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Recommendation for a

COUNCIL RECOMMENDATION

with a view to bringing an end to the situation of an excessive government deficit in 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 Article 126(7) thereof,

Having regard to the recommendation from the Commission;

Whereas:

(1) According to Article 126 of the Treaty on the Functioning of the European Union (TFEU) Member States shall avoid excessive government deficits.

(2) The Stability and Growth Pact is based on the objective of sound government finances as a means of strengthening the conditions for price stability and for strong sustainable growth conducive to employment creation.

(3) On X January 2014, the Council decided, in accordance with Article 126(6) TFEU, that an excessive deficit existed in Croatia.

(4) In accordance with Article 126(7) TFEU and Article 3 of Council Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure (EDP)[1], the Council is required to address recommendations to the Member State concerned with a view to bringing the situation of an excessive deficit to an end within a given period. The recommendation has to establish a maximum deadline of six months for effective action to be taken by the Member State concerned to correct the excessive deficit. Furthermore, in a recommendation to correct an excessive deficit the Council should request the achievement of annual budgetary targets which, on the basis of the forecast underpinning the recommendation, are consistent with a minimum annual improvement in the structural balance, i.e. the cyclically-adjusted balance excluding one-off and other temporary measures, of at least 0.5% of GDP as a benchmark. In addition, in accordance with Article 2 of Council Regulation (EC) No 1467/97 specifying the requirement under the debt criterion, the budgetary target recommended for the final year of the correction period must ensure that the required reduction in the differential between the debt to GDP level and the 60% of GDP Treaty reference value will occur over the two years following the correction of the excessive deficit, based on the Commission forecast.

(5) According to the Commission 2013 Autumn forecast, the general government deficit is projected to remain above the 3% of GDP reference value in the period 2013-2015, and the structural balance is projected to continue deteriorating throughout the forecast period, from around 4% of GDP in 2013 to nearly 6% of GDP in 2015. These

[1] OJ L 209, 2.8.1997, p. 6.

developments result mainly from increases on the expenditure side such as interest outlays combined with revenue shortfalls. The Commission 2013 Autumn forecast did not include the budgetary consolidation programme announced in September 2013 with the release of the Economic and Fiscal Policy Guidelines, as the information on measures underpinning this announced consolidation package was very limited. Measures presented in the second revision of the 2013 budget and the draft 2014 budget adopted by the government on 14 November 2013 and sent to the Parliament do not have a substantial impact on budgetary trends. Indeed, the projections for government revenues and expenditures and general government debt in the Commission 2013 Autumn forecast updated to reflect the new information that has become available since the publication, show only very modest changes. The revised projections constitute the Commission's new baseline.

(6) Regarding general government debt developments, according to the revision of the 2013 budget and the draft 2014 budget the planned general government debt-to-GDP ratio at the end of 2014 is expected to reach 62% and to increase further to about 64% and 64¾% in 2015 and 2016. The Commission 2013 Autumn forecast projects the government debt ratio to breach the Treaty reference value in 2014, reaching close to 65%, and increasing further over the forecast. An update of the 2013 Autumn forecast to incorporate additional information that became available after the forecast release, most notably a new USD-denominated bond issuance in November 2013, brings the general government debt ratio above the 60% of GDP threshold already in 2013.

(7) Against the background of high uncertainites regarding economic and budgetary developments, the budgetary target recommended for the final year of the correction period should be set at a level clearly below the reference value, in order to ensure compliance with the debt reduction benchmark in the final year of the EDP period.

(8) According to Regulation 1467/97, the correction of the excessive deficit should be completed in the year following its identification, unless there are special circumstances. In order to correct the excessive deficit by the 2015 deadline consistent with this approach and ensure the joint compliance with the debt reduction benchmark, the required structural effort would amount to at least 1.3% of GDP both in 2014 and 2015. This would result in a significant output loss and aggravate an already protracted and deep recession. Longer deadlines could be set, in particular in the case of excessive deficit procedures based on the debt criterion, when the government deficit requested to comply with the debt criterion is significantly lower than 3% of GDP.

(9) In light of this, setting the deadline for the correction of the excessive deficit by 2016 is warranted. In particular, a credible and sustainable adjustment path under this extended deadline would require Croatia to reach a headline general government target of 4.6% of GDP for 2014, 3.5% of GDP in 2015 and 2.7% of GDP in 2016, which is consistent with an annual improvement in the structural balance of 0.5% of GDP in 2014, 0.9% of GDP in 2015 and 0.7% of GDP in 2016, based on the EDP scenario. The scenario for the adjustment path has been built on the Commission 2013 Autumn forecast updated to reflect new information, including from the revision of the 2013 budget and draft 2014 budget, and extended up to 2018 relying on standard assumptions about the closure of the output gap and the sensitivity of the budget to the cycle. This adjustment path would allow bringing the headline government deficit below the 3% of GDP reference value by 2016 while at the same time ensuring that the debt to GDP ratio will approach the 60% reference value at a satisfactory pace, thus complying with the government debt criterion. Based on the EDP scenario, to reach the above-mentioned structural targets Croatia would need to adopt

consolidation measures of 2.3% of GDP in 2014, 1% of GDP in 2015 and 2016. These targets take into account the need to compensate for the negative second-round effects of fiscal consolidation on public finances, through its impact on economic activity.

(10) Budgetary consolidation measures should secure a lasting improvement in the general government balance, while being geared towards enhancing the quality of public finances. In particular, measures to prioritise growth-enhancing expenditure and investments including through the use of EU cohesion and structural funds, enhance tax compliance, and strenghten the fiscal framework would be supportive in this respect.

(11) In order to ensure an outcome most conducive to economic prosperity in the medium to long run, the correction of the excessive deficit would benefit from accompanying macro-structural reforms. These measures should aim to reinforce the growth potential of the economy by creating a more flexible labour market, improving the quality of the business environment and increasing the efficiency of public administration,

HAS ADOPTED THIS RECOMMENDATION:

(1) Croatia should put an end to the present excessive deficit situation by 2016.

(2) Croatia should reach headline general government deficit targets of 4.6% of GDP for 2014, 3.5% of GDP in 2015 and 2.7% of GDP in 2016, which is consistent with an annual improvement in the structural balance of 0.5% of GDP in 2014, 0.9% of GDP in 2015 and 0.7% of GDP in 2016.

(3) Croatia should specify and rigorously implement the measures that are necessary to achieve the correction of the excessive deficit by 2016, and use any windfall gains for deficit reduction.

(4) The Council establishes the deadline of 30 April 2014 for Croatia to take effective action and, in accordance with Article 3(4a) of Council Regulation (EC) No 1467/97, to report in detail the consolidation strategy that is envisaged to achieve the targets; thereafter the authorities should report on progress made in the implementation of these recommendations at least every six months, until full correction of the excessive deficit has taken place.

Furthermore, the Council invites the Croatian authorities to (i) carry out a thorough expenditure review with the objective to rationalise wage, social security and subsidy outlays and to provide sufficient fiscal space for implementation of growth-enhancing expenditure, including co-financing of EU-funded projects; (ii) further improve tax compliance and increase the efficiency of tax administration and (iii) improve the institutional framework of public finances, including through enhancing multi-annual budgetary programming, strengthening the role and independence of the Fiscal Policy Committee, and ensuring compliance with fiscal rules. In addition, the Council invites the Croatian authorities to implement structural reforms, notably as regards addressing labour market rigidities and an unfavourable business environment and improving the quality of public administration, with a view to raising potential GDP growth.

This Recommendation is addressed to the Republic of Croatia.

Done at Brussels,

For the Council
The President