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

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Executive summary

This is the fifth specific monitoring report under the macroeconomic imbalances procedure (MIP) for Croatia, which was identified as experiencing excessive imbalances in the 2017 European Semester. The imbalances concern the high levels of public, corporate and external debt, all largely denominated in foreign currency, in a context of low potential growth. The 2017 country-specific recommendations for Croatia are all intended to address them. This report reviews the latest policy initiatives undertaken by the Croatian authorities that are relevant for the correction of the excessive imbalances, against the background of the recent economic developments. The cut-off date of the report is 7 November 2017.

The macroeconomic outlook is broadly favourable, but short-run risks are tilted to the downside and structural challenges weigh on the long-run growth potential. A broad-based and relatively strong economic recovery started towards end-2014 and has been accelerating thereafter. According to the Commission 2017 autumn forecast, real output growth will attain 3.2% this year, and lose some of its momentum over the forecast horizon. The volume of GDP is only set to return to its pre-crisis level in 2019. The private debt-to-GDP ratio shrunk further from the record level attained in 2010, and the general government debt ratio remains on a declining path. A strong export performance – both in goods and in the all-important tourism sector – has kept the current account in a comfortable surplus position, in turn driving a further reduction of Croatia's net external liabilities. However, private and public debt, both domestic and external, remains sizable, and its large foreign currency exposure is a source of vulnerability. The unemployment rate is also falling rapidly, but partly due to the reduction in the labour force. Productivity growth remains sluggish, particularly for a catching-up economy. The Croatian Bureau of Statistics has in the meantime published revised annual national account series (including GDP and expenditure components), which do not appear to fundamentally alter the described dynamics. While the revised series improve the consistency between GDP estimates and government finance statistics, corresponding sector accounts are not yet available to users. In the short-run, the ongoing restructuring of the food-processing and retail giant Agrokor poses significant risks to the economy.

The authorities have taken steps towards reform implementation only in a few policy areas. The sale of state assets has advanced, but the announced improvement of corporate governance in state-owned enterprises has encountered delays. There has been reduction of backlogs in the judicial system, and some parafiscal charges and the administrative burden for businesses have been reduced. The adoption of the long-delayed new legislation on public sector wages is in sight, while the implementation of the education reform may finally proceed, on a pilot basis during the next school year. The Croatian Bank for Reconstruction and Development (HBOR) has undergone an asset quality review, the results of which have not yet been published.

Overall, there has been little advancement in the adoption of policy measures aimed at addressing macroeconomic imbalances. Following a period of political instability over the past two years, the reform standstill has continued as the government's focus turned to managing the Agrokor crisis. The introduction of the recurrent property tax, due in January 2018, has been postponed indefinitely, and the legislation needed to reinforce the fiscal framework has not yet been adopted. The healthcare system continues to generate payment arrears. However, the authorities have taken initial steps towards the long-planned functional

integration of hospitals. The planned policy action to address the high level of fragmentation in the public administration and to liberalise regulated professions has not been taken forward. The reform agenda in the area of social protection has been narrowed in scope, while the challenges to the pension system remain unaddressed. Active labour market policies remain largely underutilized. Some policy developments in the financial sector deserve attention. Namely, proposed amendments to the Law on the Croatian National Bank, currently under parliamentary discussion, could challenge the independence of the bank.

In conclusion, despite the recent strong macroeconomic performance, the protracted reform inaction entrenches structural weaknesses. The economy has recorded strong growth over the past two years, but Croatia continues to score poorly on several measures of goods and service market efficiency, labour participation remains low and public sector governance needs modernisation. The current good economic performance could foster reform complacency that would further delay the policy action needed to boost the long-run growth potential and the economy's overall adjustment capacity. In light of the recently announced commitment to engage in the process of euro adoption, both are key to ensure that Croatia can fully grasp the benefit of greater monetary and financial stability, while furthering the process of real economic convergence.

Table 1: Key findings on implementation of reforms¹

On track	Wait-and-see	Action wanted
<ul style="list-style-type: none"> • Disposal of state assets • HBOR's asset quality review 	<ul style="list-style-type: none"> • Reform of public sector wages • Reduction of administrative burden and parafiscal charges • Education system reform • Improving public assets management • Reduction of backlogs in judicial system 	<ul style="list-style-type: none"> • Recurrent property tax • Strengthening of fiscal frameworks • Modernisation of public administration • Pension system reform • Social protection reform • Reducing fiscal risks in healthcare • Reform of regulated professions and other service markets

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

1 Introduction

On 16 November 2016, the European Commission presented, in the context of the macroeconomic imbalance procedure (MIP), its sixth Alert Mechanism Report² to identify Member States requiring an in-depth investigation into the existence and extent of macroeconomic imbalances. The subsequent in-depth review in the country report on Croatia – published on 22 February 2017³ – examined the nature, origin and severity of macroeconomic imbalances and risks in Croatia. In its Communication published on 22 May 2017⁴, the Commission concluded that “Croatia is experiencing excessive macroeconomic imbalances, which require specific policy action”. In particular, the Commission emphasised vulnerabilities linked to high public, corporate and external debt in the context of high unemployment. On 27 April 2017, Croatia submitted its convergence programme⁵ and national reform programme (NRP)⁶, respectively outlining the fiscal strategy and policy measures undertaken or planned to improve its economic performance and to unwind imbalances. On the basis of an assessment of these programmes, the Commission proposed five country-specific recommendations (CSRs)⁷, which were subsequently adopted by the Council on 11 July 2017⁸. The CSRs addressed to Croatia were all considered MIP-relevant. They concern: public finances and taxation, labour market, social policy and pension system, public administration and business environment and financial sector. Croatia requested technical support provided by the Commission's Structural Reform Support Service (SRSS) for the implementation of reforms in various policy areas⁹.

For the purpose of the assessment of progress in the delivery of reforms within the framework of the MIP, the Commission conducted a specific monitoring mission to Croatia on 12-13 October 2017. Also based on the findings of this mission, the present report assesses the latest key policy initiatives¹⁰ undertaken by the Croatian authorities¹¹.

2 Outlook and recent developments on imbalances

Recent economic developments and outlook

Croatia came out of its six-year long recession at the end of 2014 and economic activity has been accelerating steadily since then, with internal demand progressively becoming the main

² https://ec.europa.eu/info/sites/info/files/2017-european-semester-alert-mechanism-report_en_0.pdf

³ <https://ec.europa.eu/info/sites/info/files/2017-european-semester-country-report-croatia-en.pdf>

⁴ <https://ec.europa.eu/info/sites/info/files/2017-european-semester-country-specific-recommendations-commission-recommendations-communication.pdf>

⁵ <https://ec.europa.eu/info/sites/info/files/2017-european-semester-convergence-programme-croatia-hr.pdf>

⁶ <https://ec.europa.eu/info/sites/info/files/2017-european-semester-national-reform-programme-croatia-hr.pdf>

⁷ <https://ec.europa.eu/info/sites/info/files/2017-european-semester-country-specific-recommendations-commission-recommendations-croatia.pdf>

⁸ [http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32017H0809\(10\)&qid=1508416765609&from=EN](http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32017H0809(10)&qid=1508416765609&from=EN)

⁹ For instance, the SRSS provides support for the curriculum and adult education reform, for measures aimed at strengthening governance of state-owned enterprises and at increasing transparency of social policies.

¹⁰ Details on the policy measures taken can be found in the overview table in the Annex.

¹¹ Previous MIP specific monitoring reports were published in November 2014, February and December 2015, and December 2016. See respectively:

https://ec.europa.eu/info/sites/info/files/file_import/2014-11-07_croatia_mip_specific_monitoring_report_to_epc_en_1.pdf

https://ec.europa.eu/info/sites/info/files/201503_hr_imbalances_epc_report_en.pdf

https://ec.europa.eu/info/sites/info/files/20160118_hr_imbalances_epc_report_en.pdf

https://ec.europa.eu/info/sites/info/files/croatia_mip_report_published.pdf

engine of growth. Real GDP expanded by a solid 3 % in 2016 and growth maintained a similar pace in the first half of this year, posting a 2.8 % rate in the second quarter (y-o-y). Against the background of strong high-frequency indicators, another sharp increase in the number of tourist arrivals and high confidence levels, the Commission 2017 autumn forecast projects the growth rate of real GDP in 2017 as a whole to reach 3.2 %. Employment is set to expand by 1.8 % this year, while the unemployment rate is projected to contract to 11.1 %, also as the labour force shrinks further. Continued strong growth is expected over the next two years, though at rates below those seen in 2016 and 2017. However, the volume of GDP is only set to return to its pre-crisis level in 2019. The activation of measures on extraordinary administration in Agrokor¹² contained the risk of a disorderly restructuring. However, the outcome of the company's restructuring, namely if a settlement is not reached, poses a significant downside risk to economic activity and the banking sector, in particular as financial losses and possible operational disruptions in the group and its supply chain may be sizeable. Despite a slight deterioration in the trade balance, the current account surplus is set to improve to about 3.1 % of GDP in 2017, in turn bringing about a further contraction in gross external debt.

The Croatian Bureau of Statistics recently published revised annual national account series (including GDP in volumes and values, and its expenditure components), which do not appear to fundamentally alter the described dynamics. While the revisions improve the consistency of national accounts data with government finance statistics, the validation of the corresponding sector accounts for 2013 and onwards by Eurostat is still pending due to unresolved quality issues. A complete, accurate and consistent set of national accounts is a precondition for reliable forecasts and adequate economic policies.

Developments as regards imbalances

General government debt

In 2016, the debt-to-GDP ratio decreased to 82.9 % of GDP, from 85.4% the year before. The decrease was driven by both GDP growing and the headline deficit decreasing (from 3.3 % of GDP in 2015 to 0.9 % in 2016). Furthermore, the kuna appreciation decreased the value of the large portion of debt that is denominated in foreign currency. This contributed to reducing even the nominal level of gross general government debt on an annual basis, for the first time since the beginning of recording in 1999. The debt ratio is expected to continue decreasing in 2017 and onwards as the primary balance remains in surplus and the nominal GDP growth-interest rate differential (the so-called snowball effect) turns positive, also owing to the refinancing of maturing debt at lower interest rates. However, sustainability risks remain high in the medium term, largely due to the still high stock of debt.

Household and corporate debt and the financial sector

By the end of 2016, consolidated corporate and household debt had decreased to roughly 71.5 % and 35.7 % of GDP, respectively – some 12 and 6 pps below the peak registered in

¹² In April 2017, following the unveiling of financial distress in Agrokor, the Croatian parliament adopted a law on extraordinary administration in systemically important companies aimed at maintaining business operations and reducing the risk of a disorderly restructuring. The law authorises the court-appointed extraordinary administrator, supervised by the creditors' council, to administer the processes of operational restructuring and negotiation of a settlement with the company's creditors and suppliers.

2010. During 2016 debt reduction in the corporate sector was still partly driven by active deleveraging, as net aggregate credit flows remained mildly negative. The bulk of the reduction however came from valuation effects, since the appreciation of the kuna against the euro reduced the value of outstanding liabilities indexed to or denominated in foreign currency. Credit flows have since turned positive in the corporate sector, but remain subdued. The private debt ratio is therefore set to keep decreasing, though at a slower pace than in recent years. The banking sector remains overall well capitalised and banks' profitability has been increasing since 2016. However, the restructuring of Agrokor's debt is set to hit profitability through greater provisioning this year and in 2018. Additional vulnerabilities are linked to the high currency exposure of corporations and households, which could indirectly affect banks. Asset quality has continued to improve: by mid-2017 the NPL rate declined to 13.2 %, from 17 % in 2015, as the high volumes of sales of NPLs largely offset the impact of the reclassification of Agrokor-related loans. The NPL rate, nevertheless, remains high, especially in some corporate segments (notably construction and real estate).

External liabilities and trade performance

Export market shares were up by more than 7 % in 2016, one of the strongest performances in the EU. Imports also increased, on account of the relatively high import content of tourism, but the trade balance and the overall current account balance continued to post a sizable surplus (2.8 % and 2.4 % of GDP, respectively). The decline of public and private sector debt was mirrored by a further reduction of external liabilities, with gross external debt falling to 85 % of GDP and the NIIP improving to -70 % of GDP by mid-2017, almost 30 pps below (respectively above) their highest (respectively lowest) ratios attained. The on-going appreciation of the kuna against the euro has favoured the reduction in foreign currency denominated external liabilities, but is also a reminder of the amplitude of exposure to currency shocks.

Potential output

Croatia is currently growing well above its estimated potential. The output gap is set to close this year and turn positive over the forecast horizon. The strong pick-up in investment is contributing positively to potential growth, but the utilisation of labour input and total factor productivity remain low. After having attained 17.6 % in mid-2013, the unemployment rate is estimated to have contracted to around 11 % this year and is expected to fall to pre-crisis levels by the end of the forecast horizon. The rapid fall in unemployment is only partly due to the increase in employment. Migration outflows and aging are diminishing the size of the population in working age. In the absence of policy measures to boost the participation rate, the shrinking labour force is set to continue detracting from the growth potential. Productivity growth remains comparatively low for a converging economy. The economy's overall adjustment capacity remains weak as Croatia continues to compare unfavourably to EU peers in terms of administrative capacity and a number of goods and services market performance indicators.

3 Policy implementation and assessment

3.1 Public finances and taxation

The reduction in the general government deficit helped put the debt ratio onto a declining path, but the implementation of overdue fiscal structural measures is stalling and the introduction of the property tax was postponed indefinitely. The sharp reduction of the general government deficit in 2015-2016 was driven by the economic recovery, but also by expenditure containment. This year and the next, the impact of the tax reform and higher spending on increased public sector salaries and war veterans and their families (see section 3.2) will largely offset the positive budgetary impact of the favourable cycle. Regarding the fiscal framework, the government has not yet adopted the long overdue Fiscal Responsibility Act, which should grant more authority and independence to the Fiscal Policy Commission and ensure compliance with the EU Directive on requirements for national budgetary frameworks. Similarly, the planned adoption of amendments to the Budget Act with a view to improving budgetary planning and strengthening the mid-term budgetary framework is stalling. Finally, the authorities decided to postpone indefinitely the stipulated introduction of the property tax in January 2018 (as part of the tax reform adopted in 2016). This means that Croatia remains among the EU Member States with a low level of revenue collected through taxes on property as a share of GDP, which is a source of revenue least detrimental to economic growth compared to other taxes.

There has been no progress in tackling the accumulation of payment arrears in healthcare or in addressing the inadequate financing scheme of hospitals. Payment arrears have kept increasing in hospitals, and to a lesser extent in the Croatian Health Insurance Fund (CHIF). According to the Ministry of Health, the total amount of arrears stood at 1.1 % of GDP in June 2017. Meanwhile, the financing system of hospitals remains based on ex-ante spending limits rather than the amount of services provided, which have to respond to increasing needs from an ageing population. By contrast, the number of contributors to the supplementary health insurance increased by 15 000 in 2017, and the balance of the scheme, which is managed separately within the CHIF, is positive.

In healthcare, policy reform has started slowly moving out of standstill. The National Plan for Hospital Development 2017-2020, setting the framework for the functional integration of hospitals, is expected to be adopted by end-2017. The integration process nevertheless has already started, with twelve hospitals having so far signed their integration agreements. The functions of the hospitals within the same county are being integrated in pairs, while each hospital will maintain four basic functions – surgery, internal medicine, gynaecology and paediatrics. The utilization of telemedicine, as a measure to increase, or, at least, maintain the existing levels of access to healthcare, has also advanced. As regards the rationalization of non-medical services, the measures foreseen in the NRP on introducing national standards for cleaning, laundry and non-medical equipment maintenance in hospitals are all delayed but scheduled for adoption still this year.

Overall, fiscal policy, supported by the favourable economic conditions, ensured that the debt ratio continues decreasing, but structural measures have not advanced. The authorities have not adopted the legislation needed to reinforce the fiscal framework and have backtracked on the introduction of a recurrent property tax. Some steps are being taken to

rationalize the healthcare system, in particular for hospitals. However, the arrears in healthcare continue to grow.

3.2 Labour market, education, social protection and pension system

New legislation on civil service wages is planned for government adoption in December 2017. Initially planned to cover wage setting in the public sector as a whole, the new legislation – the adoption of which has been postponed several times by the government – will be enacted in two steps, first covering civil servants only, and later, by December 2018, covering public sector workers. The aim of the law is to achieve greater harmonisation of wages across the public administration through the introduction of common wage grids and job complexity coefficients, based on more consistent job descriptions and competences frameworks. The current automatic yearly salary increase of 0.5% would be abolished, while progress to a higher grade in the grid would become dependent on performance. Finally, the new legislation would cover areas of the employment relationship of civil and public servants that are currently negotiated through collective bargaining. In the meantime, the two basic collective agreements regulating the rights of civil servants and public servants, as well as 13 sector agreements, expire by the end of 2017. The authorities are currently re-negotiating short-term agreements until the new legislation enters into force. As far as state-owned enterprises (SOEs) are concerned, no further steps have been taken in setting up a coordinated system for collective bargaining.

Active labour market policy measures (ALMPs) remain underutilized and insufficiently targeted at vulnerable groups. Coverage of ALMPs is very low, with only about 6.5% of the registered unemployed benefitting from them in 2015. In February 2017 the Croatian Employment Service adopted a new package of ALMP with focus on education. The number of ALMPs has been reduced from around 45 to 9 in order to improve targeting efficiency and transparency. The measures include education programmes for the unemployed, public utility works, workplace training and employment subsidies. The authorities expect that the new package will lead to an increase in take up of ALMPs, notably amongst vulnerable groups, such as the long term unemployed, NEETS (youth not in education, employment, nor training) and people with disabilities. Concerns however remain with regard to the capacity of the Croatian Employment Service to adapt its offer of employment/education measures to the needs of its beneficiaries. Moreover, ALMPs target only unemployed people who are registered at the Employment Service, and do not reach out to the inactive population who may want to work.

Despite encouraging announcements, there has been limited progress in the implementation of the education reform. The authorities have announced a new institutional arrangement in order to overcome the protracted stand-off in the implementation of the Strategy for Education, Research and Technology. However this has not yet translated into concrete action. The draft curricular reform, which underwent public consultation, will now be subject to independent reviews by spring 2018. The Ministry of Education intends to launch a pilot project for its implementation in September 2018 in a 3-5 % of schools. In terms of adult education, Croatia features a very low participation rate. A new bylaw on non-formal and informal learning is expected to be adopted by end-2017 with the aim of recognizing a set of skills and institutions outside the context of formal education. The authorities' efforts to increase participation in adult learning do not seem to be well coordinated with the provision of ALMPs by the Croatian Employment Service (including

reskilling and upskilling measures). By establishing a Council for the implementation of Upskilling Pathways the authorities expect increased participation in adult learning, coordinated with the provision of ALMPs by the Croatian Employment Service.

The focus of the planned measures in the social benefits system has been redefined and narrowed in scope. Based on an analysis of the institutional division of competencies in the provision of benefits at central level, the authorities concluded that previously planned reforms intended to make the system more efficient are not warranted. In particular, they abandoned the ambitious and long-planned establishment of the one-stop-shops as a central point for the administration and provision of social benefits and services. This used to be a flagship measure in this policy area in past NRPs. Moreover, the previously announced harmonisation of eligibility criteria to social benefits and plans to consolidate more benefits under the Guaranteed Minimum Benefit have been suspended. The focus has instead shifted to harmonizing definitions and classifications of social protection benefits and improving beneficiaries' records. The databases of the various central government institutions providing social benefits are being linked, in order to allow for an overview of all benefits granted per beneficiary. The authorities are also compiling a glossary of definitions of commonly used concepts (such as 'household' or 'income') used in the existing body of legislation on social benefits. They also plan to categorize the numerous types of benefits granted at the local government level following the ESSPROS (European System of integrated Social Protection Statistics) nomenclature, and establish regular reporting channels from the local to the central government level. Finally, the authorities have proposed to further extend the benefits granted to war veterans and their family members¹³, while social spending for other vulnerable groups has for the time being remain unchanged.

The adoption of the planned changes to the pension system has been further postponed, as attention shifted towards a more imminent challenge. Reform measures initially planned for December 2017 (according to the NRP) are being further postponed to mid-2018. These include the streamlining of the 100+ arduous or hazardous professions benefitting from more generous pension provisions, measures aimed at reducing access to early retirement, the increase of the statutory retirement age and the acceleration in the equalisation of retirement age for women and men. According to the authorities, the postponement is due to the necessity to tackle a pressing issue affecting the pension system. Successive interventions in the pension system – starting from the 1999 reform and including the establishment of a supplementary pillar in 2002 and the introduction, in 2007, of a pension supplement for those insured under the first pillar only – have left the cohort of people born between 1962 and 1984 with prospective pensions that could be up to 30 % lower than those for the older cohort. This is because of their short contribution history into the second pillar. Inflows into retirement from this cohort have just started and are expected to intensify in 2019. People with shorter working lives, and in particular women, will be most penalised. The authorities are exploring different options to tackle the situation. In the meantime, improvements have been introduced in the methodology applied for the medical assessment of disability pensions.

¹³The law adopted by government in August 2017 (and currently in parliamentary procedure) reopens the possibility to register as war veteran, reduces their retirement age and extends the rights of family members to inherit veterans' pensions. The law also introduces a number of additional social benefits for veterans and mandatory financing of veterans' associations (in the range of 0.3-1.0 % of local government budgets).

Overall, most of the reform plans in the areas of labour market, education, social policy and pension system are still pending. Planned measures in the social benefits system have been narrowed in scope, while the package of pension system reforms has been further postponed. Active labour market policy measures remain largely underutilized, while the education reform remains pending despite encouraging announcements.

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

Planned reforms of the public administration have not considerably advanced. The high level of fragmentation of the local administration in Croatia, coupled with lack of administrative capacity in small municipalities, entails territorial disparities and loss of efficiency in the delivery of public services. In September 2017, the government proposed amendments to the law on the financing of local government units, which are now in parliamentary procedure. The amendments aim at simplifying the complex system of transfers and financing, as well as increasing transparency. The draft legislation also introduces a new system of fiscal equalisation aimed at establishing a more efficient model of revenue sharing and reducing disparities in fiscal capacity across local units. According to the Ministry of Finance and the Institute for Public Finance, the changes are likely to have a broadly neutral impact both on the central state budget and on the budgets of most local government units. The amendments however do not streamline the functional distribution of competences across levels of government and do not help to address the weak administrative capacity in the smallest local units. The authorities have completed the analysis needed for the planned reduction of the 1200 branch-offices of the central administration (e.g. ministries) operating at local level. The rationalisation plan however is expected to start being implemented only in June 2018. The previous plans to rationalise the cumbersome state agencies system have been suspended. The authorities plan to establish first a new legal framework for state agencies, introducing a higher degree of homogeneity across the system and defining a set of criteria to which the existing agencies should comply. The number of users of centralised public procurement in postal services, electricity and mobile communications has increased. A new ordinance on public procurement is expected to enter into force in January 2018. It would oblige contracting bodies to use the Electronic Public Procurement Classifieds platform to publish structured data about their contracts in a common register.

The implementation of measures to improve the business environment is proceeding with delays in some areas and stalling in others. More than half of the measures set out in the 2017 Action Plan for administrative burden reduction has been implemented, while most of the remaining measures are expected to be implemented by early 2018. Meanwhile, the authorities have continued measuring the administrative burden in more than 40 additional areas. The findings will feed into the new Action Plan expected for February 2018, as planned. As regards parafiscal charges, two large charges were decreased. While no charges have been abolished yet, this is envisaged in a package of measures to be adopted by year end, with a potentially substantial impact on the reduction of the financial burden for businesses. The implementation of issuing electronic procedures for access to many services-market sectors is ongoing, while the introduction of an electronic system for company registration is expected during 2018. The integration of inspection services (currently scattered across different institutions) is behind schedule, but should be finalized in early 2018. Against the background of strong resistance, measures aimed at liberalising the

regulated professions are limited to the abolition of certain tariffs. Furthermore, the authorities are preparing legislation reaffirming unwarranted regulation in the transport sector.

While the sale of state assets is progressing as planned, the announced improvement of corporate governance in SOEs has encountered delays. The State Assets Management Plan for 2017 was drafted in October 2016, but has not been adopted by government. This notwithstanding, the Ministry of State Assets and the Centre for Restructuring and Sale of State Assets (CERP) have been carrying out the activities laid out in the Plan, in particular as regards the sale of state assets. The results for the first nine months of 2017 show progress in the sale of state-owned dwellings, as well as in the disposal of shares in non-strategic and not-of-special-interest state-owned companies. By September, total revenues from the management and disposal of state assets reached 90 % of the planned revenue set out in the NRP. However, there are considerable delays in the legislation aimed at improving the management of state assets and corporate governance in SOEs. Several key documents are scheduled for adoption by the end of the year, including the new Act on Management of State Assets. The authorities plan to transfer the lead management role over the central state assets register to the State Office for Digitalization, which is a welcome development. The new Corporate Governance Code is also delayed, and it is now scheduled for adoption by November.

In the justice system, backlogs continued to decrease but court proceedings remain long and there is room to better safeguard judicial independence. In the first three quarters of 2017, backlogs in first instance courts in civil, commercial, criminal and enforcement cases decreased by 6 % (compared to end 2016), with courts prioritizing oldest cases. However, proceedings in first instance courts remained slow, with civil and commercial cases taking 862 days on average. The second instance High Commercial Court further reduced its backlogs as well as the duration of proceedings. Driven by economic growth, the influx of corporate liquidation and pre-insolvency cases decreased, which helped the courts reduce backlogs. A draft report analysing the effects of the new personal insolvency framework shows an increasing, but still low number of personal insolvencies. At the same time, it shows a decreasing number of insolvency administrators. Perceived judicial independence remains low and the involvement of the National Security Agency in the appointment of first-time judges raises concerns in this regard. The issue is under constitutional review. Electronic communication is being tested and gradually implemented between courts and police (in misdemeanour cases), lawyers (particularly in commercial cases) and the FINA payment agency (in insolvency cases). Communication with other parties (e.g. public notaries, prosecutors, insolvency administrators) requires further preparation.

Overall, efforts to improve the effectiveness of the public administration, the business environment and corporate governance appear uneven. The major public administration reforms are overall at a standstill. Measures to improve the business environment have advanced somewhat in the area of administrative burden relief and less as regards reducing parafiscal charges. Some progress has been made in sale of minority shares in SOEs and disposal of state property, while backlogs in the judicial system have been marginally reduced.

3.4 The financial sector

A number of policy initiatives have been launched in the area of non-performing loans and provisioning rules. At the beginning of the year the authorities adopted transitional tax treatment rules allowing banks to deduct losses from NPL write-offs from the tax base. The measure – aimed at helping banks clean up their balance sheets – however does not appear to have had a substantial impact, partly due to the fact that the debt relief is not treated as non-taxable income for the borrowers. Regarding the sales of NPLs by banks, in August 2017 the government has adopted and put into parliamentary procedure amendments to the existing framework, requiring banks to inform the borrowers on the details of the sale, including the owed amount, maturity, and identity of the buyer. However the entities who buy the NPLs are outside the scope of the regulated financial sector, therefore they are not subject to bank supervision. The Croatian National Bank (CNB) has modified its forbearance guidance to allow for a shorter probation period for reclassifying non-performing loans into performing status. The CNB has also relaxed the provisioning rules¹⁴ that were in place since 2013 by introducing a cap of 80 % to the required coverage ratios.

The impact of the Agrokor crisis on Croatian banks has been limited so far, but risks remain and may require further policy response. Although the exposure of Croatian banks to Agrokor remains limited, the emergence of severe accounting irregularities may translate into further risks, including legal challenges. A foreign bank has initiated lawsuits outside Croatia to secure its claims. If successful, this would have an impact on the distribution of recovered debt across claims with different seniority levels.

The CNB has issued recommendations to the banks aimed at reducing interest rate-related risks. Recent trends have shown a fall in interest rates and a sharp increase in new loans contracted in HRK with fixed rates. However, risks related to the existing long-term loans remain. According to CNB's analysis, 90 % of foreign currency loans to households are exposed to currency risk and 67 % are contracted with variable interest rates (up to 81 % for house purchase loans). Against this background, the CNB recommended the banks: to offer a refinancing of the existing loans with variable rates into loans with fixed rates to all clients free-of-charge; a competitive current market interest rate for these refinanced loans; and not to charge early loan repayment fees.

The Croatian Bank for Reconstruction and Development (HBOR) has undergone an Asset Quality Review (AQR). HBOR plays an important role in the Croatian economy,¹⁵ and holds a high share of direct lending in its assets. In view of possible changes to the regulatory framework and governance structures of HBOR, in May 2017 the authorities selected an international auditor to undertake the AQR exercise. The AQR methodology closely followed the ECB methodology, incorporating the CRR/CRD IV credit risk treatment as well as the EBA guidelines on NPL exposures. The results are due to become available by the end of the year, following their official endorsement by the CNB.

A number of pending legislative proposals, discussed in parliament, may raise concerns. In summer 2017, the parliament introduced new legislation which annuls the validity of existing international loans taken with creditors which were unauthorised in Croatia. The

¹⁴These required banks to progressively increase their coverage ratios in proportion to the number of delinquency days.

¹⁵Its assets would approximately correspond to the assets of the sixth largest Croatian bank.

CNB and the ECB were not consulted on the draft law, and implementing it may prove problematic because some provisions of the law are unclear. Raiffeisen Group has submitted a complaint before the Constitutional Court. New amendments to the Law on the Croatian National Bank, aimed at subjecting the CNB to stronger audit scrutiny, have been proposed in parliament. Similarly to the previous amendments rejected in May 2017, these latest proposal could also challenge the independence of the central bank. Finally, proposed amendments to the Consumer Credit and Protection Acts aim at reducing retroactively contractual variable interest rates for existing loans. The Ministry of Finance has expressed a negative opinion on the amendments because there has been no impact assessment study and the ECB was again not consulted. On the positive side, following several postponements, on 4 October 2017 the parliament adopted the law for the transposition of the Mortgage Credit Directive. The CNB has progressed with the preparation of the related by-laws, which should soon be completed for implementation.

The formal announcement on 30 October 2017 of a strategy for Euro adoption signals the authorities' commitment to deeper EMU integration. The Croatian government and the central bank (CNB) announced Croatia's intention to engage in the process of euro adoption and presented a joint strategy document. The document is meant to inform the national debate on euro adoption, by laying out costs and benefits for the Croatian economy. It concludes that the benefits Croatia will reap from the adoption of the euro are significant and permanent, and exceed the costs. In particular, for a highly 'euroised' economy like Croatia – i.e., with a prevalence of euro-denominated assets and liabilities in the balance sheets of households, corporations and government – euro adoption would mitigate the vulnerabilities associated with the high exposure to currency risk. While the government did not fix a formal target date for euro adoption, their objective is to participate to ERM II by 2020. The strategy highlights the importance of sound fiscal, structural and macro-prudential policies, both leading up to and after euro adoption. It also acknowledges the need to carry out preparatory actions for accession to the banking union and strengthen the fiscal framework with stricter fiscal rules (i.e. by adhering to the Fiscal Compact, though no specific timeline is indicated). Regarding structural policies, it refers to the need for "comprehensive measures to improve the business environment, alleviate the tax burden and increase public sector efficiency", without however spelling them out in detail. Interestingly, it also notes that "the strengthening of reform implementation and prudent fiscal policy are necessary regardless of the introduction of the euro".

Overall, measures to address high NPLs have been put in place but vulnerabilities remain and some legislative proposals in parliament may raise concerns. These include new amendments to the Law on the Croatian National Bank, which could challenge the bank's independence. In the meantime, the CNB has issued recommendations to the banks aimed at reducing interest rate-related risks, while the Croatian Bank for Reconstruction and Development (HBOR) has undergone an AQR.

4 Annex. Summary Table A

MIP objective: Ensuring stable public finances			
Public finances and taxation			
Fiscal policy and fiscal governance			
<i>Announced measures</i>	<i>Adopted measures</i>	<i>Implemented measures</i>	<i>Sources of commitment</i>
Announced for September 2017: New Fiscal Responsibility Act, new Budget Act, new State Audit Office Act.			2017 CSR 1: "By September 2017, reinforce budgetary planning and the multi-annual budgetary framework, including by strengthening the independence and mandate of the Fiscal Policy Commission."
Broaden tax bases			
<i>Announced measures</i>	<i>Adopted measures</i>	<i>Implemented measures</i>	<i>Sources of commitment</i>
A recurrent property tax was announced and adopted in January 2017, but subsequently cancelled.			2017 CSR 1: "Take the necessary steps for the introduction of the value-based property tax."
Long term sustainability of public finances, including healthcare			

<i>Announced measures</i>	<i>Adopted measures</i>	<i>Implemented measures</i>	<i>Sources of commitment</i>
<p>Announced for November 2017: Adoption of three documents aimed at operational rationalisation in hospitals: National standard for cleaning of premises; National standard for washing and laundry services; and Guidance for preventive maintenance of non-medical equipment.</p> <p>Expected by December 2017: Adoption of the National Plan for Development of Hospitals 2017-2020.</p>	<p>July 2017: Start of the functional integration of hospitals; agreements signed with six pairs of hospitals.</p>		2017 NRP
MIP objective: Improving the functioning of the labour market, and the effectiveness of social protection			
Labour market, education and social policies			
Wages & wage setting			
<i>Announced measures</i>	<i>Adopted measures</i>	<i>Implemented measures</i>	<i>Sources of commitment</i>
<p>Announced for July 2017: Preparation of jobs and tasks catalogue in the public administration, job-complexity analysis, development of a new evaluation and assessment model.</p>	<p>October 2017: Progress with the preparatory work (job categorisation, wage grids, evaluation model) in view of the new Act on Wages in the Civil Service.</p>		2017 CSR 4: "In consultation with social partners, harmonise the wage-setting frameworks across the public administration and public services."

<p>Announced for December 2017: Draft Act on Wages in Civil Service.</p> <p>Announced for December 2017: Government Decision on the establishment of a central body for registration, coordination and monitoring of collective agreements for state and public service employees.</p>			
Active labour market policies			
<i>Announced measures</i>	<i>Adopted measures</i>	<i>Implemented measures</i>	<i>Sources of commitment</i>
<p>Announced for March 2017: Adoption of new package of Active Employment Policy Measures funded by the ESF and provided by the Croatian Employment Service in 2017.</p> <p>Announced for April 2017: Adoption of the Plan for the Education of Unemployed Persons for 2017.</p> <p>Continuous measure: Increase the number of unemployed persons covered by active employment policy measures related to education.</p> <p>Announced for September 2017: Adoption of the new Adult Education Act.</p>	<p>March 2017: Adopted new package of Active Labour Market Policy Measures.</p> <p>March 2017: Adopted Plan for Education of Unemployed Persons for 2017.</p> <p>September 2017: Adopted Revised Plan for Education of Unemployed Persons for 2017.</p>	Continuous implementation of ALMP measures.	2017 CSR 3: "Improve adult education, in particular for older workers, the low-skilled and the long-term unemployed."

Announced for December 2017: Implementation of the project Supporting the Education of Adult Learners by including them in educational priority programmes.			
Education			
<i>Announced measures</i>	<i>Adopted measures</i>	<i>Implemented measures</i>	<i>Sources of commitment</i>
Announced for September 2017: Adoption of the Amendments to the Vocational Education Act. Announced for December 2017: Draft Guidelines for rationalisation / optimisation of the network of vocational schools. Announced for December 2017: Adoption of the Act on Quality Assurance in Science and Higher Education.	September 2017: The public consultation on the Amendments to the Vocational Education Act has been finalised. The Government has not yet transmitted the Amendments to Parliament.		2017 CSR 3: "Accelerate the reform of the education system."
Poverty reduction & social inclusion			
<i>Announced measures</i>	<i>Adopted measures</i>	<i>Implemented measures</i>	<i>Sources of commitment</i>
Announced for September 2017: Draft Action Plan for consolidation of social protection for the period 2017-2020.			2017 CSR 2: Improve coordination and transparency of social benefits.

Announced for December 2017: Harmonisation and categorisation (in accordance with the ESSPROS methodology) of the terminology used for the social protection benefits provided at local government levels.			
Incentives to work, job creation, labour market participation			
<i>Announced measures</i>	<i>Adopted measures</i>	<i>Implemented measures</i>	<i>Sources of commitment</i>
Announced for May 2017: Revision of the Regulation on the methodology and assessment of disability pensions. Announced for December 2017: Amendments to the Acts regulating the Pension System to: 1. increase the statutory retirement age and accelerate the equalisation of retirement age for women and men; 2. streamline the lists of arduous or hazardous professions benefitting from more generous pension provisions; 3. restrict access to early retirement and encourage longer working lives.	2017: Adopted new Regulation on the Methodologies of Medical Assessment for disability pensions, improving the assessment model and procedure.		2017 CSR 2: "Discourage early retirement, accelerate the transition to the higher statutory retirement age and align pension provisions for specific categories with the rules of the general scheme."

MIP objective: improving competitiveness, the business environment, and institutional capacity

Public administration and business environment

Public administration

<i>Announced measures</i>	<i>Adopted measures</i>	<i>Implemented measures</i>	<i>Sources of commitment</i>
<p>Announced for September 2017: Adoption of State Administration Act for the transfer of first instance administrative and inspection activities from the ministries to state administration offices in counties.</p> <p>Announced for September 2017: Adoption of the Act establishing a regulatory framework of State Agencies aimed at the harmonisation of the agency system.</p> <p>Announced for September 2017: Adoption of the new Act on Financing of Local Government Units.</p> <p>Announced for December 2017: Adoption of the Plan for Rationalisation of State Agencies system.</p>	<p>September 2017: Government Adoption of the new Act on Financing of Local Government Units, aimed at simplifying the complex system of transfers and financing. The Act is currently under reading in the Parliament.</p>		<p>2017 CSR 4: "Reduce the fragmentation and improve the functional distribution of competencies in public administration, while enhancing the efficiency and reducing territorial disparities in the delivery of public services."</p>

<p>Announced for December 2017: Adoption of the Plan for Rationalisation (20% reduction) of the branch-offices of the central administration operating at local level.</p> <p>Announced for June 2017: Decision on expanding the number of users of central public procurement and its adoption.</p> <p>Announced for December 2017: Integration of European Single Procurement Document form into Croatian EOJN.</p>	<p>June 2017: Decision on expanding the number of users of central public procurement and its adoption.</p>	<p>June 2017: Decision on expanding the number of users of central public procurement and its adoption</p>	
State-owned enterprises			
<i>Announced measures</i>	<i>Adopted measures</i>	<i>Implemented measures</i>	<i>Sources of commitment</i>
<p>Announced for November 2017: Adoption of the new Act on Management of State-Owned Property; to be followed by adoption of the new decree on setting up the Central Registry of State-Owned Property.</p> <p>Announced for October 2017: Adoption of the new Corporate Governance Code for state-owned enterprises.</p>		<p>March 2017: Adoption of the Decree on criteria for selection of management board members in state-owned enterprises of strategic and special interest.</p> <p>Continuous in 2017: Disposal of state assets through sale of properties and shares in state-owned enterprises; improvement in activities taken and revenue collected compared to 2016.</p>	<p>2017 CSR 5: "Speed up the divestment of state-owned enterprises and other state assets, and improve corporate governance in the state-owned enterprise sector."</p>

Announced for December 2017: Removal of seven more companies from the List of Companies and Other Legal Entities of Strategic and Special Interest.			
Business environment			
<i>Announced measures</i>	<i>Adopted measures</i>	<i>Implemented measures</i>	<i>Sources of commitment</i>
Announced for September 2017: New regulations on inspection activities forming a new body. Announced for June 2017: Extension of SCM methodology measurement and targeted reduction of administrative burden. Announced for May 2017: Regulation on SME test. Continuous: Amendments to regulations stipulating non-tax payments. Announced for October 2017: Regulatory impact assessment (RIA) strategy 2017-2022. Continuous: Liberalization of sectoral regulations for legal services and tax advisers.	June 2017: Extension of SCM methodology measurement and targeted reduction of administrative burden. June 2017: Regulation on SME test. October 2017: Two big "parafiscal" charges were decreased.	Ongoing: Extension of SCM methodology measurement and targeted reduction of administrative burden. June 2017: Regulation on SME test. October 2017: Two big "parafiscal" charges were decreased.	2017 CSR 5: "Remove regulatory restrictions hampering access to and the practice of regulated professions and professional and business services." 2017 NRP

<p>Announced for December 2017: Adoption of a legislative framework enabling e-registration of businesses.</p> <p>Announced for December 2017: Plan for the functional integration of Cadastre and Land Registry Departments.</p> <p>Announced for May 2017: Action Plan for 2017 - 2018 accompanying Anti-Corruption Strategy 2015-2020</p> <p>Announced for April 2017: Formation of the Council for the Prevention of Corruption.</p>	<p>June 2017: Action Plan for 2017 - 2018 accompanying Anti-Corruption Strategy 2015-2020</p> <p>March 2017: Formation of the Council for the Prevention of Corruption.</p>		
Civil justice			
<i>Announced measures</i>	<i>Adopted measures</i>	<i>Implemented measures</i>	<i>Sources of commitment</i>
<p>Announced for September 2017: Adoption of the Courts Act.</p> <p>Announced for September 2017: Adoption of the Act on State Attorney's Office.</p> <p>Announced for December 2017: Functional merger of misdemeanour courts with municipal courts.</p>			<p>2017 CSR 5: "Improve the quality and efficiency of the justice system, in particular by reducing the length of civil and commercial cases."</p>

Announced for December 2017: Upgrade of the IT systems in Courts.			
MIP objective: building a stable and resilient financial sector			
Financial sector			
Financial services			
<i>Announced measures</i>	<i>Adopted measures</i>	<i>Implemented measures</i>	<i>Sources of commitment</i>
	<p>August 2017: Government adoption of new requirements for banks that sell NPLs to third parties.</p> <p>Ongoing: The Croatian Bank for Reconstruction and Development (HBOR) has undergone an asset quality review.</p>	<p>January 2017: Transitional tax treatment rules allowing banks to deduct losses from NPL write-offs from the tax base.</p> <p>March 2017: Modification of forbearance guidance and relaxation of provisioning guidelines by the CNB.</p>	