1 Macroeconomic and political context

This chapter describes the main governance reforms of Croatia since its independence in 1991 up until it joined the EU in 2013. It also describes the current economic context of regulatory reform efforts and points to the specific economic challenges that the country faces that hinder investment, economic growth, and well-being.

Political context: Croatia's path from independence to EU membership

Croatia declared independence and became a democratic republic on 25 June 1991, after being part of Yugoslavia for most of the 20th century. In 1989, the first free multi-party elections were held in the country and the Croatian Parliament adopted the Constitution of the Republic of Croatia on 22 December 1990 (The Miroslav Krleža Institute of Lexicography, 2013[1]).

The declaration of independence was met with resistance from many ethnic Serbs in Croatia and led to the Croatian war of independence, fought from 1991 – 1995 between Croat and Serb forces. The following years 1996 and 1997 were a period of post-war recovery and structural economic reforms.

After gaining independence, Croatia made great strides in joining the international community. In 1996, Croatia became a member of the Council of Europe, which laid down the political and economic preconditions for developing bilateral relations with Croatia soon after. In 2000, Croatia joined the World Trade Organization and became a member of NATO in 2009.

With the loss of its key export markets in Yugoslavia, Croatia looked to strengthen ties as quickly as possible with the rest of Europe to take advantage of the key political and economic benefits of integration. By 2003, Croatia had made enough progress in fulfilling the Copenhagen criteria to apply for EU membership, becoming the second former Yugoslav republic after Slovenia to do so. The treaty of Croatia's accession to the EU was ratified in 2011 and entered into force after a successful membership referendum held in 2012. On 1 July 2013, Croatia joined the European Union as its to date latest member.

Government structure

The constitution adopted in 1990 radically changed the governance system in Croatia, abandoning the primacy of the communist party over the state. After independence, Croatia emerged as a unitary state[1] with a semi-presidential system and a bicameral legislature. It later transformed to a parliamentary system with the Croatian Parliament (*Hrvatski Sabor*) being unicameral since the abolishment of the former Chamber of Counties in 2001 (European Committee of the Regions, 2012[2]).

Executive power is exercised by the Government and the President of Croatia. The prime minister is the head of government in a multi-party system. Together with four deputies, the PM forms the inner cabinet, tasked with proposing Government policies and co-ordinating and overseeing the Government's work programme. There are 16 other ministers in charge of different sectors of activity. They are appointed by the PM and approved by the Parliament. The president is elected for a five-year term and can serve maximum two terms according to the Croatian constitution. Among other duties, he or she has the power to perform functions related to the operation of the government such as calling elections to the Croatian Parliament, appointing the prime minister and call referenda.

The Government of Croatia adopts regulations and other acts such as decisions and conclusions and passes laws to the Croatian Parliament (*Hrvatski Sabor*) for adoption. The Sabor is composed of 151 members elected by direct election for a four-year term. Seats are allocated to represent the electoral districts: 140 members of the parliament are elected in multi-seat constituencies, 8 from the minorities and 3 from the Croatian diaspora.

The judiciary of Croatia is a three-tiered system of courts, led by the Supreme Court (*Vrhovni sud*) as the highest court. The lower two levels consist of 15 county courts and 32 municipal courts. With the latest judicial reform in 2018, municipal and misdemeanour courts have been merged to reduce the overall number of courts, thus increasing efficiency. The Constitutional Court (*Ustavni sud*) ensures compliance of legislation with the Constitution of the Republic of Croatia and rules on matters regarding jurisdictional disputes between the legislative, executive and judicial branches as it is not part of the judicial branch of government.

Local government structure

Croatia is a unitary state (Constitution, art. 1) with three levels of governance: central, regional/county and local level.

The basic units of regional self-government are the counties (*županija*). Croatia is divided into 21 regional government units: 20 counties and the city of Zagreb. Each county (apart from the city of Zagreb) consists of towns and municipalities. The municipal level counts 428 municipalities (*općina*) and 127 towns (*grad*) with an average municipal size of 7 625 inhabitants. The town status is given to municipalities that are seats of counties with more than 10 000 inhabitants. There are also 6 762 settlements which have their own councils and can be established by the municipalities and cities. (The Miroslav Krleža Institute of Lexicography, 2013[1]) (European Committee of the Regions, 2012[2])

The city of Zagreb has a special status, having competences of both a town and a county, and a significant role in performing state administrative tasks in its territory. (European Committee of the Regions, 2012[2]) The role of local governments is weaker, as more than half of local governments have less than 3000 inhabitants and lack financial resources (European Commission, 2018[3]).

The sub-national government system was established through the 1992 and 1993 laws on local self-government and administration. A major new phase of decentralisation took place in 2002 with the transfer of new responsibilities and financial means to counties and 32 towns with the strongest fiscal capacity. Decentralisation of tasks has been gradually extended over the last decade to counties, towns and some other units on an individual basis. In 2010, the Government adopted the *Guidelines and Principles for a Functional Decentralisation and Territorial Reorganisation*, however the breakdown of responsibilities is still quite complex and in some cases unclear (OECD, 2016[4]). A reform of local and regional government, which would result in larger regions and municipalities, is currently being discussed as part of a wider public administration reform. For information on the regulatory implications of this administrative fragmentation, see chapter 8.

Economic context

The economy of Croatia is a service-based economy with the tertiary sector accounting for 70% of the total GDP. With the declaration of independence, Croatia successfully transitioned to a stable market-based economy, after the 1990's conflict over its independence had severely affected Croatia's economy. The process leading to Croatia's gradual integration and accession to the EU shaped the country's economic development, leaving a profound impact on the institutional framework and policy-making. As of 2000, the country's economic situation began to improve with moderate but steady GDP growth, led by a surge of tourism and credit-driven consumer spending.

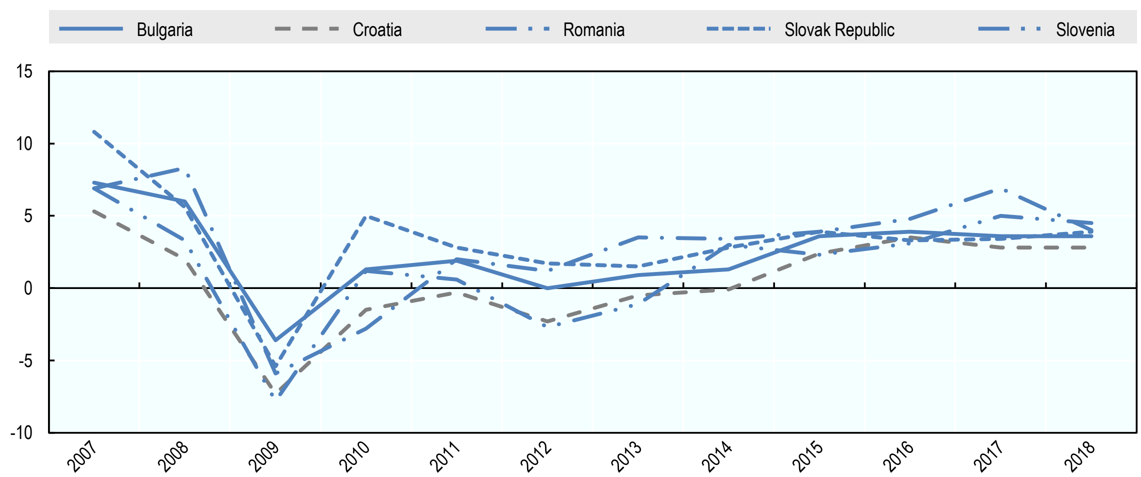
However, the 2008 global economic downturn revealed underlying structural weaknesses and the lack of serious structural reforms since the 2002 Pension reform and led to six years of contraction, where the economy entered into a sharp downturn. (OECD, 2017[5])

Current economic situation: Croatia's path of recovery from one of the EU's most severe recessions

When Croatia became a member of the EU in 2013, it gained access to the EU single market, which helped connect part of the economy to global value chains. After six years of recession and a modest recovery in 2015 (+2.4%), real GDP growth accelerated in 2016 with a 3.5% rate, mostly due to a sharp increase in trade, transportation and tourism. At the time of its accession to the EU, Croatia was wealthier than other EU-members from the Balkan, Bulgaria and Romania. The recovery began in 2015 and Croatia's economy since then has been growing at 3% annual in the three years to 2017 – a pace well above the EU annual average at 2.3% (OECD, forthcoming[6]). By 2017, Croatia's GDP per capita had reached almost USD 22 000 in purchasing power parity (PPP) terms, which equates to 63% of EU average. (The World Bank, 2018[7]).

Nevertheless, this positive development is not enough to match pre-crisis growth rates and Croatia's purchasing power and growth over time is still lagging behind its EU peers (Figure 1.1). At an average of 1.8 annual percent change (2103-2017) the real GDP growth has been slower than in countries such as Romania (4.4%) and Bulgaria (2.8%).

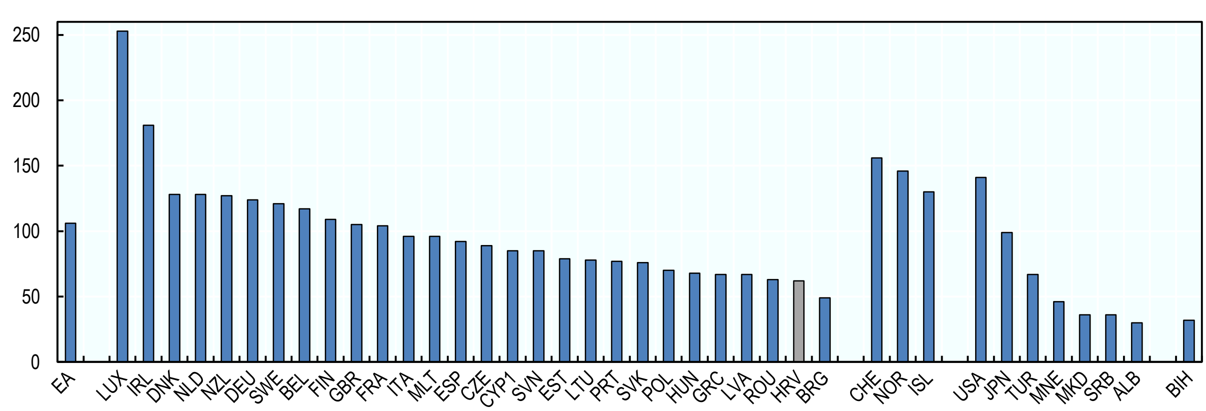
Figure 1.1. Real GDP growth in selected CEE countries, annual percent change



Source: IMF.

Croatia's GDP per capita (current USD 13.383 in 2017 according to the World Bank) is significantly lower than in other EU countries (Figure 1.2), with the GDP per capita expressed in Purchasing Power Standards (PPS) amounting to 61 % of the EU average in 2017 according to Eurostat.

Figure 1.2. GDP per capita, 2017 (EU-28=100)



Notes: The volume index of GDP per capita in Purchasing Power Standards (PPS) is expressed in relation to the European Union (EU28) average set to equal 100. If the index of a country is higher than 100, this country's level of GDP per head is higher than the EU average and vice versa.

1. Note by Turkey:
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Source: Eurostat.

The recession took its toll on the labour market, with unemployment rates going up to 16.2% in 2015, the 3rd highest in the European Union. Youth unemployment stood even higher at 31.8% in 2016 and the disproportionately low employment rates in rural areas reflect regional disparities in terms of economic performance. Furthermore, fiscal challenges need to be addressed as government debt increased rapidly during the recession and, while currently in decline, fiscal discipline needs to be sustained and underpinned by more structural measures. (EBRD, 2017[8]) The recession also negatively affected the dispersion of the regional development index, regional GDP per capita and regional productivity (GDP per employee) (Đokić, Fröhlich and Rašić Bakarić, 2016[9]) and benefits of economic growth have been unevenly distributed, to a disadvantage of small towns and rural areas.

Overall, Croatia's economy is expected to continue to grow and unemployment to contract, albeit at a slower pace (European Commission, 2018[10]). Growth remained solid in 2018 at 2.6% with private consumption being the main driver of growth, mainly due to an increase in disposable income as favourable labour market developments continued. Continued strong tax revenue growth is expected to keep the government balance in surplus and the debt ratio declining (The World Bank, 2018[11]). Despite the slow recovery, the short-term economic future looks positive for Croatia (Table 1.1), with the Central Bank and international organisations projecting GDP growth around 2.5% for 2019.

Table 1.1. Main economic indicators

	2010	2011	2012	2013	2014	2015	2016	2017	2018
Inflation	1.1	2.3	3.4	2.2	-0.2	-0.5	-1.1	1.1	1.5
Gross domestic product (GDP) growth	-1.5	-0.3	-2.3	-0.5	-0.1	2.4	3.5	2.9	2.6
Household consumption (growth contribution)	-0.9	0.2	-1.8	-1.1	-1.0	0.7	2.0	2.0	1.9 [a]
Government consumption (growth contribution)	-0.1	-0.1	-0.2	0.1	0.2	-0.2	0.4	0.4	0.4 [a]
Gross fixed capital formation (growth contribution)	-3.8	-0.6	-0.7	0.3	-0.5	0.7	1.0	0.7	1.4 [a]
Change in inventories	0.3	0.2	-0.8	0.0	0.0	0.8	-0.2	0.4	-0.2 [a]
Exports (growth contribution)	2.1	0.8	-0.1	1.3	2.6	4.3	2.7	3.0	2.9 [a]
Imports (growth contribution)	0.9	-0.9	1.2	-1.3	-1.3	-4.0	-2.8	-3.7	-3.6 [a]

[a]. Forecast.
Source: National Bank of Croatia.

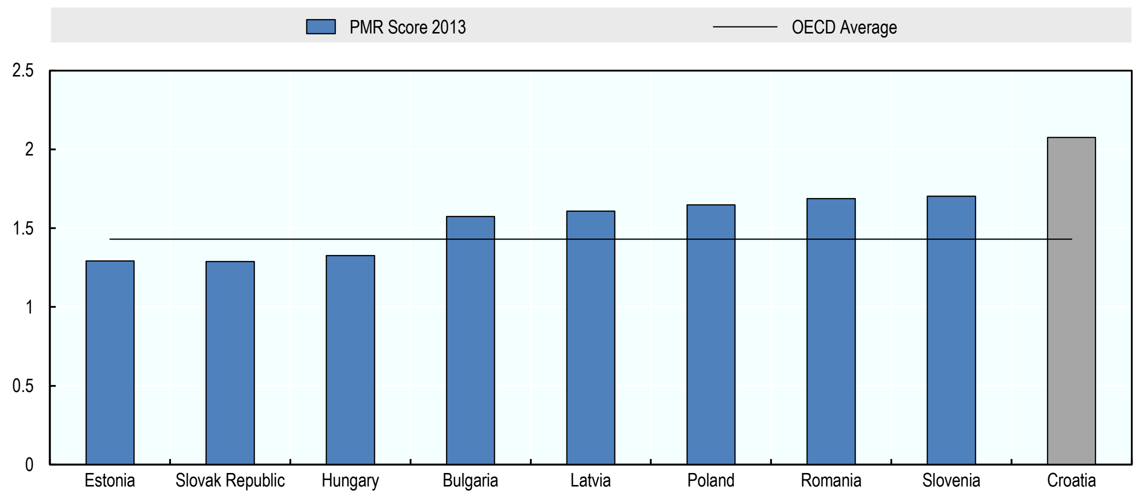
This positive development depends on a number of factors, including Croatia's capacity to attract investment and carry out structural reforms to its regulatory framework to address high public and private debt levels, improve the business climate, and boost productivity and competitiveness. Croatia would also greatly benefit from sustaining reforms to upgrade public services, key institutions and the governance of state-owned enterprises (SOEs) within the next few years. (OECD, 2017[5]) If these longstanding structural constraints are not addressed, Croatia risks a growth deceleration in the medium term.

Market regulation and competition

Croatia's economy remains highly regulated and businesses face a disproportionate level of administrative burden from regulation. Croatia has one of the strictest regulated product markets and scores higher than any of its peers in Central and Eastern Europe (CEE) in the *OECD Product Market Indicators* (Figure 1.3).

Too strict or badly designed product market regulation makes it harder for entrepreneurs to create firms and expand them and discourages the entry of foreign products and firms (Koske et al., 2015[12]).

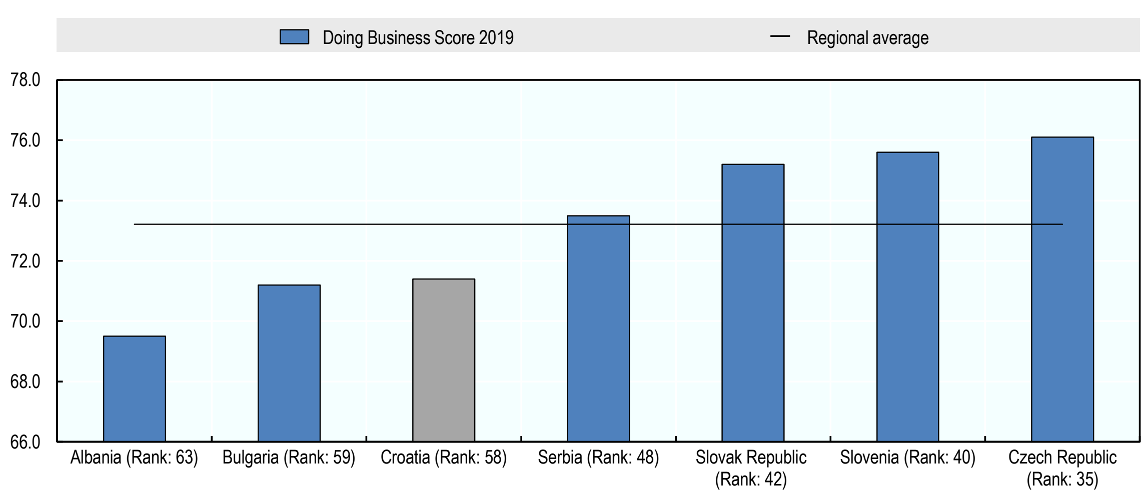
Figure 1.3. 2013 OECD Product Market Indicators score for CEE countries



Note: Scores are from 0 to 6 (least restrictive to most restrictive).
Source: (Koske et al., 2015[12]), "The 2013 update of the OECD product market regulation indicators: policy insights for OECD and non-OECD countries", *OECD Economics Department Working Papers*, No. 1200, https://dx.doi.org/10.1787/5js3f5d3n2vl-en.

Businesses in Croatia face comparatively high administrative and regulatory burdens. The World Bank Ease of Doing Business Indicator (Figure 1.4) shows Croatia scoring below the regional average, with CEE peers like Slovenia (Rank: 40) and the Czech Republic (Rank: 35) ranking higher. The regulatory environment is challenging for businesses in particular due to lengthy and costly procedures to obtain construction permits and to start a business. These procedures can vary highly between different municipalities.

Figure 1.4. World Bank 2019 Ease of Doing Business scores



Notes: The ease of doing business score captures the gap of each economy from the best regulatory performance observed on each of the indicators across all economies in the Doing Business sample since 2005. An economy's ease of doing business score is reflected on a scale from 0 to 100, where 0 represents the lowest and 100 represents the best performance. The ease of doing business ranking ranges from 1 to 190.
Source: Worldbank (2019).

Croatia has started to address these issues by introducing the SME-Test as part of RIA (further described in Chapter 5) and the Action Plan on Administrative Burden Reduction with the purpose of creating investment incentives and providing easier market access. The substantial benefits of these measures are not yet reflected in Croatia's scores, with its Doing Business rank deteriorating to 58 in 2019 from 51 in 2018.

Investment in Croatia

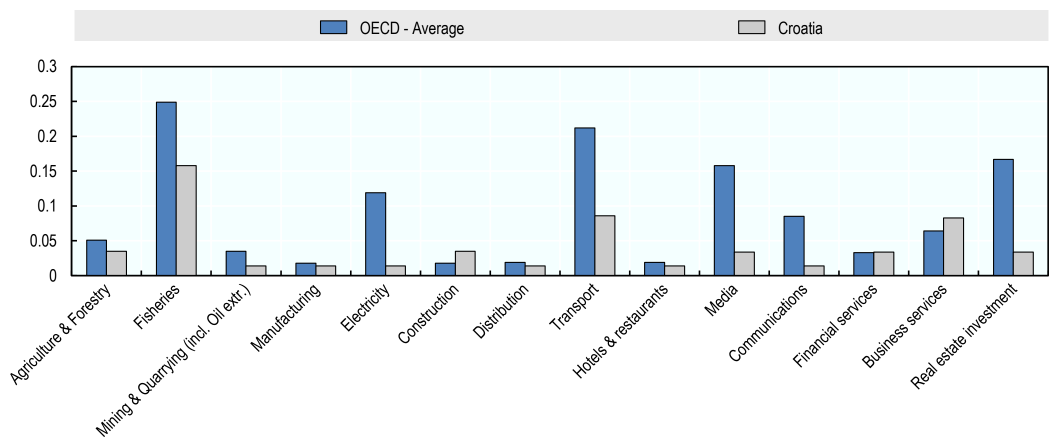
Public investment experienced a sharp decline during the crisis from around 6% of GDP in 2002 – 2008 to below 3% in 2017 (one of the lowest among peers), while private investment dropped from around 28% in 2008 to 20% in 2017. This investment gap hinders long-term growth and while private investments have started to recover, there are still some investment constraints in the form of high administrative barriers to business activity, complex and often changing regulation, and weaknesses in public administration (EBRD, 2017[8]).

As explained in the Investment Policy Review of Croatia (OECD, forthcoming), foreign direct investment (FDI) plays a significant role in Croatia's economy with FDI accounting for nearly one fifth of all financial assets and nearly half of all financial liabilities in 2017. Overall, direct investments by foreign-owned firms in Croatia far outweigh investments by Croatian firms abroad. As such, Croatia sustains a negative net FDI position, of USD -22.9 billion in the first quarter of 2018. Relative to the size of the Croatian economy, the share of inward FDI stock to GDP stands at 61%, above the OECD and EU averages (of 39% and 53%, respectively); and the share of outward FDI stock to GDP at 11%, below the OECD and EU averages (of 48% and 62% each). These levels are similar to those found in comparable economies (e.g. the Czech Republic, Slovakia and Slovenia) (OECD, forthcoming[6]).

Croatia is largely open to foreign direct investment. National treatment of foreign investors in the post-establishment phase is guaranteed, which means that foreign investors, when incorporated and headquartered in Croatia, are considered domestic legal entities, with all the rights and obligations that are applied to domestic investors. The existing exceptions to national treatment are limited to foreign ownership restrictions in a handful of sectors, namely in legal services, freshwater fisheries and air transport (Figure 1.5). Other barriers to foreign direct investment mainly concern conditions imposed at establishment (e.g. local incorporation requirement and reciprocity condition for establishment of a branch). Such barriers are few, mostly sector-specific, and typically limited in their scope, applying almost exclusively to investors from outside the EU or the European Economic Area (EEA) or to investors from countries that are not WTO members.

Figure 1.5. OECD FDI Regulatory Restrictiveness Index, 2017, by sectors

0 = open, 1 = closed

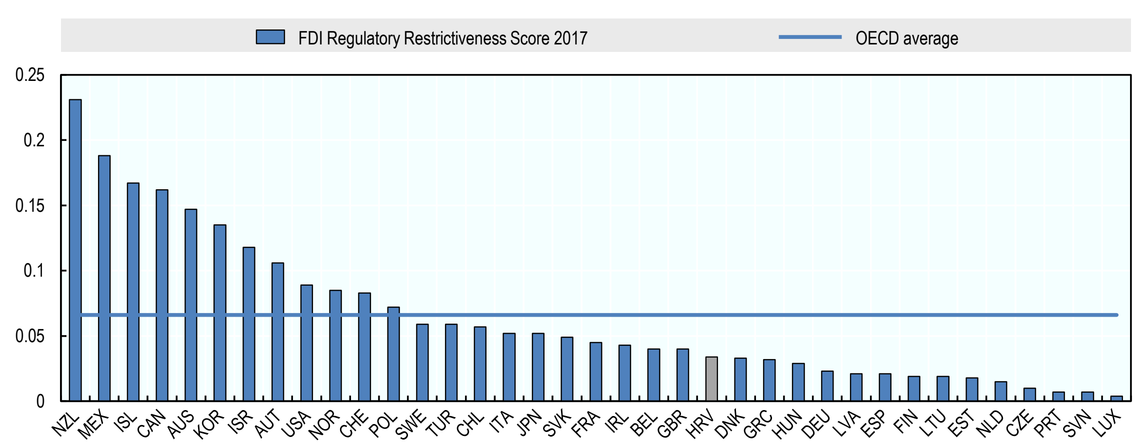


Source: OECD FDI Regulatory Restrictiveness Index, www.oecd.org/investment/fdiindex.htm in OECD (forthcoming), Draft Investment Policy Review Report.

As a result, Croatia's degree of restrictiveness is low in comparison to the OECD average, as well as against the average of non-OECD economies that have adhered to the Declaration, according to the OECD *FDI Regulatory Restrictiveness Index* (a measure of statutory restrictions on FDI, see Figure 1.6). However, the regulatory environment for foreign investment is not the only incentive that foreign investors respond to, as they are equally affected by deficiencies in the overall business environment (OECD, forthcoming[6]).

Figure 1.6. OECD FDI Regulatory Restrictiveness Index, 2017

0 = open, 1 = closed

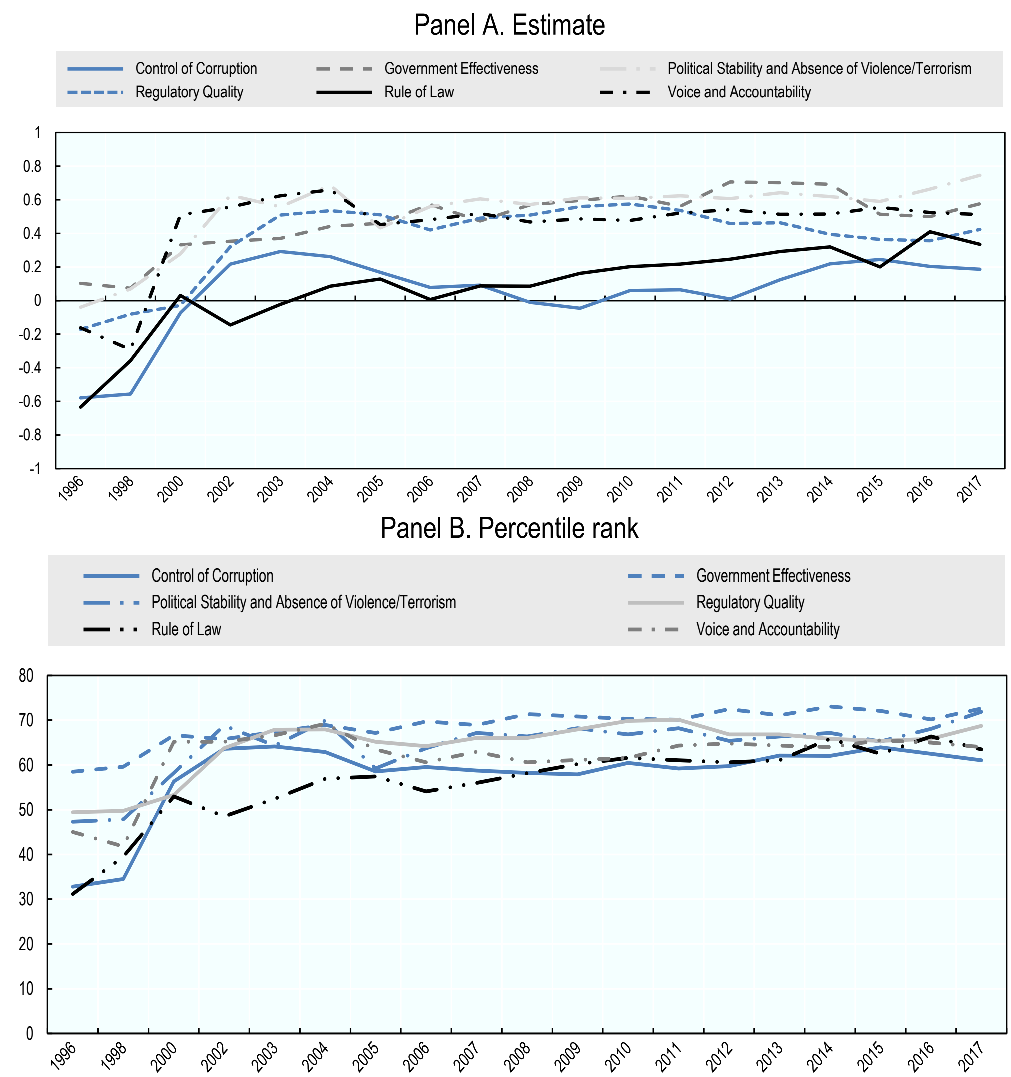


Notes: The OECD FDI Regulatory Restrictiveness Index covers only statutory measures discriminating against foreign investors (e.g. foreign equity limits, screening & approval procedures, restriction on key foreign personnel, and other operational measures). Other important aspects of an investment climate (e.g. the implementation of regulations and state monopolies, preferential treatment for export-oriented investors and SEZ regimes among other) are not considered. Data reflect regulatory restrictions as of December 2017. For Croatia, information reflects the regulatory environment as of September 2018. Please refer to Kalinova et al. (2010) for further information on the methodology.
Source: OECD FDI Regulatory Restrictiveness Index, www.oecd.org/investment/fdiindex.htm in OECD (forthcoming), Draft Investment Policy Review Report.

Public sector integrity and trust in government

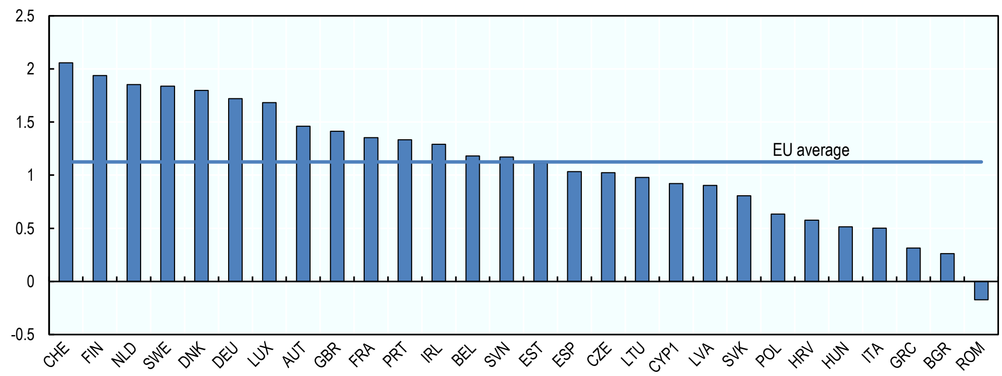
As captured by the World Bank's *World Governance Indicators* (Figure 1.7), Croatia has made progress in improving the rule of law, control of corruption, regulatory quality and other related aspects since the mid-1990s. Still, it has been scoring below the EU average on the same indicators (Figure 1.7). Furthermore, the EU polls suggest that the level of trust in government was among the lowest in the EU (only 15% reported to tend to trust the government in 2018). (OECD, forthcoming[6])

Figure 1.7. Overview of World Governance Indicators scores for Croatia, 1996-2017



Notes: Estimate of governance (ranges from approximately -2.5 (weak) to 2.5 (strong) governance performance). The percentile rank is calculated based on the country's score and that of 154 other ranked countries.
Source: World Bank's World Governance Indicators database (2018) in OECD (forthcoming), *Draft Investment Policy Review Report*.

Figure 1.8. Government effectiveness in Croatia and EU 28 according to the World Bank World Governance Indicators



Notes: Estimate of governance (ranges from approximately -2.5 (weak) to 2.5 (strong) governance performance). Results for EU 28 member states are shown.
1. Note by Turkey:
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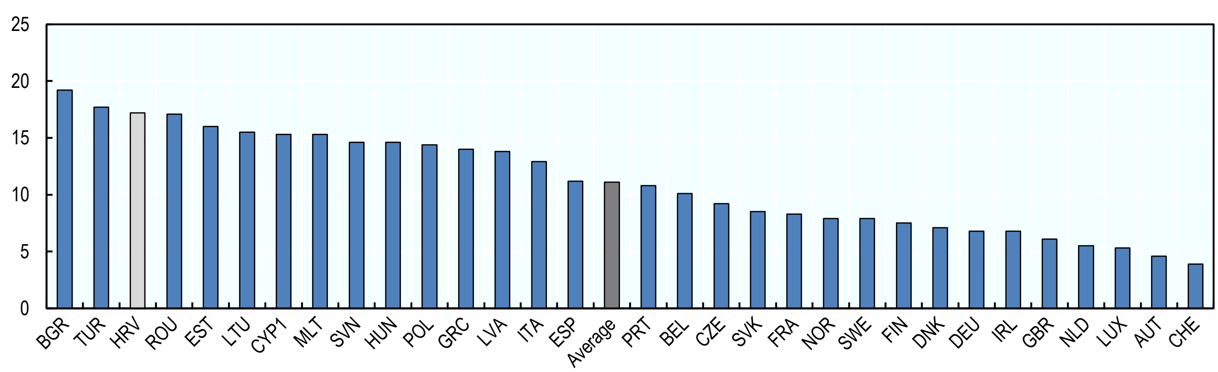
Source: World Bank's World Governance Indicators database (2018) in OECD (forthcoming), Draft Investment Policy Review Report.

Grey economy

A recent IMF report (IMF, 2018[13]) estimates the size of the grey economy in Croatia – which refers to economic activities hidden from official authorities for monetary, regulatory or institutional reasons – at 26.5% of GDP, the 3rd largest among European countries (Figure 1.9).[2]

Figure 1.9. Size of the shadow economy of 31 European countries in 2017: Adjusted MIMIC estimates



Notes: Multiple Indicators, Multiple Causes (MIMIC) approach: This method explicitly considers several causes, as well as the multiple effects, of the shadow economy. The numbers have been adjusted for do-it-yourself activities, neighbours' help, legally bought material and smuggling.
1. Note by Turkey:
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Source: (IMF, 2018[13]), "Shadow Economies Around the World: What Did We Learn Over the Last 20 Years?", https://www.imf.org/en/Publications/WP/Issues/2018/01/25/Shadow-Economies-Around-the-World-What-Did-We-Learn-Over-the-Last-20-Years-45583 (accessed on 31 January 2019).

The extent of the shadow economy might be a consequence of the heavy regulatory burdens businesses in Croatia are facing: The main factors for undeclared work in Croatia include a low employment rate and lack of work opportunities, as well as relatively high taxes and obligatory contributions on wages.

The large share of the grey economy in total GDP could have a long-term negative impact on economic growth and job creation. However, the situation seems to slowly improve as reports on conducted labour inspections indicate a gradual decrease of cases of undeclared work in Croatia. This positive trend can primarily be attributed to the wide scope of different measures designed and implemented to address undeclared work and the shadow economy in general (European Commission, 2015[14]).

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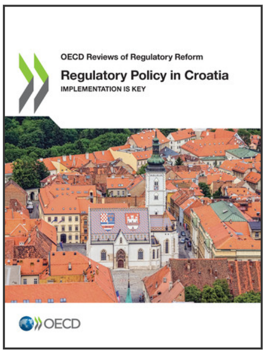
Notes

[1] As laid out in the Croatian constitution, art. 1.

[2] Grey (also known as shadow) economy is, by nature, difficult to measure (as its agents try to remain undetected) and there are various approaches to estimate its size. The IMF data has been chosen here as the approach considers several causes, as well as the multiple effects, of the shadow economy.



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