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Croatia: a Strategy for Smart, Sustainable and Inclusive Growth

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Key Messages[1]

- **Croatia's current economic challenges include sluggish growth, excessive public spending, high unemployment, and a deteriorating external environment.**
- **Expenditure-based fiscal consolidation is therefore an urgent priority for Croatia to create future space for growth-enhancing spending.**
- **The country's incomplete structural reform agenda needs attention and action to promote greater competitiveness and a shift to productivity-based, private sector-led growth.**
- **Croatia also faces the strategic challenge of maximizing the benefits of European Union (EU) membership, especially in terms of access to markets and the use of EU Structural Funds, requiring structural changes in the social sectors, education system, and business environment.**

Croatia: Effective Action Required

Croatia currently faces several critical economic challenges. The country's new government has taken office at a time when fast convergence with European Union (EU) member states is burdened by an external environment that has worsened and will likely remain uncertain – at best – for the foreseeable future. World financial markets are currently risk-averse due to the sovereign debt crisis in the Eurozone economies, and financing for emerging markets will continue to be scarcer and more expensive. Croatia now has no option but to use its own resources more efficiently and to rely on domestic savings for growth.

The new external challenges have arisen just as the Croatian economy was making a fragile recovery and dealing with slow export growth, low investment, and persistent unemployment. At the end of 2011, Croatia's GDP per capita (in purchasing power terms) declined to 61 percent of the EU27 average, a loss of 2 percentage points since 2008. Indeed, sluggish growth and slow reforms have pushed down Croatia's competitiveness rankings, as measured by the World Economic Forum and the World Bank's *Doing Business* indicators.

The near-term growth outlook suggests that Croatia faces another recessionary year, with demand for Croatian goods and tourism services uncertain and limited prospects for foreign capital inflows. Feeble growth and weak balance sheets – on the part of the government, financial institutions, and individual households – are combining to exacerbate the downturn. If the recovery continues to lose momentum, balance sheet problems would worsen and fiscal sustainability would deteriorate further.

Croatia should act decisively to set national targets for expanding or improving employment, business innovation, education quality, social inclusion, and energy efficiency.

In view of this worsening economic environment, signing the EU Accession Treaty and becoming an EU member present vital opportunities for Croatia to address its economic challenges and build a competitive economy. The continued economic uncertainties, coupled with Croatia's high debt overhang, demand policies that will protect macroeconomic stability in the near term and improve competitiveness over the medium term. Although fiscal consolidation is clearly the main economic challenge in the near term, with a poverty rate of roughly 14 percent and 40 percent youth unemployment, jobs, productivity, and social cohesion must also be in focus. Croatia should therefore act decisively to set national targets for expanding or improving employment, business innovation, education quality, social inclusion, and energy efficiency, all of which will require concerted government efforts to implement essential structural reforms. Policy responses must be both immediate and resolute.

[1] This *Knowledge Brief* is based on a series of policy notes prepared by the World Bank for the Government of Croatia.

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Table 1: Croatia: Selected Macroeconomic Indicators

	2007	2008	2009	2010	2011	2012e	2013p
National accounts (real growth rates)							
GDP	5.1	2.1	-6.9	-1.4	0.0	-1.8	0.8
Domestic demand	6.2	3.1	-10.2	-3.7	-0.3	-2.6	0.8
Labor market							
Unemployment rate (LFS)	9.6	8.4	9.1	11.8	13.5	13.8	14.0
Consumer Price Index (period average)	2.9	6.1	2.4	1.1	2.3	3.4	3.2
Exchange rate HRK/EUR p.a.	7.3	7.2	7.3	7.3	7.4	7.5	7.5
Government finance (% of GDP)							
Revenues	40.2	39.7	39.2	38.1	37.1	37.8	37.7
Expenditures	42.8	41.3	43.2	43.8	43.6	41.3	41.9
Broad deficit	-2.6	-1.6	-4.0	-5.7	-6.5	-3.4	-4.2
Broad primary deficit	-0.9	-0.2	-2.3	-3.7	-4.3	-0.9	-1.2
Public debt and guarantees	41.5	42.3	51.4	60.5	64.7	67.8	67.9
External sector (% of GDP)							
Current account balance	-7.2	-8.7	-4.9	-1.6	-0.8	-0.9	-0.9
Gross external debt	77.7	83.6	104.4	103.7	94.7	98.7	98.0
Monetary (% rate of change)							
Broad money	18.3	4.3	-0.9	4.4	3.5	2.5	3.9
Private sector credit	15.0	10.5	-0.6	6.9	5.4	-0.4	3.0

Note: e-estimate, p-projection
Source: CNB, Ministry of Finance, CROSTAT, World Bank calculations

Fiscal Consolidation Urgently Needed

Croatia's past pro-cyclical fiscal policy has left it with large macroeconomic imbalances. A growth model based on easily obtainable credit and domestic demand – and only limited progress on improving competitiveness – is proving unsustainable. Market confidence in Croatia deteriorated sharply in 2008 as the financial crisis broke, thanks to past current account deficits that averaged 6 percent of GDP, external debt that equaled the GDP, and exposure to interest and exchange rate risks. In the three subsequent years, real GDP fell by over 10 percent, led by drops in investment and private consumption. Revenue losses and inflexible spending structures widened the general government deficit to above 5 percent of GDP, with public debt, including the stock of government guarantees, widening sharply to above 60 percent of GDP.

After three years of recession, investors today view the resilience of the Croatian economy as weak. After losing its investment grade credit rating by two rating agencies (S&P and Moody's) in January 2013, spreads on credit default swaps are among the highest among emerging markets. In a more protracted recession, further revenue underperformance is likely. Moreover, because of Croatia's high volume of external debt, any adverse external financial shocks will be transmitted faster and with greater intensity. Transmission channels are likely to be a higher cost or tightened access to financing in the short and long term, either of which could negatively affect the performance of the Croatian economy. Expenditure-based consolidation (as required by the country's *Fiscal Responsibility Law*) is thus urgently needed to reduce borrowing requirements and help make debt more sustainable.

The Risks of the Present Course

The economic consequences of the country's economic policies have unfortunately left only a limited number of policy responses. Clearly, fiscal consolidation is the most powerful way to address the vulnerability. While Croatia's recent consolidation efforts have slightly reduced public spending to 41 percent of GDP, the level of public expenditure must be curbed further. The risks of failing to act are clear:

Clearly, fiscal consolidation is the most powerful way to address Croatia's vulnerability.

- Financing such high levels of spending is challenging when a country's real economy is weak and its informal economy notably large (Croatia's is estimated at 15 percent of GDP). In the last three years, when off-budget spending is included, the fiscal deficit has reached close to 6 percent of GDP. With the callable government guarantees, public debt came close to the statutory limit of 60 percent of GDP, above which public debt is generally considered to be of high risk. For a country at Croatia's level of development, a ceiling closer to 40 percent would be advised.
- During 2010-2012, the Croatian government was forced to borrow an average of 12.5 percent of GDP annually to refinance old debt and cover the deficit. Past debt

Table 2: Europe 2020 Targets, Croatia and the EU27

Headline Targets	Indicators	EU27	Croatia
		2010/2009	
75% of the population aged 20–64 should be employed.	Employment rate by gender, age group 20–64	68.6	58.7
3% of EU GDP should be invested in R&D.	Gross domestic expenditure on R&D	2.01	0.84
Greenhouse gas emissions should be reduced by 20% compared to 1990.	Greenhouse gas emissions, base year 1990	83.0	99.1
The share of renewable energy sources in final energy consumption should rise to 20%.	Share of renewables in gross final energy consumption	10.3	8.6
Energy efficiency should % increase by 20%.	Energy intensity of the economy	165.2	284.3
The share of early school leavers should be under 10%; at least 40% of those 30–34 should have completed tertiary or equivalent education.	Early leavers from education and training by gender	14.1	3.9
	Tertiary educational attainment by gender, age group 30–34	33.6	22.6
Poverty should be reduced by lifting at least 20 million people out of the risk of poverty or exclusion.	People at risk of poverty or social exclusion, %	16.4	20.6
	People at risk of poverty before social transfers, %	25.7	25.2
	People at-risk-of-poverty before social transfers, %	25.7	25.2

Source: Eurostat, CROSTAT.

could become a significant problem unless Croatia can reassure investors by implementing a credible reform program that puts the country on a more sustainable footing.

- A rise in contingent liabilities (such as guarantees to shipyards) and nondiscretionary spending, the impact of an aging population, and the present lack of space for counter-cyclical policies all call for a fiscal buffer.
- The current tax burden is the second highest in the EU10, totaling about 37 percent of GDP.
- Croatia currently lacks the fiscal space to cofinance EU-funded projects, which will increase in availability sevenfold compared to current levels. Since EU contributions are fixed but receipts of EU funds depend on successful expenditures, it is imperative that this fiscal space be created.

An ambitious path of fiscal consolidation is needed also to achieve a balanced budget over the business cycle. This means reducing spending and increasing tax compliance by over 5 percentage points of GDP. Such a stance would prepare Croatia to meet the requirements of the EU's Stability and Growth Pact and help it avoid the stringent Excessive Deficit Procedure criteria upon EU accession.

Government subsidies, the public sector wage bill, and categorical benefits – including the exceptionally high pension bill – are just some of the areas in need of more rationalized spending. At 2.4 percent, subsidies to railways, shipyards, and agriculture are fivefold those of the EU15, the public sector wage bill stands at 10.6 percent of GDP, and privileged pensions currently absorb 1.9 percent of GDP. To ensure long-term fiscal sustainability and improve efficiency and effectiveness, reforms to the pension, health, and social benefits systems are critical (see below). On health spending alone, which absorbs roughly 7.8 percent of GDP, Croatia tops the EU.

In short, fiscal consolidation should act to safeguard and support future growth by shoring up fiscal sustainability and creating the fiscal space to support private sector-led growth and build fiscal buffers against future shocks. Additional government efforts should work to shift growth, support job creation, promote the potential of sustainable and green growth, and stimulate the private sector to innovate and create new technologies.

Unfinished Reform Agenda

Accelerating economic recovery requires Croatia to complete its currently unfinished structural reform agenda and shift to productivity-based, private sector-led growth. Before the global crisis, Croatia had high and sustained economic growth that, combined with a decline in the population, resulted in an increase in per capita income from 1994 through 2008 – a growth achieved mainly through the expansion of aggregate demand and the non-tradable sector (particularly real estate). The result was large current account deficits and excessive dependence on foreign savings, even as investors were becoming more risk-averse and financial resources scarcer. At the same time, this growth did not reach the country's most vulnerable persons; at the onset of the 2008 crisis, Croatia's poverty rate was still stubbornly high at 11 percent.

Reducing the role of the state and creating the space and enabling environment for the private sector are urgent priorities to facilitate recovery and growth. Improving the investment climate by cutting red tape and strengthening the rule of law would attract new entrepreneurs and foreign direct investment (FDI); bring in new ideas, technology, and

know-how; and open new export markets. Past government policies, visible in soft-budget constraints and high subsidization, limited enterprise restructuring and new business initiatives. There are over 600 companies in state ownership, many of which could attract private interest and needed investments for modernization and growth. The government could also do more to:

- reform product market regulation
- remove administrative barriers to investments
- reduce the logistics costs in trade
- make the bankruptcy process more efficient
- modernize contract enforcement and property rights.

Reform Targets: Labor, Social Services, and Infrastructure

Croatia's labor force participation rate is among the lowest in Europe. Labor market reforms must address this deficiency, which particularly affects older workers, prime-age men (25–54), and youth, and be combined with education and social sector reforms. The labor market needs to be more flexible to support employment growth, currently at a low 59 percent compared to the Europe 2020 Strategy target of 75 percent. Labor market reforms alone are not sufficient, however. The social protection system must also be revamped to incentivize seeking or getting back to work, and the education system made more responsive to changing labor market demand, including by producing more well-trained, skills-appropriate graduates.

Croatia spends more on health and social protection than many other countries in Europe.

Creating more effective, better targeted, and fiscally responsible social safety net is an urgent task. Although Croatia spends more on health and social protection than many other countries in Europe, the overall level and quality of social services currently fall short of the needs of many Croatians. Moreover, the share of categorical benefits and entitlements – which are not distributed according to income level – is high and the share of poverty-focused programs relatively low. Rebalancing this mix would benefit both fiscal consolidation and also labor force participation. The financial problems in the pension and health systems also weigh heavily on the national deficit and present growing concerns as the population ages. Reform of the health system, including further hospital rationalization, and intensified pension reforms will be critical challenges.

To build on its unique potential to become a regional logistics and distribution hub, Croatia has to modernize core infrastructure: railways, energy, and utilities. The operational and financial performance of the national railway companies needs improvement, including by setting appropriate track access charges. Croatia will also have to make considerable and sustainable efforts to comply with the EU environmental and climate change/energy *acquis*, requiring it to rethink its financing model to incorporate private participation and efficiently absorb EU funds. These investments would need to be supported by utility sector governance reforms to reduce fragmentation and exploit economies of scale. In addition, although agriculture is vital for economic development, its large environmental footprint should be reduced and farming systems made less vulnerable to climate change.

Maximizing the Opportunities of EU Membership

EU membership generates both opportunities and challenges. For Croatia, one strategic challenge is the need to create a competitive private sector, since recent events in the Eurozone suggest that access to a large market and the implied political stability of EU membership are not sufficient in themselves to raise country competitiveness. In order for Croatia to take advantage of a large market, structural changes in social sectors, education, and the business climate are urgently needed. These measures are all aligned with the Europe 2020 Agenda for Smart, Sustainable, and Inclusive Growth with which Croatia will have to comply after accession.

Another crucial challenge and major priority for Croatia in the coming two–three years will be to create the fiscal space to absorb EU funds and avoid being a net contributor to the EU. Upon accession, the EU Structural and Cohesion funds available to Croatia will exceed €1.5 billion per year, but Croatia will be obligated to contribute about €600 million annually to the EU budget. Absorbing EU funds effectively and efficiently requires considerable preparatory work to ensure that projects are ready for the influx, and the funds can assist Croatia in such critical sectors as transport and the environment, and support job creation through innovation and the modernization of production. Despite the substantial effort involved, the new resources represent a significant and even historic opportunity for Croatia to confront and manage its many economic challenges as part of a strategy to reestablish a successful economic path.

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