



REPUBLIC OF CROATIA



2006 PRE-ACCESSION ECONOMIC PROGRAMME

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INTRODUCTION

Pre-accession Economic Programme (PEP) represents a comprehensive programme of the economic policy of the Republic of Croatia, which is prepared within the framework of multilateral fiscal surveillance. This year's PEP, Croatia's third in a row, examines in detail the direction of the country's economic policy in the period 2007-2009. In addition to macroeconomic and fiscal policies, the document also analyses structural reforms planned to be implemented as support of the overall economic policy and further development of a modern, social market economy in the context of EU accession of the Republic of Croatia.

The 2006 PEP should be viewed as an independent document, building however, in a certain way, on the previous PEP as it gives an assessment of the status of the Croatian economy and the country's performance in the implementation of the structural measures announced under the 2005 PEP. Also, individual measures and the direction of policies that will remain unchanged in the forthcoming period vis-à-vis their plans under the previous year's PEP, have not been analysed here in detail as greater emphasis has been placed on newer plans.

Croatia's economic programme for the forthcoming three-year period is based on strategic objectives and programmes of the Government of the Republic of Croatia and in terms of its main characteristics it follows the guidelines and the priorities established under the Strategic Development Framework 2006-2013. The PEP is also in line with the Economic and Fiscal Policy Guidelines 2007-2009 as well as with a number of documents arising from Croatian international economic relations with a special emphasis on the objectives and the activities determined within the framework of negotiations with the EU. It should be stressed that this document is a result of a joint effort of different line ministries, government offices and institutions, the Croatian National Bank and unions' and employers' representatives.

The 2006 PEP consists of five chapters. Chapter 1 addresses current economic developments while Chapter 2 presents a medium term macroeconomic programme which comprises development forecasts in the real sector, inflationary developments, exchange rate and monetary policies as well as development forecasts of external sector indicators. Chapter 3 deals with the medium term fiscal programme, deficit financing and public debt management plans, risk scenarios in case of failure to achieve the planned deficits, i.e. net lending/borrowing, as well as with the long term sustainability of public finance. It should be noted that in this year's PEP, the fiscal programme is analysed for the first time in accordance with the European public finance methodology ESA 95. Following the presentation of the medium term macroeconomic and fiscal policies, Chapter 4 gives a detailed overview of the main structural reforms in the enterprise sector, financial sector, labour market, agricultural sector, public administration, as well as the development of a knowledge-based society and reforms in health care, judiciary, environment protection and public procurement system. Finally, Chapter 5 gives an overview of structural reform agenda with a detailed analysis of structural reforms and the time frame for their implementation. To provide additional information and data, the 2006 PEP offers four annexes comprised of a matrix of policy commitments, fiscal effects of projects financed by EU funds, statistical appendix and structural reform agenda and achievements vis-à-vis the last year's PEP.

The 2006 PEP shows the direction of economic policy of the Republic of Croatia over a medium term with the aim of achieving sustainable economic growth over a long term and maintaining macroeconomic stability with an emphasis on achieving increased competitiveness of the Croatian economy and improved standard of living for the Croatian citizens on the road to the European Union.

1 RECENT ECONOMIC DEVELOPMENTS

Croatia's real GDP grew 4.8% in the first half of year 2006. This, together with the fact that real GDP growth in 2005 reached 4.3% (as opposed to estimate of 3.9% from 2005 PEP), suggests that this year's growth will exceed the 4.0% projected under the 2005 PEP. Under the 2006 PEP, this year's growth is estimated at 4.6%.

In the first half of 2006, investments were the main generator of faster growth. They grew by 18.1% annually in the first and 8.4% in the second quarter. Monthly investment indicators in the third quarter, including the volume of construction works, as well as output and imports of intermediate and capital goods indicate that investments will continue to grow rapidly into the third quarter. Private investment, particularly in the construction of buildings, was the most dynamic investment component, while public investment, notably motorway construction, declined slightly.

Government consumption also made a small contribution to growth acceleration in the first half of 2006, standing at 1.4%, compared with 0.8% throughout 2005. In addition, the real growth of government consumption of 1.7% in the second quarter was the strongest in the past three years.

Exports of goods and services, as well as imports of goods and services grew fast in the first half of the year. Exports were 9.0% while imports were 9.5%. With the main Croatian foreign trade partners mainly witnessing faster growth in the first half of 2006 compared with 2005, foreign demand was strong. This is particularly true of Germany, Austria, and Slovenia. At the same time, faster economic growth in the country boosted imports. Rising oil prices also made a significant impact on the value of imports.

Personal consumption grew 3.0% in the first half of the year, and is not expected to reach the annual growth rate of 3.9% projected under the previous year's PEP. Personal consumption growth was particularly slow in the second quarter (2.1%). However, available monthly indicators for the third quarter, including retail trade, point to personal consumption recovery in the second half of the year. In the first half of the year, employment growth was up while the growth of real net wages stood at a low 1.2%. Bank placements to the households, housing loans excluded, fell slightly from 19% in the third quarter 2005 to the still high 16.5% cumulatively in July and August 2006.

Speaking of GDP, note should be made of significant revisions made by the Central Bureau of Statistics, which represent adjustments with the final annual GDP calculations for 2002 and 2003. Those revisions influenced the growth rates in those years as well as GDP levels in the years that followed. Thus, though they had no direct impact on growth rates after 2003, the revisions are included in all the calculations which are based on historic time series. They are particularly important in terms of their effect on potential GDP calculation.

In accordance with economic activity in the first half of 2006, the labour market was marked by positive developments. According to data which exclude seasonal effects, unemployment fell 6.7% at end-August 2006, compared with the same month previous year. The downward trend in registered unemployment led to a steady fall in the level of registered unemployment for six consecutive months (February through July 2006). According to last available data provided by the Labour Force Survey which is conducted in accordance with the methodology and the principles of the International Labour Organisation, which are a precondition for

obtaining internationally comparable data in the area of labour market, the unemployment rate in the first half of 2006 was 11.8%, which is the lowest unemployment rate in the last years.

Real gross wages recovered visibly in 2006, as seen in the annual rates of change. The annual growth of real gross wages accelerated from 0.9% in 2005 to 2.3% in the first half of 2006. The estimated unit labour costs in 2006 did not differ significantly from their averages over the years while no strong price pressures are expected from the labour market.

Though wage growth pressures were toned down, consumer price inflation held steady throughout 2006 at levels similar to those last year. Imported inflation, resulting mainly from increased oil prices and prices of aluminium and light metals on the world market kept inflation at a relatively higher level, a contribution to which was also provided by an increase in some administrative prices. Consumer price inflation, which stood at 3.6% in December 2005, was 3.4% in August 2006, but was characterised by great variability in terms of monthly growth rates during the observed period. Overall, consumer price index is expected to rise from 3.3% in 2005, largely compliant with the 2005 PEP estimate, to 3.5% in 2006, an increase of 0.3 percentage points compared with the projection under the 2005 PEP.

Crude oil prices on the world market rose 27.3% in the first eight months of 2006. In kuna terms, this increase during the same period was only 16.0%, due to appreciation of the kuna against the American dollar. Similarly, the annual growth rate of refined petroleum products in Croatia fell from 15.7% in December 2005 to only 2.5% in August 2006, partly due to Government decision to keep the price of Eurosuper 95 at HRK 8.0.

However, the year-on-year rate of change in administrative prices remained high, falling slightly from 6.1% in December 2005 to 5.3% in August 2006. Increased health care costs and higher price of water supply and waste collection and transport services partly compensated for the slowdown in the growth of refined petroleum products prices. High growth rates of administrative prices and the prices of agricultural products led to a growing difference between consumer price inflation and core inflation. The latter fell from 3.0% in December 2005 to 2.2% in August 2006, with the biggest contribution to core inflation reduction coming from movements in the prices of meat. Their year-on-year rate of change has been falling steadily since mid-2005 when it exerted significant pressure, due to distortions on the meat market, on the level of domestic inflation.

In addition to oil prices, raw materials, particularly light metals also added considerably to imported inflation. The annual growth rate of light metal prices on the world markets rose from the already high 26.7% in December 2005 to 71.6% in August 2006. According to the European Central Bank (ECB), this was the main factor behind the recent increase in producer price inflation in the euro area. In contrast with the modest producer price inflation in Croatia since the last PEP, (up from 2.7% in December 2005 to 3.1% in August 2006), the prices of intermediate goods rose considerably, from -0.7% to 2.2%, during the same period, mainly as a result of increased prices of light metals.

Continued stability of the exchange rate of the kuna helped keeping inflation under control. During the first two quarters, the nominal exchange rate of the kuna against the euro appreciated by 0.7% and 0.9%, respectively. Somewhat more pronounced depreciation pressures were felt during the third quarter, with the exchange rate of the kuna depreciating by a total 1.7% against the euro.

The variability of the exchange rate of the kuna against the euro was low during the summer season, with average absolute change in the daily exchange rate of the kuna against the euro in July and August standing at only 0.05% and 0.07%, respectively, compared with the last year's average of 0.11%. However, the variability of the exchange rate of the kuna against the euro rose to 0.12% in September, as depreciation pressures and market tensions caused by central bank amendments to its decision on the minimum required foreign currency claims strongly shifted the exchange rate of the kuna against the euro at mid-month and end-month. For comparisons sake, exchange rate variability in September, though highest since March 2005, was much lower than its historical highs recorded in the turbulent August 2001, when it stood at 0.32%.

The central bank intervened in the foreign exchange market to help mitigate strong appreciation pressures in February, May and June, purchasing a total of EUR 582.8m from banks. In September, the central bank first intervened to relieve strong depreciation pressures, by selling banks EUR 125.5m and then intervened to slow down strong appreciation, this time purchasing EUR 138.7m from the banks.

Holding steady against the euro (appreciating by 0.1%), the kuna appreciated against the American dollar, the Swiss franc and the Slovenian tolar by 7.1%, 2.3% and 0.1%, respectively, in September, compared with the end of last year, while it depreciated by 0.5% against the pound sterling. Overall, the nominal effective kuna exchange rate index appreciated by 2.0% in the first nine months of this year. Similarly, the real effective exchange rate of the kuna appreciated by 2.7%, deflated by consumer price, and 1.8%, deflated by producer price in August compared with the end of last year.

Somewhat more pronounced inflation in 2005 and 2006 compared with the previous years prompted the central bank to keep a watchful eye on it. So far, no claims can be made that inflationary pressures are coming from the demand side. However, rapid credit growth and rising total external debt continue to be of central importance to the central bank. Since mid-2006, loans granted to the corporate and the households sectors, exchange rate effects excluded, grew by 23% annually. Total external debt of the Republic of Croatia rose by 5.0% in the first eight months of 2006 and is estimated to reach EUR 28.5bn or 84.4% of GDP until year-end, which is an increase of 1.3 percentage points compared with the previous PEP.

In an effort to address both problems, the central bank decided to tighten its marginal reserve requirement instrument in December 2005. In addition to widening the instrument's calculation base, the Croatian National Bank (CNB) raised the marginal reserve requirement rate to 55% expecting to render foreign financing more expensive for the banks and thus reduce the amount of funds available for loans. However, banks' external debt continued to grow until May 2006, rising from EUR 9.0bn at end-December 2005 to EUR 10.4bn at end-May 2006, when at end-August, it fell to EUR 9.0bn. The fall can partly be attributed to the seasonal factors as banks commonly use foreign currency inflows during the summer months to reduce their external debt. Therefore, it remains to be seen to what extent will the tightening of the instrument of marginal reserve requirement help slow down foreign borrowing and curb credit growth.

Both monetary aggregates, money (M1) and total liquid assets, grew rapidly in 2006. At end-August, money grew 19.1% annually. Robust economic growth added to increased corporate demand deposits, while strong credit growth led to increased corporate and household demand deposits.

The annual growth rate of total liquid assets (M4) at end-August was 15.3%. The main contribution to this growth was provided by fast growth of kuna non-monetary deposits, particularly those with a euro currency clause. It would be desirable to be able to account for such developments by growing confidence in the domestic currency. However, it was the central bank instrument on the minimum required foreign currency claims which obligates the banks to cover 32% of their total foreign currency liabilities by foreign currency claims that unquestionably boosted the growth of kuna deposits with a currency clause. Given that these deposits were not included in the base for the calculation of minimum required foreign currency claims, the banks were able to generate greater returns on such funds than on foreign currency deposits. Under the September amendment to the decision on the minimum required foreign currency claims, this is no longer the case.

Unlike previous years, loans to the corporate sector grew faster than those to households in 2006. If the exchange rate effects are excluded, the annual growth rate of loans to the corporate sector stood at 24.7% at end-August, while that of loans to households stood at 23.9%. Fast growth of loans to the corporate sector made a large contribution to investment growth in 2006.

Strong domestic demand and import prices growth, mainly oil prices, were the main factors which contributed to further worsening of the current account balance in 2006. Current account deficit stood at EUR 3.3bn in the first half of 2006, which is an increase of 20.9% compared with the first half of 2005. Significant worsening of the current account balance in the first half of 2006 was due mainly to the growing imbalance in foreign trade in goods and rising net factor income account outflows. Current transfers account also deteriorated during the same period. By contrast, foreign trade in services performed well, largely due to tourism.

Owing to tourist income which led to the positive third quarter current account balance, current account deficit could fall to EUR 2.5bn or 7.5% of GDP until year-end. Compared with the year before, the estimated current account deficit widened by 1.2 percentage points, and compared with the current account deficit expected under the previous PEP, it widened by 2.3 percentage points. Considerable departure of the present PEP from the previous PEP version is largely due to the poor performance in 2005, when the current account deficit outturn departed from the estimated 5.8% of GDP to a much higher 6.4% of GDP. This was mostly due to growing foreign trade deficit, which continued into 2006.

Speaking of foreign trade, the first seven months of 2006 saw accelerated growth of exports and imports. Total goods exports grew by 17.1% during that period, at constant exchange rate, which is twice faster compared with their growth in the first seven months of 2005 when it stood at 8.4%. Standard International Trade Classification (SITC) exports division other transport equipment (mainly ships) grew by 34.7% annually. The growth of exports of oil and refined petroleum products also accelerated, mainly due to price growth. Exports of ships and oil and refined petroleum products excluded, exports grew 13.6% annually, which is a fall of 1 percentage point compared with the same period previous year.

The annual growth of total goods imports was up from 11.4%, at constant exchange rate, in the first seven months of 2005, to 16.5% during the same period 2006. Oil and refined petroleum products excluded the data point to an even more considerable acceleration in the annual growth rate of imports of the remaining SITC divisions combined, from 6.8% to 15.0%. Such developments are indicative of the strong influence of aggregate demand on current account balance deterioration.

In the first seven months of 2006, in terms of geographical structure of foreign trade, there was a visible increase in the share of European Union (EU) countries in total Croatian merchandise exports, and a simultaneous decrease of these countries' share in total imports. Their share in Croatian merchandise exports in the first seven months of 2006 reached 65.8%, compared with 64.0% in the same period previous year. These countries' shares in total merchandise imports fell from 66.5% to 65.9% due to bigger imports from developing countries, such as energy products imports from Russia.

In the financial account, net foreign direct investment in the first half of 2006 were EUR 1.1bn, which is an increase of 33.6% compared with the same period previous year. The largest contribution to investment growth in Croatia was provided by growth in retained earnings of foreign-owned domestic companies, bank recapitalisation and a sale of Pliva's Research Institute to GlaxoSmithKline, a British-American pharmaceutical company. Considerable equity investment was also seen in extraction of crude oil and natural gas and various trade activities. The portfolio investment account saw a net outflow of EUR 406m in the first half of 2006, largely due to reduced government sector liabilities associated with bonds issued abroad. Thus the government, in addition to its regular semi-annual payment obligation under the London Club, settled its EUR 300m worth bond and JPY 25bn worth Samurai bond. During that period, there were no new issues of government bonds on the foreign market. Other investment account saw a net inflow of EUR 3.5bn in the first half of 2006. There was a sharp fall in foreign assets mainly in the first quarter (EUR 1.1bn), while domestic sector foreign liabilities rose by EUR 1.4bn during the same period and by additional EUR 1bn during the second quarter. Foreign assets' fall mainly reflects currency withdrawals and a fall in bank deposits abroad, whilst liabilities growth can be attributed to increased long term borrowing of banks and the corporate sector.

According to balance of payments data which do not include cross-currency changes, international reserves rose by EUR 673m in the first quarter of 2006 and by further EUR 697m in the second quarter. As stated previously, the central bank intervened several times in the first half of the year with its foreign currency purchases from the banks. In addition, international reserves growth also received a boost from the increased allocation of the foreign currency reserve requirement, including the marginal reserve requirement. According to monetary statistics data which includes cross-currency changes, international reserves rose from EUR 7.4bn at end-2005 to EUR 8.7bn at end-June. The reserves kept growing steadily throughout July until August when their growth came to a halt, mainly as a result of a fall in foreign liabilities of banks, or lower allocations under the marginal reserve requirement.

Croatia's external debt at end-2005 was EUR 25.5bn or 82.5% of that year's GDP. Although the debt's absolute amount was bigger than that expected under the previous PEP, the relative indicator was down by 0.5 percentage points, which can largely be explained by a higher GDP level resulting from GDP revisions for 2002 and 2003. The debt continued to grow steadily throughout the first half of 2006 to reach EUR 27.5bn at end-June. This increase is mostly due to banks' borrowing and a simultaneous considerable increase in corporate external debt (direct investment included), while external debt of the government sector declined. Following its increase in the first half of the year, external debt fell to EUR 26.8bn at end-August mostly as a result of a decline in banks' debt. However, it remains to be seen whether this summer decline is a short term seasonal occurrence or an indication of a new trend. External debt of the government sector did not witness any considerable change during these two months while corporate debt continued to grow sharply. The question is whether the growing external debt of the corporate sector has come to replace the slowing banks' debt.

2 MACROECONOMIC PROGRAMME

2.1 REAL SECTOR

The projections of real sector developments in the current year are based on the quarterly gross domestic product (GDP) estimate for the first and second quarters, as well as on recent monthly economic indicators available for the first seven months of 2006. The economic growth projection for the coming years is based on the Economic and Fiscal Policy Guidelines for 2007-2009. The medium term projection of fiscal developments in GDP calculation has been harmonized with the state budget plan for 2006 and the state budget projection for the period 2007-2009 according to the Guidelines. The foreign trade dynamics has been projected on the basis of developments in goods and services exports and imports included in the balance of payments projection.

According to quarterly GDP calculation, economic growth reached 3.6% in the second quarter of 2006, or, taken cumulatively, 4.8% in the first half of the year. The current year projection assumes real GDP growth of 4.6% for the entire 2006, reflecting an increase in economic growth of 0.3 percentage points relative to the previous year.¹ In the second half of the year, real GDP is expected to grow at a rate of 4.4% relative to the same period last year, with somewhat stronger growth anticipated in the last quarter, mainly due to a larger contribution of final consumption. The estimated economic growth rate of 4.6% for 2006, with anticipated growth of implicit GDP deflator of 3.5% in the current year, would result in a rise in the kuna value of gross domestic product of HRK 18.8bn, i.e. GDP at current prices would stand at approximately HRK 247.8bn at the end of the year.

Favourable developments in the real sector are expected to continue over the coming years, with GDP growth rates expected to reach 4.6%, 4.8% and 5.0% in the 2007, 2008 and 2009 respectively. The largest contributors to the stated growth will be personal consumption and gross fixed capital formation. In addition, the above-average growth of government consumption deflator in 2007, derived from the projection of nominal and real fiscal developments, will stimulate the growth of implicit GDP deflator above the level of change in consumer prices projected for the next year, despite the mildly negative contribution of export and import price dynamics. However, a mild slowdown in implicit GDP deflator (to 3.4%) is expected in the following year, and it is assumed that it will follow the trend in personal consumption deflator or consumer prices in this period. The projection assumes a continuation of these trends over 2008 and 2009.

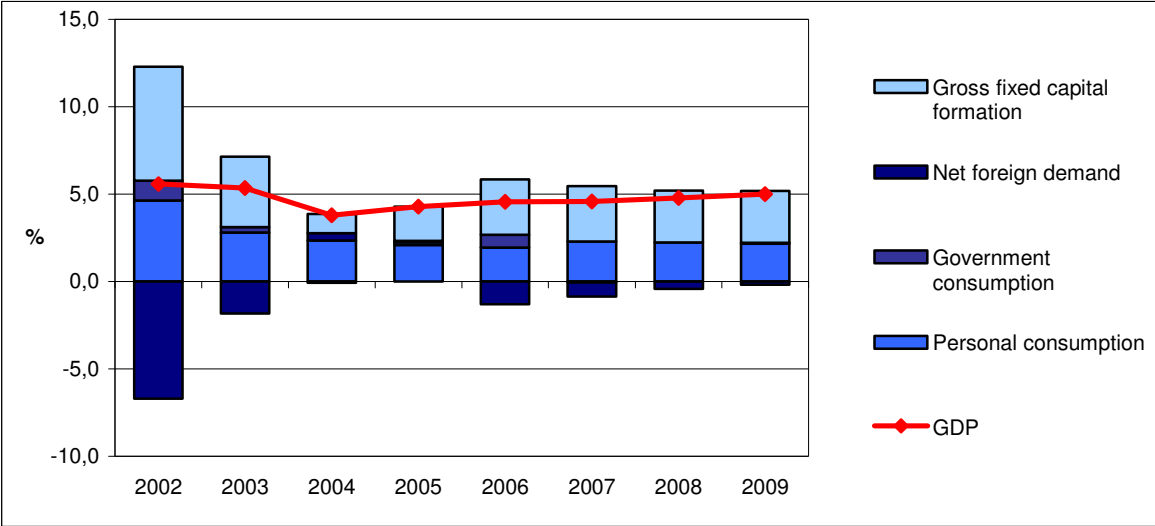
Recent indicators of personal consumption suggest its mild slowdown during the current year, but a recovery of its annual dynamics can be expected in the second half of the year. This is confirmed by the outturns for the first seven months and trend estimates for regular and irregular sources of financing in the rest of the year, according to which the real disposable income of households should rise by over 4.0% in 2006. The stated acceleration of personal consumption should also be observed in the next year, when the effect of government transfers (including pensioners' debt payments)² is expected to be most pronounced. However, in the second part of the projection period, as these effects wear off, personal consumption is

¹ The CBS data for 2004 and 2005 are preliminary and are based on quarterly GDP calculation estimates.

² The projection assumes continued growth of wage bill and transfers to households, which will be supported by the pensioners' debt payments. A total of HRK 1.2bn of these funds is scheduled to be used in the current year, HRK 2.4bn in the next year, HRK 1.9bn in 2008 and around HRK 700m in 2009. The strongest effects of the anticipated noticeable growth of disposable income of households, stimulated by the expansion of bank credit activity, should be observable in 2007.

expected to slow down (to 3.8% and 3.7% in 2008 and 2009 respectively), particularly in the latter year when wage bill is expected to grow at more moderate rates. Due an only slight slowdown in personal consumption, the contribution of personal consumption to GDP growth will remain stable throughout the projection period (the average annual contribution of personal consumption is estimated at 2.2 percentage points).

Figure 1 Contribution of Aggregate Demand Categories (in percentage points) to Real GDP growth



Source: CBS

According to the projections of real sector developments in 2006, real gross fixed capital formation is expected to accelerate strongly, mainly as a result of heightened investment activity in the private sector. However, the stated investment growth will be moderate during the second half of the year, thus influencing the total investment trend towards year-end. Thus, the projection forecasts a minor slowdown in gross fixed capital formation, from 8.4% in the second quarter to 8.3% in the third quarter, and a significant one (3.8%) in the fourth quarter. Such developments are partly due to the base period effects. In 2007, the real growth of gross fixed capital formation is expected to slowdown mildly. The sharpest decline is likely to be observed in the first quarter, owing to the high investment level achieved early in 2006. It is expected that the anticipated mild acceleration of investment growth in the remaining part of 2007 will again be subject to the private investment dynamics. A sharper increase in public investment (approximated by the general government capital expenditure) might be observed early in the year, but its trend for the entire 2007 will be stagnant. By contrast, investment growth is expected to accelerate during 2008 and 2009, in line with an anticipated improvement of the business and investment climate.³ Consequently, the contribution of this aggregate demand category in the medium term will markedly exceed its long term average and surpass the contributions of all other GDP components.

The government consumption projection is based on the nominal general government budget data, taking into account the differences between the new GFS methodology and the national

³ Given the anticipated stable economic growth of 4.6% in 2007 and its strong acceleration during 2008, this projection implies an assumed increase in overall production above the absorption capacity of the aggregate market in this period, which has an impact on the change in inventories. (Such developments may also be accounted for by more moderate price growth). In fact, in the final projection this gross capital formation category is therefore considered as residual.

accounts compilation according to ESA⁴ and incorporating the effects of the estimated trend in the number of public administration employees and of the anticipated consumer price dynamics. The number of public administration employees is expected to increase by some 1.0% in 2006, in parallel with more sizeable real growth of expenditures for the use of goods and services. This should result in a positive contribution of government consumption in the current year. Somewhat stronger government consumption growth over the second half of the year (4.2% and 7.3% in the third and last quarters respectively) is accounted for by a large increase in expenditures for the use of goods and services late in the year, as envisaged by the state budget plan, which is determined by the utilisation of pre-accession funds. Such developments will be accompanied by an only modest rise in compensation of employees. The number of public administration employees should remain stagnant in the coming years. Assuming this, and given the projected consumer price growth in the period, the contribution of government consumption to real GDP is expected to be neutral or only slightly positive in the period 2007-2009.

Foreign trade is expected to strengthen markedly over 2006 – it is estimated that the foreign trade dynamics was particularly high at the beginning of the year (goods and services exports were 14.0% larger in the first quarter relative to the same period last year, while goods and services imports grew at somewhat faster rates). A considerable slowdown in total exports in real terms recorded in the second quarter will continue into the third quarter at a rate of 1.5%, while exports are expected to grow at a rate of 10.0% toward the year-end. Imports of goods and services are expected to accelerate in the third quarter, while its considerable decline is expected in the last quarter. As a result, the negative contribution of net foreign demand for the entire 2006 will be -1.3 percentage points. In 2007, expansion of exports is expected to be accompanied by stagnation in goods and services imports. This should reduce the negative contribution of net foreign demand to GDP growth. However, the described imports dynamics should be stronger compared with those in the second half of 2006, which can be accounted for by the anticipated strengthening of personal consumption (these developments will partly reflect the anticipated impact of the pensioners' debt payments). The growth of foreign trade on account of further strengthening of the integration processes (the expansion of the Central European Free Trade zone (CEFTA) is expected by the end of 2007), productivity growth and the anticipated implementation of the Croatian export promotion project launched by the Ministry of Economy, Labour and Entrepreneurship, will further reduce the negative contribution of net foreign demand in 2008 and 2009.

Output (Sectoral Approach)

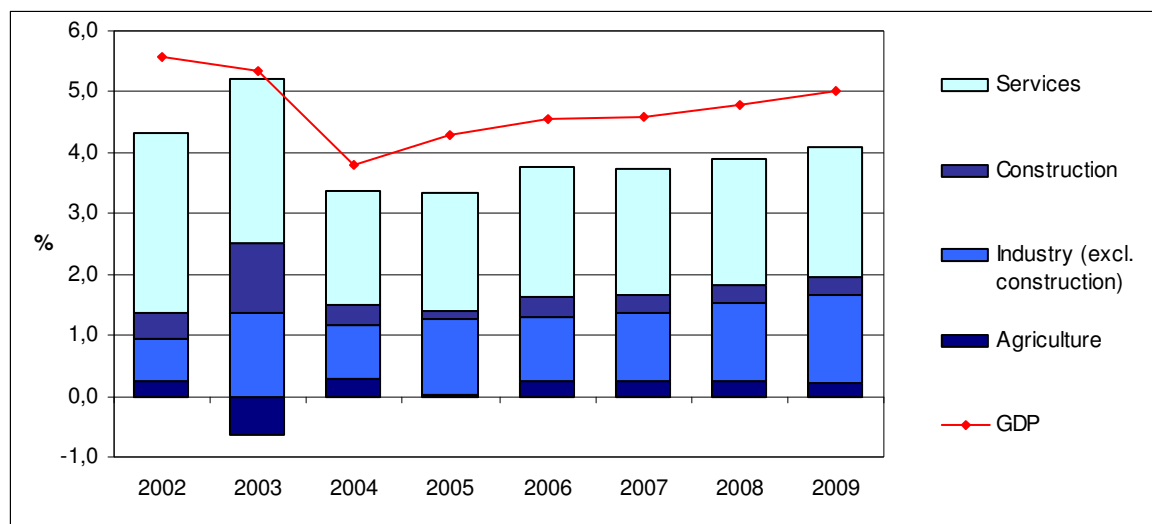
A medium term projection of gross value added (GVA) rests on the full compliance between GDP calculations according to the expenditure and the production method, i.e. it is assumed that there is no statistical discrepancy in the projection period. The projection is in line with the fiscal projection specified in the Guidelines. It envisages faster medium term growth of revenues from indirect taxes reduced by subsidies at current prices, which largely follows the projected economic growth. It is also assumed that the structure of the economy will not change significantly in the medium term. Industry and construction⁵ are expected to be the

⁴ The CBS estimate of nominal government consumption according to GDP calculations in 2004 and 2005 is about HRK 9bn larger relative to the compensation of employees in public administration (including severance pays) and expenditures for the use of goods and services. In the fiscal development projection, this amount serves as the adjustment factor (for the calculation according to the average difference for the previous two years). The stated adjustment generally reduces the volatility of the government consumption dynamics.

⁵ In 2006, all funds from the pre-accession ISPA programme, earmarked for infrastructural projects in transport and environmental protection (EUR 35m) were used up in full, with a view of providing medium term support to the

fastest-growing economic activities in the medium term, while gross value added in the services sector is expected to lag slightly behind the growth in these divisions. However, the services sector is still expected to be the largest contributor to overall economic growth. Moreover, 2006 and the coming years are expected to see the recovery of gross value added in agriculture, partly due to the utilization of the pre-accession SAPARD funds allocated for agriculture and rural development (under this programme, Croatia has been allocated EUR 25m, while domestic investors participate with 50% in the project financing).

Figure 2 Sectoral Contributions (in percentage points) to Real GDP Growth and GDP and GVA Growth



Source: CBS.

Employment, Unemployment and Wages

According to forecasts, labour market developments are going to be favourable throughout the projection period. Taking into account the preliminary nature of CBS employment data by activity,⁶ employment is expected to increase markedly as early as 2006. Given the growth of real net wages, this will also have a beneficial effect on personal consumption developments. It can be expected that the level of employment growth will remain below 2% in the period from 2006 to 2009. Assuming the continued convergence of Labour Force Survey and administrative unemployment rates, the latter rate may drop to 11.8% in the current year and continue to decline towards the end of the projection period, thus following the trends observed since early 2000. The projection implies a mild acceleration of real net wage growth in 2006 (however, at a slightly slower rate than specified in the Guidelines), which is likely to continue in the period ending 2009.⁷

reconstruction of railways, water supply systems, rehabilitation of waste dumping sites, etc. This relates primarily to local government projects.

⁶ Favourable labour market movements over the first half of 2006, primarily the sizeable employment growth, suggest an acceleration of the wage bill growth in the period. In estimating the current-year developments in the number of employees, the CBS data on employment by activity were revised (based on the official revisions made by the CBS for the previous two years), because the preliminary data underestimate the level of employment to a certain extent. This is corroborated by the data on insured persons with the CPIA, which are considered as a more reliable short term indicator of employment.

⁷ The developments in real net and gross wages, as well as implicit taxes and social contributions in the period from 2007 to 2009 are in line with the Guidelines.

2.2 INFLATION

The year-on-year consumer price inflation rate decelerated slightly from 3.6% in December 2005 to 3.4% in August 2006. The slowdown was mainly due to a decrease in the year-on-year core inflation rate (mostly caused by a drop in the year-on-year growth rate of meat prices and clothing and footwear prices) and to a smaller extent to a decrease in the year-on-year rate of change in administrative prices (mainly due to a slowdown in the year-on-year growth rate of refined petroleum products prices). In contrast, the year-on-year rate of change in agricultural products prices rose in the observed period.

Table 1 Consumer Price Index (average year-on-year rates of change)

	2005	2006	2007	2008	2009
CPI, 2005 PEP	3,3	3,2	2,8	2,6	-
CPI, 2006 PEP	3,3	3,5	3,2	2,8	2,6

Under the 2005 PEP, compiled in September 2005, the average year-on-year inflation rate was projected to drop to 3.2% in 2006 from 3.3% projected for 2005. However, consumer price growth in early 2006 was higher than projected as a result of a higher-than-expected rise in some administrative prices (primarily water supply and utility service prices). In addition, with the Ordinance on Packaging Waste Handling coming into effect in January 2006, some producers passed on additional expenses related to its implementation to consumers, which lead to an increase in the prices of alcoholic drinks, non-alcoholic beverages and milk, especially marked in the first quarter of 2006. Due to these developments, the average year-on-year consumer price inflation rate advanced to 3.5% in 2006, exceeding the rate projected under the previous PEP by 0.3 percentage points.

Table 2 Crude Oil Prices on the World Market (USD/barrel)

	2005	2006	2007	2008	2009
MMF. GAS August 2005	54,2	61,8	60,0	58,0	-
MMF. GAS August 2006	53,4	69,2	75,5	74,3	72,3

The CPI projection for 2007 was based on the assumption of a relatively stable kuna/euro exchange rate, slight appreciation of the kuna against the US dollar and a continued moderate nominal wage growth, not significantly exceeding domestic productivity growth, as all these factors facilitate maintaining a relatively low inflation rate. Due to the stabilising effect that a stable kuna/euro exchange rate has on inflationary expectations and the prices of consumer goods and raw materials imported from the eurozone, a stable kuna exchange rate policy will presumably remain the main anchor for inflationary expectations and import prices in 2008 and 2009.

It is possible that mild inflationary pressures may stem from an upturn in personal consumption growth in 2007 relative to 2006. However, it is also expected that administrative prices will slow down in the pre-election year of 2007. The entry of foreign chain stores (such as Lidl) will tighten competition in retail trade, which is likely to favourably affect inflationary trends. In addition, it is anticipated that world market crude oil prices will drop further. The inflation projection for 2007 was based on a forecasted increase in the average daily price of crude oil from USD 69.2 per barrel in 2006 to USD 75.5 per barrel in 2007, with the year-on-year price growth rate down to 9.1% in 2007 from 29.7% and 41.3% in 2006 and 2005 respectively. In addition, International Monetary Fund (IMF) analysts anticipate that

the prices of other raw materials on the world market will drop from 22.1% in 2006 to a low of -4.8% in 2007, with metal prices decreasing the most. Based on the above factors, the CNB projection indicates that the average year-on-year consumer price inflation rate will decrease from 3.5% in 2006 to 3.2% in 2007.

2.3 MONETARY AND EXCHANGE RATE POLICY

The main objective of monetary policy is to achieve and maintain price stability. In light of the openness of the country's economy, to achieve this objective the Croatian National Bank relies on its policy of exchange rate stability. It is a managed float regime which involves central bank interventions in the foreign exchange market to mitigate exchange rate volatility. Though no limits have been set for the exchange rate fluctuations, this policy has led to a very stable exchange rate of the domestic currency against the euro, ranging from +/-6% in the last ten year period, and low inflation. Such flexibility has forestalled exchange rate speculation. In addition to serving as a nominal anchor for import prices and inflationary expectations, exchange rate stability is also important in terms of financial stability, given the high level of euroisation of the Croatian economy. Despite domestic price stability in the past ten years, the Croatian citizens continue to save in foreign currency. Over 80% of deposits in Croatian banks are in foreign currency or are indexed to a foreign currency, mostly euro. To prevent their exposure to exchange rate risk, the Croatian banks grant foreign currency-indexed loans, shifting the exchange rate risk onto their debtors. Any considerable weakening of the exchange rate of the domestic currency could thus, through its effect on economic entities' balance sheets, negatively affect total economy, particularly the financial system. We find the existing managed float regime used by the CNB to achieve the stability of the exchange rate of the kuna through interventions in the foreign exchange market sustainable over long term and most appropriate for Croatia during the country's EU accession process and subsequent Economic and Monetary Union entry. This regime is also compliant with the ERM II requirements and calls for no changes.

On account of the country's EU approximation processes, i.e. real and nominal convergence, Croatia has witnessed large capital inflows in the past several years. Additional boost to capital inflows came from a number of European banks which, driven by low interest rates in the EU, shifted to the new fast-growing markets in the new Member States and candidate countries with higher interest rates. Early in 2000, the Croatian banking system came into the ownership of banks with registered offices in the EU. Since then, these banks have pursued a very aggressive credit policy in Croatia, financed by funds obtained abroad. Such capital inflows, coupled with appreciation pressures has led to current account deficit widening and fast external debt growth which stands at over 80% of GDP. The bulk of the credit activities is focused on the household sector and personal consumption and not investment that might facilitate future repayments. The central bank has been trying since 2004 to curb such activities through its instrument of the marginal reserve requirement that is calculated on any increase in foreign liabilities of banks. In 2005, the CNB raised its marginal reserve requirement rate on two occasions, first from 24% to 30% in March and then to 40% in June. In early 2006 the rate was further raised to 55%, but this time the central bank also decided to widen the requirement's calculation base. In 2006, the instrument of marginal reserve requirement underwent several modifications which were to prevent evasion of the existing measures by the banks. In addition to its measures aimed at restricting the growth of foreign sources, the central bank also responded to the fast bank credit growth with prudential measures which force the banks to improve their management of the risks associated with rapid credit expansion. Thus, in 2003, it introduced additional provisions for fast-growing banks. After several CNB warnings to the banks as regards the issue of currency-induced credit risk (credit risk arising from foreign currency or foreign currency-indexed bank loans to non-foreign currency income clients), since mid-2006, the central bank has increased capital adequacy risk weights associated with foreign currency loans to unhedged borrowers. In the context of its efforts to curb credit growth, the CNB encouraged banks to introduce a register

of credit obligations with a view to facilitating credit risk management. The increase in the rate of the marginal reserve requirement mentioned above (55%), together with the introduced prudential measures, should lead to a significant slowdown in the growth of domestic placements to other sectors which reached 22.2% year-on-year at end-August 2006. Domestic placements' growth is thus expected to stand at 17.9% in 2007, as financed from an increase in the domestic sources of funds. Placements' growth will nevertheless remain sufficient to accommodate domestic demand and continued accelerated economic growth. The central bank will continue to work towards preventing rapid external debt and domestic loans' growth and if necessary, it will stand ready to introduce any additional measures that might be needed to restrain their growth.

Large capital inflows from abroad create appreciation pressures. The central bank responds to such pressures by large foreign currency purchases. The main instrument of surplus liquidity sterilisation is the reserve requirement which is calculated at the rate of 17%. With the country's EU approximation, the central bank plans to lower gradually the rate of this requirement to facilitate future adjustment, i.e. the rate's reduction upon entry into the eurozone. As concerns liquidity fine tuning, the central bank uses open market operations in the form of regular weekly reverse repo auctions introduced in mid-2005. However, due to foreign ownership of the banking system and the role of the exchange rate, the CNB cannot use the interest rate corridor which is mainly influenced by the ECB interest rate.

2.4 EXTERNAL SECTOR

The balance of payments projection for the 2006-2009 period indicates a deterioration in the current account balance in the first two years, followed by its gradual improvement. Current account deficit in 2006 is estimated at 7.5% of GDP, an increase of 1.2 percentage points compared to the previous year, which can mostly be accounted for by unfavourable performance of foreign trade of goods in the first half of the year. The projected current account deficit growth in 2007 is largely influenced by strengthening of personal consumption, large investment activities, and consequently, imports growth. This could be followed by a gradual fall of deficit to 7.0% of projected GDP in 2009. The expected level of current account deficit in the projected period differs, to a great extent, from the one presented in the previous PEP, which is primarily a consequence of poorer results in 2005 and in the first half of 2006. At the same time, a slower deficit contraction is expected in the projected period due to a stronger domestic demand and a more pronounced strengthening of the economic activity relative to the expectations in the previous PEP version.

In the projected period, a gradual improvement of foreign trade imbalance is expected, as a result of a slower growth in both imports and exports. In addition, favourable developments in foreign trade in services, especially in tourism, are expected, as well as an improvement in the factor income account balance. Movements in the current transfers account could be largely influenced by the expected economic growth in the EU Member States.

Following an accelerated exports growth in 2006, which was primarily pronounced in the first half of the year, the following year could be marked by a somewhat slower, but still large exports growth. Such an expectation is based on the weakening of foreign demand in the EU Member States, where Croatia exports almost two-thirds of its products. In addition, the projected slowdown in the price of crude oil on the world market could mitigate an increase in the value of the exported oil and refined petroleum products, accounting for almost one-tenth of the Croatian goods exports. However, the factors which will effect positively movement in goods exports should be stressed at the same time. A further liberalisation of the foreign trade relations in the neighbouring countries is especially pronounced, as well as a more intense support to exporters provided by the Croatian Bank for Reconstruction and Development, activities of the Ministry of Economy, Labour and Entrepreneurship and Export and Investment Promotion Agency, which should result in an improved knowledge of exporters about exports conditions and access to the world markets.

In the projected period, goods imports will, to a large extent, be influenced by the expected movements in oil prices, which could contribute to a slowdown in the total goods imports. Nevertheless, the growth intensity will remain at a high level, mostly on account of a strong domestic demand and accelerated economic activity, which could be influenced, in particular, by a growth in personal consumption, as a result of pensioners' debt payments and the expected wage increase.

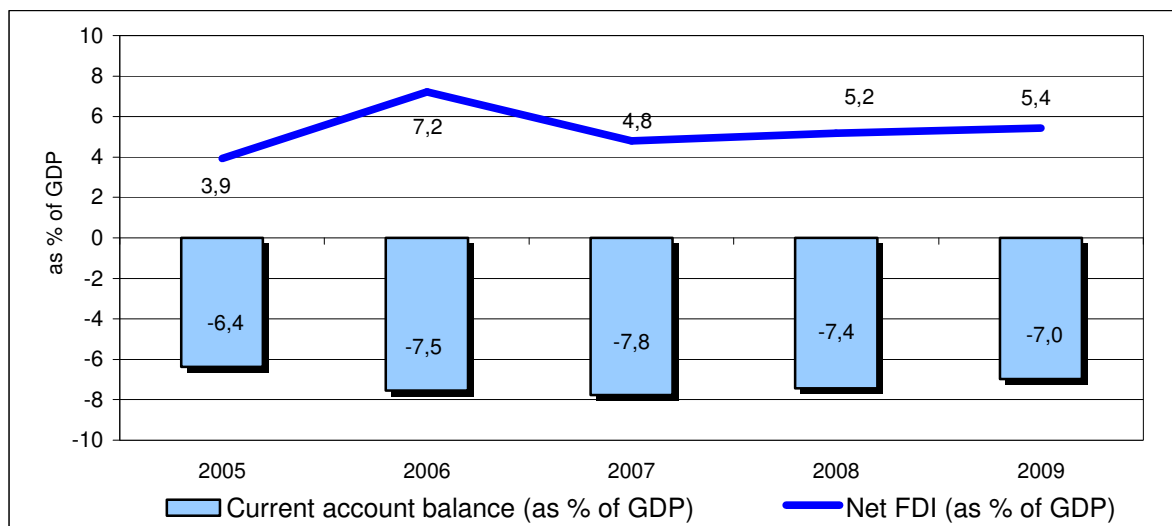
A stable net revenue growth is expected in foreign trade in services, especially in tourism. The expected rise in revenues from tourism is mostly based on the assumption of consumption growth due to a possible improvement in the tourist structure (tourists with a larger purchasing power) and/or an increase in prices of tourism services after investments in accommodation capacity and improvement in its quality. In addition, continued strong promotional activities abroad could have a favourable influence, which, along with the

stabilisation of the existing markets' performance, could also contribute to discovering of new markets.

The projected movements in the factor income account for the 2006-2009 period follow the projected interest payments on foreign liabilities, according to the data from the CNB's foreign credit relation register, as well as the projected CNB income based on investment of international reserves and the expected earnings of foreign investors. The expected deterioration in the factor income account for 2006 is primarily a result of an increase in retained earnings of foreign owners of domestic enterprises, which is recorded, for most of the reference enterprises, in the first half of the year. In the forthcoming years, an improvement in the factor income account is expected, as a consequence of smaller interest payments on foreign liabilities, due to a slower external debt growth, and a further increase in the CNB income based on investment of international reserves abroad. A slower growth in expenditures based on direct equity investments (dividends and retained earnings) could have a positive effect on the movements in the factor income account, on account of, among other things, CNB measures which could have a negative impact on the banks' performance and a strengthening of market competition in the telecommunications sector.

The projected decrease in net inflow in the current transfers account, in the 2006-2009 period, primarily reflects the expected further increase in government expenditure, especially on account of pensions paid abroad. Movements on the revenue side largely depend on the expected economic growth in the EU Member States, where a significant portion of total inflow in the current transfers account comes from.

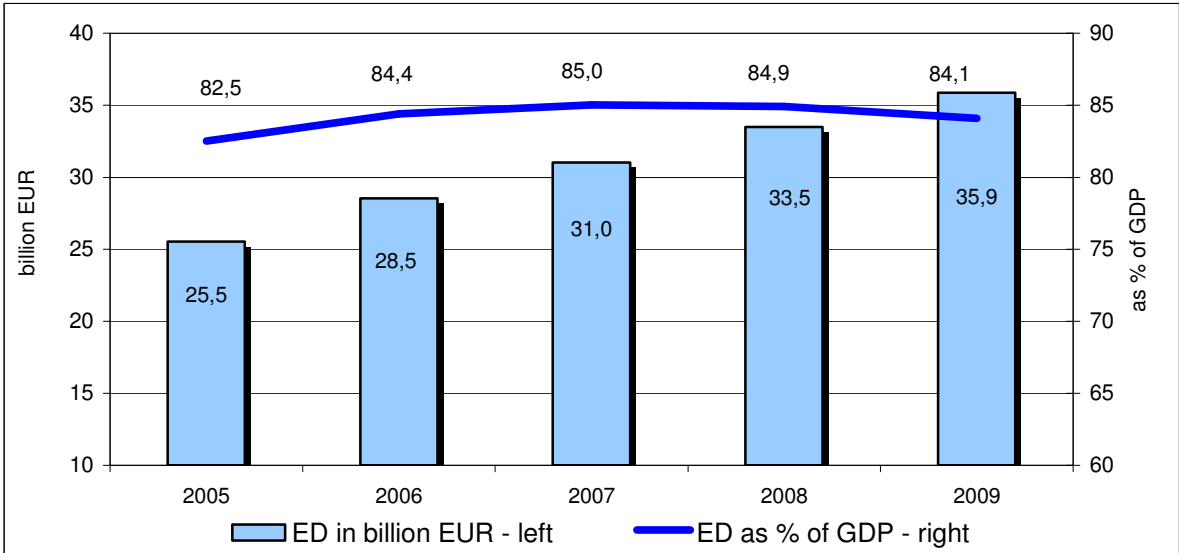
Figure 3 Current Account Balance and Net Foreign Direct Investment



According to the expectations, the balance of payment current account deficit in 2006 could be covered, to a large extent, by foreign direct investments, as a result of sizable inflows at the end of the year, arising from the takeover of the pharmaceutical company Pliva, recapitalisation of individual banks and a continued privatisation of oil company INA. Regardless of the fact that no significant privatisation projects are foreseen in the forthcoming years, the Republic of Croatia's progress in the harmonisation of legislation with the EU *acquis* is expected to influence positively the inflow of foreign investments. In addition, a more developed infrastructure, relatively more qualified workforce and favourable geographic position of Croatia, as well as the activities of the Export and Investment Promotion Agency,

aimed at providing services to foreign investors in the realisation of their projects, will also have a positive impact. Along with a further large capital inflow, the current projections also anticipate a further growth in the CNB international reserves, which could, in the projected period, suffice for more than 5 months of imports of goods and services and cover a double amount of the projected short term debt (assuming a stable share of short term debt in total external debt).

Figure 4 External Debt of the Republic of Croatia



As regards the external debt projection, a slower external debt growth is expected in the 2006-2009 period, relative to the results in the past three years, so that the annual growth rate of external debt could gradually be reduced from 11.7% in 2006 to 7.1% in 2009. Along with a slower growth of external debt, curbing of a deterioration of external debt to GDP ratio and its stagnation can be expected. A reduction in external debt of the government sector by the expected EUR 1.2bn in the said period, will contribute most to a slowdown of external debt growth, which is in accordance with the government strategy to rely primarily on domestic sources of financing, contributing thus to a deceleration of the total external debt growth. In addition to the usual settlement of liabilities to the London Club (only on the basis of Series A Bonds, since the liabilities arising from Series B Bonds have been fully repaid in the year 2006), Samurai bonds worth JPY 40bn fall due in 2007, Samurai bonds worth JPY 25bn mature in 2008, while Samurai bonds worth 25bn and eurobonds worth EUR 500m fall due in 2009. Furthermore, monetary policy measures, which make external borrowing of banks, for the purpose of credit activity financing, more expensive, will contribute to a slower growth of total external debt.

On the other hand, enterprises are expected to make the largest contribution to the debt growth in the forthcoming years, together with investment in enterprises. More specifically, under the influence of more strict CNB measures and a slower growth in bank placements, enterprises are expected to continue relying, to great extent, on foreign sources of financing. Nevertheless, the growth in their foreign liabilities is not expected to be as pronounced as in 2006, since many large enterprises, which have easier access to foreign capital markets have already borrowed abroad to a large extent. Therefore, the same pace of external borrowing, as the one estimated for 2006, is not likely to be maintained. Furthermore, a strengthening of the domestic capital market can also be expected, as a result of which a number of enterprises

could also turn to domestic non-bank sources of financing. In view of a further interest rate increase abroad, a narrowing difference between interest rates at which enterprises can borrow abroad and in the country can also be expected, which diminishes profitability of external borrowing. A strong competition in the banking sector and a fight for market shares and strong positioning of banks will effect considerably the domestic interest rate movements.

3 PUBLIC FINANCE

3.1 MEDIUM TERM FISCAL FRAMEWORK

In August of 2006 the Government of the Republic of Croatia adopted the Economic and Fiscal Policy Guidelines for 2007-2009 which defines main objectives, priorities and direction of the fiscal policy and which will contribute to assurance of the macroeconomic stability and to long term sustainable rates of growth. The main objective of the fiscal policy in the medium term will be the continuing process of fiscal consolidation and the reduction of the external imbalances. Reform aiming at rationalization and better spending targeting as well as the simplification of the tax system and enhancement of the tax collection process are set as high priority issues.

In coming years, special attention will be devoted to the reform of the education system and science with the aim to achieve better coordination of the education system and labour markets. Restructuring and privatization of the state owned companies, which generate losses, especially in sectors of shipbuilding and ferrous metallurgy, will contribute to more efficient use of budget resources in continuing regional development and capital investments. The important objective will also be the continuing process of systematic reduction in subsidies to enterprises which will contribute to the freedom of market competition and to enhancement of entrepreneurship. Also, full scale reforms will be conducted in the health sector with the goal to improve the fiscal discipline, and also in social care with the goal to enable better targeting to socially most sensitive groups of citizens. It is also planned to continue with development of the effective and fiscally acceptable public administration in line with best practice of the EU. Further reform of judiciary will contribute to more effective functioning of the legal system, which also will create positive environment for investment activities. The enhancement of measures of the population and family policies as integral parts of an overall development policy and policy of long term sustainability of the socio-economic development is marked as important Government objective. It is also worth to mention that in period of next ten years, expenditure side of the budget will substantially be affected with planned projects of equipping and modernization of Arm forces of the Republic of Croatia, which is a prerequisite of reaching the standards of NATO.

In the context of afore mentioned medium term objectives, the Government of the Republic of Croatia is determined in consistent performance of the fiscal consolidation namely in reduction of the general government deficit from 3.0% of GDP in 2006 to 2.8% of GDP in 2007, 2.6% of GDP in 2008 and to 2.4% of GDP in 2009.⁸ Alternatively presented according to ESA 95 methodology, which is used to present public finances in this PEP, the level of net lending/net borrowing will be reduced from 2.2% of GDP in 2006 to 1.5% of GDP in 2009. This reduction will contribute to the reduction of still very important role of government in the economy and to creation of more favourable conditions for private investments which have to become the main factor of economic growth.

In the same time, further reduction of public debt is envisaged, namely from 47.6% of GDP in 2006 to 43.4% of GDP in 2009. Also, it is worth to mention that it will be continued with decisive measures aiming at the improvement of public debt management, especially in the area of securing permanent software solutions for debt management and electronic system for

⁸ According to modified accrual principle best known to the general public in Croatia, which in its essence is the deficit according to GFS 1986 methodology with elaboration of some revenue and expenditure categories according to accrual system of accounting. Such level of deficit is much wider in coverage than deficit according to ESA 95.

treasury bills auctions. On the other hand, government will continue to meet its financing needs primarily on domestic market, which, together with the reduction of the fiscal deficit, will contribute to a reduction of external debt.

The Use of ESA 95 Methodology

This year PEP is the first Croatian PEP using ESA 95 methodology. Up to now, it was not possible to construct public finance statistics according to ESA 95 due to fact that this methodology was not implemented in our system. It is worth to mention that the first step towards the implementation of ESA 95 was taken within the CARDS 2003, when transfer tables between the National chart of accounts and ESA 95 methodology were constructed. These transfer tables were used as a basis for 2006 Fiscal notification and as an input for the CARDS 2003 twinning project on Public finance statistics. The main objective of this project is development of data bases according to ESA 95 methodology which will enable the comparison of the public finance statistics with other countries and definition of sectors according to ESA 95 principles. In other words, the final goal of this project is full implementation of ESA 95 methodology. It is envisaged that the project will be finished by the end of 2007. However, in this moment there are already certain results, which are primarily the result of the hard work of the staff of the Ministry of finance, based on which we use ESA 95 methodology for the first time to present public finance in the medium term.

The data for the consolidated general government refer to cash principle of accounting except for transactions of Croatian motorways and Croatian Roads which are presented according to accrual principle. Also, it is worth to say that modifications to accrual were done for certain budgetary categories wherever it was possible.

Budget Management

Anticipation and control of the future spending is one of base instruments in the improvement of the process of budget preparation, and also an important instrument for maintaining and the reduction of the level of public expenditure in the envisaged macroeconomic framework. To achieve this, it was crucial to secure, already in faze of drafting of legal proposals, the projection of financial impact of their implementation to the state and other budgets. Namely, central bodies of the state administration and technical services of Government are required to present the Statement on projection of the impact of legal proposals on state budget, budget of Local and Regional Self-government Units as well as on the number of civil servants and employees when they present their proposals of regulations and other legal proposals which are adopted by the Government of the Republic of Croatia. To speed up and to facilitate the production and control of the Forms of standard methodology for projection of financial impacts, during 2006 the web application was developed for the import of data concerning the projection of financial impacts. The use of this application is envisaged to start as of the beginning of 2007 which will enable a more transparent linkage between the financial impact of legal proposals, state budget and medium term framework.

As of 1 January 2006, the coverage of the Single Treasury Account was expanded to incorporate road charges of Croatian motorways and Croatian roads. Additional accounts of the majority of ministries and other public administration bodies were closed by June of 2006, while for the other budgetary users those will be closed until 1 January 2007. The implementation of the Single Treasury Account did not present the loss of autonomy in use of resources for the budgetary users given they still manage their revenues and expenditures with the aim to conduct planned programs. With the implementation of the Single Treasury

Account, the intention is to achieve the rationalization of use of public resources and it does not represent the loss of rights to manage budgetary resources which is the autonomous right of budget users defined by the budget. Since the beginning of the following year, the novelty is the full incorporation of the social security funds⁹ in the state budget which will contribute to an increased transparency and better control of the budget execution.

The state budget for 2006 is of expanded coverage. The budget incorporates the lottery revenues, road charges, own revenues of budgetary users, revenues under the special regulations (administrative taxes and other earmarked revenues), EU grants. Explanations according to programs – activities/projects of the ministries were compiled as supplements to the budget presented to the Parliament, for the purpose of better understanding and clearer picture of goals and purpose of certain programs and work of the ministries. The control of collection and the use of earmarked revenues are established. These activities will also continue in 2007.

With the aim to upgrading the State Treasury, project documentation is completed for development of the integrated accounting-financial system. After the implementation of this system the Treasury will (during 2007 and 2008) move to the highest development level of the accounting systems and will have complete access to data on due commitments and maturities. Currently, commitments of the budgetary users are not monitored within the system but in form of reports based on prescribed monthly reports on commitments. Prior to the definition of the final solution for the integrated accounting-financial system series of analysis were performed of which most important being “Study of rationalization”. Financial and informational systems of the ministries were analyzed and the basis for their incorporation in a unique system was defined.

Functionally independent units for internal audit were established in each ministry and in other budgetary users as well as in the City of Zagreb. Financial management and control is being implemented in each organizational unit and in all levels of budgetary users covering all budgetary resources including EU funds and others. The Ministry of finance, with its Central Harmonization Unit (CHU), has developed a system of education and certification of internal auditors in public sector, and has set the basis for the development of the educational system for financial control and management.

Tax Policy

In the following medium term period, initiated process of tax policy adjustment with EU directives will continue, especially in tax laws. The process will focus on simplifying tax system and reducing relatively high tax burden. This will have a positive impact on the investment growth and will intensify the economic activity.

Since 1 January 2006 the Financial Police started to be operational. The main objective of the Financial Police is financial supervision in order to strengthen the financial discipline of budget users, restrain unofficial economy, and disenable tax evasion. Also, efforts have been made on improvements in tax revenue collection, especially VAT, where the branch offices for large taxpayers continue with enhanced control.

With the aim of more evenly distributed tax revenues among counties, communities and cities the new Act on Financing of Local and Regional Self-government Units is adopted. With this

⁹ Croatian Institute for Pension Insurance (HZMO), Croatian Health Insurance Institute (HZZO) and Croatian Employment Service (HZZ).

new act the total amount of corporate income tax will become the revenue of the state budget, while the personal income tax will be the compensation to local and regional self-government units for corporate income tax. The change in the Act is being carried out given the fact of concentration of corporate income tax in company headquarters originating from Act on Corporate Income Tax, and consequently a problem in allocation of this tax revenue between the local and regional self-government units. With changes to the Act the fairer, more efficient and more transparent system of financing local and regional self-government units is accomplished and it is focused on more equal development of Croatian regions.

The amendments to the Act on Excise Taxes on oil derivatives are also in preparation. With these amendments the main goal is to restrain exploitation of blue diesel for unintended purposes, and to stop the outflow of funds from the state budget. With this Act the intention is to stop illegitimate use of blue diesel and all other form of criminal act, or at least reduce it to a minimum. There will be a sanction for all legal and private persons, sellers, who sell blue diesel above approved amount registered in brochure for oil. The maximum of total amount of oil for individual category of blue diesel users is provided by the Government of Republic of Croatia for current year.

Revenues of the Consolidated General Government

The projection of total consolidated general government revenue for the period 2007-2009 is based on projection of previously described macroeconomic variables and expected trends of certain revenue categories in 2006. Namely, in comparison with the budget plan for 2006, it is expected that revenues will be higher than planned and total revenues of general government budget will be around 45% of GDP in 2006. The main reason for that assumption is better collection of personal income tax, corporate income tax, VAT, excises and social contributions than expected. The property income will be a bit smaller than planned. Total revenue projection for 2007 will be around 44.8% GDP, while in 2008 and in 2009 this percentage will be 44% of GDP and 43.3% of GDP respectively. The main contribution to the revenue collection will arise from real GDP growth, as well as the measures focused on strengthening tax administration and more efficient collection of tax revenues.

Among the most significant items of total general government revenues, the most important is VAT revenue which is planned at the level of 14.0% of GDP in 2007 and 13.6% of GDP in 2009.

Total social contributions will keep the level of 13.5% of GDP till 2009, primarily due to nominal growth of gross wages and growth of number of employees. However, taking in consideration specific developments in individual items of social contributions which are present in the last few years, the different rates of growth of certain social contributions are projected. Such as, pension insurance contribution rate of growth is lower than health care contributions rate of growth. The reason for that is in the fact that health care contribution is completely the revenue of the state budget, while the pension insurance contribution is only partly state budget revenue, and these revenues partly outflow to the private sector, namely to the second pillar of pension insurance. Additionally, the number of people who pay only the first pillar of pension insurance is gradually decreasing, and the number of people who pay the first and the second pillar of pension insurance increases. Due to explained, we expect slightly lower rates of growth of pension insurance contribution in the future.

Income tax revenue will be at the level of 3.3% of GDP in the observed three years period, which is in accordance with the nominal growth of gross wages and growth of employees. Corporate tax revenue will be at the level of 2.9% of GDP till 2009, and these revenues are projected primarily with respect to the economic activity growth.

Taxes on international trade will record an average annual reduction of 3.2% of GDP in period 2007-2009 in accordance with adjustment of custom laws and further liberalization. Taxes on international trade and transactions are planned at the level of 0.6% of GDP in 2007 and 0.5% of GDP in 2009.

Taking into consideration the projected GDP growth and a reduction of the size of the unofficial economy, excise tax revenues will be around 4.5% of GDP in 2007 and 4.2% of GDP in 2009. The excise taxes on oil and oil derivatives, excise taxes on tobacco products and excise taxes on cars, other motor vehicles, boats and airplanes have major contribution in total amount of excise tax revenues. It is important to mention that road charges are included in the amount of excises.

Property income is projected at the level of 0.5% of GDP for 2007 and 0.4% of GDP in 2009.

Expenditures of the Consolidated General Government

Fiscal consolidation on the expenditure side in medium term is planned to be continued. It will be conducted with better control of total expenditures and further implementation of structural reforms aimed at savings and achieving more efficiency in spending. The trend of expenditures in medium term is determined with achieving of major goals such as stimulating entrepreneurship, education, protection of social sensitive social groups respecting the sustainable growth and development. Therefore, total expenditures of consolidated general government are estimated to decrease from 47.2% in 2006 to 46.6% in 2007 and finally 44.7% in 2009.

Within the structure of the total expenditures of the consolidated general government, the largest share refers to social benefits. Their share in GDP will show a decreasing trend from 15.1% in 2006 and 14.8% in 2007 to 14.3% in 2009. Pensions and health care represent the largest component of above mentioned expenditures and their dynamics will be defined by further conducting of structural reforms with maintaining of all rights in the same time.

The compensation of employees accounts for 11.4% of GDP in 2006 which is expected to decrease in medium term to 11.2% in 2007 and 10.8% in 2009.

Third place in the total expenditure structure is reserved for intermediary consumption. This category mostly refers to expenditures for use of goods and services. The trend of above mentioned expenditures will be partly determined with usage of pre-accession funds of the EU. By the end of 2006 they are projected on the level of 5.5% of GDP, while in the medium term slight decrease is expected which will result with their level of 5.4% of GDP in 2009.

Subsidies will stay on the same level in 2006 as the year earlier; in other words they will represent 2.6% of GDP. Never the less, in medium term subsidies will decrease from 2.5% to 2.3% primarily as a result of restructuring of Croatian Railways, privatization of its daughter companies and lowering of subsidies to this company.

Expenditures for property income which mostly refer to interests and amounts to 2% of GDP in the medium term, will be determined by the dynamics of debt incurrence in the recent years.

Other current transfers will amount to 1.6% of GDP in the medium term. This expenditure category consists mostly of current grants and current donations. Capital transfers are projected at the level of 2.4% of GDP in medium term and refer mostly to capital donations.

Gross capital formation expenditure will decrease in the medium term on the level of 3.2% of GDP. This category represents net expenditures for acquisition of fixed assets, inventories and valuables. Graduated decrease of above mentioned expenditures in GDP will primarily be determined by dynamics of construction of roads and motorways in the medium term.

Social transfers in kind will stay at the level of 2.8% of GDP in the medium term. This category of expenditures refers mostly to social security benefits in kind.

Table 3 Revenues, Expenditures and Net Lending/Net Borrowing of the General Government 2007-2009

ESA 95	% of GDP	2005	Projection 2006	Projection 2007	Projection 2008	Projection 2009
TR	Total revenue	45,0	45,0	44,8	44,0	43,3
	Main components of total revenue:					
P.1	Output	3,8	3,7	4,0	3,7	3,6
D.211	Value-added tax	14,1	14,2	14,0	13,9	13,6
D.61R	Social contributions, receivable	13,9	13,8	13,6	13,6	13,5
D.5R	Current taxes on income, wealth etc., receivable	6,1	6,7	6,5	6,5	6,5
D.212	Taxes and duties on imports excluding VAT	0,7	0,6	0,6	0,5	0,5
	Taxes on products, except VAT and import					
D.214	taxes	5,3	5,0	5,1	4,9	4,8
D.214a	- of which: excises	4,8	4,7	4,5	4,4	4,2
D.4R	Property income, receivable	0,9	0,6	0,5	0,4	0,4
TE	Total expenditure	47,9	47,2	46,6	45,7	44,7
	Main components of total expenditure:					
P.2	Intermediate consumption	4,9	5,5	5,6	5,5	5,4
D1.P	Compensation of employees	11,7	11,4	11,2	11,1	10,8
D.3P	Subsidies, payable	2,6	2,6	2,5	2,4	2,3
D.4P	Property income, payable	2,2	2,2	2,1	2,0	1,9
	Social benefits other than social transfers in					
D.62P	kind, payable	15,4	15,1	14,8	14,5	14,3
D.631	Social transfers in kind	3,2	3,0	2,8	2,8	2,7
D.7P	Other current transfers, payable	1,6	1,7	1,6	1,7	1,6
D.9P	Capital transfers, payable	2,2	2,1	2,3	2,4	2,6
P.5	Gross capital formation	3,9	3,4	3,5	3,2	3,0
B.9	Net lending/net borrowing	-2,9	-2,2	-1,8	-1,7	-1,5

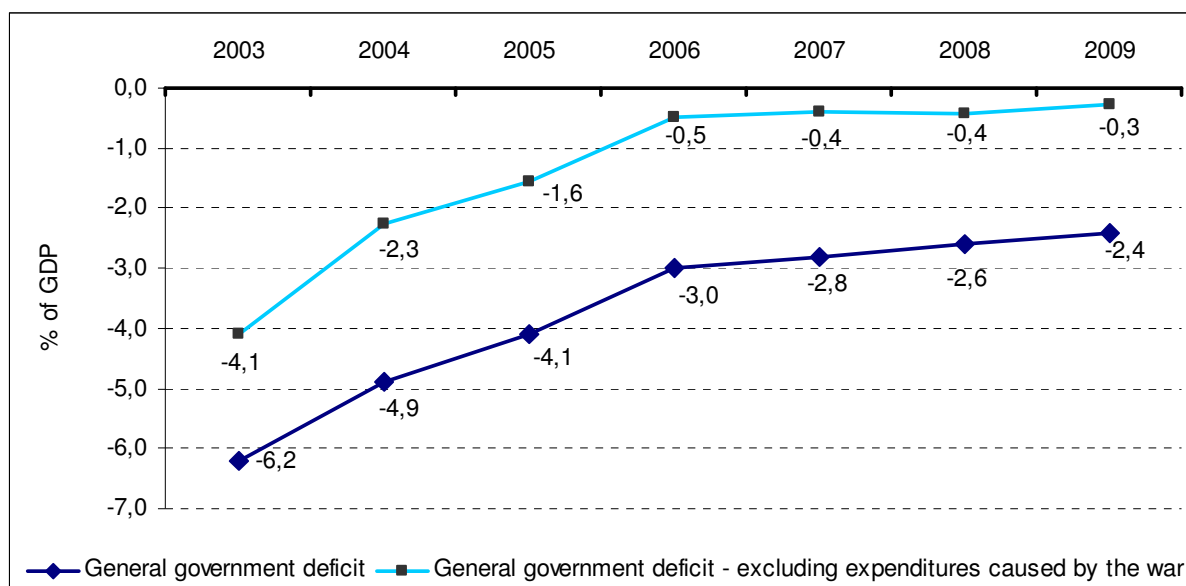
Expenditures – War Effects

Expenditures which are caused by war are projected at the level of 2.2% of GDP for period 2007-2009. In 2006 they will keep the same level as in 2005 (2.5% of GDP) while they are expected to decrease slightly to 2.1% of GDP in 2009. Indirect expenditures caused by war present significantly larger part (four fifth of total expenditures caused by war) than direct expenditures. In medium term decrease of direct expenditures is expected due to ending of process of renovation and rebuilding of houses and other objects damaged during the war.

In this chapter, expenditures caused by war are specially emphasized because those are specific expenditures not known to other European economies and because these expenditures are unavoidable and represent major fiscal burden for many years ahead. Successful fiscal consolidation which is being conducted continuously since 2004 and which decreased deficit from the level of 6.2% of GDP (measured by GFS methodology) in 2003 to the level of 3.0% in 2006 has even greater significance considering mentioned expenditures caused by war. On

the following diagram decrease in fiscal deficit in period 2003 – 2006 can be observed in comparison with deficits excluding effects of expenditures caused by war.

Figure 5 Fiscal Deficits and Expenditures – War Effects



Net Lending/Net Borrowing

In 2007-2009 period, the reduction of net lending/net borrowing, namely net borrowing of the general government, is envisaged from 1.8% of GDP in 2007 to 1,5% of GDP in 2009, while for 2006 the level of 2,2% of GDP is expected. Observed according the levels of government, the largest share in total planned net borrowing in the medium term will be that of the budgetary central government, which will record the reduction of its net borrowing from 1.2% of GDP in 2007 to the level of 1.0% of GDP in 2009. With the share in total net borrowing, extrabudgetary funds follow. They will record a reduction of their net borrowing from 0.5% of GDP in 2007 to 0.3% of GDP in 2009 primarily under the influence of the dynamics of the motorways and roads construction envisaged in the medium term. The smallest share in total net borrowing of the general government in the medium term will be that of local governments which will keep their net borrowing at 0.1% of GDP in the medium term.

Described gradual fiscal consolidation, which will take place in the medium term, can be characterized as a relatively conservative one. The reason for the more conservative reduction of the fiscal deficit lies in the fact that certain reserves are taken into account regarding the costs in the following years associated with the process of joining the EU and the NATO. With further success in conducting of key structural reforms, efficient expenditure control and even better revenue collection it is realistic to expect even stronger fiscal consolidation to take place in the medium term which could additionally bring the level of net lending/net borrowing of the consolidated general government to the level as low as 0.6% of GDP. According to GFS methodology this transposes to reaching the deficit of 1.5% of GDP in 2009.

Table 4 Revenues, Expenditures and Net Lending/Borrowing of the General Government 2007-2009 According to Government Level

ESA 95	% of GDP	2005	Projection 2006	Projection 2007	Projection 2008	Projection 2009
Budgetary central government - unconsolidated						
TR	Total revenue	37,8	38,9	38,6	38,1	37,5
TE	Total expenditure	39,4	40,1	39,8	39,1	38,5
B.9	Net lending/net borrowing	-1,6	-1,2	-1,2	-1,1	-1,0
Extrabudgetary funds - unconsolidated						
TR	Total revenue	2,8	3,1	3,2	2,9	2,8
TE	Total expenditure	4,1	4,0	3,7	3,5	3,1
B.9	Net lending/net borrowing	-1,2	-0,8	-0,5	-0,6	-0,3
Local government - unconsolidated						
TR	Total revenue	5,3	5,2	5,1	5,0	4,9
TE	Total expenditure	5,3	5,3	5,1	5,1	5,1
B.9	Net lending/net borrowing	0,0	-0,1	-0,1	-0,1	-0,1
Consolidated general government						
TR	Total revenue	45,0	45,0	44,8	44,0	43,3
TE	Total expenditure	47,9	47,2	46,6	45,7	44,7
B.9	Net lending/net borrowing	-2,9	-2,2	-1,8	-1,7	-1,5

Note on Projection of Cyclically Adjusted Primary Deficit

For the calculation of cyclically adjusted primary consolidated general government deficit in the period from year 1995 to 2009 the method of European Central Bank¹⁰ has been used. In doing so, it was assumed that cyclically sensitive elements of state budget are on the side of revenues: personal income tax, corporate income tax, VAT, excises, social security contributions and on the expenditure side: unemployment allowances. Adequate macroeconomic bases are: the mass of wages for personal income tax and social security contributions, gross operating surplus for corporate income tax, personal consumption for VAT and excises and number of unemployed for unemployment allowances. It should also be mentioned that all fiscal indicators were used in calculation according to GFS methodology.

Elasticity of cyclically sensitive elements of budget to their macroeconomic base is calculated by estimation of error correction model with quarterly data¹¹ where integration order for all variables was previously determined. In order to determine the gap between potential and realized values of macroeconomic bases and GDP gap, potential values were calculated by implementation of Hodrick-Prescott filter which smoothing parameter λ amounted to 300.

Quarterly data for the period from third quarter 2006 to the fourth quarter 2009 was obtained on the bases of projections published in "Economic and Fiscal Policy Guidelines for the Period from year 2007 to 2009". Projections of primary deficit developments are based on the assumption that the share of interest rates expenditures on the level of general government will remain constant in the observed period and they will amount to 2.2% of GDP in each year of observed period.

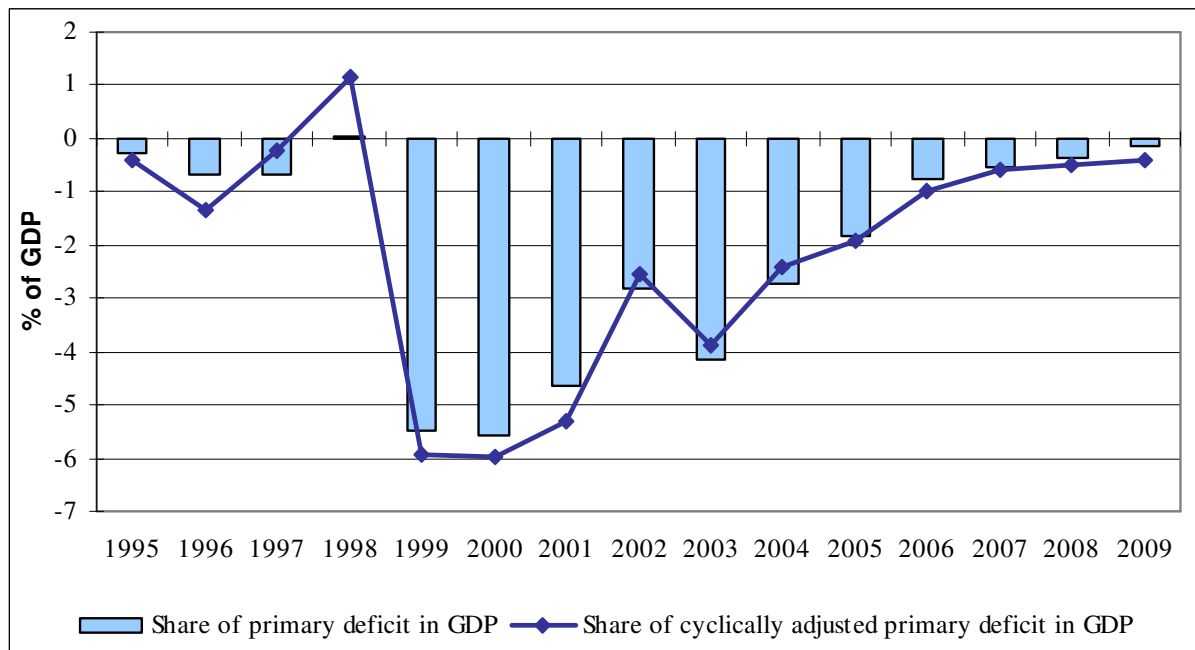
The results of calculation indicate that since year 2003 when structural primary deficit amounted to -3.89% of GDP, constant decline has been recorded which should be continued till the year 2009. Thus, in year 2006 structural primary deficit should amount to 1.0% of GDP, in year 2007 to 0.60% and in year 2008 to 0.48% while its' share should decrease to 0.42% of GDP in year 2009 according to the applied methodology and projections. Fiscal policy in the period from year 2006 to 2009 is moderately expansive and in the same time anti cyclical. Namely, this period is characterized by underemployment of economy measured by GDP gap (where GDP gap is calculated as deviation of potential GDP value from real GDP

¹⁰ Bouthevillain et al., 2001, "Cyclically Adjusted Budget Balances: An Alternative Approach", Working paper No. 77, European Central Bank.

¹¹ From the first quarter of year 1995 to the second quarter of year 2006

value). On the other side, in the period from year 1996 to 2003 fluctuations of economic cycle are more pronounced and fiscal policy is, with exception of year 2001, pro cyclical.

Figure 6 Primary Deficit and Cyclically Adjusted Primary Deficit in the Period 1995-2009



Comparison of 2005 PEP and 2006 PEP

The following table shows GDP levels of total revenues, expenditures and net lending/net borrowing according to ESA 95 methodology for the consolidated general government. As previously explained, during the time of finalizing the 2005 PEP it was not possible to present public finance statistics in accordance with the ESA 95 methodology of the EU and hence for the purpose of that document, GFS 2001 methodology of the IMF was used. GFS 2001 methodology of the IMF is in use for public finance statistics in the Republic of Croatia since mid 2004. Since that time monthly and annual publications of the Ministry of finance and longer time series data available on the internet are being developed, published and presented. However, although the 2005 PEP could not meet the requirement to use ESA 95 methodology for public finance statistics, the use of GFS 2001 enabled good preparation, and in the same time good level of comparability with the presentation of the public finance statistics in 2006 PEP which uses ESA 95 methodology.

The table provides the information on the shares of revenues, expenditures and net lending/net borrowing of the consolidated general government in GDP and elaborates differences in those levels comparing 2005 PEP and 2006 PEP for same years observed. It can be seen that there are quite significant differences in shares of GDP for all of presented categories in 2005-2008 period. These differences are the result of several important reasons which are explained further on.

Table 5 Comparison of Revenues, Expenditures and Net Lending/Net Borrowing of the General Government for Period 2005-2008, According to 2005 PEP and 2006 PEP

	2005	Projection 2006	Projection 2007	Projection 2008	Projection 2009
PEP 2006 - 2008 (% of GDP)					
Total revenue	46,1	45,9	44,9	44,2	
Total expenditure	49,2	48,3	47,1	46,1	
Net lending/net borrowing	-3,1	-2,4	-2,2	-1,9	
PEP 2007 - 2009 (% of GDP)					
Total revenue	45,0	45,0	44,8	44,0	43,3
Total expenditure	47,9	47,2	46,6	45,7	44,7
Net lending/net borrowing	-2,9	-2,2	-1,8	-1,7	-1,5
Difference: PEP 2007-2009 and 2006-2008 (percentage points)					
Total revenue	-1,1	-0,9	-0,1	-0,2	
Explained by:					
Revision of GDP	-1,3	-1,6	-1,9	-2,1	
Difference due to final outturn of 2005	0,1	0,1			
Difference due to projection for 2006		0,6	0,7	0,7	
Increase in coverage of the single treasury account			0,1	0,1	
Difference due to change in assumptions of main macroeconomic indicators			1,0	1,1	
Total expenditure	-1,4	-1,1	-0,5	-0,4	
Explained by:					
Revision of GDP	-1,4	-1,7	-2,0	-2,2	
Difference due to final outturn of 2005	0,0	0,0			
Difference due to projection for 2006		0,5	0,5	0,5	
Increase in coverage of the single treasury account			0,1	0,1	
Difference due to change in assumptions of main macroeconomic indicators			0,8	1,1	
Net lending/net borrowing	0,2	0,2	0,4	0,2	

During last year, namely since the finalization of the 2005 PEP till now, a revision of the nominal GDP for 2002 and consequently for years that follow took place. Correction of the nominal GDP can be characterized as the most influencing factor and in the same time the only one affecting the reduction of presented levels (revenues, expenditures and net lending/net borrowing) expressed as a percentage of GDP.

Also, a number of factors influenced to the increase of the share of observed categories expressed as percentage of GDP. In last year PEP, year 2005 represented a projection at that time while the final figures showed somewhat higher level of both revenues and expenditures than those projected at that time. The effect of higher revenues and expenditures is carried on to years that follow due to base effect. Also, year 2006 is characterized with much better general government revenue collection than originally planned so that in mid 2006 supplementary budgets of budgetary central government and extrabudgetary funds were passed. With these supplementary budgets the overall expected level of revenues was increased while in the same time expenditures were increased by only a half of the increased revenues resulting with stronger fiscal consolidation than originally planned. Exceptionally good revenue collection continued throughout the year and hence the new projection for 2006 was made and included in this document. These differences, namely the increase in revenues and expenditures in 2006 also affect the levels of both revenues and expenditures in following years due to base effects.

Further, since 1 January of 2007 the revenue side incorporates part of revenues of budgetary users which in previous years were out of scope of the Single Treasury Account while expenditure side incorporates expenditures in the same amount for which the abovementioned revenues are the source of financing, all in sense of reaching the transparency and full operability of the Single Treasury Account. In the end, it is worth to mention that revisions of the main macroeconomic assumptions also took place due to stronger economic activity than previously anticipated which also produced important impacts to the expected levels of revenues and expenditures of the general government.

3.2 MANAGEMENT OF PUBLIC DEBT

Institutional Framework for Public Debt Management

The legal and institutional framework for public debt management is set by the Budget Act (Official Gazette 96/2003). The Act defines the coverage of public debt, the objectives of public debt management, the conditions and authorities for borrowing as well as the reporting obligations. The Budget Act defines the category of public debt as the debt of the consolidated budget of the Republic of Croatia, i.e. the debt of the general government (which includes the consolidated budget of central government and the consolidated budgets of local and regional self-government units), plus the amount of issued guarantees.

The primary objective of public debt management is to ensure that the financial needs of the government, including the settlement of due obligations, are met with minimum costs and a prudent level of risk. The Budget Act also stipulates that the level of public debt cannot exceed 60% of GDP. The Croatian Parliament decides upon the maximum level of government debt and government guarantees based on a proposal from the Government, while the Government (based on a proposal from the Ministry of Finance) brings the main decisions concerning the public debt management, the types of borrowings and the types of collaterals for repayments. The Government also decides upon the issuance of government guarantees, except for those in the responsibility of the Parliament.

With a view to further improving the management of public debt, many reforms were carried out during the last year. Most of the reforms were implemented with the technical and financial support of the EU within the CARDS program, but also represent the extension to the technical assistance projects of the World Bank and IMF. The new, modern public debt management and recording system was introduced and the education and training of the employees in charge of public debt management was carried out. The reorganization of the Sector for Public Debt Management, segregating the issuing (*front office*), the recording (*back office*) and the analyses and planning (*middle office*) processes, was carried out as well. The planned activities, currently in the stage of implementation, include the introduction of the electronic system of treasury bills auctions, the development of a strategy for public debt management, potential proposals concerning the improvement of the legal framework for public debt management and the development of a risk management model.

Current Level and Future Public Debt Projections

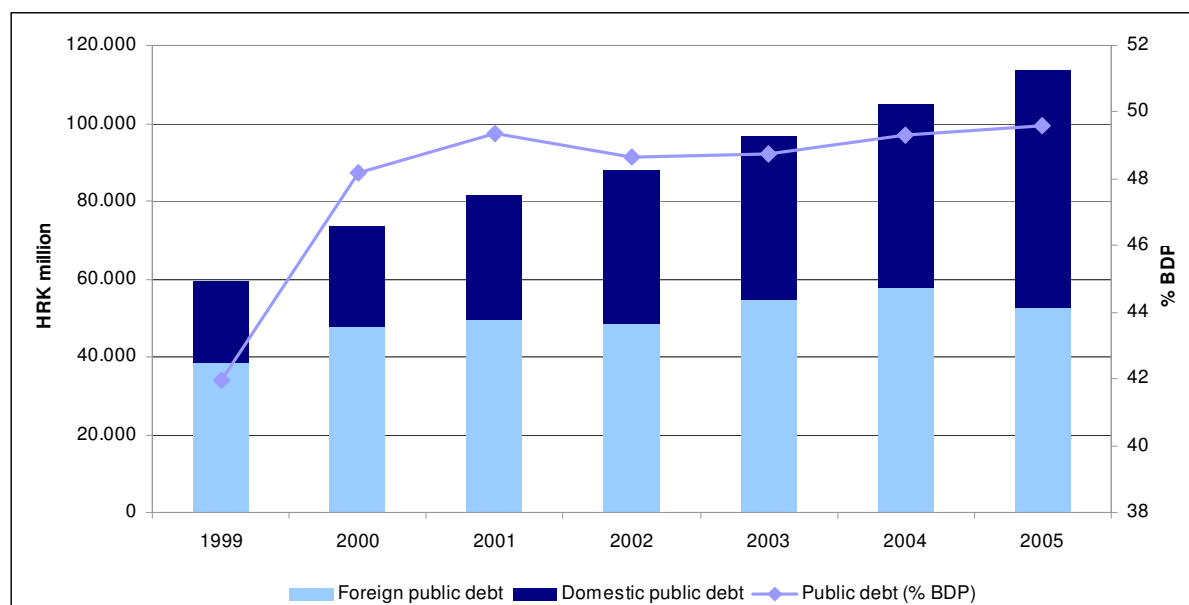
By the end of 2005, the public debt of Republic of Croatia amounted to HRK 113.3bn or 49.5% GDP, out of which 46% referred to external debt. The debt was largely (89%) created by direct borrowing of the different levels of the government, while the rest of the debt, equalling HRK 12.2bn referred to issued state guarantees.

Table 6 Public Debt of the Republic of Croatia (2002-2005)

HRK million	2002	2003	2004	2005
General government debt	72.581	81.406	92.838	101.180
Foreign	40.367	45.861	50.284	45.477
Domestic	32.214	35.545	42.554	55.602
Guarantees	15.579	15.327	12.135	12.384
Foreign	8.155	8.530	7.592	7.115
Domestic	7.424	6.796	4.542	5.269
Public debt	88.160	96.733	104.972	113.564
% BDP	48,6	48,8	49,3	49,6

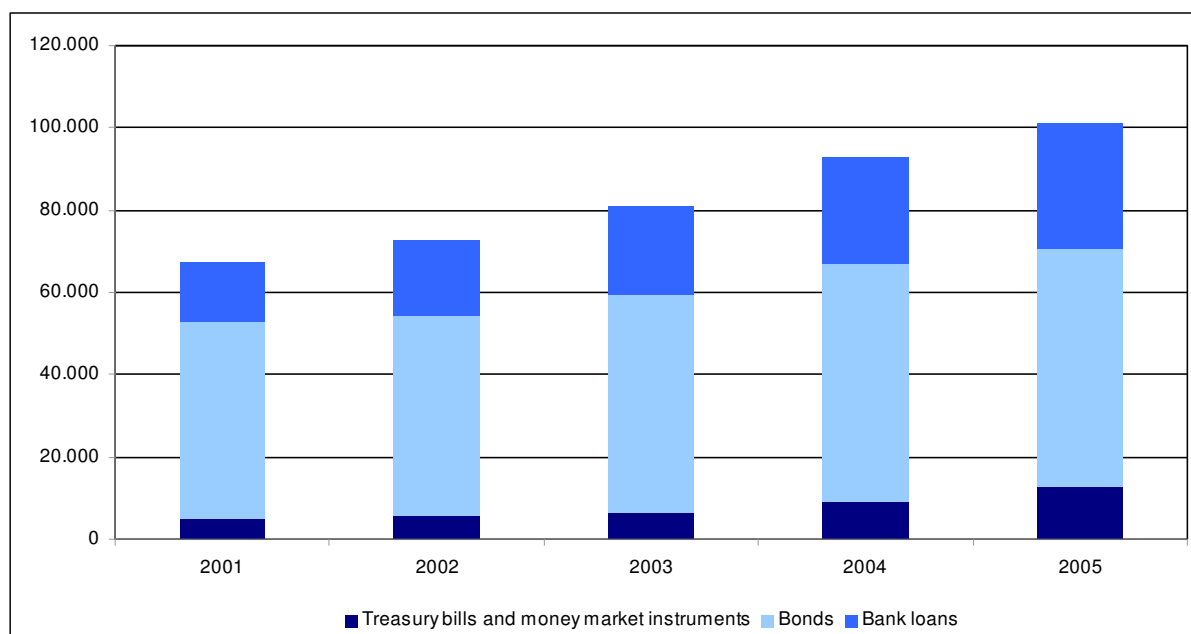
In the last couple of years, the public debt annual growth rate stabilized on a level around 8% and shows the tendency of slowing down: the growth rate amounted to 8% in 2005, compared to 9.7% and 8.5% in 2003 and 2004. These tendencies were the result of the fiscal adjustment carried out with the aim to reduce the fiscal deficit and the borrowing requirements, while at the same time limiting foreign borrowing to relieve the pressure on the growth of external debt. In addition, the issuance of new guarantees was restricted, resulting in a decrease of issued guarantees by over 20% in 2004, while their growth rate stood something above the level of 2% in 2005. The consequence was a considerable change of public debt structure in the observed period: the share of the foreign component dropped from 55% in 2002 to 46% at the end of 2005. This contributed to the decrease of the government's share in Croatia's external debt from 39% to 28%.

Figure 7 Public Debt Trends (million HRK and % of GDP)



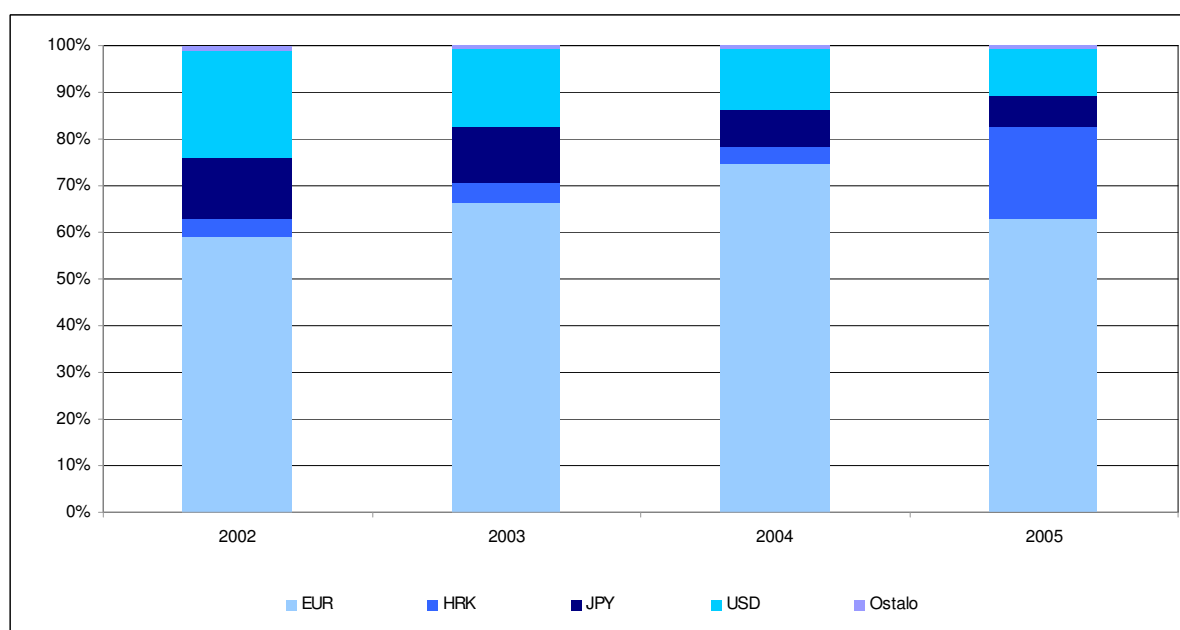
The general government debt was by large created by bonds issuance (57%) and loans (30%), while the rest relates to Treasury Bills and other instruments. The emphasis on borrowing through securities as main instruments enabled transparent and long term borrowing and contributed to the deepening of the financial market. The effect was an increased share of Treasury Bills which carry a slightly higher risk of refinancing due to the short term nature of such borrowing; but the level of risk is still acceptable. The orientation of the budgetary central government to borrowing through issuing securities is somewhat limited by the independent borrowing of extra budgetary users and local government, achieved largely through loans. This independent borrowing contributed to the increase of the share of loans in the general government debt from around 22% to 30%.

Figure 8 Instrument Structure of the General Government Debt



The budgetary government debt accounts for the largest share in the general government debt (86%), followed by the extra budgetary users (12%), while the rest is related to the local government. Regarding the currency composition, most of the debt is denominated in euros (63%), while a total of around 80% of the debt is denominated in foreign currency. The growth of kuna denominated debt share from an average of 4% in the previous period to 20% at the end of 2005 was the consequence of the increased borrowing on domestic market which is expected to increase even further. Moreover, the shares of dollar and yen denominated debt are expected to decline in the observed period, as result of maturing obligations of the London Club and the redemption of samurai bonds.

Figure 9 Currency Structure of the Budgetary Central Government Debt



The level of public debt in Croatia is a result of the high levels of government spending, which was particularly pronounced during the war and post-war reconstruction, but also due to the high initial level of debt created during the process of transition and the assumption of part of the ex-Yugoslavia's debt. Large part of domestic debt has initially been created by the issuance of bonds for the blocked foreign currency deposits and of so-called "Big Bonds" aimed for the restructuring of enterprises. The assumption of part of the ex-Yugoslavia's debt and the regulation of due obligations towards the London and Paris Clubs has enabled the access to international capital markets, causing a surge of the external debt which reached EUR 3.3bn by 1998. Borrowing on international markets increased even more after getting the first credit rating in 1997 and it was used to finance the lack of domestic savings and rising fiscal deficits.

For all the stated reasons it is necessary to insist on the fiscal adjustment measures and to direct the public debt management towards cost and risk reduction. That is the reason why the debt management strategy in the period 2007-2009 follows the borrowing policy from the previous years and it accompanies the fiscal policy planned for the upcoming three year period. The main goals of the debt management strategy are the further deceleration of general government debt growth and public debt growth along with the reduction of risk related to public debt, primarily foreign exchange risks. Complementary goals which are to be achieved are: further development of domestic capital markets, an increase in transparency and security of the debtor operations of Ministry of Finance and improvement in the public debt management, particularly risk management. In accordance with the above mentioned, the orientation to domestic financing sources is going to continue, alongside with increased kuna denominated borrowing, primarily through the issuing of Treasury Bills and bonds.

In accordance with the above stated guidelines and planned measures of fiscal adjustment the share of public debt in GDP should fall under 44%. The greatest contribution to that trend will come from the reduction of the deficit and, congruently, the reduction of the general government debt, while the guarantees are projected at an average level of around 5.4% of GDP. Beside that, the share of the foreign component of public debt shall decrease from the present value of 46% to around 30% by the end of the observed period.

Table 7 Projections of Net Lending/Borrowing, General Government Debt and Public Debt

<i>% BDP</i>	2005	2006*	2007*	2008*	2009*
Net lending (+) / borrowing (-)	-2,9	-2,2	-1,8	-1,7	-1,5
General government debt	44,2	42,1	40,5	39,3	38,1
Foreign	19,8	17,0	14,7	12,9	9,8
Domestic	24,4	25,2	25,9	26,4	28,2
Public debt	49,6	47,7	46,1	44,8	43,4
Foreign	22,9	20,2	17,8	16,1	12,9
Domestic	26,7	27,6	28,2	28,7	30,5

Public Debt Sensitivity to Risks

Testing of the debt sensitivity to changes in main macroeconomic and fiscal assumptions represents one of models for management of risks linked to the public debt. The purpose of the test is to estimate how the projected developments of public debt depend on the assumed macroeconomic and fiscal variables in the model, i.e. how the deviations from assumed variables will affect debt and therefore help in the identification of the most pronounced risk

factors. The test is carried out by setting a baseline scenario built on medium term macroeconomic projections. Then, a series of alternative scenarios is performed in which the assumed variables are kept at fixed (historic) levels or are submitted to different shocks. The shocks are usually linked to the historic values of the observed variables and their volatility, but can also be arbitrary. The applied sensitivity test is based on a model of the IMF and therefore the primary deficit is used as one of debt-creating flows instead of the net lending/borrowing.

The applied sensitivity test shows a significant sensitivity of Croatian public debt to domestic currency exchange rate developments, in particular in relation to the euro. The reason behind is the high share of debt denominated in foreign currency (about 80%) out of which about 60% is denominated euro. A 30% depreciation of the kuna raises the debt-to-GDP ratio over 60%. That is the reason why the reduction of foreign-currency denominated debt is set as one of the main priorities in the public debt management strategy. The debt shows larger sensitivity also to changes in contingent liabilities (guarantees), which draws attention to the necessity to restrict their growth and to eliminate the need for their issuance, i.e. to restructure particular sectors of the economy. Also, it doesn't come as surprise that public debt shows significant adverse medium term development in relation to changes of the primary deficit since it is the main generator of debt with the effect of the initial shock dying slowly and spreading to the end of the observed period.

Another type of impact is shown within the tests in which the assumed values are kept on present or historical (average) values. In that case, the debt development trend changes and the share of public debt in GDP displays increasing values. It means that keeping the economic and, in particular, the fiscal policy at the present level or at the level of "average" policy during last few years could lead to further debt growth and unsustainable debt. Therefore, fiscal consolidation represents the priority of economic policy in next medium term period and together with structural reforms and prudent public debt management it forms the prerequisite for a sustainable fiscal policy.

The mentioned impacts can be divided in two categories: external and internal. Due to the strong connection between Croatian economy and economy of the EU, the most important external influence is linked to the economic activity of EU countries. A growth slowdown in the EU would significantly affect the growth in Croatia, particularly in merchandise trade and in tourism. Also, due to economic and proprietary relations of the Croatian banking sector with parent banks in EU countries, it can be expected that the stronger growth of interest rates in the Eurozone would be channelled to a larger extent in Croatia. On the other hand, internal impacts to the largest extent depend on the implemented measures of economic policy, i.e. on the pace of reform as well as on achieved fiscal adjustments, with the divergence from planned strategy being the most important internal risk.

Figure 10 Test of Public Debt Sensitivity (share of debt in GDP, %)

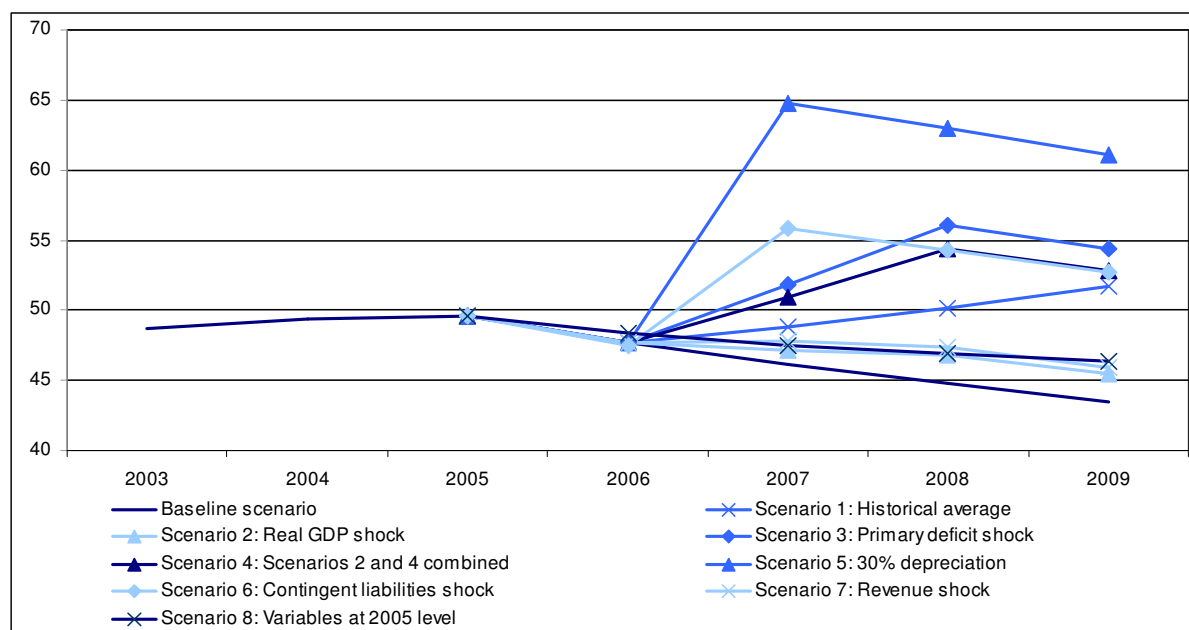


Table 8 Results of Test for Public Debt Sensitivity (% GDP, if not defined differently)

	2005	2006	2007	2008	2009
I. Baseline medium-term projection					
Public debt	49,6	47,7	46,1	44,8	43,4
o/w: foreign-currency denominated	39,7	38,2	36,9	35,8	34,8
Change in public debt	0,3	-1,9	-1,6	-1,3	-1,3
Identified debt-creating flows	-1,5	-2,1	-1,7	-1,4	-1,4
Primary deficit	1,5	0,7	0,7	0,6	0,5
Revenue and grants	45,0	45,0	44,8	44,0	43,3
Primary (noninterest) expenditure	46,5	45,8	45,5	44,6	43,7
Automatic debt dynamics	-2,5	-1,2	-1,2	-1,2	-1,2
Contribution from interest rate/growth differential	-1,0	-1,3	-1,2	-1,2	-1,2
Of which contribution from real interest rate	1,0	0,8	0,8	0,8	0,8
Of which contribution from real GDP growth	-2,0	-2,1	-2,0	-2,0	-2,1
Contribution from exchange rate depreciation	-1,5	0,1	0,0	0,0	0,0
Other identified debt-creating flows	-0,6	-1,7	-1,2	-0,8	-0,6
Privatisation receipts (negative)	-0,6	-1,7	-1,2	-0,8	-0,6
Recognition of implicit or contingent liabilities	0,0	0,0	0,0	0,0	0,0
Other (e.g. bank recapitalization)	0,0	0,0	0,0	0,0	0,0
Residual, including asset changes	1,8	0,2	0,1	0,1	0,1
Key macroeconomic and fiscal assumptions					
Real GDP growth (%)	4,3	4,6	4,6	4,8	5,0
Average nominal interest rate on public debt (%) 6/	5,5	5,4	5,4	5,3	5,2
Average real interest rate (nominal rate minus change in GDP deflator, %)	2,3	1,9	2,0	2,1	2,2
Nominal appreciation (increase of euro value of domestic currency, %)	4,0	-0,3	0,0	0,0	0,0
Inflation rate (GDP deflator, %)	3,2	3,5	3,4	3,2	3,0
Growth of real primary spending (deflated by GDP deflator, %)	1,3	2,8	3,9	2,8	2,9
II. Debt-to-GDP ratio sensitivity analysis					
1. Real GDP growth, real interest rate and primary deficit in 2007-2009 at historical average level	49,6	47,7	48,8	50,2	51,7
2. Real GDP growth in 2007 and 2008 at historical average level minus two standard deviations	49,6	47,7	46,4	45,3	43,9
3. Primary deficit in 2007 and 2008 at historical average level minus two standard deviations	49,6	47,7	47,1	46,8	45,4
4. Scenarios 2 and 4 combined using one standard deviation shocks in 2007 and 2008	49,6	47,7	51,8	56,1	54,4
5. One-off depreciation of 30% in 2007	49,6	47,7	50,9	54,4	52,8
6. Increase of other debt-creating flows (guarantees) by 10% of GDP in 2007	49,6	47,7	64,8	63,0	61,1
7. Revenue-to-GDP ratio in 2007 and 2008 at historical level minus two standard deviations	49,6	47,5	55,8	54,3	52,7
8. Shares of revenue and expense in GDP and real interest rate at 2005 level	49,6	47,7	47,8	47,4	46,0
Historical values of key variables (past 6 years)					
		Historical average		Standard deviation	
Primary deficit		3,3		1,5	
Real GDP growth (%)		4,4		1,0	
Nominal interest rate (%)		5,7		0,3	
Real interest rate (%)		1,9		0,3	
Inflation rate (GDP deflator, %)		3,8		0,6	
Public revenue in GDP (%)		46,3		1,6	

3.3 DEFICIT FINANCING

The planned process of further fiscal consolidation will reduce the total financing requirements in the period 2007-2009. The liability redemption profile will also contribute to that since the amount of due liabilities, according to the present situation, will constantly decrease until 2009 when a larger amount comes due. The budget deficit will mostly be financed by new borrowings, while the privatization receipts will contribute more significantly to financing in 2006 and 2007, whereas their importance will subsequently decrease by the end of the observed period.

Table 9 Financing of the Net Lending/Borrowing of the General Government

% BDP		2005	2006*	2007*	2008*	2009*
B.9F	Net lending (+) / borrowing (-)	-2,9	-2,2	-1,8	-1,7	-1,5
B.9F(-)	Total financingž	2,9	2,2	1,8	1,7	1,5
F.3L	Securities other than shares - liabilities	2,5	0,8	1,6	1,6	2,4
F.3LR	Repayment	3,0	1,6	2,1	1,5	1,7
F.3LI	Incurrence	5,5	2,4	3,7	3,1	4,1
F.4L	Loans - liabilities	0,7	0,2	0,3	0,4	-0,7
F.4LR	Repayment	2,0	2,5	1,6	1,5	2,0
F.4LI	Incurrence	2,8	2,7	1,9	1,9	1,3
F.7L	Other accounts receivable/payable - liabilities	-0,1	0,0	0,0	0,0	0,0
F.7LR	Repayment	0,1	0,0	0,0	0,0	0,0
F.7LI	Incurrence	0,0	0,0	0,0	0,0	0,0
F.A(-)	Net disposal of financial assets	-0,3	1,2	-0,1	-0,2	-0,2
F.5AD	of which disposal of shares and other equity - assets (privatisation)	0,2	1,3	0,8	0,5	0,4

* Projection

The financing needs of the Government will mostly be settled on domestic markets, through the issuance of bonds and with loans, while foreign financing will mostly include loans of foreign financial institutions associated with particular programs (PAL) or projects. Short term financing needs will be covered through treasury bills paying attention to the smoothing of their maturity structure (91, 182, and 364 days). The orientation to domestic financing will be additionally strengthened by means of stronger emphasis on kuna sources of financing. The objective of such policy is to reduce the exchange rate risk exposure of the Croatian public debt. Moreover, the timely structured and increased issuance of treasury bills and bonds will result with the development of the referent yield curve which will contribute to increased market liquidity and facilitate the price formation of other instruments leading eventually to a stronger domestic capital market.

In the observed period, four bonds are maturing out of which three were issued on the international market. In July 2007, the domestic euro-linked series VI bond issued in the nominal amount of EUR 400m matures as well as the samurai bond of the series II in the nominal amount of JPY 40bn. Both in June 2008 and 2009, the samurai bonds series IV and V mature with a nominal amount of JPY 25bn, while in February of 2009 a eurobond in the nominal amount of EUR 500m comes due. Beside mentioned, the regular repayments of obligations towards the London club will take place concerning bonds of the A series given that the bonds of the B series were completely redeemed during 2006.

Table 10 Projection of Budgetary Central Government Debt Repayments

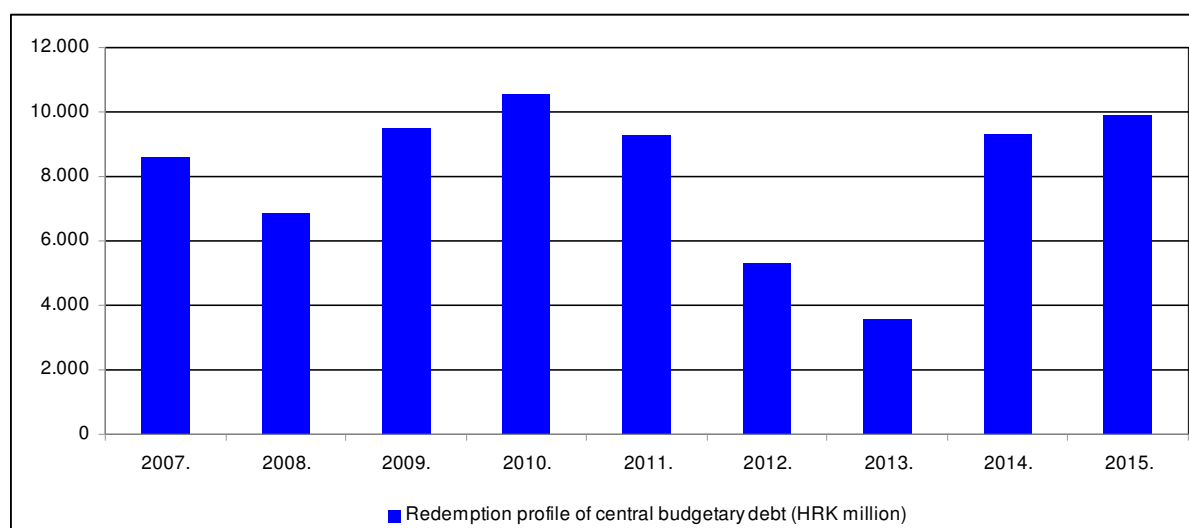
<i>HRK million</i>	2007	2008	2009	2010	2011
Foreign	4.139	3.380	7.007	5.184	6.842
Bonds	2.120	1.325	5.025	3.700	5.550
World Bank	466	478	493	582	618
EBRD	43	43	43	20	20
Eurofima	145	102	52	0	0
EIB	82	88	36	22	109
Council of Europe	59	90	134	168	206
London club	341	341	341	341	0
Paris club	373	423	457	0	0
Bank loans	510	491	428	351	339
Domestic	4.444	3.515	2.494	5.344	2.402
Bonds	3.556	2.953	275	3.288	2.212
Bank loans	225	200	2.049	1.949	84
HBOR loans	664	363	170	107	107
Total	8.584	6.895	9.502	10.527	9.244

Note: Projected as of 14/09/2006. Does not include financing costs of future deficits and refinancing.

3.4 FISCAL RISKS

Debt repayments and interest payments represent one of the fiscal risks since more significant maturity amounts increase the refinancing risk, i.e. represent larger burden on the budget. According the present debt outstanding situation, in the observed period 2007-2009 an average of HRK 10bn or 3.5% of GDP of repayments it is expected each year at the level of general government, whereas the burden is somewhat more expressed in 2007 and 2009. The interest payments burden will be around the average level of 2% of GDP, with a decreasing trend. Observing the longer term, the projections of the budgetary central government debt repayment profile show that repayments burden will decrease along with somewhat more expressed refinancing risk in 2010, 2014 and 2015, when larger maturing bond amounts are due.

Figure 11 Projections of Budgetary Central Government Debt Repayments Until 2015



The legal obligation for the repayment of pensioners' debt is regulated by the Act on Pensioners Fund (Official Gazette 93/2005). Besides the establishment of the Fund and the modalities of the Fund's asset formation, the Act stipulates the debt repayment method where the repayment burden is completely transferred to the Fund and doesn't represent a risk for the budget, while the government has the obligation of ensuring the assets to the Fund. There are two models provided by the Act between which the pensioners/users could choose: in the first model 50% of the debt is repaid over the period of two years, where the annual obligation amounts to approximately HRK 2.4bn; in the second model, the full amount of the debt is repaid over the period of eight years, with a two-year grace period, where the instalments amount to approximately HRK 700m. Since the first obligations were settled during 2006, a somewhat larger repayment burden is expected only in 2007, while the rest of the obligations are evenly allocated up to 2012.

The obligations for issued state guarantees are included into the public debt calculation pursuant to the Budget Act. In the observed period, the expected level of guarantees will be around an average of 5.5% of GDP, with slight decreasing trend at the end of the period. By means of including guarantees into public debt, the scope for a debt increase was additionally limited since, according to the Act, public debt cannot exceed 60% of GDP. As a measure of

mitigation for risks resulting from guarantees, each year a guarantee reserve is planned in the budget aimed for potential obligations for issued guarantees.

The developments of operating balance and net lending/borrowing as measures of fiscal imbalances depend to a major extent on the developments of fiscal revenues and expenditures. Depending on particular categories, the realization of revenues and expenditures depends to a larger or lesser extent on economic (fiscal) policy measures, but also on external factors (macroeconomic, demographic, social and political). The model of sensitivity test of net lending/borrowing to the changes in different variables can help quantifying the impact of the above mentioned developments.

In the presented model, the baseline scenario, which is built on medium term baseline projection of macroeconomic indicators, is compared to different alternative scenarios which test influence of possible shocks in real growth developments and revenue and expenditure realization. The lack of longer fiscal data time series is the cause for using somewhat “rough” definition of shocks which aren’t calibrated in the best way (absolute amounts, halved growth rate), but the results still give a rather good picture of the nature and power of the impacts. The possible risks which were identified are slower economic growth, lower revenues realization, increase in expenditures for social benefits and increase in expenditures for subsidies.

Slowing down of the economic growth may be possible as a consequence of slowdown in growth in EU countries which are main trade partners of Croatia, manifested through lower merchandise trade and decreased tourism revenues. On the other hand, slowing the pace of structural reforms would create additional pressures on already high government expenses and eventually end would definitely have a negative impact on growth. In the sensitivity analysis to the change in the real growth rate, the assumed growth rate in 2007 and 2008 of the alternative scenario is twice lower than projected in the baseline scenario. Slower economic growth increases the share of net lending in GDP, which reaches the level of 1.9 percentage points above baseline scenario in 2008, after which recovery follows.

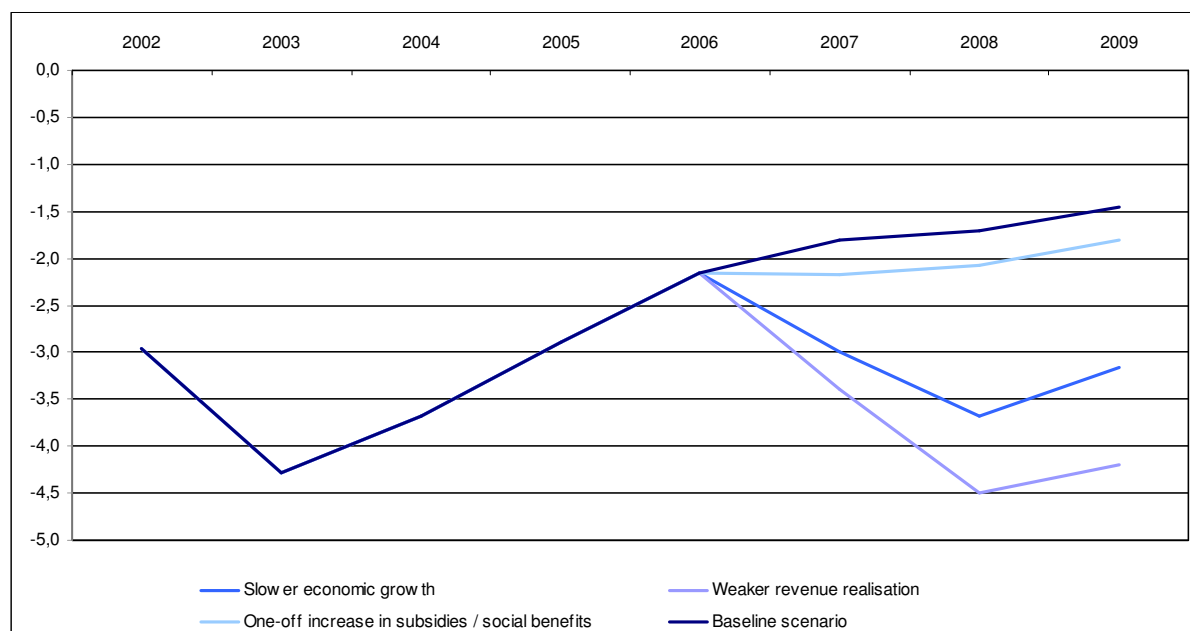
By taking into account only the impact of revenues development, the assumption of a twice lower growth in 2007 and 2008 results in even larger deviations from the baseline scenario. The share of net lending in GDP increases to 2.5 percentage points above baseline scenario in 2008 and the impact of the initial shock persists until the end of observed period, with just minor recovery.

The risk of accelerated expenses growth is primarily identified in a possible increase in social benefits or subsidies. In both categories the risk is related to structural reforms performance: in social benefits this is primarily connected to health and social welfare systems, while the level of subsidies depends on the restructuring and privatization of state-owned enterprises. The sensitivity analysis to the development of expenses assumes in the alternative scenario a one-time increase of expenses in 2007, due to an increase of social benefits or subsidies in the amount of HRK 1bn. This shock is propagated into next periods by assuming unchanged fiscal policy as the expenses for mentioned categories grow according to the rates projected in the baseline scenario, but with higher base from 2007. Despite different projected growth rates of social benefits and subsidies and their different shares in total government expenses, the total effect of initial shock is equal in both cases. The share of net lending/borrowing in GDP increases by 0.4 percentage points in 2008 due to the shock, and the initial impact is retained until the end of the period.

Table 11 Assumptions of the Baseline Scenario and Results of the Sensitivity Test

	2005	2006	2007	2008	2009
Assumptions (baseline scenario)					
Real GDP, growth rate	4,3	4,6	4,6	4,8	5,0
Inflation (GDP deflator)	3,2	3,5	3,4	3,2	3,0
Revenues, growth rate	7,0	8,3	7,6	6,2	6,4
Expenses, growth rate	6,3	6,9	7,4	6,4	6,3
Subsidies, growth rate	5,4	5,4	7,3	4,4	3,2
Social benefits, growth rate	3,5	5,6	5,4	6,1	6,2
Net lending (+) / borrowing (-) (% GDP)					
Baseline scenario	-2,9	-2,2	-1,8	-1,7	-1,5
Slower economic growth	-2,9	-2,2	-3,0	-3,7	-3,2
Weaker revenue realisation	-2,9	-2,2	-3,4	-4,5	-4,2
One-off increase in subsidies	-2,9	-2,2	-2,2	-2,1	-1,8
One-off increase in social benefits	-2,9	-2,2	-2,2	-2,1	-1,8

Figure 12 Results of the Sensitivity Tests



3.5 LONG TERM SUSTAINABILITY OF PUBLIC FINANCES

Analysis of long term sustainability of public finances in this year PEP as opposed to the previous year, takes into account long term population projections. Namely, in the previous year long term population projections until the year 2050 weren't available and were published by Central Bureau of Statistics in year 2006. For the purpose of this analysis projection of population in scenario with medium fertility and medium migration was used.

In the presented prognostic scenario it was assumed that there will not be changes in regulation and policies which regulate public expenditures for pensions and health services and no changes in calculation and collection of social contributions. It is assumed that all other public revenues, except contributions, will be unchanged as GDP share and it is in the same way assumed that that all other public expenditures, except pension, health and interest rate expenditures, will not change their share in GDP. Concerning participation rates, it is assumed that economic agents will keep their behaviour pattern i.e. it is assumed that participation rates by characteristic age groups (15-24, 25-49, 50-64) and gender will remain constant. As a result of these assumptions, it can be seen that total participation rates will decrease as a result of higher share of population in older age groups.

For labour productivity growth is assumed to amount 3.8% at the beginning of period and that it will gradually decrease in time. This assumption and rate values are derived from the projections of Economic Policy Committee of the EU (2006) for the EU countries, where the projections of 10 new member states were taken as referent for Croatia. Unemployment rate was projected as decreasing until the year 2020 when it falls down to the level of 7% which is considered as structural unemployment and which will be kept at this level until 2050. Such assumption is aligned with assumptions for 10 new member states from mentioned study. The growth of GDP per capita is result of population projections (taken from CBS 2006), labour productivity, participation rate and unemployment rate projections.

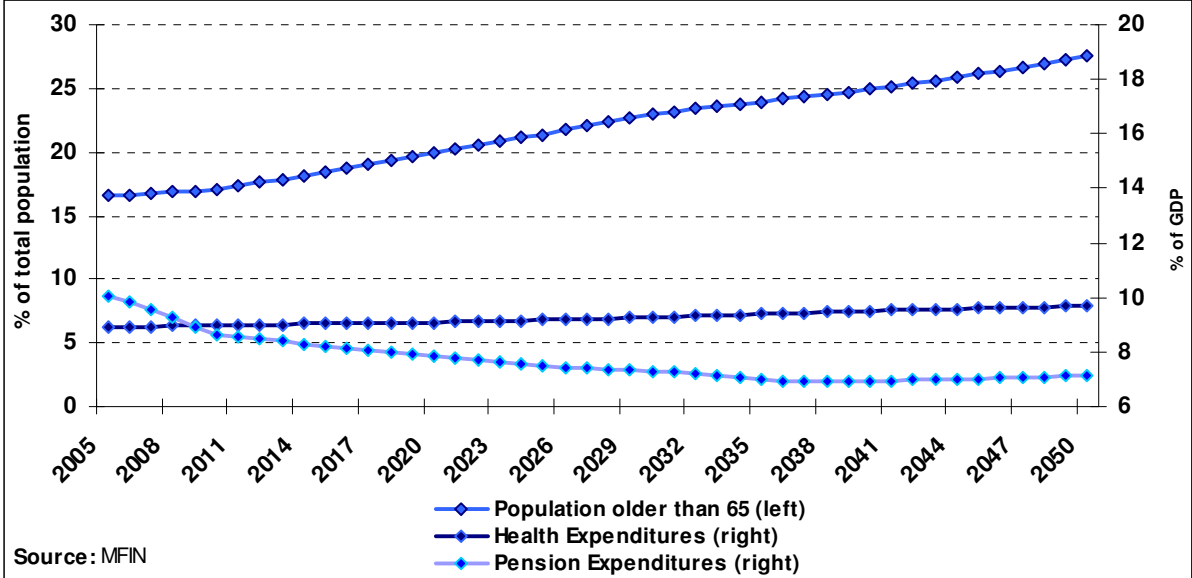
On the bases of described assumptions slight decrease of revenues from pension contributions is forecasted from 6.9% of GDP in 2005 to 6.5% of GDP in year 2020 and stabilization in extended horizon. The main reason of decrease in starting years is increase of share of employed with pension insurance in both obligatory pillars where part of contributions (5%) goes to private obligatory pension funds. Namely, older employees are to the higher extent insured exclusively in the first pension pillar where total amount of their contributions (20%) goes to public fund. As older employees will become retired, there will be more employees which pay to the public fund only part of contributions (15%). Stabilization of pension insurance contributions at 6.5% of GDP after year 2020 is result of assumptions that real growth of wage per employee is equal to labour productivity growth and of contribution rate definition as constant wage share, where by the pension insurance contributions higher contributions for the first pillar at older employees are taken into account.

Projections indicate significant decrease of public expenditures for pensions from 10.1% in 2005 to 7.1% of GDP in year 2050 where pensions and permanent rights of war veterans re excluded from analysis. Public pension expenditures include only expenditures of public pension insurance fund (Croatian Institute for Pension Insurance) but not expenditures of private retirement schemes (obligatory or mandatory). Projected decrease of public expenditures is primarily the result of relative pensions decrease (pensions and wages ratio) paid from the first pillar. This result is certain to the high extent if current parameters of pension calculation will be retained i.e. if indexation of pension will be done according to the

formula which takes into account 50% of wages growth and 50% of inflation. It is expected that payments from the second pillar will compensate or alleviate decrease of relative pensions. It should also be mentioned that projections took into account decrease of retired persons share to which the whole pension is paid from the first pillar and increase of retired persons to which pensions are paid partly from first and partly from second pillar.

Growth of public expenditures for health is projected from 6.3% of GDP in 2005 to 7.9% of GDP in year 2050. This growth is a result of estimated effect of ageing population and increase of health expenditures in line with productivity growth. Increase of expenditures on the bases of ageing population effect is a result of higher share of population in older age groups which absorb relatively higher share of health expenditures. Beside the effect of ageing population, it is additionally assumed that health expenditures for each age and gender group will grow like GDP per employee. Namely, the wages of medical personnel are the main component of health expenditures and it can be assumed that health expenditures will grow at the same pace as costs for wages in health sector which will by assumption grow like average wages in the whole economy.

Figure 13 Ageing of Population, Health and Pension Expenditures



Described developments of individual revenue and expenditure categories will determine developments of total revenues and expenditures. In line with gradual reduction of share of public expenditures in GDP, it is expected that primary deficit will slightly become primary surplus. In this way financial requirements of government will decrease, borrowing will decrease and share of public debt in GDP will decrease. Lower public debt will have positive implications on interest payments and it is expected that share of interest payments in GDP will decline from 2.2% in 2005 to 0.4% in year 2050. Decline in interest payments will result in change of total government deficit to government surplus. Taking into account all mentioned assumptions it turns out that the share of total public revenues in GDP will decrease from 45.0% in 2005 to 43.1% in year 2050 while the share of total public expenditures will decrease from 47.9% in 2005 to 43.0% in year 2050.

4 STRUCTURAL REFORMS

4.1 ENTERPRISE SECTOR

4.1.1 Privatisation

Results Achieved in 2006

Privatisation dynamics in 2006 in terms of quantitative indicators was in line with the obligations assumed under PAL 1 and PAL 2 programmes, which serves as a certain benchmark for assessment of the achievements in the implementation of this part of structural reforms. The ultimate objective remains to be fast completion of the process of privatisation either through company sale or winding up (“sterilisation”) in cases where company sale is not possible. In accordance with PAL 2, until end-August this year, Croatian Privatisation Fund (CPF) sold on the stock exchange or wound up 327 companies in minority ownership and privatised a total of 52 companies in majority ownership, of which shares of 26 companies were sold through a public tender procedure while 26 companies wound up.¹²

Table 12 Achieved Results

Privatization VI/05 - IX/06	No. of companies sold	Nominal value of stakes sold, in HRK	Price achieved, in HRK
Stock exchanges	327	361.706.906	194.100.093
Public tenders	52	2.337.117.390	447.620.741
Total	379	2.698.884.296	641.720.834

In early November 2006, CPF portfolio included 896 companies of which 675 were available for sale (the remaining 221 companies are those which at present cannot be subject of sale due to legal proceedings or because they are dormant and are subject to bankruptcy or winding up). CPF still holds majority stakes in 101 companies.

In addition to quantitative progress made in 2006, this year also saw some qualitative changes, notably those involving heightened activities on the preparation of “complex sectors” for privatisation. As concerns the agricultural sector, the privatisation of large agricultural conglomerates was successfully completed with only one agricultural conglomerate being currently held in CPF portfolio, Vupik d.d., Vukovar, whose privatisation is underway.

In the black metallurgy sector (iron, steel and other metals) a National Restructuring Programme for the black metallurgy has been drafted and submitted to the European Commission (EC) for opinion. The process of agreeing with the EC upon the elements envisaged under the National Restructuring Programme is underway. Following discussions with the EC and the adoption of the National Restructuring Programme for the black metallurgy sector, the possibilities as well as the relevant conditions for this sector’s

¹² In accordance with the obligations assumed under PAL 2, as well as economic policy matrix defined under the 2005 PEP, the basic objective of CPF privatisation until the end of the first half of 2006 was the sale and/or winding up of 45 companies which fulfil the necessary conditions, and a simultaneous sale/winding up of 300 companies in minority ownership.

privatisation will be defined. Due to extremely difficult situation in this part of the industry, it has been decided, and agreed with the EC, that the process of privatisation of the country's both ironworks should run parallel with the adoption of the National Restructuring Programme. Conditions for privatisation tender¹³ have been prepared in cooperation with the recommended consultants from the EC and the Croatian Competition Agency. In drafting the tender documentation, the criteria determined under the Stabilisation and Association Agreement (SAA) regarding market competition rules and Protocol 2 regarding steel products were taken into account.

Therefore, privatisation of the metallurgy sector has commenced with tenders announced for the sale of ironworks, Valjaonica cijevi Sisak and Željezara Split, and an aluminium factory TLM, Šibenik. The privatisation of Željezara Split is expected to be completed by the end-2006 while the privatisation of Valjaonica cijevi Sisak and TLM will be completed in the first quarter of 2007.

In 2006, preparatory activities were undertaken for the drafting of the National Restructuring Programme of the shipbuilding sector. In the context of these activities, Strategic guidelines for further development of the Croatian shipbuilding industry were drafted as well as a Study on the state of the Croatian shipbuilding industry which was prepared for the Government by an international consultant. The process of privatisation of the shipbuilding industry is directly dependent upon enactment and adoption of the National Restructuring Programme for the shipbuilding sector, which will be subject to verification by the EC and then adopted by the Government of the Republic of Croatia. The National Restructuring Programme, whose adoption is expected until end-March 2007, will also contain the planned privatisation of the shipbuilding sector (including its sequence and dynamics).

In 2007, announcement of the privatisation of three subsidiary companies of Croatian Railways is expected, which will depend on the resolution of property law issues which is the condition for the privatisation tender announcement.

Main Privatisation Objectives 2007-2009

In accordance with the adopted Strategic Development Framework 2006-2013, the main objectives in the area of privatisation generally include:

- use capital market privatisation as the main method for the forthcoming privatisation of public companies to strengthen their efficacy and competitiveness,
- complete the process of privatisation of the shipbuilding industry until 2010,
- complete restructuring of Croatian Railways and its transformation into a financially sustainable railway company until 2010,
- enable exit from the market of companies with no future and to provide appropriately for the employees through labour market institutions and social policy,
- urgently complete privatisation of companies in the state portfolio managed by the CPF,
- transform CPF into an institution that will ensure efficient and active management of state property.

¹³ Prospective owners are expected to prepare separate business plans for each ironworks, demonstrating their sustainability under normal market conditions at the end of the restructuring period (in accordance with the accepted sustainability criteria of the EC).

In the context of creating the preconditions for the achievement of these objectives, and in connection with CPF portfolio, the Government of the Republic of Croatia has intensified its efforts to prepare appropriate legislative solutions that will aim primarily at removing detected system limitations for fast completion of the privatisation process and transformation of CPF into an institution in charge of the management of the remaining state property.

In this context, activities are underway for the drafting of a new legislative framework for the resolution of the issue of privatisation and total state portfolio management¹⁴ that envisages the introduction of new additional sales models (apart from the existing models, it provides for a model that enables sale in the process of public take-over), abandons the rigid initial price setting procedure for companies to be sold through public tenders (by making it possible for a company to be offered, already with its first announcement for sale, at a price estimate based on international standards), and ensures speeding up the procedure for obtaining the necessary approvals for the sale of shares entrusted for management to CPF by other government institutions.

Furthermore, a new proposal is being prepared for a future organisation that will join CPF and the Central State Administrative Office for State Property Management of the Government of the Republic of Croatia into a single institution with the aim of managing the remaining state property.

4.1.2 Competition Policy and State Aid

Competition Policy

In 2006, the Croatian Competition Agency (the Agency), in accordance with the objectives and implementing measures determined under the 2005 PEP, continued with its efforts to ensure a more efficacious application of the competition rules and strengthened its cooperation with other regulatory bodies in Croatia, notably the Croatian Telecommunication Agency, the Croatian Financial Services Supervisory Agency and the Croatian Postal Services Council. The Agency has concluded agreements on cooperation with these bodies, thus creating additional preconditions for ensuring efficacious competition in the telecommunications, financial services, and postal and courier services markets.

The Agency was not able to achieve the planned increase in the number of expert staff¹⁵ in the area of competition and state aid in 2006.

Following substantive harmonisation of legislation with the *acquis* which marked the previous period, to achieve a higher level of protection of market competition in the country, in the forthcoming period new appropriate legislative solutions will be required that will promote Agency and judiciary procedures. In practice, this will ensure the entrepreneurs in Croatia the same level of protection as that enjoyed by entrepreneurs in the EU where the protection of market competition is one of the basic determinants of common market functioning.

¹⁴ This portfolio is comprised of companies and real estate in Republic of Croatia ownership. However, companies which are pursuant to Article 13 of the Privatisation Act defined as companies of strategic interest for the Republic of Croatia (such as the postal service, telecommunications, railways, road transport, Croatian Radio and Television (HRT), the national oil company (INA) and Croatian forests (Hrvatske šume) are excluded from this portfolio. Their privatisation is the responsibility of the Government and their privatisation procedure is governed by special laws.

¹⁵ Planned under the 2005 PEP

In accordance with the objectives and implementing measures defined under the 2005 PEP, the Agency has continued to monitor changes in the EU *acquis* in the area of competition, and has, in accordance with the findings of the screening process in connection with the Competition Policy Chapter, found that it will be necessary to supplement Croatian competition rules in certain branches of transport, most notably land, maritime and air transport, in light of the forthcoming changes in EU regulations governing these areas. In view of its current status and its activities so far in terms of promoting the system of protection of competition, the Agency will need to continue its cooperation with the Ministry of Justice on the implementation of measures needed to achieve efficacious implementation of competition rules in the manner detailed out in the 2005 PEP.

In this context, and with the aim of promoting Agency activities and efficacy, efforts will be made to:

- find solutions that would provide for the Agency's involvement in the procedure of pronouncing punishments for violations of the Competition Act or enable the Agency to have the authority to set free or mitigate punishments of entrepreneurs taking part in cartel agreements who first inform the Agency of cartel existence or provide evidence of cartel existence in accordance with EC and most EU states' practices,
- act towards identifying adequate judicial system for decision-taking on the legitimacy of Agency decisions, that will, while taking into account professional complexity of the issue of competition, ensure economic and efficient court protection. This also includes the transfer of real competence from the Constitutional Court to commercial courts, an effort that will require not only changes in the Competition Act but possibly also changes in other laws, which will be determined by an expert study presently in the making.

In the context of Agency capacity strengthening, hiring of additional expert staff is a *conditio sine qua non* for the fulfilment of the obligations assumed under the country's stabilisation and association process with the EU, given that competition efficacy is one of the most important criteria for the completion of negotiations in the area of competition policy.

For the objectives in the area of competition policy outlined above and implementation of the relevant measures to be achieved, the Agency needs to strengthen its administrative capacities thus requiring appropriate financial resources. This implies reaching a sufficient number of expert staff in the Agency and their continuous training in order to achieve higher efficacy of the Agency in fulfilling the set tasks, which asks for steady increase of Agency's budget allocations. For this purpose an increase of the Agency's budget of 64% is ensured for 2007.

State Aid

With the adoption of the new State Aid Act (Official Gazette 140/2005) towards the end of 2005, with the Ministry of Finance as the responsible institution, and coming into effect of a new State Aid Decree (Official Gazette 50/2006) in May 2006, the most important parts of legislative harmonisation of the Republic of Croatia in the area of state aid and in connection with competition policy were completed.

Among others, the new Act provides for more efficacious solutions in the procedure of granting state aid in accordance with the recommendations from the EC. The Decree provides for the procedure of Croatia's legislative harmonisation in the area of state aid which prescribes the publication of original EU state aid rules in the Official Gazette based on the decision of the Government of the Republic of Croatia.

So far, the work on state aid in the Republic of Croatia has produced the expected results as seen in raised awareness of both state aid providers and state aid users about state aid policy, preparations underway for thorough restructuring of major economic activities, and in numerical indicators of developments in state aid in GDP of the Republic of Croatia over the past years presented in Agency's annual reports.

The 2005 Annual Report on State Aid in Croatia shows that the level of state aid in GDP in 2005 was similar to that in 2004, while that in 2004 fell compared with the level of state aid in 2003. However, if agriculture, fisheries, and transport are excluded, the total state aid to GDP ratio fell in 2005 compared to that in the previous year.

In 2005, according to the Agency's data, state aid stood at HRK 6.5bn, while its share in Croatia's GDP was 2.8%, the same as in 2004. However, if the amount of state aid granted to agriculture, fisheries and railways is excluded from the total amount and only state aid granted to industry and the services sectors are taken into account, state aid was HRK 2.7bn, with its share in GDP standing at 1.2%, which is an indication of further positive trend of decline in the share of aid in GDP, present since 2003 when the state aid accounted for 1.6% of GDP.

In 2006, a comprehensive state aid computer database was set up with CARDS support. Preparations are currently underway for its launching.

In the context of efforts to strengthen and promote knowledge in the area of competition and state aid, continuous training is provided for government administration employees working in the area of state aid through seminars and conferences within the framework of the twinning project carried out by the Agency. Administrative capacity strengthening in government administration and ongoing training in the area of state aid are among the most important factors which will help achieve the planned progress in the area of competition, improve discipline of state aid providers and produce other positive effects that will follow the adoption of the concept of competition for all market participants, and lead to a more efficacious and more competitive economy.

Within the framework of the twinning project, a Practical Guide has been prepared for units of local and regional self-government in the Republic of Croatia with a view to better acquainting the professionals on the local and regional self-government levels with the procedure for granting state aid proposals as well as the content of the most common forms of state aid granted on those levels of the government.

To achieve the objectives set under the PAL programme, additional efforts are needed in the forthcoming period. Preparations in that context, such as those concerning the restructuring of individual previously mentioned economic activities, are already underway.

Therefore, efforts to prepare these activities for sustainable EU competition on an equal footing with all other market participants through restructuring and privatisation and to provide a methodical and an individual approach to the companies in difficulties, while respecting the rules on state aid will undoubtedly produce positive fiscal impacts in the end. In addition, the process of harmonisation of the existing state aid is also expected to give positive results in terms of their contribution to the use of state aid for objectives harmonised with the state aid rules.

Further harmonisation of the Croatian legislation in the area of state aid will take place in the manner prescribed under a new State Aid Decree. Decisions on the publication of a list of

rules and state aid rules prescribed by the *acquis* in the Official Gazette are issued by the Government upon proposal from the Minister of Finance. This creates the preconditions for comprehensive harmonisation of the Croatian state aid rules with the relevant EU *acquis*.

The scope and the intensity of the forthcoming reforms in the Croatian economy which largely involve state aid policy and control, require further strengthening of administrative capacities both in the Agency and in bodies of government administration, in particular in view of the relevant preparation of the competent departments for the implementation of structural reforms.

The most important elements of structural reforms involve restructuring of sectors such as shipbuilding, metallurgy and railways, further privatisation, and harmonisation of fiscal regulations. To achieve that, great efforts will be needed as well as good understanding of the competition and state aid issues on the part of the Agency and state aid providers.

In addition to the procedure of state aid proposals evaluation within the framework of restructuring, also important is the alignment process of the existing state aid programmes and their harmonisation with the State Aid Act pursuant to March 2006 Resolution of the Government of the Republic of Croatia, which will be carried out in accordance with the dynamics determined under the National Programme for the Integration of the Republic of Croatia into the EU - January 2006, i.e. the dynamics or time frames proposed to the Government by the competent bodies.

One of the horizontal instruments which help ensure the implementation of structural reforms in the economy and create the preconditions for more efficacious implementation of competition and state aid policies is a new PHARE project intended for strengthening professional and administrative capacities of the Agency and other entities, scheduled for launching in 2007.

The project covers both the area of competition and state aid and its completion is planned until end-2008. In the area of state aid, the project is planned as a continuation of the twinning project, whose completion is scheduled for end-2006, and is directed towards further development of the system of state aid control and further training of Agency staff and state aid providers, both on central government and local and regional self-government levels.

The part of the project that covers competition issues envisages the inclusion of other bodies of government administration, the judiciary and the State Attorney's Office in further education and professional training processes. Under the project, the funds have also been secured for the upgrading of the Agency's IT system in accordance with the standards of modern office operations.

4.1.3 Railway Restructuring

Structural reforms in the railway sector in 2006, in terms of institutional reforms, mainly involved the beginning of implementation of two new "railway acts". They are the Railway Act (and the ensuing ordinances) and the Act on the Division of Croatian Railways (HŽ - Hrvatske željeznice d.o.o.). The basic characteristic of the new legal framework is the application of the first package of railway EU directives and preparations for the introduction of the principle of liberalised transport market. For the new restructured railway to become

operative it is necessary to complete the process of division of the national railway company and to set up new independent railway companies. The Act on the Division of Croatian Railways envisages the division of Croatian Railways into four separate limited liability companies, one for management, maintenance and railway infrastructure development, one for passenger transport, one for freight transport and one for train traction. There are also plans to set up a fifth company, a holding company, of owners of the four companies. During the division stage, the Government of the Republic of Croatia has issued two decisions. Registration of these companies with the commercial court is now pending and its completion is expected until end-2006.

Business results from end-2005 and in the first quarter of 2006 point to an increase in the natural indicators of work. There was an increase of 39 842 000 passengers in passenger transport (+8.4%) while freight transport rose by 15 830 000 tons (+15.5%), with heavy co-financing still being provided by the state budget (accounting for around 60% of total income of Croatian Railways).

Restructuring activities concerning Croatian Railways continued. They are related to the improved financial efficacy of the company measured by a fall in the operating ratio (from 242% in 2004 to 220% in 2005), while the number of employees of Croatian Railways was reduced by a net 607 employees, achieved exclusively through voluntary employment termination and natural fluctuation. The process of non-core business privatisation has commenced successfully with the preparation and drafting of the necessary documentation for the resolution of property law issues which is the condition for the privatisation tender announcement. By the Decision of the Government of the Republic of Croatia from 9 June 2005, concerning the privatisation of dependent companies of Croatian Railways, three contracts were concluded between Croatian Railways and CPF for the privatisation of dependent companies in the ownership of Croatian Railways. The measures concerning the restructuring of Croatian Railways are being implemented in accordance and within the agreed guidelines of the PAL programme.

Pre-accession Strategy of the Railway Sector

The strategic development document for the pre-accession period is being prepared in cooperation with the Faculty of Transport Sciences. It is estimated that this document will cover the period from 2006-2009, i.e. the period until Croatia's EU entry. The basic objectives of this document will be:

- further harmonisation of the railway sector with EU rules and the sector's preparation for liberalisation,
- setting up a regulatory body and other administrative bodies as prescribed by the 1st package of EU railway directives, necessary for the smooth functioning of a liberalised transport market,
- preparing a document entitled "Network Report" and defining the criteria for the beginning of line allocations on the basis of a study prepared by the Institute of Transport Sciences, entitled "Examination and Determination of Fees for the Use of the Railway Infrastructure".

Instruments envisaged for the implementation of these objectives are the funds obtained under pre-accession EU programmes (CARDS and PHARE). The implementation of the PHARE project for the Croatian railway system restructuring and development in the framework of EU legislation is expected in the period 2007-2009, given the project has already been approved by the EC. Besides further successful cooperation with EC bodies, main benefits are

expected in terms of further legislative harmonisation and the introduction (setting up) of new administrative bodies in the railway sector important for the proper functioning of a liberalised transport market.

The planned deadline for the adoption of the Pre-accession Strategy of the Railway Sector is end-2006.

Restructuring Process

Even though the need for railway restructuring has been present since 1998, concrete steps made in that direction were only discernible after 2004 when the authorities intensified the existing reform efforts in the sector, mainly through efforts to meet the obligations assumed under the PAL matrix of measures.

The main and the ultimate objective of restructuring is to create a railway sector that will be commercially viable, competitive, and less and less dependent on budgetary sufinancing.

Continuing with the initial restructuring efforts in the context of PAL, the authorities plan to solve the main problems of the railway sector, with the expected benefits that would follow such restructuring involving: improved financial efficacy of the company, as measured through a fall in the operating ratio, solution to the problem of surplus workforce, reduction of passenger transport services that are not economically justified, solving the problem of highly uneconomical local railway lines, finding a solution to the issue of the status and the treatment of real estate with a status of public good for general use, and privatisation of dependent companies (subsidiary companies of Croatian Railways).

In the context of the railways restructuring process, measures are being implemented in accordance with the concluded arrangement with the World Bank, within the PAL II framework. In 2006, the following has to be achieved:

- further reduction in the operating ratio, reaching 190% until end-2006,
- further reduction in the number of employees by net 500 workers,
- further privatisation and preparation of the next seven dependent companies (subsidiaries of Croatian Railways) for privatisation.

The Government of the Republic of Croatia adopted on 4 August 2005 a plan for reducing subsidies in the economy for the period 2005-2007, in accordance with the guidelines determined under PAL. Within the budget divisions three different subsidies are realised: railway infrastructure management and traffic regulation, promotion of passenger and combined transport and severance pays. Observing the period 2004-2006, abovementioned subsidies recorded a decreasing trend, which is in compliance with the plan of the Government of the Republic of Croatia to reduce subsidies in the economy.

The preparation and the alignment of the last stage of restructuring with the new legislative and institutional framework, or the completion and adoption of the restructuring plans of railway companies for the period 2006-2010, will pave the way for and redefine the main guidelines for action with a view to achieving planned restructuring effects, with a simultaneous achievement of growth trends in operating own transport income of railway companies, operating costs reduction and decreasing financial dependence on public (government) funds.

Implementing Measures

Intensifying the structural reform of the railways rector implies the implementation of different complex measures, most notably in the two main segments: further harmonisation of domestic legislation with EU *acquis* and further restructuring. The specific steps to be taken involve:

- legislative harmonisation
- liberalisation of the railway transport market
- restructuring and modernisation of the national railway companies
- adoption of the National Railway Infrastructure Programme.

The plans under this document for the first five-year period (2007-2011) involve investment of HRK 9.6bn (budget funds) for the construction of new and modernisation of the existing railway network and HRK 4.9bn (budget funds) for the maintenance of the existing railway network (a five-year period total standing at HRK 14.5bn of budget funds). This document will also offer solutions for two sub-segments: the resolving of the issue of railway-road crossings and the resolving of the issue of management and financing of local railway lines.

The forthcoming period will see the realisation of the project of rehabilitation of Corridor X, from Vinkovci to Tovarnik. The basis for the realisation of this project is the memorandum of financing between the EC and the Government of the Republic of Croatia concerning grants provided under the Instruments for Structural Policy for Pre-Accession for the Vinkovci-Tovarnik project.

Table 13 Structure of Financial Resources

(in HRK)	2006 BUDGET	2007 BUDGET	2008 BUDGET	2009 BUDGET
Modernisation and construction of railway lines on X corridor - ISPA project - rehabilitation of Vinkovci - Tovarnik line	44.000.000	215.000.000	286.000.000	286.000.000
Budget funds	44.000.000	150.000.000	210.000.000	210.000.000
Pre-accession funds ISPA		65.000.000	76.000.000	76.000.000

According to available data and projections, estimates of the impact of the process of restructuring on budget expenditures for the period 2007-2009 are provided in the annex. The amounts presented in the tables in the annex equal budget projections for the same period and reflect a trend of decline in financial resources planned for subsidies and increased investment in the restructuring activities and investment in modernisation of fixed and mobile capacities of the railway sector.

4.1.4 Restructuring of the Shipbuilding Industry

The Croatian shipbuilding industry is sector of strategic importance to the Croatian economy, and in light of its export orientation, as reflected in the fact that it builds ships for the common world market in which it accounts for 1.4%, it is an important factor which contributes to the country's foreign trade balance. In terms of its national strategic importance, the shipbuilding industry employs almost twelve thousand own workforce and up to 7.5 thousand contractors

in the country's 5 largest shipyards.¹⁶ In terms of their regional importance, the Croatian shipyards represent a core activity which is associated with a line of manufacturers of ship equipment. On average, in 2005, the shipyards had business relations with around 1850 business entities with a financial turnover of HRK 3bn. Compared with the previous planned period (2006-2008), the shipbuilding industry has maintained more or less the same level of orders and ensured full employment for the next three years.

The State of the Shipbuilding Industry and Measures Taken in 2005 and 2006

Due to unfavourable conditions on the international ships markets and own weaknesses as reflected in technical obsolescence, high production costs, poor personnel structure and inadequate hedging mechanisms against negative influences of changes in input prices, most shipyards are faced with lack of financial resources for production monitoring, cumulating losses for many years now. To resolve business uncertainties in Croatian shipyards, the Government of the Republic of Croatia issued a Decision in December 2005 on the establishment of a Committee for drafting a proposal of the National Restructuring Programme of Croatian shipbuilding industry¹⁷ with an aim of preparing a National Shipbuilding Restructuring Programme.

Towards the end of September, a consultant (HVB Global Shipping) prepared a draft National Restructuring Programme which outlines the actual state of the Croatian shipbuilding industry and strategic options and measures to be taken with the aim of achieving efficient shipbuilding industry and halting negative trends through individual stages of Croatian shipbuilding restructuring. After guidelines have been determined and draft National Restructuring Programme, to be verified also by the EC and the Croatian Competition Agency, adopted, measures and strategic options will be determined for the shipbuilding sector that will prepare this industry for independent, no loss-generating operations, and remove all the detected drawbacks. With the adoption of National Restructuring Programme, future state aid policy in the shipbuilding industry will be determined that will be harmonised with the State Aid Act and the State Aid Decree. Following its harmonisation with the EC, the Government of the Republic of Croatia will adopt the National Restructuring Programme and carry out restructuring of the shipbuilding industry in accordance with the envisaged measures. The adoption of the National Restructuring Programme, together with its previous verification by the EC and the Croatian Competition Agency, is expected in the first quarter or at the latest until the end of the first half of 2007, depending on the quality of the suggested programme and EC harmonisation process.

Objectives and Measures of Croatian Shipyards Restructuring

The objective of the National Restructuring Programme is to prepare the five largest Croatian shipyards in state ownership for their autonomous and successful performance on the world market. The measures and the activities envisaged within the framework of restructuring will be aimed at eliminating external risks and promoting internal resources management processes in each individual shipyard, through individual restructuring plans for each of the five shipyards. Success in achieving viability of the shipbuilding sector through the implementation of the National Restructuring Programme will contribute greatly to regional and social stability, which will in turn, in light of its significance, make a positive impact on

¹⁶ The shipbuilding industry accounts for 12-15% of the country's total goods exports, 1.4% of the country's GDP, 1.8% of net wages and around 2% of contributions.

¹⁷ Five shipyards in majority state ownership are Brodograđevna industrija 3. maj d.d. Rijeka, Brodograđilište Kraljevica d.d. Kraljevica, Brodosplit d.d. Split, Brodotrogir d.d. Trogir and Uljanik d.d. Pula.

entire economy of the country¹⁸. In the framework of the above-mentioned basic objective of restructuring of the Croatian shipbuilding industry, plans for the shipyards involve the following:

- improve competitiveness through business rationalisation, including outsourcing and other operative measures that should lead to more efficacious and sustainable operations,
- the process of production modernisation (investment in technological renewal and IT support, leading to, together with the former, increased productivity),
- raise productivity and efficacy of business operations to a level that enables independent and successful performance on the world market in accordance with the principles of competitiveness,
- increase business flexibility by ensuring that production programmes respond to market requirements and win new markets (taking account of production programme optimisation in terms of financial results and the share of the domestic component in the value of the ship),
- raise management quality (various measures to stimulate the execution of business plans and restructuring programmes) and improve production process management,
- raise management responsibility and responsibility of the competent supervisory boards of the shipyards, achieve that the line ministry plays an active role in the supervision of shipyards' business decisions and their overall performance in terms of meeting the set shipbuilding industry restructuring targets,
- raise the level of innovation and investment in product development (in accordance with Programme LeaderShip 2015, which also implies participation in EU research and development projects and the use of state aid and relevant EU funds),
- preserve optimum level of employment and employee structure needed to ensure efficacious business processes, taking care not to jeopardise successful market performance of the shipyards.

State Aid Policy in the Shipbuilding Industry

With successful implementation of the National Restructuring Programme, the Croatian shipbuilding industry will create the conditions for its further viable operations and their alignment in the area of state aid, in accordance with the State Aid Act and State Aid Decree and regulations applicable in the Community. The present framework of state aid policy in the shipbuilding sector and the extremely high dynamics of state aid allocations which is the result of business uncertainties in the Croatian shipyards over the years are not compliant with the EC regulations and operating conditions applicable in the EU. At present, state aid is provided in the form of direct subsidies on the ship's sales price and in the form of government guarantees which provide ship construction coverage.

In 2005, further harmonisation in the area of state aid has been achieved by the adoption of the State Aid Act (Official Gazette 140/2005) and in the first quarter of 2006 by the adoption of the State Aide Decree (Official Gazette 50/2006). The adoption of competition rules in the context of the said Act has prevented the issuing of government guarantees without previous approval from the Croatian Competition Agency. Without this approval, the banks cannot grant loans against the issued guarantees, as such state guarantees are illegal. Towards the end of the third quarter 2006, the Croatian Competition Agency, on proposal from the line

¹⁸ Involving around two thousand Croatian companies with which they generate HRK 2.5bn in annual turnover. In addition, the Croatian shipyards also have significant business relations with EU companies, given that import equipment and material are largely supplied from the EU market.

ministry, approved a HRK 4.2bn worth aid package, granted on the basis of company restructuring and winding up directive and in accordance with the applicable State Aid Decree¹⁹. In the context of the operationalisation of the National Restructuring Programme, the authorities have provided for a gradual state aid policy alignment with the policies applicable in the EU. The dynamics of state aid policy harmonisation and implementation of the measures relating to the granting of state aid will depend on the final version of the National Restructuring Programme harmonised with the EC.

Privatisation

The preparation of shipyards for privatisation is a strategic objective of the Government of the Republic of Croatia, which will ensure, together with current economic policy measures, measures compatible with the economic policy of the EU, preconditions for their further successful performance. The implementation of the process of privatisation is planned to take place simultaneously with the implementation of the process of restructuring. In the context of the mentioned restructuring objectives, the choice of the majority owner is shipyard privatisation as soon as the necessary conditions for that are met. When making privatisation decision, efforts will be made to maximise privatisation proceeds and choose a strategic investor who will ensure long term sustainability of the Croatian shipyards and increase production programme competitiveness, compared with the world market.

4.1.5 Restructuring of the Metallurgy Sector and Aluminium Industry

Steel Industry

Analysis into this sector's conditions has revealed many problems, mainly due to large-scale war-related destruction and suspension of production during the Homeland War.

Massive technological and financial problems facing domestic ironworks require comprehensive restructuring efforts. Given that such restructuring requires large financial resources, the Republic of Croatia has decided to carry out the rehabilitation and restructuring of its ironworks (Željezara Split and Valjaonica cijevi Sisak) through privatisation. The process of privatisation and restructuring will be carried out in accordance with the Agreement and Protocol 2.²⁰ The main objective of restructuring and privatisation of the country's ironworks is to ensure their long term sustainability and profitability and equal conditions for competitiveness such as those in the EU.

In the first half of 2006, the authorities prepared a programme proposal for the restructuring of Croatia's steel industry and submitted it to the EC, DG Enlargement, which gave its recommendations and suggestions. The completion of this National Restructuring Programme, the drafting of which involved cooperation with EU consultants and open harmonisation with the EC, is expected until the end of the year.

¹⁹ The amount of aid is granted under the following conditions: the guarantee and a loan would be granted under market conditions; a loan would be repaid in the period of 12 months after the payment of the last instalment; the aid is granted because of serious social problems; the aid is limited to a needful amount which enables the operation of the business; it is granted for the period needed for the preparation of the restructuring plan, maximum for six months; it is granted only once.

²⁰ With the entering into force of the Interim Agreement on trade and associated issues between the Republic of Croatia and the European Communities and Protocol 2 of the SAA, the Republic of Croatia has assumed the obligation to prepare a Programme of Restructuring and Adjustment of its steel industry in order to achieve the sector's sustainability under normal market conditions.

Simultaneously with the adoption of the National Restructuring Programme, the authorities will continue with the process of privatisation of both ironworks. Tender conditions²¹ for privatisation have been prepared in cooperation with EC consultants and the Croatian Competition Agency, in compliance with the criteria determined under the SAA regarding competition rules and Protocol 2 regarding steel products. The completion of privatisation of Željezara Split is envisaged for end-2006, while the privatisation of Valjaonica cijevi Sisak is envisaged for the first quarter of 2007. The adoption and enactment of the National Restructuring Programme for Croatia's steel industry is expected until 1 March 2007 at the latest.

State Aid and the Process of Steel Industry Restructuring

Aid for restructuring in the process of privatisation will be allocated in accordance with the criteria laid out in Article 5 of Protocol 2 of the SAA between the Republic of Croatia and the European Communities and the State Aid Act and the State Aid Decree.

State aid for restructuring will be granted under the condition that:

- they lead to the sector's sustainability after restructuring,
- they are strictly limited to what is absolutely necessary to attain sustainability,
- they are related to the overall capacity reduction.

State aid will be granted by writing off claims arising from liabilities associated with issued government guarantees and other due liabilities towards government creditors. The amount of state aid in the process of privatisation of Željezara Split and Valjaonica cijevi Sisak cannot be estimated at the moment, given the fact that the public tender for the sale of the ironworks is currently underway, pursuant to the provisions of the Privatisation Act. The amount of aid involved in the process of restructuring will depend on the completion of the process of privatisation. As envisaged by Protocol 2 of the Agreement, no state aid will be provided for the steel industry after 1 March 2007.

Future State Aid Policy in the Steel Industry Sector

Following the completion of ironworks privatisation and restructuring, future aid will be granted in accordance with the rules applicable in the EU and Member States relating to aid for:

- new product development,
- introduction of new technology,
- improvement of the quality of the existing production programme,
- achieving high environment protection standards,
- employee education and training schemes, as a precondition for modern and competitive steel industry in the Republic of Croatia.

For the said objectives to be achieved, continuous investment in research and development, environment protection and employee education and training will be needed.

The Republic of Croatia will promote further development of the steel sector through a system of state aid that is compliant with the State Aid Act and relevant EU and Member

²¹ Future owners are expected to make separate business plans for each of the ironworks, demonstrating their sustainability under normal market conditions at the end of the restructuring period (according to the accepted sustainability criteria of the EC).

States' practices in that area. Below in the text, an overview is given of the conditions and the envisaged privatisation dynamics.

Željezara Split

The Government of the Republic of Croatia has issued a Decision on announcing a public invitation for bids for the purchase of shares of Željezara Split under special conditions. The terms of the tender and bidding documents were prepared in cooperation with EC consultants and the Croatian Competition Agency.²²

Valjaonica cijevi Sisak

The Government of the Republic of Croatia issued a Decision on the sale of a stake in Valjaonica cijevi Sisak at nominal value. Since the sale in the first round has not been realised, the Government of the Republic of Croatia has issued a Decision on the sale of a stake in the company with the discount (the tender is underway).

Aluminium Production

TLM Šibenik deals with the manufacture of rolled, pressed and drawn aluminium products and pressed products finalisation in construction. Employing 1593 workers, it is the most important economic entity in the sector and in the region. Despite rehabilitation and restructuring measures taken so far, TLM continues to be a highly indebted company unable to service the existing debt and create the conditions for sustainable operations without new investment and a strategic investor that will guarantee sustainable development free of loss generation and state aid in business rehabilitation and consolidation. The extremely high level of indebtedness prevents new investment needed for new capital investment in equipment and technology in order to improve efficacy and achieve business sustainability.

With a view to ensuring long term sustainability of the company and its future profitability, the Government of the Republic of Croatia has decided to privatise the company, with the future investor assuming the business risks and the associated company restructuring that would enable the company to achieve business sustainability without generating losses. The Government of the Republic of Croatia has issued a Decision on the announcement of public invitation for bids for the purchase of company shares in the government portfolio (80.2%) at nominal value.²³

In view of the extremely difficult situation in the company, its privatisation is expected to generate a certain amount of state aid in the form of government claims write-offs. Given the high level of the company's losses and debts, any sale to potential investors would be very difficult without state aid. With its sale, the intensity of state aid will diminish while the

²² The bidder is bound, among other things, to submit a Business Plan for the next 5-year period and an Investment Plan which contains structural and financial provisions which are compliant with the restructuring conditions provided for in Article 5 of Protocol 2 of the SAA and ensure long term profitability of the company; to invest the amount deemed necessary by the bidder for restructuring in accordance with the supplied investment plan by means of recapitalisation over a 5-year period; to offer a discount for the purchase of all due liabilities of the company towards government creditors (which, as at 30 June 2006 stood at HRK 194.3m); the discount offered must be absolutely necessary for the re-establishment of the company's long term profitability; to assume all other existing liabilities of the company (which, as at 30 June 2006 stood at HRK 116.4m, liabilities covered by government guarantees excluded) towards other creditors; assume all liabilities covered by government guarantees amounting to HRK 173.8m or offer substitute guarantees issued by a first-rate bank.

²³ If the shares are not sold in the first two rounds as envisaged under the Privatisation Act then the sale under special conditions will apply.

company itself will in the future be able to operate on its own without state aid which distorts market competition and violates market competition rules.

The process of privatisation and the associated restructuring will be carried out in accordance with the principles of the models formulated for the steel industry (Željezara Split and Valjaonica cijevi Sisak). Future state aid in the aluminium sector will be defined following privatisation and restructuring and it will be compliant with EU competition rules and domestic legislation in the area of state aid.

4.1.6 Small and Medium Size Enterprises

Small and medium size enterprises (SME) account for around 99% of all economic entities and around 60% of employment in the Republic of Croatia. According to data provided by the Court Register, the year 2005 saw a significant increase in the number of newly established companies (8,920). Such positive and qualitative developments in the area of SMEs are also confirmed by the Global Entrepreneurship Monitor (GEM) which points to Croatia's significant improvement in rising from 32nd place of the total of 37 countries in 2002 to the 19th place of the total of 35 countries in 2005.

The achieved progress is the result of the measures taken to speed up the process of development of SMEs by the setting up of HITRO.HR service which helped reduce the number of documents needed for registration and by the effects of more efficacious implementation of incentives. In the Republic of Croatia at the beginning of 2006, the total number of registered small and medium size companies stood at 70,729, number of crafts was 105,274 and cooperatives 1,292.

Efficacy of the Incentives for SMEs Development

With the aim of strengthening SMEs, the Government of the Republic of Croatia, launched in 2005 its One Stop Shop project, i.e. its HITRO.HR service with a view to improving and establishing IT-based communication between entrepreneurs and citizens and government administration. HITRO.HR service provides to future entrepreneurs all the necessary information in one place from where they can carry out further communication with government administration bodies.

One of the strategic measures adopted by the Government of the Republic of Croatia to strengthen SMEs is the Programme of Incentives to Small and Medium Size Enterprises 2004-2008 together with an Operative Plan for incentives to SMEs for the year 2006, formulated in the context of this programme. All the measures planned for 2005 under this programme were implemented²⁴. A total of 2,961 non-refundable incentives were granted, totalling HRK 138.4m.

In compliance with the EU Charter, in the context of measures for cheaper and faster registration of economic entities in small businesses, an e-crafts service was introduced in June 2006, providing electronic craft registration services.

²⁴ The 2005 PEP, page 61, the measures planned under the programme were as follows: education in entrepreneurship, entrepreneurship financing, business infrastructure, competitiveness, entrepreneurship marketing and promotion, target groups, cooperative-specific and crafts-specific projects.

As one of the measures aimed at removing administrative barriers for entrepreneurs, in June 2006, a WEB portal entitled „Business navigator” was launched, comprising information subsystems credit guide, business network, investment in Croatia and business centres.

The projects to improve competitiveness in 2006 were designed with a view to achieving faster and more successful transformation of research results and technological innovation into internationally competitive products. The functioning of the Croatian innovation system is encouraged through a set of integral measures with a view to achieving the effects which are compliant with the guideline providing for the knowledge-based economy.

It should be noted that Croatia boasts a well-branched business related infrastructure involving development agencies, entrepreneurship centres, entrepreneurship incubators, technological parks/technological centres, business zones. Such a framework for SMEs development provides a good-quality basis for further SMEs development which is expected to make a large contribution to value added generation and improved competitiveness of the Croatian economy.

Improving SMEs Sector Efficacy

The Government of the Republic of Croatia is committed to its development policy implementation as seen in continuous implementation of incentives through its line ministry (Ministry of the Economy, Labour and Entrepreneurship) and the strategic document of the Republic of Croatia: “Strategic Development Framework 2006-2013” adopted in mid-2006. Such a comprehensive and thorough approach to SMEs sector development points to an unambiguous orientation of the country’s economic policy towards development and improved competitiveness of the national economy, with SMEs as one of the most significant generators of the Croatian economic development.

The incentives are focused on a number of areas such as:

- the setting up of new entrepreneurial zones,
- different tax relief schemes,
- removal of administrative barriers,
- measures aimed at raising competitiveness of the country’s economy (investment in development, training, and new technology),
- a change in activity structure in favour of production,
- export orientation strengthening,
- creation of positive business environment (developing entrepreneurial culture).

The Government of the Republic of Croatia has been pursuing a proactive policy directed towards promoting SMEs development on local and regional levels and through the activities of the Croatian Agency for Small Business, Agency for Exports and Investment Promotion and institutional support provided to the SMEs by chambers, associations, entrepreneurial centres, technological parks and incubators and development agencies.

Business policies of the financial institutions (mainly commercial banks) also play an important role in determining the dynamics and the quality of SMEs development. In 2005 and 2006, qualitative improvements were seen in the financial follow-up of SMEs strengthening programme, mostly through Croatian Bank for Reconstruction and Development but increasingly also through commercial banks. This is the result of a well-designed framework for SMEs development as well as qualitative improvements in the sector. In the period 2007-2009, financial institutions can be expected to make an even greater

contribution to further SMEs development, particularly in view of the high level of stability and development of the Croatian banking system and further financial system deepening.

In the context of PHARE 2006 programme, a grant scheme project has been devised intended for the SMEs sector with the aim of increasing competitiveness and exports of the Croatian SMEs. This pilot project, whose launching is planned for mid-2007 will finance consulting services, promotion activities, market research, product development and participation at international fairs and events. The project also presents an opportunity for the adoption of the procedures and the establishment of institutional structures which would manage the grant scheme system in the pre-accession period, thus preparing the Republic of Croatia for the use of future structural funds.

The joining of economic entities for the purpose of creation of economic and interest associations or other contractual forms, and promotion of the already formed clusters with the view to achieving a higher level of joint product finalisation is one of the efficient measures taken that is expected to add to the SMEs sector quality in the Republic of Croatia.

The areas of SMEs development incentives in the future period are in line with the general objective of the knowledge-based economy and principles of the EU Charter for small businesses and they include:

- education in entrepreneurship,
- competitiveness,
- entrepreneurship financing,
- business related infrastructure.

It will be possible to make a concrete and methodologically based assessment of the fiscal impact of the projects of SMEs incentives after the setting up of a monitoring system within the Ministry and the implementation of the PHARE 2005 project entitled “SME Institutional Strengthening and Policy Alignment” which envisages the setting up of a SMEs observatory. The implementation of SMEs incentives projects is analysed by users and by counties and is processed on an annual basis, in the context of a budget year.

4.1.7 Public-Private Partnership

The Objectives of Public-Private Partnership (PPP) Model Implementation

The Government of the Republic of Croatia has adopted a concept of PPP to promote further economic development and private entrepreneurship with the view to:

- contracting and building a larger number of public constructions;
- ensuring that risks are spread among private entrepreneurs and the public authorities, all with the aim of achieving a more efficacious and effective use of tax payers’ funds;
- benefiting from greater efficiency of private entrepreneurs, for whom it has been made possible to build efficiently and effectively and to manage the completed projects more efficiently and effectively than the bodies of public authorities,
- creating value added through the pooling of resources, efforts and knowledge of the private and the public sectors,
- increasing productivity, competition, rational use of economic capacities of private and public entities;
- achieving transparency in selection and contracting,

- finding new solutions for public infrastructure construction and maintenance;
- providing medium term to long term boost to economic activities;
- ensuring rational use of the public resources to the benefit of all public services users.

The Guidelines for the Use of Contractual Forms of PPP Models

The Guidelines for the Use of Contractual Forms of PPP Models²⁵ lay down:

- the conditions that a PPP project has to meet as well as the procedures governing cooperation between public and private partners in the context of PPP,
- rules for PPP establishment and implementation that will reduce the risks to the public budget,
- the powers of the bodies of public authorities to conclude agreements within the legal framework of PPP,
- elements commonly characterising PPP.

Any decision for or against PPP projects has to be based on the consideration of the fact whether there exists for the public sector the so called “value added”. Value added is reflected in savings made, higher standard of service or lesser damage to the environment, and may be achieved through PPP:

- by means of more efficient projects which involve creative and innovative approach to problem solving,
- by not exceeding the amount of planned investment funds from the government budget,
- by optimising the project throughout its entire life cycle, by integrating the project phase, the construction phase, financing and construction maintenance.

The Guidelines define the persons that can conclude PPP contracts on behalf of the public sector and the obligatory elements of PPP contracts. With a view to further PPP model development and supervision over the bidder selection procedure, bids preparations and submissions, contracting and the implementation of the agreed projects, the setting up of a Department for Private Public Partnership within the Agency for Investment and Export Promotion is envisaged. Control of the fiscal capacities of the units of local and regional self-government will also be ensured through the activities of the Ministry of Finance. For that purpose, it has been provided that a public partner, in the context of the defined Guidelines, may conclude a PPP contract (PIF model) only if the total annual amount of all fees that the public partner pays, based on all PPP contracts, to private partners, does not exceed 35% of the generated budget revenue in the previous budget year, net of capital revenue. PPP models may be applied in different sectors. The time frame for the implementation of the Guidelines has not been determined, but it may involve the time period until other legislative acts or regulations are adopted which will define differently the elements defined under the Guidelines.

With respect to fiscal impact assessment, at this moment it is not possible to assess the impact on the budget or the economy, given a large-scale use of contractual PPP models for the realisation of public constructions projects and communal infrastructure in the Republic of Croatia. So far, contractual PPP models have aroused much interest, particularly among the units of local and regional self-government, with a number of PPP pilot projects already being in the phase of realisation.

²⁵ The Guidelines are adopted by virtue of Resolution of the Government of the Republic of Croatia at its session on 1 September 2006.

4.2 FINANCIAL SECTOR

4.2.1 Banking system

Banks continue to represent the most important segment of Croatia's financial system. However, in December 2005, for the first time in the past ten years, the share of total banking sector assets accounted for less than 80 % of total assets of the financial sector.

Table 14 Shares of Financial Institutions in Total Assets, End of Period²⁶

	2001	2002	2003	2004	2005	VI 2006
Banks, consolidated assets, in gross terms	87,5	85,0	83,3	81,4	78,6	77,6
Open-end investment funds, net assets	0,9	1,4	1,4	1,8	2,8	3,6
Closed-end investment fund, net assets*	2,3	1,6	0,4	0,4	1,2	1,2
Insurance companies	5,9	5,7	5,4	5,2	5,1	5,1
Housing savings banks, consolidated, gross	0,8	1,1	1,5	1,8	1,8	1,6
Compulsory pension funds, net assets	0,0	1,1	2,0	2,9	3,6	3,9
Voluntary pension funds, assets	0,0	0,0	0,0	0,0	0,1	0,1
Savings and loans associations	0,6	0,6	0,6	0,6	0,5	0,5
Leasing companies**	2,0	3,6	5,4	6,0	6,2	6,4
Total	100,0	100,0	100,0	100,0	100,0	100,0

*of which PIF's and War Veterans' Funds

**preliminary data

Banking sector consolidation continued through 2005 and 2006, with the number of banks further declining. At the end of 2005, the banking sector of the Republic of Croatia comprised 34 banks and 4 housing savings banks. Banking sector assets totalled HRK 266.4bn at the end of 2005. Banks accounted for 97.7% of total banking sector assets, while housing savings banks accounted for 2.3%.

The consolidation process continued in the first half of 2006, with the number of banks falling to 33 early in July due to one merger. The number of housing savings banks increased by one to a total of five housing savings banks.

Table 15 Number of Banks (Domestic/Foreign Ownership) and Their Share in Total Banking Sector Assets

Year	In domestic ownership	Share in total assets (%)	In foreign Ownership	Share in total assets (%)
2002	23	8,7	23	91,3
2003	22	9,0	19	91,0
2004	22	8,5	15	91,5
2005	20	8,7	14	91,3
VI 2006	20	9,5	14	90,5

The decrease in the number of banks in (majority) foreign ownership had no influence on the share of their assets in total banking sector assets.

²⁶ Sources: CNB, MF, Croatian Financial Services Supervisory Agency (HANFA).

Table 16 Total Banking Sector Assets (in million HRK)

	XII 2002		XII 2003		XII 2004		XII 2005	
	amount	amount	change	amount	change	amount	change	
Total assets	174.139,2	204.115,0	17,2	229.305,2	12,3	260.285,2	13,6	

There are 6 banking groups operating in the country, with the reporting requirements set by the Croatian National Bank being met by the superordinate banks in accordance with the Decision on Consolidated Financial Reports of Banking Group. In 2005, two new banking groups became obligated to deliver consolidated financial reports, while one banking group ceased to exist. Superordinate banks continue to dominate the operations of all groups.

The second half of 2005 and the first half of 2006 saw substantial changes to prudential bank regulations. The greatest number of changes resulted from the revision of International Accounting Standards (IAS) and the implementation of new International Financial Reporting Standards (IFRS), which entered into force on 1 January 2005, thus prompting the CNB to amend a great number of its subordinate legislation²⁷.

The Decision on Limitation of Banks' Exposure to Foreign Exchange Risk was amended in the second quarter of 2006 prescribing the requirement for banks to report their foreign currency exposures on daily bases for every day of the year.

Due to substantial euroisation of the balance sheets of Croatian banks, the Croatian National Bank adopted Currency Induced Credit Risk Management Guidelines. These Guidelines are aimed at helping banks to adopt policies and procedures required for determining, measuring, monitoring and controlling currency induced credit risk as well as ensure regular reporting and raise additional capital for placements to such (unsecured) clients. The application of these guidelines as well as of the amended regulations in the segment of capital adequacy has affected the movement of capital adequacy ratio of banks since mid 2006. In addition, the CNB published Guidelines Adequate Externalisation Risk Management in October 2005 and Guidelines for IT Management Aimed at Reducing Operative Risk in March 2006. Aiming at improving the quality of bank loan portfolio, especially with regard to household placements, the CNB issued Guidelines for Managing Credit Risk Arising from Placements to Households (Natural Persons) in October 2006. Banks should use this document as guidance in adjusting and improving their own policies and procedures for managing credit risk that arises from household placements.

Work on further alignment of laws and subordinate legislation with EU directives continued in 2006, with plans for the 2006 to 2009 period involving the adoption of the following banking regulations:

- Act on Credit Unions (by the end-2006)
- Deposit Insurance Act (third quarter 2007)
- Financial Collateral Act (third quarter 2007)
- Credit Institutions Act (first quarter 2008)
- Domestic Payments Act (first quarter 2008)
- Act on Reorganisation and Liquidation of Financial Institutions (first quarter 2008)
- Financial Conglomerates Act (third quarter 2008)

²⁷ Decision on the Capital Adequacy of Banks, Decision on the Classification of Placements and Contingent Liabilities of Banks, Decision on Consolidated Financial Reports of a Banking Group, Decision on the Chart of Accounts for Banks, Decision on the Statistical Report for Banks and Decision on Supervisory Reports of Banks.

In the course of 2006, special attention has been given to the implementation of the Capital Requirements Directive (CRD), aiming at transposition into national legislation of the new methodological framework for capital requirements calculation (Basel II). The Governor of the Croatian National Bank adopted an Action Plan for the Creation of the Credit Institutions Act, which is to implement the CRD, in June 2006. In accordance with the Action Plan, the adoption of subordinate legislation for the implementation of the CRD is envisaged in the fourth quarter of 2008.

Parallel with preparations for the implementation of the CRD contacts have been established and memoranda of understanding signed with home supervisors from Austria, Italy and Hungary as well as with host supervisors from Bosnia and Hercegovina, while memorandum of understanding between the home supervisors from France and the CNB is being prepared. Aiming at efficient supervision of the banking and financial sector of the Republic of Croatia, the CNB and HANFA signed a Memorandum of understanding in October 2006.

Taking into account the regulations in preparation the CNB, in its capacity as bank supervisor, continues to improve its supervisory approach placing the greatest stress on risk management supervision (credit risk, market risk, liquidity risk) as well as supervision of the system of internal controls, information technology, and implementation of monetary and foreign exchange policy measures.

A new regulation is expected to be adopted in the coming period, which will regulate payment operations in accordance with accepted European standards. A schedule for the adoption of subordinate legislation will be set within the framework of this regulation, defining individual operations from this area. Efforts invested in the harmonisation of existing regulations with the changes introduced by new International Financial Reporting Standards will be continued.

The adoption of the new Deposit Insurance Act is planned by the end of third quarter of 2007, as a way of tackling the points by which the Deposit Insurance Act currently in force diverges from the EU Directive regulating the basic postulations of bank deposit insurance systems²⁸.

4.2.2 Foreign Exchange System Regulation

Within the framework of the liberalisation of the country's foreign exchange system and in line with the previous PEP, the Republic of Croatia continued with the liberalisation of capital transactions in 2006.

In addition and although not planned by the previous PEP, aiming at complete liberalisation of the capital account, further liberalisation of cash operations between residents and non-residents as well as transactions relating to taking cash in and out of the country when crossing the state borders was continued in 2006.

By Amending the Decision on the Manner and the Conditions for Investment of Residents into Foreign Securities and Stakes in Foreign Investment Funds (Official Gazette 44/2006) the Croatian National Bank further liberalised capital transactions in the field of securities operations. Pursuant to the amendments to the said Decision residents are free to acquire stakes in foreign investment funds without checking in advance with the former Croatian

²⁸ Directive 94/19/EU)

Securities Commission (now the Croatian Financial Supervisory Authority) whether the reciprocity principle has been satisfied by the chosen fund.

The Decision Amending the Decision Governing the Conditions for and the Manner of Opening and Managing Non-Resident Bank Accounts (Official Gazette 54/2006) and new Decision Governing the Conditions for and the Manner of Opening and Managing Non-Resident Bank Accounts further liberalised cash operations of non-residents across their accounts with domestic banks. Pursuant to the provisions of new Decision, non-residents are free to deposit into and withdraw from their accounts kuna cash and foreign currency cash.

The Decision on the Amendments to the Decision Governing the Taking In and Out of the Country, Cash, Checks and Materialised Securities (Official Gazette 62/2006) enabled non-residents to freely take in and out of the country kuna cash and checks when crossing the state border as well as freely send, in postal and other parcel services, kuna and foreign currency cash complying with the regulations governing postal services in international transport. The taking in and out of the Republic of Croatia of kuna and foreign cash by non-residents has thus been fully liberalised.

Despite the liberalisation of the capital account over the past several years, a share of capital transactions remains restricted. That is why free movement of capital between participants in the capital and money markets of the Republic of Croatia and the EU was not fully achieved. This makes it harder for domestic investors to diversify their portfolios, achieve higher returns in individual markets and raises transaction costs of investments.

One of the goals set by the Republic of Croatia for 2007 is further liberalisation of capital transactions in accordance with the level of achieved macroeconomic stability and the development of the financial market as well as readiness for further opening of the capital account. The 2008 goal is to fully liberalise the capital account.

These goals will be achieved by amending and/or repealing individual provisions of the Foreign Exchange Act and subordinate legislation within the scope of responsibility of the Croatian National Bank. The key measures relate to full liberalisation of short term financial financing flows and enabling residents to open accounts with foreign banks. In addition, cash transactions between residents and non residents will be fully liberalised as well as taking in and out of kuna cash across state borders by residents.

4.2.3 Non-banking Sector Supervision

The supervision of the non-banking financial sector in Croatia is regulated by the Croatian Financial Services Supervisory Authority Act, which has been enacted in 2005. The Croatian Financial Supervisory Authority (HANFA) was established on 1 January 2006 by uniting the then-existing institutions for the supervision of the non-banking sector - the Croatian Securities Commission, Insurance Companies Supervisory Authority and the Agency for the Supervision of Pension Funds and Insurance Companies. HANFA is financed from the state budget, fees on assets and income of entities under its supervision and fees for services rendered. It is independent in its work and accountable to the Croatian Parliament.

As at 31 December 2005, there was a 51 open-end investment fund with assets totalling HRK 10.9bn and 6 closed-end investment funds with net assets totalling HRK 1.5bn. There are also 22 investment fund management companies registered in Croatia.

Complete turnover on the two stock exchanges in the Republic of Croatia, the Zagreb Stock Exchange and the Varaždin Stock Exchange is also under the jurisdiction of HANFA. At the end of June, market capitalisation at the Zagreb Stock Exchange was HRK 147bn, while that at the Varaždin Stock Exchange during the same period was HRK 56bn.

HANFA supervises the operations of 4 mandatory pension funds with total assets of HRK 11.7bn and 14 voluntary pension funds with total assets of HRK 227m. It also supervises the operation of 17 leasing companies with assets of HRK 18bn and 3 factoring companies with assets of 320m. HANFA supervises the operations of insurance companies whose number was 25 at the end of December 2005 with assets totalling HRK 16.5bn as well as insurance brokers and insurance agents.

The Croatian insurance market grew by 10.4% in the first half of 2006. Total gross premium underwritten by insurance companies in 2005 was HRK 7.35bn of which HRK 5.45bn went to non-life insurance premiums and HRK 1.9bn to life insurance premiums. Thanks to high growth of life insurance over the previous years the share of this insurance business segment in the total portfolio has been continuously rising, totalling 25.8% in 2005, while the share of non-life insurance has been gradually declining, totalling 74.2% in 2005.

In performing its public responsibilities, HANFA is authorised to:

- enact regulations relating to the implementation of the Croatian Financial Supervisory Authority Act and other Acts under its responsibility;
- perform supervision pursuant to its authorisation under the Act over operations of different entities;
- order measures aimed at elimination of determined violations and irregularities;
- issue and withdraw licences, approvals and authorisations when authorised to do so by the Act;
- facilitate, organise and supervise measures for efficient functioning of the financial market;
- keep books and registries pursuant to the provisions of the Act;
- launch initiatives for enactment of other acts and regulations and inform the public of the principles applied in the operation of the financial market;
- enact subordinate legislation;
- give opinions on the implementation of the Act;
- notify other supervisory, administrative and judicial authorities on all issues directly or indirectly related to their responsibilities and competences on proceedings run before these authorities which are connected with the proceedings under to the responsibility of HANFA.

As for its administrative capacity, HANFA introduced a new organisational structure adding 14 trainees and 6 new employees to its existing staff of 80, starting from 1 November 2006. It adopted a Code of Conduct as well as signed a Co-operation Agreement with the Croatian National Bank. In 2006, exams were carried out for 1400 insurance brokers and agents, training was prepared for 350 brokers, investment advisors and pension fund managers. HANFA also participates in the process of uniting the Zagreb and the Varaždin Stock

Exchange and it successfully demonstrated its administrative capacity on the example of the Pliva takeover.

In addition to the Croatian Financial Supervisory Authority Act, the following acts were adopted in relation to the non-banking sector in 2005: the Insurance Act, the Act on compulsory Insurance within the Transport Sector, the Act on Investment Funds and the Accounting Act. By the end of this year adoption of subordinate legislation is planned in connection with the Insurance Act, the Act on compulsory Insurance within the Transport Sector and the Act on Investment Funds.

Further efforts will be made in 2006 in connection with the regulation of the non-banking sector. As a result, the following acts will be adopted until the end of the year the Leasing Act, the Act on Credit Unions and the Act on the Amendments to the Securities Market Act.

The Leasing Act is exceptionally important because, individually speaking as well as by assets per GDP, the leasing industry is the second largest industry in Croatia. Together 15 leasing companies account for assets of some HRK 15bn, inclusive of operative and financial leasing. The Leasing Act will define the status of leasing companies from the accounting and the tax aspect. The economic impact of the leasing industry in Croatia reflected itself in the intensive external debt growth especially when the CNB introduced marginal reserve requirement on all foreign sources of funds. This turned leasing companies into SPVs (special purpose vehicles) for their parent banks. The adoption of the Leasing Act will place leasing companies under the supervision of the Croatian Financial Supervisory Authority which will enact all implementing acts within the realm of leasing companies operations.

The Act on Credit Unions will regulate the system of micro-lending in more detail, thus ensuring stability and growth of this share of financial services. The Act will also regulate in more detail the supervision over the operations of credit unions and lays down measures for securing stable operations.

The Act on the Amendments to the Securities Market Act planes changes related to the ownership structure of the stock exchange, thus enabling even unauthorised companies to establish a stock exchange. Such as for instance, investment fund management companies, pension fund management companies, insurance companies, etc. The share capital of the stock exchange will be raised to HRK 40m and a limit will be introduced for the share of the individual shareholder in the capital or voting rights. The Act will introduce changes aimed at increasing the transparency of the market. A provision will be introduced, under which HANFA has the possibility of prescribing data that issuers of securities entered in the first quotation on the stock exchange are obligated to disclose, as well as time limits and the manner of their disclosure. The Act will also regulate special trading on the stock exchange (Market Making), that is, transactions involving securities with simultaneous publication of the sale and purchase offer, for own name and account, for the purpose of maintaining constant supply and demand for certain security.

In year 2007 some more acts are planned to be adopted: the Companies Takeover Act, the Financial Conglomerates Act and the Act on the Amendments to the Act on Mandatory and Voluntary Pension Funds which will contribute further to regulation and development of non-banking system.

4.3 LABOUR MARKET

The screening process under Chapter 19 of *acquis communautaire* on social policy and employment carried out within the framework of pre-accession activities of the Republic of Croatia, which are aimed at acquiring full membership in the EU. In the Report it adopted the EC assessed that as regards this Chapter of the *acquis* Croatia may not be considered sufficiently prepared as to be able to open pre-accession negotiations because there are specific issues in the field of administrative capacity to be solved. For this purpose, the creation of an Action plan on gradual transposition of the *acquis* into national legislation is under way. It will contain detailed data on institutions and human resources assigned to every individual task as well as determine accompanying supportive actions aimed at strengthening of administrative capabilities. In the next medium term, this will require the establishment of new institutions as well as employment and training of a larger number of government employees, which will together with the necessary infrastructure make up additional expense for the state budget over the two coming years. At the moment the cost is roughly estimated at some HRK 50m per year.

4.3.1 Stimulating Employment

Labour market key indicators for the period continue to indicate continual rise in employment and decline in unemployment. In the past period, the employment rate went up to 54.8%, while after full ten years the unemployment rate fell below 13% to 12.7% in 2005. In first half of 2006 unemployment rate further decreased to 11.8%. Based on the guidelines adopted under the 2005-2008 National Action Plan for Employment, the 2006 Annual Plan for Stimulating Employment was adopted. It contains criteria and measures for allocation of government grants in the field of education and employment regulated by the Act on Government Grants and the Regulation on Government Grants Relating to Protection of Market Competition, which received positive reviews from the Agency for Protection of Market Competition. The new cycle of active employment policy measures is directed especially at particularly sensitive groups in the labour market. Their implementation so far has had positive results since the largest number of the newly employed persons was young persons without working experience as well as persons who have been unemployed for a long period of time. In addition, we deem positive that most users of active employment policy measures are small and medium-sized employers. This leads to the conclusion that precisely those employers as generators of economic growth and development open new jobs.

As a structural problem in the labour market remains the mismatch between supply and demand. Therefore continual investment in people as well as raising their employability through adoption of knowledge and skills that are required by the labour market increases their flexibility in the long term. A developed system of formal and informal education is a much more efficient protection against employment and poverty than statutory protection. Therefore continuous maintenance and increase of an individual's employability leads to learning and continual professional development, which in consequence changes the aspiration towards permanent employment and job security towards permanent employability. For this purpose, the implementation of activities initiated thus far will be continued.²⁹ Aiming at adequate monitoring, analysis and evaluation of active employment policy

²⁹ 2005 PEP

measures, co-operation was established within the framework of technical bilateral aid of the Ministry of Economy and Labour of the Republic of Austria. L&R Social Research Institute will participate in the analysis and evaluation of active employment policy measures in the Republic of Croatia and pass on the necessary knowledge, skills and experiences to the responsible experts of the Croatian Employment Service and Economic Institute. This analysis by an independent body will ensure an efficient evaluation and better economic and social purposefulness of the said measures.

Over the previous years, state administration bodies implemented active employment policy measures independently only within their individual realm of responsibility as well as individually ensured and maintained their funds for the implementation of these measures. The 2006 Annual plan integrated and united all active employment policy measures and in this way united all the funds from the state budget in the items of responsible bodies, which total HRK 360m. We expect that over the medium term the planned funds will be increased at least by the level of the expected economic growth. This is why budget expenditures in this area over in the next year will be budgeted at some HRK 400m. It is noteworthy that implemented active employment policy measures will surely have positive effects also on budgetary revenues due to the increase in employment and decline of unregistered employment. However, they are presently very difficult to assess since these effects depend on the rise in economic power of each individual as well as of economy as a whole.

4.3.2 Social Security System

The social security system in the Republic of Croatia comprises pension and health care system, the system of protection from unemployment, the system of protection of family and children as well as social assistance and social welfare system (which is officially referred to as the “social welfare system”). In contrast to many other countries, Croatia has been setting aside substantial funds for relieving the consequences of the Homeland War (the state has intervened greatly in taking care of all those affected by war: exiled persons, refugees, returnees, enlisted soldiers who participated in war, war veterans and families of persons killed or missing).

In order to facilitate faster economic growth and inclusion in European associations, the government is striving to restructure the social security sector, reduce expenses for social protection, that is, to transfer them in part directly to the citizens and civil society.

So far, insufficient attention has been given to the problem of multiplication and overlapping of rights in different areas. In fact, there was a lack of co-ordination and exchange of information between different segments of the social security system. Insufficient adjustment of rights to benefits is characteristic both for benefits realised at different state levels as well as the same state level (primarily at national level). Mutual co-ordination of expenditures for social benefits represents an important component of the Croatian fiscal programme. Therefore attention is redirected to the establishment of a relationship between different areas of social rights (benefits), instead of treating them isolated, in order to avoid unjustified accumulation of rights or multiple exclusion of potential beneficiaries (when ineligibility for one of the rights is connected with withdrawal of other rights). Legislative provisions, procedure and administrative organisation in individual segments are not harmonised and thus make it difficult realise rights. It should be born in mind that the beneficiaries of different benefits are often members of the so-called vulnerable groups within the society, whose

personal resources (lack of information, social skills, education etc.) may make it more difficult to access social benefits.

In this context, a comprehensive reform of the system will be carried out, aiming at accomplishing the following three goals: (1) decrease of expenditure on monetary benefits in GDP, combined with the parallel increase in social welfare benefits; (2) reduction in the number of rights in the social security system and (3) adjustment of rights having in mind both the beneficiaries and goals to be achieved through these rights.

By creation of the 2006-2008 Strategy for reform of social security benefits, reform of the following social security benefits has been encompassed:

- benefits which are not based on insurance: children's allowance, maternity allowance, protection of military and civil war invalids, benefits veterans of the Homeland War,
- certain benefits which arise from insurance: unemployment benefits; maternity leave up to 6 months.

The law provides different bases for the calculation of social benefits, that is, responsible ministries use different criteria for the determination of the amount of certain benefits. The basic amount for realisation of social security (assistance) rights is laid down by the Government of the Republic of Croatia and currently it amounts to HRK 400. The said basic amount was set in 2001 and it has not changed since although cost of living rose substantially. Its determination is not connected with the cost of living, average wage, the lowest pension or some other appropriate figure which would condition continuous change of the basic amount. Although it has been established that rights in the segment of social welfare are the best aimed rights and that in their largest share they do take into account the wealth census, unlike some other social benefits, the amounts of social welfare benefits are the lowest benefits to the socially most vulnerable groups. Therefore efforts have been made to introduce a unique basis for the calculation of all social security benefits, apart from benefits in the system of social welfare. Social welfare system has been singled out due to its specific role and relative small share in total assets of the social security system. In contrast to other systems the primary aim of social welfare is to mitigate poverty and social exclusion, which means that this system is not directed entirely at the poor.

The aim of social welfare is to take care of the basic needs of its beneficiaries, which is closely connected with the idea of absolute poverty. Therefore, these benefits would be set in line with the absolute poverty line, which would be calculated for a particular period by the Central Bureau of Statistics. The line in question is the absolute line which is based on the recommended minimum diet set in line with nutritionist standards and indirect assessment of other cost (food-energy intake method). Pursuant to this one of the measures of Strategy is the adjustment of the basis for realisation of social welfare rights with the absolute poverty line and its periodical harmonisation. In line with the assessment made, in order to raise the basis by 25%, i.e. to HRK 500 it is necessary to secure additional HRK 603.9m or 51.73% more than in 2005.³⁰

The social welfare system will be focused on the beneficiary by means of raising the quality of services and purposefulness of social benefits to the needy. Thereby, it is planned to introduce a new model of social welfare organisation under the principle of "one-stop-shop".

³⁰ The assessment of the fiscal impact – Reforms of social benefits do not include measures of the National Population Policy which indirectly affect socially most vulnerable groups, therefore it is estimated that the fiscal impact could be lower by some 15% to 20%.

Government of the Republic of Croatia in co-operation with the World Bank started working on systematic changes in the area of social welfare. The project of social welfare system development is contains three components. The first component is related to the improvement in the quality of social services and reduction of the volume of residential care. The second component is directed towards the development of an IT management system, while the third encompasses improvement in the conditions for residents of homes within the social welfare system and construction, i.e. reconstruction of welfare centres.

Total cost of the Project amounts to EUR 47m, of which EUR 31m is secured in the form of a World Bank loan, the Croatian Government participates with EUR 14m, and the Swedish International Development Agency (SIDA) donated EUR 1.6m as co-financing. The loan entered into force on 30 January this year.

Protection of Families and Children

Institutional and legal system – systematic protection of the rights and interests of children and vulnerable social groups and alignment with international standards

Within the framework of the protection of children and families the major goal is the prevention of violence in the family in all its shapes and forms, mitigation of consequences arising from violence that already occurred and development of a multidisciplinary approach to victims of violence improvement of co-operation and better co-ordination of responsible authorities, as well as training and awareness of experts and the broader public for the problems of violence in the family, increase in the number of experts with responsible state authorities, who will tackle these issues and contribute to the implementation of the gender equality policy.

Within the framework of the Republic of Croatia's efforts to improve the legal protection of children and vulnerable members within a family, the 2005-2007 National Strategy for Protection from Violence in the Family was adopted, as well as the Protocol for Treatment of Cases of Violence in the Family. In order to protect children more effective and in line with the provisions of the European Convention on the Protection of Human Rights and Basic Freedoms, as from 1 January 2006 some responsibilities of social security centres have been transferred to courts. Starting from that date, the courts have jurisdiction in all proceedings relating to family relationships, such as the limitation or termination of parental rights.

Support System for Families

By adopting the National Population Policy, the system of family benefits (children's allowance, maternity allowance, one-off payments for layette), as part of social security, for which funds are secured from the state budget, received all characteristics of an investment in the vital capacity of the state. The population of the Republic of Croatia is one of the oldest in the world with a prominent trend of the rise in the number of older socially dependent persons in contrast to the decline in the number of newborn children. The decline in the natural growth of the population, which accumulated over several decades, negatively impacted the structure of the fertile and working population and thus has and will continue to have long term consequence on the country's potential for further economic development and sustainability of the social standard in the broader sense (sustainability of the level of health care services, pensions and social welfare). The main aim of the National Population Policy and thus related new system of family benefits, which will be implemented from January 2007, is to make Croatia's population younger and more numerous, aiming at maintaining the birth rate above

the mortality rate in the long term. In the short term, in the following two decades Croatia's expenses on family benefits will increase, while in the long term this will result in the increase in the natural growth of the population which will strengthen and improve the deteriorated structure of the fertile and working population. The expected more numerous population would contribute to active creation of new values, reverse the demographic depression and compensate for the increased social pressure from the growth of old and older population.

Respecting the appropriate social criteria for the entitlement to children's allowance, it will be necessary to secure HRK 325m more in 2007 compared to 2006 for this form of family benefits, i.e. HRK 1.7bn. Maternity benefits and one-off layette payments for newborn children are direct measures related to the population policy and are connected directly with the birth of a child. It is estimated that the new measures within the realm of the National Population Policy will result in a mild growth of newborn children in the next three years, from 42,492 in 2005 to some 48,000 in 2009. This will also reflect itself in the growth of budget expenditures under the item of this benefit. It will be necessary to set aside HRK 800m for maternity benefits in 2007 and HRK 100m for layette for newborn children in the same year.

An estimate of the total effect of individual measures from the system of family benefits is to be made in 2009, and depending on the assessment an appropriate adjustment is to be made on the harmonisation of each form of monetary benefit in line with the results achieved.

National Minorities

The equality of all members of minority groups in the Republic of Croatia as well as realisation of special rights and freedoms is ensured pursuant to the Constitution and the Constitutional Act on the Rights of National Minorities.

The Office for National Minorities continues with the implementation of the provisions of the Constitutional Act on the Rights of Minorities in the segment relating to councils and representatives of minorities. Seminars have been held on the training and education of representatives of national minorities with an aim of providing the local and regional government and self-government information on the way of operation and ensuring conditions for work of councils and representatives of national minorities as well as their mutual co-operation. The seminars were financially supported by the OSCE mission to Croatia.

Seminars have also been held on the implementation of international documents important for the improvement of the rights of minorities, which have also been ratified by the Republic of Croatia. The third seminar on the implementation of the Framework Convention for the Protection of Minorities, organised by the Office for National Minorities and the Council of Europe, was held on 15 and 16 of September 2006. The unanimous conclusion by all the participants was that it had come to the substantial improvement in the realisation of rights by minority rights. The Government of the Republic of Croatia was praised for the measures and support provided in the realisation of the rights of national minorities.

Short term, medium term and long term measures aimed at systematically helping Roma to improve their conditions of living as well as ensure the equality of the Roma national minority with other citizens of the Republic of Croatia have been determined by the National Programme for Roma. Responsible ministries and the Office for National Minorities participate in the implementation of measures from the National Programme for Roma.

Pursuant to the National Programme for Roma the Office implements the measures of enabling Roma representatives for participation in the process of deciding and realising their rights in line with the Convention on Removal of all Forms of Discrimination against Women and the convention on the Rights of Children as well as other international documents. The Roma representatives are also being educated on how to implement the National Programme. So far eight seminars have been held in Begovo Razdolje, Topusko, Varaždinske Toplice, Samobor and Zagreb with more than 100 participants.

Within the framework of the Action Plan for the Decade of Roma Inclusion 2005-2015 better living conditions will be secured for the Roma population: improvement of their settlements (water, electricity, sewage system, access roads), free pre-school education, and better access to the education system, improvement of health care conditions, especially for women and children and better opportunities for employment.

A web site of the National Programme for Roma and the Action Plan for the Decade of Roma Inclusion 2005-2015 was launched in August 2006, which will enable better flow of information between the authorities and the Roma minority. The implementation of these two documents enacted by the Government of the Republic of Croatia will also be monitored systematically.

The funds provided in the state budget for 2007 for the implementation of the National Programme for Roma and the Action Plan for the Decade of Roma Inclusion 2005-2015 via the Office for National Minorities amount to HRK 1.9m. Aiming at improving the conditions of living of the Roma minority the Project of Support to the Roma will be financed from the PHARE programme in the amount of EUR 4.3m. The Republic of Croatia will participate in the funding of the said project with 30% of total funds.

4.4 AGRICULTURAL SECTOR

Agriculture

The competitive strengthening of the sector through modernisation and restructuring of agriculture in line with the EU standards continue to be the main objectives of agricultural policy. Therefore, the Government of the Republic of Croatia continues with the implementation of agricultural policy measures aimed at changing the structure of agricultural farms, ensuring a smooth operation of the market and improving the efficiency of public services.

Improvement of the Land Market

The main activities related to the agricultural land management are focused on the implementation of measures for the utilization of state-owned agricultural land, measures for the enlargement of agricultural land and on the preparation and implementation of optimum measures to use agricultural land as a natural resource under the current agricultural and environmental conditions.

The management of state-owned agricultural land is organised at the local or regional (county) level and includes the sale and lease of agricultural land in state ownership.

The Croatian government is responsible for granting concessions for (long term lease of) state-owned agricultural land. With a view of changing the structure of agricultural farms, support has been provided to the purchase of agricultural land based on the capital investment model. Activities on the project "Enlargement of Agricultural Land", defining models for the enlargement of agricultural land, have been continued. A pilot project on the enlargement of agricultural land at approved locations is being implemented, with the purpose of formulating agricultural land enlargement policy.

Privatisation of State-owned Companies

The privatisation of a large agricultural and food-processing company VUPIK, which is in majority state ownership, should be finalised to the end of 2006.

Regulation of the Agricultural and Foodstuffs Market

Activities on the harmonization of market mechanisms for particular agricultural products with the market organisation in the EU have been continued. Wheat has been among the first products to which some of the EU market regulation standards have been applied. In contrast to the previous practice of state-subsidized purchase of wheat, the wheat trading is fully determined by the market. Only the minimum (guaranteed) price was prescribed in 2006, in case the market price should fall below a determined level. A gradual harmonisation of this area with the EU market standards is expected during 2007 and 2008.

The establishment of a Wine Cadastre is a prerequisite for the organisation of the wine market. In the previous period, the necessary aerial photographing was completed and digital ortophoto maps were entered into a database. In addition, a fully digitalised vineyard cadastre is currently being established, which will comprise the data on vineyards (varieties, breeding forms, the number of grape-vines, slope, etc.).

In the cattle production area, activities aimed at harmonising market mechanisms have been continued, with a view of combating black market and increasing the safety of foodstuffs. A single system of obligatory animal identification has been introduced and fully applied on beef cattle, and the establishment of an identification system for other kinds of domestic animals is under way. In addition, conditions and criteria for the classification of beef and pork bodies and half-bodies on the slaughtering line, and other conditions relating to cattle and pig slaughtering have been laid down, and mechanism for the system implementation have been set in motion.

An Agricultural Market Information System operating within the Ministry is used for the regular collection, processing and distribution of data on the prices of agricultural and food products. The idea is to adjust the methodology over the coming period, in order to create the prerequisites for the harmonisation of individual agricultural product markets with those in the EU.

State Aid in Agriculture

The bulk of the state aid to agriculture is administered pursuant to the Act on State Aid to Agriculture, Fisheries and Forestry³¹. The Act was amended in 2006, with the main changes relating to further restructuring of agricultural aid by strengthening the role of cattle breeding and gradual harmonisation with the common agricultural policy of the EU. A legal framework for the introduction of good agricultural and environmental practices has been created which is in line with the new common agricultural policy guidelines of the EU.

In 2006, a total of slightly more than HRK 2bn from the state budget was earmarked for aid covered by the previously mentioned Act. The largest portion of these funds (almost 90%) is still intended for a direct support to production. Around 6% was allocated for rural development, mainly for investments. Income support to non-commercial farms participated with about 4%. The goal of the agricultural policy is to gradually increase the share of aid to rural development.

In addition to this, the Government of the Republic of Croatia has developed some special programmes (relating to beef cattle and pig breeding and multi-year plantations), which are financed by loans at interest rates that are lower than market rates, granted by the Croatian Bank for Reconstruction and Development and the Croatian Agency for Small Businesses. These programmes are aimed at boosting the competitiveness of domestic production, particularly by increasing the production of profitable products that are in high-demand. The Ministry of Finance is responsible for aid to agriculture in the case of natural disasters. Moreover, fuels used in agriculture and fisheries are exempt from excise tax.

Concerning the implementation of state aid to agriculture, activities have been continued on the establishment of an Integral Administrative and Control System (IACS), and improvement of the efficiency of agricultural inspection, as well as the establishment of a control and supervision system in line with EU standards.

Rural Development

In February 2006, the EC adopted a Rural Development Plan for the period 2005-2006, as a framework for the financing of rural development measures under the SAPARD programme. Two measures for improving the competitiveness of the sector were accredited: Investment in

³¹ The basic support models are specified in the 2005 PEP.

Agricultural Farms and Investment in the Processing of and Trading in Agricultural and Fishery Products. An information campaign (promotion) of the SAPARD programme was conducted during 2006, and the Directorate for Market and Structural Support in Agriculture (future Payment Agency) carried out intensive activities necessary to receive accreditation for the implementation of the SAPARD measures.

Over the coming period, the main activities will be focused on the preparation and adoption of the Agriculture and Rural Development Plan 2007-2013, within the Instrument for Pre-accession Assistance (IPA), component V - Rural Development, as the basis for the use of the pre-accession IPA-RD funds. These activities are paralleled with the implementation of the national rural development measures financed from the state budget. Besides the most significant support to capital investments in agricultural farms, support to the marketing of agricultural products is also important.

Phytosanitary Area

The general goal is to improve the quality of monitoring harmful organisms and to adopt a new system of registration of plant protection products in order to achieve the standards required by the EU. To achieve the said goals, it is planned to increase the number of persons employed in plant protection, as well as to provide professional training for them. A remarkable progress has been achieved in harmonizing and implementing the legislation.

Food Quality and Safety

The harmonisation of regulations in the area of basic quality requirements for individual groups of products (vertical regulations) with EU legislation continued into 2006, providing the basis for further market liberalisation and stimulation of free movement of goods.

In the forthcoming period, horizontal and vertical regulations will continue to be adopted and harmonised with the legislation on food, with a view to increasing the compliance rate. This will contribute to the free movement of goods and safety of food products, thus improving consumer protection and human health in general. Furthermore, the implementation of the afore-mentioned systems of co-financing is planned to continue into the next period, which will provide the basis for the creation of an efficient system.

The implementation of the CARDS 2002 Project "Capacity Building in the Area of Agriculture, Living Animals and Foodstuffs", jointly carried out by the Ministry of Agriculture, Forestry and Water Management and Ministry of Health and Social Welfare has entered the final stage. The implementation of the Project is expected to continue in 2007, within the framework of CARDS 2004.

Veterinary Area

The harmonisation of the Croatian veterinary legislation with that of the EU continued in 2006. In the past period, 2 veterinary border crossings were built, one of which still does not fully comply with the relevant EU standards. Numerous activities have been undertaken regarding the accreditation of the Croatian Veterinary Institute and monitoring of classical swine and wild boar plague.

In the period to come, activities will be focused on further harmonisation of the legislation, re-organisation of the veterinary service and inspection, the improvement of the animal health control system and the system of veterinary-public health, accreditation of the Croatian Veterinary Institute, continuation of the process of identification and registration of animals, and on the preparation for the building of the remaining veterinary border crossings.

Fisheries

The harmonisation of the Croatian legislation in the fisheries sector with the EU *acquis* continued during 2006. For the purpose of establishing a market of fish and fishery products in line with the EU requirements, the necessary implementation regulations are being drawn up³². The implementation of the CARDS programme aimed at strengthening the institutional capacity of the Fishery Directorate reached its final stage. In addition, the PHARE Project "Support to the Republic of Croatia in the Preparation and Implementation of the Strategy of Fishery Development for the Purpose of Adjustment and Implementation of *acquis communautaire* in the Segment of Common Fishery Policy" is being implemented and bidding documentation for the Project is being prepared.

The plans for the period 2007-2009 involve further harmonization of the legislation and the establishment of fish and fishery product market in accordance with the EU requirements, primarily as concerns the introduction of a fish trading system (construction of ports of discharge and wholesale markets, establishment of producer organisations and enactment of the relevant regulations).

Wood Industry

As a result of the need to implement and operationalise the Strategy of Development of Industrial Processing of Wood and Paper, a document "Republic of Croatia's Operational Schedule for the Development of Industrial Processing of Wood, 2006-2010" has been drawn up. The document was adopted by the Croatian Government in 2006. The Operational Schedule includes measures to improve and upgrade the industrial processing of wood. The said measures are aimed at integrating forestry and industrial wood processing, optimising primary processing capacities, increasing the manufacture of final products and boosting employment. For these purposes, it is necessary to raise the value of raw wood by manufacturing highly finalised recognisable products of high quality and creative design.

³² Ordinance on standards for putting into circulation fish and other water organisms, and Ordinance on the manner of putting into circulation fish and other water organisms

4.5 PUBLIC ADMINISTRATION REFORM

During 2006, preparations were undertaken for the creation of an integrated regulatory framework necessary to complete the process of depoliticizing public administration. The procedure for the adoption of the Act on the Amendments to the Act on the Procedure for Transfer of Authority and Act on Rights and Obligations of Government Officials by the Croatian parliament is underway. In addition, organisational prerequisites have been created to improve human resource management in the civil service. Special organisational units for the development and management of human resources have been set up in most state administration bodies. The system of planning and employment in state administration has been consolidated and the methods for recruitment and selection of staff have been improved. The majority of implementation regulations have been enacted pursuant to the Civil Service Act.

The Government of the Republic of Croatia has appointed a Commission for drawing up of the Act on Salaries in Civil Service. This Act will ensure consistency in rewarding in the state administration, introduce transparency in the system of salaries and remuneration and increase the number of merit-based elements. The preparation of the Act is currently in progress.

The Government has also approved the Proposal for the Political Parties Financing Act which currently is in the procedure of the Parliament with first reading concluded. The said measure was planned for 2007, but, according to the National Programme for the Prevention of Corruption (Official Gazette 39/2006), the drafting of the proposal for the said Act is envisaged for September 2006.

In July 2006, the Croatian Government adopted a document entitled "Guidelines for the Development and Use of Open-source Software in the State Administration Bodies". This will greatly facilitate the development and application of the open-source computer software in the public sector.

The first session of the National Information Society Council was held in June 2006.

Within the framework of the HITRO.HR programme, the introduction of the electronic submission of personal income tax returns for citizens is under way.

Concerning the state administration reform, the reform is planned to continue in the period 2006-2008. The primary objectives of the reform are: the development of a modern and efficient state administration with a view to providing high-quality and prompt services to citizens and entrepreneurs, economic progress and harmonization with EU standards, in terms of both fiscal acceptability of public administration and improvement of professional skills of employees.

In order to achieve the stated goals, within the framework of the CARDS 2003 Project Support for the Implementation of State Administration Reform, measures have been planned:

- Amending the General Administrative Procedure Act;
- Establishing an IT-supported register of civil servants, as a part of an IT-system for centralized payroll accounts and human resources management for all state administration bodies (pursuant to a Government decision adopted in August 2006).

Moreover, supported by the World Bank and the Swedish International Agency for Development and Co-operation, a functional review is planned to be carried out in ten central state administration bodies and in five state administration bodies of first instance. The analysis will result in adopting a rationalisation programme that will include providing for redundant employees, reallocation and the impact on the state budget.

The carrying out of the functional review is envisaged for the period from December 2006 to December 2007.

Within the framework of CARDS 2003 Project Support for Decentralisation of the Croatian State Administration the measures to decentralise state administration have been continued.

Within the overall state administration reform process, special consideration is given to the professional knowledge, skills, capabilities and training of civil servants at all levels of administration in order to improve their self-reliance, professional capabilities, efficiency, horizontal and vertical mobility and motivation, and, consequently, to contribute to the overall state administration performance. For that purpose, with the Danish Pre-accession Assistance provided from spring 2005 to December 2007, the following measures will be implemented:

- Strengthening of staff capacities in the Centre for Professional Improvement and Training of Civil Servants (through workshops and study tours) for the development and implementation of general education and training programmes;
- Development of general education and training programmes for civil servants;
- Making an analysis to assess the training needs in the civil service.

Further measures planned within the state administration reform include the following:

- Amending the Act on Administrative Inspection;
- Adoption of a new Regulation on Office Operations (adjusted to the electronic functioning of the administration);
- Conducting a workshop Meeting EU Requirements through Open-source Solutions, which will include presentation of the state administrations of Slovenia, Germany and Hungary in the process of EU accession, with a view to training civil servants for the application of open-source software;
- Training of IT-experts in state administration bodies to ensure high-quality IT-education in an increasingly sophisticated IT environment;
- Development of an IT- System Interoperability Programme for state administration bodies, in order to ensure a free flow of information;
- Conducting a Study on Accessibility of Public Services on the Internet, by following the methodology used in the EU for monitoring the implementation of the eEurope 2005 Programme;
- Preparing an Operational Schedule for the Implementation of the Programme e-Croatia 2007, for 2007.

Associated with the public administration reform, since good management in the state and public administration is one of the prerequisites for private sector growth as well as for the implementation of the policy that stimulates responsibility in the private sector - in fiscal terms, in line with the Loan Agreement PAL, activities have been initiated on the preparation of the project of analysis and reform of the system of salaries in state administration and public services. The project is aimed at decompression of salaries and the implementation of the remuneration system based on work results as well as at the reduction of the public sector

wage bill from the current 11% of BDP to 10% of BDP in 2008. New regulations prepared in this area will necessarily include provisions on centralised collective bargaining.

The reforms planned for the public sector in 2008 are expected to save around 1% of GDP. We do not expect that the implementation of reforms during 2007 and 2008 will result in the increase of expenditures incurred by this sector due to the programme of providing for surplus workers in the public sector, however, adequate attention should also be awarded to reforms started in this area.

4.6 DEVELOPMENT OF A KNOWLEDGE-BASED SOCIETY

The primary objective of the Republic of Croatia, in accordance with the Lisbon strategy objectives, is development of a knowledge-based society and an on-going improvement of the system of education, science and systematic quality strengthening, in order to achieve a long term economic growth and increase competitiveness, by high-quality human capital formation.

Under the Education System Development Plan 2005-2010, a strategic development document dating from 2005, the overall policy is oriented to the improvement of education, science and research, as important pre-requisites for achieving development and competitiveness in the European market economy. The contents and activities were established, which should contribute to the development of a higher-quality, more accessible, more adaptable and efficient system of science and education, for the purpose of intellectual and human capital formation, as a key asset to the economy.

In the pedagogical year 2005/2006, 15 new kindergartens were established in 15 municipalities in the areas of special state concern (Sisak-Moslavina County, Slavonski Brod-Posavina County and Karlovac County), where no preschool programs previously existed. In the school year 2005/2006, the Experimental Programme and Curriculum was introduced in 49 primary schools, based on the Croatian National Educational Standard (CNES), the implementation and realisation of which was monitored and evaluated by the Institute of Social Studies Ivo Pilar. As of the school year 2006/2007, the new Programme and Curriculum was introduced in all primary schools. In that regard, the Institute of Education of the Republic of Croatia, which was restructured and renamed to the Education and Teacher Training Agency, together with the Ministry conducted professional training for 2,762 primary school employees. As a preparation for the state secondary school leaving exam, the first national exams were carried out in general secondary school programmes, and external evaluation of education was thus introduced and the first international education quality assessment within the PISA (Programme for International Student Assessment) project of OECD was conducted. The Vocational Education Agency, together with its partners, carried out measures aimed at a reduction of vocational areas from 32 to 14, which reduced vocational specialisations from 330 to 199. The preparations began for the introduction of a prolonged compulsory education from an 8-year primary education to secondary education (11-12 years). The first phase of the Bologna process has been successfully completed and three priority objectives were thus achieved: restructuring of higher education programmes, recognition of foreign higher education qualifications and development of a quality assurance system. In January 2006, the first phase of the integrated financing of higher education institutions began - lump sum. The Ministry, together with the Development and Employment Fund, launched a project Development of Vocational Higher Education Studies, for the purpose of promoting employment in smaller urban areas in the Republic of Croatia. The Adult Education Agency has been established. The proposal of the Croatian qualification framework has been prepared, which represents an important precondition for the regulation of the overall life-long training. The Croatian Institute of Technology (HIT d.o.o.) has also been established. In addition, the Council for Pedagogical Standard and Council for Preschool, Primary and Secondary School Education System Curriculum have been established. The IT infrastructure in the education system has been systematically enhanced.

In the period 2007-2009 the establishment of a greater number of preschool programmes and equipment of preschool institutions will continue, as well as inclusion of a greater number of

children, especially those in smaller urban areas. The implementation of the new Programme and Curriculum for primary schools will systematically be monitored and evaluated, and amended accordingly. By lifting the burden from teaching contents, introducing new learning and teaching methods, practicing student oriented teaching and including students in research-oriented teaching of classes, the students will gain permanent and useful knowledge and skills, required for a life-long learning. Schools will be additionally provided with didactic equipment and the National Curriculum will be prepared.

The national exams are planned to be conducted for 8th grade students for the purpose of verifying whether their grades in regular education are compliant with the results in national exams, creation of the foundation for measuring the performance in national exams in secondary education and establishment of the external evaluation system in primary education. The National Centre for External Evaluation of Education will be additionally equipped, in terms of experts, equipment and space, and will conduct annual national exams and preparations for the state secondary school leaving exam, which will be introduced in 2009 for students in general secondary school programmes. In 2009, the Croatian students will, for the second time, participate in the PISA international knowledge assessment, which will allow for a reliable comparison with the achievements of students in Europe and throughout the world, and indicate the required improvements in the education system.

Continued efforts are planned in secondary education, aimed at the realisation of the strategic objectives, encompassing a reduction in the number of educational areas, based on the partner analysis of the labour market needs, as well as a continued work on the sector analysis and a joint work on the Croatian qualification framework, exit competencies and modernisation of the teaching programmes and curricula, and adoption of the curriculum as the final result. A systematic professional training of primary and secondary school teachers will continue, as well as of associate staff and principals, carried out by the Education and Teacher Training Agency and Vocational Education Agency. The preconditions will be ensured for the prolongation of the compulsory education. It is estimated that over 80,000 of young people aged 18, born in the same year, fail to graduate from secondary school, which indicates that this number would be significantly reduced by the prolongation of the compulsory education. This will allow for a further education for a greater number of students and contribute to an increase in the present percentage of the population with a university degree (7.82%), bringing Croatia closer to the developed European countries, in terms of population with a university degree.

Free books will be provided for all pupils in elementary schools and in first classes of secondary schools in school year 2007/2008. Estimated total cost is HRK 240m. All pupils will have obligation of keeping books because the year later they will give them to younger colleges. It's estimated that about third books will be lost or erased in year and therefore additional assets will be necessary in following years.

In higher education and science, the activities are aimed at a further implementation of the Bologna process, creation of the network of higher education institutions and a further development of vocational higher education studies, through the establishment of new higher education institutions, inclusion of a greater number of population in higher education, promotion of excellence, and an increase in investment in research and development, in order to strengthen the knowledge and technology transfer, contributing, in this manner, to the economic development.

4.7 OTHER REFORMS

4.7.1 Health Care Reform

A comprehensive health care reform encompasses a health care system reform, reform of health care system financing and public health system reform. Meeting the reform objective required the adoption of the National Health Care Development Strategy, which was adopted by the Croatian Parliament on 30 June 2006 and which defines the guidelines and entities responsible for the health care policy implementation. The primary objectives of the strategy include improvement of the health care system by 2011, so that it is capable of satisfying the needs of the Republic of Croatia's citizens for a quality and professional medical health care.

Health Care System Reform

An extensive restructuring and reform of health care, as a public sector, is based on the following principles, as defined by the National Health Care Development Strategy: centralised policy, standards and norms, implementation planning and control; establishment of an integrated health care; management and responsibility decentralisation; strengthening of primary health care as the basic element of an integrated care and establishment of efficient control of the use of secondary and tertiary capacity and general health care spending; compulsory informatisation, as the basis for the general spending and quality control; provision and rationalisation of funds and their allocation according to the basic principles (equality, solidarity, accessibility, rationality and quality) and special needs.

Aimed at improving organisation and functioning of the primary health care in 2006, privatisation of primary health care offices has continued, as well as informatisation of the primary health care by equipping the offices with IT equipment for the purpose of their linking with hospitals.

A financial stimulation of preventive examinations and health education which started in 2004 has continued, together with special financing of preventive examinations of health insurance beneficiaries above the age of 50 who have not been clinically examined or diagnostically processed in the past three years. The implementation of the National Programme for Breast Cancer Prevention - screening started in September 2006 for about 530,000 women aged 50-69.

The Ministry of Health and Social Welfare has assumed an active role in human resource management in the segment of health care activities in order to ensure an adequate number of medical doctors in all regions of the Republic of Croatia and ensure equal health care availability to all citizens irrespective of their place of residence. The Minister of Health and Social Welfare, the Director of the Croatian Health Insurance Institute and the Director of the Croatian Employment Service signed the Protocol on Establishing the Conditions and Methods of Financing Internship of Health Care Workers in 2006, on the basis of which the Croatian Health Insurance Institute determined the Priority List for volunteering of health care workers with higher-school and university degree in 2006 and entered into contracts with health care institutions for financing of internship of health care workers - interns.

The Amendments to the Health Care Act provided for the establishment of at least one community health care centre at the county level, or at least three in the City of Zagreb. For the purpose of making health care available on the islands, establishment of community health

care centres is prescribed on some of the islands. The following issues are regulated, in particular: rights and obligations of persons in exercising health care rights; development of the telemedicine system in the Republic of Croatia is provided for; individual solutions are adopted, relating to the work organisation and organisational structure of health care institutions.

With an aim of enhancing organisation and functioning of secondary and tertiary health care, and for the purpose of improving the infrastructure and renewing medical equipment, analyses have been carried out in connection with the medical and technical equipment of health care institutions. A plan of investments in medical institutions and acquisition of medical equipment is adopted every year. The objective is to connect informationally these two programmes and thus optimise the decision-making process as regards investments in renewal of hospitals, construction of new hospitals, as well as renewal of out-dated medical and technical equipment.

The process of informatisation of hospitals and networking them with the central information system continued in 2006.

Reform of Health Care System Financing

With an aim of stabilizing health care and health insurance system, and improving fiscal discipline in health care and health insurance system, which is expected to result in decreasing of a share of overall health care spending in GDP, settling of debts in the health sector and preserving of high quality health care services, the Ministry of Health and Social Welfare implemented the measures in 2006, of which the most important are the following:

- reducing expenditures on drugs: the Mandatory Health Insurance Act was adopted, which introduced the basic and supplementary drug list of the Croatian Health Insurance Institute, as a result of which savings of HRK 303.3m is foreseen as early as in 2007,
- adoption of the series of ordinances which regulate the area of drugs (registration) and their marketing, setting of the highest price of drugs, covered by the Croatian Health Insurance Institute; the application of the administrative fee for each prescription has continued, which represents a savings of HRK 380m at the annual level,
- reducing hospital costs: as a part of the contracts that the Croatian Health Insurance Institute enters into with health care institutions, a series of contractual obligations have been introduced, such as operation within the predetermined maximum amount of funds, that is, within the budget, the obligation to comply with the clinical guidelines and rational pharmacotherapy, improved work organisation, by introducing the second shift,
- the basic package of health care services is determined by the Mandatory Health Insurance Act which entered into force on 3 August 2006,
- improving the system of payment for services: the pilot project was launched of the application of payment by diagnosis related groups (DRGs) in hospital health care of patients suffering from acute diseases, which was preceded by the preparation of the proposal for the list of DRGs with the respective complexity coefficients and trial grouping algorithm for the purpose of the DRG system, and preparations for the adjustment of the information system of the Croatian Health Insurance Institute have been carried out.

For the purpose of restructuring of the health insurance system, the following acts have been adopted: Mandatory Health Insurance Act, Voluntary Health Insurance Act, and Occupational Health Insurance Act.

Notwithstanding the rights of the insured persons established by the present basic health insurance and its coverage, especially taking into account socially sensitive groups of the population, the Mandatory Health Insurance Act regulates, in particular, the following: distinction between the system of mandatory and voluntary health insurance; definition of the basic package of health care services under the mandatory health insurance; co-payment and exemption from co-payment; administrative fee which is paid when utilising health care; redefinition of transportation costs related to the utilisation of health care; organisational structure and management of the Croatian Institute for Mandatory Health Insurance, regulation of occupational health insurance.

The Voluntary Health Insurance Act regulates the types, terms and conditions and methods of taking out voluntary health insurance. Voluntary health insurance is classified into: complementary, supplementary and private health insurance. Complementary health insurance is an insurance which provides coverage of a portion of the expenses, up to the full price of the health care under the mandatory health insurance (co-payment). Supplementary health insurance provides a higher standard of health care services relative to the health care standard under the mandatory health insurance, as well as a larger coverage compared to the rights under the mandatory health insurance. Private health insurance provides health care for natural persons residing in the Republic of Croatia, who are not obliged to take out insurance under the Mandatory Health Insurance Act and Health Care of Foreigners in the Republic of Croatia Act.

The Occupational Health Insurance Act regulates health insurance in the field of occupational health, which encompasses a specific health care of workers and their rights, in the case occupational disease or injury. That Act regulates the mandatory health insurance system in connection with occupational health, mandatory health insurance providers in the field of occupational health, health care coverage and other rights of the persons insured on that basis, terms and conditions and methods of exercising and financing these rights, as well as the rights and obligations of the mandatory health insurance providers in the field of occupational health.

Public Health System Reform

The objective of the public health system reform is reorganisation of the public health system, so that it becomes the main authority responsible for the preventive activities, prescribed by the EU *acquis* in the field of human health care, as well as the authority responsible for development and systematic implementation of the preventive programmes, aimed at reducing the number of preventable diseases, lifting thus the burden from health care.

As a part of the harmonisation of the public health legislation with the EU, the Ministry of Health and Social Welfare, observing the EU recommendations and guidelines, prepares the new act on the protection of the population from the contagious diseases, which would introduce the definitions of diseases that are aligned with the EU legislation.

Since the Republic of Croatia signed the Convention on Control of Tobacco products in June 2004, the harmonisation of the act on restricting the use of tobacco products with the EU Directives is underway.

Pursuant to the Act on Donation and Transplanting Human Body Parts for the Treatment Purposes, the ordinances were adopted in 2005 and 2006, which establish the standards for quality and safety assurance of tissue and cells and define the authorisation system for tissue and cell banks and the supervision of their work in accordance with the EU requirements.

Drafting of subordinate legislation is also underway, related to the Blood Supply Act, which will regulate in more detail organisational and other issues in connection with the blood quality assurance, in accordance with the EU standards.

4.7.2 Judicial Reform

In performing the Republic of Croatia's judicial system reform in 2006, the Ministry of Justice realised, to the full extent, the determined activities and measures used to accomplish the judicial system reform objectives.

Land registry reform: In 2005 and 2006, the Ministry of Justice carried out the envisaged measures and activities for establishing order in the land registry, achieving the promptness in the operations of the land registry departments and speeding up the process of establishing digital land registry.²² From the onset of the land registry reform to July 2006, the number of unsolved land registry cases was reduced by 175,978. In the same period, a total of 1,130,502 of land registry cases were solved and 3,130,378 land registry certificates were issued. In the Municipal Court in Zagreb, the number of unsolved cases was reduced by 77,612. A total of 77% of land registry files have been transferred into the electronic form.

Creditor protection and claim collection: Pursuant to the provisions of the amended Enforcement Act, the Ministry of Justice has prepared the action plan for reducing the backlog in enforcement cases at municipal and commercial courts. Since the beginning of application of the action plan (1 October 2005), the number of unsolved cases has continuously been reduced by 8-13% per month. In the first six months of 2006, 346,871 cases were solved. The total number of unsolved cases was reduced by as much as 68.7%. Since January 2006, public notaries adopt enforcement decisions on the basis of a valid document. They have adopted 131,611 enforcement decisions so far. A total of 9,016 complaints have been filed against the issued decisions. In this manner, a considerable burden of enforcement cases has been lifted from courts. In July 2006, the Croatian Parliament adopted the amendments to the Bankruptcy Act, which eliminated the impediments to the implementation of the bankruptcy proceedings and expedited the bankruptcy proceedings.

Modernisation and more efficient operation of courts: The project for the modernisation and more efficient operation of courts continued into 2006. The Ministry of Justice started a process of rationalisation, reorganisation and restructuring of courts and in May 2006, it launched a pilot project of a merger of 8 minor offence courts and municipal courts.²³ The Supreme Court of the Republic of Croatia continued to delegate the cases from the burdened courts to less burdened courts. A total of 38,945 cases were delegated. The Ministry of Justice and courts also started with the pilot project "In-Court Conciliation" for the parties in the civil

²² 2002 CARDS project – project of modernisation and digitalisation of land registry and cadastre (I stage)

2002 CARDS project – project of modernisation and digitalisation of land registry and cadastre (II stage)

²³ 2002 CARDS program – judicial system modernisation – support to more efficient and modern functioning of the judicial system.

2004 CARDS – support to more efficient and modern court management.

procedure.²⁴ The final objective of the judicial system reform is a reduction in the total number of unsolved court cases. According to the data as at 30 June 2006, unsolved cases totalled 557,978, that is, 28% less relative to the total number of unsolved cases.

Penal legislation reform: In June 2006, the second stage of the amendments to the substantive criminal legislation was completed by the adoption of the Act on the Amendments to the Penal Act. In March 2006, the Government of the Republic of Croatia adopted the National Anticorruption Programme 2006-2008. That Programme defines the framework measures for preventing corruption and sets the time limits and the legislative, executive and judicial authorities which will implement the action plans. The Ministry of Justice is appointed a co-ordinating entity in implementing the National Anticorruption Programme.

Objectives and Measures for Performing the Judicial Reform Activities 2007-2009

Concerning activities related to the judicial reform implementation, in the period 2007-2009 special attention will be given to the following objectives and activities:

Modernisation and more efficient operation of courts: In 2007, as in the previous years, the Supreme Court of the Republic of Croatia will continue delegating the cases from the courts with an excessive case-load to less burdened courts, for the purpose of a more expedient solving of old and unsolved cases. The Ministry of Justice will perform an on-going supervision over the operation of the court administration and will propose adequate measures in order to increase efficacy of courts and eliminate the identified irregularities. In 2007, the judicial inspection will carry out supervision in all county courts and in municipal courts, as appropriate. The supervision of the court administration will be performed by the judicial inspection established within the Ministry of Justice. The standards are also being prepared for the work of judges, which will determine and assess, in an objective manner, the actual performance of each individual judge. The Ministry of Justice is determined to carry out the reorganisation of the court network, taking into account efficacy and effectiveness of the judicial system, as well as the historical, traditional and developmental characteristics of each individual area. In the period 2007-2009, it will also continue with the process of rationalisation of the court network. The Minister of Justice issued a decision on a merger of 8 minor offence and 8 municipal courts, as the pilot courts within the framework of the project for the rationalisation of the court network. The results of these pilot courts will serve as the basis for upgrading the court network rationalisation project.

Land registry reform: The setting in order of the land registries will continue in 2007 and the land registry reform will be completed by the end of the third quarter of 2008. In 2007, all the legal and technical conditions will be fulfilled for the establishment of the digital land registries and the common land registry database will be created, where land registry department data and cadastre data will be networked. The Ministry of Justice will continue monitoring systematically the situation in the land registry departments and will continue with the training of all land registry clerks. 1,402 land registry clerks have undergone training so far and 84 land registry clerks have passed the examination for the authorised land registry clerk and have gained authority to act in land registry procedures. Informatisation of the land registry department has continuously been performed.

Increase in efficiency of creditor protection and claim collection: In 2007, the Ministry of Justice will continue to implement the action plan for reducing the number of enforcement cases at municipal and commercial courts. The Ministry of Justice will monitor, on an on-going basis, the monthly inflows of new enforcement cases, solved cases and the status of

²⁴ 2005 PHARE – project of strengthening conciliation as an alternative to dispute resolution

unsolved cases at municipal and commercial courts, and especially the acting of public notaries in issuing the enforcement decisions. The programme for reducing the number of unsolved cases will be carried out in the 2007-2009 period.

The amendments to the Bankruptcy Act from July 2006 expedited the bankruptcy proceedings and imposed a greater responsibility on the bankruptcy trustees in their acting in bankruptcy proceedings. In 2007, the criteria for the appointment of the bankruptcy trustees will be established, training for the bankruptcy judges will be organised concerning the new Bankruptcy Act, as well as the examinations for bankruptcy trustees.

Penal legislation reform: In July 2006, the Ministry of Justice forwarded the Draft Act on the Amendments to the Penal Procedure Act into the parliamentary procedure. The proposed amendments introduce the audiovisual conference, as a method of providing legal assistance, expand the list of criminal offences in the case of which special investigative measures may be taken, such as receiving and giving of bribe in economic crime, and modify the provisions relating to the custody time limits in the investigation stage, for the purpose of ensuring efficacy of actions in the cases involving a remand in custody. In 2007 and 2008, training of judges and state attorneys will be carried out within the Judicial Academy, for the purpose of implementation of the amendments to the Penal Act.

Implementation of the Anticorruption Strategy: The National Anticorruption Programme 2006-2008, adopted by the Government of the Republic of Croatia in March 2006, contains a defined framework of measures for fighting corruption and time limits for the legislative, executive and judicial authorities which will adopt them.

The Ministry of Justice, as well as other authorities determined by the National Anticorruption Programme 2006-2008, will implement action plans for the purpose of implementation of the said programme. The action plans represent a concretization of the National Programme, i.e. a plan of action for every authority in fighting corruption. They, as such, contain tasks, determined by the National Programme, measures and time limits for the implementation of these tasks, responsible persons in each authority, funds required for the realisation of the required measures and sources of financing, as well as performance indicators. The National Anticorruption Programme is currently at the stage of implementation of measures set by that programme. The authorities responsible for performing the activities under that programme will deliver the reports on the implementation of the measures to the Ministry of Justice, in order to allow insight to that Ministry into the implementation dynamics of these measures.

The collective objective of the anticorruption strategy is to reduce corruption to the level at which it will not represent an obstruction to the social, economic and political development and will not be perceived by the citizens as a crucial impediment. Individual objectives of the integrated and responsible implementation of the National Anticorruption Programme 2006-2008 are the following:

- to identify and punish the corrupted individuals, in order to avoid generalisations that are detrimental,
- to strengthen the professional ethics and to guarantee a smooth development for the state and local administration, small and medium size entrepreneurs and for the economy,
- to ensure responsible public administration for the citizens,
- regain confidence of citizens in local and state authorities.

4.7.3 Environmental Protection

Significant reforms are being implemented in the area of environmental protection, for the purpose of preserving, protecting and improving the state of environment and nature, in accordance with the EU standards and requirements, as a precondition for achieving the sustainable economic development.

As regards the **harmonisation of legislation** with the EU *acquis*, the new Environmental Protection Act is currently being prepared and its adoption is planned for end 2006. The new Act will harmonise the environmental impact studies at the level of individual projects, introduce into the domestic legislation new instruments, such as: strategic environmental impact studies for plans and programmes and single environmental permit (which will contribute, in particular, to the integration of environment and nature protection into the other sector policies), and will regulate all the horizontal issues that have not been regulated so far by other sector legislation. A set of implementing regulations, harmonised with the EU requirements, have been adopted in the field of air quality. In the field of waste management, ordinances on packaging waste, waste tire management and waste oil management have been adopted and the Act on the Amendments to Waste Act, from October 2006, created the conditions for adopting a number of new ordinances on managing individual special waste categories, in accordance with the EU Directives. In December 2005, the Amendments to the Waters Act and the Amendments to the Water Management Financing Act were adopted and entered into force, and the Ordinance on Keeping Water Management Documentation was adopted in February 2006. In the area of nature protection, several pieces of subordinate legislation were adopted and the new ones are being prepared.

The new Chemicals Act was adopted and entered into force at the end of 2005, on the basis of which the List of hazardous chemicals was issued, the trade of which is prohibited or restricted and 4 implementing regulations have been prepared, the adoption of which is envisaged by the end of 2006. Four implementing regulations governing the area of restricted use of GMOs in the closed systems have also been adopted. Regulations in the field of GMO deliberate release in the environment are being prepared, as well as in the field of placing GMO on the market. In November 2005, Forest Act, Hunting Act and Forest Reproductive Material Act were adopted as the fundamental acts in the area of forestry, which are being harmonised with the EU *acquis*. In 2005 and 2006 all subordinate legislation related to Hunting Act was prepared. Furthermore, Central Hunting Register for monitoring hunting activities was established. By entering into force of the Plant Health Act, monitoring and supervision of the health status of the forest plants was placed within the competence of the Forestry Directorate, i.e. Forestry Institute Jastrebarsko. Following the entry into force of the Act on the Croatian Chamber of Forestry Engineers and Wood Technology Engineers, the establishment of the Croatian Chamber of Forestry Engineers and Wood Technology Engineers is also underway, which will contribute to establishing the order on the labour market in the field of forestry, hunting and wood processing, in accordance with the criteria of the European and world practice. For the purpose of improving the condition of forests in private ownership and carrying out tasks of approval and registration of felling and exploitation of wood from the private forests, the establishment and beginning of operation of the Forestry Advisory Service is underway, which has been founded by the decision of the Government of the Republic of Croatia, with an aim of sustainable management improvement, monitoring the condition and keeping records of private forests in Croatia. The national forest management standard, i.e. development of the Croatian FSC standard, will be completed by the end of the year. On the basis of the adopted acts, forestry-related subordinate legislation will be prepared and adopted.

Drafting and/or adoption of several **strategic documents and plans**²⁵ is underway, and the Report on the State of Nature will be issued by the end of 2006. At the end of 2005, the National Plan for the Irrigation System was accepted at the end of 2005.

In early 2006, two new stations of the state network for permanent monitoring of **air quality** started to operate, so that there are currently 8 such stations. In March 2006, the EC granted a financial assistance through the PHARE programme for the construction of the remaining 12 stations and equipping the chemical and calibration laboratories. The Republic of Croatia has prepared the National Report under the UN Framework Convention on Climate Change, for the period 1996–2003, which will be submitted to the Convention’s Secretariat by the end of 2006. The Environmental Protection Agency has established the Register of Risk-Exposed and Potentially Risk-Exposed Facilities in the Republic of Croatia, which will be upgraded in the forthcoming period. As of 1 January 2006, a fee has been introduced for the imports of substances depleting the ozone layer for the purpose of their placing in the domestic market.

The activities aimed at an **integrated waste management system** development were intensified: in early 2006, the new system of taxes, imposed on the producers/importers of packaged goods, began to be applied, and the funds collected are used for the implementation of the packaging waste management system, with an aim of recovery of valuable properties of packaging waste. In addition to the evident environmental benefits of the new system application (large quantities of packaging waste have been collected separately), this has aroused interest of the economic entities establishing and/or planning to establish new recycling plants, which will contribute to the creation of new employment. During 2006, taxes were also introduced which are paid by the importers/producers of car tires, and the funds collected will be used for waste tire management. Further subordinate legislation is also being prepared, in which the “polluter pays” principle will be applied to other special waste categories.

At the end of September 2006, the EC signed the Financing Memorandum agreed between the EC and the Government of the Republic Croatia through grants under the ISPA, for the construction of the first county waste management centre in Croatia, in Bikarac in Šibenik-Knin County. The total value of the first stage of this project amounts to EUR 8.8m. Grants obtained under the ISPA amount to EUR 6.0m whereas co-financing from domestic sources amounts to EUR 2.8m. As a part of the activities for the future utilization of funds from the pre-accession IPA instruments, the preparations are carried out, supported by the EU technical assistance and domestic sources, for the further projects of establishment of waste management centres. The preparation of the IPA Operating Programme for environment is underway, within the Regional Development component. In September 2006, the EC also signed the Financing Memorandum relating to the grants under the ISPA programme, aimed at IPA strategy (IPA Operating programme for environment) completion and preparation of the investment projects (in addition to the waste sector, the water supply and waste water purification projects are also included). The activities related to the rehabilitation of the municipal waste disposal sites have also continued, while preparatory activities are underway for the rehabilitation of the former industrial locations, contaminated with hazardous substances, and of hazardous waste disposal sites. The Environmental Protection Agency has continued developing its IT system for waste management, and several databases are available

²⁵ The Basic Principles of the Sustainable Development Strategy (drafting until end-2006), Air Quality Protection and Improvement Plan (third quarter 2007), National Strategy and Action Plan for the Implementation of the UNFCCC and Kyoto Protocol (2007), Waste Management Plan of the Republic of Croatia (adoption by end-2006), Water Management Strategy (currently in the parliamentary procedure), Intervention Plan for Cases of Accidental Sea Pollution (by end-2006), Revised National Strategy for the Protection of Biological and Landscape Diversity (end 2006/2007).

through the internet (register of waste management licenses, cadastre of waste disposal sites, etc.). A new (tenth) cleanup vessel has been constructed and delivered for use to Split-Dalmatia County.

The number of the **protected areas** has increased and the Act Promulgating Lastovo Islands Nature Park was adopted. The development of the Geographic Information System (GIS) for national parks and cultural goods within the national parks started in April 2006 and funds were provided by the Ministry of Culture, State Geodetic Directorate and Environmental Protection and Energy Efficiency Fund, but other sources of financing were planned as well. The activities have continued relating to the preparation of plans for national parks and nature parks management, establishment of visitors' centres in the protected areas, and establishment of the biological diversity IT system. As a part of the implementation of the Convention on Biological Diversity, the Third National Report on the Convention on Biological Diversity was prepared, as well as the Draft Report on the State of Nature (July 2006), on the basis of which a revision of the National Strategy and Action Plan for the Protection of Biological and Landscape Diversity has started. It is planned to be completed by end-2006/in early 2007. The action plans within the plans for the protected species (wolf, lynx) management have been successfully implemented. As a part of the CITES Convention implementation, a training of customs employees, border and criminal police has continued. The activities under the project Protection of Karst Ecological Systems have also continued and the activities related to the implementation of the PHARE project Establishment of the NATURA 2000 Network have started. As a part of the technical assistance concerning the implementation and administration of NATURA 2000, training of employees in state authorities competent for the NATURA 2000 implementation was organised in October 2006.

As regards the measures planned for the 2007-2009 period, harmonisation of legislation with the EU *acquis* will be completed in 2008 for all environment protection subsectors (horizontal legislation, air protection and climatic changes, waste management, water management, protection of sea and marine environment, nature protection, control of industrial contamination and risk management, chemicals and GMO, noise protection, forestry).

The assessment of **air quality** in the Republic of Croatia will be completed in early 2007, as well as the classification into zones and areas, which will be followed by the development of the Air Quality Protection and Improvement Plan. The 12 remaining stations of the state network for permanent monitoring of air quality will be established by 2009, with the financial support under the PHARE programme. The integrated system of air quality management will also be established. In the forthcoming period, the air quality IT system will be introduced.

The Republic of Croatia pays a special attention to the issue of implementation of the UN Framework Convention on Climate Change (UNFCCC) and the Kyoto Protocol. At the 12th UNFCCC Conference in Nairobi the decision on the Croatia's increase of the initial (base) emission quota of the greenhouse gases was adopted at the level of 3.5 Mt CO₂eq related to specific circumstances of emission before and after 1990 which is a result of structure of energetic system in former Yugoslavia. The adoption of this decision on the Croatia's application and the preparation of study "Emissions Trading and Other Cost-Effective Measures to Reduce Emissions", will allow for the institution of the Kyoto Protocol ratification procedure in 2007.

The Regulation on Monitoring the Emissions of Greenhouse Gases in the Republic of Croatia is currently being drafted and its completion is planned for the end of 2006. The National

Strategy for the Implementation of the UNFCCC and the Kyoto Protocol will be completed during 2006 and 2007, together with the Plan for the allocation of the emission quota of the greenhouse gases. In addition, the register of the greenhouse gases emissions will be set up with the Environmental Protection Agency. These activities are supported by the programme LIFE III – Third Countries and CARDS. Individual measures for the reduction of greenhouse gases emission in the energy sector, transportation and other sectors have already been implemented. The National Strategy will establish further measures which require establishment of the institutional framework and economic instruments of implementation and incentives. These measures will include increase in the share of renewable energy sources (continuation of the wind power plants construction, use of biomass for energy production), increase in energy efficiency, etc. In accordance with the Biofuel Quality Regulation, the indicative target is to increase the share of biofuel in total fuel marketed in the domestic market up to 5.75% by the end of 2010. Biofuel production will stimulate growing of the required raw materials and cultivation of idle agricultural lands, as well as the construction of the new manufacturing plants, creating thus new employment.

Important activities are being implemented, aimed at establishing the **integrated waste management system**, focused on the increase in the population encompassed by the system of organised waste collection, reduction in the quantity of waste for disposal and increase in the quantity of recycled waste. The activities have been initiated for the establishment of regional/county waste management centres. In accordance with the Waste Management Strategy of the Republic of Croatia, 21 such centres are planned to be established, where the appropriate disposal sites for waste pre-processing will be located. The Environmental Protection and Energy Efficiency Fund, an extrabudgetary institution, presently co-finances the rehabilitation of 173 official municipal waste disposal sites. The total estimated amount required for the rehabilitation of the previously mentioned disposal sites is HRK 2.63bn, of which HRK 1.38bn relates to co-financing by the Environmental Protection and Energy Efficiency Fund, which has so far invested HRK 189.9m in the rehabilitation projects. The rehabilitation of these disposal sites is expected to be completed in 2010, by closing down or changing the original purpose of disposal sites to adjust to the needs of the new waste management centres. The procedure of closing down waste disposal sites on the Adriatic islands is underway, and the final goal is to prohibit completely waste disposal on all the islands and to establish the transfer stations from which waste will be transported to the mainland centres. The establishment of the maximum number of regional/county waste management centres represents a long term task, which will be performed in accordance with the set dynamics and will be financed by the funds from the state budget and budget of local and regional self-government units, the Environmental Protection and Energy Efficiency Funds and the ISPA and IPA instruments of pre-accession assistance. In 2007 and 2008, harmonisation of legislation in the area of waste management with the EU *acquis* will continue, together with the introduction of further systems of taxes and procedures for managing special waste categories. The waste management IT system development will continue through the Environmental Protection Agency. The implementation of the rehabilitation programmes is being prepared for the former industrial locations contaminated with hazardous substances and for hazardous waste disposal sites. In the period 2007-2009, the project PHARE 2006 will be implemented – Development of the Hazardous Waste Management System, along with the “black spots” identification and management in Croatia, worth EUR 2.5m, which main objective is development of the hazardous waste management system in accordance with the targets and measures of the Waste Management Strategy of the Republic of Croatia.

In the area of **water management**, the main activities are focused on a further development of implementing mechanisms and administrative capacity for the harmonisation of the domestic legislation with the EU *acquis*, for the purpose of strengthening and establishing the system of integrated water management, along with the increased investment in water management infrastructure (maintaining/achieving adequate state of water and water-dependent ecological systems; recovery and removal of sources of pollution; providing access to safe drinking water for the population; further development of the irrigation system and system of protection from damage caused by water which ensures the required safety).

In December 2005, The Financing Memorandum was signed by the EC concerning the award of a grant to the project Programme of Water Supply and Waste Water Drainage System in the City of Karlovac. The total amount of a grant is EUR 22.5m, while co-financing from domestic sources amounts to EUR 13.5m, which includes EBRD loan repayment.

The assistance was ensured, within the 2003 CARDS project which started in May 2006, for the harmonisation of the Croatian water legislation with the relevant EU legislation. The beginning of implementation of the 2004 CARDS project - Strengthening Capacity and Preparation of Guidelines for the Application of the Framework Water Directive was envisaged for end-2006. The funds are earmarked in the state budget for the harmonisation of legislation in the area of waste management for the period 2007-2009, in the total amount of HRK 4.2m. A total of HRK 136.0m is earmarked in the state budget for the same period for water supply capital projects. A total of HRK 211.5m is planned to be allocated from the state budget for the period 2007-2009 for capital projects of protection of water and sea from pollution.

The Environmental Protection Agency has established the IT system for monitoring the state of the Adriatic Sea, under the project Adriatic Sea Environmental Master Plan (ASEMP), which will be systematically upgraded in the 2007-2009 period.

In the period 2007-2008, drafting of subordinate legislation was planned related to the ecological and spatial characteristics of beaches, as well as of the implementing legislation on sea categorization. The construction of another cleanup vessel is planned for the elimination of the Adriatic Sea pollution in the case of accidents or natural risks.

The implementation of the Project against the pollution of water in the coastal area of the Republic of Croatia (Adriatic Project) has continued, containing 47 sub-projects for the construction of facilities and municipal infrastructure. The project is implemented by the public enterprise Croatian Waters (Hrvatske vode), units of local self-government in the coastal area and on the islands, and by the Ministry of Environmental Protection, Physical Planning and Construction, which is competent for the sea monitoring. The project is financed from the state budget funds, loans granted by the International Bank for Reconstruction and Development (IBRD), budget of the local self-government units and by Croatian Waters.

In the area of **nature protection**, a revision of the sector legislation and incorporation of the nature protection determinants in other sectors will continue with a greater intensity in the period 2007-2009.

As regards the increase in the percentage of protected areas, the river Neretva valley will be proposed for protection in the nature park category. HRK 1.2m is thus earmarked in the state budget for 2007 for the establishment of a public institution -Neretva Nature Park.

Activities aimed at controlling the cross-border transfer, trade and breeding of wild life have continued. The computer system for issuing approvals under CITES, in accordance with the EU legislation, will begin to operate for that purpose by end 2007.

For the purpose of protecting the natural values, the owners and holders of property rights to a real estate, residing in the areas that are a part of the national ecological network, will be granted incentives in the total amount of HRK 3.0m from the state budget, in the 2007-2009 period, for the programmes/projects of utilisation of natural resources in accordance with the nature protection principles.

The activities will continue for the improvement of the protected areas management by adopting the management plans. The developed management plans for protected species will be implemented in 2007 as well. Afterwards, a revision of the management plans is foreseen, in terms of preparing a cross-border plan for wild life management at the species level. The planned amount for the compensation for damage caused by strictly protected species is HRK 3.15m in 2007.

HRK 2.3m is earmarked in the state budget for 2007 for issuing the revised National Strategy and Action Plan for Biological and Landscape Diversity and for the implementation of the action plans.

The administrative strengthening of the nature protection sector is planned in the 2007-2009 period (Ministry of Culture, State Office for Nature Protection and public institutions for managing national parks and nature parks) in line with budgetary constraints.

The implementation of the international projects has also continued, for which HRK 4.2m is planned to be earmarked in the state budget for 2007, together with grants under PHARE programme in the amount of HRK 11.1m (NATURA 2000 (PHARE) - HRK 444,000, KEC (World Bank) - 3.75m, INTERREG IIIA project Cross-border Co-operation in Dinaric Lynx Population Management, Protection and Research).

As regards **industrial contamination and risk management**, the alignment with the requirements of Directive 61/96/EC, related to the Integrated Pollution Prevention and Control - IPPC, represents the most important change relative to the previous practice in the field of nature protection in industry. A single environmental permit (IPPC permit) will be introduced, which will integrate all the existing individual permits. The framework provisions for the application of the IPPC Directive will be incorporated in the new Environmental Protection Act. The environmental permit ordinance (which will be adopted by the end of 2008) will provide for an obligation of setting the emission standards in accordance with the Best Available Techniques (BAT), where they are not already set by special emission regulations. Setting of the emission limit values in accordance with the BAT techniques will be taken into account when adopting other emission regulations, especially for water, air, noise and soil. The project of IPPC application development identified about 150 plants in the Republic of Croatia which are subject to the Directive implementation. The application of the provisions of the IPPC Directive will require a significant administrative strengthening and training of the competent services, which will be supported by the 2004CARDS project, the implementation of which will start in 2007. The register of emissions to the environment will be upgraded in order to be fully compliant with the requirements of the European Pollutant Emission Register- EPER, i.e. the European Pollutant Release and Transfer Register - PRTR.

The new Environmental Protection Act will define the framework for the implementation of the system for the application of the amended Directive 96/82/EC (Seveso II) on the control of major-accident hazards. The activities for upgrading the register of hazardous plants in the Republic of Croatia have continued.

The adoption of the National Chemical Safety Programme is planned by the end of 2006 for the purpose of the efficient and harmonised implementation of the national policy in the field of **chemical safety**, in accordance with the Chemicals Act.

The adoption of the remaining implementing regulations, envisaged by **the Genetically Modified Organisms (GMO) Act**, will continue and the required amendments to the Act itself will be adopted. These activities are planned to be completed by end 2008. The GMO Council, the Committee on the Limited Use of GMO and the Committee on Releases of GMO to the Environment will begin with their operations in 2007, for the purpose of the GMO Act implementation.

In the area of **forestry**, the implementation of the Ideal and Operating Plan of the National Inventory of Forest Resources of the Republic of Croatia is currently underway. In the course of the project (2007-2008), i.e. inventory, the forest data, which are highly reliable and accurate, will be obtained (area, wood mass, growth, types of forest communities, etc.), in line with the international standards of forest data monitoring. The supervision of the forest plants health status and status monitoring will be carried out by the Forestry Institute Jastrebarsko (previously, this was done by the Plant Protection Institute of the Republic of Croatia). The establishment of the register of forest damages and forest fires is also anticipated for the purpose of performing an intensive and on-going supervision of forest ecological systems. Pursuant to the Forest Reproductive Material Act, the establishment of the gene bank and preservation is planned for the end of the year, for the purpose of harmonisation with the EU *acquis* (Directive 1999/105/EC on marketing forest reproductive materials).

4.7.4 Public Procurement

The main objective of the public procurement system reform, i.e. modification and development of the public procurement system, is to establish a fully coherent, functional, effective and transparent system of public procurement, concessions and public and private partnership, and their application in practice. The reform objective is based, among other documents, on a recently adopted Strategic Development Framework 2006-2013, i.e. on the fulfilment of the basic strategic objective “development and employment in competitive market economy that is in place in the European social state of the 21st century”.

As regards the implementation of measures relating to the area of public procurement in the previous period, the list of entities liable to the Public Procurement Act was issued in February 2006 (Official Gazette 18/2006). The following first drafts were completed: Regulation on the general provisions for procurement of goods, services and for awarding of works, containing the provision relating to CPV (Common Procurement Vocabulary) and CPC (Central Product Classification), Regulation on small-scale procurement procedures for goods, works and services and Regulation on Methodology of Preparation, Assessment and Performance of the Investment Projects. These drafts were delivered to the EC for its opinion. In September 2006, the first Draft of the Public Procurement Act was completed, while the final Draft of the Public Procurement Act is expected in the first quarter of 2007. The Public

Procurement Office (hereinafter: the Office) has made intensive efforts in the development of the Public Procurement System Development Strategy in the Republic of Croatia 2006-2010. During the creation of Strategy based on SWOT analyze, both force and weakness, i.e. chances and threats for public procurement system in the Republic of Croatia, are identified. With this Strategy, aims and measures of further strengthening of defined forces, i.e. type of solving their weakness, are identified.

As a part of strengthening institutional and administrative capacity of the Office and the public procurement system, the following measures have been carried out:

- six new employees have been hired, including the deputy Director of the Public Procurement Office and the head of the Supervision Department. The Office employees participate in international and domestic seminars and workshops related to the public procurement, as well as in study tours (4) under the programme 2002 CARDS twinning project “Strengthening of the Public Procurement System in the Republic of Croatia”. For the purpose of education, the certain number of Office employees attend foreign language courses,
- for the purpose of developing professional competence of the entities liable to the application of the Public Procurement Act, in co-operation with CARDS 2002, the training programme for employees and public procurement trainers was realised in 2006, in two modules which were organised in May/June and in September 2006. The Office has also organised several larger and smaller seminars and workshops throughout the Republic of Croatia, as well as a workshop in co-operation with TAIEX (Technical Assistance Information Exchange Unit),
- due to the purpose of coordination in creating and application of politics related to the public procurement with the aim of reforming the public procurement system, the organisational development plan of the Public Procurement Office, as an expert service of the Government of the Republic Croatia, aiming at establishing the Central State Administrative Office for Public Procurement, is in the making
- in the line of public procurement strengthening, the analyze and the proposal of public procurement organisation of the entities liable to the application of the Act, are constructed
- as regards the IT system development for the Office needs, from June to December 2006 the work has been done on establishment of Database for entities liable to the application of the Public Procurement Act and Database related to reports for public procurement reporting for 2005. The Databases facilitate in creation of statistical database and then application with searching according to certain criteria as well as with exporting data from annually report base of public procurement to other programs. For the purpose of advancing communication within the Office, Intranet was put into operation in October,
- as regards the development of *e*-procurement and a possibility of public procurement centralisation, the legal conditions have been created by the Draft of the Public Procurement Act,
- for the purpose of increasing public procurement perception by specialized and other publicity, 4 public procurement Bulletins were published in the electronic form. In addition, seminars were organised where, among other topics related to public procurement area, attendants were informed with legal *acquis* of the EU related to the public procurement area. Also, attendants were informed about new public procurement actions, regulations in the Act of Amendments in Public Procurement Act and legal protection. Presentation of public procurement manual for tenderers was organised in July and its function was advertisement of public procurement system.

The implementing measures planned for the 2007-2009 period will be focused on fulfilling the primary objective of the public procurement reform, on the principles of transparency of public procurement procedures, non-discrimination and equitable treatment/equality of the participants in public procurement, and on the principle of freedom of competition. The realisation of the previously mentioned principles must be ensured through a full harmonisation of the adopted and implemented legislative framework²⁷ with the EU *acquis*.

The implementation of measures for strengthening institutional and administrative capacity of both the core institutions and the overall public procurement system is planned in short term (2007) and in medium term (2008-2009) period:

- restructuring of the Public Procurement Office as an expert service of the Government of the Republic of Croatia into the Central State Administrative Office for Public Procurement as a state administrative authority, which would act as a co-ordinator for the entire chapter of public procurement,
- strengthening of administrative capacity in basic public procurement institutions, entities liable to the application of the Public Procurement Act, potential tenderers and other parties interested in public procurement (increase the number of employees in Central State Administrative Office for Public Procurement to full capacity of 30 employees to 2009, education, manuals, public procurement dictionary),
- establishment and strengthening of legal and technical requirements for the application of electronic public procurement and strengthening of the IT system in the Central State Administrative Office for Public Procurement (upgrading the existing applications, intranet, web site, etc.) and in public procurement system,
- work on procurement planning and its connecting with the financial plan, i.e. the budget,
- work on public procurement centralization depending on its advisability,
- increase in the public procurement system transparency (bulletin, publications, web site, seminars, consulting, contacts with the media, etc.).

As regards the concessions, the Croatian legislative framework regulating the award of concessions is composed of the Concessions Act from 1992 (Official Gazette 89/1992) and about 20 sector regulations (about 20 acts and the same number of other subordinate legislations) which include different rules for concessions in such areas regulated by them.

As regards the public and private partnership, the Guidelines for the application of the contractual forms of PPP (Official Gazette 98/2006) provide for the following: principles with which a PPP project must comply, procedures of co-operation between a public and a private partner within the PPP, rules of PPP establishment and implementation, which will reduce a risk for the budget, as well as the public authorities' competence for entering into contract under the PPP legal framework.

²⁷ See Structural Reforms Agenda and Achievements and Economic Policy Matrix in short term (2007) and medium term (2008-2009).

5 ECONOMIC POLICY MATRIX

5.1 ENTERPRISE SECTOR		
5.1.1 Privatisation		
POLICY GOAL	IMPLEMENTING MEASURES	PERIOD
Privatisation through capital market	<ul style="list-style-type: none"> Speeding up the sale of remaining CPF portfolio 	2007-2009
Drafting the new legislative framework for the resolution of the issue of privatisation and total state portfolio management	<ul style="list-style-type: none"> Introduction of new additional sales models and abandonment of the rigid initial price setting procedure for companies to be sold through public tenders 	2007-2009
Improving the efficacy of the organisational structure with view to increasing the portfolio management efficacy	<ul style="list-style-type: none"> Change of the future organisation of CPF and joining CPF and the Central State Administrative Office for State Property Management 	2007
5.1.2 Competition Policy and State Aid		
POLICY GOAL	IMPLEMENTING MEASURES	PERIOD
Creating preconditions for preparing a quality legislative framework which will ensure the application of the competition policy principles	<ul style="list-style-type: none"> Harmonisation of the Croatian legislation with the EU <i>acquis</i> in the field of competition 	2007-2009
	<ul style="list-style-type: none"> Preparing a draft proposal for amendments to the Competition Act or for a new Competition Act and other regulations required to empower the Croatian Competition Agency to enact penalties and change subject-matter jurisdiction of the court deciding on the legality of the Agency's decisions 	2007-2009
Efficient implementation of competition regulations	<ul style="list-style-type: none"> Increasing the number of expert staff of the Agency and training them to ensure an efficient implementation of competition regulations 	2007-2009
	<ul style="list-style-type: none"> Implementing the PHARE project in the field of competition and acquiring computer equipment through the Project 	2007-2008
	<ul style="list-style-type: none"> Active cooperation with other Croatian regulatory bodies 	continuously
	<ul style="list-style-type: none"> Signing a co-operation agreement with the Croatian Energy Regulatory Agency and the Council for Electronic Media 	2007
Harmonisation of the Croatian legislation with the EU <i>acquis</i> in the field of state aid	<ul style="list-style-type: none"> Adopting state aid regulations pursuant to the procedure laid forth by the State Aid Decree 	2007-2009
Efficient implementation of state aid regulations	<ul style="list-style-type: none"> Increase the number of expert staff at the Agency and train them to ensure an efficient implementation of state aid regulations 	2007-2009
	<ul style="list-style-type: none"> Implementation of the PHARE project in the field of state aid 	2007-2008
	<ul style="list-style-type: none"> Continued professional training of employees in government administration bodies and local and regional self-government units related to state aid operations 	2007-2009
5.1.3 Railway Restructuring		
POLICY GOAL	IMPLEMENTING MEASURES	PERIOD
Restructuring and modernisation of the national railway company	<ul style="list-style-type: none"> Railway Act, applied 	since 1 January 2006
	<ul style="list-style-type: none"> Act on the Division of Croatian Railways (HŽ - Hrvatske željeznice d.o.o.), adopted 	December 2005
	<ul style="list-style-type: none"> Railway Transport Safety Act, final proposal drafted 	end 2006
	<ul style="list-style-type: none"> Setting up and registration of new railway companies, almost completed 	IV quarter 2006
Liberalisation of railway transport market	<ul style="list-style-type: none"> Setting up a regulatory body 	until Croatian EU entry
	<ul style="list-style-type: none"> Allocation of infrastructural lines 	from 2007
	<ul style="list-style-type: none"> Strengthening of the administrative capacities 	continuously
Adoption of the National Railway Infrastructure Programme	<ul style="list-style-type: none"> Drafting and adoption 	2007
	<ul style="list-style-type: none"> Establishing the railway infrastructure administrator 	before adoption of the National Programme
	<ul style="list-style-type: none"> Defining the concept of construction, modernisation and maintenance of railway infrastructure 	end 2006
5.1.4 Restructuring of the Shipbuilding Industry		
POLICY GOAL	IMPLEMENTING MEASURES	PERIOD
Achieving operating conditions for the shipyards' autonomous and successful performance on the world market free of loss generation and state-aid	<ul style="list-style-type: none"> National Restructuring Programme of the Croatian shipbuilding industry comprises restructuring measures directed to eliminating external risks and improving the internal resources management processes in each shipyard without further loss generation 	2007 - continuously
Improve competitiveness through business rationalisation, including outsourcing and other operative measures that should lead to more efficacious and sustainable operations	<ul style="list-style-type: none"> Preparation of individual shipyard restructuring plans and increasing the efficacy and cost competitiveness 	2007 - continuously
Increasing the sophistication of the product with an aim of increasing the value added	<ul style="list-style-type: none"> Transfer to designing and construction of more complex ships with an aim of increasing the value added. Use of synergy effects with an aim of reducing costs and more efficient participation on the ship market 	2007 - continuously

POLICY GOAL	IMPLEMENTING MEASURES	PERIOD
The preparation of shipyards for privatisation which will ensure, together with current economic policy measures, measures compatible with the economic policy of the EU, preconditions for their further successful performance	<ul style="list-style-type: none"> Creation of new ship market based on commercially justified concept aligned with the competition policy 	2007 - continuously
Alignment of the state aid system in shipbuilding industry with the provisions of the Act and Decree on state aid, as well as the EC Directives for the shipbuilding industry	<ul style="list-style-type: none"> Use of synergy effects with an aim of reducing cost and more efficient participation on the ship market, as well as the alignment of the state aid program for shipyards with the applicable EU state aid policy 	2007 - continuously
5.1.5 Restructuring of the Metallurgy Sector and Aluminium Industry		
POLICY GOAL	IMPLEMENTING MEASURES	PERIOD
Ensure a long-term sustainability and profitability of the ironworks and the conditions for competitiveness approximately equal to those in the EU	<ul style="list-style-type: none"> Enactment and adoption of the National Steel Industry Restructuring Programme in the Republic of Croatia and the restructuring of steel companies through privatisation Privatisation of Željezara Split by which a restructuring will be implemented Privatisation of Valjaonica cijevi Sisak by which a restructuring will be implemented 	until 1 March 2007 end 2006 I quarter 2006
Restructuring of TLM d.d. Šibenik to ensure the company's long-term sustainability and profitable operation	<ul style="list-style-type: none"> Privatisation of TLM d.d. Šibenik and related restructuring 	until the end of I quarter 2006
5.1.6 Small and Medium Size Enterprises		
POLICY GOAL	IMPLEMENTING MEASURES	PERIOD
Entrepreneurial education	<ul style="list-style-type: none"> Project of the National Programme for Entrepreneurial Education with defined implementing programmes in formal and informal education Coordination of activities related to entrepreneurial education e-learning (EDUNET) Monitoring 	continuously
Competitiveness	<ul style="list-style-type: none"> Specialist education Application of new technologies and technological processes Environmental protection of products Innovations and new products Introduction of EU standards Association of economic entities (clusters) Incentives to crafts and cooperatives Integration of SMEs and R&D institutions Marketing and promotion Coordination of activities related to e-commerce and e-business 	continuously
Entrepreneurship financing	<ul style="list-style-type: none"> Credit financing Venture capital Guarantees 	continuously
Entrepreneurial infrastructure	<ul style="list-style-type: none"> Improving the operation of the Croatian Agency for Small Business Support to setting up regional development agencies Support to developing entrepreneurial zones, technological parks and incubators 	continuously
5.1.7 Public-Private Partnership		
POLICY GOAL	IMPLEMENTING MEASURES	PERIOD
Legislative alignment with the EU <i>acquis</i> related to PPP	<ul style="list-style-type: none"> Implementation of the Alignment Programme of PPP legislation 	2005 - continuously
Preparation of PPP pilot projects in different sectors with an aim of ensuring, together with the current economic policy measures compatible with the EU economic policy, the preconditions for further quality construction of public structures and infrastructure	<ul style="list-style-type: none"> The choice of the PPP model will depend on the project type and it will be carried out through public tenders and defined Guidelines on PPP which were adopted by the Government of the Republic of Croatia, as well as future acts (Concessions Act and Public Procurement Act) 	2006 - continuously
Increasing the quality of public services with an aim of increasing the value added to the public sector	<ul style="list-style-type: none"> Through the adequate PPP projects, domestic and international integration and implementation of EU Directives, etc. 	continuously
Creation of new market based on commercially justified concept	<ul style="list-style-type: none"> Offering PPP projects based on concession and PFI model 	continuously
Increase of efficiency and cost competitiveness in provision of public services	<ul style="list-style-type: none"> Implementation of the PPP Projects Programme, control of the total life costs of public structures, etc. 	2005 - continuously
Use of synergy effects with an aim of reducing the total cost of living	<ul style="list-style-type: none"> Integrating the project phase, the construction phase, maintenance and use of PPP projects of utility infrastructure and public structures (for example schools, hospitals, etc.) 	continuously
5.2 FINANCIAL SECTOR		
5.2.1 Banking System		
POLICY GOAL	IMPLEMENTING MEASURES	PERIOD
Regulation of the financial collateral	<ul style="list-style-type: none"> Adoption of the Financial Collateral Act Adoption of subordinate legislation (decisions and directions for their implementation) in addition to the Financial Collateral Act 	III quarter 2007 IV quarter 2008

POLICY GOAL	IMPLEMENTING MEASURES	PERIOD
Regulation of the deposit insurance	<ul style="list-style-type: none"> Adoption of the Deposit Insurance Act Adoption of subordinate legislation (decisions and directions for their implementation) in addition to the Deposit Insurance Act 	<p>III quarter 2007</p> <p>IV quarter 2007</p>
Implementation of new standards for capital and risk assessment	<ul style="list-style-type: none"> Adoption of the Credit Institution Act Adoption of subordinate legislation (decisions and directions for their implementation) in addition to the Credit Institution Act 	<p>I quarter 2008</p> <p>IV quarter 2008</p>
Regulation of payment system	<ul style="list-style-type: none"> Adoption of the National Payment System Act Adoption of subordinate legislation (decisions and directions for their implementation) in addition to the National Payment System Act 	<p>I quarter 2008</p> <p>I quarter 2008</p>
Regulation of the reorganisation and winding up of credit institutions and insurance companies	<ul style="list-style-type: none"> Adoption of the Act on the Reorganisation and Winding Up of Credit Institutions and Insurance Companies Adoption of subordinate legislation (decisions and directions for their implementation) in addition to the Act on the Reorganisation and Winding Up of Credit Institutions and Insurance Companies 	<p>I quarter 2008</p> <p>IV quarter 2008</p>
5.2.2 Foreign Exchange System Regulation		
POLICY GOAL	IMPLEMENTING MEASURES	PERIOD
Enable domestic investors' portfolio diversification, increase capital gains on some markets and reduce transaction costs of investments	<ul style="list-style-type: none"> Annulling certain provisions of the Foreign Exchange Act which restrict free movement of capital by means of amendments to the Act Revoking the Decision on the Conditions for Issuing Approvals for Opening Foreign Exchange Accounts Abroad 	<p>2008</p> <p>2008</p>
Fully liberalise cash transactions between residents and non-residents and taking in and out of the country of domestic cash for residents	<ul style="list-style-type: none"> Amending (or revoking) the Decision on the Method and Conditions under which Residents May Execute and Receive Payments Arising from Transactions with Non-Residents in Domestic Cash, Foreign Cash and Checks Revoking the Decision Governing the Taking In and Out of the Country of Cash, Checks and Materialised Securities Revoking the Decision on the Conditions for Issuing Approvals for Personal Transfers Abroad of Assets Relating to Gifts and Grants 	<p>2007-2008</p> <p>2008</p> <p>2008</p>
5.2.3 Non-Banking Sector Supervision		
POLICY GOAL	IMPLEMENTING MEASURES	PERIOD
Further development and improvement of the non-banking sector	<ul style="list-style-type: none"> Adoption of the Act on the Take-Over of Joint Stock Companies Adoption of the Financial Conglomerate Act Compliance with EU legislation 	<p>2007</p> <p>2007</p> <p>continuously</p>
Establishment of a supervisory body, human resource development	<ul style="list-style-type: none"> Further setting up of organisational structure Education for brokers, investment advisors and pension fund managers 	<p>continuously</p> <p>2007-continuously</p>
5.3 LABOUR MARKET		
5.3.1 Stimulating Employment		
POLICY GOAL	IMPLEMENTING MEASURES	PERIOD
Increase employment and employability by aligning labour market supply with demand	<ul style="list-style-type: none"> Analysis and evaluation of annual employment incentive plans 	<p>continuously</p>
5.3.2 Social Security System		
POLICY GOAL	IMPLEMENTING MEASURES	PERIOD
Social Benefits Reform		
Reduce the share of expenditures on financial social benefits in GDP while increasing the share of social assistance benefits	<ul style="list-style-type: none"> Consolidation of social benefits to reduce their total number Introduction of income and means tests - improved targeting Enable faster and improved access to social benefits by introducing a single register of social benefits and a single register of beneficiaries, and by simplifying administration Equalisation of social benefits - index the social welfare entitlement base to the cost of living 	<p>2006 - 2008</p> <p>2006 - 2008</p> <p>2006 - 2008</p> <p>2006 - 2008</p>
Create a beneficiary -oriented system by improving service quality and social benefit targeting	<ul style="list-style-type: none"> Decentralisation Introduction of the One-Stop-Shop Programme Deinstitutionalisation - reducing the scope of institutional care (a 10% reduction in new institutionalisation in the areas covered by pilot projects and engaging 15% of beneficiaries in institutionalisation prevention programmes) Development of the information and management systems (downsizing administrative functions) 	<p>2006 - 2008</p> <p>2006 - 2008</p> <p>2006 - 2008</p> <p>2006 - 2008</p>

POLICY GOAL	IMPLEMENTING MEASURES	PERIOD
	<ul style="list-style-type: none"> Service quality improvement in social welfare facilities (reconstruction and adaptation of 13 welfare centres, construction of 13 new welfare centres and improvement of sanitary and hygienic conditions in 57 social welfare homes) Restructuring the social welfare system to ensure better allocation of social benefits through an ongoing improvement of policy and the management system (the restructuring is to be tested in three counties: the County of Split and Dalmatia, the County of Zadar and the County of Vukovar and Srijem) 	<p>2006 - 2008</p> <p>2006 - 2008</p>
Children and families' protection - systematic protection of rights and interests of children and vulnerable groups and harmonisation with international standards	<ul style="list-style-type: none"> Implementation of the obligations set out in the National Strategy for the Protection Against Family Violence and in the Family Violence Protocol Harmonisation with international standards 	<p>2007</p> <p>continuously</p>
A new system of family allowances focused on the rejuvenation and growth of the RC population, to be introduced in January 2007, aiming at achieving, in the long term, the objective of maintaining the birth rate above the mortality rate.	<ul style="list-style-type: none"> Implementation of the obligations set out by the National Population Policy 	<p>2005 - 2009 permanently</p>
National Minorities		
Protection and promotion of national minorities' rights	<ul style="list-style-type: none"> Implementation of the Constitutional Act on the Rights of National Minorities Implementation of the National Programme for Roma Implementation of the Action Plan for the Decade of Roma Inclusion 2005 - 2015 	<p>continuously</p> <p>continuously</p> <p>continuously</p>
5.4 AGRICULTURAL SECTOR		
POLICY GOAL	IMPLEMENTING MEASURES	PERIOD
Improvement of the agricultural land market	<ul style="list-style-type: none"> Incentives to the purchase of agricultural land through a capital investment model 	<p>continuously</p>
	<ul style="list-style-type: none"> "Enlargement of the Agricultural Land" Project Creation of the Agricultural Land Study Initiation of activities aimed at amending the Inheritance Act 	<p>2005-2008</p> <p>2007-2008</p> <p>2007-2008</p>
Complete the privatisation of agro-conglomerates	<ul style="list-style-type: none"> Implementation of the privatisation tender (second stage) 	<p>2007</p>
Preparation of Croatian agriculture for the implementation of the common agricultural policy of the EU	<ul style="list-style-type: none"> Regulation of the agricultural products and foodstuffs market in line with the changes in market organisation in the EU Harmonisation of state aid to agriculture with EU directives Establishment of a support system for rural development - implementation of rural development measures financed from the national budget as well as the accreditation and implementation of measures from pre-accession funds Strengthening the capacities of agricultural inspection and alignment with EU standards Establishment of the system of agricultural accounting data - creation of a study and pilot project for the establishment of the FADN Establishment of Wine Cadastre - forming a fully digitalised cadastre, collecting and entering the remaining data Alignment of phytosanitary standards with the EU: <ul style="list-style-type: none"> Construction of the new building of the Plant Protection Institute Building the capacities of the plant protection service Drafting implementing regulations Functional establishment and strengthening the capacities of the Food Agency Alignment of veterinary standards with those in the EU: <ul style="list-style-type: none"> Drafting implementing regulations Reorganisation of the veterinary service and inspection 	<p>continuously</p> <p>continuously</p> <p>continuously</p> <p>2006 - continuously</p> <p>2006-2008</p> <p>2007-2008</p> <p>2006-2008</p> <p>continuously</p> <p>continuously</p> <p>continuously</p>
Alignment of fisheries policy with the Common Fisheries Policy of the EU	<ul style="list-style-type: none"> Harmonisation of regulations Reorganisation of inspection services 	<p>continuously</p> <p>continuously</p>
Enhance the competitiveness of wood industry	<ul style="list-style-type: none"> Research, development and technology modernisation 	<p>continuously</p>
5.5 PUBLIC ADMINISTRATION REFORM		
POLICY GOAL	IMPLEMENTING MEASURES	PERIOD
Rationalisation of government administration	<ul style="list-style-type: none"> Carrying out functional analysis in government administration bodies (including the implementation of the rationalisation programme in the government administration bodies where a functional analysis has been carried out) 	<p>IV quarter 2006 until end of IV quarter 2007</p>
Simplification of administrative procedures, facilitate the realisation of citizens' rights	<ul style="list-style-type: none"> Adopting and implementing amendments to the General Administrative Procedure Act 	<p>2007</p>
Set up an efficient system of ongoing professional improvement and training of civil servants	<ul style="list-style-type: none"> Increasing employee capacity at the Centre for Professional Improvement and Training of Civil Servants Developing and implementing general education programmes for civil service employees Carrying out an analysis of civil service training needs Accelerated language lessons for civil servants participating in the harmonisation of legislation with EU legislation 	<p>2007</p> <p>continuously</p> <p>2007</p> <p>continuously</p>

POLICY GOAL	IMPLEMENTING MEASURES	PERIOD
Strengthen the role of electronic administration in the development of the economy	• Adopting a new decree on office operations (aligned with electronic functioning of administration)	2007
	• Informatisation of government administration offices in the counties	2007
	• Establishing an IT-supported register of civil servants	2007
	• Establishing the Operational Plan for the Implementation of the e-Croatia 2007 Programme for 2007	2007
Regulation of the legal status of civil servants and employees in government administration in local and regional self-government units	• Adopting Local and Regional Self-Government Employment Act	2008
Improved supervision of the work of government administration bodies	• Adopting amendments the Administrative Inspection Act	2008
	• Implementing the Administrative Inspection Act and conducting thorough inspection supervision in all government administration bodies	2009
Set up a more efficient system for the provision of public services to citizens	• Implementing administrative decentralisation of government administration operations • Professional improvement of local and regional government employees through the Academy of Local Democracy	II quarter 2006-2008 continuously
Decompression of public sector wages	• Public sector reform and adoption of a new legal framework	2008
5.6 DEVELOPMENT OF A KNOWLEDGE-BASED SOCIETY		
POLICY GOAL	IMPLEMENTING MEASURES	PERIOD
Provide all children with equal access to education and quality preparation for school	Encouraging social and private initiatives (founders) for the opening of a large number of kindergartens with a variety of preschool education programmes, implementing new programmes at at least 20 new locations (municipalities) where programmes for pre-school children have not been implemented, for 2007 and onwards, and drawing up the National Educational Standard and National Curriculum for pre-school education.	2007-2009
	Carrying out systematic professional training of preschool teachers, associate staff, preschool principals and representatives of municipalities and towns in the development of varied preschool education programmes - new programmes for preschool children to be introduced every year in five counties x at four locations (municipalities)	2007-2009 continuously
	Encouraging cooperation between government bodies and local communities to enable equality of access to preschool education, especially concerning national minority children (devoting special effort to implementing programmes for Roma minority children – three to four new programmes every year)	2007-2009 continuously
Improve learning and teaching quality	In the school year 2006/2007, introduce the new National Educational Plan and Program, based on the Croatian National Education Standard (CNES), into all	2007 - 2009
	• primary schools, monitor and evaluate its implementation, paying special attention to the promotion of creative learning and teaching methods, enhance pupils' capability to learn how to learn, as a precondition for lifelong learning	
	Enhancing information and communication skills, foreign language learning,	2007-2009 continuously
	• mathematical and scientific literacy, promote technical culture, entrepreneurship and social skills	
Develop a system of evaluation of education programmes and pupils' achievements, introduce national exams for eight grade pupils in the school year 2006/2007 and develop clear criteria for the monitoring, evaluation and self-evaluation of all the participants in the education process	2007-2009	
Develop and improve the quality of secondary education	• Drafting the National Education Standard and National Curriculum	2007-2009
	• Creating legislative, organisational and material conditions for the introduction of compulsory secondary education	2007-2009
	• Conducting annual national exams according to the plan of the National Centre for External Evaluation of Education	2007-2009 continuously
	• Developing and implementing the secondary school self-evaluation project	2007-2009
	• Creating conditions to carry out the second PISA test in 2009	2007-2009
	• Updating the teacher education proposal	2007-2009
	• Preparing a proposal for the pedagogical and psychological education of teachers in line with the Bologna process	2007-2009
	• Developing a system for the self-evaluation of all the participants in the education process	2007-2009
	• Redefining vocational programmes and specialisations, developing the National Qualification Framework, determining pupils' exit competencies, preparing new programmes and curricula	2007-2009
	• Establishing a programme network	2007-2009

POLICY GOAL	IMPLEMENTING MEASURES	PERIOD
	<ul style="list-style-type: none"> • Make systematic efforts to equip secondary schools, especially vocational schools • Developing adult education • Increasing the number of scholarships and incentives provided to national minority members, adults and unemployed persons • Creating the prerequisites for a faster inclusion of foreign nationals into the education system • Strengthening relations with economic and social partners 	<p>2007-2009 continuously</p> <p>2007-2009 continuously</p> <p>2007-2009 continuously</p> <p>2007-2009</p> <p>2007-2009 continuously</p>
Implementation of the Bologna Process	<p>Carrying out an evaluation of post-graduate studies (doctoral and specialist).</p> <ul style="list-style-type: none"> • Preparing a comprehensive action plan for the establishment of the National Qualification Framework <p>Implement the dual system by 2010-2011 Introducing the Diploma Supplement and Certificate Supplement. Drafting the Students Rights Act.</p> <ul style="list-style-type: none"> • Carrying out external evaluation of higher education programmes and institutions simultaneously with the development of quality assurance units at institutions of higher education, and in connection with the mobility of professors and students • Adjusting the mechanisms of investment and control over spending of budgetary funds and encouraging private initiatives • Training staff for the permanent monitoring and evaluation of scientific and higher education work in accordance with world standards • Stimulating cooperation with foreign faculties and universities, openness and international integration <p>Systematically increase inflow of information on labour market need into the higher education system and strengthen the cooperation between the higher education system and the private sector</p> <ul style="list-style-type: none"> • Strengthening the capacities of the Agency for Science and Higher Education and the National ENIC/NARIC Office, as a centre for promoting openness of the higher education system • Developing professional higher education programmes in small urban communities • Evaluation of economic needs to stimulate development and young people's employment in small urban communities • Evaluating needs in the segment of managerial and organisational skills • Continuing with the reorganisation of the system of science and strengthening the cooperation between the system of science, the Government of the Republic of Croatia and the economy • Evaluating and reorganising scientific organisations • Access the Seventh Framework Programme and enhance the participation of Croatian scientists and other entities in EU framework programmes • Fostering employment of young scientists and providing support to investments in the scientific infrastructure 	<p>2007-2009</p> <p>2007-2009 continuously</p> <p>2007-2009 continuously</p> <p>2007-2009</p> <p>2007-2009 continuously</p> <p>2007-2009</p> <p>2007-2009</p> <p>2007-2009 continuously</p> <p>2007-2009</p> <p>2007-2009</p> <p>2007-2009</p>
Strengthen research and development	<ul style="list-style-type: none"> • Allocating financial aid earmarked for scientific programmes and projects to priority programmes and projects (environment, health, energy, materials) <p>Increasing funding for basic research, environment protection research, research on economic development of the karst areas, the Adriatic Coast, sea and islands, agriculture, biotechnology, food, health, information and communication</p> <ul style="list-style-type: none"> • technologies, nanoscience, new materials, construction and new production processes, energy and sources of alternative renewable energy, transport and safety, social and humanistic sciences, Croatian identity, social integration, education and learning as well as lifelong learning <p>Providing quality technological infrastructure through specialised or general</p> <ul style="list-style-type: none"> • entrepreneurial incubators enabling newly established companies to start operation • Initiating new projects to promote the cooperation between the academic community and the economy • Improving the funding procedure for technological project monitoring • Drawing up guidelines to stimulate the innovation and technology system • Entrust HIT d.o.o. with operations related to these activities 	<p>2007-2009 continuously</p> <p>2007-2009 continuously</p> <p>2007-2009 continuously</p> <p>2007-2009</p> <p>2007-2009 continuously</p> <p>2007-2009</p>
5.7 OTHER REFORMS		
5.7.1 Health Care Reform		
POLICY GOAL	IMPLEMENTING MEASURES	PERIOD
Health Care System Reform		
Improvement of the organisation and operation of primary health care	<ul style="list-style-type: none"> • Completing and extending the primary health care network 	2007-2008

POLICY GOAL	IMPLEMENTING MEASURES	PERIOD
	<ul style="list-style-type: none"> • Changing the conditions for and the manner of providing specialist health care • Renewing medical equipment • Expanding the telemedicine system to primary health care and introducing telemedicine standards • Promotional activities related to raising awareness of healthy lifestyle • Informatisation of primary health care and its networking with hospital informatisation • Changing the relationship between community health centres and lease-holders with the introduction of a lease ordinance • Changing the calculation of funding for primary health care teams with the introduction of the "Fund Holding" for part of the services • Defining primary health care teams and introducing additional types of specialist teams • Establishing community health centres on islands and in areas of special state concern • Ensuring joint assistance provision by the health care system, social security system and civil society system to the most vulnerable population groups • Transforming the selected doctor into the selected family doctor • Establishing the Croatian Mental Health Institute • Harmonising laboratory check-ups and general and specialised medical and biochemical laboratories with those in the EU 	<p>2007-2008</p> <p>continuously</p> <p>2007-2008</p> <p>continuously</p> <p>continuously</p> <p>2007-2008</p> <p>2007-2008</p> <p>continuously</p> <p>2007</p> <p>continuously</p> <p>continuously</p> <p>2007</p> <p>2007-2009</p>
Improvement of the organisation and operation of secondary and tertiary health care	<ul style="list-style-type: none"> • Establishing a register of health care institutions • Accreditation of health care institutions according to their activities • Categorisation of health care institutions based on the accreditation • Plan to expand hospital capacities according to needs after the categorisation • Hospital system informatisation • Efforts to maintain high quality standards at hospital institutions accredited as clinics or clinical hospitals • Managing consumption of medicines and introducing the concept of "pharmaceutical care" • Setting up a new system of out-of-hospital emergency medical aid • Establishing an integrated system of pre-hospital, hospital and inter-hospital emergency medical care based on the concept of integrated medical care 	<p>2007-2008</p> <p>2007-2009</p> <p>2007-2009</p> <p>2007-2009</p> <p>2007-2009</p> <p>continuously</p> <p>continuously</p> <p>2007-2009</p> <p>2007-2009</p>
Reform of the Health Care System Financing		
Stabilisation of the health care and health insurance systems	<ul style="list-style-type: none"> • Reducing the share of public spending on health care • Regulating supplementary and additional health insurance • Defining a negative list of the compulsory health insurance package (procedures which are not covered by compulsory health insurance) • Improving the existing system of direct beneficiary payments • Reducing the share of income of primary health care doctors generated by head tax in favour of payment mechanism of price per service and payment per case • Categorisation and accreditation of hospitals with a possible effect on cost reduction • Preparing algorithms of diagnostic and therapeutic procedures and standardising medical procedures • Introducing hospital payments through the DRG system • Rationalising procurement and the use of diagnostic equipment in line with the accreditation and categorisation of hospitals and defined clinical guidelines • Introducing smart cards to monitor financial and physical indicators on patients and doctors • Rationalising medicine consumption through basic and supplementary medicine lists 	<p>2007-2009</p> <p>2007-2009</p> <p>2007-2009</p> <p>2007-2009</p> <p>2007-2009</p> <p>2007-2009</p> <p>2007-2009</p> <p>2007-2009</p> <p>2007-2009</p> <p>2007-2009</p> <p>2007-2009</p>
Public Health System Reform		
Reorganisation of the public health system	<ul style="list-style-type: none"> • Drawing up a new public health strategy • Drawing up a National Public Health Programme and specific institutions' programmes • Harmonisation of relevant legislation and secondary legislation with the regulations and practices of the EU • Establishing the Public Health Fund • Establishing a system of education and accreditation for the institutions and firms which are to implement public health programmes • Establishing a public health research fund • Health care prevention (promotional activities aimed at preventive health protection comprised within the so-called "lifestyle" category (e.g. prevention of addiction to alcohol, nicotine, narcotics, fight against obesity) 	<p>2007-2008</p> <p>2007-2008</p> <p>2007-2008</p> <p>2007-2008</p> <p>2007-2008</p> <p>2007-2008</p> <p>2007-2009</p>

POLICY GOAL	IMPLEMENTING MEASURES	PERIOD
5.7.2 Judicial Reform		
POLICY GOAL	IMPLEMENTING MEASURES	TIME
Modernisation and Increase in Efficiency of Croatian Courts		
Increase the efficiency of the courts - reduce case backlogs	<ul style="list-style-type: none"> • Redistribution of cases, from overburdened to less burdened courts. 	2007-2008 continuously
	<ul style="list-style-type: none"> • Implementation of the project of monitoring the resolution of «old» and unsolved cases (both civil and criminal). • Preparation of Framework measurements relating to work performance of judges for the purpose of objective assessment and evaluation of the work efficiency of judges. • Supervision over the work of judiciary network (by Judiciary Inspectorate of the Ministry of Justice) • Transfer of execution cases to public notaries on the basis of certified documents 	2007-2008 2007 continuously continuously
Alternative resolution of court disputes	<ul style="list-style-type: none"> • Pilot project «In-Court Conciliation» between parties in the civil procedure. 	2007
Faster and more economic conduct of court proceedings	<ul style="list-style-type: none"> • Adoption of amendments to the Civil Procedure Act. 	2007
Rationalisation of the court network	<ul style="list-style-type: none"> • Pilot project of the merger of 8 minor offence courts and municipal courts. • The analysis of the adequacy of the current court network. 	2007 2007-2009
Land Registry Reform		
Project of putting the land registry in order	<ul style="list-style-type: none"> • Strengthening of activities in clearing land registry backlog. • Systematic supervision over implementation of measures and land registry operations. • Training of land registry officers. • Establishment of digital land registry data base at all land registries. • Implementation of measures for creation of the joint Database containing land registry and cadastre data. • Closing of manually operated land registries. • Establishment of new land registries. 	2007-2008 2007-2008 2007-2008 2007-2008 2007 continuously
Increase the Efficiency of Creditor Protection and Claim Collection		
Increasing the efficiency of the enforcement procedure	<ul style="list-style-type: none"> • Implementation of the Action plan for reducing the number of enforcement cases at courts. 	2006-2007
Creditor protection and claim collection in bankruptcy proceedings	<ul style="list-style-type: none"> • Education of bankruptcy judges in connection with novels to the Bankruptcy Act. • Programme of expert examination for bankruptcy trustees. • Establishment of criteria for appointment of bankruptcy trustees. 	continuously 2006-2008 2007
Penal Legislation Reform		
Modernisation of the Penal procedure	<ul style="list-style-type: none"> • Implementation of the novelled Penal Act and education of judges and state attorneys 	2007-2009
Prevention of corruption and organised crime	<ul style="list-style-type: none"> • Implementation of the National Programme for Prevention of Corruption 2006 - 2008 	2007-2009 continuously
5.7.3 Environmental Protection		
POLICY GOAL	IMPLEMENTING MEASURES	PERIOD
Integration of environment protection goals into planning and implementation of other sector policies, aiming at promoting sustainable development.	<ul style="list-style-type: none"> • Enactment and start of implementation of subordinate Legislation pursuant to the Environment Protection Act relating to the assessment of the impact on the environment and strategic assessment of the impact on the environment 	2007-2009
Further development of the comprehensive system of air quality management and creation the condition for systematic resolution of problems related to climate changes	<ul style="list-style-type: none"> • Development of the Plan of Action to Protect and Improve Air Quality • Air quality assessment at state level and division into zones and areas • Construction of the remaining 12 centres for continuous monitoring of air quality • Establishment of the air quality information system. 	III quarter 2007 I quarter 2007 2007-2008 2007-2009

POLICY GOAL	IMPLEMENTING MEASURES	PERIOD
	<ul style="list-style-type: none"> • Creation of the National strategy for the implementation of the Framework Convention of the UN on climate change (UNFCCC) and the Kyoto protocol with a plane of action • Creation of the greenhouse emissions allocation plan • Creation of a register of emission of greenhouse gases • Creation of the National implementing plan for the implementation of the Stockholm Convention on organic pollutants 	<p>2007</p> <p>2007</p> <p>2007-2008</p> <p>2008</p>
Establishment of the comprehensive waste management system	<ul style="list-style-type: none"> • Construction of county/regional waste management centres • Restructuring of the waste dumping site by changing its purpose, continued use or by closing it • Further development of special waste management by introducing charges for taking care of products when they become waste • Implementation of restructuring programmes for former industrial locations polluted by dangerous substances and wild dumping sights of hazardous waste • Further development of the information system for waste management at the Environment Protection Agency • Preparation of strategic documents and projects for IPA financing 	<p>2007-continuously</p> <p>2007-continuously</p> <p>2007-continuously</p> <p>2007-continuously</p> <p>2007-continuously</p> <p>2007-2009</p>
Strengthening and establishment the system of integrated water management with more intensive investments in the water management infrastructure	<p>Strengthening/reform of the existing system of financing water management and ensuring more funds per year (amendments to/adoption of new subordinate legislation arising from the Act on Water Management Financing)</p> <p>Strengthening of water management planning and adoption of the Water Management Basis of Croatia and continuation of work on the second phase of water management plans in certain areas</p> <ul style="list-style-type: none"> • More intensive implementation of water protection measures, especially with respect to the preparation and implementation of infrastructural water protection projects; recovery and completion of the existing and building of new water discharge systems • Reduction of losses in the existing water supply systems and more connections to the public water supply systems (regional water supply systems), recovery and completion of the existing and building of new water supply systems • Establishment of zones of sanitary protection of drinking water at source • Reconstruction of the existing and development of new irrigation systems • Greater investments in the system of protection from damage caused by water. 	<p>continuously</p> <p>continuously</p> <p>continuously</p> <p>continuously</p> <p>continuously</p> <p>continuously</p> <p>continuously</p>
Sea and marine environment protection	<ul style="list-style-type: none"> • Creation of the annual National Adriatic Sea Monitoring Report. • Creation of an annual report, leaflet and map of sea water quality on beaches. • Creation and development of IT system for monitoring the Adriatic Sea. • Strengthening of supervision of the sea quality in the costal area (Project of protection from pollution in the costal area) 	<p>2007-continuously</p> <p>2007-continuously</p> <p>2007-continuously</p> <p>2007-2008</p>
Further development of the nature protection system	<ul style="list-style-type: none"> • Administrative strengthening of nature protection institutions at the state and local level • Development of national parks GIS • Development of a system of protected areas • Revision of the National Strategy for the Protection of Biological and Landscape Diversity • Development and implementation of regulations based on the Nature Protection Act • Revision of sector legislation development of mechanisms to incorporate nature protection guidelines through co-operation between various sectors 	<p>2007-2009</p> <p>2007-2009</p> <p>2007-2009</p> <p>2006</p> <p>2006-2008</p> <p>2006-2008</p>
Protection of natural values	<ul style="list-style-type: none"> • Establishment of the National Eco-Network (providing funds for protection in the area of the eco-network) • Protection of new areas (Nature Park Neretva) • Network establishment „NATURA 2000“ • Implementation of wolf and lynx management plans (revision after 2007) • Activities relating to the implementation of the CITES <p>International co-operation (implementation of international projects):</p> <ul style="list-style-type: none"> • NATURA 2000 – PHARE • KEC-World Bank • INTERREG IIA "Cross-border co-operation in the management, protection and research of the Dinara population of lynx". 	<p>2006-2009</p> <p>2007</p> <p>2008</p> <p>2006-2007</p> <p>continuously</p> <p>2006-2007</p> <p>2007</p> <p>2007-2008</p>
Introduction of a comprehensive system of environment pollution prevention and monitoring	<p>Adopt implementing regulations of the Environmental Protection Act for the application of provisions on the eco-licence (IPPC Directive). Expert workshops and implementation of projects aimed at enabling and facilitating implementation.</p>	<p>2007-2009</p>

POLICY GOAL	IMPLEMENTING MEASURES	PERIOD
Creation of a system for preventing major accidents involving dangerous substances	<ul style="list-style-type: none"> Further development of the register of dangerous and risky industrial facilities. Adoption of implementing regulations for the implementation of the provision of Seveso II Directive. 	2007 2008
Efficient and harmonised implementation of the national policy in the field of chemical safety	<ul style="list-style-type: none"> implementation of the National programme of chemical safety 2007-2009 	2007-2009
Further development of the comprehensive forestry system	<ul style="list-style-type: none"> Development and implementation of the project "National Inventory of Forestry Resources of the Republic of Croatia Establishment of the Forestry Advisory Service Adoption of subordinate legislation. Creation of the Croatian FSC standard for forest management. 	2007-2008 2007-2008 2007-2008 continuously
Establishment of a system of continuous forest supervision	<ul style="list-style-type: none"> Adoption of a programme of measures for data collection and establishment of a register on the level of damage to forests. Establishment and running of a comprehensive information system and register on forest fires. 	continuously continuously

5.7.4 Public Procurement

POLICY GOAL	IMPLEMENTING MEASURES	TIME
Establishment of a fully coherent, functional, effective and transparent system of public procurement, concessions and public-private partnership in practice.	<ul style="list-style-type: none"> Creation and entry into procedure of the Government of the Republic of Croatia of the Proposal of the new Public Procurement Act Adoption of the Public Procurement Act Creation, adoption and entry into force of the Regulation on announcements and records of public procurements Regulation of public procurement procedure of goods, works and services of small value as well as regulation of the application of CPV /CPC will be made in accordance with the new Act on Public Procurement Creation of a public procurement manual (creation of a manual for potential bidders) Creation of the public procurement dictionary Restructure of the Public Procurement Office as an expert service of the Government of the Republic of Croatia into the Central Government Office for Public Procurement Proposal of the implementation and application of IT system to serve the purposes of the Central Government Office for Public Procurement, statistics system and analysis of data related to public procurement Development of an IT system for the purposes of the Central Government Office for Public Procurement (statistics and data analysis, internal and external communication) and for the purposes of the public procurement Introduction of an Internet site of the Official journal of public procurement for all procurements in the Republic of Croatia Development of the system of electronic procurement and centralization of public procurement depending on its advisability Development of the methodology for creating procurement plans (contracting) Strengthening of the administrative capacity of the Central Government Office for Public Procurement Strengthening of the administrative capacity among those obligated to apply the Act on public procurement: education of trainers for public procurement, training of employees for procurement and supervision and their continuous education Strengthening the perception of the public procurement system by issuing bulletins and publications, maintaining a web site, holding seminars and workshops, contacting the media etc. 	I quarter 2007 end of I quarter 2007 2007-2008 2007-2008 February 2007 December 2007 II quarter 2007 December 2007 continuously 2007-2009 2007-2008 continuously 2007-2009 continuously 2007-2009 continuously 2007-2009 continuously 2007-2009 continuously 2007-2009 continuously 2007-2009

ANNEX I MATRIX OF POLICY COMMITMENTS

	2006	2007	2008	2009
OVERALL ASSESSMENT OF FISCAL IMPACTS OF MAJOR IMPLEMENTING MEASURES				
A. Implementation				
B. Net direct impact on the budget	-328.748.011	-1.431.300.459	-1.888.543.748	-1.161.338.526
B1. Direct impact on revenues	490.483.847	494.542.282	135.508.585	21.470.486
B2. Direct impact on expenditures	819.231.858	1.925.842.741	2.024.052.333	1.182.809.012
I. ENTERPRISE SECTOR				
Total (1+2+3)				
A. Implementation				
B. Net direct impact on the budget	-77.393.957	-693.937.944	-681.258.505	-775.221.537
B1. Direct impact on revenues	3.215.287	6.996.713	-7.104.000	
B2. Direct impact on expenditures	80.609.244	700.934.657	674.154.505	775.221.537
1. Market Competition Policy and State Aids				
A. Implementation			X	
B. Net direct impact on the budget	-397.763	-2.649.325	-1.421.617	2.061.775
B1. Direct impact on revenues	3.215.287	6.996.713	-7.104.000	
B2. Direct impact on expenditures	3.613.050	9.646.038	-5.682.383	-2.061.775
Note: Amounts for 2006, 2007 and 2008 include the amounts from the PHARE project (the project was planned for 2006, but will be implemented during 2007 and 2008).				
2. Railway Restructuring				
Total				
A. Implementation				
B. Net direct impact on the budget	-40.479.194	-585.733.119	-639.499.388	-722.145.812
B1. Direct impact on revenues				
B2. Direct impact on expenditures	40.479.194	585.733.119	639.499.388	722.145.812
Subsidies				
A. Implementation				
B. Net direct impact on the budget	203.168.275	57.473.000	54.300.000	73.300.000
B1. Direct impact on revenues				
B2. Direct impact on expenditures	-203.168.275	-57.473.000	-54.300.000	-73.300.000
Modernisation and Restructuring of Croatian Railways				
A. Implementation				
B. Net direct impact on the budget	-243.647.469	-643.206.119	-693.799.388	-795.445.812
B1. Direct impact on revenues				
B2. Direct impact on expenditures	243.647.469	643.206.119	693.799.388	795.445.812
3. Business Environment of SMEs				
Total				
A. Implementation				
B. Net direct impact on the budget	-36.517.000	-105.555.500	-40.337.500	-55.137.500
B1. Direct impact on revenues				
B2. Direct impact on expenditures	36.517.000	105.555.500	40.337.500	55.137.500
Incentives for Education				
A. Implementation				
B. Net direct impact on the budget	-8.800.000	-6.470.000	-3.185.000	-3.385.000
B1. Direct impact on revenues				
B2. Direct impact on expenditures	8.800.000	6.470.000	3.185.000	3.385.000
Competitiveness				
A. Implementation				
B. Net direct impact on the budget	-7.417.000	-18.885.500	-3.152.500	-3.852.500
B1. Direct impact on revenues				
B2. Direct impact on expenditures	7.417.000	18.885.500	3.152.500	3.852.500
Financing Entrepreneurs				
A. Implementation				
B. Net direct impact on the budget	-6.800.000	-78.700.000	5.000.000	-22.000.000
B1. Direct impact on revenues				
B2. Direct impact on expenditures	6.800.000	78.700.000	-5.000.000	22.000.000

Entrepreneurial Infrastructure				
A. Implementation				
B. Net direct impact on the budget	-13.500.000	-1.500.000	-39.000.000	-25.900.000
B1. Direct impact on revenues				
B2. Direct impact on expenditures	13.500.000	1.500.000	39.000.000	25.900.000
Note: The estimate does not include administrative expenditures and since monitoring has not been established, the SME estimate has been made along the line of what was possible.				

II. LABOUR MARKET				
Total (1+2+3+4)				
A. Implementation				
B. Net direct impact on the budget	-355.500.000	-480.046.000	-818.671.113	-142.891.000
B1. Direct impact on revenues	4.500.000	8.880.000	5.920.000	0
B2. Direct impact on expenditures	360.000.000	488.926.000	824.591.113	142.891.000

1. Annual Plan of Incentives for Employment				
A. Implementation	X			
B. Net direct impact on the budget	-355.500.000	-41.110.000	-50.740.000	-50.000.000
B1. Direct impact on revenues*	4.500.000	8.880.000	5.920.000	
B2. Direct impact on expenditures	360.000.000	49.990.000	56.660.000	50.000.000
*Approved PHARE project 2005				

Note: As of 2006, new measures encompass all available funds of all policy implementing entities which were previously registered and monitored as individual budgetary items, in a decentralised manner.

2. Reform of Social Welfare System				
A. Implementation		X		
B. Net direct impact on the budget			-603.931.113	
B1. Direct impact on revenues				
B2. Direct impact on expenditures			603.931.113	

Note: As the fiscal impact of the reform of social benefits was assessed, measures of national population policy, which directly have effects to most sensitive groups of citizens, were not included. Hence, it is expected that the fiscal impact of the reform of social benefits could be lower by 15% - 20%.

3. Children's Allowance				
A. Implementation		X		
B. Net direct impact on the budget		-325.000.000		
B1. Direct impact on revenues				
B2. Direct impact on expenditures		325.000.000		

Note: A novelty as of 2007 will be the allowance of HRK 500.00 for the 3rd and 4th child aimed at stimulating the birth rate.

4. Additional maternity leave and equipment for newborn children				
A. Implementation		X		
B. Net direct impact on the budget		-113.936.000	-164.000.000	-92.891.000
B1. Direct impact on revenues				
B2. Direct impact on expenditures		113.936.000	164.000.000	92.891.000

Note: Increase is the result of an increase in the budgetary base and slight increase in number of born children caused by population policy.

III. AGRICULTURAL SECTOR				
Total (1+2+3+4)				
A. Implementation				
B. Net direct impact on the budget	-197.841.650	-136.435.132	-114.550.294	-62.007.043
B1. Direct impact on revenues	45.286.450	138.407.575	140.760.825	21.416.486
B2. Direct impact on expenditures	243.128.100	274.842.707	255.311.119	83.423.529

1. State Aid in Agriculture				
A. Implementation				
B. Net direct impact on the budget	-183.285.000	-53.941.894	-57.473.013	-59.024.784
B1. Direct impact on revenues				
B2. Direct impact on expenditures	183.285.000	53.941.894	57.473.013	59.024.784

2. SAPARD Implementation				
A. Implementation	X		X	
B. Net direct impact on the budget	-7.600.000	-25.200.000	-25.200.000	
B1. Direct impact on revenues	10.000.000	75.000.000	75.000.000	
B2. Direct impact on expenditures	17.600.000	100.200.000	100.200.000	

3. Implementation of the World Bank Project for the Adjustment of Agricultural Legislation with Acquis Communautaire				
A. Implementation				
B. Net direct impact on the budget	-4.956.650	-18.193.238	-17.977.281	-6.982.259
B1. Direct impact on revenues	35.286.450	63.407.575	65.760.825	21.416.486
B2. Direct impact on expenditures	40.243.100	81.600.813	83.738.106	28.398.745
4. Research, Development and Modernisation of Technology in the Wood Processing Industry				
A. Implementation				
B. Net direct impact on the budget	-2.000.000	-39.100.000	-13.900.000	4.000.000
B1. Direct impact on revenues				
B2. Direct impact on expenditures	2.000.000	39.100.000	13.900.000	-4.000.000

IV. PUBLIC ADMINISTRATION REFORM				
Total (1+2+3+4+5)				
A. Implementation				
B. Net direct impact on the budget	-3.220.000	-10.952.425	-3.712.506	-4.588.827
B1. Direct impact on revenues	12.173.903	17.659.119		
B2. Direct impact on expenditures	15.393.903	28.611.544	3.712.506	4.588.827

1. Grant of the Swedish International Development Agency, SIDA				
A. Implementation	X	X		
B. Net direct impact on the budget	0	0		
B1. Direct impact on revenues	2.411.691	6.774.413		
B2. Direct impact on expenditures	2.411.691	6.774.413		
2. Danish Pre-Accession Aid (2005-2007)				
A. Implementation		X		
B. Net direct impact on the budget	0	0		
B1. Direct impact on revenues	6.619.327	5.698.269		
B2. Direct impact on expenditures	6.619.327	5.698.269		
3. CARDS 2003-Support to the Decentralisation of Croatia's State Administration				
A. Implementation		X		
B. Net direct impact on the budget	0	0		
B1. Direct impact on revenues	3.142.885	5.186.437		
B2. Direct impact on expenditures	3.142.885	5.186.437		
4. Development and Implementation of General Educational Programmes for Civil Servants				
A. Implementation		X		
B. Net direct impact on the budget		-9.972.425	-2.493.106	-3.116.382
B1. Direct impact on revenues				
B2. Direct impact on expenditures		9.972.425	2.493.106	3.116.382
5. Informatisation of the State Administration Offices in Counties				
A. Implementation				
B. Net direct impact on the budget	-3.220.000	-980.000	-1.219.400	-1.472.445
B1. Direct impact on revenues				
B2. Direct impact on expenditures	3.220.000	980.000	1.219.400	1.472.445

V. DEVELOPMENT OF A KNOWLEDGE-BASED SOCIETY				
Total (1+2+3+4)				
A. Implementation				
B. Net direct impact on the budget	-42.605.753	-268.396.814	-98.568.162	-111.778.629
B1. Direct impact on revenues	3.937.798			
B2. Direct impact on expenditures	46.543.551	268.396.814	98.568.162	111.778.629

1. Development of Pre-school Education				
A. Implementation	X			
B. Net direct impact on the budget	-1.950.000	-2.600.000	-2.756.000	-2.921.360
B1. Direct impact on revenues				
B2. Direct impact on expenditures	1.950.000	2.600.000	2.756.000	2.921.360

Note: A share of assets shown under B2 has been obtained from a World Bank loan (50%), while the remaining amount is being covered from the budget.

2. Primary School Education				
Total				
A. Implementation				
B. Net direct impact on the budget	-11.927.051	-209.612.764	-79.649.531	-91.508.503
B1. Direct impact on revenues				
B2. Direct impact on expenditures	11.927.051	209.612.764	79.649.531	91.508.503

Free textbooks				
A. Implementation		X		
B. Net direct impact on the budget		-192.000.000	-50.880.000	-54.572.800
B1. Direct impact on revenues				
B2. Direct impact on expenditures		192.000.000	50.880.000	54.572.800
Creation of the Curriculum				
A. Implementation		X		
B. Net direct impact on the budget		-1.927.051	-2.612.764	-2.935.703
B1. Direct impact on revenues				
B2. Direct impact on expenditures		1.927.051	2.612.764	2.935.703
Equipping Primary Schools with Laboratory and Didactical Equipment				
A. Implementation		X		
B. Net direct impact on the budget		-10.000.000	-15.000.000	-34.000.000
B1. Direct impact on revenues				
B2. Direct impact on expenditures		10.000.000	15.000.000	34.000.000

Note: A share of assets shown under B2 has been obtained from a World Bank loan (50%), while the remaining amount is being covered from the budget.

3. Secondary Education

Total				
A. Implementation				
B. Net direct impact on the budget		-28.528.702	-50.684.050	-16.770.606
B1. Direct impact on revenues		3.937.798		
B2. Direct impact on expenditures		32.466.500	50.684.050	16.770.606
Free textbooks				
A. Implementation		X		
B. Net direct impact on the budget		-48.000.000	-12.720.000	-13.643.200
B1. Direct impact on revenues				
B2. Direct impact on expenditures		48.000.000	12.720.000	13.643.200
Introduction of Extended Mandatory Secondary Education				
A. Implementation		X		
B. Net direct impact on the budget		-4.212.202	-570.000	-628.425
B1. Direct impact on revenues		3.937.798		
B2. Direct impact on expenditures		8.150.000	570.000	628.425

Note: A share of assets shown under B2 has been obtained from a World Bank loan (22%), while the remaining amount is being covered from the budget. Implementation of extended mandatory secondary education is partially funded from pre-accession funds CARDS 2003-Strengthening of schools for vocational training and education with the effect on revenues being shown in row B1. Considering that additional assets from the fund are not sufficient to cover increased expenditures arising from reforms implemented over the years under review the remaining amount is being covered from the budget.

Secondary Education Quality Improvement				
A. Implementation		X		
B. Net direct impact on the budget		-12.931.500	-1.430.950	-1.731.450
B1. Direct impact on revenues				
B2. Direct impact on expenditures		12.931.500	1.430.950	1.731.450

Note: A share of assets shown under B2 has been obtained from a World Bank loan (17%), while the remaining amount is being covered from the budget.

Increasing the Accessibility of Secondary Education				
A. Implementation				
B. Net direct impact on the budget		-11.385.000	-683.100	-767.531
B1. Direct impact on revenues				
B2. Direct impact on expenditures		11.385.000	683.100	767.531

4. Higher Education

Total				
A. Implementation				
B. Net direct impact on the budget		-200.000	-5.500.000	-578.160
B1. Direct impact on revenues				
B2. Direct impact on expenditures		200.000	5.500.000	578.160
Implementation of the Bologna Process				
A. Implementation				
B. Net direct impact on the budget		-100.000	-3.000.000	-381.000
B1. Direct impact on revenues				
B2. Direct impact on expenditures		100.000	3.000.000	381.000
Implementation of New System of Financing Higher Education				
A. Implementation				
B. Net direct impact on the budget		-100.000	-2.500.000	-197.160
B1. Direct impact on revenues				
B2. Direct impact on expenditures		100.000	2.500.000	197.160

VI. HEALTH CARE REFORM				
Total (1+2+3+4+5)				
A. Implementation				
B. Net direct impact on the budget	415.000.000	296.173.000	-157.200	-245.800
B1. Direct impact on revenues	415.000.000	303.364.000		
B2. Direct impact on expenditures		7.191.000	157.200	245.800
1. Improving the existing system for direct payments to users				
A. Implementation				
B. Net direct impact on the budget	380.000.000			
B1. Direct impact on revenues	380.000.000			
B2. Direct impact on expenditures				
2. Rationalization of expenditures for drugs through basic and supplementary drugs list				
A. Implementation	X			
B. Net direct impact on the budget	35.000.000	303.364.000		
B1. Direct impact on revenues	35.000.000	303.364.000		
B2. Direct impact on expenditures				
3. Expansion of the System of Telemedicine into Primary Health Care and Implementation of the Telemedicine Standard				
A. Implementation		X		
B. Net direct impact on the budget		-3.231.000	-129.200	-201.800
B1. Direct impact on revenues				
B2. Direct impact on expenditures		3.231.000	129.200	201.800
4. Establishment of Health Care Centres on Islands and in Areas of Special State Concern				
A. Implementation		X		
B. Net direct impact on the budget		-3.260.000		
B1. Direct impact on revenues				
B2. Direct impact on expenditures		3.260.000		
5. Establishment of the Croatian Institute for Mental Health				
A. Implementation		X		
B. Net direct impact on the budget		-700.000	-28.000	-44.000
B1. Direct impact on revenues				
B2. Direct impact on expenditures		700.000	28.000	44.000
VII. JUDICIAL REFORM				
Total (1+2+3+4+5+6+7)				
A. Implementation				
B. Net direct impact on the budget	-3.272.492	-4.672.276	2.591.358	-1.216.750
B1. Direct impact on revenues	3.671.000	1.887.280	-1.584.240	
B2. Direct impact on expenditures	6.943.492	6.559.556	-4.175.598	1.216.750
1. Land Registry Reform				
A. Implementation			X	
B. Net direct impact on the budget	-118.000	-1.000.000	4.668.000	
B1. Direct impact on revenues				
B2. Direct impact on expenditures	118.000	1.000.000	-4.668.000	
Note: Assets indicated under B2 have been obtained through a World Bank loan and partly from the State Budget.				
2. Land Registry Reform				
A. Implementation				
B. Net direct impact on the budget	0	0	0	
B1. Direct impact on revenues	191.000	430.000	-3.230.000	
B2. Direct impact on expenditures	191.000	430.000	-3.230.000	
Note: Assets shown under B2 relate to the Donation EU CARDS 2002, 2003, 2004.				
3. Harmonisation of Croatian Legislation with EU Legislation				
A. Implementation				
B. Net direct impact on the budget	-49.000		-110.200	-40.600
B1. Direct impact on revenues				
B2. Direct impact on expenditures	49.000		110.200	40.600
4. Alternative Resolution of Court Disputes «Project of Conciliation»				
A. Implementation	X			
B. Net direct impact on the budget	-575.000		-109.250	-40.250
B1. Direct impact on revenues				
B2. Direct impact on expenditures	575.000		109.250	40.250

5. Alternative Resolution of Court Disputes «Project of Conciliation»				
A. Implementation				
B. Net direct impact on the budget	-130.906	-11.176	-47.360	
B1. Direct impact on revenues	3.480.000	1.457.280	1.645.760	
B2. Direct impact on expenditures	3.610.906	1.468.456	1.693.120	
Note: Assets indicated under B1 are related to aids arising from the 2005 PHARE project.				
6. Reform of Criminal Legislation				
A. Implementation				
B. Net direct impact on the budget	-100.000		-30.400	-11.200
B1. Direct impact on revenues				
B2. Direct impact on expenditures	100.000		30.400	11.200
7. Fighting Corruption and Organised Crime				
A. Implementation				
B. Net direct impact on the budget	-2.299.586	-3.661.100	-1.779.432	-1.124.700
B1. Direct impact on revenues				
B2. Direct impact on expenditures	2.299.586	3.661.100	1.779.432	1.124.700
Note: The increase in expenditures in 2007 includes the amount of HRK 2.000.000 which was implemented in 2007 in relation to activities of "Anticorruption strategy".				
VIII. ENVIRONMENTAL PROTECTION				
Ukupno (1+2+3+4+5+6+7+8+9+10)				
A. Implementation				
B. Net direct impact on the budget	-63.914.159	-132.595.588	-174.173.606	-63.308.940
B1. Direct impact on revenues	2.699.409	17.347.595	-2.484.000	54.000
B2. Direct impact on expenditures	66.613.568	149.943.183	171.689.606	63.362.940
1. Harmonisation of Croatian Legislation Relating to Environmental Protection with Acquis Communautaire:				
Creation and Enactment of Regulations with Transposition of the Environment Acquis (Following ministries: Ministry of Environmental Protection, Physical Planning and Construction, Ministry of agriculture, Forestry and Water Management, Ministry of Culture)				
A. Implementation				X
B. Net direct impact on the budget	-560.000	-645.500	-117.600	480.100
B1. Direct impact on revenues				
B2. Direct impact on expenditures	560.000	645.500	117.600	-480.100
Note: Relates to Ministry of Environmental Protection, Physical Planning and Construction, Ministry of agriculture, Forestry and Water Management and Ministry of Culture who have registered expenditures for this purpose.				
2. Integrating Environment Protection Goals in Planning and Implementation of Other Sector Policies with an Aim of Facilitating Sustainable Development				
Enactment and Implementation of Subordinate Legislation pursuant to the Environment Protection Act on the Assessment of Impact on the Environment and Strategic Assessment				
A. Implementation	X			
B. Net direct impact on the budget	-251.000	-169.000	-16.800	-26.200
B1. Direct impact on revenues				
B2. Direct impact on expenditures	251.000	169.000	16.800	26.200
3. Improvement of the Air Quality Management System and Creating Conditions for Tackling Problems Related to Climatic Changes				
Total				
A. Implementation				
B. Net direct impact on the budget	1.387.000	2.133.000	1.605.000	1.930.000
B1. Direct impact on revenues	-410.000	4.930.000	2.925.000	0
B2. Direct impact on expenditures	-1.797.000	2.797.000	1.320.000	-1.930.000
Protection of the Atmosphere and Climatic Changes Ministry of Environmental Protection, Physical Planning and Construction				
A. Implementation				
B. Net direct impact on the budget	-1.210.000	360.000	320.000	300.000
B1. Direct impact on revenues	-410.000	30.000	400.000	
B2. Direct impact on expenditures	800.000	-330.000	80.000	-300.000
Note: Includes the non-refundable aid from the programme LIFE III-Third countries (Strengthening of the Capacity for the Implementation of the Kyoto Protocol in 2006, 2007 and 2008 - beneficiary Ministry of Environmental Protection, Physical Planning and Construction) .				
Environment Protection Agency				
A. Implementation	X			
B. Net direct impact on the budget	-583.000	-517.000	-250.000	170.000
B1. Direct impact on revenues				
B2. Direct impact on expenditures	583.000	517.000	250.000	-170.000
State Network for Air Quality Monitoring				
A. Implementation				
B. Net direct impact on the budget	4.260.000	2.290.000	2.415.000	1.460.000
B1. Direct impact on revenues		4.900.000	2.525.000	
B2. Direct impact on expenditures	-4.260.000	2.610.000	110.000	-1.460.000
Note: Includes the non-refundable Aid from the PHARE programme for construction of 12 stations in 2007 and 2008.				

State Network for Air Quality Monitoring - Regular Maintenance				
A. Implementation				
B. Net direct impact on the budget	-1.080.000		-880.000	
B1. Direct impact on revenues				
B2. Direct impact on expenditures	1.080.000		880.000	
4. Establishment of a Comprehensive Waste Management System				
Total				
A. Implementation				
B. Net direct impact on the budget	-83.415	1.023.595	-1.145.000	-110.000
B1. Direct impact on revenues	3.242.405	617.595	-2.009.000	-146.000
B2. Direct impact on expenditures	3.325.820	-406.000	-864.000	-36.000
Further Development of the Waste Management System (Documents and Plans)				
A. Implementation	X			
B. Net direct impact on the budget	-740.000	125.000	-26.000	-39.000
B1. Direct impact on revenues				
B2. Direct impact on expenditures	740.000	-125.000	26.000	39.000
Programme for Cleaning up Polluted Areas ("black spots")				
A. Implementation	X			
B. Net direct impact on the budget	-1.800.000	1.000.000		
B1. Direct impact on revenues				
B2. Direct impact on expenditures	1.800.000	-1.000.000		
Further Development of the IT System for Waste Management (Environment Protection Agency)				
A. Implementation				
B. Net direct impact on the budget	226.180	142.000	-30.000	
B1. Direct impact on revenues				
B2. Direct impact on expenditures	-226.180	-142.000	30.000	
Support to the Implementation of the Plan*, Construction and Reconstruction of the Environment - LIFE, ISPA /IPA				
A. Implementation	X			
B. Net direct impact on the budget	2.230.405	-243.405	-1.089.000	-71.000
B1. Direct impact on revenues	3.242.405	617.595	-2.009.000	-146.000
B2. Direct impact on expenditures	1.012.000	861.000	-920.000	-75.000
Note: Project LIFE III-Third countries: Creation of guidelines for the start of implementation of the Waste Management Plan in the Republic of Croatia in 2006 and 2007 (beneficiary Ministry of Environmental Protection, Physical Planning and Construction).				
5. Strengthening and Creation of the System of Integral Water Management With Stronger Investments in the Water Management Infrastructure (Ministry of agriculture, Forestry and Water Management):				
Total				
A. Implementation				
B. Net direct impact on the budget	-97.500	-117.312.500	-184.526.390	-62.528.093
B1. Direct impact on revenues				
B2. Direct impact on expenditures	97.500	117.312.500	184.526.390	62.528.093
Capital Projects Relating to Water Supply				
A. Implementation				
B. Net direct impact on the budget		-6.500.000	11.500.000	-16.500.000
B1. Direct impact on revenues				
B2. Direct impact on expenditures		6.500.000	-11.500.000	16.500.000
Capital Projects Relating to the Protection of Waters and the Sea Against Contamination and Pollution				
A. Implementation				
B. Net direct impact on the budget	13.500.000		-9.000.000	
B1. Direct impact on revenues				
B2. Direct impact on expenditures	-13.500.000	39.500.000	9.000.000	
Capital Projects Relating to Protection Against Harmful Effects of Water				
A. Implementation				
B. Net direct impact on the budget	-3.000.000	-10.000.000		
B1. Direct impact on revenues				
B2. Direct impact on expenditures	3.000.000	10.000.000		
Capital Irrigation Projects				
A. Implementation				
B. Net direct impact on the budget	-10.597.500	-61.312.500	-187.026.390	-46.028.093
B1. Direct impact on revenues				
B2. Direct impact on expenditures	10.597.500	61.312.500	187.026.390	46.028.093

6. **Sea and Marine Environment Protection (Ministry of Environmental Protection, Physical Planning and Construction and Environment Protection Agency):**

Total				
A. Implementation				
B. Net direct impact on the budget	-3.686.816	-11.153.000	-6.000	-54.000
B1. Direct impact on revenues	-132.996			
B2. Direct impact on expenditures	3.553.820	11.153.000	6.000	54.000
Monitoring of Sea Quality				
A. Implementation				
B. Net direct impact on the budget	115.000	-10.000	-6.000	-4.000
B1. Direct impact on revenues				
B2. Direct impact on expenditures	-115.000	10.000	6.000	4.000
Construction and Maintenance of Cleanup Vessels				
A. Implementation				
B. Net direct impact on the budget	1.580.000	-380.000		
B1. Direct impact on revenues				
B2. Direct impact on expenditures	-1.580.000	380.000		

Note: Maintenance costs for cleanup vessels amount to HRK 2,500,000 per annum.

Creation and Development of the IT System for Monitoring of the Adriatic Sea (Environment Protection Agency)				
A. Implementation	X			
B. Net direct impact on the budget	-381.816	237.000		-50.000
B1. Direct impact on revenues	-132.996			
B2. Direct impact on expenditures	248.820	-237.000		50.000
Strengthening of the System of Supervision over the Quality of Costal Waters (Project of Pollution Prevention in the Costal Area)				
A. Implementation	X		X	
B. Net direct impact on the budget	-5.000.000	-11.000.000		
B1. Direct impact on revenues				
B2. Direct impact on expenditures	5.000.000	11.000.000		

Note: 50% of the funds relate to the loan from the World Bank.

7. **Nature Protection (Ministry of Culture):**

Total				
A. Implementation				
B. Net direct impact on the budget	-59.119.428	15.850.000	1.254.000	-604.000
B1. Direct impact on revenues		11.100.000	-3.700.000	
B2. Direct impact on expenditures	59.119.428	-4.750.000	-4.954.000	604.000
Modernisation of the Nature Protection System				
A. Implementation	X			
B. Net direct impact on the budget	-47.819.428	3.100.000	2.300.000	-1.000.000
B1. Direct impact on revenues				
B2. Direct impact on expenditures	47.819.428	-3.100.000	-2.300.000	1.000.000
Protection of Natural Values				
A. Implementation	X			
B. Net direct impact on the budget	-11.300.000	12.750.000	-1.046.000	396.000
B1. Direct impact on revenues		11.100.000	-3.700.000	
B2. Direct impact on expenditures	11.300.000	-1.650.000	-2.654.000	-396.000

8. **Implementation of a Comprehensive System of Prevention and Supervision of Environment Pollution:**

Total				
A. Implementation				
B. Net direct impact on the budget		-510.000	-150.000	-100.000
B1. Direct impact on revenues				
B2. Direct impact on expenditures		510.000	150.000	100.000
Implementation of a Comprehensive System of Prevention and Supervision of Environment Pollution (IPPC)				
A. Implementation		X		
B. Net direct impact on the budget		-400.000		-100.000
B1. Direct impact on revenues				
B2. Direct impact on expenditures		400.000		100.000
Further Development of KEO (Emissions Register) in Accordance with EPER and E-PRTR Requirements (Croatian Environment Agency)				
A. Implementation		X		
B. Net direct impact on the budget		-110.000	-150.000	
B1. Direct impact on revenues				
B2. Direct impact on expenditures		110.000	150.000	

9. Development of the System for Prevention of Major Accidents II

Total				
A. Implementation				
B. Net direct impact on the budget	-3.000	-550.000	-45.000	-100.000
B1. Direct impact on revenues				
B2. Direct impact on expenditures	3.000	550.000	45.000	100.000
Further Development of Risk Installations Database (Croatian Environment Agency)				
A. Implementation	X			
B. Net direct impact on the budget	-3.000	50.000	-45.000	
B1. Direct impact on revenues				
B2. Direct impact on expenditures	3.000	-50.000	45.000	
Activities Relating to the Application of Provisions of Seveso II Directive				
A. Implementation		X		
B. Net direct impact on the budget		-600.000		-100.000
B1. Direct impact on revenues				
B2. Direct impact on expenditures		600.000		100.000

10. Forestry (Ministry of Agriculture, Forestry and Water Management):

Total				
A. Implementation				
B. Net direct impact on the budget	-1.500.000	-21.262.183	8.974.184	-2.196.747
B1. Direct impact on revenues		700.000	300.000	200.000
B2. Direct impact on expenditures	1.500.000	21.962.183	-8.674.184	2.396.747
Inventory of Forestry Resources of the Republic of Croatia				
A. Implementation		X	X	
B. Net direct impact on the budget		-15.583.183	10.601.214	
B1. Direct impact on revenues				
B2. Direct impact on expenditures		15.583.183	-10.601.214	
Forestry Advisory Service				
A. Implementation	X			
B. Net direct impact on the budget	-1.500.000	-4.359.000	-1.589.000	-2.156.000
B1. Direct impact on revenues		700.000	300.000	200.000
B2. Direct impact on expenditures	1.500.000	5.059.000	1.889.000	2.356.000
Reporting and Forecasting Activities in Forestry				
A. Implementation		X		
B. Net direct impact on the budget		-1.250.000	-36.000	-38.587
B1. Direct impact on revenues				
B2. Direct impact on expenditures		1.250.000	36.000	38.587
Gene Bank				
A. Implementation		X		
B. Net direct impact on the budget		-70.000	-2.030	-2.160
B1. Direct impact on revenues				
B2. Direct impact on expenditures		70.000	2.030	2.160

IX. Institutional Strengthening of the Public Procurement System in the Republic of Croatia

A. Implementation				
B. Net direct impact on the budget		-437.280	-43.720	-80.000
B1. Direct impact on revenues				
B2. Direct impact on expenditures		437.280	43.720	80.000

ANNEX II FISCAL EFFECTS OF PROJECTS FINANCED BY EU FUNDS (2007)

Users of EU funds	CARDS 2003	CARDS 2004	PHARE 2005	PHARE 2006	ISPA	TOTAL
1	2	3	5	6	7	8
Ministry of Science, Education and Sports co-financing	6.406.346	6.660.000				13.066.346
Croatian Employment Service co-financing		3.848.533	8.800.000 1.110.000			12.648.533 1.110.000
Ministry of Agriculture, Forestry and Water Management co-financing	4.918.810	15.466.000	37.515.869 4.009.000		16.650.000 9.990.000	74.550.679 13.999.000
Ministry of the Economy, Labour and Entrepreneurship co-financing	1.903.262	15.170.000	11.200.000			28.273.262
Ministry of the Sea, Tourism, Transport and Development co-financing	30.467.400	73.015.800	64.646.400 9.602.200	1.370.000 730.000	68.620.000 151.950.000	238.119.600 162.282.200
Ministry of Justice co-financing	8.172.946	18.986.592	10.265.280 142.080			37.424.818 142.080
Ministry of the Interior co-financing		46.768.000	25.574.400 3.807.300			72.342.400 3.807.300
Central Office for Development Strategy and Coordination of EU funds co-financing			9.657.000			9.657.000
Ministry of Finance - internal control co-financing		5.400.000	3.750.000			9.150.000
Ministry of Finance - customs administration co-financing	222.000		36.630.000 7.400.000			36.852.000 7.400.000
Ministry of Finance - tax administration co-financing		1.409.700	14.800.000			16.209.700
Ministry of Environmental Protection, Physical Planning and Construction co-financing		9.324.000	9.146.400		2.860.000	21.330.400
Center for Human Rights co-financing		7.104.000				7.104.000
Office for Prevention of Drug Abuse co-financing		3.256.000				3.256.000
State Bureau for Metrology co-financing		5.106.000				5.106.000
Office for National Minorities co-financing			6.388.667			6.388.667
Central Bureau of Statistics co-financing			24.464.400			24.464.400
State Geodetic Directorate co-financing			22.874.791 1.603.542			22.874.791 1.603.542
Croatian Competition Agency co-financing			10.212.000			10.212.000
State Inspector's Office co-financing			7.410.360 333.000			7.410.360 333.000
Office for Cooperation with NGOs co-financing	4.113.302	20.424.000				24.537.302
Central State Administrative Office for Public Administration of Republic of Croatia co-financing	5.706.805					5.706.805
State Institute of Radiation Protection co-financing						
State Office for Nuclear Safety co-financing			1.998.000			1.998.000
Sate Institute for Nature Protection co-financing			11.100.000 444.000			11.100.000 444.000
TOTAL - EU FUNDS	61.910.871	231.938.625	316.433.567	1.370.000	88.130.000	699.783.063
TOTAL - CO-FINANCING	0	0	28.451.122	730.000	161.940.000	191.121.122
TOTAL	61.910.871	231.938.625	344.884.689	2.100.000	250.070.000	890.904.185

ANNEX III STATISTICAL APPENDIX

Table 1: Growth and Associated Factors

Percentages unless otherwise indicated	2005	2006	2007	2008	2009
1. GDP growth at constant market prices (14+15+16)	4,3	4,6	4,6	4,8	5,0
2. GDP level at current market prices (mil HRK)	229.031	247.850	268.101	289.856	313.571
3. GDP deflator	3,2	3,5	3,4	3,2	3,0
4. CPI change (annual average)	3,3	3,5	3,2	3,0	2,8
5. Employment growth *	0,7	1,9	1,9	1,8	1,8
6. Labour productivity growth *	3,6	2,6	2,6	2,9	3,2
7. Investment ratio (% of GDP) **	31,3	32,8	34,2	35,2	36,1
Sources of growth: percentage changes at constant prices					
8. Private consumption expenditure	3,4	3,2	3,9	3,8	3,7
9. Government consumption expenditure	0,8	3,6	-0,2	0,0	0,3
10. Gross fixed capital formation	4,8	9,2	6,8	7,8	8,9
11. Changes in inventories and net acquisitions of valuables as a % of GDP ***	2,7	3,0	3,9	4,3	4,2
12. Exports of goods and services	4,6	6,4	7,3	7,5	7,4
13. Imports of goods and services	3,5	7,2	7,1	6,6	6,2
Contribution to GDP growth					
14. Final domestic demand	3,7	5,4	4,3	4,7	5,1
15. Change in inventories and net acquisition of valuables***	0,6	0,5	1,1	0,5	0,1
16. External balance of goods and services	0,1	-1,3	-0,8	-0,4	-0,2
Growth of Gross Value Added ****					
17. Agriculture *****	0,1	3,8	4,0	4,0	3,7
18. Industry (excluding construction)	5,5	4,6	4,8	5,4	6,0
19. Construction	2,2	5,8	4,7	5,1	5,4
20. Services *****	4,2	4,5	4,5	4,5	4,6

Comments: Values written in black are realisations, in blue estimates (composite of realisations and projected values) and in red projected values.

* Employment based on LFS data.

** Total investment (values at current market prices).

*** Changes in inventories including statistical discrepancy.

**** Values at constant prices.

***** Including hunting, forestry and fishing.

***** Includes following NACE categories: G, H, I, J, K, L, M, N, O, P and FISIM.

Sources: CBS and CNB

Table 2: Labour Markets Developments

Percentages unless otherwise indicated	2005	2006	2007	2008	2009
1. Population	4.442	4.442	4.442	4.442	4.442
2. Population (growth rate in %)	0	0	0	0	0
3. Working-age population (thousands) *	2.757	2.757	2.757	2.757	2.757
4. Participation rate *	63,2	63,7	64,6	65,0	65,5
5. Employment level (thousand) *	1.573	1.603	1.633	1.663	1.693
6. Employment (growth rate in %) *	0,7	1,9	1,9	1,8	1,8
7. Public sector employment (thousands) *	336	340	340	340	340
8. Public sector employm. (growth rate in %) *	-0,2	1,1	0,0	0,0	0,0
9. Unemployment rate (ILO definiton) *	12,7	11,8	11,7	11,5	11,0
10. Average real wage (growth rate in %)	0,9	2,1	2,5	3,2	2,7

Comments: Values written in black are realisations, in blue estimates (composite of realisations and projected values) and in red projected values.

* Labour Force Survey based figures.

Sources: CBS and CNB

Table 3: External Sector Developments

Euro mil. unless otherwise indicated	Year				
	2005	2006	2007	2008	2009
1. Current account balance (% of GDP)	-6,4	-7,5	-7,8	-7,4	-7,0
2. Export of goods	7.217	8.304	9.293	10.441	11.755
3. Import of goods	-14.738	-16.582	-18.302	-20.063	-21.860
4. Trade balance	-7.522	-8.278	-9.009	-9.622	-10.105
5. Export of services	8.053	8.455	9.006	9.585	10.154
6. Import of services	-2.735	-2.837	-2.935	-3.052	-3.193
7. Service balance	5.318	5.619	6.071	6.533	6.961
8. Net interest payments	-520	-498	-455	-317	-176
9. Other net factor income from abroad	-433	-499	-505	-563	-676
10. Current transfers	1.184	1.107	1.062	1.032	1.017
11. Of which: from EU	678	664	637	619	610
12. Current account balance	-1.973	-2.549	-2.835	-2.937	-2.979
13. Foreign direct balance	1.218	2.439	1.750	2.041	2.321
14. Foreign reserves	7.438	8.589	8.960	9.766	10.645
15. Foreign debt	25.541	28.523	31.025	33.489	35.882
16. Foreign debt (% of GDP)	82,5	84,4	85,0	84,9	84,1
17. Of which: public (excl. HBOR)	6.152	5.736	5.462	5.265	4.555
18. Of which: HBOR	895	1.145	1.459	1.674	2.145
19. O/w: foreign currency denominated	24.467	27.325	29.722	32.082	34.375
20. O/w: repayments due (principal)	3.942	4.950	3.799	3.147	3.831
21. Exchange rate vis-a-vis EUR (end year)	7,38	7,40	7,40	7,40	7,40
22. Exchange rate vis-a-vis EUR (annual average)	7,40	7,34	7,35	7,35	7,35
23. Net foreign saving (lines 23-26: percentages of GDP)	6,4	7,5	7,8	7,4	7,0
24. Domestic private saving *	22,8	23,1	24,2	25,4	26,7
25. Domestic private investment **	26,3	28,1	29,8	30,9	32,0
26. Domestic public saving ***	2,1	2,3	2,1	2,3	2,4
27. Domestic public investment ****	5,0	4,7	4,4	4,3	4,1

Comments: Values written in black are realisations, in blue estimates (composite of realisations and projected values) and in red projected values.

* Difference between current account deficit and net domestic public savings, increased for an estimated value of domestic private investment

** Difference between total investments (gross fixed capital formation and change in inventories) and domestic public investment

*** Difference between consolidated central government current revenues and expenses, data based on GFS 2001.

**** Consolidated central government capital expenses (capital grants to other general government units, other expenses - capital, acquisition of nonfinancial assets)

Sources: MF and CNB

Table 4: General Government Budgetary Developments (ESA 95 methodology)

Percentages of GDP	ESA code	2005	2006	2007	2008	2009
Net lending (B9) by sub-sectors						
1. General government	S13	-2,9	-2,2	-1,8	-1,7	-1,5
2. Central government	S1311	-1,6	-1,2	-1,2	-1,1	-1,0
3. State government	S1312					
4. Local government	S1313	0,0	-0,1	-0,1	-0,1	-0,1
5. Extrabudg. funds other than soc. security	S1314	-1,2	-0,8	-0,5	-0,6	-0,3
General government (S13)						
6. Total receipts	ESA	45,0	45,0	44,8	44,0	43,3
7. Total expenditures	ESA	47,9	47,2	46,6	45,7	44,7
8. Budget balance	B9	-2,9	-2,2	-1,8	-1,7	-1,5
9. Interest	D41	2,2	2,2	2,1	2,0	1,9
10. Primary balance		-0,7	0,1	0,3	0,3	0,4
Components of revenues						
11. Taxes	D2+D5	26,3	26,5	26,2	25,8	25,4
12. Social contributions	D61	13,9	13,8	13,6	13,6	13,5
13. Other		4,9	4,6	5,1	4,6	4,5
14. Total receipts	ESA	45,0	45,0	44,8	44,0	43,3
Components of expenditures						
15. Collective consumption	P32	0,0	0,0	0,0	0,0	0,0
16. Social benefits in kind	P31	3,2	3,0	2,8	2,8	2,7
17. Social transfers other than in kind	D62	15,4	15,1	14,8	14,5	14,3
18. Interest	D41	2,2	2,2	2,1	2,0	1,9
19. Subsidies	D3	2,6	2,6	2,5	2,4	2,3
20. Gross fixed capital formation	P51	3,9	3,4	3,5	3,2	3,0
21. Other		20,6	20,8	20,9	20,8	20,5
22. Total expenditures	ESA	47,9	47,2	46,6	45,7	44,7

Comments: Values written in black are realisations and in red projected values

Source : Ministry of Finance

Table 5: General Government Debt Developments

Percentages of GDP	ESA	2005	2006	2007	2008	2009
1. Gross debt level		44,2	42,1	40,5	39,3	38,1
2. Of which: repayments due		5,1	4,2	3,8	3,0	3,7
3. Change in gross debt		0,6	-2,1	-1,6	-1,2	-1,2
Contributions to change in gross debt						
4. Primary balance	B9	0,7	-0,1	-0,3	-0,3	-0,4
5. Interest	D41	2,2	2,2	2,1	2,0	1,9
6. Nominal GDP growth	B1g	-3,1	-3,4	-3,2	-3,0	-3,0
7. Other factors influencing the debt ratio		0,8	-0,9	-0,2	0,1	0,3
8. Of which: Exchange rate change		-0,3	-0,2	0,0	0,0	0,0
9. O/w: Privatisation receipts		-0,2	-1,3	-0,8	-0,5	-0,4
10. p.m. implicit interest rate on debt (%)		5,5	5,4	5,4	5,3	5,2

Table 6: Divergences from Previous PEP Update

	2005	2006	2007	2008	2009
1. Real GDP growth (% points)					
Previous update	3,9	4,0	4,1	4,3	-
Latest update	4,3	4,6	4,6	4,8	5,0
Difference	0,4	0,5	0,5	0,5	-
2. Current account balance (in mil. EUR)					
Previous update	-1.734	-1.698	-1.534	-1.401	-
Latest update	-1.973	-2.549	-2.835	-2.937	-2.979
Difference	-240	-851	-1.301	-1.536	-
Difference in percentage points*	-0,6	-2,3	-3,3	-3,7	-
3. Gross foreign debt (in mil. EUR)					
Previous update	24.924	26.699	28.684	30.906	-
Latest update	25.541	28.523	31.025	33.489	35.882
Difference	617	1.824	2.341	2.583	-
Difference in percentage points*	-0,5	1,3	1,8	1,5	-
4. Actual budget balance (% of GDP)					
Previous update	-3,1	-2,4	-2,2	-1,9	-
Latest update	-2,9	-2,2	-1,8	-1,7	-1,5
Difference	0,2	0,2	0,4	0,2	-
5. Gross public debt levels (% of GDP)					
Previous update	51,3	49,0	48,4	47,7	-
Latest update	49,6	47,7	46,1	44,8	43,4
Difference	-1,7	-1,4	-2,3	-2,9	-

Comments: Values written in black are realisations, in blue estimates (composite of realisations and projected values) and in red projected values.

Sources: MF and CNB

* Difference between the value expressed as % of GDP from the latest update and the value expressed as % of GDP from the previous update

** Difference is explained in chapter 3.1. Medium-term fiscal framework

Table 7: Assumptions on the External Economic Environment Underlying Republic of Croatia's 2006 PEP Framework

VARIABLE (annual growth rates in %, if not otherwise stated)	Assumptions for								
	2005		2006		2007		2008		2009
		change.*****		change.*****		change.*****		change.*****	
Interest rates (in % p.a., annual averages)									
Croatia: short-term (3-months T-bills, weighted average)	4,1	-0,5	3,0	-1,1	3,6	-0,1	3,5	0,1	3,4
Croatia: long-term (10-year govt bonds)*	4,3	-	4,4	-	4,6	-	4,5	-	4,4
Euro area: short term (3-months money markets)	2,2	0,0	2,9	0,2	3,4	0,6	3,8	0,9	3,9
Euro area: long term (10-year govt bonds, lowest one prevailing in euro area)	3,3	-0,5	3,9	-0,4	4,3	-0,2	4,6	0,0	4,6
USA: short-term (3-months money markets)	3,6	-0,1	5,0	0,9	4,2	-0,2	5,5	0,8	5,5
USA: long term (10-year govt bonds)	4,3	-0,3	4,9	-0,3	4,5	-0,8	5,6	0,0	5,6
Exchange rates (p.a., "-" denotes depreciation)									
HRK / EUR	7,40	-0,01	7,34	-0,11	7,35	-0,10	7,35	-0,10	7,35
USD / EUR	1,24	-0,01	1,26	0,00	1,30	0,01	1,30	0,01	1,30
Nominal effective exchange rate (index, 2001=100)	90,5	-0,2	89,5	-1,3	88,8	-1,4	88,8	-1,4	88,8
Real effective exchange rate (index, 2001=100) **	90,6	-0,1	88,9	-0,9	87,5	-1,0	86,9	-1,2	86,5
BDP (in real terms)									
World	4,9	0,6	5,1	0,8	4,9	0,6	4,8	0,4	4,8
USA	3,5	0,0	3,5	0,2	3,1	-0,3	3,2	-0,3	3,2
Japan	2,6	0,6	2,9	0,9	2,1	0,3	1,9	0,2	1,9
Euro area	1,3	0,1	2,1	0,3	1,8	-0,2	2,1	-0,1	2,2
World trade (in real terms)									
Croatia's export markets	4,3	-0,8	6,3	0,8	5,4	0,1	5,2	0,4	4,8
World imports of goods and services	7,4	0,1	9,1	1,9	7,8	0,9	7,0	0,6	6,8
International prices									
World import prices (goods, in USD) ***	3,9	-1,3	2,4	2,1	1,9	1,3	0,5	-0,1	0,5
Oil prices (USD per barrel)****	53,4	-0,8	69,2	7,5	75,5	15,5	74,3	16,3	72,3
Non-oil commodity prices (USD) ***	10,3	1,7	22,1	24,2	-4,8	-0,5	-9,1	-5,1	-7,0

Comments: Values written in black are realisations, in blue estimates (composite of realisations and projected values) and in red projected values.

* The first government 10-year kuna bond was issued on December, 15, 2005, while previously this category referred to 5-year kuna government bond issued on May, 28, 2003. Therefore it is not possible to show changes vis-à-vis last PEP's assumptions.

** Effective exchange rate calculated as a weighted geometric mean of bilateral exchange rates of HRK against: EUR (weight 72.2%), USD (27.8%). For derivation of the real effective exchange rate the CPI is used as deflator.

*** Average YOY percentage change.

**** A simple average of UK Brent, Dubai, and West Texas Intermediate.

***** Change viv-a-vis assumptions made for last PEP.

Sources: IMF, Consensus Forecast, ECFIN and CNB

Table 8: Cyclical Developments

Percentages of GDP	2005	2006	2007	2008	2009
1. GDP growth at constant prices	4,3	4,6	4,6	4,8	5,0
2. Actual balance	-4,1	-3,0	-2,8	-2,6	-2,4
3. Net interest payments	2,2	2,2	2,2	2,2	2,2
4. Potential GDP growth	4,4	4,5	4,6	4,7	4,7
5. Output gap	0,2	0,1	0,1	0,1	-0,2
6. Cyclical budgetary component	0,1	0,2	0,0	0,1	0,3
7. Cyclically-adjusted balance (2-6)	-4,2	-3,2	-2,8	-2,7	-2,6
8. Cyclically-adjusted primary balance (7+3)	-1,9	-1,0	-0,6	-0,5	-0,4

Comments: Values written in black are realisations, in blue estimates (composite of realisations and projected values) and in red projected values.

Calculated on the basis of GFS values

*Relative deviation of actual from potential gross domestic product

Sources: CBS and CNB

Table 9: Long Term Sustainability of Public Finances

<i>Percentage of GDP</i>	2005	2010	2020	2030	2040	2050
1. Total expenditure	47,9	44,6	43,5	42,9	42,6	43,0
2. Old age pensions	10,0	8,7	7,8	7,3	6,9	7,1
3. Health care	6,3	6,4	6,6	7,0	7,5	7,9
4. Interest payments	2,0	2,0	1,5	1,1	0,6	0,4
5. Total revenues	45,0	43,3	43,1	43,1	43,1	43,1
6. of which: from pension contributions	6,9	6,6	6,5	6,5	6,5	6,5
Assumptions						
8. Labor productivity growth	3,6	3,8	3,3	2,5	1,9	1,7
9. Real GDP growth	4,3	5,6	2,9	1,9	1,5	1,2
10. Participation rate males (aged 15- 64)	69,6	71,8	71,1	70,7	69,7	69,7
11. Participation rate females (aged 15- 64)	56,8	58,2	58,2	57,8	56,6	56,8
12. Total participation rate (15-64)	63,1	65,0	64,6	64,3	63,2	63,3
13. Unemployment rate (ILO definition)	12,7	10,0	7,0	7,0	7,0	7,0

ANNEX IV STRUCTURAL REFORM AGENDA AND ACHIEVEMENTS

Matrix on structural reform agenda and achievements shows realisation of the measures that were to be implemented in 2006 in accordance with the previous year's PEP.

MAIN MEASURES UNDER THE 2005 PEP	ADOPTED (YES/NO)	DATE	COMMENTS
ENTERPRISE SECTOR			
Privatisation			
Privatisation of Companies in Majority State Ownership			
Remove limiting factors which have made privatisation impossible (resolving property-law issues, balance sheet consolidation, etc.)	No (in progress)	end of I quarter 2006	Intensive work on restructuring programs in individual sectors as a precondition for privatisation is in progress.
Intensifying communication with the Ministry of Finance, line ministries and other governmental bodies with a view to ensuring timely approval for the implementation of planned measures	Yes	end of I quarter 2006	Communication with the Government and line ministries is an on-going process, which ultimately results in the definition of a strategy for the privatisation of majority state-owned companies.
Announce the sale of stakes or initiate the process of liquidation in companies in which the combined government portfolio exceeds 50% plus 1 share of their equity capital (a total of 45 companies)	Yes	end of first half of 2006	A total of 52 companies in majority ownership of the CPF were privatised or liquidated
Intensifying promotional efforts related to the forthcoming privatisation projects	Yes (in progress)	end of first half of 2006	
Privatisation of Companies in Minority State Ownership			
A sale of minority packages in companies has been made difficult due to a large number of administrative cases	in progress	completion of revision - end 2006 cancellation of the remaining reservations upon resolution of administrative cases	A part of the activities within the CPF competence has been completed, but the dynamics of court cases resolution depends primarily on the court procedure.
CPF is working on a thorough revision of the reservations	Yes		
Accelerating resolution of administrative cases	No (in progress)		A part of the activities within the CPF competence has been completed, but the dynamics of court cases resolution depends primarily on the court procedure.
Sale of minority packages in the Varaždin capital market and some 20 companies in the Zagreb capital market a month		IV quarter 2005	A total of 327 companies in minority CPF ownership was privatized in the June 2005 - September 2006 period.
Privatisation of Tourist Portfolio			
In the context of financial consolidation of companies, management boards will execute the sale of company assets by means of public invitation for bids.	Partly	IV quarter 2005 and I quarter 2006	Such a model of sale was planned for 3 tourist companies, sale of assets was executed in 1 company, while this model was abandoned in the remaining 2 companies.
Further privatisation of companies	Yes (in progress)	IV quarter 2006 / I quarter 2007	
Competition Policy and State Aid			
Monitoring on a continuous basis of all further changes in the EC acquis and their appropriate transposition into the Croatian legislation	Yes	28 November 2005 and 5 May 2006	The new State Aid Act and the new State Aid Regulation were adopted for the purpose of harmonisation with the EU <i>acquis</i> .
Increase in the number of experts on the Agency staff and their training for efficient implementation of competition rules	No		Insufficient budgetary funds of the Croatian Competition Agency
Active and continuous cooperation with other regulatory authorities in the Republic of Croatia (the Croatian Telecommunications Agency, the Council for Electronic Media, the Croatian National Bank, the Croatian Energy Regulatory Agency)	Yes		Continuous co-operation in resolving cases and other types of cooperation.
Concluding agreements on cooperation with regulatory bodies (the Croatian Telecommunications Agency, the Council for Electronic Media, the Croatian Energy Regulatory Agency)	Yes	14 July 2006, 20 July 2006 and 25 July 2006	The agreements on co-operation were signed with the Croatian Telecommunications Agency, the Council for Postal Services and the Croatian Financial Services Supervisory Agency. Signing of the co-operation agreements with the Council for Electronic Media and the Croatian Energy Regulatory Agency is expected in the forthcoming period.

MAIN MEASURES UNDER THE 2005 PEP	ADOPTED (YES/NO)	DATE	COMMENTS
Activities involving amendments to the existing Competition Act in co-operation with the Ministry of Justice (especially with regard to the possibility of pronouncing punishments based on the Agency's decisions and with regard to the jurisdiction in deciding on the legitimacy of the Agency's regulations)	Yes	10 May 2006	Initiative with the Ministry of Justice for the amendments to the Competition Act
Increase in the number of experts on the Agency staff and their training for efficient implementation of state aid rules	No		Insufficient budgetary funds of the Croatian Competition Agency
Specialisation of employees in bodies of government administration and in units of local and regional self-government responsible for proposing state aid, or processing of applications for state aid of state aid users and their additional education and training.	Yes	from January 2006 to July 2006	17 thematic seminars and expert consultations were held for state aid providers
Establishment of a comprehensive state aid computer database with the financial assistance from the CARDS program	Yes		IT equipment and program support were delivered and installed.
Railway Restructuring			
Legislative alignment:			
- Implementation of the Railway Act	Yes	1. January 2006	Start of implementation 1. January 2006
- Act on the Division of Croatian Railways (HŽ)	Yes	15. December 2005	The Act was adopted in December 2005, division of Croatian Railways (HŽ) is underway.
- Railway Transport Safety Act		end 2006	Final Act proposal is drafted, adoption is expected by end-2006.
Liberalisation of railway transport market:			
- Allocation of infrastructural lines		from 2007	The study " Examination and Determination of Fees for the Use of the Railway Infrastructure" is made.
Restructuring and modernisation of the national railway company:			
- Setting up and registration of new railway companies	In progress		Registration of the companies with the commercial court is underway and its completion is expected until end-2006.
Adoption of the National Railway Infrastructure Programme		2007	The drafting of the Programme is almost completed. Public discussion on the final draft is expected in October. Since the document has to be adopted by the Croatian Parliament on proposal from the Government of the Republic of Croatia, final date of adoption depends on the dynamics of procedural activities. National Railway Infrastructure Programme is applied as new budget programme in the budget projections 2007-2009.
Restructuring of the Shipbuilding Industry			
Completion of the preparation of the National Restructuring Programme of the Croatian Shipbuilding Industry and its adoption by the Government of the Republic of Croatia	No	March 2007	A draft of the National Restructuring Programme of the Shipbuilding Industry was finalised in end-September 2006. The adoption of the Programme, subject to the prior verification by EC and Croatian Competition Agency is expected in the I quarter or no later than at the end of the first half of 2007.
Implementation of the restructuring process in accordance with the National Restructuring Programme	No	from March 2007 onwards	The beginning of implementation of the restructuring process depends on the adoption of the National Restructuring Programme, and the process will be implemented throughout the transitional period, the duration of which will be defined by the said Programme.
Implementation of the privatisation process or liquidation of individual shipyards	No	from March 2007 onwards	During 2007, the definition of the shipyard privatisation method is expected, as well as privatisation of at least one shipyard (Uljanik Brodogradilište), while the privatisation dynamics of other shipyards in majority state ownership will be defined by the National Restructuring Programme.

MAIN MEASURES UNDER THE 2005 PEP	ADOPTED (YES/NO)	DATE	COMMENTS
Restructuring of the Metallurgy Sector and Aluminium Industry			
Adoption of the National Restructuring Programme of the Steel Industry in the Republic of Croatia, approval of the same by the EC	Yes	until 1 March 2007	The draft of the National Restructuring Programme of the Steel Industry in the Republic of Croatia was prepared in the first half of 2006, to which the EC gave its recommendations and comments. The draft Programme will be amended, with the assistance of the consultants recommended by the EC, in accordance with the suggestions made by the EC.
Privatisation of steel companies Željezara Split and Valjaonica cijevi Sisak, through which restructuring will be performed	Yes	end 2006/I quarter 2007	The Government of the Republic of Croatia has decided to perform the restructuring of steel companies through privatisation. The future owners are expected to prepare individual business plans which must prove sustainability of the steel companies under normal market conditions at the end of the restructuring period. The completion of the privatisation of Željezara Split is expected by the end-2006 and Valjaonica cijevi Sisak in I quarter 2007.
Privatisation of TLM d.d. Šibenik, through which restructuring will be performed	Yes	I quarter 2007	With an aim of ensuring a long-term sustainability of the company and future profitable operation, the Government of the Republic of Croatia has decided to perform privatisation of the company, where a future investor would assume business risks and the related restructuring of the company.
Small and Medium Size Enterprises			
Promoting entrepreneurial training	Yes	2005/2006	The measure has been implemented continuously since 2004, on the basis of the Program of Incentives to Small and Medium Size Enterprises by the Government of the Republic of Croatia, through the annual Operative Plan compliant with the annual Budget and the State Aid Act (Official Gazette 140/05).
Ensuring access to financial resources for SMEs	Yes	2005/2006	The measure has been implemented continuously since 2004, on the basis of the Program of Incentives to Small and Medium Size Enterprises by the Government of the Republic of Croatia, through the annual Operative Plan compliant with the annual Budget and the State Aid Act (Official Gazette 140/05).
Promoting entrepreneurial infrastructure	Yes	2005/2006	The measure has been implemented continuously since 2004, on the basis of the Program of Incentives to Small and Medium Size Enterprises by the Government of the Republic of Croatia, through the annual Operative Plan compliant with the annual Budget and the State Aid Act (Official Gazette 140/05).
Development of SMEs competitiveness strategy	Yes	2005/2006	The measure has been implemented continuously since 2004, on the basis of the Program of Incentives to Small and Medium Size Enterprises by the Government of the Republic of Croatia, through the annual Operative Plan compliant with the annual Budget and the State Aid Act (Official Gazette 140/05).
Promotion and marketing - entrepreneurial climate and focus on exports	Yes	2005/2006	The measure has been implemented continuously since 2004, on the basis of the Program of Incentives to Small and Medium Size Enterprises by the Government of the Republic of Croatia, through the annual Operative Plan compliant with the annual Budget and the State Aid Act (Official Gazette 140/05).
Promoting entrepreneurship of target groups	Yes	2005/2006	The measure has been implemented continuously since 2004, on the basis of the Program of Incentives to Small and Medium Size Enterprises by the Government of the Republic of Croatia, through the annual Operative Plan compliant with the annual Budget and the State Aid Act (Official Gazette 140/05).
Promoting cooperatives and crafts	Yes	2005/2006	The measure has been implemented continuously since 2004, on the basis of the Program of Incentives to Small and Medium Size Enterprises by the Government of the Republic of Croatia, through the annual Operative Plan compliant with the annual Budget and the State Aid Act (Official Gazette 140/05).

MAIN MEASURES UNDER THE 2005 PEP	ADOPTED (YES/NO)	DATE	COMMENTS
Legislative alignment with the new Recommendation of the EU Commission on the definition of SMEs	Yes	2006	The measure has been implemented continuously since 2004, on the basis of the Program of Incentives to Small and Medium Size Enterprises by the Government of the Republic of Croatia, through the annual Operative Plan compliant with the annual Budget and the State Aid Act (Official Gazette 140/05).
FINANCIAL SECTOR			
Banking System			
Adoption of amendments to the existing subordinate legislation based on changes in the International Accounting Standards and new International Financial Reporting Standards	Yes	2006	
Analysis of the early warning systems in banks, analysis of sensitivity of the banking system as a whole to macroeconomic disturbances and macroprudential analysis	Yes	continuously	
Foreign Exchange System Regulation			
Amending the Foreign Exchange Act in a manner that would repeal those provisions of that Act which explicitly forbid investment of non-residents in CNB bills and T-bills of the Ministry of Finance	Yes	IV quarter 2006	
Amending the Foreign Exchange Act in a manner that would repeal those provisions of that Act which explicitly bind resident natural persons to use domestic brokers and custodian banks for foreign securities purchases and sales	Yes	IV quarter 2006	
Non-Banking Sector Supervision			
Setting up a single non-banking financial supervisory authority	Yes	1 January 2006	The Croatian Financial Supervisory Authority was established by act in 2005 and started with work at 1st January 2006.
LABOUR MARKET			
Stimulating Employment			
Selection of the promising sectors in counties and an analysis of the employers' needs in these sectors in terms of skills and knowledge that their employees in the four counties have to have; develop a program for training of the unemployed	Yes	August 2006	The Regional Operative Developmental Programs for the four counties have been developed, containing a component of human resource development.
Defining a decentralised organisational structure of the Croatian Employment Service and of the operative management guidelines and human resource development at key positions within the Croatian Employment Service	Yes	August 2006	The new regulations on the organisational structure of the Croatian Employment Service were prepared, which represent the basis for the selection of the required staff.
Operationalisation of the National Action Plan for Employment through annual implementing measures	Yes	August 2006.	The Annual Plan of Incentives to Employment for 2006 was adopted in March 2006 .
Social Security System			
Social Benefits Reform			
Improved level of the system efficiency and social welfare system modernisation and democratisation	Implementation in progress	2008	The measure is being implemented through the new Project of social welfare system development.
Systematic protection of rights and interest of children and sensitive groups and harmonisation with the international standards	Implementation in progress	continuously	The measure is being implemented through: National Action Plan for the Youth National Strategy for Drug Abuse Prevention, National Plan for Trafficking Prevention, National Population Policy, National Strategy of Uniform Policy for the Disabled Persons, National Policy for the Promotion of Gender Equality, and National Program for Roma
National Minorities			
Improvement of the national minorities' rights in accordance with international standards - implementation of CEI	Yes	Held on 2 and 3 of October 2006	

MAIN MEASURES UNDER THE 2005 PEP	ADOPTED (YES/NO)	DATE	COMMENTS
AGRICULTURAL SECTOR			
Implementation of privatisation tender procedures for agro-conglomerates	In progress	2007	The tender has been implemented for the sale at a nominal price, where no sale has been executed; the second stage of privatisation at a discount price is currently underway
Accrediting the SAPARD Agency	Yes	2006	The national accreditation has been performed and accreditation by the European Commission is expected by end-2006
Establishment of a Wine Cadastre - setting up a fully digitalised cadastre	In progress	2008	It is a complex task, requiring special technical knowledge and significant financial resources, as a result of which it could not have been implemented at a planned dynamics.
PUBLIC ADMINISTRATION REFORM			
Adopt a strategy for public administration reform and operative plans for its implementation (measure from 2005 PEP)	In progress	IV quarter 2006	The draft strategy was prepared in December 2005. In January 2006, the draft strategy was discussed at a Round Table organised at the Croatian Academy of Science and Arts, and was forwarded to scientists and experts and to the World Bank for their opinion. The draft strategy is in its final stage of adjustment to the received opinions.
Adopt amendments to the Act on State Administration System	In progress	IV quarter 2006	
Adopt amendments to the Act on the Rights and Obligations of Government Officials	In progress	IV quarter 2006	The Draft Act is in the adoption procedure with the Croatian Parliament.
Adopt amendments to the Act on the Procedures of Transfer of Office	In progress	IV quarter 2006	The Draft Act is in the adoption procedure with the Croatian Parliament.
Adopt Political Parties Financing Act	In progress	IV quarter 2006	In 2006 PEP, the measure is planned for 2007. However, according to the National Anticorruption Program, which was adopted by the Croatian Parliament in March 2006, the drawing up of that Act is planned for September 2006. The Government of the Republic of Croatia has established the Draft Act and it was forwarded in the parliamentary procedure.
Adopt the amendments to the Conflict of Interests Prevention Act	In progress	IV quarter 2006	The Draft Act is forwarded in the procedure with the Government in November 2006.
Setting up organisational units for human resources management and development in all bodies of government administration with staff of over 50	In progress	IV quarter 2006	These units were set up in most of the bodies of government administration, while in other bodies, persons responsible for human resource management were appointed in personnel departments, until setting up the required units.
Adopt subordinate legislation on job system and classification and other implementing regulations for the Civil Service Act	In progress	IV quarter 2006	8 out of a total of 13 pieces of subordinate legislation for the Civil Service Act were adopted. 5 implementing regulations are in the adoption procedure, while the regulation on jobs and salaries of employees will be adopted by 31 December 2006, along with the Act on Salaries, since their subject matter is connected. A delay in adopting the subordinate legislation may be explained by a complexity of the subject matter and solutions of inadequate quality that are provided by foreign consultants engaged in the preparation of these regulations within the CARDS program.
Adopt Act on Salaries in Civil Service	In progress	IV quarter 2006	The Government of the Republic of Croatia has established a Commission for preparing the Act on Salaries in Civil Service. The preparation of the Act is in progress.
Strengthening the Centre for education and training of civil servants (in terms of sufficient staff)	Yes	2005 and 2006	In December 2005, the Amendments to the Regulation on the Organisational Structure of the Central State Administrative Office were adopted, which increased the maximum number of employees in the Centre for education and training of civil servants from the previous 5 to 13. In 2006, competitions were held, so that 11 civil servants and employees are employed with the Centre to date.

MAIN MEASURES UNDER THE 2005 PEP	ADOPTED (YES/NO)	DATE	COMMENTS
Develop a Study on Administrative Burden on Companies	Yes	25 September 2006	This measure has been implemented under the title Analysis of the Obstacles to the E-Business in Companies, which was ordered by the Central State Administrative Office for e-Croatia in order to identify the existing obstacles to the broader use of e-business in Croatia. The analysis was carried out in two stages - qualitative and quantitative research - which showed that the potentials for e-business in the Republic of Croatia have not been used sufficiently.
DEVELOPMENT OF A KNOWLEDGE-BASED SOCIETY			
Preschool Education			
Setting up of a larger number of kindergartens (either private and/or expanding the existing capacities of the existing ones) in units of local and regional self-government and ensure support in the provision of didactic equipment	Yes	31 August 2006	The coverage of children was increased by 2,600. Expanding the preschool program and opening of new kindergartens ensures a constant growth in inclusion of preschool children in various preschool programs. In 15 municipalities of Karlovac County, Sisak-Moslavina County and Slavonski Brod-Posavina County, new programs were introduced with the support of the Ministry of Science, Education and Sports (budget and World Bank loan) in providing didactic equipment.
Setting up new preschool programs in 30 counties and towns (in new preschools or in primary schools, cultural and sports institutions and associations)	Yes	31 August 2006	80 new kindergartens and programs were established: 30 new kindergartens (6 were founded by the units of local self-government and 24 were founded by fiscal persons), 15 municipalities in Karlovac County, Sisak-Moslavina County and Slavonski Brod-Posavina County established new programs with the support of the Ministry of Science, Education and Sports; 35 new programs at music schools and associations. Upward trend in the establishment of new kindergartens and programs for including the preschool children also increased in that period, in accordance with the Education System Development Plan 2005-2010, and owing to the financial support of the Ministry of Science, Education and Sports (partnership: municipality, fiscal persons and the Ministry).
Setting up new preschool programs particularly for children from socially deprived environments, the Roma children, children on the islands and in rural areas	Yes	31 August 2006	35 new preschool programs were established in kindergartens and in primary schools for preschool children who do not attend a kindergarten. The coverage of children by a preschool program increased by 875 children in this period, of whom 190 are of the Roma national minority. The upward trend in children coverage is also pronounced, in accordance with the Development Plan.
Drafting of the national curriculum for preschool education	Yes	June 2006	The Council for the Curriculum for Preschool, Primary School and Secondary School Education was established.
Implementing the action plan Decade of Roma Inclusion 2005-2015 (informing parents of the Roma children about the need for inclusion in preschool programs, ensuring financial conditions for the program implementation, organising preschool education for the Roma children in areas where they live)	Yes	31 August 2006	112 new programs were established (early learning of foreign languages, sports and arts programs, programs for talented children and programs for children with special needs - developmental difficulties), lasting for 3 to 10 hours a day, for the purpose of increasing work quality in kindergartens.
Primary School Education			
Drawing up the new Primary Education Act	No		The Preschool and Primary School Education Directorate prepared the draft act in May 2006.
Implementation of the PISA project	Yes	February/ March 2006	5,250 students, from 159 secondary schools and 9 primary schools, participated in the PISA knowledge assessment (93% of the planned 5,636). The performance of the Croatian students will be announced in 2007.
Drawing up a School Trips Ordinance	No		The Preschool and Primary School Education Directorate prepared the draft act in September 2006.
Drawing up an Ordinance on the Assessment of Psychological and Physical Condition of Children (for enrolment in the first grade of primary school)	No		The Preschool and Primary School Education Directorate prepared the draft act in February 2006.

MAIN MEASURES UNDER THE 2005 PEP	ADOPTED (YES/NO)	DATE	COMMENTS
Drawing up a Primary School Program and Curriculum	Yes	15 September 2006	Since the beginning of the school year 2006/2007 the new Primary School Program and Curriculum, based on the CNES, has been applied in all primary schools.
Implementation of the National Strategy of Uniform Policy for the Disabled Persons	Yes	implementation in progress	The National Strategy of Uniform Policy for the Disabled Persons has been implemented systematically; the new strategy is being prepared, which will be completed by end-2006.
Drafting a Sports Act	Yes	16 June 2006	The Act has entered into force. The National Sports Program will be adopted pursuant to that Act.
Introduction of the Croatian National Educational Standard (CNES) in all 837 primary schools planned for the school year 2006/2007	Yes	September 2006	As of the beginning of school year 2006/2007, the CNES has been implemented in all primary schools through the new Program and Curriculum. The Experimental Program and Curriculum was introduced in 49 primary schools in the last school year and monitoring and evaluation (external) was performed by the Institute of Social Studies Ivo Pilar.
Professional training of teachers, principals and associate staff from 49 primary schools with a view to achieving a more efficient implementation of the Croatian National Educational Standard (three cycles)	Yes	school year 2005/2006	Professional training of teachers, principals and associate staff from 49 primary schools, where the Experimental Program and Curriculum was introduced, was carried out in three cycles. A total of 1,931 employees of these schools participated in the training and 831 heads of the county expert councils (2,762 employees).
Professional training of teachers, principal and associate staff from the remaining 788 primary schools with a view to introducing the CNES in all primary schools in the school year 2006/2007	Yes	June-August 2006	From June to August, the first cycle of professional training for teachers, principals and associate staff (25,573 employees) was performed in 788 primary schools which have applied the new Program and Curriculum in their operation as of September 2006.
Professional training for 300 teachers-instructors in class teaching (from grade 1 to 4) and 300 teachers-instructors in subject teaching (from grade 5 to 8)	Yes	school year 2005/2006	Professional training was organised in order start with the application of the new Program and Curriculum in the school year 2006/2007 with as great expertise as possible.
Develop a model of primary school classes taught in a foreign language	No		The model has not been developed.
Building new capacities (build new schools or add extensions to the existing ones)	Yes	school year 2005/2006	In accordance with the Education System Development Plan, state budget, EIB loan and the Annual Developmental Plan, new schools were built or extensions to the existing schools were added. In the following four years, the Government of the Republic of Croatia and the World Bank will allocate around HRK 500m for building schools. Around HRK 300m was also planned annually through decentralised funds for capital investments, and around HRK 300m was secured under the EIB program in the following four years, of which a portion is earmarked for capital investments.
Introduction of work in one shift	Yes	school year 2005/2006	Until the beginning of school year 2006/2007, the number of schools operating in three shifts was reduced from 52 to 39.
Strengthen cooperation and cooperative relationship between parents, schools and local communities	Yes	school year 2005/2006	It has been implemented continuously through various forms of cooperation.
Ensure additional didactic equipment and teaching aid for the 49 schools implementing the Croatian National Educational Standard	Yes	school year 2005/2006 and school year 2006/2007	Supply of didactic equipment has continued. A part was supplied in the previous school year (49 school received HRK 50,000 each), while a part of didactic equipment will be supplied by end- 2006 (49 schools will receive additional HRK 100,000 each). Funds are provided from the state budget and a World Bank loan.
Ensure initial didactic equipment for all the schools planned to implement the Croatian National Educational Standard in the school year 2006/2007	Yes	school year 2006/2007	In progress - until the end of 2006 a number of schools (210) will be granted HRK 25,000 each, and the remaining amount in the following fiscal year.
Ensure IT literacy of teachers	Yes	school year 2005/2006	1,250 of IT teachers received a certificate European Computer Driving Licence to date, and by end-2006, the certificate will be received by 4,500 teachers and school employees.

MAIN MEASURES UNDER THE 2005 PEP	ADOPTED (YES/NO)	DATE	COMMENTS
Implementation of the action plan Decade of Roma Inclusion 2005-2015 (Assistance with enrolment of the Roma children of both sexes in primary schools. Train Roma assistants. Create conditions to reduce the number of classes attended by the Roma children only. Reduce the number of Roma children absentees. Create conditions for an increase in the number of Roma children who complete primary education).	Yes	school year 2005/2006	The Ministry of Science, Education and Sports provided significant funds for the implementation of the objectives and inclusion of the Roma children in primary and secondary schools under the National Program for the Roma and Decade of Roma Inclusion 2005-2015. Scholarships were ensured for secondary school students. Funds amounting to EUR 800,000 were granted under the PHARE program, and 551,000 EUR from the Roma Education Centre from Budapest.
Secondary Education			
Define standards and competencies for each category	Yes	from 2006 onwards	Standards and competencies sample was defined and development under the 2002 and 2003 CARDS projects is underway, while an integrated work is envisaged through the IPA program (begins in 2007).
Teacher Training Ordinance	No		The preparation of the Ordinance is within the competence of the Education and Teacher Training Agency and Vocational Education Agency.
Draft a project proposal for the pedagogical and psychological education of teachers in accordance with the Bologna Declaration	No		Preparations should be made in legislative framework and a need analysis should be conducted in order to adjust the former to the new education.
The State Secondary School-Leaving Exam Council and the National Centre for External Evaluation of Education are responsible for conducting external evaluation and for state-school-leaving exam.	Yes	during school year 2005/2006 onwards	The Council has been operating continuously. In the school year 2005/2006, the national exams were organised (1st grade students in general secondary school programs), and in the school year 2006/2007 the national exams are being prepared for 8th grade students of primary schools, 2nd grade students and 1st grade students in general secondary school programs, 1st grade students of 4-year vocational secondary schools and pre-examination of 4th grade students in general secondary school programs. The national exams are used for external assessment of knowledge and skills of students and for preparation of students for the state secondary school-leaving exam.
The State Secondary School-Leaving Exam Ordinance	No		The adoption of the Ordinance is planned for end-2006. The implementation of the vocational and general secondary school programs should be aligned.
The National Centre for External Evaluation of Education is responsible for the preparation and carrying out of external evaluation in the system of education in the Republic of Croatia. It conducts all exams based on national standards.	Yes	school year 2005/2006	The national exams for about 13,300 students were conducted (13,358 were registered) in the 1st grade of general secondary school. Knowledge and skills in the Croatian language, mathematics and first foreign language were evaluated. The students belonging to national minorities (Italian, Serbian, Czech and Hungarian) had an opportunity to take the exam in their mother tongue.
Redefinition of vocational areas	Yes	September 2006	The number of educational (vocational) areas was reduced from 32 to 14.
Drawing up a national qualifications framework	Yes	September 2006	The proposal of the Croatian qualifications framework has been prepared, which represents an important precondition for the regulation of the overall life-long training. Annexes were also drawn up - working group for the secondary school and higher education level.
Determining exit competencies	No		A part of the specialisations standards has been prepared.
Redefining specialisations	Yes	September 2006	The number of specialisations was reduced from 330 to 199.
Drawing up new and updating the existing programs	Yes	September 2006	8 new programs were drawn up, replacing the former 13. As soon as the work on competencies and qualifications is completed, drawing up of the curriculum will begin.
Drawing up program networks	No		As soon as the analysis of the market needs and all other preparatory activities are completed, drawing up of the program network will begin.

MAIN MEASURES UNDER THE 2005 PEP	ADOPTED (YES/NO)	DATE	COMMENTS
Drafting an equipment plan (continued)	Yes	September 2006	An equipment plan for vocational and general secondary school programs has been prepared, in the amount of HRK 23.6m (general secondary school HRK 5,873,626, arts programs HRK 510,654 and HRK 17,236,400 was planned for vocational schools).
Providing equipment	Yes	October 2006	A tender for 147 general secondary school programs was completed (IC technology and interactive blackboards). Tenders for equipping vocational schools are underway.
Drafting a proposal for the Adult Education Act which would ensure a uniform legislative regulation of all forms of adult education, high quality implementation of educational programs, high quality education of persons involved in adult education, financial regulation of this activity, etc.	Yes	September 2006	The Act is in the governmental procedure (passed through the first reading).
The CARDS 2004 (pending adoption by EC Delegation) envisages, among other things, an analysis of the condition in the area of adult education and a development of a database with all relevant data on adult education.	Yes	2006	Signing of the contract is underway. Terms of Reference were accepted and will be followed by drawing up of guidelines.
Project entitled For Literate Croatia: the Path to Desirable Future has been implemented since 2003 and its planned duration is the year 2012.	Yes	during school year 2005/2006 onwards	Primary school education of adults has been implemented systematically.
Collecting data into a single database in cooperation with Roma associations	No		The database has not been completed.
Collecting data on the enrolment and regular secondary school attendance in co-operation with Roma associations, determine annual reports on the granting of scholarships	Yes	during school year 2005/2006 onwards	Data have been collected systematically and secondary school students have been granted scholarships.
In co-operation with towns, municipalities and Roma associations, develop a database comprising data on students staying in student homes.	No		The database has not been completed.
Systematic application of the project Development of a Central eLearning Portal of the Republic of Croatia.	Yes	during school year 2005/2006 onwards	The Information Society Directorate in co-operation with partner has been systematically working on this issue.
Introduction of the Education Management Information System-EMIS	No		A part of the database, as a basis for EMIS, has been created.
Science and Higher Education			
Reorganisation of the system of science and higher education in accordance with the new act	Yes	2006	Amendments to the Act on Scientific Activity and Higher Education were adopted.
Introduce an international system of evaluation of scientific and highly expert work	Yes	academic year 2005/2006	Evaluation of programs and projects was conducted by foreign reviewers.
LUMP SUM (introduction of a uniform model of universities financing)	Yes	as of 1 January 2006	The first stage of the integrated financing of higher education institutions was implemented -lump sum - which introduced a uniform pursuit of university financial policy, developed and implemented by the senate, as a result of which this system represents a financial aspect of the university integration. In the first implementation stage, funds for salaries, material costs, government scholarships, student assembly and a part of the funds for the improvement of the students' standard were transferred from the Ministry level to the university level.
Setting up a Register of Institutions of Higher Education	Yes	academic year 2005/2006	It is kept with the Science Directorate, in accordance with the new Ordinance on Registering in the Register of Scientific Organisations
Setting up a Register of Scientific Organisations and a Register of Scientists	Yes	academic year 2005/2006	It is kept with the Science Directorate, in accordance with the new Ordinance on Registering in the Register of Scientific Organisations and Scientists Registration Ordinance.
Designating an Ethics Board for Science and Higher Education	Yes	February 2006	Four meetings have been held so far. As of 1 January 2007, it will be within the competence of the Agency for Science and Higher Education
Quality assurance in the national system of higher education	Yes	in 2006	Efforts to improve the quality assurance in higher education has continued. A support is provided to the establishment of the Croatian university quality assurance office, where the National Foundation for Science participates.

MAIN MEASURES UNDER THE 2005 PEP	ADOPTED (YES/NO)	DATE	COMMENTS
Conduct external quality evaluation of higher education programs and institutions simultaneously with the development of quality assurance units for higher education	Yes	in 2006	Evaluation of postgraduate study programs has continued.
Increase the share of private sector in higher education	Yes	2006	Three private schools were founded.
Issue invitations to project tenders	Yes	January 2006	The invitation to project tender was issued on 10 January 2006; 2,732 projects were received and 460 programs that are still undergoing evaluation.
Based on Scientific Organisations Evaluation Ordinance, carry out evaluation of all scientific organisations enrolled in the register of scientific and research legal entities, in accordance with the previously valid regulations	No		Evaluation of scientific organisations will begin at end 2006 and will be conducted by the Agency for Science and Higher Education, upon a proposal by the National Science Council .
Alignment of the ordinance governing scientific areas, fields and branches in accordance with remarks obtained from scientific organisations	Yes	2005	The ordinance was published in the Official Gazette 76/05 of 23 June 2005.
Implementation of the Bologna declaration guidelines and documents related to the establishment of a European system of higher education	Yes	September 2006	The proposal of the Croatian qualifications framework has been prepared.
OTHER REFORMS			
Health Care Reform			
Health Care System Reform			
Adopt the National Health Care Development Strategy 2006-2011	Yes	30 June 2006	
Amendments to the Health Care Act	Yes	26 July 2006	
Reform of Health Care System Financing			
Amendments to the Health Care Act, concerning copayment for drugs	Yes	26 July 2006	
Adopt a new Health Insurance Act	Yes	26 July 2006	
Public Health System Reform			
Adopt the Blood Supply Act	Yes	17 July 2006	
Draw up subordinate legislation to the Act on Donation and Transplanting Human Body Parts for Treatment Purposes, which regulate the quality and safety standards for donation, supply, testing, processing, safe-guarding, storing and distributing tissues and cells of human origin	Yes	2005-2006	Subordinate legislation was adopted in 2005 and 2006.
Judicial Reform			
Modernisation and Increased Efficacy of the Croatian Courts			
Delegation of cases from overburdened to less burdened courts	Yes	2006	Continuously
Transfer of enforcement cases to public notaries	Yes	January 2006	Continuously
Preparing draft of the Civil Procedure Act	Yes	May 2006	
Implementation of the pilot project "In-Court Conciliation" for the parties in the civil procedure	Yes	March 2006	
Rationalisation of the Court Network			
Implementation of the pilot project of a merger of 8 minor offence courts and 8 municipal courts	Yes	May 2006	The results of a merger of minor offence and municipal courts will represent a basis for upgrading the project of rationalisation of the court network.
Analysis of the feasibility of the current division of jurisdiction of county courts	No	2007	The results of the pilot project of a merger of minor offence and municipal courts will represent a basis for the analysis of the feasibility of division of jurisdiction of county courts.
Land Registry Reform			
The project of putting the land registry in order (clearing land registry backlog and achieving the optimum speed in land registry operation)	Yes	2006	Continuously
Transferring land registry data into digital form in all courts	Yes	2006	Continuously

MAIN MEASURES UNDER THE 2005 PEP	ADOPTED (YES/NO)	DATE	COMMENTS
Implementation of the pilot project of registering apartments and business premises in the land registry	Yes	2006	
Networking land registry data from the cadastre and land registry departments under the MATRA project	Yes	2006	Continuously
Increase the Efficiency of Creditor Protection and Claim Collection			
Implementation of the action plan for reducing the backlog of enforcement cases	Yes	October 2006	Continuously
Adopt amendments to the Bankruptcy Act	Yes	July 2006	
Reform of Criminal Legislation			
Adopt amendments to the Penal Act	Yes	June 2006	The second stage of the amendments to the substantive criminal legislation was completed (by the adoption of the amendments to the Penal Act).
National Anticorruption Programme 2006-2008 was adopted	Yes	March 2006	National Anticorruption Programme 2006-2008 was adopted
Preparing draft amendments to the Penal Procedure Act	Yes	in progress	The amendments to the Penal Procedure Act were forwarded in the parliamentary procedure
Environmental Protection			
Drawing up Environmental Protection Act	in progress	December 2006	Adoption by end 2006.
Incorporate provisions for the application of the IPPC Directive into the new Environmental Protection Act	in progress	December 2006	Adoption by end 2006
Adopt the sustainable development strategy	in progress	December 2006	
Prepare and adopt the Report on the State of Nature	in progress	December 2006	Adoption by end 2006
Develop the Air Quality Protection and Improvement Plan	No	2007	The Air Quality Protection and Improvement Plan will be developed by the third quarter of 2007, after the assessment of air quality in the Republic of Croatia and the classification into zones and areas.
Preparation of the National Report of the Republic of Croatia under the UN Framework Convention on Climate Change	Yes	September 2006	The National Report was completed in September 2006, and by the end of 2006, it will be delivered to the Secretary of the UN Framework Convention on Climate Change.
Adopt the Waste Management Plan	in progress	December 2006	The Waste Management Plan of the Republic of Croatia will be completed in December 2006, which will be followed by the county waste management plans and waste management plans at the local level.
Development of the Intervention Plan for Cases of Accidental Adriatic Sea Pollution in the Republic of Croatia	in progress	December 2006	The drawing up of the new Intervention Plan for Cases of Accidental Adriatic Sea Pollution in the Republic of Croatia Plan is underway. The plan will be developed by the end of 2006.
Construction of 1 cleanup vessel	Yes	2006	A cleanup vessel ECO 13/5, intended for cleaning the sea from floating, liquid and solid debris and for interventions in the case of accidental pollutions (tenth in a row), was constructed in 2006 and was delivered for use to Split-Dalmatia County in August..
Preparation of the annual National Adriatic Sea Monitoring Report	in progress	December 2006	The deadline for completion was extended to end 2006 (December).
Preparation of the annual report, leaflet and a map of sea water quality on beaches	Yes	2006	The annual report, leaflet and a map of sea water quality on beaches for 2005 was published. The report, leaflet and a map for 2006 will be prepared by the end of 2006.
Revision and adoption of the Revised National Strategy for the Protection of Biological and Landscape Diversity	in progress	2006	The Draft Report on the State of Nature was prepared in 2006, on the basis of which a revision of the National Strategy has started.
Develop and implement implementing regulations based on the Nature Protection Act	Yes	December 2005/2006/(2007)	4 ordinances and 1 regulation were adopted. 4 draft ordinances were prepared.

MAIN MEASURES UNDER THE 2005 PEP	ADOPTED (YES/NO)	DATE	COMMENTS
Protection of new areas	Yes	2006	The Act Promulgating Lastovo Islands Nature Park was adopted. The decision on the preventive protection of Cres-Lošinj area in the category of special sea reserve was adopted.
Implementation of NATURA 2000	No		Adoption of the proposal NATURA 2000 and establishment of implementing mechanisms will be realised by the date of the EU accession.
Establishment of the National Ecological Network	No	2007	Adoption of the National Ecological Network Regulation
Adoption of the wolf and lynx management plans	Yes	December 2004	They entered into force on 1 January 2005. A revision is planned for 2007.
Adoption of laws in the segment of chemicals	Yes	December 2005/2006/(2007)	The Chemicals Act was published in Official Gazette 150/05.
Development of implementing regulations based on the Chemicals Act	Yes	14 February 2005	The List of dangerous chemicals, the trade of which is prohibited or restricted was published in the Official Gazette 17/06 of 14 February 2006. Subordinate legislation was prepared on the basis of the Chemicals Act: ordinance on the manner of filling out safety and technical sheet, ordinance on classifying, packaging and labelling dangerous chemicals, ordinance on the registration of new substances and ordinance on registers, the adoption of which is planned for end 2006, in accordance with the 2006 NPPIU .
Preparation of implementing regulations based on the GMO Act	Yes	2006	4 implementing regulations governing the area of restricted use of GMO were adopted in 2006.
Public Procurement			
Drawing up proposal of the new Public Procurement Act	in progress	I quarter 2007	Preparation of the Draft of the Public Procurement Act was prolonged for the beginning of the first quarter of 2007, due to the large scope of public procurement regulated by this legislation
Adoption of the Public Procurement Act	No	end of I quarter 2007	
Amendment to the Regulation on small-scale procurement procedures for goods, works and services	No	2007-2008	The measure will be implemented in accordance with the provisions of the new Public Procurement Act.
Preparation of the Regulation on general provisions for procurement of goods, services and for awarding of works and on methodology of preparation, assessment and performance of the investment projects	No	2007-2008	The measure indicated implies drawing up of two pieces of subordinate legislation: drawing up the Regulation on general provisions for procurement goods and services, for yielding works, and drawing up the Regulation on methodology of preparation, assessment and performance of the investment projects. The measure will be implemented pursuant to the provisions of the new Public Procurement Act
Records on qualified economic entities	No		The measure will not be implemented because it is not provided for by the Draft of the Public Procurement Act
CPV and CPC norms	No	2007-2008	The measure will be implemented in accordance with the provisions of the new Public Procurement Act
Creation of the Public Procurement Manual	in progress	February 2007	The Public Procurement Manual for contracting authorities was prepared and presented to the professional public in July 2006. Work on the manual for the potential tenderers started in October 2006 and it should be completed in February 2007
Harmonisation (development) of real proposals for the establishment and organisation of organisational units for procurement in entities liable to the application of the Public Procurement Act:			
- Analysis of the existing organisation of public procurement in entities liable to the application of the Public Procurement Act	Yes	2006	
- Development of the proposal for the organisation of public procurement of entities liable to the application of the Public Procurement Act	Yes	2006	
- Organisation of public procurement in entities liable to the application of the Public Procurement Act	No		The complexity of implementation of this measure calls into question its implementation, i.e. determining its time frame

MAIN MEASURES UNDER THE 2005 PEP	ADOPTED (YES/NO)	DATE	COMMENTS
Development of professional abilities and capacities of public procurement units of the entities liable to the application of the Public Procurement Act: - Development of the national training program	Yes	2006	
- Training of public procurement instructors	Yes/in progress	2007-2009	The training program for employees in the public procurement system, i.e. of public procurement trainers, consisted of two modules in 2006. Module I was organised in May/June 2006 and Module II in September 2006. In 2006 PEP, this measure will be renamed to „Strengthening of administrative capacity in entities liable to the application of the Public Procurement Act“; „Training of public procurement instructors“ will also be renamed to "Training of public procurement trainers"
- Monthly training of personnel for procurement and supervision	No	2007-2009	The complexity of implementation of this measure does not allow it to be realised neither in 2006 nor at the planned monthly dynamics. In this 2006 PEP, it is renamed to "Training of personnel for procurement and supervision".
Creation of the Internet web site, Announcement Site for all public procurement procedures in the Republic of Croatia	No	2007-2008	The new Public Procurement Act will create a legal basis for the announcement of small-value public procurements, for the purpose of transparency of public procurements below and above the threshold
Elaboration of the organisational development plan of the Public Procurement Office	Yes/in progress	2007	The measure will be realised by the adoption and implementation of the legal framework which regulates the establishment of the Central State Administrative Office for Public Procurement
Support and development, as well as the creation of comprehensive measures for the development of the public procurement system (creation of the web site, publishing of bulletins and other publications, organising seminars)	Yes /in progress	2007-2009	In 2006, 4 issues of the Public Procurement Bulletin were published in the electronic form (the first issue was also published in the printed form). The Office, as an organiser or participant, held a number of seminars for contracting authorities, tenderers and other parties interested in public procurements, and some of them were presented to the public through the media (press, radio). The Office employees participated in several domestic and international seminars related to the public procurement, as well as in study trips. This measure will be renamed to Increased transparency of the public procurement system by issuing bulletins, publications, creating web sites, organising seminars and workshops, contacts with the media, etc.
Proposal for creating and developing the system of electronic procurement and implementation in practice and a possibility to centralise public procurement	No	2007-2009	The Public Procurement Act would provide a legal framework for the preparation and development of e-procurement system and a possibility to centralise public procurement through the central procurement authority.
Help (support) in the IT system development of the Public Procurement Office	In progress	2007-2009	In July and August 2006, efforts were made to establish the first version of the Database of entities liable to the application of the Public Procurement Act, while the Database relating to the public procurement reports for 2005 was being developed in September and August 2006. At the same time, the establishment of these databases allowed for the creation of the helpdesk through the e-mail address helpdesk@javnanabava.hr. In addition, during June 2006, efforts to establish the Office's intranet started, for the purpose of easier and better communication within the Office. The intranet was ready for operation in October 2006. In the 2006 PEP, this measure will be renamed to "IT system development for the Central State Administrative Office for Public Procurement"
Data statistics and analysis	In progress	2007-2009	The creation of these databases in 2006, allowed for the establishment of statistics, i.e. analysis of data relating to public procurement. Within the Database of entities liable to the application of the Public Procurement Act and the Database relating to the public procurement annual reports, it is possible to perform the analyses through a search by the certain criteria, and on the basis of data export from the database of the annual public procurement reports to other programs.