Subject: Letter of Development Policy
Croatia: Second Economic Recovery Development Policy Loan

Dear Mr. Kim,

We appreciate the opportunity to call for the World Bank support for the implementation of Croatia’s economic reform agenda. On behalf of the Government of the Republic of Croatia we kindly request the endorsement of the Second Economic Recovery Development Policy Loan in the amount of EUR150 million as jointly developed with Your staff, and incorporated in the Government Economic Program from 2013.

Before the crisis Croatia enjoyed strong economic growth at above four percent which resulted in historically low unemployment rates and rapid convergence with the European Union (EU) in per capita income terms. However, since the onset of global crisis Croatia has lost over 12 percent of its pre-crisis output. As foreign capital inflow declined, a release of both domestic and foreign currency liquidity, accumulated before the crisis, secured adequate liquidity buffers for banks, which coupled with the increase in ensured deposits, preserved confidence in the financial sector. The expansion of public expenditures during boom years and revenue underperformance at the crisis onset, however, resulted in sharp deterioration of the fiscal balance. This prompted the Government to introduce some politically and socially painful measures which the Bank recognized through the approval of the Economic Recovery Development Policy Loan in 2011.

With the estimated GDP contraction of 1 percent in 2013 and rising unemployment rate (at 17 percent in 2013), the recession continued for five consecutive years. The EU recovery has had little spillover effect on the local economy as yet. Net exports contracted and along with the drop in disposable incomes contributed to further output decline. To ensure public finance stability the government has adopted several measures in 2012 and 2013 aiming to improve tax compliance and collection of tax arrears, as well as increased the general VAT rate from 23 to 25 percent from March 2012. From January 2013, it instituted two new VAT rates of 10 for tourist services (which was from January 2014 raised to 13 percent) and 5 percent for basic foodstuff, pharmaceuticals, books and cultural services, abolishing at the same time the zero VAT rate. On the expenditure side, the Government abolished various public sector bonuses and privileged pensions for government and parliamentary officials, cut public sector wages by 3 percent, and reduced public investments. To support job creation and ease living standard costs, the Government relaxed employers’ contribution for mandatory health insurance by two percentage points from July 2012. To protect the living standard of the elderly, after liberalizing energy prices in July 2012, the Government restored the regular indexation of pensions. Aware of the urgent need to support corporate sector recovery, the Government amended the corporate income tax to reduce the taxable base for the amount of reinvested profit, reduced water and forest non-tax fees applied on corporate sector, introduced pre-bankruptcy settlement procedure into the Croatia’s bankruptcy framework, and has accelerated the privatization process of large state-owned companies.

As part of the 2013 European Semester, which Croatian Government voluntarily decided to participate in, the 2013 Economic Program of Croatia was submitted to the European Commission in April 2013. Reorienting the
economy towards exports and productivity-based growth requires structural changes in public finances, social sectors, education, innovation, privatization policies and business climate that the Economic Program proposes to address over the medium term. The initial boost to growth is, however, expected from public investments in potentially high new value added areas. To be funded primarily through EU Structural and Cohesion funds and PPP arrangements, these investments primarily refer to environmental protection, transport, water sector, entrepreneurial and scientific research infrastructure and energy sector. To promote new investments, we have adopted the Act on Investment Promotion and Improving the Investment Climate which positions Croatia as an attractive investment location in the region. In parallel, we are working on reducing administrative barriers for investments and some early recognition came from the World Economic Forum which improved Croatia's rank on the Global Competitiveness Index as well as from the Doing Business in 2014 report which recognized five administrative reforms undertaken in 2013 which will improve business climate in 2014.

However, we have recognized that growing public debt that reached 64 percent of GDP in November 2013 and the costs of its financing are becoming detrimental to growth. After initial consolidation effort in 2012 when we reduced consolidated general government deficit to 5.0 percent of GDP from 7.8 percent in 2011 (based on the ESA95 methodology), in 2013 public deficit grew again to 5.5 percent of GDP. Despite reduction of non-interest spending, a 0.5-percent of GDP in additional interest payment and a one-month loss of VAT revenues of 0.4 percent of GDP as Croatia entered the EU internal market were difficult to offset.

We are stepping up the consolidation effort under the Excessive Deficit Procedure with the EU. This medium-term fiscal strategy is built on the plan to reduce general government deficit down below 3 percent by 2016 by reforming social welfare, health care, and pension systems, strengthening public spending efficiency and rationalizing public administration. To that extent, we have amended our 2014 budget in March 2014 to reduce deficit to 4.5 percent of GDP. The fiscal consolidation effort will be significant as we are also obliged to pay 1.1 percent of GDP into the EU budget in 2014. To that extent, in December 2013, the Government adopted a set of long and short-term measures underpinning fiscal consolidation. Those include rationalization of supporting services, outsourcing, centralized public procurement, further social system reform, hospital and school network rightsizing, judicial system rationalization. At the same time Government will support a comprehensive Investment Plan for 2014 that comprises private and public sector investments funded either through the EU funds or private financing.

After joining the EU in July 2013, the new strategic goal of the Government is the successful integration within the European market. This would require setting up a sustainable macroeconomic framework in the short-term, as well as undertaking a program of structural reforms that would enhance country’s competitiveness. This letter summarizes crucial aspects of our program focused on enhancing fiscal sustainability through expenditure-based consolidation, and strengthening investment climate. These measures should not be looked at in isolation of other parallel efforts we are forcefully pursuing to meet the Europe 2020 targets such as: (i) judicial reform and anti-corruption efforts; (ii) strengthening education outcomes to avoid skill mismatches; and (iii) adopting effective framework for green-smart growth. We believe that this development loan provides the appropriate tool for the Bank’s support in addressing our medium term policy and institutional reform agenda as described below, whereby we count on the World Bank as a partner.

Enhancing Fiscal Sustainability through Expenditure-Based Consolidation

Croatia’s Ministry of Finance invested substantive efforts over the last few years in strengthening fiscal discipline through the adoption of several formal and informal fiscal rules. These range from: (i) a formal ceiling on the public debt (without guarantees) to GDP ratio at 60 percent; (ii) a mandatory fiscal impact assessment ex-ante approved by the Ministry of Finance; (iii) mandatory enactment of the three-year rolling budget; and lastly from 2011, (iv) the expenditure rule through the Fiscal Responsibility Act that seeks the reduction of general spending to GDP ratio by one percentage point of GDP per year until the primary balance is reached. While in 2012 the expenditure-based consolidation led to enforcement of the fiscal rule, the prolonged recession made the enforcement of the expenditure-based rule hard to achieve.

Through the Amendments to the Fiscal Responsibility Act from January 2014 we have harmonized the fiscal rule with the Stability and Growth Pact rule that seeks achievement of the structural balance and compliance with the Maastricht criteria. In the near term, we aim to achieve deficit and debt targets through the Excessive Deficit Procedure approved by the Council. We have also strengthened the role and independence of the Fiscal Board, our fiscal watchdog. Through the Parliament's Decision from December 2013, we have expanded the competences of
the Fiscal Board as a professional and independent committee within the Parliament, whose members are appointed by the Croatian Parliament. The Fiscal Board will thus have a surveillance role over the implementation of the Fiscal Responsibility Act. These acts transpose the Council Directive 2011/85/EU on requirements for budgetary frameworks of the Member States that stipulates the obligation of effective and timely supervision of alignment of the implementation of the fiscal policy and fiscal rules and the macroeconomic and budgetary projections by independent bodies.

To support expenditure-based consolidation and enhance efficiency of public administration, we have focused on rationalization of the public sector wage bill. In late 2012, we have renegotiated collective agreements with several bonuses (holiday and Christmas bonuses, as well as the transportation allowance) being rationalized. In March 2013, we have also reduced the basic wage for civil and public servants by 3 percent. As the central payroll system (supported by the ERDPL1) got deployed across civil and some public services in 2012 and 2013, large wage setting differences across public sector were discovered. Through the adoption of the Decree on job classification and job coefficients in public service in February 2013 we have fully harmonized wage systems of government agencies with civil service and public service. These measures are saving around 0.3 percent of GDP in 2014 in terms of wage costs.

To strengthen efficiency of health financing and comply with the EC Directive on eradication of payment arrears in commercial contracts (2011/07/EU), health sector arrears (amounting to 1.1 percent of GDP at end-2012 defined as all payments due beyond 60 days) had to be cleared. The state budget stepped up its allocation for health sector with the parallel commencement of the hospital network financial and operational restructuring (also enabled by the Law on Rehabilitation of Public Institutions from October 2012). To stem spending rise and further reduce the overall health debt, we have continued with taking additional efficiency measures such as: (i) national implementation of e-prescriptions and e-referrals from July 2013 through the Bylaw on Criteria for Distribution of Pharmaceuticals and Prescription Issuance; (ii) standardization and classification of medical equipment and orthopedic devices from April 2013 through the Bylaw on Amendments to the Bylaw on Criteria for Inclusion of Orthopedic and Other Medical Devices on the List of Supplies of the Croatian Health Insurance Fund; and (iii) central procurement for hospitals from March 2013 through the Ministry of Health’s Decisions on the Mandatory Implementation of Central Procurement by Public Institutions. Central procurement for hospitals for medical products, medicines, food, fuel, electricity, post office, telephone costs etc. launched in early 2013 brought annual savings of close to 0.1 percent of GDP.

In 2014, we plan to further tighten control of sick leave spending; continue with the pharmaceutical reference pricing revision; and finalize the National Hospital Master-Plan which is looking into the rationalization of the hospital network and of the hospital activity; reduction of the number of beds for acute cases; setting up efficient day-care service and most cost efficient long-term care. The implementation of the new hospital network is expected in 2014.

To address complexity and administrative inefficiencies of the social welfare system, the Government, during 2013, implemented a full deployment of an integrated MIS in the Centers for Social Welfare. A unique personal identification number, used to facilitate data-matching and to reduce the burden of documentary evidence by applicants, has been applied in the vast majority of government agencies and institutions collecting relevant data for the application of the means-testing procedure. Through the new Social Welfare Law from December 2013 we aim to improve social welfare system efficiency as well as effectiveness through: (a) a strengthened list of asset filters; (b) incentives for activation; and (c) the application of these new set of means-testing criteria to the Guaranteed Minimum Benefit (GMB) which replaces four programs currently administered by several line ministries (including the war veterans’ ministry). The act harmonized means-testing rules and procedures, consolidated the number of programs, reduced administrative complexity and cost, as well as reduced the scope for fraud and error. The activities on reducing error and fraud have already been underway leading to exclusion of some 15 percent of ineligible beneficiaries from the GMB. However, we are aware that the current budget allocation for GMB (at 0.2 percent of GDP) renders it low to effectively address consumption poverty that increased to 18 percent by 2012.

We are considering further plans to apply means-testing to other social benefit programs, like family programs, as well as non-insurance based benefits, and thus through improved targeting, we hope to be able to increase the budget for the most vulnerable part of the society. The Government plans to adopt the Strategy for Fighting Poverty and Social Exclusion in April 2014 which aims to eradicate poverty by supporting life-long learning and vocational
education, employment measures and ALMP, housing and energy efficiency measures, access to social protection, health and long-term care services, as well as improving financial literacy and access to finance.

To improve equity and financial sustainability of the pension system, as indicated in the Government Program, we have abolished privileged pensions of Government officials and MPs in January 2012 through the Act on Amendment to the Law on Rights and Duties of the Members of the Croatian Parliament. While the measure did not have important fiscal impact, it nevertheless had an important demonstration impact on improving equity in the pension system. We have followed with the rationalization of the list of military, customs and police forces occupations subject to early retirement with extended service period in August 2012 through the Act on the Amendment to the Law on the Pension Insurance Rights of Military, Police and Other Authorized Persons. Furthermore, we have reduced privileged pensions above HRK5,000 by 10 percent through the amendments to the Law on Reduction of Special Pensions in December 2013. This would generate around 0.13 percent of GDP in savings for 2014.

In December 2013, we have enacted the Obligatory Pension Insurance Law which increased the retirement age to 67 by 2038. Through the enactment of the Act on Obligatory Pension Funds in February 2014, we are further reducing administrative costs in funded pension pillars.

Strengthening Investment Climate

The Government Economic Program recognizes that there is a need to refocus the role of the Government from the lender of the last resort to a provider of an enabling environment for private sector growth. To that end, it focuses on cross-cutting structural reforms like improving investment climate, increasing labor market flexibility, divestiture of non-strategic assets, and strengthening innovation and research framework, which all aim to improve total factor productivity.

With a goal to increase labor market flexibility and incentives for labor force participation, we have embarked on the comprehensive overhaul of the labor legislation. Labor market conditions further worsened during the last two years with unemployment rate reaching 17 percent on a rolling basis by September 2013. Only one person of working age (15-64) in two is employed, which is due not only to high unemployment, but also to the second lowest labor force participation rate in Europe. In 2012, the Parliament enacted two laws meant to improve labor market performance. First, the Law on Criteria of Participation in Tripartite Bodies and Representativeness for Collective Bargaining from July 2012 which abolished the unlimited duration of collective agreements and allowed for unilateral cancellation of agreement under the special conditions. The law allowed the Government to renegotiate collective agreements in the public sector so as to reduce numerous fringe benefits and bonuses granted to public sector employees. However, the implications of the Law are wider, and not limited to fiscal concerns as it rectifies some of the labor market rigidities resulting from the collective bargaining agreements that are currently binding, especially in the public sector. Second, the Law on Employment Incentives from May 2012 facilitated the formalization of seasonal employment in the agricultural sector. This has a potential to improve employment prospects of vulnerable worker groups (youth, women, low-skilled workers, long-term unemployed, disabled persons), for so called “mini jobs” facilitate labor market entry and can serve as a bridge to regular employment.

To enhance hiring, firing and the working hours’ flexibility, the Parliament enacted the amendment to the Labor Law in June 2013. The conditions and time limitation for the first fixed-term contract, which was limited to 3 years in the past, has now been liberalized. This enables employers to hire fixed-term workers for a period of longer than three years, but will simultaneously increase security of workers on successive fixed-term contracts. Successive renewal of fixed-term contract has a maximum duration of 3 years unless the contract is issued for the replacement of a temporary absent worker or for other objective reasons permitted by law or collective agreement. The working hours’ flexibility was increased, reducing restrictions on overtime work, which limited the ability of employers to adjust labor input to the cyclical/seasonal fluctuations in product demand. The firing procedures in case of collective and individual dismissals were simplified. In parallel, we have launched public consultations over the second stage of labor market reforms that would consist of, among else, a reduction of high dismissal costs. We plan to reach an agreement with social partners in early 2014. With these changes the OECD Employment Protection Legislation Index for Croatia would be reduced from 2.67 to 2.23.

Aiming to improve the investment climate and reduce administrative and regulatory barriers to business, we have focused on strengthening the bankruptcy and enforcement system, as well as improving the land
and business registration systems. Additionally, in October 2012, we have enacted the amendments to the Company Act making the business registration process cheaper and faster by introducing a new corporate form entitled “Simple Limited Liability Company” with minimum capital requirement of less than US$2 and simplified incorporation procedures.

Protecting investors and dealing with construction permits were still recognized as biggest obstacles to doing business. Thus, in December 2013, we enacted the new Law on Spatial Planning and the Law on Construction which abolished the location permit and introduced a single e-permit for construction. The aim is to speed up the process which from conceptual design to construction permit took from 6 months up to 2 years. As a first step the Government digitalized spatial plans defining strict zoning rules related to the type of construction and activities. The interactive digitalized approach enables obtaining location and construction conditions directly from the on-line system, while in more complicated cases the system refers the designer to specialized public bodies for opinion/conditions on construction of planned intervention which need to be rendered within 15 days. Only with the required approvals (either from the digitalized plan or authorized bodies) the designer applies for the construction permit opposite to past two-step approval—at the stage of location and construction permit. The requests could be submitted electronically with the mandatory response time within 30 days. The settlement of communal contributions is not a condition for obtaining the e-permit.

To reduce state involvement in corporate sector, the Government accelerated privatization process of state-owned companies. Over the last two and half years we have sold or liquidated 200 minority or majority state-owned companies. At end-February 2014, there were 571 companies with some form of state ownership, of which one-third is held under reservation until restitution claims are resolved, while additional 12 are pending liquidation. We are also pleased to report that privatization of state-owned shipyards was finalized in the first half of 2013 while the state-owned insurance company Croatia Osiguranje was privatized in March 2014. In parallel we advanced several strategic privatization processes including of the fertilizer producer Petrokemija, and the national air carrier Croatia Airlines. The government expects to earn around EUR250 mn (close to 0.6 percent of GDP) in those sales in 2014.

We aim to strengthen incentives for enhancing Croatia’s innovative potential and commercializing R&D. In July 2013, the Parliament adopted amendments to the Higher Education and Science Act addressing: (i) the performance-based financing of public universities and institutes; (ii) clearer procedure for the advancements in scientific and teaching ranks, discontinuing automatic promotions; and (iii) attracting and nurturing young researchers; and (iv) enhancing managerial autonomy for public research organizations. The amendments also established an expert strategic body for the defining national policies in science, higher education and innovations—the National Council for Science, Higher Education and Technological Development. These amendments are expected to help initiate the cooperation of public research institutions with private sector on technology transfer and commercialization of research results. Following the regulation and Europe 2020 R&D goals a number of strategies in the field of Science, Education, Technology, Innovation, Roadmap Infrastructure as well as Smart Specialization Strategy are being prepared. One of the main challenges in the course of this year will be the reorganization of public research institutes and the foundation of the first Croatian Scientific Centers of Excellence. In this way a strong boost to the transition from state management to state supervision of the scientific and higher education sector in Croatia will be achieved.

In closing, we are confident that this letter outlines a coherent program of critical policy priorities over the medium term. We would like to reiterate that the continued support of the World Bank will be essential for achieving these medium-term ambitious goals and hope that the World Bank will extend its support to the government EDP process through development policy operations in the future. We trust that this request for the World Bank support for the implementation of this reform program will receive your endorsement.

Yours sincerely,

MINISTER OF FINANCE

Slavko Linić