World Bank Advises Croatia on how to Accelerate its Economic Recovery

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Prospects for Croatias strong recovery from recession and return to the pre-recession growth rates are slim unless the country vigorously moves forward in addressing the structural weaknesses of its economy, according to the World Banks new Public Finance Review: Restructuring Spending for Stability and Growth report.
The global financial crisis, coupled with a delay in the implementation of structural reforms, exposed the weaknesses of the Croatian economy, resulting in a prolonged recession in the country. Launched today with the Croatian Ministry of Finance, the Public Finance Review analyzes the key issues that are standing in the way of strengthening macroeconomic stability and of laying the foundations for a robust economic recovery.
Speaking at the launch, Mamta Murthi, World Bank Regional Director for Central Europe and the Baltic Countries , emphasized that, "We recognize the challenge that the Croatian authorities are facing in having to significantly reduce the fiscal deficit over a relatively short period of time during a prolonged economic downturn. At the same time, we strongly believe that this is achievable based on the experience of other EU countries, such as Sweden, the United Kingdom, Ireland, Germany, and Slovenia, all of which went through similar processes, most of them managing to mitigate the social cost of such adjustments.
Murthi pointed out that, "The spending review process that the Croatian government launched in October will help identify the appropriate adjustment path to putting public finances on a sustainable footing within the Excessive Deficit Procedure.
The new Public Finance Review launched today recommends that reducing the fiscal deficit and reversing the rising public debt through a restructuring of public spending, and creating the fiscal space for the absorption of large European Union (EU) funds would lay the ground for sustainable long-term growth.
At the launch, the Minister of Finance of the Republic of Croatia, H.E. Boris Lalovac emphasized that, "the Government of the Republic of Croatia brought a Decision on the implementation of the spending review that aims to reduce total public expenditures, while at the same time increasing the efficiency of public spending, and mitigating possible negative effects on the current level of public services in the country. The Decision foresees a package of measures which will bring about a reduction of expenditures in the amount of 10 percent, compared to 2014, in each of the defined categories, including: central government wage bill, subsidies, the health sector, operational costs of agencies and tax expenditures. In the context of the fiscal consolidation process and limited financial resources, the Government of the Republic of Croatia is working on strengthening the institutional capacities and creating the required fiscal space for efficient use of EU funds, to boost economic recovery in Croatia.
According to Sanja Madzarevic Sujster, Lead Author of the Public Financial Review and World Bank Senior Country Economist for Croatia, "Debt sustainability analysis suggests that a fiscal adjustment of 4 percentage points of GDP will be needed over the medium-term. This adjustment would need to be, predominantly, through expenditure measures that would not only reduce the fiscal deficit and the public debt to sustainable levels, but also improve the efficiency of the public sector. The adjustment would also create the fiscal space of 1.8 percentage points of GDP per year needed for the efficient and productive use of EU funds.
For Croatia to make this adjustment, the Public Finance Review recommends:
Maximizing the Efficient Use of EU Funds:
During 2014-2020, Croatia will have access to EU funds averaging 3.7 percent of gross domestic product (GDP) per year. At the same time, Croatia will need to create fiscal space to transfer around 1.8 percent of GDP of its revenues to the EU budget per year during 2014-2020, and to secure funds for pre-financing and co-financing of EU-funded projects. Efficient and strategic use of EU funds can help with recovery in the short-term, and increase the long-term growth potential of the country.
To improve the usage of EU funds, the report recommends:
- integrating budget procedures for EU funds into the national budgeting system;
- enhancing the institutional capacity of agencies to absorb EU transfers, specifically at the local government levels;
- improving project preparation; and
- learning from the experience of other EU member states.
Creating Revenue:
With the revenue burden already close to 42 percent of GDP, which is relatively high compared to other EU countries at a similar level of income, there seems to be limited scope for creation of additional revenues.
However, the report argues that, in fact, there are opportunities to create revenue by, among others, modernizing the countrys property taxation; broadening the tax base by removing some tax exemptions; and reducing the high levels of social contributions, such as the health insurance contribution, in order to promote growth and jobs. For example, a modern property tax could add up to 1.5 percent of GDP in new tax revenues. In addition, business and government could benefit from further simplification of the tax system and from strengthening the Croatian Tax Administration (CTA) to promote compliance. These measures could raise additional revenue of 2 percent of GDP per year.
Streamlining the Government:
Croatia spends more on public administration than the new EU member states; however, it has relatively weak performance in terms of effectiveness, rule of law, and administrative barriers to doing business. The public wage bill is close to 12 percent of GDP, with a tendency to increase further due to further decentralization, creation of new agencies, and the need to build additional capacity to absorb large EU funds.
The report recommends that some 2 percent of GDP in savings could be made over the medium-term through staff rationalization in local and national governments, and through a wage system reform to create a leaner, yet more effective and service-minded public administration.
Improving the Efficiency and Equity of Social Spending:
Croatia can achieve similar or better results in its social sector with lower and more targeted social spending. The urgency to reform the sector comes from short-term fiscal pressures and long-term aging, and its consequences on the demand for social services.
Some 2-3 percent of GDP in savings could be achieved over the medium-term if the most inefficient programs are discontinued or rationalized and targeting improved. In particular, the report highlights the need to reform:
- the health system, which is consuming 9 percent of GDP, compared to about 5.4 percent in the new EU member states, and reallocate funds for long-term care;
- the pension system, which needs to address the rapidly aging society and low labor participation; and
- the relatively generous social protection system, which needs to be better targeted and based on needs rather than categories, while providing incentives for people to look for work instead of relying on social benefits for their existence.
Rationalizing Subsidies:
Subsidies account for 2 percent of GDP in Croatia - double the amount of subsidies in all other EU members. However, there is little evidence that they helped improve the performance of the recipients, especially in railroads and agriculture.
Analysis shows that there is significant room for rationalization, with potential savings of around 1 percent of GDP if the most inefficient subsidies are reduced or abolished. This would also create opportunities to provide state aid to growth-making sectors, such as research and development (R
D). Sectors such as rail and agriculture have the opportunity to, instead, make use of large EU funds that could help them improve efficiency, and increase their competitiveness and overall performance.
Since joining the World Bank in 1993, Croatia has benefited from financial and technical assistance, policy advice, and analytical services provided by the global development institution. To date, the World Bank has supported 53 operations amounting to around US$3.5 billion, and approved 53 grants with a total value of US$70 million.

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