Economic Growth in Croatia: Potential and Constraints

Improvements to the business environment are critical to increasing Croatia's potential growth

David Moore and Athanasios Vamvakidis

Croatia's real GDP growth has averaged 4.75% over the past five years, below the average of nearly 6% achieved by peer countries in Central and Eastern Europe that recently joined the EU. With Croatia also on track to join the EU in a few years' time, the government aspires to higher growth as a means to catch up faster with living standards in the EU. But how can it realize its goals?

Our analysis finds that Croatia's potential growth rate is 4-4.5%. This suggests that recent economic growth has exceeded the economy's potential and, consequently, that reforms are needed to raise the economy's overall productivity if Croatia is to avoid a slowdown.

A reduced state role in the economy and improvements in the business environment are needed for sustaining faster growth

Many Natural Advantages

As for the factors supporting growth, Croatia has many natural advantages, including ready access to Central, Mediterranean, and Southeastern Europe, and a long and beautiful coastline that underpins the vital tourism industry. Croatia also compares favorably with other transition economies in terms of the openness of its economy, its well-developed banking system, strong public investment and infrastructure, and low inflation over the past decade. And with living standards well below those in the euro area, Croatia still has considerable scope for catch-up growth.

So what is holding growth back? Our analysis suggests that export performance, which has been weaker in Croatia than in its peers in Central and Eastern Europe, provides some clues. Over the past five years, Croatia's real exports of goods and services increased by an average 6% annually, significantly below the peer country average of over 10%. In a similar vein, Croatia has also done less well in terms of attracting new investors. Although total FDI in Croatia is close to the regional average, a disproportionately high share has come from privatizations or investment in the financial sector. The number of "greenfield" FDI projects — which are especially good for growth — remains small. Why is that? Survey evidence consistently points to a difficult business environment for both domestic and foreign investors.

Our simulations of a cross-country growth model suggest areas where economic reforms could increase Croatia's potential growth. A reduced state role in the economy — through lower fiscal deficits and faster progress in privatization — would help ensure macroeconomic stability, enhance market competition, and support private sector activity. Indeed, with general government spending as a share of GDP exceeding the regional average by several percentage points, there is considerable scope to lower the fiscal deficit. Structural reforms to improve the business environment — notably, facilitating the start-up of new businesses, streamlining the bureaucracy, increasing labor market flexibility, and reforming the judiciary — would also be needed for sustaining faster growth.

Microeconomic Problems Hinder Growth

Having conducted a "growth diagnostic" to identify binding constraints on growth, we find that growth is not held back, as is often the case, by financing problems or a lack of ideas for investment. Rather, Croatia is not yet as good a place in which to do business as it could be, even allowing for recent improvements. The diagnostic highlights the microeconomic problems stemming from the public sector: an inefficient bureaucracy and a high regulatory burden, problems with property rights, and corruption.

- The administrative and regulatory burden is particularly heavy at the local level, with investors often facing numerous non-transparent fees and delays in obtaining necessary permits. Lingering land ownership uncertainties have also hindered investment in some regions.
- Employment protection legislation is strict by regional and OECD standards, especially for temporary workers. While this legislation has helped protect jobs for existing employees it has also acted as a severe disincentive to new job creation.
- Contract enforcement is slow. The European Commission has warned that creditor and property rights are undermined by "slow and inefficient court proceedings, poor case management and low administrative and professional capacity." Transparency International's corruption perceptions index indicates that Croatia suffers from "serious" levels of corruption, a finding corroborated by other survey evidence.

In sum, the analysis highlights how improvements to the business environment are critical to increasing Croatia's potential growth. In addition, potential growth would benefit from a reduction in the still-significant role of the state in the economy, in particular by reducing the ratio of public expenditure to GDP to levels more in line with regional standards, and by eliminating the drain on public resources from state-owned enterprises that have yet to be restructured.

Thus, if Croatia is to keep up with the more successful new EU members, the pace of reform needs to accelerate. Encouragingly, the government is aware of these problem areas — and the EU accession process is providing additional impetus for new measures in some of the more difficult areas that the authorities have already targeted for reform.

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