Statement by Michael Marek  
Date of Meeting: June 3, 1999  

CROATIA - Country Assistance Strategy  

OVERVIEW  

1) We appreciate the frank and accurate diagnosis of the challenges facing Croatia. The problems in Croatia are serious and deep-rooted, calling for a fundamental shift in the operating paradigm in order to achieve a market-driven economy. Addressing these challenges will require considerable political courage on the government's part and we expect the Bank to attach rigorous and meaningful conditions to its operations to achieve progress.  

2) We agree with the Bank's approach to re-assess the commitment to reform, and make programmatic adjustments as needed, after the election.  

3) While the diagnosis of challenges is accurately identified, the CAS itself does not present a clear road map of solutions. The studies that will be undertaken should help create that road map. We regret that many of these studies, especially the Public Expenditure Review, were not undertaken as building blocks to the CAS. This approach would have resulted in a targeted set of solutions for incorporation into more meaningful and rigorous CAS triggers and SAL conditionality.  

LENDING SCENARIO  

1) Current base-case triggers have essentially already been met or are actions to which the GOC is firmly committed with or without World Bank assistance. Without more meaningful advances, the lending program, particularly the proposed SAL, may implicitly sustain some of the very problems the Bank has identified, e.g., health and pension funds, state enterprises, directed subsidies, deposit insurance, public sector wages, and corruption.  

2) We note that the base case assumes a slowdown in reform after the election. This raises the
question of sustainability of Bank programs started before the election. We would appreciate staff elaboration on this issue.

3) The $200 million SAL I serves as the centerpiece of Bank assistance under the base-case. We expect it to carry more reform-advancing conditions than the CAS base-case triggers suggest and to have strong economic conditionality attached to each tranche.

4) At a minimum, the PER should be conducted prior to preparation of SAL I and we would like to review the results carefully before committing to a SAL. The PER should analyze the broad range of existing GOC unproductive spending, including unsustainable social spending and directed subsidies, and its findings should be incorporated into SAL I benchmarks.

Among the specific issues we would expect to be addressed in the PER are:

-- subsidies to elements in Bosnia-Herzegovina, including the Bosnian-Croat army (HVO), with a view toward their eventual elimination; international financial assistance should not underwrite these subsidies;

-- the size of the public sector, in particular implementation of plans for restructuring of the pension system and the health system;

-- privatization of key industries, including telecommunications, petroleum, banking, electrical power generation and distribution, and the hotel industry;

5) Given the potential for substantial budgetary support (SAL I and perhaps SAL II), we would also appreciate staff elaboration of the state of audit and fiscal controls in the country to ensure proper channeling of Bank resources. For example, has a Country Financial Accountability Assessment been performed, or will it be performed, prior to preparation of SAL I?

THE NEED FOR A COMPREHENSIVE REFORM PROGRAM

1) The challenges facing Croatia are interrelated and should not be addressed piecemeal. For example, judicial reform and administration of the VAT (22% VAT imposed on invoices, not receipts) feed into the arrears problem.

2) If Croatia is to develop a market economy, build domestic wealth, and attract foreign investment, it will have to improve its performance on privatization. The current privatization investment funds do not appear to exert the kind of influence needed for restructuring and attracting additional investment.

-- We generally support the IFC’s plans to engage in facilitation of privatization of infrastructure services. However, given that the telecommunications privatization already looks promising and is a sector that usually has little trouble attracting private investors in all but the poorest and least hospitable environments, we wonder why IFC believes it needs to play a role in the post-privatization restructuring of telecommunications; its value-added would seem greater...
in more difficult sectors.

3) The analytical work on social spending should come sooner rather than later given that government expenditures in this area are unsustainable and the upcoming SAL and IMF programs will entail cutbacks. Analytical findings should be integrated into the social protection project for FY01. We wonder whether it is planned in conjunction with the broad macro PER or as a separate sectoral PER.

4) Addressing poverty in a middle-income country means careful targeting of transfer payments and social sector spending. While economic and regulatory reform will make for a more vibrant economy, possibly the greatest long-term boon for the most vulnerable if attention is paid to equitable distribution, the interim policies being implemented now and under the SAL and IMF program need to be formulated so as to avoid having the most severe impacts disproportionately affect the poor and/or marginalized.

-- We welcome the plan to do a comprehensive poverty assessment. We hope this will lead to effective programs and greater client understanding of the role the Bank can and should play in addressing poverty in Croatia. We found it rather striking and somewhat disconcerting that the client survey revealed that poverty reduction was not perceived to be an important area of focus for the Bank.

5) We also welcome the proposal to do an environmental action plan and expect that the work will be undertaken in close consultation with a broad cross-section of civil society.

CULTURAL HERITAGE PROJECT

1) Lastly, we would like to flag concerns about the proposed Kastela Bay Cultural Heritage Project in terms of selectivity and its value-added to the Bank’s poverty reduction agenda. More generally, the sequencing of a cultural heritage project before projects for rationalizing social expenditures and judicial reform is inappropriate. The culture/tourism sector could benefit substantially from more general economic and governance reforms that would encourage private domestic and foreign investment.