CONFERENČE

Raising Croatia’s Long-term Growth and Productivity

Zagreb, February 1, 2023
The Country Economic Memorandum is a key growth diagnostic prepared by the World Bank to analyze drivers of growth in the long term. The growth diagnostic for Croatia provides a comprehensive analysis of key challenges and opportunities for sustaining economic development.
Prevailing macroeconomic trends over the last two decades
Croatia’s growth path over the last two decades has been bumpy, in part reflecting the negative impact of large external shocks

- Growth was robust prior to the Global Financial Crisis (GFC), averaging 4.5 percent over 2002-08.
- Strong domestic demand, however, was mostly financed by debt, which generated sizable macroeconomic imbalances.
- The GFC and European debt crisis triggered a recession that lasted until 2014 in Croatia.
- Over 2015-19, growth firmed to above 3 percent a year, supported by improving external conditions and positive effects from EU accession in 2013.
- Croatia’s recovery was interrupted by the COVID-19 pandemic and then again by the Russian Federation’s invasion of Ukraine.

Contributions to GDP growth

Source: CBS
Although Croatia’s recovery from the pandemic shock was swift, Russia’s invasion of Ukraine and tighter global financial conditions bring new challenges.

- Although Croatia’s recession was deeper than the EU average during the onset of the pandemic in 2020, its recovery was far more robust.
- Croatia’s output nearly recovered to pre-pandemic trends by 2022, whereas the EU average trailed, with output remaining nearly 4 percent below pre-pandemic trends.
- The Russian invasion of Ukraine and subsequent energy shock, alongside tightening global financial conditions to dampen inflation, pose serious downside risks to the outlook.

Source: Eurostat, World Bank calculation
Despite wins in many different areas, living standard in Croatia is still far from the EU average

- GDP per capita (in PPP nominal terms) rose from 50 percent of the average EU27 level in 2001 to 70 percent in 2021.

- The GFC and subsequent European debt crisis saw convergence progress reverse and then stall until 2015.

- Convergence also backtracked slightly at the onset of the COVID-19 pandemic, but the recovery that followed in Croatia was strong relative to the EU27 average and helped close some of the per capita income gap.
Over the last two decades Croatia’s average growth was one of the lowest among CEE peers, primarily reflecting weak productivity performance.

Contributions to potential growth (2002-2008 average)

Contributions to potential growth (2015-2019 average)

Sources: EC, WB staff calculations.
Growth is expected to remain robust in near term, but to significantly decelerate over the longer term

- Growth is projected to remain relatively robust over the next years, supported by strong investments, in part financed by the EU.
- Per capita income growth is expected to slow thereafter, falling to just 1.1 percent by 2050 absent reforms.

Source: Author's calculation based on the LTGM-PC.
The slowdown in growth reflects various structural headwinds

Among these headwinds are:

- Rapid ageing, with the share of the working-age population forecast to fall from 64 percent in 2020 to 57 percent in 2050.
- Smaller capital deepening contribution after 2030.
- TFP, which is already relatively modest, is projected to fall further, from 0.6 percent in 2020 to 0.4 percent in 2050.

Source: Eurostat, World Bank staff calculations
Productivity gap explained

”Productivity isn’t everything, but, in the long run, it is almost everything.”

— Paul Krugman
Croatia’s gap in labor productivity with Germany largely reflects productivity differences within sectors rather than the composition of the economy.

Even if Croatia had the same sector composition as Germany, it would still be 57 percent less productive.
The labor productivity gap with the regional frontier is primarily due to large differences within sectors, especially manufacturing.

Differences in labor productivity across sectors between Croatia and Germany

- Differences in within-sector productivity are large and explain almost 90 percent of the productivity gap between the two countries.
- A worker in the Croatian manufacturing sector produces roughly one-quarter of the value added produced by a German manufacturing worker.
- Croatia, however, performs well in several services subsectors, particularly in low-skill tradable services.

Source: Eurostat, World Bank staff calculations.
Low firm productivity in Croatia reflects insufficient R&D investments and innovation and technology adoption.

Firms in Croatia invest only 72 euros per inhabitant—less than 10 percent of Germany and below most EU peers.

Croatia’s patent applications per million inhabitants was the second lowest in the EU across in 2017.

Sluggish firm productivity also reflects lagging managerial and organizational practices, as well as constraints on competition.
Firm level data indicates a negative impact from the reallocation of resources between sectors.

This essentially means that more productive firms are not successful at capturing market share from less productive ones.

This in part reflects low business dynamism, below-average exit rates, and higher productivity in exiting firms compared to incumbents.
Institutions and productivity
Institutional benchmarking suggests relatively weak performance with respect to public sector institutions, social institutions, and business and trade institutions.
### Institutional areas – survey of Croatian companies

<table>
<thead>
<tr>
<th>Competition and anti-monopoly policies</th>
<th>Compliance with regulations</th>
<th>Business permits</th>
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<tbody>
<tr>
<td>▪ Lack of trust towards the authorities enforcing competition rules</td>
<td>▪ Conflicting rules</td>
<td>▪ Length of procedures for obtaining business permits and licences</td>
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<tr>
<td>▪ Competition rules difficult to understand or comply with</td>
<td>▪ Lack of trust in the process, mainly due to unequal treatment of firms, especially SMEs</td>
<td>▪ Unequal treatment of firms and lack of knowledge of public officials and inspectors</td>
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<tr>
<td>▪ Low ability of the Competition Agency to effectively sanction dominant companies</td>
<td>▪ Lack of clarity of regulations</td>
<td>▪ Lack of consistency between inspectors and rules of implementation, and limited feedback in case of rejection</td>
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<tr>
<td>▪ Conflicting rules</td>
<td>▪ Complex process for disputing claims or decisions</td>
<td>▪ Too many details in definition of minimum technical requirements and standards</td>
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<th>Tax administration</th>
<th>Public procurement</th>
<th>EU funds</th>
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<td>▪ Frequency of submitting payments</td>
<td>▪ Administrative procedures before contract signature</td>
<td>▪ Unclear guidelines on how to participate and not enough information on the exact time of a call announcement</td>
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<tr>
<td>▪ Length of procedures for obtaining tax refunds and required documentation for getting a refund</td>
<td>▪ Too many administrative processes during contract execution and complicated regulations on subcontracting</td>
<td>▪ Lack of transparency, too long evaluation of application and no relevant feedback in case of rejection</td>
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<td>▪ Long process in case of dispute with tax administration</td>
<td>▪ Unequal treatment of firms</td>
<td>▪ Complex procurement rules that firms need to follow when subcontracting and difficulties in securing co-financing and bridge financing due to changes in the project</td>
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<td>▪ Firms perceive that grant contracts are typically awarded to politically connected firms</td>
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- SMEs: Small and medium-sized enterprises
Better future in reach?
Benefits from improvements in growth drivers are large, especially productivity

Reform package scenarios

Moderate reforms

Ambitious reforms

Sources: World Bank.
Ambitious reform agenda can significantly raise Croatia’s growth per capita and potentially close the income gap with the EU over the next two decades.

### Key takeaways

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<td>Increasing productivity is key for raising living standards in Croatia.</td>
<td>An ambitious and comprehensive set of reforms could almost double Croatia’s GDP per capita growth from 1.6 percent to 3 percent a year over 2025-50 period.</td>
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<td>Reforms should target productivity, labor force participation and quality of human capital.</td>
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<td>Croatia could reach average EU27 level of income within next two decades.</td>
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Key takeaways 2/2

1. Institutional areas that deserve the most attention are competition and anti-monopoly policy, business permits and public procurement.

2. Joint work of the private sector and the government is needed to accelerate productivity growth.

3. NRRP already includes a bold reform agenda and will have a major impact if fully implemented.

4. Don’t forget about demography, green agenda and inclusion.
Thank you

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