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Recommendation for a

COUNCIL RECOMMENDATION

on the 2015 National Reform Programme of Croatia

and delivering a Council opinion on the 2015 Convergence Programme of Croatia

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THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty on the Functioning of the European Union, and in particular Articles 121(2) and 148(4) thereof,

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[1], and in particular Article 9(2) thereof,

Having regard to Regulation (EU) No 1176/2011 of the European Parliament and of the Council of 16 November 2011 on the prevention and correction of macroeconomic imbalances[2], and in particular Article 6(1) thereof,

Having regard to the recommendation of the European Commission[3],

Having regard to the resolutions of the European Parliament[4],

Having regard to the conclusions of the European Council,

Having regard to the opinion of the Employment Committee,

Having regard to the opinion of the Economic and Financial Committee,

Having regard to the opinion of the Social Protection Committee,

Having regard to the opinion of the Economic Policy Committee,

Whereas:

(1) On 26 March 2010, the European Council agreed to the Commission's proposal to launch a new strategy for growth and jobs, *Europe 2020*, based on enhanced coordination of economic policies. The strategy focuses on the key areas where action is needed to boost Europe's potential for sustainable growth and competitiveness.

(2) On 13 July 2010, the Council, on the basis of the Commission's proposals, adopted a recommendation on the broad guidelines for the economic policies of the Member States and the Union (2010 to 2014) and on 21 October 2010 it adopted a decision on guidelines for the employment policies of the Member States. Together these form

[1] OJ L 209, 2.8.1997, p. 1.
[2] OJ L 306, 23.11.2011, p. 25.
[3] COM(2015) 261.
[4] P8_TA(2015)0067, P8_TA(2015)0068, P8_TA(2015)0069.

the 'integrated guidelines' which Member States were invited to take into account in their national economic and employment policies.

(3) On 8 July 2014, the Council adopted a Recommendation on Croatia's National Reform Programme for 2014 and delivered its opinion on Croatia's updated Convergence Programme for 2014.

(4) On 28 November 2014, the Commission adopted the Annual Growth Survey[5], marking the start of the 2015 European Semester of economic policy coordination. On the same day, on the basis of Regulation (EU) No 1176/2011, the Commission adopted the Alert Mechanism Report[6], in which it identified Croatia as one of the Member States for which an in-depth review would be carried out.

(5) On 18 December 2014, the European Council endorsed the priorities for boosting investment, accelerating structural reforms and pursuing responsible growth-friendly fiscal consolidation.

(6) On 26 February 2015, the Commission published its 2015 country report for Croatia[7]. This assessed Croatia's progress in addressing the country-specific recommendations adopted on 8 July 2014. The country report also includes the results of the in-depth review under Article 5 of Regulation (EU) No 1176/2011. The Commission's analysis leads it to conclude that Croatia is experiencing excessive macroeconomic imbalances which require decisive policy action and specific monitoring. In particular, in a context of subdued growth, delayed restructuring of firms and dismal employment performance, the risks associated with weak competitiveness, large external liabilities and rising public debt coupled with weak public sector governance have increased significantly.

(7) In March 2015, following the publication the country report, the Croatian authorities engaged in a dialogue with the Commission services on reforms most needed to address the excessive macroeconomic imbalances. The authorities approached the dialogue constructively and announced a number of relevant measures, including reducing parafiscal charges in 2016 and 2017, rationalising the system of state agencies and regional units of the central state administration, incentivising voluntary mergers of local self-government units, reducing legislative uncertainty and strengthening the State Audit Office. Reform plans in several other areas such as reducing administrative burdens on enterprises and improving the governance of state-owned enterprises were spelled out in greater detail. However, the level of ambition remains below expectations in a number of areas, notably as regards tightening early retirement rules and publishing and implementing the findings of the expenditure review, although some additional measures were presented to partly compensate for the shortfall.

(8) Croatia is currently in the corrective arm of the Stability and Growth Pact. In its 2015 Convergence Programme, the government plans to correct the excessive deficit by 2017, which is not in line with the 2016 deadline recommended by the Council. The government plans to gradually reduce the headline deficit to 5.0% of GDP in 2015, 3.9% in 2016 and further to 2.7% of GDP in 2017. According to the Convergence Programme, the government debt-to-GDP ratio is expected to peak at 92.5% in 2017 and to broadly stabilise at 92.4% of GDP in 2018. The macroeconomic scenario

[5] COM(2014) 902.
[6] COM(2014) 904.
[7] SWD(2015) 30 final.

underpinning these budgetary projections seems somewhat favourable, as growth is comparable while the underlying consolidation effort is higher in the programme than in the Commission forecast. Measures to support the planned deficit targets from 2015 onwards are only partially specified. Based on the Commission's 2015 spring forecast, a timely and durable correction of the excessive deficit by 2016 is not expected. Based on the amount of discretionary measures taken, the fiscal effort in 2014 was in line with the Council recommendation. This is also the case in cumulative terms over 2014 and 2015, in spite of the projected shortfall in 2015. However, the (adjusted) change in the structural balance over 2014-2015 is below the recommended value. In 2016, the fiscal effort is below the Council recommendation. Therefore, further structural measures will be needed. Based on its assessment of the Convergence Programme and taking to account the Commission's 2015 spring forecast, the Council is of the opinion that there is a risk that Croatia will not comply with the provisions of the Stability and Growth Pact.

(9) On 23 April 2015, Croatia submitted its 2015 National Reform Programme and its 2015 Convergence Programme. To take account of their interlinkages, the two programmes have been assessed at the same time.

(10) Croatia is currently reviewing its expenditure with a view to achieving efficiencies, in particular in wage, social security and subsidy outlays, and providing sufficient fiscal space to prioritise growth-enhancing expenditure and investment. Croatia’s revenues from recurrent taxes on real estate as a proportion of GDP are among the lowest in the EU. Steps have been taken over the last year to improve tax compliance, including measures to address VAT fraud, and action is now needed. Croatia’s fiscal framework has been bolstered by recent reforms, but significant challenges remain. Weaknesses in relation to effective expenditure control and the consistent application of budgetary constraints negatively impact fiscal policy-making and audit findings. The rapidly rising public debt calls for a much more active approach to public debt management.

(11) The pension system suffers from a large number of early retirees, an excessively generous system of early pensions for certain professions, and numerous special pension schemes. Early exits are facilitated by comparatively low pension reductions, or none at all for certain workers. The gap between the minimum early and statutory retirement ages is also high compared with an EU average of less than three years. Moreover, the system is highly fragmented, which squeezes out spending on standard pensions. As a result, the benefit ratio in the pension system is lower than in most Member States, despite comparable expenditure. As regards the healthcare sector, recurrent arrears continue to pose fiscal risks. Measures have been initiated to rationalise hospital funding, but there are implementation risks. The 10 % budget increase covers funding needs only partially; further efficiency savings will have to be made to ensure the full elimination of arrears by 2017.

(12) Limited wage adjustment in the post-crisis period exacerbated the negative impact on employment. The comprehensive analysis of wage-determination and wage-setting practices completed in 2014 revealed that the system was not flexible to adapt to changes in the macroeconomic environment. Particular weaknesses relate to large disparities between the private and the public sectors, including state owned enterprises, the extension of collective agreements to non-signatory parties and the difficulties related to the termination of obsolete agreements. The analysis needs to be followed up by concrete policy action. It is also important to monitor the effects of the 2013-2014 labour market reform.

(13) The labour force is negatively affected by a rapidly ageing population coupled with low activity rates, in particular for young people and workers over the age of 50. Despite the increased scope and expenditure of active labour market policies, their outreach remains insufficient as regards the long-term unemployed, older workers and young people not in education, employment or training. The tertiary education rate is one of the lowest in the EU. Skills mismatches and weaknesses in the education and training system act as deterrents for higher education attainment. The size of the informal economy remains a persisting challenge and results in a high incidence of undeclared work. The measures that the commission to combat undeclared work identified at the end of 2014 now need to be implemented. There are currently over 80 different social benefits and programmes. The consolidation of benefits has started, but further reform efforts are needed in 2015 to improve the coverage and adequacy of benefits.

(14) The distribution of competences between national and local level is complex and fragmented, which undermines the management of public finances and efficient public expenditure. The current attribution of policy functions and administrative weaknesses in the local authorities directly affect a number of areas, such as tax collection, the provision of social benefits, the management of European Structural and Investment Funds, public procurement and the provision of public services. As a short-term measure, the authorities plan to establish mechanisms that would encourage voluntary mergers or coordination of self-government units. In the central government, the reform and rationalisation of the system of state agencies has been brought forward on the basis of the analysis completed in 2014.

(15) Croatia's business environment suffers from major institutional shortcomings, including regulatory instability, weak legislative quality control, high compliance costs, discriminatory practices and excessive barriers for service providers, high administrative burdens, a plethora of parafiscal charges, low transparency and predictability in the working of administrative bodies, in particular at local level, unevenly developed electronic communication channels, and long judicial proceedings, in particular in commercial courts, where an upgrade of case management is needed. The new anti-corruption strategy lacks focus and a sufficient level of detail; this should be addressed in an action plan to implement the strategy.

(16) The supervision of public enterprises is incomplete as regards companies established at local level and subsidiaries of major public enterprises. The authorities plan to reduce the number of 'strategic' companies and to step up the privatisation agenda. Further progress on the quality of governance is needed, including as regards strengthening and harmonising surveillance across various state-owned enterprises. The nomination of board members lacks transparency and competency requirements are relatively weak, which hampers a sound management of public property.

(17) Putting in place an efficient and transparent early-rescue and insolvency framework is a key prerequisite for alleviating the considerable deleveraging pressure faced by Croatian businesses and fostering a culture of early restructuring and 'second chance'. An assessment of the pre-insolvency legislation shows that the *ex ante* efficiency of the current legislative framework is among the lowest in the EU. A reform of the insolvency framework has been initiated, with parliamentary adoption planned in the first half of 2015. The Croatian Bank for Reconstruction and Development could play a crucial role in Croatia's recovery. It is directly exposed to credit risk, which might affect public finances. It is important that it be placed under prudential supervision and strong corporate governance. There is also scope to

improve the structure and transparency of its management accountability arrangements. Following the emergence of currency and currency-induced credit risk, a long-term solution is needed that is proportional and equitable and has a solid legal basis and a focus on helping the most distressed borrowers.

(18) In the context of the European Semester, the Commission has carried out a comprehensive analysis of Croatia's economic policy and published it in the 2015 country report. It has also assessed the Convergence Programme and the National Reform Programme and the follow-up given to the recommendations addressed to Croatia in previous years. It has taken into account not only their relevance for sustainable fiscal and socio-economic policy in Croatia but also their compliance with EU rules and guidance, given the need to strengthen the overall economic governance of the European Union by providing EU-level input into future national decisions. The recommendations under the European Semester are reflected in recommendations 1 to 6 below.

(19) In the light of this assessment, the Council has examined Croatia's Convergence programme, and its opinion[8] is reflected in particular in recommendation 1 below.

(20) In the light of the Commission's in-depth review and this assessment, the Council has examined the National Reform Programme and the Convergence Programme. Its recommendations under Article 6 of Regulation (EU) No 1176/2011 are reflected in recommendations 1 to 6 below,

HEREBY RECOMMENDS that Croatia take action in 2015 and 2016 to:

1. Ensure a durable correction of the excessive deficit by 2016 by taking the necessary measures in 2015 and reinforcing the budgetary strategy for 2016. Publish and implement the findings of the expenditure review. Improve control over expenditure at central and local level, in particular by establishing a sanctioning mechanism for entities breaching budgetary limits. Adopt the Fiscal Responsibility Act and strengthen the capacity and role of the State Audit Office. Introduce a recurrent property tax and improve VAT compliance. Reinforce public debt management, in particular by publishing on an annual basis a debt management strategy and ensuring adequate resourcing.

2. Discourage early retirement by raising penalties for early exits. Improve the adequacy and efficiency of pension spending by tightening the definition of arduous and hazardous professions. Tackle the fiscal risks in healthcare.

3. Tackle the weaknesses in the wage-setting framework, in consultation with the social partners and in accordance with national practices, to foster the alignment of wages with productivity and macroeconomic conditions. Strengthen incentives for the unemployed and inactive to take up paid employment. Based on the 2014 review, carry out the reform of the social security system and further consolidate social benefits by improving targeting and eliminating overlaps.

4. Reduce the extent of fragmentation and overlap between levels of central and local government by putting forward a new model for functional distribution of competencies and by rationalising the system of state agencies. Increase transparency and accountability in the public corporate sector, in particular as regards managerial appointments and competency requirements. Advance the listing of minority packages of shares of public companies and privatisations.

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

5. Significantly, reduce parafiscal charges and remove excessive barriers for service providers. Identify and implement steps to improve the efficiency and quality of the justice system, in particular commercial courts.

6. Reinforce the pre-insolvency and insolvency frameworks for businesses in order to facilitate debt restructuring and put in place a personal insolvency procedure. Strengthen the capacity of the financial sector to support the recovery in view of challenges from high non-performing corporate loans and foreign currency mortgage loans, and weak governance practices in some institutions.

Done at Brussels,

For the Council
The President