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Recommendation for a

COUNCIL RECOMMENDATION

on the 2017 National Reform Programme of Croatia

and delivering a Council opinion on the 2017 Convergence Programme of Croatia

Recommendation for a

COUNCIL RECOMMENDATION

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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 16 November 2016, the Commission adopted the Annual Growth Survey,[5] marking the start of the 2017 European Semester of economic policy coordination.

[1] OJ L 209, 2.8.1997, p. 1.
[2] OJ L 306, 23.11.2011, p. 25.
[3] COM(2017) 510 final.
[4] P8_ TA(2017)0038, P8_ TA(2017)0039, and P8_ TA(2017)0040.
[5] COM(2016) 725 final.

The priorities of the Annual Growth Survey were endorsed by the European Council on 9-10 March 2017. On 16 November 2016, 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.

(2) The 2017 country report for Croatia[7] was published on 22 February 2017. It assessed Croatia's progress in addressing the country-specific recommendations adopted by the Council on 12 July 2016, 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 22 February 2017.[8] The Commission's analysis leads it to conclude that Croatia is experiencing excessive macroeconomic imbalances. In particular, in 2016, the general government debt ratio moved onto a declining path, but public debt is exposed to currency risk, and fiscal sustainability risks remain high in the medium term. Private sector debt has been decreasing, but remains high, especially in the corporate sector, and is heavily exposed to currency risk. The financial sector is set to support the recovery, but remains exposed to currency-induced credit risk, and the non-performing loans ratio is still high. The unemployment rate is falling rapidly, thanks to moderate job creation, but also a shrinking labour force. Finally, a cumbersome business environment depresses productive investment and productivity growth.

(3) On 27 April 2017, Croatia submitted its 2017 National Reform Programme and its 2017 Convergence Programme. To take account of their interlinkages, the two programmes have been assessed at the same time.

(4) The relevant country-specific recommendations have been taken into account in the Member States' programmes for the European Structural and Investment Funds (ESI Funds) covering the 2014-2020 period. As foreseen in the legislation governing the ESI Funds,[9] where it is necessary to support the implementation of relevant country-specific recommendations, the Commission may request a Member State to review and amend its relevant ESI Funds programmes. The Commission has provided further guidelines on the application of those rules.[10]

(5) Following the abrogation of the excessive deficit procedure, Croatia is in the preventive arm of the Stability and Growth Pact and subject to the debt rule. In its 2017 Convergence Programme, the government plans a gradual improvement of the general government balance from -0.8% of GDP in 2016 to 0.5% of GDP in 2020. The medium-term budgetary objective, set at -1.75% of GDP in structural terms, was

[6] COM(2016) 728 final.

[7] SWD(2017) 76 final.

[8] COM(2017) 90 final.

[9] Article 23 of 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.

[10] COM(2014) 494 final.

met with a wide margin in 2016, and the (recalculated[11]) structural balance is planned to be at the medium-term budgetary objective in 2017 and 2018, but with no margin. Thereafter, it is projected to slightly improve again. The Convergence Programme expects the general government debt-to-GDP ratio to continue declining to 72.1% by 2020, after peaking at 86.7% of GDP in 2015. The macroeconomic scenario underpinning these budgetary projections is favourable, in particular in view of the negative impact of the financial difficulties facing Croatia's largest private company Agrokor, which the programme projections do not consider. The Agrokor crisis also poses direct risks to the budgetary projections. Moreover, the measures needed to support the planned deficit targets from 2017 onwards have not yet been fully specified.

(6) On 12 July 2016, the Council recommended Croatia to achieve an annual fiscal adjustment of at least 0.6% of GDP towards the medium-term budgetary objective in 2017. Outturn data showing a sizeable improvement in the headline balance for 2016 indicate that Croatia already reached its medium term budgetary objective in that year. The Commission 2017 spring forecast projects the structural balance to remain above the medium-term budgetary objective in 2017, in spite of its decline from -0.3% of GDP in 2016 to -1.7% of GDP in 2017. In 2018, Croatia is recommended to remain at the medium-term budgetary objective. The Commission 2017 spring forecast expects the structural balance to further decrease to -2.1% of GDP, pointing to a risk of some deviation from the medium-term budgetary objective. Croatia is forecast to comply with the debt rule in 2017 and 2018. Overall, the Council is of the opinion that Croatia needs to stand ready to take further measures in 2018 to ensure compliance with the provisions of the Stability and Growth Pact.

(7) Croatia’s fiscal governance framework shows shortcomings. The new fiscal responsibility act, supposed to strengthen the budgetary framework as well as the independence and mandate of the Fiscal Policy Commission, has not yet been adopted. The amendment of the budget act, aimed *inter alia* at addressing the frequent revisions of budgetary plans at both central and local levels, has been delayed. The reliability of the projections underlying the budgetary plans remains weak.

(8) Croatia has relatively low revenue from recurrent taxation of immovable property. Revenue is collected by local authority units through charges linked to property, but with considerable variations in their calculation and coverage. It also relies on the less efficient taxation of property transfers. By way of follow-up to repeated country-specific recommendations, as part of the tax reform of late 2016, as of 2018 some local charges and taxes will be replaced by a recurrent property tax calculated on the basis of five parameters which approximate the value of the property. It is considered a first step to a fully fledged value based recurrent property tax envisaged for 2020.

(9) Croatia’s sovereign financing needs and the exposure of sovereign debt to currency risk highlight the importance of reliable financing sources and prudent risk management. Addressing a country-specific recommendation, in early 2017 a debt management strategy for the central government was adopted, covering 2017-2019. It came three years after the expiry of the previous strategy. The institutional set-up

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

for public debt management, including communication with the markets, risk management and the update of the strategy at regular intervals, is deficient. There is also insufficient consideration of off-budget transactions with potential impact on the debt.

(10) The labour market has continued to recover recently, but unemployment is still high, with a high share of long-term jobseekers. Along with low and declining activity, this means there is a large untapped labour potential. The decline in activity in 2016 was particularly pronounced among prime-aged low skilled workers and was driven by a shrinking working-age population due to ageing and emigration, both of which have been increasing.

(11) Inactivity is relatively high among cohorts eligible for early retirement. Short contribution periods result in low current and future pension adequacy and risks of old-age poverty. There are many pathways to early retirement, possible a full five years before the statutory retirement age. Financial incentives to work until that age are weak. Announced measures to encourage longer working lives have not been implemented. Care responsibilities contribute to low labour market participation, of elder prime-aged women in particular. There is a shortage of formal childcare and there are large regional disparities. Paternity leave is unpaid, and work contracts allow little flexibility to balance work and care. To date, the statutory pensionable age is 61 years and 9 months for women and 65 years for men. The convergence and increase of the statutory retirement ages is slow, with both sexes to reach a pensionable age of 67 in 2038. Speeding this up is under consideration but has not yet been adopted. The pension system gives entitlement to more favourable conditions to specific categories of workers in occupations classified as arduous and hazardous, and in specific sectors. The authorities have completed a review of the arduous or hazardous professions, but the rules have not yet been streamlined.

(12) According to the latest data, in 2015, almost 30 % of the population was exposed to the risk of poverty or social exclusion. The social protection system displays shortcomings in effectiveness and fairness, stemming from inconsistencies in eligibility criteria, fragmented geographical coverage, lack of coordination across authorities in charge, and low transparency. In 2016, only 0.6 % of GDP was spent on the minimum income scheme targeting the poorest households. Reform plans including the institutional reassignment of responsibilities and the harmonisation of eligibility criteria have stalled.

(13) The acquisition of skills needed in the labour market is an important condition for employability. Participation in adult education is very low, as are expenditure and coverage of active labour market policies, retraining measures and lifelong learning. Training does not sufficiently focus on older and low skilled workers and the long-term unemployed, who tend to face particular employability challenges. The preparation of legislation to improve the quality of the institutions, programmes, and teaching for adult learning has been delayed.

(14) Sufficient basic skills are essential for people to find and retain good, stable jobs and successfully participate in economic and social life. International survey information points to severe deficiencies in basic skills, applied science, and mathematics among Croatian 15-year-old schoolchildren. Since 2015, as part of the implementation of the education, science and technology strategy, a reform of the school curricula was

launched to improve on content and teaching of transferable skills. After ambivalent stakeholder reactions, the curricular reform was revised, and implementation has been significantly delayed. The process now needs to continue in line with the original objectives. Croatia recently adopted a vocational education and training (VET) strategy. This is expected to lead to an update of the VET curricula, an increased role of work-based learning, and improved VET teaching quality. The introduction of the system for recognising and validating non-formal and informal learning is pending.

(15) The territorial and functional fragmentation of public administration weighs on service delivery and the efficiency of public expenditure. Current competences and fiscal relations between levels of government are not conducive to the efficient and fair delivery of public services, notably in health, education, and social assistance. The comprehensive public administration reform faces delays. Legislation to reallocate tasks between the central and local authorities is pending, as is the streamlining of the system of State agencies. In early 2017 the authorities announced the establishment of a task force to draw up legislation on sub-national government financing.

(16) Fragmentation in wage setting in public administration continues to impede the transparency of wages and equality of treatment, as well as government control over the public wage bill, with risks of spillovers to the broader economy. In February 2017, the government adopted common guidelines for negotiating and monitoring collective agreements in the public sector, but the streamlining of the wage setting frameworks has been postponed to 2019.

(17) State-owned enterprises are on average less productive than private firms, pointing at weaknesses in their governance. They exert a negative impact on allocative efficiency, and contribute to low productivity growth in the economy. In the past year, steps to open State-owned enterprises to private control advanced slowly. Better monitoring of their performance and boards' accountability, including of firms owned by local government units, would help improve their management.

(18) The Croatian Bank for Reconstruction and Development (HBOR) has a key role in implementing the EU financial instruments and the Investment Plan for Europe in particular. To play this role fully, it needs to comply with high standards of transparency and accountability. The authorities plan an independent asset quality review of its credit portfolio by independent auditors, to be concluded by the end of 2017. Based on the findings, its regulatory framework and governance structures will be revisited.

(19) Businesses are burdened with high regulatory costs. A high number of parafiscal charges, many of which are statistically treated as taxes, complicate the business environment. Addressing a country-specific recommendation, in summer 2016 the government decided to abolish 13 and reduce another 11 parafiscal charges, but implementation has been slow. Businesses continue to suffer from a high administrative burden. An action plan for reducing the administrative burden was adopted, covering eight regulatory areas, but implementation is pending.

(20) Investment recovered in 2016, after a sharp decline during the crisis. But despite favourable macroeconomic and financing conditions, key bottlenecks weigh on a

more sustained recovery in investment. The weaknesses of public administration, the cumbersome business environment, slow implementation of the anti-corruption strategy, restrictive regulation in key infrastructure sectors, and the strong presence of the State in the economy weigh on the business climate.

(21) The modernisation of professional regulation can promote labour mobility and contribute to lower prices for professional services, thereby increasing the growth potential. Croatia's regulation for service providers and regulated professions has been restrictive, for lawyers in particular. In summer 2016, the government adopted an action plan to replace and modernise unfit regulation, which however was limited in scope and detail.

(22) The quality and efficiency of the justice system is a key determinant of the business environment. Despite reduced backlogs, first instance court proceedings are long in commercial, civil and criminal cases. The electronic filing and delivery of court documents has the potential to significantly improve the justice system, but has not yet been rolled out. Commercial judges cannot access registers online: this weighs on the efficiency of insolvency proceedings. Court judgments are only rarely available online, and case management reforms such as updating business processes have not yet been introduced at first instance commercial courts.

(23) The banking sector remains well capitalised, and its profitability recovered in 2016 following the conversion of Swiss franc into euro loans in 2015. The ratio of non-performing loans to gross loans has been declining lately but is still high, among non-financial corporations in particular. The decline appears to be driven by sales, as well as the progressive and automatic provisioning requirements introduced in 2013. As part of the recent tax reform, the government also introduced a new tax treatment for write-offs of non-performing loans, in response to a country-specific recommendation. Its effects require close monitoring. The efficiency of the recently reformed insolvency framework in facilitating the resolution of non-performing loans also deserves close monitoring.

(24) 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 2017 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 socioeconomic 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.

(25) In the light of this assessment, the Council has examined the Convergence Programme and its opinion[12] is reflected in particular in recommendation 1 below.

(26) 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 made under Article 6 of Regulation (EU) No 1176/2011 are reflected in recommendations 1 to 5 below,

[12] Under Article 5(2) of Council Regulation (EC) No 1466/97.

HEREBY RECOMMENDS that Croatia take action in 2017 and 2018 to:

1. Pursue its fiscal policy in line with the requirements of the preventive arm of the Stability and Growth Pact, which implies to remain at its medium-term budgetary objective in 2018. By September 2017, reinforce budgetary planning and the multi-annual budgetary framework, including by strengthening the independence and mandate of the Fiscal Policy Commission. Take the necessary steps for the introduction of the value based property tax. Reinforce the framework for public debt management, including by ensuring annual updates of the debt management strategy.

2. 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. Improve coordination and transparency of social benefits.

3. Improve adult education, in particular of older workers, the low-skilled, and the long-term unemployed. Accelerate the reform of the education system.

4. Reduce the fragmentation and improve the functional distribution of competencies in public administration, while enhancing the efficiency and reducing 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.

5. Speed up the divestment of State-owned enterprises and other State assets, and improve corporate governance in the State-owned enterprise sector. Significantly reduce the burden on businesses stemming from costs of regulation and from administrative burdens. Remove regulatory restrictions hampering access to and the practice of regulated professions and professional and business services. Improve the quality and efficiency of the justice system, in particular by reducing the length in civil and commercial cases.

Done at Brussels,

For the Council
The President