BRIEFING BOOK FOR THE GOVERNMENT OF CROATIA

This Briefing Book aims to introduce the newly elected Government of Croatia to the World Bank Group, its current portfolio in Croatia and its current understanding of Croatia's economic and social challenges in trying to promote sustainable and equitable growth within the framework of the European integration process. The attached documents, it is hoped, would serve as a basis for discussion of how the World Bank might continue to be a strategic partner over the near and medium term in helping the Government to address Croatia's main economic and social challenges on its way to European integration.

Attachments:

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Information on the World Bank activities in Croatia also available and regularly updated on www.worldbank.hr
Introductory Note

The main economic objectives of the newly elected Government are achieving higher standards of living of the Croatian population, and access to growth for all. These goals would be achieved through promoting sustainable and equitable innovation-led growth and through establishing appropriate European policies, standards and practices as part of Croatia's efforts to become a member of the EU in the near future. The Bank supports these objectives and looks forward to strengthen the implementation of an appropriate reform and investment agenda to be agreed with the new Government.

Growth and macroeconomic stability will facilitate the process of European integration, and help the country benefit from the opportunities that this process provides. To maximize Croatia’s growth a number of structural reforms are needed. To preserve macroeconomic stability (which is a precondition for growth), the Croatian Government will need to pursue further and more rapid fiscal consolidation for at least two reasons (i) to lower the public debt and tax burden on the economy thus facilitating faster private sector growth, and (ii) to reduce external imbalances evident in high and growing external debt.

High public debt, external imbalances and euroization leave the Croatian economy vulnerable to potential adverse shocks.1 In the event of such shocks, the economy could fall quickly into a vicious cycle of explosive public debt growth, low private investment, and recession, leading in turn to macroeconomic and financial instability. Fiscal restraint combined with less dependence on external borrowing are critical to reducing Croatia’s macroeconomic vulnerability over the medium term.

Even after the sizable expenditure reductions since 2000, public expenditures account for more than 50 percent of GDP and are significantly misaligned with the size of economy and in comparison with EU accession and candidate countries2. Financing of such a high spending level could become a problem in the medium-term. So far, Croatia has had access to external capital on favorable terms and has been able to increase tax compliance. However:

- The tax burden on the economy is extremely high compared to the EU accession countries and most of the EU countries. Croatia ‘taxes' directly and indirectly more than 40 percent of its gross value added, thus significantly reducing its competitiveness.3 Without further sustainable cuts on public spending side tax reduction possibilities are limited4;
- The use of privatization receipts to finance deficits is not a viable medium-term strategy as privatization receipts are expected to diminish significantly after 2005;
- Access to external financing is still relatively favorable in terms of costs and availability. However, these terms are not as favorable as those of accession countries due to the perception of higher investment risk;

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1 The primary fiscal deficit consistent with debt sustainability is at least 3 percentage points of GDP lower than the one Croatia currently observes.
2 The average general government spending for EU accession and candidate countries was around 40 percent of GDP in 2002.
3 The average tax burden for the EU accession and candidate countries was below 33 percent of GDP in 2002.
4 The possible avenues of spending reduction where Croatia appears as an outlier among comparative countries, as found in Croatia Country Economic Memorandum (2003) and Public Expenditure and Institutional Review (2002), are: the wage bill, public health, social spending, transport and subsidies.
• The amortization schedule for public debt over the next four years calls for careful debt management in refinancing (approximately EUR 2 bill per year in addition to financing the annual deficit). (See Macro Note and Croatia CEM attached)

The main strategic challenge that the new government faces beyond sustaining macroeconomic stability is how to shift the economic growth pattern currently based on stimulating consumption and public infrastructure investment to a sustainable growth pattern based on private sector investments and exports of goods and services. A key priority in this regard is enhancing the competitiveness of the economy to promote private sector led growth. These can be tackled by:

• Improving the investment climate through further structural reforms and reduction of the cost of doing business. The challenge is how to define the role of the Government in supporting private sector development. Current government policies, visible in soft-budget constraints and high subsidization constrain enterprise restructuring and new business development. Recommended actions in this area include: introducing further regulatory reforms, removing administrative barriers for investments (including upgrading land registration/cadastre), undertaking faster privatization, upgrading physical infrastructure, reducing administrative costs and the tax burden, undertaking faster adoption of relevant EU standards and regulations, increasing the flexibility of the labor market, and shifting to demand-driven education, training and research. An improved investment climate would attract new Croatian entrepreneurs as well as FDI, bringing new ideas, technology and know-how, and new export markets. (See Private Sector Development Note, Science and Technology Note and Croatia CEM attached).

• Strengthening governance through reforming Croatia’s public administration (also at the local government level) and judiciary to improve the quality of service to the public, to be an efficient tool for implementing reforms, and to ensure the rule of law. Benefits of these reforms would be seen in more efficient, lower cost public administration and judiciary, improved investment climate and private sector growth. (See Public Administration Note, Judicial Reform Note and Croatia CEM attached).

An important challenge is also to ensure the social and environmental sustainability of long-term growth. This challenge will require sustained reform actions over the medium term in the following areas:

• Investing in human capital through education reform and development of a knowledge economy, in order to: have a competitive workforce; to reduce unemployment (which would reduce the fiscal burden of social assistance); and attract investment; (See Human Development Sector Notes and Croatia CEM attached).

• Promoting social cohesion and regional integration, in order to bring the benefits of growth to as broad and inclusive the Croatian population as possible and thereby contribute to long-term stability, and (see Human Development Sector Notes attached).

• Ensuring sustainable use of natural resources, which, among others, represent a very important source of tourism income. (See Urban and Water Sector Note and Croatia CEM attached).

The key tactical challenge is how to balance the medium term vision provided by a comprehensive reform program with short-term actions that can deliver concrete results on the ground (early wins). Sustained implementation of a broad reform agenda is critical for Croatia’s quest for integration and growth, as recognized in the inaugural Prime Minister’s speech. The Bank (please

5 Above 3.5% of GDP in 2003 as opposed to 1.2% on average in EU.
6 Croatia spends more than 11.5 percent of GDP on public sector wages, 5 percentage points of GDP more than EU accession and candidate countries.
see Croatia Country Economic Memorandum attached) recognizes that sequencing of reforms would be critical. One group of reforms will take years to implement, but the impact of these reforms is pervasive and so they should be started right away. This group includes continued fiscal adjustment and public administration reform.

The second group of particularly urgent reforms includes the areas of bankruptcy, corporate governance, labor markets, judiciary, and land registration. Croatia has made great initial progress in adopting many of these reforms through legislation. At this point effective implementation is now needed. The third group includes improved regulation of infrastructure services and financial markets, both good for growth and good for European integration. Ideally these reforms would coincide with the fourth group of reforms in education, science and technology that would enhance the skills of Croatia’s labor force.

Reforms in agriculture and environment are also needed, but the speed of convergence to EU standards in terms of agricultural policies and the timing of investments needed to ensure Croatian compliance with EU environmental standards need to be carefully phased, noting the cost and benefits of such investments. (See Agriculture Sector Note and Croatia CEM attached).

There is a widespread recognition in Croatia of the need for these reforms; they are also high on the EU agenda. Simultaneous progress in key reforms would create a vital synergy and profoundly and rapidly improve the investment climate in Croatia and provide a framework for sustainable growth as well as short-term gains.

The WB has been actively engaged through a number of instruments with the first-wave accession countries to support the design and implementation of key structural reforms that paved the way for their joining the EU. To maximize efficiency and effectiveness of its program in those countries, the WB has given priority to systemic solutions and sustained efforts and has coordinated its program closely with the EU and other development partners. In recent years a special focus of Bank support have been helping Bulgaria and Romania to implement their reform agendas working toward their goals of EU accession by 2007.

The WBG has been actively engaged in Croatia, and more intensively since Croatia made clear its ambition to join the EU by signing the Stabilization and Association Agreement (SAA) with the EU in October 2001. Indicative annual lending from 1999 to 2004 has ranged from $100 million up to $398 million. In fact, the Bank is one of the largest foreign partners in Croatia with the portfolio value of approximately USD 1.2 bill by 2003. The attached Project Sheets provide a brief overview of objectives, results to date, and unfinished agendas for each of the WB supported ongoing projects. Currently, Bank staff is working with their counterparts on a pipeline of seven projects, some of which are in advanced stage of preparation awaiting the guidance of the new Government (see Pipeline Project Sheets). In addition to financing investments, the WB has prepared several in-depth diagnostic studies of the Croatian economy, the most recent being the two-volume “Country Economic Memorandum: A Strategy for Growth through European Integration” (July 2003), Health Financing Study (2003) and Municipal Financing Sector Note (2003).

The WB looks forward to discussing strategic priorities, use of a full range of Bank instruments (see attachment on Instruments), sequencing of this assistance, and sustaining effective partnership with the new Croatian authorities. One key instrument for this is a joint design and implementation of a new Croatia Country Assistance Strategy for 2004-2007 period (more details in the CAS Note attached), in support of its aspirations for higher standards of living and sustainable growth and development through early EU accession.
(This Macro Note serves as an update to the recently undertaken extensive macro and fiscal analysis in the 2003 Croatia Country Economic Memorandum.)

To unlock the growth potential of the Croatian economy a number of structural reforms should be undertaken to complete the transition to a market economy. These reforms include public administration and judicial reform, institutional and regulatory reforms to strengthen the business climate, and social sector reforms including education reform. But macroeconomic stability is also a precondition for economic growth. The external vulnerability of the Croatian economy increased in 2002 and 2003 due to a significant deterioration in the current account deficit and sharp increase in external debt. Despite a largely favorable economic outlook, the Government has less room to maneuver in the event of shocks. Given the high degree of euro-ization of the Croatian economy, the potential damage that such shocks could cause is substantial. Reliance on privatization revenues, substitution of external for domestic borrowing, and improved debt management could only be interim steps for reducing external vulnerability. A rapid reduction of the General Government budget deficit to a sustainable level is the most important step needed to reduce Croatia’s vulnerability. This would require fiscal reforms that could reduce public expenditure. Thus, progress on the large agenda of structural reforms should be speeded up; more importantly because the EU integration remains high on the new Government agenda and the EU integration brings new adjustment costs.

- **Real Sector Slowing Down.** In the first half of 2003, continued strong domestic activity underpinned year-on-year real growth of 5%. Both industrial production and retail sales were strong, while annual (consumer prices) inflation in 2003 fell to 1.8%. Third and fourth quarter data point to a slowdown of domestic output, industrial production and trade, partially as a reflection of restrictive monetary policy on credits to private sector. Overall growth is expected to decline to around 4.7% for 2003 as a whole and 4.0% in 2004.

- **Monetary Policy Tightening.** In response to the rapid deterioration in the current account deficit, which was largely caused by an unsustainable credit growth by the banking system, the Central Bank tightened monetary policy in several steps in 2003. In January 2003 the Central Bank introduced administrative credit ceilings on bank lending. This was augmented in September and November by increasing the local currency component of reserve requirements on banks’ foreign currency liabilities. These measures have succeeded in curtailing credit growth, but have also caused some economic distortions. Circumvention of the credit limits has resulted in the rapid expansion of unregulated leasing operations. The higher foreign exchange liquidity requirement has encouraged capital inflows, and the reluctance of the central bank to raise interest rates on its bills has led to an increase in base money. The banking system appears relatively sound: by the end of the second quarter, non-performing loans had declined to 5.4% of total loans, banks’ net open foreign exchange position had declined to 21% of capital, and profitability and capitalization remained strong. Nevertheless, given the high degree of euroization in the financial system, the financial sector remains vulnerable to a shift in sentiment to the kuna or external shocks.

- **External Imbalances.** The current account deficit remained in 2003 high despite some narrowing following stronger than expected tourism receipts. Imports continued to grow
strongly accompanied by an increase in investment income outflows. Preliminary third quarter data suggest the current account deficit may have fallen to only 7 percent of GDP by year-end. This remains an unsustainable deficit.

- **Exchange Rate Stable.** The kuna-euro exchange rate remained in 2003 fairly stable since April with minimal Central Bank intervention. The Central Bank regards a stable exchange rate as highly desirable to ensure price stability given large seasonal fluctuations in tourism revenues and a highly euroized economy. The IMF reports that the level of the exchange rate appears broadly appropriate based on standard competitiveness indicators; including unit labor costs vis-à-vis Croatia’s main competitors and trading partners.

- **Fiscal performance** in 2003 was unfavorable and the deficit target of 4.6% of GDP appears to be breached. Revenue performance has been relatively strong, even after a reduction in customs duties during the year in keeping with trade liberalization agreements. Even so, public sector wage developments remain an area of concern (due to higher severance payments and slow restructuring in the defense sector and bonuses to civil servants). Other areas of concern are the ongoing significant expenditure on highway construction, subsidies to enterprises and health sector. Given a projected drop in revenues expected in 2004 due to income and profit tax exemptions and further erosion of customs duties, additional expenditure cuts amounting to 1.1% of GDP will be needed to stay on track with deficit-reduction plans. Potential measures to ensure the budget deficit target would include efforts to contain the wage bill and reduce highway construction spending. Moreover, if the new government goes ahead with a four-year railroad infrastructure investment program it would require a further 1.2% of GDP in adjustments in 2004 alone and would pose further challenges to fiscal consolidation in subsequent years. It would also not be advisable to reverse the favorable trend of social welfare spending, whilst cutting the major revenue-generating tax (VAT). Such measures could significantly endanger prospects of medium-term fiscal consolidation that is crucial to reduce external vulnerabilities.

- **Recent Structural Reforms.** The partial privatization of the state oil company (INA), in late July, realized proceeds of $505 million (2% of GDP, and 40% above target) in October. In addition, legislation has been passed improving the bankruptcy, company, and labor laws as well as other laws that increase harmonization with EU standards. Importantly from a fiscal standpoint, the government has also made progress in better regulating the issuance of government guarantees, including setting up a register of all active guarantees, although more work is needed. Nevertheless, deeper and more broad-based reforms are needed to underpin foreign investment and sustainable growth. While progress has been made in pension reform, major reforms are still needed to rationalize health and state aid expenditures to support fiscal consolidation. Deeper reforms are needed in the legal system, labor market reforms, and privatization outside the telecom and banking sectors not only for fiscal purposes, but also for corporate governance and competitiveness’ reasons. High subsidies to agriculture and shipbuilding should be curtailed. Governance issues, and corruption in particular, remain of concern. As a result, enterprise restructuring and the overall business environment remain constrained.

- **Debt Situation and Risks.** In 2003, external debt jumped to 82% of GDP. External debt to exports of goods and services ratio also jumped from 117.5% in 2001 to 145.8% in 2002. Public sector debt rose to 52% of GDP by end-2002 and has remained stable in 2003. Thus far, Croatia’s market access has remained favorable despite the deterioration in external indebtedness.
MACRO NOTE

- **External vulnerability.** The debt profile is more vulnerable to external shocks than in 2002, particularly in the event of a substantial currency depreciation, which could result in soaring debt ratios, at least temporarily. Given significant foreign currency exposure of corporates and households, depreciation could also lead to financial sector distress and additional pressure on public finances. More generally, further deterioration in the debt profile could undermine investor sentiment. In this context, further delays in advancing structural reforms and fiscal consolidation would risk growing external imbalances, a worsening debt profile, and increasingly limited room to maneuver in the event of external shocks.

- **Fiscal consolidation.** Failure to pursue fiscal consolidation could undermine sustainability. Addressing the challenging fiscal situation will require significant near-term expenditure measures combined with deep structural reforms over the medium term to ensure sustainability. The Government should place fiscal consolidation amongst its highest priorities. Any fiscal policy slippages or relaxation of fiscal policy could seriously undermine macroeconomic stability.

- While the regulation and supervision of the financial sector has improved and stability has been maintained, the recent rise of unregulated leasing operations and a high level of euroization suggest external shocks or significant downward pressure on the kuna could cause strains on the debt service capacity of domestic bank borrowers, possibly leading to systemic problems.

- **Sources of growth.** Also of concern is the vulnerability of the economy to a downturn in the vital tourism sector, which could result from an increase in regional economic and political instability. Croatia should diversify its sources of growth. Significant public funds have been used to protect loss-making enterprises. These interventions directly result in a deterioration of the fiscal stance while distorting competition and reducing the competitiveness of the economy through an increased tax burden.
WORLD BANK’S CROATIA

Discussion Note for Government

This paper aims to brief the newly elected Government of Croatia about the services of the World Bank and serve as a basis for discussion of how the Bank might be a strategic partner over the near and medium term. The Bank team looks forward to early consultation with the new Government on priorities for this strategic partnership with Croatia.

Introduction

The Bank’s core competencies fall into the broad categories of poverty reduction and economic management, private and financial sector development, human development, environment and socially sustainable development, and infrastructure and energy sector development. The Bank supports structural and institutional reforms that promote growth, which in turn helps a country to achieve more sustainable debt levels and reduce its future dependence on debt. In addition, the Bank’s more attractive lending terms (including low interest rates, currency options, and long amortization periods), provide borrowers with opportunities to reduce their debt and debt servicing obligations, and even more so if making use of the Bank’s debt reduction loan and guarantee instruments. Bank financing also helps to ease the difficult fiscal adjustments during the transition brought on by structural reforms such as those needed for EU accession.

Bringing global experience, the Bank has since 1991 been actively engaged with the first-wave accession countries to support design and implementation of structural and institutional reforms to pave the way for their joining the European Union (EU). This engagement has been in the form of policy advice, analytical macroeconomic and sector studies (available to borrowers for no fee), financial support for structural and institutional reforms needed for a sustained transition to a market economy, and financing of strategic public investments in sectors as wide-ranging as the EU communautaire. To maximize efficiency and effectiveness of its program in the EU accession countries, the Bank gives priority to systemic rather than one-off solutions and leveraging of resources with other partners, including the European Commission (EC).

The Bank works closely with its sister institution, the International Monetary Fund (IMF). While the Bank advises its clients on structural and institutional reforms and works most closely with the Ministry of Finance as its day-to-day counterpart, the IMF works with its clients to develop a program of reforms aimed at macroeconomic stabilization and works most closely with the Central Bank as its main counterpart. The Bank and the IMF collaborate closely in supporting governments’ structural reforms in areas with significant macroeconomic – typically fiscal – implications.

In Croatia, where the Bank has been active since 1994, the collaboration between the IMF and the Bank has been in several areas, including public expenditure management, pensions, health sector and social protection reform, and labor market policy. These mutually reinforcing efforts are also closely coordinated with the EC, which welcomes the Bank’s ability to provide sector policy, structural, and institutional reform advice to Croatia. While Croatia is in many respects well positioned to achieve its overarching objective to become a member of the EU (e.g., high per capita income relative to its Eastern European neighbors, a strong financial sector), there are a number of economic challenges to be overcome before this objective can become a reality. The Bank is ready to help the new government address some of those challenges through the new Country Assistance Strategy of the World Bank for Croatia.
COUNTRY ASSISTANCE STRATEGY

For each of its clients the Bank prepares a Country Assistance Strategy (CAS) covering the upcoming three to four year period. The CAS aims to support the client country’s reform programs. It is prepared in consultation with the client government, representatives of civil society, and other partners such as the IMF, regional development banks, and in the case of pre-accession countries, the EC. The CAS document serves as the main tool for the Bank management and its Board of Executive Directors to review and guide the Bank’s programs in a given country and to assess their impact. It serves as an overall performance-based blueprint for engagement with the country by the Bank and its affiliates, the International Finance Corporation (IFC) and the Multilateral Investment Guarantee Agency (MIGA). A new CAS is informed by a retrospective on the impact of the past Bank assistance and by the results of a client survey, which provides feedback from government representatives and other stakeholders in the client country.

The CAS includes an overview of the client government’s program, analysis of the constraints to growth, assessment of the country's macroeconomic and structural performance and policies, and discussion of the external environment. It then articulates a multi-year strategy for the Bank’s support to the government’s program, and elaborates several scenarios of lending volume ceilings and the associated instruments for implementing the strategy – generally, a combination of investment and policy-based lending, analytically underpinned by advisory services. The CAS also discusses the risks to the Bank program and measures taken to mitigate those risks. A CAS program is performance-based in that it responds to the government’s pace of policy reform implementation by including multiple scenarios of lending volume ceilings. The CAS specifies what triggers must be met in order to shift to as well as to stay in the high case lending volume ceiling. In the event the high-case triggers are not met, the Bank program is considerably limited, consisting mainly of some analytical and advisory work and a few small investment operations.

The CAS document goes through a rigorous internal Bank management review, and then is discussed at the Board, after which it is translated and made publicly available in the country, with the government’s consent. Whenever possible, the Bank prepares a new CAS soon after there is a change in government in a client country, to launch a partnership with the new counterpart and to develop a program that has client ownership.

The next Croatia CAS will cover the timeframe of 2004 through 2007. The Bank’s Board expects to discuss it before the end of this fiscal year, i.e., before June 30, 2004, and it bears noting that the Bank’s senior management has decided to include two scenarios: a high-case scenario (which assumes higher lending to the country) and a low-case scenario. The last Croatia CAS lending volume ceiling was $291 million in the high case and $120 million in the low case, for the three-year period of July 1, 2001 through June 30, 2003. The high case ceiling allowed for up to about 70 percent for adjustment lending and 30 percent for investment lending, while the low case included investment lending only.

Because of the lead-time required to ensure adequate consultation and review, the Bank seeks to launch CAS discussions with Croatia’s new government as soon as possible. Early engagement is important for another reason as well: speedy agreement between the new government and the Bank on structural reforms and other activities to be supported by the new CAS will be in support of Croatia’s efforts to accelerate in meeting the EU economic criteria. For example, the Bank considers public administration reform and judiciary reform—key elements for meeting the EU accession criteria relating to the rule of law—to be a priority for the next CAS. The Bank is keen to provide advice and support in these areas in a timely manner, i.e., as the new government is deciding which public administration structures to put in place and as it is developing its strategy for the judiciary reform.
CROATIA’S ECONOMIC CHALLENGES AND OPTIONS FOR CAS PROGRAM

_Croatia_ seeks higher standards of living via sustained economic growth, and strengthened social cohesion via broad access to that growth, both of which it hopes to achieve largely through EU accession. _Croatia_’s new government is taking the helm at a time when there are three major economic challenges that need to be addressed head-on and in a sustained manner, for the country to stay on the path toward achieving these outcomes and EU membership: (i) macroeconomic vulnerability due to high levels of debt-financed public spending and increasing external indebtedness; (ii) policy and physical constraints to growth; and (iii) impediments to sustainable growth.

To help the new government meet these economic challenges, the Bank proposes that the next CAS focus on three strategic priorities, each of which correlates to various elements of EU accession criteria (see attached chart):

- Support for macroeconomic stability through fiscal restraint and reduced public borrowing;
- Support for pro-growth institutional and regulatory frameworks and physical infrastructure, to strengthen the investment climate in order to attract new-entrant firms and to reform _Croatia_’s public administration and judiciary for greater efficiency in both the public and private sectors; and
- Support for policies and investments to promote sustainability of growth through investment in human capital, policies aimed at promoting social cohesion and regional integration, in order to bring the benefits of growth to as broad and inclusive a Croatian population as possible, and policies and institutions aimed at ensuring sustainable use of natural resources.

The Bank instruments available to support the above priorities include: (i) adjustment and investment lending, (ii) analytical and advisory services, and (iii) instruments aimed at debt reduction including guarantees (see the Instruments section).

The Bank’s proposed building blocks for the high case in the next _Croatia_ CAS are (i) a series of multi-sector programmatic adjustment loans (PALs), (ii) complementary investment loans in specific sectors and with particular emphasis on facilitating access to EU grant funds, (iii) analytical and advisory services to provide the intellectual underpinnings for future policy reforms and Bank lending operations, and (iv) a debt reduction loan and guarantees aimed at helping _Croatia_ to reduce its high debt levels.

PROGRAMMATIC ADJUSTMENT LENDING

The Bank proposes to make a series of PALs the centerpiece of its assistance to _Croatia_ during the next three to four years. Fulfilling EU accession criteria calls for governments to launch an intensive structural and institutional reform program across nearly all economic sectors simultaneously. The Bank has found that the most effective tool for supporting this ambitious effort, especially accession countries, is with a comparable instrument, programmatic adjustment lending, which builds

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Debt reduction loans, usually complemented by a Fund program, help rationalize a country’s external commercial bank debt, by either converting it to lower-interest instruments or buying it back at a discount. For example, the Bank supported Bulgaria with a Debt and Debt Service Reduction Loan in 1994, to assist with a major restructuring of its public external debt.
on the findings of a Country Economic Memorandum focusing on EU integration (completed for Croatia in July 2003) to support key structural and institutional reforms across a range of sectors.

The PAL instrument, which the Bank first introduced in Thailand in 1999, has been welcomed by the EC in accession countries such as Latvia (2000), Bulgaria (2002) and Romania (planned for 2004)\(^8\). Experience has shown that PAL programs provide a vehicle for inter-ministerial collaboration around a clear policy reform agenda with clear outcomes, performance benchmarks, and monitorable indicators against which to assess progress during implementation, thus sending clear and predictable signals to the international community. An umbrella framework for policy reforms over the duration of the PAL series, together with identification of triggers for moving from one PAL to the next, would be established in the context of the first PAL, but each PAL would require Bank Board approval in sequence. Each PAL would be a single-tranche operation requiring completion of the agreed activities prior to World Bank Board approval and disbursement of funds. The Bank would work closely with the Croatian authorities and the EU to identify opportunities for accessing EU grant funds for technical assistance and other financing relevant to PAL-supported institutional capacity building. In this way, the PAL can serve as a vehicle for aligning Croatia’s development partners’ assistance.

Macro-economic stability, often associated through IMF supported program, is a prerequisite for PALs. The Bank invites the new Croatian authorities’ views on three proposed pillars for the PAL program: (i) improving the investment climate to increase private sector investment and productivity; (ii) improving the governance efficiency and effectiveness of public administration and the judicial system; and (iii) investing in human capital and strengthening social programs. Successful implementation of reforms in these areas would lead to sustainable growth, with a resulting increase in revenue-financed (as opposed to debt-financed) public expenditure, thus contributing to Croatia’s domestic and external objectives.

To maximize impact, it is proposed to complement the structural and institutional reforms supported by the PAL program by investment loans and analytical and advisory services. Possible areas may include (but are not limited to) health sector financing reform, regional electricity market integration, regional customs network integration, agriculture market development, district heating investments, education sector reform, social assistance reform, development of a knowledge economy, social and economic reintegration and revitalization of war-affected areas, and wastewater treatment. In addition, a joint Bank-IMF team proposes to provide technical assistance in the area of debt management and debt market development, to help Croatia make more efficient use of its overstretched borrowing capacity.

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\(^8\) Both the Latvia and Bulgaria PAL programs focus on (i) strengthening the credibility of the public sector through anti-corruption measures and judicial and civil service reform, (ii) strengthening public sector institutional capacity, and (iii) private sector development through privatization and strengthening regulatory frameworks and other aspects of the business environment. The Bulgaria PAL program, now in its second of three stages, also supports reforms to improve the efficiency and sustainability of the country’s education and health systems, and its pension and other social assistance programs. Romania has just started the first phase of its 3 phase PAL program, largely focused on the EU accession agenda.
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CROATIA COUNTRY ECONOMIC MEMORANDUM

Click on the link below to see the full text

Link to Croatia Country Economic Memorandum Volume 1
Link to Croatia Country Economic Memorandum Volume 2
PUBLIC ADMINISTRATION REFORM IN CROATIA

Introduction

The public administration system in Croatia suffers from many weaknesses including organizational fragmentation, over-reliance on legislation in public administration management, and an overall lack of coherence and consistency in the policy process. The quality of the system of public administration in Croatia has become one of the factors hindering progress in economic and social reforms. The lack of progress in improving the efficiency of the public administration system will create stumbling blocks for the incoming government, but also hinder Croatia’s progress towards EU accession, as adequate public administration capacities constitutes one of key requirements for EU membership.

Key medium-term priorities

**Strengthening reform management.** The creation of a strong central unit for PAR and Civil Service management should be a centerpiece of any reform strategy. A central unit should be part of a reformed Government Office, in order to ensure a strong central impetus for reform.

**Reducing organizational fragmentation.** There is a strong need to rationalize the structure of the state administration, which suffers from excessive fragmentation, both in terms of the number of line ministers and in the definition of relations between ministries and their subordinated bodies. It is important for this issue to be addressed on the basis of a thorough review of institutional functions, as the mechanical merger of institutions could exacerbate the existing problems inherent in the system, in particular institutional fragmentation. It is recommended to start immediately with the reduction of the number of ministries and the rationalization of the system of state agencies, followed by a drawn out process of institutional restructuring, over a 2-3 year period. The restructuring process should include the separation of policy-making, regulatory and service delivery functions in ministries, regulatory bodies and agencies, and should be based on a revised framework law, which would define key principles of the organization of public administration. Such a law could also help to clearly allocate types of functions (policy development, regulatory management, supervision, inspection, implementation) and responsibilities between various types of public administration institutions.

**Reducing politicization.** The current civil service system in Croatia is highly politicized, with assistant ministers having a political status under the Law on Officials. The lack of clear separation of political and career posts has created a lack of stability at the senior level of the civil service system, and in turn reduced incentives for qualified staff to stay in the civil service. The reform of the Civil Service Law, the Law on Officials and the Law on the Administrative System should address this problem by changing the position of assistant ministers to heads of directorates and putting managerial control firmly in the hands of the Administrative Secretaries of the ministries, with Ministers and, eventually, Deputy Ministers remaining the only political appointees.

**Strengthening civil service management.** The revision of legislation referred to above is also to address the problem of the fragmentation of the civil service system. A revised civil service law should impose central controls on wage systems in place in the ministries and other state institutions and also centralize all recruitment to the civil service. A new Office for the Civil Service would be required to manage the process. Human Resource units in the ministries and other state institutions are to be strengthened to undertake career management functions. The wage system is to be reformed...
making base pay the main component of total pay and introduce a performance element in civil service pay. Also, there is a lack of clarity about the scope of the civil service as different professional groups, such as teachers and medical staff, are exerting pressures through the trade unions to obtain civil service status. Improvements are needed in the system of job classification and job evaluation to clarify the boundaries of the system and reduce its scope.

**Enhancing professional development of civil servants.** There is no central policy to promote professional development in the civil service and there is no training infrastructure in Croatia to support professional development of civil service staff. The experience of candidate countries suggests the growing need for enhanced skills of civil service staff with the progress in the process of European integration. Thus, the development of a central training institution, which would be the focal point of career management, should be a further priority. The allocation of a mandatory portion of the payroll budget for training purposes should be considered.

**Strengthening strategic planning and policy coordination.** The legal framework governing the policy process is inadequate and not suitable for the effective management of policy-making. Several generally accepted key requirements for effective policy-management are either not present or not mandatory. For instance, there is no requirement to draft concept documents before drafting the legislation and there is no functioning impact assessment system, which means that the cost and desired impact of new regulations is often unclear. The existing system of policy coordination is top heavy and lacks an effective prioritization system, thus leading to blockages in the system. These problems will be aggravated, as the workload of the government will increase as a result of the requirements posed by the EU accession process. Reforming the way the policy process is managed should be a key element of the reform process. A single coordination system is recommended, led by a Minister of the Government Office, who would have the mandate to manage the policy process at the top level. Coordination of policy issues should be pushed down to the level of the ministries, with the government office only coordinating issues of key political significance. In addition the structure of the government office is to be rationalized, focusing in particular on re-organizing the now disparate system of ‘offices’ (e.g. office of strategies, office for minorities, office for legislation and some 15 other offices) and creating a unified and focused structure for the Government Office, able to provide effective policy support to the government and take the lead in the development of a strategic planning system for the government.

**PRIORITY ISSUES: WHAT CAN BE DONE IN THE NEXT SIX MONTHS**

The majority of issues discussed above require sustained and long-term attention, as both legislative changes, training and institutional development are required. However, there are several issues that should be addressed in the short term.

- A review of functions and their allocation across the public administration system should be urgently started as a basis for an informed re-organization of ministerial structures, based on the proposed reduction in the number of ministries.
- A reform unit with adequate staffing should be created, preferably based at the Office of the Government is a condition sine qua non for effective reform. This should be a first priority if planned reforms are to have an impact.
- Key legislation needs to be reviewed in order to draw up a program of required legislative amendments to reform the civil service and modernize the policy process.
• A full review of the pay system in the central state administration should be undertaken urgently, to map the existing weaknesses in the system and chart a medium term policy to reform the pay system to create a more competitive civil service and to bring Croatian practice in line with European principles.

• The reform of the Office of the Government and its committee structures needs to be considered urgently to ensure that the new government will have an effective support structure, enabling it to make rapid and well informed decisions.
JUDICIAL REFORM IN CROATIA

Introduction

One of the main challenges facing Croatia in its efforts to promote investments and growth is creating stable, progressive and predictable laws and institutions. For businesses to be successful, contracts and property rights must be observed and protected, and the court system must provide impartial and efficient adjudication of disputes. A strong, institutionally independent and efficient judiciary is essential for encouraging investments, protection of citizens’ rights and successful integration of Croatia into the EU.

In November 2002, the Government adopted a concept paper “Reform of the Justice System” which provided an overview of the situation in the judiciary and proposed measures to tackle the existing case backlog, to increase efficiency of court procedures and to enhance professional level of judges and court staff. In June 2003, the concept paper was further elaborated in an Operational Plan for the Implementation of the Justice Reform, approved by the Ministry of Justice. The proposed measures include, inter alia, changes to the existing laws and regulations, improving conditions of the court buildings and provision of computers and legislative materials to judges, increasing the number of judges and court personnel, etc. However, there are indications that modernization of court buildings and investment of more funds into the court system would not be sufficient for bringing the Croatian judiciary up to international standards, and more structural changes are needed to enhance institutional independence and efficiency of courts.

Key medium-term challenges and priorities:

1. Improving efficiency of the court system, which could be accomplished by pursuing a three-pronged strategy focusing on the rationalization of the court system, increasing the efficiency of court proceedings and improving the system of administrative justice.

Rationalizing the court system, including mergers of smaller courts into larger units, and more efficient allocation of human and financial resources within the court system. Before such restructuring is launched, it is strongly recommended to conduct a quantified analysis of existing ratios between caseloads and numbers of courts and judges in various territorial divisions and jurisdictional areas and to prepare a comprehensive strategy for such restructuring. Namely, the number of judges in Croatia per 10,000 inhabitants is among the highest in Europe, whereas a number of court supporting personnel per judges is one of the lowest. Distribution of work among the courts is highly uneven. It appears that a number of county courts (21), as courts of the second instance, is also too high for the country with the population of 4.2 million. One of the sources of large inefficiencies and backlog in the court system, both in commercial and municipal courts, is the non-adjudicative agenda that judges are tasked with, such as land registration and titling and the maintenance of the company register. The delineation of jurisdiction between municipal, commercial courts and the Administrative Court, which is affected not only by the subject matter, but also by the nature of the parties to the disputes, also adds to inefficiency of the overall system.

Increasing efficiency of court proceedings. The current situation in Croatia is characterized by a large number of pending cases (approximately 1.3 million) accumulated during previous years. Duration of court proceedings is widely considered as one of the fundamental and most important symptoms of crisis of the justice system in Croatia. There are numerous factors which contribute to

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9 After Croatia became a member of the Council of Europe in 1997, the first cases in which the European Court for Human Rights found a violation of human rights in Croatia related precisely to the right to a trial within reasonable time.
the existing inefficiencies of the court system; and they include both procedural (i.e. the current version of the Croatian Code of Civil Proceedings) and organizational problems (relating to organization of labor division between judges and court personnel, case registration and management procedures, automation of court functions, etc.). The Government is therefore recommended to consider: (i) reforming procedural legislation\(^\text{10}\) aiming at streamlining court hearings, modifying the rules for introducing and analyzing evidence, strengthening procedural discipline, etc., as well as (iii) reform case management procedures aimed at accelerating case proceedings at every stage from filing to disposition (the Court and Bankruptcy Project takes first steps in this direction).

The system of administrative law currently fails to address the demands of a modern market economy and to sufficiently protect the rights of citizens against the administrative discretion of the state. The current system is based on administrative decisions being appealed in the first instance within the state administration, and in the second instance addressed to the single Administrative Court located in Zagreb and having about 15 judges. The Court is widely criticized for being slow and not having the experience and expertise to address the plethora of matters addressed to it. It is widely recognized that the Court falls short on two important counts: it does not provide for a speedy and informed justice to the citizens and businesses that appeal the licensing, approvals and permit granting processes. Equally importantly, the Court lacks the competence to rule on appeals from the highly specialized regulatory bodies whose decisions are considered administrative decisions, such as the antimonopoly authority.

2. Development of an effective accountability and performance monitoring mechanism

The court system is perceived to be slow and lacking adequate professional capacity. There is no adequate system in place to monitor judicial performance based on objective and reliable standards. There is a need to update the current workload rates per judge and time standards for case disposition as they do not reflect the changed realities, e.g. increased complexity of cases, enlarged jurisdiction of municipal courts, explosion of insolvency cases and increase in labor disputes relating to privatization.

3. Improving professionalism of judges and court personnel

Many judges in Croatia are young and usually with insufficient practical experience. In the municipal courts in urban centers, half of the judges are under 35 years of age: e.g. in Zagreb 7% of the judges are under 30 and 27% from 30-35; in Split 21% of the judges are under 30 and 43% from 30-35. At present, the requirements for eligibility for appointment as a judge are based on a combination of academic degrees, bar examination and relevant years of professional experience in specific fields. Newly appointed judges are not required to take a specialized training which would equip them with practical skills necessary for conducting trials and administering judicial functions. Mostly the education is done “on the job”, by sharing information between more experienced judges and younger judges and discussing relevant cases at court meetings. Furthermore, there is no system for continued judicial education. The Center for Judicial Training has been recently established, but it needs substantial financial and organizational support in order to develop into a well functioning training institution.

\(^{10}\) Amendments to the Code on Civil Proceedings have been prepared and submitted to the Parliament in 2003. However, even if the proposed amendments, if and when enacted, would address some important issues, they would not remove the principal causes for delays and unreasonable duration of the process.
Priority issues for the court system: what can be done in the next six to twelve months

The majority of issues discussed above require sustained and long-term attention, as both legislative changes, training and institutional development are required. However, there are several issues that could be addressed in short term, leading to recognizable improvements.

- Preparing a revised and more comprehensive strategy for restructuring of the court system, based on a quantified analysis of the existing case ratios per judge and per court and analysis of distribution of caseload with respect to geographical and subject-matter jurisdiction criteria.

- Testing and sequenced roll out of a new court and case management information system developed in coordination with several donors (the Bank, USAID, EU, etc.) and necessary adjustments in the Book of Rules.

- Developing an organizational and governance structure of the Judicial Training Center, and initiating development of the curriculum and training courses; and preparing a comprehensive strategy for judicial education and continued training in close cooperation with judges.

- Transferring a number of non-adjudicative functions, including land and businesses registration, from judges to non-judicial court personnel, which would free judges’ time for speedy adjudicating of disputes.

- Encouraging alternative dispute resolution methods, including out-of-court settlements in civil and commercial disputes and supporting mediation in court proceedings.
PRIVATE SECTOR DEVELOPMENT IN CROATIA

Looking ahead to the European Union (EU), the conditions under which Croatia will be able to compete in the EU market – as an importer/exporter of industrial goods and services – will very much depend on its reform agenda. Policies introduced today will send a clear signal about the direction in which Croatia is heading and, if applied consistently, will create an environment in which the enterprise and service sectors will be able to meet the challenges and take advantage of the opportunities that the EU membership perspective presents.

Competitiveness

While progress has been made in improving the performance of the real sector in Croatia – profits and productivity have both increased, and the aggregate value of loss making enterprises has decreased in relative terms – Croatian enterprises are generally less competitive than enterprises of neighboring economies entering the EU in 2004 and are much less competitive than enterprises in the EU today. The structure of the Croatian industrial sector, in which both large state-owned enterprises and large privatized enterprises are still dominant employers and producers of value-added, limits the individual enterprise’s ability to improve vis-à-vis its competitors in structurally more balanced EU economies, in which the dynamic and highly competitive local SME sector provides inputs and services to larger firms, permitting the larger firms more focus on and benefit from international markets.

The competitiveness of Croatian enterprises can be increased significantly in the coming years through implementation of a two-prong reform program. The first set of reforms would seek to accelerate the improvement of the business environment and attraction of FDI, while the second set of reforms would facilitate more rapid adjustment of enterprises to the competitive markets of the EU and expansion of domestic supply networks. The combined result of these two sets of policies would be an accelerated entry of SMEs, creation of clusters, and development of local supply chains, enabling larger Croatian firms benefit from wider European markets.

Key medium term priorities:

- **Regulatory reform to reduce costs and facilitate privatization.** A credible commitment is needed to reduce still high costs of operating in the existing regulatory environment. Prompt actions are needed to simplify entry requirements for firms as well as to lower the operational regulatory costs. Key measures include, but are not limited to, reduction of costs of inspections and construction permits, simplification of the licensing regime and completion of one-stop-shops where local and foreign entrepreneurs can complete registration easily. Precise and targeted actions to achieve quick improvements in the operation of the judicial sector, in particular in the area of land registry and cadastral, should also serve to lower the regulatory uncertainty. Tight monitoring of the overall costs and benchmarking with other countries are recommended.

11 Croatia is in 53\textsuperscript{rd} place—down from 48\textsuperscript{th} position a year ago—out of 102 countries covered by World Economic Forum’s Competitiveness Index, compared to Slovenia’s 31\textsuperscript{st} or Hungary’s 33\textsuperscript{rd} ranking for 2003.

12 Germany 13\textsuperscript{th} or Austria 17\textsuperscript{th}, to mention only two major trading partners.

13 Croatia is in 51\textsuperscript{st} place—deterioration from 47\textsuperscript{th} position in 2001—on Corruption Perception Index, compared to Slovenia’s 27\textsuperscript{th}, Italy’s 31\textsuperscript{st}, and Hungary’s 33\textsuperscript{rd}.

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• Privatization. At the same time, significant assets are locked-up (in particular in the following sectors: shipyards, tourist companies, agro-combinates), be it land or in loss-making state owned enterprises, requiring significant budget funds that could be used to finance competitiveness enhancing programs. Fast release of locked-up assets to the private sector through sale of whole units or breaking-up and disposal by sale or lease, will provide the Government of Croatia with the human and financial resources required to implement measures that would make the overall Croatian enterprise sector competitive.

• Evaluation of SME programs. Croatia already has many programs to help small firms adjust to new rules and some programs are starting to target medium and large firms. These programs need to be reviewed, prioritized, expanded and managed in such a way as to ensure rapid increases in quality, design and lowered production costs. Expansion of such programs requires funding that might come from savings achieved through rationalizing existing subsidized credit lines to SMEs.

• R&D: The wider usage of R&D by the industry would help to improve competitiveness of the Croatian private sector through better quality products as well as through shifting of production towards more value-added products rather than labor intensive ones. A conducive environment should be created, providing incentives both for firms to use and invest into R&D resources and for R&D institutes to reduce their dependency on budget funds through increasing income from the private sector.

• Investing into Managers: Enhancement of management skills, at least in key sectors such as tourism, exports industries and agribusiness. Improving business knowledge of undergraduate students and introduction of obligatory entrepreneurship training at selected faculties (engineering, economy) and as an elective in high schools. Review, redesign and enhancement of vocational training for key industries.

The proposed two-pronged strategy must be complemented by the deepening of the financial sector, the increased efficiency of the public sector and the government, and the creation of working public/private partnerships.

Priority PSD issues: what can be done in the next six to twelve months to increase competitiveness of Croatian private sector exporters

Issues that could be addressed in the short term:

• Increasing competitiveness of Croatian exporters by re-channeling public funds currently drained by loss-making enterprises in portfolio of the Croatian Privatization Fund. The USAID-supported advisors recommend five priority actions: (i) establishment of a transparent competitive process for divestiture of state-owned enterprises; (ii) immediate divestment of 20 to 30 most-distressed enterprises through competitive public tender and liquidation of those not sold; (iii) restructuring of companies through divestiture of non-core assets or subsidiaries; (iv) initiation of broad-based communication on benefits of privatization to enterprises, community stakeholders and potential investors; and (v) creation of tender criteria that attract strategic partners willing to invest in and improve companies.

• Adopting and implementing EU standards. Capacity building of Agencies involved in the adoption and implementation of the EU standards and IPR systems is needed, including aligning legal and institutional framework with EU norms, as well as provision of relevant support to industry and legal community.
• **Strengthening of the institutional capacity** of the Ministry of Economy to (i) enable an in-depth review of the effectiveness of the existing multitude of SME-support programs in Croatia and (ii) lay foundations for effective monitoring of new and remaining programs.

• **Reducing administrative and regulatory costs** born by entrepreneurs in order to remain in regulatory compliance, through implementation of the FIAS recommendations, including but not limited to: (i) the enactment of the Law on Spatial Planning; (ii) finalization of the Operational Manual for harmonization of methodology and data bases between the Land Registry and Cadastre systems; and (iii) assignment of land registration work to non-judicial court personnel.

• **Improving efficiency of courts** and increasing rule of law (higher transparency/predictability) through reduction of case management time by adoption of the revised Rule Book on Case Management (developed as a part of the USAID support to Croatia and submitted to the Ministry of Justice).
STRENGTHENING THE ROLE OF SCIENCE AND TECHNOLOGY IN CREATING KNOWLEDGE BASED ECONOMY AND INNOVATION LED GROWTH

Introduction

Historically, Croatia has been active in research and high-tech industrial sectors, such as, pharmaceuticals, chemicals, shipbuilding and machinery. While its universities produced scientists and engineers of high quality, the R&D system that gradually evolved reserved fundamental research for publicly funded research institutions while applied research was almost exclusively carried out in large (non-private) enterprises. With few notable exceptions, during the initial years of transition many of the large enterprises collapsed or broke into new units, reducing so their applied research capabilities to a bare minimum and practically eliminating whatever small demand for outsourcing R&D existed in the past. The tendency of successful large companies to develop their own R&D in-house facilities, did not provide an impetus for increasing demand for non-company based applied research. Today there is a clear market failure, both on the supply side and the demand side — when it comes to links between the R&D institutions and the private sector in Croatia. Existing R&D institutions lack skills and incentives to start shifting form their fundamental to applied research work, while on the supply side, new--privately owned--firms, most of them small to medium, lack skills to define their R&D needs, lack technology acquisition information as well as information where to go for R&D assistance, and lack financing to cover the costs of outsourced R&D. Over the last decade, the link between R&D institutes and the business sector has weakened, and this has led to a decrease in capacity of many Croatian firms to compete with technologically more advanced firms. The Government, recognizing the problem has introduced a number of initiatives to make the institutions dealing with technology issues more effective and has set up several programs supporting and promoting innovations. Strengthening and diversifying the currently weak R&D institutes-private sector links present Croatia with a major opportunity and potentially an important competitive advantage vis-à-vis its transitional economy neighbors and competitors.

Key medium term challenges and priorities

The wider usage of R&D by the industry would help to improve competitiveness of Croatian private sector through better quality of exported goods and services as well as through shifting of production towards more value-added products. To foster linkages between the industry and research community, a two-pronged approach is recommended: the first would introduce incentives for both, R&D institutes to start shifting to applied research and commercialization of their work, as well as for the emerging private sector to start outsourcing R&D; the second would focus on framework/infrastructure actions that would provide an impetus to creation of a knowledge based economy and innovation led growth in Croatia. Specifically the proposed two-prong approach would focus on:

- providing adequate organizational and individual incentives for public R&D institutes and their staff to engage in contractual R&D and commercialization; Providing RDIs with appropriate flexibility and autonomy in managing their activities, including budget allocation and human resources, as well as introducing incentives for applied research and financial sustainability.

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14 Croatia is in 53rd place—down from 48th position a year ago--out of 102 countries covered by World Economic Forum’s Competitiveness Index, compared to Slovenia’s 31st or Hungary’s 33rd ranking for 2003.
15 Total expenditure on R&D increased to 1.3% of GDP in year 2000 (from 0.9% in 1999)
R&D system would also need to be consolidated to be more efficient and less burdensome for the budget. 

- stimulating industry and SMEs to develop and adopt new technologies, stimulating growth of technology and hi-tech companies, thus promoting conditions for improved quality and diversity of the products by industry. Incentives may include tax incentives, special R&D financing instruments, science parks, reform of public procurement, and other measures to be identified under the Technology Policy Study.

- strengthening institutional capacity of technology financing institutions, and providing appropriate legal framework and business environment for potential investors and particularly for Venture Capital with a view of attracting the right kind of investors and skills needed to run such risky, but rewarding, operations, which could support technology based companies and commercialization of their research outputs.

- adopting and implementing EU standards. Capacity building of Agencies involved in the adoption and implementation of the EU standards and IPR systems is needed, including aligning legal and institutional framework with EU norms, as well as provision of relevant support to industry and legal community.

Together with increasing private sector participation and strengthening of the government capacity to support innovation and launch into e-Development, will ultimately contribute to improvement of competitiveness of Croatian firms and will be instrumental for successful integration of Croatia into the European Union.

**What can be done in the next six to twelve months to address the above challenges?**

The majority of issues discussed above require sustained and long-term attention, as both legislative changes, training and institutional development are required. However, there are several issues which, if addressed, could provide visible improvements/results in the short term.

- **Prepare strategy for consolidation of public R&D**, including planning for merging/reorganizing smaller RDIs based on the industry demand and needs.

- **Improve governance of RDIs**: modify Boards and Advisory Councils of RDIs to enable private sector participation; introduce annual performance contracts between the Government and RDIs to ensure accountability and financial discipline.

- **Improve incentives framework for applied research in RDIs**: (i) introduce a competitive research program; and (ii) carry out HR reform in RDIs by giving them authority to hire full, part-time and contract staff as needed, manage redundancies and scientists’ rewards and promotions based on performance.

- **Strengthen institutional capacity of Business Innovation Center of Croatia (BICRO)** to enable it to play effective role in promoting innovation. Modify BICRO’s governance structure by bringing in private sector to its Board and Advisory Council; revise Articles of Incorporation; reorganize internal structure; and hire management and new staff.

- **Create platform for e-Government services to private sector** (such as e-Procurement, e-Registration, e-Credit Information, e-Pledge Registry of movable assets) by developing regulations and piloting some activities.

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16 According to Ministry of Science and Technology data, in 2002, there were 86 higher education institutions and 28 public institutes registered in Croatia dealing with R&D.
• **Restructure RAZUM and TEST programs** to ensure a more systemic and broader impact as well as foster linkages between the R&D and private industry communities. The governance for these programs would need to be strengthened to ensure transparency and accountability.

• **Upgrade Technology Centers’** capabilities and governance to provide demand driven better quality services to technology based SMEs (outsourcing TCs management to private sector under management contracts; achieve full self-sufficiency within reasonable time-frame).

• **Venture Capital regulations would need to be designed to provide environment conducive for venture capital development** (such legal and regulatory constrains as double taxation, blocking of accounts in case of default of any single client, and licensing difficulties would need to be addressed within existing or new legislation).

The Bank activities in Science and Technology area

Following the request of the Croatian authorities, the Bank has started cooperation in developing the proposed **Science and Technology Project (STP)**. The project, to be backed up by an investment loan, aims to support (i) strengthening and restructuring some RDIs and promoting commercialization of the research outputs; and (ii) strengthening BICRO and providing funding for programs aimed at upgrading of technological capabilities of Croatian enterprises.

Feasibility studies and some pilot activities related to the preparation of STP are supported under the on-going Bank-financed **Technical Assistance Loan (TAL-2)**. Based on the progress achieved in preparing this project, its appraisal is planned for March 2004. The technical aspects of the project preparation would be finalized during January 2004 Technical Mission. N.B. the proposed **Programmatic Adjustment Loan (PAL)** also offers opportunities to tackle the S&T reorientation and competitiveness issues at the policy level.

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17 TAL-2 may need to be extended to allow for continuity of certain activities and to keep up the momentum with the Project Agencies.
HUMAN DEVELOPMENT: PROMOTING A DECENT QUALITY OF LIFE FOR ALL CROATIANS

Reforms in education, health, pensions, social assistance, and related services are of critical importance as Croatia continues its accession to the European Union. Croatia’s social sector reforms to date have aimed to improve the effectiveness, efficiency and client orientation of social sector management, so that performance outcomes progressively close the gap with European averages. This is important to Croatia for a number of reasons:

- **Quality of Life**: The quality of life of all Croatians will depend on access to high quality schools, health facilities, and social services at a standard that is increasingly on par with the rest of Europe. Many agree that the current level and quality of these services falls well short of what many Croatians would desire.

- **National Competitiveness**: As noted in the 2003 Croatia Country Economic Memorandum, the ability of Croatian workers to compete within Europe is severely hampered by the quality of the education that they have received upon graduation. These concerns have been noted by both Croatian employers and foreign investors. Better-educated workers are essential if Croatia intends to compete through innovation-led growth. Costly social insurance programs, which in 2003 absorbed 17.2 percent of GDP, increase pressures to raise payroll contribution rates. Introduction of supplementary social care programs and expanding existing social insurance program, pensions in particular, would increase the cost of Croatian labor relative to other economies. National policy should also support the maximum flexibility of the labor market to strengthen competitiveness.

- **Macro-economic and Fiscal Stability**: Fiscal problems in pension and health systems can contribute significantly to national deficits, and can present growing concerns for aging populations such as Croatia’s. For example, Croatia’s social insurance reforms have successfully aimed to reduce the fiscal deficit and to contribute to national savings. There have been efforts to date to contain costs in the hospital sector through a combination of bed capacity reductions and hospital payment reforms, with only mixed success to date. National policy should aim to ensure that these services are affordable for the country’s overall economic health, and so that more resources will be available to invest into Croatia’s priorities as it continues towards accession. The reform of the pension system, internationally recognized as a blueprint for a successful pension reform implementation, has achieved a financial stability of the system, regular payment of pensions, stronger administrative system with higher collection and compliance rates and significant contribution to national savings and its transmission to investment through growing capital markets.

- **Equity and Adequacy of Services**: Like most other European countries, Croatia’s socio-economic well-being depends in part on its ability to target its scarce resources towards social services and cash benefits for the most vulnerable. The disabled, elderly, orphans, and poor have had particular difficulty in coping with the social and economic transition, and some communities are still attempting to rebuild from the earlier conflict. Croatian social services to these and other groups in need should be delivered efficiently, in accordance with Croatian needs, and be informed by international best practices. The many cash benefits that are currently being provided might be streamlined to focus those resources on the most deserving. Targeted cash benefits have confirmed to be the most efficient instrument for reducing poverty and to be superior to other forms of indirect social assistance, social subsidies and supplements to existing social programs.
• **Strengthening Effective Sector Management:** Croatia’s broad governance and public administration reforms can only work if they are ‘drilled down’ to the key sectors, including health, social protection and education. The country’s reforms should aim to strengthen the ability of Croatia to develop, finance and monitor sector policies with increasingly less reliance on foreign technical assistance, and increasingly more reliance on domestic knowledge and international consultation. In that respect, Croatia needs to improve its social statistics to allow policy-making process be well informed and outcomes monitorable. Social sector reforms should also aim to strengthen the accountability and transparency of all service providers, so that corruption and informal payment mechanisms are reduced.

• **Integration with the European Union:** The European Union is not developing a common social policy, but there are numerous issues that new member governments will face in the social sectors. Should the Government decide to join 14 Member States in joining the Social Policy Agreement, it would face policy objectives on employment promotion, improved living and working conditions, combating exclusion, and developing human resources. The Lisbon European Council stressed that all EU health care systems should provide a high level quality of care, financial sustainability of care systems, and access for all regardless of income or wealth, and Member State performance has been monitored against these criteria. Occupational pensions will need to be made portable outside Croatia and across member states. In addition, there are community legal acts encouraging policy cooperation between Member States in many social areas, such as recommendations, communications (e.g. on lifelong learning or quality assessment of school and university education), working documents, pilot projects, etc.; cross border social insurance agreements, EU-wide health insurance card provisions, etc.

In short, human development policy has important effects on broad national economic, social and political objectives. They also have a direct bearing on the welfare of Croatia’s citizens.
EDUCATION SECTOR DEVELOPMENT IN CROATIA

Croatia is committed to promoting the development of democracy and a knowledge-based market economy, both key requirements for successful membership in both European and global communities. The education system is playing a crucial role in fulfilling these requirements and in bringing about longer-term, sustainable social and economic development for the Croatian people. Still, Croatia spends less public resources on education than the EU accession countries (4.4% vs. 6.3% of GDP). Its adult illiteracy rate of 1.5% is on average several times higher than those in the EU accession countries (for example in Poland and Slovenia it is 0.3%, in Hungary 0.6%). Compared to the average OECD five year old, the average five year old Croat can expect to complete about four years less of education over lifetime. Croatia has only half the OECD share of tertiary completers. There is also a problem of outdated curricula and learning arrangements that don’t reflect the needs of knowledge society and innovation-driven economic growth. Given these challenges and the sector’s importance, and at the request of the Croatian Government, the World Bank successfully applied to the Government of Japan for a grant in the amount of US$766,150 to prepare a proposed Education Reform Project that would be backed by an investment loan.

Key medium term challenges and priorities

The quality of learning and the competitiveness of Croatian education system can be increased significantly in the medium-term future by combining national efforts with international expertise and through implementation of a longer-term education reform program. This program might consist of three phases:

- formulating a comprehensive medium-term education development plan, supported by targeted education sector analyses and information collection;

- implementing specific intervention to enhance the curriculum system at all levels including educational materials, supporting teachers’ professional development, improving evaluation of education processes and outcomes, and strengthening management and leadership in various levels of education system; and

- consolidating successful policies, supporting educational research, and sharing of good practices among teachers, schools and educational establishments.

Consensus-based education development plan. In a small country such as Croatia, it is paramount that all available human resources are used to push a common agenda. The challenge is not only to identify the directions and goals of education reform, but also to build consensus on these plans that is built on a widely accepted understanding of Croatian education. Engaging actively in international cooperation, studying similar education development plans and looking at related consensus-building mechanisms would be highly recommended.

Role of the state in education. The role and performance of the state is typically a principal cause of many problems in education system and impediment to fixing them. In Croatia, duties and responsibilities are not clearly set among different layers of administration, and it is quite important that the state clarifies its role in relation to other educational institutions. For example, whereas the state now has control over inputs and processes of education and turns accountability for outcomes over to the schools, it should help schools to become accountable for education outcomes by providing them with more flexibility – and the right kind of support to learn how to produce those outcomes.
**Education management and leadership.** Similar to other transition countries, authorities in Croatia have, too, experienced problems in policy consultation and coordination, strategic and analytic capacities, and policy continuity. Combined with the lack of policy-relevant statistics, analyses, and evaluations, these problems are constraining the capacity of the Government to produce a change, though the political may be present. The newly created Ministry of Science, Education and Sport can take some steps, starting with a performance audit that evaluates how well the Ministry is organized to conduct the generic tasks for which it is responsible. This would help in amalgamating scattered functions, identifying staffing and capital requirements (such as particular software packages for financial estimates), establishing a performance audit systems, defining job descriptions and hiring criteria, and identifying the needed technical assistance for efficient and effective management and implementation of new responsibilities.

**Curriculum development and evaluation of education outcomes.** In Croatia, current curriculum is widely perceived as outdated and to large extent irrelevant for the students of the information age, thus being the key barrier to developing the human capital that Croatia needs to support the development of democratic society and innovation-driven economic growth. Curriculum reform is urgently needed, and it should be based on a longer-term plan that respects Croatian traditions, taking into account current teaching cadre, and supported adequately through professional development and resources that are needed. Similarly, Croatia needs a longer-term plan for evaluating education outcomes in the system, stipulating the conceptual framework of evaluation and assessment, roles of different parties and mechanisms for collecting information. Following that plan, teachers need to be familiarized with educational assessment, quality of school-based assessments should be improved, and reliable external school-leaving examination (Matura) should be developed. At the same time, building accountability for learning outcomes around interpretable international student assessment should be realized.

**Supporting schools and teachers.** In any education reform teachers will be under pressure. Croatia has a dedicated teaching cadre that deserves to be treated accordingly as the education reform proceeds. Teachers not only need to be compensated adequately, but they need to be initially trained properly (university level education) and while in service be provided frequent opportunities to high quality professional development. Thus, current teacher education policies and practices need to be revised, continuous professional development system developed, and arrangements for supporting school improvement initiatives created.

### Priority issues: what can be done in the next six to twelve months

There are several issues that could be addressed in the short term, whilst adjusting to the new government structure.

- Working out a Medium-term Education Development Plan that would stipulate the main policy directions, principles and both qualitative and quantitative goals of education sector development until 2008. Related, identify and implement a mechanism to develop a national consensus around education reform priorities, including a process of consultations with key stakeholders.

- Continue the intensive work on curriculum and pedagogy, currently supported in part by the Center for Education Research and Development, and identify and procure related assistance under the Education Reform Project grant from the Japanese Government.
Establish an independent agency responsible for assessment of student learning (as in many other countries, the agency should be independent to maintain its credibility and to free it from any perceived conflicts of interest). At the same time, launch the policy level process to work out a national plan for evaluating education outcomes (as part of the Education Reform Program).

Strengthen the professional capacity within the Ministry of Science, Education and Sport to design, manage and monitor the Education Reform program.

The World Bank Activities in the Education Sector in Croatia

The World Bank can offer extensive expertise in the education sector reform, drawing on its global and regional expertise, as well as on the completed country specific analytical studies, notably the Croatia Country Economic Memorandum (2003) and the Croatia Public Expenditure and Institutional Review (2001). It can support reforms improving the policy and strategic structures, as well as interventions at the state and local levels leading to higher quality and better productivity within education system. As noted, at the request of the Croatian Government in October 2003, the World Bank applied to the Government of Japan for a grant in the amount of US$766,150 to prepare a proposed Education Reform Project. The grant proposal was recently approved by the Japanese authorities. The World Bank will be shortly engaging the new Government in consultations on the 2004-2007 Country Assistance Strategy for Croatia (see CAS section), which offers opportunities to discuss the scope, timing and size of the proposed Education Reform Project. Support to policy reforms in the education sector is also available through the proposed Programmatic Adjustment Loan (PAL).
CHALLENGES CONFRONTING THE
HEALTH SYSTEM IN CROATIA

Introduction

Croatia’s health system has undergone a series of health reforms that have helped to transform the fragmented health system it inherited from the former Yugoslavia into one that maintains the principles of universality and solidarity. The Health Care Law of 1993 consolidated the health financing system into a single public entity (the HZZO), while recognizing the roles that private insurance and private health care service provision play. The system has fared relatively well among the countries of the region, with a well-trained workforce, a well-established system of public health programs and health delivery programs, and better health outcomes than most countries at similar income levels.

However, these results have been achieved at a high cost, and growing deficits in the health insurance fund have been a source of particular concern. Croatia already spends more on health care services than other countries with similar levels of GDP (see below). Recent policies to contain costs are leading to problems of access to care, even as the aging population, new technologies and changing epidemiological profiles have continued to exert an upward pressure on costs. Despite the above noted progress, health outcomes still are well behind EU averages – infant mortality rates are 7.4 per 1000 live births (EU average is 4.9), and maternal mortality is 6.9 per 100,000 live births (EU – 5.5). Standard death rates for ischemic heart disease are almost twice the EU average, and the incidence of TB is almost three times the EU average. Like many countries, Croatia faces a complex and interrelated set of challenges concerning the health sector’s fiscal efficiency, effectiveness of service delivery in the face of national needs, organization and management at central, regional and local levels, and the capacity of its staff and institutions to deliver.

Key medium term challenges and priorities

Over the medium term, Croatia’s health sector will face the following pressing challenges:  

- Containing costs in health services, and targeting scarce resources to provide the most cost-effective services. In 2002 Croatia spent over 9% of GDP and over 15% of the government budget on health care, compared to an average of about 6.5% of GDP for eleven Central and East European countries. HZZO administers the single largest fund for health care in Croatia, which accounts for 94% of public spending on health and an estimated 80% of total health expenditure in Croatia. A rapid real increase in health expenditures was recorded by HZZO between 1998 and 2000, averaging about 8 percent per year in real terms. This rate of increase in spending exceeded the revenues available to HZZO, largely generated from payroll contributions, which did not increase significantly during the same period. Between 2000 and 2002 the rate of increase of HZZO spending has been slowed by a decline in spending on pharmaceuticals, primary care and outpatient specialty services which is partially offset by an

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18 The World Bank completed a draft health sector financing study in late 2003, which outlines the findings in this brief in much greater detail. This draft health study will be presented to the new Government for its review and comment before it is submitted for publication.

19 Croatia, Slovenia, Slovak Republic, Romania, Poland, Moldova, FYR Macedonia, Hungary, Czech Republic, Bulgaria, and Albania. Of these eleven countries, Croatia also had the highest health spending as a percentage of GDP.
increase in reimbursement for hospitalization. Still, the Health Insurance Law of 2002 introduced co-payments in the core social health insurance package covered by HZZO to control overuse by consumers, but at the same time, voluntary health insurance was introduced to cover these co-payments as part of a strategy to increase revenues. This measure presents significant fiscal risks to the health system, and the Government is encouraged to consider establishing a voluntary insurance program that offers coverage for services not included in the statutory program and does not cover co-payments introduced into the statutory program to mitigate demand. Shifting spending toward potentially more cost-effective primary health care has the potential to control the increase in spending even further.

- **Improving the efficiency and productivity of services through reorganization and rationalization of the delivery system; especially at the tertiary and secondary levels.** The current service delivery system is no longer best suited to address the health needs of the Croatian population as it was built to primarily address acute illnesses. As the population ages and the incidence of infectious diseases decline, the burden of disease shifts to lifestyle related and chronic conditions. The current system does not effectively promote and maintain health, manage chronic conditions, and prevent avoidable high cost events. Part of the solution will be to strengthen and reorient the primary health care system to focus on health promotion and chronic disease management. Another part will be to structure service delivery to more effectively manage continuity of care from the primary to secondary or tertiary level and back to the community level. More effective primary care, team work, and more effective case management will contribute to improving quality of care and to controlling health system costs.

- **Enhancing the purchasing role of HZZO and its contractual relationship with health care providers to achieve better alignment of payments with incentives for efficiency and quality.** As the dominant payer, HZZO has the potential to use strategic purchasing strategies to drive efficiency and quality improvements in the system. The impact of payment mechanisms that have been introduced by HZZO to change the behavior of providers, such as case-based payment to hospitals and performance based payment for primary health care, is diluted if reimbursement is only for operating costs. More profound changes are needed for HZZO to take full advantage of its power to drive system changes.

- **Improving management of the primary and secondary health delivery systems by the local authorities.** Local governments own and operate most of the public primary and secondary health care providers, including general hospitals, polyclinics, public health institutes, and community health organizations (home care and emergency care units). While these facilities receive operating funds through their contracts with HZZO, the local authority is responsible for maintenance of infrastructure, and increasingly for capital investments. In 2002, county governments spent just 3% of their revenues on health care, indicating that there may be scope for expanding local government contributions to health care. The flow of funds and implications for accountability, efficiency, and quality of care need to be examined.

- **Expanding the scope of public health programs focused on prevention and health promotion.** A significant portion of chronic disease conditions can be prevented through the promotion of healthy lifestyles, screening and primary and secondary preventive are measures. Croatia’s spending in these areas has remained relatively modest.

- **Strategic planning for health care reform.** The Government might identify a realistic subset of short, medium and longer term priorities to address, from health system organization to human resources and training, and establish and execute a related plan for implementing its strategy.
**The World Bank Activities in the Health Sector in Croatia**

The World Bank can offer extensive expertise in the health sector reform, drawing on its global and regional expertise, as well as on the completed country specific analytical studies, including the [Croatia Public Expenditure and Institutional Review (2001)](https://www.worldbank.org). A draft [Health Financing Study (2003)](https://www.worldbank.org) has been prepared, and will be submitted to the new Government for its review and comment.

The first [Health Project](https://www.worldbank.org) for Croatia was completed in 1999, and was funded by a US$40 million loan. The [Structural Adjustment Loan](https://www.worldbank.org) completed in 2003 that supported the Government’s structural reform agenda had a health-sector component to enhance fiscal discipline. The current [Health System Project](https://www.worldbank.org), funded by a US$29 million loan from the World Bank, is scheduled to end in June 2004. The prior Government requested an extension to June 2005, and this issue will be discussed with the new Government.

At the official request of the Croatian Government in October 2003, the World Bank applied to the Government of Japan for a grant in the amount of US$425,000 to prepare a follow-on [Sustainable Health System Project](https://www.worldbank.org). This grant proposal has just been approved by the Japanese authorities. After CAS approval, the new Government will be presented with a Grant Agreement for its review and execution (through Government procedures). Both the grant and the proposed loan would be managed by the Ministry of Health and Social Welfare, and there is a great deal of flexibility available to the new Government to define and finance its priorities.

The World Bank will shortly be engaging the new Government in consultations on the 2004-2007 [Country Assistance Strategy for](https://www.worldbank.org) (see CAS section), which offers opportunities to discuss the scope, timing and size of the proposed [Sustainable Health System Project](https://www.worldbank.org). Support to policy reforms in the health sector is also available through the proposed [Programmatic Adjustment Loan (PAL)](https://www.worldbank.org).
SOCIAL PROTECTION SYSTEM DEVELOPMENT IN CROATIA

Introduction

Continued improvements in Croatian national living standards will be best secured through productive employment and income generation opportunities that come from economic growth and private sector development. Many Croats have already benefited from the transition to a more open society and market-oriented economy, and European accession is likely to broaden and increase those benefits. However, the country’s socio-economic transition and the war have also resulted in difficulties for many individuals and families, many of whom have had trouble coping in the face of high unemployment and still limited service availability. Croatian poverty is estimated at roughly 10 percent by national standards.

Croatia spends 29 percent of GDP on health, education, pensions and social benefits, which is high by international comparisons. It is thus necessary to consolidate and improve the efficiency of social sector expenditures, many of which support consumption rather than investment. At the same time, spending on Croatia’s best targeted cash transfer program -- social assistance -- is quite low within this broader envelope (0.7 percent of GDP, well below the average 1.7 percent of GDP for the EU member states). The current eleven separate benefits are poorly coordinated with parallel benefit systems provided by local authorities, suggesting a need for rationalization which would improve targeting. There is a long tradition of supporting public social services, but overall the social service system is outdated, over-centralized, and over-institutionalized, even as it faces increased demand. There is also an increase in the number of young children and young adults who are being institutionalized. Further, many of the institutions are too big (the average capacity of children’s homes is 80), and residents tend to stay for long periods. International experience has shown that community social services, such as day support to elderly and disabled and foster care for children are much less expensive, and more effective, than residential institutionalization.

Croatia’s social policy will need to balance tradeoffs between: (i) raising living standards and providing effective social services to the most needy; (ii) keeping program costs affordable, given the current broader fiscal pressures and aging of the Croatian population; (iii) preserving work incentives for benefit recipients and identifying employment opportunities for them -- some fifty percent of social benefit recipients in Croatia are able-bodied for work; and (iv) keeping programs administratively simple. Related program design issues for Croatia include (i) defining who will be eligible for benefits and services; (ii) determining what factors will establish the benefits they receive, in what form, and for how long; and (iii) establishing what levels of government will be responsible for policies and rules, financing, administration, and monitoring.

Key medium term challenges and priorities

The new Government has a unique opportunity to clarify, define and introduce its reform agenda in this area. Croatia has adopted a National Poverty Alleviation Strategy, which promotes national efforts to improve living standards and to reduce poverty through employment generation and social programs. To support this effort, work has been initiated on a Croatia Social Welfare Reform Strategy (SWRS), which was widely circulated in mid-2003. The earlier described challenges and constraints suggest the need to focus on the following:

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20 E.g., the aging of the Croatian population is projected to increase demand for beds in old age homes by about 2,200 by 2040, on top of already long waiting lists for placements.
• **System Organization and Management**, through strengthening the organization and management of social service delivery through clearer national, regional, and local accountabilities for delivery and financing. This might be achieved through the creation of a new Agency for Social Work, through improvements in the work practices of the Centers for Social Welfare (CSW’s), and through improved policy development and monitoring capacity at the national level.

• **Promoting local service interventions that work.** While much has been achieved to develop community alternatives to institutionalization, there is no systematic approach in place, with the success of community-based approaches largely depending on individual local initiatives. Residential institutions should be gradually transformed, while promoting the provision of alternative community-based services. It is recommended to underpin that change through the introduction of financing schemes for innovative social service provision, while ensuring that quality control mechanisms are also in place so that minimum standards of service delivery are being met.

• **Improving the Effectiveness of the Cash Benefits System.** Croatia’s cash benefits system is complicated in design with parallel systems of benefits provided by central, county and local authorities. It comprises a large number of small benefits with various levels of targeting effectiveness, and it does not meet its policy intention to ensure that all the beneficiaries receive a reasonable minimum level of income support. Almost every second cash benefit beneficiary is able-bodied unemployed, and there has been little emphasis on promoting transition back to the workforce. The existing system of multiple social assistance benefits should be streamlined into a guaranteed minimum per capita household income that would build on the present regular support allowance.

• **Monitoring household incomes, expenditure and behavior.** While technical work has been undertaken, a national household income and poverty monitoring methodology needs to be agreed and implemented for Croatia. While improvements in the existing annual Household Budget and Labor Force surveys have been instituted, relatively limited and low cost efforts to strengthen the household survey would allow Croatia to bring its data quality up to broader European standards, better informing Croatian policy-makers and the public on household income dynamics and trends in overall poverty levels.

**The World Bank Activities in the Social Protection Sector in Croatia**

The World Bank can offer extensive expertise in the social protection sector reform, drawing on its global, regional and country specific expertise. Its Croatia specific expertise follows, among others, from the **Croatia Economic Vulnerability and Welfare Study (2000)**, which measures poverty and inequality in the country and provides advise on how to improve targeting and protection of the poor, as well as from the **Croatia Public Expenditure and Institutional Review (2001)**, which, among others, includes an analysis of the composition of expenditures, examines key issues and provides recommendation for targeted cash-transfer programs.

The Bank’s Croatia specific expertise also follows from its cooperation with the Croatian authorities on the Structural Adjustment Loan completed in 2003 (which had a component aimed at strengthening social protection), as well as on developing a reform program in the area of social protection.

In 2001, at the request of the Croatian Government, the Bank successfully applied to the Governments of Japan and United Kingdom for grants of US$200,000 and GBP 352,800 (respectively) to support the Ministry of Labor and Social Welfare (MoLSW) to prepare the SWRS and a related World
Bank project (see next paragraph). Joint international and Croatian teams of consultants selected by the MoLSW, and in cooperation with Ministry staff and other Croatian authorities, carried out a comprehensive analysis of issues to be addressed in social welfare reform, identified the measures and mechanisms for improvement. This led to an integrated report containing recommendations for implementation of the reform.

A proposed World Bank Social Protection Project (SPP) can finance renovations, equipment, technical assistance, and training, as agreed with the Government, to support its social policy reform objectives. The project is indicatively programmed for US$36 million. The Ministry can apply for a loan advance ahead of that timing. The Bank looks forward to discuss and agree with the new Government on the project strategies and investments, as well as the final amount of the Bank loan. Donor co-financing might be available to support the costs of technical assistance (TA), which would be an attractive alternative to borrowing for foreign or local TA provision. For example, the Government of Sweden (through Sida) might possibly be interested in providing grant co-financing of this project. It bears noting that support to policy reforms in the social protection sector could also be available through the proposed Programmatic Adjustment Loan (PAL).
CROATIAN AGRICULTURE POLICY IN A EUROPEAN PERSPECTIVE

Croatia faces the imperative of converging its institutional and policy framework for agriculture toward the need to compete on European markets. Agriculture is an important component of the Croatian economy, contributing around 8 percent of GDP (still above the EU candidate countries). The sector, however, faces many weaknesses which affect its capacity to compete in terms of prices, quantity, EU quality compliance, productivity and markets. For instance, in most cases, yields are below those observed in the EU, although close to the average of EU candidate countries. As with crop production, per animal production is generally well below EU standards. In addition, livestock yields are significantly below those achieved by the EU candidate countries.

Croatia’s agriculture sector faces serious structural weaknesses. The most noteworthy are:

- **Incomplete transition in farming.** Private farms operate on small, fragmented farms, unable to use any economies of scale. The average farm size is half the one in EU. Agro-combinates and cooperatives struggle to respond to the new economic environment, with production levels still at 50-60 percent of pre-independence levels. They are still majority state-owned and have applied survival strategies based on payment arrears, soft state budgets, and bad debts; all ultimately delaying their restructuring.

- **Unsettled land ownership situation.** Currently, 30 percent of the agricultural area remains under state ownership, with unclear ownership for roughly 40 percent of the agricultural land area. According to the government estimates, it will take up to 15 years to clarify all private land ownership disputes. As a result, land markets are barely functioning.

- **Weak commodity markets.** The poor development of competitive agricultural markets at the wholesale level implies that commercial margins to the small farmer are often squeezed by monopolistic behavior of traders or large processors. In Common Agricultural Policy (CAP) price and market support is mostly at the wholesale level and not at the farm gate. The competitive functioning of wholesale markets in Croatia is thus an essential prerequisite for the convergence to the CAP-like support to producers.

- **Lack of credit in rural areas.** Limited involvement of commercial banks in farm lending is caused by a lack of expertise in dealing with small farmers, low level of profitability and potentially high-riskiness of farming, relatively high transaction costs of the small loans required by small-scale farming, lack of provable title to land, and weak enforcement of contracts and bankruptcy procedures.

Creating a farming sector that has the potential to be competitive in an eventual European environment is a complex process which will require long time. The suggested key medium term priorities are:

- **Reducing the level of producer’s support and adopting new instruments of agricultural policy.** The findings of Croatia Country Economic Memorandum indicate that the aggregate level of producers’ support in Croatia (an estimate of 33 percent in 2001) is higher than in its neighboring more advanced transition countries but comparable to EU averages (which have a declining trend)\(^2\). Given the declining CAP trend and the need to start preparing Croatia’s farmers for the EU membership which will bring even stronger competition, it is recommended

\(^{2}\) The CAP levels of support are declining, and Croatia must take into account the evolving nature of the instruments and requirements of the CAP as a “moving target.”
to bring down the levels of producer’s support from the current high levels to below those currently offered within the EU. The EU-like agricultural reforms would probably have a mixed impact on incomes in Croatia. New policies would imply reduced levels of producer’s support which would negatively impact farmers’ income. However, reduction in producers’ support would lead to reduced fiscal burden, thus benefiting the population as a whole (due to lower food prices on average compared to the current situation).

- **Policy convergence to the CAP-conforming framework.** Direct payments and other current structural support measures would have to be adapted to the EU format, while new ones, such as an agro-environmental program would have to be introduced. Market support system would need to be adjusted to a transparent CAP-conforming framework, incorporating the potential use of quotas in the case of some products. Interventions ought to be based on the observed evolution of market prices (rather than production forecasts) and price support would need to be transferred to the wholesale level instead of the farm gate for most products.

- **Institutional convergence to the CAP.** Establishment of an Agricultural Intervention Agency and a Paying Agency is a necessary prerequisite for the implementation of CAP-like arrangements (the difficulties experienced by the EU accession countries suggests that this task should be given high priority). The introduction of the Integrated Administration and Control System (IACS) also constitutes a critical prerequisite for the functioning of the CAP. Establishment of an Agency or Department for Rural Development would facilitate the implementation of a coherent rural development strategy.

- **Adopting and implementing EU standards.** Capacity building of all agencies involved in adoption and implementation of the agriculture related EU standards is needed, including provision of relevant support to producers. A unified veterinary and food control authority in line with EU policy would eliminate overlapping and improve efficiency, while a central agency would need to be established to manage plant protection and adopting EU phytosanitary standards.

**Priority issues: what can be done in the near term**

- **Adopting a strategic reform document,** identifying and mapping out necessary reforms, measures to be implemented, assigning responsibilities for reform implementation, and with a clear timeline.

- **Settling remaining land ownership issues and creating conditions for a functioning land market.** Access to land is one of the key constraints on creating economies of scale, for which reason there is a need for authorities to expedite decisions on future use of the state owned farming land. A strict deadline should be set and beyond that deadline much of the state-owned land should be expeditiously privatized through auctions.

- **Accelerating the privatization and restructuring of remaining Agro-combinates and other large farming structures,** by dividing the Agro-combinates according to existing functions and offering each part for sale separately. Those units that do not find viable commercial investors within a given time period should be liquidated.

- **Allow unprofitable state-owned and privatized farms to disappear and free the resources for profitable and efficient operations.** This can only be achieved by adopting hard-budget constraints and effectively implementing the ultimate threat of bankruptcy for non-performers, regardless of farm type.

- Taxation system and the tax concessions provided need to be harmonized with the EU practices and requirements. **All tax preferences for farmers, in particular, would have to be eliminated.**
The World Bank Activities in the Agricultural Sector in Croatia

The World Bank has global, regional and country specific expertise in the field of agricultural reform. Croatia specific expertise builds on a range of projects and analytical studies, notably the Croatia Country Economic Memorandum. Project based expertise includes: (i) Farmer Support Services Project (closed in December 2002) supporting technology-related support services to private farmers, (ii) Coastal Forest Reconstruction and Protection Project (closed in June 2003) supporting reconstruction of coastal forests destroyed by war activities and improving forest fire management in Croatia, (iii) and Reconstruction Project in Eastern Slavonia, Baranja and Western Srijem (see Attachment.

The World Bank will be shortly engaging the new Government in consultations on the 2004-2007 Country Assistance Strategy (CAS) for Croatia, which would offer opportunities to discuss the possible interest in the WB investment and policy support to the agricultural sector reform in Croatia.
ENERGY SECTOR

Introduction

The efficient provision of energy services is important for promoting growth and enhancing Croatia’s ability to compete with the rest of Europe. Croatia has sought to achieve this by implementing a two-pronged reform program aimed at:

- Raising and attracting significant investment resources for the modernization of the energy infrastructure, including (i) the necessary post-war reconstruction of parts of the electricity, natural gas and oil networks, and upgrading of facilities to conform with the EU standards, (ii) maximizing the utilization of resources, diversifying sources of supply and enhancing security of supply, and (iii) extending energy networks, nationally and with neighboring countries to develop the Trans-European networks and regional energy markets.

- Creating a market based energy sector, with policies and regulatory framework compatible with those in the European Union.

A series of energy laws were enacted in 2001 to launch such reforms. Their implementation in the oil and gas sector has been generally satisfactory. Progress in the power sector has been slower and warrants close attention by the Government.

Key medium term challenges and priorities

Implementing energy policies that encourage substantial investment in infrastructure. Given Croatia’s investment needs, it is crucial that the country provides incentives for private investment in Croatia’s energy networks. This will require the creation of an incentive framework with the following key features: (i) transparency and predictability of the industry and market structures and regulatory framework, minimizing the risks perceived by potential investors; (ii) credibility of the regulatory system, through clear division of responsibilities between the Government, Parliament and the regulator; (iii) efficient, cost-reflective tariffs which provide adequate signals to investors and customers.

Improving the regulatory framework to more closely reflect the principles of the market economy and the EU directives. Steps to be taken include: (i) the formulation and implementation of energy policy; (ii) completing the ongoing restructuring of energy companies, and (iii) supporting independent functioning of the regulator for the electricity and gas markets.

Extending energy networks with neighboring countries for the Trans-European networks and regional markets. The energy strategy for South-East Europe is outlined in the Athens Memorandum. South East Europe, including Croatia, agreed to develop a Regional Energy Market (SEEREM) and committed to undertake steps towards market opening including adoption of energy strategies, setting up of independent regulators, industry unbundling, development of grid codes, cross border transmission pricing and congestion management principles, trading and commercial codes, and compatible market mechanisms. Croatia’s electricity tariffs are the highest in South-East Europe and should benefit from SEEREM.

Improving Energy Efficiency. Croatia’s energy intensity compares favorably with most countries in Eastern and South East Europe (such as Hungary and Poland, and Bulgaria and Romania). Much improvement is nevertheless needed as Croatia’s energy intensity is much higher than in Western Europe, including the neighboring Austria, and is also higher than Slovenia’s.
Priority issues: what can be done in the next six to twelve months

- **Advancing Power Sector Restructuring.** Government attention is needed to ensure that the unbundling of the main power utility (HEP) is completed and independent companies are created for transmission and distribution. The envisioned independent system and market operator (ismo) envisioned in the 2001 has still not been created. **Croatia** has established an independent gas transmission company (Plinacro) from the main oil and gas company (INA). The Bank recommends that instead of an ISMO, an independent grid company (similar to Plinacro in the gas sector) be separated from HEP for power transmission and system and market operations.

- **Strengthening the capacity of the Croatia Energy Regulatory Council (CERC) to becoming a fully-fledged independent regulator.** CERC is operating with very few staff apart from the five commissioners and relies heavily on the Energy Institute for it’s functioning. However, the Institute is also advising the main companies in the energy sector, creating a striking conflict of interest situation. EU’s electricity and gas directives and SEEREM call for energy regulators wholly independent from the energy industry. CERC’s institutional development and the CERC/Energy Institute relationship is a key issue for the Government to address.

- **Expediting the Drafting and Enacting Pending Secondary Regulation.** **Croatia** has already made many legislative changes towards aligning its energy sector with the acquis. However, full enforcement of many of those changes is pending as discussed above for power sector restructuring and energy regulation. The Energy Law of 2001 also provides for a minimum share of the energy supply mix to be met from renewable energy sources (RES). However, the required secondary legislation to establish the minimum share and a procedure for providing financial support to RES developers is still to be enacted.

The World Bank Activities in the Energy Sector in Croatia

The Bank, building on its global and regional knowledge, has been providing investment and grant support to the energy sector in **Croatia** through: Energy Efficiency project – promoting greater efficiency in energy use (i.e. modernization) and facilitating the creation of an energy efficiency market (i.e. market development/attracting private investments); Renewable Energy Resources project – helping in developing a rational policy framework for renewable energy (i.e. regulatory framework development) and promoting the development of the market for renewable energy resources. Further support is also provided through analytical and advisory services, as supported by the CEM (which, among others, analyses the situation in the energy sector in **Croatia** and recommends future strategy) and the proposed PAL (which, among others, promotes the implementation of the energy sector reforms).

The World Bank will be shortly engaging the new Government in consultations on the 2004-2007 **Country Assistance Strategy for Croatia** (Section 3), which offers opportunities to discuss possibilities for further cooperation on the energy sector in **Croatia**. Possibilities include the Bank supporting: (a) the implementation of **Croatia**’s commitments under SEEREM; and (b) the development of district heating companies and the rehabilitation of heating systems in Zagreb and Osijek.

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22 For more detail on these projects see Section 6.
TRANSPORT SECTOR

Introduction

Croatia’s activities in the transport sector since independence have been focusing on: (i) reconstructing/rehabilitating the war damaged infrastructure, modernizing the existing and building new infrastructure, (ii) establishing transport sector based on market principles, and (iii) aligning the transport sector and policy with the EU acquis communautaires. Significant progress has been made in each of these areas. Moreover, investments in new transport infrastructure have been one of the main growth driving engines in recent years. However, additional efforts are needed to enhance the sector’s competitiveness and profitability, recognizing the need to keep the financing and debt burden within manageable limits.

Key medium term challenges:

- **Promoting the competitiveness and financial self-sustainability of the rail sector.** Croatian Railways (HZ) has undertaken a number of reforms to adjust to new circumstances and improve its operating efficiency, including the enactment of the Railway Law (to come into force on January 1, 2005). The enactment of this Law is an important step in setting the stage for a more intensive railway reform agenda comprised of separation of infrastructure from operations, licensing of private operators, transfer of responsibility for passenger services to the local authorities, further alignment of staffing with business needs, and upgrading and modernization of the railway network. However, in order for the Railway Law to become effective and for restructuring of railways to progress further, enactment of additional laws is needed. Important remaining actions also include: (a) formulating a definite plan and a timetable for privatization of subsidiary companies and private sector involvement in the core activities, and (b) continuing rationalization of HZ staff.

- **Sequencing and prioritizing future investments.** Croatia has planned a very significant investment program for the period up until 2005 in the roads and motorways, and until 2007 in the railways, requiring a large external financing in addition to the budget and extra-budgetary revenues such as the fuel tax and motorway tolls. The investment plans are focusing on the development of the three Pan-European corridors, but with a large proportion devoted to enhancing the Zagreb–Split corridor. It would be desirable to revisit the proposed investments program across each sub-sector (see also the CEM note).

- **Improving road maintenance and road charges system.** Croatia has made significant progress towards establishing well-developed system of road maintenance, road charges and fuel charges. The Government may now consider introduction of incentive schemes for Croatian Roads (HC) to better perform. The principle of toll charging on motorways could possibly be extended to main roads. Greater differentiation could be also introduced in the toll-charging system.

- **Introducing market principles.** Croatia has made good progress in recent years in establishing a transport sector based on market principles. Road transport is largely liberalized. Rail sector, however, is a challenge, as it is highly unlikely that railways will regain its past status. The future market share thus depends on the ability of railways to adapt to the new environment, requiring not only restructuring of railways (discussed above) but also exploring market niches, such as long-distance freight transport, multi-modal freight transport and suburban passenger transport.
transport, and possibly establishing larger scale regional rail service providers that focus on specific market segments. A combination of appropriate investments in ports and railways, along with policy measures, will be the most important stimuli to the development of combined transport. The new Maritime Domain and Seaport Law, approved by the Parliament in September 2003, will facilitate port/city redevelopment, long-term concessions to private operators and investors in the Croatian ports, and liberalization of port related services in compliance with EU regulations.

- **Further EU alignment of the legislative and environmental standards.** In terms of social, technical and environmental standards, Croatia’s recent program of legislative change draws heavily from the EU acquis. There remains, however, some areas of discrepancy in terms of road transport (e.g., axle loads, and provisions relating to licensing of drivers), which will need to be resolved in the near future. In terms of environmental standards, the most important discrepancy relates to the continued sale of leaded petrol.

**Key near term priorities:**

- **Sequencing and prioritizing future investments** – Recommended actions include: phasing investments over a longer period to keep the financing and debt burden within manageable limits, and prioritization and phasing of the investment programs in the roads and railways.
- **Promoting competitiveness of the rail sector** – The Government might consider regaining market share through deeper restructuring and exploring market niches. Competitiveness enhancing measures also include the enactment of four more laws on separation of rail infrastructure and operations, railway safety, regulatory body, and privatization of Croatian railways.
- **Improving road maintenance** through the introduction of incentive schemes for HC’s road maintenance work.

**The World Bank Activities in the Transport Sector in Croatia**

The Bank has been very active in providing support to the transport sector in Croatia, both in form of analytical studies and investment loans. In 1999 it provided with the Government with the Policy Directions for Transport note, and in 2003 completed the Croatia Country Economic Memorandum (section 4.01) which provides detailed analysis of the sector and provides recommendations for future strategy.

The Bank supported the reconstruction of war-damaged road infrastructure through the Highway Sector and Emergency Transport and Mine Clearing projects. It is currently supporting Rijeka Gateway project, aiming to enhance the competitiveness of the port of Rijeka, as well as the modernization and restructuring of HZ through the Railway Modernization project. The closing date for the Railway Modernization project has been extended to December 31, 2004 to permit the completion of procurements and further reduction of staff.

The Bank’s support to promoting competitiveness also includes Trade and Transport Facilitation in SE (TTFSE) (see section 7). Compared with the other seven countries involved in the TTFSE program, Croatia is considered as one of the best performer in terms of facilitation at border

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23 The Government’s support is particularly important for achieving the targeted 40% reduction of Plovput’s Light Dues by end-2004, close monitoring of the progress made in improving Rijeka port operational performance and for timely implementation of LR’s staff reduction and social plan.
crossing points. The loan closing date has been extended to March 2005 to permit the completion of the remaining project components and the continuation of reforms.24

The World Bank will be shortly engaging the new Government in consultations on the 2004-2007 Country Assistance Strategy for Croatia (section 3), which offers opportunities to discuss possibilities for further cooperation in the transport sector, such as in providing further support to HZ in: (i) the setting up of the infrastructure, freight, and passenger companies and ensuring their efficient functioning; (ii) further staff reduction; (iii) privatization of non-core activities; (iv) private sector involvement in the core activities; (v) establishing a pricing policy and a regulatory body; and (vii) development of a policy for PSO contract.

24 The extension is linked to a number of actions that need to be undertaken over the next six months: (i) the Customs Directorate needs to implement a full risk management and selectivity system; (ii) other Border Agencies should implement recommendations made by the SECI TTFSE Assistance Team at Macelj and Jankomir to speed up processing; (iii) the Customs Directorate should implement an advance notification processing procedure in Jankomir responding to the expectations of forwarders; and (iv) The new Government needs to maintain/increase its contribution to the TTFSE website. The interagency border cooperation needs to be strengthened by convening relevant meetings with the Heads of these Agencies.
Housing and Urban

Housing. In Croatia, housing constitutes the largest single category of personal wealth, with the home ownership rate exceeding 90 percent. However, the condition of the housing stock has suffered from the recent armed conflicts, and from under-maintenance by residents and municipalities. The key challenges the country faces in this sector and suggested priority actions and reforms are summarized below.

Physical deterioration is decapitalizing the housing stock, while both original design decisions and deterioration drive up energy consumption, hence current costs. Government and financial market structures needed to support housing transactions are weak and limit mobility and reduce owner’s ability to capture housing value. Mobility problems have been exacerbated by very low levels of new construction and by the slow development of the rental market. One marker of these problems is that aggregate spending on new and existing housing has not reached the levels expected in a country of Croatia’s per capita income level. A sustainable housing sector is necessarily interlinked with labor, construction, capital and financial markets. But at present, public sector intervention in these markets is overly fragmented, both conceptually and administratively. As with other ECA countries, Croatian housing privatization outpaced the institutional and cultural changes needed to support an efficient private housing system. In common with other long-lived assets, housing can survive some years of neglect before mounting maintenance deficits result in either catastrophic loss of service (the roof falls in) or simply accelerating costs.

Croatia is on that cusp and faces mounting pressure to make the needed reforms. These include defining common property, developing debt-financing mechanisms for mortgages, capital repairs and upgrading, and privatizing municipal maintenance companies. To meet the needs of the poor, tenure neutral and better targeted subsidy programs must be implemented. Croatia would be aided in this process through an effort to develop and implement housing policies together with municipalities. The Bank could contribute in the housing sector through technical assistance to support reform efforts in multi-unit housing governance, the area with the most critical maintenance deficits, to help develop better-targeted subsidy schemes, and to provide policy advice on a housing sector strategy. This could lead to lending to support community/building-based organizations through renovation/upgrading or lending to capitalize partial credit guarantees for banks.

Urban Sector. Croatia’s Urban sector is marked by the contrast between the handful of larger cities, that tend to be well managed and have relatively robust financing, and the large number of small cities that hold the poorer people and serve them through professionally and financially weaker administrations. Along with an array of social services, local governments in Croatia deliver such services as water, sewage, power and gas, public transport, and sanitation. While service delivery has been decentralized, the influence of the national government on municipal affairs remains heavy due to reliance on fiscal transfers and the burden of large arrears by the national government to municipal enterprises. Fiscal power has not moved in step with the shifting locus of service responsibilities, creating a significant gap between the location of the poor and the ability to address their poverty.

To address these challenges Croatia must give priority to the strengthening of the reform of fiscal transfer mechanisms and to developing instruments and undertaking broad interventions to support small and medium size municipalities in those areas where the challenges exceed their capacity (i.e. pollution control), thus addressing the low predictability and unclear equalization outcomes of
current fiscal transfers and revenue disparities. Related reforms should support local government capacity to finance, manage, and regulate infrastructure needed for the services for which they are responsible. Targeted interventions are also urgently needed to prevent the decay of important cultural assets and improve their potential impact on growth and jobs creation. The Bank is contributing to these efforts through its ongoing projects, and could further support the government through technical assistance and sharing of experiences from other countries, particularly in the areas of municipal financing.

**WATER SUPPLY, SANITATION AND FLOOD PROTECTION**

Adequate water management is essential to the economic development of Croatia. First and foremost it is needed to ensure a safe and adequate supply of water for domestic consumption, tourism and industry. Second, Croatia’s natural water bodies must be protected from pollution from municipal and industrial wastewater, particularly the long Adriatic Sea coastline and offshore islands. Third, because much of Croatia’s territory is flood plain, effective use of these areas requires flood protection. The key challenges Croatia faces in this essential sector and the suggested reforms and priority interventions are outlined below.

**Quality and Coverage of Water Supply and Sanitation Services.** Coverage and quality of water supply and wastewater services in Croatia ranks high compared to other countries in the region, infrastructure tends to be in relatively good shape and the population is generally satisfied with the services provided. However, in contrast to water supply, wastewater treatment is greatly deficient. Less than 12 percent of all municipal wastewater receives any treatment and only 82 treatment plants are currently in operation. The majority of these plants will need to be upgraded to meet EU environmental standards. The likely consequence of not stepping up investments would jeopardize existing quality of service, constrain economic growth, and impede the country's prospects for EU accession.

In the near future, Croatia will have to invest large amounts of resources in this sector. Investments are needed to rehabilitate and replace existing aging assets and further expand connections to people without services. About US$600 million equivalent will be required to rehabilitate existing systems and extend water services. An even larger amount will be required to provide adequate treatment of all municipal wastewater. Among the highest priorities is to improve wastewater treatment and disposal on the Adriatic coast and islands, where services are currently the most deficient and impede tourist development. The current Split and Eastern Slavonia projects and the new Coastal Cities Pollution Control project, which is ready for appraisal, and Zagreb Nutrient Reduction GEF project, support Croatia’s program to address this important challenge and allow the Bank to keep this support into the medium term.

**Financial Sustainability and Efficient Financing Mechanisms.** The sector has relied until now, primarily, on financing from the central government and HV’s water use and pollution fees, but with little or no contribution from the municipal water companies responsible for delivering the service, which suffer from overstaffing and inefficient operation. The great challenge for the Croatian government will be to increase the financial resources available for the sector through a dedicated and sustained effort in: (i) improving the productivity, efficiency and financial performance of water and wastewater utilities; and (ii) establishing efficient and transparent mechanisms to channel central government and external financial support.

**Strengthening the efficiency of utility companies.** Most Croatian water and wastewater utilities have ample opportunity to improve their productivity and thereby reducing the cost of management and operations. Improving the productivity of water supply and wastewater utilities would reduce administrative costs and increase resource mobilization and investment capacity. This
effort should be based on a policy of full cost recovery of operation, maintenance and capital costs in the water supply side and partial support for wastewater treatment investments, where externalities may justify partial subsidies.

**Clarifying and streamlining present institutional and regulatory relationships and financing mechanisms.** In Croatia, municipal governments tend to micromanage their utilities and don't provide utility management with the entrepreneurial freedom and incentives that is so necessary for dynamic and responsible management in key areas of the utility business, particularly for tariff setting and investment selection. To encourage management accountability and responsibility, the government should give priority to adjusting and clarifying the regulatory framework that governs the relationship between utilities and municipal governments to increase utility autonomy and accountability. Related, and in line with the proposed actions on urban financing reform, the Government should develop a transparent financing mechanism for addressing the important investment need of the sector, that can not be covered with internally generated funds in small and medium water companies, particularly along the Adriatic coast.

**Flood Protection.** Flood protection, drainage, erosion control and river regulation works have traditionally been at the center of Croatia’s development history. However, financing resources from land tax or catchment fee charged to the beneficiaries are currently not sufficient to address still needed investments and, at the same time, guarantee the proper operation and maintenance of all existing infrastructure. Also, victims of flood damage either receive no compensation or are compensated partially from the central budget. Additionally, the planning and evaluation of flood control investments is weak and lacks appropriate recognition of economic and financial criteria. This situation represent an important risk and the repetition in Croatia of the events of last years in northern Europe, with important floods with significant economic and social impacts, cannot be ruled out.

To address the risks and problems, the government needs to urgently adopt sound procedures for justifying and evaluating projects need to better direct scarce resources to most important priorities, together with specific interventions to improve flood protection infrastructure. To this end, Croatia needs to strengthen its technical, financial and economic criteria and analytic procedures for the evaluation and prioritization of investments in flood protection and drainage projects, and to ensure that all new flood control and drainage investments are clearly justified from an economic point of view. In parallel, the government needs to reform the mechanisms for financing flood protection infrastructure and actions, so that beneficiaries are more directly involved in supporting the related costs and economic incentives are introduced to better prevent this risk. The Bank is supporting this effort through its current project in Eastern Slavonia, where, together with investments for the improvement of municipal water infrastructure and the protection of the environment, main elements of the flood protection infrastructure that were damaged during the war are being rehabilitated and improved.
### List of Operations Staff in Zagreb Office

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