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EU BOP ASSISTANCE TO LATVIA
SIXTH REVIEW UNDER POST-PROGRAMME SURVEILLANCE

EXECUTIVE SUMMARY

The main goal of the Post-Programme Surveillance (PPS) mission on 11-14 November was to assess progress in key budgetary, social, financial and structural areas since the previous PPS visit in April, putting emphasis on reforms that did not advance as expected during the PPS, as well as to review Latvia's BoP loan repayment capacity[1]*. The "green file"*[2] *states that "the end of post-programme surveillance would normally be decided by the Commission, after having consulted the EFC, but not before 70% of the loan has been repaid." Latvia repaid the first tranche of EUR 1 billion (34% of the total EUR 2.9 billion) on 25 March, while the second tranche of EUR 1.2 billion (41% of the total) is to be repaid in mid-January 2015, bringing total repayments to around 75% of the EU loan.* ***Taking into account the results of the PPS mission as laid out in this report, the Commission intends to end the Post-Programme Surveillance if the next repayment tranche is paid on schedule by Latvia.***

Overall, the assessment of post-programme developments since early 2012 is positive. Macroeconomic, fiscal and political stability has allowed Latvia to enjoy among the fastest GDP growth rates in the EU, although the Russian-Ukrainian crisis has significantly reduced growth prospects for 2014 and 2015. The euro changeover has been completed, the fiscal position is under control with projected deficits around 1% of GDP in 2014-2015, and the financial sector has been strengthened, including as regards surveillance of non-resident bank services. Two "left-overs" from the BoP Programme – the sale of Citadele bank and setting-up the Single Development Institution – are to be completed by mid-2015. The public debt-to-GDP ratio is projected to decline from 40% in 2014 to 35% in 2016.

Also, actions have been taken, inter alia, to improve the judiciary, to intensify the fight against tax avoidance, and to target science financing towards internationally competitive institutions. The electricity market is to be fully liberalised from January 2015. In addition, promising laws on construction, public procurement, insolvency, state-owned enterprise (SOE) management and the Single Development Institution have been adopted. It will be important to monitor how these laws are implemented in practice, including by finalising the needed secondary acts and appointing professional SOE board and council members.

On the other hand, little progress was made on a number of big-item, "quality-of-life-improving" reforms to tackle high social inequality and inadequate healthcare access for the poorest, improve general and higher education outcomes, deal decisively with corruption cases, and modernise public administration. This is either due to strong vested interests, to a general reform fatigue, or to difficult budgetary choices in view of tight fiscal space. Similarly, decisions on de-politicising the management of state-owned enterprises and ports have come slowly and still need follow-up. Measures to boost energy independence, in particular on gas market opening and the future management of Incukalna gas storage, need to be implemented.

Technical meetings were held to discuss the ongoing 2015 budget formation and assess jointly with experts from various DGs actions taken to address Country Specific Recommendations (CSRs) on budgetary prudence, social assistance and healthcare, higher

[1] Following the expiry of the Balance of Payments (BoP) financial assistance programme on 20 January 2012, PPS missions took place twice a year, led by DG ECFIN together with colleagues from other DGs (EMPL, EAC, ENER, JUST, SANCO, etc.) and the ECB. As Latvia repaid all outstanding liabilities to the IMF in December 2012, more than two years ahead of the original schedule, the IMF is not taking part since then.
[2] EFC secretariat note Ref. Ares 21/1/2011, revised version of 3 February 2011.

and vocational education and science, energy efficiency and market liberalisation, and judicial and public administration reforms. Also, several high-level meetings were held with secretaries of state to push for CSR reforms. As this is likely to have been the last PPS visit, the European Semester surveillance will need to be extra vigilant to keep up the pressure to reform and maintain fiscal and financial prudence (along with the leverage from the scrutiny of Latvia's application to join the OECD); this will assure that the "left-overs" from the BoP Programme and the PPS will remain high on the agenda.

A concluding meeting with the re-appointed PM Mrs Straujuma (national elections were hold on 4 October) took place on 14 November to review progress with implementing the CSRs and various commitments outlined in the June 2013 Eurogroup letter in the context of Latvia's euro accession, including supervision of non-resident deposits, reforms of state-owned assets management, state-owned bank restructuring, opening of the gas market, and establishment of the Fiscal Council.

The national authorities confirmed, when signing the last SMoU in December 2011, their commitment under the PPS to consult with EU bodies on major policy intentions and to stand ready to discuss them with the EFC, should the Commission deem that such changes may jeopardise macroeconomic stability and Latvia's repayment capacity. Overall, the authorities have been co-operative as regards the PPS obligations.

1. Macroeconomic situation and prospects

Economic growth slowed from 4.2% in 2013 to 2.5% y-o-y in the first half of 2014 and 2.1% y-o-y in the third quarter of 2014, reflecting some deceleration in private consumption and the negative fallout from the conflict between Russia and Ukraine. Retail trade statistics point to some rebound in private consumption in the third quarter of 2014 but the short-term growth outlook remains adversely affected by external risks and deteriorating business expectations. Growth is therefore projected to be relatively weak at 2.6% in 2014 and 2.9% in 2015 as compared to 3.8% and 4.1% in the spring forecast. In 2016, growth is forecast to reach 3.6% as the negative impact of geopolitical tensions is expected to peter out. The growth pattern is however highly sensitive to external developments, where the risks are tilted to the downside. On the other hand, possible resumption of production at the country's largest steel maker Liepajas Metalurgs represents a positive risk to the growth forecast for 2015.

Unemployment fell to an average of 11.3% in the first half of 2014 from 12.2% a year earlier. Employment grew only marginally for the same period amid further contraction in the labour force due to population ageing and emigration. Wages increased by 7% for the same period, pushed by the 12% minimum wage hike at the beginning of 2014, posing some risks to labour cost competitiveness in the context of an unstable external environment.

Economic performance: 2014 Autumn Forecast (actual data for 2013)

	2013	2014	2015	2016
Real GDP (%, y-o-y)	4.2	2.6	2.9	3.6
Employment (%, y-o-y)	2.3	0.3	0.5	1.1
Unemployment rate (%)	11.9	11.0	10.2	9.2
Unit labour cost (%, y-o-y)	7.3	3.8	2.2	2.5
HICP (%, y-o-y)	0.0	0.8	1.8	2.5
Current account balance (% of GDP)	-2.2	-2.2	-2.3	-2.8
Government balance (% of GDP)	-0.9	-1.1	-1.2	-0.9
Gross public debt (% of GDP)	38.2	40.3	36.3	35.1

Impact of the Russia/Ukraine conflict

Although the cycle of sanctions and countersanctions with Russia has had little direct impact on Latvian exports so far, the indirect impact through business and consumer confidence is substantial. The slowdown in economic growth is therefore mostly due to the uncertain geopolitical situation and has affected all demand components. Latvia's ports and railway cargo transit (more than 80% dependent on goods to and from Russia) are particularly exposed to risks of rising geopolitical tensions. Possible disruptions in energy supplies are not expected to have a critical effect on the economy, as the gas storage volumes kept in Latvia would be sufficient to offset potential disruptions until the end of 2015 while the oil and electricity sectors are not significantly exposed to Russian supplies. As of October 2014, the gas storage facility is 90% full. It is also assumed that the bank sector would not face systemic risks as non-resident deposits (about 80% of them coming from CIS) are well covered by highly liquid assets.

2. Public finances (CSR1)

Government finances are affected by the lower economic growth in 2014, but remain in compliance with the requirements of the preventive arm of the SGP. The fiscal deficit is estimated at 1.4% of GDP in the updated Draft Budgetary Plan, including a one-off a payment to the European Bank for Reconstruction and Development (EBRD) under the guarantee contract on the EBRD participation in solving the Parex bank restructuring during the crisis (0.4% of GDP). The underlying fiscal position has deteriorated by some 0.1% of GDP relative to the April 2014 stability programme, mostly due to weaker tax revenue in view of the slowdown in the economic activity. However, negative growth effects are muted by a somewhat stronger wage growth than previously expected. The structural deficit of 1.4% of GDP, as recalculated by the Commission services, is in compliance with the Medium-Term Budgetary Objective (MTO) of a structural deficit of 1% of GDP considering the impact of the systemic pension reform.[3]

The draft 2015 budget targets a nominal deficit on 1% of GDP, including some 0.5% of GDP for priority spending initiatives. The mission team discussed up-to-date budgetary planning. Meanwhile, on 22 November, the government reached a principal agreement on the 2015 budget and submitted the updated Draft Budgetary Plan. The detailed draft budget law is planned to be submitted to the national parliament on 10 December with the final adoption tentatively scheduled on 17 December. Fiscal space for spending initiatives was created by new taxation measures (0.3% of GDP) and lower expenditure plans in some of the line ministries (0.2% of GDP). Several smaller tax policy measures cover both taxation changes and improvements in tax collection. Moreover, already legislated tax policy measures for 2015 have remained unchanged, in particular a personal income tax rate reduction from 24% in 2014 to 23% in 2015 and an increase in social security contribution diverted to funded pension scheme. The available fiscal space is used to satisfy some of the spending initiatives in health, education, defence and agriculture sectors, with large number of spending needs remaining unanswered in 2015.

The authorities are committed to reduce the fiscal deficit below 1% of GDP over the coming years. The updated Draft Budgetary Plan targets a structural deficit of 1% of GDP in 2015, 0.9% in 2016 and 0.8% in 2017 – unchanged since the stability programme. However, in nominal terms, the fiscal position is estimated to have deteriorated by some 0.2% of GDP over the forecast horizon, largely due to lower tax revenue and higher social spending, both linked to the softening of the economy activity. This implies a reduced fiscal space for the manifold public service needs which are not fully reflected in the medium-term expenditure plans.

The medium-term expenditure plans remain tightly restrained, putting at risk their credibility in view of mounting spending pressures. After a period of tight budget control and expenditure cuts during the crisis, the authorities have allowed some nominal expenditure increases in priority areas and have resumed pension indexation in 2013. However, the expenditure plans still assume discontinuation of a wide range of existing government

[3] Latvia is eligible to the systemic pension reform clause of the preventive arm of the SGP from 2013, which allows a deviation from the MTO of 0.5%, 0.5%, and 0.8% of GDP in 2013, 2014 and 2015, respectively. Under the reform, a part of the social security contributions is being diverted from the government to funded pension scheme, thus reducing government revenue.

programmes and maintaining only the essential public services. This implies compression of the government expenditure relative to GDP, in particular in capital spending, wage bill and public purchases of goods and services. Despite intentions in line with the CSRs, for example, to expand the social safety net, to ensure competitive wage levels in the public sector and to facilitate reforms in health and education, the costs of these measures are not fully accounted for in the medium-term expenditure plans, postponing decisions to the time of annual budget preparation. In several cases this might imply that some reform strands never get financing or are overruled by short-term interests. While any budget decision reflects a fine balancing act between competing priorities for limited resources, credibility of the medium-term expenditure plans could be enhanced by incorporating more timely decisions on the spending priorities. Also, a critical look at the existing spending envelopes and a reform drive across the public sector may achieve efficiency savings.

The Tax Policy Strategy for 2015-17 was agreed by the outgoing Finance Minister and the employers' associations in October. The strategy strives at achieving predictability of taxation policy and sets a target of increasing total tax revenue to around 30% of GDP. The strategy reconfirms the continuation of the legislated personal income rate cuts to 22% in 2016 and sets out the plans to increase the minimum wage by at least 10% every year and to increase also the untaxed minimum income, thus reducing tax burden on low-income earners in line with the corresponding CSR. The monthly minimum wage will increase from EUR 320 to EUR 360 in 2015, while the plans to differentiate the amount of the non-taxable minimum are postponed to 2016. For bridging the gap between the projected tax burden of around 26% of GDP in 2017 based on the existing policies and the target of 30% of GDP, the strategy puts emphasis on combating the shadow economy and improving tax compliance, but leaves open the possibility to increase taxes on consumption and property as the second option. Given clear pressure to increase some expenditure (e.g. defence, health, social policy, specific and limited changes to the public salary grid) and the need to continue pursuing a prudent fiscal policy, increased revenues are all the more important; for this, effective tax collection is crucial.

The authorities recognise a need to tackle tax avoidance and thus unlocking tax revenue potential. Latvia has a relatively high share of shadow economy and a large gap between potential tax revenue under the existing tax laws and actual revenue collected as compared with other Member States. This is due both to occasional tax avoidance by individual companies or households as well as to a significant degree to organised criminal activities (large scale tax avoidance schemes, counterfeiting, smuggling etc.) The situation significantly worsened during the crisis, but has been improving since then, also due to the authorities' efforts to improve tax administration and to cover gaps in the taxation system. The State Revenue Service increasingly analyses risks by using existing and new registers limiting possibilities to set-up and operate fraudulent companies. The 2015 budget relies to a great extent on effective implementation of new improvements in the tax administration system. Further measures are in the pipeline, in particular changes to the public procurement law to be rolled out in 2015 which require the main contractors and sub-contractors to have no tax debts and wage levels comparable to the industry average. Against these improvements, organised crime groups tend to use more foreign residencies, often change location and use sophisticated IT solutions, complicating investigations and requiring greater cooperation with international counterparts. The authorities are working on a renewed action plan on combating the shadow economy. In this context, adequate resourcing and training of the professionals in tax administration and judiciary would further strengthen their capacity to solve complex financial crimes.

The authorities demonstrate strong commitment to the domestic fiscal framework. The Fiscal Discipline Law (FDL) entered in force and the Fiscal Discipline Council was created on 1 January 2014. The MTO of a structural deficit of 1% of GDP is the main anchor for the medium-term budgetary planning (including the 2015 budget). The Council consists of six members and a secretariat of one administrator. Its main tasks are to monitor the compliance with the FDL and to prepare regular reports on the draft budget laws and, when necessary, irregularity reports, which are made public. The Council has already been active in pointing out at irregularities in the decisions of the government and the parliament. The Council is working on the first fiscal discipline monitoring report on the 2015 budget law that will be presented to the parliament. To enhance consistency with the EU fiscal governance framework, the Commission services consider that the Fiscal Discipline Council could be clearly mandated to endorse the official macroeconomic projections underlying the budgetary plans as an independent body as defined in Regulation (EU) No. 473/2013. Establishing a clear mandate of the Council and sufficient resourcing for this function would further enhance its independence.

3. June 2013 Eurogroup letter commitments

The team together with the ECB representative took stock of the implementation of commitments made by Latvia in the June 2013 letter to the Eurogroup. The authorities have made good progress as regards fiscal policy commitments: improving cyclically-adjusted primary budget balances and reaching MTO, introducing the Fiscal Discipline Law and the Medium-Term Budget Framework Law, and implementing comprehensive pension reforms. However, progress in improving the adequacy and coverage of means-tested benefits and access to healthcare for vulnerable groups is lacking. On structural reforms, the most important unfulfilled commitments refer to the state-owned asset management and higher education reforms, as well as to revising the public sector unified wage grid (e.g., increasing senior staff salaries to around 80% of comparable wages in the private sector). Setting-up the Single Development Institution is delayed, while comprehensive insolvency regulation amendments are still to be implemented. As regards the financial sector, commitments have been implemented, in particular on closer supervision of non-resident banking and improving the anti-money laundering framework.

4. Structural policies (CSRs 2 to 5)

The issues below have formed an integral part of the BoP conditionality and are now part of the European Semester assessment framework. The five CSRs of 2014 include maintaining fiscal prudence and tackling the grey economy, advancing higher and vocational education and science reforms, implementing social assistance and healthcare financing reform, building energy interconnections to neighbouring countries and fostering energy efficiency, as well as continuing with judicial and public sector reforms, including better management of state-owned enterprises (SOE) and a stronger Competition Council. Colleagues from EMPL, EAC, ENER and SANCO joined the visit to provide a more comprehensive analysis.

Furthermore, ECFIN is in regular contact with the Paris Delegation as regards the chapter-by-chapter OECD accession negotiations with Latvia, which are expected to conclude in the second half of next year. A key review and assessment of the Latvian SOE management framework was held in Paris on 23 October; other important sectors like higher education, competition and financial supervision are being addressed in the accession talks.

Higher and vocational education and science (CSR2)

Higher education reforms are regaining some momentum. The authorities are planning to create an independent national accreditation agency in 2015, to be included in the European Quality Assurance Register for Higher Education no later than in 2018, i.e. before the next comprehensive accreditation round scheduled for 2019. Proper control of the quality of educational offer in public and private institutions has so far been lacking (only 30% of study places are public financed). Based on the recommendations from a recent World Bank study, a new higher education financing model supporting quality-criteria is being developed and some performance-oriented funding will be piloted in 2015. Other challenges include adopting changes in the governance of higher education institutions, promoting wider use of EU foreign languages in teaching, and making the study-loan system more accessible.

There have been some positive developments regarding reforms of Vocational Education and Training (VET) over the past years. The curricula reform with involvement of Sectoral Expert Councils, implementation of a National Qualifications Framework and introduction of more flexible modes of learning is in progress. The consolidation of the VET network is in the final phase. However, providing a quality work based learning and apprenticeship type schemes, especially in science, technology, engineering and mathematics fields, remains a challenge. A comprehensive VET law and secondary legislation on work based learning and formalised involvement of sectoral councils in vocational education development will need to be finalised in 2015. Motivating companies, especially SMEs, to provide quality work based learning placements remains problematic.

An independent, external evaluation of the relevance of Latvia's scientific output has been published by the Nordic Council and seems to serve as basis for determining which institutions are to be merged or liquidated and which are eligible for more EU and national funding. These are positive developments that need to be watched closely. Science issues were covered separately and in-depth during a visit of DG RTD on 29 October.

Social, labour market and healthcare policies (CSR3)

The social assistance system is weak in Latvia. The benefit adequacy and coverage is low and there is scope to improve activation and conditionality on benefit recipients, including better provision of targeted social services. The World Bank study from June 2013 proposed recommendations to reform the social assistance system. However, there has been no progress on the ground; implementation is planned only in 2017 and the planned changes are not backed by budgetary plans. Positively, the new social policy monitoring information system was launched; it will allow an improved monitoring of social benefits and services.

The labour market situation continues to improve. Active Labour Market Policy (ALMP) measures are being redesigned to reduce the overall share of public works and to increase the role of NGOs in implementation of customised support such as mentoring and counselling for the long term unemployed. The authorities are developing Active Ageing Strategy with the involvement of the World Bank, and the OECD is conducting a study on social policies for youth. However, integration into the labour market of the pre-pension age unemployed, people with disabilities and social assistance benefit recipients remains a considerable challenge. On NEETs (Not in Employment, Education or Training) outreach, guidelines for mentoring and training are being elaborated and cooperation networks with municipalities are being established. Overall, visibility of the Youth Guarantee by the target groups remains low and the career guidance system is fragmented.

Access to healthcare is hampered by low public healthcare financing and high out-of-pocket payments, leaving a high proportion of the population with unmet healthcare needs. Short-term steps are needed to improve healthcare access regionally and for the vulnerable groups, including reducing waiting times for specialist consultations and oncological diagnostics. Other challenges include improvements in sickness prevention and health promotion (country-wide screenings, information campaigns), better performance incentives for general practitioners, and implementation of the health care workforce strategy to address ageing, shortages in certain professions or geographic areas, low salaries, and up-skilling. The authorities' plans as regards mandatory health insurance are unclear.

The Ministry of Health objective for 2015 and onwards is to increase financing in outpatient services, increase accessibility in hospital care, decrease co-payments for pharmaceuticals and hospital care, increase the number of residency places, especially in rural areas, and implement e-health applications. To achieve these goals, additional and stable financing will be needed as of 2015. Still, despite the low public health financing, there is some scope for efficiency gains, inter alia, as regards pharmaceutical purchases or hospital transfers (e.g., introduction of the Diagnosis-Related-Group payment system).

Energy independence and efficiency (CSR4)

After several delays it seems that **full electricity market opening** will take place on 1 January 2015 and price regulation will end. Electricity price for households is expected to increase by around 15-30% depending on level of consumptions, but this needs to be viewed against price freeze since 2011. The incumbent Latvenergo is the designated supplier for vulnerable customers, which profit from a regulated tariff for their first 100 kWh/month. Vulnerable customers are defined on basis of their income and families with more than two children (the latest category will have an allowance for supply of electricity for the same price of 300 kWh/month) automatically qualify for support; the municipalities have the role of identifying eligible consumers. The contract to supply at least 100 000 vulnerable customers will be open for tender next year.

Prices on the wholesale market in the Latvian-Lithuanian price zone are on average still higher than in Estonia and less stable. The Estonian-Latvian connection is still heavily congested and no changes are to be expected in 2015. To alleviate the situation, Transmission System Operators (TSOs) will be offering more transmission capacities. By end-2015 the situation is likely to improve as Nordbalt, the Swedish-Lithuanian Interconnector, will be completed, thus bringing lower Swedish prices to the Latvian-Lithuanian price zone and relieving congestion on the Estonian-Latvian connection. It is unclear what will be the effect from the completion of the link between Lithuania and Poland in 2016; however it is expected to be positive.

Latvia's emergent gas market exemption expired on 4 April 2014 and the respective legislation to address obligations has been partly put in place. As a first step, the Third Party Access (TPA) rules for the transmission grid and the Incukalns gas storage facility need to be enshrined in secondary legislation. Proposals for TPA rules and associated tariffs as proposed by the gas monopoly Latvijas Gaze are being assessed by the national regulator. TPA rules will partly determine to what extent the LT Klaipeda LNG terminal can play a regional role.

Latvia's exemption as an isolated market still stands, thus TSO unbundling will need to be completed by April 2017 (e.g., making the current monopoly's transmission and distribution infrastructure accessible to potential new supplies). The authorities will need to complete the gas market opening legislation during 2015, so that Latvijas Gaze could start gradual unbundling from 2016.

Latvia's progress towards the 2020 **renewable energy target** has slowed; at the same time, a moratorium for issuing new renewable energy support licences stands until 2016. There are concerns about significant reliance on gas imports in district heating, especially Riga. Co-owned by the municipality of Riga and “Latvenergo”, Riga district heating company is currently sourcing 90% of its heat from two “Latvenergo” gas-powered Combined Heat and Power productions (TEC-1 and TEC-2), the rest being generated in smaller biomass CHPs and boiler houses. The current ownership structure dictates heating tariffs to be as low as possible in Riga, thus preventing further investments.

Judicial, public administration, SOE and competition reforms (CSR5)

The efficiency and quality of the **judicial system** has improved, though challenges remain: implementing proposed amendments to civil, administrative and criminal procedural laws, ensuring proper implementation of the insolvency law (i.e., accountability of insolvency administrators); establishing a comprehensive human resource policy linked to a professional evaluation of judges, and strengthening the role of the Judicial Council and court chairpersons in implementing judicial reforms. There has been good progress as regards the reform of arbitration courts and mediation, but further steps are needed. For 2015 and onwards the Ministry of Justice is planning work on further redistribution of caseloads across courts, further consolidation and specialisation of courts, reducing the number of prisons, simplifying investigation procedures, improving accountability of sworn attorneys in courts, and improving administrative procedures/courts. Significant EU funds financing will be allocated for trainings of investigators, prosecutors and judges in the 2014-2020 financing period.

The State Chancellery has recently proposed ambitious reforms related to common standards for **public sector** hiring, remuneration, career development, assessment, motivation and training. The Cabinet of Ministers adopted a draft Public Service Law on 16 September; however, local governments will be exempted and these initiatives may face significant resistance in the Parliament. Positively, a centralised selection of senior public officials is due to start from September 2015. Insufficient pay compared to responsibilities and private sector salaries as well as weak development opportunities result in high staff rotation. The Finance Ministry has recently prepared proposals for improvements to the unified wage grid (e.g., senior level salaries, independent institutions); however, political support is lacking.

The SOE management reform is a key issue for PPS. It was promised to be in force by early 2014 in the June 2013 Eurogroup commitment letter in the context of Latvia’s euro accession, after many delays during the EU-IMF financial assistance programme 2009-2012. To comply with the OECD accession requirements, the framework law was adopted in the final reading on 16 October; however, it is important to focus now on the actual implementation, including adoption of necessary secondary legislation. Also, the modalities for establishing a centralised SOE manager under the Cabinet of Ministers, the staffing and remuneration conditions remain unclear. There is some movement as regards the selection of boards of directors of SOEs (an instruction was passed by the Cabinet of Ministers on 23 September); however, there are doubts whether the selection processes can be shielded from political interference.

The Commission team expressed support to **the Competition Council's** proposals for amendments to the Competition Law as regards greater institutional and financial independence to intervene effectively against actions of public bodies restricting competition and prevent experienced staff from leaving. Independent budgeting of the institution is needed, outside the limitations of the unified wage grid and similar to other independent institutions (e.g., the financial and utilities regulators, air traffic controllers). Other options could be increasing fees for the Council's services (e.g., approval of mergers). The Commission has also advocated greater involvement of the Council in screening of the EU funds-financed procurements for possible cartel or bid-rigging activities (the Procurement Monitoring Bureau has been verifying legal compliance).

The team encouraged the authorities to implement actions improving **Riga and Ventspils ports' operational management**, **transparency, and regional competitiveness**, as supported by a 2013 World Bank and State Audit analysis. Few reforms have taken place in this sector due to strong vested interests and the government's inability to exercise control. State and local governments of Riga/Ventspils are equally represented on the supervisory boards; "the Law on Ports" should be changed to resolve this. Risks to the ports' business are significant in the current environment, though Russia cannot fully bypass the ports in the Baltics due to rail capacity limitations towards Russian ports and freezing of northern ports during winter months.

<u>Financial sector policies (2013 CSR2)</u>

When preparing to join the euro area, **financial supervision has been tightened and corresponding resources increased**, in particular as regards monitoring non-resident banking activities and strengthening the anti-money laundering framework. Additional liquidity and capital adequacy requirements for non-resident banks were introduced, regular on- and off-site checks are performed, the Deposit Guarantee Fund has been strengthened, banks are diversifying their funding base (issuing obligations/subordinate capital) and their activities in the domestic market are limited. Still, reliance on a single provider of US dollar correspondent accounts remains and the recent geopolitical tensions may result in weaker banks' performance. On the positive side, euro introduction has made transactions cheaper and may result in reduced reliance on US dollar payments.

On 30 October the special law for **setting up the Single Development Institution** (SDI) was adopted by the Parliament[4]. The authorities are working on operational aspects for the institution to be set-up by March; judged from past experience, delays are likely. Operational savings from streamlined staff, real estate, risk assessment and IT systems are unlikely. Also, setting up the energy efficiency revolving fund, in future part of SDI, is significantly delayed.

The agreement to sell **Citadele** bank (the "good" part of Parex bank which was nationalised in the crisis) has been signed and the final deal will be sealed by end-March 2015, the deadline set by DG COMP (final sales price may still change depending on balance sheet re-

[4] SDI will bring together the former Mortgage Bank of Latvia, the Latvian Guarantee Agency and the Rural Development Fund to implement EU funds-financed financial engineering programmes.

assessment by auditors appointed by the buyer). While the price offered is less than expected in spring due to geopolitical tensions and a severely back-loaded sales process, it is important to finalise the deal. An entrance of a new player in the domestic banking market may increase competition and lending.

Reverta (the "bad" part of Parex bank) continues wind down, but the initial forecast for divestments seems to have been too positive. The total losses for the state at the time of final wind-down in 2017 are in line with the 2010 restructuring plan projections and reflected in earlier budgets. Litigation against former shareholders continues, but will take many years.

5. Loan repayment

The cash balance of the Treasury is estimated at around EUR 2 billion (8.3% of GDP) at the end of October 2014, which is sufficient to cover the forthcoming loan repayment of EUR 1.2 billion to the Commission in mid-January 2015. Thereafter, a minimum cash balance is expected to be kept at around EUR 250 million. The country also has swift access to bond markets at favourable yields allowing for interest cost cuts upon debt rollovers. So far the Russia/Ukraine conflict has not affected Latvia's borrowing costs as yields on 10-year bonds have been steadily decreasing to 2.3% in September 2014 from 3.5% a year earlier. This reflects the overall trend on the European bond markets while the spread to German bunds has remained stable at around 140bps for the same period. The entry into the euro area at the beginning of 2014 resulted into one-notch upgrades by all mainstream rating agencies to A-/Baa1, stable outlook. The switch to the euro also increased foreign investor interest in domestic bonds as witnessed by higher bid-to-cover ratios at recent auctions.

Debt placements have been very successful allowing the Treasury to refinance its liabilities at lower cost. In January 2014, the country issued a 7-year eurobond in the amount of EUR 1 billion at a yield of 2.82% as compared to an interest rate of 3.125% charged on the 5-year EU loan repaid in March 2014. In April 2014, the country issued a 10-year Eurobond in the amount of EUR 1 billion at a yield of 2.96% to pre-finance future debt repayments. Considering the current cash balance and forthcoming debt and budget financing requirements, the Treasury estimates debt issuing needs at EUR 875 million in 2015; this is significantly lower than in previous years. Loan repayment risks are therefore very low at present even in the context of existing external risks.

Principal debt repayments under the programme (EUR million)

	2012	2013	2014	2015	2016-18	2019	2020-25	**Total**
EC			**1,000***	**1,200**		**500**	**200**	**2,900**
IMF	1,100							1,100
WB				60	240	80	20	400
Total	**1,100**	**0.0**	**1,000***	**1,260**	**240**	**580**	**220**	**4,400**
Total, % of GDP	5.2%		4.0%	4.8%		2.0%		

Repaid on 25 March 2014

ANNEX 1: PRELIMINARY ASSESSMENT OF LV CSR IMPLEMENTATION

2014 Recommendations	State of play
***1.** Preserve a sound fiscal position in 2014 and strengthen the budgetary strategy as of 2015, ensuring that the deviation from the medium-term objective remains limited to the impact of the systemic pension reform. Pursue efforts to further reduce the tax burden on low-income earners in the context of a shift towards more growth-friendly property and environmental taxes and by improving tax compliance and collection.*	• **In 2014 general government deficit is projected to be 1.4% of GDP** (deviation of 0.4% of GDP from initial plans mainly related to the sale of Citadele bank). The updated Draft Budgetary Plan targets a structural deficit of 1% of GDP in 2015. • **From 1 January 2015, the personal income tax rate will be reduced from 24% to 23%**. Far-reaching changes to PIT non-taxable thresholds will be implemented in 2016. The minimum salary will be increased from EUR 320 to EUR 360 in January 2015. • **To improve tax collection, the authorities have decided, inter alia, to:** publish information on the amount of tax paid by merchants; improve the information exchange process among government entities and make use of new and existing registers; determine the personal responsibility of board members for delayed tax payments.
***2.** Step up implementation of the higher education reform, in particular through the establishment of an independent accreditation agency and a financing model that rewards quality. Provide career guidance at all education levels, improve the quality of vocational education and training, including by strengthening apprenticeship, and make progress as regards the employability of young people including by putting in place outreach measures for non-registered youth not in employment, education or training. Take steps for a more integrated and comprehensive research system also by concentrating financing towards internationally competitive research institutions.*	• **Higher education reforms are regaining some momentum.** The authorities are planning to create an independent national accreditation agency in 2015, to be included in the European Quality Assurance Register for Higher Education no later than in 2018. Proper control of the quality of educational offer in public and private institutions has so far been lacking (only 30% of study places are public financed). Based on the recommendations from a recent World Bank study, a new higher education financing model supporting quality-criteria is being developed and some performance-oriented funding will be piloted in 2015. • **There have been some positive developments regarding reforms of Vocational Education and Training (VET) over the past years.** The curricula reform with involvement of Sectoral Expert Councils, implementation of a National Qualifications Framework and introduction of more flexible modes of learning is in progress. The consolidation of the VET network is in the final phase. However, providing a quality work based learning and apprenticeship type schemes, especially in science, technology, engineering and mathematics fields, remains a challenge. • **An independent, external evaluation of the relevance of Latvia's scientific output has been published by the Nordic Council** and seems to serve as basis for determining which institutions are to be merged or liquidated and which are eligible for more EU and national funding.

***3.** Reform social assistance and its financing further to ensure better coverage, adequacy of benefits, strengthened activation and targeted social services. Increase coverage of active labour market policies. Improve the cost-effectiveness, quality and accessibility of the healthcare system.*	• **The social assistance system is weak**. Benefit adequacy and coverage is low and there is scope to improve activation and conditionality on benefit recipients, including better provision of targeted social services. The World Bank study of June 2013 proposed recommendations to reform the system; however, there has been no progress on the ground; implementation is planned only in 2017 and the planned changes are not backed by budgetary plans. • **The labour market situation continues to improve.** ALMP measures are being redesigned to reduce the overall share of public works. However, integration into the labour market of the pre-pension age unemployed, people with disabilities and social assistance benefit recipients remains a considerable challenge. On NEETs outreach, guidelines for training are being elaborated and cooperation networks with municipalities are being established. Overall, visibility of the Youth Guarantee by the target groups remains low and the career guidance system is fragmented. • **Access to healthcare** is hampered by low public healthcare financing and high out-of-pocket payments, leaving a high proportion of the population with unmet healthcare needs. E.g., short-term steps are needed to reduce waiting times for specialist consultations and oncological diagnostics. Other challenges include improvements in sickness prevention and health promotion (country-wide screenings, information campaigns), better performance incentives for general practitioners, and implementation of the health care workforce strategy to address ageing, shortages in certain professions or geographic areas, low salaries, and up-skilling. Positively, significant additional financing for healthcare is earmarked in the 2015 budget.
***4.** Accelerate the development of gas and electricity interconnections to neighbouring Member States to diversify energy sources and promote competition through improved integration of the Baltic energy markets. Pursue efforts to further increase energy efficiency in transport, buildings and heating systems.*	• After several delays **full electricity market opening** is planned for 1 January 2015 and price regulation will end. • **Latvia's emergent gas market exemption** expired on 4 April 2014 and the respective legislation to address obligations has been partly put in place. Third Party Access rules for the transmission grid and the Incukalns gas storage facility need to be enshrined in secondary legislation. • **Latvia's exemption as an isolated market** still stands, thus Transmission System Operators unbundling will need to be completed by April 2017 (making the current monopoly's transmission and distribution infrastructure accessible to potential new supplies). The key challenge is the re-negotiation of the Incukalns gas storage management contract from 2017, including resolving ownership disputes. • Latvia's progress towards the 2020 **renewable energy target** has slowed; a moratorium for issuing new renewable energy support licences stands until 2016.

5. *Complete judicial reforms including the pending reforms of insolvency, arbitration and mediation frameworks to ensure a more business- and consumer-friendly legal environment. Step up public administration reforms, including by implementing state-owned enterprise management reform and increasing institutional and financial independence of the Competition Council.*	• The efficiency and quality of the **judicial system** has improved, though challenges remain: implementing proposed amendments to civil, administrative and criminal procedural laws, ensuring proper implementation of the insolvency law; establishing a comprehensive human resource policy linked to a professional evaluation of judges, and strengthening the role of the Judicial Council and court chairpersons in implementing judicial reforms. There has been good progress on the reform of arbitration courts and mediation, but further steps are needed. • The State Chancellery has recently proposed ambitious reforms related to common standards for **public sector** hiring, remuneration, career development, assessment, motivation and training (draft Public Service Law); however, local governments will be exempted. Positively, a centralised selection of senior public officials is due to start from September 2015. Insufficient pay compared to responsibilities and private sector salaries result in high staff rotation. The Finance Ministry has recently prepared proposals for improvements to the unified wage grid (e.g., senior level salaries, independent institutions); however, political support is lacking. • **The SOE management reform law** was adopted in the final reading on 16 October; however, it is important to focus on the actual implementation, including adoption of necessary secondary legislation. The modalities for establishing a centralised SOE manager, the staffing and remuneration conditions remain unclear. There is some positive movement on the selection of boards of directors of SOEs; however, there are doubts whether the selection processes can be shielded from political interference. • **The Competition Council** has prepared far-reaching proposals for amendments to the Competition Law as regards greater institutional and financial independence to intervene effectively against actions of public bodies restricting competition and prevent experienced staff from leaving.

ANNEX 2

EUROPEAN COMMISSION

MEMO

Commission staff conclude sixth Post-Programme Surveillance mission to Latvia

Brussels, 14 November 2014

Following the successful conclusion on 20 January 2012 of the three-year financial support programme by the EU, the sixth and most likely last Post-Programme Surveillance (PPS) mission to Latvia was carried out by staff of the European Commission from 11 to 14 November, together with the European Central Bank.

Overall, the assessment of the post-programme developments is positive, though the developments between Ukraine and Russia present downside risks to growth of Latvia's economy. The euro changeover has been completed, the fiscal position is under control with projected deficits around 1% of GDP in 2014-2015, and the financial sector has been strengthened, including as regards surveillance of non-resident bank services. Also, actions have been taken to improve the judiciary (procedural changes, mediation and arbitration laws, accountability of insolvency administrators) and to intensify the fight against tax avoidance. Further, the financing for science will be allocated based on the results of an independent international assessment. The electricity market is planned to be fully liberalised from January 2015. In addition, promising laws on construction, public procurement, insolvency, state-owned enterprise (SOE) management and the Single Development Institution have been adopted. It will be important to monitor how these laws are implemented in practice, including by finalising the needed secondary acts and appointing professional SOE board and council members.

On the other hand, big-item, "quality-of-life-improving" reforms to tackle high social inequality and inadequate healthcare access for the poorest, improve general and higher education outcomes, deal decisively with corruption cases, and modernise public administration have barely advanced. This is either due to strong vested interests, to a general reform fatigue, or to difficult budgetary choices in view of tight fiscal space. Similarly, decisions on de-politicising the management of state-owned enterprises and ports have come slowly and still need follow-up. Measures to boost energy independence, in particular on gas market opening and the future management of Incukalna gas storage, need to be implemented. Overall, a greater sense of urgency seems warranted: it is important to keep the pace of reforms to improve general living standards sustainably.

The authorities are committed to a prudent level of government borrowing. Fiscal space to address the manifold public service needs is limited; thus, either new revenue sources need to be found or existing spending has to be re-focused and improved. Shifting the tax burden from labour to consumption, property and pollution would strengthen the growth potential of the economy and help improving social equality. Positively, the 2015 budget proposals include measures supporting low income earners through an increase in the minimum wage in addition to the already scheduled personal income tax rate reduction. While the authorities foresee measures to tackle tax avoidance, more could be done in this area given the severity of the problem relative to other Member States. Importantly, resourcing and training of the professionals in tax administration and judiciary need to be further strengthened to solve complex financial crimes.

The end of post-programme surveillance will be decided in the coming weeks by the Commission, after consulting the Member States, taking into account a EUR 1.2 billion repayment planned by Latvia for January 2015 which would bring total repayments to 75% of the EU loan provided to Latvia. After the post-programme surveillance process, it will be essential to keep the structural reform momentum and fiscal and financial prudence, which will be monitored through the European Semester framework.

Background

From 2009 to 2011, Latvia benefited from a financial assistance programme (Balance of Payment Support) from the EU, provided in conjunction with an IMF (International Monetary Fund) stand-by agreement and financing commitments by the World Bank, the European Bank for Reconstruction and Development, several EU countries and Norway. Funds available amounted to EUR 7.5 billion, of which Latvia used EUR 4.5 billion (60%), with EUR 2.9 billion lent by the European Commission on behalf of the EU. The lending was subject to an ambitious action plan, including fiscal consolidation and wide-ranging structural reforms, which have proven quite effective to help the country to recover from a deep financial and economic crisis. The European Commission will continue its close surveillance of planned and implemented reforms after the Post Programme process is closed through the European Semester framework.

For more information

Post-programme surveillance for Latvia

ECFIN Occasional Paper "EU Balance-of-Payments assistance for Latvia: foundations of success"

MEMO/14/1768