



Program Information Document (PID)

Appraisal Stage | Date Prepared/Updated: 28-May-2020 | Report No: PIDA29316



BASIC INFORMATION

A. Basic Project Data

Country	Project ID	Project Name	Parent Project ID (if any)
Croatia	P173996	Crisis Response and Recovery Development Policy Operation (P173996)	
Region	Estimated Board Date	Practice Area (Lead)	Financing Instrument
EUROPE AND CENTRAL ASIA	02-Jul-2020	Macroeconomics, Trade and Investment	Development Policy Financing
Borrower(s)	Implementing Agency		
Republic of Croatia	Ministry of Finance		

Proposed Development Objective(s)

Support the Government’s efforts to: (i) mitigate the economic and social impact of the COVID-19 pandemic, and (ii) advance inclusive and sustainable recovery.

Financing (in US\$, Millions)

SUMMARY

Total Financing	300.00
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DETAILS

Total World Bank Group Financing	300.00
World Bank Lending	300.00

Decision

The review did authorize the team to appraise and negotiate

B. Introduction and Context

Country Context

1. **A severe economic recession in 2020 risks reversing the income gains, poverty reduction and hard-won fiscal stability achieved in recent years, while potentially eroding the consensus for structural reforms in Croatia.** The last five



consecutive years of economic growth and poverty reduction were underpinned by prudent fiscal management and significant institutional reforms, including improving product market regulation and the business environment, and reforming the justice system to enhance its efficiency. The impact of the two external shocks of early 2020 threatens to reverse these gains. Output is anticipated to contract by 9.3 percent in 2020, with a precipitous drop in demand for Croatia's exports – including travel and tourism, which account for two-thirds of services exports, one-fifth of GDP and one-tenth of employment. In the absence of countervailing measures, the economic impact will reverse the process of income growth. Any potential job losses from the current crises are likely to fall heaviest on the low wage earners. Meanwhile, the severe economic downturn may reduce the population's appetite for deeper structural reforms, making the recovery more difficult. To cushion the impact of the COVID-19 pandemic and the earthquake, the government's response has been swift and well-targeted. The cost of these packages is estimated at 15 percent of GDP. The measures, coupled with a steep decline in tax revenues due to the economic downturn, are expected to result in a fiscal deficit of 10 percent of GDP in 2020 (from a small surplus over the past three years), which will push the public debt-to-GDP ratio above 90 percent. Including debt amortization, total financing needs are expected to rise to 25 percent of GDP in 2020 (from 15.7 percent in 2019). While the fiscal cost of the measures introduced is relatively high, in their absence, the economy could contract by 16 percent and unemployment increase above 20 percent, reversing the process of poverty reduction.

2. **Croatia's difficulties are exacerbated by a devastating earthquake that hit the country's capital on March 22, 2020.** The city of Zagreb was struck by the strongest earthquake since 1880, measuring 5.4 on the Richter scale. Initial reports stated that some 26,000 buildings were damaged, of which 1,900 were categorized as uninhabitable. According to government's preliminary estimates, the damage caused by the earthquake amounts to around 10 percent of country's GDP and around 30 percent of Zagreb's GDP. To this end, the World Bank is preparing an earthquake response operation.

3. **The macroeconomic policy is considered adequate for the proposed operation given the temporary nature of the intervention package, strong commitment to public debt reduction and the planned introduction of the euro as the national currency.** Given the severity of the economic crisis, staff considers the government's intervention package necessary and appropriate. It reflects the experience from the 2008 global financial crisis and aims to prevent a prolonged recession and a slow recovery. While the size of the package and the economic downturn will lead to a sharp rise in public debt, it is expected that debt will be put on a declining path as of 2021. Furthermore, monetary authorities have taken all the necessary step to preserve exchange rate stability, which is crucial for financial stability. To this end, CNB has set up a swap line with the European Central Bank to provide euro liquidity. National authorities remain fully committed to entering the ERM II in July 2020 and join the euro area in the medium term. Within the limits of the exchange rate stability the CNB continues to pursue appropriately accommodative monetary policy to assure sufficient liquidity on the market and support the recovery.

Relationship to CPF

4. **While addressing the short-term needs connected with the COVID-19 crisis, the operation pursues the goals of the Country Partnership Framework for 2019-2024 which was discussed by the Board in May 2019.** The current crisis is disproportionately affecting the most vulnerable strata of the population and may derail the longstanding progress that Croatia has made in poverty reduction and shared prosperity. The operation will contribute to mitigating this risk by protecting those that are most affected in a fiscally prudent way and laying the institutional foundations for economic recovery with measures that are in line with the CPF's focus areas of "Enhancing public sector performance and institutions" and "Strengthening market institutions to enable a dynamic enterprise sector."

C. Proposed Development Objective(s)



Support the Government's efforts to: (i) mitigate the economic and social impact of the COVID-19 pandemic, and (ii) advance inclusive and sustainable recovery.

Key Results

5. **The operation supports reform actions organized in two pillars: (i) Mitigate the economic and social impact of the COVID-19 pandemic, and (ii) Advance inclusive and sustainable recovery.** The prior actions under the first pillar would help to mitigate the social and economic impact of the pandemic. The prior actions under this pillar would help to mitigate the social and economic impact of the pandemic. Some of the results achieved would include: (i) covering by wage subsidy 50 percent or more workers employed in tourism in 2020 (defined by NACE 2 classification); (ii) increase in coverage of people having the complementary health insurance paid from the state budget by at least 15 percent; (iii) liquidity ratios (defined as short term assets to short term liabilities) for non-financial firms remaining above 1, maintaining ratio's average value for 2016-2018; (iv) increase in the number of incoming bankruptcy cases would not exceed 30 percent (as compared to the 2017-2019 average). Prior actions under this pillar would help facilitate inclusive and sustainable recovery. Some of the results achieved would include the following: (i) 19,000 elderly - 70 percent women - who today have no other sources of income, would receive a new benefit; (ii) more than 90 percent of revenues from the auction of emission units (in the current trading period) allocated to climate related expenditures; (iii) the credit registry would cover 80 percent of adults; (iv) at least 35 percent of funds from the Operational Program for Competitiveness and Cohesion would be paid out to beneficiaries, up from 26.2 percent in 2019.

D. Project Description

6. **The proposed CRR-DPF is a stand-alone operation to cushion the impact of the COVID-19 crisis and ensure an early, strong, and sustainable rebound from the expected collapse of economic activity in 2020.** The operation is consistent with both the Government's anti-crisis plan and Croatia's medium-term goals. It supports nine prior actions, structured around two pillars. The first pillar supports government efforts to minimize the immediate social and economic impact of the crisis, especially on the most vulnerable individuals and firms. The goal of the second pillar is to advance inclusive and sustainable recovery; here, several measures address institutional challenges identified in the CPF for FY19–FY24 as impediments to Croatia's path to graduation: (i) Support to the elderly with no or low income—the group with the highest risk of poverty in Croatia. This will help close important institutional gaps in Croatia's social protection system; (ii) A stronger policy, and clear accountability framework for low-carbon development, to help Croatia move to a sustainable development path; (iii) Strengthened credit reporting, to make credit markets function better; (iv) Streamlined rules for administering EU funds, to improve the economy's capacity to absorb this important source of funding for investment. Overall, by supporting a speedy, inclusive, and environmentally sustainable recovery, minimizing loss in long-term growth potential, reinforcing institutions, and preserving medium-term fiscal sustainability, the CRR-DPF is consistent with Croatia's longer-term goal of becoming more competitive.

7. **The selection of prior actions is guided by the government's priorities and by the main objectives of the Country Partnership Framework (CPF) for FY19–FY24, informed by the Croatia Systematic Country Diagnostic.** Despite its relatively high income, Croatia is underperforming on institutional benchmarks, indicating underlying institutional challenges and weaknesses¹ that cut across sectors and impact both public and private sector. This proposed operation

¹ Key institutional challenges in Croatia include capacity gaps among national and local authorities, as high fragmentation of local decision-making authority raises costs and reduces the quality, effectiveness and sustainability of service delivery.



contributes to building essential institutional capacity, provides policy solutions that benefit the marginalized, most poor and vulnerable, catalyzes investment (including access and efficient utilization of EU funds) and contributes to global public goods. As such, in addition to helping Croatia meet the challenges from the current crisis, it directly meets the specific selectivity criteria set out in the CPF for IBRD lending.

8. **Croatia has consulted other development partners regarding its effort to mitigate the effects of the COVID-19 crisis.** The program has been discussed in detail with the European Commission, especially regarding the possibility to finance some of the measures from EU structural investment funds and from the new initiative to protect employment, SURE. Measures for supporting liquidity through new credit and guarantees schemes have been discussed with the EIB that could provide financing through the national development bank. Finally, the IMF has also been consulted regarding the response to the crisis.

E. Implementation

Institutional and Implementation Arrangements

9. **Successful implementation of the proposed reform program requires effective coordination among various ministries and agencies, and between the Government and the Bank.** The Government assigned the Ministry of Finance to coordinate the reform program, while line ministries are responsible for the implementation of reforms in their area. The key line ministries include the Ministry of Justice, Ministry of Demography, Family, Youth and Social Policy, Ministry of Regional Development and EU Funds and Croatian Bank for Restructuring and Development. Policy changes supported by the operation require strong institutional capacity to design, monitor and evaluate, which is regarded as adequate, based on an assessment of newly approved laws and regulations.

10. **Specific indicators will be used to monitor the implementation of the operation.** Results indicators have been discussed with relevant counterparts. Due to the relatively short timeframe of the proposed program, the uncertainty regarding the depth of the crisis caused both by the pandemic and the March 2020 earthquake and its impact on the results of the reforms supported, part of the selected monitoring indicators and associated target values is informed by the impact of the 2009 crisis, while in some cases results measure intermediate outcomes or even outputs, rather than development gains on the ground. The baseline and result indicators are either provided by the respective specialized agencies or can be tracked based on official statistics. They are tracked according to the indicators and results measures shown in the monitoring and results framework of the policy matrix (Annex 1). Gender-informed analyses will be carried out to assess and monitor the impact of the proposed reforms and identify appropriate mitigation measures as needed.

F. Poverty and Social Impacts, and Environmental, Forests, and Other Natural Resource Aspects

Poverty and Social Impacts

11. **Several prior actions are expected to have positive distributional and social impacts in the short run, with some neutral or positive indirect impacts in the medium run.** Reforms supported by the DPF that could have immediate positive poverty and social impacts are: (i) wage subsidies (Prior Action 1), complementary voluntary health insurance (Prior Action 2), and (ii) an expansion of social benefits (Prior Action 6). Wage subsidies that discourage layoffs are expected to have positive impacts on employment and labor income, the most important channel for sustainable poverty reduction. The expansion of social welfare benefits targeted to vulnerable groups, such as the elderly (65+) and increased



coverage by state paid complementary health insurance can protect vulnerable groups from the income losses associated with the economic crisis and increase affordability of health services. Financial incentives to firms, including the VAT and social security contributions postponements, as well as the liquidity programs (Prior Action 3 and 4) are expected to have a small poverty and distributional impact, considering the temporary nature of these measures, and the fact that they are not necessarily targeted to businesses with low and medium skill workers. However, the indirect effects of restoring fiscal and financial stability—through investment, and job creation—could lead to welfare improvements in the future. Other prior actions (Prior Action 5, 7-9) are not expected to have sizable poverty and distributional impacts.

Environmental, Forests, and Other Natural Resource Aspects

12. **The environmental protection system in the Republic of Croatia is based on a well-developed legal and institutional framework.** As an EU member, Croatia has fully aligned its environmental regulation with the EU Acquis. Environmental Act (OG 80/13, 153/13, 78/15, 12/18, 118/18) and Regulation on Environmental Impact Assessment (OG 61/14, 3/17) are key legislative acts ensuring sustainable implementation of projects carrying significant environmental risks. The Regulation stratifies environmental risks and includes screening procedures, while also defining EIA scope, procedures including public consultations. Ministry of Environment and Energy (MEE) and Environmental Protection and Energy Efficiency Fund (EPEEF) are cornerstones of the environmental protection system. EPEEF is the central point for collecting and investing extra-budgetary resources (based on the ‘polluter pays’ principle) in the programs and projects of environmental and nature protection and others. Monitoring and control framework are organized through the State Inspectorate Act (OG 115/18) and the work of the Environmental Inspection under the State Inspectorate.

13. **As per OP 8.60, the World Bank assesses whether specific country policies supported by the DPF are likely to cause significant effects on the country’s environment, forests, and other natural resources.** Assessment of the Crisis Response and Recovery DPF shows that proposed policy changes are not likely to have negative impacts on the country’s forests and/or other natural assets. Positive impacts on the environment are likely as a result of Law on Climate Change and Ozone Layer Protection adoption. Supporting efforts to curb the COVID-19 spread and protect human health is also an important aspect of this framework.

G. Risks and Mitigation

14. **There are substantial risks to this operation.** Macroeconomic risk will ultimately determine the success of the program. Achievement of the PDO crucially depends on the length and depth of the downturn. If the lockdown continues beyond the summer or is reimposed later in the year, the economic and social impact will be more severe, weakening the foundations for recovery. Risks related to sector strategies and policies and institutional capacity for implementation and sustainability are also substantial, reflecting possible reform reversal, large fiscal cost, and reliance on multiple implementing agencies. Risks are mitigated by Croatia’s intention to join the European Exchange Rate Mechanism (ERM II) in July 2020 (a precondition for euro adoption) entailing commitment to medium-term fiscal sustainability and structural reforms, as well as the additional financing available from the EU’s SURE program and from a swap line with the ECB, which should enhance fiscal sustainability and financial stability. Moreover, reform reversals are made less likely by the fact that several DPF measures are time-bound, well-targeted, transparent, already under implementation, and anchored in the EU policy agenda.



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APPROVAL

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Approved By

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