living. State-funded grants for social housing have not been available since 2009.

There is little data on homelessness and this phenomenon is not addressed at national level. There is no national strategic document addressing homelessness, and the scope of existing policy documents only addresses the provision of night shelter services. According to national data, in 2017, more than 6 800 people used municipal and private shelters. These service providers are mostly located in the largest cities of Latvia and data on homelessness nationwide is lacking. To address the issue of homelessness and improve the provision of social housing, investment would be needed, in particular at municipal level.

([21]) Deprivation measures include a leaking roof, damp walls, lack of light, window rot, no private indoor flushing toilet, no bath or shower

Social enterprises receive legal backing and financial support, but lack capacity. In April 2018, the Law on Social Enterprises came into force laying down the main principles and working arrangements of social enterprises in Latvia. To foster the creation of social enterprises a grant programme is available and so far 27 of around 220 planned grants have been awarded. Further investment would help to address such challenges as poor managerial and business skills of existing non-governmental organisations and limited access to business incubators (European Commission, 2018g).

3.3.3. HEALTHCARE

Poor health outcomes are linked to low public spending on health and to unhealthy lifestyles. Life expectancy is among the lowest in the EU and levels of preventable and amenable mortality are high ([22]). Cardiovascular diseases and cancer are the biggest causes of death. Behavioural risk factors are more prominent in Latvia than in the EU on average, with rising obesity rates and alcohol consumption (OECD/EU, 2018). Moreover, the low public financing for health limits access to quality and timely care for all. In response, the authorities have prioritised public spending on health and have initiated a number of reforms fostering the efficiency and quality of health services.

Restricted access to publicly funded healthcare leads to unmet needs for care and inequality of opportunities. State-paid health services are limited by a 'quota' system, which leads to long waiting times. To overcome this constraint, patients tend to pay out-of-pocket for private services. Additional significant barriers to accessing healthcare stem from: the level of user charges for the public services, co-payments for prescribed medicines and out-of-pocket payments for medicines that are excluded from coverage. In 2016, out-of-pocket payments constituted 44.6% of health spending in Latvia, well above the EU average of 18.2%. This leads to financial hardship for vulnerable groups such as pensioners and low-income households. The incidence of so-called 'catastrophic' and impoverishing out-of-pocket payments ([23]) for healthcare (13% and 4% of households respectively in 2013) is among the highest in the World Health Organization European Region (WHO 2018a; WHO 2018b). The above mentioned factors contribute to high inequality, with the poorest 20% of households reporting a much higher level of unmet needs for medical and dental care due to cost (9.9% and 25.5%, respectively, in 2017) than the richest 20% of households (0.9% and 3.3%, respectively).

Voluntary health insurance for a part of the population risks worsening their health status. A new health insurance system was set to come into effect in January 2019, now postponed to July 2019. For two baskets of health services, it defines a 'full basket', and a 'minimum basket'. The latter is limited to a basic set of healthcare services, such as care provided by general practitioners, preventive checks, emergency services and some other special conditions ([24]). Around 30 000 to 53 000 people (mainly seasonal workers and micro-enterprise workers) will have to make voluntarily health insurance payments in order to access the 'full basket'. Only some 5 000 people had made voluntary payments by early January 2019. The remaining of the affected population faces the risk of financial hardship if certain health problems occur or delaying their treatment until it becomes an emergency covered by the 'minimum basket'.

Health reforms concern a number of areas and are progressing, although they are still at an early phase of implementation. The implementation of the hospital sector reform, more specifically the configuration of new single-speciality, regional and tertiary hospitals and the operational development of local hospitals is

([22]) Amenable mortality: premature deaths that should not occur if timely and effective healthcare is provided. Preventable mortality is a broader concept and includes deaths which could have been avoided by interventions focusing on wider determinants of public health, such as behaviour and lifestyle factors.

([23]) Catastrophic out-of-pocket payments for health are payments by households out of their own pocket that are greater than 40 % of the household's capacity to pay (which is defined as the total household consumption minus a standard amount to cover basic needs). Impoverishing out-of-pocket payments for health are those which push households below a basic needs line (calculated as the average amount spent on food, housing and utilities by households between the 25th and 35th percentiles of the household consumption distribution, adjusted for household size and composition).

([24]) Services covered by the 'minimum basket' are specified in government regulation No 555 of 28.08.2018.

supported with financing from the EU funds. There are also plans to further develop the eHealth system and pilot a small number of multi-disciplinary health centres for the primary care reform in 2019. However, plans for reforming primary care, such as setting the number and location of health centres across the country, and the related investments, have not been prepared yet. An action plan to improve patient safety and health system quality has been set in motion. Early measures taken so far include educating healthcare staff in patient safety issues, and better application and assessment of clinical guidelines. Furthermore, a framework of indicators for health system performance assessment has been drawn up. Next steps will focus on structuring and analysing the data for these indicators so that benchmarking can take place at health provider, regional and international levels. To address behavioural risk factors, measures such as smoking restrictions, food regulations and restrictions in the marketing of alcohol and energy drinks have been strengthened.

There are scope and possibilities for improving the quality of healthcare and the efficiency of the health system (OECD/European Observatory on Health Systems and Policies 2017)**.** Hospital admission rates for asthma in Latvia are much higher than the EU average. This indicates that chronic disease management outside hospitals and the functioning of primary care are still below their potential. Furthermore, mortality following hospital admission for acute myocardial infarction and stroke are higher in Latvia than in other EU countries, with large variations between hospitals around the country. This suggests that there is room to raise the quality of acute care and the overall performance of the hospital sector. The planned health reforms are expected to result in improvements along the above lines.

Latvia faces health workforce shortages, which hamper the delivery of public healthcare and pose risks to the success of the health reforms. The number of doctors in Latvia is below the EU average (3.2 per 1 000 population, compared to 3.6 in 2016 respectively), and there are particular shortages of health workers in areas outside Riga, resulting in restricted access to specialised health services in those areas. Patient pathways and cooperation schemes between healthcare institutions are not yet established to ensure equal access to health services across the country. The number of nurses in Latvia is among the lowest in the EU (4.6 per 1 000 population in 2016). In addition, the number of nursing graduates per 100 000 population was well below the EU average in 2014 (27.9 compared to 39.1 respectively) and has decreased since then. Furthermore, most registered nurses find it more attractive to work outside the health sector. Low remuneration is a particular deterrent. The ratio of nurses' wages to the average national wage in Latvia is among the lowest in OECD countries (OECD, 2017).

The government is taking steps to improve recruitment and retention of health workers. These include an increase in the wages of medical practitioners in 2018 and the additional 20% increase each year in 2019-2021 ([25]). Other measures include: (i) compensation for the extended working hours of healthcare personnel; and (ii) using financing from the EU funds to provide incentives for doctors and nurses to work in regions outside Riga or to re-enter employment in the health sector. Nevertheless, a comprehensive strategy to tackle the shortages of nurses and provide a nursing workforce with the skills mix required for the reformed hospital and primary care sector is not yet in place.

The health system remains underfunded, despite the spending increases. Spending on health in Latvia is among the lowest in the EU. The net public spending for healthcare stood at 3.4% of GDP in 2016 well below the EU average of 7.4% ([26]). However, the government has increased the financing for health by 0.5% of GDP over 2017-2019, benefiting from a temporary deviation from the structural deficit target. Moreover, the new compulsory health contribution provides further financing for health of 0.3% of GDP from 2018. The adopted 20% wage increase for health workers amounts to 0.3% of GDP in additional financing in 2019, totalling 0.6% of GDP in 2020. Nevertheless, these increases are measured against unchanged expenditure plans in nominal terms. Therefore, total public financing for health as a ratio to GDP is estimated to have

([25]) The amendment to the Healthcare Financing Law of 19.12.2018.

([26]) Financing from the government schemes based on the System of Health Accounts.

increased to 3.6% in 2018 and to reach around 3.8% in 2019-2020.

The additional public financing for healthcare in 2017 and 2018 generated positive results. The availability of health services and innovative medicines is increasing. Waiting times have reduced in some areas, such as in cancer diagnosis and treatment, and in outpatient and day care. The government reports that the annual 'quotas' for state-paid health services were not exhausted in 2017 for the first time since the end of the economic crisis. Furthermore, the percentage of Latvians who report unmet needs for healthcare fell from 8.2% in 2016 to 6.2% in 2017; nevertheless, this remains much higher than the EU average.

3.3.4. EDUCATION AND SKILLS

Latvia's education system performs well on learning achievement, but some concerns regarding equity remain. Latvia invests a comparatively high share of its GDP in education (5.5% in 2017, compared to an EU average of 4.7%). Performance in basic skills, as measured by the OECD Programme for International Student Assessment (PISA) remains well above the EU average (OECD, 2016b). However, access to quality education is not fully equitable, with students in bigger secondary schools and gymnasiums receiving better quality education than students in the small schools more common in rural areas (Krasnopjorovs, 2017). Similarly, the early school leaving rate is much higher in rural areas (15%) than in urban areas (7%).

The existing network of secondary schools does not allow for the efficient use of resources. The number of students in general education (5-18 years old) has been decreasing, in line with Latvia's marked population decline (12% between 2004 and 2013) and is projected to contract by a further 14% by 2050. Numbers of teachers and schools have only partly followed the demographic trends. A large share of resources (17% vs 7% OECD average in 2015) goes to the upkeep of the large school network at the expense of investment in teaching and learning (OECD 2018a).

Government efforts to streamline the school network continue, but the introduction of a new curriculum has been delayed. New rules for upper secondary schools set quality criteria that will need to be fulfilled in 2020 in order to receive state financing. Schools that do not meet the criteria will be required to have a minimum number of students set by the government. Streamlining the school network may eventually lead to fewer, but bigger upper secondary schools that are better able to provide quality education. A new competence-based framework curriculum will be rolled out in pre-school as of the 2019/2020 school year, and gradually, in primary and secondary education between 2020 and 2023.

A gradual switch to Latvian as the sole language of instruction by 2021 has begun. The transition will start in the school year 2020/2021 in grades 7-9, and as of 2022/2023 all general subjects in upper-secondary education will be thought in Latvian. Ethnic minority students will still be able to follow courses of their language, literature and culture in their mother tongue. While the move may improve minority students' opportunities in (Latvian-taught) VET, higher education and in the labour market, the measure has raised concerns about the quality of teaching and about minority schools' capacity to deliver change without compromising quality, particularly for the 25% of students whose Latvian language proficiency in writing is not sufficient ([27]).

Many teachers in Latvian schools are approaching the retirement age and too few new teachers are joining the profession. Latvia has one of the highest shares of female teachers in the EU (87%) and one of the oldest — 28% of teachers were over 55, and only 25% were under 40 in 2016/2017 (Ministry of Education and Science, 2017). Young people are not attracted to the teaching profession: less than 1% of 15-year-olds aspire to work as a teacher: of these, only 0.2% are men (OECD, 2018b). A gradual increase in teachers' salaries from September 2018 to 2022 is linked to the consolidation of the school network.

The share of young adults with tertiary education is high and growing, but challenges remain concerning inclusiveness and fields of

[27] According to the Latvian Language Agency (2016), about 75% of youth whose mother tongue is not Latvian are fully self-sufficient (fluent) in writing in Latvian.)

studies. Tertiary educational attainment among 30- to 34-year-olds has increased from 25.7% in 2007 to 43.8% in 2017 and is now among the highest in the EU. However, inclusion of persons with disabilities in higher education at 24.5% is lower than the EU average of 30.3% (EU-SILC). Moreover, participation of men in tertiary education remains significantly lower than that of women and the proportion of tertiary-educated adults with a degree in science, technology, engineering, and mathematics (STEM fields) is, at 20.5%, below the EU average of 25.7%. As for labour market needs, 41% of state-funded study places are provided in STEM programmes ([28]).

The fragmentation of higher education institution and programmes affects education quality. Higher education remains fragmented despite the incentives for consolidation and gradual strengthening of quality assurance, supported by EU funds. Nevertheless, the number of study programmes grew by a third between 2005 and 2017, while student population declined by 38%. The quality of education and science are suffering as a result of the fragmentation. In 2017, performance-based funding (around 3% of total funding for higher education) was distributed to 14 higher education institutions that have successfully involved students in research and development, participated in international research projects and cooperated with businesses.

Despite the significant reform, participation in vocational education and training (VET) remains low. In 2017, the employment rate of recent upper secondary VET graduates dropped to 69.2%, below the EU average (74.8%) and the enrolment in VET remained, at 38.1%, also below the EU average (49.3% in EU). While the vocational school environment is significantly improved, the lack of career guidance at the lower levels of education is a potential obstacle for future enrolment. Graduate tracking is organised at school level, meaning that Latvia is still one of the few EU countries without a centralised approach. Continued investment in and stronger links with local economic and labour market needs, including through work-based learning, could help further increase the labour market relevance and attractiveness of VET.

VET curricula reform started in 2010 is advancing. Reform progress accelerated recently and the majority of occupational standards (230 from 242) had been updated by the end of 2018. Modular education programmes are gradually being introduced in initial and continued VET, but a significant share (172 out of planned 241) remain to be developed. Social partners are involved in the design of the reform through sectoral expert councils. It is expected that the reform, with the support of EU funds, will be finalised by the end of 2021.

Initial results of new work-based learning approach are promising. The introduction of the scheme started in 2017 and data shows that in the 2017/2018 school year there were around 1 000 students in work-based learning and above 4 000 in work practice. So far, 18 professional education institutions offer work-based learning for second- and third-level professional qualifications and 230 programmes for 85 professional qualifications have been adapted to include work-based learning. The EU-funded project to support work-based learning and practical training has been running since 2017 and is led by the Employers' Confederation of Latvia.

Latvia performs below the EU average as regards digital skills. Half of the population (52%) are lacking basic digital skills, and the gap with other EU countries is even wider for advanced skills (European Commission, 2018j). The national strategy aims to provide training on information technologies tailored to labour market needs, involve more young people in this field, and develop modern and interactive learning processes. Latvia would require substantial investment to improve the digital skills of its population and labour force for the digital transformation of its economy and society.

The level of adult participation in learning remains relatively low. Only 7.5% of adults participated in learning in 2017, below the EU average of 10.7% and the national target of 15%. Participation in adult learning has been strengthened thanks to EU funds. Since the launch of the programme in 2017, almost 17 000 employed people have participated. Every

([28]) State-funded study places account for 42% of the total (the remaining 58% being fee-paying) (Government of Latvia, 2018).

participant is over 45 years old and every fifth is low skilled. Efforts to enhance access to training, particularly for low-qualified adults, are impeded by limited information and guidance, shortage of skills recognition and validation services, and by insufficient non-financial and financial incentives, especially for SMEs ([29]). To address these challenges, the government has launched a national skills strategy project with the OECD, which will contribute to Latvia's 2021-2027 national medium-term strategy on education and skills.

Investment needs

Increased investment in skills, education and training, healthcare and social inclusion are important for improving Latvia's productivity and long-term inclusive growth. The shrinking working-age population is leading to growing skills and labour shortages. Further investment in human capital could improve labour market relevance of education and training, lifelong learning, flexible upskilling and reskilling opportunities, as well as regional labour mobility. This would in turn reduce skills' shortages and respond to demographic and technological change. Using the full labour potential also requires matching investment in social inclusion with a reduction of material deprivation. Matching investments are also needed to improve the population's health status and increase the accessibility, affordability and effectiveness of healthcare, childcare and long-term care, including transition from institutional to community-based care.

([29]) According to the benchmarking framework on adult skills and learning conducted within the EMCO Committee. See the draft Joint Employment Report 2019 for details.

3.4. COMPETITIVENESS REFORMS AND INVESTMENT

3.4.1. PRODUCTIVITY AND INVESTMENT

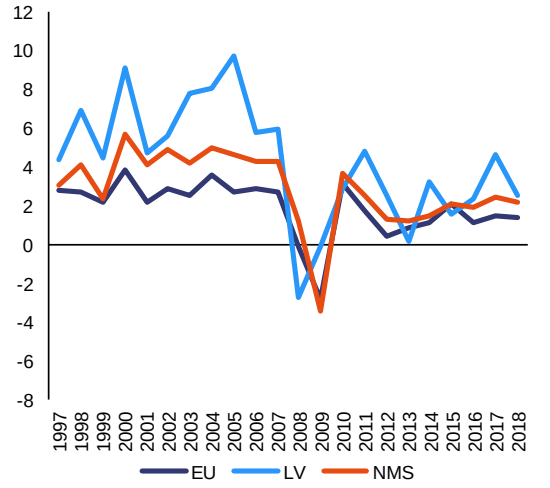
Investment needs

In order to continue converging with the EU average, investment in innovation, human capital and regional development is needed. Despite its rapid convergence, Latvia needs to continue to transform the structure of its economy towards more sophisticated products and services. Given the small domestic market, Latvia's main prospects lie with exporting higher value-added goods and services and growing its export market shares. At the moment, Latvia does relatively well in exports of knowledge-intensive services, but the share of high-tech goods in its exports is low. In order to facilitate the economy's transformation, Latvia needs to invest in human capital, including skills and health (see section 3.3.4). It needs to invest more in research and development both in the private and public sectors, including by engaging the state-owned enterprises more closely in its innovation system. Finally, Latvia needs to invest in regional development - investment in infrastructure and housing would help to integrate the lagging regions with centres of economic activity and facilitate internal labour mobility. Additionally, investment in resource efficiency is also needed in order to speed up Latvia's energy transition.

Labour productivity

Latvia's productivity has been converging with the EU average at a rapid pace, but remains among the lowest in the EU. In 2017, labour productivity in Latvia was 68 % of the EU average — considerably higher than the figure of 54 % at the height of the previous boom in 2007. The average productivity growth rate remains among the fastest in the EU, although it is currently only half of the levels attained before the 2009-2010 crisis (Graph 3.4.1)

Graph 3.4.1: **Productivity annual change, %**

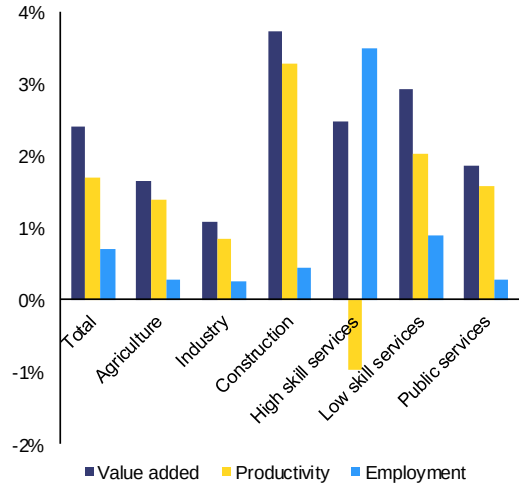


(1) EU - non-weighted average of all EU member states
NMS - non-weighted average of the EU member states that joined since 2004

Source: European Commission

Productivity growth since 2010 has been broadly based across economic activities. Productivity growth has been fairly similar among economic activities, with the exception of high-skilled services where it has been negative (Graph 3.4.2). Construction has had the highest productivity growth, but that is likely due to the recent construction boom and is potentially unsustainable. The negative productivity growth in high skill services can be attributed to investment in capacity as firms hire employees in expectation of increasing demand as evidenced by the accompanying strong increase in employment.

Graph 3.4.2: **Average annual growth 2010 - 2017, %**



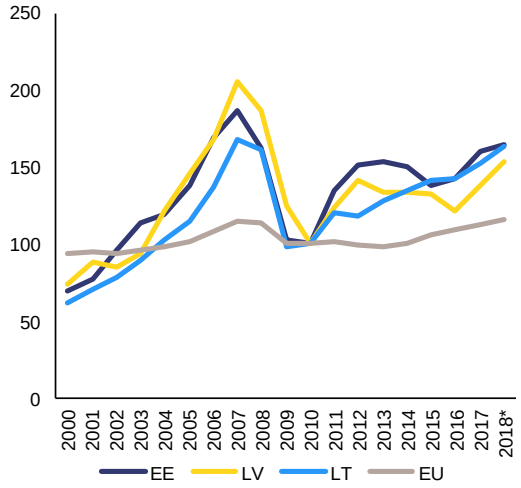
(1) High-skill services are comprised of information and communication services and financial services
Low-skill services are comprised of trade and transport services, real estate services, professional services, and arts and entertainment services
(2) The market services are grouped according to their wage level relative the economy average wage
Source: European Commission

Looking forward, due to its small domestic market, Latvia's productivity growth prospects are closely linked with its export success. Moreover, the population decline presents an additional challenge to productivity growth as the falling of the number of users puts a strain on the efficiency of infrastructure and other activities that provide solely for the domestic market (see European Commission 2018). Finally, given the large role of state-owned enterprises in Latvia's economy ([30]), their contribution to the economy's productivity growth is sizable and under government influence.

Investment

Despite a recent surge, investment levels remain only slightly above the EU average. The rapid growth over the past 2 years has helped real investments recover what was lost during the 2016 dip, yet it was only in 2018 that real investments surpassed their 2012 level. Following the initial post-crisis recovery, real investments started to decline again in 2013 before finally mounting a recovery in 2017. While public investment has increased compared to pre-crisis levels, private investment remains considerably lower and has been quite volatile (Graph 3.4.3). Since 2010 investment growth in Latvia has underperformed compared with the other Baltic countries, but has been somewhat more rapid than in most Member States that joined after 2004, although that is partially explained by the rebound from the severe decline that took place during 2009 and 2010.

Graph 3.4.3: **Real investment, index 2010=100**

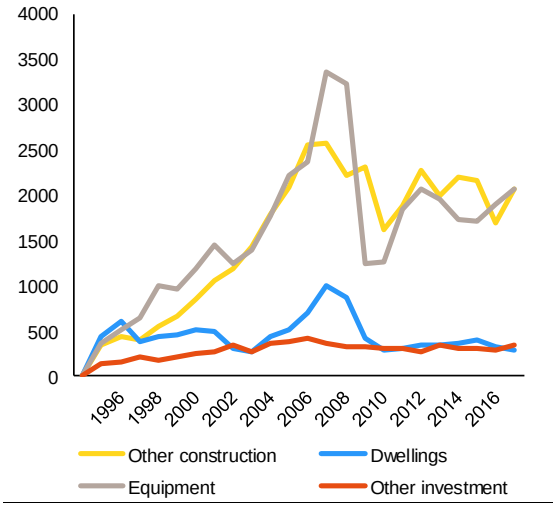


Source: European Commission

Investments in non-residential construction have had the strongest performance of all investment asset types. This is due to the increased public investment expenditure and the construction of logistics infrastructure and office space, reflecting the strong performance of the transport and business services sectors since the crisis (Graph 3.4.2). On the other hand, investment in dwellings has been weak, reflecting the effect of the declining population, deficiencies in rental and construction regulations (Section 3.2) and barriers to credit (Section 3.2). Looking at the investment trends across economic activities, manufacturing is performing particularly poorly. In 2017, investment in manufacturing was 33 % lower than it had been in 2012. This is in line with the manufacturing output growth since 2010, which has overall been weaker than the economy's growth.

([30]) The SOEs account for around 10% of all private sector employment in Latvia

Graph 3.4.4: **Real investment by asset type, million EUR in 2010 prices**



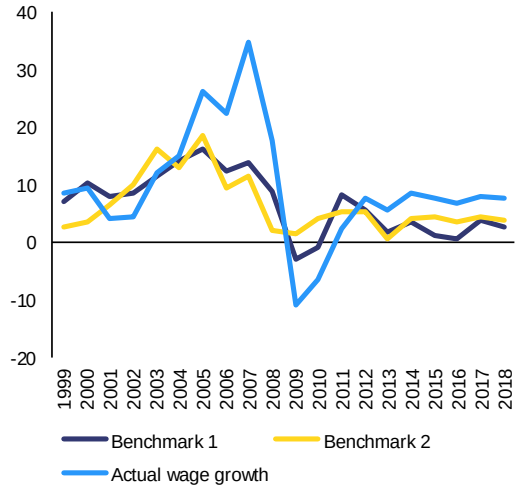
Source: European Commission

Private investment is held back by firms' concerns about demand conditions. According to the European Investment bank survey from 2018, 25% of Latvian firms considered they had invested too little over the last years, which is among the highest rates in the EU. At the same time, only 29 % of firms in Latvia report operating at or above full capacity, which is the lowest value in the EU. The share of finance-constrained firms also appears to be higher in Latvia than in other Member States. Overall, decisions by Latvian firms to withhold investment seem driven by demand conditions and some structural barriers. Weakness in internal demand may be related to the declining population, as the number of consumers in domestic markets is shrinking. In a recent Eurobarometer Survey, poor or uncertain economic outlook was seen as a major obstacle by 43 % of respondents (EU average: 29 %). In addition, a majority of respondents cited the cost and availability of external financing, and the stability and complexity of tax legislation, as obstacles to investment (European Commission, 2018i).

Cost competitiveness

Wages are growing fast on the back of favourable economic conditions and a tightened labour force. Monthly wages grew by 7.9 % on average in 2017, representing the fastest growth rate of the last 3 years. Since 2012, wage growth has exceeded the Commission wage benchmarks (see Graph 3.4.4), suggesting that wage growth may be too rapid to be sustainable. By comparison, real wages (adjusted for inflation) are increasing at a slower pace due to rising inflation. Real wages grew at a rate of 4 % in 2017. Wage pressures, however, should temper somewhat as of 2019 as the rate of investment growth normalises. However, the falling labour supply is set to ensure that the labour market will remain tight.

Graph 3.4.5: **Wage growth compared to wage benchmarks, % change**



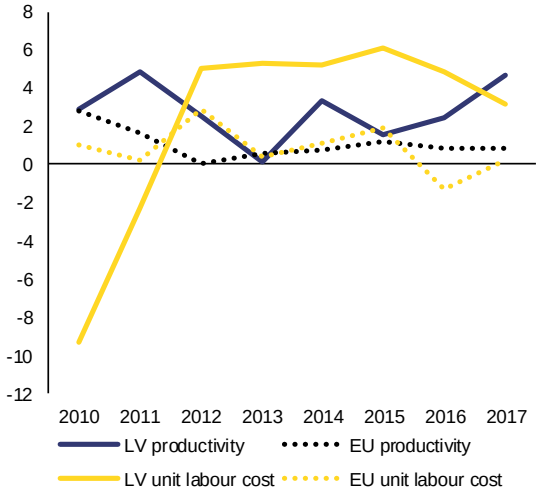
(1) Benchmark 1 is wage growth prediction based on inflation, productivity and unemployment
Benchmark 2 is wage growth that is consistent with constant unit labour cost-based real exchange rate. See Arpaia and Kiss, 2015, for details about the methodology.
Source: European Commission

Unit labour cost growth has been slowing down but remains among the highest in the EU raising concern about Latvia's cost competitiveness. After the economic crisis, unit labour cost (ULC) ([31]) growth accelerated in 2012 with growth hovering around 5% annually until 2016. In 2017, ULC growth slowed to around 3%. The ULC growth in Latvia has considerably exceeded those of its main trading partners as evidenced by the ULC-based real effective exchange rate (REER), which has appreciated by 10.3% between 2014 and 2017. The wage cost appreciation relative to the trading partners carries

([31]) Unit labour costs are calculated as nominal wages divided by real productivity. The change in ULC shows the wage inflation minus productivity growth and is used as a first-hand measure for the sustainability of wage growth.

the risk of making Latvia's exports too expensive to compete in foreign markets.

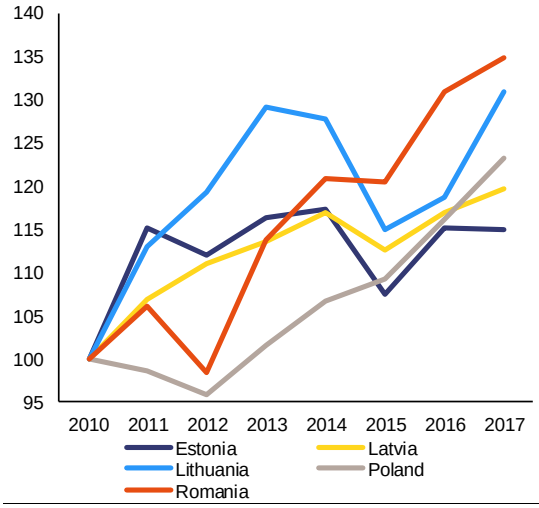
Graph 3.4.6: **Productivity and unit labour costs, annual rate of change %**



Source: European Commission

Wage growth spurred by labour market tightening is the primary driver of unit labour cost growth. The breakdown of ULC growth shows that the average productivity growth over the past 3 years has been among the fastest in the EU. However, Latvia's wage growth of around 7 % in the past 5 years has been much higher than in the rest of the EU, therefore driving the relative ULC appreciation. The reason for the recent fast wage growth is the falling labour supply and an investment-led increase in labour demand. A shrinking labour supply is set to be a permanent factor in the Latvian economy due to the demographic situation. Conversely, rapid wage growth may alleviate the pressure of falling labour supply if the country manages to stem outward migration. Further relief to the shortage of workers could come from other policies aimed at ensuring economic growth in regions outside of the Riga metropolitan area, lowering the tax wedge for low-wage workers, facilitating better internal mobility, improving the labour market relevance of training of the low-skilled and improving health outcomes.

Graph 3.4.7: **Export market shares, index 2010=100**



(1) The selected peer countries - Romania and Lithuania - have been the top performers in export market share growth among EU countries over the considered period.

Source: European Commission

Other indicators linked to external competitiveness show a more positive picture. The rapid wage growth has been slow to be passed on to prices of goods and services – unlike wage growth, inflation in Latvia has been only slightly higher than in its main trading partners. HICP inflation-based real effective exchange rate (REER) ([32]) has appreciated only modestly over the past years (see European Commission 2018). Crucially, Latvia's export market share has continued to grow, albeit slower than in other EU catching-up economies (see Graph 3.4.7) ([33]). ULC growth also has had no visible impact on the external balance as the current account has remained roughly balanced since 2010 and is forecast to remain balanced according to Commission's Autumn forecast. Furthermore, risks of domestic demand-led overheating like the

([32]) The real effective exchange rate (REER) compares the cost developments in the home country with the cost developments in its main trading partners. If the costs in the home country grow faster than in its main export markets, then REER is said to be appreciating and therefore possibly making the home country's goods less competitive in its export markets. In this report two different measures of REER are referred to - the ULC-based REER and the HICP-based REER. The first compares wage growth and the second compares inflation. The second is a more widely used benchmark for measuring price competitiveness.

([33]) Ireland, Romania and Lithuania have grown their export market share the most among EU countries since 2010

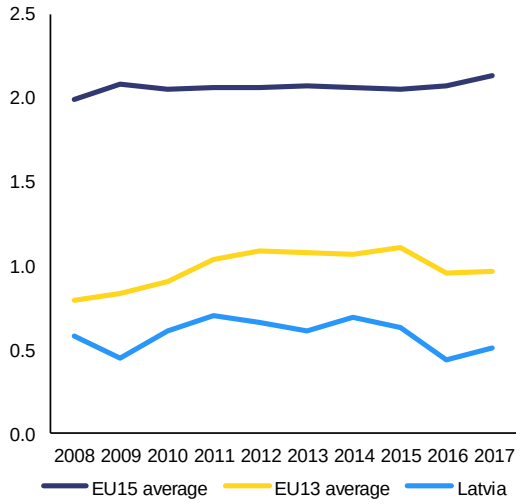
one experienced during 2004 – 2008 are low because credit growth has been sluggish and both households and non-financial corporations continue to deleverage (see section 3.2).

Research and innovation

Investment in research and development in Latvia is low and dependent on European Structural and Investment Funds (ESIFs) ([34]). In 2017, R&D intensity recovered somewhat from last year's drop, reaching 0.51 % of GDP (see graph 3.4.8). The increase was mainly fuelled by renewed ESIF funding which raised the public funding level to 0.37 % of GDP. Business expenditure on R&D also increased, but the level of 0.14 % of GDP is among the lowest in the EU. A substantial increase in investment in R&D is necessary to effectively develop a national research and innovation (R&I) system with a focus on increased and sustainable funding from national sources. Moreover, Latvia will likely not meet its national R&D intensity target of 1.5 % of GDP. Latvia's total expenditure on R&D is now at about the same level as it was a decade ago, making this the only national target where Latvia has achieved no progress, largely due to the low political importance given to R&D funding.

([34]) In 2017 Latvian national funding represented 44% of the total financing for research and development, totalling EUR 60.1 million. In comparison, amount of foreign investments (structural funds as well as other foreign funding) was 30% of the total financing for research and development, totalling EUR 41.1 million.

Graph 3.4.8: **Research and development expenditure, % of GDP**



(1) Non-weighted averages for EU15 and EU13
(2) EU15 – EU Member States that joined before 2004
EU13 – EU Member States that joined after 2004
Source: European Commission

Public research is of varying and inconsistent quality due to underfunding and the fragmentation of research performers and of the governance of the R&I system. In 2015, the share of publications in top journals was 5.9 %, compared with the EU average of 11.1 %. This is largely due the fragmentation of research institutions and because Latvia lags behind the EU average in terms of numbers of researchers, PhD students and STEM graduates. This weakness is aggravated by inadequate administrative capacity and the scattering of policymaking and implementation among a multitude of ministries and agencies. In 2018, Latvia received recommendations from the European Commission's Horizon 2020 Policy Support Facility, which advised it to put the research funding management under one roof and to increase the share of competitively-won research funding for the research institutions. The government has taken the first steps to address the latter issue, but the recommendation to tackle the fragmented governance remains to be addressed.

A broad variety of instruments to promote innovation exists but these are underutilised. The majority of the successful research-industry cooperation focuses around the 'Competence Centres' scheme, which draws industry to work together with research institutions. The portfolio of

innovation support measures includes vouchers, technology transfer and development programmes. However, the share of firms engaged in innovative activities is fairly small ([35]), which may explain the lack of demand for some of the instruments on offer. The supply of researchers from the public sector ([36]) and the mobility of researchers to the private sector is rather low and not increasing ([37]), which hinders the development of innovation activities. The government is promoting closer research cooperation among the largest state-owned enterprises and is asking them to set their medium-term innovation strategies. The poor innovation performance likely requires an adjustment in Latvia's smart specialisation strategy to focus on the areas of its economy with the most potential.

Digitalisation

Digital transformation is progressing well, but Latvia is lagging behind in integration of digital technology by businesses. Latvia continues to display a mixed performance in digital transformation. Its strongest assets are connectivity, entrepreneurial culture and ICT start-ups, where it performs above the EU average. IT-related services (public IT services in particular) improved considerably in 2018. Latvia has implemented various policy measures over the last few years to improve in areas of moderate performance (e.g. the innovation voucher) and to consolidate areas of strong performance (e.g. the Law on Aid for Start-up Companies) ([38]). However, challenges remain in the integration of digital technologies, in access to finance and in the supply and demand of digital skills. The low and decreasing number of graduates in STEM subjects contributes to the acute shortage of highly qualified human resources in the Latvian R&I system, both in the research institutions and in the productive sector. This problem may be exacerbated in the future due to demographic developments.

Integration of digital services is gradually improving but there is a shortage of skilled IT professionals. Businesses increasingly use cloud computing and electronic information sharing, but overall the use of these compared to the EU averages is limited, while Latvian enterprises continue to underexploit the potential of online selling and purchasing of goods and services, remaining considerably below the EU average for SMEs' e-commerce and related levels of turnover. Further improvements in the digitalisation of businesses are also limited by the shortage of high-skilled professionals and a persistently low proportion of ICT specialists ([39]). Among enterprises that recruited or tried to recruit ICT specialists, 50 % reported hard-to-fill vacancies. Latvian enterprises are also underinvesting in improving digital skills: only 10 % of enterprises provide training to their personnel to develop and upgrade their ICT skills, which is significantly below the EU average of 21 % (European Commission, 2018j).

Energy efficiency

More efforts are needed to improve overall energy efficiency in Latvia, in particular in the residential and transport sectors. Even though Latvia is on track to achieve its indicative Europe 2020 energy efficiency target, it is significantly behind the schedule on its energy saving obligation([40]). In 2016, it had made only 6% of the total savings it had committed to achieve over the 2014 to 2020 period. Moreover, in 2017 Latvia's energy consumption increased driven primarily by residential and transport sectors. This implies Latvia has fallen further behind its energy saving schedule. While the comprehensive renovation programme financed under the structural funds will contribute to improve Latvia's performance, more efforts are needed in order to achieve its overall energy saving's target by 2020. ESIF-funded programmes will likely not be enough to do that, incentives to draw larger private investments

([35]) Value added in high-tech (HT) and medium-high-tech (MHT) companies was 2.3 % of GDP in 2016.
([36]) The number of researchers (FTE) employed by the public sector has been steadily decreasing over the decade and in 2016 was equal to 2.7 per thousand active population, ranking 22nd, EU average — 3.9.
([37]) Researchers (FTEs) employed in businesses per thousand active population in 2016 value 0.6, ranking 24th, EU average — 3.9.
([38]) European Commission, Digital Transformation Scoreboard 2018.
([39]) The share of employed ICT specialists is one of the lowest in the EU — 2.2 % of total employment, compared with EU average of 3.7 %.
([40]) Under Energy Efficiency directive Latvia is obliged to save on average 1.5% of its final energy consumption annualy from 2014 until 2020.

in energy efficiency would be needed including through energy performance contracting ([41]) and energy efficiency obligation scheme. Latvia achieved 39.0% (according to provisional Eurostat data) share of renewable energy in 2016 and is likely to meet its 2020 target of 40%, albeit at a high cost (see European Commission, 2018h). However, the share of renewable energy in transport was only 4 % in 2016 and it is unlikely that the adopted biofuel additive requirements (into force since early 2018) will close the gap in view of achieving 10 % of renewables share in transport by 2020. Electro-mobility will contribute to this target but on a smaller scale.

Transport

The quality of transport infrastructure has improved significantly in recent years, but the quality of the road infrastructure remains well below the EU average. Latvia had a medium ranking in the 2016 EU transport scoreboard. Transport remains the principal source of energy consumption and pollution. Road TEN-T corridor infrastructure, although in place, still needs a substantial upgrade to adapt to the growing traffic intensity and to increase safety standards. Latvia has made big improvements in its road safety performance, but its fatality rate remains considerably above the EU average (70 deaths per million inhabitants in 2017, against the EU average of 49). After an impressive decrease of 14 % in fatalities compared to the previous year, preliminary figures for 2018 show an increase of 5 %. Connections between TEN-T corridors and national or local transport networks (including across borders) are rated very poorly: Latvia ranks 27th out of 28 in the EU transport scoreboard for the quality of roads). The levels of traffic congestion and related pollution, particularly in Riga, remain an issue due to the limited coordination of investments with traffic management and other policy measures for urban transport.

Latvia is lagging behind in the completion of Rail Baltica and therefore of the TEN-T conventional rail core network. The main TEN-T corridor railway infrastructure is not yet in place (the 'Rail Baltica' railway corridor connecting the Baltic states to the standard-gauge European network). The Commission Implementing Decision on the Rail Baltica expects completion of this missing link by 2026 and sets out a timeline for the intermediate steps. According to the current assumptions (Ernst & Young, 2017), further investments of about EUR 1.67 billion will be needed to complete the project in Latvia. The precise investment need will be known upon completion of the technical design phase. So far, only 14 % of railway lines are electrified (although the percentage should increase significantly with the completion of the EU-funded major project for railway electrification). Between 2005 and 2015, final energy consumption in transport in Latvia increased on average annually by 1.0 %, which is slower than the 1.8 % average annual increase of GDP. This is highly correlated with trends in passenger activity rather than with freight transport.

Business environment

The business environment in Latvia is favourable, but the shadow economy remains a challenge. Latvia is ranked 19th out of 190 in the 2018 World Bank Doing Business Review, unchanged in comparison with the previous year. Most Latvian sub-indicators are high in the ranking except for getting electricity, recovery rates in insolvency cases and dealing with construction permits. The Latvian authorities are working on further improving the business environment, especially for SMEs and start-ups, based on annual action plans. Recent policy measures include the introduction of the 'consult first' principle and the issuing of guidelines to improve cooperation between public authorities and entrepreneurs. Moreover, several e-government services have been further enhanced, such as the electronic tax declaration system and the entrepreneurship section of the Latvija.lv e-government portal, which provides information on how to start and develop a business. An SME-test and 'start-up test' are applied to all new regulations (European Commission, 2018e). However, the shadow economy remains a structural constraint and is among the largest deficiencies of the business environment mentioned by business organisations and

[41] Latvia already partly removed regulatory barriers to attract private investments in the residential sector trough energy performance contracting. Discussions between the government, municipalities and other stakeholders have started to overcome regulatory, financial and legal barriers for energy performance contracting in public sector

entrepreneur surveys. A number of measures are being implemented to enhance tax compliance. These include introducing benefits through an 'enhanced cooperation programme' and improving monitoring capacities. However, progress on tax compliance in Latvia has so far been modest (see Section 3.1.3).

Latvia performs well in terms of entrepreneurial culture and ICT start-ups. The Global Entrepreneurship Monitor shows that Latvia's strong performance in entrepreneurial culture is backed by a widespread perception of entrepreneurship as a desirable career choice. Latvia also performs particularly well on ICT start-ups, having one of the highest ICT enterprise birth rates in the EU. This also reflects the success of recent policies that are conducive to the creation of a business-friendly environment and support for start-ups (European Commission, 2018j).

Environment and climate

Despite significant investments in waste infrastructure, the landfilling rate remains high. In 2016, the waste recycling rate was 64 %, and the municipal waste recycling rate (including composting) was 25 %. Latvia risks missing the 2020 municipal waste recycling target and the 2020 landfill diversion target for biodegradable waste because recycling and waste issues are not addressed systematically (European Commission, 2018b). Effective separate collection of recyclables, including bio-waste, is not being carried out effectively yet, while economic incentives for households to separate waste at source are lacking. Moreover, extended producer responsibility schemes do not fully cover the costs of separate collection and subsequent treatment of waste. As a result, the transition to a circular economy remains challenging for Latvia. The share of secondary use of raw materials was 3.9 % in 2016, compared with the EU average of 11.7 %**.**

Investments need to be scaled up to comply with the ambitious recycling targets for the post-2020 period ([42])**.** Investments should focus on projects higher up in the waste hierarchy, such as introduction of pay-as-you-go schemes, separate collection, sorting facilities, recycling infrastructure for dry and wet recyclables, projects improving waste data reporting and extended producer responsibility, and capacity building projects for municipalities to implement the necessary waste management reforms around the country.

Latvia's eco-innovation performance is negatively impacted by businesses' low investment. The low financial capacity of SMEs means little innovation on sustainable development ([43]) is taking place. The fragmented support landscape presents another barrier. The overall position of Latvia in the Eco-Innovation Index 2017 has declined and Latvia now ranks 22nd in the EU (European Commission, 2017b). Prioritisation of research and more investment in the bio-economy, smart materials, sustainable energy solutions are beginning to deliver the first results, but they need to be continued in order to help Latvia shift its economy to environmentally sustainable foundations.

Waste water treatment is unsatisfactory in a number of agglomerations and requires further investment. The estimated investment needed to ensure adequate collection and treatment in the remaining agglomerations is EUR 64 million (European Commission, 2017b). Latvian rural areas have lower access to safe water and to the centralised water supply system than urban areas. Waste water treatment will also help with much-needed nutrient abatement in the Baltic Sea, which suffers from eutrophication, which in turn is affecting provision of ecosystem services. On climate change risks, Latvia is subject mainly to coastal erosion, river floods and drought. Investment in sustainable water management, in particular nature-based approaches, would mitigate the negative effects of flooding and droughts.

Despite past improvements Latvia's greenhouse gas intensity remains significantly above that of the EU average. Latvia is expected to over-achieve its 2020 effort sharing decision greenhouse

([42]) Directive (EU) 2018/851, Directive (EU) 2018/852, Directive (EU) 2018/850 and Directive (EU) 2018/849 amend the previous waste legislation and will set more ambitious recycling targets for the period up to 2035.

([43]) Eco-innovation is *'any innovation that makes progress towards the goal of sustainable development by reducing impacts on the environment, increasing resilience to environmental pressures or using natural resources more efficiently and responsibly'*.

gas emissions target. Its own projections expect emissions to increase by 8% relative to 2005 levels, compared to a target that allows for an emission increase of 17%. However, the situation is less positive when it comes to achieving the more ambitious 2030 target which requires Latvia to reduce its emissions by 6% by 2030 (relative to 2005 levels). They are projected to rise by 13%, instead. Moreover, despite past improvements Latvia's greenhouse gas intensity also remains significantly above that of the EU average. Achieving the 2030 targets will thus require significant additional measures and accompanying investments, in particular in the transport, agricultural and manufacturing sectors, where emissions are projected to increase the most.

3.4.2. SINGLE MARKET INTEGRATION

Internal market for goods and services

Latvia is a very open economy and well integrated in regional and EU markets. Trade openness in Latvia is about 120 % of GDP, far above the 83 % of GDP for the EU as a whole. The share of the Latvian intra-EU export of goods is about two thirds, slightly higher than in Lithuania but still below Estonia, where about three quarters of goods go to other EU Member States. The services sector accounts for about 74 % of Latvia's total value added and 68 % of total employment, and has been steadily increasing since 2010. The ICT sector has shown impressive growth over the last few years, surpassing 4 % of GDP. Overall, regulatory restrictions in the services sector are lower than the EU average.

Export volumes have grown rapidly since 2010 and stand out as the main driver of economic growth. According to provisional data from the Central Statistical Bureau of Latvia, over the first eight months of 2018, the foreign trade turnover of Latvia at current prices reached EUR 18.05 billion, which is 9.8 % more than in the corresponding period of 2017. Machinery and mechanical appliances, electrical equipment and wood articles are the most significant export products, constituting 18 % and 17 % respectively. Most Latvian producers (65 %) are concentrated in low-technology industries, such as basic wood and metal processing, with little innovation prospects. Only 2 % of manufacturing companies are active in high technology sectors.

SME internationalisation is actively promoted. The Latvian Investment and Development Agency (LIDA) offers information and has representative offices in major EU and non-EU export markets. Moreover, the 'International Promotion of Competitiveness' programme supports SMEs' internationalisation by covering costs related to participation in international trade fairs and organisation of trade missions. Companies also have access to short-term and long-term export credit guarantees. Latvia has an efficient customs system. The country continues to score among the best EU performers on both information availability and advanced rulings on customs, which facilitate the declaration, release and clearance of the intended import or export of goods (European Commission, 2018c). The performance on border agency cooperation has not changed since 2015 and still seems to indicate some room for further improvement.

The use of e-commerce and e-business is increasing. The percentage of SMEs that make use of electronic sales channels has increased by 2.5 percentage points to 10.6 %, reducing the gap with the EU average (17 %). The percentage of SME turnover from e-commerce has also increased somewhat (up 0.5 pp. to 8.6 %). While the proportion of SMEs that export to other EU Member States increased from 3.9 % to 4.7 % between 2015 and 2017, this figure is still quite low when compared to the EU average of 8.4 %. High delivery costs seem to be a major barrier encountered by firms wanting to sell online to customers in other EU countries.

Latvians are the most active users of collaborative economy platforms within the EU. According to a recent Eurobarometer survey, 40 % of Latvian citizens have used services offered via collaborative platforms, which is considerably above the EU average of 23 %. This mainly concerns collaborative platforms for transport services, which are highly developed and frequently used in the Baltic countries.

Energy union

Latvia is progressing well towards completing the key electricity infrastructure projects that

form part of the implementation of the Baltic energy market interconnection plan (BEMIP). The third interconnection between Latvia and Estonia is planned to be finalised by 2020 and the 'Kurzeme ring' in the autumn of 2019, both on schedule. The project development for the construction of an internal 330 kV powerline 'Riga TEC-2 — Riga HES' started in August 2018 and is planned to be finalised by 2020, together with the third Latvia and Estonia interconnection.

Synchronisation of the Baltics countries' grids with continental Europe remains the key priority for the years to come. The projects' main goal is to increase the security of supply of the whole Baltic region. The political roadmap signed on 28 June 2018 by the European Commission and three Baltic states and Poland paved the way for implementation of the project by 2025. This will include building the necessary infrastructure to reinforce the internal grid of the three Baltic states, building a high-voltage direct current line between Lithuania and Poland and carrying out optimisation measures. Significant investment will thus be required for the coming years to construct the necessary infrastructure for synchronisation.

Work on developing the regional gas market is ongoing, with the aim to make it operational in 2020. Estonian, Latvian and Finnish gas transmission system operators signed a memorandum of understanding on 12 October 2018 to pave the way towards integrating the natural gas markets of Latvia, Estonia and Finland in 2020. The regulatory framework is expected to be adapted in the course of 2019 and 2020.

The opening of the domestic gas market in 2017 had a positive impact on the gas prices for consumers and increased competitiveness; however, full unbundling is yet to be resolved. Despite the positive impact of the opening of the gas market in April 2017, Latvia still needs to finalise the unbundling of its transmission system operator Conexus. The national regulator certified the transmission system operator in September 2018 on condition that full unbundling of Conexus ownership will be resolved by January 2020 to ensure that it complies with the Gas Directive.

Reform of the renewable energy support scheme is expected to enable further deployment of the Latvian renewable energy potential. In the spring of 2018 the Ministry of Economy initiated a reform of the existing support scheme for the electricity produced from renewables with a view to reduce the costs to final consumers (a threshold of 0.3 % of GDP). The Ministry of Economy proposed a set of solutions for abolishing the mandatory procurement component as of January 2022. The Ministry has also proposed necessary amendments to the Electricity Market Law to ensure greater control mechanisms of the existing scheme.

Latvia has a high potential to further develop renewable energy sources in a cost-effective way. Support mechanisms to encourage more use of renewable energy sources (including in district heating) and further investments to develop additional renewable energy production, including in smart grids and energy storage infrastructures would be needed. This would be an opportunity to boost Latvia's economy, strengthen security of supply and expand exports within the EU and towards non-EU countries, hand-in-hand with the needed synchronisation of its electricity grids with the European electricity system.

Investment needs in the energy sector will be formulated in the energy plan due December 2019. On 28 December 2018, Latvia submitted to the Commission its draft integrated national and energy plan on how to achieve the 2030 energy and climate objectives. Latvia plans to submit the final plan by December 2019, according to the deadline stipulated in the Governance Regulation. In its final plan to be adopted by 31 December 2019 in line with the Regulation on the Governance of the Energy Union and Climate Action ([44]), Latvia should provide an overview of its investment needs until 2030 for the different dimensions of the Energy Union, including renewable energy, energy efficiency, security of supply, and climate mitigation and adaptation. This information will further contribute to the identification and assessment of Latvia's energy and climate-related investment needs.

([44]) Regulation (EU) 2018/1999.

Digital single market

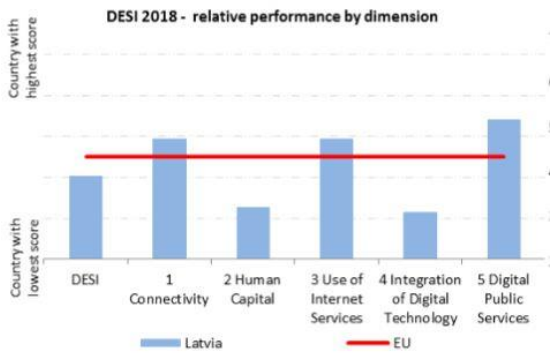
Latvia has been among the EU frontrunners on fibre and 4G deployment. It has the highest fibre to the premises (FTTP) coverage in the EU in rural areas (69%), and being well above the EU's average by the next generation access (NGA) coverage in the whole country (91%).

However notable urban/rural divide persists, in terms of fixed broadband coverage, with 18 % of the rural households lacking fixed broadband infrastructure (European Commission, 2018j). The absence of progress in fixed broadband coverage is partially compensated by a rapid increase in mobile broadband, thanks to data bundles being widely available at affordable prices and high 4G coverage. In addition, in order to keep up with the fast pace of connectivity developments, market players need appropriate spectrum blocks to be available to them for early 5G trials and deployment.

Bridging the digital divide remains a challenge, despite the progress ensured by EU-funded projects. Some progress in coverage has been made through the 'middle-mile project' financed from EU structural funds to deploy optical cables and optical network access points in places that currently have no broadband access and no plans for commercial deployment. At every access point, operators have the opportunity to create a local loop (the 'last mile') utilising the new network to offer retail services to end users. 'Last mile' investments by companies are, however, lacking in some parts of the country. Further efforts are necessary to close the last mile gap.

The use of digital services is widespread but digital skills remain a challenge. More and more Latvians are using internet services such as internet banking and e-government. However, citizens' digital skills will need to improve if Latvia is to benefit from an inclusive labour market and improve the productivity of businesses and integration of digital technologies (see Sections 3.3.4 and 3.4.1).

Graph 4.4.1: **Europe's Digital progress report (EDPR), 2018**

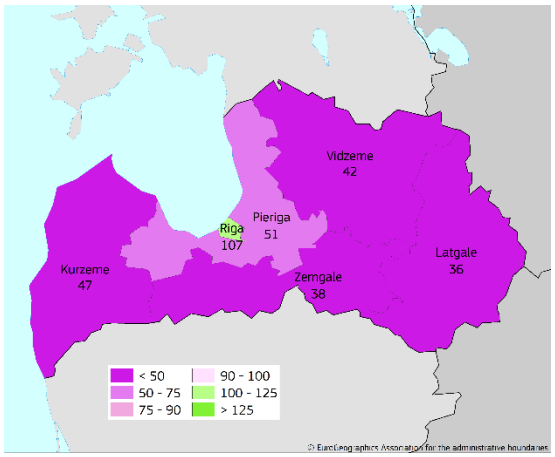


Source: European Commission

3.4.3. REGIONAL DEVELOPMENT

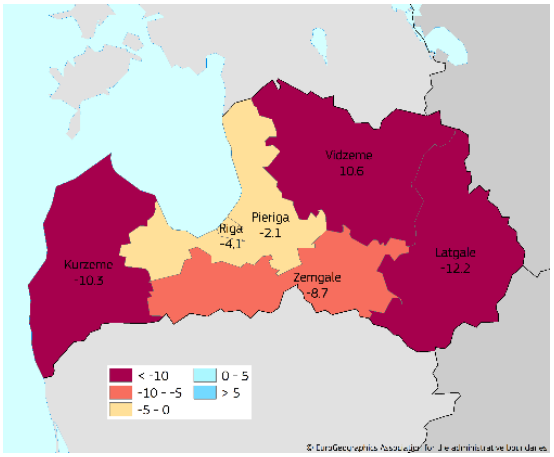
Significant economic differences persist between the capital and the other regions of the country. While the country as a whole is converging with the EU, the gap in economic performance between the capital region and the rest of the country has not narrowed since EU accession. Between 2010 and 2016, the Riga region grew 19 % more than the EU average, while the other regions' growth remained significantly lower (always below 10 %, with only 2 % growth in Zemgale). The city of Riga plays a key role in the economy of Latvia, contributing around 54 % to the total GDP. It has almost threefold higher GDP per capita (107 % of the EU average) than the regions of Latgale (36 %) and Zemgale (38 %), which are lagging behind in this area (Map 3.4.4.1).

Map 3.4.4.1: **GDP per head in Latvian regions, index EU=100**



Source: Eurostat, Own calculations

Map 3.4.4.2: **Population change in Latvian regions, 2010-2016, %**



Source: Eurostat, Own calculations

Socioeconomic disparities are linked to a rapid depopulation and ageing of the Latvian regions. Riga metropolitan area (Riga and Pieriga) constitutes 51 % of the population of Latvia and is the only region that has experienced positive net migration. In all other regions, depopulation is caused by negative natural change and negative balance of both inter-regional and international migration. Depopulation and exacerbated ageing of the society is heavily affecting peripheral regions (Map 3.4.4.2) which have lost more than 10 % of the population since 2010, while Riga region lost only 2.1 %. This is due to demographic trends and to external and internal migration. Depopulation is putting strains on the public sector capacity to deliver on the efficiency, accessibility and quality of the public services, with particularly significant pressures on education and health systems (see chapter 3.3). Regional and social disparities are partly exacerbated along language differences (25 % of Latvian population belongs to the Russian speaking minority) with the poorest of the Latvian regions, Latgale, having a large Russian speaking minority (37 %) and only 47 % of Latvian speakers. In addition to the divide among regions, socioeconomic differences persist also due to urban–rural divide, with 43.5 % of the 1.97 million Latvians living in cities (with 0.74 million in Riga), 19.4 % in towns and suburbs, 37.1 % in rural areas).

Lack of a qualified workforce and of good job opportunities heavily affect the competitiveness of peripheral regions. Lack of good job opportunities has detrimental social effects such as relatively higher levels of poverty risks in the peripheral regions ([45]) compared to Riga, and is one of the leading causes of emigration. Productivity (see 3.4.1) differs notably among Latvian regions, with the Riga region at 74 % of the EU average, with much lower levels in other regions (38 % in Latgale). Enterprises in Latvia are characterised by their lack of innovation prospects (see 3.4.1), small size (EBRD, 2017), low added value/complexity, high resource intensity and lack of integration in global value chains. Most producers (65 %) are in fact concentrated in low technology industries, such as basic wood and metal processing, with little innovation prospects. Only 2 % of manufacturing companies are active in high technology sectors. These shortcomings are even more pronounced in regions, where companies face also other hurdles such as lack of finance and access to services. Particularly in the Latgale region, most of the unemployment (15 % compared to 4 % in Riga) is structural (40 % of unemployed are long- term unemployed)). As a result, Latvian regions experience a general skills mismatch between the active workforce and the demand from the productive sectors due to the lack of adequately qualified workforce (see section 3.3.1) despite higher unemployment rates. These

([45]) The at-risk-of-poverty rate in Latgale was 27 %, while in Riga it was 13 %.

factors limit the attractiveness for the external investments which are necessary to trigger regional economic development.

The quality of public services differs notably among different Latvian regions, influencing their territorial attractiveness. Access to specialised health services is often an issue in peripheral regions, exacerbated by the shortages of health workers in areas outside Riga, resulting also in restricted access to quality healthcare (see Section 3.3.3). General education quality levels are uneven throughout the country (see Section 3.3.4). In rural areas equal accessibility to water and sanitation services by end users is sometimes challenging, with lower access to safe water and to centralised water supply systems in comparison to urban areas. Furthermore, 28 % of Latvia's rural population does not receive sanitation coverage of adequate quality (EBRD, 2016). These data show that outside the Riga metropolitan area, large parts of Latvia do not present sufficient territorial attractiveness, making it very difficult to tackle emigration, especially of young people.

Significant regional differences over mobility and digital infrastructure endowments underline distinct investment needs. Connectivity gaps with peripheral and border regions are still extremely pronounced: the share of population in a neighbourhood of 180 km radius accessible within 1h30 by road is only 37 % (compared to the EU average of 46 %). Mobility difficulties limit both the possibility for the workforce to commute but also the attractiveness for new productive investments. The lower socio-economic development in the regions is marked also by the presence of 'inner peripheries'. These are marginalised territories facing challenges of access to regional centres and to basic services of general interest throughout much of the country. These inner peripheries are especially found in the north-eastern part of the country bordering Estonia and Russia, due to poor accessibility, and in a large part of the Kurzeme region, due to poor accessibility to regional centres and/or services (ESPON, 2018). Moreover, digital public services in rural areas are hampered by a lack of broadband coverage.

Local public administration efficiency remains an issue, with municipalities struggling to be cost-efficient and to provide good quality public services. The sustainability of municipal finances and the ability to provide services is generally an issue for municipalities, particularly in the most deprived areas, with direct impacts on public services to citizens. The territorial socio-economic divide is aggravated considering that the main source of internal revenues for municipalities stem from personal income and property taxes, with revenues typically smaller for municipalities of poorer regions. The implementation of territorial development strategies is hampered by the low capacity and fragmentation of local bodies to administer integrated territorial investments, and the generally low motivation to attract investments and create jobs.

3.4.4. QUALITY OF GOVERNANCE

Quality of governance

Latvia has made efforts to improve the quality of governance. Latvia ranks high on access to government information because of long-term efforts to institutionalise it and digitalisation efforts are also positive. However, transparency does not eliminate all corruption at once. Latvia has strong strategic planning capacity and a moderately effective inter-ministerial coordination set-up. However, regulatory impact assessments are not fully deployed for evidence-based analysis, while public complaints have been made about the unpredictability of laws and regulations. Consistent human resources management across different levels of government is low and the civil service remuneration system still largely depends on the financial capacity of the ministries and agencies.

Public sector reform

The public administration reform plan adopted in November 2017 is being slowly rolled out. The stated aim remains to make the central government leaner, more effective, responsible and flexible by centralising support functions (such as accounting), reducing staff levels on average by 2 % per year, fostering innovation and training, and making the remuneration system more competitive with the private sector. In 2018, some

3 500 staff were trained, including 180 high-level managers, while staff cuts were mostly limited to eliminating vacancies. An example of good practice in the centralisation of functions is the State Treasury providing accountancy services for eight other institutions, including Ministry of Finance from 2019. The reform would benefit from clear annual targets and verifiable performance indicators.

The public sector reforms currently exclude municipalities, which enjoy a high degree of autonomy. The declining population and urbanisation leave legacy infrastructure and public services under-used in some rural areas. These trends make the case for the downsizing of municipal administrations, more efficient budgeting, and exploring innovative solutions to ensure accessibility and quality of services for residents. Local authorities account for some 60 % of all public sector employees. There is only limited benchmarking to assess the performance of administrations at municipal level ([46]). The state audit reviews have demonstrated marked differences in service delivery and costs. Out of 119 municipalities, at the beginning of 2018, 39 are under the threshold of 4 000 inhabitants and a further 18 do not meet other legal criteria. Lack of critical mass may pose challenges in ensuring sufficient labour supply to attract new investment and promote entrepreneurship. Local governments have been encouraged to cooperate voluntarily in policy areas with a cross-regional dimension, while more far-reaching regional reforms (including administrative, territorial and service reforms) would be welcome.

Digital public services

Latvia has substantially improved its digital public services. Progress has been driven by: (i) increased e-government use; (ii) the availability of pre-filled forms; and (iii) the availability of open data due to the launch of the national data portal, which makes it possible to access public administration datasets and metadata directly and to link to other data sets. Latvia has improved in its ranking of digital public services, from 14th to 9th in the EU and is ranked 6th in the EU on digital public services for businesses (European Commission, 2018k). Further efforts are planned to: (i) increase the effectiveness of public administration through the efficient use of cloud computing services; and (ii) create a more favourable business environment for entrepreneurs and SMEs by lowering administrative burden through e-services and reducing security vulnerability and preventing cyber-attacks.

Public procurement

Efficiency and transparency in public procurement have improved, but not significantly. The use of negotiated procedures without prior publication of a contract notice has slightly increased from 10 % in 2017 to 12 % in 2018 (EU average: 4 %). The share of tenders with the participation of only one bidder has also increased from 27 % in 2017 to 36 % in 2018 (EU average: 24 %). In addition, some negative perceptions of the fairness of the procurement procedures and of possible corruptive practices could lead to decreased competition because of the dissuasive effects on potential bidders (FICIL, 2018). A lack of transparency, in particular on low value procurements at municipal level, still persists, although it is hoped to be solved in 2019 with the publication of all procurement-related information on a single website. The Procurement Supervision Bureau (IUB) carries out investigations based on complaints received from whistleblowers, bidders and the media. In 2017, 45 such checks were carried out, while in 2018 there were 20 checks of procurements involving EU funds. Greater use of knowledge and use of e-procurement could improve transparency and efficiency of procedures.

Justice system and insolvency

Measures to improve the quality and independence of the justice system are being gradually implemented. The amended Law on the Judicial Power, among others, strengthened the powers of the Council for the Judiciary in appointing court presidents, transferring judges to vacant positions, and approving judicial training. The procedure for selecting candidate judges is now determined by the Council and new legal safeguards ensuring the membership of elected

([46]) Small Business Union annually publishes an index of most business-friendly municipalities, showing the importance of both size and business-orientation of local governments in attracting investment.

judges in the Commission for the Selection of Candidates for Offices of Judges are envisaged. However, with only a few employees, the administrative capacity of the Council remains very low, since the Court Administration with almost hundred employees remains under the authority of the Ministry of Justice. As regards the quality of the justice system, room for improvement remains, particularly on making legal aid more accessible (2019 EU Justice Scoreboard (forthcoming)) but remedial measures are envisaged in civil cases. Judicial map reform was implemented, reducing the need to transfer cases to less burdened courts, but the merging of courts could be accompanied by an appropriate re-distribution of vacant and other judicial posts, and court presidents using case-management tools in order to resolve the issue of certain overburdened courts..

The analyses of the effectiveness of the insolvency framework are being gradually followed-up. Judges and other experts on insolvency law published an analysis of selected insolvency cases from 2008-2014, which had been suspected of abuses, and the report concluded that in 44 of those cases signs of grave misconduct were present. While the statute of limitations has already expired and disciplinary action against the judges involved was not possible anymore, the cases were sent to the general prosecutor, who concluded there were no grounds for any criminal charges. Legislative measures aimed to address the identified deficiencies appear to be in place. A new overview of insolvency jurisprudence in 2015-2018 aims at improving consistency of case law and legal certainty and representatives of investors (FICIL) confirm a certain progress. Disciplinary liability and control of insolvency administrators by the Insolvency Control Service under the Ministry of Justice appears to be in place, but to achieve its effectiveness, continuous action by authorities is needed. On-site visits by the Control Service have discovered irregularities in 80% of visits (but mostly of minor significance, such as failing to submit a report to creditors, while sometimes more serious, e.g. charging of unreasonable costs).

Fight against corruption

Corruption remains a concern, but Latvia has improved its score on some corruption indicators. In the 2018 Global Competitiveness Report Latvia's score on the incidence of corruption has improved. Moreover, Latvia's rank as regards corruption control is better than the previous year in the 2017 World Bank Governance Indicators. However, the 2017 Eurobarometer survey showed that corruption is both more widespread and more tolerated than in EU countries on average([47]). The share of businesses pointing to corruption being an obstacle to their business has, however, decreased.

The Corruption Prevention and Combating Bureau appears to have increased its effectiveness, but there are delays in the implementation of the national anti-corruption strategy and in adopting relevant legislation. In October 2018 the Bureau for the Prevention and Combat of Corruption (KNAB) underwent a reorganisation to strengthen its analytical and investigatory capacity. The salary level of KNAB staff increased, but the staffing level is still not deemed adequate.. The number of investigations carried out by KNAB has increased by 42 % since the new head took office in June 2017. By the end of the year KNAB is expected to have adopted a mid-term report on the implementation of the 2015-2020 national anti-corruption strategy. According to the authorities, there are delays in the implementation of the strategy. All public institutions, including state-owned enterprises and municipalities have the obligation to set up by the end of 2018 a system of internal control to prevent corruption and the risk of conflicts of interest. According to a report released in July 2018, only 45% of the institutions surveyed had established a plan for anticorruption measures.

Latvia is strengthening its legal anti-corruption framework by adopting a whistleblower protection law. The whistleblower protection law was adopted in October by Parliament and will enter into force on 1 May 2019. The Law regulates channels for reporting, establishes protection for whistleblowers, and designates a contact point in the State Chancellery. A Code of Ethics, which has been under discussion for several years, was adopted by the Cabinet of Ministers on 21

([47]) 84 % consider that corruption is widespread in Latvia (EU average 68 %). 59 % consider that corruption is tolerated (EU average 26 %), whereas only 31 % consider it unacceptable (EU average 70%).

November 2018.. However, the draft does not cover politically appointed persons, an issue also been signalled by GRECO (2017). Discussions on a law regulating lobbying have been dragging on for several years.

Amendments to the Law on conflicts of interest are under discussion, but some draft proposals raise concerns. A first raft of amendments to the Law on conflict of interest was adopted by Parliament on 18 October 2018. These regulate the cooling-off period for officials leaving the public sector, extend the categories of officials who are requested to submit asset and interest declarations, extend the obligation to declare conflict of interest for Members of Parliament and clarify the difference between donations and gifts. Other amendments under discussion would exempt certain categories of officials (approximately 14 000 officials performing supervisory and control functions) from the obligation to submit interest declarations. This may open the door for abuses, as heads of institution enjoy large discretion to decide who should fill in these declarations. Moreover, there is a proposal to keep the declarations online only for a limited period, which may prevent the comparison of wealth with previous years.

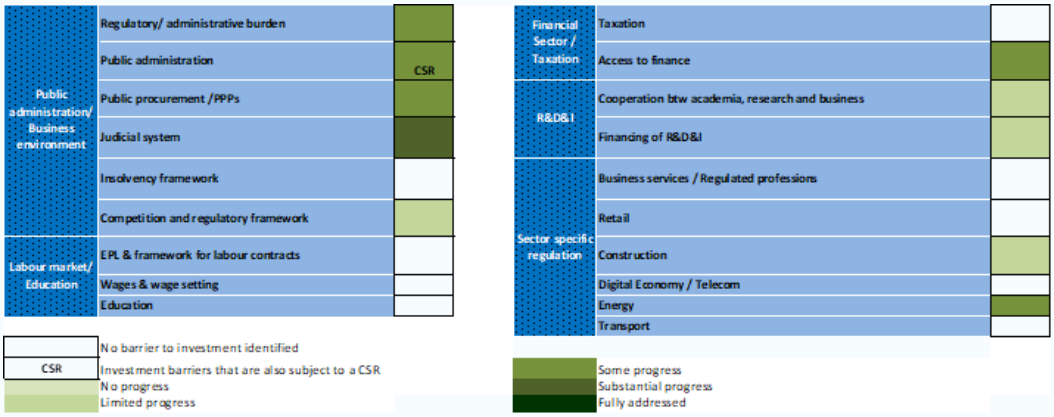
Asset and interest declarations are still not checked following a clear approach. Declarations are updated by officials on an annual basis on an electronic platform run by the State Revenue Service (SRS). Approximately 60 000 public officials submit such declarations, Latvia being among the EU countries with the most extensive conflict of interest regulation (EuroPAM). Except for personal data information, declarations are open to public scrutiny. As regards verification of these declarations, the responsibilities are split between KNAB, which is in charge with the conflict of interest part, and the SRS, which is in charge of verifying the assets. While KNAB seems to have a risk-based approach in checking these declarations, there is no similar approach on the part of the SRS. This results also from the latest GRECO report (2018), which states: '*Compared to the KNAB, no internal criteria for in-depth verifications in respect of those public officials who may be susceptible to higher corruption risks and no internal procedure on how to conduct such assessments have been elaborated (by SRS)*'. Moreover, two recommendations from 2015 by the State Audit Office for the SRS to check asset declarations against previous years and to develop performance indicators to assess the effectiveness of the asset and interest declarations system have been postponed until December 2019.

Box 3.4.1: **Investment challenges and reforms in Latvia**

Section 1. Macroeconomic perspective

In 2017 the investment rate in Latvia was 21% of GDP. This is close to the average investment rate since 2010, but significantly lower than the 30 % of GDP average investment figure for 2000-2008. The decline compared to the pre-crisis period reflects a slowing convergence process as Latvia becomes richer but also reflects lower demand for residential investment due to Latvia's population decline. Investment in equipment and non-residential construction are above the EU average, reflecting the sizeable role of financing from EU funds (Section 3.4.1). By contrast, investment in intellectual property products is substantially below the EU average and has not increased since 2000. Weak investment in housing is the flip side of weak mortgage lending (see Section 3.2). As growth in lending is expected to remain below nominal GDP growth for the foreseeable future, the reduction of household debt is expected to continue.

Section 2. Assessment of barriers to investment and ongoing reforms



Main barriers to investment and priority actions underway

1. Investment in housing is hindered by a lengthy and costly construction process, poor protection of landlords' interests in the rental law and a lack of long-term financing (of 30 years or more) for projects outside Riga. Housing investment outside Riga is crucial to regional development as it facilitates better employment opportunities through higher labour mobility within the country. Regional development is also an important ingredient in reducing emigration and thus slowing the rate of population decline.

2. The relatively large shadow economy is the primary structural obstacle to higher credit growth according to Latvian banking and other business associations. Banks are reluctant to lend to firms whom they suspect hiding some of their transactions to avoid paying taxes, even if their financial situation would allow them to obtain credit (Sections 3.1 and 3.2).

3. R&D investment in Latvia is among the lowest in the EU and is overly dependent on EU funds. While a variety of instruments are on offer to boost R&D investments, they are not fully utilised due to lack of demand. Given that some of the largest, best funded companies in Latvia are state-owned, directing them to engage in R&D activities more actively is one of the few policy levers available to promote R&D investment. Latvia has taken the first steps in this respect by requiring its largest state-owned enterprises to lay down their R&D strategies (see Section 3.4.1).

ANNEX A: OVERVIEW TABLE

Commitments	Summary assessment ([48])
2018 country-specific recommendations (CSRs)	
CSR 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.	Latvia has made **limited progress** in addressing CSR 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.	The compliance assessment with the Stability and Growth Pact will be included in spring when final data for 2018 will be available.
• Reduce taxation for low-income earners by shifting it to other sources, particularly capital and property, …	• **Limited progress.** No new measures are implemented in response to the 2018 CSR. The adopted measures are being implemented, but their effect is limited.
• …and by improving tax compliance.	• **Some progress.** Tax compliance has been strengthened by more detailed tax reports being requested from businesses and using data available in public registers. Stricter sanctions for financial and economic crimes are applied.
CSR 2: Improve the adequacy of minimum income benefits, minimum old-age pensions and income support for people with disabilities. Increase the	Latvia has made **limited progress** in addressing CSR 2:

([48]) The following categories are used to assess progress in implementing the 2017 country-specific recommendations (CSRs):

No progress: The Member State has not credibly announced nor adopted any measures to address the CSR. This category covers a number of typical situations, to be interpreted on a case-by-case basis taking into account country-specific conditions. They include the following:

no legal, administrative, or budgetary measures have been announced

in the national reform programme,

in any other official communication to the national Parliament/relevant parliamentary committees or the European Commission,

publicly (e.g. in a press statement or on the government's website);

no non-legislative acts have been presented by the governing or legislative body;

the Member State has taken initial steps in addressing the CSR, such as commissioning a study or setting up a study group to analyse possible measures to be taken (unless the CSR explicitly asks for orientations or exploratory actions). However, it has not proposed any clearly-specified measure(s) to address the CSR.

Limited progress: The Member State has:

announced certain measures but these address the CSR only to a limited extent; and/or

presented legislative acts in the governing or legislative body but these have not been adopted yet and substantial further, non-legislative work is needed before the CSR is implemented;

presented non-legislative acts, but has not followed these up with the implementation needed to address the CSR.

Some progress: The Member State has adopted measures

that partly address the CSR; and/or

that address the CSR, but a fair amount of work is still needed to address the CSR fully as only a few of the measures have been implemented. For instance, a measure or measures have been adopted by the national Parliament or by ministerial decision, but no implementing decisions are in place.

Substantial progress: The Member State has adopted measures that go a long way towards addressing the CSR and most of them have been implemented.

Full implementation: The Member State has implemented all measures needed to address the CSR appropriately.

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.	
• Improve the adequacy of minimum income benefits, minimum old-age pensions and income support for people with disabilities.	• **No progress.** The most recent plan (2018) to improve the minimum income support system 2019-2020, although announced, has not been implemented. The guaranteed minimum income increase of EUR 3.20 entered into force on 1 January 2018. Several measures were taken to improve the overall situation for the elderly e.g.: indexation of pensions with long insurance periods, supplements to old age and disability pensions for work period before 1996, a time-limited survivor's pension. In 2018, financial support for families with two and more children was increased. However, the minimum pension and state social security old-age allowance have not been increased.
• Increase the labour market relevance of vocational education and training, and foster upskilling of low-skilled workers and jobseekers.	• **Some progress**. No new measures have been taken on the vocational education and adult learning. Ongoing programmes are continuing and are supported using EU funds. VET reforms have picked up pace and work-based learning is being rolled out, but outcomes in terms of the share of VET students and recent graduate employment remain lower than the EU average. While upskilling low-skilled and jobseekers has been strengthened using EU funds, participation in adult learning and active labour market policies remains low and public expenditure on active labour market policies is low. An ESF-funded activation programme for the long-term unemployed was launched in second half of 2018. In April 2018, the Latvian government endorsed the implementation of Latvia's national skills strategy project to develop a comprehensive medium-term education and skills policy agenda.
• Increase the accessibility, quality and cost-effectiveness of the healthcare system.	• **Some progress**. Public financing for healthcare has increased, which has resulted in reduced waiting times for some interventions and increased availability of health services, but the level remains low relative to other EU countries. Structural

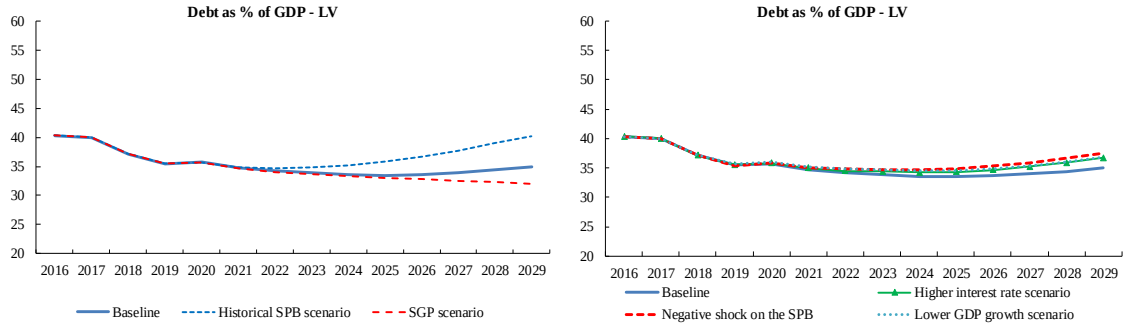
	reforms in the sector are proceeding slowly and in some cases concrete implementation plans are still to be formulated, for instance in primary care reform.
CSR 3: Strengthen the efficiency of the public sector, in particular with regard to local authorities and state-owned enterprises. Strengthen the 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.	Latvia has made **some progress** in addressing CSR 3:
• Strengthen the efficiency of the public sector, in particular with regard to local authorities and state-owned enterprises.	• **Limited progress.** The public administration reform adopted in November 2017 is being slowly rolled out. The public sector reforms exclude municipalities, which enjoy a high degree of autonomy. No measures on governance of local authorities or state-owned enterprises have been presented.
• 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.	• **Some progress**. The adoption of the whistleblower protection law shows substantial progress. Despite an increased effectiveness of the Corruption Prevention and Combatting Bureau, there are delays in the implementation of the National Anti-Corruption Strategy and in adopting relevant provisions, such as a law regulating lobbying activities or a Code of ethics covering politically elected persons. Proposed amendments to the law on conflicts of interests would exempt certain categories of officials from submitting assets and interests declarations. The approach followed for the verification of asset declarations is still unclear.
Europe 2020 (national targets and progress)	
Employment rate: 73%	The employment rate (for the 20-64 age group) increased further to 74.8% in 2017 from 73.2% in 2016. The trend remains positive (76.8% in Q2 -2018).
R&D: 1.5 % of GDP	R&D expenditure was 0.51 % of GDP in 2017, up from 0.44 % of GDP in 2016. Latvia is not on track to meet its target. In 2017, R&D intensity in Latvia was

	composed of 27% private investment (0.14% of GDP) and 73% public investment (0.37% of GDP).
Greenhouse gas emissions: increase by 17% between 2005 and 2020 (in non-ETS sectors)	According to the latest national projections and taking into account existing measures, the target is expected to be achieved: 8 % in 2020 compared to 2005 (with a margin of 9 pps). Furthermore, while the target for 2016 was an increase of no more than 12 % compared to 2005, the preliminary figures show that the non-ETS emissions increased by 4 %. The interim target has thus been achieved.
Renewable energy target: 40%	In 2017, Latvia's share of renewable energy was 39.0 %. This is 1 pps short of its 2020 target.
Energy efficiency: 5.4 Mtoe expressed in primary energy consumption (4.5 Mtoe expressed in final energy consumption)	In 2017, Latvia's primary energy consumption increased to 4.5 Mtoe from 4.3 Mtoe in 2016. The final energy consumption also increased from 3.8 Mtoe to 4.0 Mtoe. Given the current trend, Latvia is on track to achieve its energy efficiency target.
Early school leaving: 10%	The share of early school leavers from education and training decreased from 10% in 2016 to 8.6% in 2017.
Tertiary education: 34% attainment rate for age group 30 - 34	The already high tertiary attainment rate continued to increase reaching 43.8 % in 2017, up from 42.8% in 2017. Gender disparities remain strong, with the tertiary attainment rate 32.1% for men and 53% for women.
Poverty/social exclusion: reduction of the number of people at risk of poverty and/or living in jobless households by 121 000 compared to 2008.	The number of people living at risk of poverty and/or living in jobless households was reduced by 125 000 in 2017 compared to 2008, so Latvia has met its poverty target.

ANNEX B: COMMISSION DEBT SUSTAINABILITY ANALYSIS AND FISCAL RISKS

General Government debt projections under baseline, alternative scenarios and sensitivity tests

LV - Debt projections baseline scenario	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029
Gross debt ratio	**40.0**	**37.1**	**35.5**	**35.7**	**34.7**	**34.2**	**33.9**	**33.6**	**33.5**	**33.6**	**34.0**	**34.4**	**35.0**
Changes in the ratio (-1+2+3)	*-0.3*	*-2.9*	*-1.6*	*0.2*	*-1.0*	*-0.5*	*-0.3*	*-0.3*	*-0.1*	*0.2*	*0.3*	*0.5*	*0.6*
of which													
(1) Primary balance (1.1+1.2+1.3)	**0.3**	**-0.1**	**-0.2**	**0.0**	**-0.1**	**-0.2**	**-0.3**	**-0.2**	**-0.4**	**-0.5**	**-0.6**	**-0.7**	**-0.8**
(1.1) Structural primary balance *(1.1.1-1.1.2+1.1.3)*	***-0.3***	***-1.0***	***-1.0***	***-0.5***	***-0.4***	***-0.4***	***-0.3***	***-0.2***	***-0.4***	***-0.5***	***-0.6***	***-0.7***	***-0.8***
(1.1.1) Structural primary balance (bef. CoA)	*-0.3*	*-1.0*	*-1.0*	*-0.5*	*-0.5*	*-0.5*	*-0.5*	*-0.5*	*-0.5*	*-0.5*	*-0.5*	*-0.5*	*-0.5*
(1.1.2) Cost of ageing					*-0.1*	*-0.1*	*-0.2*	*-0.2*	*-0.1*	*0.1*	*0.2*	*0.2*	*0.3*
(1.1.3) Others (taxes and property incomes)					*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*
(1.2) Cyclical component	***0.7***	***0.9***	***0.8***	***0.5***	***0.3***	***0.2***	***0.0***	***0.0***	***0.0***	***0.0***	***0.0***	***0.0***	***0.0***
(1.3) One-off and other temporary measures	***0.0***	***0.0***	***0.0***	***0.0***	***0.0***	***0.0***	***0.0***	***0.0***	***0.0***	***0.0***	***0.0***	***0.0***	***0.0***
(2) Snowball effect (2.1+2.2+2.3)	**-2.0**	**-2.2**	**-1.2**	**-1.2**	**-1.0**	**-0.7**	**-0.6**	**-0.6**	**-0.5**	**-0.4**	**-0.3**	**-0.2**	**-0.2**
(2.1) Interest expenditure	*0.9*	*0.8*	*0.7*	*0.7*	*0.7*	*0.7*	*0.8*	*0.8*	*0.8*	*0.9*	*1.0*	*1.1*	*1.2*
(2.2) Growth effect	*-1.7*	*-1.5*	*-1.1*	*-1.0*	*-0.9*	*-0.7*	*-0.7*	*-0.7*	*-0.7*	*-0.6*	*-0.6*	*-0.7*	*-0.7*
(2.3) Inflation effect	*-1.2*	*-1.4*	*-0.8*	*-0.9*	*-0.9*	*-0.8*	*-0.7*	*-0.7*	*-0.7*	*-0.7*	*-0.7*	*-0.7*	*-0.7*
(3) Stock-flow adjustments	**2.1**	**-0.8**	**-0.7**	**1.4**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**



Short term	Medium term	S1	Debt sustainability analysis (detail)							DSA	S2	Long term
				Baseline	Historical SPB	Lower GDP growth	Higher interest rate	Negative shock on SPB	Stochastic projections			
			Risk category	LOW	LOW	LOW	LOW	LOW	MEDIUM			
			Debt level (2029)	35.0	40.2	36.7	36.7	37.4				
			Debt peak year	2018	2029	2018	2018	2029				
			Percentile rank	66.0%	73.0%							
			Probability debt higher						41.1%			
			Dif. between percentiles						28.8			
LOW (S0 = 0.2)	LOW	LOW (S1 = -2)								LOW	LOW (S2 = 0.7)	LOW

Note: For further information, see the European Commission Fiscal Sustainability Report (FSR) 2018.

[1] The first table presents the baseline no-fiscal policy change scenario projections. It shows the projected government debt dynamics and its decomposition between the primary balance, snowball effects and stock-flow adjustments. Snowball effects measure the net impact of the counteracting effects of interest rates, inflation, real GDP growth (and exchange rates in some countries). Stock-flow adjustments include differences in cash and accrual accounting, net accumulation of assets, as well as valuation and other residual effects.

[2] The charts present a series of sensitivity tests around the baseline scenario, as well as alternative policy scenarios, in particular: the historical structural primary balance (SPB) scenario (where the SPB is set at its historical average), the Stability and Growth Pact (SGP) scenario (where fiscal policy is assumed to evolve in line with the main provisions of the SGP), a higher interest rate scenario (+1 pp. compared to the baseline), a lower GDP growth scenario (-0.5 pp. compared to the baseline) and a negative shock on the SPB (calibrated on the basis of the forecasted change). An adverse combined scenario and enhanced sensitivity tests (on the interest rate and growth) are also included, as well as stochastic projections. Detailed information on the design of these projections can be found in the FSR 2018.

[3] The second table presents the overall fiscal risk classification over the short, medium and long-term.

a. For the short-term, the risk category (low/high) is based on the S0 indicator. S0 is an early-detection indicator of fiscal stress in the upcoming year, based on 25 fiscal and financial-competitiveness variables that have proven in the past to be leading indicators of fiscal stress. The critical threshold beyond which fiscal distress is signalled is 0.46.

b. For the medium-term, the risk category (low/medium/high) is based on the joint use of the S1 indicator and of the DSA results. The S1 indicator measures the fiscal adjustment required (cumulated over the 5 years following the forecast horizon and sustained thereafter) to bring the debt-to-GDP ratio to 60 % by 2033. The critical values used are 0 and 2.5 pps. of GDP. The DSA classification is based on the results of 5 deterministic scenarios (baseline, historical SPB, higher interest rate, lower GDP growth and negative shock on the SPB scenarios) and the stochastic projections. Different criteria are used such as the projected debt level, the debt path, the realism of fiscal assumptions, the probability of debt stabilisation, and the size of uncertainties.

c. For the long-term, the risk category (low/medium/high) is based on the joint use of the S2 indicator and the DSA results. The S2 indicator measures the upfront and permanent fiscal adjustment required to stabilise the debt-to-GDP ratio over the infinite horizon, including the costs of ageing. The critical values used are 2 and 6 pps. of GDP. The DSA results are used to further qualify the long-term risk classification, in particular in cases when debt vulnerabilities are identified (a medium / high DSA risk category).

ANNEX C: STANDARD TABLES

Table C.1: **Financial market indicators**

	2013	2014	2015	2016	2017	2018
Total assets of the banking sector (% of GDP)[1)]	128,2	130,6	131,3	117,5	104,7	74,9
Share of assets of the five largest banks (% of total assets)	64,1	63,6	64,5	66,5	73,5	-
Foreign ownership of banking system (% of total assets)[2)]	59,0	52,5	47,4	49,7	51,6	58,6
Financial soundness indicators:[2)]						
- non-performing loans (% of total loans)	-	9,7	6,5	6,3	5,6	5,9
- capital adequacy ratio (%)	18,0	20,2	21,8	20,4	20,6	22,4
- return on equity (%)[3)]	8,8	10,2	10,7	14,3	7,6	8,2
Bank loans to the private sector (year-on-year % change)[1)]	-2,0	-4,5	-0,1	6,3	-0,6	3,6
Lending for house purchase (year-on-year % change)[1)]	-4,5	-3,4	-3,3	-0,5	0,2	0,6
Loan to deposit ratio[2)]	-	67,3	59,9	62,4	60,6	70,6
Central Bank liquidity as % of liabilities[1)]	-	0,3	1,0	1,0	1,0	0,2
Private debt (% of GDP)	92,6	96,2	88,9	88,0	83,5	-
Gross external debt (% of GDP)[2)] - public	30,6	36,4	30,4	32,7	29,8	28,6
- private	42,0	39,1	40,3	40,9	39,6	39,0
Long-term interest rate spread versus Bund (basis points)*	177,0	134,5	46,8	44,4	51,7	47,4
Credit default swap spreads for sovereign securities (5-year)*	110,3	99,6	76,5	62,0	48,9	41,2

1) Latest data Q3 2018. Includes not only banks but all monetary financial institutions excluding central banks.
2) Latest data Q2 2018.
3) Quarterly values are not annualised
* Measured in basis points.
Source: European Commission (long-term interest rates); World Bank (gross external debt); Eurostat (private debt); ECB (all other indicators).

Table C.2: **Headline Social Scoreboard indicators**

	2013	2014	2015	2016	2017	2018 [6]
Equal opportunities and access to the labour market						
Early leavers from education and training (% of population aged 18-24)	9.8	8.5	9.9	10.0	8.6	:
Gender employment gap (pps)	4.2	4.6	4.1	2.9	4.3	4.4
Income inequality, measured as quintile share ratio (S80/S20)	6.3	6.5	6.5	6.2	6.3	:
At-risk-of-poverty or social exclusion rate[1] (AROPE)	35.1	32.7	30.9	28.5	28.2	:
Young people neither in employment nor in education and training (% of population aged 15-24)	13.0	12.0	10.5	11.2	10.3	:
Dynamic labour markets and fair working conditions						
Employment rate (20-64 years)	69.7	70.7	72.5	73.2	74.8	76.8
Unemployment rate[2] (15-74 years)	11.9	10.8	9.9	9.6	8.7	7.5
Long-term unemployment rate[3] (as % of active population)	5.7	4.6	4.5	4.0	3.3	3.2
Gross disposable income of households in real terms per capita[4] (Index 2008=100)	:	:	98.5	103.9	107.0	:
Annual net earnings of a full-time single worker without children earning an average wage (levels in PPS, three-year average)	8231	8670	9348	10082	:	:
Annual net earnings of a full-time single worker without children earning an average wage (percentage change, real terms, three-year average)	2.6	5.0	7.0	7.4	:	:
Public support / Social protection and inclusion						
Impact of social transfers (excluding pensions) on poverty reduction[5]	25.4	21.5	17.6	21.6	21.9	:
Children aged less than 3 years in formal childcare	23.0	21.6	22.9	28.3	28.4	:
Self-reported unmet need for medical care	13.8	12.5	8.4	8.2	6.2	:
Individuals who have basic or above basic overall digital skills (% of population aged 16-74)	:	:	49.0	50.0	48.0	:

1 People at risk of poverty or social exclusion (AROPE): individuals who are at risk of poverty (AROP) and/or suffering from severe material deprivation (SMD) and/or living in households with zero or very low work intensity (LWI).
2 Unemployed persons are all those who were not employed but had actively sought work and were ready to begin working immediately or within two weeks.
3 Long-term unemployed are people who have been unemployed for at least 12 months.
4 Gross disposable household income is defined in unadjusted terms, according to the draft Joint Employment Report 2019.
5 Reduction in percentage of the risk of poverty rate, due to social transfers (calculated comparing at-risk-of poverty rates before social transfers with those after transfers; pensions are not considered as social transfers in the calculation).
6 Average of first three quarters of 2018 for the employment rate, unemployment rate and gender employment gap. Data for unemployment rate is seasonally adjusted.
Source: European Commission

Table C.3: **Labour market and education indicators**

Labour market indicators	**2013**	**2014**	**2015**	**2016**	**2017**	**2018** [4]
Activity rate (15-64)	74.0	74.6	75.7	76.3	77.0	:
Employment in current job by duration						
From 0 to 11 months	16.4	14.7	14.5	13.5	15.0	:
From 12 to 23 months	10.8	11.3	10.1	10.2	10.0	:
From 24 to 59 months	18.7	20.1	19.1	20.1	20.5	:
60 months or over	54.1	53.8	56.2	56.1	54.5	:
Employment growth* (% change from previous year)	2.3	-1.3	1.4	-0.3	0.0	1.9
Employment rate of women (% of female population aged 20-64)	67.7	68.5	70.5	71.8	72.7	74.6
Employment rate of men (% of male population aged 20-64)	71.9	73.1	74.6	74.7	77.0	79.0
Employment rate of older workers* (% of population aged 55-64)	54.8	56.4	59.4	61.4	62.3	64.9
Part-time employment* (% of total employment, aged 15-64)	7.5	6.8	7.2	8.5	7.7	7.0
Fixed-term employment* (% of employees with a fixed term contract, aged 15-64)	4.3	3.3	3.8	3.7	3.0	2.9
Participation in activation labour market policies (per 100 persons wanting to work)	6.8	6.8	4.3	5.8	:	:
Transition rate from temporary to permanent employment (3-year average)	44.3	50.2	57.2	57.9	:	:
Youth unemployment rate (% active population aged 15-24)	23.2	19.6	16.3	17.3	17.0	12.1
Gender gap in part-time employment	3.8	4.2	5.5	4.7	5.8	5.4
Gender pay gap[1] (in undadjusted form)	16.0	17.3	17.0	17.0	:	:
Education and training indicators	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**
Adult participation in learning (% of people aged 25-64 participating in education and training)	6.8	5.6	5.7	7.3	7.5	:
Underachievement in education[2]	:	:	21.4	:	:	:
Tertiary educational attainment (% of population aged 30-34 having successfully completed tertiary education)	40.7	39.9	41.3	42.8	43.8	:
Variation in performance explained by students' socio-economic status[3]	:	:	8.7	:	:	:

* Non-scoreboard indicator

1 Difference between the average gross hourly earnings of male paid employees and of female paid employees as a percentage of average gross hourly earnings of male paid employees. It is defined as "unadjusted", as it does not correct for the distribution of individual characteristics (and thus gives an overall picture of gender inequalities in terms of pay). All employees working in firms with ten or more employees, without restrictions for age and hours worked, are included

2 PISA (OECD) results for low achievement in mathematics for 15 year-olds.

3 Impact of socio-economic and cultural status on PISA (OECD) scores. Values for 2012 and 2015 refer respectively to mathematics and science.

4 Average of first three quarters of 2018. Data for youth unemployment rate is seasonally adjusted.

Source: European Commission, OECD

Table C.4: **Social inclusion and health indicators**

	2012	2013	2014	2015	2016	2017
Expenditure on social protection benefits* (% of GDP)						
Sickness/healthcare	3.3	3.4	3.5	3.6	3.7	:
Disability	1.2	1.2	1.3	1.4	1.4	:
Old age and survivors	7.8	7.7	7.4	7.4	7.3	:
Family/children	1.0	1.2	1.3	1.6	1.7	:
Unemployment	0.5	0.6	0.6	0.6	0.7	:
Housing	0.1	0.1	0.1	0.1	0.1	:
Social exclusion n.e.c.	0.2	0.1	0.1	0.1	0.1	:
Total	14.1	14.4	14.3	14.7	15.0	:
of which: means-tested benefits	0.4	0.3	0.2	0.2	0.2	:
General government expenditure by function (% of GDP, COFOG)						
Social protection	11.4	11.5	11.4	11.9	12.0	:
Health	3.9	3.7	3.8	3.8	3.7	:
Education	5.7	5.7	5.9	5.9	5.5	:
Out-of-pocket expenditure on healthcare (% of total health expenditure)	:	38.5	39.1	42.1	44.6	:
Children at risk of poverty or social exclusion (% of people aged 0-17)*	40.0	38.4	35.3	31.3	24.7	23.9
At-risk-of-poverty rate[1] (% of total population)	19.2	19.4	21.2	22.5	21.8	22.1
In-work at-risk-of-poverty rate (% of persons employed)	8.6	8.9	8.1	9.2	8.3	8.8
Severe material deprivation rate[2] (% of total population)	25.6	24.0	19.2	16.4	12.8	11.3
Severe housing deprivation rate[3], by tenure status						
Owner, with mortgage or loan	7.6	8.3	10.6	6.9	6.9	7.9
Tenant, rent at market price	29.9	23.1	28.3	26.7	25.8	24.7
Proportion of people living in low work intensity households[4] (% of people aged 0-59)	11.7	10.0	9.6	7.8	7.2	7.8
Poverty thresholds, expressed in national currency at constant prices*	1980	2029	2263	2517	2743	2844
Healthy life years (at the age of 65)						
Females	6.4	4.2	4.6	4.0	4.5	:
Males	5.3	4.0	4.0	4.1	4.4	:
Aggregate replacement ratio for pensions[5] (at the age of 65)	0.5	0.5	0.4	0.4	0.4	0.4
Connectivity dimension of the Digital Economy and Society Inedex (DESI)[6]	:	:	54.8	58.7	63.3	63.7
GINI coefficient before taxes and transfers*	53.1	52.0	51.2	49.8	48.6	48.1
GINI coefficient after taxes and transfers*	35.7	35.2	35.5	35.4	34.5	34.5

* Non-scoreboard indicator
1 At-risk-of-poverty rate (AROP): proportion of people with an equivalised disposable income below 60 % of the national equivalised median income.
2 Proportion of people who experience at least four of the following forms of deprivation: not being able to afford to i) pay their rent or utility bills, ii) keep their home adequately warm, iii) face unexpected expenses, iv) eat meat, fish or a protein equivalent every second day, v) enjoy a week of holiday away from home once a year, vi) have a car, vii) have a washing machine, viii) have a colour TV, or ix) have a telephone.
3 Percentage of total population living in overcrowded dwellings and exhibiting housing deprivation.
4 People living in households with very low work intensity: proportion of people aged 0-59 living in households where the adults (excluding dependent children) worked less than 20 % of their total work-time potential in the previous 12 months.
5 Ratio of the median individual gross pensions of people aged 65-74 relative to the median individual gross earnings of people aged 50-59.
6 Fixed broadband take up (33%), mobile broadband take up (22%), speed (33%) and affordability (11%), from the Digital Scoreboard.
Source: European Commission, OECD

Table C.5: **Product market performance and policy indicators**

Performance indicators	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**
Labour productivity per person[1] growth (t/t-1) in %						
Labour productivity growth in industry	-2.44	-2.90	3.13	4.47	4.34	7.86
Labour productivity growth in construction	10.26	-2.35	2.03	0.05	-7.25	13.21
Labour productivity growth in market services	1.72	-0.92	1.28	0.07	2.91	3.93
Unit Labour Cost (ULC) index[2] growth (t/t-1) in %						
ULC growth in industry	9.85	8.44	5.30	1.97	2.83	0.17
ULC growth in construction	1.22	9.71	7.55	5.54	15.95	-6.88
ULC growth in market services	7.49	4.29	6.03	7.33	5.00	4.04
Business environment	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**
Time needed to enforce contracts[3] (days)	469	469	469	469	469	469
Time needed to start a business[3] (days)	15.5	12.5	12.5	5.5	5.5	5.5
Outcome of applications by SMEs for bank loans[4]	:	0.85	1.19	0.49	0.84	0.30
Research and innovation	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**
R&D intensity	0.66	0.61	0.69	0.63	0.44	0.51
General government expenditure on education as % of GDP	5.70	5.70	5.90	5.90	5.50	:
Number of science & technology people employed as % of total employment	44	44	43	45	45	46
Population having completed tertiary education[5]	25	27	27	28	30	30
Young people with upper secondary education[6]	84	86	87	86	85	87
Trade balance of high technology products as % of GDP	-1.17	-1.03	-1.24	-1.67	-1.31	-1.78
Product and service markets and competition				**2003**	**2008**	**2013**
OECD product market regulation (PMR)[7], overall				:	:	1.61
OECD PMR[7], retail				:	:	0.40
OECD PMR[7], professional services				:	:	:
OECD PMR[7], network industries[8]				:	:	2.66

1 Value added in constant prices divided by the number of persons employed.
2 Compensation of employees in current prices divided by value added in constant prices.
3 The methodologies, including the assumptions, for this indicator are shown in detail here: http://www.doingbusiness.org/methodology.
4 Average of the answer to question Q7B_a. "[Bank loan]: If you applied and tried to negotiate for this type of financing over the past six months, what was the outcome?". Answers were codified as follows: zero if received everything, one if received 75% and above, two if received below 75%, three if refused or rejected and treated as missing values if the application is still pending or don't know.
5 Percentage population aged 15-64 having completed tertiary education.
6 Percentage population aged 20-24 having attained at least upper secondary education.
7 Index: 0 = not regulated; 6 = most regulated. The methodologies of the OECD product market regulation indicators are shown in detail here: http://www.oecd.org/competition/reform/indicatorsofproductmarketregulationhomepage.htm
8 Aggregate OECD indicators of regulation in energy, transport and communications (ETCR).
Source: "European Commission; World Bank — Doing Business (for enforcing contracts and time to start a business); OECD (for the product market regulation indicators); SAFE (for outcome of SMEs' applications for bank loans)."

Table C.6: **Green growth**

Green growth performance		2012	2013	2014	2015	2016	2017
Macroeconomic							
Energy intensity	kgoe / €	0,23	0,22	0,22	0,21	0,20	0,20
Carbon intensity	kg / €	0,58	0,56	0,55	0,54	0,52	-
Resource intensity (reciprocal of resource productivity)	kg / €	2,00	2,07	2,02	2,01	1,83	1,95
Waste intensity	kg / €	0,12	-	0,13	-	0,12	-
Energy balance of trade	% GDP	-6,1	-5,6	-4,2	-3,2	-2,3	-3,0
Weighting of energy in HICP	%	15,7	15,9	15,4	15,1	14,3	13,8
Difference between energy price change and inflation	%	7,3	-1,7	-1,7	4,4	-6,8	-1,4
Real unit of energy cost	% of value added	24,2	23,7	22,7	23,1	23,5	-
Ratio of environmental taxes to labour taxes	ratio	0,21	0,24	0,26	0,26	0,26	-
Environmental taxes	% GDP	3,0	3,2	3,4	3,5	3,6	3,5
Sectoral							
Industry energy intensity	kgoe / €	0,20	0,19	0,19	0,19	0,18	0,17
Real unit energy cost for manufacturing industry excl. refining	% of value added	21,0	20,6	20,0	20,6	21,3	-
Share of energy-intensive industries in the economy	% GDP	9,5	8,6	8,4	8,5	9,0	-
Electricity prices for medium-sized industrial users	€ / kWh	0,11	0,11	0,12	0,12	0,12	0,12
Gas prices for medium-sized industrial users	€ / kWh	0,04	0,04	0,04	0,03	0,03	0,03
Public R&D for energy	% GDP	0,01	0,01	0,01	0,01	0,01	0,01
Public R&D for environmental protection	% GDP	0,01	0,01	0,01	0,02	0,01	0,01
Municipal waste recycling rate	%	14,7	25,9	27,0	28,7	25,2	23,27
Share of GHG emissions covered by ETS*	%	24,0	23,2	20,7	20,0	19,4	-
Transport energy intensity	kgoe / €	0,51	0,51	0,52	0,59	0,56	0,55
Transport carbon intensity	kg / €	1,38	1,40	1,44	1,66	1,55	-
Security of energy supply							
Energy import dependency	%	56,4	55,9	40,6	51,2	47,2	44,1
Aggregated supplier concentration index	HHI	47,3	47,2	23,1	41,9	30,4	-
Diversification of energy mix	HHI	0,30	0,30	0,29	0,30	0,32	0,35

All macro intensity indicators are expressed as a ratio of a physical quantity to GDP (in 2010 prices)
- Energy intensity: gross inland energy consumption (in kgoe) divided by GDP (in EUR)
- Carbon intensity: greenhouse gas emissions (in kg CO2 equivalents) divided by GDP (in EUR)
- Resource intensity: domestic material consumption (in kg) divided by GDP (in EUR)
- Waste intensity: waste (in kg) divided by GDP (in EUR)

Energy balance of trade: the balance of energy exports and imports, expressed as % of GDP
Weighting of energy in HICP: the proportion of 'energy' items in the consumption basket used for the construction of the HICP
Difference between energy price change and inflation: energy component of HICP, and total HICP inflation (annual % change)
Real unit energy cost: real energy costs as % of total value added for the economy
Industry energy intensity: final energy consumption of industry (in kgoe) divided by gross value added of industry (in 2010 EUR)
Real unit energy costs for manufacturing industry excluding refining : real costs as % of value added for manufacturing sectors
Share of energy-intensive industries in the economy: share of gross value added of the energy-intensive industries in GDP
Electricity and gas prices for medium-sized industrial users: consumption band 500–20 00MWh and 10 000–100 000 GJ; figures excl. VAT.
Recycling rate of municipal waste: ratio of recycled and composted municipal waste to total municipal waste
Public R&D for energy or for the environment: government spending on R&D for these categories as % of GDP
Proportion of GHG emissions covered by EU emissions trading system (ETS) (excluding aviation): based on GHG emissions (excl. land use, land use change and forestry) as reported by Member States to the European Environment Agency.
Transport energy intensity: final energy consumption of transport activity (kgoe) divided by transport industry gross value added (in 2010 EUR)
Transport carbon intensity: GHG emissions in transport activity divided by gross value added of the transport industry
Energy import dependency: net energy imports divided by gross inland energy consumption incl. consumption of international bunker fuels
Aggregated supplier concentration index: covers oil, gas and coal. Smaller values indicate larger diversification and hence lower risk.
Diversification of the energy mix: Herfindahl index covering natural gas, total petrol products, nuclear heat, renewable energies and solid fuels
* European Commission and European Environment Agency
Source: European Commission and European Environment Agency (Share of GHG emissions covered by ETS); European Commission (Environmental taxes over labour taxes and GDP); Eurostat (all other indicators)

ANNEX D: INVESTMENT GUIDANCE ON COHESION POLICY FUNDING 2021-2027 FOR LATVIA

Annex D Investment Guidance on Cohesion Policy Funding 2021-2027 for Latvia ([49])

Building on the Commission proposal for the next Multi-Annual Financial Framework for the period 2021-2027 of 2 May 2018 (COM (2018) 321), this Annex D presents the preliminary Commission services views on priority investment areas and framework conditions for effective delivery for the 2021-2027 Cohesion Policy. These priority investment areas are derived from the broader context of investment bottlenecks, investment needs and regional disparities assessed in the report. This Annex provides the basis for a dialogue between Latvia and the Commission services in view of the programming of the cohesion policy funds (European Regional Development Fund, Cohesion Fund and European Social Fund Plus).

Policy Objective 1: A Smarter Europe – Innovative and smart industrial transformation

Latvia's innovation performance lags behind most other EU countries with low added value/complexity, high resource intensity and lack of cooperation and integration in global value chains. This has direct consequences on the country's productivity and competitiveness. High priority investment needs ([50]) have therefore been identified to **enhance research and innovation capacities and the uptake of advanced technologies**, where appropriate in cooperation with other countries, in line with the EU Strategy for the Baltic Sea Region, and in particular to:

- strengthen innovation performance and foster productivity growth by identifying smart specialisation areas on the basis of national and regional needs and potential;
- increase the number of innovative firms in the smart specialisation sectors by fostering research and innovation to facilitate the transition towards new technologies and value added activities;
- strengthen research and innovation by increasing the attractiveness and the competitiveness of the research system;
- support collaborative research between universities and businesses.

Latvia rates highly in the offer of digital public services by the government with some weaknesses in quality and open data availability. However, companies and people (for lack of skills) do not make sufficient use of the digitalisation opportunities. Priority investment needs have therefore been identified to **reap the benefits of digitalisation for citizens, companies and governments**, in particular to:

- upscale and accelerate e-government, interoperability of systems and open data availability;
- increase information and communications technology uptake in small and medium-sized enterprises, including supporting infrastructures and services;
- increase e-services provision and their uptake, with special focus on rural areas, elderly people and in a cross-border context.

([49]) This Annex is to be considered in conjunction with the EC Proposal for a Regulation of the European Parliament and of the Council on the European Regional Development Fund and on the Cohesion Fund COM(2018) 372 and the EC Proposal for a Regulation of the European Parliament and of the Council on the European Social Fund Plus COM(2018) 382, in particular as regards the requirements for thematic concentration and urban earmarking outlined in these proposals.

([50]) The intensity of needs is classified in three categories in a descending order – high priority needs, priority needs, needs.

In Latvia the level of private research and development expenditure is the lowest in the EU, inevitably limiting the advancement of companies towards the technological frontier, as well as their productivity and competitiveness. High priority investment needs have therefore been identified to **enhance growth and competitiveness of small and medium-sized enterprises**, in particular to:

- promote entrepreneurship, in particular start-ups and accelerators, also via technology transfer and development programmes and promoting alternative sources of financing;
- strengthen the competitiveness and growth prospects of innovative small and medium-sized enterprises for more sophisticated products and services, to move up the global value chain;
- support small and medium-sized enterprises to internationalise activities and identify new export markets, cooperation networks and interregional clusters, particularly in the Baltic Sea region.

The transition to new technologies in Latvia is hampered by low digital proficiency within companies. Moreover, insufficient availability of skilled human resources is one of the country's biggest issues.. Investment needs have therefore been identified to **develop skills for smart specialisation, industrial transition and entrepreneurship**, in particular to:

- reskill and upskill small and medium-sized enterprises in smart specialisation areas, with a particular attention to digital skills and entrepreneurship in order to increase productivity;
- enhance market relevance, innovation and viability of research institutions' projects, via ad hoc training activities.

Policy Objective 2: A low carbon and greener Europe – Clean and fair energy transition, green and blue investment, circular economy, climate adaptation and risk prevention ([51])

Latvia's economy is still relatively energy intensive, well above the EU average. Although Latvia is on track to achieve its indicative energy efficiency target for 2020, further efforts are needed to achieve more ambitious energy and climate targets for 2030. High priority investment needs have therefore been identified for **energy efficiency and renewable energy**, in particular to:

- improve energy efficiency in public buildings in housing and in businesses;
- support further deployment of renewables, including in district heating;
- deploy solutions for smart electricity distribution grids and storage.

The climate change risks Latvia is facing are coastal erosion and river floods, with impacts on the economy and infrastructure damage. Investment needs have therefore been identified for **climate change adaptation, risk prevention, disaster resilience**, in particular to:

- address risks identified in the national risks assessment, with the focus on prevention;
- promote coordinated and cooperative preventive measures in line with the EU Strategy for the Baltic Sea Region.

([51]) While outside of the scope of the ERDF and the Cohesion Fund (art. 6, paragraph 1(h), COM (2018)372), energy interconnectors could be financed by the Connecting Europe Facility in line with its objectives (art. 3, paragraphs 1 and 2 (b), COM(2018) 438)

Latvia lacks a systematic approach to addressing recycling and waste issues, in particular separate collection and treatment of biodegradable waste. Priority investment needs have therefore been identified to **promote the transition to a circular economy**, in particular to: support waste prevention, reuse and recycling; develop the use of recycled materials as alternatives to raw materials.
Equal accessibility to water services by end-users is sometimes challenging, particularly in rural areas. Investment needs have therefore been identified to **promote sustainable water management**, in particular to: • Complete drinking water and waste water treatment schemes, principally in rural areas.
Policy Objective 3: A more connected Europe – Mobility and regional information and communications technology connectivity
The transport infrastructure in Latvia remains far below the EU average standards in terms of the network's coverage, carbon emissions and safety issues, with significant regional accessibility issues. High priority investment needs have therefore been identified to **develop a sustainable, climate resilient, intelligent, secure and intermodal Trans-European Transport Networks and their accessibility**, in particular to: bring national sections of the Trans-European Transport Networks road core and comprehensive network to meet EU standards, including safety; complete the Trans-European Transport Networks conventional rail core network; improve access to the Trans-European Transport Networks and cross border mobility.
Levels of traffic congestion in larger Latvian cities remain an issue due to the limited coordination of investments with policies for urban transport. Priority investment needs have therefore been identified to **promote sustainable multimodal urban mobility**, in particular to: develop urban transport systems within relevant integrated territorial development strategies and sustainable urban mobility plans, with a focus on functional areas.
There is a significant digital divide, in terms of coverage and take-up, between urban and rural areas in Latvia, even though the country performs relatively well in terms of overall broadband connectivity. Investment needs have therefore been identified to **enhance digital connectivity**, in particular to: deploy very-high capacity networks, eliminating coverage gaps in rural and less populated areas; improve the cybersecurity and physical security of public very high capacity networks investments.
Policy Objective 4: A more social Europe – Implementing the European Pillar of Social Rights
A shrinking working age population, caused in part by ageing and emigration, leads to growing skills and labour shortages; social partners' capacity is limited. Priority investment needs have therefore been identified to **improve access to employment and promote the social economy**, in particular to:

strengthen the capacity of labour market institutions and services; improve the outreach and coverage of active labour market policies; support voluntary sectoral and regional labour mobility; promote the social economy and support for start-up social entrepreneurs; enhance the work ability of workforce, support safe and healthy working lives; foster bipartite social dialogue and support social partners in capacity building.
The education and training system lacks efficiency; participation in adult learning is low; and regional differences in access exist. High priority investment needs have therefore been identified to **improve the quality, effectiveness and labour market relevance of education and training** and **to promote lifelong learning, flexible upskilling and reskilling better anticipating change and new skills requirements**, including through infrastructure, and in particular to: improve access to quality and affordable early childhood education and care; strengthen work-based learning and incentivise investment in training by employers; attract, motivate and retain more students in science and technology related subjects; support training for teachers and trainers and innovative actions to improve the attractiveness of the teaching profession; reduce fragmentation in higher education and increase research capacity; enhance inclusive quality education for persons with disabilities; expand lifelong learning, reflecting anticipation of skills needs; support skills acquisition and recognition, including language and digital skills.
Poverty and social exclusion remain high, especially for people with disabilities, the elderly and the unemployed; social housing is scarce and income inequality is a challenge. High priority investment needs have therefore been identified to **foster active inclusion, improve employability** and **address material deprivation through food and basic material assistance**, including accompanying measures, and in particular to: support integrated active inclusion measures with involvement of local communities and civil society; improve access to personalized and integrated social services for disadvantaged groups; reduce homelessness and housing exclusion, improve access to social housing, including through infrastructure.

Health outcomes are weak and timely access to affordable healthcare and long-term care is limited. High priority investment needs have therefore been identified to **enhance equal and timely access to social, healthcare and long-term care services,** including through infrastructure, and in particular to:

ensure equal access to affordable, accessible and good quality social services and healthcare;

support reskilling, upskilling and retention of healthcare, long-term and social care workforce;

support the transition from institutional care to independent living and community-based care services with a focus on cooperation between health and social services;

strengthen disease prevention and functioning of healthcare following a person-centred approach.

Policy Objective 5 – A Europe closer to citizens by fostering the sustainable and integrated development of urban, rural and coastal areas and local initiatives

Latvia's principal cities, and Riga in particular, have played a dominant role in Latvia's speedy convergence, but there are large disparities in income and employment opportunities. In particular the lack of affordable housing has been an obstacle to regional development. Also, there is a strong urban-rural divide in economic and social development. High priority investments needs in tailor-made sustainable and integrated development of urban, rural and coastal areas and local interventions, addressing urban-rural linkages have therefore been identified in order to complement policies to **address the socio-economic disparities** and the demographic challenges, in particular to:

improve the attractiveness of urban areas and business environment and create links with the functional urban areas;

address the needs and potential of the areas that are lagging behind in economic and social development, by combining adaptation and quality of life measures with investments enhancing growth;

invigorate the capacity of local authorities to develop sound integrated territorial strategies and to assess and select projects.

Factors for effective delivery of Cohesion policy

promotion of social innovation and social experimentation of projects and programmes;

development of a roadmap for administrative capacity building necessary for the effective administration and implementation of the Funds;

improved and more efficient measures to prevent and address conflict of interest, fraud and corruption;

broader use of financial instruments and/or contributions to a Latvian compartment under InvestEU for revenue-generating and cost-saving activities;

simplified requirements and shorter procedures in the implementation of EU funds, particularly for applicants and beneficiaries;

increased capacity of beneficiaries and intermediate bodies to prepare and implement projects;

increased partnership capacity of social partners and of civil society organisations;

improved public procurement performance, in particular by making efforts to reduce the rate of 'single-bidding' and by enhancing e-services and more transparent procurements at municipal level.

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