

# C R O A T I A



## A POLICY AGENDA FOR REFORM AND GROWTH

OVERVIEW  
VOLUME 1



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## ACRONYMS AND ABBREVIATIONS

AKs	-	Agro-Kombinats
BRA	-	Bank Rehabilitation Agency
CAP	-	Common Agricultural Policy
CEE	-	Central and Eastern Europe
CIHI	-	Croatian Institute for Health Insurance
CNB	-	Croatian National Bank
CPF	-	Croatian Privatization Fund
CRA	-	Central Registry of Affiliates
CROSEC	-	Croatia Securities and Exchange Commission
DB	-	Dubrovačka Banka
DCR	-	Directorate for Commodity Reserves
DFI	-	Direct Foreign Investment
DRG	-	Diagnostic Related Groups
EBFs	-	Extra Budgetary Funds
EFSAL	-	Enterprise and Financial Sector Adjustment Loan
EU	-	European Union
FSOEs	-	Former Socially-Owned Enterprises
GEF	-	Global Environment Facility
HBOR	-	Croatian Bank for Reconstruction and Development
HEP	-	Electric Power
HMID	-	Croatian Pension Investment Company
HMOs	-	Health Maintenance Organizations
HRK	-	Kuna
HV	-	Hrvatske Vode
IPOs	-	Initial Public Offerings
MAF	-	Ministry of Agriculture and Forestry
MES	-	Ministry of Education and Sport
MMATC	-	Ministry of Maritime Affairs, Transport and Communications
MRD	-	Ministry of Reconstruction and Development
NEAP	-	National Environmental Action Plan
ORESE	-	Office for Economics and Restructuring of State-Owned Enterprises
PBZ	-	Privredna Banka Zagreb
PEs	-	Public Enterprises
PF	-	Pension Fund
PSD	-	Private Sector Development
PSOs	-	Public Service Obligations
RIA	-	Regulatory Impact Assessment
ROE	-	Return on Equity
SDA	-	Security Depository Agency
SDPNE	-	State Directorate for the Protection of Nature and Environment
SFRY	-	Socialist Federal Republic of Yugoslavia
SME	-	Small and Medium Enterprise
SOEs	-	Socially-Owned Enterprises
TPA	-	Third Party Access
TSSP	-	Transport Sector Strategy (Policy) Paper
VAT	-	Value Added Tax
WHO	-	World Health Organization
WTO	-	World Trade Organization
ZAP	-	Institute for Payments

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## EXECUTIVE SUMMARY

### *Croatia's Challenge*

For a brief moment now, Croatia enjoys a rare and precious opportunity. In the wake of the recent elections, global and especially European structures are opening up to Croatia. An opportunity existed in 1996 to take the sometimes painful, yet necessary, measures for sustained growth. A few were taken; most were not.

Croatia now has a second chance in 2000 to put itself on the high road of sustained growth, better living standards and integration into European structures. The new government must seize this moment to launch the long overdue structural reforms necessary to achieve these important goals. This demands that Croatia maintain its successful stabilization effort, reduce the size of the public sector through structural reforms and make itself more hospitable to foreign and domestic investment.

### *Reforms and Declining Performance*

Croatia launched a successful stabilization program in 1993, bringing down inflation and stabilizing the exchange rate. By 1998, however, initially buoyant economy slowed down and by 1999 it had contracted. Why? First, progress in public finance reforms as well as in the banking and enterprise sectors was inadequate. Second, the earlier economic growth was based largely on reconstruction efforts and domestic consumption, instead of investments that would have enhanced the country's competitiveness. This, in turn, contributed to the large current account deficit which has been financed increasingly from external borrowing, thereby leading to a rapid and unsustainable build up in external debt. In the meantime, the size of the state in the economy grew by 15 percentage points of GDP to one of the highest levels in CEE transition economies. The country ended up with too much government in the wrong place, and too little where a technically strong public sector presence is required.

As a result, Croatia that had a head start over other transition countries in the region in 1990, has fallen behind in the transition to a market economy.

### *The Main Issues – Objectives of Reforms*

The new Government needs to deal with daunting economic problems. These include a weak real economy, high unemployment, large macroeconomic imbalances, and a fragile banking sector. Postponing corrective policy actions and deep structural reforms will not only undermine the ultimate policy objectives of *placing Croatia on a sustainable growth path and convergence towards the European Union*, but also will require more costly adjustments in the future.

That is why Croatia now has a unique opportunity: to halt its economic decline and address the underlying impediments to sustainable growth and convergence to the European Union.

### *The Proposed Strategy*

Addressing the challenges requires a credible reform strategy that ensures continued stability, reduces the size of the public sector, and creates a business friendly environment.

In these challenging circumstances, the sequencing of policy actions is essential to the overall outcome of the reform process. The proposed reform strategy contains two sets of policies. *The first set of policy actions* include **immediate measures** to reduce macroeconomic imbalances to ensure stability, and to introduce complementary reforms to address the underlying structural causes of imbalances. Measures to address the fiscal imbalance and financial stability need to be given top priority.

A credible commitment to policy reform early on in 2000 would send a strong signal to the international financial community that the Government is determined to implement the necessary reforms. The depth and speed of actions undertaken at the outset are essential to convince international financial markets about the credibility of the program. This, in turn, will improve Croatia's ability to finance the country's borrowing requirements on favorable terms. International financial markets are also likely to react positively to the new Government's success in securing support from the international financial institutions.

Sequencing of policy actions across the sectors is also essential for the success of the reform process. What are the key criteria to set priorities? Above all, the contribution of a particular reform measure to *sustainable reductions in the fiscal deficit and financial stability*. Moreover, *availability of financing*,

*implementing capacity, pace of macro adjustment envisaged and political and social constraints need to be considered.*

This report identifies three critical short-term priorities:

- **Reducing current spending by at least containing and at best cutting transfers, defense, social security, and public sector wages and employment.** Early actions that demonstrate a strong commitment to ongoing pension and health sector reforms are essential. These efforts need to be complemented by the establishment of a more efficient and transparent government to ensure rules for the competitive market and equality of opportunities are respected.
- **Safeguarding financial stability to buttress confidence in the banking system** through completing bank deposit pay outs as planned, accelerating efforts to privatize State banks, and enforcing resolution mechanisms of distressed banks.
- **Creating a business friendly environment that is conducive to investments,** especially FDI. The most urgent measures in this area are: strict enforcement of both contractual obligations and bankruptcies, improving property rights, simplification of administrative procedures for business activity, and privatization of remaining state assets, including agriculture. Improvements in the quality of public services/utilities and better enterprise governance will encourage private business activity.

Admittedly, it is not possible to implement all short-term reform measures presented in this document concurrently. However, deepening of the reform process is crucial, so long as it does not undermine sustainability of the reform measures already initiated. Each additional reform will increase the benefits of reforms already undertaken, as it improves the coherence between the policy areas. This, in turn, provides additional incentive to continue deepening the process already initiated.

*The second set of policy actions* recommended in this document comprise **medium-term measures** designed to: (i) improve efficiency in the allocation and use of the factors of production by reducing prevailing distortions; and (ii) increase the long-run growth rate of output by providing incentives for domestic savings and investments, and promoting educational and technological innovation. These measures are identified and discussed in detail in this volume.

Successful implementation of the overall reform program will: (i) ensure stability; (ii) increase long-term growth through its positive effects on productivity and investment; (iii) create a business friendly environment that generates employment; (iv) improve income distribution; and (v) lead to a smaller but more efficient public sector which facilitates not hinders the functioning of the competitive market. All of which will enhance Croatia's prospects for benefiting from closer integration with Europe and the world economy.

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# **1. RECENT PERFORMANCE, VULNERABILITIES, AND REQUIRED POLICY ACTIONS**

## **A. THE CURRENT SITUATION**

1. Croatia faces a unique opportunity. With its opening towards global and European structures, it has an opportunity to embark upon a period of sustained and rapid growth. However, seizing this opportunity requires sustaining its successful stabilization effort and undertaking deep structural reforms that reduce the size of the public sector and create a more hospitable environment for foreign and domestic investment.

2. In 1993, Croatia launched a very successful macroeconomic stabilization program which stabilized the exchange rate and brought down inflation. This macroeconomic environment, in turn, helped attract large capital inflows and contributed to the strong economic growth between 1994 and 1997. However, as economic activity slowed in 1998 and turned negative in 1999, it became clear that the growth during this period was not based on a firm foundation due to at least two reasons. First, reform of public finances, including addressing the structural problems of the banking and enterprise sectors, has been inadequate. Second, growth was based largely on reconstruction efforts and domestic consumption, not on investments that would have enhanced the country's competitiveness. Croatia's recent unsatisfactory growth and weak export performance signals the need for deeper reform.

3. Moreover, high level of consumption and investments were financed by large transfers from abroad. This led to high levels of current account deficits in the external balance. The current account deficit which peaked in 1997 at 11.7 percent of GDP in 1997, was still at around 7 percent of GDP in 1999 despite the economic slowdown and contractionary monetary policy -- signaling an underlying competitiveness problem. There has also been a worrying change in the way that the current account is financed. While during the period before 1997 the deficit was mainly financed by non-debt creating inflows, since 1997 it has been financed mostly by external borrowing. As a result, external debt rose to 41 percent of GDP in 1999 from 22.5 percent in 1994 -- a rapid and unsustainable build up.

4. Concurrently, the Government's fiscal position has also deteriorated sharply. Excluding privatization revenues, the fiscal deficit (on a cash basis) is estimated to have increased to 5 percent of GDP in 1999 from 1 percent of GDP in 1998. This excludes arrears in the extra-budgetary funds, particularly the health and pension funds as well as potential cost of guarantees. It could reach 5.7 percent of GDP in 2000 unless fundamental adjustments and reforms are undertaken.

5. Existing social safety net programs have kept the poverty level in Croatia low compared to other countries in the region, even though the country has one of the most unequal income distributions in the region. The poverty situation could deteriorate substantially unless these programs are equipped to deal with temporary unemployment arising from public and enterprise restructuring.

6. In sum, the new Government faces a difficult situation characterized by:

- A weak real economy, which is unable to generate employment and further increases in income;
- A large current account deficit, primarily due to a lack of export capacity, and a rapidly growing external debt coupled with a rise in re-payment stemming from earlier debt restructuring;
- A fragile banking sector susceptible to adverse shocks;

- A structural fiscal imbalance which stems from the large expansive role that the Government has taken in the economy including excess wage increases, large defense outlays, and deficits in extra budgetary funds; and
- A slow progress in efficiency enhancing reforms and in creating a conducive environment for private sector development, which, in turn, undermined the occurrence of a private investment-led growth.

7. It is now clear that without the implementation of key structural reforms in support of prudent macroeconomic policies, the country runs the risk of being unable to attain the ultimate policy objectives of *putting Croatia on a sustainable growth path and of the convergence towards the European Union*. The urgency of taking policy measures to promote and ensure macroeconomic and financial stability combined with the implementation of fundamental structural reforms has never been greater.

### **B. HOW DID CROATIA GET HERE?**

8. Growing domestic demand fueled by post-war reconstruction and large capital inflows led to an artificial boom that came on the heels of the successful stabilization program. While privatization progressed, the vestiges of workers self-management and insider buyouts undermined genuine equity based ownership. An influential interplay emerged among managers of large firms, banks and local government which prevented fully competitive market structure to develop. Directed lending by State-owned banks helped provide a lifeline support to many enterprises, including even those that were not in the reconstruction effort. Inefficient enterprise management, loss of traditional markets, poor marketing and sharp wage hikes made it increasingly difficult for enterprises to turn out a profit. An earlier practice of non-payment in the country surfaced again, and arrears began to accumulate in the economy. A wave of bank failures and widespread enterprise insolvency heralded an oncoming financial crisis since 1996, but bankruptcies and liquidations were postponed. Assets were often stripped in the process, leaving behind empty shells. A strong supply response to stabilization and privatization did not materialize. Unemployment levels remained high with the officially registered level reaching 20 percent by 1999<sup>1</sup>.

9. With expansionary fiscal policy and wage adjustments above productivity increases, Croatia's competitiveness has eroded. Tourism and agro-industry, where Croatia's comparative advantage is strongest, have not performed anywhere near potential even before the outbreak of the Kosovo hostilities. Most investments were concentrated on reconstruction. Croatia witnessed high level of decapitalization in large public enterprises and in the private sector. With growing political interference in the enterprise sector, a lack of clarity on privatization goals, non-transparent governance structures, Croatia could not become attractive for direct foreign investment. Croatia's total DFI of US\$2.4 billion since independence is low in comparison to other countries in the region and there were hardly any greenfield ventures.

10. The size of the state in Croatia's economy grew by about 15 percentage points of GDP since independence, reaching an extraordinarily high level around 54 percent by 1998 (not including arrears). Sharply rising public expenditures boosted public consumption, including wages, inefficiently provided social services, and overly generous entitlements with leakages from the system, transfers to Croats in Bosnia and Herzegovina and support to non-viable enterprises within the national territory. Public expenditure and wage policies were, in effect, sacrificed in an attempt to satisfy expectations of high living standards and benefits that the Croatian state simply could not afford. Public administration reforms were also postponed, and the country ended up with too much government in the wrong place, and too little where regulation and oversight require technically strong public sector presence in a market economy. Corporate governance was weak, and public enterprises could not be held accountable.

11. Tight monetary policy has been the main policy tool to counter the sharp increase in the current account deficit—a deficit stemming mainly from a sharp increase in domestic demand, especially

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<sup>1</sup> Unemployment levels based on a labor force survey are estimated to be significantly lower.

consumption. As a result of the easing of the fiscal stance, monetary policy had to bear the brunt of the policy tightening. This policy of tight money depressed economic activity as it led to very high real interest rates.

### C. WHERE DOES CROATIA GO FROM HERE?

12. *Placing Croatia on a sustainable growth path and converging towards the European Union* constitute the ultimate policy objectives.

13. Achievement of these objectives will require a reform strategy that will ensure stability, reduce the size of the State, and create a business friendly environment. A more efficient and more transparent (but not larger) state apparatus to facilitate the functioning of markets should be built in parallel with policy actions to reduce the size of the public sector and expand the role of the market.

14. The proposed reform strategy contains two sets of policies.<sup>1</sup> *The first set of policy actions include immediate measures* to redress macroeconomic imbalances to ensure stability and *complementary structural reforms* to address the underlying structural causes of imbalances. Clearly, measures to address the fiscal imbalance and ensure financial stability should receive priority. In the absence of bold reforms in these fronts, both the success and sustainability of macroeconomic adjustment and early recovery of growth will be at risk.

15. How should policy makers determine priority among the proposed measures across the various sectors? The contribution of a particular reform measure to *sustainable reductions in the fiscal deficit and financial stability* will be among the most important determinants of priority across sectors. Moreover, *availability of financing, implementing capacity, pace of macro adjustment envisaged and political and social constraints* are also important factors that need to be considered.

16. Short-term measures need to focus on reductions in current expenditures through either containing or cutting *transfers, defense, social security, and public sector wages and employment*. Commitment to pension and health sector reforms will also be essential to the success of fiscal consolidation.

17. In parallel with these efforts, measures to ensure financial stability will need to be implemented. Priority in this area is to buttress confidence in the banking system via completion of bank deposit pay outs as planned, resumption of efforts to privatize all State banks, and enforcement of resolution mechanisms of distressed banks as underscored by the new banking law

18. Creation of a business friendly environment will complement the effectiveness of the above policy measures. It will help establish an environment that is conducive to investments. The most urgent measures include: strict enforcement of both contractual obligations and bankruptcies, improving property rights, simplification of administrative procedures for business, and privatization of remaining state assets, including agriculture. Improvements in the quality of public services/utilities and their supervision will encourage private business activity. Early success in these areas will attract DFI to Croatia.

19. Admittedly, it is not possible to implement all reform measures concurrently. However, deepening of the reform process so long as it does not undermine the sustainability of reform measures already initiated is crucial. Each additional reform will increase the benefits of reforms that have already been carried out, as it improves the coherence between the policy areas. This, in turn, provides additional incentive to continue deepening the process already initiated.

20. A credible commitment to policy reform, early on in 2000, would send a strong signal that the Government is determined to carry on the reform process. The level of the Government's commitment and the depth and speed of actions undertaken at the outset are essential to convince international financial

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<sup>1</sup> Getting the timing and the sequencing of the policy actions is important because inappropriate timing and sequencing may raise doubts as to the sustainability of the reform and deter the private sector from undertaking the expected adjustments.

markets of the credibility of the program. This, in turn, will improve Croatia's ability to finance the country's borrowing requirements on favorable terms. International financial markets are also likely to react positively to the new Government's success in securing support from the international financial institutions.

21. *The second set of policy actions* comprise **medium-term measures** designed to: (i) improve efficiency in the allocation and use of the factors of production by reducing prevailing distortions; and (ii) increase the long-run growth rate of output by providing incentives for domestic savings and investments, and promoting educational and technological innovation.

#### **D. MAIN REFORM OBJECTIVES**

22. What are the main goals of recommended policy actions? They include: (i) promoting macroeconomic and financial stability; (ii) establishing a smaller and more efficient public sector; (iii) promoting private sector activity through improvements in the incentive and legal frameworks and encouraging foreign investments; and (iv) supporting the development of a dynamic and competitive market economy.

23. Success in reforming the economy will hinge, inter alia, on how well the short term and temporary adverse consequences of the proposed policy actions are managed. To deal with the ensuing social costs effectively, the government needs to strengthen the existing safety net and protect the population from falling into poverty. Adverse social consequences are primarily expected from the dislocation effects resulting from the lay-off of labor through downsizing or closure of enterprises. A study group needs to be set up as a matter of urgency to look into the socially and financially most effective tools that could strengthen the existing safety-net. The study group would also need to review how to address emerging poverty issues.

#### **E. THE PURPOSE OF THE REPORT**

24. This report summarizes both short- and medium-term macroeconomic and structural reform measures that need to be undertaken to attain Croatia's two main policy objectives of sustainable growth and convergence with the EU. The report is intended to provide a basis for discussions on the design of an overarching reform strategy and policy actions between the new Croatian authorities and the country's external partners and donors in early 2000.

25. The report is organized as follows: Section 2 provides an overview of the proposed public sector reforms. These reforms focus on: fiscal reform; public utilities and infrastructure; and governance and institutional reforms. Section 3 describes the necessary short-term and medium-term measures to ensure financial stability along with the implications of the second pillar component of pension reform for the financial system. Section 4 presents the necessary policy actions to establish more dynamic and competitive real sector. Section 5 underscores the necessary short-term and medium-term policy actions to ensure that economic growth occurs in an environmentally sustainable manner, focusing on agriculture and municipal development.

26. In a second volume, 13 policy notes, including one on fiscal issues, are compiled, providing a more detailed diagnostic of each sector in the economy, discussion of options, and a summary of the proposed policy actions.

## 2. TOWARDS A SMALLER AND MORE EFFICIENT PUBLIC SECTOR

27. In view of Croatia's vulnerabilities and the weakness of public institutions, public sector reform needs to focus on three essential areas: (i) *fiscal reform*; (ii) *public enterprises and infrastructure*; and (iii) *public sector governance and institutional reforms*.

### A. FISCAL REFORM

28. *Fiscal reforms are key for addressing macroeconomic imbalances and promoting stability. It will also be essential for equitable and sustainable economic development, thereby supporting implementation of the medium-term policy measures. Important aspects of the fiscal reform are: (i) a credible reduction (or elimination) in the public sector deficit and its overall size; (ii) a reduction in the state's role as a producer and provider of services which are not in the public domain; (iii) increasing transparency and enhancing accountability in the management of public funds and of public institutions; (iv) strengthening the state's role as regulator of markets where there is market failure and where externalities warrant state intervention; and (v) strengthening the ability of the State to alleviate poverty among individuals who are adversely affected by the reforms.*

29. With a public expenditures level of 54 percent of GDP, Croatia has the largest government in Central Europe. It also has one of the highest taxed economies in the region. Government expenditures rose by 15 percentage points of GDP during the last nine years. The expansion in social spending and wages have not been matched by a reduction in war-related public expenditures. The Government's increasing share in the economy poses a threat to the country's ability to achieve economic growth.

30. Priority areas for fiscal reforms in Croatia are: (i) *government wages and employment*; (ii) *tax policy*; (iii) *defense expenditures*; (iv) *pensions*; (v) *health*; and (vi) *transfers and subsidies*. Cross-country experience has shown that the success of fiscal adjustment hinges crucially on how the adjustment is achieved: cuts in current expenditures tend to be more sustainable over time than tax increases and cuts in public investments. Evidence suggests that fiscal adjustments which primarily rely on expenditure reductions, in particular, on cuts in transfers, social security and government wages and employment have a better chance of being successful and expansionary than those that mainly rely on tax increases and public investment cuts. The first type of fiscal adjustment can be expansionary not only because of credibility and wealth effects, but also because of reduced unit labor costs, particularly in unionized and open economies. Tax reductions before achieving substantial retrenchment in expenditures would seriously threaten the success of the fiscal reform.

31. To properly assess the composition and level of public expenditures, a *public expenditure review* (PER), looking at budget allocations, sectoral policies, and budget procedures will be essential. *Inter-enterprise arrears* constitute a potential fiscal liability of the government and therefore need to be reviewed. A public expenditure review would also need to assess carefully contingent liabilities which result from the fragile situation in the banking system and from public guarantees issued to facilitate borrowing of public enterprises and for public investments.

## Central Budget

### *Government Wages and Employment*

32. *Public sector wages and salaries* currently correspond to 11.5 percent of GDP -- a level well above the average of 3.5 percent of GDP observed in transition economies. Croatia needs a slimmer, more efficient and better-organized public sector. Strengthening of the civil service is essential. There is little reliable information pertaining to key areas of employment in the public sector. Anecdotal evidence points to over-staffing in various areas of the public sector. Recent public wage increases have only aggravated the fiscal situation for 2000. Reductions in the public wage bill can make a major contribution to fiscal retrenchment.

33. To this end, the following measures need to be considered in the short-term:

- An immediate freeze in public sector wages;
- Strengthening the supervision and monitoring functions of ORESE for the public enterprise wage bill; and
- Unifying the system of civil servants compensation by ending the separate treatment for “high government officials”.

34. The medium-term policy actions for rationalizing public sector employment involve the following:

- As part of a comprehensive civil service reform (paras 86-89), review the overall structure of public wages and personnel hiring policies and practices;
- Identify services that can be contracted out, thereby achieving budgetary savings; and
- Introduce a severance payment policy to facilitate planned reductions in the public labor force.

### *Tax Policy*

35. The current level of *payroll taxes* in Croatia is high and tends to penalize labor. Labor income is subject to a heavy tax burden because of a combination of high payroll contributions and personal income taxes. Altogether these two taxes drive a wedge of about 80 percent between take-home pay and employers' labor costs. A reduction in payroll taxes would not only decrease labor costs, thus lowering unemployment, but also could facilitate the re-entry of labor into the formal sector.

36. The short-term measures include:

- Eliminate payroll contribution to the Chamber of Commerce, which is currently at 0.375 percent of gross wage; and
- Inclusion of all labor income in the definition of assessable wages for contributions.

37. The medium-term policy actions include:

- Reduction in unemployment contributions, currently at 1.7 percent of gross wage, to levels compatible with the aggregate cost of unemployment insurance benefits; and
- Initiate and support social security reform in order to cut labor costs further.

38. The VAT has become the main revenue source for the budget, engendering revenues equivalent to 14.6 percent of GDP. In view of its importance, the Government should refrain from any further extension

of the zero rate to other goods and services, reduction of the VAT rate or the introduction of intermediary rate for other goods and services - i.e., tourism. Such an extension to a particular sector would not only reduce tax collection by reducing the tax base, but also would open holes in the tax system leading to tax evasion.

### ***Defense Expenditures***

39. *Defense expenditures*, as a percentage of GDP in Croatia are very high. Cross-country evidence has demonstrated that defense expenditures retard growth through an adverse impact on capital formation and resource allocation. This suggests that reductions in military expenditures -- now affordable because of new peace conditions in the region -- will engender a substantial long run "*peace dividend*" in the form of higher capacity output. Indeed, if aligned with the expenditure in other transition countries, annual savings could reach 2 percent of GDP.

40. In this area, the short-term measures need to include:

- A significant reduction in the defense budget for the year 2000 as justified by new regional peace conditions; and
- A comprehensive review of defense staffing needs to identify potential reduction.

41. In the medium term, the objective is to adopt a plan to modernize defense by re-aligning defense spending according to European countries, while maintaining fiscally affordable spending levels.

### **Extra Budgetary Funds**

#### ***Pension Reform***

42. *Pension reform* is a policy area in which Croatia joined the ranks of other reformers in Central and Eastern Europe. Croatia enacted difficult decisions to rationalize and stabilize its pay-as-you-go pension system in 1998. Furthermore, in 1998 and 1999 Croatia also legislated the elements necessary for a funded "second pillar," along the lines of earlier and more publicized reforms in Hungary and Poland. If implemented carefully, the second pillar pension system both offers the prospect of better pensions for younger workers and the promise of greater economic growth by bringing depth and genuine competition to Croatia's financial markets. Croatia's decision to create a special administrative structure for the second pillar will help minimize its indirect and direct costs, ensure workers' privacy rights, and, if done correctly, consolidate and buttress revenue collection and compliance across-the-board. The public administration and financial market aspects of the reform are discussed more fully later in this Section (para 93-98) and Section 3 (paras 119-125), respectively. This Section focuses on the financing challenges of the existing pay-as-you-go pension system and its management.

43. Croatia's "first pillar" reform, enacted in 1998 and initially implemented in 1999, attempted to stabilize the basic pay-as-you-go system by raising retirement ages and gradually lowering replacement rates. In theory, those reforms were also going to finance much of the transition costs associated with the funded second pillar's introduction. It now appears, however, that the reforms in the 1998 law came too late and were not large enough (nor could they be) to completely address the system's fiscal legacy from 1990 and 1998. During this period, the pension system was used in various ways as the "last resort" to handle labor surpluses, especially among older workers in declining sectors. This led to a doubling in the pensioners/insured ratio from 0.33 to 0.65. Despite a tapering off from 1997 to 1998, the 1998 reform, coupled with the deteriorating economy in 1999, precipitated another "rush to retirement" in 1999 with a further deterioration in the ratio to around 0.70. Traditional pension spending (contribution-based and traditional "merit" pensions), after having stabilized as a share of GDP in 1998, grew about 8 percent in 1999 (from 10.3 to 11.2 percent of GDP). In contrast, contributions as a share of GDP grew less than 3 percent from 1997 to 1999 (from 8.4 to 8.6 percent of GDP).

44. Taking into account only pension spending for periods covered by contributions and traditional “merit” pensions, spending as percent of GDP has exceeded its pre-transition (1990) levels of around 11 percent of GDP. But to compensate for more than a doubling in the pensioners/insured ratio, benefits as a percent of *net* average wages have fallen to a ratio of about 46 percent, compared to pre-1990 levels of over 70 percent. In 2000, assuming compliance remains at the roughly 80 percent level previously estimated for 1997 and before, the contribution rate would have to be raised from 21.5 percent to 25 percent or more.

45. The lowering in the average value of pensions, coupled with concerns for those affected by the war of independence, has had political consequences. One reaction was the creation of new budget financed pensions for war-related victims at much higher levels than those in the regular contribution-based pension system. This spending, by itself, was at least 0.083 percent of GDP in 1999. The second reaction was the so-called “small law” restitution to pensioners for periods of time in the mid-1990s when the Budget did not transfer amounts due for merit pensions, thus causing benefits to be compressed more than otherwise. This constitutes yet another 1.2 percent of GDP in 1999. All types of pension spending are now about 13.2 percent of GDP.

46. Pensioners were not satisfied with the small law and have pressed for retroactive benefits and “re-based” benefit levels compatible with the old Yugoslav practice of wage-indexing, both to determine initial benefit levels and to adjust benefits in pay status. This is an acute issue across the region, especially when, as happened in Croatia after 1996, new awards were allowed to encapsulate a fuller measure of post-1990 wage growth, but existing pensioners have been held to price indexing or less.

47. A complete re-basing of the 1998 law’s benefit formula to Yugoslav levels, at today’s pensioners/insured ratio, logically implies an increase in spending as a percent of GDP and payroll *by a factor of at least 60 percent*. Even assuming repeal of the small law and half of the special war-related pensions as an offset, this factor implies spending for contribution-based and merit pensions of at least 17 percent of GDP, which implies contribution rates just for pensions at 35 percent or more. A further increase in spending for back-due adjustments has been estimated at around HRK 30 billion, or roughly 20 percent of 1999 GDP. If amortized over 10 years, that implies another 2 percent of GDP per annum, *double* the level of the 1 percent contained in the small law restitution.

48. To satisfy these claims would greatly impede any lowering in total size of government, for it is unlikely that offsetting savings elsewhere (e.g., defense) would compensate. Without offsetting reductions, the size of government would grow, necessitating further increases in some combination of contributions, income taxes and VAT rates. Today’s compliance gap likely would grow (at least not improve) despite administrative efforts to the contrary.

49. Finally, Croatia may need to revisit aspects of the 1998 and 1999 reforms to assure their medium- and long-term financing and to improve equity, targeting and economic efficiency. In addition, there has been a lack of management focus in the Pension Institute that administers the first pillar, caused in part by the distracting burden of managing an asset portfolio. Liquidating this asset portfolio, supplemented by the more substantial values expected from privatization of state-owned enterprises, can be one means to further satisfy the claim of pensioners for past-due adjustments to benefits from the 1990s.

50. The following policy actions are recommended in the short term:

- Adoption of a plan of action to assure first pillar pension fiscal stability, including a concrete and realistic policy that settles the “pensioners’ debt” and that balances popular desires for higher benefit levels with fiscal and compliance realities;
- Decision on funding/assistance required for administrative reform of the Pension Institute (first pillar agency); and
- Consolidation of management of Pension Institute’s portfolio with like portfolios in the government consistent with a disposition strategy to be developed by the Government.

51. These measures could reduce the expected shortfalls on the order of 1 percent of GDP relative to ongoing costs under the 1998 reform law, and, more important, prevent increases in pension spending as much as 6 or 7 percent of GDP. Measures directed toward better compliance at least would prevent further deterioration in revenue compliance and possibly improve compliance as much as 10 percent.

52. The medium-term policy measures include:

- Analyses of necessary steps to assure long term stability of residual first pillar through equalization of female and male retirement ages and changes in special early retirement provisions for hazardous jobs. In this context, the cost and equity implications of the minimum benefit need review as well as, and if early retirement is retained, the size of the decrement for early retirement. In addition, the size of the special pensions for war-related victims should be re-considered; and
- Preparation of plans to reengineer the first pillar agency.

53. Inaction on these matters could lead to chronic deficits in the first pillar system on the order of at least one-half percent of GDP per annum.

### ***Health Reform***

54. *Croatia's health system* is at a critical and unstable point, with its health finances hemorrhaging and its care delivery system under strain. Croatia currently spends around 9 percent of its GDP on health, with an estimated 7.2 percent of GDP from public expenditure. This is well above CEE comparators. Moreover, the Croatian Institute for Health Insurance (CIHI) has consistently run a large deficit with arrears accumulating at an unsustainable rate. By the end of 1998, outstanding liabilities stood at HRK 3.76 bln. or around 2.7 percent of GDP, an increase of almost 1 percentage point of GDP each year in the period 1996-98. Although the notional level of outstanding contributions was around 90 percent of liabilities (much of it from the public sector), prospects for collection were low, and the monthly deficit of the CIHI had risen to HRK 160 mln. by May 1999. The sector therefore represents a major fiscal problem, and increases the vulnerability of overall public sector finances.

55. Although changes in the mix of revenue sources and the efficiency of revenue collection are needed, the high level of expenditures relative to GDP implies that medium-term solutions lie primarily in more effective health spending, not higher health revenues. The health system must commit to bold systemic reforms or else regress. Through further reforms, Croatia could build on the initial stabilization that flowed from 1993 health reforms to achieve long-term sustainability. Otherwise, the health system would become increasingly dysfunctional and ineffective.

56. The Government needs to move rapidly and decisively to put in place the structure and incentives for a health care system which is fiscally sustainable, addresses priority health needs (including an emphasis on preventive programs), and does so with due concern for equity. To do this, there is a range of short- and medium-term measures and processes which are of high priority. There has been recognition in Croatia of the need for such measures in the 1999 draft Health Reform Program.

57. In the short term, the measures which would help to control spending and also engender improvements on the revenue side include:

- Retain global hospital budgets, and introduce hard budget caps on outpatient polyclinics;
- Moratoria on large capital expenditure, both on construction/major renovation and expensive equipment;

- Enter into no new open-ended contracts for secondary and tertiary level services. This would be part of a wider attempt to control public sector pay increases, and needs to be coordinated with the recommended public sector pay review;
- Reducing prices paid by CIHI on pharmaceuticals by a fixed percentage of the current rate;
- Integrate the CIHI contribution collection and enforcement into the unified reporting and enforcement system being developed within the context of the pensions reform, in collaboration with CRA and ZAP;
- Increase co-payments on a range of services from current rates, which would have a dual effect of putting a brake on unnecessary visits and increasing revenues; and
- Reduce the share of the population entitled to fee exemptions to those who are most needy. Presently around 80 percent of the population are entitled to fee exemptions, which is unsustainable.

58. The proposed medium-term policy actions consist of:

- Defining a basic package of care that would be publicly financed;
- Improving clinical and prescription practices;
- Rationalizing health infrastructure based on a rapid inventory and categorization of all health facilities;
- Improving investment decisions; and
- Development of “A National Drug Policy”, which takes an integrated approach to developing a more efficient and accountable drugs policy.

59. Although it is structural reforms that can provide the major impetus to a fiscally affordable public health sector, health finance and provider payment reform remains essential. Priority areas for reform are: (i) an evaluation of the financing base of the CIHI, and development of a more appropriate *division of financing responsibilities between CIHI and budget*; (ii) the range of *social benefits currently financed by CIHI* needs to be reviewed, both with respect to the appropriate source of financing, and whether current benefit levels are fiscally sustainable; and (iii) there is also a need to build upon the 1993 *reforms in provider payments* via (a) developing proposals for phased introduction of a case mix payment system for hospitals; and (b) developing proposals for reforms in primary care provider payment systems which minimize incentives for unnecessary referrals to more expensive levels of care.

### Transfers and Subsidies

60. *Transfers* have grown by 7 percentage points of GDP over the past five years. They have been the fastest growing component of the budget and now amount to 16 percent of GDP. Transfers consist of social transfers to households, such as pensions, unemployment benefits, and of other war-related social costs. Recently, payments for contingent liabilities, such as state guarantees and insured bank deposits, became a significant item, expected to reach some 2 percent of GDP in the budget for the year 2000.

61. The short-term measures designed to achieve reductions include:

- Defining a clear criteria for transfers to local governments in a manner consistent with decentralization policies and devolution of public responsibilities; and

- Recognition and appropriate budgeting of contingent liabilities arising from banking sector rehabilitation, deposit insurance schemes, and government guarantees.

62. Proposed policy actions in the medium term consist of:

- Phasing out the transfers to Bosnia and Herzegovina based on the findings of the public expenditure review; and
- Re-evaluation of social assistance, in light of the results of the “Economic Vulnerability and Social Welfare” study currently underway, and other relevant studies based on the Household Budget Survey, in order to achieve better targeting; and
- Even if targeting is improved, spending on social assistance may need to rise to alleviate temporary social costs of structural reforms.

63. *Direct subsidies in Croatia*, at some 2 percent of GDP, appear to be relatively low compared to other transition countries. Direct subsidies are mainly concentrated in transport -- railways and the national airline -- and agriculture. However, the actual magnitude of subsidies are likely to be well above 2 percent of GDP, as indirect subsidies in the form of Government waivers for the obligation of selected enterprises to the social security funds take place frequently. Moreover, debt of enterprises is often assumed by the government through different channels -- debt to equity swaps.

64. The use of indirect subsidies to postpone the bankruptcy of inefficient enterprises leads to misallocation of resources and undermines the country’s production potential. Consequently, it is essential to recognize any form of subsidy in the budget and to discontinue the use of waivers that enterprises have been enjoying.

65. The guiding principle in tackling subsidies both in direct and indirect forms should distinguish between public services/utilities and manufacturing. In services/utilities, subsidies should be linked to privatization goals and action plans for improved cost recovery. While in manufacturing, subsidies need to be phased out.

66. The following measures need to be considered in the short term:

- Maintain overall subsidies at its current level in real terms;
- Define clear criteria and a timeframe for phasing out subsidies to enterprises;
- Discontinue indirect subsidies and make all subsidies transparent and explicitly included in the budget; and
- Discontinue to waive payroll contributions and other obligations of shipbuilding industry, as arrears in their obligations currently amount to around 1.7 percent of GDP.

67. Medium-term policy recommendations include:

- Update the existing plan including a timetable, for reducing subsidies to railways, which currently amount to 0.9 percent of GDP; and
- Phasing out subsidies to distressed enterprises.

**B. PUBLIC ENTERPRISES AND INFRASTRUCTURE****Corporate Governance**

68. The central issues of corporate governance are: *what institutional/administrative arrangements are in place in Croatia for the state to exercise its rights as owner of all enterprises in which it retains equity holding<sup>2</sup>? Can the state exercise these rights in a transparent and economically efficient manner, and ensure that enterprise management is held accountable, and that state policies regarding the future disposition and management of these assets/enterprises can be enforced effectively?*

69. Current institutional arrangements raise serious concerns about the feasibility of effective corporate governance. *First*, the performance of large public enterprises/utilities are supposed to be monitored by the Office for Economics and Restructuring of State-owned Enterprises (ORESE) -- though this central agency developed considerable technical know-how over the last years, reporting requirements and its oversight were not enforced by the Government -- and by the Croatian Privatization Fund (CPF) in former SOEs. *Second*, supervisory boards of individual enterprises generally have not been sufficiently active in providing minimal oversight and holding managers accountable -- board members were often appointed without much concern for the required skills and despite a conflict of interest -- and the predominant motivation of high fees paid by the enterprises to the board members further diluted the effectiveness and professionalism of the boards. *Third*, residual equity in former SOEs is held through a diffuse institutional framework, involving the CPF, Bank Rehabilitation Agency (BRA), Pension Fund as well as sector ministries, including the Ministry of Economy and Ministry of Transport. Uniform criteria for managing state assets and the necessary technical capacity are not in place in all these entities.

70. The government often did not provide a clear guidance to the enterprises on strategic issues, such as restructuring, plant closure and labor redundancy, but even where it did, under the fragmented institutional relationships described above, enterprises did not have compelling reasons to follow through instructions.

71. A comprehensive privatization strategy was not adopted. After conclusion of the voucher privatization, the Government failed to address the future of the state's residual portfolio. Inadequate corporate governance only aggravated uncertainties in the absence of a clear privatization program.

72. To address issues of corporate governance and improve asset and enterprise management, the following recommendations are made:

- Concentrate residual portfolios of equity holdings in SOEs under one entity;
- Review effectiveness of holding arrangements for state owned enterprises currently overseen by ministries (transport enterprises, utilities, shipyards, etc.);
- Restore the capacity of ORESE, and enforce its oversight functions over a well-defined set of public enterprises;
- Review existing regulations for the establishment and functioning of supervisory boards of public enterprises and non privatized SOEs, with a view to maximizing private sector participation and accountability, and regulating compensation of board members; and
- Draw up a comprehensive strategy with a time bound plan for management/disposition of state-owned enterprises and assets, with a view to speeding up privatization/liquidation of enterprises or effective restructuring of those in which the state expects to continue holding an interest (municipal services, railways, temporarily, some utilities, etc.)..

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<sup>2</sup> This applies to the two categories of State-owned enterprises, non-privatized former socially owned enterprises (SOEs) as well as to the large public enterprises (PEs)/utilities governed by different laws than the SOEs.

## Public Utilities and Energy Sector

73. The four large Public Enterprises (PEs) – HEP (Electricity), INA (Oil and Gas) and, HPT (now split into HT-telecoms and HP-posts) and the HZ (railways) represent the bulk of remaining State-owned enterprises in Croatia outside the banking sector. The three vertically integrated companies, HEP, INA and HT dominate their sectors, enjoying a quasi-monopoly (with the limited exception of mobile phone services in the case of HT and fuels retail with INA). The lack of genuine competition in energy is not conducive to the needed increase in quality of services and reduction in prices, as currently seen in European countries where the application of the EU directives has resulted in significant reduction of prices.

74. Despite their dominant position, the PEs' financial performance has been and remains disappointing. This poor performance is particularly disappointing for HEP, considering that it faces very little competition and that electricity tariffs are high for the region. Furthermore, the cash generated from operations by INA and HEP has been far from adequate compared to their investment requirements related to major modernization and expansion needs. With inadequate investment levels (with annual capital expenditures which averaged only 5.5 percent of net fixed assets over the last five years), a significant part of the assets of both companies has gradually become obsolete. This investment backlog needs to be urgently addressed to achieve an increase in productivity, expand production, and improve the quality of services needed to sustain Croatia's development. The financing burden of large investment needs cannot be shouldered by the State and should essentially be shifted from the State to private investors -- essentially strategic investors who will bring significant improvements in efficiency through better governance and know how.

75. Successful efforts to start privatization of PEs have been limited, except for the recent sale of 35 percent of HT. Similarly, to date, direct foreign investments in new energy facilities has been limited to only one medium-size joint venture in power generation. In this respect, the *energy sector* faces serious obstacles to privatization through strategic investors and investments by foreign groups due to: (i) lack of a clear privatization program; (ii) absence of an official comprehensive sector strategy; (iii) lack of modern energy legislation; and (iv) inadequate regulatory and institutional set-up for public utilities, which is not conducive to competition and drive for efficiency. A comprehensive strategy for Croatia's energy sector should be articulated around the following core objectives: assuring an efficient energy supply in environmentally sustainable manner at realistic but socially acceptable prices; and achieving sustainable financing and efficient operations.

76. Additional problems in the energy sector are: (i) declining domestic oil and gas production and thus the need to increase significantly fuel imports; (ii) inadequate pricing policy, with distortions in favor of households; and (iii) lack of concrete programs for improving Energy Efficiency (EE) and developing Renewable Energy (RE) resources, partly due to institutional barriers.

77. The proposed short-term policy actions are:

- Taking the draft Energy Strategy of the Government for second reading by parliament for final adoption and enacting a new comprehensive energy legislation, closely modeled on the latest EU directives;
- Creating independent regulatory agencies for telecom and for energy sector, with adequate powers and resources;
- Restore ORESE's oversight to closely monitor the PEs and having active supervisory boards (with new appointees when necessary) that exercise proper control over PEs for the period they remain under partial State ownership;
- Implementing fully restructuring programs of HEP and INA: unbundling HEP, with full vertical and horizontal separation of generation and distribution and divesting HEP's non core activities; reducing overstaffing of both PEs; cutting down INA's loss-making activities (such part of its

refining business) and setting up subsidiaries for specific businesses such as natural gas; all as essential steps toward privatization;

- Commencing privatization of both PEs with strategic investors: in INA, with sale of minority stake in the group and/or participation of investors in selected businesses (such as gas); and in HEP, by selling power generation (thermal as well as hydro power) plants -- to introduce competition in generation -- and distribution networks, to strategic investors;
- Planning investments on an integrated resources basis, with emphasis on attracting private investors and reinforcing power interconnections with neighboring countries/UCTE (400 kV loop in Bosnia and Herzegovina) and on Croatia's role as transit country for gas and electricity supply to other countries. Constructing key gas import pipelines (from Italy and/or Hungary) and high voltage substations (Ernestinovo) for transmission;
- Carrying out tariff studies to devise and implement new tariff systems, starting with gas, district heating (with fair benefits/cost sharing between power and heat) and power (based on updated least-cost investment plans); and
- Adopting a modern concession regime, with new legislation conducive to private investment in public utilities at the national level as well as at the county/ municipal level.

78. The following medium-term policy measures are recommended to complete reforms, achieve additional efficiency gains, and to develop the sector further:

- Completing privatization of HT, of the INA group and all HEP assets/activities-- except for core transmission/dispatching function (remaining for some time under State control);
- Implement further competition in energy markets, with full third party access (TPA) and other specific reforms following latest EU directives;
- Completing international power interconnections to fully incorporate electricity trade with other countries as essential component of Croatia's electricity supply and demand balance;
- Completing the reform of pricing policy in line with the new market structure; and
- Removing barriers to energy efficiency and renewable energy projects and implementing concrete programs launched with selected demonstration projects, with potential support of the Global Environment Facility (GEF).

## **Water Sector**

79. Adequate water management is important to the economic development of Croatia. First and foremost it is needed to ensure a safe and adequate supply of water for domestic consumption and industry. Second, Croatia's natural water bodies must be protected from pollution from municipal and industrial wastewater, particularly the 1,780 km-long Adriatic Sea coastline and 1,185 offshore islands.<sup>3</sup> Third, because much of Croatia's territory is flood plain effective use of these areas requires flood protection.

80. The great challenge for the Croatian government and the sector community will be to increase the financial resources available for the sector through a dedicated and sustained effort in improving the productivity and financial performance of water and wastewater utilities. The main challenges to achieve this objective are: (i) strengthening the efficiency of utility management and operations to reduce

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<sup>3</sup> Water quality in the Adriatic coast and islands is important to the success of the tourism industry, which contributes significantly to the economy and generates 85 percent of Croatia's foreign exchange.

administration and operating costs; (ii) increasing resource mobilization from internal cash generation by utilities; (iii) concentrating scarce resources on cost effective investments; developing a cost effective strategy for investments in wastewater treatment; (iv) encouraging private sector entry in utility management and operation and funding of investments; and (v) clarifying and streamlining present institutional and regulatory relationships.

81. In light of the above underscored issues, the following immediate actions are recommended:

- Creation of a National Sector Reform Task Force to consider more enabling sector policies, including cost recovery, regulation for private entry and an investment strategy for waste-water treatment and practices;
- Preparation and execution of demonstration projects in support of reform principles;
- Encourage and facilitate demonstration projects with private sector participation; and
- Preparation of a national plan for investments in wastewater treatment.

82. In terms of flood protection, existing policies and practices regarding flood control investment projects are most likely to lead to less than optimal solutions. New planning and evaluation policies should be introduced to establish rigorously the technical, social, financial, institutional and economic feasibility and justification of such projects. The possibility of introducing a flood insurance scheme should be considered.

### **Transport Policy**

83. *Transport policy* affects one of the most important components of the public investment program. Rationalization of transport investments/expenditures along with the privatization and commercialization of transport activities are the key outstanding issues requiring policy actions. Priority areas to focus on are: (i) uneconomic motorway investments that have been started; (ii) maintenance of existing roads deferred because of the war and costly motorway program; (iii) Government consideration to purchase four cranes and conveyor system for Rijeka Port in the absence assurances that those will be used efficiently; and (iv) efficiency of most transport organizations is low, while the level of Government financial support is high, thereby hindering economy and alignment with EU policies.

84. The proposed short-term policy actions involve:

- Estimation of the cost of motorway program, including contingent liabilities and repayment obligations, and reduce/stage investment program where practicable;
- Budget a minimum US\$100 million for road maintenance in 2000;
- Defer purchase of the cranes and conveyor system for Rijeka Port by which time a comprehensive and adequate port development program needs to be developed;
- Implement HZ's restructuring plan to increase efficiency and minimize the level of required fiscal support;
- Reverse, or significantly modify the 12-year priority concession granted to Luka Rijeka;
- Undertake institutional study to complement recently completed Zagreb Urban Transport Plan;
- Study privatizing Croatia Airlines, Croatia Line, other organizations; and

- Study reducing central financial support for secondary ports and airports.

85. The proposed medium-term policy measures are:

- Base future investment decisions on cost/benefit analysis;
- Increase road maintenance budget in stages to US\$160 million per year and study possibility of road maintenance concessions;
- Reduce HZ's staff by 2,382 in 2000;
- Implement HZ's service/line reduction plan;
- Reduce HZ's accounts payable;
- Implement HZ's subsidiary privatization plan;
- Concession terminals at Rijeka Port with substantial private participation;
- Privatize 14 Road Maintenance Capital Enterprises;
- Implement institutional improvements and justified transport investments in Zagreb;
- Implement privatization Croatia Airlines and Croatia Line; and
- Turn over secondary ports and airports to local Governments and private investors where justified.

### **C. PUBLIC MANAGEMENT REFORMS**

#### **Public Administration Reform**

86. A broad *public administration reform* is essential if Croatia is to achieve a smaller and more efficient public sector. Over the last decade Croatia created the institutions of a sovereign state. Policy-makers now must fine tune those institutions and their missions to be more compatible with the state's role in a modern market economy -- a neutral and effective umpire of clear and enforceable "rules of the game" for the market, and an efficient provider of core public services. This requires transforming Croatia's public administration into a leaner, technically stronger and more effective bureaucracy.

87. Public administration reform encompasses both national and local government, the judicial and legislative functions as well as the executive. Public administration reform at central level should be tightly coordinated with devolution of power to local governments. Legal and judicial reforms, including some general aspects of legislative functions, are discussed in Section 4. The comments here focus on key issues relating to the government apparatus.

88. A key task is civil service reform, including:

- Creating a qualified and properly sized public work force, armed with adequate skills, materials, and incentives for career development;
- Ensuring continuity in public administration by limiting political appointments to a well defined top echelon of officials in the administration;

- Designate a separate government unit to be in charge of rationalizing the civil service, investing it with authority to access information regarding employment at different levels of the public sector, including local governments. Although different government bodies, such as the State Directorate for State Administration, monitor a subset of the overall civil service, there is no single administrative unit with an overall view of the public sector staff; and
- A management system oriented toward maintaining an effective civil service, including a system of personnel evaluation and promotion, and adapting the civil service's capacity to respond to evolving conditions over time.

89. This will require the introduction of modern technology, administrative practices, work methods and streamlined procedures, as well as upgrading skills and an understanding of the state's economic management role in a market economy.

### **Reforming the Budgeting Process**

90. *Current budgeting process* fails to capture the actions of the government as a whole. Transactions in the foreign currency account, contingent liabilities, and expenditure arrears are not fully captured in the budget. Furthermore, hidden subsidies to public enterprises are not included in the budget at all, although the budget is the main instrument used in rehabilitating the enterprises. Cross-country experience has demonstrated that more "hierarchical-transparent procedures" are associated with more fiscal discipline. Hierarchical procedures are those that assign more power to the Treasury than to spending ministers in intra-government negotiations and that limit the role of the parliament in amending the budget proposed by the government. Consequently, improvements in the budgetary process would not only ensure a more transparent system of public finances, but also would enhance accountability and fiscal discipline. Indeed, Government estimates suggest that the introduction of the Treasury could engender savings in central budget expenditures amounting to as high as five percent of GDP.

91. In this connection, the proposed short-term measures include:

- Introduce the Treasury mechanism;
- Adopt the annual budget in a transparent way, broken down by government institutions and functions;
- Full disclosure of all public sector arrears including local governments;
- Include in the central budget receipts and expenditures of Croatian Privatization Fund, Croatian Bank for Reconstruction and Development;
- Review and disclose concession agreements and guarantees; and
- Define areas and amounts of future state guarantees.

92. The medium-term measures consist of:

- Introduce Ledger Two -- a ledger with full description of state portfolio, tangible and intangible property;
- Adopt a plan for the privatization of non-essential assets;
- Analyze the introduction of fiscal accountability; and
- Introduce accrual basis accounting with arrears shown in the budget.

**Revenue Compliance and the Role of ZAP**

93. Croatia has had a persistent *revenue compliance* problem since the early 1990s, although Croatia's revenue record is not the worst in the region. The key reason for compliance not being even worse is the residual role of ZAP as a payment agent in the economy (and successor to the SDK), especially with respect to monies owing the government based on payroll (contributions and income tax withholding). Under current arrangements, ZAP knows only the aggregate flows of revenues from employers to the Tax Administration Service and the several extra-budgetary funds. In effect, ZAP operates as a withholding agent for government revenues. Employers report separately to these revenue collectors and to other (statistical) agencies at year's end on similar, but different, forms. The compliance function is scattered across agencies, though in theory, because of an extant government decree, audit and compliance could be consolidated in the Tax Administration Service, with little additional cost to it and savings to the other agencies.

94. In the course of developing the second pillar pension reform design, it became clear that the second pillar would require more frequent *reporting* -- quarterly or monthly -- by employers on wages and salaries paid to individual workers. Without this more frequent reporting, second pillar moneys would be held in a special holding account on the average of six or more months, earning only a government bond rate. Those working on the reform believed such lags would be unacceptable to most Croatians, and, accordingly, planning proceeded on the basis of more frequent reporting, most probably every month. It also became clear that imposing more frequent reporting with respect to all workers -- rather just with respect to the roughly 70 percent initially participating in the second pillar -- would be easier on employers than forcing them on two different reporting cycles, depending on whether workers were in the second pillar or not.

95. This requirement of more frequent reporting also offers the prospect of improving compliance across-the-board. Auditors would become aware of discrepancies sooner, and having to understate workers' wages on a frequent basis is likely to make employers more hesitant in what they understate. A consolidated (and more frequent) reporting system will eliminate the need for employers to report separately to different revenue collectors and statistical agencies. Consolidation in reporting would also allow consolidation in audit and follow-up compliance in the Tax Administration Service and the Financial Police.

96. As with the development of a *Treasury* (see previous section), the previous government made headway. But, as noted elsewhere, serious work on a consolidated and more frequent reporting system just started in late 1999. The prerequisites for a consolidated withholding and compliance system are: (a) an integrated database, using the Health Fund's database as the core; and (b) a fully tested system by which employers report on each worker's wages, and revenues due therefrom, on a monthly (or quarterly) basis. The Bank's view is that such a system could be ready sometime during the first half of 2000, *but only if the government largely leaves in place the existing team and its implementation plan* (working on the Registry of Affiliates for the second pillar). This planning is closely connected with work done on developing a Treasury system, for the moneys collected in a consolidated system naturally would flow into a consolidated Treasury operation.

97. In addition, this revised reporting and withholding system would build on the existing payment agency (ZAP). As ZAP's functions are broken apart and de-monopolized, agreement must be found among the Government as to how to preserve the existing sanction of today's de facto withholding that wages and salaries cannot be paid without contributions first having been paid in. It also requires the development of a concrete plan to determine what parts of ZAP are retained to run a withholding and information system along the lines described and for Treasury operations, and which parts are spun off to be privatized and perhaps used by the banks to clearing payments among their branches and across banks. This should be done in a deliberate manner to maintain and improve compliance during the transition.

98. Recommended actions include development of a time bound plan for ZAP, determining which components should be retained in the Government for Treasury and withholding operations, and which components should be privatized and left to market determinations.

**Public Investment**

99. *Public investment* in Croatia currently lacks a clearly defined procedure to choose among competing investment projects. Although there is expertise to carry out cost/benefit analysis, it is often not used as an input in the decision making process. The allocation of funds for investment tends to be biased towards new projects at the expense of maintenance and rehabilitation. Furthermore, the payment invoices with equity shares of government owned companies of unknown market value, not only undermines budgetary control, but also engenders all sorts of non-transparent behavior and escapes the standard monitoring procedures.

100. In the short term, the proposed policy measures include:

- A thorough assessment and plan for the remaining reconstruction needs for the medium term;
- Reducing government investments for cars, office equipment, and furniture;
- Re-assessing “social” capital transfers for houses and housing credits to war veterans, which currently amounts to 0.3 percent of GDP; and
- Discontinuation of the practice of paying liabilities with CPF shares.

101. The proposed medium-term measures are:

- Review the public investment program in motorways and other transport infrastructure of doubtful economic return;
- Re-balance spending in maintenance vis-à-vis new projects;
- Phase out reconstruction expenditures, which currently amount to 0.8 percent of GDP in cash plus an estimate of 1.4 percent paid in shares from HPF; and
- Adopt transparent procedures for contracting concessions and enforce measures against misuse of public funds.

**D. EDUCATION POLICY**

102. The Government of Croatia has kept education reform on its agenda since the country gained its independence in 1991. However, a coherent national strategy has not been pursued, as education remained a mostly political issue. The general goal has been to help the country define itself as an independent state with its own culture and language, and as part of Europe. Consequently, the government documents include references to general educational models and norms about national traditions and European standards, but they have little detail about quality, efficiency and equity objectives, measures, and rationale or implementation strategy.

103. Lack of education is one of the strongest predictors of poverty in Croatia. Hence, a strong and effective education system is crucial to reducing future poverty.

104. Before any significant investment in education is considered, the new government will need to think through both its short and medium term approaches to education. It will need to decide how it intends to improve and sustain its public education system, and its approach to private provision and non-state financing. Further, the government will need to engage in a sector dialogue with the major in-country stakeholders and international partners, and seek consensus to regain the momentum for a new reform program and implementation.

105. The most important questions the government strategy needs to deal with are the following:

- What are the main objectives of the country's educational policy in the context of Croatia's modernization and closer integration with Europe? What are the main priorities and how are they translated into a medium term strategy?
- How to best divide responsibilities between various central and local governmental agencies and service providers in order to assure that individual needs are met, efficiency improves and performance is measured/rewarded?
- How to assure an adequate level and structure of public funding for education while overall fiscal retrenchment is being implemented over the next few years? How to structure the expenditure program including the split between investment/recurrent spending? What policies should be put in place to stimulate alternative sources of provisions and funding? and
- How to adjust the education system and curriculum in order to focus on general skills and abilities rather than specific factual information. In order to make the system more flexible, how to allow more choice over what and how students study when they enter, leave, and re-enter education and modify their school career?

106. The short and medium term issues are conditioned by long-term risk stemming from the apparent under-investment in education. The present 3.4 percent share of GDP the budget is low compared to the European averages and compared to the needs the country has in its effort to develop market economy and open society. The low level spending could limit long-term productivity with negative implications on long-term growth. While at present, fiscal pressures could make any increase difficult, strategic planning and reforming the educational programs will need to take into account this long-term risk. In absence of a plan concerning the medium term educational budget, recommendations for the short and medium terms can only indicate potential benefits and risks instead of measurable outcomes and costs.

107. The previous government lacked a **strategic vision** that would integrate the main objectives for a new education policy, including improving quality, efficiency and equity. In addition, the government did not attempt to seek consensus with the major stakeholders on these issues. Therefore, the main objective for the new government is to develop its strategic capabilities to develop a sector strategy and policy agenda for dialogue with the stakeholders.

- *In the short term*, an intergovernmental Task Force should be established to set policy including agenda and priorities. The Task Force should include representatives of central and municipal agencies including those who supervise education as well as those who control public finance. Dialogue with teacher unions, employers, academia, student and parent representatives would help develop partnership, refine priorities and needs for changes in the regulation, and may help mobilize additional financial and human resources to support reform;
- *In the medium term*, the above activities will result in a sector strategy including output objectives, level of public resources and legislative reforms. The government will also need to establish independent advisory units focusing on targeting specific issues, including assessments, teacher training, accreditation and management; and
- *Risks* are indirect: a dialogue and planning could identify investment areas calling for additional funding at times of scarce resources and could also point at inefficiencies, thus threatening some vested interests.

108. The inadequate delineation of responsibilities between different levels of *government* and the strong role of central authorities in regulating day-to-day activities limit the government's capacity to pursue policy objectives. Meanwhile, such governance does not provide the stimulus for local authorities or for those delivering services to engage in innovative practices to improve quality, relevance to market economy and open society and efficiency.

- *In the short term*, a review of the inter-governmental roles and responsibilities will need to identify the present limitations and compare it to the additional opportunities that would result from a realignment of the present governance. Such surveys proved to be instrumental in Bulgaria, Czech Republic, Hungary, Poland and Romania in assessing the governmental capabilities and propose ways of realignment. The method used in the above countries is available and easily adaptable to Croatia;
- *In the medium term*, governance and administration will need to be re-structured allowing effective policy making and incentives at the level of local governance and management of innovation, and improved delivery of education services; and
- *Risks* include a lack of interest and limited capacity in policy making and management of reform for changing the present system. These risks should be reduced through training and participatory practices.

109. In absence of significant potential to increase public spending on education, the new government will need to rethink and adjust the **expenditure structure**, the allocation system and the incentives to service providers.

- *In the short term*, incentives will need to be put in place for targeting efficient spending and service delivery, for user fees at least in tertiary, but also in certain elite or vocational forms of post-compulsory education. Upon reviewing the current geographical distribution of public education spending, the government needs to develop formulae to compensate for inequities;
- *In the medium term*, the government should introduce a new budgetary allocation system, including block grants and student-based allocation schemes. This would lead to improvements in local and school level financial management and increase financial capacity at the central level to finance national priorities and investments and reward performance; and
- *On the risk side*, block grants and other new financing schemes will exacerbate the need (resulting in additional costs) for more transparency, a better information system and regular auditing.

110. The new government will need to redesign the system of *assessments and examinations* including improving the central capacities and issuing new regulations:

- *In the short term*, an Assessment Board should be established to set priorities and institutional arrangements for assessments, as well as to change the framework of examinations;
- *In the medium term*, an independent professional assessment unit will need to be established to carry out regular assessments, new standards will be set by the Board. The standards together with feedback from sector wide assessments should be the basis of policy adjustments. New standard examinations will need to be piloted and introduced at the end of compulsory and secondary education, bringing about more transparency into the selection system; and
- *On the risk side*, assessment as a policy instrument will bring about additional expenses. However, streamlining other parts of the educational governance and administration should result in savings. More reliable information about the institutions' performance could also attract more non-state funds into education. Also, the new examination schemes may not be successful if introduced without parallel development of a new curriculum policy.

111. The demand of establishing Croat and European issues in the subject matters conceals the real issue that **curriculum** is rigid and is based on fact acquisition instead of skills development and active learning. Departure from the traditional approach will require from the new government broad dialogue and consensus.

- *In the short term*, the Government should set up an Advisory Group to develop and discuss the new framework of curriculum development. Based on the Advisory Group's recommendations, the Government should seek new agreement on the objectives of a core curriculum, which promotes skills and facilitates active learning and teaching;
- *In the medium term*, the government will need to adopt the framework for core curriculum. This framework will require the revision of textbooks and other materials, adjustment of examinations and training. Moreover, decentralized governance should authorize schools and teachers to adjust teaching and learning to local conditions and individual need; and
- *Risks*: Changes in the curriculum and related issues are politically contested issues requiring extended dialogue, expert work and technical assistance. Once a framework is set, implementation will require new funds to cover the expenses of producing educational materials, redesigning and enforcing pre-, and in-service training and finance school level innovation.

112. The new government needs to address the issues related to the *structure of educational provisions* as at present, it is not suitable to meet the needs of an increasingly market and Europe-oriented society.

- *In the short term*, the Ministry of Education needs to make recommendations to: (a) delay tracking into vocational programs; (b) establish broader fields of specialization; (c) provide bridging programs between secondary study tracks; and (d) establish standard selection procedures at the end of 12<sup>th</sup> grade;
- *In the medium term*, the governance and adaptation of the education structure should better reflect demand. Local authorities should be given more of a role in defining the profile of public education, post-compulsory education should reflect individual need and user choice, and vocational programs should be more closely connected to economic actors (through provisions, funding and guidance). A new structure will need to be more flexible and take into account the increasing demand to change one's individual schooling and educational career, switch between tracks, leave and re-enter education, and find continuing opportunities for further training and re-training; and
- *Risks* are related to the increasing complexity of the educational provisions. The government will need to develop alternative forms of regulation through finance, examinations and indirect means of governance as schools, study tracks and programs will become less unified or homogenous (as other European examples show similar trends).

113. The new government needs to develop a new comprehensive approach to address various issues related to the *training and employment* of teachers:

- *In the short term*, the government needs to review the pre- and in-service training and propose improvement as well as additional funding for in-service training. Meanwhile the present system of salaries and compensations suggest inefficiencies. Salary and employment policy will need to be based on a review and reform of the overall public employment system;
- *In the medium term*, the government needs to introduce measures to assess and reward performance and curriculum innovation as well as new pre- and in-service training programs; and
- *Risks* are related to increasing funds for in-service training and for rewards and the possible divisions within the teaching force once performance incentives are introduced. However, the government should be able to use teachers as implementers of change.

### 3. TOWARDS PROMOTING STABILITY AND EFFICIENT RESOURCE ALLOCATION: FINANCIAL SECTOR REFORM

114. The Asian crisis, like the Mexican and Nordic crises earlier, has underscored again the complementarity between macroeconomic stability and financial stability. Since it became clear that, alone, neither is sufficient, policy commitment to strengthen banking and financial systems through the implementation of necessary reforms is essential for ensuring overall stability. In addition to its contribution to overall stability, financial sector reform is also pivotal for economic development. Cross-country evidence suggests that financial stability provides a favorable environment for efficient resource allocation and more rapid economic growth. Instability has been associated with lower levels of savings and investment, fiscal costs, and setbacks to GDP. It is, therefore, unavoidable that securing stability should be a concern of public policy authorities. In this connection, *policy actions to buttress financial stability and to eliminate the key barriers to financial and banking efficiency* are needed to complement measures that can ensure macroeconomic stability and sustainable growth.

115. To ensure financial stability Croatia needs to *enhance the coordination between various financial supervisors and regulators* (bank supervision, securities regulation, small savings institutions supervision, financial police, supervision of pension funds, etc.).

#### A. BANKING SECTOR

116. Monetary tightening (to counter the sharp increase in the current account deficit), economic contraction, and the marked decline in inflows revealed the underlying insolvency of a group of banks during 1998 and 1999. As a result, the central bank, often without a parallel support from the fiscal authority, had to intervene in 21 distressed banks -- corresponding to 23 percent of total assets of the banking sector -- and undertook actions during 1998 and the first half of 1999.<sup>4</sup> In spite of this intervention, however, the ability of the banks to withstand an adverse shock still warrants concern.<sup>5</sup> Against this background, the main objective of the short-term measures should be to preserve the public's confidence in the financial system.

117. In the short term, measures to be taken should include pay out for insured deposits, the completion of the resolution of failed/distressed banks, and the completion of privatization. More specifically these measures include:

- The resolution of failed banks and the 'pay out' of deposit insurance needs to be completed; Payouts should cover liabilities that started to be paid in 1999, as well as those that have been postponed into year 2000;
- The State budget must explicitly deal with the costs of insured deposits and the resolution of distressed banks in a comprehensive and transparent manner;

<sup>4</sup> The authorities initiated bankruptcy proceedings against twelve banks, considered the rehabilitation of three banks, maintained temporary administrators in two banks, and provided special liquidity support to four banks.

<sup>5</sup> This is because evidence suggests that Croatia experienced a "supply-driven" lending boom between 1997 and 1998, which was accompanied by a large current account deficit reflecting high consumption spending. As previous experiences suggest, economic expansions are more likely to affect banks adversely when they stem from a rise in consumption in lieu of investment. Under such expansions, an adverse shock is likely to lead to a sharp decline in the country's deposit base, thereby causing a major disruption in the banking system.

- Bank's bankruptcies currently under way must be accelerated and concluded in a transparent manner. To this effect, resources and technical assistance to deal with bank's bankruptcies needs to be made available to the commercial courts and appointed trustees; proper coordination among all parties needs to be improved to assure transparency in the process;
- The resolution of troubled banks should continue to be pursued in a comprehensive manner and in the context of the market mechanisms determined in the new banking law.<sup>6</sup> Specifically: (i) all banks identified as clearly insolvent should be promptly put under bankruptcy; (ii) the associated deposit insurance liabilities have to be honored; and (iii) more emphasis needs to be put on the use of resolution mechanisms -- as spelled out in the banking law -- in stages prior to the bank's failure, that is, when a provisional administrator takes control of a distressed bank;
- Additional Government bailouts should be avoided (including those done through the BRA). Public funds should only be used to the extent of covering the shortfall in funds to pay-out insured deposits, or to facilitate 'assisted mergers' of troubled banks that have been intervened and that seem suitable to be taken over by healthy ones; efforts to deal with the assisted mergers of distressed banks should continue to be pursued, and foreign assistance should be considered;
- Ongoing privatization efforts to complete sale of all State banks under the BRA should remain on track, including efforts to put the new banks currently under the BRA (i.e., Croatia and Dubrovačka Banka) under a short-term restructuring program and fast-track privatization/resolution.

118. In addition to immediate policy issues, policy makers need to design a medium-term strategy for further structural reform in the financial system. This strategy should primarily include policies to:

- Foster competition in the banking system and ultimately lead to the consolidation of the financial sector;
- Circumscribe the role of the State to provide an adequate regulatory and prudential environment, not to manage or own banks or to interfere in credit decisions;
- Promote an adequate level of financial deepening in order for the financial sector to be a key element to further correct years of misallocation of resources,
- Foster the institutional development of key financial institutions beyond that of the monetary authority, that is, the strengthening and close coordination of other supervisory agencies for pensions and insurance, reinforcement of the Croatian Securities Commission (CROSEC) and Securities Depository Agency (SDA), the creation of credit rating agencies, improvements in registries of movable and non-movable property;
- Develop a business enabling environment under which property rights are respected, contracts enforced, adequate accounting and auditing standards routinely used, and secured lending transactions properly structured; and
- Improve transparency and disclosure, and continue to modernize and make more effective the regulatory and supervisory framework.

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<sup>6</sup> It should be highlighted that much of the progress made in problem banks resolution during 1998-99 has relied extensively on the actions and initiative of the CNB, often without counterpart effort from the fiscal authority.

**B. IMPLICATIONS OF THE “SECOND PILLAR” COMPONENT OF PENSION REFORM FOR THE FINANCIAL SYSTEM**

119. Croatia's 1998-1999 pension reform also contained a so-called “second pillar”: a system of funded pensions for those under the age of 40 and optional for those between ages 40 and 50. Croatia would miss a critical opportunity not to proceed with the second pillar and let it fall victim to its current financing problems. The second pillar pension funds potentially constitute a major new source of capital in Croatia, growing from 0.5 percent of GDP per annum to 2 percent as the second pillar is gradually phased in over the next 20 years. Accordingly, the second pillar pension system would accelerate development of financial intermediaries in Croatia, force an improvement in and more effective coordination among regulatory agencies, and potentially increase national savings. More efficient allocation of capital from a funded pillar can bolster a country's growth rate by 0.5 percent or more a year. The effects are even greater if the nation's overall saving rate increases.

120. The second pillar contribution level was set at the relatively low rate of 5 percent of payroll. This amount is what could be safely covered with some increases in retirement ages and gradually lower replacement rates, holding the amount of “transition cost” to be financed from the Budget at less than 10 percent of GDP over the next decade. Below 5 percent, it is questionable whether a funded pension system would be economically effective and cost efficient.

121. It will be a challenge, however, to be sure that the second pillar funds do not become another soft lending opportunity for established interests. Part of this challenge will be to assure that the regulatory agencies do not work at cross-purposes. In time, this may require a review of whether separate pension supervision (especially of annuity products) is an optimal arrangement in the longer term from either the perspective of development of contractual savings or their effective supervision.

122. Unfortunately, the *previous government was slow in putting in place the necessary appointments to manage and supervise the second pillar*. Only now has serious work begun, and that work is hampered by inadequate resources for personnel and space. These factors, make the legislated July 1, 2000 effective date for the second pillar not feasible, a view that Croatian counterparts had begun to accept even before the recent elections. Effective dates now being discussed in the press and informal conversations include January 1, 2001, July 1, 2001 and January 1, 2002.

123. Realistic effective dates for different aspects of second pillar implementation -- enrollment, the start of monthly (or quarterly) reporting on workers' individual wages and contribution and tax payments, and the start of monies flowing to second pillar fund managers -- need to be set as soon as possible. In addition to these systemic issues (also see Section 2), there is a parallel, and equally time consuming, process of authorizing and licensing pension funds under the 1999 pension law and getting them also qualified under Croatia's commercial law. The second pillar regulator needs to be organized, staffed and housed before it can issue the necessary regulations. *Contingency planning must become part of the implementation endeavor, a view that the Croatian officials in charge have taken on board.*

124. The final issue is whether a subsidy for voluntary third pillar savings, enacted as part of the second pillar law, will be effectively targeted and is worth the cost to the budget. Experiences from the Czech Republic and some of the literature on “tax advantages” in OECD countries suggests that this provision may rebound to the relatively well off.

125. The following policy actions are recommended:

- Decision that the second pillar remains part of Croatia's pension policy and agreement on a realistic timetable for creating the regulatory regime and authorizing, licensing and otherwise creating pension funds. In this context, an analysis should take place concerning roles of financial market supervisors, including how the pension supervisor should be organized, and whether in the longer term it should be integrated in other financial sector regulations;
- Analysis of the cost and efficiency implications of the current second pillar annuity policy;
- Careful monitoring of second pillar fund operations to assure market allocation of new funds vs. discretionary decisions motivated by the vested interests of existing enterprise-financial elites; and
- Analysis of distributional and efficiency implications of third pillar subsidy.

### **C. CENTRAL BANK INDEPENDENCE**

126. Cross-country evidence suggests that an independent central bank can make an important contribution to growth. Countries with independent central banks committed to price stability are more likely to have low and stable inflation and, therefore, better functioning market systems. With more efficient markets, a country can potentially grow faster.

127. The Central Bank in Croatia enjoys the institutional independence (secured by Law), operational independence (free to choose the monetary instruments without any interference), financial independence (able to finance itself with its own revenues).<sup>7</sup> It does not, however, enjoy personal independence; namely, the Governor and Board members are elected for a six-year term, but can be replaced by a simple majority of parliament. In order to consolidate the independence of the central bank, the Governor and Board members should be elected for the full term, as is the case in many other independent central banks in countries under accession to the European Union.

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<sup>7</sup> The central bank finances itself with its own revenues and transfers the unspent surplus to the Ministry of Finance (MoF) budget. In the event of a deficit, the MoF budget is required to finance it.

## 4. TOWARDS A MORE COMPETITIVE AND DYNAMIC REAL SECTOR

### A. PROMOTING PRIVATE SECTOR ACTIVITY

128. The Croatian enterprise sector (Socially Owned Enterprises (SOEs) plus existing private companies) started the reform process in 1991 with significant handicaps: break-up of Yugoslavia, with the consequent loss of a major part of its former markets, and a war situation. This made privatization and Private Sector Development (PSD) more complex and difficult than in other transition countries. Also, Croatia has since its independence not benefited from large foreign assistance programs like other Central and Eastern European (CEE) countries received from the foreign donors (EU, US etc). In the other CEE countries, these generous financial and technical assistance programs contributed much to create a better environment for PSD through a wide spectrum of assistance for implementation of market reforms and support to enterprises and entrepreneurs (including training).

129. Even so, eight years later Croatia's results in terms of positive effects of privatization, foreign investment, enterprise restructuring and development of the private sector in general -- are disappointing-- putting Croatia largely behind most countries of the region. This is not only because of the initial handicaps mentioned above, but also because major distortions were not corrected and not many remedial actions have been taken during the last five years while Croatia's external environment was improving. For instance, important deficiencies which are for example glaring in the vital tourism sector, which continues to underperform despite Croatia's many comparative advantages in tourism affect enterprises in other sectors.

130. The key problem areas where a wide range of actions is needed to bring Croatia's enterprise sector to a path of sustained development include the following:

- Dealing with the unfinished privatization agenda;
- Fostering direct foreign investment;
- Accelerating and completing enterprise restructuring;
- Improving the business environment;
- Developing the SMEs sector; and
- Developing capacity for a market economy.

131. There are other elements indispensable for sustained private sector development which are dealt with in other sections of the report (financial sector, judiciary) and are thus not detailed below. The urgency of the needed remedial actions is such that the majority of these should be started without delay, as soon as possible.

132. Although privatization of many former SOEs is virtually complete, their governance has changed little.<sup>8</sup> As the main privatization method was through sales to managers/employees, very few companies changed managers, in contrast to the experience in countries like Hungary, Czech Republic, and Poland. As a result, management methods hardly changed and the legacy of workers self-management survived. The

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<sup>8</sup> It should be pointed out that the State controlled Bank Restructuring Agency (BRA) and especially the pension fund still holds significant stakes in a large number of enterprises.

SOE privatization program strengthened further the dominant position of the former managerial class without opening up the real sector to competition, injection of additional equity, marketing technology, etc., contributing to interlocking ownership between banks and enterprises, and

133. The proposed policy measures in the area of privatization include:

- Concentrating the different residual portfolios of SOE shares now indirectly held by the State under different State-owned entities (CPF,<sup>9</sup> Pension Fund, BRA) under one single entity with a clear objective of fast divestiture, instead of an unclear extended holding of shares;
- Completing divestiture of all this residual State-owned portfolio<sup>10</sup> (selling at realistic, market price the shares of viable enterprises; liquidating non viable enterprises); and
- Improving enterprise governance, among other things, by encouraging secondary trading of shares through a clear signal from the Government that it will not bail out distressed enterprises (thus encouraging current owners to seek additional capital from other investors or completely sell out the enterprise to them).

134. In fostering foreign investment the following measures are proposed:

- Sending strong signals of change to the foreign investor community by setting new precedents, creating a favorable environment for strategic investors, and privatizing the residual State-owned portfolio of shares of SOEs<sup>11</sup> and public enterprises (HT, energy sector);
- Educating the general public through a public relations campaign about of the benefits of foreign investment;
- Reviewing the whole investment framework and comparing it with that of other successful CEE countries (“benchmarking Croatia”) and adapting Croatia’s regulatory and incentive framework accordingly;<sup>12</sup>
- Undertaking a promotional campaign to attract foreign investors, benefiting from examples of specific success stories, communicating clearly all sector policies, and removing obstacles to potential foreign investors. In this respect, a primary candidate is the tourism sector; and
- Building up an administrative capacity for informing and supporting potential investors, particularly during their search of business opportunities and investment phase.<sup>13</sup>

135. In spite of the loss of profitability of many enterprises -- and thus their illiquidity/insolvency -- the overall number of enterprises (existing private and former SOEs) entering bankruptcy and liquidation, is exceedingly low (low (600 cases per year on average out of a total of more than 100,000 registered

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<sup>9</sup> Also after enforcing strictly the rule whereby CPF should repossess shares from the purchasers which defaulted on their defined payments obligations.

<sup>10</sup> This should also include the portfolio of shares held by the pension fund under its new closed-end investment fund, the purpose and efficiency of which should be reviewed.

<sup>11</sup> Incentives should be provided not only through carefully targeted tax or customs incentives, but more generally through efficient assistance to potential investors -- starting with a pool of attractive project proposals. Agencies need to make sure that the projects they show to potential investors are attractive.

<sup>12</sup> For example, relaxing restrictions for foreign employees and their family members.

<sup>13</sup> The assistance to potential investors should continue during the investment’s implementation, offering assistance in obtaining licenses and permissions, working visas and other resource intensive administrative procedures. A good approach would also be to consider the establishment of local investment promotion agencies that are providing this type of assistance and service on local and regional levels, perhaps within each municipality.

enterprises) -- well below other transition countries. Failure to liquidate a company has the consequence of freezing a large pool of assets (real estate, location, skilled labor, and even market share) that is unavailable for other ventures. In the absence of “creative destruction”, the environment will not be conducive to the development of small- and medium-sized enterprises (SMEs).

136. Accelerated and in depth restructuring of the enterprise sector will involve the following measures:

- Changing the State’s role vis-à-vis enterprise, by discontinuing subsidies (direct as well as indirect, as for instance, loan guarantees); support should be granted only under exceptional circumstances (severe regional impact), limited and conditioned upon strict implementation of in depth restructuring programs;<sup>14</sup>
- Strict enforcement by the State of its claims (fiscal, social security contributions) against enterprises in arrears (including initiating bankruptcy proceedings after a period of delinquency);
- Reinforcing the bankruptcy implementation capacity of commercial courts and trustees, thus ensuring the proper functioning of the exit mechanisms which would be reinforced if central and local authorities refrained from interfering with the bankruptcy-liquidation of non-viable enterprises;<sup>15</sup>
- Reinforcing the social safety net and implementing other remedial measures to tackle mass lay-off and higher temporary unemployment associated with accelerated restructuring of enterprises; and
- Encouraging enterprises to use more international expertise for restructuring (for example under programs financed by donors).

137. In order to improve the business environment, the following measures need be considered:

- Correcting the non payment culture and deflating the “mountain” of arrears by, among others, having the State set an example in paying its arrears, and keeping its accounts payable within a reasonable period;
- Reinforcing the rule of law (see section on judiciary), including prosecution of managers who broke the law and holding negligent board members accountable;
- Improving market competition through strict enforcement of anti-trust laws through a strengthened Agency for Market Competition, and rooting out rent seeking;<sup>16</sup>
- Reviewing and simplifying administrative procedures for business; training officials to adopt an enterprise-friendly attitude but adhering strictly to ethics (anti-corruption program);
- Improving property rights regime, by modernizing the legal framework and beefing up the institutions/registries (modernizing cadastre/land book, setting up collateral registries);

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<sup>14</sup> The costly program of help to the shipyards should now be revisited, the progress of restructuring of the industry should be reassessed, severe obligations imposed on the managers to rationalize, downsize and consolidate the yards, and private investors actively sought to buy the remaining State-owned stakes in the yards and/or their assets at market prices.

<sup>15</sup> Through increased efficiency and more timely bankruptcy proceedings, faster enforcement of collateral collection, providing better protection for creditors and improving the overall level of financial and business discipline, the difficulties of accessing and costs of loan financing will be greatly reduced.

<sup>16</sup> Plus monitoring closely/regulating remaining monopolies (in case the continued existence of some is still justified).

- Harmonizing business laws/regulations with best practices in the EU and building up enforcement capacity;
- Reducing the tax burden on business;
- Advancing restitution of nationalized property;
- Reviewing business ethics and educating managers and the population at large on ethics in a market economy;
- Educating managers on the importance of transparency and increasing the standards of financial reporting/auditing;
- Reviewing the role of the Chamber of Economy and the adequacy of services it provides to business; and
- Reviewing the labor legislation to improve flexibility in hiring and dismissing.

138. In light of the high unemployment rate and slow performance in job creation, the promotion of SMEs -- through market based mechanisms -- can be a promising approach in Croatia. This is because SMEs: (i) make a significant contribution to employment and also allow ample flexibility in the use of labor (overtime, internal mobility, etc.); (ii) play an important complementary role to large firms in the economy;<sup>17</sup> (iii) provide a more conducive environment for green field foreign direct investment; and (iv) exhibit a higher degree of efficiency in utilizing capital and mobilizing savings, entrepreneurial talents and other idle resources. Moreover, SMEs can geographically spread development and wealth through the country, thus limiting socially unsettling migration to urban centers and abroad.

139. Supporting development of the SME sector involves the following measures:

- Revisiting the overall framework for SMEs and adopting a pro-SME policy in line with best practices in EU and other market economies;
- Implementing an SME support program (business advisory services, incubators, etc.) that is demand driven, and managed and executed by the private sector; and
- Fostering transfer of know how through twinning programs with foreign SME associations and chambers of commerce.

140. Building up the human resource capacity for dealing with business issues in a market economy in the enterprise sector and the administration cannot be achieved overnight. But immediate actions can be taken to address the most pressing needs and lay the ground for a sustained capacity building program, such as:

- Programs for training managers, educating members of supervisory boards about their obligations, developing the auditing profession;
- Encouraging associations/twinning of local consultants firms with foreign firms to sharpen the skills of the local consulting industry;
- Opening up the market of legal representation/other services to foreign firms; and

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<sup>17</sup> The Italian experience with SMEs is a case in point: over the latest decades, Italian industrial growth has been carried forward to a large extent by SMEs. Italian SMEs are often clustered into productive systems, where they can avail themselves of factors of competitiveness external to the individual firm but internal to the local system.

- Developing business schools/improving the curriculum and teaching methods of existing education institutions.

## B. LEGAL AND JUDICIAL REFORM

141. Over the last decade significant changes in the laws and legal institutions have accompanied Croatia's transformation towards market economy. A number of laws and regulations building infrastructure for a market economy were adopted, including Company Law, Bankruptcy Law, Banking Law, Securities Law, the Law on Protection of Market Competition (Anti-Monopoly Law), Real Estate Law, Land Law, etc. The organizations critical to implementing these laws and regulations were set up, such Securities and Exchange Commission, Anti-Monopoly Agency, Bank Rehabilitation Agency, etc.

142. Fostering the development of rule of law and thereby improving the business environment in the country should be the focal point of the reform process. Unless the Government speeds up and mobilizes more resources for the reform process, the economic benefits which Croatia, with its strong legal traditions and culture, would otherwise gain, will take longer time to materialize.

143. There are several factors which make the law drafting and regulatory reform process in Croatia particularly challenging. First, the transition process itself is extremely demanding on the legislative efforts. The dynamism and novelty of the political and economic changes create high demand for developing new laws, while it takes time to develop appropriate mechanisms and techniques for ensuring the quality of laws. Second, success of a legal reform hinges critically on an institutional framework that ensures effective implementation and enforcement of laws. In addition, the need to meet the requirements of the European integration imposes additional dimension which needs to be accounted for in the legal drafting process.

144. The following recommendations are offered for the consideration of the Croatian authorities in view of the issues discussed above:

- While the present judicial reform program is a good beginning for developing a comprehensive legal reform strategy, the proposed reform strategy needs to be consistent with the overall economic and structural reform program and to include clearly evaluated resource requirements and sources. Such strategy should be prepared in broad consultation with representatives of the judiciary, legal professionals, legal scholars, business community, as well as general public which is an ultimate beneficiary of legal and judicial services. To ensure an adequate design for the reforms, institutional authorities and responsibilities for the reform management need to be assigned;
- Croatia has made a significant progress in enacting new laws supporting market-based economy. However, success of a legal reform hinges critically on an institutional framework that ensures implementation of laws. Effective implementation of laws should be ensured through: (i) capacity building of the institutions and regulatory agencies responsible for the implementation of specific laws, particularly, in the areas of bankruptcy, capital markets, protection of fair competition, land and real estate registration; (ii) issuance of enabling regulations required for the implementation of legislative acts; and (iii) supporting public awareness of new legislative initiatives and promoting better understanding of new laws by business community, legal professionals and public at large;
- In view of the ongoing law drafting work, including amendments to the existing laws, the following measures could be considered for the improvement of legal drafting mechanism: (i) effective consultation process (through private sector participation, advocacy groups, public opinions, etc.) to ensure consistency of the proposed laws with the underlying policy objectives; (ii) the introduction of effective coordinating mechanism between sector ministries and other governmental structures; and (iii) adoption of a regulatory impact assessment (RIA) as a tool of measuring expected impacts of alternative legislative proposals;

- Further effort should be focused at: strengthening of the European integration structures; upgrading mechanisms for compliance monitoring, and developing a core group of legal experts in European integration. The neighboring countries, such as Slovenia, can serve as a good example to study and, eventually, follow;
- In the area of judicial reform, more concerted efforts should be invested in structural changes in order to promote judicial independence and accountability, specifically: (i) ensuring independent status of the judicial branch, particularly, vis-a-vis the executive, in such areas as budget financing, appointment, promotion and removal of judges, and administrative control and supervision of courts; (ii) enhancing judicial self-governance by strengthening the voice of judges in such areas as allocation of financial and personnel resources, appointment and dismissal of judges, ethical rules and disciplinary proceedings, court administration and case management, judicial training; and (iii) improving accountability of the judiciary;
- The pilot programs for commercial courts need to be implemented as a matter of urgency to test the effectiveness of the selected reform approach for improving bankruptcy administration, and determine -- based on an evaluation of the outcome of the pilot programs -- how similar programs might be replicated effectively in the country's remaining commercial courts, followed by courts of general jurisdiction;
- The Government should consider the opportunities for improving efficiency of training of the judicial professionals through improvements in the following areas: integration of training into human resource management; ensuring that the design of training programs is based on forward looking training needs assessment; including training plans for individual judges in their professional development plans updated at regular performance reviews; and close monitoring of the impact of training on performance.

## 5. TOWARDS ENVIRONMENTALLY SUSTAINABLE DEVELOPMENT

### A. OVERDUE REFORMS IN AGRICULTURE

145. Recent agriculture sector performance has been modest, with moderate growth rates and a gradual decline in the sector's contribution to GDP. The underlying incentive structure for crop production changed little from 1995 to 1998 and the composition of crop production remained fairly stable. Available data suggest that more change has taken place in the livestock sector, notably in the dairy sector, where some productivity gains have been achieved.

146. Improvements in agriculture can lead to structural reductions in poverty in rural areas, where poverty rates are substantially higher than the national average.

147. The competitiveness of Croatia's agriculture sector is hampered by a series of: (a) structural constraints; (b) sector policy issues; and (c) macroeconomic factors, many of which are mutually reinforcing. Structural issues confronted by the sector include: small farm size and high levels of land fragmentation, thin land markets, and problems with ownership and management structures among the agro-kombinats and agro-processors which are not conducive to efficiency and competitiveness. Sector policy issues pertain to the appropriateness of rural credit programs and institutions, the need to refine price and trade policy, and the efficiency and transparency of commodity markets.

148. Some important initiatives have been taking recently in the areas of agriculture price and trade policy and land administration. The immediate challenge will be to develop initiatives and implement them. Difficult decisions are yet to be made in some areas, i.e., agriculture enterprise privatization and restructuring, and the future use of state-owned agriculture land. Policy decision on rural credit and commodity markets require more information and analysis.

149. A logical starting point for determining support to the sector is an evaluation of achievements under the Green Strategy adopted by Parliament in 1995. In particular, progress and remaining issues need to be reviewed in farm consolidation and enlargement, and privatization of agriculture sector SOEs. These are key elements of the Green Strategy on which progress has been marginal, yet they are determinants of future sector performance. A forward looking review of price and trade policy and public expenditures is needed in response to new challenges created by WTO membership closer convergence towards the CAP of the EU.

150. The proposed measures in the short term include:

- Re-engineer the Land Administration System; and
- Accelerate the Privatization and Re-Structuring of SOEs.

151. Over the medium term, to promote sustainable sector growth, measures will be necessary to address the issues of land administration, land markets and land ownership; the ownership and management of ex-social sector agriculture and processing enterprises; rural credit and commodity markets. Although further study of these issues is needed for policy choices, priority for action should be given to measures concerning land markets and restructuring of agro-processors and agro-kombinats.

152. As any initiative on land administration may be politically contentious, the issue of illegal disenfranchisement will need to be anticipated in program design. An early start is essential to get inherently slow process moving. These initiatives would be donor financed and so would not burden the budget.

Initiatives to strengthen land markets can be introduced at a later stage. They, too, can be donor financed at the outset until the private sector takes over.

153. As restructuring and privatization of SOEs will have direct and adverse policy and budgetary implications (unemployment, bankruptcy, temporary loss of production, etc.), they should be initiated as soon as possible, thus ensuring that the benefits of growth materialize within the current parliamentary cycle. Restructuring are also urgent, because of deteriorating environment for revitalizing these enterprises, and the economy-wide implications of continuing the current culture of non-enforcement of contracts.

## **B. ENVIRONMENTAL SUSTAINABILITY**

154. The key environmental policy issue for the government is how to manage the country's future growth and development, while protecting the environment. Central issues include the strengthening of environmental agencies; management and enforcement of environmental protection; and integration of environmental concerns into sector policies and plans.

155. To this end, the proposed short-term policy actions include:

- The environment sector's capacity to enforce environmental regulations is limited. Therefore, the lead environment agency should be elevated to ministerial level, either as a stand alone or in combination with another environment-related ministry;
- Continue to clear land mines according to agreed priorities;
- Croatia has many environmental problems and limited financial and institutional capacity to deal with them. Therefore, the Government needs to define priorities and intervene in the most cost effective way. The National Environmental Action Program currently under preparation should be instrumental in this endeavor; and
- Water resource management is key to preserving the environment. The Government will benefit from the demonstration effects of an integrated river basin management approach for the major river basin in the country, the Sava. This would include institutional restructuring to move the level of management from a national to a river basin level. Investments to ensure environmental protection of the basin would be identified in a river basin management plan.

156. The following long-term measures are recommended:

- Many ecologically fragile areas of high biodiversity value are being degraded due to unsuitable development or encroachment of protected areas. The Government should strengthen protection of these areas and encourage more sustainable land use. Clear and enforced land use planning, especially in tourist areas, must be a priority. This will require integrating environmental protection measures into development plans and sector projects, e.g., roads;
- Tourism often has a deleterious effect on the environment. Ensure responsible tourism by enforcing environmental regulations and incorporating environment into county and regional development plans;
- The new environment ministry should take a leadership role in fostering a dialogue among sector ministries and the municipal environmental agencies in order to strengthen enforcement capabilities and clarify responsibilities at various levels of government;
- To make enforcement more efficient, economic instruments/incentives need to be designed, thus reducing the need for close oversight. Suitable partners such as NGOs need to be mobilized to assist environmental protection;

- Improve civil society's role in environmental protection. Increase public participation in the design and implementation of environmental policies. Improve environmental education at the primary school level; amongst the general populace; and at tourist locations with natural resource attractions;
- Viability of Croatia's natural resources and ecosystems in many instances depend on maintenance of contiguous protected areas in neighboring countries. Effective conservation is thus a regional issue. Trans-border, regional coordination should be established in these areas and opportunities for collaborative projects explored, e.g., the Neretva Delta and Danube; and
- Continue to close gaps/discrepancies with EU environmental legislation.

### C. MUNICIPAL DEVELOPMENT

157. The socialist system inherited after independence and the progress made since then in institutional and administrative structures suggests that Croatia is more ready for fiscal decentralization than most of its East European neighbors. However, the war in the early 1990s had stalled Croatia's decentralization, as resource allocation decisions had to be fully centralized. Improved prospects for peace in the Region since the Kosovo crisis in 1999, and strengthening of relations with the EU since the recent political change provide new impetus to continue reforms, including decentralization. Present intentions for restructuring of public expenditures/reducing the fiscal deficit and a growing demand for more local autonomy are likely to promote decentralization. A backlog of infrastructure investments and maintenance may create additional pressures for delegating responsibilities to the local level without the required central funding.

158. During the 1990s, economic policy and intergovernmental relations in Croatia have been governed by the needs of: (i) the transition from a war-torn to a peaceful society; and (ii) the transition from a socialist to market economy. The two forces have not always reinforced each other. While the restoration of peace and the concomitant stabilization of the economy relied on centralized decision making and limited the autonomy of sub-national entities, the transformation from a centrally planned to an increasingly market driven economy required greater autonomy of political and socioeconomic decisions at the level of local authorities.

159. Local institutions were better developed in the former Yugoslavia than in other socialist countries, yet Croatia has remained a highly centralized economy as post-war macroeconomic policies limited the scope for greater fiscal and financial autonomy. Local authorities depend to a large extent on shared taxes as their principal source of revenue, which they cannot supplement through borrowing because there are strict limits imposed by the budget law. These controls not only helped maintain budget discipline, but they also allowed for an undue influence of central policies on local decisions much more so than in neighboring transition countries.

160. In order to avoid an undesirable combination of shrinking investments and worsening service delivery to local populations, the review of the following issues, along with efforts to ensure *substantial cost recovery*,<sup>18</sup> are imperative: (i) *inter-governmental fiscal relations*; (ii) *local government capacities to undertake new responsibilities*; and (iii) *the overall fiscal and financial situation of municipalities*.

161. To deal with the above highlighted issues, the following short-term policy actions can be considered:

- Review of Expenditure Obligations and Revenue Sources, particularly with regard to nationally mandated responsibilities and revenues from the national government. The objective would be to develop transparent criteria for selection of investment and rationale for national government

<sup>18</sup> In socialist economies often less than 10 percent of the costs of municipal services is directly recovered from households. This compares with about 40 percent in most OECD countries where standards are higher than in socialist economies.

support, including block transfers/grants, and to review the role of national government in the pricing of services and choice of investments;

- Review the administrative structure and the role of the different levels of the Government, particularly that of counties;
- Review municipal finances, with a view to building municipal capacities to: (a) develop a credible solution to the problem of arrears, particularly of inter-governmental arrears; (b) improve overall collections of municipal taxes and utility charges; and (c) manage municipal assets and liabilities efficiently;
- Assess the impact of the restrictions on borrowing at the local level, while maintaining the strong monitoring role of the national government;
- Review municipal investment plans and priorities as part of the budget planning exercise; develop indicative rolling three-year budgets at the municipal level, including long-term investments, and institute wide use of cost-benefit criteria for selection of investments; and
- Undertake a study of ongoing cases of private sector participation in providing services to learn about the potential and risks associated with the various modalities of private sector involvement.

162. The following medium-term measures are recommended:

- Undertake measures to improve the efficiency of municipally-owned enterprises, such as adoption of commercially-based operations that can move towards substantial cost recovery and reduced levels of subsidy;
- Enhance local government capacity to negotiate and implement private sector arrangements;
- Review the current legal framework with a view to improving incentives for private sector participation; and
- Assess the potential for introduction of value based property taxation to replace the current ad hoc property tax system.