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On 25 January 2022, the OECD Council decided to open accession discussions with Croatia as well as five other countries (Argentina, Brazil, Bulgaria, Peru and Romania). On 10 June 2022, the Council at Ministerial Level adopted the Roadmap for the Accession Process of Croatia [C/MIN(2022)23/FINAL], setting out the terms, conditions and process for the accession of Croatia to the OECD. In accordance with this Roadmap, 25 OECD technical committees, composed of expert policy-makers from each of the 38 OECD Members, will conduct an in-depth assessment of Croatia's legislation, policies and practices against OECD legal instruments as well as OECD best policies and practices covering multiple areas of government policy, including but not limited to economic policy, labour market and social policy, education, and health.

The overarching objective of the OECD accession process is to promote Croatia's convergence with OECD standards, best policies and best practices, resulting in better outcomes for OECD Members as well as for Croatia and its citizens. Throughout the accession process, the OECD will work closely with Croatia to support the adoption of long-lasting reforms for this purpose.

The Economic Survey of Croatia was discussed at a meeting of the Economic and Development Review Committee (EDRC) on 4 July 2023 and is published on the responsibility of the Secretary-General of the OECD. The cut-off date for data used in the Survey is 12 September 2023. Information on other Surveys and how they are prepared is available at https://www.oecd.org/economy/surveys/

Publication of this document, and the analysis and recommendations contained therein, do not prejudge in any way the results of the review of Croatia by the Economic Development Review Committee as part of its process of accession to the OECD.

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BASIC STATISTICS OF CROATIA, 2022

(Numbers in parentheses refer to the OECD average)[1]

LAND, PEOPLE AND ELECTORAL CYCLE					
Population (million, 2021)	3.9		Population density per km² (2021)	68.9	(38.7)
Under 15 (%, 2021)	14.1	(17.4)	Life expectancy at birth (years, 2021)	76.4	(78.7)
Over 65 (%, 2021)	22.0	(17.7)	Men (2021)	73.4	(75.9)
International migrant stock (% of population, 2019)	12.5	(13.2)	Women (2021)	79.6	(81.7)
Latest 5-year average growth (%)	-1.4	(0.5)	Latest general election	July-2020	
ECONOMY					
Gross domestic product (GDP)			Value added shares (%, 2021)		
In current prices (billion USD)	71.0		Agriculture, forestry, and fishing	3.5	(2.6)
In current prices (billion EUR)	67.3		Industry including construction	23.8	(26.6)
Latest 5-year average real growth (%)	3.2	(1.6)	Services	72.7	(70.8)
Per capita (thousand USD PPP, 2021)	34.5	(50.9)			
GENERAL GOVERNMENT Per cent of GDP					
Expenditure (OECD: 2021)	44.9	(46.3)	Gross financial debt (OECD: 2021)	89.1	(109.6)
Revenue (OECD: 2021)	45.2	(38.8)	Net financial debt (OECD: 2021)	36.6	(71.0)
EXTERNAL ACCOUNTS					
Exchange rate (EUR per USD)	0.95		Main exports (% of total merchandise exports)		
PPP exchange rate (USA = 1)	0.43		Machinery and transport equipment	19.5	
In per cent of GDP			Mineral fuels, lubricants, and related materials	18.3	
Exports of goods and services	60.9	(33.3)	Manufactured goods	16.7	
Imports of goods and services	65.3	(34.9)	Main imports (% of total merchandise imports)		
Current account balance	-1.6	-(1.1)	Mineral fuels, lubricants, and related materials	25.7	
Net international investment position	26.5		Machinery and transport equipment	21.2	
			Manufactured goods	16.1	
LABOUR MARKET, SKILLS, AND INNOVATION					
Employment rate (aged 15 and over, %, 2021, OECD: 2022)	47.8	(57.5)	Unemployment rate, Labour Force Survey (aged 15 and over, %, 2021, OECD: 2022)	7.6	(5.0)
Men (2021, OECD: 2022)	54.1	(65.4)	Youth (aged 15-24, %, 2021, OECD: 2022)	21.9	(10.9)
Women (2021, OECD: 2022)	42.1	(50.2)	Long-term unemployed (1 year and over, %, 2021)	2.8	(1.7)
Participation rate (aged 15 and over, %)	52.3	(60.9)	Tertiary educational attainment (aged 25-64, %, 2011, OECD: 2021)?	18.3	(39.9)
Average hours worked per year (2021)	1,835	(1,716)	Gross domestic expenditure on R&D (% of GDP, 2020)	1.2	(3.0)
ENVIRONMENT					
Total primary energy supply per capita (toe, 2020, OECD: 2021)	2.0	(3.8)	CO_2 emissions from fuel combustion per capita (tons, 2020, OECD: 2021)	3.6	(7.9)
Renewables (%, 2020, OECD: 2021)	26.4	(11.6)	Renewable internal freshwater resources per capita (1 000 m³, 2019)	9.3	
Exposure to air pollution (more than 10 μg/m³ of PM 2.5, % of population, 2019)	96.9	(61.7)	Municipal waste per capita (tons, 2021, OECD: 2020)	446	(0.5)
SOCIETY					
Income inequality (Gini coefficient, 2019, OECD: latest available)	0.289	(0.315)	Education outcomes (PISA score, 2018)		
Poverty gap at USD 6.85 a day (2017 PPP, %, 2019)	0.7		Reading	479	(485)
Median disposable household income (thousand USD PPP, 2021, OECD: 2018)	18.7	(25.5)	Mathematics	464	(487)
Public and private spending (% of GDP)			Science	472	(487)
Health care (2020)	7.8	(9.7)	Share of women in parliament (%, 2021)	31.1	(32.4)
Pensions (2020, OECD: 2019)	8.2	(9.5)	Net official development assistance (% of GNI, 2017)	0.1	(0.4)
Education (% of GNI, 2020)	3.7	(4.4)			

Note: The year is indicated in parenthesis if it deviates from the year in the main title of this table.

1. Where the OECD aggregate is not provided in the source database, a simple OECD average of latest available data is calculated where data exist for at least 80% of member countries.

Source: Calculations based on data extracted from databases of the following organisations: OECD, International Energy Agency, International Labour Organisation, International Monetary Fund, United Nations, World Bank.

Executive summary

Croatia's economy has been resilient

Croatia's strong recovery from the COVID crisis was slowed in 2022 by surging inflation and weaker global growth. Growth ahead will be supported by recovering household real disposable incomes arising from wage and employment growth, strong services exports, and by expanding investment (Table 1). Integration in the euro and Schengen areas provides a further fillip to external demand. Limited spare capacity, notably from skill shortages, is constraining output growth. Returning inflation to low rates while expanding the economy's productive potential will be key to sustaining economic growth.

Croatia's economic policy has forcefully countered the COVID-19 and energy price crises. In response to rising prices, generous public support packages have buttressed the incomes of households and firms. Largely untargeted price subsidies make up the bulk of these measures, along with support for vulnerable groups and investments to improve energy efficiency. Following the most recent extensions, the measures will largely expire by October 2023 and April 2024, and are becoming less significant as energy prices decline. Retreating energy prices are lowering headline inflation (Figure 1). However, rising input costs, capacity constraints and wages, along with elevated price expectations, are slowing the decline in inflation. If energy prices were to surge again, private consumption, public finances, and international competitiveness risk weakening.

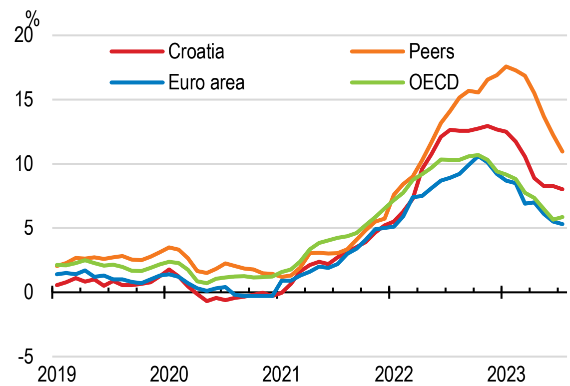
Table 1. Growth is set to be sustained

Annual growth rates, unless specified	2021	2022	2023	2024
Gross domestic product (GDP)	13.1	6.2	3.0	2.4
Private consumption	9.9	5.1	2.3	2.3
Government consumption	3.0	3.2	2.0	3.5
Gross fixed capital formation	4.7	5.8	2.6	2.6
Exports of goods and services	36.4	25.4	-0.2	1.9
Imports of goods and services	17.6	25.0	-4.6	2.2
Unemployment rate (% of labour force)	7.6	7.0	6.0	5.8
Consumer price index	2.7	10.7	8.5	4.3
Fiscal balance (% of GDP)	-2.5	0.4	-0.1	-1.0
Primary budget balance (% of GDP)	-1.1	1.6	1.3	0.5
Underlying primary fiscal balance (% of potential GDP)	-2.5	-1.9	-2.2	-3.0
General government gross debt (% of GDP, Maastricht definition)	78.3	68.8	63.8	61.0

Source: OECD Economic Outlook 113 (database), updated.

The banking sector appears in reasonable health. The removal of most exchange rate risks from banks' balance sheets has freed liquidity. This is temporarily limiting the transmission of tighter euro-area monetary policy into Croatia. Ensuring that the increased liquidity supports economically valuable investment would help make the most of euro-area integration. A large rise in low-quality lending or a deterioration in banks' health due to contagion from international banking difficulties would imperil credit for investment.

Figure 1. The surge in inflation is slowly abating



Note: 'Peers' is the unweighted average of Czech Republic, Hungary, Slovak Republic, and Slovenia.
Source: OECD Price Statistics database.

StatLink https://stat.link/34mau8

While public debt is declining, ageing pressures remain a key challenge

Sustained primary budget surpluses provided fiscal space for the COVID-19 and energy price responses and have contained public debt ratios. Ensuring that public finances act counter-cyclically while investing in infrastructure, the green transition and coping with fiscal headwinds from ageing remains a core challenge.

Economic growth, rising prices and the return to a budget surplus in 2022 have reduced the public debt ratio towards 60% of GDP. Spreads on government bonds and agencies' ratings improved when euro membership was confirmed and have since been stable. The shift back to budget deficits in 2023 and 2024 will add to demand and inflationary pressures. Looking ahead, fiscal consolidation would help macroeconomic stabilisation and ensure resources are available for future investment needs, including in skills, the green transition and digitalising the public sector. Croatia is gradually improving how it prepares and monitors its budget and is developing spending reviews, that can help improve allocations for more growth-supporting spending. Overall, income tax and indirect tax rates are similar to those in many OECD countries. However, numerous tax expenditures, notably for the tourist sector, narrow the revenue base and distort investment decisions. Despite the ongoing digitalisation of the tax administration, complex processes add to compliance burdens.

Croatia is a relatively large recipient of European Union funds and is advancing well with its Recovery and Resilience Plan. The Plan is accelerating structural reform and investments, from further developing adult skill training to improving energy efficiency and how the state operates and regulates. The government has developed dedicated bodies to implement the Plan. Their success demonstrates how greater organisational capacity and better coordination could help improve how other public programmes and investments are implemented.

Complex government structures plus shortages of key administrative personnel compromise the quality of public services. The number and size of subnational governments is similar to many OECD countries relative to population. However, overlapping responsibilities and coordination challenges reduce the efficiency and delivery of essential social services, and complicate regulatory processes. Civil-service pay may not be competitive, weakening administrative capacity.

A faster green transition is needed

Croatia's greenhouse gas emissions declined modestly in recent years and the economy remains relatively emissions intensive. Raising living standards while reducing emissions will require an accelerated decoupling of emissions from economic activity.

Pricing emissions consistently, as part of a policy mix with regulation and support for investment, can help reduce emission intensity. About one third of Croatia's emissions are subject to carbon pricing via the European emission trading scheme. However, subsidies or reduced tax rates on some fossil fuels work against emission reduction. Also, Croatia produces more emissions from transport per capita than most OECD countries, partly reflecting relatively under-developed public transport and an ageing vehicle fleet. Addressing these will require substantial outlays by households and the public sector. Building retrofits can cut emissions and reduce energy poverty, but the upfront costs are a barrier.

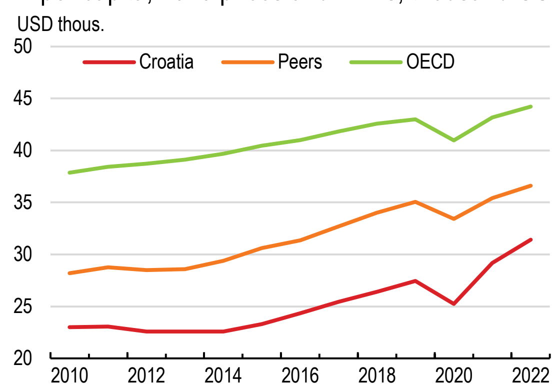
Croatia is vulnerable to a warming climate. Damages from extreme weather events, such as floods, are likely to increase, raising costs for the private sector and public finances. Meanwhile, insurance coverage is limited.

Improving the business environment can raise investment and productivity

Stronger productivity and investment growth will be essential to accelerate economic convergence (Figure 2). While the tourism sector has been key for Croatia's income and export growth, businesses in all sectors tend to be less productive than their OECD peers. Aggregate productivity is dragged down by the many long-established, low productivity firms, and by the relatively small share of dynamic, high productivity firms.

Figure 2. Growth must remain robust for incomes to catch up

GDP per capita, 2015 prices and PPPs, thousand USD



Note: 'Peers' is the unweighted average of Czech Republic, Hungary, Slovak Republic, and Slovenia.
Source: OECD Annual National Accounts (database).

StatLink https://stat.link/8clxth

Weak regulatory and governance quality contribute to productivity gaps. The design of some regulatory frameworks present barriers to business. Furthermore, where design is sound, regulations are often burdensome in practice. Measures to reduce these burdens are compromised by shortages of expert staff to design and implement reforms. High caseloads and little use of out-of-court solutions contribute to prolonged legal proceedings. Many citizens lack trust in courts and judges, and perceptive levels of corruption and clientelism to be high.

Businesses have few non-bank financing options, and spend relatively little on R&D. Most firms do not appear constrained in their access to finance. However, banking finance dominates, which is less accessible for younger, smaller, and more innovative firms. Public equity market structures are overly complex. R&D support programmes are fragmented.

State Owned Enterprises (SOEs) continue to play a relatively large role in the economy. SOEs employ about 6% of workers and often compete in the same markets as private firms. Low-productivity SOEs retain workers and capital that private-sector firms could potentially use more productively. SOEs' financial performance is often weaker than their private-sector peers and SOEs in other countries, in part due to weaknesses in their governance and vulnerability to political influence.

Raising employment and skills can improve incomes and well-being

Scarce skills are a growing barrier for investors. School students' performance lags peer countries. Most adults have only completed intermediate levels of education and few return to upgrade their skills. Employment rates among prime-age men and women are higher than in most OECD countries, but lag among younger and older adults, putting these groups at greater risk of poverty. Population ageing and emigration add to labour supply challenges.

Shortfalls in advanced skills are a key barrier to raising employment and incomes. Reforms are underway to regularise school hours, improve teaching quality, and expand early childhood education. However, gaps with OECD countries, notably in STEM subjects, remain significant. Few adults are motivated to access adult education, and programmes' cost and availability dissuade many from enrolling (Figure 3), Take-up of a new voucher-based adult education system has been strong and the programme is being expanded.

The government is reforming active labour market programmes. These are providing the more tailored and intensive training, work experience and job search support needed by those with limited formal work experience or skills. In poorer regions especially, active labour market policies will require greater resources.

Figure 3. Raising participation in adult education can help fill skills gaps

Participation in education and training by employment status, % of the population aged 18-64, 2022

Note: 'Peers' is the unweighted average of Czech Republic, Hungary, Slovak Republic, and Slovenia.
Source: Eurostat.

StatLink https://stat.link/jtk5w4

Early exit from the labour force increases retirees' risk of poverty. Low employment rates among older adults leads to lower pension savings and retirement incomes. Early retirement is more frequent among those with low skills and suffering ill health. Transfer rules encourage many retirees to shift from self-funded accounts back to the general government-funded pension, undermining earlier pension reforms and increasing fiscal costs. Women's official retirement age is being aligned to that of men. For the broader population, reforms are strengthening the minimum income social safety net and improving the targeting of social support. However, municipalities provide much social support, and those in the areas with the greatest needs often lack the necessary resources.

High homeownership, rising house prices and a thin rental market impede relocation to the most economically dynamic areas. Little new construction and damage by two earthquakes in 2020 have contributed to housing shortages and overcrowding, especially in the main cities. Unused property and secondary home use further reduce dwelling availability. Low recurrent taxes on property limit incentives for owners to make the greatest use of their properties. Government loan subsidy schemes have contributed to house-price growth. Planning and approval complications constrain new development, while the ongoing clarification of the cadastre can help attract investment.

Main findings and recommendations

MAIN FINDINGS	KEY RECOMMENDATIONS
Public finances to support the recovery and growth	
Growth has been robust, absorbing spare capacity in fast-growing sectors. Integration into the euro and Schengen areas is adding to demand. Inflation is gradually abating but exceeds the euro-area average and price pressures have broadened. After a budget surplus of 0.4% of GDP in 2022, the government budget sees a return to deficit in 2023 and 2024. Spending in response to high energy prices has been substantial. Much of the support to households and businesses further subsidises fossil fuels.	Promptly phase out energy price support measures. Avoid fiscal stimulus while inflation remains high. Ensure the medium-term fiscal stance contributes to trend decline in the public debt burden, while strengthening social protection.
The banking sector appears to be in reasonable health. The full introduction of the euro has added to the sector's free liquidity and reduced some types of risk.	Remain vigilant to banks' stability, including the growth and quality of lending. Stand ready to tighten further prudential tools such as minimum capital and risk ratios to prevent risks from materialising.
In public services, despite some recent consolidation, coordination and allocation of responsibilities among different administrative structures can be improved, to streamline regulatory processes and ensure consistent and higher quality delivery of public services, especially in lagging regions.	Clarify and consolidate responsibilities for delivering public goods and services, and use improving information systems to support greater cooperation, integration and improved resource allocation across different government bodies.
European Union funding is an important driver of public investment and policy priorities. Implementation of the Recovery and Resilience Plan, so far, compares well but still involves challenges.	Over the medium-term, complement European Union funding with increased nationally resourced investment to comprehensively address public investment and reform needs.
Income tax and contribution rates are moderate following recent reforms. Many tax exemptions or low rates, notably in tourism, for property and for some types of labour income, weaken the tax base and distort investment incentives.	Identify and phase out tax expenditures and align treatment of different forms of income, including that related to tourism. Progressively introduce a general recurrent tax on immovable property based on improved land value.
Improving environmental quality and cutting greenhouse gas emissions	
Environmental tax revenues are high, yet fossil fuels continue to be subsidised. The EU Emission Trading Scheme, the primary means of pricing greenhouse gas emissions, covers about one-third of emissions.	Cut fossil fuel subsidies, including tax expenditures, align the effective carbon prices in sectors not covered by the EU Emission Trading Scheme to the Scheme's price. Use the carbon tax revenues to support vulnerable households and investments for energy efficiency.
High reliance on passenger road transport, plus a preponderance of old vehicles contribute significantly to greenhouse gas emissions. Rail transport quality and infrastructure investment are low.	Replace purchase grants for low-emission cars with subsidised loans to improve affordability and encourage fleet renewal. Continue higher investment in public transport, informed by cost-benefit analysis.
Improving the business environment to raise investment and productivity	
Croatia's regulatory framework can potentially assure effective regulation. However, shortfalls in implementation mean regulatory burdens on businesses often remain high.	Apply regulations more effectively and ensure close monitoring of progress in paring back regulatory burdens.
High workloads put pressure on Croatia's judicial system. Cases, including those involving businesses, often take a long time to process and the legal system is perceived to lack judicial independence.	Promote out-of-court solutions, for example by making an initial mediation session mandatory and by recognising mediation agreements as enforceable.
Both high-level and petty corruption along with clientelism are still perceived to be widespread. Behavioural changes and expectations of higher standards are needed among elites and the wider public.	Improve transparency and accountability in the actions of policymakers and public officials by: deterrence through prosecution and sanction; ensuring adherence to ethical behaviour codes; creating lobbying registries; setting positive examples; and conducting information and awareness campaigns.
R&D support is low and fragmented.	Better coordinate R&D support schemes, ensure they have ongoing funding, and expand the scale of public support.
State-owned enterprises make up a large part of Croatia's economy and their financial performance and delivery of public services often lag peers.	Align state owned enterprise governance with OECD guidelines.
Strengthening skills and raising labour market participation	
Very few adults return for vocational or skill training after completing their education, in part due to cost and scheduling constraints.	Increase the number of participants and range of training covered by the recently introduced adult education voucher scheme and apply the new quality certification to more programmes.
Availability and enrolment in early childhood education and care for younger children is very limited, although costs are low.	Extend efforts to expand access to quality early childhood education and care and progressively lower the age of compulsory attendance.
Croatia is expanding its active labour market policies and improving focus on groups with weak labour-force attachment. The public employment service could focus more on the outcomes from its measures.	Invest in activation services, especially in lagging areas of the country. Modernise the PES operations, including to take local needs better into account.
Many elderly people have low incomes. Significant numbers of workers leave the workforce early, limiting their retirement incomes.	Strengthen incentives for workers to remain in work until full pension age.

1 Achieving sustainable convergence

Croatia has undertaken many reforms and investments in recent decades to raise incomes and well-being. Following a protracted recession in the early 2010s, growth picked up and, despite the disruption from COVID-19 and the energy price crisis, GDP per capita is converging (Figure 1.1). Moreover, over the past decade, employment has risen, helping to reduce poverty rates. Environmental quality improved, many public services were upgraded and laws and regulations modernised. With this progress, Croatia compares well with OECD countries on many dimensions, ranging from business start-ups, renewables in the energy mix, gender equality in the workforce to life satisfaction among youth (Figure 1.1, Panel E).

The economy has proved resilient. Robust tourism and goods exports and substantial government support have countered the strong headwinds from surging energy prices and heightened uncertainty since Russia's war of aggression against Ukraine. The public-debt burden is declining, and ratings of sovereign debt have been upgraded. At the start of 2023 the country integrated into the euro and Schengen areas, expanding investors' access to finance and to markets. Looking ahead, continued economic convergence will require robust rates of growth: if output per person is to reach the average of OECD countries within three decades, GDP growth per capita must average 3% annually.

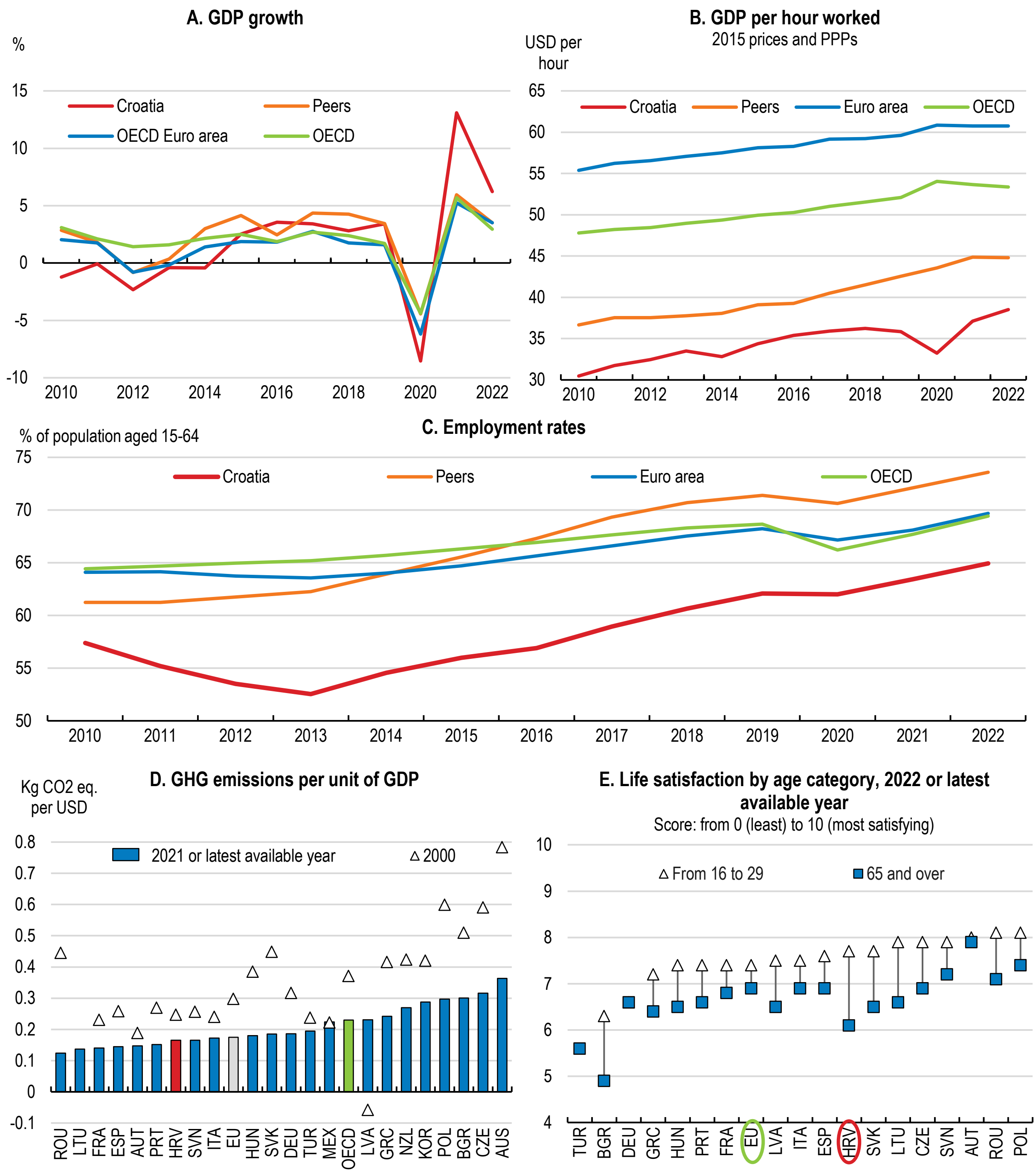
Croatia faces important challenges on its path to sustainable income convergence. In the near term, maintaining competitiveness and real incomes will require slowing inflation to the euro-area inflation target. Longer-term challenges loom. Prior to COVID-19, productivity convergence was slowing (Figure 1.1 Panel B) and it is unclear whether recent productivity gains signal a sustained improvement. Furthermore, the number of working-age adults is declining reflecting long-standing low fertility and emigration. The latter has included departures by many highly educated young people, especially following the recession of the early 2010s. Progress in reducing greenhouse gas emissions has been limited so far. Achieving net-zero by mid-century and adapting to a climate that is already becoming more prone to summer droughts and winter floods, will require large investments.

Comprehensive plans are underway to overcome many of these challenges but not all issues are being tackled sufficiently vigorously. Croatia's Recovery and Resilience Plan, along with the 2030 Development Strategy and National Reform Programmes are providing roadmaps for important improvements to the investment climate, the labour market, and public services (Box 1.1). Fully implementing these programmes, ensuring better outcomes on the ground, and making full use of European institutions' significant financial support will boost the economy's potential (Box 1.2). The country is among the EU countries most advanced in achieving its Recovery and Resilience Plan's milestones. Nonetheless, implementation challenges are likely to grow as reforms move to more difficult issues (Chapter 2). In addition, over time shortfalls and gaps in the programmed menus of measures are likely to emerge that should be addressed to ensure a fully effective structural reform programme.

Improving the effectiveness of public institutions, notably the justice system, and addressing corruption are ongoing challenges for Croatia and remain key priorities in the current reform programmes. These efforts are reflected in improvements in governance perceptions indicators in recent years, even if Croatia still lags most OECD countries on many dimensions. The efforts spearheaded by the Recovery and Resilience Plan to, for example, to accelerate the digitalisation of the public administration and to strengthen public services can contribute to reducing opportunities and incentives for corruption and build confidence in public institutions. Addressing these challenges is key to ensuring other reforms and public investments effectively improve conditions for investors and citizens. It is also central to the areas of focus of this

Survey, including reducing undeclared and informal economic activity, and achieving a more dynamic and productive business sector, greater numbers of high-skilled jobs and more effective social protection.

Figure 1.1. Since the early 2010s recession, incomes have been converging and well-being has improved



Note: Panel A, B and C: Peers: unweighted average of Czech Republic, Hungary, Slovak Republic, and Slovenia (choice of peer countries is discussed in Box 1.3). Panel D: GHG emissions include LULUCF. Panel E: Life satisfaction refers to the respondent's opinion/feeling about the degree of satisfaction with his/her life "these days" rather than specifying a longer or shorter time.

Source: OECD Productivity (database); OECD National Accounts (database); OECD Labour Force Statistics (database); OECD Environment Statistics (database); OECD Analytical (database); and Eurostat.

StatLink https://stat.link/da2nfc

Box 1.1. Croatia's recent and planned investments and reforms, selected examples

Croatia's current reform programme is guided by its National Development Strategy 2030, its Recovery and Resilience Plan, and the Government Programme 2019-2024. The examples of recent and ongoing reforms and investments relate to the priorities discussed in this *Survey*.

Macroeconomic management and strengthening fiscal policy

- Budget law amended in 2021 to improve budgetary processes.

Environment and the green transition

- Financial support for building renovations and reconstruction following the 2020 earthquakes and for improving energy efficiency.
- Investments of EUR 390 million (0.5% of GDP in 2022) and reforms to upgrade road and public transport system and improve intermodality.
- Reinforcement of the electricity grid and other investment to increase the share of renewables and electricity storage capacity.

Improving the business environment to support stronger productivity and investment

- Reforms and investments of EUR 570 million (0.8% of GDP in 2022) to digitalise and improve public sector efficiency. Regarding the justice system these reforms aim to amend civil procedural codes and upgrade case management systems. Civil servant recruitment and wage models are being reviewed.
- Reforms and investments of EUR 320 million (0.4% of GDP in 2022) to support digitalisation and innovation, including by improving digital connectivity in remote areas, streamlining innovation support schemes, and improving infrastructure of research institutes.
- Reforms to reduce administrative and fiscal burdens, and to liberalise regulated professions.
- Reforms to align governance of state-owned enterprises with OECD guidelines.

Strengthening the labour market for stronger and more inclusive employment and incomes

- Reforms and investments of EUR 870 million (1.2% of GDP in 2022) to develop digital and green skills, improving early childhood education and care infrastructure and enrolment, reforming school curricula, raising and standardising teaching hours, developing vouchers for greater access to adult education and assessing course quality, and better monitoring of the effectiveness of the public employment service.
- Reforms and investments of EUR 420 million (0.6% of GDP in 2022) to strengthen the health and long-term care system, including by creating a joint procurement system, restructuring health services to promote territorial coverage, and developing social mentoring services.
- Labour law reforms to promote flexible working modes and work-life balance.

Source: Recovery and Resilience Fund and Stability Programme 2024-2026; (Ministry of Physical Planning, 2023[1]).

The main messages of this *Survey* are:

- The expected increase in the fiscal deficit in 2023 and 2024 risks adding to inflationary pressures. Ensuring that fiscal policy is counter-cyclical would help to reduce inflation, while continuing to reduce public debt relative to GDP. Improving the capacity of the public sector to deliver quality services and investments and broadening the tax base would support growth. Achieving the green transition will require sustained investments and policy efforts into the long term.

- Robust productivity growth is needed for continued convergence in living standards. A more productivity-supportive business environment requires improving regulatory processes, the judicial system, the governance of state-owned enterprises, addressing corruption, and better supporting research and development.
- Sustaining inclusive growth, supporting incomes and addressing the growing demographic challenges require raising workers' skills through better schooling, more adult education, greater labour-force attachment among young and older adults, and increased mobility and well-being, including through expanding housing supply.

This *Survey* is structured as follows. Chapter 2 focuses on the macroeconomic outlook and on ensuring that public finances and policies support growth that is economically and environmentally sustainable. Chapter 3 discusses measures that can raise productivity growth by improving the business environment. Chapter 4 focuses on raising incomes, by raising the skills of the workforce, bringing those out of work into the labour force, and on promoting well-being and mobility notably by raising housing availability. Simulations suggest that these recommendations can extend the benefits of the current reform agenda (Box 1.2).

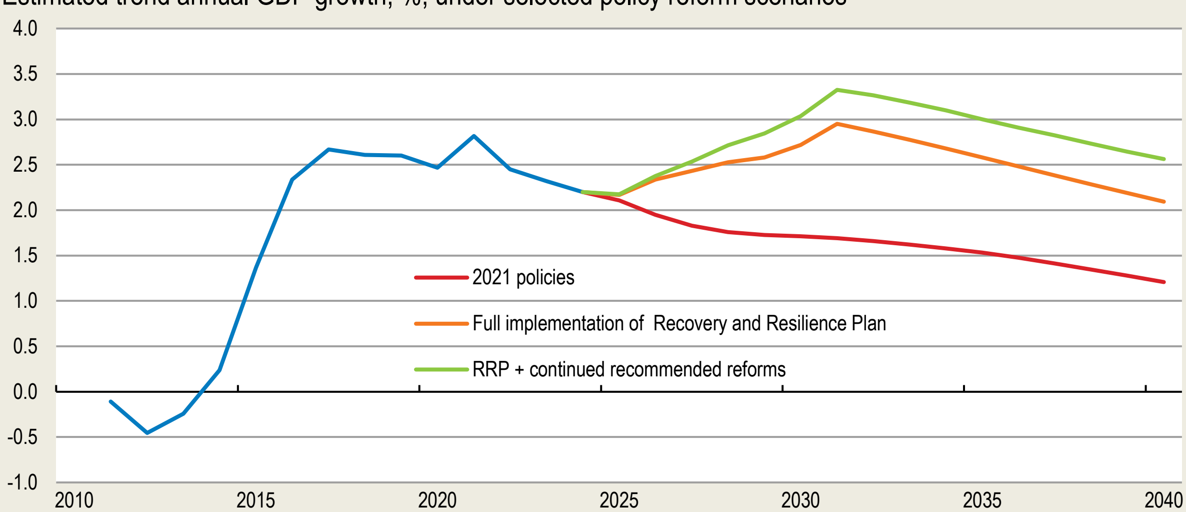
Box 1.2. Sustaining reforms and investments can bolster growth into the long run

Figure 1.2 and Table 1.1 present simulations of how packages of reforms and investments presented in this *Survey* would bolster GDP growth. Measures to improve the institutional environment, such as those targeting administrative processes, judicial responsiveness and regulatory barriers, would generate stronger growth largely through higher productivity growth and investment. The proposed measures, together with further efforts to raise the effectiveness of spending and to improve tax compliance would generate fiscal space to reduce the overall tax burden (Chapter 2).

The simulations suggest that growth is likely to slow as the benefits of Croatia's Recovery and Resilience Plan (RRP) investment and reforms fade, while the ageing of the workforce will continue to exert a drag on aggregate output. Continuing efforts to raise investment and productivity, labour force participation and skills would sustain stronger growth.

Figure 1.2. Continuing reforms can sustain higher growth

Estimated trend annual GDP growth, %, under selected policy reform scenarios



Note: Policy scenarios are described in Table 1.1 below.
Source: Simulations based on the OECD's Global Long-Term Model.

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Table 1.1. Ongoing reforms would accelerate convergence

	Policy scenario	Policy actions	Cumulative effect on real GDP relative to baseline of 2021 policies, %		
			2025	2030	2040
1	Fully implementing Croatia's Resilience and Recovery Plan	Codification of regulations, digitalisation of government services and judicial processes, and clarity around spatial planning lift perceptions of the rule of law from the 14th to the 33rd percentile of OECD countries by 2030, then stabilises.	0.1	3.7	14.9
		Reforms to regulations regulatory processes, and state-owned enterprise governance lower the overall Product Market Regulation index from 2025.			
		By 2025 increase spending on active labour market policies by the equivalent of 15% of GDP per unemployed person (one standard deviation of the range of OECD countries) and on in-kind family policies increases by 0.5% of GDP (one standard deviation of the range of spending of OECD counties).			
		Improvements in education quality closing the gap in PISA scores between Croatia and the OECD average, and increased participation in adult skill training raise years of schooling across the workforce by 1.1 years relative to the baseline scenario, to 13.6 by 2060.			
2	Programme of continuing the reform and investment momentum beyond the Recovery and Resilience Plan	In addition to the measures in Scenario 1, improved judicial processes, anti-corruption measures and regulatory simplification allow an index of perceptions of the rule of law to progressively rise to the OECD average by 2040 and further reduce the Product Market Regulation index; reforms increase spending on R&D by 1% of GDP by 2030; increased participation in adult skill training further raise the average years of schooling across the workforce by 0.4 years relative to Scenario 1 by 2060, to 14.0 years. By 2030 spending on active labour market policies increases by an additional 15% of GDP per capita per unemployed person (one standard deviation of the range of OECD countries) and spending on in-kind family policies increases by an additional 0.5% of GDP (one standard deviation of the range of spending of OECD countries).	0.1	4.6	20.8
Of which:					
2a	The continued reform programme: improving the business environment (Chapter 3)	Institutional reforms to improve judicial processes, anti-corruption measures and regulatory simplification allow perceptions of the rule of law to progressively rise to the average of OECD countries by 2040. Regulatory process improvements and state-owned enterprise governance reforms further improve the Product Market Regulation index by 2030. R&D investment rises by 1% of GDP by 2030.	0.1	3.7	16.9
2b	The continued reform programme: strengthening the labour market (Chapter 4)	Increased spending on active labour market programmes equivalent to 30% of GDP per unemployed person, and on in-kind support to families by 1% of GDP by 2030. The pension age is linked to life expectancy from 2030. Reforms to the education system and greater participation in adult skill training raise by 1.5 years to 14.0 the average years of education across the adult population by 2060.	0.1	4.6	18.7

Note: The baseline projections take into account the alignment of male and female retirement ages by 2030. The GDP effects of reforms in scenarios 2a and 2b are non-additive.
Source: Simulations based on the OECD's Global Long-Term Model, and OECD Economic Outlook 113 (database) updated.

Box 1.3. Choice of illustrative 'peer' countries

Many figures through this *Survey* compare Croatia with an unweighted average of 'peer' countries of Czech Republic, Hungary, Slovak Republic, and Slovenia. These countries were selected as they are members of the OECD, and are similar to Croatia including in regard to institutional backgrounds, demography and geographical locations.

2 Key policy insights

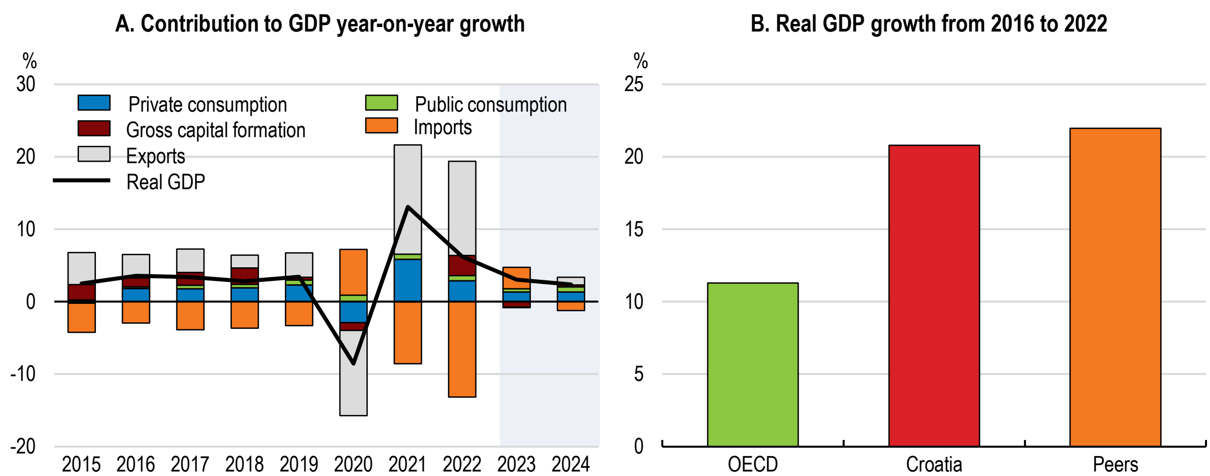
Croatia’s strong recovery from the COVID-19 crisis has been slowed by the surge in global energy and food prices following Russia’s war of aggression on Ukraine. Robust services exports led by tourism, a tightening labour market and rising investment, the latter fuelled by the implementation of the Recovery and Resilience Plan, are maintaining robust growth. Demand and access to finance are being bolstered by Croatia’s integration into the euro and Schengen areas. However, the surge in inflation is abating slowly, as capacity constraints and rising wages broaden cost pressures. Ensuring that fiscal policy does not add to demand pressures while inflation is high, and that new lending funds quality investments, can help maintain robust growth and moderate inflationary pressures. Reallocating public spending to areas that best support growth, raising more revenues from sources with lower burdens on activity, and encouraging greater formalisation of activity can help maintaining healthy and growth-supporting public finances. Implementing an ambitious programme to reduce greenhouse and other polluting emissions and to adapt to a changing climate would hasten the transition to a green economy and improve well-being.

Challenges lie ahead for managing sustainable catch-up

Croatia recovered strongly from the COVID-19 crisis, and output growth is now returning to the average rates of the late 2010s (Figure 2.1). In 2022, the surge in global prices and uncertainty, especially following Russia's war of aggression on Ukraine slowed the recovery. However, robust tourism exports, fiscal support measures augmented by spending of the Recovery and Resilience Plan, and the boost to access to finance and external demand from Croatia's integration in the euro and Schengen areas are supporting demand. Capacity limits, most notably for skilled workers in the labour market, are a growing barrier to expansion. These are contributing to rising wages and broadening inflation pressures, even as the headline rate abates from recent highs.

Looking ahead, robust growth is projected to be sustained by growing public investment spending, abating inflation, and the tight labour market and rising wages supporting households' incomes. Integration into the euro area increases the importance of fiscal policy in managing demand pressures and acting promptly to balance the business cycle, while continuing to bring public debt down to below 60% of GDP. Improving the state's spending effectiveness and tax mix would allow fiscal policy to be both prudent and to better support growth. Building fiscal buffers now is also important to prepare for the longer-term challenges, including reducing the economy's emissions, improving the quality of the environment, and adapting to an ageing population and a changing climate.

Figure 2.1. Consumption and exports have lifted GDP growth, while investment has lagged



Note: 'Peers' is the unweighted average of Czech Republic, Hungary, Slovak Republic, and Slovenia for the selected indicators (discussed in Box 1.3). Panel A: Components of GDP growth may not sum to aggregate GDP growth due to the statistical discrepancy and the non-additivity of chain-volume measures. Shaded area indicates projections.
Source: OECD Economic Outlook(database).

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The surge in inflation has slowed growth

Croatia's strong post-COVID-19 recovery has been slowed by surging prices

GDP expanded by 6.2% in 2022, following the post-COVID-19 rebound of 13.1% in 2021 (Figure 2.1). Growth slowed abruptly in the second half of 2022, following the shocks from the surge in energy costs, and the rise in international supply disruptions and uncertainty following Russia's war of aggression against Ukraine. The slowdown was moderated by the late and mild winter, which supported construction activity and private consumption. Croatia's limited economic relations with Russia as well as Ukraine limited the direct impact of the war (Box 2.1). Growth picked up in the first half of 2023 as strong services exports – largely tourism – and the tight labour market supported incomes and a recovery in consumers' spending. Construction and investment activity, with the rebuilding of housing following the 2020 earthquakes (Chapter 4) and the implementation of the Recovery and Resilience Plan projects (discussed below) have also supported growth. Overall, Croatia's post-COVID-19 recovery takes GDP growth back to its 2015-19 trend, with output growth near the rates of its peers.

Box 2.1. Croatia's direct exposure to the war in Ukraine has been modest

Croatia's trade and humanitarian exposure to the war in Ukraine has been limited. In 2021, Russia and Ukraine received respectively 1.1% and 0.3% of Croatia's total goods exports, mostly chemicals and related products, machinery, and transport equipment. These markets jointly made up 2% of Croatia's tourism nights in 2021. Russia and Ukraine were respectively sources of 1.6% and 0.2% of Croatia's total goods imports.

Croatia's energy supplies have been its main exposure to the war in Ukraine, though Croatia is less exposed than many of its peers thanks to its significant renewable energy and gas import capacity. In 2021, 9% of Croatia's oil imports and 22% of its gas supply came from Russia, smaller shares than many of its neighbours, although the shares are likely to be higher through exports by Hungary of fuels refined from Russian-sourced oil. Croatia sourced 57% of its gas from imported liquified natural gas (LNG) and produced the remainder domestically. The capacity of the LNG import facilities on the island of Kirk, opened in 2021, are near Croatia's total domestic demand, and the government has approved a project to more than double the terminal's capacity to 6.1 billion m^3 of gas a year as part of its plan to become a regional energy entrepot. New export pipelines are expected to be completed in 2025. In addition, Croatia's Adria oil pipeline between the Croatian island of Krk and states in central and south-eastern Europe plays an increasingly important role in the region's energy supply. Ensuring fair pricing of transit fees facilitates a level playing field in access to the pipeline.

About one-quarter of Croatia's domestic energy consumption is used by the petrochemical industry, which produces mineral fertiliser. Croatia generates 31% of its total energy needs from renewable sources, a higher share than most OECD countries, and investments in its Recovery and Resilience Plan and energy support packages are expanding this capacity (discussed below).

The humanitarian impact has also been limited. Croatia has provided over 21 000 refugees with temporary protection visas (UNHCR), about 0.5% of the population. Some social services and temporary accommodation arrangements have been established, for example making use of hotels in some northern and coastal cities. However, Croatia's response capacity has been constrained by the ongoing support for the population displaced by the 2020 earthquakes (Box 4.3). Up to 6 000 refugees are assessed as being employable including in professions suffering shortages In Croatia. To date they have mostly been employed in low-skilled jobs as they lack language skills or due to the slow process to recognise their qualifications (Chapter 4).

Government support measures have mitigated the impact of inflation on real disposable income (Box 2.2). The surge in consumer prices in 2022 led to the strongest fall in households' real incomes since the deep recession in the early 2010s. Strengthened in September 2022 and extended in March 2023, support measures have reduced energy and some other basic food costs. Price subsidises, via price ceilings for certain consumption volumes, reduced prices or tax reductions, have made up most of the cost of these measures. In addition, there have been increases in transfers to minimum income, minimum pension and several other categories of social support recipients. These follow substantial policy measures to support household incomes during the COVID-19 crisis (Christl et al., 2021[1]). Avoiding any further extension of announced measures, and instead developing the social protection system to provide an adequate and responsive safety net (Chapter 4) would better ensure support for the households at greatest risk of hardship while preserving fiscal space.

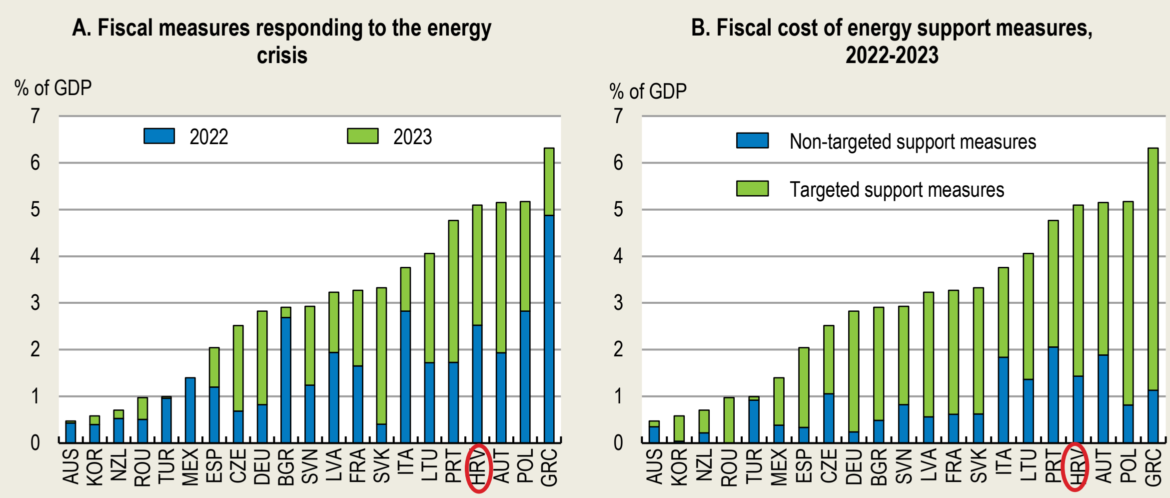
Box 2.2. Measures taken in response to the energy price shock

In March 2023 Croatia announced its fourth package of measures to offset the effects of the surge in energy prices. This package continued the goals of the earlier packages of mitigating energy price rises, limiting the effects of inflation, supporting real incomes, and reducing reliance on fossil fuels. Together, the value of these packages is substantial and larger than those introduced in many European OECD countries (Figure 2.2). The bulk of spending caps or reduces energy prices, in some cases with limits on the volume of energy products subject to the capped price for individual users or in total. Targeting is broad and a number of measures benefit business users. Income and other support measures targeting vulnerable households focus on existing social protection recipients, although targeting and take-up of social protection remain a challenge (Chapter 4).

The March 2023 package of EUR 1.7 billion (2.3% of 2023 GDP) is allocated to subsidising energy and other prices (EUR 1.2 billion), supporting the shift to renewable energies, and raising energy efficiency (EUR 0.3 billion) and income support (EUR 0.16 billion). Most of the measures are one-off transfers or are scheduled to terminate by October 2023 or April 2024.

These measures largely build on the September 2022 package, itself worth 3.7% of annual GDP, and that included tax relief and excise rate cuts (2.6% of GDP); income support for vulnerable groups (0.8% of GDP); and support for energy renovations (0.3% of GDP). That package also included support for loans and grants to businesses valued at 1.7% of GDP and raised social benefits for pensioners and other vulnerable groups, and public servant wage rates.

Figure 2.2. Croatia's energy support measures are substantial and are largely price subsidies



Note: Panel B: Support measures are taken in gross terms, i.e., not accounting for the effect of possible accompanying energy-related revenue-increasing measures, such as windfall profit taxes on energy companies. Where government plans have been announced but not legislated, they are incorporated if it is deemed clear that they will be implemented in a form close to that announced. Gross fiscal costs reflect a combination of official estimates and assumptions on how energy prices and energy consumption may evolve when the support measures are in place.
Source: OECD calculations based on the OECD Energy Support Measures Tracker.

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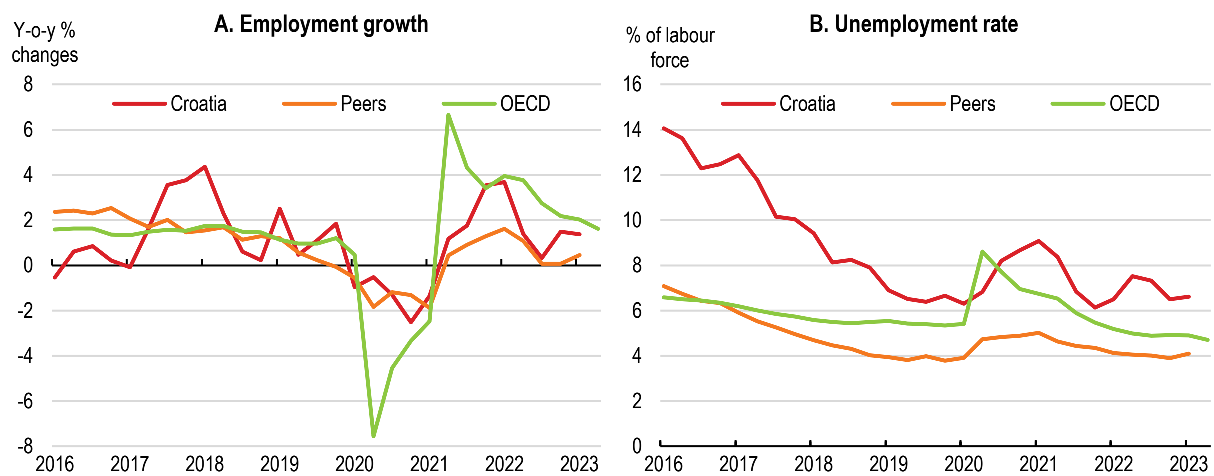
The improving labour market has supported households' incomes. Employment growth has averaged 2.5% annualised from the start of 2021 to mid-2023 (Figure 2.3). This, and the declining working-age population, brought the unemployment rate to near historic lows in early 2023 and the participation rate among those aged between 15 and 74 years reached 60%, the highest rate on record. Rising numbers of immigrant workers have helped address labour shortages. Nevertheless, the number of positions advertised or open vacancies point to a tightening labour market. Nominal wages have increased. The national accounts measure of the wage rate increased by 7.5% in 2022 compared with 2021, while the statutory minimum wage rate was increased by 10.3% in 2022, and by 12% in 2023.

Job creation has varied across sectors and regions. Employment has risen in many sectors, with tourism-related and business services struggling to fill vacancies. Employment growth has been strongest in regions such as Zagreb and along the coast, and weaker in the interior and east, such as Slavonia, thus accentuating existing regional inequalities. The youth unemployment rate has declined less than the overall rate. It only partly recovered following the COVID-19 crisis and has been broadly stable near 18% since late 2021, several percentage points above the rates in most euro-area and OECD countries.

Figure 2.3. Stronger employment growth is making inroads into unemployment



Note: 'Peers' is the unweighted average of Czech Republic, Hungary, Slovak Republic, and Slovenia (discussed in Box 1.3).
Source: OECD Economic Outlook database.

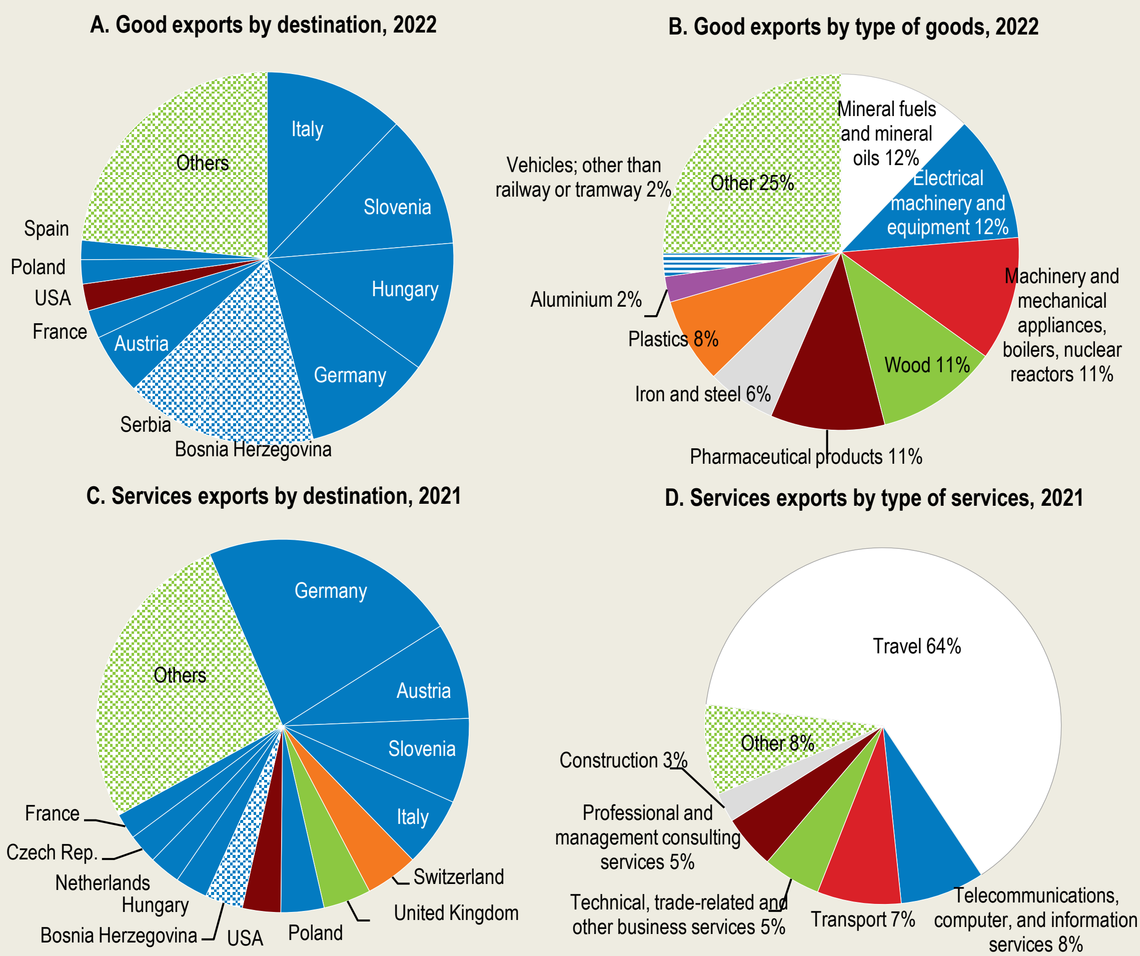
Strengthening exports of goods and services have contributed to GDP growth in recent years. In 2022, exports of both goods and services were above the historic highs of 2019 in real terms. Contributory factors include robust demand in other EU economies and for Croatia's less technologically advanced manufactures, plus Croatia's lower exposure to the disruptions in global supply chains than of many Central and Eastern European economies (CEE). Meanwhile, the increased cost of energy imports widened the trade deficit and pushed the current account into deficit in 2022. In most years Croatia runs a goods trade deficit, which is only partly offset by a surplus on services trade, about 70% of which is tourism. The increased inflows of European Union grants, notably from the NextGeneration EU facility, have supported the current account.

Box 2.3. Tourism leads exports, and more technologically advanced manufacturers have an emerging role

Exports of goods and services increased strongly after Croatia joined the European Union in 2013, from about 40% of GDP to about 50% in 2021. Trade is strongly linked to other EU countries. In 2022, about 60% of both goods and service exports went to EU member countries (Figure 2.4, Panel A and C), and about three quarters of imports came from EU countries.

Tourism services are the largest export category. Services make up almost two thirds of exports, of which 64% are travel (Figure 2.4, Panel D). After the sharp fall in 2020 during the initial phase of the COVID-19 crisis, tourism revenues partially recovered in 2021, reflecting incoming tourism by road and the attractiveness of Croatia for remote workers. In 2022, total travel receipts were 24% above their previous peak in 2019. The tourism sector contributed 11.3% to total gross value added in 2022, compared with 2% on average in Central and Eastern European countries, and 6.6% of employment (Eurostat, 2023[2]). Integration into the Schengen and euro areas is likely to have lifted demand by reducing costs of visiting Croatia. As a comparator, for France, being part of the Schengen area is estimated to add between 5% and 15% to tourism receipts (Aussilloux and Le Hir, 2016[3]).

Figure 2.4. European markets, tourism services and manufactures account for most exports



Note: Panel A and B: Data are collected on the basis of the Harmonised System 2017; Panel C and D: Data are collected according to the Balance of Payments methodology.
Source: United Nations Comtrade database.

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Inflation is gradually abating

Inflation surged in in 2022, by more than in most OECD countries but by less than in many of Croatia's peers in Central and Eastern Europe (Figure 2.5). Harmonised consumer price inflation peaked at 13.0% in November 2022, the highest rate since the 2000s, led by energy prices. With the latter having retreated headline inflation has been abating very gradually; as of August 2023 it was 8.5%. However, price pressures broadened over this period, with many non-energy prices, notably of food and services items, rising fast, lifting some measures of underlying inflation above the headline rate. For example, prices were up by 20.4% for hotels and other accommodation and by 12.9% for food and beverages in July 2023 from a year earlier. The relatively strong increases in food and heating prices particularly harm the well-being of poorer households due to the higher share of their incomes spent on such items (Figure 2.5, Panel F).

Inflation expectations of businesses across different sectors and of consumers progressively retreated from their peaks of 2022 but remain well above levels associated with low and stable inflation (Figure 2.5, Panel D). The retreat of industrial businesses' inflation expectations has been more pronounced than of services businesses' expectations, reflecting the falls in many international industrial input prices on the one hand, and rising wage and food costs and demand pressures in services on the other. While the price level in Croatia is similar to many of its peers (Figure 2.5, Panel E), swiftly restoring price stability will be key to maintain the country's competitiveness for foreign investment and export production, and to support real incomes.

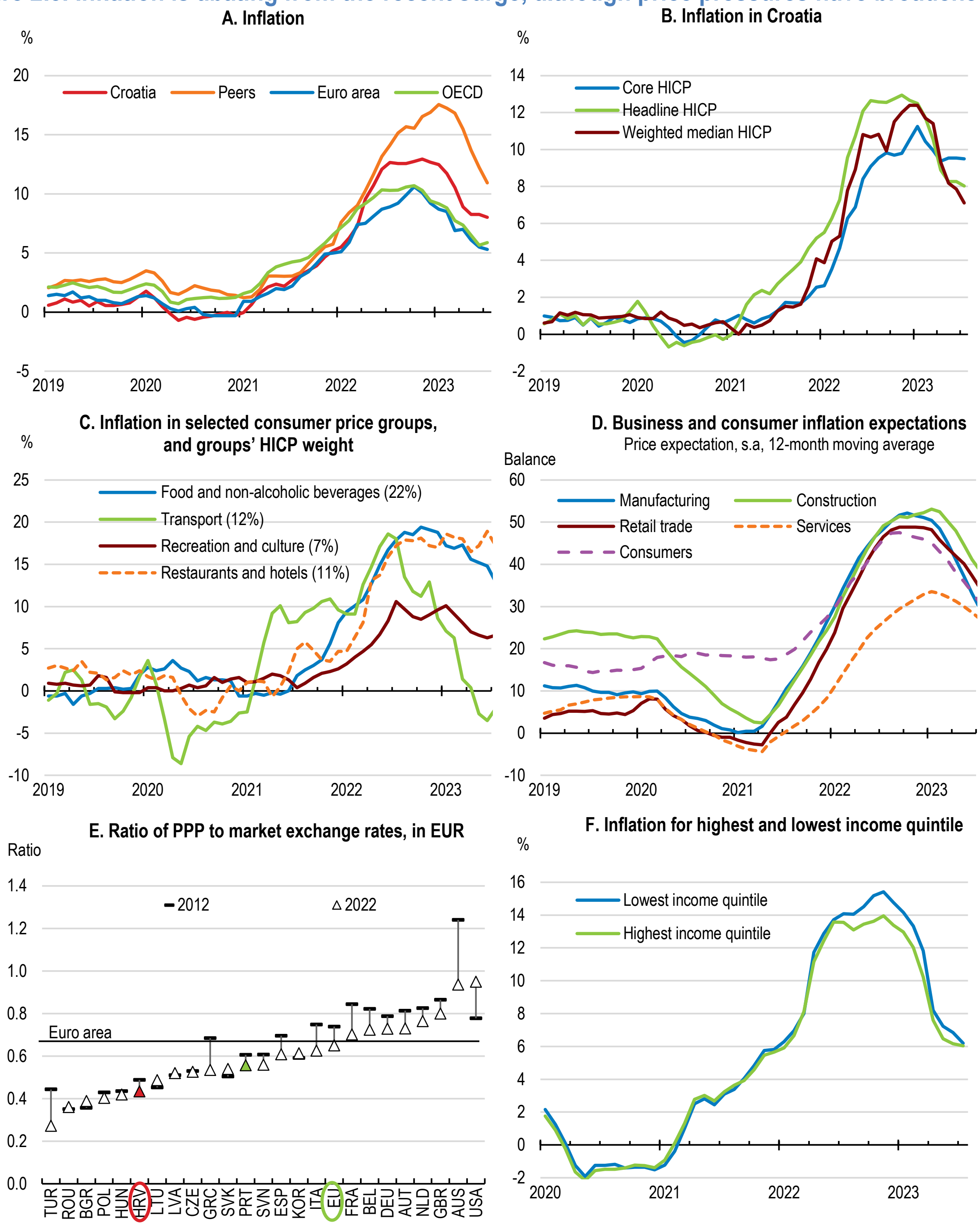
The episode of high inflation coincided with Croatia shifting to the euro for everyday transactions on 1 January 2023. Consumer surveys report a perception that retailers have used the currency change to round prices higher. This is despite requirements that prices be displayed in both currencies until the end of 2023, rules on the rounding of prices, and increased inspections for compliance with pricing rules. An analysis of detailed price data by the European Central Bank and the Croatian National Bank found evidence only of moderate price increases in some service sectors that could be linked to euro adoption. The analysis estimated that the currency changeover added 0.4 percentage points to overall inflation (Falagiarda et al., 2023[4]). This is consistent with the experience of other countries that joined the euro area earlier on (e.g., (Mastrobuoni, 2004[5])).

The financial sector appears robust but ongoing vigilance is warranted

Croatia's banks appear to be in sound shape prudentially. Their liquidity coverage ratio increased to 229% in March 2023 compared with 164% on average in the European Union and with 199.3% in March 2022 in Croatia (EBA, 2023[6]). Overall, banks appear reasonably well protected from spillovers due to bank failures elsewhere. There have been no significant consequences from the failure of some US or European banks in early 2023 (ECB, 2023[7]). Banks' profitability has been relatively high, with returns on equity of 4.5% in in March 2023 almost double the EU average for the same period (ECB, 2023[8]). The ratio of non-performing loans to total loans decreased from 5.7% at the end of 2021 to 4.1% in March 2023 – though still above the EU average of 2.5% at the end of 2022 (Figure 2.6, Panel C). Despite these healthy indicators, a close watch is needed on the financial sector, in particular the quality of new lending, and the spillover risks in the event of further difficulties in banks elsewhere.

Integration into the euro area has had various implications for the banking sector (Croatian National Bank, 2023[9]). The switch to the euro entailed an estimated short-term loss of 20% of banks' total profits, through reduced foreign-exchange transactions and fees and lower interest income, along with one-off transition costs. Meanwhile, there are reduced foreign exchange risks and lower costs from regulatory requirements. Before the switch to the euro, about half of Croatian bank deposits and loans were denominated in euros and subject to currency risks. Adopting the euro has freed EUR 5 billion of foreign exchange currency buffers, and EUR 4.5 billion of liquidity – as the minimum reserve requirement protecting against currency risks has declined from 9% to 1%, supporting liquidity (Figure 2.6, Panel D).

Figure 2.5. Inflation is abating from the recent surge, although price pressures have broadened



Note: Panel A: 'Peers' is the unweighted average of Czech Republic, Hungary, Slovak Republic, and Slovenia (discussed in Box 1.3). Panel B: Headline and core inflation are based on the harmonised consumer price index. Core inflation excludes energy and food products. The weighted median inflation is the price change of the item at the middle of the distribution of price changes, accounting for the items' expenditure weights. Panel C: 2023 annual expenditure weights of the expenditure group are shown in brackets. Panel D: Inflation expectations are obtained from business and consumers opinion surveys on price expectation for the next 3 months for businesses, and for the next 12 months for consumers. Data are expressed as the balance between weighted percentages of positive and negative replies. 'Services' excludes retail trade and banking. Panel F: inflation rates by income quintile are calculated by applying the 2020 COICOP subgroup consumption weights for each income quintile to the corresponding price index in June 2020, and then applying the monthly change in the respective subgroup price index. This approach does not allow for substitution across different items in the consumption basket.

Source: OECD Analytical database; Eurostat; European Commission Directorate General for Economic and Financial Affairs via Refinitiv; and OECD calculations.

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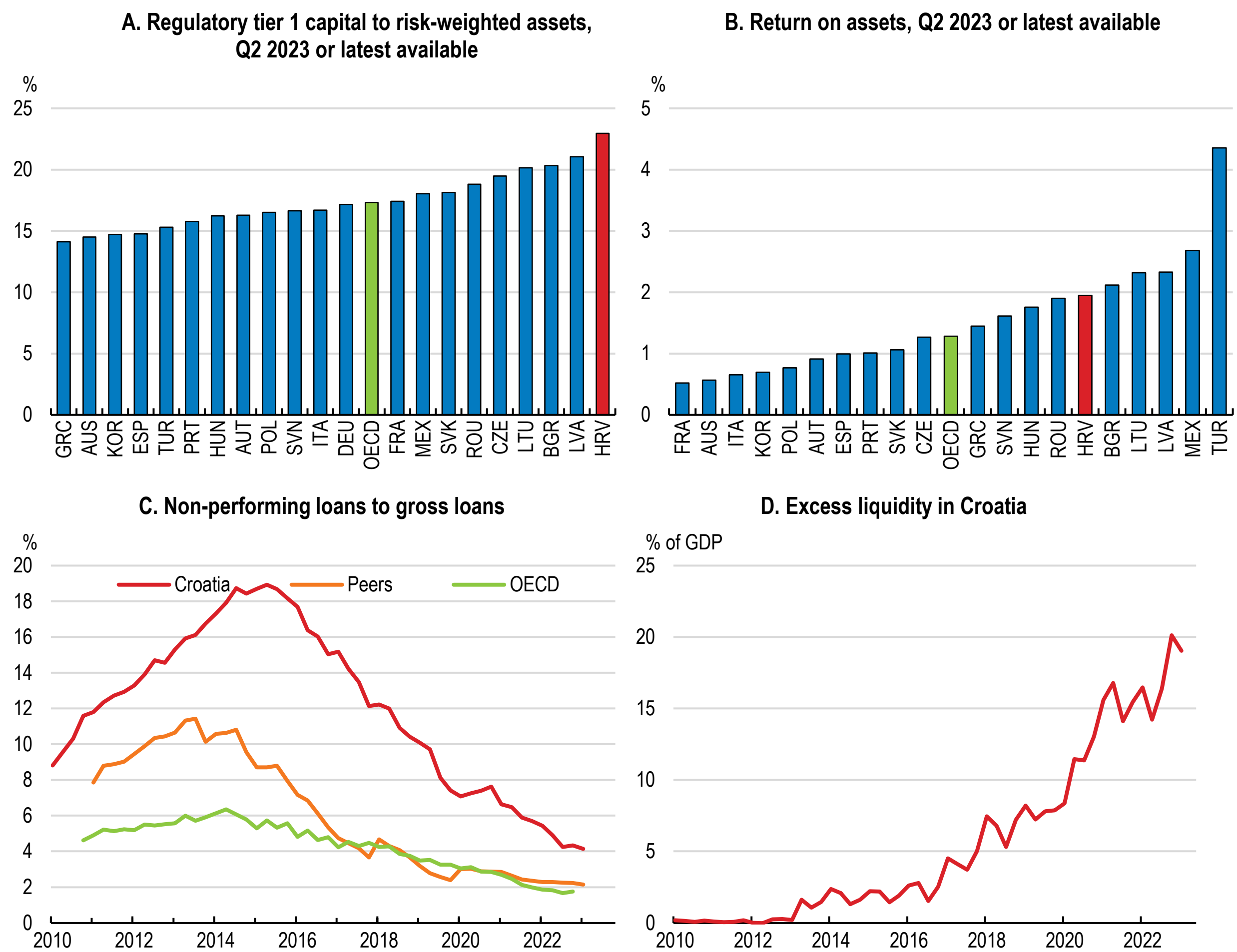
To support capital reserves, the Croatian National Bank will increase the countercyclical buffer rate to 1.0% from 31 December 2023 and to 1.5% from 20 June 2024, following an increase from 0.0% to 0.5% in March 2023. It motivated these increases by the upturn in the financial cycle, with increasing lending for mortgages and to non-financial corporations, mostly reflecting rising property prices and operating expenses for businesses (Croatian National Bank, 2023[9]). As financial institutions generally have surplus capital, the central bank does not expect this adjustment to significantly affect the costs and availability of bank credit. In other respects, Croatia is less exposed than other countries to current financial sector risks. Among the relatively few households that have mortgages, 34% were at variable rates in December 2022. Among new mortgages, 6.6% had variable interest rates in December 2022, compared to the euro-area average of 25.4%. To maintain financial stability, ongoing monitoring and precautionary policy actions, such as adjusting risk weights on certainty types of lending, can ensure that banks maintain the quality of their lending and other assets as they manage their increased liquidity.

Figure 2.6. The banking sector's health appears solid



Note: OECD is the unweighted average across OECD countries. Panel C: 'Peers' is the unweighted average of Czech Republic, Hungary, Slovak Republic, and Slovenia (discussed in Box 1.3). Panel D: Excess liquidity is computed as the sum of the banks' current account balances (in excess of the minimum reserve requirement) and the deposit facility.
Source: IMF, Financial Soundness Indicators database; and Croatian National Bank (HNB).

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The budget will return to deficit, while monetary conditions are tightening

The budget balance shifted to an unexpected surplus in 2022 of 0.4% of GDP, following the substantial deficits of the COVID-19 period (Figure 2.7). Stronger-than-expected activity and price growth bolstered revenues. Spending fell short of plans, most notably for public investment, which fell by 6.8% from 2021 in nominal terms, to 3.8% of GDP, although this remains above the average of OECD countries relative to GDP. After accounting for the business cycle, the 2022 surplus represented a modest tightening in fiscal policy (Figure 2.7).

The government's 2023 Stability Programme projects the budget shifting back to deficits from 2023, representing a fiscal stimulus (Figure 2.7 and Table 2.1). The widening reflects, in part, increases in personal income tax thresholds and credits, and increased tax allowances for business cost deductions. Slower growth in activity and abating inflation are also slowing revenue growth. A temporary extra profits tax, at a rate of 33% applied to large companies with profits at least 20% above recent years' average, is likely to support revenues in 2023. Social spending is projected to increase markedly in 2023 in some areas, notably pensions as the number of recipients and pension rates increase and reductions introduced in the early 2010s are unwound, but also maternity and family benefits and support services for the disabled. Increases in wage and intermediate costs (e.g., costs of medicine and energy for government operations) are also projected to raise spending. Capital expenditures are projected to increase, also supporting demand, although these are largely financed through European grants, limiting their impact on the budget balance.

Table 2.1. With lower revenues, the budget is projected to return to deficit

Per cent of GDP

	2020	2021	2022[1]	2023[1]	2024[1]
Spending and revenue					
Total revenue	46.8	46.2	45.5	43.9	43.4
Income tax	6.5	5.7	6.8	6.5	6.4
Social contributions	11.6	11.1	10.9	10.6	10.4
Other receipts	28.7	29.4	27.8	26.8	26.7
Total expenditure	54.1	48.7	45.1	44.0	44.4
Of which:					
Government consumption	24.0	22.2	20.7	20.0	20.6
Social transfers	14.5	13.0	12.1	12.4	12.3
Gross fixed capital formation	5.5	4.7	3.8	3.9	4.0
Gross interest payments	2.0	1.5	1.4	1.6	1.7
Budget balance					
Fiscal balance	-7.3	-2.5	0.4	-0.1	-1.0
Primary fiscal balance	-5.5	-1.1	1.6	1.3	0.5
Cyclically adjusted fiscal balance[2]	-2.6	-2.4	-1.0	-1.7	-2.7
Underlying primary fiscal balance[2]	-1.0	-2.5	-1.9	-2.2	-3.0
Public debt					
Gross debt (Maastricht definition)	86.9	78.3	68.8	63.8	61.0
Gross debt (national accounts definition)[3]	107.0	98.3	89.6	85.6	84.5
Gross financial assets (EUR billion)	3.0	3.2	3.5	4.0	4.2
Net debt	47.9	42.6	36.8	32.8	31.7

1. OECD estimates unless otherwise stated.
2. As a percentage of potential GDP.
3. National Accounts definition includes state guarantees, among other items.
Source: OECD (2023), OECD Economic Outlook 113 (database), updated.

In 2024, the government plans to widen the budget deficit, before reducing it in 2025. Revenue growth is projected to slow with slower growth in activity and prices, and with tax and social contribution rate cuts valued at 0.5% of GDP (discussed below and Box 2.4). Expenditures will be supported by increased public sector salaries and social spending, including pensions, by increased investment spending under the Recovery and Resilience Plan, and by the delivery of defence equipment. The government plans to partly finance this increased spending by drawing some of its allocation of credits in the EU Recovery and Resilience Facility. The scheduled termination of the energy support measures in late 2023 and early 2024 will reduce some spending pressures.

Box 2.4. The planned 2024 tax reforms

The government is preparing a package of tax and social contribution cuts in 2024, reducing revenues by up to 0.5% of GDP. The measures are likely to include:

- Reduced personal income tax through increased values of tax rate brackets, increased values of certain types of incomes, such as bonuses or tips, that are not taxable, and the suppression of the income tax surcharge
- A reduced pension contribution rate at low wages to boost disposable income among low wage earners, with the government contributing the difference with the standard contribution rate to the pension accounts. This is expected to benefit 1.52 million out of the 2.84 million taxpayers in total.
- An increase in local governments' fiscal autonomy by allowing them to independently prescribe the tax rate for taxes on income from independent work, independent activity and other income.

Tighter euro-area monetary policy is feeding through only partially. Indeed, in the interbank money market, one of the key transmission channels of monetary policy to the real economy, the increase in interest rates has been lessened by limited turnover, as banks’ high liquidity reduces their use of the market. Even so, interest rates have risen on loans to businesses and households and banks have tightened their lending conditions, contributing to slowing lending growth (Figure 2.7). Yields on long-term government bonds have increased by less than elsewhere in the euro area following the tightening in monetary policy, as spreads narrowed following the confirmation in June 2022 that Croatia would join the euro area (Box 2.5). Croatia’s sovereign debt rating is two or three steps above investment grade, depending on the rating agency, and agencies’ outlook has been stable since they upgraded their ratings in mid-2022. The ECB’s quantitative tightening policies do not affect the country directly, as it was outside the euro system before 2023 so was not included in the purchase programmes.

Box 2.5. Croatia became the twentieth member of the euro area in 2023

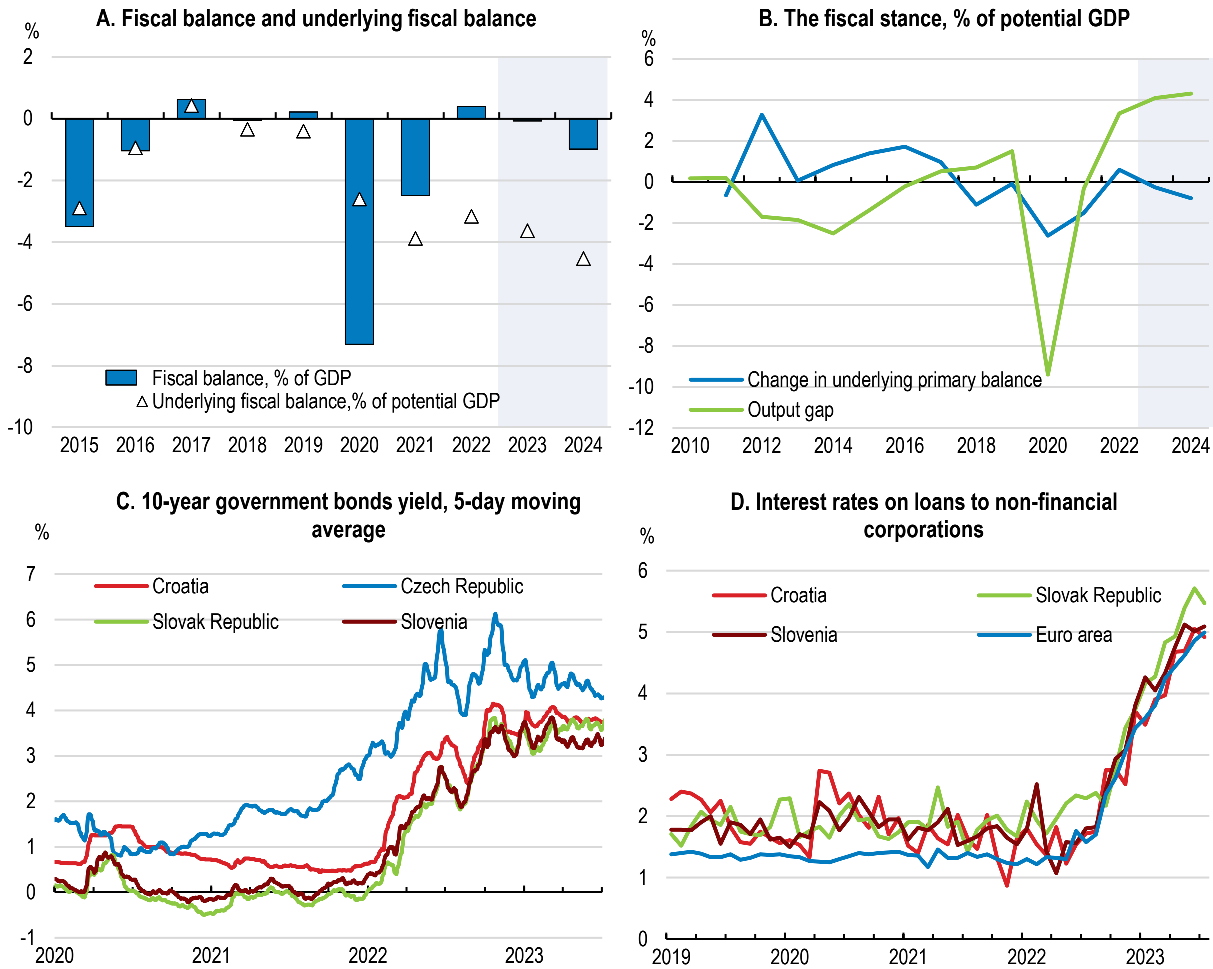
Since its independence Croatia has pegged its exchange rate first to the Deutsche Mark, followed by the euro. On 1 January 2023 Croatia officially joined the euro area, at an exchange rate of 7.53450 Croatian kuna per euro. This followed the European Commission and the ECB concluding in July 2022 that Croatia had fulfilled the four nominal convergence criteria of price stability, public finances sustainability, exchange rate and long-term interest rate alignment and that its legislative framework was fully compatible with the relevant treaties. The downward trend in public debt towards 60% of GDP following its increase during the COVID-19 pandemic was assessed to be adequate. Preparing for integration into the euro area required some important legislative reforms, which have better aligned Croatia's institutions and governance with those of euro-area countries. Many of these reforms address the issues discussed in this *Survey*, notably around improving the business environment (Chapter 3).

The physical changeover of currencies was assessed by the Commission to have proceeded smoothly, supported by preparation of euro reserves, distribution of the new currency and information campaigns ahead of time. Communications, a voluntary code of ethics for businesses, plus a monitoring campaign helped largely prevent abusive re-pricing practices with the changeover, and Croatia's approach offers lessons for countries adopting the euro in the future. However, pricing practices remain a concern for many citizens, even after inflation data were published showing a limited impact of the euro adoption on prices (European Commission, 2023[10]).

Joining the euro area means that Croatia's Central Bank becomes part of the Eurosystem, the Ministry of Finance participates in the Eurogroup meetings, and that Croatia integrates into the Banking Union and the European Stability Mechanism. This will support prudential supervision of Croatia's banks by eliminating parallel supervision of Croatia's banking sector and integrate crisis management and bank resolution.

The government's plans for widening budget deficits and the temporarily slower, albeit improving, transmission of tighter euro-area monetary policy to Croatia's economy suggest that growth in demand may continue to outpace growth of the economy's capacity for some time. This will accentuate capacity constraints and price and wage pressures. Given current projections of inflation remaining above target, maintaining the budget near 2022's surplus rather than providing a fiscal stimulus would better support macroeconomic stability, sustain growth and reduce inflation pressures. Such a counter-cyclical fiscal stance need not entail lower spending on productivity-enhancing or social policy goals. Transfers and subsidies that are poorly targeted or that encourage inefficient consumption, such as fossil fuel price subsidies, can be cut while protecting spending that expands productive capacity and supports inclusiveness, such as in education and skills, infrastructure, and in public service delivery. If revenue outperforms projections, these funds can repay debts and build fiscal buffers.

Figure 2.7. Fiscal policy remains supportive while monetary conditions are tightening



Note: Panel A: the underlying fiscal balance measures the governments fiscal stance once cyclical variation in revenues and spending are taken into account and excludes net one-off operations. Panel B: The fiscal stance is illustrated by the change in the underlying primary balance.
Source: OECD Economic Outlook 113 (database), updated; Refinitiv, Datastream; and ECB (database).

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Growth is projected to remain robust

Output growth is projected to remain at robust rates, having rebuilt in the first half of 2023 after the slowdown thein the second half of 2022. Annual growth is projected to be 3.0% in 2023, and 2.4% in 2024 (Table 2.2). Rising growth in consumer spending is expected to support growth, with ongoing wage increases and jobs growth expected to outpace inflation to support households' real disposable incomes. Improved global supply conditions and the large share of imports in domestic consumption are expected to reduce the pass-through of rising wages into consumer price inflation. Government spending, including energy price support measures, will support demand in 2023, adding to price pressures. Croatia's integration in the euro and Schengen areas at the start of 2023 and higher disbursement by the government of European funds are expected to bolster investment and exports, adding to demand and to pressures on capacity, especially in construction.

However, continued inflationary pressures and narrowing spare capacity are projected to partially counter improving demand so as to slow output growth. Inflation is projected to abate only gradually from current high rates. While the retreat in energy and some other international prices subtract from inflationary pressures, ongoing large increases in wholesale prices in many sectors and rising wages and limited spare capacity in some service sectors are expected to slow the disinflation process. The expiry of energy support measures, scheduled for October 2023 and April 2024, will temporarily lift headline inflation.

Table 2.2. Growth is projected to remain robust

	2019	2020	2021	2022	2023	2024
	Current prices (EUR billion)	Percentage change, volume (2015 prices)				
Gross domestic product (GDP)	55	-8.5	13.1	6.2	3.0	2.4
Private consumption	31	-5.1	9.9	5.1	2.3	2.3
Government consumption	11	4.3	3.0	3.2	2.0	3.5
Gross fixed capital formation	12	-5.0	4.7	5.8	2.6	2.6
Housing	2	-4.5	6.7	7.4	10.8	2.9
Final domestic demand	54	-3.1	7.4	4.8	2.3	2.6
Stockbuilding[1,2]	1	0.0	-1.1	1.6	-1.3	-0.3
Total domestic demand	55	-0.8	9.8	5.6	1.2	2.3
Exports of goods and services	28	-23.3	36.4	25.4	-0.2	1.9
Imports of goods and services	28	-12.4	17.6	25.0	-4.6	2.2
Net exports[1]		-5.4	6.6	-0.2	2.9	-0.1
Other indicators (growth rates, unless specified)						
Employment	..	-1.3	1.3	1.7	2.7	1.2
Unemployment rate (% of labour force)	..	7.5	7.6	7.0	6.0	5.8
GDP deflator	..	0.7	2.0	8.2	9.1	4.2
Harmonised consumer price index	..	0.0	2.7	10.7	8.5	4.3
Harmonised core consumer price index	..	0.4	1.3	7.6	9.0	4.7
Terms of trade	..	-1.6	-2.0	-4.7	1.7	-1.3
Household saving ratio, net (% of disposable income)	..	9.2	7.6	-0.4	7.3	7.5
Trade balance (% of GDP)	..	-7.0	-1.5	-4.7	-0.6	-1.5
Ten-year government bond yield, average	..	0.8	0.4	2.7	3.8	4.0

1. Contributions to changes in real GDP. 2. Including statistical discrepancy.
Source: OECD (2023), OECD Economic Outlook 113 (database), updated.

Risks to this outlook remain pronounced with both downside risks and the challenge of managing upside surprises. In the short term, high inflation is a key source of risks. If inflation in Croatia remains above the euro-area average, or if inflation across the euro-area stays above the policy target, sharper policy responses will be needed, by fiscal policy in Croatia in the former case and by euro-area monetary policy in the latter. This could lead to a more abrupt downturn. The adjustment of global financial markets and economies to higher interest rates also brings negative risks to external demand. A renewed surge in energy prices and disruption in energy supply among trading partners, especially if the 2023/24 winter is exceptionally cold or long, would extend inflationary pressures, and weaken competitiveness, external demand and public finances. In the medium term, the potential boost to investment and demand from integration into the euro and Schengen areas bring risks of low-quality investments and lending, and greater price pressures. This would require responsive macroeconomic management, especially from fiscal and macroprudential policy, to ensure that demand growth remains sustainable and raises the economy's productive capacity. Conversely, integration could bring an extended period of stronger-than-expected growth. Into the longer term, the potential disruptions from a changing climate present significant risks, as infrastructure and other physical investments could be made redundant or production and demand patterns could shift markedly. Adaptation policies will reduce these risks. Table 2.3 presents some risks that could lead to major changes to the longer-term outlook.

Table 2.3. Events that could lead to major changes to the outlook

Shock	Possible impact	Policy response options
A colder 2023/24 winter and limited supplies of gas or alternative energy sources cause a new surge in energy prices and slowdown among external markets.	Inflation ramps up driven by energy price increases, destabilising inflation expectations. Renewed public support measures weaken the government's fiscal position, diverting resources from more growth-supporting spending. Weaker activity among Croatia's trading partners cuts export demand.	Support vulnerable households' incomes. Continue efforts to improve energy efficiency and reduce fossil fuel needs.
Price and wage inflation are not contained.	Wages growth remains elevated in response to high inflation, further entrenching higher inflation.	Ensure that the fiscal stance is counter-cyclical, prioritising cuts in poorly-targeted transfers while continuing efforts to expand the economy's productive capacity. Seek to improve coordination in wage setting between export-oriented and domestic sectors.
Geopolitical tensions emerge and deepen in Croatia's region.	Trade flows, including tourism visits, and foreign direct investment inflows weaken, slowing growth. Higher rates of out-migration resume.	In the short term, ensure that firms can access financing to cover cash flow needs. In the medium term, encourage diversification of export markets and activities. Continue to improve the business environment and skills to attract foreign investment and migration.
Global monetary conditions tighten for longer to reduce inflation, weakening global financial conditions and leading to more bank failures.	Financing becomes scarcer and more expensive, slowing lending growth and foreign investment. External demand weakens. Higher interest costs lead to an increase in domestic non-performing loans, weakening banks' balance sheets and lending.	Align domestic policies with the efforts of European authorities to restore liquidity and confidence in financial markets, including, as necessary, through adjustments to banking regulation.

Healthy public finances to sustain stronger growth

Croatia's fiscal stance is its major tool of macroeconomic stabilisation, especially now that it is a full member of the euro area. It was highly responsive to the COVID-19 crisis, with a large deficit in 2020 progressively unwound in 2021 and 2022 to support the economy through the crisis and sustain the recovery. In earlier years it was less consistently counter cyclical (Figure 2.7, Panel B). Improving automatic stabilisers can improve the responsiveness of fiscal policy to the economic cycle (World Bank, 2020[11]). Revenue and social protection reforms can improve automatic stabilisers. For example, improving the targeting of social protection, as current efforts to better identify households in need and to strengthen the guaranteed minimum income, work in this direction (Chapter 4). They will better support incomes and spending through downturns, and reduce overall social spending as employment recovers. Ensuring that any future reforms to personal income tax rates maintain their progressivity would similarly help to stabilise households' disposable income through the economic cycle. Designing policy responses to exceptional shocks so as that they cease once conditions pass thresholds, such as energy prices falling below a prescribed level, would ensure that exceptional measures remain in place only temporarily. Some OECD countries, such as Ireland, have found this approach effective (OECD, 2022[12]).

Croatia's medium-term fiscal stance is guided by European fiscal rules and institutions, which are currently being reassessed (discussed in the 2023 OECD *Economic Survey of the European Union*). The new framework is expected to still require Croatia to establish a credible medium-term path to reduce the debt-to-GDP ratio below 60% of GDP. It is expected that medium-term expenditure rules will be required to guide that path, accounting for long-term expenditure pressures, including those relating to ageing and to reducing greenhouse gas emissions and adapting to climate change. Croatia is developing the institutions that help achieve these fiscal goals. The 2021 Budget Act raises the role of a medium-term perspective on Croatia's budgeting. Institutions such as the Fiscal Policy Commission will have a permanent staff from 2023. These institutions can strengthen the design, implementation and sustainability of the government budget and track compliance with fiscal rules (Box 2.6).

Box 2.6. The Fiscal Policy Commission can help fiscal policy achieve its goals

Croatia has been developing its fiscal policy framework and associated institutions over the past decade. The Fiscal Policy Commission started operating in 2014 as a parliamentary committee, and started functioning independently in 2021. From 2023, is gained the resources for a full-time staff and research capacity. Such institutions can provide effective support for the design and implementation of the government budget, and can help ensure that fiscal policy aligns with the government's medium-term objectives and with fiscal rules. They can improve the quality of the economic assumptions and analysis underlying the budget, and the general discussion of economic trends and policy responses. The Fiscal Policy Commission has found that Croatia has broadly complied with its national fiscal rules, an improvement on earlier periods when that was the case in less than half of the years between 1998 and 2019 (Manescu et al., 2023[13]).

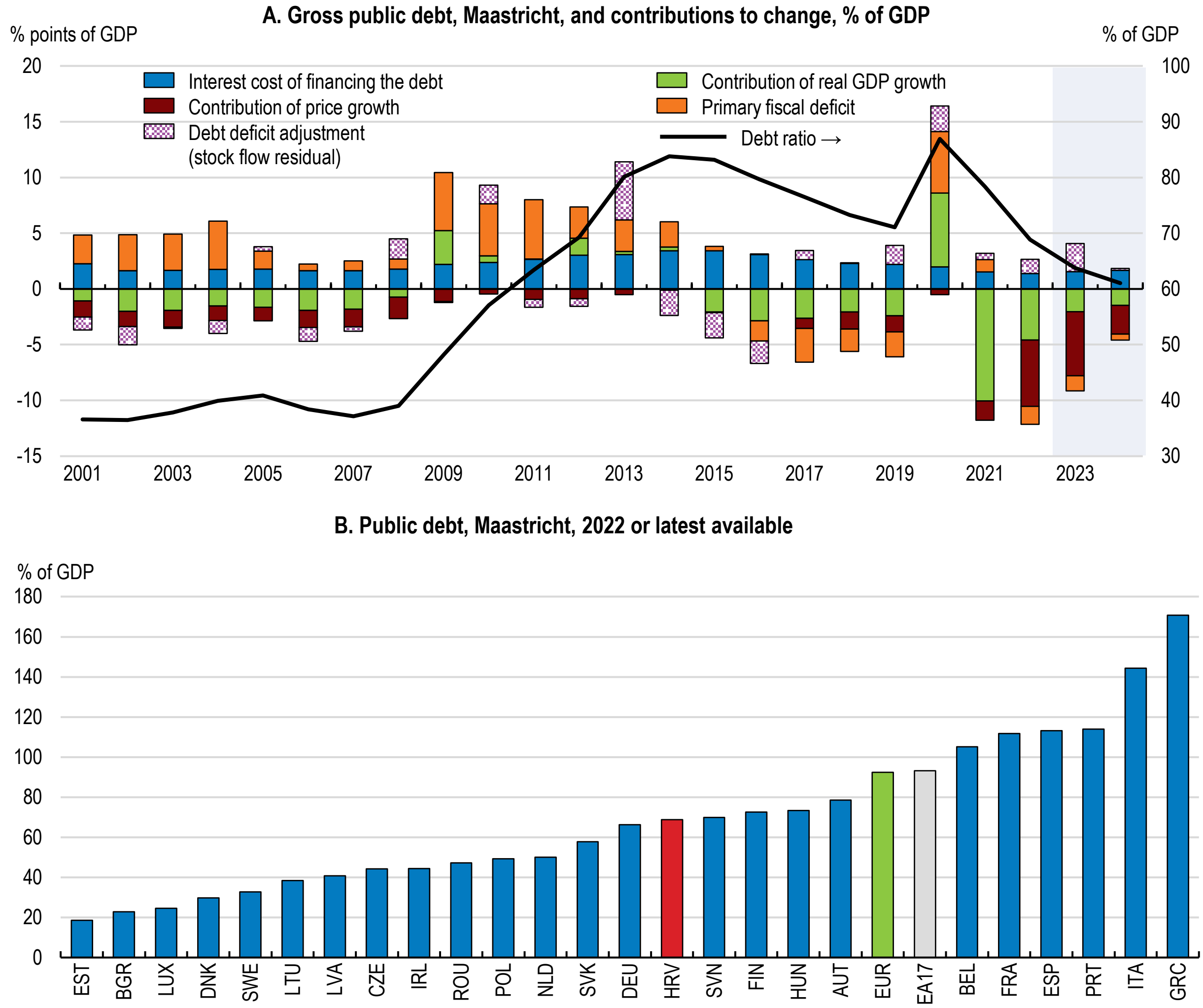
A particular challenge to developing such independent fiscal institutions is scarce human resources, with many of those with the right mix of economic and policy analysis skills already contributing through other public institutions or think tanks. In other smaller euro-area countries, such as Estonia or Ireland, the office is made up of part-time academics or policy experts, including members of the country's diaspora, and a small staff of several experts and support staff. In some euro-area countries, such as Estonia, it is attached to the central bank. This can help pool resources and establish the office's expertise in macroeconomic analysis.

Source: (von Trapp, Lienert and Wehner, 2016[14]); (Council of the OECD, 2014[15]).

The public debt ratio fell below 70% of GDP in 2022, its lowest level since the protracted recession of the early 2010s although still higher than many of Croatia's peers (Figure 2.8). The rebound in activity and surge in prices since the COVID-19 crisis, adding to the low interest rates of recent years, have dramatically reduced Croatia's public debt-to-GDP ratio, as in many OECD countries. These factors are projected to be temporary, as inflation abates and output growth moderates in the coming years. Achieving the government's medium-term fiscal plans will enable Croatia to reduce and maintain the public debt ratio to the Maastricht objective of less than 60% of GDP in the coming years. This would support Croatia's sovereign debt rating, reducing the cost of financing for both the public budget and private investors, and would build a buffer to finance responses to future shocks or contingent liabilities.

Further reducing the public debt-to-GDP ratio will require maintaining primary budget surpluses, while fully implementing the government's current reform programme (Figure 2.9). For instance, maintaining the average primary budget surplus near 1% of GDP and then near 0.5% from 2040 would stabilise the public debt ratio near 55% of GDP. Extending the reform and investment programme, as recommended in this *Survey*, and achieving primary budget surpluses averaging 1.0% of GDP is likely to see improvements in financial markets' risk assessment of Croatian debt and a narrowing in interest rate spreads on government debt, and would enable the public debt-to-GDP ratio to fall further. Conversely, in a negative scenario with reforms stalling, smaller primary budget surpluses, and a modest widening of spreads on Croatia's bonds, the public debt ratio would rise above 100% of GDP. The reforms recommended in this *Survey* would generate fiscal savings, which can be used to sustain a larger budget surplus or to lower Croatia's overall tax burden (Box 2.7).

Figure 2.8. Rising prices and growth have reduced the public debt ratio



Note: Panel A: Values for 2023 and 2024 are projected. Negative 'primary fiscal deficit' indicates a surplus. Panel B: EA17 refers to euro-area countries that are members of the OECD.
Source: OECD Economic Outlook 113 (database), updated.

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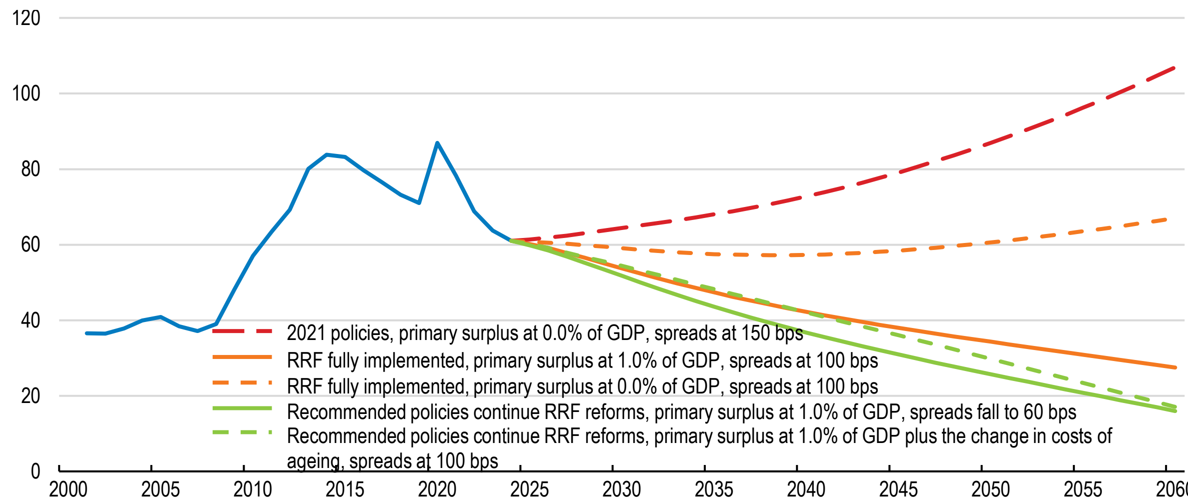
The longer-term fiscal pressure from population ageing is expected to be contained under current policies, although the projections may under-estimate these pressures. The total costs of population ageing, including costs for pension, health and long-term care will rise slightly to 22.2% of GDP in 2030 and then gradually decline under current policies, according to the European Commission's most recent *Ageing Report* exercise (European Commission, 2021[16]), despite the increasing retiree population and rising care costs. Figure 2.9, inter alia, illustrates the effect on the ratio of public debt to GDP if the primary balance reflects no absorption of the change in the projected fiscal cost of ageing from its level in 2024. The decline largely reflects projected falls in the fiscal costs of pensions, as more retirees transition into the self-funded regime (Chapter 4), more than offsetting rising health and long-term care costs. Disability pension payments, currently predominantly awarded to Croatia's war veterans, are expected to decline by 1.2 percentage points of GDP by 2070. Improvements in the coverage ratio (the number of pensioners relative to the population aged over 65) will also reduce public pension spending, as more retirees accumulate sufficient pension savings to fund their retirements, and as women's official retirement age is aligned with men's by 2030. The projections also assume that the benefit ratio will decline, despite existing challenges of low incomes and poverty among the elderly. Improving incentives for workers to work to the official retirement age would further improve the retirement incomes and reduce the fiscal cost of pensions into the longer term. Pressures to support retirees' incomes suggest that the fiscal costs of ageing may be substantially higher than these projections, especially if there is little progress in increasing employment among older adults (Chapter 4).

Figure 2.9. Modest primary surpluses and stronger growth through continued reforms will reduce the debt ratio to below 60%

Public debt, Maastricht definition, percent of GDP



Note: Policy scenarios are described in Table 1.1. Market interest rates are assumed to remain at 3.3% through the projection period. The GDP deflator is projected to increase by 2.0% annually from 2025. The scenario incorporating the change in costs of the ageing adds to the primary budget surplus of 1.0% of GDP the change in the total cost of ageing relative to the projected value for 2024, from the European Commission's 2021 *Costs of Ageing* (European Commission, 2021[16]) exercise with annual values interpolated linearly.
Source: Simulations based on the OECD's Global Long-Term Model, and OECD Economic Outlook 113 (database), updated.

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Box 2.7. The recommended reforms would generate fiscal savings

Table 2.4 presents the estimated fiscal impact of the recommended reforms with significant fiscal effects, allowing for limited behavioural responses. Many of the recommended reforms have small overall fiscal impacts. The recommendation to progressively introduce a price on greenhouse gas emissions consistent with the emission trading scheme price foresees this being fully offset by increased transfers to vulnerable households and support for investments reducing emissions. The overall balanced fiscal impact is consistent with maintaining a primary budget surplus averaging near 1% of GDP.

Table 2.4. The recommended reform package would free resources for reducing taxes or debt

Fiscal savings (+) and costs (-), % current year GDP

Policy measure:	2025	2030
Progressively remove fossil fuel subsidies	0.6	1.4
Support inclusive employment opportunities by raising in-kind family spending by an additional 0.5% of GDP by 2030	0.0	-0.5
Expand active labour market policies, raising spending by an additional 0.5% of GDP by 2030	0.0	-0.5
Increase R&D support	0.0	-0.3
Overall budget impact of specific measures of recommended reform package	**0.6**	**0.0**
Expected revenue gains not included in assessment of policy recommendations:		
Boosting tax compliance and enforcement	0.3	0.5
Revenue gain from higher growth following recommended reform package	0.0	0.4
Memo: GDP % difference from scenario of full implementation of RRF	*0.01%*	*0.90%*

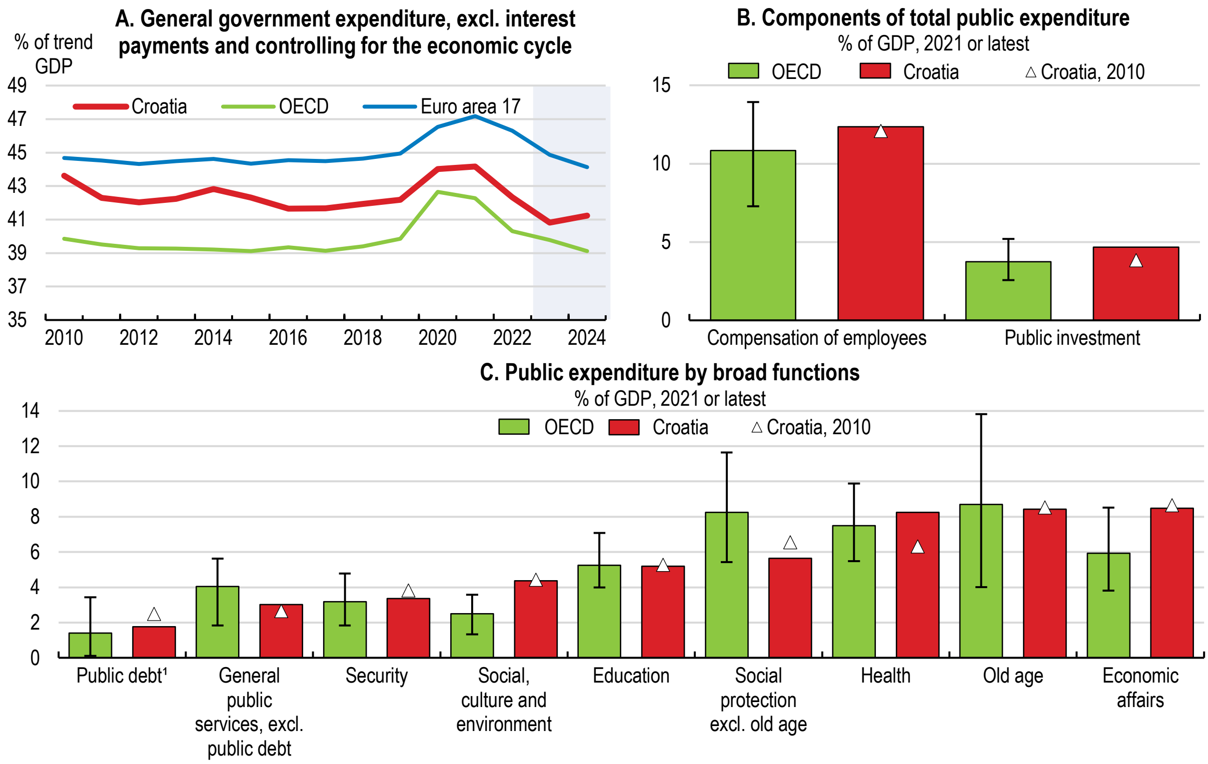
1) Only measures with significant ongoing fiscal implications are included.
2) Potential revenue gains from reducing tax evasion and improving collections are based on OECD estimates of the gap between realised and potential VAT revenues, adjusted for projected nominal GDP growth, and given revenue gains from past compliance measures.
Source: OECD secretariat estimates. Fossil fuel subsidy values are sourced from the IMF Energy Subsidy Template.

Improving the allocation and execution of spending

Public spending relative to GDP is similar to European OECD countries, but higher than in most of Croatia's peers or other countries near Croatia's level of income per capita (Figure 2.10). The resources allocated to the more growth-supporting broad categories of spending, such as public investment and education, are comparable to the average of OECD countries. Important shares of spending are in areas where spending cannot be readily adjusted, such as personnel expenses, interest payments or various welfare transfers, restricting the extent to which public finances can respond to changing conditions or priorities.

Public spending reviews can be an effective tool to reallocate resources to areas that best support a government's objectives. Croatia has developed experience in spending reviews first through a comprehensive review in the mid-2010s, followed by sector-specific reviews. Incorporating such reviews regularly and early in the annual budget cycle can help budgets reallocate funding. Spending reviews can be more effective when they engage with expertise in the parts of government responsible for spending and implementing programmes, including line ministries, agencies and sub-national governments. A specialised unit in a central finance agency, such as the Ministry of Finance, working collaboratively with delivery bodies to assess and improve spending could be an effective approach, given the diffused responsibilities and the thin spread of technical and analytical capacity.

Figure 2.10. Overall spending is near OECD countries, although the public payroll is high



1. Public debt expenditure includes interest payments and outlays for underwriting and floating government loans.
Note: Panels B and C: The whiskers show the range between the first and last (unweighted) decile of the OECD countries. The figure shows public expenditure by broad function. The OECD averages are not weighted and do not include Canada, Mexico, New Zealand and Türkiye.
Source: OECD Economic Outlook 113 (database), updated; OECD National Accounts Statistics (database).

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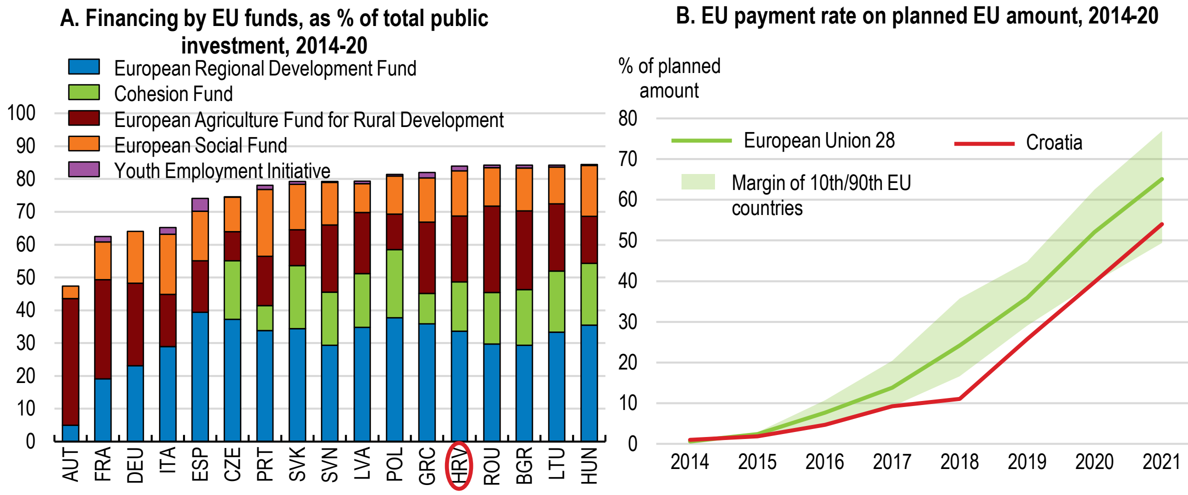
Croatia has accessed substantial volumes of European Union funds relative to its GDP over the past decades and they have made up a larger share of overall public investment spending than in most other EU countries (Figure 2.11, Panel A). The funds have enabled Croatia to accelerate its reconstruction, and achieve a quality of infrastructure and public policies and programmes comparable to many OECD countries. The importance of European support in funding public investment and reform programmes can lead the priorities agreed at European level to dominate Croatia's development agenda. While these priorities broadly tally with the reform objectives needed for Croatia's further development, there is a need to fine-tune with nationally-driven initiatives. In light of this, developing greater national capacity to fund investments and implement the national reform programme would help Croatia to address a broader range of the constraints to its growth, complementing European Union resources.

In the current European funds programming period, Croatia is among the leading countries in accessing its Recovery and Resilience Facility grants (Box 2.8). This is a marked improvement from previous EU funds programme periods, when Croatia's absorption rate lagged other EU countries (Figure 2.11, Panel B). To improve disbursement, it has developed ministries and bodies dedicated to managing and implementing European funds. Still, challenges remain. The fall in nominal investment spending in 2022, despite the increased funds available and investment projects' rising costs, is an example of the impact of such disbursement challenges. Drawing on the effective practices supporting implementation of the Recovery and Resilience Programme to better prepare and track projects and improve coordination between the different levels of government, could raise the disbursement rate of Croatia's total public investment.

Figure 2.11. Public investment is highly reliant on European funds



Source: European Commission, European Structural and Investment Funds.

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Box 2.8. Croatia is making good progress implementing its Recovery and Resilience Plan

Croatia's Recovery and Resilience Plan provides an ambitious and detailed programme of reforms and investments focused on supporting the country's resilience and accelerating the green and digital transitions. As Croatia progresses through the 372 milestones in its plan, it is gaining access to tranches of its allocation of EUR 5.5 billion in grants from the EU's NextGeneration facility. At 9.5% of 2021 GDP, Croatia's allocation is the second largest allocation relative to GDP of any country (Figure 2.12, Panel A). Activities funded through the Recovery and Resilience Plan must be completed by August 2026.

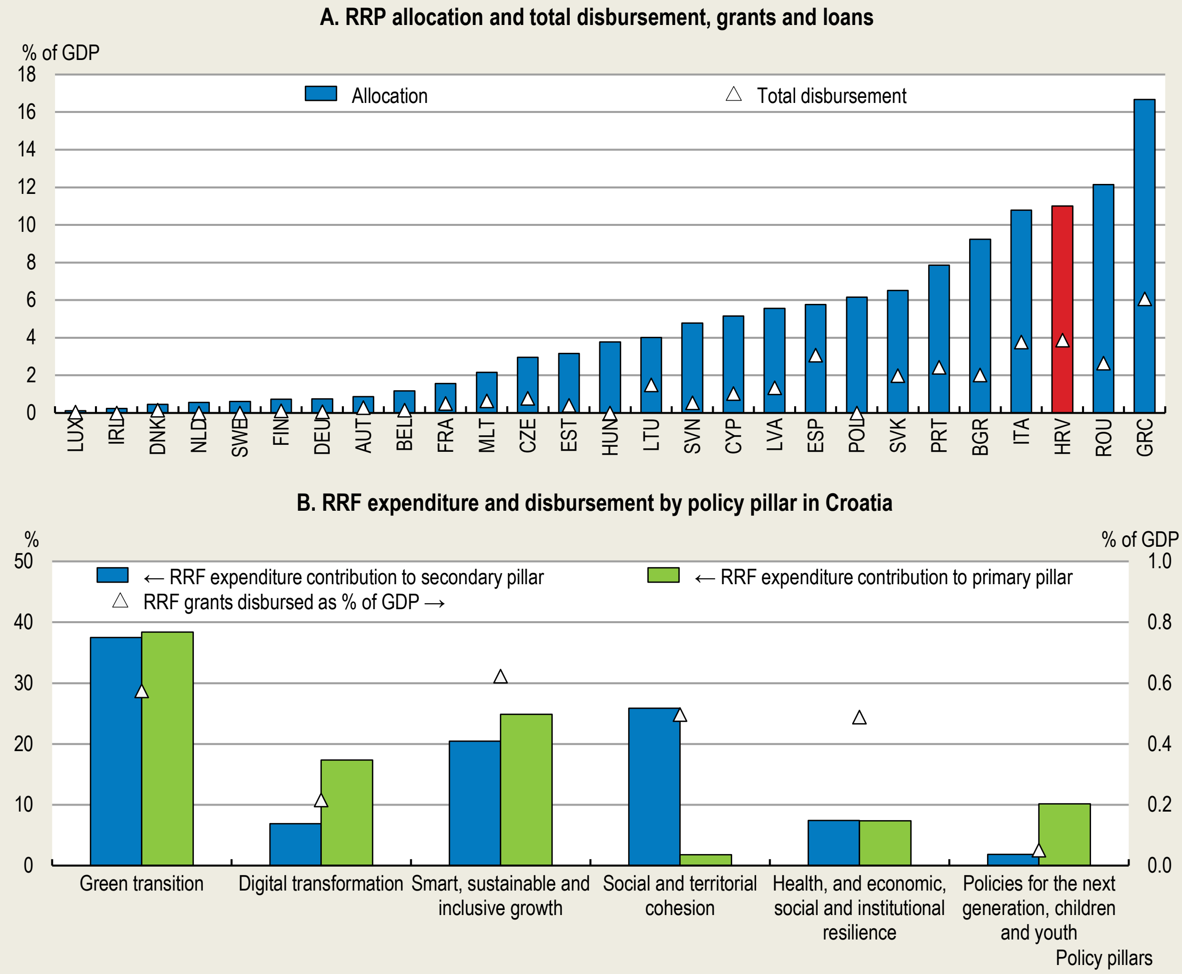
Croatia's Plan includes 146 investments and 76 reforms, similar numbers as in much larger countries. Forty per cent of its funds are allocated to green objectives, 20% to the digital transition and 26% to social spending, mostly welcome investments in general and early childhood education (Chapter 4) (Figure 2.12, Panel B). Support for rebuilding following the 2020 earthquakes makes up the main regional development component.

Croatia has made strong initial progress, thanks to the development of a specialised implementation structure, led by senior officials at the centre of government and with consistent, high-level political support. A steering committee is responsible for the Plan's overall management and monitoring. The committee meets regularly, informed by implementation reports prepared by a dedicated coordination body. An implementation committee brings together the different central government bodies responsible for putting the Plan into action and for obtaining and disbursing payments. This body then works with the government authorities responsible the respective components of the Plan, and for auditing and for the management of payments. Ongoing monitoring of progress, identifying blockages and having channels to address those impediments have contributed to improved disbursements

Croatia's Plan was among the first submitted and approved for access to the NextGenerationEU Facility and Croatia is among the leading countries in the approval of its disbursement requests (Figure 2.12, Panel A). By mid-2023 it will have received 53% of its fund allocation, through a series of biannual instalments of EUR 700 million (1% of GDP). Croatia has created a dedicated body at the centre of government focused on delivering the Recovery and Resilience Plan reforms and investments. As other countries have found with such dedicated bodies for exceptional projects, this body has been instrumental in overcoming coordination challenges between different units and levels of government.

The government estimates that, fully implemented, the Plan will directly raise GDP by between 1.9% and 2.9% by 2026, and employment by 1.2%. While capital investments will absorb most of the funds, some of the administrative and policy reforms funded from the Plan or linked to access to the funds will bring more enduring benefits for Croatia's investment climate, labour markets and social welfare.

Figure 2.12. Croatia's Recovery and Resilience Plan is substantial



Note: Panel A: the chart shows the funding allocated to each endorsed recovery and resilience plan (RRP) to this date and the disbursements made under the RRF as a share of 2021 GDP. For those Member States whose RRPs have not yet been endorsed, the amount displayed is the maximum allocation in grants according to the RRF Regulation.
Source: EC, Recovery and Resilience Scoreboard.

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Delivering public goods and services across many government agencies and levels

A wide distribution of decision and implementation responsibilities across central government ministries, and between central and subnational government is often cited as a barrier to the delivery of public goods and services and as a source of regulatory complexity. The overall number of subnational governments (21 countries and 556 towns and municipalities), their average size or the number with very small populations is comparable to many OECD countries. However, the allocation of responsibilities and resources appears to create barriers to delivering quality public goods and services and for approving investments, as many are devolved to subnational governments with differing approaches and service quality. For example, differences in social support can be great between the several larger cities, led by Zagreb, and other localities, while different regulatory approaches in different municipalities can add to investors' challenges.

Effective allocation of responsibilities across layers of government entails balancing localised expertise and accountability with the efficiency of scale and coordination (OECD, 2019[17]). Legislation in 2015 provided for voluntary mergers of local governments but it was not accompanied by financial incentives and its use has been limited. Croatia adopted a Public Administration Development Strategy 2015-2020 that encourages inter-municipal co-operation but without supporting this with funding or an institutional framework. Cooperation is most common among larger local governments on strategic planning to attract economic development, and in joint ownership of municipal companies and service delivery agencies. Investments in the Recovery and Resilience Plan will develop a digital platform for monitoring the capacity of subnational governments, to assess their capacity to meet their public goods and service delivery responsibilities, and with the goal of encouraging greater joint service provision. Other investments will expand subnational governments' access to information via new digital platforms. Developing support in the central government for subnational governments' digitalisation, for example by creating standard platforms, can also help achieve higher quality and more consistent digitalisation of public goods and services across Croatia. Building bodies and practices, such as regular conferences of different agencies engaged on a particular topic, supported by a secretariat, could help different government bodies to better collaborate. Longer-term, a broad review of the responsibilities and resources of the different levels of government could improve their allocation and delivery.

Local governments rely on transfers from the central government for part of their budgets. The planned 2024 tax reforms (Box 2.4) will increase subnational governments' fiscal autonomy. At the same time, Croatia is improving its approach to these transfers and the Recovery and Resilience Plan investments will provide additional data to better inform these transfers. Croatia could draw on Italy's experience with fiscal equalisation mechanisms to adjust grants to subnational government for differences in the cost of service delivery and needs, for example for remoter or poorer areas. The mechanism assesses the cost of delivering particular public services, the actual costs incurred, and the needs and capacity of each government body to provide those services.

Better managing public investment and procurement

Strengthening public procurement and public investment management would improve spending efficiency and disbursement rates. Public procurement spending is slightly above the average of OECD countries, at 13.2% of GDP in 2021 (Ministry of Economy and Sustainable Development, 2021[18]). Croatia has been improving many aspects of its public investment management, for example by expanding the role of cost-benefit analysis in informing selection and design of projects ranging from entrepreneurial zones, to wastewater treatment investments, and to a new energy efficiency renovation financing model (OECD, 2019[19]; World Bank, 2019[20]; European Commission, 2021[21]). Investments in its Recovery and Resilience Plan will expand the use of digital platforms to support more efficient and responsive public procurement by some agencies. Still, challenges in investment management and procurement have contributed to delays in starting priority projects, such as the reconstruction works following the 2020 earthquakes. Much procurement, especially for non-standard purchases, is fragmented across the different agencies and levels of government responsible for spending. While the large role of European funds greatly expands the range of investments Croatia can finance, their implementation can complicate procurement, for example by adding uncertainty over when funds will be available and by adding additional verification requirements.

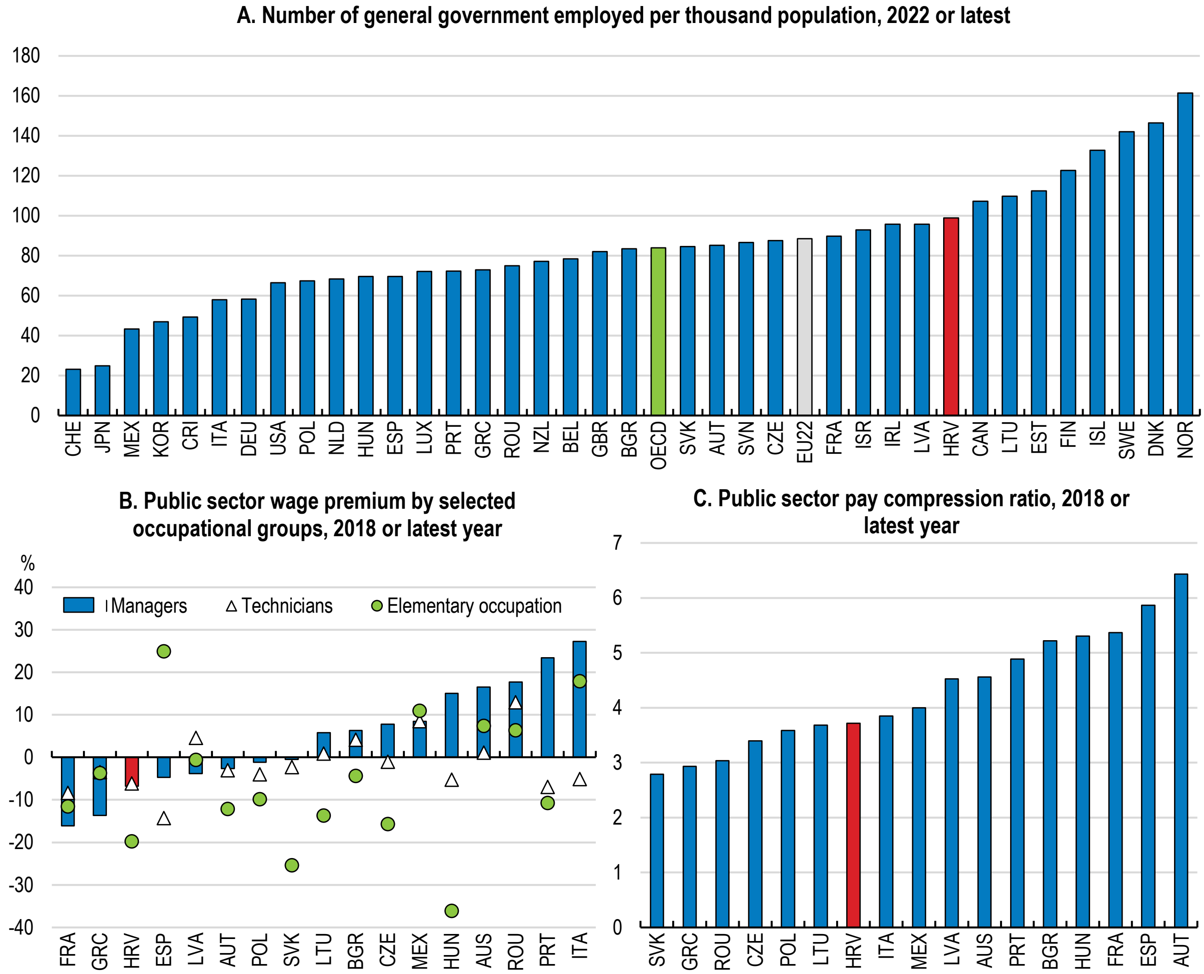
Croatia is seeking to better use public procurement to support policy goals such as achieving a greener and more innovative economy, at the same time as it targets the still-significant corruption risks (Chapter 3). The Recovery and Resilience Plan includes measures to improve procurement. It is consolidating into one specialised agency more public procurement, including for non-standard purchases. This is a welcome step. Currently this agency is mostly engaged in bulk procurement of standardised goods and services for the public sector. Experience in OECD countries suggests that this approach can develop the expertise to engage in more sophisticated procurement processes. These agencies are able to assess bids on more sophisticated grounds than on simply the lowest cost criterion. This can help achieve the government's broader goals. By having a better overview of all the government's purchases, it is able to give the market more information about future demand, and work with suppliers on improving the goods and services they supply.

Staffing a high-performing public service

Delivering quality, timely and cost-effective public goods, services and investments requires having sufficient public servants with the necessary technical skills in place. Overall, Croatia has a similar number of public servants relative to its population and its overall workforce as most OECD countries (Figure 2.13, Panel A). They are on average more educated than their private sector counterparts – over half of workers have completed tertiary education, compared with 20% in the private sector – although this share lags many OECD countries. Nonetheless, shortages of skills are often identified as a barrier to delivering public goods and services or implementing reforms. Efforts to digitalise the public sector in particular have been slowed by shortages of advanced IT skills. The relatively large number of different public bodies is likely to spread staff skills thinly. Rather than general increases in staff numbers and wage rates, ensuring that staff are in the positions where their skills can be best used, and ensuring that specialised skills are rewarded competitively, can help Croatia better use its public sector resources.

The wage bill is higher as a share of GDP than in many OECD countries, but in the central government public servants receive less than their private sector counterparts for equivalent skills (Figure 2.10, Panel B; Figure 2.13, Panel B). Private employers who can offer better wages and other working conditions, especially for workers with specialised skills, can attract workers from the public sector. For example, the large taxpayer office established in the 2010s has had difficulties retaining staff skilled in functions such as audit, due to uncompetitive pay (World Bank, 2020[22]). The government and social partners have agreed to substantial increases in public servants' nominal pay rates in 2022, 2023 and 2024. An overall review of the public service pay system is underway. Future reforms should seek to ensure that pay rates are competitive with the private sector for specialised skills, while ensuring that workers' performance is also comparable and that pay rates do not distort the overall labour market or incentives within the public sector.

Figure 2.13. Overall public service numbers are above most OECD countries, but some wage rates are lagging



Note: Panel A: EU22 and OECD are unweighted averages. OECD excludes Australia, Chile, Colombia, and Costa Rica. Panel B: Public sector wage premium as compared to formal wage employees. Panel C: Ratio of 90th/10th percentile earners in the public sector.
Source: OECD Economic Analytical (database); OECD National Accounts (database); ILOSTAT; World Bank, Worldwide Bureaucracy Indicators (database).

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Filling staffing gaps while containing the wage bill is likely to require a mix of improved, more agile and competitive public servant recruitment and staff allocation. Reforms are underway with a focus on digitalising and standardising public administration recruitment processes, and focusing selection more on candidates' competencies rather than their knowledge of administrative law. A recalibration of pay rates and the introduction of performance-based pay rewards can improve the competitiveness of public service careers in the job market. Deeper reforms are being prepared, which can re-allocate existing staff to fill gaps. Croatia could make greater use of temporary staff to meet short-term needs, while ensuring that rules are in place so as that temporary staff do not become a parallel cadre of staff.

Ensuring that senior positions are filled by technical and managerial experts can support public sector effectiveness, help retain and motivate capable staff and build the public's confidence in the public sector by countering concerns over politicisation (Koprić, 2019[23]). In most smaller OECD countries, political appointments extend to the second level of the public sector hierarchy. Experience across OECD countries suggests that in a context such as Croatia, a hybrid appointment process where the political decision-maker selects candidates from a shortlist prepared by an independent body, with a focus on technical and managerial skills, can balance political responsiveness with operational needs. Appointing senior officials under performance agreements, including measurable and realistic outcome or output indicators, and supported by 360º reviews, can support a focus on results and professionalism (OECD, 2019[24]; OECD, 2021[25]).

Broadening the tax base to support revenues

Overall, Croatia collects a slightly smaller share of GDP through taxes and social contributions than most OECD countries (Figure 2.14). Indirect taxes generate a larger share of total revenues than in most OECD countries, reflecting the relatively high rate, while income taxes and property taxes make up relatively modest shares, reflecting rates that are near or below the averages of OECD and European countries in most situations (Table 2.5) (Eurostat, 2023[26]). This follows cuts in rates over recent years. The government is planning a package of further reductions in tax and contribution rates in 2024, worth up to 0.5% of GDP (Box 2.4).

Croatia currently applies low recurrent taxes to property values. As discussed in Chapter 4, these taxes are among the most economically efficient. Progressively introducing a general recurrent tax on property values, supported by digital tools to keep property valuations up-to-date, while ensuring arrangements are in place for asset-rich but vulnerable households, can support government revenues and encourage property owners to put dwellings to their full use.

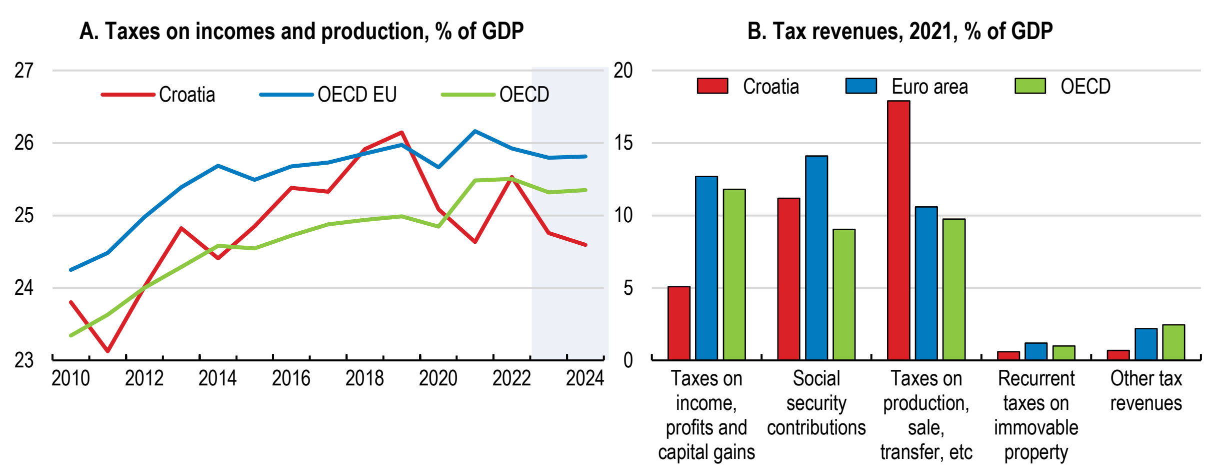
Reviewing and reducing tax expenditures and tax-free exemptions on certain income sources would broaden the tax base, which would allow the more distortionary tax rates to be reduced. Tax exemptions, tax-free allowances and reduced rates distort investments and business decisions. A prime example is a flat fee applied to tourism accommodation income, rather than applying the standard income tax system. This encourages owners to let out their properties as a source of supplementary income, discouraging the development of hotels or other larger facilities that would be better positioned to lengthen the tourism season into more of the year. Further, tourism tax receipts are allocated to tourism boards, rather than contributing to general revenue. Similarly, not taxing tips or bonus payments below relatively generous thresholds, which will be raised in 2024 under planned reforms (Box 2.4), weakens the tax base and workers' retirement savings and incomes, and distorts how employers pay workers. Undertaking a comprehensive review of existing tax expenditures and assessing their fiscal costs relative to their economic benefits can drive reform. Tax expenditures may also be more effective if they are designed and implemented by one expert agency, rather than fragmented through different, at times competing, agencies.

Table 2.5. Croatia's personal income tax wedge is near OECD averages, corporate income rates are lower, and indirect rates are relatively high

			Croatia	OECD	European Union	Euro area
Net personal income tax wedge, % (2022):						
	Wage rate, % of average wage:					
Household type:	Primary earner	2nd earner				
One-earner couple	100	0	35.4	35.6	37.1	37.3
One-earner couple, two children	100	0	27.8	28.4	29.2	30.2
Two-earner couple	100	67	37.4	36.5	38.0	38.2
	100	100	39.1	38.1	39.7	40.3
One-earner couple, two children	100	67	32.1	32.5	33.6	34.1
	100	100	34.6	34.8	36.0	36.8
Single	67	–	31.3	30.8	31.7	30.5
	100	–	35.0	34.1	35.6	35.3
	167	–	39.1	38.1	39.7	40.3
Single parent, two children	67	–	42.5	42.2	43.6	44.7
Corporate income and indirect tax rates, %:						
Statutory corporate income tax (2022):			18.0	23.1	21.5	23.3
Composite effective average tax (2021):			16.5	22.1	19.3	21.2
Composite effective marginal tax (2021):			7.3	10.8	8.0	8.7
Value added tax (2022):			25	19.2	21.8	21.1

Note: OECD, European Union and euro-area averages are unweighted averages of the countries with available data. The Tax Wedge measures net taxes (i.e. income tax plus social security contributions paid minus benefits received) as a % of total labour cost for the employer.
Source: "OECD Tax and Benefit Model, preliminary results: http://oe.cd/TaxBEN; OECD (2022). OECD Tax Database; OECD (2022), Consumption Tax Trends 2022: VAT/GST and Excise, Core Design Features and Trends, OECD Publishing, Paris.

Figure 2.14. Tax revenues are moderate, and are weighed towards indirect taxes



Note: Panel A: OECD EU is the unweighted average of OECD countries also currently European Union members. Figure does not include social security contributions. Taxes on incomes and production include direct taxes on income, wealth and other recurrent taxes, and indirect taxes on production and imports. OECD unweighted average excludes Chile and Türkiye.
Source: OECD Economic Outlook 113 (database), updated; OECD (2022), OECD Global Revenue Statistics (database); Eurostat; and OECD calculations.

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Some indicators of tax compliance are positive, including relatively small outstanding arrears and VAT collection gap. However, undeclared business activity is sizeable (Box 2.9). Business surveys report concerns with tax compliance burdens, with the time to prepare and pay taxes well above most OECD countries. This is partly due to the many parafiscal fees (i.e. fees for a specific purpose), which are progressively being consolidated, removed, or their payment simplified through digitalisation and other procedural reforms. It is also due to low digitalisation of the tax administration; an issue also being progressively addressed by reforms of the tax administration over the past decade and by investments and reforms in the Recovery and Resilience Plan. By reducing the cost of compliance, and improving monitoring of activity, digitalisation is likely to reduce undeclared activity, and to reduce formal businesses' recourse to professional tax advisors. Improvements to the tax administration accelerated with the European Union membership process and have been given a further boost by the Recovery and Resilience Plan investments. Many measures have focused on modernising the administration's physical and digital infrastructure, and on developing specialised capacities, such as for large taxpayers or streamlining the VAT system. Future reforms could seek to simplify processes and to develop greater management and resource autonomy, combined with a robust monitoring framework to assess taxation authorities' effectiveness at improving compliance while easing compliance burdens (World Bank, 2020[22]). Developing a stronger tax administration culture that seeks to support taxpayers in complying would raise tax morale and payments. This approach could motivate tax authorities to, for example, simplify tax forms.

Box 2.9. Tackling under-declared activity

Croatia is making inroads into its relatively high level of un- and under-declared economic activity. Estimates of informal activity vary widely, but generally suggest that it is above 10% and may be as high as 35% of GDP. Perception surveys suggest that informal work is spread across many service sectors, including construction and tourism, as well as in agriculture. In Croatia, undeclared work is mostly used as an occasional, supplementary source of income for own-account workers, rather than as the main source of income. The importance of the shadow economy has declined over the past decade according to indicators such as tax receipts or the increased demand for electronic point-of-sale terminals. This may reflect improved enforcement and simplified processes for complying with the tax system following ongoing reforms. It has been helped by the acceleration in digitalisation spurred by the COVID-19 crisis, by businesses switching to electronic cash registers with the introduction of the euro, and by increasing income-earning opportunities in declared work.

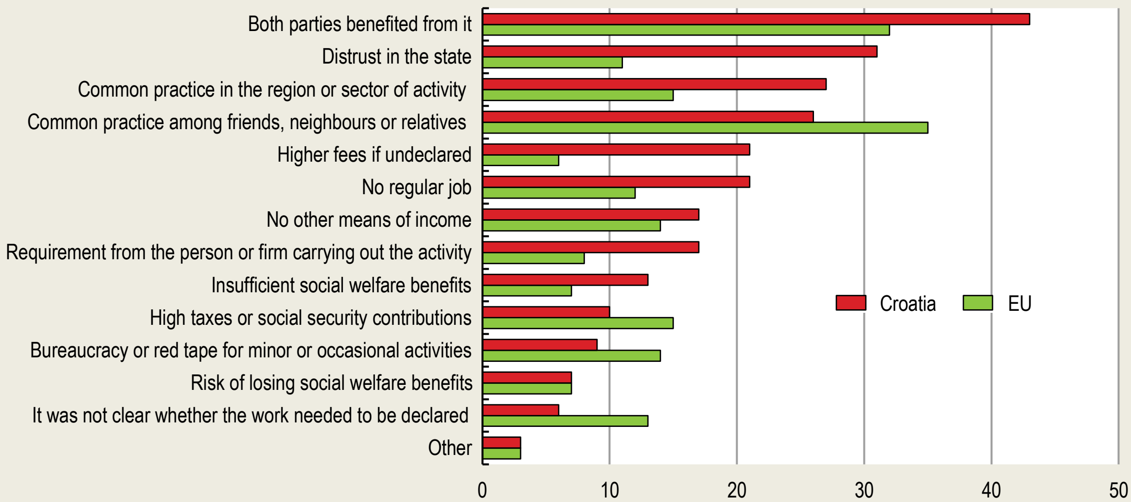
Greater coordination across government would reduce informal activity further, as many government ministries and agencies are involved in identifying and reducing informality in different sectors. For example, inspectors from both the labour and tourism authorities are responsible for identifying labour-related problems in tourism businesses. Croatia has established a Commission for Prevention of Undeclared Work, which should improve coordination.

Progress in improving trust, in both public institutions and general society, would encourage formalisation. Interesting analysis of Eurobarometer survey results finds that shadow activity is strongly associated with lower trust towards the government or the rule of law. In Croatia, trust in the labour inspectorate is low. Many people know people who engage in undeclared activities. A new law, part of the Recovery and Resilience Plan, intends to strengthen control of undeclared work, and to regulate the process of transferring workers from undeclared to declared work.

Low confidence in the justice system and weak tax morale likely contribute to informality. Ongoing and planned efforts to improve the performance of regulators and the justice system (Chapter 3) are likely to counter these patterns. Credible sanctions can complement these efforts to build trust in formal institutions. Over the past decade Croatians became more likely to expect sanctions of informal activity. Education campaigns to change perceptions about the frequency and consequences of undeclared activity can help.

Figure 2.15. Despite recent progress, informality remains significant in Croatia

Reasons for undeclared work, % of respondents, September 2019



Note: Based on the respondents to the Special Eurobarometer 498, who have carried out undeclared paid activity in the last 12 months.
Source: Anon, 2020. Special Eurobarometer 498: Undeclared work in the European Union. Available at: http://data.europa.eu/88u/dataset/S2250_92_1_498_ENG.

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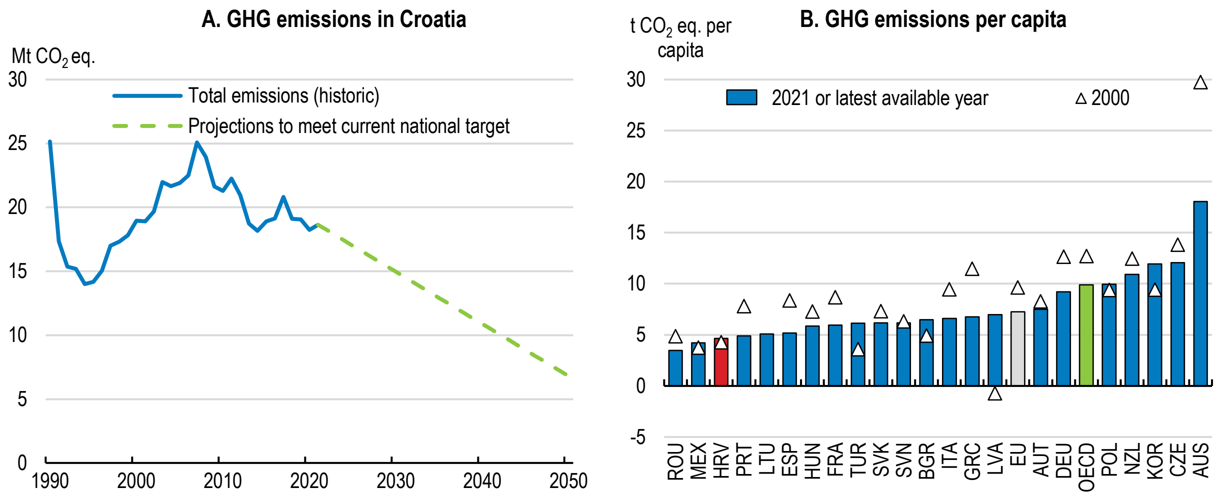
Boosting the energy transition for a higher-quality environment

Reducing greenhouse gas emissions

Croatia's greenhouse gas (GHG) emissions peaked in 2008 but substantial further reductions are needed to reach the country's GHG reduction goals (Figure 2.16, Panel A). Its 2019 National Energy and Climate Plan and Low-Carbon Development Strategy commits to reducing emissions covered by the EU Emission Trading Scheme (ETS) by 43% in 2030 compared to 2005 (e.g. emissions from electricity and heat generation, large business in energy-intensive industry sectors and aviation within the EU), and by 7% for emissions not covered by the EU ETS (e.g. fossil-fuelled cars or heating systems burning fossil fuels directly at home) (Ministry of Environment and Energy, 2019[27]; Ministry of Economy and Sustainable Development, 2021[28]). For 2050, Croatia currently envisages to cut GHG emissions by at least 57% and up to 73% compared to 1990 levels. Since this plan was prepared, EU-level targets have been revised to envisage cutting total GHG emissions by 55% – up from 40% – in 2030 compared to 1990 levels. This implies that larger emission reduction targets will be needed for Croatia to meet EU-level targets.

Reducing emissions while achieving economic convergence will require deeper decoupling of economic activity from GHG emissions. Croatia generates fewer emissions per capita than most OECD countries, largely reflecting lower levels of activity (Figure 2.16, Panel B). In recent years its economy has reduced emissions relative to output but remains more emission intensive than most OECD countries (Figure 2.16, Panel C).

Figure 2.16. Achieving emission reduction goals will require large cuts in emissions intensity



Note: GHG emissions includes LULUCF.
Source: OECD Environment Statistics (database).

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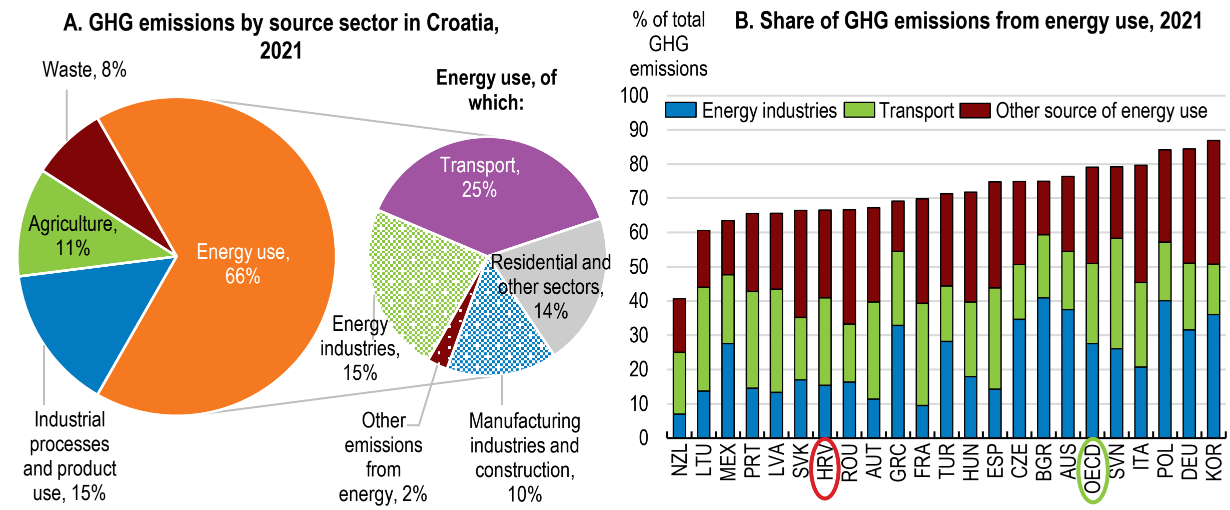
Cutting emissions from energy use will be key, as they account for about two-thirds of total emissions (Figure 2.17, Panel A). Transport accounts for the plurality of emissions from energy use and one-quarter of total emissions (Figure 2.17, Panel B). Energy industries – for example the burning of gas or coal to produce electricity – contribute only 15% of overall emissions. While still sizeable, this share is small compared to OECD countries, reflecting Croatia's reliance on energy imports, including electricity produced from a jointly-owned nuclear generator located in Slovenia, and a high share of renewable generation. Energy used in buildings – for example burning fuels at home for heating and cooking – produces about 14% of total emissions. The 2021 Low-Carbon Development Strategy sets out paths for reducing GHG emissions from electricity and heat generation by between 49.7% and 53.3% by 2030 and by between 61.0% and 93.3% by 2050.

Improving Croatia's environmental tax mix can help to cut GHG emissions. Pricing emissions can encourage cost-effective emission cuts especially for the about two-thirds of emissions not covered by the EU-ETS, as most are severely under-priced. Croatia's revenues from environmental taxes in 2020 at 3.9% of GDP were high compared to 1.3% on average in Central and Eastern European (CEE) countries (OECD, 2023, forthcoming[29]). However, taxes on pollution are relatively low. Meanwhile, Croatia subsidises fossil fuels albeit less than most CEE countries. For example, fossil-fuel subsidies were approximately 1.4% of GDP in 2021 versus 8.7% in Bulgaria. Subsidies apply in the agriculture, forestry and fishing, electricity, gas, steam and air conditioning, transportation and storage, and mining and quarrying sectors, and include reduced VAT rates, excise duty exemptions and reimbursements, and energy tax relief (European Commission, 2022[30]). This suggests that, overall, Croatia's tax system imposes relatively high emission prices for at least some emission sources, but various policy measures weaken price signals. The EU Emission Trading Scheme-2 will apply to road transport and building from 2027-28, expanding emission pricing. In the meantime, and complementing these measures, more emission cuts may be achieved by assuring that emissions from all sources are priced at the same unit price per emission, whether gas for heating or diesel for transport. This could be achieved by assuring that emissions in all sectors and from all sources are priced at a harmonised rate by expanding the coverage of fossil fuel taxes and cutting subsidies, ensuring that tax rates achieve a price floor so that all emissions cost at least a minimum price, leaving higher-priced emissions unaffected.

Higher emission prices will raise living costs, especially for poorer households. analysis for several OECD countries shows that additional revenues generated from introducing a minimum price floor would be more than enough to fund income transfers that offset higher living costs for low-income households, and to support additional investments to reduce emission intensity (OECD, 2023[31]).

Figure 2.17. Reducing emissions from energy use is key



Source: OECD Environment Statistics (database).

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Reducing high emissions from transport

Croatia's reliance on passenger road transport and its relatively old vehicle fleet contribute to a relatively high share of emissions from transport. Most passenger transport is done on road; in 2020, about 96% of passenger kilometres travelled in Croatia were by car or bus, compared to 93% in the EU on average (European Commission, 2022[32]). Croatia has a relatively old vehicle fleet. About 63% of passenger cars – a higher share compared to other EU countries – are at least 10 years old (Figure 2.18, Panel A). Continued reliance on fossil-fuelled cars also contributes to poor air quality, which in Croatia – despite improvements – remains worse than in most OECD countries (Figure 2.18, Panel B) (European Environment Agency, 2021[33]).

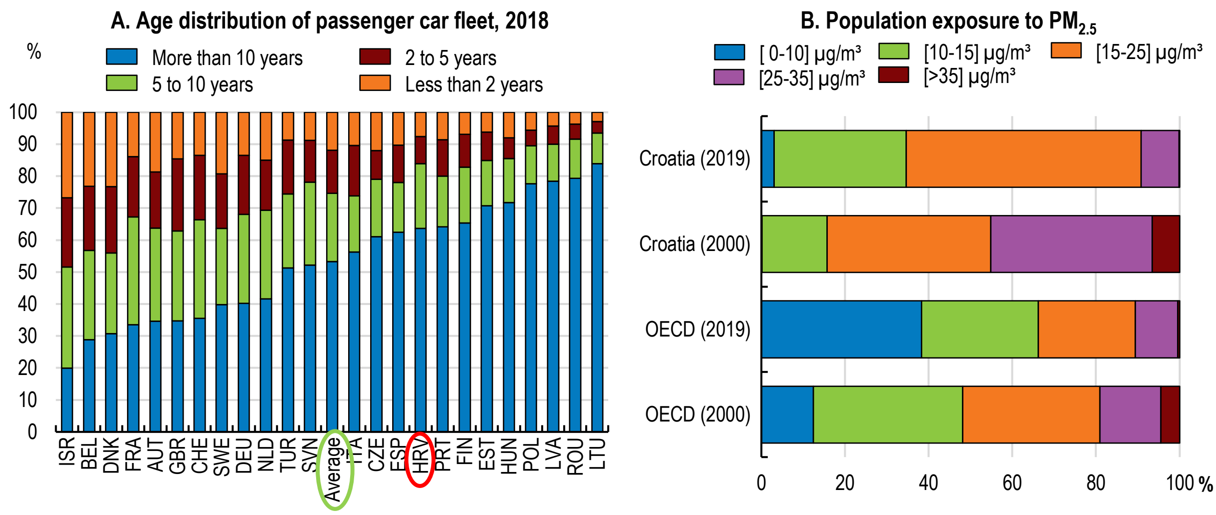
Making transport alternatives including public and active transport more attractive than car transport, subject to project selection and design being informed by robust environmental cost-benefit analysis (OECD, 2018[34]), will help cut transport emissions. Public transport's share of passenger traffic has declined over recent decades and is lower than in most EU OECD countries. Croatia's train services in 2019 ranked 87th out of 141 countries in terms of efficiency in the World Economic Forum's Global Economy Index, and spending on rail infrastructure in recent years as a share of GDP has been less than the OECD average. The Recovery and Resilience Plan's allocation of EUR 728.7 million for sustainable transport, including low emission public transport and improving data and user information systems, and EUR 228 million to upgrade and digitalise Croatia's railway networks, are welcome.

Overall uptake of low or no-emission vehicles has been lagging other EU countries. In 2021, about 3% of newly registered passenger cars in Croatia were zero emission vehicles, compared to a 9% EU average (European Commission, 2022[32]). Various measures will boost uptake (European Commission, 2019[35]). Croatia will be subject to the EU-wide ban on the sale of non-e-fuel combustion engine cars from 2035 onwards. Uptake of electric cars has been supported with purchase subsidies of up to EUR 10 000 (ACEA, 2022[36]). Croatia's Recovery and Resilience Plan aims to extend financial incentives for the purchase of 2000 low or zero emission vehicles, equivalent to about 0.1% of Croatia's passenger vehicle fleet in 2021

(European Commission, 2022[32]). These sizeable subsidies tend to mostly benefit high income households – as the purchase price of low-emission cars is usually substantially higher than for conventional vehicles (Borenstein and Davis, 2016[37]). Ending direct grants and instead subsidising zero-emission vehicle purchase loans for lower income households, similar to a scheme in Scotland, could address financial constraints by overcoming low emission vehicles' high upfront costs and lower running costs, while mobilising more private funding and limiting the costs for public finances (ICCT, 2020[38]).

Croatia is investing through its Recovery and Resilience Plan in 1 300 charging stations. This is a step towards achieving the European Union's Alternative Fuel Infrastructure Directive recommendation of one charger per ten vehicles. The EU will require buildings with more than 10 units to install private charging stations. Complementing these incentives and investments with tighter restrictions of higher-emission vehicles – for example through emission-free zones in cities where other transport modes are readily available – could encourage buyers to switch to zero emission vehicles. For example, Amsterdam, Oslo, Paris, Rome, London and Milan are gradually limiting access for higher emission cars (ICCT, 2020[38]).

Figure 2.18. Heavy use of an ageing car fleet contributes to high transport emissions



Source: OECD Transport Statistics (database); OECD Environment Statistics (database).

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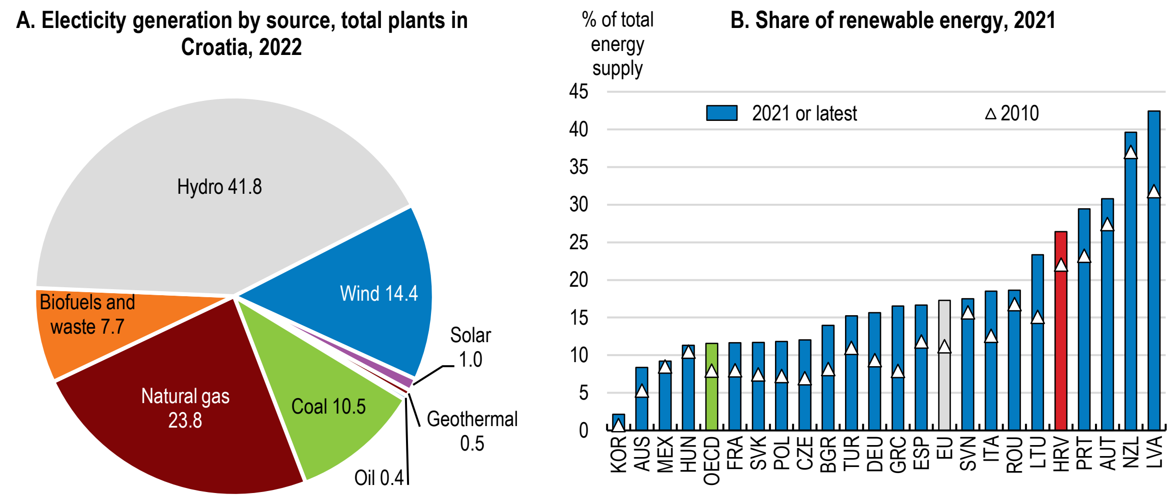
Expanding renewable energy sources and containing energy consumption

Producing more energy from renewable sources and containing energy consumption can cut emissions while making Croatia less dependent on energy imports. Croatia already relies more on renewable energy than many OECD countries (Figure 2.19). The 2021 Low Carbon Development Strategy aims to further increase the share of renewable energy sources in gross direct energy consumption from about 30% in 2021 to 36.6% in 2030 and between 53% and 65% by 2050, mostly by expanding hydropower, solar photovoltaics, and wind in generating electricity (Ministry of Environment and Energy, 2019[27]; Ministry of Economy and Sustainable Development, 2021[28]). Untapped potential from renewable sources exists especially in coastal and island regions (European Commission, 2021[39]). A feed-in tariff scheme (i.e. a fixed price for renewable electricity) was discontinued in 2016 and replaced with a feed-in-premia scheme (i.e. a mark-up on the market price) in 2022. The shift is welcome as premia schemes allows investors to recover their investments in renewable energies while limiting fiscal costs if electricity prices are low.

Scaling up renewable energy generation requires substantial investments in the electricity grid. The Recovery and Resilience Plan's investments of EUR 418 million (0.6% of GDP) to upgrade Croatia's electricity grid and to expand capacity for geothermal energy for district heating are steps in the right direction, but are likely to be modest compared with needs (European Commission, 2021[39]). The Energy Efficiency Programme for the Decarbonisation of the Energy Sector, which will improve the energy efficiency of central heating systems, will help too. Uncertainty about property rights, the legacy of multiple cadastres, cumbersome spatial planning and regulatory arrangements slow development of renewable energy infrastructure; Chapter 3 discusses how to facilitate investments by reducing regulatory burdens, including from spatial planning. Croatia's substantial nuclear energy capacity can maintain base and balancing capacity for the rising share of renewable sources (OECD/NEA, 2012[40]; NEA, 2019[41]). Croatia plans to further improve electricity interconnections with other countries, which will add balancing capacity (European Commission, 2019[35]). Croatia also plans to deploy smart meters which, combined with dynamic pricing, can provide incentives for electricity customers to shift demand to periods when supply is more plentiful (IEA, 2021[42]).

Figure 2.19. Renewable energy sources already supply an important share of Croatia's energy



Note: Panel A does not include imported electricity, including that generated by a nuclear plant located in Slovenia and jointly owned by Croatia.
Source: OECD based on IEA Electricity Information (2020) and Eurostat energy statistics (2021).

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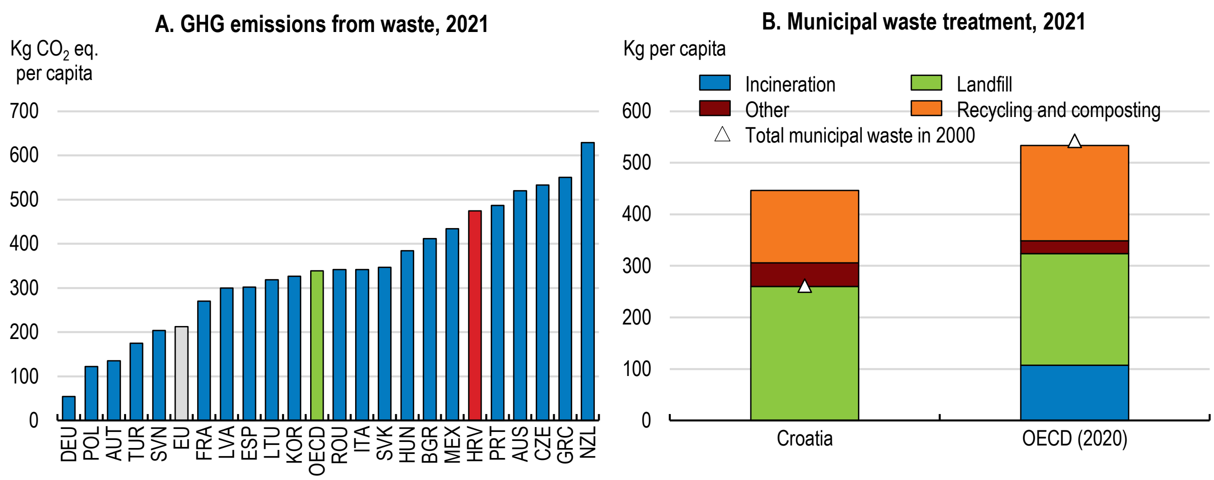
Improving energy efficiency and the use of renewable energy in housing – by producing renewable energy directly at home and by electrifying energy use – can contribute to cutting overall emissions. Croatia's Recovery and Resilience Plan allocates EUR 790 million (1.1% of GDP) to support building renovations, aiming to renovate 3% of buildings annually by 2030, and the energy crisis responses packages introduced in 2022 and 2023 supplement these funds (Box 2.2). This builds on the Long-term Strategy for Mobilising Investment in the Renovation of the National Building Stock (2020), and investments in seismic safety complements these renovations (BPIE, 2022[43]). Ensuring that repairs and reconstruction of buildings damaged by the 2020 earthquakes improve their energy efficiency, and transitioning heating and cooling systems to renewable energy sources can accelerate energy savings.

Combining financial support with gradually tightening energy efficiency standards and improved access to information can encourage owners to renovate. EU plans foresee stricter minimum energy efficiency standards from 2033. Croatia plans for a one-stop shop for energy and seismic renovations to better inform people about building renovations and to lighten the administrative process. Previous financial support programmes offered grants to encourage renovations (ODYSSEE-MURE, 2021[44]). Energy efficiency-improving renovations are often cost efficient, but their high up-front costs may deter owners. Greater financial support may be needed to meet future minimum standards. Publicly subsidised loans that are repaid through utility bills, rather than providing grants, can address high up-front costs, leverage more private capital and limit fiscal costs (Economidou, Todeschi and Bertoldi, 2019[45]). They can particularly promote renovations in multi-owner buildings, where agreeing on renovations may be easier if upfront costs of renovations are financed by future energy savings (Castellazzi, Bertoldi and Economidou, 2017[46]).

Reducing high emissions from waste

Croatia plans to reduce the high share of emissions from waste. Waste contributed 8% of total GHG emissions in Croatia in 2020, compared to about 3% in OECD countries on average. Emissions from waste in Croatia are also higher per capita than in OECD countries (Figure 2.20, Panel A). Croatia processes less municipal waste per capita than most OECD countries. However, rather than producing less waste, this reflects a large share of waste that remains untreated.

Figure 2.20. Improving waste collections and recycling would reduce emissions



Source: OECD Environment Statistics (database); OECD Analytical (database); and Eurostat.

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Despite substantial improvements in waste management in recent years, recycling rates lag other EU countries (European Commission, 2022[47]), and there are reports that irregular and substandard landfills continue to operate. For example, in February 2023 the European Commission charged Croatia for failing to comply with its obligations under the Waste Framework Directive over its continued use of an illegal landfill site in Bilijane Donje (European Commission, 2023[48]). Chapter 3 discusses how improving the governance of state-owned enterprises can improve their performance, including those engaged in waste collection.

Better waste management will require large investments, for example to modernise recycling and waste treatment infrastructure (European Commission, 2021[39]). Measures included in Croatia's Recovery and Resilience Plan on improving water and waste management amount to EUR 860 million (1.4% of 2022 GDP), including investment for recycling facilities and waste sorting centres, are welcome. The plan also includes reforms to promote recycling and reduce landfill by improving responsibilities of producers for waste management and promoting pay-as-you-throw schemes.

Adapting to a warming climate

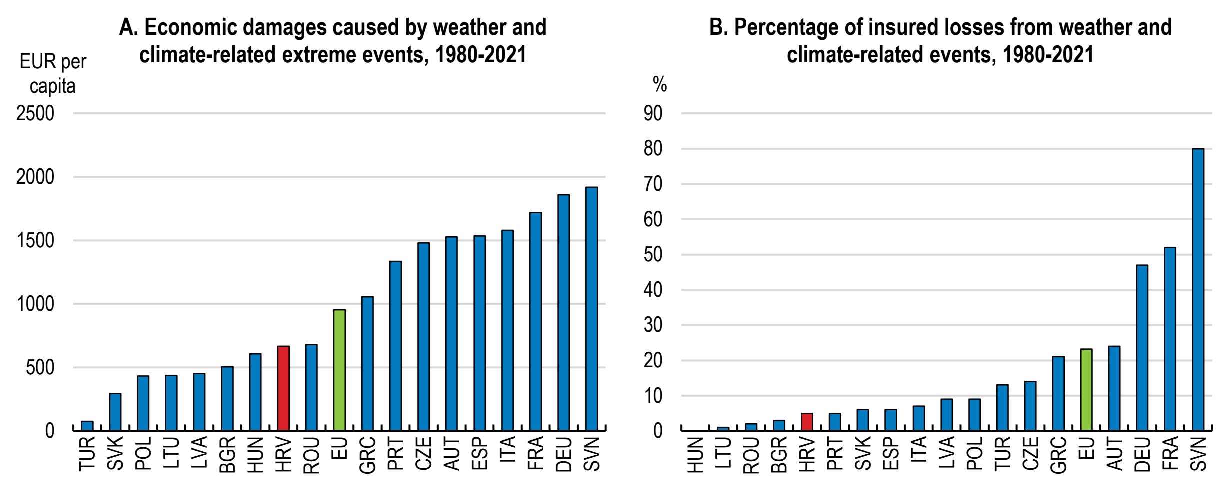
While economic damages from climate-related events have so far been modest in Croatia (Figure 2.21, Panel A) these are likely to increase, directly impacting businesses and households and adding contingent risks to Croatia's public finances and banking system. As a Mediterranean country with an extended coastline, Croatia is particularly exposed, although the impact will differ across regions (Republic of

Croatia, 2020[49]; Ministry of Environment and Energy, 2017[50]). Under a scenario of global emissions moderately exceeding the Paris Agreement's targets, average annual temperatures in Croatia are expected to increase by 1 to 1.2 degrees in 2040 and by up to 2 degrees in 2070. Under a scenario of higher global emissions, average annual temperatures are expected to rise by up to 2.9 degrees. Besides rising temperatures, climate change is likely to change precipitation and seasonal patterns. Extreme weather events such as forest fires, heat waves and floods, are also likely to become more frequent and severe (Republic of Croatia, 2020[49]). For example, deaths from heat waves in southern Europe will likely be 10-to-40 times higher by 2050 than in the period before 2010 (Naumann et al., 2020[51])

Helping people and businesses to adapt to the changing climate and investing in protective and resilient infrastructure can reduce exposure and limit damages. Analysis by the Croatian National Bank suggests that more frequent extreme weather events may adversely affect a range of economic variables from industrial production to inflation, for example by destroying infrastructure or raising energy costs (Škrinjarić, 2023[52]). The Strategy for Adaptation to Climate Change, with a perspective on Croatia's needs to 2070, focuses on eight key sectors and two cross-sectoral areas (spatial planning and development, and risk management), however most of its measures are described in general terms. The Recovery and Resilience Plan provides for investments in protective structures for floods, upgrades to the water network, and water metering to reduce losses and improve efficiency (European Commission, 2021[39]). Incorporating adaptation concerns into infrastructure projects can improve resilience to climate change. However, adaptive measures are often costly. Requiring project design and procurement to account for adaptation needs would help (OECD, 2018[53]).

Expanding private insurance coverage for climate-related and seismic events can encourage households and businesses to limit exposure and invest in reducing risks if the right regulatory parameters and incentives are in place (Škrinjarić, 2023[52]) (Scholer and Schuermans, 2022[54]). It can also reduce the contingent liability for the government and raise the involvement of private finance. Insurance coverage for weather and climate related extreme events in Croatia has been low compared to OECD countries (Figure 2.21, Panel B). Promoting private insurance, for example by extending mandatory property insurance to cover more climate- and earthquake related risks, would cover more losses but may raise premiums. Providing a public backstop for losses borne by insurance providers can limit uncertainty, and thus costs, for private insurance and help ensure that policies are financially viable. Setting a maximum compensation for damages above a threshold can limit fiscal exposure (OECD, 2021[55]). Direct insurance subsidies for vulnerable households may also be warranted, while monitoring competition in the insurance market is crucial to assure that risk premia remain competitive (OECD, 2021[56]).

Figure 2.21. Damages from climate-related events have been modest but are likely to increase



Source: European Environment Agency.

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Findings and recommendations

FINDINGS	RECOMMENDATIONS (Key recommendations are in bold)
Supporting a fiscally sustainable recovery	
Growth has been robust, absorbing spare capacity in fast-growing sectors. Integration into the euro and Schengen areas is adding further to demand. Inflation is gradually abating but exceeds the euro-area average and price pressures have broadened. After a budget surplus of 0.4% of GDP in 2022, the government budget sees a return to deficit in 2023 and 2024. Fiscal support helped the economy through the COVID-19 and energy price crises. Spending in response to high energy prices has been substantial. Much of the support to households and businesses further subsidises fossil fuels. Inflation is gradually abating, but exceeds the euro-area average and price pressures have broadened. Wage increases have picked up. Transmission of tighter euro-area monetary policy is gradual as Croatia's financial system integrates into the euro area.	**Promptly phase out energy price support measures** **Avoid fiscal stimulus while inflation remains high.** Ensure the medium-term fiscal stance contributes to a trend decline in the public debt burden while strengthening social protection. Use any unplanned revenues to reduce public debt. Anticipating future shocks, strengthen social protection by developing better data on potential recipients' needs, and transparently link any future temporary measures to the specific shock rather than time-limited or 'one-off' transfers. Improve the responsiveness of fiscal policy to the economic cycle by strengthening automatic stabilisers.
The banking sector appears to be in good health. The full introduction of the euro has added to the sector's free liquidity and reduced some types of risk.	**Remain vigilant to banks' stability, including the growth and quality of lending. Stand ready to tighten further prudential tools such as minimum capital and risk ratios to prevent risks from materialising.**
Public finances that support convergence	
Public debt has fallen below 70% of GDP and spreads and credit rating are stable. More efficient spending is the best way to achieve further reduction in the public debt burden. Ageing costs are projected to remain relatively small, but additional investments will be needed to raise skills, to reduce greenhouse gas emissions and to adapt to a changing climate.	Develop the independent Parliamentary Budget Office to monitor and guide the fiscal framework and compliance with medium-term fiscal objectives. Institutionalise regular spending reviews, led by a team in a central agency such as the Ministry of Finance collaborating with implementing ministries and bodies, and ensure results are available early in the budget cycle.
The public sector overall wage bill is high although the number of public servants is comparable to OECD countries. Indicators suggest that pay rates lag those in the private sector especially for more advanced skills. A lack of staff with the necessary skills impedes implementing policies and delivering public goods and services. A welcome review of the public sector's pay and management is underway.	Make greater use of existing skills in the public service, invest in public servants' skills, and develop the role of shorter-term recruits to fill specific skill gaps. Limit political engagement in the recruitment and retention of senior public servants, including through greater use of performance agreements and reviews.
In public services, despite some recent consolidation, coordination and allocation of responsibilities among different administrative structures can be improved, to streamline regulatory processes and ensure consistent and higher quality delivery of public services, especially in lagging regions.	**Clarify and consolidate responsibilities for delivering public goods and services, and use improving information systems to support greater cooperation, integration and improved resource allocation across different government bodies**. Develop more forums such as regular conferences to improve collaboration between different agencies and levels of government.
European Union funding is an important driver of public investment and policy priorities. Implementation of the Recovery and Resilience Plan, so far, compares well but still involves challenges.	**Over the medium-term, complement European Union funding with nationally resourced investment to comprehensively address public investment and reform needs.**
Government revenues overall are comparable to OECD countries. Income tax and contribution rates are moderate following recent reforms. Many tax exemptions or low rates, notably in tourism, for property and for some types of labour income, weaken the tax base and distort investment incentives.	**Identify and phase out tax expenditures, and align the treatment of different forms of income, including related to tourism.** **Progressively introduce a general recurrent tax on immovable property based on improved land values.** Allow for deferred payments by households that are asset-rich but income-poor. Pursue the digitalisation of the tax administration. Consider developing the financial and management autonomy of the tax administration, within a robust framework to monitor for improving tax compliance and declining compliance burdens.
Improving environmental quality and cutting greenhouse gas emissions	
Environmental tax revenues are high, yet fossil fuels continue to be subsidised. The EU Emission Trading Scheme, the primary means of pricing greenhouse gas emissions, covers about one-third of emissions.	**Cut fossil fuel subsidies, including tax expenditures, and align the effective carbon prices in sectors not covered by the EU Emission Trading Scheme to the Scheme's price.** **Use the carbon tax revenues to support vulnerable households and investments for energy efficiency.**

High reliance on road transport, plus a preponderance of old vehicles contribute significantly to greenhouse gas emissions. Rail transport quality and infrastructure investment are low.	**Replace purchase grants for low-emission cars with subsidised loans to improve affordability and encourage fleet renewal.** Gradually tighten restrictions for using fossil-fuel vehicles in cities, for example through low-emission zones. **Continue higher investment in public transport, informed by cost-benefit analysis.**
The building stock generates a significant share of emissions. Much is energy inefficient, leading to significant rates of energy poverty among low-income households.	Increase support for renovations through interest-subsidised loans that can be repaid via energy savings.
Damages from extreme weather events are likely to increase with climate change. Insurance coverage is low, and public compensation for damages imposes fiscal costs and provides little certainty.	Promote insurance for climate- and earthquake-related events, for example by mandating property insurance to cover more risks.

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3 Improving the business environment to accelerate convergence

Raising productivity growth is central to closing the gap with the incomes and well-being enjoyed in many OECD countries. Croatia has internationally competitive firms, and a dynamic economy with many young and potentially productive firms. However, overall performance has been limited by the presence of many less productive firms and more productive firms that often fail to grow. This likely reflects a business environment that weakens competitive pressures and makes investments more costly and risky. Reducing the burdens of lengthy and unpredictable regulatory procedures, resolving legal disputes faster with a more efficient judicial system, and improving public sector integrity, will be key for boosting productivity growth. Developing public equity markets and expanding R&D support would improve access to finance for young and innovative firms. State-owned enterprises play a comparatively large role in Croatia's economy but tend to underperform financially and in delivering goods and services. Improving their governance, by strengthening the state's oversight and governance arrangements, can improve outcomes.

Improving Croatia's business environment is key to boosting productivity growth. The country's productivity gap to OECD countries narrowed little in recent years. A very wide range of policy areas influence the environment for business. Prominent are education and skills policy (discussed in Chapter 4), and policies supporting research and development. This Chapter focuses on another important issue; the role of allocative efficiency in productivity. The share of low-productivity firms is high, while productive firms often struggle to grow. Obstacles to greater productivity include lengthy licensing procedures with uncertain outcomes, long and frequent legal disputes and weak competitive pressures (Section 3.2). Croatia's reliance on banking for access to finance means that young and more innovative firms may find it more difficult to get financing (Section 3.3). Meanwhile, state-owned enterprises continue to play a sizeable role for Croatia's economy. Indicators suggest, however, that they often underperform and that they remain vulnerable to political influence (Section 3.4). Addressing each these issues can bring direct benefits of higher investment and stronger and broader productivity growth. Together, these efforts can also contribute to addressing perceptions of corruption and the quality of the rule of law, essential for fostering stronger and more inclusive growth.

Widespread productivity gaps call for improving the business environment

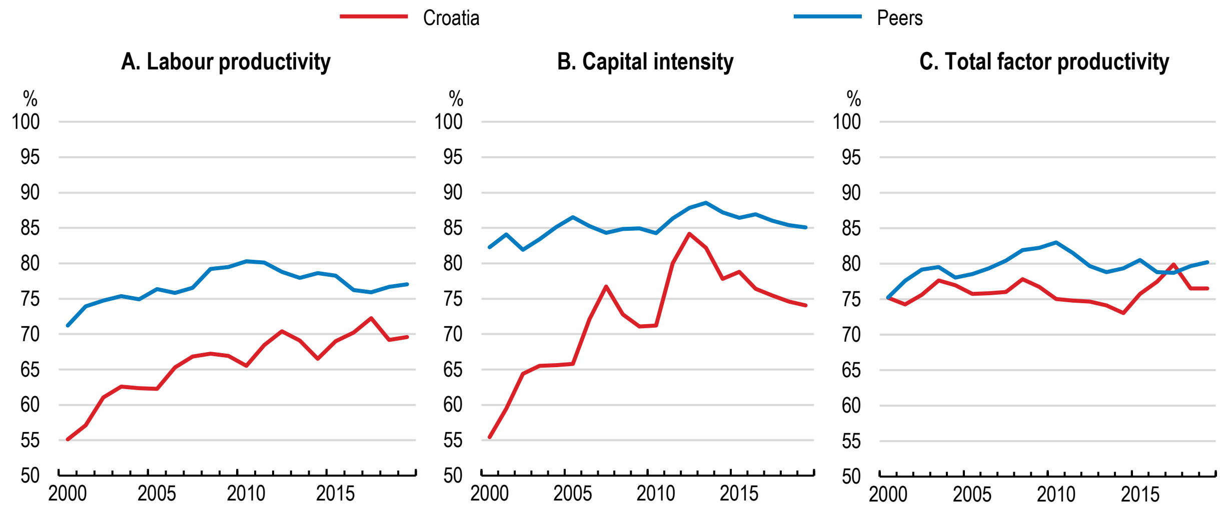
Productivity gaps between Croatia and OECD countries remain large. On average, workers in Croatia are about two thirds as productive as those in the OECD area (Figure 3.1, Panel A). The pace of catch- up in productivity was brisk in the in the early 2000s but has slowed in recent years. At the aggregate level, this partly reflects low investments in physical capital (Figure 3.1, Panel B). The slow catch-up in total factor productivity also suggests scope for improving innovation, technology adoption, and managerial practices (Figure 3.1, Panel C).

Closing productivity gaps will require raising performance across all sectors of the economy. Croatia's composition of economic activities explains only a small part of its relatively weaker productivity performance. The large size of the tourism sector is often seen as key barrier to faster productivity growth, yet it is among Croatia's most productive sectors. All sectors exhibit lower labour productivity compared to the EU average (Figure 3.2). A World Bank study finds that even if Croatia had the same sector composition as Germany, it would still be 57% less productive (World Bank, 2023[1]). Rather than focusing on the challenges in individual sectors or groups of firms, fostering a business environment that supports higher investment and dynamism across all of the economy will be essential to continue Croatia's convergence.

Firm level data suggest that Croatia's low productivity within sectors derives from a comparatively large share of poor-performing firms and relatively few high performers (Figure 3.3, Panel A) (OECD, Forthcoming[2]). The "long tail" of low-productivity firms can reflect a number of issues. Technological adoption appears to be one factor. A relatively large share of firms (around 40%) are recorded as operating with very low digital intensity (Figure 3.3, Panel B) and the share of firms participating in global value chains through importing or exporting is smaller than elsewhere (Figure 3.3, Panel C). Studies also suggest managerial skills may be a limiting factor (Criscuolo et al., 2021[3]). Improving allocative efficiency would better leverage managerial talent, for example by assuring that better managed firms grow. Boosting access and participation in adult education and training, as discussed in Chapter 4, alongside the support included in the Recovery and Resilience Plan to mentor individual businesses, could help to deepen managerial skills.

Figure 3.1. Productivity catch-up with the average of OECD countries has slowed

Labour productivity and its components from 2000 to 2019 as a percentage of the OECD average



Note: 'Peers' is the unweighted average of Czech Republic, Hungary, Slovak Republic, and Slovenia. Labour productivity is measured as real GDP at current USD at purchasing power parity, divided by the number of persons employed. Capital intensity is computed as the capital stock at current USD at purchasing power parity per person employed. The computation of total factor productivity is described in (Feenstra, Inklaar and Timmer, 2015[4]).
Source: OECD calculations based on Penn World Table Version 10.0.

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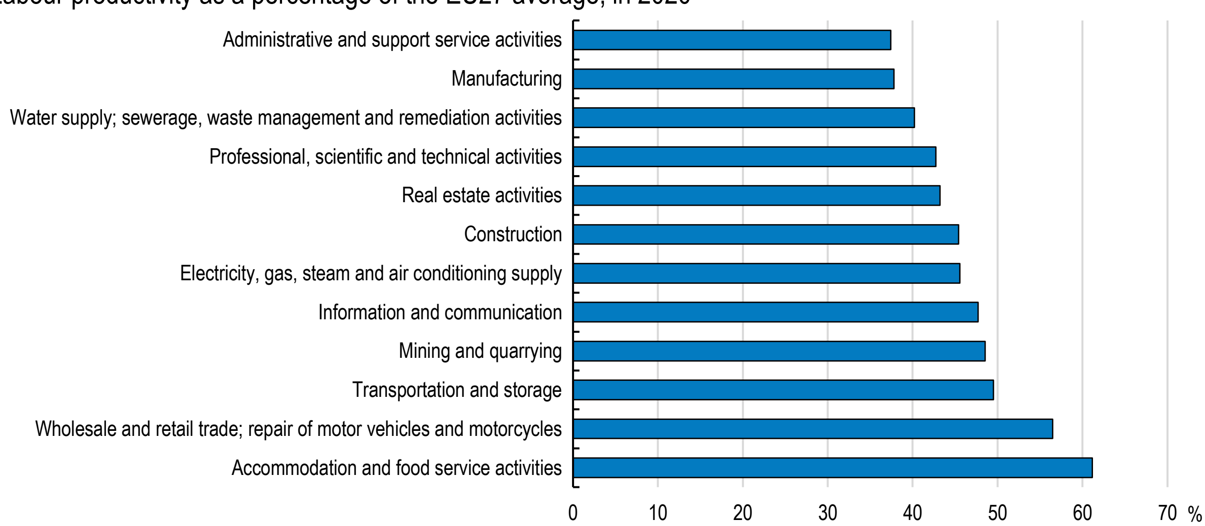
Figure 3.2. Closing productivity gaps requires improving performance across all sectors

Labour productivity as a percentage of the EU27 average, in 2020



Note: Labour productivity is defined as the value added expressed in EUR (using average exchange rates) divided by the number of persons employed.
Source: Eurostat.

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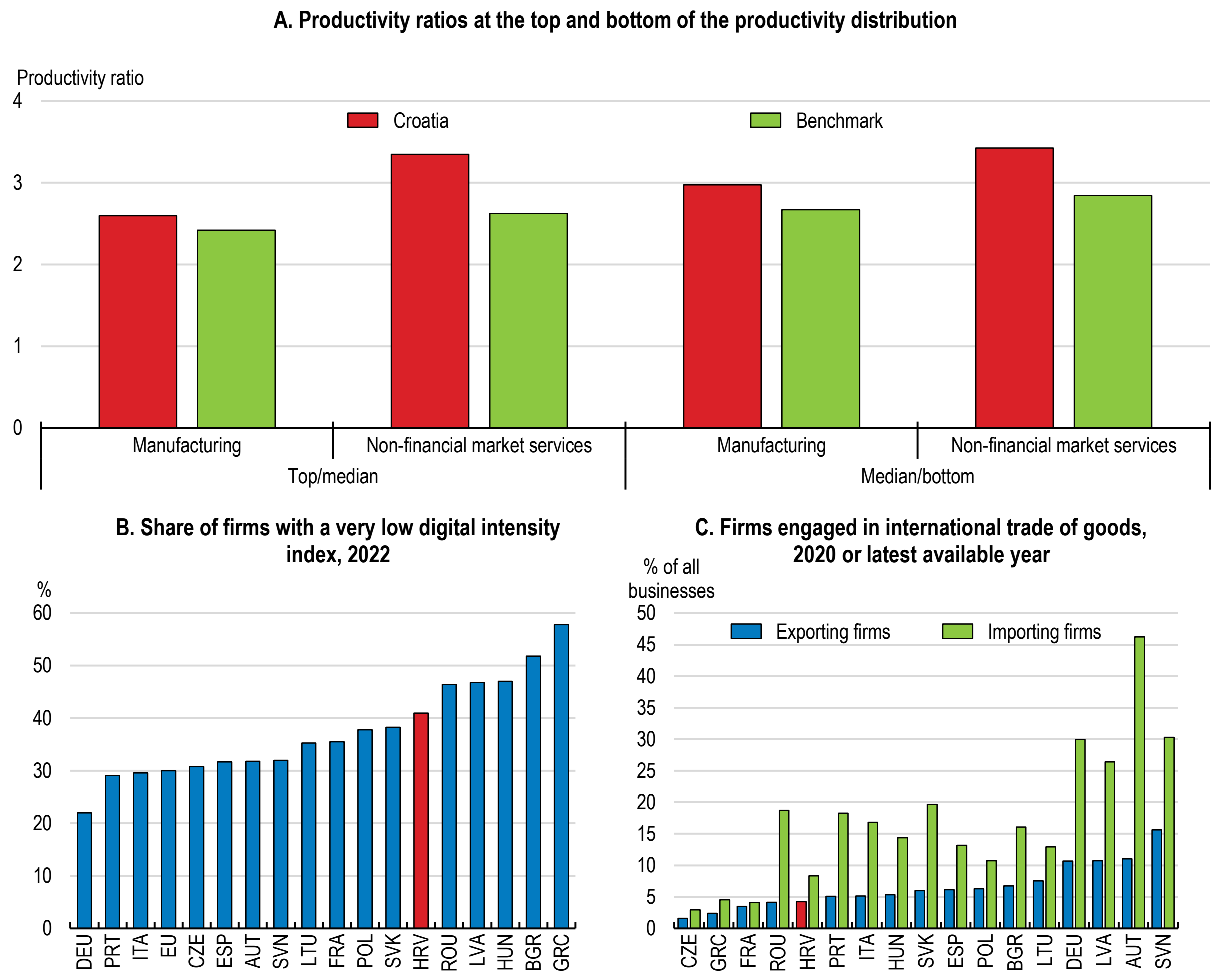
Firm entry can introduce new technologies into the market and challenge incumbents. Croatia has high firm entry rates compared to OECD countries (Figure 3.4, Panel A). Firm survival rates are on a par with OECD countries (Figure 3.4, Panel B). However, young firms on average grow less rapidly than entrants in OECD countries, both in terms of employment (Figure 3.4, Panel C) and capital (Figure 3.4, Panel D), suggesting that they make a weaker contribution to raising overall productivity than elsewhere.

Figure 3.3. Overall productivity is weighed down by many unproductive firms



Note: Panel A: The figure shows the dispersion of productivity within SNA A38 industry, according to the SNA A38 classification, and year by country, averaged across macro sectors and country groups. Within macro sectors, observations at the level of the country-SNA A38 industry-year are aggregated weighted averaged to the country-year level using the share of the SNA A38 industry in total value added of the country-year as weight, and country-years over the period 2014-2018 are aggregated to the country-level using unweighted averages. The “benchmark” group of countries is a simple average of Belgium, Finland, France, Hungary, Italy, Latvia, Netherlands, Portugal, Slovenia and Sweden. Panel B: Digital intensity index version 4 for all enterprises of 10 persons employed or more in all activities except financial services.
Source: Calculations based on the OECD MultiProd v2 project; Eurostat; and OECD, Main Science and Technology Indicators (database).

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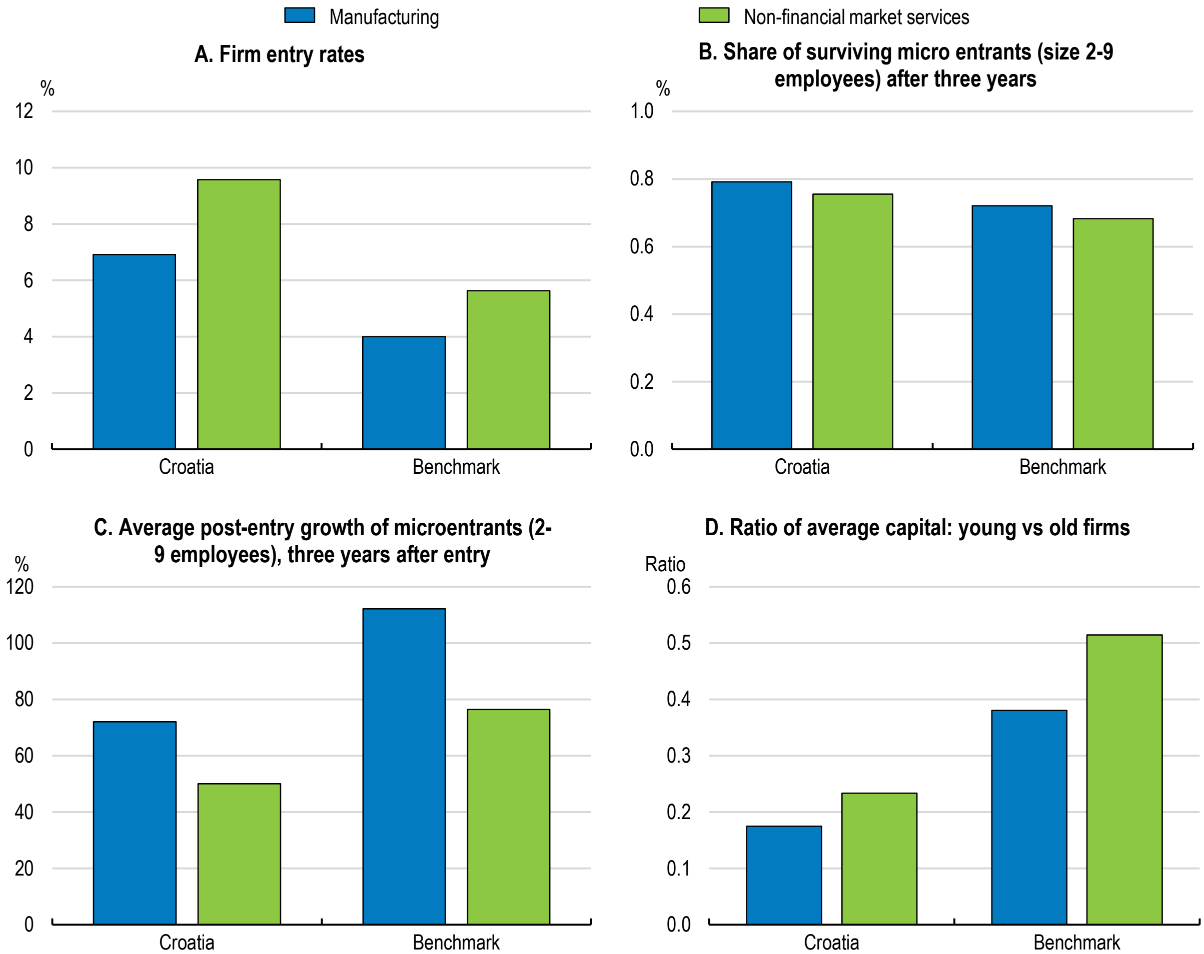
Croatia appears to have fewer linkages with global value chains (GVCs) and lower foreign direct investment than its neighbours, which may imply weaker transfer of productivity enhancing knowledge and know-how (Figure 3.5). The share of foreign value-added content in exports accounted for about 25% of the value of exports in 2018, well below the 38% on average in central and eastern European (CEE) economies. Some of this difference may reflect the country’s later accession to the EU than other CEE economies; sectors involving substantial cross-border production, for instance in car manufacturing, make up a smaller share of activity in Croatia than elsewhere in CEE. These limited linkages may also reflect lower private investment than Croatia's peers in recent years (Figure 3.5).

Figure 3.4. Strong business dynamism translates less well into sustainable productivity gains



Note: The figures are based on weighted averages across SNA A38 industries in manufacturing and non-financial market services. Within these SNA A7 macro sectors, observations at the level of the country-SNA A38 industry-year are aggregated to the country-year-macro sector level using the share of the SNA A38 industry in the total number of firms in the country-year as weight, and country-years over the period 2014-2018 are aggregated to the country-level using unweighted averages. The comparison group of countries ("benchmark") is composed of Belgium, Finland, Hungary, Italy, Latvia, Slovenia, and Sweden, and the blue bars reflect the unweighted average across these countries. Owing to methodological differences, figures may deviate from officially published national statistics. Panels B and C relate to the number of employees.
Source: Calculations based on the OECD DynEmp v3.2 project and OECD MultiProd v2 project.

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Accelerating firms' digitalisation, building on the progress spurred by the COVID-19 crisis, can enable faster productivity growth, notably among lagging firms (Gal et al., 2019[5]). Firms' investments have accelerated in recent years in cloud computing, online sales platforms, communications platforms, and in workforces' digital skills. Still, digitalisation lags the typical OECD EU country (European Commission, 2022[6]). For example, broadband coverage has fallen further behind the averages of OECD and EU countries, although investments in the Recovery and Resilience Plan and the roll-out of 5G technologies may bring gains. Despite strong levels of general digital skills, scarce high-level digital skills have also impeded firms' digitalisation. Investments in the Recovery and Resilience Plan, the government's new digital transformation strategy and the push to expand adults' access to digital skill development (discussed in Chapter 4) are steps in the right direction to support firms' digitalisation (Sorbe et al., 2019[7]).

Also reflecting low productivity, Croatia's manufactured exports are traditionally concentrated at the low end of the technology scale, though the composition is changing. One study finds that about two-thirds of goods exports are in low-technology manufacturing products, for example in wood, paper and printing. These make up a higher share of exports than in other CEE countries. However, competitiveness and exports in several higher-technology intensive manufacturing goods, such as pharmaceuticals, machinery and equipment and chemicals improved in recent years (OECD, Forthcoming[8]). This is being supported by a growing share of greenfield foreign direct investment in higher technology sectors. Policy measures to improve Croatia's attractiveness for foreign direct investment are discussed in (OECD, Forthcoming[8]).

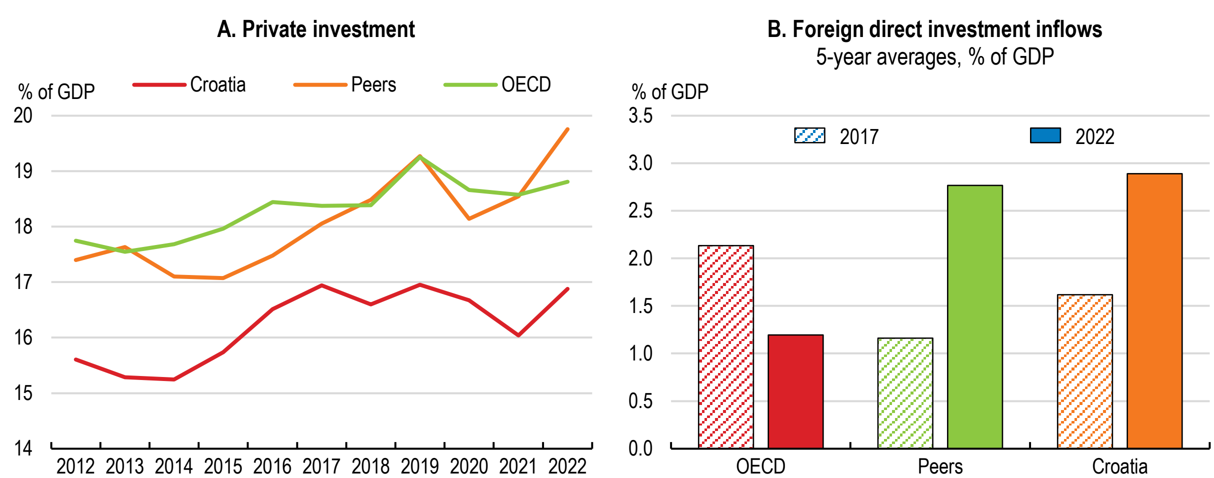
Strengthening framework conditions for business

Reducing regulatory burdens

Croatia's regulatory framework – in so far as it reflects de jure regulations at the national level – is generally conducive to competition. Its product market regulation index scored close to the OECD average in 2018 (at 1.43 versus 1.42 in the OECD on average), which suggests that regulatory burdens are not exceptionally burdensome for businesses but also that there is scope for improvement (OECD, 2018[9]). Box 3.2 outlines some of Croatia's efforts over recent years to improve its regulatory framework. Complementing these are the ongoing reforms to improve revenue administration, including the consolidation and suppression of the many parafiscal fees charged by different public entities and simplification of their payment processes.

Areas where the formal regulatory framework can be improved appear to relate to firm entry and businesses operations in services – notably for pharmacies, lawyers and notaries (Figure 3.6, Panels B and E). For example, abolishing territorial restrictions for notaries, or allowing a wider variety of owners of pharmacies would improve competitiveness in those sectors. OECD countries have undertaken related reforms (Box 3.3). Croatia's Recovery and Resilience Plan, which envisages further waves of regulatory simplification, including cutting at least 300 regulatory requirements for professional services by 2024, promises important improvement.

Figure 3.5. Private and foreign direct investment have lagged peers



Note: 'Peers' is the unweighted average of Czech Republic, Hungary, Slovak Republic, and Slovenia.
Source: OECD International Direct Investment Statistics (database) and United Nations Conference on Trade and Development Statistics.

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While Croatia's de jure regulatory framework often appears competition-friendly, in practice regulatory burdens are often significant. Regulatory quality is perceived to be lower, and burdens of government regulations higher, than in most OECD countries (Figure 3.8, Panels A and B). Such burdens weigh on firms' investment and productivity, and contribute to perceived corruption (discussed below). For example, a comparatively large share of potential investors in Croatia reports that business regulations are a major obstacle to investing (Figure 3.8, Panel C). Unpredictably or slow implementation often makes regulation burdensome in practice (OECD, 2019[10]). For example, it takes businesses on average 122 days to obtain a construction-related permit in Croatia, longer than in most OECD economies (Figure 3.8, Panel D). Estimates suggest about 50% of businesses in Croatia – more than in most EU countries – lack confidence in effective investment protection due to, among others, unpredictable and non-transparent administrative conduct and frequent changes in the related legal frameworks (European Commission, 2022[11]).

The digitalisation of public services has lagged typical OECD EU countries, contributing to more burdensome administrative and regulatory processes (European Commission, 2022[6]). Measures included in Croatia's Recovery and Resilience Plan, worth EUR 283 million (0.4% of GDP in 2022), to digitalise its public administration and improve its effectiveness will contribute to reducing regulatory burdens. Nevertheless, even with comprehensive plans and financial support, on-the-ground achievement in paring back regulation and ensuring efficient application is challenging. Reviewing and simplifying the administrative and regulatory processes that are being digitalised, and monitoring progress can only be encouraged.

Expanding the role of regulatory impact assessments

Regulatory impact assessments (RIAs) – when considering new or reviewing existing regulations – help inform policymakers on how to design regulations that achieve policy goals with minimal collateral costs (OECD, 2012[12]). They inform policymakers whether less costly and more effective alternatives - ranging from the option to do nothing to steering or nudging behaviour with information campaigns or incentives - are available (OECD, 2020[13]). Comprehensive RIAs can also reduce burdens from how the regulation is enforced, for example whether inspections are needed, or by promoting proportionate and risk-based approaches (OECD, 2018[14]).

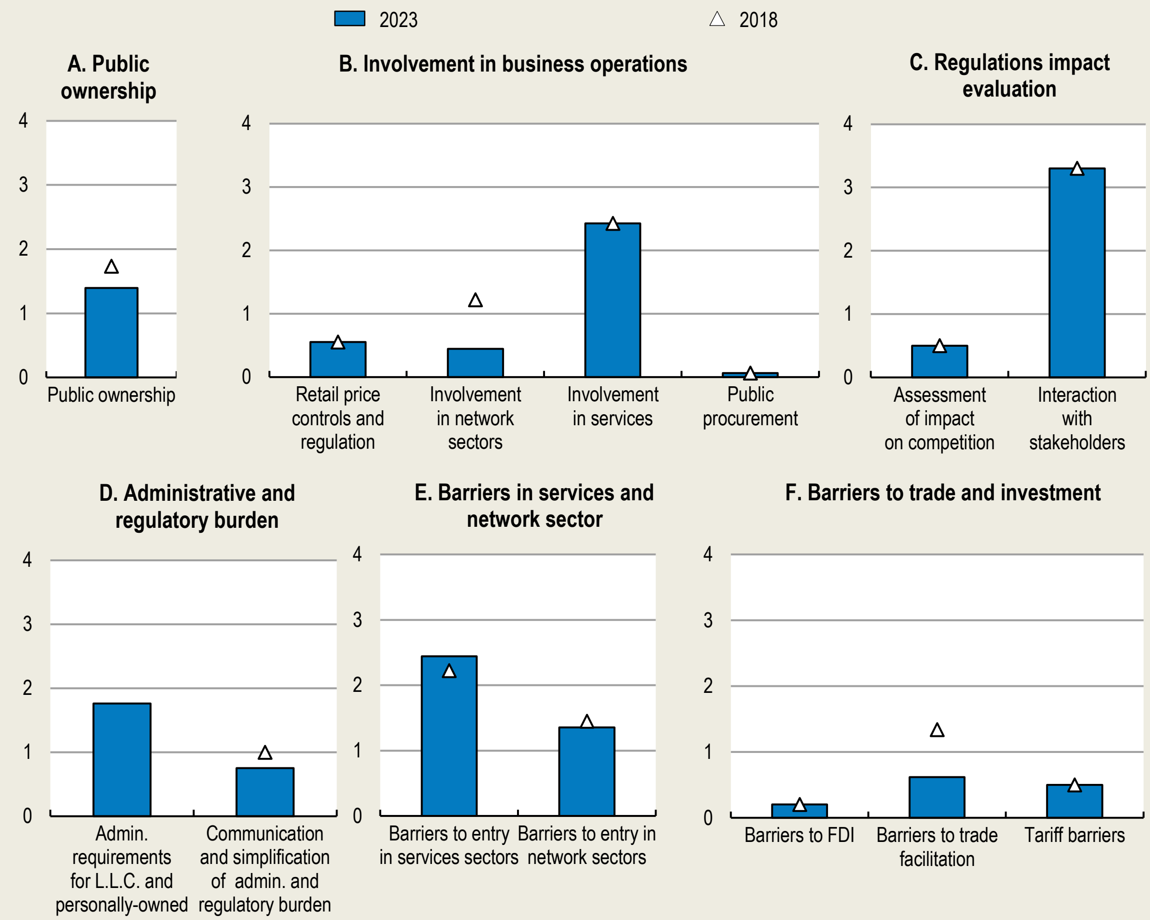
Box 3.1. Croatia's recent reforms to improve its regulatory environment

Several reforms in recent years have mad Croatia's regulatory framework more competition friendly. The largest improvement was in reducing administrative burdens for starting a business (reflected in Figure 3.6, Panel D) with the establishment of the one-stop shop 'START' (https://start.gov.hr/). Procedures have been digitalised and streamlined.

Reforms improved competition in network sectors by giving the state a more active role in assuring transparency for prices and other information (Figure 3.6, Panel B), for example by introducing independent price comparison tools in gas retail markets to make it easier for customers to identify competitive suppliers, or setting up a platform providing 5G or fibre network operators with information about existing and planned infrastructure (European Commission, 2020[15]). International competition has been strengthened by simplifying procedures to appeal in disputes between contracting parties from different countries (Figure 3.6, Panel F).

Figure 3.6. Croatia's formal regulatory framework has improved

Sub-indicators of the OECD Product market regulation index, 2018 and 2023, scale 0 to 6, with 0 indicating most competition-supportive regulation



Note: Preliminary results based on OECD PMR 2023 methodology. 2018 values based on 2023 methodology may deviate from 2018 values based on 2018 methodology.
Source: OECD PMR database.

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Box 3.2. Reforms to reduce regulatory barriers in professional services

Expanding access to notarial services in France

Until 2015 in France, notaries could only access private practice by being appointed to an existing office. This mechanism had led to a stagnation in the number of notaries and a disconnect between the supply of notaries and the demand from individuals and companies. In addition, the profession was not able to absorb the flow of graduate notaries. This process led notarial density to become inversely proportional to population density, which betrayed a flagrant imbalance between supply and demand. Hence a new procedure for the creation of notary offices was introduced with the Macron Law in 2015, which requires the Autorité de la Concurrence (the French competition watchdog) to submit to the government, every two years, a proposed map of areas where the creation of offices appears useful, accompanied by recommendations on the rate of establishment compatible with a gradual increase in the number of professionals in the areas in question. The reform has resulted in the establishment of nearly 2,300 new private notaries since 2017, an increase of more than 30% in supply. This has resulted in greater availability of notaries, a reduction in the time taken to process files and increased use of digital tools.

Opening access to legal services in the UK

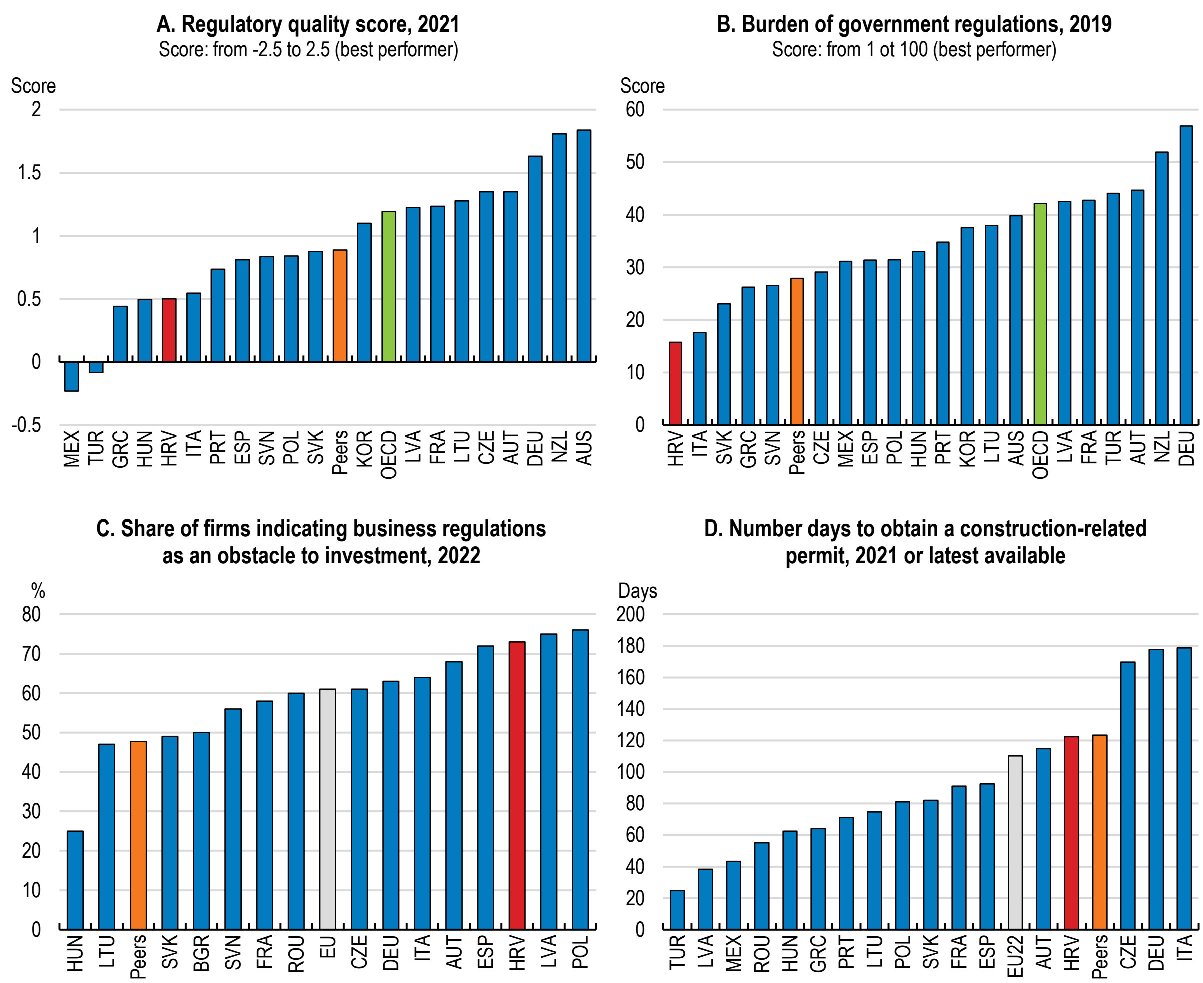
In March 2001 the UK competition watchdog produced a report on Competition in Professions that recommended the removal of unjustified restriction on competition in particular in the legal professions. This led to the passing of the Legal Services Act in 2007. Among other changes, the act introduced the concept of Alternative Business Structures that allow non-lawyers to own and manage law firms and that can deliver legal activities alongside other professional services.

Croatia has put in place a solid framework for developing and assessing regulations (Figure 3.8). For example, new primary laws are legally required to be assessed for their necessity, benefits and administrative costs, using threshold criteria for potential impacts to decide whether an in-depth RIA may be needed. Croatia also systematically engages stakeholders when drafting new regulations, for example through the interactive consultation portal e-Savjetovanja. It can improve this framework further. RIAs are not required for subordinate regulations, – i.e., regulations that provide detail and enforcement arrangements for the primary laws (OECD, 2019[16]). A welcome expansion is underway of a special assessment of regulatory impact on SMEs (the “SME Test”) that covers areas missed by the RIA system.

Reviewing the existing stock of regulations can help make deeper inroads into regulatory burdens. Regulations that were issued when regulatory policies were less developed may have more unintended consequences and may simply have become redundant as circumstances changed (OECD, 2020[17]). Croatia has conducted several reviews of regulation over recent years and has established a special unit within the Ministry of Economy and Sustainable Development, the Business Environment Improving Service (BEIS). The latter conducts policy analysis and evaluates regulations in consultation with other state administration bodies. Regulatory assessment can be further improved by establishing a regular forum to discuss regulation that includes the presence of businesses and union representatives, as well as government, for example by building on the existing Economic and Social Council. For example, Denmark achieved substantial reductions in regulatory burdens by establishing a Business Forum for Better Regulation, as described in Box 3.3.

Concerted efforts to improve the quality of regulatory impact assessments (RIAs) would help ensure regulations are designed to be less burdensome in their implementation. Reports suggest that RIAs in Croatia are often conducted as a formality with limited influence on decision making (OECD, 2019[16]). Impact assessments often contain little quantitative analysis and consist in filling checkboxes on the scale of regulations' impact. Alternatives to regulations are sometimes considered only after it has been decided to adopt the regulation. Consolidating oversight responsibilities at the centre of government could improve their analytical quality, as they are often prepared by different government bodies which often lack capacities to carry out cost-benefit analysis. Consolidating the responsibilities of the Government Legislation Office and the Ministry of Economy in reviewing proposed regulations would reduce coordination challenges and duplication. This could also help concentrate skilled staff, including those experienced in cost-benefit and other economic analyses, and reduce turnover rates. The national-level institution could improve the quality of sub-national regulations, which can be particularly burdensome for businesses. Improving transparency, for example by using online portals to disseminate information on consultations and regulatory practices across regions, and providing focused analytical support from the national to sub-national governments, can help reduce regions' regulatory burdens.

Figure 3.7. Regulatory burdens, in practice, are a major obstacle to investments in Croatia



Note: Unweighted average for OECD. and 'Peers' is the unweighted average of which include Czech Republic, Hungary, Slovak Republic, and Slovenia. Panel D: EU22 covers OECD countries which are EU Members.

Source: World Bank, World Governance Indicators (database); World Economic Forum, Global Competitiveness Index; European Investment Bank (2022), EIB Investment Survey 2022: European Union overview; and World Bank, Enterprise Surveys data (database).

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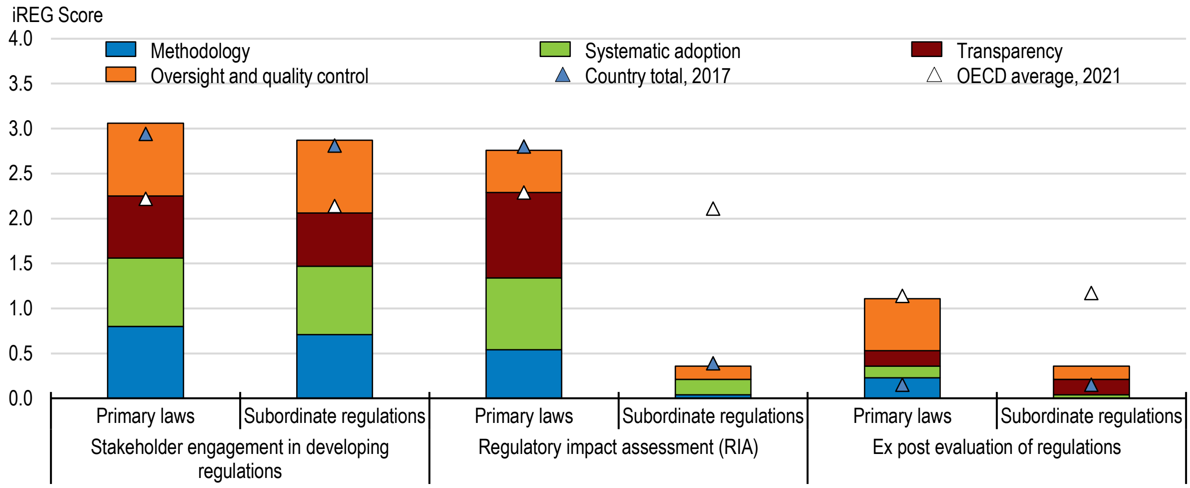
Figure 3.8. Croatia has improved its regulatory framework

Indicators of Regulatory Policy and Governance (iREG): Croatia, 2021



Note: The more regulatory practices as advocated in the OECD Recommendation on Regulatory Policy and Governance a country has implemented, the higher its iREG score. The indicators on stakeholder engagement and RIA for primary laws only cover those initiated by the executive (85% of all primary laws in Croatia).

Source: Indicators of Regulatory Policy and Governance Survey 2017 and 2021, http://oe.cd/ireg.

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Box 3.3. Denmark's Business Forum for Better Regulation

The Danish Business Regulation Forum was launched by the Danish Minister for Business and Growth in 2012. It aims to ensure the renewal of business regulation in close dialogue with the business community by identifying those areas that businesses perceive as the most burdensome and propose simplification measures. These could include changing rules, introducing new processes, or shortening processing times. Besides administrative burdens, the Forum's definition of burdens also includes compliance costs in a broader sense as well as adaptation costs ("one-off" costs related to adapting to new and changed regulation).

The 19 members of the Business Forum include industry and labour organisations, businesses, as well as academic experts with expertise in simplification. Members are invited by the Ministry for Business and Growth either in their personal capacity or as a representative of an organisation. The Business Forum meets three times a year to decide which proposals to send to the government. So far, the proposals covered 13thirteen themes, ranging from "The employment of foreign workers" to "Barriers for growth". In addition, interested parties can submit proposals for potential simplifications through the Business Forum's website. Information on meetings and the resulting initiatives is published online.

Proposals from the Business Forum are subject to a "follow or explain" principle. This means that the government is committed to either implement the proposed initiatives or to justify why initiatives are not implemented. As of October 2016, 603 proposals were sent to Government, of which so far 191 were fully and 189 partially implemented. The cumulated annual burden reduction of some initiatives has been estimated at DKK 790 million (EUR 106 million). Information on the progress of the implementation of all proposals is available through a dedicated website. The results are updated three times a year on www.enklereregler.dk. The Business Forum publishes annual reports on its activities. The Danish Minister for Business and Growth also sends annual reports on the activities of the Business Forum to the Danish parliament.

Source: (OECD, 2019[16]).

Improving spatial planning to improve land use

Improving land administration and spatial planning would further reduce administrative burdens and reduce the risks of corrupt behaviour. Responsibilities for developing spatial plans in Croatia lie mostly with counties, municipalities and city administrations. However, weak coordination between these bodies, unclear rules about amending spatial plans, and overlapping mandates in the assignment of land can lead to difficulties (OECD, Forthcoming[8]). Cadastral and land registries often do not reflect the actual state of property rights, leading to delays in securing land rights and building projects. Inefficiencies in Croatia's judicial system, discussed below, suggest additional delays in clarifying land ownership in case of land disputes.

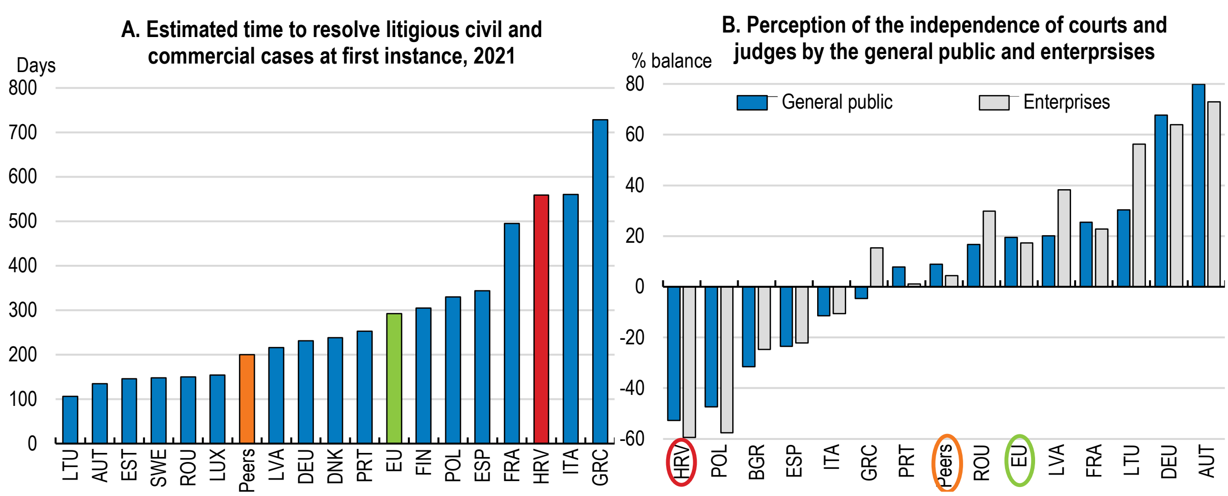
Coordination between subnational authorities could be improved by clarifying responsibilities about assigning land and development rights. For example, counties could be given planning responsibilities for investments that involve land spanning several municipalities, such as for electricity grid connections. Formalising rules and procedures for amending county and municipal plans, including setting a maximum number of days for reviews, could help reduce delays in amending spatial plans.

Croatia is planning to make information about land administration and tenure more accessible, including welcome investments within its Recovery and Resilience Plan to develop digital platforms for spatial plans and the contents of cadastres. More will be needed. Croatia could develop a one-stop shop guiding investors through all stages of the process for securing land rights (OECD, Forthcoming[8]).

Improving legal certainty and trust with a more efficient judicial system

An effective legal system can provide firms with greater certainty when doing business and limit costs when disputes arise (OECD/WJP, 2019[18]; OECD, 2021[19]). It can also help to reduce corruption risks. Prolonged times to resolve cases and lack of trust in the judiciary are cited as important impediments to investment in Croatia (overall, Croatia ranked 63rd out of 140 countries in the latest assessment) (World Economic Forum, 2019[20]). They detract from the effectiveness of the anti-corruption system (discussed below) (European Commission, 2023[21]). Resolving commercial and civil cases took on average nearly 500 days in Croatia in 2019. This is almost double the average of EU countries (Figure 3.9, Panel A). In addition, trust in judges' independence is the lowest among EU countries (Figure 3.9, Panel B).

Figure 3.9. Resolving cases is slow and trust in courts and judges is low



Note: 'Peers' is the unweighted average of Czech Republic, Hungary, Slovak Republic, and Slovenia. Panel A: EU average excludes Belgium, Bulgaria, Cyprus, Ireland and Netherlands. Panel B shows the net percentage of respondents of the general public/enterprises answering having a good perception minus those having a bad perception vis-à-vis the independence of courts and judges. The negative/positive values show that the perception of the independence of courts and judges is predominantly negative/positive.
Source: European Commission (2023), The 2023 EU Justice Scoreboard.

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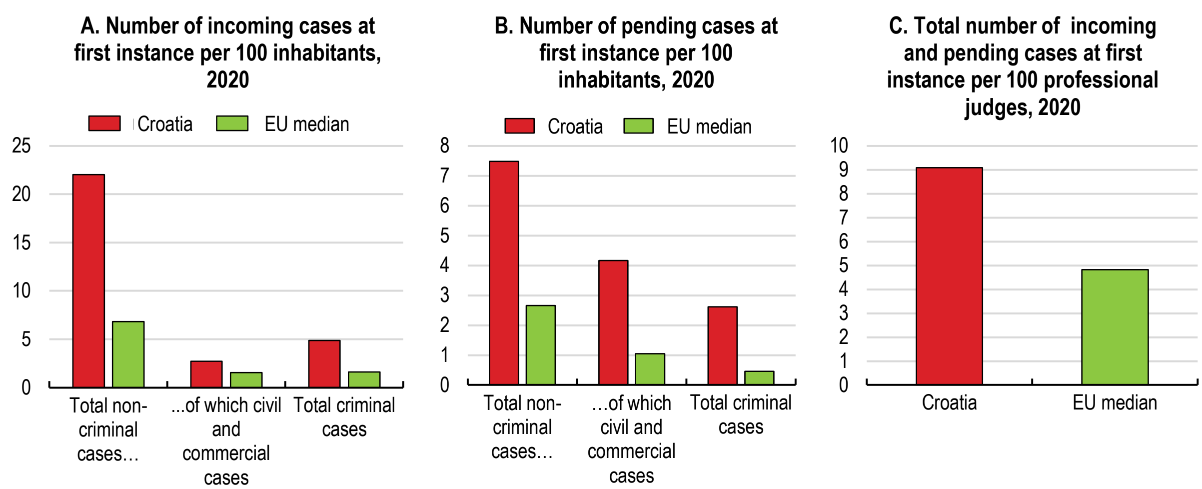
Promoting out-of-court processes to solve disputes faster and at lower cost

Croatia's court system remains under pressure from a high case load even as recent efforts make inroads. Croatia employs more judges per inhabitant and spends a larger share of GDP on the judicial system than most EU countries (CEPEJ, 2022[22]), yet judges face a higher workload (Figure 3.10, Panel C), reflecting more cases per inhabitant being brought to courts (Figure 3.10, Panel A) and a larger backlog of older cases (Figure 3.10, Panel B) than in most EU countries. This contributes to delays and may compromise the quality of judgments. Investments and reforms included in Croatia's Recovery and Resilience Plan, amounting to at least EUR 100 million (0.15% of GDP in 2022), will contribute to resolving cases faster, for example by upgrading the ICT system and developing digital platforms for case management, amending legal procedures, developing alternative dispute resolution, and improving the transparency of the court system notably through digital technologies.

Figure 3.10. Large numbers of incoming and pending cases pressure courts' performance



Source: EC (2021), Study on the functioning of judicial systems in the EU Member States: Facts and figures from the CEPEJ questionnaires 2012 to 2020 – Part 2 Country fiches.

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Resolving more cases through alternative dispute resolution mechanisms (ADRs) – such as mediation (described in Box 3.4) – would help reduce delays and resolve cases faster and at lower cost (European Parliament, 2016[23]). It would free court resources to address more complex cases, which could reduce procedural mistakes, make appeals less likely and improve trust. While Croatia is well equipped with accredited mediators (CEPEJ, 2022[24]) and is developing mediation services, mediation is used very rarely (World Bank, 2019[25]), as is the case in most EU countries (European Parliament, 2016[23]).

Requiring, or strongly encouraging, attending an initial mediation session or other ADRs can promote out-of-court solutions. On average across EU countries, using mediation before deciding whether to go to court has been shown to reduce the overall time to resolve disputes by up to 60%, and to cut average costs per case – comprising the use of courts, mediators and lawyers – by up to 33% (De Palo et al., 2014[26]). Mediation may nevertheless be used rarely for several reasons. People may not be aware of mediation as an option (Rozdeiczer and Alvarez de la Campa, 2006[27]), or – reflecting cognitive biases – they may overestimate their chances of winning in court (Nissito, 2022[28]), or because they lack trust that mediation can provide a fair and enforceable decision. Attending an initial mediation session – overseen by a neutral expert would help to overcome these obstacles. Several countries promote pre-court mediation or other forms of ADRs, for example by making an initial session mandatory (Box 3.5).

Measures are underway to strengthen mediation, and ensuring these change disputing parties' practices will be key. The Act on the Peaceful Resolution of Disputes aims to address shortcomings in the use of mediation. It reforms court processes to increase their promptness and efficiency. It establishes a Center for Peaceful Dispute Resolution to, for instance, provide professional training and improvement of mediators, and publish information on the peaceful resolution of disputes. To ensure that mediation services are used, additional actions should be considered, including making mediation mandatory and recognising mediation agreements as enforceable.

Box 3.4. Alternative dispute resolution mechanisms to solve disputes outside of courts

Alternative dispute resolution mechanisms (ADRs) are procedures attempting to resolve disputes outside of courts, with the assistance of a neutral third party as opposed to a presiding judge, and with the aim to reduce costs and delays compared to litigation.

ADRs differ along several dimensions (Table 3.1). ADRs are usually voluntary, i.e., conflicting parties can decide whether to enter the process and to continue until they settle the case. If conflicting parties are mandated to attempt ADR, they can still decide to end the process after attempting in good faith. ADRs can be either binding or non-binding. In a binding ADR, for example arbitration, conflicting parties are bound to accept a third party's decision about how to resolve the conflict. In a non-binding ADR, such as negotiation or mediation, conflicting parties have to jointly agree on an outcome. However, once they reached an agreement, they can be bound to the outcome through contractual obligations or through court decisions.

Mediation is the most common ADR and is a particularly broad procedure. In contrast to litigation, which is a rights-based process focusing on legal arguments, mediation expands the dispute beyond legal rights, including for example examining underlying interests, and emotions, and helping to improve communication. In addition, the mediator may also help clarify strengths and weaknesses of parties' legal positions to explore potential outcomes from going to court.

Table 3.1. Examples of alternative dispute resolution mechanisms

Characteristics	Negotiation	Mediation	Arbitration
Voluntary/involuntary	Voluntary	Voluntary / mandatory attempt	Voluntary (can be mandatory based on contract clause)
Outcome binding/non-binding	Mutually acceptable agreement sought, if agreement, enforceable as contract	Mutually acceptable agreement sought, if agreement reached it is enforceable, as a contract or court decision.	Binding principled decision or compromise, subject to review on limited grounds
Nature of processing	Usually informal and unbounded presentation of evidence, arguments and interests	Usually informal and unbounded presentation of evidence, arguments and interests	Less formal than litigation with procedural rules and substantive laws being set by parties; opportunity to present proofs and arguments

Source : (De Palo et al., 2014[26]; Rozdeiczer and Alvarez de la Campa, 2006[27])

Fostering trust in judges and courts

Surveys suggest widespread mistrust towards the judicial system. Over half of surveyed individuals and businesses report lacking trust in Croatia's judicial system because they presume politicians or businesspeople have undue influence on the decisions of courts and judges, whom they also believe lack safeguards from such interference (European Commission, 2022[11]; CDCJ, 2022[29]). Low levels of trust may partly reflect historical rather than recent experience, and may be linked to relatively high perceived incidence of corruption (discussed below). For example, the period from the mid-1990s to 2000 saw particularly frequent instances of political interference with judicial independence, including in the selection and dismissal of judges (Venice Commission, 2022[30]).

The State Judicial Council plays a key role protecting the independence and impartiality of the judiciary. The Council's responsibilities include appointing and dismissing judges and court presidents, conducting disciplinary proceedings, and verifying asset declarations of judges. It also provides training for judicial personnel. Croatia is among the first EU countries providing training for judges on negative stereotyping and non-discrimination (CDCJ, 2022[29]). The Council's role has been strengthened in recent years. For example, powers of the Minister of Justice in the selection procedure of court presidents and attorneys have been abolished (CDCJ, 2022[29]). A previous change to the selection procedure of judges, which in effect made it more difficult for the State Judicial Council to choose candidates, has been amended to strengthen the role of the Council (European Commission, 2022[31]). Staffing and IT systems have been improved to facilitate verifying judges' asset declarations (European Commission, 2022[31]).

Box 3.5. Country schemes encouraging alternative dispute resolution mechanisms

The United Kingdom's small claims mediation service

Free of charge, the small claims mediation service by Civil Courts of England and Wales offers confidential and effective alternative dispute resolution for claims of up to GBP 10,000 via telephone. While the mediation process is a voluntary commitment, its agreements are binding. Only if mediation fails, is a formal court procedure is launched to resolve the dispute.

Australian Small Business and Family Enterprise Ombudsman

In 2016, the Australian Small Business and Family Enterprise Ombudsman was established. Striving to foster a viable business environment for small businesses and family enterprises, the Ombudsman provides information on dispute resolution options, access to mediation and facilitates alternative dispute resolution processes on a wide range of issues such as contract, franchise, lease, payment or product and service quality disputes.

France's Court-Annexed Mediation

In France, the judge hearing a civil case may, after having obtained the agreement of the parties, refer the case to a mediator. Mediation can also be ordered during proceedings by the judge handling the case with the ultimate objective of enabling the parties to find a solution to the conflict between them.

Denmark's Arbitration Act (2005)

In Denmark, the Arbitration Act, based on the UNCITRAL Model Law of 1985, centralizes party autonomy for dispute resolution. Arbitration proceedings are voluntary and most rulinge are non-binding as parties can largely decide together on how the arbitration is conducted. Several specialised arbitration institutions, which work often on a non-profit basis, can help resolve disputes

Source: United Kingdom small claims mediation; Australian Small Business Ombudsman; France Court-annex Mediation; Denmark Arbitration Act

There may be room to further strengthen the Judicial Council's independence and capacities. Notably, the Council of Europe Action Plan on strengthening judicial independence and impartiality recommends that Council membership should not be allocated by virtue of holding an executive office or a position in the legislature (Council of Europe, 2016[32]). Two of the eleven seats on the State Judicial Council in Croatia are allocated to members of Parliament representing the ruling party and the opposition (European Commission, 2022[31]). Reports by the Consultative Council of European Judges of the Council of Europe and the European Committee on Legal Co-operation suggest that lack of resources and competencies limit the Council's capacity to fulfil its mandate (CCJE, 2019[33]; CDCJ, 2022[29]). Disciplinary and criminal proceedings against judges can take several years (CDCJ, 2022[29]), which weakens the Council's authority and contributed to public mistrust of the judiciary (CCJE, 2019[33]; CDCJ, 2022[29]). Ensuring the State Judicial Council has all the resources and authority it needs to pursue disciplinary proceedings and any other responsibilities in a timely manner would support its role in fostering judicial independence.

Croatia belongs to a small number of EU countries allowing higher courts to take the initiative to amend lower court decisions (European Commission, 2022[11]). This can assure the consistent application of laws. At the same time, being subject to instructions from higher courts on how to decide an individual case can weaken judicial independence. For example, according to the Venice Commission, a hierarchical organisation of the judiciary, so that higher courts can impose their ruling on lower ranking judges, violates the principle of internal independence (European Commission, 2022[11]). Imposing limits for reviewing decisions through higher courts, for example requiring a third party to initiate a review or being allowed to give only non-binding decisions on its own initiative, can promote consistency while safeguarding the independence of individual judges. Most EU countries do not allow higher courts to issue decisions, especially binding ones, on specific cases on their own initiative. , while in Croatia, registration judges at several courts can alert a judge when a draft judgment diverges from previously delivered case law, and propose to discuss the divergence and to issue a decision binding on all judges in the court (European Commission, 2022[11]). Reviewing rules to adapt decisions may identify scope to further strengthen judicial independence.

Helping the public to better understand court decisions

Given the widespread mistrust of the judiciary, it is important that public debates about judges' decisions reflect all relevant facts in an objective manner. The Council of Europe recommends taking steps to ensure that politicians and journalists are respectful of judicial decisions and judges (Council of Europe, 2016[32]). Misleading or impartial media reports and statements by politicians – including for example media reports of judges' rulings which omit facts, generalising statements by politicians against judges as a whole, or politicians expressing wishes about rulings of ongoing cases – have been cited as reducing trust in the judiciary in Croatia (CCJE, 2019[33]). The government is establishing a communication service to make the vast majority of court decisions readily available electronically, and to communicate on specific issues, such that the judiciary can better clarify and respond to criticism (Council of Europe, 2016[32]). Box 3.6 provides examples from OECD countries for measures taken to improve trust in the judicial system through communication strategies and engaging with the public.

Reducing the complexity of the legal framework and the frequency of amendments would make the judicial system more efficient and transparent. Frequent changes to the legal framework can make it more difficult to understand judicial decisions, for example because seemingly similar cases at different times may be judged differently. Croatia's institutional developments of the past decades – including, war, independence, the transition to a market economy, joining the EU, integrating into the euro and Schengen areas, and now ensuring laws align with OECD standards – have led to many changes in the legal framework (World Bank, 2019[25]). To allow for more time to simplify the legal framework, legislators could agree on a schedule for amending fundamental laws, abstaining from changes in between these dates except in exceptional cases (World Bank, 2019[25]).

Levelling the playing field through tackling corruption and clientelism

Levels of perceived corruption in Croatia remain higher than in most OECD and EU countries, including peer countries (Figure 3.11). Corruption, such as paying or requesting bribes to get better access to public services or win contracts, undermines trust in public services and equitable access to them, reduces value-for-money of public spending and distorts decision making. Croatia's Recovery and Resilience Plan aims to tackle corruption with several measures enhancing prevention and sanctioning, for example digitalising processes of local governments and speeding up court proceeding, which is welcome. In recent years, investigations of high-level corruption cases have continued, with more leading to inditements and judgements (European Commission, 2023[21]).

Box 3.6. Country examples on fostering trust in the judiciary through public engagement

Germany's Federal Constitutional Court's communication strategy

The German Federal Constitutional Court continuously invests in a comprehensive communication strategy. Not limited to communicating on recent decisions and litigated constitutional meaning, the Court's Code of Conduct states that judges should impart knowledge on the Court's functioning and the relevance of its case law. Pursuing a multimedia and interactive outreach agenda, the Court aims at strengthening legal and constitutional literacy among the people via nationwide campaigns.

Columbia's Supreme Court's communication strategy

In 2012, the Supreme Court of Justice of Columbia launched its own YouTube channel and further regularly updates several social media channels, such as Facebook and Instagram. Adopting a people-centred approach to translate its actions into audience-tailored formats, the Court disseminates videos and podcasts on its functioning and constitutional litigation.

United States' courts' public engagement strategy

In the United States, many courts established specific committees to engage with the population. In Washington, Public Engagement and Education Committees at courts strive to foster a relationship with the public based on accountability and understanding through collaboration with judicial, legal and community groups and organizations.

Sources: Colombia ; United States

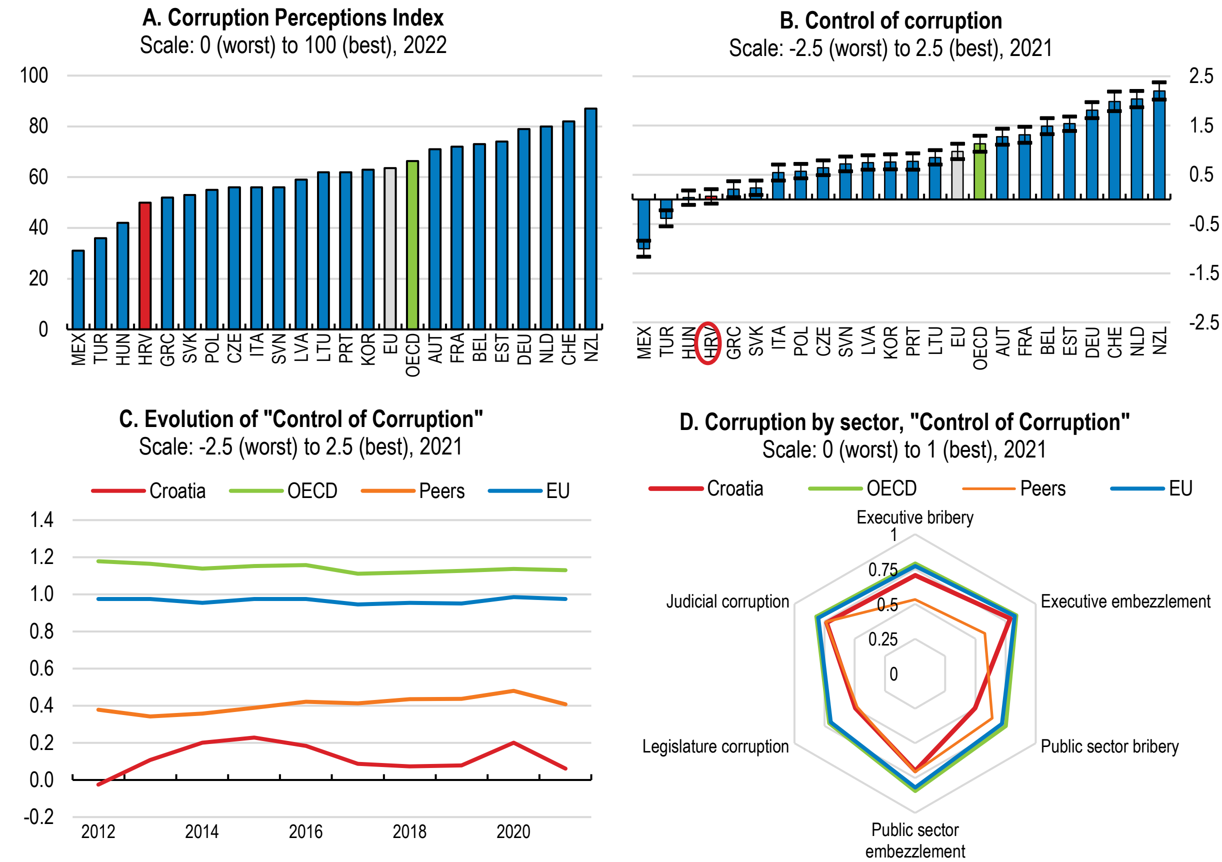
Tackling corruption in Croatia requires attention to both low- and high-level corruption. High profile cases have, for instance, involved high-level politicians (GRECO, 2019[34]). In addition, personal experiences with corruption are also relatively widespread. Around one-quarter of the population – a higher share than in most other EU countries – report to have experienced corruption within the last year or know someone who has (Figure 3.13, Panel A and B). Some of those experiences may also reflect activities similar but not identical to corruption, such as clientelism – for example awarding positions to personal connections or political allies with little regard to their merit. More businesses than in most other EU countries report patronage and nepotism as an important problem (Figure 3.12), and about one-quarter of businesses believe corruption prevented them from winning a public contract. Widespread personal experiences with corruption are accompanied by relatively lenient public attitudes. The share of people who find corruption unacceptable, or consider valuable gifts to public officials constitute a bribe, is lower than in most other EU countries (Figure 3.13, Panel C and D).

Better transparency can foster trust in policy makers and officials

Ensuring the Commission for the Resolution of Conflicts of Interests has adequate resources may support transparency. In Croatia, public officials are required to submit a self-declaration of their assets and other involvements to the Commission for assessment (GRECO, 2019[34]). Recent changes to the rules for asset declarations mean that more assessments are likely to need to be made, which are likely to require increased staff resources (European Commission, 2022[31]).

Oversight of lobbying activities is improving. Croatia recently extended the cooling-off period for people leaving top executive functions from 12 to 18 months (European Commission, 2022[31]), which is welcome. Also, a new Lobbying Act is in the pipeline that importantly includes provisions for a registry of lobbyists, a feature of policies in a number of countries (Figure 3.13). Ensuring this operates effectively and transparently can contribute to improving corruption perceptions and integrity.

Figure 3.11. Perceptions of corruption are high



Note: 'Peers' is the unweighted average of Czech Republic, Hungary, Slovak Republic, and Slovenia. Panel B shows the point estimate and the margin of error. Panel D shows sector-based subcomponents of the "Control of Corruption" indicator by the Varieties of Democracy Project.
Source: Panel A: Transparency International; Panels B & C: World Bank, Worldwide Governance Indicators; Panel D: Varieties of Democracy Project, V-Dem Dataset v12.

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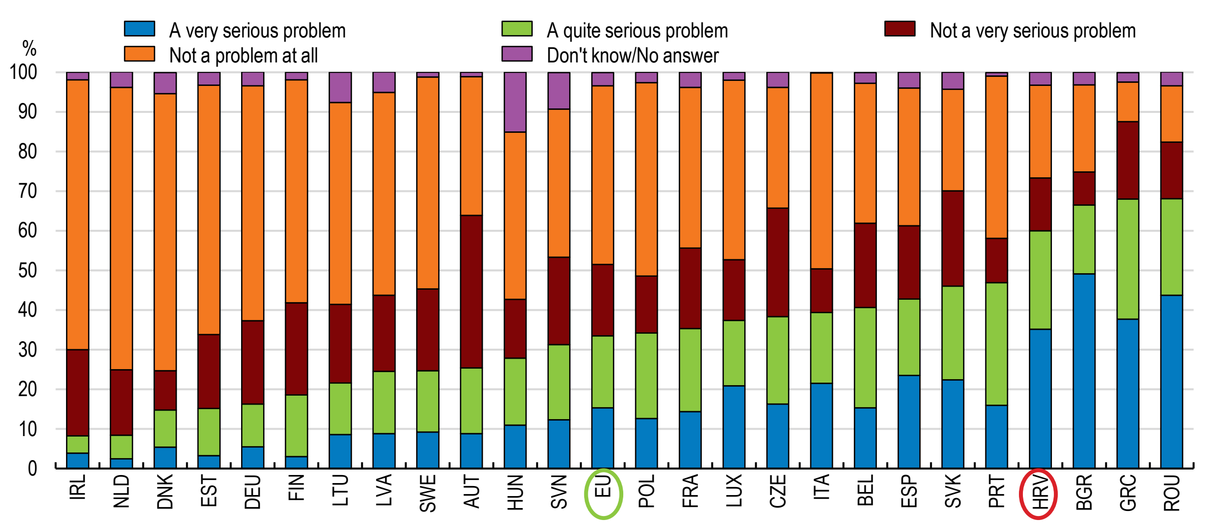
Figure 3.12. Many businesses report clientelism to be a problem

Share of people indicating patronage and nepotism to be a problem for their company when doing business



Source: (European Commission, 2022[35]).

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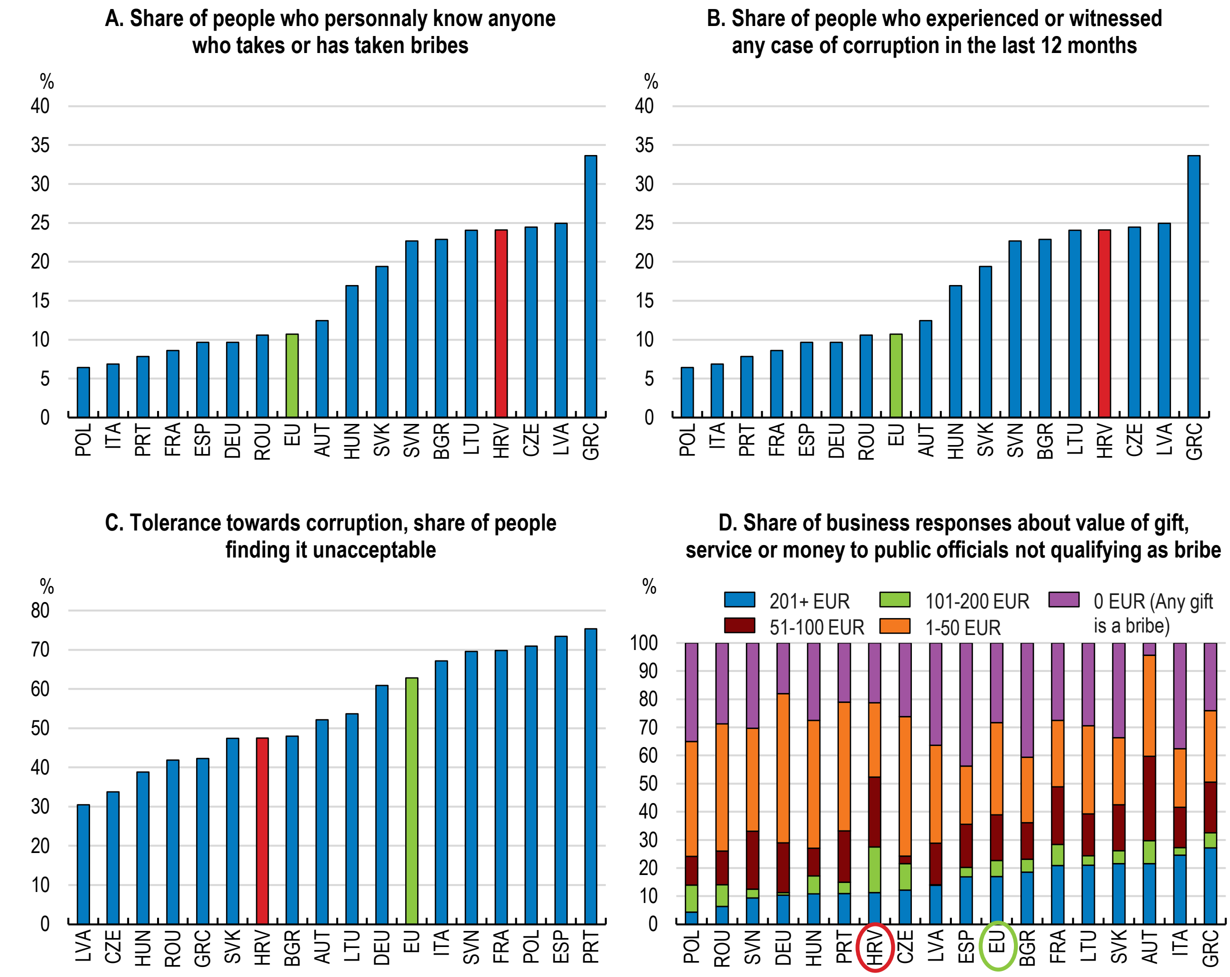
Figure 3.13. Experience with corruption is common and tolerance of it is relatively high



Source: (European Commission, 2022[36]); and (European Commission, 2022[35]).

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Complementing deterrence with promoting values of integrity and advocating positive examples will be crucial to tackle widespread low-level corruption. Experience among OECD countries suggests that approaches relying mostly on more rules and stronger deterrence have been of limited effectiveness (OECD, 2017[37]). Indeed, overly stringent rules or aggressive enforcement even contributed to reinforcing corruption and other unethical behaviour in some cases (Schulze and Frank, 2003[38]; Bandiera et al., 2021[39]), while adding costs to firms and weakening confidence (Bulman, 2021[40]). Corruption often results not from intentionally breaking the rules but from expectations about reciprocity and what constitutes common behaviour in certain situations (OECD, 2018[41]).

Codes of conduct for officials in executive bodies and parliamentarians have recently been expanded, addressing an important gap in measures to combat corruption. In May 2022, in line with recommendations from GRECO, the government adopted a code of conduct for state officials (GRECO, 2019[34]). Those covered by the code include members of the government and all the other officials in executive bodies, such as head of the Office of the Prime Minister and heads of state administrative bodies. Almost all regional and local administrations have adopted them too (European Commission, 2023[21]). A code of ethics for parliamentarians was adopted in November 2022. Completing the adoption of an updated code of ethics for police officers could help improve perceptions of an institution central to the robust rule of law.

Setting positive examples through information and awareness campaigns can help change behaviours. Research suggests information campaigns need to be careful to avoid further adding to perceptions that corruption is widespread, as this may inadvertently reinforce corruption by normalising it (Ajzenman, 2021[42]). By contrast, examples of appropriate behaviour can help to build trust that corruption is not the norm, and so change perceptions about how acceptable corruption is and how likely people are to engage in corruption. Such information campaigns may be most effective in building trust if executed by institutions that are not engaged in sanctioning violations (OECD, 2018[41]). As part of the Recovery and Resilience Plan, a national media campaign is planned from the end of 2023 to the end of 2024 to raise awareness of the harmfulness of corruption and inform the general public about existing anti-corruption mechanisms. Croatia can plan further campaigns and ensuring that they draw on the lessons on the effectiveness of this campaign.

Box 3.7. Australia's implementation of codes of ethics

In the past, the Australian Public Service (APS) Commission used a statement of values expressed as a list of 15 rules. In 2010, the Advisory Group on Reform of the Australian Government Administration recommended that the APS values be revised, tightened, and made more memorable. APS values were revised to a set of core values that follow the acronym "I CARE":

- **Impartial -** The APS is apolitical and provides the government with advice that is frank, honest, timely, and based on the best available evidence.
- **Committed to service -** The APS is professional, objective, innovative and efficient, and works collaboratively to achieve the best results for the Australian community and the government.
- **Accountable -** The APS is open and accountable to the Australian community under the law and within the framework of ministerial responsibility.
- **Respectful -** The APS respects all people, including their rights and heritage.
- **Ethical -** The APS demonstrates leadership, is trustworthy, and acts with integrity, in all that it does.

The Australian Government also developed and implemented strategies to enhance ethics and accountability in the APS such as the Lobbyists Code of Conduct, and the register of 'third parties', the Ministerial Advisers' Code and the work on whistleblowing and freedom of information. A model was developed to help public servants make decisions process when facing ethical dilemmas. The model follows the acronym REFLECT:

1. **RE**cognise a potential issue or problem
2. **F**ind relevant information
3. **L**inger at the 'fork in the road' (talking it through)
4. **E**valuate the options
5. **C**ome to a decision
6. **T**ake time to reflect

Sources: Australian Public Service Commission (2011),"Values, performance and conduct", https://resources.apsc.gov.au/2011/SOSr1011.pdf; Australian Public Service Commission , "APS Values", https://apsc-site.govcms.gov.au/sites/g/files/net4441/f/APS-Values-and-code-ofconduct.pdf; Office of the Merit Protection Commissioner (2009), "Ethical Decision Making", http://www.apsc.gov.au/publications-and-media/current-publications/ethicaldecision-making.

Continuing productivity-supporting reforms through a productivity board

Establishing a productivity board could support continuous evidence-based reforms to improve productivity in Croatia. Policies tackling widespread productivity gaps and weak allocative efficiency, discussed below, likely require sustained efforts over a prolonged period. Many OECD countries have established pro-

productivity institutions to inform and monitor policymaking (Cavassini et al., 2021[43]; Pilat, 2023[44]). The European Commission recommends euro-area countries set up national productivity boards. In Croatia, such an institution could bring together academic experts and policy makers, and could use existing or collect micro-data to better design policies and to evaluate the impacts of existing policy. Australia has a long-established pro-productivity institution (Box 3.8), that has often served as a model for similar institutions in other OECD countries. More recently established institutions include Slovakia's National Council for Productivity (established 2019). In some cases, productivity policy analysis is enhanced by expanding the role of an existing institution. For instance, in 2019 Germany's Council of Economic Experts was appointed as the National Productivity Board.

Box 3.8. Pro-productivity institutions and the Australian example

A national productivity board can be a valuable tool for improving the policy environment to boost economic growth and ensuring the long-term prosperity of a country. A well-resourced, permanent body dedicated to developing policies can accelerate reforms. Although they are often called "Productivity Boards" or "Commissions", governments often set a wider mandate that can include green growth and social issues, as well as the public sector's role and effectiveness. These bodies evaluate government policies, with a goal of recommending reforms. They support a "whole-of-government" approach, helping to overcome the frequent fragmentation in policy making across different public agencies or layers of government. They can identify trends, produce robust evidence and in some cases collect data and make the case for reforms by presenting clearly the benefits of reforms. They can serve as a platform to share ideas and help forge a common view, thus deepening national ownership of reforms, including among the government bodies that will be responsible for implementation.

These bodies fall into three broad types:

1. Stand-alone inquiry bodies, such as the Australian and New Zealand Productivity Commissions. These are generally well resourced with strong analytical skills, independent and have inquiry and consultative mandates.
2. Advisory councils, such as the French Conseil National de Productivité, the US Council of Economic Advisers, and the Belgian Conseil National de la Productivité, These may tap into the existing knowledge of several well-established, high quality institutions without necessarily building their own capacity.
3. Ad hoc task forces, such as the Norwegian Productivity Commissions These may be formed with temporary mandates to assess particular issues.

Countries' experience suggests that these bodies are generally most effective when they can work autonomously and have strong internal analytical, consultative and communication skills. Regular independent audits can protect these bodies' independence and contribute to the quality of their work. Institutions located outside government can better promote reforms that challenge vested interests and work with longer-term policy goals.

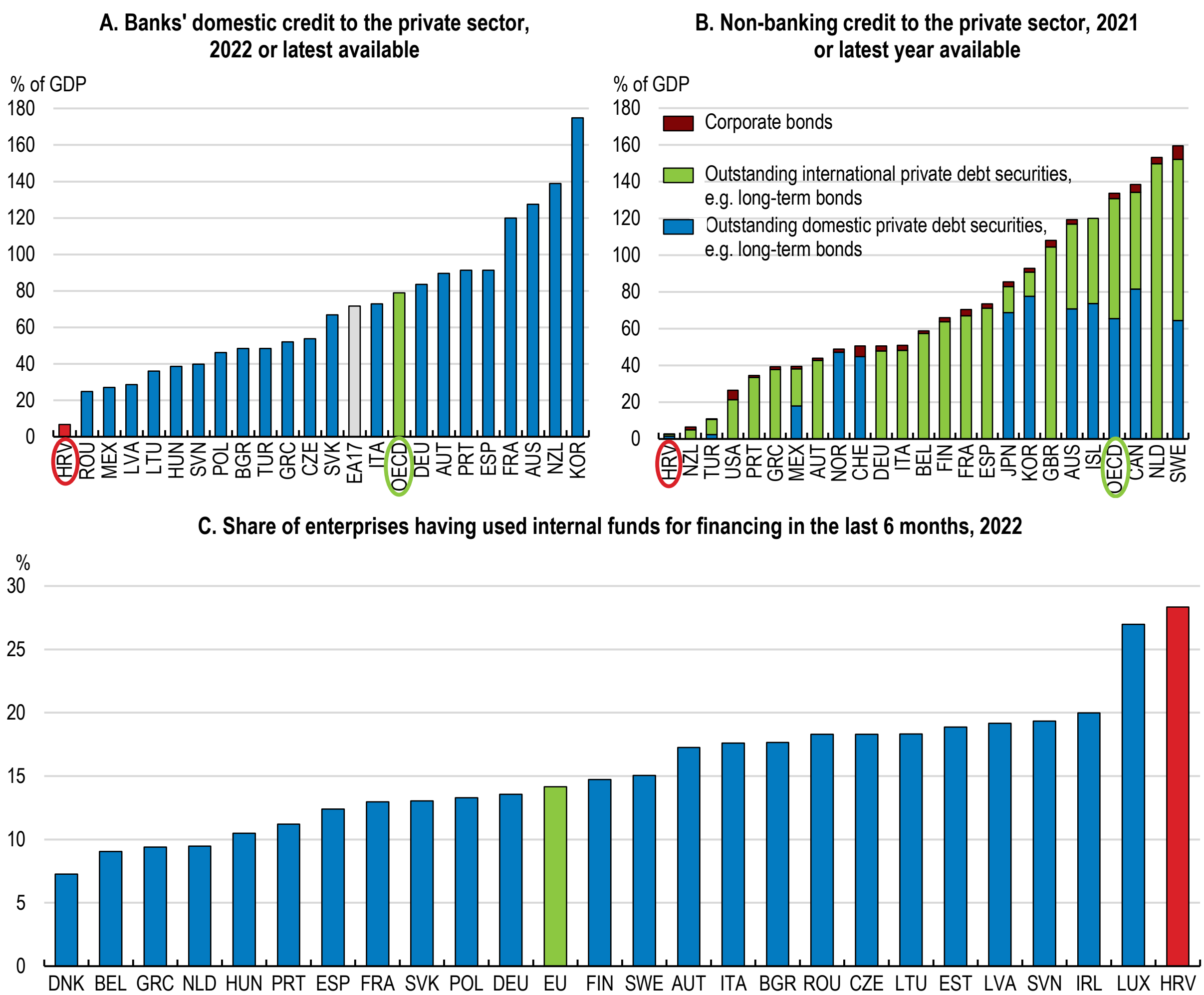
Australia has one of the longest-standing pro-productivity institutions. The Productivity Commission was established in 1998 as an independent statutory body with the mandate to provide advice to the Australian government on policies and reforms that can enhance productivity and improve living standards for Australians. The Commission conducts research and analysis on a wide range of policy areas, including education, health, infrastructure, and industry, and provides recommendations to the government on ways to improve productivity and efficiency across these sectors. Its work has led to numerous policy changes and reforms in areas such as competition policy, trade, and regulation, which have helped to boost productivity and economic growth in Australia.

Source: Cavassini, F., et al. (2022), "Pro-Productivity institutions at work: Country practices and new insights on their set-up and functioning", OECD Productivity Working Papers, No. 32, OECD Publishing, Paris; https://www.pc.gov.au/

Expanding financing options to encourage innovative investment

Businesses in Croatia use less external financing than their peers in OECD countries. Bank credit to the private sector as a share of GDP is low relative to most OECD countries (Figure 3.14, Panel A and B) and the share of non-bank credit ranks even lower. Meanwhile, the share of firms using internal funds for financing is comparatively high (Figure 3.14), Panel C). The heavy reliance on internal financing and dominance of banking in external financing suggests limits in the range of financing available to investors. Croatia's integration into the euro area has the potential to contribute to greatly expanding firms' access to finance, if the regulatory environment is supportive and vigilantly limiting risks (Chapter 2). In 2023 Croatia was 'grey listed' by the Financial Action Task Force (FATF), following a peer evaluation of progress implementing some specific controls to prevent terrorist financing and money laundering. This highlights the importance of continued efforts to improve the regulatory environment, so as to enable a deepening integration into the global financial system Figure 3.17).

Figure 3.14. Businesses' use of external financing is low



Note: Panel B: Data on corporate bonds from 2021, from outstanding private debt securities from 2020.
Source: IMF, International Financial Statistics; World Bank, Global Financial Development Database 2022; and ECB, Survey on the Access to Finance of Enterprises (SAFE) 2022.

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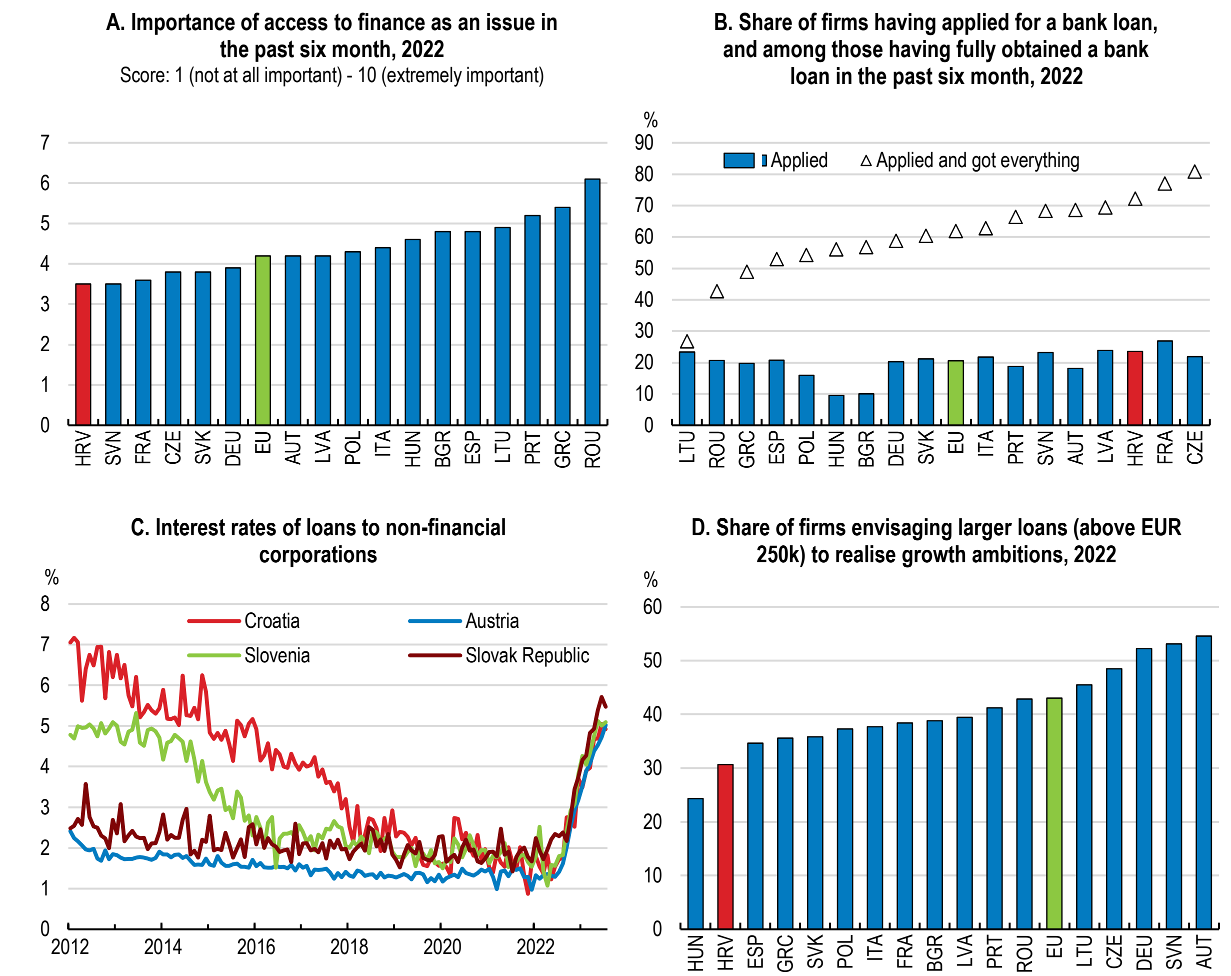
Businesses overall do not appear to be overly constrained in accessing finance, despite their relatively low use of external funds (Figure 3.15, Panel A). Most firms applying for bank loans – and a larger share than in most other EU countries – are successful (Figure 3.15, Panel B), and average loan costs are comparable to other EU countries (Figure 3.15, Panel C). Total volumes of bank financing may be low, even though the share of firms applying for loans is comparable to other countries, as firms tend to apply for smaller loans: the share of businesses reporting demand for loans of more than EUR 250 000 is lower than elsewhere in the European Union (Figure 3.15, Panel D).

Figure 3.15. Demand for finance is relatively low



Note: Panel C: New business loans of up to 1 year. For Greece new business loans with an initial rate fixation period of less than one year. Loans other than revolving loans and overdrafts, convenience and extended credit card debt; loans adjusted for credit and securitisation.
Source: ECB, Survey on the Access to Finance of Enterprises (SAFE) 2022; and ECB, MFI Interest Rates (MIR) Statistics.

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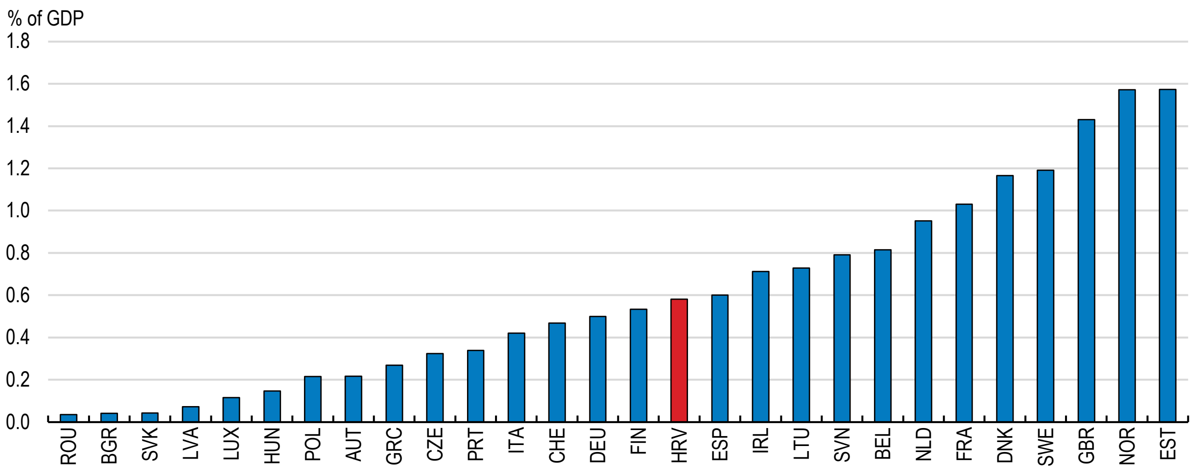
However, SMEs in Croatia are among the most likely of any EU country to report access to finance as a major obstacle (European Commission, 2022[45]). Developing financial markets to provide a broader range of financing options can boost investment especially among smaller and higher productivity and higher growth-potential firms. Croatia's reliance on banking finance means that firms planning innovative projects, especially small and young firms with limited collateral or histories, find it difficult to obtain funds. Indeed, while the share undertaking these investments remains small at 9%, access to a range of financing sources is particularly important for investments in intangible assets – such as databases, designs, organisational capital or distribution networks –, which are crucial complements to adopting digital technologies. These investments are more difficult to finance through bank loans as they are less well suited to be pledged as collateral and their resale value in the event of a default is lower, while their returns tend to be more uncertain (Demmou and Franco, 2021[46]). Private equity markets in Croatia are relatively well developed and funded investments of almost 0.6% of GDP in 2021 (Figure 3.16). However, there is scope to improve access to finance for more innovative projects via banking, public equity markets, and R&D support.

Figure 3.16. Private equity markets are relatively well developed

Private equity inflows, % of GDP, 2021



Source: Invest Europe (2022), 2021 Central and Eastern Europe Private Equity Statistics.

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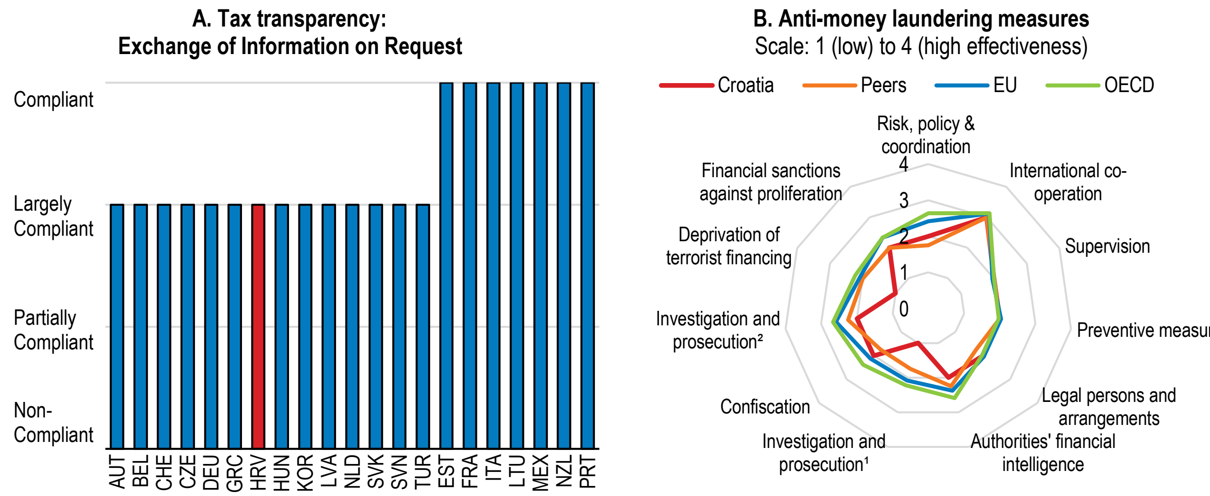
Foreign direct investment (FDI) inflows are another potentially important source of financing. They are below the OECD average (discussed above), although this is likely to relate to the composition of economic activity, with a greater role for low-capital intensity activities rather, than policy restrictions. Over 2011-2022, average net FDI inflows to Croatia stood at 2.4% of GDP per year, compared to about 4% in OECD countries, with greenfield investments – i.e. new establishments of foreign-owned businesses in Croatia – being concentrated in construction and services, especially tourism and lower- technology services such as wholesale and retail trade or real estate activities (OECD, Forthcoming[8]). The relatively low capital intensity of these sectors, compared to, for example, vehicle manufacture possibly explains the relatively low average net FDI inflow. Croatia's FDI rules are less restrictive than most OECD and EU countries across all of the sectors covered by the OECD's FDI restrictiveness index, except for business services and financial services, in which they are assessed to be near but slightly more restrictive than the average of OECD countries (OECD, 2023[47]). Experience across OECD countries suggests that the types of broader improvements in the business environment discussed through this *Survey* can raise foreign direct investment alongside domestic investment.

Figure 3.17. Croatia's financial regulations enable relative transparency but need to better address terrorist financing and money laundering risks



Note: Panel A summarises the overall assessment on the exchange of information in practice from peer reviews by the Global Forum on Transparency and Exchange of Information for Tax Purposes. Peer reviews assess member jurisdictions' ability to ensure the transparency of their legal entities and arrangements and to co-operate with other tax administrations in accordance with the internationally agreed standard. The figure shows first round results; a second round is ongoing. Panel B shows ratings from the FATF peer reviews of each member to assess levels of implementation of the FATF Recommendations. The ratings reflect the extent to which a country's measures are effective against 11 immediate outcomes. "Investigation and prosecution" refers to money laundering. "Investigation and prosecution" refers to terrorist financing.
Source: OECD Secretariat's own calculation based on the materials from the Global Forum on Transparency and Exchange of Information for Tax Purposes; and OECD, Financial Action Task Force (FATF).

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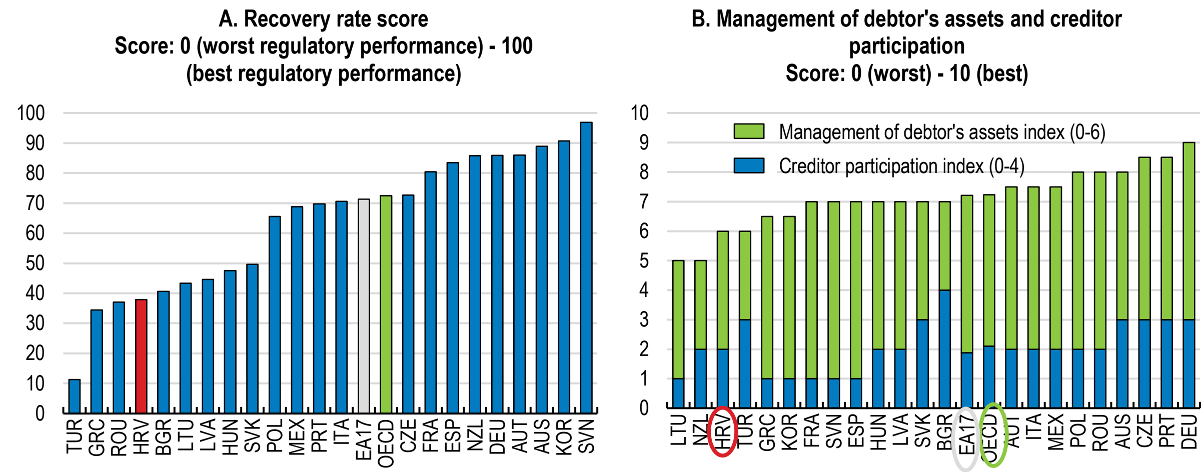
Improving business insolvency can facilitate bank financing especially for high-risk projects

Improving Croatia's insolvency framework would reduce risks for banks and investors and stimulate financing for more innovative projects. Legislative reforms were approved in 2022 and improvements in insolvency management are underway. Improving the insolvency framework can reduce default risks, for example by detecting financial problems early to facilitate restructuring and helping to avert bankruptcies. It can also limit losses in the case of default, for example by providing rapid information about how much debt can be repaid, speeding-up procedures to recover the debt, and then allowing debtors a fresh start.

Croatia's recovery rate – reflecting the costs and time to resolve insolvency cases and chances to avoid liquidation – lags most OECD economies (Figure 3.18, Panel A), while its insolvency framework could be further improved (Figure 3.18, Panel B). The OECD insolvency indicator highlights scope for improvement in the process for the initiation of restructuring, the involvement of court involvement, and the rights of employees (André and Demmou, 2022[48]). For example, allowing debtors to obtain new credits, which would be given priority over previous unsecured creditors, can facilitate restructuring and raise the final recovery value for all creditors (McGowan and D, 2016[49]). Reforms legislated in 2022 and currently being implemented are intended to improve these areas. To improve stakeholder involvement in insolvency proceedings, creditors could be granted the right to approve the sale of substantial assets and to request information from the insolvency representative (World Bank, 2020[50]; Coutinho, Kappeler and Turrini, 2023[51]).

Figure 3.18. Croatia's insolvency framework leaves room for improvement



Note: Panel A: The recovery rate score was calculated based on the time, cost and outcome of insolvency proceedings in each economy. The higher the score the better is the framework assessed. Panel B: Management of debtor's assets and creditor participation are two components of the strength of insolvency framework index. The strength of insolvency framework index measures the legal framework applicable to judicial liquidation and reorganization proceedings and the extent to which best insolvency practices have been implemented in each economy. The higher the score the better is the framework assessed.
Source: World Bank, Doing Business 2020 (database).

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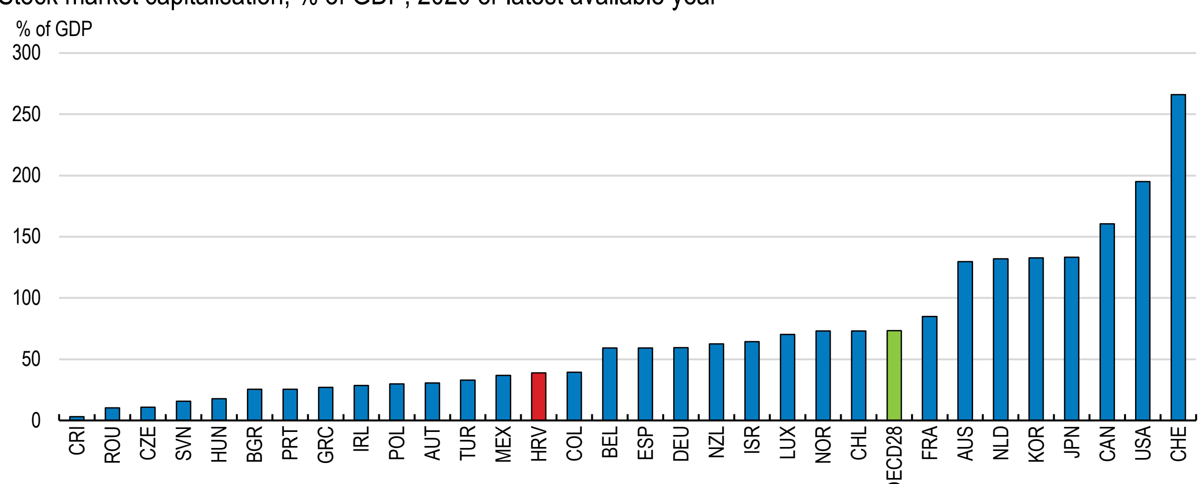
Mobilising public equity markets

Improving scale and liquidity would deepen Croatia's public equity markets. Croatia's domestic stock market, the Zagreb Stock Exchange (ZSE), was established in 1991 and is a for-profit corporation mostly owned by banks and insurance companies. Its capitalisation relative to GDP is comparatively small (Figure 3.19). The low number of listings and trading volumes makes it less attractive for people or firms to invest or raise funds, hindering it from reaching critical scale.

Figure 3.19. The domestic stock market's capitalisation is low

Stock market capitalisation, % of GDP, 2020 or latest available year



Note: OECD28 is the unweighted average and excludes Denmark, Estonia, Finland, Iceland, Italy, Latvia, Lithuania, Slovak Republic, Sweden, and United Kingdom.
Source: World Bank, Global Financial Development Database.

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The ZSE's market structure could be simplified. The ZSE hosts three markets, which are differentiated by increasingly stringent requirements for governance, transparency and capitalisation. The Prime Market with the strictest requirements only lists six stocks. Many European or other countries with larger market sizes have simpler stock market structures, including a single market or one more regulated and one alternative market (OECD, 2021[52]). Reducing the number of markets, for example by merging the two lower segments, would create a larger and thus more attractive domestic stock market. Providing financial incentives to firms listing or issuing new stocks, for example subsidies for issuance costs, could encourage more firms to move to the Prime Market and help reach critical scale.

A stronger corporate governance framework for listed companies would improve investor confidence and make listed companies more attractive. Croatia's corporate governance framework ranks below most OECD and peer economies in the 2019 World Economic Forum Global Competitiveness Index (World Economic Forum, 2019[20]). Greater alignment with G20/OECD principles for corporate governance (OECD, 2015[53]; OECD, 2021[52]) would improve governance along several dimensions. Specifically:

- Parts of Croatia's corporate governance code for listed firms could be made legally binding. Only a small number of OECD countries rely on codes combining binding and voluntary elements. Croatia's code currently has no legally binding elements. While voluntary codes allow for flexibility, their effectiveness ultimately rests on interested and relevant stakeholders monitoring compliance, which may be less effective in Croatia given the relatively small size of its stock market.
- Strengthening independence criteria for audit committees could improve trust in company audits. Most OECD countries require listed companies to establish independent audit committees. While listed companies in Croatia are required to establish an audit committee, there are no independence requirements. For example, the audit committee can be organised as a committee of the board of directors of the audited company.
- Croatia recently strengthened approval requirements for related party transitions, effectively requiring approval by the supervisory board or shareholders. However, minority stakeholder rights could be further strengthened by giving a greater role to independent supervisory board members for reviewing transactions.

Besides stock markets, corporate bonds can fund firms' longer-term investments. While corporate bonds have become an increasingly important source for corporate financing globally (OECD, 2021[52]), very few firms in Croatia issue corporate bonds (Figure 3.14, Panel B). Most corporate bonds have been issued at foreign exchanges instead of the ZSE, likely reflecting the lack of intermediaries – from domestic credit rating agencies to investment banks – and high listing costs. For example, listing a EUR 500 million corporate bond is three- to two-times more expensive at the ZSE compared to Luxembourg or Prague (OECD, 2021[52]). Supporting the issuance of domestic corporate bonds would help expand the market and reduce costs. For example, to compensate for the lack of domestic rating agencies – which is an obstacle especially for SMEs to obtain ratings and issue bonds – alternative credit rating mechanisms could be provided by public institutions such as FINA. To tackle high listing costs, government support schemes could provide financial assistance when listing a bond to help kick-start the market.

Listing state-owned enterprises (SOEs) on the stock market can support investment in such enterprises, improve their governance and deepen the stock market. Out of Croatia's approximately 1000 SOEs, only 14 are listed on the ZSE. Only one is listed on the Prime Market, although about half of listed SOEs would satisfy the Prime Market's capitalisation criteria (OECD, 2021[52]). Issuing secondary public offerings would help meet liquidity criteria to move more SOEs to the Prime Market and improve SOE performance through the market's more stringent governance criteria. In addition, more unlisted SOEs could be listed. For example, the large national power company Hrvatska Elektroprivreda or the Croatia's toll road company Hrvatske Autoceste provide services that in many other countries are provided by listed companies (OECD, 2021[52]). SOEs could also help stimulate corporate bond markets. While Croatian SOEs have issued corporate bonds in the past, they mostly relied on foreign exchanges and their use remains limited (OECD, 2021[52]).

As a small country, Croatia stands to benefit from integrating its public equity markets with neighbouring countries. The ZSE has strengthened international links by acquiring full ownership of the Ljubljana Stock Exchange in 2015 and minority ownership of the Macedonian Stock Exchange in 2019. Together with the former it created the ADRIAprime index to jointly trade Croatian and Slovenian Prime Market stocks. The integration of Croatia's public equity markets with neighbouring countries appears to be compromised by shortfalls in the technical infrastructure for selling and buying stocks. For instance market participants have encountered difficulties with settling cross-border transactions with Croatia's Central Depository and Clearing Company (CDCC). Limited technical capacity is also hampering the full integrations of Croatia's central depository framework into the pan-European TARGET2-Securities system (T2S), which facilitates the simultaneous exchanges between investors from 20 participating European markets. Promoting investments in CDCC's technical capacity to enhance operations, connectivity, efficiency, and security would allow bring a better integration with international markets.

Improving the framework and expanding public support for research and development

Public support for business R&D is low. Croatia provided R&D support of 0.007% of GDP in 2021, compared to about 0.2% across OECD countries on average. It provides both tax incentives and R&D grants, which are mostly implemented via its Agency for Small Business, Innovation and Investment (HAMAG-BICRO). For example, depending on the type of research project, up to 200% with a maximum of EUR 300 000 of eligible R&D expenses can be deducted from the tax base. In 2021, however, 97% of R&D support was provided in the form of grants (OECD, Forthcoming[8]). An evaluation of the existing tax incentives is envisaged within the Recovery and Resilience Plan, to inform revisions to the support programme. The limited use of tax incentives seems to reflect low uptake, with most applications being approved, but only 100 applications being received, over the period 2019-2021. Low uptake may reflect their relatively modest advantages given low corporate tax rates (discussed in Chapter 2), lack of awareness of the schemes, or weak demand for innovative investments.

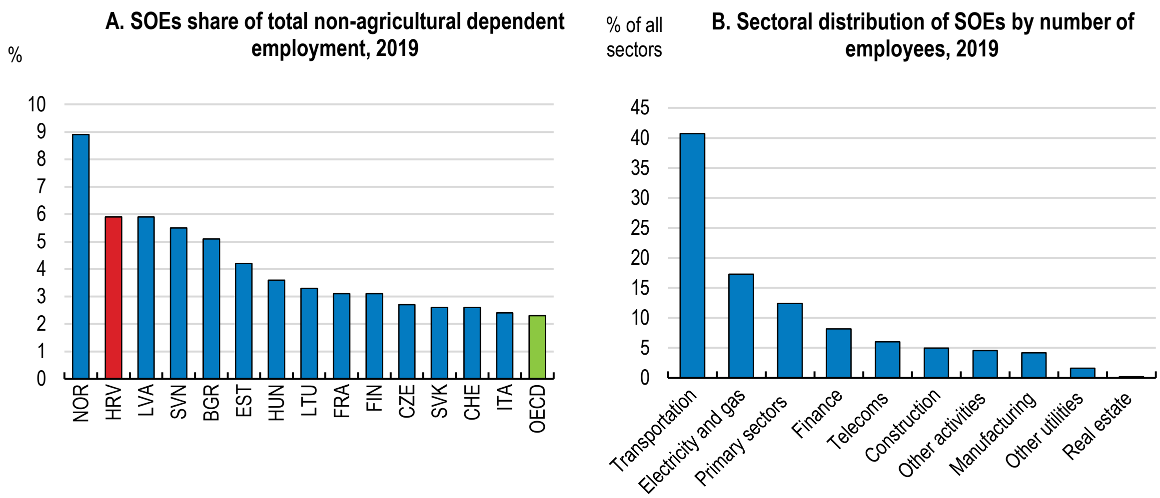
First improving the framework, then expanding the resources for R&D support programmes could stimulate more business R&D. Application costs for grants are high (OECD, Forthcoming[8]). For example, obtaining grants often requires several proposals with different objectives, timeframes, target groups and implementing authorities. Firms often employ consultants to assist with application and project management. In addition, many firms reported significant delays in procedures to obtain funds. Investments in the Recovery and Resilience Plan to digitalise the support programmes can make them more accessible. In addition, simplifying application procedures and design of R&D grants and tax incentives could help to make applications less burdensome and costly, allowing firms to focus on the research and development tasks.

Better coordinating and linking R&D support schemes could help to better match the financing needs of innovative firms. Support schemes often fail to provide firms with a longer-term perspective, for example because of lack of continuity between different schemes (OECD, Forthcoming[8]). Key players in managing Croatia's R&D support currently include the Ministry of Economy and Sustainable Development, the Ministry of Science and Education and the National Innovation Council (NIC). Unclear division of responsibilities between these players hampered coordination in the past (European Commission, 2023[54]). More recently, Croatia's Smart Specialisation Strategy has streamlined governance for R&D support and clarified the role of the NIC National Innovation Council, which is welcome. Pursuing the government's plans to consolidate the large number of institutions involved in research could strengthen public-private collaboration on research, development and innovation.

Strengthening the performance of state-owned enterprises

State-owned enterprises (SOEs) play a greater role in Croatia's economy than in most OECD economies. A large number of previously socially-owned enterprises were privatised during Croatia's transition to a market economy in the 1990s, but the SOE sector remains comparatively large. In 2019, a larger share of workers worked in SOEs in Croatia than most EU and peer countries (Figure 3.20, Panel A) (OECD, 2021[55]). SOEs' assets are equivalent in value to about half of annual GDP (OECD, 2021[55]), among the highest ratios in central and eastern European countries (EBRD, 2018[56]).

Figure 3.20. State-owned enterprises play a significant role in some sectors



Source: (OECD, 2021[55]).

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Companies owned by the state engage in a broad range of activities, often in competition with private businesses. Most of the SOE sector is under central government ownership. These firms account for about 90% of SOE employment and include among the largest individual businesses. They are mostly engaged in transportation, electricity and gas, finance, and construction (Figure 3.20, Panel B). A large number of generally smaller SOEs are owned by sub-national governments and mostly provide utilities. Box 3.9 provides examples of companies owned by the Croatian state.

Box 3.9. Examples of Croatia's state-owned enterprises

Hrvatska Elektroprivreda (HEP)

HEP is a 100% state-owned energy supplier engaging in generation, transmission, distribution, supply and trade of electricity, thermal energy and natural gas, with about 11 000 employees. The company has a natural monopoly in the electricity transmission and distribution segments but also holds a dominant position in electricity generation and retains a large market share in the supply segment.

The Group has been showing positive financial results in recent years. It is governed by a five-member supervisory board (including one employee representative) directly appointed by the relevant line ministry (Ministry of Economy and Sustainable Development) through the General Assembly, as well as a management board of six members, all of whom are appointed and may be dismissed by the supervisory board, upon proposals by the line ministry. Members of the supervisory board include one member of another SOE's executive team, one state official, one employee representative and two independent members from the private sector and/or academia.

Hrvatske Ceste – HC (Croatian Roads)

HC is a 100% state-owned company in charge of the management, construction and maintenance of state roads in Croatia. It has about 460 employees. The company is mainly financed through proceeds from the fuel tax and several other fees related to vehicle use. However, it still heavily relies on government support.

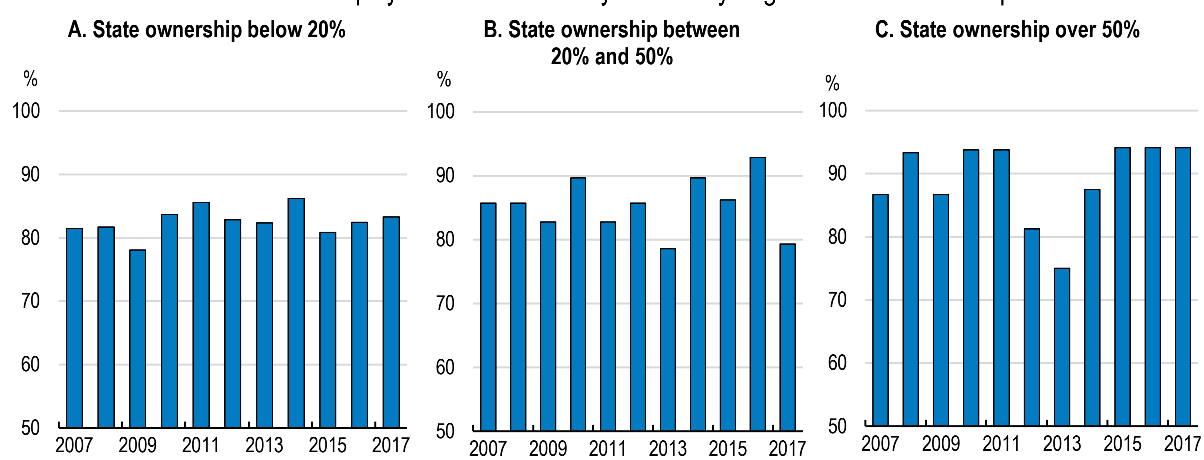
The Republic of Croatia as the sole owner of the company exercises its ownership rights through the corresponding line ministry (Ministry of Sea, Transport and Infrastructure) and the Ministry of Physical Planning, Construction and State Assets. All members of the management and supervisory board are elected and dismissed by the company's General Assembly at the proposal of the line ministry, with the exception of the employee representative who is elected according to the Labour Law.

Source: (OECD, 2021[55]).

The SOE sector appears to underperform. The return on equity for most SOEs is below the median of other firms in the same industry in Croatia, and performance is generally weaker at companies in which the state holds more shares (Figure 3.21, Panels C-E). Evidence suggests that SOEs record lower productivity or sales growth than private firms, though the analysis is complicated by differences in sectoral composition (OECD, 2021[55]). Croatia's SOEs perform weakly also compared to SOEs in peer countries (World Bank, 2019[57]; EBRD, 2018[56]). While SOEs' financial performance weaknesses may be due to their obligation to serve public policy objectives, SOEs without those objectives, and are envisaged to be sold, also record relatively weak performance (OECD, 2021[55]). Further, SOEs' underperformance often extends to delivering on their public policy objectives. For example, waste management in Croatia is largely delivered by SOEs and suffers from inadequate investment in more environmentally friendly treatment compared with most other EU countries (Figure 3.22).

Figure 3.21. Public ownership is associated with weaker financial performance

Share of SOEs with a return on equity below their industry median by degree of state ownership



Note: SOEs stands for state-owned enterprises.
Source: (OECD, 2021[52]).

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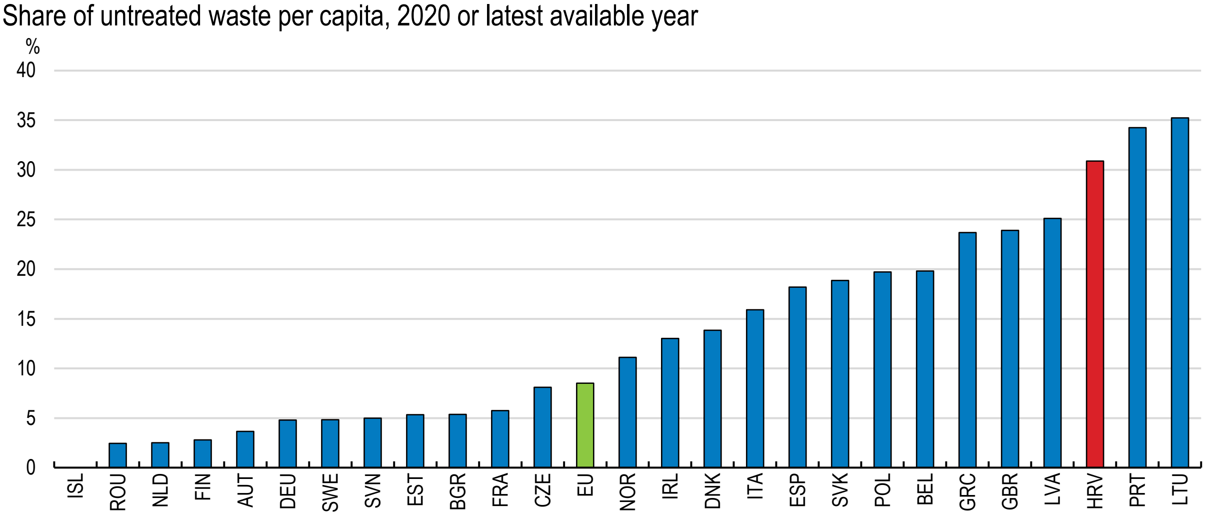
Undue influence for political or private gains is cited as one of the main causes of Croatia's SOEs' weak performance. Experience among OECD countries suggest that SOEs can be particularly vulnerable to being used for the advantage of political and private interests through weaknesses in governance, for example lack of oversight, poorly defined performance indicators, or lack of autonomy of boards (OECD, 2023[58]). In Croatia, indicators of politicisation include changes in government frequently leading to changes of SOE boards, public controversies about appointments of senior positions, and high-level corruption cases involving SOEs (OECD, 2021[52]; World Bank, 2019[57]; EBRD, 2018[56]). Such weaknesses are likely to contribute to broader corruption perceptions (discussed above). Aligning Croatia's SOE governance framework with the OECD Guidelines on Corporate Governance of SOEs (OECD, 2015[59]) and the OECD Guidelines on Anti-Corruption and Integrity in SOEs (OECD, 2019[60]), as envisaged by Croatia's Recovery and Resilience Plan, will help improve SOE performance and provide more gains for society.

Croatia is reviewing its rationale for maintaining individual companies in state ownership. State ownership can contribute to welfare, for example by assuring supply of some essential goods and services or to address a market failure (Estrin et al., 2009[61]). However, it can also make companies more vulnerable to politicisation or corruption (OECD, 2023[58]; OECD, 2021[55]). Making justifications for public ownership transparent can help assure that state ownership serves public interests. Out of the about 1000 companies in which the state holds shares, it currently plans to sell its shares in at least 342 companies, although progress with divesting companies has been slow in the past (OECD, 2021[55]) (European Commission, 2020[62]). The Recovery and Resilience Plan foresees further SOE privatisation. This is welcome, given the large role of SOEs in the economy. For those companies planned to remain in state ownership, responsible line ministries must justify state ownership based on public interest. Plans to develop an ownership policy in line with the OECD Guidelines on Corporate Governance of SOEs (OECD, 2015[59]) are welcome. Assuring that the ownership policy provides a clear rationale for public ownership of all SOEs that are fully or majority-owned would further improve transparency.

Figure 3.22. Delivery of public services could be improved, such as in waste management

Share of untreated waste per capita, 2020 or latest available year



Note: Computed as treated relative to total hazardous and non-hazardous waste from all NACE activities plus households, in kilograms.
Source: Eurostat.

StatLink https://stat.link/rmixh9

Improving the state's role as owner

Ensuring that the state acts as an effective owner is essential to realise the benefits from public ownership. For example, according to the OECD Guidelines on Corporate Governance of SOEs (OECD, 2015[59]), as owner the state should set broad objectives and monitor performance – i.e. deciding what individual SOEs should achieve and monitoring their delivery –, while allowing SOEs' management to decide independently on business operations – i.e. how to achieve these broad objectives and then using the firms' employees and capital as effectively as possible to realise these.

In Croatia, management of the state's SOE portfolio has been dispersed, has varied between SOEs and often involves several actors. While ownership rights for non-strategic SOEs are largely exercised by the Centre for Restructuring and Sale (CERP), for SOEs of "special interest" they have been split between the Ministry for Physical Planning, Construction and State Assets, respective line ministries, and the Ministry of Finance (OECD, 2021[55]). The role of the Ministry of Finance as a central coordinator of the state's ownership is being bolstered and this can improve governance and better align Croatia's settings with OECD guidelines (OECD, 2015[59]). Strengthening the role of a central, de-politicised entity can overcome overlapping responsibilities and coordination problems (OECD, 2021[55]). To further consolidate SOE management, Croatia could consider making such an entity the direct owner of its SOEs.

Developing a more transparent ownership policy can allow SOE governance to be further aligned with OECD guidelines:

- First, setting clear and transparent objectives for SOEs would improve monitoring and detecting shortfalls in operations, supporting SOEs' financial and delivery performance. There is no comprehensive overview of SOEs' individual objectives in Croatia. Broad mandates may instead derive from a range of national or sectoral strategic documents or laws and can be unclear for some SOEs. In addition, these financial targets are generally set by SOEs and may not be shared with line ministries, and in some cases not even with supervisory boards (OECD, 2021[55]).
- Second, interactions between SOEs and oversight bodies could be further formalised. Using an SOE for political or private gains hinges on having channels of communication and influence, and oversight bodies can be vehicles for this. Accordingly, OECD guidelines suggests governments should not interfere with business operations and limit communications to formal exchanges involving the supervisory board (OECD, 2015[59]; OECD, 2019[60]). There is no law in Croatia forbidding government bodies to give direct instructions to SOE supervisory boards or management. While interactions between SOEs and, under reformed arrangements, the Ministry of Finance are more formalised, for example through letters, reports to the OECD suggest that line ministries often communicate directly with CEOs of SOEs on operational matters without involving the supervisory board (OECD, 2021[55]).

Empowering supervisory boards to foster good management

A firm's top managers are crucial in its performance, including for SOEs (Criscuolo et al., 2021[63]; Gibbons and Henderson, 2013[64]; Syverson, 2011[65]). Supervisory boards play an important role in ensuring professional management that acts in all stakeholders' interests (OECD, 2015[66]; OECD, 2023[58]).

The independence criteria of Croatia's supervisory boards could be strengthened. In OECD countries, the risk for undue influence in appointments and operations is lower in SOEs with a higher share of board members who are independent (OECD, 2023[58]). In Croatia, except for companies listed on the stock exchange, there is no formal requirement that at least some members of supervisory boards be independent, contrary to OECD Guidelines (OECD, 2015[59]). Most SOEs do not have any independent board members. In the largest SOEs, on average about one-quarter of board members are classified as independent, albeit with 'independence' defined weakly, to include, for example, civil servants that do not come from the department supervising the SOE criteria (OECD, 2021[52]). Several board members considered as independent have political affiliations as party members or political representatives (OECD, 2021[52]). Board independence could be strengthened by mandating a minimum number of independent board members, while strengthening the criteria for independence so that no state representatives, including civil servants, are considered as independent (OECD, 2021[52]). In addition, in line with G20/OECD Principles of Corporate Governance (OECD, 2015[66]), appointments could be made for fixed terms – to reduce incentives to shore-up support among particular stakeholders while serving on the board. Staggering these terms would additionally improve independence from the electoral cycle.

More supervisory boards could be given the right to appoint top managers, in line with OECD Guidelines (OECD, 2015[59]). For SOEs of special interest, members of the management board are generally appointed by the government based on a proposal of the respective line ministry. This increases the risk of political appointments. Supervisory boards are also not generally allowed to remove top management without consulting the government, which limits their ability to hold management accountable.

Higher pay for supervisory boards may be needed to attract high calibre members, especially from the private sector. The large share of board members hired from the government and public sector may partly reflect difficulties in attracting candidates from the private sector because of the low remuneration (OECD, 2021[52]). Board-member remuneration among private sector competitors of SOEs can be two-to-three times higher than at the SOEs (OECD, 2021[55]). Also, SOE management board pay rates are not typically benchmarked to firm performance.

Main findings and recommendations

FINDINGS	RECOMMENDATIONS (Key recommendations in bold)
Improving regulation, judicial efficacy and government integrity	
Croatia's regulatory framework can potentially assure effective regulation. However, shortfalls in implementation mean regulatory burdens on businesses often remain high. Responsibilities for conducting regulatory impact assessments are dispersed, staff turnover is high, and staff often lack sufficient economic background or training. Lack of coordination in devising and implementing spatial plans across subnational authorities often lead to delays in securing land rights.	**Apply regulations more effectively and ensure close monitoring of progress in paring back regulatory burdens.** Ensure follow-through on plans to expand the "SME test" on regulation. Require all subordinate legislation that potentially has a high impact on businesses to be reviewed and evaluated. Re-enforce regular forums between government administration, businesses and other relevant stakeholders to review existing regulations. Concentrate responsibilities for quality control of regulatory impact assessment in one central body, for example the Government Legislation Office (GLO). Clarify the responsibilities of different government bodies in spatial planning. Make greater use of time limits for decisions in planning processes. Establish a one-stop shop guiding investors through the processes for securing land rights.
High workloads put pressure on Croatia's judicial system. Cases, including those involving businesses, often take a long time to resolve and the system is perceived to lack in judicial independence. Long disciplinary proceedings against judges undermine public trust. The State Judicial Council's capacities have been strengthened, but shortfalls remain. Misleading and impartial reports about judicial decisions contribute to low trust.	**Promote out-of-court solutions, for example by making an initial mediation session mandatory and by recognising mediation agreements as enforceable.** Continue improving the training of judges. Assure the State Judicial Council has sufficient staff and competencies to fulfil its tasks. Revise rules to end ex officio appointments of members of the executive or legislature to the Council. Improve the judiciary's capacity to communicate its decisions, for example by establishing communication services or spokespersons.
Both high-level and petty corruption along with clientelism are perceived to be widespread. Behavioural changes and expectations of higher standards are needed among elites and the wider public. While prosecution of high-level corruption cases appears effective, delays in court proceedings further undermine trust. Detection, transparency and accountability continue to be improved through whistle-blower protection, changes to the legal system and introducing codes of ethics.	Ensure the Commission for the Resolution of Conflicts of Interests has sufficient resources to tackle its case load. **Improve transparency and accountability in the actions of policymakers and public officials by: deterrence through prosecution and sanction; ensuring adherence to ethical behaviour codes; creating lobbying registries; setting positive examples; and conducting information and awareness campaigns.**
Widespread productivity gaps and slow productivity catch-up to OECD countries are holding back convergence in living standards.	Establish a productivity board to sustain, inform and monitor productivity enhancing policy into the longer term.
Widening financing options for businesses	
The financial system is geared towards bank financing, which is often less suitable for innovative firms. While private equity markets are relatively well developed, the small scale and liquidity of public equity markets makes them less attractive for investors. R&D support is low and fragmented. The insolvency regime is being reviewed towards better anticipating insolvencies and hastening their resolution.	Develop the Zagreb Stock Exchange stock market, by simplifying its structure, listing more SOEs on the prime stock market, improving the governance framework for listed companies, and improving technical capacities for cross-border trading. Support reaching critical scale for domestic corporate bond markets, for example by providing ratings. **Better coordinate R&D support schemes, ensure they have ongoing funding, and expand the scale of public support.** Further improve the business insolvency framework, for example by strengthening creditor rights.
Improving the performance of state-owned enterprises	
State-owned enterprises (SOEs) make up a large part of Croatia's economy and their financial performance and delivery of public services often lag peers. Progress with planned divestments has been slow. Croatia's governance framework for SOEs is dispersed among several bodies which lack coordination and safeguards against undue influence for management and supervisory boards remain weak.	Continue selling off or restructuring SOEs that are not of "special interest". **Align SOE governance with OECD guidelines.** Develop a unified ownership policy with a clear rationale for public ownership for all SOEs. Set out broad mandates and objectives for SOEs. Formalise interactions between government bodies and SOE boards. Strengthen independence requirements and competencies for supervisory boards. Consider revising remuneration policies for SOE supervisory boards.

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4. A better performing labour market for inclusive convergence

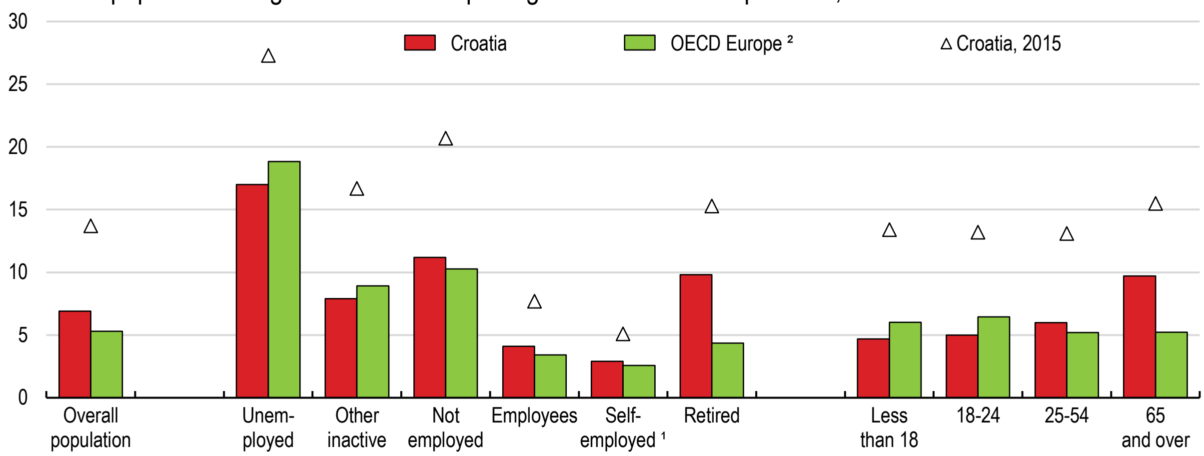
Croatia’s labour market has made important progress over the past decade. Employment rates are rising, reducing the gap with OECD countries, and poverty has fallen. While important weaknesses remain, many dimensions of equity and working conditions are similar to OECD countries. Continuing this progress is essential for Croatia’s incomes and well-being to converge with OECD countries, to counter accelerating population ageing and to make the most of emerging opportunities, including from digitalisation and the green economy transition. For employers, filling increasingly advanced skill needs is a growing obstacle. Relatively few of the young and older adults are in work – contributing to weakening skills, lower incomes and higher poverty risks. Addressing these challenges will require dramatically expanding participation in re-skilling and adult education programmes, and raising the workforce’s flexibility, for example by strengthening active labour market policies, improving the housing market’s dynamism and making the most of immigrants and returned emigrants’ skills.

Introduction

Croatia's social and labour market conditions have improved over recent decades and now compare well with OECD countries in many important dimensions. Unemployment has fallen to approach historic lows and the share of adults in work is reaching historic highs. Poverty has declined considerably (Figure 4.1). Income inequality overall is relatively low and the social safety net is being strengthened and targeting improved. Employment and wage gaps between men and women are smaller than in many countries (Figure 4.2). Personal income tax and social security contribution rates are less of a burden than in many OECD countries (discussed in Chapter 2).

Figure 4.1. Poverty has declined significantly

Percent of population living in households reporting severe material deprivation, 2020 or latest



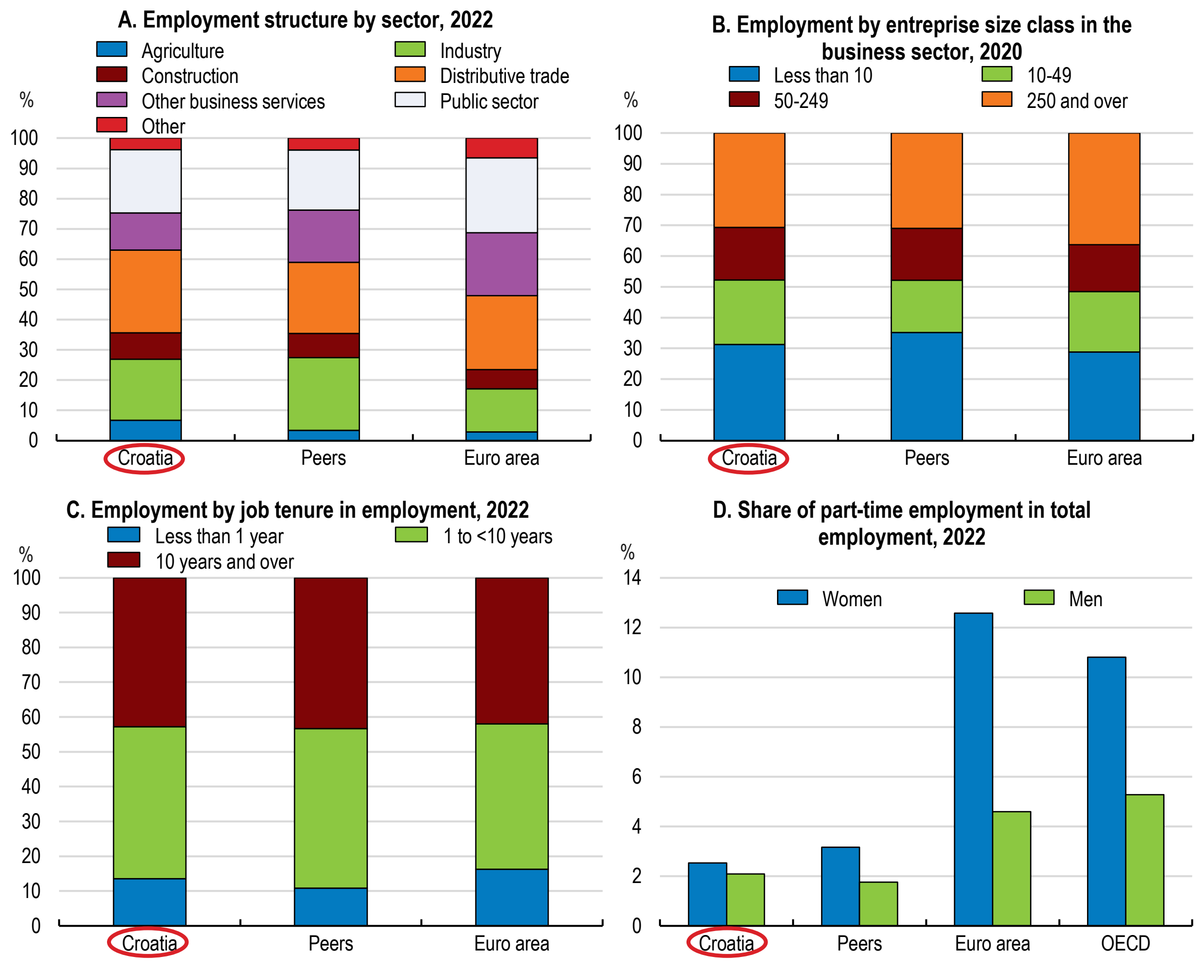
Note: The severe material deprivation rate is the proportion of the population group living in households unable to afford at least four of the following items: unexpected expenses, a one-week annual holiday away from home, a meal involving meat, chicken, or fish every second day, the adequate heating of a dwelling, durable goods like a washing machine, colour television, telephone, or car, or are confronted with payment arrears. This indicator of well-being and poverty is not affected by income underreporting.
1. 'Self-employed' is the category 'employed other than employees'.
2. EU countries that are OECD members plus Iceland, Norway, Switzerland, Türkiye and United Kingdom.
Source: Eurostat.

StatLink https://stat.link/oxyw0s

With this progress, Croatia's labour market now faces two core challenge. The first is strengthening skills. A growing share of employers report that recruitment has become a major constraint, especially for skills that are critical to advancing Croatia's digitalisation and the green economy transition (Chapter 2 and Figure 4.3). Fewer school students aim to continue into advanced education and fewer adults have completed it than in most OECD countries. Weaknesses in the vocational education system hamper students' transition from education to work. It is rare for adults to return to training or education later in life. For many, weak skills from schooling make retraining later in life more challenging.

A second, related core challenge is to raise the share of adults in formal work. Working lives in Croatia are relatively short, especially among adults with low skills living in lagging regions, and informal or undeclared activity remains significant (discussed in Box 2.9). Across groups, labour market participation lags peers and OECD countries among the young and older adults, while the share of prime-age women in employment is comparatively high (Figure 4.4) Active labour market measures provided through the public employment service have lacked the capacity to help individuals improve their employment situation and fall short of needs particularly in Croatia's lagging regions. These shortfalls in employment rates add to the challenge of a declining working-age population following decades of low fertility and significant emigration in the wake of the deep recession of the early 2010s. The number of adults aged between 25 and 64 is expected to decline by almost one-quarter between 2020 and 2050, faster than the overall population (Figure 4.5). Data suggest compromised labour mobility may be one constraint to higher labour force participation and career progression. Workers change jobs less often and those out of work are less likely to move into jobs than in many OECD countries (Figure 4.6).

Figure 4.2. The structure of Croatia's workforce in international comparison



Note: Peers is the unweighted average of Czech Republic, Hungary, Slovak Republic and Slovenia.; Panel A: Agriculture includes forestry and fishing; Industry includes energy; Distributive trade includes repairs, transports, accommodation and food service activities, Other business services include: information and communication, financial and insurance activities, real estate activities, professional, scientific, technical activities, administrative and, support service activities; Public sector includes public administration, compulsory social security, education and human health.

Source: OECD National accounts (database); OECD Structural Business Statistics (database); and OECD Labour Force Statistics (database).

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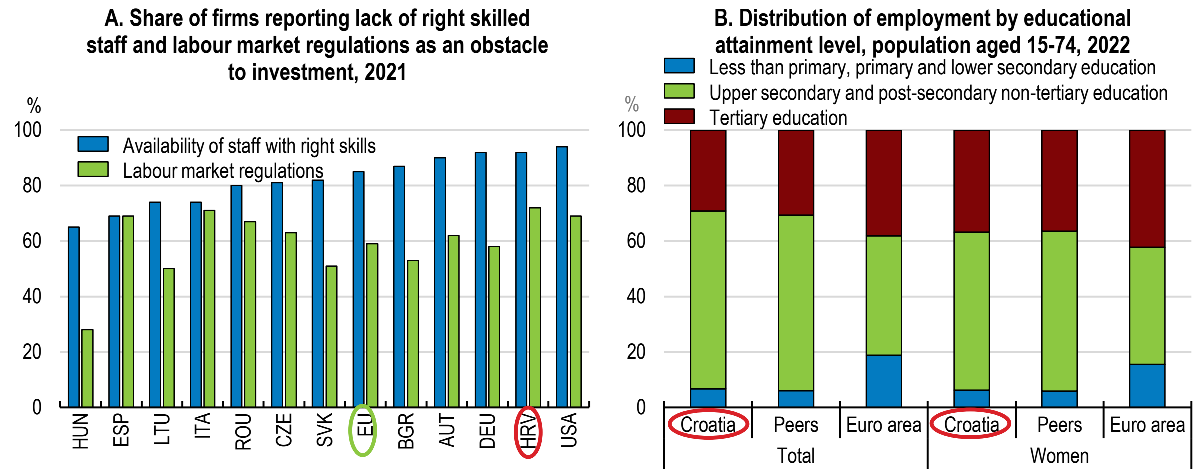
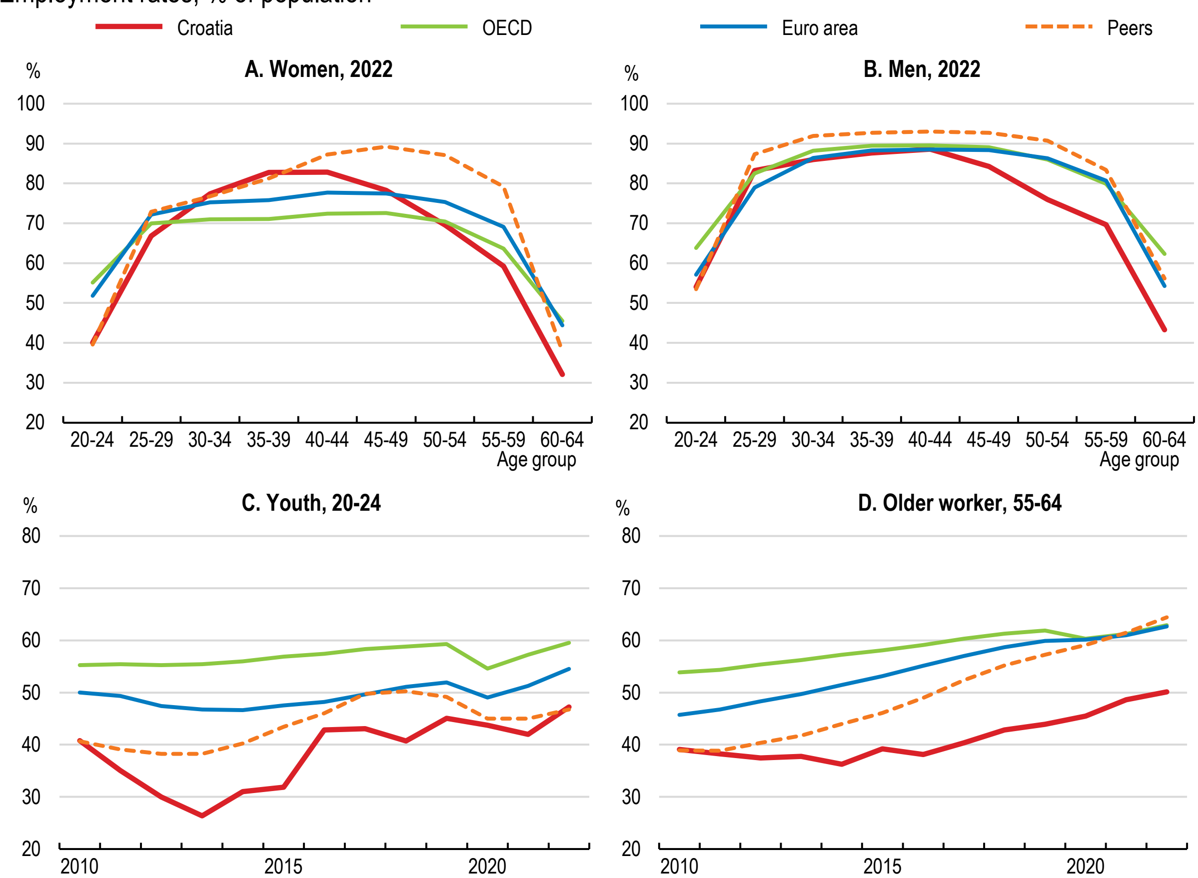
Figure 4.3. Raising the share of workers with advanced skills would address a key challenge



Source: EIB (2022), Investment Survey; Eurostat.

Figure 4.4. Croatia can further raise employment rates of younger and older adults

Employment rates, % of population

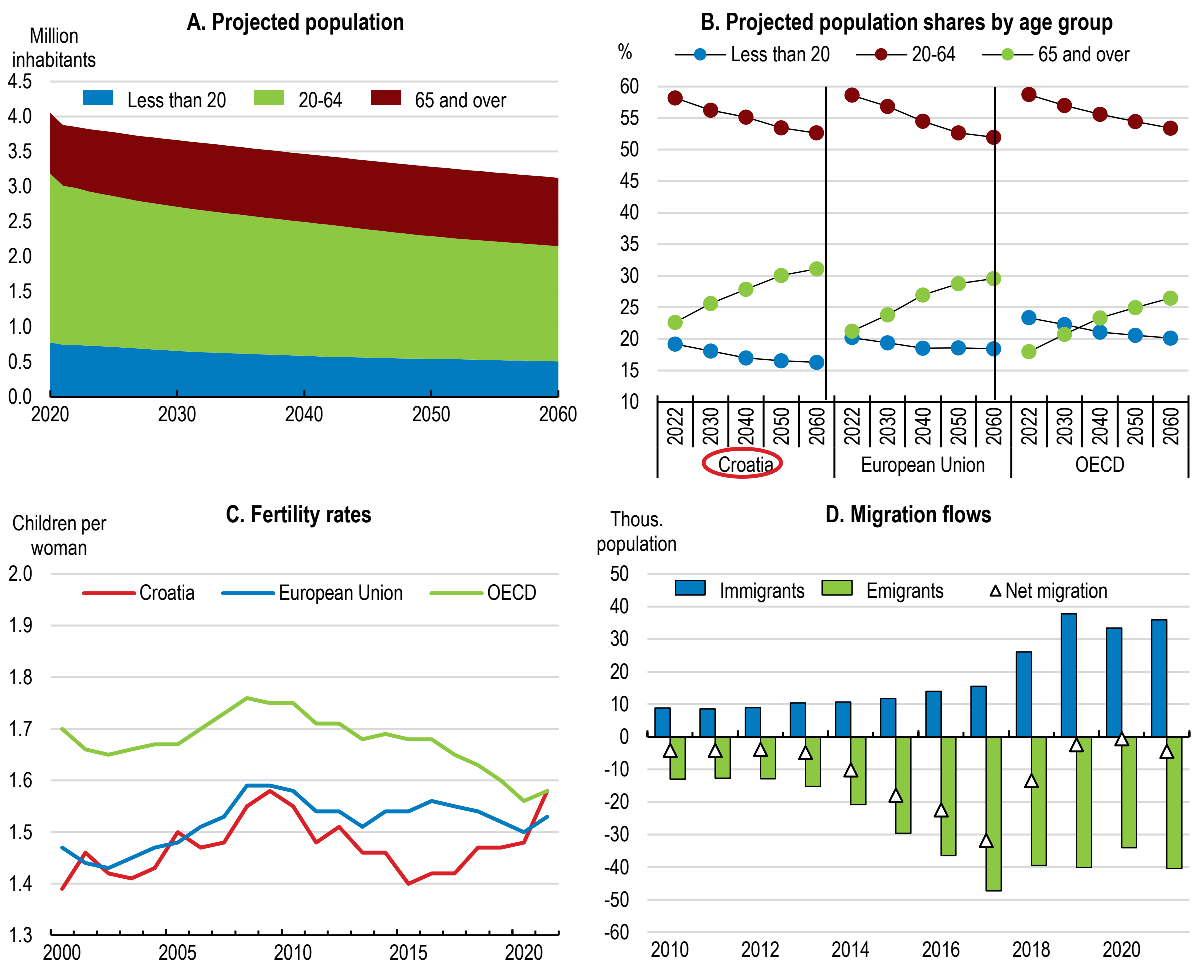


Note: Peers is the unweighted average of Czech Republic, Hungary, Slovak Republic, and Slovenia.
Source: OECD Labour Force Statistics (database).

StatLink https://stat.link/dea13l

Housing and pensions policies have a role to play in addressing these two core challenges, and in raising the share of adults in work and improving well-being. Many adults who want to relocate to areas with greater opportunities face the practical impediment of a thin rental market and high and rising house purchase prices. Also, there is some evidence of overcrowding in housing. Ensuring there are no undue disincentives to continuing work among older cohorts is a key consideration for pension policies and reducing retirees' risk of poverty.

Figure 4.5. Low fertility and net out-migration contribute to an ageing and declining population



Source: OECD Population Statistics (database); OECD Family Statistics (database); and Eurostat.

StatLink https://stat.link/yp092l

The government is accelerating reforms and investments to improve the labour market's performance, led by measures in its Recovery and Resilience Plan. It aims to raise the employment rate from 63.4% in 2021 to 70% by the end of 2024, which would be 2 percentage points above the OECD average and would represent remarkable progress. This Chapter presents priorities that align with and extend this agenda, towards strengthening how Croatia's labour market supports incomes, productivity and well-being. Primordial is a stronger push to raise skills, and other measures can support participation and movement to higher-productivity jobs:

- Investing in active labour market policies, skill development and helping adults transition into and between jobs can help those with little experience of formal work transition into sustained career.

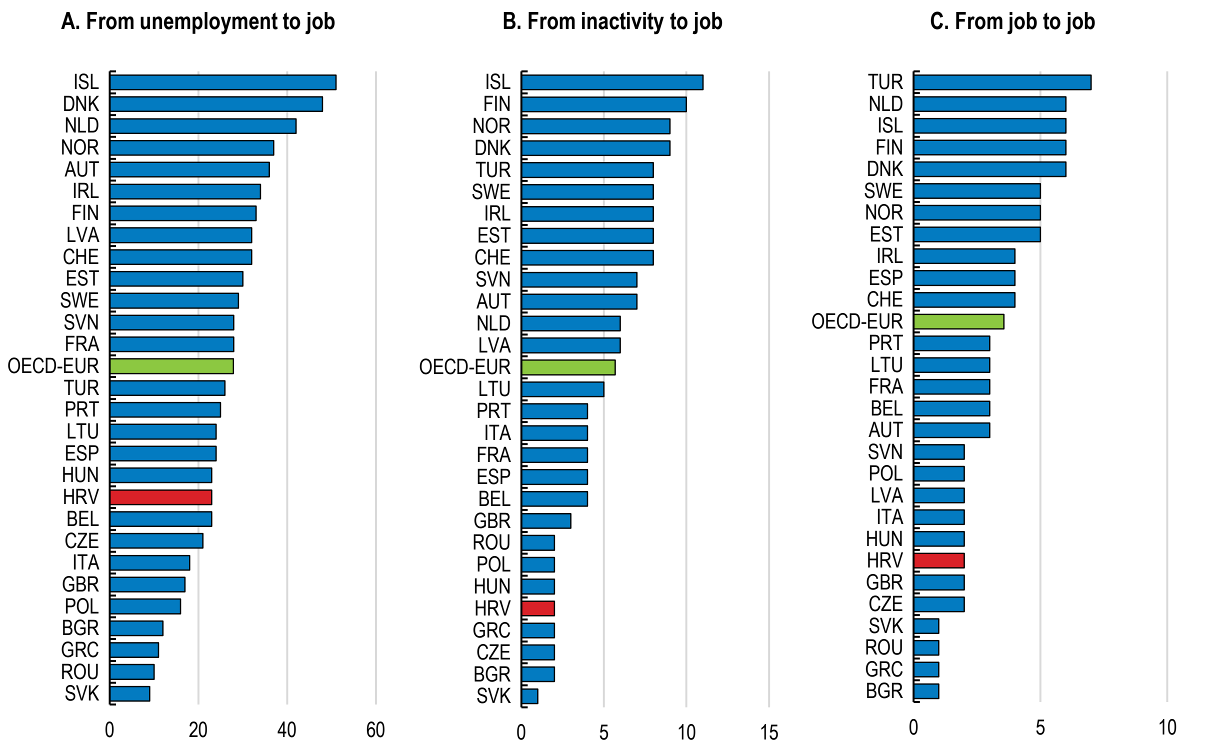
- Greater support to caregivers, by improving access to early childhood education and care and by making workplace arrangements more flexible, can reduce the obstacles for adults having careers, families and engaging in education.
- Gradually strengthening the social safety net, as fiscal conditions and measures to reduce informality allow, can improve inclusiveness while giving workers more confidence to shift jobs.
- Reforming housing taxation and construction approval processes can mobilise more of the existing stock for rental and purchases, and encourage new dwelling construction, making it easier for workers to relocate to Croatia's most economically dynamic areas.
- Creating incentives and support for older workers to continue working and to further build their pensions can extend their contribution to the economy and improve their quality of life in retirement.

Raising skills for a more productive and dynamic workforce

Levels of education are increasing but remain well below those of many OECD countries. High shares of Croatia's working age population have not gone beyond intermediate levels of education (Figure 4.3). The share who has completed tertiary education is rising fast among the younger population but is still only one in five across the population, well below OECD and EU averages. A relatively modest share of mostly older adults has only completed very low levels of education. Relatively low shares of the workforce are over- or under-skilled for their current jobs (ILO, 2021[1]). In the workforce, the growth in employment over the past decade has been led by low-skilled jobs relative to moderate- and high-skilled jobs (Figure 4.7). Digital skills exemplify Croatia's broader skill patterns. A larger share of Croatia's population has above-basic digital skills than the European averages, especially among cohorts who are younger or more educated. However, a large shortfall remains in ICT specialists, who make up a lower share of the workforce than the EU average, and this shortage impedes businesses' integration of digital technology and ability to achieve the digital transformation (European Commission, 2022[2]).

Figure 4.6. The labour market could be more dynamic

Annual averages of quarterly labour market transitions, 2022, %



Note: Annual averages of quarterly transition probabilities estimated by Eurostat. Transitions from unemployment to job are expressed as share of previously unemployed people, while job-to-job transitions are expressed as share of previously employed persons and transitions from inactivity are expressed as share of previously inactive people.
Source: Eurostat.

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Upgrading adults' skills

Croatia's adults can build on their high completion rates of intermediate education by participating more in formal and informal skill upgrading programmes. More adult skill training can also help the minority with low levels of education reduce their risk of economic and social exclusion. Very few adults in Croatia, lower shares than in most OECD countries, participate in ongoing education, regardless of their previous education or engagement in the labour market (Figure 4.8). Survey data show four-fifths of respondents who did not participate in adult learning did not want to. This is despite more qualified workers receiving significant wage premiums, higher than in many OECD EU countries (Pipień and Roszkowska, 2018[3]), (Botrić, 2016[4]). Key reasons for not participating included the cost of training, and inflexible scheduling (Figure 4.8, Panel D). Raising adults' participation in skill development will require addressing both training supply and demand.

Expanding access to quality skill-upgrading programmes

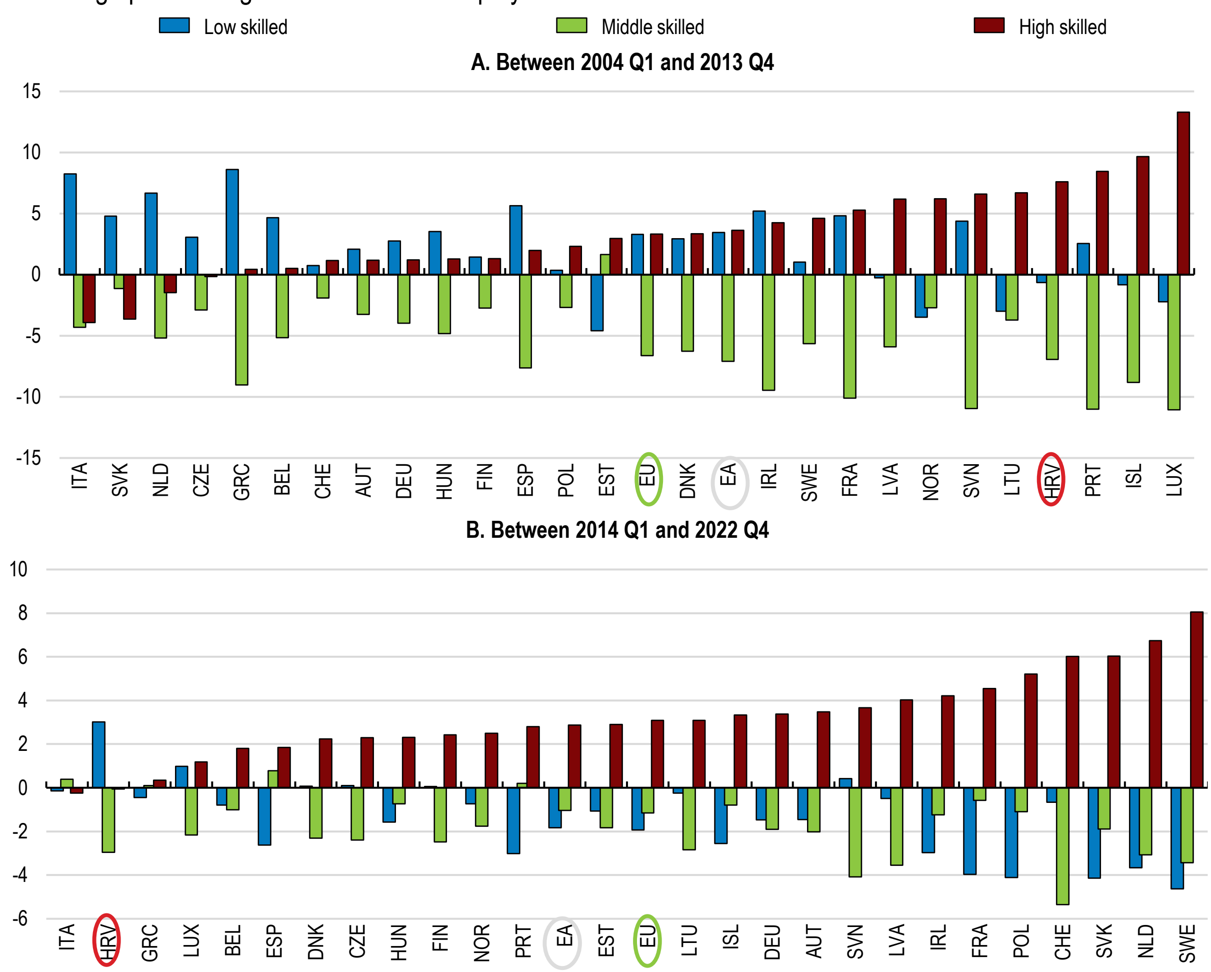
Croatia is raising the number of adults engaging in adult education with a voucher programme that targets groups in greatest need of skill upgrading. Introduced in 2022, the scheme is funded by the Recovery and Resilience Plan, which limits the programme to digital and green skills. Vouchers are awarded based on an assessment of skills conducted by the Croatia Employment Service's officers. The programme's initial capacity is modest. The government plans to cover 26 400 people in the programme, including 13 000 who are inactive, long-term unemployed, or young people not in education or employment by 2025. In late

2022, the labour force survey reported 91 000 people aged 15 to 29 years to be out of employment or education, and 107 000 aged 25 or older were long-term unemployed, while the Croatian Employment Service had 118 000 registered unemployed.

Demand in its first year has exceeded providers' capacity for digital skills programmes but has lagged for green skills. Participants have been predominately higher-skilled adults, who often are already in work and want to deepen their skills, rather than lower-skilled adults out of the workforce. In response, the government is expanding the programme, while ensuring that more places provide the broader training needed by lower-skilled adults out of employment. The strong initial demand and the government's planned expansion, in a context where motivating adults to participate in education programmes has been challenging, are welcome and merit being further pursued.

Figure 4.7. The share of low-skilled jobs has grown over the past decade

Percentage point change in share of total employment



Note: Total employment refers to civilian employment excluding agricultural workers. High-skilled occupations include jobs classified under the ISCO-88 major groups: legislators, senior officials, and managers (group 1), professionals (group 2), and technicians and associate professionals (group 3). Middle-skilled occupations include clerks (group 4), craft and related trades workers (group 7), and plant and machine operators and assemblers (group 8). Low-skilled occupations include service workers and shop and market sales workers (group 5), and elementary occupations (group 9).
Source: Calculations based on Eurostat data.

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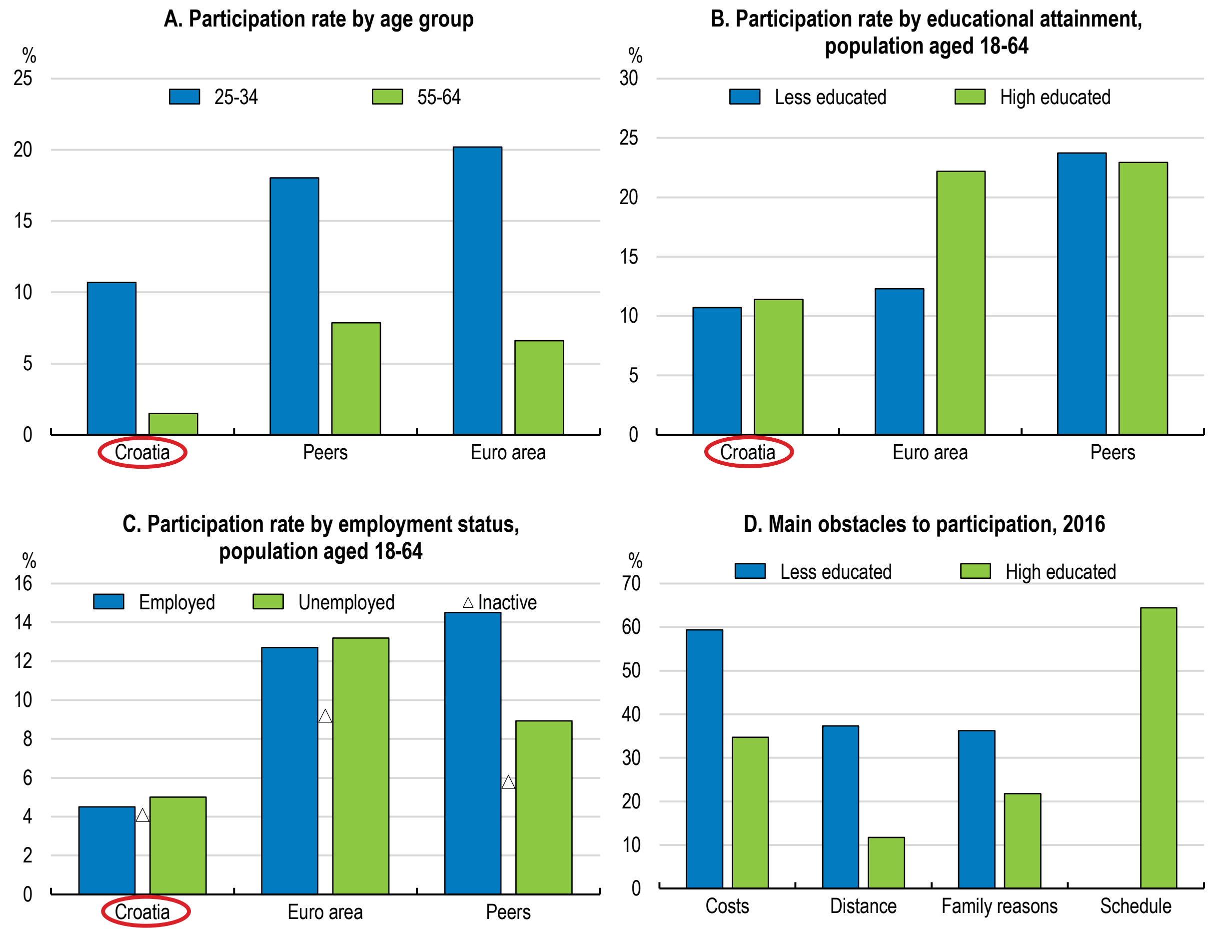
Further measures to increase the availability of adult education courses would help make the voucher system a success and more broadly strengthen adult education. These could include:

Figure 4.8. Few adults participate in training, partly due to programmes' cost and inflexibility

Participation rate and obstacles to participation in education and training, % of the population, 2022



Note: 'Peers' is the unweighted average of Czech Republic, Hungary, Slovak Republic, and Slovenia. Includes formal as well as non-formal education and training. The reference period for participation is the four weeks prior to the interview. Low educational attainment refers to below upper secondary education (ISCED 0-2) and high refers to tertiary education (ISCED 5-8).
Source: Eurostat.

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- Expanding the number of educational programmes that meet the voucher programme's standards. Croatia already has over 350 institutions providing adult education which could be brought into the programme. Implementing the 2021 Law on Adult Education's new framework for quality assurance in adult education would provide greater transparency to participants.
- Developing distance learning opportunities could expand access to education for adults, notably those in lagging regions, and for those with busy schedules. Adult education providers in many OECD countries have shifted to hybrid formats, for example with part of course work provided online. Legal reforms in 2021 allow all educational programmes to be taught at distance, subject to the approval of the Agency for Vocational Education and Training and Adult Education. Introducing territorial targets for the number of training voucher users could motivate providers to reach under-served populations.

- Building greater flexibility into the design of adult education programmes can help adults tailor learning programmes to their capacity and schedules. A system of learning credits, aligned with the European Credit Systems and the Bologna process, can support this. Croatia adopted a renewed classification of complete and partial qualifications and associated them with the national qualifications framework in 2018. The system has been only partly implemented and does not yet allow programmes to be tailored (European Commission/EACEA/Eurydice, 2021[5]). Implementing the 2021 Law on Adult Education's recognition of micro-credentials and obliging providers to harmonise educational programs with the occupation and qualification standards registered in the Register of the Croatian Qualification Framework would be positive steps.
- Providing more opportunities for those who have not completed lower secondary education, with a special focus on vulnerable groups (e.g., Roma). To access higher level adult education programmes, participants must have completed lower secondary education. The government finances this training. Still, it adds a barrier for the mostly older adults who have completed only basic schooling. A number of OECD countries allow these adults to access shorter, practical VET programmes. In countries without a minimum education-level requirement, such as Ireland, Finland or Sweden, the education provider has the discretion to determine if a candidate has the necessary knowledge or skills to complete a learning programme.

Encouraging greater demand for adult education and training

Croatia provides income support and subsidises programme costs for those undertaking educational programmes, prioritising those with the fewest qualifications. However, this support may be insufficient for many potential participants. Further, the process for providing financial support is relatively bureaucratic, which may impede access or scaling-up programmes. For example, for subsidies for primary education for adults (osnovna škola za odrasle), the Ministry of Science and Education covers programme costs and provides the Croatian Employment Service (CES) the names of those enrolled. Registered unemployed can receive reimbursements of their transport costs and income support of 50% of the gross minimum daily wage less compulsory social security contributions of 20%. This support may be insufficient to motivate adults to forgo employment income. At the same time, income support needs to be designed to ensure that it does not discourage participants from completing their studies and starting work.

Measures that improve the transparency and comparability of skills can raise demand for skill training programmes. In 2018, Croatia adopted a renewed classification of complete and partial qualifications and associated them with the national qualification framework. Recruiters report that this is helping to set national standards for courses. Greater progress can be made to applying the Quality Framework for Traineeships standards to open-market traineeships (non-mandatory, bilateral, and private agreements agreed between a trainee and a traineeship provider) (European Commission, 2023[6]).

Croatia's introduction of a credit system for adult learning courses is welcome, but implementation is lagging. The system does not allow study programmes to be customised to an individual's needs and capacities. Currently skills are validated primarily through labour market participants. Croatia has committed to recognise prior learning. Adopting a system, similar to many OECD countries, of an independent or neutral institution that validates education courses, would improve the transparency and attractiveness of adult learning, and reduce barriers for adults with few qualifications. Being able to obtain generally recognised post-secondary qualifications through adult education courses, especially in an environment where such qualifications are rare, could further motivate participation.

Skill audits can help encourage more adults to upgrade their skills. Croatia is one of a minority of European countries that provides skills audits (or skills assessments) of those registering as unemployed or at risk of unemployment (European Commission/EACEA/Eurydice, 2021[5]). Modest, although higher than the EU average, shares of working-age adults report receiving free information or advice. This maps out skills acquired through work experience, and supports job matching and training. Greater use of skill audits can help adults whether in employment or out of the workforce to analyse their career background, position in the labour force, and plan training needs or validate non-formal training.

Croatia is developing a system to validate non-formal and informal learning outcomes, aligning standards with the learning outcomes laid out in the Croatian Qualification Framework Registry. Measures introduced with the new training voucher (discussed above) are strengthening this accreditation. Such validation adds value to participating in adult learning and helps employers identify candidates with needed skills, and merits being implemented and its effectiveness monitored.

Engaging children in education from an earlier age

Children's participation in early childhood education and care, at near 80%, lags most OECD countries and is exceptionally low among children younger than three. This is due in part to compulsory school attendance starting late, even after recent reforms lowered it to the age of six years. The availability of places falls well short of demand for children below the age of compulsory schooling. Costs are not a primary barrier to enrolling children. In Croatia, parents contribute to the cost of early childhood education and care for the years prior to compulsory pre-school. Still, the net fees for children of all ages are low relative to incomes, even if they vary between localities, reflecting in part the high share of places provided publicly. Even though parents from vulnerable groups receive targeted support for childcare costs and preferential access to places, children from more advantaged backgrounds are better able to secure places, contributing to a larger enrolment gap between the two groups than in most OECD countries.

The government is using Recovery and Resilience Plan resources to expand the number of places available, with the commendable goal of raising enrolment rates among children aged from 3 years to school age from 76.3% in 2018 to 90% in 2026, and to 96% by 2030. Expanding access to childcare can make inroads into several of Croatia's long-term challenges. It is associated with stronger educational progress at school, particularly benefiting children from disadvantaged households. It can improve the inclusiveness of the labour market and reduce gender inequalities (OECD, 2017[7]) (Matković, Dobrotić and Baran, 2019[8]). When affordable facilities are not accessible or not trusted, families often turn to their extended family to care for children. While this may reduce costs, there is often less attention to learning, and relying on this care makes relocating more difficult.

The long gap between when parental leave expires and when guaranteed places in kindergartens becoming available can be a barrier for women who are considering having children. Even if a place can be found, the preschool year is short. In practice, hours are also short in the compulsory early childhood education and care system and the government aims to increase the number of hours during the compulsory year of preschool from 250 to 700. Extending them to at least standard school hours, and ideally standard work hours, would help parents manage the demands of care and work, especially if they have children in different levels of the education system. For example, in the Czech Republic facilities are available for up to 60 hours per week, while in Slovenia, 98% of children attend full-time kindergarten programmes offering six to nine hours per day (30-45 weekly hours) (European Commission/EACEA/Eurydice, 2019[9]).

Ensuring schools provide solid educational foundations

Strengthening Croatia's school system has been, rightly, a high public priority for many years. Croatia's schooling compares favourably with many OECD countries on several dimensions including completion rates, equality of opportunity and outcomes, student well-being, classroom discipline and bullying. Also, resources for education in Croatia appear relatively ample. Overall spending on education, at above 5% of GDP, is higher than many OECD countries. Pay rates for teachers are comparable to other countries relative to GDP per capita, teacher-to-student ratios are comparatively low, especially for tertiary education, and relatively few principals report staff shortages.

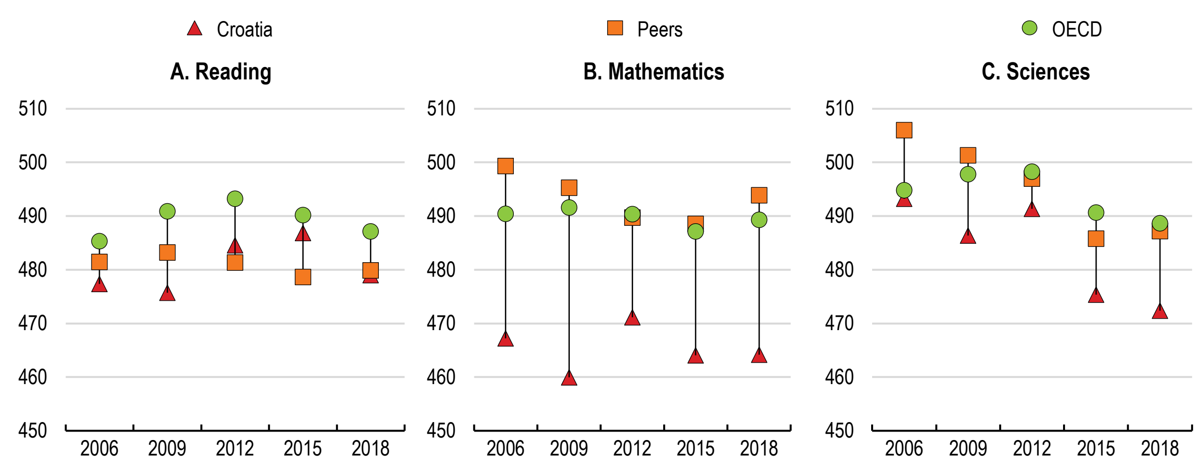
However, there remain shortfalls in learning performance, particularly in mathematics and science. The OECD's Programme for International Student Assessment (PISA) tests suggest that Croatia's 15-year-old students lag significantly behind their regional peers or the OECD average, especially for mathematics, and their performance has declined for sciences notably among the lowest-achieving students (Figure 4.9). Comparatively high shares of parents use after-school tutoring, which also suggests teaching in schools may be underperforming, adding to the pressures to achieve well on the state exam. There remain important gender differences, such as in study interests, for example: 11% of high-performing boys but 1% of high-performing girls want to study ICT (Avvisati et al., 2019[10]).

Croatia is using its Recovery and Resilience Plan to improve education. For older students, strengthening vocational education is appropriately a high priority. To encourage greater participation in education in STEM and in ICT, the government's Recovery and Resilience Plan provides grants to develop scholarships in related subjects and to promote these fields from the earliest levels of education. The government is improving curricula, and developing new teaching materials, training opportunities for teachers and regional skill centres. More than half of 15-year-olds in Croatia were enrolled in vocational programmes, compared with 14% on average in OECD countries, highlighting vocational schools' central role in providing education. Analysis of the PISA data suggests that Croatia could improve schools' performance and students' foundation and job skills by extending schools' teaching time, developing educators' autonomy and accountability, and by providing students with greater guidance about their subject and career choices (OECD, 2020[11]).

Limited classroom space has impeded raising school hours to lengths typical of most European countries. Hours in class are comparatively short in Croatia and shorter hours are statistically associated with poorer results on standardised tests, especially among students from disadvantaged backgrounds. Many schools run multiple shifts of classes over the day to make full of use of their classrooms, which creates challenges in scheduling for schools, students and parents. The scheduling problems mean 80% of students and over 90% in disadvantaged schools report taking additional classes outside of normal school hours (OECD, 2020[11]). To an extent, declining student population is freeing up classroom space to achieve this but new school facilities are also needed.

Figure 4.9. Croatia's education needs to improve, especially in mathematics and sciences

Mean PISA score in reading, mathematics, and sciences



Note: The unweighted OECD average covers all OECD countries depending on data availability. Unweighted average of Peers covers Czech Republic, Hungary, Slovenia, and Slovak Republic.
Source: OECD, PISA 2006, 2009, 2012, 2015 and 2018 databases.

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Developing greater autonomy for educators and schools, accompanied by ensuring accountability, can improve educational outcomes. Schools in Croatia have had limited autonomy, notably in curriculum and assessment, and in allocating resources. Developing autonomy requires investing in teachers' and school administrators' capacities. This autonomy better supports schools' performance when accompanied by transparent accountability around educational performance. Relatively few schools post achievement results publicly in Croatia, and the share doing so declined between 2006 and 2018 (OECD, 2020[11]).

The government's 'whole day' schooling reform is its flagship programme to address many of the school system's challenges. It focuses on primary school, and its first pilot will commence with the 2023/24 school year, with full implementation expected by 2027/28. It will bring harmonised hours and support for students after class. It will provide teachers with greater resources and flexibility to adapt learning to students' needs, and will expand access to extracurricular and extra-academic education for all students, with the goals of improving students' achievements, reducing inequalities and improving teachers' working conditions. Implementing these reforms effectively will require good dissemination strategies, for instance to inform and train teachers in curriculum changes. Implementation will also need strong coordination across levels of government and across agencies, for example by ensuring that local governments, which are responsible for maintaining school buildings, have the resources and capacity to do so.

Guidance about how students can best structure their studies to achieve their career ambitions and be ready for labour market needs improves job-readiness and students' satisfaction and ambition. However nearly 30% of students in Croatia do not have access to such guidance, a share that is much higher than most OECD countries and has risen over the past decade, although, encouragingly, such guidance is more readily available in disadvantaged schools. Career guidance helps students (as well as adults out of school) make informed choices about their education and occupation. Students who receive career counselling focus more on their studies (Rupani, Haughey and Cooper, 2012[12]). Low-achieving and low-income students tend to benefit the most, as they are less likely to have other sources of information and assistance. To achieve this, Croatia can pursue plans to develop its career guidance system, and ensure that students have access to guidance prior to key decision points in their studies such as when selecting subjects for the final years of secondary schooling (OECD, 2004[13]; OECD, 2019[14]).

Helping youth graduate into work

While Croatia's youth unemployment rate has fallen dramatically over the past half decade, many youth struggle with the transition from study to work. The share neither working nor in education is higher than in many OECD countries (Figure 4.10). This joblessness weighs heavily on those individuals' life-time employment, income and well-being prospects (Schmillen and Umkehrer, 2017[15]). Efforts are underway to improve the vocational education system, and the preparation for work from schooling, and realising these can help improve the job-readiness of Croatia's youth.

Greater access to effective career guidance in schools would help students choose studies that better suit both their interests and the labour market's needs. It can strengthen social mobility by informing young people of career paths that their family and social networks may not suggest. However, career guidance services were not available to over one-quarter of students in Croatia's schools in 2018, and to nearly 15% of disadvantaged students, well above the OECD average (OECD, 2020[11]).

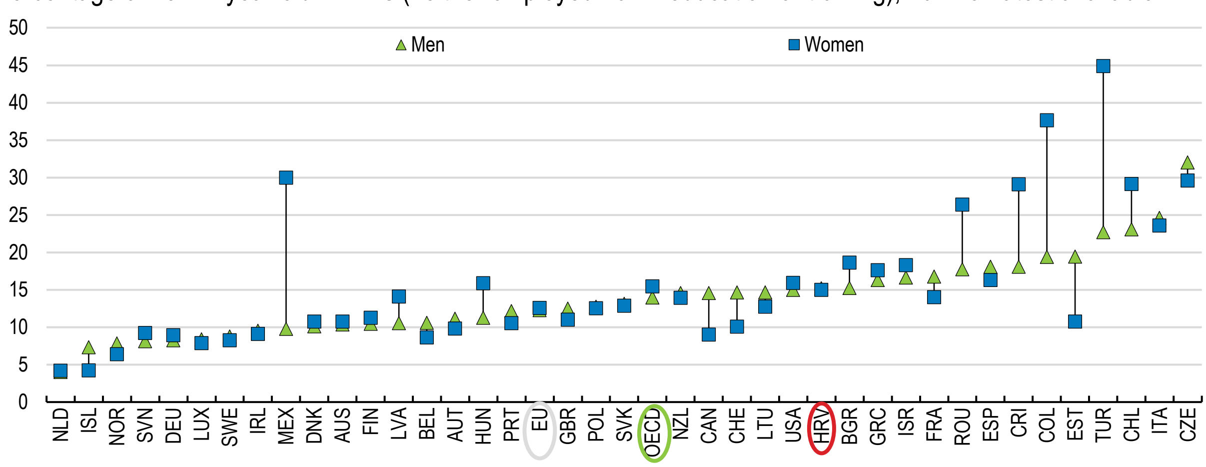
Improvements to vocational education and training at the high school level can help reduce the numbers of young people neither in work nor in education. A relatively high share of upper-secondary school students is enrolled in vocational education and training schools. Modernising these schools' curricula to better align with employers' current and future needs and students' interests, and incorporating greater work-based learning can improve students prospects of successfully transitioning from school to work. The government is expanding the place of in-work experience in educational programmes, which is welcome. Pursuing planned reforms in these directions would be an appropriate complement to the whole-day school reforms (discussed above).

Ensuring that more vulnerable youth enter and complete apprenticeship programmes is a challenge in Croatia, as it is in many OECD countries. At-risk youth may lack the motivation and skills to find a position for an apprenticeship or to complete it, with high non-completion rates in many countries (OECD, 2014[10]). Croatia is currently reforming its programmes dedicated to higher-risk youth. These focus on developing essential practical skills for performing less demanding work so students are job ready. It may consider developing pre-apprenticeship programmes targeting disadvantaged youth. In OECD countries including Austria and Germany, such programmes prepare young people by improving their skills, building motivation, familiarising them with work routines and giving them short spells of work experience (OECD, 2018[16]).

Improved apprenticeship renumeration should also be considered. A study found the low levels of income provided to trainee participants younger than 30 in Croatia (50% of the minimum wage, less the 20% social contribution) discouraged youth from participating in the programme. Very low wage rates for trainees risks leading employers to cycle through trainees rather than recruiting and developing staff, and can make participation difficult for those coming from disadvantaged backgrounds. Currently in Croatia employers of young people undertaking workplace training are not obliged to contribute to trainees' social security, which excludes some trainees from certain benefits. A public consultation found that ensuring participants receive social security benefits while participating in traineeships would improve traineeships' attractiveness (European Commission, 2023[6]).

Figure 4.10. A significant share of young people is neither employed or in education

Percentage of 18–24-year-old NEETs (neither employed nor in education or training), 2022 or latest available



Source: OECD (2023), Education at a Glance Database, http://stats.oecd.org; and Eurostat.

StatLink https://stat.link/o3q2xj

Making the most of immigrants' and returning emigrants' skills

Increasing numbers of young and skilled immigrants are helping Croatia address skills shortages. Immigration can also help to counter the ageing workforce. Croatia received significant inflows of migrants over the 1990s and early 2000s especially, largely related to movements during the 1990s' wars. About 10% of the population aged between 15 and 64. was born outside of Croatia, but largely speak Croatian and have Croatian nationality. The composition of immigrants is changing and is likely to change further over coming years and numbers are set to rise, following Croatia's integration into the Schengen area and the introduction of skilled immigrant visas (Figure 4.5).

The skilled immigration strategy could be improved. The recently introduced approach provides immigrant working visas following requests from employers, where the employer reports a skill gaps. A more proactive approach would be to anticipate the labour market's needs and to seek immigrants with the needed skills. Croatia is planning to augment its policy with new measures to support immigrants' education and training as part of its Recovery and Resilience Plan. However, more courses helping immigrants integrate into Croatian society should be considered, such as encouraging immigrants to participate in Croatian language classes. Currently the government only provides such classes to immigrants under protection visas, and some employers provide them too. Participation in language and cultural courses could be combined with a skills and job assessment. An evaluation of such a combined programme in Switzerland found that it improved immigrants' training and integration (OECD, 2022[17]). Immigrants' qualification and skills could be better recognised. Currently recognition processes can be long, bureaucratic and costly. For instance, they have contributed to highly qualified refugees from Ukraine taking low-skilled jobs.

Emigration from Croatia rose considerably when Croatian citizens could move freely to other member countries of the European Union. Between 1 July 2013, when Croatia joined the European Union, and 2020, departures rose to average almost 33 000 per year and peaked at over 47 000 in 2017. Approximately 44% of these emigrants were aged between 20 and 39, the equivalent of 1.5% of residents in this age group. This compares with a little over 10 000 residents emigrating each year on average between 1999 and 2012. Flows fell over the COVID crisis period, but recent anecdotal reports suggest that emigration of younger, skilled workers remains a drag on the labour market.

Emigrants can benefit Croatia's economy. Workers' remittances reached EUR 5.1 billion (7.6% of GDP) in 2022, comprising employee compensation from residents of Croatia working elsewhere and from personal transfers from those residing outside Croatia. In the longer-term, the measures discussed throughout this *Survey* to expand opportunities for the young and for productive businesses, by improving Croatia's business environment, government effectiveness and reducing corruption, are among the most effective means of ensuring skilled residents stay and encouraging emigrants to return (Carling and Talleraas, 2016[18]). Croatia is developing efforts to encourage emigrants and their descendants to return, such as the Scholarship for Croatian Language Learning programme, or the "I choose Croatia" scheme. Additional measures could be considered (Box 4.1).

Box 4.1. Policies to encourage emigrants to return

Several OECD countries have developed policies to maintain a global network of emigrants and to support and encourage those who wish to return, such as Ireland's 'Global Irish'. Some countries, such as Lithuania and Poland, have developed dedicated information services to communicate to emigrants who left for better economic opportunities elsewhere on the improved situation in their origin country. To support returnees, some countries integrate support with that for immigrants. This can include dedicated one-stop shops providing access to social support services, or dedicated employment services (Lithuania or Spain's "Service Labour Mediation"). Programmes such as Ireland's "Back for Business" mentoring programme provide returning emigrants with business mentoring and support for creating a business plan, on financial management skills, navigating bureaucratic processes, and accessing finance. To enhance financial incentives to return, several countries provide reduced tax rates or other financial incentives, including Greece, Portugal and Lithuania.

These policies have succeeded in supporting limited numbers of returning emigrants relative to the outflows. Some OECD members and partners, including Mexico, Colombia and South Africa, have struggled to achieve significant return migration flows. Constantly evaluating and adjusting policies supporting returning emigrants can contribute to more effective programmes. Overall, ensuring a supportive economic environment and growing opportunities and prospects, as discussed in Chapter 3, is likely to be the most effective means of limiting emigration and encouraging emigrants' return.

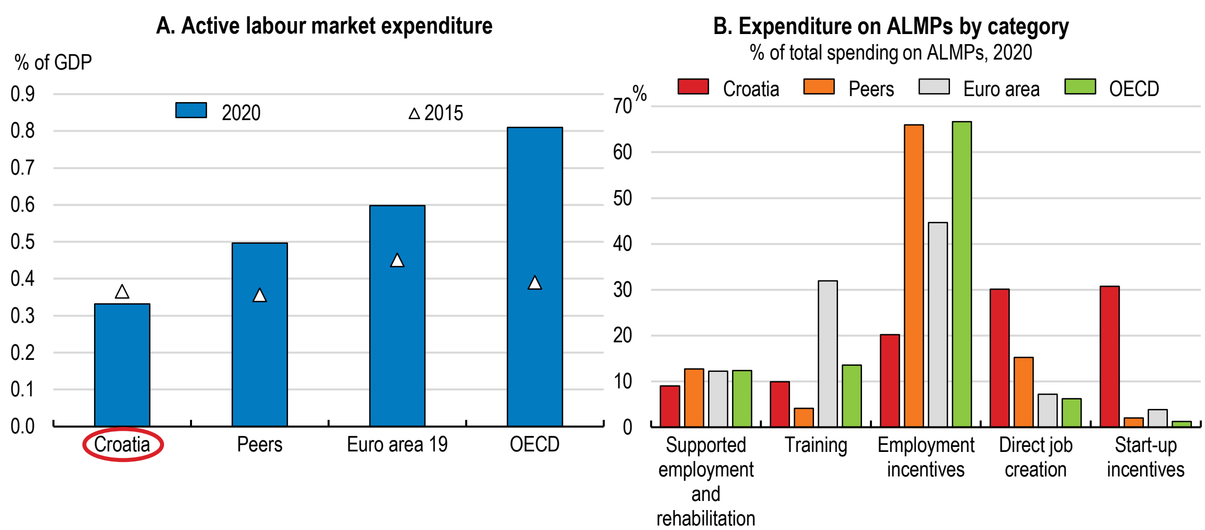
Source: (Boros and Hegedűs, 2016[19]; OECD, 2016[20]; Hajn-Schaur and Frelak, 2019[21]).

Improving active labour market policies

Over the past 15 years Croatia has been developing a system of modern active labour market policies, and spending is comparable to Croatia's peers and many OECD countries (Figure 4.11). Initially these efforts focused on employment through direct job creation and start-up incentives or self-employment subsidies. Assessments suggest these policies have been effective at getting the recently unemployed with skills and experience back into work. Their effectiveness has been weaker among those with short or disrupted work histories and with lower skills (Srhoj and Zilic, 2020[22]). This is consistent with assessments of the effectiveness of active labour market policies internationally (Card, Kluve and Weber, 2017[23]).

Croatia's development of active labour market policies has more recently focused on strengthening the Croatian Employment Service and expanding support for training and education. Such measures are often among the more effective for the groups that Croatia now needs to activate. Funding has grown significantly since the mid-2010s. The Recovery and Resilience Plan allocates EUR 277 million (0.4% of 2023 GDP) around four interventions that can further strengthen active labour market policies: i) the development of new activation policies; ii) a voucher system for adult education especially in green and digital skills (discussed above); iii) strengthening polices for inclusion and the monitoring of vulnerable groups in the labour market; and iv) digitalisation of the public employment services.

Figure 4.11. Croatia's spending to help people into work is comparable with peers and focused on job creation



Note: Peers is the unweighted average of Czech Republic, Hungary, Slovak Republic, and Slovenia. 2019 data shown given the exceptional measures introduced by all countries in response to the COVID-19 crisis in 2020.
Source: European Commission - Directorate-General for Employment, Social Affairs, and Inclusion (DG EMPL); and OECD Labour Market Policies (database).

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Croatia's strengthening of the public employment services includes the development of profiling and case management. These tools can adapt support to those with low education or with little time spent in formal work. Experience across countries is that youth new to the workforce, older adults and the long-term out-of-work, whose activation needs are greatest, tend to require greater resources to move into work. Tailored programmes provided by dedicated support services tend to be most effective (Kluve et al., 2016[24]). Croatia is also expanding its Lifelong Career Guidance Centre (CISOK) by increasing its monitoring capabilities and making it accessible to all citizens, but the programmes' scale is modest.

Better linking activation and other social policies

A tailored programme of support for an out-of-work individual, applying a mix of social, educational and other resources, is more likely to lift that individual into a lasting job than more standardised interventions. Enabling the Croatian Employment Service to follow individuals through different types of support, including social support, education, job placement and training, and comprehensive job search, would improve outcomes. This requires high levels of communication and cooperation between different institutions and the ability to ensure that resources can follow individual jobseekers' needs, often for extended periods, rather than undertaking one-off needs assessments or short interventions. The development and planned expansion of a voucher system for vocational training (discussed above), in part administered by the Croatian Employment Service, are steps in the right direction, as is the introduction of social mentoring services for particularly socially disadvantaged individuals. However effective coordination and extended support has been a challenge in Croatia (European Commission, 2020[25]; Cipcic, 2019[26]). Developing these would constitute a useful next step in Croatia's upgrading of its active labour market policies.

Croatia's formal activation requirements for access to unemployment benefit are stricter than in most OECD countries. Activation support when combined with some sanction mechanisms linked to social support can raise employment rates. However, excessively punitive enforcement of activation requirements can be counterproductive. Studies in some OECD countries over periods when activation requirements and sanctions were particularly strong, such as the United Kingdom over the 2010s, have found that they can discourage the households with the greatest needs from engaging with services providing income support and other social services (Work and Pensions Committee, 2018[27]; Wright et al., 2016[28]). Excessively punitive sanctions may also discourage individuals from looking for work (Immervoll and Knotz, 2018[29]).

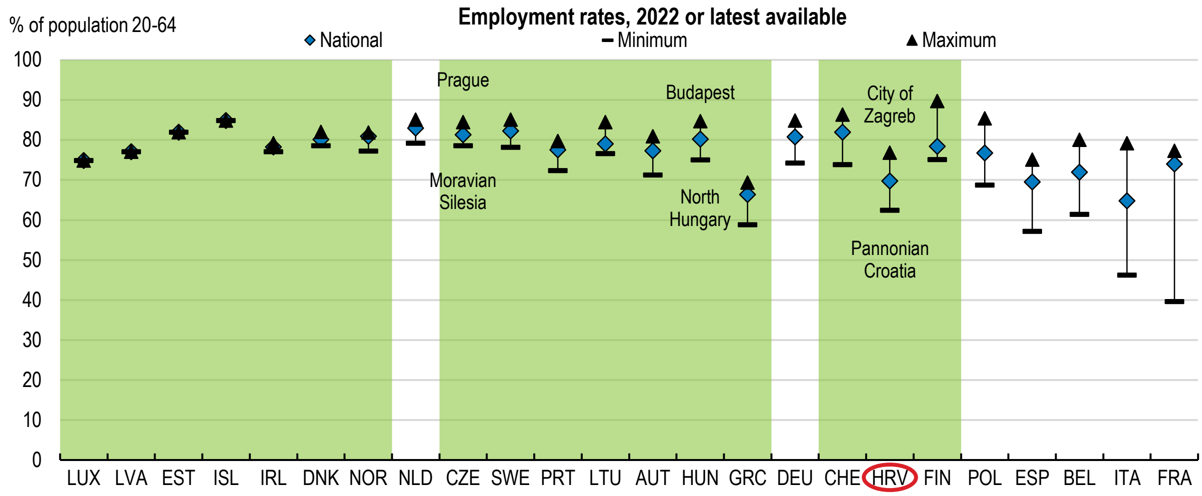
Croatia is making welcome investments in monitoring and evaluating the performance of the Croatian Employment Service. It is piloting customer and staff feedback surveys with plans to roll these out nationally once their design is completed. In 2025 it plans to review the effectiveness and outcomes of the programmes supported by its Recovery and Resilience Plan. Performance indicators can help shift the Croatian Employment Service and other providers from a managerial approach to one focused on achieving better outcomes.

Tailoring activation policies to regional needs

Differences in employment rates between regions are large considering Croatia's relatively small size. Yet, the Recovery and Resilience Plan actions do not focus strongly on adapting support to varying regional needs (Figure 4.12). Currently services available in lagging areas such as Slavonia lack adequate capacity (Christiaensen et al., 2019[30]). The Plan proposes expanding the regional network of Lifelong Career Guidance Centres and greater tailoring of support measures to needs. However much of the policy builds on the existing management structure of active labour market policies. These are relatively centralised. For example, the central ministry defines objectives and leaves local operators with little autonomy in service provision (Corti and Ruiz La Ossa, 2023[31]).

Further developing local providers' autonomy and access to additional resources, including more explicit focusing of active-labour-market spending in areas with lower share of adults in paid work, could help reduce these inter-regional inequalities. The ongoing investments in digitalising the public employment services can make inroads into the service's process-heavy operations, which have limited staff's time to work with jobseekers, and these efforts can benefit from further measures to transform the service's internal operations to a greater service-delivery focus (European Commission, 2020[25]).

Figure 4.12. Employment rates vary considerably across Croatia



Note: Small countries having a population of less than 11 million are shaded. Regions are at the large (NUT2/TL2) levels, of which Croatia has four. Data refer to 2020 for Türkiye and 2019 for the United Kingdom.
Source: Eurostat.

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Social protection to support employment, inclusiveness, and well-being

Croatia has made significant inroads into poverty in recent years to achieve rates comparable to many OECD countries (Figure 4.1). Rising employment and wages have contributed to much of this improvement. As in many countries, formal employment is the best protection from poverty. Poverty rates are highest among out-of-work younger households, and older households. The latter are often poor because short or disrupted employment has meant they have accumulated limited pension savings (discussed below). Disposable income is more equally distributed than in many OECD countries, largely as wages overall are relatively narrowly dispersed (discussed below) and through the income tax system.

Social protection spending can be better targeted. Overall social protection spending is higher than in many of Croatia's peers, and near the average of OECD countries. However, a higher share than in most countries is not means tested. Significant shares of social benefits are provided to war veterans and the disabled without means testing. This squeezes the resources available to support other groups. Indeed, Croatia's social transfers apart from pensions make smaller inroads into poverty and inequality than in most OECD countries (Figure 4.13). Boosting targeting can improve the effectiveness of social spending at reducing poverty and provide greater confidence to individuals suffering economic shocks or considering shifting jobs. Effective targeting systems can improve policy responses to shocks, such as the recent COVID-19 and energy price crises. Current approaches have led to much of the support being allocated to households who are not the most vulnerable. For example, about 14% of those who report great difficulty making ends meet received COVID-pandemic related government support, the lowest share across EU countries (Eurofound, 2023[32]). The planned digitalised household registers intended to identify individuals in need and eligible for support can greatly improve targeting. Such a system would bring Croatia's social protection system ahead of many OECD countries. It will link together information sources including tax filings, demographic information and asset registers. Putting this to work this will require building public confidence in data integrity and confidentiality, especially if it is to encourage more informal activity to be declared.

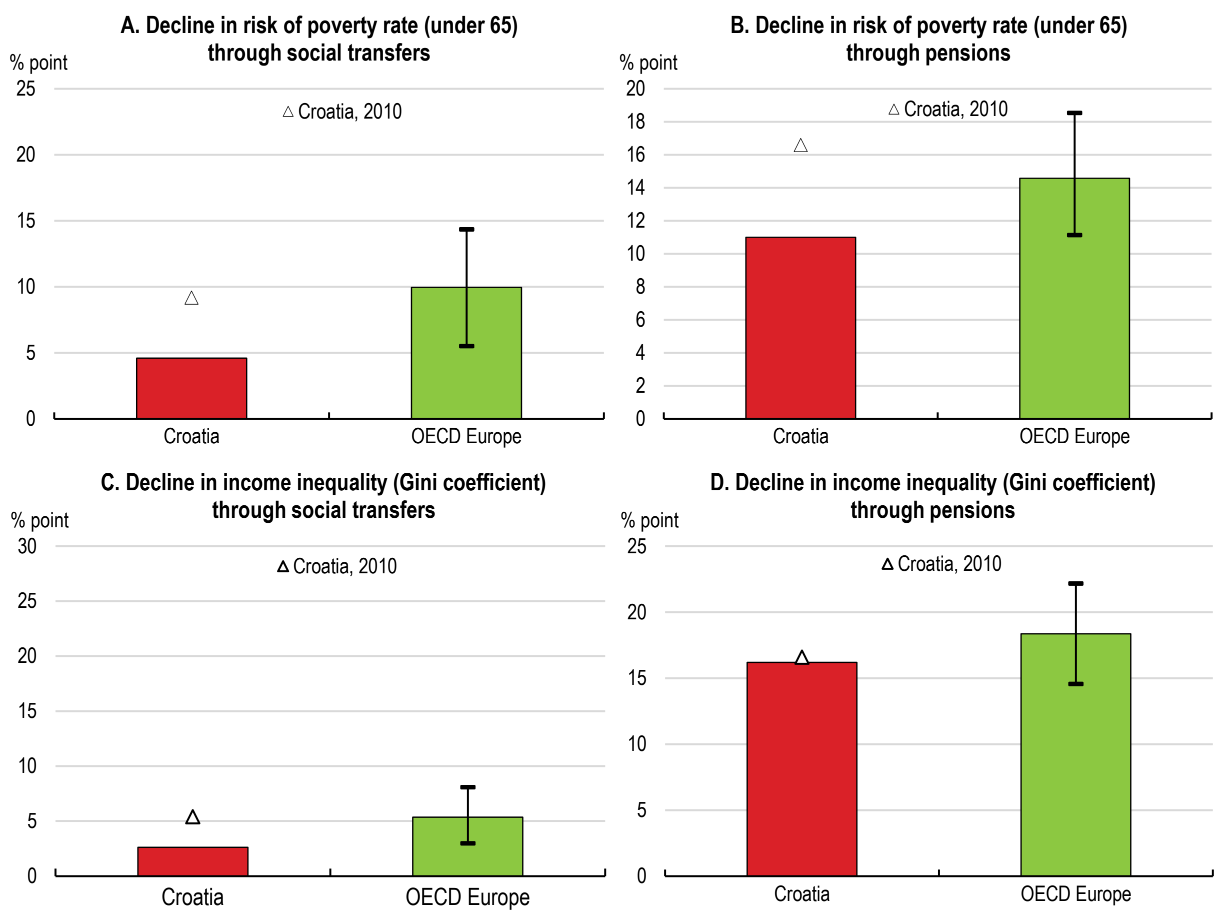
Developing the minimum social safety net

Croatia raised its main social benefits as part of its response to high energy prices (Chapter 2), following almost a decade of minimal nominal growth. For the lowest-income households, the ‘guaranteed minimum benefit’ is Croatia’s key social safety net. The benefit is lower than most OECD countries’ minimum benefit relative to the poverty line or median disposable income (Figure 4.14). Eligibility criteria are strict. If a recipient of the minimum income for at least six months enters employment, the benefit is withdrawn over three months, which is a positive design feature to encourage recipients to shift into work, rather than being withdrawn immediately. Measures in the Recovery and Resilience Plan, and recent and planned reforms of the Welfare Act are aiming to develop the link between the guaranteed minimum benefit system, other social transfers and access to employment and to social support and education services.

Croatia could also consider further developing an in-work benefit, for instance with reimbursable tax credits. It could follow other improvements to the social protection system, given the ongoing challenge of addressing un- and under-declared work. The design of further in-work support would need to avoid creating adverse financial incentives, for instance spikes in marginal effective tax rates with rising income, and to ensure that publicly funded social protection does not in practice subsidise employers' salary costs.

Figure 4.13. Pensions rather than social transfers reduce inequality and poverty in Croatia

Reduction in risk of income poverty and income inequality through social transfers and pensions, 2021 or latest available year



Note: “OECD Europe” is an unweighted average of OECD countries that are EU members plus Norway, Türkiye, and United Kingdom. The whiskers show the range between the first and last decile of the OECD Europe. Panel A and B: Poverty rate is defined at 50% of median income.
Source: OECD calculations based on Eurostat data.

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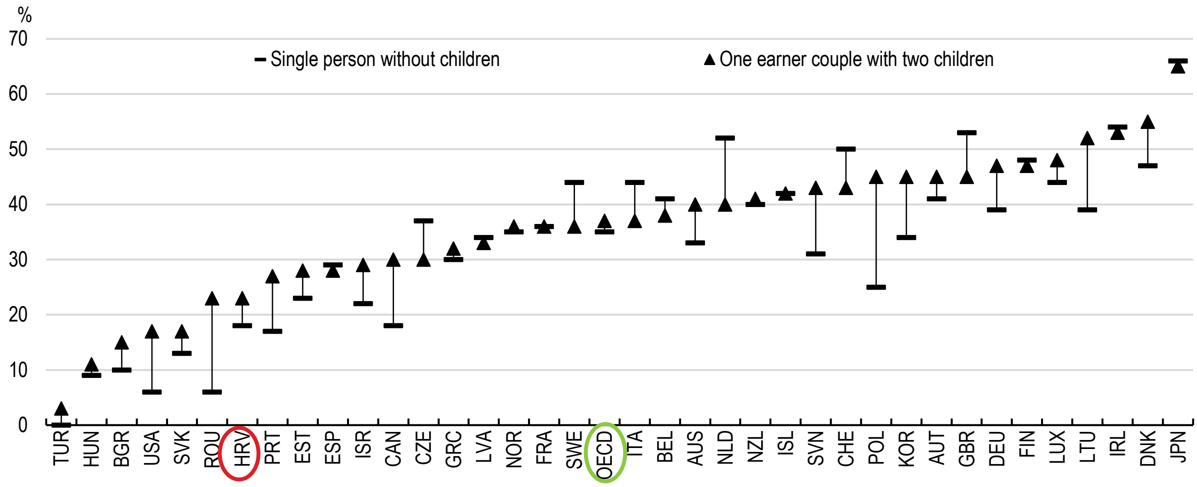
Figure 4.14. Guaranteed minimum income benefits are lower than in most OECD countries

Guaranteed minimum income amount, in % of median disposable income, 2022 or latest available year



Note: Adequacy of guaranteed minimum income is shown for a jobless person, for two sorts of family type: one single person without children and one earner couple with two children. The calculations include the impact of family benefits, housing benefits, taxes, and social contributions.
Source: OECD Benefits, Taxes and Wages (database).

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Family policies to support higher quality employment and care

Effective family policies can support access to paid employment and reduce the obstacles in choosing to have children. In Croatia, women have fewer children than in most OECD countries. Fertility fell below the replacement rate of 2.1 in the late 1960s, and, since 2000, has fluctuated between 1.4 and 1.6. Of the relatively few households who do have children, nearly three-quarters have at least two.

In the labour market, the gaps in employment and wages between men and women are smaller than in many OECD countries. Nevertheless, challenges remain in addressing differences in treatment and outcomes both in and outside the workplace. 'Glass ceilings' appear to limit women's pay rates accounting for their relatively higher education and skills (Figure 4.2, Panel E) (Nestić, 2010[33]). This is often attributed to time out from careers due to family and other care responsibilities, and may partly reflect many employers remaining inflexible on working hours or locations (Boll and Lagemann, 2018[34]). Part-time and flexible work arrangements are used less than in many OECD countries. Increase flexibility in work arrangements can help caregivers better juggle work and other tasks, and is increasingly shown to support more productive workplaces.

The tax-benefit system provides various cash payments for new parents, tax credits and cash transfers. Some distortive policies are being addressed. For example, Zagreb is discontinuing its subsidy for a stay-at-home parent in Zagreb (*Novčana pomoć za roditelja odgojitelja*), which provided a generous benefit to a non-employed parent who provided care for at least three children until the youngest child turned 15 years, and identifying and reforming similar policies elsewhere would be beneficial, and would complement measures to expand access to quality early childhood education and care discussed above.

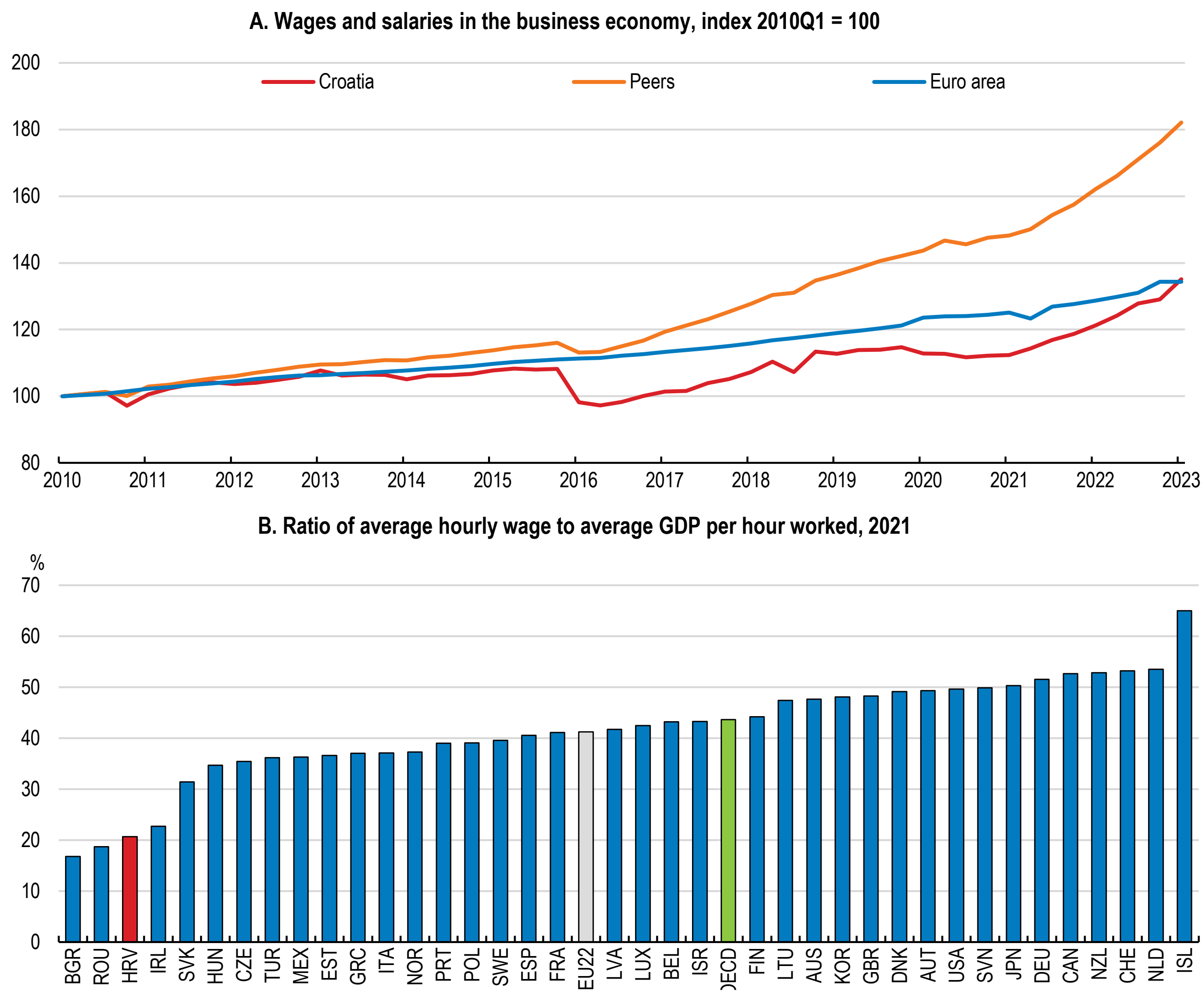
Wage setting to encourage higher productivity

Wages in Croatia have been growing firmly and faster than in many OECD countries recently, but remain moderate relative to other euro-area countries and to workers' output (Figure 4.15). The range of wage rates is narrower than in many OECD countries, and the share of workers earning a low wage relative to the median is well above the average of OECD and EU countries. Non-wage labour costs, including bonuses and employment-related taxes, have grown less than wages, moderating the overall growth in labour costs for employers. This has contributed to slower growth in the overall cost of labour per unit of output in Croatia than in many other OECD countries. Wages across the workforce in Croatia are somewhat less widely distributed than in many OECD countries, and wage dispersion has narrowed slightly over the past decade.

Improving wage bargaining

Wage setting in Croatia is fragmented, as shown by the limited coverage of collective agreements. The share of workers covered by collective agreements has declined to 47%, which is below the average of OECD countries but typical of Croatia's OECD neighbours (Figure 4.16). Company-level collective agreements cover a much larger share of workers than sectoral or higher-level agreements. Union membership rates are moderate (about one-quarter of the workforce in 2018, similar to neighbouring OECD countries) but Croatia has a large number of unions and union umbrella groups relative to the workforce's size.

Figure 4.15. Wages have been rising but are low relative to productivity



Note: Panel A: Nominal wages and salaries index. Panel B: Estimates for Bulgaria, Croatia, and Romania based on calculations using Eurostat data on labour costs index and structure of earnings statistics. OECD and EU22 averages are unweighted averages. The OECD average excludes Chile, Colombia, and Costa Rica.
Source: Eurostat and OED Analytical database.

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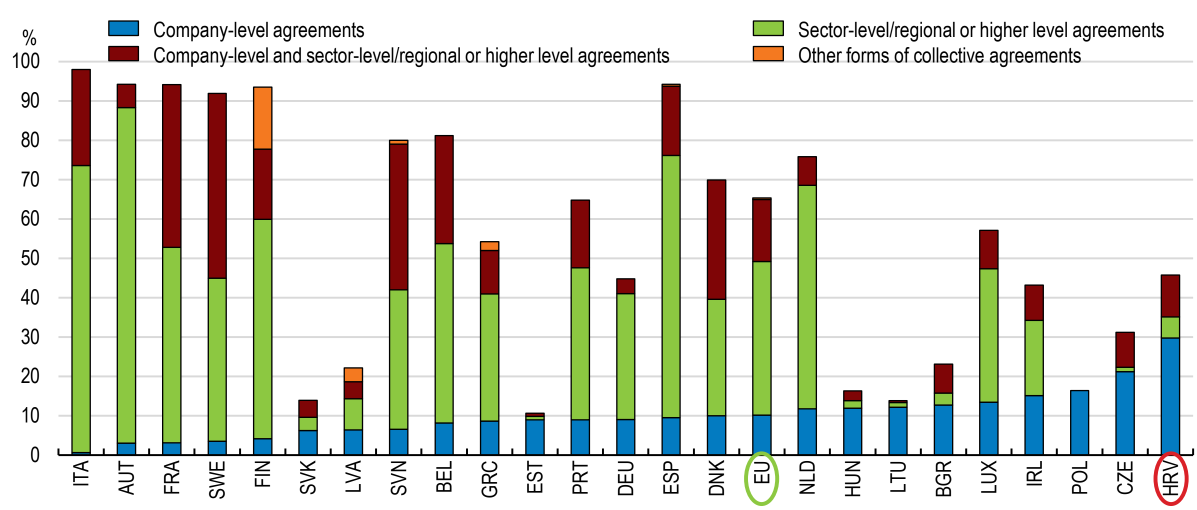
Better supporting coordination in wage-setting through collective agreements can help Croatia maintain its tradables sectors' competitiveness while ensuring that workers benefit from rising productivity. As a member of the euro, adjustment in relative prices via the exchange rate is no longer available, making adjustments to misaligned wages potentially costly in terms of lost employment or activity. In theory, collective bargaining may introduce distortions to the wage-setting process, for example, by strengthening the power of those covered by agreements relative to 'outsiders' who are not covered, but in practice empirical evidence supporting such costs is scarce (OECD, 2019[35]). In addition, effective, well-informed and constructive social dialogue accompanying coordinated wage-setting processes can bring broader benefits, such as improving the design and implementation of structural reforms or policies responding to macroeconomic shocks such as the recent surge in prices.

Coordinated wage-setting entails arrangements whereby wage increases account for prevailing macroeconomic and labour market conditions, as well as the economy's structure and other labour market institutions such as employment protection or minimum wage adjustments. This approach can help to protect Croatia's relatively low wage inequality, given that wage inequality tends to be higher in OECD countries with firm-level bargaining only or no collective bargaining compared with countries where workers are covered by sectoral bargaining. Croatia will be required to develop an action plan to promote collective bargaining to comply with a new EU directive. Across the spectrum of approaches to coordinating wage-setting (Box 4.2), one that supports greater coordination through pattern-based negotiations with workplace-level agreements may best build on Croatia's recent approach to wage-setting. Croatia's small and open economy, including the important international markets for services ranging from information technology to transport and storage to food and retail services, underlines the importance of information sharing and coordination across sectors. Croatia could strengthen an existing body such as the Economic and Social Council to make it more effective in supporting coordination across sectors and in sharing information about macroeconomic conditions, broader cost movements, wage agreements in other sectors, and developments among Croatia's competitors. Developing its role as a strong mediator would further support effective coordination.

Figure 4.16. Croatia's wage-setting is relatively decentralised

Estimated collective bargaining coverage, 2019



Source: Eurofound (2022), Moving with the times: Emerging practices and provisions in collective bargaining, Publications Office of the European Union, Luxembourg.

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Box 4.2. Approaches to wage-setting coordination

Wage co-ordination takes different forms across OECD countries. Approaches can be categorised according to whether co-ordination is imposed by the state, follows agreements in leading sectors, and by the degree of co-ordination (OECD, 2019[35]).

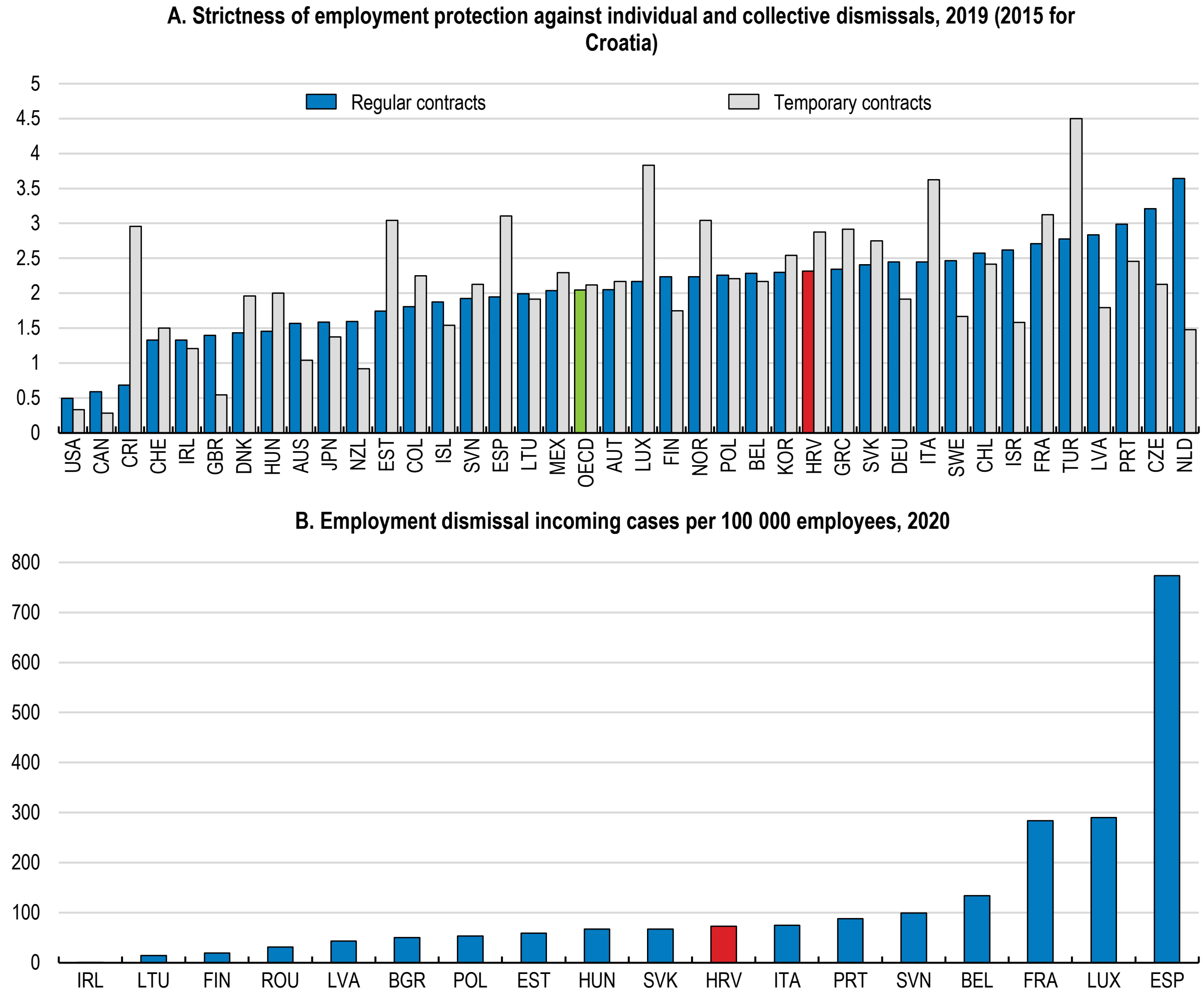
- Co-ordination is strongest when it is imposed by the state. It can operate through indexation rules, binding minimum wages and/or rules for maximum adjustments. Belgium is currently the only OECD country that follows this approach. Wages are indexed to living costs but capped by a "wage norm" which accounts for (weighted) wage developments in its main trading partners (France, Germany and the Netherlands) on top of a statutory minimum wage negotiated between social partners.
- Pattern bargaining, where a sector (usually manufacturing, which is most exposed to trade) sets the targets, and other sectors follow. Nordic countries, Austria, Germany and the Netherlands take this approach.
- Inter- or intra-associational guidelines provide a third model of coordination. Peak-level organisations either set some norms or define an intra-associational objective that lower levels (e.g., individual workplaces) should follow. This approach is usually binding only in countries where peak-level trade unions or employer organisations are relatively strong and centralised (typically Nordic countries and to a significantly lower extent France and Italy).

Elements of coordination in Japan may be pertinent to Croatia. Coordinated wage negotiations emerged out of fragmented and politicised trade unions, and remains highly decentralised, taking place at the company level. Coordination takes place both within and across sectors. Annual negotiations typically start with large companies, with the national trade union confederation setting the intra-associational guidelines for wage adjustments, to be further specified by each sectoral-level trade union federation. This provides a minimum benchmark, and firm-level unions can negotiate over wages, bonuses and working conditions. Employers coordinate their bargaining through their organisations. While this approach has lost some of its effectiveness over recent decades, it has allowed wage setting in Japan to adjust and distribute the costs of major macroeconomic shocks while protecting employment.

Balancing protecting employees, flexibility and workplace relations

Croatia's employment protection has been liberalised to a similar level of strictness for permanent contracts as in many OECD countries, notably by the 2014 labour law (Figure 4.17, Panel A). Dismissal conditions are slightly stricter for temporary contracts, which reduces incentives for firms to use temporary rather than permanent contracts. Some relatively onerous rules remain in place, such as restrictions on which workers can be dismissed for redundancy depending on whether the worker has family dependents, for example, and limits to firms' ability to re-hire workers following redundancies. Dismissal for misconduct can take three to five years, and severance pay is mandatory for employment contracts of over two years. Addressing high protection of formal employment can contribute to reducing Croatia's still significant levels of undeclared and informal activity (discussed in Box 2.9).

Figure 4.17. Employment protection laws are somewhat stricter than the OECD average, and many dismissal cases end up in court



Source: OECD indicators of employment protection (database); and European Commission, Directorate-General for Justice and Consumers (2021), Study on the functioning of judicial systems in the EU Member States: facts and figures from the CEPEJ questionnaires 2012 to 2020. Part 1, Data tables per indicator for all EU Member States.

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Employment relations appear to be more litigious than in many of Croatia's peers, although less than in several OECD countries, for example regarding the number of dismissal cases that go to court (Figure 4.17, Panel B). Litigiousness adds to employment costs and uncertainty. Efforts should be made to reduce the number of employment disputes going to court. Part of the solution could lie in a review of compensation rules in dismissal cases. For example, large differences in compensation paid to dismissed workers depending on the reason for their dismissal can encourage conflicts. Complementing this, to hasten resolution and to minimise costs, especially for the court system, Croatia can build on the arbitration arrangements enabled by the legislation introduced over the 2010s. Most OECD countries use arbitration extensively to address labour disputes (Box 4.3 discusses the approaches used in Australia). Reducing recourse to courts would also be helped by continuing to develop the role of a dedicated service to support mediation. This could be based in Croatia's Economic and Social Council. Measures discussed elsewhere in this Chapter, including continued strengthening of active labour market policies and social protection, can reduce the pressure for strong employment protection and litigation, as dismissed workers will have greater confidence in their ability to maintain their incomes and find new and potentially more rewarding opportunities following dismissal.

Box 4.3. Australia's arbitration and mediation tools for managing employment disputes

Mediation plays an important role in resolving employment disputes in Australia. It is seen as a way of avoiding costly and time-consuming litigation. Its use reflects, among other factors, the role employment legislation gives to mediation, and to the clarity of the process. For example, in most circumstances a court or tribunal will be required to certify that mediation and conciliation is unlikely to resolve the matter before exercising its arbitrary powers.

Mediation generally consists of three stages:

1. Pre-session: The parties are prepared to mediate by setting realistic expectations about possible outcomes and encouraging them to identify desired behaviours and issues they wish to raise. The mediator discusses with human resources alternative outcomes if the mediation does not lead to an agreement. The mediator meets each party individually to understand the issues, provide information about the process and assess parties' capacity to participate in the mediation. The mediator synthesises this information and plans the mediation session.
2. The session: These are typically two to four hours. The mediator leads the session through an opening statement, venting, identifying issues and setting an agenda, discussing the issues and building an agreement, then closure.
3. Post-session: The mediator finalises the agreement and sends it to the parties to sign and implement, and follows-up with human resources on the mediation's success. Beaches of the agreement, or of confidentiality of the mediation process, can lead to penalties.

Critiques of alternative dispute resolution in Australia include that it does not develop precedent (i.e., an outcome decision does not inform future decisions), the difficulty of balancing stronger and weaker parties, and the risk that mediators favour the interests of employers, who tend to pay the mediators' costs and who may employ the mediator for other services.

Sources: (Van Gramberg, 2006[36]); (HCA, 2016[37]); (MacDermott and Riley, 2011[38])

Minimum wage setting to support vulnerable workers' incomes

Croatia's minimum wage rose by 40% between 2019 and 2023, double the increase in consumer prices and ahead of the increase in the average wage over the same period. These increases have lifted the minimum wage to similar levels with other OECD countries relative to the median disposable income (Figure 4.18, Panel A). It is higher than in most OECD countries relative to output per hour worked (Figure 4.18, Panel B). Pressure to raise the minimum wage in part reflects minimum wage earners' low incomes relative to the poverty line, in part as take-home pay is below the gross minimum wage, unlike most OECD countries where minimum wage earners' incomes are supplemented by benefits (Figure 4.18, Panel A). In the longer-term, as fiscal space and improvements to the social protection system allow, developing direct, targeted benefits to support all households at risk of poverty (discussed above) rather than relying on the minimum wage can ensure adequate incomes without risking lower competitiveness or pricing lower skill or lower-productivity workers out of formal employment (OECD, 2018[16]).

Croatia's minimum wage setting process contains many of the qualities of a system that balances protecting workers' incomes with ensuring the minimum wage does not price those workers out of employment. The government mandates increases in the minimum wage following consultations with social partners and the advice of the Commission for Monitoring and Analysis of the Minimum Wage. The Commission, established in 2019, is composed of representatives of trade unions, employers, government and academia. It analyses recent relevant trends and proposes an adjustment, although the government is not required to adopt its proposal. The legislation governing the Council stipulates factors to consider, including raising the minimum wage relative to the median wage, unemployment and employment trends, demographic trends and the state of the economy in total, paying particular attention to low-wage and vulnerable groups of employees. As Croatia's minimum wage is approaching a similar ratio to the median wage as in many OECD countries, it may be appropriate to remove the requirement that minimum wage adjustments further reduce the ratio to the median wage.

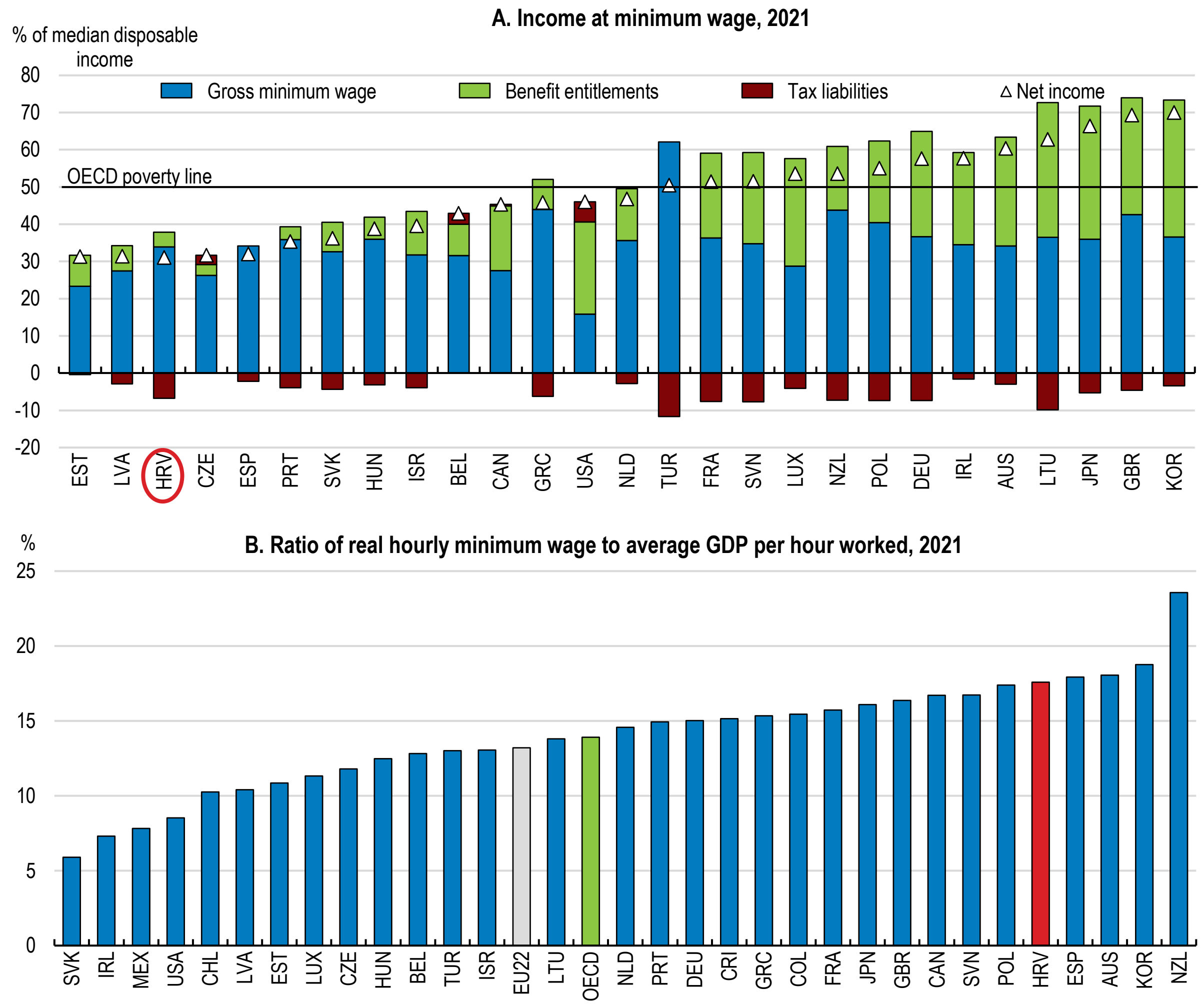
Improving access to housing to support mobility and well-being

The cost, quality and access to housing are growing concerns in Croatia, like in many OECD countries. After falling in the first half of the 2010s, prices and rents have grown rapidly in real terms since 2016 (Figure 4.19). Some of the housing stock has been damaged and destroyed over recent decades in some regions, first by the wars during the 1990s and, most recently, by the earthquakes of 2020. In the most economically dynamic regions, rapidly rising housing costs have become a barrier to growth in employment and activity.

Indicators suggest the quality of housing compares well with OECD countries across a number of dimensions. Nearly two-thirds of Croatia's population, a far higher share than in most OECD EU countries, live in a detached house, while most urban dwellers live in apartments. The housing stock compares well for quality indicators such as having a leaking roof, sufficient light or the ability to heat the dwelling adequately. Their energy efficiency compares less well, contributing to relatively high rates of energy poverty. Housing energy efficiency and engineering robustness varies considerably with age. For example, seismic engineering standards were introduced in 1963 and progressively improved over the following decades, meaning only part of the building stock meets modern standards.

Also, high homeownership, much of it without outstanding mortgage debt, means many households are secure in terms of accommodation, have sizeable housing-asset wealth and face modest outlays related to housing costs. As for some other eastern European countries, the high rate of home ownership has origins in the transfer of ownership rights from the state to households in the 1990s. Eighty-five percent of the population live in their own house without a mortgage or loan, a far higher share than in most OECD countries. Around 6% live in their own home with a mortgage and the rental market, at least among the resident population, is small (Jakopic et al., 2015[39]). Furthermore, provisions for helping low-income households with accommodation costs seem in reasonable shape. For low-income households, small housing allowances, such as housing vouchers, benefits, or rent supplements, support rental and other housing costs, temporarily or on a long-term basis. Several municipalities provide the bulk of these. Croatia's spending, at about 0.2% of GDP in 2018, was typical of many OECD EU countries.

Figure 4.18. Minimum wages are near other countries relative to incomes and high relative to productivity



Note: Panel A: Tax liabilities incudes direct taxes and social security contributions. Panel B: OECD and EU22 averages are unweighted averages. The EU22 average excludes Austria, Denmark, Finland, Italy, and Sweden. The OECD average also excludes Iceland, Norway, and Switzerland.

Source: Calculation based on data from OECD (2022), OECD Employment and Labour Market Statistics (database), OECD Productivity (database) and OECD Analytical (database).

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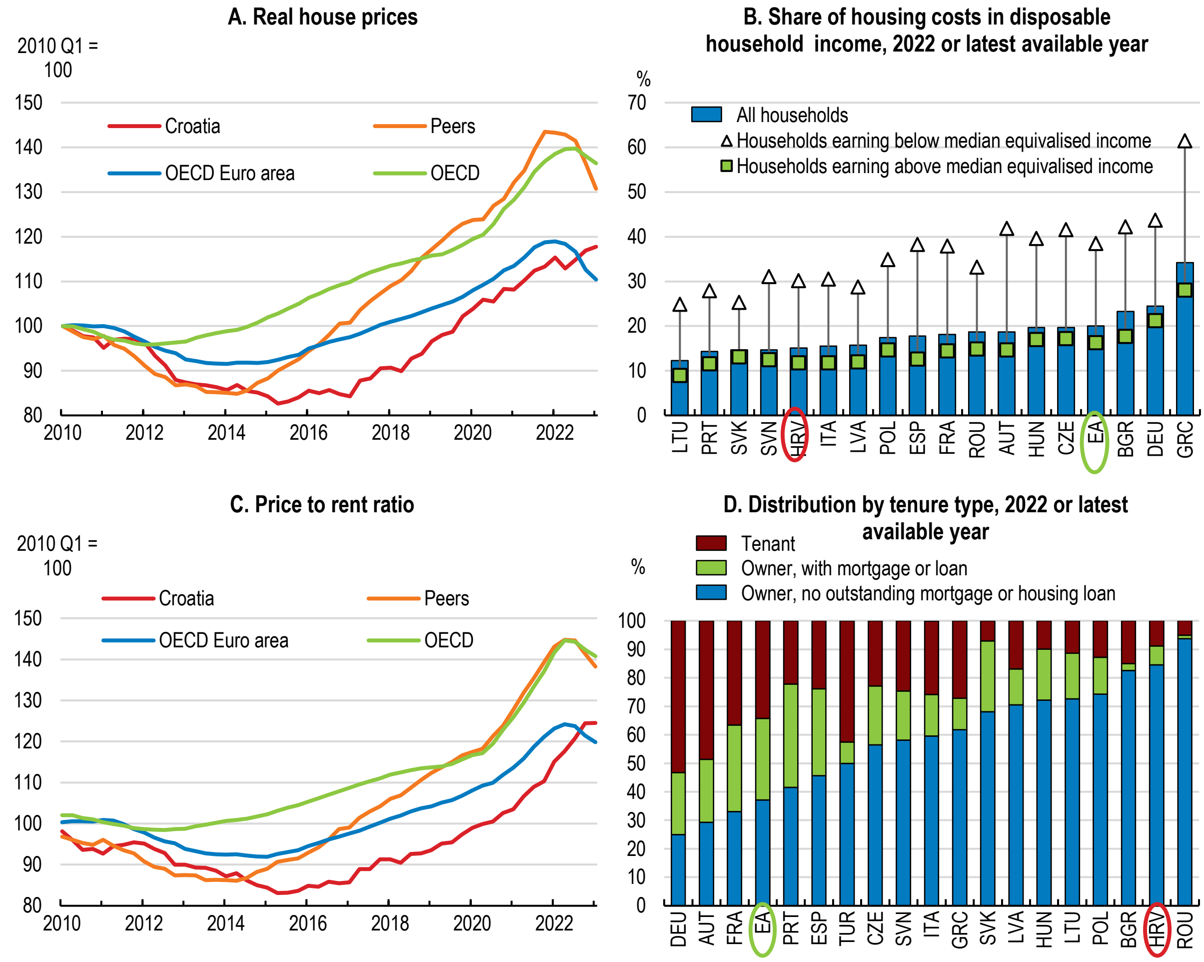
However, the very high share of owner-occupiers and small rental market suggest geographical mobility and labour market dynamism may be compromised (Causa, Luu and Abendschein, 2021[40]). Renters on the housing market were four times more likely to have relocated over a five-year period in Croatia than those who owned their residence or rented below the market price, according to data collected for the 2012 EU-SILC wave, the latest available across countries. Overall, only 5% of the population relocated over this period, one of the lowest rates across the European Union and lower than in most OECD countries.

Figure 4.19. Housing prices have been rising in Croatia



Note: 'Peers' is the unweighted average of Czech Republic, Hungary, Slovak Republic, and Slovenia. 'OECD Euro area/"EA17' refers to countries which are both members of the OECD and the Euro area.
Source: OECD Analytical house price (database); and Eurostat.

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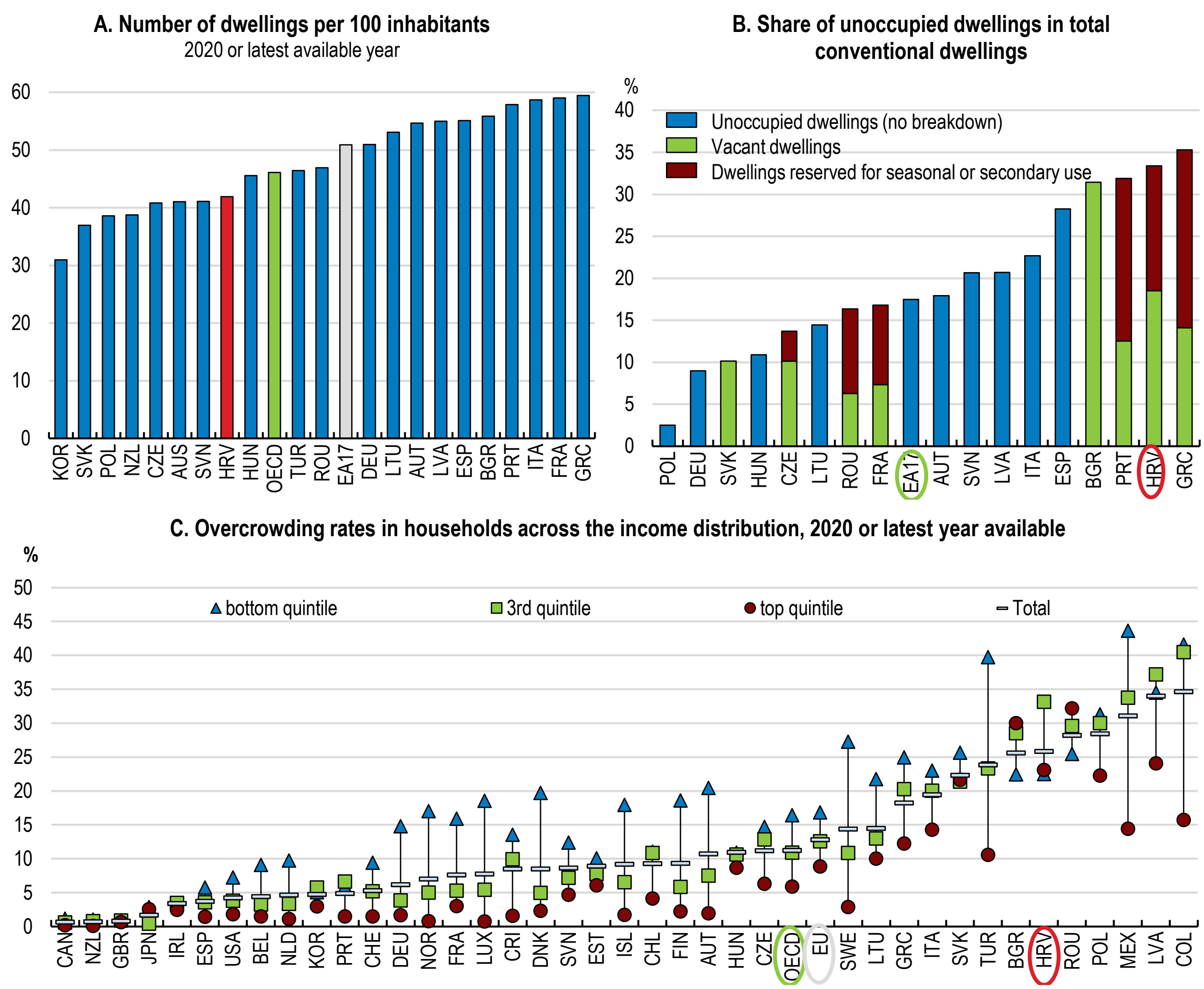
Evidence points to shortages in the supply of primary residences, and relatively high rates of overcrowding (Figure 4.20). Even accounting for the falling population in all regions apart from greater Zagreb, the total number of dwellings fell over the 2010s to 411 per 1000 inhabitants, well below the average of OECD countries (OECD, 2022[41]). The 2020 earthquakes damaged over 35 000 buildings, rendering over 10 000 dwellings at least temporarily unusable, equivalent to 0.6% of the national housing stock (Box 4.3). Demand for secondary residences, particularly by foreigners, has also increased the cost and limited the availability of primary residences, notably on the coast and in central Zagreb (Vizek, Barbić and Časni, 2023[42]; Mikulić et al., 2021[43]). Reforms in 2009 and 2012 made buying property easier for foreign owners, and online short-term rental platforms have further boosted demand. In 2021, foreign buyers accounted for more than 20% of the total value of purchases. Foreign demand is likely to have been further boosted by Croatia's integration into the euro and Schengen areas.

Box 4.4. Two earthquakes in 2020 damaged housing and public buildings

Croatia is in a seismically active area. In March 2020 a magnitude 5.5 earthquake struck with an epicentre 7 kilometres from the centre of Zagreb followed by a series of aftershocks. In December 2020, a magnitude 6.4 earthquake struck central Croatia. Together these earthquakes caused seven deaths and scores of injuries.

The recovery and reconstruction needs from the 2020 earthquakes are estimated at EUR 26 billion (around 39% of 2022 GDP), with the largest share related to housing, much in central Zagreb. However, the estimated impact on output was minor, especially relative to the pause in activity due to the COVID-19 epidemic and response measures (Government of Croatia, 2020[44]; Government of Croatia, 2021[45]). Reconstruction work was delayed first by the difficulties created by the COVID-19 related restrictions, then by delays in mobilising the construction workers and materials to undertake the work. Work accelerated in 2022 and 2023.

Figure 4.20. A large share of dwellings is unoccupied yet many households are overcrowded



Note: Panel A: Unweighted OECD and EA17 averages. GBR refers to England only; Panel B: The figure on unoccupied dwellings for Sweden refers to dwellings without registered occupants. Panel C: Share of overcrowded households by quintiles of the income distribution.
Source: OECD Affordable Housing Database – http://oe.cd/ahd; European Statistical System, Census Hub website, https://ec.europa.eu/CensusHub2/query.do?step=selectHyperCube&qhc=false.

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Some households have more complex ownership and occupation arrangements, due to the legacies of the communist period and the 1990s wars, and this contributes to low housing mobility and supply (Jakopic et al., 2015[39]). The government is undertaking a welcome consolidation of the cadastre, as multiple cadastres contribute to uncertain ownership rights, although the process is likely to take many years to complete. Ensuring that these legacies are resolved, for example at the time of inheritance, can minimise disruption to existing residents while improving the transparency and certainty of a well-documented modern property titling system.

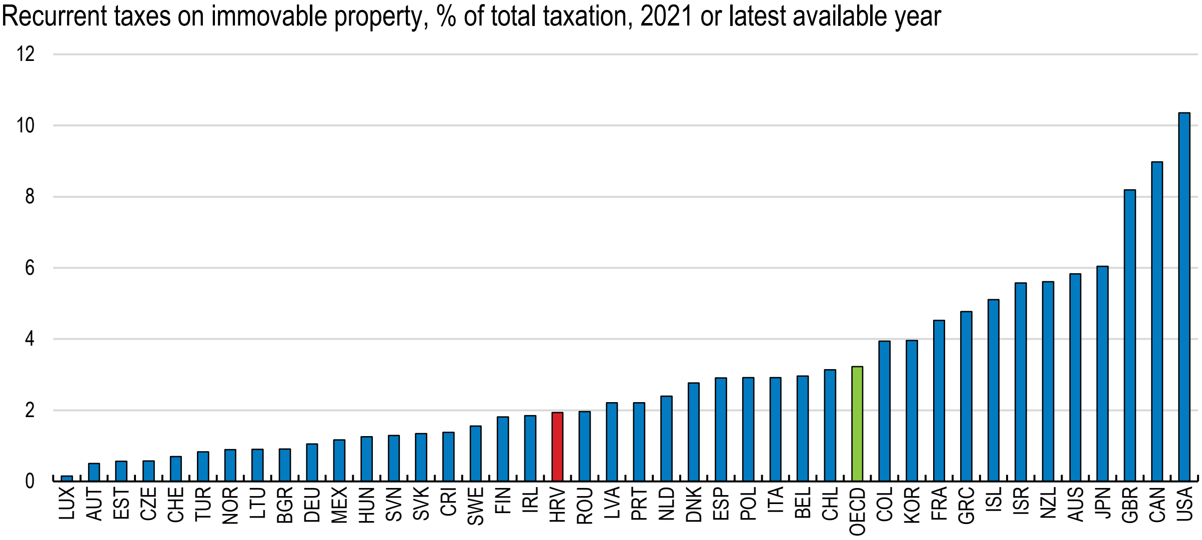
Croatia is supporting the development of new dwellings in part through subsidising housing construction. The Housing Construction programme, Poticana stanogradnja, originated in 2001 offers state support for newly constructed dwellings, and, since 2019, loans for renovating existing dwellings. In addition, Croatia's Recovery and Resilience Plan allocates EUR 764 million (1.0% of GDP) to renovate buildings including EUR 591 million for reconstruction, including EUR 96 million for residential buildings.

Support for purchases of existing dwelling should be phased out and reallocated. The Subsidised Loan Programme, *Subvencioniranje stambenih kredita*, provides citizens aged below 45 with a subsidised loan for the purchase of a house or an apartment, or the construction of house. It grants subsidies of up to EUR 1500 per square metre for loans up to EUR 100 000 with the annual interest rate capped at 3.8% per year. A new round of subsidised loans was introduced in March 2023. Experience in Croatia, and across OECD countries with similar schemes, is that such programmes contribute to faster price growth especially in areas with restricted supply or already strong demand, and have limited impact on resolving housing shortages (Kunovac and Žilić, 2020[46]) (OECD, 2021[47]).

Further addressing Croatia's procedural barriers to constructing or renovating housing would encourage supply. Building larger integrated developments is particularly complicated due to heavy processes in consolidating urban land plots, that the rights of first refusal for the public sector in transactions. Incomplete, out-of-date and inconsistent cadastres and urban plans can impede redevelopment. Meanwhile, slow judicial processes mean delays to resolve contractual disputes. Addressing these constraints through the measures discussed in Chapter 1 to review and streamline regulatory and administrative processes and to improve the judicial system's responsiveness, would contribute to reviving housing construction.

Figure 4.21. Croatia can increase revenue from recurrent taxes on immovable property

Recurrent taxes on immovable property, % of total taxation, 2021 or latest available year



Source: OECD Revenue Statistics (database); and calculations based on data from Eurostat.

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There is scope to reform housing taxation. Croatia currently imposes a property transaction tax of 3%, which is around mid-range among OECD countries. Lowering this tax would add dynamism to the property market. Croatia taxes profits gained on the resale of a property as personal income, which is highly efficient and effective. Income from leasing a dwelling is taxed at a 15% personal income tax rate, after allowing for expenses. General recurrent taxes on property are very limited in scope. There is an annual tax on holiday homes based on the surface area, but unlike in most OECD countries, there is no general property tax linked to the value of a property. Introducing such a tax, and applying it to all properties, including secondary residences or properties that are rented would encourage owners to make full use of the housing stock and improve the availability of housing for primary dwellings. Ensuring that any reforms treat investments in private rental housing and owner-occupied housing equivalently would help develop a bigger rental market. Taxing owner-occupied housing in line with other saving vehicles, such as equity, can also help creating a neutral tax framework for investments.

Box 4.5. A recurrent property tax for equitable and effective use of property

All OECD countries have some sort of recurrent tax on immovable property. In most cases the tax is based on the improved value of the property. This type of tax has attractive features, including low deadweight costs, relatively easy administration and capacity to support goals of equity. New technologies make it possible to maintain up-to-date registers of property values at low administrative cost. For example, Norway has introduced a machine learning tool that uses information on the relationship to determine holiday homes' value for the purposes of its wealth tax. The tool uses information on the property's size, construction date, location, topography, and distance from facilities and services. Initial testing found the model generated values within 20% of market values for half of properties. Public acceptance of these model-based values can be supported by allowing owners to self-report property values subject to audit.

The political acceptability of recurrent property taxes can be improved by making them part of broader tax and expenditure reforms. Some countries have introduced them alongside cuts to high personal income tax rates, or adjustments to the financing of local governments. Some governments such as the Netherlands have introduced important property tax reforms gradually, for example by adjusting rates over a number of years until the target tax rate is reached. The Australian Capital Territory is part way through a 20-year tax reform that includes increases in annual land tax.

Recurrent property taxes can be challenging for households with significant property assets but limited income from which they can meet their tax obligations. A number of OECD countries, including Canada, Denmark, Ireland and some jurisdictions in the United States, allow certain classes of taxpayers with certain types of properties to defer their recurrent property tax payments. For example, the scheme in the Canadian province of Alberta is restricted to residents over 65, charges a below-market interest rate on the deferred payments related to the primary residence and secures repayment against the sale of the dwelling.

To further encourage owners to make use of their properties, several cities in OECD countries have introduced tax surcharges on vacant dwellings. Where these are accompanied by penalties and credible enforcement, such as in Vancouver or several French cities, they have been effective at reducing the vacancy rate especially in areas with constrained housing supply. One implementation challenge of such taxes is to discourage owners from nominally declaring the property available for short-term rental. For rental income, applying the same tax treatment as other capital income supports the neutrality of the tax system.

Source: (OECD, 2021[47]) (OECD, 2022[48]; OECD, 2021[49]).

Ensuring the pension system supports longer working lives and well-being in retirement

Croatia modernised its pension system in the late 1990s and early 2000s, introducing second- and third-pillar pensions, with several rounds of reforms later (Box 4.6). Requiring individuals to contribute to their future retirement incomes through mandatory and optional retirement funds while they are employed has generated a substantial pool of investable funds, and has helped to protect public finances. Pension and ageing costs are modest and are projected to rise only moderately in the coming years, and to decline in the longer term. The European Commission's Ageing Report projects that contributions to the public pension system will rise from 6.0% of GDP in 2019 to 7.1% of GDP in 2050, compared with an EU average near 10% of GDP (European Commission, 2021[50]). These calculations do not account for the planned 2024 tax reforms (Box 2.4), which will reduce low wage earners' pension contributions, with the difference to be covered by public funds, raising the fiscal cost of the pension system. Other costs of ageing, such as for long-term and health care, are moderate and are projected to rise relatively modestly (Figure 4.22).

Pension system reforms have continued. For retirees with very low incomes, new and strengthened public schemes are supporting well-being. Greater flexibility is allowing workers to continue working part-time after they reach retirement age. The share of pensioners receiving disability pensions has almost halved over the past decade to a little below the average of OECD EU countries as the definition of invalidity has been aligned with that applied in other countries. However, many of these reforms have been controversial and some have been delayed or unwound, notably those seeking to extend working lives.

Key ongoing challenges include ensuring workers are motivated to continue working until retirement age, and that pension funds and complementary public support ensure adequate incomes. Pension incomes are generally low and are projected to rise little, and retirees are among the groups with the highest risks of poverty (Figure 4.1). Early retirement is relatively common, notwithstanding declining numbers of early retirees over recent years. This drags Croatia's employment rates among older adults lower and reducing Croatia's productive capacity, public revenues and well-being. At the same time, the pension system is in deficit, which the government budget finances.

Supporting longer working lives

Croatia would gain greatly from lifting employment among older workers. Croatia's ageing population means that the number of people in work contributing to the pension system is projected to fall from 2 per person aged over 65 in 2020 to just above 1 by 2070 (European Commission, 2021[50]). Adults in Croatia start working later and finish working at a younger age on average than in most OECD countries (Figure 4.22). Under current policies, the increase in participation rates is projected to lag behind most OECD countries. The development of part-time work from the currently very low rates in Croatia, as workplaces become more flexible and preferences change, will offset some of the gains from higher participation. Encouraging more Croatian workers to work longer is likely to require a mix of tightening the penalties for early retirement, increasing the incentives for later retirement, and improving older workers' work environment and health to ensure that they are able to stay in work.

The statutory retirement age is 65 for men currently and will rise from 63 years and 3 months in 2023 to 65 years for women by 2030, with 15 years of contributions. Long-term insures must reach 60 years and 41 years of contributions to access the old-age pension. In 2018, Croatia adopted a reform to increase the pensionable age to 67 by 2033, but this was subsequently cancelled following protests. The planned increase in the overall statutory retirement age increase would have brought it above that in most EU OECD countries. Despite gains in healthy life years, Croatians aged 65 expect a little over five further years of good health, less than half of the EU average (Figure 4.22, Panel E). Indexing the statutory retirement age to expected number of years in good health would ensure that workers' pension contributions keep pace with lengthening time in retirement and quality of life. Several OECD countries have introduced an automatic link with life expectancy over the past decade to improve the sustainability of their pension systems and retirees' incomes (OECD, 2021[51]). Modelling by the European Commission's Ageing Working Group suggests that linking with life expectancy would reduce aging costs by 1.5% of GDP by 2070 in Croatia (European Commission, 2021[50]).

Box 4.6. Selected features of Croatia's pension system

Croatia shifted from a 'Pay-As-You-Go' (PAYGO) system to a system of mandatory and elective private individually-defined contribution schemes in the late 1990s and early 2000s, although public bonuses have weakened the shift to individually-funded retirement incomes. When it was introduced in 2002, the individual account was voluntary for older workers and mandatory for workers younger than 40. Workers under the mandatory scheme will start reaching retirement age over the coming years.

Mandatory contribution rates are comparable to OECD countries, at 20% of income (compared with 18.2% on average in OECD countries). Payments under the PAYGO system are based on points that weight years of contribution and wage rates relative to the average wage, plus a supplement of 27% for first pillar pensioners or 20.25% for two-pillar pensions for those earning more than the minimum pension but less than the maximum over the years of contributing to an individual account. Payments from the mandatory account depend on the return on those investments and are converted into a lifetime annuity. Some 20% of the working age population has a voluntary retirement account, although this may include dormant accounts and payments from these accounts make up a minor share of pension income.

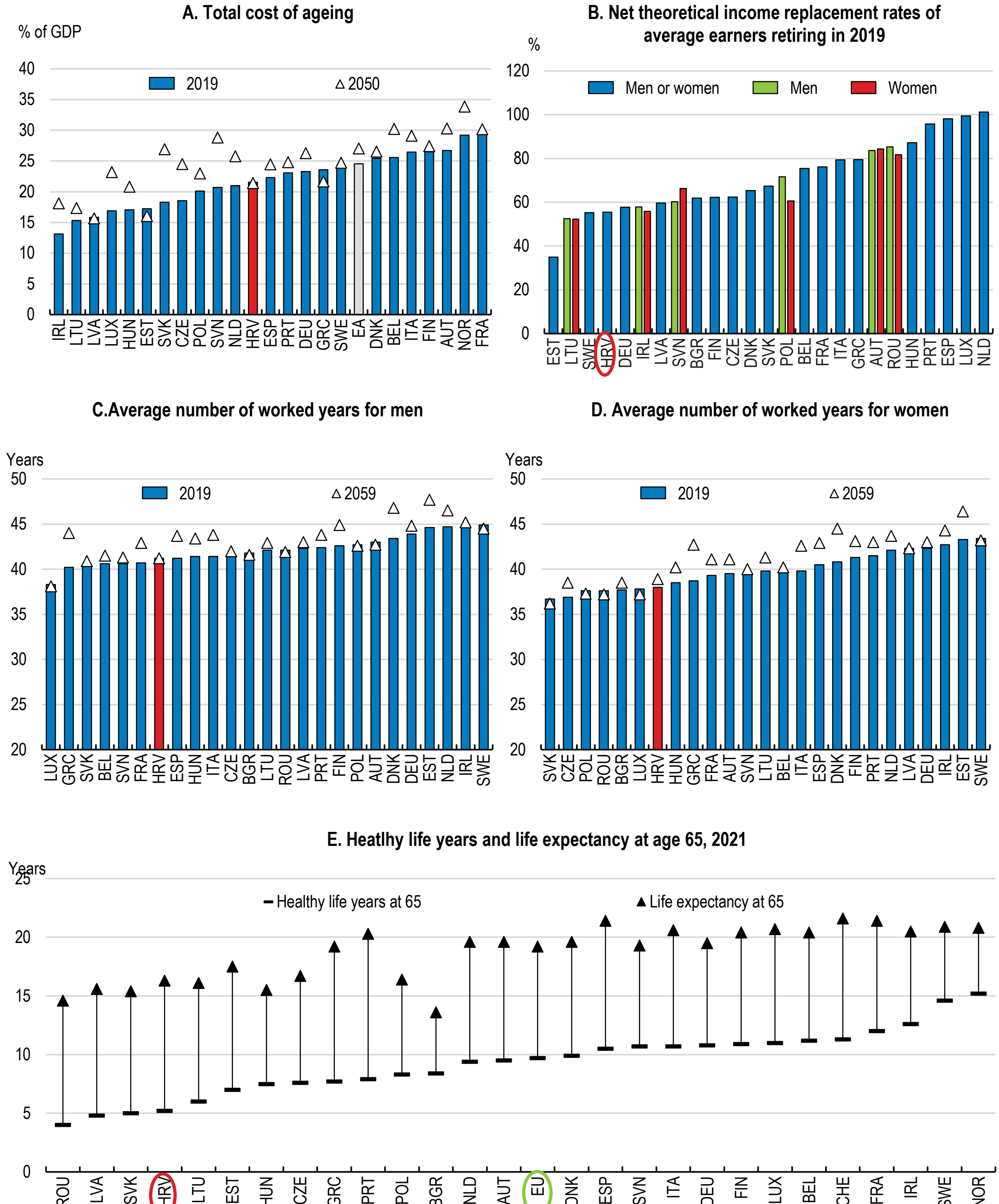
Indexation rules support pension incomes. Since 2019 Croatia adjusts PAYGO pensions twice a year with a formula that prevents pension incomes from being cut, and increases pensions by 70% of the increase in prices and 30% of the increase in wages if consumer prices grow faster than wages; or vice versa if wages grow faster than prices. It increases pensions paid from the mandatory pension accounts by the consumer price inflation rate.

A national benefit for the elderly supports low-income beneficiaries. For a single household, it provided EUR 121 per month in 2023, about one-third of the at-risk-of-poverty threshold of 50% of the median income. Eligibility is subject to relatively strict income tests. It is further boosted by various in-kind benefits provided by local governments, such as housing and transport, which, in the highest income cities, make substantial inroads into poverty.

Additional steps towards making Croatia's retirement system gender neutral are needed. The retirement age of women will align with that of men by 2030. However, allowances for time out of paid employment due to childbirth or other care responsibilities are limited, covering contributions if the parent is out of work for a child's first year or if the parent must care for a disabled child. The 2018 pension reform added six months to the contributory period of the mother or father for each child born or adopted, but this remains less than in most European OECD countries. Ensuring that such offsets are neutral or even provide an additional top-up for carers, as countries such as France or Spain provide, would be welcome. Rather than setting fixed periods, some countries such as Denmark link the length of pension contribution credits to family tax credits or other benefits paid to carers, including adjustments for time spent in part-time paid employment while providing care.

Modest penalties from retiring early contribute to the shorter working lives in Croatia (Table 4.1). While improved labour market conditions and the effects of reforms are reducing the rate of early retirement in recent years, less than 17% of retirees in 2019 had completed the 41 years of employment required to receive the full pension. The share of workers retiring early reached 16.4% in 2020, the second highest ratio among EU OECD countries and compared with under 10% a decade earlier. The 2018 reforms increased the penalty for early retirement. Still, it remains less than in many OECD EU countries.

Figure 4.22. In Croatia, ageing costs are moderate, while relatively low pensions reflect shorter working lives



Note: Panel A: Includes pension, long-term and health care costs, based on current policies. Panel B: Net theoretical replacement rate is the average new pension as a share of the average gross wage at retirement. These show the case of 40 years' uninterrupted career ending with the standard pensionable age for men and women average earners retiring in 2019. The blue bars indicate that the retirement rate is the same for men and women.

Source: EC (2021) Ageing report 2021; EC (2021), 2021 Pension adequacy report; and Eurostat.

StatLink https://stat.link/z28pcv

Very few workers work beyond the statutory retirement age and the benefits of doing so could be developed (Table 4.1). The Labour Act and public service employment laws automatically terminate employees once they reach 65 years of age. All OECD countries allow pensioners to work, although many reduce pension benefits or do not count pension contributions towards future pension income, effectively imposing a high labour income tax rate for these workers (OECD, 2022[52]). Relaxing the rules in Croatia so workers may continue to work up to full time after their statutory retirement age while opting to receive part of their pensions may encourage those workers to stay in work longer while supporting retirement incomes.

Ensuring adults can remain in good health, work in appropriate conditions and update their skills for workplaces' evolving needs can encourage them to continue working rather than retiring early. In Croatia, many of those who are retired in any age group assess their health to be bad or very bad – around one-quarter among those retired aged between 55 and 64, a significantly higher share than among the equivalent groups in OECD EU countries and compared with 8% among their contemporaries in work. Early retirees, and those with chronic health issues, often have completed little schooling, and make up large shares of the populations in lagging areas, such as Slavonia. Strengthening measures to prevent and manage chronic health conditions, especially in the workplace, can help workers stay in employment and support workplaces' productivity.

Table 4.1. Croatia's rules on early retirement

Retiring before the statutory age	Retiring after the statutory age
Fifteen years of contributions are required to qualify for an old-age pension, while 35 years are required for early age pension (currently 33 years and 3 months for women but will rise to 35 years in line with the statutory retirement age). Full pension is possible from age 60 with at least 41 years' contributions. Pension is reduced by 0.2% for each month the worker retires before reaching the retirement age of 65 years, reaching 12% reduction for the maximum of retiring five years early.	If the worker has made at least 35 years of contributions, receives a bonus of 0.45% for each month. Retirement can be delayed beyond the statutory retirement age for up to five years or to a maximum age of 70. May receive pension while working if employed less than 50% of full-time hours.

Financing adequate retirement incomes

Retirees' incomes are low in Croatia and are projected to fall relative to the wages of those in work over the coming decades (European Commission, 2021[53]). Incomes of new retirees are about 55% of their incomes immediately before retirement, a much lower ratio than in most OECD countries, despite a small rise over the past decade.

Current incentives to convert individual accounts back to PAYGO payments add administrative costs and potentially reduce investment returns to pensions. Individual pension account holders can convert back to the public pension under some conditions. Initially this was to protect the retirement incomes of those who shifted to the individual contribution-based accounts after 2002. This transitional arrangement was extended to all workers by the 2018 reforms. Special arrangements apply for some groups: for those working in hazardous and arduous jobs the employer pays additional contributions for pension insurance; for employees during maternity, parental leave or sick leave, contributions are paid and this period is counted in completed qualifying period; for apprentices and volunteers contributions are paid regardless of whether they receive a salary for that work; and non-working parents who care for a dependent and receive compensation are considered to be in employment and contributions for pension insurance are paid. In practice, these measures have meant that the PAYGO pensions are more generous than those based on the returns generated by the individual accounts. More than 65% of retirees have opted to be paid fully by the PAYGO system, meaning that funds are collected and managed in the private account system before being moved back to the public PAYGO system. Having pension contributions managed by pension funds, and then shifting these reserves back to the public pension system once the worker retires creates administrative costs without raising investment returns or retirement incomes.

Boosting the investment performance of individual pension accounts can raise retirement incomes and reduce the demands on the public pension system. The pension schemes have achieved moderate investment returns, averaging 2 percentage points above real GDP growth from their inception until 2018 (Casey, 2022[54]). Management fees are capped below levels in most OECD countries, especially following the 2018 reforms, at 0.284% of assets, although the cap for fees in the voluntary third pillar is higher at 3% of assets. Fund investments have been lower risk than mandated by regulations. A 2019 analysis found that pension funds invested less than the permitted maximum in higher risk assets, and instead exceeded the minimum required investment shares allocated to domestic government bonds (World Bank, 2019[55]). Most fund members are allocated to the 'B' fund with a moderate risk profile. More than 60% of its assets are invested in government bonds and only 23% was invested abroad at end-2021, which is less than funds in many other European countries. This may change as recent reforms have made the 'A' Fund (with the highest risk profile) the default for new members and widened fund investment possibilities. Achieving stronger returns through a broader array of investments requires improving corporate governance in Croatia, as discussed in Chapter 3. Developing Croatia's capital markets, alongside the integration into the euro area, can support more stable and stronger returns for pension funds.

Croatia's obligatory contribution rates are comparable to OECD countries. Pension contributions are nearly fully paid by employees, with some top-up by employers of workers in arduous or hazardous jobs. In most OECD countries, pension contributions are paid by both employees and employers. While increasing obligatory contribution rates risks encouraging greater un-declared work, Croatia could encourage social partners to agree to compensation increases that combine an increase in the wage with pension contributions. Some OECD countries such as Australia have followed this approach in their development of a third pension pillar.

A potentially growing challenge for ensuring adequate retirement incomes is the over 20% of the workforce who have career breaks or non-standard employment. Compulsory pension contributions on contracts for services from the self-employed are set at 10%, compared with 20% for standard employment contracts. Aligning contribution rates across different types of employment income, and allowing the self-employed to make additional contributions to offset breaks in their employment histories, would help to ensure their incomes in retirement are adequate. Without stronger compulsory measures that counter workers' tendency to under-save for retirement, these workers risk relying on the basic minimum retirement income financed through the public budget. However, raising compulsory contributions faces the challenge that the self-employed tend to understate their monetary income in Croatia, like in many OECD countries. Higher compulsory pension saving may exacerbate this. Tax credits or other incentives for the self-employed contributing to their pensions may encourage greater income declarations and retirement savings. To avoid such tax expenditures becoming regressive, they need to target particularly those self-employed at greatest risk of low retirement incomes. Such measures can be complemented with educational programmes to improve the financial literacy of the self-employed. Recent reforms to enable workers who have met the minimum number of contributions to combine pension and work income go in the right direction, especially for older, higher-skilled workers who may wish to continue work, often as part-time contractors, and their effectiveness merits monitoring.

To provide a income safety net for the older population who are ineligible for pensions, Croatia has strengthened a national benefit for the elderly, which is now paid to about 70 000 retirees (0.8% of the population aged 65 or older) (Box 4.6). Take-up in the first year has fallen short of the government's targets and estimated number of eligible people. This may reflect early implementation and information issues that will pass with time (Bađun and Urban, 2022[56]). It may also reflect broader challenges for social protection reaching the most vulnerable groups in Croatia, and may benefit from deeper improvements in the management of social welfare in Croatia (discussed above).

Policy finds and recommendations

FINDINGS	RECOMMENDATIONS (Key recommendations are in bold)
Strengthening education and skills	
Access to skills is growing constraint for investors. Adults generally have completed intermediate levels of education but the share with advanced levels is low. Very few adults return for vocational or skill training after completing their education, in part due to cost and scheduling constraints.	**Increase the number of participants and range of training covered by the recently introduced adult education voucher scheme and apply the new quality certification to more programmes.** Extend this to in-demand areas beyond digital and green skills. Improve access to education programmes by further developing remote and flexible learning courses. Develop adults' demand for education and reskilling through skill assessments, and better certifying adults' skills and training completed.
School students' performance lag many of Croatia's peers even if socio-economic equality and student well-being outperform. Teachers' pedagogical autonomy is relatively limited. School hours are short.	Increase the number of regular school hours and provide more organised after-school support for all students. Develop greater autonomy for teachers, supported by training and transparent assessment process.
Availability and enrolment in early childhood education and care for younger children is very low, although costs are low.	**Extend efforts to expand access to quality early childhood education and care and progressively lower the age of compulsory attendance.**
Strengthening active labour market policies	
Croatia is expanding its active labour market policies and improving focus on groups with weak labour-force attachment. The public employment service could focus more on the outcomes from its measures. Groups with greater activation needs are geographically concentrated, while service provision has been locally driven. he public employment service has not given a high focus to service delivery outcomes.	**Invest in activation services, especially in lagging areas of the country. Modernise the PES operations, including to take local needs better into account.** Strengthen evaluation of active labour market policies.
There is scope to improve the linkage between active labour market policy and access to benefits.	Ensure mutual obligation and administrative requirements are clear and implemented, but are not so stringent as to discourage potential beneficiaries from registering.
Supporting families, expanding access to housing and making more of the contribution of migrants	
Fertility rates have been low for many years. Many gender equality indicators compare well with OECD countries. Large numbers of Croatian residents have emigrated, especially to other EU countries following Croatia's accession. Some are returning. Immigrants have a growing role in filling the skill and employment gaps in Croatia's labour force.	Invest in networks linking together emigrants, and policies that can support those returning. Improve measures to recognise immigrants' skills and to support their integration into Croatia's labour force, for example through language training courses.
Rising house prices, a thin rental market and a high share of housing that is vacant or for short-term rental contribute to overcrowding and are a barrier to moving to more dynamic economic areas. The government has provided temporary schemes to subsidise borrowing costs for first-time home buyers.	Discontinue schemes subsidising home buyer loan interest costs.
Wage-setting that supports competitiveness, productivity and incomes	
Coordination in wage setting is limited, generating risks that wage growth in some sectors weakens general competitiveness.	Encourage social partners to negotiate more flexible work arrangements and access to training as part of wage-setting discussions.
A large share of employees earn the minimum wage. Minimum wage earners earn low incomes relative to the poverty line. Minimum wage increases have been used as a policy lever to bolster welfare. Significant informal and undeclared activity supplements low-income households' incomes.	Develop more comprehensive benefits for low-income households. Consider weakening the focus of minimum wage adjustments on raising the minimum rate towards the median wage. Focus considerations for minimum wage adjustments on economic conditions and employment of low-skilled workers, without explicitly targeting reducing the difference between the minimum and the median wage. Continue efforts to discourage informal work; ensure decisions about the minimum wage rate and income tax and contribution and social benefit policies encourage greater formalisation.
Ensuring the retirement system encourages employment and ensures adequate and sustainable incomes	
Many elderly people have low incomes. Significant numbers of workers leave the workforce early, limiting their retirement incomes.	Complete planned alignment of the retirement age of men and women and improve the allowance for carers' time out of paid employment due to childbirth or other caring obligations. **Strengthen incentives for workers to remain in work until full pension age.** Once male and female retirement ages are aligned, link further increases in retirement age to improvements in expectancy of years in good health. Support employers to adapt work to older adults, for example through part-time and other flexible working arrangements.

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CROATIA

Croatia has navigated well the COVID-19 crisis and the price shocks following Russia's war of aggression on Ukraine. It has achieved robust output growth, rising employment and improving well-being, although inflation has surged. Integration into the euro- and Schengen areas at the start of 2023 are testament to progress, and are providing a further fillip to the economy. Ensuring that fiscal policy is counter-cyclical and that lending supports productive investments can help contain inflationary pressures and sustain growth. Croatia's ongoing and ambitious reforms and investments must continue for incomes to converge with OECD levels while also preparing for climate change. Reducing regulatory burdens, more responsive judicial processes, addressing corruption risks and improving the performance of state-owned enterprises can foster a more dynamic business environment with stronger growth by higher productivity firms. A big push to strengthen adults' skills would ensure that employers can fill high-skilled positions and support rising incomes. Better engaging younger adults in work, encouraging older adults to work until the full retirement age, and attracting needed skills through immigration would reduce poverty risks, raise productivity and help Croatia adapt to an ageing population.

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