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Recommendation for a

COUNCIL RECOMMENDATION

on Croatia's 2014 national reform programme

and delivering a Council opinion on Croatia's 2014 convergence programme

{SWD(2014) 412 final}

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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, which will focus 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, adopted a decision on guidelines for the employment policies of the Member States, which together form

1 OJ L 209, 2.8.1997, p. 1.
2 OJ L 306, 23.11.2011, p. 25.
3 COM(2014) 412 final.
4 P7_TA(2014)0128 and P7_TA(2014)0129.

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

(3) On 29 June 2012, the Heads of State or Government decided on a Compact for Growth and Jobs, providing a coherent framework for action at national, EU and euro area levels using all possible levers, instruments and policies. They decided on action to be taken at the level of the Member States, in particular expressing full commitment to achieving the objectives of the Europe 2020 Strategy and to implementing the country-specific recommendations.

(4) Croatia participated in the 2013 European Semester on a voluntary and informal basis by submitting an economic programme; there were no country-specific recommendations. On 21 June 2013, the Council adopted conclusions welcoming Croatia's economic programme, emphasising that Croatia is expected to progress towards meeting the requirements of the Stability and Growth Pact and that it needs to embark on a credible consolidation path, whilst safeguarding growth-enhancing expenditure and ensuring room for co-financing the inflow of EU funds.

(5) On 13 November 2013, the Commission adopted the Annual Growth Survey[5], marking the start of the 2014 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.

(6) On 20 December 2013, the European Council endorsed the priorities for ensuring financial stability, fiscal consolidation and action to foster growth. It underscored the need to pursue differentiated, growth-friendly fiscal consolidation, to restore normal lending conditions to the economy, to promote growth and competitiveness, to tackle unemployment and the social consequences of the crisis, and to modernise public administration.

(7) On 5 March 2014, the Commission published the results of its in-depth review for Croatia[7], 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 specific monitoring and strong policy action. In particular, policy action is required in view of the vulnerabilities arising from sizeable external liabilities, declining export performance, highly leveraged firms and fast-increasing general government debt, all within a context of low growth and poor adjustment capacity.

(8) On 24 April 2014, Croatia submitted its 2014 national reform programme and its 2014 convergence programme. In order to take account of their interlinkages, the two programmes have been assessed at the same time.

(9) The objective of the budgetary strategy outlined in the 2014 Convergence Programme is to correct the excessive deficit by 2016, whilst at the same time moving back to a path of sustainable economic growth. This is projected to be achieved by a continuous reduction in the deficit from 4.9% of GDP in 2013 to below 3% of GDP by 2016, the deadline for the correction of the excessive deficit. The programme projects that government debt will peak at around 72% of GDP in 2014, slightly drop in the following year and level off thereafter. The

[5] COM(2013) 800 final.
[6] COM(2013) 790 final.
[7] SWD(2014) 82 final.

macroeconomic scenario underpinning the budgetary projections in the programme is optimistic over the entire programme period. According to the programme scenario, GDP would stagnate in 2014, whilst moderate growth of 1.2% is projected in 2015; against a decline of 0.6% and growth of 0.7%, respectively, in the Commission 2014 Spring Forecast. The programme's budgetary forecast figures deviate from the standards of the European System of National and Regional Accounts (ESA), giving rise to inconsistency with past data and the macroeconomic scenario and hindering an appropriate comparison with the Commission 2014 spring forecast. Moreover, the programme does not provide a sufficient level of detail on the consolidation measures for 2015 and 2016, in particular on the expenditure side. According to the Commission 2014 spring forecast, the headline balance is expected to reach 3.8% and 3.1% of GDP in 2014 and 2015. After the necessary adjustment to make these projections comparable to the targets set in the context of the Excessive Deficit Procedure (i.e. excluding the impact of the transfer of second pillar pension assets) the Commission projection for the deficit in 2014 would be 4.6% of GDP and 3.8% in 2015. As the Convergence Programme constitutes the first report on the action taken by the authorities following the opening of the Excessive Deficit Procedure on 28 January 2014, the Commission assessed the action taken by Croatia in a Communication published on 2 June 2014. In particular, the headline target is projected to be met in 2014, while the deficit is expected to be somewhat above target in 2015. The improvement in the structural government balance falls marginally short of what is required both in 2014 and 2015. Finally, while the change in the adjusted structural balance is below the recommended effort, the effort measured by the underlying amount of discretionary measures is estimated to be delivered both in 2014 and 2015. In order to reduce the negative impact on growth and enhance the sustainability of the consolidation, greater attention to the quality of the measures and a transition to expenditure based measures are warranted. Based on its assessment of the programme and the Commission forecast, pursuant to Council Regulation (EC) No 1466/97, the Council is of the opinion that, while Croatia has taken effective action by 30 April 2014 to correct its excessive deficit as recommended, additional efforts are needed in order to comply with the recommendation under the Excessive Deficit Procedure to correct the excessive deficit by 2016 and ensure the credibility of the correction.

(10) Budgetary consolidation measures should be geared towards enhancing the quality of public finances, with a view to achieving efficiencies notably in wage, social security and subsidy outlays and to providing sufficient fiscal space for prioritising growth-enhancing expenditure and investments, including in projects funded by the Union. Croatia has implemented significant reforms in its fiscal framework in recent years. However, weaknesses remain in relation to budgetary planning, effective control over expenditure and consistent application of budgetary constraints, which negatively impact on fiscal policy-making. Although recently changed, the design of the fiscal rules should be further improved. Notably, the effectiveness of the fiscal framework is undermined by the absence of preventive mechanisms and weak compliance with the debt rule, and an ambiguous formulation of the structural balanced-budget rule. While the establishment of the Fiscal Policy Commission is welcome, additional measures are deemed necessary to strengthen its position in the budget planning and monitoring, most notably its independence from all budgetary authorities.

(11) Croatia faces the challenge of pursuing fiscal consolidation without harming competitiveness and prospects of economic recovery. Against such background, the

revenue side of public finances is constrained by a narrow definition of the bases for taxes that offer a stable tax yield and have little distortionary impact on growth. In this context, the national reform programme announces a plan to introduce a recurrent property tax in 2016 but its operational design, including that of the tax base, is yet to be specified. Croatia is also determined to take measures to improve tax compliance by reducing the grey economy. Steps have been taken on this front. The gradual introduction of fiscal cash registries has increased tax receipts by enhanced oversight of transactions. The reorganisation of the tax administration is expected to improve the efficiency and effectiveness of tax collection while lowering compliance burdens for taxpayers. However, in light of fiscal consolidation needs, and also taking into account data pointing to significant amounts of uncollected taxes, there seems to be scope to increase further the efficiency of tax collection and continued efforts are needed to improve tax compliance by providing more e-services to taxpayers.

(12) Croatia has taken measures with a view to improving the sustainability and adequacy of pensions: since November 2010, the statutory retirement age, the early retirement age and the qualifying period for women have been gradually increased and are set to be fully harmonised by 2030. The amendments to the Pension Insurance Act adopted in December 2013 raise the statutory retirement age from 65 to 67 and the early retirement age from 60 to 62. However, this increase will become effectiveonly as of 2031, which is insufficiently ambitious taking account of demographic trends. Despite reforms implemented over recent years, various possibilities for early retirement still exist. Considering the extent of exemptions, the penalties for early retirement and the late retirement bonus create little incentive to work to the statutory retirement age, impacting negatively on labour supply and the sustainability of the pension system. The Act on the Single Forensic Expertise Body was adopted in 2013 to help limit the inflow of disability pensioners and reduce fraud by unifying disability assessments. Together with increased inspections, this addresses a definite need but the effect on expenditure will depend on how measures are implemented and the extent to which decisions are enforced. Pensions under special schemes that were above a certain threshold were cut by 10%, albeit on a temporary basis, while their indexation has been tied to a GDP trigger. Despite recent attempts to curb expenditure and increase transparency, the pace and extent of convergence of pensions under special schemes towards general rules are slow and overall progress is still limited.

(13) The health sector achieves reasonably good health outcomes and, with some regional variation, services are accessible, but the system contributes significantly to pressure on the public finances. The authorities identified remediable inefficiencies in the hospital network. The master plan presented in March 2014 for the reorganisation of hospital care provides for measures that would improve cost-effectiveness, such as rationalisation of the hospital network, reduced average lengths of hospital stays, a better allocation of hospital beds, including for long-term care, and further changes in hospital financing. Strong monitoring and implementation capacities in both hospitals and central government should be ensured to put the plan into practice. Long-term care is characterised by dispersed services between the health and the social welfare systems, low coverage rates and formal care, high costs of provision and long waiting lists.

(14) Employment and activity rates are amongst the lowest in the EU, and are particularly low for young people and older people. Beyond cyclical developments, these labour

market outcomes are partly related to institutional and policy settings. Croatia has embarked on labour market reforms to increase flexibility on the labour market. A first phase of the reform, was completed in 2013, focused on regulation of fixed-term employment contracts. The government adopted a second legislative proposal in January 2014 which provides for reducing dismissal costs by shortening and simplifying procedures and increasing working-time flexibility. In addition, more flexible forms of employment such as part-time contracts would be introduced. These changes would put Croatia broadly on a par with its peers, as far as the employment protection index is concerned. Although these reforms are expected to have a positive effect on overall employment, they also entail an increased risk of labour market segmentation, including the development of fixed-term contracts. Meanwhile, no changes are foreseen to the wage-setting institutions despite Croatia's particular combination of relatively high average wages and very low employment. Despite further rising unemployment, spending and coverage of active labour market policy measures to enable improved access to, and longer stay in, the labour market are still below average, especially as regards young people, long-term unemployed and older workers. The administrative capacity of the Croatian public employment service is under severe pressure, including at regional level. An overall system to monitor and evaluate developments on the labour market and labour market needs including skills forecasting does not exist nor is there a regular evaluation of active labour market policy measures. There is high proportion of undeclared paid activity.

(15) The situation on the labour market is of particular concern for young people as their unemployment increased drastically and reached almost 50% in 2013, while the proportion of young people not in education, employment or training keeps increasing. Important challenges include outreach to non-registered youth and mobilisation of the private sector to offer more apprenticeships, in line with the objectives of a youth guarantee. Croatia also faces serious challenges in education as regards labour-market relevance and quality of provision across all educational sectors. Work-based learning and career guidance across secondary and tertiary education are lacking while employers' engagement with vocational education and training, and secondary and tertiary education is low. Employment rates among recent graduates are significantly lower than in the rest of the EU. The outdated vocational education and training system is undergoing a reform in the form of piloting new school curricula. The implementation of the Croatian Qualifications Framework and the Strategy on Education, Science and Technology is pending but should improve educational outcomes and align them with labour market needs.

(16) High unemployment and low labour market participation have led to a deterioration of the social situation in Croatia. The proportion of persons at risk of poverty and social exclusion has increased in recent years and is significantly above the EU average. The design of the social benefit system makes it possible for recipients to accumulate overlapping cash transfers. When recipients move into work, they lose the benefit of some of these social transfers, thereby creating disincentives for them to enter the labour market. There is scope to make the social protection system more efficient and transparent: currently, the allocation of income support schemes and benefits is scattered across many institutions and levels of government, with inconsistent application of criteria and overlaps. The 2013 Social Welfare Act introduced stricter means-testing and merged four of more than 70 benefits at national level, including some targeting specific groups, into the General Minimum Income. A national ‘one-stop shop’, through which all national level cash benefits will be administered, is being implemented gradually until 2016. However,

systematic monitoring and evaluation will be difficult as the income support schemes and programmes at local and regional levels and the various non-means tested cash benefits targeting specific categories of the population, have not been integrated. Despite several legislative reforms since 2011, the design of the social benefit systems failed to effectively target, people most in need.

(17) The current regulatory framework for doing business in Croatia imposes a high burden on businesses, including lack of legal certainty, untransparent decision-making in particular at local level, and numerous para-fiscal charges. Moreover, high fragmentation of public administration responsibilities at regional and local level and a complex split of competencies between ministries and agencies at central level complicate business decisions and lengthen administrative procedures. A structured approach has been put in place at central government level to identify obstacles for business; however, a consistent methodology for measuring administrative burden is not applied, which decreases the effectiveness of measures already taken. The existing one-stop shop for businesses covers limited functionalities only. There is a need to rationalise and improve control over public subsidies and guarantees; a central register of supported companies and individuals would represent a first step in this area. Croatia has initiated reforms of the public administration to strengthen its administrative capacities and to improve the client-orientation of public services for citizens and businesses. However, the quality of public governance remains low, with weak coordination across different levels of government and little or overformalistic use of evidence-based policy-making and assessment. The adoption of the public administration reform strategy is a step in the right direction; the strategy should be thoroughly implemented at all levels of government. The experience of the implementation of the pre-accession funds points to deficiencies in terms of strategic planning and institutional capacity and weaknesses in project elaboration and follow-up.

(18) State-owned or state-controlled companies are negatively affected by weak governance while the implementation of the new strategy for the management of public assets and enterprises has encountered delays. Currently, there is no competitive selection procedure for supervisory board members and management, and appointments are not published. While measures have been taken to improve the anti-corruption framework, more efforts are required in the prevention of corruption, at all layers of government. The key elements currently missing in the anti-corruption framework include effective verification mechanisms for conflict of interest and asset disclosure of public officials, as well as specific safeguards for state-owned and state-controlled enterprises. The verification powers of the Commission for the Resolution of Conflict of Interest rely on the competences and pro-activeness of other authorities. Despite the progress made to increase transparency of public procurement procedures, risk assessment tools are not being systematically used and vulnerable sectors appear to be insufficiently prioritised. The oversight over the effective implementation of public procurement rules needs to be reinforced, also in view of the allocation of EU funds in the coming years.

(19) The wide-spread application of the pre-bankruptcy procedure in 2013 met with some success in addressing debt-servicing problems faced by companies in the context of complex, expensive and lengthy bankruptcy procedures. However, there is scope to considerably strengthen the instrument by addressing various shortcomings, such as insufficient clarification of the role of the state in the process, strengthening the role of commercial courts in validating claims and sound restructuring plans, extending

the scope of the procedure to allow for effective restructuring before the debtor becomes insolvent, and addressing deficiencies in implementation of the law. Despite a number of reforms to improve the effectiveness of the justice system, judicial proceedings in litigious civil, commercial and administrative cases are unduly long, particularly in first instance. The backlog of cases increased in 2013 and is very high, particularly as regards civil and commercial proceedings. Continued effort to create and enforce the right incentives to resolve proceedings in a timely manner and to promote out-of-court settlements, especially in the case of small claims, is needed to address these issues, as they hamper business activity and reduce Croatia's attractiveness for foreign direct investment.

(20) The conservative approach adopted by the Croatian National Bank to macro-prudential regulation, notably in relation to capital levels, has meant that banks have built up a degree of resilience that has proven to be useful given the challenges they now face from the weak economy. However, with the economy entering its sixth year of recession and increasing non-performing loans, there are risks to banks' asset quality. It is welcome that certain portfolios of the four largest Croatian banks, which are foreign-owned, will be covered by the euro area asset quality review/stress test of the new Single Supervisory Mechanism. Nevertheless, the exercise excludes some materially important portfolios from a Croatian perspective, as portfolios are selected based on their relevance at a banking group level. Furthermore, the exercise does not cover mid-size and smaller banks, which may have lower capital levels and less robust asset quality, and which are potentially important for financial stability. Complementing the Single Supervisory Mechanism exercise by an additional supervisory diagnostic exercise designed specifically for the Croatian financial system (and which would cover significant portfolios of Croatian subsidiaries that are not part of the Single Supervisory Mechanism exercise, as well as key mid-size and smaller banks) would improve the overall understanding of banks' loan classification and the adequacy of their loan loss provisions.

(21) In the context of the European Semester, the Commission has carried out a comprehensive analysis of Croatia's economic policy. It has assessed the convergence programme and the national reform programme. 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 reinforce the overall economic governance of the European Union by providing EU-level input into future national decisions. Its recommendations under the European Semester are reflected in recommendations (1) to (8) below.

(22) 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.

(23) 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 (8) below.

HEREBY RECOMMENDS that Croatia take action within the period 2014-2015 to:

1. Fully implement the budgetary measures adopted for 2014. Reinforce the budgetary strategy, further specifying announced measures for 2015 and 2016, and considering additional permanent, growth-friendly measures in order to ensure a sustainable

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

correction of the excessive deficit by 2016. At the same time, ensure that the structural adjustment effort as specified in the Council recommendation under the Excessive Deficit Procedure is delivered. Align programme projections with ESA standards and Stability and Growth Pact requirements. Take measures to reinforce control over expenditure. By March 2015, carry out a thorough expenditure review. Reinforce the budgetary planning process, in particular by improving the accuracy of macroeconomic and budgetary forecasts and strengthening the binding nature of the annual and medium-term expenditure ceilings and improve the design of fiscal rules. By October 2014, ground in law the newly established Fiscal Policy Commission, strengthen its independence from all budgetary authorities, broaden its mandate, notably with respect to monitoring of all fiscal rules and the ex-ante and ex-post assessment of forecasts, and ensure adequate resourcing. Building on plans outlined in the national reform programme, present a concrete strategy to reform recurrent property taxation. Initiate a process of reporting and reviewing of tax expenditures. Improve tax compliance, in particular by further enhancing the efficiency of the tax administration; present an action plan to this end by the end of 2014.

2. Adopt legislation by March 2015 to accelerate the planned harmonisation of statutory retirement ages of women and men and to advance the planned increase of the statutory retirement age to 67 years. Reduce access to early retirement. Ensure enforcement of tighter disability pensions assessments and controls and accelerate the integration of pensions under special schemes into the general pension system. Strengthen the cost-effectiveness of the healthcare sector, including in hospitals.

3. Implement the second phase of the labour law reform, following consultation with the social partners, notably as regards conditions for dismissals and working time, and with a view to preventing further labour market segmentation including for young people, by March 2015. Review the wage-setting system with a view to better aligning productivity developments and wage conditions. Present the conclusions of this review by the end of 2014. Strengthen the effectiveness and reach of active labour market policies by reinforcing the administrative capacities of the public employment services, including at regional level, and by increasing the coverage of the young, long-term unemployed and older workers. Prioritise outreach to non-registered youth and mobilise the private sector to offer more apprenticeships, in line with the objectives of a youth guarantee. Outline plans, by the end of 2014, to address undeclared work. Implement measures to improve the labour market relevance and quality of education outcomes by modernising the qualification systems, by putting in place quality assurance mechanisms and by improving school-to-work transitions, notably through strengthening vocational education and work-based learning.

4. Review tax and benefits systems by the end of 2014, and present an action plan to improve the reactivation of inactive and unemployed persons. Strengthen the effectiveness and transparency of the social protection system by further consolidating benefits, unifying eligibility criteria and linking data from all relevant levels and government entities in the "one-stop shop". Improve the effectiveness and adequacy of social assistance benefits through their better targeting.

5. Take further measures to improve the business environment. Notably, by March 2015 set a target for considerably lowering administrative requirements, including para-fiscal charges. Address the high level of fragmentation and overlapping responsibilities by streamlining administrative processes and by clarifying the decision-making and accountability framework across various levels of government

and at central government level between ministries and agencies. Improve administrative capacity and strategic planning of units entrusted with the management of European Structural and Investment Funds and provide them with adequate and stable staffing levels.

6. Present, by October 2014, a detailed plan for public property management for 2015. Ensure that companies under state control are governed in a transparent and accountable manner, in particular, strengthen the competency requirements for members of management and supervisory boards nominated by the state and introduce a public register for appointments. Reinforce prevention of corruption in public administration and state-owned and state-controlled enterprises, including by increasing the verification powers of the Conflict of Interest Commission. Strengthen transparency and efficiency of public procurement at both central and local levels, and the capacity to monitor implementation and to detect irregularities.

7. By the end of 2014 reinforce the role of commercial courts in the monitoring of transparency and legality in the application of the corporate pre-bankruptcy procedure. Review the compulsory test of insolvency/illiquidity to access pre-bankruptcy settlement proceedings and streamline the insolvency/liquidation process to reduce its length. Improve the quality and efficiency of the judicial system, in particular by providing incentives to resolve proceedings in litigious civil and commercial cases and in administrative cases in a timely manner and to resort to out-of-court settlement especially for smaller claims.

8. Complement the 2014 European Central Bank's asset quality reviews and stress test exercises, undertake a comprehensive portfolio screening exercise designed specifically for the Croatian financial sector, with a focus on important portfolios that are not covered by the European Central Bank exercise and including key mid-size and smaller banks.

Done at Brussels,

For the Council
The President