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**INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT
AND INTERNATIONAL FINANCE CORPORATION
AND MULTILATERAL INVESTMENT GUARANTEE AGENCY
COUNTRY PARTNERSHIP STRATEGY**

FOR

THE REPUBLIC OF CROATIA

FOR THE PERIOD FY14-FY17

June 27, 2013

**Croatia Country Office
Central Europe and Baltic Countries
Europe and Central Asia Region**

**The International Finance Corporation
Europe and Central Asia**

The Multilateral Investment Guarantee Agency

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CURRENCY EQUIVALENTS
(Exchange Rate as of May 17, 2013)
Currency Unit = Croatian Kuna (HRK)
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FISCAL YEAR

January 1 – December 31

ABBREVIATIONS AND ACRONYMS

AAA	Analytical and Advisory Activities	IMF	International Monetary Fund
BiH	Bosnia and Herzegovina	INTOSAI	International Organization of Supreme Audit Institutions
CTA	Croatian Tax Administration	IPSAS	International Public Sector Accounting Standards
CEB	Council of Europe Development Bank	IT	Information Technology
CEE	Central and Eastern European	JASPERS	Joint Assistance to Support Projects in European Regions
CFAA	Country Financial Accountability Assessment	JEREMIE	Joint European Resources for Micro to Medium Enterprises
CNB	Croatian National Bank	JPR	Joint Portfolio Review
CPAR	Country Procurement Assessment Report	LTO	Large Taxpayer Office
CPS	Country Partnership Strategy	M&E	Monitoring and Evaluation
DG ECFIN	Directorate General for Economic & Financial Affairs	MAP	Mediterranean Action Plan
DPL	Development Policy Loan	MDG	Millennium Development Goal
EIA	Environmental Impact Assessment	MIGA	Multilateral Investment Guarantee Agency
EBRD	European Bank for Reconstruction and Development	MoF	Ministry of Finance
EC	European Commission	MRDEUF	Ministry of Regional Development and EU Funds
ECA	Europe and Central Asia	NPL	Non-Performing Loan
EIB	European Investment Bank	OECD	Organization for Economic Co-Operation & Development
ERDPL	Economic Recovery Development Policy Loan	PDO	Project Development Objectives
ERP	Economic Recovery Program	PEP	Pre-Accession Program
ESI	EU Structural and Investment Fund	PforR	Program for Results
ESW	Economic and Sector Work	PPA	Project Preparation Advance
EU	European Union	PPP	Public Private Partnership
FDI	Foreign Direct Investments	RAS	Reimbursable Advisory Services
FMIS	Financial Management and Information System	R&D	Research and Development
FY	Fiscal Year	SDP	Social Democratic Party
GDP	Gross Domestic Product	SEA	Strategic Environmental Assessment
GEF	Global Environment Facility	SEE	South Eastern Europe
HBOR	Croatian Bank for Reconstruction and Development	SME	Small and Medium Enterprise
HBS	Household Budget Survey	SOE	State Owned Enterprise
HRK	Croatia Kuna	TA	Technical Assistance
HZ	Croatian Railways	TBC	Tuberculosis
IBRD	International Bank for Reconstruction & Development	TRE	Treasury
ICT	Information and Communication Technology	UN	United Nations
IFC	International Financial Corporation	VAT	Value Added Tax
IFI	International Financial Institution	WBG	World Bank Group

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COUNTRY PARTNERSHIP STRATEGY FY14-17

REPUBLIC OF CROATIA

I. Introduction

1. **On July 1, 2013, Croatia will crown 20 plus years of economic and social progress since declaring independence by becoming the 28th Member State of the European Union (EU).** The demanding negotiations, launched in 2005 and concluded six years hence, were sealed by the December 2011 signing of the EU accession treaty. The EU accession presents a remarkable opportunity to address Croatia's many needs, by providing strong impetus to adopt reforms, harmonizing legislation with the EU *acquis communautaire* and upon accession, accessing EU Structural and Cohesion Funds amounting to more than 3 percent of GDP per year to help in areas such as transport, environment and innovation.

2. **Despite being one of the richest World Bank borrowers, Croatia is facing significant challenges. In its fifth year of recession and affected by the global and Eurozone crisis, Croatia is hard pressed to demonstrate more robust progress in fiscal consolidation.** Recent credit rating downgrades in spite of a strong revenue performance in 2012 constitute a tangible sign that sustained fiscal adjustment through microeconomic reforms at the sector level is a priority. In parallel, the need for better resilience to external shocks, improved private sector competitiveness and strong EU membership will also define Croatia's development strategy during the next decade. The risks to the strategy are significant as any delay in reform would hinder expected recovery and macroeconomic stabilization on the eve of Croatia's accession.

3. **The FY14-17, Country Partnership Strategy (CPS) aims to assist Croatia's convergence with the EU through an engagement that is focused on key reform-based outcomes, adjusted according to achievements and changing needs.** For the World Bank Group (WBG), priority will be placed on aspects of the Europe 2020 'smart, sustainable and inclusive growth' strategy and the Government's new reform agenda that focus on the fundamentals of economic management, state institutions, business environment, and responsibility toward shared regional assets. If Croatia is to convert the opportunity of increased public funds into better public projects, attention will also be needed to prepare Croatia's public sector systems meet the EU requirements for funds absorption. Accordingly, three thematic areas comprise the strategic pillars and form the basis of the results framework: (i) fiscal adjustment through reforms at the sector level, (ii) innovation and trade competitiveness for growth and shared prosperity, and (iii) helping maximize the economic benefits of becoming an EU member state.

4. **While maintaining its focus on specific outcomes, the CPS embodies an evolution in the WBG's partnership along two dimensions – the nature of Bank assistance and the instruments to use.** Bank assistance would gradually turn its focus away from funding projects and towards technical assistance to build institutional capacity to better absorb EU Funds and implement structural reforms. Second, the type of instruments will evolve as well. While development policy loans (DPL) will continue to convene and underpin major reform initiatives, public investment support will increasingly be results-based, analytical and advisory activities

(AAA) engagement will increasingly be offered on a reimbursable basis, and private sector support will increasingly be non-sovereign based. This evolution would be a significant challenge for Croatia but is in line with the change of relationship which has occurred in other borrowing EU member states.

5. **The risks to the CPS result outcomes are significant both in terms of impact and probability and will need to be closely monitored in a program framework.** Croatia's economy is exposed to the shocks of global adjustment and European deleveraging through multiple transmission mechanisms. The trade in goods and services which accompanies Croatia's position as a gateway has been badly affected, as have Croatia's export industries that rely on buoyant external demand. At the same time, the shrinking balance sheets of large European banking institutions will indirectly affect the availability of loanable funds through their subsidiaries in Croatia, particularly as the level of Croatian non-performing loans (NPL) rise. Therefore, implementing the comprehensive reform packages is critical to the achievement of the outcomes envisioned under the CPS. Delivery of any reforms in Croatia requires a degree of coordination across sectors and among various levels of government which could be difficult to achieve despite all invested efforts. EU memberships will provide great opportunity but the tendency toward policy complacency will be equally strong.

6. **Without implementation of the key sectoral reforms, fiscal consolidation would be difficult and could negatively affect DPLs.** In that case the WBG program would scale back to results-based lending, some sector investments and a program of AAA, all of which would be gradually replaced with reimbursable advisory services (RAS). On the other hand, overcoming the risks and implementing the package of sector reforms would not only enable a program of DPLs and strengthen creditworthiness, but it would also enhance the International Financial Corporation (IFC) lending program.

II. Country Context and Development Agenda

II.A. Social and Political Context

7. **The coalition Government, led by the Social Democratic Party (SDP), was endorsed by the Croatian Parliament in December 2011 and now maintains a stable majority in parliament.** The key guiding documents for its work are (i) the Government Program for 2011-2015 and (ii) the Structural Reform Matrix adopted in August 2012. As a central part of the program, the Government proposed to implement budgetary and economic reforms which are increasingly met with opposition by trade unions, public sector employees and workers adversely impacted by privatization and industry closures. With the positive impact from these reforms back loaded to the medium-term along with weak near term prospects of economic recovery, public discontent may increase and slow down Government's reform efforts.

8. **The Government reform efforts face a number of implementation difficulties.** To date, Croatia's economic and political reforms have been driven in large part by a need to engage in the complex processes involved in preparing for EU membership. As a new Member State, Croatia will assume additional responsibilities and needs to ensure adequate pace of reforms. The administrative capacity for effective policy design and implementation of complex reforms presents one of the most difficult tasks for Croatia, as it tries to absorb a seven-fold increase in EU funds as compared to the pre-accession period.

II.B. Recent Economic Developments and Poverty Profile

9. **Four years of recession has resulted in an over ten percent reduction in output in Croatia.** Like other countries in the region, the global financial crisis adversely impacted the economy through multiple transmission mechanisms, including trade and finance. As economic conditions deteriorated amid the weak external demand, lower confidence in households and firms led to a decline in personal consumption and investment. Export growth remained equally slow as some of the most important and technologically advanced exporters – including shipbuilding and metals - witnessed significant declines. The bright spot – a robust tourism industry which grew by almost 5 percent in real terms – was not enough to offset the economy's broad based decline.

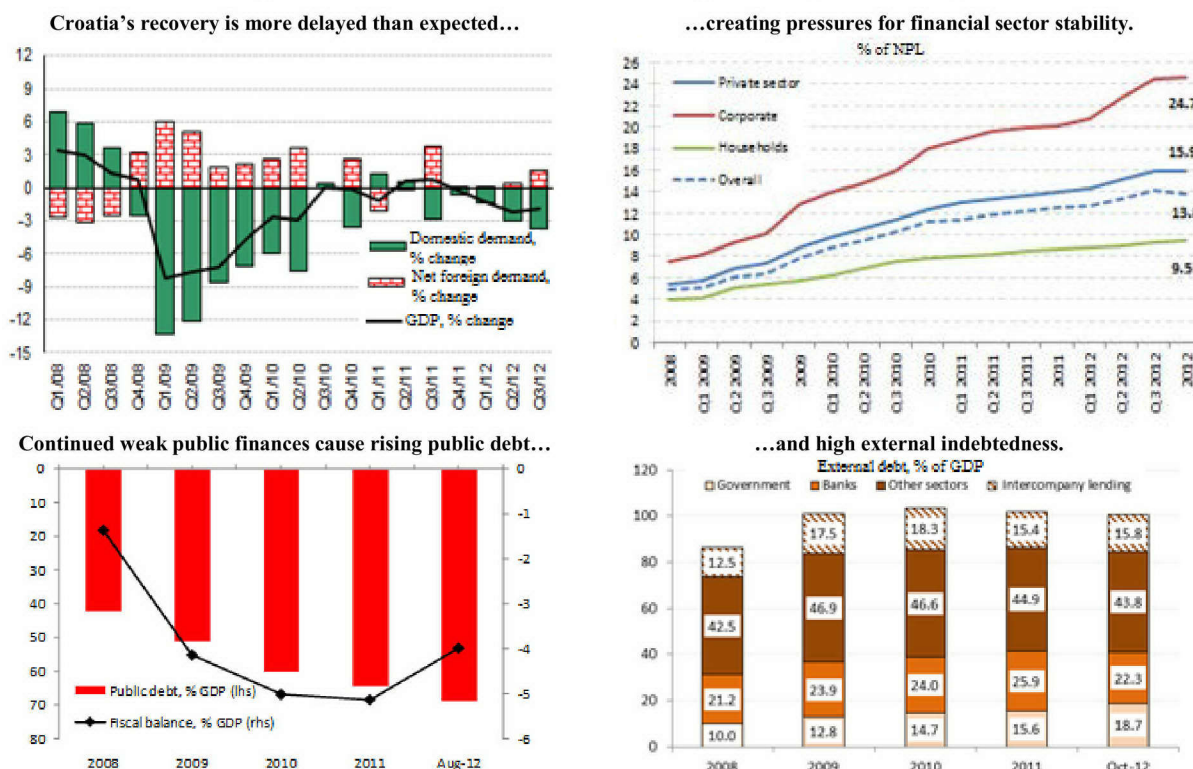
10. **Although the recession's initial impact on employment was modest, the pace of job loss accelerated.** Total registered employment fell by more than eleven percent over the past four years, with almost 190,000 jobs lost in construction, trade and manufacturing. Registered unemployment rate stood at around 21 percent while the survey-based rate stood at 15.8 percent in December 2012 - the second highest among all EU10 member states. Importantly, broader indicators of labor market are not improving as labor participation continues to be the lowest among all countries in EU.

11. **Deteriorating public finances resulted in annual deficits and a rise in public debt ratios.** Following fiscal deficits, on average, higher than 5.5 percent of GDP (once adjusted for the shipyards' guarantees), the new Government was able to reverse the trend in 2012 with a reduction in the deficit to around 3.8 percent of GDP. This improvement in 2012 was a result of increased revenues, attributable to the VAT hike and improved tax compliance, along with some reduction in subsidies, maintenance and capital spending. However, the achievement was accompanied by overruns in the wage bill and pension/health care spending, which had to be offset by squeezing capital spending.

12. **Despite the strong revenue achievement in 2012, the fiscal outlook for 2013 could lead to a reversal in the 2012 fiscal gains.** Both S&P (December 2012) and Moody's (January 2013) downgraded Croatia's credit rating to a speculative grade. The Government subsequently adopted budget revision on March 21, 2013. The revised 2013 fiscal deficit amounts to 3.6 percent of GDP. However, without additional policy measures, both expenditure-based fiscal rule (requiring an annual 1 percentage point reduction in spending until the primary balance is reached) as well as the statutory public debt limit of 60 percent of GDP are likely to be breached by end-2013. The debt to GDP ratio has already reached 69 percent when including publicly guaranteed debt.

13. **Lower consumer demand and sluggish economic activity, while relieving some pressure on external balances, is equally harming prospects for employment and sustained recovery.** With weak export performance and low domestic demand, the current account deficit closed in 2011-2012 and external debt ratios declined to 102 percent of GDP at end-2012. However, the European deleveraging meant that in 2012 alone, foreign owners of local banks reduced their exposure by 4.8 percent of GDP, thus reducing their share to 16 percent of Croatia's total bank financing by end-2012. In addition to a lack of domestic financing available for recovery, foreign direct investment (FDI) has not returned to pre-crises levels.

Figure 1: Recent Economic Developments (2008-2012)



Note: General government deficit data are estimates and are under revision in light of the full change-over to ESA methodology. Harmonized data expected in October 2013. Public debt includes government guarantees.

Source: CNB, Croatian Bureau of Statistics (CROSTAT), staff calculations

14. **The Croatian National Bank (CNB) maintained an accommodating monetary policy stance in the context of subdued economic activity, while maintaining exchange rate and price stability.** Monetary policy continued to operate a tightly managed Kuna/Euro exchange rate with little variability. Given the high degree of Euroization of the economy, exchange rate policy options remain limited. In spite of a slight Kuna depreciation against the Euro, monetary policy was able to maintain an accommodating stance in persisting recessionary conditions which help to ensure financial system stability through the active use of reserve requirement and foreign exchange interventions.

15. **To encourage lending to the private sector, the CNB decreased significantly its regulatory costs since 2009.** The last intervention was in April 2012 when the reserve requirement rate was cut from 15 percent to 13.5 percent, injecting HRK4 billion into the system. CNB helped keep the Kuna/Euro exchange rate on average at HRK7.52 throughout 2012 – a depreciation of 1.1 percent from 2011. Gross international reserves increased slightly to €11.2 billion in 2012, equivalent to around 7.2 months of imports. The level of both gross and net usable reserves continued to be much higher than money (M1).

Table 1: Key Macroeconomic Indicators (2009-2015)

Indicators					Projections		
	2009	2010	2011	2012	2013	2014	2015
National Accounts							
Real GDP growth	-6.9%	-2.3%	0.0%	-2.0%	-0.4%	1.5%	2.3%
Total Investment	24.9	20.9	20.4	19.4	19.4	20.2	20.6
Gross National Savings	20.5	20.1	19.3	19.3	20.4	20.6	20.8
Foreign Savings	5.1	1.1	0.9	-0.1	-0.9	-0.4	-0.2
Public Sector							
Revenues	39.2	38.4	37.5	38.2	38.4	37.9	37.7
Expenditures	43.2	44.2	44.1	42.0	42.0	41.3	40.8
Interest payments	2.0	2.2	2.6	3.0	3.3	3.4	3.3
Fiscal Balance	-4.0	-5.8	-6.6	-3.8	-3.6	-3.4	-3.1
Primary Balance	-3.1	-3.9	-4.3	-0.8	-0.4	0.1	0.2
Balance of Payments							
Trade Balance	-16.1	-12.9	-13.8	-13.7	-13.5	-13.5	-13.4
Current Account Balance	-5.1	-1.1	-0.9	0.1	0.9	0.4	0.2
FDI	3.4	1.0	2.4	2.4	1.5	1.8	2.2
Debt							
Gross External Debt	101.0	104.6	103.0	102.3	100.4	99.0	96.4
Public Debt (incl. govt guarantees)	51.3	60.9	65.4	70.0	70.5	69.1	67.5
Gross Internat. Res. (months of imports of G&NFS)	7.0	7.2	7.2	7.2	7.1	7.1	7.0
<i>Memo items:</i>							
GDP (EUR millions)	44,781	44,441	44,412	43,929	44,562	46,021	48,011
GDP (US\$ millions)	62,244	58,874	61,789	56,442	58,479	60,393	63,004
Inflation (p.a, %)	2.4	1.1	2.3	3.4	3.0	2.1	2.0
Debt service to export ratio	54.4	54.3	50.0	46.2	48.3	49.9	50.1
Exchange rate HRK:US\$ (p.a.)	5.28	5.50	5.34	5.85	5.75	5.75	5.75

Note: General government deficit data are estimates and are under revision in light of the full change-over to ESA methodology. Harmonized data expected in October 2013. Public debt includes government guarantees.

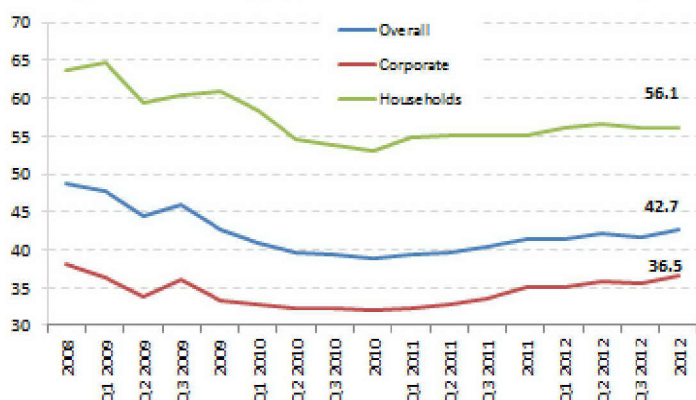
Source: Ministry of Finance (MoF), CNB, CROSTAT, World Bank staff calculations.

16. Risks to the banking sector are increasing as a result of the protracted recession. NPLs stood at 14 percent of the total loans at the end of 2012, with corporate NPLs at 25 percent largely from the construction and real estate sectors. Although loan loss provisions are about 42 percent, the banking system remains well capitalized with capital adequacy rates at around 21 percent in 2012 - almost double the minimum requirement. The banking sector's net profit decreased 27 percent mostly due to the increase in NPLs and the consequent loss provisioning. Profitability of the banking sector will likely remain in check as CNB implements new regulation imposing stricter rules on asset classification and higher provisioning in 2013.

17. Over the short term, the outlook for Croatia's economy is weak, given the slow growth in Croatia's trading partners and the bank credit contractions. The 2012 GDP decline of 2 percent is lowering confidence at home while the difficult external environment, limited FDI inflows and slow progress in structural reforms, means that growth is unlikely to rebound rapidly without a comprehensive policy response. Such a response will need to include

fiscal consolidation to restore debt sustainability and retain market access as well as an accelerated implementation of the structural reform agenda to improve Croatia's competitiveness. Maintaining a delicate balance between financial stability to restore public sector balance and recovery of credit growth to restore private sector growth will be a challenge.

Figure 2: Coverage (provisions as % share of NPLs)



Source: CNB, World Bank calculations

impact of the recession was mainly felt by better off households who, unlike households in the bottom decile, experienced a decline in consumption. This resulted in a decline in inequality with the Gini coefficient moving from 23 to 22. Looking ahead, simulations indicate that the increase in the poverty rate has accelerated, reaching an estimated 17 percent in 2012, accompanied by an increase in inequality.

Table 2: Trends in Poverty and Inequality, 2008-2012

	2008	2009	2010	2011 simulation	2012 simulation
Poverty					
Poverty headcount rate (%)	13.3	14.0	14.6	15.3	16.9
Poverty gap (%)	2.9	3.2	2.8	3.0	3.6
Squared poverty gap (%)	1.1	1.2	0.9	1.0	1.3
Gender of the household head					
Male (%)	12.9	12.4	14.4	14.9	16.8
Female (%)	14.3	19.0	14.9	16.3	17.5
Inequality					
Gini coefficient	23.9	23.0	22.1	22.6	22.9

Notes: Poverty is measured using the absolute (or anchored) poverty line fixed at 60% of median equivalent consumption in 2008. Estimates and projections are based on the 2008-2010 household budget survey (HBS) by using post-stratification weights for individuals constructed to match age and sex structure of the population. Projected growth rates of consumption and income in 2011 and 2012 are based on projections of the household income (depending on labor market flows, changes in social safety nets, developments in subsistence farming, small businesses and capital markets, and changes in income taxation). Income changes are then transposed to the corresponding change in consumption.

Source: Staff estimates based on the 2008-2010 HBS.

II.C. Development Challenges and Opportunities

II.C.1. Fiscal Consolidation, Reformed Social Welfare, and Improved Competitiveness

19. **The central challenge facing the Croatian authorities is fiscal consolidation. The authorities seek a reduction of primary deficit by 0.3 percent on average per year until primary balance is reached in 2016.** The focus is on fiscal sustainability, balanced with the need to support growth in a recessionary environment. The growth support would mostly come from the EU grant-funded investment projects which would then ensure long-term fiscal sustainability. Additional fiscal space in the order of 1 percent of GDP per year is needed as counterpart funds for the full absorption of EU structural funds. In 2013, Croatia will have access to a cash-flow facility to ensure its net beneficiary status upon accession; that is, upon accession, Croatia will pay into the EU budget approximately 0.5 percent of GDP, while the available EU funds in 2013 will be 1.2 percent of GDP.

20. **Croatia spends more on health and social protection than other countries in Europe with a high share of benefits and entitlements distributed according to the person's attributes (rather than their income level) as compared to the much lower share of poverty-focused programs.** Rebalancing this mix of social spending would contribute to fiscal consolidation and a strong more flexible social safety net, while the inclusion of activation measures would encourage higher labor force participation. Social services are costly, but fall short of what Croatians desire, while costly social insurance programs reduce labor competitiveness. Finally, as demographics point to an aging Croatia, the pension and health systems require bold and innovative reforms to safeguard the well-being of the population.

21. **As the needed 2012 fiscal adjustment was primarily revenue based, the next phase of fiscal consolidation will focus on expenditures, namely on the areas of entitlements, state owned enterprises (SOE) and health expenditures.** Such second generation fiscal adjustment can only be achieved through microeconomic reforms at the sector level covering (i) the social welfare system including planned pension reform and better targeted social benefits; (ii) health expenditures including the rationalization of hospital networks and (iii) state utilities such as railways and water.

22. **At the same time, fiscal consolidation needs to be accompanied by public policies to promote the private sector in support of future growth.** Recovery cannot be achieved without private sector confidence and investment, both of which have been affected by the crisis. Croatia has been receiving low rankings for market efficiency and remains at the bottom of EU countries in terms of labor force participation and governance effectiveness. As Croatia remains less competitive than most European and many other comparator countries, growth will not return easily without initiatives from the public sector to spur competitiveness. Croatia's advantage as a science and technology center, as a gateway to Europe and as a trade and logistics hub as well as other potential sources of growth will be realized through Government efforts to encourage entrepreneurship and investment in knowledge-based higher technologies throughout the country. To accomplish this, strong policy measures in support of private sector innovation need to be developed and strengthened.

23. **Creating space for the private sector requires finding ways to reduce the large public sector footprint, while improving role of the state as a service provider.** Modernized public enterprises with improved governance and performance along with a reduction of the logistics costs in infrastructure (e.g. railways, energy, and information technology) is needed to accomplish Croatia's two edged goal of fiscal responsibility and public sector service delivery. Public enterprises continue to play an excessively large role in the Croatian economy, but suffer from poor performance, financial losses that are covered by the state, and weak and overly politicized Boards as managers. State subsidies to public enterprises amounted to HRK 9 billion, or 2.7 percent of GDP, compared to an EU average of 0.8 percent of non-crisis aid. The role of public enterprises is critical to the overall competitiveness of the economy as public enterprises provide inputs (water, energy) for the private sector and facilitate trade and logistics support (transport – rails, ports, roads) for the economy as a whole.

II.C.2. Governance, Climate Change and Gender

24. **Croatia has made concerted efforts to improve governance and fight corruption.** Judicial reform and anti-corruption programs have resulted in increased prosecution of corruption cases, although challenges remain. Croatia's new Strategy for the Development of the Judiciary for the period 2013-2018 proposes legislation and organizational changes, such as court network rationalization, automated case management, internet availability of decisions, shifting simple cases to clerks for decisions and uncontested claims to notaries for enforcement; and strengthening court procedures. In addition, concerted efforts are being made by the Ministry of Justice and the State Geodetic Administration to develop a joint cadaster and land registration system.

25. **Croatia will have to make efforts to comply with the EU environmental and climate change/energy *acquis*.** Global climate change has already left its mark as Croatia's precipitation decreases and temperatures rise. Although the Government has taken action in accordance with the Kyoto protocol, the effects of the global climate change cannot be avoided. Most affected sectors will be agriculture, fisheries, hydropower, and tourism, which account for 25 percent of the Croatian economy, employ 35 percent of the labor force, and represent total annual GDP of €9 billion. GHG emissions today are smaller compared to the base year, 1990. Croatia's GHG are now less than 0.1 percent of global emissions, giving it one of the lowest per capita emissions records in Europe among Kyoto Protocol Annex I countries. GHG emissions recorded an 11 percent increase between 1995 and 2007, but the economic crisis produced a significant drop to 10 percent of the 2007 level in 2009 based on good power generation and lower industrial activities in cement and lime.

26. **Available gender diagnostics point to notable gaps in labor market outcomes.¹** Gender diagnostics find that as Croatia prepares to join the European Union, the progress in reducing gender gaps has been good both in terms of institutions and legislative frameworks as well as in outcomes in the areas of health, education, and access to finance. However, gender gaps in the labor market persist along with underrepresentation of women in certain areas of

¹ Recent diagnostics are available in Hazl and others (2011), Croatian Bureau of Statistics (2012), a publication by Ministry of Foreign Affairs and European Integration analyzing Croatia's progress on the Millennium Development Goals, the European Commission (Progress reports for 2011 and 2012), and World Bank (2013).

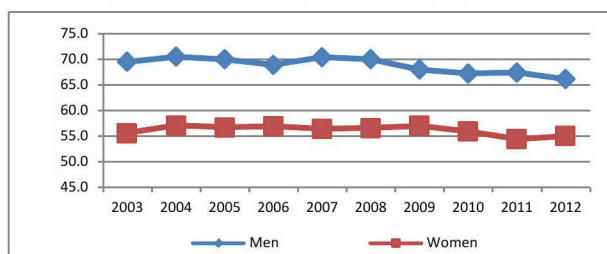
public life. The European Commission (2011 and 2012) notes good progress in institutions and laws supporting gender equality. For example, the Ombudsperson for Gender Equality strengthened its capacity and continued to implement the Gender Equality Act. The National Policy for Gender Equality 2011-2015 is under implementation. In terms of human development outcomes, maternal mortality rates and adolescent fertility rate are comparable to the Organization for Economic Cooperation and Development (OECD) countries as is the six year gap in life expectancy favoring women (80 years for women and 73.9 for men). Gender gap in school enrollments is minimal. Yet learning outcomes for both boys and girls lag behind their peers in the EU. Subject specialization at the tertiary level may be contributing to the occupational segregation seen in the labor market that leads to less favorable outcomes for women.

27. Before the recession, 70 percent of men and 56 percent of women of working age participated in the labor market. Although equality of pay is required by the EU *acquis* and regulated through the Labor Act, there is a gender gap in monthly earnings of about 10 percent of male earnings. The average gender pay gap is larger in certain sectors. For example, in wholesale and retail trade, where 53 percent of employees are female, women earn only 80 percent of male earnings. As expected, women predominate in health and social sector (79.2 percent), education (76.6 percent), and financial and insurance work (69.6 percent). In contrast, more than 75 percent of employees in sectors such as mining, transportation, and construction are male.

28. The recession has had a larger impact on men's than women's labor market outcomes. By 2011, labor force participation rates declined to 67 percent for men and 54 percent for women. In addition, the recession led to an increase in unemployment rates for both women and men. In 2008, the unemployment rate was 10 percent for women and 7 percent for men. However, by 2011, unemployment rates increased to 14 percent for both women and men, thereby eliminating the gender difference in unemployment rate. For men, the drop in labor force participation rate and the doubling of unemployment rate between 2008 and 2011 reflects the impact of the recession on sectors dominated by men such as construction and manufacturing.

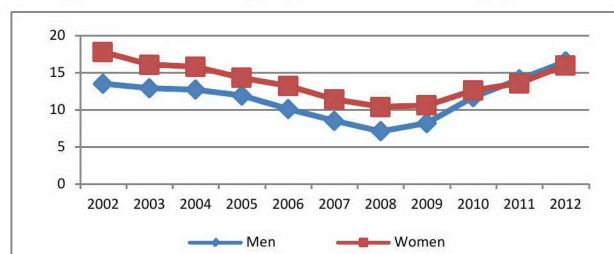
29. Gender focus will feature prominently in the implementation of the CPS. The WBG lending instruments in the CPS will feature gender-informed projects that include gender diagnostics and increasingly gender-based actions. For example, the Bank's Export Finance Intermediation Loan (EFIL), the Science and Technology 2 (STP2) project, the Partial Credit Guarantee Project (PCGP) all include gender monitoring indicators. In addition, the Poverty and Social Impact Analysis (PSIA) conducted for Economic Recovery Development Policy Loan 2 (ERDPL2) will include attention to gender. All future Bank reimbursable advisory services (RAS) activities will also be gender-informed as well as in IFC investments.

Figure 3: Activity rates by gender



Source: World Bank staff calculation using data accessed through EUROSTAT.

Figure 4: Unemployment rates by gender



III. World Bank Group Engagement Strategy

III.A. Government Program and Medium Term Strategy

30. **The Government's 2013 Economic Program, approved on April 18, 2013 confronts the country's main development challenges with a commitment to Europe 2020 "smart, sustainable and inclusive" growth strategy.** Partly due to the heavy emphasis on social spending, Croatia is well on track to meet its Millennium Development Goals (MDG)², as well as fulfilling its Europe 2020 Targets. According to the recent review by the Commission Croatia's most pressing development challenges include: (i) low labor market participation, (ii) under-developed knowledge-based factors of growth, (iii) environmental protection and climate change, (iv) education system, and (v) public governance at the central and local levels.³ Accordingly, the 2013 Economic Program, which like any member country will be reviewed by the EU for conformation with the Europe 2020 strategy, contains reference to progress on the five targets being monitored by the Europe 2020: (i) employment, (ii) R&D investment, (iii) climate change and energy, (iv) education, and (v) poverty and social inclusions.

Table 3: 2013 Economic Program of Croatia - Targets

Main goal	Croatia (2011)	Croatia (2020)	Europe 2020
1. Employment (employment rate)	57%	59%	75%
2. R&D (% of GDP invested in R&D)	0.75%	1.4%	3%
3. Climate change/energy			
3a. Reduction of greenhouse gas emissions (compared to 1990)	95.2%	106%	80%
3b. Ratio of renewable energy in overall energy consumption	13.8%	20%	20%
3c. Energy efficiency		20% (9192 TOE)	20% (1474000 TOE)
4. Education			
4a. Ratio of early school leavers	4.1%	4%	10%
4b. Ratio of population between 30-34 with completed tertiary education	24.5%	35%	40%
5. Poverty/ social exclusion (number of poor)	1382000	1282000	Reduction of 20 million

31. **The 2013 Economic Program recognizes that achieving these targets requires restarting economic growth after a half-decade of decline.** It therefore goes further to identify ten elements of its National Growth Strategy - five priorities from its yearly growth review and five supplemental areas which recognize that implementation of microeconomic reform at the sector level is fundamental to fiscal consolidation and strengthening competitiveness for private sector driven growth. These reforms will be complemented by Government's commitment to strengthen the effectiveness, efficiency and transparency of Government, including the

² Croatia has met and largely exceeds the Global MDG with regards to Poverty, Education, Gender, Health, ICT and Environment indicators,

³ March 2013 Position Paper of the Commission Services on the Development of Partnership Agreement and Programs in the Republic of Croatia for the period 2014-2020

acceleration of reform in public sector enterprises, greater emphasis on environmental and energy sector investments and even reorganization and rationalization of the civil service. Accordingly, the 2013 Economic Program of Croatia identifies an, integrated program based on policy objectives. The degree to which these policies objectives translate into economic recovery will be determined by the strength, speed and harmony of implementation – across economic sectors, government functions and among Croatia’s disparate stakeholders. Given the mixed track record of reform implementation in recent years, success will require intensive and sustained attention from top policy makers, middle level technicians, local leaders, as well as managers of private sector industry and social union leaders in order to all work in a harmonious and mutually reinforcing manner.

32. **Croatia is voluntarily participating in the European Semester**, a process of ex-ante economic policy coordination among member states. Its purpose is to enhance sustainability of public finances. Croatia delivered its April 2013 Economic Program, consisting of elements of the Convergence Program and the National Reform Program, as well as key strategic documents required of Member States in the context of EU economic governance.

Box 1: 2013 Economic Program of Croatia

- *Fiscal consolidation* with particular focus on pension reform and rationalizing hospitals.
- *Improved functioning of domestic credit markets* with focus on State Banks, development funds and bankruptcy act.
- *Promoting growth and competitiveness* through the “smart specialization strategy” and other sector related programs.
- *Reducing unemployment* and social consequences of the crisis through improved functioning of labor markets and better job related education.
- *Deinstitutionalization of social protection* and improving social benefits system through means testing for better targeting the most vulnerable.
- *Modernization of public administration* through improved systems and rationalization in judiciary regulation, state agencies, bureaus, funds, centers and other legal entities with public authority.
- *Privatization and restructuring of SOEs* including shipyard restructuring, railway sector liberalization and reorganization of water sector
- *Reform of State Subsidies through an* improved and efficient system of state subsidies monitoring, for improved use and outcomes.
- *Infrastructure development measures* including for railways, port and shipping, inland waterways, broadband internet, rural areas and sustainable water management.
- *Improving agriculture competitiveness and rural development through* agglomeration of agriculture land and organizing markets for agricultural products.
- *Nature and environment protection* through improving the state of sea environment and coastal areas and EU Natura 2000.

III.B. Proposed World Bank Group Partnership Strategy

III.B.1. Lessons from CPS Completion Report and Stakeholder Consultations

33. **A flexible design structure enables timely adjustments to evolving country needs and mitigates risks of pursuing unachievable CPS objectives.** The flexible design allowed program modifications during the outbreak of the crisis and was an important element in the moderately satisfactory performance of the previous CPS. Acknowledging that fiscal consolidation is likely to take several years, the Bank was able to shift to a programmatic support through for the Economic Recovery Development Policy Loan (ERDPL), which successfully supported the Government's economic recovery program. Going forward, the CPS Progress Report should take stock of implementation to allow for mid-term adjustment in the strategy, as needed, to ensure alignment with country development objectives. This should entail regular monitoring and evaluation to ensure that the CPS objectives remain relevant to country goals. For example, the existing annual Joint Portfolio Review, led by the Ministry of Finance, which gathers project stakeholders from line ministries and administrative bodies together with Bank teams could serve to monitor regularly progress in achieving the CPS objectives.

34. **A strengthened focus on client absorption capacity and a better selectivity of engagement areas will drive the new partnership with Croatia.** Fulfilling the requirements of the intensive EU negotiations process was difficult, absorbing the public administration resources. Capacity in the public administration to implement projects remains vulnerable, as reflected in moderately satisfactory portfolio performance during the CPS period. With Croatia's upcoming opportunity to use large amounts of grant funds, Bank support to help prepare and manage projects could be considered. As initiated under the CPS mid-term review, more emphasis will be on maximizing readiness for absorbing the EU Funds, with traditional financing likely to be considered for addressing the country priorities that cannot be funded by EU institutions.

35. **Portfolio performance has been uneven during the last CPS period and can be improved through greater monitoring and a focus on CPS results.** At its peak in 2009, Croatia's portfolio was the sixth largest in the Europe and Central Asia Region (ECA), with commitments of over \$1.2 billion for 19 projects. The Croatian portfolio has since scaled back to 10 projects in FY13. With the current schedule of project closings, the portfolio will consist of only two or three projects by end-2016. Several projects experienced implementation delays due to poor preparation and problems with information systems that use ICT solutions (such as, tax, land registry, and judicial case management systems).⁴ The application of a stricter implementation readiness criteria and the use of project preparation advance have proven useful in mitigating risks for implementation delays. An in-depth portfolio review carried out in 2009 by the Government and the Bank adopted a set of corrective measures that mitigated implementation constraints. The Government and the Bank have also conducted annual Joint Portfolio Reviews (JPR) since 2006, as required by legislation. During the new CPS period, the JPRs will include annual monitoring of CPS objectives.

⁴ Complexity of such systems is often underestimated both by the borrower and the Bank teams which resulted in problems with contract implementation, delays, increased costs and functional shortcomings. To prevent this, assessing the users' capacity to absorb, maintain and manage the systems, as well as design and procurement should be shifted in the preparation stage or latest in the first year of project implementation.

36. **This CPS is the product of dialogue between the WBG Team and the Croatian authorities as well as with a series of stakeholder consultations.** These consultations took place over the course of 2012, mostly in Zagreb and Brussels, with the European Commission, the Delegation of the European Commission in Zagreb; members of parliament; the private sector; think-tanks, academia; diplomatic community; international organizations (United Nations agencies, etc.), European international financial institutions (European Bank for Reconstruction and Development, European Investment Bank, etc.), civil society and the media. The main challenges discussed were how to improve the competitiveness of the economy, with emphasis on job creation and improvement of the business and investment climate, and public sector reforms to improve efficiency and accountability. In addition, the role of the WBG in helping the authorities raise the capacity for absorption of forthcoming EU structural funds was highlighted.

37. **Overall, the feedback from all stakeholders was encouraging and provided both a realistic vision of the efficacy of the WBG's work in Croatia to date, and provided valuable input on future directions the partnership should take during the FY14-17 CPS period.** The stakeholders emphasized the important role of the WBG in Croatia as a knowledge provider, a source of international best practices, and an advocate for change. In discussions with senior Government officials, the Deputy Prime Ministers, Line Ministers and Agency Heads, the authorities expressed three categories of desired WBG involvement: (i) the WBG as a strategic partner in supporting structural reforms; (ii) the WBG as a source of technical assistance especially on regional and local levels to help in EU Funds absorption and institutional capacity building; and (iii) the WBG as a source of last resort by doing what others do not.

38. **To inform the CPS on the broad range of opinions on the WBG work in Croatia, the Bank undertook a Strategic Survey in October 2011 and a Client Survey in May 2012.** Respondents were asked to rank several sectors and subsectors of the economy based on their perceived country needs for the next CPS period and their evaluation of the WBG's operations in the previous CPS period. Key development themes for the new CPS were identified, including implementation of reforms to achieve and sustain economic growth, focusing on job creation, removing barriers to doing business, competitiveness of the private sector, reform of the public sector, education system, labor market and accelerating convergence with the EU15 by increasing Croatia's institutional capacity for EU Fund absorption. These themes are consistent with the priorities identified in this CPS. Less positively, the respondents noted the slowness and complexity of WBG processes and identified interaction with stakeholders outside government as an area for improvement.

III.B.2. Overview of World Bank Group Partnership Strategy

39. **The previous Country Partnership Strategy for FY09-FY12 was discussed by the World Bank's Board of Directors on September 30, 2008 and extended to FY13 to allow the new FY14-17 CPS to coincide with Croatia's EU membership.** The 2011 Progress Report adjusted the engagement to include in the WBG partnership strategy, alignment to the EU when the European Council gave the green light for Croatia to become a new member state. This CPS was prepared collaboratively with a new coalition Government, which began its mandate following parliamentary elections in December 2011 at a time of global financial and economic crises. The 2013 Economic Program of Croatia will address the many challenge facing Croatia,

and the CPS engagement is aligned to support selected engagements, especially in sectors that show a strong commitment to change and reforms and a drive for results.

40. **The proposed CPS coincides with the start of Croatia's membership in the European Union and the unique opportunity to make good use of large amounts of EU grants to develop the country's economic potential as a gateway to Europe, as a transit point for exchange, and as a knowledge-based economy.** There are two types of risks identified: external and domestic. Challenges remain in Croatia's ability to achieve fiscal sustainability and foster private sector competitiveness – both needed to compete within the EU from a position of economic strength rather than weakness.

41. **The Government and the Bank agreed to continue their partnership covered by the FY14-17 CPS.** Despite its high income, institutional capacity to implement reforms and absorb EU Funds remains uneven, and the Croatian authorities have expressed support for continued engagement with the WBG. Formal graduation discussions are envisioned beyond the FY14-17. The Government has expressed a need for continued WBG partnership beyond EU accession, citing reform-promoting support fostered by DPLs and institutional capacity building from 'learning-by-doing' fostered from investment loans. However, the Government recognizes the Bank's exposure limits and the need to modify the lending relationship in light of Croatia's entry into the EU and access to large grant funds.

42. **The CPS envisages a maturing of the Bank's program away from lending while concurrently envisaging a gradual increase in RAS.** With the majority of Bank lending front-loaded at the beginning of the FY14-17 CPS period, the strategy envisages the upfront development of new instruments including: (i) results-based engagements (for example, Programs for Results, PforR) linked to and complementing the DPLs to support sector-specific reforms; and (ii) reimbursable advisory services (RAS), mostly in the form of analytical and advisory activities (AAA) with a focus on Croatia's current structural and institutional challenges.

43. **The potential for RAS engagements come from a demand-driven desire to use the WBG as a knowledge partner providing solutions for the country's economic challenges.** Following established RAS models from other member states, AAA-RAS support will be maintained in areas of strategic importance to the reform program. For Croatia, these include higher education, pension, public administration, judicial, and state-owned enterprise reforms where the Bank has a continuing dialogue and in some cases evolving engagement. As the FY14-17 CPS period overlaps with the 2014-2020 programming period, partnership arrangements between the EC, the Croatian authorities, and the Bank will be explored.

III.B.3. Engagement Areas, supported by Lending and Non-Lending Activities

44. **During the next four years, the WBG's CPS centers on assisting Croatia achieve its objective of initiating EU membership from a position of strong economic fundamentals.** To achieve the objective, Croatia's policy makers recognize the inter-dependence of the key reform areas. In particular, the WBG engagement during the FY14-17 period will be driven by Croatia's specific challenges reflecting the need for a comprehensive and mutually dependent set of reforms, programs and activities, as encompassed in three separate but inter-related pillars, with each pillar having three distinct themes that are linked to nine attributable results indicators.

- The first pillar focuses on *Public Finance*, based on the need for continued fiscal consolidation to underpin renewed and sustained growth, along with an emphasis on expenditure rationalization to ensure fiscal sustainability over the medium term. Under the Public Finance Pillar, the three themes examined are: Revenue Consolidation, Efficiency of Social Protection, and Rationalized Health Spending.
- The second pillar seeks an improvement in *Competitiveness* required to spur growth, centering on the required structural, institutional and governance reforms, as Croatia lags its EU peers in a range of competitiveness related indicators. Under the Competitiveness Pillar, the three themes examined are: Strengthening Public Enterprises, Improved Judicial and Regulatory Market Oversight, and Promoting a Private Sector-led Transition to a Knowledge Economy.
- The third pillar seeks to maximize the benefits of *EU Membership* in order to implement harmonized policies, improve the country's capacity to absorb a substantial increase in EU Funds and help use these resources effectively to turn the economy around toward EU convergence. Under the EU Membership Pillar, the three themes examined are: Supporting the Convergence Process, Preparing National Reform Programs for Use of EU Funds, and Strengthening the Capacity of Public Sector for EU Funds Absorption. Improving Croatia's Regional Cooperation will be additionally examined under the third pillar.

Pillar I: Public Finance

45. **The greater fiscal adjustment is needed, even though Croatia has made efforts in the area of fiscal consolidation during the past years to strengthen the macroeconomic underpinning for growth and prosperity.** Emphasis on revenue enhancements and social expenditure rationalization to ensure fiscal sustainability over the medium term is central to this debate. Under this pillar, the WBG engagement will focus on overall economic policy dialogue through the DPL series, supplemented by AAA-RAS support for revenue-generating tax reforms, and complementary results-based engagement in the social protection and health sectors for expenditure-rationalizing reforms.

46. **To address the immediate economic challenges, the Bank foresees continued and increased levels of policy-based lending to continue supporting the Government's reform agenda, especially in the first half of FY14-17.** Policy-based lending, in particular DPLs, provides the basis for the Bank's policy engagement in Croatia and serves to convene multiple stakeholders to discuss reforms at a comprehensive level. Therefore DPLs will likely account for a large proportion of Bank lending during the FY14-17 period. The policy-based lending instruments are rooted in on-going AAA in the area of Public Finance Review, Labor and Pension Policy Notes, Hospital Rationalization Note, Railways Policy Note, and Technical Assistance (TA) for Means-testing amongst other existing AAA.

47. **The Bank will deploy new results-based instruments, complementing DPLs, to support sector-specific reforms during the CPS period.** The Bank is partnering with key stakeholders to improve the social assistance system – both through parametric changes, as well as improvements to the administration of the system. The Bank is also engaged in the health sector to help introduce cost rationalization measures that allows Croatia to sustain its good

health outcomes but at a lower cost. In addition, the Bank is working with the Croatian Tax Administration (CTA) to support revenue enhancing measures such as improved tax compliance. In all three areas, (i) reforms to improve the social assistance system through improved targeting of social assistance programs; (ii) reforms to the health system from hospital rationalization and health expenditures reductions; and (iii) revenue enhancement and efficiency by modernizing the tax revenue system, the Bank will explore the potential for results-based engagements (e.g. PforRs).

48. **The Bank is working with the Croatian National Bank (CNB)**, supported in part by the newly established Vienna-based FinSAC Center, on crisis simulation exercises, to deal with challenges stemming from the ongoing Eurozone crisis. The Bank's Treasury team will explore with the Ministry of Finance, hedging operations, partial credit guarantees operations for sub-sovereign (public enterprises and municipalities), and debt management advisory services.

Revenue Consolidation

49. **Croatia's tax compliance and collection efficiency has made strides in recent months, but further improvements are ongoing to modernize its tax administration.** Information and Communication Technology tools for compliance, risk management, and audit are being updated to strengthen strategic planning and implement institutional reforms. Central to the Bank's engagement is the restructuring of the Large Taxpayer Office to separate and administer taxpayers according to size, market segments and risks.

50. **The results of the Bank's engagement to support revenue enhancing measures will be measured by tax compliance/tax gaps.** Through Bank lending instruments, like the ERDPL2 and the Revenue Administration Modernization Project, the Bank will continue to support the modernization of the CTA.

Efficiency of Social Protection

51. **Croatia has an extensive, but costly and fragmented social assistance system, with a large number of categorical entitlements.** At three percent of GDP, spending on social assistance programs is higher than that of other Central and Eastern European (CEE) countries, with a large share of spending going to war veterans and families. The Government is aiming to improve the efficiency and effectiveness of its social assistance through improved targeting and administrative rationalization of social welfare system. Measures such as data exchange between the social protection information system and other public databases and an improved Social Inspectorate will help enable some savings. However, the largest fiscal gains would be generated through introduction of means testing for increased number of social benefits, including for veterans and families.

52. **The Bank is working with the Ministry of Social Policy and Youth on a Social Protection results-based project and through the ERDPL2,** which would support implementation of the Government's reforms to improve the social assistance system through: consolidation of benefits to reduce fragmentation, broader application of a means-test to improve targeting of social assistance programs, the inclusion of activation measures to bolster the labor force, and the introduction of tools to tackle error and fraud in order to generate savings.

53. **Means-tested programs as a share of all social assistance programs will be used as the results indicator to measure the Bank's social protection engagement.** The challenge of improving the targeting and efficiency of social assistance programs will be supported by Bank interventions that seek to contribute to the Government's goal to ensure sustainability of social sector spending.

Rationalized Public Health Spending

54. **Croatia is achieving good health results but at a substantial cost.** Health care is almost entirely publicly funded (nearly 85 percent), and health insurance contributions have been the main source of financing (91 percent). At 7.8 percent of GDP, Croatia's health spending is near the top for new EU member states. The Government seeks improvements in health care financing through cost cutting and redirecting expenditures towards quality and efficiency. Cost cutting is to be achieved by redirecting some hospital capacity toward day care and away from extended treatment, while expanding more cost effective capacities for acute and chronic conditions in hospitals. Efficiency gains are expected from information and communication systems to centralize and integrate information management.

55. **The Bank will continue to help with the introduction of further cost rationalization measures in the health sector by monitoring public health spending, health sector arrears and rationalizing the public hospital network.** Instruments involved in supporting these activities include ERDPL2 and the Development of Emergency Medical Services and Investment Planning Project are providing the analytical and operational basis to deepen the Bank's engagement in the sector through a results-based engagement such as the proposed health sector results-based project.

56. **The two results indicators in the health sector are the total reduction in public accrual health spending and the reorganization of the hospital system.** These indicators will measure the efficiency of health sector spending, focusing on the unsustainable level of health spending and the inefficient, high cost long-term care services provided by hospitals.

Pillar II: Competitiveness

57. **The Croatian economy is less competitive than its peers.** In the latest Global Competitiveness Survey, Croatia ranked 81 out of 144, worse than a year ago while most CEE countries improved in ranking, making Croatia's decline more poignant. More important, Croatia's private sector share of GDP has remained at 70 percent, a level lower than its EU peers, during 2007-2011. To achieve private sector-led growth and faster EU convergence, actions are needed to jump start enterprise restructuring and new business creation and old firm exit required for the economy to reorient itself away from resource efficiency toward one reliant on knowledge, innovation and transit related services for its geo-economic edge as Europe's transport hub. Within this pillar, specific areas for WBG engagement include: (i) strengthening public administration through efficiency improvements in the governance and management of public enterprises; (ii) better market governance through improved judicial processes and better regulatory oversight of private sector activities, and red tape reforms to facilitate doing business; and (iii) facilitation of private sector activities in the areas of energy efficiency and renewable energy, FDI, small and medium enterprises (SME), and R&D and innovation support.

58. To enhance Croatia's competitiveness, the Bank will focus on AAA-RAS engagements with curtailed lending, while the IFC expects to increase its investment support. Under the competitiveness pillar, the Bank will provide limited lending support and only in areas where the desire and momentum for reforms are high. Instead, the Bank engagement will predominantly be AAA-RAS. Much of the AAA-RAS engagements to advance the country's competitiveness are in the discussions stage, predicated on a demand-driven platform, in select areas where the Bank has a clear technical and comparative advantage to deliver. Given deleveraging and lower capital inflows to Croatia, IFC expects to increase its role in Croatia in support of private enterprise. To improve competitiveness, IFC will seek to provide long-term financing to export oriented companies, promote foreign investors and transfer of technologies, invest in infrastructure and help Croatian companies to expand markets and even invest in the region. MIGA will also consider supporting foreign investors in Croatia through provision of political risk guarantees.

Strengthening Public Enterprises

59. Promoting public enterprise restructuring and governance will focus on structural reforms aimed at the Croatian Railways (HZ) system as one of the key strategic sectors for the country as well as some of its largest loss making public enterprises (HZ Infrastructure and HZ Passenger Transport). Given its vital transit position in Europe, one of the main competitive advantages and opportunities for Croatia is that its railway network is deeply embedded in Europe's major transport corridors. Croatia Railways sit at the junction of several pan-European transport corridors (e.g. the East-West Pan-European Rail corridor X, corridor Vb connecting Rijeka with Zagreb and the Hungarian border, and corridor Vc connecting Ploce and running South-North across Bosnia and Herzegovina). But the system faces severe operational and financial challenges. Reduced rail traffic and limited operational performance by passenger and cargo operations have raised operating costs and undermined the financial sustainability of HZ, which depends on large amounts of state support. In 2012, it received HRK 2 billion in subsidies while outdated infrastructure and rolling stock require large capital investments for renewal.

60. The Bank's work on the railways sector will seek to contribute to a dialogue on how to improve governance and management of other loss making public enterprises in the future. The goal of turning around key strategic public enterprises is aimed at both reducing budgetary subsidies to ailing public enterprises and improving Croatian public enterprise competitiveness as it enters a highly competitive EU market. The Bank is currently working with the various companies created from Croatian Railways and Croatian Electricity Corporation, engaged in discussions with Government on sector restructuring options, and may also engage other strategic public enterprises that have longstanding cooperation with the WBG such as the Ports Authorities in Rijeka and Ploce and Croatian Waters and local water utilities.

61. The instruments for the Bank's engagement will be predominantly AAA-RAS support. Through two economic and sector work (ESW), the Railways Sector Policy Note and the Energy Sector Review, the Bank is engaged in policy dialogue. These ESW will help gauge the desire for reforms and the consequent depth of future Bank engagement. Future lending engagement, especially in the Railways to support the country's transport and logistics links, could be developed if other financing sources are not available.

62. **The results indicator for this engagement entails a broad measure to monitor the development of public enterprise restructuring strategies.** The engagement aims to contribute to the development of coherent strategic directions and priorities for key strategic public enterprise in particular in the railway and energy sectors. As the magnitude and depth of the Bank's public enterprise engagement remain uncertain, sector strategies prepared and adopted by the Government will be used as a proxy measure.

Improved Judiciary and Regulatory Market Oversight

63. **Public administration in Croatia is large, expensive, and relatively low in effectiveness.** Its excessive size slows decision making and service delivery. Often cited highly in the list of barriers to doing business in Croatia, public administration in Croatia is hampered by many of the organizational rigidities, functional overlaps, and remuneration concerns which exist in many countries and discourages the emergence of a professional managerial staff.

64. **Removing barriers to doing business in Croatia will require improving the delivery of public services, expediting judicial processes and eliminating needless red tape.** One area where significant progress has been made is justice reforms, due in part to the EU accession process. Partly due to the high demand for adjudicative services, Croatia supports one of the largest court networks in Europe with 43 judges per 100,000 inhabitants, compared to the EU10 average of 26.4. This results in judicial expenditures of 0.7 percent of GDP, more than double the EU10 average of 0.3 percent. In addition, performance challenges remain including those covering (i) resource management (financial, human, physical, and ICT); (ii) capital investment; and (iii) transparency of judicial decision making processes. Courts are now disposing of cases faster, have reduced backlogs, and have begun to automate case management. Cadastre and land registry data have been digitalized and are available online to citizens and legal entities, which is vital for the protection of property rights, transparency of the land administration system, business transactions, and access to credit. But many institutional challenges affecting government-business interface in Croatia remain.

65. **Both the IFC and the Bank will assist in red tape reforms to facilitate doing business and promote foreign direct investments.** The Bank-administered REPARIS program ("Road to Europe Program of Accounting Reforms and Institutional Strengthening"), aimed at removing obstacles and creating a better environment for a private sector growth, will continue into the CPS period. The Bank is engaged in developing Croatia's smart specialization strategy through technical assistance support. The Bank's Integrated Land Administration System (ILAS) Project will continue to support the development of a joint information land registration and cadaster system, with possible follow-up AAA-RAS in areas such as Land Governance Assessment Framework, Real Estate Modernization System, and Crowd Sourcing Harmonization of Land Record. The Justice Sector Support Project (JSSP) and two ESW, the Justice Sector Public Expenditure Review and the Governance Case Study, have advanced the Bank's engagement with the Ministry of Justice. Follow-up AAA-RAS such as a Justice Sector Functional Review is envisaged.

66. **The results indicators under this engagement will monitor the efficiency and effectiveness of the judicial system, with the aim of facilitating the ease of doing business in Croatia.** The unreasonable lengthy duration of proceedings and the slow and inefficient judicial process has been a challenge to domestic and foreign investors alike. To create a business-

friendly environment, further reductions in the high backlog of court cases are warranted. As such, the results indicators will monitor the reduction in the backlog of cases in the judiciary and the reduction in the number of courts in the country.

Promoting a Private Sector-Led Transition to a Knowledge Economy

67. **Croatia seeks a private sector driven transition to a knowledge economy while providing appropriate public sector support to achieve the country's goals of smart, sustainable and inclusive development strategy.** In the near term, the objective is being pursued by increasing the renewable share of energy consumption along with an increase in energy efficiency as called for by the Europe 2020 strategy to which Croatia has targets aligned with Europe 2020 numerical targets.⁵

68. **Croatia will need to ensure access to reliable and affordable knowledge inputs as part of the effort to ensure private sector competitiveness in the knowledge economy, by providing support to SMEs** - in particular access to finance for new, smaller firms attempting to export - in view of the upcoming EU accession and enhanced competitive pressures - and by facilitating a research agenda which seeks the commercialization of basic and applied R&D. Cooperation between innovative firms and public research organizations, where 60 percent of public R&D investments goes, is limited to 24 percent in Croatia, as compared to 38 percent in Slovenia and 64 percent in Finland. In the private sector, the volume of business R&D is low. Despite generous tax based subsidies of about 35 percent for R&D, Croatian businesses spend about €30 per capita compared to Slovenia that spends around €130 per capita. Overall, Croatia would benefit from improved governance and performance-based financing in the tertiary education and science sectors to support its competitiveness goals.

69. **IFC expects to increase its engagement in the country, given deleveraging of European banks and overall low international capital flows to Croatia, as well as changes in the Government policies to further open up the economy to the private sector participation.** During the next four years, IFC expects to invest in Croatia up to US\$600 million for its own account. Through its investments IFC will support Croatia's return to sustainable economic growth. IFC will seek to provide long-term financing to improve competitiveness of local export oriented companies, to increase SME access to financing, to promote foreign investors and transfer of know-how and technologies, to support private sector investments in the infrastructure sectors, and to help Croatian companies to expand their market and invest in the region.

70. **IFC will also be open to support through post-privatization financing for the corporate and financial sectors.** In the corporate sector IFC will focus its financing in the agribusiness, manufacturing and retail sectors. In the financial sector, given that the banking sector is well developed and highly competitive, IFC will limit offering of senior debt to larger banks for special products, including SME support and sustainable energy investments. In addition, IFC will support regional trade through trade finance programs. IFC will also seek to play a more active role in developing capital markets, including local currency products. In the

⁵ The Croatian targets includes: (i) 20 percent share of renewable sources in final consumption; (ii) 10 percent share of biofuel in gasoline and diesel fuel; and (iii) 35 percent of electricity from renewable sources.

infrastructure sector, IFC will seek to support private sector participation in the transport sector (e.g. road concessions, inter-modal transport center, LNG terminal). In coordination with the Bank and the EC, IFC will look for opportunities to support municipal infrastructure projects including solid waste management and transport projects, through municipal finance products or through PPPs, including advisory services and investments. IFC will continue to support Croatia to improve diversity and security of energy supply by seeking opportunities to finance private sector investments in renewable energy projects and energy efficiency projects (cleaner production, residential energy efficiency, and sustainable energy projects). Multilateral Investment Guarantee Agency (MIGA) will also be open to support foreign investors in Croatia through the provision of political risk guarantees.

71. The Bank will support the private sector through Government channels introducing new and innovative instruments, such as Partial Credit Guarantees (PCG). With a view to fostering the supply of long term credit and crowding in private investment, the Bank provides credit lines through the Croatian Bank for Reconstruction and Development (HBOR) for on-lending by commercial banks to exporters and foreign exchange earning companies. The PCG for HBOR is innovative in that the Bank guarantees a financial intermediation loan, with a view to assisting HBOR access international financial markets. Future guarantees, supported by MIGA, will be explored. The Bank will also be exploring additional engagement instruments, such as venture capital financing that can help with the commercialization of research by supporting innovative, start-up companies develop balance sheets for eventual venture capital and private equity financing. Any new Bank lending engagement under this pillar will be innovative and path-breaking in line with Croatia's middle-income status.

72. IFC and the Bank will continue to provide complementary support to the country in the infrastructure sector. IFC will continue to provide financial intermediation support to SMEs, renewable energy sector firms, and competitive Croatian firms investing in the region. IFC is considering structuring a public private partnership (PPP) for the Brijuni National Park, a project which was initiated by the Bank. On-going Bank ESW in the energy sector should help pave the way for additional IFC investments, in particular, to support energy efficiency and renewable energy projects. The Bank's work in the health reforms could lead to increased IFC support for private activities in the sector. The Bank and IFC may also collaborate in private sector participation in infrastructure, for example when activities are concessional under the umbrella of the current Rijeka Gateway II projects.

73. The results indicators under this pillar measure the level of IFC support to corporations investing in energy efficiency and renewable energy projects. Through this engagement, IFC seeks to contribute to the diversity and security of energy supply by financing energy efficiency and renewable energy projects. IFC will also support competitive local companies to expand in the region and increase exports.

Pillar III. EU Membership

74. On July 1, 2013, Croatia will become the 28th European Union member state. Upon joining the Union, Croatia will confront enormous opportunities as well as major challenges. Croatia will immediately have improved access to a market of 500 million people,

benefitting from the flow of labor and capital as well as gain from new information and technology transfers. Most of all, the amount of EC Structural and Investment (ESI) funds⁶ available to Croatia will be well in excess of its annual contributions to the EU budget. But equally, EU membership brings with it serious challenges for Croatia - of aligning strategies and reform programs to meet the Europe 2020 targets, and of developing processes, institutions and policies to absorb and manage the funds allocated to Government. As seen from the experience of other new member states, many governments have been successful in developing the necessary documents to secure funds from the European Commission (EC), but weaknesses in implementation, especially institutional arrangements, public investment planning and management, procurement and financial management, often limit absorption.

75. To maximize the benefits from joining the EU, the WBG will support Croatia's convergence with and alignment to EU strategies, policies and targets; and help in the absorption of EU Funds. The pillar will also support the country's participating in regional initiatives, especially those supported through EU initiatives. The Bank will only engage in lending activities in sectors that complement, not displace, the support provided by European financial institutions. While lending will be limited, the Bank is expected to grow its AAA-RAS engagement under arrangements involving the Government, the Commission, and the Bank – following the same model used in other new member states. Under the third pillar, in the short-term, Bank instruments would focus on contributing to the preparation of the National Reform Programs for effective use of EU Funds, while over the medium-term, the Bank would redirect its focus toward strengthening the capacity of the public sector for the absorption of EU Funds. The achievement of these objectives involves building country systems for project management according to EU standards, raising counterpart funding for large civil works projects, and mobilizing/organizing various arms of government to adapt and comply with EU standards and systems.

Supporting the Convergence Process

76. To accelerate growth and achieve faster EU convergence, the Bank will support the formulation and implementation of structural reforms. In the absence of reforms, the country's competitiveness will suffer and further stall an already tepid private sector-led recovery. The convergence process showcases the inter-related nature of the three pillars: to achieve fiscal consolidation, structural reforms are required; structural reforms are necessary to meet many of the Europe 2020 targets; where reforms support both the growth and convergence process. In addition, the potential windfall from a large infusion of EU funds could help revive growth in the economy. But while EU Funds are expected to provide a source of investment boost, the needs for co-financing will put pressures on the national budget when fiscal consolidation is a priority. To better absorb the EU Funds, the Government will have to prioritize spending patterns to ensure that EU-funded projects are closely linked to Croatia's strategic priorities; create the fiscal space to ensure co-financing needs are met; and upgrade administrative capacity to ensure that projects qualify for financing.

⁶ The European Structural and Investment funds comprise: the Cohesion Fund, the European Regional Development Fund, the European Agricultural Fund for Rural Development, the European Social Fund, and the European Maritime and Fisheries Fund.

77. **Croatia is still far from achieving its Europe 2020 Headline Targets, and meeting these targets will require structural reforms.** Adhering to European 2020 Targets could help the country's R&D and innovation agenda, improve labor market flexibility, and establish the foundations for sustainable growth. In this regard, Croatia is currently at 24 percent relative to a target of 40 percent of 30-34 year olds with completed tertiary education; Croatia is currently the lowest in the EU at 57 percent relative to a target of 75 percent for increasing employment rate amongst 20-64 year olds; Croatia severely lags behind Europe investing just 0.73 percent of GDP relative to a target of 3 percent of GDP invested in R&D and Innovation; and Croatia is at 15 percent relative to a target of 20 percent of using energy from renewable sources. To fulfill its obligations to Europe 2020, Croatia's development challenge in its first year of EU membership highlights the need for continued and comprehensive reforms.

78. **The Bank has focused its current portfolio to better align World Bank projects with the country's EU agenda and to only support activities that promote structural reforms.** In the previous FY09-13 CPS, the program was aligned around Croatia's EU accession goals to help fulfill the country's EU benchmarks and negotiations requirements, and the Bank's policy lending instruments were designed around the same objectives found in the Pre-Accession Economic Program. In the current CPS, the Bank's portfolio is realigned to support the convergence process by supporting the country's structural reforms agenda through policy based instruments and by helping with EU Funds absorption through AAA/RAS assistance. As such, no specific results are envisaged under the convergence pillar.

Preparing National Reform Programs for Use of EU Funds

79. **As part of this process of the Europe 2020 Strategy, each member state has to develop an annual National Reform Program (NRP)** which addresses European flagship initiatives. A major challenge Croatia will face with accession is the preparation of all the documents and institutions for the new 2014-2020 programming period. Through programming, the principles, the strategy, and the management process are laid down for a specific geographic area with specific thematic focus. Croatia will have to get EC approval for its programming documents, as the EC is responsible for the programming process and ensuring the compliance of key documents with regulations. The Bank has been working with the Ministry of Regional Development and EU Funds (MRDEUF) through the EU Preparedness TA as well as sector investment projects to review sector strategies and support the development of the National Reform Agenda.

80. **The results indicators will measure the development of sector specific strategies required for the use of EU funds.** Improving the coherence and credibility of national strategic and policy documents, some of which are ex-ante conditionality, will be essential for the absorption and management of EU funds because individual project proposals need to be embedded in national strategic documents.

Strengthening Capacity of the Public Sector for Absorption of Funds

81. **The large amount of European Structural and Cohesion Funds available to Croatia presents a major windfall but poses the challenge of absorption.** Once it joins the EU, Croatia will be obliged to contribute about €500 million annually to the EU budget; but will have access to annual EU Structural and Cohesion Funds of about €1.5 billion and an additional €450

million in Rural Development Funds, amounting to nearly 33 percent of GDP. Some new member states have had difficulty in absorbing these funds, ending up as net contributors to the EU. The Government is keen to avoid a similar fate, and has requested complementary technical assistance support to ensure the smooth absorption of EU funds.

82. To accommodate, the Bank will expand its AAA program to facilitate the Government's EU funds absorption. Through project lending, the Bank has been working on strengthening the capacity of many public sector ministries and agencies to improve its public investment management (nature protection, emergency medical services, science and technology, waste water management, justice, land administration systems etc.) to comply with EU directive and absorb EU funds. In addition, the Bank is providing specific technical assistance and carrying out analytical work on the state of Croatia's EU preparedness - looking at how to increase the level of readiness of selected institutions to utilize EU funds, how to strategically program for EU Structural Investment Funds, and to highlight bottlenecks to EU funds absorption process. Additional project investment lending to facilitate structural funds absorption could be considered in the water and waste water sector or other infrastructure as counterpart fund support. Innovative lending involving a blend of EC and European Investment Bank financing in a revolving fund arrangement to support real sector activities could also be considered.

83. The Bank is working with the Government to identify policy, institutional and structural reform gaps, that need to be addressed to ensure the effective utilization of the EU funds. The proposed arrangements will present an opportunity for Croatia to contract the World Bank to provide specialist advice, using EU funds to bolster the size and scope of the Bank's engagement. The AAA-RAS arrangement is only envisaged in the early years of the 2014-2020 programming period. The AAA-RAS engagements will seek to support sector strategic frameworks, sector policy notes and functional reviews, as well as the development of processes, and institutional guidelines to develop a solid pipeline of projects and strengthen project management capacity.

84. The results indicator to measure Croatia's readiness and capacity to absorb EU funds will be the project pipeline developed for absorbing EU Funds. The Bank's role in supporting Croatia's fund absorption is measured by the development of EU-related project pipeline and the financing mechanisms/framework for EU funding.

Improving Croatia's Regional Cooperation

85. To help the Government honor its responsibility to protect regional and global assets that lies within the sovereign domain of Croatia, the Bank will promote regional cooperation in the areas of water and waste water, waste management and environmental compliance, transport corridors, and management of the Danube River and the Adriatic Sea. In the latter context, the Bank is assisting the Government to prepare the GEF Adriatic Sea Environmental Pollution Control Project for Croatia and Bosnia and Herzegovina, in cooperation with United Nations Environment Programme Mediterranean Action Plan (UNEP MAP), to finance demonstration projects that reduce solid waste discharge through leachate treatment and

TA for project preparation of priority investments identified in the ‘Hot-Spots’ assessment.⁷ The Bank will also seek to discuss mitigation and adaption measures for Croatia in response to the global climate change agenda. Finally, part of the current portfolio will remain active during the CPS period and contribute to the regional positioning of Croatia as a gateway to Bosnia and Herzegovina (Trade and Transport Integration Project) and Hungary and Austria (Rijeka Gateway Project). The Danube River Basin Water Utilities Trust Fund will provide regional support to utilities reform, and together with the Global Environment Facility (GEF) Adriatic Sea Project, will pave the way for broader AAA/RAS engagements on water/waste water management, on waste management and environmental compliance.

III.C. Implementing the FY14-17 Country Partnership Strategy

III.C.1. Financial Envelope

86. **The indicative financing envelope for the FY14-17 Country Partnership Strategy provides for up to US\$800 million in lending.** For the FY14-17 lending program, DPLs will continue to play an important role based on the need to combine policy reform with budget finance. At the same time, Croatia and the Bank intend to explore the use of new investment financing instruments like results-based operations as the share of traditional investment financing decreases during the CPS period. Reflecting lessons from previous CPS, flexibility will be retained in managing IBRD financing, applying the range of World Bank Group instruments, and addressing areas of engagement in response to global conditions and country priorities. An indicative front-loaded lending program coupled with a back-loaded AAA-RAS program is presented below. By their nature, the AAA-RAS engagements require intense dialogue between three parties and will take time to develop.

87. **Table 4 summarizes the indicative lending program for the first two years of the CPS.** The content of the program for the second part of the CPS period and the overall scope of Bank partnership will be reviewed and revised as appropriate in the CPS Progress report at mid-term of the CPS.

Table 4: Indicative lending program for FY14-15

Policy Support	Program Support	Project Support
ERDPL 2 DPL *	Health Sector (results-based) Social Protection (results-based)	Railways (investment)

** DPL will be contingent on continued reforms implementation.*

88. **During the next four years, IFC expects to invest in Croatia up to US\$600 million from its own account.** Through its investments IFC will facilitate Croatia’s return to sustainable economic growth. IFC will seek to provide long-term financing to improve competitiveness of local export oriented companies, to increase SMEs access to financing, to promote foreign investors and transfer of know-how and technologies, to support private sector investments in the infrastructure sectors, and to help Croatian companies to expand their market and invest in the region.

⁷ The World Bank Adriatic Sea Hot Spots Assessment 2011.

89. **MIGA's outstanding gross exposure in Croatia as of February 28, 2013 was US\$943.6 million** in support of an Italian financial institution and a Slovenian investor in the retail sector.

90. **The CPS addresses only a fraction of the country's external financing needs. Around 40 percent of Croatia's financing requirements are projected to come from FDI and portfolio investments with IBRD projected to cover less than 2 percent.** Debt service to the IBRD will remain around 3 percent of total public debt service. Other multilaterals (European Bank for Reconstruction and Development, European Investment Bank, Council of Europe Bank) have announced increased exposures, so in the CPS, WBG financing will be geared toward areas outside the scope of other multilateral partners. Additionally, consideration of exposure limits means delivery of government-selected services will require exploring various leveraging and cost-sharing options, including from the private sector.

III.C.2. Partnership and Donor Coordination

91. **Partnership with the European Commission and European Institutions (European Bank for Reconstruction and Development, European Investment Bank, Council of Europe Bank, etc.) is central to the CPS.** A partnership between the Bank, the European Commission, and the Government will be developed to ensure consistency of the various programs contributing to Croatia's strategic goals. When Croatia becomes a full EU member state, donor coordination activities will be entirely shifted towards the Ministry of Regional Development and EU Funds (MRDEUF) as the Managing Authority responsible for coordinating the activities of member states, the Government and the international financial institutions. Strengthening MRDEUF capacity for inter-ministerial coordination, and the technical strategy development capacity of the Implementing Agencies, will be essential.

92. **With the Bank's continuing engagement in support of the Government's reform and recovery efforts, cooperation with the International Monetary Fund (IMF) and Directorate General for Economic and Financial Affairs in the European Commission (DG ECFIN) will remain critical.** As the Bank continues the policy dialogue on structural and institutional reforms, and the Fund assists with macroeconomic policy advice as part of their Article IV consultations, the two institutions will coordinate engagement, especially on issues affecting the country's macroeconomic and competitiveness challenges. This coordination will also involve DG ECFIN to ensure a consistent dialogue with the authorities on the reform and recovery agenda.

III.C.3. Managing Program Implementation

93. **Croatia has made progress in government budget transparency with further improvements expected.** Croatia's score on the Open Budget Index shows that the public is provided with detailed semi-annual reports on the central Government's budget and financial activities, but it still remains somewhat difficult to track spending, revenue collection and borrowing on a timely basis.

94. **Harmonization with the EU, both in legislation and in practice, has advanced and the public finance management framework provides a solid basis for the Bank's increased use of Croatia's public financial management systems.** Since the 2005 Country Financial

Accountability Assessment (CFAA), Croatia took actions supported by the World Bank Programmatic Adjustment Loan (PAL) program and the EU, to enact the Law on Financial Management and Control Systems in the Public Sector 2008 and establish internal audit units and appoint controllers for all line ministries, as well as for central state organizations, extra-budgetary funds and selected local governments. Consolidation of all government accounts under the Single Treasury Account improved cash and debt management as well as budget planning system. The treasury single account now includes all line ministries and the major extra budgetary funds such as health, pensions and employment.

95. Croatia has maintained a high level of transparency in government financing, supported by an effective and independent Supreme Audit institution. Croatia's audit report (annual audit of Government) is publicly available, and external audits now meet the requirements of International Organization of Supreme Audit Institutions (INTOSAI) auditing standards. A long-term development strategy formally adopting INTOSAI and developing audit tools is in place.

96. The public sector broadly complies with International Public Sector Accounting Standards (IPSAS) standards for accounting and reporting. Ministries and other budget users use a modified accrual basis where revenues are recorded on a cash basis and expenditures recognized when an invoice has been received. The Government Financial Management and Information System (FMIS) is being strengthened to include budgetary users under the Treasury's information system, supported by the Bank Strengthening Accountability and the Fiduciary Environment Trust Fund (SAFE TF). The authorities present budget plans based on the ESA95 framework, while Government finance statistics are produced on a monthly basis and available monthly on the Ministry of Finance website. Data on the operations of local governments and consolidated general government are available on a quarterly basis, but local government data are partial. Further improvements are expected in 2013, when data coverage will expand to include all local governments, railways, and shipyards' guarantees.

97. The Croatian MOF has prepared a strategy for modernization of the processes in the State Treasury. The Government is developing specific action plans across various technical areas of Public Financial Management, and the Bank will actively support the Government and ensure that this support is in line with the Government's EU accession priorities. The Bank will continue providing technical support related to the establishment of a proper fixed assets registry of the Croatian Government and to align this with internationally recognized practices and standards.

98. The Public Procurement Act⁸ which sets the legal framework for public procurement in Croatia is aligned with EU Directives. Significant measures were introduced to strengthen the institutional framework for public procurement in Croatia, for example, the Directorate for Public Procurement was established in the Ministry of Economy to coordinate the entire public procurement system; the State Commission for Supervision of Public Procurement Procedures was established as an autonomous body responsible for deciding on appeals in public procurement procedures, awarding concessions, and selecting the private partner in PPP projects.

⁸ The Public Procurement Act was adopted in 2011 and became effective in January 2012 except certain stipulations that will become effective on the day of accession.

The 2012 EC Court of Auditors assessment positively viewed Croatia as meeting the requirements and commitments in the field of public procurement and is expected to implement the *acquis* as of accession. However, further efforts are required in the implementation of the new public procurement act, especially at local level, with a view to the future management of structural funds. The fight against local-level corruption also needs to be enhanced particularly in public procurement, by establishing effective management and control systems.

99. **In the latest 2012 EC Progress Report and 2013 Monitoring Report, harmonization with the EU environmental *acquis* and capacity building is assessed positively, although additional efforts are required for the implementation.** Croatia transposed the environmental *acquis* into legislation, and it serves as a good safeguards mechanism. The governing Law on Environment, aligned with the EU environmental *acquis*, introduced strategic environmental assessment, strengthened public access to environmental information and environmental liability, and includes provisions of the SEVESO II and Integrated Pollution Prevention and Control directive. Basic Environmental Impact Assessment (EIA) competence is high and further strengthened by the adoption of the new Law on the Environmental Protection and secondary EIA, which achieved full alignment with the EC EIA Directive (85/337/EEC). Regulation on EIA introduces decentralization of EIA process transferring certain types of projects to county administrative bodies, implying need for capacity building. The Reports emphasize the need for additional attention on the quality of environmental impact assessments for all investment projects, the timely issuing of permits, and the upgrading of the Industrial Pollution Control and Risk Management installations. Sector environmental analyses are done on a regular basis by the country itself as well as the EU and are supported by contributions from the Bank and other international financial institutions.

100. **A Safeguards Diagnostic Review carried out by the Bank compared the legal and regulatory framework for environmental and social compliance with the Bank's Safeguard policy 4.00.** The review (Equivalency Analysis) found acceptable equivalence between the Croatian system and World Bank policies on Environmental Assessment (EA) and Natural Habitats. The few potential gaps, which should rarely arise, could be addressed on a case-by-case basis. The Croatian system is also fully equivalent to Bank policies on Physical Cultural Property and on Forests, and equivalent to major parts of the Pest Management and Dam Safety policies. However, the Analysis concluded that Croatia's regulatory framework is not fully in line with Bank policy on Involuntary Resettlement. Closer monitoring, and supervision of projects triggering the Operational Policy on Involuntary Resettlement (OP 4.12) is warranted.

101. **The EU has emphasized the need for strengthening administrative capacity and timely allocation of financial resources for implementing environmental *acquis* as two major challenges.** The Bank is working directly with the Ministry of Environment and Nature Protection on strengthening institutional capacity through the implementation of the EU Natura 2000 Integration Project and the GEF Adriatic Sea Environmental Pollution Control Project under preparation. Specifically, apart from the capacity building at the central ministerial level, the EU Natura 2000 Integration project is also instrumental at building the absorption capacity for EU grant resources at the county and parks level.

IV. Managing Risks

102. **The significant risks to the outcomes identified in the CPS need to be closely monitored within a flexible but active program framework.** Croatia's economy is exposed to shocks of global adjustment and European deleveraging through multiple transmission mechanisms. Moreover, delivery of the outcomes envisioned under the program will require coordination across sectors, ministries, with the private sector and among various levels of government. As achieving program outcomes naturally requires sustained efforts at policy coordination, fine tuning and implementation, the prospect and achievement of EU memberships can lead to policy complacency at a critical time, as demonstrated by other new member states in the recent past. The mid-term review of the CPS and the Progress Report will need to be thought through with a view to adapt the CPS based on the achievements of the first two years of implementation. Each risk is described in more detail. The CPS mid-term review (MTR), planned in end FY15 or early FY16, will assess the evolution of Croatia two years after accession and confirm the relevance of the CPS program.

103. **Croatia continues to be exposed to high external risks, notably affected by severe economic downturn in Europe and the world.** The trade in goods and services which accompanies Croatia's position as a gateway to Europe has been affected by the crisis, as have Croatia's traditional export industries that rely on buoyant external demand. At the same time, the shrinking balance sheets of the large European banking institutions will indirectly impact the availability of loanable funds through their subsidiaries in Croatia, particular as the level of Croatian NPLs rise. Lower FDI means less technology transfer which will in turn affect future growth. These external risks are recognized and embodied in the CPS. The WBG will monitor and engage through policy dialogue with the authorities, at the same time, innovative ways to support private sector growth opportunities are being explored through partial credit guarantees and risk sharing mechanisms to maintain commercial lending levels, particularly to competitive exporting firms, so that deleveraging does as little harm to productive firms as possible.

104. **Policy design and implementation of a program of such ambitious objectives requiring comprehensive rather than sector by sector reforms involves a high level of coordination.** Indeed, one of the challenges for any government attempting to steer the country in an agreed direction of reform is the coordination of 476 separate local governments entities in 21 counties in such a small country – have made top down implementation difficult in many areas (e.g. for hospital, court, schools, water utility rationalization). In addition, when developing effective programs to reform entitlements coupled with activities to shift employment to private sector rather than public sector activities, coordination across sectors and ministries at all levels of government is required. Currently, it is difficult to coordinate and convene different actors to comprehensively address issues. This is partially reflected in the marginally satisfactory performance of the current Bank portfolio. The Bank and Government need to remain vigilant to monitor the CPS progress. Strengthening the Joint Portfolio Review mechanisms and applying reinforced project restructuring, including partial cancellation of funds, should help mitigate the implementation obstacles. The CPS also proposes more frequent reviews of the portfolio, jointly with Government, as needed to bring the portfolio on track. Selectivity of areas of engagement in the current CPS, primarily driven by project ownership, should also alleviate the challenges of portfolio performance.

105. **There is a possibility that even upon the EU accession reforms may slow down.** Croatia's negotiations with the EU brought a significant number of difficult policy issues on the table, including institutional and structural issues, and the country struggled to pursue adequate reforms to meet the EU obligations, including major changes in the legislative and institutional frameworks related to the judiciary, agriculture and state aid. However, after a certain period of important reforms, a slowdown in the reform pace can destabilize even the earlier achievements. While Croatia has experienced delays and at times setbacks in implementing reforms, such as for shipyard restructuring or for civil service de-politicization, there is a possibility that reforms may slow down upon the EU accession, as was evidenced in the case of some other member states. Should Croatia enter the EU with weak macro fundamentals, the EC will implement a strong monitoring framework under the Excessive Deficit Procedure. Many of the Commission's mechanism to align Croatian policies to EU-related goals are broadly consistent with many of the CPS results indicators. Hence, ensuring the close collaboration and partnership with the EC will be crucial for Bank activities in the FY14-17 CPS period.

Country Partnership Strategy for FY2014-2017

Annex 1: Results Matrix

Country Development Goals	Issues and Obstacles	Expected CPS Objectives and Indicators	WBG Instruments and Partner Activities
Pillar I : Public Finance			
Theme 1: Ensuring Fiscal Consolidation for Macroeconomic Sustainability			
Increasing tax revenues while decreasing fiscal expenditures	<ul style="list-style-type: none"> • High level of public spending and of public debt • Croatia needs to improve tax compliance 	<p>1. Improving sustainability of revenue enhancing policy as indicated by:</p> <ul style="list-style-type: none"> • Improved tax gap as a percentage of total GDP <p><i>Baseline:</i> 2.7% (2012) <i>Target:</i> 2.0% (2017)</p>	<p>WBG Ongoing activities:</p> <ul style="list-style-type: none"> • ERDPL 2 • RAMP <p>Planned activities:</p> <ul style="list-style-type: none"> • Tax Administration project • DPL • Debt Advisory <p>Partners:</p> <ul style="list-style-type: none"> • EC Macro-monitoring • IMF Article IV
Ensuring sustainability of social spending	<ul style="list-style-type: none"> • Social assistance programs are not well targeted to the most vulnerable groups and a large number of categorical entitlement programs increases spending on social assistance 	<p>2. Improving the targeting of social assistance programs as indicated by:</p> <ul style="list-style-type: none"> • Means-tested programs as a share of all social assistance programs increased <p><i>Baseline:</i> 16% (2012) <i>Target:</i> 20% (2017)</p>	<p>WBG Ongoing activities:</p> <ul style="list-style-type: none"> • ERDPL2 <p>Planned activities:</p> <ul style="list-style-type: none"> • Social Protection project • DPL • Activation TA <p>Partners:</p> <ul style="list-style-type: none"> • EC

Country Development Goals	Issues and Obstacles	Expected CPS Objectives and Indicators	WBG Instruments and Partner Activities
Improving efficiency of the health system	<ul style="list-style-type: none"> Unsustainable level of health spending at 7.8% of GDP near the top for EU12 member states Inefficient hospital services and high costs of long-term care services provided by hospitals 	<p>3. Introducing cost rationalization measures in the health sector as indicated by:</p> <ul style="list-style-type: none"> Total public accrual health spending reduced <p><i>Baseline:</i> 6.6% (preliminary, 2012) <i>Target:</i> 6.1% (2017)</p> <ul style="list-style-type: none"> Further rationalization and reorganization of hospital system <p><i>Baseline:</i> 6 beds used for hospital admissions per 1000 inhabitants (2012) <i>Target:</i> 5 beds used for hospital admissions per 1000 inhabitants⁹ (2017)</p>	<p>WBG</p> <p>Ongoing activities:</p> <ul style="list-style-type: none"> ERDPL 2 Development of Emergency Medical Services and Investment Planning <p>Planned activities:</p> <ul style="list-style-type: none"> Health project DPL <p>Partners:</p> <ul style="list-style-type: none"> EC CEB
Pillar II: Competitiveness			
Theme 1: Promoting Public Enterprises Restructuring			
Enhancing the capacity of public enterprises, in railway and energy sectors, to enable faster convergence towards operational and financial performance of EU27 countries	<ul style="list-style-type: none"> Railway companies will be affected by a new market structure, reduced subsidies, and the challenge of absorbing EU funds The energy sector needs to undertake important 	<p>4. Contributing to the coherence and implementation of strategic plans in railway and energy sectors as indicated by:</p> <ul style="list-style-type: none"> Implementation of restructuring plans for railway sector companies and medium-term strategy for the rail sector consistent with the EU 2014-20 funding period 	<p>WBG</p> <p>Ongoing activities:</p> <ul style="list-style-type: none"> Railway Policy Note Croatia Energy Sector Review <p>Planned activities:</p> <ul style="list-style-type: none"> Railway Lending

⁹ Excluding day care beds

Country Development Goals	Issues and Obstacles	Expected CPS Objectives and Indicators	WBG Instruments and Partner Activities
	adjustments to become financially and environmentally sustainable as to prepare for a highly competitive EU	<ul style="list-style-type: none"> Implementation of Croatia Energy Strategy 2009-20 related to the renewable energy and district heating <p><i>Baseline:</i> Revised restructuring plans of railway companies</p> <p>Energy Strategy in place (2012);</p> <p><i>Target:</i> Railway Modal Strategy 2014-2020 and medium term contracts in place for Passenger Services and Infrastructure Management consistent with the strategy</p> <p>Action plan adopted for feed-in tariffs for renewable energy resources and for improving the efficiency of the district heating sector.</p>	<ul style="list-style-type: none"> TA for Public Enterprise Reform <p>Partners:</p> <ul style="list-style-type: none"> EBRD EC
Theme 2: Strengthening Doing Business			
Strengthening the effectiveness of judiciary as to promote enabling environment for doing business	<ul style="list-style-type: none"> Croatia still has a high backlog of court cases, above the EU average, resulting in lengthy duration of proceedings 	<p>5. Improving efficiency and reducing arrears in the judicial system as indicated by:</p> <ul style="list-style-type: none"> Case backlog in judiciary decreased 	<p>WBG Ongoing activities:</p> <ul style="list-style-type: none"> Integrated Land Administration System project

Country Development Goals	Issues and Obstacles	Expected CPS Objectives and Indicators	WBG Instruments and Partner Activities
		<i>Baseline:</i> 498,601 (2012) <i>Target:</i> 300,000 (2017)	<ul style="list-style-type: none"> Justice Sector Support project ERDPL2 Planned activities: <ul style="list-style-type: none"> TA on Public Administration DPL Partners: <ul style="list-style-type: none"> EC
Theme 3: Promoting Private Sector-Led Growth			
Increasing use of renewable sources and promoting energy efficiency – in line with Europe 2020 Strategy	<ul style="list-style-type: none"> Croatia needs to increase the share of renewable energy in final energy consumption, and achieve an increase in energy efficiency to reduce greenhouse gas emission 	6. Contributing to diversity and security of energy supply by financing energy efficiency and renewable energy projects as indicated by: <ul style="list-style-type: none"> Share of installed renewable energy resources capacity increased: <i>Baseline:</i> 180 MW (2012) <i>Target:</i> 354 MW (2017) GHG emission as tCO₂ equivalent decreased: <i>Baseline:</i> 0 (2013) <i>Target:</i> 0.32 million (2017) 	WBG Ongoing activities: <ul style="list-style-type: none"> IFC investment in a wind farm IFC financing to support renewable energy projects Planned activities: <ul style="list-style-type: none"> IFC financing renewable energy and energy efficiency projects Partners: <ul style="list-style-type: none"> EBRD EC

Country Development Goals	Issues and Obstacles	Expected CPS Objectives and Indicators	WBG Instruments and Partner Activities
Improving growth through support to the private sector, primarily SMEs and FDI	<ul style="list-style-type: none"> Croatia needs to ensure favorable conditions for private sector investments, notably for SMEs, to enhance their competitiveness 	<p>7. Supporting competitive local companies to expand in the region and increase exports as indicated by:</p> <ul style="list-style-type: none"> Level of exports of beneficiary companies <p><i>Baseline:</i> HRK 4.35 billion (2011) <i>Target:</i> At least preserve the level of exports (2017)</p>	<p>WBG</p> <p>Ongoing activities:</p> <ul style="list-style-type: none"> Export Finance Intermediation Loan IFC investments (Atlantic, Agrokor, CIOs) REPARIS <p>Planned activities:</p> <ul style="list-style-type: none"> Croatia Export Financing Guarantee Project IFC financing to export oriented companies, SMEs, private sector infrastructure investments, FDIs and regional initiatives REPARIS¹⁰ <p>Partners:</p> <ul style="list-style-type: none"> EIB CEB KfW

¹⁰ Road to Europe Program of Accounting Reforms and Institutional Strengthening

Country Development Goals	Issues and Obstacles	Expected CPS Objectives and Indicators	WBG Instruments and Partner Activities
Pillar III: EU Membership			
Theme 1: Maximizing the Benefits of EU Membership			
Preparing National Reform Program for effective use of EU Funds	<ul style="list-style-type: none"> Croatia needs to prepare National Reform Program for EU 2014-2020 programming period, and Operational Programs, as well as a number of sector strategies in support of priority project applications for financing from EU Funds 	<p>8. Improving coherence and credibility of national strategic and policy documents needed for the EU funds absorption and management as indicated by:</p> <ul style="list-style-type: none"> National strategic and policy documents, including sector specific strategies, needed for the use of EU Funds, adopted by relevant authorities <p><i>Baseline:</i> no documents in place (2012) <i>Target:</i> Sector strategies adopted: (i) National Education, Science and Technology Strategy; (ii) National Innovation Strategy; (iii) Research and Innovation Strategy for Smart Specialization; (iv) Policy advice/recommendations in the areas of irrigation, rural development, transport, SME and water/environment sector; (v) National Technical and Economic Study for Management of Wastewater Treatment Sludge (2017)</p>	<p>WBG</p> <p>Ongoing activities:</p> <ul style="list-style-type: none"> EU Preparedness TA Public Finance Review EU Natura 2000 Integration Integrated Land Administration System Science and Technology 2 <p>Planned activities:</p> <ul style="list-style-type: none"> EU Water sector compliance Project <p>Partners</p> <ul style="list-style-type: none"> EC
Strengthening capacity of public sector for the absorption of EU Structural Funds	<ul style="list-style-type: none"> Croatia needs to improve the capacity to prepare full-scale projects for funding, and public investment management of the 	<p>9. Contributing to Croatia's readiness and capacity to build the project pipeline for absorbing EU Funds in selected sectors as indicated by:</p>	<p>WBG</p> <p>Ongoing activities:</p> <ul style="list-style-type: none"> EU Preparedness TA

Country Development Goals	Issues and Obstacles	Expected CPS Objectives and Indicators	WBG Instruments and Partner Activities
	EU-funded project	<ul style="list-style-type: none"> Number and value of project applications prepared and/or submitted for financing from EU Funds in research and innovation and nature protection <p><i>Baseline:</i> no project proposals (2012) <i>Target:</i> (i) At least 6 project applications for financing in research, development and innovation sector, for the total value of projects amounting to € 50 million; (ii) At least 25 project applications for financing in the nature protection sector, for the total value of projects amounting to € 50 million (2017)</p>	<ul style="list-style-type: none"> Entire WB portfolio <p>Partners</p> <ul style="list-style-type: none"> EC

Annex 2: Country Partnership Strategy Completion Report for FY09-FY13

Date of CPS: September 30, 2008 - Date of CPS Progress Report: September 19, 2011

1. **The Country Partnership Strategy (CPS) was prepared in the midst of Croatia's negotiations for European Union (EU) membership, and right before the financial crisis hit the country.** The stable growth that Croatia enjoyed in the years prior to this CPS, averaging four percent, was discontinued at the end of 2008. Increasing economic decline continued during the CPS period, at the end of which Croatia hit the fourth year of recession. This setting was at times aggravated by an uneven and lengthy EU accession process. After almost six years, Croatia closed the negotiations in June 2011 and signed the accession treaty that December, which led to a positive outcome of the EU entry referendum. Croatia now expects to become the 28th EU member state in July 2013. Therefore, the World Bank and the Government agreed to extend the current strategy by one year so that the next CPS is aligned with country's first four years of membership¹¹.

Overview of Program Achievements

2. **The CPS was centered on Croatia's goal of joining the EU, with a flexible program that was rapidly adjusted when the crisis broke out.** The program was set to help accelerate Croatia's income convergence with those of other member states. It envisaged \$300 million of annual lending under a base case scenario of investment loans, with a provision for possible development policy loans (DPLs), under an 'upside' lending scenario of about \$400 million per year. As the crisis hit, about half of the Bank's total lending of \$1.1 billion went to budget support. The two DPLs responded to Croatia's evolving financing needs and supported the Government's Economic Recovery Program. The first single-tranche DPL addressed most urgent short-term measures through rationalized public expenditures and strengthened crisis management and financial sector regulation, while the Economic Recovery DPL supported the medium-term reform efforts for fiscal consolidation and fostering private sector growth. Moreover, a \$202 million line of credit for exporters through the Croatian Bank for Reconstruction and Development (HBOR) were added to the program and helped private sector companies maintain their export levels and workforce.

3. **Through partnership with Government and EU stakeholders, the CPS assisted in preparing Croatia's public sector institutions to assume EU membership.** The lending program funded many activities required to close some of the EU negotiations chapters. In agriculture, the institutions and systems have been set and capacitated to implement the Common Agricultural Policy and use the EU funds, and specialized agencies were equipped and aligned with the EU agricultural and rural development requirements¹². In judiciary, several projects helped improve the efficiency of the sector, through reduction of case backlog, upgrading the land registry and cadastre systems, and improving the efficiency and

¹¹The extension of the CPS that originally covered FY2009-2012 by one year has been agreed upon through an exchange of letters.

¹²Under *Agricultural Acquis Cohesion Project (AACP)*.

transparency of courts¹³. Further, the Bank-funded activities helped transpose EU legislation, capacitate the public institutions for absorption of pre-accession and post-accession funds, and made direct investments in EU-required infrastructure in particular in the environment sector.

4. **Against the challenging context of the crisis and uneven reform pace, the achievements made under this CPS are assessed as *moderately satisfactory*.** The program proved to be very relevant to country goals and achieved most critical CPS objectives to a good extent. These objectives helped the Government address key priorities, in particular maintaining macroeconomic stability in the context of a severe crisis and closing the EU negotiations. Croatia initiated the fiscal consolidation through a strengthened legislation framework, rationalization of expenditures and reduction of arrears. It improved the efficiency of the social sectors, with reduction of pension costs and reduced health spending, while initiating better targeting of vulnerable groups in the social welfare sector. Though some CPS outcomes were not fully achieved, due to the crisis and as a result of project implementation delays, most major outcomes were met. Demanding requirements for Chapter 23 on Judiciary and Fundamental Rights were substantially met. Croatia has been implementing the judiciary reform measures with continued success and steady improvements in efficiency indicators, and has, among other, reduced a significant case backlog. Finally, a substantial alignment with the EU was among achieved CPS outcomes, such as in the agricultural and environment sectors.

Progress towards Croatia's Development Goals

5. **Severe economic decline and the country's strong commitment to the EU accession have marked the CPS period.** This environment has not only shaped Croatia's priorities but it also dictated its political context. On the one side, attending to the EU accession goals required a laborious approach in meeting the EU *acquis communautaire* requirements to close all the benchmarks. Even if the bulk of the work was carried out by the governing administration, the opposition was on board, through the parliamentary work, and in particular as it was heading the parliamentary committee for tracking the progress of EU accession negotiations during the 2008-2011 parliamentary term. Political parties remained united around the European goal and shared its accomplishment. In parallel to this essentially administrative work, Croatia was expected to prepare its public and private sector to face a highly competitive EU economy with income levels much higher than its own. This required a different kind of political and public consensus, around major reforms. However, a fierce financial and economic crisis caught Croatia largely unprepared and the convergence and competitiveness goal was swiftly replaced by a crucial need to maintain macroeconomic stability and protect those most affected.

6. **The authorities succeeded to maintain the country's macroeconomic stability throughout the prolonged recession.** With Croatia's high external debt, reliance on tourism sector and exports to Europe, the authorities undertook rapid economic recovery measures to prevent further deterioration. Croatia's convergence gap with EU 27 widened by about 3 percent since the 2008 crisis and the country has lost 10 percent of its output. The

¹³Under *Real Property Registration and Cadastre Project (RPRCP)*, *Integrated Land Administration System (ILAS) Project*, *Programmatic Adjustment Loan (PAL)*, *Fiscal, Social and Financial DPL (FSF DPL)* and *Economic Recovery DPL (ERDPL)*.

Government adopted the Economic Recovery Program in April 2010 to redefine the role of the state through fiscal consolidation, public administration reform, restructuring of loss-makers, and privatization, as well as to support economic recovery through judicial and labor market reforms and removing bottlenecks to investments. Rationalization measures were taken in pensions and other social sectors, while mitigating the effects on the most vulnerable, and the parliament approved a spending freeze in 2011 and 2012, keeping it constant at 2010 level. While fiscal policy in 2011 contained negative consequences of the recession, the consolidation continued in 2012 under the framework of the Fiscal Responsibility Act. The 2012-2014 budget managed to reduce the general government fiscal deficit to preliminary 3.8 percent in 2012. The deficit reduction was achieved through spending cuts of 1.5 percentage point of GDP.

7. In 2012, the Government adopted a Structural Reform Matrix to support macroeconomic stability and recovery. The Government's objective to ensure sustainability of public finances and regain the confidence of investors, together with restoring the credit rating remains a priority, especially since the crisis in the euro area has affected the recovery prospects. Moreover, the authorities recognized the need to accelerate structural reforms to stimulate recovery and growth. The Structural Reform Matrix aims to: (i) secure macroeconomic stability through improved fiscal governance and sector spending reforms; (ii) strengthen government effectiveness and the rule of law; (iii) adjust labor market conditions; and (iv) strengthen competitiveness and innovation, by reducing the administrative barriers, promoting R&D agenda and finalizing the privatization. The implementation however may prove difficult given that some of the affected groups have expressed opposition to the reforms.

8. On the EU accession front, Croatia made two major accomplishments – progress in judiciary and anticorruption reforms and meeting the requirements of the competition policy. The EU's endorsement of the implementation pace and results achieved under the justice reform led to a conclusion of EU talks. Major changes were undertaken as part of the implementation of 2008 and 2011 Judicial Reform Strategies, ranging from the legislation framework reform, the rationalization of the judicial network, improved efficiency of the judiciary, to the strengthening of human resources planning and management. Institutional overhaul of the judiciary sector took place, with reforms of the State Judicial Council and State Prosecutorial Council, which resulted in an improved independence, accountability and professionalization of the judiciary. With regard to the fight against corruption, an adequate legal and institutional framework was put in place, and Croatian judiciary raised and processed high corruption cases, including prosecuting former high level Government officials or business executives. The EC's Monitoring Report of March 2013 acknowledges continued good track record of implementation of the anticorruption cases and that the law enforcement bodies remain pro-active. Finally, Croatia also met the EU requirements for the competition policy. This process was confirmed by a positive opinion of the European Commission related to privatization and/or restructuring of the three large state-owned shipyards that were facing problems and losses over the past decade.

Highlights of Progress in Achieving CPS Outcomes

Sustaining Macroeconomic Stability

9. Croatia managed to contain its macroeconomic stability in the context of its fourth year in recession. After revenue fall during the global crisis, which led Croatia's

deficit to surge to above 5.0 percent of GDP in 2010 and 2011, the Government managed to address large fiscal imbalances. General government deficit is preliminary at 3.8 percent of GDP for 2012, due to increased revenues (VAT increase and improved tax compliance) and reductions in subsidies, maintenance and capital spending. The Bank's *Fiscal, Social and Financial Sector DPL (FSF DPL)* supported short-term fiscal consolidation efforts, by reducing the wage bill, general government investment, health sector arrears and pension spending, while maintaining adequate spending on unemployment benefits and increased means-tested social support allowance to mitigate the social impact.

10. Croatia's fiscal sustainability is improved through expenditure-based consolidation in pension systems and health spending. Supported by the *Economic Recovery DPL (ERDPL)*, the Government reduced the privileged pensions by 20 percent. Privileged pensions for government officials were abolished, and rationalized for military employees. Administrative costs of the second pillar were reduced in 2010 and 2011 through a reduction of mandatory pension funds' asset management fee from 0.75 percent to 0.45 percent. Progress was made in rationalizing the health spending through a number of measures including streamlining pharmaceutical spending and decreasing co-payment exemptions by 36 percent.

11. Reforms in tax administration, with improved tax compliance and tax collection contribute to enhancing efficiency of public finances. Most importantly, Croatian Tax Administration improved the tax compliance from 84 percent to 87 percent between 2007 and 2011. The e-taxation increased significantly from 8 percent in 2010 to 52 percent in 2012. The Tax Administration has improved its business processes, and focuses on clearing the tax arrears. The new tax arrears have been slightly reduced each year. Under the *Revenue Administration Modernization Project (RAMP)*, the Large Taxpayers Office (LTO) has been established as a separate unit, to focus its efforts on large taxpayers that represent some 600 entities covering about 46 percent of taxes and contributions, and this is expected to further increase tax compliance.

Improving the Outcomes in Social Sectors

12. Croatia initiated reform measures to improve the efficiency and quality in the social assistance system, though a substantial agenda remains. During the crisis, the Government simplified the different social protection programs at central and local levels to enhance administrative efficiency. The Bank's analytical work *Social Impact of the Crisis and Building Resilience*, the support by the *ERDPL* and the *Social Welfare Development Project (SWDP)*, informed these measures as well as a new Social Welfare Law, introduced to reduce social exclusion and improve targeting and efficiency. The policy dialogue under the proposed *ERDPL 2* is assisting the Government in conceiving a major overhaul in the social safety nets, starting with reinforcing the means-testing for major social benefits programs. The management information system, built under *SWDP* and recently adjusted, is currently used for data exchange among various institutions and means-testing of all social benefits in the centers of social welfare in Zagreb.

13. Performance of the education system was substantially improved, through strengthened institutions and improved management. Under the *Education Sector Development Project (ESDP)*, a new curriculum framework for pre-school, primary and secondary schools was developed, allowing the teachers a more adaptive approach in the classroom. Establishment of the national center for external evaluation and successful introduction of a school exit exam – matura at the end of secondary school are important

measures in getting towards improvement of student learning. Croatian students score slightly below OECD countries in PISA, but subtle improvements are noticeable in matura results between 2010 and 2011. Croatia managed to reduce the number of triple-shift schools, and it strengthened its education sector management and planning tools; still more work is ahead in ensuring systemic and regular training for advancing the teachers' skills, critical to influence the students' learning results.

Promoting Private Sector Growth and Convergence

14. **Croatia's progress in creating an enabling environment for the private sector has been partial and more systemic reforms are needed.** Reforms in public administration, which are considered essential in creating conditions for private sector-led growth, have been delayed and the administration costs for society are high compared to the quality of services delivered. The policy changes made towards professionalization of the civil service, supported through *Programmatic Adjustment Loan 2 (PAL2)*, aimed at nurturing a competent and professional civil service, were reversed in 2012, except for the positions of secretary general in ministries and deputy director of smaller state administrative organizations. Long-delayed improvements in human resources management system were initiated under the *ERDPL*, which supported establishment of the central payroll and HR registry that improved the management of budgetary resources. The project also supported amendments to the Civil Service Law to strengthen the appraisal system and help retain the highly skilled in public administration. However, reforms that would introduce a performance-based remuneration system are postponed and remain difficult, constrained by high opposition from the trade unions. Notwithstanding, the Government made decisive steps to harmonize the salary system among various administrative bodies and entities in public administration, which represents progress towards establishing 'equal pay for equal job' principle among jobs with similar complexity and competences across the administration, regardless of the legal status of the entity.

15. **In the judiciary, Croatia achieved substantial progress in improving efficiency and reducing the court case backlog.** The EU negotiations were an important engine for keeping the pace in pursuing the judicial reforms. Under the *ERDPL*, the Government launched a major enforcement system reform, which succeeded to reduce a large case backlog and removed enforcement of uncontestable cases away from judges. The reduction in court case backlog was also supported by *PAL2*, the *Real Property Registration and Cadastre Project (RPRCP)* and continued under the ongoing *Integrated Land Administration System Project* and *Justice Sector Support Project (JSSP)*. *RPRCP* helped reduce the backlog in land registration by 80 percent. The EC's last Monitoring Report of March 2013, acknowledges this major achievement, stating that in 2012 the courts succeeded to resolve more cases than the influx. The *JSSP* supports these efforts through upgrading the Integrated Case Management System, designed to generate data analytics on performance of various judiciary indicators, and has helped establish the system of court and justice performance indicators, thus increasing the accountability and transparency of judicial system.

16. **Progress on privatization has been made, while the measures taken to improve business environment are not yet effective.** Overall, administrative barriers continue to hinder businesses and are considered as a critical obstacle for foreign and domestic investors. However, the Government took measures to liquidate state-owned enterprises, while the restructuring of shipyards was addressed as part of the EU chapter on Competition. Under *Trade and Transport Integration (TTI)* and *Rijeka Gateway (RG)* projects, the state also continued to decrease its ownership in the two strategic ports, in Ploce and Rijeka, and

secured private sector investments for operation of port terminals through concession agreements. Steps have been taken to eliminate investment barriers by simplifying the business registration and reducing its cost, under *ERDPL*, and legislative changes are in process to abolish the location permit and establish e-construction permit. *Real Property Registration and Cadastre Project* and *Integrated Land Administration System (ILAS) Project* supported reductions in transactions processing time and harmonization of data in land registry and cadastre with the situation on the ground. Still, further decisive measures and a more systemic approach are needed to make a full and visible impact on the ground.

17. Croatia made good progress in the R&D sector in promoting cooperation between research institutions and industry, albeit with still low levels of R&D spending. Under the *Science and Technology Project (STP)*, major R&D institutions in Croatia were able to commercialize research results, through patenting, research contract, spillovers and license agreements, concluded for instance with the Massachusetts Institute of Technology and Brown University. This has brought knowledge institutions closer to the business sector and opened the opportunity for cooperation of researchers and the business sector, which was earlier seen as contentious. It also mobilized private sector R&D through participation in R&D financing for innovative SMEs, which increased the share of SMEs with new or improved products¹⁴. R&D financing thus contributes to the higher-level objectives of increasing competitiveness of Croatian firms and integration with the EU. As Croatia intensified the preparations for the EU Funds, *STP* helped leverage about EUR40 million of IPA and other EU funds in R&D. While the paradigm of R&D expenditures share between the public and private sector is no longer so prominent in the EU, the overall R&D expenditure levels of 3 percent of GDP per Europe 2020 Strategy remain. Croatia will thus need to increase its R&D spending levels from current only 0.8 and the EU funds present an important opportunity for this endeavor.

18. During FY09-12, IFC was largely supporting the local companies in increasing competitiveness, with a focus on green energy and long-term funding. IFC has invested \$194 million in Croatia supporting the local companies to become more competitive and expand in the region, while promoting green energy. Together with syndication partners, IFC promoted generation and use of green energy in Croatia through its EUR 55 million financing of a 43.7 MW green-field wind power plant near the city of Sibenik, sponsored by RP Global, Austria. Through its EUR40 million investment to CMC Sisak, IFC helped post-privatization restructuring of the company and supported it to strengthen the supply chains and improve environmental standards. To support investors with much needed long-term funds for infrastructure projects during the crisis, IFC, through its Infrastructure Crisis Facility, committed about \$70 million in Croatia. In FY13, given deleveraging of European banks and overall low international capital flows to Croatia, IFC substantially increased its program in the country. As of May 2013, IFC has invested about \$100 million and is expected to invest \$83 million more by the end of this fiscal year. Through its financing IFC is supporting local companies to be more competitive and increase exports, helping Croatia to improve diversity and security of energy supply, and supporting infrastructure privatization project (Zagreb airport).

19. IFC has also invested in three regional projects in the Western Balkans, including in Croatia. These were: (i) EUR 25 million equity investment in Triglav, the

¹⁴ EU Community Innovation Survey

largest insurance company operating in the Western Balkans; (ii) EUR20 million loan to Scholz, a regional leader in metal scrap recycling industry, to help the company in its regional expansion and enhancement of its E&S standards; and (iii) EUR126 million to Gorenje, a regional household appliance manufacturer in the Western Balkans. Finally, IFC financed EUR40 million loan to Frikom, Croatia Agrokor's ice-cream and frozen food subsidiary in Serbia, for investments in new processing and cooling equipment, storages and fruit and vegetable farms.

Supporting Long-Term Development

20. **Croatia is making good progress in aligning its environmental agenda to EU requirements.** As part of the EU accession agreement, Croatia needs to increase the water supply coverage, the quality of wastewater services and maintain the coastal waters quality in line with EU standards. The *Coastal Cities Pollution Control Project (CCPCP)* helped establish the monitoring program of seawater quality, and reduce the waste load in the Adriatic Sea directly connecting about 220,000 people to wastewater network. This project was the first in a programmatic¹⁵ series designed to maintain the quality of coastal water at current high level, meeting the EU standards. The *Inland Waters (IW) Project* has supported wastewater investments in inland municipalities, but also helped analyze the institutional options in water supply and wastewater sector, which will be essential to pursue the agglomeration of the water and sewerage utilities in line with the EU water directives. The project supported preparation of documentation needed for the project applications to absorb future EU funds, which is considerable given that estimated investments that Croatia needs to undertake in the environmental sector amount to EUR 3 billion. In nature conservation, Croatia will have to meet the requirements of the Birds and Habitats Directives, the EU's main legal instruments for biodiversity protection. The ongoing *EU Natura 2000 Integration* project has assisted Croatia to implement Natura 2000 (EU network of protected areas) objectives in investments and strengthen capacity for EU-compliant reporting and biodiversity monitoring.

21. **In agriculture, Croatia made good alignment with the EU *acquis communautaire*.** The *Agricultural Acquis Cohesion Project (AACP)* supported EU accession negotiations in agriculture, representing one of the most challenging chapters. The project helped the Government build the institutional capacity and strengthen the management and information systems for implementation of the EU Common Agriculture Policy and the use of pre-accession and post-accession funds. From supporting the establishment of the EU Paying Agency, and developing the capacity of the Croatian Food Agency to apply EU *acquis* procedures, to building the land parcel information system and upgrading the veterinary institutes, these efforts were closely linked with the Chapter 12 benchmarks, until the EC reaffirmed a satisfactory level of harmonization with EU requirements.

World Bank Performance

Program Performance Rating

22. **The report assesses the Bank's performance as *moderately satisfactory*.** The Bank was successful in setting the design of the strategy, its relevance and alignment with country development goals - the EU accession efforts. It has remained well-positioned during the

¹⁵ Adaptable Program Lending for *Coastal Cities Pollution Control*

country's EU negotiations phases in assisting these efforts through policy advice, technical assistance, capacity building and project preparation. The flexibility to respond to the Government's request at the time of the financial crisis was also adequate. The less successful aspect of design was an ambitious results framework and lack of mechanism to monitor the achievement of CPS objectives. In spite of that, a solid program was delivered and a proactive monitoring of project implementation led to good progress in achieving most major results envisaged. The Bank has also succeeded in building a good partnership with the new Government and agreeing on a solid program of ongoing activities for the next strategy period.

Design

23. The CPS focused on two challenges: (i) completion of the EU accession process and (ii) convergence of the country's income levels with that of EU member states. The first challenge was to assist in compliance with increasingly complex EU requirements, ranging from institutional and legislative harmonization, to investments, and capacity for management of EU funds. The Bank and the Government identified most critical EU areas among the CPS priorities, notably, judiciary and agriculture, environment and competitiveness. The second challenge, focused on addressing structural reforms, had a twofold agenda. The first was to improve the public finance and address selected inefficiencies in the public sector, including social sector, public administration and judiciary. The other tackled the enabling environment needed to kick off the growth generated by the private sector. The convergence objective was supported through policy lending and a series of investment operations in selected sectors. Analytical work complemented the policy lending and helped prepare grounds for new legislation, such as the new Fiscal Responsibility Act¹⁶.

24. A flexible design of the CPS allowed the Bank to make timely program adjustments. At the peak of the crisis, the Government sought Bank financing to help mitigate the impact of the crisis. A \$300 million single tranche DPL was approved in FY10, and a \$213 million DPL – the first in a programmatic series – was added to the program in FY11, in support of the Government's economic recovery measures. A financial intermediation loan to HBOR helped the exporting private companies strengthen their long-term business opportunities, and ride out the crisis. The project disbursed the majority of funds in less than three years, and in a context of a prolonged recession, HBOR sought additional funding. Hence a \$67 million loan was approved to HBOR in FY13. The Bank and HBOR are currently discussing support to the real economy through a guarantee operation to support HBOR's future bond issuance.

25. The Bank remained less intensively engaged in several specific areas where commitment to reforms proved difficult over the earlier CPS. These areas include public administration reform, railways and shipyard restructuring, as well as the energy sector. The first two areas had proven extremely difficult to address without full political commitment. The Bank's engagement in these areas was limited to the activities supported through policy lending, and recent re-engagement on the *Railway Policy Note* with the new Government. The Bank opted to discontinue the engagement in the energy sector, upon completion of several smaller scale projects, as there was no interest to undertake major reforms needed to

¹⁶ Under *Fiscal Responsibility Framework Policy Note*. *Labor and Pension Policy Notes* have provided impetus for the new government to launch the labor and pension reform supported under the *ERDPL2*.

sustain the systems. However, the engagement with the current Government, and the challenges posed by the need to increase the country's competitiveness as it becomes an EU member have opened discussions on all three fronts – indicating possible future engagement through knowledge and advisory activities.

26. The CPS results matrix reflects well the strategic program objectives and enables the Bank and the Government to assess the impact of Bank interventions. Originally consisting of 19 CPS outcomes, the results matrix was revised at mid-term to reflect major restructuring of several projects. This included reformulation of outcomes and/or downsizing of some of the targets that were assessed as overly ambitious. Several outcomes were split as they were considered overly complex or dropped as the interventions did not materialize. This revision could have been taken to a further step because some of the outcomes remained complex, and few could not be directly influenced by Bank projects (for instance, increase in R&D spending by private sector or as a share of GDP, or improving agricultural productivity). A more selective approach and fewer CPS outcomes are advisable and would facilitate monitoring of the progress. Overall, majority of outcomes are clearly linked with country's objectives and the Bank interventions are able to influence them.

27. The CPS risk analysis was appropriate and identified three critical areas – external vulnerability, public administration capacity and uneven reform pace. High external debt and deficit levels left Croatia prone to unfavorable external developments, and its economy was severely affected by the global crisis. The capacity of public administration to prepare projects and carry out the implementation in a timely manner has been challenged throughout the CPS period. In recent years, the Bank-funded projects have been facing a paradox. The projects directly linked with the EU agenda are attended to with close care. However, the EU negotiations requirements were highly demanding and meeting all the benchmarks for opening and closing the chapters naturally took precedence. Moreover, high pressure and constrained timetables related to the absorption of EU funds, which are mostly grants, often consumed the capacity of Croatia's public administration, affecting the implementation of Bank-financed projects. With respect to the reforms, a slow pace continued throughout the CPS period in spite of the urgency, though this was to an extent mitigated by the EC's monitoring of Croatia's reform efforts and the Government's fiscal consolidation plans.

Implementation

28. IBRD portfolio has been gradually decreasing towards a more focused and selective program. The portfolio was at its peak in 2009 with commitments of \$1.2 billion for 19 projects. Upon accession, about EUR 1.9 billion per year, mostly grants, will become available to Croatia in 2014-20 period, through EU Funds. This prompted the Bank and the Government at CPS mid-term to become more selective with traditional IBRD financing. Current commitments of about \$900 million are expected to be further downsized over the next two years.

29. Progress in project implementation has been uneven and this was addressed through project restructuring and regular annual portfolio reviews. Overall, about half of the projects in the portfolio have been performing in a satisfactory manner and several projects have faced mild to serious problems. In recent years, four projects closed with unsatisfactory outcomes, and one more was assessed as unsatisfactory by IEG. Annual joint portfolio reviews (JPR) revealed that projects experienced problems due to poor project readiness and insufficient capacity at start up, ending up with very low disbursement over the

first two years. The Ministry of Finance has taken on a stronger coordinating role in identifying and resolving the bottlenecks, through the JPR process. Following an in-depth review in 2009, restructuring became essential to returning the projects on track and at times involved partial cancellation and changes to project development objectives. In recent years, the Bank and the Government applied more rigorous implementation readiness criteria for new Bank-funded projects, including ensuring that monitoring and evaluation frameworks are in place. Taking advantage of project preparation facilities also improved the portfolio performance. The upcoming 2013 JPR will address the portfolio performance strategically, focusing on problem projects, with a view to informing the design and the program of the new CPS.

30. **As a result of the mid-term review, the Bank adjusted the lending program by adding three new loans and several advisory activities to the program.** The Integrated Land Administration System Project (approved in FY12) supports further modernization of the land administration and the spatial data infrastructure in line with the EU's INSPIRE Directive. Additional Financing for the *Trade and Transport Integration* project (approved FY12) focused on improving the port competitiveness along the EU corridors. This project has a regional relevance as the port of Ploce is equally important in serving Bosnia and Herzegovina, and indirectly other countries in the region. A third project, follow up to the Science and Technology project will support Croatia's R&D institutions to prepare for the use of EU Structural Funds. The analytical work after the mid-term focused on selected policy areas that await Croatia post-accession and priority economic challenges. *Croatia Policy Notes: A Strategy for Smart, Sustainable and Inclusive Growth* facilitated the engagement with the new Government and envisaged three directions consistent with the policy program of the new Government, notably: fiscal consolidation, structural reforms and maximizing the benefits of EU membership. The *Policy Notes* were a useful instrument to connect with the Government that came into office in late December 2011, and confirm the continuation of the ongoing and planned program.

31. **In the last year of CPS implementation, the program started to gradually transition from a project to knowledge based partnership.** This should further align Bank activities with the EU policy agenda and increase synergies, while facilitating the management of a smaller Bank portfolio. Besides the proposed Second Science and Technology Project and a guarantee operation with HBOR, the Bank and the Government are preparing the Second Economic Recovery Development Policy Loan. *Public Finance Review*, *Railways Policy Note*, *EU Preparedness Technical Assistance*, and *Higher Education Technical Assistance*, which are currently in progress, are at the core of this knowledge-based partnership. They focus on major post-accession challenges Croatia will face, from improving its access to markets and competitiveness, through expenditure rationalization, to increasing the opportunity to efficiently absorb a new major source of financing, the EU Structural Funds. For instance, the *Railways Policy Note* helped inform the restructuring plans of railway companies. As the transition proceeds, it will be important to integrate the monitoring and evaluation of the knowledge products, in addition to lending. The annual reviews that are jointly led by the Ministry of Finance and the Bank could be a suitable instrument and an opportunity to establish regular monitoring of the future CPS outcomes with Government.

Key Lessons for the New CPS

32. **CPS program alignment with the EU accession objectives was critical for achieving envisaged program objectives and initiating the country's reform program.** High relevance of the CPS program, designed around Croatia's EU goals, is reflected in good achievement of CPS objectives that directly helped fulfill the country's EU benchmarks and negotiations requirements. On the economic front, the EC's annual Progress Reports and the Pre-Accession Economic Program (PEP) helped Croatia formulate and monitor the progress towards accession. Therefore, designing the policy lending as integral part of the PEP, and aligning the core CPS outcomes for macro-stability around the same objectives, was an appropriate approach.

33. **Overall, CPS design was adequately flexible, which helped mitigate somewhat the ambitious CPS objectives.** A flexible structure allowing timely modifications, for instance with the outbreak of the crisis, should be continued and even scaled up in Croatia's evolving EU context. Equally, the Bank should be realistic in assessing the objectives that it can influence. For instance, the Bank has acknowledged that fiscal consolidation is a medium-term process and the policy actions supported by the DPLs, with clear indicators and targets, are a small step in the process, which is likely to take several years. This lesson was applied during the CPS, with adequate shift made to a programmatic support through the *ERDPL*, which also supported the Government's economic recovery program (ERP) in the context of the global crisis. The Government and the Bank are recognizing the challenges for achieving the fiscal consolidation efforts over the medium-term, and the Bank is likely to stay engaged in support of these efforts.

34. **Monitoring and evaluation of specific CPS objectives, rather than deliverables, would be beneficial in evaluating the program's contribution to country objectives.** The CPS did not envisage a specific mechanism for monitoring the progress of achieving the program's objectives. This is regrettable especially in light of the Government's mandatory annual review of portfolio financed from International Financial Institutions, which could have been used as a platform to assess the progress of CPS objectives. While the Bank and the Government were tirelessly applying the EU agenda criteria whenever reviewing the options of new engagement and instruments, this has not been applied to specific CPS objectives. Hence, the mid-term review of the CPS remained the only tool to verify the progress in achieving the objectives and reviewing its relevance to country goals.

35. **Pressures on time and demand for intensive EU negotiations process and requirements were heavy, absorbing the public administration resources.** Public administration's capacity to prepare and implement projects remains vulnerable, as reflected in implementation constraints that the portfolio experienced throughout the CPS period. The projects closely linked to achieving the EU agenda displayed highest ownership, albeit they also experienced difficulties in implementation. With Croatia's upcoming opportunity for the use of major EU post-accession funds, the pressures on the administration to absorb these funds efficiently will be naturally increasing. Therefore, the Bank initiated a shift in its program at the time of the CPS mid-term to focus its support on improving capacity for the management of future EU funds.

36. **The EU focus as key criterion for engagement should be complemented by increased selectivity in intervention areas, and building on existing engagement, where appropriate.** The pressures on administration and absorption of EU funds also imply more

selectivity with respect to traditional Bank financing instruments and more selective program objectives. While constant alignment with the evolving EU agenda has been endorsed, the impact of Bank-funded activities is usually more significant in the areas where continuous engagement has been ongoing. Follow up projects and additional financing not only entail that implementation setup is in place, but also that trust is established as a prerequisite for successful cooperation.

37. There is a close correlation between project performance and project implementation readiness. Several projects experienced chronic implementation delays due to poor preparation, resulting in multiple extensions of closing dates and delayed achievement of project objectives. Applying stricter implementation readiness criteria and using project preparation advances (PPAs) have proven useful to avoid this. In general, the PPAs have been very well absorbed, helped familiarize the implementing bodies with World Bank policies and procedures and improved project ownership. One of the tools for spotting the problems early on is using the monitoring and evaluation (M&E) systems properly. Many projects were approved without adequate monitoring and evaluation (M&E) system, with inappropriate indicators or missing baselines long into the mid-term of project implementation. The quality of M&E systems should be assessed as a rule as part of project readiness, otherwise the assessment of project progress and final evaluation of objectives are compromised.

38. Another systemic issue that adversely affected the portfolio performance is related to implementation of information systems. Several projects experienced problems with information systems, which use ICT solutions for developing country-wide systems such as tax system, land registry system and judicial case management system. Such systems are increasingly used to support many different business processes or functionalities, including governance issues; however, their complexity is often underestimated both by the borrower and the Bank teams. Inadequate preparation and involvement of relevant experts and stakeholders early in the design stage are part of the problem, whereas the real difficulties start already with contract implementation. In most cases, the users lack the capacity to supervise implementation adequately, which results in delays, increasing the costs and functional shortcomings. To prevent this, assessing the users' capacity to absorb, maintain and manage such systems is needed at the project preparation stage, with its design and preparation of procurement taking place in the first year of project implementation at the latest.

Attachment 1. Summary of CPS Program Self-evaluation				
Country Develop. Goal	CPS Outcomes	Status of CPS Outcomes and Evaluation Summary	Lending and Non-lending Activities	Lessons for the new CPS
I. Sustaining Macro-Stability				
Enhancing the efficiency and effectiveness of public finances	<ul style="list-style-type: none"> Further fiscal consolidation as per the Government's program to contain general government deficit from 2.5 percent of GDP in 2008 and its peak of 5.8 percent of GDP in 2011 to below 5 percent of GDP in 2012.¹⁷ Improved tax compliance rate from 84 percent in 2007 to 87 percent in 2011. 	<ul style="list-style-type: none"> ACHIEVED - Fiscal consolidation efforts were supported continuously through PAL2, SFS DPL and ERDPL. Revenue fall during the global crisis led the deficit to surge to over 5.0 percent of GDP in 2010 (from 2.6 percent in 2007), and 2011. In 2012, the new Government reversed the trend and general government deficit stood at preliminary 3.8 percent of GDP in 2012, thus achieving the revised CPS target. This is due to increased revenues as a result of improved tax compliance and VAT increase, and some reductions in subsidies, maintenance and capital spending. The 2013-15 budget projects a slower trend, setting the deficit at 4.1 percent of GDP for 2013 and 3.0 percent for 2015. Progress made in improving enabling environment with adoption of Fiscal Responsibility Act aimed at reducing spending, supported through Fiscal Responsibility Framework Policy Note. ERDPL 2 supports amendments to the law to strengthen the role of the Fiscal Board (under way). Arrears were reduced by 0.3 percent of GDP from 1.1 percent in 2007 to 0.8 percent in 2010 and 0.6 percent in 2011. ACHIEVED – Target for tax compliance rate achieved, at 89 percent in 2011, as supported through RAMP, including additional indicators: E-taxation increased to 52% in 2012 (target was 20 percent) since introduction in 2007 (from 7.7 percent in 2010). Tax arrears reduced by 22% from HRK 31.8 billion in 2006 to HRK24.65 billion in 2012. RAMP facilitated institutional reorganization of Tax 	<p>Lending - Ongoing</p> <ul style="list-style-type: none"> Revenue Administration Modernization Project (FY07); ISR: MU/MU¹⁸ <p>Lending - Closed</p> <ul style="list-style-type: none"> PAL2 (FY07-09); ICR: MS Fiscal, Social & Financial Sector DPL (FY10); ICR: S Economic Recovery DPL (FY11); ISR: S/S <p>AAA</p> <ul style="list-style-type: none"> Public Administration Reform Support TA (FY09) Institutional Framework & Fiscal Risk Assessment for PPP (FY10) Fiscal Responsibility Framework (FY11) Croatia Policy Notes: A Strategy for Smart, Sustainable and Inclusive Growth (FY12) Justice Sector Public Expenditure and Institutional Review (FY13) <p>Regional AAA</p> <ul style="list-style-type: none"> Performance-Based 	Fiscal consolidation is a medium-term process and the policy actions supported by DPLs, with clear indicators and targets, are a small step in the process, which is likely to take several years. Hence, a flexible CPS adequately shifted to a programmatic support through the ERDPL, which also supported the government's economic recovery program (ERP) in the context of the global crisis.

¹⁷ Outcome revised at mid-term review; original wording: "...to reduce general government deficit from 2.3 percent of GDP towards balanced budget by 2010-11."

¹⁸ ISR (Implementation Status and Results) ratings first indicate DO (Development Objective) rating, then IP (Implementation Progress) rating. Rating indications: MS – Moderately Satisfactory, S – Satisfactory, MU – Moderately Unsatisfactory.

		<p>Administration and in October 2012, Croatia established the Large Taxpayers Office (LTO) as a separate unit, through amendments to the Tax Administration Law. Large taxpayers represent a major share in the overall tax revenue, i.e. some 600 entities covering about 46% of taxes and contributions. Developing specific protocols, programs and initiatives for monitoring the tax compliance of large taxpayers (to be defined through secondary legislation based on specific sectors and the annual gross turnover), will result in improved efficiency of the tax administration, strengthened compliance risk management system and increased compliance rate.</p> <ul style="list-style-type: none"> Organizational changes were made to the Central Office of CTA, 20 regional offices and 122 local branches including simplification of administration of tax system and harmonization of procedures. This resulted in the increase of tax revenue and social contributions by 4.1 % in the first eight months of 2012 (compared to same period of 2011), reverting a declining trend that started in 2008. New regulations introduced tax audit procedures to supervise cash transactions and putting in place the plans to implement the exchange of information between tax administration and other public services for tax purposes. 	<p>Budgeting (FY10)</p> <ul style="list-style-type: none"> Regular Economic Report 	
	<ul style="list-style-type: none"> Programming budgeting improved and performance budgeting piloted. 	<ul style="list-style-type: none"> ACHIEVED – 2008 Organic Budget Law introduced medium-term performance budgeting – now in implementation for the third year, supported through Performance-Based Budgeting AAA. 		
Strengthen financial sector supervision	<ul style="list-style-type: none"> Strengthened regulatory/supervisory framework for banks and non-banks with improved financial stability 	<ul style="list-style-type: none"> ACHIEVED - FSAP recommendations: all addressed under the Fiscal, Social and Financial Sector DPL. Supervisory frameworks for banking and non-banking institutions aligned with Basel II through implementation of Credit Institutions Act, Capital Market Act and Consumer Credits Act. Corporate governance codes: mandatory for all listed companies introduced through the Capital Market Act. 		
II. Strengthening Private Sector Led-Growth and Accelerating EU Convergence				
Improving effectiveness of public sector governance and judiciary	<ul style="list-style-type: none"> Government effectiveness improved as measured by World Bank Governance Indicators from 70 percent in 	<ul style="list-style-type: none"> NOT ACHIEVED - Public administration reform: Slow progress with slight increase of World Bank Governance index to 71.4 in 2008, after which it declined to 69.2 in 2011 as a result of lack of reforms in investment climate and policy reversal related to depoliticization. 	<p>Lending - Ongoing</p> <ul style="list-style-type: none"> Revenue Administration Modernization Project (FY07); ISR: MU/MU Trade and Transport Integration Project (FY07); 	PAL has been grounded in analytical work that set forth the agenda for growth and EU accession. This was continued during CPS implementation with a

and reducing corruption	<p>2006 to over 72 percent in 2011.¹⁹</p> <ul style="list-style-type: none"> Civil service depoliticized. Improvement in the efficiency of judiciary evidenced by independently verifiable performance indicators, including a steady reduction in court case backlogs. 	<ul style="list-style-type: none"> NOT ACHIEVED – This target was initially achieved and supported under PAL2, as following 2007 elections, civil service was depoliticized to the level of directors (former assistant ministers), which were appointed based on competitive selection process. The objective of this reform was to nurture a competent and professional civil service at the policy making level and ensure that expertise standards are maintained over political cycles. New Government changed the organizational hierarchy whereby, directors became sector heads, while the position of assistant ministers as political appointees was reinstated. The positions of secretary general in ministries and deputy director of smaller state administrative organizations remained civil servant positions. Under way. Strengthening the human resources management system is in progress, as part of ERDPL the Government established the central payroll and HR registry, which enhances the transparency and efficiency of the payroll system and management of budgetary resources, while planned introduction of performance-based remuneration system through the new Law on Civil Service Salaries is delayed. The Government is currently harmonizing the salary system across all administrative bodies in public administration. ACHIEVED – Key indicators of judicial performance - established and tracked with support of JSSP – show steady improvement. As of 2012, improvements are registered in reducing the processing time in pilot courts and improving efficiency in Zagreb State Attorney's Office where an automated case tracking system is in place, supported under JSSP. Overall Croatia made significant progress in increasing the efficiency of judiciary, which enabled the completion of EU accession talks in 2011. Court case backlog: Case backlog reduced by 23 percent between 2006 and 2009 to 800,000 cases, supported under PAL2, RPRCP and JSSP. Approximately 40% of reduction 	<p>ISR: MS/S</p> <ul style="list-style-type: none"> Rijeka Gateway Project II (FY09); ISR: MU/MU Export Finance Intermediation Loan Project (FY10; Additional Financing FY13); ISR: S/S Justice Sector Support Project (FY10); ISR: MS/MS Integrated Land Administration System Project (FY12); ISR: MS/MS Second Science and Technology Project / Project Preparation Advance (approved in FY12) <p>Lending - Closed</p> <ul style="list-style-type: none"> Real Property Registration and Cadastre Project (FY03-10); ICR: S Science and Technology Project (FY06-11); ICR: S PAL2 (FY07-09); ICR: MS Fiscal, Social & Financial Sector DPL (FY10); ICR: S Economic Recovery DPL (FY11); ISR: S/S Rijeka Gateway Project (FY04-13); ICR: MU; <p>AAA</p> <ul style="list-style-type: none"> EU Convergence Report (FY10) Institutional Framework and Fiscal Risk Assessment for PPP (FY10) 	<p>number of policy notes – on pension, labor, social and other emerging issues – and helped inform the policy lending.</p> <p>Equally, the EU Convergence report provided diagnostics and options for accelerating the convergence of Croatia with EU economies – as a backbone of the CPS - designed to support country's EU accession agenda as a cross-cutting theme.</p>
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¹⁹Outcome revised. Original wording: "...from 70 percent in 2006 to over 75 percent in 2011."

		<p>in case backlog is in Zagreb that accounts for the largest share of backlog. By 2010, RPRCP helped reduce the backlog in land registry, which was part of the aggregate backlog, by 80 percent. Case backlog for 74²⁰ courts, monitored under JSSP, continues to decrease and went down from 384,038 in 2009 to 369,090 in September 2012. This is an important commitment arising from EU accession negotiations and this trend is recognized in the EC's October 2012 Monitoring Report, indicating that in the first semester 2012 the backlog of criminal cases continued to fall by 12 percent, while the March 2013 report affirmed that during 2012 the courts overall managed to resolve more cases than the influx.</p> <ul style="list-style-type: none"> • Integrated Case Management System (ICMS), an information analytical system supported through JSSP, provides data on performance of the judicial system and enables the management of resources as to resolve the backlog and income workload. JSSP supports the upgrade of ICMS, while its roll out in remaining 33 municipalities is supported through EU-financed projects. The upgrade takes into account the ongoing court network consolidation and changes in court practices and procedures as to reflect key business process changes. 	<ul style="list-style-type: none"> • Labor Market Issues in Croatia (FY11) • Doing Business follow-up (FY11) • Enhancing Corporate Financial Reporting IDF (FY07-11); Completion: S • MiFID Assessment (FY11) • EU & Croatian Bank Resolution Regimes (FY11) • Science, Technology and Innovation Policy (FY12) • Croatia Policy Notes: A Strategy for Smart, Sustainable and Inclusive Growth (FY12) • Justice Sector Public Expenditure and Institutional Review (FY13) • Croatia Case Study on Justice and Anticorruption Reform (FY13) • Public Finance Review (FY13) • Railways Policy Note (FY13) 	
Improve the investment climate and decreasing informality of the economy	<ul style="list-style-type: none"> • Increased private sector share in GDP towards 80 percent through continued privatization of the CPF portfolio and accelerated removal of regulatory obstacles and reduction of cost of doing business. 	<ul style="list-style-type: none"> • PARTIALLY ACHIEVED - Private Sector Share of GDP: increased from 60% in 2006 to 70 percent of GDP in 2011. 237 companies were either sold or liquidated (August 2012) under the ERDPL, and the progress is on track to increase private sector share in GDP further in 2013 as state-owned shipyards got privatized, while a postal bank and an insurance company are to be privatized (in progress). • 2013 Cost of Doing Business: Croatia ranked 84 among 185 countries in 2012, 4 places down compared to 2011. • Under the ERDPL2, the authorities have simplified business registration and reduced its cost, while enforcement over the cash assets was made more efficient. Further legislation changes are in process to abolish location permit and create e-construction permit. Under ILAS, continuous reduction of transaction processing time in land registry and cadastre offices, and reduction of cadastre and land registry backlog contributing to reduced cost of doing business. In spite of the 	<ul style="list-style-type: none"> • Regional AAA • Justice Sector Peer Assisted Learning (FY11) • Innovating through the Crisis (FY11) • Program of Accounting Reform & Institutional Strengthening (REPARIS) (FY09-12) 	ILAS has inherited difficulties with a particular information system (Joint information system of land registry and cadastre), developed under the Real Property Registration and Cadastre Project, which delayed the main project component by more than a year. Complexity of building information systems through ICT solutions are undermined and insufficient attention is paid to capacity assessments of beneficiaries and stakeholders to carry out the

²⁰ 74 courts monitored include 13 commercial, 40 municipal and 21 county courts.

		<p>good progress in reducing the cost of doing business under both projects, these reforms still remain fragmented and need to be reinforced by increasing the predictability and transparency of procedures and regulation, as well as rule of law.</p> <ul style="list-style-type: none"> • Tax compliance cost: stands at 0.2% of total taxpayers' revenues in 2010 (baseline). 		<p>procurement and contract management, and then absorb and maintain the systems. In addition, remuneration system in public administration is not attractive enough to retain highly skilled staff, which is needed for management of such systems.</p>
Align provision of infrastructure and related services with demand	<ul style="list-style-type: none"> • Increased capacity of the Port of Rijeka and Port of Ploce with significant private sector investment.²¹ 	<ul style="list-style-type: none"> • PARTIALLY ACHIEVED – Under two Rijeka Gateway Projects, Rijeka Container Terminals: physical expansion under way under Brajdica Container Terminal will increase the capacity for container traffic from currently 150,000 TEU to 300,000 TEU by June 2013. A five-year contract for a scaled up Zagreb Container terminal has been signed in April 2012, following a complex design and build procurement process, which took more than two years, thus significantly delaying the start of construction works. • Ploce Container Terminal opened for operation in 2011 with initial capacity of 66,000 TEU, supported under TT1. The port capacity will further increase with the construction of Bulk Cargo Terminal that started in April 2012, and will accommodate for 4.6 million tons in capacity and for up to 180,000 dwt. Target is not fully achieved because of implementation delays related to prolonged procurement, including preparation of technical documentation and delayed issuing of permits. • Port Concession agreements: Extension of Rijeka's Brajdica Container Terminal is underway with majority ownership transferred to international private operator against \$38 million of private capital, resulting in increased productivity. Two concession agreements signed for new terminals in Ploce in 2010; all concessions on cost recovery basis. 		
Enhancing technology adoption and innovation	<ul style="list-style-type: none"> • Commercialization of public research results promoted, more private sector 	<ul style="list-style-type: none"> • PARTIALLY ACHIEVED - In 2006, the Government adopted two strategic documents to support the R&D agenda – “Science and Technology Policy 2006-2010” and the “Action Plan for increasing the level of investment in 		<p>Mainstreaming innovation policies into major R&D expenditure programs requires a programmatic</p>

²¹ Outcome revised. Original wording: “Increased capacity of the Port of Rijeka and Ploce with revenues increasing from \$80 million in 2007 to \$115 million in 2012 by addressing critical port capacity constraints, with significant private sector investment.”

	<p>innovation generated and increased share of R&D spending by private sector from current one-third of total towards the Lisbon agenda target of two-thirds.²²</p> <ul style="list-style-type: none"> Research and Development spending as a share of GDP increases to 1.1 percent by 2012.²³ 	<p>Research and Development”, under STP. The R&D funding for SMEs, research organizations and collaborative projects between academia and industry was aimed at promoting the transfer of research results and technology to the business. The targets of commercialization of public research (patenting, licensing, research contracts and spillovers) were exceeded and more private sector innovation achieved: 69 contracts between R&D institutions and industry (2011) from 2 in 2006 (target of 30); 59 license agreements, spillovers and patents cumulative (2011) from none in 2006 (target of 30); €13M private R&D mobilized for innovation projects (2011) from €6M in 2006; between 2006 and 2008, the share of Croatian SMEs with new or improved products (EU Community Innovation Survey) increased from 7.2 to 10.8 percent.</p> <ul style="list-style-type: none"> Private sector R&D spending went from 27 percent in 2006 (Eurostat) to 32 percent in 2010. Under STP, BICRO R&D programs directly supported 89 SMEs, for projects of over €38 million, of which 30 to 50 percent provided by SMEs. STP also helped mitigate the effect of the crisis that hit Croatia in 2009 and reallocated more funds towards innovative SMEs. NOT ACHIEVED – R&D spending as a share of GDP remains 0.8 percent due to fiscal consolidation efforts. STP helped create the initial policy basis; however the financial crisis diminished this effect. Access to EU Structural Funds could mitigate this and Croatia prepares applications for R&D grants schemes for 2014-20 allocations, estimated at €m150/year for R&D (40 percent of Croatia’s R&D spending) – this work is supported through Project Preparation Advance for proposed STP II. 		<p>approach and policy dialogue, which was attempted through ERDPL. However, the Government efforts have not been successful in carrying major reforms.</p> <p>At mid-term review, the Bank added a very ambitious CPS outcome on the increase of R&D spending as a share of GDP. This decision was based on the envisaged STP repeater project (in FY12) and ERDPL 2 measures for innovation programs, though from a distance it could be argued that this is more a country level goal. However, the preparation of both projects slowed down with the elections and change in administration. This and the effects of the prolonged crisis have made it impossible for the operation to contribute to the CPS outcome.</p>
III: Improving Quality and Efficiency in Social Sectors				

²² Outcome revised. Original wording: “Applied research promoted and increased share of R&D spending by private sector from current one-third of total towards the Lisbon agenda target of two-thirds.”

²³ Outcome added at mid-term review.

Increasing sustainability and equity of the pension system	<ul style="list-style-type: none"> Administrative cost of pension funds reduced. 	<ul style="list-style-type: none"> ACHIEVED – Supported by the ERDPL, privileged pensions were reduced by 20 percent, privileged pensions for government officials abolished and rationalized for military employees. Early retirement decrement doubled except for beneficiaries with more than 40 years of service. Administrative costs of second pillar reduced in 2010 and 2011 through a reduction of mandatory pension funds' asset management fee from 0.75 percent to 0.65 percent and further to 0.45 percent, while in 2011 the Government imposed a flat account management fee for REGOS onto pension fund management companies. 	<p>Lending – Ongoing</p> <ul style="list-style-type: none"> Revenue Administration Modernization Project (FY07); ISR: MU/MU Development of Emergency Medical Services & Investment Planning Project (DEMSIPP) (FY09); ISR: S/S <p>Lending – Closed</p> <ul style="list-style-type: none"> Pension System Investment Project (FY03-09); ICR: MS 	
Making the health system more efficient and improving health outcomes	<ul style="list-style-type: none"> Improved efficiency of health spending and effectiveness of the Emergency Medical Services (EMS) system. 	<ul style="list-style-type: none"> ACHIEVED - Exempt population reduced by 36 percent between 2009 and 2011 and co-payment exemptions streamlined through legislation. Hospital network rationalization carried out in Zagreb. Central procurement for hospitals and e-health services introduced under the ERDPL. From 2005 to 2010, the shares of pharmaceuticals in HZZO's mandatory insurance-related care expenditures each decreased from 21 to 19 percent though the number of prescriptions increased by 69.3 percent. This improved efficiency is the result of two new ordinances that have regulated the market since 2009, and were supported under ERDPL. The first ordinance put in place a mechanism for setting a maximum wholesale price based on international price comparisons, specifically prices in Italy, France, and Slovenia. The second ordinance defined the criteria for including medicines in the HZZO's basic and supplementary reimbursement drug lists, based on medical evidence and cost-benefit analysis. Improved effectiveness of EMS through an overhaul of EMS system including separation of pre-hospital EMS from primary health care, new national EMS system management, standardized dispatchers protocols, and massive training of staff in EMS system, under DEMSIPP - with response time for EMS interventions at the scene reduced from 17 to 12 minutes in 2012; emergency field calls as percentage of total field calls increased from 9.7 percent in 2005 to 100 percent in 2011 as the non-emergency workload moved to other areas of health system; improved coverage of EMS across Croatia due to redistribution of teams from earlier uneven coverage, reflected in reduction of variation of EMS teams per capita 	<ul style="list-style-type: none"> Social Welfare Development Project (FY05-11); ICR: S; IEG: MU Fiscal, Social & Financial Sector DPL (FY10); ICR: S Education Sector Development Project (FY06-12); ICR: MU Economic Recovery DPL (FY11); ISR: S/S <p>AAA</p> <ul style="list-style-type: none"> Financing, Providing & Regulating Long-term care for the Elderly (FY11) Pension Reform Options (FY11) Poverty Assessment Update (FY11) Croatia Policy Notes: A Strategy for Smart, Sustainable and Inclusive Growth (FY12) Public Finance Review (FY13) <p>Regional AAA</p> <ul style="list-style-type: none"> Long-term Care (FY11) 	<p>The Bank's engagement in the health sector through various instruments, DPLs, investment lending and advisory activities, was a favorable context for a reform-oriented program of the new Government. The team in the line ministry is determined to increase the sector's efficiency with a significant impact on cost control, through implementation of the hospital rationalization plan, outsourcing of some non-medical services, expanding the health technology assessment and introducing, for medical devices, regulations similar to those that were successfully designed for pharmaceuticals.</p> <p>Reforms that require regulatory changes and setting up new management institutions at central and local levels will likely take time that needs to be counted in - as they often involve ample consultations with</p>

		by regions by 20 percent in 2011.		stakeholders, as it was the case in rolling the EMS system under DEMSIPP.
Enhancing educational system to better respond to needs of knowledge-based society	<ul style="list-style-type: none"> Improved student learning and system performance with performance of Croatian pupils at PISA 2009 stable or improved compared to EU average. 	<ul style="list-style-type: none"> PARTIALLY ACHIEVED – Improved student learning not fully achieved due to decreased scores of 2009 PISA in math (467 to 460), reading (477 to 476) and science (493 to 486). However, matura, a school exit exam, saw the scores improving between 2010 and 2011 in math (from 50.8 to 55.1%) and Croatian language (from 70.7 to 71.7%) despite of increase of exam-passing thresholds by 5-8 percent, as supported under Education Sector Development Project. Pre-school and secondary school enrollment rates: increased from 43 and 79.2 percent respectively in 2005 to 55.6 (falling short of revised target of 58) and 81.4 in 2011 (exceeded). Primary school gross enrollment rates decreased from 96.5 to 91.9 percent (2011). Number of students in triple shift primary schools reduced from 9 percent in 2006 to below 2 percent in 2010 (exceeded the target of 7%) while number of students in primary and secondary single-shift schools increased from 12 and 18 percent in 2006 to 48 and 35 percent in 2011 (exceeded), under ESDP. System performance substantially improved with support of ESDP, with new national curriculum framework for pre-school, primary and secondary education developed and approved; establishment of national center for external evaluation and successful introduction of matura for all gymnasium and VET students wanting to enroll in tertiary education, introduction of integrated information system and new management and leadership training for school principals, as well as reduction in VET programs from 300 (2005) to 197 (2010), slightly below target of 190. 		<p>ESDP provides lessons related to results framework - projects should avoid combination of objectives when one is dependent on the completion of the other, and indicators with infrequent data are not suitable to signal problems, and may pose problems with credibility due to a small sample/short trend (two PISA tests, two exit exams).</p> <p>The SWAp design and annual development programs allowed the line Ministry to be in charge of the reform program and helped develop its capacity to prepare and implement the yearly plans, carrying out yearly evaluations, and defining resource allocation based on progress towards plans. The implementing agencies have developed stronger capacity to pursue their objectives, based on experience they and their staff gained first-hand during implementation.</p>
Improving social inclusion and better targeting of social assistance	<ul style="list-style-type: none"> Improved efficiency and transparency of social programs. 	<ul style="list-style-type: none"> PARTIALLY ACHIEVED - New social policy planning methodology: under SWDP, developed and implemented in 10 of 21 counties, including multi-year master plans for the provision of inclusive, qualitative and cost-effective services based on need and demand. By involving the county centers of social welfare, this planning tool attracts new and innovative providers to deliver those services more efficiently and effectively. 		Developing complex information systems over a standard project lifetime is challenging – in SWDP it involved prior policy changes, stakeholders’ consultations, problems with design and procurement, with time-intensive and uncertain

		<ul style="list-style-type: none"> • Management Information System (MIS) software for social welfare, developed under SWDP, was initially piloted in three counties and then withdrawn. The new Government has adjusted and upgraded the MIS and it is currently used in all 12 social welfare centers in Zagreb, with a plan to roll out the system countrywide starting in June 2013. Data exchange between Zagreb social welfare centers and Tax Administration is fully in place. • Social workers' time spent on direct work with clients significantly increased, from 30 percent in 2005 to 65 percent in 2007 (survey) as a result of the introduction of one-stop-office work model in centers for social welfare, supported through SWDP. • Deinstitutionalization: despite decrease in number of persons in state-owned residential institutions, total number of persons in residential institutions declined only slightly from 25,543 in 2007 to 25,523 in 2009 due to increase in private residential care. • Social Welfare Reform Strategy 2011-2016 and the Social Welfare Law were enacted in 2011, supported by ERDPL, aimed to reduce social exclusion and improve efficiency of the system, including through better targeting of benefits. The law linked the Guaranteed Minimum Income to the poverty line as calculated by the Bureau of Statistics, so that the eligibility threshold of relative poverty is indexed and functions as automatic stabilizer. 		<p>testing and fine-tuning.</p> <p>Engagement under SWDP and ERDPL led to policy changes through new legislation (more community-based services, consolidation of benefits), and comprehensive interventions in sectors require combination of instruments.</p>
IV. Increasing sustainability of Long-Term Development				
Strengthen environment and nature protection	<ul style="list-style-type: none"> • Improved water supply and wastewater services and flood protection measures in Croatia's inland municipalities.²⁴ 	<ul style="list-style-type: none"> • ACHIEVED - Improved inland water and wastewater services: Under IW, the infrastructure in water and wastewater services has been constructed and/or upgraded through constructing of wastewater and water treatment plants, pumping stations, water reservoirs, and supply/collection pipelines thus ensuring the main conditions for increasing the number of population receiving reliable water and wastewater services. The project closed in December 2012, and while a certain portion of the population has already been connected to the 	Lending – Ongoing <ul style="list-style-type: none"> • Inland Waters Project (FY07); Last ISR before closing: S/S • Coastal Cities Pollution Control Project II (FY09); ISR: MS/MS • EU Natura 2000 Integration Project (FY11); 	<p>Performance monitoring indicators should be carefully selected, in particular for Adaptable Program Loans (APL), monitoring the program and project objectives. In the case of Coastal Cities Project, APL allowed adjustments in the results framework and the</p>

²⁴ CPS originally envisaged one outcome for water and wastewater services, which was split at mid-term into two separate outcomes: (i) for inland municipalities and (ii) for coastal cities. The original outcome was: "Improved coverage of water and wastewater services in 25 municipalities, contributing to the government's plan to increase it from 75 percent and 44 percent respectively."

	<p>network, in some municipalities the secondary network (that was not part of project financing) is still under way. Once the secondary network is completed, the percent of population in participating municipalities benefitting from water supply will increase from 40 percent (2008) to 85 percent, and from wastewater services from 35 percent to 73 percent. Overall about 80,000 people are expected to be connected to new or upgraded water and wastewater services.</p> <ul style="list-style-type: none"> • To harmonize with EU environment requirements, Croatia needs to invest some €3 billion in the environment sector. The preparation of eight project applications for future EU funds, supported under IW, will contribute to improving the water supply and wastewater services. • Flood Protection: Under IW project, retention volume for flood protection increased from 600M m³ in 2008 to 800M m³ in May 2012, safeguarding the population and property in Sava River Basin. • Reducing water nutrient discharge - Per APCP April 2012 survey (785 farmers), 94 percent of farmers have adopted at least one of preventive measures like organic manure usage, proper manure storage, three year crop rotation, or similar - thus contributing to reducing water nutrient discharge – up from 35 percent of farmers in 2009. 	<p>ISR: S/S</p> <p>Lending-Closed</p> <ul style="list-style-type: none"> • Coastal Cities Pollution Control Project I (FY04-10); ICR: MS • Energy Efficiency Project IBRD and GEF (FY04-10); ICR: MS • Social and Economic Recovery Project (SERP) (FY05-11); ICR: MS • Renewable Energy Resources (RER) Project GEF (FY05-10); ICR: MU • Agricultural Acquis Cohesion Project IBRD, Dutch TF (FY06-13); Last ISR: S/S • Agricultural Pollution Control Project (APCP) GEF (FY08-13); Last ISR: MS/S <p>AAA</p> <ul style="list-style-type: none"> • Integrated Waste Management Facility (FY09) • Croatia Policy Notes: A Strategy for Smart, Sustainable and Inclusive Growth (FY12) <p>Regional AAA</p> <ul style="list-style-type: none"> • SE Europe Water & Climate Adaptation (FY11) 	<p>project design for a subsequent phase. However, monitoring of the performance of participating municipal water and sewerage companies have been significantly delayed due to the lack of capacity in the implementing agency. Next CPS should preempt M&E problems at the project preparation stage.</p>
<ul style="list-style-type: none"> • Maintained quality of Croatia's coastal waters to meet applicable EU and national standards in participating municipalities. 	<ul style="list-style-type: none"> • ACHIEVED – Quality of coastal waters participating municipalities is maintained as indicated by percent of samples (98 percent) from monitoring bathing and shellfish areas complying with EU standard. Seawater quality monitoring was established under CCPCP. Coastal water pollution in the Adriatic Sea adjacent to the participating cities was reduced, as indicated from the increase in the percentage of wastewater produced in coastal municipalities that is treated and disposed of in line with EU and Croatia requirements from 6 percent to 45 percent. The number of population in participating cities able to connect to a wastewater collection system went from 56 to 68 percent, meaning that in total 220,000 people directly benefited from the project. 		
<ul style="list-style-type: none"> • Increase in annual 	<ul style="list-style-type: none"> • ACHIEVED – Annual capital and other investments across 		

	capital and other investment expenditure across the parks estate ²⁵	the park estate increased by 9 percent from 2010 to 2011, under EU Natura project. There are 15 infrastructure and two research project proposals under preparation for submission to the pipeline for EU Structural Funds for programming period of 2014-20 in the value of EUR42 million – with one project already for financing		
Improving disaster risk management and mitigation	<ul style="list-style-type: none"> Increased coverage in precise weather event now-forecasting (from 30 percent to 80 percent of the territory) and reduced response time to disasters and emergencies. 	<ul style="list-style-type: none"> DROPPED - This indicator was dropped since associated project did not materialize. 		
Preparing Croatia for adapting to and mitigating climate change	<ul style="list-style-type: none"> Increased irrigated area for farming (increased from 9000 ha). Implemented framework with incentives for provision of renewable energy and scaled-up roll-out of programs for energy efficiency. 	<ul style="list-style-type: none"> DROPPED - This indicator was dropped since associated project did not materialize. ACHIEVED - Framework for RE incentives implemented under the RER project, incl. legislation and EU compliant regulatory setting - new Energy Law, secondary legislation for feed-in tariffs, RE Advisory Facility with RER Registry to help build pipeline and finance pre-feasibility studies, and RE grid integration. Renewable energy projects for 70 MW capacity ready (2013), of which 37 MW achieved financial closure – with two projects constructed and one under construction; the remainder of projects are on track to reach financial closure in 2013. Under Energy Efficiency Project, HEP ESCO financed energy efficiency investments totaled US\$33.8 million in December 2011. 		<p>Creating new regulatory and institutional setting and developing projects to operate in this setting is too complex within a standard investment operation. Under RER project, a delayed legislation adversely affected the achievement of objectives, i.e. developing RE projects.</p> <p>The Recipient's ICR stressed the importance of TA provided for developing the RE market framework and resolving legal issues that led to creation of a successful RER Registry.</p>
Reducing regional and urban/rural disparities	<ul style="list-style-type: none"> Established capacity to develop a pipeline of high quality regional and municipal-level development projects including for donor 	<ul style="list-style-type: none"> ACHIEVED - 405 projects completed under SERP: 125 for social inclusion (target 120); 69 for small community infrastructure (target was 60); and 211 in support of SMEs, crafts and cooperatives (target was 240) benefitting 84,000 people residing in areas of special state concern; 1,359 new jobs were created and €11 million in additional revenue was 		Projects involving demand-driven community-based investments require substantial time to build up, including intensive work with various groups of beneficiaries on

²⁵ Outcome revised. Original wording: "Improved conservation of biodiversity and management of natural resources, including an increase of protected areas from 11 percent to 15 percent of national territory."

	<p>financing in 13 counties.</p> <ul style="list-style-type: none"> Improved agriculture productivity and further alignment with the EU <i>acquis</i>. 	<p>generated by the SMEs.</p> <ul style="list-style-type: none"> PARTIALLY ACHIEVED - Alignment with EU's agricultural <i>acquis</i>: EU October 2011 Progress Report assessed that Croatia overall made good progress in aligning its agriculture and rural development sector (EU chapter 11) with the EU <i>acquis</i>, and implementing food safety <i>acquis</i> transposition (chapter 12). Under AACP, the capacity of the EU Paying Agency was developed, the land parcel information system was built as part of the integrated administration and control system, and the line ministry's information management systems enhanced. The capacity of the Croatian Food Agency was built and its staff trained to apply EU <i>acquis</i> procedures. This has overall strengthened the management and administration system for implementation of the EU rural development programs. Agricultural productivity has many facets and because it was not defined, it is difficult to assess its status, hence a "partially achieved" rating for the overall outcome. Establishment of the systems supported by AACP and APCP played a major role in alignment with the EU <i>acquis</i> and opening market opportunities for Croatian production, the projects were not designed to significantly influence the agricultural productivity. Integrated and upgraded cadastre and land registry data in 6 percent of the country (target was 5 percent), under RPRCP. 		<p>rising awareness and familiarizing them with all procedural requirements.</p> <p>M&E systems should have project-specific provisions allowing testing the indicators early on to ensure their applicability. Clearly defined Project development objective (PDO) statement are needed to ensure credible evaluation defined (e.g. a concept of social cohesion needs to be specified in a given project context and measured adequately).</p> <p>PDO that significantly depends on externalities (closing of EU chapter on agriculture) poses risks of delays that are beyond control of the implementing body and could be difficult, if not impossible, to mitigate.</p>
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Attachment 2: Croatia – Planned Lending Program and Actual Deliveries FY2009 – 2013

CPS PLANS (September 30, 2008)			STATUS	
FY	Project	US\$(M)	Project	US\$(M)
2009 Part I	Development of EMS and Investment Planning	27.0	Actual	28.3
	Rijeka Gateway II	130.0	Actual	122.5
	Coastal Cities Pollution Control II	90.0	Actual	87.5
	Disaster Risk Management	48.0	Dropped	
	Justice Sector Support Project	35.0	Forwarded to FY10	
			<i>Additional Actual Project:</i> GEF Coastal Cities Pollution	6.4
	Subtotal	330	Subtotal	244.7
2010 Part I	Justice Sector Support Project	35.0	Actual	36.3
	Climate Adaptation/irrigation	100.0	Dropped	
	Education II (or Additional Financing)	100.0	Dropped	
	EU Natura 2000 Integration	30.0	Forwarded to FY11	
	Trade & Transport Integration (Additional Financing)	70.0	Forwarded to FY12	
2009-10 Part II	Fiscal, Social and Financial DPL	Tbd	Actual	297.0
	Railway development	Tbd	Dropped	
	Energy generation or transmission	Tbd	Dropped	
			<i>Additional Actual Project:</i> Export Finance Intermediation Loan	141.2
	Subtotal	335	Subtotal	474.5
2011	EU Natura 2000 Integration	30.0	Actual	28.8
			<i>Additional Actual Project:</i> Economic Recovery DPL	213.0
	Subtotal	30.0	Subtotal	241.8
	Subtotal FY2009-11	695.0	Subtotal FY2009-11	961.0
PROGRESS REPORT PLANS (September 19, 2011)			STATUS	
2012	Trade and Transport Integration (additional financing)	70.0	Actual	66.9
	Integrated Land Administration System	24.0	Actual	23.8
	Science and Technology II	29.0	Forwarded to FY13	
			<i>No Additional Project</i>	
	Subtotal	123.0	Subtotal	90.7
2013	Economic Recovery DPL II	195.0	Negotiated March 14, 2013; Board scheduled for April 26, 2013	
	Science & Technology II	29.0		
			<i>Additional Actual Project:</i> Export Finance Intermediation Loan Additional Fin.	61.4
	Subtotal	224.0	Subtotal	61.4
	Subtotal FY2012-13		Subtotal FY2012-13	
	TOTAL FY2009-13		TOTAL ACTUAL DELIVERY FY2009-13	

Attachment 3: Croatia – Non lending Services and Actual Deliveries (FY2009 - 2013)

CPS PLANS (September 30, 2008)		STATUS
2009	Waste Management Facility in NW Croatia: private sector participation (PPIAF) EU Convergence Report IDF Grant: Enhancing Corporate Financial Reporting Health / Social Services / Long Term Care FSAP follow-up Programmatic PER / Public Sector Policy Notes (FY09-10)	Actual Completed in FY10 Completed in FY11 Policy Note on Long Term Care for Elderly completed in FY11 Dropped Various policy notes completed in FY10-11 <i>Additional Products:</i> Public Administration Support TA
2010	Brownfield Redevelopment (FY10-11) Transport Sector Review/Climate (FY10-11) Energy Sector Review (FY10-11) Investment climate/competitiveness CFAA/CPAR	Actual Dropped Dropped Dropped Dropped <i>Additional Products:</i> Social Impact of the Crisis and Building Resilience Institutional Framework and Fiscal Risk Assessment for PPP (PPIAF) Diagnostic Review of Consumer Protection and Financial Literacy
2011	Public Sector Policy Notes: Fiscal Responsibility Framework Policy Note on Labor Market Issues Policy Note on Long Term Care for the Elderly Policy Note on Pension Reform Options Policy Note on Poverty Assessment Update Doing Business Update Science, Technology and Innovation Policy Governance Assessment (Competitiveness) planned under Public Policy Notes Justice Sector Public Expenditure and Institutional Review Croatia Case Study on Justice and Anticorruption Reforms	Actual Actual Actual Actual Completed in FY12 Actual Completed in FY12 Dropped in FY13 Forwarded to FY12 Forwarded to FY12 <i>Additional Products:</i> Assessment of Croatia's Markets in Financial Instruments Directive Impl. Dutch EFO Justice Sector Support – Underway (Justice Sector Project)
PROGRESS REPORT PLANS (September 19, 2011)		STATUS – Completion Report April 2013
2012	Croatia Policy Notes: A Strategy for Smart, Sustainable and Inclusive Growth Public Finance Review Higher Education TA Railway Policy Note EU Preparedness TA Justice Sector Public Expenditure and Institutional Review Croatia Case Study on Justice and Anticorruption Reforms	Actual Forwarded to FY13 Underway (to be completed in FY13) Underway (to be completed in FY13) Underway (to be completed in FY13) Underway (to be completed in FY13) Underway (to be completed in FY13)
2013	Public Finance Review Higher Education TA Railway Policy Note EU Preparedness TA Justice Sector Public Expenditure and Institutional Review Croatia Case Study on Justice and Anticorruption Reforms	Underway Underway Underway – Draft delivery to Government March 2013 Underway Underway Underway

Annex 3: Selected Indicators of Bank Portfolio Performance and Management

As Of Date
4/4/2013

Indicator	2010	2011	2012	2013
Portfolio Assessment				
Number of Projects Under Implementation ^a	14	12	12	9
Average Implementation Period (years) ^b	3.7	4.1	4.8	4.5
Percent of Problem Projects by Number ^{a, c}	21.4	8.3	8.3	22.2
Percent of Problem Projects by Amount ^{a, c}	16.5	2.8	2.3	22.0
Percent of Projects at Risk by Number ^{a, d}	21.4	8.3	8.3	22.2
Percent of Projects at Risk by Amount ^{a, d}	16.5	2.8	2.3	22.0
Disbursement Ratio (%) ^e	24.3	23.1	23.4	20.8
Portfolio Management				
CPPR during the year (yes/no)				
Supervision Resources (total US\$)				
Average Supervision (US\$/project)				

Memorandum Item	Since FY 80	Last Five FYs
Proj Eval by OED by Number	34	12
Proj Eval by OED by Amt (US\$ millions)	1,927.3	796.4
% of OED Projects Rated U or HU by Number	29.4	33.3
% of OED Projects Rated U or HU by Amt	19.1	20.9

a. As shown in the Annual Report on Portfolio Performance (except for current FY).

b. Average age of projects in the Bank's country portfolio.

c. Percent of projects rated U or HU on development objectives (DO) and/or implementation progress (IP).

d. As defined under the Portfolio Improvement Program.

e. Ratio of disbursements during the year to the undisbursed balance of the Bank's portfolio at the beginning of the year: Investment projects only.

* All indicators are for projects active in the Portfolio, with the exception of Disbursement Ratio, which includes all active projects as well as projects which exited during the fiscal year.

Annex 4: Operations Portfolio (IBRD/IDA and Grants)

Operations Portfolio (IBRD/IDA and Grants)

As Of Date 4/4/2013

Closed Projects		37										
<u>IBRD/IDA *</u>												
Total Disbursed (Active)		266.87										
of which has been repaid		5.18										
Total Disbursed (Closed)		1,817.41										
of which has been repaid		1,101.52										
Total Disbursed (Active + Closed)		2,084.27										
of which has been repaid		1,106.70										
Total Undisbursed (Active)		415.41										
Total Undisbursed (Closed)		12.66										
Total Undisbursed (Active + Closed)		428.07										
<u>Active Projects</u>												
			<u>Last PSR</u>			<u>Original Amount in US\$ Millions</u>				<u>Difference Between Expected and Actual Disbursements^{a/}</u>		
			Supervision Rating									
Project ID	Project Name		<u>Development Objectives</u>	<u>Implementation Progress</u>	Fiscal Year	IBRD	IDA	GRANT	Cancel.	Undisb.	Orig.	Frm Rev'd
P104749	JUSTICE SECTOR SUPPORT (EFO)		MS	MS	2010	36.3				26.88528	1.8915115	
P102732	COASTAL CITIES POLLUTION CTRL		MS	MS	2009	87.5				55.73296	26.251604	14.04827
P102395	COSTAL CITIES POLL CTRL II (GEF)		MS	MS	2009			6.4		5.596294	4.4629605	
P086669	EMS & INVEST PLANNING (DEMSIP)		S	S	2009	28.3				10.09953	10.564743	1.169293
P111205	EU NATURA 2000		S	S	2011	28.8				21.4533	9.0711398	5.705973
P116080	EXPORT FIL INTEGRATED LAND ADMIN SYSTEM		S	S	2010	202.63				68.64221	14.670267	28.78027
P122219			MS	MS	2012	23.8				17.75431	0.3824642	
P102778	REVENUE ADMIN MODERN (RAMP)		MU	MU	2007	68			34	22.34486	56.339007	22.33901
P102365	RIJEKA Gateway II (new FY09)		MU	MU	2009	122.5				114.8718	51.892641	
P093767	TRADE & TRANS INTEG		MS	S	2007	142.22				77.62737	7.4544353	37.78777
Overall Result						740.05		6.4	34	421.0079	182.98077	109.8306

Annex 5: Statement of IFC's Committed and Outstanding Portfolio

Amounts in US Dollar Millions

Commitment	Institution	Loan	Equity	Quasi Loan + Quasi Equity	ALL	ALL	LN	ET	QL + QE	ALL	ALL
Fiscal Year	Short Name	Cmt'd - IFC	Cmt'd - IFC	Cmt'd - IFC	Cmt'd - IFC	Cmt'd - Part	Out - IFC	Out - IFC	Out - IFC	Out - IFC	Out - Part
2013	Atlantic Trade	20.6	0	0	20.6	0	20.6	0	0	20.6	0
2005	PBZ	26.2	0	0	26.2	0	26.2	0	0	26.2	0
2012	RP Global	18.3	0	7.8	26.2	45.8	3.5	0	1.5	5.1	8.9
2013	SAME DTZ Zetelic	15.7	0	0	15.7	0	15.7	0	0	15.7	0
2004/ 2005/ 2010/ 2013	Schwarz Group	45.8	0	0	45.8	26.2	6.5	0	0	6.5	0
Total Portfolio		126.6	0	7.8	134.4	71.9	72.6	0	1.5	74.1	8.9

As of April 30, 2013

CROATIA

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|---|----------------------------|-----|------------------------------|
| ○ | SELECTED CITIES AND TOWNS | — | MAIN ROADS |
| ⊙ | COUNTY (ŽUPANIJA) CAPITALS | — | RAILROADS |
| ⊕ | NATIONAL CAPITAL | — | COUNTY (ŽUPANIJA) BOUNDARIES |
| — | RIVERS | --- | INTERNATIONAL BOUNDARIES |

