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Subject:	Recommendation for a COUNCIL RECOMMENDATION on the 2016 national reform programme of Croatia and delivering a Council opinion on the 2016 convergence programme of Croatia

Delegations will find attached the above mentioned draft Council Recommendation, as revised and agreed by various Council committees, based on the Commission proposal COM(2016) 331 final.

COUNCIL RECOMMENDATION

of …

on the 2016 National Reform Programme of Croatia

and delivering a Council opinion on the 2016 Convergence Programme of Croatia

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,

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,

[1] OJ L 209, 2.8.1997, p. 1.
[2] OJ L 306, 23.11.2011, p. 25.

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 November 2015, the Commission adopted the Annual Growth Survey, marking the start of the 2016 European Semester for economic policy coordination. The priorities of the Annual Growth Survey were endorsed by the European Council on 17-18 March 2016. On 26 November 2015, on the basis of Regulation (EU) No 1176/2011, the Commission 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 2016 country report for Croatia was published on 26 February 2016. It assessed Croatia's progress in addressing the country-specific recommendations adopted by the Council on 14 July 2015 and Croatia's progress towards its national Europe 2020 targets. It also included the in-depth review under Article 5 of Regulation (EU) No 1176/2011. On 8 March 2016, the Commission presented the results of the in-depth review. The Commission's analysis leads it to conclude that Croatia is experiencing excessive macroeconomic imbalances. In particular, it is essential to address vulnerabilities linked to high public, corporate and external debt in the context of high unemployment. Further weaknesses requiring specific policy action include fiscal governance, the governance of state-owned enterprises, the efficiency of public administration, and the resolution of non-performing loans.

(3) On 28 April 2016, Croatia submitted its 2016 National Reform Programme and its 2016 Convergence Programme. In order to take account of their interlinkages, the two programmes have been assessed at the same time. The National Reform Programme presents a fairly ambitious reform agenda, which, if fully implemented within the indicated timelines, would help address its macroeconomic imbalances. It outlines relevant measures to improve the management of public finances, the health sector and the business environment and commits to ambitious reforms in the public administration, the pension system, social protection and the improvement of governance in state-owned enterprises. Based on the assessment of Croatia's policy commitments, there is no need at this stage for a stepping-up of the macroeconomic imbalances procedure.

(4) Relevant country-specific recommendations have been addressed in the programming of the European Structural and Investment Funds for the 2014-2020 period. As foreseen in Article 23 of Regulation (EU) No 1303/2013 of the European Parliament and of the Council[3], 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 this provision in guidelines on the application of the measures linking the effectiveness of the European Structural and Investment Funds to sound economic governance.

[3] 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).

(5) Croatia is currently in the corrective arm of the Stability and Growth Pact. In its 2016 Convergence Programme, the Government expects that the headline deficit will be below 3 % of GDP, at 2,6 % of GDP, in 2016 and will fall further thereafter, reaching 1,0 % of GDP by 2019. Moreover, the Government expects to reach its medium-term budgetary objective — a deficit of 1,75 % of GDP in structural terms – throughout the programme period. The government debt-to-GDP ratio peaked at 86,7 % in 2015 but, according to the Convergence Programme, is projected to gradually decline to 80,0 % in 2019. Taken at face value, the debt-to-GDP projections in the Programme comply with the debt reduction benchmark. However, while the macroeconomic scenario underpinning these budgetary projections is plausible in real terms, nominal GDP growth is higher than projected in the Commission forecast, especially for 2016. The projected reduction in the debt ratio therefore relies on favourable nominal growth projections; in addition, it factors in significant debt-reducing stock-flow adjustments from the sale of financial assets, which are not sufficiently specified. Furthermore, the measures needed to support the planned deficit targets from 2017 onwards are mostly unspecified. Based on the Commission 2016 spring forecast, the general government deficit is projected to reach 2,7 % of GDP in 2016, in line with the headline deficit target included in the Council Recommendation of 21 January 2014 under Article 126(7) TFEU. The recommended fiscal effort under the excessive deficit procedure is projected to be achieved. By contrast, the Commission forecast does not point to compliance with the forward-looking debt reduction benchmark. Whereas a structural adjustment of 0,2 % of GDP in 2017 would be sufficient to reach the medium-term budgetary objective, a higher structural adjustment would be needed to ensure compliance with the debt reduction benchmark. In particular, an adjustment above the 0,5 % of GDP benchmark would seem appropriate given the high debt and current cyclical conditions in Croatia. Currently, the structural balance is projected to deteriorate by 0,2 % of GDP in 2017. Based on its assessment of the Convergence Programme and taking into account the Commission 2016 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. Therefore, further measures will be needed to ensure compliance in 2017.

(6) Croatia's budgetary planning continues to suffer from major weaknesses despite some improvements made by the 2015 amendment of the Budget Act. Linkages between the multiannual budgetary framework and annual budgets remain weak, and there are no clear rules on changing budgetary plans within the year. The strategic planning of individual budgetary units is not subject to systematic scrutiny and does not sufficiently support the alignment of policy priorities with medium-term fiscal targets. The budgetary process gives little consideration to the sizeable off-budget transactions and accounting adjustments impacting general government deficit and debt. Numerical fiscal rules are currently being revised. One of the main challenges is to make them more operational and better aligned with the Stability and Growth Pact. Efforts are also needed to improve the statistical basis of budgetary planning.

(7) The Fiscal Policy Commission, which is in charge of monitoring compliance with fiscal rules at the national level, is closely linked with national fiscal authorities and is understaffed. Under these conditions, its political and functional independence is not ensured. A revision of the institutional setup and the mandate of the Fiscal Policy Commission has been announced for the third quarter of 2016.

(8) Croatia has started to reform the system of communal charges, presented as a step in a broader reform of immovable property taxation. Combined revenue from recurrent taxes on immovable property and communal charges is relatively low as a proportion of GDP.

(9) A high level of tax arrears, VAT fraud and the shadow economy are key challenges. Measures are being taken to improve tax compliance, including the development of a compliance risk management system. Yet, evidence on the effectiveness of the measures taken is still limited.

(10) The stock of public debt is high and still increasing, making it indispensable to adopt a forward-looking proactive approach to public debt management. A debt management strategy for 2016-2018 is planned to be adopted soon. However, Croatia is still lacking a more comprehensive approach to debt management comprising inter alia annual revisions that take account of market developments, an appropriate risk management strategy, and the strengthening of the function to carry out the associated tasks.

(11) A large proportion of the working-age population does not participate in the labour market. One of the main reasons for this is early retirement, also among prime-aged men. Early retirement is possible a full five years before the statutory retirement age and financial incentives to work until (and beyond) that age are weak. In addition, the pension system is characterised by a number of special provisions for specific categories of workers and generous early retirement options for certain occupations. Statutory retirement ages for men and women are being brought into line and increased to 67, but only slowly. Both the current and future adequacy of pensions is low and creates high risks of poverty in old age, especially for those with short working lives.

(12) The problem of high inactivity is compounded by high unemployment; the low utilisation of the labour potential holds back growth. Youth unemployment remains a key concern, pointing to weaknesses in the education system, and there is still room to improve the effectiveness, monitoring and evaluation of the Youth Guarantee. Long-term unemployment rates have fallen recently but are still about twice the EU average. Participation in lifelong learning remains very low, due to an underdeveloped adult education system.

(13) There are regional differences in per capita spending on social protection, and inconsistencies as regards the eligibility criteria for general social protection schemes and those targeting special categories. Moreover, only a small share of the overall social protection budget is spent on the nation-wide minimum income scheme. This results in inefficiencies and provides insufficient protection to the poorest. The reform of the social protection system suffered delays in terms of consolidating various benefits and establishing one-stop shops as single administrative points for the delivery of social protection services.

(14) The functional distribution of competences of public administration between central and local levels is complex, and the system is fragmented. The allocation of decentralised administrative functions is not in line with the fiscal capacity of the local units in charge. This makes the local units strongly reliant on central government transfers while leaving considerable regional disparities in the provision of public services. The fragmentation of public administration weighs on service delivery, the business environment and the efficiency of public expenditure. The reform of public administration has not been taken forward in substance. A legal framework was introduced for the voluntary merger of local government units, but incentives to take up this option were not provided. The rationalisation of the system of state agencies is proceeding slowly.

(15) Public sector wages are regulated by inconsistent provisions across public institutions in the definition of job complexity, fringe benefits and wage supplements. This limits the Government's control over the wage bill and weighs on the efficiency of the public sector. Due to the relatively high proportion of total employment accounted for by the public sector, public wage developments are also relevant to the wider economy.

(16) State ownership of companies is highly present in the economy. Weaknesses in governance, including the lack of appropriate performance monitoring, continue to result in significantly lower profitability of state-owned enterprises relative to comparable private corporations, with negative impacts on public finance. Listing shares of state-owned enterprises on the stock exchange can help improve their corporate governance, in particular by fostering reporting and internal control mechanisms. In the past year, steps to open up state-owned enterprises to private ownership advanced slowly.

(17) The national promotional bank "Croatian Bank for Reconstruction and Development" (HBOR), a state-owned entity, could play a crucial role in Croatia's recovery. Its lending activity could have a substantial impact on promoting investment while addressing market failures. An appropriate regulatory framework and sound corporate governance are needed to contain the risk associated with its activity, especially since HBOR is increasingly engaging in direct lending.

(18) The independent asset quality review of HBOR's credit portfolio that the authorities are planning to carry out in 2017 is one step in addressing the above-mentioned challenges. In the meantime, it is necessary to strengthen the monitoring and accountability mechanisms applying to HBOR.

(19) The absorption rate of European Structural and Investment Funds has so far been low due to factors such as insufficient administrative capacity, burdensome procedures and the limited number of ready-to-implement projects.

(20) Croatia’s business environment continues to suffer from major shortcomings that weigh on the investment climate. Many parafiscal charges levied on firms still hamper the business environment. The regulatory environment for service providers and regulated professions remains restrictive. There are restrictions on access to and the conduct of certain regulated professions, including legal professions and tax advisors. Croatia has been reviewing the need for and the proportionality of these restrictions, but the delivery of action has been delayed. Furthermore, regulated professions and businesses suffer from high administrative burdens.

(21) Regulatory instability and a perceived low quality of legislation also weigh on the business environment. With lengthy proceedings, significant backlogs and inconsistent case-law, the quality and efficiency of the judicial system and of commercial courts in particular are facing challenges. ICT systems are under-developed in particular in the communication with parties in court proceedings and electronic delivery of court documents.

(22) The resolution of non-performing loans is critical in addressing the debt overhang in the economy. In this regard, important steps have been made by reinforcing the pre-insolvency and insolvency frameworks for businesses and adopting a personal insolvency procedure. The impact of the new frameworks requires detailed monitoring. However, legal uncertainty in the tax treatment of write-offs still constitutes a barrier to the swift unwinding of banks’ stocks of non-performing loans.

(23) 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 2016 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 EU's overall economic governance by providing EU-level input into future national decisions. The recommendations under the European Semester are reflected in recommendations (1) to (5) below.

(24) In the light of this assessment, the Council has examined the Convergence Programme, and its opinion[4] is reflected in particular in recommendation (1) below.

(25) 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 (5) below,

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

HEREBY RECOMMENDS that Croatia take action in 2016 and 2017 to:

1. Ensure a durable correction of the excessive deficit by 2016. Thereafter, achieve an annual fiscal adjustment of at least 0,6 % of GDP in 2017. Use any windfall gains to accelerate the reduction of the general government debt ratio. By September 2016, reinforce numerical fiscal rules and strengthen the independence and the mandate of the Fiscal Policy Commission. By the end of 2016, improve budgetary planning and strengthen the multi-annual budgetary framework. By the end of 2016, start a reform of recurrent taxation of immovable property. Reinforce the framework for public debt management. Adopt and start implementing a debt management strategy for 2016-2018.

2. By the end of 2016, take measures to discourage early retirement, accelerate the transition to the higher statutory retirement age, and align pension provisions for specific categories with the rules of the general scheme. Provide appropriate up- and re-skilling measures to enhance the employability of the working-age population, with a focus on the low-skilled and the long-term unemployed. Consolidate social protection benefits, including special schemes, by aligning eligibility criteria and integrating their administration, and focus support on those most in need.

3. By the end of 2016, start reducing fragmentation and improving the functional distribution of competencies in public administration to improve efficiency and reduce territorial disparities in the delivery of public services. In consultation with social partners, harmonise the wage-setting frameworks across the public administration and public services. Advance the divestment process of state assets and reinforce the monitoring of state-owned enterprises' performance and boards' accountability, including by advancing the listing of shares of state-owned companies.

4. Significantly reduce parafiscal charges. Remove unjustified regulatory restrictions hampering access to and the practice of regulated professions. Reduce the administrative burden on businesses.

5. Take measures to improve the quality and efficiency of the judicial system in commercial and administrative courts. Facilitate the resolution of non-performing loans, in particular by improving the tax treatment of the resolution of non-performing loans.

Done at Brussels,

For the Council
The President