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from:	Mr Joe GRICE, President of the Economic Policy Committee
date of receipt:	25 April 2006
to:	Mr Karl-Heinz GRASSER, President of the (ECOFIN) Council
Subject:	EPC Report on Structural Policy Challenges in Croatia

Dear President,

The ECOFIN Council, at the dialogue at political level with the candidate countries in July 2005, invited the EPC to complement its 2004 work on the structural challenges in the candidate countries by an analysis on Croatia for the 5 May 2006 Ministerial dialogue. I am pleased to attach our report for your considerations.

I would draw your attention to the key messages on the first page, where we have summarised the report for your convenience. After the Dialogue meeting on 5 May, the report would be published on the Committee's public website.(1)

(Complementary close)

(s.) Joe GRICE

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Encl.

(1) http://europa.eu.int/comm/economy_finance/epc/epc_publications_en.htm#enlargement

ECONOMIC POLICY COMMITTEE

Brussels, 11 April 2006
ECFIN/EPC(2006)REP/51951 final

Structural policy challenges in Croatia

Key messages

Croatia has made important progress with the implementation of its structural reform agenda, but there remains scope to accelerate the pace of reforms in a number of key areas.

Between 2000 and 2004, the Croatian economy showed solid, but, from 2002, slightly decelerating real growth rates, according to Eurostat averaging at around 4% annually. Growth in 2005 appears to have been around the same level, with initial indications suggesting growth at 4%. Real convergence in income and productivity levels with the EU-25 remains a major challenge. In 2004, average per capita income (in purchasing power standards) amounted to 46% of the EU-25 average. The following key structural challenges have been identified in Croatia:

1. **Completing privatisation and restructuring.** The pace of privatisation has been too slow and the cost to the taxpayer of subsidising state-owned enterprises has remained high. The development of the private sector should be further promoted. Progress on the large unfinished privatisation agenda is a key deliverable for the Croatian government. In some key sectors, restructuring in preparation for privatisation should be advanced, and efforts to improve financial discipline and the workings of the market mechanism be strengthened.

2. **Continuing fiscal consolidation and reforms to welfare systems**. Croatia should continue efforts to reduce the general government deficit in the context of their medium term fiscal programme, also in view of pressures on the pension and health care systems due to an ageing population. The sustainability of public finances should, therefore, be monitored closely. A comprehensive health care reform has been delayed, including a reduction in the exemptions for co-payments, a re-definition of a basic health care package, and a restructuring/privatisation of the supplemental health insurance. If the government is to meet its own targets for controlling costs, ambitious reform proposals in this respect will need to be designed and implemented rapidly. Social benefit reforms need to be better aligned to provide more effective support for the neediest parts of the population.

3. **Improving the flexibility of the labour market.** There remains scope to accelerate the pace of labour market reform. Croatia is still faced with very high rates of unemployment – especially for younger and older workers, and high long-term unemployment. Employment rates have fallen significantly since the mid 1990s, below the EU-10 average, and are rebounding only very slowly. There are also high regional disparities. It is not clear that there is a coherent strategy in place to improve the incentives to work and to provide the workforce with the skills required to succeed in a more dynamic and rapidly changing labour market. Though the new labour code in 2004 relaxed some restrictions, the level of employment protection is still relatively high.

4. **Improving the business environment and the regulatory framework for network industries.** There is more work to do to introduce market discipline into the network

industries: energy, communication and transport sectors. Progress has been made at improving the functioning of the legal and judiciary system but further efforts are required to bring it into line with the needs of a modern market economy. Finally, there is scope to do more to simplify the tax code and reduce the burden of regulation – creating the right surroundings for entrepreneurs.

Mandate

The Ecofin Council, at the dialogue with the candidate countries in July 2005, invited the EPC to complement its 2004 work on the structural challenges in the candidate countries by an analysis on Croatia for the 5 May 2006 dialogue.[1] This report is based on published material from the Croatian Government, the Croatian National Bank, the European Commission, the International Monetary Fund and World Bank, contributions by the Munich Osteuropainstitut, the WIIW and national delegations, and an EPC mission to Croatia in February 2006. To promote comparability across candidate, accession and member states and in line with the treatment of statistics in the 2004 report on Romania, Bulgaria and Turkey, the report uses, where possible, published EUROSTAT data, even where more recent data are sometimes available from national sources.

1. The macroeconomic context

Although the Croatian economy began its transition to a market economy from a relatively good starting position, further catching up to EU average income and productivity levels remains a major challenge. In 2004, average per capita income (in purchasing power standards) amounted to 46% of the EU-25 average.

Between 2000 and 2004, the Croatian economy showed solid, but, from 2002, slightly decelerating real growth rates, averaging at around 4% annually. Growth in 2005 appears to have been around the same level, with initial indications suggesting growth at 4%, driven by domestic demand in particular. Growth rates are at the lower end within the candidate countries but well above the average growth rates of the EU-25. The Commission forecasts growth to register at 4% in 2006 and accelerate to 4.4% in 2007, based on stronger private investment in the context of ongoing privatisation and enterprise restructuring and a continued strong export and tourism performance. Data produced by the Croatian authorities at the end of March 2006 suggests growth at slightly higher levels, averaging at around 4.8% annually between 2000 and 2004 and registering 4.3% in 2005.

Table 1: Real GDP Growth*

	2002	2003	2004	2005**
Croatia	5.2	4.3	3.8	3.6
Bulgaria	4.9	4.5	5.6	6.0
Romania	5.0	4.9	8.3	5.2
Turkey	7.9	5.8	8.9	5.0
EU-25	1.2	1.2	2.4	1.5
EU-10	2.4	3.8	5.0	4.0

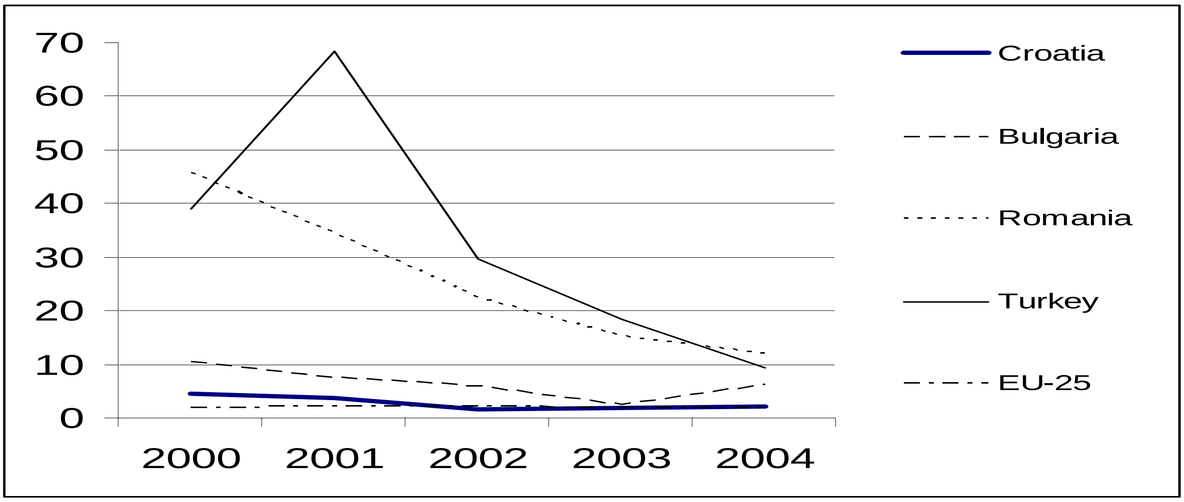
Notes: * based on constant price national currency series (%); **forecast
Source: Eurostat

Nominal convergence

[1] The structural challenges facing the Candidate Countries (Bulgaria, Romania, Turkey) (August 2004), http://europa.eu.int/comm/economy_finance/epc/epc_publications_en.htm#enlargement

Average annual inflation was gradually reduced from 4.6% in 2000 to 3.8% in 2001 and to around 2% in each year during 2002-2004, before it reaccelerated to 3.3% in 2005 as a result of higher prices of energy, transport and food. Due to the high degree of de-facto euroisation, monetary policy is geared towards holding the exchange rate stable. Croatia has been showing a level of price stability more or less in line with the EU-25 and significantly better than in any other candidate country. The real effective exchange rate of the Kuna, measured on the basis of CPI inflation, has constantly been rising over the past 5 years, leading to a cumulative appreciation of 11% between 2000 and 2004. During the same period the nominal effective exchange rate of the Kuna to the Euro appreciated by 8.9%. Hence, the relatively strong real exchange rate appreciation has been mostly driven by a nominal exchange rate appreciation (especially because of the high nominal appreciation of the Kuna against the U.S dollar in 2001, 2002 and 2003) and also by comparably higher inflation, in particular in 2000 and 2001.

Graph 1: Inflation rates in the candidate countries (annual percentage changes)



Source: Eurostat

Labour productivity, wage costs and competitiveness

Labour productivity has continued to rise over the past five years, on average by around 3.2% annually, while total employment has moderately increased over the same period. In 2004, labour productivity stood at 57% and the employment rate at 87% of the EU-25 average. This is significantly better than in the other candidate countries.

The Croatian labour market is characterised by relatively high real wages and high unit labour costs. In comparison with central and Eastern European states, the wage level is high once adjusted for productivity. Currently only in Slovenia gross wages and unit labour costs are higher than in Croatia. Despite the recent change in the wage setting in the public sector, which has been traditionally the benchmark for the overall economy, the wage setting process might be improved to better reflect differences across sectors and skill profiles.

Rising real unit labour costs in combination with a stable nominal exchange rate have slightly eroded Croatia’s price competitiveness. Real unit labour costs increased by around 0.8% in 2004 compared to 2003, as real wage growth (3%) was higher than the growth of average labour productivity (2.2%) as derived from labour force survey data.

Table 2: Labour productivity per person employed* (EU-25 = 100)

	2000	2001	2002	2003	2004**	2005**
Croatia*	49.8	54.6	54.7	56.3	56.4	57.5
Bulgaria	31.3	32.5	32.6	32.0	31.5	32.6
Romania	27.9	29.8	32.1	32.9**	35.3	36.3
Turkey	39.5	35.2	37.1	38.6	41.1	42.0
EU-25	100	100	100	100	100	100

Notes: * GDP in Purchasing Power Standards per person employed relative to EU-25; **Forecast; *** Estimated value;
Source: Eurostat

Fiscal consolidation and external accounts

The Croatian Government has made important progress at fiscal consolidation. A deficit of 6.7% of GDP in 2001 was reduced, by 2004, to 4.9% of GDP, but remained still above the initial target of 4.5% of GDP, which had been announced in the first Croatian Pre-Accession Economic Programme of Autumn 2004. Non-compliance was due to lower than expected one-off revenues. Further progress was made in 2005, taking the deficit to 4.1% of GDP according to the preliminary data of the Croatian Ministry of Finance. The target for 2006 is 3.3% of GDP and for 2007 3% of GDP. Meeting the ambitious targets that the Croatian authorities have set for themselves will, especially given the electoral cycle, and – for the future – the challenge of EU accession, be a matter of political commitment. Croatia also faces still high budgetary costs for reconstruction of war damages. The stock of gross public debt has continued to increase from 42.2% of GDP at end-2003 to 44.8% at end-2004 and further to 45.3% by end-October 2005.

External imbalances have improved markedly. The country's current account balance improved from -8.6% of GDP in 2002 to -7.4% in 2003 and -5.3% in 2004, and it will show a deficit of about 6% in 2005. A deficit of this order is not out of line with expectations for a small economy experiencing relatively rapid growth. The country's current account balance is generally characterised by a large merchandise trade deficit that is only partly offset by surpluses in the service balance.

However, gross external debt in EUR terms has grown constantly over the past years as FDI inflows failed to match the deficit in the current account balance. The debt rose from 77.6% of GDP at end-2003 to 82.1% at end-2004, largely due to strong commercial bank borrowing from abroad, and partly as a result of statistical adjustments in 2004. In the first half of 2005, the ratio of external debt to GDP stabilised at around 83% of GDP, due to a shift of government borrowing from external to domestic markets, but increased further to around 85% of GDP by end 2005. Efforts at fiscal consolidation, and the measures of the CNB to curb foreign borrowing, have contributed to the strong deceleration of the growth rate with regard to the gross external debt.

The marginal reserve requirement on the net increase in foreign borrowing, introduced in 2004, was raised several times last year to reach 55% in December 2005. This measure has cooled down credit expansion. According to the Croatian National Bank this level could be the breaking point at which it is no longer profitable for banks to refinance themselves abroad which is an encouragement for banks to issue bonds domestically. Official reserve assets of the Croatian National Bank at the end of December 2005 stood at slightly above €7.4 billion, equivalent to 5.1 months of 2004 imports of goods and services.

It would be important for the Croatian authorities to take steps to improve the quality of economic statistics in order to allow for better surveillance and monitoring of macroeconomic and structural developments.

2. Structural reform challenges

Structural reform in Croatia must mean a far reaching reform and rationalisation of the public sector; further and faster progress with a transparent privatisation process; continued reforms of the social welfare systems; particular attention to the persistently high unemployment and low activity and employment rates; the creation of more attractive conditions for private sector development (improving the operation of the judiciary; simplifying the tax code, and enhancing the quality of regulation); introducing competitive pressures into the network industries; and more work to ensure that research and technology are efficient and competitive. Some work has already been done, but there remains scope to accelerate the pace of reforms, especially in labour markets. The central risks to the efficient management of the public sector are the ongoing privatisation process and the plans for health care reform.

Public sector efficiency

The central target for reform in Croatia remains the structure and efficiency of the public sector. Croatia's public spending ratios of around 50% of GDP are high compared to other transition economies and are above the average level of EU-25 and EU-15. This high ratio reflects an extensive government sector and significant state intervention, including subsidies, guarantees and bail outs to non-viable enterprises. A large public sector does not in itself necessarily represent a barrier to growth, but inefficiencies within that sector do constitute legitimate targets for reform.

Regarding the quality of public finances, over the past few years the Croatian authorities have implemented public finance reforms with a view to enhancing fiscal transparency and expenditure control. The new budget law, adopted in mid-2003, established a new budgeting framework, including a multi-annual budget planning and improved budget reporting. While a large number of the provisions of the new budget law have been implemented, budget formulation and execution need to be further strengthened. Moreover, internal audit and financial control functions are still relatively weak. The government has continued to implement a Single Treasury Account, but does not provide for a full coverage of all general government accounts, which implies limited commitment control.

In the context of Croatia's accession plans, the government might devote attention to the development of a comprehensive regional development strategy. This would require a significant increase in administrative capacity, consistent with the need for creating the right environment for business.

Table 8: Size of general government (% of GDP)

	Revenue		Expenditure	
	2000	**2004**	**2000***	**2004**
Croatia (1)	46.1	46.6	52.7	51.6
Bulgaria	38.7	39.2	39.7	37.5
Romania (2)	31.2	30.7	35.3	32.4
Turkey (3)	27.1	24.5	37.4	19.4
EU-25	46.0	44.7	45.7	47.3
EU-15	46.2	44.9	45.7	47.4
EU-10	41.8	41.1	45.2	44.7

Note: *2000 figures taken from previous report on Bulgaria, Turkey and Romania. The implementation of ESA95 in national accounts in Croatia is still in an initial phase.
(1) Deficit presented for 2004 includes in other revenues HRK197m secured in December 2004 at auction of a GSM license, but not received in cash until February. Expenditure 2000 from IMF database, saved as Excel doc. (2) The figures for 2004 are 2nd supplementary budget from 27 Aug 2004. (3) Central government figures, 2004 preliminary figure. Non-interest expenditure.
Source: EU data from Eurostat, IMF

Privatisation and restructuring

The private sector share in the economy was only 60 percent in 2005, unchanged in recent years, and considerably below the average level in the new EU member states and other candidate countries. According to national figures the share of agriculture in Gross Value Added has declined from 9.5% in 2000 to 7.9% in 2004, while the share of industry has marginally fallen from 28.8% to 28.2% over the same period, and the share of services has risen slightly. Within this context, the tourism sector appears to be emerging as an increasingly important contributor to growth and to seasonal employment. Employment in services has markedly increased from 60% in 2000 to 62.5% in 2004 which reflects in large part the significant growth of the tourism sector.

Despite an early start to the privatisation process and successive improvements of the relevant legal and institutional framework, Croatia is left with a large unfinished privatisation agenda. The pace of privatisations appears to have slowed, as reflected in privatisation receipts as a share of GDP, which have fallen from 4.6% in 1999 to 0.2% in 2004 according to national figures. The Croatian authorities do have an agenda in place for privatisation with intended completion by 2007 and timelines for progress on key industries appear to be clear in the mind of the government. The challenge will be to accelerate the pace of privatisations so that the government can keep pace with the agenda they have set for themselves.

The Croatia Privatisation Fund still holds minority and majority stakes in more than 1,000 companies. A large number of these companies are heavily indebted and continue to incur losses, putting a strain on public finances and the efficiency of the economy at large. According to official data, the importance of state aid schemes has increased and the share of total state aid has continuously risen from 2.8% of GDP in 2002, to 3.2% in 2003 and 3.4% in 2004 (compared with a EU25 average of 0.6 percent and a EU10 average of 1.1% in 2004). This is very high in international comparison, and the trend does not appear to be moving in the right direction. Most aid is focused on specific sectors and horizontal aid accounts for only a minor share of state aid.

The privatisation process needs to be strictly adhered to in order to raise efficiency, employment and growth. Significant state interventions to support legacy industries need to be reduced markedly to allow for a more efficient allocation of resources. In view of this, the imposition of hard budget constraints and financial discipline on the enterprise sector remains a particular economic policy challenge. This should go hand in hand with a greater willingness to liquidate loss-making enterprises. In this context, the preparation and implementation of comprehensive restructuring strategies for the Croatian shipbuilding and steel sectors should be rapidly advanced.

There is scope to improve the transparency of the privatisation process, which might sometimes delay the pace of restructuring. Problems with the process of privatisation remain: political interference has sometimes impacted the bidding process for strategically important enterprises. The Croatia Privatisation Fund appears to have procedures in place to promote an open and transparent process, including the use of external advisors, the publication of tenders in the international press, and the open launch of tenders, with the media present. However there is scope to do more to dispel the impression that the privatisation process is only open to insiders.

The Croatian government intends to use the proceeds from privatisation to finance a substantial one-off payment associated with the so-called old-age pensioners' debt. The 'pensioners' debt' arose from a 1998 Constitutional Court ruling that the state was liable for unpaid pensions during 1993-98. The overall size of the established debt – estimated at around 6% of GDP - suggest significant implications for public finances and the economy as a whole. Pensioners will be given the options of either an early cash payment with a discount or a repayment of the full amount over a longer period. Details of the scheme still need to be worked out. It is not entirely clear that the plans for privatisation necessary to finance the repayment of the debt, the funds for which are not present in the budget, are in place. Ensuring that the requisite funds are in place remains a significant challenge for the government.

A large informal economy distorts competition and erodes the tax base. Studies estimate its size to be from 15% to above 30% of GDP. Even though the tax wedge may not be excessive by international standards, almost all studies point out that the tax and social security burden is one of the most important factors in explaining the size of the shadow economy.

Healthcare, pension and social spending reforms

A series of health care reforms have been undertaken in the past and have led to generally improving health outcomes in terms of population coverage, service delivery and public health standards. However, these achievements have come at a high cost. In 2002 Croatia was spending about 9% of GDP on healthcare, almost fully financed by public households, which was very high in comparison with countries at similar income levels. Since then, the level has come down, and in 2004 it stood at 7.1% of GDP.

A combination of factors including an aging population, a generous system of exemptions from medical and pharmaceutical costs, weak incentives for cost savings, and the increasing costs of medical technology, have driven up the cost of healthcare and placed a significant burden on the fiscal position. The Croatian government has stated the objective of bringing the level of public expenditure on healthcare down to a sustainable level of 6% of GDP by 2008, linked with higher private sector involvement. The current budget assumes significant savings from healthcare spending. The objectives for savings are ambitious and it is not clear that the plans currently on the table will be sufficient to deliver them.

Healthcare reform remains a sensitive subject. The Croatian government has adopted a package of laws that is now in the Parliamentary procedure. The challenge for the government will be to progress with a more ambitious programme of reforms, reducing the number of exemptions from co-payments and encouraging the development of the private sector, ensuring that the Croatian healthcare sector can continue to deliver improving health outcomes whilst containing and controlling the costs.

Reforms of the PAYG pension system started in 1998 and a mandatory second pillar was introduced in 2002. Early reforms aimed at strengthening the fiscal sustainability of the pension system, measures included an increase of the retirement age[2], a widening of the calculation period, a change of the indexation formula to a wage-price composite, as well as a tightening of eligibility criteria for early retirement and disability pensions. In 2004, pension legislation was amended to re-introduce full wage indexation and to apply it to both base pensions and pension supplements, which put the long term sustainability of the pension system at risk. Eventually, in mid-2005, the pension indexation formula was again changed to a wage-price composite in the context of a broader fiscal consolidation package. However, risks on fiscal sustainability still exist due to a relatively unfavourable ratio of working to retired people.

The high level, and poor targeting, of social spending, is an issue of concern. Croatian households will face differential impacts and challenges from economic transition and

[2] At the moment, women retire at the age of 55 and men at the age of 60 with 20 years of coverage or five years later with 15 years of coverage. The retirement age is gradually changing to 60 for both men and women with 15 years of coverage by 2007.

European accession, and the impact of the war is still felt by many. Social services will be an important tool to mitigate those impacts. With this clearly in mind, more could be done to ensure that the system is efficient, and targets resources on areas of greatest need. Estimates by the World Bank suggest that only about half of the spending reaches the bottom quintile of the population. Consolidation of benefits and greater focusing of spending on means tested allowances and, where appropriate, work incentives, are all areas where the government could consider further reforms.

Labour Markets

Employment

The Croatian labour market performance has been characterised by persistently high unemployment and low activity and employment rates, especially among the young. The officially registered unemployment rate fell from 14.4% in 2003 to 13.8% in 2004. The employment rate increased by 1.1% over the same period.

Following an early sharp decline during the end nineties the employment rate in Croatia has been rising again between 2000 and 2004 by 3 percentage points (see table 3). Croatia as the other Candidate countries, however, is lagging far behind the EU-25 in employment levels. This points to a underutilisation of the labour force potential.

Table 3: Employment rates (15-64) in 1996- 2004*

	1996	*1997*	*1998*	*1999*	*2000*	*2001*	*2002*	*2003*	*2004*	*2004 EU-25*	*2004 EU-10*
Total employment rate	58.7	57.1	55.3	53.2	51.3	51.8	53.6	53.2	54.3	63.3	56.0
Male	65.8	63.6	61.7	59.0	57.4	59.0	60.1	59.6	60.7	70.9	62.0
Female	51.9	50.9	49.4	47.8	45.5	44.9	47.4	47.0	47.9	55.8	50.2

Note: * Proportion of the total, male and female population aged 15-64 that is in employment
Source: Croatia 2005 Progress Report, European Commission, 9 November 2005

Croatian unemployment is above the levels of many other candidate countries. Although the high unemployment rate has declined from 17% in 2000 to 13.8% in 2004, it remains in double digits and poses a major economic policy problem. Youth unemployment is very high and above the average for the new Member States as well as the other candidate countries. Long-term unemployment, in particular of women, is high compared to EU-25 but also to EU-10 and candidate countries. More could be done to promote equal possibilities for men and women to participate in the labour market.

Table 4: Youth unemployment rate and long-term unemployment rate in 2004*

	Youth unemployment rate	*Long-term unemployment rate*
Croatia **(1)**	33.8	6.9
Bulgaria	25.8	7.2
Romania	23.2	4.5
Turkey	19.6	4.0
EU-25	18.9	4.1
EU-15*	16.7	3.4
EU-10	31.7	7.6

* Proportion of the civilian labour force proportion of the labour force aged <25 that is unemployed (%) and proportion of the labour force aged 15-64 that have been unemployed for more than 12 months (%) (1) Second half of the year.
Source: Commission services; Eurostat, and EUROSTAT Pocket book on Candidate Countries and Western Balkans

Furthermore, considerable regional differences in income levels and unemployment exist in Croatia, whereby the poorest county is reporting the highest official unemployment rate (36%) and the second wealthiest county in terms of GDP per capital is registering the lowest rate (11%). Continuing high unemployment contributes to ongoing net emigration, including of highly trained specialists.

Table 5: Unemployment rates (15-64) in 2000-2004*

	2000	*2001*	*2002*	*2003*	*2004*
Croatia (1)	17.0	16.3	14.4	14.4	13.8
Bulgaria	16.4	19.5	18.1	13.7	12
Romania	6.8	6.6	7.5	6.8	7.6
Turkey	6.5	8.3	10.3	10.5	10.3
EU-25	8.6	8.4	8.8	9.0	9.1
EU-15*	7.7	7.3	7.6	8.0	8.1
EU-10	13.6	14.5	14.8	14.3	14.2

* Proportion of the labour force aged 15-64 that is unemployed (%)
(1) Second half of the year.
Source: Eurostat, and EUROSTAT Pocket book on Candidate Countries and Western Balkans

Croatia shows considerable gaps to the Lisbon and Stockholm targets of employment, comparable to those of Bulgaria and Romania but generally more advanced than Turkey.

Table 6: Employment rates: Progress towards the Lisbon and Stockholm targets

	Total employment rate (15-64)			Female employment rate (15-64)			Employment rate among older workers (55-64)		
	2004	Gap below 2010	Change 2000-04	2004	Gap below 2010	Change 2000-04	2004	Gap below 2010	Change 2000-04
Croatia	54.3	15.7	3.0	47.9 (1)	12.1	2.4	30.4 (1)	19.6	6.2
Bulgaria	54.2	15.8	3.8	50.6	9.4	4.3	32.5	17.5	11.7
Romania	57.7	12.3	-5.3	52.1	7.9	-5.4	36.9	13.1	-12.6
Turkey	46.1	23.9	-1.7	24.3	25.7	-1.5	33.2	16.8	-3.1
EU-25	63.3	6.7	0.9	55.7	4.3	2.1	41	N/A	4.4
EU-15	64.7	5.3	1.3	56.8	3.2	2.7	42.5	7.5	4.7
EU-10	56	14	-1.4	50.2	9.8	-1.1	32.3	17.7	2.7
2010 Target	*70%*			*More than 60%*			*50%*		

(1) Second half of the year.
Source: Eurostat, and EUROSTAT Pocket book on Candidate Countries and Western Balkans

Tax benefit system and employment protection

According to the ILO (2004) the tax wedge at the average income in Croatia is not excessive. It is lower than in any of the new Member States and prospective Eastern European member countries and on par with Ireland which has the lowest tax wedge in the EU. This suggests that high unemployment and low employment rates are not caused by labour taxation.

Although a new labour law, which came into effect into 2004, relaxed some of the existing restrictions, strict employment protection legislation continues to characterise Croatia's labour market. The labour code with significant regulation on hiring and firing has provided for one of the strictest employment protection systems among transition economies in central and Eastern Europe.

Whilst the level of education is considered to be high in general, the current skills mismatch reflects the limited ability of the country's education system to adapt to changes in labour demand. Education still suffers from a number of shortcomings, such as outdated curricula at all levels, inappropriate financing systems, and poorly equipped schools. The EPC shares the view of the National Competitiveness Council that a greater involvement of the private sector in the education system might help align the curriculum with the skills needs of the economy.

The business environment

The Croatian Government has already taken significant steps to improve the environment for doing business. But there is more to do to create the right environment for private sector development in Croatia.

Improving the efficiency of the judiciary

Reform of the judiciary has consistently been identified as a priority for Croatia – for example in the Competitiveness Council's 55 Policy Recommendations for improving Croatia's competitiveness. Some progress appears to have been made in this area, with a rationalisation of the court process. The creation of an electronic land registry should also go some way toward addressing the underlying problem of uncertainty in property rights. Whilst some elements of the right framework are now in place, the backlog of cases in the court system has yet to be cleared, indicating an ongoing lack of administrative capacity. An inefficient judiciary impedes market entry and exit, and effective enforcement of creditor and property rights. Faster expansion of administrative capacity is required to reduce the backlog of cases, and show the system can credibly enforce new laws.

Simplifying the tax code and reducing the burden of regulation

The Croatian tax system is regarded by business in particular as excessively complicated, resulting in a low level of effective taxation obscured by a complicated system of exemptions. In addition, the ability of sub-national government to set taxes at different levels adds to the complexity, and the uncertainty, of the environment for business and private households. Reducing the complexity of the tax code would help create a better environment for business and would go some way toward reducing the appeal of the shadow economy. The suggestion of the National Competitiveness Council for a register of all taxes, levies and fees collected by all levels of government would be an important first step toward increasing the transparency of the system.

The Croatian government has taken steps to simplify the process of creating a business – reducing the time, and cost of the process. Beyond this, there is scope to do more to promote better regulation – ensuring that the body of existing and the development of future regulation is consistent with the needs of an entrepreneurial economy. Whilst the Croatian government is clearly working toward the timely transposition of EU regulations – and this is no small task – attention should be given, at a strategic level, to a better regulation agenda, with a view to ensuring that the regulatory regime in Croatia promotes economic development.

Fostering innovation and improving the regulatory framework for foreign direct investment

Although public spending on research and development has remained at a level of just over 1% of GDP over the last few years, it is still above average in comparison to the 10 new

Member States but far below the level of the EU as a whole. It appears that Croatian enterprises tend to turn to licences rather than to produce their own innovations and only a small share of business sector employees works in R&D. Further efforts are needed to ensure that Croatia's research and development policy, e.g. as regards the efficiency of public research institutions and their link with business, enables Croatian research and technology to be efficient and competitive.

With regard to foreign direct investment (FDI), slow progress in fully privatising state owned organisations has restricted the levels of FDI that have so far been received. There is a low share of Greenfield investment. Privatisation receipts account for nearly two thirds of FDI and almost three quarters of inflows have come from the EU. The largest share of FDI has been directed into services such as telecoms and banking, while manufacturing received approximately a third (mainly to the pharmaceutical industry). Croatia has received little in the way of FDI targeted at export-oriented manufacturing sector. If the economy is to attract more non-privatisation FDI to help it grow in the medium to long term, authorities have to transform the Croatia business environment into a friendlier and less costly location to invest.

Network Industries

The introduction of competitive discipline is particularly important in network industries. Inefficiency in the utilities companies and in the transport infrastructure has a knock on effect on the entire economy, driving up the cost of doing business. Reform in these areas, the first elements of which are already in place, must be a priority for the Croatian government.

In the railway sector, the separation between the infrastructure management and railway operations has taken place in accordance with the *acquis communitaire*. Measures to introduce non-discriminatory access to rail networks came into force in 2005 in accordance with the EU rail legislation. Continued high levels of investment in this sector must be focused on modernisation to develop the potential for comparative advantage for Croatia in transportation.

In the energy sector, INA, the dominant oil and gas company, was partially privatised in July 2003. A second phase of privatisation is expected in 2006 involving a tender for a further 15 percent stake. A new legislative framework, aimed at alignment with the *acquis* on electricity, was adopted in December 2004 and envisaged a gradual opening of the electricity market for the period 2006 to 2008 and an unbundling of the state-owned Electricity Company (HEP). However, plans for restructuring have now been delayed and prospects for privatisation of remaining shares appear uncertain. Some restrictions to entry into the energy market still remain.

In the sector of telecommunications, the privatisation of HT (Hrvatska Telekom – Croatia Telecom) is well under way. Competition in the mobile telecommunications market has also increased through the granting of licenses to private operators.

Price control systems in energy and telecommunications markets are currently being replaced by regulatory bodies in line with the continuing liberalisation of the sectors. Telecommunications are already close to free price mechanisms status. While price liberalisation is advanced, administrative prices remain significant with the share of administered prices in the CPI basket amounting to 23% in 2003.

Financial sector

The financial sector is dominated by foreign-owned banks operating in a highly concentrated environment. The banking sector, with almost 80% of total financial sector assets dominates the financial sector. Following the banking sector crisis and restructuring at the turn of the century, more than 90% of banks' assets are held by banks with majority foreign ownership, mostly from Italy and Austria. Building on this tradition of openness, in respect of financial services, Croatia should ensure non-discriminatory treatment of Community companies from all Member States. The banking sector appears highly concentrated despite a large number of banks. The two largest banks had a combined 42.8% market share at end-December 2005, the top four banks 65.4%, and the top ten banks controlled more than 92% of banking assets. Domestic banks appear well capitalised and profitability remains high and has increased since 2001.

In response to the banking crisis of 1998-99, a new Banking Law was adopted in 1998, reinforcing the CNB's (Croatian National Bank) authority in banking supervision.[3] The recommendations of the 2001 FSAP mission, assessing Croatia's compliance with the Basel Core Principles for Banking Supervision (BCP) were addressed by the new Banking Law which came into force in July 2002. Key changes introduced by the new law and subsequent regulations include the legal immunity of supervisors, coverage of market risks in capital adequacy calculation, inclusion of options in net open foreign exchange positions, consolidated supervision of banks, and cooperation with foreign supervisory agencies. In addition, the CNB's bank supervision was reorganised to conduct more risk-based on-site supervision. As the banking sector is largely dominated by euro-area banks, the CNB is stepping up its cooperation with euro-area supervisory agencies. Memorandum of understandings have been signed with Hungary and Austria (the dominant players in the domestic market) and also with Bosnia-Herzegovina (as Croatian banks own a significant share of the Bosnian market).

The Croatian banking sector has certainly strengthened over the last five years, but remains subject to risks. The banking sector is well-capitalised, profitable and has achieved higher standards also due to the massive entry of euro-area banks. Borrowing has increased rapidly starting from low levels. However, possible currency mismatches in the balance sheets of corporations and households could be a matter of concern as three fourths of bank lending is in foreign currency. While the banks dispose of exchange rate hedges via foreign exchange refinancing, the non-tradable sector is likely to be more exposed in the case of a sudden depreciation. This could in turn impair the quality of bank's portfolios.

[3] The CNB has been responsible for bank supervision since 1992, the year in which the Republic of Croatia gained independence.

Annex: General economic indicators

	Croatia					EU 25				
	2000	2001	2002	2003	2004	2000	2001	2002	2003	2004
Economic background										
Real GDP[4]	2.9	4.4	5.2	4.3	3.8*	3.9	1.9	1.2	1.2	2.4
Labour Productivity[5]	49.8**	54.6**	54.7**	56.3**	56.4	100	100	100	100	100
Labour productivity growth	-1.2	10.5	0.7	4.2	2.2	2.1	0.8	0.8	0.8	1.8
Real Unit Labour Cost[6]	3.3	-9.5	2.3	-2.6	0.8	0.8	0.4	-0.4	-0.5	-0.9
Inflation rate[7]	4.6	3.8	1.7	1.8	2.1	2.4	2.5	2.1	2.0	2.1
Product market reforms										
Relative price levels[8]	55.5	57.9	58.6	59.1	60.2	100	100	100	100	100
Total trade-to-GDP ratio[9]	99.4	103.3	101.9	107.9	107.4					
Investment and knowledge based economy										
Total FDI inflows [10]	5.7	6.8	4.9	6.8	3.5	***	1.3	1.4	1.3	0.5
Educational attainment[11]	***	***	90.3	90.7	92.5	76.4	76.2	76.5	76.6	76.7
R&D expenditure[12]	1.2	1.1	1.1	1.1	***	1.9	1.9	1.9	2.0	***

Notes: *Forecast, **Estimate, *** Data not available in series

[4] EUROSTAT, growth rate of GDP at constant prices (2000) – percentage change on previous year. GDP data are just being updated. This revision is not yet taken into account.
[5] EUROSTAT, GDP in Purchasing Power Standards per person employed relative to EU 25 (EU-25 = 100)
[6] Commission calculations, Unit Labour Costs real (LFS) GDP deflator
[7] CNB, EUROSTAT, Annual average rate of change in CPI (Croatia) and HICP (EU-25)
[8] Of GDP (EU25=100)
[9] Croatian figures, Average value of imports and exports of goods and services in % of GDP
[10] In % of GDP. Source: Croatian National Bank/Croatian Statistical Office. 2005: 4.1% end of 3Q, on 4 quarters rolling basis.4.1
[11] Eurostat and Croatian figures, proportion of the population aged 20-24 having completed at least upper secondary education (%)
[12] EUROSTAT pocketbook, Gross domestic expenditure on Research and Development as a percentage of GDP