



Brussels, 5.6.2019
COM(2019) 511 final

Recommendation for a

COUNCIL RECOMMENDATION

**on the 2019 National Reform Programme of Croatia and delivering a Council opinion
on the 2019 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 policies¹, 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 imbalances², and in particular Article 6(1) thereof,

Having regard to the recommendation of the European Commission,

Having regard to the resolutions of the European Parliament,

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 21 November 2018, the Commission adopted the Annual Growth Survey, marking the start of the 2019 European Semester for economic policy coordination. It took due account of the European Pillar of Social Rights, proclaimed by the European Parliament, the Council and the Commission on 17 November 2017. The priorities of the Annual Growth Survey were endorsed by the European Council on 21 March 2019. On 21 November 2018, on the basis of Regulation (EU) No 1176/2011, the Commission also adopted the Alert Mechanism Report, in which it identified Croatia as one of the Member States for which an in-depth review would be carried out.
- (2) The 2019 country report for Croatia³ was published on 27 February 2019. It assessed Croatia's progress in addressing the country-specific recommendations adopted by the

¹ OJ L 209, 2.8.1997, p. 1.

² OJ L 306, 23.11.2011, p. 25.

³ SWD(2019) 1010 final

Council on 13 July 2018, the follow-up given to the recommendations adopted in previous years and Croatia's progress towards its national Europe 2020 targets. It also included an in-depth review under Article 5 of Regulation (EU) No 1176/2011, the results of which were also published on 27 February 2019⁴. The Commission's analysis led it to conclude that Croatia is experiencing macroeconomic imbalances linked to high levels of public, private and external debt in a context of low potential growth. However, imbalances have been narrowing over recent years supported by robust nominal growth and a prudent fiscal policy. The negative net external position has been improving due to continued current account surpluses. Public debt has declined significantly since its 2015 peak. Private sector debt reduction is ongoing, though its pace is set to abate as credit growth and investment recover. The financial sector is well capitalised and profitable, but the share of non-performing loans, although declining, remains high. Policy action has been stepped up, but thorough implementation of structural measures remains crucial for strengthening the resilience of the economy. Despite some progress, issues with the completeness, accuracy and timelines of economic and government finance statistics remain.

- (3) On 18 April 2019, Croatia submitted its 2019 National Reform Programme and its 2019 Convergence Programme. In order to take account of their interlinkages, the two programmes have been assessed at the same time.
- (4) Relevant country-specific recommendations have to some extent been addressed in the programming of the European Structural and Investment Funds ('ESI Funds') for 2014-2020. As provided for in Article 23 of Regulation (EU) No 1303/2013 of the European Parliament and of the Council⁵, where it is necessary to support the implementation of relevant Council recommendations, the Commission may request a Member State to review and propose amendments to its Partnership Agreement and relevant programmes. The Commission has provided further details on how it would make use of that provision in guidelines on the application of the measures linking the effectiveness of the ESI Funds to sound economic governance⁶.
- (5) Croatia is currently in the preventive arm of the Stability and Growth Pact and subject to the debt rule. Starting from a general government surplus of 0.2% of GDP in 2018, the 2019 Convergence Programme plans the headline balance to deteriorate to -0.3% of GDP in 2019 and then to gradually improve to a surplus of 0.8% of GDP in 2022. Based on the recalculated structural balance⁷, the medium-term budgetary objective – which has been changed from a structural deficit of 1.75% of GDP in 2019 to 1% of GDP as of 2020 — is planned to continue to be overachieved throughout the programme period. According to the 2019 Convergence Programme, the general government debt-to-GDP ratio is expected to fall from 71.6% of GDP in 2019 to 68.5% in 2020 and to continue declining to 62% in 2022. The macroeconomic scenario underpinning those budgetary projections is plausible. However, the planned budgetary targets appear cautious. The Commission 2019 spring forecast projects the

⁴ COM (2019) 150 final.

⁵ Regulation (EU) No 1303/2013 of the European Parliament and of the Council of 17 December 2013 laying down common provisions on the European Regional Development Fund, the European Social Fund, the Cohesion Fund, the European Agricultural Fund for Rural Development and the European Maritime and Fisheries Fund and laying down general provisions on the European Regional Development Fund, the European Social Fund, the Cohesion Fund and the European Maritime and Fisheries Fund and repealing Council Regulation (EC) No 1083/2006 (OJ L 347, 20.12.2013, p. 320).

⁶ COM(2014) 494 final.

⁷ Cyclically-adjusted balance net of one-off and temporary measures, recalculated by the Commission using the commonly agreed methodology.

general government balance at 0.1% and 0.5% of GDP in 2019 and 2020, respectively. Based on the Commission 2019 spring forecast the structural balance is forecast to stand at -0.8% of GDP in 2019 and at -0.5% of GDP in 2020, remaining above the medium-term budgetary objective. Croatia is forecast to comply with the debt rule in 2019 and 2020. Overall, the Council is of the opinion that Croatia is projected to comply with the provisions of the Stability and Growth Pact in 2019 and 2020.

- (6) In December 2018, the Croatian Parliament adopted the Fiscal Responsibility Act. It aims to reinforce the set-up and mandate of the Fiscal Policy Commission and lay down numerical fiscal rules, including a structural budget balance rule. In March 2019, the mandate of the State Audit Office was strengthened through the introduction of sanctioning mechanisms for cases of non-compliance with its recommendations and a broadening of the scope of its audits. The fiscal framework will be further strengthened with the adoption of the amended Budget Act. This is expected to improve budgetary planning, collection of fiscal data and the criteria for the issuance of government guarantees.
- (7) The territorial fragmentation of Croatia's public administration affects its efficiency and exacerbates regional disparities. Many small local governments often lack adequate financial and administrative resources to provide the services under their remit. This creates wide disparities in public service provision between financially and administratively strong and weak local units across Croatia. At the central government level, the authorities have taken steps towards the simplification of the cumbersome state agencies system, but the legal framework introducing a higher degree of homogeneity across the system is pending. It is planned to devolve the responsibilities of branch-offices of the central administration operating at local level to the counties' administration.
- (8) The health care system has accumulated further debt in 2018, which poses a risk for public finances. Financing of the system relies on contributions by the working population and state budget transfers, though the latter have been consistently below full cost coverage. The financial situation of the health care system is expected to improve due to the increase in the health insurance premium introduced in 2019 and the excise duties on tobacco in December 2018. The ongoing functional integration of hospitals and actions aimed at improving primary care could lead to increased efficiency in spending, but implementation is proceeding slowly.
- (9) The wage-setting framework lacks consistency across the public administration and public services, which affects equality of treatment and hinders central control over the public wage bill. New legislation on wage setting for civil servants has been postponed several times. The aim of the law is to achieve greater harmonisation across the public administration through the introduction of common wage grids and job complexity coefficients, based on more consistent job descriptions and competence frameworks. Croatia has a social dialogue framework, but the social partners express concerns that the working methods and procedures hinder real dialogue. The fragmentation of the trade unions also weakens the effectiveness of social dialogue.
- (10) In 2018, the unemployment rate continued its rapid decline. Youth unemployment also decreased considerably, but remains high. However, activity and employment rates in Croatia remain low, with early retirement and care responsibilities playing an important role in inactivity. Access to employment needs to improve, for example by anticipating and providing appropriate skills. Many drivers of inactivity are still present and the current measures to help people enter the labour market appear to be

insufficient. The capacity of labour market institutions remains limited and cooperation between employment services, social services and other relevant stakeholders is weak. An important package of pension system reforms entered into force in 2019. The main objectives of the reform are threefold: i) to address design inconsistencies, which have resulted in unfair treatment of certain cohorts of pensioners; ii) to improve the adequacy of the pension system by extending working lives; and iii) to strengthen the institutional setup and performance of the second pension pillar.

- (11) Socio-economic differences are an important determinant of educational attainment in Croatia. The country performs below the EU average when it comes to education, in particular early childhood education and care, basic skills, tertiary educational attainment, adult participation in learning, and the labour market relevance of vocational education and training. Croatia is implementing the curricular reform as a pilot project, but the reform will achieve its full potential only if it is implemented in full and accompanied by training of teachers.
- (12) Despite still relatively high unemployment, labour shortages are affecting some sectors of the economy, mainly because of skills gaps. Improving digital skills could raise productivity and close some skills gaps. The limited labour market-relevance of vocational education and training contributes to low employment rate among graduates. Student participation in programmes that include work-based learning is low. The establishment of the Regional Centres of Competences and the experimental programme in dual education should improve the quality of vocational education and training and facilitate the identification of skills needs. Participation in adult education programmes, offered as part of measures to help people find work or training, is low. This is especially true of those most in need of education, such as low-qualified and unemployed persons.
- (13) The proportion of the population at risk of poverty or social exclusion is declining, but remains above the EU average. This risk mainly concerns the elderly and people with disabilities. The capacity of social benefits to reduce poverty remains weak compared to the EU average. The authorities have taken steps to improve the recording of social benefits provided at the local level by harmonising their classification. This should result in a better overview of the benefits provided across the territory, which could then be used to improve the effectiveness of the social protection system in reaching those most in need.
- (14) The transport network is unbalanced, with railway infrastructure lagging significantly behind, resulting in low quality of service and barriers to workers' mobility. Public transport in smaller cities lacks adequate infrastructure. Greenhouse gas emissions from road transport have increased significantly over the last five years. The share of renewable energy sources in the transport sector is far below the 2020 target of 10%. Additional efforts and investments are needed to effectively reduce the high proportion of fossil fuel-powered cars, promote inter-modality and more generally curb rising greenhouse gas emissions from the transport sector.
- (15) Croatia's high energy intensity could be decreased by investments in energy efficiency and smart energy systems. Particular attention could go to reducing the energy consumption in buildings and improving the energy efficiency of district heating networks. Investments in wind and solar have considerable potential too, as have renewables in heating and cooling. Their promotion would also enable Croatia's islands to increase self-reliance in energy, in line with the 'Clean Energy for EU

islands' initiative. In addition, Croatia is particularly vulnerable to climate risks, especially floods and forest fires.

- (16) Investments could also promote the transition to a circular economy. They are needed to support separate waste collection and recycling as alternatives to landfilling, develop alternatives to raw materials and increase demand for recycled content and raise public awareness of sustainable consumption practices and behaviour. In addition, significant investment is also necessary to ensure the collection and treatment of wastewater in agglomerations above 2 000 population equivalent. Investment in water networks could reduce leakage of drinking water and fulfil unmet quality requirements.
- (17) Research and innovation capacities and the uptake of advanced technologies need investment to strengthen innovation performance and foster productivity growth, which is being hampered by fragmented and inefficient research and innovation policies. Croatia's 2016-2020 'smart specialisation' strategy (RIS3) aims to foster innovation, overcome fragmentation in the system and ensure that research and development activities are organised around key economic priorities, but its implementation is expected to accelerate further. Investment could support collaboration between universities and businesses, to enable the transfer of technology and commercialisation of research outcomes and could strengthen governance.
- (18) Measures to improve corporate governance in state-owned enterprises have slowly progressed. A new Code of Corporate Governance was adopted and mid-term planning and performance reporting were mandated. Still, the combination of state-owned enterprises' heavy presence in many sectors and their low profitability and weak productivity continue to weigh on the economy. In 2018, the list of companies of special interest was further reduced and more companies are now formally eligible for sale, but there is no clear privatisation strategy in place. The authorities' efforts appear to focus on disposing of the large remaining stock of minority shares and activating non-productive assets. Corruption is perceived to be widespread and growing. Effective tools to prevent and sanction corruption are lacking, in particular at local level. There remains a need to enhance oversight and sanctioning mechanisms for appointees to local public companies.
- (19) Excessive administrative and legislative requirements and parafiscal (non-tax) charges burden businesses, particularly smaller ones. The identification of administrative burden has been completed, allowing the authorities to proceed with the implementation of warranted relief measures. Cuts in parafiscal charges have been lagging. The high number of overly regulated professional services hampers competition. There has been progress in certain sectors, most notably taxi services, but excessive restrictions remain in place for many economically important professions.
- (20) Substantial backlogs and lengthy proceedings in civil and commercial courts reduce legal certainty, while inefficiencies in criminal justice hamper the fight against economic and financial offences. The perception of independence of the judiciary has further deteriorated. Amendments to the law on the State Judicial Council were adopted in 2018. With the exception of the High Commercial Court, the continued reduction in backlogs was mainly due to a decline in the incoming caseload. Electronic communication is being tested in some courts but has yet to be extended nationally.
- (21) The programming of EU funds for the period 2021-2027 could help address some of the gaps identified in the recommendations and in particular in the areas covered by

Annex D to the country report⁸. This would allow Croatia to make the best use of those funds in respect of the identified sectors, taking into account regional disparities. Strengthening the country's administrative capacity to manage these funds is an important factor for the success of these investment. The institutional setup for public procurement requires strengthening to improve compliance and enable strategic procurement to achieve policy objectives and ensure efficient public spending.

- (22) In the context of the 2019 European Semester, the Commission has carried out a comprehensive analysis of Croatia's economic policy and published it in the 2019 country report. It has also assessed the 2019 Convergence Programme and the 2019 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 socioeconomic policy in Croatia, but also their compliance with Union rules and guidance. This reflects the need to strengthen the Union's overall economic governance by providing Union-level input into future national decisions.
- (23) In the light of this assessment, the Council has examined the 2019 Convergence Programme and is of the opinion⁹ that Croatia is expected to comply with the Stability and Growth Pact.
- (24) In the light of the Commission's in-depth review and this assessment, the Council has examined the 2019 National Reform Programme and the 2019 Convergence Programme. Its recommendations under Article 6 of Regulation (EU) No 1176/2011 are reflected in recommendations (1) to (4) below. Fiscal policies referred to in recommendation (1) contribute inter-alia to address imbalances linked to high government debt.

HEREBY RECOMMENDS that Croatia take action in 2019 and 2020 to:

- 1. Reinforce the budgetary framework and monitoring of contingent liabilities at central and local level. Reduce the territorial fragmentation of the public administration and streamline the functional distribution of competencies.
- 2. Deliver on the education reform and improve both access to education and training at all levels and their quality and labour market relevance. Consolidate social benefits and improve their capacity to reduce poverty. Strengthen labour market measures and institutions and their coordination with social services. In consultation with the social partners, introduce harmonised wage-setting frameworks across the public administration and public services.
- 3. Focus investment-related economic policy on research and innovation, sustainable urban and railway transport, energy efficiency, renewables and environmental infrastructure, taking into account regional disparities. Increase the administration's capacity to design and implement public projects and policies.

⁸ SWD(2019) 1010 final

⁹ Under Article 9(2) of Regulation (EC) No 1466/97

4. Improve corporate governance in state-owned enterprises and intensify the sale of such enterprises and non-productive assets. Enhance the prevention and sanctioning of corruption, in particular at the local level. Reduce the duration of court proceedings and improve electronic communication in courts. Reduce the most burdensome parafiscal charges and excessive product and services market regulation.

Done at Brussels,

For the Council
The President