CROATIA COUNTRY SNAPSHOT

Country Context

Croatia became a member of the EU in July 2013, in the midst of the six-year long recession. Joining the single market and being able to absorb EU grant funds helped the recovery that started in 2015. Yet, GDP is still roughly 9% lower than in the pre-crisis period, and the unemployment rate has remained high at 13.8%. Youth unemployment remains at an excessive 34%, while poverty at US$5 a day at purchasing power parity (PPP) remains at 9%—high for a high-income country.

Croatia’s immediate economic challenges include restoring macroeconomic stability while promoting private sector productivity and competitiveness to create jobs and growth. This will help reduce high public sector debt and also reduce barriers to private sector investments and productivity growth.

An equally important issue is Croatia’s projected population decline and aging. Both present significant risks to growth and higher living standards, as well as to fiscal sustainability. The policy response needs to focus on investing in raising skills and promoting healthy aging to prepare Croatians for longer and more productive working lives while modernizing and rationalizing the social protection and health systems.

There is also a need to continue modernizing public services, the judiciary, and the governance of state-owned enterprises (SOEs), including the network industries, to better support the needs of people and firms.
The World Bank and Croatia

The World Bank's activities in Croatia are guided by the Country Partnership Strategy (CPS) of June 2013, which covers the period until 2017.

With this strategy, the Bank has envisaged transitioning from a focus on projects and lending to a knowledge partnership. The Bank is gradually developing a stronger partnership in advisory services, with a focus on structural and institutional reforms to boost economic competitiveness and institutional capacity building related to EU membership, particularly relevant to Croatia's ability to absorb EU funds.

About half of the Bank's financial engagement focuses on the transport sector, and about a third is focused on the health and social protection sectors. The remaining portfolio is aimed at innovation and venture capital, with a small intervention in the environment. The projects incorporate significant support to public administration, helping Croatia maximize the benefits of EU membership, including EU funds absorption (the CPS program finances the development of an EU project pipeline worth €500 million).

Key Engagement

Croatia is situated along three pan-European transport corridors between the EU and Southeast Europe, an advantage that has directed the Bank's decade-long partnership and more than half of its portfolio toward helping the country's transport sector become more competitive and develop into an important engine of growth.

Most recently, the World Bank has been engaged with the Ministry of the Sea, Transport and Infrastructure and with roads companies in preparing the Modernization and Restructuring of the Roads Sector. Designed as a blend of an investment loan and a guarantee, this intervention is aimed at supporting the operational and financial restructuring of roads companies in Croatia. The loan portion is envisaged to fund the implementation of reforms, while the guarantee aims to help restructure liabilities to better match road-asset cash flows, reduce interest costs, and lengthen maturities.

Since mid-2015, the Bank has been working with three Croatian railway companies to improve their operational efficiency in order to deliver better services in a financially sustainable way.

The Sustainable Croatian Railways in Europe project complements major investments in infrastructure on international corridors funded by the EU by focusing on overall sector restructuring and the sustainability of the public companies. This includes select financing of critical bottlenecks in railway infrastructure and safety measures, the modernization of IT systems, the rehabilitation of the rolling stock fleet, the separation and management of assets, and staff right-sizing.

The Bank’s long engagement in land property administration was recently crowned with the nationwide rollout of the Real Property Registration and Cadastre Joint Information System (JIS). Among other outcomes, the JIS has enabled the online submission of requests and issuance of cadastral data and led to an increase in the speed and quality of services provided to citizens, businesses, and investors.

This streamlining of the property registration process increases the level of legal security in property transactions and also serves to rationalize business processes.
**Recent Economic Developments**

Growth strengthened in 2016 to 2.9% on the back of accelerated private consumption and a rebound of investment after six years of decline. The recovery was broad-based, with a surge in industrial production and construction and record-high tourism contributing the most to the accelerated growth.

Labor market performance improved, with a decline of unemployment to 13.8% by September. A high level of emigration (around 54,000 people left the country) and continued outflows from inactivity into early retirement led to declines in labor force participation. Thus, the employment rate remained at a low 44.5%, far below the EU average. Real net wages increased by 3% due to the deflationary and labor market pressures in sectors that face skill shortages.

Fiscal consolidation continued in 2016, with the general government deficit (European System of Accounts methodology) narrowing to below 2% of GDP from 3.3% in 2015. Revenues increased substantially, led by rising tax revenues (especially corporate tax, value added tax, and excises), while spending was restrained due to the temporary financing in effect throughout the first quarter after the general elections and because the government was only provisional until the snap elections in September 2016. Given the robust primary surplus, public debt decreased to 85% of GDP from 86.7% at end-2015. Croatia will likely exit the Excessive Deficit Procedure with the EU in 2017.

Sustaining the fiscal consolidation going forward to reduce public debt will remain challenging. The Government adopted the 2017 budget with a deficit of 2.1% of GDP, relaxing both revenue as well as spending to cater to pre-election promises, amid an optimistic growth projection of over 3%. Debt refinancing needs remain high at 12% of GDP, or 27% of general government revenues over the next three years, requiring tight fiscal policy.

**Economic Outlook**

The economy is expected to grow by 2.9% in 2017 and around 2.6% in 2018–19. Growth will be led by strengthened personal consumption, service exports, and investments, benefiting from the EU funds absorption. Personal consumption is expected to intensify, reflecting personal tax reform, the labor market recovery, and a pickup in lending activity. The current account surplus will decline, however, to 1.6%, given the high import reliance of the growth model.

Public finances are projected to continue to improve, with the headline fiscal deficit amounting to 1.7% of GDP in 2017–19, although the structural deficit could grow to 3% of GDP. Positive labor market developments and an increase in real pensions are expected to support the growth of disposable income for all segments of the welfare distribution.

A tax reform package that includes personal tax cuts, with income brackets changed from 12, 25, and 40% to 24 and 36%, along with an increase in non-taxable income of 46%, is expected also to support income growth.

Risks are still skewed to the downside. Although fiscal outcomes are better than expected, the new fiscal expansion and domestic policy uncertainty add to the risks related to slowing the pace of structural reforms and achieving the sustainability of public debt.

Still, high levels of private and public sector indebtedness amid the upcoming monetary tightening and the increased volatility on the financial market are set against the country’s borrowing requirements. Sustained fiscal consolidation and competitiveness reforms are needed to reduce macroeconomic imbalances and protect the nascent recovery.
Project Spotlight

EU Natura 2000 Integration Project

In February 2011, a US$28.8 million EU Natura 2000 Integration Project was launched to support park and county public institutions to implement Natura 2000 objectives in investment programs; strengthen capacity for EU-compliant reporting and biodiversity monitoring; and introduce programs that involve a wide group of stakeholders.

EU accession required an expanded ecological network beyond the core national and nature parks to be designated and aligned with EU nature protection legislation. The Croatian Natura 2000 network was officially designated in 2013 and amended in 2015. It covers 36.3% of Croatian land area (the second-largest network in the EU). Croatia designated 741 sites under Habitat Directive and 38 sites pursuant to the Birds Directive.

The Project supported 37 Ecological Network Investments using requirements similar to those required by the EU Structural Funds, demonstrating how investments, including educational and interpretive materials, can support the goal of maintaining “favorable conservation status” at Natura 2000 sites as defined by the EU Habitat Directives.