



## Republic of Croatia: Staff Concluding Statement of the 2018 Article IV Mission

December 10, 2018

A Concluding Statement describes the preliminary findings of IMF staff at the end of an official staff visit (or ‘mission’), in most cases to a member country. Missions are undertaken as part of regular (usually annual) consultations under [Article IV](#) of the IMF's Articles of Agreement, in the context of a request to use IMF resources (borrow from the IMF), as part of discussions of staff monitored programs, or as part of other staff monitoring of economic developments.

The authorities have consented to the publication of this statement. The views expressed in this statement are those of the IMF staff and do not necessarily represent the views of the IMF's Executive Board. Based on the preliminary findings of this mission, staff will prepare a report that, subject to management approval, will be presented to the IMF Executive Board for discussion and decision.

*Macroeconomic developments have been positive. Growth continues to be strong, inflation benign, and unemployment has steadily declined. However, the labor participation rate remains low. The Croatian authorities have skillfully utilized the economic upturn to reduce indebtedness and further build external buffers. Yet, important challenges remain. Relatively low public and private investment hampers medium-term growth prospects, as does the emigration of the young. Emigration and population aging are generating labor shortages. They also challenge the long-term sustainability of the pension and the healthcare systems. This calls for a smartly focused transformation to a more dynamic economy, and a more efficient State. A sizable restructuring of public administration is central to this effort. Durably fixing the healthcare and pension systems are two of the other important issues to tackle. Some welcome progress is being made on these fronts, but the momentum needs to be sustained. Acting decisively now—under favorable conditions—would ensure higher living standards in the future.*

### **Translating short-term progress into long-term prosperity**

The economic expansion has been driven primarily by private consumption and export of goods and services. Fiscal performance has been strong, due to sound budget management by the authorities. Primarily driven by these efforts, together with the Central Bank's policies and favorable global conditions, interest rates on Croatia's public debt have fallen. Over the next few years, growth is expected to moderate gradually, as the economy moves closer to its potential. However, there are negative risks to this outlook, mainly due to possible changes in regional and global economic and financial conditions.

Sustained strong growth is needed to catch up to the income levels of wealthier EU countries. Achieving this requires an infusion of greater dynamism and resilience to the economy. Further integration into Europe via the entry into ERM II and the banking union will set the stage for the envisaged adoption of the euro. Yet, to enjoy the full benefits of the currency union, deeper structural changes are essential, as is continued careful management of the country's public finances.

### **Structural transformation to a more dynamic economy**

Today's economic conditions provide fertile ground for the needed structural changes. Such changes require up-front compromises from all stakeholders and the rewards are harvested with time, once the efforts bear fruit. Therefore, they have greater chances of success if initiated when economic conditions are improving, as they are currently. The authorities have made some progress with respect to the National Reform Program, which covers a wide area of structural reforms. While welcoming this progress, we encourage the authorities to push forward a focused structural agenda with stronger impetus.

A more *dynamic State* can facilitate durable growth. Compared with regional peers, Croatia currently has one of the largest expenditures on total public employment proportional to the size of its economy. Furthermore, many municipalities do not have sizable populations, making the scope significant to merge services thereby generating greater efficiencies. Decisive progress with reforms in this area will free up funds for investment in infrastructure and workers. It will also lead to better services for households and businesses.

- The new draft law on merit-based civil service employee compensation is a first step towards a more efficient public service. If complemented with an appropriate reduction in total public employment expenditure, it could open the space for high performing public employees to enjoy *higher* wages.
- New public employees can be hired where they are needed, for example to enhance administrative capacity to absorb EU funds, which will help raise public investment spending, and improve medium-term growth prospects.
- The further easing of administrative, tax, and parafiscal fees, will also produce collateral benefits by *improving the business climate*, enabling higher private investment and more job creation.
- Reforms to judicial and legal processes are important to keep on the agenda. They are likely to take time but once completed, complement public administration restructuring well.

*The recently passed pension reform* is an important step in putting the system more in tune with the reality of increasing life-spans, and to make it more sustainable and equitable across generations. Reinforcing measures that discourage early retirement, increasing the statutory

retirement age, and eliminating group-specific pension provisions sets the stage for further measures to improve the system's viability. Examining the underlying weaknesses of the second pillar of the pension system is rightly on the authorities' agenda. Without such measures, pensions are likely to decrease, directly affecting the standard of living of the elderly.

### **Securing better employment prospects for the young, and for women**

Employment has picked up notably over the last two years and the challenge is to sustain this expansion. The authorities cite active labor market policies as a significant factor behind this and such policies can be useful. Yet, the *labor market participation rate* remains one of the lowest in the EU. Structural unemployment, especially among youth and women, is high. This calls for steps to improve education and training. Here, some promising changes are being made to encourage more scholarships by raising tax exemption limits and providing financial coverage for apprenticeships to allow employers to train young workers in accordance with their needs.

Labor market flexibility needs to be enhanced, but this needs to be done carefully. It should not lead to a two-tiered system, wherein employers invest significantly less in workers on temporary contracts and offer them less security relative to those on open-ended contracts. Such a situation could encourage further emigration of the young, to the detriment of medium-term growth prospects. This situation would benefit neither employees nor employers.

Solutions that better balance the considerations of both employers and employees are needed. This requires innovative thinking and compromises from all stakeholders. A solution could take the form of a "hybrid" between the current fixed and open-ended contracts for an initial probationary period, to be followed by mandatory conversion to the full open-ended contract, upon completion of the probation. It could also take the form of encouraging qualified public-sector workers who are interested in private sector employment, but fear losing the relative safety of their jobs to try their hand in the private sector with suitable but temporary safeguards to induce some risk-taking. To be clear, any solution needs to be thought through in detail, but the scope for innovation exists. Given that currently there are labor shortages, this would be a good time to work on suitable solutions.

Measures to increase child care access would incentivize greater participation from women. Improved targeting of all social benefits to those who are most in need is also likely to induce greater labor force participation. Planned improvements in IT systems will be helpful to achieve better targeting. There may also be merit in further reviewing social security contributions, so long as it is strictly subject to the realization of an offsetting increase in the participation in the system and does not endanger its overall solvency.

## **Fiscal Policy: Charting a course for the next five years**

Croatia's recent budget performance has been commendable. The first surplus since independence was achieved in 2017. A small surplus might also materialize in 2018, depending on the size of one-off expenditures related to shipyard guarantees. Looking ahead, the government's fiscal objectives embed the desire to continue this strong performance and strengthen medium-term fiscal planning, including through the new Fiscal Responsibility Law and the Budget Act, which is currently at the advanced stage of drafting.

Our fiscal recommendations are motivated by two equally important medium-term goals—to rebuild room for fiscal policy maneuver that can be used in the event another recession hits the economy and to improve medium-term growth prospects. To achieve these results, we recommend steadily increasing the fiscal surplus towards 1 percent of GDP over the next five years, and thereby accelerating the reduction of public debt to below the Stability and Growth Pact (SGP) threshold of 60 percent of GDP by 2023. This would help to reduce the vulnerability to potentially negative changes in regional and global conditions. Our recommendations to strengthen the budget include a more growth-friendly composition of public expenditures, and a gradual shift to more stable revenue collection from a broader set of sources.

- On expenditures, increasing public investment, reducing the total expenditure on public employment, and reforming social benefits to better target the most vulnerable in society, are the top priorities.
- On the revenue side, recent gains need to be preserved. *At the appropriately receptive time* and with careful design and communication, the introduction of a modern property tax merits reconsideration. It can provide a more stable revenue base, make the system more progressive and fair, and create room to reduce higher and distortionary taxes elsewhere. Yet, it needs to ensure that it does not place an undue burden on individuals who are cashflow constrained, such as those on a limited pension. Preparatory steps for possible future reconsideration dovetail with other reforms such as the ongoing modernization of the land registry and the cadaster.

*Health spending needs to be made more efficient*—first and foremost, to reduce administrative costs and improve the quality of health services provided to citizens. There is also a need to reduce the drain on the budget caused by health sector arrears, which the authorities are working towards. It is encouraging to note the number of new entrants contributing to the healthcare system, and the reduction in the numbers of non-paying participants for supplementary benefits, although some of this is also due to emigration. Still, a more comprehensive transformation requires a more rational premium and co-payment structure, ensuring that exceptions are minimized to protect only the most vulnerable. As IT system improvements and more rigorous income-testing come onstream, more improvements should be possible.

*Enhancing governance and performance of state-owned enterprise (SOE)* will further reduce contingent liabilities and risks. The size of SOEs in Croatia is large relative to both regional and EU peers. Yet, their revenue generating capacity is amongst the lowest. Persistent loss-making SOEs are a drain on the budget, taking up more in subsidies than they pay back to the state. Therefore, they are also a loss for the taxpayer. They are not doing enough to support the economy's growth potential. Strengthening SOE governance and increasing accountability to their budgets would help improve their efficiency and discipline.

### **Anchoring stability through monetary and financial sector policies**

The Croatian National Bank (CNB) continued to deftly navigate the environment of low interest rates and ample liquidity. Going forward, the CNB will need to pursue policies, which will allow the economy to accommodate potentially tighter external conditions and harness inflation expectations.

Strong bank supervision and macroprudential policies have effectively contained possible pressure points. The banking system is, on average, very liquid, well capitalized and profitable. The non-performing loan ratio is declining, in part due to their sales to third parties. Additional measures to prevent excessive household borrowing, e.g., more comprehensive debt service-to-income based measures, could be considered for introduction *at the appropriate time*, if real estate prices accelerate or high growth of cash loans persists.

Further corporate sector deleveraging would be welcome, including through making the bankruptcy procedures even more efficient, e.g., by facilitating out-of-court settlements. Despite recent changes in the bankruptcy legislation, consideration could be given to conducting a comprehensive review to ensure that the insolvency framework aligns with best practices.

*The mission would like to thank the authorities and all interlocutors for the constructive dialogue and kind hospitality.*