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COMMISSION STAFF WORKING DOCUMENT

Assessment of the 2012 national reform programme and convergence programme for LATVIA

Accompanying the document

Recommendation for a

COUNCIL RECOMMENDATION

on Latvia's 2012 national reform programme and delivering a Council opinion on Latvia's updated convergence programme, 2012-2015

CONTENTS

EXECUTIVE SUMMARY

After a strong rebound in 2011, Latvia's GDP growth is expected to decelerate to 2.2% in 2012. The rate of unemployment dropped substantially in 2011 and is expected to decrease further to 14.8% in 2012 but youth and long-term unemployment rates remain high.

The government has ensured financial stability and fiscal consolidation by over-achieving its fiscal targets. In 2012, the general government deficit is expected to decrease to 2.1% of GDP. In other areas, however, reform efforts have been limited, particularly as regards the public administration and the unified wage grid, management of state owned assets, strengthening of the competition framework, setting up of the Development Bank and outlining proposals for managing the EU funds in the new financing period.

Latvia continues to face important policy challenges: building on the significant progress made regarding public finances, further fiscal consolidation is necessary to meet the medium-term objective to maintain market confidence. Latvia has one of the highest long-term and youth unemployment rates in the EU. There is a relatively high tax wedge on low-wage earners and a high level of undeclared work. A high share of the population is at risk of poverty or social exclusion. The coverage of unemployment benefits is low and the impact of social transfers on poverty reduction is small. Inefficiencies in the civil justice system have a negative impact on the business environment. The education and training systems are not adapted to labour market needs and not geared to improving Latvia’s innovation performance. Improving energy efficiency, in particular of the building stock, would contribute to growth and jobs, while reducing energy dependence.

1. INTRODUCTION

Procedural aspects

In July 2011 the Council of the European Union adopted only one country-specific recommendation for Latvia: implement the balance of payments programme conditions.

In November 2011 the Annual Growth Survey for 2012 (AGS 2012) presented the basis for building the necessary common understanding about the priorities for action at national and EU levels in 2012. It focused on five priorities — ensuring growth-friendly fiscal consolidation, restoring normal lending to the economy, promoting growth and competitiveness, tackling unemployment and social consequences of the crisis, and modernising public administration — and encouraged Member States to implement them in the 2012 European Semester.

Against this background, Latvia presented its national reform programme and convergence programme in April 2012. The documents outline the fiscal consolidation efforts in a consistent manner, based on medium-term macroeconomic projections and key structural reforms. The national reform programme evaluates the progress made towards meeting the national targets for employment, R&D, education, energy and climate change, and poverty reduction for 2020. It also describes the measures Latvia plans to take under the Euro Plus Pact.

This Staff Working Document assesses the state of implementation of the balance of payments programme condition, as expressed in the latest Supplemental Memorandum of Understanding, identifies current policy challenges and, in this light, examines the country's latest policy plans.

Overall assessment

Overall, the policy plans submitted by Latvia are adequate, but in some areas they lack the ambition to address the challenges in a comprehensive way. The most pressing challenges facing Latvia are to continue growth-friendly fiscal consolidation and implement wide-ranging structural reforms to achieve sustainable growth and catch up with other EU countries. In particular, strong implementation of the conditions outlined in the latest Supplemental Memorandum of Understanding will be important, inter alia in the fields of energy markets and energy efficiency, higher education and vocational training, management of state-owned enterprises, public administration and the judicial system, competition and public procurement policies, restructuring and sales of state-owned banks and management of EU funds.

2. ECONOMIC DEVELOPMENTS AND CHALLENGES

2.1. Recent economic developments and outlook

Recent developments

After a severe economic contraction in 2008-09, the Latvian economy started to grow again towards the end of 2010 and switched to a rapid recovery in 2011. The economy expanded by 5.5% in 2011 driven mainly by exports and investments and was quite resilient to the adverse external demand shocks in the second half of the year. At the beginning of 2012, industrial production, retail trade and transport services were also performing relatively well, indicating some decoupling from the weak performance in many EU Member States. The economic sentiment indicator rebounded to a four-year high at the beginning of 2012 with improvements recorded in both the household and corporate sectors. Unemployment remains among the highest in the EU after deteriorating to about 20% at the beginning of 2010 from 6-7% in the pre-crisis period.

However, the unemployment rate dropped substantially to 16.1% in 2011 and 15.0% in the last quarter of the year. The harmonised index of consumer prices (HICP) inflation was in line with expectations at 4.2% in 2011, including a large contribution from the increase in VAT rates. The constant-tax price index is estimated at 2.7% in 2011.

The current account balance turned to a deficit of 1.2% of GDP in 2011 after surpluses in 2009 and 2010. The country remained in a net lender position, however, as the net inflows in the capital account reached 2.1% of GDP. The rebalancing of the economy towards tradable sectors continued at a fast pace as the share of exports in GDP expanded to 59% in 2011 from 54% in 2010. The net inflows of foreign direct investments rebounded substantially in 2011 while the share of external debt to GDP decreased further.

Outlook

The Commission spring forecast projects that Latvia's growth rate will slow down to 2.2% in 2012 due to weakening external demand in the first half of the year combined with some downward correction of the consumption propensity of households as a result of global economic uncertainties. However, in line with the expected improvement in external demand, growth is set to regain momentum in the second half of 2012 and to accelerate to 3.6% in 2013. Unemployment is expected to decrease further in 2012-13 though at a relatively weak pace set by slower economic growth. Inflation is projected to decelerate to 2.6% in 2012 and 2.1% in 2013 as the impact of the tax increases in 2011 weakens substantially. Uncertainties about prices of primary energy resources pose a significant risk to the inflation forecast, as the country depends heavily on energy imports.

Both the national reform programme and the convergence programme share the same economic outlook, but neither of them gives any figures on the impact of the proposed structural reforms on growth. The economic growth outlook for 2012-13 is broadly in line with the most recent Commission forecast. In 2014-15, the annual growth rate is expected to accelerate to 4%, which is seen as the medium-term potential growth in the country. This rate remains unchanged from the projections presented in the 2011 programmes but could be subject to slight downside risks as the results of the 2011 census show a faster decline in the population than previously estimated.

2.2. Challenges

Although growth has resumed after the financial crisis, Latvia should speed up its reforms to improve growth potential. In particular, Latvia has amongst the highest long-term and youth unemployment rates in the EU. This, along with the relatively high tax wedge on low wage earners and the high level of undeclared work, indicates a need for appropriate labour market policies, a review of the tax and benefit system and greater efforts to tackle the grey economy (e.g. without effective activation and support measures, the marginal tax rate for low-earners will remain discouragingly high, increasing both unemployment and poverty). The high share of the population at risk of poverty or social exclusion is also a cause for concern: families with children and the unemployed are particularly affected. The coverage of unemployment benefits is low and the impact of social transfers on poverty reduction is small. Ensuring an effective system of social assistance to protect the most vulnerable while maintaining incentives to work remains a challenge.

Despite relatively good overall educational attainment, the quality of tertiary and vocational education remains a cause for concern. There is evidence of skills mismatches on the labour market, including an insufficient number of graduates in science and technical subjects. There is also a low degree of employment in knowledge-intensive activities. More efforts to implement the necessary reforms in higher and vocational education (in line with the commitment made in the Supplemental Memorandum of Understanding) would help to adapt education and training systems further to labour market needs. Latvia's poor innovation performance impairs its competitiveness and the country has no systematic and effective research and innovation policy. There is little R&D investment by domestic companies or large foreign affiliates to support specialisation in knowledge-intensive and innovation-driven sectors.

Completing the restructuring and sales of the three state-owned banks — Parex, Citadele and MLB — to comply with the Commission's state aid decisions is the most pressing issue in the field of financial stability. Consistent implementation of the plans for these banks would further increase confidence in the financial sector and allow the public sector to withdraw from commercial activities. The 2011 Latvian Competitiveness Report also highlights the underdeveloped financial markets as one of the main weaknesses of the economy.

Regional economic disparities have widened, mostly due to the rapid growth of the capital Riga. Regional problems are most acute in the eastern parts of the country, which have particularly low levels of investment per capita, relatively few enterprises and very high unemployment rates. Disparities are widening due to an increasing urban/rural divide, triggered largely by migration to Riga from rural areas and other cities.

The poor overall condition of transport infrastructure is undermining the growth and competitiveness of the country. Significant differences also exist in the development of ICT infrastructure and expansion of broadband connections between urban and rural areas.

Isolation from the EU gas and electricity markets and low energy efficiency are key challenges facing Latvia. One centrepiece could be to improve significantly the energy efficiency of the building stock, thereby contributing to growth and jobs, while reducing energy dependence. Low energy efficiency is also a challenge for the transport sector.

Further environmental challenges lie in the water and wastewater treatment sectors and waste management, with landfills remaining the main option for disposal of municipal waste (around 90 %).

Progress with reforming management of both state-owned enterprises and public real estate will require a sharp focus. The new state-owned enterprises governance model is supposed to be in place by the end of March 2013, while action is still needed to adopt a special law on management of state-owned enterprises, to transfer assets under the new state-owned enterprises management authority and to give the centralised state-owned enterprises manager appropriate capacity. Further centralisation of public real estate management under the Finance Ministry and divestments of assets not used for public needs are planned.

Progress is expected in the next few months on a number of key conditions included in the latest Supplemental Memorandum of Understanding: preparing a strategy for management of human resources, implementing energy-related EU legislation, strengthening energy efficiency programmes, making amendments to the Public Procurement Law, improving the quality assurance system for roadbuilding, reviewing the port management and taxation system, adopting a Construction Law, etc.

Given the notable impact of EU cohesion funds on the economy, creating the conditions for effective support and reinforcing strategic programming of funds for 2014-2020 will be important in order to deliver on the Europe 2020 priorities.

Inefficiencies in the civil justice system have a negative impact on business and the economic environment, as they increase the risk and cost of doing business. There is a large backlog of civil and commercial cases before the first- and second-instance courts, together with excessively long procedures. There are still weaknesses in the insolvency law. The professional performance and accountability of judges are not always up to standard. Training of both judges and prosecutors is not sufficient to ensure that they have the appropriate qualifications.

3. ASSESSMENT OF THE POLICY AGENDA

3.1. Fiscal policy and taxation

The main goal of the medium-term budgetary strategy of the 2012 convergence programme is to secure correction of the excessive deficit situation by the deadline recommended by the Council (2012) and subsequently to approach the medium-term objective (MTO), which has been revised to a more ambitious target of a structural deficit of 0.5% of GDP. Under the convergence programme strategy, the headline general government balance will reach a near-balanced position in 2015. The adjustment is front-loaded, with greater improvement in the structural deficit in 2012-2013 than in 2014-2015.

Budgetary developments and debt dynamics

As a result of the ambitious front-loaded fiscal consolidation implemented since 2009 and of the faster-than-expected recovery in growth, Latvia's general government position improved strongly in 2011, reaching a deficit of 3.5% of GDP, which is considerably better than both the initial deficit target set under the balance-of-payments assistance programme (deficit of no more than 6% of GDP) and the target of a deficit of no more than 4.5% of GDP in the 2011 convergence programme. This was achieved thanks to stronger-than-expected economic recovery and lower exceptional costs related to the restructuring of the banking sector. Moreover, while tax revenue as a share of GDP was broadly in line with expectations in the previous programme, several expenditure categories not related to absorption of EU funds (notably social benefits) were kept under tight control, leading to a reduction in their share in GDP.

The programme expects the general government headline deficit to decline further to 2.1% of GDP in 2012, which is in line with the projections in the Commission spring 2012 forecast and better than the target of a deficit of 2.5% of GDP in the previous programme. The macroeconomic scenario underpinning these projections is broadly in line with Commission projections; however, the most recent information (notably the estimate of economic growth in the first quarter of 2012) indicates that this scenario can be considered as cautious. According to estimates in the programme, measures in the 2012 budget law to improve the budgetary position add up to 0.7% of GDP (see Box 1). The budget law was adopted by the Saema (Parliament) on 15 December 2011. The programme thus aims to bring the excessive deficit below the 3% reference value — with sizeable leeway against adverse developments — by the date recommended by the Council. Risks to fiscal projections for 2012 stemming from the macroeconomic scenario seem on the upside, taking into account the most recent information. However, the programme acknowledges that consideration is being given to reducing the VAT rate; the letter accompanying the programme, along with recent public information, suggest that this will take place in 2012 already (see also the section on the '*Tax system*').

Nevertheless, the planned reduction in the VAT rate is unlikely to endanger meeting the current target for 2012.

Box 1: Main budgetary measures

Revenue	Expenditure
2011	
1.6% of GDP	-0.7% of GDP
2012	
Legislative measures to support the fight against the grey economy, including application of reversed VAT in some sectors, and changes in taxation of the gambling industry (0.25% of GDP) Broadening the real estate tax base and abolishing the limits on increases in real estate tax (0.03% of GDP)	Nominal wage freeze in the public sector and other measures to limit or reduce expenditure, notably cuts in subsidies to transport and road maintenance and review of the sickness benefit scheme (-0.4% of GDP)
2013	
Resuming contributions to the private mandatory funded pension scheme at 6% of gross wages, compared with the current temporarily lowered contribution of 2% (-0.6% of GDP)	Reforming the system of family allowances and social safety net (impact not specified) Continue limiting maximum amounts of family and sickness benefits (impact not specified)
2014	
n/a	n/a
2015	
n/a	n/a

<u>Note</u>: *The budgetary impact in this table is the impact reported in the programme, i.e. by the national authorities. A plus sign means that revenue/expenditure increases/decreases as a consequence of the measure.*

For 2013, the authorities are aiming for a nominal budget deficit of 1.4% of GDP, which is better than the target of a deficit of 1.9% of GDP in the previous programme. The macroeconomic projections in the programme for 2013 are plausible. According to the programme scenario, the reduction in the headline deficit will be achieved through continuous restraint in compensation of employees (i.e. a nominal wage freeze in the public sector) and through further cuts in intermediate consumption. These measures, however, currently do not seem to be backed by any specific action and thus represent risks to attainment of the target. While in the past the Latvian authorities have demonstrated their ability to implement planned expenditure cuts, these have often taken the form of 'across-the-board' expenditure reduction. Such a strategy entails risks related to slippages in implementation, excessive cuts in public employment being detrimental to efficiency, and uncompetitive wages which could lead to better performing employees quitting the public sector, a trend which is already visible in higher-level positions. It will thus be important to identify targeted and sustainable measures in the 2013 budget to support the planned expenditure restraint. At the same time, there are several areas — notably social benefits — where expected savings in 2013 are already backed by legislation. Another risk comes from the planned tax cuts that are being considered but are not yet reflected in the programme scenario (see the section on the '*Tax system*').

The structural balance[1] is expected to improve by ¼% of GDP in 2013 (compared with an improvement of ½% based on estimates in the Commission spring 2012 forecast), taking the structural deficit to below 1% of GDP, according to the information in the programme.[2] These projections take into account the negative impact on both the nominal and (recalculated) structural balance of restoring contributions to the mandatory funded private pension scheme to 6% of gross wages from 2013, compared with the current reduced level of 2%. In the Commission estimates, the current lower level of contributions is treated as a temporary measure excluded from the structural balance. Thus its reversal in 2013 will affect only the nominal but not the structural balance. The impact of this reversal on the 2013 nominal balance is, however, assessed to be higher in the Commission's projections than in the programme's estimates, posing another risk to attainment of the target.

Latvia's medium-term budgetary objective has been revised in the 2012 convergence programme. The new medium-term objective of a structural deficit of 0.5% of GDP is higher than the previous figure and adequately reflects the requirements of the Stability and Growth Pact. The revision of the medium-term objective is linked to a major reform of fiscal governance in Latvia which is discussed in more detail below.

In 2014 and 2015, the programme aims for a continuous improvement in the nominal balance, reaching a near-balanced position in 2015. The targeted improvement comes from continuing restraint in government consumption. Thus risks applicable in 2013 will remain relevant. Planned tax cuts pose another risk. According to the programme, the structural deficit will approach the medium-term objective by the end of the programme period in 2015.

Based on the information provided in Tables 2a, 2b and 2c in the Annex to the programme, the expenditure benchmark is set to be met in all the years following correction of the excessive deficit (i.e. 2013-2015). However, taking into account the discretionary impact on revenue of restoring contributions to the mandatory funded pillar to 6% of gross wages (included in Table 7.8 of the programme, but not reflected in Table 2b), the expenditure benchmark would be missed, albeit only narrowly, in 2013. Taking the Commission estimate of the discretionary impact, the deviation in 2013 would be somewhat higher. However, in both cases the average deviation in 2012 and 2013 would remain negative, given the substantial front-loaded expenditure restraint in 2012. In the outer years of the programme the planned expenditure restraint would ensure that expenditure growth remains significantly negative, and hence in line with the expenditure benchmark in the Stability and Growth Pact.

In the programme scenario the general government debt is projected to increase from 42.6% of GDP in 2011 to 46.7% in 2014, falling thereafter rapidly to 38.9% of GDP in 2015. This profile reflects accumulation of financial assets in anticipation of large repayments of loans under the financial assistance programme (as evidenced by high stock-flow adjustment in 2012-2014) and the subsequent repayment of a large share of these loans in 2014-2015. In June 2011, the authorities successfully returned to international financial markets and a second major international bond issue took place in

[1] Cyclically-adjusted balance net of one-off and temporary measures, recalculated by the Commission on the basis of the information provided in the programme, using the commonly agreed methodology.

[2] Compared with the recalculated structural balance, the programme forecasts higher structural budgetary improvement, by 0.5% of GDP annually in 2013-2015. The discrepancy is mainly due to a different assessment of the starting cyclical point between the common methodology and the approach taken in the programme. Subsequently, the programme attributes a higher share of the targeted nominal improvement to the structural component than in the recalculated information.

February 2012. All major credit-rating agencies have revised Latvia's sovereign ratings to the investment grade. The latest upgrade took place in May 2012.

Long-term sustainability

Assuming no policy change, debt would stand at 42.7% of GDP by 2020. Ensuring continued sufficient primary surpluses over the medium term, as planned in the programme, would further improve the sustainability of public finances.

Fiscal framework

The current fiscal framework in Latvia lacks an effective mechanism to limit expenditure growth in good economic times. In particular, there are no fiscal rules at central government level that could impose a binding constraint on the annual budgetary process. Recognising the need to develop a multi-annual and rules-based budgetary framework that would minimise the risk of pro-cyclical fiscal loosening in the new growth phase, in November 2011 the Latvian government adopted the draft Fiscal Discipline Law, which is currently being scrutinised by Parliament. The draft law is in line with the commitments made by the Latvian government under the balance of payments programme and seeks to implement the evolving EU *acquis* in the area of fiscal governance in Latvia's legislation. The authorities also intend to pass constitutional amendments to enhance the legal standing of the law.

Once implemented, the new law would considerably strengthen the fiscal framework in Latvia. The current draft clearly lays down: the principles of a counter-cyclical fiscal policy; a balanced budget rule as an instrument for a sustainable and counter-cyclical policy; a debt rule; transitional provisions, including consistency with the Stability and Growth Pact; escape clauses; the requirement to publish a report in case of deviations from the target; and regular monitoring and reporting requirements to ensure compliance with the fiscal rules. Once the Fiscal Discipline Law is adopted, the authorities also plan to adopt the medium-term budget framework law, setting binding expenditure ceilings for 2+1 years on a rolling basis.

Tax system

Latvia has one of the lowest tax-to-GDP ratios in the EU, at 27.8% of GDP in 2011. The tax system relies relatively heavily on consumption taxes, compared with other EU states, although labour taxes (in particular, social contributions) still form the largest tax revenue category. The taxation framework can be considered growth-friendly, although the high tax wedge on low wage earners requires some attention. The government plans to shift taxation further from labour to other sources. The overall tax system shows a low degree of progressivity.

The government plans to lower the tax burden on labour substantially — by about nine percentage points in the long run according to the programme. The Parliament recently approved in the first reading a bill to reduce value added tax rate (from 22% to 21% as of 1 July 2012) and the personal income tax rate (from 25% to 20% over the three-year period starting from 2013). The tax cuts were not accompanied by measures to improve the structural balance. The reduced VAT rate runs contrary to the strategy of shifting the burden of taxation to other sources and limits further opportunities to reduce taxes on labour. Even though the NRP mentions tax policy as one of the main instruments to tackle poverty and foresees several measures (increasing non-taxable PIT threshold, increasing tax reliefs for dependants or introducing progressive income taxes), these considerations were not reflected in the recent tax changes.

The sizeable fiscal consolidation that took place in 2009-2012 helped to adjust public finances to a more sustainable growth pattern. Over half of the consolidation effort, which was equivalent to 17% of GDP over these years (albeit coming after a period of unsustainable growth of public spending prior to 2009), took place on the expenditure side. These cuts took the form, in particular, of downsizing government expenditure by implementing large-scale reforms in health and education along with the territorial administrative reform. On the revenue side, although tax rates increased in almost all tax categories during the period of fiscal consolidation in 2009-2012, the biggest increase was in consumption taxes. The consolidation thus supported growth in the medium term, since to a large extent it took the form of the least harmful measures — cuts in government consumption and increases in consumption taxes.

The full benefit of the significant increases in consumption tax introduced between 2009 and 2012[3] did not materialise, however, as they were accompanied by growth in the share of the informal economy, as demonstrated by an increase in the VAT compliance gap[4] from 16% in 2007 to 47% in 2011. Recent studies[5] suggest that the informal economy is considerably larger in Latvia than in peer group countries and is concentrated in sectors like construction, services and retail. Part of the reason for engaging in informal economic activities stems from dissatisfaction with the taxation system and with government spending as well as poor law enforcement. The 'Doing Business 2011' report ranks Latvia the lowest of the three Baltic countries in the category 'paying taxes'. This is due to time-consuming tax compliance procedures (on average it takes 293 hours to comply with tax administration requirements), whereas the number of taxes and the tax rate in relation to profits score favourably.

The government is stepping up the efforts to combat the informal economy. After several initial delays, the Action Plan to Combat the Shadow Economy is now being implemented and several legislative measures (e.g. application of reverse VAT in sectors prone to undeclared activity) have entered into force from 2012. Moreover, the Law on Individual Declaration of Property and Reporting of Undeclared Income was adopted recently with effect from June 2012. It introduces the possibility to legalise previously undeclared taxable income and aims to improve oversight over an individual's financial position, in particular the accuracy of expenses incurred and the payment of taxes and the legality of income derived. However, the results of the strategy will not be visible until the medium term and the impact is difficult to quantify.

Environmental taxes remain relatively underdeveloped and are heavily dominated by motor fuel taxation, whereas taxation of other energy sources, pollution and use of natural resources is below the EU average, sometimes significantly so, even though taxes on disposal of municipal, construction and industrial waste increased considerably in 2009. Nevertheless, further broadening the tax base to other sources of environmental taxation, in particular on pollution, combined with broader-based taxation of energy sources would help to achieve environmental goals while providing room for a shift away from taxation of labour.

3.2. Financial sector

Financial stability

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[3] In particular, an increase in the standard VAT rate from 19% to 22% and in the reduced rate to 12% while significantly narrowing the scope of the reduced rate, but also numerous excise tax increases.

[4] The VAT compliance gap measures the ratio between VAT actually collected to theoretically possible collection, based on the value of private consumption taking into account the existence of preferential rates. While the gap is likely to reflect the illegal tax avoidance, it could also mirror other aspects like a shift in consumption preferences towards goods with lower rates and/or recourse to legal means of tax avoidance.

[5] See Sauka, A. and Putniņš, T. (2011), Shadow Economy Index for the Baltic Countries 2009 and 2010, Stockholm School of Economics in Riga, May 2011.

In the banking sector, both solvency and liquidity risks have abated substantially. Despite a delayed return to profitability, continued capital support from parent institutions and from government for two state-owned banks (Parex Bank, the second largest bank prior to the crisis, and the Mortgage and Land Bank (MLB)) kept capital adequacy ratios comfortable at 15 % on average at the end of 2011. The deterioration of the loan quality has come to an end, as the proportion of non-performing loans (overdue by more than 90 days) peaked at 19.4 % in July 2010 before declining to 18.4 % in 2011. In the framework of the international financial assistance, banking supervision and regulation have been tightened (capital, liquidity and reporting requirements) and cooperation with foreign supervisors improved.

The restructuring and sales of the three state-owned banks — Parex, Citadele and MLB — to comply with the Commission's state aid decisions are the most pressing issues in the field of financial stability. The strategy for the work-out and sale of the assets of Parex Bank and Citadele Bank, taking into account possible market interest, state aid-related issues and any pending legal challenges, is being implemented. MLB's divestment of commercial assets to form the basis for a real development bank is well under way.

To assess clients' creditworthiness and lending risks better, the authorities, in consultation with experts, are making legislative changes to increase transparency and regulated access by operators in the financial sector to wider information on individuals' solvency situation (e.g. the online State Revenue Service and State Social Security Agency data or the reports of state- and municipality-owned companies on individuals' payment discipline).

The policy agenda is not sufficiently focused on surveillance of the non-resident banking sector, especially in view of the experience of Parex Bank and Latvijas Krajbanka. Regulatory and supervisory measures, as illustrated in the case of Krajbanka, have not fully covered possible risks associated with this particular sector.

Access to finance

Access to finance is a challenge and the cost of capital is relatively high, hindering both debt and equity financing. Information disclosure, corporate governance and entrepreneurial culture would need to be improved to allow greater access to financing. Most of the support programmes available for SMEs and start-ups, financed mostly from EU structural funds, are rather fragmented and lack coherence; the programmes offering loans and guarantees for the manufacturing industry as well as the microcredit programme for SMEs have had moderate success. Only a small part of the available venture capital funds (seed and start-up financing for SMEs and microenterprises) have been invested so far. Consolidation of various state support programmes is planned, with the creation of a Financial Development Institution (in line with the commitment made in the Supplemental Memorandum of Understanding).

Given the problems with access to credit financing and equity capital and the need to increase knowledge transfer, there is room for improving promotion of Latvian SMEs among potential foreign investors. Ongoing measures and coordination to attract foreign investment are being re-assessed in line with effectiveness criteria and in view of the strong competition from the other Baltic countries and Poland.

3.3. Labour market, education and social policies

Labour market policies

The labour market is slowly recovering from the effects of recession, but the employment levels are still far below the pre-crisis levels and the unemployment rate is among the highest in Europe. High long-term unemployment (7.4 % of the active population) and youth unemployment (26.3 %) are the most serious legacies of the crisis. Most of the young unemployed have no professional qualifications (only basic or general secondary education), partly due to the fact that the vocational education and training system and curricula are generally considered weak and unattractive. Together with the high inactivity rate and emigration, these issues pose threats to future labour supply. The level of early school leaving is relatively high.

To tackle unemployment, the government reallocated some structural funds financing for active labour market policies in 2011. However, activation of unemployed is still among the lowest in the EU. In previous years, active labour market policies were financed almost exclusively by the European Social Fund. However, its financing will be exhausted soon and no national financing is planned. Consequently, the funding and activation of the unemployed for 2012-2013 have decreased compared with 2010-2011 and are insufficient given the challenges on the labour market. Due to the low social protection of the unemployed, the active labour market policies are also performing the role of a social safety net, as the public works programme and training grants are a significant source of income for the unemployed. This dual role of the active labour market policies limits the resources available for genuine activation measures and decreases their efficiency.

Efforts have been made to improve the effectiveness of active labour market policies (e.g. planned introduction of profiling, evaluations of active labour market policies, monitoring and assessment system of training providers, activation measures in the public works programme, planned measures to facilitate regional mobility, etc.). However, active labour market policies could still be made more effective, in particular by making training more relevant to labour market needs, simplifying and increasing the choice within the training voucher system, providing effective counselling and job-search assistance, increasing the efficiency of the wage subsidy and on-the-job training programmes, introducing safeguards to prevent abuse, keeping programmes attractive for employers, setting clear goals for the programmes and promoting the self-employment and business start-up programmes managed by MLB and the State Employment Agency. To increase the employment rates, the government plans to lower taxes on labour, improve the effectiveness of active labour market policies and stimulate demand for labour (measures to support entrepreneurship) and support for regional mobility.

To tackle youth unemployment, specially designed active labour market policies targeted at youth have been implemented: a 1-1.5-year short-cycle vocational education and training programme, 'job trials' in vocational schools, voluntary work and wage subsidies for young workers. However, given the scale of the problem, these limited activities have a relatively small impact. Insufficient efforts and financing are directed towards bringing unemployed youths with no professional qualifications back into education. Cooperation between the Education Ministry and municipalities to improve career guidance and social services for 15- to 19-year olds is also weak.

Following the European Council of 30 January 2012, the Latvian authorities together with the Commission examined possible action to reduce youth unemployment, including through refocusing structural funds, the government plans to tackle youth unemployment through twelve measures. Most proposals focus on using existing measures and the available national and EU funding allocations. In some cases it is proposed to adjust measures and sharpen the focus on youth: for example, an additional 300 training vouchers targeted specifically at youth. Only two measures — modernisation of vocational education and training infrastructure and the additional 2 000 short-term vocational education stipends — envisage additional funding through over-commitments. In view of the extent of the problem these measures will not be sufficient to make a significant impact.

Social policies

During the last three years the income inequality and relative poverty rates have been on a downtrend trend, but they are still among the highest in the EU. Severe material deprivation has increased considerably over the same period. In 2011, 40% of the population were at risk of poverty or social exclusion. This is not only a major social problem, but also has implications for the employability of the workforce and future growth prospects. Families with children and unemployed are at a particularly high risk of poverty. The coverage of unemployment benefits is low — around one quarter of the unemployed are entitled and the entitlement rules have been tightened with effect from 2012. Child poverty affects not only children living in jobless households but also households with high work intensity. Social transfers have little impact on reducing child poverty. Older people are the only group of the population who benefited from improvements in the poverty rate during the crisis. However, the pension indexation has been frozen until the end of 2013, while wage growth and inflation are projected to be relatively high. Consequently, the at-risk-of-poverty rate amongst older people is likely to increase again in 2012-2013.

While social protection expenditure as a share of GDP increased during the crisis (automatic stabiliser effect), Latvia spends relatively little on social protection and social transfers have little impact on poverty reduction, as a large share of them are redistributed back to middle- and high-income earners. Spending on means-tested benefits is low and the active labour market policies grants are partly performing the role of a social safety net. The design of social assistance benefits also contains poverty and unemployment traps and there are concerns about benefit targeting, adequacy and insufficient activation of the benefit recipients. Large inequalities exist in access to social assistance across local governments. Poor transparency, lack of effective data management and monitoring systems, and lack of research in this area complicate evidence-based decision-making (in line with the condition set in the Supplemental Memorandum of Understanding, the World Bank will undertake a comprehensive social assistance study in 2012-2013).

Government policies to reduce poverty are concentrating on reducing income inequality, lightening the tax burden on working families and increasing access to the labour market. The government has decided to continue in 2012 most of the measures in the Emergency Social Safety Net Strategy. The main components are the public works programme for the unemployed, an increase in the guaranteed minimum income (50% co-financed from central government), free healthcare for the poor, central government co-financing for housing benefits (to be phased out in April 2012) and transport compensation for vulnerable groups.

The effects of an ageing population and emigration will appear soon, posing serious challenges to the future sustainability and adequacy of the pension system. Several reforms have been introduced in line with the conditions set in the Supplemental Memorandum of Understanding: retirement and early retirement age limits will be gradually increased from 2014 on, the minimum insurance period will be raised from 10 to 15 years and the pension indexation will remain frozen until the end of 2013 (consumer price index-linking will be introduced afterwards). Also, the contribution rates to the mandatory funded pension scheme are to be restored from 2% to 6% in January 2013 (in line with the commitment made in the Supplemental Memorandum of Understanding). The national reform programme mentions plans to increase the retirement age as of 2014.

Education and lifelong learning

Education and training budgets suffered significant cuts during the crisis and measures are being taken to ensure cost-efficiency: for example, the general education school network has been consolidated and the ‘money follows pupil’ funding model introduced. Funding from the EU structural funds has been invested in developing specialised vocational schools, modernising higher education and creating competence centres.

Despite the relatively high educational attainment (tertiary attainment rates improved significantly from 18.6% in 2000 to 32.3% in 2010 and have almost reached the EU average), a significant share of the workforce have no professional qualifications and limited access to quality education, especially higher education. Universities perform poorly in worldwide rankings (also compared with other Baltic countries). Higher education suffers from low international competitiveness (low share of international students, publications and international lecturers) and weak cooperation between universities and businesses. The share of mathematics, science and technology graduates is the lowest in the EU. There are concerns about decision-making and governance in higher education institutions. One of the main measures implemented in higher education is a large-scale assessment of study programmes that will form the basis for future decisions. Performance-based financing is not expected to be introduced before 2013.

The share of students enrolled in vocational education and training is among the lowest in Europe. The challenge remains to improve the quality, effectiveness and attractiveness of vocational education and training, including providing modern material and technical bases in vocational education and training institutions, adapting curricula to match labour market needs better and promoting quality apprenticeships. Delays are reported in implementation of the measure funded by the European Regional Development Fund on ‘Vocational education infrastructure’, putting at some risk the end of 2015 deadline for completing the programme. Additional resources (more than EUR 44 million) to fulfil the initial programme goals are to be found within the current Operational Programme. Targeted measures to bring early school leavers back into education are missing. More support for poor families with children in vocational or general education institutions, coupled with more budget places and scholarships and wider availability of student loans in universities, would be one way to reverse this trend.

Participation in lifelong learning is also low. There has been little progress on implementing the strategy and the quality and effectiveness of the existing schemes should be improved, especially by increasing their relevance to labour market needs. Since enterprises are not active in training their staff, support for companies providing training for their employees could be considered.

The government has planned a number of measures to make vocational education and training more attractive, such as modernisation of infrastructure and equipment, development of modular vocational education and training, improvement of vocational education and training programmes in cooperation with sectoral expert councils and development of the National Qualifications Framework. In the area of higher education, the main measure is the evaluation of study directions which will provide a basis for taking further decisions. There are also plans to improve the infrastructure and equipment and to introduce a new model for financing higher education institutions plus legislative amendments to improve the quality and flexibility of higher education.

3.4. Structural measures promoting growth and competitiveness

Latvia’s export structure has become more diversified over the years and the recent growth in exports has contributed significantly to the overall economic recovery and the rebalancing of the economy towards tradable sectors. Nevertheless, major structural problems remain. Latvia's labour productivity, in terms of real GDP per employed person, is still significantly below the EU average and countries with economic similarities such as Lithuania and Estonia.

The role of EU funds

For the period 2007–2013, Latvia has been allocated EUR 4.5 billion from the structural funds and the Cohesion Fund under the 'Convergence' objective. Latvia is implementing three Operational Programmes: 'Human resources and employment' supported by the European Social Fund, 'Entrepreneurship and innovations' supported by the European Regional Development Fund and 'Infrastructure and services' supported by the European Regional Development Fund and the Cohesion Fund. Absorption of EU funds stands at 36.4% of the total available financing, corresponding to the EU-27 average of above 35% (European Social Fund execution is high at 60.04%, with execution of the European Regional Development Fund at 33.4% and of the Cohesion Fund at 32.1%). In 2010 and 2011 absorption of structural funds was delayed compared with the ambitious budget plans, mainly due to delays in public procurement, insufficient administrative capacity in line ministries and lack of bank financing.

Implementation of financing is critical for major Cohesion Fund projects in the transport sector, e.g. the modernisation of railway stock and reallocation of port activities in Krievu sala. The poor overall condition of transport infrastructure is being slowly addressed with EU financing, though the quality standards for roadbuilding need further improvements in line with the conditions set in the Supplemental Memorandum of Understanding. Also, the development of ICT infrastructure shows a significant divide in broadband coverage between densely populated and rural areas.

Overall, the experience gained from implementing cohesion policy in Latvia highlights weaknesses related to the intervention logic of investments, including the evaluation capacity. Coordination of support with neighbouring Member States is insufficient, in particular in the context of the Baltic Sea Strategy.

Research and innovation

Latvia's poor innovation performance — the country is consistently ranked amongst the last on the Innovation Union scoreboard — could impair its long-run competitiveness. There is no systematic and effective research and innovation strategy and little research and innovation investment by either domestic companies or foreign affiliates to support specialisation in knowledge-intensive and innovation-driven sectors. Latvia also has the lowest business R&D intensity in the EU (0.22% of GDP in 2010) and licence and patent revenue is rather low. The national innovation system is overshadowed by low scientific performance, as measured by the share of publications in the top 10% most cited which, at only 2.9%, is the second lowest score in Europe.

The national research and innovation system faces a number of challenges:

(i) There is limited capacity to design, implement and coordinate research and innovation policy: Latvia has a complicated decision-making process for such a small country and the effectiveness of policy measures has been undermined by a lack of systematic evaluations (an external evaluation is ongoing and planned to be finished by the end of November 2012).

(ii) The scientific and research infrastructure is underdeveloped and the limited research and innovation resources available are spread too thinly to be efficient.

(iii) Cooperation between businesses and academics continues to be poor: companies are barely using the research potential of universities or state research institutes and their participation in the ongoing competence centres programme is rather low. The level of commercialisation of research is low: the technology transfer contact points operating in several universities produce modest results, in part due to the incomplete legal framework for protecting intellectual property rights.

(iv) There is a lack of highly qualified scientists and engineers; the number of new doctorates awarded remains low and many scientists pursue their careers abroad.

In the course of fiscal consolidation, R&D intensity fell to 0.46% in 2009 after peaking at 0.7% in 2007. With the help of structural funds (EUR 466 million or 10% of the total allocations are earmarked for implementation of R&D and innovation policies), R&D intensity recovered somewhat to 0.6% in 2010, which is still one of the lowest in the EU. In view of the heavy dependence on structural funds and the low level of business investment, the national target of increasing R&D intensity to 1.5% by 2020 is rather ambitious.

There is no systematic monitoring to create a continuous and stable basis for basic research activities. The growing share of structural funds in R&D funding is tilting the previous balance between institutional and competitive funding more towards project-based, competitive funding. One major issue is funding of R&D after 2013, before the new round of structural funds is available. Moreover, as the level of support will remain constrained and there is a risk of some of the direct support measures being poorly funded, the merits of introducing broader tax incentives for research and innovation have to be considered.

In order to address these weaknesses, Latvia has taken the following steps: (i) governance is being improved by setting up a cross-departmental coordination centre under the Prime Minister; (ii) efforts are being made to modernise the scientific infrastructure — nine national research centres were established in 2011; (iii) measures have been taken to attract foreign academics, to increase the number of researchers and to attune the education system more to business needs by involving employers' organisations in the governance of universities and assessing vocational study programmes; (iv) steps are being taken to promote commercialisation of science, encourage industrial innovation and support the development of innovative enterprises (business development involving new products and technologies, competence and technology transfer centres, innovation vouchers, etc.).

Further efforts should be made to improve the quality of the science base and to rationalise research and higher education institutions in line with the thematic priorities and budgetary constraints. This should result in fewer but larger entities more able to build up critical mass in specialised areas of education and research, coupled with progressive introduction of competitive funding based on independent evaluation. In order to address the current challenges and to qualify for the EU funding within the post 2013+ period, Latvia should draw up a research and innovation strategy for smart specialisation, so that EU structural funds can be used more efficiently and synergies between different EU and national policies, as well as public and private investments, can be increased.

Energy markets

Energy markets in Latvia remain dominated by horizontally and vertically integrated monopolies. Due to limited interconnection, the gas and electricity markets are largely separated from other EU Member States. Increasing interconnection capacity would contribute to enhancing competition in energy markets.

The concentration in the electricity generating sector is very high: the dominant utility Latvenergo produced more than 90% of all power in the country in 2010. In the gas market, 100% of imports are purchased by JSC 'Latvijas Gaze' from Russia. Concentration at retail level is very high on both the electricity and gas markets. Latvia has notified measures fully transposing both the electricity and the gas directives (with a derogation for gas) and the regulator — the Public Utility Commission — is legally independent since amendments to the relevant law came into force in August 2011.

A risk assessment is under way on gas interconnections with Estonia and Lithuania, plus an assessment of pipeline projects (the Poland-Lithuania 'Baltic Connector' gas pipeline) and of a regional liquefied natural gas terminal. As regards electricity, for historical reasons the system is interconnected with the networks of Belarus, Russia, Estonia and Lithuania (BRELL Ring agreement). Consequently, synchronisation with the EU electricity system is not possible without negotiations with Russia and Belarus on technical operation of the networks.

The policy response to the challenges facing the energy sector consists mainly of: (i) following the legal transposition, it is time to implement the Third Energy Package in practice for both electricity and gas, which as a first step entails the certification of the independence of the electricity transmission system operator which is expected later this year; (ii) preparing the gas sector for the end of isolation and subsequent creation of market structures (e.g. decision on a regional liquefied natural gas terminal in the Baltic region); (iii) linking the gas network to the EU (e.g. the Latvia/Lithuania reverse-flow project); (iv) strengthening Latvia's national electricity grid to transport energy from Finland, Sweden or Poland; (v) continuing cooperation with the Commission in negotiations with Russia and Belarus on operation of the electricity network; and (vi) continuing work with a view to joining Nord Pool Spot and creating a Baltic regional electricity market.

Renewable energy

Latvia has committed itself to meet a target of 40% of renewable energy sources in final energy consumption and a 10% share for renewable energy in the transport sector by 2020 (in 2010 Latvia was close to its interim target for 2011/2012 of 34%). Latvia has notified measures fully transposing the EU Renewable Energy Sources Directive. However, insufficient progress has been made on developing a coherent, stable and predictable framework to support renewable energy. Support schemes are not fully adequate in terms of the tariff levels and/or cost reductions due to technical development, but retroactive changes must be avoided given the negative effect on overall investor confidence.

Resource efficiency and the environment

The Second National Energy Efficiency Action Plan assumes that both the EU Cohesion Policy Fund and the Climate Change Financial Instrument will continue to play a major role in financing improvements in energy efficiency. Latvia has put forward a mix of policy measures addressing energy saving in the main sectors of the economy. In the years ahead more than 70% of energy savings are expected to be generated in the buildings sector. However, without placing any major burden on public budgets, Latvia could significantly increase the benefits derived from energy efficiency investments by introducing the legal and fiscal framework necessary for energy performance contracting.

The tax system does not provide sufficient incentives for reducing energy costs and shifting consumption towards energy-efficient products (vehicles or insulation of buildings and heating systems). The impact of the natural resources tax is small and insufficient to penalise inefficient energy use. Quality standards in construction and waste management are low. The potential for reducing dependence on energy imports is untapped and the share of net energy imports in the foreign trade balance for goods increased to about 50% in 2010-11.

In 2011, the Energy Strategy for 2030 was launched to complement and update the 2007–2016 Energy Development Guidelines. It includes large-scale infrastructure projects, fiscal measures (including energy and carbon taxes) and national targets in the energy sector. In this context, programmes to increase energy efficiency in public buildings and production facilities are in progress. Measures include technological upgrades and replacing fossil fuels by renewable energy in heating systems. Also, a first set of agreements have been signed for projects to reduce emissions from public lighting. The EU funds and the Climate Change Financial Instrument have been playing a key role in financing energy efficiency measures already implemented or planned. However, considering that Latvia's energy intensity is still more than double the EU-27 average, especially for industrial companies, further efforts are clearly necessary. For example, Latvia could significantly increase the benefits reaped from investments in energy efficiency by introducing the legal and fiscal framework necessary for energy performance contracting.

Latvia has committed itself to limit the increase in greenhouse gas emissions in sectors not covered by the emissions trading system by 17% (of 2005 levels) by 2020. According to the latest projections, based on existing measures, emissions are expected to increase by 14.7% (compared with 2005), leading to an overachievement by 2 percentage points. However, energy efficiency is low in transport, which is the sector with the largest emissions in Latvia, with 25.9% of the country's greenhouse gas emissions in 2009. The public transport network is not sufficiently consolidated and use of renewable energy and further electrification of the railways have not been fully explored. While acknowledging the high share of the transport sector in Latvia's greenhouse gas emissions, the national reform programme does not put forward specific measures addressing this problem (e.g. intermodal shifts). Although the national reform programme reports compulsory admixture and exemptions from excise duties for biofuels, the action taken so far has not led to significant emission cuts.

The structure of the waste management system in Latvia is still not in line with the principles of resource efficiency. Latvia still landfills 90% of municipal waste and the level of landfill taxes remains low compared with other countries. Separate waste collection, reuse, recycling and recovery are limited. The limited producer responsibility system is not able to cover the full costs of separate collection and recycling of the main waste streams. No incentives are in place to promote prevention and participation in separate collection (pay-as-you-throw schemes). Latvia is not likely to reach the 2020 recycling target (50%) without substantial investment. This creates significant opportunities for growth in sectors connected with waste management and recycling. Latvia has also taken major steps to develop quality water supply and waste water management services further. Continued efforts are needed in the years ahead to ensure steady growth of the share of the population with access to these services.

Other structural measures

To tighten management of state-owned enterprises and real estate, in line with the commitments made in the Supplemental Memorandum of Understanding, in December 2011 the authorities adopted the 'Concept paper on state-owned enterprises governance' that lays down the principles for setting up a centralised state-owned enterprises manager, governing relations with line ministries, measuring the performance of state-owned enterprises, revising dividend and remuneration policies and reviewing the institutions responsible for supervising government- and municipality-owned companies. Also, plans for the final stages of further centralisation of state real estate management under the State Real Estate Agency have been developed, deciding which real estate assets to keep or to auction off and which need to be transferred to the Agency, while centralising decisions on real estate investment projects in the process of drafting the state budget.

The competition climate in Latvia can be improved, especially in sectors like construction, healthcare and pharmacy, public services and food supply (dominated by two big chains). The Competition Council has inadequate capacity to perform more active, targeted market surveillance. There is also insufficient competition in public procurement, notably for maintenance works and construction of roads and bridges. As regards public services, port authorities occasionally run commercial-like activities and prevent private companies from offering their services, leading to legal disputes. In this context, the Supplemental Memorandum of Understanding contains a commitment to introduce, by mid-2012, a proper assessment system to monitor observance and uniform application of the criteria for government and municipal authorities to engage in commercial activities, including port services.

Latvia adopted the horizontal law transposing the Services Directive with some delay in April 2010. The law was amended in March 2012 to ensure better compliance with the directive. In general, no major obstacles have been identified but some restrictions on cross-border provision of services still exist in tourism and construction. The number of restrictions on regulated professions is moderate, except for the profession of notary where Latvia refused to repeal the nationality requirement, despite the judgments of the Court of Justice of the EU of 24 May 2011 (concerning six other Member States). The 'point of single contact' provides relatively good information, except on cross-border service provision. Completion of procedures is mostly possible for national service providers, whereas technical solutions are needed for cross-border use of e-identification and e-signatures.

The 'Rail Baltic' project, which has gained new impetus in the reviewed trans-European transport network policy, would connect the main EU networks with north-east Europe. Electrified European-gauge railway infrastructure is to be built, providing a strong stimulus for economic growth and reducing greenhouse gas emissions through a modal shift to rail. In this context, it is important to ensure that competition in the rail freight sector, including rail traffic management, is effective and that new entrants can gain access to the market.

The take-up of broadband internet is below the EU average due to the rural broadband gap. The rural broadband state aid scheme co-financed by EU funds and approved in 2011 should lower the broadband deployment cost in rural areas; however, it needs to be implemented as part of an overall national broadband strategy, which the authorities plan to adopt by the end of 2012. Also, in accordance with the recently agreed EU policy on radio spectrum for wireless broadband, Latvia should work on authorising use of the digital dividend spectrum to stimulate competitive and ubiquitous mobile broadband services.

3.5. Modernisation of public administration

Latvia has allocated EUR 22.8 million, or 3.9 % of the overall EU funding available, to modernisation of public administration under the priority 'Administrative capacity-building' of the Operational Programme on 'Human resources and employment' funded by the European Social Fund. Although some improvements have been made, a great deal remains to be done. In particular, the authorities need to move away from financing basic operations (e.g. temporary staff recruitment) that lead to supporting low value-added, short-term projects. Instead, narrowing the number of eligible activities and clearly targeting them on reforms in public administration would provide greater efficiency.

Despite earlier delays in implementing the relevant conditions in the previous Supplemental Memorandums of Understanding, the authorities have committed themselves to preparing a strategy on public administration by spring 2012, which will, inter alia, establish a stronger institutional model responsible for human resources and recruitment policy and payroll, normalise the distribution of employees within the unified wage grid based on effective skills assessment, introduce central control for establishment of new posts and reward the performance of employees through earnings and career development. In this area, however, given past delays, it is unclear how far these commitments will be put into practice.

While Latvia has made efforts to lighten the administrative burden on businesses, a focus on real efficiency gains is lacking and the initiatives taken have been fragmented. The government lacks a comprehensive strategy on supporting enterprises and improving the business environment. Nevertheless, in 2010 and 2011 a number of measures were taken to help micro-companies and self-employed to start a business, especially by reducing start-up costs related to registration, equity capital requirements and taxation. In addition, the time it takes to obtain a permanent electricity connection has been shortened and the management of EU structural funds projects has been simplified. However, the new Construction Law, supposed to simplify construction procedures, as well as legislation for the protection of investors, are yet to be adopted by Parliament. Also, the compliance requirements for tax administration remain to be simplified and the electronic registration of enterprises, the electronic procurement system and the one-stop shop for the registration of property are yet to be completed.

As regards the efficiency of the Latvian civil justice system, the main challenges are the large case backlog and the lengthy proceedings in civil and commercial cases. The situation is similar for administrative courts, which are empowered to rule on licences, registrations and tax issues. Latvia has a low clearance rate (i.e. the capacity of courts to deal with new and pending cases) and a high disposition time (i.e. the number of days necessary to dispose of pending cases). The situation has deteriorated in the last few years, with only 73 % of cases adjudicated within one year in 2011. Moreover, many cases do not get resolved at first instance, which creates delays and backlogs at all instances, up to the Supreme Court. The inefficiency was particularly acute in insolvency proceedings. New insolvency legislation has been adopted to streamline and expedite the insolvency process and introduce a reorganisation option for companies. However, its effects still need to be fully analysed. Further improvements of Latvia’s insolvency laws are being discussed. There is also some concern that the Latvian judiciary is not maintaining and updating its knowledge of EU law.

The number of cases handled per year by judges is very high, while the judicial support staff may not always be sufficiently qualified to assist the judges. There is also concern about the qualifications and the accountability of the judiciary. The creation of an independent Council for the Judiciary in 2010, responsible for evaluating the professional performance of judges, should improve the situation, while guaranteeing the independence of the judiciary.

The authorities are taking measures to improve the performance of the judicial system. In particular, they are working towards improving court infrastructure (audio, videoconferencing and IT solutions) and the efficiency of procedural law, setting up a system for publication of judgments, levelling the workload of different courts and developing the legal framework for mediation. The *Annual Action Plan for Improvement of the Business Environment* for 2012 includes measures to ensure use of e-services in legal proceedings. It is too early to assess the relevance and efficiency of the measures proposed.

In 2011 the government also passed the Electronic Government Development Plan for 2011–2013 estimating that 50 % of the population will use e-government in 2015. By late 2011, 20 e-services had been introduced and about 150 more are expected to be introduced in 2012 followed by another 50 e-services in 2013.

4. OVERVIEW TABLE

2011 commitments	Summary assessment
Euro Plus Pact (national commitments and progress)	
• Adoption of fiscal discipline principle: committed to cut deficit below 3% of GDP for 2012 and aiming for a 2.5% of GDP deficit; the goal is to improve the fiscal position so that the general government deficit would be 1.9% of GDP in 2013 and 1.1% in 2014. • Preparation of a Medium-Term Budget Framework Law. • Measures to ensure the long-term financial stability of the state pension system: in accordance with the draft law submitted to Parliament, from 2016 to 2021 a gradual increase is planned in the retirement age from 62 to 65 years and in the qualification period from 10 to 15 years; measures to preserve the sustainability of the three pension pillars and to restore contributions to the second pillar to 6% of gross salaries by 2013.	Latvia has almost fully implemented the commitments in the fiscal and fiscal governance field, in particular as regards strong and front-loaded fiscal adjustment which should allow the country to exit the Excessive Deficit Procedure in spring 2013. On the down side, there have been some delays as regards the Fiscal Discipline Law and there is still some uncertainty about reversing the second pension pillar contributions to 6%.
• Tax measures beneficial to labour: priority is given to substantial increases in indirect taxation, with VAT increased to 22%, higher excise tax and doubling of the real-estate tax rates from initially low levels; the tax policy for 2011-2014 is directed in a way to ensure stability and predictability with limitations of new revenue measures; a further shift of the tax burden from labour to consumption and property is planned over the medium term; the tax system could include action to support entrepreneurship. • Measures to fight the shadow economy. • Labour market reform: plan to carry out a set of comprehensive and interrelated policy measures supported by the EU structural funds with the aim of decreasing the risk of structural unemployment, increasing labour market participation, investing in job quality and increasing the competitiveness of the education system.	The commitments have been implemented partly. The government has proposed to start reducing the tax wedge on labour (personal income tax rate and non-taxable thresholds) from January 2013, but it remains to be seen how ambitious the reforms will be: e.g. some of the ambition can be taken away by the proposed VAT reduction or Maastricht inflation criteria considerations. The fight against the grey economy, in particular against envelope salaries that hinder fair competition, has not been ambitious and aggressive enough. There has been a welcome reassessment of the effectiveness of existing active labour market policies and their financing, but further and more comprehensive steps are needed to address the high levels of structural and youth unemployment. There has been some progress as regards streamlining the vocational school system, mostly with the financing from EU funds.
• Measures to align salary and productivity developments: to link the future increase in the wage bill in the public sector with the productivity growth rates in the economy. • Measures to promote international cooperation in the area of research and raise the competitiveness of research. • Higher education reform: develop an improved external quality assurance system for higher education by preparing a transition from study programme accreditation to study direction accreditation and introducing performance-based funding —the 'money follows quality' principle — in national legislation. • Measures to promote vocational education: further work is planned to develop a national qualification system and restructure	The commitments have been implemented partly. The new Education Minister has proposed a number of ambitious and long overdue reforms/measures as regards vocational and higher education and research and science, inter alia: refocusing EU funding in the vocational school programme; highlighting the education quality issues; proposing a wage scheme for teachers that would reward merits; attracting external assessment of the science base and policy, etc. It remains to be seen how much of the above will actually be implemented. There have been some steps towards improving the business environment (as evidenced by the high Doing Business rankings). However, much remains to be done as regards tax compliance procedures, construction procedures, ensuring fair

vocational education, including development of module-based vocational education programmes: optimisation and differentiation of vocational education institutions. • Measures to improve the business environment: reducing the administrative burden on businesses, as well as ensuring appropriate e-services for businesses; measures to provide on-line business registration, to reduce the procedures and the time taken to obtain a construction permit and to improve legislation for investor protection by providing greater transparency. • Measures fostering innovations by developing a framework for more efficient cooperation between scientists and entrepreneurs.	procurement, providing a sufficiently skilled labour force, making the support to businesses from EU funds more efficient, improving the justice system, etc. The efforts/measures by the Latvian Investment and Development Agency to attract foreign investment are insufficient and rarely produce successful outcomes.
• Measures to strengthen supervision of the financial system: amendment of the supervisory framework as needed to keep pace with evolving international best practice; amendments to the legal acts strengthening the capital base and liquidity requirements will be adopted in 2011–2012 to implement the Fourth Capital Requirements Directive; intensive supervision will continue focusing, in particular, on capital adequacy and the quality of restructured loans, as well as close monitoring of lending to non-residents. • Measures to improve risk and crisis management: the work on practical arrangements for cooperation (coordinated decision-making, burden sharing, establishment of a common database and monitoring of financial stability) is going on at the level of the working groups established and the results will be presented to the Stability Group during its meeting at the end of 2011. • Incentives to tackle bad loans and renew lending, promotion of responsible lending. • Restructuring of the state-owned banks.	The Latvijas Krajbanka experience shows that these commitments have not been implemented fully, though follow-up action should further improve the stability of the financial system. In particular, closer relations with neighbouring financial sector regulators are important to avert future cross-border crises. There has been good progress, albeit belated, as regards restructuring of the Mortgage and Land Bank, although the sale of commercial assets has not yet happened. It is unclear if anything has been achieved as regards encouraging banks to tackle bad loans.
Europe 2020 (national targets and progress)	
Employment rate target (in %, 20-64 age group): 73%	The employment rate stood at 67.1% in 2009, 65% in 2010 and 67.2% in 2011. All these figures will be revised downwards based on the latest population census.
R&D target (% of GDP): 1.5%	Gross domestic expenditure on R&D stood at 0.46% of GDP in 2009 and 0.6% in 2010. In view of the heavy dependence on structural funds and the low level of business investment, the national target of increasing R&D intensity to 1.5% by 2020 is rather ambitious.
Greenhouse gas (GHG) emissions target: +17% (compared with 2005 emissions)	Change in greenhouse gas emissions between 2005 and 2010: +5% (this figure corresponds to the current scope of the emissions trading scheme).
Renewable energy target: 40% by 2020 (RES Directive 2009/28/EC).	In 2009 Latvia had achieved its 2011/2012 interim target of 34% but, based on the data in the National RES Progress Report, in 2010 the share of renewables slipped back again (to 32.5%). Further efforts are needed to sustain the progress towards the target for 2020.
Energy efficiency — reduction in primary energy consumption by 2020 (0.67 Mtoe)	The energy efficiency objectives are based on national circumstances and national formulations.

	As the method to express the impact of these objectives on energy consumption in 2020 in the same format was agreed only recently, the Commission is not yet able to present this overview.
Early school leaving target: 13.3 %	The proportion of early leavers from education and training (percentage of the population aged 18-24 with at most lower secondary education and not in further education or training) stood at 13.3 % in 2010. Over the last decade Latvia has made progress on reducing the number of early school leavers (from 16.9 % in 2002 to 13.3 % in 2010). It is currently performing better than the EU average of 14.1 %. Based on current trends, Latvia is likely to achieve its national target of 13.9 %, but it is not ambitious enough (the EU headline target is set at 10 % in 2020).
Poverty target: At risk of poverty 21 % 121 000 people (at-risk-of-poverty and jobless households)	The at-risk-of-poverty rate fell from 25.7 % in 2009 to 19.3 % in 2011. Thus, the target in relative terms has been reached. The main driver behind the developments in the at-risk-of-poverty rate was a significant drop in the poverty threshold (the population as a whole is worse off). The improvements in the target value are not the result of any deliberate policy action and will have no long-lasting impact. The real challenge will be to prevent the at-risk-of-poverty rate from increasing as the economy continues to recover.
Tertiary education target: 32.3 %	Tertiary educational attainment stood at 32.3 % in 2010, a 5.3 pps increase since 2008. Tertiary attainment rates have improved significantly over the last decade (from 18.6 % in 2000 to 30.1 % in 2009 and 32.3 % in 2010) and have almost reached the EU average of 33.6 %. Latvia has set a national target of 34–36 % of graduates by 2020, which, based on current trends, is likely to be achieved.

ANNEX

Table I. Macroeconomic indicators

	1995-1999	2000-2004	2005-2008	2009	2010	2011	2012	2013
Core indicators								
GDP growth rate	3.8	7.4	6.9	-17.7	-0.3	5.5	2.2	3.6
Output gap [1]	-2.6	-0.9	9.0	-10.3	-9.4	-4.3	-3.1	-1.5
HICP (annual % change)	4.8	3.2	9.7	3.3	-1.2	4.2	2.6	2.1
Domestic demand (annual % change) [2]	6.8	8.7	7.5	-27.4	0.1	10.2	2.8	4.6
Unemployment rate (% of labour force) [3]	16.6	11.9	7.3	17.1	18.7	16.1	14.8	13.2
Gross fixed capital formation (% of GDP)	18.9	25.3	31.9	21.6	19.5	22.4	23.2	24.8
Gross national saving (% of GDP)	14.5	19.1	18.3	29.1	23.9	25.0	25.0	25.6
General government (% of GDP)								
Net lending (+) or net borrowing (-)	**-0.9**	**-1.9**	**-1.4**	**-9.8**	**-8.2**	**-3.5**	**-2.1**	**-2.1**
Gross debt	**12.5**	**13.9**	**13.0**	**36.7**	**44.7**	**42.6**	**43.5**	**44.7**
Net financial assets	**9.9**	**8.9**	**4.0**	**-5.6**	**-13.7**	**n.a**	**n.a**	**n.a**
Total revenue	37.9	33.9	35.9	34.7	35.7	35.6	36.0	34.9
Total expenditure	38.8	35.9	37.3	44.5	43.9	39.1	38.1	37.0
of which: Interest	0.9	0.8	0.5	1.5	1.4	1.5	1.7	1.8
Corporations (% of GDP)								
Net lending (+) or net borrowing (-)	**-3.3**	**-4.1**	**-9.3**	**17.1**	**12.6**	**5.2**	**3.4**	**2.4**
Net financial assets, non-financial corporations	**-56.3**	**-80.8**	**-90.4**	**-94.9**	**-108.7**	**n.a**	**n.a**	**n.a**
Net financial assets, financial corporations	**-5.1**	**-1.2**	**-1.7**	**8.3**	**11.7**	**n.a**	**n.a**	**n.a**
Gross capital formation	17.4	23.7	26.1	12.7	14.3	20.5	21.0	22.7
Gross operating surplus	23.1	34.2	30.2	30.5	33.5	35.2	35.9	36.9
Households and NPISH (% of GDP)								
Net lending (+) or net borrowing (-)	**-1.1**	**-1.5**	**-5.5**	**3.6**	**0.6**	**-1.4**	**-1.1**	**-0.7**
Net financial assets	**30.2**	**33.6**	**17.4**	**10.1**	**11.0**	**n.a**	**n.a**	**n.a**
Gross wages and salaries	34.2	33.9	41.2	41.8	38.9	36.8	36.2	35.5
Net property income	7.1	11.8	6.6	5.2	5.3	6.2	7.7	8.4
Current transfers received	16.7	18.3	16.7	20.2	20.6	18.5	18.0	16.7
Gross saving	0.3	-0.1	-0.6	7.0	2.8	0.0	0.5	1.0
Rest of the world (% of GDP)								
Net lending (+) or net borrowing (-)	**-5.7**	**-7.5**	**-16.2**	**11.1**	**4.9**	**0.9**	**0.8**	**0.1**
Net financial assets	**22.4**	**40.2**	**71.4**	**83.8**	**101.9**	**n.a**	**n.a**	**n.a**
Net exports of goods and services	-7.7	-11.0	-17.5	-1.5	-1.4	-3.9	-4.5	-5.3
Net primary income from the rest of the world	0.3	-0.4	-2.1	7.6	2.1	0.7	0.1	-0.1
Net capital transactions	0.1	0.6	1.5	2.4	1.9	2.1	2.6	2.7
Tradable sector	54.6	52.0	47.0	46.8	51.5	53.0	n.a	n.a
Non-tradable sector	33.5	37.7	41.6	43.5	38.1	36.6	n.a	n.a
of which: Building and construction sector	4.9	5.8	8.0	7.2	5.3	5.5	n.a	n.a
Real effective exchange rate (index, 2000=100)	87.9	93.3	127.0	145.5	129.0	131.0	129.0	127.2
Terms of trade in goods and services (index, 2000=100)	99.9	101.5	105.1	104.8	105.6	109.1	108.8	109.0
Market performance of exports (index, 2000=100)	109.8	104.8	116.2	124.3	122.4	125.9	128.2	129.9

Notes:

[1] The output gap constitutes the gap between actual and potential gross domestic product at 2000 market prices.

[2] The indicator for domestic demand includes stocks.

[3] Unemployed persons are all persons who were not employed, had actively sought work and were ready to begin working immediately or within two weeks. The labour force is the total number of people employed and unemployed. The unemployment rate covers the age group 15-74.

Source :

Commission spring 2012 forecast

Table II. Comparison of macroeconomic developments and forecasts

	2011		2012		2013		2014	2015
	COM	CP	COM	CP	COM	CP	CP	CP
Real GDP (% change)	5.5	5.5	2.2	2.0	3.6	3.7	4.0	4.0
Private consumption (% change)	4.4	4.4	2.2	1.9	3.3	3.7	4.0	4.0
Gross fixed capital formation (% change)	24.6	24.6	6.0	7.4	10.4	7.3	6.5	6.4
Exports of goods and services (% change)	12.6	12.6	4.5	3.8	6.3	5.4	5.9	5.6
Imports of goods and services (% change)	20.7	20.7	5.1	5.1	7.5	5.8	6.0	5.8
Contributions to real GDP growth:								
- Final domestic demand	8.6	8.6	3.0	3.2	5.1	4.5	4.6	4.7
- Change in inventories	2.1	2.1	0.0	0.0	0.0	0.0	0.0	0.0
- Net exports	-5.2	-5.2	-0.8	-1.2	-1.4	-0.8	-0.6	-0.7
Output gap[1]	-4.3	-3.9	-3.1	-3.2	-1.5	-1.8	-0.3	1.1
Employment (% change)	3.4	3.1	0.7	0.7	1.2	1.1	1.2	1.2
Unemployment rate (%)	16.1	15.4	14.8	14.1	13.2	13.3	12.1	10.7
Labour productivity (% change)	2.0	2.2	1.5	1.3	2.4	2.6	2.7	2.8
HICP inflation (%)	4.2	4.2	2.6	2.6	2.1	2.0	2.0	2.0
GDP deflator (% change)	5.4	5.4	2.1	1.7	1.6	2.0	2.0	2.0
Comp. of employees (per head, % change)	4.2	4.3	1.7	2.7	2.2	2.9	3.8	4.1
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	0.9	0.9	0.8	-0.5	0.1	-1.1	-1.4	-1.7

Note:

[1]In per cent of potential GDP, with potential GDP growth according to the programme as recalculated by the Commission.

Source :

Commission spring 2012 forecasts (COM); Convergence programme (CP).

Table III. Composition of the budgetary adjustment

(% of GDP)	2011	2012		2013		2014	2015	Change: 2011-2015
	COM	COM	CP	COM	CP	CP	CP	CP
Revenue	**35.6**	**36.0**	**37.4**	**34.9**	**35.1**	**34.1**	**32.8**	**-2.8**
of which:								
- Taxes on production and imports	11.5	11.8	11.8	11.8	11.7	11.5	11.3	-0.2
- Current taxes on income, wealth, etc.	7.4	7.4	7.5	7.4	7.5	7.4	7.3	-0.1
- Social contributions	8.8	8.7	8.8	7.7	8.0	7.6	7.5	-1.3
- Other (residual)	7.9	8.1	9.3	8.1	7.9	7.6	6.7	-1.2
Expenditure	**39.1**	**38.1**	**39.5**	**37.0**	**36.5**	**34.9**	**33.1**	**-6.0**
of which:								
- Primary expenditure	37.6	36.5	37.8	35.2	34.7	32.8	31.0	-6.6
of which:								
Compensation of employees	9.6	9.4	9.4	9.1	8.9	8.5	8.1	-1.5
Intermediate consumption	7.1	7.0	7.1	6.8	6.5	5.9	5.4	-1.7
Social payments	11.4	10.9	11.0	10.3	10.2	9.6	9.1	-2.3
Subsidies	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.0
Gross fixed capital formation	4.2	4.2	4.2	3.8	2.9	1.5	1.2	-3.0
Other (residual)	5.1	4.7	5.9	4.9	5.8	7.0	6.9	1.8
- Interest expenditure	1.5	1.7	1.7	1.8	1.8	2.1	2.1	0.6
General government balance (GGB)	**-3.5**	**-2.1**	**-2.1**	**-2.1**	**-1.4**	**-0.8**	**-0.3**	**3.2**
Primary balance	**-2.0**	**-0.4**	**-0.4**	**-0.3**	**0.5**	**1.4**	**1.8**	**3.8**
One-off and other temporary measures	0.8	1.0	0.0	0.0	0.0	0.0	0.0	-0.8
GGB excl. one-offs	**-4.3**	**-3.1**	**-2.1**	**-2.1**	**-1.4**	**-0.8**	**-0.3**	**4.0**
Output gap[2]	-4.3	-3.1	-3.2	-1.5	-1.8	-0.3	1.1	5.4
Cyclically adjusted balance[2]	-2.3	-1.2	-1.2	-1.7	-0.9	-0.7	-0.6	1.7
Structural balance[3]	**-3.2**	**-2.2**	**-1.2**	**-1.7**	**-0.9**	**-0.7**	**-0.6**	**2.5**
Change in structural balance		*0.9*	*1.9*	*0.6*	*0.3*	*0.2*	*0.1*	
Structural primary balance[3]	**-1.7**	**-0.6**	**0.5**	**0.1**	**0.9**	**1.4**	**1.5**	**3.2**
Change in structural primary balance		*1.1*	*2.1*	*0.7*	*0.4*	*0.5*	*0.1*	
Expenditure benchmark								
Public expenditure growth[4] (real)		-2.81	-3.03	3.71	-0.49	-0.67	-1.07	-
Reference rate[5,6]		1.19	1.19	1.19	1.19	*1.19*	*1.19*	-
Lower reference rate[5,7]		-0.11	-0.11	-0.11	-0.11	*-0.11*	*-0.11*	-
Deviation in % of GDP from applicable reference rate		-0.99	-0.94	1.33	-0.12	*-0.16*	*-0.27*	-
Two-year average deviation in % of GDP from applicable reference rate		n.a.	n.a.	0.17	-0.53	*-0.14*	*-0.22*	-

Notes*:*

[1]On a no-policy-change basis.

[2]Output gap (in % of potential GDP) and cyclically-adjusted balance according to the programme as recalculated by the Commission on the basis of the information in the programme.

[3]Structural (primary) balance = cyclically adjusted (primary) balance excluding one-off and other temporary measures.

[4]Modified expenditure aggregate used for the expenditure benchmark, growth rates net of non-discretionary changes in unemployment benefit and of discretionary measures.

[5]The reference rates applicable to 2014 onwards will be available from mid-2012. For illustrative purposes, the current reference rates have also been applied to the years 2014 onwards.

[6]The (standard) reference rate applies starting in the year following the one in which the country reaches its MTO.

[7]The lower reference rate applies as long as the country is adjusting towards its MTO, including the year in which it reaches the MTO.

Source :

Convergence programme (CP); Commission spring 2012 forecasts (COM); Commission calculations.

Table IV. Debt dynamics

(% of GDP)	Average 2006-10	2011	2012		2013		2014	2015
			COM	CP	COM	CP	CP	CP
Gross debt ratio[1]	**24.2**	**42.6**	**43.5**	**44.5**	**44.7**	**45.8**	**46.7**	**38.9**
Change in the ratio	6.4	-2.1	1.0	1.9	1.2	1.3	0.9	-7.8
Contributions [2] :								
1. Primary balance	**3.7**	**2.0**	**0.4**	**0.4**	**0.3**	**-0.5**	**-1.4**	**-1.8**
2. 'Snowball' effect	**0.9**	**-2.9**	**-0.1**	**0.2**	**-0.3**	**-0.5**	**-0.4**	**-0.5**
Of which:								
Interest expenditure	0.9	1.5	1.7	1.7	1.8	1.9	2.2	2.1
Growth effect	0.6	-2.2	-0.9	-0.8	-1.5	-1.6	-1.7	-1.8
Inflation effect	-0.5	-2.2	-0.9	-0.7	-0.7	-0.9	-0.8	-0.9
3. Stock-flow adjustment	**1.9**	**-1.1**	**0.7**	**1.3**	**1.3**	**2.3**	**2.7**	**-5.4**
Of which:								
Cash/accruals diff.								
Accum. financial assets								
Privatisation								
Val. & residual effects								

Notes:

[1]End of period.

[2]The snowball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator). The stock-flow adjustment includes differences in cash and accrual accounting, the accumulation of financial assets, and valuation and other residual effects.

Source :

Convergence programme (CP); Commission spring 2012 forecasts (COM); Commission calculations.

Table V. Long-term sustainability indicators

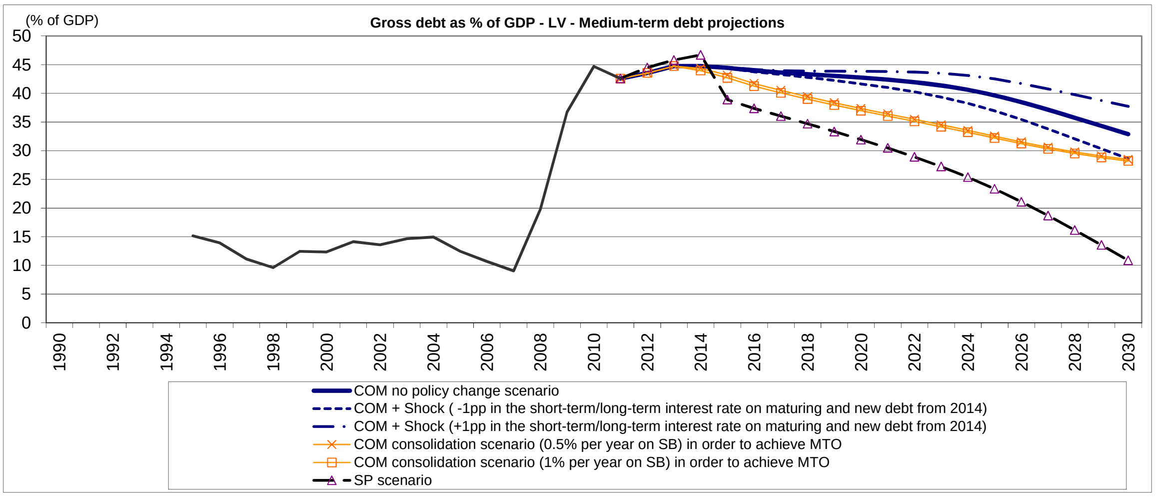
	LV		EU27	
	No policy change scenario	Convergence programme scenario	No policy change scenario	SCPs scenario
S2	-0.7	-2.2	2.9	0.7
of which:				
Initial budgetary position (IBP)	0.9	-0.8	0.7	-1.6
Long-term change in the primary balance (LTC)	-1.6	-1.3	2.3	2.4
of which:				
pensions	-1.6	-1.3	1.1	1.2
health care and long-term care	0.5	0.5	1.5	1.5
others	-0.6	-0.6	-0.3	-0.3
S1 (required adjustment)[1]	-1.9	-3.7	2.2	-0.1
Debt, % of GDP (2011)	42.6		82.8	
Age-related expenditure, % of GDP (2011)	17.2		25.8	

Notes:
The 'no policy change' scenario depicts the sustainability gap under the assumption that the budgetary position evolves according to the spring 2012 forecast until 2013. The 'convergence programme' scenario depicts the sustainability gap under the assumption that the budgetary plans in the programme are fully implemented

[1]The required adjustment of the primary balance until 2020

Source:
Commission, 2012 stability and convergence programmes

Figure. Medium-term debt projection



Source: Commission, 2012 convergence programme.

Table VI. Taxation indicators

	2001	2005	2007	2008	2009	2010
Total tax revenues (incl. actual compulsory social contributions, % of GDP)	28.9	29.2	30.6	29.2	26.7	27.3
Breakdown by economic function (% of GDP)[1]						
Consumption	10.7	12.3	11.9	10.6	10.3	10.8
of which:						
- VAT	6.8	7.8	8.2	6.7	6.0	6.6
- excise duties on tobacco and alcohol	1.3	1.3	1.1	1.5	1.6	1.5
- energy	1.7	2.2	1.7	1.7	2.1	2.0
- other (residual)	1.0	0.9	0.9	0.7	0.7	0.7
Labour employed	14.6	14.0	14.6	14.4	13.6	13.9
Labour non-employed	0.1	0.1	0.1	0.1	0.3	0.4
Capital and business income	2.0	2.1	2.9	3.3	1.7	1.2
Stocks of capital/wealth	1.3	0.7	1.0	0.8	0.8	1.0
p.m. Environmental taxes[2]	2.2	2.7	2.1	2.0	2.3	2.4
VAT efficiency[3]						
Actual VAT revenues as % of theoretical revenues at standard rate	49.0	59.5	63.7	49.2	38.0	42.8

Note:

1 Tax revenues are broken down by economic function, i.e. according to whether taxes are raised on consumption, labour or capital. See European Commission (2012), Taxation trends in the European Union, for a more detailed explanation.

2 This category comprises taxes on energy, transport and pollution and resources included in taxes on consumption and capital.

3 The VAT efficiency is measured via the VAT revenue ratio. The VAT revenue ratio is defined as the ratio between the actual VAT revenue collected and the revenue that would theoretically be raised if VAT was applied at the standard rate to all final consumption. A low ratio can indicate a reduction of the tax base due to large exemptions or the application of reduced rates to a wide range of goods and services ('policy gap') or a failure to collect all tax due to e.g. fraud ('collection gap'). See European Commission (2011), Tax reforms in EU Member States, European Economy 5/2011, for a more detailed explanation.

Source: Commission

Table VII. Financial market indicators

	2007	2008	2009	2010	2011
Total assets of the banking sector (% of GDP)	147.0	141.1	162.0	169.1	150.5
Share of assets of the five largest banks (% of total assets)	67.2	70.2	69.3	60.4	…
Foreign ownership of banking system (% of total assets)	57.7	68.3	69.2	…	…
Financial soundness indicators:					
- non-performing loans (% of total loans) [1]	0.8	3.6	16.4	15.9	15.1
- capital adequacy ratio (%) [1, 2]	11.1	11.8	14.6	13.9	15.6
- return on equity (%) [1, 3]	24.3	4.6	-41.6	-19.7	9.8
Bank loans to the private sector (year-on-year % change)	34.5	10.2	-7.3	-8.4	-6.9
Lending for house purchase (year-on-year % change)	44.7	4.4	-4.2	-4.4	-7.7
Loans-to-deposits ratio	236.7	278.4	254.7	213.4	201.2
CB liquidity as % of liabilities	0.0	3.0	0.7	0.0	0.0
Banks' exposure to countries receiving official financial assistance (% of GDP)[4]	…	…	…	…	…
Private debt (% of GDP)	89.1	90.1	103.2	97.5	…
Gross external debt (% of GDP) [4]					
- Public	5.0	9.2	24.8	32.2	31.3
- Private	36.2	41.0	46.3	45.3	44.7
Long-term interest rates spread versus Bund (basis points)*	106.6	244.8	913.5	759.4	329.9
Credit default swap spreads for sovereign securities (5-year)*	…	790.1	703.6	358.8	235.6

Notes:

[1] Latest September 2011.

[2] The capital adequacy ratio is defined as total capital divided by risk-weighted assets.

[3] Net income-to-equity ratio. After extraordinary items and taxes.

[4] Latest data 2011Q3.

* Measured in basis points.

Source :

Bank for International Settlements and Eurostat (exposure to macro-financially vulnerable countries), IMF (financial soundness indicators), Commission (long-term interest rates), World Bank (gross external debt) and ECB (all other indicators).

Table VIII. Labour market and social indicators

Labour market indicators	2006	2007	2008	2009	2010	2011
Employment rate (% of population aged 20-64)	73.5	75.2	75.8	67.1	65.0	67.2
Employment growth (% change from previous year)	5.2	2.8	0.6	-12.6	-4.3	3.1
Employment rate of women (% of female population aged 20-64)	69.1	70.7	72.1	66.8	64.9	65.8
Employment rate of men (% of male population aged 20-64)	78.2	80.1	79.7	67.4	65.1	68.7
Employment rate of older workers (% of population aged 55-64)	53.3	57.7	59.4	53.2	48.2	51.1
Part-time employment (% of total employment)	6.7	6.7	6.6	9.2	9.9	9.4
Part-time employment of women (% of women employment)	8.7	8.3	8.4	10.6	11.7	11.1
Part-time employment of men (% of men employment)	4.8	5.1	4.7	7.7	8.0	7.7
Fixed-term employment (% of employees with a fixed-term contract)	7.1	4.2	3.3	4.3	6.8	6.5
Unemployment rate[1] (% of labour force)	6.8	6.0	7.5	17.1	18.7	16.1
Long-term unemployment[2] (% of labour force)	2.5	1.6	1.9	4.6	8.4	8.4
Youth unemployment rate (% of youth labour force aged 15-24)	12.2	10.7	13.1	33.6	34.5	29.1
Youth NEET[3] rate (% of population aged 15-24)	11.1	11.8	11.4	17.4	17.8	:
Early leavers from education and training (% of pop. 18-24 with at most lower sec. educ. and not in further education or training)	14.8	15.1	15.5	13.9	13.3	:
Tertiary educational attainment (% of population 30-34 having successfully completed tertiary education)	22.9	26.3	28.7	31.2	33.9	:
Labour productivity per person employed (annual % change)	5.9	5.8	-4.2	-5.3	4.7	2.0
Hours worked per person employed (annual % change)	-0.9	-1.3	-4.3	-2.9	-0.8	1.0
Labour productivity per hour worked (annual % change; constant prices)	6.9	7.2	0.1	-2.4	5.5	1.0
Compensation per employee (annual % change; constant prices)	10.8	11.9	2.4	-11.6	-3.4	-1.1
Nominal unit labour cost growth (annual % change)	16.4	27.7	20.7	-7.9	-9.8	2.1
Real unit labour cost growth (annual % change)	4.6	5.8	6.9	-6.7	-7.7	-3.1

Notes:

[1] According to ILO definition (age group 15-74).
[2] Share of persons in the labour force who have been unemployed for at least 12 months.
[3] NEET are persons who are neither in employment nor in any education or training.

Sources:
Commission (EU Labour Force Survey and European National Accounts)

Expenditure on social protection benefits (% of GDP)	2005	2006	2007	2008	2009
Sickness/Health care	3.37	3.77	3.39	3.68	3.92
Invalidity	0.89	0.87	0.74	0.92	1.29
Old age and survivors	5.69	5.51	4.81	5.44	7.52
Family/Children	1.32	1.21	1.17	1.39	1.73
Unemployment	0.52	0.52	0.41	0.51	1.59
Housing and social exclusion n.e.c.	0.07	0.10	0.13	0.17	0.13
Total	12.8	12.7	11.3	12.7	16.8
of which: means-tested benefits	0.18	0.19	0.20	0.25	0.32
Social inclusion indicators	**2006**	**2007**	**2008**	**2009**	**2010**
Risk of poverty or exclusion[1] (% of total population)	41.4	35.8	33.8	37.4	38.1
Risk of poverty or exclusion of children (% of people aged 0-17)	42.8	33.7	33.2	38.0	42.0
Risk of poverty or exclusion of elderly (% of people aged 65+)	51.0	49.2	58.1	55.5	37.7
At-risk-of-poverty rate[2] (% of total population)	23.1	21.2	25.6	25.7	21.3
Value of relative poverty threshold (single household per year) - in PPS	2668	3309	4354	4394	3580
Severe material deprivation[3] (% of total population)	30.6	24.9	19.0	21.9	27.4
Share of people living in low work-intensity households[4] (% of people aged 0-59 not student)	7.0	6.1	5.1	6.7	12.2
In-work at-risk-of-poverty rate (% of persons employed)	11.2	9.7	11.0	11.2	9.7

Notes:

[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] At-risk-of-poverty rate: share of people with an equivalised disposable income below 60% of the national equivalised median income.

[3] Share of people who experience at least 4 out of 9 deprivations: people cannot 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.

[4] People living in households with very low work intensity: share of people aged 0-59 living in households where the adults work less than 20% of their total work-time potential during the previous 12 months.

Sources:

For expenditure on social protection benefits ESSPROS; for social inclusion EU-SILC.

Table IX. Product market performance and policy indicators

Performance indicators	2002-2006	2007	2008	2009	2010	2011
Labour productivity[1] total economy (annual growth in %)	**6.3**	**5.9**	**-4.2**	**-5.2**	**4.6**	**1.8**
Labour productivity[1] in manufacturing (annual growth in %)	**5.5**	**2.3**	**-4.4**	**-0.7**	**13.1**	**n.a.**
Labour productivity[1] in electricity, gas, water (annual growth in %)	**n.a.**	**n.a.**	**n.a.**	**n.a.**	**n.a.**	**n.a.**
Labour productivity[1] in the construction sector (annual growth in %)	**5.4**	**-6.0**	**-2.8**	**8.2**	**-6.6**	**n.a.**
Patent intensity in manufacturing[2] (patents of the EPO divided by gross value added of the sector)	**0.8**	**0.8**	**0.9**	**n.a.**	**n.a.**	**n.a.**
Policy indicators	**2002-2006**	**2007**	**2008**	**2009**	**2010**	**2011**
Enforcing contracts[3] (days)	**n.a.**	**279**	**279**	**309**	**309**	**369**
Time to start a business[3] (days)	**n.a.**	**16**	**16**	**16**	**16**	**16**
R&D expenditure (% of GDP)	**0.5**	**0.6**	**0.6**	**0.5**	**0.6**	**n.a.**
Tertiary educational attainment (% of 30-34 years old population)	**18.4**	**25.6**	**27.0**	**30.1**	**32.3**	**n.a.**
Total public expenditure on education (% of GDP)	**5.3**	**5.0**	**5.7**	**n.a.**	**n.a.**	**n.a.**
	2005	**2006**	**2008**	**2009**	**2010**	**2011**
Product market regulation[4], Overall (Index; 0 = not regulated; 6 = most regulated)	**n.a.**	**n.a.**	**n.a.**	**n.a.**	**n.a.**	**n.a.**
Product market regulation[4], Retail (Index; 0 = not regulated; 6 = most regulated)	**n.a.**	**n.a.**	**n.a.**	**n.a.**	**n.a.**	**n.a.**
Product market regulation[4], Network industries[5] (Index; 0 = not regulated; 6 = most regulated)	**n.a.**	**n.a.**	**n.a.**	**n.a.**	**n.a.**	**n.a.**

Notes:

[1] Labour productivity is defined as gross value added (in constant prices) divided by the number of persons employed.

[2] Patent data refer to applications to the European Patent Office (EPO). They are counted according to the year in which they were filed at the EPO. They are broken down according to the inventor's place of residence, using fractional counting if multiple inventors or IPC classes are provided to avoid double counting.

[3] The methodologies, including the assumptions, for this indicator are presented in detail on the website http://www.doingbusiness.org/methodology.

[4] The methodologies for the product market regulation indicators are presented in detail on the website http://www.oecd.org/document/1/0,3746,en_2649_34323_2367297_1_1_1_1,00.html. The latest available product market regulation indicators refer to 2003 and 2008, except for network industries.

[5] Aggregate ETCR.

*figure for 2007.

Source:

Commission, World Bank - *Doing Business* (for enforcing contracts and time to start a business) and OECD (for the product market regulation indicators).

Table X. Green growth performance

		2001-2005	2006	2007	2008	2009	2010
Green growth performance							
Macroeconomic							
Energy intensity	kgoe / €	0.40	0.33	0.31	0.31	0.35	0.37
Carbon intensity	kg / €	1.06	0.85	0.81	0.81	0.88	n.a.
Resource intensity (reciprocal of resource productivity)	kg / €	3.49	3.26	3.18	2.79	2.62	n.a.
Waste intensity	kg / €	n.a.	0.13	0.11	0.10	n.a.	n.a.
Energy balance of trade	% GDP	-4.3%	-5.7%	-4.6%	-5.8%	-4.4%	-4.8%
Energy weight in HICP	%	13	12	11	11	12	14
Difference between change in energy price and inflation	%	-0.16	8.8	3.5	20.4	6.9	0.6
Environmental taxes over labour taxes	ratio	16.9%	16.4%	14.1%	13.5%	16.8%	n.a.
Environmental taxes over total taxes	ratio	8.5%	7.8%	6.8%	6.7%	8.7%	n.a.
Sectoral							
Industry energy intensity	kgoe / €	0.41	0.36	0.27	0.23	0.28	n.a.
Share of energy-intensive industries in the economy	% GDP	6.7	6.3	6.1	6.8	7.1	n.a.
Electricity prices for medium-sized industrial users	€ / kWh	n.a.	0.04	0.04	0.07	0.09	0.09
Public R&D for energy	% GDP	n.a.	0.01%	0.02%	0.01%	0.02%	n.a.
Public R&D for the environment	% GDP	n.a.	0.01%	0.01%	0.01%	0.02%	n.a.
Recycling rate of municipal waste	ratio	3.8%	4.1%	5.3%	6.8%	7.8%	n.a.
Share of GHG emissions covered by ETS	%	n.a.	24.8%	23.1%	23.0%	23.2%	n.a.
Transport energy intensity	kgoe / €	0.68	0.73	0.70	0.58	0.54	n.a.
Transport carbon intensity	kg / €	1.97	2.08	1.99	1.63	1.46	n.a.
Change in the ratio of passenger transport and GDP	%	n.a.	-0.3%	0.1%	-5.4%	n.a.	n.a.
Security of energy supply							
Energy import dependence	%	62.2%	65.8%	61.5%	57.9%	58.8%	n.a.
Diversification of oil import sources	HHI	n.a.	0.00	0.00	0.00	0.00	n.a.
Diversification of energy mix	HHI	0.29	0.29	0.29	0.29	0.30	n.a.
Share of renewable energy in energy mix	%	32.0%	30.9%	29.6%	30.0%	36.2%	n.a.

Country-specific notes:

The year 2011 is not included in the table due to lack of data.

General explanation of the table items:

Source: Eurostat unless indicated otherwise; ECFIN explanations given below.

All macro intensity indicators are expressed as a ratio of a physical quantity to GDP (in 2000 prices):

Energy intensity: gross inland energy consumption (in kgoe) divided by GDP (in EUR).

Carbon intensity: Greenhouse gas emissions (in kg CO2 equivalent) 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.

Energy weight in HICP: the share of the "energy" items in the consumption basket used in the construction of the HICP.

Difference between energy price change and inflation: energy component of HICP, and total HICP inflation (annual %-change).

Environmental taxes over labour or total taxes: from DG TAXUD's database "Taxation trends in the European Union".

Industry energy intensity: final energy consumption of industry (in kgoe) divided by gross value added of industry (in EUR).

Share of energy-intensive industries in the economy: share of gross value added of the energy-intensive industries in GDP.

Recycling rate of municipal waste: ratio of municipal waste recycled over total municipal waste.

Public R&D for energy or for the environment: government spending on R&D (GBAORD) for these categories as % of GDP.

Share of GHG emissions covered by ETS: based on greenhouse gas emissions as reported by Member States to EEA (excl LULUCF).

Transport energy intensity: final energy consumption of transport (in kgoe) divided by gross value added of industry (in EUR).

Transport carbon intensity: greenhouse gas emissions in transport divided by gross value added of the transport sector.

Passenger transport growth : measured in %-change in passenger kilometres.

Energy import dependence: net energy imports divided by gross inland energy consumption incl. of international bunkers.

Diversification of oil import sources: Herfindahl index (HHI), calculated as the sum of the squared market shares of countries of origin.

Diversification of the energy mix: Herfindahl index over natural gas, total petrol products, nuclear heat, renewable energies and solid fuels.

Share of renewable energy in energy mix: percentage-share in gross inland energy consumption, expressed in tonnes of oil equivalent.