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**Assessment of the 2013 economic programme for
CROATIA**

Provisional Version

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EXECUTIVE SUMMARY

Economic Outlook

The Croatian economy continues to struggle with recession. The pre-crisis boom, which had been fuelled by a high inflow of foreign investment, gave way in 2009 to a protracted downturn, amplified by the structural weaknesses of the economy. The recession deepened in 2012, with real GDP falling by 2%. According to the Commission's 2013 spring forecast, the economy is expected to contract by 1 % in 2013 on the back of continuing bank deleveraging and unfavourable developments in the labour market. The improved international environment, EU accession and new legislation adopted to reinforce the investment climate should underpin a moderate recovery in 2014. The unemployment rate increased substantially in 2012, reaching 15.9%, with youth unemployment rising to 43%. Overall unemployment is expected to rise to 19.1% in 2013 and 20.1% in 2014. Inflation averaged 3.4% in 2012 and is expected to remain high at 3.1% in 2013 before falling to 2% in 2014.

The authorities are committed to bring the general government deficit below the 3% of GDP reference value by 2016. The 2013 Commission's spring forecast projects that the headline deficit in 2013 will increase to 4.7% of GDP and then reach 5.6% of GDP in 2014, while the debt-to-GDP ratio is expected to exceed the reference rate of 60% of GDP in 2014 due to both higher deficits and lower GDP growth than projected in the programme.

Key Issues

The Croatian authorities adopted several reform measures in 2012. In particular, the government took further steps to shift the tax burden towards taxes less harmful to growth and introduced measures against tax evasion. Moreover, a new law was adopted to facilitate the resolution of non-performing loans and some progress has been made to reduce the high cost of starting a business. Measures to increase the flexibility of the labour market, to strengthen the education system and to reduce the administrative burden on businesses are in the pipeline. In other areas, reform efforts have been more limited, especially as regards reducing the implicit liabilities and fragmentation of the pension system, improving the efficiency of the judiciary and enhancing corruption prevention mechanisms in public administration.

Croatia faces important challenges. After five years of recession, kick-starting job-rich growth while ensuring that fiscal consolidation remains on track is a key challenge for the short term, while improving competitiveness and strengthening confidence in the financial sector is crucial in the medium term. Croatia will need to make further efforts to reduce the high budget deficit and to resolve the liabilities carried by state-owned enterprises while safeguarding investment and other growth-enhancing expenditure. There is also scope to increase the efficiency of taxation. Labour market rigidities and an unfavourable business environment have to be addressed urgently.

- **Public finances:** High government deficits are contributing to a rapid build-up of public debt, which the Commission forecasts will soon exceed the reference value of 60% of GDP on unchanged policies. Implementing a clear and sustainable consolidation strategy is key: on the revenue side, there is scope to broaden tax bases (the tax-to-GDP ratio was 32% in 2011, much lower than the EU average of nearly 40 %) and to step up the fight against tax fraud and evasion. On the expenditure side, the challenge is to embark on a credible consolidation path whilst safeguarding growth-

enhancing expenditure and leaving sufficient room for co-financing the EU funds. There is also scope to review the effectiveness, sustainability and adequacy of expenditure on social protection and pensions. Finally, the state maintains an important role in a large number of companies, many of which are loss-making and highly indebted, posing risks to public finances.

- **Financial sector:** The economy is saddled with a large share of non-performing loans (14% at the end of 2012) and the private sector is exposed to currency risk as a high share of its debt is denominated in or indexed to foreign currency (75.3% in February 2013). Making provisions for these risks would enhance the soundness of the financial sector but may curb credit growth in the medium term.
- **Labour market:** Job creation is hindered by an inflexible labour market and by the disincentives embedded in the benefit system. Dismissals are complex and costly and can run in court for several years. This contributes to a large shadow economy (estimated to account for up to 40% of GDP), which negatively affects public finances. The unemployment rate has almost doubled since 2008 (from 8.6% to 15.9% in 2012), hitting younger workers hardest and exposing a third of the population to the risk of poverty.
- **Public administration and the business environment:** The quality of the business environment is low, as indicated by Croatia's unfavourable ranking in international surveys. The low efficiency of the judiciary and a high perception of corruption in public administration are a cause of concern. Enhancing administrative capacity will be particularly important if EU co-financed investments are to be successfully implemented.

1. INTRODUCTION

Croatia will join the EU on 1 July 2013, following the completion of the ratification process of the Accession Treaty by all EU Member States. In view of the EU accession, the country is already taking part in the 2013 European Semester on an informal basis. To this end, in April 2013 Croatia voluntarily submitted an economic programme. This staff working document (SWD) provides a qualitative assessment of the programme.

This SWD assesses economic challenges and policy measures in light of the findings of the Commission's Annual Growth Survey 2013 (2013 AGS),¹ which was published in November 2012. The AGS sets out the Commission's proposals for building the necessary common understanding about the priorities for action at national and EU level in 2013. It identifies five priorities to guide Member States to renewed growth: pursuing differentiated, growth friendly fiscal consolidation; restoring normal lending to the economy; promoting growth and competitiveness for today and tomorrow; tackling unemployment and the social consequences of the crisis; and modernising public administration.

This programme provides detailed information on the macroeconomic outlook and fiscal policy as well as on the future government reform plans in relation to the AGS, to the Europe 2020 targets and to the identified barriers to growth. The information contained in the programme provides the basis for the assessment made in this SWD.

The programme submitted was prepared jointly by the Ministry of Regional Development and EU Funds and the Ministry of Finance, in collaboration with representatives from the line ministries and representatives of the Prime Minister's Office, the Government Office for Cooperation with Non-governmental Organisations, the Government Asset Management Agency, the Croatian Competition Agency, the Croatian Institute for Health Insurance, the Croatian Employment Service, the Central Bureau of Statistics and the Croatian National Bank. The working group for the economic programme at the Ministry of Regional Development and EU Funds included representatives of regional authorities, civil society and other stakeholders. However, the national parliament was not consulted. The programme was placed on the website of the Croatian government.

2. ECONOMIC DEVELOPMENTS AND CHALLENGES

2.1. Recent economic developments and outlook

Recent economic developments

In 2012 and early 2013, Croatia continued to struggle with recession. In 2009, the pre-crisis boom, which had been fuelled by a high inflow of foreign investment, gave way to a protracted downturn, amplified by structural weaknesses in the economy. The recession deepened again in 2012, with real GDP falling by 2%, echoing the slowdown of activity in Croatia's main trading partners and deteriorating labour market conditions. High unemployment and on-going private sector deleveraging weighed on domestic demand, which made a negative contribution of 2.9 pps to real GDP growth in 2012. Investment decreased for the fourth year in a row, although the pace of contraction slowed to -4.6%. Employment decreased by 2.4% and the unemployment rate increased substantially, reaching 15.9%, with youth unemployment rising to 43% in 2012. These developments are mirrored in the

¹ COM(2012) 750 final.

worsening social situation and the rising number of people at risk of poverty and social exclusion. Only net exports contributed positively, mainly due to the decline in imports (reflecting weak domestic demand), coupled with healthy growth in exports of services, in particular tourism. Industry and construction, which jointly account for 30% of GDP, were particularly hard-hit by the recession and continued on a negative trend. In line with sluggish productivity growth, unit labour costs increased. This, together with changes in taxation (notably a hike in the standard value-added tax (VAT) rate in March 2012) and an increase in energy prices, pushed up consumer prices, with inflation averaging 3.4%.

Economic outlook

According to the 2013 Commission's spring forecast, the economy is expected to contract by 1.0 % in 2013. With domestic demand continuing to exert a drag on growth and net exports no longer expected to exert a significant impact, near-term prospects remain clouded. Investment is expected to fall further due to ongoing bank deleveraging and weak domestic demand. In line with developments in the real economy, the labour market is not expected to recover in 2013. In the absence of demand pressures, inflation would still remain relatively high, at 3.1%, driven mainly by increases in indirect taxes.

The Croatian economy is unlikely to rebound strongly in 2014. Investment growth is expected to resume under the impulse of the improvement in the international environment, EU accession, and new legislation adopted to improve the investment climate. The implementation of some delayed large public investment projects could provide additional support. However, the labour market situation is expected to continue to deteriorate in 2014 and this in turn will continue to hold back private consumption.

The macroeconomic scenario underpinning the economic programme is optimistic compared to the Commission's spring forecast. According to the programme, real GDP growth is expected to reach 0.7% and 2.4% in 2013 and 2014 respectively, compared to -1.0% and 0.2% in 2013 and 2014 in the Commission's spring forecast.

2.2. Challenges

Croatia faces important challenges in terms of reviving growth, strengthening public finances and promoting competitiveness. High general government deficits are curtailing growth-enhancing expenditure and implicit liabilities represent a risk to the sustainability of public finances. The economy is adversely affected by labour market rigidities, the slow pace of restructuring of state-owned enterprises, a heavy administrative burden and financial vulnerabilities associated with the high levels of non-performing loans and household debt. Meanwhile, the unemployment rate has almost doubled since 2009, hitting younger workers hardest and exposing a third of the population to the risk of poverty. After five years of recession and with the perspective of a solid recovery slipping further away, kick-starting job-rich growth is a major challenge for the short term, in particular in view of the necessary fiscal consolidation.

Continued high government deficits are contributing to a rapid build-up of public debt. Committing to a clear and sustainable consolidation strategy is key to bolstering confidence and supporting a stable financial and economic environment. On the revenue side, there is scope to increase the efficiency of taxation by broadening tax bases and to step up the fight against tax fraud and evasion. On the expenditure side, the challenge is to embark on a credible consolidation path whilst safeguarding growth-enhancing expenditure and ensuring sufficient room for co-financing the inflow of EU funds. There is also scope to review the adequacy, sustainability and effectiveness of major social protection expenditure, in particular

in the pension system. Finally, the state maintains an important role in a large number of companies, many of which are loss-making and highly indebted, posing risks to the sustainability of public finances through the accumulation of implicit liabilities.

A number of structural factors continue to weigh on the medium-term outlook. A relatively inflexible labour market, with high hiring and firing costs, together with disincentives created by the benefits system, restrain employment growth, slow down the adjustment in wages relative to productivity and create a large informal economy, with negative effects for public finances. Falling investment undermines long-term growth prospects. The quality of the business environment is low, as indicated by Croatia's unfavourable ranking in international surveys.² In this respect, both the low efficiency of the judiciary and a high level of perception of corruption in public administration are a cause of concern. Enhancing administrative capacity will be particularly important if EU co-financed investment is to be successfully implemented. Moreover, the economy is saddled with a large share of non-performing loans while the private sector is exposed to currency risk, as a high share of its debt is denominated in foreign currency. The banking sector remains well capitalised, but making provision for these risks may curb credit growth in the medium term. Finally, the financial sector is sensitive to the financing strategies of the parent institutions of foreign-owned banks. Ongoing deleveraging pressures could lead to credit for corporate investment being rationed.

3. ASSESSMENT OF POLICY AGENDA

3.1. Fiscal policy and taxation

Budgetary developments and debt dynamics

The objective of the programme's budgetary strategy is to pursue growth-friendly fiscal consolidation consistent with EU governance rules and Croatia's fiscal framework. The authorities are committed to bring the general government deficit below the 3% of GDP reference value by 2016 but have yet to specify the medium-term budgetary objective (MTO) in accordance with the Stability and Growth Pact. The programme predicts an increase in the structural deficit in the period between 2013 and 2016 by 1.8 pps.³

The assessment of budgetary developments is complicated by the lack of fiscal statistics that conform with the standards set out in the European System of Accounts (ESA) and ongoing methodological revisions. The assessment of compliance with the 2012 target, as well as a comparison of budgetary projections for 2013-2016 with the Commission's spring forecast is not possible because Croatia's general government data are currently under revision owing to the full change-over to the ESA methodology. Data for the general government sector for 2012 are expected to be formally notified to Eurostat, for the first time ever, only in autumn 2013. A number of parameters that are needed to produce meaningful reference benchmarks, against which budgetary developments could be assessed, are still being discussed at technical level in relevant EU fora. This is the case, for instance, for the

² See World Bank (2013): Doing Business Report and the Global Competitiveness Index 2012–2013 of the World Economic Forum.

³ On the basis of the information provided in the programme, the cyclically adjusted balance net of one-off and temporary measures (structural balance) could not have been recalculated by the Commission using the commonly agreed methodology. All subsequent references to the structural balance are based on figures reported in the programme.

assumptions underlying the computation of the structural budget balance according to the EU methodology and of the expenditure benchmark. Similarly, long-term projections of ageing-related expenditure, needed to assess the sustainability of public finances and to compute the minimum MTO, have not been reported in the programme. All these metrics are, however, expected to be provided in the 2014 convergence programme, together with other standard tables, to fully comply with the requirements of Regulation 1466/97 and the Code of Conduct.⁴

According to the information provided in the programme, the 2012 target for the general government deficit was met. The general government deficit, as reported in the programme, reached 3.8 % of GDP in 2012, in line with the target set in the 2012 pre-accession programme (2012 PEP). The programme indicates that the target was met mainly on the basis of revenue-increasing measures and reallocation in expenditure, which countered the negative impact of a weakened macroeconomic environment.⁵ However, most of the discretionary revenue measures were already reported in the 2012 PEP and had therefore already been factored in. Only a measure preventing the payment of salaries before contributions are paid to the government was implemented on top of the measures presented in the 2012 PEP, with a positive contribution to revenue of 0.4 % of GDP. It is not possible to assess the contribution of discretionary measures to meeting the target since comparable fiscal data for 2011 are not available.

The 2013 target for the general government deficit was increased by 0.3 pps to 3.6 % of GDP compared to the 2012 PEP. The revision is largely due to the denominator effect of lower nominal GDP (0.2 pps). In 2012, the authorities adopted a broad set of measures that are expected to increase tax revenue in 2013. Most notably, the government introduced a reduced VAT rate of 5% for goods that were previously not taxed⁶ and increased excise duties on tobacco and energy. These measures are projected to offset the adverse effect of lower-than-expected economic activity, raising general government revenue by 0.2 pp to 38.4% of GDP in 2013. The new deficit target takes into account budget amendments adopted by the government in March 2013, which aimed to contain expenditure growth and amounted to planned savings of about 0.5% of GDP. The measures included in the budget amendment were spread broadly and equally between the state budget and the investment expenditure of extra-budgetary funds and public companies such as Croatian Waters and Croatian Roads.⁷ Compared to 2012, the general government expenditure ratio is projected to remain stable at 42% of GDP. The 2013 Commission's spring forecast projects that the headline deficit in 2013 will increase to 4.7% of GDP. A major part of the difference compared to the target of the authorities (3.6% of GDP) is due to a more cautious macroeconomic outlook which gives rise to lower tax revenue. In addition, the Commission's spring forecast is underpinned by more conservative estimates of the impact of the discretionary revenue measures reported in Box 1. On the expenditure side, the differences are less significant as both the national and the Commission forecasts take into account planned savings in the central government wage bill and additional expenditure related to EU accession. Apart from the risk of lower-than-

⁴ Available at:

http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/coc/code_of_conduct_en.pdf.

⁵ The 2012 target was underpinned by the assumption of real GDP growing by 0.8 % in that year but the latest data show that real GDP actually decreased by 2 %.

⁶ This concerned bread, milk, books, medicines, orthopaedic aids, scientific magazines and screenings of films.

⁷ The cuts in the central government budget affected all expenditure categories except those of the ministries of education, labour and finance and the government office.

expected economic growth, meeting the 2013 target is also conditional on controlling local authority finances and extra-budgetary funds. Methodological changes in the treatment of these units in general government accounts are an additional risk.

The programme anticipates a gradual narrowing of the general government deficit in 2014 and beyond but and the budgetary plans are not supported by concrete measures.

The projected pace of the fiscal retrenchment is broadly constant over the programme period, leading to a decrease in the deficit from 3.4% of GDP in 2014 to 2.6% of GDP in 2016 according to the programme baseline. The share of both revenue and expenditure in GDP is projected to fall but, based on the information in the programme, roughly two-thirds of the planned fiscal retrenchment is expenditure-based. The programme does not outline the discretionary measures that underpin these outcomes. However, the tables accompanying the programme suggest that the authorities envisage achieving a decrease in public subsidies and further containing growth in social expenditure and in the public wage bill. Public investment is one of the expenditure items that is expected to rise in percentage of GDP, in line with the planned increase in expenditure needed to co-finance the EU funds. From a sub-sectoral perspective, the projected decrease in the general government deficit in the programme reflects an improvement in the central government budget; projections for other subsectors of the general government have not been reported. The structural deficit is projected to increase over the entire programme period and deteriorate from 2.4% of GDP in 2012 to 4.5% of GDP in 2016. Although Croatia has not specified its MTO yet, the consolidation effort is not consistent with the minimum annual structural adjustment that would normally be required by the Stability and Growth Pact, taking into account the current budgetary position, the public debt ratio and the macroeconomic outlook.

The consolidation strategy presented in the programme is underpinned by an optimistic macroeconomic scenario compared to the Commission's spring forecast.

According to the programme, real GDP growth is expected to reach 2.4% in 2014, compared to 0.2% in the Commission's spring forecast. In the later years of the programme, real GDP growth is projected to be 3.5%, substantially above the economy's potential GDP growth estimated by the authorities (0.6% in 2015 and 0.8% in 2016). Given the lack of concrete measures that would underpin the targets, the possibility that the macroeconomic environment will be worse than projected by the authorities is therefore a considerable risk to the consolidation strategy. In addition, the retrenchment in public wage bill and other government consumption expenditure may be difficult to implement without a clearly articulated strategy.

The general government debt-to-GDP ratio is projected to stay close to but below the reference rate of 60% of GDP.

The programme expects the gross debt-to-GDP ratio to peak at 57.5% of GDP in 2015, up from the 2012 level of 53.7%. While the primary deficit is expected to decrease gradually and to turn to a surplus in 2016, the increase in the debt ratio will be due mostly to the 'snow-ball' effect of high interest rate payments, which are projected to exceed 3% of GDP over the programme period. Since the debt-to-GDP ratio would remain below the reference rate of 60% of GDP in the programme baseline, the debt reduction benchmark would not be applicable. However, the Commission's spring forecast envisages the debt ratio to exceed the 60% of GDP threshold in 2014 due to both higher deficits and lower GDP growth than projected in the programme.

The debt developments presented in the programme are subject to several risks. First, as analysed below, the state maintains an important role in public corporations. As some of them are undergoing restructuring or privatisation processes, the implicit liabilities carried by some of these corporations may materialise and become an additional burden for public finances. In

2012, this was the case for shipyards, whose liabilities (2.8 % of GDP) were transferred into the general government debt. Secondly, more than 70 % of general government gross debt is denominated or linked to foreign currencies, mostly the euro, taking into account hedging operations. While the central bank has a track record of maintaining a broadly stable exchange rate to the euro, fluctuations in the exchange rate would be mirrored in the debt-to-GDP ratio. Finally, the delineation of the general government sector in line with ESA methodology, including its overall gross debt, is still to be established by national statistical authorities and has to be validated by Eurostat.

Box 1. Main measures	
Main budgetary measures	
Revenue	Expenditure
2013	
<ul style="list-style-type: none"> • Changes in excise duties (+0.4 % of GDP) • Introduction of a reduced VAT rate of 5 % for previously untaxed goods and services (+0.3 % of GDP) • Reduction in the health insurance rate from 15 % to 13 % (-0.3 % of GDP) • Property income from state oil companies and dividends from the Croatian central bank (+0.2 % of GDP) • Change in payments of social contributions (+ 0.2 % of GDP) • Introduction of fiscal cash registers (+0.2 % of GDP with an additional impact of + 0.1 % in 2014) • Introduction of a tax exemption on reinvested profits (-0.1 % of GDP) 	<ul style="list-style-type: none"> • Reduction in compensation of employees at central government level (-0.6 % of GDP) • Increase in contributions to the EU common budget (+0.5 % of GDP with an additional impact of +0.6 % in 2014) • Increase in investment expenditure at central government level (+0.6 % of GDP) • Restructuring of health care institutions (+0.3 % of GDP)
2014	
<ul style="list-style-type: none"> • n.a. 	<ul style="list-style-type: none"> • n.a.
<p>Note: The budgetary impact in the table is the impact reported in the programme, i.e. by the national authorities. A plus sign implies that revenue/expenditure increases as a consequence of the measure. The degree of detail reflects the information made available by the authorities in the convergence programme and, among others, in the multiannual budget.</p>	

State-owned enterprises

The state maintains an important role in the economy through the ownership of and holdings in a large number of companies. Overall, these pose a significant risk to public finances through operational losses, debt assumptions and the extension of financial guarantees.⁸ In mid-January 2012, the portfolio of the ‘Government Asset Management

⁸ According to the economic programme, public guarantees amounted to 11.7 % of GDP in 2012. National data indicate that eight state-owned companies generated a loss of HRK 1.3 billion in 2012 (0.4 % of GDP), which is a considerable increase compared to 2011.

Agency' comprised 682 companies and had a value of EUR 5.4 billion. Privatisation of the portfolio is proceeding at a slow pace overall but some progress has been made, in particular regarding large tourist complexes, former military assets (mainly real estate) and shipyards. A revision of the state portfolio was concluded in April 2013, too late to be included in the economic programme.

Despite ongoing restructuring, state subsidies to railways constitute a considerable financial burden for public finances. According to national data, railways received almost 78% of state subsidies in 2011. A restructuring process has been in progress for several years. In 2008, for instance, Croatia divested all the debts of HZ Railway and more recently, in August 2012, organisational reforms unbundled the holding of HZ Railway into three independent companies: HZ Infrastructure, HZ Cargo and HZ Passenger Transport. HZ Infrastructure has been the largest beneficiary of state subsidies, despite some reduction in 2012. Its low operational efficiency⁹ is partly a result of the lack of competition in the railway market, which prevents it from setting adequate access charges. HZ Cargo is currently being privatised but the overall attractiveness of rail transport is limited due to the underdeveloped infrastructure. Finally, HZ Passenger Transport was on the brink of bankruptcy in 2012, despite the debt relief received in 2008. Continuous capital injections diminish incentives to improve cost efficiency and performance. Hence the sector will continue to pose a fiscal risk until the profitability of the railways is ensured and/or the extent of public involvement is resolved

Restructuring is underway in shipyards and the national airlines. Privatisation contracts were signed for Brodosplit and Brodotrogir shipyards at the beginning of 2013. Both contracts involved a modest increase in restructuring aid and associated compensatory measures in view of the lower production capacity in the restructuring period. As regards the '3. Maj' shipyard, the Commission is assessing a revised restructuring plan in view of its planned acquisition by the recently privatised Uljanik shipyard. Kraljevica, the smallest shipyard with about 400 workers, has been in bankruptcy proceedings since August 2012. Croatia Airlines is also experiencing financial problems. Its operational result has been negative since 2008 and the loss has significantly increased in 2012, according to preliminary national data. The economic programme reports that an analysis of the underlying causes for the weak performance and further restructuring efforts are underway but it is not specific about the timeline of the process.

Fiscal framework

The fiscal framework has been significantly reformed over the past years. Three key legal acts have entered into force over the last three years: i) the Budget Act (2009), which introduces a three-year timescale for the general government budget planning; ii) the Fiscal Responsibility Act (2011), which specifies numerical fiscal rules; and iii) the 2011 Government Decision on the establishment of the Fiscal Policy Committee. After its accession to the EU, Croatia will have to transpose EU Directive 2011/85 on national budgetary requirements into national law by the end of 2013.

The numerical rule imposes expenditure-based consolidation going beyond the fiscal effort presented in the programme. According to the existing rule, the expenditure-to-GDP ratio for the general government has to decrease annually by one percentage point until a

⁹ According to preliminary national data, the loss made by HZ Infrastructure more than tripled from 2011 to 2012.

primary balance in nominal terms is reached. Subsequently, the permanent objective is to maintain a zero or positive cyclically-adjusted primary fiscal balance. An assessment of compliance with this rule in 2012 will be carried out by the Fiscal Policy Committee in May 2013 once complete general government data for 2012 is available. The risk of non-compliance with the rule in 2013 is high as, according to the programme, the authorities are targeting a flat expenditure-to-GDP ratio compared to 2012. In addition, the Budget Act prescribes that the annual debt-to-GDP ratio of the central government can only exceed the ratio of the previous year if the latter is below 60 % of GDP, setting a de facto debt ceiling of 60 % of GDP.

The recently adopted expenditure rule is under revision. The government has embarked on a consultation process, involving the IMF, to make the rule more responsive to the cyclical situation of the economy and to foster compliance with EU rules on national budgetary frameworks. The revision is still in a very early stage. The consistency of the new proposal with EU rules will be assessed on whether it ensures a durable and enforceable lowering of the high deficit, and, in view of the recent downgrades of Croatian sovereign bonds, strengthens the credibility of the consolidation strategy.

The role and independence of the Fiscal Policy Committee could be strengthened. The Committee is responsible for the assessment of compliance of the budget with the national fiscal rules, in both the planning and execution stage. It also assesses the main fiscal documents to be adopted by the government. The seven members of the Committee have been appointed by the government from selected independent institutions for a five-year non-remunerated mandate.¹⁰ However, adequate resources have not been secured to date. The Minister of Finance presides over the Committee but has no voting rights. According to the programme, the revision of the Fiscal Responsibility Act would also aim to strengthen the role and independence of the Committee vis-à-vis the Ministry, potentially transforming it into a body within the parliamentary Finance and Central Budget Committee. Isolating the Committee from the influence of the Ministry of Finance is a welcome step, as independence from instructions of the budgetary authority is an important feature of any national fiscal council. While the proposal is still in the making and cannot be assessed at this juncture, factors on which it will be assessed next year include an independent legal status, capacity to communicate publicly and in a timely manner, transparent procedures for nominating members based on experience and competence, adequate resources and access to information.

Tax system

The overall tax-to-GDP ratio in Croatia is lower than the EU average, but available evidence points to scope for improving the efficiency of the tax system and broadening tax bases. Overall, the tax-to-GDP ratio in Croatia was 32 % in 2011, i.e. much lower than the EU average of 38.8 %. Regarding taxes on labour and capital in particular, the economic programme reports that current taxes on income and wealth, including social contributions, accounted only for 17.3 % of GDP in 2012. However, this low tax-to-GDP ratio is not fully consistent with the statutory tax rates and tax wedges applicable in the Croatian economy for those who are tax compliant.¹¹ While part of the low tax income from labour might be related

¹⁰ The members of the Committee come from the following institutions: Institute for Public Finances, National Bank, State Audit Office, Zagreb Institute of Economics and from university faculties for economics and law.

¹¹ The personal income tax is progressive, with rates of 12 %, 25 % and 40 % and an additional surtax is applied by local communities. Social contributions are borne fully by employees (at a rate of 20 % of gross salary) while another 15.2 % of gross salary is paid by employers in the form of health, unemployment and injury insurance

to tax exemptions and reliefs, the fairly large relative gap in terms of tax revenue in Croatia and the EU is consistent with substantial underreporting of earnings and profits and undeclared work. There is scope for efficiency gains in corporate income taxation as well.¹²

The structure of taxation continues to shift away from labour and capital towards indirect taxes, which already represent the main source of general government revenues.

To alleviate the effective tax burden on employers, the government reduced the contribution rate for health insurance by 2 percentage points to 13 % in 2012. Regarding capital taxation, from 2013 entrepreneurs are allowed to reduce their taxable profits by the amount of reinvested earnings.¹³ This measure can decrease the effective corporate income tax but it also narrows the tax base for corporate taxation. At the same time, the standard VAT rate was raised by 2 percentage points to 25 % in March 2012.¹⁴ This was followed by the introduction of a 5 % VAT rate in January 2013 for goods and services that had previously not been taxed, such as some basic food commodities, books and medical aids. As announced in the economic programme, further changes in indirect taxes and excises are expected to follow upon EU accession. These measures are relevant steps towards shifting the tax burden towards taxes that are less harmful to job creation and growth.

The government has taken steps to fight tax fraud and evasion and to improve tax collection but Croatia is still facing substantial challenges in this area.

In particular, the size of the informal economy is relatively large in Croatia, with estimates ranging from 25 % to 40% of GDP. In addition to this, the value of charged but uncollected taxes and social contributions more than tripled between 2005 and 2010 and amounted to about 13 % of the total taxes and contributions collected in 2010.¹⁵ In order to reduce the amount of untaxed transactions and to improve tax collection, in 2013 Croatia introduced fiscal cash registers and directed that wages could be paid out to employees only after social contributions have been paid to the government. The administration is also working on improving its effectiveness. For instance, the authorities have recently set up a new department of strategic coordination, whose staff complement was strengthened with employees from the disbanded fiscal police and a specialised office for large taxpayers was established. Moreover, a tax compliance strategy for 2011–2015 outlines further steps to fight corruption and enhance human resources. These are all relevant measures that can help fight tax evasion and fraud and improve tax collection; however, they may not be sufficient to fully address the challenge. There is scope to further improve tax compliance by extending automatic exchange of information with other jurisdictions, by enhancing risk management techniques and by reinforcing cooperation with social security authorities. In this respect, the emergence of VAT ‘carousel’ fraud following the EU accession is a particular risk.

contributions. Urban (2009) reports that the tax wedge for individuals earning an average gross wage is relatively high in the light of Croatia’s relative income level (Urban, 2009: *The Tax Burden on Labour in Croatia*, Institute of Public Finance).

¹² See Bratić (2012): (In)efficiency of corporate income tax expenditures on underdeveloped areas of special tax treatment in Croatia. *Financial Theory and Practice*, 36, 4.

¹³ The average effective tax rate is estimated at 16.5 %, i.e. below the EU average. See ZEW, Project for the EU Commission, TAXUD/2008/CC/099, *Effective Tax Levels Using the Devereux/Griffith Methodology*.

¹⁴ At the same time, the threshold for registering for VAT was increased and selected goods were moved from the standard rate to a reduced rate of 10 %.

¹⁵ For estimates of the share of the informal economy see International Labour Office (2006): *Employment Policy Review Croatia*, and World Bank (2011): *Undeclared Economic Activity in Central and Eastern Europe*. For tax debt, see Bronić (2011): *Collected and Uncollected Taxes in Croatia and in the European Union*, Institute of Public Finance.

Pension System

The Croatian pension system comprises a mandatory public pay-as-you-go pillar (first pillar), a mandatory private fully-funded pillar (second pillar) and a very small voluntary private fully-funded pillar (third pillar). When the second pillar was introduced in 2002, participation was mandatory for persons below the age of 40. Persons aged 40 to 49 could choose to join but subsequent amendments allowed these voluntary participants to return to the first, public pillar. People above the age of 50 in 2002 remained fully in the first pillar. The combined contribution rate to the two mandatory pillars is 20% of the gross wage, of which 15 pps are attributed to the first and 5 pps to the second pillar.¹⁶ Pensions are indexed according to the ‘Swiss formula’ (50% nominal wages, 50% prices) with adjustments taking place every six months. Although indexation was suspended in 2010 and 2011, the bi-annual adjustment and the high proportion of real wages that is taken into account in the indexation are both generous compared to a pure annual price indexation rule and lead to upward pressures on public pension expenditure with implications for fiscal sustainability.¹⁷

The old-age dependency ratio is set to double in the next 50 years. The public pension system is currently running deficits, with pension contributions to the first pillar covering only 80% of contributory pension expenditure in 2010 and only slightly more than half of total public pension expenditure.¹⁸ Over the next 50 years, life expectancy at age 65 is projected to increase by four years from 16.7 years at present and the old-age dependency ratio is set to double from the level of 27.8% reached in 2010.¹⁹ While the introduction of the second pillar may mitigate ageing-driven expenditure increases in the public pillar, official projections of the fiscal sustainability of the pension system are not yet available on a basis that would allow direct comparison with other EU Member States. National projections show a decrease in public pension spending as a share of GDP in the long-run; however they do not take into account recent and planned policies described below.

Implicit liabilities may impair the sustainability of the system. The 1999 pension reform and the subsequent introduction of the multi-pillar pension system gave rise to inequalities in the level of pensions between, on the one hand, pensioners in the first pillar before and after the reform, and on the other, between those who remained in the first pillar after the reform and those who joined both pillars.²⁰ These inequalities have already led to the adoption of compensatory measures, increasing pension expenditure. A special pension supplement of up to 27% was introduced in 2007 to smooth the differences in first-pillar pensions before and after the reform. Moreover, optional multi-pillar pensioners (i.e. those aged 40-50 in 2002) have been given the possibility to transfer fully back to the first pillar. Both amendments are set to significantly increase public pension expenditure in the long run with negative

¹⁶ The authorities envisage a gradual increase in contributions to the second pillar from 2014.

¹⁷ The authorities are considering revising the indexation scheme. A concrete proposal is still to be announced but the economic programme indicates that the new rule could be more favourable for pensioners, which would lead to higher pension expenditure.

¹⁸ See World Bank (2011): Policy Note on Options for Further Pension System Reform.

¹⁹ See UN (2010): World Population Prospects, Volume II, Demographic Profiles.

²⁰ The latter inequality (between pensioners after the reform) was partly due to the fact that the reduction in pension entitlements in the first pillar was larger than the expected value of entitlements that could be accumulated in the second pillar based on the contribution rate. The share of contributions to the funded pillar was set to increase gradually after the implementation of the reform but the increase has never materialised. Currently, the authorities plan to increase the contribution rate to 6% in 2014 and to 9% by the end of 2017 but concrete measures have not been presented yet.

implications for the sustainability of the pension system. Moreover, they may give rise to similar demands from the remaining group of mandatory multi-pillar pensioners (i.e. those who were younger than 40 in 2002), especially if it were to turn out that pensions from the second pillar fall short of compensating the loss in first-pillar pensions. This possibility, acknowledged in the economic programme, would further increase pension expenditure.

The pension system is fragmented, which increases its financial cost, gives rise to unequal treatment and opens pathways to an early exit from the labour market. Special, and generally more favourable, pension rules exist for war veterans, former political prisoners, military service personnel and some other privileged groups, representing some 15% of all pensioners. Expenditure on these pensions accounts for about 20% of overall public pension expenditure. These schemes provide substantially higher replacement rates than the standard first pension pillar and moreover allow earlier retirement.²¹ Privileged pensions above HRK 3 500 were last reduced by 10% in 2010 and some tightening of eligibility conditions was introduced in 2012.²² The authorities are in the process of reviewing how the special schemes could be integrated into the general pension system but the timeline for this is unclear, which weakens the credibility of the commitment. Standard disability pensions account for another 28% of pension expenditure (received by 23% of pensioners in the first pillar), suggesting that eligibility criteria may be too generous.²³ However, data provided by the authorities indicate that the number of new disability pensioners has radically decreased compared to 2009 and now account for about 10% of all new pensioners. The procedure for determining the remaining work capacity should be further enhanced by 2014 to ensure consistency of assessment.

Statutory retirement ages are set to be fully harmonised for men and women in 2030.

The current statutory retirement age is 65 for men and 60 years and 9 months for women. The retirement age for women is set to rise by 3 months per year until 2030, when it will reach 65. The alignment of the retirement age for both sexes with life expectancy is currently being discussed. Early exit from the labour market is possible 5 years before reaching the statutory retirement age, conditional on achieving a sufficient number of qualifying years. The gap between the early and statutory retirement age is relatively large. A set of measures to financially discourage early retirement was introduced in 2010, when the penalties for early retirement doubled to 0.34% per month.²⁴ Further changes to the penalty system are envisaged in the economic programme, which could reduce the number of early old-age pensioners. A concrete plan is yet to be presented. The average age of new old-age pensioners in 2011, including early and disability pensioners, was 60.0, which is below the EU average of 62.1. However, the effective retirement age is expected to rise in line with the decrease in the number of new disability pensioners and the gradual increase in the statutory retirement

²¹ See ASISP (Analytical Support on the Socio-Economic Impact of Social Protection Reforms), 2012: Annual National Report on Croatia. Also, World Bank (2011): Policy Note on Options for Further Pension System Reform reports that the average war veterans' benefit was 2.3 times higher than the old-age pension, while the average age of beneficiaries is only 50.

²² Since February 2012, Members of Parliament, members of the government, judges of the constitutional court and the chief state auditor are no longer eligible for pensions on favourable conditions.

²³ See ASISP (Analytical Support on the Socio-Economic Impact of Social Protection Reforms), 2012: Annual National Report on Croatia.

²⁴ The level of the penalty also depends on the length of service and can lead to a permanent reduction from 1.8% up to a maximum of 4.1% per year, with a cap of 20.4% for all years. This is broadly in line with the level of penalties applied in some EU Member States. The bonus for retiring later is 0.15% per month, which provides little incentive to work beyond the statutory retirement age.

age for women. Increased labour force participation of older workers would help ensure more adequate pensions of future retirees.

3.2. Financial sector

The financial sector is dominated by foreign-owned banks, which are well-capitalised but sensitive to the financing strategies of parent institutions. Banks account for 75% of the total financial sector balance sheet and have remained stable in spite of the persistently weak economic situation. The banking system held EUR 53 billion of total assets (120% of GDP) at end-2012 and is thus significantly smaller than the euro-area average (344% of GDP) when scaled to overall economic activity. With the five largest banks holding about 76% of total banking assets, market concentration is relatively high. More than 90% of Croatian banking sector assets are foreign owned.²⁵ Until now deleveraging pressures from parent institutions have been moderate and liquidity conditions in Croatian banks remain relatively comfortable, not least because of buoyant resident deposits. Croatian banks are on the whole well-capitalised, with an average capital adequacy ratio of 20.5% in September 2012.

The rate of non-performing loans (NPLs) has increased considerably since the beginning of the crisis. NPLs reached 14 % at the end of 2012 while the corporate sector is most affected, with a NPL rate of around 25 %. Provisions for NPL are on average 40 %, i.e. lower than in most European countries, and are even lower for corporate loans. The collateral values are also relatively low. In the event of further NPL increases, loan loss provisions would put pressure on the capital and profitability of banks which could reinforce credit tightening pressures. The newly adopted Act on Financial Operations and Pre-bankruptcy Settlement aims at facilitating the resolution of NPLs and, therefore, contributes to containing credit rationing.

Furthermore, there is a currency-induced credit risk, given that a high share of non-financial private sector debt is denominated in or linked to foreign currency. Croatia has a long-standing track record of maintaining broad exchange rate stability as the kuna has been closely linked to the euro, the anchor currency for the vast majority of external transactions. The tightly managed float aims, inter alia, at containing exchange-rate induced credit risk.

Small and medium-sized enterprises (SMEs) have been particularly affected by the increased risk aversion in the financial system.²⁶ Furthermore, alternative funding sources such as private equity remain underdeveloped. In order to facilitate access to credit for SMEs, the authorities have established a privileged financing scheme supported by two specialised agencies, the Croatian Bank for Reconstruction and Development (HBOR) and HAMAG Invest that provide loans to SMEs under more favourable conditions. These include lower interest rates, extended repayment periods, provision of guarantees and risk-sharing. As outlined in the economic programme, the funding capacity of HBOR for 2013 amounts to around 3% of GDP, of which 1.3 pps are ear-marked for SMEs. HAMAG Invest's measures include a micro-lending scheme for start-ups and a programme financing research projects.

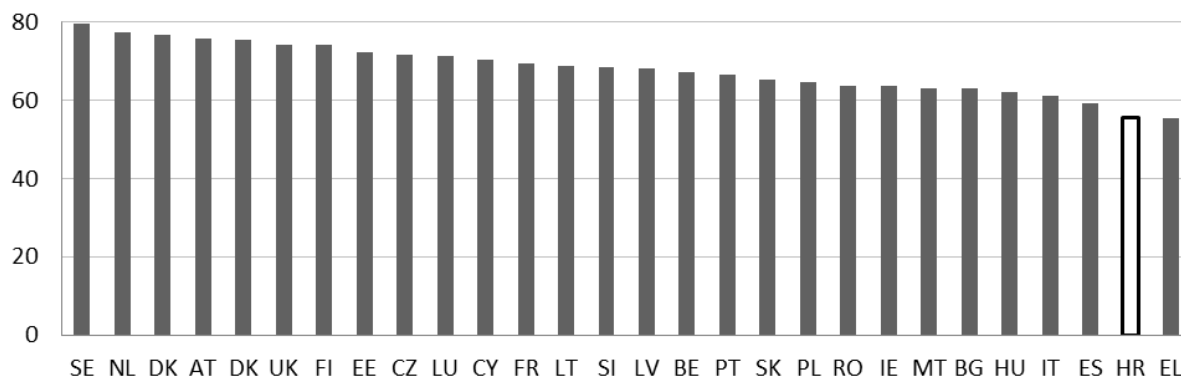
²⁵ At the end of 2012, Italian shareholders accounted for 44 % of total banking sector assets in Croatia, the Austrians for 34 %, the French for 7 % and the Hungarians for 3.2 % (Croatian National Bank data).

²⁶ Commercial interest rates increased to 7.5 % in 2012 and banks are asking for more valuable collaterals. See Croatian National Bank (2013): Bulletin, 190.

3.3. Labour market, education and social policies

The potential of the labour market in Croatia is severely underutilised. The employment rate (for the 20-64 cohort) has decreased by 7.5 pps since 2008 and at 55.4% in 2012, it was lower than in almost any EU Member State.²⁷ The economic programme indicates that national employment target has been set at 59% for 2020. Taking into consideration past and expected demographic changes, economic developments and labour market outcomes, the national target is not sufficiently ambitious. The unemployment rate (for the 15-74 cohort) increased from 8.6% in 2008 to 15.9% in 2012 and around 65% of unemployed had been out of a job for more than a year (43% in the EU). Women, young people and the elderly are particularly underrepresented in the labour market. In 2012, the employment rate for women, aged 20-64, was 50.2% compared to 60.6% of men. Women face difficulties in entering the labour market also due to insufficient childcare provision. The use of formal childcare in all age categories up to compulsory school age is well below the EU average and below the Barcelona targets.²⁸ The youth unemployment rate reached 43% in 2012, which places Croatia among the countries with the highest unemployment rate for young people.²⁹ At the same time, the size of the informal economy is relatively high and employment in the informal economy is thus likely to be relatively high as well.³⁰

Graph 1: Employment rate (20-64, 2012)



Source: Eurostat

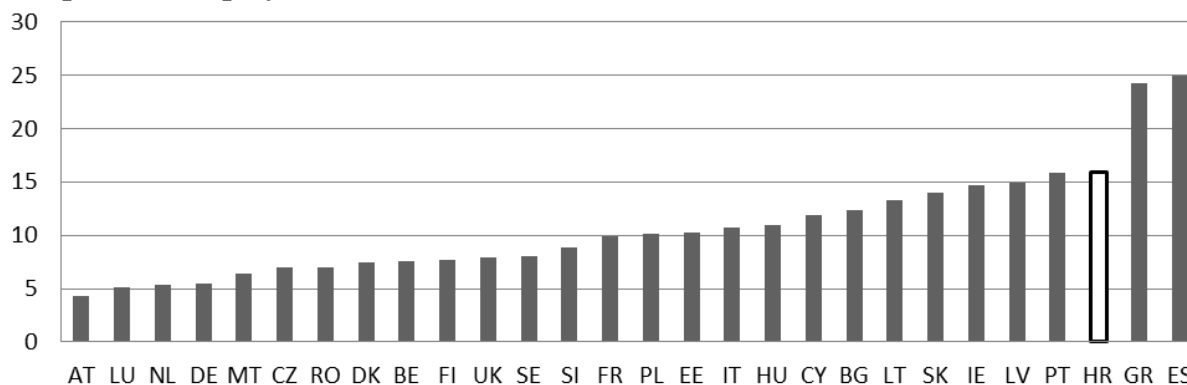
²⁷ The gender gap is around the EU average, as employment rates are low for both men and women.

²⁸ Better support, including through the availability and accessibility of high quality early childhood facilities, would facilitate the access of women to the labour market. See the HR Country Fiche on Gender Equality and Policy Developments (ENECE, 2013) and Conclusions of the European Council in Barcelona (2002).

²⁹ The employment rate of the 55-64 cohort was 36.7% in 2012, one of the lowest in the EU-27.

³⁰ International organisations' estimates on the share of the informal economy range from 25% (European Training Foundation, 2011: Croatia Review of Human Resources development) and 35-40% of GDP (World Bank, 2011: Undeclared Economic Activity in Central and Eastern Europe -How taxes contribute and how countries respond to the problem).

Graph 2: Unemployment rate (15-74, 2012)



Source: Eurostat

Unit labour costs increased steadily before the onset of the crisis but have improved somewhat since. Compared with other countries, notably those that joined the EU over the past decade, Croatia has experienced a more modest trend in nominal wage increases but also lower productivity gains. As wage bargaining often takes place at firm level, wage developments should reflect conditions at the individual establishments. However, this does not appear to have dampened economy-wide labour cost increases before the crisis. In addition, the level of compensation per employee in Croatia is higher than in any neighbouring country, except Slovenia. Nonetheless, cost competitiveness as proxied by changes in relative unit labour costs, has started to improve since 2009.

The government adopted several measures in 2012 that should lower labour costs and simplify hiring. In particular, the government reduced health contributions (paid by employers) by 2 pps to 13% and adopted the Employment Incentive Act, which exempts employers from paying health and other contributions if they take on long-term unemployed or young people without work experience (duration of employment for up to two years). This Act also introduced a voucher system to simplify the operation of seasonal employment in agriculture and, in particular, to facilitate the daily hiring of unemployed persons (without changing the status of the unemployed person), pensioners and other job seekers. According to national data, the voucher system has helped to reduce the level of undeclared work. All these measures should help decrease the cost of employing workers and therefore stimulate labour demand.

The social protection system discourages employment. The design of the social assistance programme for low-income persons gives rise to important threshold effects, as assistance is discontinued when a person takes up paid work in the formal labour market. This is because earned labour income — even at low earnings — typically exceeds the threshold set for eligibility for benefits. Such benefit traps are particularly relevant as benefits can be topped up, for instance, with child benefits or subsidies granted by local governments.³¹ Moreover, as explained above, the pension system offers a number of incentives and channels for early withdrawal from the labour force. Overall, this may suppress the labour supply from some groups within the active population and push workers into the informal sector of the economy.

³¹ Analysis by the Croatian Institute for Public Finances shows that there are negative incentives to work for people on low wages, families receiving several social benefits and assistance, families with only one employed adult, and families with more than one child. See Bejakovic, Urban, Bezeredi, Matejina (2012): *Isplati li se raditi u Hrvatskoj?*, Rev. Soc. Pol., 19/1.

On the other hand, the design of unemployment benefits is broadly in line with practices in some EU Member States even if activation of the unemployed has traditionally been weak.³²

Rigid employment protection legislation is another key factor leading to weak labour market performance. In particular, dismissal procedures are complex and lengthy, sometimes running in court for several years.³³ This discourages job creation because it gives rise to higher effective severance pay in the case of negotiated dismissals, as employers have an interest in avoiding appeals. Statutory severance pay is set at one third of monthly remuneration per year of service but collective agreements may increase it. The cost of dismissals has also led to an increase in the incidence of fixed-term contracts (12.8% in 2012).³⁴ The current trend of the rising use of fixed-term contracts could exacerbate labour market segmentation in Croatia. According to the programme, the first phase of a new labour market reform, to be adopted in the first half of 2013, includes measures to relax the duration of a first fixed-term contract for an employee (previously limited to a maximum of three years), to simplify the collective redundancy procedure, to extend the range of activities of temporary employment agencies and to abolish a monthly limit on overtime work. The amendments also address the implementation of relevant EU directives but no concrete proposals have been communicated yet. The economic programme indicates that a second phase of labour market reform should revise the rules for the notice period and severance pay and introduce greater flexibility in working hours. The reform has not been described in detail in the economic programme; the assessment of a more concrete proposal will depend on the extent to which the reform ensures the streamlining of dismissal procedures and effective lowering of dismissal costs.

On current evidence, active labour market policies (ALMPs) are little used in Croatia. Despite some recent improvements, spending on ALMPs amounts to 0.14% of GDP and only around 13% of the unemployed participated in such activities in 2012, in both cases at around a third of the EU average.³⁵ Public works, on-the-job training and hiring and training subsidies are the most important types of ALMPs. The public employment service (PES) is establishing a framework for monitoring the outcomes of ALMP measures but there is no regular evaluation in place, which heightens the risk of inefficiencies given the relatively frequent changes in ALMP measures.³⁶ The capacity of the PES to address the growing challenge of rising unemployment is limited. However, the service is being decentralised and

³² The unemployment benefit amounts to 70% of previous earnings for the first three months and 35% afterwards for a maximum duration of fifteen months depending on the previous employment record. Drawing unemployment benefit is limited to 450 days, except for older workers with 32 years of employment, who have up to five years until retirement. To qualify for unemployment benefits, a person must provide proof of a period of paid work of at least nine months in the last 24 months and be actively seeking a job. The overall coverage of unemployment benefits among the unemployed is rather limited and, according to national data, only 24% of unemployed persons received unemployment benefits in 2011. The reasons for this low coverage include the increasing number of long-term unemployed and of young people entering the labour market without previous paid work and hence not entitled to unemployment benefits.

³³ Relatively recently, specialised labour sections were created in law courts in the country's main cities.

³⁴ New staff are increasingly hired with fixed-term contracts (over 90% in 2012). Women and young workers find it particularly difficult to find permanent employment. According to national data for 2012, 92.8% of all women and 92% of young workers up to the age of 29 were newly employed (employed from the unemployment register) on a fixed-term contract.

³⁵ Corresponding figures for the EU (2009) are around 0.5% of GDP in terms of spending and 30% in terms of coverage.

³⁶ The National Employment Promotion Plan defined the ALMP measures for 2011-2012. The Plan was subsequently extended to July 2013.

re-organised to better cater for regional and local needs and to better tailor activities depending on the degree of employability. These are relevant measures. Looking forward, the success of these measures seems to hinge on strengthening the administrative and resource capacity to implement ALMPs, and to ensure that programmes are in line with labour market skills needs. Finally, to cope with the severe youth unemployment, the authorities plan to present specific measures to address youth unemployment in the new Youth Act and amendments to the Youth Advisory Boards Act, both of which are expected to be adopted by the end of 2013. A concrete proposal has not been presented yet, despite the urgency of the issue.

Education

Progress has been achieved in terms of the tertiary education attainment rate but low educational outcomes at primary and secondary level do not augur well for the quality of education. Croatia's education system performs well in terms of the number of early school leavers³⁷ but educational outcomes are relatively weak in international comparison. Fourth graders score lower than the international median performer and their scores are predicted to be among the lowest in the EU, especially in mathematics.³⁸ Educational outcomes do not improve as pupils progress to secondary education: the educational achievements of 15-year-old pupils in mathematics are far below the EU average and achievements in reading and writing are somewhat below the EU average.³⁹ Moreover, all values have deteriorated compared to the previous testing in 2006. Results from the national school leaving exam show some improvement over time but this has not yet manifested itself in international comparisons. The vocational education and training (VET) system does not seem in tune with the labour market and the duration of VET study programmes does not necessarily equate with quality.⁴⁰ Rising enrolment rates in tertiary education are starting to improve the attainment rate of the cohort 30-34 cohort. The rate has increased rapidly in the five years prior to 2012, when it reached 23.7% (compared to 35.8% in the EU), which in part can be attributed to participation in the Bologna Process and to the effect of previous reforms.⁴¹ However, growth in the attainment rate has been levelling off since 2011 and Croatia may have to step up efforts to reach the national target of 35%. The target is set at an appropriate level.

Croatia is currently drawing up further educational reforms. A key point on the agenda of national authorities to improve the quality of education is the Croatian national quality framework (CROQF). A framework law was adopted in March 2013. The law aims at formulating and establishing study programmes with clearly defined learning outcomes at

³⁷ The early school leavers rate rose marginally from a record low level of 3.7% in 2008 to 4.2% in 2012 while the EU average was 14.8% in 2008 and 12.8% in 2012 respectively. See EU LFS.

³⁸ See Trends in International Mathematics and Science Study 2011.

³⁹ See Pisa (2009). In mathematics, the proportion of 15-year-old pupils who fail to achieve basic skills in the PISA test ('low achievers') is 33.2% in Croatia (the EU-25 average is 22.2%). In reading, the percentage is lower but still above the EU-25 average (there are striking gender differences).

⁴⁰ See World Bank (2012): Croatia — Policy Notes, a strategy for smart, sustainable and inclusive growth for the links of VET schools to the labour market. There is evidence that three-year VET schools prepare the workforce for the labour market better than the four-year ones because the latter lack good quality practical training (European Training Foundation, 2009: Transition from school to work: internships and first entry to the labour market in Croatia).

⁴¹ Among these, Croatia introduced national educational standards, a national curriculum framework and a standardised secondary school-leaving exam. Professional profiles in VET schools have also improved and higher education is becoming more open in the international context.

each level of education. This reform, drawn up in consultation with stakeholders, is a relevant measure to increase the transparency and the quality of education over the medium term and will be phased in gradually. For instance, a comprehensive register of qualifications in line with the European Qualification Framework is not expected to be in place before 2015. The reform also concerns the VET system and aims at redefining its study programmes following the analysis of VET qualifications and competences.⁴² Croatia is also developing a Strategy of Teaching, Education, Science and Technology 2013-2020, which is expected to provide direction for several sectoral strategies that have been developed but not yet implemented. Public consultations should start in July 2013. This strategy also includes life-long learning, for which there has been no strategy existed so far. Given the early stage of implementation, the effects of educational reforms have to be monitored closely going forward.

Social Policies

The social situation in Croatia has been severely impacted by the protracted recession.

High unemployment and low labour-market participation increased the share of population at risk of poverty and social exclusion to 32.7% in 2011, significantly more than the 24.2% average for the EU. Older women are particularly vulnerable as 38.4% of women aged 65 or above were at risk of poverty or social exclusion in 2011 (compared with 27.6% of men of the same age); the figure rises to 43.2% for women aged 75 or above (28.4% for men). The pension system, in combination with the relatively short duration of working lives, therefore does not seem to ensure adequate protection in the old age. The overall social protection expenditure ratio, i.e. unemployment and social benefits, but also pensions and healthcare, rose to 20.8% of GDP in 2009, which is still below the EU-27 average of 29.5% of GDP.⁴³ Croatia aims to reduce the number of persons in poverty or social exclusion by 100 000 to 1 282 000 persons by 2020. Taking into account the scale of the social challenge Croatia is facing, the target is not sufficiently ambitious.

There is scope to improve the effectiveness of the social welfare system. Measured against the results achieved in alleviating the risk of poverty, the effectiveness of social transfers in Croatia is below the EU average. Social transfers, including pensions, reduce the 'risk of poverty' rate by 54% in Croatia and by 62.2% in EU27 (2010). Two main factors reduce effectiveness. First, 93.5% of benefits are not means-tested.⁴⁴ Secondly, there is little systematic monitoring of social assistance and benefits at national and local level. The attribution of different social benefits is scattered among services which hinders the exchange of information and opens the way to abuse.

The Social Welfare Reform Strategy 2011-2016 and the 2011 Social Welfare Act introduced some relevant changes. The strategy outlined steps to be undertaken in 2011-2016 in order to increase the system's effectiveness and to improve the availability of social services. The Social Welfare Act standardised conditions for granting social benefits, clarified means testing and introduced a link between a guaranteed minimum income and an official poverty threshold. This link effectively ensures an automatic indexation of eligibility for social benefits. Furthermore, the act defined the parameters of an electronic database that would register all beneficiaries and their claims, as well as the service providers. The

⁴² See Cedefop (2013): Analysis and overview of NQF developments in European countries. Annual report 2012.

⁴³ Croatian Bureau of Statistics (2013): Social protection in the Republic of Croatia 2008-2010

⁴⁴ Source: national data for 2010. According to World Bank, well-targeted means-tested social assistance programmes such as a guaranteed minimum income scheme account for only 0.3 % of GDP (WB, 2012: Croatia policy notes — A strategy for smart, sustainable and inclusive growth).

implementation of the system is ongoing. Once fully operational, the database could improve transparency and allow for better targeting of social benefits. The 2012 revision of the Act simplified administration of social benefits somewhat and removed a regional layer of social-welfare institutes. A new Social Welfare Act is currently in the pipeline and should be ready by the end of 2013. This reform should introduce a guaranteed minimum social benefit and implement the 'one-stop shop' concept for the payment of all social benefits. This is expected to increase the effectiveness of controls that are currently shared by many different institutions. These measures are relevant steps but their contribution to improving the social-welfare system will depend on how they are actually implemented; a detailed calendar of implementation is yet to be specified.

3.4. Structural measures promoting growth and competitiveness

Inadequate quality of the business environment and the lack of competition in key markets weigh on the growth prospects for the Croatian economy. Despite recent improvements, administrative and regulatory obstacles are still a major hurdle for investment activity and for setting up a business. There is also scope to improve the efficiency of the judiciary, so that the legal framework supports a swift resolution of insolvent firms. Markets for energy, transport and postal services are dominated by single suppliers, which distorts competition and undermines cost-competitiveness of Croatian businesses. Looking forward, productivity growth and a faster transition to a knowledge-based economy are hampered by a low level of spending on research and development and by inefficiencies in the policy framework. Some of these structural weaknesses have been acknowledged by the authorities and are partly reflected in measures and reform intentions presented in the economic programme.

Business environment

Croatia scores poorly in international surveys on the quality of the business environment. Croatia ranks 81st out of 144 countries in the 2012-2013 Global Competitiveness Index (GCI), five ranks lower than in the previous year and worse than most EU Member States. The most problematic factors for doing business, according to the GCI, are inefficient government bureaucracy and corruption. In fact, government regulation receives one of the lowest rankings globally (139th out of 144). An unfavourable assessment is also conveyed by the 2013 Doing Business Report. According to the report, procedures for starting up a new business still remain relatively costly and burdensome. In particular, the registration costs are estimated at 7.3% of per capita income in 2013, a significant improvement from 16.3% in 2003 but still higher than the EU average of 4.9% and the value achieved by regional peers. Furthermore, protection of investors is weak due to insufficient disclosure of information on transactions affecting corporate ownership and on conflict of interest.

Investment promotion and support to SMEs

Several measures have been taken to reduce the administrative burden and revive investment. First, the recently adopted Act on Investment Promotion and Development of the Investment Climate establishes investment and employment incentives in the form of tax exemptions and direct aid for job creation. Secondly, the Agency for Investment and Competitiveness and the 'SME Observatory' were created to provide information and advisory services in relation to investment and the SME sector. Finally, a new strategy for

encouraging entrepreneurship is currently under discussion.⁴⁵ The strategy is expected to outline measures to improve access to finance for SMEs, to reduce red tape and to promote exports of products with a high added value. The success of the adopted and planned measures will crucially depend on their effective implementation and mutual consistency, including with the Industrial Strategy for 2013-2020 which is also being drawn up. By the end of 2013, the authorities also plan to adopt an Act on Strategic Investment Projects, which should establish an accelerated administrative procedure for investments granted a strategic status. This measure could have merit in that it would provide a focused approach but it risks creating inequalities between ‘strategic’ and other investors. Streamlining administrative processes for all players would be the ‘first-best’ approach.

Efficiency of the judiciary

Despite recent improvements in the efficiency of the judiciary, a large backlog of unresolved cases still remains in civil and commercial cases. The case resolution rate has improved in recent years. For instance, the clearance rate for enforcement cases was 93.7% in 2010 and the number of enforcement cases increased by around 5% in the first semester of 2012. However, the duration of civil cases remains very high compared to the majority of EU Member States. Shortcomings in the functioning of the justice system undermine the confidence of citizens and businesses in the public institutions and weigh on Croatia’s business environment.

Energy, climate and resource efficiency

The Croatian internal energy market is dominated by single suppliers. While the framework for allowing non-discriminatory access by competitors to transmission and distribution networks is already in place, incumbents still maintain effective control over markets. As regards electricity, for instance, the state-owned monopoly *Hrvatska Elektroprivreda* generates 95% of the electricity output and is also responsible for the transmission and distribution of electricity. The 2012 amendment to the energy act made HERA, the energy market regulator, the only entity responsible for approving energy prices. It also removed other price controls previously in place so that energy prices now more closely reflect the real production and distribution costs. This led to a strong increase in gas and electricity prices in 2012. Currently, end-user electricity prices for industrial consumers are somewhat below the EU average and for households they are significantly below.⁴⁶

The energy intensity of the Croatian economy is comparable with the EU average, despite the relatively low share of energy-intensive sectors.⁴⁷ This offers considerable scope for improving energy efficiency. Despite the improvement observed in industry and transport, energy saving opportunities remain in all sectors. A comprehensive long-term strategy for energy efficiency has not been adopted but the energy policy framework includes legal provisions and measures to promote the efficient use of energy. A refurbishment programme for public buildings, put in place in 2012 – 2013, is expected to lower energy consumption in the building sector. Additionally, public financial support is provided for energy efficiency initiatives, including energy audits, in the public sector, industry and the

⁴⁵ Entrepreneurship Development Strategy 2013-2020.

⁴⁶ According to Eurostat, 2012 end-user prices for households are 0.121 euro per kW/h (EU: 0.186 euro per kW/h) and end-user prices for industry are 0.090 euro per kW/h (EU: 0.117 euro per kW/h).

⁴⁷ See Ministry of Economy (2011): Energy in Croatia, Annual Energy Report.

transport sector and, to a lesser extent, households. Overall, these initiatives are relevant measures to increase energy efficiency.

Caps on greenhouse gas emissions and targets for renewables are in place. Croatia has committed to not exceeding greenhouse gas emissions in sectors not included in the emission trading system (ETS) by more than 11% in 2020 compared to 2005. As the emissions level was only 1.9% higher in 2010 than in 2005, it is likely that Croatia will not increase by more than 5% its non-ETS emissions by 2013 and subsequently will meet its legal obligations under the Effort Sharing Decision. However, as projections concerning non-ETS emissions are not available, progress towards the 2020 target cannot be assessed. The percentage of renewable energy was 14.6% in 2010, a level broadly equivalent to that in 2005.⁴⁸ By adopting the third energy package, Croatia has set itself a national renewable energy target of 20.0% to be achieved by 2020. The economic programme envisages that the target can be achieved through a set of measures raising the use of renewables in electricity generation, heating and biofuels. A national renewable energy action plan has, however, not yet been adopted and effective support schemes have not been implemented in all sectors.⁴⁹ This makes it more difficult to assess whether the targets set are achievable. The promotion of renewable energy in transport currently lacks adequate attention.

An integrated waste management system is currently being developed. However, most of the waste generated is still going to landfill and the incentives to start moving waste management up the waste hierarchy towards prevention, reduction, reuse and recycling are still insufficient. In particular, landfill taxes are relatively low, the ‘pay as you throw’ and ‘extended producer responsibility’ schemes are not being applied and incentives for a separate collection at municipal level seem low. In 2013, the authorities plan to adopt a new Sustainable Waste Management Act to align the national legislation with requirements imposed by the EU Directive on Waste.

Transport

Accession to the EU will bring opportunities but also challenges to the monopolistic railway market. While Croatia’s geographical position affords the potential for increased rail traffic,⁵⁰ especially in terms of international cargo, rail freight is likely to be the most exposed to market pressures upon accession to the EU because there are no transition periods for railway transport. Croatia has unbundled Croatian Railways and also taken the first steps to regionalise the ‘public service obligation contracts’ for rail passenger transport. However, the market is still monopolistic and operating costs have not shown any significant downward trend. Increased competition in the railway market would help improve the financial situation of the infrastructure manager, which is grappling with a significant maintenance backlog in railway infrastructure. The network is old and of relatively low technical quality. Modernisation plans exist but critically they hinge on support provided both by the government and EU funds.

⁴⁸ See Ministry of Economy (2011): Energy in Croatia, Annual Energy Report.

⁴⁹ While feed-in tariffs and, to a lesser extent, loans offered by the commercial banking sector are used to increase the share of renewable energy sources in the electricity sector, few policy measures are in place in the heating sector.

⁵⁰ The major railway lines connect Croatia with neighbouring countries (i.e. Hungary, Slovenia, Bosnia and Herzegovina) and Croatian ports to the biggest cities. Croatia is also well integrated in the Pan-European Rail corridors X and V and in three pre-identified corridors in the context of the TEN-T revision.

Plans to upgrade airport, motorway and maritime transport infrastructure are ongoing.

The existing passenger terminal at Zagreb airport is set to be refurbished as part of a EUR 280 million expansion programme with works scheduled to start in the autumn of 2013. This is being done under a concession contract, which hands the management of Zagreb airport to a foreign airport company and also includes the potential construction of a second parallel runway in the future. Furthermore, there are concrete plans for a public-private partnership for motorway operation aimed at limiting costs to the general government accounts. Finally, an ambitious development plan for maritime ports is being pursued in line with the objective to give access to the hinterland and to develop intermodal transport. As many of the projects are being undertaken in cooperation with the private sector, contract design need to be guided by principles of sound and prudent public finance management to take into account all relevant public sector liabilities and risks for public budgets stemming also from contingent liabilities.

Postal sector

A new postal law implementing the 3rd Postal Directive and establishing the full liberalisation of the postal markets in Croatia by 1 January 2013 entered into force in January 2013.⁵¹ The incumbent, *Hrvatska pošta*, which is 100% state owned, currently retains a major share in the letter mail market. Although the legislation adopted follows the letter and objectives of the postal *acquis*, there are indications that the new postal law may not always be interpreted and applied by the Croatian authorities in line with the principles and objectives of the EU, notably in the area of postal services and public procurement as well as competition law. This could lead to a serious distortion of competition and exclusion of alternative operators from the market, by preventing these operators from accessing public tenders and/or by applying anticompetitive practices, such as unjustified discounts and tariffs.

Research and Innovation

Croatia is a moderate innovator with the research and innovation system showing a number of inefficiencies.⁵² Inefficiencies mainly concern cooperation between public research organisations and the private sector, the commercialisation of research results and technology transfer mechanisms. At the same time, the policy frameworks in the area of research, innovation and industrial policy are not sufficiently developed. In addition, the total level of R&D expenditure reached 0.75% in 2010 and 2011, which is below the EU average and too low to advance the transition to a knowledge-based economy. In particular, public R&D investment spending in 2011 amounted to 0.41% compared to the EU average of 0.74%. Business expenditure on R&D stood at 0.33% in 2011, well below the EU-27 average (1.26%). Croatia aims to achieve a level of 1.4% by 2020, which should be facilitated by the expected contribution of EU Structural Funds.

Croatia is in the process of taking a set of measures to strengthen its research and innovation capacity. The Act on Scientific Activity and Higher Education is being amended and is expected to be adopted by summer 2013. The Act aims at a more competitive and open national funding system with clear selection criteria and more synergetic funding through programming rather than on a project basis. A number of relevant strategies are currently being drawn up with a view to strengthening the research and innovation capacity in line with

⁵¹ The 3rd Postal Directive (Directive 2008/6/EC) represents a final legislative step in the gradual opening up of the market that began in 1997 with the 1st Postal Directive. While providing for the full liberalisation of the postal sector in the EU, it also ensures that basic postal services (universal service obligation) are safeguarded and further strengthens the role and independence of national regulatory authorities.

⁵² See Innovation Union Scoreboard 2013.

the smart specialisation strategy.⁵³ However, the pace of adopting and implementing the reforms is very slow (e.g. amendments to the above Act on Science were announced already in 2010). The development of the strategies will require good coordination and a strong political commitment to ensure an integrated approach, all contributing to more and better investment in research and innovation.

3.5. Modernisation of public administration

Croatia has taken important steps to improve its public administration. However, there is scope for further improvement in terms of its professionalisation, efficiency, transparency and citizen-orientation. A strong political commitment is an important pre-requisite for successfully implementing the reform.

While a Civil Service Act is in place, the current performance evaluation system does not ensure merit-based career progression which would attract and retain qualified staff. Amendments to the Civil Service Act are currently under preparation with a view to streamlining recruitment procedures and introducing performance appraisal. A draft Act on Salaries in State Administration has been prepared but there have been delays in finalising the overall legal framework for a transparent and merit-based salary system in the whole public administration. On the other hand, a new register of public sector employees has been established, which is increasing the efficiency of processing, analysing and following up relevant civil service data. The new State School for Public Administration has improved its capacity to provide training for civil servants, local and regional self-government officials and public officials.

Despite considerable effort, corruption in public administration is perceived to be a cause of concern in Croatia. In 2012 Croatia ranked 62nd out of 176 countries in Transparency International's Corruption Perception Index and is therefore set to join the group of the six worst performing EU Member States. Moreover, 90% of respondents of a recent international survey believed corruption to be widespread in business activities.⁵⁴ While the legal and institutional anti-corruption framework is now largely in place, key concerns remain as regards implementation. In particular, prevention mechanisms relating to conflicts of interests, detection of potential unjustified wealth of public officials and the effectiveness of control mechanisms within public administration including in public procurement provide substantial scope for improvement. The politicisation of the public administration and the supervision of state-owned companies also remain an issue.

Ensuring effective and timely use of EU funds will be a challenge. Croatia was able to demonstrate that it fulfils the conditions for the waiver for ex ante controls for all components of the pre-accession programme (IPA). However, the capacity to manage, and benefit from, a much larger number of projects funded from EU funds hinges on further progress in building an efficient and strong public administration, on finalising investment strategies and on preparing a stock of high quality and mature projects that would allow a swift increase in the absorption rate. The government has already started to recruit expert staff and has established working groups to draw up strategies for structural reforms and investment in priority areas

⁵³ The National Innovation Strategy for 2013-2020 as well as a new Strategy for Education, Science and Research are currently being drawn up and are expected to be adopted by July 2013. In addition, a National Industrial Strategy for 2013-2020 is also under preparation, prioritising 12 sectors as priority for economic growth.

⁵⁴ See Ernst & Young (2013): Europe, Middle East, India and Africa Fraud Survey.

for cohesion policy.⁵⁵ A fully functioning management, monitoring and evaluation system for the EU funds is, however, not yet in place. This may hinder the future absorption capacity or lead to subsequent monetary corrections with a negative budgetary impact.

⁵⁵ The government adopted decisions in July and December 2012 on recruiting additional staff for managing of EU funds (Commission, 2012: Comprehensive Monitoring Report on Croatia).

4. OVERVIEW TABLE

Europe 2020 (national targets and progress)	
Employment rate target: 59 %	2012: 55.3 % (Source: LFS, Eurostat)
R&D target: 1.4 % of GDP	2011: 0.75 % of GDP
Greenhouse gas (GHG) emissions target: +11 % (compared to 2005 emissions, ETS emissions not covered by this national target)	Change in non-ETS greenhouse gas emissions between 2005 and 2010: +2 %.
Renewable energy target: 20 % Share of renewable energy in all modes of transport: 10 %	Total renewable energy as a proportion of gross final energy consumption was 15.7 % in 2011 and 0.2 % in the transport sector (Source: Eurostat, April 2013.) Note: Only formally reported biofuels compliant with Articles 17 and 18 of Directive 2009/28/EC are included.
Energy efficiency — reduction of energy consumption in Mtoe: n.a. (Croatia is not expected to specify the target on energy efficiency this year)	Not available.
Early school leaving target: 4 %	The early school-leaving rate in 2012 reached 4.2 %, up from 3.7 % in 2010 (Source: LFS, Eurostat)
Tertiary education target: 35 %	The attainment rate in 2012 was 23.7 %, down from 24 % in 2010 (Source: LFS, Eurostat)
Risk of poverty or social exclusion target: reduction to 1 282 000	2011: 1 382 000 (Source: national data)

5. ANNEX

Table I. Macroeconomic indicators

	1995-1999	2000-2004	2005-2009	2010	2011	2012	2013	2014
Core indicators								
GDP growth rate	3.3	4.4	3.0	-2.3	0.0	-2.0	-1.0	0.2
Output gap ¹	n.a	0.3	2.2	-3.5	-2.1	-2.7	-2.9	-2.6
HICP (annual % change)	4.3	3.2	3.4	1.1	2.2	3.4	3.1	2.0
Domestic demand (annual % change) ²	3.7	5.2	1.9	-5.1	-0.3	-3.1	-1.4	0.4
Unemployment rate (% of labour force) ³	10.6	14.2	10.1	11.8	13.5	15.9	19.1	20.1
Gross fixed capital formation (% of GDP)	18.6	21.9	25.8	20.8	19.2	18.4	18.3	19.1
Gross national saving (% of GDP)	14.8	20.0	21.9	19.5	19.4	19.3	19.8	20.3
General Government (% of GDP) ⁴								
Net lending (+) or net borrowing (-)	n.a	n.a	-3.4	-5.2	-5.7	-3.8	-4.7	-5.6
Gross debt	n.a	35.6	34.0	42.2	46.7	53.7	57.9	62.5
Net financial assets	n.a	6.9	0.8	-2.1	-9.4	n.a	n.a	n.a
Total revenue	n.a	n.a	41.0	40.1	40.4	36.8	36.7	36.2
Total expenditure	n.a	n.a	44.4	45.3	46.1	40.6	41.5	41.8
<i>of which: Interest</i>	n.a	n.a	1.6	2.0	2.2	2.7	3.2	3.5
Corporations (% of GDP)								
Net lending (+) or net borrowing (-)	n.a	n.a	n.a	n.a	n.a	n.a	n.a	n.a
Net financial assets; non-financial corporations	n.a	n.a	n.a	n.a	n.a	n.a	n.a	n.a
Net financial assets; financial corporations	n.a	n.a	n.a	n.a	n.a	n.a	n.a	n.a
Gross capital formation	n.a	n.a	n.a	n.a	n.a	n.a	n.a	n.a
Gross operating surplus	n.a	n.a	n.a	n.a	n.a	n.a	n.a	n.a
Households and NPISH (% of GDP)								
Net lending (+) or net borrowing (-)	n.a	n.a	n.a	n.a	n.a	n.a	n.a	n.a
Net financial assets	n.a	n.a	n.a	n.a	n.a	n.a	n.a	n.a
Gross wages and salaries	n.a	n.a	n.a	n.a	n.a	n.a	n.a	n.a
Net property income	n.a	n.a	n.a	n.a	n.a	n.a	n.a	n.a
Current transfers received	n.a	n.a	n.a	n.a	n.a	n.a	n.a	n.a
Gross saving	n.a	n.a	n.a	n.a	n.a	n.a	n.a	n.a
Rest of the world (% of GDP)								
Net lending (+) or net borrowing (-)	n.a	n.a	n.a	n.a	n.a	n.a	n.a	n.a
Net financial assets	n.a	n.a	n.a	n.a	n.a	n.a	n.a	n.a
Net exports of goods and services	-8.2	-5.8	-6.3	-0.4	-0.1	0.7	0.9	0.6
Net primary income from the rest of the world	-0.6	-2.0	-2.5	-3.4	-3.4	-3.4	-3.2	-3.4
Net capital transactions	n.a	n.a	n.a	n.a	n.a	n.a	0.0	0.0
Tradable sector	47.8	46.4	44.1	43.0	43.5	43.3	n.a	n.a
Non tradable sector	36.0	37.1	41.1	42.5	42.3	41.6	n.a	n.a
<i>of which: Building and construction sector</i>	5.6	5.2	6.9	5.7	5.2	4.6	n.a	n.a
Real effective exchange rate (index, 2000=100)	n.a	n.a	n.a	n.a	n.a	n.a	n.a	n.a
Terms of trade goods and services (index, 2000=100)	90.8	95.7	102.5	105.6	105.8	105.0	104.4	104.0
Market performance of exports (index, 2000=100)	n.a	n.a	n.a	n.a	n.a	n.a	n.a	n.a
Notes:								
¹ The output gap constitutes the gap between the actual and potential gross domestic product at 2005 market prices.								
² The indicator on domestic demand includes stocks.								
³ Unemployed persons are all persons who were not employed, had actively sought work and were ready to begin working immediately or within two weeks. The labour force is the total number of people employed and unemployed. The unemployment rate covers the age group 15-74.								
⁴ General government data have not been formally validated by Eurostat.								
<i>Source:</i>								
<i>Commission services' 2013 spring forecasts (COM); Convergence programme (CP).</i>								

Table II. Comparison of macroeconomic developments and forecasts

	2012		2013		2014		2015	2016
	COM	CP	COM	CP	COM	CP	CP	CP
Real GDP (% change)	-2.0	-2.0	-1.0	0.7	0.2	2.4	3.5	3.5
Private consumption (% change)	-2.9	-2.9	-2.0	-0.7	-0.5	1.5	3.7	3.6
Gross fixed capital formation (% change)	-4.6	-4.6	-0.5	6.3	4.0	9.9	7.3	6.4
Exports of goods and services (% change)	0.4	0.4	1.3	1.6	3.5	3.2	4.5	5.1
Imports of goods and services (% change)	-2.1	-2.1	0.4	1.2	3.7	4.3	6.2	6.2
<i>Contributions to real GDP growth:</i>								
- Final domestic demand	-2.9	-2.8	-1.6	0.4	0.4	2.7	3.9	3.8
- Change in inventories	-0.3	-0.3	0.1	0.0	0.0	0.1	0.3	0.2
- Net exports	1.1	1.1	0.4	0.2	-0.1	-0.4	-0.7	-0.5
Output gap ¹	-2.7	-3.6	-2.9	-2.8	-2.6	-1.2	0.6	1.8
Employment (% change)	-3.9	-2.2	-4.2	-1.0	-1.8	0.9	1.6	1.8
Unemployment rate (%)	15.9	15.5	19.1	16.0	20.1	15.2	14.1	13.0
Labour productivity (% change)	2.0	0.3	3.3	1.6	2.1	1.4	1.8	1.6
HICP inflation (%)	3.4	n.a.	3.1	n.a.	2.0	n.a.	n.a.	n.a.
GDP deflator (% change)	2.0	2.0	2.0	2.0	1.5	2.1	2.0	2.0
Comp. of employees (per head, % change)	3.2	3.3	4.2	0.8	3.0	2.8	3.6	3.9
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	-0.1	0.1	n.a.	0.7	n.a.	-0.1	-0.8	-1.3

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

Source :
 Commission services' 2013 spring forecasts (COM); Convergence programme (CP).

Table III. Financial market indicators

	2008	2009	2010	2011	2012
Total assets of the banking sector (% of GDP)	n.a.	n.a.	n.a.	n.a.	n.a.
Share of assets of the five largest banks (% of total assets)	n.a.	n.a.	n.a.	n.a.	n.a.
Foreign ownership of banking system (% of total assets)	n.a.	n.a.	n.a.	n.a.	n.a.
Financial soundness indicators:					
- non-performing loans (% of total loans) ¹⁾	4.9	7.7	11.1	12.3	13.2
- capital adequacy ratio (%) ^{1), 2)}	15.1	16.4	18.8	19.6	20.2
- return on equity (%) ^{1), 3)}	12.8	8.8	8.3	8.7	7.8
Bank loans to the private sector (year-on-year % change)	n.a.	n.a.	n.a.	n.a.	n.a.
Lending for house purchase (year-on-year % change)	n.a.	n.a.	n.a.	n.a.	n.a.
Loan to deposit ratio	n.a.	n.a.	n.a.	n.a.	n.a.
CB liquidity as % of liabilities	n.a.	n.a.	n.a.	n.a.	n.a.
Banks' exposure to countries receiving official financial assistance (% of GDP) ⁴⁾	n.a.	n.a.	n.a.	n.a.	n.a.
Private debt (% of GDP)	n.a.	n.a.	n.a.	n.a.	n.a.
Gross external debt (% of GDP) ⁵⁾					
- Public	10	12.9	14.7	15.5	18.8
- Private	54.2	64.6	64.7	60.2	59.5
Long term interest rates spread versus Bund (basis points)*	2.2	3.2	3.6	3.9	4.9
Credit default swap spreads for sovereign securities (5-year)*	389.5	305.7	239.5	321.9	383.9
Notes:					
¹⁾ Latest data (December 2010). Please note that this information differs from country to country depending on the availability of latest IMF FSI data.					
²⁾ The capital adequacy ratio is defined as total capital divided by risk weighted assets.					
³⁾ Net income to equity ratio.					
⁴⁾ Covered countries are CY, EL, ES, LV, HU, IE, PT and RO.					
⁵⁾ Latest data 2012Q3.					
* Measured in basis points.					
Source:					
<i>Bank for International Settlements and Eurostat (exposure to macro-financially vulnerable countries), IMF (financial soundness indicators), Commission (long-term interest rates), World Bank (gross external debt) and ECB (all other indicators).</i>					

Table IV. Labour market and social indicators

Labour market indicators	2007	2008	2009	2010	2011	2012
Employment rate (% of population aged 20-64)	62.3	62.9	61.7	58.7	57.0	55.4
Employment growth (% change from previous year)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Employment rate of women (% of female population aged 20-64)	54.5	55.2	55.4	53.0	50.9	50.2
Employment rate of men (% of male population aged 20-64)	70.3	70.7	68.2	64.7	63.2	60.6
Employment rate of older workers (% of population aged 55-64)	35.8	36.7	38.5	37.6	37.1	36.7
Part-time employment (% of total employment, 15 years and more)	8.6	8.8	9.0	9.7	9.9	8.4
Part-time employment of women (% of women employment, 15 years and more)	11.3	11.5	11.6	12.5	12.4	10.0
Part-time employment of men (% of men employment, 15 years and more)	6.4	6.7	6.9	7.3	7.9	7.1
Fixed term employment (% of employees with a fixed term contract, 15 years and more)	12.6	12.1	11.6	12.3	12.7	12.8
Transitions from temporary to permanent employment	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Unemployment rate ¹ (% of labour force, age group 15-74)	9.0	8.4	9.1	11.8	13.5	16.0
Long-term unemployment rate ² (% of labour force)	5.5	5.3	5.1	6.7	8.6	10.3
Youth unemployment rate (% of youth labour force aged 15-24)	24.0	21.9	25.1	32.6	36.1	42.8
Youth NEET rate (% of population aged 15-24)	11.3	10.1	11.9	14.9	15.7	16.7
Early leavers from education and training (% of pop. 18-24 with at most lower sec. educ. and not in further education or training)	3.9	3.7	3.9	3.7	4.1	4.2
Tertiary educational attainment (% of population 30-34 having successfully completed tertiary education)	16.7	18.5	20.6	24.3	24.5	23.7
Formal childcare (from 1 to 29 hours; % over the population less than 3 years)	0.0	0.0	0.0	1.0	1.0	n.a.
Formal childcare (30 hours or over; % over the population less than 3 year)	0.0	0.0	0.0	7.0	14.0	n.a.
Labour productivity per person employed (annual % change)	1.5	1.0	-5.2	3.9	2.4	-0.9
Hours worked per person employed (annual % change)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Labour productivity per hour worked (annual % change; constant prices)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Compensation per employee (annual % change; constant prices)	1.5	1.1	-1.8	3.6	0.9	-1.6
Nominal unit labour cost growth (annual % change)	4.1	5.8	6.6	2.6	1.6	0.8
Real unit labour cost growth (annual % change)	0.0	0.1	3.6	1.7	-0.6	-0.5

Notes:

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

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

Sources:

Commission (EU Labour Force Survey and European National Accounts)

Expenditure on social protection benefits (% of GDP)	2006	2007	2008	2009	2010
Sickness/Health care	n.a.	n.a.	6.3	7.1	6.9
Invalidity	n.a.	n.a.	3.2	3.5	3.6
Old age and survivors	n.a.	n.a.	6.9	7.6	7.7
Family/Children	n.a.	n.a.	1.5	1.6	1.6
Unemployment	n.a.	n.a.	0.2	0.4	0.5
Housing and Social exclusion n.e.c.	n.a.	n.a.	0.0	0.0	0.0
Total	n.a.	n.a.	18.2	20.2	20.3
of which: means tested benefits	n.a.	n.a.	1.2	1.3	1.3
Social inclusion indicators	2007	2008	2009	2010	2011
At-risk-of-poverty or social exclusion ¹ (% of total population)	n.a.	n.a.	n.a.	31.3	32.7
At-risk-of-poverty or social exclusion of children (% of people aged 0-17)	n.a.	n.a.	n.a.	30.6	32.2
At-risk-of-poverty or social exclusion of elderly (% of people aged 65+)	n.a.	n.a.	n.a.	34.7	34.0
At-Risk-of-Poverty rate ² (% of total population)	18.0	17.3	17.9	20.5	21.1
Severe Material Deprivation ³ (% of total population)	n.a.	n.a.	n.a.	14.5	14.8
Share of people living in low work intensity households ⁴ (% of people aged 0-59)	n.a.	n.a.	n.a.	15.4	17.0
In-work at-risk-of poverty rate (% of persons employed)	n.a.	n.a.	n.a.	5.9	6.5
Impact of social transfers (excluding pensions) on reducing poverty	28.0	31.6	29.8	32.1	31.3
Poverty thresholds, expressed in national currency at constant prices ⁵	23493	23732	24830	22697	21597
Gross disposable income (households)	191696	n.a.	n.a.	n.a.	n.a.
Relative median poverty risk gap (60% of median equivalised income, age: total)	23.0	25.0	24.4	28.6	27.4
Notes:					
¹ People at-risk-of poverty or social exclusion (AROPE): individuals who are at-risk-of poverty (AROP) and/or suffering from severe material deprivation (SMD) and/or living in household with zero or very low work intensity (LWI).					
² At-risk-of poverty rate (AROP): share of people with an equivalised disposable income below 60% of the national equivalised median income.					
³ Share of people who experience at least 4 out of 9 deprivations: people cannot afford to i) pay their rent or utility bills, ii) keep their home adequately warm, iii) face unexpected expenses, iv) eat meat, fish, or a protein equivalent every second day, v) enjoy a week of holiday away from home once a year, vi) have a car, vii) have a washing machine, viii) have a colour tv, or ix) have a telephone.					
⁴ People living in households with very low work intensity: share of people aged 0-59 living in households where the adults (excluding dependent children) work less than 20% of their total work-time potential during the previous 12 months.					
⁵ For EE, CY, MT, SI, SK, thresholds in nominal values in Euros; HICP - index 100 in 2006 (2007 survey refers to 2006 incomes)					
Sources:					
For expenditure for social protection benefits ESSPROS; for social inclusion EU-SILC.					

Table V. Product market performance and policy indicators

Performance indicators	2003-2007	2008	2009	2010	2011	2012
Labour productivity ¹ total economy (annual growth in %)	2.1	1.0	-5.2	3.0	2.4	2.0
Labour productivity ¹ in manufacturing (annual growth in %)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Labour productivity ¹ in electricity, gas, steam and air conditioning supply (annual growth in %)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Labour productivity ¹ in the construction sector (annual growth in %)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Total number of patent ² applications per million of labour force	16.7	14.9	14.2	12.8	n.a.	n.a.
Policy indicators	2003-2007	2008	2009	2010	2011	2012
Enforcing contracts ³ (days)	561	561	561	561	561	572
Time to start a business ³ (days)	27	22	22	9	9	9
R&D expenditure (% of GDP)	0.9	0.9	0.9	0.8	0.8	n.a.
Tertiary educational attainment (% of 30-34 years old population)	16.9	18.5	20.6	24.3	24.5	23.7
Total public expenditure on education (% of GDP)	3.97	4.30	4.33	4.27	n.a.	n.a.
	2007	2008	2009	2010	2011	2012
Product market regulation ⁴ , Overall (Index; 0=not regulated; 6=most regulated)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Product market regulation ⁴ , Retail (Index; 0=not regulated; 6=most regulated)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Product market regulation ⁴ , Network Industries ⁵ (Index; 0=not regulated; 6=most regulated)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Notes:						
¹ Labour productivity is defined as gross value added (in constant prices) divided by the number of persons employed.						
² Total number of patent applications to the European Patent Office (EPO) per million of labour force.						
³ The methodologies, including the assumptions, for this indicator are presented in detail on the website http://www.doingbusiness.org/methodology .						
⁴ The methodologies of the product market regulation indicators are presented in detail on the website http://www.oecd.org/document/1/0,3746,en_2649_34323_2367297_1_1_1_1,00.html . The latest available product market regulation indicators refer to 2003 and 2008, except for Network Industries.						
⁵ Aggregate Energy, Transport and Communications Regulation (ETCR).						
*figure for 2007.						
Source:						
Commission, World Bank - <i>Doing Business</i> (for enforcing contracts and time to start a business) and OECD (for the product market regulation indicators).						

Table VI. Green Growth

		2002-2006	2007	2008	2009	2010	2011
Green Growth performance							
<i>Macroeconomic</i>							
Energy intensity	kgoe / €	0.32	0.29	0.28	0.29	0.29	0.29
Carbon intensity	kg / €	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Resource intensity (reciprocal of resource productivity)	kg / €	1.98	1.90	2.15	1.82	n.a.	n.a.
Waste intensity	kg / €	n.a.	n.a.	0.13	n.a.	0.11	n.a.
Energy balance of trade	% GDP	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Energy weight in HICP	%	n.a.	12	12	11	12	13
Difference between change energy price and inflation	%	n.a.	-2.8	0.8	4.5	6.1	0.3
Environmental taxes over labour taxes	ratio	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Environmental taxes over total taxes	ratio	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
<i>Sectoral</i>							
Industry energy intensity	kgoe / €	0.25	0.24	0.24	0.22	0.22	n.a.
Share of energy-intensive industries in the economy	% GDP	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Electricity prices for medium-sized industrial users**	€ / kWh	n.a.	0.07	0.09	0.09	0.09	0.09
Gas prices for medium-sized industrial users***	€ / kWh	n.a.	0.02	0.02	0.03	0.04	0.04
Public R&D for energy	% GDP	n.a.	0.00%	0.00%	0.00%	0.00%	0.00%
Public R&D for the environment	% GDP	n.a.	0.00%	0.01%	0.00%	0.00%	0.00%
Recycling rate of municipal waste	ratio	n.a.	3.0%	3.0%	3.0%	4.0%	n.a.
Share of GHG emissions covered by ETS*	%	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Transport energy intensity	kgoe / €	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Transport carbon intensity	kg / €	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Security of energy supply							
Energy import dependency	%	57.2%	56.6%	60.0%	51.0%	52.2%	n.a.
Diversification of oil import sources	HHI	n.a.	0.55	0.44	0.48	0.31	n.a.
Diversification of energy mix	HHI	0.35	0.35	0.33	0.34	0.31	0.30
Share renewable energy in energy mix	%	9.8%	7.5%	8.7%	10.8%	13.2%	10.4%

Country-specific notes:

The year 2012 is not included in the table due to lack of data.

General explanation of the table items:

Source: Eurostat unless indicated otherwise; ECFIN elaborations indicated below

All macro intensity indicators are expressed as a ratio of a physical quantity to GDP (in 2000 prices)

Energy intensity: gross inland energy consumption (in kgoe) divided by GDP (in EUR)

Carbon intensity: Greenhouse gas emissions (in kg CO₂ equivalents) divided by GDP (in EUR)

Resource intensity: Domestic Material Consumption (in kg) divided by GDP (in EUR)

Waste intensity: waste (in kg) divided by GDP (in EUR)

Energy balance of trade: the balance of energy exports and imports, expressed as % of GDP

Energy weight in HICP: the share of the "energy" items in the consumption basket used in the construction of the HICP

Difference between energy price change and inflation: energy component of HICP, and total HICP inflation (annual %-change)

Environmental taxes over labour or total taxes: from DG TAXUD's database "Taxation trends in the European Union"

Industry energy intensity: final energy consumption of industry (in kgoe) divided by gross value added of industry (in 2005 EUR)

Share of energy-intensive industries in the economy: share of gross value added of the energy-intensive industries in GDP

Electricity and gas prices medium industrial users: consumption band 500 - 2000MWh and 10000 - 100000 GJ; figures excl. VAT.

Recycling rate of municipal waste: ratio of municipal waste recycled over total municipal waste

Public R&D for energy or for the environment: government spending on R&D (GBAORD) for these categories as % of GDP

Share of GHG emissions covered by ETS: based on greenhouse gas emissions as reported by Member States to EEA (excl LULUCF)

Transport energy intensity: final energy consumption of transport activity (kgoe) divided by transp industry gross value added (2005 EUR)

Transport carbon intensity: greenhouse gas emissions in transport activity divided by gross value added of the transport sector

Energy import dependency: net energy imports divided by gross inland energy consumption incl. energy consumption international bunkers

Diversification of oil import sources: Herfindahl index (HHI), calculated as the sum of the squared market shares of countries of origin

Diversification of the energy mix: Herfindahl Index over natural gas, total petrol products, nuclear heat, renewable energies and solid fuels

Share renewable energy in energy mix: %-share in gross inland energy consumption, expressed in tonne oil equivalents

*Provisional data (15 April 2013). Commission Services and EEA.

** For 2007 average of S1 & S2 for DE, LU, NL, FI, SE & UK. Other countries only have S2.

*** For 2007 average of S1 & S2 for IT, NL, FI, SE & UK. Other countries only have S2.