POLO-Cro28 Policy Paper

# THE SIGNIFICANCE OF THE EUROPEAN SEMESTER FOR ECONOMIC POLICY REFORMS IN CROATIA AND SELECTED NEW EU MEMBER STATES

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More information about the project available at: http://polocro28.irmo.hr/.

The publication reflects the views of the authors, and the Commission cannot be held responsible for any use which may be made of the information contained therein.

**CONTENT**

**LIST OF ACRONYMS**

ESIF - European Structural and Investment Funds

IDR - In-Depth Review

NRP - National Reform Program

MIP - Macroeconomic Imbalance Procedure

EDP – Excessive Deficit Procedure

SGP – Stability and Growth Pact

MTO – Medium-Term Objective

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## INTRODUCTION

This paper analyses the significance of the European Semester for carrying out the economic reforms in Croatia and compares it with the experience of selected new EU Member States. The purpose of the paper is to contribute to the understanding of the European Semester i.e. the instrument of surveillance and coordination of economic and fiscal policies of the EU Member States, being also the framework for more efficient implementation of reforms in Croatia. The starting points of analytical approach are as follows: to investigate the aspects of functioning of the European Semester at the EU level and its significance for the Member States, to analyse experiences of selected new Member States and define recommendations for implementation of the European Semester in Croatia.

The research for the purpose of this paper has been carried out within the framework of the ERASMUS+ Jean Monnet support to institutions project POLO-Cro28, with the function of the observatory of public policies in Croatia. The study is based upon a common methodology and a multidisciplinary approach to the analysis which is to be applied to monitor six selected policy fields during the three-year implementation period of the project.

In accordance with the POLO-Cro28 project methodology, for the purpose of the comparative analysis new EU Member States from Croatia's close geographical surroundings were selected, namely Czech Republic, Slovakia, Hungary and Slovenia. With those countries Croatia shares similar economic and social challenges[1]. Further selection criterion was the equal representation of the euro area countries (Slovakia, Slovenia) and countries that are not part of the euro area (Czech Republic, Hungary).

The research relies on European Commission communications, national strategic documents, academic sources and statistical indicators. In addition, the analysis of fiscal consolidation components in selected new Member States was made, together with evaluation of the consolidation performance. Apart from relevant analytical and strategic documents of the EU, those of new Member States and Croatia, as well as various academic sources, the analysis also refers to the round table debate on the topic of the European Semester held in Zagreb on November 2015[2]. The general public in Croatia associates the European Semester exclusively with endeavours to reduce the excessive budget deficit and public debt. It is less known that its objective is to move the implementation of a comprehensive spectrum of reforms which are at the present crucially important for Croatia. In particular, besides strengthening the fiscal framework and managing the public finances, the European Semester is focused on correction of a wider spectrum of imbalances and implementation of reforms concerning growth, employment, pension

[1] The level of GDP per capita in all selected states is below the EU average, but higher than in Croatia. According to the *Eurostat* indicators, in 2014 GDP per capita PPS index (EU28=100) for Croatia amounted 59 and for other countries as follows: Hungary 68, Slovakia 77, Slovenia 83, and the Czech Republic 85.
Source: http://ec.europa.eu/eurostat/tgm/table.do?tab=table&init=1&language=en&pcode=tec00114&plugin =1

[2] The round table ˝The Challenges of the European Semester for the New Member States and Croatia –how to proceed? ˝ held in the framework of the POLO-Cro28 project: Observatory of the Policies in Croatia, on November 25, 2015 at the House of Europe in Zagreb, in cooperation between IRMO and the Representation of the European Commission in the Republic of Croatia (http://polocro28.irmo.hr/category/dogadjanja/).

system, healthcare system, system of social benefits, public administration, business environment, competitiveness, the bankruptcy proceedings and structural reforms in general. All these reforms are necessary to foster economic growth and employment in Croatia, contributing thus to citizens´ prosperity. The analysis of the Croatian situation and its positioning by comparison with other EU Member States on the basis of various applicable indicators in the framework of the European Semester provides more precise insight on the progress achieved and challenges in Croatia in the areas covered by the European Semester, but also on further steps which are to be unavoidably undertaken.
Croatian version of the paper was finalised in April 2016.

## THE EUROPEAN SEMESTER – SUPERVISION AND COORDINATION OF ECONOMIC AND FISCAL POLICIES OF THE EU MEMBER STATES

The European Semester is the key instrumentof the EU's economic governance framework for annual ex ante planning and coordination of the Member States' economic policies and harmonization of the reporting, supervision and evaluation procedures for mentioned policies at the European level. It was established in 2010 as a part of an EU economic governance reform, by co-called six-pack legislation, in response to the line of failures in performance of the EU economic governance that became visible during the economic and financial crisis (Stuchlik, 2016). The legal basis for establishment of the European Semester is the Article 121 of the Treaty on the Functioning of the European Union. The first cycle of the European Semester took place in 2011.

The European Commission implements the European Semester in a partnership with Member States on the basis of previously established institutional architecture of economic governance mechanisms, respectively the instruments following from the Stability and Growth Pact (SGP) and Europe 2020 Strategy. The Macroeconomic Imbalance Procedure (MIP) as the third component is a novelty in the EU economic governance (Dalić, 2015, p. 10). In this way, the European Semester represents a comprehensive framework for coordination and harmonization of mentioned mechanisms and an integrated surveillance tool of implementation of their provisions.

To recall, the **Stability and Growth Pact – SGP**[3] (adopted in 1997) is the main instrument for the efficient functioning of economic policies of the EU Member States. It contains a set of rules for monitoring and coordination of their fiscal and economic policies, having target to ensure compliance with the Maastricht criteria, i.e. with the reference values concerning the fiscal deficit limits (to 3% of the GDP) and public debt limits (to 60% of the GDP) in order to provide a long-term sustainable public finances in the EU. It is consisting of the preventive and corrective part. The *Preventive Arm* aims to ensure the fiscal sustainability in the EU by setting the Medium-Term Objective (MTO) for each Member State, while the *Corrective Arm* enables corrections of the serious problems of the Member States´ fiscal policy by means of the Excessive Deficit Procedure – EDP (European Commission, 2015a).

[3] More: http://ec.europa.eu/economy_finance/economic governance/macroeconomic imbalance procedure/index_en.htm

**Europe 2020 Strategy**[4] (adopted in 2010) is a long-term EU strategy for sustainable, smart and inclusive growth of the European economy until 2020. It is based upon five headline targets including the following fields: education; employment; environmental protection, energy efficiency and fight against climate change; research and development; social inclusion and poverty reduction. These headline targets are supported by sevenflagship initiatives. Considering their initial development position and their abilities to contribute to the EU 2020 targets, each Member State determined the national reference values for main headline targets of Europe 2020 (European Commission, 2010).

**Macroeconomic Imbalance Procedure (MIP)**[5] is a new element of the EU economic governance, adopted in the framework of six-pack legislation which entered into force in 2011. It represents the main mechanism for supervision and correction of harmful macroeconomic imbalances in Member States' economies. It is consisting of the preventive and the corrective part. Within the *Preventive Arm* once per year the potential risks of macroeconomic imbalances are assessed by means of the *Alert Mechanisms.* The annual *Alert Mechanism Reports* (AMR) in the MIP framework are based upon economic interpretation of the scoreboard of 14 indicators covering the most significant macroeconomic imbalance fields. The main indicators are as follows: investment share in GDP, percentage changes in export market share, labour costs and exchange rate; share of the public debt in GDP and unemployment rate. In this way, the *Alert Mechanism Report* identifies those Member States for which in-depth review (IDR) of their macroeconomic state is necessary. After being subject of an in-depth review, the Member State is provided with preventive recommendations for correction of the macroeconomic imbalances. In the case of detection of harmful excessive imbalances, the Commission initiates a corrective arm i.e. the *Excessive Imbalance Procedure (EIP).* In the framework of that procedure, implementation of corrective recommendations is monitored more strictly (Regulation (EU) 1176/2011**;** 1174/2011). In the case of insufficient corrective actions under the EIP, the euro area Member States may be subject to financial sanctions. For all EU Member States, noncompliance with the EIP may lead to the suspension European structural and investment funds[6]. It should be highlighted that the Excessive Imbalance Procedure has not yet been initiated for any EU Member State.

Considering all the above, the European Semester is an important instrument, which covers a wide spectrum of policies, including public finances and the reforms of financial sector, taxation, pension and health system, employment and social policies, but also the structural reforms in a wider sense concerning public administration, competitiveness, research, development and innovation, education and other.

[4] More: http://ec.europa.eu/europe2020/europe-2020-in-a-nutshell/index_en.htm
[5] More: http://ec.europa.eu/economy_finance/economic_governance/macroeconomic_imbalance_procedure/index_en.htm
[6] More: http://eur-lex.europa.eu/legal-content/HR/TXT/?uri=URISERV%3Aec0019

Table 1. Components of the European Semester

| THE EUROPEAN SEMESTER | | | | | | |
|---|---|---|---|---|---|---|
| **EUROPE 2020 STRATEGY (thematic supervision)** | | **STABILITY AND GROWTH PACT (fiscal supervision)** | | | **MACROECONOMIC IMBALANCE PROCEDURE (macroeconomic supervision)** | |
| *-Education policies*<br>*-Employment policies*<br>*- Environmental protection policies and energy efficiency*<br>*-Research and development*<br>*-Poverty reduction and social inclusion* | | ***Preventive part***<br>*Deficit<3% GDP*<br>*Debt<60%*<br>*Debt>60% which is decreasing* | ***Corrective part***<br>*Excessive Deficit Procedure* | | ***Preventive part***<br>*1.Alert Mechanism Report*<br>*2.In-Depth Reviews* | ***Corrective part***<br>*Excessive Imbalance Procedure* |

Source: European Commission, ˝Six-pack˝ and ˝Two-pack˝ legislation (according to: Dalić, 2015)

The European Semester proceeds in annual cycles and refers to the first six months of a year. The other six months refer to ˝the National Semester˝ when Member States work on implementation of the recommendations, taking them into account especially in the process of drafting their national budgets for the next year. The European Commission supervises implementation. Participation in the European Semester is mandatory for all EU Member States.

The European Semester cycle (Table 2) starts every year in November, when the Commission simultaneously publishes the Annual Growth Survey (AGS), the Alert Mechanism Report (AMR) and the Joint Employment Report. The *Annual Growth Survey* sets out the general economic and social priorities for the EU for the following year which Member States shall take into account when preparing their national economic and budgetary plans. The *Alert Mechanism Report* is the starting point of the Macroeconomic Imbalance Procedure (MIP). It is based on a scoreboard of eleven basic and additional indicators[7] and represents the base for possible in-depth review of Member States with a potential risk of harmful macroeconomic imbalances. On the basis of in-depth review, the Commission decides whether to initiate the *Excessive Imbalance Procedure (EIP)*. The *Joint Employment Report*, the third document which the Commission publishes in November, analyses main trends in the field of employment and social policies in the EU and in the Member States (Stuchlik, 2016). All mentioned documents provide Member States with guidelines for preparing their National Reform Programs (NRP) in which they present reforms and measures for achieving the Europe 2020 objectives and the *Stability* (euro area Member States) or *Convergence Program* (the other EU Member States) wherein the policies for sustainable public finances in line with the SGP rules are presented. Both programs are submitted to the Commission in April. The Commission evaluates received documents alongside the assessment of Member States' progress in implementation of the last year's Country specific recommendations (CSRs) and priorities indicated in the AGS. On the basis of such assessment, the Commission proposes a new set

[7] The indicators are referring to the following areas: economic growth, inflation, balance of payments, private sector and households´ indebtedness, foreign trade balance, investments, competitiveness, real property prices, employment and unemployment rate and other.

of Country-Specific Recommendations (CSRs) which are finally endorsed by the Council in July. The *Country Specific Recommendations* provide Member States with guidelines for implementing responsible fiscal policies and key reforms related to the growth-enhancing and employment-friendly policies. The *Country Specific Recommendations* give concrete measures which are to be implemented within the next 12 to 18 months (The European Alliance, 2014). From the issued Country Specific Recommendations mandatory are those issued in the framework of the Excessive Deficit Procedure – EDP (corrective part of the SGP) and the Macroeconomic Imbalance Procedure (MIP), therefore non-compliance with them may lead to sanctions. All other recommendations Member States shall take into account during the process of their policy-making. In the case of noncompliance, the Commission may issue warnings and carry out stronger monitoring or issue a new set of recommendations (Darvas, Leandro, 2015).

To recall, the Excessive Deficit Procedure – EDP is initiated in the case of breaching the limits of budget deficit (to 3% of GDP) and public debt (to 60% GDP) (EU) 1467/97). Member States subject to the EDP are provided with recommendations for correction of the excessive deficit or public debt which are to be implemented within a set timeframe. In the case of noncompliance, the euro area Member States may be sanctioned by financial fines, while for other Member States payments from EU Structural and Investment Funds may be temporary suspended.

The EDP will be abrogated when the excessive deficit is corrected in a sustainable manner. In particular, when submitted data for previous year and the Commission´s evaluation for the next two years indicate the deficit level below the reference values (European Commission, 2015a; 2015b). In the context of the Macroeconomic Imbalance Procedure (MIP), Member States which were subject to the in-depth review are provided with preventive recommendations to correct their macroeconomic imbalances. When macroeconomic imbalances are assessed excessive, the Commission will decide on possible initiation of a corrective part, i.e. the Excessive Imbalance Procedure (EIP). In this case the Commission supervises more strictly implementation of Corrective Action Plans of the Member States. In the case of ineffective action, sanctions may be imposed on the euro area Member States in form of an interest-bearing deposit or a financial fine amounting 0.1% of Member States GDP in the previous year (Directive (EU) 1176/2011; Directive (EU) 1174/2011). However, this procedure has never been initiated.

From 2013, when the two-pack legislation entered into force, additionally enforcing the Stability and Growth Pact, the last step in the process of the European Semester is the Commission´s *Analysis of Draft Budgetary Plans of the euro area Member States*. The aim of this analysis is to align fiscal policies of the euro area. Upon the analysis, the Commission issues recommendations to the euro area Member States before they adopt their national budgets (European Commission, 2015b).

Table 2. Annual Cycle of the European Semester

| **Annual term plan** | **Europe 2020 (thematic surveillance )** | **Stability and Growth Pact and Macroeconomic Imbalance Procedure (macroeconomic and fiscal surveillance )** |
|---|---|---|
| November | Annual Growth Survey (published by the European Commission) | |
| | | Alert Mechanism Report (issued by the European Commission) |
| April | National Reform Programs (drafted by the Member States) | Stability or Convergence Programs (drafted by the Member States) |
| June/July | Country Specific Recommendations (issued by the European Commission and adopted by the European Council) | |
| October | | Analysis of the Draft Budgetary Plans of the euro area Member States (performed by the European Commission) |

Source: According to *The European Alliance for a Democratic, Social and Sustainable European Semester (2014), p.6*

Considering that the European Semester is a new and complex instrument of coordination and surveillance, its implementation mechanisms are still improving. In 2015 the Commission adopted several important changes to the process of the European Semester. The improvement of the European Semester is also one of the priorities set out in the Five Presidents Report[8] and the Commission´s report on concrete steps for the first stage of that plan. Changes are focused towards better implementation of the CSRs. The streamlined European Semester implies greater focus on priority areas in order to address main challenges. The Commission has shortened the amount (number) and the length of CSRs issued to the Member States. Also, recommendations for euro area as a whole are rescheduled for November (at the beginning of the European Semester cycle). The aim of these changes is to enable the Member States to implement the recommendations more efficiently. (Darvas and Leandro, 2015; Gern, Jannsen and Kooths, 2015).

In addition, new elements to foster social dimension within the European Semester process refer to a greater inclusion of the relevant stakeholders in the process of drafting national documents. It was suggested to set up the evaluation procedure on social aspects of the macroeconomic adjustment programs. The first cycle of the European Semester has been disproportionately directed towards issues related to the fiscal consolidation and austerity programs (in the framework of the Stability and Growth Pact), while social issues (in the framework of Europe 2020) have been less represented (Derruinea and Tiedmann, 2011; Vanhercke, 2013; Zeitlin and Vanhercke, 2015). The Commission strives to include the social dimension in each stage of the European Semester cycle, and the positive shifts to a better balance between economic and social issues and priorities are more evident. In this regard, in 2013 a *´´Social Scoreboard´´* including indicators of social and employment policies was created as a part of the Joint Employment Report. Moreover, in order to better evaluate social implications of measures suggested within the MIP framework, the Commission added three social indicators (rate of citizens´ activity, long-term unemployment rate and unemployment rate of the young) to the existing main indicators of the MIP Alert Mechanisms on which basis the imbalance assessment is made, Besides, many social indicators

[8] More: https://ec.europa.eu/priorities/sites/beta-political/files/5-presidents-report_en.pdf

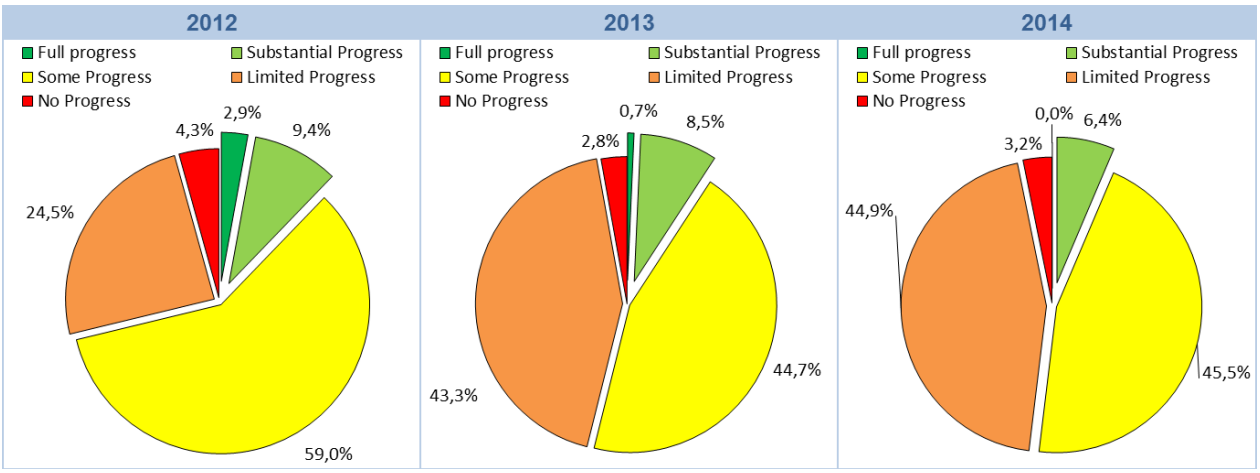
are part of the additional indicators of the MIP Alert Mechanism. Social issues, such as employment and education, are also analysed in Country Reports, which also include the evaluation of macroeconomic imbalances and if necessary those issues are also reflected in the Country Specific Recommendations (Vanhercke, 2013; Zeitlin and Vanhercke, 2015). To additionally enhance social dimension of the European Semester, the establishment of two new institutions – National Council for Competitiveness and Advisory European Fiscal Council was proposed (Gern, Jannsen and Kooths, 2015; Stuchlik, 2016).

In the streamlined 2015 European Semester, the Commission proposed an integrated approach to the economic policy. Thus, the 2015 Annual Growth Survey was based on the three main pillars: re-launching investment, pursuing structural reforms and responsible fiscal policies (European Commission, 2015c). The aim was to integrate structural, fiscal and monetary policies into an uniform approach which will be implemented at all levels, taking into account the specific situation of each Member State. Also, these three main pillars are more connected with the Country Specific Recommendations (CSRs). In line with changes adopted in 2015, the Commission issues fewer recommendations per Member State (in 2014 a total of 165 recommendations were issued, and in 2015 106 in total, while the average number of CSRs per Member State has diminished from 6 to 4). Also, the 2015 CSRs were better connected with the priority areas of the AGS (Gern, Jannsen and Kooths, 2015, p.10-11).

The 2016 cycle of European Semester started with the publication of the AGS, the AMR and the draft Joint Employment Report, accompanied for the first time by the publication of euro area recommendations. The 2016 Annual Growth Survey builds on the three main pillars from 2015 and defines what else can be done to help Member States in fostering growth, ensuring economic convergence, creating the new jobs and strengthening the social justice. The 2016 Alert Mechanism Report, which also includes three new social indicators for the first time, identified 18 Member States having a potential risk of macroeconomic imbalances (including Croatia) for which in-depth reviews deemed necessary. The results of in-depth reviews showed that out of these 18 Member States, 6 have no imbalances, 7 have imbalances, and the remained 5 (including Croatia) have the excessive macroeconomic imbalances. However, at the time of writing this paper the Commission has still not decided whether to initiate Excessive Imbalance Procedure for 5 identified Member States. The 2016 Joint Employment Report indicates certain improvements in the EU regarding the employment and social situation, but highlights a problematic increase of inequality and a risk of poverty between but also within the Member States. This particularly concerns the employment end education of the young and the representation of woman in the labour market (Stuchlik, 2016, p. 5-6).

So far, the analyses on the European Semester implementation (Gern, Jannsen and Kooths, 2015; Darvas and Leandro, 2015) have demonstrated insufficient implementation by Member States. Namely, during 2012 – 2014 the share of Country Specific Recommendation for which the Commission assessed that a limited progress was made or that there was no progress at all increased from 29% in 2012 to 48% in 2014. The average of fully implemented recommendations or recommendations wherein the substantial progress was made amounted to 10% approximately (Gern, Jannsen and Kooths, 2015, p. 8).

Figure 1. Implementation of country-specific recommendations by EU Member States, 2012–2014




Source: Gern, K.-J., Jannsen, N. and Kooths, S. (2015) pg. 8

## THE IMPLEMENTATION OF THE EUROPEAN SEMESTER IN CROATIA

### The State of the Croatian Economy and Challenges in 2016

From the previous analysis, it is clear that the reforms instigated by the European Semester are necessary for stimulating growth and employment in Croatia, reforms which should have a positive effect on the lives of Croatian citizens. Upon entering the EU, Croatia took on the responsibility of implementing measures to stimulate investment, implement structural reforms and implement responsible fiscal policies within the framework of the European Semester. The reforms tied to the European Semester should therefore not be looked upon merely as a responsibility imposed by the European Commission, but as steps that are crucial preconditions for successful economic growth and improving the standard of living for Croatian citizens. The initiative brought forth by the European Commission in June 2015 by which it created the Structural Reform Support Service (SRSS, European Commission, 2015d), is quite helpful in this regard, as it shall provide technical assistance to Member States in implementing administrative and structural reforms that stimulate growth.

Indicators have shown that Croatian citizens believe reforms are necessary and have expressed high understanding and approval ratings for the implementation of deficit and national debt reduction measures. The results of a 2015 poll conducted by Eurobarometer showed that Croatia (and Slovenia) are among the countries whose citizens feel these measures are imperative, ahead of those in other Member States. As many as 85% of Croatian citizens feel that deficit and national debt reduction measures are imperative, while 10% of Croatian citizens do not agree, and 5% do not have an opinion on the matter (at the EU-28 level, a positive opinion on the need to reduce the deficit and national debt was expressed by 73% of citizens, a negative opinion by 17%, and no opinion expressed by 10% of citizens). Among Member States with a percentage of citizens who believe reforms are necessary above the EU average, we find Hungary and the Czech Republic, each with 78% approval ratings, with Slovakia located immediately behind at 77% (European Commission, 2015e, page 206). Conversely, 56% of Croatian citizens feel that reducing the deficit and national debt are a priority for the country (above the EU-28 average of 48%) while 38% of Croatian citizens feel that these measures are not currently a priority (the

EU-28 average is 42%). The proportion of Slovakian citizens is the same as that of Croatia, while Czech citizens are among the lowest of all Member States at 33%. The proportion of Slovenian citizens who feel that reforms are not a priority is 54%, while the same statistic for Hungary is 60%, which is the highest among new Member States and among Member States in general (European Commission, 2015e, page 2018).

The challenges Croatia is facing in participating in the European Semester are significantly higher than those facing other countries that have already implemented deep reforms. More specifically, deep structural reforms have been delayed over the past few years for various reasons and then "inherited" by consequent governments. Although all governments formed to date have been positive about reforms and have accepted the recommendations, suggestions and requirements given by the European Commission, the International Monetary Fund and World Bank in principle, these reforms have not been systematically implemented. It is expected that the new government (confirmed in Croatian Parliament on 22 January 2016) will, with the support of Parliament, manage public finances responsibly, and will reform the fiscal and tax systems (among other measures). Therefore, the state administration is currently facing great challenges in implementing the structural reforms needed to encourage economic growth through improving competitiveness and lowering fiscal imbalances (Institute for Public Finances, 2016).

After accession to the EU, Croatia's budget process was not harmonised with the dynamics foreseen by the European Semester regarding deadlines for preparing strategic three-year periodic documents,[9] which has been reflected further on the dynamics of the process of implementing and planning sustainable public finances. Moreover, strategies and plans were based on macroeconomic assumptions that were not always accurate, and poor implantation resulted in frequent budget rebalances and poor macroeconomic results (Ott, 2013).

In 2015 the Croatian economy showed signs of recovery and for the first time since 2008, and after six years of negative trends in economic activities, positive growth of GDP is expected at around 1.8% in 2016 (European Commission, 2016a). For 2017 and 2018 that same institution expects very slight growth of 2.1% per annum. Domestic demand was the main generator of economic growth in 2015, and over the next two years it is expected that investments will grow fuelled by the use of EU funds, which presents a further challenge. The tendency for exports and imports to grow appeared in 2014 and 2015. Unemployment, which reached the high level of 17.3% in 2014, should decrease slightly and reach 13.8% in 2017 (however, this continues to be one of the highest unemployment rates in the EU). This points us to a slight but still inadequate improvement in structural imbalances.

**Bringing Croatia Closer to the Europe 2020 Headline Targets and Using European Funds**

As stated above, the European Semester has a key role in implementing and monitoring the implementation of the Europe 2020 headline targets. The employment targets for most Member States analysed in this paper are the same as the EU targets (75% in 2020), with the exception of Slovakia (72%) and Croatia (62.9%), countries that have set less-ambitious national targets. According to the latest data provided by Eurostat (2014), the Czech Republic has come closest to achieving its national employment target (73.5%). In its Country Report on Croatia for 2016, the Commission forecasted that the national employment target could be achieved by 2020, but it is set significantly below the EU level even though the

[9] This has continued into the first years of membership. For example, the Guidelines for Preparing Economic and Fiscal Policies for 2014-2016 were completed in September 2013 (instead of mid-June), while the Guidelines for 2015-2017 were approved in November 2014. For more information, see www.minfin.hr

employment rate is among the lowest in the EU (only 59.2% in 2014). Regarding the target of increasing the proportion of public and private investment in research and development as a portion of the GDP (the target being 3% of GDP by 2020 at the EU level), Croatia and Slovakia have set the lowest target for 2020 (Croatia's target is 1.4%, while Slovakia's is only 1.2%) without planned dynamic necessary for achieving even this low target. In the field of education, Hungary exceeded its national target for reducing the average share of early school leavers in 2014 with a rate of 11.4%, which is still over the EU target of less than 10%. Croatia's national target of 4% is significantly higher than the EU commitment, but it is important to note that Croatia has the lowest average share of early school leavers in the EU (2.7% in 2014). Regarding the share of tertiary education graduates, Croatia is close to achieving its national target of 35% (32.2% in 2014), a target which is more ambitious than that set by Hungary (30.3%) and the Czech Republic (32%), but it still significantly below the EU target of 40%. The Commission has stated that Croatia is on its way to achieving its national 2020 target for decreasing the population of people at risk of poverty or social exclusion by 150,000 persons. Furthermore, with its proportion of renewable energy sources (renewables) at 27.9%, Croatia has met the target of 20% of renewables in final energy use by 2020. However, its low rate of 2.1% of renewables in transport in 2014 is far below the 2020 target of 10%. Finally, according to its final analyses the Commission has estimated that Croatia is on its way to achieving the target for lowering greenhouse gas emissions (European Commission, 2016b).

Monitoring Croatia's implementation and progress towards fulfilling the Europe 2020 headline targets is defined and monitored by the National Reform Program (NRP). The latest NRP for 2015 includes various measures (strategies, legislation, plans, programs, initiatives, platforms and more) but in practice progress in most areas has been slow. In order to come close to achieving the Europe 2020 headline targets in the expected dynamic, passing legislation is not enough; legislation must be implemented, EU funds must be used more effectively and efficient human resources must be developed.

The funding available in the framework of European Structural and Investment Funds (ESIF) should play a key role in the implementation of the stated reforms in Croatia. After Croatia's accession to the EU, the funds allocated in the ESIF framework doubled, and the 2014-2020 program period has nine times more total funding allocated. More specifically, for the 2014-2020 period Croatia has a financial envelope of 972 million euros allocated (for the 2007-2013 period), while a total of 10.7 billion euros are allocated for the 2014-2020 period (European Commission, 2016b, page 74). In order to be granted the allocated funding from the ESIF, projects must effectively fulfil the *ex ante* conditions in their area of activity by 31 December 2016. Furthermore, to achieve increased funding from the EU, Croatia must invest significant efforts in increasing its capacity to use the available funding. In its Report on Croatia for 2016, the European Commission stated that the current rate of financial absorption is up to 46% of allocated funding for 2007-2013, which is significantly below the EU average of 76.7% (European Commission, 2016b, page 75). The main reasons for this are that the conditions for administering EU funding have partially changed since Croatia's accession, which has affected the implementation of certain programs; however, the number of well-prepared projects was also too low for effective implementation. As a result, administrative burdens must be decreased, a better operational system for funding management must be ensured and the transfer of information must be improved. This can only be achieved by strengthening the business and administrative environment, improving strategic planning and coordination and by solving structural issues, in other words more diligently implementing the necessary structural reforms (European Commission, 2016b).

**The European Semester's Corrective Measures for Croatia**

From 2013 to its accession to the EU, Croatia was informally included in the European Semester on a voluntary basis, at which time it prepared and submitted a National Reform Program to the European Commission. In return, the Commission provided recommendations based on the NRP. EU membership has required that Croatia participate in the European Semester regularly, including preparing strategic annual documents and implementing recommendations necessary for creating the preconditions for a modern, open market economy, for dealing with the challenges of competition and the development of sustainable, mutually integrated policies. The indicators monitored within the European Semester should help the state position itself realistically, comparing it with advancements in other (especially newer) Member States. They should also encourage states to use the experience of other EU Member States to help guide their own development. In 2014 Croatia participated in all the activities of the European Semester for the first time, taking on the responsibilities that membership entails. In that year, two important documents were prepared: the first was the National Reform Program followed by the Convergence Program (adopted during the Government Session on 24 April 2014). In the years that followed Croatia continued to file strategic documents – the National Reform Program (a second one, for 2015) and the Convergence Program (also a second document, for 2015-2018).

Croatia has been subjected to the corrective arm of the Stability and Growth Pact (SGP) since 2014. The **Excessive Deficit Procedure (EDP)** was initiated on 28 January 2014 for two reasons: the first was deviation from budget deficit reference values and the second public debt levels above allowed threshold. A three-year timeline was approved in order to correct this deviation, which expires at the end of 2016. When the procedure was initiated the Commission assessed that Croatia's public debt was too high and had a tendency for strong growth, estimating that it would reach 93.9% of GDP in 2016 (European Commission, 2014). Should positive changes occur, it was expected that Croatia would be party to the preventative arm of the SGP after 2016. However, the real preconditions for fulfilling these expectations have not been met, and as a result in 2016 Croatia will receive new recommendations for the forthcoming period.

In addition to Croatia, eight other Member States were party to the EDP in 2015 (Cyprus, Portugal, Slovenia, France, Ireland, Greece, Spain and the United Kingdom The EDP has been opened and subsequently closed for 17 Member States, and procedures were not even conducted for two Member States (European Commission, 2015f, see table 3). Disregard for the recommendations might result in sanctions from the Commission which include temporary suspension of EU funds for that member state.

Table 3. Excessive deficit procedure – EU-28, an overview (2016)

| Overview of ongoing excessive deficit procedures, deadlines for correction (9 MS) | Overview of closed excessive deficit procedures (17 MS) | No excessive deficit procedures (2 MS) |
|---|---|---|
| Ireland (2015), Greece (2016), Spain (2016), France (2017), Croatia (2016), Cyprus (2016), Portugal (2015), Slovenia (2015), UK (2016–17) | Austria, Belgium, Bulgaria, Czech Republic, Denmark, Germany, Hungary, Italy, Finland, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Poland, Romania, Slovakia | Estonia<br>Sweden |

Source: http://ec.europa.eu/economy_finance/economic_governance/sgp/corrective_arm/index_en.htm

**The instruments of the Macroeconomic Imbalance Procedure (MIP)**. Since February 2015 Croatia has been subject to increased monitoring due to macroeconomic imbalances identified in the 2015 Alert Mechanism Report (AMR). However, excessive macroeconomic imbalances had also been identified for Croatia in previous years. According to MIP alert mechanism (Scoreboard) indicators, in 2013 Croatia exceeded the maximum limits in four indicators (general government debt, unemployment rate, international investment position, share of world exports). The 2014 Alert Mechanism Report confirmed the presence of excessive imbalances because Croatia had not managed to bring the above-mentioned four indicators to acceptable levels. The Alert Mechanism Report for 2015 confirmed that the excessive imbalance "requires decisive policy action and specific monitoring." In the final, fifth Alert Mechanism Report for 2016 (European Commission, 2016g, page 102) Croatia had exceeded the maximum limits for six indicators (among which were some new ones). This report put Croatia at the bottom of the list in the area of macroeconomic imbalances. The indicators that exceeded the maximum limits were as follows (data for 2014): general government sector debt according to EU indicators was 85.1% of GDP (the threshold is 60%), the three-year backward moving average of unemployment rate was 16.9% (the threshold is 10%), net international investment position was -88.6% (threshold -35%), the five-year percentage change of export market shares measured in values (the percent of world exports, changed as a percentage over the past five years) was -18.0% (threshold -6%). New employment indicators were also added: the three year change in the long-term unemployment rate, expressed for the active population aged 15-74 years old (change over the past three years expressed as a percentage) was 1.7% (threshold 0.5%), the three year change in the youth unemployment rate (the percent of the active population aged 15-24, expressed as a percentage for the past three years) was 8.8% (threshold 2.0%) and the activity rate expressed as a percentage of total population aged 15-64 (change over the past three years was 2.0% (threshold - 0.2%).

Based on these and other indicators Croatia was grouped among 18 EU Member States (including, both for the first time, Austria and Estonia) that required an in-depth review in order to determine the gravity of the stated imbalances (see Table 4).

It must be noted that in Microeconomic Imbalance Procedures (MIP) held to date, the Commission has ranked imbalances into six categories, and that in 2016 the number of assessment categories was lowered from six to four in order to ensure greater transparency and simplify MIP implementation.[10] The four assessment categories used since 2016 are as follows: (1) No imbalances, (2) Imbalances, (3) Excessive imbalances, (4) Excessive imbalances with corrective action (implementing a corrective mechanism). All Member States for which imbalances or excessive imbalances have been identified are subject to specific monitoring adapted to the degree and nature of the imbalances in their economies (European Commission, 2016c).

[10] The six categories, used until recently, included the following: (1) No imbalances, (2) Imbalances, which require monitoring and policy action, (3) Imbalances, which require monitoring and decisive policy action, (4) Imbalances, which require specific monitoring and decisive policy action, (5) Excessive imbalances, which require specific monitoring and decisive policy action, (6) Excessive imbalances, leading to the Excessive Imbalance Procedure (corrective mechanism).

Table 4. Macroeconomic Imbalance Procedure (MIP) - EU-28

| Year | No imbalances (10) | Outcome of the in-depth reviews* for 16 MS | | | | Program countries (2) |
|---|---|---|---|---|---|---|
| | | No imbalances | Imbalances (11) | Excessive imbalances (5) | Excessive imbalances with corrective actions [11] | |
| 2015 | Austria; Czech Republic; Denmark; Estonia; Latvia; Lithuania; Luxembourg; Malta; Poland; Slovakia | - | Belgium; Finland; Germany; Hungary; Ireland; Netherlands; Romania; Slovenia; Spain; Sweden; UK | Bulgaria; Croatia; France; Italy; Portugal | - | Cyprus, Greece |
| Year | No imbalances (8) | Outcome of the 2015 in-depth reviews for 18 MS | | | | Program countries (2) |
| | | No imbalances (6) | Imbalances (7) | Excessive imbalances (5) | Excessive imbalances with corrective actions | |
| 2016 | Czech Republic; Denmark; Latvia; Lithuania; Luxembourg; Malta; Poland; Slovakia | Austria; Belgium; Estonia; Hungary; Romania; UK | Finland; Germany; Ireland; Netherlands; Slovenia; Spain; Sweden | Bulgaria; Croatia; France; Italy; Portugal | - | Cyprus, Greece |

* Adjusted to the streamlined categories
Source: http://ec.europa.eu/europe2020/pdf/csr2015/cr2015_comm_en.pdf ; http://ec.europa.eu/europe2020/pdf/csr2016/cr2016_comm_en.pdf

The most recent results of the in-depth review on preventing and correcting macroeconomic imbalances were published for Croatia on 26 February 2016 as a part of the Commission's 2016 Country Report for Croatia (European Commission, 2016b). The Report gives a detailed analysis of key economic parameters, trends and challenges facing the Croatian economy. The Report also includes a critical assessment of Croatia's progress in meeting the six country-specific recommendations (CSRs) from 2015. The Commission assessed that Croatia has achieved some improvements in fulfilling only one of the CSRs, while limited improvements were made on the other five.

The main findings in the 2016 Country Report for Croatia were as follows (European Commission, 2016b): Croatia is facing the problem of high public debt (85.1% of GDP in 2014) which continues to grow and poses a significant economic burden, while also presenting a source of vulnerability. The greatest challenge is to permanently lower the debt and stabilize its percentage in GDP without hurting growth. Private sector debt is high with no tendencies towards decreasing, and bad loans pose a challenge for the financial sector. High foreign debt is another economic burden (net foreign payments account for almost 80% of GDP, and are mostly in foreign currencies). General government debt accounts for almost one-third of total foreign debt, which is an additional risk. Unemployment rates continue to be high, especially for youth and low-skill workers.

[11] Corrective arm of the MIP i.e. Excessive Imbalance Procedure.

In 2016 Croatia was part of the group of EU Member States with excessive macroeconomic imbalances, which also included countries such as Portugal and France (countries included in the EDP), Bulgaria and Italy (countries not included in the EDP). In its 2016 Report (European Commission, 2016b), the Commission states that Croatia is currently under specific monitoring, but excessive imbalance procedures have not been activated. Should the negative trends continue, a decision on activating corrective measures could be taken in May 2016, after evaluating the National Reforms Program and assessing the implementation of structural reforms. Since this will be the second time Croatia is facing this possibility, the successful implementation of measures is extremely important. It must be noted that the above-mentioned corrective measures of the Macroeconomic Imbalance Procedure (MIP) have never been started for any EU member state.

The trends described above have also been reflected on Croatia's credit rating. The Moody's Credit Agency lowered Croatia's credit rating in March 2016, with a negative forecast. Moody's also lowered Croatia's credit rating in foreign currencies from Ba1 to Ba2, with a negative forecast. The reason for this was high public debt with a trend of further growth and low expectations with regards to reform implementation (Moody's, 2016).

**Recommendations for Croatia in the European Semester Framework**

Croatia has been given two sets of country-specific recommendations within the European Semester framework, in 2014 and 2015. Both sets of recommendations included similar areas, which cannot be fully compared due to changes in methodology in the same period.[12] These areas are public finances, the financial sector, goods and services market, public administration, employment and social policies and the labour market. Croatia did not receive any recommendations in the areas of education and social inclusion.

The first set of the Council's recommendations for Croatia, based on its National Reform Program, were sent on 8 July 2014 and included recommendations for the following areas: sustainable public finances, sustainability of the pension and healthcare systems, decreasing unemployment, effective social protections, improving the business environment, more prudent inclusion of the state in the economy, a more effective illiquidity and discharge regime and banking system quality (The European Council, 2014). According to the 2015 Country Report on Croatia (Including an In-Depth Review on the prevention and correction of macroeconomic imbalances), the Commission found that Croatia had made significant improvements in only one area (quality of the banking system), and had made limited improvements in only two areas (decreasing unemployment and effective social protections).

On 8 May 2015 the European Commission sent Croatia a further six CSRs. These are directed towards the main areas included in the 2015 National Reform Program, and the foreseen changes should be implemented over the span of 18-20 months. Regarding expected improvements, at the beginning of 2016 the European Commission estimated that certain general improvements had been made in only one area (European Commission, 2016b), namely improving pre-bankruptcy and bankruptcy frameworks

[12] In order to simplify the procedure, the European Commission decreased the number of areas they provide recommendations for. Up to 2014 these included four areas with a total of 17 sections. Since 2015 the recommendations are given for seven areas (public finances and social security, financial sector, labour market, product and service market, education, social inclusion and administration) with a total of 14 sections. Even though this change was intended to make the procedure simpler, during the first year it has caused difficulties due to the fact that the results from 2014 and 2015 cannot be compared, which has complicated this analysis.

and strengthening the financial sector, noting that significant improvements had been made in the former. Croatia made limited improvements in the remaining five areas, which puts it at the bottom on the list of successful countries.

The implementation of the European Semester measures is initiated by the Ministry of Finance (2016b). The working group for the coordination of the Republic of Croatia's participation in the European Semester was founded in 2014 with the mission of preparing national documents (National Reforms Program and Convergence Program). The Ministry of Finance is in charge of preparing the Convergence Program, while the National Reforms Program includes numerous ministries, each working on individual structural reforms and coordination of EU funds. In March 2016 a new coordination function was created at the Government (Cabinet) level, Chief Integration Officer (CIO) whose job includes technical coordination of the European Semester, among other duties.

Croatia has made positive strides in certain areas, which have not been equal in all areas. This can be seen for example in the financial sector, where the Commission noted that some progress had been made in implementation. Only limited progress had been made in other areas (according to the Commission's 2015 assessment), which means that decisive implementation of reforms will be necessary in the upcoming period. Areas awaiting reforms are the labour market, goods and services market, education and social inclusion and public administration. These areas will be explained in this section, while the implementation of recommendations regarding public finances, an important priority area for Croatia, will be analysed comparatively together with data for the selected four new EU Member States.

In the financial sector (banking system) the European Commission's recommendation for Croatia in 2014 involved the implementation of a comprehensive portfolio screening exercise at all credit institutions. This was implemented, and in 2015 the Commission assessed that substantial progress had been made in this area (European Commission, 2015i). In the 2016 Report (European Commission, 2016b) some improvement in strengthening the capacities of the financial sector was noted.

With regard to the labour market, the Commission's 2014 recommendations stated that Croatia should continue the second phase of reforming the Labour Act, implementing a revision program for the wage-setting system, improving the efficiency and reach of active labour market policies (especially those geared towards youth, long-term unemployed and older workers), implementing measures for improving the quality and adequacy of educational outcomes with the needs of the labour market and decreasing (unreported) illegal employment. In order to address these challenges Croatia continued to pass legislation (the Labour Act) and implement labour legislation, conducted an analysis of wage policy systems, began reforming the Croatian Employment Institute (HZZ), passed the Guidelines for the Development and Implementation of Active Employment Policies for 2015-2017, passed the necessary preconditions for implementing the Youth Guarantee and began implementing other measures (Government of the Republic of Croatia, 2015b). In its 2015 Report, the overall Commission's assessment was that Croatia has made some progress in addressing CSRs in this area. In particular, the second phase of the Labour Act reform was fully implemented. Substantial progress was made regarding youth employment policies. Some progress had been made in reviewing the wage-setting system, strengtheningthe effectiveness of active labour market policies, outlining plans to address undeclared work and in implementing measures to improve the labour market relevance and quality of education outcomes (European Commission, 2015i).

With regard to the goods and services market, the recommendations given to Croatia in 2014 deal with decreasing administrative burden including parafiscal charges, rationalisation and increased efficiency

for the public administration and increasing capacities for using ESI funds. The parafiscal burden was lessened by lowering some levies, improvements to the land registrar continued, the E-Citizen (*e-građani*) system was implemented, the Strategy for Public Administration Development 2015-2020 was passed (NN[13] 12/15) and a decision was taken to increase the human resources for the ESI fund administration system (Government of the Republic of Croatia, 2015b). According to the Commission's assessment, Croatia achieved limited progress in 2014 (in improving the overall business environment and dealing with the fragmented and overlapping responsibilities at various levels of administration) and some progress in improving administrative capacities for managing ESI funds (European Commission, 2015i). The Commission's 2015 recommendations in the area of business environment included a further decrease of parafiscal charges, especially for service providers, and improving the efficiency of the judicial system, especially the commercial courts. In this area (according to the 2016 Report), Croatia made only limited progress, by decreasing non-tax payments while the main barriers to service providers remained. The assessment of the judicial system remained the same, as the number of cases continued to be significant and electronic communication with parties had not been completely implemented (European Commission, 2016b).

In the area of education, in 2014 the Commission recommended that Croatia implement measures for improving the the labour market relevance and quality of education outcomes by modernising the qualifications system, implementing mechanisms for quality assurance and improving school-to-work transitions, especially through strengthening vocational education and work-based programs (Council of the European Union, 2014).

In the area of social protections, in 2014 the Commission recommended that Croatia implement tax system reform and strengthen the efficiency and transparency of the social protections system, in addition to better activating inactive or unemployed persons. In the 2015 Report (European Commission, 2015i), the Commission assessed that overall, Croatia had achieved some progress in the areas of tax and benefits reforms and had made limited progress in the area of social protections. In 2015 the Commission issued a recommendation that Croatia tackle the weaknesses in its wage-setting framework, stimulate the employment of unemployed and inactive persons and to reform the social protections system. In its 2016 Report, the Commission assessed that Croatia had achieved limited progress in the wage-setting framework, stimulating the employment of unemployed and inactive persons and in reforming the social protections system (European Commission, 2016b).

With regard to the modernisation of the public administration and rule of law, according to the 2014 recommendations Croatia had to approve a plan for public property management, responsibly manage state-owned companies as well as strengthen anti-corruption measures and transparency in public procurement proceedings. The State-Owned Property Management Plan was approved for 2015. In the interest of transparency, a public register of appointments with records on all management and supervisory board members of limited liability companies and corporations was created and the Anti-Corruption Strategy for 2015-2020 was passed (NN 26/15). In 2014 the Commission assessed that progress in improving the management of state-owned companies and in strengthening anti-corruption measures was limited. In 2015 the Commission recommended that Croatia implement a new model for functionally dividing the jurisdictions of various bodies at the state (central) and local levels and to rationalise the system of state agencies, ensure greater transparency and responsibility in public companies and continue to privatise public companies. In its 2016 report the assessment stated that in general, limited progress had been made (limited because the all-encompassing administration reforms

[13] Narodne novine (NN) refers to the Official Gazette (OG) of the Republic of Croatia. This abbreviation will be used further in the text.

at the local level are lagging behind and the rationalisation of the state agencies system had been initiated, but has since been stopped; limited progress in the privatisation of public companies; some progress in increasing transparency and responsibility in the public companies' sector due to new legislation). Furthermore, the Commission's 2015 recommendations to Croatia urge that the role of commercial courts be strengthened and that preinsolvency and insolvency frameworks be improved, stating that some progress had been made in 2015, while the 2016 report stated that substantial progress had been made (European Commission, 2016b). Improvements in the quality and efficiency of the judicial system were assessed as limited in 2015. The 2015 recommendations for Croatia also include the need to introduce personal bankruptcy procedures into law (European Commission, 2015i).

Annex 1 summarises all the recommendations and progress Croatia has achieved, while Annex 2 shows a comparative view of the recommendations for Croatia and other selected EU members in various areas (according to the above-mentioned topical structure of European Semester recommendations for Member States in 2014 and 2015).

## COMPARATIVE ANALYSIS OF THE IMPLEMENTATION OF THE EUROPEAN COMMISION'S RECOMMENDATIONS IN THE AREA OF PUBLIC FINANCES – CROATIA AND SELECTED NEW EU MEMBERS

### Public Finances and Fiscal Consolidation – Challenges for Croatia

The following analytical review includes only the areas which are the most challenging and of the highest priority for Croatia, namely public finances and fiscal consolidation.

The European Commission's recommendations for Croatia (2014 and 2015) are directed towards fiscal consolidation, strengthening the budget strategy and supervising expenditures, strengthening tax discipline and forming an effective fiscal framework. First it must be said that progress in implementing the recommendations has been achieved by improving budget planning, preparing detailed analyses of the state budget, reorganizing the Tax Authority and beginning preparations for a new Fiscal Responsibility Act.[14] Changes to the Budget Act have harmonised the national budget planning process with the European Semester, and the significance of projections passed by Croatian Parliament with the budget have been strengthened. Additionally, there is a new requirement for a fiscal rule whereby the year's budget deficit must not be greater than the deficit projected in the previous year's calculation (this will be applied starting from the budget for 2017) (Government of the Republic of Croatia, 2015b).

According to the Commission's recommendations for 2014, the deadline for lowering the excessive budget deficit is the end of 2016, with the following planned corrections: 4.6% in 2014, 3.5% in 2015 and 2.7% in 2016. According to the European Commission's assessment (European Commission, 2015i), Croatia has achieved limited progress, especially in harmonising program prognoses with EU standards, strengthening budget expenditure supervision and in the independence of the Fiscal Policy Commission. Some progress was achieved in analysing expenditure and improving budget planning procedures, reporting on tax expenditure and improving tax discipline (European Commission, 2015i, page 91-92). However, in 2014 the deficit was 5.7% of GDP, while in 2015 it was estimated at 4.2% of GDP. The Convergence Program for the Republic of Croatia for 2015-2018 foresaw a decrease to 3.9% in 2016,

[14] Details on the Convergence Program for the Republic of Croatia for 2015-2018 available at: http://ec.europa.eu/europe2020/pdf/csr2015/cp2015_croatia_hr.pdf

with the level falling to 2.7% in 2017 (Government of the Republic of Croatia, 2015a, page 21). This dynamic for decreasing the deficit was not approved by the European Commission.

In 2015, the Commission issued a new recommendation requiring that the deficit be below 3% by 2016. The required corrections are strengthening the budgetary strategy, improving control of expenditures, passing the Fiscal Responsibility Act and strengthening public debt management. In its 2016 Report the Commission assessed that limited progress had been made in implementing these recommendations in the areas of executing auditor's findings and managing expenditures. On the other hand, no progress had been made in strengthening public debt management because the publication of the Managing Public Debt Strategy was postponed to the end of 2016 (European Commission, 2016b).

The level of public debt and its growth dynamic continues to be a significant problem for Croatia's economy. Public debt trends over the past few years have maintained a strong but unsustainable growth rate with less than 40% of GDP in 2008 up to 86.7% of GDP (in December 2015, according to data provided by the Croatian National Bank). Over the next two years continued growth of the public debt is expected, with the value remaining below 90% of GDP[15] (Government of the Republic of Croatia, 2015a; Bajo, Primorac, 2014).

The Economic and Fiscal Policy Guidelines for 2016-2018 (Ministry of Finance, 2015) are based on a fiscal consolidation framework using national strategic documents from the European Semester. The implementation of measures for both the revenue and expenditure sides of the budget have been foreseen, including decreased expenditure on most main expenditure categories and savings from public companies in the public sector through accelerating restructuring and redirecting financing sources to EU funds. The Fiscal Management Framework, as it has been announced, includes stricter fiscal rules and strengthening the Fiscal Policy and Mid-Term Budget Planning Commission. Planned revenue activities are moving towards increasing the tax base (taxing capital gains), improving the efficiency of tax audits and modernising the Tax Authority. The current government's economic plan for the mid-term period of 2016-2018 is not available but there has been information that it will be based on efforts in two key areas: stabilising and decreasing public debt as well as structural reforms based on strengthening the foundation for growth (Ministry of Finance, 2016c). There has been discussion on the economic recovery process in Croatia being based on the implementation of the Program for Economic Reforms for Sustainable Growth and Employment written by the Croatian Democratic Union Party (HDZ) in collaboration with the IFO Institute for Economic Research in Munich and the MOST (List of Independents) Reform Plan, which formed the basis for the government-forming agreement at the beginning of 2016.

The direction and targets of Croatia's economic policies in 2016 (according to the Explanation of the State Budget for 2016) emphasise continued fiscal consolidation which should not damage the foundations of economic growth, directed towards the following key areas: stabilising and decreasing public debt (based on fiscal consolidation and decreasing the budget deficit, activating state property and encouraging economic recovery) as well as implementing structural reforms with the goal of strengthening growth in the mid-term. The planned activation of state property requires intensifying the

[15] It is important to note that from September 2014 onwards all EU Member States are required to implement the budget planning process methodology prescribed in the ESA 2010 System. Due to the new way of presenting certain budget items relating to the national economy, the inclusion of the business sector has changed. Aside from changes in calculating GDP, these changes have also been reflected on the inclusion and size of the deficit and general government debt. The use of this methodology increased the 2013 deficit from 4.9% to 5.2% of GDP, while the general government debt grew from 66.7% to 75.7% for the same year (Government of the Republic of Croatia, 2015a; Bajo, Primorac, 2014).

privatisation process for state-owned companies, with the exception of those of strategic importance. Furthermore, improvements in the investment climate and strengthening the efficiency of the state administration is planned. A key driver for increased investment activities is expected to come from increased absorption of EU structural and investment funds, with a planned increase of 30%. Structural reforms that the government plans on prioritising include economics and social protections as well as the public administration (managing public finances, healthcare, labour market, public administration) (Government of the Republic of Croatia, 2016a). In 2016, an in-depth analysis of the tax system is planned, but tax reforms have not yet been planned.

In 2015 the budget process was harmonised with the European Semester through amendments to the Budget Act.[16] The 2016 budget was approved at the Government Cabinet Session on 11 March 2016, including the conditions of necessary fiscal consolidation and correction of macroeconomic imbalances in the European Semester framework[17] (Ministry of Finance, 2016a) and was passed in Croatian Parliament on 15 March 2016 with minor amendments. The budget does not present significant policy changes, but seeks to stabilise public debt with the intent of lowering it in the upcoming years, while the deficit is planned to remain within acceptable levels (total deficit of the general budget according to national methodology is foreseen at 2.7% of GDP from the existing 3.8% of GDP which is still below the accepted limit of 3% using EU methodology). The budget is based on an assumed growth rate of 2%. An increase in expenditure is expected as a result of contributing to the EU budget in financing EU projects and other responsibilities. The budget also foresees structural savings, including lower welfare pay-outs (affecting the poorest members of society) and implementing an income census, decreasing funds for science and education (which means that new knowledge will be less supported) and decreasing employment subsidies, including economic subsidies effectively lowering growth potential. The budget is directed to stabilising public debt as the main macroeconomic risk and lowering the budget deficit, which necessary for sustainability, organisation and management as well as the success of the implemented reforms. This represents a compromise solution given the conditions the country finds itself in, and does not include the publicised changes and in-depth reforms. Budget implementation will demonstrate whether the targets will be met or whether a budget rebalance will be necessary, as it has been in the past.

On 21 March 2016 the State Budget of the Republic of Croatia was adopted by Croatian parliament. It foresees a budget deficit decrease from 12.8 billion HRK achieved in 2015 to 7.5 billion HRK, thus implementing the European Semester's recommendations for lowering the general government deficit to permitted levels (2.7% of GDP, according to national methodology), the lowest level since 2008. According to the explanation provided by the Ministry of Finance, the planned deficit is also below 3% of GDP when using ESA Methodology 2010, used for comparison with other EU Member States. The budget foresees structural savings which will be achieved by more rational and effective state spending without lowering pensions and wages.

The Ministry of Finance's 2016-2018 Strategic Plan states that "Without continually improving public finance management and ensuring the consistent implementation of reforms there is a risk of financial stress and other possible and unexpected surprises" (Ministry of Finance, 2016c, page 4). Fiscal discipline and consistent implementation of clearly defined reforms with precise deadlines are therefore necessary and cannot be postponed.

[16] Legislative amendments to the Budget Act, National Gazette 015/2015

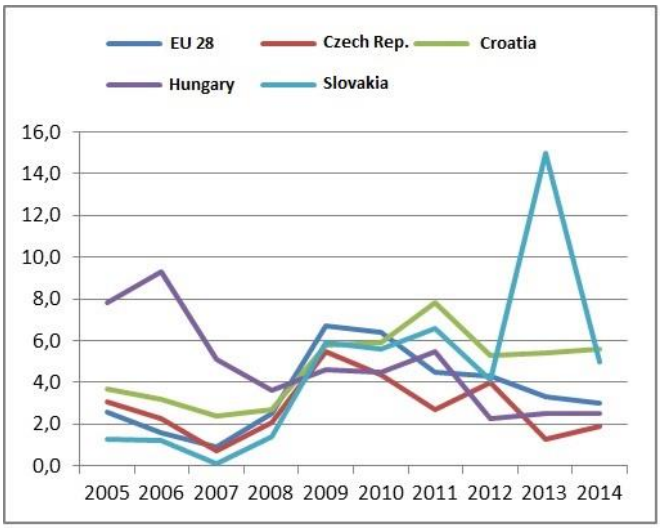
[17] The fiscal consolidation framework was foreseen in the Government's Strategy (2016) and prepared in accordance with the Council of Minister's recommendations for solving excessive budget deficits, written in 2014.

**A Comparative Analysis of Public Finances and Fiscal Consolidation in Selected Member States**

The selected new EU members analysed in this paper generally had government deficits in accordance with the EU average, with a decrease between 2005-2007, followed by a large increase which was the result and answer to the 2008-2010 economic crisis and attempts to consolidate public finances that ensued. At this time the Czech Republic had a general government deficit lower than the EU average, with a smaller increase during the crisis and faster decrease as early as 2010. Slovenia's deficit was below the EU average before the economic crisis and up until 2010 also followed that average, but with the end of consolidation practices in 2011 and escalation of the deficit in 2013, the deficit reached as high as 15% of GDP. Hungary had a very atypical fiscal policy with a very large deficit before the crisis and a significantly lower deficit throughout the crisis, making it procyclical. As a result, consolidation in Hungary did not succeed in 2011, but over the past three years the deficit has been successfully stabilised and brought to levels that are in accordance with EU standards.

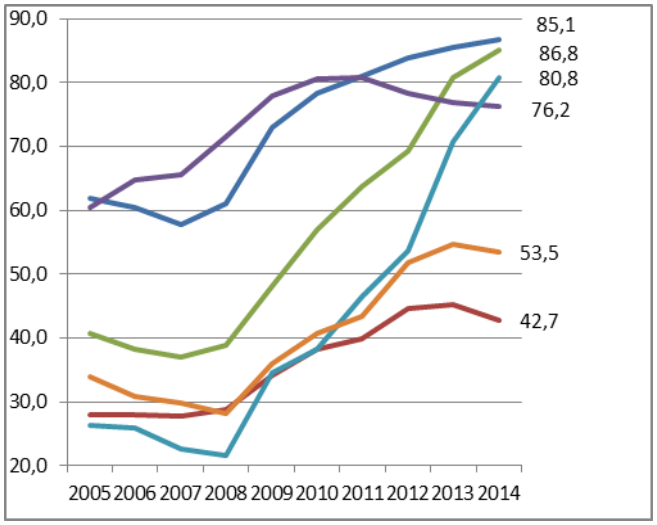
The Czech Republic, Hungary, Slovakia and Slovenia continually received recommendations for public finances (except Slovakia in 2015). The Czech Republic and Slovakia successfully and relatively quickly exited the EDP. After 2009, the general government deficit reached a peak of 5.8% in **the Czech Republic** and was lowered to 1.5% of GDP by 2013, within the timeline set out by the European Council. **Slovakia** lowered its general government debt from 8% of GDP in 2009 to 2.8% in 2013.

Figure 2. General public deficit as a % of GDP




Source: Eurostat data

Figure 3. General public debt as a % of GDP




Source: Eurostat data

**Hungary** had been under the EDP since 2004. After numerous unsuccessful attempts to achieve the necessary budget deficit targets it was only the decision to suspend the availability of the Cohesion Funds that convinced the government to implement deficit correction measures which allowed Hungary to reach the set target by 2012. From 2009 onwards the government terminated the so-called *13th salary* in the public sector and decreased unemployment benefits. In 2011 the government implemented the Szell-Kalman Plan, which focused on lowering expenditure in healthcare, education, social transfers, transport and local government. Lowered expenditure in 2011 and 2012 was at the level of 2% of GDP (Guerson, 2013), but as that was not sufficient in 2012 the Commission suspended 29% of Hungary's

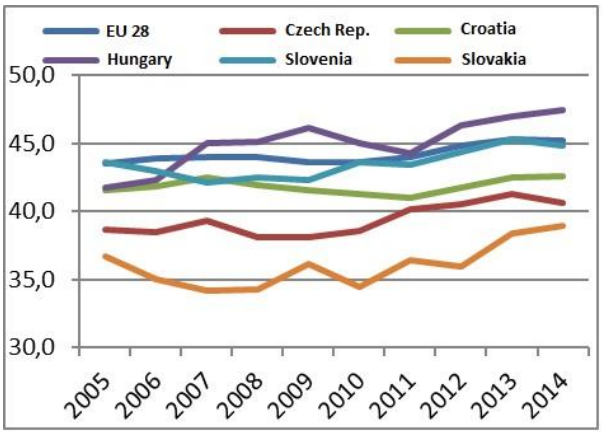
funding from the Cohesion Fund. As a result, the Hungarian government implemented numerous measures (for example implementing a tax on bank transactions, mobile phone calls and messages, increasing taxes on the revenue of energy companies active in Hungary) and as early as June 2012 the EU reinstated the suspended funding, but the EDP continued. In 2012 the Hungarian government implemented expenditure-lowering measures by banning the employment of new persons when someone would retire in the public sector for three years, by postponing wage increases for teachers until 2014 and enacting a tax on money withdrawn from bank machines. Finally, in March 2013 it announced "freezing" part of its planned public expenditure and exited the EDP in June 2013, after nine years. **Slovenia** has been in the EDP since 2009. Its first deficit correction deadline was 2013, but due to unexpected negative economic trends the Commission extended the deadline to 2015. In order to ensure the stability of its public finances and economy as a whole, in 2015 Slovenia rebalanced its budget foreseeing a reduction of the general government deficit to 2.9% of GDP. Before the economic crisis **Croatia** had a deficit above the EU average, and after the onset of the crisis the trends were similar to those in Slovenia (without consolidation in 2011) with the deficit remaining unsustainably high, near 6% of GDP for 2013-2015.

The trends described here have significantly affected the indicators for the general government debt. Hungary, whose debt was higher than the EU average successfully consolidated it within the EDP and in 2014 its share of general government debt in the GDP was 10.2 percentage points lower than the EU average. Croatia, and especially Slovenia, had low levels of government debt ten years ago, which dynamically increased during the economic crisis due to a lack of adequate reform measures. According to indicators used, the Czech Republic and Slovakia have managed their fiscal policies appropriately and responsibly with low initial values, a moderate reaction to the financial crisis and an end to growth in 2012. This leads to conclusion that there is space for increasing public expenditure in the function of growth. The 2015 state budget foresaw the recovery of state investment in the Czech Republic, especially in the construction sector and transport infrastructure, especially in the modernization, renewal and maintenance of the road and railway networks

With regard to tax policies, there is an important difference between tax as a revenue and as an expenditure in the budget. Since revenues are not immune to changes in GDP, the effect of the economic crisis is not visible because the general government tax (and other) revenues decreased in the same measure as the GDP fell during the crisis and continued to account for the same proportion of GDP (Image 3). The general government revenue as a proportion of GDP began growing in 2012 due to the consolidation of the budget deficit, leading to the conclusion that the selected countries were more likely to increase tax burdens than to lower budget expenditures. However, a certain fall in the proportion of general government revenue in GDP in 2014 implies that there are limited possibilities for raising taxes in Croatia and Slovenia while the Czech Republic and Slovakia did not have to do so as a result of the already described favourable overall state of public finances. With regard to revenues in **Slovenia** numerous measures were implemented in 2015, including increasing the tax rates for financial services and insurance and increasing the price of CO2 emissions for 20% as well as increasing the tax collection efficiency.

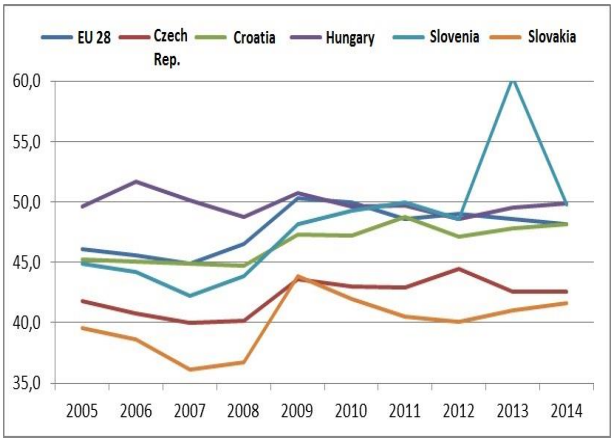
The European Commission recommended that **Croatia** introduce a real estate tax, but only limited progress has been made on the implementation of that recommendation.

Figure 4. Share of budget revenues in GDP (%)




Source: Eurostat data

Figure 5. Share of budget expenditures in GDP (%)




Source: Eurostat data

Regarding the Commission's taxation recommendations, **Hungary** stated that maintaining national sovereignty is important and has refused the Commission's recommendations including lowering, eliminating or increasing existing taxes (Government of Hungary, 2015). As such, in 2014 there were no significant changes in the tax system even though the government implemented measures to improve adherence to tax laws and decreased tax evasion in the grey market. As such, the Commission assessed that some progress had been made only in the area of tax adherence resulting from the successful implementation of real time *online* links between points of sale (cash registers) and the new system for monitoring commerce of goods whose price includes VAT (European Commission, 2015j). **The Czech Republic** should continue its work in decreasing tax evasion, simplify its tax system and implement its anticorruption plan. Furthermore, it should increase transparency and efficiency in public procurements by implementing a central registrar for public contracts and improve administration and supervision (European Council, 2015a). **Slovakia** should take measures to increase the tax collection (European Council, 2015b).

**On the side of budget expenditures**, the financial crisis increased the proportion of the general government in GDP in all the countries being analysed. The proportion of the general government in GDP in Croatia was around the EU average, but with a small increase during the crisis. The same happened in Slovenia, but with a slightly lower proportion of GDP than in Croatia (bank recapitalisation) in 2013. For this indicator, Hungary continued to be atypical with slight oscillations around 50% of the proportion of general government expenditures in the GDP.

The most important expenditure measure in **Slovenia** in 2015 was in the field of wage limitations in the public sector. The social partners signed a social agreement in January 2015 whereby wages in the public sector cannot rise faster than wages in the private sector. At the same time, labour taxes are in the process of being lowered. Limited progress and fiscal savings were noted from 2013-2014 (expenditure for pensions, which according to estimates accounted for 11.8% of GDP in 2013, lowered to 11.6% of GDP in 2014). A further decrease in expenditures for pensions was planned for 2015, with pensions representing 11.5% of GDP. Although healthcare system reforms were not planned, limited progress was made with in-depth analyses of healthcare sector expenditures, and the government is planning

comprehensive healthcare system reforms based on the above-mentioned expenditure analyses and the National Healthcare Resolution (Government of Slovenia, 2015; European Commission, 2015k).

In 2008 the emphasis in **Hungary** was on decreasing expenditures, including decreasing wages in the public sector in the amount of 1% of GDP, terminating the 13th pension for people who had retired early and limiting the maximum pension for all others (to the equivalent of 0.2% of GDP). Furthermore, indexation of certain social benefits was postponed or terminated (0.2%) and the majority of public expenditures were lowered by a further 0.5% (Myant et al., 2013). In 2009 social benefits were lowered, with a cumulative decrease of 1.6% of GDP for that year and as high as 3.6% for 2010, due to decreased pension benefits. At the end of 2010 the government decided to nationalise private pension funds and in doing so gain capital in the amount of 9% of GDP (Matos, 2013), of which 5/9 was directed towards lowering the deficit and 4/9 towards covering the radical tax cuts.

The long-term sustainability of the **Czech** pension system is improving, but the government has refused to implement the recommendation for hastening the increase in retirement age, since the average time spent in retirement is no longer than that of the majority of EU countries, and the employment rate of workers over 55 years of age is 54.7%, which is higher than the EU average of 52.4%. Upon temporarily lowering the indexation of pension benefits in 2013 and 2014 as a result of financial consolidation, the 2015 budget foresaw an increase of 1.8%. In addition, the government has paid special attention to increasing household spending, supported first and foremost by adapting pension indexing and indirectly increasing the taxation on salaries and other payments in the public sector. The Czech Republic is obligated to further improve economic efficiency and management in the healthcare sector (European Commission, 2015l; Czech Government, 2015).

Reforming the pension system in **Slovakia** decreased pressure on future public finances. After introducing a second (private) pension pillar in 2004, in 2013 social protections for veterans (military and police) were reformed. Since 2015 an adjusted system for pension payments from the second pension pillar has been used. The most significant changes have included removing the minimal savings period of ten years and the possibility of inheriting the savings over at least seven years. On the other hand, Slovakia has made partial progress in the area of healthcare system economics. Slovakia is obligated to improve the economic efficiency of its healthcare system, including improving the management of hospital care and strengthening the primary healthcare system (European Commission, 2015m).

In 2014 **Croatia** received recommendations directed towards decreasing early retirement, implementing stricter assessments and controlling disability pensions as well as strengthening the cost effectiveness of the healthcare sector. In this regard Croatia has completed its calculation of pension system costs up to 2060 and through implementing stricter assessments and controls has worked to decrease the level of new disability pensions awarded, while changes to the Retirement Insurance Rights Act are underway for certain professions. The proposed National Development Plan for Clinical Hospital Centres to 2016 has been adopted. According to the Commission, in 2015 Croatia achieved limited progress in addressing the recommendations. It did not achieve any progress with regard to decreasing early retirement, and the number of disability pensions awarded in 2014 was higher than in 2013. However, limited progress was made in strengthening cost effectiveness of the healthcare system. Recommendations for 2015 emphasise the areas in which progress was weaker. In its 2016 Report, the European Commission (2016b) assessed that progress is still limited in two areas – de-stimulating early retirement and improving the efficiency of pension expenditures and solving fiscal differences in the healthcare sector.

**Analysis of the Components of Fiscal Consolidation**

Numerous studies were devoted to the components of fiscal consolidation in OECD countries after the financial crisis, but surprisingly, their conclusions are rather different. Alesina et al. (2015) concluded that consolidation in the period 2009-2013 was mostly based on decreasing expenditures, while Kataryniuk and Vallés (2015) proved that consolidation during the 2009-2014 period was almost equally on the revenue and expenditure sides. Both studies concluded that decreasing expenditures was less detrimental for economic growth than increasing revenues.

The concept of fiscal consolidation includes increasing revenues and/or decreasing expenditures, in real (fixed prices) or relative (in relation to GDP) terms. However, analyses have pointed to the key relationship between the change indexes for these two basic budget elements compared to the GDP dynamic. Consolidation is possible even with decrease in revenues if these are less than the decrease in expenditure. In addition, analyses often ignore the important role played by the GDP growth, whereby countries that achieve dynamic economic growth can attain consolidation along (real) increased deficit, by increasing the budget deficit denominator (as a portion of GDP) more intensively than increasing the real deficit.

In order to evaluate whether fiscal consolidation has been conducted mostly on the revenue or expenditure side, taking into account also the GDP dynamics, the analysis in this paper was conducted for the 2009- 2014 period, when there were no fiscal escalations in the selected countries. Data for the European Union as a whole have been shown alongside countries of the Euro-zone as well as the aggregated data for the four selected countries, with Croatia being shown separately.[18]

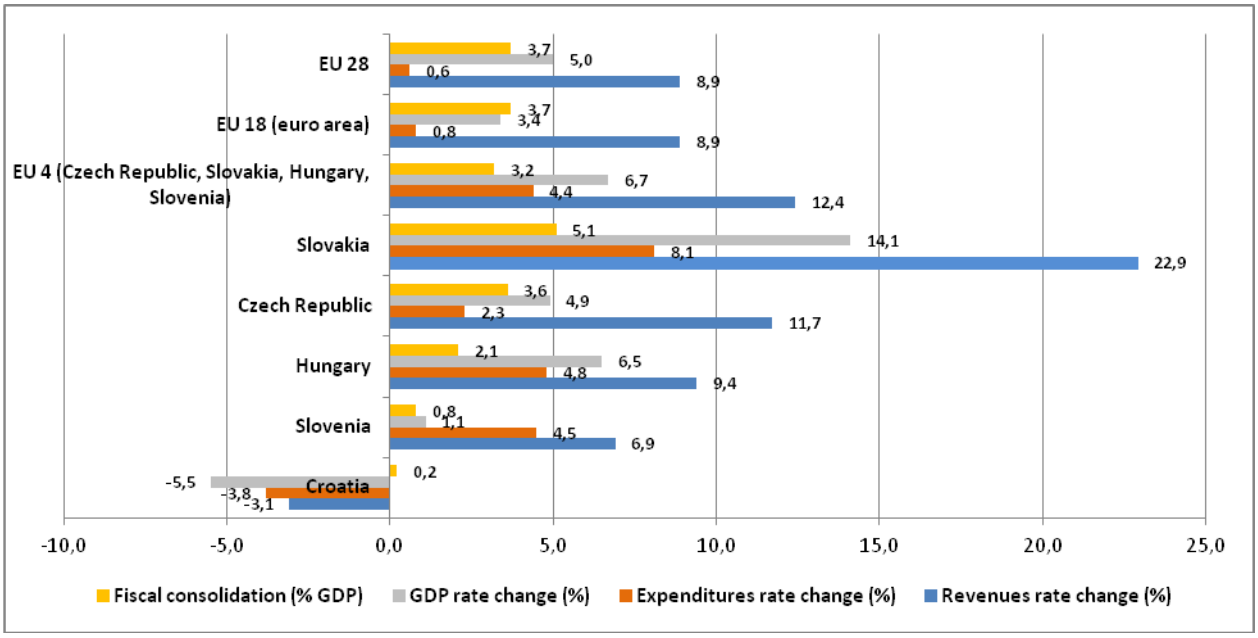
The analysis was focused on the indicator of total consolidated general government revenues and expenditures, including interest spending, without the so-called cyclic adjustments. Fiscal consolidation is defined as a decrease of fiscal deficit (share in GDP) in 2014 as compared to 2009. Changes in GDP, fiscal revenue and expenditure are expressed in real terms (adjusted by the GDP deflators for each country concerned). The conclusion on the predominance of consolidation on the revenue or expenditure side is possible based on the differences in the changes of these two variables and the GDP growth rate.

At the European Union level, it can be concluded that 3.7% GDP consolidation was achieved by revenue increase 3.9 percentage points above the GDP growth and expenditure increase 4.4 points less than GDP growth, therefore with a small predominance of the expenditure side. For the selected 4 EU countries (Czech Republic, Hungary, Slovakia and Slovenia), as a while, consolidation was mostly achieved by increasing revenue 5.7 percentage points above the GDP growth, while the expenditure increase lagged 2.3 points behind GDP. Slovakia achieved the highest consolidation (5.1% of GDP), also mostly on the revenue side. However, high economic growth (14.1%) allowed for the decrease in the proportion of fiscal expenditures in GDP, although they actually experienced significant (8.1%) increase in real terms. A more detailed study on the experience of Slovakia, which was successful in dynamically increasing its budget revenues without decreasing the economic growth may be needed.

[18] For the purposes of this paper fiscal consolidation was defined as decrease of the share of the consolidated general government deficit in GDP for 2014, as compared to 2009. Percent changes have also been calculated for three variables: GDP, consolidated general government revenue and expenditure, all in euros, as real values (based on GDP deflators for each country). The conclusion on the balance of consolidation on the revenue or expenditure side is possible based on the differences in indicator percentage changes for these two variables and percentage changes in GDP. If the difference in the revenue and GDP dynamics is greater than the difference in the expenditure and GDP dynamics, consolidation was predominantly on the revenue side and *vice versa*.

Hungary followed a similar path, but at a lower (GDP growth rate) level, making the consolidation less successful. In the Czech Republic the revenue side was the major component of consolidation (6.6 percentage points difference to the GDP growth, as compared to 2.6 for expenditure). Slovenia is an exception with expenditure increased more than GDP (by 3.4 percentage points) so the expenditure side contribution to consolidation was negative, compensated by 5.8 percentage revenue increase above the GDP growth, resulting in rather modest total consolidation of 0.8% of GDP. Data for Croatia are very different than for the other countries under review with all the indicators decreasing so only insignificant consolidation (0.2% of GDP) was achieved by a slightly higher decrease in expenditure over the revenue decrease.

Figure 6. Components of Fiscal Consolidation in selected countries 2009 - 2014




Source: Eurostat, data compilation by authors

## CONCLUSION AND RECOMMENDATIONS

### Conclusions

In the aftermath of the crisis, efforts for a stronger coordination of Member States' economic policies, harmonization of processes of national budgetary policies and policies for growth and employment as well as boosting the investment have been intensified at the European level. Within the framework of the European Semester, EU Member States harmonize their budgetary and economic policies with commonly agreed objectives and rules at the EU level, defining and implementing reforms for economic growth. Participation in the European Semester is mandatory for all EU Member States, implying regular reporting as well as harmonization of economic policies according to the commonly agreed objectives at the EU level. The most important part of the European Semester refers to the Country Specific Recommendations (CSRs) adopted by the European Council and implemented by Member States. The

comparative positioning of Member States with regard to CSRs implementation on the basis of a number of indicators provides a clear picture of performances and challenges in terms of implementation of reforms, fiscal consolidation and boosting growth.

The public finances in the EU, including those of new Member States analyzed in this paper, have been greatly affected by the global economic crisis during the last decade. Despite the fact that there has been some progress achieved in reducing the public deficit at the EU level and that the number of Member States subject to the Excessive Deficit Procedure (EDP) has been decreased, the public debt in a number of EU Members is still unsustainably high. There are substantial differences in structural adjustments of Member States, depending on the level of their indebtedness and their position with regard to the Medium-Term Objectives (MTO). In the period 2011-2014 selected new Member States (and the EU as a whole) had very limited room for maneuver to reduce expenditures so they have also consolidated their budgets by increasing revenues. In the period 2015-2018 majority of EU Member States plan to reduce expenditures rather than to increase revenues. However, the reduction of growth-enhancing expenditures should be avoided. Member States also plan significant adjustments of wages in the public sector and social benefits, which in principle have lower impact on growth. According to the European Commission analysis, in the period 2015-2018 only Croatia and Sweden plan to increase the revenue side of their budgets.

The analysis of new EU Member States carried out in this paper has revealed some interesting facts and highlighted different experiences in participating in the European Semester. Compared to an EU average, in the pre-crisis period Croatia, the Czech Republic, Slovenia and Slovakia had low levels of the public debt, while on the other hand Hungary was highly indebted. All selected new Member States were running high public deficits in 2009 and 2010 and the period thereafter. The Czech Republic and Slovakia have planned and consolidated their public finances in a proper way and were able to maintain low levels of indebtedness, having even managed to reduce their public debts in 2014. On the other hand, Hungary had rather poor control of its public finances with no room for expansionary fiscal policies during the crisis period because it has been confronted with necessary reductions of its public deficit. Hungarian example also highlights the fact that the process of European Semester does not represent declarative control wherewith obligations could be avoided, given that the country was sanctioned with a suspension of 29% of the EU Funds in 2012. Hungary significantly increased tax revenues by implementing some measures which did not correspond with the principles of the economic functioning in the EU, such as sectoral taxes. This Member State has been under the Excessive Deficit procedure (EDP) for a long time. The Czech example demonstrates that it is possible to refuse to implement a part of Commission's recommendations, if reforms are adequately planned and implemented but also if the argument is supported with an appropriate verification by the analytical data. In particular, the Czech Republic refused to implement recommendation on increasing the retirement age with faster pace on the grounds that the average retirement period in Czech Republic is below an EU average level, while the employment rate of older workers is higher than the EU average. The Czech and Slovak examples also highlight the fact that there is a more room for maneuver in creating the budgetary policies if levels of the public deficit and the public debt are within agreed limits. For example, in 2014 the Czech Republic has increased pensions and wages in the public sector, considering these measures supportive to the

prospects of the economic growth. The example of Slovenia highlights the importance of deploying early-warning systems in detecting economic imbalances. At a glance this Member State did not have any difficulties regarding the deficit of public finances. However, the accumulated debts in the banking and private sectors have resulted in an unexpected increase of the public deficit and the public debt, which rose form 22% of GDP to more than 80% of GDP within the period of six years.

The mechanism of the European Semester (especially the CSRs issued to the Member States) is a good opportunity for Croatia to correct its public policies and direct them towards faster economic growth and employment. All reforms which Croatia is ought to implement within the framework of the European Semester are necessary to foster economic growth and employment, contributing thus to citizens' prosperity. These reforms are not exclusively related to the reduction of the public deficit and public debt but are much wider in their scope. Apart from the measures aimed at strengthening the fiscal framework and managing public finances, the European Semester is also focused on correcting a broader spectrum of imbalances and implementation of reforms in a wider sense. These include reforms related to the labour market, pension and healthcare systems, social benefits system, education, public administration as well as bankruptcy procedures. The comparative positioning of Croatia with other new Member States on the basis of a number of indicators applied in the context of the European Semester allows for better insights on the progress achieved and challenges facing Croatia in terms of the European Semester.

In 2015 Croatia finally came out of the six years of recession and the GDP turned into positive trend but nevertheless it is still on the low level (1.6% in 2015). The main challenges for Croatia are detected in the area of ensuring the long-term sustainability of public finances and implementing structural reforms, in which it lags behind other EU Member States. There is no room for maneuver to further delay fiscal consolidation, which is currently the highest priority for the country. The high level of the public debt and notably its structure and dynamics pose a significant macroeconomic risk. Croatia is under the Excessive Deficit Procedure (EDP) since its formal participation in the European Semester (2014) due to the high levels of its public deficit. Currently, there are 8 other EU Member States under the EDP. In addition, since 2014 Croatia is experiencing excessive macroeconomic imbalances, which are considered as the highest level of economic imbalances according to the Commission's categorization. Besides Croatia, macroeconomic imbalances are also considered excessive in Portugal and France (these Member States are also under the EDP) as well as in Bulgaria and Italy. Croatia is currently under special monitoring by the European Commission, while the Excessive Imbalance Procedure has not been initiated.

So far, two sets of Country Specific Recommendations (CSRs) have been issued to Croatia within the framework of the European Semester. In 2014 Croatia received a total of 8 CSRs, while achieving the subnational progress in implementation of 1 CSR (ensuring the quality of the banking system) and some progress in implementation of 2 CSRs (tackling the unemployment and reviewing the social benefits system). To recall, the European Commission assesses the implementation of CSRs by means of five qualitative categories, ranging from 'no progress', to 'fully addressed CSRs'. In 2015 the Commission has made 6 CSRs to Croatia. The country has achieved some progress in implementation of only 1 CSR (in the area of the pre-insolvency and insolvency frameworks and the financial sector), while limited progress

was assessed in implementation of other 5 CSRs thus ranking the country at the bottom of the performance list. The Commission's assessment is that the period of slower growth, delayed restructuring of state enterprises and high unemployment has significantly increased the risks related to the low competitiveness, large and growing international debt and poor public administration management. In June 2016 the Commission will decide whether to initiate the Excessive Imbalance Procedure for Croatia, based on the assessment of the National Reform Program and implementation of reforms.

Considering Croatia's participation in the European Semester so far one could assess that Croatia has addressed certain aspects of CSRs issued by the Commission and some progress has been achieved. Croatia has put a greater focus on the reforms and has identified key problems to be addressed. Positive examples of reform implementation include better regulation and management of state enterprises, reduction of parafiscal charges and public disclosure of the register of parafiscal charges as well as rationalization of the public agencies system. However, Commission's assessments point to the fact that not all of implemented measures were equally relevant for addressing the specific problem, meaning that in many cases Croatia has taken only particular steps and did not manage to solve the problem in a holistic manner.

Dynamics of implementation and intensity of reforms in Croatia are still not at the satisfactory level. One part of the problem is related to the instability of coordination mechanism for the European Semester implementation, considering that changes of the government in power are usually followed by personnel changes, often including places which should not be influenced by politics. This results with the loss of "institutional memory". Hence, it is important to ensure continuity of work of teams in charge of the implementation of the European Semester, as it was the case in the period of Croatia's EU accession negotiations. Furthermore, the European Semester is still not completely integrated in Croatia's strategic and budgetary planning. This is evident form the CSRs issued by the Commission, which are based on the analysis of national strategic documents.

Numerous areas still require greater efforts, including sustainability of public finances, pension and social benefits systems, judiciary and the capacity of financial sector. During the initial phase of Croatia's participation in the implementation of the European Semester, the focus was set on the necessity of drafting the analytical documents and strategies. The CSRs issued to Croatia in that period were emphasizing the need of determining current situation and conditions in different areas as a background analysis for the reforms. Later on actual implementation of envisaged reforms became the main criterion when assessing the success of implementing the European Semester. The 2015 CSRs have already required less of analytical tasks and more of concrete activities. It should be expected that future recommendations will also follow that direction[19].

The social dimension of the economic adjustments is an important aspect and should be taken into consideration in the process of implementing the European Semester.

[19] Based on the debate from the POLO-Cro28 Round Table related to the European Semester. More informaiton: www.irmo.hr .

Besides the political will, the successful implementation of the European Semester also depends on administrative capacities and human resources (which lack in many areas) and ensured financial means. These are the reasons why some reforms cannot be implemented fast enough. In addition, one should not neglect the fact that the reform processes should have start earlier.

**Recommendations for Croatia resulting from this paper**

1. The European Semester should have a priority role when planning reform activities in Croatia, while obligations arising from the Council's recommendations should be responsibly considered and implemented. In addition, one should take into consideration an intertwined relation between the European Semester and the Europe 2020 headline targets. Challenges related to implementation of the European Semester are greater for Croatia as compared to other EU Member States which have systematically implemented reforms. This is reflected in the fact that dynamics of implementation and intensity of reforms in Croatia are still not at the satisfactory level. Therefore, it is important to make more efforts in implementation of recommendations related to the fiscal responsibility, structural reforms and strengthening the institutional capacities of the public administration by ensuring the continuity of work of experts in the public administration regardless the changes of political parties in power.

2. The political commitment and responsibility in implementation of reforms in the framework of the European Semester is highly required, including implementation of structural reforms. The long process of forming the new Government (in 2016) has reduced a room for manoeuvre in implementing reforms. Therefore, it is necessary to start as soon as possible with a clear reform program positioned in the context of the European Semester and define terms of work, determine responsibilities, set and respect deadlines. In this regard, it is important to ensure broader consensus and support for implementation of envisaged reforms form all relevant stakeholders (the Government, the Parliament, social partners, academia and civil society) and Croatian citizens.

3. The priority task is to establish sustainable public finances, which implies stabilization of the public debt by reducing the public deficit. The level of public debt and its growth dynamic continues to be a significant problem of Croatian economy. The stabilization of public debt should be addressed by multiannual budgetary strategy and by improving control of expenditures at the central state and local level as well as by strengthening the budgetary discipline. The solution should not be focused only on reducing the budgetary expenditures but also new ways should be found to increase revenues. It is very important to respect European Semester deadlines in the budgetary process and base analytical documents on realistic and sustainable assumptions. In addition, organization, management and implementation of the budgetary process should be improved. Furthermore, it is necessary to strengthen the public debt management on the basis of a clear strategy, establish good coordination mechanism between measures and instruments for implementation of the fiscal and monetary policies as well as strengthen institutions. It is necessary to consider all possibilities for permanent reduction of the public debt. In this regard, a special attention should be given to the social dimension of implementation of these measures and seek to balance required economic measures and social aspects of their implementation, which is also gaining more consideration at the EU level.

4. It is useful to learn from experiences of other EU Member States in implementing the European Semester as much as possible, especially form the new ones. The exchange of experiences could contribute to more efficient implementation of recommendations and avoid negative consequences or could offer more insightful consideration of the impacts of implemented measures. Furthermore, Croatia should use possibilities available via new Structural Reform Support Service established by the Commission. The Service coordinates and provides tailor-made technical support to EU Member States at their request and offers financial support for reform implementation in the context of the European Semester.

5. Transparent communication with the wider public should be continuously maintained to clarify the fact that implementation of reforms (especially structural reforms) is not just an obligation related to implementation of the CSRs and participation in the European Semester but rather a necessary prerequisite for strengthening the economic growth potential, which is also in the interest of citizens. Unpopular measures should not be exclusively linked with the context of the European Semester. Structural reforms are not just budgetary reductions but a key prerequisite for encouraging the economic growth and employment. These reforms are related to the functioning of the public administration, the labour market, tax and pension policies, education system and other areas.

6. CSRS issued in the context of the European Semester should be used as a support for successful implementation of reforms at the national level. Considering that these recommendations are numerous, it is important to rank them according to their impact on the areas of a long-term interest for Croatia. In addition, it is important to focus on the top priorities and continuously work on their implementation. Commission's recommendations and assessments should be backed by national analysis and supported by continuous process of consultation with key stakeholders (social partners, civil society organizations and academia).

7. The European Semester should be better integrated in the strategic planning at the national level. Therefore, a better coordination between budgetary framework and envisaged reforms is required. Improved business environment by the means of enhanced transparency and reduction of administrative burdens and rationalization of administrative procedures should contribute to investors' interest to invest in Croatia and enable more efficient use of European structural and investment funds.

8. It is necessary to further strengthen analytical capacities within the public administration. This implies additional investments in education and training of human resources in the areas of drafting and preparing macroeconomic analysis, strategic documents and background materials for multiannual budgetary planning, impact assessment of fiscal measures etc. Besides economic aspects, greater attention should be given to social and ecological impacts of reforms in the framework of the European Semester on the society as a whole, taking into consideration goals of smart, inclusive and sustainable development.

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**ANNEXES**

**Annex 1:** Recommendations for a Council recommendations on the 2014 and 2015 national reform program of Croatia and delivering a Council opinion on the 2014 and 2015 convergence program of Croatia

| **2014 Country-specific recommendations (CSRs) (including summary assessment)** | **2015 Country-specific recommendations (CSRs) (including summary assessment)** |
|---|---|
| 1. Fully implement the budgetary measures adopted for 2014. Reinforce the budgetary strategy, further specifying announced measures for 2015 and 2016, and considering additional permanent, growth friendly measures in order to ensure a sustainable correction of the excessive deficit by 2016. At the same time, ensure that the structural adjustment effort as specified in the Council recommendation under the Excessive Deficit Procedure is delivered. Align programme projections with ESA standards and Stability and Growth Pact requirements. Take measures to reinforce control over expenditure. By March 2015, carry out a thorough expenditure review. Reinforce the budgetary planning process, in particular by improving the accuracy of macroeconomic and budgetary forecasts and strengthening the binding nature of the annual and medium-term expenditure ceilings and improve the design of fiscal rules. By October 2014, ground in law the newly established Fiscal Policy Commission, strengthen its independence from all budgetary authorities, broaden its mandate, in particular with respect to the monitoring of all fiscal rules and the ex ante and ex post assessment of forecasts, and ensure adequate resourcing. Building on plans outlined in the National Reform Programme, present a concrete strategy to reform recurrent property taxation. Initiate a process of reporting and reviewing of tax expenditures. Improve tax compliance, in particular by further enhancing the efficiency of the tax administration; present an action plan to this end by the end of 2014.<br>*Summary assessment:*<br>Croatia has made **limited progress** in addressing CSR 1 of the Council recommendation (this overall assessment of CSR 1 excludes an assessment of compliance with the Stability and Growth Pact) | 1.Ensure a durable correction of the excessive deficit by 2016 by taking the necessary measures in 2015 and reinforcing the budgetary strategy for 2016. Publish and implement the findings of the expenditure review. Improve control over expenditure at central and local level, in particular by establishing a sanctioning mechanism for entities breaching budgetary limits. Adopt the Fiscal Responsibility Act and strengthen the capacity and role of the State Audit Office. Introduce a recurrent property tax and improve VAT compliance. Reinforce public debt management, in particular by publishing on an annual basis a debt management strategy and ensuring adequate resourcing.<br>*Summary assessment*<br>Croatia has made **limited progress** in addressing CSR 1 (this overall assessment of CSR 1 does not include an assessment of compliance with the Stability and Growth Pact): |
| 2. Reduce access to early retirement. Adopt legislation by March 2015 to accelerate the planned harmonisation of statutory retirement ages of women and men and to advance the planned increase of the statutory retirement age to 67 years. Ensure enforcement of tighter disability pensions assessments and controls and accelerate the integration of pensions under special schemes into the general pension system. Strengthen the cost effectiveness of the healthcare sector, including hospitals | 2. Discourage early retirement by raising penalties for early exits. Improve the adequacy and efficiency of pension spending by tightening the definition of arduous and hazardous professions. Tackle the fiscal risks in healthcare.<br>*Summary assessment*<br>Croatia has made **limited progress** in addressing CSR 2. |

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| *Summary assessment*<br>Croatia has made **limited progress** in addressing CSR 2 of the Council recommendation | |
| 3. Implement the second phase of the labour law reform, following consultation with the social partners, in particular as regards conditions for dismissals and working time, and with a view to preventing further labour market segmentation including for young people, by March 2015. Review the wage-setting system with a view to better aligning productivity developments and wage conditions. Present the conclusions of this review by the end of 2014. Strengthen the effectiveness and reach of active labour market policies by reinforcing the administrative capacities of the public employment services, including at regional level, and by increasing the coverage of the young, long-term unemployed and older workers. Prioritise outreach to non-registered youth and mobilise the private sector to offer more apprenticeships, in line with the objectives of a youth guarantee. Outline plans, by the end of 2014, to address undeclared work. Implement measures to improve the labour market relevance and quality of education outcomes by modernising the qualification systems, by putting in place quality assurance mechanisms and by improving school-to-work transitions, in particular through strengthening vocational education and work-based learning.<br>*Summary assessment*<br>Croatia has made **some progress** in addressing CSR 3 of the Council recommendation | 3. Tackle the weaknesses in the wage-setting framework, in consultation with the social partners and in accordance with national practices, to foster the alignment of wages with productivity and macroeconomic conditions. Strengthen incentives for the unemployed and inactive to take up paid employment. Based on the 2014 review, carry out the reform of the social protection system and further consolidate social benefits by improving targeting and eliminating overlaps.<br>*Summary assessment*<br>Croatia has made **limited progress** in addressing CSR 3 |
| 4. Review tax and benefits systems by the end of 2014, and present an action plan to improve the reactivation of inactive and unemployed persons. Strengthen the effectiveness and transparency of the social protection system by further consolidating benefits, unifying eligibility criteria and linking data from all relevant levels and government entities in the 'one-stop shop'. Improve the effectiveness and adequacy of social assistance benefits through their better targeting<br>*Summary assessment*<br>Croatia has made **some progress** in addressing CSR 4 of the Council recommendation: | 4. Reduce the extent of fragmentation and overlap between levels of central and local government by putting forward a new model for functional distribution of competencies and by rationalising the system of state agencies. Increase transparency and accountability in the public corporate sector, in particular as regards managerial appointments and competency requirements. Advance the listing of minority packages of shares of public companies and privatisations.<br>*Summary assessment*<br>Croatia has made **limited progress** in addressing CSR 4. |
| 5. Take further measures to improve the business environment. In particular, by March 2015 set a target for considerably lowering administrative requirements, including para-fiscal charges. Address the high level of fragmentation and overlapping responsibilities by streamlining administrative processes and by clarifying the decision-making and accountability framework across various levels of government and at central government level between ministries and agencies. Improve | 5. Significantly reduce parafiscal charges and remove excessive barriers for service providers. Identify and implement steps to improve the efficiency and quality of the justice system, in particular commercial courts.<br>*Summary assessment*<br>Croatia has made **limited progress** in addressing CSR 5 |

| | |
|---|---|
| administrative capacity and strategic planning of units entrusted with the management of European Structural and Investment Funds and provide them with adequate and stable staffing levels.<br>*Summary assessment*<br>Croatia has made **limited progress** in addressing CSR 5 of the Council recommendation: | |
| 6. Present, by October 2014, a detailed plan for public property management for 2015. Ensure that companies under state control are governed in a transparent and accountable manner, in particular, strengthen the competency requirements for members of management and supervisory boards nominated by the State and introduce a public register for appointments. Reinforce prevention of corruption in public administration and state-owned and state controlled enterprises, including by increasing the verification powers of the Conflict of Interest Commission. Strengthen transparency and efficiency of public procurement at both central and local levels, and the capacity to monitor implementation and to detect irregularities<br>*Summary assessment*<br>Croatia has made **limited progress** in addressing CSR 6 of the Council recommendation: | 6. Reinforce the pre-insolvency and insolvency frameworks for businesses in order to facilitate debt restructuring and put in place a personal insolvency procedure. Strengthen the capacity of the financial sector to support the recovery in view of challenges from high non-performing corporate loans and foreign currency mortgage loans, and weak governance practices in some institutions.<br>*Summary assessment*<br>Croatia has made **some progress** in addressing CSR 6. |
| 7. By the end of 2014, reinforce the role of commercial courts in the monitoring of transparency and legality in the application of the corporate pre-bankruptcy procedure. Review the compulsory test of insolvency/illiquidity to access pre-bankruptcy settlement proceedings and streamline the insolvency/liquidation process to reduce its length. Improve the quality and efficiency of the judicial system, in particular by providing incentives to resolve proceedings in litigious civil and commercial cases and in administrative cases in a timely manner and to resort to out-of-court settlement especially for smaller claims.<br>*Summary assessment*<br>Croatia has made **limited progress** in addressing CSR 7 of the Council recommendation: | |
| 8.Complement the 2014 European Central Bank's asset quality reviews and stress test exercises, undertake a comprehensive portfolio screening exercise designed specifically for the Croatian financial sector, with a focus on important portfolios that are not covered by the European Central Bank exercise and including key mid-size and smaller banks.<br>*Summary assessment*<br>Croatia has made **substantial progress** in addressing CSR 8 of the Council recommendation. | |

Source: European Commission (2015i) http://ec.europa.eu/europe2020/pdf/csr2015/cr2015_croatia_hr.pdf
European Commission (2016b) http://ec.europa.eu/europe2020/pdf/csr2016/cr2016_croatia_hr.pdf

**Annex 2:** Comparative overview of EU Country Specific Recommendations in the context of the European Semester- Croatia, Czech Republic, Hungary, Slovakia and Slovenia (2014)

| Country Specific Recommendations – 2014 | | | | | | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **EU MS** | **Public finances** | | | | **Financial sector** | | **Structural reforms** | | | | | **Employment and social policies** | | | | | |
| | Public finances | Pension and healthcare system | Fiscal framework | Taxation | Banking and access to finances | Housing market | Network industires | Competition in service sector | Public administration and smart regulation | R&D and innovation | Resource efficiency | Labour market participation | Active labour market policy | Wage setting mechanisms | Labour market segmentation | Education | Poverty and social inclusion |
| **Croatia** | ■ | ■ | ■ | ■ | ■ | | | | ■ | | | ■ | ■ | ■ | ■ | ■ | ■ |
| **Czech Republic** | ■ | ■ | ■ | ■ | | | | ■ | ■ | ■ | ■ | ■ | ■ | | | ■ | |
| **Hungary** | ■ | | ■ | ■ | ■ | | ■ | ■ | ■ | | ■ | | ■ | | ■ | ■ | ■ |
| **Slovakia** | ■ | ■ | ■ | ■ | | | ■ | | ■ | ■ | | ■ | ■ | | | ■ | |
| **Slovenia** | ■ | ■ | ■ | | ■ | | | ■ | ■ | | | ■ | ■ | ■ | ■ | ■ | |

*Grey fields in the table mark the area for which the selected EU Member State received recommendations

Source: European Commission, http://ec.europa.eu/europe2020/pdf/csr2014/overview_recommendations_2014_by_member_state_en.pdf

Supplement 2: Comparative overview of EU Country Specific Recommendations in the context of the European Semester- Croatia, Czech Republic, Hungary, Slovakia and Slovenia (2015)

| Country Specific Recommendations - 2015 | | | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **EU MS** | **Public finances and welfare system** | | | | **Financial sector** | | **Labour market** | | | **Product and service market** | | **Education** | **Social inclusion** | **Administration** |
| | Public finances | Taxation | Pension system | Healthcare system | Banking and access to finances | Housing and private debt | Labour market | Labour taxation | Wage setting | Services and network industries | Innovation and business environment | Education and skills | Poverty and social inclusion | Administrative modernization and rule of law |
| **Croatia** | ■ | ■ | ■ | ■ | ■ | ■ | ■ | | ■ | ■ | | | | ■ |
| **Czech Republic** | ■ | ■ | | ■ | | | | ■ | | | | ■ | ■ | ■ |
| **Hungary** | ■ | ■ | | | ■ | | ■ | ■ | | ■ | | ■ | ■ | ■ |
| **Slovakia** | | ■ | | ■ | | | ■ | | | ■ | | ■ | ■ | ■ |
| **Slovenia** | ■ | | ■ | ■ | ■ | | ■ | | ■ | | | | | ■ |

* Grey fields in the table mark the area for which the selected EU Member State received recommendations

Source: European Commission, http://ec.europa.eu/europe2020/pdf/csr2015/csr2015-overview-table_en.pdf

**Annex 3:** National Europe 2020 targets and progress achieved - Croatia, Czech Republic, Hungary, Slovakia and Slovenia

| Employment (% of population aged 20-64) | | |
|---|---|---|
| | **2014** | **2020 target** |
| **EU 28** | 69.2 | **75** |
| **Czech Republic** | 73.5 | 75 |
| **Croatia** | 59.2 | 62.9 |
| **Hungary** | 66.7 | 75 |
| **Slovakia** | 65.9 | 72 |
| **Slovenia** | 67.8 | 75 |
| **R&D (% of GDP)** | | |
| | **2014** | **2020 target** |
| **EU 28** | 2.03 (p) | **3** |
| **Czech Republic** | 2(p) | 1(d) |
| **Croatia** | 0.79 | 1.4 |
| **Hungary** | 1.38 | 1.8 |
| **Slovakia** | 0.89 | 1.2 |
| **Slovenia** | 2.39p | 3 |
| **Greenhouse gas emissions (Index 1990=100)** | | |
| | **2014** | **2020 target** |
| **EU 28** | 80.2 | **80** |
| **Czech Republic** | 66.02 | : |
| **Croatia** | 69.89 | : |
| **Hungary** | 61.6 | : |
| **Slovakia** | 57.89 | : |
| **Slovenia** | 98 | : |
| **Share of renewable energy in gross final energy consumption (%)** | | |
| | **2014** | **2020 target** |
| **EU 28** | 15.0 | **20** |
| **Czech Republic** | 12.4 | 13 |
| **Croatia** | 18.0 | 20 |
| **Hungary** | 9.8 | 14.65d |
| **Slovakia** | 9.8 | 14 |
| **Slovenia** | 21.5 | 25 |
| **Final energy consumption (million tonnes of oil equivalent (TOE)** | | |
| | **2014** | **2020 target** |
| **EU 28** | 1104.6 | **1086** |
| **Czech Republic** | 23.9 | 25.3 |
| **Croatia** | 5.8 | 7.8 |
| **Hungary** | 15.0 | 18.2 |
| **Slovakia** | 10.9 | 10.0 |
| **Slovenia** | 4.8 | 5.09 |
| **Early school leavers from education and training (% of population aged 18-24)** | | |
| | **2014** | **2020 target** |
| **EU 28** | 11.2 (b) | **10** |
| **Czech Republic** | 5.5(b) | 5.5 |

| | | |
|---|---|---|
| **Croatia** | 2.7(bu) | 4 |
| **Hungary** | 11.4b | 10 |
| **Slovakia** | 6.7b | 6d |
| **Slovenia** | 4.4b | 5 |
| **Tertiary educational attainment (% of population aged 30-34)** | | |
| | **2014** | **2020 target** |
| **EU 28** | 37.9(b) | **40** |
| **Czech Republic** | 28.2(b) | 32 |
| **Croatia** | 32.2b | 35 |
| **Hungary** | 34.1b | 30.3 |
| **Slovakia** | 26.9b | 40 |
| **Slovenia** | 41.0b | 40 |
| **People at risk of poverty or social exclusion (% of total population)** | | |
| | **2014** | **2020 target** |
| **EU 28** | 24.4 | : |
| **Czech Republic** | 14.8 | : |
| **Croatia** | 29.3 | : |
| **Hungary** | 31.1 | : |
| **Slovakia** | 18.4 | : |
| **Slovenia** | 20.4 | : |

b = break in time series; d = definition differs; p = provisional value; bu= break in time series, low reliability
Source: Eurostat, 2015 http://ec.europa.eu/eurostat/cache/Euro_2020/E2020_EN.html