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POLICY NOTES 2016

**RESTORING MACROECONOMIC
STABILITY, COMPETITIVENESS
AND INCLUSION**

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The following country team members have made significant contributions to this report: Jeremie Amoroso (Consultant), Zoran Anusic (Senior Economist), Aneesa Arur (Senior Public Health Specialist), Blanka Babic (Consultant), Roberta Malee Bassett (Senior Education Specialist), Nataliya Biletska (Public Sector Specialist), Marcelo Bortman (Senior Public Health Specialist), Ana Cestari (Senior Water Resources Specialist), Fernando Dancausa (Financial Sector Specialist), Ivan Drabek (Senior Operations Officer), Jonas Arp Fallov (Senior Public Sector Specialist), Stjepan Gabric (Senior Water and Sanitation Specialist), Iva Hamel, (Senior Private Sector Development Specialist), Georgia Harley (Public Sector Specialist), Mariana Iooty De Paiva Dias (Senior Economist), Caterina Ruggeri Laderchi (Senior Economist), Sanja Madzarevic-Sujster (Senior Country Economist), Moritz Meyer (Economist), David Michaud (Senior Water and Sanitation Specialist), Ismail Radwan (Lead Public Sector Management Specialist), Suzana Petrovic (Consultant), Ljiljana Tarade (Operations Officer), Emil Daniel Tesliuc (Senior Economist), Mika-Petteri Torhonen (Lead Land Administration Specialist), and Winston Yu (Senior Water Resources Specialist). The team benefitted from the comments of Ivailo Izvorski (Practice Manager), Andrea Kucey (Country Program Coordinator), Marina Wes (Country Manager for Poland and Baltics) and Doerte Doemeland (Lead Economist).

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Overview

Croatia returned to positive growth in 2015 after more than half a decade of recession, but the structural weaknesses exposed by the financial crisis have yet to be fully addressed. Since 2008, Croatia has witnessed six years of recession, with GDP declining by 13 percent and unemployment doubling to over 17 percent, with youth unemployment reaching 50 percent, and poverty rates rising. The fiscal deficit averaged around six percent of GDP, with public debt more than doubling to 85 percent of GDP by 2014, exposing a large structural deficit due to persistent spending rigidities. Corporate sector debt remains relatively high and the banking sector continues to deleverage and constrain credit, weighed down by declining profitability and high levels of non-performing loans. Productivity and export performance has been lackluster, characterized by low export diversification, loss of competitiveness, a lack of product sophistication, and limited expansion of new products and new markets. These factors increase Croatia's vulnerability to shocks and continue to drag on growth.

Croatia's prospects for reinvigorating inclusive growth are limited without further reforms to restore macroeconomic stability, boost productivity, invest in people and modernize public services. Croatia's immediate economic challenges include restoring macroeconomic stability, while promoting private sector productivity and competitiveness to create jobs and growth. Restoring macroeconomic stability will help provide a more stable basis for investment, while freeing the private sector from constraints will help promote productivity and ease the burden of high rates of unemployment. Beyond the short term, Croatia's projected population decline and aging present significant risk to growth and convergence of living standard with its West European neighbors as well as to fiscal sustainability. The policy response centers around investing in people to raise skills and promote healthy aging so as to prepare Croatians for longer and more productive working lives, while modernizing and rationalizing the social protection system. There is also a need to continue to upgrade public services, key institutions like the judiciary and the governance of state owned institutions, and infrastructure to better support the needs of people and firms.

This note explores policy areas to support the objective of restoring macroeconomic stability, competitiveness and inclusion. It identifies policy options that can inform debate and enhance the reform process in these areas. More detailed analysis and reform options are contained in the supporting overview of macroeconomic and competitiveness issues and a series of Policy Notes on individual areas¹.

Restoring Macroeconomic Stability

Despite the gradual recovery, large financial, social and fiscal vulnerabilities remain. Stagnant growth, the poor performance of firms and the high rates of unemployment are rooted in the current structure of the economy and its inability to adjust since the crisis. While growth rates turned positive in 2015, ending a six year recession, the medium-term outlook remains subdued with potential growth estimated at around 1 percent. The quality of bank's loan portfolios has deteriorated, with a high level of non-performing loans (NPLs of 17 percent in September 2015), profitability has declined and the private sector continues to deleverage rather than invest. While EU integration helped the recovery of exports, competitiveness levels are low, and rigid labor markets hold back job creation and progress in addressing inactivity and unemployment—the main causes of the recent rise in poverty—remains slow.

Croatia is facing twin challenges of bringing down the budget deficit, and reversing the growth of public debt, while creating fiscal space needed to utilize large EU funds. Only a portion of the fiscal deterioration is caused by the crisis, while the majority is of a structural nature, with the structural deficit running at 4 percent of GDP. With the current level of debt, assumed growth for 2016, inflation and interest rates on sovereign debt, the fiscal balance required to stabilize the level of debt would be 1.8 percent of GDP, equivalent to turning the 1.1 percent of GDP primary deficit in 2015 into a surplus of 2 percent of GDP. This will require an increase in revenues and/or a reduction in primary expenditures of 3.1 percentage points of GDP, in addition to expenditure switching to make use of substantial EU funds for growth enhancing investment. While the adjustment is urgent (and many countries have successfully undertaken such adjustments), so as not to deepen vulnerabilities and

¹ Options for sector reforms are discussed in more detail in later sections and in individual *Policy Notes*.

risks of higher borrowing costs, the strategy needs to balance between a credible consolidation path and the potential impact on depressing growth². Publication of a credible medium-term fiscal adjustment plan designed to restore growth and public debt sustainability could help to bolster public and market confidence in Croatia's prospects. While it is important to manage the speed of adjustment, the burden should largely fall on less productive public expenditures.

Strengthening the financial sector to reinvigorate lending growth faces challenges. Despite the decline in profitability and high levels of NPLs the banking sector appears well supervised and capitalized, with perhaps only smaller banks requiring special attention from the regulator. Nonetheless, it is important to expedite the resolution of NPLs by strengthening the pre-bankruptcy settlements system, introduced in October 2012, and insolvency practices. This will enable lending to resume. In addition, completing the regulatory framework and promoting venture capital could provide much needed finance for high growth small and medium enterprises.

Reducing the disincentives to work and rigidity of labor markets would help address high and chronic unemployment. Not all of the recent rise in unemployment is of a temporary/cyclical nature. Croatia's labor market continues to suffer from significant rigidities despite a recent reform to the labor legislation. High relative labor costs explain in part the very high job destruction rates since 2008. Labor force participation (15 years+), at 52.4 percent in 2014, was also among the lowest in the EU and is strongly linked to low household income and vulnerability to poverty. Policy options to help to reduce disincentives to work and to better align wages with productivity include reducing the high levels of tax of labor and smoothing the rate at which benefits are withdrawn for low wage earners. Consideration could be given to the introduction of a single contract to overcome labor market segmentation between those on temporary and permanent contracts, while the recently revised labor law could be further simplified. In addition, equalizing the expected benefits of public and private sector employment could reduce rigidity that is also, in part, driven by public sector collective wage agreements.

Addressing fiscal vulnerabilities and existing social challenges requires faster implementation of structural reforms that underpin private sector growth and job creation. Current revenue and spending patterns offer significant scope for rationalization—particularly in areas where spending is relatively high and/or inefficient, such as subsidies, public wages, and public consumption³—suggesting that an adjustment of 4-5 percentage points of GDP could be implemented over the medium term. Revenue measures could raise 2 percent of GDP through reductions in exemptions, the introduction of a modern property tax, as well as strengthening tax collection. More fiscal space can be created by rationalizing the wage bill, subsidies, procurement, as well as improving the effectiveness and equity of social spending. Undertaking a new series of transparent spending reviews could help the government develop and commit to a clear strategic vision for fiscal consolidation that identifies specific savings and spending options that also meet national priorities. More effective use of EU funds also requires additional fiscal space and expenditure switching, averaging up to 1.8 percent of GDP a year in 2014-2020 (for transfers to the EU budget, pre- and co-financing of projects), but would release much more in available grants for investment.

Improving the strategic planning, effectiveness of the administration and the governance of SOEs would support the adjustment and improve competitiveness. Strengthening the public administration in particular in terms of corruption, the rule of law, regulatory quality, and government effectiveness would address some of the main barriers for doing business as well as enhancing the performance of public services and the effectiveness of investment of EU and national funds. In addition, there is scope to reduce fragmentation and overlap between the central and local authorities, introduce a new model of decentralization and rationalize state agencies, and improve State Owned Enterprises (SOEs) governance—the latter is an ongoing source of inefficiency and boosted public debt as many contingent liabilities have been realized or are at risk of being called.

Fostering Productivity and Competitiveness to Create Jobs

Croatia is facing a prolonged period of sluggish growth where uninspiring export performance is reinforced by low levels of productivity, firm level creative destruction and innovation. Croatia needs to promote more productivity-based innovation-driven growth. One of the most

² These trade-offs are considered in the Excessive Deficit program (EDP) agreed between the EU and Croatia, which includes an annual adjustment plan

³ Options for sector reforms are discussed in more detail in later sections and in individual *Policy Notes*.

promising signals for the country's export competitiveness outlook stems from a fringe of dynamic small exporters in innovative niche sectors. Supporting such a strategy, based on employment and productivity increases, exports and innovation, implies investing into innovative SMEs and accompanying human capital. By creating new goods, or upgrading existing ones, implementing new processes or introducing new market strategies these firms can play a key role for lifting Croatia out of recession and back into sustained growth and full employment.

Accelerating structural reforms to improve the investment climate would boost competitiveness and prospects for recovery of growth and jobs. These include an unfriendly business environment, limited competition in product markets, a lack of early stage financing and worker skills deficits. Despite the reform efforts in the last years Croatia's business environment still suffers from major institutional shortcomings, as highlighted by a number of international reviews⁴. In addition, the lack of early stage financing prevents innovative ideas with commercial potential from reaching the market, which reinforces the vicious cycle of reduced renewal process in the economy. A significant share of Croatian youth leave the education system with poor cognitive foundation skills such as in reading and mathematics, which leaves them ill-equipped for the demands of a competitive, innovation-driven economy. At the same time, the share of Croatian workers participating in lifelong learning activities is one of the lowest in the EU.

The Government should continue reforming the business registration. It can eliminate outdated requirements through legal amendments, merging and streamlining the registration processes of multiple departments and agencies, and making all registration processes (including post-incorporation) electronic. Reforms that make regulation more efficient and transparent can also help reduce corruption and informality, which are major costs for businesses. Liberalizing the service sector, in particular professional and business services, is strongly supportive of growing firms as would the full implementation of the new spatial planning and construction permitting system. In the area of construction permits, authorities' focus should be on enforcing the new laws, ensuring safety standards that protect the public while making the permitting process efficient, transparent and affordable for both building authorities and the private professionals who use it.

Further, integration into the EU internal market should help boost productivity. Services account for a large share of GDP and employment, but are also critical as inputs into other sectors, including manufacturing, thus playing a pivotal role in economy-wide productivity. High-quality, low-cost services can boost firm productivity and enhance overall competitiveness. A strong service sector is vital to diversifying and expanding a country's exports since exporting firms tend to be more productive. Meanwhile, service imports can serve as an important channel for introducing new technologies, boosting exports and helping countries to integrate into global value chains.⁵ However, regulation in network and professional services remains particularly rigid in Croatia, compared to the rest of EU and could be made more flexible and streamlined.

Enhancing the performance of courts would support firms' investments and business transactions. Despite recent reforms, the court system still exhibits large inefficiencies as seen through the backlog of cases, large budget allocated for delayed rulings or a comparatively large number of cases rejected by higher courts. Improvements in court efficiency are associated with a lower share of the informal sector in the overall economic activity, increased investor confidence and increased bank financing of firms for new investment. Further efforts could be made to reduce the time needed for enforcement procedures by strengthening the use and capacity of alternative resolution bodies, like Financial Agency (FINA), which can directly execute court judgments and court settlements on debtors' bank accounts. Moreover, Croatia approved significant amendments to the Civil Procedure Act in 2013 to streamline the way the litigation process is administered, including the way litigants submit evidence.

Preparing for Demographic Decline and Aging by Investing in People

Croatia can mitigate risks to economic growth and fiscal sustainability resulting from population decline and aging through policies that equip its people for longer and more productive working lives and that modernize education, health and social protection systems. Government efforts to protect social assistance benefits and old-age pensions during the crisis have

⁴ 2016 Doing Business Report, the 2014-15 Global Competitiveness Report of the World Economic Forum and the OECD product market regulation Index.

⁵ <http://www.oecd.org/sti/ind/global-value-chains.htm>

partially mitigated the impact on poverty and shared prosperity. However, the population is aging rapidly and shrinking, resulting in an increase in the old age dependency ratio. Ensuring that workers productivity rises in this environment requires investment in people's skills, health and incentives to work for longer. Given the demographic outlook, policies to activate the socially excluded will have a positive economic and social effect. On the other hand, without further reforms, the changing demographics will also put increasing pressure on the budget, with fewer actively contributing workers and larger claims on pension, health and long-term care.

Croatia needs to skill up its current and future workforce to cope with rapid technological change and aging population. In addition to expanding employment by increasing the employment rate and the working life of individuals, productivity gains are central to addressing demographic decline and aging. Youth have been particularly affected by the lack of economic growth, with unemployment rates of around 50 percent, limited job prospects, and a skills mismatch. Croatia is one of the EU countries where high shares of 15 year-olds who score poorly in mathematics in the Program for International Student Assessment (PISA) goes hand in hand with high rates of youth who are neither in employment, education or training (NEET). This combination of poor basic skills and idleness risks undermining the next generation's preparedness for the longer and more productive working lives called for by the aging challenge. Despite recent education reforms, increasing emphasis needs to be placed on improving the quality of general education, lifelong learning programs, and adult education to ensure a competitive and adaptive workforce. Better labor market information on job trends and skills would strengthen labor market outcomes while apprenticeships, reskilling programs, and lifelong learning programs would address high youth unemployment.

Croatia can do more to improve health outcomes for all, while containing pressures on spending driven by an aging population and new technologies. While Croatia enjoys relatively good and improving health outcomes, socio-economic and geographic disparities remain wide. Chronic and non-communicable diseases dominate the burden of disease and are projected to rise with rapid population aging. To counteract these trends, hospital service delivery models could be rationalized, and the functioning of primary and preventive care improved, to provide more cost-effective care. A significant portion of long-term care for the elderly is also provided at high cost by hospitals and could be more suitably and cost-effectively provided in other most appropriate settings. Other measures to contain costs and reduce persistent arrears include centralizing procurement systems, notably for drugs, implementing clinical guidelines and pathways, and better linking payments to hospitals and primary care facilities to performance and quality, and developing more transparent systems for monitoring and accountability.

Without further reform Croatia's pension system is fiscally and socially unsustainable in the long run. Croatia's pension system has seen significant change since the introduction of a multi-pillar design in 1998, although ad-hoc interventions in recent years have led to larger expenditures than expected for the pay-as-you-go (PAYG) pillar, a relaxation of early retirement rules, more generous indexation and rising concerns over fiscal affordability going forward, in addition to substantial equity and adequacy challenges, including as a result of low coverage. Pension reform therefore remains an unfinished agenda, with the need for reforms including tightening early retirement windows, raising the retirement age faster, and stimulating elderly activity (as participation rates remain low). Consideration also needs to be given to awarding pension credits on the basis of contributions, reducing the minimum pension per year of service or means testing it, and accelerating the convergence of the privileged pensions to the general PAYG rules. Overall, these policies need to address both fiscal and equity aspects of pension reform.

Consolidating and rationalizing the social protection system would help ensure it is affordable and to better target support to the poor and vulnerable. Croatia's generous and complex social welfare system is overly reliant on categorical rather than poverty-focused benefits. In order to improve its ability to tackle poverty and promote active inclusion while reducing spending, Croatia has embarked on a critical reform to consolidate the number of social benefit programs and increase the share of spending on poverty-focused programs, including through greater use of means-testing. This would include transferring the administration of the means-tested Guaranteed Minimum Benefit (GMB) into the *One Stop Shop* (OSS) benefit administration, followed by child allowance, non-contributory maternity/paternity allowances, unemployment benefit, and other social benefits in subsequent years as well as introducing the means-testing for these programs. This would also enhance Croatia's ability to reduce errors, fraud and corruption in social benefits as well as enhance

the screening of new entrants. Lastly, further reducing institutionalized care is more effective and cheaper, especially for child services, for example through community based services.

Improving Government, Public Services and Strengthening the Judiciary

There is considerable scope to strengthen the efficiency and responsiveness of government, despite the need for fiscal consolidation. Croatia spends more on public services than most EU countries, but performs poorly in indicators of public administration effectiveness, rule of law and administrative barriers to doing business. This presents both a challenge and an opportunity, and will require a transparent strategy that is communicated to all stakeholders to improve the public sector's performance while managing the fiscal consolidation over the medium-term. Transparently communicating and monitoring of performance should help to bolster support for, and the credibility of, reforms during the transition, and inform the design of any adjustments.

The public sector wage bill could be reduced to more sustainable levels, while continuing to deliver, or even improve, public services. The public wage bill, at close to 12 percent of GDP, is already high and could continue to rise with proposed measures for further decentralization, the creation of new agencies, and the need to build additional capacity to absorb sizeable EU funds. However, it is estimated that some 2 percent of GDP could be saved over the medium term through staff rationalization in local/regional and national governments to create a leaner, but more effective administration. Improving the flexibility and performance components of public sector pay agreements—through more merit and performance based pay, recruitment and management systems—would help to align wages to productivity and equalize wages with the private sector.

This also requires measures to improve the efficiency, effectiveness, and responsiveness of public institutions. It includes building institutional capacity to manage and coordinate increasingly complex policy issues more efficiently, particularly those related to EU membership. In addition to the sector reforms highlighted above, this includes the professionalization of public institutions, through the depoliticizing of appointments (including in state owned enterprises, SOEs), rationalizing agencies and SOEs across all levels of government, and strengthening strategic planning, M&E and reporting systems. There are also significant opportunities to offer more efficient and responsive services to citizens and businesses through the expansion of e-services.

Croatia's tax system could be more efficient, equitable, and supportive of labor and business. The objective is to build an efficient tax system that raises sufficient revenue in a way that is fair, minimizes distortions, has low compliance costs, and promotes job creation. However, Croatia's relatively high tax burden falls disproportionately on indirect and labor taxes, while the shadow economy remains large and paying taxes is burdensome. Additional revenue could come from the introduction of a modern property tax—generating revenues of up to 1.5 percent of GDP and abolishing outdated local real estate-related taxes and fees—and eliminating the large number of ineffective tax exemptions given to households and businesses—saving up to 1.1 percent of GDP. Tax policy and administration measures should also incorporate more of the large shadow economy while continued modernization of the tax administration is needed to protect and expand the revenue base, including the implementation of a modern compliance risk management system, and reduce compliance costs for citizens and businesses.

Improving Public Investment Management (PIM) would help boost economic growth and competitiveness. Strengthening PIM planning, contracting, and implementation capacity, along with improvements to the strategic planning and medium term budgetary framework (MTBF), can improve the efficiency of public infrastructure and unlock substantial EU funds. Creating the required fiscal space for new investments (and co-financing), through expenditure switching, needs to be combined with greater coordination and alignment between national priorities and EU policies. Strengthening strategic planning, regulation, implementation and monitoring processes could help to better utilize Croatia's own funds as well as around €10.7 billion of EU funds over the 2014-2020 financial perspective (equivalent to an average of 3.7 percent of today's GDP per year). For example, the National Transport Development Strategy, once finalized, should provide the overall direction and should be complemented by clear medium-term implementation plans for investment and management of the sector, with central administration guiding the various agencies (e.g. in road, rail and ports) as well as guiding the utilization of EU funds and its coherence with other funding sources.

Consolidating and rationalizing local government should improve services for citizens. Large cities provide most decentralized public services, although there are also many small counties and

municipalities, and overall subnational government is too fragmented, with overlapping responsibilities and relatively limited taxing powers, and over half of spending going for wages and maintenance. Clarifying responsibilities, amending the revenue collection powers and consolidating subnational government, through a combination of merging units and/or greater use of shared services, would help to avoid duplication and would be the basis for strengthening subnational administrative capacity to improve service delivery and investment, particularly of EU funds. Consolidation of water utilities is an example of such actions.

Improving trust and confidence in the court system would also help overcome one of the largest barriers to business, investment and growth. Building on recent reforms, improvements in the quality and speed of court judgements would signal a change to the general public and businesses. This would include further modernization and automation to increase the courts' online services and boost responsiveness for both users and government, in addition to reducing costs through more active caseload management between courts to reduce the backlog, and the consolidation of management functions at hubs in the network (e.g. finance, procurement, maintenance, statistics etc.). Clearer and stricter rules on ethical standards, along with more training and mainstreaming of rules into daily practice, and the clear sanctioning and control in courts and prosecution offices, would enhance the predictability and transparency of the court system as well as enabling greater use of EU funds to upgrade facilities and capacity.

Policy Options

This report seeks to identify potential policy options that can inform debate and enhance the reform process in Croatia. Some of the overarching policy options for Croatia, along the lines discussed above, are summarized in the table below. These are not designed to be an exhaustive list of potential reforms, but seek to identify possible priorities and inform the debate around the reform process. This is followed by a series of more in-depth *Policy Notes*, which provide additional analysis along with policy and implementation options in areas where the World Bank often has experience in supporting countries with their reform programs. The subsequent table loosely maps the specific *Policy Notes* to the four main policy reform areas identified above, although many of the areas are interlinked and often complementary to a number of Policy Notes in practice.

Summary of Policy Options	
SHORT-TERM MEASURES	MEDIUM-TERM MEASURES
<i>Restoring Macroeconomic Stability</i>	
<ul style="list-style-type: none"> • Introduce a credible medium-term fiscal consolidation plan to reverse growth of public debt and restore confidence in fiscal sustainability • Implement transparent spending reviews to develop clear strategic vision for fiscal consolidation that meets national priorities • Ensure the fiscal rule is enforced • Reform the wage system to reduce the public wage bill • Contain costs of SOEs and review subsidies (and limit contingent liabilities) 	<ul style="list-style-type: none"> • Make fiscal discipline, budget transparency, and streamlined budget planning priorities • Ensure that the medium-term budget plan maximizes the use of EU funds for priority investments • Introduce a modern property tax and eliminate ineffective tax exemptions • Publish and implement plans to restructure SOEs (transport, energy, utilities etc.)
<i>Fostering Productivity and Competitiveness to Create Jobs</i>	
<ul style="list-style-type: none"> • Reduce high levels of labor taxation and reduce tax/benefit wedge for low wage earners • Continue reforming business registration, merging and streamlining registration processes, making all electronic. • Strengthen the use and capacity of alternative dispute resolution bodies (e.g. FINA) • Expedite resolution of NPLs by strengthening pre-bankruptcy and insolvency settlements 	<ul style="list-style-type: none"> • Complete regulatory framework and promote venture capital for SMEs • Create an administrative agency from the merger of land registry offices and the cadaster. • Continue to make regulation more efficient, smart and transparent to help reduce red tape, corruption and informality • Consider introducing a single labor contract to reduce labor market segmentation
<i>Preparing for Demographic Decline and Aging by Investing in People</i>	
<ul style="list-style-type: none"> • Clear the stock of health sector arrears, with measures to prevent further arrears • Launch the implementation of the hospital network masterplan, improve hospital governance and centralize procurement • Transfer administration of the means-tested Guaranteed Minimum Benefit (GMB) into the <i>One Stop Shop</i> (OSS) benefit administration • Introduce means-testing to family and other social benefits 	<ul style="list-style-type: none"> • Improve the quality and inclusiveness of preschool and school education and build a lifelong learning system with appropriate financial and regulatory incentives • Reduce the fragmentation in health care, enhance preventative measures and shift long-term care services from the health to the social sector • Tighten early retirement windows, raise the retirement age faster, stimulate elderly activity, link credits to contributions, and accelerate convergence of privileged pensions to PAYG • Consolidate other allowances and benefits into the OSS
<i>Improving Government, Public Services and Strengthening the Judiciary</i>	
<ul style="list-style-type: none"> • Publish clear medium-term strategic and implementation plans for investment and management in general and for key sectors • Improve and streamline public sector collective wage agreements • Strengthen strategic planning and medium term budgetary framework 	<ul style="list-style-type: none"> • Depoliticize appointments (inc. SOEs), rationalize agencies and SOEs across all levels of government (water, regulators), strengthen strategic planning, M&E and reporting systems • Strengthen PIM planning, contracting, and implementation capacity, particularly for EU funds • Expand e-services to enhance user-responsiveness, particular for court services • Consolidate and rationalize local government to enhance service delivery

Policy Notes

<i>Restoring Macroeconomic Stability</i>
<ul style="list-style-type: none">• Main Note on <i>Restoring Macroeconomic Stability</i>
<i>Fostering Productivity and Competitiveness to Create Jobs</i>
<ul style="list-style-type: none">• Main Note on Fostering growth and Competitiveness to create Jobs• Making a Business Friendly Croatia• Strengthening Real Estate Registration
<i>Promoting Inclusive Growth in an Aging Society</i>
<ul style="list-style-type: none">• Skills for the Future• Social Welfare• More Effective, Inclusive and Sustainable Health System• Pension System Reform• Addressing Energy Affordability
<i>Improving Government, Public Services and Strengthening the Judiciary</i>
<ul style="list-style-type: none">• Strengthening Public Administration• Tax Policy and Tax Administration• Strengthening Public Investment Management and EU Funds Absorption• Competitive Transport as an Engine for Growth• Managing Water Resources, Services and Risks for Growth• More Sustainable Subnational Government• Strengthening Rule of Law and Judicial Efficiency

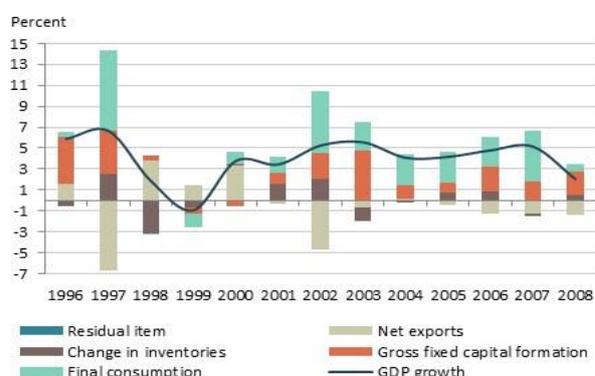
Restoring Macroeconomic Stability

1. **Croatia has achieved major development results over the last two decades.** Between 1995 and 2008, per capita national income (World Bank Atlas method) more than doubled to \$13,960—making Croatia a high-income country⁶. During this period Croatia has been fast converging to the EU levels—the average real growth amounted to 4.2 percent, which is 2 percentage points higher than in the EU27. The at-risk-of-poverty rate fell to 19 percent in 2007, while income inequality, measured by the Gini coefficient, at 0.31 made Croatia a country with moderate inequalities. Public debt and fiscal deficit remained low, while inflation declined to low single digit. Important institutional reforms, such as reform of judiciary, regulatory framework, competition policies, supported the transition toward membership of the European Union (EU) that eventually came on July 1, 2013 when it became the 28th member. These achievements created a sense of optimism about Croatia’s future and the promise of further shared prosperity within the world’s richest economic block.

From Boom to Bust

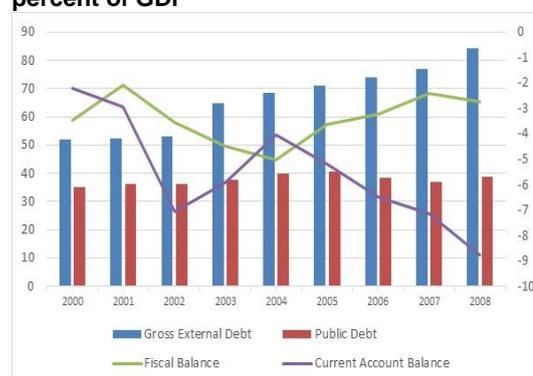
2. **However, the 2008 global crisis exposed fundamental weaknesses of the Croatia’s growth model.** The economic boom from 2000 to 2008, based on large capital inflows, local credit and real estate growth, created large vulnerabilities. The aggregate demand expansion (Figure 1) supported by large inflow of foreign capital and strong credit growth led to a rise in overall indebtedness. At the same time, the fiscal policy turned pro-cyclical, with government engaging in large public infrastructure and housing projects contributing to further overheating, offsetting largely a restrictive monetary response. Given weak domestic supply, foreign capital created large external imbalances—growing imports worsened the trade balance leading to the widening of savings–investments gap. Croatia’s large current account deficit at close to 9 percent of GDP in 2008 and external debt of above 84 percent of GDP (compared to 52 percent in 2000) (Figure 2) raised immediate concerns in particular after the collapse of the international financial markets in 2008.

Figure 1. Contribution to GDP Growth



Source: CROSTAT, CNB, World Bank staff calculations.

Figure 2. Croatia’s Twin Deficits and Debt, percent of GDP



3. **During the boom period, the dominant contribution to growth came from investments, while total factor productivity remained negative** (Figure 3). This put Croatia in contrast to peer countries that were in that period converging faster with its productivity well above the level of EU15 countries (Figure 4). Further, with investment ratios high and their small elasticity to growth when compared to the fast-growing economies in the region (especially given its focus on civilian construction), a strategy of expanding potential output based on further capital accumulation did not seem to be realistic. In order to sustain and accelerate growth, Croatia had to shift towards a more productivity-based and export-led growth pattern. Raising productivity of both capital and shrinking labor (given the fast aging population), deepening trade integration and fostering innovation were proposed levers.⁷ However, Croatia’s response was delayed and lukewarm hoping that adverse global economic conditions were temporary and that the stimulus for a significant share of Croatia’s pre-crisis growth will come back.

⁶ According to the World Bank classification.

⁷ World Bank (2009) Croatia’s EU Convergence Report.

4. **As the large stimulus to growth dried up, Croatia fell into recession.** The bust period that followed, led the country into a prolonged recession—one of the longest in the recent economic history in Europe. While the EU accession process helped Croatia’s income, competitiveness and living standards converge toward EU averages⁸, economic integration and connectivity also meant that the Eurozone recession was quickly transmitted to Croatia. In late 2008, triggered by increasing borrowing costs on financial markets Croatia’s economy went into recession that persisted over the next six years. The cumulative output loss over this period (2009-14) amounted to 13 percent of 2008 GDP. Unemployment doubled by 2013 to 17.3 percent, with youth unemployment reaching 50 percent.

Figure 3. Growth Accounting (Contribution to Growth, percentage points)

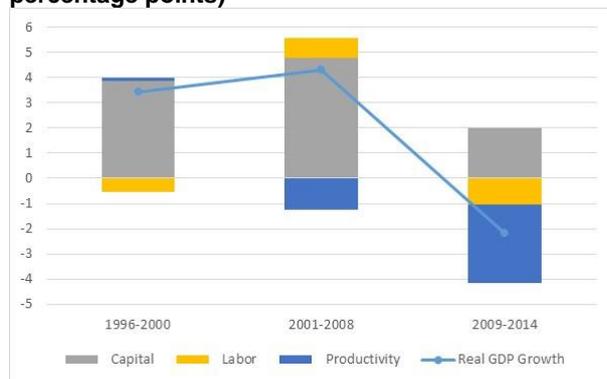
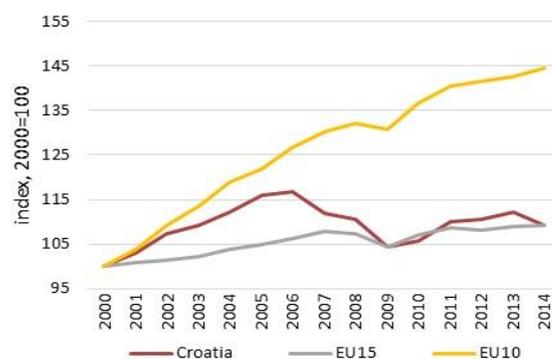


Figure 4. Croatia and EU Productivity



Source: CROSTAT, CNB, EUROSTAT, World Bank staff calculations.

5. **Fiscal vulnerabilities swiftly deepened as revenues declined and spending rigidity remained unaddressed.** Fiscal deficit stood at 6 percent of GDP on average since 2009 resulting in a steady increase in public debt, which more than doubled by 2014 (at over 85 percent of GDP) (Table 1). Structural deficit remained on average at 4 percent of GDP suggesting the root causes are of a structural rather than a temporary/cyclical nature. Further, the growth outlook remained weak within the more competitive, risk adverse post-crisis international environment. Credit agencies took note, reducing Croatia’s sovereign debt to speculative status in 2013. The opportunity cost of not addressing the structural rigidities through fiscal consolidation as well as competitiveness reforms inflated the sovereign risk premium that has by now tripled compared with its peers. The interest payments on Croatia’s sovereign debt amounting to 3.5 percent of GDP—crowds out productive spending.

Table 1. Croatia: Key Macroeconomic Indicators (Percent of GDP)

Indicators	Actual							Prelim.
	2008	2009	2010	2011	2012	2013	2014	2015
National Accounts								
Real GDP growth	2.1%	-7.4%	-1.7%	-0.3%	-2.2%	-1.1%	-0.4%	1.7%
Total Investment	31.4	25.0	21.4	20.6	19.3	19.1	18.2	18.5
Gross National Savings	22.9	20.4	20.5	20.0	19.4	20.1	19.0	22.5
Foreign Savings	8.8	5.1	1.1	0.7	0.1	-1.0	-0.8	-4.1
Public Sector								
Revenues	41.9	41.5	41.3	41.0	41.7	42.5	42.6	42.4
Expenditures	44.7	47.3	47.2	48.8	47.1	47.8	48.2	47.1
Interest payments	1.9	2.3	2.5	3.0	3.4	3.5	3.5	3.6
Fiscal Balance	-2.7	-5.8	-5.9	-7.8	-5.3	-5.4	-5.6	-4.7
Primary Balance	-0.8	-3.5	-3.4	-4.7	-2.0	-1.9	-2.1	-1.1
Balance of Payments								
Trade Balance	-22.4	-16.5	-13.2	-14.3	-14.3	-15.1	-14.8	-14.8
Current Account Balance	-8.8	-5.1	-1.1	-0.7	-0.1	1.0	0.8	4.1
FDI	5.5	2.9	2.1	2.6	2.7	1.9	3.0	2.0
Debt								
Gross External Debt	84.3	101.1	104.2	103.7	103.0	105.6	108.4	106.5

⁸ In 2014, Croatia stood at 59 percent of GDP per capita in Purchasing Power Standards of EU27, up from 51 percent in 2001, but slipped from 63 percent in 2008.

Public Debt	38.9	48.0	57.0	63.7	69.2	80.8	85.1	87.8
Gross Internat. Reserves (months of GNFS imports)	4.9	7.2	7.5	7.3	7.5	8.4	8.0	8.0
<i>Memo items:</i>								
GDP (EUR millions)	48,135	45,093	45,022	44,737	43,959	43,516	43,045	44,035
GDP (US\$ millions)	70,482	62,703	59,680	62,250	56,486	57,770	57,114	48,885
Inflation (p.a. %)	6.1	2.4	0.9	2.2	3.4	2.2	-0.2	-0.5
Debt service to export ratio	32.1	64.8	68.2	66.1	63.6	51.4	52.9	51.0
Exchange rate HRK:US\$ (p.a.)	4.93	5.28	5.50	5.34	5.85	5.70	5.75	6.86

Source: CROSTAT, MoF, CNB, World Bank.

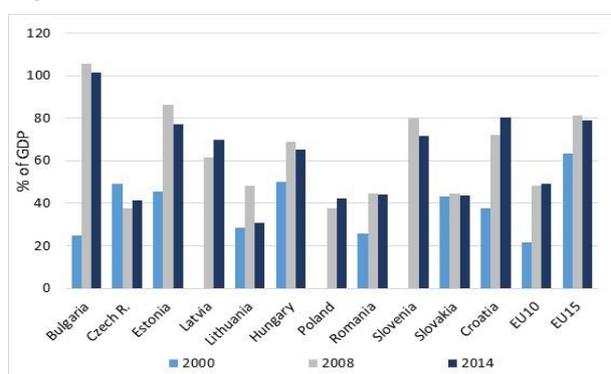
6. **Croatia returned to growth in early 2015, although large financial, social and fiscal vulnerabilities remain.** By September 2015, real GDP reached an annual rate of 1.5 percent - the highest since the end of 2008, supported by external demand and personal consumption. Credit crunch during recession affected loan portfolio quality leading to high level of non-performing loans (at over 17 percent in September 2015) and reducing credit institutions' profitability, as well as their risk appetite to invest in Croatia. While integration to the EU helped with the recovery of exports, still weak competitiveness, private sector deleveraging (Figure 5) and rigid labor markets hold back the stronger recovery of private sector and jobs. Progress in addressing inactivity and unemployment as the main causes of the recent rise in poverty remains slow. Addressing fiscal vulnerabilities and existing social challenges requires faster implementation of structural reforms that would underpin private sector growth and job creation.

Increased Financial Sector Vulnerability

7. **Throughout the period, monetary policy continued to operate a tightly managed kuna/euro exchange rate with little volatility, but without a formal peg to the euro.** In light of the high degree of euroisation of deposits and loans (more than two-thirds), exchange rate policy options remain limited. However, monetary policy was able to maintain an accommodating position throughout the recession, by ensuring financial system stability and addressing liquidity concerns swiftly through the active use of regulatory requirements and FX interventions.

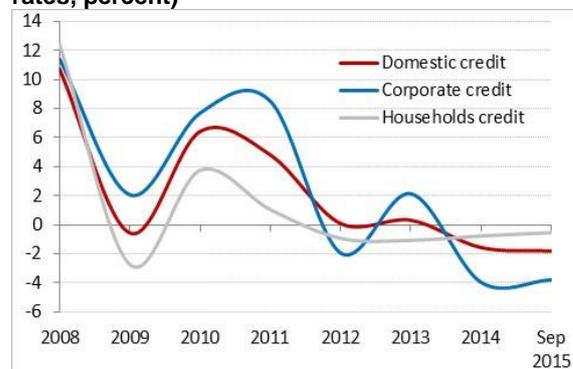
8. **Unlike some European countries, Croatia went through the prolonged recession with a relatively stable banking system.** Much of the credit goes to the macro-prudential measures taken during the pre-crisis years that aimed to prevent overheating led by abundant foreign capital inflow. Croatia's banks had faced comparatively larger reserve requirements rates (including the marginal rate on foreign exchange capital flows) as well as larger requirements on the capital adequacy than its European peers. Although this had to some extent prevented massive credit growth (domestic credits rising by 12 percent annually during the pre-crisis period), still the non-financial corporations debt to GDP ratio grew to 72 percent in 2008 well above average for EU10 and only behind Bulgaria and Estonia (Figure 5). Due to decreased aggregate demand and real estate boom reversal, credit activity came to an abrupt halt at the beginning of 2009. With the exception of 2010, deleveraging trend of domestic sectors persisted until late 2015 (Figure 6).

Figure 5. Corporate Sector Debt, percent of GDP



Source: CNB, EUROSTAT, World Bank staff calculations.

Figure 6. Credit Growth, 2008-15 (annual growth rates, percent)



9. **The deleveraging was accompanied by a worsening loan portfolio quality.** The share of non-performing loans (NPLs) to total loans increased from 4.9 percent in 2008 to 17.1 percent in September 2015 led by the corporate sector NPLs which quadrupled to 31.1 percent in 2015. The household sector NPLs stayed moderate at 12.1 percent. The resolution of NPLs through pre-bankruptcy settlements,

introduced in October 2012, has so far been modest, as companies that entered the procedure had been operating at a loss for an extended period.

10. **Profitability indicators in 2014 reached their lowest level since 1998.** The only exception was 2013 when preparations for the asset quality review and changes to the regulatory framework took place. Due to the growth in NPLs, provisioning surged from 48.7 percent in 2008 to 53 percent in June 2015. In addition to declining loan quality and high level of provisions, bank profitability declined also due to the banks' lending focus on lower-yield government financing. Consequently, return on average asset and return on average equity fell to 0.5 percent and 2.8 percent in 2014, respectively, compared to 1.6 percent and 9.9 percent in 2008.

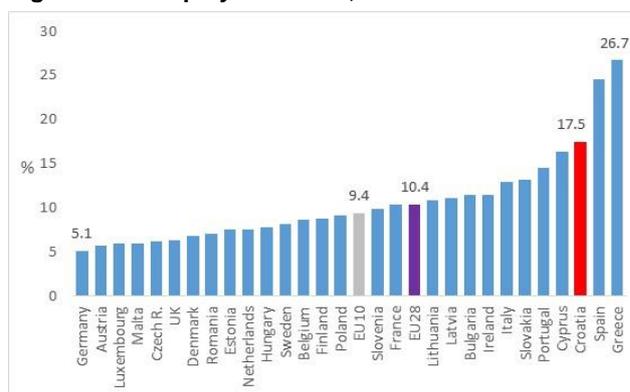
11. **Despite decreasing profitability, the banking sector still demonstrates a satisfactory capacity to absorb potential losses.** The average capital adequacy ratio (CAR) for the system reached 21.8 percent in 2014 (compared to 15.2 percent in 2008), the region's highest. The stress test for the banking sector for 2015 and 2016, conducted by the Croatian National Bank in July 2015, indicates that banks are capable of withstanding highly unlikely but plausible shocks. Under the shock scenario, a deterioration of the corporate portfolio quality would generate increase in total NPLs to 24.5 percent by 2016, with banks' earnings declining further in 2015 and 2016. The capitalization of the system would remain above 15 percent on average. Nevertheless, small banks in particular would show some weaknesses, which indicates the need for special attention from the regulator or would require further banking sector consolidation.

12. **The ongoing consolidation of the banking sector⁹ is expected to proceed further during 2016.** This would be further motivated by the impact of the September 2015 law to convert all CHF-loans to EUR-loans addressing 53,000 debtors (or 4 percent of households). The conversion was assessed to result in bank losses of around 2.1 percent of GDP. Additionally, foreign exchange reserves would decline by EUR1 bn or 8 percent, while the capital adequacy would still remain high at 19.7 percent. The process of applying for conversion (that is voluntary) ended in December 2015 and the resulting impact on the banking system is being assessed.

High Structural Unemployment and Absolute Poverty

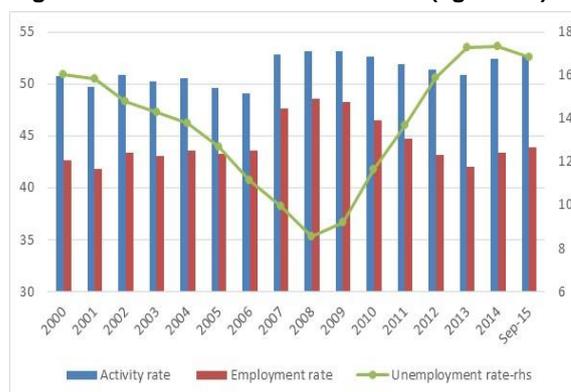
13. **The prolonged crisis led to labor market worsening and a rise in poverty.** After initial resilience due to labor market support measures, employment contracted sharply with a loss of 230,000 (or 12 percent) jobs since the crisis outbreak. Many companies, especially those trading on the local market, struggled to service debts and there have been notable bankruptcies and job destruction, particularly in manufacturing, construction and trade. The survey-based unemployment rate, the principal determinant of poverty, doubled by 2014 from an average 8.6 percent in 2008 (Figure 7). This has been coupled with labor force withdrawals, particularly among youth. At the same time, the share of long-term unemployment in total unemployment has risen to 58.4 percent.

Figure 7. Unemployment Rate, 2014



Source: CBS, World Bank staff calculations.

Figure 8. Labor Market Performance (ages 15+)



Source: Eurostat, World Bank staff calculations.

14. **Six years of recession have undermined poverty reduction gains from 2000s.** Real per capita income in 2014 stood 8 percent below its pre-crisis level, while relative poverty rate increased modestly from 18.9 percent in 2008 to 19.4 percent in 2014 as incomes of the high and middle income households declined more significantly. However, the absolute poverty rate measured at US\$5 at PPP increased more

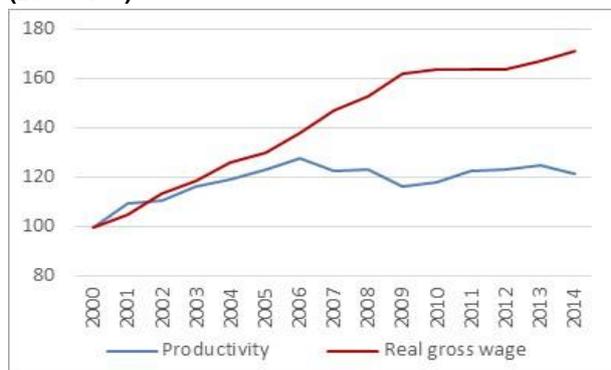
⁹ The number of banks in Croatia shrank from over 50 in 2000 to 28 banks in 2015.

severely from 5.9 in 2009 to 9.8 percent in 2014 and is expected to only moderately decline by 2016. This is a high level for the high-income country that Croatia is classified in according its GDP per capita level.

15. **However, not all of the rise in unemployment is of a temporary/cyclical nature and will not be resolved by the growth recovery.** A high rate of unemployment even during the boom times indicates that the economy has been operating well below its potential. This aspect is important for evaluating the contribution of transitory factors (domestic and external) and of permanent/structural shifts towards more inclusive growth. Labor force participation (15 years+), at 52.4 percent in 2014 (Figure 8), was among the lowest in EU. Low labor force participation (or high inactivity) is a strong determinant of low household income and of vulnerability to poverty in Croatia. This correlation even strengthened after the crisis. Therefore, part of the answer to be sought is how to increase labor participation and job creation.

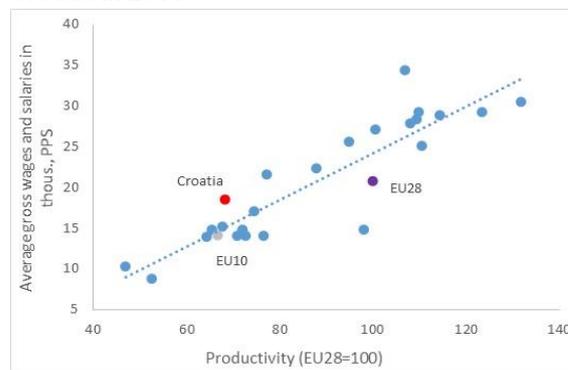
16. **Downward wage rigidity and high relative labor costs explain in part very high job destruction rates Croatia observed since 2008.** Wages grew continuously above productivity and adjusted more slowly to the economic contraction (Figure 9) in Croatia than in other EU countries. This wage rigidity is driven by disproportionately large public sector and its collective wage agreements that prevented a faster adjustment to the 'new normal' levels of productivity. The unit labor costs (ULC) grew substantially until 2010 followed by high job destruction rate. Despite moderation since 2010, the average wage level (in PPS) in 2014 was still misaligned with the productivity performance and vis-a-vis the EU peers (Figure 10).

Figure 9. Real Wages and Value Added Per Worker (2000=100)



Source: CBS, World Bank staff calculations.

Figure 10. Productivity and Wages, EU and Croatia in 2014

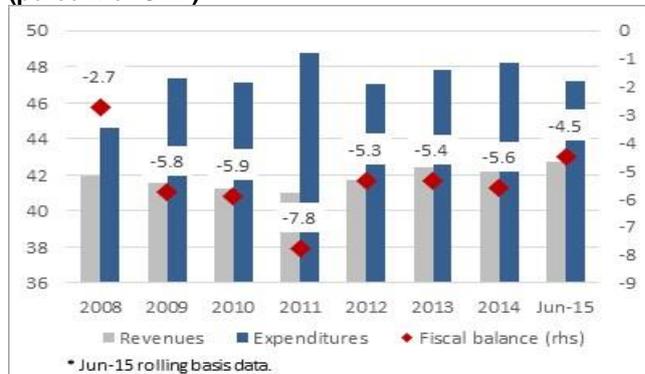


Source: Eurostat, World Bank staff calculations.

Worsening Public Finance Sustainability

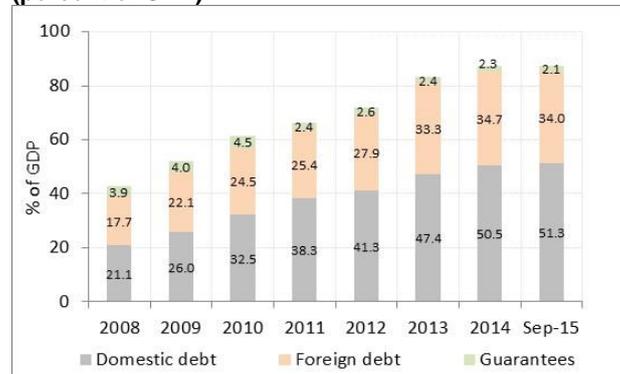
17. **As a heavily euroized economy, there is greater reliance on fiscal policy in the macro policy mix.** Yet, the contribution to macro stability from the fiscal policy was largely missing even before the crisis. Over the most of the period since 2000's fiscal policy was procyclical thus amplifying the boom as well as the recession period that followed. Furthermore, it was misaligned with the monetary policy that acted counter-cyclically thus undermining its stabilization role.

Figure 11. Croatia's Fiscal Performance, 2008-H12015 (percent of GDP)



Source: MoF, EUROSTAT, World Bank staff calculations.

Figure 12. Evolution of Croatia's Public Debt, 2008-15 (percent of GDP)



18. **Since the crisis onset, Croatia has experienced a swift deterioration of deficit and public debt.** Prolonged recession resulted in weakening revenues and rising expenditures, in part because of

automatic stabilizer spending, but in a large part due to assumption of contingent liabilities. The fiscal deficit rose from 2.7 percent of GDP in 2008 to 7.8 percent in 2011, out of which 2.4 percent are paid guarantees for public enterprises. Despite some consolidation efforts in 2012 and entering the Excessive Deficit Procedure (EDP) at the beginning of 2014, fiscal deficit remained elevated at close to 5 percent in 2015 (Figure 11). Public debt, excluding state guarantees, escalated, from less than 30 percent of GDP in 2008 to above 85 percent in September 2015¹⁰. When guarantees were included, total public debt reached 87.4 percent of GDP (Figure 12).

19. **While Croatia's fiscal trends since 2009 have been similar to other EU countries, its public debt and interest payments are now higher than in EU10¹¹ countries.** Comparison with EU10 countries is also indicative of Croatia's rising vulnerabilities. Croatia's public debt rose much faster than that of EU10 from the lower level in 2009 (Figure 13). Reflecting the rising strain public debt is putting on the budget, interest expenditures also increased significantly and much faster than in EU10. In 2014, interest spending in Croatia was at 3.5 percent of GDP, three-fourths of total capital investments, while EU10 countries on average decreased the interest burden compared to year before (Figure 14). It is indicative that even though Croatia has lower public debt than mature EU economies (EU15), its interest payments are higher. This suggests that Croatia's public debt generates a comparatively larger pressure on the budget, squeezing other productive expenditures.

Figure 13. Croatia, EU10 and EU15: General Government Debt, Percent of GDP

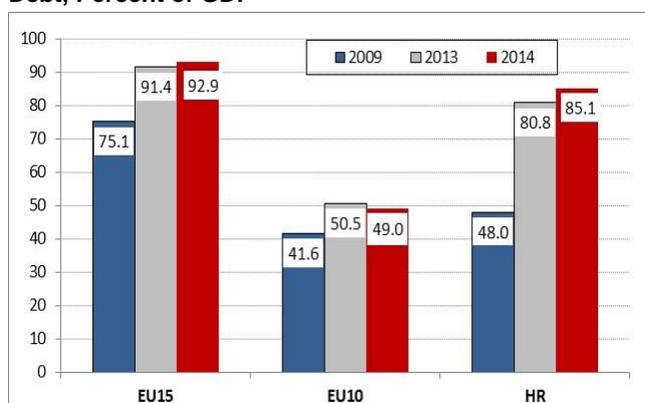
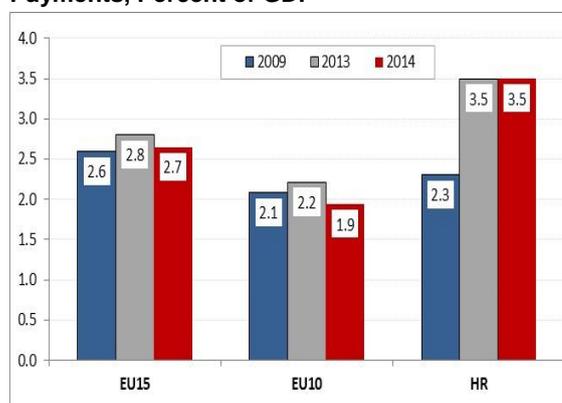


Figure 14. Croatia, EU10 and EU15: Interest Payments, Percent of GDP



Note: General Government debt, as defined by Maastricht criteria, does not include guaranteed debt.

Source: EUROSTAT, MoF, World Bank staff calculations and estimates.

20. **These developments are reflected in Croatia's debt profile and uncomfortably high cost of sovereign borrowing** (Figure 14). In late 2012 and early 2013, rating agencies (Moody's, Standard & Poor's) downgraded Croatia's sovereign debt below the investment grade. Croatia's cost of borrowing rose as sovereign spreads increased from 124 (at end-August 2008) to above 300 basis points in 2013. Also, because of its fiscal position and macro vulnerabilities, Croatia still does not borrow very long-term in sovereign bond markets (mostly 5-10 years). A large share of Croatia's debt is denominated in foreign currency (Box 1) making it highly sensitive to changes in the exchange rate. Medium-term bonds recently carried a large premium over the German bund of about 300 basis points. Even this premium, however, is higher than of some EU countries with significant fiscal challenges, indicating the precariousness of Croatia's sovereign borrowing conditions. Finally, Croatia's sovereign rates clearly and significantly exceed its medium term growth rate under any reasonable scenario, implying unsustainable debt dynamics.

Box 1. Structure of the Croatian General Government Debt

The largest share of public debt is in long-term securities (above 50 percent), followed by loans and T-bills. A significant share of debt is denominated in foreign currency, where Euro-denominated debt accounts for two thirds of the overall debt (Eurobonds, project loans from international financial institutions, and borrowing in the domestic market through syndicated loans denominated in Euro). The share of the debt with fixed interest rate amounts to around 80 percent.

¹⁰ As per the ESA2010 methodology.

¹¹ EU10 represents EU countries from 2004 and 2007 enlargement without Malta and Cyprus. EU15 includes Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden, United Kingdom.

Table 2. Public Debt Structure and Dynamics, Percent of GDP

	2008	2009	2010	2011	2012	2013	2014
General government gross debt	38.9	48.0	57.0	63.7	69.2	80.8	85.1
1. breakdown by residents							
- domestic	21.1	26.0	32.5	38.3	41.3	47.4	50.5
- foreign	17.7	22.1	24.5	25.4	27.9	33.3	34.7
2. breakdown by original maturity							
- short-term (T-bills)	4.4	5.9	6.3	6.2	5.8	7.1	7.6
- long-term	34.6	42.3	50.7	57.6	63.5	73.7	77.6
Change of General government gross debt	1.8	9.2	9.0	6.7	5.5	11.5	4.4
<i>Implicit interest rate</i>	5.6	5.6	5.2	5.4	5.3	5.0	4.3
Contributions to change of general government gross debt:							
Primary balance	0.8	3.5	3.4	4.7	2.0	1.9	2.1
Snowball effect	-0.8	4.3	3.0	2.3	3.8	3.7	3.8
Interest payments	1.9	2.3	2.5	3.0	3.4	3.5	3.5
Growth of nominal GDP	-2.7	2.0	0.4	-0.8	0.4	0.2	0.3
Stock-flow adjustment	1.8	1.4	2.6	-0.3	-0.2	6.0	-1.5
Guaranteed debt	3.9	4.0	4.5	2.4	2.6	2.4	2.3
Public debt (including guaranteed debt)	42.8	52.0	61.5	66.1	71.8	83.2	87.5

Source: MoF, CNB, CROSTAT, World Bank staff calculations and estimates.

21. **Disentangling the fiscal accounts shows that only a portion of the fiscal deterioration is caused by the crisis, while large part of it is being of a structural nature** (Table 3). This means that even if growth rates return to more 'normal' long-run averages, fiscal consolidation will still be required. The structural deficit remains high, on average close to 4 percent over the last five years. Therefore, out of the average general government deficit of 6 percent in the 2010-15 period, 60 percent are due to structural fiscal problems. This is important to recognize, as remedies to be applied are those with longer-term effect than those that would cure the short-term crisis impact.

Table 3. Croatia: Disentangling Crisis from Structural Impact

(in percent of GDP)	2011	2012	2013	2014	2015e
Real GDP, %	-0.3	-2.2	-1.1	-0.4	1.7
Potential GDP, %	1.0	1.1	3.0	3.9	4.3
Output gap, % of potential GDP	-1.3	-3.3	-4.1	-4.3	-2.6
General government balance, % GDP	-7.8	-5.3	-5.4	-5.6	-4.7
Primary balance, % GDP	-4.7	-2.0	-1.9	-2.1	-1.1
One-off and other temporary measures <i>o/w debt assumption and repayment</i>	-2.7	-0.3	-0.2	-0.3	-0.2
Government gross fixed capital formation, % of GDP	3.5	3.5	3.7	3.7	3.7
Cyclically-adjusted balance	-6.7	-4.1	-3.9	-4.3	-3.5
Cyclically-adjusted primary balance	-3.7	-0.7	-0.4	-0.8	0.1
Structural balance*	-4.0	-3.8	-3.8	-4.0	-3.3
Structural primary balance*	-1.0	-0.4	-0.3	-0.5	0.3

*Cyclically-adjusted balance excluding one-off and other temporary measures.

Source: EC, Eurostat, WB staff estimates.

22. **Under the EDP, the government committed to bring down the fiscal deficit to the Maastricht criterion by 2016.** As an EU Member State with excessive deficit, Croatia was put under the EDP. The EDP for Croatia laid out a three-year fiscal consolidation program that would bring fiscal deficit levels down to Maastricht threshold by 2016. A credible and sustainable adjustment path required Croatia to reach a headline general government target deficit of 4.6 percent of GDP in 2014, 3.5 percent of GDP in 2015 and 2.7 percent of GDP in 2016. This was not met. Although, the EC decided not to activate the corrective action procedure against Croatia in June 2015, it pointed out that the 'level of ambition' of the Croatian authorities, 'remains below expectations in a number of areas', and gave Croatia six country-specific recommendations (CSRs) to meet in 2015 and 2016:

- (i) ensure the permanent correction of the excessive deficit by 2016, including by introducing the reformed property tax;
- (ii) discourage early retirement by increasing penalties and remove fiscal risks in the health system;

- (iii) adjust wages to productivity, including by pursuing reform of social benefits and insurance;
- (iv) reduce fragmentation and overlap between the central and local authorities, introduce a new model of decentralization and rationalize state agencies, and improve State Owned Enterprises (SOEs) governance;
- (v) reduce para-fiscal fees, remove excessive administrative barriers for service providers, increase efficiency and quality of the judiciary; and
- (vi) strengthen the pre-settlement and bankruptcy framework and introduce personal bankruptcy procedures.

23. **However, the progress has been slow.** By December 2015, progress had been made only on a couple of CSRs, including improvement of the SOEs governance framework, reduction of para-fiscal fees and strengthening of corporate and personal bankruptcy frameworks. Also, the Government accepted only one set of recommendations from the Spending Review, which aimed to rationalize the costs of 187 state agencies (saving about HRK1 billion or 0.3 percent of GDP a year). Except agencies, a broad-based spending review process of budget expenditures was looking for a 10-percent spending reduction in public wages, health, tax expenditures and subsidies.

24. **The Economic and Fiscal Policy Guidelines for 2016-18 proposed a delay in achieving the EDP targets to 2017.** The revenue side measures included tax base broadening, strengthening the efficiency of the tax inspection, and withdrawal of SOEs profits. On the expenditure side, the biggest savings is expected from lower material expenses, the wage bill and the accelerated SOEs' restructuring. The estimated structural effort amounted to 1.5 percent of GDP in 2015 and 1.2 percent in 2016. As a result, fiscal deficit is projected at 4.7 percent of GDP in 2015, 3.9 percent in 2016, 2.7 percent in 2017 and 2.4 percent in 2018 (Table 4). Public debt is expected to reach 89.8 percent of GDP in 2015 and stabilize only in 2018.

Table 4. Fiscal Developments and Prospects 2011-2017

Percent of GDP	2011	2012	2013	2014	2015 estimate	2016 plan	2017 plan
Total Revenue	41.0	41.7	42.5	42.6	42.4	41.8	41.3
Direct Taxes	17.8	17.6	17.6	17.9	17.6	17.4	17.4
Indirect Taxes	17.5	18.3	19.0	18.7	18.8	18.2	17.7
Nontax Receipts	5.4	5.0	5.7	5.7	5.7	5.9	5.8
Capital revenues	0.4	0.8	0.2	0.3	0.3	0.3	0.3
Expenditures and Net Lending	48.8	47.1	47.8	48.2	47.1	45.7	44.0
Consumption	7.5	7.3	7.8	8.0	7.6	7.1	6.7
Wage bill	12.4	12.2	12.1	11.8	11.4	10.9	10.4
Interest	3.0	3.4	3.5	3.5	3.6	3.5	3.5
Current Transfers	16.7	17.1	17.5	17.9	17.7	17.3	16.7
Subsidies	2.4	2.2	2.1	2.0	1.8	1.8	1.7
Capital expenditures	6.7	4.8	4.9	5.0	5.0	5.2	5.0
Overall balance	-7.8	-5.3	-5.4	-5.6	-4.7	-3.9	-2.7
Primary balance	-4.7	-2.0	-1.9	-2.1	-1.1	-0.4	0.8
External financing	6.9	5.8	9.4	5.2	3.1	3.1	1.9
Domestic financing	0.9	-0.4	-4.0	0.7	1.8	1.0	0.9
o/w privatization	0.1	0.0	0.1	0.3	0.2	0.2	0.2

Note: General Government ESA2010, 2016-2017 data show the July 2015 government MTEF.

Source: MoF, EUROSTAT, World Bank staff estimates.

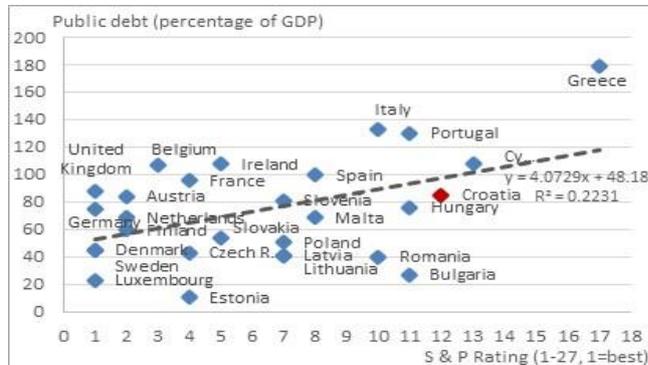
Risks and Debt Sustainability Analysis

25. **Risks of delayed adjustment as well as implementation risks are high.** Unless Croatia implements a sustained and sufficient medium-term fiscal adjustment, fiscal and macroeconomic risks could be escalated:

- First, the rise of the fiscal deficit and public debt would likely result in a further downgrade of Croatia's sovereign ratings, raising its relative cost of external borrowing, and squeezing other productive expenditures in the budget. Croatia's rating is already notably worse than that of several EU countries with significant fiscal problems (e.g., Italy, Spain, and Portugal) even if its public debt is lower (Figure 15).
- Second, high sovereign costs adversely affect private sector borrowing costs, stifling investments and adding a drag to the overall economic recovery.

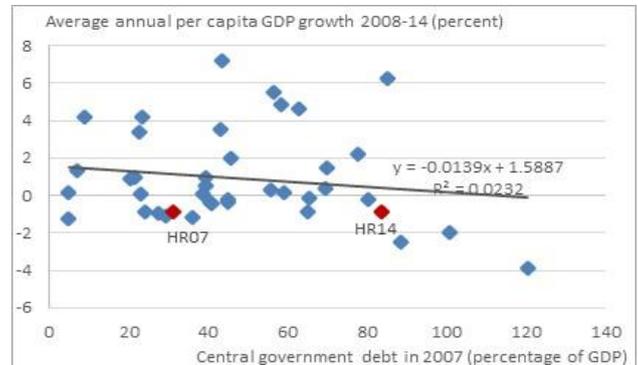
- Third, unchecked increase in public debt resulted in breaching of the 60 percent debt ceiling in Croatia's budget law as well as the Maastricht debt ceiling, creating a debt "overhang" that constitutes a drag on growth. Research¹² has shown that levels of debt that Croatia is already facing are consistent with particularly weak growth performance and rising fiscal and debt risks, especially after the global crisis (Figure 16).

Figure 15. Public Debt and Sovereign Ratings, 2014



Source: Standard & Poor's Ratings Services, Eurostat, World Bank staff estimates.

Figure 16. Public Debt and Economic Growth, 2008-14



Source: Eurostat, World Bank staff calculations.

Debt Sustainability Analysis and Required Fiscal Adjustment

26. **To reverse adverse debt dynamics, Croatia will need to implement more ambitious, sustained fiscal adjustment over the medium term.** With the current level of debt (at above 85 percent of GDP), the assumed 2016 growth, inflation and interest rates on sovereign debt, debt-stabilizing fiscal balance should be 1.8 percent of GDP. Or, specifically to prevent further debt growth, the government will need to turn the 1.1 percent of GDP primary deficit in 2015 into a surplus of 2 percent of GDP. This adjustment is equal to a reduction in primary expenditures and/or rise in revenues of 3.1 percentage points of GDP (Table 5). While the adjustment is urgent not to deepen vulnerabilities and risks of much higher borrowing costs, in a lower potential growth environment, an adequate balance needs to be found between credible consolidation and a burden that an over-excessive consolidation may have on depressing growth and growth expectations. The burden of adjustment should largely fall on unproductive public expenditures.

27. **There are additional possible risks and shocks that could derail the needed adjustments.** Fiscal prudence would consider the implications of different growth scenarios, interest rates and inflation. Were real growth to be a meager 0.5 percent as opposed to 1.7 percent under the baseline scenario, or were inflation to be zero, or were interest rates to be 50 basis points higher, the debt-stabilizing primary balance would be substantially tighter, between 2.4 and 3 percent of GDP rather than the 2 percent deficit calculated under the baseline scenario (Table 5). These deviations from the baseline scenario are reasonable and the authorities would be well advised to consider their implications for elaborating the fiscal stance.

28. **Even with the more ambitious fiscal consolidation strategy than the one presented in the government guidelines in 2015, the debt and interest rate levels will require constant vigilance to deepen and sustain the gains of adjustment.** In 2016, debt levels will remain at close to thrice the level before the crisis. Interest spending on public debt at somewhat above 4 percent will still exceed the growth of nominal output, while borrowing requirements will remain large at around 14 percent of GDP over the medium term.

¹² Baldacci, Gupta et al., 2010.

Table 5. Debt-Stabilizing Balance

Real interest rate less real GDP growth rate	Real GDP growth	Real Interest Rate	Nominal Interest Rate	Inflation rate	Primary Balance	Fiscal Balance
		(In percent)			(In percent of GDP)	
2015 Outcome						
2.9	1.7	4.4	4.4	0	-1.1	-4.7
Baseline Scenario						
2.3	1.7	4.0	4.5	0.5	2.0	-1.8
Growth Scenarios						
3.5	0.5	4.0	4.5	0.5	3.0	-0.8
3.0	1.0	4.0	4.5	0.5	2.6	-1.2
2.0	2.0	4.0	4.5	0.5	1.7	-2.1
Interest Rate Scenarios						
2.8	1.7	4.5	5.0	0.5	2.4	-1.8
3.8	1.7	5.5	6.0	0.5	3.3	-1.8
5.8	1.7	7.5	8.0	0.5	5.0	-1.8
Inflation Scenarios						
2.8	1.7	4.5	4.5	0.0	2.4	-1.4
1.8	1.7	3.5	4.5	1.0	1.6	-2.2
0.8	1.7	2.5	4.5	2.0	0.8	-3.1

Source: MoF, Eurostat, CROSTAT, staff calculation

Proposed Fiscal Adjustment Scenario

29. **The good news is that current spending patterns offer significant scope for rationalization.** At 48.2 percent of GDP in 2014, Croatia's spending level was 6.6 percentage points of GDP higher than in its EU10 peers (Table 6). At the same time, total revenues were 3.7 percentage points higher than in EU10.

Table 6. General Government Expenditures by Economic Classification, Percent of GDP

	EU15		EU10		Croatia	
	2009-13	2014	2009-13	2014	2009-13	2014
Total Revenues	44.5	45.6	38.1	38.9	41.6	42.6
Direct taxes	12.8	13.2	6.6	6.7	6.4	6.1
Indirect taxes	12.8	13.4	13.1	13.2	18.0	18.7
Social contributions	13.6	13.7	11.9	12.3	11.7	11.8
Sales	3.1	3.2	2.8	2.8	3.3	3.7
Other current revenue	2.2	2.2	3.6	3.9	2.2	2.3
Total Expenditures	49.6	48.7	42.9	41.6	47.6	48.2
Current Expenditures	44.8	44.5	37.1	36.0	41.8	43.2
Consumption	6.5	6.4	6.1	6.1	7.4	8.0
Wage bill	10.7	10.3	9.8	9.6	12.2	11.8
Interest	2.8	2.7	2.2	1.9	2.9	3.5
Subsidies	1.3	1.4	1.1	0.9	2.3	2.0
Social benefits	21.2	21.5	15.9	15.4	16.0	16.6
Current transfers	2.4	2.3	2.1	2.1	1.0	1.3
Capital Expenditures	4.8	4.1	5.8	5.5	5.8	5.0
Capital transfers	1.7	1.4	1.1	1.0	1.9	1.3
Investments	3.2	2.7	4.7	4.5	3.9	3.7
Deficit	-5.1	-3.0	-4.8	-2.7	-6.0	-5.6
Gross GG Debt	84.4	92.9	46.9	49.0	63.7	85.1

Note: Data reflect ESA2010 harmonization and are still preliminary.

Source: MoF, Eurostat, CROSTAT, WB staff calculation.

30. **Public spending is particularly excessive in areas such as subsidies, public wages, and consumption:**

- Overall subsidies, mostly to railways, shipyards, and agriculture, at 2 percent of GDP are double the EU15 and EU10 spending.

- The public sector wage bill at 11.8 percent of GDP is 2.2 percentage points of GDP higher than in EU10 or 1.5 percentage point of GDP higher than in EU15.
- At 8 percent of GDP that Croatia allocates to current public sector consumption, there is at least 1-2 percentage points' space for further rationalization of these costs. Average spending on operations and maintenance in Croatia is higher than the levels observed in the comparator countries which may also reflect inefficient consumption of inputs (e.g., energy consumption, space renting) or higher unit prices resulting from insufficiently competitive public procurement or outsourcing to high operating costs SOE subsidiaries (rail and motorway maintenance).

31. Looking at the functional breakdown of spending, five distinct differences to the comparator groups prevail (Table 7):

- Spending on general administration services is 1.9-3 percentage points of GDP higher in Croatia than in EU15 and EU10, respectively.
- Spending on public order and safety is at the same level as in EU10, but 0.4 percentage points of GDP higher than in EU15, also reflecting higher spending on judiciary.
- Spending on economic affairs is 2-1 percentage points of GDP higher than in comparator groups, suggesting high subsidization of economic sectors.
- Health spending is 1.6 percentage points of GDP above the EU10, but below (0.5 percentage points) the EU15, partly reflecting a different basic insurance coverage.
- In parallel, spending on environment protection is half of the comparators' spending, indicating an area of future spending pressures to align environmental standards with those of the EU.
- Education spending mostly stayed on par with the comparators in 2013.
- Social protection, although much lower than in EU15, is on par with EU10. Croatia's social welfare system also provides substantial benefits to war veterans', a type of spending not found in other comparator countries.

32. In some of the above areas, Croatia will have to look for rationalization options; however, it would also need to apply an expenditure switching strategy to support recovery. The fiscal adjustment will need to be accompanied by spending reallocation to those projects that could be financed by EU grant funds (with substitution sometimes possible, probably in some agriculture and SME investment subsidy schemes) as well as privatization, both of which would lead to a faster decline in public debt.

33. Moreover, Croatia is rated comparatively low with respect to the effectiveness of its administration (Figure 17).

World Bank governance indicators point to general weaknesses of Croatian public administration in particular in terms of corruption, the rule of law, regulatory quality, and government effectiveness. Croatia lags behind the EU15 and EU10 by around 20 and 6 percentage points, respectively, on the Governance Indicators ranking. The World Economic Forum's Competitiveness Report 2015-2016 ranked inefficient public administration as the top barrier for doing business in Croatia. Although improvement has been observed in the quality of enforcing contracts and court decisions, simplification of distress procedures, as well as the functioning of the judiciary in general, similarly show the degree to which Croatia lags other EU countries with respect to selected administrative/judicial processes. This happens while the amount of public resources allocated to the sector that is above EU10 and EU15 countries.

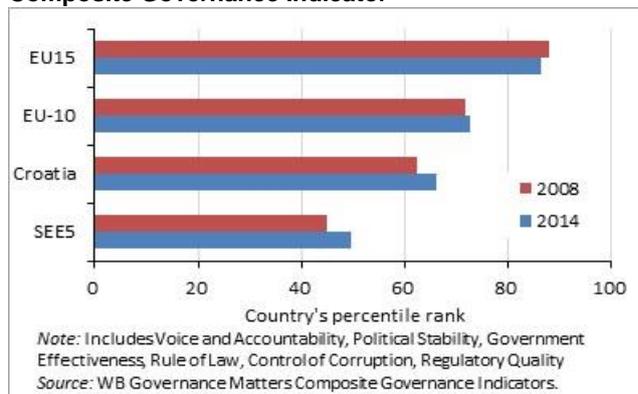
Table 7. General Government Expenditures by Function (COFOG) in 2013, Percent of GDP

	EU15	EU10	Croatia
Total	49.0	41.6	47.7
General public services	6.9	5.8	8.8
Defense	1.4	1.2	1.4
Public order and safety	1.8	2.2	2.2
Economic affairs	4.2	5.2	6.2
Transport	1.9	3.0	3.2
R&D Economic affairs	0.4	0.2	0.4
Environment protection	0.8	0.8	0.4
Housing and community	0.7	0.8	1.0
Health	7.3	5.2	6.8
Recreation, culture and religion	1.0	1.2	1.5
Education	5.0	4.8	5.1
Social protection	19.9	14.5	14.4

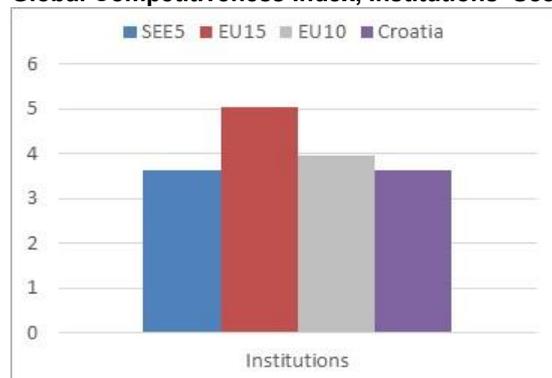
Note: Difference in total expenditure as per Table 6 due to rounding.

Source: Eurostat, CROSTAT, WB staff calculation.

Figure 17. Croatia's Administration Effectiveness Composite Governance Indicator



Global Competitiveness Index, Institutions' Score



Note: SEE5 refers to South-East European countries: Serbia, Montenegro, FYRoM, Albania and BiH.

Source: World Bank (<http://data.worldbank.org>) and the World Economic Forum (<http://www.weforum.org>).

Options for Ensuring Macro-Fiscal Sustainability

34. Croatia's fiscal vulnerabilities pose substantial risks for the country's potential growth.

There is a case for sustained medium-term adjustment to substantially reduce those risks, putting its public debt on a downward trajectory. However, addressing this would not be an easy task given the intertwined challenges Croatia is facing today: (i) to bring down the fiscal deficit and reverse adverse public debt dynamics; and (ii) create fiscal space for the absorption of large EU funds, preparing the ground for recovery and sustainable long-term growth.

35. To achieve debt sustainability, the government will need to turn a 1.8 percent primary deficit in 2015 into a surplus. This will require an increase in revenues and/or a reduction in primary expenditures of 3.1 percentage points of GDP. While the adjustment is urgent, so as not to deepen vulnerabilities and risks of much higher borrowing costs, in a depressed environment, an adequate balance needs to be found between credible consolidation and the potential impact this may have on depressing growth and growth expectations.

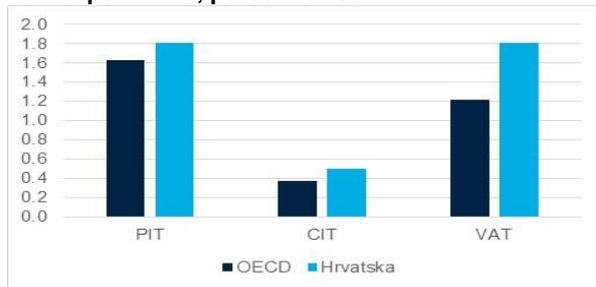
36. The consequences of not addressing twin challenges might be detrimental to Croatia's short and long-term growth perspectives:

(i) By not insisting on more forceful absorption of EU funds, Croatia may face a possible loss of EU funds and more importantly an opportunity to finance its growth through grants thus helping both its growth and fiscal consolidation objectives. However, Croatia will need to create fiscal space averaging up to 1.8 percent of GDP a year (for transfers to the EU budget, as well as pre- and co-financing of EU projects) in 2014-2020 to support EU funds absorption. This can be achieved through consolidation of spending in other areas funded through the national budget means, combined with substitution of budget funding with EU financing (where allowed).

(ii) By not reducing fiscal vulnerabilities, the country may face further deterioration in investors' sentiment resulting in higher financing costs and/or lack of access to affordable long-term borrowing. This would deepen the recessionary trends and require much more urgent and deeper fiscal consolidation actions. Croatia's spending and revenue pattern suggest that a sizeable fiscal adjustment of 4-5 percentage points of GDP could be implemented over the medium term. While revenue measures could raise additional revenue of 2 percent of GDP through reducing exemptions (Figure 18), introducing a modern property taxation, as well as strengthening tax collection, more fiscal space can be created on the spending side, in particular of the wage bill, subsidies, procurement, as well as improving effectiveness and equity of social spending.

37. Several countries in the EU have gone through fiscal consolidation episodes in the recent history. When corrected for the cycle, over the last four years Greece achieved an annual rate of primary deficit reduction of 4.1 percentage points of GDP on average (2009-2013), the highest in the developed world in recent years. Latvia had a similar experience over the same period. While one can argue that both countries experienced a large social cost due to such rapid adjustment, the required adjustment in Croatia would be similar to the consolidation episodes of Sweden, UK or Ireland. While such an adjustment is urgent, it is also achievable so Croatia can strengthen the hopes for future prosperity.

Figure 18. Examples of Cost Savings
Tax expenditure, percent of GDP



Source: OECD

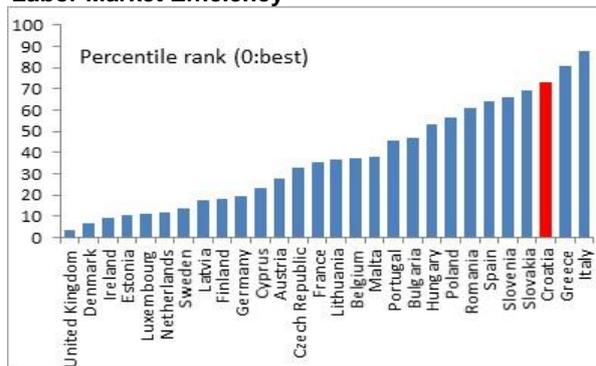
Eliminating Elite Capture From Social Programs

Non-contributory programs and policies	SA	% of GDP, 2012	Elite capture % Benefits to Q4-Q5	Potential savings (% of GDP)
Child tax allowance		1.0	54%	0.5
Child allowance		0.5	12%	0.1
Support allowance		0.2	9%	0.02
Other programs		2.2	11%	0.23
Total		3.8		0.85

Source: CROSTAT, Household Budget Survey, MOF.

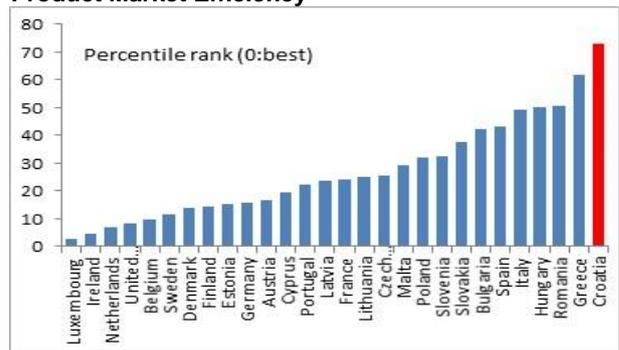
38. **Fiscal consolidation process would be less painful if the economy is in an upturn.** Without accelerating structural reforms, especially in the area of investment climate, and public sector efficiency, Croatia will face further stifled competitiveness and slow prospects for recovery of growth and jobs. Croatia's labor markets are still among the most rigid in the EU (Figure 19) and this is a large part of the reason behind high and chronic unemployment¹³. In the product markets, there are number of barriers to investors (in particular in the network and business services) that prevent stronger competition and thus increase investors' interest. Although Doing Business indicators rank Croatia 40th among 189 countries, a country that achieved so much and entered the EU still lags behind EU peers. Broader competitiveness indicators provide similar results (Figure 19). Without additional improvements of the business environment, these weaknesses are also likely to undermine the potential benefits of European financial integration, in terms of lower interest rates and greater, more stable and productive capital inflows.

Figure 19. Croatia's Competitiveness Indicators
Labor Market Efficiency



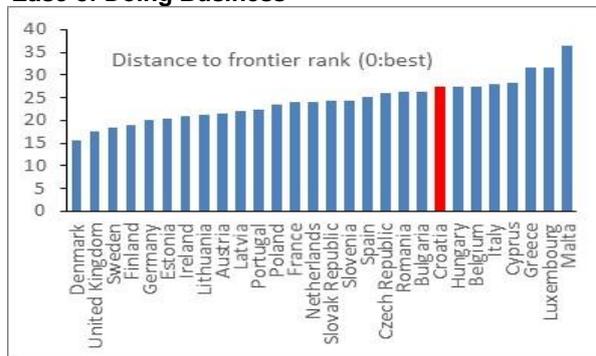
Source: World Economic Forum Global Competitiveness Index (2015-16).

Product Market Efficiency



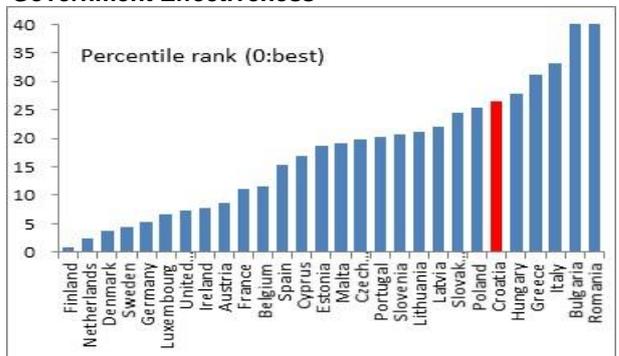
Source: World Economic Forum Global Competitiveness Index (2015-16).

Ease of Doing Business



Source: Doing Business (2015).

Government Effectiveness



Source: Worldwide Governance Indicators (2014).

¹³ World Bank (2011), "Employment Protection Legislation and Labor Market Outcomes: Theory, Evidence and Lessons for Croatia".

Fostering Growth and Competitiveness to Create Jobs

Export Performance

39. **Croatia's export sector has displayed an uninspiring performance over the last decade.** This is evident along three key dimensions of competitiveness: growth and shares (intensive margin), diversification (extensive margin) and quality and sophistication (quality margin).¹⁴

40. **In terms of *intensive margin*, export growth in Croatia has been virtually stagnant, while export market share changes have even declined.** Data shows that Croatian exports grew by 4.1 percent on average per year during the 2006-2014 period. Croatia exhibited the slowest export growth against double-digit growth in Poland and the Slovak Republic, and stronger growth in Hungary and Slovenia (Table 8). At the same time, Croatia's export market share—a common way to measure export competitiveness—showed a declining performance (at -1.4) over the period (Figure 20). This negative performance was mainly driven by pull factors, reflecting negative market and sector composition, a common factor to all its peers. Push factors - describing a country's own supply-side capacity to expand export market shares (through volume, prices and value) – helped to offset slightly the negative performance. “Push” factors were positive in all peer countries (particularly in Poland and Slovakia).

Table 8. Export Market Share and Growth Decomposition, 2006Q1-2014Q3

	Export growth	Export market share change	Pull factors		Push factors		
			Geographical	Sectoral	Values (Overall)	Price	Volumes
Croatia	5.4	-1.4	-1.6	-0.4	0.6	-0.2	0.8
Hungary	6.8	0.1	-0.4	-1.2	1.7	0.6	1.1
Poland	10.7	3.9	-0.7	-0.9	5.5	0.0	5.5
Slovakia	10.7	4.2	-0.6	-0.9	5.6	0.0	5.6
Slovenia	8.1	1.1	-0.8	-0.9	2.8	-0.3	3.0

Source: Export Competitiveness Database.

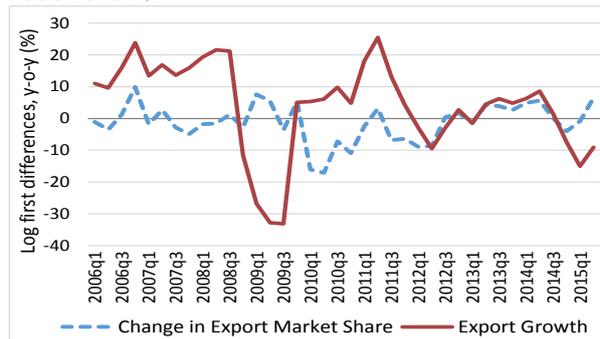
Note: Indicators are expressed in log-difference form, which allows for additivity across indicators.

41. **When it comes to *extensive margin*, Croatia's export markets were more diversified in 2014 than a decade earlier, mainly due to a shift away from Western European markets and towards emerging and fast growth regional markets (such as the EU12, Middle East and Russia).** Data suggests that European countries remained Croatia's main export destination (Figure 21), showing almost the same share of about 86 percent of total exports over 2002–14. However, the market composition within Europe changed: while the traditional block of the 15 older EU members (EU15) is still important, their export share fell from 53 percent to 42 percent, explained by increased market saturation and severe export competition. By contrast, the export share to new EU12 member countries increased from 13 percent to 22 percent. Other faster growing markets - as non-EU countries in Europe, Middle East and North Africa and NAFTA – also presented a growing export share.

42. **Meanwhile, Croatia's performance became more concentrated in terms of product scope, and this sectoral specialization has been unfavorable as the growth in these sectors is subdued.** Seven sectors covered about two-thirds of Croatia's export basket in 2013. They were machines (19 percent), mineral products (14 percent), chemicals (10 percent), metals (8.5 percent), foodstuffs (7.1 percent), transportation (6.3 percent) and textiles (5.7 percent). Out of the 3407 products at the HS-6 digit level that Croatia exported in 2012, only four were winners in growing sectors. These products are “medicaments of other antibiotics, for retail sale”, “cane of beet sugar in solid form, n.e.s.”, “articles of leather or of composition leather”, and “revolvers and pistols”. Behind each of these niche market-leading products is a successful domestic firm or one that has consolidated following infusion of foreign capital.

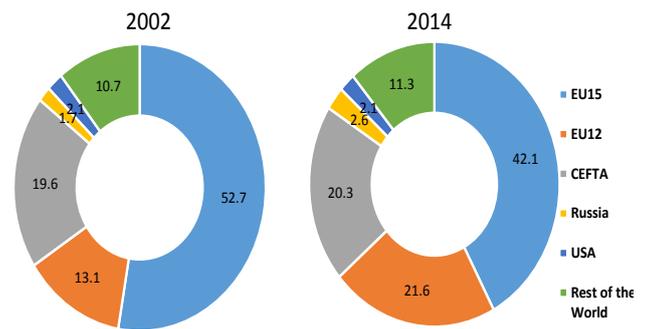
¹⁴ This section summarizes the main findings of the 2014 technical note “Croatia's Trade: Performance, Competitiveness & Potential” authored by Daria Taglioni, Michael Ferrantino, and Swarnim Waglé.

Figure 20. Export Growth and Change in Market Share, 2006-2015 Q2



Source: Export Competitiveness Database based on Gaulier et al. (2013).

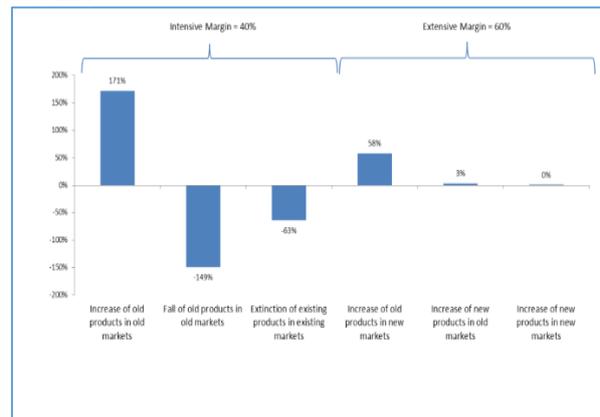
Figure 21. Export Market Distribution, Croatia, 2002 vs. 2014



Source: CROSTAT.

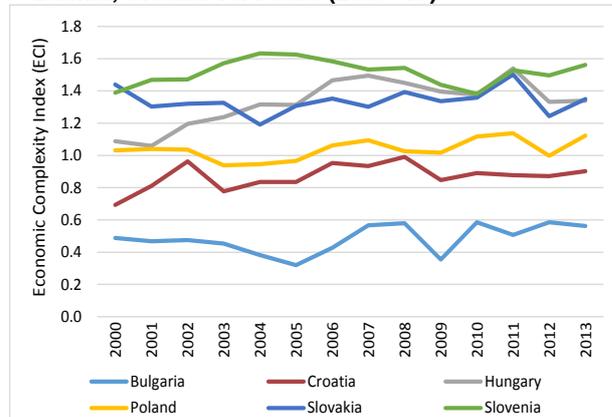
43. **The above findings suggest that Croatia is in a transition phase, specializing in existing markets but showing little growth in new products and markets.** The contribution of old products in old markets to export growth is higher than the contribution of old products in new markets, new products in old markets, and, vitally, new products in new markets (Figure 22).

Figure 22. Intensive and Extensive Margin of Trade, Croatia



Source: Export Competitiveness Database based on Gaulier et al. (2013).

Figure 23. Economic Complexity of the Export Basket, Croatia vs. Peers (2000–13)



Source: The Observatory of Economic Complexity.

44. **In terms of quality margin, Croatia's export economic complexity has been on the rise but it still lags behind its regional peers.** Data shows that although Croatia's Economic Complexity Index increased from 0.7 in 2000 to 0.9 in 2013, it has yet to match those of peers like Hungary, Poland, the Slovak Republic, and Slovenia (Figure 23). Looking at individual products it emerges that the main reason for this result is compositional: a large proportion of the main exports are goods that, by global standards, are not very complex. Table 9 lists the country's top 20 exports at the Standard International Trade Classification (SITC) 4-digit level for 2012–13.¹⁵ None of Croatia's most important 15 export sectors rank in the top decile by economic complexity.

¹⁵ The stage of processing in this SITC classification is easier to identify than that in an HS classification, as the latter emphasizes the description of the material properties of goods. In most cases, they reflect finely grouped industries rather than individual products.

Table 9. Croatia's Top Exports and Their Product Complexity Rank

	SITC	Export	Share in 2012-13	Complexity rank
1	9310	Unclassified Transactions	11.00%	552
2	5417	Medicaments	4.00%	277
3	7932	Ships and Boats	3.85%	278
4	2483	Non-Coniferous Worked Wood	2.40%	671
5	7711	Electrical Transformers	1.95%	257
6	6842	Processed Aluminium	1.80%	347
7	8211	Chairs and Couches	1.80%	312
8	5621	Nitrogenous Fertilizers	1.75%	625
9	9710	Gold	1.50%	745
10	980	Miscellaneous Edibles	1.45%	525
11	7731	Electric Wire	1.40%	427
12	2820	Iron Waste	1.35%	528
13	3510	Electric Current	1.32%	480
14	8510	Footwear	1.25%	551
15	3414	Petroleum Gases	1.20%	719
16	6612	Cement	1.10%	649
17	612	Refined Sugars	1.10%	641
18	7284	Machinery for Specialized Industries	1.09%	10
19	7721	Circuit Breakers and Panels	1.05%	201
20	3413	Liquified Petroleum Gases	0.97%	757

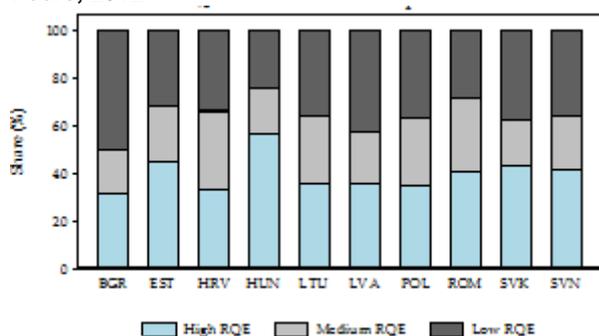
Source: The Observatory of Economic Complexity.

Note: Products ranked on complexity from 1 to 762 (1 being the most complex).

45. In addition, Croatian manufacturing exports are still dominated by products where price competition is more important than quality competition, which suggests that Croatia has in fact much catching up to do. Croatia's share of quality-dominated (high relative quality elasticity -RQE) export industries is less than the share dominated by price competition (low RQE) (Figure 24).¹⁶

46. When it comes to service exports, Croatia presents an unexpected feature with value of service exports outperforming goods exports. However, the sophistication of these service export is behind that of its peers. While similar countries export a greater value of goods than the value of services, Croatia's services exports are higher than its goods exports (Table 10). However, despite services exports showing greater sophistication, the increasing share of tourism reduced the share of more sophisticated services, such as transport and other commercial services.

Figure 24. Relative Quality Elasticity, Croatia vs. Peers, 2012



Source: Author's regrouping of UN Comtrade data based on Aiginger (2001).

Table 10. Exports of Goods and Services, Croatia and Regional Peers, 2014 (US\$ billion)

Country	Goods	Services	Service/goods ratio (%)
Croatia	13.0	13.7	105.5
Slovak Republic	83.1	9.1	10.9
Slovenia	30.5	7.4	24.2
Serbia	14.1	5.0	35.7

Source: IMF BoP statistics.

47. Despite all these uninspiring performances – on both goods and service exports fronts – there are also some promising signs for the country's export competitiveness, as a fringe of small dynamic exporters is emerging in sophisticated niche products. The Product Space analysis of Croatia suggests that several exports, marginal at present, are close to existing competencies and

¹⁶ Exports are classified as belonging to industries that have high, medium, and low relative quality elasticity (RQE). Industries with high RQE compete on quality, whereas those with low RQE compete on price. More specifically, quality-elastic industries are those where the positive difference between export and import unit values leads to a trade surplus, that is, a positive difference between export and import quantity; low relative unit value, in contrast, leads to a trade deficit. The intuition is that in quality-elastic industries, high price does not necessarily lead to low quantities sold because those products embody intangible traits like design, service, and reliability. Price-elastic industries are those where low costs lead to more exports and higher prices lead to fewer exports.

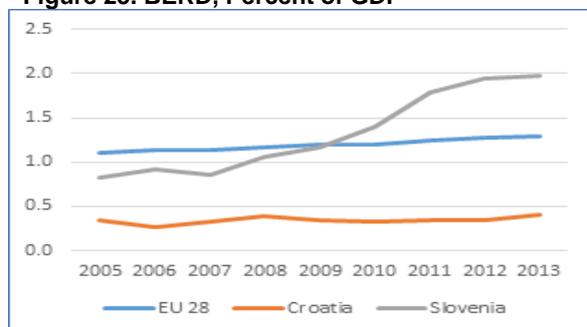
desirable for their industrial complexity. Moreover, many of these emerging and marginal exports are also embedded in dense networks of products, which augurs well for future growth. Inferring from existing capabilities, Croatia is poised to do well in industrial and electronic manufacturing, processed food, and beverages.

Innovation

48. **Lagging export performance in Croatia reflects weak economic renewal process which is evidenced by a modest innovation performance.**¹⁷ Innovation performance relative to the EU reached a peak of 59 percent in 2009 and dropped to less than 56 percent in 2013, as measured by the EU Innovation Scoreboard. Croatia is performing below the EU average in most dimensions (except human resources due to above average performance in new doctorate graduates and youth with upper secondary level education). Overall, Croatia has shown a lackluster performance in business research and innovation. Statistics point to a low level of business R&D (BERD) as percentage of GDP, compared with the average of the EU28 region. Croatia BERD has continually underperformed both the EU28 average and Slovenia (Figure 25), a country at a comparable income level.

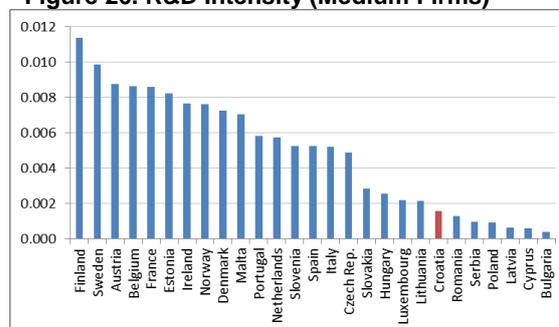
49. **In fact, innovative SMEs are still an exception in the Croatian entrepreneurial landscape despite a generous tax break system and a reasonable infrastructure to support business R&D.** Lack of innovation within SMEs is a main explanatory factor of the disappointing aggregate features. The R&D intensity of small firms in Croatia is at 0.34 percent (16th place in the EU) and the one of medium-sized firms stands at a substandard 0.16 percent (21st place in the EU) (Figure 26).¹⁸ In fact, business investment in R&D in Croatia is concentrated within a few multinational companies, which appear to also have a relatively high research intensity (1.98 percent).¹⁹ The country provided in 2008 a tax break of about 35 percent for US\$1 of R&D, second only to France (42 percent).²⁰ A study of R&D tax incentives²¹ shows that around 77 percent of state aid for R&D came from tax incentives in 2009 (€14.6 million). However, although small firms are the majority of beneficiaries of tax incentives for research and development, the large firms receive most of the benefits. When it comes to infrastructure to support business R&D, estimates indicate that Croatia has 27 regional development agencies, 44 entrepreneurial centers, 23 business incubators (most attached to regional development agencies) and 8 technology parks, including those of the Technology Infrastructure Programme (TEHCRO).²²

Figure 25. BERD, Percent of GDP



Source: Eurostat

Figure 26. R&D Intensity (Medium Firms)



Source: Community Innovation Survey (2010)

Firm Dynamism and Productivity Growth

50. **Another explanation of the subdued performance of Croatian exporters, and the limited capacity of the country to renew its productive structure, is the reduced firm dynamism.**²³ Entry in Croatia into the formal sector, measured by registration of new limited liability firms, is low when compared

¹⁷ This section summarizes Chapter 3 “Innovation Challenges for Smart Specialization” of 2015 World Bank report “Smart Specialization in Croatia”.

¹⁸ World Bank (2014) Smart Specialization in Croatia: Inputs from Trade, Innovation, and Productivity Analysis drawing from the last Community Innovation Survey (2010)

¹⁹ Ibid.

²⁰ European Commission 2014. “ERAWATCH Country Reports 2013: Croatia”

²¹ Švaljek, S. 2012. “R&D Tax Incentives in Croatia: Beneficiaries and their Benefits.” Zagreb, Institut za javne financije.

²² WBC-INCO.NET, 2011, as cited in OECD (2014), OECD Reviews of Innovation Policy: Croatia 2013, OECD Publishing. <http://dx.doi.org/10.1787/9789264204362-en>

²³ Findings from Ilojty, M., P. Correa, S. Radas, and B. Škrinjarić. 2014. “Stylized Facts on Productivity Growth: Evidence from Firm Level Data in Croatia: Vol. 1.” Policy Research working paper no. WPS 6990.

to what would be predicted by its income level. Figure 27 below displays the relationship between the density in firm entry (measured by the average annual number of new limited liability firms registered per 1,000 working-age people during 2008–12) and the level of economic development (measured by the average per capita income for the same period) across 117 countries. As expected, firm entry is positively associated with GDP per capita, but Croatia's rate of entry density is substantially below what its income level would suggest. By contrast, regional peers—Bulgaria, Romania, and Hungary—are located above the predicted line, displaying substantially higher entry rates.

Figure 27. Entry Density and GDP per capita, 2008–12

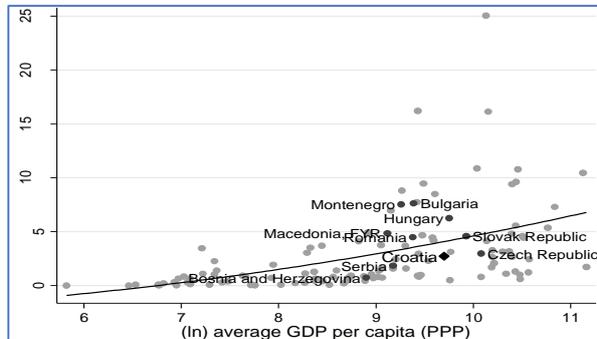
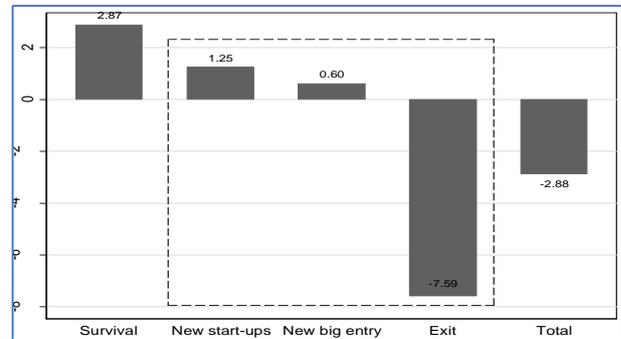


Figure 28. TFP Change Decomposition by Type, 2008–12



Note: TFP is used in natural logarithm form.

Figure 29. High-Growth Firms' Rate (%), 2010

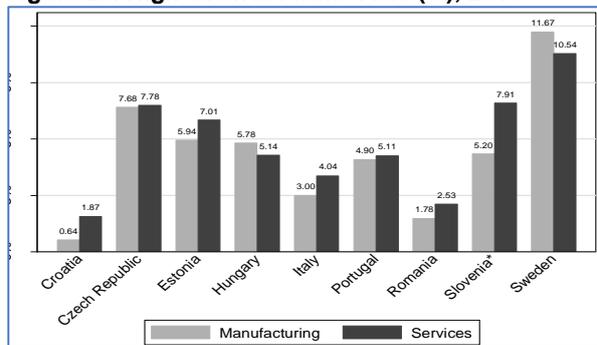
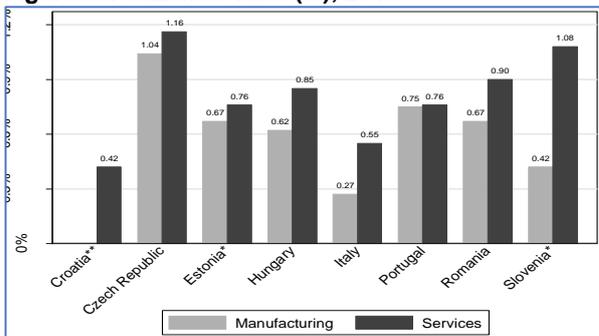


Figure 30. Gazelles' Rate (%), 2010



Source: Ilo et al (2014).

Note: Rate is defined as the number of high-growth enterprises, measured by turnover growth, as a percentage of the population of enterprises with 10 or more employees. * For Slovenia, data are for 2009. * For Estonia and Slovenia, data are for 2009; ** for Croatia, we did not identify any gazelles in 2010 (a sample of firms was used).

51. **Lack of firm dynamism in Croatia is also evidenced by an uninspiring performance of a critical segment of the firm landscape: high growth firms, particularly young ones, known as ‘gazelles’.**²⁴ These types of firms are of particular importance because of their extraordinary growth and their innovation driver. First, they can make the largest contribution to net job creation, despite typically representing a small proportion of the business population. Second, because their success often comes from innovation—such as a product or process; or innovative approaches to marketing, distribution, or organization; or from entering a new market—these types of firms (particularly gazelles) outperform average industry growth in a Schumpeterian sense:²⁵ they combine existing factors of production in a new way and thus produce an innovation that enables them to outperform the market. Recent analysis shows that Croatia seems to lag behind selected European countries on high-growth firms and gazelles (Figure

²⁴ Based on the OECD definition, high-growth enterprises are those with average annualized growth in employees (or turnover) greater than 20 percent a year, over a three-year period, and with 10 or more employees at the beginning of the observation period. (“Gazelles” are a subset of high-growth enterprises up to five years old).

²⁵ The Schumpeterian process of “creative destruction” is crucial to fostering innovation and, therefore, economic growth. This process features the entry of new innovative firms in the market, and the exit of uncompetitive, incumbent firms. This entry-and-exit dynamic reallocates factors of production across firms, from unproductive companies to productive firms, increasing aggregate productivity. Entry into innovation activities can occur in two ways: vertical entry or horizontal entry. Vertical innovations are related to the upgrading of the quality of existing products and services; horizontal innovations are associated with the creation of new goods and services. Entry always entails a fixed cost. However, vertical innovations tend to cost less, as they relate to incremental innovations. But horizontal innovations are usually expensive, as they typically involve a breakthrough.

29 and Figure 30), although these findings have to be treated with caution because the numbers were not drawn from total population figures.²⁶

52. **The lack of vitality of Croatian economy is confirmed when looking at firm entry and exit process.** Evidence for developed economies suggests that healthy market economies exhibit a high pace of firm churning, whereby a significant number of business startup or close their operations.²⁷ Croatia has showed a reduced firm dynamism when compared with regional peers.²⁸ Only 5.5 percent of all firms were new to the market on average every year in the 2008-12 period; regional peers present an average rate ranging from 9 to 18 percent (Table 11). Croatia also lags behind in terms of exit process: 6.5 percent of total firms leave the market on average every year while exit rate in ECA peers varies from 7 to 26 percent on average. When looking at net entry rates (entry minus exit) Croatia presented negative values, which indicate that exit outpaced entry during the 2008-12 period. This finding reinforces the perception that Croatia is a stagnant economy with a reduced “creative destruction” process, as proxied by net entry.²⁹

Table 11. Exports Entry and Exit Rates, Croatia and Eastern European Peers, 2008–11 (%)

Country	Entry	Exit	Net entry
Bulgaria	14.54	9.62	4.92
Czech Republic	9.18	8.96	0.22
Latvia	16.57	13.27	3.30
Lithuania	18.61	26.82	-8.21
Hungary	9.83	10.92	-1.09
Poland	13.07	10.42	2.65
Romania	10.92	14.19	-3.27
Slovak Republic	14.86	11.56	3.30
Slovenia	10.89	7.53	3.36
Croatia, 2008-12	5.50 ³⁰ ("start-ups")	6.50	-1.00

Source: World Bank staff elaboration based on FINA data (for Croatia) and Eurostat data.

Note: For all countries except Croatia, values are averages of Eurostat data for 2008–11 (not 2008–12). Eurostat's yearly measure of entry is defined as number of enterprise births in the reference period (t) divided by the number of enterprises active in t. The yearly exit rate is defined in Eurostat as number of enterprise deaths in the reference period (t) divided by the number of enterprises active in t. For both entry and exit rates from Eurostat, the sector coverage is “Business economy except activities of holding companies”.

53. **Furthermore, the contribution of firm dynamism (proxied by net entry) for productivity growth in Croatia is surprisingly negative suggesting that market selection process appears inefficient.** Empirical evidence for developed countries also shows that the churning process is productivity enhancing, in the sense how new business entry and the market exit of less productive firms contribute to spur productivity average.³¹ The decomposition of this variation in contributions from survival, start-up entry, big entry and exit firms has revealed interesting results, some of them surprising. As expected, productivity growth is largely driven by survival firm performance while the entry effect is normally (but not always) positive (depending on the analytical cut). The striking result comes from the negative contribution from firm exit effect. In addition, as this exit contribution outpaces the positive effect of firm entry, the overall contribution of the net entry effect becomes negative. This is contrary to what is expected and suggests that the destructive creation process in Croatia has not been efficient as the market might be eliminating firms that are potentially productive.³²

²⁶ See Ilo et al (2014)

²⁷ See Bartelsman et al. (2009) for a relevant cross country analysis.

²⁸ See Ilo et al (2014) for more details.

²⁹ There is some sector variation, however. All macro sectors have showed a negative entry effect, but services showed to be the one where this process seems to be less prominent. In addition, when focusing only on service activities there is evidence of a strong firm dynamism for both knowledge intensive services (such as telecom, computer related activities, R&D activities, etc) and other less knowledge services (such as personal activities).

³⁰ The rate for “big entry” is 2.5

³¹ See Bartelsman et al (2009).

³² When performing this exercise across several analytical criteria, results suggest that this inefficient market selection process is more pronounced among private sector firms, Continental region firms and firms in the service sector. Not

54. **Evidence presented so far points to a sub-optimal equilibrium in terms of export performance, innovation and firm productivity growth.** Lagging performance of Croatian exporters reflect the reduced capacity of the country to renew its productive structure, which is then hindered by a modest innovation performance and a reduced “creative destruction” process.

55. **Against this backdrop, innovative SMEs can play a key role for lifting Croatia back into sustained growth.** In the case of Croatia, SMEs account for a large share of both total number of firms and employment. Recent numbers from Structural Business Statistics, Eurostat, show that SMEs represent more than 99 percent of the total number of firms and account for 68 percent of employment.³³ The largest share of the country’s SMEs (67 percent) can be found in services. A particular sub-set of SMEs, those in innovation-driven activities, namely young knowledge-intensive enterprises³⁴, can leverage the country’s cost basis to sustain long periods of substantial export growth. They do so by innovating: they create new goods (products or services) or significantly upgrade existing ones, implement new processes, or introducing new marketing strategies. In Croatia, innovation-driven sectors as computer programming, architectural and engineering activities; technical testing and analysis, scientific activities and research, and manufacturing of computers, electronic, and electrical equipment, account for approximately 8 percent of SMEs.³⁵

Environment for Supporting Businesses and Creating Jobs

56. **Croatia’s business environment has been identified as a priority area for reform by the several subsequent Croatian Governments.** More recently, under the Government Working Group for Business Climate and Private Investments, the Agency for Investment and Competitiveness has been designated to lead the dialogue with the private sector and coordinate the consultations with stakeholders, including international organizations on the design of a new wave of business environment reforms.

57. **Several concrete measures have been undertaken recently to improve the quality of the business environment.** The authorities have begun an audit of administrative burden, applying the standard cost model to the Trade Act and the Mediation in Immovable Property Transactions Act. The pilot phase has been completed in April 2015 and an action plan for the simplification of the administrative burden will be presented soon. The initiative was led by the Ministry of Economy and was supported by the Agency for Investment and Competitiveness. Furthermore, there is an ongoing effort to improve the online communication between the public administration and citizens. Despite the introduction of the e-citizen web portal and the online services for businesses provided by HITRO.HR, the Chambers of Commerce, and the Financial Agency FINA, challenges remain for the users having to familiarize themselves with the different interfaces. The authorities are planning the development of a new platform – a single contact point, which would integrate all existing services. In the area of the judiciary, the implementation of the reform of the judicial map could improve the efficiency of some courts. The reform aims to increase specialization and balance out the uneven workload of judges by merging courts. The reform also involves a change in the allocation of cases before second instance civil courts.

58. **Although Croatia has implemented business reforms every year since 2006, and was among the global top ten improvers in Doing Business in 2008, the reform momentum in some areas has been stronger and more sustained than in others (Box 2).** The getting credit indicator captured the setting up of the new private credit bureau, HROK, and the launching of a unified and geographically centralized collateral registry in 2008. The time required to register property was reduced through improvements at the land registry. Since 2011, litigation proceedings were streamlined and enforcement procedures over cash assets transferred from the courts to the state Financial Agency, FINA. In 2015, further improvements were made with the introduction of an electronic system to handle public sales of movable assets and to streamline the enforcement process as a whole.

59. **As a result, Croatia is doing relatively well in the Doing Business 2016 report.** It ranks 40th out of 189 economies worldwide and 8th amongst the 26 economies in Europe and Central Asia. Compared with 2015, Croatia dropped one place in its global ranking. On the Distance to the Frontier

all service sub sectors had a negative performance however. The exercise showed also some untapped potential for productivity growth in services industry coming entry of knowledge intensive service companies.

³³ Eurostat data for 2012 (Structural Business Statistics). According to Eurostat, SMEs are firms that employ between 1-249 persons.

³⁴ Knowledge intensive SMES (and startups) are understood to mean those SMEs (and startups) with a business model that emphasizes intellectual property as the main asset and include technology-based firms (e.g. IT firms), as well as firms that compete on the basis of product, process or service innovation. Innovation can be either incremental or radical, and either new to the Croatian market or new to the world.

³⁵ Eurostat Structural Business Statistics, latest available data (2012).

(DTF) metric which shows Croatia's performance relative to global good practice, Croatia scores 72.71 points in Doing Business 2016. Compared with 2015, progress has been made mainly in the areas of starting a business and registering property where Croatia improved three and seven positions in the ranking, respectively. In addition, Croatia made enforcing contracts easier by introducing an electronic system to handle public sales of movable assets and by streamlining the enforcement process as a whole, though this has not been reflected in the ranking.

Box 2. Recent Reform Efforts in Croatia Doing Business Areas

Starting a business became easier with the introduction of HITRO.HR, a one-stop shop (OSS) for company registration, and with the subsequent expansion of its functionality, which allowed limited liability companies to file their registration applications with the court registries electronically through the notary public and HITRO.HR. In 2013 a new form of simple limited liability company with a lower minimum capital requirement was introduced, which further simplified incorporation procedures and in 2014, some notary fees, related to company incorporation, were reduced.

The Dealing with Construction Permits indicator captured a series of reforms since 2007. In 2008, a new building code was put in place that eliminated several procedures for obtaining a building permit. In 2009, an OSS for construction permits was set up, which enabled the enforcement of the new building code. Further streamlining followed in 2010 and 2014, including the abolishment of the location permit and project design confirmation, reducing the requirements and fees for building permits, and speedier final building inspections. These improvements led to further simplifying and speeding up the overall construction permitting process.

On the Trading across Borders indicator, Croatia has considerably harmonized and streamlined its export and import custom procedures in preparation for the July 1, 2013 accession to the European Union. Important improvements were also introduced in its port infrastructure, resulting in further reductions in the time for exporting and importing.

As reflected in the Resolving Insolvency indicator, Croatia made improvements in 2007 through amendments to its Insolvency Act regulating the profession of bankruptcy administrators and in 2013, introduced an expedited out-of-court restructuring procedure.

Under Paying Taxes, in 2008, paying taxes became easier for companies through the wider use of online filing. In 2012, the health insurance contribution rate was reduced, followed by the introduction of an electronic system for social security contributions and by the reduction of rates for the forest and Chamber of Economy contributions in 2013. In 2014, the Chamber of Economy contribution was completely abolished. On the other hand, in 2010, a tourist fee was introduced, which made paying taxes more costly for companies and in 2014, Croatia made paying taxes more complicated by raising the health insurance contribution rate and introducing more detailed filing requirements for VAT.

60. **However, despite the strong reform momentum Croatia still suffers from a number of shortcomings that entrepreneurs experience in the day-to-day running of their business operations.** Doing Business data shows there is room for improvement particularly in the areas of resolving insolvency, protecting minority investors and getting credit (Figure 31).

61. **In addition, stricter product market policies have been stifling competition in Croatia while posing excessive burdens on entrepreneurs particularly in service sectors.** OECD Product Market Regulation (PMR) Index suggests Croatia performs badly when compared with other EU Member States and intensity of local competition is weak. Croatia is the worst EU Member State performer in the OECD Product Market Regulation Index, which is largely due to a high degree of public ownership and government involvement in network sectors and in general business operations.³⁶ The large share of public enterprises in the economy creates an uneven level playing field for private businesses. In addition, shortcomings in product market regulation specifically for services hits the cost structure of firms that use the output of services as intermediate inputs in production and affects the whole economy.³⁷ The OECD's PMR index for professional services ranks Croatia relatively unfavorably as regards entry restrictions in all regulated professions it covers and among the three worst Member States in terms of conduct restrictions in all professions but accounting services. This overall scenario – combined with the limited ability of the Competition Authority to foster more intense competition in the Croatian economy due to a shortage of

³⁶ The measurement is not updated as of 2015 and, due to more recent acquis harmonization and privatizations, may not reflect the current situation for Croatia. For more information, please visit: <http://www.oecd.org/eco/growth/indicatorsofproductmarketregulationhomepage.htm>.

³⁷ As highlighted by European Commission Country report – Croatia 2015, examples of sector-specific regulations that pose excessive burdens on entrepreneurs in services include, for instance, laws applicable to specific services that require prior authorization from a competent authority in Croatia, including entry in a register or registration with a professional body or association.

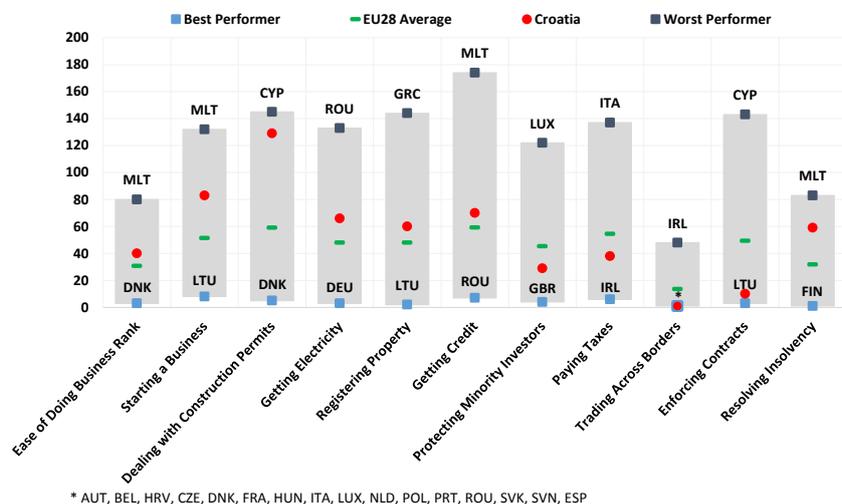
staff and other resources³⁸ - has been limiting competition on the internal market, as suggested by the most recent Global Competitiveness Index (2014-15). According to this indicator, the intensity of local competition in Croatian economy appears to be well below many of its peers: Croatia finds itself in the bottom half of the ranking (out of 144 economies) for the intensity of local competition (83rd), extent of market dominance (110th), and effectiveness of anti-monopoly policy (97th).

62. Additional rigidities for business environment stems from regulatory instability and low transparency and predictability in the working of administrative bodies.

Weak legislative planning has weighed down the quality of new regulations. In 2014, half of the laws passed were not planned. Although there is a Regulatory Impact Assessment (RIA) mechanism in place, in practice most legislations go through a fast track legislative process and circumvent RIA altogether. Even when performed, RIA is not properly done, due to weak quality control and lack of high level commitment. Poor legislative quality in turn leads to frequent amendments to address shortcomings and complications for SMEs.³⁹ Moreover, the administrative burden in Croatia is higher than in most EU member states. Despite a public wage bill close to 12 percent of GDP, Croatia scores low on the EU Public Administration Scoreboard, particularly on indicators on effective implementation, cost and time to export, and irregular payments and bribes. Businesses find that inconsistencies in decision making at the local level, as well as lack of strict timeframes for issuing opinions on tax issues are a key source of concern. These implementation gaps are often caused by high turnover rates, nonexistence of performance-based wage system, limited training opportunities, and lack of transparency in staff recruitment in public administration. Additional issues that contribute to a poor business environment include long judicial proceedings, in particular in commercial courts, where an upgrade of case management is needed, among other factors.⁴⁰

63. Structural problems and rigid and complex labor legislation and regulations impede both employment and labor productivity gains.⁴¹ Croatia's employment rates in general are low relative to the EU28 average, especially for younger and older workers. The low employment rate is due both to high unemployment and, more importantly, to the low labor force participation rate (Figure 32). Unemployment is often long-term. Despite recent changes to labor law, it remains complex and retains rigidities. There is scope to explore the introduction of a single contract to overcome labor market segmentation between those on temporary and permanent contracts. Expected costs of (individual) dismissals are high, impeding

Figure 31. How Far has Croatia Come in the Areas Measured by Doing Business?



* AUT, BEL, HRV, CZE, DNK, FRA, HUN, ITA, LUX, NLD, POL, PRT, ROU, SVK, SVN, ESP
 Source: Doing Business

³⁸ Though Croatia has aligned its legislation in the fields of anti-trust and mergers and of state aid, and has also kept up its efforts to build a positive enforcement record, the ability of the Competition Authority to foster more intense competition in the Croatian business environment is hampered by a shortage of staff and other resources. The Authority is small compared with its counterparts in other Member States of similar size, as is its budget (approximately EUR 1.7 million in 2015 for a staff of 47, of which 31 work in the Competition Division).

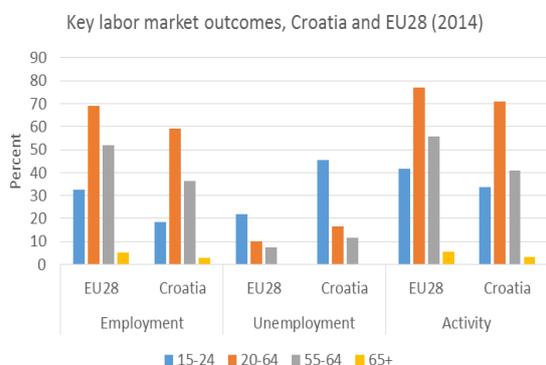
³⁹ There is a plan in place to introduce the “two out, one in” check for new regulations and other specific measures are being planned to improve the overall quality of impact assessment. For more details, see: Republic of Croatia, National Reform Program, April 2015. The English version of the document can be found at: http://ec.europa.eu/europe2020/pdf/csr2015/nrp2015_croatia_en.pdf

⁴⁰ Improving the efficiency and quality of the justice system also remains a challenge. In 2014, the length of trials was comparatively long at first instance both in civil and commercial cases (378 days) and in administrative cases (427 days). At first instance administrative courts, backlog increased by 17%, despite more cases being resolved. At the High Commercial Court, backlog increased by 16% and disposition time reached 1234 days in 2014, up from 1142 days the previous year.

⁴¹ These problems are documented in World Bank (2011), Employment Protection Legislation and Labor Market Outcomes: Theory, Evidence and Lessons for Croatia, and in Kunovac, M. (2014), Employment protection legislation in Croatia, Financial Theory and Practice, 38(2), 139-172.

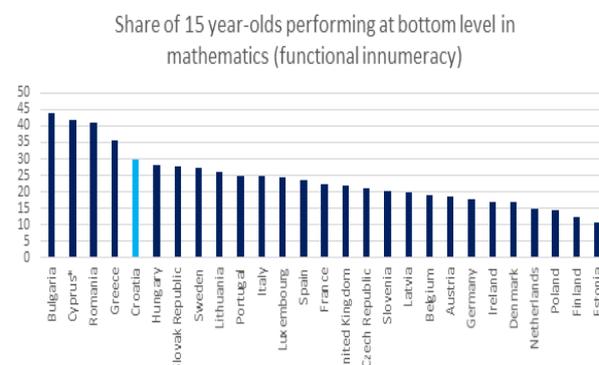
labor productivity gains which could come from labor reallocation. There is a need to equalize the expected benefits of public and private sector employment, and to support efficient allocation of labor resources. Other notable factors are labor supply disincentives created by the social protection system.

Figure 32. Croatia's Employment Outcomes Lag EU28 Averages



Source: Eurostat

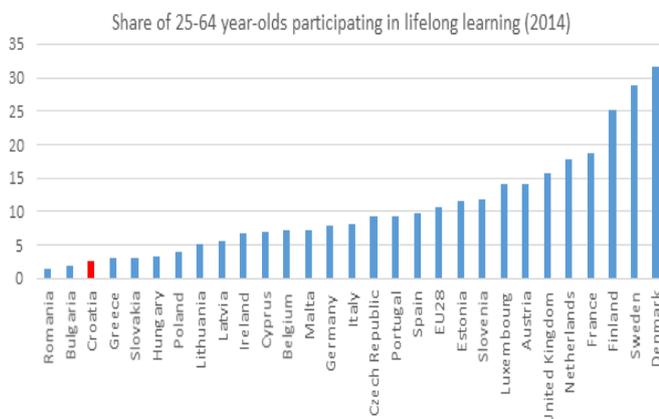
Figure 33. Poor Basic Cognitive Skills



Source: World Bank staff calculations using PISA 2012 and Eurostat data.

64. **Croatia also faces challenges in equipping its workforce with cognitive and technical skills** (Figure 33). First, cognitive foundation skills of young Croatians are poor. Croatia has one of the highest shares of 15 year-olds (29.9 percent) who perform at the bottom levels (below level 2) of mathematics in the OECD Program for International Student Assessment (PISA). This level of performance is equivalent to functional innumeracy (the equivalent share for reading at 18.7 is lower, though still formidable). Given technological change and Croatia's challenge of aging and population decline, this provides a significant risk to long-term economic growth prospects. Poor cognitive foundation skills like mathematics and reading are a barrier to effective lifelong learning and continued acquisition and upgrading of technical skills. There are also significant gaps in PISA performance between students from the richest and poorest socio-economic quintile (equivalent of two years of schooling) which signals an important equity dimension in skills acquisition. Second, participation in lifelong learning remains rare, with a rate of 2.5 percent – much lower than the EU average of 10.7 percent of the working age population aged 25-64. Croatia's lifelong learning participation is the third lowest in the EU, slightly higher than Bulgaria and Romania (Figure 34).

Figure 34. Participation in lifelong learning in Croatia is low



Source: LFS Eurostat (2014)

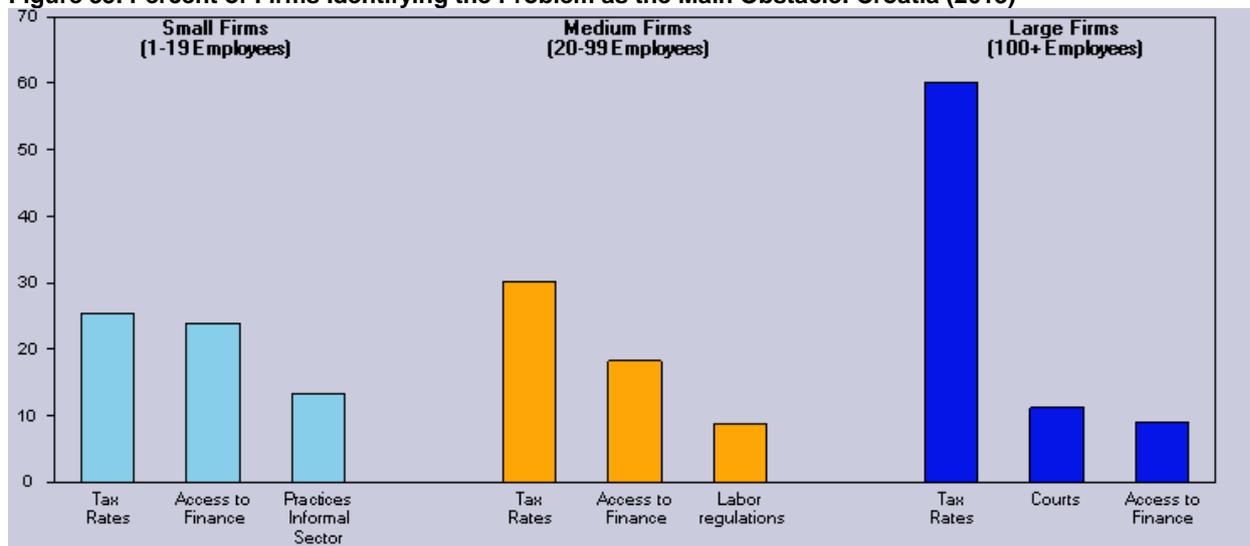
Risk Capital Financing for Innovative SMEs

65. **If supporting innovative SMEs is key to promote trade integration and economic growth in Croatia, it is important to tackle access to finance as this has been constantly cited as an essential constraint for business in the country.** Getting credit is still a key constraint for SMEs in Croatia. Data from the last Enterprise Survey (2013) in Croatia reveals that access to finance is among the main obstacles for business for both small (1-19 employees) and medium (20-99) firms (Figure 35).

66. **For innovative SMEs in particular this constraint is even more severe, as innovation tends to be underfinanced even in well-functioning markets due to structural market failures.** In principle, innovation tends to be underfinanced due to structural market failures as asymmetric information and

appropriation risks⁴². This problem is more apparent for new entrants and startups as they lack track record to signal their ability to investors, and because they produce an intangible asset that does not typically constitute accepted collateral, as well as due to the intrinsically risky nature of innovative ventures.⁴³

Figure 35. Percent of Firms Identifying the Problem as the Main Obstacle: Croatia (2013)



Source: Croatia Country profile 2013⁴⁴

67. **In Croatia, the lack of risk capital financing is exacerbated, and this is due not only to the reduced size of economy but also to significant institutional and, more important, coordination failures.** Three main problems can be identified:

- (i) **Business environment issues related with weak insolvency regulation.** Spurring innovation depends not only on a sound financial market, where financial resources can be easily reallocated across firms, but also on an effective bankruptcy system. Stringent bankruptcy regimes, with high costs for failed entrepreneurs, can provide disincentives for entrepreneurs in general, and SMEs specifically, to innovate therefore preventing the introduction of new products, processes and methods. In Croatia, as shown by recent Doing Business numbers, resolving insolvency practices are still far from the most efficient practices in the world.
- (ii) **Lack of risk capital financing culture.** There are predominant coordination failures that are translated into a lack of a proper risk capital culture, which constitutes a typical “chicken and egg” problem.⁴⁵ Unless the market is fully developed, it will not be able to support the development of a robust and continuous pipeline of promising startups. In turn, this would stall the emergence of a strong business angel community that can back innovative companies in the earlier stages, of lawyers able to negotiate venture capital deals and IP agreements, while sufficient experienced investment professionals and developed exit markets will struggle to emerge. In addition, until venture capital funds have been investing in the country for a relatively longer period, there will be

⁴² Information asymmetry between the inventor and the potential investor about how promising an innovation project is. As a result there is a gap between the return of private innovation and the cost of capital, which is translated into a reduced willingness to finance new ideas/process. Appropriation risks are related to externalities that prevent inventors to capture all the returns of their invention. As a result the social return to innovation investment is higher than the private return and markets tend to invest less than is socially optimal.

⁴³ In principle, innovation activities are more difficult to finance than other types of investment for several reasons. The most important are: i) the fact that innovation produces an intangible asset that does not typically constitute accepted collateral to obtain external funding; and ii) the technological and market uncertainty of innovation activities makes the returns to investment highly uncertain, creating significant problems for the standard risk adjustment methods used by providers of funds. See Hall and Lerner, 2009.

⁴⁴ <http://www.enterprisesurveys.org/~media/GIAWB/EnterpriseSurveys/Documents/Profiles/English/Croatia-2013.pdf>

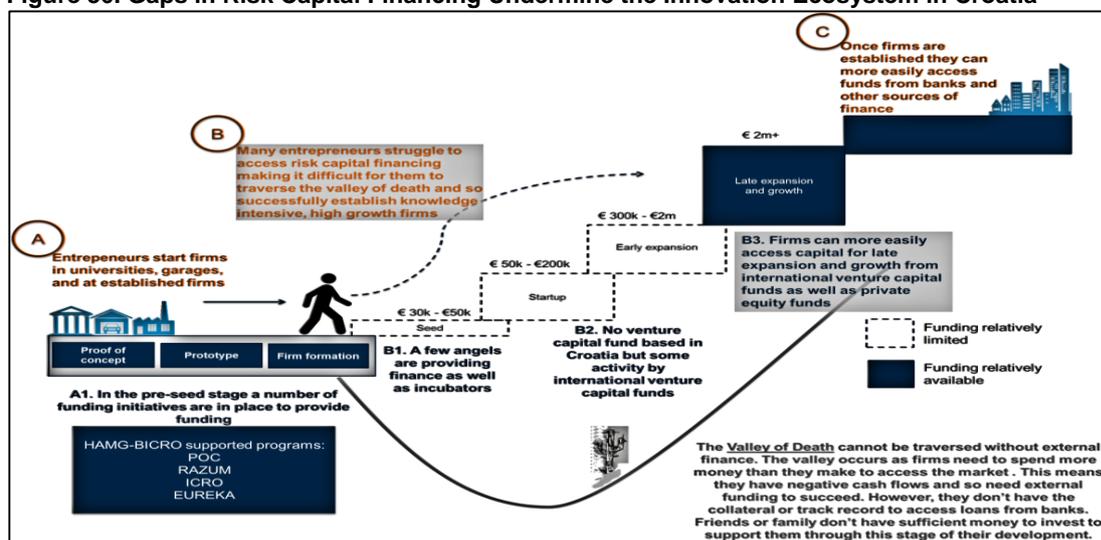
⁴⁵ Because innovation happens within a system where actors might have different incentives, there is always the risk that individual actors do not act in a coordinated way. Therefore, “...most (if not all) parts of the system need to be in place for it to function well, and missing parts may not emerge if some others are missing (World Bank (2014)).

no history of returns. However, without a history of returns, venture capital investors are reluctant to invest, even when underlying investments may offer the potential for healthy returns.

- (iii) **An incomplete regulatory framework for a venture capital industry.** Important regulatory barriers that directly impact seed and early stage finance include the ease with which venture capitalists and business angels can organize themselves. In this regard, Croatia transposed the EU's AIFM Directive⁴⁶ into national legislation in 2013 when the Alternative Investment Funds Act was adopted. This primary legislation laid the conditions for establishing and operating alternative investment funds and alternative investment fund managers, including marketing and distribution of such funds, the delegation of duties to third parties and supervising and managing AIFMs, AIFs and depositaries and those marketing AIFs. Recent analysis conducted under World Bank projects suggest there are certain inconsistencies in the way Croatia has transposed the EU AIFM Directive, which prevents the country to replicate best practices in the creation of the seed and venture capital funds. First, the Croatian Alternative Investment Funds Act does not make a distinction between small and large investment funds, and as a result, small funds tend to be overregulated, preventing the pick-up of private VC activity. Second, the same Act does not envisage an option to establish a venture capital fund as a limited partnership, which is best practice. Third, according to Corporate Income Tax Act open-ended investment funds are exempted from tax payment while closed-ended funds are not; while the international practice is to establish venture capital funds in this form.

68. **Drawing on these constraints the emerging picture in Croatia is the one with insufficient supply of risk capital financing.** Available evidence suggests that Croatian firms have access to financing for the initial (pre-seed) stage, as well as for the expansion stage, but limited funding is available for the critical phase in between these two points of development, the so-called “valley of death”. Figure 36 shows that in Croatia entrepreneurs have access to funds for pre-seed and late expansion and growth stages. However, they have few sources for funding in the seed, start-up and early stages. For the pre-seed stage, and partially for the seed phase, there are programs managed by Croatian Agency for SMEs, Innovation and Investments (HAMAG-BICRO) to help start-ups with the development of new technologies with commercial potential. For the late expansion phase, funds are available, often provided by private equity funds; however these have not trickled down to finance innovative SMEs. Thus, the private sector is not currently a reliable channel for financing technology driven startups in need of early-stage financing.

Figure 36. Gaps in Risk Capital Financing Undermine the Innovation Ecosystem in Croatia



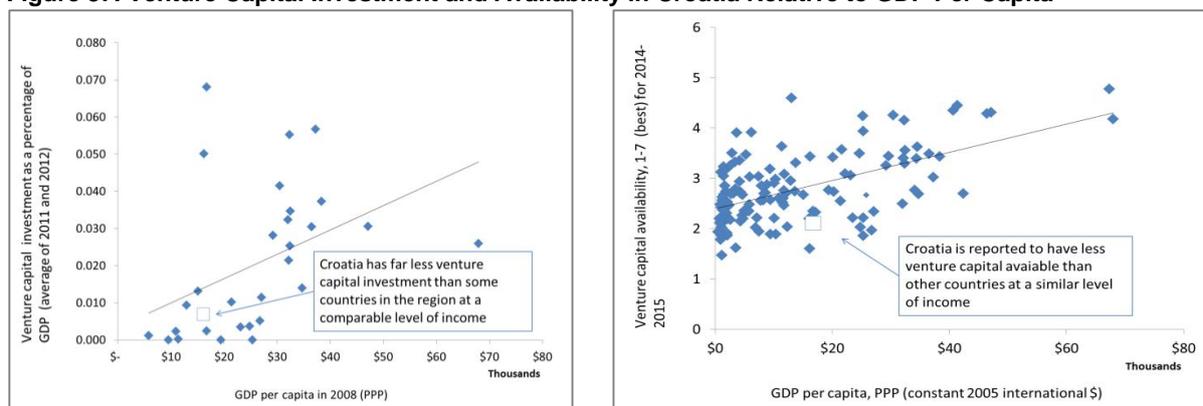
Source: World Bank 2015 Project Appraisal Document.

69. **In addition, data suggests that the supply of risk capital in Croatia is below that of countries at a comparable level of income.** The left hand side panel of Figure 37 below shows that Croatia has less venture capital available as a percentage of GDP than a number of other countries in Europe at a comparable level of income. The left hand side panel presents results from the World Economic Forum's Global Competitiveness Report, which shows that executives in Croatia report lower levels of venture

⁴⁶ The Alternative Investment Fund Managers Directive (AIFMD) or Directive 2011/61/EU was adopted by the EU to regulate and supervise alternative investment fund managers (AIFMs) who manage alternative investment funds (AIFs), including private equity (PE) funds, VC funds, hedge funds etc. operating in the EU.

capital availability than most other countries. Results from the Global Competitiveness Report rank Croatia at 114th in the world for the availability of venture capital.

Figure 37. Venture Capital Investment and Availability in Croatia Relative to GDP Per Capita



Source: Own elaboration based on data from World Development Indicators, the World Economic Forum Global Competitiveness Report 2014, the European Private Equity and Venture Capital Association (EVCA) and the Croatian Private Equity and Venture Capital Association (CVCA)

Opportunities for Reforms

70. **Against this backdrop, potential (legal, regulatory or administrative) reforms would allow the Government to have a direct impact on business conditions by addressing some of the shortcomings that affect entry, survivability and exit of firms in Croatia.** To get out of this low level equilibrium, where uninspiring export performance is reinforced by reduced creative destruction and innovation, Croatia needs to shift more forcefully towards a productivity-based and innovation-driven growth model. One of the most promising signals for the country's export competitiveness outlook stems from the existence of a fringe of dynamic small exporters in innovative niche sectors. Supporting such a route is consistent with putting in place a new growth model based on employment and productivity increases, exports and innovation, as suggested by the World Bank 2009 EU Convergence Report for Croatia. This implies investing into innovative SMEs and accompanying human capital. These firms - by creating new goods (or upgrading existent ones), implementing new processes or introducing new market strategies – can play a key role for lifting Croatia out of recession and back into sustained growth.

71. **In order to foster such development, it is key to tackle factors holding back entrepreneurship in Croatia. These include an unfriendly business environment, limited competition in product markets, lack of early stage financing and skills deficits.** Despite the reform efforts in the last years Croatia's business environment still suffers from major institutional shortcomings, as highlighted by a number of international reviews⁴⁷. In addition, the lack of early stage financing undermines the innovation ecosystem by preventing innovative ideas with commercial potential from reaching the market, which reinforces the vicious cycle of reduced renewal process in the economy. A significant share of Croatian youth leave the education system with poor cognitive foundation skills such as in reading and mathematics which leaves them ill-equipped for the fast evolving demands of a competitive, innovation-driven economy. At the same time, the share of Croatian workers participating in lifelong learning activities is one of the lowest in the EU.

Business Entry

72. **The Government of Croatia should continue reforming the business registration.** It can do so by focusing on eliminating outdated requirements through legal amendments, merging and streamlining the registration processes of multiple departments and agencies, and making all registration processes (including post-incorporation) fully electronic without any need for physical paper trails or physical interaction. In Canada, UK, Singapore or Slovenia, for example, an integrated IT system links the databases of relevant agencies (company registry, tax administration, social security system, and statistics institute). The entrepreneur submits the information and the payment electronically via the website through a single form and the company is automatically registered with all agencies. Norway even took this a step further. Since 2005, all public registers and public authorities have a legal obligation to use the data

⁴⁷ 2016 Doing Business Report, the 2014-15 Global Competitiveness Report of the World Economic Forum and the OECD product market regulation Index.

registered in the Central Coordinating Register for Legal Entities instead of requiring businesses to resubmit this data to the concerned agency.

Survivability of Firms

73. **Reducing the cost of doing business through regulatory reforms, reduction of quasi-fiscal fees, and protection of fair market competition can help ensure survivability of firms.** Reforms that make regulation more efficient and transparent can also help reduce corruption and informality. Croatia can also benefit from liberalizing its service sector, in particular of professional and business services.

74. **Croatia should continue and deepen its efforts to ease the regulatory burden on firms.** Croatia should continue with the full implementation of its new spatial planning and construction system, as well as introduce the deadline and procedures for the mandatory update of land registry and cadaster data. After all titles being digitalized and connected to the cadaster data, In the area of construction permits, authorities should focus on enforcing the new laws, ensuring safety standards that protect the public while making the permitting process efficient, transparent and affordable for both building authorities and the private professionals who use it. Croatia has passed three new laws in January 2014: a Building Act, a Physical Planning Act, and an Inspection Act. The new Building Act established a single building permit as the sole administrative act allowing construction, and enabled the building permit to directly reflect zoning maps, thus eliminating the need for a location permit in the vast majority of cases.⁴⁸ Furthermore, it introduced disciplinary proceedings for non-performing municipal officials that resulted in more prompt processing of the usage permit. The Physical Planning Act created a Croatian Institute for Spatial Development, a national level body in charge of developing and implementing national zoning plan, and a Physical Planning Information System (ISPU), which – once fully implemented – will enable free and fast access to physical planning data for the whole country.

75. **Further, efforts to integrate fully into the EU internal market need to be reinforced.** Croatia needs to liberalize its service sector regulation, which is holding back the productivity of other industries. Services account for a large share of GDP and employment in Croatia. They make up 70 percent of its GDP, close to the EU average of 74 percent, but around 64 percent its employment. Growth in services affects many dimensions of the economy. Finance, accounting, transportation, communications, legal support, and other commercial services are not only forms of economic output in themselves, but are also critical as inputs into other economic sectors, including manufacturing, thus playing a pivotal role in economy-wide productivity. High-quality, low-cost services can boost firm productivity and enhance overall competitiveness. A strong service sector is vital to diversifying and expanding a country's exports since exporting firms tend to be more productive. Meanwhile, service imports can serve as an important channel for introducing new technologies to the domestic economy and thus boosting exports and helping countries to integrate into global value chains.⁴⁹

76. **Yet, services are not delivering their full potential in Croatia.** Even within the EU internal market, services remain limited to borders that the single internal market aims to remove. In 2014, services represented only around 31 percent of Croatia's intra-EU trade. Low productivity growth in services can partly be explained by regulatory barriers at the national level. Regulation in network and professional services remains particularly rigid in Croatia compared to the rest of EU⁵⁰.

77. **In the absence of efficient courts, firms make fewer investments and business transactions while informal transactions become more attractive.** Improvements in court efficiency are associated with a lower share of the informal sector in the overall economic activity, increased investor confidence and increased bank financing of firms for new investment.⁵¹ The Enforcement Act from 2012 aimed to reduce the time needed for enforcement procedures by transferring certain procedures from the court to other bodies, such as the Financial Agency (FINA). FINA is competent to directly execute court judgments and court settlements on debtors' bank accounts. As a result, creditors no longer need to obtain an

⁴⁸ The location permits is now required only for exceptional situations, such as the construction on properties that have an unclear title or have to be expropriated.

⁴⁹ <http://www.oecd.org/sti/ind/global-value-chains.htm>

⁵⁰ The level of regulation at sectoral level is proxied by the OECD's Product Market Regulation (PMR) indicator that translates policy action into a quantitative indicator.

⁵¹ Among other papers, see G.B. Ramello and S. Voigt, 2012. "The economics of efficiency and the judicial system," *International Review of Law and Economics*; Mehnaz Safavian and Siddharth Sharma, 2007. "When Do Creditor Rights Work?" *World Bank Policy Research Working Paper No. 4296*; John Ahlquist and Aseem Prakash, 2010. "FDI and the costs of contract enforcement in developing countries," *Policy Sciences*, Springer, vol. 43(2), pages 181-200, June; Inessa Love, 2011. "Settling Out of Court: How Effective is Alternative Dispute Resolution," *Viewpoint Note No. 329*, The World Bank Group, October.

enforcement decision from the court in addition to the final judgment. Moreover, Croatia approved significant amendments to the Civil Procedure Act in 2013 to streamline the way the litigation process is administered, including the way litigants submit evidence. However, the court system still exhibits large inefficiencies as seen through the backlog of cases, large budget allocated for delayed rulings or a comparatively large number of cases rejected by higher courts.

78. **Reforms to the Labor Law in 2013 and 2014 represented a significant step toward greater labor market flexibility in Croatia.** As a result, Croatia is now closer to the OECD average in terms of the strictness of the employment protection legislation. The main objective of the recent labor market reforms was to foster hiring and employment growth by relaxing some regulatory restrictions. As part of the reform, *hiring costs* were lowered by raising the permissible cumulative duration of employment with Temporary Work Agencies (TWA) from one to three years as well as eliminating the three-year duration of the first fixed-term contracts. *Individual dismissals* were made easier and less costly by (i) abolishing the requirement to retrain and reassign the redundant worker to a different job; (ii) allowing employers to dismiss worker who are on long-term sick leave (for six months or more), and (iii) reducing the maximum compensation for unfair dismissal from 18 to 8 monthly wages. *Collective dismissals* were made easier by abolishing the requirement to prepare a “social plan” (which was meant to specify measures taken to minimize the impact of the redundancy). *Working time flexibility* was enhanced by allowing employers to redistribute working hours (i.e. to increase working hours during the peak periods and to proportionately reduce them during the slack period) with a maximum of 50 working hours per week (60 hours/week if provided for by a collective agreement). *Part time employment* was made less costly for the employer by introducing a *pro rata* principle, whereby all monetary benefits (bonuses, allowances, etc.) are paid in proportion to the actual working time.

79. **However, a number of rigidities is still in place, and there is room to improve labor market performance through further reforms.** The following issues stand out and need to be addressed in order to improve labor market performance.

- *Complexity of the Labor Law.* Despite reforms, Croatia’s Labor Law is difficult to understand, many provisions are unclear or ambiguous and can be subject to different interpretations. There is substantial space to simplify and streamline the Labor Law.
- *Adjudication of cases of unfair dismissal.* The expected costs of (individual) dismissals are high in Croatia because it is difficult for employers to prove poor performance or misconduct, and courts tend to rule in favor of the dismissed worker (almost invariably according to anecdotal evidence). When the court rules that the dismissal was wrongful, the employer is obliged to pay the dismissed worker all forgone wages (from the time the complaint was lodged until the court’s ruling). Given the protracted court’s proceedings (from 3 to 5 years), the cost to the employer can be prohibitive, which can act as an effective deterrent to dismissals. As long as court jurisprudence does not change so as to recognize the right of employers to exercise management prerogatives, the firing costs will remain high.
- *Collective agreements in the public sector* grant public sector employees monetary and non-monetary privileges that are significantly higher than in the private sector, which leads to labor market segmentation and inefficiency. There is a need to equalize the expected benefits of public and private sector employment, and to support efficient allocation of labor resources.
- *Specific provisions of the Labor Law that limit labor market flexibility* include short probation period (maximum of six months), priority rules for redundancies (e.g. the employer is obliged to take into consideration family responsibilities of workers to be made redundant), less working time flexibility in the case of firms not covered by collective agreements (which can be particularly problematic for small firms), and the possibility of a mandatory extensions of collective agreements to non-participating employers (without providing them with an opt-out option). There is room to revise these provisions so as to improve labor market performance, without lowering the overall level of employment protection.

80. **Croatia can adopt a strategic approach to building skills along the life cycle** starting with ensuring that all students graduate with the right cognitive foundation skills like reading and mathematics to prepare them for continuous learning and with adult education and training policies that help older workers improve their skills, facilitate shifts to sectors with higher productivity, and help the unemployed find jobs. Given the projected decline and aging of Croatia’s population, the imperative is to ensure that schools offer quality education for all students, including children and youth from disadvantaged background. Students in the poorest socio-economic quintile are roughly two years behind their peers in

the richest quintile in their reading and mathematics skills measured by PISA. To reduce inequities, it is important to understand the key factors which affect student achievement in the contexts that are specific and particular to the Croatian reality. Such knowledge comes through comprehensive data collection and analysis of existing conditions, to support impact evaluations of any policy and activity levers implemented to address national concerns. One key factor to understand thoroughly is teacher quality. Leading researchers have determined that teacher quality is the main school-based predictor of student achievement.⁵² As such, to ensure a high quality cadre of teachers, a national system of competence standards for teachers should be developed. The development of such a system is included in Croatia's education strategy. Implementation of the strategy has been slow, however. Improving the quality of teachers in general education will help to reduce the performance gap among socio-economic groups.

81. Croatia can strategically promote lifelong learning by improving labor market information, providing adequate incentives to firms and workers, and raising the capacity of firms and training providers. The government could use its convening power to create mechanisms to improve the flow of information on skill needs and encourage coordination and cooperation between firms, industry associations, and training providers. Improving the availability and quality of information is a critical first step to building demand-driven lifelong learning. As a holder of information of vacancies and due to its role of placing the unemployed, Croatia's Employment Services can play an important role in bringing the supply and demand side of training closer together. Government financing could be used strategically by leveraging private resources from employees and firms. Government resources could also be deployed to improve the skills of the unemployed, given the social returns from reduced social welfare payments and higher tax revenue when they transition to paid work.

82. The supply of early stage financing in Croatia is expected to increase in the coming years with funding coming from European Structural and Investment Funds (ESIF). However, unless the country has a risk capital culture already in place this money will not be fully absorbed. In the next few years, Croatia is expected to be the recipient of substantial funds from the European Union. A portion of these funds will be allocated towards supporting science, technology, innovation and entrepreneurship; this will include funding towards venture capital vehicle and other risk financing instruments. Preliminary figures indicate that €20 million will be allocated for venture capital in Croatia from structural funds during the upcoming period under Thematic Objective 3 of the Operational Programme Competitiveness and Cohesion 2014-2020.⁵³ Another initiative supported by the European Union is the development by the European Investment Fund (EIF) of a regional venture capital fund for the Western Balkans – the Western Balkans Enterprise Innovation Fund (ENIF). This fund will invest in countries across the region, which will likely include Croatia. As the country will make larger investments in research and innovation systems as part of its integration process in the EU and is preparing itself to receive EU funding, developing a sound mechanism for early-stage financing is even more pressing. There is therefore a need for preparing a framework that will allow the absorption and effective use of the expected inflow of EU funds. From the regulatory review side, Croatia needs to revise the transposition of the Croatian Alternative Investment Funds Act vis-à-vis the EU Alternative Investment Funds Management Directive to guarantee that the legal environment will allow to replicate best practices.

Firm's Exit

83. Evidence from previous work in this area suggests that reforming an insolvency regime can help lower interest rates and increase lending volumes, making credit more affordable. In Italy, the 2005 bankruptcy law reform that deeply reformed the liquidation procedure led to a decrease in interest rates⁵⁴. In particular, firms with higher numbers of bank creditors saw the most pronounced reduction in interest rates due to the enhanced coordination provided by the bankruptcy law.

84. Croatia has intervened into the bankruptcy framework several times to allow for out-of-court insolvent firm reorganization, to introduce strict deadlines to bankruptcy processes, and increase the capacity of the bankruptcy trustees. Despite all these initiatives, the reform process has not resulted in a significant improvement of the current system and firms still find it difficult to reorganize, while bankruptcy procedures still last three years on average. While the legal framework regulating the prebankruptcy settlement has been significantly improved in 2015, it is widely agreed that the institutions in charge of applying the recent reforms (courts, registries, FINA) lack the resources, skills, leadership, and experience to adequately enforce the law. It would be key to focus future reform efforts on strengthening the

⁵² Hanushek and Woessmann. (2007).

⁵³ The venture capital facility is planned to be a 50-50 funding match with private investors.

⁵⁴ Rodano, Serrano-Velarde, Tarantino (2012).

institutional capacity of the system in order to maximize the benefits of recent reforms on corporate insolvency.

85. A series of reforms targeted at strengthening the bankruptcy framework are necessary. These could improve the implementation of the recently approved legal framework and ensure that the legal changes achieve the results initially envisaged by the authorities. Specifically, the following is recommended:

- i. Closely monitor the application of the new (pre bankruptcy settlement (PBS) provisions in order to ensure its correct implementation by the institutional framework. Some adjustments might be required in the first months.
- ii. Review the tax treatment of NPLs, including the tax relief from the sale of NPLs below book value, and the tax implications of a write-down (in restructuring or liquidation) to the debtor and creditor.
- iii. Introduce training programs targeted at members of the judiciary, insolvency trustees, restructuring professionals and borrowers.
- iv. Develop Out-of-court Workout Guidelines and provide support & incentives to encourage banks to pursue restructuring of the largest, most complex defaulted corporate borrowers.
- v. On personal insolvency, provide resources and increase the capacity of FINA and the courts to ensure they can effectively play their role in this insolvency framework.
- vi. Consider the possibility of regulating the profession of insolvency commissioners.
- vii. Implement a coordinated policy towards NPL resolution in Croatia, by bringing together all relevant public and private sector stakeholders and reviewing, in a holistic way, current impediments to NPL resolution.
- viii. Review and improve the existing enforcement of executive procedures, especially for mortgages, to reduce the time spent in court proceedings, for example by introducing a limited list of admissible defenses.
- ix. Introduce an out-of-court enforcement regime for mortgages and, eventually, to pledges over movable assets, if the backlog of cases cannot otherwise be reduced.



Croatia Policy Notes 2016

Restoring stability, reviving growth and creating jobs

Strengthening Public Administration

Key Messages

A central challenge will be to reduce the wage bill to a sustainable level while continuing to deliver public services. This requires measures to improve the efficiency and effectiveness of public institutions and build institutional capacity to manage and coordinate increasingly complex policy issues, particularly now that Croatia is an EU member.

Key Actions

- Review how functions are allocated across the public administration and identify measures to rationalize ministerial structures, agencies, regulators, and local governments. Implementation will likely require the adoption of firm commitments and a time-bound action plan, monitored by a central unit to provide impetus for reform.
- Strengthen HR systems and management across the civil service by: (i) Professionalizing public institutions by establishing merit and performance based systems of recruitment, promotion and discipline for civil servants, harmonizing pay scales and facilitating mobility across institutions; and (ii) Reducing the number of political appointees in central and local administrations, and SOEs, and professionalizing leading positions in state administration bodies and professional services, including the management of majority state-owned and public companies.
- Promote strategic planning and a stronger performance orientation in public institutions through the strengthening of monitoring and reporting systems. Building on the early success of the e-citizen project there are significant opportunities to offer more responsive services to citizens and businesses.

Where Croatia Stands Now

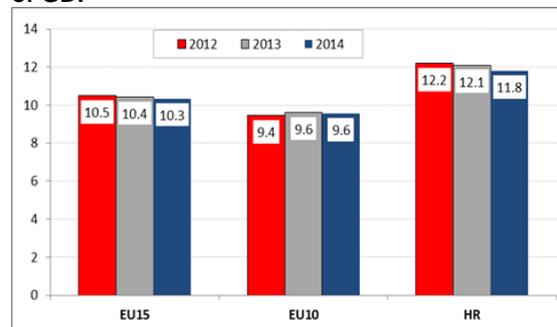
Public administration in Croatia is characterized by its high cost and relatively low effectiveness. According to the World Economic Forum Competitiveness Report 2015-2016, the two largest barriers to doing business in Croatia are inefficient government bureaucracy and policy instability. Severe rigidity in organizational structures, politicization of the civil service and the remuneration system are part of the problem. Functions overlap across various government institutions and different layers of government, policy coordination is poor and lines of accountability between ministries, agencies and subordinate public entities are often unclear. Local government units are fragmented into inefficient small units, which are not self-sustained and have excessively high wage bills.

A central challenge will be to bring the wage bill to a sustainable level. Further, it would need to make public administration more effective and ensure there is capacity for increasingly complex policy coordination, particularly now that Croatia is an EU member. Although previous governments recognized the importance of civil service and administrative

reforms, the process has been slow and reversible.

The public sector wage bill, at close to 12 percent of GDP, is well above average EU levels. Croatia spends more on public administration than most other EU countries (Figure 1), but performs poorly in indicators of public administration effectiveness (Figure 2), the rule of law and administrative barriers to doing business.

Figure 1. General Government Wage Bill, Percent of GDP



Source: Eurostat, MOF. Weighted average for EU15 and EU10 (member states that joined the EU after 2004).

The high wage bill reflects the growing number of public sector employees, rather than high wages. The rationalization of military

staff has been more than offset by growing local government employment in education and health services. With around 293,000 employees, general government represents 17 percent of the labor force and is the largest employer in the country. This number excludes more than eighty thousand staff employed by public enterprises, which jointly amounts to 22 percent of the Croatian labor force, some 4 percentage points above the EU average.

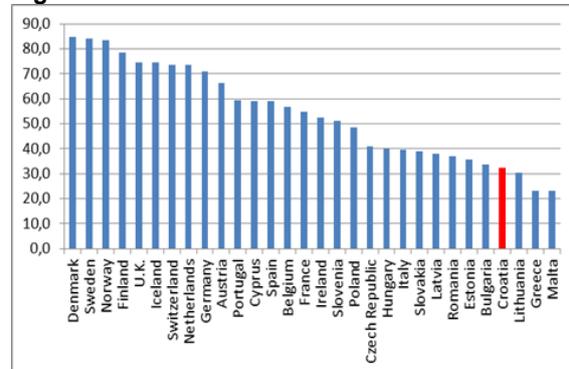
The growing number of public servants does not seem to reflect the demand for their services. For example, Croatia's public education staffing continues to grow despite a significant decline in the number of students enrolled. Croatia has the largest per capita ratio of judges and court personnel in Europe; yet there is evidence of a backlog of cases and concerns about service quality. The Bank estimates that some 2 percent of GDP in cumulative savings could be achieved over the medium term through staff rationalization in civil and public service to create a leaner, but more effective administration.

Public sector pay is based on seniority rather than performance. The reliance on benefits for years of service places an additional burden on the wage bill and increases incentives for older workers to stay. Croatia has a large cohort of middle-aged staff that entered the service around independence. Since there is a built-in incentive to stay in the system (i.e. staff receiving 0.5 percent increments per year of service and a strong bargaining power of public sector unions), the rate of natural attrition is low. At the same time, a staff retrenchment program, with severance packages based on years of service, would be costly (for someone with 30 years of service it would equal around EUR15,000), and will increase as this cohort ages. In addition to the years-in-service allowance, there are 15 different bonuses that range from 4 to 150 percent of basic salary, that are not mutually exclusive and can be greater than the basic pay. None of these allowances are performance related. Extensive use of allowances across the administration leads to upward pressure on wages. Total remuneration may therefore tend to be driven by bargaining power rather than qualifications, merit or performance.

Croatia's public administration performance score is the fourth lowest in the EU better only than Malta, Greece and Lithuania. According to the Global Competitiveness Report 2015-2016, Croatia ranks 126th out of 140 countries on the wastefulness of government spending. Given the high cost, Croatia's taxpayers are paying a high price for public services, close to the level in Scandinavian countries, but receive services that

tend to be of lower quality. These relative inefficiencies show that there is an opportunity for large savings and efficiency improvements without compromising the quality of service delivery.

Figure 2. Public Administration Performance



Note: a composite index of governance; capacities; and business-friendly design in key areas of companies' dealings with the administration.

Source: http://ec.europa.eu/growth/industry/competitiveness/public-administration/index_en.htm.

Dealing with red tape is time-consuming for businesses, drawing senior managers away from more productive tasks. According to the World Bank Business Environment and Enterprise Survey (BEEPS) 2014, senior managers in firms spend an average of 23 percent of their time dealing with public officials and public services. This is nearly double the average in EU countries that joined after 2004. In a worrying trend, the amount of time firms in Croatia spend dealing with red tape has increased by nearly 50 percent since 2008. According to the World Economic Forum Global Competitiveness Report 2015-2016, Croatia ranks 137th out of 140 economies for the burden of government regulation on business.

Government decision-making remains opaque. According to the World Economic Forum Global Competitiveness Report 2015-2016, Croatia ranks 113th out of 140 economies for transparency in decision-making. With the Act on the Right of Access to Information as well as the Act on Regulatory Impact Assessment, the legal framework for ensuring rights to access information as well as participating in the policy formulation has been improved. There have also been improvements regarding the availability of data on public finances, political donations, and the content and integration of public registers. Nonetheless, further reforms could continue to embed open governance practices.

The e-citizen project has demonstrated that Government service delivery can be quick, easy, accessible and effective. The e-citizen project has the potential to transform citizen's engagement with the central government and

public perceptions of service delivery in key areas such as health, education and pensions. Building on recent success with some services, the focus could now shift to full implementation of the e-citizen project, embedding the maximum number of services into the online interface.

Nonetheless, in many areas, interactions with government are slow and performance is sometimes deteriorating. For example, the number of days that firms wait for new water connections, electrical connections, operating licenses and import licenses have all risen since 2008. Some have more than doubled. For example, according to BEEPs, in 2008, firms waited an average of 27 days for an operating license, but by 2014, they were waiting an average of 55 days.

How Croatia Can Improve the Efficiency of Public Administration

Public administration reform needs strong political leadership and reform management. Adoption of firm commitments and a time-bound action plan, monitored by a strong central unit could provide impetus for reform.

While a number of agencies have merged in recent years, more could be done. The structure of state administration remains excessively fragmented with overlapping functions at the level of line ministries and among ministries and subordinated bodies. Further rationalization should be based on a thorough review of institutional functions, because mechanical merger of institutions could exacerbate the problems already inherent in the system, especially fragmentation. Restructuring could incorporate the separation of policy-making, regulatory, and service delivery functions within ministries, regulatory bodies, and agencies, all based on a revised law that would define the principles for the organization of public administration. Such a law could clearly allocate functions (policy development, regulatory management, supervision, inspection, and implementation) and responsibilities between public institutions.

Improvements in human resource management within the civil service could help develop a professional cadre of officials. The European Quality of Government Index 2013 rates Croatia's public service among the least impartial and the least meritocratic in Europe. Systematic use of more objective criteria for recruitment, evaluation and promotion might help instill a more merit-based, professional culture and reward performance. The wage system also needs to be reformed to make base pay the main component of pay. Standardized job

classifications could help ensure equitable pay across the public sector. The central payroll system should be merged with the HR management information system to strengthen controls and facilitate management.

There is also a need to professionalize the civil service. According to the Global Competitiveness Report 2015-2016, Croatia ranks 100th out of 140 economies for favoritism in decisions of government officials. The lack of a clear separation between political and career posts also creates significant instability among senior civil servants, reduces corporate institutional memory and learning, as well as incentives for qualified staff to stay. Depoliticizing top managerial positions in ministries, state agencies and SOEs could prevent brain-drain and operational gaps emerging after elections. This should be combined with more continuous skills development to help civil servants build their professional capacities. There is currently no central policy to promote professional development in the civil service, despite the training infrastructure to support it. The experience of EU countries suggests that the need for more skilled civil servants will grow with progress in the process of European integration. Over time, this will ensure that Croatia has a stable, well equipped and agile cadre of civil servants, capable of meeting modern public service delivery challenges.

Most of the issues described require sustained and long-term attention; however, several important steps could be taken in the short term:

1. **Rationalize the structure of public administration:** (i) Conduct a functional review and analysis to inform further rationalization of ministerial structures, agencies, regulators, and local governments; (ii) Prepare the time-bound plan for rationalization.
2. **Strengthen HR systems across the civil service:** (i) Install a Human Resource Management Information System to link staff personal information to payroll payments as a basis for reforming the civil service salary system; (ii) Reform salary systems for the civil service, public service, and local governments to harmonize pay scales and facilitate mobility and better performance. This will require new job classifications and wage scales and a reliable system of performance appraisal; (iii) Establish an objective system of evaluation, promotion and discipline for civil servants; (iv) Offer greater continuing education for civil servants to build their capacity and boost their performance; (v) Limit the number of political

appointees in ministries, subnational government and other agencies; and (vi) Professionalize the leading positions in state administration bodies and Government professional services, including the management of majority state-owned and public companies.

3. **Strategic planning and policy coordination** could be strengthened. Policy-making needs to be closely linked to financial planning and implementation. Effective policy management would imply, for instance, drafting concept policy documents along an analysis of the expected impacts before drafting legislation. The current system for policy coordination appears top heavy with little effective prioritization, leading to blockages in the system. There is also no functioning system to assess the impacts of reforms, which means that the cost and even the desired impact of new regulations are often unclear. Fiscal impacts are often not well articulated or planned, resulting in reforms that cannot be

initiated and gaps in rollout and implementation.

How the World Bank Group Can Help

The Bank offers strong experience working with clients on civil service reform – globally, regionally and in EU countries. This experience is focused on rolling out reforms that increase efficiency and effectiveness in the public service delivery to people and businesses. This includes supporting functional reviews, right-sizing of public administration, business process re-engineering, wage system reforms, citizen-centric service delivery models and e-government services. The Bank support in EU countries is also focused on supporting the establishment of Government Delivery Units, aimed at mainstreaming modern techniques of decision making, monitoring and communicating the reform agenda, and Strategy Units, to help coordinate and monitor strategic planning.

This Policy Note was produced by the World Bank to inform policy debate in Croatia. This note was prepared by Public Sector Specialist Georgia Harley and Senior Economist Sanja Madzarevic Sujster.

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For any questions regarding this note, please contact Vanja Frajtic, Communications Associate (vfrajtic@worldbank.org).

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Croatia Policy Notes 2016

Restoring stability, reviving growth and creating jobs

Tax Policy and Tax Administration

Key Messages

Croatia's tax system raises significant revenue and has undergone major improvements in recent years. Further improvements include making it more equitable, and labor and business friendly. Tax administration could be more efficient and user friendly through ongoing efforts to improve IT systems, consolidate the reorganized administrative structures and upgrade staff skills.

Key Actions

- Introduce modern property taxation (generating revenues up to 1.5 percent of GDP) while abolishing outdated local real estate-related taxes and fees.
- Eliminate a large number of tax exemptions given to households and businesses (saving up to 1.1 percent of GDP).
- Shift the tax burden from labor to indirect taxes to help support growth (revenue neutral).
- Introduce tax policy and tax administration measures to incorporate the shadow economy and strengthen and modernize tax administration to protect and expand the revenue base, including the implementation of a modern compliance risk management system.

Where Croatia's Tax Policy Stands Now

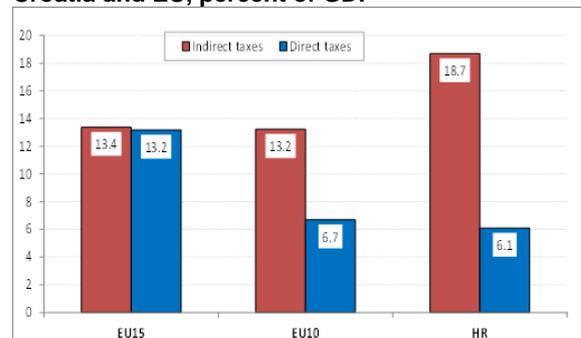
The objective of tax policy is to build a modern and efficient tax system that raises sufficient revenue in a way that is fair and minimizes distortions. Reform measures typically emphasize measures to broaden the tax base, focusing on consumption taxes, eliminating ineffective exemptions or tax expenditures before increasing the rate. This also involves removing negative externalities, such as disincentives to work, and strengthening tax compliance.

With a revenue burden at 42.6 percent of GDP in 2014 there is some, but limited scope for additional revenues in Croatia. While the EU15 average is 45.6 percent, Croatia's tax burden is higher than its neighbors at similar levels of development. Therefore, the focus for Croatia's tax policy should be on ensuring the most appropriate composition of taxes that will drive growth and job creation through efficient tax collection with minimum distortions or exemptions. Both business and government benefit from a tax system that is simple to administer and encourages voluntary compliance.

Croatia has the highest indirect tax to GDP ratio among EU countries. To respond to a revenue fall during the crisis, the basic VAT rate was increased to 25 percent, among the highest in the EU, and the zero rate was replaced with a

5-percent rate, while tourism and catering services apply a 13 percent rate. The overall revenue foregone due to these differing thresholds amount to close to 1.8 percent of GDP.

Figure 1. Indirect and Direct Taxes in 2014, Croatia and EU, percent of GDP



Source: EUROSTAT

Direct taxes on the contrary are comparably low, largely eroded by large tax exemptions.

The effective rate for personal income tax is only around 9 percent, despite a top marginal rate of 40 percent. In the case of households, there are several exemptions e.g. tax allowances on dependent family members and children, as well as for underdeveloped regions. Businesses also enjoy exemptions if located in underdeveloped regions, for reinvested earnings, R&D, and tax reliefs as part of the investment promotion act, with the estimated revenue loss amounting to 2.3 percent of GDP in 2014.

Croatia has moved to reduce labor taxes further since 2014 through an increase in the non-taxable part of income (or personal allowance, which reduces the revenue collection by 3.5 percent of GDP), and by shifting the highest PIT bracket upwards to reduce the tax burden on middle-income groups. Social security contributions for young employees have also been reduced to incentivize employers to recruit more.

Croatia has no recurrent property tax and raises the lowest revenues (0.3 percent of GDP) in the EU from property taxes. A modern value-based property tax could add up to 1.5 percent of GDP in new tax revenues⁵⁵. In addition to the revenue potential, the burden of a property tax would largely rest on middle- and upper-income families, and be less distortionary for business and consumer decisions. Currently the property tax base is deeply eroded by a combination of legal exemptions, an incomplete cadastral registry (which fails to capture all properties) and a real estate market that does not provide transparent information on valuations. However, the proposed property tax remains unpopular and in 2015 the previous government postponed the introduction until the land registration and cadaster data are fully harmonized and updated.

The size of the shadow economy, at 28% of GDP⁵⁶, is one of the largest in the EU. This is challenging for the tax administration and reduces the tax collection potential. Various policy and administrative measures can be taken to tackle the shadow economy. A three-pronged approach could comprise the following elements:

- (a) Introduce strategies to improve tax enforcement, particularly measures to identify and then reduce underreporting or non-reporting of sales, or inflating expenses through false invoices;
- (b) Incentivize formal payments for business transactions through banking channels, including electronic payments, and “plastic money”;
- (c) Enhance tax simplification and taxpayer services to reduce the costs of tax compliance, including by simplifying tax laws, and filing and payment systems.

How Croatia Can Enhance Tax Policy

Croatia could: (i) introduce a modern property tax; (ii) reduce the large number of tax

exemptions; and (iii) continue its “fiscal devaluation” by reducing labor taxes.

Introducing a modern property tax requires capable local governments to administer it and a comprehensive reform plan. Four main reform steps include: (i) identification of the property being taxed; (ii) assessment of the property value and the tax base; (iii) establishment of the tax rates; and (iv) abolition of other property-related taxes. It is unlikely that such a tax would generate significant revenue until the cadastral registry is updated and the real estate market better developed so that valuations can be more transparently calculated. Considering that a fully updated cadaster with all necessary information for property valuation will take time to build, a short-term alternative might consider an interim self-valuation procedure.

Reducing the large number of tax exemptions could raise an additional one percent of GDP, while improving effectiveness and fairness.

For example, a recent review of child tax allowance—a tax rebate offered for families with children that results in forgone taxes of around 0.6 percent of GDP, undertaken by the World Bank, shows that the program is highly regressive, as it does not cover low-income groups and maximizes the benefit for high-income groups. The program also discourages work for lower-income groups (in contrast to a tax credit system). Similarly, reinvested earnings tax relief for businesses reduces revenue, by 0.6 percent of GDP in 2013, while the gains through new investments are questionable. Overall, the design of taxes and social benefits should also reduce disincentives for moving from either benefits or inactivity to work.

Payroll taxes and social contributions can suppress employment and labor-intensive growth.

In OECD countries, the burden of labor taxes can account for up to 40 percent of labor costs, particularly for lower-wage individuals. Labor taxes are also disproportionately high in European countries. For instance, in Poland, Romania, and the Slovak Republic, social security contributions make up 45–49 percent of the gross wage; while in Chile they were 13 percent and in the Republic of Korea 16 percent. With the contribution rate of 37 percent Croatia follows the EU path, with the caveat that the pension contribution rate is moderate, while the health insurance contributions, at 15 percent of gross wage, is high—almost double the EU average. High levels of labor taxation, combined

⁵⁵ World Bank 2014, Public Finance Review

⁵⁶ “The Shadow Economy in Europe 2013”, AT Kearney, F. Schneider

with tax incentives for capital investment, can exacerbate high unemployment.

Where Croatia's Tax Administration Stands Now

A modern tax administration ensures that taxes can be paid quickly and cheaply and do not deter investment or value adding activities. Modern tax administrations are citizen-centric, ensuring that (i) taxpayers know their rights and responsibilities, (ii) processes are transparent and simplified, and (iii) there is support for taxpayers and deterrents for evasion.

Strengthening and modernizing Croatia's tax administration (CTA) would help protect and expand the revenue base. The CTA is responsible for collecting national and some local taxes, social insurance contributions, and a large number of levies, fees, and other charges. The Customs service collects excises, customs and imported VAT. As Croatia becomes more integrated into the global economy, the CTA will face challenges of increasing complexity. For the quality of its services to meet modern standards the CTA will have to move from being procedure-oriented to results-based. The objectives of modern tax administration include: (i) promoting a voluntary compliance culture, (ii) improving taxpayer services, and (iii) efficient collection systems.

Significant progress has been made in reorganizing the CTA. The CTA has been reorganized along functional lines at the central and regional levels; a Large Taxpayers Office (LTO) was established at the national level in 2012 along with a Taxpayer Service Unit and a unit for Sector Strategy and Development. The taxpayer identification number (OIB) has been introduced and fully integrated into the e-citizen initiative. Many of these reforms have been introduced in partnership with World Bank support.

Important tax administration reforms have been implemented. Fiscal registers were introduced from January 2013 for cash-based services to increase compliance; and public listing of tax delinquents was launched in June 2012. In 2013, a strengthened tax administration code strengthened powers to collect tax-related information from taxpayers and third-parties and enforce payment of tax arrears. It also introduced formal tax opinions for taxpayers, thereby removing ambiguities in tax settlements.

Advances are being made to expand the use of technology. These include Information and Communication Technology (ICT) tools for Compliance Risk Management, e-Audit, and e-Learning. The CTA has overseen the move to

electronic filing mechanisms (e-VAT, e-pension, e-health and e-PIT) with the percentage of e-filing by the corporate sector increasing from less than 3 percent in 2007 to more than 99 percent in 2015. CTA has also upgraded its website, which has more than 26 million visits per year, making it one of the most popular government websites. CTA is moving ahead with the procurement of enhanced hardware and software and the creation of a disaster recovery and business continuity center (DRBC).

Table 1. Compliance Costs in Croatia

Tax or mandatory contribution	Payments (number)	Notes on Payments	Time (hours)
Social security contributions	1	online	96
Tourist fee	1	online	
Forest contribution	1		
Chamber of Economy fee	12		
Tax on company name	1		
Corporate income tax	1	online	58
Value added tax (VAT)	1	online	52
Employee paid - Social security contributions	0	online and jointly	
Fuel tax	1		
Totals:	19.00		206.00

Source: World Bank, www.doingbusiness.org

Taxpayer compliance has been steadily improving. The VAT tax gap in percent of GDP has been steadily falling, from 2.05 percent in 2011 to 1.52 percent in 2013. Croatia also shows significant improvement in its position in the Doing Business 2015 indicator on paying taxes: rising from position 43 in DB 2013 to 38 in DB 2015 (see Table 1). The results show that Croatia's indicators are very near OECD averages in terms of the number of payments per year (19 Croatia/12 OECD); and hours spent on tax compliance per year (206/175).

The CTA faces three interlinked challenges to further improving performance. These are: restructuring its organization; building human capacity; and improving its IT systems.

CTA can strengthen the role of HQ in designing programs and providing strategic guidance. There are too many field offices and they rely heavily on manual procedures and frequent contacts with taxpayers, especially at the local level. This not only overwhelms staff, it prevents them from doing more complex and important tasks, such as audits and collection enforcement. The inefficiencies associated with a large network of local offices will worsen as business processes become more automated and e-filing (including CTA pre-filing of tax declarations using third party data) and e-enforcement is extended.

The CTA headquarters' has too few staff to adequately direct the large number of local offices, which operate with considerable autonomy and minimal effective oversight.

The way CTA is organized does not correspond to the principles of modern tax administrations, which distinguish between the role of HQ in designing programs and providing strategic guidance and the operational role of local and regional offices. Consequently, corporate governance should clearly allocate responsibilities between HQ, regional, and local offices.

Building capacity of CTA staff in the LTO is also a high priority for improving revenue collection. This is often a complex task given the various corporate models and requests for highly specialized skills. CTA has made significant progress in getting a fully-fledged national LTO in operation in 2012. The new office has been assigned 650 large taxpayers who account for about half of Croatia's tax revenue. The LTO is fully aligned with the taxpayer segmentation approach, which is a core strategy of modern tax administration.

Building capacity in the new Office for Taxpayer Services will also help reduce voluntary compliance costs. Croatia has recently established a dedicated unit for taxpayer services and assistance, with a call center, and services tailored to the unique characteristics and risk profiles of taxpayers (the taxpayer segmentation approach). Strengthening this unit and using the call center to control non-filers and delinquent taxpayers is a priority to enhance compliance.

CTA could be given more operational autonomy to administer the tax system, with stronger accountability provisions. CTA staffing levels have been eroded due to recruitment restrictions. Additionally, CTA lacks the flexibility and autonomy to: (i) design and implement its organizational structure to meet changing requirements; (ii) determine the level and mix of staff and influence or negotiate their remuneration; (iii) influence the staff recruitment process; (iv) allocate resources to respond effectively to changed priorities and risks; (iv) make tax rulings; and (v) set service standards. Therefore, giving CTA semi-autonomous status and enough power to administer the tax system effectively could be considered.

A modern Compliance Risk Management System (CRMS) could help improve tax compliance and enforcement. Introducing a CRMS to systematically identify, assess, rank, and deal with tax compliance risks is a priority. Its overarching objective is to stimulate and facilitate

voluntary compliance with tax laws and prevent noncompliance by understanding the tax base and taxpayer risk profiles. Pursuing a risk management approach would help CTA to: (i) craft a compliance strategy that directs efforts at major compliance risks (e.g., large taxpayers who are the highest compliance risk to revenues); (ii) reflect the strategy in annual operational plans and instructions (e.g., national audit plans, audit selection parameters, taxpayer service plans, and debt collection plans); and (iii) improve compliance tools (e.g., audit organization and methods, taxpayer services, and enforced collection) and the skills of tax administration management and staff to efficiently realize strategies and operational plans.

CTA has a range of strategic planning documents, but implementation is challenging. The Sector Strategy and Development Unit could enhance the institutional awareness and understanding of strategic directions and manage coordination efforts across CTA to ensure that strategic and business planning processes are linked and translated into instructions and procedures for the day-to-day work of local and regional offices. Other priorities could include strengthening IT governance to put in place an integrated management information system, and improve the planning and exploitation of information. Strengthening human resource capacity is also central to modernizing tax administration. The CTA training strategy therefore needs to be aligned with the reform priorities, current organizational conditions, business reengineering processes, and IT developments.

How Croatia Can Enhance Tax Administration

CTA should focus on three issues in the short term: (i) implementing the CRMS system, (ii) implementing the disaster-recovery and business continuity system, (iii) increasing the capacity and training of staff especially within the LTO.

The CRMS system would include three key modules: (i) a risk management module that will select taxpayers for audit on the basis of risk analysis, (ii) a data warehouse, and (iii) general audit support (GAS). The system implementation is underway with the core system provided by the private sector and the GAS module developed in-

house through APIS-IT⁵⁷. Once implemented the system should enhance CTA's ability to detect fraudulent practices and thus optimize the effectiveness of the audits system. This will not only increase recovery of unpaid taxes but, will also serve as a powerful incentive to foster voluntary compliance.

Further, the security and integrity of CTA data is of critical importance to Croatia. As such, the CTA is developing a disaster recovery and business continuity (DRBC) facility. Once completed the DRBC facility will allow the CTA to continue its operations should anything happen to the main data center in Zagreb.

Training of CTA staff has increased in recent years through the introduction of e-learning modules in various areas including: anticorruption, E-Tax, VAT, value-for-money purchasing, information security, effective management, specification of unmatched payments, forced collection and enforcement. These specialized courses as well as general IT and language training are important to upgrade the skills of CTA staff. It is important that these pilot efforts are mainstreamed into a sustainable offering including tests and certifications for staff that complete the various modules which are linked to the CTA modernization strategy.

The tax office network consolidation needs to be continued. As the CTA moves to electronic communication, in the medium term CTA can consider the physical consolidation of its offices starting with its offices in Zagreb, which continue to be fragmented across more than 13 offices. Bringing them together could greatly improve operational synergies and reduce administration costs.

CTA staff continues to be skewed towards clerical and administrative functions. In future the ratio of audit staff to other functions should gradually rise to achieve the target of 65 percent of staff in audit functions (up from the current level of close to 50 percent). This will require strengthened efforts to recruit, train and retain qualified and competent staff. Achieving such an

objective within the confines of the broader civil service structure will be extremely challenging.

Finally, the strategic functions of the CTA headquarters need to be strengthened. This would include preparing, monitoring and evaluating of the CTA medium-term strategic plan and its results, proposing policy and system reforms that would be needed to increase CTA efficiency, reduce the compliance costs and improve the compliance rates, as well as rendering high-quality analytical inputs for decision making to the CTA management, the MOF and the Government.

How the World Bank Group Can Help

The World Bank has significant experience working with countries worldwide, including a significant number of EU countries, on tax policy and tax administration. This experience includes the recently concluded Revenue Administration Modernization Project (RAMP) in Croatia, which closed in June 2015. The Bank has produced a number of diagnostic studies on tax policy in recent years, including the Public Finance Review (PFR) of 2014 and Child Tax Allowance Policy Note of 2015, which looks at both tax and benefit incidence. As outlined above, a number of reforms in tax policy were started and have been postponed e.g. the proposed introduction of a property tax. The World Bank would be ready to partner with the government in carrying out proposed reforms along with further strengthening CTA efficiency.

This Policy Note was produced by the World Bank to inform policy debate in Croatia. This note was prepared by Ismail Radwan, Lead Public Sector Specialist and Sanja Madzarevic-Sujster, Senior Economist.

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For any questions regarding this note, please contact Vanja Frajtic, Communications Associate (vfrac@worldbank.org).

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⁵⁷ The CRMS system was supported by the World Bank Revenue Administration Modernization (RAMP) project until it closed in June 2015



Croatia Policy Notes 2016

Restoring stability, reviving growth and creating jobs

Strengthening Public Investment Management and EU Funds Absorption

Key Message

Strengthening Public Investment Management (PIM) can improve the growth impact and efficiency of public infrastructure and unlock more of the substantial committed resources from the EU during the 2014-2020 financial perspective. Strengthening PIM planning, contracting, and implementation capacity, along with improvements to the strategic planning and medium term budgetary framework (MTBF), should therefore be a key component of Croatia's growth reviving strategy.

Key Actions

- Create fiscal space to support EU funds absorption through expenditure switching and substitution policies.
- Strengthen capital budgeting processes, including the link between investment planning and the MTBF, and between national priorities with the Cohesion Policy priorities.
- Introduce a broader PIM-decree, with a comprehensive set of underlying regulations and guidelines, and a PIM information system to enhance the planning, selection, procurement and monitoring of public investment projects.
- Strengthen individual and organizational PIM capacities, including project management capacity in line ministries and SOEs, and SOE governance arrangements.

Where Croatia Stands Now

Improving Public Investment Management (PIM) has the potential to boost Croatia's economic growth and competitiveness.

Croatia's overall level of public capital spending is relatively high, but lower than in other EU member states that join since 2004: Croatia invested 3.7 percent of GDP in 2014 for general government, compared to an average of 2.7 percent in EU15 and 4.5 percent in EU10 (this figure rises in Croatia to 6.2 percent including SOEs). However, indicators suggest that this has yet to lead to the expected outcomes in terms of economic growth, competitiveness and improvement of public services. This is at least in part explained by institutional and process weaknesses in the PIM system itself leading to lower quality spending and inefficiencies in implementation.

International evidence suggests there are significant benefits from improving PIM.

Countries with the most efficient PIM systems tend to have higher growth for each dollar spent on public infrastructure investment than the least efficient countries⁵⁸.

PIM supports the effective absorption of EU Structural and Investment (ESI) Funds.

As a new member of the European Union (EU), Croatia benefits from sizeable EU transfers. ESI funds available total around €10.7 billion over the 2014-2020 financial perspective (equivalent to an average of 3.7 percent of today's GDP per year), while Croatia's annual contribution to the EU budget is about €530 million. Effectively utilizing ESI funds is an opportunity to boost growth and improve public services, including through co-financing for public investments. Given that much of the ESI-funds go towards public investment, effective planning, preparation and implementation will make a positive contribution to absorption rates.

A key question for Croatia is how to create fiscal space through expenditure switching and substitution to support fiscal consolidation and ensure the most efficient use of EU funds to support growth. Croatia's pre-accession and post-accession record for absorbing EU funds is relatively good. By end-October 2015, Croatia had contracted over 89 percent of the allocated IPA and ESI 2007-13 funds and paid half of the contracted funds for

⁵⁸ IMF, Making Public Investment More Efficient, 2015.

which the disbursement deadline is end-2016. Croatia was also a net recipient of EU funds in the first two years post accession (by 0.12 and 0.42 percent of GNI). However, the fivefold increase in funds available to Croatia under the current EU financial perspective raises new challenges—while ESI Funds are expected to provide the bulk of investment financing, in the short and medium-term this will add to the fiscal consolidation pressures as Croatia will need to provide some of the upfront funds and co-financing.

The coordination of the national strategic priorities and harmonization with Cohesion Policy objectives is challenging. The EU Partnership Agreement aims to align strategies at national, regional and local levels to ensure that funds have cumulative and long-term impact on growth, rather than being allocated to one-off projects. All Operational Programs have been adopted along with the preliminary allocation of funds among implementing bodies and beneficiaries, although several ex-ante conditionalities remain to be cleared by the EC. However, Croatia’s strategic planning function is still being developed at the national, regional and local level to set clear priorities, objectives and performance indicators.

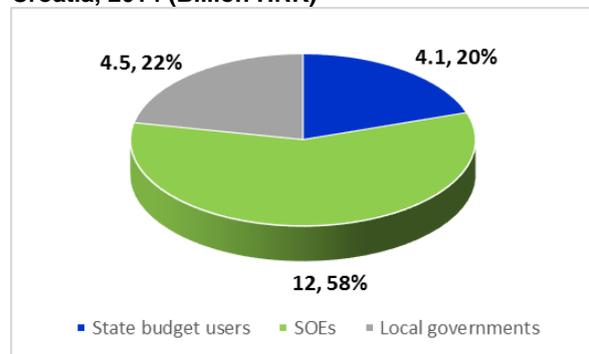
Croatia should continue to strengthen the management of capital expenditures and EU funds management. The adoption of the new Organic Budget Act in 2008 spurred several reforms in public expenditure management, including strengthening the multi-year fiscal planning system and establishing a capital spending evaluation unit. As envisaged in the Budget Act, the Ministry of Finance (MOF) has launched work on a Decree that will fill an important gap in the methodology for appraisal of public investment projects financed from the State Budget and other sources. Moreover, the National Reform Program emphasized the importance of enhancing the planning and preparation of public investment projects and the management of public resources to strengthen the absorption capacity of EU funds. However, challenges remain in establishing clear roles and responsibilities and formalizing steps in the PIM-cycle.

Public investment in Croatia is dispersed across a number of organizations, with the largest share carried out by SOEs. SOEs continue to play an important role in supplying public infrastructure, although the rationale for the choice of organization is not always apparent. Of an estimated HRK20.6 billion infrastructure investment in 2014, 12 billion was carried out by SOEs (of which some are part of the general government coverage), while the remaining 8.6 billion was shared among central and local government. The dispersal of public investment

means that a coherent approach to PIM will have to consider the adequacy of current SOE governance arrangements as well as more centralized regulations and processes.

The lack of clear national regulations and guidelines presents a significant risk for the quality and efficiency of core PIM-functions. Currently, there is little or no assurance that projects are effectively screened against government policies and strategies, appraised using formalized appraisal tools and independently reviewed. The roles and responsibilities of key stakeholders lack clarity, resulting in ambiguity concerning the levels of approval and overlap of some functions. There are also gaps in terms of formalizing the requirements for project management and monitoring, especially for state budget funded projects.

Figure 1: Public Sector Capital Expenditure in Croatia, 2014 (Billion HRK)



Source: MoF, www.mfin.hr, budgets and financial reports

In the absence of a coherent national regulatory framework, the use of several procurement methods and financing sources risks creating and deepening parallel administrative structures. While governmental agencies prepare and implement projects co-financed by the EU according to EU regulations, these need to be translated into a coherent set of national rules and guidelines. The Government has developed a comprehensive regulation on Public Private Partnerships (PPP) while the EU’s new Investment Plan for Europe (the so-called Juncker plan), comes with a financing vehicle, the European Fund for Strategic Investments (EFSI) that sees mobilizing private investments into commercially viable projects as a key priority. While leveraging additional funds from the private sector or other agencies and utilizing new financial instruments can be appropriate for certain projects, separate institutional arrangements for PPPs is a cause for concern as international good practice points towards harmonization of the processes at the pre-appraisal, appraisal and independent review stages for investment projects regardless of the procurement method. This helps to ensure a level playing field in the selection of

projects. Yet, these processes are largely separate in Croatia.

A comparison with good international practice shows gaps in key steps of the PIM cycle. A methodology developed by the Bank allows a comparison of current Croatian practices with good practices in key stages of PIM. These stages include:

- *Strategic guidance and preliminary screening.* **The lack of an overarching national strategy clearly articulating public investment priorities inhibits effective pre-screening of project ideas.** Considerable emphasis should be given to filtering out “bad project ideas” at an early stage. This is to ensure that only those projects with a clear rationale in relation to government policies and strategies proceed, and to avoid wasted resources on project appraisal and design. Projects also tend to get their own planning momentum, which makes it more difficult to stop at a later stage. Yet, in Croatia, the planning framework offers little strategic guidance on which to base screening of project ideas. There is, consequently, no centralized process and guidelines stipulating the format and requirements for screening initial project proposals for consistency with overall policy priorities. Line ministries may to some degree screen proposals from their departments for relevance with sector policies. However, SOE-investment proposals generally are not subject to systematic screening. Line ministries review SOEs financial plans, but tend to be concerned with the overall capital investment envelope rather than the relevance and rationale of individual projects.
- *Formal appraisal and independent review.* **Currently, there are no specific guidelines for the appraisal of public investment projects to be financed by domestic revenue.** While standardized appraisal tools are internationally recognized as important to ensure that chosen project options are feasible and of socioeconomic value, current regulations do not specify any requirements for such feasibility studies. The PIM decree under the Budget Act is set to address this gap, but is still being developed. The appraisal of capital expenditure requests by the line ministries is extremely basic without a proper cost-benefit analysis. In a similar vein, there is usually no pre-feasibility study that would include costing and cost-benefit analysis of a broader range of options contemplated for significant projects.

However, public investment projects intended for EU and other external financing undergo more comprehensive appraisal, as required by the relevant institutions. EU-

financed projects are subject to pre-feasibility and feasibility studies with demand forecast, financial and economic cost-benefit analysis including risk and sensitivity analysis, and assessment of environmental impacts. International financial institutions require similar evaluation for projects that they finance. As in many other EU members, there is scope for utilising the capacity created through compliance with EU requirements at the local and ministry level for nationally-funded projects.

Independent review of appraisal is underdeveloped. Good practice countries typically formalize independent checks of any bias in project documentation. This is particularly important as line ministries are not in all cases following a stringent model for separating internally the roles of “project proposer”, “appraiser”, “reviewer” and “approver”. For example, pre-feasibility and feasibility studies would in many cases be outsourced with the contractor reporting to the same unit or authority that has proposed the project. At the same time it is not clear on what basis projects would be approved at the line ministry level and to what extent line ministries would use technical committees or other methods to ensure quality. Review at the line ministry level in some cases also takes place at the program rather than project level, creating a gap in review of the quality of project proposals.

The role of the Budget Analysis and Capital Projects Evaluation Department within the MoF as an independent reviewer at the central level, is currently inhibited from effectively filling this role. The regulation and procedures do not specify the submission by line ministries of sufficiently detailed project documentation nor a specific approval process that the independent review could feed into. The department also has limited capacity – currently a total of two officers – that can be assigned to the task, while four more positions are currently unfilled. This lack of MoF oversight of appraisals is true for domestically financed as well as externally financed projects, although there are separate procedures for scrutinizing external financing requiring state guarantees.

- *Selection and Budgeting.* **A fundamental aspect of a well-functioning PIM system is the appropriate linkage between the appraisal and selection of projects and the budget cycle.** Desirable features of a selection and budgeting system are: transparent criteria for selecting projects; a well-structured budget preparation process with the scope to integrate investment and recurrent implications of projects over the medium to long term; effective gate-keeping to ensure that only appraised and

approved projects are selected for budget financing; and, finally, ensuring adequate financing for selected projects, including operation and maintenance costs after completion.

No explicit criteria exists for the prioritization and selection of public investment projects other than higher level programmatic strategic planning. Three-year strategic plans by line ministries should contain missions, visions, strategic goals, as well as actions to achieve them and their correlation with the organizational and program classifications, and performance evaluation measures. The program budgeting initiative is however at an early stage and is currently mainly used to classify the budget along program lines rather than consistently arranging the budget process according to a program logic.

The selection of projects is further inhibited by the lack of a comprehensive project pipeline. Save for a list of EU-financed projects maintained by the Ministry of Regional Development and EU Funds and separate lists for some sub-sectors, there is no project pipeline that could be used more proactively – from the side of the government – to shape the composition of capital investment and to speed up the uptake of EU funding. Nor is there any comprehensive database for on-going and planned projects.

The gate-keeping function is currently inadequate due to the lack of regulation and guidance on appraisal and approval of projects. The Budget Act requires line ministries to formally appraise projects before entering into liabilities, but the absence of more specific regulation and guidelines means there is little certainty that projects selected for financing have gone through rigorous appraisal and approval.

The capital budgeting process is vested within a MTBF, but design limitations may affect project prioritization and funding predictability. First, it appears that the MTBF does not operate as a rolling framework. While a distinction between new and on-going activities has been introduced, it is not clear that the fiscal year budget takes its starting point in a “roll forward” of the outer year from the previous year’s budget cycle. Second, there is no clear concept of fiscal space for the whole of government and no clear procedure for deciding on the priorities for its utilization, including trade-offs between different investment projects and between capital and other spending. In practice, decisions on the utilization of fiscal

space is to a large degree decentralized to line ministries, which are given much discretion to decide on resource allocations as long as they operate within their agreed budget ceilings. Despite these limitations, there is no available data to indicate that adequate financing is not made available for selected projects.

The operation of an effective MTBF is also hampered by capacity constraints in the MoF. A well-functioning MTBF is normally associated with a longer term shift in the focus of the budget office-function away from compliance checking and budget administration towards budget analysis emphasizing the analytic scrutiny of budget proposals. Officials of the MoF have however indicated that there are capacity constraints on their ability to effectively play a more analytical role.

- **Project implementation, finalization and ex-post evaluation. While there are no hard data on time and cost overruns, there are indications of implementation challenges** e.g. Procurement of public investment was noted as posing difficulties at this stage of the public investment cycle.

Budget preparation and execution procedures appear to have a mixed impact on effectiveness of implementation. There is no evidence to indicate that allocation levels are insufficient to ensure timely completion of projects, and there are mechanisms in place to allow multiyear commitments with possible expenditure consequences for future fiscal years. On the other hand, a skewed pattern of in-year spending, with 28 percent of capital spending happening in the last month of the fiscal year, indicates that there are issues either with the timely initiation of activities related to investment projects or insufficient in-year and end-of-year flexibility.

While project management procedures and organization are well established for EU and other externally funded projects, including via dedicated PIUs, there is a lack of requirements and guidance for state budget funded projects. The level of project management training and capacity building is unknown, but interviews with government officials have not indicated the existence of any systematic training or capacity building programs, neither at central or line ministry level, except for some EU-related training.

The absence of a central monitoring system results in the lack of updated information and overview of the public investment portfolio. Various parallel reporting streams generate partial information.

Requirements for adjustments to project values and scope are unclear. No regular mechanisms exist in relation to the formal adjustment of public investment projects under the Budget Act. For PPP projects, the PPP Act stipulates the obligation of the public partner to a PPP contract to seek the approval of the designated PPP-agency for any substantial changes.

There are also no specific formal requirements or institutional arrangements in place to guide ex-post review and evaluation of public investment projects. Neither the Croatian Budget Act, nor the PPP-law and regulation prescribe completion reviews or evaluations. For EU-projects, very large projects are subject to completion reviews following relevant EU-guidelines and regulation. The national audit office has so far played only a limited role in the evaluation of public investment.

How Croatia Can Improve PIM and EU Funds Absorption

Improvements to PIM and EU-funds absorption in Croatia fall into four main phases:

1. Enhancing the knowledge base for reform.

Many of the weaknesses of the PIM-system appear to be systemic and inter-related. At the same time, data is missing on aspects of the PIM-system, including on the current portfolio of investment projects. Without a comprehensive overview across the PIM-cycle, there is a risk of sub-optimization and initiating ineffective reforms. In the first instance, the Government could consider:

- Conducting a comprehensive survey of planned and on-going investment projects across all modes of procurement and financing, including data that would allow analysis of various implementation patterns. Such a survey could support a review and possible rationalization of the portfolio.
- Reviewing the governance arrangements for investment carried out by SOEs with a view to assessing whether the governance mechanisms for such investment are still suitable; and identifying any adjustments that would strengthen strategic alignment and efficiency of such investment.
- Assessing the functional, organizational and individual capacities in the MoF to carry out the oversight role of PIM envisaged in the Budget Act and the draft Decree on appraisal and monitoring of PIM.

- Assessing the capacity of line ministries and other budget users to implement public investment projects timely and efficiently, including the individual and organizational project management capacities. This lack of technical capacity and efficient processes underscore the importance of connecting with design firms, universities and other institutions during project preparation.
- Analyzing project implementation challenges in a sample of projects. The assessment should include a mapping of the various implementation sub-stages, analyze the main causes of delays and make suggestions for “unblocking”. The review should also suggest how to improve capacity to prepare EU-funded projects, including options for connecting with design firms, universities and other institutions during project preparation.

2. Harmonizing the medium-term planning and budgeting framework.

The strategic planning framework should be developed further to better integrate PIM and foster the development of priorities across different financing sources. An overarching medium to long-term development cum investment strategy should be developed into which future external funding, most importantly EU-funding, can be slotted. Such a strategy should, besides national and local government investment, include strategic infrastructure investment financed by non-budgetary funds. Regional and national priorities of the strategy should be better linked with the Cohesion Policy priorities. Guidance should include ‘when and why’ different types of financing and different forms of institutional setup should be chosen. The overarching strategy should be underpinned by coordinated medium to long-term sector development and investment strategies (from transport, environmental protection, energy via science, R&D, primary education, pre-school education, health care, social welfare to the economy and agriculture) prepared within the strategic parameters set by the overarching strategy and financing envelopes derived from realistic financing forecasts. The overarching and sector strategies should be updated on a rolling basis.

Based on the overarching strategy, there is a need to revisit how public investment projects are incorporated and scrutinized as part of the MTBF. This includes decisions on how projects are prioritized within the medium term whole-of-government fiscal space.

Budget management systems and processes should be harmonized to avoid different approaches to financing sources. Strategic documents prepared for EU financing should be in

line with national strategic documents. Existing budget regulations separate EU funds management from the national budget management. This complicates Croatia's ability to switch resources to the highest priorities through the budget, while the fiscal consolidation process will require significant expenditure switching within a comprehensive budget.

3. Formalizing essential steps of the PIM-system. A set of comprehensive regulations and guidelines is necessary to fill the observed gaps in the PIM-system. While the work on a decree covering public investment under the scope of the Budget Act is a good start, it will need to be accompanied by comprehensive guidelines. Future regulation will also need to consider investment by SOEs, while recognizing the need for special governance arrangements for SOEs. Objectives of the regulatory changes and accompanying guidelines should include:

- Drawing on EU requirements, harmonize as much as possible the regulations and procedures for projects regardless of source of financing and procurement modality while specifying the additional steps for PPP and EU-financing
- Clarify the roles and responsibilities of stakeholders throughout the PIM-cycle, including on monitoring of public investment projects, and assigning roles that are currently unclear or not defined
- Strengthen pre-screening and formal appraisal of investment projects through formalized rules and comprehensive guidance
- Clarify the levels of appraisal, review and approval for various project sizes and establish clearly defined criteria for project selection
- Formalize rules and establish effective institutional arrangements for monitoring, project adjustment and completion review and ex-post evaluations.

4. Building ICT-systems and capacities in support of improved PIM and EU-funds absorption. In order to maximize the uptake of projected EU funding, a pipeline of appraised and ready-to-go projects should be prepared in all sectors and linked to the MTBF. A database of projects planned within the MTBF as well as ongoing investment and completed projects regardless of source of financing, should be created. The database should be interfaced with the budget preparation, budget execution, procurement, and accounting modules of the Government Integrated Financial Management Information System. The database should include financial as well non-financial information,

including indicators to monitor the outputs and results of the projects. In order to track such performance information, it would be necessary to build the information requirements into the original project identification and preparation formats.

Requirements for regular monitoring of project progress should be defined. A new monitoring system should ideally replace the several existing monitoring and reporting streams and should be preceded by a stock-take of existing monitoring. The new system should be based on clear guidelines and, at a minimum, capture information on cost and time overruns and physical progress of works. The system should keep track of the reasons and scope of contract variation orders in order to enhance project management capacity of implementing organizations.

How the World Bank Group Can Help

Croatia could benefit from the experiences from Bank-led PIM assessments and technical assistance programs worldwide, including countries in the EU. This would build on the World Bank's recommendations to improve PIM in Croatia, submitted to the Government in September 2015, which outlined a broad agenda for which further technical assistance is required. In this respect, Bank assessments and policy advice provided to date offer comparative information on issues and practices from best practice countries as well as those which are in the process of reforming their systems. The Bank is also providing detailed advice on PIM-related regulations, guidelines and in reforming PIM processes and systems. Recent Bank experience includes EU-processes and PPPs. As a next step, the Bank could facilitate PIM reforms by assisting the Government to design a comprehensive program of technical assistance.

This Policy Note was produced by the World Bank to inform policy debate in Croatia. This note was prepared by Senior Public Sector Specialist Jonas Arp Fallov, Public Sector Specialist Nataliya Biletska and Senior Economist Sanja Madzarevic-Sujster.

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Croatia Policy Notes 2016

Restoring stability, reviving growth and creating jobs

More Sustainable Subnational Government

Key Message

The current fragmentation of local government units (LGUs) makes it hard to serve citizens effectively while also limiting their financial and human capacity to effectively absorb EU funds. Large cities provide most decentralized public services, raising questions about the necessity for many counties and municipalities, while over half of spending goes for wages and maintenance. Subnational governments also have relatively limited taxing powers, while the equalization system is a disincentive to collect local taxes.

Key Actions

- Croatia needs to consolidate the system of overly fragmented LGUs, through a combination of mergers and/or shared services, and increase fiscal and administrative capacities if decentralization is to be sustainable.
- Spending responsibilities need to be redefined to avoid duplication and overlap of functions and to increase the accountability of LGUs for the tasks allocated to them.
- Strengthening subnational administrative capacity for public investment management, revenue collection, financial and asset management to improve service delivery.

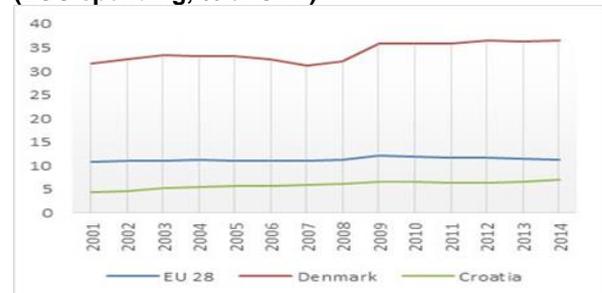
Where Croatia's Decentralization Stands Now

Decision-making, financing and public service delivery is still highly centralized. Despite legislative improvements after 2001, the degree of decentralization remains low. Subnational government corresponds to 14 percent of general government spending, or 5 percent of GDP, compared with an average of 10 percent in the EU (Figure 1). Governments have been aware of the importance of giving citizens more voice and strengthening accountability in matters of local interest, and recognize this can help deliver public services more effectively. However, legal and administrative structures constrain further decentralization.

Croatia's two-tier subnational government structure is highly fragmented. There are municipalities and cities at the local level and counties at the regional level. The large number of relatively small local and regional self-government units (LGUs) weakens fiscal and administrative capacity. Croatia has 21 regional (20 counties plus the capital city, Zagreb) and 556 local (127 cities and 428 municipalities) self-government units, of which over 70 percent cover fewer than 5,000 inhabitants—the benchmark many countries consider appropriate to enable basic self-sufficiency (Table 1). In addition, over 47 percent of Croatia's 127 "cities" do not meet

the required threshold of at least 10,000 inhabitants.

Figure 1. The degree of Decentralization is limited (LGU spending, % of GDP)



Source: Eurostat, 2015

Table 1. The average size of LGUs is small

	Population (000s)	Number of LGUs	Average population of LGUs (000s)	LGUs below pop 5000	Capital city in total	Average density (people/sqkm)
Croatia	4,285	556	7.7	71%	18%	97
Serbia	7,749	170	45.6	1%	21%	395
Slovenia	2,063	212	9.7	52%	14%	102
Denmark	5,699	103	55.3	4%	35%	133
Ireland	4,588	31	148.0	0%	28%	65

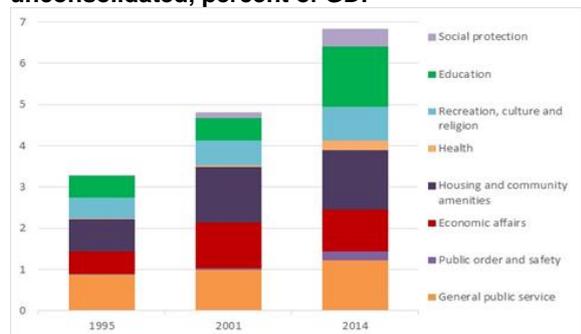
Source: national statistical offices

Functional responsibilities among LGUs are complex and unclear. All municipalities and cities, except the very largest, have the same

responsibilities for providing public services no matter what their development level or fiscal capacity. Cities that have more than 35,000 inhabitants (32) or that are county seats are exceptions because they can also perform tasks otherwise allocated to counties. This creates a risk of duplication of tasks and inequality in service provision because small municipalities and cities with little fiscal capacity cannot provide residents with the same range and quality of public services as larger cities.

Large cities provide most decentralized public services undermining the rationale for other local government structures. Although counties have been given wide responsibilities for subnational public services (primary and secondary education, health care, urban planning, economic development, and local traffic and transport infrastructure), they usually have less fiscal capacity than cities. Thus, the role of counties in providing public services, as measured by spending in per capita terms, is very small. That is also true for municipalities, which perform a limited range of public functions. Consequently, cities are the most active level of local government in terms of service provision.

Figure 2. Subnational Expenditures by Functions, unconsolidated, percent of GDP



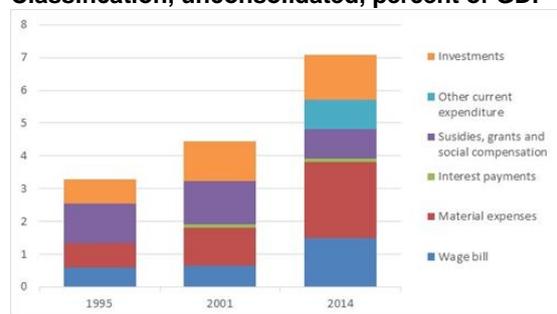
Source: Ministry of Finance (MOF).

However, even at the cities' level, service provision varies and an asymmetric decentralization approach was pursued (Figure 2). Only a quarter of Croatian cities finance primary education (which is decentralized at the level of school maintenance and investments, while wages are provided centrally). Of the four main public functions (education, health care, welfare, and fire protection) that were partly transferred to LGUs after 2001, only fire protection is almost completely decentralized. In effect, subnational governments spend mostly on preschool education, community development (housing and communal infrastructure) and general public services, which in reality means mostly financing the functioning of the LGU executive and legislative bodies' i.e. local administration.

Half of LGU spending is allocated to wages and operational costs, while a little less than a quarter goes to investment.

Before the economic crisis, about 23 percent of subnational budgets were directed to investment. By 2013-14, investment had fallen to about 17 percent of expenditures. In contrast, employee compensation has increased steadily, without a noticeable improvement in the quality of local services. The second largest category of LGU spending is salaries, even though national government pays teachers and doctors (Figure 3). Since 2010 the number of LGU employees increased by almost 7 percent, to over 42 thousand, while the time private sector has been shedding labor to respond to the crisis.

Figure 3. Subnational Expenditures by Economic Classification, unconsolidated, percent of GDP

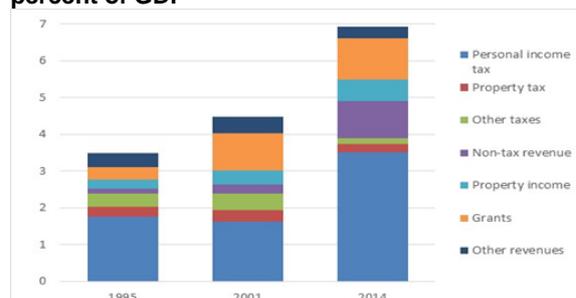


Source: MOF.

Subnational governments have relatively limited powers of taxation and the equalization system offers little incentive.

Personal income tax and surtax are key sources of revenue, comprising over half the total (Figure 4). Local tax sources (inheritance and gifts; taxes on motor vehicles, boats and vessels, and gambling machines) are often subject to central government caps. Nontax revenues are therefore an important subnational revenue source, of which communal fees (serving de facto as a flat-fee property tax) account for the largest share. However, the second most important revenue source are grants through the equalization fund or direct from central government.

Figure 4. Subnational Revenues, unconsolidated, percent of GDP



Source: MOF.

The fiscal equalization system is mainly led by regional development objectives. Equalization of fiscal and service capacity is realized through tax-sharing (Table 2), the Equalization Fund, and grants. The central government determines the tax rate and the tax base giving LGUs little control over the collection of shared revenues.

Table 2. Tax Autonomy of LGUs

Shared taxes with Central Government	County Taxes	Municipal/City Taxes
Personal income tax	Inheritance tax	Consumption tax
Real estate transfer tax	Tax on motor vehicles	Tax on holiday houses
	Tax on vessels	Tax on the use of public land
	Tax on gambling machines	Tax on corporate title
		Surtax (on PIT)

Source: MOF.

The equalization system lacks transparency. Equalization formulas are usually supplemented with additional ad-hoc transfers. Grants that have an equalization purpose for decentralized functions are also not necessarily used for their intended purpose. Many current transfers to municipalities, cities and counties from the central government are not based on clear criteria and have unclear effects.

Table 3. Personal income tax sharing scheme as of January 1, 2015 (in %)

Group	City/municipality	County	Decent. functions	Equalisation grants	Grants for EU projects	Capital projects
Lagging regions	88	12				
Zagreb	76.5		6	16	1.5	
Islands	60	16.5	6		1.5	16
Other	60	16.5	6	16	1.5	

Source: MOF.

The current transfer design does not relieve fiscal capacity disparities. Full revenue equalization reduces the incentives to increase the local tax base by attracting new economic activity or increasing the efficiency in service delivery. To create this incentive, the national government could opt for less than complete equalization, so that the gap between the local and the average tax base is only partially compensated. The grant system could, for instance, be designed so that after equalization the tax capacity of the poorest jurisdiction is within 10–20 percent of average tax capacity. Another possibility is to design equalization, as in Sweden, to reduce the difference between a

minimum guaranteed tax capacity and actual tax capacity.

While LGUs have relatively low debt, there are contingent liabilities in terms of guarantees to local government-owned utility companies (Table 4). Due to restrictive borrowing limits, LGUs have relatively little direct debt (1.2 percent of GDP in 2014). However, LGUs circumvent these limits by borrowing through local-government-owned enterprises. In 2015, the limit of the total borrowing of LGUs increased to 3 percent of total operating revenues of all LGUs. In addition to the cumulative borrowing restrictions that seek to limit the total amount of local debt, there are individual limitations prescribed by the Budget Act. They limit the total annual obligation of LGUs, which can be up to 20 percent of revenue generated in the previous year. These borrowing limits, however, do not include borrowing limits for communal utilities and/or guarantees issued by LGUs. Guarantees for utility companies' borrowing create contingent liability for LGUs amounting to 0.6 percent of GDP in 2014. The City of Zagreb holds almost half these guarantees.

Table 4. The size and the structure of local government debt, 2014 (in HRK billion)

	Cities	Zagreb	Municip.	Counties	All
Debt	1.8	1.5	0.3	0.4	4.0
Guarantees		0.9			1.9

Source: MOF

LGUs own significant financial and non-financial assets (33 percent of GDP in 2014).

The structure of financial assets are dominated by shares, which are not recorded according to their market value since they are not actively traded on the stock exchange. Non-financial assets owned are mostly recorded, but their valuation is not systematic. There is no single registry of assets owned by LGUs, nor are there strategies and/or guidelines for asset management.

There are large revenue and efficiency gains from strengthening the Public Financial Management (PFM) systems in LGUs.

Local units hold high tax arrears--at the end of 2014 around HRK5.7 billion (1.7 percent of GDP). The structure of uncollected claims is dominated by claims for administrative fees (claims for utility charges and contributions). LGUs have mostly outsourced the function of revenue collection to the Tax Administration and companies performing the collection of the utility charges. Due to a rather large number of employees, the LGUs should not need to delegate such functions (especially revenue collection) to other legal entities. There is also significant scope for

savings through the inclusion of budgetary users and institutions owned by local government units in the treasury system and processing transactions through the single treasury account. About 170 local units are currently included in the treasury system. Savings could be made from other shared services. In addition, Local companies are seen as separate entities, and are under no obligation to draw up consolidated financial statements.

How Croatia Can Restore Fiscally Sustainable Decentralization

The current fragmentation of LGUs makes it hard to serve citizens effectively, and there is scope for consolidation and creating shared services. Croatia has one of the lowest numbers of inhabitants per LGU in the EU with a large concentration of citizens in the capital city. Large cities provide most decentralized public services. Defining the optimal territorial organization and functional and fiscal decentralization matrix should be a priority to address the disproportionate number and resources assigned to LGUs. If consolidation is not politically feasible, LGUs should be encouraged to merge for joint provision of public services, i.e. with incentives for shared services. Good examples of such approaches include Estonia (integrated back offices, like accounting and payment processing), Finland (incentives for mergers) or Spain (integrated service delivery). The benefits from association would help LGUs capture economies of scale and scope to improve service delivery and cost effectiveness.

Larger, stronger LGUs would have a better access to EU funds. Financially stronger LGUs could conduct more profitable infrastructure projects and have a better bargaining position. The consolidation process could also enhance LGUs administrative and technical capacity to access and implement EU funds while generally reducing the costs of local administration.

Spending responsibilities need to be redefined to avoid duplication and overlap of functions and to improve accountability. Fiscal decentralization should clearly define functional responsibilities (for example, in such areas as education, social protection and health) and identify the resources needed to finance them. Accountability and efficiency concerns imply that expenditure assignments should have clear lines of demarcation between various fiscal units. There should be transparent reporting of progress in carrying out tasks and closely related activities should be assigned to the same level of government.

Greater reliance on own-source revenues would create incentives for local economic development and reduce central government transfers. The ideal LGU tax is one that can be levied on a relatively immobile and well-demarcated local tax base—e.g. a property tax. Administrative capacity is also an important consideration in defining revenue assignments. Croatia could start by simplifying the framework guiding tax-sharing, eliminating a number of local taxes and relaxing the upper limits for them, and improving the design and administration of property taxes that can provide a stable yield and are indirectly linked to income so are progressive.

The fiscal operations of LGUs need to be closely monitored to ensure fiscal prudence and alignment with the EU Excessive Deficit Procedure. It is critical that LGUs be fully transparent in reporting all balance sheet and off-budget activities. Timely and comprehensive information is needed on both budget operations and debt under new EU fiscal governance rules. In this vein, some countries (e.g., Portugal) require municipal accounts be consolidated with those of their public enterprises and submitted to external audit. While the existing legislative framework in Croatia does not provide for consolidation of the financial statements of LGUs and their utility companies, consolidation is required under International Public Sector Accounting Standards (IPSAS). The application of these regulations would allow a comprehensive view of the exposure of LGUs to direct and contingent liabilities arising from the financial operations of their utility companies.

Subnational administrative capacity could be strengthened in three priority areas:

- (i) **Public investment management.** This is particularly important considering the expected availability of large inflows of EU funds. Ideally, LGUs should – through the use of EU funds – be the main drivers of capital investments. The experience of Estonia and Latvia demonstrate that there is undoubtedly a correlation between size and capacity. The requirement for small municipalities to employ qualified persons, and comply with procedures, proved to be a serious problem for the Baltic countries and the Czech Republic as there were very few professionals at the local level, and no resources to finance the qualified staff from other areas. The financial absorption capacity of Croatia's LGUs might be strengthened by creating incentives or binding rules for local governments to merge or associate to jointly provide shared public services, attract the private capital and

participate in public-private partnership projects.

- (ii) **Revenue Administration.** Most LGUs transferred authority for the collection of revenue to the Tax Administration (with a commission of 5 percent of revenue), which is subject to provisions regarding tax confidentiality (Art. 8 of the General Tax Code). As a result, LGUs have little information on tax debtors and debt. The collection of tax and non-tax revenues related to property, such as taxes on holiday houses, is particularly problematic (owners do not submit data on the status of the property). Similar problems occur with tax on inheritance and gifts (the Tax Administration has no obligation to report decisions issued to relevant LGUs).
- (iii) **Financial management.** Improvements in financial management capacity would help LGUs rationalize their costs and generate revenues from improved asset management. Many local units do not have inventories of their assets in their balance sheets, and do not have professional departments and individuals trained to deal with asset management. Deploying existing local property could also bring additional revenues along with the privatization of companies involved in commercial business.

How the World Bank Group Can Help

The Bank offers experience working with Ministries of Finance and Administration – globally and in EU countries – in implementing reforms that increase the sustainability of subnational governments. This includes supporting strategic development planning in the context of EU funds absorption, infrastructure planning and upgrades, automation of processes and ICT improvements, strengthening debt, revenue, financial and asset management of LGUs, and the implementation of institutional reforms that embed sustainable fiscal and functional decentralization. More recently, the Bank in a cooperation with the Association of

Cities undertook Public Expenditure and Financial Accountability assessments in four selected cities, as well as conducted several capacity building programs for strengthening governance and public finance management in local governments.

Support ranges from:

- facilitating peer-exchange with reformers across Europe and the world;
- conducting analyses that address specific policy problems and inform reform processes;
- implementing assessments and monitoring platforms and tools to increase the effectiveness of public finance management programs;
- sharing know-how and international best practice in cutting-edge areas of decentralization reforms, such as in the design of fiscal equalization transfers and shared service centers;
- implementing capacity building programs for public finance management programs for LGUs; and
- providing finance, and financial instruments, for capital investment, capacity building and information systems.

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Croatia Policy Notes 2016

Restoring stability, reviving growth and creating jobs

Strengthening Rule of Law and Judicial Efficiency

Key Messages

Despite progress in recent years, inefficiencies and the unpredictability of the courts is one of the largest barriers to business, investment and growth. Improving user trust and confidence in the court system requires further improvements in the quality and speed of judgements to signal change to the general public and businesses, with reforms led by the Ministry of Justice and the Supreme Court.

Key Actions

- Harness technology and intensify modernization and automation to increase the courts' online services and boost two-way electronic exchange with both users and government systems. Modernization could utilize available EU structural funds for capital investment.
- Embed reform of the new court network: Reduce costs by consolidating management functions (finance, procurement, maintenance, statistics etc.) at hubs in the network. Equalize caseloads by transferring judges and staff between courts with the heaviest workloads or by transferring cases across courts. Prioritize reducing the case backlog with targets and incentives at the court level. Intensify training for consolidated court presidents as key agents of change and harmonize case law through improved dialogue among heads of departments and the training of judges on new laws.
- Gradually adjust the resource mix across the sector to raise productivity. Reduce the number of judges and staff by attrition and use the savings to finance greater investments in infrastructure, ICT and specialist roles that drive innovation and productivity.

Where Croatia Stands Now

EU countries that have tackled under-performing rule of law institutions over the last decade are now benefitting from revitalized growth. These includes Poland, Czech Republic and Slovenia. These countries are now better able to attract FDI and spur innovation because their business climates offer greater certainty and speed, with easier firm entry and exit and a more equal playing field, with fewer ambiguities and constraints. By contrast, those jurisdictions which did not make progress experienced slower growth.

In Croatia, the performance of the justice system has improved significantly in recent years, as recognized by the completion of Croatia's EU accession negotiations and monitoring benchmarks⁵⁹. According to the European Commission for the Efficiency of Justice (CEPEJ) EU Justice Scoreboard 2015, Croatia now has rates of case efficiency for civil cases comparable with other EU member states.

However, reforms remain incomplete. The Government's 2013 reform strategy prioritizes efficiency, independence, EU integration, human resource (HR) management and ICT upgrades. Yet, results have been less than anticipated. The inefficiency and unpredictability of the court system continues to be among the greatest impediments to business and investment. And the public has yet to 'feel' much change, so perceptions remain negative.

Despite progress, courts of general jurisdiction and commercial courts are still too slow in processing cases, and this causes frustration for providers and users alike. Businesses continue to perceive the courts as too slow for their needs. The 2015 World Economic Forum ranks Croatia 137th out of 140 economies in terms of the efficiency of the legal framework for settling disputes. According to the Doing Business Report 2016, contract enforcement takes 572 days and costs 16.7 percent of the value of the claim, which is lower than OECD averages and of countries across

⁵⁹ The World Bank Justice Sector Support Project (JSSP) has supported the MOJ, courts and SAOs in this process.

Europe and Central Asia. In the 2014 World Bank Business Environment and Enterprise Performance Survey (BEEPS), only 15 percent of firms report that the court system is quick.

This poor performance is an obstacle to business. According to BEEPS, only 60 percent of firms report that the courts are not an obstacle to their current operations. This is 12 percent lower than the average of member states that joined the EU after 2004 (excepting Cyprus and Malta). Against a backdrop of poor perceptions, firms try to resolve their disputes outside of the court system. Despite a series of piecemeal reforms, the promise of an Alternative Dispute Resolution (ADR) mechanism remains elusive for most court users. In 2014, less than 5 percent of resolved civil litigation cases were resolved using court-annexed mediation. For many businesses, disputes languish and remain unresolved, thereby hampering operations. A targeted in-depth analysis of the constraints to ADR and possible solutions is needed.

Backlogs have fallen, but there are still too many old unresolved cases lingering idle in the system. The number of unresolved cases has fallen by half over the last decade. Average clearance rates in courts have improved, and were above 100 percent in 2014 and 2015. Nonetheless, Croatia still has among the largest number of old pending cases per capita in the EU, according to CEPEJ. Essentially, the pace of backlog reduction is too slow, with many judges focused on resolving easier cases, while leaving old cases unresolved. With over 366,000 backlogged cases still in the courts, at these rates, elimination of the backlog would take another decade. Further, the legacy of backlogs and long case duration diverts much-needed funds. From 2011 to 2013, Croatia paid more than 10 million EUR in compensation to individuals whose right to a trial within a reasonable timeframe had been violated. Such funds would be better spent on reforms that improve efficiency for all citizens and businesses. By purging backlogs and improving timeliness, Croatia could both reduce delays and save money.

A further challenge for the general public and small businesses is the lack of an effective fast-track procedure for resolving minor disputes. For the majority of the population, especially the poor and micro and small businesses, disputes such as contract disputes over small sums, tenant/landlord disputes, consumer claims and other minor matters are the most likely interaction with the justice system (other than traffic violations). Despite reforms in 2008 to simplify case processing of some of these cases, little expedition occurs in practice.

This is unlike most EU member states, where small claims courts have eased peoples' interface with courts, often combined with automation, websites and apps. Applying lessons from other EU member states and getting small claims right has the potential to significantly boost user confidence and public perception of the justice system. More could also be done to ensure that urgent cases (such as labor disputes) are resolved within the legal timeframes.

The business community lacks confidence in the courts' ability to enforce decisions. According to BEEPS, only 43 percent of firms report that the court is able to enforce its decisions, which is 12 percent lower than the average of member states that joined the EU after 2004 (excepting Cyprus and Malta). After a series of stop-starts, the 2012 reforms regarding enforcement rights over cash assets have been partially successful – caseloads have reduced in the courts, and procedures have been streamlined. But much of the workload has shifted to the Financial Agency (FINA), at least for the enforcement over cash assets. To prevent the enforcement problem merely shifting from one actor to another, FINA needs greater support and capacity building to fulfill its mandate. Further, commensurate improvements are needed to increase court efficiency to enforce claims over immovable and movable property.

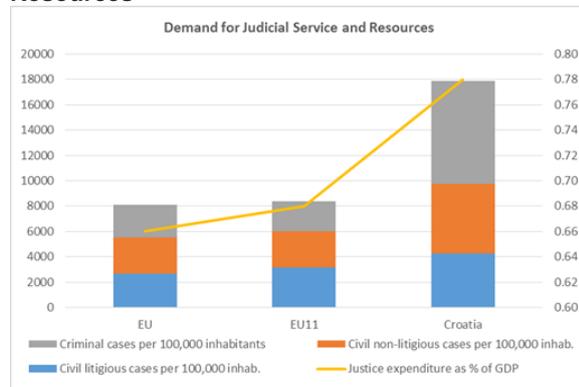
Spending on the Judiciary is around the EU average. In the current fiscal environment, the justice sector will likely have no option but to use its resources more efficiently, and to finance longer-term goals out of savings it generates. After two phases of court network reforms, lasting over 7 years, there remain large inefficiencies in the ways courts operate. So far, the 2015 rationalization has done little more than convert 'courts' to 'court units'. The real work of the reform has only just begun, and there are opportunities to embed the rationalization, make savings and improve user satisfaction simultaneously.

Uneven caseloads have long been a key source of inefficiency in court operations. In the past, the proposed remedy for uneven distributions has been to transfer cases between courts. More than 70,000 cases were transferred during 2011-2013. Under the new court network, judges and staff as well as cases can be transferred more easily to nearby courts. The sector should take advantage of this increased flexibility to finally equalize caseloads across courts, based on sound analysis.

There are also potential efficiency gains in 'hubbing' management functions. A range of

functions, such as procurement, financial management, maintenance, training, statistics, and performance tracking, could all be co-located at hubs in the network and deployed among several courts to maximize efficiency. This shared-service model has been adopted in many countries across the EU.

Figure 1. Demand for Judicial Service and Resources



Source: *Justice-at-a-Glance*, World Bank

There are too many judges and staff in the court system. Croatia has one of the highest numbers of judges per capita anywhere in the world – 45.3 per 100,000 inhabitants, which is more than double the EU average of 21. Salaries of Croatian judges are 2.3 times higher than national average salaries, which is on par with CEPEJ and new EU member countries. Further, Croatia has one of the highest court staff-to-judge ratios and one of the highest staff-to-population ratios in the world. For example, Croatia has 163 non-judge staff per 100,000 inhabitants, as opposed to 67 for the EU average. As a result, the wage bill for judges and staff is extremely high and crowds out almost all other expenditure, leaving little room for innovation, infrastructure and automation.

A part of the explanation behind the high demand for judicial service is that the justice sector provides a large range of non-litigious administrative services. Company registration, land ownership registration, electorate commissions, are services provided in many EU countries as out-of-court administrative services.

Meanwhile, the sector is not investing enough in capital planning and upgrading. Most courthouses are small and in poor condition – some are unfit to be courts and incapable of accommodating modern needs, such as wiring for ICT and service-delivery interfaces to meet citizen expectations. For example, an average of 4 judges share a single office in Croatia’s largest court, the Zagreb Municipal Court. Croatia’s expenditures for physical facilities have been roughly half the EU average. Infrastructure asset management could be strengthened at the MOJ.

‘Building-centric’ performance measures to monitor the health of infrastructure capitalization could assist in budgeting and maintaining facilities. Developing a medium-term plan and prioritizing key locations to build modern courthouses equipped with ICT to meet basic requirements and better serve users would signal reform to judges, staff and users alike.

Transparency, corruption & undue influence remain a concern. Croatia continues to struggle with judicial corruption. Among the EU member states that joined since 2004, Croatia has the 5th highest rate of perceived corruption, according to Transparency International. The judiciary ranks poorly in comparison to neighboring countries, including both EU and non-EU members. Respondents reported the judiciary as being the institution that is most affected by corruption and undue influence, worse than the perception for politicians and political parties. Rules regulating conflicts of interest are not well understood within the judiciary. Clearer and stricter rules on ethical standards are needed, along with more training and mainstreaming of rules into daily practice, and the clear sanctioning and control in courts and prosecution offices. Court presidents and heads of State Attorney Offices (SAOs), under the leadership of the Councils, have a clear role to improve the operational efficiency, but also improve the system’s transparency.

The lack of predictability in decision-making also highlights the need for greater court practice consistency. This can occur by convening more regular meetings of heads of departments and judges to discuss recent reforms and emerging cases. There is also scope for more intensive continuing education for judges in emerging areas of law, particularly on the rollout of new legal reforms. Again, ICT can help harmonize case law. Cases could be uploaded to the web more quickly after judgment and ongoing efforts to integrate Croatian case law with EU case law, via the e-justice portal (European case law identifier – ECLI), could be intensified to ensure that case law is harmonized and user friendly for judges.

The lack of predictability in dealing with courts impacts the business climate. In the 2014 BEEPS Survey, only 36 percent of firms in Croatia report that their court system is fair, impartial and uncorrupted. This lags the EU averages, and this view has remained unchanged for at least the last 5 years. Similarly, the WEF ranks Croatia 101st out of 140 economies in terms of undue influence and 99th in terms of judicial independence. While not a panacea, increased automation plays a role in reducing vulnerabilities to corruption and acting as a confidence-building measure for users. Over

time, intensified automation can improve perceptions of professionalism and integrity among court users.

How Croatia Can Improve Judicial Efficiency

There are significant opportunities to strengthen the justice system to stimulate investor and public confidence, drive competitiveness, and improve the business environment. Examples include:

1. Signal change to the public and business.

- Ensure effective rollout of the 2015 personal bankruptcy reforms, with training and public awareness campaigns.
- Ensure FINA has the resources and training it needs to fulfill its mandate for enforcing judgments expeditiously.
- Eliminate backlogs through targets and incentives for individual courts.
- Establish a fast-track procedure for minor disputes, applying lessons from EU member states. Encourage the public and small business to use streamlined services through public information campaigns and training court providers.
- Embed the practice of user surveys. Use the results to inform reform and managerial decision-making to instill a more user-oriented culture.
- Consider removing non-adjudicative work (company and land registration) from the courts, based on sound analysis (see also the Policy Notes on Land Administration and Business Environment).
- Clarify conflicts of interest and provide training across the justice system to signal a new era of higher judicial integrity.

2. Intensify modernization and automation efforts.

- Continue upgrades of the Integrated Court Management System (ICMS) in courts and Case Tracking System (CTS) in SAOs, leveraging the results so far from JSSP. Transition to paperless methods across all courts and SAOs. Ensure availability of case data and integration with ECLI.
- Hasten processing and strengthen coordination by improving information exchange between ICMS and CTS with government systems (FINA, tax administration, land registry, licensing etc.)

- Enable more two-way electronic communication between courts and users.
- Intensify automation in externally-facing services, via improvements to websites, e-service, e-filing, fee calculators, e-payment, mobile apps etc.
- Use EU structural funds to upgrade courthouses in critical locations.

3. Embed court network reforms for a leaner, smarter system focused on service-delivery.

- Equalize caseloads by transferring cases, judges and staff, based on sound analysis.
- Consolidate management functions (financial management, procurement, statistics, performance tracking, etc.) at hubs across the network.
- Adjust the resource mix to spend less on salaries and operational costs and more on capital and innovation. Gradually reduce the wage bill by attrition and equalize workloads via transfers and secondment opportunities in areas of need.

How the World Bank Group Can Help

The Bank offers experience working with Ministries of Justice and judiciaries – globally and in EU countries – in rolling out reforms that increase efficiency in the delivery of justice services to people and businesses. This includes supporting infrastructure planning and upgrades, automation of processes and ICT improvements, court process re-engineering, caseload analysis and equalization (including reforms to case weighting methodologies), performance management, and the implementation of institutional reforms that embed new court networks and rollout of legal reforms. Support ranges from:

- facilitating peer-exchange with reformers across Europe and the world;
- conducting analyses that address specific policy problems and inform reform processes;
- sharing know-how and international best practice in cutting-edge areas of justice reform; and
- financing capital investment and automation.

Through the existing JSSP, the Bank has applied some of its expertise to support Croatia's justice sector in key areas. The project has helped to reduce backlogs, increase clearance rates, reduce case processing times and modernize internal processes through automation, among other reforms. The existing

JSSP has performed well and is due to close in June 2016, but it can support emerging needs and priorities of the new government.

This Policy Note was produced by the World Bank to inform policy debate in Croatia. This note was prepared by Georgia Harley, Public Sector Specialist.

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For any questions regarding this note, please contact Vanja Frajtic, Communications Associate (vfrajtic@worldbank.org).

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Croatia Policy Notes 2016

Restoring stability, reviving growth and creating jobs

Making a Business Friendly Croatia

Key Message

There has been steady improvement in the Business Environment in Croatia. However, despite the strong reform momentum Croatia still suffers from a number of shortcomings that entrepreneurs experience in the day-to-day running of their business operations. Croatia is also still grouped with the poor performing EU countries.

Key Actions

- There is room for improvement particularly in the areas of land registry, business registration, resolving insolvency, construction permits.
- Incorporate a more consultative process with the private sector on existing barriers as well as while initiating new reforms.
- E-government would enable the public sector to play a more facilitative role to businesses.

Where Croatia Stands Now

Croatia has implemented business reforms every year since 2006, and was among the global top ten improvers in Doing Business in 2008. Several concrete measures have been undertaken to improve the quality of the business environment over the last three years. These include simplification of business registration, strengthening of the contract enforcement, bankruptcy framework as well as land registration. The authorities have also begun an audit of administrative burden, applying the standard cost model to the Trade Act and the Mediation in Immovable Property Transactions Act. Despite the introduction of the e-citizen web portal and the online services for business provided by HITRO.HR, the Chambers of Commerce, and the Financial Agency FINA, challenges remain for the users having to familiarize themselves with the different interfaces. The authorities are planning the development of a new platform – a single contact point, which would integrate all existing services. In the area of the judiciary, the implementation of the reform of the judicial map could improve the efficiency of some courts. The reform aims to increase specialization and balance out the uneven workload of judges by merging courts. The reform also involves a change in the allocation of cases before second instance civil courts.

Despite the strong reform momentum, Croatia suffers from a number of shortcomings that entrepreneurs experience in the day-to-day running of their business

operations. Some of the most burdensome challenges in the business environment, as highlighted in the 2015 EC Country Report on Croatia, include regulatory instability; high administrative burden; low transparency and predictability in the working of administrative bodies; and long judicial proceedings.

Weak legislative planning has weighed down the quality of new regulations. In 2014, half of the laws passed were not planned. Although there is a Regulatory Impact Assessment (RIA) mechanism in place, in practice most legislations go through a fast track legislative process and circumvent RIA altogether. Even when performed, RIA is not properly implemented, due to weak quality control and lack of high level commitment. Poor legislative quality in turn leads to frequent amendments to address shortcomings and complications for SMEs.

How Croatia Can Strengthen its Business Environment

Consultation with private sector is a crucial aspect of any reform process affecting businesses. Without understanding the private sector's concerns and the barriers that prevent them from starting, operating and growing their businesses, no government can claim to set up a comprehensive reform agenda that will bring a real difference to its businesses.

Business Start-up. Economies with the most efficient registration systems use simplified and standardized laws and documents, operate a single electronic interface between the user and authorities, a central database with

interoperability between agencies involved, one single company ID, and one flat fee. To achieve measurable results in the short to medium term, the Government of Croatia may want to focus on eliminating outdated requirements through legal amendments, merging and streamlining the registration processes of multiple departments and agencies, and making all registration processes (including post-incorporation) fully electronic without any need for physical paper trails or physical interaction. It also may consider the following:

- Give HITRO.HR full powers to handle all transactions at the Commercial Court and undertake an information campaign to publicize the services provided by HITRO.HR. At the moment, HITRO.HR officials can assist entrepreneurs in carrying out the steps necessary to complete a company registration, but in certain transactions, their power is limited. For instance, they can check whether the chosen company name is available and submit a name reservation request through the e-Company Service (e-Tvrtka), but if the request is rejected by the Court, HITRO.HR cannot retrieve the documents on their client's behalf. These limitations reduce HITRO.HR's appeal to entrepreneurs, who often choose more expensive –but effective- intermediaries.
- Transfer the power to decide on company registration applications to qualified Court administrative personnel. Currently company registration in Croatia is a judicial procedure. The Commercial Courts in Zagreb, for instance, effectively employ 55 judges, 7 of which are tasked with procedures related to company registration⁶⁰. Such tasks could be performed by qualified court clerks, which may decrease the time to start a business. It could also speed up the resolution of litigation and insolvency cases, since judges currently allocated to company registration could be used elsewhere.
- Implement e-signatures for individuals and make all registration processes fully electronic with no need for submission of physical documents or physical interactions. At the moment, the biggest obstacle to the implementation of an efficient online registration system is the lack of a functioning e-signature system for individuals.

⁶⁰ The remaining judges are mainly tasked with litigation cases and insolvency cases. The information

- Eliminate the paid-in minimum capital requirement for Limited Liability Companies (DOO).
- Make the notarization of the articles of association optional and introduce clearer fee schedules for notary services. Presently, companies must notarize the articles of association with a public notary. This is the most expensive step in the process of company registration. Private sector practitioners state that the fee schedules used to calculate the notary fees are not transparent. The Croatian government could lower the cost of starting a business by developing standardized articles of incorporation that are flexible enough to accommodate the majority of small businesses, thus allowing entrepreneurs to draft and file deeds of incorporation themselves. Eliminating the requirement to notarize incorporation documents would represent a significant cost-saving measure, especially for small businesses. Larger companies, with more complex structures, could still resort to notary services, if needed.
- Introduce single business identifier for interactions with all government agencies. To achieve greater integration of registration services, the Government could introduce a single business identification number, which businesses would use as unique identifier for all interactions with government agencies. This would reduce the risk of errors in identifying the same companies and facilitate enforcement.
- Introduce a single platform for out-of-court business registration by integrating the incorporation process with the registration to (1) all taxes, the (2) the Croatian Bureau of Statistics, the (3) Croatian Institute for Health Insurance, and the (4) Croatian Institute for Pension Insurance. After the introduction of a single registration form for all agencies, it is recommended that the systems and databases of multiple agencies be gradually linked towards a “single interface” for business registration, which would allow an entrepreneur to complete company creation in one interaction with the Government.

Registering Property. Since 2008, the time to register property in Croatia has decreased from 956 to 72 days. Such an astonishing result is due to legislative improvements introduced by the Land Registry Act of 2004 and the subsequent computerization efforts undertaken by the

was collected by the team during a visit to the Commercial Court of Zagreb in March 2015.

Croatian government. Further improvements include:

- Complete Land Registry and Cadaster data harmonization. The Land Registry is under the jurisdiction of the Ministry of Justice while the Cadaster is managed by the State Geodetic Administration. Currently, the data contained in the two databases is not fully integrated, though the process is ongoing as the Joint Information System is rolled out and the data harmonized. The current lack of data harmonization contributes to delays and inconsistencies in Government to Business services. To solve this problem and give full implementation to the Land Registry Act, Croatian authorities should give priority to finalizing the Real Estates Registration and Cadaster Joint Information System (JIS) project – which will harmonize the two databases mentioned above⁶¹ (see also *Policy Note on Real Estate Registration*).
- Allow electronic Land Registry extracts to be considered as official documents and make them accessible through e-citizen government portal. At the moment, only extracts obtained in paper directly at the Land Registry (or stamped by a Land Registry official) have legal standing. Considering the progress in the computerization of the Land Registry over the past years, these restriction could soon be abolished to allow electronic extracts to be used officially⁶². Also, extracts should be accessible through the e-citizen government portal.
- Consider institutional reform in the county courts, the Land Registry and the Cadaster. The land registration as well as cadastral processes should be considered administrative processes as elsewhere in modern societies and Croatia can consider making them out-of-court processes (see Land Registration Note).

Building Permitting System. Efficient building permitting systems share key features. Clear building codes written with a consultative process are at the core of well-designed construction permitting systems, and countries like Canada and New Zealand are increasingly steering towards performance-based codes⁶³. Croatia

has three new laws regulating this area since January 2014: a Building Act, a Physical Planning Act, and an Inspection Act and their full enforcement may require to:

- Engage stakeholders and private sector practitioners in an information campaign aimed at explaining the benefits introduced by the new legislation. At the moment, not all the benefits of the new legislation are clear to the building sector professionals operating in the country. For instance, many of them still visit the Cadaster to obtain a list of neighbors that has then to be submitted to the Municipality together with the application for the building permit (i.e. geodesic study annex). Given the progress introduced by the ISPU, such procedure should no longer be necessary, since such list can be retrieved online.
- Expedite integration of all the necessary IT systems and databases into the ISPU. The geographic information system (ISPU) represents a great leap ahead towards a fast and efficient building permitting process. In order to fully reap the benefits of this important reform, Croatian authorities should press ahead with the harmonization of all the necessary databases that might contribute to its completeness. At the moment, the Ministry of Construction and Physical Planning is working to harmonize the ISPU system with the databases of Ministry of Maritime Affairs, Transport and Infrastructure and the Ministry of Culture. Also, additional work will be necessary to harmonize Cadaster and Land Registry entries, especially at the local level. These measures are a priority.
- Review the current statutory time limits for permit-related approvals, introducing - where necessary – stricter deadlines. According to the Administrative Procedures Act of 2009 (OG 47/09), for instance, the Municipality of Zagreb has 8 days to check whether the application for a building permit is complete (i.e. all the necessary documents have been submitted) and in line with the urban plan. This is only one of the first steps required for the issuance of a building permit, and a lengthy one. Considering technological progress brought about by the physical planning database, which allows a quick confirmation of

⁶¹ <http://www.uredjenazemlja.hr/default.aspx?id=22>

⁶² Article 7 of the Land Registration Act (Official Gazette No. 91/96, 68/98, 137/99, 114/01, 100/04, 107/07, 152/08, 126/10, 55/13 and 60/13) currently says “Extracts from the main register and copies or print-outs from the collection of deeds shall be issued by the land registries”. Additional information on why electronic extracts are not considered official

documents can be found here: <http://www.uredjenazemlja.hr/default.aspx?id=101>

⁶³ Performance-based codes provide more flexibility and support innovation by focusing on outcomes to be achieved rather than prescribing how the building must be constructed. The use of performance-based codes, however, requires a higher level of technical competence to enforce than do other approaches.

the information provided in the application, the deadline for first formal check performed by the Municipality could be shortened to 48 or 24 hours. In order to make the new deadlines effective, their implementation should be accompanied by tighter monitoring of the performance of the municipal officials charged with document review.

- Eliminate the requirement to stamp the copy of the cadastral plan at the County Office before it can be submitted as part of the application for the building permit. Following the introduction of the Physical Planning Information System, cadastral maps can now be found online. The online system eliminates the need for architects and engineers to visit the Cadaster to finalize their projects. The City of Zagreb, however, does not consider cadastral maps that have not been stamped at the Cadaster as valid documents when processing building permit applications. As a result, architects and engineers continue to visit the cadaster unnecessarily to obtain a stamp on a map they have downloaded online.
- Further streamline construction-related approvals and clearances by improving the e-permitting system and extend its usage to all counties. The application for a building permit is composed, among other documents, by a set of approvals that are a necessary condition for the building permit application to be considered valid (and thus processed by the city or county). For a simple two-story warehouse, such approvals are issued by the Inspectorate for Fire (Ministry of Internal Affairs), the National Croatian Electric Grid, the Waste Collection Department, and the Water Authority.

Credit Information. A credit reporting system is an integral part of a well-functioning credit market. In 2007, Croatia set up a new private credit bureau - the Croatian Credit Information Registry (HROK) - that distributed positive and negative information only on individuals. Starting from July 2010, HROK expanded its coverage to firms. In December 2010, the bureau started distributing this information to financial institutions. Currently, the HROK database counts more than 3 million individuals and over 130 thousands firms. Further, it can:

- Expand the sources of information to include retailers and utility companies. In addition to the data provided by financial institutions, more advanced credit reporting systems also collect credit information from retailers or utility companies (electricity, water, and mobile phone providers) and include such data in the credit reports. This is the case in 58 of 189

economies covered by Doing Business, including Denmark, Germany, and the United Kingdom. Doing so is an effective way of expanding coverage by credit bureaus.

Legal Rights of Creditors and Borrowers in Secured Transactions. The legal and institutional framework plays an important role in facilitating the use of movable assets as collateral. Having to give up the possession of the asset pledged to a creditor would disable the debtor from using such asset, which could hamper the business's productivity and ability to operate. Croatia considerably strengthened its secured transactions system in 2006 by launching a unified and geographically centralized collateral registry (Law on Register of the Judicial and Notary Public Insurance of Claims Over Movable Properties and Rights). Since then, the Croatian Financial Agency (FINA) has been keeping a public registry on the securities (pledge and fiduciary transfer of ownership) acquired over movables and rights. This may further be improved through:

- Allowing businesses to grant a non-possessory security right in a single category of movable assets, without requiring a specific description of collateral. In addition, security rights should extend to future or after-acquired assets and extend automatically to the products, proceeds or replacements of the original assets. These arrangement offers flexibility because it gives creditors both the incentive to extend credit, as well as the security of knowing that they will be able to realize their security interest if the debtor defaults.
- Creating an integrated or unified legal framework for secured transactions that extends to the creation, publicity and enforcement of four functional equivalents to security interests in movable assets like: fiduciary transfer of title; financial leases; assignment or transfer of receivables; and sales with retention of title.

Commercial Dispute Resolution. In the absence of efficient courts, firms make fewer investments and business transactions while informal transactions become more attractive. In Croatia, a new Enforcement Act came into force in October 2012. Its aim was to reduce the time needed for enforcement procedures by transferring certain procedures from the court to other bodies, such as FINA. Under the new Enforcement Act, FINA is competent to directly execute court judgments and court settlements on debtors' bank accounts. As a result, creditors no longer need to obtain an enforcement

decision from the court in addition to the final judgment. The authorities still may want to:

- Assess court procedures to identify points of delay and formulate solutions. In Zagreb, it takes almost 20 months on average to resolve a commercial dispute. It is recommended to map out both the procedures required by the law and the steps required in practice by the court to take a case from filing through enforcement.
- Strengthen efforts to promote Alternative Dispute Resolution (ADR). Promoting ADR measures could help reduce the current backlog in the Croatian courts. ADR, along with other measures aimed at speeding up judicial proceedings and their enforcement, does not only increase efficiency but also reduces the cost of legal fees entrepreneurs have to pay for dispute resolution.
- Continue improving the e-courts system by introducing e-filing and electronic service of process. Since 2007, Croatia has achieved important progress towards the establishment of an e-court system. Over the past years, all county, commercial, and municipal courts have been connected to an Integrated Case Management System (ICMS/eSpis)⁶⁴. In spite of these efforts, the process of computerization is not yet completed. E-filing and electronic service of process are not yet available. Similarly, the submission of evidence by the parties (as well as witnesses' opinions) must be carried out in paper format. Because of this, court staff, judges and users have to cope with a dual system where only a part of the information they are required to assess - e.g. minutes of the hearings and past court decisions - can be found online. Adequate measures should be taken to gradually introduce a paperless e-court system.

How the World Bank Group Can Help

The World Bank Group is recognized as a world leader in supporting the design and implementation of business environment reforms.

Currently, there is a technical assistance project under preparation aiming to upgrade the business registries in line with global good practice standard. The project will include: (1) an analysis of the current legal and administrative framework, stakeholder analysis, and analysis of the EU directives in the business registries; and

⁶⁴ The eSpis system was introduced starting from 2008, all courts were covered by August 2013 with the World Bank support.

(2) recommendations for policy options to be pursued based on the findings of the analysis.

The World Bank Group also offers support in:

(i) Improving Business start-up and operations

- Streamlining and simplifying business registration and licensing procedures;
- Reforming inspections – regulatory, procedural and institutional reforms;
- Inventories of business laws, regulations and procedures;
- Implementing e-registries for business registration, licenses, permits, inspections and other formalities;
- Deployment of risk assessment and risk classification tools to focus regulatory oversight.
- Promotion of regulatory compliance through incentives, guidance, and strategic communications campaigns.

(ii) Integrating government services

- Process mapping and re-engineering of G2B and G2G services.
- Establishing integrated G2B and G2G services such as one-stop shops, informational and transactional portals (e.g. business registration and licensing portals).

(iii) Promoting good regulatory practice

- Timely notification and open and inclusive consultation on new regulatory measures.
- Appropriate assessment of the impact of proposed regulations.
- Efficient coordination in the delivery of reform.
- Systematic review and monitoring of regulatory performance and quality, and reduction of implementation gaps.
- Provision of regulatory information that is accessible, reliable, and timely.
- Efficient mechanism for grievances and complaints.

(iv) In all programs WBG client support could include:

- Diagnostics,
- Mapping and re-engineering of business processes,
- Legal and regulatory review and reform,
- Stakeholder mapping and consultations,
- Institutional reform including the establishment of clear and transparent legal mandates for

regulatory agencies and improved coordination across regulatory agencies,

- Transparency through greater access to laws and regulations in force,
- Peer to peer learning.

This Policy Note was produced by the World Bank to inform policy debate in Croatia. This note was prepared by Iva Hamel, Senior Private Sector Development Specialist, World Bank Group.

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For any questions regarding this note, please contact Vanja Frajtic, Communications Associate (vfrajtic@worldbank.org).

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Croatia Policy Notes 2016

Restoring stability, reviving growth and creating jobs

Strengthening Real Estate Registration

Key Message

Ineffective real estate registration is limiting Croatia's economic development, in part due to weaknesses in the current governance framework, which hinders the delivery of public services, increases the workload for courts and undermines the development of a modern property tax. The majority of EU real estate registration agencies have been transformed through the adoption of OECD good practices and management within a single, self-financed agency.

Key Actions

- Create a new, independent real estate registration agency from the merger of the land registry offices of the courts and the cadastre of the State Geodetic Administration.
- Provide a self-financing business model for the agency to collect the majority of its income from registration fees and electronic services – with the necessary safeguards.
- Implement a two-tier board system: a supervisory board of non-executive members appointed by a responsible line minister; and management board of agency executives.

Where Croatia Stands Now

Croatia's land and real estate sector is underperforming and hinders economic development in key areas. Land and real estate reform has been slower in Croatia than in comparable countries across Europe and its neighbors in the region, mainly due to the fragmentation of the institutions – i.e. the land registry is located in the Courts, with a parallel system for the cadastre and a separate inventory of state real estate. The impact of incomplete and ineffective real estate registration is significant and includes the following:

- Poor quality information deters investment: Investors are deterred by the lack of clarity of real estate title. Also, the use of real estate as collateral for credit is seriously hampered.
- Use of the State real estate portfolio is constrained: State-owned real estate is often a valuable asset, but cannot be managed effectively unless it is properly inventoried, valued, audited, maybe saleable, or managed.
- Lost opportunities for property taxation: Current fiscal records collected from real estate transactions are inadequate for a fair and efficient recurrent real estate taxation (See Policy Note on Tax).

Therefore, there is an immediate need to reform the real estate sector. In particular this means addressing the fragmentation and modernizing governance arrangements in line

with good practices in public agencies and real estate registration governance in the EU and internationally.

Real estate registration agencies tend to be public agencies capable of generating substantial incomes from registration fees and services. A number of good practices have emerged regarding the governance of public sector agencies across the OECD that have informed the reform of real estate agencies across the EU. This section describes common governance arrangement improvements that can guide the real estate registration reforms in Croatia:

- **Integration of institutions:** Reflecting the global public sector trends, single agencies that combine the cadastre and registration service and collect their income from service fees have been identified as more efficient and less administratively costly than public budget funded institutions and dual agency systems.
- **EU guidance on administrative vs. judicial systems:** The EU recommends that real estate registration activities fall under the administrative function that is most appropriate and efficient to apply the rules of land tenure. However, the right of appeal should remain under the court system as the judiciary is entitled to interpret and apply the law, as well as resolve disputes. However, land registries should not be vested in judicial systems, as is the case in Croatia.

- **Role of and trends in agency governance:** There has been a trend in the EU towards improving the performance of government agencies by enhancing governance practices, in particular, through better definition of functions versus agency management. In the past, the lack of clarity on roles often permitted excessive political intervention in agency operations which, in turn, contributed to poor performance. In addition, there has been a trend among agencies with revenue generating capacity towards greater financial and operational independence.

The principal method for achieving better performance has been to draw clearer distinctions between decision-making responsibilities of government versus agency executives. Ideally, government provides strategic policy direction while executives take day-to-day managerial decisions. Clearer distinctions are generally accompanied by greater decision-making autonomy of executives while, at the same time, ensuring stronger accountability. Stronger accountability to the State and stakeholders is entrenched through proper documentation that sets out policies and procedures, and defines missions, roles, and internal structures. Better accountability and planning are also supported by formal performance contracting and performance measurement.

Enhancing Board structures is important to improve governance. Though unitary Board structures are feasible for agencies, the goal of creating clear distinctions between policy setting and oversight, and operations can be reinforced by the use of a two-tier board. In a two-tier structure, a supervisory board, composed exclusively of non-executives, exercises oversight of a management board composed exclusively of executives. Irrespective of the structure, success is typically determined by the capacity of board members and executives to work together while respecting each other's distinct roles.

Supervisory Boards should have a mix of skills and backgrounds not limited to public sector representatives. It is critical that Board nominations, while subject to political overview, be based on merit and competence. Other important contributors to good agency governance are stakeholders and users. Stakeholders need not sit on Boards, however, their views should be taken into account through formal or informal consultative groups. Proper stakeholder input promotes a client focus and enhances public accountability.

Revenue generating agencies typically aim to operate a balanced budget, (i.e. to cover their costs) and be sustainable. Clear principles and rules are needed for: a) setting fees and achieving full cost recovery; b) determining how to handle surpluses or deficits; c) providing for earnings to cover future investment needs; d) defining the proper level of retained earnings and investment; and e) safeguarding agency financial autonomy. Given that agencies have the power to set prices in a captive market, financial autonomy should be accompanied by systems for incentivizing performance and efficiency. The system design should provide incentives for quality service delivery, cost reduction, and the efficient use of resources.

Reporting and disclosure norms, as well as regulated fee and profit margins, are key for good governance in revenue collecting public organization. EU cadaster and real estate registration agencies tend to agree on annual targets and investments with the government in a form of either rolling multi-annual plans / contracts or annual plans. They publish activity reports and audited financial statements annually and manage operational profits and losses in a regulated and transparent manner.

Allocating core tasks and modernizing staff management would improve efficiency. EU cadastre and real estate registration agencies tend to maintain cadastre and registry records and maps and often also produce core topographic maps of the country. Real estate registration and/or cadastral surveys generate the main duty and source of income, and are able to raise considerable revenue. In a stable and predictable operational and financial environment, agencies are able to pay competitive salaries for high market value personnel and operate efficient infrastructure and services.

New approaches to agency governance have shown tangible benefits. As decision-making is made more politically independent, both government and executives are able to focus on their respective responsibilities, and agencies are able to better focus on achieving their mission. Self-financing and greater financial independence also bring important advantages: stable funding by delinking from government budgets and funds for critical investments; and agencies are less of a drain on state budgets. As a whole, new governance techniques help agencies focus on their mission, and result in better services for end users.

Key success factors are organization and business models. The World Bank's experience

from real estate registration projects in various countries, including in the EU region, indicate that organization and business models are key for sustainable governance of such agencies. Lithuania and the Netherlands provide good illustrations as both are leaders in governance improvements. Due to their success in managing and delivering real estate registration, their governments have extended their remit to include further government registers.

- **Lithuania:** The Centre of Registers (Centre) administers the Real Property Cadastre and Register, the Address Register, the Register of Legal Entities and a mass property valuation system for Lithuania. The Centre is established in law as a State-Owned Enterprise (SOE) liable to taxation and vested to the Ministry of Justice. Its governance is further established in a number of internal rules that define work procedures, staff policies and codes of conduct, and relations between the employees and the Centre. The Centre has a board of seven members that reports to the Ministry of Justice (MoJ). Board members and the Chairperson are appointed and dismissed by the MoJ and the Board also includes the Director General of the Centre, who manages the SOE with sole powers. The Centre is financed from fees and programmatic funds allocated by the MoJ from the State Budget and is a profitable operation that retains 5 percent of annual profits in a reserve fund. Annual reports and financial statements are published and annual plans are submitted to the MoJ for approval. The Centre adheres to national business accounting and disclosure standards and is subject to an annual independent audit.
- **The Netherlands:** The Cadastre, Land Registry and Mapping Agency (Kadaster) is the legal land registry and cadastre of the Netherlands, established as a non-departmental public body. The governance framework and structure is stipulated in the Civil Code and in the Kadaster-specific, and public sector generic, legislation and norms. The Kadaster is subordinated to the Ministry of Infrastructure and the Environment and governed by a two-tier board structure with the Supervisory Board overseeing the Management Board that manages the Kadaster. A legally stipulated Users' Council is part of its formal governance structure. Annual reports and financial reports are published and an independent parliamentary review of the Kadaster's activities is conducted every five years. Kadaster is financed through fees on a balanced budget basis, with fees being agreed annually with the Ministry having considered

the advice of the Users' Council and the Supervisory Board. In addition, the Kadaster receives about 15 percent of its funding from the State Budget as project financing, mainly related to e-Government.

The responsibilities for real estate registration in Croatia are currently split. The division is between the Land Registration Management Sector (LRMS), a department within the MoJ that regulates and monitors the Court-based Land Registers; and the State Geodetic Administration (SGA), an authority within the Ministry of Construction and Physical Planning that operates the cadastre in Croatia. The SGA manages a network of 20 Regional Offices and 112 Cadastral Offices across Croatia to deliver cadastral services and maintain a fiscal cadastre. The LRMS coordinates the network of Land Registration Offices within 107 courts that maintain independent Land Book Registers under the judicial system.

The cadastre and the court-based land registers are financed through the state budget. The World Bank has supported the establishment of a Joint Information System (JIS) that manages and integrates a joint land database unifying the land register and cadastre data. The development of the JIS is currently being rolled out to all cadastre and land registration offices.

Real State assets are also separately managed. In addition, the Central State Office of State Asset Management (DUUDI) is a central state body vested with the duty to coordinate, inventory and manage all state assets including real estate. It currently lacks proper records and resources, but is investing in property management information systems as a first step towards a fit-for-purpose inventory.

The current real estate registration arrangements are not effective and are having a number of negative impacts. These include:

- **Poor quality services:** The fragmentation of real estate registration institutions impacts services and customers. Legal and cadastral processes of real estate registration remain separated and complex. This has led to expensive real estate transactions and also contributed to the historical inconsistencies in land information. This has resulted in poor quality services, reduced public trust in the institutions and an increase in real estate transaction costs without current legal registration.
- **Inefficient use of court resources:** The legal land registration system continues to be

judicial and ties up scarce court resources on real estate registration which is, essentially, an administrative function.

- **Limited support for wider land sector development:** The lack of available comprehensive, authoritative real estate registration and cadastral information reduces the effectiveness of spatial planning, restricts the option to implement local property taxes and prevents essential revenue streams to support local government.
- **Reduced opportunities for e-Government:** The implementation of successful e-Government services is dependent upon using spatial base registers, such as real estate registry, cadastre maps, buildings and addresses. These registers should be provided by LRMS and SGA, but the lack of nationally harmonized data limits the effectiveness of a range of e-Government services.
- **Embedded cultural differences:** Although real estate registration institutions do collaborate on a daily basis at local levels in delivering land administration services, there is no evidence that these institutions integrate the sector or make joint decisions. Resistance to change is embedded and a stalemate has been reached between professional groups that have distinct professional cultures.
- **Impact on staff capacity and retention:** Organizations do not have the freedom to manage staff outside of the constraints of civil service policies. This restricts their ability to attract and retain high market value personnel with the necessary skills, such as ICT.
- **Overcapacity of office network:** The current office network is still designed around the manual era and includes over 200 offices. In comparison, the Netherlands has five offices. The implementation of the Joint Information System allows the office network to be rationalized and the introduction of a one-stop-shop for all property transactions.
- **No common vision and strategy:** Although these issues are well known, there is no joint business strategy for the sector across the institutions or even mutually sensitive strategies. Instead, the LRMS have developed a short-term business strategy (as part of the new Ministry-level strategy) without any input from SGA while SGA has initiated separate strategy work in parallel.

Over the long run, Croatian real estate registration institutions cannot focus adequately on the design and alignment of

long-term strategies and business plans. This is due to unpredictable funding decisions and overarching changes in public administration policies. Closing the gap in institutional arrangements, processes and services to those needed in the digital era requires further investment. State funding is both insufficient and unreliable for such long-term investments, and new approaches to financing and corporate management maybe needed to bolster investment, predictability and operational enhancement.

The overall impact of these deficiencies is a restricted inward investment. Many investors find the insecurity of real estate rights too high a risk for investment in Croatia. Many families and entrepreneurs encounter problems in accessing credit due to the risk associated with their land rights and restricting economic development of the land market. .

How Croatia can improve real estate registration

The current system is detrimental to both economic development and social stability. A new governance structure might be considered, informed by international good practice, for real estate registration and could include:

- **Creating an independent agency:** from the merger of the land registry offices of the courts and the cadaster. A number of options are available for creating semi-autonomous legal entities within the Croatian public sector.
- **Combining registration and cadastral services:** The new agency's remit could include core real estate registration and cadastral services (covering all private and state real estate), and mass property valuation for multiple purposes, e.g. property market information improvement, state asset valuation, and revenue enhancement. Geodetic and topographic responsibilities could also remain in the domain of the new agency. The scope could be extended to include state land management at a later stage.
- **Introducing a self-financing model:** The new agency would be self-financing, perhaps an SOE or another financially and operationally independent entity, which collects the majority of its income from registration fees and electronic services, and operates on a balanced budget. Funding from the state budget would only be obtained and ring fenced for government-specific activities and new development, e.g. support of specific e-Government initiatives or maintaining and

developing the geospatial infrastructure and services. Accountability for the use of funds, mechanisms for dealing with operational surpluses and retained earnings to cover future investments would be needed for the new agency to achieve its mission and maintain a high level of trust among the public. Fee levels could be reviewed annually through consultation with key stakeholders and set by a supervisory board and confirmed by a responsible minister. A self-financing agency should adhere to national business accounting and disclosure standards and be subject to an annual independent audit.

- **Adopting new governance arrangements:** The implementation of a two-tier Board system in the new agency would include: (i) A supervisory Board of 5 to 7 non-executive members appointed by the minister based exclusively on professional merit; and (ii) a management Board composed of the CEO and other executives also appointed exclusively based upon merit. The role of the supervisory Board would be to approve the strategy of the new agency, measure progress against strategic goals and performance objectives, and ensure that systems are in place to safeguard that the agency operates in a transparent and effective fashion. The management Board would be composed wholly of full-time directors employed at the agency and would be responsible for the institution's day-to-day operations. The management board would answer to the supervisory board through the CEO.
- **Adjusting the regulatory framework:** The creation of a new independent agency within the Croatian public sector would require robust and transparent regulation. Therefore, an appropriate regulatory framework would have to be created.

- **Introducing legislation as needed:** New legislation would be introduced, when required, to transform real estate registration from a judicial to an administrative-based service.
- **Conducting reforms over a two-year period:** This is a significant change management process and best practice indicates that if a new agency is created/merged a two-year timespan might be appropriate.

How the World Bank Group Can Help

The World Bank has significant experience in providing advisory services, technical assistance and financing on land registration and cadaster programs in many countries worldwide including Croatia and other EU countries, on national land registration and cadastre programs. This experience includes implementing institutional reforms involving the merger of land registration and cadastre organizations. The ongoing work on the Integrated Land Administration System, a Bank-financed project, is supporting the roll-out of the Joint Information System. The project is closing in April 2017.

This Policy Note was produced by the World Bank to inform policy debate in Croatia. This note was prepared by, Mika-Petteri Törhönen, Lead Land Administration Specialist.

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For any questions regarding this note, please contact Vanja Frajtic, Communications Associate, (vfrajtic@worldbank.org).

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Croatia Policy Notes 2016

Restoring stability, reviving growth and creating jobs

Addressing Energy Affordability

Key Message

Energy sector reforms are well advanced, but addressing affordability concerns—by finalizing the design and the implementation of effective compensatory measures for vulnerable groups—is a priority. However, two major obstacles to include: the highly decentralized system that is dependent on municipal resources, with no accountability mechanisms to ensure reforms are delivered; and the lack of fiscal resources available for a compensation scheme.

Key Actions

- Tailored policy responses to help vulnerable households cope with energy price increases include:
- Reaching poor and vulnerable households with means-tested social assistance, as part of central social assistance;
- Promoting energy efficiency investments and other efforts to help consumers manage energy demand for all income levels; and
- Communication and transparency to enhance consumers' acceptance of market liberalization.

Where Croatia Stands Now

Croatia has made speedy progress in liberalizing energy prices for commercial and public sector users. This was enacted through a number of laws introduced between 2004 and 2012. In 2012, with the passing of a new Energy Act and the Act on Regulation of Energy Activities, Croatia liberalized its energy market in line with requirements of the European Union's (EU) Third Energy Package. In comparison with peer countries like Romania and Bulgaria, Croatia has advanced quickly in the implementation of this agenda. A set of well-designed measures that protect vulnerable consumers, however, is lagging.

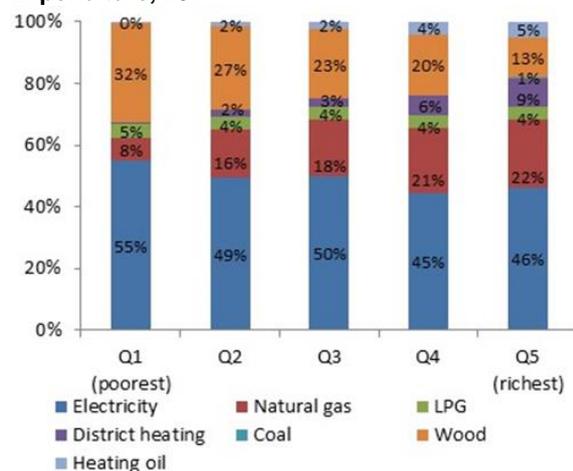
The deregulation of prices alongside common tariff setting mechanisms initially led to increased energy prices for consumers. From 2007 to 2014, electricity and gas prices for domestic consumers increased from 0.09 Euro/KWh to 0.13 Euro/KWh and 8.20 Euro/GJ to 12.90 Euro/GJ, respectively. Looking ahead, further price increases are expected for electricity and gas to reach cost recovery levels, even if the trend in international prices has currently reduced some of that pressure. In addition, the investment needs in the District Heating system suggest that prices for this service will also have to increase going forward.

Croatian households' energy budget share declines with income such that high energy budget shares coincides with low household income. This along with evidence on high shares of the population being in arrears on their utility bills, and qualitative evidence on poor households having already limited their consumption to the minimum suggests that with further tariff increases, concerns about affordability will emerge particularly for the poor and for those in rural areas. In addition to a focus on improving affordability for the poor, an integrated and broader approach to addressing affordability is needed for vulnerable households of all income levels who face growing concerns related to high spending on energy.

Croatian households use a variety of energy sources. They use energy for lighting, heating, cooking, and hot water, and there is significant heterogeneity in spending patterns on energy across income groups (Figure 1). The poorest quintile has extremely limited access to district heating and rarely use in-house central heating systems. There is also significant heterogeneity in spending patterns on energy across regions. This reflects the geographical concentration of poverty in rural areas, and in Central and Eastern Croatia, as well as the climate variation across regions. Also, seasonality plays an important role in household energy expenditures. Based on the estimates of expenditures from the Household

Budget Survey (HBS) data, there is moderate seasonality in expenditures on electricity and high seasonality in expenditure on natural gas and district heating.

Figure 3: Composition of Household's Energy Expenditure by Quintiles of Per Capita Expenditure, 2011



Source: Authors' estimates based on the 2011 Household Budget Survey (HBS).

Households differ significantly in the availability of energy sources they can rely on, with the availability of gas and district heating being the two most important heating options whose coverage is limited. District heating is available in 18 cities, reaching an estimated 8.5 percent of all households while the gas network reaches only 30 percent of households and does not extend at all to the Adriatic south.

Affordability represents a challenge. This is illustrated by delays in bill payment, reflecting households' inability to pay on time, and by households choosing to under-heat their homes in an effort to lower bills. Furthermore, households rely on other energy savings measures, like a two tariff meter, whereby "cheap electricity" is available for off-peak demand hours (after 10pm). However this means that households are trying to meet their electricity needs at night, which can have detrimental impacts on quality of life, especially of women who are typically in charge of domestic chores.

Simulations suggest that increasing energy prices since 2011 have resulted in an increase in poverty of 0.5 percentage points (Table 1). Although price increases have not yet seen a large impact on poverty rates, impacts do appear to have been felt across the income distribution, with substantial heterogeneity across regions. Simulations based on the additional increases needed to align electricity and gas prices with international prices and to bring district heating to cost-recovery levels, suggest that poverty rates could increase

between 0.3 and 0.9 percentage points above its 2011 level. The indirect impact of price increases have not been modelled as these are not expected to be significant.

Table 1: Simulated poverty impact (using anchored poverty line, in percentage terms)

%	Baseline 2011	Real price increase 2011-2013	Further increases to cost recovery
Poverty headcount rate	13.2	13.7	14.6
Poverty gap	2.9	3.0	3.3
Squared poverty gap	1.0	1.0	1.1

Note: Poverty indicators are calculated using the poverty line anchored (fixed) at 60% of median per capita expenditure in the baseline case. In simulations, expenditure of each household is reduced by the amount equal to the increase in energy expenditure compared to the baseline case.

Source: Estimates based on the 2011 HBS.

Policy makers need to have a better understanding of vulnerability to price increases. Key variables associated with being a 'high energy spender' were identified in order to construct "profiles" of groups most likely to be affected by price increases. This exercise helped reveal that vulnerability to energy price increases compounds a number of other deprivations which already limit opportunities available to poor households, such as having a head-of-household with low education or out-of-work. This exercise also illustrated that even groups which have characteristics typically associated with better off households (such as living in a modern multi-family building), could face significant stress on their budgets and see their energy poverty more than double.

Households lack understanding of the justification for increasing energy tariffs. Institutional and stakeholder assessments through focus group discussions revealed that households associate price increases with corruption or bad sector governance. One of the advantages of liberalization, the benefit of a more competitive market, is not panning out for respondents – the majority of participants in the focus group discussions do not trust new electricity providers and so do not transfer their services. Respondents often complain about energy providers, namely about high and unclear bills for electricity and district heating and are also dissatisfied with the quality of natural gas.

How Croatia Can Mitigate the Social Impact of Rising Energy Prices

International evidence shows that the government can rely on three complementary

approaches to support energy affordability for the population:

- First, Guaranteed Minimum Benefit (GMB), that adequately covers the poor, can be used effectively to deliver cash compensation to the bottom quintiles in order to prevent adverse coping mechanisms in the face of rising electricity and gas prices.
- Second, demand management measures for poor and vulnerable households, especially energy efficiency investments to improve heating, will help households meet their heating needs efficiently.
- Finally, a tailored public communications campaign together with measures to enhance transparency of the energy sector will strengthen sustainability of reform efforts.

Finishing the design and operationalizing efforts to protect vulnerable consumers remains a priority.

The reforms started before Croatia joined the Energy Community in 2006, and continue now that it is an EU Member State. In 2013, the government adopted a Social Action Plan detailing its intentions to address the broad social consequences of energy sector reform. As far as protection of vulnerable consumers is concerned, the Plan envisages measures aimed at: (a) supporting energy consumption through direct subsidies for the poorest citizens, including both social assistance recipients, and those who would fall into poverty due to a price increase, even if they are not currently receiving social assistance; and (b) providing support to a broader category of households which would be affected by tariff increases, most probably through support for energy efficiency measures. Among the crucial steps identified in the plan is establishing criteria for the identification of vulnerable energy consumers to receive state support, making explicit reference to energy poverty as the relevant criteria in this respect.

Removing indirect support to households through subsidies embedded in the tariff calls for strengthening other tools to bolster affordability.

Current social assistance programs offer limited support measures for energy affordability of vulnerable groups (through local government heating allowance and, from end-2015, the energy vouchers), and result in wide disparities in treatment of vulnerable households. While the GMB support is financed by the central government, housing and fuel wood transfers are financed by local governments and there is no enforcement mechanism to guarantee that they meet their assistance obligations. The uncoordinated nature of the system means that there are often

big disparities among eligible households depending on the finances of the municipality they live in. The possibility to accumulate benefits is not monitored either. Furthermore, there is no common registry of beneficiaries (except for GMB) which further hampers coordination between local and central government structures and leads to poorly targeted support in many cases. Qualitative evidence points to the fact that households are aware of the disparities in treatment among inhabitants of rich or poor municipalities as well as the lack of oversight to ensure that local authorities with less revenue still provide these benefits and that the beneficiaries to whom they are providing it are in fact those who need it. The unsatisfactory performance of these measures stands out in Croatia's current social assistance system which is overall well targeted, though it provides relatively low coverage and generosity. Simple scenarios suggest that cushioning the impacts of the tariff increases required to reach cost recovery would require mobilizing significant resources, even if those could be perfectly targeted.

Consideration needs to be given to the financing and targeting of compensation programs, particularly given the fiscal constraints.

Simulations suggest that fully compensating the bottom 20 percent of the welfare distribution (roughly equivalent to the share of the poor in 2011) for the energy price increases since 2011 and those that are expected, could cost 0.13 percent of Croatia's GDP. To implement such an agenda, the potential conflict between targeting programs to support affordability to "the vulnerable" if those are identified in terms of energy poverty, and targeting "the poor" as it is done through targeted social assistance needs to be explored and clarified. Simulations also showed that current expected budget for support of vulnerable consumers, to be collected through solidarity tariff, is enough to support a significant part of either electricity or heating needs of social assistance recipients, but it is far from sufficient to cover significant part of needs of low-income families.

Energy efficiency investments can help in reducing heating expenditures.

This can consist of interventions such as thermal renovation of the building envelope or more efficient and cleaner stoves. Their implementation can reduce energy consumption between 40 and 50 percent, but this savings level is characterized by a payback time of more than 10 years given current prices. Modelling work on potential energy and cost savings from thermal modernization in residential buildings in Croatia

highlights that low cost energy efficiency investment for family houses can bring down modelled energy budget shares, however, for households in the bottom quintile who are already under-heating, the budget share would remain unchanged and they could experience payback times of over a century.

In an environment where energy prices are increasing to cost-recovery levels, governments are well advised to scale up residential building energy efficiency programs. If public subsidies are used in a smart way to leverage private financing, a large number of households would benefit from such programs and would be less exposed to higher heating costs. For those low-income households that are already experiencing high energy budget shares and/or under-heating and who should be among the first to benefit from public programs, additional public financial support is required to make up for the lack of access to commercial financing.

Sources of funding could include the following:

- State government budgets, European Structural funds and other funds from financial institutions (See Policy Note on Public Investment Management), although this is also dependent on the general fiscal consolidation program;
- Special sources such as electricity (or other fuel) levies, climate change levies, special purpose EU funds, and others, such as Green Investment Schemes;
- Heating subsidies redirected to provide grants for energy efficiency investments, where applicable;
- Special resources at the municipal level, such as income from the sale of dwellings in municipal buildings;
- Instead of spending funds regularly for compensating poor and vulnerable households for energy price increases, one-time payments to improve the energy efficiency of their homes may be preferable.

Additional supporting measures could include:

- Adapt Home Owners Associations or owner's legislation to facilitate decision processes;
- Provide technical assistance to Home Owners Associations/owners for capacity building in management and financial issues;
- Set up a strong interdisciplinary/inter-ministerial and intergovernmental unit which

can provide necessary support to governments, regulators, beneficiaries and other; organizations involved in implementation;

- Develop a system for the supervision of renovation works quality.

The gaps in households' understanding of different aspects of the energy sector reform need to be addressed. A shared aspiration to become an EU Member State appears to have facilitated the implementation of reforms. However, now that the goal has been achieved it seems that a greater effort to communicate effectively about the next generation of reforms might be needed, especially in light of gaps in households' understanding of different aspects of the reform ranging from price-setting mechanisms to electricity suppliers to billing processes or compensatory measures to support energy affordability.

There is also need to clearly articulate a vision for the future reform process and identify the public compensatory measures that are going to be put in place. This is particularly the role that energy efficiency investments and the new program to protect vulnerable households are going to play. In addition to closing information gaps, special attention should be paid to simplifying processes and procedures as well as facilitating better government coordination to lower transaction costs, and ensure access to support services for vulnerable households. The communication effort should convey the reform as a means of achieving economic and social objectives such as better service delivery and sustainable and secure energy sector.

How the World Bank Group Can Help

The Bank offers experience working with governments – globally and in EU countries – in rolling out reforms that increase energy efficiency, design affordable and well targeted compensatory schemes and manage the design of supportive institutional reforms and strategy development. This includes analytic and advisory support, as well as supporting infrastructure planning and upgrades, automation of processes and ICT improvements.

The recommendations to improve the energy affordability program in Croatia submitted to the Government in January 2016 outline a broad agenda to be addressed. In this respect, Bank assessments and policy advice provided to date offer a wealth of comparative information on issues and practices from best practice countries as well as countries which are in the process of reforming their energy affordability and energy

efficiency systems. The Bank is also supporting the modernization of the social assistance system through the investment operation (See Policy Note on Social Welfare).

This Policy Note was produced by the World Bank to inform policy debate in Croatia. This note was prepared by Caterina Laderchi, Moritz Meyer, staff of the World Bank.

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Croatia Policy Notes 2016

Restoring stability, reviving growth and creating jobs

Managing Water Resources, Services and Risks to Growth

Key Message

The overall water management framework in Croatia is sound, but EU membership compliance with water Directives is bringing operational and financial challenges that require the largest investment cycle in its history and in parallel reforms to improve technical and operational efficiency. Irrigation of agricultural land was neglected over an extended period of time, which undermines agricultural competitiveness, and exacerbates the risks of climate change impacting agricultural production. While flood protection systems in Croatia are fairly well developed, the country still needs to improve river basin based cross border cooperation, and develop additional flood protection infrastructure, in response to the increased frequency and intensity of extreme weather events.

Key Actions

- Finalize preparation of and implement the water utilities sector reform.
- Strengthen capacity and remove barriers for preparation, implementation and optimal utilization of EU compliance investments.
- Implementation the National Irrigation Strategy and develop water user associations (WUAs).
- Strengthen the water quality monitoring system and improve flood forecasting and real time coordination with neighboring countries.

Where Croatia Stands Now

The Water Management Strategy adopted by the Government of Croatia in 2009 sets the number of important objectives for the water sector. These include: (i) provision of sufficient quantities of drinking water of good quality for the population; (ii) provision of the required quantities of water of adequate quality for various economic purposes; (iii) protection of people and assets against floods and other adverse effects of water; and (iv) achieving and preserving the good status of water in order to protect aquatic and water-dependent ecosystems.

These objectives underline the importance of sound management of water resources, water services and risks for the economy and the environment. Indeed, Croatian tourism generates significant income, which is heavily dependent on good quality of coastal waters, representing 17 percent of the GDP; and agriculture, which is heavily dependent on water availability, provides employment to 9.5 percent of the labor force (compared to 5 percent of EU27), while recent floods and droughts have

demonstrated the growing human and economic impact of extreme weather events.

Prior to joining the EU in 2013, Croatia undertook significant efforts to meet the EU environmental *acquis communautaire*. Differently from many candidate countries in the region, in 1995 Croatia established a strong national water agency, Croatian Waters⁶⁵. Thanks to rich water resources and functional organization of the water management sector, Croatia today is in a more advanced position than other recent EU members in terms of compliance with EU requirements: River Basins Management Plan have been adopted and are under implementation; the Floods Directive 2007/60/EC has been already transposed into national legislature (Water Act, 2009) and is being implemented; and the Government has put forward and is implementing a comprehensive plan to achieve compliance with the relevant EU directives (Urban Wastewater Directive and Drinking Water Directive). However, some very important implementation challenges remain, as highlighted in the following paragraphs.

Water Resources and Status

⁶⁵ The public institution is a non-profit institution responsible for managing water and public water

estate, and protective and hydro-ameliorative water structures.

In the Constitution, water is stated as a good of public interest alongside to sea, airspace, mineral resources, land and forests. All water matters are legally regulated by three main laws: Law on Waters, Law on Water Management Funding and Law on Local Public Utilities. The line ministry (usually the Ministry of Agriculture) supervises the operation of Croatian Waters, as the agency that is responsible for management and administration of all water issues. Croatia cooperates with other riparian countries through international agreements and conventions, which are part of the legal framework for water management in Croatia and in the region.

Croatia is endowed with relatively abundant water and is characterized by great rivers. The Sava and Drava on the northern/eastern Slavonia plain, and the karst coastal area in the west and south. The northern and the eastern area of Croatia belongs to the Danube/Black Sea catchment area (about 60 percent of the territory) and the coastal zone to the Adriatic Sea catchment area (about 40 percent of the territory). Despite being a water-rich country according to FAO (Aquastat 2015), water flow is very seasonal, especially in the Adriatic Sea catchment area.

The reduction of industrial activity and the decline in the use of fertilizers and pesticides in agriculture have considerably eased the pollution in surface water sources. However, surface water still shows relatively high nutrient pollution, especially in the Danube basin. The entire Danube basin, and smaller parts of the Adriatic basin are classified as “sensitive areas” in the context of the EU Water Framework Directive (EC 2000). Only a small portion of all available water resources is actually used (for example only 4 percent of renewable groundwater is being used against 96 percent of potable water supply), indicating overall water richness.

Although climate change is expected to exacerbate floods and droughts, water availability is not an immediate concern as demand is low, although localized climate change impact could be expected.

The quality of groundwater is generally considered good throughout the country, with noticeable exceptions on some of the islands, where salinity is an issue in a dry season. The reports on the state of the sea and its water quality indicate that a considerable part of the Croatian portion of the Adriatic Sea is oligotrophic and clean, but some of the big cities ports, and the industrial zones along the coast are at some locations polluted by organic and

inorganic substances (from domestic and industrial polluters).

Water Services

Water and sanitation services are provided through more than 150 local or regional public water utility companies. However, the local service providers are regulated and supported by national-level institutions, including: National Water Council, Ministry of Agriculture, Croatian Waters, and Water Services Council. Croatia has benefited from having Croatian Waters as a strong water management agency that represents important technical and financial resource for the water service provision sector. Service regulator role is being played by Water Services Council that reviews and approves any tariff revision. Economic regulation is based on the cost recovery principle and a price-cap approach, with a requirement that tariff structures consider subsidy schemes in case an expected water bill is over 2.5 percent of average household income. The Council also monitors service quality and performance through the collection of a series of performance indicators.

The sector reform agenda remains unfinished. Since 2010, the government has initiated a series of utility sector reforms. Besides establishment of a proper water sector regulatory framework, this includes proposed merger of utility service providers into smaller number of regional utilities to take advantage of economies of scale, ensure improved performance and more efficient operating costs, and provide further cross-subsidies inside the service area. However, this reform has not yet been implemented, and the reorganization of the utility service areas that currently exists as a proposal, is waiting for the new government decisions.

Water service provision at household level in Croatia is generally good and similar to other countries in the region. 99 percent of the population has access to piped water, 75 percent has access to organized water supply, 45 percent of population has wastewater collection and 95 percent has flush toilets.

However, water supply and wastewater infrastructure is in need of a major rehabilitation and upgrading to reach EU required levels. There are still significant challenges linked with: (i) the quality of drinking water where only 85 percent of samples are compliant, against good practices of above 99 percent in particular in areas not covered by public utilities; and (ii) only 45 percent of all wastewater collected and only 28 percent treated, which is much below than in EU15 countries.

The efficiency of public water and sanitation service providers remains an issue. At 44 percent, nonrevenue water is much higher than the levels in the Western Europe. Commercial practices are largely sound with universal metering, despite a billing collection ratio of around 90 percent on average. With an average of 3 staff per 1,000 connections, the sector is less productive than the international best practices, but still more productive than the countries in the region.

Sector is relying on transfers to cover its operational costs. Water use and water protection fees represent around 18 percent of the sector funding, while tariffs collected by utilities account for 57 percent of the total financing coming into the sector, but failed to fully cover O&M utility costs. As a result, funding of investment costs rely heavily on national taxes and transfers. External transfers represent 23 percent of overall sector financing, and this proportion is expected to rise significantly as EU Cohesion Funds become dominant form of financing necessary for EU alignment investments.

Current investment levels are much lower than needed to achieve compliance with the EU acquis. They can cover only around one-third of the level necessary to achieve the country's commitments. An estimated €0.85 billion of investments are needed to achieve compliance by 2023 with the Drinking Water Directive and another €2.9 billion for the Urban Wastewater Treatment Directive. While EU Cohesion Funds will cover important part of investments needs (around 70 percent of EU-financed capital expenditures), overall EU allocations will likely be less than 70 percent of investment needs for full EU directive compliance, indicating considerable financial gap.

Tariffs are expected to continue rising in the future to help cover the financial gap. Tariffs has increased on average by 7.5 percent annually between 2005 and 2012 (while average annual inflation was 3 percent), and are expected to continue increasing, given the significant investments and subsequent operating costs linked to Croatia meeting the European environmental acquis. Affordability is still not a serious constraint for most people in Croatia, but is likely to become growing issue for a poorer segments of the population as tariffs continue rising. In 2012, the water bill for an average family was around 2.3 percent of household income, and 3.6 percent for the bottom 40 percent of population, which is above the designated Croatian affordability level of 2.5 percent.

Floods management

While Croatia has a relatively well-developed and operational flood protection system, including flood protection structures (combination of dikes, canals pumping stations and flood retention areas), heavy seasonal rainfalls still pose a risk of severe flooding. The southern part of the Sava river basin has been most affected during the 2014 floods. At the same time, torrential rains have caused more localized but widespread flooding, power outages, landslides, transport infrastructure damages, and have disrupted water and wastewater services, with severe economic impacts. Croatia is planning to scale up its efforts to further build its flood resilience, and improve flood predication and cooperation with neighboring countries (particularly in Sava and Danube catchment area).

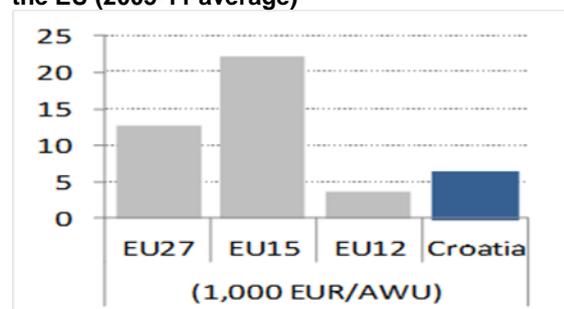
To address its flood risk, Croatia is working within the Floods Directive 2007/60/EC. The directive was transposed into national legislature (Water Act) in 2009. Preliminary Flood Risk Assessment – PFRA was completed in 2013, reported to the EU in 2014. With the EU support, Croatia has completed Flood Hazard and Flood Risk Maps. Croatia's Flood Risk Management Plan (FRMP) is an integral part of its River Basin Management Plan (RBMP), over which Croatian Waters has a full responsibility. Croatia's draft RBMP with FRMP were completed and published for public review in April 2015, while reporting to the EU is scheduled for March 2016.

Irrigation

An important constraint to increased performance in the agricultural sector is the lack of adequate and reliable supply of water for irrigated agriculture. The country has one of the lowest ratios of irrigated-to-irrigable land in the region: only 18,000 ha are currently irrigated out of 244,000 irrigable ha. This is a considerable limitation on the country's agricultural potential, as analysis shows that it is not feasible to increase the production of high-value crops without supplemental irrigation. Overcoming this constraint would involve (i) the repair, modernization and expansion of the on-farm irrigation facilities, (ii) the more secure provision of bulk water in the summer season and the drainage of surplus water in the wetter seasons, and (iii) the strengthening of the institutions for sustainable water management and increased productivity of irrigated agriculture. These challenges prevail across the country, despite the diversity of meteorological and topographic conditions (with marked differences, say, between the karstic mountainous coastal region and the Slavonian plain).

The productivity of agricultural sector is comparably low. Its productivity in the period of 2012-2014 was at 1/5 of average productivity level in EU15. In fact, it declined over the last three years by close to 16 percent if measured as gross value added per worker. While before 2009, Croatia had nearly twice as high productivity than new EU member states, this advantage has been almost entirely lost over the last three years. A high share of small and subsistence-oriented agricultural holdings weakens overall labor productivity. Three quarters of all farms operate on less than 5 hectares, and almost 60 percent of these (or half of the total number) consume more than half of their agricultural output⁶⁶. However, the sector budget currently slightly exceeds 1 percent of GDP, which is higher than in most other EU countries, where levels generally range between 0.3 and 0.8 percent.

Figure 1. Farm Labor Productivity, Croatia and the EU (2005-11 average)



Note: EU12 countries that joined after 2004 w/o Croatia.
Source: Eurostat

The revitalization of the agricultural rests, inter alia, on the following policies: (i) land consolidation; (ii) modernization and expansion of irrigation; and (iii) a system of agricultural subsidies that is harmonized with the EU rules. The irrigation effort aims at mitigation of water shortages that have a seasonal (notably in the northern part of the country) or structural nature (notably in the southern Adriatic coastal zone that is predominantly karstic). In nearly all cases, the irrigation is supplemental, i.e. only required to supplement rainfall and bridge dry spells. The first National Communication of the Republic of Croatia to UNFCCC on the impact of climate change notes that soil moisture during the summer months in lowland Croatia is expected to decrease by 30-60 percent and in the coastal areas by 25-56 percent, as a result of increased temperatures and lower rainfall during the summer.

Despite some progress on the institutional and policy framework, implementation remains slow. The Government in 2005 adopted

its National Plan for Irrigation and Management of Agricultural Land and Water Use (“National Irrigation Plan”) as part of its policies to modernize its agricultural base. In recent years, Croatia has made some progress towards pursuing important agricultural reforms that include: (i) transferring the management and maintenance responsibilities of irrigation systems from the state to the counties (requiring institutional strengthening at local levels), (ii) introducing payment for water use, determining the tariff of irrigated water to cover O&M costs of the infrastructure and developing an effective fee collection system; and (iii) initiating the development of water user associations (WUAs). All counties have now also completed a County Irrigation Strategy.

How Croatia Can Manage Its Water Resources

Despite seasonal and regional disparities, Croatia is a water rich country, and those potentials could be better deployed. Croatia’s water sector could contribute to economic stability of the country, reviving growth and creating jobs in a number of ways, including:

- **Water Resources.** The areas of improvement for water resource management in Croatia are following: (i) strengthening of water quality monitoring system in the rivers and coastal areas to be able to track changes in water quality status, (ii) improving cooperation with neighboring countries with whom Croatia shares its main river basins with the objective of optimizing water use, but also improving management of flood and draught risks.
- **Flood and drought management.** The 2014 floods represented an overall damage of €80 million, and with frequent occurrence of the extreme weather events, similar events could be expected in the future. Elimination/reduction of flood risks (both from large rivers as well as from torrential rains) would minimize damages, and create additional jobs for flood protection infrastructure construction sector. The Government needs to scale up its efforts to improve flood risk management, including developing additional structural measures, like: (i) improvement of flood protection infrastructure (including modernization of lower Sava River dikes); (ii) development of Natural Water Retention Measures; (iii) development of remote sensing for flood defense, and improvement of Flood Defense Centers, with state of the art information management and communications systems.

⁶⁶ Eurostat, Agricultural Census 2010

Croatia Waters estimated that this would require about €1.5 billion over the next 30 years, of which large part will be financed by EU. On non-structural measures, Croatia needs to: (i) improve the flood forecasting and early warning and alert systems (including data collection, modeling, data exchange platform); (ii) improve modelling and simulation of flood hazards; (iii) improve flood risk management planning, systems, maps etc. The above measures present an integrated approach to floods/drought risk management, and they require extensive and effective regional cooperation. Real time data exchange and joint forecasting are the critical steps Croatia is working on. Croatia's efforts are compounded by similar undertakings in the other countries sharing the river basins.

- **Water services.** The main issues that need to be addressed in the coming period are the following: (i) secure sufficient financial resources to cover EU compliance needs estimated at around €3.75 billion, requiring almost triple the current levels of investments, (ii) secure project preparation and implementation capacity needed for EU compliance - the implementation capacity of the water utilities will need to be significantly improved through capacity building and better organization of utilities; (iii) implement utility sector reform to strengthen capacity and improve service efficiency - operation, maintenance and assets depreciation of the EU financed infrastructure will represent financial and operational challenge, unless capacity of service providers is timely strengthened and sufficient financial resources are provided. Utility regionalization process aiming to merge service providers into a smaller number of regional utilities, and cover the whole country with better organized service provision is yet to be implemented; (iv) ensure affordability of future tariffs - appropriate mitigating mechanisms will need to be developed to address affordability of tariff hikes needed to cover the construction and operation of the new infrastructure to comply with the environmental acquis, as well as apply cost recovery principle; (v) strengthen regulation in the water sector - despite the relatively well-developed legal and regulatory framework, the Water Service Council is still in the process of fully deploying its regulatory reach. It has developed instruments for that purpose, including specific bylaws on performance standards, but those have not yet been widely applied. As a result, regulation of water services needs to be strengthened in terms of human and financial resources, and

by the introduction of a functional benchmarking platform.

- **Irrigation.** The main issues that need to be addressed in the next period are the following: (i) implementing NAPNAV and developing water user associations (WUAs) in parallel. Importantly, WUAs need to commit up-front to payment of water use fees, be closely involved in the design of the irrigation schemes, and be supported through a dedicated extension service and credit system that can help them achieve water efficient irrigation, link to markets and maximization of the on-farm investments; (ii) identifying and preparing priority irrigation investments that are economically, financially and environmentally sustainable within a regional or local rural water management vision. Irrigation charges should cover the costs of the irrigation infrastructure, at the very least, to ensure the financial sustainability of these investments; (iii) strengthening the institutions in charge of the development, management, operation and maintenance of the irrigation systems. This would also include introducing the principle of payment for water use, outlining the methodology for determining the water irrigation tariff as well as the fee collection system; and (iv) developing a set of actions to support the farmers that would benefit from new irrigation infrastructure or improved services (including agriculture knowledge and technical information regarding the use of new irrigation methods (if any), and WUA organization, management, and financing).

How the World Bank Group Can Help

The World Bank has been a leading and long-standing partner of the Croatian water sector for the last 15 years, providing financial and technical assistance worth of €335 million, in the field of water supply and wastewater management, water quality monitoring, flood protection and irrigation planning. Through its last projects: the Inland Water project and the Coastal Cities Pollution Control 1-2 (APL) projects, the Bank has supported financing of the investments in flood protection, wastewater collection and treatment, contributing in particular to a much cleaner coastal area even before EU accession, and establishment of a comprehensive seawater monitoring system for a thriving tourism industry. During this last period, the Bank has enabled knowledge sharing and provided continued technical assistance to the water utility sector regulation and reform process.

Today's Croatia is very different from the one 15 years ago. Joining the EU meant that the Croatian water sector had to adopt a water

management approach based on River Basins Management Plan; commit to ambitious drinking water and wastewater management targets to satisfy EU water directives and revise the way floods management and irrigation infrastructures are being developed. Based on the involvement in many EU countries, the Bank's engagement in water sector could take a number of different forms:

- **Technical engagement.** The Bank could provide continued support to the government in addressing sector challenges of EU membership, such as the implementation of the water services reform, the adaptation of water infrastructure and climate change management, the prioritization of investments to optimize EU funds usage and absorption while supporting government priorities, or the introduction of new technologies for more efficient water use in irrigated agriculture and water supply. Such a technical support could be financed from the Bank or from EU funds, as is the practice already in Romania and Bulgaria.
- **Financial engagement.** The Bank could also provide co-financing for EU funds as is currently the case in Poland, either to the national or local governments, in order to support and accelerate the investment program necessary to comply with EU requirements. It could also contribute to finance investments not eligible from EU funds but important to accomplish the government's strategy, such as irrigation or floods protection infrastructure, or support to smaller settlements below EU water supply or urban wastewater requirements.

- **Programmatic engagement.** The Bank could also provide direct technical and financial support to the implementation of the government's operational program, by agreeing on a series of concrete milestones and results and supporting those financially and technically. In this case, the Bank's engagement would be focused on helping the government in delivering the overall program and achieving the specific results agreed upon, rather than reviewing individual investment packages – a relationship that reflects the increased maturity of the country compared to past times.

The World Bank strives to maintain an active policy and sector dialogue building on its excellent knowledge of Croatia, its regional knowledge of EU membership compliance issues and its unique global knowledge of water sector.

This Policy Note was produced by the World Bank to inform policy debate in Croatia. This note was prepared by Senior Water and Sanitation Specialist Stjepan Gabric, Senior Water and Sanitation Specialist David Michaud, Senior Water Resources Specialist Ana Cestari and Senior Water Resources Specialist Winston Yu.

The findings, interpretations, and conclusions expressed herein do not necessarily reflect the views of the Board of Executive Directors of the World Bank or the Governments they represent.

For any questions regarding this note, please contact Vanja Frajtic, Communications Associate (vfrajtic@worldbank.org).

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Croatia Policy Notes 2016

Restoring stability, reviving growth and creating jobs

Competitive Transport as an Engine for Growth

Key Messages

Transport SOEs are not managed on a commercial basis and their restructuring is slow and inefficient, leading to a drain on the public budget, worsening deteriorated services, and hampering the use of EU funds. The road companies' debt, equal to 11 percent of GDP, is one of the largest pressure points on public finances. The transport sector lacks effective multi-modal planning, which takes account of available financial resources and implementation capacity. Transport projects can take up to 10 years, with substantial delays due to weak project management capacities, and inefficient permitting and procurement processes.

Key Actions

- Form a task force coordinated by the transport ministry to develop sector-wide and multi-year implementation plans for sector investments. A separate team in the ministry could be assigned to introduce electronic portfolio monitoring according to predefined key performance indicators (KPIs).
- Accelerate SOE restructuring by strengthening management and governance, imposing budgetary limits and supervision on public expenditures, increasing private sector involvement, and ensuring that European Structural and Investment (ESI) funds are prioritized for planned investments.
- For railways, review the network size, discontinue low traffic services, and rationalize asset management. For roads, urgently restructure companies' debt and operations.
- Simplify, shorten and digitalize permitting processes for infrastructure projects. Likewise, standardize procurement processes, improve the quality of tender documentation and the evaluation procedures.

Where Croatia Stands Now

Croatia does not have a strategy and implementation plan for the transport sector.

After more than 15 years, Croatia approved an interim National Transport Development Strategy in July 2014, which is expected to be finalized in 2016. The Strategy defines a new approach to transport planning, emphasizing multimodal, safe and sustainable transport services and the completion of the Croatian part of the Trans-European network of corridors. However, an overarching implementation plan that would define, prioritize, and sequence transport infrastructure investments in a complementary, affordable and consistent manner in the medium term is still missing. Transport investment planning still rests upon respective sub-sector or companies' strategies and plans (e.g., Public Road Construction and Maintenance Programs, HZ Infrastructure Business Plan), which are independently prepared by companies and approved by the government. This approach often leads to inconsistent policy making, either

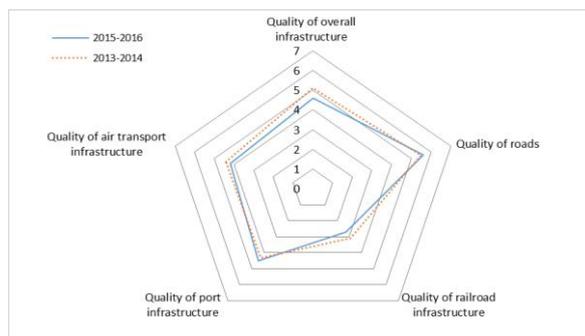
within a sub-sector (e.g. HZ Infrastructure investing in railway lines that are not priorities for HZ Passenger Transport) or across sub-sectors (e.g. Rijeka port investing in terminal expansion for which road and rail access is not developed). Moreover, it creates a discrepancy between the companies/sub-sector objectives, as defined by these plans, and available financial and human resources to implement them, i.e. European Structural and Investment (ESI) funds require additional staff capacities.

At an operational level, implementation of larger transport projects often span 3-5 years, with 2-4 years spent beforehand on project preparation, including technical documentation, permitting, land expropriation and procurement. Planning documents usually do not estimate correctly these constraints, especially project preparation and procurement phases, which leads to suboptimal delivery and a lack of credibility of planning documents themselves. In 2013, the government passed a law on Strategic Investment Projects, which enables priority projects to follow an accelerated track for permitting, procurement complaints resolution, and approval of various administrative

procedures. The development of a container terminal in Rijeka port is the only transport project declared as strategic, but with little visible impact on the speed of delivery as internal processes in various parts of the administration still seem to be a hindrance.⁶⁷

Investment and Sector Financing. Despite increased budget financing, Croatia continues to rank relatively low in the quality of infrastructure, especially in rail⁶⁸. In 2014 alone, the state allocated over 1.3 percent of GDP in direct subsidies and transfers.

Figure 38. Competitiveness of Transport Infrastructure



Source: The Global Competitiveness Report 2015-2016, WBF

Although over EUR 1.3 billion of ESI funds⁶⁹ is available for the 2014-2020 period for transport connectivity and mobility, transport infrastructure investments in Croatia have been largely financed by the State budget and State Owned Enterprises (SOEs). The ESI funds allocation varies by sector, but appears to exceed the absorption potential. This was evident in the sub-optimal utilization of the Instrument for Pre-accession Assistance (IPA) during 2007-2013. Transport was eligible for some EUR 280 million, of which EUR 237 million was allocated and EUR 93 million paid, resulting in one of the lowest absorption rates in the EU.⁷⁰ The main obstacles to higher absorption are inadequate project documentation (feasibility studies and technical designs), ineffective procurement, co-financing requirements (especially for land acquisition),

⁶⁷ Rijeka port's development of the Zagreb Pier (HRK 1.6 billion) was declared a strategic project of national interest in 2014.

⁶⁸ World Economic Forum, Global Competitiveness Report 2015-2016.

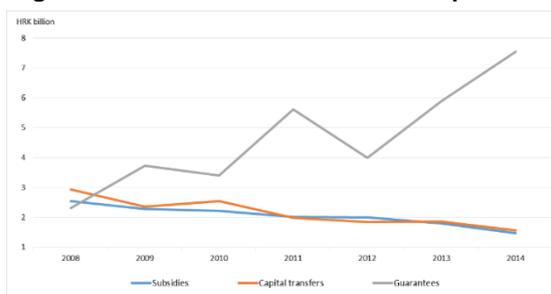
⁶⁹ EUR 1.3310 billion of ESI funds are available to Croatia for transport sector during 2014-2020, of which EUR 910 million is from the Cohesion Funds and EUR 400 million from the European Regional Development Fund.

⁷⁰ Data as of December 31, 2015; MRDEUF. Absorption rates for OP Transport in other Member

and insufficient administrative implementation capacity.

Many companies have taken expensive commercial loans or rely on the State budget to finance their business plans. These investments do not entail the level of monitoring and evaluation associated with EU-funded projects, resulting in HRK1.6 billion of capital transfers to transport in 2014, of which two thirds went to railways. At the same time, the transport ministry received HRK1.5 billion⁷¹ in subsidies, primarily to cover operational losses in railways. The State has also been a lender of last resort for a number of transport SOEs, either by providing loan guarantees, taking over loans, or by covering operating losses through subsidies. In 2014, state guarantees outstanding to transport companies exceeded HRK12 billion⁷² and were used mostly for refinancing rail and road debt. The cost of borrowing remains high and access to finance limited for companies due to their indebtedness.

Figure 39. State Transfers to the Transport Sector



Source: Ministry of Finance, World Bank

Prolonged recession and weak recovery exacerbated losses and exposed operational weaknesses of transport SOEs. Most companies are now in a dire financial state, as suggested by financial data of 22 transport SOEs of strategic and special interest.⁷³ Many SOEs have not faced hard budget constraints and were the largest recipients of subsidies and transfers from the budget.⁷⁴ High operating costs (and financing costs for some) arose primarily due to oversized maintenance standards (for infrastructure managers), large wage bills, contracting to subsidiaries, and non-transparent

States are difficult to compare due to the extended use of IPA in Croatia.

⁷¹ Excluding subsidies to agriculture and to road and rail infrastructure managers for routine maintenance.

⁷² Ministry of Finance, Overview of State Guarantees in 2014

⁷³ Aggregate data for 9 transport SOEs of strategic and 13 transport SOEs of special interest for the Republic of Croatia.

⁷⁴ In 2014, the State support to 22 transport SOEs was HRK 4.4 billion (HRK 1.7 billion to HC and HRK 1 billion to HZI).

procurement processes for external services, while revenue generation has remained limited.

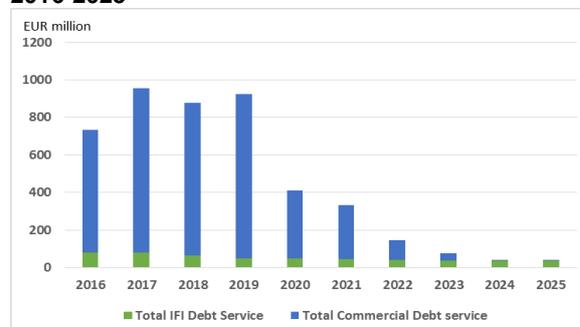
Though some restructuring has recently been initiated, notably in the rail sector, progress has been slow. Companies were tasked with preparing and implementing their own restructuring programs, and had few incentives to improve performance because operating deficits were covered by the State. Their strategic direction was often subject to change, as evident in the suspended Initial Public Offering (IPO) of HZ Cargo (HZC) and Croatian Motorways (HAC). Most companies still carry excess-staff with over 21,000 employees in 22 strategic and special interest SOEs, with many staff hidden in subsidiaries, which increases employees by at least 5,000. Favorable collective agreements and inflexible labor laws also make staff retrenchment problematic during restructuring. Voluntary departures are the norm, whereas collective redundancies take at minimum 6-9 months, during which companies must consult with the worker's council and adhere to a three months termination period. This further reduces productivity and increases costs for cash-strapped companies. On the other hand, retention and promotion of qualified staff is challenging given overstaffing coupled with well-paid low qualified staff.

Roads. Croatia has one of the highest density motorway networks in Central and Eastern Europe (22.79 km of network /1000 km² land area); in part due to the expansion during 2001-2008. Development of 660 kilometers of motorways marked a significant achievement, with high quality construction and design. The road sector SOEs (Croatian Roads-HC, HAC, and Rijeka-Zagreb Motorway-ARZ) largely financed their network expansion with commercial loans fully covered by government guarantees. By 2013, some EUR7.7 billion of guarantees had been issued, with a combined debt of public road companies of EUR5.6 billion or approximately 11 percent of GDP. The debt currently cannot be serviced by the revenue generated by the companies.

In 2012, the government began to explore ways to reduce the debt burden of HAC and ARZ. A long-term concession process was cancelled in late 2014, as well as a subsequent IPO of HAC-ONC amid concerns about the attractiveness of such a model. Meanwhile, around EUR2.3 billion, or 41 percent of outstanding loans, matures in 2017-19, putting burden on public finances. While the government is deciding how to restructure and manage the sector, the risks are

exacerbated by unfavorable borrowing terms for most loans, short maturities of around seven years, variable interest rates (as high as 6-7 percent), and euro denomination that creates foreign exchange risk.

Figure 40. Road Sector Debt Service Needs for 2016-2025



Source: HAC, ARZ, HC, World Bank

In addition to capital expenditures and poor investment planning, road sector liabilities increased because of operating inefficiencies. Though the quality of the road network is perceived as good, road conditions have deteriorated in recent years and road safety is a concern. Croatia ranks among the five worst EU performers in terms of fatalities by population.⁷⁵ In an effort to rationalize motorway operations and increase efficiency, HAC-ONC was created as a joint subsidiary of HAC and ARZ to perform routine maintenance and toll collection. However, it is contracted on a non-competitive basis and per-km maintenance costs charged by HAC-ONC largely exceed that incurred by private concessionaires in Croatia and comparable companies abroad.

Similarly, HC needs to review maintenance standards, contracting and investment financing strategies to the level of traffic and available funds. HC's capital investment program has been underfunded from public sources, leading to higher borrowing needs and over EUR1.2 billion of debt. The inability of some local authorities to manage country and local roads also led HC to assume these roles. Some improvements were made through pilot performance-based contracting and asset management systems, but improving road preservation is imperative as a condition for EU funding.

Railways. Croatia initiated a restructuring of the railway sector and dissolved the railways holding into three separate companies in 2012. Despite significant level of State support, the railway sector has deteriorated from all standpoints. Decline in traffic (by 36 percent for freight and 48 percent for passenger services between 2008

⁷⁵ European Road Safety Observatory, 2015 Scoreboard.

and 2014), low productivity and high cost of labor, and slow implementation of infrastructure investments that could improve the overall quality of service, have all contributed to the dire situation of the sector.

There are no clear service requirements or measures to rationalize subsidies, which account for over 85 percent of operating costs of HZ Infrastructure-HZI and 52 percent of HZ Passenger Transport-HZP. Likewise, the separation of assets between companies has yet to be finalized. The potential to commercialize these assets is limited, while a significant number are still classified as public domain.

Table 12. Key Railway Data for 2014

In million	HRK	HZ Passenger Transport	HZ Cargo	HZ Infrastructure
Staff		2885	2939	5097
Net income		7.96	-169.72	0.16
Subsidy		504.55	20.03	989.18
Investments		-	60.17	998.47
Guarantees		816.22	250.00	1554.88

Source: HZ companies, Ministry of Finance, World Bank

Compared to earlier years, HZI has constrained its investment plans in 2014-15. Significant maintenance backlogs have not been addressed due to lack of resources, old-fashioned planning practices, and significant works costs charged by its subsidiary, Pruzne Gradjevine, whose restructuring has started but is long overdue. The company also struggles to implement its EU-funded program due to weak management capacities. HZI retains a very strong position to influence railway operations through traffic management, especially for freight, and has been taking little feedback from operators as regards programming of its investment.

The ongoing restructuring of the operators, HZC and HZP, needs to be vetted by the European Commission because of state aid implications. HZP's restructuring is aimed at improving the quality of service with newly acquired rolling stock and the still ongoing ticketing modernization. However, it still runs very unprofitable services and has not rationalized its cost, including that of staff. HZC is seeking opportunities in strategic partnerships with foreign operators, as the open railway market is

gradually bringing competition, while its cargo services are deemed uncompetitive. It has also started revamping its commercial policy to introduce block train workings and undertaken several redundancy programs since 2014. The company, however, has been in the most critical financial position of all transport SOEs.

Ports & Logistics. Croatia's geographical location at the crossing of major European corridors make it well positioned to become a logistics hub for Central and South-Eastern Europe. Rijeka has evolved from a feeder port for small vessels to a port of call for containers, with much larger vessels calling (up to 11,000 TEU in capacity). Container throughput in Rijeka grew from 15,000 TEU in 2002 to 162,000 TEU in 2015, with significant upwards potential. The growth was a result of a surge in container transport from the Far East to Central European markets and increasing use of the North Adriatic ports⁷⁶ because of favourable transit times, lower land transport and port costs. In total, Far East container ships can save about USD 400,000 per trip by calling at North Adriatic ports⁷⁷. Similar potential also exists for bulk traffic in Rijeka and Ploče.

The World Bank Logistics Performance Index⁷⁸ places Croatia 55th out of 160 surveyed countries, the lowest ranking of EU Member States. Development of the logistics sector largely depends on the ability to control costs, which are in part a function of infrastructure quality, efficiency of trade facilitation, and integration of various components into a logistics chain. Infrastructure outside roads is considered largely underdeveloped, in particular ports-rail interfaces. Port competitiveness is further hindered by slow and unreliable rail operations that handle low capacities. Integration of the Inland Waterways Transport into the overall logistics chain remains an untapped opportunity.⁷⁹

Trade and logistics also suffer from the lack of cooperation and communication among stakeholders. For example, instead of port authorities, most initiatives to develop a competitive logistics chain are driven by private stakeholders. Cargo management is inefficient due to paper data exchange and few links

⁷⁶ Ports of Rijeka, Koper, Trieste and Venice

⁷⁷ The distance between Hong Kong and Rijeka is 7,700, and North European ports about 10,040 nautical miles. This translates into 3-4 days in costs savings of between USD 80,000 to 100,000 per day. The land distance between Rijeka and Central European markets is also shorter by about 500 km.

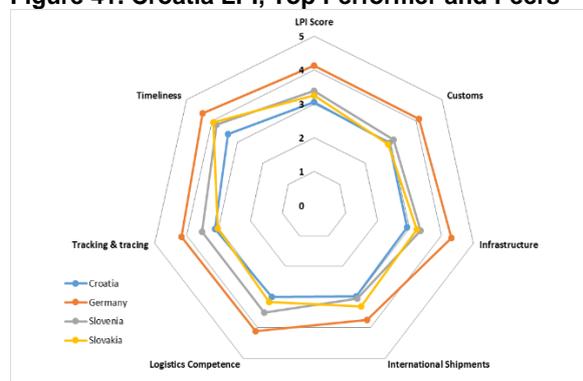
⁷⁸ The World Bank International LPI 2014. The ranking between the sub-components is as follows: customs

(50th), infrastructure (55th), logistics competence (56th), tracking and tracing (59th), international shipments (61st), timeliness (62nd).

⁷⁹ In 2014, the World Bank discontinued negotiations of a regional project for the Sava river rehabilitation project, in spite of EU funding provided for it and a full project appraisal by the Bank.

between computerized systems. Customs still need to strike a balance between efficient trade facilitation and securing logistics chains. Around 18 percent of import shipments still undergo physical inspection, while transit to non-EU countries is more complex.

Figure 41. Croatia LPI, Top Performer and Peers



Source: WB Logistics Performance Index 2014

There are also cross-cutting challenges affecting transport sector competitiveness as well as most infrastructure sectors:

(i) Permitting. Despite series of reforms, construction permitting remains one of the biggest obstacles to timely implementation of transport infrastructure. Removing location permits was one of the biggest simplifications, although they are still required in case of phased construction and land ownership issues. Construction permits often take several months or even years to be issued, and even minor changes in project description may require the process to start anew. Such significant delays compound preparation delays or lead to disputes and penalties with contractors during implementation. The process is further complicated by the many actors, including several local and state administrations, and frequent changes in secondary legislation.

(ii) Procurement processes. Among the 10 largest users of public procurement are three transport SOEs⁸⁰, which alone accounted for 21 percent of the public procurement value in 2014. Open tender procurement procedure was used in around 85 percent of contracts, with on average only 3 bids received per tender. Moreover, the most economically advantageous tender criterion was used in less than 2 percent of contracts, leading to sub-optimal outputs and difficulties with contract management. Procurement in transport projects is paper heavy,

inefficient, and non-transparent, with weak quality of tender documentation and too little emphasis placed on bid quality vis-à-vis the price. This led to frequent appeals and complaints, repeating or extending the duration of the process. Complaint resolution deadlines are generally unclear and often span several months, with inconsistencies in decisions for complaint resolutions by the State Commission for Supervision of Public Procurement Procedure. EU funded investments are not exempted from these problems, as shown by the railway line rehabilitation between Dugo Selo and Krizevci.⁸¹ Moreover, many bids face limited or distorted competition due to participation of current or former subsidiaries of public companies in tenders, whereas independent local companies are still building capacities to participate both in works and consulting services.⁸²

Procurement weaknesses in infrastructure projects:

- Low level of technical document preparation
- Limited benchmarking and cost related statistics
- Fragmented tendering processes
- Lack of standardized tendering documentation
- Non-uniformed recording of information
- High costs of tendering process for clients and suppliers
- No ex-post evaluation of contracts
- Inefficient complaint handling mechanism
- Insufficient staff capacity

(iii) Management and governance. SOE ownership policy does not clearly separate the role of the State from that of the transport companies. The State, through the transport ministry, exercises ownership, regulatory, policymaking and client roles. SOE management is also often reluctant to sign-off on projects with Ministry endorsement amidst increased anti-corruption efforts and frequent accusations of conflict of interest. Exercising ownership rights, while avoiding meddling in management, could be achieved through the Supervisory Board and its committees. Government control of SOE performance is weak mostly due to inadequate technical capacity and lack of monitoring tools for SOEs. The Ministry collects very detailed operational and financial data from SOEs, but is unable to provide comprehensive status of performance (e.g., SOE liabilities, which can neither be accurately reported by the Ministry of

⁸⁰ Croatian Roads, HZP and HZ Cargo.

⁸¹ The Dugo Selo-Krizevci railway project, estimated at over EUR 200 million, was initiated in 2009. It was tendered three times since the EC approved its financing in 2013, but has still not been contracted.

⁸² HZ Infrastructure's current subsidiary, Pruzne Gradjevine, and a former one dealing with technical studies, ZPD.

Finance). The organization of the Ministry is also fragmented with capacity issues in most technical areas and coordination with other state institutions. The 2013 Act on the Management and Disposal of State Assets further complicates supervision of transport SOEs, as the Ministry shares the ownership function in companies of strategic and special interest with the State Office for State Property Management (DUUDI)

SOEs lack professional management and boards have been appointed according to political affiliations. Nominations are made by the ministry, with DUUDI's prior approval, and approved by the government. Turnovers are frequent, as in the example of HZI where management was dismissed three times in four years. Board compensation is not linked to the performance and includes various benefits that recur post-employment. In 2015, the government passed a regulation on criteria for appointment of management board members in SOEs of strategic and special importance which should be selected through public tenders. It marks a major step towards professionalization and increased accountability of management and supervisory boards.

How Croatia Can Restore Stability, Revive Growth and Create Jobs

Croatia needs to strengthen strategic planning in the transport sector. The National Transport Development Strategy, once finalized, together with a sector traffic model that is already in place, should provide an overall framework for the transport sector development. The Strategy should be translated into robust multi-year and multi-modal implementation plans for sector investments that define priority projects in a holistic manner, lead to a stable pipeline of projects and ensure consistency in decision-making. For example, should the improvement of a competitive position of the Rijeka port be defined as a strategic objective of Croatia, the implementation plan should lay out specific projects to be implemented over 5-7 years to meet this goal, such as competitive rail corridors, multimodal connections to port terminal, development of a port community system, and introduction of a block train working. A similar approach to integrated planning needs to be continued for the largest agglomerations in Croatia, especially Zagreb and Rijeka.

Multi-year implementation plans should be regularly updated with optimized investments based on the overall budget constraints for a given period. Further, investments need to be linked to appropriate funding sources, such as national budget or different EU sources. Sources of funding should

be defined at project preparation, as projects used to apply to several different EU calls and for IFI funding. The budgeting procedures for EU funds would also need to be better integrated into the national budgeting system in terms of counterpart funding. At individual project level, the government should re-introduce the need for economic feasibilities with alternatives, where applicable (see specific Note on Public Investment Management and EU funds absorption).

The Ministry of Transport plays a major role, in particular by providing guidance and strategic direction defined at the government level, ensuring consistent policy decisions across different sectors, endorsing strategies and facilitating operations of companies, and leading efforts to increase private participation when preferable. The Ministry could create a task force whose mandate would be to prepare and publish sector-wide implementation plans before the next budget approvals by the parliament, as well as to strengthen the quality of project prioritization, appraisal, and management. Such task force needs to include the Ministry of Finance's Department for Capital Investments.

Investment and sector financing needs to be balanced with the sovereign budget constraints. The overall approach to sector financing needs to be revisited, in particular to reduce the amount of State support and incentivize the companies to perform. The State could play a role in refinancing existing loans to transport SOEs, specifically by taking the advantage of low interest rate environment. Capital spending control across all transport SOEs needs to be introduced, together with a redefined criteria for obtaining State guarantees for commercial borrowing. Subsidy allocation could be made more effective to ensure value for money. This too pertains to public service obligations in rail, air and ferry transport.

Considering the fragile financial situation of most transport SOEs, Croatia could maximize the EU funds absorption and leverage various EU investment initiatives. In addition to EUR1.3 billion of ESI funds, Croatia has at its disposal EUR456 million from the Connecting Europe Facility (CEF) for development of corridors between 2014-20, as well as an opportunity to participate in the EC's EUR315 billion Investment Plan for Europe supported by private investment. Under the CEF, the EC proposes financial instruments, such as project bonds, loan guarantees and other debt and equity instruments in order to incentivize more private and public funding in large infrastructure projects. Most eligible candidates for the use of financial instruments for EU funds are railways

and water transport infrastructure, public green transport and infrastructure development for electric vehicles. Strengthening administrative and technical capacities for EU funds absorption should be an immediate effort, recognizing that they would take time to yield results.

To complement EU funds and pending fiscal space, the government could use IFIs to support the immediate sector restructuring and obtain favorable loans and guarantees for investments that are critical but not eligible for EU financing (e.g., retrenchment or road or railway periodic maintenance). Once the restructuring of SOEs is well underway and fiscal space less constrained, other capital raising instruments, such as project bonds, could be considered. Project bonds provide access to cheaper capital with longer maturities and allow institutional investors to participate in projects. The bond financing is undoubtedly more complex to structure and negotiate, given the risk that projects may not be able to generate cash flows to service the debt. As such it may be challenging to find investors in non-investment grade bonds. Also some forms of Private-Public Partnerships in transport projects may result in faster project implementation, increased transparency, transfer of knowledge and skills through private sector innovation, reduced costs and budgetary certainty. Logistics, building on the successful Brajdica container terminal concession in Rijeka, and urban transport projects could qualify for such opportunities.

Restructuring of loss-making SOEs, in particular in railways and roads. The EC has requested Member States to improve SOE performance through restructuring, privatization and review of financing. The primary aim is to bring down the level of SOE liabilities and arrears. Restructuring would entail substantial rightsizing of operations for which the government should adequately budget public funds. Unviable SOEs and subsidiaries should be liquidated or put into insolvency, while non-core subsidiaries divested. To ensure efficiency and improved resource allocation, the government could consider greater involvement of the private sector through concessions, IPOs, strategic majority investors, or full privatizations. Such actions cannot be taken by the companies, but should be guided by the Ministry with support from specialized financial, legal and technical advisors.

Appoint professional managers to implement sound restructuring programs. Modern long-term planning and monitoring tools, which would

integrate financial and investment planning and procurement systems, should support management decisions. Companies need to introduce realistic medium-term financial planning, define targets and benchmarks against sector peers, and take preventive measures when needed. Such incentives are limited for road sector companies that hold significant public domain assets in their books, as the capital approach method defined in the Roads Act allows them to book losses against the public capital they hold.⁸³ Professionalizing HR services in transport SOEs is imperative to attract, retain and promote talent, introduce modern HR policies, better administer staff compensation, and improve labor relations.

Roads. As a priority, the government needs to decide the reform path for the motorway sector. The sector's organizational restructuring would start with a review and redefinition of asset ownership roles, affordable level of services, and operational merger of HAC and ARZ. An optimal sector debt management plan would consist of refinancing existing road debt to maximize the share that the sector can service from own sources in the long-term and reduce the extent to which future debt is guaranteed by the State. Additional opportunities to reduce debt would be by involving private investors in the motorway sector at the time when doing so can optimize state revenue. Concurrently, sustainable mechanisms should be put in place to fund road companies. Fuel tax and toll revenue provide secure, though unpredictable, funding for maintenance, but are not based on the service definition and cannot cover investment and financing costs. Options include e-tolling, GPS based road usage, and vignette systems, together with charging other commercial parts of the network for heavy vehicles that need to be shifted to highways.

Operations and maintenance (O&M) improvements in all companies would move from input- to output-based O&M (e.g., contract a level of service, not for quantities), roll-out of a performance-based contracting, definition of performance improvement targets to assess future sector costs, development of modern asset management and investment planning tools, and restructuring of HAC-ONC to make it more cost effective. In the medium term, an overall reclassification of the 26,778km of the road network should be considered. State, county, and local road assets should be managed coherently, which implies determining

⁸³ Between 2011 and September 2015, the public capital in HAC decreased by HRK 2.2 billion.

new sources of funding for these road assets based on their condition.

Railways. There are opportunities to reinforce government oversight and determining the affordable level of service and investment, based on a realistic budget constraint. The network size could likely be reduced, with discontinuation of unviable passenger services or replacement by bus a priority. Such efforts should be translated into new multi-annual and performance based infrastructure contracts for HZI and Public Service Obligation contracts for HZP. Repartition of assets among companies should be finalized to limit the public domain to what is really needed for rail operations and commercialize “dead capital”.

In all companies restructuring and EU-related opportunities require a significant change of mindset and an overall capacity building. Project management in HZI needs to be overhauled, or outsourced if performance remains weak. Government needs to obtain from HZI a clear picture of the network condition and its main rehabilitation priorities to ensure a minimum quality of service. The government needs to ensure equal access to the network for all operators – HZI’s operating requirements should not restrict competitiveness of operators. The privatization of HZ Cargo could be considered, while encouraging some forms of private-public partnership, such as for rolling stock leasing. HZC should fully implement a commercial policy based on block trains rather than individual wagon consignments at earliest. Similarly, HZP needs to review its commercial policy to adapt to current conditions and modernize its operations beyond the introduction of new trains and IT systems.

Ports & Logistics. Logistics and trade development rest upon resolute and rapid finalization of the Corridors from Rijeka, including rail intermodal yards and road interfaces (D403), and improvement in port operations. The planned expansion of the Port of Rijeka would increase its total container capacity to about 900,000 TEU after 2018. Though other North Adriatic ports have announced expansion plans that could add 700,000 TEU, Rijeka should preserve its first mover advantage and accommodate the largest container vessels.

Development of a “single window” and port community system for all of its stakeholders needs to be started in Rijeka as a matter of urgency, with a strong coordination by the Port

Authority.⁸⁴ It is not advisable to have competing system promoted by the Port Authority and the port operator, as is the case in Ploce. The Ministry could limit its involvement in safety related systems and not deter the port communities to build an integrated system at local level.

Private sector participation could help improve both the services and the infrastructure. For example, multi modal hubs still need to be developed in Zagreb and Rijeka (Skrljevo). Many bulk activities could be developed with external partners of Luka Rijeka in grain, timber and wood, while Luka Ploce has already started such partnership for oil products. The concession of the Zagreb Container Terminal in Rijeka is soon to be relaunched. Similarly, the selection of a strategic operator should be considered for the Danube River port of Vukovar, where the EU-funded port upgrade has opened door to further logistics chain integration. The initiative to restore the Sava River navigability could be relaunched with the support of institutional partners and the neighboring states.

Permitting. Croatia has improved its physical planning, building permitting and inspection processes. A newly introduced physical planning information system (ISPU) linked the systems of the Cadaster, the Registry and the Ministry of Finance, and set preconditions for establishing e-permitting facility. However, these reforms have mostly benefited individual or business related permits and simple projects. For major public investments to benefit fully several additional improvements should be done including the following:

- Integrate databases of the Ministry of Maritime Affairs, Transport, and Infrastructure in the ISPU system to allow for faster processes and reduce the amount of paperwork needed.
- Fully digitalize permitting system, introduce online tracking of applications, requests for clearances and submission of various forms.
- Implement shorter times and stricter deadlines for permit-related approvals.
- For construction permits, which process remains essentially unchanged except for partial introduction of digitization in the case of infrastructure projects, further streamline processes by eliminating steps, and simplify permit amendments.,

⁸⁴ Port Community System only exists in the Port of Ploce, but is not fully in use. The Ministry also runs its parallel system that collects but does not disseminate

data among stakeholders and is mostly dedicated to safety.

- Evaluate opportunity to remove usage permits, which may not always be needed as contracting authorities carry out a technical acceptance already.
- For public investments of special importance, designate ministry staff in charge of handling processes and resolving issues at local and state levels, which is not always the case, will remain a second best option.

Procurement Processes. Once all primary legislation (procurement and PPP laws) have been adjusted to recent EU directives, secondary legislation for public procurement needs to be enhanced to improve the quality of tender documentation and process efficiency. The introduction of clearer guidelines for public procurement, standard bidding documents and requests for proposals, as well as being more standardized and quality oriented on bid specifications or terms of reference could make public procurement less open to subjective interpretation. Replacing the lowest bid price criterion with the most economically advantageous tender criterion would allow more weight towards quality, in particular for complex advisory services and technically sophisticated goods. Evaluation would take into account the price associated with the life cycle of assets, including their renewal/maintenance costs. Besides these, a unified supplier registry and further upgrade of the e-procurement system are needed, e.g. availing bids in languages other than Croatian to foster competition, or to improve fraud or collusion detection through use of electronic bid data.

From a regulatory point of view, the complaint handling mechanism could be improved, in particular to avoid complete stoppage of projects, and to introduce stricter deadlines and unified approach to complaints resolution. SOEs operating in the competitive market should either be privatized or liquidated, and when this situation is not possible be subject to clear requirements to avoid conflict of interest. Tools to detect irregularities and corruption in public procurement could be improved, including by detailed screening of specifications and bids, full disclosure of bid results, and use of post review processes by procurement authorities for the SOEs that are more efficient in contracting.

Corporate Governance of SOEs. Relationships between the State and the transport SOEs could be designed as per the best practices outlined in the OECD Guidelines on Corporate Governance of SOEs. They usually take the form of multi-annual contracts that include clear and measurable conditions for allocation of financial

support. The transparent appointment of experienced and independent individuals to its Supervisory Boards according to clear eligibility criteria are highly recommended. Following a competitive selection of a professional management, management contracts should be enhanced with performance targets linked to salaries and revised remuneration levels to attract talent. However, efforts to professionalize staff and strengthen human resource management should begin with the Ministry. Recruitment system and terms of reference for civil servants need to be improved, as competencies are currently low both in terms of technical and soft skills (IT, languages). As for the entire public administration, regular performance appraisals and setting of yearly performance objectives in line with modern HR practices should be mandatory for all ministry employees. Performance incentives and penalties, as well as regular training opportunities, should be introduced.

Public oversight could be improved by moving to electronic collection and distribution of reports on sector performance. Such reports could be simplified and enhanced with more analytical assessments and recommendations. SOE performance could be measured against set targets and sector-wide KPIs. Particular focus should be placed on financial performance, use of subsidies, and reduction of arrears. A small SOE monitoring unit could be developed to disclose performance results and publish timely annual reports. In contrast, SOEs reporting could be improved in line with International Financial Reporting Standards. This includes, *inter alia*, addressing qualifications in audit reports, timely preparation and disclosure of financial statements.

To exercise its various roles, the Ministry could also be reorganized and HR policy revised to attract and retain qualified staff. Organization by sectors is considered more efficient (contrary to the current separation of infrastructure from operations), while the Minister's cabinet could be supported by the aforementioned units for SOE monitoring and reporting, and investment planning and financing. Any initiatives related to restructuring or private sector involvement in SOEs needs to be handled by highly-qualified ministerial staff with strong coordination with the MoF and DUUDI.

How the World Bank Group Can Help

The World Bank has a long-standing engagement in the transport sector in Croatia, which comprises a third of the lending portfolio. Most recently, the World Bank proposed, at the request of the government, a concept for the

Modernization and Restructuring of the Roads Sector, designed as a blend of an investment loan and guarantees, aimed at supporting operational and financial restructuring. The loan portion would fund reform implementation, while the guarantee aims to help restructure liabilities to better match road asset cash flows, reducing interest costs and lengthening maturities.

In 2015, the Bank approved three loans totaling EUR 163.5 million to Croatian railways companies as a part of the Sustainable Croatian Railways Project. The Project is aimed at improving the operational efficiency and the financial sustainability of the sector. It finances investments in critical infrastructure bottlenecks and safety measures, the modernization of IT systems, rolling stock rehabilitation, separation and management of assets, and staff right-sizing. Further support can be directed towards subsidies optimization and cost-efficient maintenance in HZ Infrastructure. Rijeka Gateway II and Trade and Transport Integration Project for Ploce, worth EUR 192.8 million, are helping transform the largest international seaports in Croatia. The projects envisage long-term concessions by private investors and development of additional capacity in the ports, integrating them with existing transport corridors.

The Bank is well positioned to provide sustainable solutions in multiple transport modes, through financing and by providing advisory services in areas of improving and simplifying infrastructure permitting processes; the reform of the legal and regulatory framework for public procurement and process streamlining; as well as multi-modal operational planning, supervision of transport SOEs, transport public investment management and project selection.

This Policy Note was produced by the World Bank to inform policy debate in Croatia. This note was prepared by Consultant Blanka Babic and Program Leader Jean-Francois Marteau.

The findings, interpretations, and conclusions expressed herein do not necessarily reflect the views of the Board of Executive Directors of the World Bank or the Governments they represent.

For any questions regarding this note, please contact Vanja Frajtic, Communications Associate (vfrajtic@worldbank.org).

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Croatia Policy Notes 2016

Restoring stability, reviving growth and creating jobs

Providing Skills for the Future

Key Message

Youth have been significantly affected by the lack of economic growth, evident in youth unemployment rates around 45 percent, limited job prospects, and a skills mismatch. Despite a number of recent education reforms, including a national curriculum framework in preschool, primary, and secondary education, as well as a secondary school-leaving exam and the piloting of performance-based financing in tertiary education, demographic decline means that increasing emphasis needs to be placed on improving the quality of general education, lifelong learning programs, and adult education to ensure a competitive and adaptive workforce.

Key Actions

- Improve the quality of general education to mitigate the challenges posed by population decline, aging, and the skills mismatch.
- Provide better labor market information on job trends and skills to strengthen labor market outcomes of graduates from education in its different levels.
- Consider piloting performance-based financing in non-university education.
- Maximize skills for jobs through apprenticeships, reskilling programs, and lifelong learning programs to address high youth unemployment.

Where Croatia Stands Now

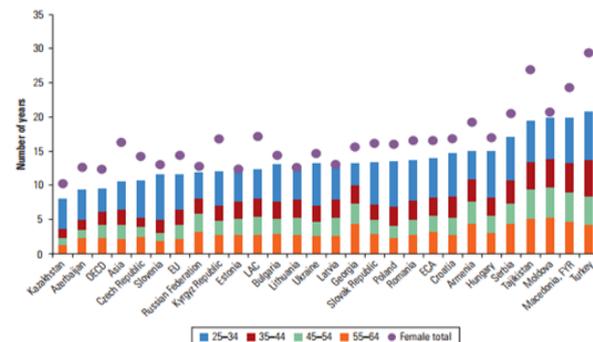
Since the global financial crisis that began in 2008, growth in Croatia has been marred by a prolonged recession. Recent accession to the EU has contributed to the return to positive, but low, economic growth in 2015. The effects of the recession, however, point to areas for overdue policy reforms to reduce poverty and unemployment which have increased in recent years.

Demographic decline, aging, and lost years of employment are significant barriers to growth. As the recovery from the lengthy recession continues, Croatia's growth prospects remain vulnerable to dual demographic trends of a population that is both aging and shrinking. These challenges prompt the need to balance policy reforms in education and the broader economy. For Croatian living standards to converge with its Western European neighbors, the labor force must be more productive and become more flexible in a rapidly changing labor market, where the employment participation rate has experienced a downward trend since 2008.

In addition to demographic decline and aging, years of lost employment is also a significant problem. Among 25-34 year-olds, 35-44 year-olds, and 45-54 year olds, the average Croatian

spends three years in unemployment or inactivity. This number doubles among 55-64 year olds. Among women, the average female in Croatia spends 17 years of her working life in unemployment or inactivity. This compares unfavorably with other EU countries (Figure 1).

Figure 1. Average years of lost employment for an individual, circa 2010



Source: World Bank (2014), *Back To Work: Growing with Jobs in Europe and Central Asia*

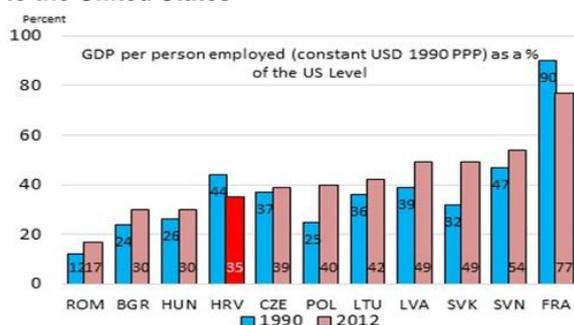
These adverse population trends have current and long-term implications for Croatia's human capital and macroeconomic agenda. Human capital remains critical to Croatia's service sector which dominates the country's employment landscape. Expanding employment, both through increasing the

employment rate and the length of the working life, will be key to resolving the impacts of demographic decline and population aging.

Opportunities to enhance skills are not leveraged, as evident in low labor productivity. Participation in lifelong learning remains rare, with a rate of 2.5 percent – much lower than the EU average of 10.7 percent. Croatia’s lifelong learning participation is the third lowest in the EU, slightly higher than Bulgaria and Romania.

Croatia’s lack of economic growth in recent years is reflected in low labor productivity. In addition to expanding employment by increasing the employment rate and the working life of individuals, productivity gains are central to addressing demographic decline and aging. While many European neighbors experienced low, but positive growth in productivity relative to the United States, Croatia’s productivity declined significantly (Figure 2), and now lags many EU countries. As such, there is a dual challenge to increase both labor force participation and labor force productivity.

Figure 2. Productivity Levels in Europe compared to the United States



Source: International Labor Organization, *Key Indicators of the Labor Market Database*

Youth are most affected by the struggling economy. There is a strong generational dimension to employment. Youth are among the most affected by the struggling economy. Youth without tertiary education struggle more to find a job than in other EU countries. The employment rate of recent tertiary education graduates aged 25-29 years old is 69 percent – below the EU average of 79 percent. Among those in the same age group, the employment rate of early school leavers is alarming at 30 percent – significantly lower than the EU average of 52 percent.

⁸⁵ World Bank (2009). *Croatia’s EU Convergence Report – Overview*

⁸⁶ World Bank (2015a). *Central Europe and Baltics PISA Analysis*. This section draws from the discussion on the importance of cognitive skills.

The skills gap is evident throughout the Croatian education system. In 2009, a World Bank report on Croatia’s convergence process to join the EU, noted the factors contributing to the skills gap. These factors included: deficiencies in the provision of vocational education and training (VET), in addition to an inadequate match between courses offered and labor market needs; low participation in lifelong learning; and rigidities of tertiary education in adapting to the needs of the economy.⁸⁵ Given these factors and recent data, it is apparent that the skills gap remains largely unaddressed.

Addressing the Challenges in Education and Training⁸⁶

International evidence shows the economic impact of workforce skills on growth and shared prosperity. This evidence suggests that quality of education is one of the most important determinants of long-term economic growth.

There are three dimensions of skills. It is possible to differentiate skills along separate, yet mutually reinforcing dimensions. These dimensions are cognitive, socio-emotional, and technical skills. Cognitive skills include literacy and numeracy – as measured in PISA (Programme for International Student Assessment) – but can also include competencies like critical-thinking and problem-solving. Socio-emotional skills capture one’s ability to interact with others, as well as determination, and focus on getting a job done. Technical skills capture one’s ability to perform technical tasks in any occupation – e.g. work performed as a plumber or engineer.

It is important to note that measuring the level of educational attainment is not necessarily a proxy for measuring actual skills. While many countries in Central and Eastern Europe have seen educational attainment expand – such as years of education and level of education completed – since the start of the economic transition, they have not necessarily seen improvements in their performance in international student assessments that measure cognitive skills, such as PISA⁸⁷.

PISA evidence has been used to measure the impact of cognitive skills on GDP growth. Leading researchers estimate that a score improvement of roughly 50 points in PISA would imply an increase of the annual growth rate of

⁸⁷ Sondergaard, Lars; Murthi, Mamta; Abu-Ghaida, Dina; Bodewig, Christian; Rutkowski, Jan. 2011. *Skills, not just diplomas: managing education for results in Eastern Europe and Central Asia*.

GDP per capita by 1 percentage point⁸⁸. Evidence also suggests that both the share of students achieving basic literacy and the share of top-performing students matter for growth. A recent OECD (2015) report presents economic returns to universal basic skills, defined as all students enrolled in secondary schooling, and the performance of those young people currently not in school raised to achieving Level 1 skills (420 points) in PISA by 2030⁸⁹. While low income countries with lagging education systems stand to gain the most, advanced middle income and high income countries can expect a significant boost in long run economic growth (until 2095) solely from making their education systems deliver better for the weakest students.

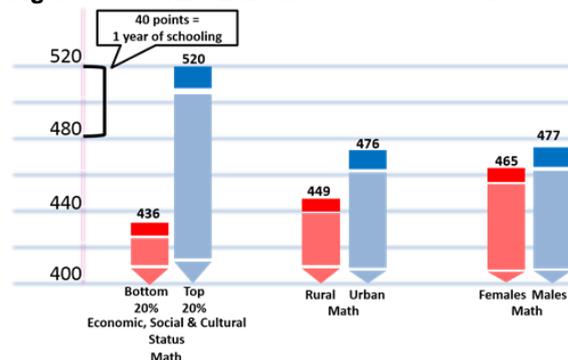
The report on universal basic skills finds that, on average, high income countries could gain a 3.5 percent higher discounted average GDP over the next 80 years if they were to ensure that all students achieve basic skills defined as Level 1 in PISA. A significant share of Croatian 15 year-olds currently perform below Level 1 of PISA. Ensuring universal basic skills in Croatia would add 3.9 percent discounted future GDP.

Croatia's performance in PISA has improved, but the skills gap remains significant. Croatia's performance indicates marginal improvement since its initial participation in 2006, with a decline across all subjects – math, reading, and science – in the 2009 PISA test. Overall, between 2006 and 2012, there was a slight increase in the share of low performers in math, while there was a marginal decline in reading. In PISA, roughly 40 points equals to one year of schooling. Using this estimate, there is a wide gap between the top and bottom socio-economic groups in Croatia (Figure 3). This gap of 84 score points is roughly equal to two years of schooling, similar to OECD countries.

The high share of low performers has adverse implications for individuals at various stages of life and for the economy overall. Based on PISA 2012 Croatia has reduced the share of 15 year-olds performing below Level 2 in reading, compared with 2006. However, the share of 15 year-olds performing below the same level in mathematics increased to 30 percent. This increase is alarming, and points to significant challenges regarding cognitive skills for the present and the future at various levels of the education system. The high share of 15 year-olds performing below Level 2 in math indicates a poor foundation of cognitive skills.

⁸⁸ Hanushek, E., and L. Woessmann. (2007). *The Role of Education Quality in Economic Growth*. World Bank Policy Research Working Paper 4122

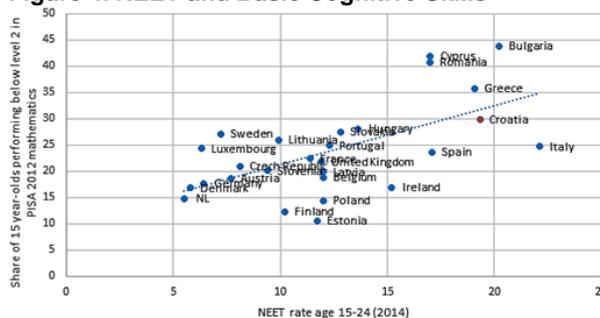
Figure 3. PISA 2012 Math Scores for Croatia



Source: Authors' elaboration of PISA 2012 data

The lack of cognitive skills constrains the ability of individuals to learn in higher education, vocational education and training, as well as lifelong learning, or find and retain a productive job. Further, the lack of cognitive skills are hurdles given population aging and technological change. Some countries with a high share of poor performers in math such as Croatia also have high shares of youth who are not in education, employment, or training (NEET) (Figure 4).

Figure 4. NEET and Basic Cognitive Skills



Source: World Bank staff calculations using OECD PISA 2012 and Eurostat data

Improving the skill level of low-performers would narrow the skills gap and boost long-run growth. As mentioned above, Croatia would observe a boost to long run growth by focusing on the weakest students, given its classification as a high-income country. Beyond aggregate growth, education improves the living standards of individuals. More educated individuals are able to acquire even more skills – and higher-order skills as well – making them more productive and employable. Through more, higher-order skills, individuals can extend their labor market participation over their lifetime. This skill acquisition, in turn, leads to higher earnings and better quality of life. The declining labor force participation rate requires policy reforms to reduce unemployment – particularly among

⁸⁹ OECD (2015). *Universal Basic Skills: What Countries Stand to Gain*

youth – and increase productivity. As such, education reforms designed to provide higher-order skills address this need.

Education is an engine of social mobility: human capital is a key asset in income generation and hence critical to reducing poverty and increasing shared prosperity. Croatia's youth are being left behind, however. At more than 45 percent, Croatia has one of the highest rates of youth unemployment in Europe, trailing only Greece and Spain.

How Croatia Can Ensure Maximizing Skills for Jobs and Economic Growth

Croatia's education reforms in recent years have covered many aspects of the system, ranging from preschool to university. The most recent education strategy – the Strategy for Education, Science, and Technology – was adopted in 2014, with a focus on reforming the education and training system.

The next wave of policy reforms should be guided by the need to promote a more modern skills agenda. Specifically, additional reforms in education should prioritize the development of relevant cognitive and adaptive skills. These skills are central to policies intended to expand employment and productivity. As such, a number of policy options are presented below to emphasize the need for such skills.

1. Improve the quality of general education to reduce inequities and stem the impact of the demographic decline. Evidence from PISA suggests a need to address the quality of general education to reduce the inequity between the top and bottom socio-economic groups. As discussed, students in the bottom socio-economic group are roughly two years behind their peers in the top group.

To reduce inequities, it is important to understand the key factors which affect student achievement in the contexts that are specific and particular to the Croatian reality. Such knowledge comes through comprehensive data collection and analysis of existing conditions, to support impact evaluations of any policy and activity levers implemented to address national concerns.

One key factor to understand thoroughly is teacher quality. Leading researchers have determined that teacher quality is the main school-based predictor of student achievement⁹⁰. As such, to ensure a high quality cadre of teachers, a national system of competence standards for teachers should be developed. The development of such a system is

included in the education strategy. Implementation of the strategy has been slow, however.

Croatia needs to remedy the large share of its 15-year olds with poor math skills to ensure growth in the long-term and mitigate the challenges posed by population decline, aging, and the skills mismatch. Improving the quality of teachers in general education will help reduce the performance gap among socio-economic groups.

2. Better labor market information is needed to improve the relevance of skills developed through education. A growing challenge for policymakers globally is the need not only for more immediate job creation but to supply the job market with a workforce equipped with the relevant and adaptable skills for both the present and the future labor market. Improved labor market information on job trends and skills is needed to overcome these challenges. Better labor market information would help to reduce skills mismatches and enhance the responsiveness of education, at various levels, to labor market needs.

The demographic trends facing Croatia require strategic thinking about skills for the present and skills for the future. Periodic skills assessments and surveys of the business environment can provide key evidence-based insight into balancing labor force needs in the short-, medium-, and long-term.

Regarding evidence-based insight on skills, Croatia participates in many global assessments such as PIRLS, PISA, and TIMSS. Students in the cohorts being assessed, however, are at most 15 years old. On average, these students are still a few years away from joining the labor force. In upper secondary education, there are no evidence-based tools to support reforms designed to: evaluate the quality of student competencies over time and across countries.

Students participating in the first PISA cohort from Croatia in 2006 are between 23-25 years old today. While PIAAC (Programme for the International Assessment of Adult Competencies) evaluates competencies, it focuses on the working-age population. The cohorts being assessed in PIAAC include individuals of upper secondary school age, but the assessment is intended for working-age adults, not students. Croatia's absence from competency-based assessments – such as PIAAC – which evaluate adults is a missed

⁹⁰ Hanushek and Woessmann. (2007).

opportunity to gather critical data on various skills to help address the skills mismatch.

3. Build on the progress of current higher education reforms. The implementation of performance-based funding (PBF) in higher education is a growing global trend as countries face persistent budgetary pressures in education and across their fiscal obligations. In countries where the majority of higher education institutions (HEIs) receive public funding, PBF is a recognized tool to implement more efficient and adaptive funding norms. Moreover, PBF can help to achieve improved quality and relevance, research excellence, and better accountability and autonomy, among others important outcomes of finance reform. PBF allows for flexibility in selecting appropriate indicators to achieve wide-ranging goals.

Existing PBF reforms in Croatia began in recent years with a pilot funding agreement for its public universities. These reforms aim to maximize the quality and accessibility of the higher education system. Full funding agreements will be implemented in another phase of reforms. The transition to performance-based funding in Croatia coincides with the unforeseen advent of a new public university and anticipated fiscal challenges across the entire national budget.

The existence of indicators as the basis for funding norms, however, results in clear guidelines for both established and nascent institutions to contribute to the national agenda. This agenda prioritizes an increase in the number of low-income students; enrolled STEM students; student transitioning to their second year; grants provided to students; as well as improved university management.

In addition to governments introducing PBF in higher education globally, the policy interest in implementing this funding approach for other sectors of education is also growing. The non-university higher education sector could build on the existing public university reforms to further improve the education sector by introducing PBF to all public HEIs. These HEIs would include polytechnic institutions and colleges.

4. Accelerate policies to address high youth unemployment. Workforce development can also contribute to a significant reduction in youth unemployment. Performance-based funding reforms being implemented in public universities would be a driver of workforce development as the higher education sector becomes more relevant and cost efficient through the selected performance indicators.

⁹¹ World Bank (2015b). *Croatia Partnership, Country Program Snapshot*.

These reforms would not, however, impact individuals who have already graduated, and remain unemployed.

The longer an individual is unemployed, the more hurdles he/she has to face in (re)joining the labor market. The long-term unemployed face both a deterioration of skills and social stigma. As such, a combination of complementary programs targeted toward apprenticeships, reskilling, and lifelong learning are policy options which can address high youth unemployment in Croatia.

Regarding apprenticeships, an EU-led response to utilizing apprenticeships more effectively was launched in 2013. The European Alliance for Apprenticeships convenes policymakers, leaders of industry, businesses, and education/training providers, among others, to promote apprenticeship programs across Europe. It remains to be determined how useful a broader apprenticeship system would be for Croatia, but given the focus on jobs and skills across the region—particularly to reduce youth unemployment—the utility of apprenticeships deserves closer consideration. As a member of the Alliance, therefore, Croatia has indicated its commitment to this potential tool by outlining its plans to develop a system of quality apprenticeships to provide relevant skills and competencies based on labor market needs.

To date, the Alliance's progress is foundational: youth guarantees; and pledges from chambers of commerce, social partners, and VET providers. As such, there is a need to accelerate the initiatives of the Alliance locally to achieve its objectives, and reduce youth unemployment. High youth unemployment requires strong action in the short- and medium-term.

How the World Bank Group Can Help

In recent years, the World Bank has supported education reforms in Croatia to develop a national curriculum framework for preschool, primary, and secondary education. In addition, the Bank has supported the introduction of a secondary school-leaving exam and the implementation of major school construction and rehabilitation programs⁹¹.

As Croatia continues to develop its path for growth after a prolonged recession, the World Bank Group can support the Government's ongoing efforts to reform and strengthen the education system utilizing tools such as advisory services, technical assistance, investment

financing for policy reform, and strategic frameworks to enhance the use and absorption of EU funds.

The state has an important role to play in developing and financing education policies that foster improved learning outcomes and adaptable skills. Students enrolled in general education require a strong foundation of cognitive skills that can lead them toward futures in the dynamic economies of today and tomorrow. Students who are enrolled in tertiary education need strong incentives to obtain knowledge and skills and to forgo emigrating for better opportunities, given the alarming youth

unemployment rate. Students who enter the workforce as graduates with in-demand skills will help to improve the quality of Croatia's dwindling labor force.

This Policy Note was produced by the World Bank to inform policy debate in Croatia. This note was prepared by Jeremie Amoroso and Roberta Malee Bassett.

The findings, interpretations, and conclusions expressed herein do not necessarily reflect the views of the Board of Executive Directors of the World Bank or the Governments they represent.

For any questions regarding this note, please contact Vanja Frajtic, Communications Associate (vfrajtic@worldbank.org).

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Croatia Policy Notes 2016

Restoring stability, reviving growth and creating jobs

Pension System Reform

Key Message

Croatia's pension system has seen significant change since the introduction of a multi-pillar design in 1998. While performance of the second pension pillar has been adequate, ad-hoc interventions in recent years in the first, pay-as-you-go (PAYG) pension pillar have led to larger expenditures than expected and became less affordable going forward. In addition to concerns about future adequacy, the system overall faces substantial equity and fiscal challenges, because of low labor activity and coverage. Without further reforms, Croatia's pension system will remain fiscally and socially unsustainable in the long run.

Key Actions

- Tighten early retirement windows, raise retirement age faster, and stimulate elderly activity.
- Equalize the eligibility to the supplement of 27 percent for PAYG-only and multi-pillar pensioners.
- Converge privileged pensions to general PAYG rules faster.
- Award PAYG pension credit only for paid contributions.
- Consolidate the fiscal space for financing the second pillar transition cost.

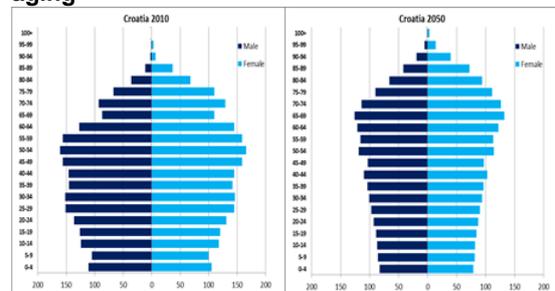
Where Croatia Stands Now

Reforming Croatia's pension system is a critical priority in view of the projected rapid population aging. Croatia's population pyramid is inverting and thinning, with an aging and shrinking population and a resulting increase in the demographic dependency ratio (Figure 1). In anticipation of demographic change, Croatia launched reforms of its pension system in 1998 by changing the pay-as-you-go (PAYG) system parameters and in 2002 introducing a second, mandatory fully funded pillar.

However, pension reform remains an unfinished agenda. Numerous interventions in the pension system between 2001 and 2007⁹² created additional fiscal pressures, induced large differences in pension benefits paid to consecutive cohorts, and delayed the planned increase of the contribution rate for the second pillar from 5 percent to 10 percent over five years⁹³. Ad-hoc interventions in the pension system continued during the recent financial crisis. In 2010 the retirement age for women was

raised to 65 (in 3-month increments, until 2030) and early retirement age to 60, but with reduced penalty.

Figure 1. Croatia's population is shrinking and aging



Source: UN Population Prospects

A number of distortive changes were also introduced in the pension system in 2013 and 2014: a penalty-free retirement with 40 years of service (decrements for service below 40 years of service were slightly increased) and a more generous (wage growth dominant) pension indexation pattern for both PAYG pensions and

⁹² Including pension supplements of 1999 and 2001 for certain cohorts, the 2004 repayment of "pensioners' debt," restoring wage indexation in 2005, and a 2007 pension supplement of 27 percent on total PAYG pension for PAYG-only retirees, but not for PAYG benefit of the multipillar participants.

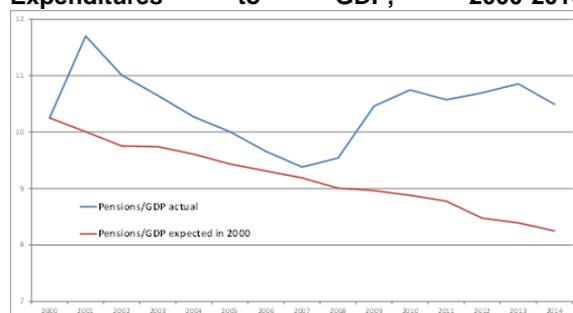
⁹³ Initial pension reform package in 1998 envisaged initial contribution rate to the second pillar of 5%, rising to 10% over five years. However, in the law this schedule was formulated less strictly with „at least 5% to be paid into the second pillar“.

second pillar annuities⁹⁴. The PAYG pension for multi-pillar participants (both basic and points parts) was increased in proportion to the PAYG share of the contribution (currently 75 percent), as a compensation for not raising second pillar contribution rate above 5 percent. Inability to finance larger transition cost will transform into higher future PAYG expenditures. Closing the second pillar savings for employees with extended service periods (hazardous and arduous occupations), nationalizing their second pillar accounts and restoring their PAYG-only benefit yielded a temporary fiscal relief in 2014 but added to the future PAYG deficit and implicit pension debt.

At the same time, there were several positive measures taken: the retirement age was increased to 67 (with a full transition by 2038), privileged pensions were reduced and rationalized, while a new functionally-based disability assessment methodology and new integral disability assessment infrastructure has been introduced. The inflow of new disability pensioners has been significantly slowed and relative pension expenditures curtailed.

Ad-hoc interventions in the pension system have led to larger PAYG expenditures than expected and locked contribution rate to the second pillar at 5 percent. Instead of an expected continuous decline of PAYG expenditures, providing fiscal space for financing transition costs of increasing the portion of contribution rates going to the second pillar, the actual PAYG expenditures remained high (Figure 2). As a consequence, second pillar contribution rate remained at 5 percent while its transition cost continued to fuel into the pension system deficit.

Figure 2. Expected and Actual Pension Expenditures to GDP, 2000-2014



⁹⁴ Given the uncertainty and lack of matching assets, such an indexation pattern is uncommon in the second pillar. As a consequence, initial second pillar annuities could be reduced by 20 percent or more.

⁹⁵ The real rate of return on second pillar accounts, commonly quoted and expected by the analysts was 3 percent.

Source: Pension Reform Working Group and World Bank calculations.

Second pillar performance has been positive and close to public expectations. The annualized rate of return on second pillar accounts since inception in 2014 has been at 5.9 percent - 2.4 percentage points above nominal wage growth, and almost 4 percentage points above consumer price inflation (CPI)⁹⁵. Second pillar accumulation in 2015 reached HRK 72 billion (22 percent of GDP). However, more than 70 percent of funds are invested in public debt, with fund management fees, although low by international standards, set relatively high for such passive portfolio⁹⁶.

Distortions and ad hoc measures have worsened Croatia's pension system sustainability. The largest distortion in the system is the 27-percent supplement that PAYG only participants get for all years of service and those in second pillar only for the pre-2002 service:

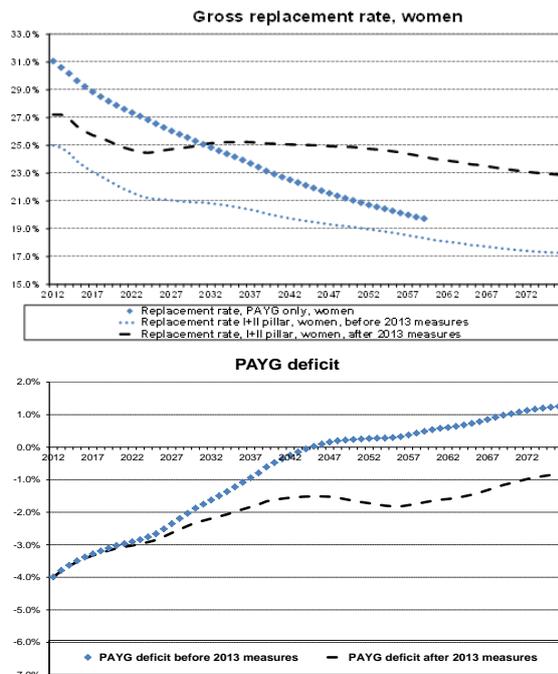
Benefit structure	Service before 2002	Service after 2002
PAYG-only pensioners	Points + 27%	Points + 27%
Multipillar pensioners	Points + 27%	75% of points + II pillar annuity

With higher PAYG benefit for second pillar participants (both basic and points part), introduced in 2013, the gap is somewhat narrowed and average replacement rate stabilizes in the long run, but the gap still remains (Figure 3). Second pillar annuity compensates for the reduced PAYG benefit, but not for the 27-percent supplement. Participants that had the choice to voluntarily join the second pillar in 2002 (those aged 40–50) have been given the opportunity to opt back to PAYG-only at retirement. Opting back gives them full pension benefit including the 27-percent supplement to post-2002 PAYG pension. This unfair choice makes the decision easy (and currently automatically executed by the authorities unless an individual indicates otherwise): in 2015 less than 1 percent of the pensioners (i.e. those with large second pillar accumulations and short service periods) chose the multipillar benefit. As Figure 3 shows, without the adjustment, combined multi-pillar pension would remain

⁹⁶ In 2014 life-cycle portfolios were introduced, but the effective floors for investing in public debt were not reduced. 95 percent of funds remain in balanced portfolios with heavy exposure to public debt.

below the PAYG-only pension for the next decade or two, i.e. prolong into the retirement of mandatory participants without the opt-out option, which may provoke reversal appeals. As indicated earlier, measures implemented in 2013 and 2014 have further worsened the system's fiscal sustainability (Figure 3), and reduced fiscal space for action.

Figure 3. Projected Replacement Rate and PAYG Deficit in Croatia



Source: World Bank team calculations, PROST model

Croatia's pension system still faces substantial coverage and adequacy challenges. Compared to EU, Croatia has the lowest labor force participation rates (of 15-64 cohorts - 59.6 vs. 71.9 percent for the EU28), second lowest average service period (31.1 years vs. 35 years for the EU28), and among the lowest exit age from work in the EU (1.2 years below EU for both men and women)⁹⁷. Croatia already pays the lowest relative pension in EU, which, without further reforms, is likely to deteriorate further. Recent PAYG measures improved future adequacy but not as much as would higher second pillar contribution rate.

Croatia's second pension pillar requires fiscal support as well as policy and outcome monitoring. In the long run, the second pillar is expected to provide a higher value-for-contributions than the PAYG pillar. With equal PAYG conditions and the same contribution rate, the multi-pillar replacement rate would yield up to 10 p.p higher replacement rate. However, the

second pillar requires a double-dip into current tax and contribution payers' income – to pay PAYG pensions and to fill the gap of diverting a part of pension contributions (presently 5 percent) to the second pillar accounts. Transition costs currently stand at 1.5 percent of GDP, and are largely financed by selling debt second pillar pension funds. Second pillar annuities would thus be financed predominantly by future generations' interest payment instead of from higher activity rates stemming from productive and diversified second pillar investment.

How Croatia can Strengthen its Pension System

Several simultaneous reforms could improve system equity and adequacy. The key systemic issue to be addressed is whether to extend the 27 percent supplement to all beneficiaries or to abolish it for current beneficiaries. With 27 percent supplement extended to all (proportional to service in the PAYG pillar) or abolished for all, for most individuals the multipillar pension would exceed the PAYG-only one. Opting-out, if needed, would then be made a fair choice. Abolishing it is both politically and socially difficult. Extending it generates more PAYG expenditures, rising in parallel with retiring second pillar cohorts. In addition to already narrowed fiscal space with redefinition of pension for second pillar participants and other 2013-14 measures, extending the supplement would cause the PAYG deficit to remain at 4 percent of GDP. A set of policies to strengthen the PAYG system, addressing both fiscal and equity aspects could provide the needed fiscal space. The list includes i) abolishing early retirement or reducing it to 1-2 years prior to retirement age (with a bridging system for hazardous occupations), ii) abolishing or faster convergence of privileged pensions to PAYG rules, iii) faster increase in legal retirement age, iv) awarding pension credits only for contributions, v) introducing wage valorization of initial pensions and CPI indexation of pensions in payment, and vi) reducing minimum pension per year of service or means testing it.

Abolishing or reducing the second pillar would bring short-term fiscal relief but exponentially raise the long run pension liabilities and implicit debt. Multi-pillar pension reform was designed as a reform for the future, a contribution of the current generation to lower burden for the future generations. At the launch of the second pillar it was emphasized that it would require fiscal support in the form of a fiscal

⁹⁷ EU: The 2015 Aging Report: Economic and Budgetary Projections for 28 EU States 2013-2060.

surplus or a small sustainable deficit and debt. Instead, public spending exploded, added to both deficit and public debt, postponing the second pillar's diversification towards more productive investment and abroad. Among the countries recognizing the inability of the current generation to curtail fiscal deficits for longer run benefits, only two (Argentina and Hungary) annulled the reform by abolishing second pension pillar. A larger group of countries, including Poland, Estonia, Latvia, Lithuania, Bulgaria, Romania, and Slovak Republic, have striven through the fiscal crisis by temporary freezing or reducing second pillar contribution rate, and/or allowing some degree of voluntary participation in the system. Unless truly temporary, such relief measures carry serious long-run risks. Prolonged reduction or freeze of second pillar contribution rate bites into future adequacy and worsens the elderly poverty prospects. Similarly, those that opt-out from the second pillar are more likely to appear as social assistance beneficiaries in the future.

How the World Bank Group Can Help

The World Bank has supported pension reform in Croatia from its beginning through analyses, investment projects, policy adjustment operations, and advisory services. In the last five years, the World Bank produced a Pension Policy Note (2011), simulation model of Croatian

pension system (so-called PROST pension model delivered to counterparts in 2011 and 2012), policy reports on severance pay in the context of the pension system (2013) and the extended service period (2013), as well as supported the pension policy reforms through Development Policy Loans (2011-13).

Further World Bank support to pension policy in Croatia could include analyzing and evaluating policy options and assisting the counterparts to efficiently implement them.

Croatia has prepared its pension system forecasts together with other EU countries. EU's 2015 Aging Report findings for Croatia are similar to the World Bank's. The status quo projection for Croatia indicates long-run social inadequacy despite fiscal sustainability, but does not address or evaluate policy options and implementation patterns in both PAYG and funded pension pillars, as well as on the labor market side. The World Bank could facilitate such an integrated pension, social and labor market reform review and assist in implementing policies emerging from it. Reimbursable Advisory Services (RAS) may include policy and financial analyses, modeling (PROST), preparing reports such as the Active Aging Report (the World Bank prepared a similar report for several EU Member States) or other type of active engagement.

This Policy Note was produced by the World Bank to inform policy debate in Croatia. This note was prepared by Zoran Anusic, Senior Economist.

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For any questions regarding this note, please contact Vanja Frajtic, Communications Associate, (vfrajtic@worldbank.org).

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Croatia Policy Notes 2016

Restoring stability, reviving growth and creating jobs

More Effective, Inclusive and Sustainable Health System

Key Messages

Croatia's main challenge in the coming decade is to improve health outcomes for all, while containing upward pressures on health spending driven by an aging population and new technologies. Chronic and non-communicable diseases dominate the burden of disease and projected rapid population aging will exacerbate this. Croatia's hospital-centric health system and service delivery network is not well suited to its changing care needs. Improving the functioning of primary care is critical for strengthening more cost-effective preventive care and rationalizing hospital service delivery.

Key Actions

- Upgrading and rationalizing the service delivery model: modernizing the health network through changes to the structure and organization of health care institutions to improve integration of care and implementing clinical guidelines.
- Expanding public health and preventive services: expanding coverage of individual preventive care and public health services, particularly among the less well-off.
- Improving quality, efficiency and fiscal responsibility through active purchasing: linking primary care and hospital payments to clinical guidelines, improving performance feedback, and enforcing fiscal discipline, improved hospital management and accountability.
- Rationalizing spending on drugs and devices and prescription patterns: implementing Health Technology Assessment and expanding centralized procurement.

Where Croatia Stands Now

Croatia enjoys relatively good and improving health outcomes. Between 1990 and 2013, life expectancy increased from 72.5 to 77.85 years, infant mortality fell from 6.3 to 4.06 infant deaths per 1,000 live births⁹⁸ and the age-standardized mortality rate decreased by 33 percent from 1,060 to 713 deaths per 100,000 inhabitants⁹⁹. Life expectancy at birth is one to two years longer than that of neighboring countries with similar income levels, such as Hungary and Slovakia but over three years less than the EU average (Figure 1)¹⁰⁰.

But Croatia could do much better in tackling chronic and non-communicable diseases which dominate the burden of disease. Ischemic heart disease, cerebrovascular disease and lung and colorectal cancers are the top four

causes of death¹⁰¹. Circulatory diseases and cancers combined account for approximately 75 percent of deaths. Risk factors underlying this burden of disease include a combination of unhealthy diet, physical inactivity, smoking and high alcohol consumption, and metabolic conditions such as high blood pressure, high blood sugar, obesity and high cholesterol. Death rates due to ischemic heart disease in Croatia are twice the EU average, those due to circulatory conditions are 70 percent higher and those due to lung, trachea and bronchus cancers are 22 percent higher¹⁰². Croatia's population is rapidly aging. The population aged 65 and above now makes up over 17 percent of the Croatian population and will rise to over 20 percent by 2020¹⁰³. Aging means that the burden of chronic and non-communicable disease will increase, with concomitant implications for increases in health care costs. A concerted policy focus on

⁹⁸ European Health for All Database (HFA-DB).

⁹⁹ All causes all age SDR, European Health for All Database (HFA-DB)

¹⁰⁰ Comparison for 2010 as this is the latest year data are available for many comparator countries.

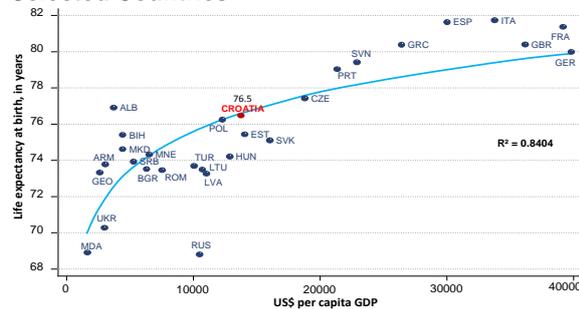
¹⁰¹ <http://www.healthdata.org/croatia>

¹⁰² European Health for All Database. Data presented are Standardized Death Rates all ages per 100,000.

¹⁰³ World Bank. 2015. Golden Ageing: Prospects for Healthy, Active and Prosperous Ageing in Europe and Central Asia

tackling chronic and non-communicable diseases and promoting healthy aging is therefore particularly important in Croatia.

Figure 1. GDP and Life Expectancy at Birth in Selected Countries



Source: World Development Indicators, World Bank.

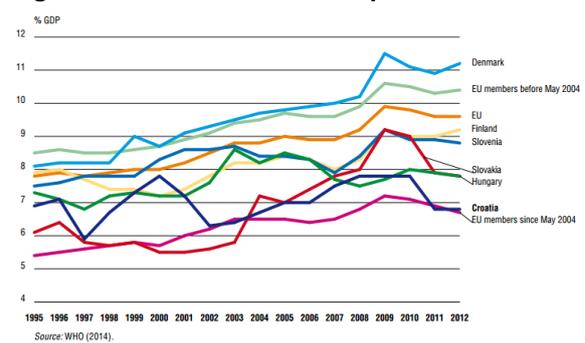
By regional and international standards, financial protection is good and the health system is responsive to public expectations. At approximately 12 percent of total health expenditure, out of pocket spending by households in Croatia is lower than the WHO's 15 percent threshold for financial protection and also lower than the EU average of 14 percent¹⁰⁴. Finally, some 70 percent of respondents are satisfied with the quality and efficiency of the public health system. This puts Croatia just below Western Europe, Turkey, and Estonia (80, 79, and 78 percent, respectively) and at the same level as Slovenia and Latvia¹⁰⁵.

Croatia's health expenditure is converging with that of its neighbors in Central Europe and the Baltics. In 2013, Croatia spent approximately 7.3 percent of GDP on health, which puts the country above the average of 6.8 percent for EU members since 2004 and above comparator countries like Estonia which spent 5.7 percent but below the average for EU members before 2004 (Figure 2)¹⁰⁶.

Public health spending in Croatia appears higher than the EU average but this also reflects differences in the definition of public health spending. The Croatian Health Insurance Fund (HZZO), the Ministry of Health (MoH) and local government spending on health was about 15.3 percent of general government spending in 2014¹⁰⁷. This is higher than the average of 14.7 to 14.8 percent for EU member states in 2013¹⁰⁸. However, national accounting standards in Croatia include mandatory (first six months) maternity and sick leave compensation, which are not considered to be health

expenditures by international standards, in estimates of health expenditures. These accounted for about 0.7 percent of general government spending. Complementary health insurance expenditures, which were a little under 0.7 percent of GDP in 2014, are also considered to be public health spending in Croatia, while some part of it (those that do not refer to vulnerable groups access to health services) should be considered 'private' health spending since they are voluntary supplementary insurance premium payments made by individuals¹⁰⁹.

Figure 2. Total Health Expenditure Trends



Source: WHO-European Health for All Database 2014

Health sector arrears are an important concern. Stock of arrears as of September 2015 are substantial at approximately HRK2.8 billion or about 0.8 percent of GDP. Hospital arrears are three-quarters of health sector arrears with clinical centers (tertiary care category 0 and 1 hospitals) accounting for half of arrears (Table 1).

Table 1. Arrears, stocks

Billions Kuna	2013	2014	2015
As of	31-Dec	31-Dec	30-Sep
HZZO	1.43	0.94	0.59
Hospitals	2.35	1.74	2.11
Other HCIs*	0.22	0.13	0.09
Total	4.00	2.80	2.79

Source: Ministry of Health, HZZO. Note: HCIs=Health Care Institutions

The health sector as a whole added no new arrears in 2015, and HZZO achieved substantial reductions in its arrears stock. After peaking in 2013, the stock of arrears—calculated after taking into account debt forgiveness 'rehabilitation' transfers—has dropped substantially. HZZO achieved savings of HRK0.35 billion in the first nine months of 2015, and non-hospital health facilities also achieved some savings. Although hospitals

¹⁰⁴ World Development Indicators 2015, The World Bank. Data are for 2013

¹⁰⁵ EBRD, Life in Transition- After the Crisis, 2010

¹⁰⁶ European Health for All Database (HFA-DB).

¹⁰⁷ HZZO annual report 2014-HZZO expenditures; Budget execution data for MoH and local government 2014.

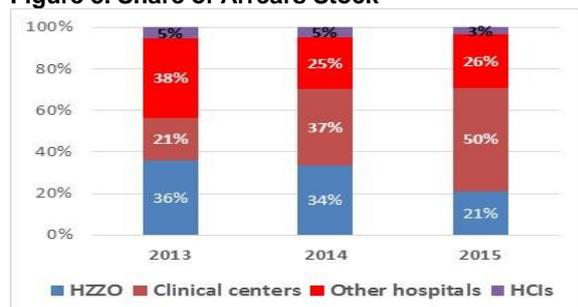
¹⁰⁸ Eurostat, COFOG methodology

¹⁰⁹ HZZO annual report 2014

under rehabilitation added HRK0.38 billion in new arrears in Jan-Sep 2015, this represents a 76 percent decline in new arrears generated relative to 2014 and continues a trend of decline since 2013.

Halting the growth of arrears at hospitals, particularly at clinical centers, will be key to fiscal sustainability. Of the new arrears added in 2015, Kuna 0.36 billion are at the clinical centers (tertiary care, category 0 and 1 hospitals). This represents a 64 percent decline over the previous year but merits attention as the main generators of new arrears (Figure 3). An analysis of hospital arrears from 2012 found that most arrears are for pharmaceuticals, medical materials, blood, and blood derivatives¹¹⁰. This is unsurprising since supplier contracts are the more ‘flexible’ part of hospital expenditures (relative to, say, staff costs which are close to half of all hospital expenditures). Tackling arrears will require policy actions at and beyond hospitals to improve fiscal responsibility and deliver better value from health spending without compromising access to or quality of care.

Figure 3. Share of Arrears Stock



Source: Ministry of Health, HZZO. Hospital data are for hospitals under financial rehabilitation. 2015 data are for Jan-Sep 2015

The health system’s sustainability is complicated by rapid population aging. The burden of chronic and non-communicable diseases typically increases in aging populations along with the need for long term social and medical care¹¹¹. Mobilizing the resources to finance the increasing demand for health services from a shrinking working age population with payroll taxes will be increasingly challenging, as contribution levels for mandatory health insurance are already quite high. However, the impact of aging on health spending in Croatia will depend critically on health system

interventions and other policy actions to ensure that additional years of life are healthy and on health expenditure increases driven by new technologies¹¹². Nevertheless, projections under all scenarios suggest that health care will continue to exert continuous upward pressures on public spending from a baseline of 5.7 percent of GDP in 2013 to between 6.7 percent and 9.7 percent in 2060¹¹³.

Socio-economic and geographic disparities in health remain wide. Geographic disparities between rich and poor districts imply considerable room for improvement. In rich districts like Zagreb, Zadar, Bjelovar and Bilogora and Karlovac, infant mortality rates have been comparable to the EU average or even lower. By contrast, infant mortality rates in poorer areas such as Lika and Semk, Osijek and Baranja, Virovitica and Podravina are double those in richer areas.

Croatia needs to optimize hospital inpatient capacity and adjust the service delivery network to changing care needs. Croatia’s health system is not well suited to its needs. A significant portion of long term care for elderly people is provided at high cost by hospitals. This is care that could be more suitably and cost-effectively provided in other settings. There is a growing need for palliative and chronic care which is also better provided in non-hospital settings. Advances in technology, anesthesia and surgical techniques mean that more services can be delivered in ambulatory and day care settings therefore reducing the need for acute care beds and increasing the need for integrated health networks.

Croatia’s network of facilities is fragmented. The national figures also mask the geographical concentration of these health services. A large number of Croatia’s hospitals are in Zagreb (more than two per 100,000 inhabitants), of which several are small-scale and have narrow medical profiles. High referral rates from primary care to hospitals in Croatia – 25 percent as compared to the typical range of 5 to 12 percent – suggest that improving the functioning of primary care has a part to play in rationalizing hospital service delivery as well as improving preventive care in order to improve health outcomes.

¹¹⁰ World Bank. 2014. Croatia Public Finance Review; authors calculations as of December 2013

¹¹¹ Considering demographic change alone, public expenditures on health and long term care as a proportion of GDP are projected to increase by 1.3 percentage points in a ‘medium case’ scenario. *Long Term Care and Ageing. World Bank Report.* November 2010.

¹¹² Studies in the U.S. suggest that so called ‘death-related’ costs in the final few years of life, and especially in the last year of life, are high, and range between 25-30 percent of total Medicare expenditure. World Bank, 2015

¹¹³ European Commission. The 2015 Ageing Report: Economic and budgetary projections for the 28 EU Member States.

How Croatia Can Strengthen its Health System

Croatia's main challenge in the coming decade is to improve health outcomes while containing upward pressures on health spending driven by an ageing population and new technologies. This will mean improving the quality and efficiency of health spending, targeting inequities in health outcomes, and containing cost escalations, particularly from new drugs and technologies. Policy makers should give priority to: (i) upgrading and rationalizing the service delivery model; (ii) expanding public health and preventive services; (iii) improving quality, efficiency and fiscal responsibility through active purchasing; and (iv) rationalizing spending on drugs and devices and prescription patterns.

Upgrading and rationalizing the service delivery model

Modernizing the health network: This includes a number of changes to the structure and organization of health care institutions to improve integration of care. This means:

- Defining networks of health care institutions;
- Rationalizing the number, distribution and service profile of hospitals to reduce acute care, removing from the public basic insurance health spas and increase sub-acute, long-term, palliative care and day bed capacity;
- Promoting ambulatory services, including specialized ambulatory surgeries, diagnostic and treatment services;
- Strengthening first level care; and
- Promoting two-way referrals across levels of health care institutions.

HZZO has reduced the number of acute care beds contracted by 12.5 percent and increased the number of day beds contracted by 11 percent in contracts for 2015. This is a step in the right direction. A hospital masterplan, which lays out a proposal to reshape hospital service delivery was approved by Parliament in 2015. Accelerating implementation of the hospital masterplan will be important to realign the service delivery network and realize further gains in quality and efficiency. Pilot projects, potentially supported through EU funds, could help to fine tune the organization of the service delivery network by trying out different models to identify the right one for Croatia.

Implementing clinical guidelines through hospital accreditation and technical audits, and monitoring sentinel events to flag quality

of care failures: Hospitals in Croatia now report on sentinel events, i.e., extreme events that signal critical quality of care failures at hospitals and primary care facilities, providing vital information that are a first step to diagnose and address quality failures. The implementation of technical audits of hospital quality and hospital accreditation – currently at a design stage – needs to be accelerated urgently.

Expanding public health and preventive services

Expanding coverage of individual preventive care and public health services, particularly among the less well-off, will be key to improving health. About 50 percent of the life expectancy gains from the so-called 'cardiovascular revolution' in the EU-15 have come from primary and secondary prevention activities that promoted healthy lifestyles, targeted reductions in alcohol and tobacco consumption and aimed to prevent or reduce complications from obesity, high blood pressure or diabetes. These are all key contributors to the burden of disease in Croatia. The educated and better off are more likely to use preventive services in most countries, and this is likely the case in Croatia as well. Improvements in the coverage and quality of preventive services could also be a tool to reduce socio-economic and geographic inequities in health outcomes in Croatia. Strategies to increase private participation in health care costs must protect the poor from catastrophic health spending and avoid copays or cost sharing for primary and secondary preventive services or drugs.

Improving quality, efficiency and fiscal responsibility through active purchasing

Linking primary care payments to clinical guidelines, and improve performance feedback: Payment reforms since 2008 have increased the share of activity-based payments to General Practitioners to 30 percent to incentivize preventive care and increase access to primary care services. In addition, doctors receive approximately 5 percent more as a bonus for joining a group practice. Over 50 percent of primary care doctors now work in multi-disciplinary group practices enabling them to share resources and expertise. This should have the effect of expanding the range of services that can be delivered at the first level of care, and reduce referral rates. HZZO reviews prescription practices of doctors to identify over-prescribers and provide feedback to reduce over-prescription. The impact of these changes on patient care needs to be assessed systematically. Possible interventions to consider include linking payments to appropriate

prescription practices, preventive service coverage/ quality and appropriate referral practices. Providing systematic feedback on key quality parameters to GPs based on adherence to clinical protocols would be a complementary 'enabling' intervention to consider. E-prescription systems to monitor prescribing behavior are already in place, and on-going e-health investments will enable better oversight and monitoring.

Incentivizing fiscal discipline and improving hospital management and accountability:

Until recently, hospital payment mechanisms contributed to poor fiscal discipline. Although hospital payments were notionally based on Diagnosis Related Groups (DRGs), hospitals received all of their estimated DRG payments in advance as a monthly transfer of 1/12th of the annual contract amount. Underperforming hospitals seldom returned funds they were not entitled to at the end of the year and inflexible contract ceilings meant that funds could not be redistributed from poor-performing to high-performing hospitals therefore rewarding poor performers.

Adjustments to hospital payments made in mid-2015 are a step forward to improving hospital fiscal discipline. Funding now follows patients. Reimbursement ceilings are flexible and funds can be redistributed from hospitals that do not deliver services to those that do. The proportion of contract funds disbursed in advance to hospitals is being reduced with a target of 25 percent by end-2016. At the moment, the proportion of advance funds stands at 80 percent.

Organizational reforms to introduce professional management at hospitals and improve hospital governance – a key factor mediating impact – remain an important as-yet unaddressed priority. Measures to improve the fiscal accountability of hospitals should also consider, and if necessary, address, the real autonomy that hospital managers have to manage and control expenditures. The MoH has established a robust system of regular financial and performance reporting by clinics and hospitals under rehabilitation, and monthly monitoring meetings with managers. This is good practice that increases accountability and should be continued.

Linking hospital payments to clinical guidelines and improving feedback on quality

¹¹⁴ HZZO annual report 2014

¹¹⁵ Two ordinances have been key to this. The first ordinance put in place a mechanism for setting a maximum wholesale price based on international price comparisons. The second ordinance defined the

based on technical audits: Hospital payments now promote ambulatory service delivery for elective surgeries. Payment rates for elective surgeries are 10 percent higher if performed in an ambulatory setting. As a result, delivery of elective surgeries on an outpatient basis has increased considerably in 2015. To illustrate, 57 percent of elective surgeries for five tracer elective surgeries are now performed on an outpatient basis, potentially reducing unit costs by 30-70 percent. By contrast, only 1.8 percent were performed on an outpatient basis in 2011. These reforms should continue.

Hospitals can also earn a performance bonus of up to 5 percent based on a set of five indicators intended to capture quality of care and hospital efficiency. This is a step towards incentivizing hospitals to improve quality and efficiency. However, the current performance bonus formula rewards hospitals delivering a low volume of services at high quality levels disproportionately over hospitals that deliver a high volume of services at high quality levels. Furthermore, the quality indicators could be refined to better capture clinical quality of care, given differences in hospital case mix. These concerns can be addressed in the immediate future. Ultimately, hospital payments should be linked to accreditation scores and implementation of clinical guidelines as monitored through technical quality audits.

Rationalizing spending on drugs and devices

Implementing Health Technology Assessment and expanding centralized procurement:

Access to prescription drugs in Croatia has increased while the average cost per prescription has declined (Figure 4). HZZO expenditures on prescriptions medicines decreased from HRK3,447 million in 2010 to HRK3,260 million in 2014¹¹⁴ accounting for approximately 16 percent of HZZO health care expenditure. Expenditures on orthopedic devices also declined by HRK174 million and were about 3 percent of HZZO health care spending in 2014. Overall, spending on prescription drugs, orthopedic devices, insulin pumps and expensive drugs was 23 percent of HZZO health care spending in 2014.

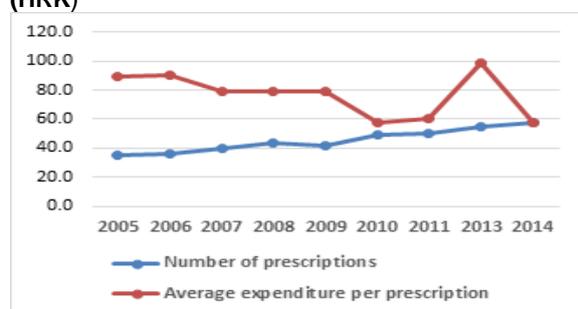
Croatia has taken important steps to regulate the drugs market and public expenditures on drugs since 2009¹¹⁵, which have contributed to these results. In line with international best practices, HZZO monitors GPs' prescription patterns to

criteria for including medicines in HZZO's basic and supplementary reimbursement drug lists, based on medical evidence and cost-benefit analysis. HZZO

identify and nudge over-prescribers into rationalizing prescription practices. Moving forward, monitoring and feedback should focus more closely on aligning prescription practices with clinical guidelines to maximize impact on outcomes and costs.

Expenditures on expensive drugs for hospitals have continued to grow at a high rate, however, increasing by 44 percent from HRK450 million in 2010 to HRK634 million in 2014, although it still accounts for a relatively small proportion (approximately 3 percent) of HZZO health care expenditures. These need to be monitored carefully and the potential for value-based purchasing explored and exploited.

Figure 4. Expenditures on Prescriptions Medicines (HRK)



Source: HZZO Annual Report 2014

Joint procurement of hospital drugs, supplies and devices are a strategy to standardize quality and lower costs through economies of scale. The first round of centralized procurement for generic drugs in 2012 yielded about HRK187 million in savings. However, the potential for savings could be further exploited by expanding joint procurement to cover more supplies and medical devices after an assessment of the experience so far. The Ministry of Health has taken steps towards this: by issuing an order expanding the scope of joint procurement to also include devices and consumables. However, implementation progress on this needs to be accelerated.

How the World Bank Group Can Help

The World Bank has been supporting the development of Croatia's health system for over 15 years through two investment projects, current program-for results, and a number of technical assistance activities.

Currently, the Government of Croatia is implementing Health Program-for-Results, with financing from the World Bank, in support of a set of reforms to strengthen the country's health system and make it more

also defined reimbursement limits for most prescription medicines through annual internal reference pricing. HZZO also uses risk-sharing

cost-effective. More broadly, the World Bank stands ready to support Croatia in strengthening its health system through a range of types of support including:

- (i) Supporting a systematical measurement of the impact of health sector reforms so far, and diagnosing drivers of arrears. Croatia has implemented key reforms to re-orient the country's service delivery model and improve quality and efficiency of care. The impact of these reforms on patient care and satisfaction as well as implications for efficiency and health outcomes needs to be assessed systematically to supplement the evidence already available. Given concerns around hospital arrears, a diagnostic of the main remaining health systems drivers of arrears both at and beyond hospitals, could complement current monitoring by the Ministries of Health and Finance. A systematic evaluation could help to deepen successes, inform course corrections and also serve as a basis for future communications on the reforms.
- (ii) Supporting the implementation of the hospital masterplan: realigning the hospital infrastructure by reducing acute care beds, while increasing sub-acute, long-term and palliative beds and day beds and services will be critical to reorient service delivery to Croatia's changing needs cost-effectively. Implementation of the hospital masterplan needs to be accelerated, and detailed plans for at least one 'hospital reshaping' schemes developed and implemented.
- (iii) Supporting implementation of quality-related reforms: The implementation of hospital accreditation and technical audits is lagging relative to other elements of Croatia's health reforms. Not a single hospital has been accredited yet, nor are technical audits being implemented. Clarifying the role of the Agency for Quality and resourcing it appropriately will be key to facilitate implementation of these reforms. Organizational changes are also needed at the hospital level to reinforce a focus on improving quality. Hospital performance bonus indicators could be revised to link performance bonuses more closely to quality of care. In addition, hospital payments could be reviewed to identify medium-term opportunities to incentivize improvements in quality and efficiency.

agreements to ensure that suppliers have a financial interest in keeping within budget limits.

- (iv) Identifying opportunities to improve health services with a focus on preventive and public health services and poor areas. Reviewing the quality and coverage of service delivery for primary and secondary prevention and implementation of tobacco and alcohol use public health campaigns with a focus on service delivery to the poor is a good starting point to identify intervention opportunities to address socio-economic disparities in health.

This Policy Note was produced by the World Bank to inform policy debate in Croatia. This note was prepared by Marcelo Bortman and Aneesa Arur, Sr. Public Health Specialists.

The findings, interpretations, and conclusions expressed herein do not necessarily reflect the views of the Board of Executive Directors of the World Bank or the Governments they represent.

For any questions regarding this note, please contact Vanja Frajtic, Communications Associate, (vfrajtic@worldbank.org).

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Croatia Policy Notes 2016

Restoring stability, reviving growth and creating jobs

Social Welfare

Key Messages

Croatia's generous and complex social welfare system relies excessively on categorical rather than poverty-focused benefits. To improve its ability to tackle poverty, and to do so in a more cost-effective way, Croatia needs to consolidate its social benefit programs and increase the share of spending on poverty-focused programs, including through a broader use of means-testing mechanism. The previous Government has embarked on a reform program to strengthen its social welfare system and to increase its efficiency and effectiveness in combatting poverty. These efforts would need to be continued.

Key Actions

- Initiate transfer of the administration of the GMB into the OSS in 2016, followed by the consolidation of the child allowance, non-contributory maternity/paternity allowances, the unemployment benefit, and subsequently of other social benefits, into the GMB in subsequent years.
- Introduce means-tested eligibility procedures for family-related benefits and review family-related tax expenditures.
- Accelerate the deinstitutionalization process by speeding up the transformation of large residential institutions into smaller care units, with a reduction in the inflow of new entrants into institutions and an expansion of alternative care models.

Where Croatia Stands Now

Six consecutive years of recession since the start of the global financial crisis in 2008 have led to a rise in poverty in Croatia. Using an absolute poverty line of \$5 per day, the poverty rate was estimated at 9.8 percent in 2013, while relative poverty (the share of population with equivalized incomes below 60 percent of the median) was 19.4 percent in 2014, falling slightly from a high of 20.9 percent in 2011.

Spending on non-contributory social welfare is high and was protected during the crisis. Croatia spends 4.8 percent of GDP on different types of non-contributory programs and policies¹¹⁶, which is significantly higher than other Central and Eastern European countries. Spending is substantial even for cash transfer programs; Croatia spends about 2.5 percent of GDP on such programs. Government efforts to protect social assistance benefits and old-age pensions during the crisis have served to partially mitigate the impacts of the crisis on poverty.

Croatia operates a generous and complex social welfare system that relies heavily on categorical as opposed to needs-based

benefits. Croatia allocates 4.8 percent of public spending to non-contributory programs and policies, but only 0.3 percent allocated to social assistance (Table 1) is well targeted to the poor. This suggests significant scope to raise the effectiveness of social welfare to address poverty and vulnerability by scaling down on some of the categorical programs and replacing them with income- or means-tested programs.

Table 1. Targeting Accuracy of Social Protection Programs, 2011

	Total	Quintiles of consumption per adult equivalent, net of each social transfer				
		Q1	Q2	Q3	Q4	Q5
Overall social protection	100.0	48.2	24.7	14.3	8.4	4.3
Social insurance	100.0	53.2	23.5	12.9	6.6	3.9
Old-age pension	100.0	65.0	16.7	10.3	5.4	2.7
Disability and survivors pension	100.0	64.7	16.4	8.8	5.0	5.2
Sickness benefit incl nursing, disability	100.0	67.3	6.5	8.8	11.8	5.6
Unemployment benefit	100.0	53.6	17.8	17.8	8.1	2.7
Social assistance programs	100.0	59.2	17.6	12.4	5.5	5.3
Social assistance in cash	100.0	76.7	7.8	6.6	4.9	4.0
SA in kind (food, firewood, clothes)	100.0	88.5	10.9	0.0	0.6	0.0
Family allowances (child allowance, maternity leave, layette)	100.0	50.6	22.1	15.5	5.8	6.0
Remittances and private transfers	100.0	32.3	15.5	16.9	15.9	19.4

Source: Based on the latest available 2011 HBS.

¹¹⁶ This definition includes traditional cash transfer programs for poor, war veterans' pensions and child tax allowance.

Croatia's social welfare system has over time also become costly to administer, with responsibilities scattered across different ministries and institutions. Three separate ministries are in charge of setting social welfare policy (Ministry of Social Policy and Youth, Ministry of Labor and Pension System, Ministry of War Veterans) and four ministries with multiple specialized agencies and their networks administer social welfare programs. This fragmented administration raises the personal costs to beneficiaries applying for benefits at multiple agencies, augments the risk of error and fraud in the social protection system, and hinders policy making.

How Croatia Can Strengthen Its Social Welfare System

The Government has embarked in 2013 on a reform program to strengthen its social welfare system and to increase its efficiency and effectiveness in combatting poverty. It includes reforms to consolidate and improve the targeting and administration over its social welfare programs in recent years, with the introduction of the means-tested Guaranteed Minimum Benefit (GMB), the launch of a One Stop Shop (OSS) approach to benefit administration, a centralized disability certification, and efforts to reduce error, fraud and corruption in social benefits. Croatia has also launched a process of deinstitutionalization and transformation of its social welfare institutions, along with a reduction in the inflow of new entrants into large institutions. The reform agenda would benefit from continued efforts to reach wanted results.

Consolidating and improving the targeting of social welfare

In 2013 Croatia started to implement a set of reforms to consolidate and improve the targeting and administration of the social welfare system to better and more efficiently protect those in need. As a first step, social policy was centralized under the Ministry of Social Policy and Youth to improve administrative coordination. The Government also rolled out a comprehensive management information system, developed with World Bank support, which increases the transparency and availability of information for policy making, and reduces the scope for error and fraud.

Efforts to consolidate some cash transfer programs and improve targeting were legislated in a Social Welfare Law adopted in

December 2013. The law created a new Guaranteed Minimum Benefit (GMB), introduced in 2014, which consolidated four different social welfare benefits (the social allowance program, the extended unemployment benefit, the homeland war veterans' benefit and the disabled World War II support allowance) and applied means-testing with a changed equivalence scale to protect the most vulnerable (single elderly and single parents).

Another important step towards consolidating the administration of major social welfare benefits and the unemployment benefit is the planned creation of a One-Stop-Shop (OSS), to be placed in the existing network of public administration offices throughout the country. In addition to reducing the personal costs to beneficiaries and the administrative costs of processing applications and paying benefits, the OSS will lay the foundations for deeper structural reforms, such as stronger policy coordination, harmonization of rules and procedures, and benefit consolidation. It is a gradual process which is expected to take several years. According to initial plans, the creation of the OSS was supposed to commence in 2015 with the transfer of the administration of the GMB into the public administration offices. This reform has been postponed to 2016, however. Administration of the child allowance, non-contributory maternity/paternity allowances, the unemployment benefit and, subsequently, of other social benefits is expected to be transferred into the OSS in subsequent years.

Croatia's 2015 National Reform Program articulates the objective of consolidating social benefits through the GMB and implementing the OSS. It describes key milestones that need to be achieved and sets a deadline for completing the transfer of administration of four main benefits to the OSS by 2017. European Commission's 2015 Country Specific Recommendations¹¹⁷ provide proposals to further consolidate social benefits (as there are still over 80 different social benefits) and increase the share of means-tested social benefits (currently accounting for less than 7 percent of all social protection benefits).

Strengthening the administration of disability benefits

Croatia's system of disability benefits is among the largest in the EU, both as a legacy of the conflict in the early 1990s and of weaknesses in the design and administration

¹¹⁷ EC, Country Report Croatia 2015, and Council Recommendation of July 14, 2015

of the programs. Croatia spends about 3.6 percent of GDP on disability programs (disability pensions, transfers and other benefits), significantly above EU averages. This is largely the legacy of the Homeland War, but is also due to non-standard and loose disability criteria, lack of control, and lack of governance in the disability assessment system. This has resulted in large numbers of Croatians on the disability rolls.

Reforms to disability certification introduced in early 2015 are showing first positive effects. Until the recent creation of a Central Disability Certification Institute (CDCI) within the Institute for Disability Certification, Professional Rehabilitation and Employment of Persons with Disability, disability certification was spread across six sectors and agencies with no consistent methodology. Under the reforms, disability certification previously conducted separately by the pension, health, veteran, social, employment and education systems were consolidated, and a unified disability certification methodology was adopted and applied as of January 2015.

CDCI's technical and operational capacity has been improving and initial results have been encouraging. The reform has helped reduce the inflow into disability programs, which was higher in Croatia than in comparable countries and might have been affected by error and fraud. New disability pensioners in 2015 stood at around 2,100, almost 4 times below the average new disability pensioners in the last decade. Strong implementation of the new methodology for disability assessment in 2015 yielded direct savings of almost 0.1 percent of GDP. Apart from fiscal savings, this reform is expected to result in faster, more transparent, and more client friendly certification process and service for clients.

Tackling error, fraud and corruption

Croatia's institutions and mechanisms to combat error, fraud and corruption (EFC) in the social protection and labor system need strengthening. Croatia operates a number of cash benefits with high a-priori risk of EFC, including disability pensions and allowances, income and means-tested programs (the child allowance and GMB programs), and income replacement programs. In November 2015, the Government approved a Strategy for Combating Error, Fraud and Corruption in the Area of Social Protection in the Republic of Croatia 2015-2020 and an action plan to operationalize the strategy

needs to be developed in the first quarter of 2016. Successful implementation of the strategy and the action plan could generate significant fiscal savings in the system.

Promoting deinstitutionalization

Croatia has made progress over the last years in the deinstitutionalization and transformation of residential social welfare institutions. Deinstitutionalized care is overwhelmingly more effective than institutional care, especially for children, and deinstitutionalization has been a longstanding policy objective in Croatia. The implementation of deinstitutionalization had been lagging behind, however. Toward this end, Croatia developed a Master Plan on Deinstitutionalization and Transformation of Social Welfare Institutions in 2010, adopted an Operational Plan to implement the Master Plan in late 2014, and formed a national team for deinstitutionalization comprising of four full-time engaged experts in early 2015. Each residential institution has come up with a transformation plan, and the Ministry of Social Policy and Youth has been actively supporting the transformation process to date in 32 such institutions.

Significant progress has been made on the deinstitutionalization of individuals from a number of large institutions into organized housing and foster care. Continuous support is also being provided to the residential social welfare institutions in the preparation of project proposals for developing new community services or the transformation of existing social welfare institutions, to be financed under the European Social Fund (ESF) and the European Regional Development Fund (ERDF). Unfortunately, the inflow of new entrants into institutions has not been reduced. As a result, the targets for deinstitutionalizing individuals have not been reached.

Strengthening work incentives in the social welfare system

A significant reliance of Croatia's jobless on social welfare benefits raises questions on how to ensure that programs do not create disincentives to work. More than 36 percent of the unemployed population and about 47 percent of the out-of-work population¹¹⁸ in the bottom quintile receive some kind of social welfare benefits. The new Social Welfare Act introduced a number of provisions aimed at encouraging work-able beneficiaries to transition from

¹¹⁸ Out of work is defined as the combination of inactive and unemployed individuals, as opposed to employed, retired, in education or training and with disabilities

assistance to work, including: penalties for workable beneficiaries who refuse a job offer; incentives for beneficiaries to transition to work, by offering a 3-month period when the benefit is gradually adjusted downwards; and measures to ensure cooperation between social welfare centers and local public employment offices. The Croatian Employment Service (CES) has to cater to the needs of a larger and more heterogeneous population of jobseekers, making it more challenging to fulfil its mission of counseling. The CES does not have clear rules to establish categories of jobseekers and no systematic way to prioritize resources and allocation of programs based on categories. The World Bank provides technical assistance for statistical profiling techniques as a tool to support activation and counselling work.

How the World Bank Group Can Help

The World Bank has been supporting the development of Croatia's social welfare system for over 17 years through two investment projects and a number of technical assistance activities.

Currently, the Government of Croatia is implementing a EUR70 million Social Protection System Modernization Project, with financing from the World Bank, in support of a set of reforms to strengthen the country's social protection system and make it more cost-effective. Reforms supported by the project include (i) the consolidation of major social welfare and unemployment benefits under a one-stop-shop network; (ii) harmonization of disability certification; (iii) development of a system to prevent, detect, and correct error and fraud; (iv) de-institutionalization of vulnerable children and adults by increasing family-type environments outside of the institutions, and improving care and quality standards for these groups; and (v) development of better activation measures for those at risk of becoming long-term unemployed.

The project combines a results-based approach, with EUR50 million allocated for disbursement upon the achievement of 14 results indicators, and another EUR20 million allocated for critical investments and technical assistance. The project became effective in December 2014 and has so far disbursed EUR1.9 million or 2.7 percent of the loan. Another EUR4 million is ready to be disbursed for two achieved disbursement-linked indicators. The project has initiated activities in all areas supported by the operation, albeit at a slower pace in the second half of 2015. The World Bank team stands ready to provide strong implementation support to enable the government's reform efforts.

More broadly, the World Bank stands ready to support Croatia in strengthening its social welfare system through a range of types of support including via (i) ex-ante evaluation of social protection reforms (in pensions, active aging, employment policies; social welfare and social services); (ii) implementation support for such reforms; and/or (iii) evaluation of the performance of existing programs (i.e. assessments of the quality of implementation processes, their success in reaching the poor, their impact on the welfare outcomes of their beneficiaries and the cost-benefit ratio of these programs). Support efforts could further include data collection and analysis in areas where the evidence base on the Government's reforms efforts is limited.

This Policy Note was produced by the World Bank to inform policy debate in Croatia. This note was prepared by Ivan Drabek, Senior Operations Officer and Emil Tesliuc, Senior Economist.

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