The World Bank

EU10+1
Regular Economic Report

Croatia Supplement

December 2011

Key messages:

- Contagion from the market turmoil that has surged owing to renewed concerns about fiscal sustainability in Europe has increased the risk aversion and uncertainty. These events have pushed the cost of borrowing up and reduced capital flows to the region.
- The consequent plummeting of business and consumer confidence, coupled with fiscal austerity across the Eurozone and slow down in the global economy, will likely lead to a contraction in Europe in 2012.
- The Croatian economy is reliant on economic cycles of the EU and, therefore, has a significant probability of another contraction after positive growth in 2011. Uncertainties emanating from the international banking system and financial markets are major downside risks.
- A front-loaded expenditure-based fiscal adjustment is thus a priority for Croatia to alleviate refinancing risks and protect the investment credit rating. The 2012 outlook for Croatia hinges on the implementation of a credible reform agenda. The country needs to enforce the fiscal responsibility act and reduce the fiscal spending and deficit. While all EU10 countries are tightening their fiscal positions in response to tightened financing and to re-build buffers, the general government fiscal deficit in Croatia will likely increase for the third consecutive year in 2011.
- In addition, Croatia needs to proceed with structural reforms to enhance productivity and thus competitiveness of the economy so that it is in a position to take advantage of the eventual global recovery. Structural reforms underpinning the expenditure adjustment will need to be implemented in early 2012 to have a full effect in 2013. These reforms need to address the efficiency and sustainability of the public sector wage bill, pension, health and social benefit systems.
- On the revenue side, introducing a modern property taxation system, rationalizing quasi-fiscal fees and improving tax collection could help reduce pressures. In 2012, there will be no fiscal space for tax rate cuts. The acceleration of privatization and the resolution of insolvent and illiquid companies would help reduce budget financing pressures.
- Unemployment in Croatia remains high: 60 percent higher than before the 2008 crisis. Since 2008 the industry alone has lost around 38 thousand jobs, while construction and trade sectors have downsized by another 65 thousand jobs. About two thirds of the registered unemployed have been jobless for more than a year, which negatively affects their re-employment chances. The reform of labor regulation, retraining and horizontal business-sector support could reduce pressures on the labor market.

External Environment

The 2011 has not quite turned out as expected. The external environment has been more challenging than hoped for, especially in the second half of the year. Growth of the global economy is losing momentum, and the expansion in EU is coming to a halt, as the sovereign debt crisis continues to jumble financial markets.

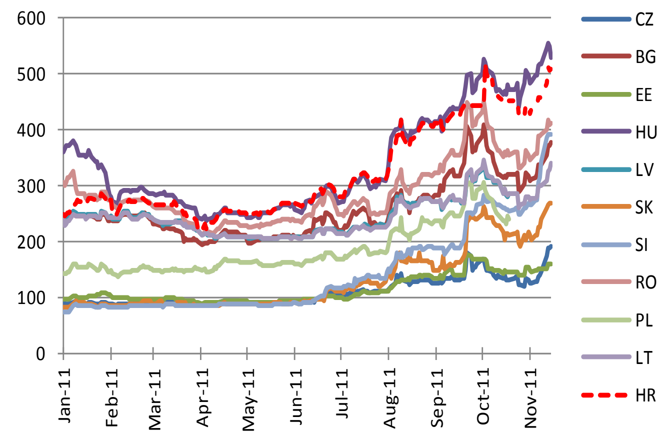
Growth is slowing across Europe, dampened by the crisis in parts of the euro area and worries about the global economy. Prospects are not only weaker, but also more uncertain. Downside risks to the growth outlook have increased significantly and the EU10 countries and Croatia might likely see another contraction in 2012. With around two-thirds of their exports going to the EU, and around four-fifths of banking assets in foreign ownership, recent European and global tensions make adverse shocks more likely. In particular, the loss of confidence in sovereign debt and in the banking sectors' asset sheets in the euro area could make investors more risk averse and spread to the EU10 region and Croatia.

Table [1]. Growth performance, percent

	2010	2011
Croatia	-1.2	0.5
EU10	2.1	3.0
Bulgaria	0.2	2.0
Czech Republic	2.2	2.1
Estonia	3.1	7.6
Latvia	-0.3	4.0
Lithuania	1.3	5.8
Hungary	1.2	1.7
Poland	3.8	4.0
Romania	-1.3	1.5
Slovenia	1.4	1.3
Slovak Republic	4.0	3.0

Source: National statistical offices, World Bank staff calculations

Figure [1]. 10Y CDS spreads for EU10 countries and Croatia, basis points



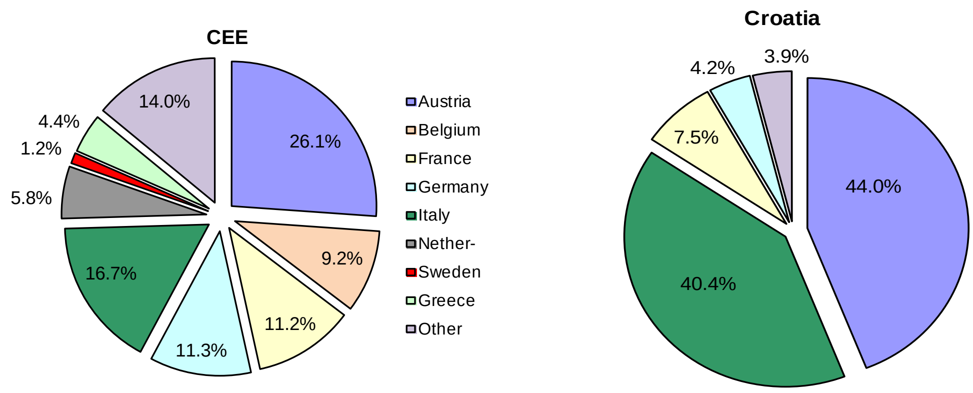
Source: Reuters, Bloomberg, own calculations

The volatility of sovereign credit default swap spreads remains high in line with fragile market sentiment. The risk perception of the EU10 countries was remarkably robust in the face of sovereign debt concerns in the euro area early in the year. However, the latest phase of euro area turbulence has triggered concerns throughout the region. Nevertheless, markets have continued to differentiate across countries, with spreads of some countries above 500 bps (including Croatia) and some below 200 bps (Czech Republic and Estonia). Spreads of major European banking groups operating in the region have increased over the last six months as well. The sovereign debt crisis in some euro area countries have made the roll-over of wholesale funding more difficult for credit institutions, especially as governments compete with banks for scarce financing.

In a severe tail-risk event affecting the entire euro area, the EU10 and Croatia could face financial distress despite improved capital and liquidity positions of the financial sector. However, liquidity support from the ECB and national central banks, support schemes from governments, and measures from host supervisors could limit the spillovers. Nevertheless, in such a scenario, European banking groups could still scale back their exposures to subsidiaries in the region over time, slowing down credit growth. The policy challenges for these countries entail preparing for such risks and boosting sustainable long-term growth. This will include supportive monetary policy, bolstering financial sector resilience, strengthening the fiscal framework, and advancing structural reforms.

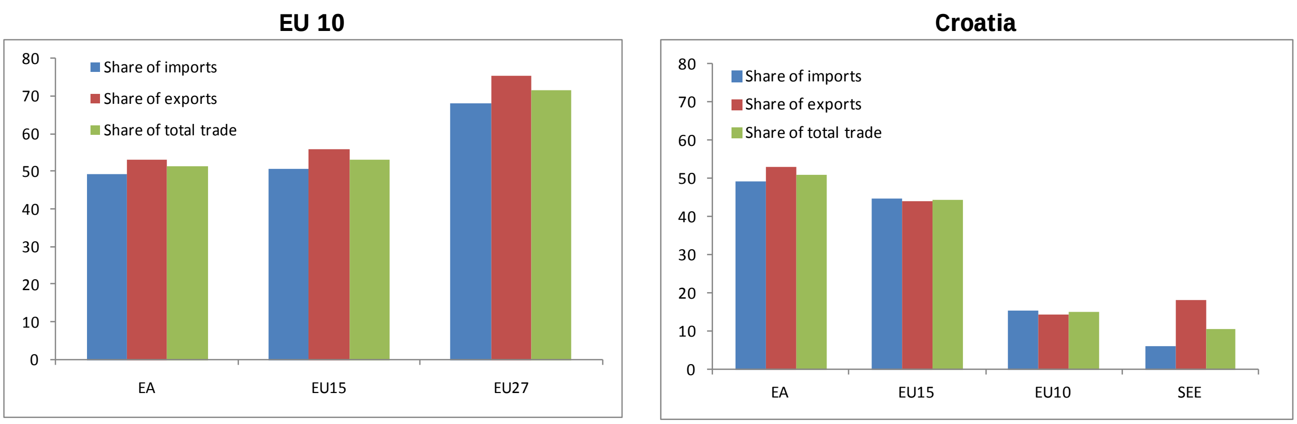
The principal channels of contagion between the euro area and the region are trade and financial flows. While the EU10 countries and Croatia make up less than 1/10 of the EU's 2010 GDP, the wider euro area constitutes their largest market -- over half of the total trade. Germany is their most important trading partner. The euro area is also the source of around 4/5 of the FDI flows into the region. The banking sector is another channel of transmission, with almost 80 percent of assets in the banking system being foreign-owned, and overwhelmingly so by euro area banks. The financial contagion would be transmitted mainly via this foreign-owned component of the banking system, as direct exposure to stressed euro area sovereign assets by the domestic banks is negligible.

Figure [2]. Geographic Breakdown of Foreign Claims in the Banking Sector



Note: CEE denotes Central and Eastern Europe
Sources: BIS, own calculations

Figure [3]. Geographic Breakdown of Foreign Trade, January-September 2011



Sources: Eurostat, Crostat, own calculations

Recent Developments and Future Prospects

Output

Average EU10 and Croatia growth improved by about 6 percentage points from 2009 to 2010 and surpassed the EU15 growth of 1.7 percent in 2010. However, the pace of the recovery differed across EU10 countries and Croatia, reflecting, among other factors, the overheating prior to the crisis, trade openness and competitiveness.

Croatia's output started recovering in the second quarter of 2011. The first half of the year thus observed a stagnation with domestic demand still on decline (–0.7 percent year-on-year). Consumption growth of 0.3 percent was insufficient to offset the decline in gross investments (by 3.3 percent y/y). Government consumption increased only marginally in the first half of the year, with a strong rebound in Q2 only. Real exports of goods and services went down both year-on-year and relative to the previous half-year period. Both the balance of payments data and indicators of export prices suggest that this fall was due to a sharp contraction in goods exports. By contrast, exports of services, notably tourism, recovered. However, the contribution of foreign demand to growth increased by 0.8 percentage points. In Q2 construction and agriculture were still on decline, while by contrast, in Q1, value added declined in all activities except traffic, communications and industry. While net indirect taxes cushioned the output fall somewhat in 2010 — suggesting that the informal economy remains high — they remained flat in the first half of 2011.

Figure [4]. Contributions to annual GDP growth, expenditure side

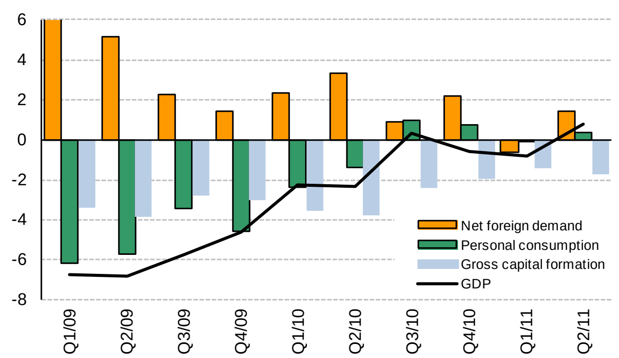
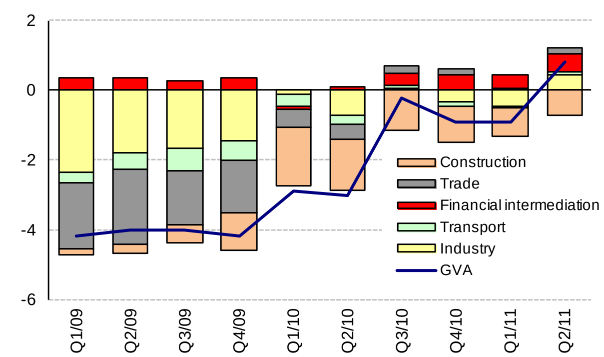


Figure [5]. Contributions to annual GDP growth, production side



Source: CROSTAT, own calculations

Economic activity has been moderating in the second half of 2011, dampened by the crisis in parts of the euro area and worries about the global economy. Preliminary calculations show GDP growth of 0.6 percent y/y in Q3 2011. Confusingly, robust growth of exports of goods and services did affect the industrial output and retail trade. Industrial production contracted by 1.7 percent y/y in the first nine months in 2011 even though new orders of industrial products rose by over 15 percent y/y. Real retail sales rose by only 1.4 percent y/y in Q3 2011, despite tourism data pointing to a record season with annual growth in tourist nights and arrivals by 5.8 and 7.0 percent, respectively. Construction activity is likely to have hit the bottom of the cycle in the first half of 2011, but still does not show signs of pick up with a cumulative fall in the first eight months of 2011 by 10 percent y/y.

The business sector financial indicators as well as the increased profit tax revenues suggest better performance of the economy than high frequency indicators indicate. Over the first nine months of the year, revenues of business entities rose by 7.1 percent y/y, while profits grew by 39.4 percent y/y. Even the profit tax (pad on the last year's profit) revenues rose by 16 percent y/y in the first nine months of 2011. The statistical data and underreported income make it difficult to assess the real economic performance of the economy.

Figure [6]. SA Retail trade (2005=100) and VAT

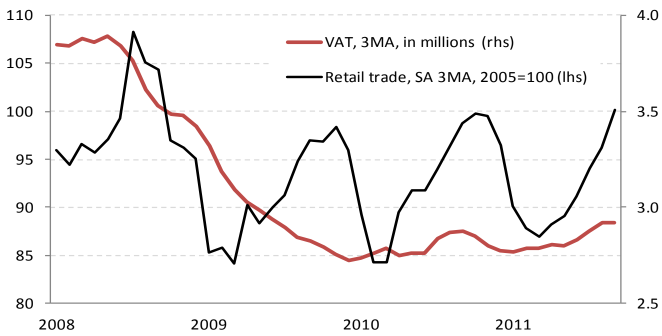


Figure [7]. Industry components, rolling annual growth rates, in %

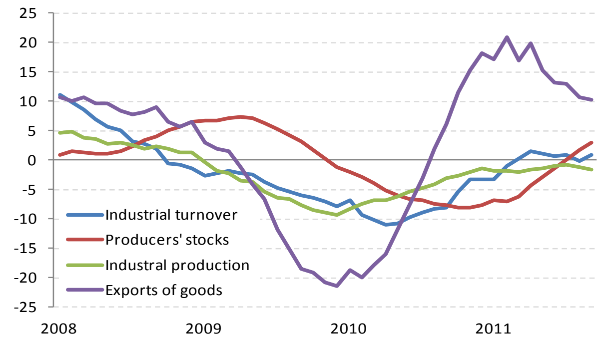


Figure [8]. Nominal retail trade, growth rate, and Tourist nights, rolling annual growth rates, in %

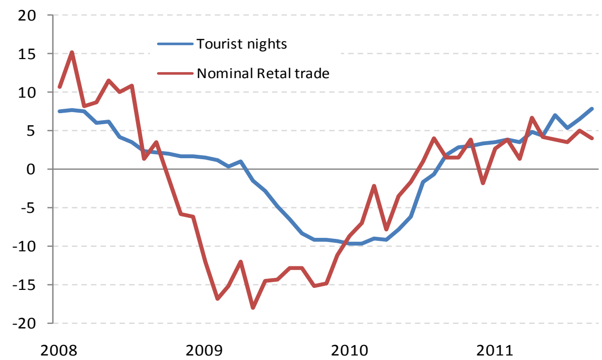
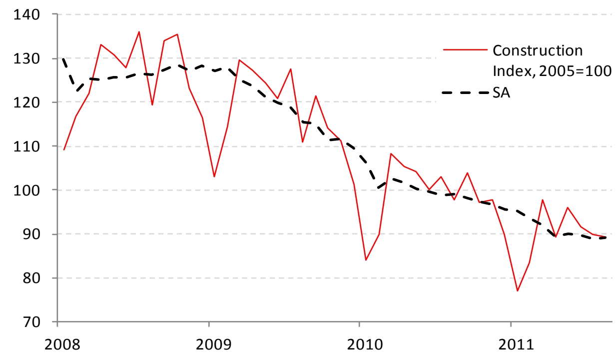


Figure [9]. Construction, 2005=100, original data and seasonally adjusted



Source: CROSTAT

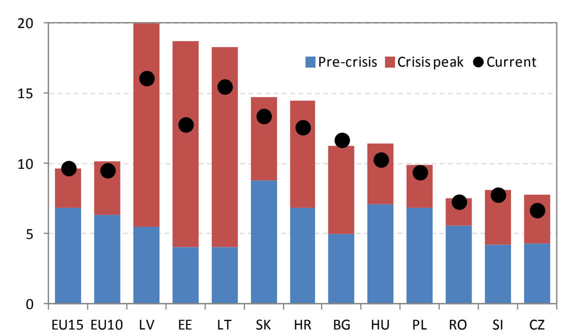
The expected euro area slow down and still depressed investments and personal consumption will likely lead Croatian economy into another recession in 2012. Uncertainties emanating from the international banking system and financial markets are the major downside risk to growth. Risk aversion, as seen in mounting CDSs, has driven the financing costs up and delayed decisions on investments.

Labor market

The economy remains too sluggish to create jobs in most countries in the region. Unemployment remains stubbornly elevated. Job market conditions remain especially difficult for workers with low education and little work experience as well as long-term unemployed. Wage pressures remain subdued across the region.

The delayed recovery in Croatia negatively impacts labor market conditions. Although the unemployment has declined below its crisis peak, it remains stubbornly high in Croatia, as well as in EU10 and EU15 countries. Total registered employment fell by around two percent in 2011, with the active population shrinking by more than one percent from already low levels. The labor force participation rate remains low in Croatia, with only 58 percent of the population (between the ages of 20 and 64) working.

Figure [10]. Harmonized unemployment rates, percent



Source: EUROSTAT

Box [1]: Employment Protection Legislation and Labor Market Outcomes

Substantial labor market gains can be expected if Croatian labor regulations are revised to create a more dynamic labor markets by ensuring labor force flexibility and job security. Relaxation of labor legislation across the best performing OECD countries (e.g., Sweden, Denmark, and Belgium) has led to better employment prospects, shorter spells of unemployment, less informality, and higher productivity and ultimately incomes. This involves moving from protecting jobs to protecting workers—an idea known as flexicurity.

Key recommendations to accomplish this are as follows:

☐ To encourage job creation and hiring after the crisis Croatia needs to reduce the cost of hiring and firing, which are higher than in most OECD countries. Otherwise, unemployment is likely to stay at an elevated level. Current hiring and firing costs negatively affect employment chances of the unemployed and new labor market entrants, which leads to lower employment and a longer duration of unemployment.

☐ Dismissal costs need to be lowered to encourage job creation and hiring. This could be done by: (i) removing the requirement that fixed-term contracts can be used only on an exceptional basis (a specific task or the occurrence of a specific event); (ii) relaxing conditions for lawful dismissal when some individuals and some categories of protected workers need to be dismissed for business reasons; (iii) relaxing the conditions for collective dismissal (consultations with the workers' council on a detailed redundancy social security plan and its approval by the employment bureau).

☐ Wage rigidities need to be addressed to promote adjustment of wages rather than employment as the labor demand falls. Collective bargaining agreements are an important source of wage rigidities and they need to be more flexible. This can be achieved by providing the possibility to cancel the collective agreement concluded for a definite term, and by limiting the extension of an expired agreement to a maximum of six months.

Source: Labor Policy Note, www.worldbank.hr

The private sector has borne the brunt of the crisis -- since the beginning of the crisis, public sector employment increased by some 7,500 people, while private sector employment decreased by around 10 percent or some 115,000 people. The industry alone lost around 38,000 positions, while construction and trade sectors downsized by 39,000 and 26,000, respectively. However, the informal sector cushioned the adverse employment impact somewhat. Croatia's registered unemployment rate stood at 17.4 percent in October 2011, down by 0.4 percentage points over October 2010, while according to the latest survey-based data, the unemployment rate stood at 13.5 percent. Still, the number of unemployed is currently about 60 percent higher than before the crisis. About two thirds of the registered unemployed have been jobless for more than a year, which negatively affects their re-employment chances.

Figure [11]. Registered and Survey-based unemployment, in thousands

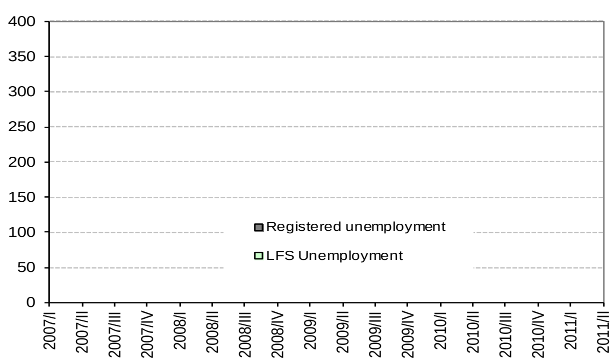
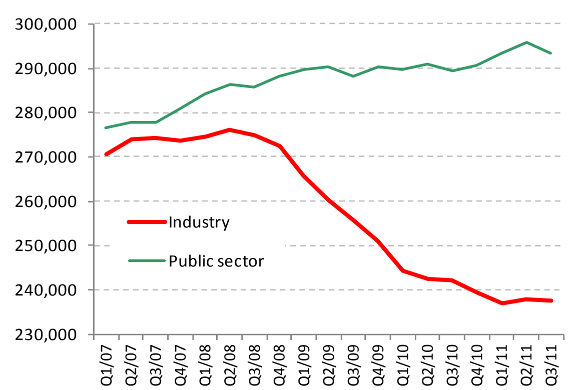


Figure [12]. Registered employment in Industry and Public sector



Source: Croatian Employment Bureau, CROSTAT

Up to October 2011, outflows from unemployment to jobs were 32 percent higher than a year earlier. The growth in labor demand was widespread in the industry, trade, tourism and construction. In addition, more than 27 percent of people were erased from the registry of unemployed, either because of their exit from the labor force or non-compliance with labor regulations. Of these, around 27,000 people were erased from the registry because of retirement, creating further pressures on already unsustainable system dependency rates. With 38,300 new retirees in 2011, system dependency rate fell to 1.21, i.e. one pension is financed by 1.2 workers. At the same time, the number of newly registered unemployed increased by 7.2 percent y/y, although the number of unemployed dropped by 3.5 percent y/y.

Box [2]: Policy Options for Further Pension System Reform

The pension insurance system needs a comprehensive overhaul to ensure long-term fiscal and social sustainability as the population ages and fiscal pressures increase. With first pillar PAYG expenditures inflated (at 10.6 percent of GDP), Croatia's current pension system also faces the challenges of worsening demographic rates, low labor participation rates, low and declining replacement rates, inadequate pensions for multi-pillar cohorts, large cross-cohort differences in pensions, and overly generous special schemes.

Given the high general government deficit and rapidly rising public debt, the government aims to achieve a primary budget balance in the medium term. The reform options therefore need to be balanced with the pressing fiscal consolidation needs. To tackle this, consideration needs to be given to reforms which aim to: (i) reduce special pension benefits and align them with the general pension system; (ii) switch to wage valorization and price indexation; (iii) eliminate early retirement; (iv) raise the retirement age; (v) reduce second pillar administrative costs by restructuring fees and sharing the cost of collecting contributions with the companies that manage mandatory pension funds; and (vi) reduce the fiscal impact of the 2007 supplement. Although simulations show that these measures would yield savings, by 2028 they would not be sufficient to cover the entire net-of-mandatory-transfers deficit.

Delaying a rise in the second pillar contribution rate would negatively affect future multi-pillar replacement rates and burden future generations with an even larger problem. An alternative would be to increase the pension contribution rate to support the lost revenues due to transition cost. However, the higher the contribution rate, the higher the labor cost, the lower the competitiveness, and the larger the shadow economy. This should therefore be considered a measure of last resort. Finally, options for protecting a fall in replacement rates for current pensioners and PAYG-only participants should be discussed only when the fiscal space would allow such interventions.

Source: Pension Policy Note, www.worldbank.hr

Figure [13]. Employed from the Register

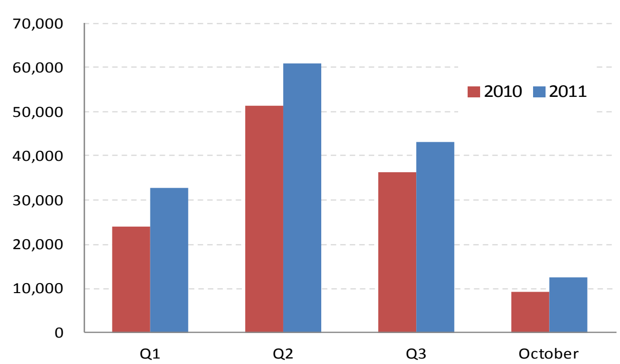
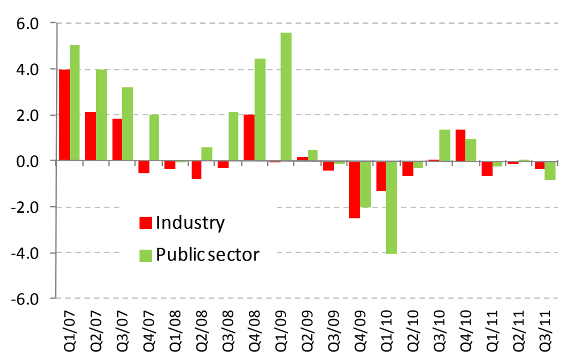


Figure [14]. Average real net wage in public sector and industry



Source: Croatian Employment Bureau

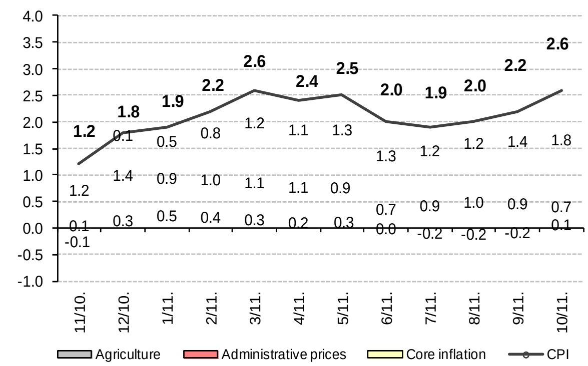
The unit labor costs have continued to decline in 2011. This has been due to favorable movements in labor productivity, which has continued to grow faster than gross wages. As prices have increased, the real unit labor costs have continued to fall, easing the cost pressures on inflation. The first ten nine saw an increase in real net wages, which, coupled with movements in employment, prevented a further fall in the real net wage bill. The labor productivity slowed down to 2.5 percent y/y in January-September 2011, following increases above 3 percent in the months before. Labor productivity went up in manufacturing, where it grew by 3.1 percent y/y, as well as in mining and quarrying, where it was up by 12.6 percent y/y. At the same time, productivity in electricity, gas, steam and conditioning supply dropped by 4.9 percent y/y.

Inflation and monetary policy

With an easing of international commodity prices, a slowdown in growth and monetary policy tightening in some countries, inflation started to moderate in the second half of the year. However, the renewed volatility in euro area financial markets has led to depreciation of several currencies in the region.

Inflation rose by 2.6 percent by October 2011. The boost of consumer price inflation was driven by core inflation, which started picking up after the beginning of 2011. Prices of non-tradables fell by 0.8 percent y/y in October, while tradables rose by 3.6 percent y/y. Oil derivatives have continued to push the inflation, recording an average growth of 16 percent y/y in 2011. Domestic factors, especially weak domestic demand and adverse labor market developments have continued to have a dampening effect on administrative prices and prices in agriculture. The annual growth in producer prices has recorded an increase of 6.8 percent y/y as a result of price hikes in energy and, in particular, intermediate goods.

Figure [15]. Inflation rate, y/y (in percent)



Sources: CROSTAT

Against the backdrop of weak economic activity, banks have continued to increase their portfolios at a moderate pace in 2011. Consolidated bank assets in September reached 116.8 percent of GDP and were 3.1 percent higher than in December 2010. Year on year, however, there has been a noticeable asset growth acceleration: September saw a rise of 5.3 percent, with more than half of the growth attributable to loans to businesses, and another 40 percent to increased lending to the central government. Capital adequacy remained strong and amounted to 19.3 percent in September 2011. Banks' profits after taxes in the first nine months of 2011 reached HRK 3.1 billion and are almost 13 percent higher than in the same period last year. Despite the further deterioration in the quality of placements in the third quarter, and consequently the loan-loss provisions (a 20 percent increase compared to end-2010), banks have managed to increase profits due to still elevated interest margin, cuts in operating costs and net non-interest income. Retail deposits in September were 4.3 percent higher than at end-2010, while corporate deposits in late September were 2.5 percent lower due to lower liquidity.

Figure [16]. Private sector placements

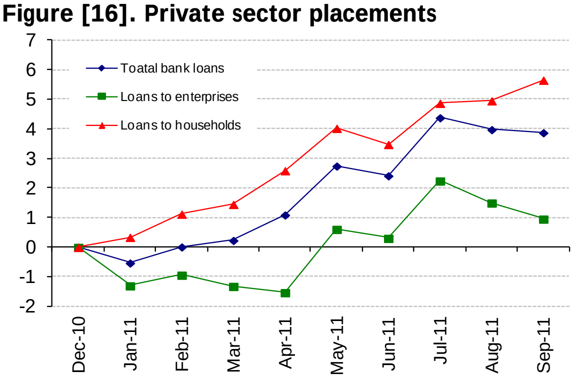
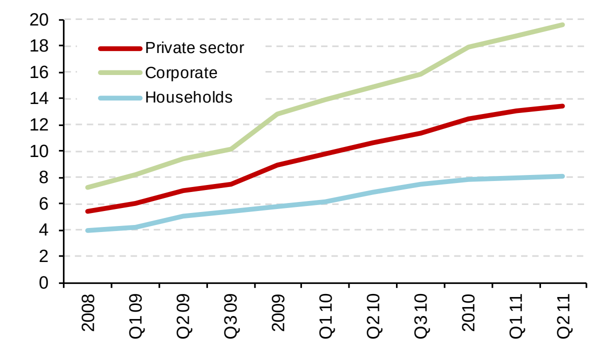


Figure [17]. Share of NPLs in total loans

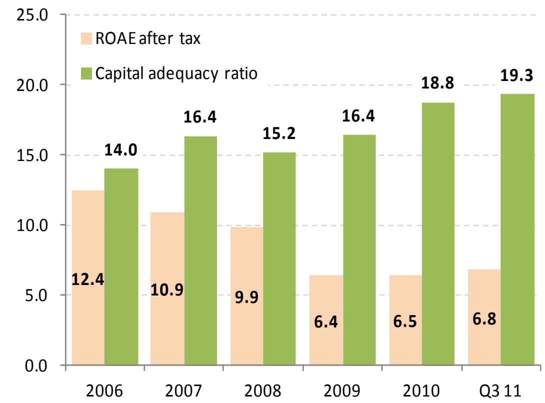


Source: CNB

Credit flow recovery is still muted, as placements grew by 6.7 percent y/y in September. The sectoral structure shows that the credit growth was exclusively in the corporate sector (5.7 percent y/y) while loans granted to the household sector continued to contract (excluding the exchange rate effects). Non-performing loans (NPL) continued rising to 11.9 percent by end-June 2011, which is 0.7 p.p. higher than at end-2010, partially driven by tightened prudential regulations. Uncertainties remain about the level of potential losses hidden in banks' balance sheets, in particular in construction and real estate industries. The renewed turbulence in international financial markets may become a challenge for Croatia's foreign-owned banks. The expected further growth in NPLs and uncertainties regarding future value adjustments heighten the importance of creating buffers (primarily capital) banks could use in case of the quality of their portfolios further deteriorates.

To ease downward pressures on the domestic currency, the central bank has intervened in foreign exchange markets and increased the reserve requirement (from 13 to 14 percent). This has reduced the liquidity in the monetary system. The central bank sold to banks EUR238.9m in July and another EUR180.5m in September, thus withdrawing a total of HRK3.1bn from the system. The increase in the reserve requirement rate by one percentage point reduced kuna liquidity by around HRK2.6bn. The kuna/euro exchange rate averaged HRK7.45/EUR in the third quarter, depreciating slightly from HRK7.39/EUR in the first half of the year. In November 2011, to prevent any potential market disruptions due to constrained capital inflows caused by the debt crisis in Eurozone, the central bank introduced a new instrument – a temporary usage of the reserve requirement within a certain period of time at special terms. Banks will have to submit and explanation to the central bank of the reasons for seeking those funds and they will be charged an interest on the amount banks use from the reserve requirement. In parallel, the central bank reduced the marginal lending rate from 9 percent to 6.25 percent.

Figure [18]. Banking sector trends



Source: CNB

Figure [19]. FX Reserves

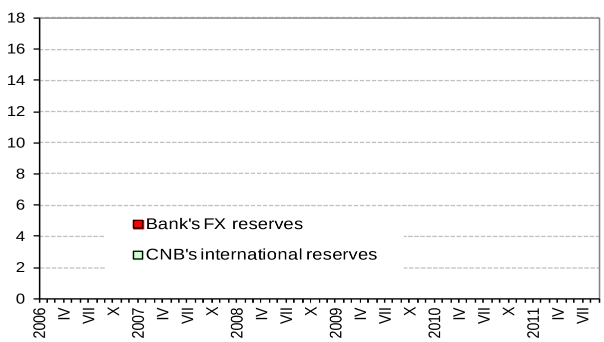
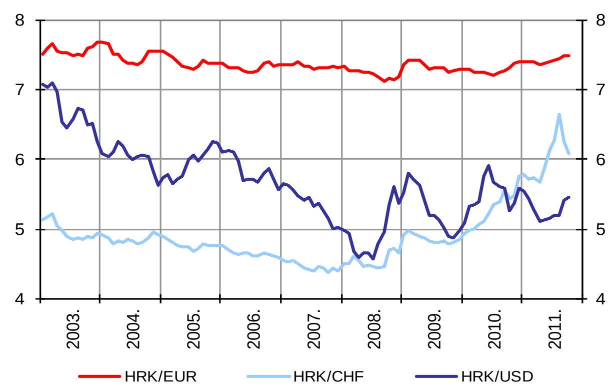


Figure [20]. Exchange rate developments



Source: CNB

Gross FX reserves went up 6.2 percent from the beginning of the year, standing at EUR11.3bn in late September. The increase in gross international reserves in the first nine months of 2011 was largely owing to the purchase of foreign exchange from the government (EUR1.0bn), while the sale of foreign exchange to banks (EUR0.4bn) had the opposite effect. A mild growth in foreign currency reserve requirements also added to the rise in international reserves. In the same period, net usable reserves grew by 6.3 percent, to EUR9.9bn. The level of both gross and net usable reserves continued to be much higher than money (M1) and reserve money (M0) at end-September.

External vulnerability

Current account deficits remained at a moderate level across the region and were adequately funded through portfolio and FDI investments. As risk appetite declined, gross capital inflows contracted. Bank and bond flows declined, while equity flows remained robust.

After the adjustment of external imbalances in 2009-2010, Croatia's current account improvement halted due to a slowdown of exports and a minor increase in imports. Sharply reduced capital inflows and domestic demand resulted in much lower trade and current-account deficits. The latter fell to 1.1 percent of GDP in 2010, compared to near 9 percent two years earlier. In the first half of 2011, the current account deficit remained low at 1.1 percent of GDP on a rolling basis. Imports of goods, which started to show signs of recovery in mid-2010, decreased in Q2 2011 as imports of capital goods, raw materials for industrial production and energy products fell (except oil, as its import value grew due exclusively to the rise in oil prices). Trade in services improved thanks to an increase in tourism receipts, which rose by 10 percent y/y in the first half of 2011 (15 percent alone in Q2). Interest payments and foreign direct investment expenditures (dividends and reinvested earnings, especially in the oil industry and banking) have prevented further improvement of the CAD.

Figure [21]. External imbalance, % of GDP

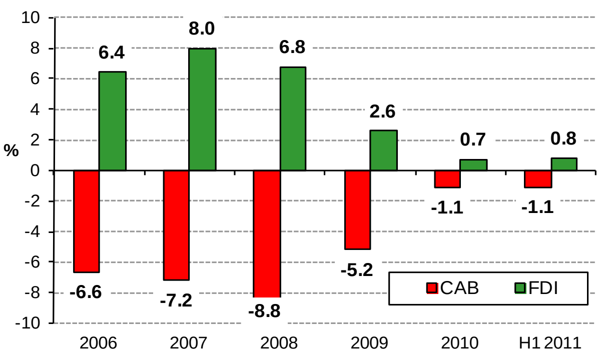
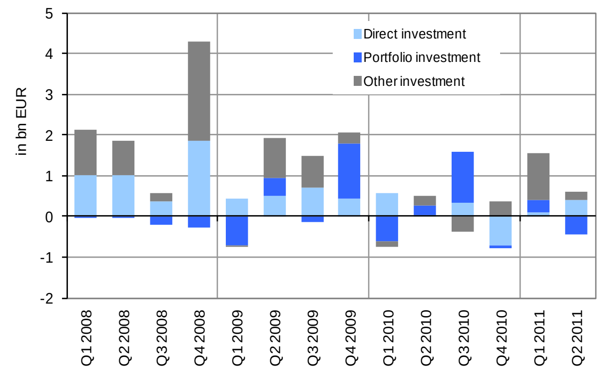


Figure [22]. Capital inflow in Croatia, in EUR billion

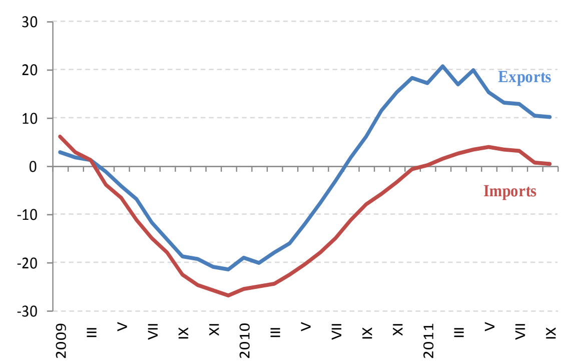


Source: CNB, CROSTAT, own calculations

A low current account deficit was accompanied by meager capital inflows. Gross capital inflows have remained on a downward trajectory since the beginning of 2009. FDI inflows, amounting to 1.1 percent of GDP in H1 2011, included small projects in trade, real estate and tourism, indicating continued foreign investor reluctance and perception of high risk. Although equity investment and reinvested earnings increased by 5.3 percent (amounting to EUR0.9bn in H1 2011), direct debt investments fell considerably, driving the overall FDI inflow down by 20 percent y/y in the first half of 2011. Thus, the structure of direct investment changed in favor of direct equity investment, as affiliated companies deleveraged. Net outflows of portfolio investments have continued, mainly due to excess liquidity, in particular in equity. Foreign borrowing of banks has increased considerably, reflecting both liquidity release from the central bank and new borrowing.

Croatia's trade deficit narrowed further, led by a strong external demand and sluggish domestic demand. The trade deficit in Q3 of 2011 declined to EUR1.5 million, led by exports growth of 6 percent y/y in Q3 and a decline in imports by 5.2 percent y/y. Cumulatively, over nine months of 2011, imports fell by 0.7 y/y and exports increased by 5.2 percent y/y (o/w 3 p.p. came from exports of ships). Capital goods, fuels, pharmaceuticals, food and beverages and industrial supplies drove the rise in exports. The exports/imports coverage rate improved to 61.2 percent. However, the export rates moderated in Q2 and Q3 suggesting reduced external demand by major trading partners.

Figure [23]. Trade in goods, rolling annual growth rates, percent



Source: CROSTAT, own calculations

External debt has stagnated as access to foreign funding has declined. The external debt amounted to EUR46.4 billion in August 2011 or equivalent to 99.2 percent of GDP. After increasing by EUR0.7 billion in the first half of the 2011, it started declining, recording a nominal decline of EUR140 million in August compared to end-2010. The foreign borrowing by the state and the banking sector increased, while the corporate sector saw a significant contraction in particular in direct intercompany investments. The share of short-term debt in total debt remained around 12 percent or half of the FX reserves.

Figure [24]. Gross external debt, in % of GDP, August 2011

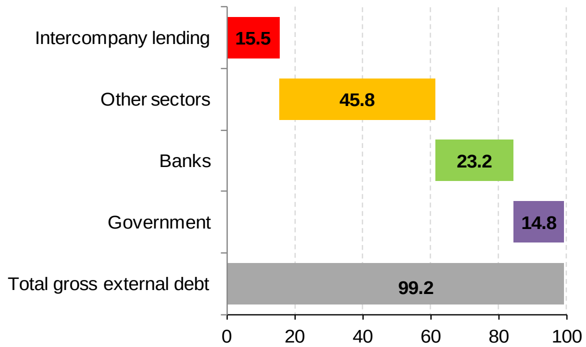
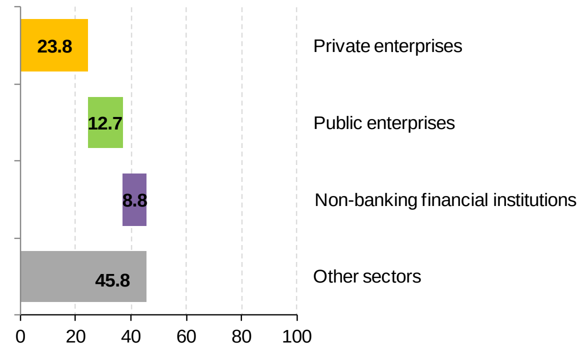


Figure [25]. Gross External Debt of Other Sectors, in % of GDP, August 2011



Source: CNB, CROSTAT, own calculations

Fiscal Policy

As markets watch public finances closely, EU10 governments have proceeded with fiscal consolidation in 2011 in spite of weakening growth. Fiscal balances improved in all EU10 countries; but not in Croatia. In other countries, fiscal consolidation has helped to moderate the rise in public debt-to-GDP ratios. In light of elevated and continued market pressures, EU10 countries are moving ahead with fiscal adjustment in 2012-13.

The general government deficit will increase for the third consecutive year in Croatia. The expected deficit of 5.5 percent of GDP[1] (based on ESA methodology) in 2011 largely reflects the projected decline in revenues, fuelled by last year's legislative changes, such as the repeal of the special tax on salaries, pensions and other income, income taxation changes, and reduction of oil excises. Overall, revenues are set to decrease by 1.3 percentage points of GDP. Expenditures have been estimated to increase by 1.5 percent in 2011 and their share in GDP is set to decline by 0.8 percentage points.

Figure [26]. Fiscal outlook, % of GDP

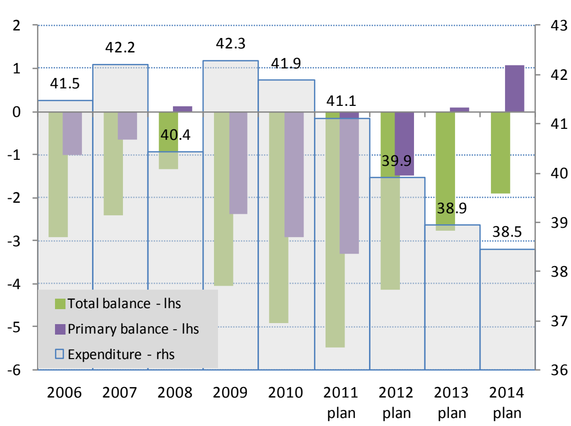
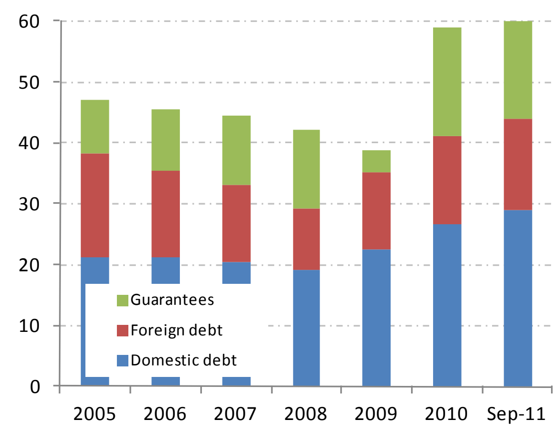


Figure [27]. Public debt, % of GDP



Source: MoF, own calculations

Based on fiscal outturns in the first nine months of the year, fiscal targets can be expected to be achieved. By September 2011, revenues had decreased by 0.5 percent (due to a decline in social contributions and excises) compared to the same period in 2010. VAT revenues increased by 1.8 percent in January–September 2011 period, suggesting a modest upturn in retail trade, due in part to favorable results in tourism. Revenues from direct taxes grew sharply in the first months of 2011, largely thanks to improved profit tax

[1] 6.0 percent of GDP if Motorway Company (HAC) included.

collection. A significant contribution came also from property income revenues, as a result of Government's decision to withdraw half of the SOEs' profits in 2010. At the same time, expenditures declined by 0.2 percent due to lower social benefits, subsidies, transfers to local government units and Croatian Motorways. In parallel, interest payments spiked by a quarter compared to the same period last year, which can be largely attributed to the high debt stock as well as increased interest rates on short- and long-term government borrowing. As a result, the consolidated general government deficit stood at HRK 10.3bn (3 percent of GDP), an increase of 6.8 percent compared to the same period of 2010.

Early in the year, the government secured funds from domestic and foreign markets to refinance public debt in 2011 and early 2012. Public debt with guarantees grew above 61 percent of GDP by end-September 2011. A temporary financing that was approved for the first quarter of 2012 due to general elections held in December, limited the spending at the one-fourth of the 2010 level and prevented any new foreign borrowing.

Table [2]. Public debt flows, in percent of GDP

	Jan-Sep 2010	Jan-Sep 2011
Change in total debt stock	**6.9**	**4.2**
Change in domestic debt stock	**2.9**	**3.1**
– Treasury bills	-0.5	0.3
– Money market instruments	0.0	0.0
– Bonds	3.1	1.7
– Credits from banks	0.3	1.1
Change in external debt stock	**2.0**	**0.9**
– Bonds	0.6	1.5
– Credits	0.5	0.0
– Money market instruments	0.9	-0.6
Change in total guarantees issued	**2.1**	**0.2**

Source: MoF, own calculations

The government strategy is to safeguard stability through front-loaded expenditure-based fiscal adjustment. The medium-term fiscal framework, supported by the Fiscal Responsibility Act, aims to achieve a primary balance by 2013 and stem further public debt growth. In this effort the focus should be on special pensions (1.9 percent of GDP); subsidies to railways, shipyards and agriculture (2.5 percent of GDP); and public sector wages (10.5 percent of GDP). Further, to ensure fiscal sustainability, adjustments to expenditures need to be accompanied by structural reforms – reforms to the pension and health systems, social security benefits and public administration. Better targeted expenditures would create the fiscal space to allow more public spending on growth-enhancing expenditures that enhance productivity of the economy.

To improve productivity and thereby competitiveness, fiscal adjustment needs to tackle the revenue side as well. The tax burden at around 38 percent of GDP is high and hampers private sector competitiveness. On the revenue side, introducing modern property taxation and rationalizing quasi-fiscal fees (e.g. water management fees, utility connection fees, Chamber of Commerce and notary fees, etc.) while folding them into the formal tax system can raise revenues and improve compliance. Tax collection can also be improved, as tax evasion is estimated to be around 8 percent of GDP. Measures to fold informal transactions into the formal tax system, introducing mandatory fiscal cash registers aimed at capturing cash-based transactions in industries with high incidences of cash transactions (e.g., restaurants, coffee shops, hair dressers, professional handyman services) could be considered.

Box [3] Fiscal Responsibility Framework in Croatia

The Fiscal Responsibility Law aims (FRL) to ensure medium- and long-term sustainability, transparency and discipline for public finances and applies to all general government bodies. It contains fiscal rules aiming to stabilize and reduce the ratio of public debt to GDP, by reducing total general government expenditure by a minimum of 1 percent of GDP annually. Once the primary fiscal balance has been brought back to zero, it has to be kept in balance (or in surplus) in cyclically-adjusted terms. The law also contains general provisions on financial control, including presentation of annual statements of fiscal accountability. Responsibility for the enforcement of the law lies mainly with the Ministry of Finance, but in March 2011 the government established a Fiscal Policy Committee, consisting of non-governmental experts, to monitor implementation of fiscal rules. The Fiscal Policy Committee role should be reinforced and become more active.

There is scope to improve the legislation to meet internationally accepted FRL standards. Based on the relevant lessons that can be distilled from the international experience, Croatia could extend the coverage to all budget operations and possible losses of state-owned enterprises. Given the objective of compliance with Maastricht criteria in the medium term, regular fiscal reporting should be accompanied by information on general government fiscal performance consistent with the ESA 95 methodology. The rule should cover co-financing for EU projects because that would provide incentives to free up resources for co-financing, which would be in line with the goal of reducing the size of government over time.

Also, the proposed FRL should bind not only the current government and parliament but also future ones. Thus, as some other countries have done, the authorities could consider proposing the FRL as an organic law requiring a two-thirds majority.

The FRL would benefit from regular quarterly monitoring (semi-annual does not allow enough time to make corrections) and reporting on deviations from fiscal targets, including reasons for deviations (e.g., changes in macro forecasts, policies, or accounting standards).

Source: Fiscal Responsibility Policy Note, www.worldbank.hr