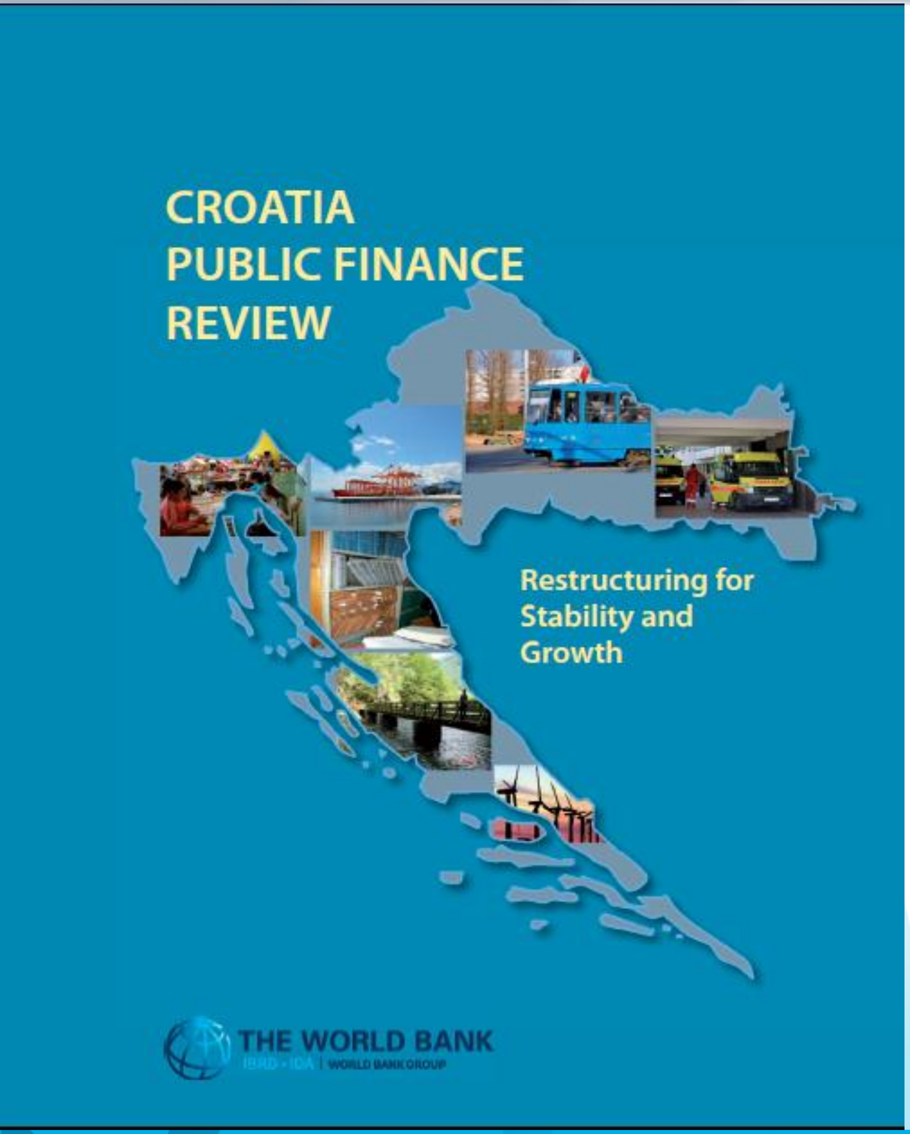


CROATIA: PUBLIC FINANCE REVIEW

Restructuring Spending for Stability and Growth

Sanja Madzarevic-Sujster

December 2014

Key Messages

- Croatia's fiscal weaknesses and vulnerabilities pose substantial risks for future
    - required fiscal adjustment of 4 pp of GDP over the medium term
- Croatia needs to maximize the efficiency of using EU funds to support recovery and competitiveness
    - required fiscal space of 1.8 pp of GDP per year
- Croatia's spending and revenue pattern offers a sizeable scope for fiscal adjustment of 4-5 pp of GDP
- Such a fiscal adjustment is achievable and should be supported by the EDP

Despite major development achievements…

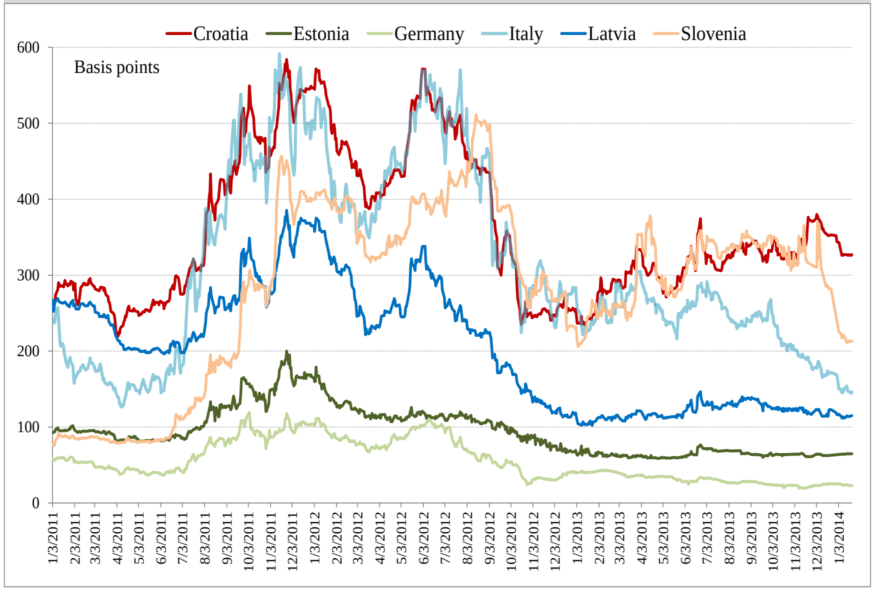
- Income per capita more than doubled between 1998 and 2008 (WB Atlas) → high-income country
- At-risk-of-poverty rate fell; moderate inequality
- Relatively low and stable fiscal deficit, sustainable debt levels
- Inflation declined, stable exchange rate
- Institutional strengthening - judiciary, regulatory framework, competition policies
- 28th member of the EU

…the global crisis exposed macroeconomic imbalances

- Output loss over the last five years - 12% of 2008 GDP
- Unemployment rate more than doubled (17% in 2013); youth unemployment grew above 50% in 2013 and the labor force participation (50% in 2013) was among the lowest in EU

- Fiscal deficits increased to an average of 6% since 2009 and public debt doubled to 76% of GDP in 2013
- External debt stayed elevated at 105% of GDP

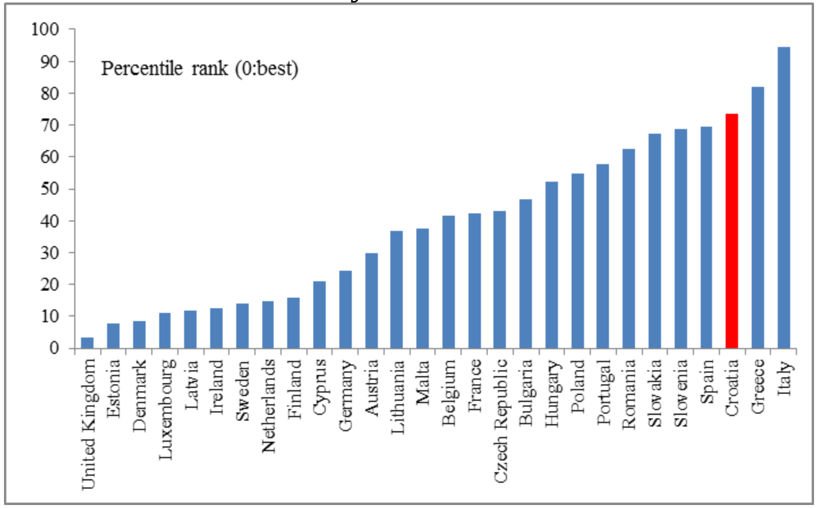
5-Year CDS Spreads: Croatia in the Eurozone Perspective



Source: Bloomberg.

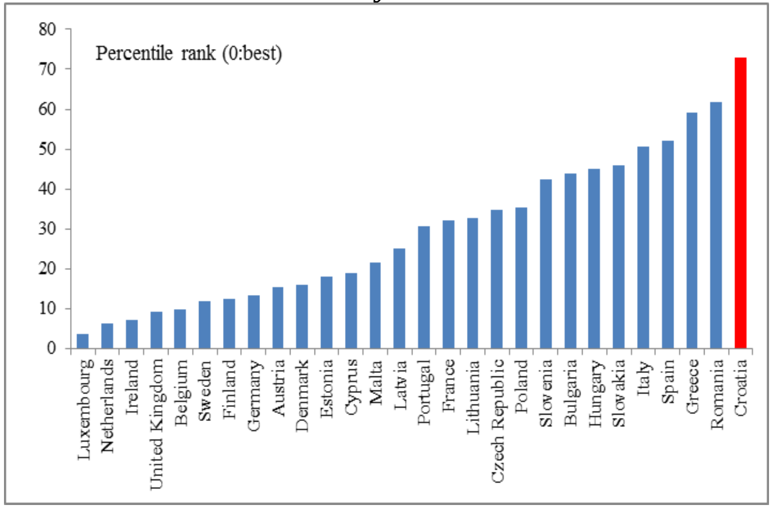
Structural problems hold back a recovery

Labor Market Efficiency



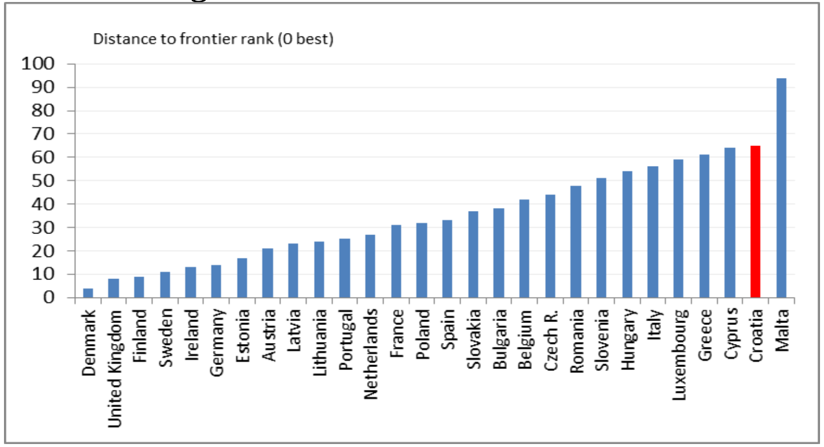
Source: World Economic Forum Global Competitiveness Index (2014-15).

Product Market Efficiency



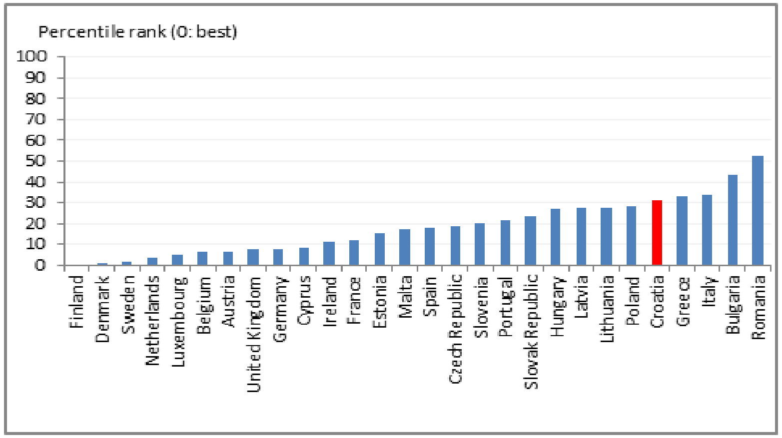
Source: World Economic Forum Global Competitiveness Index (2014-15).

Ease of Doing Business



Source: Doing Business (2014).

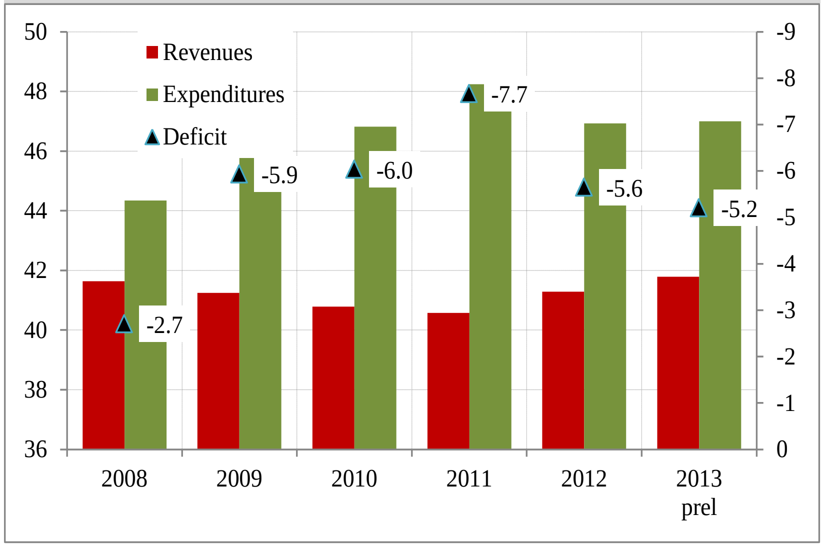
Government Effectiveness



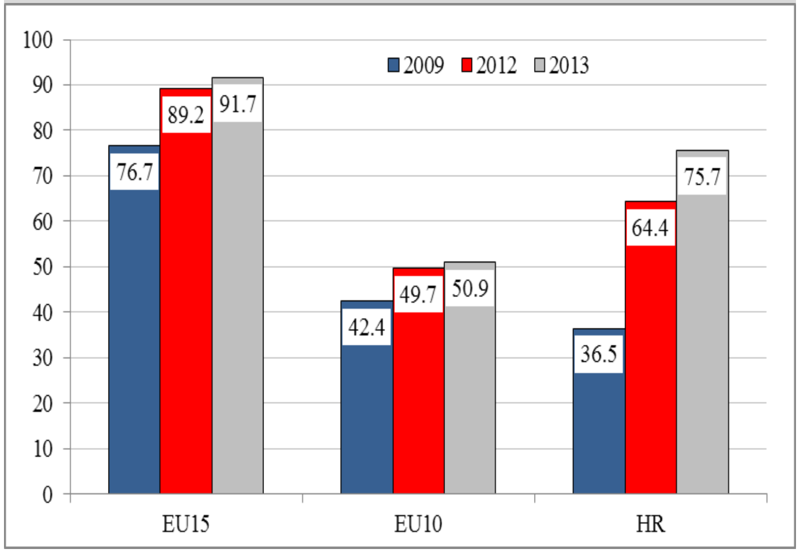
Source: Worldwide Governance Indicators (2012).

Growing fiscal vulnerability

Croatia's Fiscal Performance, % of GDP



Croatia, EU10 and EU15: General Government Debt, % of GDP



Source: MoF, EUROSTAT, World Bank staff calculations. Fiscal data are shown per ESA2010.

- Delayed response to longer-term structural and (temporary) cyclical shocks
- Public debt and interest payments higher and rose much faster than of EU10 from the lower level in 2009
- 2/3 of the fiscal deterioration is structural → structural deficit at 4% of GDP requires remedies with longer-term effect

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Why is fiscal consolidation needed?

- To stem further public debt growth and put it back on the sustainable path → important for retaining macro stability
- To create fiscal space needed to absorb EU funds → important to support recovery and growth
- To create buffers for aging-related costs → important to insure against the long-term shocks

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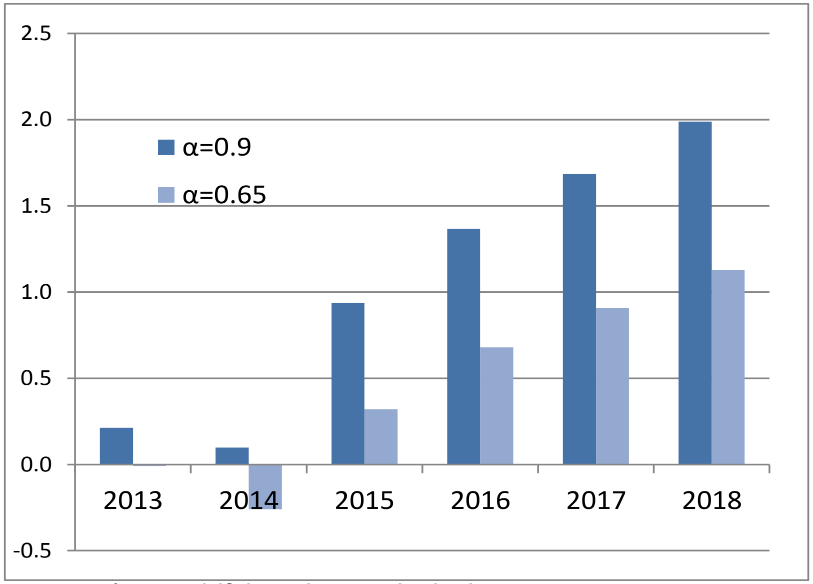
EU funds: an opportunity…

Croatia: First-Round Demand Effect of EU Funds,
% of GDP



Note: when α=1 if there is no substitution.
Source: World Bank Staff, based on Rosenberg and Sierhej (2007)

- Overall effect on economic growth positive, but could be lagged
- Short term: modestly higher domestic demand (less than ½ percent GDP in the first few years)
- Long run: should contribute to economic growth from the supply side.
- During 2009-11, ESI represented over 70% of public investment in HU, SK, BG, LT, EE and over 50% in PL and CZ

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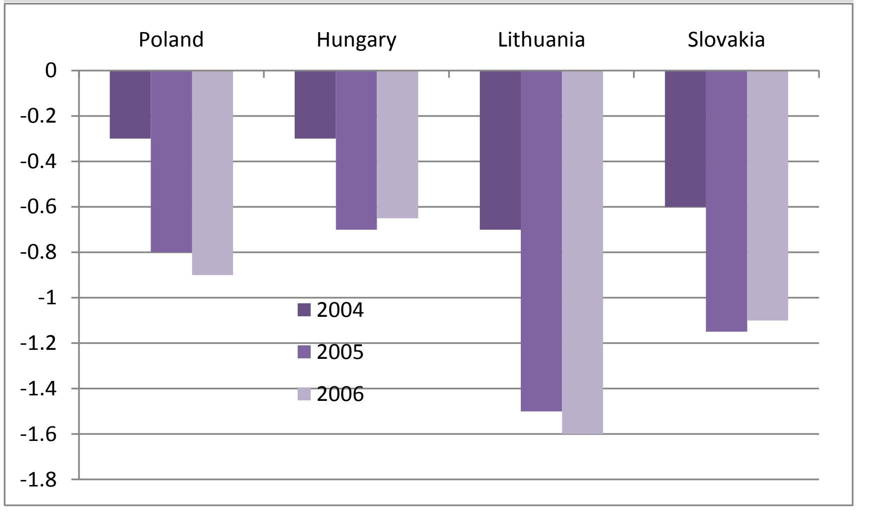
EU funds:…and the fiscal challenge

Croatia: Net fiscal effect,
cash basis, % of GDP

	2014	2015	2016	2017	2018	2019	2020
EU related revenues	**1.7**	**2.2**	**2.0**	**2.3**	**2.6**	**2.9**	**3.1**
Budget compensation	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Refunds on EU projects	1.6	2.2	2.0	2.3	2.6	2.9	3.1
EU related expenditures	**3.0**	**4.0**	**3.7**	**4.1**	**4.5**	**4.8**	**5.2**
Contribution to EU	1.1	1.1	1.1	1.1	1.1	1.1	1.0
National co- and pre-financing	0.2	0.6	0.6	0.7	0.8	0.9	1.0
EU projects (refunded by EU)	1.6	2.2	2.0	2.3	2.6	2.9	3.1
Net fiscal impact	**-1.3**	**-1.8**	**-1.7**	**-1.8**	**-1.9**	**-1.9**	**-2.0**
Net Inflow of EU Funds	**0.3**	**0.4**	**0.4**	**0.5**	**0.7**	**0.9**	**1.1**

Notes: The strict additionality principle assumed.
Source: World Bank staff estimates, based on data from MFF 2014-2020

Net Impact of EU-related Funds on the Fiscal Deficit, ESA95, % of GDP



Note: Substitution as reported by the authorities for HU; maximum substitution according to EU rules for other
Source: Rosenberg, Sierhej (2007)

- Fiscal space 1.8% of GDP a year needs to be created to support their absorption.
- Manage EU Funds through expenditure switching and substitution policies.

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What should be the fiscal adjustment policy mix?

- Some revenue adjustment policies
- Most of the adjustment should come from the spending side
- Important to focus on effectiveness as well

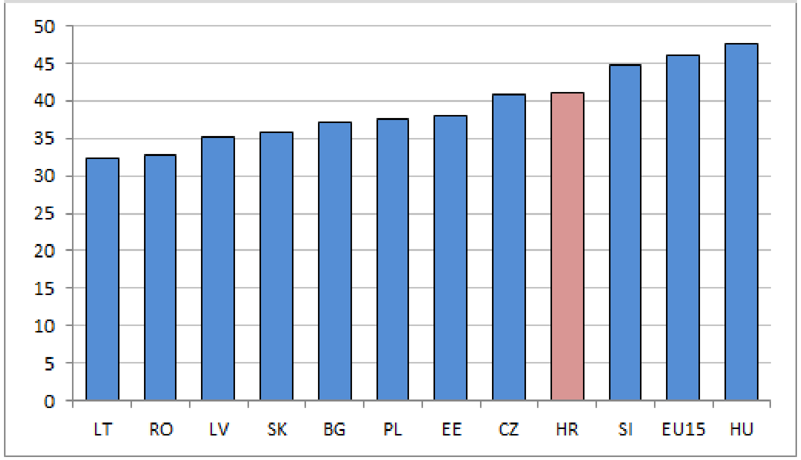
Revenue composition

General government revenues, % of GDP

	EU15	EU10	Croatia
	2013	2013	2013
Total Revenues	**45.6**	**38.7**	**41.8**
Direct taxes	13.2	6.6	6.3
Indirect taxes	13.2	13.3	18.8
Social contributions	13.7	12.4	11.3
Sales	3.1	2.8	3.6
Other current revenue	2.5	3.6	1.8

Source: MoF, Eurostat, CROSTAT, staff calculation.

General government revenue, 2013, *% of GDP*



- Croatia has the second highest revenue burden among the EU10 (41% of GDP) → high indirect taxation and low direct taxes.
- Tax space (the amount of revenue given the country's economic strength rather than what the legislature has mandated) is negative
- Nevertheless, there is still some scope for raising revenues.

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Revenue-side adjustment…policy options

- Introduce value-based modern property taxation.
  - Could add up to 1.5% of GDP in new tax revenues over time

- Support fiscal devaluation through labor taxes while in parallel eliminate a large number of tax exemptions given to households and businesses
  - Could bring an additional 1% of GDP to new revenues
  - Design of personal income taxation and exemptions should reduce disincentives to work

- Strengthen and modernize Croatia's tax administration (CTA) to protect and expand the revenue base:
  - a compliance risk management system;
  - strong administration at HQ and the LTO strengthened;
  - a streamlined network of regional and local tax offices; and
  - a sound IT governance.

Spending composition

General government expenditures by economic and functional classification, % of GDP

	EU15	EU10	Croatia
Total Expenditures	**48.9**	**41.8**	**47.0**
Current Expenditures	**44.7**	**36.7**	**42.4**
Consumption	6.4	5.8	7.7
Wage bill	10.4	9.4	12.0
Interest	2.8	2.2	3.4
Subsidies	1.2	1.1	2.0
Social benefits	21.4	16.0	15.7
Current transfers	2.4	2.2	1.6
Capital Expenditures	**4.3**	**5.1**	**4.6**

	EU15	**EU10**	**Croatia**
Total	51.7	42.6	46.9
General public services	6.8	5.5	7.1
Defence	1.5	1.0	1.5
Public order and safety	1.9	1.8	2.6
Economic affairs	4.1	4.9	5.3
Environment protection	0.8	0.8	0.4
Housing and community amenities	0.8	0.8	0.4
Health	7.5	4.8	9.2
Recreation, culture and religion	1.1	1.4	1.2
Education	5.2	4.6	5.0
Social protection	20.2	14.3	13.1
Transport	1.5	2.5	1.2
R&D Economic affairs	0.3	0.1	:

Source: Eurostat.

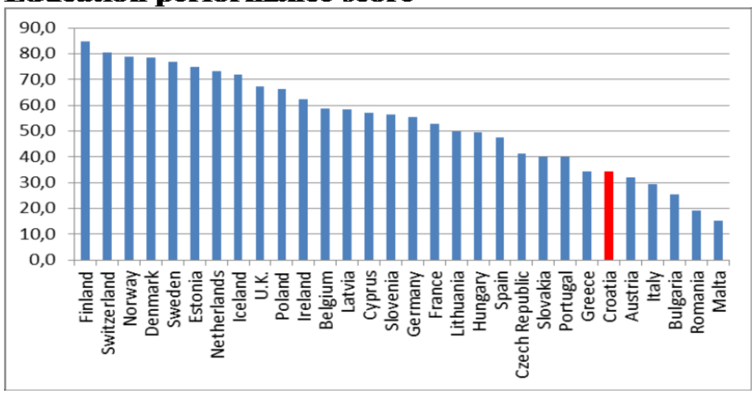
- Croatia's spending much higher than in its EU10 peers
- Spending is particularly high for subsidies, public wages and consumption; additionally health is an outlier.

Spending effectiveness

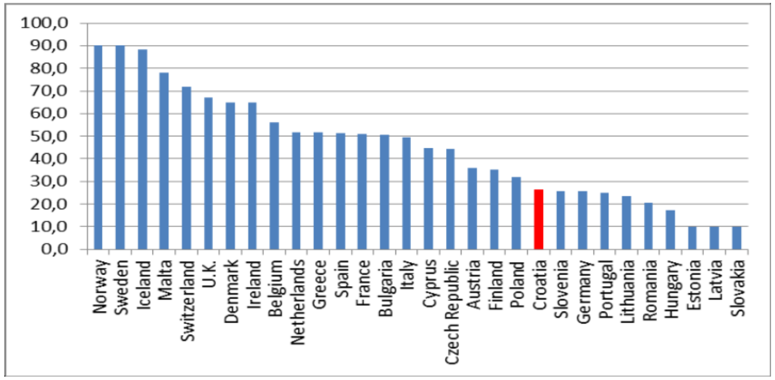
Apart from addressing the level, effectiveness is an issue→ contradicts the amount of public resources allocated

Performance of Government Services

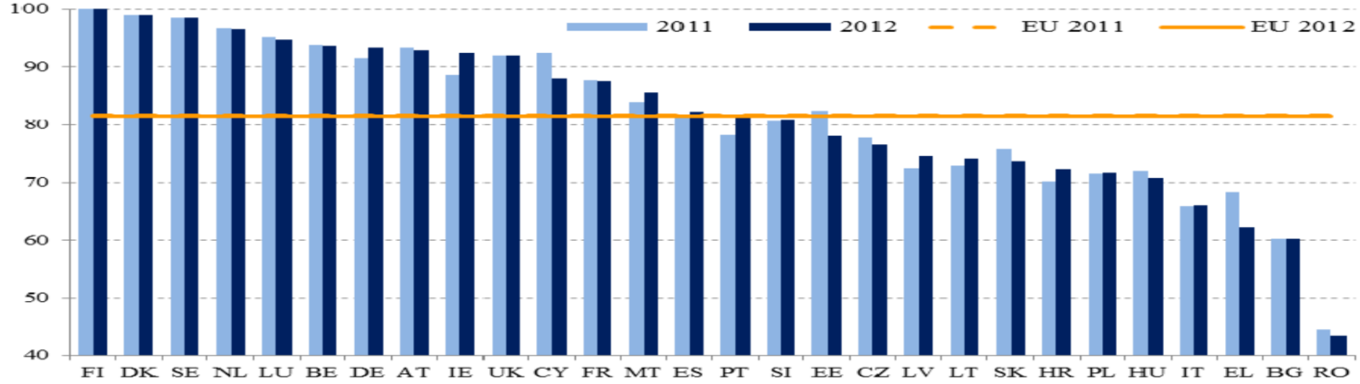
Education performance score



Health system performance score



Government effectiveness



Source: Eurostat, http://ec.europa.eu/europe2020/pdf/themes/34_quality_of_public_administration_final.pdf

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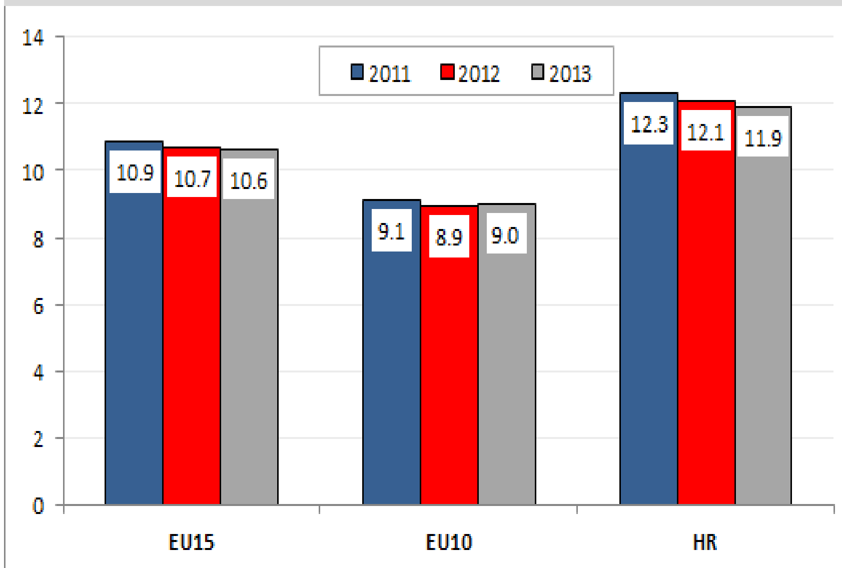
I. Rightsizing the government

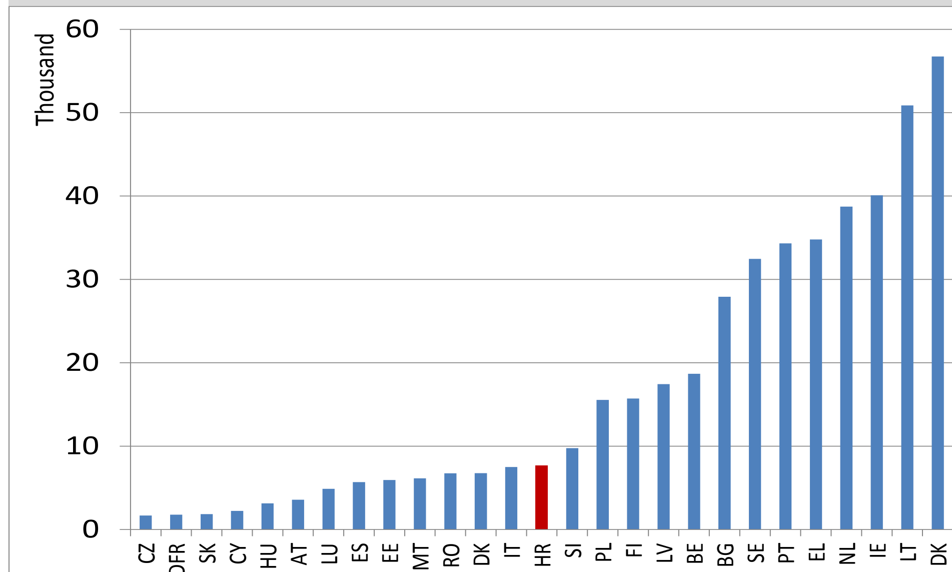
- Cost of government services is high: large size (17% of the labor force)
- Pay is largely based on seniority; not performance
- Excessive fragmentation of LGUs→ half of their budget for wages and operational costs
- Yet, low level of decentralization and limited fiscal independence → 2/3 of revenues are national government transfers

General government wage bill, % of GDP



Source: Eurostat, MoF, Weighted average for EU15 and Eu10.

Average Inhabitant per Local Government, EU, 2011



Source: Eurostat.

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Rightsizing the government…policy options

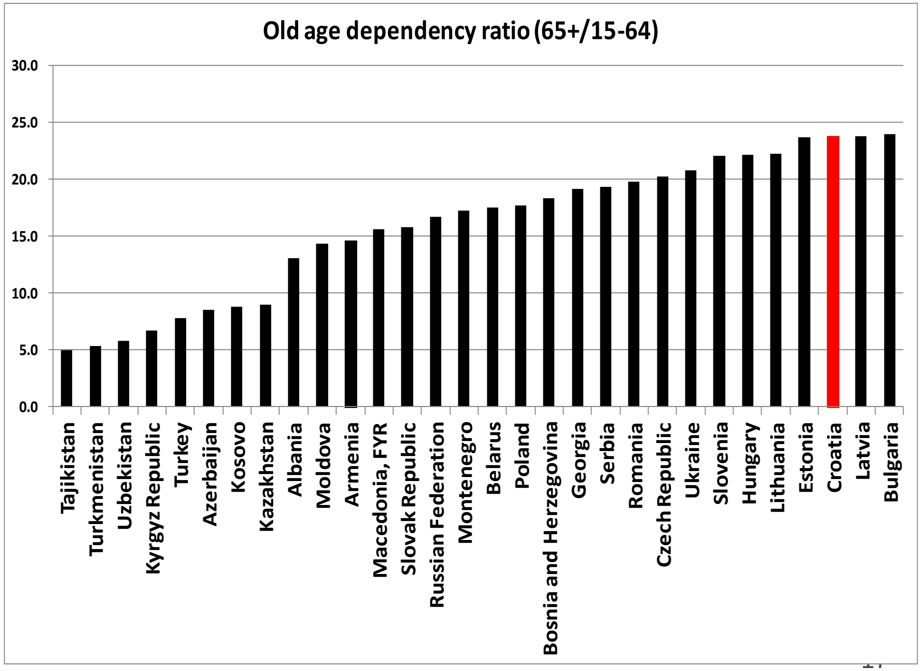
Some 2% of GDP in cumulative savings could be achieved over the medium term

- Rationalization of the wage bill (targeted downsizing; the wage system reform; a full application of the HRMIS)
- Criteria for the creation and management of agencies
- Professionalization and the introduction of performance based management practices
- Territorial reorganization or incentives to encourage joint provision of services
- Redefine spending responsibilities of local governments to avoid duplication and overlap of functions and to increase accountability of LGUs for service delivery
- Increase LGUs' reliance on own-source revenues to reduce central government transfers
- Monitor fiscal operations of subnational governments to ensure fiscal prudence and alignment with the EDP

II. Improving the Efficiency and Equity of Social Spending

- Worsening demographic ratios: non-communicable, chronic diseases and morbidity will continue increasing, with need for additional health, pension and LTC.
- Inverse dependency ratio: by 2050 six potential care providers for each severely dependent person and two potential taxpayers for each person of retirement age.
- Good health outcomes but at high cost (9% of GDP compared to 5.4% of GDP in EU10)

- LTC basic infrastructure exists, but public spending on LTC will grow from the current 0.15% of GDP to about 1.3% of GDP in the medium variant
- Inadequate pensions for multipillar cohorts, and overly generous privileged pensions (2.4 times higher than the old-age pension).



Improving the Efficiency and Equity of Social Spending

- Poorly targeted, categorical rather than needs-based benefits → persistence of poverty and social exclusion
- Low coverage and generosity of social assistance program – around 1/2 of the poorest quintile and about 27 percent of overall resources
- Disincentive employment effect (family-based social assistance)

Targeting Accuracy of Social Protection Programs, 2011

Quintiles of consumption per adult equivalent, net of each social transfer						
	Total	Q1	Q2	Q3	Q4	Q5
Overall social protection	100.0	48.2	24.7	14.3	8.4	4.3
Social insurance	100.0	53.2	23.5	12.9	6.6	3.9
Old-age pension	100.0	65.0	16.7	10.3	5.4	2.7
Disability and survivors pension	100.0	64.7	16.4	8.8	5.0	5.2
Sickness benefit incl nursing, disability	100.0	67.3	6.5	8.8	11.8	5.6
Unemployment benefit	100.0	53.6	17.8	17.8	8.1	2.7
Social assistance programs	100.0	59.2	17.6	12.4	5.5	5.3
Social assistance in cash	100.0	76.7	7.8	6.6	4.9	4.0
SA in kind (food, firewood, clothes)	100.0	88.5	10.9	0.0	0.6	0.0
Family allowances (child allowance, maternity leave, layette)	100.0	50.6	22.1	15.5	5.8	6.0
Remittances and private transfers	100.0	32.3	15.5	16.9	15.9	19.4

Health and Long-Term Care…policy options

Some 1% of GDP in savings could be achieved without adversely affecting the level and equity of service

- Consolidate health service networks like in the National Plan
- Create high-frequency lower-cost specialized centers for ambulatory diagnosis and treatment (could reduce unit costs by about 30 to 70%)
- Reduce further the referral rates in the primary health care and expand public health services to reduce the prevalence of behavioral risk factors
- Strengthen public FM systems to prevent arrears reoccurring
- Rationalize exempt copayment categories (40% of population) and adjust the complementary health insurance premium with actuarial standards
- Expand eHealth systems
- Shift LTC services from the health to the social sector because they will be mostly social services, and cost less than health services.
- Favor community-based over institutional care and private-producing.
- Consider voucher financing.

Pension system…policy options

- Gradually raise the second pillar contribution rate.
- Accelerate the retirement age increase before 2030 and tighten and phase out the early retirement.
- Rationalize the categories of privileged pensions and accelerate convergence of privileged pensions to PAYG by equalizing the maximum privileged pension with the old-age maximum pension.
- Use means-testing for granting minimum pensions and award pension points only for periods with contributions paid.
- Revisit the pension indexation.
- Tighten the disability assessment procedures.

Social assistance…policy options

Savings of about 0.85% of GDP could be achieved while improving targeting

- Introduce a single, unified set of criteria to assess eligibility for needs-based social assistance programs (through one-stop-shop).
- Extend means-testing to most social assistance and family programs.
- Introduce a parametric redesign of the child tax allowance.
- Implement "make-work-pay" benefit reforms.
- Strengthen oversight and inspection.
- Consolidate the administrative system at national and local levels.

Eliminating 'Elite' Capture in Non-Contributory Social Assistance Programs

Non-contributory SA programs and policies	% of GDP, 2012	Elite capture % Benefits to Q4-Q5	Potential savings (% of GDP)	Political difficulty
Child tax allowance	1.0	54%	0.5	Moderate
Child allowance	0.5	12%	0.1	Moderate
Support allowance	0.2	9%	0.02	Small
Other programs	2.2	11%	0.23	Moderate
Total	3.8		0.85	

Source: Estimates based on HBS 2011

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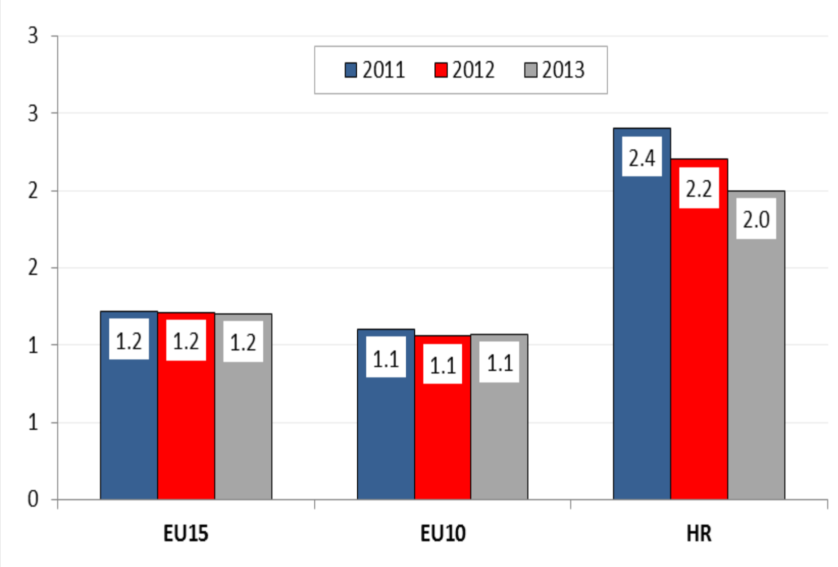
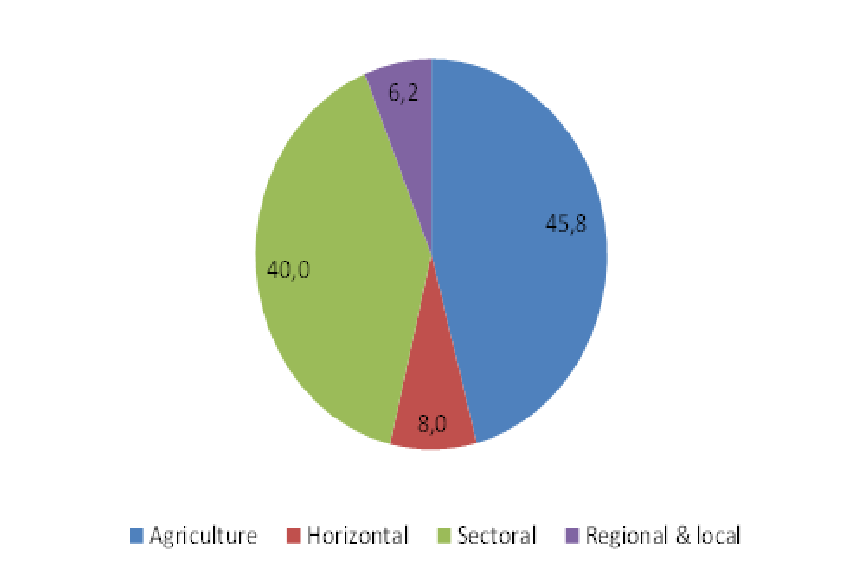
III. Rationalizing subsidies

- At 2% of GDP spending double compared to the EU; dominated by selective, sectoral and firm-specific state aid
- Low effectiveness of state aid, especially for railroads and agriculture.
- Transition from sector-specific to horizontal types of state aid (like R&D)

Potential savings of about 1% of GDP

Croatia's Total Non-Crisis State Aid and Its Structure, % of GDP





Source: EUROSTAT, Croatian Competition Agency (CCA).

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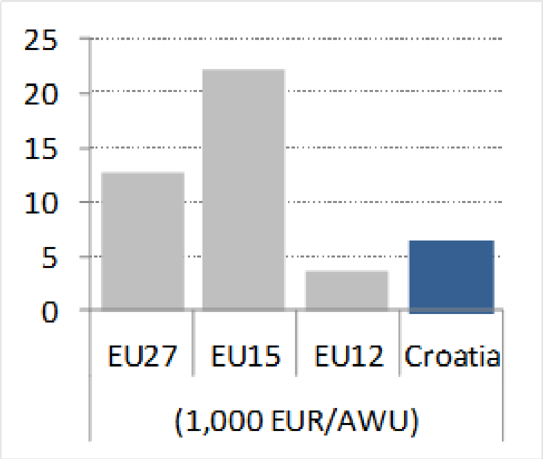
Rationalizing subsidies

- Railways at 0.6% of GDP (half for infrastructure), while agri above 1% of GDP
- Low small farm productivity; a high share of subsistence-agricultural holdings (the standard output of an average farm 5 times smaller than that of EU15)
- Significant decline in rail transport demand (by 36% since 2007), poor operating performance, and an aging rolling stock (the majority of assets are more than 30 years old)
- Low efficiency of railways: labor productivity low and falling due to overstaffing; wage bill remains unsustainably high (70% of operating revenues for labor costs, compared to 40% in EU)

Farm Labor Productivity, Croatia and the EU (2005-11 average)



Key Performance Indicators of Railways

	2005	2007	2009	2010	2011	2012*
Traffic units (mill pass-km + ton-km)	4,372	5,482	4,706	4,474	4,249	3,525
Traffic intensity [traffic units/km]	1,603,778	2,013,924	1,728,876	1,643,644	1,560,985	1,295,004
Total staff	14,152	13,411	12,843	12,491	12,468	11,493
Labor productivity [traffic units/staff]	308,925	408,761	366,425	358,178	340,792	306,708
Labor cost as % of operating revenue	76.20%	64.60%	71.20%	70.60%	78.6%	71.3%
Average unit operating Cost less depreciation [Eurocents]	0.084	0.066	0.077	0.078	0.081	0.113
Operating ratio with state support	1.25	1.27	1.12	1.12	1.04	1.33
Operating ratio without state support	66%	79%	72%	72%	69%	58%

Source: HZ, State budget, World Bank calculations.

Railways…policy options

Subsidies could be decreased by 0.3 percent of GDP without significantly affecting the service

- Define an affordable level of funding for the sector, along with an overall transport investment program.
- Set the structure of the financial support to railways through PSC and MAIC.
- Adjust the level of services and the network size.
- Strengthen the contractual relationships of the infrastructure manager and passenger operator.
- Enforce the restructuring program to meet planned cost cutting targets (a 50% staff cut from 2012 levels would bring staff productivity to EU27 levels)
- Maximize EU Funds absorption for investments and secure national contribution (close to EUR600 million) from operational savings

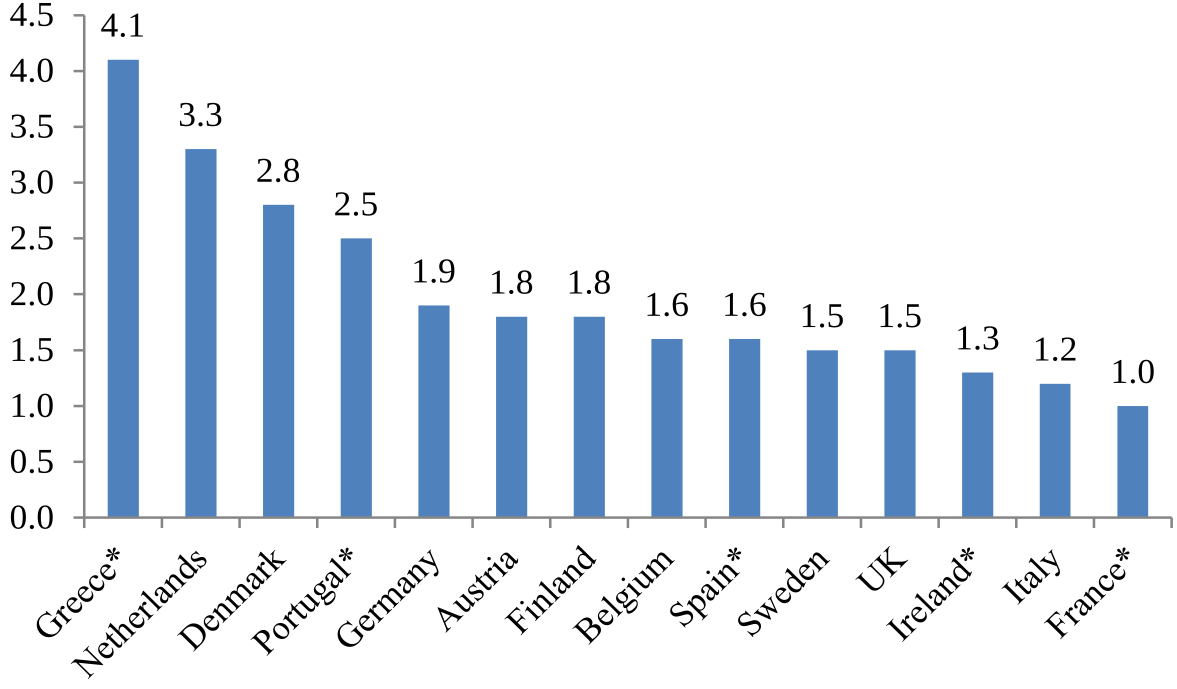
Agriculture…policy options

Reduce spending by 0.2-0.5 percentage points of GDP to align its spending level to most other EU countries

- Decide on the allocation of the sector budget between the nationally-funded expenditure categories and avoid duplicating EU-funded interventions
- Enforce subsidy modulation and eliminate blue diesel and income support (instead consider means-testing minimum pensions)
- Strengthen and rationalize public services in agriculture (25% of total sector spending)
- Ensure fiscal discipline and budget transparency
- Terminate “market interventions” on specific products
- Take advantage of the option to transfer Pillar 2 funds into the CNDP envelope for 2014-16 (would save 0.13% of GDP)

Can it be done?

Average annual cyclically adjusted primary balance improvement, % of GDP



Source: *EUROSTAT, World Bank staff calculations*

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