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Assessment of the 2014 national reform programme and convergence programme for CROATIA

Accompanying the document

Recommendation for a COUNCIL RECOMMENDATION

on Croatia's 2014 national reform programme and delivering a Council opinion on Croatia's 2014 convergence programme

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EXECUTIVE SUMMARY

Croatia is forecast to experience its sixth consecutive year of recession in 2014. Real GDP is projected to edge down by 0.6 % in 2014, before returning on a positive path in 2015 on the back of a mild recovery in net exports. The unemployment rate is expected to increase further in 2014 and to stabilise at around 18 % in 2015 as the recovery gradually starts to take hold. The employment rate, already one of the lowest in the EU, is set to continue declining. Weak economic activity, which contributed to the slowdown of inflation in 2013, is likely to keep inflationary pressures subdued in the medium term. Fiscal consolidation measures introduced in the context of the Excessive Deficit Procedure are expected to help reverse the negative deficit trajectory but, given subdued nominal growth, are unlikely to stop the increase in the ratio of public debt to GDP by 2015.

The 2014 national reform programme and the 2014 convergence programme are the first programmes Croatia submitted following its accession to the EU in July 2013. Croatia participated in the 2013 European Semester on an informal and voluntary basis and consequently was not issued country-specific recommendations. The 2014 national reform programme describes measures taken in 2013 and outlines measures to be taken in 2014-17 to address the main structural weaknesses of the Croatian economy, which were fully exposed by the protracted recession. Notably, the programme announces measures intended to increase the flexibility of the labour market, simplify the business environment and boost professionalism and client-orientation in public administration.

Promoting competitiveness and job-rich growth, while at the same time reducing fiscal imbalances and managing the corporate debt overhang, are the key economic policy challenges for Croatia. In a context of favourable external developments, growth in the decade before the global financial crisis was sustained by sizeable accumulation of debt on the part of businesses and large capital inflows in the least productive sectors of the economy. Weak productivity growth resulted in substantial competitiveness losses and gradually eroding export market shares. A range of challenges in the labour market and in the wider business environment and substantial delays in restructuring large, non-viable industrial sectors, in particular shipbuilding, have amplified the impact of the crisis and hindered the recovery, with considerable social consequences. Loose fiscal policies in the downturn and rising public indebtedness have substantially reduced the room for fiscal policy and have created an additional burden for the economy. The range and ambition of the measures presented in the national reform programme and the convergence programme echo these challenges. To this end, addressing the most pressing challenges for the country requires reforms in the following areas:

- **Reviving growth and competitiveness:** Croatian companies operate in an environment that is not conducive to improving productivity and fostering investment. The high administrative and regulatory burden and lengthy proceedings, numerous para-fiscal charges, weak protection of investments and policy uncertainty combine to create a substantial drag on businesses. Significant dependence on public subsidies, the presence of financially weak and poorly accountable state-owned enterprises across many sectors and relatively weak corruption prevention mechanisms create an uneven level-playing field for private investors.

- **Unlocking the potential of the labour market and fighting poverty:** Croatia has one of the lowest employment rates in the EU and unemployment, including youth unemployment, has risen to new heights since the onset of the recession. Job creation is hindered by various factors including labour regulation, high average labour costs compared to peers and limited alignment between policies, notably those affecting net labour income and social benefits. These in some cases prevent re-activation of inactive and unemployed persons and contribute to a high incidence of undeclared work. In addition, numerous pathways facilitating an early exit from the labour market cement the low participation rates of prime-age workers. The adverse economic and labour market trends are reflected in a significantly higher proportion of persons at risk of poverty and social exclusion than in the EU generally, and in the increasing incidence of poverty. The social protection system is fragmented and programmes are often poorly targeted, with the result that the provision of benefits is not always levelled to those most in need.

- **Improving public administration and the justice system**: Public administration across different levels of government suffers from weak coordination and limited capacity, which affects policy formulation and slows down implementation of reforms. These concerns are a clear challenge especially in view of ensuring strategic programming and effective management of EU Structural and Investment Funds. Inefficiencies in public administration also impose a high burden on entrepreneurs. Companies continue to face difficulties with insolvency procedures, contract enforcement and the length of judicial proceedings, which impinges on the protection of investors' rights and delays corporate deleveraging.

- **Addressing fiscal imbalances:** The deficit in 2013 remained high, because of slippages on the expenditure side and revenue shortfalls, in a context of overly optimistic budgetary assumptions and a weak fiscal framework. The public pension and healthcare systems show important weaknesses that limit their effectiveness and control over public expenditure in these areas is not achieved. Persistent budget deficits have contributed to a significant increase in government debt in recent years and have become a major policy challenge.

- **Monitoring the quality of banks' portfolios:** Macro-prudential measures of the Croatian National Bank put in place to limit the rapid growth in private indebtedness helped to build resilience in the banking sector. However, given the protracted weakness in the economy, banks' non-performing loans to corporates have risen sharply. The asset quality of the parent banks of the four largest Croatian subsidiaries is being assessed in the comprehensive assessment exercise performed by the European Central Bank, but the exercise might not be fully revealing for the Croatian exposures. This provides an opportunity for the Croatian National Bank to exploit the synergies of a defined methodological framework and take additional diagnostic actions that could provide more information on Croatian banks' balance sheets, including those of the mid-sized and smaller banks.

1. INTRODUCTION

Croatia joined the EU on 1 July 2013 and is participating in the European Semester on a formal basis for the first time.[1] This staff working document assesses policy measures in light of the findings of the Commission's Annual Growth Survey (AGS) 2014[2] and the third annual Alert Mechanism Report (AMR)[3], which were published in November 2013. The AGS sets out the Commission's proposals for building the necessary common understanding about the priorities for action at national and EU level in 2014. It identifies five priorities to guide Member States to renewed growth: pursuing differentiated, growth-friendly fiscal consolidation; restoring normal lending to the economy; promoting growth and competitiveness for today and tomorrow; tackling unemployment and the social consequences of the crisis; and modernising public administration. The AMR serves as an initial screening device to determine whether macroeconomic imbalances exist or risk emerging in Member States. The AMR found positive signs that macroeconomic imbalances in Europe are being corrected. To ensure that a complete and durable rebalancing is achieved, Croatia and 15 other Member States were selected for a review of developments in the accumulation and unwinding of imbalances. These in-depth reviews were published on 5 March 2014 along with a Commission Communication.[4]

Against the background of the 2013 Council Recommendations, the AGS and the AMR, and the in-depth review, Croatia presented a national reform programme and a convergence programme on 24 April 2014. The information contained in these programmes provides the basis for the assessment made in this staff working document. The convergence programme was drafted by the Ministry of Finance in cooperation with the Croatian National Bank and the national reform programme was prepared by the Working Group for the Coordination of Participation of Croatia in the European Semester and its Operative Team, under constrained resources. The key reform measures included in the programmes were consulted with social partners and the public.

Regarding content and quality, the 2014 national reform programme presents a succinct, yet detailed description of measures taken in 2013 and outlines measures that are to be implemented in 2014-17. Reform priorities are grouped in four key areas: public finances (e.g. reforming the fiscal framework, restructuring state-owned enterprises), the financial sector (supervision activities), labour market (e.g. increasing its flexibility, improving public employment services) and competitiveness (e.g. decreasing the administrative burden on businesses). These priorities echo the main challenges identified in the in-depth review on Croatia and this staff working document. Some of the measures presented in the national reform programme are accompanied by detailed indicators and their targeted values that will facilitate their monitoring in the following years. The priorities presented in the national reform programme and some of the measures described in greater detail signal welcome reform intentions which could help to effectively tackle the challenges faced by Croatia if implemented in a rigorous and timely manner.

[1] Croatia participated in the 2013 European Semester on a voluntary and informal basis by submitting its economic programme to the Commission.

[2] COM(2013) 800 final

[3] COM(2013) 790 final

[4] Aside from the 16 Member States identified in the AMR, Ireland was also covered by an in-depth review, following the conclusion by the Council that it should be fully integrated into the normal surveillance framework after the successful completion of its financial assistance programme.

2. ECONOMIC SITUATION AND OUTLOOK

Economic situation

Croatia has been mired in recession since 2009. Five years of contraction have reduced Croatia's real GDP by 12 % and only a muted recovery is forecast from 2015. In 2013, the economy contracted by 1 % (after a 1.9 % decline in 2012) as a result of falling household consumption and investment activity. As exports fell slightly more than imports, the contribution to growth of net exports is slightly negative. Government consumption growth remained very modest after three years of decline. In the absence of demand-side pressures, consumer inflation moderated to 2.3 % in 2013 from 3.4 % a year earlier.

The protracted recession has hit the labour market. The unemployment rate kept growing at a high pace in 2013, adding 1.3 percentage points on the year to 17.2 %, a twofold increase since 2008. The economic crisis has particularly affected young people and low-skilled workers. Youth unemployment (in the 19-24 age group) soared to 50 % in 2013.

Economic outlook

According to the Commission spring 2014 forecast, the Croatian economy is expected to remain in recession in 2014 with real GDP declining by 0.6 %. Domestic demand is expected to remain weak and its negative contribution to GDP growth is set to outweigh the positive growth impetus from net exports. Factors holding back a faster recovery in domestic demand include the implementation of fiscal consolidation measures, rising unemployment, on-going household sector deleveraging, muted private investment in the context of constrained demand and an on-going restructuring process related to pre-bankruptcy settlements. A modest recovery in economic activity is projected in 2015 (GDP growth of 0.7 %) that will be driven by net exports. In view of subdued demand, consumer price inflation is expected to ease to 0.8 % in 2014 before edging up slightly in 2015. The deterioration of the labour market is projected to continue in 2014 and come to a halt in 2015 as economic activity starts to recover.

The macroeconomic outlook underlying the convergence programme and the national reform programme is optimistic. Both strategic documents share the same economic outlook. According to the convergence programme, real GDP growth is expected to be 0.0 % and 1.2 % in 2014 and 2015 respectively, compared to -0.6 % and 0.7 % projected in the Commission 2014 spring forecast. The difference between the two forecasts reflects mainly the assessment of domestic demand dynamics: the Croatian government expects a more limited decline of public and private consumption and a rebound of gross fixed capital formation already in 2014, followed by a considerable strengthening in 2015. According to the Commission 2014 spring forecast, the on-going labour market deterioration and the additional fiscal consolidation package would have a more sizable negative impact on household consumption. Furthermore, investment activity is expected to recover at a slower pace than projected by the authorities due to a more gradual pick-up in public investment and the constraints to private investment growth arising from the high corporate debt overhang and still feeble business optimism. The national reform programme does not quantify the macroeconomic impact of structural reforms.

3. CHALLENGES AND ASSESSMENT OF POLICY AGENDA

3.1. Fiscal policy and taxation

Budgetary developments and debt dynamics

The two main objectives of the budgetary strategy as defined in Croatia's 2014 convergence programme are swift fiscal consolidation and setting the economy on a sustainable growth path. Although fiscal consolidation takes place in a context deeply impacted by five years of recession, the authorities consider it necessary to contain the rising public debt and its financing costs. Envisaged fiscal policy measures aim to ensure full compliance with the Council recommendation with a view to bringing an end to the situation of excessive government deficit in Croatia, namely to bring the deficit below 3% of GDP by 2016 and to bring the public debt on a downward trend.

The assessment of budgetary developments in the programme is complicated by the on-going transition in the Ministry of Finance of applying to budgetary data the standards set out in the European System of Accounts (ESA). In October 2013, the Croatian Bureau of Statistics for the first time formally notified to Eurostat fiscal data for the general government compatible with the standards of the European System of National and Regional Accounts (ESA). In April 2014, the second fiscal notification was also validated without reservations by Eurostat. Except for historical data which, following a technical corrigendum to the convergence programme, are consistent with the latest EDP notification, the data reported in the convergence programme do not correspond fully to the ESA standards. For the purposes of budgetary planning, the Ministry of Finance uses a different delineation of the general government, in which some units of the ESA-based general government sector are not included in the budgetary figures (such as Croatian Radio Television and Croatian Railways infrastructure operator) and some other entities that are classified outside the general government sector are included (the State Agency for Deposit Insurance and Bank Rehabilitation). Moreover, certain transactions (e.g. reduction of arrears in the health-care sector) have erroneously been reflected in the deficit reported in the programme.[5] Hence, projections for 2014 and the following years are not compatible with ESA standards, giving rise to inconsistencies with past data. This, on the one hand, constitutes a breach of the Code of Conduct[6] requirement to "ensure the formal and substantial consistency of the required information on budgetary aggregates and economic assumptions with ESA concepts" and, on the other hand, makes comparison with Commission 2014 spring forecast impracticable. Moreover, the convergence programme does not contain a medium-term objective (MTO), except a single reference that the fiscal policy upon the exit from EDP will be based on the new fiscal framework and aimed towards reaching the MTO.[7]

The general government deficit remained broadly unchanged in 2013, reaching 4.9% of GDP, after 5.0% of GDP in 2012. When compared with the planned 2013 general government deficit in last year's economic programme (3.6% of GDP) the outturn in 2013 was 1.3 pp. higher. In 2013, the government revised the budget twice, in April and December, due to higher expenditures relative to the initial plan and some unexpected revenue shortfalls.

[5] Such data issues may be further aggravated by the methodological changes which will ensue with the switch-over from ESA 95 standards to ESA 2010 standards in September 2014.

[6] Specifications on the implementation of the Stability and Growth Pact and Guidelines on the format and content of Stability and Convergence Programmes.

[7] The absence of MTO in the convergence programme is not in line with the Code of Conduct However, setting an MTO was hindered by the fact that problems with the availability and quality of demographic projections prevented the Economic Policy Committee from approving projections for the cost of ageing in Croatia which, in turn, did not allow the Commission to set a minimum MTO.

In particular, corporate income tax receipts were weaker than expected after the introduction of a tax break on reinvested profits. Revenues were also adversely impacted by the change in the VAT collection system, in the context of joining the EU. Meanwhile, total expenditures increased, chiefly due to higher social expenditures, including a 1%-of-GDP clearance of arrears of the health sector and growing interest expenditures. This, together with some methodological issues such as differences in the number of local government units included in the general government budgetary statistics, largely explains the difference to the deficit target of 3.6% of GDP in the economic programme of 2013.

In the convergence programme, the headline deficit is targeted to gradually decline from 4.4% of GDP in 2014 to 3.5%, 2.7% and 2.5% of GDP over 2015 – 2017. The ratio of the (recalculated) structural balance[8] to GDP underlying these headline targets would deteriorate by 0.2 pp. in 2014[9] and improve by 0.9 ppt., 1.3 ppt. and 0.1 ppt. over 2015 – 2017. The headline deficit target for 2014 incorporates the March 2014 budget revision and the additional set of measures that were adopted in April to ensure compliance with the Council EDP recommendation to Croatia (for details see Box 1 and Box 2).

The profile of the general government headline balance in 2014 and 2015 is strongly affected by the transfer of pension assets from the second pillar to the pay-as-you-go scheme. In line with currently prevailing accounting rules, the programme's 2014 and 2015 headline deficit targets include the impact of the two-step transfer of accumulated pension assets from the capitalised second pillar to the central government budget. However, under new national accounting rules that will come into force as of September 2014 (ESA 2010), such asset transfers will no longer be deficit reducing. Excluding the asset transfers, the headline deficit foreseen in the programme would amount to 4½% and 4% of GDP in years 2014 and 2015, respectively[10]. The profile of the general government headline balance in the Commission 2014 spring forecast is also affected by the transfer of pension assets.[11]

A large part of the consolidation measures are taken in 2014. The amount of envisaged measures stands at 2.3% in 2014 and 1.0% of GDP in 2015 and 2016. This profile has to be seen against a gradual turnaround in a persistently high underlying deficit, a positive corollary to a successful fiscal consolidation. As regards the structure of the consolidation package, the bottom-up presentation in the programme indicates broadly equal amount of measures on the expenditure and the revenue side of the budget throughout the programming period. However, despite sizable revenue side measures and, somewhat surprisingly, against the background of the projected reacceleration of GDP, the revenue-to-GDP ratio drops slightly in 2015. The expenditure-to-GDP ratio is targeted to drop by 1.5 pps in 2015 and reach 45.7%, mostly on account of envisaged savings in the health sector. Thereafter, it is expected to keep decreasing in the next two years, and reach 45.2% in 2017. Overall, a decreasing share of social transfers due to the savings in the health and pension system is mostly offset by rising expenditure in co-financing of EU funds-related projects[12].

[8] Cyclically adjusted balance net of one-off and temporary measures recalculated by the Commission services on the basis of the information provided in the programme, using the commonly agreed methodology.

[9] As noted above, the convergence Programme uses different accounting methodologies for past and future years. This artificially and substantially (by at least 0.5% of GDP) reduces the improvement in the (recalculated) structural balance from 2013 to 2014.

[10] These figures also adjust for the healthcare arrears that were erroneously included in the government projections for 2014.

[11] Excluding these the Commission deficit projections for 2014 and 2015 would stand at 4.6% and 3.8% of GDP respectively.

[12]Although grants paid from structural funds are in general channelled through the government budget they represent an expenditure of the EU rather than of the government itself and hence these are filtered out from government accounts. Therefore, payments from EU funds only affect government deficit either when a

Box 1. Main measures from the convergence programme of Croatia

In 2014, the main measures on the revenue side are the increase in social security contributions for health, increase in concession fees (including telecom fees for the usage of RF spectrum), withdrawal of SOEs profit and changes in the lottery and gambling tax. Pension contributions will increase due to a shift in some contributions from the second pillar to the pay-as-you-go public pillar. On the expenditure side, savings are planned in many categories, most importantly subsidies, intermediate consumption and social transfers.

For 2015, on the revenue side the government plans to introduce a new tax on deposit interest and to reduce corporate income tax credits for reinvested earnings. Planned expenditure savings are again piecemeal and across-the-board, with relatively small cuts distributed across many categories. Savings in intermediate consumption depend on the further implementation of common public procurement procedures and the application of more business-type processes in the public sector. Social transfers are expected to decline through the re-negotiation of the contracts with private providers of social security services. Lower compensation of employees hinges on the introduction of a plan on the restructuring of the existing school network.

In 2016, the main measure on the revenue side is the introduction of a real estate tax, which still faces many uncertainties. On the expenditure side, similarly to 2015 relatively small savings are planned across many different categories, most of them subject to implementation risk.

Main budgetary measures

Revenue	**Expenditure**
2014	
• Transfer of accumulated assets from the second pension pillar (+0.8% of GDP)* • Increase of the rate of healthcare contributions from 13% to 15% (+0.5% of GDP) • Increase of telecom fees and other concession fees (+0.16% of GDP) • SOEs dividend and profit withdrawal (+0.15% of GDP) • Increased social security contributions due to the shift of part of the future pension contributions to first pillar (+0.12% of GDP) • Changes in the lottery and gambling taxes (+0.1% of GDP) • Higher fuel excises (+0.1% of GDP)	• Reduction of subsidies, mostly to shipyards and HBOR (-0.33% of GDP) • Lower intermediate consumption due to savings, among other, on maintenance costs, transportation allowances, IT services (-0.2% of GDP) • Savings in social transfers, mostly in health sector (-0.2% of GDP) • Reduction of current transfers, mostly due to replacement with EU funding (-0.14% of GDP) • Lower public investment (-0.1% of GDP) • Net savings on the compensation of employees (-0.03% of GDP)
2015	

government unit is the final recipient of the funds (i.e. it is a revenue for the government) or when government is co-financing the project (i.e. the co-financing is a genuine government expenditure).

• Transfer of accumulated assets from the second pension pillar (+0.6% of GDP)* • Partial reduction of corporate income tax credits for reinvested earnings (+0.15% of GDP) • Introduction of a tax on deposit interest (+0.1% of GDP)	• Lower intermediate consumption due to centralized public procurement for telecom services, fuel and energy; integration/outsourcing of supporting activities in the public sector (-0.14% of GDP) • Savings in transfers to science and higher education institutions and additional savings in the social security system (-0.1% of GDP) • Reduction of subsidies in agriculture (-0.09% of GDP) • Reduction of transfers to higher education sector (-0.09% of GDP) • Savings on compensation of employees due to reorganization of the school network (-0.07% of GDP)
2016	
• Introduction of a real estate property tax (+0.4% of GDP)	• Reduction in social transfers due to further implementation of hospital masterplan and new contracting arrangements in the social security system (-0.16% of GDP) • Reduction of intermediate consumption due to further introduction of centralized public procurement and outsourcing/integration of supporting activites in the public sector (-0.14% of GDP) • Reduction of other transfers obtained through suspension of third (voluntary) pension pillar and housing savings benefits (-0.14% of GDP) • Reduction of subsidies in agriculture (-0.09% of GDP) • Additional savings on compensation of employees due to reorganization of school network (-0.03% of GDP)
Note: The budgetary impact in the table is the impact reported in the programme, i.e. by the national authorities. A positive sign implies that revenue / expenditure increases as a consequence of this measure. * These measures have an impact on revenues under ESA95 but not under ESA2010.	

The consolidation measures are not spelled out in sufficient detail, especially in the later years of the programme, and the quality of the consolidation merits greater attention. Measures on the expenditure side lack sufficient detail, especially in the outer years; moreover they are mainly of temporary character and carry less weight in the consolidation than what would be desirable. A large share of expenditure measures concern cutting capital spending, which may be counterproductive in the longer run. The revenue-increasing measures appear to be of a more permanent nature, but even in this case the information provided is sparse. For example, as regards the real estate tax, no information on tax rates, tax basis and exemptions is provided, which hinders an assessment of the projected yields. In order to reduce the negative impact on growth of the consolidation and ensure a sustainable correction of the excessive deficit, greater attention to the quality of the measures and a transition to expenditure based measures would be warranted. The programme provides estimates of the budgetary impact of most envisaged measures for the period 2014-2016 (see Box 1). Additional measures for 2017 and their estimated impact are not presented. Some additional measures, such as the introduction of a new electronic form for the provision of data to the tax administration, organizational changes in tax administration and customs administration, the introduction of a centralized payroll system for civil servants, are mentioned in the programme but their estimated impact is not presented due to difficulties in the assessment of potential savings. However, as mentioned in the National Reform Programme, the macroeconomic projections incorporate the effect of all measures in the package.

The balance of risks to the programme deficit targets overall is tilted to the negative side. The macroeconomic scenario underlying the convergence programme is overly optimistic; however, revenue projections are slightly inconsistent with the scenario and appear to be prudent. The most substantial risks to the programme targets therefore relate to the implementation of the measures. For 2014, the achievement of the headline target from the programme appears broadly within reach but residual risks persist, related in particular to some savings on subsidies, notably in the shipbuilding sector. Implementation risks widen further towards the end of the programme period, partly due to the piecemeal design of the adjustment package. Estimated expenditure savings depend on a relatively high number of small measures dispersed across many different categories and items, which multiplies the possibility that not all measures are followed through. Implementation risks also apply to some revenue side measures, as specific legislation will need to be adopted and a number of flanking measures will have to be in place. This is the case of the real estate tax, on which relies a large part of the adjustment in 2016. Risks of slippages in healthcare expenditure also may continue to persist, in case of delays of the on-going process of reform and if monitoring and control mechanisms are not strengthened.

Croatia is currently subject to the corrective arm of the Pact. The Council opened the Excessive Deficit Procedure for Croatia on 20 January 2014 and recommended to bring the government deficit down to 4.6% and 3.5% of GDP in 2014 and 2015, and to correct the excessive deficit by 2016 by reaching 2.7% of GDP (see Box 2). Moreover, the EDP recommendation requires Croatia to achieve an improvement in the structural balance of 0.5 pp. of GDP in 2014 and of 0.9 pp. of GDP in 2015, and take measures for an amount of 2.3 pp. of GDP in 2014 and of 1.0 pp. of GDP in 2015, in order to reach the required adjustment of the structural balance. Croatia was given a deadline of 30 April 2014 to take effective action to ensure a sustainable correction of the excessive deficit. Croatia submitted a report on action taken in the context of its convergence programme.

On the basis of the programme and the Commission 2014 spring forecast, the nominal target set in the Council recommendation for 2014 is expected to be reached. The deficit objectives of the Convergence Programme amount to 4.4%, 3.5% and 2.7% of GDP in 2014-16, in line with the recommended levels. The Commission services' baseline scenario does not incorporate the full set of measures in the consolidation package, because of insufficient specification of some of the measures (such as savings on subsidies or social transfers) and of some uncertainties about the accounting treatment of some measures (such as in the case of withdrawal of profits from state-owned enterprises). In the Commission 2014 spring forecast the general government deficit is projected to reach 3.8% of GDP in 2014 and 3.1% of GDP in 2015. If these projections are adjusted to exclude the transfer of pension assets (in line with the statistical rules that will be in effect as of September 2014), they would stand at 4.6% and 3.8% of GDP in 2014 and 2015, respectively. Hence, with this adjustment the nominal target set in the context of the EDP is expected to be attained in 2014, while in 2015 the nominal target would be missed by ¼ pp of GDP.

The change in the structural balance in 2014 is slightly below the recommended effort. The structural balance as recalculated based on the programme deteriorates by 0.2%. of GDP in 2014; however, this is to a large part due to the programme's deviation from the ESA methodology. In 2015, the programme's planned structural improvement of 0.9% of GDP is exactly in line with the EDP recommendation. The structural balance according to the Commission 2014 spring forecast, on the other hand, improves by 0.4% in 2014 and by 0.8% in 2015, with a small shortfall in both years compared to the improvement of 0.5% and 0.9% of GDP required in the EDP recommendation.

The budgetary adjustment envisaged in the programme is underpinned by a large set of measures. The overall size of the package, according to the Croatian authorities, is 2.3% of GDP in 2014 and 1.0% of GDP in 2015, as indicated in the recommendation. Similarly, the bottom-up assessment of the fiscal effort based on the Commission 2014 spring forecast is estimated to be delivered, both in 2014 and 2015, with measures amounting to 2.3% of GDP in 2014, in line with the requirement, and 1.1% of GDP in 2015, slightly above the recommended 1% of GDP. When corrected for the downward revision in potential growth since the January 2014 Council Decision as well as for revenue developments compared to the forecast underlying the Council Decision, the adjusted structural balance would show an improvement in 2014 of 0.2% and an effort of 0.8% for 2015; this would be below the requirement in 2014, but only marginally so in 2015.In the context of the careful analysis it should be considered that all of these measures were adopted after and in response to the January 2014 Council decision on the existence of excessive deficit. Strong commitment to adhere to the Council recommendation is reflected in the fact after it became evident that the revision of the 2014 budget in March 2014 was not sufficient to meet the EDP recommendations the authorities have taken additional measures of 0.4% of GDP.

To conclude, in 2014 the nominal target is expected to be attained and the deviation from the structural improvement requirements is minimal. Moreover, the careful analysis and other qualitative factors point out that the required fiscal effort in 2014 is currently expected to be delivered. However, considering that in 2015, and prior to the presentation of the 2015 budget, the Commission services expect the headline balance and the structural improvement to be below the targets recommended by the Council, the 2015 budget needs to include structural adjustment measures to ensure compliance with the Council recommendation.

Box 2. Excessive deficit procedure for Croatia

Croatia is currently subject to the corrective arm of the Pact. The Council opened an Excessive Deficit Procedure for Croatia because of non-fulfillement of both the deficit and the debt criteria on 28 January 2014. Croatia was given a deadline of 30 April 2014 to take effective action to ensure a sustainable correction of the excessive deficit by 2016 while at the same time ensuring that the government gross debt ratio will approach the 60% of GDP reference value at a satisfactory pace. To this end, Croatia was invited to reach a headline general government deficit target of 4.6 % of GDP for 2014, 3.5 % of GDP in 2015 and 2.7 % of GDP in 2016, which is consistent with an annual improvement in the structural balance of 0.5 % of GDP in 2014, 0.9 % of GDP in 2015 and 0.7 % of GDP in 2016. Also, Croatia should specify and rigorously implement the measures that are necessary to achieve the correction of its excessive deficit by 2016, use any windfall gains for deficit reduction and report in detail on the consolidation strategy that it envisages in order to achieve the targets; thereafter the Croatian authorities should report on progress made in the implementation of recommendations at least every six months until the excessive deficit has been fully corrected..

Furthermore, the Council invites the Croatian authorities to:

(i) carry out a thorough expenditure review with the objective of rationalising wage, social security and subsidy outlays and to provide sufficient fiscal space for the implementation of growth-enhancing expenditure, including co-financing of projects funded by the Union;

(ii) further improve tax compliance and increase the efficiency of its tax administration, and

(iii) improve the institutional framework of public finances, including by enhancing multi-annual budgetary programming, by strengthening the role and independence of the Fiscal Policy Committee, and by ensuring compliance with fiscal rules.

In addition, the Council invites the Croatian authorities to implement structural reforms, in particular as regards addressing labour market rigidities and an unfavourable business environment and improving the quality of public administration, with a view to promoting potential GDP growth.

An overview of the current state of excessive deficit procedures is available on: http://ec.europa.eu/economy_finance/economic_governance/sgp/deficit/index_en.htm.

Uncertainty towards the end of the programme period emphasises the importance of a more decisive and clearer budgetary consolidation strategy. Although in the short term revenue based measures are unavoidable and warranted, when they aim to broaden the tax base and redistribute the tax burden, excessive reliance on the increase in revenues in a will eventually become counterproductive. Moreover, reliance on tax increases cannot indefinitely postpone the need to decisively tackle expenditure dynamics. Against this background and in line with the need for additional consolidation efforts towards the end of the EDP deadline additional structural expenditure cuts would have to be considered. A comprehensive expenditure review could identify the additional sources of savings, reduce inefficiencies, lead to a more targeted cost reduction and reallocate spending to areas with greater growth potential.

The projected stabilisation of general government gross debt at around 71% of GDP is not substantiated by the programme. Debt is projected to decrease to 71.0% of GDP in 2015 from 71.7% in 2014 and then to increase marginally to 71.2% at the end of the programme period. The discussion of public debt developments in the convergence programme is very limited. Discrepancy between projected deficit levels and ensuing debt levels is explained by huge and largely unexplained negative stock-flow adjustments throughout the programme period. The only explanation provided in the programme for the stable public debt ratio is the positive effect of the fiscal consolidation measures which is "expected to stabilize the debt ratio at the level of 71.2% of GDP by the end of the programme period."

Risks to the debt-to-GDP ratio are tilted to the upside. These risks arise from the factors listed in relation to the deficit targets and from possible additional financial transactions. Possible slippages in the privatisation proceeds, planned in the convergence programme in the amount of 0.5% of GDP on average in the period 2014-2017, constitute another negative risk.

Fiscal framework

Croatia's fiscal framework continues to exhibit weaknesses despite significant reforms implemented in recent years. In the run-up to EU accession, Croatia adopted the Budget Act in 2009 and the Fiscal Responsibility Law in 2011. The latter was amended in January 2014 with the aim of transposing Council Directive 2011/85/EU on requirements for budgetary frameworks of the Member States. A Fiscal Policy Committee, Croatia's fiscal council, was established in 2011. Despite these reforms, budgetary planning and consistent application of fiscal rules remain challenging, with a negative impact on fiscal policymaking. The legislative timeline for the preparation of the budget is not being respected.

There have been repeated discrepancies between macroeconomic and budgetary variables and actual outcomes. Official macroeconomic forecasts by the Ministry of Finance tend to be overoptimistic, impairing budgetary planning. This leads to frequent budgetary revisions[13] and affects the credibility of the fiscal policies conducted by the authorities. Discrepancies – sometimes significant- are common between the Guidelines for Economic and Fiscal Policy, a three-year document that serves as the basis for annual budgetary planning, and the draft budgets. Recurrent changes to the budgetary projections that extend beyond the annual horizon undermine the credibility of the Guidelines as a basis for medium-term budgetary planning. Some improvements, in line with the Council Directive, have been implemented but some gaps remain, notably in terms of addressing the observed forecast bias and publishing alternative fiscal scenarios (e.g. the unchanged policies baseline).

Despite progress with numerical fiscal rules that was made with recent legislative amendments, there is scope for further improvement. The structural balanced budget rule introduced in January 2014 establishes the need for the structural balance to respect the medium-term objective and follow the convergence path towards it. However, preliminary assessment of the amended law raises two concerns. First, the medium-term objective as defined in the law (a structural balance that ensures that the general budget deficit is not higher than 3% of GDP and that the debt-to-GDP ratio does not exceed 60 %) does not necessarily coincide with the one used at EU level. Secondly, escape clauses can be triggered in cases where the annual growth rate of real GDP is 'significantly below' the potential GDP growth. However, the law does not define what level may be considered as significantly below, which might lead to excessive use of escape clauses. This risk will be to some extent mitigated by the required assessment for the occurrence of such clauses by the fiscal policy body.

The efficiency of the debt rule that was introduced with the 2009 Budget Act is undermined by the absence of preventive mechanisms and a track record of weak compliance. The rule stipulates that the central government debt-to-GDP ratio can exceed the previous year's ratio only if the latter did not exceed 60 % of GDP. The debt ceiling was raised to 62 % with the 2014 budget. The transparency and credibility of the rule could be improved by extending the scope of its application to include the general government rather

[13] For example, the 2013 budget was revised twice in the course of the year.

than the central government and elaborating preventive mechanisms that should apply earlier in the process to avoid breaching the numerical limit. Furthermore, the credibility of this fiscal policy anchor is undermined by the lack of information on the monitoring process and the absence of corrective mechanisms in case of non-compliance.

In early 2014, a Fiscal Policy Commission was established to replace the previously existing Fiscal Policy Committee that was chaired by the Minister of Finance. The power of appointment of the Commission members was transferred from the government to the Croatian Parliament. The Commission chair is the head of the Finance and State Budget Committee: the other six members of the body, all of whom have a five-year mandate and should not be politically affiliated, are experts from the National Bank of Croatia, the State Audit Office, research institutes and academia. While these are useful steps, the Fiscal Policy Commission still lacks a strong legal grounding: it was established only by a Parliamentary Decision. Its independence from the national budgetary authority is open to question as it is headed by a Member of Parliament. Furthermore, the mandate of the Commission is not sufficiently specific in particular regarding the *ex ante* and *ex post* assessment of macroeconomic and budgetary forecasts. The Commission's work would also benefit from enshrining in law adequate resourcing and timely access to data requirements.

Pensions

There is still scope to improve the sustainability and adequacy of the pension system. The pension system remains fragmented into a high number of special pension schemes which increases its cost, gives rise to unequal treatment and facilitates early exit from the labour market. Pensions under special schemes[14] accounted for 15 % of beneficiaries and 19 % of all pension expenditures. The inequalities between pensions paid under different pillars gives rise to non-systemic policy reversals such as the 2014 transfer of funds from the second pillar to the first pillar for military personnel, police and some other categories of public servants. In 2013, standard disability pensions accounted for more than 25 % of overall pension expenditure (one of the largest shares in the EU), suggesting that eligibility criteria for disability pensions are too generous.

Current plans for increasing the statutory retirement age do not seem sufficiently ambitious. Since November 2010, the statutory retirement age, the early retirement age and the qualifying period for women have all been gradually increasing and are set to be fully harmonised by 2030. The current statutory retirement age is 65 years for men and 61 years for women. Amendments to the Pension Insurance Act adopted in December 2013 further raise the statutory retirement age from 65 to 67 and the early retirement age from 60 to 62. This is a step in the right direction but as the increase will be implemented only as of 2031, the ambition of the measure is low. The retirement age has not yet been linked to life expectancy.

Various avenues for early retirement remain open, contributing to the low labour market participation. Despite reforms implemented over recent years, various possibilities for early retirement still exist and new ones have recently been introduced. With the 2013 reform, the government introduced two institutes for early retirement without penalisation – one applying to people with more than 41 years of service and 60 years of age, and another concerning people who have been registered as unemployed for a minimum of two years following insolvency of their employer (subject to meeting minimum requirements on age and years of service). Considering the extent of exemptions, existing penalties for early retirement and the late retirement bonus offer little incentive to work until or even beyond the statutory retirement age. The early retirement gap of five years remains wide compared with the EU average, decreasing labour supply and the sustainability of the pension system.

[14] This refers to pensioners who have a legal entitlement to receive pensions under privileged conditions based on their status, such as homeland war veterans.

In the absence of long-term projections of ageing-related expenditure based on the common macroeconomic assumptions and validated by the EU's Economic and Financial Committee, it is not possible to assess the impact of population ageing in Croatia on a basis comparable with the other Member States. The country will be a part of the regular Ageing Report on long-term economic and budgetary projections from 2015 onwards. However, taking into account the age structure of the population and the low ratio of workers to pensioners, it can be expected that the long-term budgetary impact of ageing will be above the EU average. Improving the structural budgetary position over the medium term would thus contribute to containing risks to the sustainability of public finances. Croatia also faces serious problems regarding current and future pension adequacy, as the already low aggregate replacement ratio continues to decrease (0.36 as compared with 0.54 in the EU-28 in 2012). In combination with short working lives, in particular for women, this constitutes a severe risk of poverty in old age.

The Act on the Single Forensic Expertise Body was adopted in 2013 to help limit the inflow of disability pensioners and reduce fraud by unifying disability assessments. Obligatory checks of both new and existing claims have now been introduced with the new Pension Insurance Act, including the possibility of *ad hoc* examinations. Stricter controls in 2013 resulted in a decrease on disability pensioners by 4.6 %. The likely positive effect of these measures on expenditure will depend on their rigorous enforcement.

Pensions from special schemes above a certain threshold were cut by 10 % as of 2014, albeit on a temporary basis, while their indexation has been tied to a GDP trigger.[15] Despite recent attempts to curb expenditure and increase transparency, the pace of convergence of special pension schemes towards general rules is still limited. A separation of standard pension entitlements from pensions paid under special arrangements is under way. This could help elucidate the actual costs of the special regimes and improve the targeting of future policy measures, including differentiated indexation. Once the indexation freeze for special schemes is revoked, their indexation is set to mimic the generous formula for regular pensions, thus further slowing their convergence.

Limited progress has been made on ensuring the adequacy of pensions. The amended Pension Insurance Act introduces a more favourable indexation formula for old-age pensions and adjusts the basic pension formula. On the other hand, the previously announced increase in contribution rates to the second pillar has been postponed. The proposal for social pensions for those not receiving another form of pension or basic social assistance seems to have been abandoned. The national reform programme informs about plans to extend the current pension supplement paid to pensioners who do not participate in the second pillar. While this measure would help increase adequacy of pensions, it would also impose significant costs on the state budget and needs therefore to be carefully considered in the context of the sustainability of public finances. Overall, by simultaneously implementing the adopted measures and seeking to prolong working lives, the high and increasing risk of old-age poverty is being addressed to some extent.

Health care

The health sector achieves reasonably good health outcomes and, with some regional variation, services are accessible, but the system contributes significantly to pressure on the public finances. While public expenditure on health (6.6 % of GDP in 2011) is below the EU average (7.8 %), it is higher than in most central and eastern European Member States,

[15] The reduction is automatically revoked once real GDP growth exceeds 2% during three consecutive quarters compared with the same quarter in the previous year, and the budget deficit is below 3%. The cut does not apply to war veterans with 100% disability or to surviving children of war veterans. Indexation has been put on hold until the same conditions are met.

continuously generates arrears, and accounts for a large proportion of public expenditure[16]. The absence of comparable long-term projections hinders a precise assessment of the impact of population ageing on healthcare expenditure. However, the current (public) expenditure on healthcare, the age structure of the population and non-demographic drivers point to a substantial long-term budgetary impact of increasing healthcare expenditure. Funding of health expenditure relies largely on health insurance contributions. Private co-payments on health expenditure are in place. Co-payments cover a small proportion of health expenditure and their primary purpose is to address the moral hazard and tendency towards over-consumption that arise within insurance-based systems. However, Croatia's supplemental insurance system fully covers these co-payments, effectively exempting large numbers of patients from co-payments and cancelling-out the system's intended behavioural incentives. Furthermore, over a third of those benefitting from supplemental insurance receive it for free, with the financing coming straight from the state budget. This system brings additional administrative costs and complexities and introduces an adverse selection problem, attracting the patients with the highest healthcare costs, which could jeopardise the system's ability to break even over time. The existing coverage of co-payments by supplemental insurance is incompatible with achieving the co-payments system's objectives. The underlying co-payments system, which has financial effects on only a minority of patients, may also discourage use of and limit access to preventive and chronic care so there is room for better targeting of the instrument.

The national reform programme identifies remediable inefficiencies in the hospital network. There is scope to achieve savings through reorganisation of the services provided by hospitals, better allocation of hospital beds, reducing the high share of administrative staff and catching up with trends on the provision of ambulatory care, while nevertheless ensuring broad access to high quality care. The Croatian Health Insurance system seems to have inadequate capacity and responsibilities to ensure efficient use of funds. In 2013, the government cleared the accumulated arrears of hospitals and the Croatian Health Insurance Fund. The arrears had stood at close to 1 % of GDP but they may re-emerge in 2014 given the underlying trends and the track record of budgetary projections and budgetary control throughout the health system. As regards long-term care, services are dispersed between the health and the social welfare systems, with low coverage rates of formal care associated with a high degree of family care which is mainly provided by female relatives, [17] which alongside childcare responsibilities, may constrain female labour supply. In many cases, formal care is provided at high cost and the pressure on institutional forms of care is constant with long waiting lists, even in cases when social services would satisfy user needs better than medical services, while community based services or formal home care services are in scarce supply.[18]

In line with the 2012 National Healthcare Strategy and earlier policy initiatives, the government has taken a number of useful steps to improve the efficiency of the system. As recalled in the national reform programme, notable reform measures in recent years include the partial centralisation of procurement for hospitals, the reduction of approved prices for pharmaceuticals and medical devices, principally through the introduction of generics, reorganisation of emergency medical services, the introduction of e-health in primary healthcare, a new model of referrals to specialist examinations and hospital treatment and the final roll-out of diagnosis-related groups in hospital care. There is, however, a lack of

[16] There are potential data comparability issues, to the extent that cash entitlements such as maternity pay are channelled through the health insurance fund and captured within public health expenditure totals.

[17] The scale of family care in Croatia is above the EU27 average, with, notably, 24 % of female respondents and 13 % of male respondents in the 50-64 age group involved in elderly care. These are the third highest rates in Europe, after Italy and Estonia (Eurofound, 2010, available at: http://www.eurofound.europa.eu/pubdocs/2010/02/en/1/EF1002EN.pdf).

[18] The World Bank (2012) Croatia Policy Notes

systematic evaluation of the impacts of these reforms. In March 2014, the Ministry of Health presented a master plan for the reorganisation of hospital care, which seeks to address many of the limitations identified above. In particular, it outlines plans for a changeover of some hospitals into rehabilitation centres, reduction of the average length of hospital stays, and further changes in hospital financing. The plan could help improve the cost-effectiveness of the healthcare sector and contribute to containing risks to the sustainability of public finances in the medium term. As presented, the plan is ambitious and complex and would therefore require strict monitoring and implementation capacity in both hospitals and central government.

Tax system

To pursue fiscal consolidation, Croatia faces the challenges of increasing revenues without impairing growth prospects, by broadening tax bases, shifting the tax burden towards immobile assets such as real estate and further improving tax compliance. The overall tax burden in Croatia is lower than the EU average[19] and some scope for improving tax efficiency and broadening the tax base does exist. The tax structure is heavily skewed towards consumption, whereas receipts from labour and, in particular capital, are well below the EU average.[20] The relatively low proportion of taxes on labour is not fully consistent with the statutory tax rates applicable in the Croatian economy. While tax exemptions and reliefs may partly explain the relatively low revenue from taxes, under-reporting of earnings and profits and undeclared work are also likely to play a role. There is also scope for efficiency gains in corporate income taxation, in particular for streamlining tax expenditures.

The previous shift of taxation away from labour was reversed in 2014. In April, the authorities revoked the reduction by two percentage points of the contribution rate for health insurance, which had been introduced in 2012 with the aim of alleviating the tax burden on employers. In addition, from 2014 indirect taxes were further increased: the reduced VAT rate was hiked by three percentage points to 13 %, excises on energy products and tobacco were raised and the base on the tax on lotteries was broadened. A tax break on reinvested earnings introduced in 2013, although decreasing the effective tax rate, has contributed to some loss in budget revenues by narrowing the tax base. According to the national reform programme, the tax break will be modified in the course of 2014 with the objective to better contribute to encouraging investment activity, while reducing its negative revenue impact.

Recourse to less distortionary taxes, such as a recurrent property tax, is not sufficiently exploited and the base of the personal income tax can be broadened to tax additional sources of capital income.[21] Receipts from property taxes, which offer a stable tax yield and are considered to have little distortionary impact on growth, currently amount to only 0.3 % of GDP in Croatia - the lowest ratio in the EU.[22] As announced in the national reform programme, Croatia plans to introduce an ad valorem property tax from 2016 but its operational design, including that of the tax base, is yet to be specified. Furthermore, the authorities plan to broaden the tax base of the personal income tax to cover interest on savings. If implemented, and accompanied by a comparable decrease of taxation of labour,

[19] The tax-to-GDP ratio in Croatia was 35.7 % of GDP in 2012, compared with 39.4 % in the EU.

[20] Taxes on consumption account for 17.5 % of GDP, ranking Croatia first in the EU. Taxes on labour account for 14.5 % of GDP (EU average 19.7 %), while taxes on capital represent 3.7 % of GDP (8.2 %). Given the extent of unemployment and inactivity, the scope for increased taxes on labour appears limited in the short term.

[21] Croatia did take some steps to broaden the tax base of both personal and corporate income taxes. In particular, in January 2014 incentives for regions under special government protection and for hilly areas were replaced by incentives for assisted areas, which is projected to lead to a reduction of tax expenditures of HRK 490 million.

[22] Croatia currently levies a real estate transfer tax and a tax on second homes. Sources: Institute of Public Finance, Croatian Tax System (as of January 2014) and Taxes in Europe Database.

these measures would represent positive steps towards shifting the burden towards taxes that are less harmful to job creation and growth.

The authorities have taken important measures to fight tax fraud and evasion and to improve tax collection but are still facing substantial challenges in this area. Uncollected taxes represent a significant amount.[23] There appears to be scope to improve the efficiency of VAT revenue collection by improving compliance and reducing VAT fraud. In 2013, in order to reduce the amount of untaxed transactions and to improve tax collection, Croatia introduced electronic fiscal cash registers and directed that wages could be paid to employees only after social contributions had been paid to the government. Since mid-2013, reporting obligations for individuals and income of non-profit organisations have been strengthened while at the same time reporting was simplified with the introduction of a single e-form, which has also broadened the information access powers of tax officials. The tax administration is undergoing restructuring aimed at improving its efficiency. It was authorised to publish lists of employers not complying with their tax obligations and the names of taxpayers whose assets cannot be justified by their declared income. Croatia has joined the OECD/Council of Europe Multilateral Convention on Mutual Administrative Assistance in Tax Matters. These are all highly relevant measures to fight tax evasion and fraud and improve tax collection; however, they may not be sufficient to fully address the challenge. Croatian customs are currently also being reorganised. It is too early however to evaluate the effect of the reorganisation and to assess whether it has an impact on the time to import and export.[24]

Public subsidies and guarantees

Public support to companies has been an integral part of Croatia's development strategy. In the period between 2009 and 2013, public subsidies decreased from 2.5 % of GDP to 2.1 % but remained relatively high compared to both the EU-28 (1.2 % of GDP in 2009-13) and the average of the 12 newest Member States (0.9 % of GDP in the same period). In recent years, subsidies to public corporations (mainly to Croatian Railways, Croatia Airlines and public service broadcasting) were higher than subsidies paid to private enterprises (mainly to agriculture). According to the convergence programme, public guarantees reached 16.4 % of GDP in 2013. Compared to 2012, the level of guarantees is reported to have decreased by 0.2 pp.[25] The highest share of guarantees was granted to companies involved in the construction and operation of roads and highways. The programme envisages that revenues generated from the concession contract on highways, to be finalised in 2014, will be used to repay part of the guaranteed loans. However, new guarantees are planned to be issued in the context of the restructuring of Croatian Airlines and HZ Cargo. While some level of well-designed, targeted and monitored financial support can contribute to achieving Croatia's sustainable development goals, it may also prevent the necessary restructuring towards activities with higher productivity growth.

There is scope to rationalise and improve control over public subsidies and guarantees. The high amount of subsidies to the private sector is combined with a degree of decentralisation in their distribution. Many different instruments and institutions are involved, including, at national level, several line ministries and funding agencies, the Croatian Bank for Reconstruction and Development and the Croatian Agency for SMEs and Investment, each of which applies its own criteria and procedures. This indicates that there is substantial

[23] They are estimated at HRK 22 billion, or nearly 7 % of GDP, in early 2014 (for more information see http://www.ijf.hr/upload/files/file/newsletter/84.pdf).

[24] The 2014 World Bank Doing Business survey ranks Croatia 99th country globally in terms of the ease of trading across borders, from 104th rank in the 2013 report, but this remains the second worst result in the EU.

[25] However, the 2013 economic programme reported that guarantees amounted to 11.7 % of GDP in 2012. The difference between the reported figures for 2012 is not explained in the convergence programme.

room for efficiency gains. Moreover, a central public register of supported companies and individuals, including those receiving financial support from the regional and local level of government, does not exist at present and creation is not announced in the national reform programme.

3.2. Financial sector

Croatia is a small economy, subject to volatile capital flows and exhibiting a high degree of euroisation. In contrast to some neighbouring countries, Croatia's banking sector is characterised by a very high degree of foreign ownership, minimum presence of the state and overall high capital levels.

Croatia operates a tightly managed float, and the kuna has remained broadly stable against the euro over the past few years, despite a challenging external and domestic environment. Together with relatively low inflation, this has allowed the National Bank of Croatia to maintain an accommodative monetary policy stance. Tight macro-prudential policies in the past have ensured the build-up of high reserves and liquidity buffers in the financial system, some of which were gradually released in the course of the crisis. The authorities also implemented credit support schemes involving the Croatian Development Bank to stimulate lending, but the protracted recession has reduced demand for bank loans and domestic credit has contracted since mid-2012. With the exchange rate as a monetary policy anchor, and given the high level of euro-denominated debt, the central bank's room for manoeuvre remains limited. An improvement in macroeconomic fundamentals, in particular export competitiveness, would help to underpin exchange rate stability in the medium term and increase leeway for monetary policy to support economic recovery.

During the years before the global financial crisis, the authorities relied on macro-prudential measures to contain credit growth and limit balance sheet risks for banks. These policies helped to build the necessary resilience in the banking sector by ensuring adequate capital and liquidity buffers. While lending from domestically-supervised banks was constrained, indebtedness still grew very rapidly. This was partly due to external borrowing (directly from foreign parent banks) and partly due to borrowing from non-banks (e.g. leasing companies). Since the crisis, the corporate sector's financial position has deteriorated significantly due to the protracted weakness in the economy, and banks' non-performing loans to corporates have risen sharply. Overall non-performing loans reached 15.6 % at the end of 2013, up from 5 % in 2008. Corporate non-performing loans stood at 28 % in the same period, up from 23 % in the previous year, with construction, real estate and trade being the sectors most affected. Household indebtedness also increased to high levels, but non-performing loans are much lower in this sector, notwithstanding some risks related to past high borrowing in Swiss francs.

In comparison with other countries that experienced a similar contraction in GDP in recent years, non-performing loans in Croatia are high. While provision coverage ratios have been increasing recently, they remain low compared to other Member States and to the pre-crisis period. However, Croatian banks have high capital buffers, well above the levels of most EU countries, which could easily accommodate further provisioning needs. Nonetheless, high levels of non-performing loans represent a challenge for the banking sector, which could become more acute in the event of a further worsening of the economy. While it is welcome that the four largest Croatian subsidiaries are participating in the European Central Bank's Comprehensive Assessment exercise via their parent banks, there is scope for the Croatian National Bank to complement this by undertaking additional supervisory diagnostic actions that could provide more information on Croatian banks' balance sheets (e.g. the adequacy of banks' asset classification and collateral valuation and related provisions, the treatment of forbearance, etc.), and possibly including other institutions that will not participate in the Comprehensive Assessment, in particular mid-size and smaller banks which may have lower capital levels and worse asset quality than the average. This would assure compliance with the recommendations of the European Banking Authority. Moreover, ensuring that there is a high degree of comparability between the supervisory diagnostic actions for Croatia and the Comprehensive Assessment exercise of the European Central Bank would guarantee consistency across exercises and enhance their credibility and transparency.

Faced with reduced private demand for credit, banks have compensated by increasing lending to state-owned enterprises. Going forward, these trends should be closely monitored, both in view of doubts about the viability and indebtedness of some state-owned enterprises, and to avoid any future potential bias in lending to the detriment of newer, private companies.

In 2013, the Croatian government introduced a number of measures to regulate interest rates, which are impacting banks' ability to lend and reducing their profitability. There are three different types of interest rate arrangements that banks are obliged to apply. First, on housing loans denominated in Swiss francs, a maximum interest rate of 3.23 % was set, which is lower than the rate on domestic currency loans. Second, a ceiling on the maximum interest rate that can be charged to clients in arrears (11 % for retail and 15 % for corporates) was introduced, which may constrain loans granted to some client categories. Third, banks are required to base interest rates offered to clients on an official interest rate as a reference plus a margin, with the aim to increase transparency for customers. Overall, these measures limiting banks' ability to set interest rates could have adverse effects on competition and could hinder some borrowers from accessing loans, thus further constraining credit supply to the economy.

The conditions for access to finance for small and medium-sized enterprises in Croatia have deteriorated due to increased risk aversion in the financial system. Only a quarter of the small and medium-sized enterprises meet the necessary conditions for loans, and they face shortened loan periods. Regional disparity with regard to access to finance is also visible, especially in peripheral regions. Financing constraints, including for small and medium-sized enterprises, also come from the very limited availability of alternative funding sources such as private equity and venture capital. Furthermore, existing state venture capital funds, as well as the Funds for Economic Cooperation, appear to be geared towards the restructuring of large businesses rather than towards supporting start-ups. The role of venture capital financing is likely to gradually increase in the future, as several state institutions consider setting up venture capital funds for start-up and export-oriented companies.

3.3. Labour market[26], education and social policies

Employment and activity rates are among the lowest in the EU, and are particularly low for young people and older people. Beyond cyclical developments, these dismal labour market outcomes are partly related to aspects of underlying institutional and policy settings. While employment protection legislation is being revised, a number of potentially problematic labour market regulatory issues remain. The employment challenge is particularly acute, notably in terms of improving the labour market attachment of people with weaker employment potential. Persistent weaknesses in labour market matching particularly stemming from the outdated vocational education and training system and uninformed higher education choices, present obstacles to successful school-to-work transitions and may contribute to the low employment rates of younger age cohorts. Croatia's youth

[26] For further details, see the 2014 Joint Employment Report, COM(2013)801, which includes a scoreboard of key employment and social indicators.

unemployment rate has increased markedly and reached 50 % in the course of 2013, becoming one of the highest in the EU. The proportion of young people not in education, employment or training also increased and is above the EU average. Inadequate alignment of policies and the complex system of social benefits stand in the way of better activation and, in some cases, they create disincentives to work. The high and increasing incidence of poverty highlights the limitations in terms of effectiveness and adequacy of the social protection system. Generous pension eligibility criteria, various early retirement schemes, and low participation in lifelong learning combine to restrict participation of older workers. Compared with the rest of the EU, active labour market policy measures still have limited budgets and coverage.

Labour market

Croatia is facing worsening labour market conditions due to the protracted crisis with continued lack of job creation and severely underutilised labour market potential. The employment rate has been decreasing annually since 2008 from an already low level (62.9 % in 2008 to 53.9 % in 2013) and was one of the lowest in the EU in 2013. The activity rate is also significantly below the EU average and reached a record low in 2012. In common with southern European labour markets, there is particular under-representation of young people, the elderly and women and these groups account for a major proportion of long-term unemployment, which itself stands at more than double the EU-28 average. The average labour market exit age was 60.6 years in 2009 (61.5 in the EU-27). As a result the duration of working lives is also substantially below the EU average (31.1 years vs. 35 years in the EU-27 in 2012). The labour market situation of young people is of particular concern. Youth unemployment has increased to 49.7 % in 2013 and is now among the highest in the EU. The proportion of young people not in employment, education or training is also increasing; it reached 18.6 % in 2013. The crisis has impacted employment levels much more severely than wages.[27] The national reform programme recognises the cyclical employment challenge facing Croatia, particularly for younger people, but does not clearly diagnose or recognise important underlying structural challenges that were identified in the in-depth review, including as regards labour costs and competitiveness. Accordingly, the national reform programme outlines a number of useful policies to improve labour market performance and help key groups, as assessed in this section, but it stops short of presenting a full strategy addressing the root causes of low employment and labour force participation across most age groups.

[27] Vuksic (2014), available at http://www.ijf.hr/upload/files/file/ENG/newsletter/86.pdf

Box 3: The delivery of a Youth Guarantee in Croatia[28]

Important challenges that need to be addressed to deliver on the Youth Guarantee[29] in Croatia:

- Lack of data and analysis about young people not in employment, education or training, which calls for measures to identify the most vulnerable groups and their particular needs;

- Insufficient outreach activities to non-registered young people not in employment, education or training and increased pressure on the capacities of the Public Employment Service;

- Insufficient labour-market relevance and quality of vocational education and training and higher education;.

- Lack of effective systems for labour market monitoring and evaluation and skills forecasting;

- Heavy reliance on subsidized offers instead of a better mobilization of the private sector.

Until recently the Croatian labour market was considered relatively rigid in international comparison. As well as having possible effects on overall employment levels, labour legislation can also affect segmentation, which is materialising in increased use of fixed-term contracts, especially for the young. One of the aims of the first phase of amendments to the Labour Act in June 2013 was to facilitate the use of fixed-term employment contracts and to provide employers with the possibility to employ workers on an extended fixed-term basis, when necessary and justified. Implementation of this first phase would require close monitoring to assess the extent to which it promotes employment while guarding against unjustified use of fixed-term contracts and further labour market segmentation. In January 2014, the government launched the second phase of the labour market reform, proposing to amend dismissal procedures and working time arrangements, and re-opened discussions with social partners on the draft law. The national reform programme remains rather vague as to the content of this second phase. As and when the envisaged changes to the Labour Act are in force, the authorities expect an improvement in Croatia's Employment Protection Index. If these expectations are realised, the reforms would bring the country largely on a par with its peers. However, Croatia's adjustment challenge may be greater than those of its peers, as indicated by the weak labour market outcomes described above, even after accounting for the continued economic downturn. Overall, measures taken so far show an appropriate direction of reform but effective implementation will be crucial.

Average labour costs remain high compared with Member States with similar levels of economic development, despite some moderation in recent years. Average compensation of employees in Croatia is nearly 50 % higher compared with countries with comparable GDP per capita. Even after correcting for the low proportion of employed population, compensation per employee is still above the levels recorded in Member States with similar labour productivity. Given the poor labour market conditions, unit labour costs in Croatia have grown at a slower pace than those in most other central and eastern European countries since 2008, correcting part of the accumulated imbalances. The applicability of rules derived from overlapping collective agreements and the frequency under which they can be re-negotiated are two aspects of the wage-setting system that may currently facilitate wage developments out of line with productivity growth. In the government sector and state-owned enterprises, employment conditions and wage negotiations, including the timing of

[28] Croatia adopted a Youth Guarantee Implementation Plan in May 2014.

[29] Pursuant to the Council Recommendation of 22 April 2013 on establishing a Youth Guarantee (2013/C 120/01): "ensure that all young people under the age of 25 years receive a good-quality offer of employment, continued education, an apprenticeship or a traineeship within a period of four months of becoming unemployed or leaving formal education".

negotiations in relation to budget approvals, can also have relevant impacts due to their potential signalling role for the private sector.

The incidence of undeclared paid activity is relatively high and the prevalence of cash ('envelope') wages is above the EU average. Lack of regular jobs on the labour market is the most common reason given for undertaking undeclared work.[30] In 2012, simplified rules for employment and payment of contributions for seasonal workers (voucher system) were introduced which, according to national data, has led to an increase in the number of registered workers. The 2013 Law on Nannies aims to regularise the employment of women providing childcare in the home. Positive effects are expected but it is too early to assess the full impact of the law. Overall, Croatia has a fragmented approach to addressing the issue as no lead department has been assigned, and coordination between government bodies and levels is lacking, as too are adequately inter-connected databases. Remedial measures are less common and soft action to foster tax morale is relatively new[31] while trust in state institutions remains low.[32]

Inadequate alignment of policies and lack of transparency have tended to inhibit activation and, in some cases, have created disincentives to work. The issue is most evident with low-income families, families with inactive members and families with many children, but it also affects a wider range of persons. The challenge was recognised in the 2013 Social Welfare Act, which merged four of the more than 70 existing benefits at national level into the new guaranteed minimum benefit, subject to: stricter means testing (including also for assets); a limitation of duration to two years; restricted possibilities to reapply and to refuse job offers; gradually decreased benefits in case of employment for persons who have been drawing them for more than 12 months; adapted equivalence scales favouring single and single-parent households; and a maximum amount per household at approximately the level of the minimum gross wage. Despite the lack of an integrated response, cooperation between the public employment service and social welfare centres is now slowly improving, also due to higher normative standards on cooperation and data exchange under the new Social Welfare Act. However, it is still possible to accumulate overlapping income support entitlements, which may affect incentives to work, although individual benefits are not high.[33] At the same time, some benefits are abruptly reduced upon entering paid employment depending on the type of benefits received, suggesting scope to fine tune the combined effect of the tax and benefits systems to reduce inactivity traps. In short, progress has been made in aligning policies but lack of transparency remains.

Despite recent improvement, active labour market policy measures are still little used in Croatia. In 2012 the Law on Employment Incentives was adopted addressing the young and long-term unemployed and active labour market policy measures were revised. In July 2013, new measures targeting the most vulnerable groups, such as the young and long-term unemployed, were introduced. Active labour market policies have until now been over-concentrated in public works. Both the financial allocations for active labour market policies and their coverage have increased, according to national data, but they remain well below the EU average. Lifelong career guidance centres were established as part of the public employment service along with Youth Centres to support the young. Low coverage of older workers in active labour market policy measures is an issue. The extent of the employment challenge in Croatia and new work procedures place the administrative capacity of the public

[30] Special Eurobarometer 402 – Undeclared work in the European Union
[31] Eurofound - Tackling undeclared work in Croatia and four EU candidate countries (2013)
[32] ESDE 2013 report
[33] The levels and coverage of unemployment benefits and social assistance are particularly low.

employment service under severe pressure and regional variations are substantial.[34] However, the national reform programme reports that targeted training for public employment service staff and new on-line tools for the unemployed are planned. Across all initiatives, regular evaluations and effective labour market monitoring systems are missing, so programme effectiveness is not well understood. The national reform programme also reports on an Act on State Aid for the Preservation of Jobs, under preparation, which would serve to regulate employer-facing support for job preservation schemes such as short-time working and schemes for education and re-training. Such schemes are already in existence but have low take-up and the national reform programme does not clearly explain how the new regulation will boost their effectiveness and reduce inflows into unemployment by the expected amount.

Challenges remain regarding longer working lives, despite recent changes. The new Pension Insurance Act introduced a possibility for old-age pensioners to work part-time (but not in self-employment) while still receiving a full pension. The national reform programme reports that plans to extend the possibility to combine pension with income from work are under way but details of this measure have not been disclosed. The system of assessing capacity to work has also been improved and a new Law on Vocational Rehabilitation was adopted in 2013 in order to prolong working lives. However, an integrated active ageing strategy to encourage and enable older workers (notably women) to stay in employment longer is yet to be pursued. The challenges facing measures to prolong working lives and to raise the effective retirement age remains substantial given the slow phasing-in of the new statutory retirement age and the persistence of numerous early retirement options.

Measures are being taken to improve work-life balance and gender equality in the labour market but there is still a long way to go. Only 51 % of children between the age of three and the mandatory school age are in formal childcare, one of the lowest rates in the EU, and regional differences in provision are large. This may result from widespread lack of access and the related high use of informal care (itself facilitated by low labour force participation). The Early Childhood Care and Education Act was amended in 2013 to introduce compulsory pre-school education starting from August 2014. Parental leave rights for both mothers and fathers, self-employed and foster parents were aligned and the Law on Nannies was adopted, all in order to boost female employment. It is still too early to assess the impact of these measures. However, it is clear that the current set-up of early childhood education and care still does not ensure universal access to all families needing such services and does not support employment of parents.

Social policy

The increasing incidence of poverty reflects adverse economic and labour market trends and highlights the limits to the effectiveness and the adequacy of the social protection system. The proportion of persons at risk of poverty and social exclusion is significantly higher than in the EU as a whole (32.3 % in Croatia, as compared with 24.8 % in the EU in 2012) and has increased from 30.7 % in 2010. In addition, overall government spending on social protection was well below the EU average (20.6 % of GDP in Croatia, as compared with 29.1 % in the EU in 2012) and skewed towards disability and healthcare and away from social assistance and family benefits. A large proportion of spending is devoted to 'categorical benefits' that are neither means nor income tested, predominantly in the form of cash payments linked to disability or special status. In addition, the allocation of income support schemes and benefits is scattered across many different institutions and levels of

[34] EEPO review (August 2013) - Labour market reforms in Europe 2011-2013; Guidelines for the implementation of ALMP measure for 2014; World Bank (2010) Social Impact of the crisis and building resilience.

government where unified criteria are lacking and overlaps occur[35]. Overall benefit entitlements have not kept up with inflation.

A series of reforms seeks to improve the effectiveness and adequacy of social protection but progress is uneven. According to the national reform programme, the poverty reduction target has been increased to 150 000 people in the draft Strategy for Fighting Poverty and Social Exclusion (2014-20); the strategy's effectiveness is conditional on clearly defining responsibilities, timelines, quantitative indicators and sub-targets as well as on implementing ambitious targeted measures. Whereas the above-mentioned 2013 Social Welfare Act has been implemented, including the introduction of the Guaranteed Minimum Benefit, the scheduled adoption of the Disability Inclusion Allowance Act, which aimed at consolidating various rights, has been postponed. Crucially, despite several reforms since 2011,[36] the proportion of non-means tested cash benefits for specific population groups remains high, diverting spending from people most in need. A single electronic database now covers all social welfare centres but full administrative roll-out and connections to other entities administering benefits are pending. A national 'one-stop shop' for national-level cash benefits[37] is gradually being implemented up to 2016, according to the national reform programme, but does not cover substantial local, regional and categorical benefits. This very complex and opaque system makes policy development, systematic monitoring and evaluations difficult. Consequently, although targeting and, to a certain extent, transparency are continuously being improved, overall progress has been limited.

Education

The main challenges in education are labour market relevance and quality of provision across all educational sectors. Achievements of 15-year-olds, as measured by the Programme for International Student Assessment (PISA), remain below the EU average, particularly in mathematics[38]. There is no national system of systematic evaluation and quality assurance of educational establishments to promote improvements in outcomes. More than 95 % of 20-24 year olds complete a form of upper secondary education, and the majority of vocational education and training students continue onto higher education. However, according to the Agency for Vocational Education and Training and Adult Education, fewer than half of vocational education and training graduates on the labour market end up employed in a job that matches their field of study. More than 70 % of first year students surveyed in 2011 planned to eventually enrol in a graduate course. This level of attainment and ambition masks the fact young people may be lacking skills or motivation to enter the labour market at an earlier stage. Employer engagement, work-based learning and career guidance across secondary and tertiary education are lacking. At tertiary level, some 60 % of students study social sciences and humanities, whereas the numbers graduating in technical and medical sciences continue to fall. Employment rates of recent graduates are significantly lower than in the EU-28 and statistics show that between 29 % and 54 % of young people

[35] According to the Ministry of Social Affairs, there are more than 50 different welfare programmes managed by local self-governments which cost HRK 1.5 billion HRK annually, more than double the amount envisaged for the new guaranteed minimum benefit.

[36] Since 2011 a Social Welfare Reform Strategy (2011-16) and two acts have been adopted, standardising the conditions for granting social assistance, clarifying means-testing, linking the level of social assistance to the official poverty threshold and defining the parameters for a new database to increase transparency.

[37] According to the national reform programme, the plan is to standardise processes for child allowance, maternity and parental benefits, and unemployment benefits, which would cut costs and reduce administrative burden.

[38] See PISA (2012). In mathematics, the proportion of 15-year-old pupils who fail to achieve basic skills in the PISA test ('low achievers') is 29.9 % (the EU-25 average is 23 %). In reading and science, Croatia is slightly below EU average, although there are striking gender differences in reading (27.6 % low achievers among boys and 9.5 % among girls).

worked in a job outside their field of study.[39] Although tertiary education enrolment has risen, attainment has levelled off since 2010 and drop-out rates are extremely high. Croatia's population has lower digital skills than the EU average.[40]

Croatia is reforming several sectors of the education system to improve educational outcomes and align them with labour market needs, but implementation is delayed. The outdated vocational education and training system is undergoing reform in the form of new school curricula based on sector skills analyses and comprehensive occupational and qualification standards. Pilot curricula tested on a sample of 54 schools in 2013-14 will be evaluated and expanded to all vocational education and training schools. The ordinance implementing the Croatian Qualifications Framework is still pending. The national reform programme envisages that a large survey of employers' needs would take place in 2014, followed by the work of sector councils on occupational standards, which in the long run feed into updated school curricula. However, the Croatian Qualifications Framework under preparation may not be fully consistent with the draft Strategy for Education, Science and Technology, to be adopted in 2014, which aims to build national consensus around the quality culture in education and envisages an enhanced system of self-assessment of schools and external evaluation of educational outcomes. In addition, the tracking of labour market outcomes of trade and craft graduates and higher education graduates has recently been launched to improve the evidence base. However, skills forecasting systems are missing.

Adult participation in education and training is one of the lowest in the EU. Only 2.6 % of Croatian adults participate in education and training, compared to the EU average of 10.7 %. Incentives for employers in the form of tax deductions of up to 50 % of adult education and training costs (70 % in the case of small and medium-sized enterprises) are in place, but their uptake by companies is low, in part because of a lack of awareness and in part because of the complexity of the administrative procedures involved.[41] Lifelong learning is one of the pillars of the new Strategy for Education.

3.4. Structural measures promoting sustainable growth and competitiveness

Croatia has been mired in a recession since 2009. Weak export competitiveness, which reflects a combination of cost and non-cost factors, has exacerbated the deep and prolonged economic downturn triggered by the global financial crisis. Export performance was also negatively affected by delayed restructuring of major economic sectors such as shipbuilding and transport. Structural weaknesses, including a poor business environment and a malfunctioning labour market, have added to the competitiveness challenges. Slow progress with restructuring of state-owned enterprises, which still play a dominant role, also had a negative impact on economic performance. In this context, in which moreover private sector balance sheet repair continues, albeit at a slow pace, productive investments, including foreign investments, have been curtailed. The ensuing lower potential growth increases the required fiscal consolidation effort, severely restricting the margins available to support growth through fiscal policy. Hence, improvement of the business environment, coupled with further strengthening of the labour market adjustment capacity, is essential to encourage a new investment cycle, in particular in export-oriented sectors. Further development of energy and transport infrastructure and concerted efforts to unleash Croatia's innovative capacity will be also of major importance to lead the country out of recession and support sustainable and job-rich economic growth.

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[39] Matkovic (2009) UNDP and Croatian Ministry of Health and Social Welfare, Youth between education and employment: is it worthwhile going to university?

[40] The proportion of the population with medium or high internet skills is 37.5 % compared with a 46.8 % EU average. The proportion of the population with medium or high computer skills is also below the EU average (44.7 % compared with 50.9 %).

[41] Rinaldi, S., Klenha, V., Feiler, L. and Petkova, E. (2012). *Croatia – Review of human resources development.*

Box 4. Conclusions of the March 2014 in-depth review on Croatia

The first in-depth review on Croatia under the Macroeconomic Imbalances Procedure was published on 5 March 2014.[42] On the basis of this review, the Commission concluded that Croatia is experiencing excessive macroeconomic imbalances which require specific monitoring and strong policy action. The main observations were:

- **External rebalancing is beset by important risks pending the reduction of Croatia's high foreign liabilities.** Domestic economic weakness reduces the affordability of foreign liabilities and limits the appeal of Croatia to lenders and existing investors in inward-oriented industries, thereby increasing Croatia's vulnerability to capital flow reversals.
- **Croatia's low competitiveness had been eroding export market shares, particularly for goods exports, even before the crisis.** Despite moderate cost dynamics since 2009, cost levels remain relatively high and this combines with a wide range of non-cost competitiveness deficiencies to disadvantage export performance.
- **Weaknesses in the labour market and in the wider business environment have amplified the impact of the crisis and prevent adjustment towards stronger, more sustainable growth and employment.** Beyond cyclical developments, which have caused a jump in unemployment (overall, youth and long-term), dismal labour market outcomes are also partly related to aspects of underlying institutional and policy settings. There are numerous, severe obstacles in the business environment.
- **The non-financial private sector, and in particular non-financial corporations, entered the crisis highly leveraged as a result of rapid credit growth in the preceding years.** The reduction in corporate sector indebtedness is proceeding at a rather slow pace. Many state-owned enterprises, in particular, appear to have comparatively high debt levels. Household balance sheets, although also under pressure, are somewhat less vulnerable.
- **The largely foreign-owned banking system has shown resilience.** Previous macro-prudential measures led to significant capital and liquidity buffers that proved useful during the crisis. Still, the weak economy has started to interact with the banking sector, and non-performing loans to corporate borrowers have risen to high levels. Banks have compensated for reduced private sector demand for credit by increasing lending to public entities.
- **Loose fiscal policies in the downturn have exerted sustained pressure on the general government deficit and caused the debt to rise sharply in comparison with peers.**

The in-depth review also discusses possible policy avenues to address the challenges identified.

- Carefully reconsidering, and where necessary, adjusting a number of institutions and policies affecting labour market functioning would be instrumental to addressing the low activity and employment rates and facilitate the labour market adjustment.
- Building on reforms recently undertaken, there could be further scope to reduce inactivity traps, to make employment protection less onerous for businesses and to enhance the effectiveness and reach of active labour market policies.
- Improving the business environment would help to attract foreign capital and innovations into productive sectors, which in turn would increase export competitiveness.

[42] http://ec.europa.eu/economy_finance/economic_governance/macroeconomic_imbalance_procedure/index_en.htm

- There is scope to consider complementing the ongoing European Central Bank's comprehensive assessment exercise with additional supervisory diagnostic steps.
- Implementing high-quality, structural fiscal consolidation measures to reverse the rapidly deteriorating public debt trajectory.
- Ensuring the conditions for a smooth continuation of the deleveraging process, including through the proper functioning of insolvency and debt-restructuring regimes, in order to address the over-indebtedness of the private sector.

Business environment

Croatian companies operate in an environment that is not conducive to improving productivity and attracting foreign investors. High administrative burdens and lengthy proceedings, numerous para-fiscal charges, prolonged litigation and bankruptcy procedures, weak protection of investments and high policy uncertainty combine to create a substantial drag on businesses. All these shortcomings are reflected in Croatia's poor ranking in various international surveys in terms of business climate and competitiveness. Specifically, Croatia is among the worst EU performers in the Doing Business survey of the World Bank, the Global Competitiveness Index of the World Economic Forum and the Index of Economic Freedom of the Heritage Foundation.

A consistent methodology for measuring the overall administrative burden is not being used. The authorities are actively involved in the World Bank Doing Business exercise and have set up a high-level working group to map Croatian legislation to the Doing Business' indicators in order to identify and remove some of the obstacles. While this approach may result in improving Croatia's ranking in this particular survey, it covers only part of the multiple challenges businesses face in complying with central- or local-level regulations, administering and paying various charges and fees, and handling administrative proceedings, in particular at local level.[43] Developing an own methodology based on international best practices would allow the authorities to better reflect the specificities of the Croatian business environment and would facilitate the setting of measurable targets and monitoring of their achievement. A review of para-fiscal charges conducted in 2013 detected 572 administrative charges and, according to the information provided in the national reform programme, 41 of them have been removed or reduced (such as those paid for forest maintenance and the Croatian Chamber of Economy). In 2014-15, the authorities plan to remove or reduce further 12 charges (the programme is not specific about which charges will be removed). This is a step in the right direction which, however, does not significantly decrease the excessive administrative burden on businesses.

Policy uncertainty and weak policy coordination are significant deterrents for investments and business activity. The high number of legislative as well as non-legislative regulatory changes (averaging to more than two legal acts per day), in some cases adopted through a series of marginal amendments and without adequate consultation with business stakeholders, impinge on the predictability of the policy framework, increase compliance costs and reduce the effectiveness of the regulatory impact assessment. Additional uncertainty stems from an uneven interpretation and enforcement of the legislation across local administrative units and from legislative vacuums created by a delayed issuance of bylaws implementing already effective legislation. In an effort to improve the quality of legislation, the regulatory impact assessment was introduced in 2012. However, available administrative capacity is insufficient to carry out the assessment fully in accordance with the prescribed

[43] Other indicators used by the Commission to assess the business environment and business-friendliness of public administration include criteria related to the implementation of the Small Business Act and 'SME Performance' and indicators covered by the Innovation Union Scoreboard.

procedure, mainly because the current set-up does not allow applying it proportionately to the likely impact of the new legislation. Similarly, the 'SME Test' and a regular dialogue with stakeholders are not systematically used and their funding is currently dependent on support from EU funds.[44]

Measures to improve the business environment have been introduced, but more concerted and systematic efforts are needed to improve the competitive edge of the economy. In 2012, company registration procedures and costs were significantly streamlined through the introduction of a 'simple limited liability company' and online procedures for setting up other types of activity. Moreover, some licensing procedures were shortened by the introduction of a 'silence is consent' clause after 30 days. In 2013, the issuance of construction permits and registration with the Land Register were also simplified. These all are relevant steps to improve specific aspects of the business environment in Croatia. In parallel to these changes, the authorities adopted the Law on Strategic Investments, which allows selected large-scale private investors to bypass standard administrative procedures and expedite their projects. While this measure may help kick-start selected investments, much needed in the current macroeconomic context, it also illustrates that the authorities are aware of the difficulties in the normal procedure applied to smaller investments concerning the length and transparency of administrative procedures, regulatory uncertainty and the institutional capacity of public administration, in particular at local level. Investment activity will continue to be promoted through the Investment Promotion Act that entered in force in October 2012. The Act created a new system of investment incentives such as tax advantages, non-refundable financial support or exemption from custom duty.

Some progress with digitising government services relevant for businesses has been made. Croatia has introduced some e-services for businesses; notable examples include the electronic system for social security contributions launched in 2013, e-Customs system supporting imports and exports and the e-Company service enabling online establishment of a limited liability company. In addition, a number of e-projects in construction and physical planning are being implemented with the aim to decrease the number of days needed to obtain a construction permit from 314 to 74 in 2014. However, only relatively basic services can be accessed through the point of single contact, partly due to the lack of a clear cooperation framework across government bodies. Ensuring full interconnectedness of databases relevant for businesses, with due regard to adequate protection of private information, will be of critical importance for lowering the regulatory burden on businesses.

Box 5. Potential impact of structural reforms – results of a benchmarking exercise

Structural reforms are crucial for boosting growth. It is therefore important to know the potential benefits of these reforms. Benefits of structural reforms can be assessed with the help of economic models. The Commission uses its QUEST model to determine how structural reforms in a given Member State would affect growth if the Member State narrowed its gap vis-à-vis the average of the three best EU performers on key indicators such as labour market participation. Improvements on these indicators could raise Croatia's GDP by about 5 % in a 10-year period. Some reforms could have an effect even within a relatively short time horizon. The model simulations corroborate the analysis of Sections 3.1 and 3.3,

[44] The 'SME Test' analyses the likely economic, environmental and social effects of legislative proposals by assessing the costs and benefits of policy options and thus helps reach balanced and sustainable decisions. Examples of relevant projects being implemented include the 'BIZIMPACT II' project (2013-15), which promotes the economic impact assessment system in Croatia, with a specific focus on the SME sector and the 'Improvement of Administrative Efficiency at the National Level' project, which introduces the 'SME Test' and the 'Think Small First' principle to regional groupings of local governments and entrepreneurs.

according to which the largest gains would likely stem from reducing the pathways to early retirement and strengthening the labour market participation of women. The simulations also support the priority placed by the authorities on reforming the labour market legislation and improving public employment services. The potential impact of other promising reform areas, such as the degree of competition in the economy, labour taxes, or the benefit replacement rate cannot be simulated due to data limitations.

Table: Structural indicators, targets and potential GDP effects[45]

Reform areas		HR	Average 3 best EU performers	GDP % relative to baseline	
				5 years	10 years
Market regulation	Entry costs	8.60	0.13	0.2	0.5
Skill enhancing reforms*	Share of high-skilled	4.6	10.7	0.1	0.2
	Share of low-skilled	20.7	7.5	0.2	0.3
Labour market reforms	Female non-participation rate (25-54ys):			0.6	1.3
	- low-skilled	44.9	26.4		
	- medium-skilled	22.9	10.5		
	- high-skilled	6.4	4.3		
	Low-skilled male non-participation rate (25-54ys)	29.9	7.7	0.0	0.1
	Elderly non-participation rate (55-64ys):			1.1	2.4
	- low-skilled	32.6	13.4		
	- medium-skilled	16.3	4.8		
	- high-skilled	11.0	3.3		
	ALMP (% of GDP over unemployment share)	9.0	37.4	0.3	0.3
Total				2.5	5.2

Source: Commission services. Note: Simulations assume that all Member States undertake reforms which close their structural gaps by half. The table shows the contribution of each reform to total GDP after five and ten years. If the country is above the benchmark for a given indicator, we do not simulate the impact of reform measures in that area; however, the Member State in question can still benefit from measures taken by other Member States.[46] *The long-run effect of increasing the share of high-skilled labour in the population could be 4.3% of GDP and of decreasing the share of low-skilled labour could be 2.8%. **EU average is set as the benchmark.

State-owned enterprises

The state still maintains a strong role in the economy through ownership in a large number of companies. Despite some improvement compared with the previous year, these continue to pose a risk to public finances through operational losses, debt assumptions and the extension of financial guarantees. While the national reform programme indicates that financial results of 59 state-owned companies of strategic interest are expected to improve in 2014, their indebtedness should further rise from nearly 25 % of GDP reached in 2013.

The institutional framework for management and privatisation of the state-owned enterprises is in place, but its implementation faces delays. In June 2013, the Parliament adopted a new strategy for the management of public assets in the period 2013-17. Under the strategy, by end-October each year the government, through the State Property Management Office, is obliged to present a programme for public property management for the following year. A plan for 2014, due in October 2013, has been adopted only in April 2014. Convincing steps to speed up the disposal of state assets and restructuring of state-owned enterprises are

[45] Final goods sector mark-ups is the difference between the selling price of a good/service and its cost. Entry cost refers to the cost of starting a business in the intermediate sector. The implicit consumption tax rate is a proxy for shifting taxation away from labour to indirect taxes. The benefit replacement rate is the % of a worker's pre-unemployment income that is paid out by the unemployment scheme. For a detailed explanation of indicators see Annex.

[46] For a detailed explanation of the transmission mechanisms of the reform scenarios see: European Commission (2013), "The growth impact of structural reforms", Chapter 2 in QREA No. 4. December 2013. Brussels; http://ec.europa.eu/economy_finance/publications/qr_euro_area/2013/pdf/qrea4_section_2_en.pdf

needed to limit the amount of financial support and to provide a level playing field that would help bolster competitiveness and efficiency of the real sector. To this effect, the national reform programme outlines a plan to introduce a system to report on the financial situation of state-owned enterprises. This is a relevant step as up-to-date monitoring is a precondition for sound public oversight and effective management. The programme also specifies that the Restructuring and Sale Centre, which manages the state portfolio of stocks and equity shares in non-strategic companies (561 companies at the end of 2013), is to conduct privatisation of companies under its disposal within three years. Respecting international best practices when implementing the sales would be key to maximising the value received by the state (nominally, the portfolio is worth 1.9 % of GDP).

The authorities stepped up efforts to privatise state assets but the implementation record is limited. The sale of the biggest domestic insurance company, Croatia osiguranje, was finalised in March 2014. However, the tender for the sale of the largest state-owned bank, Hrvatska Postanka Banka, did not succeed as the offer submitted was deemed unsatisfactory. In early 2014, talks failed with the only bidder for the sale of a 75 % stake in the railway cargo company HZ Cargo and consequently the government initiated a restructuring and recapitalisation plan for the company. While the national reform programme outlines concrete plans regarding HZ Cargo, it is less specific about the passenger transport branch of railways. Attempts to attract strategic partners for fertiliser company Petrokemija and the national air carrier Croatia Airlines have broken down recently. In 2013, the government has initiated a multiannual restructuring programme for Croatia Airlines with expected total costs of 0.5 % of GDP, which is underpinned, among others, by a reduction in operating costs and a conclusion of new collective agreement. In the national reform programme, the authorities further expect to receive 6.8 % of GDP (this information is not factored in the convergence programme) at end 2014 from granting a concession for toll collection and highway maintenance, activities outsourced from public companies HAC and ARC. Core activities (design and construction of highways) should continue to be carried out by the state.

The governance of state-owned enterprises remains problematic, weighing on the profitability of companies under state control. Legislative amendments adopted in 2012 replaced a competitive selection procedure for members of supervisory boards of state-owned enterprises with direct political appointments. Only general criteria apply to the background of nominees but these do not relate to expertise in the particular field of activity of a company or experience on similar boards.[47] According to the 2014 EU Anti-corruption Report, mechanisms for verification of conflicts of interests remain weak. Inadequate safeguards between state-owned enterprises and the political sphere risk impinging on the allocation of public funds and creating room for mismanagement of public resources.

Energy, climate and environment

Reforms in the electricity and gas sectors, also required by the internal market rules, aim to improve the market model and increasing transparency and competition. In 2013, Croatia continued to introduce regulatory reforms in these areas. As a result of the unbundling obligations in the new Electricity Market Act, changes were made in the structure of the Transmission System Operator and the capital and structure of the parent company Hrvatska Elektroprivreda, but the process of unbundling is still to be finalised. There is still no clarity about the process of certification by the energy regulatory agency HERA. In the gas sector, the new gas law addressed some barriers to competition such as price caps. However, the

[47] The Decision on the determination of the requirements of 17 February 2012 lists conditions such as a university degree, five years of work experience at 'adequate' (further unspecified) positions within the candidate's profession and clean criminal record.

limitation on exports of domestically produced gas, which does not seem compatible with the internal market rules, was retained.

The electricity supply market was opened up to competition, in practice, in July 2013. Several providers, both domestic and international, have entered the market that was previously dominated by the incumbent power operator Hrvatska Elektroprivreda. Competition is more restricted in the gas sector, where prices for households remain administratively regulated and are currently set at low levels. Excluding taxes and levies, gas prices for households are the third lowest in the EU. Further regulation of gas prices was introduced with legislative changes from early 2014. Under these, the incumbent energy utility company became a wholesale gas supplier for three years from April 2014. Furthermore, the oil and gas company INA was obliged to sell domestically produced gas to Hrvatska Elektroprivreda at a regulated price. These changes, coupled with export restrictions on gas, risk depressing competition and investments in the sector and undermining the basis for the integration of Croatia in the internal market.

Croatia achieved progress in implementing specific energy efficiency measures, in particular in the public sector. These included improvements in the advanced energy network and the introduction of a web-based tool for monitoring public sector energy use. A two-year energy renovation programme for public buildings is in place with the objective of reducing energy consumption and greenhouse gas emissions. Nevertheless, energy-saving opportunities remain largely untapped across all sectors. The coverage of advanced metering systems is still very limited, leading to elevated energy consumption in buildings. Across sectors, there seems to exist significant scope for improvement in energy efficiency of households.[48]

The proportion of renewable energy increased to 16.8 % in 2012 from 14.3 % in 2010. As a result, the country is well placed to meet its renewable energy target of 20 % in 2020. The production of renewable energy is mainly promoted through a feed-in tariff for renewable electricity generation, a quota obligation and tax exemptions for biofuels, and state financial assistance. However, future development of renewable energy will be constrained by a cap on the capacities of such sources (in particular for wind and solar power) that was introduced with the National Renewable Energy Action Plan adopted by the government in October 2013. The plan envisages a limit of 20.1 % on the share of renewable sources in final energy consumption by 2020. It also provides that, in the years from 2015 to 2020, the installed capacities of solar and wind power must not increase. Croatia's carbon intensity is almost twice as high as the EU average despite the decrease of greenhouse gas emissions by 14 % in 2005-12.

Preventing and reducing waste generation, together with the necessary increase in reuse and recycling, could improve the resource efficiency of the Croatian economy and increase business opportunities. However, managing waste efficiently and fulfilling obligations under the EU directives on waste remains a challenge. Separate collection is critical to developing the value of waste, and creating the market: incentives for private sector actors to engage are therefore crucial. In July 2013, Croatia adopted the Sustainable Waste Management Act to align national legislation with the requirements and targets set out in the EU directives on waste. In particular, landfill fees planned in the Act, one for the local government and the other for the landfill operator, will have to be adopted. Moreover, pay-as-you-throw schemes for waste collection and extended producer responsibility are mentioned but without the necessary level of detail. A well thought-through design and thorough

[48] Energy efficiency in the household sector rose by 4 % in the period 1995-2010 compared with a 20 % improvement for the industrial sector

implementation of these measures will be crucial to ensure that they contribute to improving resource efficiency.

Transport

Croatia is in the process of developing its first comprehensive transport strategy. It will serve as a basis for developing the necessary transport infrastructure in the country, with full interoperability and connection to the trans-European transport network. The effective implementation of the strategy requires clear policy choices regarding the organisation of the sector, potentially in a form of a specialised agency. The main weaknesses of the Croatian transport system are the imbalance between modes of transport in favour of the least environmentally friendly – road - and an outdated railway infrastructure with historically insufficient maintenance and rehabilitation funds.

While the motorway network in Croatia is relatively well developed, rehabilitation of the rail infrastructure network is a major challenge. Sizeable investment gaps have negative effects, in particular as regards the infrastructure network of commercial speeds of trains, especially those of international rail freight services on the core trans-European transport network corridors. Rail access to major shipment points, such as industrial sites, ports, and inland ports, and safety at level crossings ('distributed projects') require specific attention in infrastructure development programmes. In this context, opening of the monopolistic railway market, even if challenging, would bring new opportunities.

The modal shift in the transport sector from road to rail and other cleaner transport modes is lagging behind. This is mainly due to the investment deficit in rail infrastructure but the connection of the land transport network with inland waterways (Danube, Sava) and with maritime ports is also underdeveloped. Both inland waterways are mostly shared with Serbia and Bosnia and Herzegovina respectively; any improvement therefore requires a joint effort.

Research and innovation

Croatia's research and innovation capacity is constrained by limited public funding, low quality of the public research system, weak commercialisation, and a venture capital market too shallow to provide funding for risk investment.[49] The legal framework for innovation, including taxation, is not sufficiently well developed[50] and a long-term strategy for research or innovation has not yet been adopted. The level of investment in research and development in Croatia stagnated at 0.75 % of GDP in 2012, significantly below the government's 1.40 % target for 2020. The share of government co-funding in business research and development expenditure was nearly zero in 2012. Apart from the use of the European Structural and Investment Funds, there is no real prospect of increasing Croatia's investment in research and innovation capacity in the coming years.

A major challenge for Croatia is to build up research and innovation capacities through targeted public investment from ESI funds and national resources to leverage private investment. This requires designing and implementing a smart specialisation strategy to provide a long-term investment framework to focus efforts in fields where there is a potential for the development of related competitive economic activities. Such a smart specialisation strategy, to be based on the industrial and innovation strategies, is in preparation. Recognising innovation priorities through a coordinated inter-ministerial process, involving stakeholders

[49] The Innovation Union Scoreboard 2014 classifies Croatia as a moderate innovator. Croatia's innovative performance relative to the EU has deteriorated from 60 % in 2011 to 55 % in 2013 mainly due to declining sales of new innovative products.

[50] Croatia offers a generous R&D tax incentive. Up to 150 % of expenses for R&D can be deducted from the corporate income tax base. The limited number of beneficiaries, however, suggests that the efficiency of the tax support may be hampered by administrative obstacles.

and complementing it with measures to further develop research and innovative skills and create attractive conditions for researchers would maximise its positive effects for the economy. In terms of digital technologies, a plan for full deployment of broadband connection is outlined in the Strategy for Broadband Development for 2012-15. The coverage of very fast broadband lines is currently substantially below the EU average.[51] Targets laid set in the Digital Agenda for Europe envisage that until 2020 Croatia should achieve download rates of 30 Mbps for 100 % of the population and above 100 Mbps for 50 % of households.

With respect to the key European Research Area priorities, Croatia has introduced performance-based criteria for institutional research funding. Project funding has been entirely outsourced to the National Science Foundation. This should result in more open and competitive financing based on international peer review principles. Furthermore, scientific centres of excellence will be established in 2014. However, concerning cooperation between public research organisations and the private sector, there has been no progress towards encouraging the commercialisation of research results and transfer of technology. In addition, there have been delays in the adoption of policy frameworks[52] that should have facilitated integration of Croatian research entities in European networks and participation in Horizon 2020, the new Union programme for research and innovation.

3.5. Modernisation of public administration

Despite some important initiatives, the quality of public governance remains low, holding back progress in growth-oriented reforms and posing risks for effective access to EU funds. At all levels of government, inadequate capacity to implement sound policies for the private sector is the common denominator of the serious issues analysed in previous sections. Specifically, Croatia ranks as the worst-performing Member State in terms of regulatory quality in the 2013 Worldwide Governance Indicators.[53] Croatia also scores very low on indicators of accountability, rule of law and control of corruption. High turnover rates, the lack of transparency in staff recruitment and the absence of evidence-based approaches for implementing reforms are other weak points.

These concerns are a clear challenge especially in view of ensuring strong and effective management of EU Structural and Investment Funds in 2014-20. The experience of the implementation of the pre-accession funds points to deficiencies in terms of strategic planning and institutional capacity and weaknesses in project elaboration and follow-up. The total allocation for Croatia amounts to EUR 8.3 billion. Its commitment is conditional on proposing a clear, prioritised and results-oriented investment strategy. The use of these funds also requires that a strong and effective implementation, monitoring and evaluation system is in place, as well as the necessary capacities to manage the funds and ensure a proper preparation and implementation of projects. Stable staffing levels of units entrusted with the management of funds helps build a knowledge –base and ensure institutional memory which is needed to ensure an efficient use of funds. Experience of other Member States also suggests that submitting a large number of proposals early in the programming period is instrumental to minimise the risk of decommitment of funds.

Administrative fragmentation weighs on the efficiency and transparency of public administration. Public administration responsibilities are shared among 20 counties, 126 cities and 429 municipalities. At central level, competencies are split between ministries and a

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[51] The coverage of very fast broadband lines is one of the lowest in the EU (21.9 % in Croatia compared with 53.8 % in the EU. Only 63.6 % of households have broadband connection (75.9 % in the EU).

[52] The Strategy on Higher Education, Science and Technological Development and the Strategy on Innovation

[53] The World Economic Forum's Global Competitiveness Report 2013 ranks Croatia's competitiveness 75th overall (up six places compared with 2012) and 93rd in terms of the quality of institutions. This is in particular due to the high perceived burden of government regulation (143rd), wastefulness of government spending (123rd) and efficiency of legal framework in settling disputes (140th).

number of agencies entrusted with implementing policies but also some strategic tasks. This complex distribution of responsibilities gives rise to significant uncertainties that complicate business decisions and lengthen administrative procedures. The high fragmentation of governance is also a challenge for policy coordination, monitoring and evaluation and may hinder a broader policy perspective. Restructuring regional and local responsibilities and consolidating small individual administrative units and central agencies performing similar tasks would facilitate the transformation of Croatian public administration towards a client-oriented approach.

The national reform programme presents relevant measures that could help increase the administrative capacity of government and subordinated bodies. Following the roll-out of a central payroll system for public employees (to be completed in October 2014), which is expected to increase transparency and consistency in salaries, a strategy for public administration reform for 2014-20 is expected to be approved in the third quarter of 2014. The reform defines standards for performance management and key competencies for all categories of public officials and improves training and hiring procedures. It also aims at merging several state administrative agencies and at replacing the current county-based organisation of public administration with fewer sub-national offices with wider territorial jurisdiction. This is a relevant step towards better coordination and more harmonised decision-making. The effectiveness of these reforms will depend on implementation and application to all levels of government. In 2014, the government also plans to launch the e-Citizens portal as a one-stop shop for citizens to access information and receive certificates from a range of interconnected public registers (framework conditions will be defined in the Act on the State Information Infrastructure).

Anti-corruption policies

A convincing track-record for an effective implementation of preventive anti-corruption policies is yet to be established. A number of anti-corruption safeguards are in place (e.g. an ethics code for civil servants, hotlines to report corruption, internal control mechanisms) and the ‘conflict of interest’ and ‘freedom of information’ legislation is being implemented. Public entities and state-owned enterprises publish regular reports on monitoring the corruption risk.[54] Moreover, some ministries and agencies publish a complete list of grant recipients, including the level of the grant. Beyond developing a strong track record of implementing the safeguards already in place, the key elements currently missing in the anti-corruption framework include verification mechanisms for conflicts of interest and asset disclosure of public officials, protection of whistle-blowers, specific safeguards for the healthcare sector and effective risk control in public procurement. The verification powers of the Commission for the Resolution of Conflicts of Interest rely heavily on the competences and pro-activeness of other authorities; its own tools and databases to perform checks that cannot be covered in a systematic manner by other institutions are still being developed.[55] According to the national reform programme, a new Strategy for the Suppression of Corruption and an accompanying action plan are going to be developed in 2014.

Some progress has been made in improving the transparency of public procurement rules but significant challenges remain regarding the operational aspects of existing legislation. Notably, all public bodies are obliged to publish concluded and executed contracts. Contracting authorities are also obliged to publish a list of businesses with regard to which conflicts of interest may arise or to expressly confirm the absence of such situations. A

[54] The fifth consolidated report on the anti-corruption programme for companies with majority public ownership was published in February 2013 and covered 86 enterprises. Six implementation reports have been published since November 2012 to provide systematic monitoring of the anti-corruption strategy. A report on transparency of local and regional self-governments was published in February 2013 covering more than 600 units.

[55] European Commission (2014), *EU Anti-corruption Report*.

public contract concluded in breach of these provisions is null and void. Furthermore, the Ministry of Justice has started monitoring the level of transparency of local governments. In 2012, a Freedom of Information Act was adopted, aiming to make public administration more transparent. The above-mentioned efforts to increase transparency are steps in the right direction. However, there appears to be some discrepancy between the formally compliant and fairly sound legal and institutional framework and its effective and transparent implementation. Notably, risk assessment tools are not being systematically used, in particular at local level, and there is no systematic reporting on costs of public works and contracted services. Responsibilities for monitoring of public procurement rules are shared by a number of public institutions, which may decrease the effectiveness of oversight. The capacity of the State Commission for Supervision of Public Procurement Procedure (less than 20 professional councillors in 2012) appears low given the considerable challenges it faces. Moreover, vulnerable sectors (those with more prominent corruption risks) appear to be insufficiently prioritised. Adequate monitoring and reporting, in particular of the implementation of rules on access to public information, is a precondition for building up the envisaged anti-corruption environment.

Justice system

Despite reforms adopted in 2012 and 2013, improving the quality and efficiency of the civil justice system remains a challenge. The effectiveness of enforcement of rulings on monetary assets has improved following the introduction of immediate enforcement through the financial agency FINA. However, the effectiveness of enforcement on immovable property is a weak point in view of low recovery rate; the national reform programme outlines relevant amendments for improving the transparency, efficiency and timeliness of enforcement (e.g. by introducing electronic auction of immovable property). The time to resolve land registry cases was shortened from 50 days in 2010 to 38 days in 2013, and the backlog was reduced by 38 %.[56] However, the impact of reforms improving the effectiveness of the justice system in other areas has yet to materialise. Despite a slight reduction, the length of proceedings at courts of first instance in 2013 remained very high in litigious civil and commercial cases (417 days) and in administrative cases (493 days). In both of these areas, the courts are having difficulties in responding to a rise in incoming cases and in enforcing procedural discipline to arrive to a final sentence in a timely manner: as a result, the backlogs in 2013 increased and are very high particularly in civil and commercial proceedings.[57] The incentives to use alternative dispute resolution mechanisms, especially for small claims, appear insufficient. One important aspect that weighs on the efficiency and quality of the justice system is the lack of a comprehensive ICT system for registration and management of cases based on a consistent methodology — such a system is currently being developed. According to the 2014 EU Justice Scoreboard, the ICT tools for communication between courts and parties are not sufficiently developed. At the beginning of 2014, the government announced a reorganisation of the court system with a view to improving efficiency by merging courts and improving allocation of workload.

Strengthening the out-of-court debt settlement procedure could ensure successful financial restructuring of distressed companies. The widespread application of the pre-insolvency procedure in 2013 had a certain degree of success in addressing debt-servicing problems faced by companies in the context of complex, expensive and lengthy insolvency

[56] Disposition time. Sources: Croatian Ministry of Justice and Council of Europe (CEPEJ), *Study on the functioning of judicial systems in the EU Member States: Facts and figures from the CEPEJ 2012-2014 evaluation exercise*, study prepared for the European Commission (DG Justice).

[57] In 2013, pending civil and commercial cases increased by 12 % (compared with 2010) and pending administrative cases increased by 70 % (compared with 2012). The rate of resolving civil and commercial cases decreased from 102 % in 2010 to 95 % in 2013, while the rate in administrative cases increased from 41 % in 2012 to 64 % in 2013. Sources: Croatian Ministry of Justice, 2014 EU Justice Scoreboard, CEPEJ Study.

procedures that still prevail in the country. However, significant shortcomings remain. Above all, the role of commercial courts in the monitoring of transparency and legality in the application of the procedure is relatively weak; this concerns particularly checking the correctness of reported claims and the validation of restructuring plans. An important feature of the current system is that it provides a compulsory formal test of insolvency or illiquidity as a pre-condition to access the pre-insolvency procedure. This means that proceedings are likely to be opened only when the company is already insolvent, thereby severely limiting the chances of success of the restructuring process and lowering the total value for creditors and employees. The obligation to enter pre-insolvency proceedings in all cases also results in delaying the liquidation procedure for those companies which are unviable.[58] Finally, the role of the state in the process, currently acting as both an administrator/supervisor and as a creditor in the same proceedings, could appear disproportionate and give cause to public concern about potential conflicts of interests. The national reform programme does not provide detailed information on how the pre-insolvency procedure could be improved; it only mentions its possible integration into the insolvency framework. In terms of the insolvency procedure, a significant problem that lengthens the closure of liquidation proceedings is that the current limitation to three attempts to sell debtor's assets is not respected in practice. A reform imposing the closure of the insolvency proceedings after all legal sale attempts regardless of possible parallel civil proceedings is expected to be adopted in summer 2014. Introduction of personal bankruptcy is also announced for the first half of 2014.

4. CONCLUSIONS

Croatia has been experiencing a prolonged downturn, in which a range of external and internal imbalances have come to the fore. These include uncompetitive exports, a corporate debt overhang and public sector indebtedness as particular vulnerabilities. Structural deficiencies have contributed to these imbalances and are now impeding a swift rebalancing process. A poor business environment and an impaired labour market stand out among the shortcomings. State-owned enterprises still play a dominant role in some sectors and some of them are highly indebted. These factors also combine to lower potential growth, which hinders private-sector balance sheet repair and increases the required fiscal consolidation effort.

Having joined the EU in July 2013, Croatia participated in the 2013 European Semester on an informal and voluntary basis only and was not issued country-specific recommendations. Croatia has undertaken reforms aimed at ending the prolonged recession and returning to a sustainable and job-rich growth path. Recent reform efforts, in particular targeting improved labour market flexibility and streamlining the benefits system, are welcome steps, although their success will largely depend on robust implementation. The national reform programme also outlines relevant plans to enhance the businesses environment and the efficiency of public administration but further concerted efforts are needed. Improving the functioning of the justice system would help reinforce Croatia’s appeal to investors. Acceleration of the restructuring of state-owned enterprises would be conducive to increased competitiveness and would ultimately also reduce contingent liabilities for the state arising from loan guarantees and capital injections.

The priorities presented in the 2014 national reform programme echo the main challenges identified in the 2014 in-depth review on Croatia and this staff working

[58] According to the 2013 SBA Fact Sheet on Croatia, the time and costs required to close a business are approximately 50 % higher than the EU average, and the degree of support for a second chance for honest entrepreneurs trails the EU average by 10 percentage points.

document. These measures signal welcome reform intentions, which could help to effectively tackle the challenges faced by Croatia, if implemented in a rigorous and timely manner.

The convergence programme affirms Croatia's commitment to correct the excessive deficit by 2016 and to bring the public debt on a downward trend in line with the excessive deficit procedure. The two main objectives of the budgetary strategy as defined in Croatia's 2014 convergence programme are swift fiscal consolidation and setting the economy on a sustainable growth path. Greater details on the further fiscal consolidation measures required to sustainably achieve the stated objectives of the programme would further enhance the robustness of the document.

OVERVIEW TABLE

Europe 2020 (national targets and progress)	
Policy field target	**Progress achieved**
Employment rate target set in the 2014 national reform programme: 62.9 % of the population aged 20-64	Employment rate of the population aged 20-64 in 2013: 53.9 %
Target on the reduction of population at risk of poverty or social exclusion in number of persons in the 2014 national reform programme: Reduction to 1 220 000, equivalent to a decrease by 152 000 persons compared to 2011	1 370 000 (2012)
Early school-leaving target: 4 %	The rate dropped to 3.8 % in 2013 from 4.2 % in 2012. This is far below the EU average of 12 %.
Tertiary education target: 35 %	Tertiary education attainment (30-34 year olds) amounted to 24.6 % in 2013 (EU average of 36.6 %). High drop-out rates and unequal access to higher education are main barriers to tertiary attainment.
2020 Renewable energy target: 20 % Share of renewable energy in all modes of transport: 10 %	The percentage of renewable energy 16.9 % in 2012. The share of renewables in the transport sector was only 0.4 % in 2012.
Energy efficiency target: 20 % Croatia has set an indicative national energy efficiency target of 20%, which implies reaching a 2020 level of 9.19 million tonnes of oil equivalent (Mtoe) primary consumption and 7.82 Mtoe final energy consumption.	Croatia's energy intensity is above the EU-28 average. Croatia notified the policy measures it plans to adopt to implement Article 7 of the Energy Efficiency Directive. Progress has been made in implementing specific energy efficiency measures in the public sector at local and regional levels.
Non-Emissions Trading System emission reduction target: +11 % compared to 2005 emissions.	Change in total greenhouse gas emissions between 2005 and 2012: -14 %. According to the latest national projections and taking into account existing measures, the target is expected to be achieved: -6 % in 2020 compared to 2005 (with a margin of 17 percentage points).
R&D target: 1.4 % of GDP	R&D intensity amounted to 0.75 % of GDP in 2012 (of which 0.41 % public R&D intensity and 0.34 % business R&D intensity) The level of investment has stagnated at 0.75 % of Croatia's GDP since 2010: this level of investment is not only much lower than the EU average of 2.06 %, but also lower than the level in most of the other Member States in central and eastern Europe. Public R&D intensity is only 0.41 % of GDP (2012) compared with 0.5 % in 2008, which means a decrease. Building up the required research and innovation capacities therefore requires a reversal of this decreasing trend.

ANNEX

Table I. Macro-economic indicators

	1996-2000	2001-2005	2006-2010	2011	2012	2013	2014	2015
Core indicators								
GDP growth rate	3.4	4.5	0.6	-0.2	-1.9	-1.0	-0.6	0.7
Output gap [1]	n.a	0.3	2.6	-1.7	-2.2	-2.9	-3.8	-3.7
HICP (annual % change)	4.3	2.9	3.0	2.2	3.4	2.3	0.8	1.2
Domestic demand (annual % change) [2]	3.1	5.9	0.1	-0.1	-3.3	-1.0	-1.3	0.0
Unemployment rate (% of labour force) [3]	13.3	14.3	10.1	13.5	15.9	17.2	18.0	18.0
Gross fixed capital formation (% of GDP)	19.7	23.1	25.0	19.6	18.6	18.4	18.5	18.9
Gross national saving (% of GDP)	16.2	20.8	21.5	19.8	18.7	19.1	20.2	20.7
General Government (% of GDP)								
Net lending (+) or net borrowing (-)	**n.a**	**n.a**	**-5.8**	**-7.8**	**-5.0**	**-4.9**	**-3.8**	**-3.1**
Gross debt	**n.a**	**n.a**	**40.8**	**52.0**	**55.9**	**67.1**	**69.0**	**69.2**
Net financial assets	**n.a**	**7.5**	**1.9**	**-11.3**	**-15.8**	**n.a**	**n.a**	**n.a**
Total revenue	n.a	n.a	40.7	40.3	40.8	41.0	43.0	43.5
Total expenditure	n.a	n.a	46.5	48.1	45.7	45.9	46.8	46.6
of which: Interest	n.a	n.a	2.1	2.6	3.0	3.1	3.4	3.6
Corporations (% of GDP)								
Net lending (+) or net borrowing (-)	**n.a**	**-4.9**	**-3.2**	**3.4**	**0.2**	**n.a**	**n.a**	**n.a**
Net financial assets; non-financial corporations	**n.a**	**-102.1**	**-139.4**	**-155.7**	**-152.3**	**n.a**	**n.a**	**n.a**
Net financial assets; financial corporations	**n.a**	**-2.4**	**-8.3**	**4.1**	**4.0**	**n.a**	**n.a**	**n.a**
Gross capital formation	n.a	19.2	19.3	14.3	13.8	n.a	n.a	n.a
Gross operating surplus	n.a	18.0	20.9	19.9	18.3	n.a	n.a	n.a
Households and NPISH (% of GDP)								
Net lending (+) or net borrowing (-)	**n.a**	**2.4**	**1.2**	**3.1**	**4.1**	**n.a**	**n.a**	**n.a**
Net financial assets	**n.a**	**48.8**	**53.5**	**59.9**	**65.8**	**n.a**	**n.a**	**n.a**
Gross wages and salaries	n.a	43.9	43.4	42.8	44.5	n.a	n.a	n.a
Net property income	n.a	0.8	0.8	1.0	0.9	n.a	n.a	n.a
Current transfers received	n.a	19.3	18.0	18.8	18.7	n.a	n.a	n.a
Gross saving	n.a	5.7	5.0	6.5	7.3	n.a	n.a	n.a
Rest of the world (% of GDP)								
Net lending (+) or net borrowing (-)	**-4.5**	**-4.6**	**-5.4**	**-0.7**	**-0.4**	**0.5**	**1.5**	**1.6**
Net financial assets	**n.a**	**48.2**	**92.6**	**103.7**	**99.1**	**n.a**	**n.a**	**n.a**
Net exports of goods and services	-7.2	-6.4	-5.1	-0.5	0.6	0.6	1.4	2.0
Net primary income from the rest of the world	-1.0	-2.1	-2.6	-2.8	-3.7	-2.6	-2.6	-3.1
Net capital transactions	n.a	n.a	n.a	n.a	n.a	0.0	0.0	0.0
Tradable sector	47.1	46.3	43.6	43.1	42.9	43.1	n.a	n.a
Non tradable sector	36.7	37.5	41.8	42.6	41.9	41.8	n.a	n.a
of which: Building and construction sector	5.4	5.7	6.7	5.2	4.6	4.4	n.a	n.a
Real effective exchange rate (index, 2000=100)	88.0	95.4	107.7	106.3	102.6	104.1	104.2	103.3
Terms of trade goods and services (index, 2000=100)	91.9	97.2	103.6	105.9	105.1	105.0	105.6	105.5
Market performance of exports (index, 2000=100)	95.0	99.9	92.5	83.9	86.5	85.1	84.3	83.1

Notes:

[1] The output gap constitutes the gap between the actual and potential gross domestic product at 2005 market prices.

[2] The indicator on domestic demand includes stocks.

[3] Unemployed persons are all persons who were not employed, had actively sought work and were ready to begin working immediately or within two weeks. The labour force is the total number of people employed and unemployed. The unemployment rate covers the age group 15-74.

Source:

Commission 2014 spring forecast (COM); Convergence programme (CP).

Table II. Comparison of macroeconomic developments and forecasts

	2013		2014		2015		2016	2017
	COM	CP	COM	CP	COM	CP	CP	CP
Real GDP (% change)	-1.0	-1.0	-0.6	0.0	0.7	1.2	1.3	1.5
Private consumption (% change)	-1.0	-1.0	-1.3	-0.8	0.0	4.0	0.8	1.3
Gross fixed capital formation (% change)	-1.0	-1.0	0.0	1.9	3.0	5.7	5.7	4.3
Exports of goods and services (% change)	-1.8	-1.8	2.6	2.0	3.7	2.7	2.9	3.0
Imports of goods and services (% change)	-1.7	-1.7	1.3	1.3	2.3	2.9	3.2	3.4
Contributions to real GDP growth:								
- Final domestic demand	-0.7	-0.7	-1.3	-0.3	0.0	1.2	1.3	1.6
- Change in inventories	-0.3	-0.3	0.0	-0.1	0.0	0.0	0.1	0.0
- Net exports	-0.1	-0.1	0.5	0.3	0.7	0.0	-0.1	-0.1
Output gap[1]	-2.9	-3.1	-3.8	-3.6	-3.7	-3.1	-2.8	-2.5
Employment (% change)	-1.0	-1.0	-2.5	-2.3	-1.0	-0.4	0.5	1.4
Unemployment rate (%)	17.2	17.1	18.0	17.9	18.0	17.7	17.3	16.5
Labour productivity (% change)	0.0	0.0	1.9	2.4	1.7	1.6	0.7	0.1
HICP inflation (%)	2.3	2.2	0.8	0.6	1.2	1.7	1.9	1.9
GDP deflator (% change)	0.9	0.9	0.8	0.9	1.2	1.7	1.9	1.9
Comp. of employees (per head, % change)	1.9	1.9	2.5	1.7	2.0	2.0	2.1	2.5
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	0.5	1.4	1.5	2.3	1.6	2.2	1.7	1.2

Note:

[1] In percent of potential GDP, with potential GDP growth recalculated by Commission services on the basis of the programme scenario using the commonly agreed methodology.

Source :

Commission 2014 spring forecast (COM); Convergence programme (CP).

Table III. Composition of the budgetary adjustment

(% of GDP)	2013	2014		2015		2016	2017	Change: 2013-2017
	COM	COM	CP	COM[1]	CP	CP	CP	CP
Revenue	**41.0**	**43.0**	**43.2**	**43.5**	**42.8**	**42.6**	**43.3**	**2.3**
of which:								
- Taxes on production and imports	18.6	18.8	18.2	18.8	18.0	18.1	17.9	-0.6
- Current taxes on income, wealth, etc.	6.3	6.4	5.8	6.5	5.9	5.9	5.9	-0.4
- Social contributions	11.3	11.7	12.9	11.8	12.6	11.9	11.9	0.6
- Other (residual)	4.8	6.1	6.3	6.4	6.3	6.7	7.7	2.8
Expenditure	**45.9**	**46.8**	**47.6**	**46.6**	**46.3**	**45.6**	**45.8**	**-0.2**
of which:								
- Primary expenditure	42.9	43.4	44.0	43.0	42.7	41.8	42.1	-0.8
of which:								
Compensation of employees	11.9	11.9	11.2	11.6	10.8	10.5	10.3	-1.6
Intermediate consumption	7.8	7.4	6.2	7.2	6.1	5.9	5.9	-1.9
Social payments	15.8	16.1	17.7	16.0	16.9	16.3	16.0	0.2
Subsidies	2.1	1.9	2.0	1.8	1.8	1.7	1.8	-0.3
Gross fixed capital formation	2.2	2.5	2.5	2.8	2.4	2.2	2.3	0.1
Other (residual)	3.1	3.6	4.5	3.6	4.7	5.3	5.7	2.7
- Interest expenditure	3.1	3.4	3.5	3.6	3.7	3.8	3.7	0.7
General government balance (GGB)[2]	**-4.9**	**-3.8**	**-4.4**	**-3.1**	**-3.5**	**-2.7**	**-2.5**	**2.5**
Primary balance	**-1.9**	**-0.4**	**-0.8**	**0.4**	**0.1**	**0.7**	**1.3**	**3.1**
One-off and other temporary measures	-0.2	0.9	0.8	0.7	0.6	0.0	0.0	0.2
GGB excl. one-offs	**-4.7**	**-4.6**	**-5.2**	**-3.8**	**-4.2**	**-2.7**	**-2.5**	**2.2**
Output gap[3]	-2.9	-3.8	-3.6	-3.7	-3.1	-2.8	-2.5	0.5
Cyclically-adjusted balance[3]	-3.7	-2.2	-2.8	-1.6	-2.2	-1.6	-1.4	2.3
Structural balance (SB)[4]	**-3.5**	**-3.1**	**-3.7**	**-2.3**	**-2.8**	**-1.6**	**-1.4**	**2.0**
Change in SB	*0.5*	*0.4*	*-0.3*	*0.8*	*0.9*	*1.3*	*0.1*	-
Two year average change in SB	*1.8*	*0.5*	*0.1*	*0.6*	*0.3*	*1.1*	*0.7*	-
Structural primary balance[4]	-0.4	0.3	-0.2	1.3	0.8	2.2	2.3	2.6
Change in structural primary balance		*0.7*	*0.2*	*1.0*	*1.0*	*1.4*	*0.1*	-
Expenditure benchmark								
Applicable reference rate[5]	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Deviation[6] (% GDP)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Two-year average deviation (% GDP)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

Notes:

[1] On a no-policy-change basis.

[2] The Convergence Programme uses different accounting methodologies for past and future years. This artificially and substantially increases the headline balance in 2014 and 2015.

[3] Output gap (in % of potential GDP) and cyclically-adjusted balance according to the programme as recalculated by Commission services on the basis of the programme scenario using the commonly agreed methodology.

[4] Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.

[5] Reference medium-term rate of potential GDP growth. The (standard) reference rate applies from year t+1, if the country has reached its MTO in year t. A lower rate applies as long as the country is adjusting towards its MTO, including in year t.The reference rates applicable to 2014 onwards have been updated in 2013.

[6] Deviation of the growth rate of public expenditure net of discretionary revenue measures and revenue increases mandated by law from the applicable reference rate. The expenditure aggregate used for the expenditure benchmark is obtained following the commonly agreed methodology. A negative sign implies that expenditure growth exceeds the applicable reference rate.

Source:
Convergence programme (CP); Commission 2014 spring forecast (COM); Commission calculations.

Table IV. Debt dynamics

(% of GDP)	Average 2009-2012	2013	2014		2015		2016	2017
			COM	CP	COM	CP	CP	CP
Gross debt ratio[1]	**47.4**	**67.1**	**69.0**	**71.7**	**69.2**	**71.0**	**71.2**	**71.2**
Change in the ratio	6.4	11.2	1.9	4.6	0.2	-0.7	0.2	0.0
Contributions[2] *:*								
1. Primary balance	**3.7**	**1.9**	**0.4**	**0.8**	**-0.4**	**-0.1**	**-0.7**	**-1.3**
2. "Snow-ball" effect	**2.6**	**3.1**	**3.2**	**2.9**	**2.4**	**1.7**	**1.4**	**1.3**
Of which:								
Interest expenditure	2.4	3.1	3.4	3.5	3.6	3.7	3.5	3.7
Growth effect	0.6	0.6	0.4	0.0	-0.5	-0.8	-0.9	-1.0
Inflation effect	-0.7	-0.5	-0.6	-0.7	-0.8	-1.2	-1.2	-1.4
3. Stock-flow	**0.1**	**6.2**	**-1.7**	**0.9**	**-1.7**	**-2.2**	**-0.4**	**0.0**
Of which:								
Cash/accruals diff.								
Acc. financial assets				2.5		0.6	0.6	0.3
Privatisation				0.6		0.6	0.6	0.3
Val. effect & residual				1.9				

	2013	2014		2015		2016	2017
		COM	CP	COM	CP	CP	CP
Gap to the debt benchmark[3,4]	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Structural adjustment[5]	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
To be compared to:							
Required adjustment[6]	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

Notes:

[1]End of period.

[2]The snow-ball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator). The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other residual effects.

[3]Not relevant for Member Sates that were subject to an EDP procedure in November 2011 and for a period of three years following the correction of the excessive deficit.

[4]Shows the difference between the debt-to-GDP ratio and the debt benchmark. If positive, projected gross debt-to-GDP ratio does not comply with the debt reduction benchmark.

[5]Applicable only during the transition period of three years from the correction of the excessive deficit for EDP that were ongoing in November 2011.

[6]Defines the remaining annual structural adjustment over the transition period which ensures that - if followed – Member State will comply with the debt reduction benchmark at the end of the transition period, assuming that COM (SP/CP) budgetary projections for the previous years are achieved.

Source :

Covergence programme (CP); Commission 2014 spring forecast (COM); Commission calculations.

Table V. Taxation indicators

	2002	2006	2008	2010	2011	2012
Total tax revenues (incl. actual compulsory social contributions, % of GDP)	37.9	37.1	37.1	36.4	35.3	35.7
Breakdown by economic function (% of GDP)[1]						
Consumption	19.1	17.9	17.2	17.3	16.7	17.5
of which:						
- VAT	12.4	12.2	11.9	11.7	11.4	12.3
- excise duties on tobacco and alcohol	1.5	1.3	1.3	1.3	1.3	1.4
- energy	2.7	2.2	1.8	2.2	1.8	1.7
- other (residual)	2.5	2.3	2.3	2.2	2.1	2.1
Labour employed	14.6	14.4	14.9	15.2	14.5	14.4
Labour non-employed	0.2	0.1	0.2	0.2	0.1	0.2
Capital and business income	3.0	3.6	3.6	2.6	2.9	2.6
Stocks of capital/wealth	1.0	1.0	1.2	1.1	1.1	1.0
p.m. Environmental taxes[2]	4.1	3.8	3.4	3.7	3.3	3.2
VAT efficiency[3]						
Actual VAT revenues as % of theoretical revenues at standard rate	79.9	84.3	83.0	75.2	72.8	72.8

Note:

1. Tax revenues are broken down by economic function, i.e. according to whether taxes are raised on consumption, labour or capital. See European Commission (2014), Taxation trends in the European Union, for a more detailed explanation.

2. This category comprises taxes on energy, transport and pollution, and resources included in taxes on consumption and capital.

3. The VAT efficiency is measured via the VAT revenue ratio. It is defined as the ratio between the actual VAT revenue collected and the revenue that would be raised if VAT was applied at the standard rate to all final (domestic) consumption expenditures, which is an imperfect measure of the theoretical pure VAT base. A low ratio can indicate a reduction of the tax base due to large exemptions or the application of reduced rates to a wide range of goods and services ('policy gap') or a failure to collect all tax due to e.g. fraud ('collection gap'). It should be noted that the relative size of cross-border shopping compared to domestic consumption also influences the value of the ratio, notably for smaller economies. See European Commission (2012), Tax Reforms in EU Member States and OECD (2012), Consumption tax trends for a more detailed discussion.

Source: Commission

Table VI. Financial market indicators

	2009	2010	2011	2012	2013
Total assets of the banking sector (% of GDP)	-	-	133.0	132.9	133.8
Share of assets of the five largest banks (% of total assets)	-	-	-	-	-
Foreign ownership of banking system (% of total assets)	-	-	-	-	-
Financial soundness indicators:					
- non-performing loans (% of total loans)[1)]	7.7	11.1	12.3	13.8	15.4
- capital adequacy ratio (%) [1),2)]	16.4	18.8	20.5	20.9	20.9
- return on equity (%) [1)]	8.8	8.3	8.7	6.1	2.4
Bank loans to the private sector (year-on-year % change)	-	-	-	-3.9	-0.1
Lending for house purchase (year-on-year % change)	-	-	-	-0.6	-1.5
Loan to deposit ratio	-	-	108.8	100.7	96.2
CB liquidity as % of liabilities	0.0	0.0	0.0	0.0	0.0
Banks' exposure to countries receiving official financial assistance (% of GDP)	-	-	-	-	-
Private debt (% of GDP)	128.0	137.0	134.8	132.7	-
Gross external debt (% of GDP)[3)]					
- Public	13.0	14.8	16.2	19.6	21.2
- Private	64.9	65.7	61.4	62.0	62.0
Long term interest rates spread versus Bund (basis points)*	-	364.0	393.1	463.4	311.1
Credit default swap spreads for sovereign securities (5-year)*	304.2	239.5	322.5	382.9	303.7

Notes:

[1)] Latest data 2013Q4.

[2)] Basel II introduced in 2010.

[3)] Latest data 2013Q3.

* Measured in basis points.

Source:

Bank for International Settlements and Eurostat (exposure to macro-financially vulnerable countries), IMF (financial soundness indicators), Commission (long-term interest rates), World Bank (gross external debt) and ECB (all other indicators).

Table VII. Labour market and social indicators

Labour market indicators	2008	2009	2010	2011	2012	2013
Employment rate (% of population aged 20-64)	62.9	61.7	58.7	57.0	55.4	53.9
Employment growth (% change from previous year)	3.1	-1.8	-5.1	-2.3	-3.9	-1.1
Employment rate of women (% of female population aged 20-64)	55.2	55.4	53.0	50.9	50.2	49.7
Employment rate of men (% of male population aged 20-64)	70.7	68.2	64.7	63.2	60.6	58.3
Employment rate of older workers (% of population aged 55-64)	36.7	38.5	37.6	37.1	36.7	36.5
Part-time employment (% of total employment, 15 years and more)	8.8	9.0	9.7	9.9	8.4	7.9
Part-time employment of women (% of women employment, 15 years and more)	11.5	11.6	12.5	12.4	10.0	9.3
Part-time employment of men (% of men employment, 15 years and more)	6.7	6.9	7.3	7.9	7.0	6.8
Fixed term employment (% of employees with a fixed term contract, 15 years and more)	12.1	11.6	12.3	12.7	12.8	14.1
Transitions from temporary to permanent employment	:	:	:	43.7	:	:
Unemployment rate[1] (% of labour force, age group 15-74)	8.4	9.1	11.8	13.5	15.9	17.2
Long-term unemployment rate[2] (% of labour force)	5.3	5.1	6.7	8.6	10.3	11.0
Youth unemployment rate (% of youth labour force aged 15-24)	21.9	25.1	32.6	36.1	43.0	49.7
Youth NEET rate (% of population aged 15-24)	10.1	11.9	14.9	15.7	16.7	18.6
Early leavers from education and training (% of pop. 18-24 with at most lower sec. educ. and not in further education or training)	3.7	3.9	3.7	4.1	4.2	3.7
Tertiary educational attainment (% of population 30-34 having successfully completed tertiary education)	18.5	20.6	24.3	24.5	23.7	25.9
Formal childcare (from 1 to 29 hours; % over the population less than 3 years)	:	:	1.0	1.0	0.0	:
Formal childcare (30 hours or over; % over the population less than 3 year)	:	:	7.0	14.0	12.0	:
Labour productivity per person employed (annual % change)	-1.0	-5.2	3.0	2.2	2.1	0.0
Hours worked per person employed (annual % change)	:	:	:	:	:	:
Labour productivity per hour worked (annual % change; constant prices)	:	:	:	:	:	:
Compensation per employee (annual % change; constant prices)	-1.2	-1.8	1.0	0.1	1.4	1.0
Nominal unit labour cost growth (annual % change)	5.8	6.6	-1.1	-0.3	1.1	:
Real unit labour cost growth (annual % change)	0.1	3.6	-1.9	-2.0	-0.7	:

Notes:

[1] Unemployed persons are all persons who were not employed, had actively sought work and were ready to begin working immediately or within two weeks. The labour force is the total number of people employed and unemployed.

[2] Long-term unemployed are unemployed persons for at least 12 months.

Sources:
Commission (EU Labour Force Survey and European National Accounts)

Expenditure on social protection benefits (% of GDP)	2007	2008	2009	2010	2011
Sickness/Health care	:	6.3	7.1	7.0	6.8
Invalidity	:	3.2	3.5	3.6	3.5
Old age and survivors	:	6.9	7.6	7.7	7.7
Family/Children	:	1.5	1.6	1.7	1.6
Unemployment	:	0.2	0.4	0.5	0.5
Housing and Social exclusion n.e.c.	:	0.0	0.0	0.0	0.0
Total	:	18.2	20.2	20.5	20.2
of which: means tested benefits	:	1.2	1.3	1.3	1.4
Social inclusion indicators	**2008**	**2009**	**2010**	**2011**	**2012**
At-risk-of-poverty or social exclusion[1] (% of total population)	:	:	30.7	32.3	32.3
At-risk-of-poverty or social exclusion of children (% of people aged 0-17)	:	:	28.9	31.4	33.8
At-risk-of-poverty or social exclusion of elderly (% of people aged 65+)	:	:	36.2	35.1	33.2
At-Risk-of-Poverty rate[2] (% of total population)	17.3	17.9	20.5	21.3	20.5
Severe Material Deprivation[3] (% of total population)	:	:	14.3	14.8	15.4
Share of people living in low work intensity households[4] (% of people aged 0-59)	:	:	13.7	15.4	16.2
In-work at-risk-of poverty rate (% of persons employed)	:	:	6.1	6.9	6.1
Impact of social transfers (excluding pensions) on reducing poverty	31.6	29.8	30.7	29.5	32.6
Poverty thresholds, expressed in national currency at constant prices[5]	23 732	24 830	22 878	21 795	21 028
Gross disponsable income (households)	208 712	210 385	212 804	214 312	217 580
Relative median poverty risk gap (60% of median equivalised income, age: total)	25.0	24.4	28.1	27.9	28.8

Notes:

[1] People at-risk-of poverty or social exclusion (AROPE): individuals who are at-risk-of poverty (AROP) and/or suffering from severe material deprivation (SMD) and/or living in household with zero or very low work intensity (LWI).

[2] At-risk-of poverty rate (AROP): share of people with an equivalised disposable income below 60% of the national equivalised median income.

[3] Share of people who experience at least 4 out of 9 deprivations: people cannot afford to i) pay their rent or utility bills, ii) keep their home adequately warm, iii) face unexpected expenses, iv) eat meat, fish, or a protein equivalent every second day, v) enjoy a week of holiday away from home once a year, vi) have a car, vii) have a washing machine, viii) have a colour tv, or ix) have a telephone.

[4] People living in households with very low work intensity: share of people aged 0-59 living in households where the adults (excluding dependent children) work less than 20% of their total work-time potential during the previous 12 months.

[5] For EE, CY, MT, SI, SK, thresholds in nominal values in Euros; HICP - index 100 in 2006 (2007 survey refers to 2006 incomes)

Sources:

For expenditure for social protection benefits ESSPROS; for social inclusion EU-SILC.

Table VIII. Product market performance and policy indicators

Performance indicators	**2004-2008**	**2009**	**2010**	**2011**	**2012**	**2013**
Labour productivity[1] total economy (annual growth in %)	1.8	-4.6	2.7	2.1	1.3	n.a.
Labour productivity[1] in manufacturing (annual growth in %)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Labour productivity[1] in electricity, gas, water (annual growth in %)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Labour productivity[1] in the construction sector (annual growth in %)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Patent intensity in manufacturing[2] (patents of the EPO divided by gross value added of the sector)	17.8	13.0	10.8	8.8	n.a.	n.a.
Policy indicators	**2004-2008**	**2009**	**2010**	**2011**	**2012**	**2013**
Enforcing contracts[3] (days)	561.0	561	561	561	572	572
Time to start a business[3] (days)	25.2	22	9	8	8	8
R&D expenditure (% of GDP)	0.9	0.9	0.8	0.8	0.8	n.a.
Tertiary educational attainment (% of 30-34 years old population)	17.2	20.6	24.3	24.5	23.7	25.9
Total public expenditure on education (% of GDP)	4.0	4.3	4.3	n.a.	n.a.	n.a.
	2008	**2009**	**2010**	**2011**	**2012**	**2013**
Product market regulation[4], Overall (Index; 0=not regulated; 6=most regulated)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Product market regulation[4], Retail (Index; 0=not regulated; 6=most regulated)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Product market regulation[4], Network Industries[5] (Index; 0=not regulated; 6=most regulated)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

Notes:

[1] Labour productivity is defined as gross value added (in constant prices) divided by the number of persons employed.

[2] Patent data refer to applications to the European Patent Office (EPO). They are counted according to the year in which they were filed at the EPO. They are broken down according to the inventor's place of residence, using fractional counting if multiple inventors or IPC classes are provided to avoid double counting.

[3] The methodologies, including the assumptions, for this indicator are presented in detail on the website http://www.doingbusiness.org/methodology.

[4] The methodologies of the product market regulation indicators are presented in detail on the website http://www.oecd.org/document/1/0,3746,en_2649_34323_2367297_1_1_1_1,00.html.

[5] Aggregate ETCR.

Source :
Commission, World Bank - *Doing Business* (for enforcing contracts and time to start a business) and OECD (for the product market regulation indicators).

Table IX. Green growth

		2003-2007	2008	2009	2010	2011	2012
Green Growth performance							
Macroeconomic							
Energy intensity	kgoe / €	0.31	0.28	0.29	0.29	0.29	0.28
Carbon intensity	kg / €	1.06	0.96	0.96	0.96	0.95	n.a.
Resource intensity (reciprocal of resource productivity)	kg / €	1.98	2.15	1.82	1.48	1.53	n.a.
Waste intensity	kg / €	n.a.	0.13	n.a.	0.11	n.a.	n.a.
Energy balance of trade	% GDP	-2.9%	-4.4%	-2.8%	-3.3%	-4.6%	-5%
Energy weight in HICP	%	n.a.	12	11	12	13	n.a.
Difference between change energy price and inflation	%	n.a.	0.8	4.5	6.1	0.3	11.4
Environmental taxes over labour taxes	ratio	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Environmental taxes over total taxes	ratio	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Sectoral							
Industry energy intensity	kgoe / €	0.25	0.24	0.22	0.22	n.a.	n.a.
Share of energy-intensive industries in the economy	% GDP	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Electricity prices for medium-sized industrial users**	€ / kWh	n.a.	0.08	0.09	0.09	0.09	0.09
Gas prices for medium-sized industrial users***	€ / kWh	n.a.	0.02	0.03	0.04	0.04	0.04
Public R&D for energy	% GDP	n.a.	0.00%	0.00%	0.00%	0.00%	0.00%
Public R&D for the environment	% GDP	n.a.	0.01%	0.00%	0.00%	0.00%	0.00%
Recycling rate of municipal waste	ratio	n.a.	2.8%	2.3%	4.0%	8.3%	14.9%
Share of GHG emissions covered by ETS*	%	n.a.	34.6%	32.3%	30.2%	n.a.	n.a.
Transport energy intensity	kgoe / €	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Transport carbon intensity	kg / €	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Security of energy supply							
Energy import dependency	%	56.4%	59.9%	51.0%	52.1%	54.4%	53.6%
Diversification of oil import sources	HHI	n.a.	0.44	0.48	0.31	0.29	n.a.
Diversification of energy mix	HHI	0.35	0.33	0.34	0.31	0.30	0.29
Share renewable energy in energy mix	%	9.5%	8.7%	10.9%	13.2%	10.4%	12.1%

Country-specific notes:
The year 2012 is not included in the table due to lack of data.
General explanation of the table items:
Source: Eurostat unless indicated otherwise; ECFIN elaborations indicated below
All macro intensity indicators are expressed as a ratio of a physical quantity to GDP (in 2000 prices)
Energy intensity: gross inland energy consumption (in kgoe) divided by GDP (in EUR)
Carbon intensity: Greenhouse gas emissions (in kg CO2 equivalents) divided by GDP (in EUR)
Resource intensity: Domestic Material Consumption (in kg) divided by GDP (in EUR)
Waste intensity: waste (in kg) divided by GDP (in EUR)
Energy balance of trade: the balance of energy exports and imports, expressed as % of GDP
Energy weight in HICP: the share of the "energy" items in the consumption basket used in the construction of the HICP
Difference between energy price change and inflation: energy component of HICP, and total HICP inflation (annual %-change)
Environmental taxes over labour or total taxes: from DG TAXUD's database "Taxation trends in the European Union"
Industry energy intensity: final energy consumption of industry (in kgoe) divided by gross value added of industry (in 2005 EUR)
Share of energy-intensive industries in the economy: share of gross value added of the energy-intensive industries in GDP
Electricity and gas prices medium industrial users: consumption band 500 - 2000MWh and 10000 - 100000 GJ; figures excl. VAT.
Recycling rate of municipal waste: ratio of municipal waste recycled over total municipal waste
Public R&D for energy or for the environment: government spending on R&D (GBAORD) for these categories as % of GDP
Share of GHG emissions covered by ETS: based on greenhouse gas emissions as reported by Member States to EEA (excl LULUCF)
Transport energy intensity: final energy consumption of transport activity (kgoe) divided by transp industry gross value added (2005 EUR)
Transport carbon intensity: greenhouse gas emissions in transport activity divided by gross value added of the transport sector
Energy import dependency: net energy imports divided by gross inland energy consumption incl. energy consumption international bunkers
Diversification of oil import sources: Herfindahl index (HHI), calculated as the sum of the squared market shares of countries of origin
Diversification of the energy mix: Herfindahl Index over natural gas, total petrol products, nuclear heat, renewable energies and solid fuels
Share renewable energy in energy mix: %-share in gross inland energy consumption, expressed in tonne oil equivalents
* Commission and EEA.
** For 2007 average of S1 & S2 for DE, HR, LU, NL, FI, SE & UK. Other countries only have S2.
*** For 2007 average of S1 & S2 for HR, IT, NL, FI, SE & UK. Other countries only have S2.

List of indicators used in Box 5 on the potential impact on growth of structural reforms.

Final goods sector mark-ups: Price-cost margin, i.e. the difference between the selling price of a good or service and its cost. Final goods mark-ups are proxied by the mark-ups in selected services sectors (transport and storage, post and telecommunications, electricity, gas and water supply, hotels and restaurants and financial intermediation but excluding real estate and renting of machinery and equipment and other business activities[59]).
Source: Commission services estimation using the methodology of Roeger, W. (1995). "Can imperfect Competition explain the Difference between primal and dual Productivity?" *Journal of Political Economy* Vol. 103(2) pp. 316-30, based on EUKLEMS 1996-2007 data.

Entry costs: Cost of starting a business in the intermediate sector as a share of income per capita. The intermediate sector is proxied by the manufacturing sector in the model.
Source: World Bank, Doing Business Database. www.doingbusiness.org. 2012 data.

Implicit consumption tax rate: Defined as total taxes on consumption over the value of private consumption. In the simulations it is used as a proxy for shifting taxation away from labour to indirect taxes. The implicit consumption tax-rates are increased (halving the gap vis-à-vis the best performers) while labour tax-rates are reduced so that the combined impact is ex-ante budgetary neutral.
Source: European Commission, Taxation trends in the European Union, 2013 edition, Luxembourg, 2013. 2011 data.

Shares of high-skilled and low-skilled: The share of high skilled workers is increased, the share of low-skilled workers is reduced (halving the gap vis-à-vis the best performers). Low-skilled correspond to ISCED 0-2 categories; high-skilled correspond to scientists (in mathematics and computing, engineering, manufacturing and construction). The remainder is medium-skilled.
Source: EUROSTAT. 2012 data or latest available.

Female non-participation rate: Share of women of working age not in paid work and not looking for paid work in total female working-age population
Source: EUROSTAT. 2012 data or latest available.

Low-skilled male non-participation rates: Share of low-skilled men of working age not in paid work and not looking for paid work in total male working-age population
Source: EUROSTAT. 2012 data or latest available.

Elderly non-participation rates (55-64 years): Share of the population aged 55-64 years not in paid work and not looking for paid work in total population aged 55-64 years.
Source: EUROSTAT. 2012 data or latest available.

ALMP: Active Labour Market Policy expenditures as a share of GDP over the share of unemployed in the population.
Source: EUROSTAT. 2011 data or latest available.

Benefit replacement rate: Share of a worker's pre-unemployment income that is paid out by the unemployment insurance scheme. Average of net replacement rates over 60 months of unemployment.
Source: OECD, Benefits and Wages Statistics.
www.oecd.org/els/benefitsandwagesstatistics.htm. 2012 data.

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[59] The real estate sector is excluded because of statistical difficulties of estimating a mark-up in this sector. The sector renting of machinery and equipment and other business activities is conceptually part of intermediate goods sector.