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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 fourth specific monitoring report under the macroeconomic imbalances procedure (MIP) for Croatia, which was identified as experiencing excessive imbalances in the 2016 European Semester. The imbalances concern the high levels of public, corporate and external debt in a context of high unemployment. The 2016 country-specific recommendations for Croatia are all intended to address them. The report reviews the latest economic developments and policy initiatives undertaken by the Croatian authorities that are relevant for the correction of the excessive imbalances. The cut-off date for this report is 24 November 2016.

The unwinding of internal and external imbalances is progressing, although vulnerabilities persist. Economic activity picked up steam in the first half of the year and real GDP growth is now expected to attain 2.6% in 2016. The economic recovery is supported by tailwinds that are expected to subside in the medium run and growth is projected to decelerate slightly over the forecast horizon. Yearly inflation is expected to slip to -0.9% in 2016, but prices are set to resume growing in 2017. The pick-up in growth is facilitating the unwinding of imbalances:

- **Private sector deleveraging is progressing, but private debt, especially in the corporate sector, remains high.** Besides the improved economic conditions, other factors also contributed to the reduction of the Croatia's total debt over the past year, namely the legislated conversion of CHF household loans and a mild appreciation of the HRK against the EUR, as a large share of Croatia's debt is held in EUR. By contrast, the contribution to deleveraging of net credit flows turned broadly neutral. Going forward, as the banking sector remains well capitalised and the quality of its assets improves, the positive growth is expected to result in mildly positive net credit flows. At just below 110% of GDP, private debt remains high, especially among corporations (72% of GDP). Exposure to currency risk declined in the first six months of 2016, but vulnerability remains, as roughly 80% of corporate debt and 65% of household debt was contracted in EUR.
- **The general government debt to GDP is also set on a declining trend.** The projected significant decline in the deficit to 2.1% of GDP this year, combined with the acceleration of growth and exchange rate-related valuation effects, is expected to set public debt on a declining trend. However it remains relatively high, at a projected 85% of GDP in 2016 and, like private debt, it remains largely exposed to currency risk (almost 80%).
- **External liabilities are contracting, as the current account remains in solid surplus.** The deleveraging of all three sectors of the economy is reflected in the continued current account surplus, which is set to contract only mildly over the forecast horizon. The progressive abatement of gross external debt, down to 97% of GDP by mid-2016, from 108.6% in 2014.
- **The reduction of unemployment is continuing, but also on account of a further reduction in the already low labour force.** In the third quarter of 2016, the unemployment rate fell to 12.8%, from 16.5% one year earlier. Whereas job creation intensified, more than half of the contribution to this decline came from a further contraction of the labour force on account of adverse demographic dynamics and net migration outflows. Combined with protracted weak productivity growth, this implies that Croatia's growth potential remains low, which amplifies the risks related to imbalances.

The run up to the second round of general elections in September 2016 delayed further the policy action needed to address the macroeconomic imbalances and the 2016 CSRs, and the reform agenda of the new government is not yet known in detail. The withdrawal of parliamentary support to the government in the summer 2016 was followed by a second round of general elections in September 2016. This prolonged the reform standstill that started in the run-up to the parliamentary elections of November 2015. As a result, few of the ambitious policy commitments put forward in the national reform programme (NRP) that the Croatian authorities submitted in April 2016 have been implemented to date. At the time of writing this report, the new government had not yet presented a detailed structural reform programme. Therefore it remains unspecified which of the policy commitments contained in the 2016 NRP will be maintained.

While on 10 November 2016 the government adopted a proposal for a comprehensive tax reform, the adoption of major policy measures announced in the national reform programme has been postponed.

- **Public finances and taxation**: The authorities are still preparing amendments to the Fiscal Responsibility Act, which is aimed at strengthening Croatia's fiscal framework, and the government has not yet adopted a public debt management strategy, despite a gap of two years since the previous strategy. Planned measures in healthcare are being reconsidered, and no specific measures have been taken to address the accumulation of arrears. The newly adopted draft tax reform is aimed at lowering the corporate and personal income tax, simplifying procedures and modernizing the Tax Authority. While the planned income tax cuts may encourage investment and consumption, they may come with a significant budgetary cost, without being specifically targeted to foster employment growth. The draft reform also envisages the introduction of a simple form of recurrent property taxation by 2018. Yet this still depends on a significant administrative input from local government units, which may pose risks to its timely implementation.
- **Labour market, social protection, and pension system**: The challenge of a low labour utilisation has still not received adequate policy attention. The planned law on public sector wages and the measures addressing pension adequacy concerns by encouraging longer working lives have not been carried out. The consolidation of social benefits has advanced very slowly. Progress with regard to the up- and re-skilling of the workforce has been mixed and the implementation of the education reform has been significantly delayed.
- **Business environment, public administration and the judiciary system**: The main pillars of the public administration reform as well as the implementation of measures aimed at improving the business environment have largely been delayed. The management of public assets is improving and privatisation endeavours yielded 0.2% of GDP in 2016, but the planned legislation to improve governance in state-owned enterprises has not yet been adopted and there are no clear plans for their privatisation or restructuring. The preparation of the asset quality review in the national promotional bank (HBOR) is advancing according to plans, but in the meantime there has been no progress in improving its governance and regulatory framework. As the implementation of the reform of the justice system progresses, the system's efficiency and quality remain a challenge. However, the number of pending cases has reduced, though this is partly due to a lower workload.
- **Financial sector**: The amended corporate and personal insolvency frameworks are starting to deliver some results, but the absence of an adequate monitoring system hampers their timely evaluation. In the banking sector, the accelerated sale of non-

performing loans (NPLs) has been a key driver of the reduction in their stock. The tax reform proposal includes provisions on the tax treatment of the write off of NPLs, which may further contribute to improving the quality of banks' assets.

In conclusion, although the ongoing recovery is facilitating economic adjustment, vulnerabilities persist and policy action has not yet contributed to promote a more structural and long-lasting adjustment. Croatia still faces several challenges. Albeit declining, public and private debt remains high, and is reflected in a large stock of external liabilities. Its high exposure to foreign currency risk is a source of vulnerability. The economic recovery is becoming more broad-based, but the growth potential of the economy remains low. Ensuring a durable adjustment will require reversing the current trend in the labour force and boost productivity growth. After more than a year of reform standstill, the regained political stability and the broadly favourable macroeconomic environment offer the opportunity to step up the reform momentum (see Table 1).

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

On track	Wait-and-see	Action wanted
• Reduced number of pending cases in judicial system	• Tax treatment of non-performing loans' write-offs • Recurrent property tax • Strengthening of fiscal frameworks • Reduction of administrative burden • Reduction of parafiscal charges • Education system reform • Improving public assets management • Insolvency frameworks' effectiveness monitoring • HBOR's asset quality review	• Modernisation of public administration • Public Debt Management Strategy • Reform of public sector wages • Pension system reform • Social protection reform • Reducing fiscal risks in healthcare • Reform of regulated professions and services market • Development of e-procedures for businesses • Adoption of Corporate Governance Code for state-owned enterprises

[1] The table classifies reforms under review on the basis of their respective adoption and implementation process and their credibility and 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 26 November 2015, the European Commission presented, in the context of the macroeconomic imbalance procedure (MIP), its fifth 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 26 February 2016[3] – examined the nature, origin and severity of macroeconomic imbalances and risks in Croatia. In its Communication published on 8 March 2016[4], the Commission concluded that "Croatia is experiencing excessive macroeconomic imbalances, which require specific policy action". In particular, the Commission emphasised vulnerabilities linked to high public, corporate and external debt in the context of high unemployment. On 28 April 2016, 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 five country-specific recommendations (CSRs)[7], which were subsequently adopted by the Council on 12 July 2016[8]. The CSRs addressed to Croatia were considered MIP-relevant. They concern: public finances and taxation, labour market, social policy and pension system, public administration and business environment and financial sector.

For the purpose of the assessment of progress in the delivery of reforms, the Commission conducted a specific monitoring mission within the framework of the MIP to Croatia on 8-10 November 2016. Also based on the findings of this mission, the present report assesses the latest key policy initiatives[9] undertaken by the Croatian authorities[10]. In order to avoid overlap of surveillance processes, the report does not provide an assessment of fiscal policy.

2 Outlook and recent developments on imbalances

Recent economic developments and outlook

Economic activity picked up steam in the first half of the year and growth is projected to remain sustained over the forecast horizon. Domestic demand grew buoyantly in the first half of the year, driven by continued growth of private consumption and a rebound in investment. Exports of goods continued to perform strongly, but strong final demand ushered in dynamic imports so that the contribution of net external demand turned slightly negative. Moderate deflation and the 2015 tax reform compounded with favourable developments in

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[2] http://ec.europa.eu/europe2020/pdf/2016/ags2016_alert_mechanism_report.pdf
[3] http://ec.europa.eu/europe2020/pdf/csr2016/cr2016_croatia_en.pdf
[4] http://ec.europa.eu/europe2020/pdf/csr2016/cr2016_comm_en.pdf
[5] http://ec.europa.eu/europe2020/pdf/csr2016/cp2016_croatia_en.pdf
[6] http://ec.europa.eu/europe2020/pdf/csr2016/nrp2016_croatia_en.pdf
[7] http://ec.europa.eu/europe2020/pdf/csr2016/csr2016_croatia_en.pdf
[8] http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32016H0818(23)&from=EN
[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. See respectively:
http://ec.europa.eu/economy_finance/economic_governance/documents/2014-11-07_croatia_mip_specific_monitoring_report_to_epc_en.pdf
http://ec.europa.eu/economy_finance/economic_governance/documents/201503_hr_imbalances_epc_report_en.pdf
http://ec.europa.eu/economy_finance/economic_governance/documents/20160118_hr_imbalances_epc_report_en.pdf

the labour market in delivering sustained growth in private consumption, while EU funds absorption prompted a strong rebound in public investment. On the external side, Croatia continued to benefit from the post-EU accession export boom, gaining further export market shares. The Commission 2016 autumn forecast projects growth to remain robust in the second half of the year, as the favourable trends registered in the first two quarters are set to continue, while record tourist arrivals in the third quarter herald a strong expansion of exports of services. Overall, real GDP growth is forecast to attain 2.6% in 2016. In the outer years, positive tailwinds are set to abate, but GDP growth is expected to slow down only moderately, to 2.5% in 2017 and 2.3% in 2018, while turning more broad-based in composition.

The unemployment rate is set to fall sharply amidst sustained employment growth and a further contraction in the labour force. The unemployment rate fell sharply to 12.8% in the third quarter of 2016, down from 16.5% in the same quarter of the previous year. Less than half the reduction, however, was driven by job creation, while the remaining share was due to a further contraction of the labour force. Both trends are expected to continue, bringing the unemployment rate down to just above 10% by 2018.

Up to October 2016, prices continued to fall, but increasing energy prices will result into a turnaround in inflation dynamics. Prices continued to fall in 2016, with annual average HICP contracting by 0.8% in October. The reduction was largely driven by falling oil prices and the significant reduction in gas tariffs. Core inflation, however, was also subdued. As oil prices have started to resume, the average fall in prices is projected to stabilise at around -0.9% in 2016 before picking-up to 0.8% and 1.5% in 2017 and 2018 respectively.

Developments as regards imbalances

In March 2016, Croatia was found to be experiencing excessive macroeconomic imbalances. Vulnerabilities are linked to high levels of general government, corporate and external debt in a context of high unemployment. Below is an update of the developments as regards the imbalances.

Public debt

General government debt remains high, but the shrinking deficit and sustained economic activity are setting the debt-to-GDP ratio on a declining trend. Public debt is expected to decline to 85.0% of GDP in 2016, from 86.7% in 2015. The decline in 2016 is to a large extent driven by the sharp reduction in the general government deficit: after hitting a record high of 7.8% of GDP in 2011, the deficit contracted to 3.3% of GDP in 2015 and is expected to attain 2.1% of GDP this year. This large improvement is mainly the outcome of windfall revenues from accelerating activity, which more than offset the small reduction in the personal income tax introduced in 2015. Expenditure is expected to fall significantly short of budget ceilings, more driven by across-the-board under-execution than by quality fiscal consolidation measures. Valuation effects are also contributing to the decline in the general government debt: as a large share of it is issued in EUR, the mild appreciation of the HRK since the beginning of the year is delivering a reduction in the value of outstanding liabilities. Going forward, the Commission 2016 autumn forecast expects the debt-to-GDP ratio to further decline over the forecast horizon to 82.8% in 2018, as growth continues, prices recover and the general government deficit declines. However, in the absence of a budget for 2017, risks to this forecast include the outcome of the public sector wage negotiations and of the dispute with banks over plans to convert CHF-denominated loans, as well as the comprehensive tax reform adopted by the government on 10 November 2016.

Household and corporate debt and the financial sector

The reduction in private sector debt is accelerating, but deleveraging pressures are projected to abate, while vulnerabilities related to the sizable currency exposure remain high. After reaching a record high of 83.2% of GDP in 2010, the consolidated corporate debt-to-GDP ratio gradually decreased to 76.1% of GDP in 2015. According to non-consolidated quarterly accounts, corporate debt decreased by 3.7% of GDP between the end of 2015 and the second quarter of 2016. It is expected to decrease further by the end of 2016 on the back of stronger growth and currency-related valuation effects, while the contribution of net credit is turning broadly neutral. In the household sector, deleveraging progressed more slowly due to the longer average maturities of mortgage loans. The debt-to-GDP ratio decreased from the peak value of 42% of GDP in 2010 to 39% of GDP in 2015. It is estimated that the legislated conversion of CHF mortgage loans into EUR delivered by September 2016 a 20% y-o-y decline in the value of outstanding liabilities, and the ongoing appreciation of the HRK against the EUR is contributing further to this devaluation. Overall, household debt decreased by 2.3 pps between the end of 2015 and the second quarter of 2016. As interest rates remain relatively low, deleveraging pressures are set to abate further. Meanwhile, net credit flows are expected to turn mildly positive, especially in the corporate sector, as higher growth stimulates credit demand, while the improving quality of banks' assets (see section 3.4) facilitates credit expansion. Yet, a large share of domestic borrowing – around 70% - remains denominated in (or indexed to) EUR and is thus exposed to currency risk. The size of the positive valuation effect due to the mild appreciation of the HRK against the EUR (amounting to over 1% of GDP of total private debt) is also a reminder of the risks linked to high foreign currency exposure.

External liabilities and trade performance

The current account is expected to post a solid surplus over the forecast horizon, paving the way to further reductions in external liabilities. A sharp contraction of imports in the wake of the global financial crisis initiated the adjustment of the current account balance, which turned into a small surplus already in 2013. Following EU accession, however, exports of goods started performing strongly – largely reversing the losses in export market shares recorded in previous years. In 2015, as the conversion of CHF loans mainly hit the profits of foreign-owned banks, the balance of primary incomes improved sharply, and tourism revenues accelerated pushing the current account to a record surplus of 5.1% of GDP. According to the Commission autumn forecast, the current account balance is set to normalise over the forecast horizon, but to remain in a comfortable surplus – also on account of growing absorption of EU funds. As a result of these dynamics, gross external debt to GDP ratio decreased from a peak of 108.6% of GDP in 2014 to 104% of GDP in 2015. In the first half of 2016, the external debt to GDP has further decreased to 97% of GDP, and a further contraction is projected by the end of the year.

Labour market adjustment

Labour market reforms have facilitated the reabsorption of unemployment, but temporary employment has become the main driver behind job creation, while the

labour force keeps shrinking. Job destruction bottomed out by the end of 2013 and employment growth resumed in the course of 2015. Employment creation, however, relies to a large extent on the new flexible fixed-term contracts, as highlighted by the increase in the share of temporary employment, from 15.7% of total employment in Q2-2013 to 23.5% in Q2-2016. Moreover, the almost 3 pps reduction in the unemployment rate between the 3rd quarter of 2016 and the same quarter of last year is mainly due to the continued decrease in the labour force, driven by both adverse demographic dynamics and net migration outflows.

Over the past years falling wages have underpinned competitiveness gains, but wage moderation is set to abate as labour market conditions improve. After contracting for several quarters in a row, both nominal and real wages started growing again in the first half of 2016 (around 2% and 3% respectively, on account of negative inflation developments). Over the forecast horizon, wages are projected to increase above productivity, bringing about a small increase in unit labour cost. Sustained wage growth also suggests that despite the still high unemployment rate, labour shortages may constrain employment growth in some segments of the economy. A long delayed wage negotiation in the public sector could lead to up to 6% increase in public sector wages. Beyond the direct fiscal impact, this risks slowing down further adjustment on the labour market on account of potential spill-over effects to other sectors.

Low participation rates and sluggish TFP growth constrain Croatia's potential growth. Real GDP growth is set to continue to run above potential over the forecast horizon. Investment was strongly hit during the six-year recession, but is finally growing again, thus contributing to capital deepening. TFP growth nevertheless remains sluggish, particularly for a catching-up economy, while low activity rates, net migration outflows and rapid demographic aging weigh on labour input.

3 Progress with policy implementation

3.1 Public finances, taxation, and healthcare

This section describes measures to strengthen the fiscal framework, improve the public debt management framework, reform the tax system and reduce fiscal risks in healthcare.

Progress in improving the fiscal framework stalled in the last year, but efforts are resuming. The authorities have completed a new draft of the Fiscal Responsibility Act, which is intended to ensure compliance with the provisions of the Directive 2011/85/EU on budgetary frameworks and thus strengthen the framework for fiscal discipline. It should be adopted by year end, a few months later than envisaged in the 2016 NRP. The new draft improves the design of the domestic numerical fiscal rules and strengthens the independence of the monitoring institution – the Fiscal Policy Commission. The authorities are also preparing amendments to the Budget Act in relation to the revision and execution of the budget, including rules on the reallocation of funds within or across budget lines. Overall, progress remains uncertain with regard to addressing the weaknesses in the multiannual budgetary framework that were identified in the 2016 country report. While these are only draft provisions that still require adoption, they alone would not improve the accuracy of budgetary planning, including for extra-budgetary users (such as SOEs and other entities classified within the general government sector). In order to rationalize spending, the authorities have implemented standard cost guidelines for budgetary users, covering costs financed from the state budget. In the first half of 2016, savings of more than 0.1% of GDP in the expenditure items covered by the guidelines were realised. However, this could also be the result of across-the-board under-execution of the budget in the first half of the year. The authorities have prepared a new law aimed at strengthening the role of the State Audit Office by introducing penalties in cases where its recommendations are not followed.

The authorities have not yet published a public debt management strategy and the public debt management function has not been reinforced. The government's high financing needs and the high exposure of sovereign debt to currency risk highlight the importance of developing and maintaining reliable financing sources, subject to a prudent risk management and a predictable strategy. Following a gap of over two years from the 2011-2013 period covered by the latest strategy, the authorities were due to adopt a three-year public debt management strategy in May 2016, but this has not happened yet. Nor has the public debt management function within the government been reinforced.

On 10 November 2016, the government adopted a proposal for a reform of the corporate and personal income tax and the value added tax. The draft reform has been submitted to Parliament for final adoption. It lowers the corporate income tax (CIT) general rate from 20% to 18% and introduces a new reduced rate of 12% for small farmers and entrepreneurs. Meanwhile, most CIT tax breaks currently in place will be abolished and small businesses will be able to choose between two methods of calculating their CIT liability. The number of personal income tax (PIT) rates will be reduced from three (12%, 25%, 40%) to two (24% and 36%) and the personal allowance will be significantly increased (from a threshold of HRK 2600 to HRK 3800). The envisaged reform will therefore bring about a reduction of the already narrow tax base and further limit the number of households liable to personal income tax, while the change in the rates for the various brackets will mostly benefit higher income earners. The reform also affects the VAT, with some items being reshuffled across rates with the aim of: increasing disposable income (electricity is moved to the reduced rate); broadening the base of the general rate (restaurants and cafes are moved from a reduced rate to the general rate); and aiding small farmers (inputs in agriculture are moved to the reduced rate). The authorities have estimated the first round budgetary impact of the reform in the order of -0.6% of GDP in 2016, which will in their view be partly offset by second round positive effects through increased consumption and investment (in the order of +0.2%-0.3% of GDP). The 2017 country report will include an assessment of the reform.

The envisaged tax reform changes the tax treatment of NPL write-offs and lays the ground for the introduction of recurrent property taxation. The reform proposal includes a new tax treatment of the write off of non-performing loans (NPLs). The write-offs undertaken in 2017 will be tax-deductible, but only for those NPLs that were recorded as such in the banks' books as per end-2015. The tax reform proposal also envisages the introduction of the recurrent property tax through a two-step approach: in 2018 as a simple property tax, with two new criteria for the calculation of the existing utility fee, and in 2020 with the introduction of a value-based property tax. The registration of properties by local government units is progressing well (with 99% of local government units having completed the exercise by the end of November 2016). However, the fact that the implementation of the property tax relies on the administrative capacity of local government units may be challenging.

The planned reforms in healthcare are being reconsidered, while no specific measures have been taken to address the accumulation of arrears in the health sector. A number of structural reforms planned by the previous government and, among other, aimed at increasing the fiscal sustainability of the healthcare system have been abandoned. These include: an increase (from 70 to 89 HRK) of the basic insurance payment to the Croatian health insurance fund (HZZO); an increase in the cap (from 2000 to 3000 HRK) to patients' co-payment; a reform of the 'additional insurance' scheme; and the introduction of new rules for emergency services. The long-awaited reorganisation of the hospital system and its functional integration is stalling, and the reform of hospital financing has also been halted. The latter was intended to gradually reduce the share of hospital funding based on ex-ante spending limits, in favour of funding based on the amount of care provided. The authorities are preparing a central information system collecting data on the medical services provided to each patient by all the hospitals in the country, which would allow to better control over-supply in the system and possible abuse. In order to decrease pharmaceutical expenditure, the list of benchmark countries has been updated and the authorities also envisage cost containment measures in primary care and the establishment of a central commission to distribute particularly expensive medicines to hospitals. Over the past months the authorities have enlarged the network of emergency medicine. However, there are still no concrete plans in the short term to address the accumulation of arrears in healthcare. The health care system thus continues to pose significant risks to public finances.

Overall, policy measures aimed at improving the fiscal framework and tacking fiscal risks in healthcare have not advanced. The authorities have adopted a tax reform proposal, which, among other, lowers the corporate and personal income tax, modifies the tax treatment of NPL write-offs and lays the ground for the future introduction of recurrent property taxation.

3.2 Labour market, social protection, and pension system

This section describes measures to improve the functioning of the labour market and the effectiveness of social protection, and to improve the equity and sustainability of the pension system.

The adoption of new legislation on public sector wages has been postponed by one year, to the end of 2017. The aim of the law would be to achieve greater harmonisation of wages across the public administration and public services through the introduction of common wage grids and job complexity coefficients, based on more consistent job descriptions and competences frameworks. Much of the preparatory work has already been done over the past years, but during the mission the authorities argued that analysis is still needed and a delayed pilot project has to be completed before any new legislation can be adopted. Still some progress has been made in developing an IT-system in support of the introduction of a universal system of wage grades. The authorities have also developed a common methodology and some guidance for the negotiation, coordination and monitoring of collective agreements in the public administration. However, these still need to be adopted by the Government. The two basic collective agreements regulating the rights of civil servants and public servants expire in 2016. They will both be temporarily extended and re-negotiated in the course of 2017, also with a view to increasing synchronization of bargaining cycles[11]. Meanwhile, the government is due to negotiate a 6% wage increase for civil servants under a

[11] It is worth nothing that the delayed adoption of the law on public sector wages, which is meant to also regulate aspects of working conditions and rights that are currently negotiated under the collective agreements, creates a time inconsistency, whereby the two basic agreements may be negotiated before the new Law comes into force.

2009 agreement with the trade unions. This would have a substantial direct fiscal impact, and could negatively affect competitiveness through demonstration effects in other sectors. As far as SOEs are concerned, no further steps have been taken in setting up a coordinated system for collective bargaining.

The new government does not exclude introducing further labour market reforms. The authorities are still analysing the impact of the 2013-14 labour market reforms on temporary employment. This is likely to have contributed to boosting job-creation, but also to a substitution effect between open-ended and temporary contracts. While fixed-term contracts have increased, open ended contracts have continued to fall resulting in an increase in the share of temporary employment in total employment, as mentioned in Section 2. Following discussions with employers' and employees' organisations, the authorities may consider introducing further changes to the reformed labour law. The findings of a recent study point to a differentiated impact of the minimum wage across regions, groups and sectors. This is currently subject to a broader discussion with the social partners in view of possible legislative interventions.

There has been mixed progress with regard to up- and re-skilling measures. The programme for the development of vocational education training has been adopted. In parallel, new legislation is being prepared with the aim to improve the quality of institutions, programmes and teaching for adult learning. However, so far only a few interested institutions have benefitted from the European Social Fund-financed projects to upgrade their training offer in line with new demands on the labour market. The scope of training actions provided by the Public Employment Services targeting the unemployed seems inadequate in view of the size of the challenge. Furthermore, there are no significant developments in relation to the recognition of skills and validation of non-formal and informal learning. As regards primary and secondary education, the extensive reform of teaching approaches and school curricula – initiated in 2014 – is experiencing difficulties. The implementation of the reform has been significantly slowed down by the political stalemate of the past year, but also by disagreements over the content of curricula. Although there is commitment to continue the reform in some form, the momentum seems lost.

Reform commitments in the area of the pension system have not been carried forward. The authorities have completed a review of the over one hundred arduous or hazardous professions benefitting from more generous pension provisions, including lower retirement age. The planned streamlining however has not yet taken place. Measures aimed at reducing access to early retirement (including on the basis of Article 35 of the Pension Law[12]) and redefining pension provisions for specific categories[13] are still under consideration. The same applies for the announced acceleration in the equalisation of retirement age for men and women. Work on reforming the methodology and assessment framework for disability pensions is ongoing. In 2015, the assessment of disability claims was moved from the Croatian Pension Insurance Institute to a new Single Expert Evaluation Body. The authorities reported that in the course of 2016, a new organisational and management model has been set up in order to address the large backlog of cases to be examined.

[12] Article 35 allows retirement without penalty at 60 years of age if the worker has completed at least 41 years of insurance.
[13] This includes among other the pension systems of active military personnel, police officers and officials.

The consolidation of social benefits has not advanced according to plans. The draft Action Plan outlining the reform of the social protection system has not yet been adopted and the new government is reviewing it. The authorities have completed the analysis of 49 benefits granted at the central government level with a view to categorizing them, agreeing on the institutional division of competencies and harmonising eligibility criteria. The planned introduction of means-testing for the child allowance is being questioned, in the context of a broader reflection on the purpose of the allowance itself – as primarily serving either to counter social exclusion or to foster demographic growth. The establishment of the one-stop-shops (OSS) for the administration and provision of social services is being postponed for the second time in a year. Initially, the OSS was planned to be placed in local administration offices, then in the Social Welfare Centres and now other options are being considered. The continuous changes have had the effect of delaying the implementation of all the relevant reform measures, including further consolidation of benefits under the Guaranteed Minimum Benefit (GMB) and the transfer of their administration to the OSS, with no clarity about the future timeline.

Overall, most of the reform plans in the areas of labour market, education, social policy and pension system have been postponed. For a number of measures, such as the legislation on public sector wages or the establishment of the one-stop-shop for social benefits, previously completed analytical work underpinning the measures is being re-discussed.

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

This section describes measures to modernise the public administration, to improve the business environment and EU funds absorption, to increase the efficiency and quality of the justice system and enhance public assets management.

The main pillars of the public administration reform have all been postponed. The adoption and implementation of the ambitious reform plans in this area has suffered from lack of political commitment. The authorities have developed, in line with the 2015 Strategy, a new version of the Action Plan for the Modernisation of the Public Administration 2017-2020. Its delayed adoption, now planned for end-2016, is further delaying the use of financial support from the ESF. Analytical work has been undertaken on the fragmentation of the local government units and the functional distribution of competencies, but no measure has been adopted. The authorities have decided to condition the reform upon the establishment of an information system that records expenditure of local units by beneficiary, which may prove challenging and thus risks significantly delaying the reform process. New legislation on the public administration, redefining the division of tasks between the central and local state administration offices, was due to be adopted in December 2016, but is still under preparation. There is no clear timeframe on the plan to reduce by 20% the more than 1200 local branches of central administration offices. The planned rationalisation of the state agencies system has been put on hold. This includes legislation aimed at regulating their establishment and introducing a higher degree of homogeneity across the system, as well as merging the existing agencies. The forthcoming local elections of May 2017 are likely to delay further the policy action in this area.

Most NRP commitments aimed at improving the business environment are maintained, but policy action has largely been delayed. The draft Action Plan for administrative burden reduction has been completed and endorsed by stakeholders. Its implementation is scheduled for 2017 and should result in administrative burden savings worth 0.4% of GDP. The measurement of administrative burden on the basis of the Standard Cost Model (SCM) methodology has been performed in eight areas so far and is planned to cover all economically relevant regulation in 2017. As regards services and regulated professions, new legislation opening up regulation of tax advisers' and auditors' activities was drafted by the previous government, while restrictions in legal services have not yet been addressed. The introduction of e-procedures for online registration of companies and the obtaining of necessary documentation for service providers has been heavily delayed, with many legislative amendments still needed as a prerequisite for the implementation of the technical solutions. The government adopted a decision in July 2016 to abolish 13 and reduce 11 parafiscal charges in 2016-2017, in total amounting to HRK 250m, 25% less than the NRP commitment. Until now, 5 charges were abolished and 5 were reduced (in total amounting to HRK 130m) and amendments needed to abolish or reduce 4 more charges have been prepared.

The creation of a new dedicated Ministry can potentially improve the management of state assets. The new status of the central office for state assets management (SDUUDI) as a Ministry could potentially improve the management of state assets by making it responsible and accountable for political decisions and fostering a more coordinated approach[14]. In the meantime, the number of companies in which the State has a strategic or special interest has decreased, as eight companies have been removed from the list of strategically important companies, paving the way to their privatisation. The stakes in three major companies have been successfully sold to private investors, yielding over 0.2% of GDP in revenues. However, as part of the 2013-2017 Strategy for public assets management, the draft Operational Plan for 2017 seems to lack ambition in achieving the remaining goals of the Strategy, and no concrete future steps in privatisation have been outlined yet. State owned enterprises' (SOE) restructuring and the mobilisation of state assets is one of the main policy goals in the new government agenda, but it has not yet been spelled out in detail. A government Decision on the sale of state-owned apartments is under preparation, enabling sales of almost 4000 properties.

Little advances have been recorded in improving governance in state-owned enterprises. While there has been some improvement with regards to transparency in Boards' nominations in the SOE sector, the planned adoption of a Decision on Board members' remuneration and of a new Corporate Governance Code, intended to introduce more rigorous standards in the governance of SOEs, has not taken place. The Decision on the selection processes of Board members (adopted in 2015) was revised in the first half of 2016 to make the mandatory participation of professional recruitment agencies optional, allegedly for cost-saving purposes of smaller SOEs. With a view to improving medium term planning, the authorities are launching a project to improve target setting in SOEs and the monitoring of SOEs performance against the targets.

No measures have been put in place to improve governance and the regulatory framework in the Croatian Bank for Reconstruction and Development (HBOR), but the asset quality review (AQR) is advancing according to plans. The methodology for the

[14] The new ministry will take over the management of major state owned enterprises that were until now dispersed among different line ministries.

AQR has been developed by the Croatian National Bank, tailored to the characteristics of a promotional bank. The AQR is envisaged for the second quarter of 2017 by external auditors for which a public tender has not been launched yet. It will be performed on the basis of end-2016 data. The results and final reporting are announced for the second half of 2017, and the authorities plan to use the findings as basis for deciding on possible changes to the regulatory framework and governance structures of HBOR.

Improving the efficiency and quality of the justice system remains a challenge, despite some positive developments in reducing backlogs. While the pending civil, commercial, enforcement and administrative cases at first instance courts decreased by 7% (compared to end 2015), the backlog of criminal cases increased. Proceedings at first instance courts remain long, with civil cases and commercial cases taking 877 and 712 days, respectively, and first instance criminal cases taking 498 days (at Municipal Courts) and 1158 days (at County Courts), on average. Regarding the quality of the justice system, there have not been significant developments, but improvements are planned for 2017. The electronic filing and delivery of court documents, which could bring significant savings and would reduce the workload of court staff, is still lacking in insolvency cases (for the payment agency FINA), enforcement cases (for public notaries), administrative cases (for the tax authority), and civil and commercial cases (for lawyers). By contrast, the High Commercial Court has successfully joined the ICT case-management system, with the Supreme Court remaining the only outstanding court to be included in 2017.

Absorption of EU funds is hindered by limited administrative capacity and insufficient number of ready-to-implement projects. In view of the large envelope of European Structural and Investment Funds (over EUR10.6bn in the period 2014-2020) allocated to Croatia, further efforts are needed to improve the delivery capacity of the funded programmes. The main delaying factors are a limited number of ready-to-implement projects, the limited administrative capacity in the ESIF Ministries and agencies, and burdensome administrative procedures. In June 2016 the Government adopted a priority action plan for increasing funds absorption for the 2016-18 period, and the provision of training programmes for coordinators has improved.

Overall, major gaps remain in the efforts to improve competitiveness and the business environment. Reform measures in the area of public administration and the business environment have been largely delayed, while there has been some improvement in the management of public assets and the judiciary system.

3.4 The financial sector and its capacity to support economic recovery

This section describes measures to enhance the non-performing loans resolution, to maintain financial stability and to improve access to finance.

The quality of banks' assets has been improving. According to the national definition, the share of non-performing loans (NPLs) to gross loans stood at just below 15% in June 2016, the lowest level since 2013. While the improved economic conditions are facilitating the recovery of some non-performing placements and reducing the net flow of new NPLs, preliminary analysis shows that NPLs sales have been the principal driver of the reduction in the existing stock of NPLs. Most of the sold NPLs relate to the loans to non-financial corporations. Nevertheless, this loans' portfolio continues having the largest NPL rate (30% in June 2016, or 66% of Total NPLs*)*. The proposed tax reform includes provisions on the tax treatment of the write off of NPLs, aimed at helping banks to clean up their balance sheets. The assessment of the tax reform in the forthcoming 2017 country report will examine these provisions.

A monitoring system of the impact of the reformed corporate and personal insolvency framework is not yet in place. The available evidence on the effectiveness of the amended legislation provides a mixed picture. Despite a large influx of insolvency cases for companies, the average length of insolvency cases decreased markedly. At the same time, the number of pre-insolvency cases decreased in 2016. As regards the new personal insolvency framework, in force since 1 January 2016, only few cases have reached the Municipal Courts in 2016. There is a need for continued training of judges and restructuring/insolvency practitioners in order to achieve an effective implementation of the recent insolvency reform.

The conversion of CHF loans into EUR loans resulted in severe losses for the banking sector, but bank profitability is now improving and the sector remains highly capitalised. The conversion that took place predominantly in the first half of 2016 allowed CHF borrowers to convert their loans into EUR at historical currency and interest rates. The Commission initiated a procedure for possible infringement of the freedom of movement of capital and freedom of establishment as regards the conversion legislation. The conversion may have created a significant contingent liability for the public finances, as some of the banks which suffered the highest losses related to the conversion are launching legal proceedings on the international courts, with uncertain outcome.

The independence of the central bank is potentially challenged by pending amendments to the Central Bank Act. The draft act amending the Law on the Croatian National Bank is currently in the parliamentary voting process. The ECB issued two opinions on the draft act[15], expressing concerns regarding the remit of the State Audit Office's increased audit powers in relation to the CNB, the Parliament's right to vote on the CNB's semi-annual information, also including the level of price stability achieved and monetary policy implementation and the CNB's annual report. Finally, it also expresses its view on the reduction of the permissible number of terms of office of the Governor and the other members of CNB's Council. It is not clear to what extent the concerns raised by the ECB will be taken into account.

Access to bank loans for SMEs is gradually improving but financing sources other than bank lending remain largely untapped. The latest Survey on the Access to Finance of Enterprises (SAFE) indicates that in comparison to other Member States, access to finance remains a problem for Croatian SMEs. However, bank lending seems to have increased and a set of new financial instruments supported through the European Regional Development Fund (ERDF) and the European Social Fund (ESF) has potential to increase the SME's access to finance. Some measures have been put in place to improve SMEs' access to alternative funding sources, such as venture capital and crowd-funding, which are poorly developed for the time being. One such measure is the loan of EUR 20 million from the World Bank to Croatia, managed by the Croatian Agency for SMEs, Innovation and Investments (HAMAG-BICRO). The loan will be used over a five-year period (2016–2021) to set up a venture capital fund and a seed co-investment fund in order to strengthen risk capital financing for innovative SMEs and start-ups (IBRD, 2015).

[15] https://www.ecb.europa.eu/ecb/legal/pdf/en_con_2016_52_en.pdf
https://www.ecb.europa.eu/ecb/legal/pdf/en_con_2016_33_f_sign.pdf

Overall, the financial system's profitability has recovered after the one-off CHF loans conversion, and non-performing loans have been steadily decreasing. The access to finance for SMEs has improved. Certain developments require monitoring, namely the adoption of the draft Central Bank Act which could bring CNB's independence into question.

4 Annex 1: Overview table of MIP-relevant reforms

MIP objective: Ensuring stable public finances			
Public finances and taxation			
Fiscal policy and fiscal governance			
Announced measures	*Adopted measures*	*Implemented measures*	*Sources of commitment*
By end-2016: Adoption of the Strategy for Public Debt Management 2016-2018; Strengthening the capacity of the Public Debt Management Function; Hiring Freeze in Public Administration and Public Services; Budget Act; Adoption of the Fiscal Responsibility Act; Amendments to the State Audit Office Act		**July 206**: Hiring Freeze in Public Administration and Public Services	CSR (1) - 2016: "…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. […] Reinforce the framework for public debt management. Adopt and start implementing a debt management strategy for 2016-2018."
Broaden tax bases			
Announced measures	*Adopted measures*	*Implemented measures*	*Sources of commitment*
By end-2016: Action Plan for the introduction of a real property tax;	**November 2016:** Government Adoption of the Tax Reform,	Completion of the registration of LGUs real property and database on	CSR (1) - 2016: "…By the end of 2016, start a reform of recurrent

Completion of registration of LGUs real property and database on payers of municipal fees **By end-2017:** Adoption of the Regulation on Mass Assessment of Property Values	including first steps for introduction of real property tax	payers of municipal fees	taxation of immovable property..."
Long term sustainability of public finances, including pensions and healthcare			
Announced measures	*Adopted measures*	*Implemented measures*	*Sources of commitment*
<u>Pensions</u> **By December 2016:** Amendments to the Pension Insurance Act; Amendments to the Act on Extended Duration of Pensionable Service; Amendments to the Act on Single Expertise Body; Amendments to the Civil Servants Act in terms of requirements for retirement; Amendments to the Act on Vocational Rehabilitation and Employment of Disabled Persons <u>Healthcare</u> **By December 2016:** Reform of supplementary health insurance and patient participation costs; Hospital Network Reorganisation; Reorganization of emergency medical	**June 2016:** (Previous Government)[16] Adoption of Amendments to the Act on Single Expertise Body for the assessment of disability; (Previous Government) Amendments to the Civil Servants Act in terms of requirements for retirement **May 2016:** (Previous Government) Adoption of the new Emergency Medicine Network; Reorganization of outpatient emergency medical services		CSR (2) – 2016: "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." NRP 2016

[16] A number of measures adopted by the previous government were not transmitted to parliament due to the early general elections of September 2016.

services and primary health care; Adoption of the new Emergency Medicine Network			
MIP objective: Labour market, competitiveness, public administration and business environment			
Labour market			
Employment protection legislation & framework for labour contracts			
Announced measures	*Adopted measures*	*Implemented measures*	*Sources of commitment*
By December 2016: New Act on Wages in the Public Sector; Conclusion of the Collective agreement for public servants; Establishment of a central authority for coordination of collective agreements in public administration **By August 2017:** Revised acts regulating the salaries of state employees in LGUs			CSR (3) – 2016: "In consultation with social partners, harmonise the wage-setting frameworks across the public administration and public services."
Social policy, labour market participation, education system			
Announced measures	*Adopted measures*	*Implemented measures*	*Sources of commitment*
Social Policy **By September 2016:** Amendments to			CSR (2) – 2016: "Consolidate social protection benefits, including special

the Social Welfare Act; Action Plan for Consolidation of Social Benefits 2016-2020; Amendments to the Act on Child Allowance; Adoption of standardized means/income test threshold; **May 2017:** Establishment of One Stop Shop Education / Labour participation **By July 2016:** Adoption of new National Curricula and experimental implementation; First set of occupational and qualifications standards; Plan for the Training of Unemployed Persons **By December 2016:** new Adult Education Act; Amendments to the Vocational Education Act; new Programme on Vocational Education and training; Strategic Plan for non-formal and informal learning system	**September 2016:** Programme on Vocational Education and Training **May 2016**: Plan for the Training of Unemployed Persons		schemes, by aligning eligibility criteria and integrating their administration, and focus support on those most in need." CSR (2) – 2016: "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." NRP 2016
Public administration and business environment			
Public administration			
Announced measures	*Adopted measures*	*Implemented measures*	*Sources of commitment*
By May 2016: Action Plan for the development of public administration;			CSR (3) 2016: "By the end of 2016, start reducing fragmentation and

Implementation Plan for the transfer of tasks from central to regional state administration bodies **By December 2016:** Amendments to regulations establishing the agencies and other legal entities with public authority; Regulations on internal organization of central state administration bodies; Decision on the implementation of the LGUs reform			improving the functional distribution of competencies in public administration to improve efficiency and reduce territorial disparities in the delivery of public services."
State-owned enterprises			
Announced measures	*Adopted measures*	*Implemented measures*	*Sources of commitment*
By September 2016: Amendments to the List of Companies and Other Legal Entities of Strategic and Special Interest; Amendments to the Management and Disposition of the Property Owned by Croatia; First-phase development of the information system for state asset management; Privatization Plan of non-strategic companies; Corporate Governance Code; Sale of non-strategic companies (no deadline) **By November 2016**: Developing standardized medium-term business plans for all strategic companies; Adoption of SOE restructuring plans		**2016:** Sale of stakes in non-strategic companies yielding income of 0,2% of GDP **May 2016:** Removal of eight companies from the List of Companies and Other Legal Entities of Strategic and Special Interest **July 2016:** Completion of the first-phase development of information system for state asset management	CSR (3) – 2016: "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."

Business environment			
Announced measures	*Adopted measures*	*Implemented measures*	*Sources of commitment*
By June 2016: Introduction of electronic procedures for registration of business establishment and services market access; Para-fiscal Burden reduction Plan; Expansion of Standard Cost Model measurements for reducing the administrative burden; Implementation of the European Single Procurement Document and e-procurement **By December 2016:** Action Plan for Administrative Burden reduction; Amendments to laws and by-laws regulating the services market of auditors, tax advisers, accountants, lawyers and driving-schools, architects and engineers	**June 2016:** (Previous Government) Adoption of amendments to laws and by-laws regulating the services market. **July 2016:** (Previous Government) Adoption of Para-fiscal Burden reduction Plan with a list of para-fiscal levies to be reduced or eliminated	Entry into force of amendments to regulations governing para-fiscal relief	CSR (4) - 2016: "Significantly reduce parafiscal charges. Remove unjustified regulatory restrictions hampering access to and the practice of regulated professions. Reduce the administrative burden on businesses."
Justice System			
Announced measures	*Adopted measures*	*Implemented measures*	*Sources of commitment*
By July 2016: Amendments on the establishment of the Commission for the promotion of alternative and out of court settlements; Amendments to the Civil Procedure Act; Implementation	**July 2016:** (Previous Government) Decision on promotion of the out of court settlements for civil and commercial cases in which one of the parties is the State		CSR (5) – 2016: Take measures to improve the quality and efficiency of the judicial system in commercial and administrative courts.

of the Electronic Filling System *eSpis*. **By December 2016:** Amendments to the Courts Act; Amendments to the State Judiciary Council Act; Adoption of the Act on the Amendments to the Enforcement Act	**June 2016:** Implementation of the Electronic Filling System *eSpis* in the High Commercial Court		
MIP objective:			
Financial sector			
Banking sector			
Announced measures	*Adopted measures*	*Implemented measures*	*Sources of commitment*
By July 2016: Amendments to the Corporate Income Tax Act enabling tax deductibility of the non-performing loans' write-off	**November 2016:** Government Adoption of the Tax Reform, including new provisions on the tax treatment of the write off of non-performing loans		CSR (5) – 2016: "Facilitate the resolution of non-performing loans, in particular by improving the tax treatment of the resolution of non-performing loans."