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CROATIA — REVIEW OF PROGRESS ON POLICY MEASURES RELEVANT FOR THE CORRECTION OF MACROECONOMIC IMBALANCES

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Executive summary

This is the sixth specific monitoring report under the macroeconomic imbalances procedure (MIP) for Croatia, which was identified as experiencing excessive imbalances in the 2018 European Semester. The imbalances concerned the high levels of public, private and external debt, all largely denominated in foreign currency, in a context of low potential growth. While the economic environment had improved, there had been little progress in the adoption of policy measures aimed at ensuring a durable correction of imbalances. The 2018 country-specific recommendations for Croatia are all intended to address the imbalances. This report reviews the latest policy initiatives undertaken by the Croatian authorities that are relevant for the correction of excessive imbalances, against the background of recent economic developments. The cut-off date of the report is 8 November 2018.

The macroeconomic outlook remains supportive, despite a projected moderation in real GDP growth. Having peaked in 2016 and moderated in 2017, real GDP growth is projected to edge further down to 2.8% in 2018. Economic activity is expected to maintain a similar pace in 2019, and to slow down and move closer in line with its potential in 2020. Domestic demand, and in particular household consumption, is set to remain the main growth driver, as disposable incomes benefit from rising wages and employment, as well as the announced tax cuts. The unemployment rate is falling rapidly and is expected to continue declining, but low labour utilisation continues to weigh on potential growth, as does subdued productivity growth. Driven by a combination of GDP growth and prudent fiscal policy, the debt-to-GDP ratio has been decreasing steadily for three years in a row. Continued deleveraging of both the public and private sectors led to a further reduction of Croatia's external liabilities. The financial sector is well-capitalised, however non-performing loans remain high, especially for corporates, and their fast decrease of recent years seems to have slowed down in 2018.

Long-awaited policy measures are in the pipeline. An important package of pension system reforms is in parliamentary procedure. It aims at improving pension adequacy by addressing structural inconsistencies in the existing system and promoting longer working lives. Measures designed to strengthen the fiscal framework are also in the adoption phase. An umbrella act on the management of state-owned assets and enterprises entered into force in June and now awaits implementing legislation, while disposal of state-owned assets advances in line with commitments, which are however of limited ambition. Similarly, the liberalisation of services is proceeding, though it remains marginal. The measurement and reduction of the identified administrative burden is nearing completion, while there has been no significant reduction of parafiscal charges, which weigh on businesses. A substantial rationalisation of the cumbersome state agencies system is due to be adopted by the end of the year, while new legislation aimed at harmonising wage-setting for civil servants is planned for early 2019. Long planned education and training reforms have been finally set in motion, but participation in active labour market policy measures remains low. Despite initial progress in efficiency-enhancing measures in the hospital system, debts in the healthcare system are still on the rise, while the consolidation of the social benefits system remains in a preparatory phase. Measures aimed at improving the judiciary are gradually advancing, while the new personal insolvency framework has still to prove its effectiveness.

Overall, while relevant policy measures have been initiated, their full implementation remains crucial to decisively address Croatia's structural weaknesses. Economic activity is set to maintain positive momentum over the next two years, however potential growth is estimated to remain relatively low for a catching-up economy, underpinned by weak labour utilisation and total factor productivity. Recent policy initiatives, aimed at improving public sector governance and the business environment and improving pension adequacy in a sustainable manner, are promising, although many of the planned measures are at different stages of progress – with some still in preparation, others awaiting full parliamentary adoption or effective implementation. Increasing the reform momentum will be important to build a more resilient economy and enable faster real economic convergence, also in light of Croatia's announced commitment to engage in the euro-adoption process.

Table 1: Key findings on implementation of reforms[1]

On track	Wait-and-see	Action wanted
• Reduction of backlogs in judicial system • Education system reform • HBOR's asset quality review follow-up	• Pension system reform • Strengthening of fiscal frameworks • Modernisation of public administration • Reduction of administrative burden • Improving public assets management • Disposal of state assets • Reform of regulated professions • Reduction of NPLs	• Reform of wage-setting for civil servants • Reduction of parafiscal charges • Consolidation of social protection benefits • Reducing fiscal risks in healthcare

[1] The table classifies reforms under review on the basis of their respective adoption and implementation process, uncertainty and their level of detail. “On track” are measures for which the legislative or implementation process has been completed or is progressing well according to the foreseen timeline, and which are expected to be sufficiently effective. “Wait and see” are measures for which the legislative process is on-going, but is still in a relatively early phase, or measures for which there is still uncertainty on the complete implementation and effectiveness. “Action wanted” are measures for which limited or no action has been taken, or measures that have been announced but which are not sufficiently detailed yet to be assessed.

1 Introduction

On 22 November 2017, the European Commission presented, in the context of the macroeconomic imbalance procedure (MIP), its seventh Alert Mechanism Report[2] to identify Member States requiring an in-depth investigation into the existence and extent of macroeconomic imbalances. The subsequent in-depth review in the country report on Croatia – published on 7 March 2018[3] – examined the nature, origin and severity of macroeconomic imbalances and risks in Croatia. In its Communication published on 7 March 2018[4], the Commission concluded that Croatia is "experiencing excessive macroeconomic imbalances". In particular, the Commission emphasised vulnerabilities linked to high levels of public, private and external debt, all largely denominated in foreign currency, in a context of low potential growth, and overall little progress in the adoption of policy measures addressing macroeconomic imbalances. On 26 April 2018, Croatia submitted its convergence programme[5] and national reform programme (NRP)[6], respectively outlining the fiscal strategy and policy measures undertaken or planned to improve its economic performance and to unwind imbalances. On the basis of an assessment of these programmes, the Commission proposed four country-specific recommendations (CSRs)[7], which were subsequently adopted by the Council on 13 July 2018[8]. The CSRs addressed to Croatia were all considered MIP-relevant. They concern: fiscal frameworks and taxation, pension system, education, public administration and wage-setting, business environment and judiciary.

For the purpose of the assessment of progress in the delivery of reforms within the framework of the MIP, the Commission conducted a mission to Croatia on 10-12 October 2018. Also based on the findings of this mission, the present report assesses the latest key policy initiatives[9] undertaken by the Croatian authorities[10].

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[2] https://ec.europa.eu/info/sites/info/files/economy-finance/com-2017-771-en.pdf
[3] https://ec.europa.eu/info/sites/info/files/2018-european-semester-country-report-croatia-en.pdf
[4] https://ec.europa.eu/info/sites/info/files/2018-european-semester-country-report-communication_en.pdf
[5] https://ec.europa.eu/info/sites/info/files/2018-european-semester-convergence-programme-croatia-hr.pdf
[6] https://ec.europa.eu/info/sites/info/files/2018-european-semester-national-reform-programme-croatia-hr.pdf
[7] https://ec.europa.eu/info/sites/info/files/file_import/2018-european-semester-country-specific-recommendation-commission-recommendation-croatia-en.pdf
[8] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=OJ:JOC_2018_320_R_0010&rid=18
[9] Details on the policy measures taken can be found in the overview table in the Annex.
[10] Previous MIP specific monitoring reports were published in November 2014, February and December 2015, December 2016 and November 2017. https://ec.europa.eu/info/business-economy-euro/economic-performance-and-forecasts/economic-performance-country/croatia/macroeconomic-surveillance-croatia_en

2 Outlook and recent developments on imbalances

Recent economic developments and outlook

Croatia continues on its steady path of economic recovery from the financial crisis and the six-year recession that followed. Having peaked at the rate of 3.5% in 2016, real GDP growth slowed to 2.9% in 2017 and is projected to edge down to 2.8% in 2018. In 2019, the pace of economic activity is forecast to remain steady at 2.8%, but to moderate further to 2.6% in 2020, moving closer to its still relatively low potential. Consumer spending accelerated further in 2017 and remained strong in the first half of 2018, underpinned by steadily rising disposable incomes. The momentum is projected to moderate going forward, but private consumption is expected to remain the main driver of growth, as households continue benefitting from higher employment and rising wages, with additional support expected from consumption tax cuts in 2019 and 2020. Following 3 years of sharp declines, the unemployment rate is projected to contract to 9.1% in 2018, and to continue declining at a moderate pace, in parallel with a mildly recovering labour force. In the corporate sector, financing conditions remain favourable and the uncertainties related to the restructuring of Agrokor are winding down[11]. As a result, investment activity is increasing, albeit moderately. Public investment continues lagging, but is projected to intensify as the uptake of EU funding is assumed to pick up towards the end of the programming period. While demand for Croatian exports remains solid, the strong export market share gains that followed EU accession are projected to moderate. At the same time, while slowing somewhat, imports of goods and services continue recording high growth rates.

Reliable statistics are a precondition to economic and budgetary surveillance and informed economic policy making. While close cooperation between the Croatian Bureau of Statistics and Eurostat has led to some progress in the production of national accounts and in ensuring consistency between government finance statistics and national accounts, sector accounts are not yet available and there remain some concerns with the completeness, accuracy and timeliness of macroeconomic and government finance statistics.

Developments as regards imbalances

General government debt

The debt-to-GDP ratio has been decreasing strongly for three years in a row, reaching 76.1% in the second quarter of 2018, from a 2015-Q1 high of 86.2%. The decrease was driven by a combination of dynamic GDP growth and significant improvements in the general government balance resulting from a counter-cyclical fiscal policy. The debt ratio is expected to dip to 68.2% by 2020 on account of continued economic growth and mild surpluses. In the past two years, Croatia benefited from the low interest rate environment in the refinancing of its maturing debt, including loans, by issuing bonds at interest rates lower than those of maturing debt. In addition, a lengthening of the average life of outstanding debt and increased issuances of debt at national currency have somewhat decreased the vulnerability associated to government debt.

[11] On October 26 the High Commercial Court in Zagreb confirmed the settlement agreed by Agrokor's creditors in July 2018, clearing way for the process of the Group's financial and operational restructuring to start.

Household and corporate debt and the financial sector

In 2017, strong private sector deleveraging continued with private sector debt falling to 98.4% of GDP, compared to 105.3 % at the end of 2016. Corporate and household debt decreased to 64.4% and 34.1% of GDP, respectively – which is 18 and 8 pps below the peak registered in 2010. Debt reduction in the corporate sector in the course of 2017 was driven mainly by write-offs and price adjustments, as well as the moderate appreciation of the Kuna against the euro. However, the overall debt reduction in 2017 could be overestimated given the large amount of non-performing claims sold by the banking sector to financial sector institutions that are currently not supervised or regulated and thus not covered by official debt statistics. Still, NPLs in the banking sector remain high (8.9% of total loans in Q1 2018), especially for corporates (21.1 % of total loans to corporates). The downward trend of NPLs seems to have considerably slowed in early 2018 as the NPL ratio has remained broadly stable since December 2017. This has been largely due to lower NPL sales and the entry-into-force of more stringent domestic rules for NPL classification. Following a pickup in credit activity in 2017, new credit disbursements to both household and the non-financial corporate sector have grown significantly in the first eight months of 2018. Currency and interest risks for households and non-financial corporations are present, although subsiding, due to a noticeable shift in currency denomination of new loans issued towards Kuna-denominated loans, and increasing propensity of households towards fixed-rate loans. The agreement between Agrokor's creditors[12] mitigated risks to the financial sector but the operational and financial stability of the company and its suppliers still depend on its successful implementation.

External liabilities and trade performance

The ongoing deleveraging of both the public and private sector is reflected in Croatia's continued current account surplus. In 2017, the surplus rose to 3.9% of GDP, compared to 2.5 % in 2016. The improvement was to a large extent due to a one-off upward adjustment in the primary income balance as banking sector profitability was affected by higher provisioning associated with the Agrokor crisis. By contrast, the trade surplus declined, as imports growth outpaced that of exports and Croatia's export market shares expanded modestly. The continued positive current account position led to a further reduction of external liabilities. Compared to end 2017, gross external debt declined by 1.8 pps to 80 % of GDP while NIIP rose by 1.6 pps to -60.33 % of GDP by June 2018. The current account surplus is projected to decrease to below 3% of GDP in 2018, and further down to below 2% by 2020, as the trade surplus continues deteriorating. The NIIP is thus set to continue improving, though at a slower pace.

Potential output

While still growing faster than its estimated potential growth, Croatia's real GDP growth is forecast to gradually converge down towards potential, estimated at 2.4% in 2020. The output gap closed in 2017 and is set to grow increasingly positive over the forecast horizon. Despite the positive developments on the labour market, participation rates remain low. In addition, over the past years the rapid fall in unemployment was in part due to the increase in

[12] See footnote 11.

employment, as it also reflected labour force shrinking due to population ageing and outmigration. As of 2018, higher participation rates translate into a marginally positive labour contribution to potential growth. Total factor productivity (TFP) is also at relatively low levels, as Croatia does not perform well on measures of goods and service market efficiency and public sector governance indicators. Overall, Croatia's potential growth, while increasing, is estimated to remain relatively low for a catching-up economy.

3 Policy implementation and assessment

3.1 Public finances and taxation

Supported by GDP growth and a counter-cyclical fiscal policy, the government balance recorded a surplus in 2017 and measures aimed at strengthening the fiscal framework are in adoption phase. The continued containment of expenditure against the background of growing revenues has led to significant improvements in the general government balance, which recorded a surplus of 0.9% of GDP in 2017. An increasing primary surplus has upheld the strong decrease of the public debt ratio, which reached 76.1% in 2018-Q2, 10 pp below the peak recorded in 2015-Q1. Conversely, the activation of contingent liabilities is expected to have a strong (in excess of 1% of GDP) yet temporary negative effect on the government balance in 2018 and 2019. In addition, as the government uses fiscal space to cut taxes, fiscal policy is expected to shift towards a pro-cyclical stance. Still, the decrease in the debt ratio is expected to continue – albeit at a slower pace – throughout 2020, driven by mild surpluses and GDP growth. In 2018, Croatia continued to benefit from the low interest rate environment, refinancing its maturing debt at considerably lower rates. With respect to the fiscal framework, the Fiscal Responsibility Act – aimed at strengthening the Fiscal Policy Commission and prescribing numerical fiscal rules – is currently in parliamentary procedure, having been adopted by the government in September. The Budget Act – aimed at specifying the short and mid-term budgetary framework at central and local level – is scheduled for adoption by the government in December 2018.

After the tax reform that entered into force in 2017, the authorities have proposed a new wave of tax cuts that should become effective in 2019-2020. The cuts include a shift of several foodstuffs from the general (25%) to the reduced (13%) VAT rate, a slight decrease in social security contributions (-0.7 pp) and a widening of the first personal income tax bracket (24%). In 2020, the general VAT rate should be reduced from 25% to 24%. In addition, the government has abandoned plans to introduce a recurrent tax on immovable property, and the real property transfer tax will be reduced from 4% to 3%. At the same time, the maximum amount at which local governments can set the tax on short-term accommodation rentals will be increased. The decreases in VAT rates are expected to support consumption to the extent that they are passed through to consumers. In addition, being largely concentrated on essential goods, the reductions have the potential to disproportionately benefit (in relative terms) lower income households. The positive effects of the changes to social contributions and the personal income tax on employment may be limited as they do not appear to be sufficiently targeted at making work pay and insofar as employment growth is restrained by other factors unrelated to labour income taxation (e.g. skills mismatches and the availability of alternative sources of income). In this context, the proposed increase in the ceiling for the tax on short term accommodation rentals should help reduce the large gap between the tax burden on labour and on holiday rental income, while increasing the economic benefits of tourism.

Debts in the healthcare system continue rising despite increased health contributions on account of higher employment. In June 2018, the total debt of the system stood at roughly 2% of GDP, with payment arrears still increasing in hospitals, albeit at a slower pace than the year before. Hospitals remain financed according to ex-ante spending limits that are not in line with the services they provide. Instead, the Croatian Health Insurance Fund plans to use some of the additional revenue expected from the 1 pp net increase in the health contribution rate to increase the spending limits for the debt-generating hospitals in 2019. The Ministry of

Health estimates that with this additional revenue the system could stop generating debt in 2019. The functional integration of hospitals, which is expected to rationalise operations and improve access to healthcare, progresses according to plan in the six initially paired hospitals. Furthermore, the recently adopted National Hospital Development Plan 2018-2020 now provides legal basis for the functional integration of all hospitals in Croatia, and no longer necessarily in pairs only. Amendments to the Act on Healthcare aimed at strengthening primary care by investing in equipment and personnel are reported to be under adoption procedure. This is expected to reduce the comparatively high patient referral rate in Croatia, in turn reducing strain on hospitals.

Overall, the fiscal space created by a favourable economic environment and a prudent fiscal policy is being partly used for tax cuts while keeping the debt ratio on a declining path. The 2019-2020 tax cuts aim at supporting households' disposable income and further reducing the tax burden on labour. Meanwhile, the activation of contingent liabilities (some of which have already materialised) in 2018-2019 will negatively impact the government balance. In addition, rising debt in the healthcare system remains a concern. Measures aimed at strengthening the fiscal framework, long delayed, are now in the adoption phase.

3.2 Labour market, education, social protection and pension system

New legislation on civil service wage-setting is planned for the first quarter of 2019. The new legislation, which has been postponed several times by the government, will cover civil servants of the public administration, while wages of public sector workers will be addressed in a second phase. The aim of the law is to achieve greater harmonisation of wage setting across the public administration through the introduction of common wage grids and job complexity coefficients, based on more consistent job descriptions and competences frameworks. The new legislation would also cover areas of the employment relationship of civil and public servants that are currently negotiated through collective bargaining, conditional upon the implementation of a new performance evaluation system for civil servants. As for state-owned enterprises (SOEs), for the time being no further steps have been taken in setting up a coordinated system for collective bargaining.

Participation in active labour market policy measures (ALMPs) remains limited. Despite some improvements, the coverage of ALMPs remains low, with marginal effects on the employability of participants. The package of ALMPs introduced in 2018 presents a number of important improvements: increased amounts of employment and self-employment subsidies, the possibility for the self-employed to enter upskilling programmes, and simplifications in procurement procedures related to the provision of training. Furthermore, access to "vocational training for work without commencing employment", originally designed for young people aged 18-29 years, has been extended to people aged 30+ without work experience. However, the risk of deadweight loss associated to this measure has not been addressed. Overall, the effects of the 2018 ALMP package still need to be monitored and assessed. One of the most used measures is public works, targeted at vulnerable groups from municipalities with poorer labour market outcomes. Nevertheless, the latest analysis[13] shows that public work schemes do not increase substantially the employability of the

[13] Matković (2018). Employment Policy and Unemployment. The Social Policy of Croatia – Textbook (Politika Zaposljavanja i Nezaposlenost. Socijalna Politika Hrvatske – Udzbenik). *Forthcoming*

participants. Similarly, measures offering reskilling/upskilling so far have not proven to significantly increase employability levels. Therefore, concerns remain with regards to the targeting efficiency of vulnerable groups and the capacity of the Croatian Employment Service to adapt its offer to the needs of its beneficiaries.

In October, the government submitted to parliament an important package of pension system reforms. The purpose of the reforms is multifaceted and can be summarised in three main objectives: first, addressing structural design inconsistencies which resulted in an unfair treatment of certain cohorts of pensioners; second, improving pension system adequacy through longer working lives; and third, strengthening the institutional setup and performance of the 2nd pillar. On the first objective, the government proposes to extend the 27% supplement of the pension entitlement (that is currently paid out to individuals receiving a pension from the 1st pillar only) to all pensioners in a proportional way[14], while retaining the possibility for all to opt-out of the 2nd pillar and shift savings to the 1st pillar at retirement. The authorities argue that this is an equitable solution that would avoid severely undermining the 2nd pillar, as according to their estimates under the current proposal only low-wage earners would find it convenient to move back to the 1st pillar. The authorities also plan to increase the minimum pension by 3.13% from mid-2019. On the second objective, the reform proposal includes: (i) accelerating the planned increase in the statutory retirement age to 67, bringing it forward from 2038 to 2033; (ii) accelerating the equalisation of retirement age for man and women, brought forward to year 2027; (iii) increasing penalties for early-retirement and bonuses for deferred retirement, while retaining the relatively large gap of five years between early and statutory retirement age; (v) introducing the possibility to work part-time while receiving a pension; and (vi) streamlining the list of arduous and hazardous professions benefitting from more favourable pension entitlements, while preserving a number of special pension schemes (e.g. for military personnel and police).

A dedicated set of measures addresses the design of the compulsory funded 2nd pillar. The measures aim at increasing the efficiency and performance of the compulsory funded 2nd pillar, as well as the voluntary 3rd pillar. In this area, the authorities received technical support from the Commission's Structural Reform Support Service, which has been partly taken into account in the proposed amendments to the relevant legislative acts. The latter introduce more stringent rules to tackle potential conflict of interest arising in the private funds and lower caps on membership management fees paid by 2nd pillar members. The amended Acts also modify some of the investment rules, introducing a new investment category which allows pension funds to invest in infrastructural projects in Croatia within prescribed limits. Furthermore, all 2nd pillar members can choose the risk profile of their pension fund[15], though a new default option is foreseen for those who do not express their choice upon first employment. The amended Acts enable the Croatian Pension Insurance Institute to establish a public pension insurance company that would be in charge of the pay-out of annuities from the 2nd and 3rd pillar. On pension insurance companies, the proposed legislation also introduces new governance rules for cross-border transactions and for managers (in terms of

[14] Pensioners covered by both the 1st and 2nd pillar would receive a supplement 27% for the contribution period until December 2001 and a supplement of 20.25% for the years after 2002 when they started paying also into the 2nd pillar. For an explanation of how the 27% supplement in the current system works, see Croatia Country Report 2018 and the MIP Specific Monitoring Report 2017.

[15] Under the 2nd pillar, pension funds in Croatia are required to offer three different funds knowns as A, B and C categories. They differ by their investment and risk profile with A-funds having the highest risk level and C-funds the lowest.

fitness and probity), new requirements in terms of capital shares and technical reserves, a cap on certain administrative costs and the obligation for the insurance companies to adjust the annuity payments to the consumer inflation rate twice a year. The new legislation allows life insurance companies to pay-out 3rd pillar annuities (under certain conditions of compliance with the relevant legislative rules). Furthermore, among other measures, perspective pensioners can request a lump-sum payment of up to 15% of their capitalised savings upon retirement, provided their pension is at least 15% higher than the minimum pension. Finally, pension insurance funds have now the legal obligation of promoting financial literacy in Croatia with regard to pension savings.

Major policy measures in the social benefits system remain in a preparatory phase. There are marked and persistent disparities in terms of labour market outcomes and risk of poverty rates across counties. A fragmented social protection system, closely related to the fiscal capacity of local government units, is unable to address these disparities. In the medium term, the authorities aim to amend eligibility criteria for benefits provided centrally taking into account all benefits received by individuals from local government units. To this end, the categorisation of the numerous types of benefits granted at the local government level following the ESSPROS (European System of integrated Social Protection Statistics) nomenclature was completed. The authorities plan to improve the information flow from the local to the central government level on benefits being paid out. The project of linking the databases of the various central government institutions providing social benefits – in order to allow for an overview of all benefits granted per beneficiary – is proceeding gradually. In July, the authorities have widened the scope of recipients of child allowances, by increasing the income eligibility thresholds for families with children. In the area of Early Childhood Education and Care (ECEC), a number of projects aimed at improving capacities, educational programmes, and infrastructure have been initiated, however more efforts are needed to address the weaknesses of the ECEC funding model in order to increase participation rates.

The long planned education and training reforms have been set in motion. In September, the authorities launched the newly developed general education curricula in 74 schools as a pilot project, ahead of their full implementation. The establishment of 25 sectoral councils is supporting the implementation of the Croatian Qualifications Framework, with the aim of improving quality and better aligning education and training with labour market needs. In addition, the establishment of Vocational Education and Training (VET) competence centres is under way. Their objective is to offer better quality VET to high school students, but also to unemployed adults and teachers from the general VET school network, all in cooperation with employers. Quality should be ensured by the introduction of a compulsory re-accreditation every 5 years, and the performance of the VET competence centres will be monitored by looking at the employment outcomes of students. Despite progress in the preparation of performance-based funding for universities, higher education efficiency and its links with the labour market remain unaddressed in the current reform efforts. The participation rate in adult education is steadily decreasing, at 2.3% in 2017 compared to the EU average of 10.9%. The adoption of the Adult Education Act has been further postponed. It aims at increasing quality and relevance of adult education by streamlining the adult education programmes and introducing periodical re-accreditation of adult education providers. Overall, the success of the announced reforms in meeting the objectives set in the Education and Training 2020 Strategic Framework will depend on their full implementation, with possible adjustments along the way as needed.

Overall, important measures in the pension and education system have been initiated, while progress in other areas is slower. A comprehensive package of pension system reforms was submitted to parliament, addressing both the mandatory 1st and the 2nd pillar, and the 3rd pillar. Steps taken to address adequacy concerns through longer working lives go in the right direction. A preliminary assessment of the changes being proposed to the 2nd pillar provides a mixed picture. On the one hand, the new governance and control rules appear commendable, and the commitment to the mandatory multi-pillar system is strengthened by the extension of the supplement to all pensioners. On the other hand, there appears to remain excessive rigidity in the definition of investment rules of the pension funds and the retained opt-out option from the 2nd pillar at retirement may weaken the two-pillar system. Education and training reforms have started being implemented, while the participation and impact of ALMPs remains limited. The consolidation of the social benefits system is still in preparatory phase, while the long-due legislation on civil service wage-setting is planned for adoption by the first quarter of next year.

3.3 Public administration, the business environment and state-owned enterprises, and judiciary system

Measures addressing the efficiency of the public administration are making progress. In August the government adopted a Decision on a substantial rationalisation of the cumbersome state agencies system, which is a step towards simplification and efficiency. A total of 54 state agencies, state institutions and state-owned enterprises will be either suppressed or merged with agencies or within line ministries. For the remaining agencies, the authorities plan to establish a new framework introducing a higher degree of homogeneity across the system. The relevant legislation is planned for adoption in autumn, with full implementation in January 2019. In 2018, the new law on the financing of local government units streamlined the system of central government transfers and introduced a new system of fiscal equalisation, no longer based on geographical criteria but on fiscal needs. This new financing model improved the fiscal capacities of most local government units, although the financing of decentralised functions retains some design flaws. In broader terms, the local administration in Croatia remains fragmented, and the smallest municipalities often lack administrative capacity for the delivery of public services. The authorities have completed drafting the legislation which envisages a transfer of competences from branch-offices of the central administration (e.g. ministries) operating at local level to the county-level administration. The new legislative framework is planned for adoption in April 2019, and it would in part address the fragmentation of the state administration system, pending the settlement of some inter-institutional arrangements[16].

The long-awaited umbrella act on the management of state-owned assets was finally adopted in June 2018. However, the substantial delay in its adoption has effectively postponed the adoption of several implementing acts aimed at addressing the identified bottlenecks in disposal of assets, such as lack of interest for the less commercially attractive items and overly cumbersome and costly access to the stock exchange. In particular, a new Decree on the disposal of shares and stakes aims at simplifying the procedure of sale of shares in minority state-owned companies, while the announced Decree on promoting

[16] The salaries of the civil servants of the central state administration are not harmonised with those of the county-level officials (which on average have a higher salary). This discrepancy will have to be resolved before the transfer of public officials to the county administration takes place.

investment sets forth a new model of promoting private investment through activation of currently non-active state-owned assets. Meanwhile, the disposal of assets continues based on existing models and remains limited to minority-owned enterprises and non-active assets, with the sales revenue coming in substantially lower than last year. The new Code of Corporate Governance has now been adopted by all major majority-state-owned enterprises. The next step – the introduction of obligatory reporting on business planning and performance in state-owned enterprises – has been initiated recently with the adoption of guidelines on drafting and delivering business plans and performance reports. The announced legislation to regulate the use of tourist and other land which was not evaluated during the process of transformation and privatisation in the 1990s, is still pending. Once implemented, this legislation should provide for higher revenue from concessions on the use of such land, and open up opportunities for private investment, particularly in the tourism sector.

Progress with measures aimed to improve the business environment and liberalise services markets is mixed. The measurement of administrative burden has been completed in all planned areas of the economy, with more than 900 legal acts and 3,000 administrative requirements analysed. The final two tranches of removal of identified burden should be completed in 2019. Overall, out of the identified HRK 12.3 billion (3% of GDP) of cost-equivalent administrative burden for entrepreneurs, around 20% will have been removed by then. The areas with most improvements are work safety and tax administration. On the other hand, there is only moderate progress with the removal of parafiscal charges, as many of them represent key sources of revenue for certain public bodies. Some progress was made with cutting red tape related to parafiscal charges (e.g. simplifying payment methods and frequencies). As regards the liberalisation of services and professions, a number of measures have been implemented this year (most notably in the areas of passenger taxi transport and audit services) and many more are nearing implementation (e.g. in healthcare, accounting, private education, construction), but many big-ticket items such as tariffs in legal professions remain largely unaddressed. In cooperation with the World Bank, the authorities are preparing the first of two action plans which will contain measures for the liberalisation of the services market to be implemented in 2019-2020. However, the fact that many of the restrictive regulations are under the jurisdiction of professional chambers outside the government remains a systemic impediment for liberalisation.

In the justice system, there is gradual progress with reducing case backlogs, further digitalisation and the reform of the judicial map, but quality and efficiency remain challenges, as does the effectiveness of the personal insolvency framework. All commercial courts are now connected through e-communication with lawyers, notaries and prosecutors. The amendments to the Courts Fees Act aim at incentivising online payment of fees by offering a 50% discount in case of immediate payment. As of 2019, personal and corporate insolvency documents should be delivered from the Financial Agency (FINA) to the courts electronically. The Supreme Court has fully adopted the integrated court case management system and plans to increase the number of published first and second instance court rulings, also with the objective of improving the consistency of case law. The reform of the judicial map (to be implemented from 1 January 2019) will merge 24 municipal and 22 misdemeanour courts into 34 municipal courts. This is expected to increase efficiency and quality by better distributing workload. The reduction of backlogs in litigious civil and commercial first instance cases is partly due to the reduced inflow of new cases. Still, at 817 days, the average length remains high in first instance litigious civil and commercial cases, weighing on the business environment. Meanwhile, both the backlogs and duration of proceedings at the High Commercial Court are decreasing. The focus on resolving the oldest cases (10 years and older) has allowed substantially reducing their backlog (by 31% compared with end-2016). Perceived judicial independence is very low and the involvement of the National Security Agency in the appointment of first time judges raises further judicial independence concerns. As of 1 January 2019, the Financial Agency will be authorised to initiate ex officio certain personal insolvency cases. While this is expected to lead to an increased use of the personal insolvency procedures and resolving over-indebtedness of certain natural persons, the effectiveness of the personal insolvency framework remains a challenge.

The implementation of anti-corruption measures is mixed. Despite some progress with the implementation of the anti-corruption plan, the capacity to prevent and sanction instances of corruption remains limited. New laws on the protection of whistle-blowers and on the prevention of conflicts of interests are planned for adoption by the end of 2018, however they do not fully incorporate provisions to improve transparency and strengthen enforcement mechanisms. The Commission for the Prevention of Conflicts of Interest faces administrative limitations in its capacity to monitor asset declarations and legal limitations in its ability to sanction officials. The adoption of a code of ethics for members of Parliament and lobbying regulation plans have been put on hold. There are concerns regarding integrity risks at the local government level, where numerous officials have relatively wide discretion with regard to spending and appointments without significant control.

Overall, progress with improving the business environment and governance in state-owned enterprises is mixed, while measures addressing the public administration and the judiciary are advancing. Measures to improve the disposal of state-owned assets are in the pipeline, while the overall policy commitment in this area remains limited. The liberalisation of services and the reduction of parafiscal charges remain piecemeal. There is progress with the removal of the administrative burden and efficiency improving measures in the judiciary, but not as much on personal insolvency and anti-corruption. A substantial rationalisation of the state agencies system is due to be adopted by the end of the year, although the fragmentation of the public administration system remains an issue.

3.4 The financial sector

Croatia has progressed further in reducing non-performing loans, but the pace of reduction slowed in early 2018 due to slowing sales and the introduction of new provisioning and loan classification rules. In Q1 2018, the NPL ratio was 8.9%, representing a significant reduction from 14.2% three years ago. However, there are indications that the pace of NPL reduction slowed in the first half of 2018. This is due to a combination of factors, including shifting investor appetite for purchasing NPLs and the nature of assets remaining on banks' balance sheets (i.e. less severely impaired loans). These factors suggest that the declining trend in the NPL ratio may stall for an extended period, which would necessitate strengthening the banks' own workout capacities. In addition, a number of measures entered into force on 1 January 2018 under the forbearance and risk classification guidance issued by the Croatian National Bank (CNB) in late 2017[17] may also have had an impact on the decline in NPL reduction. The prescription that when more than

[17] Decision on the classification of exposures into risk categories and the method of determining credit losses (OG 114/2017), which was published on 22 November 2017.

20% of the total exposure to borrower is in default, all exposures to that borrower should be considered as non-performing[18] was also included in the guidance.

The impact of the Agrokor crisis on the banking system appears to be contained. Most of the impact, of Agrokor's difficulties in paying its creditors and suppliers, on NPLs has already materialised in 2017. A settlement was agreed upon in July 2018 by the firm's largest creditors, representing nearly 80% of the outstanding debt. On 26 October 2018, the Croatian High Commercial Court dismissed all of the appeals lodged by several of the remaining debtholders, effectively approving the settlement. The settlement involves a debt-to-equity swap applicable to most of the firm's outstanding debt, and corresponding write-offs to ensure that the firm remains solvent. However, at least one foreign-owned bank has a so-called "super senior" jumbo loan on Agrokor and some of its subsidiaries. This loan is not covered by the settlement but its likelihood of default is likely to be low.

The interest rate exposure of households remains high, but continues to subside as fixed-rate loans become more common. The share of loans with fixed rates and long fixation periods is increasing, as more than 60% of new consumer loans are issued with a fixed-rate. Furthermore, in line with the recommendation published by the CNB on October 2017 to mitigate the exposures of consumers to interest rate risk banks have been offering customers the possibility to switch to fixed-rate loans. The wider use of fixed-rate loans, however, shifts the interest rate risk to banks. Although banks may use synthetic hedging instruments to absorb potential losses from higher interest rates, hedging instruments in local currency remain costly.

Another risk component – albeit of lesser importance – stems from currency mismatches in the balance sheets of households and non-financial corporations. While the earnings of most households are in Kuna, nearly half (49%) of their outstanding loans is either in foreign currency or indexed to foreign currency, mostly euro. At the same time, households do have significant foreign currency deposits, representing nearly two-thirds (65.7%) of the total. However, this ratio has been declining. The open positions of non-financial corporations are even larger, with non-Kuna loans and deposits representing 67.4% and 36.4%, respectively.

Follow-up to the 2017 Asset Quality Review and on-going efforts are set to help improve governance and strategic planning of the Croatian Bank for Reconstruction and Development (HBOR). The management of HBOR is working to address some of the operational inefficiencies that were uncovered during last year's AQR exercise. Over the past year, HBOR has taken a number of measures to improve its core IT system, implement IFRS 9 and EBA guidelines on NPLs, and introduce new credit risk management procedures, including collateral valuation. An on-going project financed by the Commission's Structural Reform Support Service, which was kicked off in early October 2018, will help produce a medium-term strategy and identify market failures which will be for HBOR to address.

The conversion of CHF-loans remains subject to legal challenges. Following Croatia's Supreme Court ruling in October 2017, the High Commercial Court upheld the ruling on legal nullity of: (i) unilateral interest rate increases, and (ii) the foreign currency clause in the

[18] In the EU, the so-called "pulling effect" for NPLs will be applicable starting from 1 January 2021, under EBA/GL/2016/07.

case of the CHF-indexed loans. Questions arise as to how lower-instance courts will interpret the ruling. For example, it is not clear whether it applies only to non-converted CHF-indexed loans or more broadly. Moreover, it is not clear whether the courts will question both outstanding and paid out loans. The draft new Act on the State Audit Office includes provisions subjecting the CNB to stronger audit scrutiny. The ECB issued a positive opinion on the new act in October 2018.

Overall, financial sector stability does not appear to be at risk, despite a slowdown in NPL reduction. The CHF-indexed loan conversion remains subject to legal challenges. There is room to improve banks' own NPL workout capacities to speed up NPL reduction as NPL sales slow. HBOR is proceeding with the implementation of recommendations from the AQR exercise and the discussion on its mid-term strategy is ongoing.

4 Annex. Summary Table A

MIP objective: Ensuring stable public finances			
Public finances and taxation			
Fiscal policy and fiscal governance			
Announced measures	*Adopted measures*	*Implemented measures*	*Sources of commitment*
Announced for July-October 2018: New Fiscal Responsibility Act and State Audit Office Act, amendments to the Budget Act.	**September 2018:** Fiscal Responsibility Act adopted by the government.		2018 CSR 1: "Strengthen the fiscal framework, including by strengthening the mandate and independence of the Fiscal Policy Commission."
Long term sustainability of public finances, including healthcare			
Announced measures	*Adopted measures*	*Implemented measures*	*Sources of commitment*
Announced for November 2018: Enactment of amendments to the Act on Medicines, aimed at harmonising prices for medicines and orthopaedic devices. **Announced for December 2018:** Completion of the project of introduction of a central management	**September 2018:** Adopted - National Plan for Development of Hospitals 2018-2020 (including parameters for the functional integration of hospitals). **October 2018:** Adoption of the amendments to the Act on Healthcare	Process of the functional integration of hospitals is ongoing.	2018 NRP

system for managing the organisational structure of the healthcare system.	aimed at improving primary care.		
MIP objective: Improving the functioning of the labour market, and the effectiveness of social protection			
Labour market, education and social policies			
Wages & wage setting			
Announced measures	*Adopted measures*	*Implemented measures*	*Sources of commitment*
Announced for September 2018: Act on Wages for Civil Service. **Announced for November 2018**: Regulation on the jobs categorisation and tasks catalogue in the public administration; Regulation on a new evaluation and assessment model.			2018 CSR 3: "In consultation with social partners, introduce harmonised wage-setting frameworks across the public administration and public services." 2018 NRP
Education system and active labour market policies			
Announced measures	*Adopted measures*	*Implemented measures*	*Sources of commitment*
Announced for December 2018: Establishment of the National Classification of Occupations Register.	**March 2018:** Amendments to the Vocational Education Act **July 2018**: Initial phase of the	Continuous implementation of ALMP measures.	2018 CSR 2: "Deliver on the reform of the education and training system to improve its quality and labour market relevance for both young people and

Announced for December 2018: Review of the Guidelines for the development of occupation standards; Establishment of a labour market web-portal outlining labour market trends (employment, unemployment, number of pupils and students in education programmes by occupation and region). **Announced for December 2018:** Act on Adult Education to increase quality, relevance and appeal of adult education and lifelong learning programmes.	development of the network of VET Competence Centres.		adults." 2018 NRP
Poverty reduction & social inclusion			
Announced measures	*Adopted measures*	*Implemented measures*	*Sources of commitment*
Announced for December 2018: Infrastructure investments and improvements of physical environment of pre-school institutions/kindergartens. **Announced for December 2018:** Ordinance on methodology, documentation, data submission and reporting from local government units on the provision of social benefits.			2018 CSR 2: "Consolidate social benefits and improve their poverty reduction capacity." 2018 NRP

Incentives to work, job creation, labour market participation			
Announced measures	*Adopted measures*	*Implemented measures*	*Sources of commitment*
	October 2018: Government adoption of a reform package composed of six Acts regulating the pension system, both for the first pillar and the second mandatory funded pillar, and the third voluntary pillar.		2018 CSR 2: "Discourage early retirement, accelerate the transition to a higher statutory retirement age and align pension provisions for specific categories with the rules of the general scheme." 2018 NRP
MIP objective: improving competitiveness, the business environment, and institutional capacity			
Public administration and business environment			
Public administration			
Announced measures	*Adopted measures*	*Implemented measures*	*Sources of commitment*
Announced for December 2018: Amendment of the legal framework the regulating establishment of the state agencies system, and implementation of the agencies rationalisation plan. **Announced for December 2018:** Development of a database on	**August 2018:** Government Decision on streamlining of the number of legal entities of the agency type.	**December 2017:** new Act on Financing of Local Government Units, aimed at simplifying the system of transfers and financing.	2018 CSR: "Reduce the territorial fragmentation of the public administration, streamline the functional distribution of competencies and enhance the capacity to design and implement public policies." 2018 NRP

fiscal/administrative capacities of local government units.			
State-owned enterprises			
Announced measures	*Adopted measures*	*Implemented measures*	*Sources of commitment*
Announced for December 2018: Adoption of the Regulation on method of disposal of stocks and shares; Adoption of the Regulation on investment incentives (pursuant to the Investment Incentives Act). **Announced for December 2018:** Enactment of the Act on the Amendments to the Act on Tourist and Other Land Not Evaluated in the Transformation and Privatisation Process.	**August 2018**: Decision on obligatory reporting on planning and performance in SOEs; Instruction issued to management boards of majority-state-owned enterprises in September 2018.	**Continuous in 2018:** Sale of properties and minority shares in state-owned enterprises through public tendering; Corporate Governance Code adopted in all majority-state-owned enterprises.	2018 CSR 5: "Improve corporate governance in state-owned enterprises and intensify the sale of state-owned enterprises and non-productive assets." NRP 2018
Business environment			
Announced measures	*Adopted measures*	*Implemented measures*	*Sources of commitment*
Announced for June 2018: Adoption of an ordinance on electronic business start-up. **Announced for June 2018**: Adoption	**May 2018**: Adoption of the Road transport Act. **August 2018**: Electronic business start-up legislated through the new	**May 2018**: Implementation of the Road transport Act. **September 2018**: SCM measurement of administrative burden completed.	2018 CSR 4: "Significantly reduce the burden on businesses arising from parafiscal charges and from cumbersome administrative and legislative requirements. Enhance

of the Road transport Act liberalising taxi services. **Announced for September 2018**: Completion of SCM measurement, determination of additional measures for administrative and non-tax relief. **Announced for September 2018**: Completion of analysis of restrictiveness of the professional services market and measures for its liberalisation. **Announced for September 2018**: Adoption of the State inspectorate Act merging economic inspections. **Announced for October 2018**: Development of a one-stop-shop electronic procedure for starting a business. **Announced for October 2018**: Adoption of the Act on Electronic Invoicing in Public Procurement. **Announced for December 2018:** Adoption of the Action Plan for Liberalisation of the Services Market (*Note: the Aaction Plan was subsequently divided in two parts).*	FINA law.	Around two thirds of the measures from the 2018 Action plan have been implemented (the major remaining part to be implemented together with the tax reform changes). The new (2019) Action plan was drafted. **September 2018**: Analysis of restrictiveness of 50 professional services is completed; around 40 measures across 5 areas have been implemented in 2018, (another 40 expected until the end of the year). **October 2018:** Act on Electronic Invoicing in Public Procurement adopted in the parliament.	competition in business services and regulated professions." 2018 NRP
Civil justice			

Announced measures	*Adopted measures*	*Implemented measures*	*Sources of commitment*
Announced for July 2018: Adoption of the Act on Areas and Seats of Courts and amendments to the Courts Act with the aim of reorganizing the court network. **Announced for December 2018**: Adoption of the Court fees Act and introduction of e-communication in commercial courts.	**July 2018**: Adoption of the Act on Areas and Seats of Courts and amendments to the Courts Act. **September 2018**: Draft court fees Act adopted by the government.	**June 2018**: Introduction of e-communication in commercial courts.	2018 CSR 4: "Reduce the duration of court proceedings and improve electronic communication in courts."
MIP objective: building a stable and resilient financial sector			
Financial sector			
Financial services			
Announced measures	*Adopted measures*	*Implemented measures*	*Sources of commitment*
	Ongoing: The Croatian Bank for Reconstruction and Development (HBOR) is taking steps to implement results of Asset Quality Review (AQR).	**November 2017**: Decision on the classification of exposures into risk categories and the method of determining credit losses (OG 114/2017), which was published on 22 November 2017.	