IN-DEPTH ANALYSIS

Economic Dialogue with Croatia

ECON on 27 March 2017

This note presents selected information on the current status of the EU economic governance procedures and related relevant information in view of an Economic Dialogue with Zdravko Maric, Croatia's Minister for Finance, in the ECON committee of the European Parliament. The invitation for a dialogue is in accordance with the EU economic governance framework.

Croatia's economy is recovering strongly from the deepest recession of its history. The recovery is driven by both exports (mainly tourism) and internal demand (including investments supported by European funds). However, the growth has not translated into a satisfactory decrease in **unemployment**, as the new jobs are essentially of temporary nature, and labour force is shrinking because of emigration and demographic effects.

Public finances are recovering: the deficit is now below the Maastricht threshold (the Commission may propose that Croatia exit the Excessive Deficit Procedure in May 2017) and the rather high public debt-to-GDP ratio is decreasing (partly due to exchange rates developments).

According to the Commission, **Croatia is experiencing excessive macroeconomic imbalances,** mainly due to high public and private debt, in a context of low productivity and weak potential growth.

Croatia's main weaknesses are identified in these areas:

- inefficient public administration, including the governance of the State Owned Enterprises;
- poor fiscal framework;
- weak business environment, with high administrative burden and many regulatory restrictions;
- a pension system that facilitates early retirement and leaves the elderly at risk of poverty and social exclusion;
- a system of social protection characterised by inconsistencies, fragmented coverage and lack of transparency;
- a financial sector characterized by high level of non-performing loans and low profitability, as well as by exposure to exchange rate risks.

Croatia: some key facts

Croatia joined the EU in July 2013

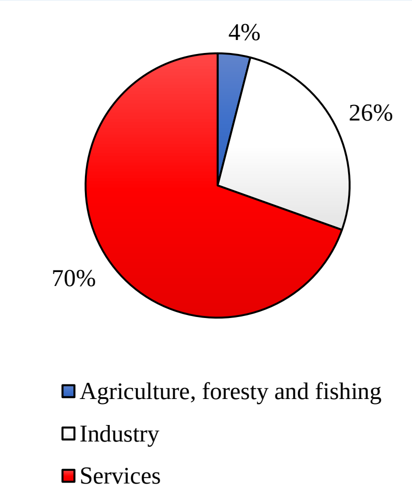
Population: ca 4.2 million.

GDP per capita in 2015: 16.700 Euro compared to EU average 28.900 (in Purchasing Power Parities).

Currency: Croatian Kuna (HRK): 1 euro is exchanged for 7.4 kuna.

Last elections: November 2015, September 2016.

Structure of the Economy in 2016:



In 2015, tourism corresponded to 18% of GDP.

The **Country Specific Recommendations** issued to Croatia referred to these weaknesses. However, they have been implemented to a **limited extent over the years.** These recommendations have been adopted under the preventive arm of the Macroeconomic Imbalance Procedure.

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1. Economic developments

After being severely hit by the financial and economic crisis, Croatia's economy has progressively returned to growth. Croatia's economy shrank by nearly 13 percent between 2008 and 2014, due to sharp contraction in domestic demand following the global crisis[1]. In 2015, the economy returned to growth, driven by strong exports as well as by a rebound in private consumption and investment (besides favourable base effects, the former benefitted from lower energy prices, reductions in personal income tax, while the latter reflected, *inter alia*, increased public investment via enhanced absorption of EU structural funds). The growth further gathered momentum in 2016 on the back of strong and broad-based recovery, with real GDP expanding by 2.6%.

Looking ahead, Croatia's economy is expected to continue growing at a robust pace in both 2017 and 2018 (by 3.1% and 2.5% respectively, according to the Winter 2017 Commission's forecast) reflecting buoyant private consumption, though net exports are projected to contribute negatively to growth (as imports are to grow at the faster pace than exports)[2]. The balance of risks to this outlook is tilted to the downside, as weaker-than-expected external demand and the projected normalisation of monetary policy are to weigh on the pace of Croatia's recovery.

Headline inflation, as measured by Harmonised Index of Consumer Prices (HICP), was negative in both 2015 and 2016 (-0.3% and -0.6% respectively), mainly reflecting declines in energy and subdued core inflation. However, inflation is set to pick up in 2017 (1.7%) and 2018 (1.6%), driven by demand-side factors (falling unemployment and wage increases) as well as raising of commodity prices. This upward trend is already visible in monthly HICP data: headline inflation turned positive towards the end of 2016 and accelerated to 0.9% in January 2017.

After peaking at 9% of GDP in 2008, Croatia's current account deficit progressively narrowed and turned into surplus in 2013, in line with the collapse in domestic demand, before posting a surplus of 5% of GDP in 2015(the highest on record since the series started in 2000), reflecting large net current transfers (essentially remittances from Croatian citizens working abroad), positive trade balance (as surplus in net transactions of services more than offset deficit in net transactions of goods) and one-off contraction in the primary income deficit reflecting the conversion of Swiss franc-denominated loans (See Box 1). Over the period 2016-2018, the current account surplus is expected to progressively narrow down, in line with strengthening domestic demand.

Unemployment has resumed its downward trend but still remains at high levels. After its peak of 17.3% in 2013 and 2014, the unemployment rate fell to 16.3% in 2015, as the economy emerged from recession. The decline in the unemployment rate accelerated in 2016 (12.8% for the year as a whole) on the back of both shrinking labour force (due to demographic dynamics and net migration outflows) and rising employment. This trend is to continue into 2017, bringing the share of unemployed persons in the labour force to 11.3% in January 2017[3]. Youth unemployment has also been sizeably reduced, but still remains at elevated levels (28.1% in December 2016 as compared to a peak of 54.5% at the start of 2013). According to the Commission Winter 2017 forecast, the unemployment rate is to fall to a single-digit figure in 2018.

Public deficit steadily declined from its peak of 7.8% of GDP in 2011 to projected 1.8% of GDP in 2016, reflecting fiscal adjustment, in particular on the expenditure side[4], in the context of the Excessive Deficit Procedure and, more recently, increasing tax revenues on the back of improved macroeconomic environment. Consequently, Croatia may expected to exit the EDP in the course of 2017, as the headline deficit is projected to stand at 2.1% of GDP in 2017 and 1.8% of GDP in 2018. However, the structural balance is set to deteriorate markedly over this period on the back of the customary no-policy change assumption underpinning the Commission's projections. Finally,

[1] This marked the longest recession on record since the country emerged from a war in 1995.
[2] Nevertheless, even if Croatia's GDP were to expand in line with the latest Commission's forecast, the size of the economy would still remain below its 2008 level by the end of the forecast horizon.
[3] This was the fifth highest level among the EU 28 countries, after Greece, Spain, Cyprus and Italy.
[4] Including reductions in public subsidies and public wages.

general government gross debt, expressed in terms of GDP, reached its record high of 86.7% in 2015, before resuming its downward trend on the back of "*strong growth, fiscal consolidation, appreciation of the kuna against the euro and favourable refinancing conditions*". As a result, public debt is set to gradually decrease from 84.1% of GDP in 2016 to 81.3% of GDP in 2018.

Box 1: The conversion of Swiss franc-denominated loans

During the credit boom in the 2000s, Croatian households and enterprises contracted loans denominated in Swiss-franc, driven by low interest rates, that were primarily used for mortgages or buying commercial property. However, when in January 2015 the Swiss central bank lifted its cap on the value of the franc ceiling and the franc suddenly surged, the repayment of those loans and interest rate payments became far more expensive.

In September 2015, Croatia adopted a law which ordered the conversion of loans denominated in Swiss francs to loans denominated in Euros, at the banks' expense. The mandatory conversion was aimed at alleviating the effects of the Swiss franc surge, shielding borrowers at the expense of lenders. In fact, the conversion rate set by the law (using the exchange rates under which the loans were initially issued) imposed approximately 1 billion euros of losses on banks in Croatia.

The legality of that law, however, has been put into question, both by banks and by the European Commission. Lord Hill, who at that time was the European Commissioner in charge of the dossier, responded in May 2016 to related questions raised by members of ECON and said that the Commission was carefully monitoring the situation, was in close contact with the Croatian government, and was promoting a solution that, consistent with EU legislation, would strike the right balance by protecting consumers, investments, and the single market.

The Commission's country report of 2017 does not mention whether the Commission has started or is still envisaging to start an infringement procedure regarding the mandatory conversion of loans initially denominated in Swiss francs.

2. Public finances

2016 Country Specific Recommendation

1. *Ensure a durable correction of the* ***excessive deficit*** *by 2016. Thereafter, achieve an annual fiscal adjustment of at least 0.6% of GDP in 2017. Use any windfall gains to accelerate the reduction of the general government debt ratio.*
By September 2016, reinforce numerical fiscal rules and strengthen the independence and the mandate of the ***Fiscal Policy Commission****.*
By the end of 2016, improve ***budgetary planning*** *and strengthen the multi-annual budgetary framework.*
By the end of 2016, start a reform of recurrent taxation of ***immovable property****.*
Reinforce the framework for ***public debt management****. Adopt and start implementing a debt management strategy for 2016-2018.*

In January 2014, the Council decided that Croatia in 2013 (the year of its accession to the EU) had an excessive deficit. It therefore opened an Excessive Deficit Procedure (EDP) and recommended that Croatia put an end to the excessive deficit by 2016. This recommendation is still valid: it means that the COM needs to decide whether to recommend to the Council to close the EDP, and it will do it on the basis of (1) the final deficit data for 2016 (to be submitted by Croatia and validated by Eurostat in April 2017), (2) the fiscal commitments made by the Croatian authorities in the Convergence Programme (to be submitted by April 2017) and (3) the COM spring 2017 economic forecast (expected for May 2017).

Table 1 shows that on the basis of the COM Winter 2017 forecast, the headline deficit is significantly below the 3%-threshold in 2016, 2017 and 2018 (and below the Council targets for 2015 and 2016), even though the table also shows that the year-on-year change of the structural balance indicates that the fiscal effort requested by the Council was not fully met over the period 2014-2016.

Table 1: Overview of Croatia's key fiscal indicators

Year	**Headline budget balance targets** requested by the Council under EDP as % of GDP	**Fiscal effort in structural terms** requested by the Council under EDP as % of GDP	**COM forecast - winter 2017** (under no policy change scenario)				
			Nominal budget balance as % of GDP	**Structural budget balance** as % of GDP yearly value	**Structural budget balance** as % of GDP y-o-y change	**Debt** % of GDP	**GDP growth** % change
2013	-	-	-5.3	-3.2	0.6	82.2	-1.1
2014	-4.6	0.5	-5.4	-3.6	-0.4	86.6	-0.5
2015	-3.5	0.9	-3.3	-2.1	1.5	86.7	1.6
2016	-2.7	0.7	-1.8	-1.4	0.7	84.1	2.8
2017	-	-	-2.1	-2.8	-1.4	83.0	3.1
2018	-	-	-1.8	-3.2	-0.4	81.3	2.5

Sources: Council EDP recommendation (January 2014) and COM winter 2017 forecast annex tables: 1 (GDP growth), 36 (nominal budget balance), 41 (structural budget balance) and 42 (gross debt).

The 2017 year-on-year change of the Croatian structural budget balance projected by the recent COM winter forecast amounts to -1.4% of GDP. This forecast indicates that the fiscal effort of at least 0.6% of GDP in 2017, requested in the CSR July 2016 on the basis of the assumption that Croatia exits the EDP, might be missed significantly.[5] In accordance with the rules of the preventive arm of the SGP, "significant" is defined as a deviation of 0.5% of GDP in 1 year or cumulatively over 2 years from the Medium Term Objective or from its adjustment path. Therefore, if Croatia is in the preventive arm of the SGP as from summer 2017, the COM may decide to issue an 'early warning'.

In its country Croatian chapter of the winter 2017 forecast, the COM explains that the improvement of Croatia's general government balance in 2016 can largely be attributed to windfall revenues and contained expenditure growth. The document also mentions tax cuts in the personal income tax and, to a lesser extent, VAT reduction. "*The total cost of the reform is however expected to be partially offset by the stronger growth, as the tax cuts boosts consumption and investment.*" The COM also judges that the "*revenue-reducing impact of the tax reforms and the projected increase in expenditure indicates an expansionary fiscal stance*." The expected decline of the debt ratio can be explained by a combination of strong growth, the appreciation of the *kuna* against the euro and favourable refinancing conditions. The recent upgrade of the Croatia's outlook by the rating agency Moody's, from negative to stable (at Ba2), already made the recent issues of debt financing less expensive.

While there are positive figures relating to the EDP, the COM assessment in its February 2017 Country report, is less positive. Regarding fiscal frameworks, the COM notes:

- Limited progress in reinforcing fiscal rules and strengthen the Fiscal Policy Commission[6];
- Limited progress in improving budgetary planning and the multi-annual framework;
- Some progress in reforming recurrent taxation;

[5] When assessing the compliance with the required fiscal effort, the COM will also take into account all relevant factors applicable under the preventive arm (for more information, see EGOV notes on structural balances and on the SGP rules).

[6] This corresponds to the "independent fiscal body" referred to in EU law.

- Some progress in reinforcing the public debt management framework and adopting a debt management strategy.

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

The above mentioned Country Report also states that the medium term budgetary framework is expected to be strengthened soon, while the credibility of budgetary targets varies across items: "*The new fiscal responsibility act should soon be adopted. It is **intended to transpose the EU Directive on requirements for budgetary frameworks of the Member States (Council, 2011), including the strengthening of the autonomy and role of the Fiscal Policy Commission**. The adoption of a new budget act is also expected, with the aim of making the budgetary framework of the central and local government more binding (...). This is set to help reduce the frequency and significance of the revisions to the targets throughout the year that was observed in the past. Still, in order to enhance the robustness of annual and multiannual budgetary planning and execution, ensuring the quality of the underlying projections remain important pre-requisites*."

Furthermore, the COM considers, in the Debt Sustainability Monitor of January 2017on the basis of sensitivity analysis of the public debt trajectory under alternative scenarios, that Croatia's fiscal sustainability risk is expected to remain **high in the medium term**. However it is expected to be **low in the long-term**, given that a still unfavourable initial budgetary position and the projected increase in healthcare costs are more than offset by a substantial projected drop in pension spending as a result of previous reforms.

3. Macroeconomic Imbalances

2016 Country Specific Recommendations

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

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

5.a. *Take measures to **improve the quality and efficiency of the judicial system** in commercial and administrative courts.*

The COM established in February 2017 that Croatia is still experiencing **excessive macroeconomic imbalances,** as it has being since 2014**.** Imbalances are mainly related to the high levels of external and domestic debt, in a context of low employment and low productivity, which are hampering potential output growth. All the Country Specific Recommendations (CSRs) have been issued under the MIP legal basis (Annex 2 presents the MIP scoreboard since 2007 and Annex 4 presents the 2015 and 2016 CSRs, as well as the assessment of their implementation).

Specific concerns are related to the fact that both public (86.7% of GDP in 2015) and private debt (115% of GDP in 2015) are largely denominated in foreign currency. The *kuna*'s ongoing appreciation is reducing the value of the outstanding liabilities. Nevertheless, such valuation effects also point to the economy's sensitivity to exchange rate fluctuations. Around 42% of public debt, 63% of household debt and almost 80% of corporate debt is denominated in euro, thus exposed to currency risks. Furthermore, private sector debt is highly concentrated in a few companies, most of which are state-owned enterprises (SOEs). Corporations' debt amounted to 76% of GDP in 2015. Since March 2017, Agrokor, a relevant enterprises in terms of employment and turnover, is facing debt problems (see Box 2).

Box 2: The Agrokor case

According to Reuters, Agrokor (based in Zagreb) is the biggest food producer and retailer in the Balkans, employing almost 60.000 people across the region, with an annual revenue of some 50 billion *kuna* (6.7 billion euro).

Its credit rating has been recently downgraded, and yields on its bonds jumped to 30%, showing the company's difficulty to service its debt. According to a government press release (reported by the news agency Hina) "*the government recognises the importance of Agrokor for Croatia's economy, its numerous suppliers, partners and employees*". Croatia's Prime Minister said that his government "*would make sure that debt problems faced by Agrokor do not destabilise the country's economy and financial system*".

At the end of September 2016, Agrokor had debt of about 45 billion *kuna* ($6 billion euro) against capital of around 7.5 billion kuna (1 billion euro). Russian banks, such as Sberbank, are among Agrokor's major creditors. Local media have reported this week that Agrokor is in talks with Sberbank on further financing, but Agrokor has not confirmed it. It could be noted that the European headquarter of Sberbank is in Austria: it is the holding company for the bank's business activities in Central and Eastern Europe – and that entity is directly supervised by the ECB

According to the news agency Hina, the Speaker of the Parliament, Bozo Petrov, proposed that the state should help Agrokor by purchasing its shares, but his proposal was dismissed.

The current Finance Minister Zdravko Maric used to be a senior executive in Agrokor.

Potential output growth is low, due to both weak labour utilisation and subdued growth in productivity. As for the **labour market**, the participation rate of 66.8 is one of the lowest in the EU, and the activity rate after the age of 50 continue to decline fast, because of the widespread recourse to early retirement (see also Section 5 below).

Productivity growth is also hampered by **weak business environment** and **poor public sector governance**. According to the Commission, Croatia made limited progress in the implementation of recommendations related to the business environment, including improving the corporate governance of State Owned Enterprises and the divestment process of state assets (see annex 4 for detail). "*Structural reforms are needed to tackle the bottlenecks in productivity growth, but the reform agenda has broadly stalled*". This could be attributed to two elections in less than one year (November 2015 and September 2016), so that "*as a result, few of the ambitious policy commitments put forward in the national reform programme submitted in April 2016 have been implemented*."

In its Global Competitiveness Report 2015–2016 (page 148), the World Economic Forum places Croatia at 77th place among 140 countries: the main reasons of the poor performance are inefficient government bureaucracy and policy instability.

4. Financial sector

2016 Country Specific Recommendation

5.b. Facilitate the resolution of non-performing loans*, in particular by improving the tax treatment of the resolution of non-performing loans.*

Croatia's banking system, supervised by the Croatian National Bank, is characterised by a relatively high concentration and high degree of foreign ownership. Table 2 presents some information on the five largest banks, which hold around 72% of the total financial assets: they are all subsidiaries of other European banks (from Italy, Austria, and France). Those two features characterised the Croatian banking system since 2005 (see Reiniger/Walko OENB 2005).

Table 2: The five largest banks in Croatia in 2015

Bank Name	Sector Share	Total Asset		Total Capital Ratio		Impaired loans	
		2015	**2011-15**	**2015**	**2011**	**2015**	**2011-15**
(subsidiary of)	%	EUR bn	% change	%	%	%	% change
Zagrebacka Banka (Unicredit)	27%	16,8	+6%	20,5%	21,7%	16,3%	+67%
Privredna Banka Zagreb (Intesa Sanpaolo)	17%	10,3	+5%	22,3%	21,6%	12,1%	n.a.
Erste & Steiermärkische Bank (Erste Bank Group)	14%	9,0	+7%	16,6%	14,0%	15,5%	+35%
Raiffeisenbank Austria (Raiffeisen Landesbanken)	7%	4,6	n.a.	19,4%	n.a.	17,3%	n.a.
Splitska Banka (Societe Generale)	6%	4,0	unvaried	18,7%	16,0%	11,0%	+14%

Source: Orbis Bank Data

At the end of 2015, the reported total capital ratios of the largest Croatian banks stood on average close to 20%, a figure well exceeding the average Total Capital Ratio of all banks in the euro area (circa 17%).

The level of non-performing loans (NPLs) continues to weigh on the performance of the banking sector; the risks stemming from NPLs, however, are comparatively well-provisioned in Croatia. The Commission's country report of 2017 points at a positive development (p. 13), as overall the proportion of non-performing loans fell to below 15% (by Q3-2016), the lowest in 3 years. However, in the corporate sector, the level of NPLs remains much higher, in particular in the sub-sectors that were most affected by the crisis (construction and real estate, wholesale and retail trade).

That positive trend is also reflected in the NPL figures reported in the Risk Dashboard (Q3 2016) of the European Banking Authority (EBA), which likewise suggests that the level of NPLs has over the last year significantly come down. However, the NPL figure reported by EBA (10.5% weighted average in September 2016) is notably much lower than those in the Commission's country report, which uses the local non-performing loans definition as provided by the Croatian National Bank, based on local loan classification rules and granular risk categories.

One other sensitive issue was in particular highlighted in the Commission's country report of 2016 (p. 8): "*Although high capital levels and the review of the banking sector's asset quality have provided reassurance about the sector's stability, administrative measures governing the conversion of CHF [Swiss francs] household loans into EUR will substantially reduce banks' profitability*". (See Box 2).

5. Progress towards EU 2020 targets

> **2016 Country Specific Recommendation**
>
> ***2. By** the end of 2016, **take measures to discourage early retirement, accelerate the transition to the higher statutory retirement age, and align pension provisions for specific categories with the rules of the general scheme.***
>
> *Provide appropriate up- and re-skilling measures to enhance the employability of the working-age population, with a focus on the low-skilled and the long-term unemployed.*

According to the Commission, Croatia's progress towards the EU2020 targets is mixed (Annex 3 presents the progress towards the targets for both Croatia and the whole EU since 2012).

The **employment rate** target for the country stands at 62.9%, and the latest data show a steady progress with 60.5% in 2015. In 2016, the unemployment rate fell to 12.8%, a decrease of more than 3.5 percentage points compared to the previous year. However, these improvements are mainly due to a shrinking labour force, and the majority of the new jobs was under fixed and short-term contracts. In addition, youth and long-term unemployment remain high. According to the Commission's assessment of the implementation of the 2016 CSRs 2016 (see also Annex 4), no progress was observed in addressing the main weaknesses related to the labour market. In particular, the announced measures encouraging longer working lives and streamlining pension provisions were not implemented. Limited progress was registered in providing up- and re-skilling measures: this is of particular concern, as 50 % of the unemployed are long-term unemployed who run a higher risk of becoming inactive due to their obsolete or eroded skills. It should be noted that, even if Croatia meets its employment target, it will be still below the level of other European countries. Indeed, according to the Commission, the objective for the EU was to increase the employment rate of the population aged 20-64 to at least 75%.

In 2015 Croatia met its commitment to reduce the number of **people at risk of poverty**. However, according to Eurostat, the percentage in 2015 was higher than the average in Europe (28.9% vs 23.7%). According to the Commission's assessment of implementation of CSRs 2016, there was no progress on the reform of the social protection system, which is characterised by inconsistencies, fragmented coverage and lack of transparency, which weaken its effectiveness and fairness. Finally, both current and future adequacy of pensions is low and creates high risks of poverty and social exclusion among the elderly, especially those with short working lives women.

Croatia has the lowest **early school leavers** among EU Member States, at 2.8 % in 2016, against a national target of 4% (compared to the EU target of 10%). The **tertiary educational attainment, showed a positive trend until** 2014, and decreased in 2015 and 2016, thus increasing the gap towards the national target of 35%.

As regards the **energy-related** EU2020 objectives, Croatia already met its target on share of renewable energy and further EUR 95 million will be invested by the EU cohesion policy over 2014-2020 in this domain. The primary and final energy consumption are already below the target but, for the Commission, several efforts are needed to keep these levels until 2020.

Finally, limited progress was made towards the target of **expenditure on R&D**. Indeed Croatia spent 0.85% of GDP on R&D in 2015, marginally up from 0.79% of GDP a year earlier. However, Croatia's R&D expenditures remain well below the national target of 1.4% of GDP (the EU target being set at 3% of GDP). The reduction in public R&D investment was slightly compensated by private R&D investment. However, based on current trends, the opinion of the Commission is that Croatia will not reach its R&D target, leaving the country within the lowest level of R&D in the EU. This under expenditure is likely to weigh on future productivity growth.

6. Progress with Country Specific Recommendations 2014-2016

Table 3 below depicts Croatia's progress with Country Specific Recommendations (CSRs) over the 2014-2016 European Semester cycles, based on the Commission's assessment outlined in its Country Reports. The number of CSRs addressed to Croatia has decreased over the period under review, reflecting the Commission efforts to streamline the European Semester process by, inter alia, proposing fewer and more targeted recommendations. At the same time, most of these recommendations have remained broadly unchanged, as the reform agenda has been delayed in several areas in the context of two parliamentary elections within less than 12 months (8 November 2015 and 11 September 2016). From the legal perspective, recommendation related to public finances (CSR 1) was underpinned by both the SGP and MIP legal bases, while all the remaining CSRs were given based on the MIP legal framework.

All in all, taking the Commission's assessment at face value, Croatia's implementation track record has significantly worsened over time, to the point where no or limited progress was made on all recommendations during the 2016 cycle (see Annex 4). Note that this evaluation masks progress made in several areas, most notably: (1) a durable correction of the excessive deficit (part of 2016 CSR 1); (2) some progress in reforming recurrent property taxation and public debt management (parts of 2016 CSR 1) and (3) some progress in facilitating the resolution of non-performing loans (part of 2016 CSR 5). On the other hand, weaknesses in the pension and social protection systems were not addressed (2016 CSR 2). Furthermore, limited progress was made in (1) reinforcing fiscal rules and budgetary planning (parts of 2016 CSR 1); (2) reforming public administration (part of 2016 CSR 3); (3) reducing para-fiscal charges and removing regulatory restrictions (2016 CSR 4) and (4) improving the quality and efficiency of the justice system (part of CSR 5).

Table 3: Croatia's progress with Country Specific Recommendations

	Legal base (EU secondary law)							
European Semester	**SGP & MIP**	**MIP**						
2014	CSR 1	CSR 2	CSR 3	CSR 4	CSR 5	CSR 6	CSR 7	CSR 8
2015	CSR 1	CSR 2	CSR 3	CSR 4	CSR 5	CSR 6		
2016	CSR 1	CSR 2	CSR 3	CSR 4	CSR 5			

Source: EGOV based on the Commission's Country Reports (2015, 2016 and 2017).
Note: SGP (Stability and Growth Pact), MIP (Macroeconomic Imbalances Procedure). The assessment grid of CSRs implementation is as follows: full/substantial progress, some progress and limited/no progress.

Annex 1: Key macro-economic indicators

	2012	2013	2014	2015	2016f	2017f	2018f
Real GDP growth – *% change on previous year*							
Croatia	-2.2	-1.1	-0.5	1.6	2.9	3.1	2.5
EU	-0.5	0.2	1.6	2.2	1.9	1.8	1.8
GDP per capita – *Purchasing power parities, Euro*							
Croatia	16,000	15,900	16,100	16,700	n.a.	n.a.	n.a.
EU	26,600	26,700	27,600	28,900	n.a.	n.a.	n.a.
General government budget balance – *% of GDP*							
Croatia	-5.3	-5.3	-5.4	-3.3	-1.8	-2.1	-1.8
EU	-4.3	-3.3	-3.0	-2.4	-1.9	-1.7	-1.6
General government structural budget balance* – *% of potential GDP*							
Croatia	-3.8	-3.2	-3.6	-2.1	-1.4	-2.8	-3.2
EU	-2.7	-1.8	-1.8	-1.6	-1.5	-1.6	-1.6
General government gross debt – *% of GDP*							
Croatia	70.7	82.2	86.6	86.7	84.1	83.0	81.3
EU	83.8	85.7	86.7	85.0	85.1	84.8	83.6
Interests paid on general government debt – *% of GDP*							
Croatia	3.4	3.5	3.5	3.6	3.4	3.4	3.2
EU	2.9	2.7	2.5	2.3	2.1	2.0	2.0
Inflation (HICP) – *% change on previous year*							
Croatia	3.4	2.3	0.2	-0.3	-0.6	1.7	1.6
EU	2.6	1.5	0.5	0.0	0.3	1.8	1.7
Unemployment – *% of labour force*							
Croatia	16.0	17.3	17.3	16.3	12.8	10.8	9.3
EU	10.5	10.9	10.2	9.4	8.5	8.1	7.8
Youth unemployment – *% of labour force (15 – 24 years)*							
Croatia	42.1	50.0	45.5	43.0	30.5	n.a.	n.a.
EU	23.3	23.7	22.2	20.3	18.7	n.a.	n.a.
Current account balance – *% of GDP*							
Croatia	-0.2	1.0	2.1	5.0	2.8	1.8	1.3
EU	0.6	1.1	0.9	1.1	2.1	1.9	1.9
Exports – *% change on previous year*							
Croatia	-0.1	3.1	7.6	10.0	6.7	4.7	4.3
EU	2.4	2.2	4.4	6.4	3.0	3.5	3.8
Imports – *% change on previous year*							
Croatia	-3.0	3.1	4.5	9.4	7.3	5.2	5.8
EU	-0.2	1.7	5.0	6.3	3.6	3.9	4.1
Total investments – *% change on previous year*							
Croatia	-3.3	1.4	-2.8	1.6	4.6	5.2	5.8
EU	-2.5	-1.5	2.7	3.6	1.9	2.9	3.1
Total investments – *% of GDP*							
Croatia	19.6	19.8	19.4	19.5	19.7	n.a.	n.a.
EU	19.7	19.3	19.4	19.5	19.6	n.a.	n.a.
General government investments – *% of GDP*							
Croatia	3.5	3.7	3.6	3.2	3.6	3.8	4.0
EU	3.1	3.0	2.9	2.9	2.8	2.8	2.8
Total final consumption expenditure – *% change on previous year*							
Croatia	-2.5	-1.3	-1.4	0.8	2.9	n.a.	n.a.
EU	-0.4	0.0	1.1	1.9	2.2	1.8	1.6
Households final consumption expenditure – *% change on previous year*							
Croatia	-3.0	-1.9	-1.6	1.2	3.3	n.a.	n.a.
EU	-0.6	-0.2	1.2	2.1	n.a.	n.a.	n.a.
Income Inequality (Gini Coefficient) – *Scale 0-100: 0 = total income equality; 100 = total income inequality*							
Croatia	30.9	30.9	30.2	30.6	n.a.	n.a.	n.a.
EU	30.5	30.5	30.9	31.0	n.a.	n.a.	n.a.
Unit labour cost – nominal – *% change on previous year*							
Croatia	-1.3	-2.3	-2.4	-0.5	0.9	1.4	1.5
EU	2.9	0.3	1.1	1.9	1.1	1.3	1.4

*Sources: Eurostat, extracted on 08/03/2017; * = DG ECFIN/AMECO; (f) = European Economic Forecasts Winter 2017*

Annex 2: Macroeconomic Imbalance Scoreboard

Indicators			Threshold	2007	2008	2009	2010	2011	2012	2013	2014	2015
External imbalances and competitiveness	**Current account balance** as % of GDP	**3 year average**	-4/+6%	-6.4	-7.6	-7.2	-5.2	-2.4	-0.7	0.0	1.0	2.7
		Year value	-	-7.3	-9.0	-5.3	-1.2	-0.8	-0.2	1.0	2.1	5.0
	Net international investment position as % of GDP		-35%	-89.1	-73.8	-86.9	-94.3	-91.7	-90.8	-88.9	-86.8	-77.7
	Real effective exchange rate - 42 trading partners	**% change (3 years)**	± 11%	1.8	5.3	5.8	2.0	-4.4	-8.3	-4.0	-1.0	0.1
		% change y-o-y	-	0.3	3.9	1.5	-3.3	-2.7	-2.6	1.2	0.4	-1.5
	Share of world exports	**% change (5 years)**	-6%	12.9	-5.7	-5.0	-12.9	-15.8	-23.5	-22.8	-18.6	-3.5
		% change y-o-y		1.9	1.5	-0.7	-12.7	-6.0	-7.6	2.5	4.7	3.5
	Nominal unit labour cost	**% change (3 years)**	12%	18.7	22.2	27.8	12.5	7.6	-0.6	-3.0	-5.8	-5.0
		% change y-o-y	-	13.6	5.2	6.9	0.1	0.6	-1.3	-2.3	-2.4	-0.5
Internal imbalances	**House prices** % change y-o-y deflated		6%	8.8	-2.5	-8.0	-7.8	-2.2	-4.6	-5.7	-1.1	-2.4
	Private sector credit flow as % of GDP		14%	16.7	16.0	2.6	4.9	-2.3	-3.0	-0.6	0.4	-1.3
	Private sector debt as % of GDP		133%	100.7	110.3	118.6	125.2	122.6	119.7	118.4	119.5	115.0
	General government gross debt (EDP concept) as % of GDP		60%	37.7	39.6	49.0	58.3	65.2	70.7	82.2	86.6	86.7
	Unemployment rate	**3 year average**	10%	11.5	10.0	9.2	9.8	11.5	13.8	15.7	16.9	17.0
		Year value	-	9.9	8.6	9.2	11.7	13.7	16.0	17.3	17.3	16.3
	Total Financial Sector Liabilities % change y-o-y , non-consolidated		16.5%	24.2	-9.1	5.0	3.3	2.4	1.7	2.8	0.9	2.1
Employment indicators	**Activity rate % 15-64 total pop.** (3 year change)		-0.2%	2.2e	2.5e	2.6e	-0.6	-1.7	-1.7	-1.4	2.0	2.9
	Long-term unemployment active pop. 15-74 (3 year change).		0.5%	-1.3	-1.7	-1.3	0.6	3.1	5.1	4.4	1.7	0.1
	Youth unemployment % active pop. 15-24 (3 year change)		0.2%	-7.6	-8.2	-3.6	7.2	13.0	16.9	17.6	8.8	0.9

Source: Eurostat MIP Scoreboard indicators, data updated on 8 March 2017, see also MIP procedure.

Indicators above/ below the thresholds

Annex 3: Croatia's progress towards EU2020 targets

Indicator	HR			EU28	
Employment rate (% of population aged 20-64)	**62.9**		**Target 2020**	**75**	
	60.5		2015	70.1	
	59.2		2014	69.2	
	57.2		2013	68.4	
	58.1		2012	68.4	
Expenditure on R&D (% of GDP)	**1.4**		**Target 2020**	**3**	
	0.85		2015	2.03	
	0.79		2014	2.04	
	0.82		2013	2.03	
	0.75		2012	2.01	
Greenhouse gas emission[1]	**Total n.c.s.t.[1]** (Index 1990 = 100)	**Non-ETS 111[1]** (Index 2005 = 100)	**Target 2020**	**Total 80** (Index 1990 = 100)	
	n.a.	74.74	2015	n.a.	
	73.40	77.68	2014	77.06	
	76.14	80.12	2013	80.26	
	79.06	81.76	2012	81.83	
Share of renewable energy (%)	**20**		**Target 2020**	**20**	
	29.0		2015	16.7	
	27.9		2014	16.1	
	28.0		2013	15.2	
	26.8		2012	14.3	
Primary energy consumption (million tonnes of oil equivalent-TOE)	**11.15**		**Target 2020**	**1483**	
	8.0		2015	1,529.6	
	7.7		2014	1,508.3	
	8.0		2013	1,569.9	
	8.3		2012	1,585.4	
Early school leaving (% of population aged 18-24)	**4**		**Target 2020**	**10**	
	2.8		2016	10.8	
	2.8		2015	11.0	
	2.7		2014	11.2	
	4.5		2013	11.9	
Tertiary educational attainment (% of population aged 30-34)	**35**		**Target 2020**	**40**	
	30.5		2016	39.0	
	30.9		2015	38.7	
	32.2		2014	37.9	
	25.6		2013	37.1	
Population at risk of poverty or social exclusion (thousand - % of total population)	**Reduction to 1,220 thousand**	**n.c.s.t.**	**Target 2020**	**Reduction by 20 million**	**n.c.s.t.**
	1,216	29.1	2015	118,820	23.7
	1,243	29.3	2014	121,897	24.4
	1,271	29.9	2013	122,703	24.6
	1,384	32.6	2012	123,614	24.7

Source: Eurostat (data extracted on 20/03/2017).

Note: (1) The Effort Sharing Decision (2009/406/EC) sets country-specific targets for non-ETS emissions only and an EU target for ETS-emissions. For Croatia, non-ETS emissions will be increased by 11% compared to 2005 levels. For the EU, ETS-emissions will be reduced by 21% compared to 2005 level and overall emissions by 20% compared to 1990 levels.

n.c.s.t. = "no country specific target"; n.a = "not available".

Annex 4: Croatia's 2015 and 2016 Country Specific Recommendations and assessment of their implementation

HR	Country Specific Recommendations 2015 SGP: CSR 1 MIP: CSR 1, 2, 3, 4, 5, 6	Assessment of implementation of CSR 2015 (COM Country Report, February 2016)	Country Specific Recommendations 2016 SGP: CSR 1 MIP: CSR 1, 2, 3, 4, 5	Assessment of implementation of CSR 2016 (COM Country Report, February 2017)
	1. **Ensure a durable correction of the excessive deficit** by 2016 by taking the necessary measures in 2015 and reinforcing the budgetary strategy for 2016. Publish and implement the findings of the expenditure review. **Improve control over expenditure at central and local level**, in particular by establishing a sanctioning mechanism for entities breaching budgetary limits. Adopt the Fiscal Responsibility Act and strengthen the capacity and role of the State Audit Office. **Introduce a recurrent property tax and improve VAT compliance**. Reinforce public debt management, in particular by publishing on an annual basis a debt management strategy and ensuring adequate resourcing.	**Limited progress** (this overall assessment of CSR 1 does not include an assessment of compliance with the Stability and Growth Pact): **Limited progress** in the publication and implementation of the spending review, as only some of the identified saving measures are being implemented (namely in the area of health care and the rationalisation of public agencies). Preparatory work has been undertaken on public-sector wage-setting. The findings of the review have not been published nor presented to Parliament. **Limited progress** in improving control over expenditure at central and local level, adopting the Fiscal Responsibility Act (FRA) and strengthening the capacity and role of the State Audit Office (SAO), as the government adopted a new standard form for fiscal impact assessments on new legislation and secured additional funding for the SAO. The adoption of the new FRA has been postponed. **Limited progress** in introducing a recurrent property tax and improving VAT compliance, as measures are being taken to improve tax compliance, including a gradual development of a compliance risks management system. A reform of communal charges, presented as a step in broader property taxation reform, has been initiated.	**1. Ensure a durable correction of the excessive deficit by 2016.** Thereafter, achieve an annual fiscal adjustment of at least 0,6 % of GDP in 2017. Use any windfall gains to accelerate the reduction of the general government debt ratio. By September 2016, reinforce numerical fiscal rules and strengthen the independence and the mandate of the Fiscal Policy Commission. By the end of 2016, **improve budgetary planning and strengthen the multi-annual budgetary framework.** By the end of 2016, **start a reform of recurrent taxation of immovable property**. Reinforce the framework for public debt management. **Adopt and start implementing a debt management strategy for 2016-2018.**	**Limited progress** (this overall assessment of CSR 1 does not include an assessment of compliance with the Stability and Growth Pact): **Limited progress** in reinforcing numerical fiscal rules and strengthening the independence and the mandate of the Fiscal Policy Commission. While a new draft of the fiscal responsibility act and budget act were prepared, they have still not been adopted. **Limited progress** in improving budgetary planning and strengthen the multi-annual budgetary framework. **Some progress** in reforming recurrent property taxation. The authorities have introduced a simple recurrent real estate tax through amendments to the law on local taxes. The tax will enter into force as of 2018. **Some progress** regarding public debt management, related to the adopted debt management strategy, which covers the 2017-2019 period.

		<u>No progress</u> in reinforcing public debt management and ensuring adequate resourcing, as the publication of a debt management strategy is delayed for end-2016 and no sufficient steps have been taken to ensure adequate resourcing.		
	2. Discourage early retirement by raising penalties for early exits. Improve the adequacy and efficiency of pension spending by tightening the definition of arduous and hazardous professions. **Tackle the fiscal risks in healthcare**.	**Limited progress:** **<u>Limited progress</u>** in discouraging early retirement and improving the adequacy and efficiency of pension spending, as planned policy action to encourage particular categories of workers to stay in longer employment has been put on hold. **<u>Limited progress</u>** in tackling the fiscal risks in healthcare, as the reduction in arrears in the health care system is not proceeding according to plan even though the financial situation of the hospital sectors is improving overall.	**2.** By the end of 2016, **take measures to discourage early retirement, accelerate the transition to the higher statutory retirement age, and align pension provisions for specific categories with the rules of the general scheme.** Provide appropriate up- and re-skilling measures to enhance the employability of the working-age population, with a focus on the low-skilled and the long-term unemployed. **Consolidate social protection benefits**, including special schemes, by aligning eligibility criteria and integrating their administration, and focus support on those most in need.	**No progress:** **<u>No progress</u>** in reforming the pension system Announced measures encouraging longer working lives and streamlining pension provisions have not been implemented. The authorities have completed a review of the arduous or hazardous professions benefiting from more generous pension provisions. However, the planned streamlining has not yet taken place. **<u>Limited progress</u>** in providing up- and re-skilling measures. The programme for developing vocational education training has been adopted and new legislation is being prepared to improve adult learning. However, the scope of training actions provided by the Public Employment Services seems inadequate in view of the size of the challenge. There are no significant developments on recognition of skills and validation of non-formal and informal learning. **<u>No progress</u>** in improving the social protection system. The action plan setting out the reform priorities has not yet been adopted. The authorities have completed the analysis of benefits granted at central government level with a view to categorising them and harmonising eligibility criteria. The planned introduction of means-testing for the child allowance is currently being reviewed. The establishment of one-stop shops to administer and provide social services is being postponed for the second time in a year. This has delayed the implementation of all the related reform measures.

	3. Tackle the weaknesses in the wage-setting framework, in consultation with the social partners and in accordance with national practices, to foster the alignment of wages with productivity and macroeconomic conditions. Strengthen incentives for the unemployed and inactive to take up paid employment. Based on the 2014 review, carry out the reform of the social protection system and further consolidate social benefits by improving targeting and eliminating overlaps.	**Limited progress:** **Limited progress** in tackling the weaknesses in the wage-setting framework as preparatory steps have been taken to reform the wage-determination system in the public sector, but concrete measures have yet to be adopted. **Limited progress** in strengthening incentives to take up paid employment and carrying out the reform of the social protection system as the consolidation of social benefits is proceeding slowly and concrete reform plans following the 2014 review have not yet been put forward.		
	4. Reduce the extent of fragmentation and overlap between levels of central and local government by putting forward a new model for functional distribution of competencies and by rationalising the system of state agencies. Increase transparency and accountability in the public corporate sector, in particular as regards managerial appointments and competency requirements. Advance the listing of minority packages of shares of public companies and privatisations.	**Limited progress:** **Limited progress** in reducing fragmentation and overlap between levels of central and local government as a comprehensive reform of local governance is lagging behind and the rationalisation of the agency system had been initiated but is currently on hold. **Some progress** in increasing transparency and accountability in the public corporate sector, as new legislation on managerial appointments has been adopted, though it remains to be established how the new provisions will be implemented. **Limited progress** in advancing the listing of minority packages of shares of public companies and privatisations as no new privatisations took place, apart from the recapitalisation of the state bank HPB with an increased share of private owners.	**3.** By the end of 2016, **start reducing fragmentation and improving the functional distribution of competencies in public administration** to improve efficiency and reduce territorial disparities in the delivery of public services. In consultation with social partners, harmonise the wage-setting frameworks across the public administration and public services. Advance the divestment process of state assets and reinforce the monitoring of state-owned enterprises' performance and boards' accountability, including by advancing the listing of shares of state-owned companies.	**Limited progress:** **Limited progress** in reforming the public administration. The main pillars of the reform have all been postponed due to lack of political commitment. In December 2016 the government adopted a new version of the 2017-2020 action plan for the modernisation of the public administration. New legislation redefining the division of tasks between the central and local state administration offices was due to be adopted in December 2016 but is still under preparation. There is no clear timetable for the plan to reduce the over 1 200 local branches of central administration offices by 20 %. The planned harmonisation and rationalisation of the state agencies system has been put on hold. **No progress** in harmonising the wage-setting frameworks. The adoption of new legislation on public sector wages has been postponed by two years, to the end of 2019. Preparatory work has been carried out to develop an IT system to support the introduction of a universal system of wage grades. The authorities have also developed

				common guidelines for the negotiation, coordination and monitoring of collective agreements in the public administration. As far as state-owned enterprises are concerned, no further steps have been taken in setting up a coordinated system for collective bargaining. **Limited progress** in improving performance monitoring and corporate governance of state owned enterprises, and in divestment from state assets. Eight companies were removed from the government's list of companies and other legal entities of strategic and special interest, whereas the sale of stakes in non-strategic companies yielded income of 0.2 % of GDP in 2016.
	5. Significantly, **reduce parafiscal charges and remove excessive barriers for service providers**. Identify and implement steps to improve the efficiency and quality of the **justice system**, in particular commercial courts.	**Limited progress:** **Limited progress** in significantly reducing parafiscal charges and removing excessive barriers for service providers as 12 parafiscal charges were reduced or abolished (and 1 added), but main barriers for service providers remain unresolved, especially in professional and business services. **Limited progress** in identifying and implementing steps to improve the efficiency and quality of the justice system as proceeding and backlogs remain considerable and the use of electronic means to communicate with parties remains a challenge (despite some progress).	**4. Significantly reduce parafiscal charges. Remove unjustified regulatory restrictions** hampering access to and the practice of regulated professions. **Reduce the administrative burden on businesses.** *See CSR 5 (justice system)*	**Limited progress:** **Limited progress** in reducing parafiscal charges. The authorities have decreased or cut only five parafiscal charges, with an impact significantly lower than planned in the national reform programme. **Limited progress** in removing regulatory restrictions in regulated professions. An action plan was submitted in July 2016, but it entails only limited reform proposals and does not provide details on the substance of the amendments. For a number of professions, the action plan states that current regulation is adequate and no modification is needed. **Limited progress** in reducing the administrative burden. An action plan for the reduction of administrative burden was adopted by the government.

	6. Reinforce the pre-insolvency and insolvency frameworks for businesses in order to facilitate debt restructuring and put in place a personal insolvency procedure. **Strengthen the capacity of the financial sector to support the recovery in view of challenges from high non-performing corporate loans and foreign currency mortgage** loans, and weak governance practices in some institutions.	**Some progress:** **Substantial progress** in reinforcing the pre-insolvency and insolvency frameworks for businesses and putting in place a personal insolvency procedure as implementation of the amended corporate insolvency legislation is expected to contribute to faster resolution of impaired debt and the legislative framework for personal insolvency entered into force, tough implementation could prove challenging. **Some progress** in strengthening the capacity of the financial sector to support the recovery in view of challenges from high non-performing corporate loans. Although no additional measures to tackle the issue have been prepared, the non-performing loans (NPL) ratio is stabilising at a high level. The reform of the insolvency framework is expected to support a faster resolution of NPLs. **Limited progress** in strengthening the capacity of the financial sector to support the recovery in view of challenges from foreign currency mortgage loans, as the CHF loan conversion legislation puts strain on public finances and causes substantial losses for banks. **Some progress** in addressing the challenges from weak governance practices in some institutions, as there is a commitment from the authorities to carry out an asset quality review of the credit portfolio of the Croatian Bank for Reconstruction and Development (HBOR) in 2017.	5. Take measures **to improve the quality and efficiency of the judicial system in commercial and administrative courts**. Facilitate the resolution of **non-performing loans,** in particular by improving the tax treatment of the resolution of non-performing loans.	**Limited progress:** **Limited progress** in improving the justice system. The number of pending cases and length of court proceedings remain among the highest in the EU. Few measures have been implemented to improve the efficiency of justice (e.g. limited introduction of case management reforms) and it will take time for the implemented judicial map reform to show effects. Improving the quality of the justice system remains a challenge, particularly the electronic communication with courts, where no measures have been implemented that would allow public bodies, parties and legal professionals to send and receive court documents in electronic form. **Some progress** in facilitating the resolution of non-performing loans, as sales accelerate. The recent tax reform's provisions on deductibility of non-performing loan write-offs may facilitate a faster resolution in 2017.