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.

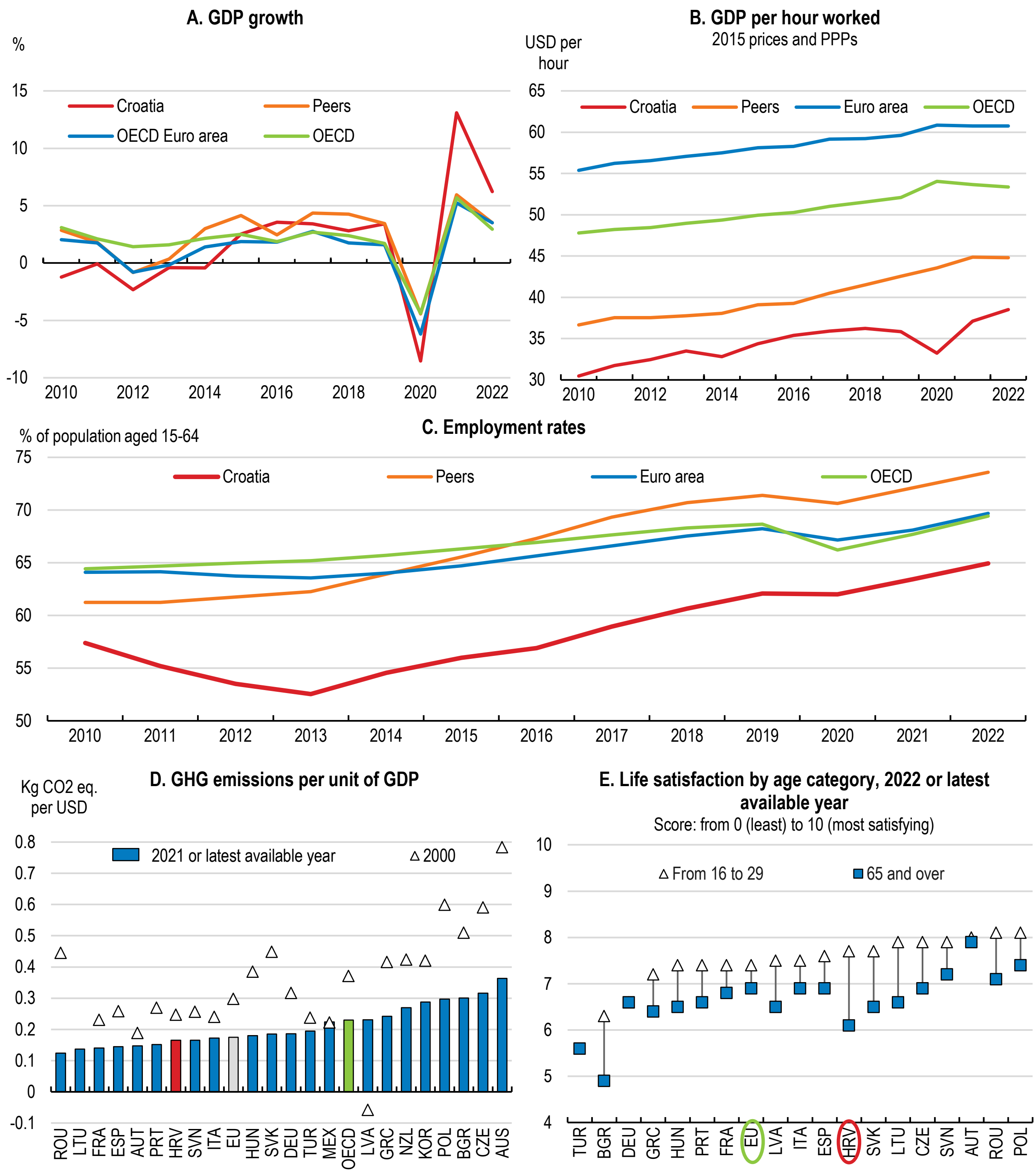
Croatia faces important challenges on its path to sustainable income convergence. In the near term, maintaining competitiveness and real incomes will require slowing inflation to the euro-area inflation target. Longer-term challenges loom. Prior to COVID-19, productivity convergence was slowing (Figure 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).

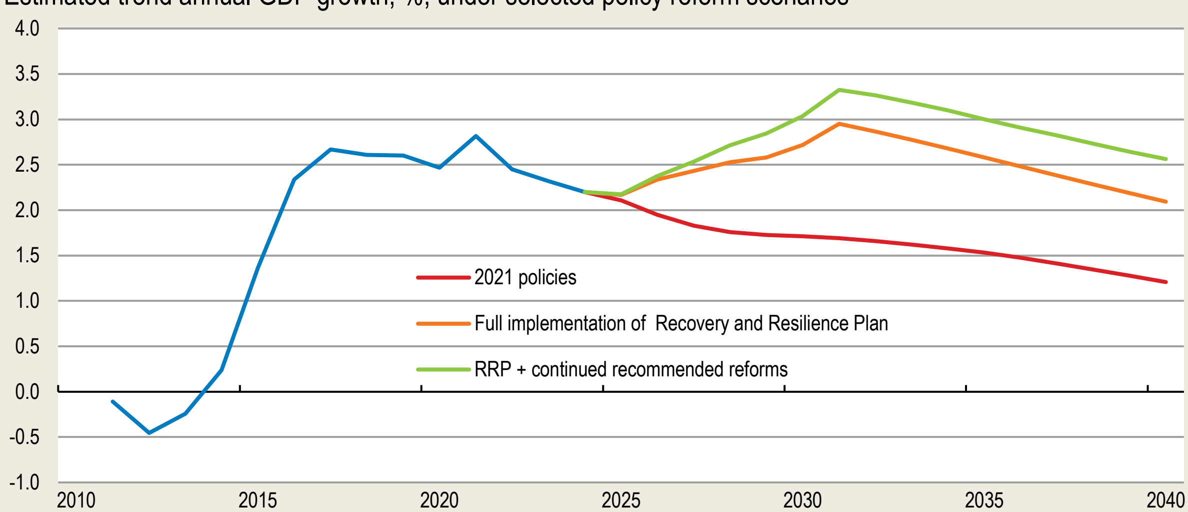
Box 1.2. Sustaining reforms and investments can bolster growth into the long run

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.

StatLink https://stat.link/052fms

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.

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