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.

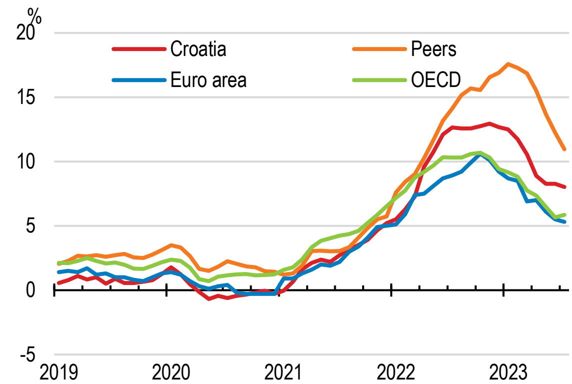
Table 1. Growth is set to be sustained

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.

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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.

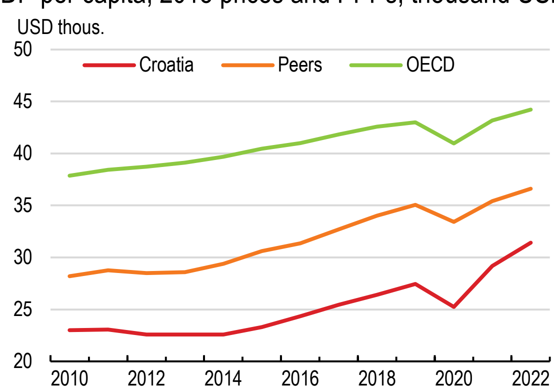
Croatia is vulnerable to a warming climate. Damages from extreme weather events, such as floods, are likely to increase, raising costs for the private sector and public finances. Meanwhile, insurance coverage is limited.

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).

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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

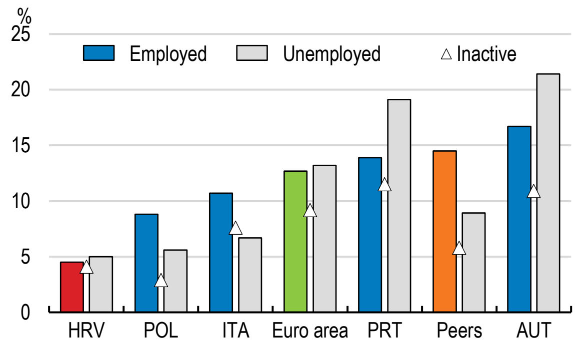
Scarce skills are a growing barrier for investors. School students' performance lags peer countries. Most adults have only completed intermediate levels of education and few return to upgrade their skills. Employment rates among prime-age men and women are higher than in most OECD countries, but lag 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.

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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.

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