

3.11 Croatia

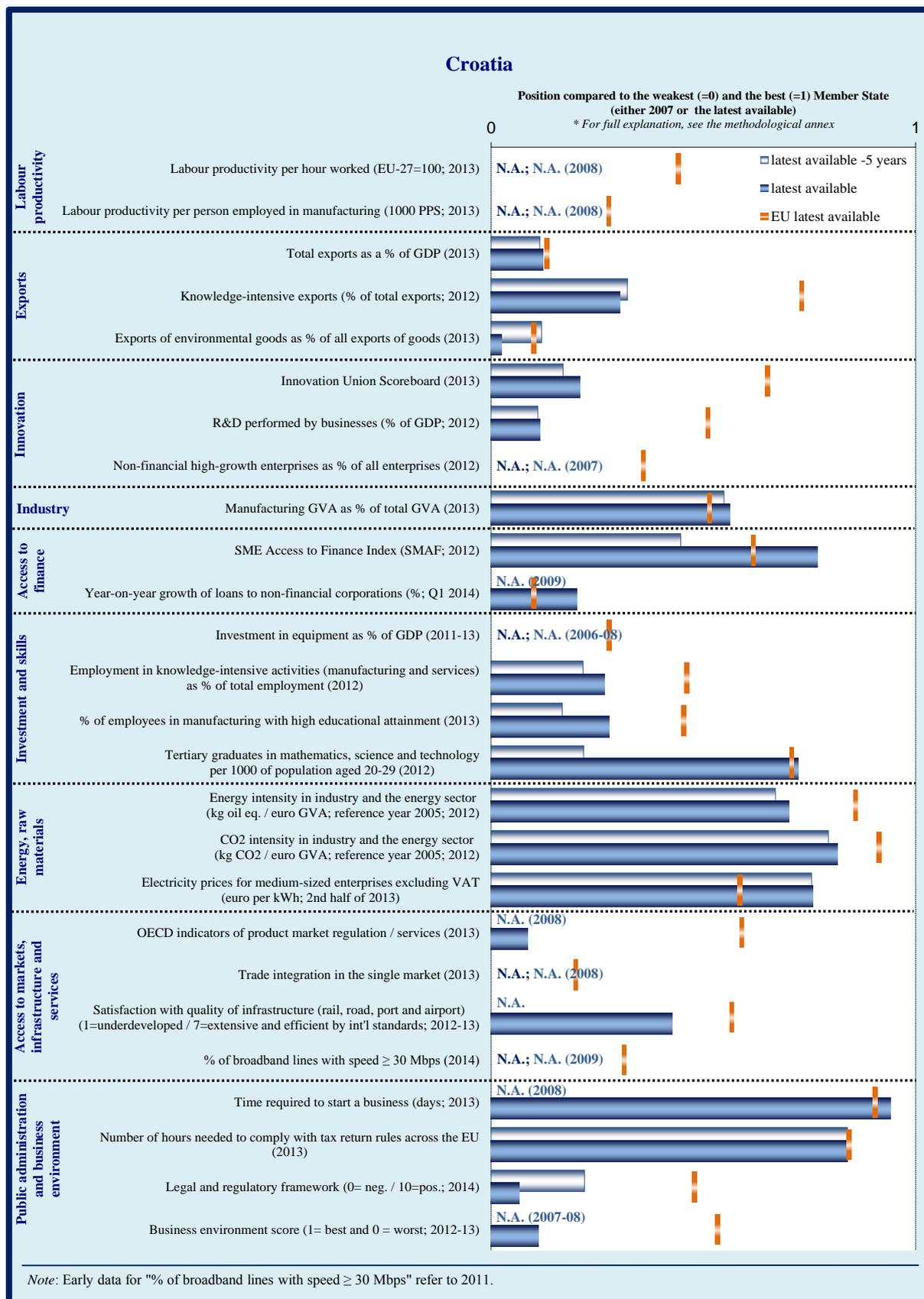
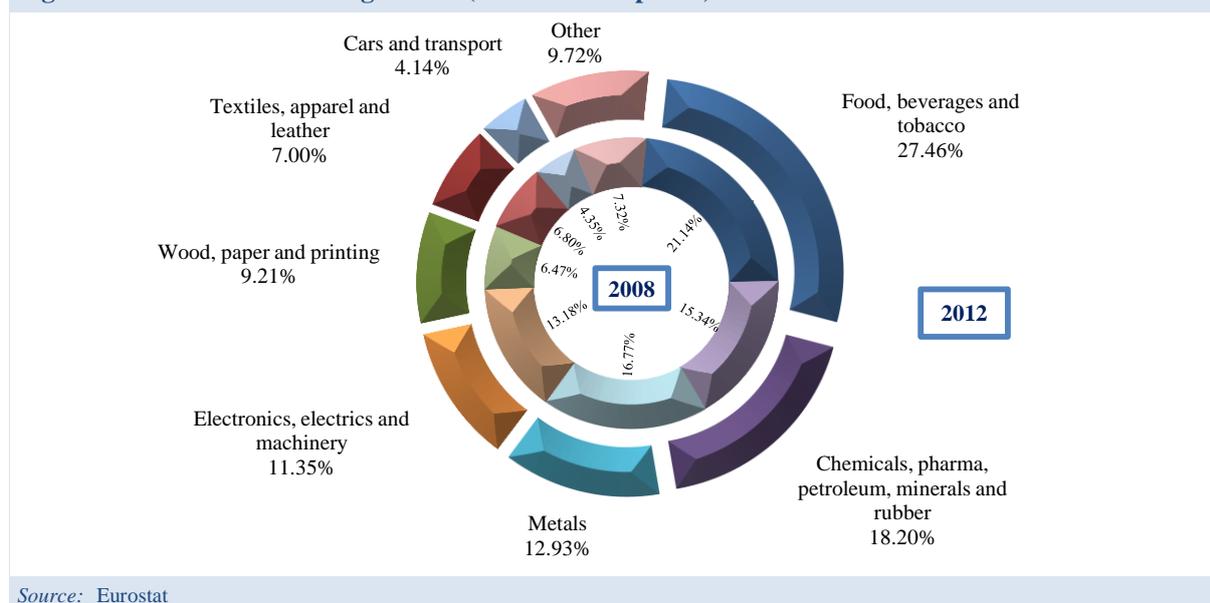


Figure 3.11.1: Manufacturing sectors (GVA at basic prices) - Croatia

3.11.1 Introduction and performance

Croatia's economy continues to suffer from the effects of a long recession — in 2013 growth stood at 1 % and is expected to fall by 0.6 % in 2014. Labour productivity decreased by 0.2% in 2013 comparing to 2012 and stays at 80.1 %. The current account has improved to 0.1 % of GDP due to falling imports, although high-knowledge exports remain low, at 7.4 %. Innovation performance has not improved in recent years and industrial production has been falling since 2009, and, in contrast to most other Member States, did not recover in 2010-11. The manufacturing sector accounts for 16.2 % of GDP. Regional disparities persist, but the Law on Regional Development, to be renewed in 2014, addresses this.

3.11.2 Access to finance and investment

The financial system is conservative and dominated by traditional banking products — bank loans account for more than 75 % of total financing, and for SMEs this figure is 97 %. Only 1 % of SMEs used equity financing in 2013, the second-lowest percentage in the EU.

Access to finance has worsened in recent years, limiting companies' growth potential. SMEs particularly have problems here, as only short-term financing is available at high rates. Their capital position has continued to deteriorate, and this was

reflected in a further deterioration in the quality of loans made to SMEs. Banks that finance SMEs are faced with negative selection, asymmetry of information, and high transaction costs, all of which influence their willingness to give loans to this sector. About 23 % of polled SMEs reported access to finance as their most pressing problem, the third-highest level in the EU. The rate of non-performing loans is high at around 25 %, with an even worse situation in peripheral regions. The use of loans over EUR 1 million has decreased from 7 % to 4 %, and there has been a large drop in banks' willingness to lend. In 48 % of cases, SMEs reported high interest rates as the limiting factor.

The existing support framework is based around two state agencies, HBOR and HAMAG BICRO, providing favourable loans and guarantees. HAMAG BICRO is the result of a merger of HAMAG Invest and BICRO, the business innovation agency. The merger strengthened the agency, which has now signed a contract with the European Investment Fund and started a microloan scheme for SME financing.

HBOR is the Croatian export credit agency, and supports exports by insuring against political and commercial risks. In 2013, it approved 1256 loans for a total of HRK 7.8 billion.

A state venture capital fund instrument exists (the Economic Co-operation Funds) but it has been criticised as being a very slow, rigid and risk-averse system, geared towards restructuring large enterprises

rather than towards start-ups. It has invested only HRK 704 million by 31 March 2014.

An annual support measure called the *Entrepreneurial impulse* is regularly carried out, and in 2013 supported over 1800 companies, mainly in export-related activities. The 2014 impulse will focus on entrepreneurial support institutions, mainly in less developed regions, and on further strengthening the SME sector's export potential.

Investment

Gross fixed capital formation fell in 2012, from 19.6% to 18.6%, but is still above the EU average of 17.9%. Historically, foreign direct investment has played an important role but has collapsed since 2008. In 2013, due to a lack of economic recovery, a high fiscal deficit and no structural reform, rating agencies downgraded Croatia's sovereign rating to the non-investment grade.

The Act on Investment Promotion and Development of Investment Climate started bearing fruit in 2013. The framework conditions have improved due to new investment incentives and a different approach towards strategic investments. The agency for investments and competitiveness, together with other partners, has produced a catalogue of investment projects ready for foreign and domestic co-financing.

3.11.3 Innovation and skills

Innovation

Croatia's innovation performance is below the EU average; it has stagnated in recent years and in some respects deteriorated further. In 2002-12, R&D expenditure decreased from 0.96% of GDP to 0.75% (the EU average is 2.6%), while private expenditure on R&D fell from 0.41% to 0.34% (the EU average is 1.3%). Public research is constrained by limited funds and by the fact that there is little commercialisation of research. Private innovation is also held back by the lack of a venture capital market to provide funding. In the Innovation Union Scoreboard 2014, Croatia fell by one place and is now the sixth worst performer in the EU, doing relatively well on human resources but very poorly on business investment. In the Regional Innovation Scoreboard, the Zagreb region's ranking also fell.

So far, not much attention had been paid to developing and commercialising private innovation. The law on higher education and science was adopted in August 2013, but covers only early aspects of innovation. Three further strategies, on innovation, industrial policy and smart specialisation, aim to restructure the innovation framework and to promote the commercialisation of research. They have been delayed, however.

The innovation strategy aims to increase the share of business sector investment in R&D and innovation by: stimulating basic and applied industrial research in the scientific research sector, fostering the innovation potential of the business sector, increasing knowledge dissemination, and strengthening human resources.

The industrial strategy defines strategic industrial manufacturing activities, and aims to expand production, exports and employment in these sectors. The smart specialisation strategy attempts to create 12 competitiveness clusters by encouraging cooperation between the public, private and research sectors. The clusters were identified during a largely top-down process to emphasise potential for innovation, value added, export potential, and value in the domestic market. The sectors are: automotive, wood processing, food processing, chemical, defence, electrical and machinery, health, cultural and creative industries, ICT, maritime, textile leather and footwear, and construction. However, none of these three strategies has been adopted yet, and the links between them are unclear.

Skills

The quality of education is a challenge across all educational sectors, tertiary education attainment is low (at 23.7%, compared to 35.8% in the EU), brain drain is a problem, and there is a significant skills mismatch. Vocational education and training plays a large role with 70.7% of regular secondary education students enrolled (2011) — the system is currently under reform, as it has not been sufficiently responsive to the needs of the labour market.

Following a skills analysis, new curricula based on competencies prescribed by occupational standards are being piloted in 54 schools. To further analyse skills mismatches, a system of tracing graduates' employment patterns has been introduced. An implementing act for quality assurance in vocational

training and adult education is expected in 2014, and will put in place a system of external monitoring.

The qualifications framework is under development, with the aim of standardising qualification profiles to better fit the needs of the labour market. It is an ambitious project which risks being difficult to implement.

3.11.4 Energy, raw materials and sustainability

Croatia scores lower on sustainability than the EU average, but it performs well in some areas. Reforms in the areas of energy and raw materials are progressing. Although the economy's resource productivity is low, at EUR 0.81 per kg in 2011 (the EU average is 1.59), domestic material consumption is lower, at 10.6 tonnes per capita (the EU average is 14.72). ⁽¹⁾ Greenhouse gas emissions per capita are lower than in the EU on average, at 6.4 tonnes (the EU average is 9.06). Gas and electricity prices are broadly in line with EU levels. The share of renewable energy in gross final energy consumption is higher, at 15.7% (the EU average is 13%), thanks to the use of hydroelectric power and biomass heat. However, small-scale reusable energy sources are still underdeveloped.

In October 2013, a programme for the energy renovation of public buildings was adopted and a feed-in tariff was introduced. HAMAG BICRO launched a pilot project providing business advisory services to 25 participants in the fields of energy efficiency, renewable energy sources and environmental protection. Energy renovation programmes for family houses, residential buildings and commercial non-residential buildings are under preparation.

The Act on Sustainable Waste Management was adopted in 2013. It brought regulations in this area in line with EU directives, and increased landfilling fees. Local governments are required to introduce separate collection by July 2014.

The renewable energy sources act is still in preparation.

⁽¹⁾ Resource Efficiency Scoreboard, Eurostat.

3.11.5 Access to markets, infrastructure and services

Internal market and internationalisation

The development of high-value-added exports is a priority for the government, with many ongoing projects promoting exports, including SME exports.

In 2013, exports of goods and services accounted for 43% of GDP, with the EU as Croatia's main trading partner. The trade balance has improved since 2008 due to falling domestic demand. However, exports are still dominated by low- and medium-value-added products — the main exports are tourism, machinery, fuels, chemicals, base metals, foodstuffs and transport equipment. High-tech exports accounted for only 7.4% of total exports in 2012 (the EU average is 15.6%).

In 2013, a commission for the internationalisation of the economy was set up to coordinate the work of all involved institutions and to provide a single point of contact for exporters. In addition, an action plan for export promotion 2014-15 was adopted in May 2014.

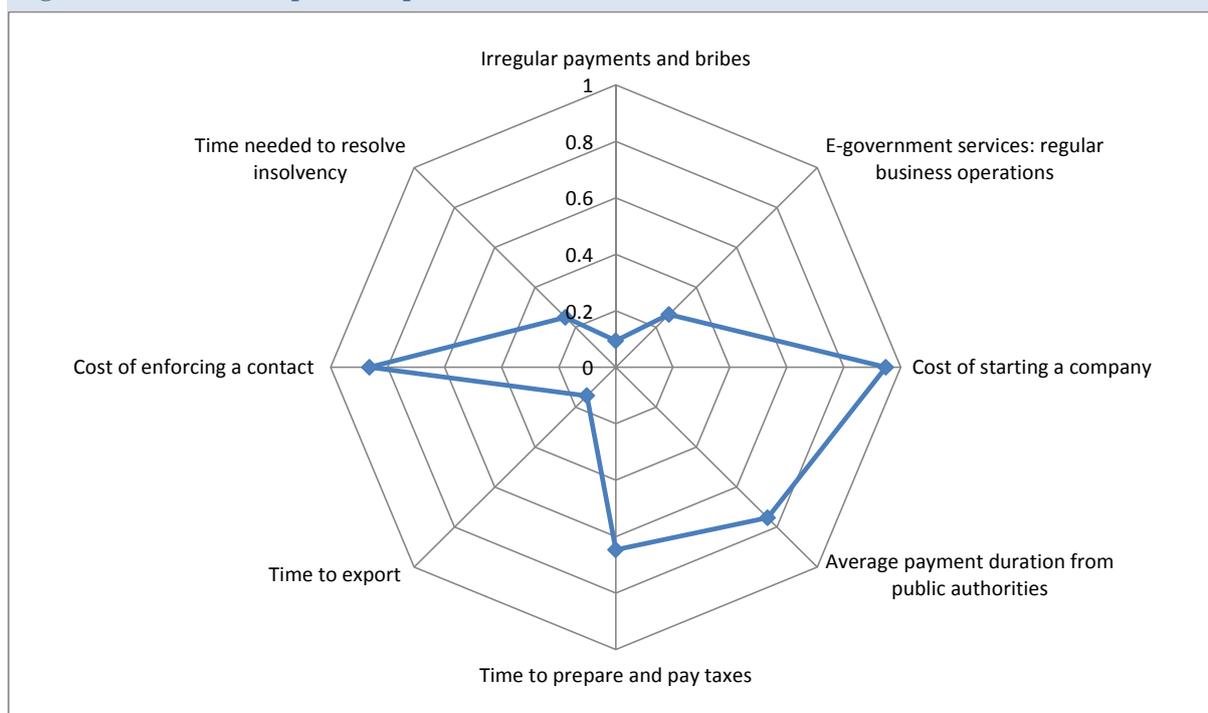
Since the creation of the Agency for Investment and Competitiveness, Croatia is also actively targeting foreign direct investment. The agency supports prospective investors, works to identify the regulatory barriers found most burdensome by businesses and informs the authorities responsible about its findings. This has led to improvements in licensing and specific charges (see below).

Business services and network industries

The market share of the largest electricity generator is high at 73%, with a growing number of electricity providers due to market liberalisation. The gas market was also liberalised. The Croatian Energy Regulatory Agency was set up in 2014.

Infrastructure

Road transport infrastructure is of high quality. Significant investment (backed by EU funds) is planned for developing railway infrastructure, sea ports and inland waterways. On the digital agenda, the coverage of very fast broadband lines is currently below the EU average, and so is the availability of e-government services.

Figure 3.11.2: Overall profile of public administration - Croatia

Note: Values have been scaled so that the best observation (Member State) gets 1 and the worst gets 0.

Source: World Bank Doing business; Intrum Justitia; OECD; World Economic Forum; European Commission

In 2013, approximately EUR 165 million was invested through the infrastructure programme, an increase of 20% in comparison with the previous year. Investment in energy infrastructure in cities and municipalities, reconstruction of roads and business zones, and investment in modernising and extending the work of local and regional government-owned utility companies were the priorities.

3.11.6 Public administration and business environment

Entrepreneurship and Small Business Act

Entrepreneurship and self-employment are not sufficiently developed, but education is seen as a positive factor in developing an entrepreneurial attitude and a strategy for entrepreneurial education has been implemented.

The entrepreneurial infrastructure improvement act was passed in July 2013, supporting the creation of entrepreneurial zones and introducing an entrepreneurial register.

In 2013, the new pre-insolvency procedure was adopted and has been widely used. It increased the

security of entrepreneurs by addressing debt-servicing problems faced by companies in the context of complex, expensive and lengthy insolvency procedures. However, there is still a problem with its fair implementation across the country.

Administration modernisation

Dealing with the public administration remains a significant problem for businesses. Fragmented and inefficient administration is an issue and civil justice remains a challenge despite reforms adopted in 2012 and 2013. Enforcement of rulings on monetary assets has improved following the introduction of immediate enforcement. However, the recovery rate on immovable property is low. The length of proceedings is very high both in civil, commercial and administrative cases, while the backlogs are high in civil and commercial proceedings.

Work has been carried out in recent years to improve the anti-corruption framework, but there is no convincing track record of effectively implementing measures to prevent corruption.

Stakeholders' main complaint is about regulatory instability. It is true that too much legislative activity may lead to overlapping legislation, legal uncertainty

and inefficient implementation. Concerns about regulatory stability, especially when implementation of regulatory changes is uneven across the fragmented and non-transparent local administrations, should be judged against the need to put in place a clearer and more rational legislative framework. Although regulatory impact assessment is carried out, resources are insufficient for this to happen systematically.

Broadening the use of e-government is a priority. A central payroll system is being rolled out in 2014 and will cover employees from education, health, justice, courts, agencies, culture, and all employees paid from the state budget. It will provide transparency and rationalise spending.

The strategy for modernising the public administration, to be presented in 2014, might address the administration's fragmentation. It covers state, agency and local administration authorities, and seeks to improve budgetary monitoring, resource management, service quality, standardisation of rules, and performance management. It reduces the number of regional offices from 20 to five.

Preparations for a law on state information infrastructure are also ongoing. This law will establish a legal basis for the development of integrated systems following the 'just once' principle and including a national identification and authentication system.

Reducing administrative burden

The World Bank's Doing Business Report 2014 ranks Croatia 89th globally, behind all EU countries except Malta. Croatia's position has improved significantly since 2005, but has worsened in the last three years.

Registration of new companies has been significantly streamlined by the 'simple limited liability company' procedure, now in its second year of operation. Better internal coordination has reduced the number of needed documents from 30 to six or seven. Licensing procedures have been shortened with the introduction of 'silent consent' after 30 days — although not for all types of licences. Electronic registration of businesses is planned via the Point of Single Contact, and administrative procedures for particular service activities will be simplified in line with the Services Directive.

A new building act and physical planning act have been adopted, simplifying construction permit procedures. Moreover, linking data of the land registry and that of the cadastre is ongoing, with 50 % completed so far. However, it is the non-controversial cases that were linked first, so completion is still far off.

In 2013, the working group on the business climate and private investment adopted 181 measures to improve the business environment, concentrating on reducing the number of non-tax levies; 52 such levies were eliminated as a result. Non-tax levies are considered a major problem for the business environment, not so much because of the amount due but more because of their number (more than 400) and the associated administrative burden.

Facilitating tax payments

The taxation system is not overly burdensome for businesses and corporate income tax is one of the lowest in the EU. In 2013, tax procedures were simplified with the introduction of an electronic system for social security contributions.

The tax administration is being reorganised to rationalise and unify working methods and ensure the equal treatment of taxpayers. The Large Taxpayers Office introduced in 2013 is not yet operating at full capacity, but authorities estimate that it has already made a significant positive impact.

3.11.7 Conclusions

The manufacturing sector accounts for a somewhat higher proportion of the Croatian economy than in the EU, but in recent years most growth can be attributed to the development of services.

The European Investment and Structural Funds, which are available in Croatia for the first time, represent a great opportunity for investment in key bottlenecks to growth. Strong administrative capacity and strategic planning will be crucial to make efficient use of the funds. To increase the value-added of manufacturing and especially of exports, the planned strategies in the areas of industry, innovation and smart specialisation must be implemented.

Access to finance conditions, worsened by the crisis, pose particular difficulties and are exacerbated by the lack of alternative sources of finance.

The business environment and public administration remain unfriendly to business. The government is aware of this and is addressing the problem. Some progress has been achieved in the field of the business environment and public administration, especially on reducing the regulatory burden, but implementation needs to be complete and consistent for the situation to improve.