# CROATIA - SYSTEMATIC COUNTRY DIAGNOSTIC

WORLD BANK GROUP

# SYSTEMATIC COUNTRY DIAGNOSTIC SUMMARY

**In the two decades after peace was restored, Croatia made remarkable progress.** Croatia created a liberal democracy, established a market economy, achieved the status of upper-middle income country and joined the European Union (EU) on July 1, 2013. By 2017, Croatia's GDP per capita had reached US$22,000 or 63 percent of the average EU level[1]. And Croatia's growth had also benefited the bottom 40 percent of the income distribution—income growth of the bottom 40 was higher than that of the average Croatian.

**Growth prior to the 2008 crisis was to a large extent driven by an increase in domestic demand, rather than exports.** Such developments were fueled by an expansionary fiscal policy, capital accumulation and household consumption, financed by abundant liquidity in the global financial markets. From the supply side, rapid growth prior to the crisis reflected massive capital investment and rising labor force participation, rather than increases in Total Factor Productivity than made small or negative contribution to growth in the period between 2002 and 2014.

**The 2008 crisis exposed the inherent weaknesses of Croatia's growth model**. When the crisis hit, interest rates rose, capital flows came to a sudden stop and exports plummeted. The bubble burst, and a six-year long recession followed. Between 2009 to 2014, the economy contracted by 12 percent. The share of poor and vulnerable households in the population (those who live on less than US$10 per day[2]) increased from one quarter to one third of the population[3]. The rise in poverty was the largest among the EU's newer member states.

**The challenge going forward**. For Croatia to continue the convergence process, an action-oriented reform agenda needs to be implemented with a sense of urgency. The reforms need to support the opportunities for firms to drive a more dynamic business sector, boost the opportunities for people to participate in economic and social development, and refocus the role of the state in supporting inclusive growth. The strategic elements of the reform agenda are outlined below.

## Creating Opportunities for Firms

**Doing business in Croatia is difficult**. Private sector development is hampered by excessive and costly red tape, cumbersome business environment, constrained access to finance, low levels of product and services market competition, regulatory uncertainty and lack of regulatory neutrality, a high administrative burden, low transparency and predictability of administrative bodies, and long judicial procedures related to business activities. As a result, it is simply very difficult to set up and successfully run a business in Croatia.

**Access to finance is constrained.** Croatian firms view access to finance as a more binding constraint than the average in the European Union. In the 2017 Doing Business report, Croatia is one of the worst performers in Europe in terms of getting credit. Numerous government programs to support access to finance exist, but are poorly coordinated, have overlapping mandates, and are inadequately monitored and evaluated.

**Courts are inefficient, unpredictable and slow.** Delays in court processing cases are among the greatest impediments to business. The World Economic Forum 2017-2018, ranks Croatia 135th out of 137 economies in terms of the efficiency of the legal framework in settling disputes. While improvement was

[1] In PPP nominal terms.
[2] In PPP of 2005.
[3] From 26.6 percent in 2009 to 33.4 percent in 2014.

achieved in recent years, the number and disposition time in litigious civil and commercial cases remain among the highest in the EU. Effective fast-track procedure for resolving minor disputes are lacking. The negative impact of the judicial sector on the business environment is further compounded by the slow and uncertain provision of the many administrative services the justice sector still provides to the private sector, e.g. the registration of company and property rights.

**Competition is weak.** The regulatory framework is less conducive to competition than in many European and Central Asian(ECA) countries. Perceptions of the effectiveness of anti-monopoly policy in Croatia are far below the ECA average, calling in question the effectiveness of the Croatian Competition Agency The Organization for Economic Co-operation and Development (OECD) finds that product market regulations in Croatia are more restrictive than in peer countries. Regulatory restrictions appear particularly burdensome in the services sector, notably in network economies and professional services. A still-inefficient insolvency framework obstructs exit and re-entry of business into markets, impairing the efficiency of resource allocation among firms.

**State-owned enterprises (SOEs) operate in many commercial sectors, undermining competitiveness.** SOEs account for over 10 percent of employment, a fifth of total turnover and a third of total assets. Rates of return on assets are below that of SOEs in other Central and Eastern European countries, and the rate of state subsidies is higher than the EU average. Partially or wholly central state-owned enterprises operate in rail, road and air transport, hotels and restaurants, food processing, pharmaceuticals, water supply, financial services, forestry and services of motor vehicles. Another 600 companies report to sub-national, regional and municipal authorities rather than respond to the market. In 2014, the average return on equity was 4.5 percent for private companies but almost zero for SOEs. SOEs drive up wages, affect factor returns, influence output prices and impair market incentives, leading to inefficient resource allocation. As a result, productivity and allocative efficiency are higher in sectors with low state presence.

**Innovation in Croatian firms is limited.** The same factors which hinder overall private sector development also constrain the emergence of an innovation ecosystem, especially among medium and small firms. This includes limited access to internal and external resources (both funds and qualified personnel), limited information on technology and markets, the concentration of tax incentives with large firms, and barriers to science-industry collaboration. The weak performance of the innovation ecosystem is reflected in the limited complexity of Croatia's goods export basket.

**Croatia's export sector is still underdeveloped.** Export growth from 2006 to 2016 was significantly below that of regional peers and was unable to pull the economy out of the recession. Croatia has not developed the diversified and sophisticated export sector, connected to global and European value chains, which now characterizes several other Central European new member states. While Croatia remains at the margin of global value chains, accession to the European Union has helped boost export growth. Furthermore, tourism is booming and continues to dominate the export sector. Including indirect income effects, the contribution of tourism to GDP rose to over 25 percent in 2016, and is projected to reach 32 percent of GDP by 2027.

## Boosting Opportunities for People

**The crisis exposed the lack of inclusion of the pre-crisis growth model**. After the crisis, unemployment and poverty increased sharply. The crisis hit the very poor—the bottom 20 percent—the hardest. A closer look at the earlier income trends revealed that, among the income growth of the bottom 40 percent masked the lack of inclusion of the bottom 20 percent, which saw its poverty level unchanged at around five percent of the population. Only half of the bottom 20 households benefited from social assistance—below the average for the European Union.

**Social assistance was insufficient to avoid a sharp rise in poverty following the crisis.** General government spending on social protection accounts for 14.2 percent of GDP, which is in line with other Member States in the European Union. However, Croatia spends a higher fraction of social protection on contributory social insurance benefits, including disability pensions, sickness benefits and old age pensions. Fragmentation of public transfer programs, different sets of eligibility criteria for different services, the lack of monitoring and information systems, and weak coordination between agencies at the central and regional level also limit the effectiveness of social protection spending.

**Temporary employment contracts have risen sharply, with ambiguous outcomes for the poor and on-the-job skills upgrading.** The share of individuals with temporary contracts increased to 19.3 percent of those employed between 15 and 64 years in 2016 (the EU average is 12.0 percent). The share of temporarily employed was highest among poorer working-age individuals. More than 60 percent of all unemployed who transitioned into a job worked under temporary contracts, which illustrates how labor market deregulation can provide an entry path into permanent employment. However, the rise in temporary employment undermines the incentives for both workers and employers to invest in on-the-job skills upgrading. Only 3 percent of adults between 25 and 64 years participate in some form of workforce education or training, far below many peers in the EU, which limits employability in a quickly changing labor market.

**Education and vocational training outcomes are below average.** The working age population (aged 15 to 64) is projected to decline by 30 percent by 2050. This puts a premium on creating a better educated workforce. Croatia scores relatively low on PISA and TIMSS scores, particularly in mathematics and science. In 2016, only 29 percent of 30-34-year-olds had tertiary education, far below the EU average of 39 percent. In addition, the number of tertiary education graduates in science, technology, engineering and mathematics (STEM) is particularly low. While participation in post-secondary vocational training (TVET) is high, the training curricula do not reflect employers' demand for skills: nearly half of those with vocational training work outside of their field of specialization. Continuous delays in the drafting and implementation of new legislation have further impeded retraining of an aging work force**,** including (long-term) unemployed and inactive workers.

**Tax and social insurance policies reduce the incentives to work for the poor and for women.** The marginal effective tax rate is particularly high for potential low-wage single earners with children. Generous eligibility criteria for a multiple of pension and disability insurance schemes also bias against labor market participation. And flexibility in working arrangements is low: only 6 percent of Croatia's employed population worked part-time in 2016, compared to nearly 20 percent in the EU. Combined with the limited formal care for children and the elderly, this creates a particular burden for women in reconciling work and family responsibilities.

**Several Croatian regions and many rural areas are lagging.** In the eastern part of the country, employment rates in the 15 to 64 age group are lower, unemployment rates are higher and poverty rates are higher. Rural areas are lagging everywhere: the share of the population living below the US$10 PPP threshold in 2013 was 45 percent in rural areas but only 29 percent in urban areas.

**Lacking opportunities at home, Croatians seize opportunities abroad**. Finally, the lack of opportunities for people fuels high levels of external migration. Croatia's external migration is among the highest in the EU. It is driven by the combination of the lack of opportunities for firms and people at home, on the one hand, and the large wage gap between Croatia and the traditional countries of destination for migration (Germany and Austria).

## Refocusing the Role of the State

**The governance of Croatia's public sector lags its EU peers across the board**. Insufficient coordination and cooperation between agencies and levels of government impairs policy coherence. Poor legislative quality has led to frequent amendments to address shortcomings, increasing uncertainty and raising the costs of compliance. And the high fragmentation of local government units raises costs, and reduces the quality, effectiveness and sustainability of services delivery. Finally, frequent changes in government are also accompanied by changes in technical staff, making it difficult to carry through with consistent policies and coherent oversight.

**Fiscal management is weak.** Current expenditures on subsidies and public wages are significantly higher than most EU peers. Since 2008, the level of public debt doubled since 2008, and was at 80 percent of GDP in 2017. In addition, the bulk of the debt accumulated during the crisis was either issued abroad or issued domestically in, or indexed to, the euro. In spite of the tightly managed float of the kuna's exchange rate against the euro, the cost of credit default swaps for Croatia is higher than for its peers, indicating the market's pricing of the risk associated with Croatia's sovereign borrowing. Finally, current debt management ignores the financing needs of extra-budgetary entities, which have contributed to a large extent to the build-up of debt and contingent liabilities.

**Public infrastructure investment is inefficient.** Croatia made large infrastructure investments after independence, during the 2000s in response to the need for a visible integration of Croatian territory, efforts to spur industrial growth and tourism, and the desire to integrate into the broader European network. However, Croatia underperforms all EU peers in the World Bank Logistics Performance Index. Port-rail interfaces are under-developed, and rail operations are slow and unreliable. Infrastructure SOEs suffer from weak corporate governance, low profitability, and high indebtedness.

**The use of EU funds needs improvement.** Measures to enhance the efficiency and growth impact of public infrastructure funds, including the projected large inflow of EU funds, involve strengthening public investments management (PIM) planning, contracting, and implementation capacities, along with better strategic planning and establishment of a medium-term budgeting framework. Dispersion of public investment across various levels of government and SOEs pose additional challenges of coordination, rationalization and effectiveness of investment decisions.

**The preservation of natural capital will remain critical to growth.** The increase in tourist visits to the major national parks will require an increase in their carrying capacity. Internal migration is also placing additional pressure on local resources.

**Croatia ought to significantly transform the role of the state in the economy to reignite the process of inclusive growth**. How firms, people and the state interact should change. A better balance needs to be found between the state as an economic actor or as a regulator of competition. Powerful groups, and perhaps public attitudes, can obstruct reforms. The deep politicization of the civil service, the prevalence of the SOE sector and weak governance structures provide a terrain favorable to clientelism and capture. A substantial number of autonomous, self-organized groups have considerable ability to prevent generally beneficial changes that threaten their privileges. The 2016 Life in Transition III survey suggests that public support for a market economy is among the lowest in ECA, and the Global Entrepreneurship Monitor for Croatia 2016 finds that successful entrepreneurs do not hold high social status and their activities are mostly not covered by the media. These attitudes may play a role in undermining support for reform.

## Increasing Resilience and Deepening the Reform Agenda

**Croatia urgently needs an action-oriented program to accelerate reforms, avoid the "middle income trap", and continue catching up with the EU**. Croatia lags behind the income levels of its Eastern European peers, driving public discontent and contributing to emigration of young and skilled workers. High public debt, an aging population, low labor force participation, strict rules controlling in-migration, and an institutional and an incoherent policy framework threaten the economic and social progress achieved prior to the recession. Without a step-up in its reform agenda, Croatia could experience prolonged economic stagnation or deterioration of social conditions. Dissatisfaction with limited economic prospects and continued barriers to social mobility could increase political and social tensions.

**Greater effort is needed to generate public support for the reform program.** Powerful groups and frequent political changes have undermined the continuity and effectiveness of the political actions and limited reforms that are essential to growth and development. Transparent communication, as well as greater attention and resources devoted to explaining the benefits of reform could increase public understanding of the policy changes that are needed for the sustainability of the economic and social system.

**Reshaping the role of the state to set the right incentives for enterprises and individuals to prosper is the cornerstone of the reform agenda that Croatia needs according to the WBG.** Building 'efficiency-enhancing' institutions will require changing how the government provides for public services and how it regulates capital, product and labor markets. Key priority reform areas can be articulated around the following three objectives:

- Creating opportunities for firms to drive a more dynamic enterprise sector;
- Boosting the opportunities for people to participate in economic and social development, and
- Refocusing the role of the state in supporting higher and more inclusive growth.

**Time is pressing.** The longer the delay in improving skills and enabling Croatian firms and individuals to participate effectively in improved productivity growth, the more difficult it will be to catch up. Rapid technological change is increasing the returns to skills and boosting productivity in more successful and sophisticated economies. Finally, the aspiration to adopt the Euro also requires accelerating structural reforms to compensate for the loss of monetary policy intervention and help absorb external shocks. Experience suggests that, in addition to satisfying the macro-fiscal convergence criteria, successful adoption of the Euro and resilient convergence within the EU, will hinge on Croatia improving the institutions which enable its firms and individuals to thrive domestically.