



# FDI Qualities Review of Croatia

ADVANCING THE STRATEGIC FRAMEWORK  
FOR INVESTMENT PROMOTION AND FACILITATION



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# Preface

Since its independence in the early 1990s, Croatia has achieved remarkable economic growth that contributed to a successful convergence towards OECD and EU average incomes. The accession to the World Trade Organisation in 2000 and the European Union in 2013 were a pivotal juncture, which helped foster support for leveraging foreign direct investment (FDI) to enhance Croatia's productive capacity and growth potential, drive job creation and improved living standards. These achievements have paved the way for an increase in foreign investment over the last two decades, with Croatia's FDI stock passing from merely 13% of GDP in 2000 to 59% in 2021, above the OECD and CEE average.

Croatia's strong performance has been supported by continuous efforts to maintain an open and enabling environment for foreign investment, with the country now ranking as one of the most open economies to FDI in the OECD area. Croatia has also demonstrated a strong commitment towards fostering a conducive business environment, as evidenced by its successful administrative and regulatory simplification programme as well as efforts to optimise business registration procedures and digitalise a range of public administration processes, among other initiatives.

These reforms alongside important progress in several aspects of its investment climate have allowed Croatia to benefit from the sustainable development potential of FDI. As demonstrated by this study, foreign-owned firms, while constituting just 5% of active economic entities, have spurred innovation and R&D in knowledge-based services sectors, supported Croatia's export performance and delivered greener technologies that reduced the country's carbon footprint. Their impact is further seen in the job market, where foreign-owned firms pay higher wages than their domestic counterparts and employ significantly more women in ICT services and R&D-intensive industries.

Amidst intensifying global competition for FDI, mobilising sustainable investment remains a strategic priority and a necessity for Croatia for the next decade. Although in recent years notable progress has been achieved in attracting investment in the digital and renewable energy sectors, diversifying the economy towards high-tech and knowledge-intensive activities will require enhanced efforts in upgrading firms' capabilities, addressing labour market inefficiencies, and boosting productivity growth which remains relatively low compared to advanced EU economies. Addressing the emigration of young talent and building a skilled workforce is another important priority for Croatia that could further strengthen the country's appeal to foreign investors. To this end, it is crucial to proactively promote and facilitate investments that align with these objectives and help build a more diversified, innovative and environmentally sustainable economy.

The need for concerted action is heightened particularly now as multinational enterprises (MNEs) adjust their supply chains amid the economic uncertainty surrounding the aftermath of the COVID-19 pandemic and Russia's war of aggression against Ukraine. Croatia's Recovery and Resilience Plan, along with the 2030 Development Strategy, aim to harness the benefits of FDI through the development of a strategic framework for the promotion and facilitation of private investment. The forthcoming adoption of a National Plan and Action Plan for Investment Promotion and the revision of the Investment Promotion Act could help Croatia shift its economy towards high value-added activities and advance on its path towards the twin green and digital transition. This will require increased attention to policy coherence and coordination and a whole-of-government approach to investment and business climate reform.

The FDI Qualities Review of Croatia contributes to a better understanding of what drives FDI towards Croatia and identifies reform options to strengthen its economic, social and environmental benefits. We believe that the assessment and policy considerations put forward in this report will support Croatia in the development and implementation of the new strategic framework and, ultimately, help promote and attract investment that is greener, promotes quality jobs and upskilling, improves gender equality and contributes to a more productive and innovative economy.

The Government of Croatia and the OECD are very pleased to have joined forces in the preparation of this review. We are grateful to the European Union for funding the report and for the support provided throughout the project development and implementation. We also acknowledge the assistance of the Ministry of Economy and Sustainable Development in jointly coordinating consultations with Croatian ministries, agencies, companies and other stakeholders whose experiences on Croatia's business environment further enriched the review.

We hope that this assessment will help lay the foundations of a more sustainable and resilient economy.



**Hrvoje Bujanović**

State Secretary, Ministry of Economy and  
Sustainable Development of Croatia



**Yoshiki Takeuchi**

Deputy Secretary-General, OECD



# Foreword

The *OECD FDI Qualities Review of Croatia* uses the OECD Policy Framework for Investment (PFI) and the OECD FDI Qualities Policy Toolkit and Indicators to provide policy recommendations on how to strengthen the sustainable development impact of foreign direct investment (FDI) in Croatia. The Review provides an assessment of how FDI contributes to productivity and innovation, job quality and skills development, decarbonisation and regional development, and examines the institutional and policy framework for investment promotion and facilitation at national and subnational levels. It also outlines Croatia's investment incentives regime and provides recommendations for a more transparent and effective design and implementation of investment tax incentives. The findings and recommendations of this FDI Qualities Review aim to support the Government of the Republic of Croatia to develop a Strategic Framework for the Promotion and Facilitation of Private Investment, including a National Plan on Investment Promotion, a related Action Plan, and an amendment to the Investment Promotion Act. The reform is part of Croatia's National Recovery and Resilience Plan and is supported by the European Commission (EC).

The Review was prepared in close collaboration with the Ministry of Economy and Sustainable Development of the Republic of Croatia, in consultation with an inter-ministerial taskforce created for the Review. The report has also benefited from consultations with OECD Investment Committee Delegates, representatives from international organisations, the private sector, civil society and academia, whose experiences on Croatia's business environment further enriched the Review.

The Review was prepared by Stratos Kamenis, Fares Al Hussami, Katharina Böhm and Katharina Längle from the OECD Investment Division, under the overall guidance of Martin Wermelinger, Head of Investment Qualities and Incentives Unit. The authors are also grateful to Stjepan Srhoj from the University of Split and Taufeeq Khan Marcos from the OECD Investment Division for their contribution to the analytical work undertaken for this project. Lucinda Pearson prepared the report for publication and Angèle N'Zinga provided administrative assistance. The report benefitted from comments and inputs from the following OECD colleagues: Ana Novik, Stephen Thomsen, Alexandre de Crombrughe, Monika Sztajerowska, Sarah Dayan, Joachim Pohl, and Martin Wermelinger from the Investment Division; Tim Bulman and Timo Leidecker from the Economics Department; Supriya Trivedi and Paul Davidson from the Directorate for Public Governance; and Luisa Dressler and Alessandra Celani from the Centre for Tax Policy and Administration. Comments from Croatian ministries, implementing agencies and subnational governments were received with the assistance of the Internationalisation Directorate in the Ministry of Economy and Sustainable Development. This report was approved for publication by the OECD Investment Committee on 6 November 2023.

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# Abbreviations and acronyms

AIK	Agency for investments and Competitiveness
ASIP	Act on Strategic Investment Projects
BERD	Funding and tax support of business enterprise R&D expenditure
CEE	Central and Eastern Europe
CES	Croatian Employment Service
CICE	Competitiveness and Employment Tax Credit
CIT	Corporate Income Tax
CRM	Customer relationship management system
EC	European Commission
EDO	Economic Development Organisation
EIZ	Institute of Economics Zagreb
ESIF	European Structural and Investment Funds
ETR	Effective Tax Rates
EU	European Union
EU28	European Union consisting of 28 Member States (including United Kingdom)
EUR	Euro
FDI	Foreign Direct Investment
FINA	Financial Agency of Croatia
FIT	Feed-in-Tariffs
GBER	General Block Exemption Regulation
GDP	Gross domestic product
GloBE	Global Anti-Base Erosion
HAMAG-BICRO	Croatian Agency for Small and Medium-Sized Enterprises, Innovations and Investments
HBOR	Croatian Bank for Reconstruction and Development
HIPA	Hungarian Investment Promotion Agency
HRK	Croatian Kuna
HROTE	Croatian Energy Market Operator
ICT	Information and Communications Technology
IPA	Investment Promotion Agency
IT	Information Technology
KPI	Key Performance Indicator
OECD ITID	OECD Investment Tax Incentives Database
LLDs	Least developed districts
M&E	Monitoring and evaluation

MESD	Ministry of Economy and Sustainable Development
MNE	Multinational Enterprises
MRDEUF	Ministry of Regional Development and EU Funds
MSMEs	Micro-, Small and Medium-sized Enterprises
NACE	European Classification of Economic Activities
NCC	National Competitiveness Council
NFIA	Netherlands Foreign Investment Agency
NIC	National Innovation Council
NPOO	Croatia's National Programme of Recovery and Resilience
OG	Official Gazette
PIT	Personal Income Tax
R&D	Research and development
RVO	Netherlands Enterprise Agency
SBIE	Substance-based income exclusion
SDG	Sustainable Development Goals
SME	Small and medium-sized enterprise
SSC	Social security contributions
USD	U.S. dollar
VAT	Value-added tax
VET	Vocational education and training

# Executive summary

Over the past few decades, Croatia has achieved remarkable economic growth, including a doubling of per capita incomes since the mid-1990s and improved living standards. Croatia's economy centers primarily around services, with tourism playing a pivotal role. The integration of the economy into global value chains (GVCs) remains less pronounced than that of its Central and Eastern European (CEE) counterparts and has not substantially evolved during the past two decades. Croatia's labour productivity also ranks behind the OECD and other CEE economies' averages. Diversifying economic activity and further integrating in GVCs could boost productivity growth.

Foreign direct investment (FDI) has played an important role in Croatia's economic growth, with a significant surge in the early 2000s primarily fueled by state-owned enterprise privatisations. New establishments of foreign-owned firms (i.e. greenfield FDI) are concentrated in construction and services, particularly tourism. In recent years, investments have increasingly been geared toward green and digital industries such as electricity generation from renewables as well as ICT and internet infrastructure. Foreign-owned firms, despite constituting only 5% of active businesses, demonstrate almost double the productivity of domestic firms, and contribute significantly to value added, exports, and research and development (R&D) expenditure. FDI is also instrumental in job creation, particularly among women, and plays a crucial role in Croatia's transition toward a low-carbon economy. However, there is room for improvement in fully harnessing FDI's potential to create jobs and foster environmental sustainability.

In Croatia, the Ministry of Economy and Sustainable Development (MESD) oversees investment promotion through its Internationalisation Directorate, established in 2020 following the abolishment of the Agency for Investment and Competitiveness (AIK). While the Directorate has been progressively developing its investment promotion tools and processes, including by disseminating investment information and providing support to foreign multinational enterprises (MNEs) in establishing their operations, there remains a need for more targeted investment generation activities and enhanced coordination with subnational governments to improve the quality of investment facilitation services. Although the Directorate's financial resources have substantially increased in recent years, staff shortages undermine efforts to engage in more sophisticated investment promotion activities. The forthcoming National Plan and Action Plan on Investment Promotion present an opportunity to address these challenges and equip the Directorate with the necessary tools and processes to advance its investment promotion agenda.

To promote knowledge-intensive investments, Croatia could enhance government support for R&D, as it currently lags behind OECD and EU economies in this regard. Complex application procedures, low awareness, and fragmented funding sources deter firms from benefiting from R&D incentives. The Government of Croatia could better target and coordinate funding sources, combine them with technical assistance and promote collaboration of investors with R&D institutions and science and technology parks. Policy inter-linkages across the areas of investment promotion, employment and skills development could also be strengthened to attract FDI in job-creating and skill-intensive activities. The Investment Promotion Act offers tax benefits and financial grants for investments contingent on creating a certain number of jobs. Yet, there is currently no systematic and coordinated skills anticipation process that considers MNEs' changing needs with regard to workforce skills. Over the past decade, the government has taken steps

towards promoting green investments by setting low-carbon transition targets that send investors, including foreign ones, strong signals regarding the government's climate ambitions. However, the incentive system for investments in renewable energy has suffered from discontinuity and delays. The recent introduction of a premium-based incentive scheme is a positive step, but regulatory barriers for green investments could be further removed to achieve decarbonisation targets.

FDI's effects are unevenly distributed across subnational regions. The majority of FDI is concentrated in the Adriatic and northwestern regions, while Eastern Croatia attracts substantially less investments. Foreign firms outperform domestic ones in all parts of Croatia, but FDI's positive impacts on productivity, innovation and R&D are often most pronounced in Zagreb and weakest in the region of Pannonia. The job creation intensity of FDI also varies across regions. The same amount of greenfield investment generates twice more jobs in Zagreb than in Pannonia. Disparities in FDI impacts are driven by regional differences in sectoral distributions, skills availability (or their shortages) and R&D activity.

To achieve balanced regional development, Croatia could leverage international investment more effectively. Although the Investment Promotion Act outlines regional development as an objective, a well-defined investment promotion strategy with specific targets and place-based policies is currently lacking. Beyond promoting regions as attractive investment destinations, place-based investment tax incentives and entrepreneurial zones and infrastructure are the main policies implemented to attract FDI in support of regional development. However, overlapping mandates of the MESD and the Ministry of Regional Development and EU Funds (MRDEUF) and ambiguity in the role and responsibilities of county and local development agencies pose challenges for policy coherence and coordination. Clarifying responsibilities across tiers of government and developing coordination mechanisms that bring together national and subnational actors could address these challenges. Equipping the forthcoming National Plan on Investment Promotion with a regional pillar and embedding FDI attraction priorities in regional and local development strategies can help Croatia to better leverage FDI in support of less developed regions.

The reform of Croatia's strategic framework for investment promotion and facilitation provides an opportunity to evaluate and enhance the existing investment incentives system. Currently, the Investment Promotion Act offers a range of incentives, including tax benefits, grants, and in-kind benefits. Primary among these incentives are reduced corporate income tax (CIT) rates, which are conditional to investment levels, job creation and technological upgrading with higher caps on benefits in less developed regions. Croatia could re-evaluate the design of its main tax incentives to adopt a stronger expenditure-based approach, which allows to better target investments that contribute to sustainable development and might not have occurred without the incentive.

While requiring investors to achieve certain outcomes (e.g. minimum number of new jobs created) to benefit from incentives is an important means to promote FDI spillovers on the local economy, it requires careful monitoring, resources and close coordination with other government institutions to ensure that the desired outcomes have been met. The MESD closely monitors compliance of beneficiaries with incentive conditions and related costs as per the EU State Aid Requirements. But more could be done to evaluate the impact of investment tax incentives on the economy. Coordination between the Ministry of Finance and the MESD's Internationalisation Directorate appears to work effectively. Information sharing across government bodies involved in incentives could be further strengthened, however.





# 1 Overview and key policy considerations

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This chapter provides an overview of the main challenges and opportunities for investment promotion and facilitation in Croatia, and the role that foreign direct investment plays in supporting sustainable development, including productivity and innovation, job quality and skills development, regional development, and the low-carbon transition. Based on an assessment of Croatia's regulatory and policy framework at national and subnational levels, the chapter also derives overarching policy considerations to strengthen the economic, social and environmental benefits of foreign investment.

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## Trends and qualities of foreign direct investment in Croatia

Croatia's remarkable economic journey over the past few decades has seen per capita incomes doubling since the mid-1990s and living standards substantially improved. Croatia's accession to the World Trade Organization (WTO) in 2000 and the European Union (EU) in 2013 substantially boosted exports of goods and services, with about two-thirds of its exports and three-quarters of imports originating from or destined for EU Member States, most prominently Italy, Germany, and Slovenia. Croatia's economic landscape is characterized by a pronounced emphasis on services, with a particular spotlight on tourism. In comparison to other Central and Eastern Europe (CEE) economies, Croatia's share of value-added in manufacturing is lower, signalling an opportunity for reinvigorating industrialization and enhancing productivity. Its integration into global value chains (GVCs) is less pronounced than that of its CEE counterparts, with lower foreign value-added content in its exports. Boosting the integration of the Croatian economy in GVCs could be instrumental in elevating productivity. Although the country has achieved commendable productivity growth, it still lags behind the OECD and CEE averages.

FDI has played a pivotal role in Croatia's economic growth. A surge in FDI occurred during the early 2000s, primarily driven by privatizations of state-owned enterprises. However, the global financial crisis in 2008 caused a substantial divestment. FDI has since rebounded, although it continues to lag behind the average of other CEE countries in absolute terms. New establishments of foreign-owned firms (greenfield FDI) are concentrated in construction and services, reflecting Croatia's specialisation in services – especially tourism but also software and IT services.

Foreign-owned firms represent only 5% of active economic entities in Croatia but they are almost twice as productive as domestic firms and contribute to around 30% of total value-added, 45% of exports and 60% of private expenditures on research and development (R&D). Beyond positive effects on productivity, innovation, and exports, FDI is key for job creation, including for women, and supports the transition to a low carbon economy in Croatia. For instance, foreign firms have on average a higher share of female employees than domestic firms. Although Croatia attracted FDI in labour intensive services, it doesn't fully capitalise on the potential of FDI to create jobs. The number of jobs created per million of USD invested over recent years is below the CEE average. Foreign-owned firms play a crucial role in Croatia's transition toward a carbon-free and environmentally sustainable economy. FDI in the energy sector is increasingly concentrated in renewables and foreign firms steadily improve their energy efficiency. However, compared to domestic peers, foreign firms fall short in environmental expenses and only slightly increased expenses for environmental purposes over the past decade.

Croatia could aim to further diversify FDI into activities where it has an existing comparative advantage in production and exporting, which would strengthen productivity and competitiveness in these activities and foster sustainable development more broadly. Despite not having a comparative advantage in most of its exports, the country's production and export basket encompasses a wide range of manufacturing products. Croatia's products with a traditional or emerging comparative advantage are less complex and hold smaller market shares than those of its competitors, in particular CEE economies. Croatia's emerging comparative advantages are also concentrated in relatively small markets. While this presents some challenges, it also offers the opportunity to excel in specialized products.

### Box 1.1. Databases used to assess FDI trends and impacts in Croatia

**Census data of the Financial Agency (FINA) of Croatia:** include information on demographic and financial details of firms operating in Croatia. This dataset encompasses all publicly listed and private limited companies incorporated in Croatia and provides details on domestic and foreign sales, R&D and material expenditure along with demographic information such as firm employment, NACE 4-digit industry, and micro location of the firms' headquarters (i.e. county and municipality). Analyses of this report focus on all "active" firms in Croatia between 2008 and 2021, i.e. firms that had positive sales and employment in a given year, thus covering the universe of Croatian firms regardless of revenue or employment thresholds. NACE 4-digit industries

**Croatian Pension Insurance Institute (HZMO):** provides detailed information on employment of individual firms by occupation and gender as well as average wages from 2014 until 2021. The report classifies occupations by skill level according to the International Standard Classification of Occupations (ISCO) (ILO, 2023[32]). Accordingly, high-skilled occupations include managerial, professional, technical, and associated professional occupations.

**Financial Times' fDi Markets Greenfield FDI database:** includes cross-border greenfield investments covering all countries. It provides real-time information on capital investment and job creation by economic activity, source country, and location (region). For this study, cross-border greenfield investment projects directed to Croatia from 2003 to 2022 Q2 as well as cross-border greenfield investment projects directed to other CEE economies from 2017 to 2021 were selected from all countries of origin and covering all economic activities. Economic activities were reclassified to correspond to the ISIC Rev4 sectoral classification.

In addition, several other OECD and non-OECD databases have been used in this report including the OECD FDI Statistics, OECD Trade in Value Added (TiVA) indicators, OECD Gender Portal, OECD Green Growth Indicators, IMF Balance of Payments and International Investment Position Statistics, as well as ILO and World Bank Indicators, including the World Bank Enterprise Survey.

## Investment promotion and facilitation for a sustainable and resilient recovery

As highlighted in the OECD Policy Framework for Investment and the OECD FDI Qualities Policy Toolkit, investment promotion and facilitation can be powerful means to attract investment and maximise its contribution to sustainable development, but their success depends on the quality of investment-related policies and on the overall investment climate. As such, many countries worldwide decide to not only remove restrictions on foreign direct investment (FDI) and provide high standards of protection to investors, but also to proactively promote and facilitate investment to maximise potential economic, social and environmental benefits to the host economy. Effective investment promotion and facilitation can be particularly important to address the economic consequences of the COVID-19 pandemic and the energy crisis, which have weakened economic prospects and increased the risk of slowing down progress to make societies and economies more resilient, inclusive, and sustainable.

In Croatia, the Ministry of Economy and Sustainable Development (MESD) is responsible for investment promotion and facilitation. The MESD's Internationalisation Directorate, established in 2020 after the abolishment of the Agency for Investment and Competitiveness (AIK), aims to promote Croatia as an attractive investment destination and assist foreign multinational enterprises (MNEs) in establishing their operations there. The Directorate has been gradually developing its investment promotion tools, including disseminating information on investment opportunities, creating investor guides and other promotional materials, and supporting investors to set up their business operations in different regions.

Unlike most OECD Investment Promotion Agencies (IPAs), the Directorate does not prioritize specific investment projects, sectors, or countries and lacks a dedicated unit for that purpose. Facilitation services offered by the MESD mainly focus on assisting investors during their establishment phase. Subnational governments like regional counties and municipalities offer complementary services in the regions, such as resolving legal issues and helping investors identify local suppliers and qualified employees. To leverage FDI's development potential, the Directorate could consider scaling up its investment generation activities by pro-actively targeting and prioritising investments that contribute to sustainable and inclusive economic growth. Synergies with subnational actors could be further developed to provide support to foreign MNEs on the ground and standardise the quality of investment facilitation services across Croatian regions.

The MESD's Internationalisation Directorate has been facing challenges to fulfil its investment promotion mandate due to inadequate resources and insufficient staff. It's crucial for the Croatian Government to equip the Directorate with the necessary financial and human resources to offer a broader range of services to potential investors. Although investment promotion budgets have increased in recent years, staff shortages put a strain on the activities of the Directorate. The fragmented institutional environment poses another challenge for investment promotion and facilitation in Croatia. Many investment-related mandates are shared with other government bodies (e.g. sectoral ministries, subnational governments), resulting in limited coordination and disjointed actions. To overcome this, the Internationalisation Directorate could consider establishing formal coordination mechanisms with other parts of the government, share resources and implement joint initiatives that support foreign MNEs at every stage of their investment process. The forthcoming National Plan and Action Plan on Investment Promotion, that will be adopted by the government in the course of 2024, present an opportunity to rethink Croatia's investment promotion framework, address existing challenges and equip the Directorate with the necessary tools and processes to fulfil its role.

Besides providing a source for financing, FDI can support sustainable development in Croatia by diversifying the economy, transferring technology and knowledge, developing the skills base, boosting productivity and innovation, and establishing linkages with local firms (OECD, 2022<sup>[1]</sup>; OECD, 2015<sup>[2]</sup>). However, FDI does not always go where it is most needed and its impacts on sustainable development are not always positive. To realize the potential benefits from international investment, effective policies and institutional arrangements that link investment promotion with complementary policy areas are crucial (Box 1.2).

Regarding the promotion of knowledge-intensive investments, Croatia provides one of the lowest levels of government support to R&D among OECD and EU economies. The limited number of firms benefitting from R&D incentives may be caused by complex application procedures, a lack of awareness, and the fragmentation of funding sources, which have different objectives, timeframes and implementing authorities and do not always provide the necessary long-term perspective that is necessary when foreign MNEs decide where to locate their R&D activities. Funding sources should be better targeted, coordinated and supplemented with technical assistance to link applied university research with the needs of foreign investors, provide R&D workforce training, and facilitate collaboration with science and technology parks.

Investment promotion and incentive policies play a key role in supporting job creation and skills development. Croatia's Investment Promotion Act offers tax benefits and financial grants conditioned to the creation of a certain number of jobs depending on the level of unemployment in each subnational county (Government of Croatia, 2022<sup>[3]</sup>). Similarly, training grants are available covering up to 70% of costs incurred for training employees in newly created jobs. Although labour and skill shortages appear to be one of the biggest obstacles for foreign MNEs operating in Croatia, policy inter-linkages across the areas of investment promotion, employment, and skills development are limited. The Croatian Employment Service is responsible for analysing the needs of the labour market and accordingly prepare recommendations for training and educational programmes, but there is no evidence that this has any influence on workforce development policies. The establishment of systematic and coordinated skills

anticipation processes that involve the investment community and take into consideration MNEs' changing needs is essential to attract skill-intensive investment. The MESD's Internationalisation Directorate could further promote sectors in alignment with the existing skills base and help investors identify local workers with relevant skills.

### Box 1.2. The OECD FDI Qualities Initiative

The **OECD FDI Qualities Initiative** provides governments with the policies, data and expertise they need to encourage sustainable investment that is greener, promotes quality jobs & upskilling, improves gender equality, and contributes to a more productive and innovative economy. Even before the COVID-19 pandemic, it was estimated that achieving the Sustainable Development Goals (SDGs) required financing of USD 2.5tn per year - a gap which may have since increased by 70%. Meanwhile, fulfilling the commitments made in the Paris Agreement to curb climate change requires investment in renewable energy to triple by 2030. Foreign direct investment (FDI) is an important source of finance to help meet these global commitments to sustainable development. Beyond the quantity of FDI, its quality also matters. A key challenge for the international community is to mobilise significant financial resources to accelerate the implementation of the 2030 Agenda for Sustainable Development and ensure that plans for a “decade of action” to advance the SDGs are not side-tracked.

The OECD FDI Qualities Initiative comprises three components:

- The **FDI Qualities Indicators**, originally developed in 2019, seek to measure the sustainable development impacts of FDI in host countries (OECD, 2019<sup>[4]</sup>).
- The **FDI Qualities Policy Toolkit** helps governments identify priorities for policy and institutional reforms to enhance the impacts of investment on sustainable development (OECD, 2022<sup>[1]</sup>). For each area of sustainable development covered, it describes how to assess the impacts of FDI and provides policy recommendations related to governance, domestic and international regulation, financial and technical support, and information and facilitation services.
- The **FDI Qualities Policy Network** provides a platform to engage in policy dialogue and stakeholder consultations with development partners, international organisations, businesses, civil society and academia.

The **OECD Council Recommendation on FDI Qualities** draws on these three core elements and is the first government-backed agreement to help policy makers to leverage FDI to finance the SDGs and optimise the strength and quality of the recovery.

Source: OECD (2022<sup>[1]</sup>), FDI Qualities Policy Toolkit, <https://doi.org/10.1787/7ba74100-en>

Croatia's government has prioritized creating an enabling environment for green investment by setting clear low-carbon transition targets and long-term policy strategies (e.g. Low-Carbon Transition Strategy, Energy Development Strategy) that send investors, including foreign ones, strong signals regarding Croatia's climate ambitions. However, over the past decade, the incentive system for investments in renewables has been characterised by a lack of continuity and delays in its implementation. The recent introduction of a premium-based incentive scheme, which provides financial support to a winning bidder under a contract made with the Croatian Energy Market Operator (HROTE), is a step in the right direction and could help Croatia achieve its decarbonisation targets as long as it is accompanied by reforms to remove regulatory barriers for green investments and targeted policy interventions to create conducive framework conditions for private investment (e.g. ease of granting licenses and permits, access to land, access to finance).

Overall, Croatia performs well in regulatory complexity and simplification of licensing and permit systems. However, administrative, regulatory, and technical barriers hinder further investment in large-scale renewable energy projects. Procedures for obtaining environmental approvals – namely environmental impact assessments – take significantly longer than the legal deadlines prescribe. Technological upgrades of existing renewable energy projects can take several years to be approved since they usually require amendments to the location and building permits, which cannot be obtained before a new environmental impact assessment is conducted – resulting in delays and a lack of predictability for investors. Ongoing policy efforts to digitalise certain licensing and permit requirements will not be sufficient to reduce regulatory burden unless they are accompanied by simplification measures, interoperability between government bodies and enhanced coordination between levels of government. Finally, administrative challenges in securing land tenure often cause delays in licensing procedures for large-scale investment projects. Weaknesses in local authorities' spatial planning capacity and the low quality of cadastral and land registries do not always allow to determine the status of land plots with certainty. Improving access to information regarding land administration and tenure through digitalization can help streamline investment procedures.

### Policy recommendations

- **Ensure that Croatia's forthcoming National Plan on Investment Promotion is guided by clearly identified strategic objectives** and that these are reflected in the Internationalisation Directorate's governance processes, allocation of resources, key functions and activities.
- **Expand investment generation activities to identify and approach potential investors that can support national development objectives**, notably by targeting companies in priority sectors and in high value-added activities.
- **Improve the internal governance of investment facilitation and aftercare services by exploiting synergies with subnational actors** that may have more staff on the ground to provide the services that are currently not provided by the MESD.
- **Continue efforts to address resource-related challenges faced by the Internationalisation Directorate** and strengthen its capacity to generate prospective investment leads and maximise the number of realised investments.
- **Develop a comprehensive investment prioritisation framework with clearly defined criteria** that will be used for the pro-active targeting of activities, sectors, and investments that contribute to the sustainable development of the Croatian economy.
- **Introduce robust monitoring and evaluation (M&E) systems to track the investment promotion and facilitation activities undertaken by the Internationalisation Directorate**, and evaluate its organisational performance and success in reaching the target objectives set in the forthcoming National Plan and Action Plan for Investment Promotion.
- **Set up coordination mechanisms that place the MESD at the epicentre of cross-government efforts to promote investment** and allow the Internationalisation Directorate to effectively collaborate with sectoral ministries, subnational IPAs, regional and local governments.
- **Review the innovation support programmes to make them more accessible to foreign and domestic firms** that seek to engage in innovation-based partnerships.



- **Strengthen knowledge and technology spillovers from FDI by helping foreign MNEs identify local suppliers** and strengthening the capacities of Croatian SMEs to collaborate with them.
- **Address skills shortages in FDI-intensive sectors through targeted sectoral upskilling programmes that allow foreign MNEs to tailor them to the needs of their employees.** The MESD's Internationalisation Directorate could further promote sectors in alignment with the existing skills base and help investors find qualified employees.
- **Establish robust labour market information and skills anticipation systems that involve investment actors** to design evidence-based employment or training policies and effectively monitor their impacts. The MESD could bring forward its sectoral expertise to the National Council for Human Resource Potential and voice the concerns of investors in terms of skill shortages and future training needs.
- **Step up policy efforts to promote and facilitate renewable energy investments** by removing regulatory barriers, simplifying licensing and permit systems, ensuring the continuity of the new feed-in-premium incentive scheme, and strengthening interoperability between government bodies.
- **Harmonise and improve the governance of spatial planning rules to facilitate land acquisition for large-scale investment projects.** Emphasis should be placed on streamlining information on land administration and tenure for potential investors through digital means.

## Harnessing investment for regional development

Foreign investment has a significant impact on sustainable development in Croatia, but its effects are uneven across regions. FDI is concentrated in the Adriatic and north-western regions, particularly in the capital city of Zagreb, Istria, Primorje-Gorski Kotar and Split-Dalmatia. Eastern Croatia has attracted less FDI: Pannonian Croatia concentrates only 3% of the national FDI stock, reflecting its lower business density compared to other regions. Foreign firms perform better compared to domestic firms in all parts of Croatia, especially in terms of labour productivity, but the positive impact of FDI is stronger in Zagreb and in the Northern region, as companies with R&D activities are concentrated in larger cities. The impact of FDI on job creation is also uneven. One million of greenfield FDI in Croatia generates around 4 direct jobs per million USD invested, but this varies by a factor of two between Zagreb (6 jobs) and Pannonian Croatia (3 jobs). Disparities in FDI impact on jobs are largely driven by sectoral distributions, skills availability (or their shortages) and R&D activity. .

To achieve balanced regional development, Croatia could leverage FDI more effectively. While the Investment Promotion Act includes regional development as an objective, there is currently no well-defined investment promotion strategy with specific targets and place-based policies beyond what is outlined in the Regional Aid Map on how to better utilize FDI in support of regional development. In contrast, many OECD countries that are EU members have integrated regional aspects into their national investment promotion strategies and made FDI attraction a central component of their regional convergence plans. A key challenge for Croatia is determining the appropriate subnational level for implementing the strategy. With 20 counties and 555 local governments (428 municipalities and 127 cities), many of them geographically or economically small, strategic planning on investment policies is difficult while attractiveness factors such as business density, skilled labour and local supply chains often transcend administrative boundaries. Although Croatia's four larger regions could potentially develop attractive FDI value propositions aligned with their distinct priorities, they lack the administrative capacities for policy design and implementation and may need to rely on institutions operating at the local or county level.

Croatia's policy and institutional framework for investment promotion has become increasingly complex in a decentralised setting with fragmented subnational bodies. At the national level, the Internationalisation Directorate of the Ministry of Economy and Sustainable Development recognises regional development as important; yet, it does not prioritise it to the same extent as the IPAs of OECD countries, which often lead investment promotion efforts at the regional and local levels. Additionally, the Ministry of Regional Development and EU Funds (MRDEUF) plays a significant role in policies at the intersection of FDI and regional development, overseeing the European Structural and Investment Funds (ESIF) and Integrated Territorial Investments (ITIs) of the EU Cohesion Policy, which shape regional development policies and orient EU funds to specific sectors or activities to unleash regional competitiveness. The MRDEUF also coordinates the recently established Industrial Transition Plans for the Adriatic, Pannonian and North Croatia regions, which aim to support the development of regional value chains through EU-funded financing instruments. However, there is some ambiguity regarding the role of each ministry in overseeing or coordinating investment promotion at the subnational level.

The MESD's Internationalisation Directorate employs various policies to influence investors location decisions in support of regional development such as enhancing the attractiveness of regions as investment destinations and offering tax incentives in accordance with the Regional Aid Map. However, further evidence is needed to assess the impact of these incentives in attracting FDI that creates high-wage jobs in less developed regions and mitigates brain drain. Unlike OECD national IPAs, the Directorate places less emphasis on generating FDI projects for less developed regions but provides FDI-related intelligence to subnational bodies. While it is reasonable for the Directorate not to consider talent attraction as a way to promote FDI in less populated areas, the new policy of facilitating the entry of foreigners could prompt a re-evaluation of how investment promotion can support the broader goal of retaining youth from migrating.

At the subnational level, the establishment and operation of Entrepreneurial Zones (EZ) and Entrepreneurial Support Infrastructure (ESI), which are managed by subnational governments with administrative assistance from the MESD's Internationalisation Directorate, have helped attract and facilitate investments. While the EZ network effectively attracts foreign investment projects, its ability to redistribute economic activity and generate spillovers beyond nearby urban areas is somewhat limited. Local and county development agencies, which are one type of ESI entities under the Act on Improving Entrepreneurial Infrastructure, are entrusted with the responsibility of promoting investments in their regional and local jurisdictions alongside other functions. However, the large number of county and local development agencies often leads to confusion about which entity holds the mandate for investment promotion and facilitation.

Croatia's first step toward enhancing policy coherence and coordination in investment promotion and regional development should involve clarifying mandates across tiers of governments. Although the MESD's Internationalisation Directorate has good but only informal bilateral relationships with subnational governments, primarily covering aspects like business establishment support, these informal mechanisms are insufficient for addressing comprehensive and strategic policy issues related to investment promotion and regional development. These issues require collective agreements since they can range from strategy design, sectoral targeting, maintaining a pipeline of investment projects to jointly agreeing on common and harmonised approaches to investment facilitation.

## Policy recommendations

- **Equip the planned National Plan on Investment Promotion with a regional pillar**, in consultation with relevant subnational entities. The pillar sets FDI targets based on regional priorities and strengths, identifies investment promotion efforts, and clarifies the tasks of national and subnational entities and related coordination mechanisms.
- **Integrate the wide range of place-sensitive policies in the regional pillar of the investment promotion strategy**, beyond typical investment promotion efforts, to make FDI work for regional development.
- **Set the appropriate subnational level for the regional pillar of the investment promotion strategy to overcome fragmented planning**. Croatia's four large regions allow to consider broad regional specificities while still offering attractive FDI value propositions.
- **Embed FDI attraction priorities in relevant County Development Strategies, Urban Areas Development Strategies and the Plans for Industrial Transition of the three NUTS2 regions**. Including a regional pillar in the National Plan on Investment Promotion is not sufficient in a decentralised setting where the central government's ability to attract FDI depends on regions taking planned actions to improve their attractiveness.
- **Consider revising the legislative framework to clarify which subnational bodies have the mandate to promote investment**. The Act on Improving Entrepreneurial Infrastructure refers to local and county development agencies, creating confusion and overlap with bodies of the same name operating under the Act on Regional Development. The Acts should be aligned and clarify which entities carry investment promotion and facilitation mandates.
- **Clarify responsibilities and strengthen cooperation at the central level**. The Investment Sector of the MESD's Internationalisation Directorate promotes Croatia as an FDI destination while the Incentives and Entrepreneurial Infrastructure Sector is tasked with improving the investment climate for balanced regional development by supporting the ESI network. Close coordination and joint planning between the two Sectors are crucial.
- **Develop coordination mechanisms to address multi-level investment promotion challenges**. The MESD's Internationalisation Directorate could develop with relevant national and subnational entities a cooperation agreement, protocol or guidelines that describe the rules of engagement of each actor with a clear distribution of tasks at different stages of the investment process.
- **Leverage digital tools to support national-subnational investment promotion activities**. The MESD's Internationalisation Directorate could establish, in cooperation with the relevant subnational entities, a digital platform to announce foreign investors' expressions of interest received by the ministry.
- **Strengthen the effectiveness of place-based policies on attracting FDI that supports regional development**. This includes better integrating EZs into their regional ecosystem to generate further economic spillovers; further provision by the MESD of FDI-related intelligence to subnational bodies to help them identify and target unique FDI markets; and assessing local incentives' impacts on attracting job-creating FDI to regions with higher unemployment rates.
- **Consider talent attraction and retention as tools to attract FDI in disadvantaged regions**. The central and subnational governments should consider how investment promotion serves broader goals of retaining youth from migrating while facilitating foreigners' entry to avoid labour shortages.

## Towards more effective investment tax incentives

As Croatia develops and implements its National Plan on Investment Promotion, it should explore ways to enhance the existing investment incentive system, ensuring it aligns effectively with the country's investment policy goals. The new Plan could also serve as an opportunity to actively promote incentive policies to potential investors. More broadly, incentives are only as attractive as the wider investment climate. They should complement, rather than replace, policies that create a predictable and attractive investment environment.

Croatia offers a variety of incentives to attract investors, including tax incentives, grants and in-kind benefits, such as rent-free lease of land and buildings. The primary investment incentives are reduced corporate income tax (CIT) rates, linked to job creation and investment amount, that are granted through the Investment Promotion Act. Reduced CIT rates substantially reduce the statutory rate by 50-100% for up to ten years – though the total value of benefits investors can receive (including grants and other tax benefits) is capped, with higher caps on benefits in less developed regions. Besides the benefits offered under the Investment Promotion Act, other incentives include a tax allowance and grants for firms that engage in research and development (R&D), tax and in-kind benefits for companies in entrepreneurial and free zones as well as assistance from entrepreneurial support institutions. Sub-national governments provide additional non-tax incentives, including financial grants, exemptions from fees, or in-kind benefits (e.g. land at reduced cost).

Croatia has aligned incentives under the Investment Promotion Act with EU Regional Aid requirements, with a positive effect on incentive design. Incentives are accessible to companies of any size and across most sectors, preventing opportunities for rent-seeking behaviour through favoured sectors. Eligibility conditions are clear and specific, and tied to positive development goals, notably, job creation, and regional development. Tax and financial benefits are capped with a ceiling per project as well as annual spending limits for the regime as a whole, proving a check on government expenditure. EU regulations also positively mandate thorough monitoring and reporting on incentive uptake and costs, an essential first step to evaluating the impact of incentives.

Tax and non-tax incentives under the Act aim to support the growth of substantive private sector investment, both domestic and foreign, while fostering job creation, regional development and technological upgrading. CIT incentives under the Act support these goals through eligibility conditions to receive benefits: investors need to create a minimum number of new jobs, invest a certain amount in fixed assets or increase productivity through using high-tech production equipment. Such outcome conditions (e.g. requirement to create a minimum number of new jobs) can promote positive spillovers of investment; however, they require careful monitoring to ensure that the outcome has been met. This necessitates resources, administrative capacity, and close coordination with other government agencies.

Looking forward, the government could consider revising some of its incentives to maximise positive spillovers and limit potentially excessive benefits to firms. Carefully designed and targeted incentives may help address market failures and promote social and economic development. While CIT rate reductions in Croatia are linked to investment size and job creation, promoting a firm's physical presence in the country, income-based incentives (CIT exemptions and reduced rates) often disproportionately benefit investments that are already profitable early in the tax relief period. They may also benefit firms that might have invested without the incentive, rendering the incentive redundant while potentially costing the state substantially in terms of revenue forgone.

Croatia could consider re-evaluating the design of its main tax incentives to adopt a stronger expenditure-based approach. Expenditure-based incentives (tax allowances or credits) might be more effective at attracting investment that would not have occurred otherwise. They are better targeted at reducing specific costs (i.e. qualifying expenditure) and thereby encourage spending that might not occur without the incentive, including costs of job creation and technological upgrading. Furthermore, expenditure-based

incentives are expected to be less affected by the new international tax agreement (OECD, 2022<sup>[5]</sup>). Under these rules, jurisdictions that grant large multinational enterprises (MNEs) effective tax rates below 15% may lose tax revenues as other jurisdictions start to impose top-up taxes on MNEs with low tax rates. Croatia is thus advised to consider the implications of these new rules for its tax incentives regime.

The upcoming reform of the Act provides an opportunity for the MESD to evaluate whether tax incentives and grants are achieving their stated objectives, including employment creation and regional development. While most investment incentives of the Investment Promotion Act have primarily supported well-established domestic industries that have played an important role in the growth of the Croatian economy, such as metal processing manufacturing and tourism, they may have also helped grow the ICT sector. Foreign firms made up a quarter of incentive beneficiaries over the past decade, with a slight increase in the number of foreign firms applying for incentives in recent years. Although most recipients are small firms, larger investments are increasingly benefitting from incentives.

Besides investment tax incentives under the Investment Promotion Act, Croatia offers other incentives through multiple pieces of legislation that are governed by different public bodies at central and subnational levels. For example, R&D incentives are authorised in a separate act. Coordination between government institutions involved in incentives appears effective, for example between the Ministry of Finance and the MESD's Sector for Incentives and Entrepreneurial Infrastructure. However, information sharing could be strengthened across different bodies that grant incentives, including within departments of the MESD's Directorate for Internationalisation, between different ministries, and with representatives at the subnational level to support policy coherence.

The effective use of investment incentives requires regular monitoring and evaluating the costs and benefits of incentives, including vis-à-vis public revenue mobilisation, investment attraction, and the respective policy objective. Croatia closely monitors beneficiaries' compliance with incentive conditions, and the costs of various incentive schemes as required by the EU State Aid rules. This provides a strong foundation for policy evaluation, and there is potential for further assessment to determine whether incentives generate additional investments and are optimally designed to support their policy goals, including those related to sustainable development.

### Policy recommendations

- **Assess whether tax incentives are best designed to support their stated objective.** The government could consider whether targeted expenditure-based tax schemes (tax allowances or credits), could be more effective at promoting certain outcomes.
- **Explore what complementary policies are required** (e.g., infrastructure, connectivity, regulations, education or labour market and broader-based personal income tax reforms) to best incentivise investment policy goals, including as part of the planned National Plan on Investment Promotion.
- **Reinforce regular coordination at the national level, within departments of the MESD, and particularly within its Directorate for Internationalisation, as well as between different ministries,** and with sub-national authorities at the local level to support policy coherence when designing and implementing incentive policies.
- **Enhance clarity of investment incentives by adding to the existing online investor guide more information on all available incentives programmes** and relevant criteria. This could include information on incentives granted by sub-national authorities and English translations of all relevant laws and regulations in an online platform.

- **Croatia should continue its efforts to improve administrative and financial burdens and increase transparency of fees due.** While Croatia has already progressed in recent years, investors still report lengthy procedures and unexpected fees.
- **Implement a regular and structured evaluation mechanism to assess how incentives are used, if they are supporting their intended policy goals, and their costs.** Embedding periodical evaluation processes in the law and clearly attributing responsibilities can support more effective evaluation mechanisms. Depending on the outcomes, the MESD should consider adjusting existing incentives and phasing out benefits that are no longer needed.

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## **2 Trends and qualities of foreign direct investment in Croatia**

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This chapter provides an overview of trends and qualities of foreign direct investment (FDI) in Croatia. It first shows how Croatia has improved living conditions and the extent to which trade and investment integration have contributed to it. The chapter then examines FDI trends in more details, including its sectoral distribution and technology-intensity. An assessment of Croatia's comparative and competitive advantage further supports where the potential for additional FDI may lie. The chapter concludes with a comprehensive overview on how existing FDI and activities of affiliates of foreign multinational enterprises (MNEs) have already contributed to sustainable development in Croatia.

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## Summary

Croatia improved living standards substantially over recent decades. Per capita incomes doubled since the mid-1990s, and Croatia reached the status of a high-income economy in 2017. Although FDI plays an increasingly important role, Croatia's FDI stock corresponds to merely 0.1% of the OECD total and 40% of the average FDI stock in other Central and Eastern European (CEE) countries.<sup>1</sup> Croatia is less integrated in global value chains (GVCs) of Western European economies than its neighbouring countries, due to the relatively early accession of several CEE economies to the European Union and the associated outsourcing of Western production to the new member countries. New establishments of foreign-owned businesses (greenfield FDI) are concentrated in construction and services, reflecting Croatia's specialisation in services – especially tourism and lower technology services such as wholesale and retail trade as well as repair of motor vehicles and real estate activities.

Croatia could aim to further diversify FDI into activities where it has an existing comparative advantage in production and exporting, which would strengthen productivity and competitiveness in these activities and foster sustainable development more broadly. Croatia's production and export basket covers a wide range of manufacturing products, although measures of revealed comparative advantage (RCA) show that it currently doesn't have a comparative advantage in most of its exports. Activities that are revealed to have a comparative advantage are on average less complex in production and account for relatively smaller market shares than those in other CEE economies. Beyond diversifying into higher productivity activities, attracting FDI across sub-national regions in Croatia can support country-wide economic development and exploit regional strengths (see Chapters 3 and 4).

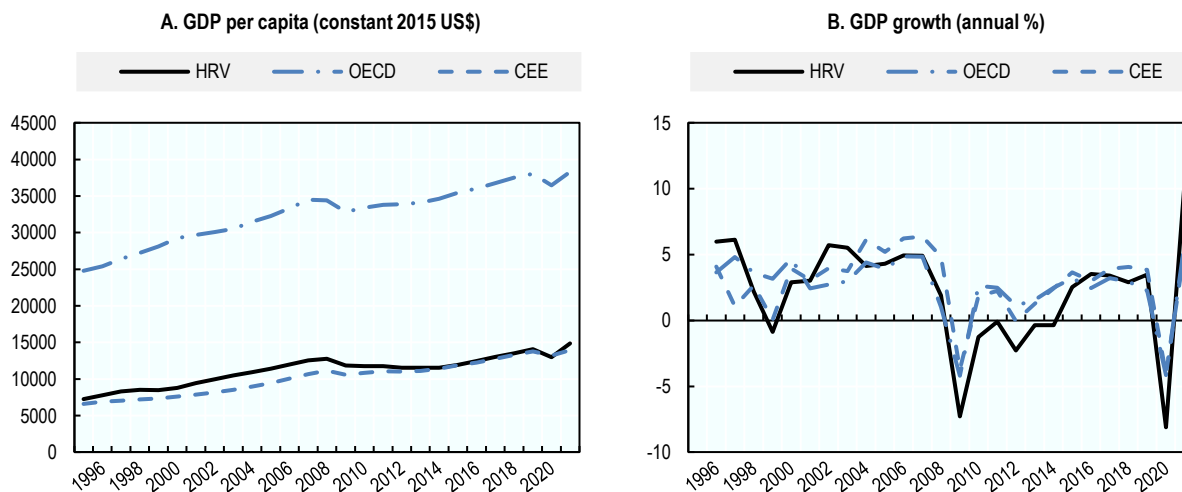
Foreign-owned firms represent only 5% of active economic entities in Croatia but they are almost twice as productive as domestic firms and contribute to around 30% of total value-added, 45% of exports and 60% of private expenditures on research and development (R&D). Beyond positive effects on productivity, innovation, and exports, FDI is key for job creation, including for women, and supports the transition to a low carbon economy in Croatia: Foreign firms employ 20% of all registered employees and have on average a higher share of female employees than domestic firms. Although Croatia attracted FDI in labour intensive services, it doesn't fully capitalise on the potential of FDI to create jobs. The number of jobs created per million of USD invested over recent years is below the CEE average. FDI helped Croatia on its path to a green economy: FDI in the energy sector is increasingly concentrated in renewables and foreign firms steadily improve their energy efficiency. However, compared to domestic peers, foreign firms fall short in environmental expenses and only slightly increased expenses for environmental purposes over the past decade.

## Potential for increased integration in global production networks

Croatia experienced substantial economic growth over the past decades, contributing to improving living standards (Figure 2.1). The average Gross Domestic Product (GDP) per capita doubled from USD 7,000 in 1996 to almost USD 15,000 in 2021, on par with the trends seen in CEE economies. Croatia reached high-income status in 2017 but still has significant potential to improve incomes to reach the OECD average. Despite substantial growth in terms of GDP per capita, growth has been volatile over the past decades, mainly due to external economic turbulences. After a period of economic growth from 1999 onwards, GDP growth collapsed after the global financial crisis in 2008 and again after the outbreak of the COVID-19 pandemic in 2020. GDP growth in Croatia largely followed the trend seen in the OECD and other CEE countries, although with deeper recessions than in the OECD and CEE region on average.

**Figure 2.1. In recent decades, Croatia experienced a significant rise in living standards**

Trends in GDP and GDP per capita, 1995-2021



Source: OECD elaboration based on the World Bank (2023<sup>[1]</sup>).

Growth was sustained by a growing integration in the global economy. Its accession to the World Trade Organisation (WTO) in 2000 as well as to the European Union (EU) in 2013 spurred exports of goods and services over the past two decades (Figure 2.2, Panel A). Croatia is tightly linked to the EU market. In 2021, about two thirds of Croatia's exports and around three quarters of imports went to or came from EU Member Countries – most notably Italy (13% of exports; 13% of imports), Germany (12% of exports; 15% of imports) and Slovenia (11% of exports, 11% of imports) (Croatian Bureau of Statistics, 2023<sup>[2]</sup>).

Value added in Croatia is concentrated in services, especially in tourism (Figure 2.2, Panel B). While services generally account for about the same share of value added in the Croatian economy and other CEE countries (54%), tourism contributes far more to value added in Croatia (9%) than in other CEE economies (2%). Conversely, Croatia has a lower value-added share in manufacturing (15%) compared to other CEE economies (21%), pointing to the potential for revamping industrialisation and boosting productivity.

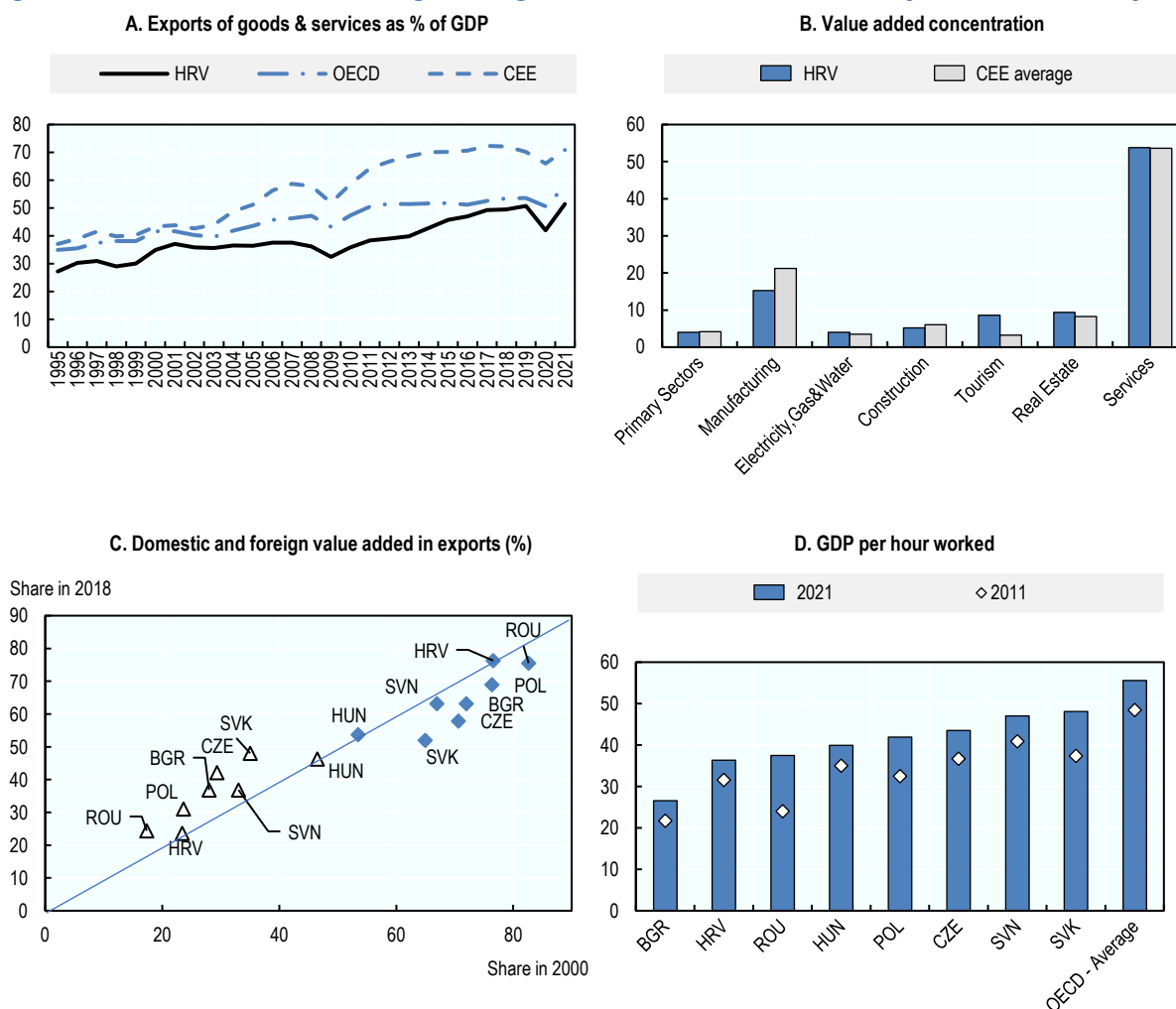
Croatia's integration in global value chains (GVCs) is less pronounced than the integration of other CEE economies and did not change tremendously between 2000 and 2018. The foreign value-added content of exports captures the use of foreign intermediates in the production of exports thus serving as an informative proxy for the integration of an economy in GVCs (Figure 2.2, Panel C). With 24% of foreign value-added in its exports, Croatia's backward integration in GVCs is substantially smaller than the integration of other economies in the region which source on average 38% of their export value from foreign suppliers. In 2018, Croatia's manufacturers with the highest foreign value-added content in their exports were coke and refined petroleum products (52%), other transport equipment (such as e.g. building of ships and boats, air and spacecraft and related machinery) (46%) and basic metals (42%) (OECD, 2022<sup>[3]</sup>).

On the flip side, and in line with the high relevance of services in the Croatian economy, the domestic value-added content of exports in Croatia is comparably large. Almost two thirds of Croatia's exports consist of services which typically have a high domestic content. On average, one third of the 76% of domestic value added in exports is driven by foreign final demand – above all tourism, where 73% of value added depends on foreign final demand (OECD, 2022<sup>[3]</sup>).

Diversifying economic activity and further integrating in GVCs could boost productivity. Croatia's labour productivity ranks behind the OECD and other CEE economies' averages. In 2021, Croatia's GDP per

hour worked corresponded to about 90% of the CEE average and 65% of the average of OECD members (Figure 2.2, Panel D). While Croatia's productivity growth of 15% aligns with the average increase among OECD members, it is less than the average productivity increase of other economies in the region that experienced productivity growth of 26% on average.

**Figure 2.2. Croatia can further integrate in global value chains and diversify economic activity**



Note: In Panel A, CEE includes Bulgaria, Czechia, Hungary, North Macedonia, Poland, Romania, Serbia, Slovakia, and Slovenia. In Panel B, North Macedonia and Serbia are not covered in CEE. In Panel D, GDP per hour worked is captured in constant 2010 prices PPPs. Source: OECD elaboration based on World Bank (2023<sup>[1]</sup>), OECD Inter-Country Input-Output (ICIO) Tables (2023<sup>[4]</sup>), OECD TiVA database (2023<sup>[5]</sup>) and OECD (2023<sup>[6]</sup>).

## Boosting FDI as driver of future growth

FDI has also contributed to improved living standards since the turn of the millennium. During the early 2000s, a wave of privatisations of state-owned enterprises contributed to an increase in the FDI stock until the outbreak of the global financial crises in 2008 (Figure 2.3, Panel A; Bule and Cudina (2020<sup>[7]</sup>)). While Croatia's stock of FDI was merely 13% of GDP in 2000, it rose to 40% in 2008 and to 59% in 2021 thereby slightly surpassing the OECD aggregate of 56% as well as the average of other CEE economies whose FDI stock accounted for 57% of GDP in 2021 (Figure 2.3, Panel B).

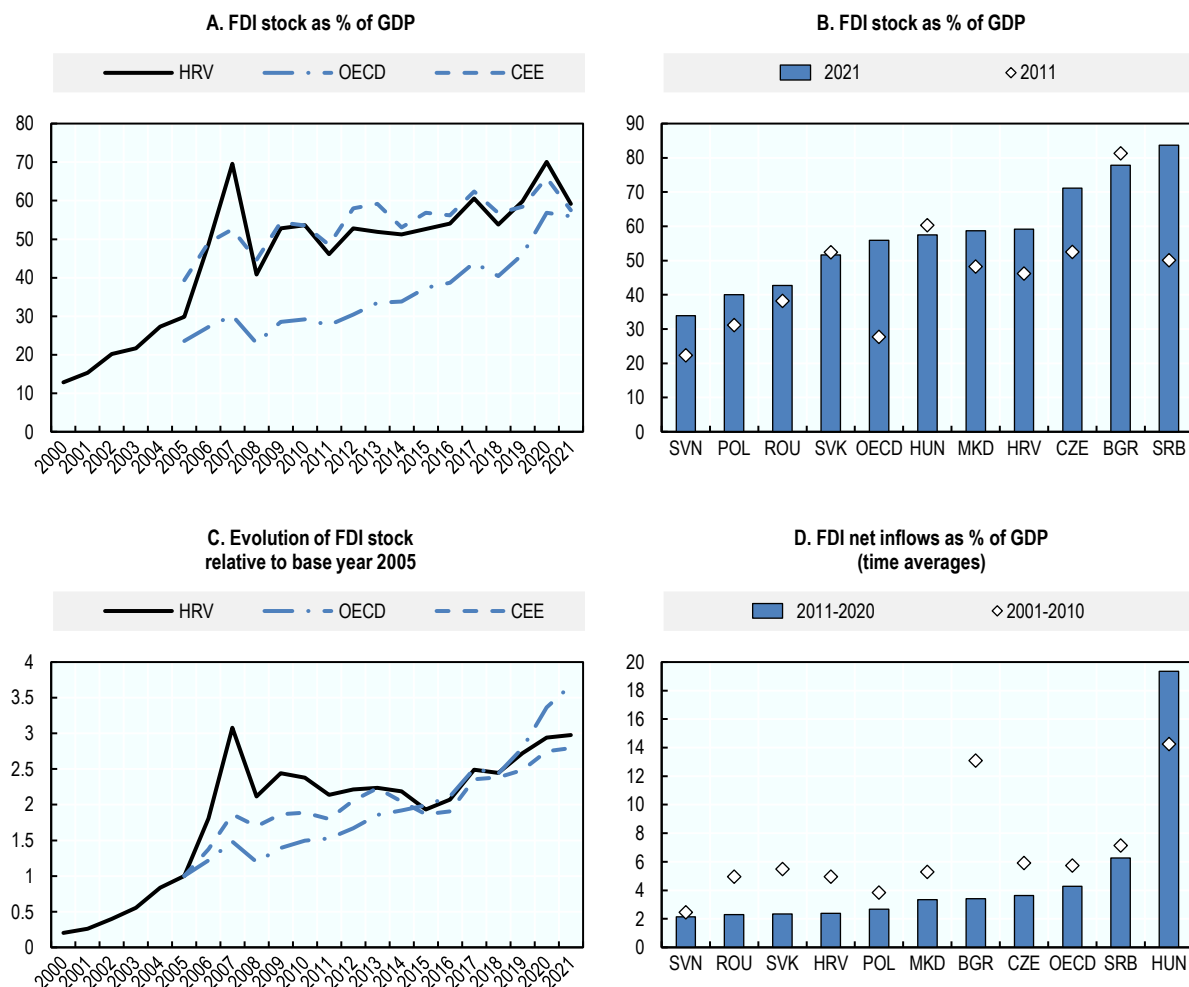
Although Croatia's stock of FDI relative to GDP is comparable to economies of the OECD and the CEE region, it is far below the average of other economies in absolute terms. By 2021, Croatia's FDI stock corresponded to only 0.1% of the OECD total and about 40% of the average FDI stock in other CEE countries (OECD, 2023<sup>[8]</sup>; International Monetary Fund, 2023<sup>[9]</sup>). Hence, further accumulating FDI and thus productive assets would support economic growth in the future (Iamsiraroj, 2016<sup>[10]</sup>).

Because of the global financial crisis in 2008, Croatia experienced considerable divestment and thus a decline of the FDI stock in absolute terms. FDI stocks started to recover only in 2015 and FDI reached the pre-2008 crisis levels just recently (Figure 2.3, Panel C). Given the particularly deep recessions experienced by Croatia, the impact on FDI was stronger than in other regions, where FDI stocks just stagnated for some years (CEE) or continued increasing (OECD). Using FDI as a mean to diversify economic activity can thus foster sustainable economic growth and build resilience to external economic shocks.

Slowed attraction of FDI in recent years is also reflected in comparatively low average FDI inflows. Despite an increase in net FDI inflows in absolute terms in 2019 and 2021, FDI inflows as a share of GDP have slowed over the last decade. With average net FDI inflows of 2.4% of GDP between 2011 and 2020, net FDI inflows per GDP in Croatia were clearly lower than the region's average which amounts to about 5% (Figure 2.3, Panel D). Croatia's FDI stock built up most intensively in the early 2000s when the country's average net FDI inflows represented 5% of GDP.

Croatia lost some of its competitive edge to attract FDI in 2004 when some CEE economies— including Poland, Czechia, Hungary, Slovenia, and Slovakia – joined the EU. They benefited from their relatively earlier accession to the EU compared to Croatia and experienced a surge in FDI from Western European economies that offshored some of their manufacturing production to new EU Member States (Bule and Čudina, 2020<sup>[7]</sup>; Marin, 2006<sup>[11]</sup>). Consequently, these countries deepened their integration in international trade and fostered their participation in GVCs.

**Figure 2.3. While Croatia's FDI stock is competitive in relative terms, FDI net inflows did not significantly recover since the global financial crisis**



Note: In Panel A and C, CEE includes Bulgaria, Czechia, Hungary, North Macedonia, Poland, Romania, Serbia, Slovakia, and Slovenia.

Source: OECD elaboration based on OECD (2023<sup>[9]</sup>), IMF (2023<sup>[9]</sup>) and World Bank (2023<sup>[1]</sup>).

## Diversifying into high productivity activities through FDI

The distribution of greenfield FDI in Croatia reflects domestic specialisation patterns but also shows the increasing importance of digital industries and renewables (Figure 2.4). In recent years, Croatia attracted a substantial share of its greenfield FDI not only in activities that already concentrate a lot of value added like construction and services, but also in infrastructure activities related to electricity generation from renewables as well as ICT and internet infrastructure (communications). Over 2017-2021, almost one third of greenfield FDI went into infrastructure i.e. electricity generation from renewables (18%) as well as ICT and internet infrastructure (13%) while 27% was concentrated in construction activities predominantly in real estate (19%) and the tourism industry (8%).

**Figure 2.4. Greenfield FDI in Croatia reflect existing specialisation patterns but also the increasing importance of digital industries**

Greenfield FDI in Croatia by main activity and sector, total over 2017-2021



Note: This chart shows the distribution of all opened and announced greenfield FDI projects in Croatia from 2017 until 2021 by activity and sector. The inner circle shows how greenfield FDI is split among activities while the outer circle shows how greenfield FDI is distributed across sectors within these activities. Infrastructure activities include electricity generation and ICT & internet infrastructure; Service activities include business services, customer contact centres, headquarters, logistics, distribution & transportation, sales, marketing & support. For industries, chemicals summarise biotechnology, chemicals and pharmaceuticals while hotels and tourism summarises hotels, tourism and entertainment (label adjusted for presentation purposes).

Source: OECD elaboration based on FT fDi Markets (2023<sup>[12]</sup>).

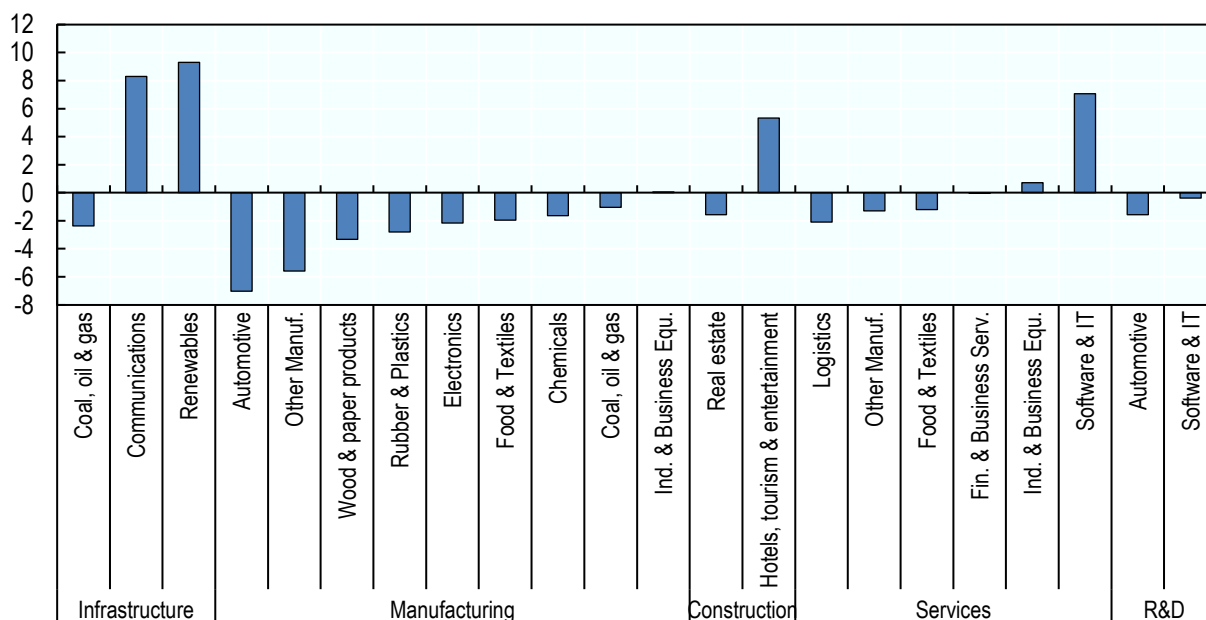
Foreign investors may enter a country to expand sales in a new market (i.e. market-seeking); to tap into natural resources (resource-seeking), which is often the case in commodity sectors and agribusiness; to achieve efficiency (efficiency-seeking) by reducing costs (e.g. labour costs) or by seizing new local assets in the form of technology, innovation and related skills (i.e. asset-seeking) (OECD, 2023<sup>[13]</sup>). Relatively small FDI inflows into tradable manufacturing (15%) and large proportions of sales on the domestic market,

particularly in services, suggest that foreign investors enter Croatia, at least partially, to seek the Croatian market.<sup>2</sup>

Other CEE economies attract more FDI in tradable manufacturing than Croatia mirroring their tight integration in manufacturing GVCs and a strong motive of investors to seek efficiency gains in these economies. In recent years, greenfield FDI in other CEE economies was more concentrated in manufacturing like the automotive industry as well as services such as logistics whereas Croatia's greenfield FDI inflows were more concentrated in infrastructure, the construction of hotels as well as software and IT services (Figure 2.5).

**Figure 2.5. Compared to other CEE economies, greenfield FDI in Croatia is more concentrated in construction and infrastructure as well as software and IT**

Differences in the concentration of greenfield FDI inflows between Croatia and other CEE economies, %-point differences (positive values = Croatia's FDI is relatively more concentrated in sector; negative values = FDI in other CEE economies is relatively more concentrated in sector), 2017-2021



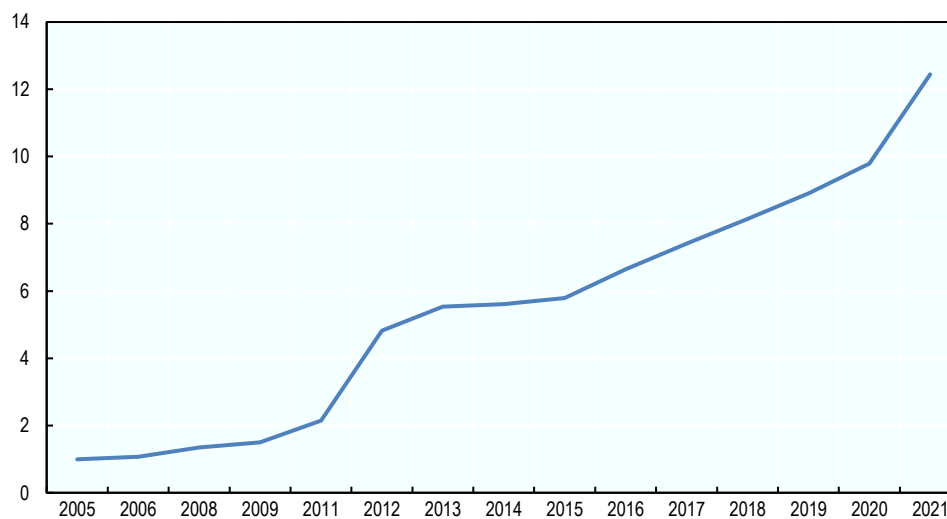
Note: This chart shows the concentration of opened and announced greenfield FDI in Croatia versus other CEE economies across different activities (infrastructure, manufacturing, construction, services, and R&D) and sectors. For presentation purposes, only sectors and activities that account for at least 1% of greenfield FDI in Croatia or CEE economies are shown. Differences are computed as sectoral greenfield FDI shares in CEE economies subtracted from sectoral greenfield FDI shares in Croatia. Differences are expressed in %points. CEE includes Bulgaria, Czechia, Hungary, North Macedonia, Poland, Romania, Serbia, Slovakia, and Slovenia.

Source: OECD elaboration based on FT fDi Markets (2023<sup>[12]</sup>).

FDI in ICT manufacturing and ICT services offers the potential to unlock new growth and productivity opportunities and attract more investment in digital-intensive industries in the future. Following an amendment to the Investment Promotion Act in 2015, that lowered the minimum investment threshold from 150,000 to 50,000 EUR while simultaneously increasing the minimum threshold of new jobs created from 5 to 10, Croatia experienced steady growth in the stock of greenfield FDI in ICT-related sectors. Over 2015-21, the stock of greenfield FDI in the Croatian ICT industry grew by 22% more than during the years prior to the policy change suggesting that investment promotion policies can contribute to investment momentum in target sectors. Chapter 5 discusses the use, design, and effectiveness of investment incentives in greater detail.

**Figure 2.6. Greenfield FDI in Croatia's ICT-related industries steadily increased following an amendment of the Investment Promotion Act in 2015**

Increase of the cumulated greenfield FDI stock of opened and announced projects in ICT-related sectors (2005 = 1), 2005-2021



Note: This chart shows the increase of the cumulated greenfield FDI stock of opened and announced projects in ICT-related sectors in Croatia between 2005 and 2021.

Source: OECD elaboration based on FT fDi Markets (2023<sup>[12]</sup>).



### Box 2.1. Classification of economic activities

The successful diffusion of FDI benefits hinges on the attraction of FDI into sectors that have sufficient domestic absorptive capacities and the potential to further diffuse advanced FDI technologies, knowledge, and best practises. Given the relevance of productivity and innovation spillovers, the sectoral analysis in this chapter is based on technology-intensity. As such, most sectoral analyses focus on four main sectoral groupings based on R&D-intensity, which are adapted from Galindo-Rueda and Verger (2016<sup>[14]</sup>): higher technology manufacturing, lower technology manufacturing, higher technology services and lower technology services. R&D-intensity is measured by the ratio of business R&D expenditure relative to gross value added in each industry covered in a given group. Table 2.1 lists industries based on ISIC Rev. 4 two-digit sectors, which is the classification applied for most of the data used (e.g. OECD and BACI), as well as sectors from fDi Markets. The classification has the caveat that R&D-intensity is an imperfect measure of innovation and innovation potential across industries. Not all firms that are successful at developing or implementing innovation are necessarily R&D performers. Many of these firms are successful adopters of technology that they have not developed. Measuring R&D intensity or embedded R&D in their purchases may not effectively characterise the innovative performance of firms or industries. Other OECD indicators measure skill intensity, patenting activities and innovation by industries that facilitate a more refined description of the overall knowledge intensity in different economic activities, although these measures are not always widely available across a majority of OECD and partner economies (OECD, 2015<sup>[15]</sup>). Another caveat of this classification is related to the fact that it is not entire sectors that involve either higher or lower technologies, but it is specific activities or segments within these sectors that involve different technology intensities. This caveat needs to be considered for any conclusions made.

**Table 2.1 Sectoral grouping based on R&D-intensity**

Economic grouping	Industries covered based on ISIC Rev. 4	Industries covered based on fDi Markets
Lower technology manufacturing	Food products, beverages and tobacco; Textiles, wearing apparel, leather and related products; Wood and products of wood and cork; Paper products and printing; Rubber and plastic products; Other non-metallic mineral products; Basic metals; Fabricated metal products; Other manufacturing; repair and installation of machinery and equipment.	Metals, building materials, plastics, wood products, textiles, paper, printing & packaging, rubber, ceramics & glass, food & beverages.
Higher technology manufacturing	Chemicals and pharmaceutical products; Computer, electronic and optical products; Electrical equipment; Machinery and equipment; Motor vehicles, trailers and semi-trailers; Other transport equipment.	Automotive OEM, automotive components, semiconductors, aerospace, consumer electronics, non-automotive transport OEM, consumer products, chemicals, renewable energy, pharmaceuticals, space & defence, business machines & equipment, medical devices, biotechnology, industrial equipment, engines & turbines, electronic components.
Lower technology services	Administrative and support service activities; Wholesale and retail trade; repair of motor vehicles; Transportation and storage; Financial and insurance activities; Real estate activities.	Business services, financial services, hotels & tourism (other than construction activities), leisure & entertainment, transport & warehousing and real estate.
Higher technology services	IT and other information services; Professional, scientific and technical activities; Publishing, audio-visual and broadcasting activities.	R&D activities as well as communications (ICT & internet infrastructure) and software & IT services.

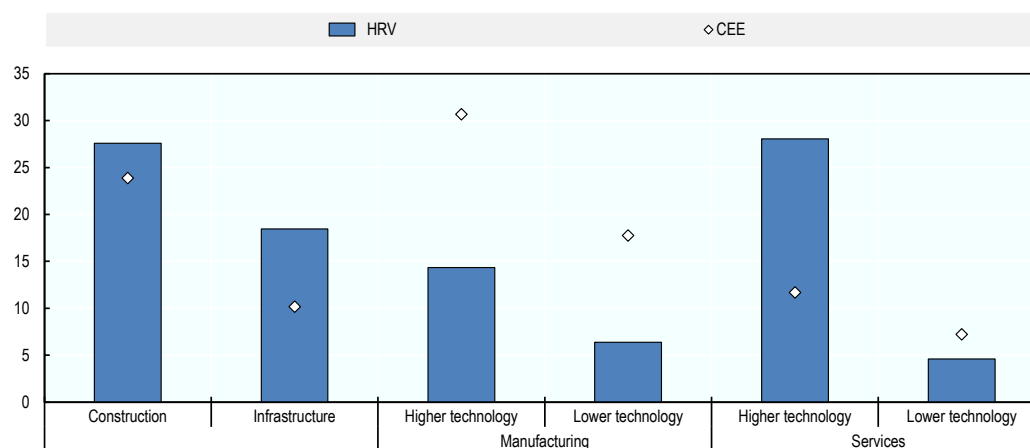
Note: Mining and extraction (Mining and quarrying; Coke and refined petroleum products); Infrastructure (Electricity, gas, water supply, sewerage, waste and remediation services; Telecommunications) and other services (Public administration and defence; Compulsory social security; Education; Human health and social work) are not classified in these groups as they are either highly specialised and would require a more focused analysis, or their role/potential for FDI spillovers is limited.

FDI can generate knowledge and technology spillovers to the host economy. For example, by implementing foreign technology in subsidiaries abroad, foreign multinational enterprises (MNEs) contribute to the diffusion of tacit and formal knowledge as well as technology to workers and local firms engaging with foreign affiliates (OECD, 2023<sup>[13]</sup>). This diffusion is likely to be more important for investments in manufacturing and services sectors, which use higher technologies more intensively and are closely integrated in GVCs such as the automotive sector or software and other IT services (Criscuolo and Timmis, 2018<sup>[16]</sup>; Timmer et al., 2015<sup>[17]</sup>).

Using a standard classification of lower and higher technology sectors reveals that, in Croatia, almost half of greenfield FDI in manufacturing and services is in higher technology intensity activities (Box 1.2). These sectors attracted in total 42% of opened and announced greenfield FDI projects since 2017 (Figure 2.7). Software and IT services as well as communications made up for the largest inflows in higher technology services – each accounting for almost 14%. In manufacturing, automotives attracted the largest share of greenfield FDI inflows (4%) followed by consumer products, industrial equipment, and aerospace (around 2-3% respectively).

**Figure 2.7. Higher technology services received the largest share of greenfield FDI in Croatia**

% of total greenfield FDI in Croatia and CEE economies, 2017-2021



Note: The chart shows the distribution of open and announced greenfield FDI projects across different sector aggregates measured as percentage of total capital expenditure values per sector aggregate. See Box 2.1 for an overview of the classification of sectors and activities in higher and lower technology manufacturing and services. *Infrastructure* refers to electricity generation from renewables and coal, oil & gas; *Construction* refers to construction activities mainly in the real estate and hotel sector. *Other services* (healthcare as well as space and defence), *mining* and *extraction* each receiving less than 1% of greenfield FDI in Croatia and other CEE economies are not shown for presentation purposes.

Source: OECD elaboration based on FT fDi Markets (2023<sup>[12]</sup>).

## Building on existing comparative advantages

FDI into high value-added activities and sectors with growing markets can support productivity, job creation and economic growth. Croatia can capitalise on existing advantages in the production and export of certain products to further develop key industries and to foster sustainable development. Croatia's production and export basket covers a wide range of manufactured products, although Croatia currently doesn't have a comparative advantage in most of its exports (Figure 2.8). Analysing more than 1,000 manufacturing products over two time periods from 2007-2013 and 2014-2020 allows to distinguish if Croatia has a traditional revealed comparative advantage (RCA) that is persisting over both time periods, whether an

RCA is emerging in the second time period, or if Croatia has a declining or marginal RCA implying that it lost its RCA in recent years or that Croatia didn't have an RCA in neither of the two periods (Box 2.2).

## Box 2.2. Assessing Croatia's competitiveness

### **Identification of Croatia's revealed comparative advantage: methodology and data**

The revealed comparative advantage (RCA) measures the relative advantage or disadvantage of a country in a given sector, as evidenced by its trade flows (*Feenstra, 2016*<sup>[18]</sup>).

Croatia has an RCA in a good if it exports relatively more of that good than the rest of the world. Tracing the RCA over time allows to identify if an RCA of the Croatian economy persists, emerges, or declines. Accordingly, the analysis assigns RCA outcomes of goods to four different categories depending on the development of respective RCA developments over 2007-2013 and 2014-2020, respectively:

- Goods with a *traditional* RCA are those in which Croatia has had an RCA in at least 5 years in both 7-year periods used in the analysis. Consequently, goods with a traditional RCA are those in which Croatia has traditionally had a comparative advantage in exports.
- Goods with an *emerging* RCA are those in which Croatia has gained a comparative advantage more recently; that is, Croatian producers had an RCA in at least 5 years in 2014-2020, but in less than 5 years in 2007-2013. Consequently, goods with an emerging RCA can be considered as potential new growth pools.
- Goods with a *declining* RCA are those where Croatia has lost its comparative advantage in the last decade. These goods had a comparative advantage in the past but experienced an RCA in less than 5 years in 2014-20.
- Goods with a *marginal* RCA are those that did not have an RCA in at least 5 years in both periods. These sectors may therefore be further away from gaining a competitive advantage in Croatia.

The analysis distinguishes a total of 1,158 4-digit HS products (HS 2007) that map into sixteen manufacturing sectors (*Gaulier and Zignago, 2010*<sup>[19]</sup>).

### **Evaluation of revealed comparative advantages with respect to product complexity and market potential**

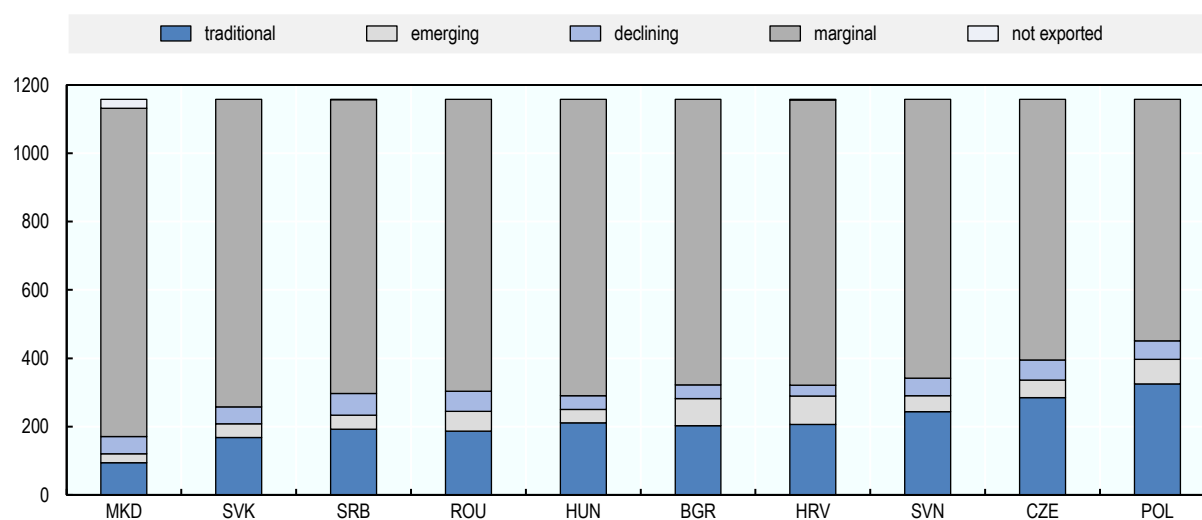
To evaluate the quality of Croatia's RCAs, the analysis focuses on the product complexity, i.e. knowledge intensity, of goods in which Croatia has a *traditional* or *emerging* RCA as well as on global market shares of these products.

- The *economic complexity of products* captures "the amount of diversity of know-how required to make a product" and is calculated based on "how many other countries can produce the product and the economic complexity of those countries". The product complexity of exports has empirically been proven to be a good predictor for future economic growth of countries and can thus be used to assess to what extent Croatia is an effective exporter of goods that add higher value and support higher wages (Hausmann et al., 2013<sup>[20]</sup>; The Growth Lab at Harvard University, 2023<sup>[21]</sup>).
- *Market potentials* are assessed by considering the global market shares of Croatia's export products in which manufacturers have a traditional or emerging RCA. While large market shares can imply fierce competition that make it difficult for manufacturers to expand their activity, they are also indicative for sales potentials and productivity gains.

Out of the scope of about 1,150 analysed products, Croatian manufacturers had a *traditional* comparative advantage in 18% of goods, an *emerging* comparative advantage in 7% of goods and a declining comparative advantage in 3% of goods. Croatian manufacturers have no comparative advantage in 72% of analysed goods. Croatia has generally fewer products with a *traditional* or *emerging* RCA (25%) compared to other economies in the region like Czechia (29%) or Poland (34%) but more products with a *traditional* or *emerging* RCA than other CEE economies like for example North Macedonia (10%) or Slovakia (16%).

**Figure 2.8. Croatia has a competitive number of products with a revealed comparative advantage**

Absolute numbers of comparative advantages, 2007-2020



Note: This chart shows the number of products in which different CEE economies have an RCA. See Box 2.1 for details on methodology and data.

Source: OECD elaboration based on international trade data from BACI (Gaulier and Zignago, 2010<sub>[19]</sub>).

Both Croatia's *traditional* and *emerging* RCAs are predominantly in lower technology manufacturing. While lower technology manufacturing products account for about two thirds of Croatia's RCA products, lower technology products make up for around half of RCA products of less advanced CEE economies and for 38% of products of advanced CEE economies (Table 2.2). Within lower technology manufacturing, Croatia has more products with a *traditional* or *emerging* comparative advantage than both advanced and less advanced CEE economies in the wood industry (56%), paper products and printing (46%) as well as in food products (36%). Although advanced CEE economies are generally more dominant in higher technology sectors, Croatia has more products with a *traditional* or *emerging* RCA in other transport equipment (40%) and pharmaceuticals (30%).

Advanced CEE economies are more established in manufacturing and have on average more products with a *traditional* comparative advantage than Croatia, both in lower and higher technology manufacturing. However, compared to the average of CEE economies, Croatia has more products with an *emerging* RCA in all lower technology manufacturing sectors and also in a few higher technology manufacturing industries like pharmaceuticals, machinery and equipment as well as chemicals.

**Table 2.2. Croatia's revealed comparative advantages are most concentrated in lower technology manufacturing**

% of products per industry in which CEE economies have a traditional or emerging RCA, 2007-2020

Technology	Industry	% of goods with traditional RCA			% of goods with emerging RCA		
		Croatia	less advanced CEE	advanced CEE	Croatia	less advanced CEE	advanced CEE
Higher technology manufacturing	Chemical and chemical products	8	5	11	5	3	2
	Computer, electronic and optical equipment	3	4	14	3	4	5
	Electrical equipment	21	22	45	8	6	9
	Machinery and equipment, nec	19	9	28	9	5	7
	Manufacturing nec; repair and installation of machinery and equipment	11	8	11	3	4	4
	Motor vehicles, trailers and semi-trailers	24	18	61	6	12	4
	Other transport equipment	33	16	27	7	8	2
	Pharmaceuticals, medicinal chemical and botanical products	15	2	12	15	4	3
Lower technology manufacturing	Basic metals	12	17	20	4	2	3
	Fabricated metal products	24	17	35	9	5	6
	Food products, beverages and tobacco	25	21	18	11	5	4
	Other non-metallic mineral products	31	15	34	5	4	4
	Paper products and printing	29	12	30	17	6	7
	Rubber and plastics products	19	27	40	16	4	8
	Textiles, textile products, leather and footwear	15	21	10	8	5	3
	Wood and products of wood and cork	52	32	41	4	4	4

Note: This chart shows the share of products per sector in which Croatia and other CEE economies have a traditional or emerging RCA. Less advanced CEE includes the following upper-middle income economies: Bulgaria, North Macedonia, Romania, and Serbia. Advanced CEE includes the following high-income economies: Czechia, Hungary, Poland, Slovakia, and Slovenia. Income classifications are based on the World Bank (2022) for 2021/22.

Source: OECD elaboration based on international trade data from BACI (Gaulier and Zignago, 2010<sub>[19]</sub>).

The product complexity or knowledge intensity of a country's exports as a predictor for future economic growth in conjunction with world market shares of exported goods are insightful indicators of competitiveness regarding the potential for sustainable economic development (Box 2.2). Croatian manufacturers produce and export a comparably high number of products with a *traditional* or *emerging* comparative advantage, but these products are on average less complex and account for relatively smaller market shares than those of competitors from other CEE economies.

Although Croatian products with a *traditional* or *emerging* RCA are on average less complex than RCA products from their competitors in the region, there are signs that Croatian manufacturers have started to catch up (Figure 2.9). While large complexity gaps exist between Croatia and other advanced CEE economies for products with a *traditional* RCA in both higher and lower technology manufacturing, the gap for products with an *emerging* RCA is narrowing, suggesting that Croatian manufacturers are expanding their capacity to produce more sophisticated goods in recent years.

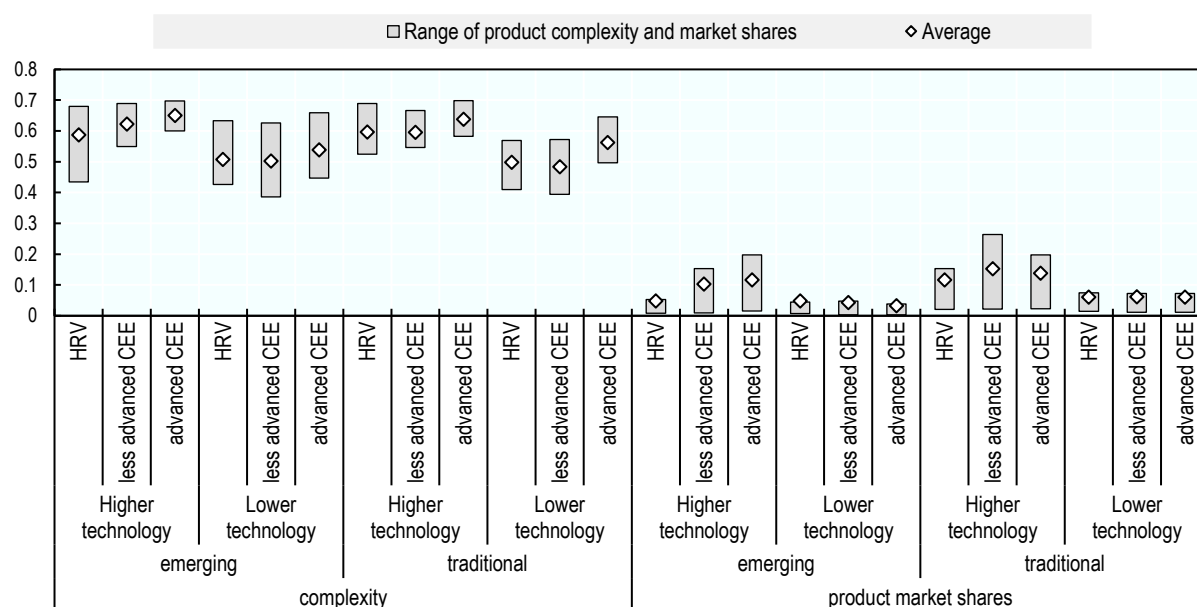
RCAs of Croatian manufacturers are concentrated in relatively small markets which can have different effects (Figure 2.9). Croatia's *emerging* RCAs in higher technology intensive manufacturing are focused on products with comparatively lower global market shares than other CEE economies. On the one hand, this pattern may imply an unfavorable competitive position on the world market due to the limited absorption

capacity for exports, but on the other hand, it may also present an opportunity for Croatian manufacturers to develop a strong competitive position in certain specialised products.

Based on its current know-how in the production of certain goods, Croatia can further expand and intensify its export portfolio of manufacturing goods to uncover growth opportunities. Studies from the Growth lab at Harvard University on economic complexity identify products that require knowledge that is close to the existing know-how in a country and are thus feasible to be produced and exported more intensely. Within higher technology manufacturing, opportunities are identified especially for the machinery industry (for example, lifting machinery or pumps for liquids) or for the transport industry (for example, parts of motor vehicles and vehicle bodies) while opportunities are identified for lower technology manufacturing for textiles (for example, textile articles for technical use) or for the metals industry (for example, flat rolled products of other alloy steel) (The Growth Lab at Harvard University, 2019<sup>[22]</sup>).

**Figure 2.9. Croatia has RCAs in products that are on average less complex and account for relatively smaller market shares than those of other CEE economies**

Distribution of product complexity and market shares across manufacturing products in which Croatia and other CEE economies have an emerging or traditional RCA



Note: This chart shows the median, i.e. the midpoint, as well as the range of complexity and market shares of products in which Croatia and countries of reference groups have a *traditional* or *emerging* RCA. Outliers above and beyond the upper and lower quartiles, i.e. bottom and top 25% of observations, are left out. Product complexity values are taken from the Growth Lab at Harvard University for 2019 and are normalized to range between 0 (least complex) to 1 (most complex). Global product market shares are calculated based on international trade data from the BACI database. Less advanced CEE refers to upper-middle income economies in the region: Bulgaria, North Macedonia, Romania, and Serbia. Advanced CEE refers to high-income economies in the region: Czechia, Hungary, Poland, Slovakia, and Slovenia. Income classifications are based on the World Bank (2023<sup>[23]</sup>) for 2021/22.

Source: OECD elaboration based on international trade data from BACI (Gaulier and Zignago, 2010<sup>[19]</sup>) and the Growth Lab at Harvard University (2019<sup>[22]</sup>).

## Leveraging higher productivity and innovation performance of foreign firms

While FDI can support diversification into high productivity activities that build on existing comparative strengths, foreign firms in any sector contribute to higher productivity and innovation in Croatia. Foreign firms – as compared to domestic ones – contribute more than proportionally to various metrics of Croatia's economic performance (Table 2.3). In 2021, there were about 100,000 active firms in Croatia of which around 95,000 firms were domestic micro firms with less than or around 10 employees while 5,000 firms were foreign owned.<sup>3</sup> Although foreign firms represent merely 5% of the total number of active firms in Croatia, they account for almost a third of value added (28%) and almost half of exports (45%).<sup>4</sup> On the domestic market, foreign firms have a smaller market share than domestic firms. Yet, the majority of foreign firm's sales is sold locally (68%).

FDI can contribute to boost innovative capacity in Croatia. Although Croatia's spending on research and development (R&D) as a share of GDP is in line with R&D spending in other CEE economies, Croatia spends less in R&D than the OECD average. In 2021, Croatia and other CEE economies spent on average about 1.2% of GDP on R&D, while OECD members invested about 2.2% (OECD calculation based on World Bank (World Bank, 2023<sub>[1]</sub>)). Croatia's innovative capacity benefits from the presence of foreign firms. While high R&D intensive manufacturing counts far less foreign than domestic firms (49 vs. 407), foreign firms account for more than half (62%) of private R&D expenditure in Croatia (Table 2.3). Attracting FDI in high R&D intensive sectors may thus not only help generate knowledge and technology spillovers to other sectors but also spur innovation in Croatia.

**Table 2.3. Foreign owned firms are important drivers of economic activity and innovation in Croatia**

Descriptive firm level statistics based on FINA, 2021

Variable	Total	Domestic firms' share	Foreign firms' share
# of firms	100,168	95	5
Value added	268,285	72	28
Exports	185,141	55	45
Domestic sales	616,523	72	28
R&D expenditure	2,018	38	62

Note: Apart from the number of firms and the number of employees, total values are represented in millions of kuna. A firm is classified as foreign owned if the share of foreign ownership exceeds 10%.

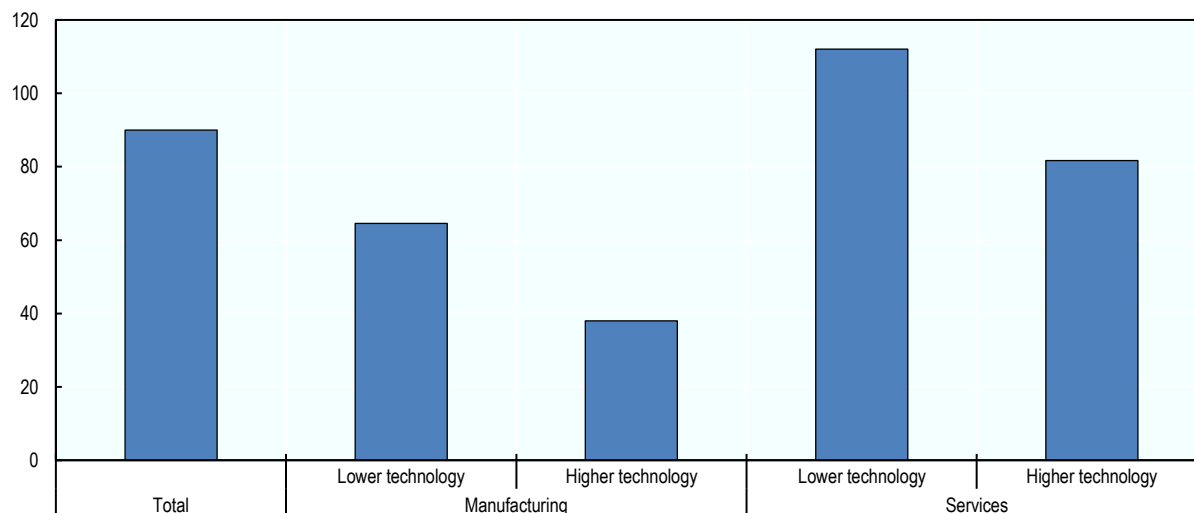
Source: OECD elaboration based on census data from the Financial Agency (FINA) of Croatia.

Labour productivity in Croatia hinges substantially on the presence of foreign firms. In recent years, foreign firms' labour productivity exceeded the labour productivity of domestic firms by about 90% (Figure 2.10 and OECD (2022<sub>[24]</sub>)).<sup>5</sup> Relatively high premia in non-tradable services and relatively low premia in tradable manufacturing indicate that international competition in export-oriented industries increases the efficiency of firms in these industries and leads to lower productivity differentials between foreign and domestic firms (Bule and Ćudina, 2020<sub>[7]</sub>). FDI in export oriented, higher technology industries can thus leverage competitiveness by raising the productivity of the Croatian export sector and to foster GVC participation and the integration in international trade.



## Figure 2.10. Foreign owned firms outperform domestic competitors in terms of labour productivity

Labour productivity premia of foreign ownership across different sectors, 2021



Note: This chart presents the foreign ownership premium of labour productivity across sectors (evaluated at the median productivity of foreign and domestic firms). The premium is computed as  $((\text{median labour productivity of foreign firms} / \text{median labour productivity of domestic firms}) - 1) * 100$ . A foreign ownership premium above 0 thus indicates that foreign firms are more productive than domestic peers. Original NACE 4-digit industries were converted into ISIC rev. 4 industries and classified into lower and higher technology intensive sectors as described in Box 2.1. Source: OECD's elaboration based on census data from the Financial Agency (FINA) of Croatia.

## Supporting sustainable development through FDI

Beyond its role for growth, GVC integration, productivity, and innovation, FDI can promote sustainable development on labour markets and can support gender equality and decarbonisation in Croatia. Despite the improvement of living standards in recent decades, Croatia's performance in terms of labour market conditions, gender equality and decarbonisation is mixed.

### ***FDI creates jobs in Croatia but contributes to income inequality among workers as foreign firms pay higher wages than domestic firms***

Labour market conditions in Croatia are less favourable than in the OECD on average and pose challenges to sustainable development. There are gaps of about 10 percentage points in both labour force participation and educational attainment levels between Croatia and OECD members (OECD calculation based on the World Bank (2023<sub>[1]</sub>) and ILO (2022<sub>[25]</sub>)). Ongoing emigration and the demographic change risk to further tighten labour market conditions in Croatia. In 2021, net emigration amounted to -4,512 and the population shrank by almost 400,000 inhabitants over the past decade (Croatian Bureau of Statistics, 2022<sub>[26]</sub>; World Bank, 2023<sub>[1]</sub>). Attracting FDI into sectors and activities that create quality jobs and pay competitive wages can thus help tackling brain drain, i.e., the emigration of well-educated, young individuals, by promoting employment and career advancement opportunities domestically (see also Chapter 3).

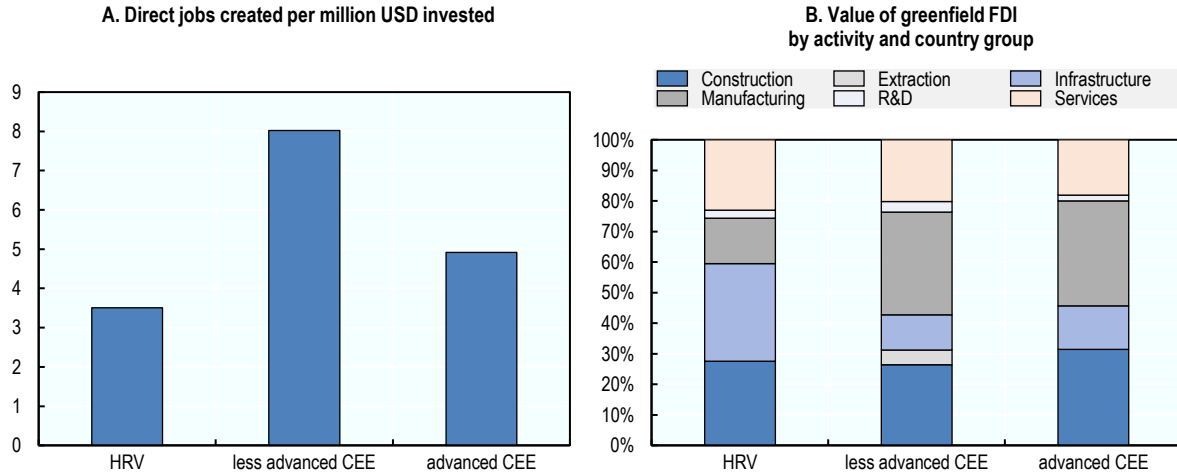
Greenfield FDI created jobs in Croatia over recent years although other CEE economies were more successful in exploiting job creation opportunities through investment. Between 2017 and 2021, greenfield FDI created on average 3.5 jobs per USD million invested in Croatia – half of the job creation intensity of less advanced CEE economies (8) and slightly less than the job creation intensity of investments in advanced CEE economies (5) (Figure 2.11, Panel A).



Differences in the job creation intensity across countries are linked to the structure of FDI inflows. With a high concentration of investment in infrastructure like renewable energy as well as ICT and internet infrastructure, which require relatively fewer human resources, Croatia harvests fewer direct jobs from investment than other, especially less advanced, CEE economies (Figure 2.11, Panel B).

**Figure 2.11. FDI created relatively less jobs in Croatia than in other CEE economies**

Direct job creation through greenfield FDI and FDI concentration across activities, 2017-2021



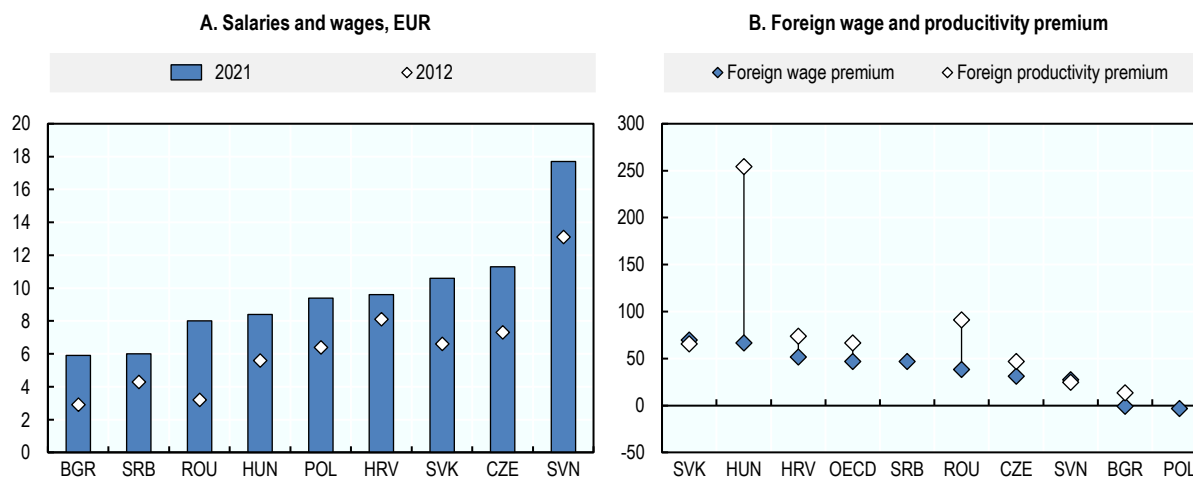
Note: This chart shows the number of direct jobs created per invested million USD by all opened and announced greenfield projects in Croatia and other CEE economies between 2017 and 2021. Less advanced CEE refers to upper-middle income economies in the region: Bulgaria, North Macedonia, Romania, and Serbia. Advanced CEE refers to high-income economies in the region: Czechia, Hungary, Poland, Slovakia, and Slovenia. Income classifications are based on World Bank (2023<sup>[23]</sup>) for 2021/22.

Source: OECD elaboration based on FT fDi Markets (2023<sup>[12]</sup>).

Although wages in Croatia are comparable to levels in other CEE economies, they did not grow substantially over the past decade. Between 2012 and 2021, Croatian wages increased by 19%, while they increased by 68% on average in other CEE economies (Figure 2.12, Panel A).

FDI can contribute to sustained wage growth in Croatia but can also exacerbate domestic income inequalities (OECD, 2022<sup>[27]</sup>). Productivity differentials between domestic and foreign firms typically translate into higher wages paid by foreign firms. Even though productivity advantages of foreign firms in Croatia translate into higher wages for employees to a certain extent, there is still a gap between the productivity and wage premia in the Croatian economy (Figure 2.12, Panel B). While differences in productivity and wage premia of Croatia are comparable to the OECD average, other CEE economies like Slovenia and Slovakia have neglectable gaps between productivity and wage premia of foreign firms.

**Figure 2.12. Productivity differentials between domestic and foreign firms in Croatia translate into higher wages paid by foreign firms**



Note: Panel A shows salaries and wages of CEE economies in 2012 and 2021. Panel B shows wage and productivity premia of foreign firms in CEE economies and OECD members. Wage and productivity premia of foreign firms are computed by dividing average wages (productivity) of foreign firms by average wages of domestic firms. Premia above zero imply that foreign firms pay higher wages (are more productive) than domestic firms.

Source: OECD elaboration based on Eurostat (2022<sup>[28]</sup>), World Bank Enterprise Surveys (2022<sup>[29]</sup>) and census data from the Financial Agency (FINA) of Croatia.

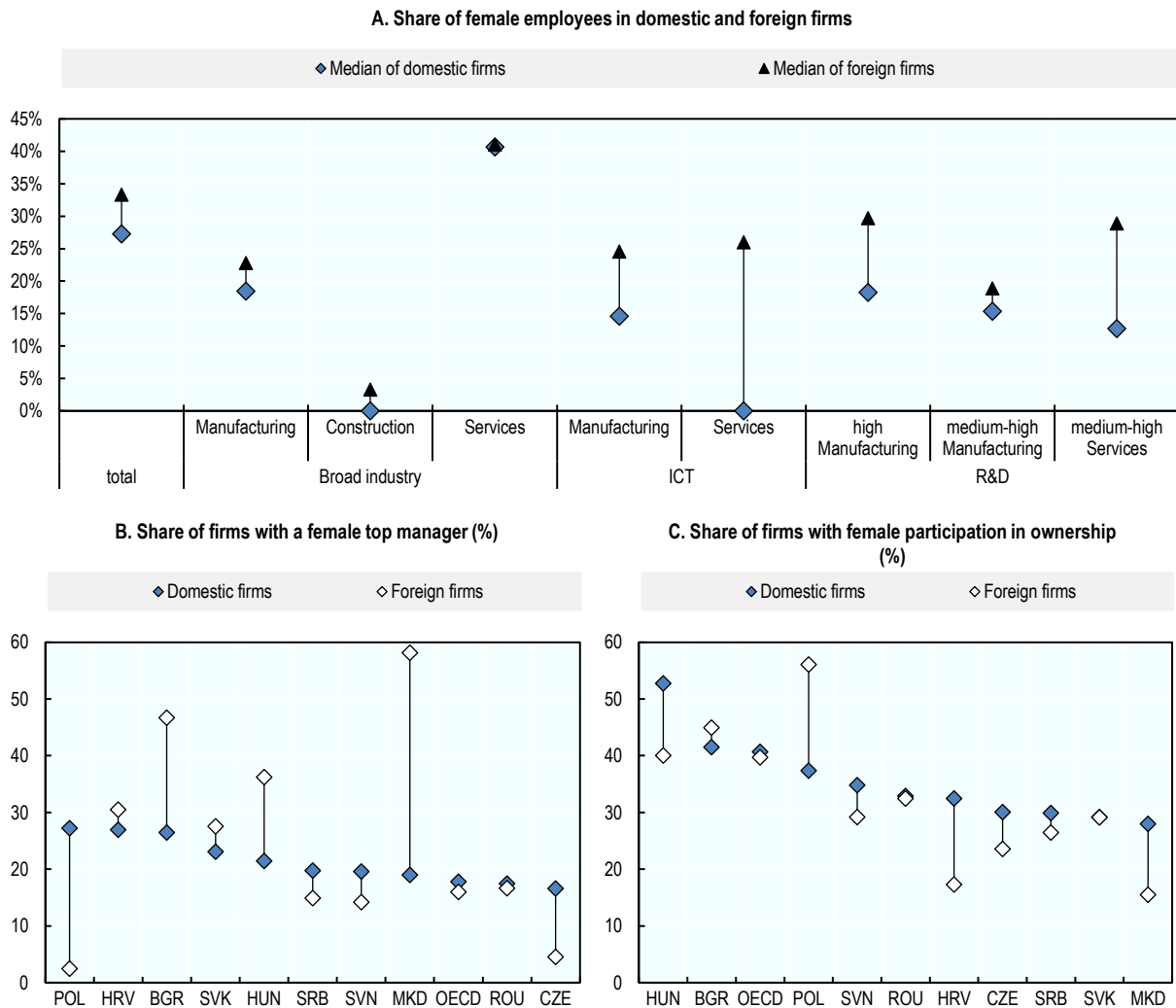
### **Foreign firms create employment opportunities for women**

Croatia performs comparatively well in terms of gender equality and can build on existing advantages to further improve labour market conditions for female employees. Similar to other CEE economies, the Croatian labour market is shaped by communist labour practices that aimed to create equal opportunities for women and men in education and the labour market in order to accelerate industrialisation (ILO, 2018<sup>[30]</sup>). While the labour force participation of women in Croatia aligns with the OECD average, wage differentials between women and men are lower on the Croatian labour market than in OECD countries. In Croatia, women earn on average around 8% less than men whereas the wage gap amounts to an average of 13% in OECD countries (Figure 2.11).

Foreign firms create important employment opportunities for women in Croatia – especially in sectors where women would otherwise be under-represented. While employment differentials among domestic and foreign firms are small at the aggregate level, there is evidence that foreign firms employ significantly more women in ICT services and R&D intensive industries than domestic competitors (Figure 2.13, Panel A). Relatively high average wages in these sectors, with an extra wage premium paid by foreign companies, can further reduce gender pay gaps and thus foster more equitable pay in Croatia.

FDI supports career advancement of women but does not promote female participation in ownership. Considering career advancement by the percentage of firms with a female top manager, Croatia performs relatively well compared to the OECD average as well as to other CEE economies. In Croatia, women are represented in top management in about 30% of foreign and 27% of domestic companies, while in OECD countries only 16% of foreign and 18% of domestic companies have a female top manager (Figure 2.13, Panel B). However, large gaps among foreign and domestic firms persist with respect to the participation of women in firm ownership. Although one third of domestic companies report that women are involved in ownership, women are involved in ownership in only 17% of foreign companies (Figure 2.13, Panel C).

**Figure 2.13. Women benefit from employment and career advancement opportunities in foreign firms but are merely involved in ownership**



Source: OECD elaboration based on census data from the Financial Agency (FINA) of Croatia and World Bank Enterprise Surveys (2022<sub>[29]</sub>).

**FDI supports sustainable resource management and the expansion of the renewable energy sector in Croatia**

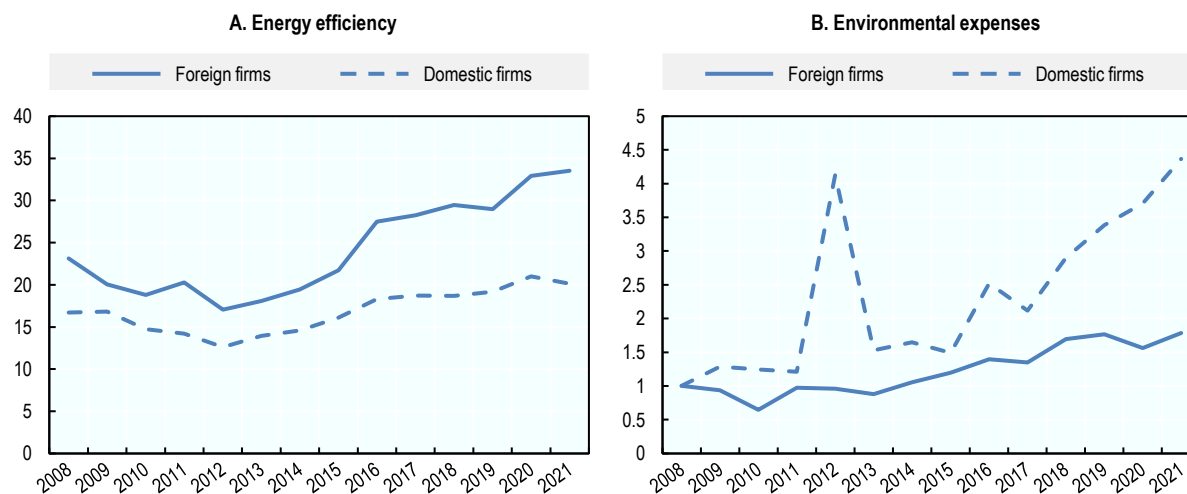
The transition of Croatia into a carbon-free and environmentally sustainable economy is on its way but there is room for further investment into green technology and renewable energy generation. Although carbon emissions in the Croatian economy is relatively low, Croatia has higher levels of air pollution and produces less electricity from renewable sources than OECD countries (OECD calculation based on World Bank (2023<sub>[1]</sub>) and OECD (2023<sub>[31]</sub>)). Attracting FDI in renewables and incentivising the use of green technologies offer Croatia the opportunity to tap into sustainable industrial growth potential and to drive forward the decarbonisation of the economy. Chapter 3 discusses opportunities for FDI in renewables in Croatia in more detail.

Foreign firms are important drivers of energy efficiency in Croatia and contribute to a substantial share of environmental expenses. Despite the relatively small number of foreign firms in the Croatian economy, foreign companies accounted for about 30% of private environmental expenses in Croatia between 2008

and 2021 (Figure 2.14, Panel A). Moreover, foreign firms contribute to energy efficiency of the Croatian economy implying opportunities for technology and knowledge spillovers to local entities. In the last decade, energy efficiency, i.e. the value added per energy use, has increased by about 20% for domestic companies and 45% for foreign companies, so foreign companies play an important role in the efficient use of resources in Croatia.

**Figure 2.14. Foreign owned firms perform well in terms of energy efficiency but spend substantially less on environmental protection**

Energy efficiency and environmental expenses of domestic and foreign firms in Croatia, 2008-2021



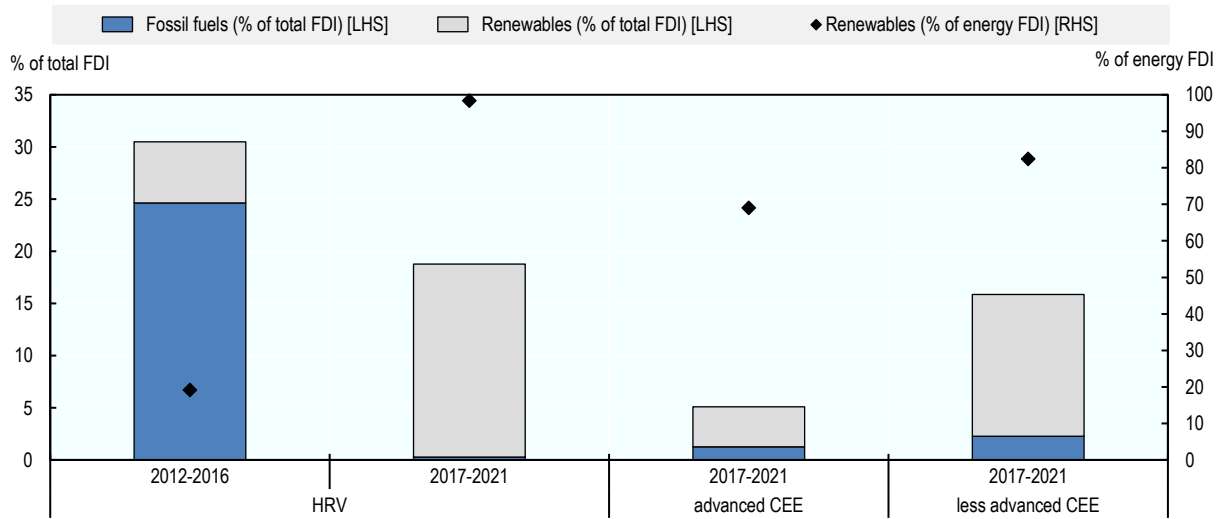
Note: Panel A shows energy efficiency measured as value added over energy costs at the firm level (median among all firms). Panel B captures environmental expenses of domestic and foreign firms in Croatia measured as percentage of total environmental expenses.

Source: OECD elaboration based on the Financial Agency (FINA) of Croatia.

Croatia can further capitalise on investments in renewable energies. Greenfield FDI in renewables did not only become more important in the Croatian energy sector but also in total greenfield FDI inflows. While renewables accounted for 6% of all opened and announced greenfield FDI between 2012 and 2016, the share rose to 18% between 2017 and 2021 when almost all greenfield FDI in the Croatian energy sector (98%) went into renewables (Figure 2.15). Conversely, the share of fossil fuels in Croatia's total greenfield FDI inflows declined from 25% to 0.3% in the same time span. In other CEE economies, renewable energy sources also have the largest share of FDI in the energy sector, but fossil fuels still play a more important role than in Croatia, accounting for around 30% and 20% of FDI in the energy sector in the advanced and less advanced CEE economies, respectively.

**Figure 2.15. Greenfield FDI in renewables has picked up in recent years**

Greenfield FDI in fossil fuels and renewables, 2012-2016 and 2017-2021

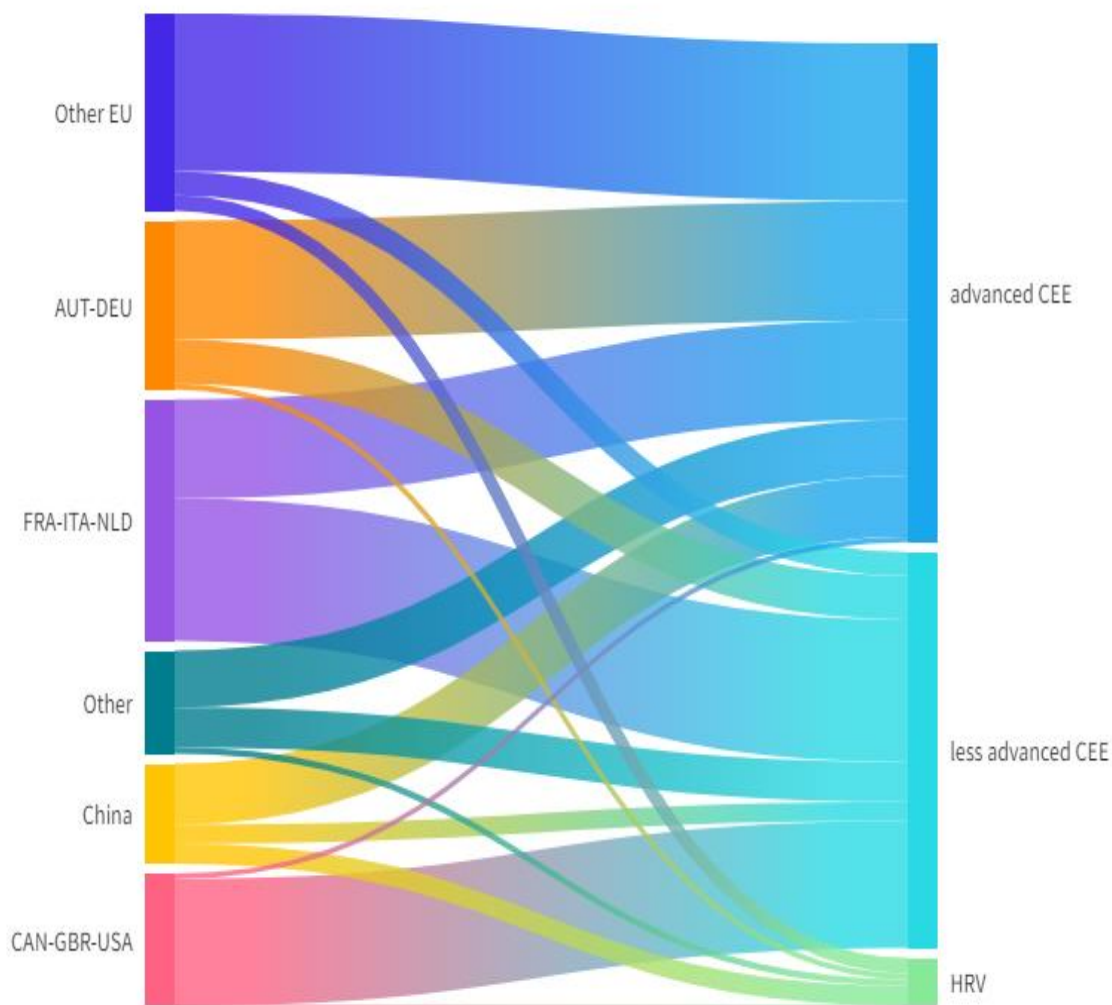


Note: This chart shows the share of fossil fuels (coal, oil and gas) and renewables in all opened and announced greenfield FDI projects.  
 Source: OECD elaboration based on FT fDi Markets (2023<sup>[12]</sup>).

Even though Croatia succeeded in attracting more greenfield FDI in renewables over the past few years, Croatia is not fully exploiting the investment potential of its renewable industry. Over the past decade, Croatia’s greenfield FDI inflows in renewables increased by 13% but are still much smaller than greenfield investment in renewables in other CEE economies. Even considering the economic size of countries, the average value of announced and opened greenfield FDI projects in renewable energy in other CEE economies is almost four to five times higher than the total value of greenfield FDI projects in renewable energy in Croatia (Figure 2.16). EU members, especially Austria and Germany, as well as China are the largest investors in renewable energy in Croatia, with 44%<sup>6</sup> and 42% respectively. While a similar pattern holds for advanced CEE economies, less advanced CEE economies also receive almost one-third of their greenfield FDI from Canada, the UK, and the US.

**Figure 2.16. EU members and China are the largest investors in renewable energy in Croatia**

Greenfield FDI in renewables, total 2017-2021



Note: This chart shows the value of all opened and announced greenfield FDI projects in renewables in Croatia and other CEE economies. The chart is based on total capital expenditure values weighted by average GDP before aggregating flows in different country groups. Less advanced CEE includes the following upper-middle income economies: Bulgaria, North Macedonia, Romania, and Serbia. Advanced CEE includes the following high-income economies: Czechia, Hungary, Poland, Slovakia, and Slovenia.  
Source: OECD elaboration based on FT fDi Markets (2023<sup>[12]</sup>).

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## Notes

<sup>1</sup> CEE economies that are covered in the analysis are Bulgaria, Czechia, Hungary, North Macedonia, Poland, Romania, Serbia, Slovakia, and Slovenia.

<sup>2</sup> In 2021, domestic sales of foreign firms in Croatia accounted for 68% of total sales (OECD calculation based on census data from the Financial Agency (FINA) of Croatia).

<sup>3</sup> A firm is defined as “active” if it has positive sales and labour costs in a given year.

<sup>4</sup> A firm is defined as “foreign firm” if 10% or more are owned by a foreign investor.

<sup>5</sup> The productivity premium of the overall economy aligns with results from the literature where foreign productivity premia are calculated taking into account differences in the distribution of firms across sectors, firm sizes etc. For example, Bule and Cudina find a productivity premium of 87.8 which is close to the unconditional labour productivity premium of 90 presented in Figure 2.10.

<sup>6</sup> Austria and Germany accounted for about 12% of opened and announced greenfield FDI projects in Croatia between 2017 and 2021.

# **3** Investment promotion and facilitation for a sustainable and resilient recovery

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This chapter provides an assessment of the investment promotion and facilitation framework in Croatia. It discusses the existing strategies and institutions governing investment promotion and highlights key reforms to improve the investment climate and attract high value-added investments that contribute to a sustainable and resilient recovery. It also focuses on specific sustainable development outcomes and examines whether and how the investment promotion framework in Croatia contributes to them.

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## Summary and policy recommendations

As highlighted in the OECD Policy Framework for Investment and the FDI Qualities Policy Toolkit, investment promotion and facilitation can be powerful means to attract investment and maximise its contribution to sustainable development, but their success depends on the quality of investment-related policies and on the overall investment climate. As such, countries worldwide decide to not only remove restrictions on foreign direct investment (FDI) and provide high standards of protection to investors, but also to proactively promote and facilitate investment to maximise potential economic, social and environmental benefits to the host economy. One size does not fit all, and different approaches are suitable for different countries. Effective investment promotion and facilitation can be particularly important to address the economic consequences of the COVID-19 pandemic and the ongoing energy crisis, which have weakened economic prospects and increased the risk of slowing down progress to make societies and economies more resilient, inclusive and sustainable.

In Croatia, responsibility for investment promotion and facilitation falls primarily under the Ministry of Economy and Sustainable Development (MESD). The MESD's Internationalisation Directorate was established in 2020 after the abolishment of the Agency for Investment and Competitiveness (AIK) with the aim to promote Croatia as an attractive investment destination and support foreign MNEs to set up their operations in Croatia. Since then, the Directorate has gradually started to develop its investment promotion and facilitation tools and strategies. Efforts have focused primarily on collecting and disseminating information on the MESD's website, developing investor guides and other promotional materials, and accompanying investors in regions to facilitate their investment projects. What distinguishes the Directorate from other OECD Investment Promotion Agencies (IPAs) is the significantly higher allocation of resources for the implementation of image-building activities and the rather limited emphasis placed on investment generation, including direct investment targeting and prioritisation.

As the Internationalisation Directorate seeks to consolidate many of the nascent organisational and functional aspects of its work, insufficient resources and inadequate staff are the two greatest challenges that it has to face to fulfil its investment promotion mandate. Although in recent years, financial resources have started to gradually increase, staff shortages put a strain on the activities of the Directorate and jeopardise the use of the available budget, a large part of which remains underutilised. Endowing the Directorate with capacities to provide a fuller portfolio of services to potential investors should be a priority for the Croatian government. The development of the forthcoming National Plan and Action Plan on Investment Promotion provides an opportunity to rethink Croatia's strategic framework for the promotion and facilitation of private investment, address existing challenges stemming from the transition to the new institutional set-up and equip the new structure with tools that have previously been missing.

The fragmentation of the institutional environment is another factor that should be taken into consideration for the elaboration of investment promotion and facilitation policies in Croatia. Many of the investment-related mandates of the Internationalisation Directorate are shared with other government bodies, in particular ministries that are responsible for investments in sectors of strategic importance for the Croatian economy (e.g. energy, agriculture, financial services) and subnational governments (e.g. regional development agencies, counties, municipalities) that often promote their own regions and provide investment facilitation services. Coordination and collaboration among these actors are limited and takes place on an ad hoc basis and through informal channels, often resulting in disjointed actions and separate strategies across different ministries and implementing agencies. These findings highlight the importance of policy coordination and the need for the Internationalisation Directorate to foster synergies with other parts of the government, share resources, implement joint initiatives and strengthen its coordinating role.

The Croatian government implements several policies to leverage international investment for the sustainable development of the economy. Investment tax incentives are conditioned to undertaking R&D and creating a certain number of jobs, while additional financial grants are available to support job creation, innovation and workforce skills development. However, Croatia is placed among OECD and EU economies that provide one of the lowest levels of total government support to R&D investments. Recent initiatives to promote green investment have focused on providing incentives for investments in renewables and setting low-carbon transition targets that send investors, including foreign ones, strong signals regarding the government's climate ambitions. There are, however, administrative, regulatory and technical barriers remaining, including lengthy procedures for authorisation and permitting, as major challenges for further investment in renewable energy.

### Policy recommendations

- **Ensure that Croatia's forthcoming National Plan on Investment Promotion is guided by clearly identified strategic objectives** and that these are reflected in the Internationalisation Directorate's governance processes, allocation of resources, key functions and activities. The National Plan should be clear and specific about Croatia's FDI attraction targets, tools to reach the set targets, performance indicators to measure progress, and the procedures in place to coordinate effectively with other relevant government bodies (e.g. ministries, public agencies, subnational authorities) and stakeholders (e.g. the private sector).
- **Expand investment generation activities to identify and approach potential investors that can support national development objectives**, notably by targeting companies in priority sectors and in high value-added activities. Boosting investment generation activities will require thorough sector-specific knowledge and a good understanding of MNEs' internationalisation strategies.
- **Improve the internal governance of investment facilitation and aftercare services by exploiting synergies with subnational actors** that may have more staff on the ground to provide the services that are currently not provided by the MESD. As a first step, specific areas for collaboration could be identified, such as for instance helping investors navigate the licensing process, the joint development of an online suppliers database and the organisation of matchmaking events, business fairs and sector-specific promotional activities.
- **Continue efforts to address resource-related challenges faced by the Internationalisation Directorate** and strengthen its capacity to generate prospective investment leads and maximise the number of realised investments. Financial resources available for investment promotion and facilitation are gradually increasing, but staff shortages hinder the use of these resources.
- **Develop a comprehensive investment prioritisation framework with clearly defined criteria** that will be used for the pro-active targeting of activities, sectors, and investments that contribute to the sustainable development of the Croatian economy. Such an approach would facilitate the work of the MESD by allowing to manage the current limited resources more efficiently and support investments with the greatest impact. The criteria should be carefully selected to reflect Croatia's priorities with regard to sustainable development, be the result of consultations with key stakeholders in the business community, and subject to regular reviews.
- **Introduce robust monitoring and evaluation (M&E) systems to track the investment promotion and facilitation activities undertaken by the Internationalisation Directorate** and evaluate its organisational performance and success in reaching the target objectives set in the forthcoming National Plan and Action Plan for Investment Promotion. The recent

establishment of a Customer Relationship Management (CRM) system should be complemented by the development of Key Performance Indicators (KPIs) to assess the types of firms and investments that benefit from public assistance, and their sustainability-related impacts.

- **Set up coordination mechanisms that place the MESD at the epicentre of cross-government efforts to promote investment** and allow the Internationalisation Directorate to effectively collaborate with sectoral ministries, subnational IPAs, regional and local governments. This would require, however, clarity about the official mandates, roles and responsibilities of the various entities that are currently involved in investment promotion and more broadly the provision of business support services.
- **Review the innovation support programmes to make them more accessible to foreign and domestic firms that seek to engage in innovation-based partnerships.** The various sources of funding should be better linked, be more targeted and coordinated and supplemented with technical assistance that allows foreign MNEs to perform R&D in Croatia, identify qualified R&D workers, and collaborate with domestic R&D institutions, sectoral clusters and science and technology parks.
- **Strengthen knowledge and technology spillovers from FDI by helping foreign MNEs identify local suppliers and strengthening the capacities of Croatian SMEs to collaborate with them.** The Internationalisation Directorate could consider implementing a supply chain development programme jointly with the MESD's Directorate for Industry, Entrepreneurship and Crafts, HAMAG-BICRO, and subnational governments.
- **Address skills shortages in FDI-intensive sectors through targeted sectoral upskilling programmes that allow foreign MNEs to tailor them to the needs of their employees.** The MESD's Internationalisation Directorate could further promote sectors in alignment with the existing skills base and help investors find qualified employees. Better coordination and collaboration between the Directorate and the Croatian Employment Service will be key to improve FDI's contribution to skills development.
- **Establish robust labour market information and skills anticipation systems that involve investment actors** to design evidence-based employment or training policies and effectively monitor their impacts. The MESD could bring forward its sectoral expertise to the National Council for Human Resource Potential and voice the concerns of investors in terms of skill shortages and future training needs.
- **Step up policy efforts to promote and facilitate renewable energy investments** by removing regulatory barriers, simplifying licensing and permit systems, ensuring the continuity of the new feed-in-premium incentive scheme, and strengthening interoperability between government bodies. Procedures for obtaining environmental approvals take significantly longer than the legal deadlines prescribe, and licensing approval rules are also not always clear. Croatia's long-term goal of at least 65% renewable energy generation by 2050 will require policy coordination and consultation with industry to keep a fast pace of investment in clean energy.
- **Harmonise and improve the governance of spatial planning rules to facilitate land acquisition for large-scale investment projects.** Emphasis should be placed on streamlining information on land administration and tenure for potential investors through digital means. Subnational governments could be further supported to effectively coordinate with county authorities and resolve challenges arising from potential overlapping spatial planning rules.

## The institutional framework for investment promotion and facilitation

### ***The institutional framework for investment promotion and facilitation has gone through many organisational reforms***

IPAs are key players in bridging information gaps that may otherwise hinder the realisation of foreign investments, and their potential sustainable development impacts. Their primary role is to create awareness of existing investment opportunities, attract investors, and facilitate their establishment and expansion in the economy, including by linking them to potential local partners (OECD, 2018<sup>[1]</sup>). The organisational structure and legal form of IPAs can determine their degree of autonomy in the design, coordination and implementation of promotional activities. Depending on the way they are supervised, managed and controlled, it can also have a particular incidence on how they interact with other government actors and the type of strategic relations they form with them.

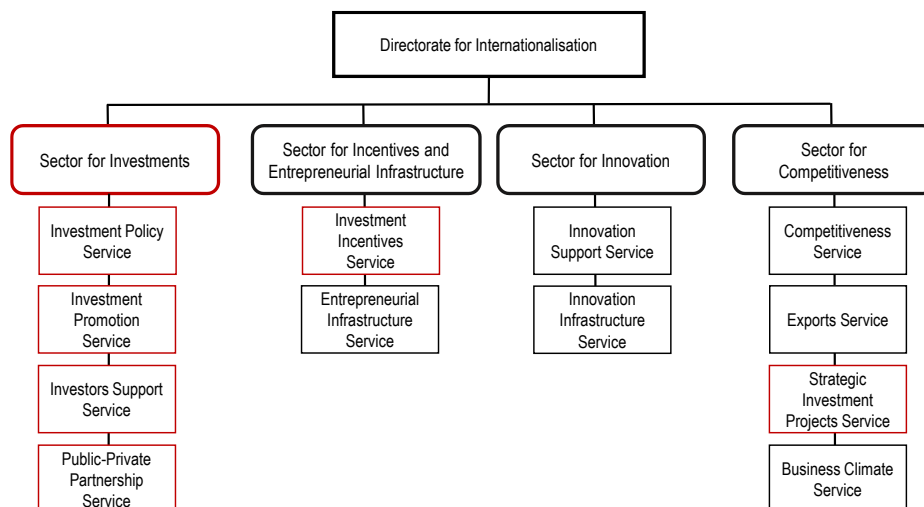
The Croatian investment promotion framework has undergone several organisational reforms over the past decade. Until 2019, an autonomous public agency, the Agency for investments and Competitiveness (AIK, *Agencija za investicije i konkurentnost*), was responsible for promoting Croatia as an attractive investment destination, proactively attracting and assisting in the implementation of investment projects and facilitating the development of the Croatian economy (OECD, 2019<sup>[2]</sup>). During the same period, investment promotion competencies had been also assigned to the Croatian Agency for Small and Medium-Sized Enterprises, Innovations and Investments (HAMAG-BICRO), which was however expected to focus on SMEs and other smaller, primarily domestic, investors. There were also separate agencies responsible for investment attraction in certain sectors such as the Centre for Monitoring Energy Sector Operations and Investments, as well as several actors operating at the subnational level. In this context, as part of a wider government reform aiming to streamline central state bodies, AIK was abolished, effective as of 1 January 2019, and all of the agency's responsibilities and staff were absorbed by the Ministry of Economy, Entrepreneurship and Crafts – which was later on restructured to become the current Ministry of Economy and Sustainable Development (MESD). A separate regulation was officially adopted in 2020, outlining the new organisation of the Ministry and the structure of the newly established Internationalisation Directorate, which is currently considered AIK's natural successor (Figure 3.1).

AIK's absorption into the MESD could have potentially given Croatia's investment promotion framework more political clout and strengthen its investment prioritisation and policy advocacy functions. In fact, one third of OECD IPAs are fully governmental and operate as a department or unit in a ministry (OECD, 2018<sup>[1]</sup>), which allows them to potentially benefit from greater access to resources and more opportunities to influence the design of investment climate reforms due to their proximity to the centre of government. Many IPAs also undergo reforms in search of the right institutional and organisational set-up to adapt to changing environments, shifted policy priorities and emerging challenges. Reforms often involve modifications to their organisational structure and legal status and changes to their reporting ministry, responsibilities and mandates.

In the case of Croatia, however, the 2019 organisational reform was motivated by reasons other than improving the quality of the institutional framework for investment promotion and lacked a thorough reflection on key strategic factors pertaining to the new Directorate's functions, the services offered to foreign investors, the allocation of financial resources, and the risks that had to be managed during the transition. Although in recent years significant efforts have been made to ensure continuity and improve the effectiveness of services offered to investors, the delay observed between the abolishment of the agency and the establishment of the new Directorate severely impacted the delivery and level of coordination of investment promotion and facilitation services. Interviews with private sector representatives conducted for the purpose of this Review point towards the disruption of services, the lack of resources and the loss of autonomy (in contacting investors, performing tasks, or hiring workers, for example) as key barriers to attracting quality FDI. Many also stressed that the dismantling of AIK as a

separate entity led to lack of clear guidance to investors in terms of who to contact to acquire information on investment opportunities in Croatia<sup>1</sup>.

**Figure 3.1. Structure of the MESD's Internationalisation Directorate**



Note: Departments and units whose work touches upon investment promotion and facilitation are highlighted in red.

Source: OECD based on MINGOR (2022<sup>[3]</sup>), <https://mingor.gov.hr/UserDocsImages//O%20ministarstvu//Organigram%20MINGOR.pdf>

The government will need to ensure that Croatia's investment promotion framework is guided by clearly identified strategic objectives and that these are reflected in the Directorate's governance processes, allocation of resources, key functions and specific activities related to investment promotion and facilitation. As the Internationalisation Directorate is still consolidating many of the nascent organisational and functional aspects of its work, it is important to address existing challenges stemming from the transition to the new institutional set-up and equip the new structure with tools that have previously been missing. The overall goal should be to learn from the past performance and develop certain best practices to ensure tangible improvements. Advancing Croatia's strategic framework for the promotion and facilitation of private investment will also require high-level political commitment to overcome potential policy siloes, mobilise public resources and government actors and build momentum behind the investment policy agenda. To assist in this process, the following sections will present the results of the benchmarking of the Internationalisation Directorate to OECD IPAs and draw comparisons with and examples from other EU countries, which present significant opportunities for mutual learning and the exchange of good practices. The analysis is complemented by a comparison of the Internationalisation Directorate with AIK on the basis of the latter's responses to the 2018 OECD-IDB IPA Survey and the findings of the 2019 OECD Investment Policy Review of Croatia (OECD, 2019<sup>[2]</sup>).



### Box 3.1. The OECD-IDB survey of IPAs

The OECD and the IDB have partnered to design a comprehensive survey of IPAs. The questionnaire provides detailed data that reflect the multiple recent policy developments as well as rich and comparable information on the work of IPAs in different countries. The survey was displayed and shared with IPA representatives from OECD and Latin America and Caribbean (LAC) countries in the form of an online questionnaire that was divided into nine parts:

- Basic profile;
- Budget;
- Personnel;
- Offices (home and abroad);
- Activities;
- Prioritisation;
- Monitoring and evaluation;
- Institutional interactions; and
- IPA perceptions on FDI.

National IPAs from 32 of the then 35 OECD countries participated in the OECD-IDB survey, representing a 94% response rate. IPA respondents completed the questionnaire between May and September 2017. The data gathered through the survey served as a basis for a preparation of a mapping report of IPAs in OECD countries, as well as benchmarking with other regions (e.g. LAC, Middle East and North Africa, and Eurasian countries).

### ***The Internationalisation Directorate has been entrusted with a higher number of mandates than other OECD IPAs***

IPAs have been created with the primary mandate to promote and attract inward foreign investment. There are however substantial variations in the number and scope of mandates for IPAs in OECD and non-OECD countries. In certain cases, IPAs are part of a broader agency that includes additional mandates such as the promotion of exports, innovation, regional development, domestic investment, and the granting of business permits or incentives, among others. The combination of these mandates can be motivated by the need to maximise synergies and foster economies of scale by grouping together policy areas that target various aspects of investment and business growth (e.g. internationalisation, innovation, productivity). This is particularly true for governments that seek to strengthen the domestic business environment by attracting export- and R&D-intensive investors, as similar industries and markets can be targeted.

The MESD's Internationalisation Directorate reported in its responses to the IPA survey to have 10 official mandates (out of 18 possible mandates) (Table 3.1), including inward foreign investment promotion; export promotion; innovation promotion; domestic investment promotion; granting fiscal incentives; granting financial incentives; granting other incentives; screening and prior approval of investment projects; management of public-private partnerships; and management of free trade or special economic zones or industrial parks.



**Table 3.1. Evolution of mandates entrusted to MESD's Internationalisation Directorate compared to other OECD IPAs**

	Croatia (2022)	Croatia (2018)	OECD total
Inward foreign investment promotion			100%
Export promotion			56%
Innovation promotion			53%
Promotion of regional development			47%
Domestic investment promotion			38%
Outward investment promotion			29%
Granting financial incentives			29%
Screening and prior approval of investment projects			24%
Trade Facilitation (e.g. single window for trade, assistance in custom issues)			24%
Granting other incentives			15%
Operation of one-stop shop (e.g. business registration, permits, licenses)			12%
Management of public-private partnerships (PPPs)			9%
Granting fiscal incentives			9%
Negotiation of international trade, investment or other agreements			9%
Management of free trade or special economic zones or industrial parks			3%
Negotiation and administration of public concessions			3%
Issuing of relevant business permits			0%
Management of privatisations			0%

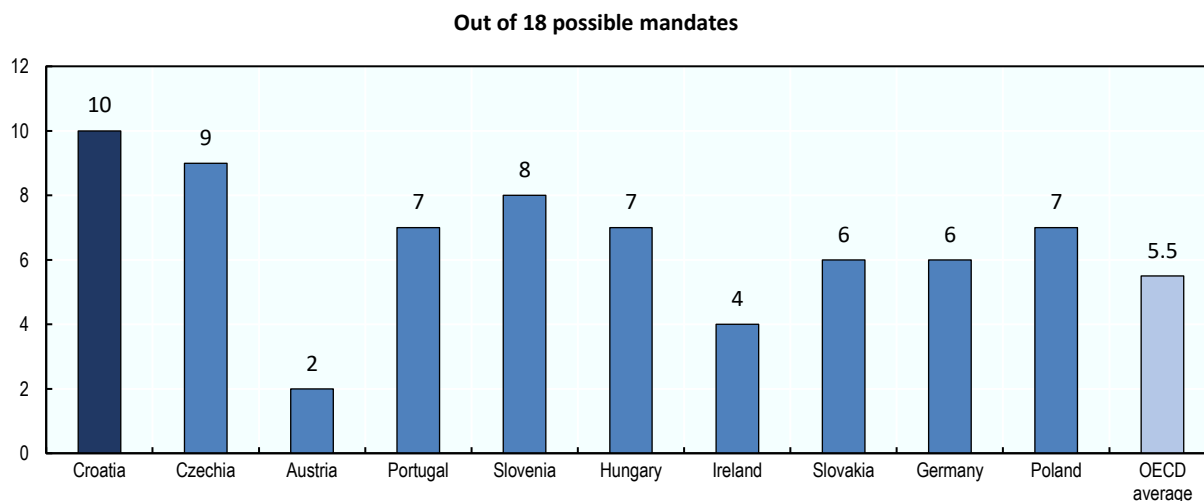
Note: The information on the OECD total dates from 2018. It includes data from new OECD member countries (i.e. Colombia and Costa Rica), which may explain differences from previously published OECD data.

Source: OECD based on the OECD-IDB Investment Promotion Agencies Survey (2018<sup>[4]</sup>; 2022<sup>[5]</sup>)

Overall, it is rare for an IPA to have so many mandates integrated under the same roof. Compared to AIK, the number of official mandates has more than doubled (10 compared to just 4 in 2018), reflecting the new Directorate's wide scope of responsibilities and activities, which are strongly articulated around policy areas that support the openness and competitiveness of the Croatian economy. The new institutional set-up allows to address and build synergies with a more diverse range of policy areas that affect investors' experience and decisions about where to locate their investments, such as for instance the quality of the business environment and the (export and innovation) performance of the economy. It also allows to link investment promotion activities to specific types of policy instruments such as the granting of financial and other incentives, the management of business zones and industrial parks, the promotion of public-private partnerships and the approval processes for certain investment projects. Combining inward FDI promotion with export promotion and innovation promotion is common among OECD IPAs, included as mandates in 56% and 53% of IPA respectively (Table 3.1). The other reported mandates are entrusted to IPAs less frequently, however.

In the OECD area only four IPAs have 10 or more mandates while half of them report to have a maximum of five, reflecting their desire to pursue a more targeted and specialised role. The MESD's Internationalisation Directorate ranks far from the OECD average of 5.5 mandates as well as far from the number of mandates that other Central European IPAs have (e.g. Slovak Republic, Slovenia, Austria) (Figure 3.2). This may be due its legal status, i.e. being part of a ministry implies proximity to many other policy areas that may affect investors' decisions, including those touching upon regulation or policymaking (e.g. operation of one-stop shops, granting of incentives, issuing of relevant licences, negotiation of international treaties, screening and prior approval, etc).

**Figure 3.2. Number of mandates entrusted to the MESD's Internationalisation Directorate and to other IPAs in peer EU countries**



Source: OECD based on the OECD-IDB Investment Promotion Agencies Survey (2018<sup>[4]</sup>; 2018<sup>[4]</sup>)

Although the wide scope of responsibilities may help place investment promotion closer to broader policy objectives that support the sustainable development of the Croatian economy, it can also lead to potential risks if the new institutional set-up is not supported with the necessary resources, processes and tools. For instance, some studies show that those IPAs focusing exclusively on investment promotion achieve significantly higher results in attracting investors than those which carry out both regulatory and promotional tasks (World Bank, 2011<sup>[6]</sup>). Some governments choose to establish agencies with a narrow mandate to ensure that their skillsets are sufficiently specialised, and activities targeted to respond to the needs of their respective clients. Beyond the number of mandates, a broader range of factors affect the effectiveness of IPA activities. More recent studies using firm-level data on IPA assistance and firms' investment decisions show that outcomes depend on the type of mandate and the agency's budget per mandate, among others. For instance, IPAs with more, better-funded mandates that are also responsible for innovation promotion, green investment promotion or regional development show higher effectiveness in attracting new foreign MNEs (Volpe Martincus et al., 2021<sup>[7]</sup>). The Internationalisation Directorate's expanded mandates require, therefore, both a wide scope of skillsets, administrative capacities, financial and operational resources, and a clear strategic orientation that all divisions and units can hang on to.

Another challenge is that the multiplicity of mandates increases the risk of policy overlaps with the work of other government bodies that may be involved in investment promotion activities at the national or subnational levels. The results for Croatia from the OECD-IDB IPAs survey demonstrate that many of the investment-related mandates of the Internationalisation Directorate are shared with several public institutions, in particular other directorates within the MESD as well as sectoral ministries that are responsible for investments in the energy, agricultural, financial services, health and social services sectors (Table 3.2). Investment promotion activities are also undertaken by many regional development agencies as well as local authorities. In this context, emphasis should be placed on ensuring robust coordination mechanisms with other directorates within the MESD (e.g. Energy Directorate, Climate Activities Directorate, Directorate for Environmental Impact Assessments) as well as other ministries (e.g. Ministry of Science and Education, Ministry of Regional Development and EU Funds) and subnational agencies (see section on policy coordination).

**Table 3.2. Other government institutions in Croatia performing investment promotion activities**

	Other national agencies performing this function	Other subnational agencies performing this function
Inward foreign investment promotion	YES	YES
Domestic investment promotion	YES	YES
Outward investment promotion	YES	NO
Negotiation of international trade, investment and other agreements	YES	NO

Source: OECD based on the OECD-IDB Investment Promotion Agencies Survey (2022<sup>[6]</sup>)

### ***Resources devoted to investment promotion and facilitation are gradually increasing but challenges remain***

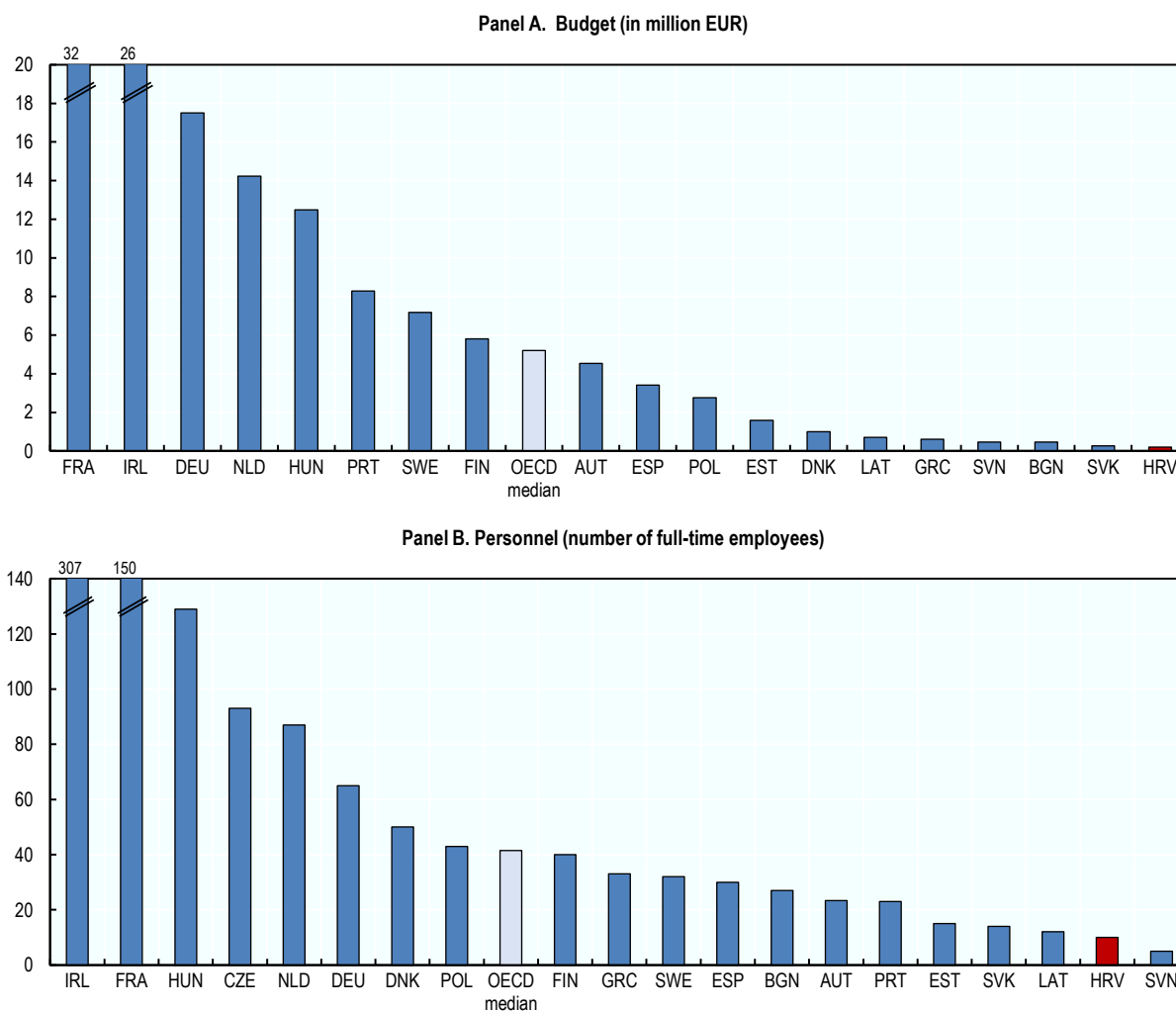
Adequate financial and human resources are essential success factors of any institution and IPAs are no exception. Access to resources determines the scope of the IPA's activities, the quantity and quality of staff, the mechanisms to evaluate success, and other important organisational aspects (OECD, 2018<sup>[1]</sup>). For those agencies that have a high number of mandates, the difference between the total IPA budget and the one dedicated to investment promotion can be quite significant.

In 2022, with an investment promotion budget of EUR 0.2 million and 11 employees, the Investment Sector at the Internationalisation Directorate was one of the smallest IPAs across the OECD and peer EU countries (Figure 3.3). The OECD-IDB IPAs survey finds that the two greatest challenges faced by the Internationalisation Directorate in the mid- to long-term to fulfil their investment promotion mandate are respectively inadequate resources and inadequate staff. Other challenges such as the instability of the mandates and the lack of political support for the IPA are also mentioned as obstacles. The limited financial resources for the implementation of investment promotion and facilitation activities has been a longstanding issue in Croatia. The 2019 OECD Investment Policy Review, which was undertaken before AIK's abolishment, found that, although the agency's total budget had increased since 2012, the resources devoted to FDI promotion had stayed constant and were still far from the average budget of OECD IPAs (OECD, 2019<sup>[2]</sup>).

A similar picture emerges when looking at the evolution of resources over time (Figure 3.4). When comparing AIK's average annual budget for investment promotion in the period 2012-16 (for which data are available), to the Internationalisation Directorate's budget since its establishment in 2020, it becomes clear that the share of investment promotion within the IPA's total budget has been significantly reduced (from 9% to 1%) – the difference reflecting the relative importance of other mandates that are currently entrusted to the new Directorate. This may also be due to shifting policy priorities, the change in AIK's legal status and the subsequent loss of autonomy, and the limited political clout of the Ministry's investment promotion agenda over other policy issues – such as, for instance, the streamlining of public administration services and the reduction of regulatory burden on business which have been prioritised by the government in recent years.

Overall, in absolute nominal terms, it appears that the average annual budget in the period 2020-2022 is slightly higher than in the period 2012-2016, reflecting recent efforts by the Internationalisation Directorate to scale up its activities (Figure 3.4). This may be interpreted with some optimism given that many IPAs have experienced budget cuts due to the COVID-19 pandemic and the pressure that the economic crisis has put on government budgets. According to interviews conducted with MESD officials, the investment promotion budget is expected to continue its upward trend and almost double in 2023. This is a step in the right direction as it could help the Directorate scale up its activities.

**Figure 3.3. IPA resources for investment promotion and facilitation in Croatia and selected EU countries**

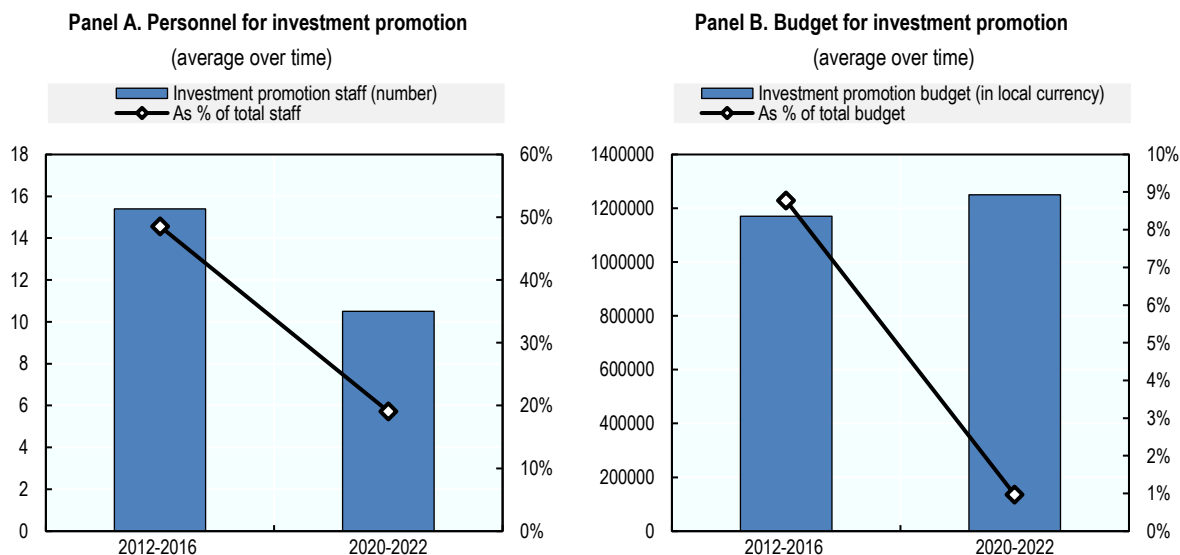


Note: The most recent data on IPA resources date from 2018, with the exception of Bulgaria (2021) and Croatia (2022).

Source: OECD based on the OECD-IDB Investment Promotion Agencies Survey (2018<sup>[4]</sup>; 2022<sup>[5]</sup>)

Another challenge is the “brain drain” observed since the transition to the new legal status. As presented in Figure 3.4 (Panel A), the Internationalisation Directorate has lost almost one third of its investment promotion staff. Similarly, the share of investment promotion employees has moved from an average of 48% in 2012-2016 to less than 20% in 2020-2022. Although the current staff is significantly experienced in investment promotion and facilitation, the departure of a large number of employees over the past few years has put a strain on the activities of the Directorate and jeopardised the use of the available budget, a large part of which remains underutilised. This is further undermined by the government’s decision to avoid the increase of employment in the public sector and by the lower wages that ministry officials receive compared to AIK, resulting in a lack of incentive for investment promotion staff to remain in the MESD. Human resources are the most important asset of an IPA. They usually represent the highest share of OECD IPAs’ budget expenditures, and their quality and motivation are a prerequisite to the success of an IPA (OECD, 2018<sup>[11]</sup>). Attracting adequately skilled staff in sufficient numbers can highly influence the ability of the new Directorate to scale up its nascent activities and attract investments in line with its targeted objectives.

**Figure 3.4. Evolution of financial and human resources devoted to investment promotion and facilitation activities in Croatia**



Note: There is no available data for the period 2017-2019. The figures compare the average of personnel and budget that were available for investment promotion and facilitation activities during the periods 2012-2016, when AIK was operational, and 2020-2022 under the Internationalisation Directorate of the Ministry of Economy and Sustainable Development (MESD).

Source: OECD based on the OECD-IDB Investment Promotion Agencies Survey (2018<sup>[4]</sup>; 2022<sup>[5]</sup>)

Addressing these various challenges will require a concerted effort on the part of the government to ensure that resource-related challenges arising from the transition to the IPA's new legal status are addressed effectively. This becomes even more crucial in the context of the forthcoming National Plan for Investment Promotion, whose implementation will likely further strain the limited capacities of the Investment Sector in the Internationalisation Directorate. The latter should be supported with the necessary resources to strengthen its capacity to generate prospective investment leads and maximise the number of realised investments. Given that financial resources are gradually increasing but staff shortages remain an issue, one option would be for the Croatian government to consider hiring additional qualified staff. Another, potentially complementary, option is for the Investment Sector to collaborate with other ministries, subnational IPAs and local business support institutions for the implementation of joint promotional activities and the development of new tools that help investors acquire information on investment opportunities. This would allow to leverage the human resources available in other parts of the Croatian government and put the current investment promotion budget into use until staff shortages in the Directorate are addressed.

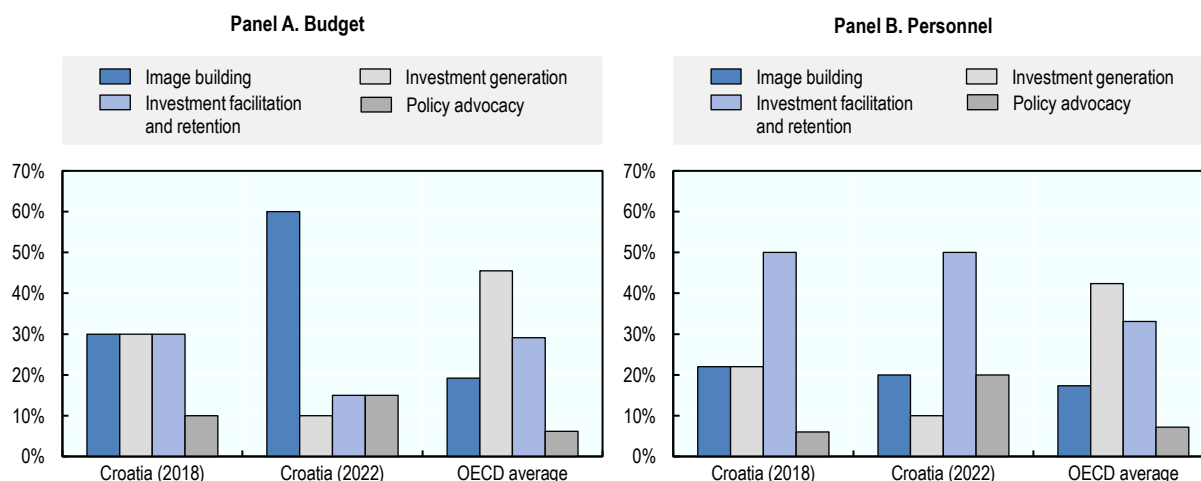
Higher budgets are found to be associated with a larger number of investment generation and facilitation activities (including aftercare services). In addition, IPAs that prioritise certain investors and projects tend to have higher budgets enabling them to provide higher quality services to selected firms (OECD, 2018<sup>[11]</sup>). Recent evidence suggests that support from IPAs with larger budgets (both overall budgets and those specifically targeting investment promotion) makes it more likely for foreign firms to open a first affiliate in the respective countries than support from less well-endowed counterparts. This holds both when considering the absolute investment promotion budget and when normalizing this budget by country size as proxied by GDP (and population) (Volpe Martincus et al., 2021<sup>[77]</sup>).

### Investment generation efforts could be strengthened and better targeted

In the vast majority of countries, IPAs are major players in the implementation of four core investment promotion functions: i) *image building* consists of fostering the positive image of the host country and branding it as a profitable investment destination; ii) *investment generation* deals with direct marketing techniques targeting specific sectors, markets, projects, activities and investors, in line with national priorities; iii) *investment facilitation and aftercare* is about providing support to investors to facilitate their establishment phase as well as retaining existing ones and encouraging reinvestments by responding to their needs and challenges; and iv) *policy advocacy* includes identifying bottlenecks in the investment climate and providing recommendations to the government in order to address them.

According to the results from the OECD-IDB IPAs survey, 60% of the budget devoted to the Sector for Investments of the Internationalisation Directorate is spent in the implementation of image building activities, while less resources go for investment generation (15%), investment facilitation (15%) and policy advocacy (10%)<sup>2</sup> (Figure 3.5, Panel A). These findings set Croatia apart from other OECD and EU IPAs who exhibit a more balanced allocation of resources across their four core functions as well as more focus on direct investor engagement and targeting. The average trend among OECD IPAs is to allocate the bulk of their resources to investment generation (46% of total budget) and investment facilitation and retention (30%), while image building (18%) and policy advocacy (6%) receive less attention (OECD, 2018<sup>[1]</sup>). When looking at human resources within the Sector for Investments, the relatively high allocation of staff to investment facilitation (50%) should be expected considering the important labour-intensive activities that this function includes (Figure 3.5, Panel B). However, the overall balance remains skewed compared to the OECD average – significantly less staff works on pro-actively generating investment leads and projects (10% in Croatia compared to 42% on average among OECD IPAs).

**Figure 3.5. Resources of the MESD's Sector for Investments devoted to the four core functions of investment promotion and facilitation compared to the OECD average**



Source: OECD based on the OECD-IDB Investment Promotion Agencies Survey (2018<sup>[4]</sup>; 2022<sup>[5]</sup>)

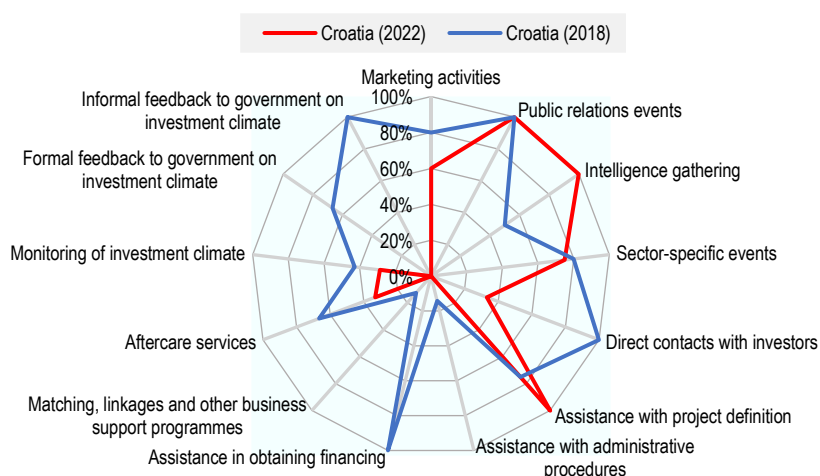
These findings reveal the ongoing challenge of equipping the new Directorate with the necessary tools to engage in more sophisticated investment promotion activities. When compared to AIK, the Internationalisation Directorate exhibits a narrower scope of activities, focused primarily on public relations events (e.g. road-shows and business fora, general investor missions abroad and at home), producing investor guides and other promotional materials, and disseminating information to potential investors (Figure 3.6). Certain investment facilitation activities that help foreign MNEs define their investment projects are also undertaken while aftercare services are limited to the sharing of information on regulatory

developments through digital means (e.g. emails, newsletters). Other activities such as comprehensive aftercare services, assistance with administrative procedures, monitoring of investment climate, formal and informal feedback to government take place less frequently.

Given that Croatia's IPA operates as part of a ministry and investment-related mandates are spread across multiple departments (Figure 3.1), it is important to note that some of these core functions are undertaken with financial resources other than the investment promotion budget managed by the Sector for Investments (and which was considered for the purpose of the OECD-IDB IPAs survey). For instance, this is the case of policy advocacy activities which are primarily conducted by the Directorate's Competitiveness Sector. The Competitiveness Sector is tasked with monitoring the business environment and consulting with market stakeholders to identify hurdles in doing business in Croatia as well as potential business climate reforms. Indicatively, in 2022, the Competitiveness Sector managed more than EUR 1 million while the Sector for Investments EUR 0.2 million – pointing towards potential complementarities between the two departments in the execution of certain investment-related responsibilities.

**Figure 3.6. Extent of investment promotion and facilitation activities in Croatia**

In % of possible activities for each category



Source: OECD based on the OECD-IDB Investment Promotion Agencies Survey (2018<sup>[4]</sup>; 2022<sup>[5]</sup>)

Since the establishment of the Internationalisation Directorate, investment promotion efforts have focused primarily on collecting and disseminating information on the MESD's website (Table 3.3). A set of interactive maps have been created to provide information on land sites and business zones that are ready to receive investment projects and indicate public and private sector projects that seek investors or strategic partners. A regional map was also launched in 2022, offering statistical data for each subnational county, including the availability of infrastructure, trade and investment-related trends, investment incentives applying to specific areas, labour market characteristics as well as the contact details of regional development agencies and local authorities.

Having a single-entry point for investors to acquire information on investment opportunities is indeed a cost-efficient way to offer centralised, available, up-to-date and key information for a large audience of prospective foreign investors. Focusing investment promotion efforts on specific, ready-made investment projects is common in other countries too, and can constitute a good selling point for some specific investors, but targeting should not be limited to this practice, as most businesses appreciate flexibility as to where and how their investments will be channelled. Croatia should complement these efforts with more direct marketing techniques to identify and approach potential investors that can support national



development objectives, notably by targeting companies in priority sectors and in high value-added activities. Such activities may include initiating one-to-one meetings with potential investors, holding pro-active campaigns in Croatia and abroad, and undertaking market studies (e.g. on Croatia's relative position vis-à-vis its competitors).

Boosting investment generation activities will require thorough sector-specific knowledge and a good understanding of MNEs' internationalisation strategies. The Directorate's staff members have to be able to grasp companies' investment location decision processes and identify their requirements long before their investment decision is taken, to effectively respond to their needs and enquiries during their investigation phase and influence their decision making. Endowing the directorate with capacities to provide a fuller portfolio of services to potential investors should therefore be a priority for the Croatian government. Such an approach highlights, however, the importance of resources and cross-government collaboration, mentioned earlier, to allow the department to appropriately serve its function, develop new services and improve its functioning.

The policy advocacy function could be also strengthened by fostering synergies between the Directorate's Investment Sector and the Business Climate Service. The latter operates under the Competitiveness Sector and is responsible for undertaking consultations with business enterprises operating in Croatia and collecting their feedback on how to improve the business climate. Collaboration could focus on developing specific channels and tools through which investors supported by the MESD's Investment Sector could be regularly consulted and their feedback transmitted to higher levels of the government. This could include dedicated surveys of foreign investors, periodic consultation meetings with the private sector and industry associations, and the production of reports or position papers that include investors' perspectives and can be used when evaluating investment promotion policies.

**Table 3.3. Digital tools used by MESD's Internationalisation Directorate to promote and attract FDI compared to other OECD IPAs**

	Croatia (2022)	OECD total
Social media campaigns		97%
Videoconferencing, e-meetings, webinars, virtual fairs		94%
Internal communications, management and collaboration tools (e.g. cloud computing, e-signature, internal messaging services, file sharing platforms)		81%
Big data analytics (e.g. to predict investors' behaviour or target specific investors)		47%
Online interactive maps or platforms with access to geographic information systems (e.g. to locate or visualise the location of local suppliers or lead multinationals)		39%
Virtual site selection visits and VR-based technologies		31%
Digital customer support service (e.g. AI-based chat assistant)		22%
AI-based marketing tools (e.g. AI-powered website)		14%

Source: OECD Survey on Investment Promotion and Digitalisation (2021<sup>[8]</sup>).

### ***Investment facilitation could focus more on embedding foreign MNEs in local value chains***

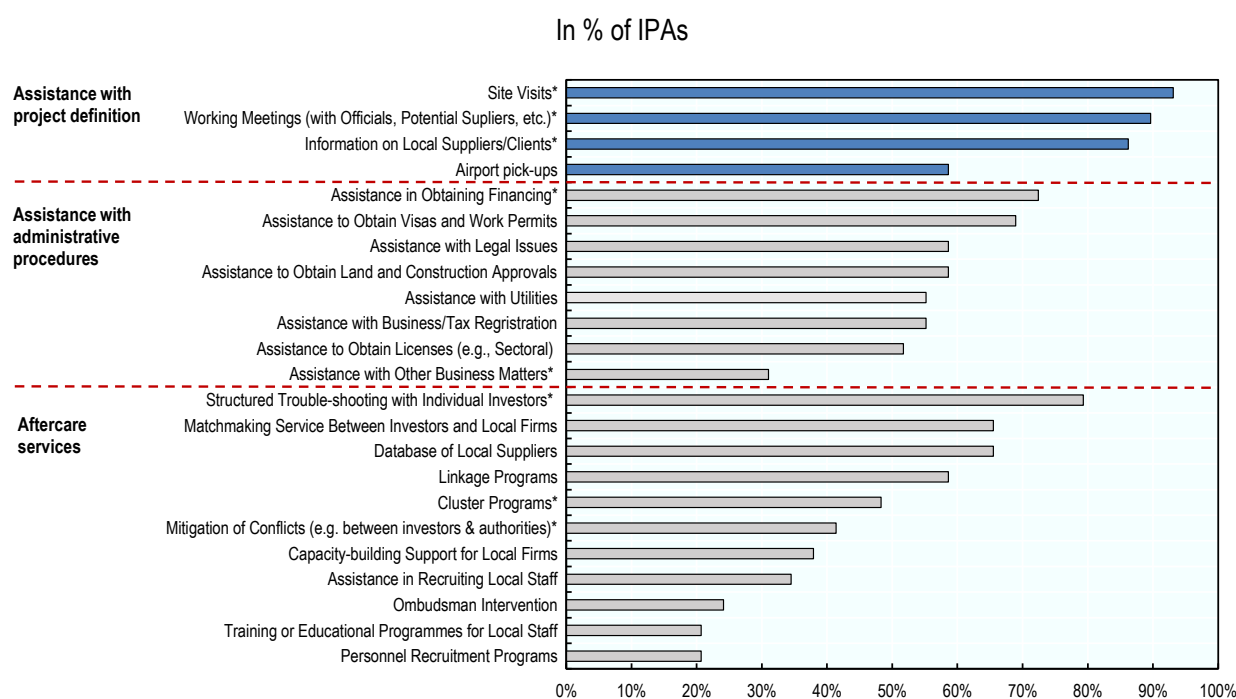
Investment facilitation and aftercare services can be instrumental in encouraging greater embedding of foreign affiliates in local economies and building relationships that contribute to greater use of local SME suppliers (OECD, 2022<sup>[9]</sup>). They often involve accompanying investors in their project definition, ensuring



that they identify local suppliers and clients, providing additional assistance once the project is implemented and encouraging expansions and reinvestments through aftercare.

In Croatia, the MESD's facilitation activities are primarily concentrated on offering assistance to investors during their establishment phase (e.g. site visits, working meetings, airport pick-ups) (Figure 3.7). Investors are often accompanied in regions to identify appropriate sites for their investment projects, receive information on sectoral regulations and the availability of land in business zones, and get connected with other parts of the Croatian government which are responsible for licensing procedures, construction permits and business support services. Currently, the MESD's Internationalisation Directorate does not implement any active FDI-SME linkage programmes and does not operate a suppliers database, which is a common tool used by IPAs to support foreign MNEs' local sourcing strategies. When foreign investors need information on local suppliers, the MESD connects them with the Croatian Chamber of Economy and subnational governments, which may have the capacity to identify domestic firms depending on the sector and region of the investment project.

**Figure 3.7. The share of IPAs conducting different investment facilitation and aftercare services in Croatia relative to OECD**



Note: The bars representing activities that the MESD conducts at the time of the survey are highlighted in blue. Activities marked with an asterisk (\*) were conducted by AIK before its abolishment.

Source: OECD based on the OECD-IDB Investment Promotion Agencies Survey (2018<sup>[1]</sup>, 2022<sup>[5]</sup>)

Interviews conducted with regional and local authorities in the cities of Osijek and Novska for the purpose of this Review revealed that a wider range of facilitation services are offered to investors at the subnational level (see Chapter 4). These often include information on tax and other incentives offered by local municipalities and counties, assistance to obtain land and resolve legal issues that may arise from investors' activities, and matchmaking services to help investors identify local suppliers and find qualified employees. In some cases, subnational governments form dedicated investor support teams made up of different local officials, which accompany investors during the pre- and post-establishment phase of their investments. In Osijek, the city's administration has also connected a recently established foreign MNE

with local universities in order to explore (re-)training opportunities of the local workforce to accommodate the skill needs of the investor. As highlighted in Chapter 4, there are large disparities in the availability and quality of services offered by subnational actors to foreign investors, while the dispersion observed in their provision raises the issue of coordination and standardisation.

Efforts to improve the internal governance of facilitation and aftercare services should be stepped up and coupled with sufficient resources and dedicated staff that is trained to identify the sourcing needs of foreign investors and steer FDI projects towards locations with the greatest potential for supporting supplier linkages. This can be done by exploiting synergies with subnational actors that may have more staff on the ground to provide the services that are currently not provided by the MESD. Given existing resource constraints, the Internationalisation Directorate could consider playing a coordinating role through an inter-institutional network as suggested in the following sections (Figure 3.9). As a first step, specific areas for collaboration could be identified, such as for instance the joint development of an online suppliers database, helping investors navigate national and local licensing procedures and identifying skilled workers, and the implementation of a series of matchmaking events and business fairs throughout Croatia. Box 3.2 presents examples of linkage programmes implemented by EU IPAs. Synergies with the local supply chain development programmes implemented by the Ministry of Regional Development and EU Funds (MRDEUF) could be also enhanced to ensure that the MESD's clients are involved. As part of its 2021-2027 programming for the industrial transition of the Adriatic, Panonian and North Croatia regions, the MRDERUF plans to introduce new financial instruments that promote strategic partnerships for innovation focusing in particular on networking between SMEs and large companies in regional value chains.

To reduce the disparities that are currently observed in the quality of facilitation services offered by subnational actors, the Internationalisation Directorate could provide training to regional and local authorities on how to effectively facilitate investments, in particular in regions with lower capacities, as well as how to collaborate and complement the support provided by the MESD<sup>3</sup>. In recent years, similar standardisation efforts have been made in the area of entrepreneurship policy through the BOND network that is managed by HAMAG-BICRO. The network established an online educational platform, which allows its members to communicate, exchange experiences, and undertake virtual trainings to standardise and improve the quality of their services. Up until 2022, more than 22 thematic workshops and seminars had been organised throughout Croatia, with the participation of more than 1100 representatives of local entrepreneurial support institutions. A similar approach could be followed by the MESD.

### Box 3.2. Promoting value chain linkages and strategic partnerships: EU country examples

Most IPAs provide matchmaking services to reduce the information barriers that prevent foreign investors from identifying local suppliers or customers. In the Slovak Republic, SARIO supports several matchmaking programmes targeting foreign firms and their affiliates, including the flagship *Business Link* events and *Slovak Matchmaking Fairs*, implemented under the auspices of the Ministry of the Economy (OECD, 2022<sup>[10]</sup>). The use of online tools and platforms is common in this area. In Bulgaria, the national SME promotion agency BSMEPA runs an online platform to advertise requests of foreign companies looking for partners in the domestic industry (e.g. local suppliers, local exporters, potential business partners). The Hungarian Investment Promotion Agency (HIPA) maintains a database of domestic firms to help large companies identify suppliers that meet their requirements and could integrate their value chain.

Many EU governments organise or actively support the participation of domestic SMEs in knowledge exchange and information events, which can provide matching opportunities with foreign partners. The Spanish agency Red.es, in collaboration with ICEX Spain Export and Investment, organises national stands in international events to support the internationalisation of domestic firms operating in the digital economy. In Bulgaria, the BSMEPA runs a dedicated project to support domestic SMEs' participation in business fairs, exhibitions and conferences within the country and abroad, in a view to enhancing their export activities, facilitating the establishment of direct contacts and commercial linkages with foreign partners, and fostering their integration in European and international markets.

Source: EC/OECD Survey of Institutions and Policies enabling FDI-SME Linkages (2021<sup>[11]</sup>).

## Promoting and attracting investment: strategy and tools

### ***A well-articulated national strategy and action plan could provide a coherent framework for investment promotion***

Specific measures to promote and facilitate investments can be successful if they take place within the context of, and not substitute for, a coherent and well-articulated strategic framework that takes full account of a country's policy priorities and implementation capacity. Croatia has a few elements of such a strategic framework (e.g. investment promotion law); however, they are largely used for the provision of incentives and allocation of EU funds. Stakeholders consulted in the course of this review also stressed the lack of a more comprehensive and long-term government vision about the role of private investment in the country's economic development, resulting in disjointed actions and separate strategies across different ministries and local authorities.

The Act on Investment Promotion, adopted in 2015, sets the goals of Croatia's investment policy, lists specific activities and investment projects that can benefit from the state support, and outlines the type of support available and the applicable requirements. The criteria set out in the act are used primarily for the allocation of investment incentives (see Chapter 4). Furthermore, the Act on Strategic investment Projects, adopted in 2013, serves a complementary role to the Act on Investment Promotion, defining what constitutes a "strategic investment project" in Croatia as well as providing information on the applicable selection criteria and procedures and the associated benefits. The main goal of the law is the provision of more expeditious administrative proceedings for strategic projects, which can involve private, public or private-public investments. Available data on the number and type of investment projects recognised as

strategic show that the Act's contribution to the promotion of private investment has been limited so far since it has been used primarily to facilitate the execution of public investment projects.

More recent strategic documents of the Croatian government fall short of laying out specific measures, reforms and policy initiatives to improve the investment climate as well as providing a long-term and country-wide vision for inward investment attraction. The National Development Strategy 2030, which aims to support the twin digital and green transition of the Croatian economy, provides some general direction on the priorities that should guide investment policy until 2030. For instance, it calls for measures to encourage investments in R&D and from high-tech foreign firms and acknowledges the importance of infrastructure development as a precondition for attracting FDI. Similarly, the government's National Reform Programme 2020 recognises the need to “establish an effective system for promoting private investments into sustainable development goals, in order to contribute to a proper and inclusive transition to a competitive green and digital economy” (Government of Croatia, 2020<sup>[12]</sup>). However, the document makes no reference to the role that FDI can play in achieving these objectives and does not include specific measures or policies to be implemented by the MESD's Internationalisation Directorate. Overall, the latter's role in the promotion and facilitation of private investment does not seem to be sufficiently reflected in national strategic documents while policy linkages with other areas that affect investors are limited.

As Croatia seeks to advance its investment promotion framework, a more comprehensive and long-term National Plan on Investment Promotion could help further define and consolidate the work of the MESD's Internationalisation Directorate by providing a clear and coherent framework for its activities. The National Plan should be very clear and specific about FDI attraction targets, tools to reach the set targets, and performance indicators to measure progress. It should provide clear indications on its implementation, including how resources should be allocated, the main activities it should focus on, the key performance indicators to measure outputs and outcomes, and the procedures in place to collaborate effectively with other relevant government bodies (e.g. ministries, public agencies, subnational authorities) and stakeholders (e.g. the private sector).

Investment promotion plans are prepared to ensure that promotion efforts are well-targeted and contribute to the government's broader national development objectives, including those related to productivity growth, innovation, regional development, job creation, and the digital and low-carbon transitions (OECD, 2022<sup>[9]</sup>). They revolve around the question of what to promote (i.e. sectors, countries, projects, investors) and how to implement this promotion in practice. Clearly delineating the role of private investors, both domestic and foreign, in achieving these sustainable development objectives can help adequately tailor investment promotion efforts to target investors that help further these objectives. Such a strategic document would therefore be an opportunity to demonstrate the government's commitment to foster investment and provide a positive signal to potential and existing investors about the economy's openness to FDI.

While a National Plan for Investment Promotion would provide an overarching framework for the relevant public institutions, a short-term Action Plan could play a complementary role as a more focused and operational policy tool. It should refer to specific actions and policy initiatives that will be undertaken by the government over a defined timeframe and link them to the policy priorities and targets set in the national strategy. By specifying the institutions that should lead and/or contribute to the implementation of each action, the action plan can serve as an instrument for policy coordination and mobilise the necessary resources and actors behind the government's investment promotion agenda.

### ***Clearly defined investment prioritisation criteria could help Croatia target quality FDI in line with its development objectives***

Through prioritisation, i.e. choosing to focus on certain types of sectors and countries, investment projects or individual investors – either because they have a higher probability of being realised or because they may bring unique benefits to the host economy – IPAs can focus better their resources and tailor the

services offered to investors considered as the most important (Sztajerowska and Volpe Martincus, 2021<sup>[13]</sup>). Targeting can be a difficult function as it requires clearly defined criteria, strong coordination mechanisms to ensure alignment with the government's sectoral strategies, and the ability to adapt existing investment promotion tools and focus on some firms and investment projects more than others. In the OECD area, 84% of IPAs target specific sectors, 59% target specific countries, 78% target investment projects and 47% target specific types of investors (OECD, 2018<sup>[11]</sup>).

Unlike the majority of OECD IPAs, the MESD's Internationalisation Directorate reported not to prioritise specific investment projects, investors, sectors or countries. The MESD's website provides information on a few sectors with potential for investment growth (e.g. automotive, pharmaceuticals, logistics, tourism, creative industry). The Act on Investment Promotion also stipulates that investment aid should be provided to investment projects in manufacturing and processing activities, development and innovation activities, business support activities and high added value services (Government of Croatia, 2022<sup>[14]</sup>). However, interviews with Ministry officials revealed that the sectors and types of investment stipulated by the Act are primarily used for the provision of investment tax incentives (see chapter 4) and that they are not taken into account when promotional campaigns are organised or investment facilitation services offered to foreign MNEs. In addition, no specific criteria are used when pro-actively approaching potential investors even though the Act sets out certain performance criteria that investment projects should fulfil such as contributing to the green and digital transition of the economy, using technologically advanced Industry 4.0 solutions, generating higher employment and training opportunities for employees and contributing to regional development, among others.

Another aspect illustrating the limited capacity of the Directorate to promote investments in a more targeted way is the exclusion of many sectors, which fall under the jurisdiction of other government bodies. These include, for instance, agriculture, infrastructure, energy and water supply, financial and insurance services, health and social services, arts and the entertainment industry as well as construction, trade and real estate. Investment promotion activities for these sectors are usually undertaken by other directorates in the MESD or by other ministries and government agencies, reflecting the fragmentation of the institutional set-up for investment promotion and facilitation in Croatia. It also highlights the importance of policy coordination and the need for the Internationalisation Directorate to foster synergies with other parts of the government, share resources, implement joint initiatives and strengthen its coordinating role.

The MESD should consider developing a comprehensive investment prioritisation framework that will go beyond investment aid and also include the pro-active targeting of activities, sectors, and investment projects that contribute to the sustainable development of the Croatian economy. More detailed and clearly defined prioritisation criteria should be included in the forthcoming National Plan for Investment Promotion and guide the work of the Internationalisation Directorate. Such an approach would also facilitate the work of the Directorate by allowing to manage the current limited resources more efficiently and support investments with the greatest impact. While having a clear list of priority activities can be helpful, it should be the result of consultations with key stakeholders in the business community and specialised bodies that have thorough knowledge of challenges and opportunities in specific industries. It is important that the elaboration of the priority list be given due attention and subject to regular reviews, especially as it can translate into special treatment such as in the form of faster replies to inquiries and tailored investment facilitation solutions.

The prioritisation criteria should be carefully selected in order to also reflect Croatia's policy priorities with regard to sustainable development. Recent OECD work on IPAs' practices found that sustainability is an important objective for IPAs when setting their internal prioritisation criteria, with some of them using specific indicators and scoring mechanisms to quantify investment projects' contribution to sustainable development and decide about the agency's assistance (Sztajerowska and Volpe Martincus, 2021<sup>[13]</sup>). Business Finland, for instance, uses an internal quality scoring to categorise firms; and Germany Trade and Invest has recently adopted a new sustainability scoring for this purpose. The Croatian government

could consider developing such a framework, although this will require a robust monitoring and evaluation system to collect and analyse data on investors' activities (see next section).

It would also be advisable to prioritise sectors that, on the one hand, help diversify the economy, and, on the other hand, offer the possibility for investors to rely on strong domestic capacities. Drawing on Chapter 2 of the Review on trends and impacts of FDI in Croatia, the MESD's Internationalisation Directorate could focus on investment projects in sectors where FDI's performance is higher than domestic firms, notably in terms of productivity and innovation (e.g. lower technology services), wages and skills development (e.g. ICT services and R&D-intensive industries), and environmental performance and clean technologies (e.g. electricity generation, renewables), as well as on sectors for which Croatia exhibits emerging specialisation patterns (e.g. machinery, transport, and metals industries).

***M&E tools and processes will be crucial to track and evaluate the implementation of the forthcoming strategic framework for investment promotion and facilitation***

The monitoring and evaluation (M&E) of investment promotion activities are important to manage FDI attraction and facilitation on the basis of results and to ensure, on the one hand, that investors are satisfied and, on the other hand, that the IPA learns from experience and provides value for money (Sztajerowska and Volpe Martincus, 2021<sup>[13]</sup>). A comprehensive strategic framework for investment promotion should therefore not only include well-articulated FDI attraction targets and adequate prioritisation criteria but also a solid M&E system and well-targeted performance indicators to measure the effectiveness of IPA services (OECD, 2018<sup>[1]</sup>).

As a first step for effective M&E, an IPA needs to know well what it does, how it does it, and how these actions translate into firm investment decisions over time. For this purpose, IPAs use a customer relationship management system (CRM), which allows the agency to have an institutional memory and an overview of its current and past activities. It allows, among others, to track the assistance offered to prospective investors, the sources of investment leads and contacts, and the investor's eventual decision to establish or not. Most IPAs in OECD have a CRM (about 94%) albeit their quality differs widely (Volpe Martincus and Sztajerowska, 2019<sup>[15]</sup>; OECD, 2018<sup>[1]</sup>).

As a small IPA, the MESD's Internationalisation Directorate should aim to ensure that its actions achieve the maximum possible effect with limited resources by investing in robust M&E systems, particularly in internal data collection and analysis. Until recently, the Directorate did not have a specific framework to track its investment promotion and facilitation activities. At the time of writing this Review, a basic version of a CRM system was being developed with the aim to be officially launched in 2022. The CRM will allow the Directorate to track the provision of investment generation and facilitation services on the basis of several criteria such as the month and year of first contact with potential investors, the status of supported investments (e.g. initial enquiries, follow up meetings, granting of permits, start of construction, post-investment support), the sectors and subnational counties in which supported projects take place, the size of investment, the number of jobs created as well as the country of origin of the foreign firm.

The establishment of the CRM system is important since it will help the Directorate improve its internal data management and facilitate systematisation of investors' information for proactive targeting. The system should be pilot tested first to ensure functionality and potentially adjusted and upgraded in the future to include additional aspects of the Directorate's work. For instance, beyond services offered to investors, the CRM could keep track of the Directorate's broader promotional and policy advocacy activities (e.g. number of investor missions organised, public relation events attended, actions to monitor the investment climate, consultations with the private sector, business associations and foreign embassies, etc). Some of its functions could be also improved to facilitate internal resource management, for instance by tracking response times to each inquiry and sending automatic reminders to project managers if an investment does not move forward after some pre-defined time. As development and tailoring of CRM

systems takes time and often is a reiterative process, the Directorate may need to consider future resources required for the upkeep and adjustments of the system and any possible training of staff.

The data acquired from the CRM would facilitate the use of Key Performance Indicators (KPIs) to measure the organisational performance of the Directorate and its success in reaching the target objectives set in the forthcoming National Plan for Investment Promotion. IPAs' performance indicators can be divided into two sets (OECD, 2018<sup>[1]</sup>). Activity indicators focus on the agency itself, its inputs (e.g. number of campaigns launched), processes (e.g. time to respond) and results (e.g. number of assisted firms). Performance indicators focus on characteristics of the attracted investment and measure the benefits of IPA actions in the economy (e.g. size of FDI, number of jobs created). Unlike the majority of OECD IPAs which usually combine several indicators from both categories, the Internationalisation Directorate uses mostly activity indicators, namely the number of assisted firms, number of promotional events, and the time to respond to investors' inquiries (Table 3.4). Performance indicators focus only on the number of investment projects supported, the number of jobs to be created, and general business climate reforms.

**Table 3.4. Monitoring and evaluation indicators used by the MESD's Internationalisation Directorate compared to other OECD IPAs**

		Croatia (2022)	Croatia (2018)	OECD total	
<b>Activity / input indicators</b>	Number of assisted firms			65%	
	Time to respond			50%	
	Replies to requests/inquiries subject to assessment			44%	
	Costs			38%	
	Time to organise visits			26%	
	Market studies subject to peer review			24%	
	Other – Number of promotional events			-	
<b>Performance / output indicators</b>	<i>FDI indicators</i>	Investment projects			91%
		Total FDI			81%
		Investing firms			66%
	<i>Socio-economic indicators</i>	Jobs			88%
		Innovation / R&D			50%
		Regional development			38%
		Exports			38%
		Country's image			29%
		Wages			26%
		Capacity of domestic firms			24%
		Green investment			21%
		Sustainability			18%
		Competition			18%
		Tax revenue			15%
	Investors record on RBC			6%	
	<i>Other indicators</i>	Client satisfaction			65%
Business climate reforms				29%	

Note: Information on the input and output indicators used by OECD IPAs may have changed since the survey was conducted in 2017-2018. For instance, it is very certain that the share of IPAs using green investment and sustainability-related indicators is currently much higher.

Source: OECD based on the OECD-IDB Investment Promotion Agencies Survey (2018<sup>[4]</sup>; 2022<sup>[5]</sup>)

The implementation –and subsequent evaluation– of the National Plan for Investment Promotion will require a comprehensive set of KPIs that will enable the MESD to display a clear track record of its accomplishments and inform future resource allocation and strategic decisions at management level. The Directorate could consider developing and using a broader range of KPIs that will help get a better

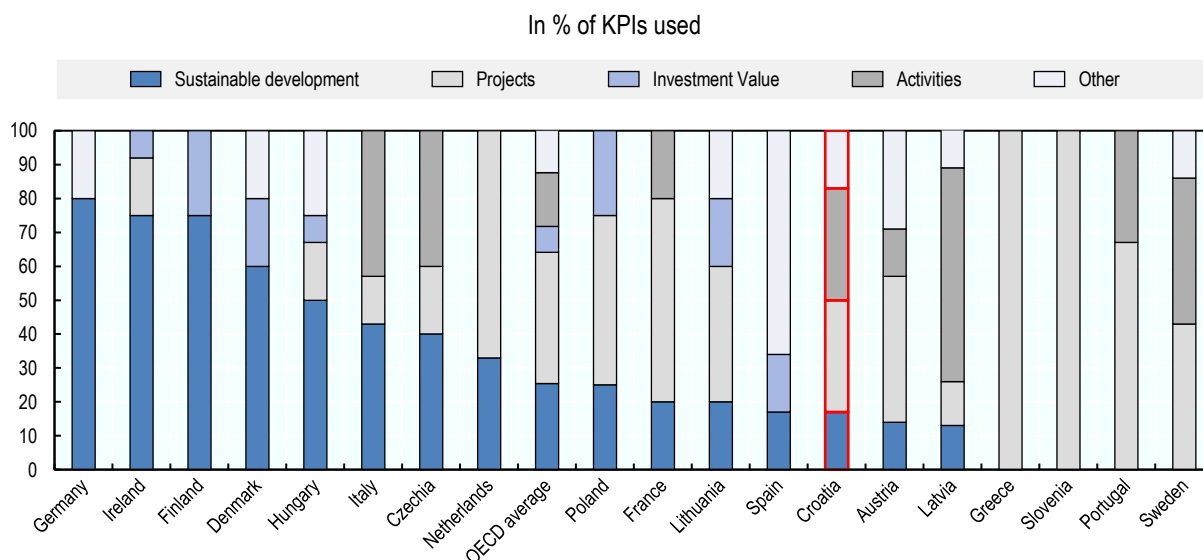
understanding of the types of firms and investments that benefit from public support (e.g. metrics on number and value of investment projects), the activities of the Directorate (e.g. number of meetings, participants, inquiries and visits), and the sustainability-related impacts of supported investments (e.g. jobs created, R&D projects, projects related to green energy). These indicators are common among OECD and EU IPAs (Figure 3.8). Agencies tend to rely predominantly on metrics relating to the type of projects supported and the IPA activities undertaken, but many IPAs put attention on sustainability-related indicators (such as Germany, Ireland, Denmark and Hungary) (Sztajerowska and Volpe Martincus, 2021<sup>[13]</sup>). The Hungarian IPA, for instance, uses indicators on jobs and skills (e.g. number of new employees, number of firms supported with training subsidies), productivity and innovation (e.g. number of R&D projects, number of suppliers recommended) and exports (e.g. trade balance) while IDA Ireland goes even further by monitoring the gender balance within its portfolio of clients.

For many OECD countries, the development of better systems to track and collect reliable statistical data based on international standards is a pre-requisite to the development of more robust outcome indicators. For example, in order to be able to better assess the effects of IPA's assistance on sustainable development, the agency could ensure access to relevant granular data from external data providers and relevant public agencies (e.g. Croatian Statistics Bureau, Financial Agency), for example on trade patterns of firms or census of foreign investors present in the country. In some countries, IPAs are able to gain access to administrative data on firm-level emissions, energy consumption and other environmental and social variables from environmental protection, certification and emission-disclosure monitoring bodies. Cross-checking data provided by investors with these official statistics and tracking a wider range of data through the Directorate's CRM system could help evaluate the impact of investment promotion activities in a more consistent and accurate way.

The use of qualitative evaluation methodologies (e.g. surveys, consultations), and the establishment of data tracking tools and feedback processes can also provide some relevant data on IPA services and assisted firms. The Investment Sector already monitors the findings of business surveys undertaken by private sector associations (e.g. Employers' Association, American Chamber of Commerce, Advantage Austria), but does not conduct targeted surveys to receive feedback from its own clients. Although it is a resource-intensive process, data from the Directorate's new CRM system could be combined with surveys of supported firms to gain insights on how to adjust services and help identify key obstacles to investment. Publishing surveys' results or using them in conversations with the government can be a potent policy advocacy tool (De Crombrugghe, 2019<sup>[16]</sup>).



Figure 3.8. KPIs used by EU IPAs for monitoring and evaluation by type



Note: “Sustainability” encompasses KPIs relating to the number and quality of jobs or full-time equivalents (total, created, maintained), R&D projects or R&D expenditure, exports or trade balance, regional development, projects related to green energy and indicators relating to gender, digital, diversification, and other sustainability related metrics (e.g., IPA sustainability scoring). “Projects” encompass KPIs relating to new projects, assisted projects, completed projects, won projects, greenfield or brownfield projects, and leads. “Investment Value” encompasses KPIs relating to investment value, CAPEX, FDI stock or other metric of the value of the investment project. “Activities” encompass KPIs relating to the number of meetings, inquiries, site visits, number of participants, campaigns, PR activities, roadshows, and other indicators relating to IPA’s own activities. “Other” encompasses all other KPIs (e.g., customer satisfaction).

Source: OECD survey on IPA monitoring & evaluation and prioritisation, (Sztajerowska and Volpe Martincus, 2021<sup>[13]</sup>), [www.oecd.org/daf/inv/investment-policy/Investment-Insights-Investment-Promotion-Prioritisation-OECD.pdf](http://www.oecd.org/daf/inv/investment-policy/Investment-Insights-Investment-Promotion-Prioritisation-OECD.pdf)

### **Formal coordination mechanisms could help address resource constraints**

Actions to attract and facilitate FDI that contributes to national development priorities need to be aligned with the objectives and priorities set across different policy areas and tiers of government. IPAs operate in a dense and complex network of public stakeholders (e.g. ministries, implementing agencies, subnational authorities), which requires strong cooperation and coordination skills and processes. Although there is no standard inter-institutional coordination approach to the successful implementation of investment promotion policies, much of the success or failure of attempts to coordinate appear to depend upon country contexts (e.g. complexity of the institutional environment, coordination mechanisms in place).

The OECD-IDB IPAs survey finds that the MESD’s Internationalisation Directorate coordinates its work primarily with subnational IPAs, i.e. local and county-level Economic Development Organisations (EDOs), which are often contacted to undertake joint investment facilitation in regions; entities responsible for the management of business zones and industrial parks (usually subnational governments), which provide information to potential investors on how to access investment-ready land plots; and the Ministry of Foreign Affairs and its network of diplomatic missions abroad. These entities are also qualified as the Directorate’s key strategic partners in the delivery of investment promotion and facilitation services. Interactions with other stakeholders such as sectoral ministries (e.g. Ministry of Physical Planning, Construction and State Assets, Ministry of Tourism and Sports, Ministry of Finance) and industry groups (e.g. Chambers of Commerce) take place to acquire information on regulatory matters and other investor support schemes as well as to address specific investor enquiries (e.g. construction permits, licenses for specific sectors, domestic suppliers availability).

These findings are generally in line with the practices of OECD IPAs, the vast majority of which consider their relationships with subnational entities, embassies and consulates and the ministry of foreign affairs of critical importance for the effective delivery of investment promotion and facilitation services to foreign investors (OECD-IDB, 2018<sup>[4]</sup>). According to the 2022 Sustainable Governance Indicators, however, Croatia exhibits a weak performance about the quality and frequency of inter-institutional coordination, ranking 39 out of 41 countries behind most EU economies (Kotarski et al., 2022<sup>[17]</sup>).

OECD consultations with the Croatian government suggest that coordination on investment policy matters between the MESD and other government actors takes place on an ad hoc basis and through informal channels (Table 3.5). Several government officials described the lack of willingness to cooperate as an important challenge that they have to face in their everyday work, and indicated that inter-agency collaboration often depends on personal relationships between ministry officials. In certain cases, coordination provisions may be stipulated in sectoral laws and regulations but are rarely implemented in practice. The coordination challenge is further undermined by the high employee turnover in the MESD and other sectoral ministries (e.g. Ministry of Foreign Affairs), which results in communication channels being halted once officials leave their post and move to a different part of the public administration.

**Table 3.5. Main coordination mechanisms used by the MESD and selected EU IPAs**

	Croatia	Lithuania	Finland	Portugal	EU total
Laws and regulations					43%
Inter-institutional committees and councils					43%
Inter-agency joint programming					36%
Contracts, protocols and MoUs					29%
Exchange of experts and civil servants					14%
Specific programme rules					7%
Informal coordination					7%

Note: The EU total includes IPA responses from Austria, Bulgaria, Croatia, Czechia, Finland, France, Hungary, Italy, Lithuania, Luxembourg, Portugal, Romania, Slovak Republic.

Source: EC/OECD Survey of Institutions and Policies enabling FDI-SME Linkages (2023<sup>[18]</sup>), <https://doi.org/10.1787/688bde9a-en>

Similarly, despite the existence of several high-level government councils, the Investment Sector of the Internationalisation Directorate is not usually represented in their deliberations. For instance, although the National Competitiveness Council (NCC), which falls under the Directorate's jurisdiction and is managed by the Competitiveness Sector (Figure 3.1), could theoretically drive inter-ministerial coordination on investment policy, it lacks a clear mandate on the actual monitoring and coordination activities that should be undertaken by its members, while delays have been observed in the past with regard to the approval of its annual budget (Figure 3.9). Given that the forthcoming National Plan for Investment Promotion will require high-level political commitment, an Investment Policy Working Group or Task Force could be created in the NCC, which will be responsible for monitoring the implementation of the National Plan, addressing bottlenecks in coordination and mobilising public resources to ensure that the investment promotion targets are achieved.

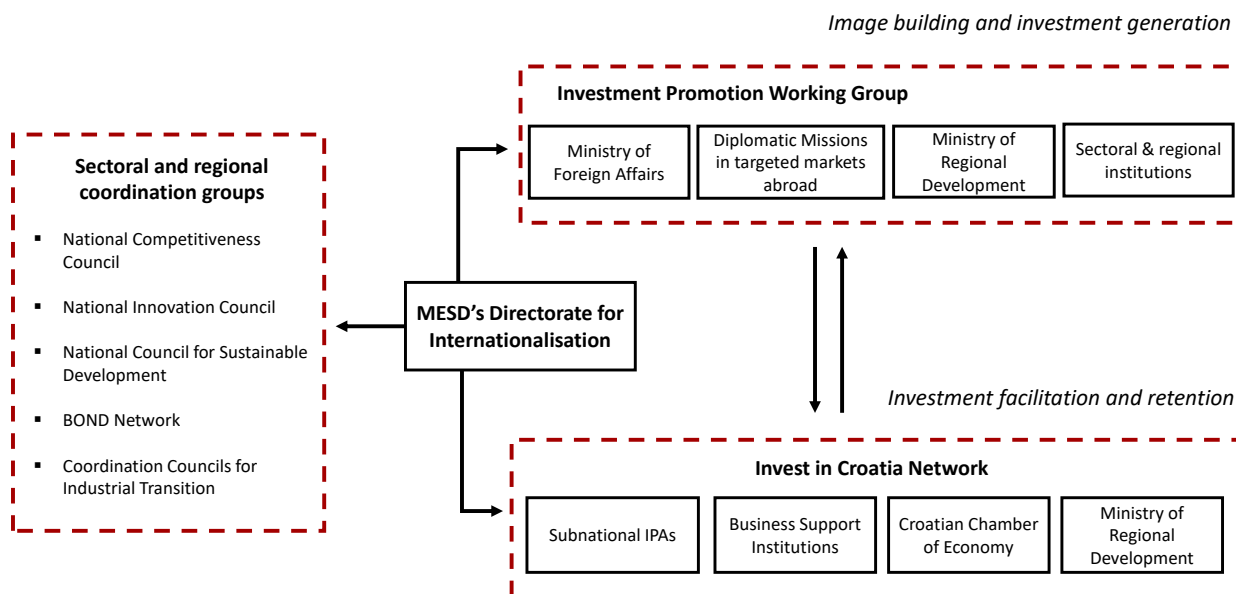
The capacities and inclusiveness of high-level government councils could be also strengthened so that they can play their role as independent advisory and coordination bodies. It is important to ensure that the Internationalisation Directorate is adequately represented in those council meetings and activities that relate to investment policy and business climate reforms more generally. Participating in the activities of other councils focusing on productivity, innovation, sustainability and skills development could help foster greater synergies between sustainable development policy areas and the MESD's investment promotion priorities (e.g. National Innovation Council, National Council for Sustainable Development) (Figure 3.9).

Regarding subnational IPAs and regional/local authorities, coordination is often challenged by the ambiguity in the role and responsibilities of many local and county-level economic development organisations (EDOs) (see Chapter 4). Depending on the region, it is not always clear which subnational body (e.g. Local Development Agencies, County Development Agencies, Entrepreneurial Centres, etc.) is responsible for investment promotion and facilitation, while in many cases subnational entities are in contact with, and provide facilitation services to, potential investors without the MESD being involved or aware of it. It is important to note that an earlier version of the Act on Investment Promotion and Improving the Investment Climate included provisions that called the national and subnational investment bodies to coordinate by forming joint teams for specific investment projects. However, these provisions were reportedly never implemented in practice, and were eventually dropped at the last revision of the Act in 2018. Chapter 4 of this Review focuses on the role that subnational IPAs can play to promote and facilitate investment and provides specific recommendations on how to improve collaboration between the MESD and regional/local actors.

Although informal coordination is frequent among OECD IPAs, and can suggest a relatively well-developed culture of trust and communication among public administration officials, it may not be sufficient in the case of Croatia given the increased complexity and fragmentation of the institutional environment. Formal coordination mechanisms that place the MESD at the epicentre of investment promotion efforts and allow it to serve as a coordinating platform will be key for the effective implementation of the forthcoming National Plan and Action Plan. To this end, the Croatian Government could consider the establishment of inter-institutional networks, teams and working groups for specific investment promotion functions (Figure 3.9). Such an approach could also help address current resource constraints by allowing the Directorate to exploit resources available in other parts of the government and broaden the scope of its activities in areas and regions in which these are currently limited.

To strengthen investment generation activities, as mentioned earlier, the existing ad hoc collaboration with the Ministry of Foreign and European Affairs and its diplomatic missions abroad could be further consolidated through the establishment of a working group comprising representatives of Croatian consular offices located in countries of strategic importance for FDI attraction, and other sectoral and regional institutions. Coordination with diplomatic missions in foreign countries can be very important for IPAs and for investment promotion in general because it spearheads the efforts of a country to promote itself and establish strategic relationships with investor networks abroad (OECD, 2018<sub>[1]</sub>). Alternatively, the Internationalisation Directorate could consider appointing its own representatives in targeted markets abroad, who will provide investment information and advice to potential investors and conduct intelligence work by collecting information and monitoring investment attraction opportunities.

**Figure 3.9. Illustrative example of inter-institutional coordination for investment promotion and facilitation in Croatia**



Note: This figure is presented for illustrative purposes to showcase the type of institutions with which coordination could take place in a more structured manner. Subnational IPAs refer to those regional and local entities that undertake investment promotion and facilitation irrespective of their current legal status. Business Support Institutions include other types of entities that provide business support services or infrastructure which may be of relevance to foreign investors (e.g. Entrepreneurship Centres, Innovation Centres, Industrial Parks, Science and Technology Parks, and Competence Centres).

Source: OECD elaboration.

Three out of four OECD IPAs have their own offices abroad, meaning that they have personnel abroad, dedicated to investment promotion, on their payroll (OECD, 2018<sup>[1]</sup>). IDA Ireland, for example, shares local market plans and teams with embassies abroad. Invest in Canada, in addition to its network of 35 offices abroad, relies on some 140 diplomatic missions around the world. Among them, 24 are located in strategic markets and are tasked to actively attract FDI, whereas other missions are given “reactive” mandates. IPAs’ overseas offices can make a difference for the agencies’ ability to attract FDI. Nonetheless, they can strongly weigh on agencies’ finances. IPAs have different arrangements to operate their secondary offices overseas with reduced cost. Some agencies hire local staff in foreign offices to lower costs. Other agencies do not have their own offices abroad, but place staff in the foreign diplomatic representations or cooperate closely with them.

Similarly, the creation of an inter-institutional network, comprising subnational IPAs, local business support institutions (e.g. entrepreneurial centres, science and technology parks, industrial parks), and city administrations could be envisaged for the coordinated provision of investment facilitation and retention services to foreign firms. This would allow the Directorate to get involved in a broader set of activities provided by other organisations and offer complementary guidance and support in a more consistent manner, including assistance with administrative procedures, matchmaking services between investors and local firms, and troubleshooting for investors on the ground. Box 3.3 presents the *modus operandi* of the Invest in Holland Network, which is managed by the Netherlands Foreign Investment Agency (NFIA) and provides a good example of how IPAs operating as part of a ministry can leverage the power of collaboration to streamline the quality of services provided to foreign MNEs.

Such an approach would require, however, clarity about the official mandates, roles and responsibilities of subnational entities which are currently involved in investment promotion and more broadly the provision

of business support services. As presented in Chapter 4 of this Review, there are currently overlapping responsibilities between county-level and local Economic Development Organisations (EDOs) while in certain regions other types of entrepreneurial support institutions (e.g. Entrepreneurship Centres) undertake investment facilitation too. Reforming the currently fragmented institutional environment at the subnational level is a pre-condition for the effective functioning of such a network (see chapter 4 for recommendations).

Involving the Ministry of Regional Development and EU Funds (MRDEUF) in the strategic oversight of these networks would also facilitate the mobilisation of local actors and bring in complementary resources for joint actions. The MRDEUF manages the allocation of several EU funding instruments that could be used to promote investments in less developed areas. It also possesses the necessary knowledge and experience in identifying the comparative advantages of regions as well as managing regional coordination groups such as the Coordination Councils for Industrial Transition. These have been established at the NUTS2 level and have been tasked with the implementation of industrial transition plans that define regional value chains and priority niches of the regional economy.

Effective collaboration across policy areas and tiers of government will need well-functioning processes and mechanisms such as shared customer relationship management systems, dedicated communication channels and tools, and clear and well-defined responsibilities to enable follow-up on investment project leads and requests. These strategic links could be formalised through inter-agency collaboration agreements (e.g. contracts, MoUs) that define the responsibilities of each institution and specify the internal management processes that will be used for the delivery of investment promotion services. Collaboration could also build upon existing initiatives such as the BOND Network that is managed by HAMAG-BICRO and comprises more than 100 entrepreneurial support institutions operating in different regions across Croatia.

### Box 3.3. Coordination on investment promotion and facilitation: The Invest in Holland Network

The Netherlands Foreign Investment Agency (NFIA) operates as a department in the Ministry of Economic Affairs and Climate Policy while its activities take place under the umbrella of the Netherlands Enterprise Agency (RVO). In 2021, there were 28 NFIA offices abroad, including own premises in countries of strategic importance for FDI attraction, as well as agency representatives located across the Dutch embassies and consular offices. Although the agency has no subnational offices, it manages the Invest in Holland Network, which comprises 14 organisations, including regional development agencies, city administrations and other non-profit entities. The network aims to provide a continuum of support services to foreign investors and connect them with the right public and private sector partners depending on the type and location of their investments. The Invest in Holland Strategy 2020-2025 describes the policy areas for which the network operates jointly while indicating that each partner is free to undertake complementary investment promotion activities in line with their own priorities. In the period 2015-2019, approximately 1800 investment projects were successfully completed with the help of the Invest in Holland Network, with a total investment value of EUR 12 billion and having created or maintained approximately 57.000 jobs.

The network is coordinated through the National Acquisition Platform (NAP), which is chaired by the NFIA Commissioner, and includes representatives of each organisation. Members meet once per quarter to discuss on the basis of joint short-term activity plans, take stock of progress in achieving FDI targets and evaluate the implementation of the Invest in Holland Strategy. Throughout the year members benefit from networking and knowledge sharing events as well as brainstorming meetings on how “working together” can be further simplified. To ensure consistency in the quality of services provided to foreign investors, the Invest in Holland Academy has been established to provide courses and seminars for new employees that join one of the 14 organisations as well as for more senior members and investment promotion staff located in the Dutch diplomatic missions abroad.

Investment prioritisation takes place through inter-agency Focus Teams that work on promoting investments in high-priority activities (ICT, Agri food, Life sciences and health, sustainable energy). Focus Teams hold regular meetings with companies and research institutions operating in various industries with the aim to identify new investment opportunities. They are also responsible for monitoring the business climate and bringing opportunities and threats to the attention of policymakers. For instance, in 2019, the Focus Team ICT, with NFIA and 5 regional partners, developed various value propositions, drew up target lists and visited conferences and events to generate new investment leads. Thanks to these efforts, a total of eight high-quality ICT investment projects were attracted in 2019.

The increased attention that investment generation activities receive in the Netherlands is reflected in the annual resources dedicated for that purpose. Roughly 70% of the NFIA resources are spent to find and guide potential initial investments, 20% of them are spent to find and guide potential follow-up investments (i.e. maintaining and expanding activities), 5% is spent for the role of the NFIA in the Invest in Holland network (i.e. cooperation between regional partners) and 5% to collect feedback from foreign companies on opportunities for improvement of the business climate.

Source: OECD based on NFIA (2020<sup>[19]</sup>), Evaluatie van de NFIA 2010-2018, <https://open.overheid.nl/repository/ronl-2342ca2e-27ee-4da1-a407-ea24af4d63ad/1/pdf/bijlage-evaluatie-van-de-nfia.pdf> and NFIA (2020<sup>[20]</sup>), Invest in Holland Strategie 2020-2025, <https://open.overheid.nl/repository/ronl-1b3f0055-62a6-4757-80e7-7f32236d8f43/1/pdf/bijlage-invest-in-holland-strategie.pdf>

## Leveraging investment promotion and facilitation for sustainable development

Besides providing a source for financing, FDI may support sustainable development in the host country by contributing to the diversification of the economy; the transfer of technology and knowledge; the development of the host country's skills base; a boost of productivity, and the establishment of linkages with local firms, which help them access new markets and integrate in global value chains. The rest of this chapter investigates how investment promotion policies can contribute to selected aspects of sustainable development (i.e. the Sustainable Development Goals, SDGs), including productivity growth and innovation, notably through FDI-SME linkages, the creation of quality jobs and the development of skills in the local workforce as well as green growth and the transition to a low-carbon economy.

### ***Knowledge spillovers from FDI require strengthening domestic firms' capacities***

Business linkages between foreign firms and domestic firms can be an important channel for the transfer of technology, knowledge and skills (OECD, 2023<sup>[18]</sup>). Business linkages can take many forms. They may involve buyer-supplier arrangements along local value chains or formal strategic partnerships such as joint ventures, contract manufacturing, and R&D collaborations. While foreign MNEs can generate knowledge and technology spillovers depending on the spillover potential of the particular type of investment in the host economy, domestic firms, in particular SMEs, will benefit from them if they have sufficient absorptive capacities and can become successful suppliers and partners of foreign investors. SMEs and their productive capacities are an important determinant of FDI location decisions. Foreign MNEs choose to invest in specific countries or regions based on the availability of local suppliers and the capabilities of domestic entrepreneurial ecosystems. Creating a business environment that is favourable for both domestic and foreign firms, supplemented by SME development policies and programmes to maximise their absorptive capacities, should be an equally important component of the Croatian government's strategy to attract FDI that is firmly anchored in the local economy.

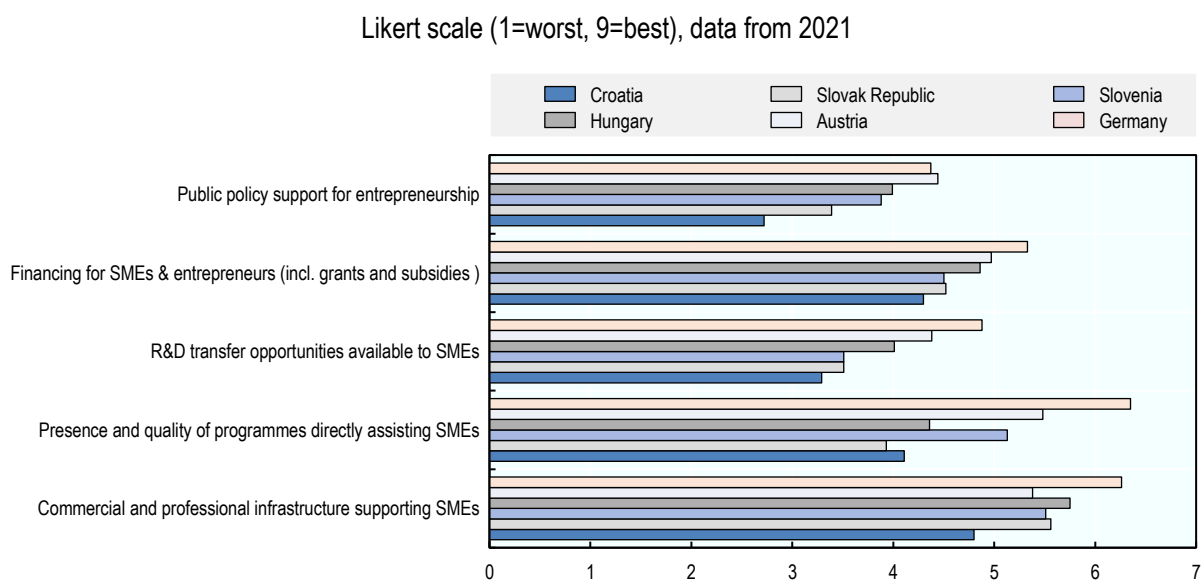
In Croatia, SME policies are implemented by several institutions. The MESD's Directorate for Industry, Entrepreneurship and Crafts is responsible for promoting entrepreneurship and encouraging the application of innovation and new technologies in industry, in particular SMEs. The Directorate has been coordinating the implementation of the Strategy for Entrepreneurship Development 2013-2020 and the Cluster Development Strategy 2011-2020. A new National Plan for Industrial Development and Entrepreneurship is currently being developed with the aim to operationalise the strategic priorities identified in Croatia's National Development Strategy 2030. HAMAG-BICRO and the Croatian Bank for Reconstruction and Development (HBOR) are the two key institutions that offer scale-up and financial support to Croatian SMEs to help them grow, improve their competitiveness, and engage in innovative activities. HBOR also serves as Croatia's official export bank and export credit agency, supporting local SMEs' internationalisation efforts through supplier/buyer credit lines and export guarantees. HAMAG BICRO focuses on supporting SME investments in innovation and R&D and facilitating their access to finance and collaboration with business networks abroad.

In recent years, several measures aimed to strengthen the performance of domestic firms have been implemented. The MESD operated the Business Internationalisation of SMEs programme, which provided financial support to facilitate the presentation of SME products and services, foster international market cooperation with foreign partners and participate in international fairs and B2B meetings. Efforts have been also made to encourage R&D collaboration between domestic enterprises and academia, introduce product certification schemes to facilitate SMEs' access to foreign markets, and foster SMEs' in-house R&D capacities through innovation vouchers. Until 2016, the development of industrial clusters was supported through financial and technical support and had led to the emergence of collaborative business initiatives (e.g. in the wood processing, and automotive sectors); however, when support was discontinued, several cluster organisations ceased their activities.



Despite policy efforts, several indicators point towards weaknesses in Croatia's policy framework. At the EU's Small Business Act (SBA) 2019 performance assessment, Croatia scored below the EU average in 6 out of 10 dimensions pertaining to SME policy, including entrepreneurship support, access to finance, skills and innovation, with many of them following a downward trend over the past decade (EC, 2019<sup>[21]</sup>). When compared with a group of Central European countries (e.g. Slovak Republic, Hungary, Austria, Slovenia, Germany) Croatia exhibits the lowest performance in the quality of the overall policy support system, access to financing and R&D transfer opportunities, and the availability of commercial and professional infrastructure supporting SMEs, according to the Global Entrepreneurship Monitor 2022 index. Croatia does perform better than the Slovak Republic in terms of programmes directly assisting SMEs, but its score is still far from most Central European countries and the EU average (Figure 3.10). Key reasons for the limited effectiveness of the current policy system appear to be the lack of a strategically targeted and coordinated approach to SME development, the lack of continuity of measures and the insufficient focus on tackling SMEs' practical needs, in particular the lack of skilled labour for SMEs in the manufacturing sector (CEPOR, 2022<sup>[22]</sup>).

**Figure 3.10. The quality of public policy support provided to domestic SMEs in Croatia and selected Central European countries**



Source: OECD based on Global Entrepreneurship Monitor (2021<sup>[23]</sup>), [www.gemconsortium.org/data](http://www.gemconsortium.org/data)

It is important to note the disconnect that currently exists between investment promotion policies implemented by the Internationalisation Directorate and SME/entrepreneurship and more broadly industrial policies undertaken by the MESD and HAMAG-BICRO. Supplier development programmes should be aligned with the priorities and objectives of investment promotion and facilitation (e.g. in terms of sectors, activities and types of firms targeted, see previous section) and combined with other types of support such as capacity building for local firms, training programmes for local staff, and cluster development initiatives (OECD, 2022<sup>[9]</sup>). Evidence from OECD economies shows that MNE-SME linkage programmes and other matchmaking services are often combined with policy initiatives aimed at promoting supply chain development and strengthening SME absorptive capacities. This mix of policy instruments allows to align domestic supplier capabilities with the needs of foreign investors.

The Investment Sector could consider implementing a supply chain development programme jointly with the MESD's Directorate for Industry, Entrepreneurship and Crafts and HAMAG-BICRO. The Supplier Clubs programme implemented by the Portuguese SME agency IAPMEI in collaboration with the investment



promotion agency AICEP is a good example of how public policy can mobilise actors across the business ecosystem to help local SMEs collaborate with foreign MNEs (OECD, 2022<sup>[24]</sup>). The programme combines matchmaking services to help foreign multinationals established in Portugal and domestic firms identify collaboration opportunities and agree on jointly implemented projects; business consulting services and training programmes provided by foreign affiliates to their suppliers based on an assessment of the latter's performance; and financial support through EU-funded incentive schemes to help SMEs upgrade their technological capabilities for the implementation of the agreed joint projects.

The 2021-2027 programming period of the EU Structural and Investment Funds provides opportunities to channel the necessary technical and financial support to sectors and regions with higher potential for FDI-SME linkages and spillovers. In the coming years, the MESD plans to devote EUR 250 million in the form of grants and other financial instruments to encourage the establishment of companies in smart specialisation areas, promote the inclusion of SMEs in value chains and support them to adopt product certification standards and participate in international fairs and business networking events. These interventions are expected to further support the internationalisation of Croatian companies and enhance their exposure to the product and service quality standards expected by global investors.

### ***R&D investments could be scaled up by facilitating collaboration between Croatia's business and innovation ecosystems***

Croatia is placed among OECD and EU economies that provide one of the lowest levels of total government support to R&D investments (0.007% of GDP in 2021), ranking far from top innovators such as the UK, France, Belgium and Portugal (OECD, 2022<sup>[25]</sup>). An R&D tax allowance is administered by the Sector for Innovation of the MESD's Internationalisation Directorate and several direct funding instruments (e.g. innovation vouchers and grants) are managed by HAMAG-BICRO. The tax allowance was introduced in 2019 under the Act on State Aid for Research and Development Projects in order to increase private sector investment in R&D and encourage cooperation of entrepreneurs with R&D organisations (Abdellatif et al., 2022<sup>[26]</sup>), but its uptake has been limited. In 2021, it accounted for only 3% of the total government support to business R&D (as opposed to 97% for direct financial support).

The overall small magnitude of public support by international standards (in absolute and relative terms) could be a barrier to attracting additional investment in R&D-intensive activities, in particular given that peer economies in the geographical vicinity of Croatia, such as Slovenia, the Slovak Republic, Czechia and Hungary, provide significantly more generous schemes. Cross-country differences in the generosity of R&D tax allowances can lead to differences in the cost of capital faced by foreign firms – and subsequently encourage or discourage them from increasing their R&D investment or locating their R&D functions in a country (OECD, 2022<sup>[9]</sup>). Additional analysis is also required to understand the reasons behind the limited uptake of the R&D tax allowance. It could be caused in part by complex application procedures and a lack of awareness about the incentive among knowledge-intensive firms. It may also be a sign of weak domestic capacities in the area of innovation, which could be an important barrier for domestic enterprises, in particular SMEs, to develop value chain linkages and knowledge-intensive partnerships with foreign investors operating in Croatia.

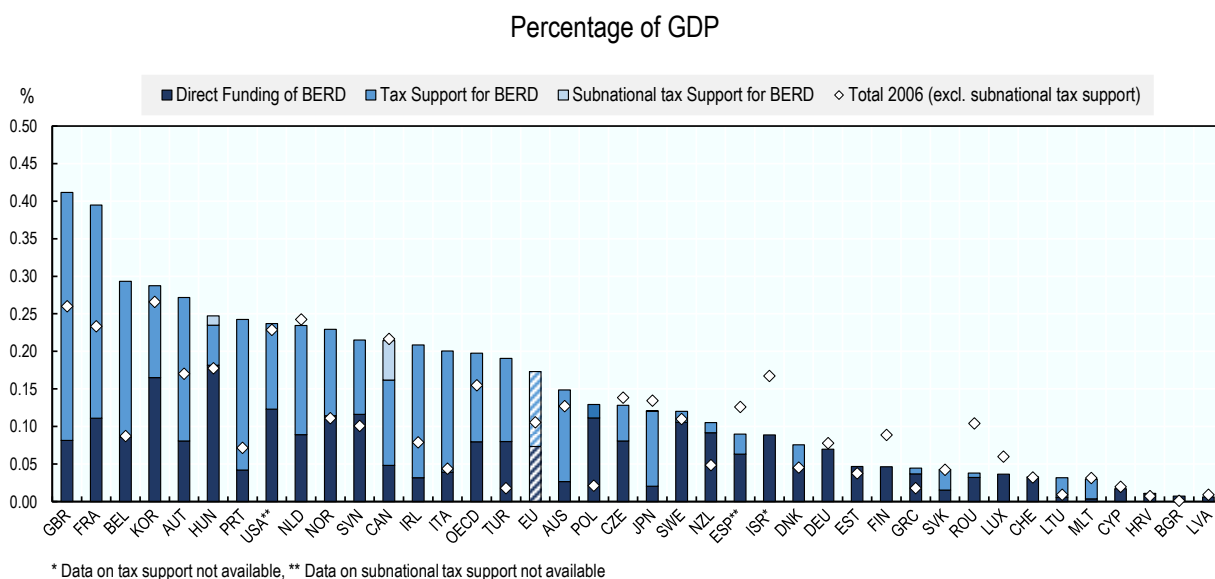
The MESD could consider monitoring the scheme's impact and evaluating whether its benefits outweigh potential costs (e.g. in terms of forgone public revenue, market distortions, etc). It is crucial that the MESD examines whether certain provisions, application procedures and design features could be simplified to make the scheme more attractive and less burdensome for firms that seek to engage in innovative activities. The Ministry's intention to digitise the application procedure, which is one of the reforms envisaged by Croatia's Recovery and Resilience Plan, is a step in the right direction and could help increase the number of companies that benefit from incentives.

Similarly, direct funding instruments could be increased, better coordinated, targeted and linked to each other to leverage FDI for Croatia's transition towards a knowledge-based economy. In the period 2014-

2020, EUR 0.53 billion of EU funds were made available to stimulate the innovation performance of the Croatian economy through targeted support to Croatian companies and investments in R&D infrastructure. Based on 9 tenders, a total of 868 contracts were signed with SMEs for the development of innovative products and services, with a total project value of EUR 1 billion. Additional investments are envisaged in Croatia's National Programme of Recovery and Resilience (NPOO) for the period 2021-2026, which will support newly founded SMEs to engage in innovation (e.g. innovation vouchers and grants), use advanced technologies, digitalise their business processes and develop skills for smart specialisation.

Direct financial support includes a variety of calls and funding tenders with different objectives, timeframes, target groups and implementing authorities that do not provide the necessary long-term perspective, which is important when foreign and domestic firms consider engaging in innovation. Recent World Bank analysis has found that smaller and younger firms are less represented among beneficiaries of support programmes funded from the EU Structural and Investment Funds (ESIF) and linkages between the business and research sectors are very weak (World Bank, 2021<sup>[27]</sup>). Application costs for innovation support programmes are high and firms usually have to bring in experts and consultants to assist with application and project management. Many firms have also reported significant delays between the publication of the funding calls and contract signing, which can severely disrupt business planning and in the case of R&D partnerships undermine business-to-business collaboration.

**Figure 3.11. Croatia's government support to R&D investments is among the lowest in the EU**



Source: OECD R&D Tax Incentives Database (2022<sup>[25]</sup>), <http://oe.cd/rdtax>

Many of these shortcomings stem from challenges in Croatia's governance framework for R&DI. R&DI policy is jointly managed by the MESD and the Ministry of Science and Education, while high-level governance is ensured by the National Innovation Council (NIC). In the past, the lack of clarity over decision-making responsibilities for Croatia's Smart Specialisation Strategy and the need to coordinate with other government actors responsible for the management of the EU Structural and Investment Funds, had resulted in weak enforcement of government decisions and bottlenecks in coordination (European Commission, 2023<sup>[28]</sup>). The 2021-2027 Smart Specialisation Strategy of Croatia, which will be officially adopted in the course of 2023, has streamlined the governance structure and clarified the power and functionality of the NIC.

Incentives are not the only policy tool to boost R&D investment, putting aside the question of their effectiveness and the forgone revenues that they can generate. To be successful, public support to R&D investments should be accompanied by technical assistance, training and the necessary infrastructure that allows foreign and domestic firms to interact, network and engage in collaborative R&D projects. In many cases, the expansion of existing investors seems to be the most common entry mode of R&D-intensive FDI. Foreign MNEs are encouraged to perform science and technology development work when they can develop ties with local universities, public research institutions and participate in business networks led by local industry associations. Building connections between Croatia's business and innovation ecosystems can be achieved through open innovation mechanisms such as testing and piloting infrastructures/platforms.

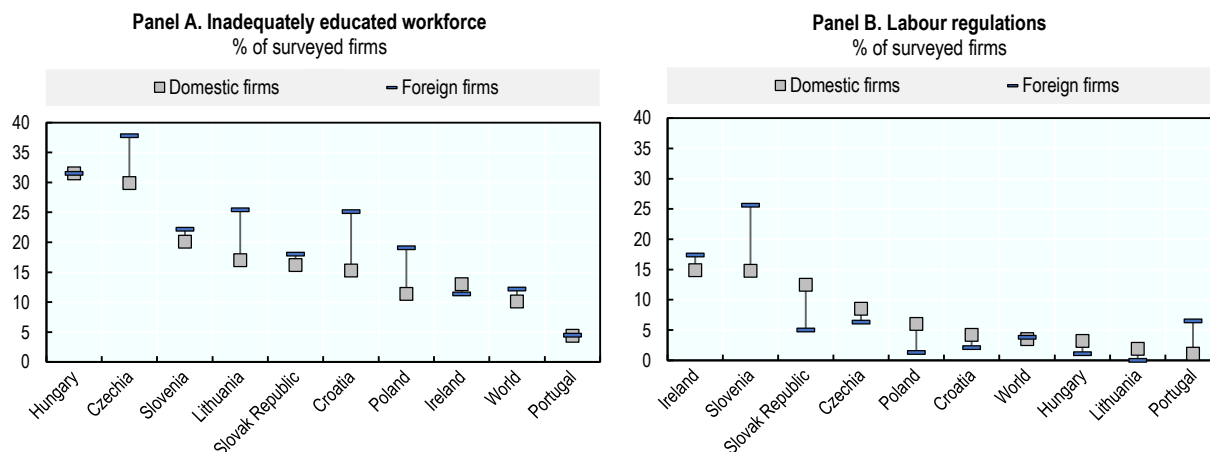
The MESD could increase efforts to convince already established firms to relocate their R&D activities to Croatia. This will require stronger support from the government with regard to advanced technology and machinery, technical assistance to link applied university research with the needs of foreign investors, as well as training and skills development programmes to help investors find qualified R&D workers. The existing network of science and technology parks could be further supported and leveraged to attract knowledge-intensive foreign MNEs in line with the specialisation patterns of local economies. The Investment Sector of the Internationalisation Directorate could collaborate with the Entrepreneurial Infrastructure and Innovation Infrastructure Services to identify challenges and opportunities in linking established investors with actors of Croatia's research and innovation ecosystem.

### ***Strengthening labour market institutions could improve FDI's contribution to job creation and skills development***

Balanced labour market regulations can support foreign firms' adjustments while providing a level of employment stability that encourages learning in the workplace. In Croatia, labour market regulations do not appear to be the biggest constraint for either domestic or foreign firms (Figure 3.12). In 2013-2014, the government reformed the employment protection legislation with the aim to increase labour market flexibility and harmonise the Croatian labour market regulations with those of the EU (World Bank, 2023<sup>[29]</sup>). Reforms included reducing hiring costs, liberalising collective dismissals, introducing working time flexibility and making part-time employment less costly for employers (World Bank, 2019<sup>[30]</sup>). Less rigid labour market regimes imply that firms' adjustment costs when hiring or firing workers in response to FDI entry and spillovers are not likely to restrain labour mobility and wider resource reallocation (OECD, 2022<sup>[9]</sup>). For foreign investors, flexibility of the host country's labour market matters for their location choice and investment volumes – and thus job creation potential.

Despite the progress achieved in striking the right balance between workers' protections and firm adaptability, the Croatian labour market faces challenges. Delays in court rulings regarding dismissals, abstruse labour law amendments and subordinate decrees and the high costs of dismissals, even in the case of misconduct or performance issues, make the legal framework complex. Skills shortages and mismatches have also accentuated over the past decade due to the outflow of talent and the overall shift of employment towards services sectors, which tend to be more reliant on highly skilled workers (World Bank, 2023<sup>[29]</sup>). According to the 2019 World Bank Enterprise Survey of Croatia, the inadequately educated workforce appears to be a bigger constraint for foreign than domestic firms (25.1% vs 15.3%) (Figure 3.12). This may be due to the high concentration of FDI in sectors that experience significant labour and skills shortages such as higher-technology services (e.g. software and IT), construction and tourism sectors. Croatia's plan to hasten its transition towards a knowledge-based economy and to attract investment accordingly, will be possible if labour shortages and skills gaps are addressed quickly. Ensuring that everyone has the right skills for an economy increasingly driven by the green and digital transitions is essential to spur innovation, productivity and economic growth.

**Figure 3.12. Share of firms identifying skill shortages and labour regulations as their biggest obstacle**



Source: OECD based on World Bank (2019<sub>[31]</sub>), [www.enterprisesurveys.org/en/enterprisesurveys](http://www.enterprisesurveys.org/en/enterprisesurveys)

The Croatian government has sought to incentivise investors to create quality jobs and offer on-the-job training to their employees through the Investment Promotion Act, which stipulates several tax benefits that are conditioned to the creation of a certain number of jobs. Additional financial grants are available to support job creation depending on the level of the unemployment rate in each of Croatia's subnational counties. For labour-intensive investment projects, i.e. projects that create more than 100 jobs, several top-ups apply that raise the generosity of the grants. Similarly, training grants are available for all sectors covered by the Act, and cover up to 70% of costs incurred for training employees in newly created jobs. Incentives conditioned to increasing employment or providing on-the-job training are common among EU and OECD countries. Evidence on their effectiveness is mixed, however, in both developed and developing countries (OECD, 2022<sub>[9]</sub>). When they are not well targeted, incentives might benefit firms that did not need support to hire or train workers in the first place. As suggested in Chapter 5, which provides an assessment of investment tax Incentives, the MESD could consider undertaking an impact evaluation to ensure that their targeting and design remain effective in the attraction of productivity-enhancing and skill-intensive investments. Systematic ex-post evaluations could help ensure that the costs of financial incentives, in terms of revenue forgone and potential economic distortions, outweigh their benefits.

While incentives can help prioritise FDI in job-creating and skill-intensive activities, it is as relevant for the Croatian government to align the existing skills base with the needs of global investors. Overall, policy inter-linkages across the areas of investment promotion, employment and skills development appear to be limited. There is currently no systematic and coordinated skills anticipation process that takes into account MNEs' changing needs with regard to workforce skills. The Croatian Employment Service (CES) is responsible for analysing the needs of the labour market and accordingly prepare recommendations for training and educational programmes, but there is no evidence that this has any influence on workforce development policies (CEDEFOP, 2022<sub>[32]</sub>). The National Council for the Development of Human Potential is also responsible for making recommendations about how the skills supply system should respond to the changing skills demand. But its recommendations are not binding for education and training providers. Cooperation between the various institutional labour market actors is limited and active policies and programmes in support of labour participation and activation have been traditionally underfunded and short in duration (World Bank, 2019<sub>[30]</sub>; Corti and Ruiz de la Ossa, 2023<sub>[33]</sub>). Many of these challenges are often attributed to the limited administrative and financial capacities of the CES and regional disparities observed in the quality of services offered by its subnational offices. Although participation in vocational education

and training (VET) is high, upskilling and re-skilling programmes face challenges in targeting their objective population and are insufficiently aligned with the needs of employers (World Bank, 2019<sup>[30]</sup>).

If Croatia wants to attract more skill-intensive investment, it needs to strengthen its labour market institutions so that they can support the development of a broader set of workforce skills, beyond those required in sectors where FDI is already present. This will require robust skills anticipation systems that involve the investment community and allow to design evidence-based and forward-looking programmes that match expected skills needs in emerging sectors, in particular digital and knowledge-intensive services. The MESD's Internationalisation Directorate could collect information on foreign firms' operations and skill needs and participate in the skills anticipation assessments organised by the CES. It could also further promote sectors in alignment with the existing skills base and provide appropriate information to investors on labour market characteristics. Currently, the Directorate does not provide any services to help foreign investors identify local workers with relevant skills. Some of the labour market monitoring tools developed by the Ministry of Labour, Pension System, Family and Social Policy could be leveraged to improve the quality of investor services. This includes the Catalog of Green and Digital Skills (<https://vjestine.hzz.hr>) and the Labour Market Portal (<http://trzisterada.hzz.hr/hr>), which provide data on the supply and demand for specific occupations and skills as well as general information about labour market characteristics at the county level.

Recent policy efforts to align upskilling and reskilling programmes with emerging market needs (e.g. digital and R&D skills, skills related to emerging green technologies) should continue and be scaled up. The implementation of a voucher system, introduced by the Ministry of Labour, Pension System, Family and Social Policy in 2021, can enable greater participation of unemployed and employed persons in lifelong education with an emphasis on the acquisition of skills related to the green and digital transition. As of the end of 2022, 64 educational programmes for acquiring green and digital skills had become available through the vouchers programme and were offered by 107 accredited educational institutions (CES, 2023<sup>[34]</sup>).

Experience from peer EU countries suggests that such sectoral training programmes should be flexible enough to allow foreign MNEs to tailor them to the needs of their employees. For instance, IDA Ireland has partnered with Skillnet Ireland, the Irish public agency responsible for skills development, to facilitate foreign investors' access to Skillnet's talent development programmes. Sometimes, foreign MNEs create their own training centres, and many IPAs support them by ensuring that trainings are recognised by the relevant authority. The Croatian Ministry of Labour is currently developing a set of guidelines for the development of non-formal education programmes for the acquisition of competencies required for work, which will allow companies that already have their own in-house education programmes to align them with the Croatian Qualifications Framework and become eligible for funding through the voucher system.

### Box 3.4. Tailored skills development programmes for foreign investors in Ireland

In 2022, Ireland's investment promotion and skills development agencies, IDA Ireland and Skillnet Ireland respectively, launched a strategic talent development partnership. The partnership aims to supporting FDI companies who are looking to attract and retain talent by offering them access to tailored skill development initiatives implemented across Skillnet Ireland's 73 networks nationwide. This new engagement model combines the IDA's business development and support services for foreign MNEs with Skillnet Ireland's talent development expertise and extensive delivery network to help drive companies' growth.

Before the official launch of the partnership, the two agencies successfully piloted the programme by helping a selected number of foreign MNEs put together a strategic training and development plan to meet their business objectives. The programme involved coaching and mentoring to help companies assess their talent needs. External consultants were also assigned to work with them and help them address skill gaps and identify strengths and opportunities for further improvement. By the end of 2022, more than 20 companies are expected to have gone through the programme in a wide range of different sectors such as financial services, biopharmaceuticals, aviation communications, manufacturing and software development.

Skillnet Ireland has previously teamed up with IDA Ireland and Technological University Dublin to develop its Transform programme, an accredited course designed to help companies equip their staff with automation and tech skills. The programme has had notable success for Dell Technologies in supporting the company to enhance the talent capacity of 600 members of its Ireland-based workforce and has resulted in the development of 190 business innovation projects. In 2021, Skillnet invested EUR 1m to bring the programme to a wider network of businesses in Ireland. This will support businesses – large and small – in their adoption of digital transformation and propel their workforce to embrace digitisation as it applies to leadership, strategic business models and advancing human digital capital capabilities.

Source: OECD based on IDA Ireland (2022<sup>[35]</sup>)

### ***Promoting green and low-carbon investment will require removing regulatory barriers for renewable energy projects***

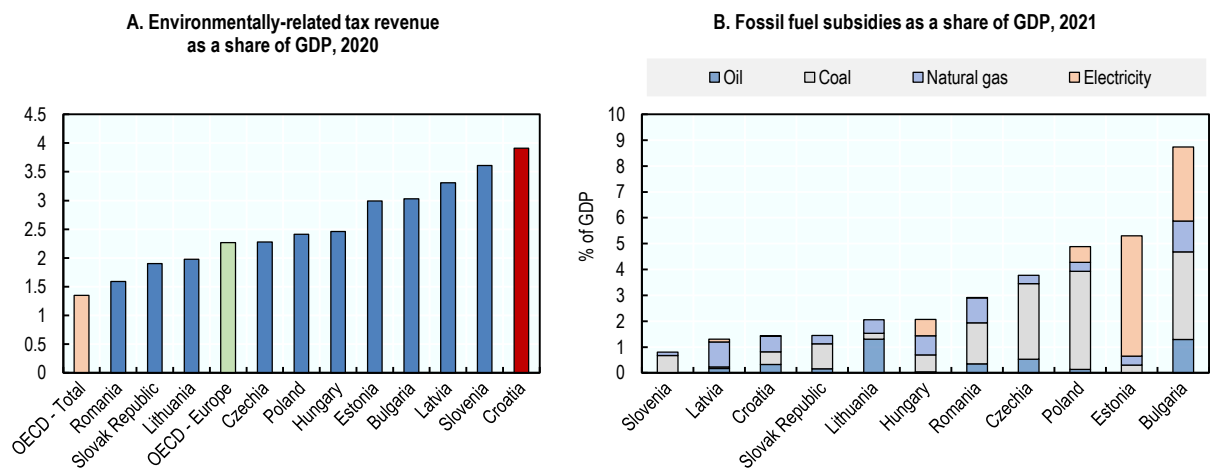
Promoting green investment is an opportunity for Croatia to avoid locking in environmentally and economically unsustainable development. The government has taken steps towards promoting green investment by setting low-carbon transition targets and long-term policy strategies that send investors, including foreign ones, strong signals regarding the government's climate ambitions. The Croatian Low-carbon Transition Strategy, adopted in 2021, includes a commitment to reduce greenhouse gas emissions (GHG) by 57%-73% by 2050 compared to the 1990 baseline and the Energy Development Strategy, adopted in 2020, includes a long-term target for a renewable energy share of 65% by 2050 (European Parliament, 2021<sup>[36]</sup>). 40% of Croatia's Recovery and Resilience Plan is also dedicated to climate objectives, featuring crucial reforms and investments to step up the transition to a more climate-resilient economy (European Commission, 2022<sup>[37]</sup>). Such clear and long-term targets are critically important to build capacity for investors to understand transition risks and to attract foreign investment that contributes to the country's climate agenda.

Environmental taxes play an important role in Croatia's sustainable development policy. Environmental tax revenue reached 3.9% of GDP in 2020, significantly higher than all CEE countries and the OECD average of 1.35% (Figure 3.13). The taxes cover environment pollutants, excise duties on energy products and

electricity, the environmental impact of waste and a special environmental charge for motor vehicles. These carbon- and environmentally-related pricing instruments provide a technology-neutral case for low-carbon investment and consumption. While they do not specifically target FDI, they are a necessary first step to send the socially optimal price signals to all investors, including foreign ones, and raise the returns on low-carbon relative to high-carbon investments. This is also the case for fossil fuel subsidies. Reducing and reforming economically-inefficient and environmentally-harmful fossil fuel subsidies has become a key issue on the political agenda of governments across the world. Policy makers are now better informed and more aware of the negative fiscal, social, environmental and climate-related impacts of government support to fossil fuels (OECD, 2021<sup>[38]</sup>). Croatia provides one of the lowest levels of fossil fuel subsidies among EU and CEE countries, reaching only 1.4% of GDP in 2021, as opposed to 8.7% in Bulgaria (Figure 3.13).

In 2020, renewable sources produced 65% of electricity (Figure 3.14, Panel A); natural gas was still used to generate one quarter of total electricity. When looking at the use of renewables in total energy consumption, Croatia is significantly above the EU average (31% compared to 21%) and above most CEE countries with the exception of Latvia and Estonia (Figure 3.14, Panel B). These findings suggest that Croatia’s renewable energy generation capacity has gained traction over the past decade, allowing it to reduce fossil fuel dependency and the exposure to energy price shocks. The long-term goal of at least 65% renewable energy by 2050 will require to further accelerate investments in clean energy. As suggested by Figure 3.14 and the findings of a recent energy sector assessment funded by the European Bank for Reconstruction and Development (EBRD) (OIE, 2022<sup>[39]</sup>), there is still room for further expanding solar and wind energy generation in coastal areas as well as geothermal energy in the continental part of Croatia.

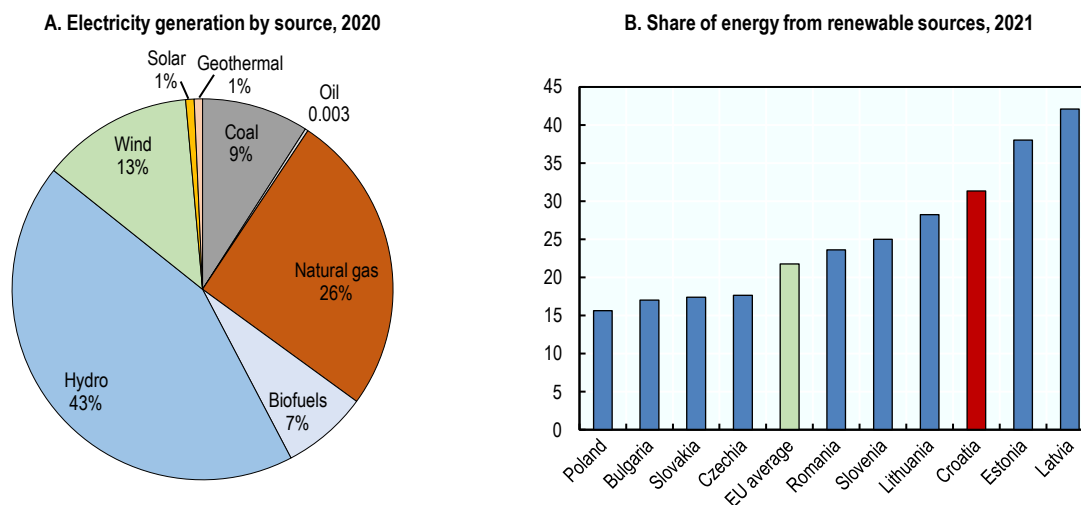
**Figure 3.13. Policy instruments that raise the returns on low-carbon relative to high-carbon investments in Croatia and CEE countries**



Source: OECD database of Policy Instruments for the Environment (2020<sup>[40]</sup>), <https://stats.oecd.org/Index.aspx?DataSetCode=ERTR>, and IMF Climate Change Indicators (2021<sup>[41]</sup>), <https://climatedata.imf.org/>



**Figure 3.14. Renewables represent an important share of Croatia's energy mix**



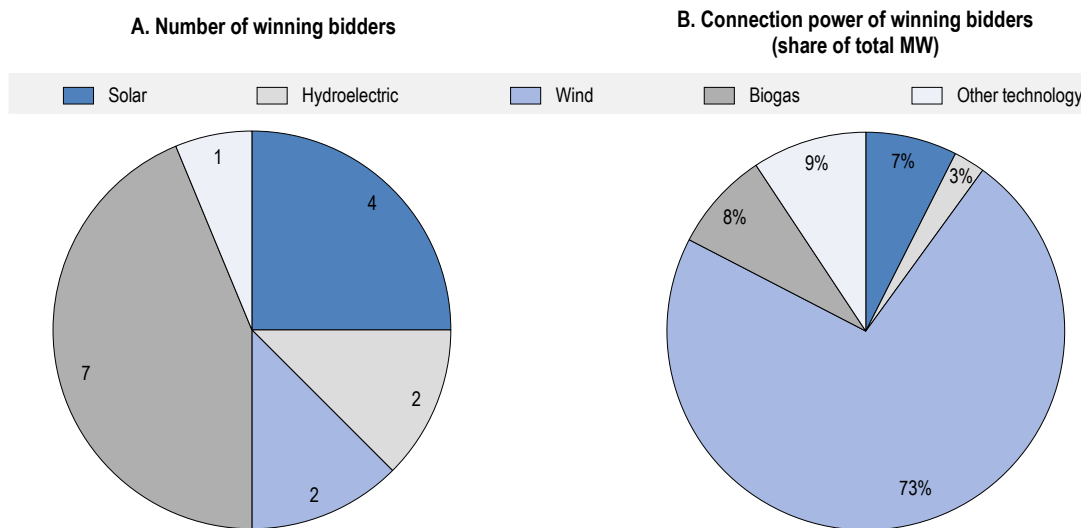
Source: OECD based on IEA Electricity Information (2020<sup>[42]</sup>), [www.iea.org/data-and-statistics/data-product/electricity-information](http://www.iea.org/data-and-statistics/data-product/electricity-information), and Eurostat energy statistics (2021<sup>[43]</sup>), [https://ec.europa.eu/eurostat/web/products-datasets/-/nrg\\_ind\\_ren](https://ec.europa.eu/eurostat/web/products-datasets/-/nrg_ind_ren)

Over the past decade, Croatia's incentive system for investments in renewables has been characterised by a lack of continuity and certain delays in developing and implementing the necessary legal framework for the provision of state support. In 2016, the feed-in-tariffs (FiT) scheme (OIE, 2022<sup>[39]</sup>), a type of incentive that reduces the risk of energy investments by guaranteeing a pre-determined price (or revenue) for the electricity generated for a predefined period of time, was discontinued. In 2018, the Act on Renewable Energy Sources and Highly Effective Cogeneration was amended to re-introduce the FiT scheme for small-scale power plants of a maximum output of 500 KW and complement it with a feed-in-premium (FiP) system for large-scale power producers (above 500 KW). The FiP offers financial support to a winning bidder under a contract made with the Croatian Energy Market Operator (HROTE) (Lexology, 2020<sup>[44]</sup>). The subsequent adoption of implementing regulations and revision of the Electricity Market Act to create a legal framework for the tendering procedures led to significant delays in the implementation of the new incentive system, with the first public auctions for small (FiT) and large-scale (FiP) projects taking place in 2020 and 2022 respectively (Figure 3.15).

The establishment of a premium-based incentive scheme is a step in the right direction and could help Croatia achieve its decarbonisation targets as long as it is accompanied by reforms to remove regulatory barriers, and targeted policy interventions to create conducive framework conditions for private investment. The effectiveness of incentives will depend on energy market conditions, the ease and speed of granting licenses and permits for the construction of large-scale power plants, and the ability of investors to access land (see next section) and secure the necessary financing. On the latter, interviews with government and private sector stakeholders conducted for this Review revealed that investors face significant challenges in Croatia to ensure the bankability of their renewable energy projects. In certain cases, licenses are being granted and incentives provided by government agencies, but many renewable energy projects are cancelled or postponed due to the lack of financing.



**Figure 3.15. Renewable energy projects supported by Croatia's feed-in-premium scheme in 2022**



Source: HROTE (2022<sup>[45]</sup>), Public Tender Results,

[https://files.hrote.hr/files/PDF/OIEIK/2022/Javni\\_natjecaj\\_1\\_2022/tablice%20za%20objavu%202022-07.pdf](https://files.hrote.hr/files/PDF/OIEIK/2022/Javni_natjecaj_1_2022/tablice%20za%20objavu%202022-07.pdf)

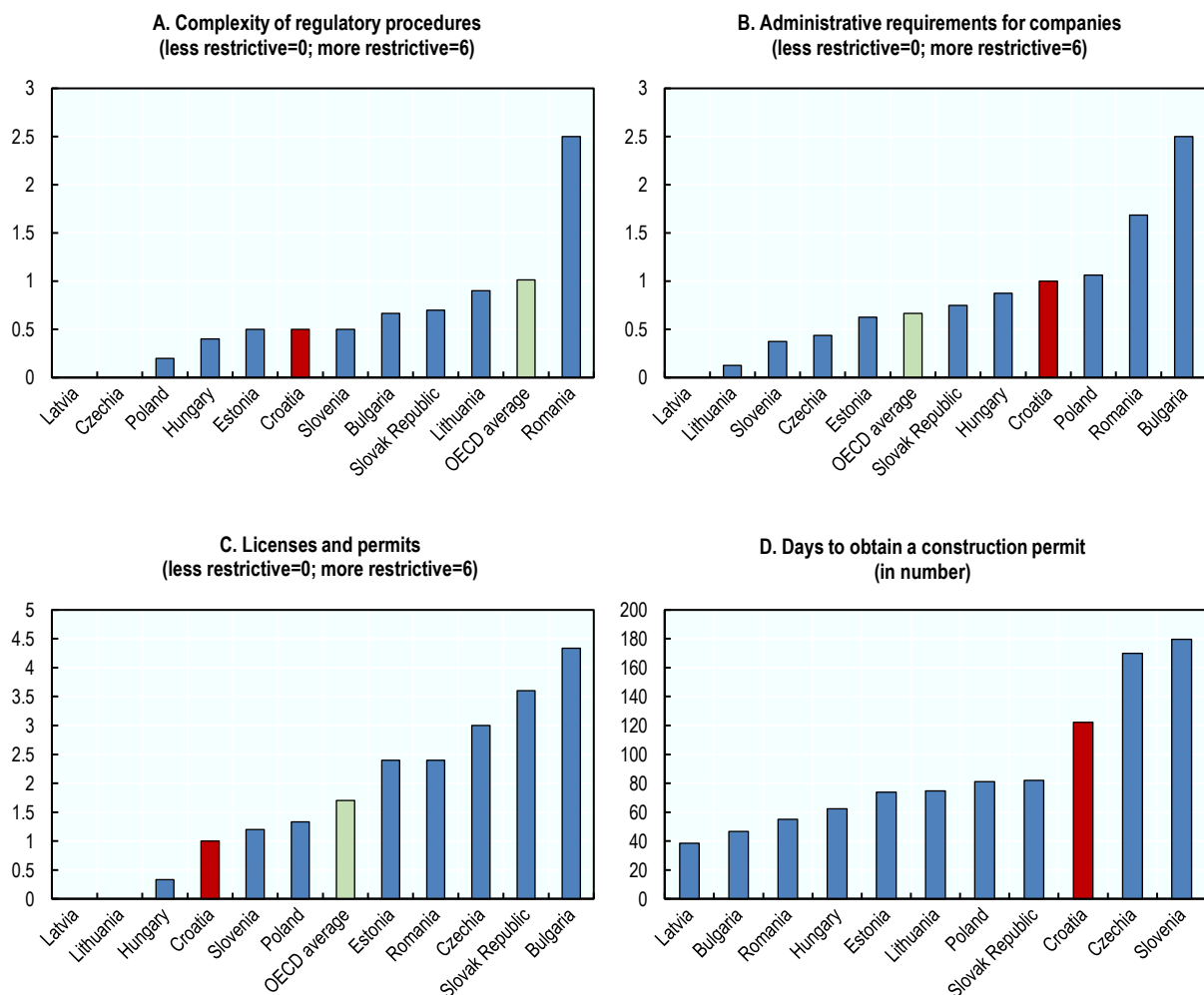
Regarding regulatory barriers, Croatia performs significantly better than CEE economies in the area of regulatory complexity and simplification of licensing and permit systems (Figure 3.16). In the period 2018-2020, the government adopted three Action Plans and undertook several reforms, including 356 measures, to simplify administrative procedures and digitalise a range of processes, achieving a culminated savings of approximately 245 million EUR (1.85 billion HRK) in burden reduction (as of September 2022) (Government of Croatia, 2022<sup>[46]</sup>). The MESD has developed the START platform to optimise the business registration process, effectively creating a portal where procedures are merged in a single platform. The Ministry of Physical Planning, Construction and State Assets has also established the e-Permit (e-Dozvola) information system to facilitate communication between investors and licensing authorities and accelerate the issuance of building and construction permits.

Despite the progress achieved so far, the European Commission's 2022 country report for Croatia identifies administrative, regulatory and technical barriers, including lengthy procedures for authorisation and permitting, as major challenges for investments in renewable energy (European Commission, 2022<sup>[37]</sup>). Procedures for obtaining environmental approvals – namely environmental impact assessments and assessments on the impact of investment projects on Croatia's ecological Natura 2000 network take significantly longer than the legal deadlines prescribe (OIE, 2022<sup>[39]</sup>). Licensing approval rules are also not always clear. Although the deadline for the approval of a preliminary environmental impact assessments by the relevant authority can be prolonged beyond the legally prescribed two months, the Environmental Protection Act does not specify what the maximum time for the approval process must be, resulting in delays and a lack of predictability for investors.

Many of these challenges stem from the weak administrative and strategic planning capacities of the MESD's Energy Directorate and the Directorate for Environmental Impact Assessment and Sustainable Waste Management. These Directorates, and more broadly the Croatian public administration, are facing significant human resources issues directly hindering their ability to hire and retain trained and qualified staff that is able to handle the workload of licensing and permit systems. The Directorates should be sufficiently supported with the necessary resources to effectively implement the renewable energy incentives and handle the associated licensing requirements. Policy efforts should also focus on optimising digital services offered by the public administration. The transformation of paper-based processes to online

procedures will not be sufficient to reduce regulatory burden unless it is accompanied by simplification measures, interoperability between government bodies and enhanced coordination between levels of government.

**Figure 3.16. Regulatory burden on business in Croatia compared to CEE countries**



Source: Author's elaboration based on OECD (2021<sup>[47]</sup>), Product Market Regulation database, [www.oecd.org/economy/reform/indicators-of-product-market-regulation/](http://www.oecd.org/economy/reform/indicators-of-product-market-regulation/), and World Bank (2019<sup>[31]</sup>), Enterprise Surveys, [www.enterprisesurveys.org/en/enterprisesurveys](http://www.enterprisesurveys.org/en/enterprisesurveys)

Given the rapid pace of technological developments in the renewable energy sector, emphasis should be also placed on ensuring that licensing procedures are flexible enough to accommodate technological upgrades of existing projects (or projects under development), and that regulatory requirements for changes to investment projects are proportional and provide a degree of predictability. Currently, changes to the initial technology model for renewable energy projects under development usually require amendments to the location and building permits, which cannot be obtained before a new environmental impact assessment is conducted (European Commission, 2022<sup>[37]</sup>; OIE, 2022<sup>[39]</sup>). While scrutiny of changes to investment activities that may have negative impacts on the environment is necessary and legitimate, screening should remain closely tailored to risk in the case of investment projects that have already been subject to prior impact assessments and involve activities that contribute to the green and low-carbon transition. Portugal's zero-licensing scheme is a good example of government efforts to ensure

that existing rules serve a legitimate public interest purpose (OECD, 2014<sup>[48]</sup>). Under this scheme, license requirements in non-risk activities were largely replaced by a simple prior notification to the authorities through electronic means, combined with reinforced ex-post inspections and sanctions for non-compliance.

### ***Spatial planning rules could be further harmonised to facilitate land acquisition for large-scale investment projects***

Secure rights for land tenure and an efficient, reliable system for land administration are indispensable for investors in many countries, including Croatia. This requires a clear legal framework for acquiring, registering and disposing of land rights, as well as land use plans at all levels of government. In Croatia, the 2013 Physical Planning Act regulates the spatial planning system (Katurić and Simov, 2021<sup>[49]</sup>). Depending on the type of land that is needed for an investment project, different public bodies are responsible for regulating land rights and issuing the necessary permits (Table 3.6). Responsibility at the national level lies with the Ministry of Physical Planning, Construction and State Assets, which has recently adopted the National Spatial Development Strategy, a document laying out Croatia's strategic objectives for spatial development up to 2030, including policy priorities and guidelines for public bodies involved in the design and approval of spatial plans (MPGI, 2020<sup>[50]</sup>). Apart from this strategic document, there are no binding planning instruments in force at the national level. Practically, all responsibilities are with the county authorities, municipalities and city administrations (Scharmann and Cibilić, 2020<sup>[51]</sup>), each one of which issues complementary regional (i.e. county) and local (i.e. cities, municipalities) spatial plans specifying the type of economic or other activities that can be undertaken in different areas of their territory. According to the current legal framework, subnational plans shall be mutually aligned and aligned with higher-level plans.

While decentralisation was generally welcomed, it has created some persistent governance concerns associated with coordination issues between the various national and subnational entities that hold responsibilities for land administration. For foreign firms to undertake investment projects in Croatia, alignment between local and regional spatial plans is of paramount importance given that plans set conditions for economic and building activities and serve as the basis for issuing permits. In practice, disparities in the scope and level of detail of subnational plans as well as overlapping mandates in the assignment of land for business activities often result in delays in licensing procedures for large-scale investment projects (OIE, 2022<sup>[39]</sup>). An analysis of the provisions of county spatial plans undertaken for Croatia's recent Spatial Development Strategy showed that some of them are very prescriptive with regard to defining conditions and criteria while others delegate responsibility to municipalities (MPGI, 2020<sup>[50]</sup>).

**Table 3.6. Government bodies responsible for land rights in Croatia**

Ownership	Type of land	Relevant body
National government	Forest land	Ministry of Agriculture (Department for Forestry)
	Agricultural land	Ministry of Agriculture (Department for Agricultural Land)
	National public roads	Croatian Roads Ltd.
	County and local roads	County administration for roads
	Other state property	Ministry of Spatial Planning, Construction and State Assets
Municipalities	Unclassified roads	Municipal Council
	Municipal properties	Municipal Council
Private property	Land owned by private persons or legal entities	Agreement with owner or expropriation through the county authorities

Source: OIE (2022<sup>[39]</sup>), Guide for the Development and Implementation of Renewable Energy Projects in Croatia, <https://oie.hr/wp-content/uploads/2022/02/RESC-EBRD-Guide-for-develop.-impl.-of-RES-projects-in-Croatia.pdf>

The quality of spatial planning processes is further undermined by weaknesses in the capacity of local authorities to fulfil their spatial planning obligations, as well as by a lack of clarity and formal procedures for amending municipal plans to accommodate new investment activities (Katurić and Simov, 2021<sup>[49]</sup>). These weaknesses are reflected in the quality of cadastral and land registries which are often not aligned with the actual state of property rights – in particular regarding municipal and state property –, resulting in significantly prolonged procedures for securing land rights since the status of land plots cannot be determined with certainty (OIE, 2022<sup>[39]</sup>).

The current fragmented system has serious implications particularly for investment projects in the energy sector due to the different land tenure needs of energy generation technologies. Some renewable energy projects may require direct land acquisition by the investor (e.g. biogas plants) while others may be developed on third parties' land by securing servitude or the right to build (e.g. wind and solar panel farms) (OIE, 2022<sup>[39]</sup>). Resolving issues relating to land rights and other location permits is crucial for the bankability of capital-intensive projects since investors are often required to pledge any rights to land as collateral in order to receive debt financing. Securing land rights is also a prerequisite for foreign firms to benefit from incentive schemes enacted by the Croatian Government. Until 2023, a valid location or building permit was required for investors to participate in public auctions for renewable energy projects and benefit from public support provided in the context of the FiT and FiP schemes. A recent law passed by the Croatian government has abolished this requirement, allowing winning bidders to acquire and submit their construction permits after the conclusion of public tenders.

The Government of Croatia could scale up efforts to harmonise spatial planning rules and ensure that the status of land plots can be determined with certainty. Subnational governments could be further supported to effectively coordinate with relevant county authorities and resolve challenges arising from potential overlapping spatial planning rules. To this end, county and municipal authorities could consider at which level the assignment of land tenure rules should be made for certain activities that may require large land areas or technical infrastructure that goes beyond the responsibilities and capacities of a single municipality (e.g. electricity grid connections for renewable energy projects). The Government of Croatia is aware of these challenges and is taking steps to address them. In 2023, the Spatial Planning Act was amended to make the process of developing county and municipal spatial plans more efficient through the digitalisation and e-verification of all the necessary documents, data and procedures. The Ministry of Physical Planning, Construction and State Assets is also planning to establish a comprehensive information system, which will enable better communication of all participants in the process of creating spatial plans.

Access to information regarding land administration and tenure might also be improved. Emphasis should be placed on streamlining information for potential investors through digital means. Croatia's Recovery and Resilience Plan sets out measures to upgrade the Spatial Planning and State Property Information System (ISPU) and enable the digitisation of procedures related to the preparation and implementation of investment projects, from identifying the localisation of the project, acquiring digital spatial plans, downloading satellite images of land plots, and obtaining the necessary permits (Government of Croatia, 2021<sup>[52]</sup>). The creation of a digital platform that guides investors through every stage of the process could further facilitate investments.

For large-scale investments of strategic importance for the sustainable development of the Croatian economy, different institutional arrangements could be envisaged too. In 2018, the MESD amended the Act on Renewable Energy Sources and High-Efficiency Cogeneration to create a centralised public tendering procedure for the allocation of state-owned property for investments in renewables. Such an approach could indeed replace the current fragmented system whereby several approval processes are managed by different public bodies involving different timeframes and permit requirements. At the time of writing this Review, the government had not approved an implementing regulation to specify how the public tenders would be organised. The delay has made relevant authorities to temporarily halt any pending procedures regarding state-owned property while in some cases ministries have rejected the issuance of

location permits for renewable energy projects planned on state-owned land in anticipation of the new tendering procedures (OIE, 2022<sup>[39]</sup>). Moving forward, the adoption of an implementing regulation should be prioritised by the government so that the process for the organisation of public tenders can be unlocked.

Croatia also offers investors advantages associated with locating in one of the entrepreneurial zones, i.e. designated land areas for investment activity owned by the Republic of Croatia, local municipalities or private entities. In most of these zones, legal issues with regard to land ownership have been settled and spatial plans adopted specifying the types of economic activity that are permitted (e.g. manufacturing, logistics, production and services activities). Several financial and non-financial benefits are also made available for investment projects located in the zones such as full or partial exemption from county and/or municipal fees and taxes, low-price schemes for land acquisition, financial incentives offered by subnational governments as well as high quality transport, energy and ICT infrastructure (MESD, 2021<sup>[53]</sup>).

Although entrepreneurial zones have been found to have a positive impact on domestic and foreign investment (Chapter 4 and 5) (Stojčić, Pylak and Alibegović, 2022<sup>[54]</sup>), interviews conducted with the Croatian Government and local authorities in the municipalities of Osijek and Novska pointed towards challenges arising from the size and quality of certain zones, in particular in less developed regions. According to the MESD, a key concern is the small size of certain zones, which does not allow large-scale investors to set up their operations and benefit from the available support. Other concerns relate to administrative delays in their expansion through the merger of various land plots. Creating areas of such type of good quality and that deliver broad-based development impacts for the local economy can be a difficult task. The government could reflect on the factors needed to ensure a good governance framework. Given that responsibilities for land administration in the zones lies on municipalities, these should be sufficiently supported with the necessary financial and strategic resources to ensure high quality infrastructure. The Entrepreneurial Infrastructure Service of the Internationalisation Directorate could play a coordinating role to ensure that challenges faced by zone authorities are identified and resolved. For instance, beyond the management of the register, the MESD could regularly collect information on available facilities and their characteristics, and help decide about the zones' current value-added and potential reforms needed.

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## Notes

<sup>1</sup> AmCham has recently called on the government to re-establish the agency and strengthen its role as a single point of contact for potential investors (AmCham, 2021<sup>[55]</sup>).

<sup>2</sup> Policy advocacy functions are undertaken by the Competitiveness Sector of the Internationalisation Directorate, which is responsible for consulting with the private sector on the quality of the business environment and other business climate reforms.

<sup>3</sup> Training on investment promotion and facilitation was provided by the Internationalisation Directorate to regional and local authorities in 2019-2020 as part of the Croatian Government's 2010 Reform Programme.

# **4 Harnessing investment for regional development**

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This chapter examines investment trends and policies in Croatia at the subnational level and how policy action can promote sustainable investment in regions. The first section examines regional FDI disparities and the strategic context for FDI in support of regional development. The other sections review strategies, policies and institutions related to investment and regional development. The chapter provides policy recommendations that can guide the government of Croatia in the setting up of coordination mechanisms for regional and national investment promotion and facilitation.

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## Summary and policy recommendations

Foreign investment significantly contributes to sustainable development in Croatia (Chapter 2), but its impact is uneven within the country, potentially taking a toll on inclusiveness. FDI is concentrated in the Adriatic and north-western regions, particularly in the capital city of Zagreb, Istria, Primorje-Gorski Kotar and Split-Dalmatia. Eastern Croatia has attracted less FDI: Pannonian Croatia concentrates only 3% of the national FDI stock, reflecting its lower business density compared to other regions. Foreign firms perform better compared to domestic firms in all parts of Croatia, especially in terms of labour productivity, but the positive impact of FDI is stronger in Zagreb and in the Northern region, as companies with R&D activities are concentrated in larger cities. The impact of FDI on job creation is also uneven. One million of greenfield FDI in Croatia generates around 4 direct jobs per million USD invested, but this varies by a factor of two between Zagreb (6 jobs) and Pannonian Croatia (3 jobs). Disparities in FDI impact on jobs are largely driven by sectoral distributions, skills availability (or their shortages) and R&D activity.

Croatia could better leverage FDI to support balanced regional development. One objective of the Investment Promotion Act is regional development, but there is no dedicated investment promotion strategy with specific goals and place-based policies, beyond the Regional Aid Map, on how to leverage FDI in support of regional development. All national investment promotion strategies of OECD countries that are EU Members have a regional dimension and many developed their regional convergence plans with FDI attraction as a core component. A challenge for Croatia is to set the strategy cursor to the suitable subnational level. Most of the 20 counties and 555 local governments (428 municipalities and 127 cities) are geographically or economically too small for strategic planning on investment, and attractiveness factors such as business density, skilled labour and local supply chains hardly follow their administrative borders. On the other hand, Croatia's four larger regions could develop attractive FDI value propositions aligned with their distinct priorities. Large regions lack the administrative setting for policy design and implementation, however, although they could rely on institutions operating at the local or county level.

The multi-layered policy and institutional framework on investment promotion became increasingly more diffused in a decentralised setting with fragmented subnational bodies, and where traditional IPA functions were transferred in 2019 into a department of a Ministry (Chapter 3) – the Internationalisation Directorate of the Ministry of Economy and Sustainable Development (MESD). At the national level, the Directorate recognises regional development as a prime concern but not to the same extent as IPAs of OECD countries, which often lead investment promotion at the subnational level. The Ministry of Regional Development and EU Funds (MRDEUF) is also involved in policies at the intersection of FDI and regional development. It oversees the European Structural and Investment Funds (ESIF) and the Integrated Territorial Investments (ITIs) of the EU Cohesion Policy, which shape regional development policies and orient EU funds to specific sectors or activities to unleash regional competitiveness. The MRDEUF also coordinates the recently established Industrial Transition Plans for the Adriatic, Pannonian and North Croatia regions, which aim to support the development of regional value chains through EU-funded financing instruments. Some ambiguity exists on the role of each ministry in overseeing or coordinating investment promotion at the subnational level.

Policies of the MESD's Internationalisation Directorate to promote FDI in support of regional development include typical instruments to influence investors' location decisions such as improving the image of regions as attractive investment destinations and providing tax incentives according to the Regional Aid Map (Chapter 5). Further evidence on the impact of incentives in attracting FDI that creates high-wage jobs in less developed regions and help reduce brain drain is needed. The Directorate relies less on investment generation to win FDI projects to less developed regions, in contrast with OECD national IPAs, but provide FDI-related intelligence to subnational bodies. It is reasonable that the Directorate does not go beyond typical investment promotion efforts to also consider talent attraction as a way to promote FDI in

less populated areas, but, with the new policy of facilitating foreigners' entry, it could consider how investment promotion strategy could support broader goals of retaining youth from migrating.

At the subnational level, important policies to attract and facilitate investment are the Entrepreneurial Zones (EZ) and Entrepreneurial Support Infrastructure (ESI), which are established and run by subnational governments with administrative support from the MESD's Internationalisation Directorate. The network of EZs is effective in attracting foreign projects but creates little spatial redistribution and spillovers beyond zones' nearby urban areas. Local and county development agencies – one type of ESI entity under the Act on Improving Entrepreneurial Infrastructure – have, in principle, the mandate to promote investment among several responsibilities. There is a plethora of county and local development agencies, however, and their engagement on investment promotion is unclear; in 2018 some or all of them started operating under the Act on Regional Development, generating confusion on what subnational body, if any, has the mandate over investment promotion and facilitation.

Clarifying mandates across tiers of governments should be Croatia's first step to improve policy coherence and coordination on investment promotion and regional development. The MESD's Internationalisation Directorate has good but only informal bilateral relationships with subnational governments that typically cover business establishment support such as land availability. Notwithstanding their effectiveness, informal coordination mechanisms are not suited to address holistic and strategic policy issues on investment promotion and regional development that should require collective agreements. These issues range from strategy design, sectoral targeting and operating a pipeline of investment projects to jointly agreeing on common and harmonised approaches on specific investment facilitation aspects.

### Policy recommendations

- **Equip the planned National Plan on Investment Promotion with a regional pillar**, in consultation with relevant subnational entities. The pillar sets FDI targets based on regional priorities and strengths, identifies investment promotion efforts, and clarifies the tasks of national and subnational entities and related coordination mechanisms. The pillar must consider investment promotion at the subnational level as a mutual responsibility of different ministries and levels of government. It should be aligned with the national strategy on regional development, subnational development plans, and the EU Cohesion Policy priorities.
- **Integrate the wide range of place-sensitive policies in the regional pillar of the investment promotion strategy**, beyond typical investment promotion efforts, to make FDI work for regional development. Lagging regions lacking economic and population density could further reinforce their institutions and invest in human capital, while denser lagging areas could benefit from investments in trade logistics to be better integrated with dynamic external markets.
- **Set the appropriate subnational level for the regional pillar of the investment promotion strategy to overcome fragmented planning**. Croatia's four large regions allow to consider broad regional specificities while still offering attractive FDI value propositions. Should Croatia opt for this level, then the pillar should be backed by all counties to ensure clear and unified messages, and commitments on implementing it within their jurisdiction, in cooperation with the counties of their region. Croatia should also consider cities' ITIs as one relevant unit for strategic planning on FDI to harness Croatia's largest cities as poles of regional attractiveness.
- **Embed FDI attraction priorities in relevant County Development Strategies, Urban Areas Development Strategies and the Plans for Industrial Transition of the three NUTS2 regions**. Including a regional pillar in the National Plan on Investment Promotion is not sufficient in a decentralised setting where the central government's ability to attract FDI depends on regions taking planned actions to improve their attractiveness. Subnational governments should

assess how their development plans can better leverage FDI to achieve their goals and identify what local improvements will help attracting the FDI needed to reach these goals, as well as broader investment reforms required at the national level.

- **Consider revising the legislative framework to clarify which subnational bodies have the mandate to promote investment.** The Act on Improving Entrepreneurial Infrastructure refers to local and county development agencies, creating confusion and overlap with bodies of the same name operating under the Act on Regional Development. The Acts should be aligned and clarify which entities carry investment promotion and facilitation mandates. Responsibilities should be balanced across levels of government, adequately funded, explicit, and mutually understood for all actors. This will also help clarify which bodies are part of the Integral Entrepreneurial Infrastructure Register (IEIR) and better assess their impact. The Act on Improving Entrepreneurial Infrastructure could include provisions on monitoring and evaluation.
- **Clarify responsibilities and strengthen cooperation at the central level.** The Investment Sector of the MESD's Internationalisation Directorate promotes Croatia as an FDI destination while the Incentives and Entrepreneurial Infrastructure Sector is tasked with improving the investment climate for balanced regional development by supporting the ESI network. Close coordination and joint planning between the two Sectors are crucial (see also Chapter 3). Overlapping mandates of the MESD and the MRDEUF would be partly overcome by clarifying if subnational bodies responsible for investment promotion belong to the ESI framework or the Act on Regional Development. Aligning the National Plan on Investment Promotion and the ITIs is another way to nurture strategic cooperation between the two ministries.
- **Develop coordination mechanisms to address multi-level investment promotion challenges.** The MESD's Internationalisation Directorate could develop with relevant national and subnational entities a cooperation agreement, protocol or guidelines that describe the rules of engagement of each actor with a clear distribution of tasks at different stages of the investment process. This can be a "light-touch" way to coordinate investment promotion and facilitation efforts across tiers of government and to collectively adopt, when reasonable, unified approaches, for instance on non-disclosure agreements with prospective investors. The OECD Recommendation on Effective Public Investment Across Levels of Government provides some guidance to encourage improved coordination of actions across levels of government.
- **Leverage digital tools to support national-subnational investment promotion activities.** The MESD's Internationalisation Directorate focus on imagine building to promote Croatia's different regions, while most of OECD national IPAs favour investment generation activities. The Internationalisation Directorate could establish, in cooperation with the relevant subnational entities, a digital platform to announce foreign investors' expressions of interest received by the ministry. This type of platform can help build trust while strengthening fair competition among subnational bodies that must put strong and clear value propositions to win FDI projects.
- **Strengthen the effectiveness of place-based policies on attracting FDI that supports regional development.** This includes: better integrating EZs into their regional ecosystem to generate further economic spillovers by aligning EZs' targeted or prioritised sectors and the local supply chains they serve with the County Development Plans, Urban Area Development Plans and the ITIs; further provision by the MESD of FDI-related intelligence to subnational bodies to help them identify and target unique FDI markets; assess local incentives' impacts on attracting job-creating FDI to regions with higher unemployment rates (see Chapter 5).
- **Consider talent attraction and retention as tools to attract FDI in disadvantaged regions.** The central and subnational governments should consider how investment promotion serves broader goals of retaining youth from migrating while facilitating foreigners' entry to avoid labour shortages. Addressing skills shortages faced by investors does not have to be a task of the

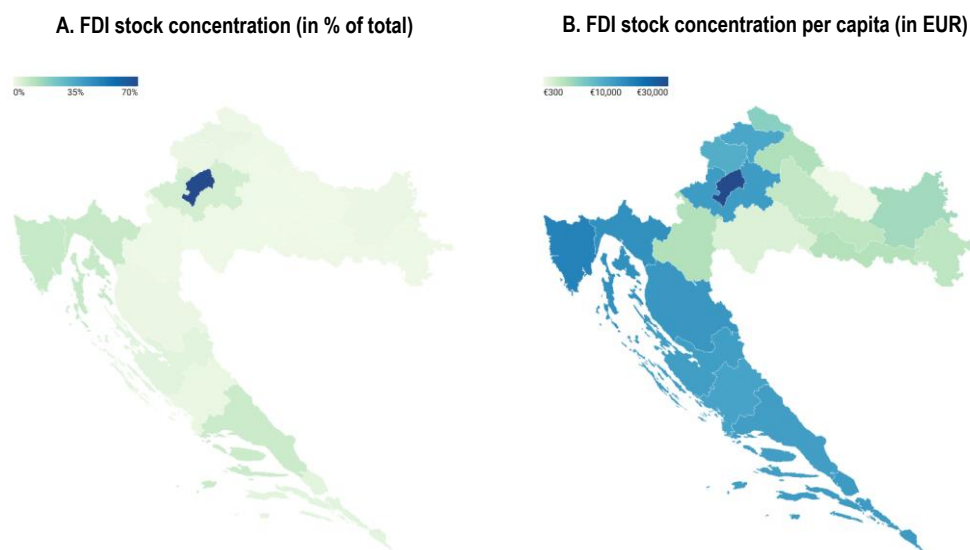
MESD's Internationalisation Directorate, but the Directorate could consider broader policy complementarity. Identifying trained workers or helping investors establish a training centre can be handled by local agencies that are close to firms' operations and know best their needs.

## Investment in support of regional development in Croatia: trends and impacts

### *The geography of foreign investment in Croatia*

Regional attractiveness has shaped the geography of foreign investment in Croatia as it also did within OECD countries (OECD, 2022<sup>[11]</sup>). The spatial distribution of FDI closely follows the contours of Croatia's four large regions, with the City of Zagreb – both a region and a county – hosting 62% of the national FDI stock, twice the Adriatic region (27%), eight times the Northern region (8%) and 21 times the Pannonian region (3%). Disparities between the smaller 21 counties are equally marked and further highlight the concentration of FDI in the capital (Figure 4.1, Panel A). Disparities are also large across other counties than Zagreb City. The county of Istria on the Adriatic Sea, the second top FDI performer, concentrates 100 times more FDI than the landlocked county of Virovitica-Podravina in Pannonia. The disparities are visible, albeit smaller, even when considering differences in population levels across counties and neatly illustrate the broader inequalities between the four large regions (Figure 4.1, Panel B).

**Figure 4.1. The distribution of FDI stock across Croatia's regions and counties**

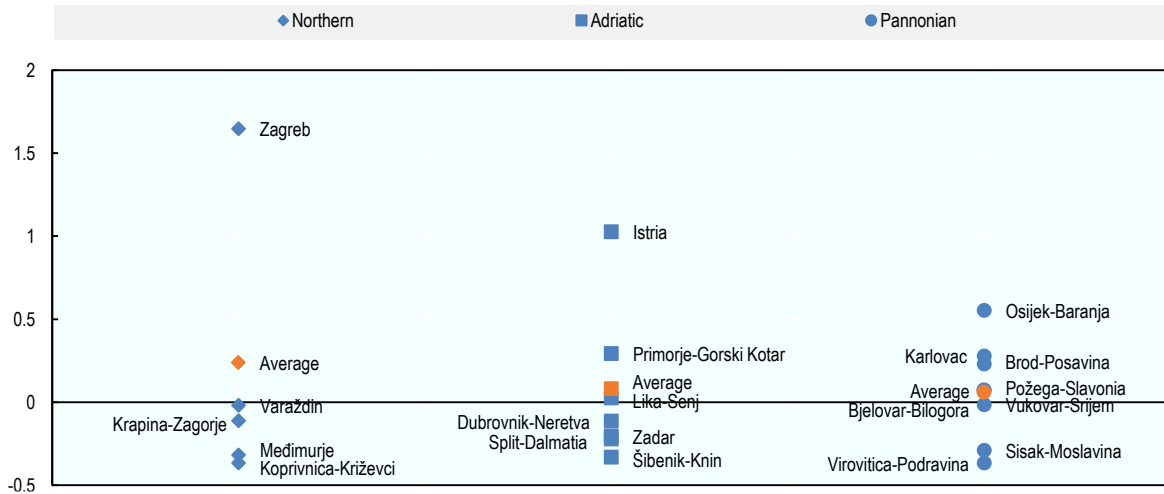


Source: OECD based on Croatian National Bank and Croatian Bureau of Statistics.

Regional disparities in FDI are also driven by disparities within the large regions of Croatia and not only between them. These disparities capture the concentration of business activity in urbanised counties and the challenge of more remote or rural counties within the same region to keep pace with urban hubs. They also reveal the extent to which a place-based approach to investment promotion is much desirable. The region with the largest levels of FDI stock per capita disparities is the Northern region, followed by the Adriatic and Pannonian regions (Figure 4.2). For the Northern and Adriatic regions, the main driver of the disparities in FDI is the attractiveness of the highly urbanised counties, respectively Zagreb and Istria. On the other hand, it is the significantly low density levels in the less developed counties of Sisak-Moslovina and Virovitica-Podravina that drives the regional disparities in FDI within the Pannonian region.

**Figure 4.2. FDI stock per capita disparities within Croatia’s large regions**

Dispersion in FDI stock per capita of counties (from large NUTS2 region average)

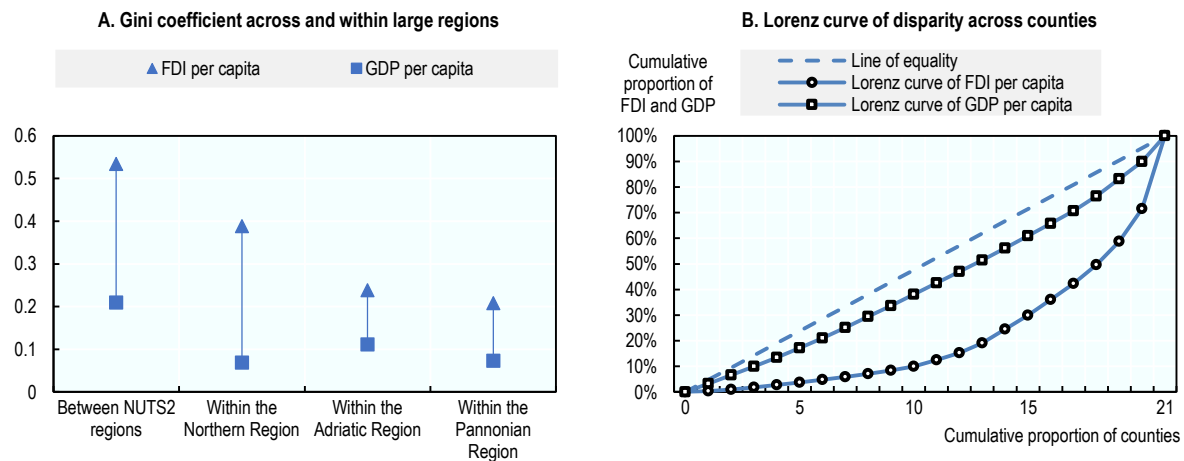


Note: To allow for comparability between the regions, the Theil indices (called average) have been adjusted by dividing by the LOG(n), where n is the number of counties in the region. Zagreb refers to Zagreb County in Northern Croatia.  
 Source: OECD based on Croatian National Bank and Croatian Bureau of Statistics.

Foreign investment can lift regional development and productivity growth in Croatia, but it can also exacerbate existing spatial inequalities if it is significantly more concentrated than broader economic activity. Regional disparities in FDI are larger than in GDP both between and within Croatia’s large regions, although the gap between the two strongly varies across regions (Figure 4.3, Panel A). The gap is significantly higher within the Northern region, where disparities in FDI are nearly six times larger than disparities in GDP – the region has the lowest levels of disparities in economic activity, however. Gaps in the disparities between FDI and GDP are smaller in the Adriatic and the Pannonian regions. Large gaps between FDI and GDP disparities are also visible across counties. The bottom 50% of counties, for instance, represent 38% of the cumulative GDP but only 10% of the cumulative FDI (Figure 4.3, Panel B).

**Figure 4.3. Comparing disparities in FDI and GDP across Croatia’s large regions and counties**

A higher Gini coefficient indicates larger regional disparities in FDI and GDP



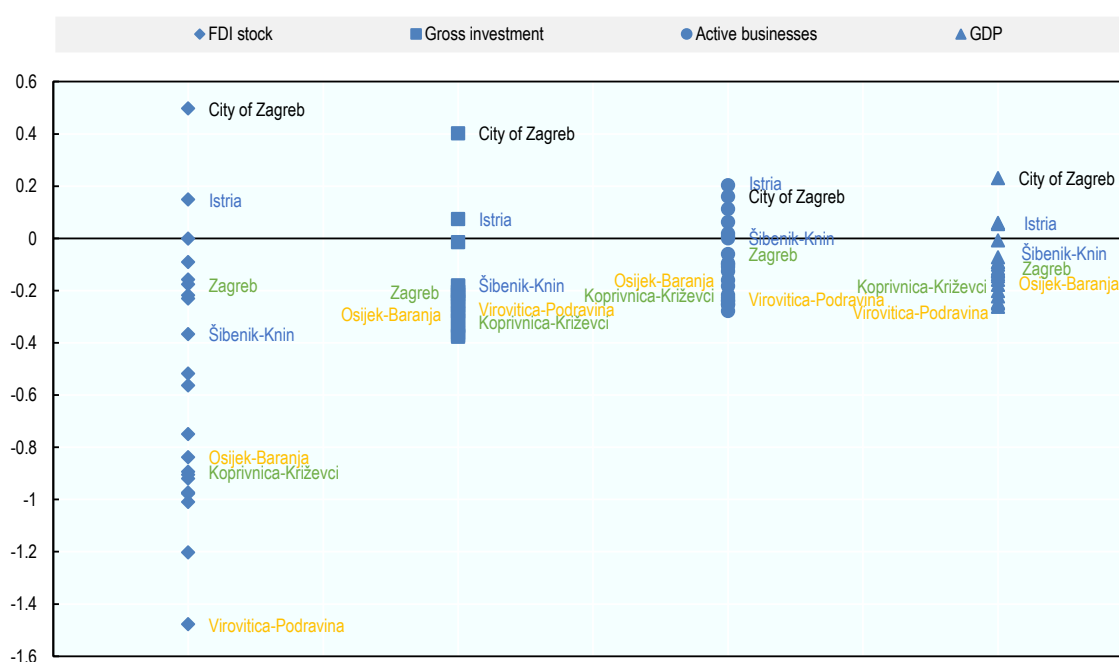
Note: Gini indices in Panel A are adjusted by dividing by (n-1)/n, where n is the number of counties in the region, to ensure comparability.  
 Source: OECD based on Croatian National Bank and Croatian Bureau of Statistics.



The large regional disparities between and within Croatia's regions are expected as foreign multinational activity tends to be less widespread than domestic activity (Lejárraga and Ragoussis, 2018<sup>[2]</sup>; OECD, 2022<sup>[1]</sup>). Usually, industrial and economic hubs represent the main entry point for foreign investors, especially for transition economies, implying a concentration of FDI in these regions despite the efforts by the governments to achieve balanced regional development (Lovrinčević and Mikulić, 2012<sup>[3]</sup>). This hints to agglomeration effects in counties such as Zagreb at the higher end of the FDI distribution. The least developed or attractive counties also strongly drive the dispersion of foreign investment relative to domestic investment and broader business activity (Figure 4.4). But the concentration of FDI in specific regions is not unique to Croatia. The top 10% of OECD regions in terms of FDI attractiveness concentrate half of the total amount of FDI hosted by the OECD area and 40% of total GDP and R&D spendings (OECD, 2022<sup>[1]</sup>).

**Figure 4.4. Dispersion of investment and broader economic activity across Croatia's counties**

Log of ratio of per capita regional foreign and domestic investment, active businesses and GDP to national averages



Note: Values above (below) zero indicate that the county's outcome is higher (lower) than the national average. The shown counties are the best and worst performers in FDI per capita variations from each region. Yellow = Pannonian, Blue = Adriatic, Green = Northern. FDI (1993 – 2021), Gross investment (2020 – 2021), Active businesses (as of 2020), GDP (2015 – 2020). Zagreb refers to Zagreb County.

Source: OECD based on Croatian National Bank and Croatian Bureau of Statistics.

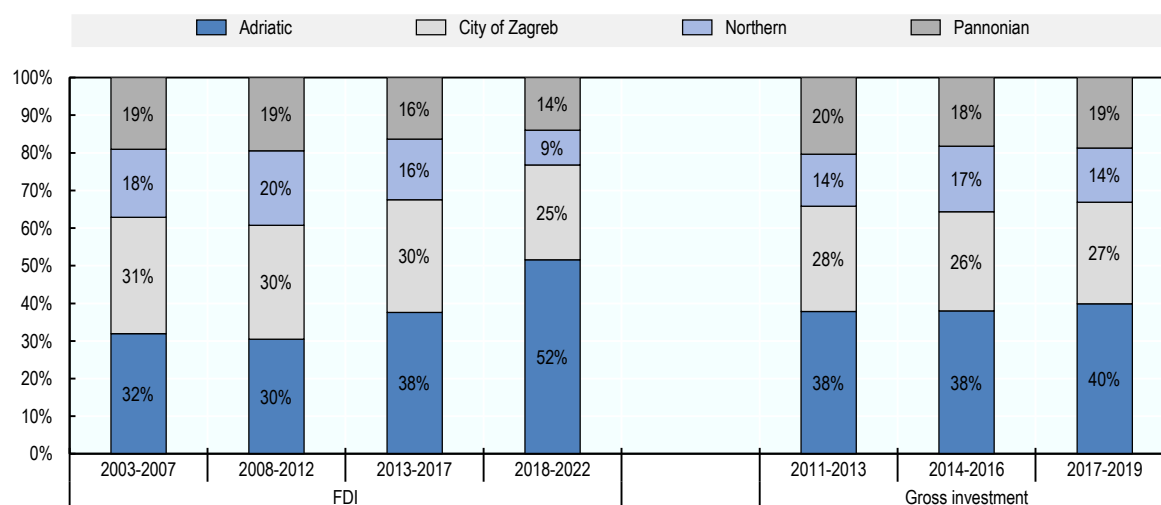
As a country with strong regional disparities, Croatia is struggling to achieve balanced regional development. Ultimately, policy intervention aims to reduce disparities between the most and the least developed areas. Unchanged or even increased concentration of foreign investment across the four regions suggests that decentralisation in the 2000s and subsequent reforms did not contribute to reducing regional disparities in FDI. Regional income disparities even increased between 2004 and 2015 (Jakšić, Erjavec and Cota, 2018<sup>[4]</sup>). From 2003 to 2012, there was a slight reduction in the concentration in greenfield FDI projects across large regions that was reversed in the last decade in favour of the Adriatic region, which received more than half of the total greenfield FDI in the last four years (Figure 4.5). The distribution of gross investment also shifted towards the Adriatic regions but in much lower proportions.

The EU's Cohesion policy promotes regional development. On the other hand, the increased concentration of foreign investment coincides with the entry of Croatia in the EU in 2013, when a series of liberalisation



reforms were implemented. From a global perspective, reduced barriers to trade and investment narrows FDI disparities between countries but can exacerbate disparities within countries as regions become the frontline of competition for global investment and the most prosperous regions are better able to compete. This was the case for the Adriatic region, which in the last decade has become one of Europe's "winners" in FDI attraction, allowing local actors to enjoy higher levels of connectivity and providing new growth opportunities (Crescenzi and Iammarino, 2017<sup>[5]</sup>). Similarly, international trade did not support economic convergence of Croatian regions (Mikulić and Galić Nagyszombaty, 2015<sup>[6]</sup>). More recently, remote or less attractive regions were more adversely affected by the COVID-19 pandemic as foreign investors tend to avoid "riskier" regions when faced with higher uncertainty (OECD, 2022<sup>[1]</sup>).

**Figure 4.5. Changes over time in the concentration of regional foreign and domestic investment**



Source: OECD based on Financial Times fDi Markets and Eurostat.

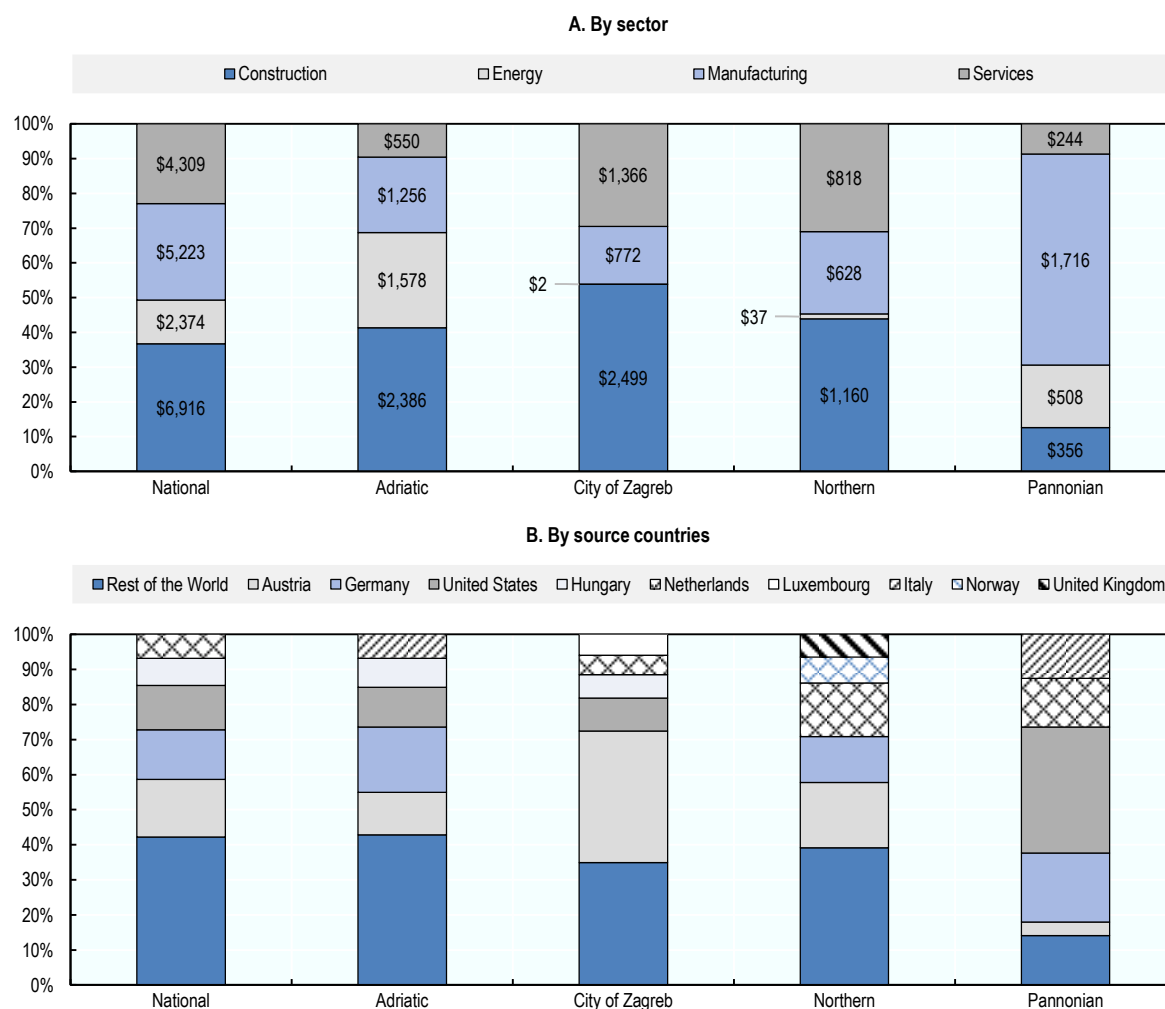
Notwithstanding the concentration of FDI in some regions, counties or cities, it does not mean that all of them compete over the same investors and in the same sectors (Burger, van der Knaap and Wall, 2012<sup>[7]</sup>). In most regions, construction and real estate is the sector with the highest levels of greenfield FDI (Figure 4.6, Panel A). This holds for the Adriatic and Northern regions, as well as for the City of Zagreb where it represents more than half of greenfield FDI. Nevertheless, the nature of the projects varies among these regions. In the City of Zagreb and the Northern region, FDI is mostly in real estate while in the Adriatic region it is primarily in the tourism and involves the construction of hotels and resorts. The Pannonian region is the only one where the manufacturing sector attracted more than half of greenfield FDI. Most of these foreign investments were in capital-intensive activities such as in renewables and wood sector.

Regional specificities and how they shape the sectoral distribution of FDI highlight the value of a place-based approach to investment promotion. Some Croatian regions compete against each other over FDI, while a few have rivals among CEE countries, and a minority, including perhaps the metropolitan area of Zagreb compete in broader Europe or worldwide. Foreign competitors can be very different from one region to another depending, inter alia, on regions' sectoral specificities and distinct positions in global supply chains. The City of Zagreb, having the highest broadband connection density and highest share of skilled workers concentrates services projects and ICT innovations. The Adriatic region attracts larger amounts of FDI in tourism due to its access to the sea and cultural heritage sites and, therefore, most likely competes with other touristic regions in Europe and less with other Croatian regions. Similarly, Pannonia competes against other European regions with similar features, for instance in the wood industry.

Differences in source countries of FDI are another demonstration of the distinct characteristics of the foreign investments that regions compete for and, in turn, the potential benefits from targeted investment

generation activities by national and subnational bodies involved in investment promotion. Akin to trade, FDI in Croatia is closely linked to the EU market, with two thirds of greenfield FDI originating from the EU – other sources include the United States, China and the United Kingdom (Chapter 2). However, FDI source countries vary at the subnational level (Figure 4.6, Panel B). The City of Zagreb attracts a disproportionate amount of FDI from Austria while in Pannonia the United States is the leading investor with 36% of the region’s total FDI, which is much above the country’s share at the national level. Pannonia is also the least diversified in terms of source countries in contrast with the Adriatic and Northern regions.

**Figure 4.6. National and regional greenfield FDI by sector and source countries (million USD)**

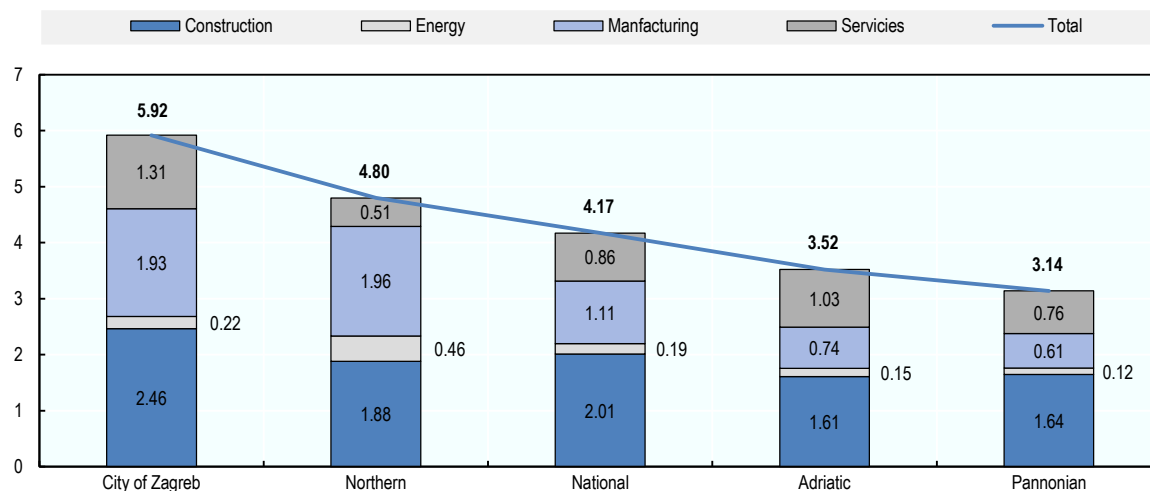


Source: OECD based on Financial Times fDi Markets.

### ***The impacts of FDI on regional development are positive but unevenly distributed***

Foreign investment in Croatia can support regional productivity growth – the main driver for higher living standards – through innovation, skills development and the creation of quality jobs that can help retain youth living in disadvantaged regions from migrating. However, not all regions benefit equally from FDI (OECD, 2022<sup>[1]</sup>). Foreign firms tend to perform better compared to domestic firms in all parts of Croatia, but FDI impacts on productivity, innovation and R&D are often strongest in Zagreb and weakest in Pannonia. The impact of FDI on job creation is also geographically uneven – the same amount of greenfield foreign investment generates twice more jobs in Zagreb City than in the region of Pannonia (Figure 4.7).

**Figure 4.7. Number of jobs created per million USD of greenfield foreign investment per sector**



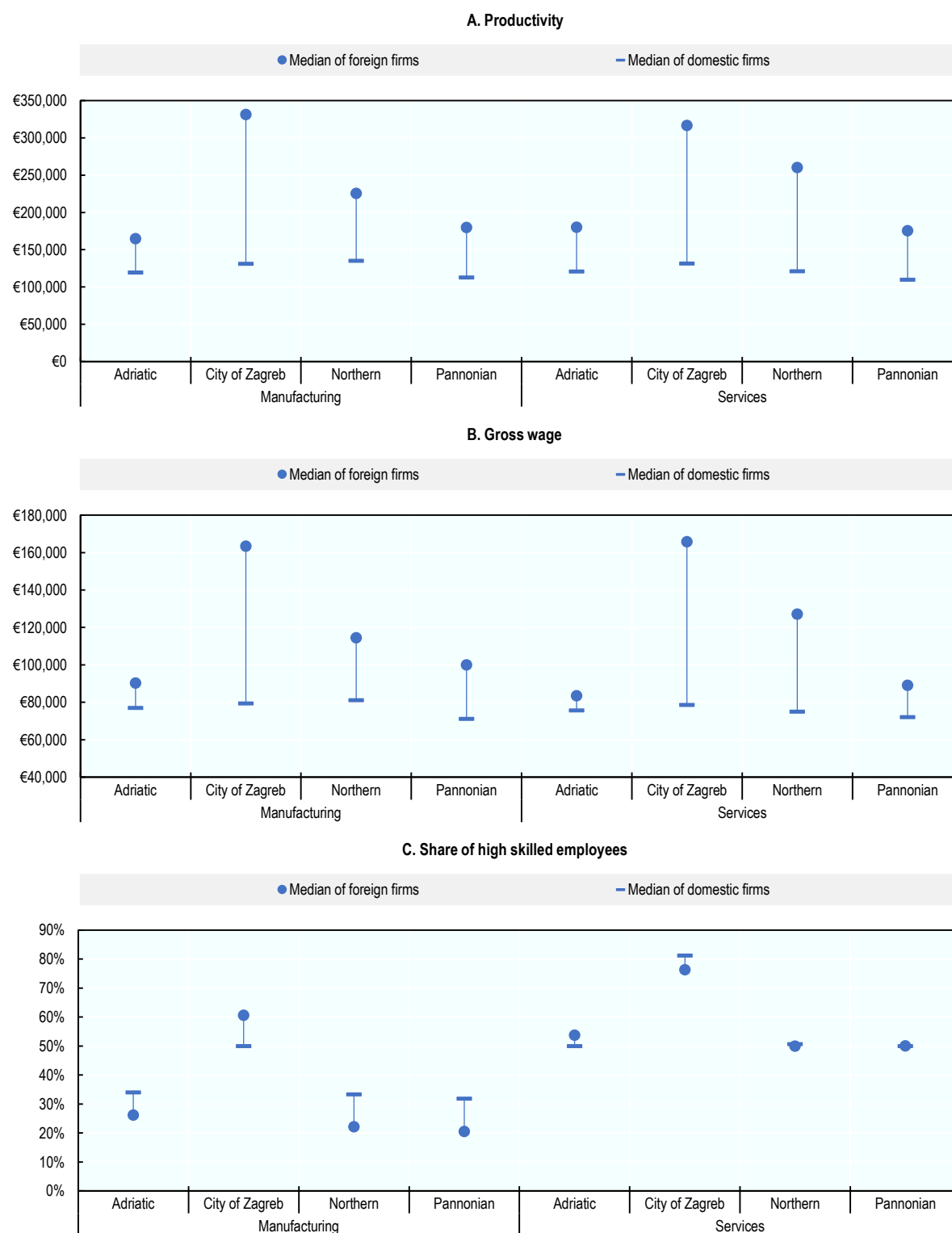
Source: OECD based on Financial Times fDi Markets.

Disparities in FDI impact on jobs across Croatia's regions are largely driven by sectoral compositions, skills availability (or shortages) and R&D activity. Foreign projects in services in the City of Zagreb are the most labour intensive. They often consist of activities relying on high-skilled workers such as business services or IT. Services FDI in the Adriatic region is also highly labour-intensive as it is concentrated in the hospitality industry, in contrast with the Pannonian region where manufacturing is the sector with the highest job creation intensity – most projects are in labour-intensive activities such as textile, food and beverages and industrial equipment. Notwithstanding the large share of manufacturing FDI in the Pannonian region, its job creation intensity is the lowest. Projects are concentrated in capital-intensive manufacturing activities. For instance, one of the biggest foreign investments in the region was a renewable energy manufacturing project that amounted for 878 million USD. Overall, the Pannonian region has a higher unemployment rate than other regions but it attracts FDI in activities with lower labour intensity.

Beyond job creation, FDI affects other local outcomes such as labour productivity, wages and skills development. Foreign firms in Croatia are more productive in all regions, particularly in services, but the productivity premium is much higher in Zagreb City (Figure 4.8, Panel A). Relatedly, organisational and technological premiums of foreign ownership, such as higher wages and stronger R&D intensity, while present in all the country, are more noticeable in the capital and the main urban hubs. This is expected, as companies with significant R&D activities are concentrated in larger cities (Bule and Cudina, 2020<sup>[8]</sup>). For example, the City of Zagreb's foreign wage premiums are the highest for both manufacturing and services investments as the region fosters the most competitive business environment (Figure 4.8, Panel B). While all regions have higher foreign productivity and wages premiums, these premiums do not necessarily translate into higher shares of high-skilled workers in foreign firms (Figure 4.8, Panel C). Nonetheless, the higher productivity and wage premiums are associated with an overall higher share of skilled workers.

The impacts of FDI on regional development in Croatia are also the result of the indirect activities of foreign firms. Compared to other CEE countries, Croatia concentrates low-technology manufacturing FDI but high-technology services FDI (see Chapter 2). Regions with higher shares of services FDI such as the city of Zagreb and the Northern region are therefore expected to generate more knowledge or technology spillovers than those concentrating manufacturing FDI. Furthermore, while services and manufacturing FDI in Croatia tend to create positive spillover effects on local firms in downstream sectors, suppliers only benefit from services FDI. On the contrary, the presence of foreign firms can lead to negative effects on the productivity of local rivals both in services and manufacturing activities (Stojčić and Orlić, 2019<sup>[9]</sup>).

Figure 4.8. Performance comparison of foreign firms versus domestic firms in Croatia's regions



Source: OECD based on the Financial Agency (FINA) of Croatia.

## Place-sensitive policies to promote FDI for regional development

Croatia has not sufficiently and strategically prioritised FDI that supports balanced regional development. This is in contrast with many new EU member states that have developed their convergence strategies with FDI attraction as a central component. In those countries, FDI played a transformative role for regional development by boosting productivity, export diversification, and in upgrading activities in Global Value Chains (World Bank, 2019<sup>[10]</sup>). The 2030 National Development Strategy of Croatia aims to address this gap and provides directions on improving regional competitiveness and attractiveness.

This section reviews Croatia's place-sensitive strategies and investment promotion policies to attract FDI in support of balanced regional development. It leverages the results of the *OECD survey on investment promotion and regional development* filled by national IPAs from the OECD and by Croatia's Ministry of Economy and Sustainable Development (Box 4.1).

### **Decentralisation has shaped Croatia's policy and institutional framework on investment**

The policy and institutional configuration for investment promotion and regional development is inherently complex and Croatia is not an exception. This configuration is largely shaped by the level of centralisation of economic policy and the related governance mechanisms between central and subnational governments or authorities of regions, provinces, cities, etc. Some countries choose to centralise investment promotion at the level of the national body in charge of investment promotion and facilitation, which may or may not have a network of subnational offices. Others, often with more decentralised governance or economic systems, might establish subnational IPAs or similar bodies such as economic development organisations (EDOs) that are partly or fully independent from the central agency (OECD, 2022<sup>[1]</sup>)(Box 4.1).

The process of decentralisation that started in 2001 shaped the architecture for investment promotion and facilitation in Croatia, which became multi-layered, involving many subnational entities in a country of small geographical size. Croatia is subdivided into 4 regions, 21 counties and approximately 555 local governments (428 municipalities and 127 cities) – the city of Zagreb has the status of both a region and a county. Only the third (municipality/city) and second (county) levels are self-governments, however, and therefore nearly all subnational institutions operate at the county and municipality/city level, including those in charge of investment. The first level (regions) is a statistical subdivision created after the country's accession to the EU in 2013 (and revised in 2021 to include 4 NUTS2 regions) and serves to set the amount of EU aid to regions. OECD countries with similar geographical size like Czechia, Costa Rica, Denmark or the Slovak Republic are divided into comparable or slightly higher numbers of third level administrative subdivisions but are composed of significantly fewer second and first levels subdivisions than Croatia (Table 4.1).

**Table 4.1. Tiers of governments and investment bodies in Croatia and selected OECD countries**

	Croatia			Costa Rica			Denmark			Slovak Republic		
	Number	IPA	EDO	Number	IPA	EDO	Number	IPA	EDO	Number	IPA	EDO
Central (NUTS 1)	1	Yes	-	1	Yes	-	1	Yes	-	1	Yes	-
Region (NUTS 2)	4	No	No	6	No	Yes	5	No	No	4	No	No
County (NUTS 3)	21	No	Yes	6	No	Yes	11	Yes*	No	8	No	No
City/municipality	560	No	Yes	82	No	Yes	98	No	Yes	79	No	No

Note: \* Copenhagen Capacity serves greater Copenhagen, an urban area that covers 2 out of the 5 provinces of the Capital region of Denmark. Source: OECD Survey on Investment Promotion and Regional Development (2022); OECD Territorial Grids; EU NUTS classification.

#### Box 4.1. The OECD Survey on Investment Promotion and Regional Development

The OECD IPA Network – a platform that brings together senior investment promotion practitioners to facilitate peer-learning – is exploring how governments can promote, facilitate and retain FDI in support of regional development and what is the role of IPAs. The OECD designed a survey to collect information on investment promotion and regional development. It focuses on the role of national IPAs, their relationships with subnational bodies and their objectives and priorities with regards to attracting FDI in support of regional development. The survey was shared with IPA from OECD countries in the form of an online questionnaire that was completed in 2022 by 36 OECD countries. The results of the survey were presented at the 7th OECD IPA Network meeting in October 2022.

The survey was completed by the Croatian Ministry of Economy and Sustainable Development in 2022 as part of the project on “Advancing the Strategic Framework for the Promotion and Facilitation of Private Investment in Croatia”. The Regional Development Agency and Regional Coordinator of Medimurje County – REDEA – and the Public Institution Development Agency of Lika-Senj County – LIRA – completed the EC/OECD Survey of Institutions and Policies enabling FDI-SME Linkages, which also informed the analysis in this Chapter.

The architecture for investment promotion and facilitation varies greatly from one country to the other. It can be multi-layered and involve several types of subnational entities. The survey defines subnational bodies in charge of investment promotion and facilitation in the following way:

- **Subnational IPAs**, which are organisations fully or principally dedicated to the promotion and facilitation of FDI in their region, state, province, municipality or city, independent from the national IPA or the central government, and usually reporting to subnational authorities.
- **Subnational economic development organisations (EDOs)**, which are also independent entities from the central IPA and government, reporting to subnational governments, but with a broader portfolio that often includes investment promotion and facilitation.
- **Subnational authorities**, many of which are directly involved in economic development issues that sometimes include an investment promotion or facilitation component.
- **Subnational offices of the national IPAs**, which are sometimes established in specific or all regions of their jurisdictions.

Note: See [www.oecd.org/investment/investment-promotion-and-facilitation.htm](http://www.oecd.org/investment/investment-promotion-and-facilitation.htm) for more information.

Source: OECD (2022), “The geography of foreign investment in OECD member countries: How investment promotion agencies support regional development”, OECD Business and Finance Policy Papers, No. 20, OECD Publishing, Paris, <https://doi.org/10.1787/1f293a25-en>.

Defining the “right” territorial division for effective regional planning is a central but complex issue that goes beyond the scope of this report. However, it is crucial to examine what are the implication of Croatia’s territorial divisions on policies at the intersection of investment and regional development. Subnational governments have the autonomy in decision making and management over a widely defined range of policies, including economic development, and the autonomy in establishing independent bodies to implement these policies. They independently dispose of their own income, can adopt general acts for their independent internal organisation and that of their administrative bodies and can cooperate at the national and international levels – an aspect that is potentially non-negligible for investment promotion. State control over subnational governments is limited to verifying the constitutionality and legality of their actions.

The process of decentralisation in Croatia has implications on the capacity of subnational governments to deliver effectively on their economic priorities. Dispersed funding, administrative and oversight responsibilities across different agencies, and the large number of subnational governments spreads

capacity thinly, creates inefficiencies and adds to the challenges of coordinating and monitoring policy (OECD, forthcoming<sup>[11]</sup>). Large Croatian cities are economically influential as attractive investment hubs but politically they depend on their counties, except for Zagreb city that has the administrative status of a county. Furthermore, the bulk of budget continues to come from the central government. In general, decentralisation processes with unfunded mandates, that is, a mismatch between the powers transferred to subnational governments and the resources allocated to them, can represent a serious drag on the positive economic effects of decentralisation (Rodríguez-Pose and Vidal-Bover, 2022<sup>[12]</sup>). For the benefits to materialise in Croatia, it is crucial to ensure that finance adequately follows mandates.

### ***Strategies should better connect investment promotion to regional development***

*The National Plan on Investment Promotion should include a place-based dimension...*

Investment promotion strategies should consider the challenges but also the reasons for FDI to locate in different regions. Croatia has no investment promotion strategy and, in turn, has not set a vision with goals and activities to leverage FDI in support of regional development. The future National Plan on Investment Promotion is an opportunity to consider subnational specificities while also ensuring a balanced approach across regions. If most of Croatia's regions share similar comparative advantages and attractiveness factors, there are also unique specificities. The tourism and wood sectors are obvious examples. Investment promotion efforts – and policy more broadly – to attract FDI in one of these sectors has different effects on the coastal Adriatic region or the hinterland region of Pannonia. In OECD countries that are EU members, all investment promotion strategies include a regional dimension (OECD, 2022<sup>[11]</sup>). In some of them, such as Ireland, regional development is even at the core of the strategy with clear targets (Box 4.2).

The National Plan on Investment Promotion could set targets that reflect FDI attraction priorities of regions, identify specific policies and activities to reach these targets and clarify the role played by different institutions and the related coordination mechanisms. A regional pillar in the Plan should be aligned with the 2030 National Development Strategy, national strategy on regional development, Urban Areas Development Strategies and County Development Strategies. It should be also aligned with EU Cohesion Policy priorities, including priority regions, sectors or activities receiving aid. The development of a regional pillar should involve national and subnational actors such as the Ministry for Regional Development and EU Funds (MRDEUF), local governments of main urban areas and EDOs operating at the county level. In OECD countries, 60% of national investment promotion strategy are developed in cooperation with subnational EDOs (OECD, 2022<sup>[11]</sup>).

*...and subnational governments' strategies should include an investment promotion angle*

Proactive and coordinated efforts to attracting FDI in support of regional development in Croatia require regional plans. Including a regional dimension in the National Plan on Investment Promotion is not sufficient in a decentralised setting where the central government's ability to attract FDI depends on regions taking actions in a planning and development context to improve their attractiveness. Subnational governments may craft their own investment promotion strategies, but most of them are geographically or economically too small to develop a different value proposition from their neighbours. Should a few have a distinct value proposition, possibly urban hubs as the city-county of Zagreb, their investment promotion strategy must be aligned with the National Plan on Investment Promotion. Nearly 75% of OECD countries have regional investment promotion strategies, and 67% of the strategies are embedded in broader regional development strategies. The ministry in charge of investment, subnational EDOs and local authorities are most often leading – or at least involved in – the regional investment promotion strategy design. The private sector and civil society are also strongly involved (OECD, 2022<sup>[11]</sup>).



#### Box 4.2. The Regional pillar of IDA Ireland Investment promotion strategy 2021-2024

IDA Ireland Investment Promotion Strategy 2021-2024 is framed through five interlinked pillars: Growth, Transformation, Regions, Sustainability, and Impact. The Region pillar covers the following dimension:

**Overall objectives.** Partnering with existing regional clients to transform through innovation and upskilling, developing clusters to support transformation, spillovers and linkages, collaborating with clients and stakeholders to facilitate remote working opportunities, and continue to roll-out IDA Ireland essential regional property programme (provision of land).

**Alignment with regional development strategies.** The national context for IDA's approach to attracting FDI for the regions is set by Project Ireland 2040 and the associated National Planning Framework, National Development Plan and Regional Spatial and Economic Strategies. The overarching ambition of national policy on regions is to promote balanced, compact and sustainable growth outside of Dublin. The realisation of these strategic outcomes, through the growth and development of regional cities and towns, would significantly enhance Ireland's value proposition to FDI and support emerging urban locations of scale to become future FDI growth drivers.

**Region's attractiveness to FDI, initiatives and targets.** The pillar has sections for each of the six NUTS-3 level regions with dedicated economic rationale, goals, initiatives to undertake as well as specific targets of investments. In setting goals and targets for each region, IDA considered key attractiveness factors such as population, talent availability, quality of life, industry specific clusters and ecosystems, land availability, local infrastructure and connectivity, availability of property solutions (public and private sector), and alignment with IDA's sector targets.

**Cooperation.** The Strategy indicates that key to IDA Ireland success is strategic collaboration with national and local stakeholders on the enhancement of the regional value proposition for FDI. It recognises that the regional targets will not be achieved without the collective effort and collaboration of all stakeholders with responsibility for regional development. This includes the delivery of necessary infrastructure, the availability of a skilled and future ready workforce, and better quality of life as pre-requisites to attracting FDI. On skills, the IPA will deepen collaboration with training providers and actively participate in the Regional Skills Fora, which provide a single point of contact in each region for employers to connect with the providers as they seek to address emerging skills needs.

**Role of local authorities.** The Strategy indicates that local authorities have a very specific role in placemaking, the provision of infrastructure and services and in ensuring that their regions are seen as attractive to FDI. IDA's ability to attract and retain FDI is dependent upon local authorities successfully and consistently taking actions in a planning and development context to improve the liveability of towns and cities. This includes interrelated policies to ensure: critical population mass and density levels to support services and infrastructure; appropriate mix of housing solutions; access to multiple modes of transportation; and social and cultural amenities to support vibrant communities.

**IDA Ireland Property Division.** IDA Ireland seeks and develops partnerships with key regional stakeholders and local authorities to ensure land, infrastructure and building permits are available in all regions. The Strategy defines specific and concrete actions that IDA Ireland will undertake with local authorities to ensure the availability of property solutions.

Source: (IDA Ireland, 2021<sup>[13]</sup>), IDA Ireland Investment Promotion Strategy 2022-2024: driving recovery and sustainable growth, Government of Ireland, <https://www.idaireland.com/driving-recovery-and-sustainable-growth-2021-2024>



A more realistic and potentially more effective option for Croatia is to embed private investment in County Development Strategies and Urban Areas Development Strategies. Subnational governments should assess how regional development strategies can better leverage FDI to achieve their targets. Strategies should identify what local improvements will help attracting the FDI needed to reach their goal, primarily on land, infrastructure, services and skills, as well as broader investment reforms required at the national level. They should be aligned with sectoral strategies and, if developed, the regional pillar of the National Plan on Investment Promotion. Not all the counties have County Development Plans, however, which largely focus on budget allocation to respective policy areas. They do not include an investment promotion angle but define key sectors that can steer broader regional development. There is no information on Urban Areas Development Strategies, although from the perspective of investment promotion they can be crucial considering the central role of agglomerations on attracting FDI that may also benefit close rural areas.

*Setting the “right” subnational level for an investment promotion strategy can help overcome fragmented planning*

A challenge for Croatia in crafting investment promotion and regional development strategies that echo each other is in setting the cursor to the “right” subnational level. But dimensions such as economic density, connectivity, or local supply chains only partly follow Croatia’s administrative borders. The reform in 2019 that realigned first-level subdivisions – statistical regions – from two to four regions carries opportunities to improve regional planning and, relatedly, aligning investment promotion strategy with regional development (World Bank, 2019<sub>[14]</sub>). The initial first-level subdivisions in just two regions were too large to serve as the basis for regional planning and lacked a clear mandate. From the perspective of investment promotion, the realignment can allow to consider broad regional specificities while generating an attractive FDI value proposition with still large regions allowing for economies of scale. It might be less relevant in terms of investment facilitation, however, as services are best delivered when they are closest to investors.

Should Croatia adopt the first-level subdivision as the unit for the regional dimension in the National Plan on Investment Promotion, then the Plan should be backed by all counties with commitment on implementing it within their jurisdiction and in cooperation with other counties of their first-level subdivision – clear and unified messages across the counties will be essential to ensure implementation. This commitment is crucial as the first-level subdivision lacks a proper institutional setting. Partnership Councils of the first-level subdivision have not fully operated since the realignment of the regions while they could ensure stronger inter-county strategic planning. The realignment to four regions might continue to suffer weaknesses in becoming the basis for broader strategic planning, however, including fragmenting the City of Zagreb from its metro area and vicinity, and separating Karlovac from the more dynamic Zagreb metro to which it is connected. In addition, the other three regions are still large, with the Adriatic region, for instance, remaining unchanged (World Bank, 2019<sub>[14]</sub>).

Croatia should also consider the Integrated Territorial Investments (ITIs) as one relevant unit for strategic planning and implementation of the National Plan on Investment Promotion. The Plan should be aligned with, and supported by, the ITIs to harness Croatia’s largest cities as poles of regional attractiveness. The ITIs is a territorial development tool of the European Structural and Investment Funds that enables the implementation of a territorial strategy with the aim of providing a response to the specific needs or challenges of this territory. The ITIs covers Croatia’s seven largest cities, comprising one fifth of municipalities and nearly half the national population. The impact of the ITIs has been moderate, however, as the underlying strategies have sometimes pooled the distinct priorities of their municipalities, rather than creating a unified approach (World Bank, 2019<sub>[14]</sub>). Furthermore, the ITIs was accountable to the central government – the MRDEUF – rather than their municipalities. It also has narrow geographical boundaries, creating a risk that hinterland rural areas have poor coordination with their nearby cities.

### ***Craft place-sensitive policies to attract FDI for balanced regional development***

Croatia's national and subnational strategies and plans relating investment to regional development should consider the wide range of place-sensitive policies to make FDI work for regional development. They should also identify the complementary reforms and development measures needed to unlock the benefits of investment in the most disadvantaged regions, at the forefront of these institutional and skills development reforms. Furthermore, Croatia should also anticipate how reforms such as the National Plan on Investment Promotion may affect regions differently. While the place-blind nature of national policies, including investment, is often unavoidable and mostly desirable, it is difficult to use them to address challenges in specific regions (OECD, 2019<sub>[15]</sub>).

Croatian regions are not always affected in the same way by national policies such as trade and investment agreements; horizontal or sector-specific FDI restrictions, including on land ownership; company registration; and sectors-specific tax and non-tax incentives. Trade and investment liberalisation, for example, is in aggregate positive for a country, but not all regions benefit equally from it (OECD, 2019<sub>[15]</sub>). In Slavonia, for instance, the central government could better align investment incentives with the region needs and reassess regulatory barriers to FDI in some dynamic sectors of the region such as the wood industry (World Bank, 2019<sub>[10]</sub>).

Place-based investment promotion and facilitation policies that can directly influence the location choice of foreign firms include tax and non-tax incentives (see also Chapter 5), establishing industrial parks or special economic zones and, as discussed in the next section, creating dedicated subnational bodies in charge of promoting and facilitating investment (OECD, 2022<sub>[11]</sub>). Other policies encompass broader regional business climate policies, such as public investment in skills and infrastructure, as well as support to local firms – including advice on how to enter foreign markets, financing of R&D activities and policies to favour labour mobility (OECD, 2018<sub>[16]</sub>). By improving the local ecosystem, a region not only becomes more attractive but can also benefit more from FDI, including through high-skilled job creation and higher productivity spillovers (OECD, forthcoming, 2023<sub>[17]</sub>). Chapter 3 reviews broader business climate policies.

#### *Investment promotion efforts to attract FDI for regional development can be improved*

Targeted policy tools and measures used by Croatia to promote FDI in support of regional development are similar to those used by OECD countries, with one main difference (Table 4.2). The services provided by the national IPA is the most frequently reported measure in OECD countries while in Croatia the MESD's Internationalisation Directorate indicates that the services it provides are less relevant than granting tax and non-tax incentives and establishing industrial parks or Entrepreneurial Zones. This corroborates the discussions in the next section that the Directorate does not see itself as the main institution responsible for promoting FDI in support of regional development.

**Table 4.2. Policy tools and measures to promote FDI in remote or less developed regions**

Ranking	Croatia	OECD average
1	Non-tax incentives (e.g., grants, subsidies, loan guarantees)	The IPA services
2	Tax incentives	Non-tax incentives (e.g., grants, subsidies, loan guarantees)
3	Industrial, business or science and technology parks	Tax incentives
4	Provision of infrastructure	Industrial parks
5	The MESD's Internationalisation Directorate services	Provision of infrastructure
6	Local/regional business environment improvements	Local/regional business environment improvements
7	Free Zones	Special economic zones
8	Local/regional fairs	Local/regional fairs

Source: OECD Survey on Investment Promotion and Regional Development (2022).

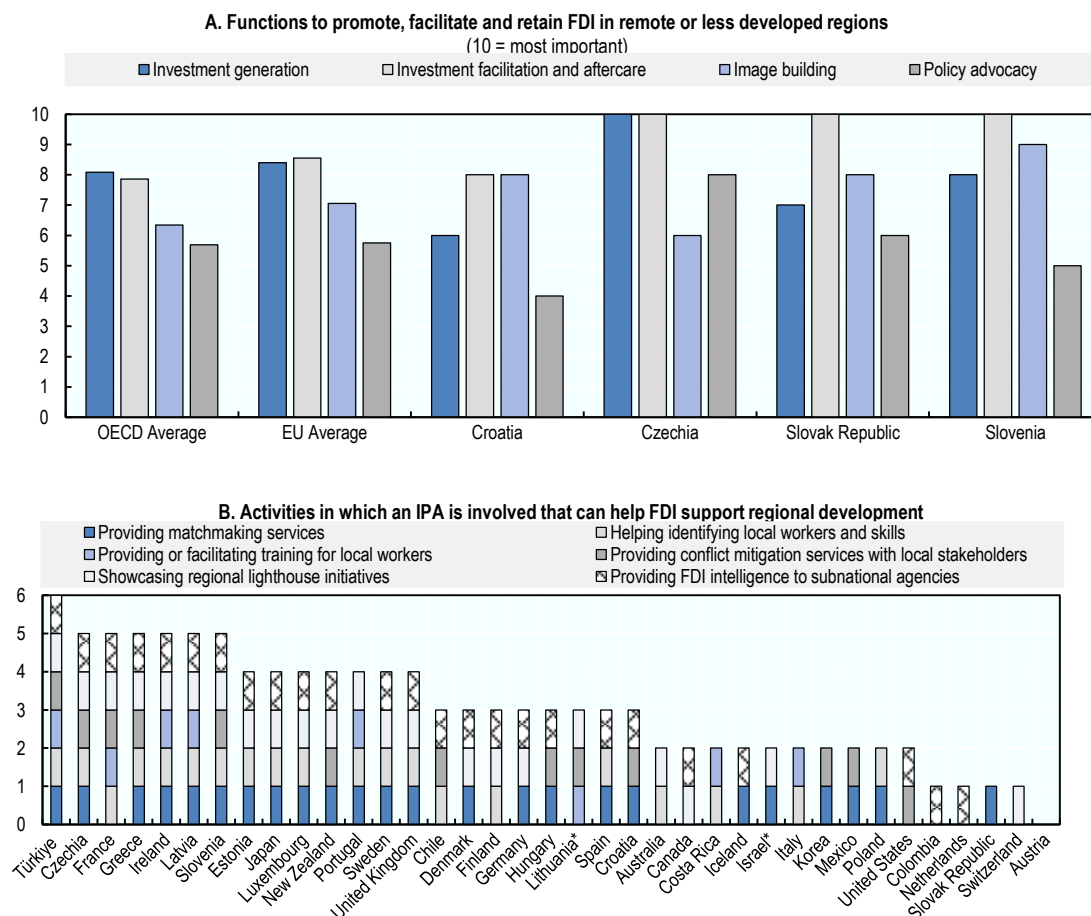
Entrepreneurial Zones are established under the Act on Improving Entrepreneurial Infrastructure (Figure 4.11). Most of them provide amenities to businesses such as energy, utilities, transport and communication infrastructure. In some cases local governments also provide benefits in form of reduced communal fees or buying land for buildings at favourable conditions. It is not mandatory to locate in a business zone, but they provide a fast-track to establish an investment in an area equipped with the adequate infrastructure. Croatia counts 313 zones that are listed on the MESD website. The occupancy rate of zones in Northern Croatia is higher than in other regions and in some zones it reached 100%.

Place-based tax incentives are commonly used by Croatia and OECD countries, but the schemes vary across countries depending on their policy goals (OECD, 2022<sup>[11]</sup>). Their effectiveness is uncertain, however, particularly since some of Croatia's schemes use the unemployment rate to single out beneficiary locations (see Chapter 5). In fact, the job creation intensity of FDI projects in the City-County of Zagreb or Northern Croatia is higher than in Pannonia. Incentives in Croatia are financed by the state budget but must comply with EU state aid rules. Evidence suggests that much of the success of the FDI-led economic growth policies of CEE Countries is due to investment incentives that national governments made available in the form of state aid. Not all types of state aid are equal in their impact on attracting FDI for regional development, however (Schito, 2022<sup>[18]</sup>). Overall, there is no relationship between EU spending and FDI inflows in poorer regions that also receive the bulk of financial support (Crescenzi, Di Cataldo and Giua, 2021<sup>[19]</sup>).

Entrepreneurial Zones have a positive impact on domestic and foreign investment – the share of foreign firms is higher than outside of the zones, sales and export of firms located within them. Their positive effects are confined to host and neighbouring urban areas, however, with limited spatial redistribution and economic spillovers effects (Stojčić, Pylak and Alibegović, 2022<sup>[20]</sup>). This calls for better integrating Entrepreneurial Zones into their regional ecosystem by aligning targeted sectors – if any – and local supply chains they serve with County and Urban Area plans. Organising or attending fairs and establishing free zones are the least frequently used tool to attract FDI in support of regional development according to the MESD; free zones have lost much of their benefits since Croatia joined the EU.

Among the different activities of the MESD's Internationalisation Directorate to attract FDI in less developed or remote regions, image building and investment facilitation are more used than investment generation and policy advocacy (Figure 4.9, Panel A). Investment facilitation is also the most useful function for national IPAs in the OECD, yet equally with investment generation, while image building is less important. Among CEE countries, the IPAs of the Slovak Republic and Slovenia rank their functions in a way comparable to Croatia, while the Czech IPA relies more on investment generation than image building. The focus on image building may be related to the fact that the less developed regions of recent EU members are less known to investors and suffer from a negative image due to, *inter alia*, perceptions of corruptions, labour shortages and distance from target markets. Regions' unfavourable image is listed by the MESD as a more important challenge for FDI to locate in remote or less developed regions than for OECD countries (Table 4.3). Surprisingly, advocating for reforms that can promote FDI in support of regional development is a relatively unimportant function of the Directorate, while an IPA that is part of a Ministry could give it more political clout.

**Figure 4.9. Activities of national IPAs to promote and facilitate FDI in support of regional development**



Note: \* Countries with no subnational IPAs or EDOs and therefore excluded from the category "Providing FDI intelligence".

Source: OECD Survey on Investment Promotion and Regional Development (2022).

The MESD's Internationalisation Directorate provides other services to investors or subnational partners that can make FDI work for regional development, in addition to core investment promotion and facilitation activities. They include typical activities such as matchmaking services to investors – this is even more relevant in the case of Croatia as SME development is one of the MESD's mandates – and providing FDI-related intelligence to subnational EDOs (Figure 4.9, Panel B). Providing FDI intelligence reflects a good degree of collaboration between national and subnational agencies and can help identify distinct FDI markets across Croatian regions (Box 4.3).

Conflict mitigation between investors and local stakeholders is one service that the Directorates provides that is less commonly delivered by IPAs of OECD countries. This could be due to the need for third-party intervention in a context of regional autonomy. The service could be also a result of the Act on Strategic Investments that the MESD oversees. The Act aims at solving conflicts with subnational governments, often on land issues, to fast-track business establishment. The Act covers only large investment projects; most of them are public investments and only few are foreign owned.

### Box 4.3. FDI intelligence can help craft strategies and policies tailored to regions' potentials

The multiplicity of investment promotion activities at the subnational level does not necessarily have to generate a race to the bottom. While the risk of exacerbated competition between Croatian counties or cities is real, particularly considering the small size of the country, competitors can often be regions outside the national borders. If FDI concentrates in Zagreb, it does not mean that all Croatian regions compete for the same investors and in the same sectors, as shown in section one. This underlines the importance for IPAs involved in investment promotion, either the MESD's Internationalisation Directorate or local agencies, to know whom their rivals are and for which economic activity they are competing. This comparative information can help the Internationalisation Directorate and some EDOs craft investment promotion strategies tailored to the competitive strengths and potentials of each territory. It can also help developing policies that connect foreign investors with local suppliers. For instance, small cities may deploy massive efforts to attract large, top-end, companies (e.g. by offering generous and discretionary tax incentives, although EU state aid rules limit this) instead of focussing on smaller investors that they can realistically attract. Investment promotion efforts to attract such second-tier firms might prove useful as these may forge stronger linkages with local companies than large top-firms because of lower absorptive capacity gaps and higher labour mobility (OECD, 2022<sup>[21]</sup>).

#### *Attracting FDI for regional development goes beyond typical investment promotion efforts*

Policies to increase regional attractiveness in Croatia – and, in turn, reduce FDI disparities – should go beyond investment promotion to address the country's broader regional development challenges, including skills shortages or imbalances, inadequate infrastructure and logistics and low business density levels (Table 4.3). Policies addressing regional disparities are often designed and implemented at national level, however, with limited involvement of subnational governments. This is also the case in other EU countries where subnational authorities execute only a small share of public expenditure such as Hungary, Portugal and Slovenia (European Commission, 2022<sup>[22]</sup>). Measures that can support improving the broader regional business climate should also be better tailored to the needs and potential of the different Croatian regions. Lagging-behind regions lacking economic and population density could further reinforce their institutions and invest in human capital, while denser lagging areas could benefit from investments in trade logistics to be better integrated with dynamic external markets (World Bank, 2019<sup>[14]</sup>).

**Table 4.3. Main challenges for FDI to locate in remote or less developed regions**

Ranking	OECD average	Croatia
1	Lack of adequately skilled labour	Lack of adequately skilled labour
2	Poor infrastructure or connectivity	Poor infrastructure or connectivity
3	Distance to suppliers and clients	Distance to suppliers and clients
4	Difficulties in interacting with regional or local authorities	Unfavourable image
5	Lack of dedicated state support	Difficulties in interacting with regional or local authorities
6	Unfavourable image	Lack of dedicated state support

Source: OECD Survey on Investment Promotion and Regional Development (2022).

Addressing labour and skills shortages or imbalances in Croatia is potentially the most pressing policy action to attracting FDI to regions (see also Chapters 2 and 3). In the Adriatic region, for instance, a third of people are not yet familiar with using a computer, which has a direct incidence on using e-government services to start a business (European Commission, 2022<sup>[22]</sup>). With Croatia's new policy of facilitating foreigners' entry, the central and subnational authorities should consider how investment promotion efforts

serve broader policies to retain the youth from migrating while letting foreign workers enter to reduce labour shortages. This may improve the situation in the tourism and construction sectors, for instance, on which Western Croatia strongly relies to attract FDI. The inadequacy of skills available with investors' needs is one related challenge. Attracting talent, including foreign, and facilitating workers' entry is becoming intrinsically connected with FDI attraction (OECD, 2022<sup>[21]</sup>). The MESD's Internationalisation Directorate connects human resources agencies with investors as in several OECD countries where the national IPA helps investors identify local workers with relevant skills (Figure 4.9, Panel B). Agencies such as IDA Ireland go even further by collaborating with local training providers to facilitate training and by participating in regional skills fora to anticipate and, in turn, address emerging skills needs (Box 4.2).

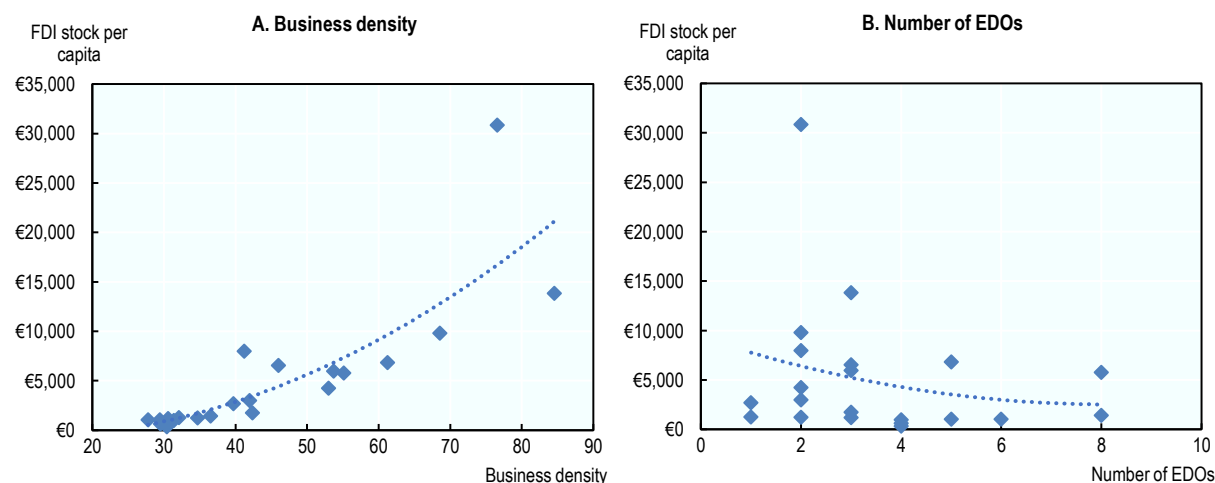
Providing support to investors to address skills shortages does not have to become an activity of the MESD's Internationalisation Directorate, but the Directorate should consider broader policy complementary. In fact, identifying suitably trained workers or helping investors establish a training centre can be successfully addressed by relevant subnational bodies such as EDOs as they are close to investors' operations and know best their skills needs (Crescenzi, Di Cataldo and Giua, 2021<sup>[19]</sup>). Reducing labour or skills shortages is not only important to attracting FDI in less attractive regions of Croatia but also to ensure that FDI generates positive impact. Less heated local labour markets mitigate possible adverse effects of FDI on the labour market. Foreign entrants' competition for talent with domestic firms drives up wages, but potentially reduces the ability of the latter to hire or retain more skilled workers. This effect is stronger in industries facing skills shortages and in locations with limited labour mobility (OECD, 2022<sup>[21]</sup>). In Croatia, employees that left their employers to work in a foreign firm were likely to do it because they held temporary contracts, were better educated, and worked in a small firm that did not invest in workers' training and offered lower average wages. Employees moving from a domestic to foreign firm often move within the same region, suggesting limited geographical labour mobility (Laengle and Srhoj, forthcoming<sup>[23]</sup>).

The OECD team consultations with the cities of Osijek and Novska, where foreign firms account respectively for 14% and 10% of employment, revealed how the local government coordinates with local actors such as public employment services and universities to address skills shortages by granting scholarships or opening education centres to provide skills in high demand such as ICT expertise. The consultations also indicated that domestic companies sometimes fear that large foreign entrants might hire their talented workers by offering higher wages. While reskilling or upskilling support is essential to respond to skills shortages, pre-employment training programmes can also be considered by Croatia to help some host regions prepare future workers, particularly youth transitioning from school to work, with relevant skills. Pre-employment training programmes could be even designed specifically to quickly respond to the needs of large foreign firms considering investing. One example is Assured Skills, a state programme in Northern Ireland that prepares and trains workers for guaranteed jobs in new foreign firms (OECD, 2020<sup>[24]</sup>). Supporting investors – for instance through targeted tax incentives or administrative simplification – in establishing their own training centres or programmes is another avenue to addressing labour shortages.

Lack of infrastructure connectivity is another obstacle for the attractiveness of regions in Croatia, particularly in denser areas that could benefit from investments in trade logistics to be better integrated with dynamic external markets (World Bank, 2019<sup>[14]</sup>). Croatia enjoys high levels of accessibility to international markets and a strong network of transport infrastructure (namely ports and motorways), but road performance is lower than most EU countries (European Commission, 2022<sup>[22]</sup>). Furthermore, Croatia lacks essential connectivity complements, such as trade logistics, which inhibit its trade capacity, human capital movement and overall integration to global value chains. On the other hand, FDI can finance infrastructure connectivity needs in Croatia, but spatial differences exist. The region of the City of Zagreb, for instance, attracts more than two thirds of greenfield FDI in the ICT sector. Furthermore, the City of Zagreb and the Adriatic region concentrate two thirds of total transportation and logistics greenfield FDI while the Pannonian region receives the lowest amount of FDI in connectivity-related projects. The lack of skilled workers, critical for sectors such as ICT, has only exacerbated the problem (World Bank, 2019<sup>[25]</sup>).

Other major challenges for the attraction of FDI into remote and less developed regions – particularly those in the East of Croatia – are the low business density and low productivity levels of local SMEs. Businesses tend to concentrate in large urban hubs, contributing to agglomeration effects that help attract FDI (Figure 4.10, Panel A). Regions in East of Croatia tend to report more that regulations, including business licensing, are major challenges. Policies to address these challenges include local bodies in charge of facilitating business establishment. A higher number of ESIs that are local or county development agencies are present in regions with lower levels of FDI and business density, which may indicate an effort to addressing existing challenges. More broadly, the quality of local institutions is a strong factor of FDI attractiveness, including to attract higher quality FDI with larger gains from spillovers (Amendolagine, Crescenzi and Rabellotti, 2022<sup>[26]</sup>). Increased transparency and reduced corruption levels, faster procedures in courts and, relatedly, land ownership are all essential to unlocking regional development in Croatia.

**Figure 4.10. Relationship between FDI per capita, business density and EDOs**



Source: OECD based on Croatian National Bank and Croatian Bureau of Statistics.

Cluster policies can also help increase business density and boost local productivity in less developed regions through industrial specialisation (i.e., specialised skilled workers and suppliers) and geographical proximity that make knowledge spillovers more likely to happen (OECD, 2022<sup>[21]</sup>). For instance, firms that form part of the Croatian wood cluster in the Pannonian region presented higher productivity levels, higher revenues and above average wages compared to non-members as they facilitate knowledge-sharing between actors and help firms reduce transaction costs (Stojčić, Anić and Aralica, 2019<sup>[27]</sup>). In the past, the development of clusters was supported by the MESD and resulted in collaborative business initiatives such as those in the wood processing and automotive sectors (see Chapter 3).

## The multi-level institutional framework for investment and regional development

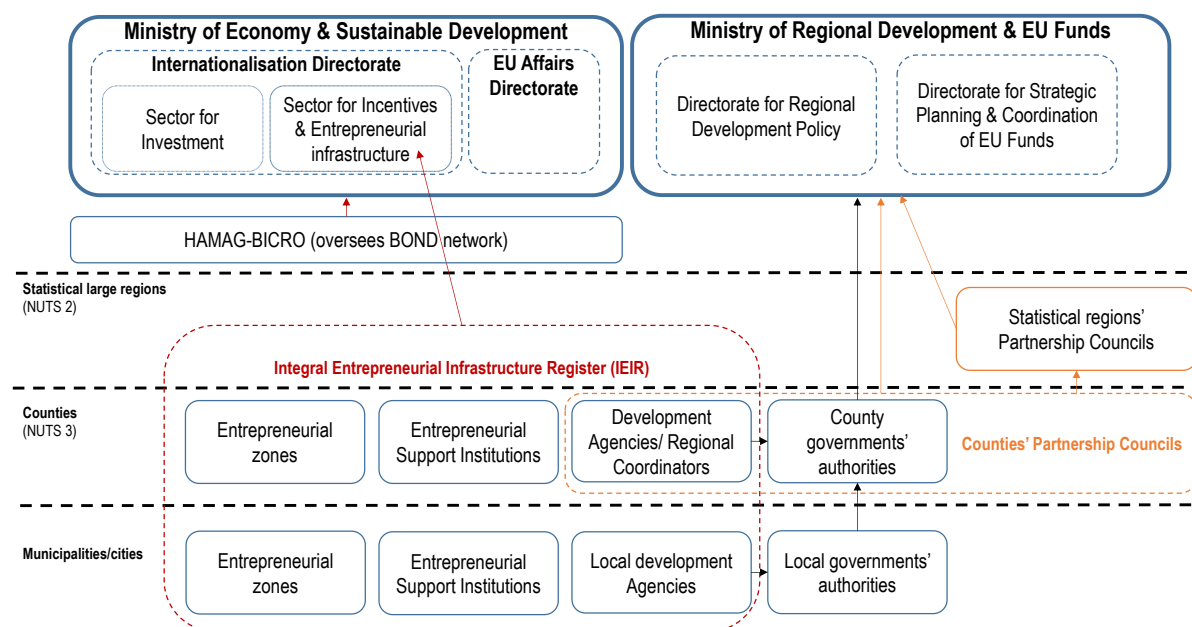
This section reviews the multi-level institutional framework for investment promotion and facilitation practices in Croatia. The way Croatia and governments around the world organise the institutional framework relating investment promotion to regional development reflects their strategic priorities and policy objectives. These choices can influence success in attracting FDI at the subnational level and reap its benefits for balanced regional development. The section leverages the results of the *OECD survey on investment promotion and regional development* (Box 4.1). The responses of the Regional Development

Agency of Medimurje County and of Lika-Senj County to the *EC/OECD Survey of Institutions and Policies enabling FDI-SME Linkages* also informed the analysis in this Chapter (see also Chapter 3).

### **Several national and subnational bodies share the mandate to promote investment**

With the decentralised governance arrangements in place, policymaking in Croatia should consider FDI in support of regional development as a mutual responsibility shared by different ministries and levels of government. Rather than a clear-cut separation of responsibilities, most duties, including investment, have increasingly been shared across different ministries and levels of government, each with different reporting lines (Figure 4.11). The trend toward shared responsibilities has increased over the past decades in other countries too (OECD, 2019<sup>[28]</sup>). The need to share responsibilities arises for practical reasons – as is common between different tiers of government around issues of transport, infrastructure, and environment. On the other hand, decentralised investment promotion calls for investment priorities defined at the subnational level to be effectively aligned with national strategies and policies.

**Figure 4.11. Croatia's institutional framework for investment in support of regional development**



Source: OECD elaboration.

At the national level, the MESD has authority over several levers to channel FDI in support of regional development that are comparable to those in the hands of national IPAs of OECD countries (Table 4.4). Regulation No. 97 of 2020 organising the Ministry's work states that the Internationalisation Directorate oversees improving the investment climate and the country's entrepreneurial infrastructure for balanced regional development. The Directorate has also the mandate to coordinate investment promotion and facilitation activities, in cooperation with all relevant national and subnational government units and agencies. Responsibilities of the Directorate go beyond typical investment promotion and facilitation to also cover policy or supervisory mandates influencing regional development, particularly the responsibility over the Act on Improving the Entrepreneurial Infrastructure that provides for the creation of entrepreneurial zones and entrepreneurial support infrastructure (ESI) discussed in the next sections.



**Table 4.4. Investment promotion mandates related to regional development in Croatia and OECD**

	Croatia		OECD	
	MESD	Autonomous agency	Department in a Ministry	
Promote and facilitate FDI in support of regional development	Yes	92%	90%	
Promote and facilitate FDI in specific regions	No	48%	60%	
Promote SME development or domestic investment	Yes	48%	40%	
Promote regional development	No	36%	10%	
Manage special economic zones or industrial parks	Yes	12%	20%	

Note: Autonomous agencies include public, private and public-private investment promotion agencies.

Source: OECD Survey on Investment Promotion and Regional Development 2022 and OECD Survey of Investment Promotion Agencies 2018.

In practice, however, the MESD does not seem to use all levers it has at its disposal – or does not use them to their potential – to promote investment for regional development. The greatest impediments seem to be the lack of resources within the Ministry, unclear mandates or overlapping responsibilities with other ministries and limited coordination with relevant national and subnational bodies. The Internationalisation Directorate indicates in the *OECD Survey on investment promotion and regional development* that it is the least important body in promoting and facilitating FDI at the subnational level (Table 4.5). This contrasts starkly with OECD countries where the national IPAs overwhelmingly report being the main agencies in charge of this mandate. Relatedly, the Internationalisation Directorate places regional development at 6 on a scale from 1 to 10 in terms of its priority, against an average of 7.3 for IPAs of OECD countries and 7.5 for those that are also EU members (OECD, 2022<sup>[1]</sup>). In Czechia and the Slovak Republic, both national IPAs place regional development as a top priority, with a score of 10.

**Table 4.5. Agencies promoting FDI in support of regional development in Croatia and OECD**

Ranking of agencies from the most to least important (1= most important agency)

	OECD average		Croatia
The national IPA	1.4	4	MESD's Internationalisation Directorate
The national IPA's headquarters	2.1	--	--
The subnational EDOS	2.6	2	Local & county development agencies
The subnational IPAs	2.6	--	--
The regional or local authorities	2.9	3	Cities, municipalities & counties
The national IPA's subnational offices	3.9	--	--
Other	4.3	1	Ministry of Regional development & EU Funds

Source: OECD Survey on Investment Promotion and Regional Development 2022.

Regional development is less of a priority for the MESD's Internationalisation Directorate because it perceives the MRDEUF as the most important body for promoting FDI in support of regional development (Table 4.5). Regional development policies of the MRDEUF aim at improving working and living conditions in all parts of Croatia, especially in less developed areas. These policies also contribute to improving the overall attractiveness of regions and, in turn, should complement the work of the MESD on attracting FDI and improving the investment climate. Overlaps exist over which ministry is acting as the central coordinating body for the network of subnational local and county development agencies established under the Act on Improving Entrepreneurial Infrastructure. Regulation No. 97 of 2020 on the organisation of the MRDEUF states that the Ministry manages their accreditation process, as indicated in the Act on Regional development of 2018. Other areas of overlap exist but they are less problematic. For instance, according to Regulation No. 97, the MRDEUF's Department of Island Development Policy coordinates and implements promotional activities to attract investment. It is not clear if these activities overlap with or complement the work of the MESD's Internationalisation Directorate.

Beyond regional development policies, the MRDEUF is also the coordinating body for the management of the European Structural and Investment Funds and for implementing the EU Cohesion Policy (Figure 4.11). This mandate is behind most of the overlapping responsibilities between the two ministries on FDI in support of regional development. The EU-level policy shapes Croatia's priorities and targets of development policies, including in terms of focus sectors, through mandatory co-financing and various regulatory constraints. EU policy also directs regional fundings towards specific sectors and activities to unleash regional competitiveness.

The MRDEUF has also undertaken work on regional value chains and investment promotion, including a project on leveraging FDI as a driver of economic growth in Pannonia. The project includes a component on establishing an institutional framework for investment promotion in this region (Box 4.4). MRDEUF has also established Coordination Councils for industrial transition on NUTS 2 level for Adriatic, Pannonian and North Croatia, which consists of County perfects. Cooperation between the MRDEUF and the MESD should be reinforced in this area.

#### Box 4.4. FDI Promotion: Ministry of Regional Development and EU Funds project with Pannonia

Croatia launched in 2017 a project aimed at helping Slavonija, Baranja and Srijem increase the efficiency and effectiveness of EU funding. The region includes the five counties of Osijek-Baranja, Vukovar-Srijem, Brod-Posavina, Pozega-Slavonia, and Virovitica-Podravina. In 2020, the counties of Bjelovar-Bilogora, Sisak-Moslavina and Karlovac have been added to the project to reflect the new NUTS-2 territorial classification, and now cover Croatia's Pannonia region (NUTS 2 level). The World Bank was requested to support the government through a technical assistance intervention labelled "Growth and Jobs in Eastern Croatia". The assistance covers several aspects, including one pillar on promoting FDI in Eastern Croatia. The MRDEUF initiated the project and set the framework, but the beneficiary of the work would be the MESD. Activities under the pillar include:

1. **Planning and sector prioritisation.** Develop an FDI Action Plan for Eastern Croatia to set targets, prioritise promising subsectors (ICT, agribusiness, mechanical engineering), outline investor services and clarify other investment-related aspects of the strategy.
2. **Investor services.** Detail the specific services provided to potential and existing investors in the priority subsectors (proactive promotion) as well as in other subsectors where investors show interest (reactive promotion). Investor services will cover the full investment lifecycle, including FDI attraction, retention, growth and linkages to the domestic economy.
3. **Institutional Framework.** Ensure a coordinated, mutually reinforcing agency framework with clear roles and responsibilities. New elements relate to the Eastern Croatia FDI Steering Committee (strategic role), the Eastern Croatia Investment Hub (operational role), the County Governments (operational role) and the Ministry of Economy, Entrepreneurship and Crafts (operational role). The framework will be underpinned by a Memorandum of Understanding and operating procedures.
4. **Recruitment, capacity building and office space.** Boost the investment promotion resources and capacity of all agencies, and to develop a capacity building programme on investment promotion for staff both at the Hub and in the County Governments.

The project's document indicates that operations would run through to the end of 2022, but funding would be required beyond this date for the FDI Promotion activities to continue running throughout the 2021-2027 period. Point 3 on the revamped institutional framework has not been implemented yet.

Source: (World Bank, 2019<sup>[25]</sup>), Strategic projects for Slavonija, Baranja & Srijem 2014-2020: FDI Promotion, The World Bank.

### ***Subnational investment promotion evolved with the absorption of the IPA into a Ministry***

Challenges in delineating the responsibilities of the MESD and MRDEUF in promoting FDI in support of regional development are expected for a mandate that can hardly sit in one single body. This challenge is ever greater in a context where EU Funds play a massive role in determining investment and regional development policies. Unclear or overlapping responsibilities are, however, only one reason why promoting FDI across regions is not a top priority for the MESD. The configuration where a directorate in a ministry – and not an autonomous agency as it was the case until 2019 – is responsible for promoting investment might be another, albeit related, reason (see also Chapter 3). Among the IPAs of OECD countries, for instance, more than two-thirds of autonomous agencies have a mandate to promote regional development, while this ratio is of 10% for IPAs that are departments in a ministry (Table 4.4). On the other hand, managing SEZs or industrial parks is more common in IPAs within Ministries, as in Croatia, than when they are separate agencies.

The national IPA that was dismantled – AIK – did not have regional development as part of its official mandate, but it has *de facto* supported regional development in certain ways (OECD, 2019<sup>[29]</sup>). For example, AIK helped promote regions in its activities with investors and created promotional materials for certain regions. Most importantly, under the Strategy for the regional development of the Republic of Croatia until 2020, AIK was in charge of creating a unified communication model towards investors on all levels of the Government, providing support to the activities of regional development agencies and developing joint actions for several counties and local units in attracting foreign and domestic investments.

The absorption of the AIK into a Ministry can give it more political clout, but it is likely that autonomous IPAs have more flexibility in promoting FDI for regional development. They operate at the implementation level with often limited involvement in the policymaking process, in contrast with IPAs in departments of Ministries that tend to combine investment promotion with regulatory or policy functions, as it is the case in Croatia. Furthermore, autonomous agencies can report to different ministries or to an inter-ministerial taskforce. In France, for instance, the national IPA is an autonomous agency that reports to four different Ministers, including the Minister of Economy and the Minister of Regional Cohesion, and, in turn, the agency has the mandates of promoting both investment and regional development. The IPA established Team France Invest, a system that brings together public actors in charge of attractiveness at regional, national and international level to support new investors and to anticipate the needs of already established firms and of territories. The structure supports coordinated action at different levels of government to ensure better clarity of the available offer vis-à-vis foreign targets (OECD, 2022<sup>[1]</sup>).

Notwithstanding the existing governance challenges, Croatia's revamped institutional framework to channel FDI for regional development presents some opportunities. Realising them implies to clarify responsibilities, ensure coherence of objectives, and facilitate cooperation not only between the MESD, other ministries and subnational bodies, but also within the MESD. The absorption of the AIK into the MESD brought the mandates over investment promotion and the oversight of subnational entrepreneurship support institutions and free zones under the same roof – the one of the Internationalisation Directorate. Accordingly, the Directorate is home to the Investment Sector, a department composed of former AIK staff, and the Sector for Incentives and Entrepreneurial Infrastructure, which was historically part of the Ministry.

If the MESD's Investment Sector promotes Croatia as an FDI destination, in cooperation with local bodies, it is the Incentives and Entrepreneurial Infrastructure Sector that is tasked with improving the investment climate for balanced regional development. The division of labour between the two Sectors on promoting FDI for regional development could be further clarified as both are mandated to conduct investment promotion and provide services to potential and established investors as per the Ministerial Regulation. Furthermore, within the Incentives and Entrepreneurial Infrastructure Sector, it appears that, while the Sector is formally the central body for ESI, the *de facto* oversight bodies are the subnational authorities. There is no central coordinating body for the network of ESI (OECD, 2019<sup>[29]</sup>).

### ***Subnational agencies promoting investment are crucial but highly fragmented players***

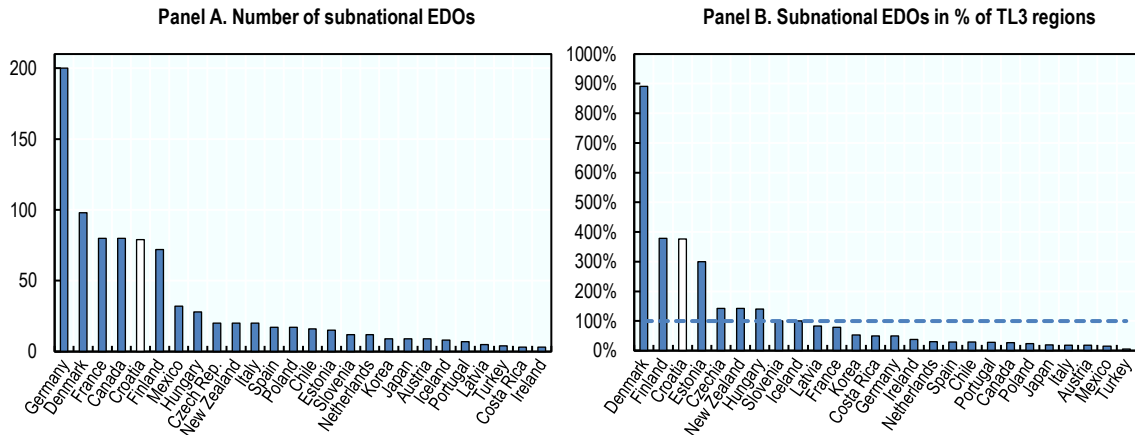
Croatia's subnational bodies and authorities dealing with investment-related matters operate at the county and city/municipality levels (Figure 4.11). The most relevant actors are the local and county development agencies of the ESI – referred to as EDOs in Box 4.1, followed by regional and local government authorities (Table 4.5). Croatia has no dedicated subnational IPAs, as 58% of OECD countries, and the MESD's Internationalisation Directorate has no subnational offices, in contrast with 61% of OECD national IPAs (OECD, 2022<sup>[1]</sup>). Most OECD countries with no subnational IPAs also rely on EDOs to promote and facilitate investment at the local level, although differentiating between the two bodies is not always straightforward – some subnational IPAs operate within wider EDOs such as in Spain “Catalonia Trade & Investment”, which is part of the regional Agency for Business Competitiveness (Lewis and Whyte, 2022<sup>[30]</sup>). EDOs are often independent entities from the central government, reporting to subnational authorities. Likewise, EDOs in Croatia are legal entities that are established subnational governments, although they must be registered within the MESD's database of ESI as a prerequisite for using the ministry's grants for the creation of the agency.

The mandate of Croatian EDOs goes beyond investment promotion and facilitation, as it is the case of EDOs in OECD countries (OECD, 2022<sup>[1]</sup>). Croatian EDOs operate, in principle, under the Act on Improving Entrepreneurial Infrastructure and are responsible for the operational implementation of measures for the development of the economy and entrepreneurship, encouraging and attracting investments, and initiating and implementing projects to encourage economic development and entrepreneurship, unifying the work of economic entities, local and regional entrepreneurial institutions, and higher education institutions and knowledge centres. The Act states the conditions and criteria for granting incentives through EDOs (see Chapter 5). The group of ESI includes a large variety of institutions other than EDOs such as technology parks, business incubators and entrepreneurial centres. They differ by services offered and firms served, but their common goal is to encourage business activity through training programmes, counselling, informing and connecting companies (see also Chapter 3).

*There is a plethora of subnational development agencies but their impact on FDI is unclear*

Despite Croatia's small geographic size, the country counts 79 EDOs according to the MESD's database of ESI, which is significantly more than in OECD countries, both in absolute value – Croatia has as many EDOs as Canada or France – and relative to the number of second-level subnational governments, i.e. counties in Croatia (Figure 4.12). There is, on average, 3.8 EDOs serving each of the 21 Croatian counties. Among the group of OECD countries with a similar geographical size, only Denmark has significantly more EDOs than Croatia. Overall, the MESD's database of ESI included 212 ESI institutions in 2022.

Figure 4.12. Subnational Economic Development Organisations in Croatia and OECD countries

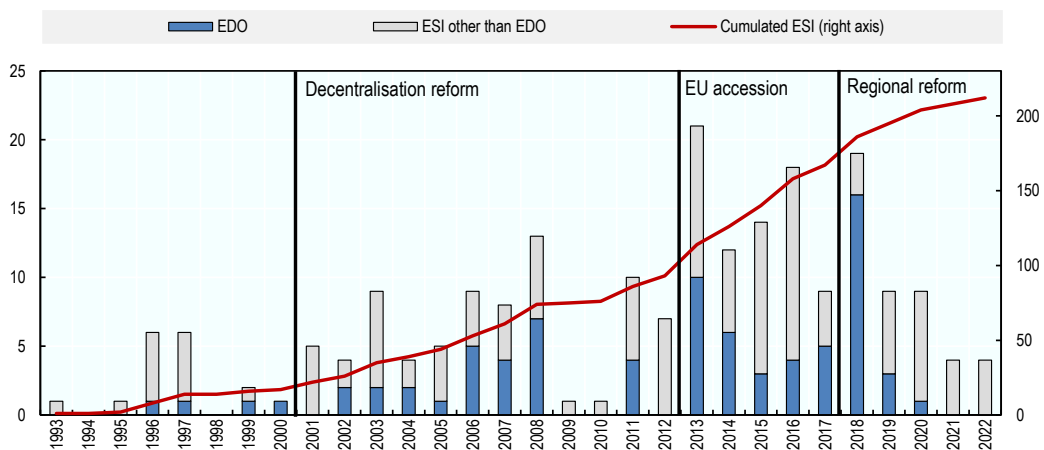


Note: Subnational EDOs refer to local and county development agencies in the Register of Entrepreneurship Support Institutions.  
 Source: OECD Survey on Investment Promotion and Regional Development (2022).

There is a lack of a coherent, unified and strategic approach and a clear economic rationale to setting up as many ESI, however, and the Act on Improving Entrepreneurial Infrastructure is silent on this matter. Plethora of EDOs – and of business support infrastructure more broadly – were established after the autonomy that counties and their 555 municipalities/cities have gained in 2001 (Figure 4.13). This was also enabled by the low population threshold to be administratively counted as a *grad* or city and, in turn, have the rights to establish their own business infrastructure. In some cases, two or more towns or municipalities have founded joined ESIs. The accession of Croatia to the EU in 2013 and the related EU aid received since then to reduce territorial disparities seem to have accelerated the creation process of ESI, particularly in economically less developed regions (Stojčić, Pylak and Alibegović, 2022<sup>[20]</sup>).

Figure 4.13. The impact of reforms on the creation of business support infrastructure over time

Number of entrepreneurship Support Institutions created between 1993 and 2022

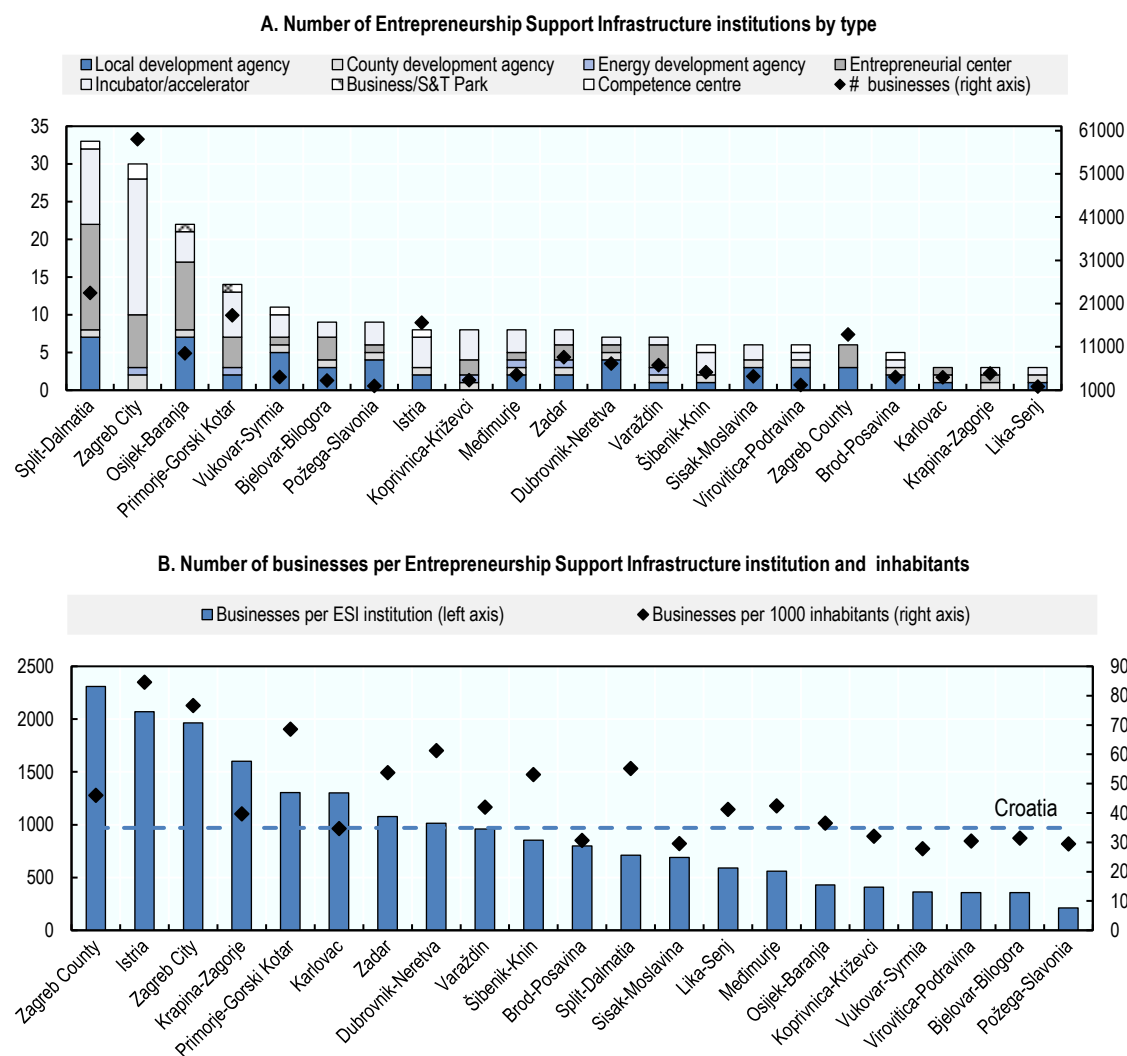


Note: EDOs in Croatia correspond to local and county development agencies listed in the Register of Entrepreneurship Support Institutions.  
 Source: OECD based on the Ministry of Economy and Sustainable Development Register of Entrepreneurship Support Institutions.

The distribution of EDOs is uneven across Croatian counties, which are more concentrated in the less developed regions with lower business density levels. If there is one county development agency operating

at the level of each of the 21 counties, the number of EDOs varies significantly at the municipality/city level. Osijek-Baranja and Split-Dalmatia, for instance, have each seven local development agencies while Istria and Primorje-Gorski Kotar have two, reflecting differences in business activity (Figure 4.14, Panel A). This uneven configuration remains unchanged when examining the distribution of all ESI bodies. Split-Dalmania and, to a lower extent, Osijek-Baranja continue to stand out as the counties with many ESIs, often serving fewer businesses than in other counties (Figure 4.14, Panel B). The two counties also rely on entrepreneurial centres more than incubators or accelerators, in contrast with the more developed regions of the northwest such as Istria, Primorje-Gorski Kotar and Zagreb. For instance, 18 of the 30 ESI bodies of the City-County of Zagreb are incubators or accelerators and only seven are entrepreneurship centres. This highlights the more R&D-intensive nature of investment projects in a metropolitan area like Zagreb.

**Figure 4.14. Entrepreneurship support institutions by county, type and business density levels**



Note: EDOs in Croatia correspond to local and county development agencies listed in the Register of Entrepreneurship Support Institutions.  
 Source: OECD based on the Ministry of Economy and Sustainable Development Register of Entrepreneurship Support Institutions.

Croatia’s different tiers of government should better assess the performance of EDOs and design more strategic, responsive, reforms to address potential bottlenecks. The large number of EDOs should, in principle, help promoting and facilitating investment as subnational bodies endowed with such tasks proved to be effective in other contexts (Box 4.5). Their cost-effectiveness in Croatia is not established, however,

considering the relatively low performance on increasing productivity, competitiveness, and innovation (World Bank, 2019<sup>[14]</sup>). The concentration of ESI institutions does not correlate with business density, including of foreign firms, which may suggest that existing facilities do not address the most important bottlenecks to foreign and domestic investment. On the other hand, this might indicate that economically less developed regions needed to deploy more of these bodies to address severe business climate issues (Kontošić Pamić and Belullo, 2018<sup>[31]</sup>; Stojčić, Pylak and Alibegović, 2022<sup>[20]</sup>). In fact, the more developed regions established most of their ESI earlier before the less developed regions.

It is critical to design robust M&E mechanisms to monitor EDOs – and ESI more broadly – performance. At the central level, and as the administrator of the IEIR, the MESD could develop a unified set of indicators to help EDOs monitor their impacts as well as the impact of reforms that affects them. The MESD's only tool to monitor the impacts of its activities on regional development is FDI distribution across regions. Furthermore, the MESD's Customer Relationship Management (CRM) is not connected to the CRM of EDOs – should they have one – but this is the case in most OECD countries as well (OECD, 2022<sup>[11]</sup>). Overall, performance-monitoring systems of decentralised investment environments need to be simple, with a reasonable number of standardised indicators. Higher levels of government should be able to monitor subnational performance of governments below them.

#### Box 4.5. Establishing subnational IPAs: why and for what? a brief review of the literature

Agencies promoting and facilitating investment are playing an increasingly central role in the development of the regional economies in which they operate – most OECD national IPAs have put regional development high on their agenda, regardless of the size of their economy (OECD, 2022<sup>[11]</sup>). At the same time, the number of subnational IPAs has grown significantly over the past couple of decades, with the geographic proximity between local IPAs and investors becoming more important (Lewis and Whyte, 2022<sup>[30]</sup>). Subnational factors became crucial in the location and expansion decisions of firms in a globalised world economy with fewer national barriers to trade and investment and, more recently, with changes in GVCs following the COVID-19 pandemic (Crescenzi and Harman, 2023<sup>[32]</sup>).

The rationale for establishing a subnational IPA can be related to specific economic challenges or opportunities that a region faces such as industrial restructuring leading to the need for sector diversification and new job creation. IPA creation may also be influenced by situations in which national and subnational economic goals and priorities are different, for example, in relation to the focus on different priority sectors (Lewis and Whyte, 2022<sup>[30]</sup>). The intensity of investment promotion at the subnational level can also be related to the situation in the regional labour market. For instance, Czech, Polish and Slovak regions with higher unemployment rate and lower income levels developed more holistic investment promotion approaches (Capik, 2020<sup>[33]</sup>).

The rationale for setting-up subnational IPAs became stronger with FDI forming an integral part of regional growth policies and strategies, including of CEE Countries. Many subnational IPA mandates are set within a wider regional economic strategy, with investment promotion forming one pillar of the growth plans for the territory, alongside policies that promote trade, improve skills, support SME development, and enhance infrastructure for the region. That positioning enables the subnational IPA to influence wider regional competitiveness and attractiveness factors, making advocacy for investment reform more straightforward (Lewis and Whyte, 2022<sup>[30]</sup>).

Subnational institutions striving at informing investors about the attractiveness of regions and improving the local business climate proved to be effective. They can ensure that the geographical distribution of FDI is governed by local market conditions and not information asymmetries or transaction costs. Regions are the most knowledgeable when it comes to providing specific information of critical interest to foreign investors, such as land location options, access to local talent or contact with local partners (Fernández, Blanco and Aranda-Larrey, 2021<sup>[34]</sup>). Foreign firms prospecting potential locations face information asymmetry and business uncertainties that create information costs. When information is scarce, investors mimic the decisions of already established firms and, in turn, existing agglomerations of investors become the only signals for decision-making (Mariotti, Piscitello and Elia, 2010<sup>[35]</sup>).

Furthermore, subnational IPAs act as local ‘institutional plumbers’ in support of foreign investors and their operations (Crescenzi, Di Cataldo and Giua, 2021<sup>[19]</sup>). Their activities can cut operational or search costs of foreign investors – for example when setting up a training centre or contributing to its creation, reducing transaction costs when interacting with local actors. The relevance of IPAs is stronger when information asymmetries are more severe, markets less transparent and institutional conditions weaker. Furthermore, by enhancing the local supply of human capital and modern infrastructure and by improving other fundamentals for growth, not only do regions become a more attractive location for investors but the extent of benefits FDI generates can increase through spillover mechanisms.

#### *Croatia should clarify subnational bodies’ engagement on investment promotion*

The revision of Croatia’s Act on Regional Development in 2018 led to a reorganisation of EDOs, generating some confusion but also an opportunity to clarify their role in promoting and facilitating investment. The



Act on Regional Development provided for the creation of local and regional development agencies – or Regional Coordinators. These agencies have broader mandates than EDOs, including regional strategic planning, formally interact with the MRDEUF and sit on local or county Partnership Councils. This has led some EDOs operating under the Act on Improving Entrepreneurial Infrastructure as development agencies to rename themselves or to separate their business functions from the broader regional development activities. For instance, the Regional Development Agency of Zagreb County, created in 2004, split after 2018 into the Development Agency of Zagreb County, which started to operate under the Act on Regional Development, and the Entrepreneurship Centre of Zagreb County – another type of ESI – that continues to operate under the Act on Improving Entrepreneurial Infrastructure.

If the reorganisation of EDOs following the 2018 reform on regional development seem to have taken place – or is taking place – smoothly, there is no sufficient clarity on which subnational agency took over the tasks of investment promotion and facilitation. A disproportionate number of EDOs were added to the register of ESI in 2018 following the 2018 reform, although these agencies operate under the Act on Regional Development (Figure 4.13). For instance, the Regional Development Agency (or Regional Coordinator) of Medimurje County – REDEA – was added to the register in 2018 while in the OECD Survey the agency indicates reporting to the county government authorities and the MRDEUF. Furthermore, it is not clear if the revamped local and regional development agencies (or regional coordinators) created under the 2018 reform are, in practice, carrying the investment promotion mandate of their predecessors of the Act on Improving Entrepreneurial Infrastructure. For instance, the Regional Development Agency of Lika-Senj County – LIRA – indicated that regional development is its sole core responsibility, in contrast with REDEA that listed FDI promotion as a core responsibility, together with regional development.

Furthermore, EDOs listed in the IEIR are, in principle, the development agencies that are mandated with IPA-type of activity at the subnational level, but there is a large discretion in the extent to which they carry such responsibility, both vis-à-vis other ESI bodies and the development agencies created under the Act on Regional Development. OECD consultations indicated that local or county development agencies are perceived by the central and subnational government actors as bodies mostly in charge of managing EU aid – and thus operating under the Act on Regional Development, with little or no involvement in attracting FDI. They also have a misperception that investment promotion only includes offering incentives rather than promoting a full investment offer (World Bank, 2019<sup>[10]</sup>). On the other hand, the Entrepreneurship Centre of Zagreb County, for instance, identifies itself as the *de facto* IPA, although most of the services of an Entrepreneurship Centre focus on SMEs and are limited to some business facilitation aspects such as providing support on the location of the project through the business zone map. In practice, most foreign firms rely on their own lawyers to navigate business rules instead of ESI institutions.

Any future revision of the Act on Improving Entrepreneurial Infrastructure should clarify the existing references to local and county development agencies to avoid confusion with those created under the Act on Regional Development. The Act should also clarify which, if any, of the subnational ESI carry explicit investment promotion and facilitation mandates that are recognised and clearly understood by all central and subnational, public and private, actors. Their role should be also clearly distinct from the development agencies operating under the Act on Regional Development to avoid overlap, unless it is the latter that are put forward to carry the investment mandate. Furthermore, the MESD's registry of ESI should be updated. The database continues to include bodies than are established under the Act on Regional Development, creating uncertainty on the exact composition of the network of ESI and limiting the possibility to properly evaluate their role in and impact on local development.

### ***There is a large discretion in how local government authorities attract investment***

Another important actor in the investment climate landscape of Croatia are the subnational local and county self-governments (Table 4.5). Likewise, many local authorities of OECD countries such as economic departments of city authorities are directly involved in economic development issues that sometimes

include an investment promotion or facilitation component (OECD, 2022<sup>[11]</sup>). Most of the support provided by municipality/city officials happens once the potential investor knocked on their door. The type of support often relates to allocating land in business zones – over which they have responsibility – with the adequate infrastructure (e.g. electricity, roads) and issuing local permits such as construction permits. They dedicate less efforts to promote themselves as investment destinations or to identify potential projects through investment generation activities.

There is a large amount of discretion in the efforts subnational governments in Croatia put on attracting FDI, and their level of involvement varies strongly both across levels of government and from one local government to another. It is likely that self-governments of large cities with attractive urban hubs are more inclined to engage in foreign investment promotion and facilitation, in contrast with smaller cities or municipalities of rural areas that have less specific value proposition as investment destinations and that might rely on their development agencies or on the MESD to attract investors. Ultimately, the question is not only whether subnational governments should engage in FDI attraction or not, but to have clarity among all involved actors on the responsibilities of each.

Croatia could further clarify why and how some subnational government authorities carry themselves the task of promoting and facilitation investment while others leave that to their development agency, when such task is ever performed. This can have consequences on investment priorities, the financial resources allocated by the county or central government and on reporting lines – development agencies operating under the Act on Regional Development report to the MRDEUF on several matters while self-government authorities do not. Relatedly, the political parties in power at the national level can be different from those at the subnational level and, in turn, the degree of confidence that local governments have in the ability and willingness of the national IPA or central government to represent their priorities can influence the need for and scale of investment promotion and facilitation activities. That factor can be accentuated when different sector priorities exist at the national and subnational levels (Lewis and Whyte, 2022<sup>[30]</sup>).

The OECD team consultations with elected government officials of the cities of Novska, Osijek and Zagreb revealed some of the different approaches to attracting FDI across subnational governments. When there is a potential and large foreign investment project, cities form a dedicated, albeit *ad hoc*, team comprising representatives from different city departments (Economy, EU Funds, etc.) to support the investor – the team does not include representatives from the county or the MESD's Investment Sector. It is possible that cities such as Osijek directly engage in investment promotion and facilitation partly because they did not establish their own local development agencies, in contrast with the smaller city of Novska that seems to also rely on the local agency – NORA – as an entry point for foreign investors, although the agency focuses mostly on SMEs and export facilitation.

The involvement of municipalities/cities significantly facilitates the business establishment process, but the success of this support can largely be discretionary and depend on the proactiveness of staff, including of elected officials. This can generate conflicts of interest and distort the level-playing among investors, particularly in cases where the approval of the municipality/city council for sizeable investment projects is required. Separating oversight (municipality/city Council) and implementing (the entity providing support to investors) functions increases transparency. Providing clear information as well. The city of Zagreb, for instance, has a single window where investors can get information on permits needed to start a business, thereby reducing any discretionary behaviour and corruption risks by officials.

## Coordination mechanisms could be improved across tiers of government

Considering Croatia's complex institutional architecture and the plethora of national and subnational actors involved in investment promotion and facilitation, maintaining a good relationship with peers is key to achieve successful results. Relationships between the central and subnational bodies in charge of investment can face obstacles and bottlenecks of different natures. They are also different depending on

the subnational level and subnational institution with which they interact, be it an EDO or local authorities of self-governments. Uncoordinated activities at subnational levels can lead to redundant activities, conflicting messages to investors, a misuse of public spending, unhealthy competition across regions and increased regional disparities (OECD, 2022<sup>[1]</sup>).

### ***Coordination can hardly take place when mandates are not well defined in the first place***

The main challenge faced by the MESD's Internationalisation Directorate in its relationship with subnational entities relates to the confusion over the strategic issue of mandates (Table 4.6). This has major implications on which subnational bodies the MESD should coordinate with, at what level of subnational government and on what and how to coordinate with them. The Directorate has no formal mandate to coordinate subnational initiatives. While this certainly represents a limit to effective coordination, it is a challenge that is shared by other IPAs. What is specific to Croatia – and more problematic – is the lack of clarity over the mandates assigned to each actor. Coordination can hardly take place in a context where responsibilities are not well defined in the first place or not clearly communicated to all actors. This also affects the strength and quality of the relationships. The MESD is often in contact with subnational EDOs and subnational governments. Most IPAs of OECD countries report having strong relationships with their subnational EDOs (Figure 4.15).

**Table 4.6. Main challenges faced by the Croatian IPA in their relationship with subnational entities**

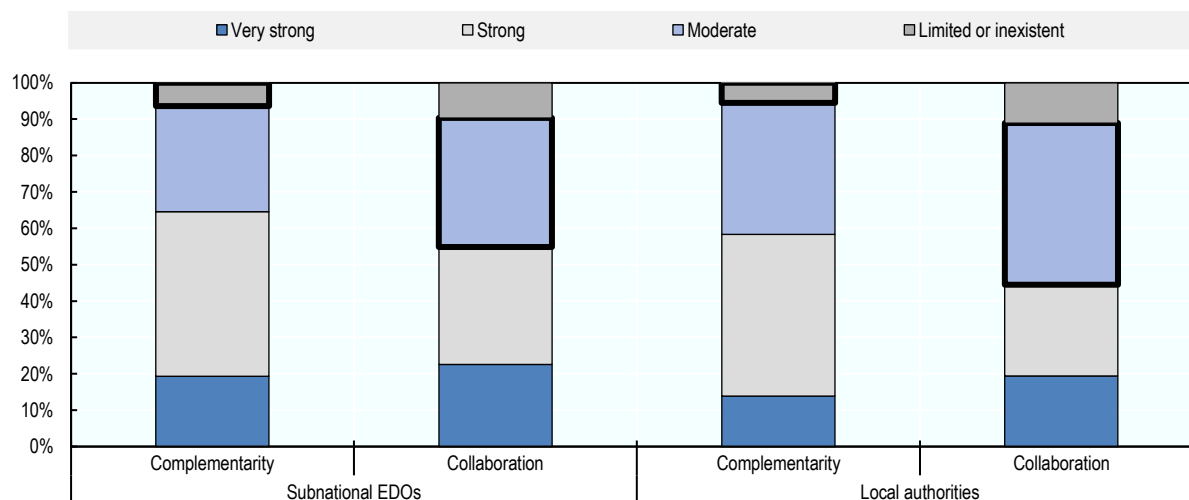
	<b>Croatia</b>	<b>OECD average subnational EDO</b>	<b>OECD average local authority</b>
1	No formal mandate from the national IPA to coordinate subnational initiatives	No formal mandate from the national IPA to coordinate subnational initiatives	Lack of knowledge of strategies and activities
2	Lack of clarity of mandates	Lack of resources to cooperate properly	Lack of resources to cooperate properly
3	Lack of communication or inefficient communication channels	Lack of knowledge of strategies and activities	Lack of communication or inefficient communication channels
4	Lack of resources to cooperate properly	Lack of clarity of mandates	Lack of clarity of mandates
5	Contradictory political or economic development objectives	Lack of communication or inefficient communication channels	No formal mandate from the national IPA to coordinate subnational initiatives
6	Lack of knowledge of subnational strategies and activities	Contradictory political or economic development objectives	Lack of willingness to cooperate at political level
7	Lack of willingness to cooperate at technical level	Lack of willingness to cooperate at political level	Contradictory political or economic development objectives
8	Lack of willingness to cooperate at political level	Lack of willingness to cooperate at technical level	Lack of willingness to cooperate at technical level

Source: OECD Survey on Investment Promotion and Regional Development (2022).

The MESD's Internationalisation Directorate relationship with the subnational level is particularly limited or inexistent when it comes to complementarity of activities, in contrast with collaborative aspects involving, for instance, information-sharing (Figure 4.15). It is the opposite in OECD countries where there is often better complementarity of activities than collaboration, reflecting the clearer roles national IPAs and subnational bodies play vis-à-vis investors (OECD, 2022<sup>[1]</sup>). The MESD also indicates that the lack of willingness to cooperate is the least of the challenges it faces with subnational entities (Table 4.7). This suggests that conducting complementary activities is more complex than working jointly in Croatia, highlighting again the necessity of clarifying responsibilities across levels of government as a first step to avoid overlapping activities and achieve effective coordination and good cooperation. The fact that the coordination challenges the MESD faces are identical for EDOs and local government authorities – while they vary for OECD national IPAs – also reveals that there is no clear distinction in the work of different subnational entities in Croatia.

**Figure 4.15. Relationships between national IPAs and subnational entities in OECD and Croatia**

The MESD's Internationalisation Directorate responses are indicated by the bold frames



Note: Complementarity: the national IPA and the subnational bodies bring different qualities that are improved or accentuated by the relationship (e.g. exploiting synergies, ensuring mandates and activities reinforce each other). Collaboration: the national IPA and the subnational bodies decide to work together to achieve a result or produce something jointly (e.g. sharing information, co-ordinated activities);

Source: OECD Survey on Investment Promotion and Regional Development (2022).

### **Coordination could be particularly reinforced over some strategic investment matters**

The coordination challenge in Croatia is further undermined by the fact that there are no formal coordination mechanisms between the MESD's Internationalisation Directorate and EDOs, despite that they are in the IEIR and need approval from the Ministry on land allocation (Table 4.7). Financial support from the MESD stopped in 2014, although it was allocated afterwards on couple of occasions through EU funds. Relationships are informal, albeit frequent, and consist to a large extent of bilateral interactions on land availability in entrepreneurial zones and on other aspects related to businesses' establishment (see also Chapter 3). National IPAs of OECD countries also largely rely on informal coordination mechanisms with subnational agencies such as information exchange and co-ordination meetings, as opposed to more constraining mechanisms involving budgetary contributions and board membership. These informal mechanisms can sometimes be perceived by IPAs to be more effective (OECD, 2022<sup>[11]</sup>).

**Table 4.7. Coordination mechanisms between the national IPA and EDOs in Croatia and OECD**

	OECD	OECD EU	Croatia	Czechia	Slovenia
Exchange of information	90%	94%			
Ad-hoc coordination meetings	71%	72%			
Regular coordination meetings	52%	44%			
Formal agreements	29%	44%			
Part of an inter-institutional coordination body	23%	28%			
Shared offices at subnational level	13%	11%			
Member of the boards (or vice versa)	6%	6%			
Budgetary contributions	6%	6%			

Source: OECD Survey on Investment Promotion and Regional Development (2022).

Notwithstanding the effectiveness of informal coordination mechanisms between national and subnational investment bodies in Croatia, they are not suited to address all sorts of challenges. While good informal relationships between the MESD and local entities can help assist foreign investors in establishing their business and operations, they cannot address holistic, long-term and strategic policy issues. The development agency of the city of Novska, for instance, mentioned four ways through which the MESD could further assist them: put at the disposal of subnational entities a database or a pipeline of potential investment projects, invite them more often to participate in fairs to reinforce networking opportunities, consider local specificities in the prioritisation of subsectors for FDI promoting – even if minor, and provide clear information on industry requirements. Support by the MESD on matters that are largely related to investment promotion functions can hardly be achieved through existing *ad hoc* coordination mechanisms.

Reinforcing coordination on investment facilitation challenges in Croatia also requires a collective decision process involving multiple actors. This cannot be achieved through ad hoc, bilateral, exchanges between the MESD and subnational entities. For instance, some prospective investors ask the authorities to sign non-disclosure agreements until the project is concluded to avoid information leaks. The MESD policy is to not sign such agreements, while some local governments have no such policy. Notwithstanding the relevance or not of such agreements, this may lead to situations where one actor – the central government – is excluded from the negotiations with the investor. This increases the risk that the project does not materialise due to the uncertainty created by the asymmetry of information and the less holistic approach to supporting the investor. This and other similar issues warrant that the MESD with all or at most relevant subnational actors collectively agree on a common approach (see also Chapter 3).

### ***Croatia has several options to strengthen coordination on subnational investment***

There are several avenues Croatia could opt for to strengthen coordination over investment promotion and facilitation, including on more strategic matters. These avenues should be realistic considering the decentralised political landscape. A desirable option would be to set coordination mechanisms at the level of large NUTS 2 regions in light of the great number of subnational governments and bodies for a small country like Croatia. This can also help develop an attractive value proposition in terms of investment promotion – most counties are economically too small to make a difference. There is no legal framework to allow for such cooperation and counties may not be politically willing to engage to the extent that a coordination mechanism at the NUTS 2 level would require a joint and new body (World Bank, 2019<sup>[25]</sup>).

A more realistic option is that the MESD, MRDEUF, subnational EDOs and relevant departments of large cities involved in IPA type of activities, for instance, jointly develop a cooperation agreement, protocol or guidelines that describe the rules of engagement of each actor with a clear distribution of functions and roles at different stages on both investment promotion and facilitation aspects (see also Chapter 3). This can be an effective “light-touch” tool to coordinate subnational governments across administrative boundaries, and to coordinate between central ministries and local authorities, without creating new bodies (World Bank, 2019<sup>[14]</sup>). In the OECD, 44% of national IPAs that are also EU Members signed formal cooperation agreements with EDOs, as for instance in Czechia (Table 4.7). This document could clarify if and how each actor is involved in investment promotion activities, including in targeting specific subsectors that are relevant to the region, and address a variety of investment facilitation issues – adopting a unified approach on non-disclosure agreements is one example of such issues.

A cooperation agreement can also reinforce coordination and cooperation by clarifying and streamlining the tasks and composition of the teams subnational entities sometimes create to assist foreign investors. Forming a team with different levels of government can ensure alignment while reducing uncertainty for the investor – investors engage sometimes in separate and overlapping discussions with the central and local government. The previous Act on Investment Promotion and Improving the Investment Climate included a provision that requests the national and subnational investment bodies to coordinate by forming joint ad hoc bodies for specific investment projects that must include at “least one representative from the

local government, one from the county development agency responsible for promoting and attracting investment, and one from the central body responsible for promoting and attracting investment”. This provision was hardly implemented. This provision is now inexistent as the Act itself was abolished.

Croatia could strengthen coordination mechanisms on investment promotion activities. The MESD could establish, in cooperation with relevant subnational entities, a platform to announce foreign investors’ expressions of interest received by the ministry. This would enable a proactive approach to attracting FDI and provide insight into investment projects in the county that will contribute to growth and regional competitiveness (World Bank, 2022<sup>[36]</sup>). Croatia is a small country, but investors may still not be aware of differences between different regions or counties. This platform can help build trust while strengthening fair competition among subnational bodies that must put strong and clear value propositions. Shared investment pipelines are a feature of some national-subnational collaborations (Fernández, Blanco and Aranda-Larrey, 2021<sup>[34]</sup>). The Spanish national IPA, for instance, has an online tool that allows all subnational IPAs to view leads, identify those they would like to compete for, and notify the national agency (Box 4.6). Similar mechanisms are in use by subnational bodies such as Copenhagen Capacity (Lewis and Whyte, 2022<sup>[30]</sup>).

#### **Box 4.6. Interactua: Spain’s ICT coordination tool on subnational investment promotion**

ICEX-Invest in Spain, the national IPA, in conjunction with the subnational IPAs of the 17 autonomous communities, have developed several mechanisms, tools and activities that have enabled good collaboration, including the Interactua ICT platform, an innovative CRM-type software that became a fundamental tool in articulating ICEX-Invest in Spain relationship with subnational IPAs.

The tool allows the joint management of numerous activities related to investment projects, the management of investment promotion activities, and the exchange of information (news, documentation or databases, among others). The most attractive functionality of the platform is a mechanism to announce foreign investors’ expressions of interest received by ICEX-Invest in Spain, and its subsequent dissemination through the platform to subnational IPAs.

Once the project information is disseminated through the platform, the subnational IPAs can submit their proposals by presenting their value propositions as potential locations for the investment project. The coordination tool also helps communicate and coordinate with the potential investors, making the announcement of the potential investment project confidential with respect to the client and transparent with respect to the subnational IPAs, ensuring that the latter are all informed of the opportunities.

Interactua is an example of successful platform for the foreign investors, who may not be always aware of the differences between locations, and at the same time strengthens fair competition among subnational IPAs that must put strong and clear value propositions. The transparency of the platform can also help maintain of trust among the diverse range of stakeholders.

Source: (Fernández, Blanco and Aranda-Larrey, 2021<sup>[34]</sup>), National-Subnational Coordination for Investment Attraction: The Case of Spain, Washington, DC: World Bank, <https://openknowledge.worldbank.org/handle/10986/35235>.

An additional yet complementary avenue Croatia could consider is to establish an informal network or an inter-institutional coordinating body that brings together all relevant actors involved in subnational investment promotion and facilitation. Developing a joint agreement that clarifies the role and functions of each body or a digital tool sharing the pipeline of potential investment projects require effective dialogue platforms between the MESD’s Internationalisation Directorate and subnational entities. France, Czechia, the Netherlands or Portugal all established formal or informal networks or coordination bodies that bring together national and subnational actors involved in investment promotion and facilitation (Box 4.7). These

bodies often bring together subnational IPAs or bodies of the same territorial subdivision – the one thought to be the most suitable. Overall, coordination mechanisms are more prevalent and sophisticated between national and subnational IPAs than with EDOs or local authorities (OECD, 2022<sup>[1]</sup>).

Another option is to leverage existing networks of bodies involved in investment and regional development. Croatia's IEIR represents the most natural starting point. It is only a database, however, that includes too many agencies with different functions and spreading over both the county and municipality/city self-governments. The MESD has also no role as a central coordination body. BOND, an informal network established by HAMAG-BICRO, brings together around 100 ESI bodies – nearly half of the MESD register – with the objective of building their capacity, including through peer-learning, and improving the quality of services provided to entrepreneurs as well as their harmonisation. The focus of BOND is not on FDI promotion and facilitation, however, and the MESD's Investment Sector is not part of the network. Croatia could consider expanding the topics of BOND to cover FDI and regional development.

### Box 4.7. Multi-level investment promotion and facilitation coordination tools in the OECD

IPAs have at their disposal several coordination mechanisms with subnational agencies, but not all are used with the same intensity. In general, there are more coordination mechanisms with subnational IPAs than with EDOs. The difference is particularly striking in the cases of regular coordination meetings, formal agreements and shared offices abroad. Half of IPAs in the OECD have formal agreements with subnational IPAs, but only 29% with EDOs. Furthermore, there is approximately one national IPA out of five that shares its offices abroad with subnational IPAs, but none has the same approach at subnational level, except with few EDOs (13%). This reinforces the fact that coordination tends to be easier with agencies that have similar mandates and objectives.

To improve cooperation with local agencies and authorities, some national IPAs established specific departments or networks. In **Türkiye**, the IPA had originally a dedicated department whose main mandate was to develop cooperation mechanisms with subnational IPAs. Eventually, the department did not go beyond organising "cooperation meetings" and could not present any concrete results. It was hence dissolved and the responsibility was given to an operational department of the agency that is now able to carry out concrete activities in cooperation with subnational IPAs. The IPA of **Costa Rica** adopted the opposite approach and established a specialised division for investment promotion outside of the Greater Metropolitan Area. This unit works with several constituencies in the community, including municipalities and private-public development agencies as well as academia and training institutions.

**France** launched in 2021 Team France Invest and the IPA has a formal information-sharing process to increase the efficiency of the collaboration with subnational IPAs. The IPA created a "marketplace" of projects and shares information weekly with its regional partners about new FDI projects identified, and requests made at the regional level. Thanks to this platform, partners can coordinate their responses and identify areas for joint action. This framework guarantees the impartiality and neutrality of the IPA vis-à-vis all the regions (not favouring one over the other when bringing new projects).

**Portugal** also launched in 2021 the National Economic Internationalisation Programme, which aims to strengthen the promotion of territories and the skills of territorial agents in their investment promotion and follow-up processes. The programme promotes inter-institutional action to increase FDI flows and achieve a balanced distribution of investment across the country. AICEP Portugal Global closely collaborates with local authorities, promoting different locations across regions to foreign investors.

**Spain's** Investment Attraction Committee (CAI), a permanent inter-administrative collaboration body, is composed of ICEX-Invest in Spain (which serves as permanent Secretariat), IPAs of the 17 autonomous communities, the Confederation of Business Organisations, and the Chamber of Commerce and Industry. Investment promotion activities, technical workshops, business missions, improvements of the investment climate and the analysis of sectors hold prominent places in the CAI. The CAI is one of the two committees of the Interterritorial Council for Internationalisation – established by law – that sets out the foundations for the coordination between the state administration, autonomous regions and the private sector. Institutional cooperation on FDI attraction is one of the Council's objectives

Source: OECD (2022), "The geography of foreign investment in OECD member countries: How investment promotion agencies support regional development", OECD Business and Finance Policy Papers, No. 20, OECD Publishing, Paris, <https://doi.org/10.1787/1f293a25-en>



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# **5 Towards more effective investment tax incentives**

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Croatia uses tax and other incentives to attract investment and support policy goals including job creation and regional development. This chapter provides an overview of Croatia's incentive regime, with a particular focus on tax incentives granted under the Investment Promotion Act. It analyses design features and how incentives intend to support their stated policy goals, offering suggested areas of reform. The chapter also highlights the importance of monitoring and evaluation of incentive policy to encourage more effective use of incentives.

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## Summary and policy recommendations

As Croatia develops and implements its National Plan on Investment Promotion, it could consider how the current investment incentive framework could be improved to best support investment policy goals. The new Plan could also serve as an opportunity and platform to better promote incentive policies to prospective investors. More broadly, incentives are only as attractive as the wider investment climate. They should be used to complement, not replace, policies to ensure a predictable and attractive investment framework, explored throughout this report.

Croatia offers investors a mix of tax incentives, grants, and in-kind benefits (including rent-free lease of land and buildings). The primary investment incentives are granted under the Investment Promotion Act, and include reduced corporate income tax (CIT) rates conditioned on investment amount and job creation, with higher caps on benefits in less developed regions. Reduced CIT rates lower the statutory rate substantially by 50-100% for up to ten years – though the total value of benefits investors can receive (including grants and other tax benefits) is capped.

Croatia has aligned incentives under the Investment Promotion Act with EU requirements on Regional Aid, with a positive effect on incentive design. Incentives are available to firms of any size, in a broad range of sectors, preventing opportunities for rent-seeking behaviour by favoured sectors. Eligibility conditions are clear and specific, and tied to positive development goals, notably, regional income convergence and job creation. Tax and financial benefits are capped with a ceiling per project as well as annual spending limits for the regime as a whole, proving a check on government expenditure. EU regulations also positively mandate thorough monitoring and reporting on incentive uptake and costs, an essential first step to evaluating the impact of incentives.

Tax and non-tax incentives under the Act are designed to support the growth of substantive private sector investment (domestic and foreign), job creation, regional development and technological upgrading. CIT incentives under the Act support these goals through eligibility conditions to receive benefits: investors must meet outcomes of job creation, modernisation of assets, or productivity increases, and can receive greater benefits if they invest more or locate in certain locations. Outcome conditions such as employment creation can promote positive spillovers of investment; however, they require careful monitoring to ensure that the outcome has been met. This necessitates resources, administrative capacity, and close coordination with other government agencies.

Looking forward, the government could consider revising some of its incentives to maximise positive spillovers and limit potentially excessive benefits to firms. Carefully designed and targeted incentives may help correct market failures and advance social and economic development. Positively, CIT rate reductions in Croatia are conditional on investment size and job creation, promoting a firm's physical presence in the country. However, in general, income-based incentives (CIT exemptions and reduced rates) disproportionately benefit projects that are already profitable early in the tax relief period, and might have invested without the incentive, rendering the incentive redundant while potentially costing the state substantially in terms of revenue forgone.

Croatia could consider re-evaluating the design of its main tax incentives to adopt a stronger expenditure-based approach. Expenditure-based incentives (tax allowances or credits) could enable better targeting of incentives towards reducing specific costs, thereby encouraging spending that might not occur without the incentive, including costs of job creation and technological upgrading. These incentives might be more effective at attracting additional investment that would not have occurred otherwise. Furthermore, expenditure-based incentives are expected to be less affected by the new international tax agreement (OECD, 2022<sup>[1]</sup>). Under these rules, jurisdictions that grant large multinational enterprises (MNEs) effective tax rates below 15% may lose tax revenues as other jurisdictions start to impose top-up taxes on MNEs with low tax rates. Croatia is thus advised to consider the implications of these new rules for its tax incentives regime.

The MESD could use the upcoming reform of the Act to assess if tax incentives and grants seem to be incentivising their stated goals, including employment and regional development. Investment incentives of the Investment Promotion Act have primarily supported domestic industries that are already strong actors in the economy, including metal processing manufacturing and tourism. However, incentives may have helped grow the ICT sector. Foreign firms make up a quarter of beneficiaries of incentives over the past decade, with the number of foreign firms applying for incentives only slightly increasing. Most recipients are small firms, though a growing number of large investments are receiving incentives.

In addition to investment tax incentives under the Investment Promotion Act, Croatia offers other incentives through multiple pieces of legislation that are governed by different public bodies at central and subnational levels. For example, R&D incentives are authorised in a separated act. Coordination between some agencies involved in incentives seems to work efficiently, for example between the Ministry of Finance and MESD's Sector for Incentives and Entrepreneurial Infrastructure. However, information sharing could be strengthened across different bodies that grant incentives, including within departments of the MESD's Directorate for Internationalisation, between different ministries, and with representatives at the local level to support policy coherence.

The effective use of investment incentives requires regular monitoring and evaluating the costs and benefits of incentives, including vis-à-vis public revenue mobilisation, investment attraction, and the respective policy objective. Croatia closely monitors compliance of beneficiaries with incentive conditions, and costs of different incentive schemes as per EU State Aid requirements. This provides a solid foundation for policy evaluation, and more could be done to assess if incentives seem to be generating additional investment and are best designed to support their policy goals, including related to sustainable development.

### Policy recommendations

- **Assess whether tax incentives are best designed to support their stated objective.** While eligibility requirements (on job creation or modernising assets) are one means to encourage the desired policy goals, they do not directly reduce the costs of meeting these goals, and require administrative resources to monitor if firms are complying with requirements. The government could consider whether targeted expenditure-based tax schemes (tax allowances or credits), could be more effective at promoting certain outcomes.
- **Explore what complementary policies are required (e.g., infrastructure, connectivity, regulations, education or labour market and broader-based personal income tax reforms) to best incentivise investment policy goals,** including as part of the planned National Plan on Investment Promotion. Incentives should be used to complement, not replace, wider efforts to improve the investment climate. While tax and non-tax incentives can help promote certain investor behaviour, other policies might be more appropriate. For example, to ensure that tourism investment supports environmental conservation, regulatory changes may be more suitable.
- **Reinforce regular coordination at the national level, within departments of the MESD, and particularly within its Directorate for Internationalisation, as well as between different ministries,** and with sub-national authorities at the local level to support policy coherence when designing and implementing incentive policies. For example, more formal data sharing could be established between MESD and other incentives-granting departments and ministries. Similarly, coordinating with the Croatian Employment Service, the Ministry of Labour, Pension System, Family and Social Policy and the Ministry of Regional Development could be beneficial to understand which type of support is required and to identify the most suitable policy response.

- **Enhance clarity of investment incentives by adding to the existing online investor guide more information on all available incentives programmes** and relevant criteria. This could include information on incentives granted by sub-national authorities and English translations of all relevant laws and regulations in an online platform.
- **Croatia should continue its efforts to improve administrative and financial burdens and increase transparency of fees due.** While Croatia has already progressed in recent years, investors still report lengthy procedures and unexpected fees. Continuing these efforts is crucial for boosting the competitiveness of its investment climate.
- **Implement a regular and structured evaluation mechanism to assess how incentives are used, if they are supporting their intended policy goals, and their costs.** Embedding periodical evaluation processes in the law and clearly attributing responsibilities can support more effective evaluation mechanisms. The government already closely monitors compliance of beneficiaries with incentive conditions and costs (including tax expenditure) of each incentive programme as per EU State aid requirements. This could be leveraged to conduct specific studies to estimate forgone revenue from different programmes, and ideally, additional investment generated. An assessment could also be done to analyse the performance of firms with and without incentives. This could shed light on the behaviour of recipients of incentives and if they are supporting spillovers. The MESD could evaluate in coordination with subnational governments or other ministries the impact of incentives on stated policy goals, for example, whether investments are appropriately stimulating investment in different regions. Depending on the outcomes, the MESD should consider adjusting existing incentives and phasing out benefits that are no longer needed.

## The tax system is only one of many factors for investment decisions

Statutory corporate income tax (CIT) rates are often the first reference point for investors when evaluating the tax competitiveness of a jurisdiction and provide the benchmark from which CIT incentives deviate. Croatia's statutory CIT rate of 18% is in line with those of other CEE countries, and below the OECD average of 21.5% (Figure 5.1) (OECD, 2022<sup>[2]</sup>). Reforms in 2017 reduced the statutory CIT rate from 20% to 18% and introduced a 12% rate for small enterprises (up to EUR 400 000 or HRK 3 million annual revenue). In 2020, the government expanded its definition of small firms to all enterprises with up to EUR 1 million (HRK 7.5 million) annual revenue, followed by a reduction of the rate for small enterprises to 10% in 2021. Reflecting the important role SMEs play in the Croatian economy, around 90% of corporate income taxpayers pay the 10% CIT rate.<sup>1</sup> Other CEE countries also have progressive CIT rates for small enterprises, ranging from 5% (Latvia) to 15% (Slovak Republic) (OECD, 2015<sup>[3]</sup>).

A country's tax burden is one of many, and often not the most important factor considered by potential investors when making investment decisions. Macroeconomic and business conditions, market size, labour force, and the legal and regulatory framework are often as relevant for investors as tax considerations, and are explored throughout this report. The importance of taxation for investors depends in large part on these other factors. A higher tax burden can be acceptable to investors if the country's overall framework for investment is attractive (OECD, 2015<sup>[4]</sup>).

Other features of the tax system, including its governance and administration, are also important for investors. In Croatia, investors have reported high administrative burdens when doing business, including time-consuming and lengthy processes with the Ministry of Finance (Box 5.1). The speed of responses related to CIT matters (e.g., distinction of taxable and non-taxable expenditures), is longer than in other CEE countries; however, some administrative relief efforts were recently undertaken by the Ministry of



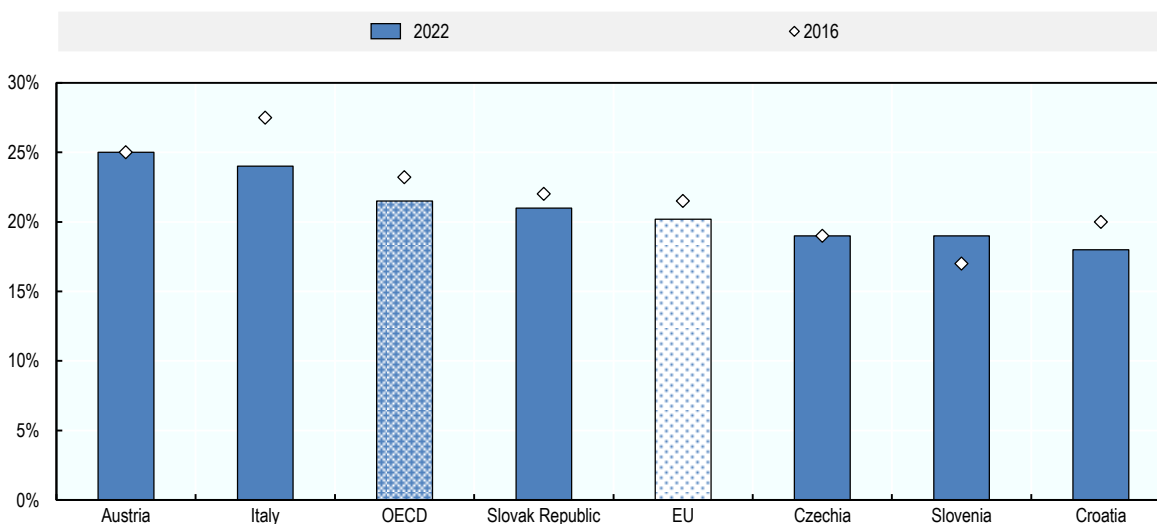
Finance and the government has made progress digitising many processes, which could improve speed of processes (Šonje, 2020<sup>[5]</sup>).<sup>2</sup>

In addition to statutory CIT rates and tax administration, investment incentives can form a key part of the policy framework for investment, and investment promotion strategies in particular. Investment tax incentives provide favourable deviations from the standard tax treatment for a specific group of corporate taxpayers, based on sector, activity, location or other investor- or project-related characteristics. The benefits and costs of granting tax incentives are not always clear. Tax incentives could attract investors that would not otherwise enter the market, help correct market failures and encourage positive spillovers from investment. Incentive policies can also be ineffective, providing windfall gains to projects that would have occurred without the incentive, with potential high and hidden costs, including to forgone government revenue, as well as from rent-seeking behaviour and economic distortions.

The effectiveness of tax incentives are context-specific, depending on the investor (and project sensitivity to incentives over other factors), the country and its investment climate, and the design of the incentive (OECD, 2022<sup>[1]</sup>). Certain types of investors may be more sensitive to tax burden and investment incentives than others. Economic studies and investor surveys suggest that market- or natural resource-seeking investors, which value the location-specific elements of a jurisdiction, are less swayed by tax incentives than efficiency-seeking investors that look for low-cost production sites (IMF, OECD, UN, World Bank, 2015<sup>[6]</sup>; James, 2014<sup>[7]</sup>; OECD, 2020<sup>[8]</sup>). But investor response varies by country. While lower effective tax rates are associated with higher FDI flows, this effect is significantly stronger in countries with good investment climates, and can have almost no effect in economies with weak investment climates (James, 2014<sup>[9]</sup>). Tax incentives – particularly reduced CIT rates and exemptions – are also often introduced due to competition with neighbouring countries. Most CEE countries offer numerous investment incentives, providing generous tax relief, adding to pressure on Croatia to offer similar or more advantageous benefits to investors (Schito, 2022<sup>[10]</sup>).

**Figure 5.1. Croatia's CIT rate is in line with other CEE countries**

Statutory CIT rates in %



Note: Starting from 2023, Austria reduced its CIT rate to 24% and plans to further reduce it to 23% in 2024.

Source: Authors calculated based on OECD (2022<sup>[2]</sup>), OECD Corporate Tax Statistics: Fourth Edition, <https://www.oecd.org/tax/beps/corporate-tax-statistics-database.htm>.



### Box 5.1. Parafiscal fees increase business costs in Croatia

In Croatia, investors have reported high administrative burdens when doing business, including related to numerous parafiscal fees. Croatia collects more than 250 para-fiscal charges, e.g., for water sanitation, fire protection, preservation of monuments, in addition to other taxes and contributions. These parafiscal fees are managed in an uncoordinated way by different institutions, which may impede transparency regarding the extent investors are subject to these fees (OECD, 2019<sup>[11]</sup>). While the government has started to simplify administrative procedures and reduce parafiscal charges, consultations with private sector representatives suggest that these charges remain burdensome for businesses. The government is recommended to continue its efforts towards reducing administrative and financial burdens and increasing predictability of fees due.

Source: (OECD, 2019<sup>[11]</sup>).

## Landscape of investment tax and non-tax incentives

Croatia offers a range of tax and non-tax incentives to domestic and foreign investors under various regimes (Figure 5.2). The main investment incentives are CIT benefits, grants and in-kind benefits introduced through the Investment Promotion Act (the Act) and are the focus of the chapter. Other tax incentives and grants are available to companies that engage in research and development (R&D), and firms in free zones or entrepreneurial zones can receive tax and in-kind benefits, as well as assistance from entrepreneurial support institutions. Sub-national governments provide additional non-tax incentives including financial grants, exemptions from fees, or in-kind benefits (e.g., land at reduced cost). A few other incentives are authorised in other legal acts, including the Profit Tax Act (CIT exemptions for investments in and around Vukovar city, accelerated depreciation for certain assets), and laws relevant to social security (grants and reductions to certain social security contributions). This section provides an overview of the main investment incentives and their governance; a more in-depth assessment of design of tax incentives under the Act follows.

Figure 5.2. Croatia offers investment incentives under several legal frameworks

Incentives for investment projects	R&D incentives	Zone incentives, business support	Local incentives
Investment Promotion Act, Act on Strategic Investment Projects (ASIP)	Act on State Aid for Research and Development Projects	Law on Free Zones, Entrepreneurial Infrastr. Improvement Act	Granted by sub-national governments via legal instruments or ad hoc
<ul style="list-style-type: none"> <li>• Reduced CIT rates</li> <li>• Financial grants for job creation               <ul style="list-style-type: none"> <li>• Increase for labour-intensity</li> <li>• Increase for selected activities</li> </ul> </li> <li>• Financial grants for training</li> <li>• Financial grants for capital costs for new assets</li> <li>• Rent-free lease of state-owned land and buildings</li> <li>• Quicker admin. procedures (ASIP)</li> </ul>	<ul style="list-style-type: none"> <li>• CIT allowance</li> <li>• Financial grants (granted via public tenders)</li> </ul>	<ul style="list-style-type: none"> <li>• Customs relief</li> <li>• VAT relief</li> <li>• Unlimited time for storing goods</li> <li>• Infrastructure-equipped zones</li> <li>• Forwarding and logistics services</li> <li>• Assistance &amp; consultation services</li> <li>• Training programs</li> </ul>	<ul style="list-style-type: none"> <li>• Reductions/exemptions of local taxes and fees</li> <li>• Financial grants</li> <li>• Reduced price of land</li> <li>• Facilitated access to industrial sites</li> <li>• Utility connections</li> </ul>

Note: This graph does not include accelerated depreciation (doubling of regular depreciation rates) for certain assets and a tax benefit for CIT tax payers in Vukovar City and surrounding areas, granted through the Profit Tax Act.

Source: Investment Promotion Act (OG 63/22), Act on Strategic Investment Projects (OG 29/18, 114/18), Act on State aid for Research and Development Projects (OG 64/18), Ordinance on State aid for research and development projects (OG 9/19), Law on Free Zones (OG 44/96, 92/05, 148/13), Entrepreneurial Infrastructure Improvement Act (93/13, 114/13, 41/14) .

### ***Incentives are governed by EU State aid rules***

Croatia introduced key reforms to its investment incentives before 2013 as it moved towards accession to the EU, revising the Investment Promotion Act to comply with EU State aid rules (Box 5.2). EU State aid rules set comprehensive requirements on how governments can grant incentives, the value of benefits, to which sectors, as well as reporting requirements. The regulations in many respects promote better incentives policy, meant to be less distortionary to competition, and encourage monitoring of incentives policies. Governments must ensure aid programmes are below an annual spending ceiling and investors are restricted in the amount of aid (tax and non-tax) they can receive per project. Incentives in the Promotion Act fall under the General Block Exemption Regulation (GBER) for Regional Aid, which has an annual state budget ceiling of EUR 150 million per year (Box 5.2). Tax and non-tax incentives for investors are capped at a certain percentage of eligible costs related to investment or job creation. These caps (“maximum aid intensity”) vary by region in Croatia, ranging from 35-60% of eligible project costs for large investors and can be increase for SMEs (more details on the Regional Aid Map below in Figure 5.5).<sup>3</sup>

Reforms to the Act over the past decade have made more firms eligible for incentives by reducing minimum investment and job creation requirements to receive benefits. This has expanded SME access to incentives. In 2015, minimum investment thresholds were lowered to support information and communications technology (ICT) sectors with potentially lower investments in fixed assets, while job creation thresholds were increased to encourage substantive investment in the country. This was done shortly after Romania introduced similar legislation. According to the government, these reforms led to a rise in incentive applications from SMEs and ICT enterprises in subsequent years. The latest amendment in 2022 introduced a new Regional Aid Map, with higher caps on benefits in less-developed areas. The reform also adjusted eligibility criteria for financial grants related to county unemployment rates, and changed certain provisions to respond to consequences of the COVID-19 pandemic.

## Box 5.2. Incentive design is influenced by EU State Aid rules

### State aid can be granted under certain conditions

EU competition policy generally prohibits State Aid, defined as action by a national, regional or local public authority, using public resources, to favour certain undertakings or the production of certain goods. A business that benefits from such aid has an advantage over its competitors. This can affect trade or distort competition, which is prohibited under Article 107 of the Treaty on the Functioning of the European Union. However, EU State Aid rules determine several exceptions to this general prohibition when State Aid is justified by reasons of economic development, including regional development.

In general, Member States are required to notify and receive authorisation from the European Commission (EC) prior to granting State Aid, with the exception of aid schemes conforming to sectoral block exemptions for agriculture and fisheries, certain *de minimis* aid, and the General Block Exemption Regulation (GBER). GBER sets parameters for aid in support of regional development, SMEs, R&D, environmental protection, infrastructure, and other areas of economic development. A recent amendment introduced new possibilities for aid measures that support the twin transition to a green and digital economy.

### GBER sets parameters for regional aid schemes

Regional Aid under the GBER is meant to support horizontal development; it does not include aid that targets a limited number of specific sectors (defined as less than five sectoral classes under NACE Rev. 2). Aid to certain sectors, such as transportation, is also excluded (see Box 5.3 below).

Regional Aid aims to attract investment in disadvantaged locations. In areas where GDP per capita is lower than 75% of the EU average, aid caps are higher. Regional Aid can also be granted in sparsely populated areas with less than 12.5 inhabitants per km<sup>2</sup>. Regional Aid rules set out the types of activities eligible for support, which costs relating to these activities may be covered, and the maximum aid intensity (aid cap) per beneficiary that may be granted for the various activities.

The annual State Aid budget of the scheme is capped at EUR 150 million per year. Otherwise, aid is subject to prior notification under general rules for State aid. For this reason, many countries, including Croatia, design their regional aid schemes to remain below this cap.

### Maximum amount of aid depends on the region

Regional Aid rules also set a cap (maximum regional aid intensity) per beneficiary, expressed as a percentage of eligible investment costs, defined through Regional Aid Maps. The maps, set within the framework of the revised Regional Aid Guidelines, are proposed by the national government and approved and published by the EC, and are periodically reviewed. Eligible expenses are tangible or intangible assets (such as construction, acquiring or leasing of assets) or the estimated wage costs over 24 months of new jobs created for the investment project. A combination of investment costs and estimated costs for wages can be possible but must not exceed the amount of whichever category is higher. Costs related to previously built buildings, land or previously used equipment are not eligible. All types of benefits (e.g., tax incentives, financial grants) received must be accumulated when calculating maximum aid caps.

### Annual reporting is required

Countries using State Aid schemes, including aid granted under the GBER, are subject to ex-post annual reporting to the EC. The EC then publishes the annual State Aid Scoreboard which provides a comprehensive overview of EU State Aid expenditure based on the reports provided by the Member States.

Notably, aid granted under the GBER can be challenged by other Member States, through a case in national court or a complaint to the Commission. The EC then verifies whether the aid has an incentive effect, its “appropriateness”, and if its benefits outweigh its costs. State Aid is appropriate when no other intervention can achieve the same results with less distortion of competition. The EC can determine that even though the aid fulfils the conditions set by the GBER, it may not be compatible with rules of the internal market. The EC has ruled in the past that distortion of competition was greater than potential benefits for regional development. It has also determined that aid was proportionally too great, even though it fell within the limits set by the GBER (OECD, forthcoming<sup>[12]</sup>).

Source: Commission Regulation (EU) No 651/2014 of 17 June 2014 declaring certain categories of aid compatible with the internal market in application of Articles 107 and 108 of the Treaty (OJ L 187 26.6.2014, p. 1).

### ***The Investment Promotion Act grants tax and financial incentives to spur new investment, job creation and regional development***

The Investment Promotion Act (63/22) sets the main incentives available to investors. The regime targets new investment or firms that invest in a new economic activity, with benefits rising with investment value. The regime also aims to enhance regional development – through higher caps on benefits in less developed areas – and encourage employment. CIT incentives are the core of the Investment Promotion Act and are complemented with financial grants as well as in-kind benefits in form of rent-free lease of state-owned land and buildings. Incentives are not available to several sectors on a negative list, set by the government and compliant with the GBER on Regional Aid (Box 5.3).

Accumulated aid from incentives (including tax relief and non-tax benefits governed by other laws) cannot exceed the maximum amount of State Aid per beneficiary, as determined by EU State Aid rules. The maximum amount is expressed as a percentage of eligible costs –expenses related to investment (tangible or intangible assets) or costs for newly created jobs (i.e., gross wage costs for 24 months). Costs related to previously built buildings, land or previously used equipment are not eligible. The cap varies depending on regions (defined under Regional Aid Maps); in Croatia as of 2022 the cap is higher in less developed and sparsely populated regions. In addition to this cap, the Act states that the annual amount of aid cannot exceed EUR 7 million per beneficiary.

Investors are required to carry out the planned investments, i.e., acquire new fixed assets or create new jobs, within three years from the project starting date. In addition, the Act requires a minimum period for maintaining investments, set at three years for MSMEs and five years for large enterprises (definitions on enterprise size set by EU regulations). This is enforced through annual reporting requirements by firms to the MESD’s Sector for Incentives and Entrepreneurial Infrastructure (referred to throughout as Sector for Incentives). If investors do not comply with this obligation, they are required to repay the full amount of State Aid received.

### Box 5.3. Sectors not eligible for Regional Aid

GBER establish a negative list of sectors and activities which cannot be supported through Regional Aid schemes of EU Member States. These sectors are excluded from incentives in Croatia's Investment Promotion Act and include:

- agriculture, aquaculture and fishery production,
- steel, coal, synthetic fibres, transport sector and related infrastructure,
- energy production and distribution, energy infrastructure
- development of broadband networks,
- research infrastructures,
- shipbuilding sector,
- financial and insurance sector,
- health sector, social care sector and education sector,
- trade sector,
- construction and real estate sector,
- water management, waste management and environmental upgrading sectors,
- mining and quarrying sectors,
- transportation and storage sectors.

Other activities not eligible for aid under Croatia's Investment Promotion Act and the GBER include subsidising costs of export activities to third countries or undertakings in difficulties or insolvency, conditioning aid upon the use of domestic goods over imported goods or other practices violating EU internal market law.

Source: Commission Regulation (EU) No 651/2014 of 17 June 2014 declaring certain categories of aid compatible with the internal market in application of Articles 107 and 108 of the Treaty (OJ L 187 26.6.2014, p. 1) and Investment Promotion Act (OG 63/22).

### *CIT incentives offer substantial reductions from statutory rates*

According to MESD's Sector for Incentives, tax benefits are the most used incentives provided by the Act. They are offered in the form of reduced CIT rates that lower the statutory rate by 50-100%, depending on the investment volume (tangible or intangible assets) and the number of new jobs created, and subject to caps as noted above.

Tax benefits are available to new investments or new economic activities in a range of manufacturing and service sectors (excluded sectors are listed in a negative list described in Box 5.3):

- **Manufacturing and processing activities,**
- **Development and innovation activities,** defined as activities affecting the development of new or significantly improving existing products, production series, production processes or production technologies,
- **Business support activities** which include centres for product design, multi-media-contact, IT development, ICT system and software development, logistics and distribution or data centres,
- **High-added value activities,** defined as including architecture, design, marketing or media communication, accommodation and activities related to tourism and industrial engineering.

Larger projects receive the greatest benefits; projects investing EUR 3 million that create at least 15 new jobs are eligible for 100% CIT reductions (Table 5.1). The duration of the reduced rates is 10 years (except for micro enterprises) – or until the cap (maximum aid intensity per beneficiary) is reached. The ten-year period begins at the starting date of the investment project as indicated in the application for incentives.

**Table 5.1. CIT incentives are tied to investment and job creation conditions**

CIT rate reduction	Period (years)	Investment amount (EUR)	New jobs created	Retention period, in years*
50%	5	50.000+ (micro-enterprises)	3	3
50%	10	50.000 (ICT system and software development centres)	10	3(SME) / 5(large)
50%	10	150.000 – 1 mln	5	3(SME) / 5(large)
75%	10	1 mln - 3 mln	10	3(SME) / 5(large)
100%	10	3+ mln	15	3(SME) / 5(large)

Note: \*minimum period for maintaining the investment project and jobs after the completion of the investment.

Source: Art. 12f Investment Promotion Act (OG 63/22).

The government recently introduced CIT incentives to boost the transition to Industry 4.0. Benefits are available to firms in the manufacturing and processing industry that conduct automation, robotisation and digitalisation of production processes, and that meet minimum investment values. Instead of creating a minimum number of jobs, investors need to demonstrate a 10% productivity increase per employee after three years. This is measured as an increase in the value of the total income in relation to the number of employees on an annual basis (Table 5.2).

**Table 5.2. Incentives seek to modernise business processes & increase productivity**

CIT reduction	Period (years)	Investment amount (EUR)	Productivity increase* (after 3 years)	Retention period, in years**
50%	10	500.000 – 1 mln	> 10%	3(SME) / 5(large)
75%	10	1 mln – 3 mln	> 10%	3(SME) / 5(large)
100%	10	3+ mln	> 10%	3(SME) / 5(large)

Note: \*expressed as an increase in the value of the total income of beneficiaries on an annual basis, in relation to the number of employees on an annual basis.

\*\* minimum period for maintaining of the investment project and initial number of jobs after the completion of the investment.

Source: Art.19 Investment Promotion Act (OG 63/22).

### *Financial grants are available for job creation and training*

Financial incentives are available to support job creation through investment projects across sectors. Depending on the level of the unemployment rate in one of the 20 counties or the city of Zagreb, non-refundable grants substitute 10-30% of wage costs incurred for new employees with certain characteristics. These criteria relate to age, disabilities, length of unemployment or in case their previous work contract was terminated due to bankruptcy proceedings. For employees that do not meet any of these criteria, aid is reduced to 40% of the amount eligible for employees with special characteristics (Table 5.3). Grants are also capped depending on the county unemployment rate.

Several top-ups related to the number of jobs created or the investment project's business activity can be accumulated and may increase the employment grant by up to 150%. For example, labour-intensive investment projects with at least 100, 300 or 500 newly created jobs raise the generosity of the grant by 25%, 50% or 100%, respectively. Top-ups are also available for development and innovation activities

(including development of new production processes or technologies), business support activities (primarily related to the ICT sector), and high value-added activities covering a range of professions including architecture, design, marketing or media communication, certain tourism activities, and industrial engineering. The definitions of the different activities are specific and defined in the Investment Promotion Act (Art. 16) and regulations.

**Table 5.3. Grants support job creation costs in low employment regions & for high value-added activities**

Employment incentive	County unemployment rate			Other conditions
	< 10%	10% - 15%	> 15%	
Grant as a % of wage costs*				
Grants for wage costs per new job **	4% (max. EUR 1,200)	8% (max. EUR 2,400)	12% (max. EUR 3,600)	Opening 5-15 new positions, Min. retention of employees for 3 (MSMEs) years or 5 (large) years*
Grants for wage costs per new job for specified employees***	10% (max. EUR 3,000)	20% (max. EUR 6,000)	30% (max. EUR 9,000)	
<b>INCREASE (activity-based)</b>				
Development and Innovation activities	+ 50%			
Business support activities	+ 25%			
High added value activities	+25%			
<b>INCREASE (labour-intense)</b>				
100+ new jobs	+ 25%			
300+ new jobs	+50%			
500+ new jobs	+100%			

Note: \*Wage costs refers to the estimated wage costs over 24-months per new job created

\*\*Grants are a one-time payment.

\*\*\*Special employee characteristics are determined by regulation and refer to persons registered as unemployed with the Croatian Employment Service (CES): (i) for at least 6 months, regardless of the length of the work experience and level of education, (ii) that are older than 50 years, (iii) without work experience or (iv) whose employment contract has been terminated due to the opening of bankruptcy proceedings.

Source: Article 14 Investment Promotion Act (OG 63/22)

Training grants are available for all sectors covered by the Act and bear up to 50% of costs incurred for training employees in newly created jobs. The benefit increases to 60% of costs for medium-sized enterprises and up to 70% for small enterprises or if the training is for workers with disabilities employed by SMEs. Eligible costs include training personnel and operating costs (e.g., supply of equipment, accommodation). While training grants can be used on top of employment grants, it cannot exceed 50% of the amount received from the job creation grant for the respective employee.

#### *Financial grants target capital costs related to high-technology equipment*

Financial grants also support upgrading machinery and equipment in capital-intensive investment projects in manufacturing and processing activities, again conditional on minimum investment and job creation. The aid is only available if the respective county unemployment rate is at least 10% and supports expenses related to the acquisition of new machinery and equipment or the construction of a new factory or industrial plant (Table 5.4). At least 40% of the total investment value must constitute investment in machinery and equipment, out of which 50% must be high-tech equipment. Investors are obliged to fulfil the minimum period of maintaining the investment project for five years (large investor) or three years (MSMEs) after the completion of the investment.



**Table 5.4. Aid for capital costs requires a minimum share of high-technology equipment**

Incentive for capital costs	Grant for % of capital expenditure*	Investment amount (million EUR)	Other requirements
County unempl. rate: 10-15%	10% (max. EUR 500.000)	5	- Min. 40% invested in mach. & equip.,
County unempl. rate > 15%	20% (max. EUR 1 M)	5	- Min. 50% of mach.& equipment high-tech

Note: \*in long-term assets

Source: Article 17 Investment Promotion Act

### *Land and buildings can be leased rent-free under certain conditions*

Land or buildings owned by the Republic of Croatia that are not in operation (“inactive”) can be leased rent-free for up to ten years. Investors are required to “activate” these state-owned assets by investing at least EUR 3 million in fixed assets and create at least 15 new jobs within three years. In less developed regions this incentive can be approved without a legal tender procedure. The application process is governed by regulations on the management of state assets owned by the Republic of Croatia and requires the conclusion of a leasing agreement between the Republic of Croatia and the beneficiary. After the end of the leasing period, the beneficiary may purchase the asset or continue to lease without aid.

### **Faster administrative procedures available for Strategic Investment Projects**

The Act on Strategic Investment Projects (ASIP) (OG 29/18, 114/18) complements the Investment Promotion Act. It defines what constitutes “strategic investment projects”, using criteria linked to business activity, minimum capital investment thresholds (HRK 10 million, approximately EUR 1.3 million), and requires the project to comply with physical planning documents. The primary objective of the law is to provide quicker administrative processes by elevating procedures to the central government instead of the local level.

Additionally, the ASIP outlines the terms for the sale of state-owned property, awarding concessions, and issuing administrative licenses. It applies to private, public, and private-public investments. Strategic investment projects are governed by the Sector for Competitiveness within the MESD’s Directorate for Internationalization.

### **R&D activities incentivised through tax benefits and financial grants**

The regime for R&D incentives is separate from other investment incentives in Croatia. It has been in place since 2019 and is governed by the Law on State aid for Research and Development Projects (OG, 64/18) and the ordinance on State aid for research and development projects (OG, 9/19). The MESD is the responsible authority for setting the incentive policy, although the Croatian Agency for SMEs, Innovation and Investments (HAMAG BICRO) is the implementing body.

The regime targets basic research, industrial research, experimental development, and feasibility studies. It is thus eligible for projects at different stages, ranging from the early research phase to further development of already existing products. Investors have three years to implement the project, starting from the announcement of the positive incentive decision.

Depending on the type of research project, 125-200% of eligible R&D expenses can be deducted from the taxable base, with the total amount of support reaching up to EUR 300 000 per entrepreneur and project. Eligible expenses include current expenditure (including wages and salaries) and certain capital expenditure (e.g., equipment). The regime is also regulated by the GBER (under provisions related to R&D aid rather than the Regional Aid scheme), which sets a ceiling for maximum State aid intensity per beneficiary and determines the amount deductible. For basic research projects, an additional 100% of

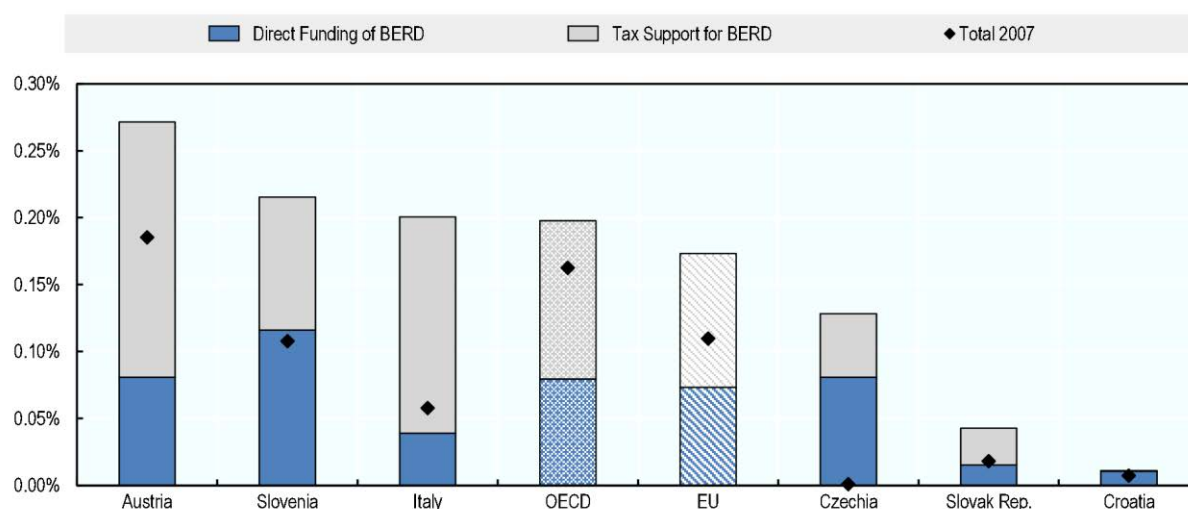


eligible project costs are deductible, whereas for other types of research projects (e.g., feasibility studies) the ceiling is lower. This enhanced tax allowance enables investors to deduct up to twice the amount of the actual expenses incurred.

Croatia, like most OECD countries, uses a mix of tax relief and direct funding to encourage R&D and innovation. This helps to support different R&D policy objectives. Studies suggest that R&D tax incentives are more effective to support projects that are closer to market, while direct funding appears more important for longer research (such as for pharmaceuticals) (Appelt et al., 2020<sup>[13]</sup>). In Croatia, 97% of R&D incentives awarded are grants (Government of Croatia, 2022<sup>[14]</sup>). Even though most applications for tax incentives are approved, the number of applications is relatively low (around 70 projects received R&D tax incentives in the period 2019-2021 out of around 100 applications) (Figure 5.3). Additional analysis is required to understand why this is the case (see Monitoring and Evaluation for a discussion on take-up of the incentives under the Investment Promotion Act). Relatively low take-up of R&D tax allowances could be due in part to complex application procedures or a lack of awareness about the incentive regime among SMEs. Compared to other CEE countries and the OECD and EU28 average, funding and tax support of company R&D expenditure is significantly lower in Croatia (Figure 5.3). The MESD is aware of these challenges and plans to reform R&D tax incentives and respective application and granting procedures until 2025.

**Figure 5.3. Croatia spends little in support of business R&D compared to peers**

Direct government funding and tax support for business R&D as a percentage of GDP, 2019



Note: Funding and tax support of business enterprise R&D expenditure (BERD).

Source: OECD R&D Tax Incentives Database, accessed January 2023.

### ***Economic zones offer other tax and non-tax benefits and business support services***

Croatia also offers benefits and services associated with locating in special economic zones. There are two zone regimes in Croatia: free zones and entrepreneurial zones. The objective of free zones is to build the industrial infrastructure for the production of goods aimed for export, while the goal of entrepreneurial zones is enhancing regional development. In 2022, Croatia operated six free zones and 313 entrepreneurial zones. Benefits for companies in free zones – which can be established at seaports, airports, river piers or along international roads – include an exemption of customs duties or certain taxes, including VAT, levied on goods stored in the zone and unlimited time for storing goods in the zone. The zone users can also benefit from forwarding and logistics services and consultations. The founders of free

zones can be regional authorities, institutions, public or private companies and zones are governed by the Free Zones Act (OG 44/96, 58/20).

Entrepreneurial zones target companies and entrepreneurs operating in manufacturing, processing, logistics, distribution activities and selected services. While they do not provide special tax incentives, a key benefit of operating in one of the zones is that they are equipped with infrastructure (i.e., energy, transport, ICT and municipal infrastructure) and that related costs can be lower due to multiple users in the zone. Zones can also provide lower land prices, reduced parafiscal charges (e.g., lower utility charges) and assistance and consultation services. Local and regional authorities can be the founding bodies and the MESD grants financial and planning assistance to these bodies when creating the zones. These zones are governed by the Entrepreneurial Infrastructure Improvement Act (OG 93/13, 138/21). The act also sets the framework for entrepreneurial support institutions. These local institutions can take different forms, including development agencies, entrepreneurship centres, business incubators, business parks or competence centres. They are intended to strengthen entrepreneurial competences by offering services to existing and future entrepreneurs. The main services of these institutions are counselling, assisting and educating entrepreneurs. In September 2022, the number of entrepreneurial support institutions in the country amounted to 214, ranging from two to 33 per county.

### ***Sub-national governments grant additional incentives***

Sub-national governments and county development agencies offer various types of incentives (see Chapter 4 for more on regional development). These can include in-kind incentives such as easy access to industrial sites, utility connections, reduced price of land and exemptions from local taxes and administrative fees. There is no complete overview of all incentives granted at the local level. Some of the local incentives are displayed in the catalogue of regional and local grants, provided on the homepage of the Croatian Employment Service (Croatian Employment Service, 2022<sup>[15]</sup>).

A special case is the incentives regime for the city of Vukovar, which was significantly damaged during the homeland war in 1991. The incentive was introduced at the national level through the Income Tax Law (article 43) and the Profit Tax Act (article 28.a). To encourage rebuilding and reestablishment, investors operating in the city of Vukovar are fully exempt from paying Personal Income Tax (PIT) or CIT if they employ five or more workers and if at least half of their employees are residents of the city or surrounding assisted areas. Additionally, if taxpayers perform activities in the areas of the local self-government units (categorised as group 1, as defined per regulation on regional development), half of their taxable income is CIT or PIT exempt.

### **Incentives are governed by different institutions and under various legal acts**

While most incentives for investors are authorised in the Investment Promotion Act, the governance of investment incentives is split across different institutions and legal frameworks. This is not unique to Croatia; however, it raises the importance of coordination to ensure that incentive programmes complement each other.

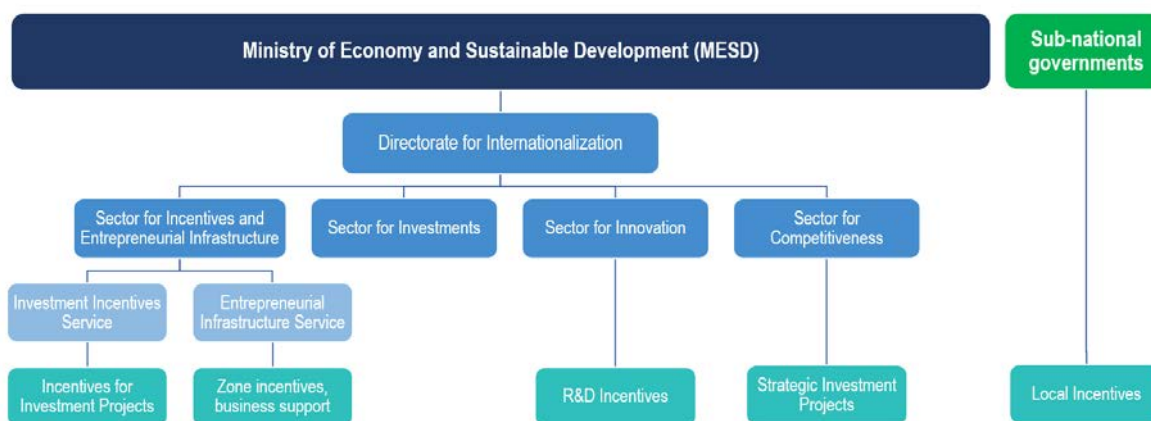
Incentives granted under the Investment Promotion Act are governed by the Sector for Incentives and Entrepreneurship (referred to throughout as Sector for Incentives), a department under the Directorate for Internationalisation in the MESD. The Sector is responsible for implementing incentives granted by the Act, monitoring the compliance of beneficiaries, and is also involved in proposing policy changes and amendments of the Act. The Sector is divided into the Investment Incentives Service and the Entrepreneurial Infrastructure Service. The Investment Incentives Service is in charge of the operational aspects of incentives for investment projects. It receives applications, checks project eligibility, and meets with applicants prior to approval. It coordinates with the Ministry of Finance (MoF) before granting

incentives, to request information about potential tax arrears, it receives MoF approval and shares which investors have been granted beneficiary status with the MoF.

Other incentives are governed by different units or institutions under separate legislation. The Entrepreneurial Infrastructure Service is involved in the creation of zones and business support institutions and maintains a register of existing zones and support institutions. It also evaluates requests of local authorities for donating state-owned land from the national to the local level for the establishment of new zones. Free zones are governed by the Free Zones Act (OG 44/96, 58/20) and entrepreneurial zones and support institutions by the Entrepreneurial Infrastructure Improvement Act (OG 93/13, 138/21), although not the MESD but the zones' founding bodies (e.g., regional authorities) determine the concrete benefits.

Another unit in the MESD's Directorate for Internationalisation (Sector for Innovation) is responsible for R&D incentives, regulated under the Act on State aid for Research and Development Projects (OG 64/18) and related ordinance (OG 9/19). The Sector is solely responsible for the implementation of R&D incentives though according to representatives from the MESD it coordinates with other units when designing incentive policies. Lastly, other (mostly non-tax) incentives are granted at the local level by sub-national governments or local development agencies and may vary in each of the 20 counties and the city of Zagreb. There appears to be no formal coordination between national institutions in charge of incentives and sub-national governments or local development agencies.

Figure 5.4. Different sectors of MESD responsible for incentives



Source: Authors' elaboration.

Split governance frameworks can result in challenges for coordination on design and implementation of incentive policy, and can make it more difficult for the government and investors to understand the scope of incentives offered. Some agencies seem to coordinate more than others. Both the Sector for Incentives (responsible for the main incentives granted in the Act) and the MoF reported a well-functioning coordination process to share information on potential tax arrears of applicants and which investors receive incentives. However, coordination between all incentive-granting sectors within the MESD, other ministries and different incentive-granting authorities at the local level appears to be limited. The MESD's Entrepreneurial Infrastructure Service is responsible for zone policy and monitors the development of entrepreneurial zones. It appears, however, that there is no central oversight or coordinating body at the central government level that coordinates zone activities (OECD, 2019<sub>[16]</sub>).

Many countries grant tax and other incentives in a variety of laws, including investment laws, administered by different agencies (Celani, Dressler and Wermelinger, 2022<sub>[17]</sub>). Investment laws can add transparency to the investment regime and are more often used in developing and emerging economies than in OECD

countries. However, investment policymakers tend to be inclined to offer fiscal benefits to attract investment, perhaps without full consideration of the state's fiscal needs. Close coordination with the Ministry of Finance is therefore key to ensure that incentives are cost-effective. Moreover, without mechanisms to share information between incentive-granting authorities, incentives may overlap, be inconsistent, or work at cross-purposes (OECD, 2013<sup>[18]</sup>). This is particularly a risk if different ministries offer CIT incentives. While the Sector for Incentives is responsible for granting most CIT benefits, it does not oversee R&D incentives and incentives for investors in Vukovar city, and coordination could become a greater challenge if tax incentives for tourism move under the remit of the Ministry of Tourism and Sports. Sharing information across levels and bodies of government on beneficiaries of incentives is important to curb potential redundancies in granting benefits to the same investors (Jedlicka and Sabha, 2017<sup>[19]</sup>).

Croatia could consider how to improve coordination in its reform efforts, both at the national level (within sectors of the MESD and between different ministries) and with representatives from the local level. This is important to counteract the risk of operating in silos when designing both tax and non-tax incentive policies independently, particularly between the national and sub-national level.

## Assessing design of investment tax incentives

The forthcoming National Plan on Investment Promotion provides an opportunity to assess Croatia's investment incentive policies, including their design, goals and use, whether incentives are supporting policy goals. Of the incentives outlined, according to the MESD, CIT incentives granted through the Investment Promotion Act are the primary incentives used by investors (83% of incentive spending via the Act is on tax benefits, compared to 17% on grants) (Government of Croatia, 2022<sup>[14]</sup>). This section assesses the implications of the design of these tax incentives for their policy goals, suggesting potential areas for reform. It also considers the implications of the international tax agreement on incentive policies.

Empirical evidence on the benefits of tax incentives is limited but confirms that in addition to context and framework conditions of the jurisdiction, incentive design is critical for their success (see OECD (2022<sup>[11]</sup>) for a literature review on effectiveness of incentives). Incentive design relates to the type of incentive (how the incentive reduces taxation, including qualifying income or expenditures), eligibility conditions (which investors and projects qualify to receive the incentive), and governance (how the incentives is awarded to investors) (Celani, Dressler and Wermelinger, 2022<sup>[17]</sup>). These aspects affect incentive uptake and investor behaviour, and thus are key to assessing if incentives seem to be contributing to stated policy goals, and at what costs.

As detailed above, Croatia has aligned incentives under the Investment Promotion Act with EU regulations on Regional Aid, with a positive effect on incentive design. Incentives are available to firms of any size, in a broad range of sectors, preventing unfair distortions to competition or opportunities for rent seeking behaviour by favoured sectors. Eligibility conditions are clear and specific, and tied to positive development goals, notably, regional convergence and job creation. Tax and financial benefits are capped with a ceiling per project as well as annual spending limits for the regime as a whole, proving a check on government expenditure. As will be explored in the following section, EU regulations also positively mandate thorough monitoring and reporting on incentive uptake and costs, an essential first step to evaluating the impact of incentives.

Looking forward, the government could consider revising some of its incentives to maximise positive spillovers, limit potentially excessive benefits to firms, and ensure incentives are in line with broader investment policy goals. Moreover, though not covered in this chapter, as the government elaborates its investment promotion plan and goals, it should also evaluate if other policy instruments – including regulations – may be more appropriate for certain economic and sustainable development objectives.

### **Consider moving from income-based to expenditure-based tax incentives**

The key design features of investment tax incentives determine how the incentive provides tax relief. The four most frequently used CIT incentive instruments and their main design features are summarised in Box 5.4. Income-based tax incentives (CIT exemptions, reduced CIT rates) reduce the rate applied to generated income and generally attract investments that are already profitable early in the tax relief period. These firms may not be most in need of government support; profitable firms are arguably more likely to have undertaken the investment even without incentives (IMF, OECD, UN, World Bank, 2015<sup>[6]</sup>). CIT reductions and exemptions can lower effective tax rates substantially, even to 0%, with potential significant costs in terms of revenue forgone (Celani, Dressler and Hanappi, 2022<sup>[20]</sup>).

#### **Box 5.4. Tax incentive instruments**

The most commonly observed CIT incentives can be categorised as income-based tax incentives (CIT exemptions and reduced CIT rates), which reduce the rate applied to generated income, and expenditure-based tax incentives (tax allowances and tax credits), which relate to the capital or current expenditure of firms.

- **Tax exemptions** provide a full or partial exemption of qualifying taxable income and apply on a temporary or permanent basis.
- **Reduced rates** are CIT rates set below the standard rate for a sector or firm type and apply on a temporary or permanent basis.
- **Tax allowances** are deducted from taxable income (i.e., income subject to taxes) and may target current expenditure (e.g., operation expenses) or capital expenditures. Tax allowances may allow for a faster write-off of value of capital expenditure from taxable income up to 100% of incurred costs (i.e., acceleration) or can go beyond 100% of acquisition cost (i.e., enhancement). This could include, for example, allowing firms to deduct 150% of the value of a new machine. Tax allowances for current expenditure are always enhancing (i.e., deductible expenditures are higher than actual costs incurred).
- **Tax credits** are deductions from the amount of taxes due (i.e., tax liability) that may relate to capital expenditures or current expenditures.

Note: Additional information on how the key design features affect tax relief is discussed in Celani, Dressler and Hanappi (Celani, Dressler and Hanappi, 2022<sup>[20]</sup>).

Source: (Celani, Dressler and Wermelinger, 2022<sup>[17]</sup>).

Investment tax incentives in Croatia take the form of reduced CIT rates (income-based). Positively, reduced rates are conditional on substantive investment in the country, with minimum investment value and employment requirements. Investors are required to retain fixed assets and jobs for three to five years. Tax incentives in Croatia are also capped as a share of the investment value, which can limit excessive costs in terms of revenues forgone. Tax incentive caps are set in Croatia's regional aid map for 2022-2027, with higher caps in regions with lower levels of GDP per capita.

In many cases, it seems income-based incentives are used primarily because of tax competition with other economies, making it difficult for countries to unilaterally remove such benefits (Klemm and Van Parys, 2012<sup>[21]</sup>). Czechia and the Slovak Republic also offer income-based incentives under Regional Aid schemes, with similar tax relief as Croatia for up to ten years, also conditioned on minimum investments and capped at a percentage of eligible costs. Countries with higher levels of GDP, including Austria and Slovenia, as most countries in the EU, primarily use expenditure-based tax incentives (targeted for R&D) and enhanced allowances for the acquisition of certain new assets.

Looking forward, especially as GDP levels in Croatia rise and allowances of incentives under EU Regional Aid changes, Croatia could consider phasing out the use of income-based in favour of expenditure-based incentives, such as accelerated depreciation and tax allowances or credits. While the effects of policies depend on the individual country context, there is evidence suggesting that accelerated depreciation and immediate expensing have been effective at increasing investment in OECD countries (Maffini, Xing and Devereux, 2019<sup>[22]</sup>; Zwick and Mahon, 2017<sup>[23]</sup>; House and Shapiro, 2008<sup>[24]</sup>; Cohen and Cummins, 2006<sup>[25]</sup>). Similarly, among developed countries, evidence of the effectiveness of expenditure-based R&D tax incentives is much more conclusive than for income-based tax incentives (OECD, 2022<sup>[1]</sup>; Hall, 2019<sup>[26]</sup>; Appelt, González Cabral and Hanappi, 2022<sup>[27]</sup>; Guceri and Liu, 2017<sup>[28]</sup>; Gaessler, Hall and Harhoff, 2018<sup>[29]</sup>). However, expenditure-based incentives still have costs, necessitating regular monitoring and analysis. Tax revenues are a key source of public finances, crucial for delivering public goods and services, such as infrastructure, education and skills development – factors that also affect the country’s investment climate.

Expenditure-based incentives could enable better targeting of incentives towards reducing specific costs, thereby encouraging spending that might not occur without the incentive. While income-based incentives in Croatia are conditioned on expenditure, the definition of eligible investment costs is broad (assets or wages); transforming the reduced rate into a tax allowance could allow to support specific policy objectives through targeting of relevant qualifying expenditure, for example, high-tech machinery. Because expenditure-based incentives directly target investment expenses, they reduce the cost of capital, making investments more profitable at the margin (IMF, OECD, UN, World Bank, 2015<sup>[6]</sup>). The benefit for the company depends on the size of the investment it undertakes and can also be linked to specific activities and policy objectives (e.g., R&D, skills development etc.).

Expenditure-based incentives are also likely to be less affected by the recently agreed Global Minimum Tax for large MNEs (Box 5.5). The agreement, by more than 135 jurisdictions, requires large MNEs (with revenues above USD 750 million) to pay a 15% minimum effective tax rate in all jurisdictions in which they operate. If in-scope MNEs in Croatia are subject to ETRs below 15% (for example through reduced CIT rates) Croatia could potentially forgo revenues that could be collected by other jurisdictions through a top-up tax, in the absence of tax reform or other policy actions.

As more countries are moving to implement the global minimum tax, it is important for Croatia to analyse the implications for its domestic tax system. In December 2022, EU Member States unanimously adopted a directive to implement the minimum tax for large MNEs and large domestic groups. OECD analysis shows that income-based incentives for in-scope MNEs will be strongly affected, whereas expenditure-based incentives are less likely to be affected. The current design of income-based incentives in Croatia ties tax support to creating economic substance in the country. The minimum tax rules allow a carve-out for profits associated with economic substance (OECD, 2022<sup>[1]</sup>).<sup>4</sup> This means that if incentives in Croatia are successful at attracting investment and generating employment, they should be better protected from the minimum tax. In consultations, the MESD noted that developments related to the minimum tax are being closely observed and that incentives for MNEs will be adjusted in close cooperation with the Ministry of Finance. It will be important to ensure coordination across ministries on this issue given the fast pace of action of reform in this area.



### Box 5.5. Tax incentives and the global minimum tax for MNEs

#### ***A global minimum effective taxation level for large MNEs***

Pillar Two of the new international tax agreement establishes a global minimum effective corporate tax rate of 15% for large multinational enterprises (MNEs). Where an MNE's effective tax rate (ETR) in a jurisdiction falls below 15%, the MNE would potentially be subject to top-up taxes under the Global Anti-Base Erosion (GloBE) Rules, a core component of Pillar Two. The GloBE Rules establish the minimum corporate tax and are complemented by the subject-to-tax rule which will allow developing economies to tax certain base-eroding payments (such as interest and royalties) when they are not taxed up to the minimum rate of 9%. The GloBE Rules apply top-up taxes to profits in excess of a substance-based income exclusion (SBIE), which allows some profits based on economic substance (tangible assets and payroll) to be deducted from the GloBE base.

A recent OECD report prepared under the request of the G20 Indonesian Presidency explores the impact of GloBE Rules on tax incentive use (OECD, 2022<sup>[1]</sup>). This report draws on the OECD Investment Tax Incentives Database (ITID) to provide evidence on tax incentives use in developing countries; outlines key provisions of the GloBE Rules; analyses the impact of GloBE on different common tax instruments and outlines some options for policymakers to explore.

#### ***Impact on the use of tax incentives***

The GloBE Rules will not affect all jurisdictions, MNEs and tax incentives in the same manner. The impact of the GloBE Rules on tax incentives will depend on their design, on the jurisdiction's tax system (its baseline tax system and its use of base narrowing provisions), and on the characteristics of MNEs and the activities they perform in the jurisdiction. For example, existing tax incentives may continue to be used by MNEs below the EUR 750 million revenue threshold, without them being affected by the GloBE Rules.

The impact of the GloBE Rules will strongly depend on the design of tax incentives. Certain types of tax incentives will be strongly affected, particularly certain income-based tax incentives such as full exemptions or significantly reduced CIT rates, which as shown above are widely used across the world. Others may not be affected at all, such as accelerated depreciation for tangible assets. Understanding the degree to which tax incentives may be affected by the rules requires careful consideration of the detailed design of tax incentives.

Targeted tax incentives, incentives with economic substance requirements and expenditure-based tax incentives targeted at tangible assets may be less affected. The targeting of tax incentives to certain categories of income or expenditure or limitations to tax benefits will impact which tax incentives might be affected. Expenditure-based tax incentives targeted to payroll tangible assets or tax incentives with substantive economic substance requirements may be less likely to be affected by the GloBE Rules due to the SBIE. However, the value of providing strongly reduced CIT rates or CIT exemptions to in-scope firms might merit a reassessment of the use of these tax incentives.

The GloBE rules should prompt jurisdictions to review the use of tax incentives and consider tax incentive reform. This is particularly the case for tax incentives that may become inefficient due to the operation of the GloBE rules.

Source: (OECD, 2022<sup>[1]</sup>)



### ***Consider if eligibility conditions best support policy goals***

Many countries design investment incentives not only to attract investment but also to advance certain economic, social, environmental and other goals. Carefully designed and targeted incentives may help correct market failures and advance social and economic development (OECD, 2022<sup>[30]</sup>; IMF, OECD, UN, World Bank, 2015<sup>[6]</sup>). This can be done through eligibility conditions that require investors to meet certain project or outcome requirements (e.g., investment size, job creation) to receive the incentive, or operate in certain sectors (e.g., renewable energy), or by designing the incentive to reduce certain expenditures (e.g., tax credits for R&D, infrastructure) or taxes on certain income (e.g., revenue from exports) (Celani, Dressler and Wermelinger, 2022<sup>[31]</sup>).

Tax and non-tax incentives under the Investment Promotion Act are designed to support the growth of substantive private sector investment (domestic and foreign), job creation, regional development and technological upgrading. CIT incentives under the Act (most used by investors) support these goals through eligibility conditions to receive benefits: projects must meet outcomes of job creation, modernisation of assets, or productivity increases, and can receive greater benefits if they invest more or locate in certain locations. Outcome conditions such as employment creation can promote positive spillovers of investment; however, they require careful monitoring to ensure that the outcome has been met. This necessitates resources, administrative capacity, and often coordination with other government agencies (e.g., cross-checking with social security information on number of jobs created or salary) (Celani, Dressler and Wermelinger, 2022<sup>[31]</sup>). The government is encouraged to critically evaluate if incentives are contributing to their goals, and if some policies could be adjusted to better target their aims.

#### *Incentives could further support costs of job creation and skills development*

Tax incentives promote job creation through an employment requirement (between three and 15 new jobs depending on the size of the firm) to receive reduced CIT rates. Investors are also encouraged to invest in areas with low employment, where caps for maximum State Aid per project are higher. Employment is also incentivised through grants, supporting costs of job creation and training employees in new jobs. The Investment Promotion Act further encourages employers towards more inclusive practices; grants are higher for disabled or older employees, and long-term unemployed people. Separate subsidies (not detailed in this chapter) are available through the Croatian Employment Services and other bodies, including reductions on social security contributions for hiring young employees (Government of Croatia, 2022<sup>[14]</sup>).

According to MESD's figures, since 2013 investment incentives under the Act have supported around 800 projects, which have created an estimated 27 000 new jobs (planned to be created from projects). That is approximately 5.4 jobs per USD million invested, higher than estimated job creation intensity of foreign investment in Croatia overall (3.5 jobs per USD million, see Chapter 1). This suggests that incentives could be supporting investment with greater employment potential. However, it is not clear how many jobs would have been created in the absence of the incentive. Results could also be linked to the sectors that most apply and benefit from incentives, notably metal processing, tourism, and ICT according to MESD.

It is also not clear how effectively a job creation requirement for reduced CIT rates incentivises new jobs. It requires close monitoring that the firm adheres to this requirement, and administrative costs to remove the incentive if firms are not complying. Income-based incentives also do not directly decrease the cost of employment. Social security contributions (SSC) in Croatia, as is in many countries in Central and Eastern Europe, are above the OECD average (OECD, 2019<sup>[11]</sup>). In consultations, investors frequently cited high employment costs as a constraint on growth.

Moving from income-based to expenditure-based tax incentives, for example, could directly reduce hiring or social security costs for employers, incentivising job creation. There is evidence that a well-designed tax credit in France, which was temporary and targeted at jobs with rigid wages, had a clear positive affect

on employment for small firms. Box 5.6 provides several examples of such policies in peer countries. However, CIT incentives cost the state revenue; taxing corporate incomes could allow the state to lower the labour tax burden, which could also support employment. Notably, other incentives in Croatia do seek to directly reduce the costs of employment, including grants in the Investment Promotion Act as well as other grants and reductions to SSC set in different legal acts (not covered in this chapter). It would be pertinent to explore if investors are using these benefits and if they are contributing to reducing employment costs.

More broadly, the government could consider other barriers to job creation, and other labour market goals. Job quality – including wage and non-wage working conditions – and skills development are key for inclusive labour markets (OECD, 2022<sup>[32]</sup>). Consultations with private sector associations revealed that investors are in many cases ready to employ but face constraints due to a lack of workers and skills mismatches of the available workforce. Consultations with the Croatian Employment Service and the Ministry of Labour, Pension System, Family and Social Policy supported these findings. The institutions emphasised on the need for up-skilling the Croatian population and mentioned that emigration trends of highly skilled Croatians are contributing to the low supply of workers. The government recently established tools as a base for a skills prediction system, such as the Labour Market Portal for monitoring labour supply and skills potential and labour demand on a county level. Further upskilling and educational programmes are planned. The MESD could use the upcoming reform of the Investment Promotion Act to assess if tax incentives and grants seem to be incentivising employment and skills development. Coordinating with the Ministry of Labour or the Croatian Employment Service might be insightful for discussing how to support up-skilling or re-skilling of the workforce and securing quality jobs.

### Box 5.6. Targeting employment and skills development through tax incentives

Many governments use tax incentives to target employment and skills development, for example through CIT allowances or credits, or through reductions or exemptions to other taxes such as social security contributions. CIT incentives can address employment outcomes by linking benefits to qualifying expenditure (e.g., wages or payroll expenses) or outcome conditions (e.g., creating a minimum number of new jobs). By using dedicated eligibility conditions and design features, incentives can support existing jobs, or encourage beneficiaries to create new jobs or invest in training opportunities of staff. Sometimes these goals overlap with other priorities; many countries that support employment costs via incentives also encourage skills development or promote R&D.

#### Reducing employment costs through tax credits

France has offered different tax credits to target employment costs. The Competitiveness and Employment Tax Credit (CICE) amounted to 6% of annual payroll charges paid and could be claimed for salaries that are up to 2.5 times the amount of the French minimum wage. It thereby significantly decreased the costs of medium and low wages. In 2019, a reform permanently decreased employers' social contributions and phased-out the credit.

France introduced a hiring credit to counter the effects of the 2008 recession. The credit relieved firms from paying social contributions for new employees hired between December 2008 until the end of 2009. It targeted small firms with less than ten employees and low-wage jobs. An econometric assessment of the credit found that it had a statistically positive effect on job creation (Cahuc, Carcillo and Le Barbanchon, 2019<sup>[33]</sup>). The success of the measure was due to certain design features: the credit was temporary, targeted at jobs with rigid wages and not anticipated by the labour market.

#### Targeting employment and innovation

In the Netherlands, investors can benefit from an employment incentive if their business is engaged in R&D activities. The country offers a payroll withholding tax credit (also known as the WBSO R&D credit scheme) that reduces wage costs of R&D employees. Such an incentive has the potential to boost employment and could generate knowledge spillovers, if researchers acquire skills on the job that they can transfer to other jobs. The incentive may also attract innovative companies. The benefit amounts to 32% for the first EUR 350,000 of R&D costs and 16% if expenses (wages or other expenses) exceed the threshold.

#### Tax allowances can support skills development

Italy offers a tax allowance for companies investing in training of staff for Industry 4.0. The goal is to support the up-skilling of staff related to the technological and digital transformation of businesses. Large companies can deduct 30% and medium-sized companies additional 50% of training costs from their taxable base, capped at max. EUR 250,000. For small companies, these thresholds increase to 70% of respective costs, capped at EUR 300,000.

Source: (Cahuc, Carcillo and Le Barbanchon, 2019<sup>[33]</sup>), (Grant Thornton, 2021<sup>[34]</sup>), (Insee, 2019<sup>[35]</sup>)

### *Assess if changes to tax incentives are supporting regional development*

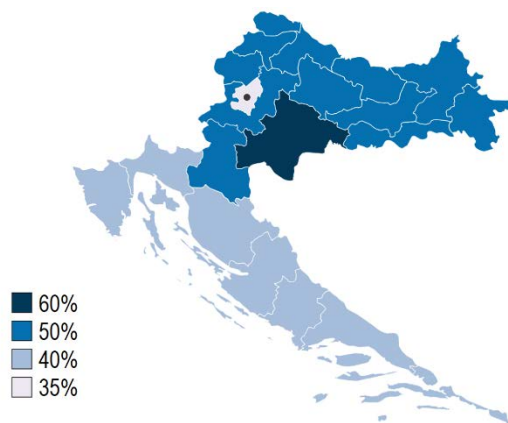
Many governments design incentives to promote regional development, often through eligibility conditions that require investors operate in certain locations to receive benefits. In Croatia, investors in under-developed regions or regions with higher unemployment rates can receive greater benefits: larger grants

to support job creation and equipment upgrades, and as of 2022, higher caps on incentives. The government recently revised its Regional Aid Map, which sets caps – as a percentage of eligible investment costs (assets or wages) – on the total amount of tax and non-tax incentives an investor can receive over the project lifecycle. The 2022-2027 map sets caps between 35-60% of eligible costs for large investors, with higher ceilings in less developed regions, notably in Pannonian and Northern Croatia (Figure 5.5). The government recently increased the cap to 60% for the county of Sisak-Moslavina, one of the least developed areas in Pannonian Croatia. These changes revised the previous map, which capped benefits at 25% of costs regardless of project location. Regional Aid Maps are proposed by the government and approved by the European Commission (Box 5.2). For SMEs, the caps can be increased to up to 75% of eligible project costs (see note in Figure 5.5).

According to Croatian government officials, incentives have thus far not had the desired effect on promoting investment in less developed locations, and it is too soon to evaluate if the new Map will change this. However, since the differentiating caps were introduced, the Sector for Incentives reported receiving a rising number of applications for projects in some of the affected locations. Officials also noted that caps are among the highest across the EU, which it hopes might attract more investors to Croatia overall and these regions in particular.

### Figure 5.5. Croatia's regional aid map (2023 – 2027) caps aid at up to 60% of eligible project costs

Maximum aid expressed as a % of eligible project costs



Note: A recent change to the regional aid map introduced a 60% threshold for large investors in Sisak-Moslavina county that was previously supported by 50% (highlighted in dark blue). In all counties, maximum aid intensities can be increased by 10% for investments made by medium-sized enterprises and by 20% (except in Sisak-Moslavina, where the increase is limited to 15%) for investments made by small enterprises.

Source: MESD.

Studies suggest that in Europe, financial, in-kind and tax incentives have helped encourage investors to locate to less favoured regions, particularly for efficiency-seeking investors when this support helps offset disadvantages related to a more peripheral region. However, these concessions have in general been far more generous than what is necessary to compensate for extra costs of investors to locate in these areas (Amin et al., 1994<sup>[36]</sup>). Overly generous incentives in certain locations can increase the risk of aggressive tax planning by firms (for example, shifting profits to areas with lower taxation while keeping operations elsewhere), and a race to the bottom among regions (OECD, 2021<sup>[37]</sup>; IMF-OECD-UN-World Bank, 2015<sup>[38]</sup>). Case studies also highlight the importance of other complementary policies in attracting investors to under-served regions, including investment in infrastructure (Amin et al., 1994<sup>[36]</sup>).

If well designed, incentives can nonetheless help to offset certain costs or risks of investing in less developed regions, and the Croatian government could consider adopting a more targeted approach to location-based benefits. For example, tax allowances or credits could reduce costs related to infrastructure

and utilities. Incentives could also be used to increase the positive impact of investment across regions. Firms generally locate in less developed regions for cost advantages, including low wages. Incentives that support training costs and labour productivity through equipment upgrades (also discussed below) can help promote positive FDI effects (Amin et al., 1994<sup>[36]</sup>; OECD, 2022<sup>[30]</sup>). Grants for job creation costs could be further tailored towards training.

Designing incentives to attract additional investment in particular regions requires clear understanding of the challenges and opportunities for investors in these locations. MESD should ensure close coordination with subnational self-governments and agencies, who also grant their own incentives, to ensure that place-based incentives are relevant and coherent (Chapter 4). For example, some local authorities already grant in-kind incentives such as utilities and reduced price of land. The national government should consider the effectiveness of these measures. Overall, more evaluation is required to determine how investors are responding to existing incentives, and if these benefits can be revised to overcome costs of locating in less developed areas.

#### *Expenditure-based incentives could support technology upgrading*

One of the more specific goals of the Investment Promotion Act is supporting modernisation of business equipment via grants for equipment, requiring a minimum share of high-tech machinery (Table 5.4) and the transition to Industry 4.0, via CIT reductions for firms operating in the manufacturing and processing (Table 5.2). In 2015, the government also adjusted requirements to benefit from reduced CIT rates for the service-intensive ICT sector, by decreasing minimum investment thresholds in assets and increasing minimum job creation requirements. According to the government, the change led to a clear rise in incentives applications from ICT enterprises. Analysis of FDI trends confirms an increase in ICT investment; stock of greenfield FDI in ICT (manufacturing and services) grew by 22% more in the years after 2015 than during years prior to the policy change. Half of this increase was in ICT and internet infrastructure – essential to boosting the enabling environment for the digital economy – and around 40% in software and ICT services (Chapter 2). These figures do not imply a causal link between the incentives and rise in investments, which could also be due to a general growth in ICT sector in Croatia in recent years, particularly since the COVID-19 pandemic. Incentive policies, however, can also have an important signalling effect to alert investors to opportunities.

As outlined above, the government could consider adopting expenditure-based incentives rather than income-based benefits to better target relevant qualifying expenditure, and more directly support the policy objective. Tax allowances and credits are more likely to be effective at reducing the cost of technology upgrading, as opposed to equipment modernisation requirements. While reduced CIT rates in Croatia are tied to expenditure, eligible costs (assets or wages) go beyond investing in high-tech equipment and could be less effective in encouraging this purchase compared to more targeted expenditure-based incentives. Grants can also be useful to support technological upgrading, and it would be worthwhile for the government to explore why these are not used more widely by firms.

Croatia could consider examples from other countries that provide targeted support to firms specifically to pursue digital transformations (across sectors), using a mix of tax and financial support, as well as business advisory services (e.g., consulting and technical support). For example, Australia recently introduced a temporary tax credit to support digital upgrades in small firms (Box 5.7). Many countries in Central and Eastern Europe (CEE) are trying to position themselves as front runners in ICT services, innovation and high-tech industries (McKinsey, 2022<sup>[39]</sup>). Improving local digital skills is important in this regard, particularly for strengthening local linkages with SMEs. When SMEs have some digital tools, they are more appealing as domestic suppliers, which in turn supports their entry into global value chains. SMEs with basic digital skills are also more likely to benefit from more advanced technology transfers from international firms (OECD, 2022<sup>[32]</sup>).

### Box 5.7. Investment for digital upgrades and skills training in Australia

Australia has introduced a comprehensive package of investment incentives for digital upgrades across firms. Under the Technology Innovation Boost programme, small businesses with annual turnover of less than USD \$50 million can claim a 20% enhanced deduction (120% tax deduction) for cost of expenditures and depreciating assets up to a threshold. Eligible expenditure includes digital solutions such as portable payment devices, cyber security systems and subscriptions to cloud-based services. The policy is notable in using specifically, targeting relevant expenditure for digital upgrades, and in that it is time-bound, the boost applies only to expenditure incurred between March 2022 and June 2023. Time limits on incentives can facilitate policy evolution. The Skills and Training Boost programme provides similar tax benefits (enhanced tax deduction/allowance) for training courses to employees..

Source: (Government of Australia, 2022<sup>[40]</sup>).

#### *Assess tourism incentives ahead of planned reforms*

In addition to the areas mentioned above, tourism seems to be a priority for the government. The incentives of the Investment Promotion Act target “sustainable high value-added tourism services”, which include accommodations with at least four stars, related services (e.g. congress, sports-recreational, entertainment, health, tourist-ecological, nautical) and amusement theme parks. The tourism industry has been rapidly growing and upscaling towards more high-end establishments in the last recent years but it is unclear to what extent incentives helped support this growth.

Croatia’s current reform plans include creating a new legal act to grant specific incentives for the tourism sector that will be governed by the Ministry of Tourism and Sports. The tourism sector is one of the top recipients of incentives under the Investment Promotion Act, according to MESD. MESD noted in consultations that one rationale for this move is to create an incentives programme that is more adapted to the tourism industry. The reform would also allow more projects to receive incentives (and greater government spending) under the Investment Promotion Act, subject to a EUR 150 million cap under EU Regional Aid rules, if tourism projects fall under a different aid scheme (Box 5.2). While there are clear benefits for countries to keep incentives under GBER thresholds (not least to avoid lengthy approval procedures), introducing several aid schemes involves costs to the government.

Tourism already contributes to 20% of Croatia’s GDP. It also received up to 25% of total regional investment aid granted between 2013 to 2021. Tourism is in many ways location-specific, raising questions about whether investors are likely to enter Croatia’s tourism market regardless of incentives. This underscores questions around whether the type of incentives currently in place are generating additional investment in the country that would not have entered without the incentive. Before implementing the new tourism incentives programme, more studies on the impact and need for tourism incentives would be beneficial.

### Transparency can increase take up of incentives

Many countries face difficulties enhancing the transparency of their incentive regimes to investors. Transparency concerns the legal basis (e.g., clear criteria stated in law) but also relates to the governance of incentives (e.g. administrative burden of application, discretion during granting process) and promotion

(accessibility of incentive legislation and available incentives) (OECD, 2023<sup>[41]</sup>). From the perspective of investment facilitation – i.e., improving practical procedures for investors entering and operating in a market – greater transparency on available incentives and conditions for receiving them could help countries to attract untapped investment sources, by levelling the playing field among investors. SMEs have fewer resources to navigate the often complex legal framework governing incentives, and may be deterred by incentives that require lengthy or complex approval processes. Foreign investors that are less familiar with the local market may not be aware of potential assistance to support new investment; greater transparency could help overcome information asymmetries (Jedlicka and Sabha, 2017<sup>[19]</sup>).

Croatia has taken successful measures to enhance transparency on incentives for investors. The “Invest Croatia” homepage features an incentives calculator that allows investors to calculate the total value of benefits they can receive, depending on their project characteristics and investment costs. Furthermore, Incentives are granted based on clear and measurable criteria outlined in the law. This is positive compared to many other countries, including in CEE, where governments have more discretion in granting decisions. In consultations, investors noted that they consider requirements for receiving incentives clear and did not experience unpleasant surprises during the granting procedure. Based on information shared by the MESD, the Ministry did not approve around one-third of applications for incentives received in 2021. The most common reasons for the rejection were that applicants had already started the investment project prior to the application, which is not in line with EU requirements or indebtedness of applicants.

The availability of information on incentives is in line with other CEE countries. The MESD’s Sector for Investments maintains an up-to-date guide on the incentives offered under the Investment Promotion Act on the “Invest Croatia” website. The guide provides details on eligibility criteria and the different categories of aid available, as well as an English translation of the law. This is good practice to ensure that investors are aware of incentives and their requirements. The homepage also features the Investment Promotion Act, relevant regulations and the application form translated in English. These documents are important as they detail the application process and full incentive requirements.

However, additional efforts could further support investors in understanding the incentives regime. As outlined, incentives in Croatia are governed by several pieces of legislation and authorities which may create challenges for investors to understand the full system. While MESD’s Sector for Investments has made strides in providing information on various regimes (beyond the Investment Promotion Act) on its “Invest Croatia” website, a comprehensive guide that highlights all available schemes – including at the local level – and relevant legislation could provide investors with a more complete picture of the scope of benefits available. This could be further enhanced through an interactive online tool that provides information on how a given investor can benefit from incentives. One example is in Spain, where the Investment Promotion Agency features an “Incentives and Aids Search Engine” on its website that lists different grants per region and sector. Croatia could also consider translating guides, websites and promotion material in the languages of its main investors (e.g., German or Italian). In consultations the MESD noted that administrative costs of keeping this information up to date were high; promoting information should be balanced with the administrative costs of doing so.

## Monitoring and evaluation

Better understanding whether incentives contribute to policy goals, and at what costs, requires careful monitoring and evaluation. Monitoring can include tracking investor compliance with qualifying conditions and audits to detect potential fraud or abuse. Monitoring should also involve collecting data on tax incentives expenditure (direct or revenue forgone), which supports evaluation on costs of policies. Regular reporting of tax expenditures also creates accountability and better control over the use of public funds (OECD, 2021<sup>[37]</sup>; Redonda, von Haldenwang and Aliu, 2022<sup>[42]</sup>). Croatia already conducts extensive monitoring of its incentive policies, including on incentive uptake and compliance, as well as on costs to



verify incentive caps per investor and for the Regional Aid programme as a whole. The EU also mandates annual reporting on expenditure on all incentives and descriptive details on aid recipients. The government could use its comprehensive set of data to inform evaluations on the impact of incentive policies, including if incentives seem to be effectively supporting stated policy goals, and if benefits outweigh costs.

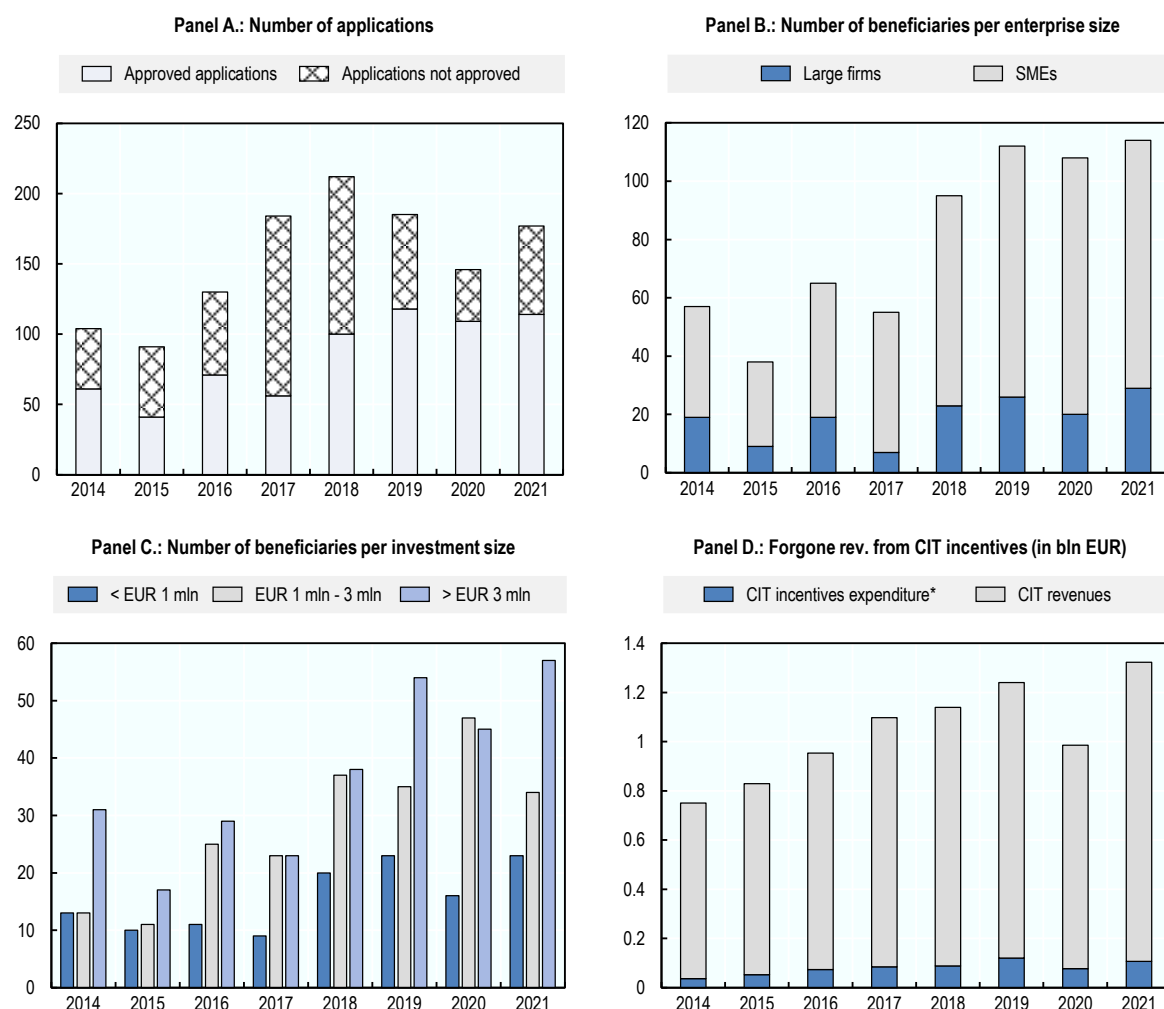
### ***Croatia monitors incentive take-up and compliance***

The Sector for Incentives closely monitors compliance of incentive beneficiaries with the conditions set in the Investment Promotion Act and to ensure that the amount of aid received does not exceed the maximum amount of state aid, as per EU GBER reporting requirements. This includes tracking whether investors comply with minimum investment and job creation requirements. Companies are required to submit annual reports to the MESD that show this information, as well as the amount of benefits already received. The Sector for Incentives reported that it closely coordinates with the Croatian Employment Service to ensure that newly created jobs are maintained for the required period. Another component of monitoring compliance is surprise audits of one to four companies per year. Out of nearly 800 companies that have received tax and non-tax incentives under the Investment Promotion Act since 2013, the Sector has identified 15 companies that did not comply with the requirements and consequently had to repay the amount of incentives received.

As a result of this reporting, the Sector for Incentives compiles detailed information on projects and companies benefiting from incentives, including enterprise size, sector, if foreign- or domestic-owned, project location, and other descriptive firm information. Based on data shared with the OECD, applications for incentives rose notably after 2015 amendments to the Investment Promotion Act but have remained fairly steady in terms of yearly requests since 2017 (Figure 5.6A). The ratio of approved projects to applications has been increasing in recent years, though overall the number of new projects supported (around 100 per year) is relatively low in absolute terms. Most incentive recipients operate in metal industry, wood processing, tourism and ICT sectors. While most of these sectors are well established in Croatia, the ICT sector has seen notable recent growth (Chapter 2). Incentives are predominantly used by SMEs (roughly two-thirds of recipients) and investment volumes commonly exceed EUR 3 million (Figure 5.6B and C). Most recipients are also domestic firms, one-fourth of supported firms are foreign owned.

The Sector for Incentives also collects detailed information on incentive costs. The Sector and the Ministry of Finance conduct some analysis on costs of incentives, though the methodology was not shared with the OECD. Data provided (on costs of CIT incentives in terms of revenue forgone as a share of overall tax revenue) suggests revenue lost on CIT incentives is relatively low (Figure 5.6D). However, full analysis would require better understanding on how tax expenditures are calculated. There are different methods to estimating revenue forgone from tax incentives, the most straightforward of which uses simple accounting to capture a static measure of revenue forgone as the difference in tax revenue under a scenario in which the tax incentive applies relative to the benchmark tax scenario, and when the tax incentive is removed. Such a measure does not consider changes in the behaviour of taxpayers owing to the removal of the incentive (OECD, 2021<sup>[37]</sup>) (IMF, OECD, UN, World Bank, 2015<sup>[6]</sup>).

**Figure 5.6. Initial data shows incentive applications and beneficiaries rising**

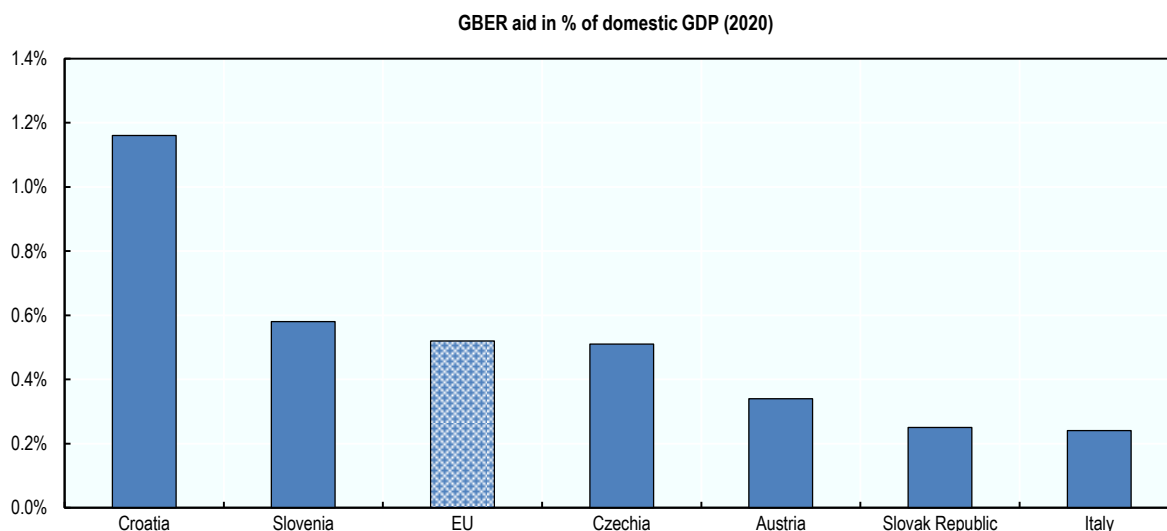


Note: \*CIT incentives expenditure reflects tax expenditures in terms of revenues forgone (Panel D.), as calculated by the Croatian government. All data provided by MESD, who indicated that revenue data (Panel B) was collected by the MoF.  
Source: Sector for Incentive, MESD.

### **Efforts to evaluate incentive policies could be strengthened**

The data collected through the monitoring process and for EU reporting could inform assessments of how incentives are used, if they are supporting their intended policy goals, and their costs. The data is already being used to inform amendments of the Investment Promotion Act. For example, the annual amount of aid granted under the Investment Promotion Act was EUR 122 million in 2019, just under the maximum limit of EUR 150 million for Regional Aid set by GBER. The Sector for Incentives consequently initiated discussions to move incentives for tourism – which received up to 25% of total regional investment aid granted per year in the period from 2012 to 2021 – under a separate aid programme, also determined by GBER parameters, governed by the Ministry of Tourism and Sports. Croatia's spending on incentives under the GBER is relatively high; double as a percent of GDP than the EU average (Figure 5.7). According to the draft 2021 State Aid report prepared by the Ministry of Finance, State Aid overall (including all programmes of support beyond incentives described in this chapter), made up almost 12% of state expenditure (Government of Croatia, 2022<sub>[14]</sub>). This spending might be justified if it leads to increased investment with positive spillovers on the economy, which additional evaluations could help assess.

Figure 5.7. Croatia spends relatively more on incentives under GBER than peers



Source: European Commission (DG Competition), (2021<sup>[43]</sup>), State aid Scoreboard 2021 (database).

It would be pertinent to assess whether incentives generate additional investment, in support of different policies. Regular and structured evaluations of policies provide crucial insights on a measure's impact and allow governments to consider adjusting, phasing out or continuing a policy. Ideally, this is done through an econometric study that seeks to isolate impact of a specific policy. For example, the Slovak republic recently evaluated that their Regional State Aid scheme has been effective in reducing unemployment rates in economically lagging regions of the Slovak Republic (Box 5.8). However, evidence from an evaluation of the direct and indirect effects of the scheme on FDI suggests that FDI inflows to the Slovak Republic have been significantly and positively influenced more by the grants and wage subsidies than tax relief, which was found to have a negative impact on inward FDI (Bobenič Hintošová, Sudzina and Barlašová, 2021<sup>[44]</sup>).

The MESD could consider engaging in (or commissioning) an empirical assessment to compare firms that have benefited from incentives with those that have not, in terms of performance and other firm characteristics (e.g., share of innovative or loss-making firms). This could be envisaged by matching the list of firms that have benefited from incentives with census data from the Financial Agency (FINA) of Croatia, including detailed financial and performance information on all active firms in Croatia. While the concrete effect of incentives cannot be determined in such an evaluation, these data could nevertheless be used to assess whether incentives are supporting investment with positive effects on productivity, exports, jobs, wages, skills and other outcomes in different regions. Similarly, Italy's Ministry of Economy and Finance recently evaluated the impact of its hyper-depreciation for Industry 4.0 investments and results suggested the measure to be effective in supporting Italy's digital technology transformation (Bratta et al., 2020<sup>[45]</sup>).

An intermediary step that might require fewer resources would be to periodically compare selected indicators of beneficiaries with a sample of non-benefiting firms, e.g., SMEs vs. large firms, share of innovative firms, temporary loss-making firms. Such analysis can provide first insights into the take-up of incentives and can inform future policy amendments while moving towards more sophisticated, regular evaluation methods.

### Box 5.8. Findings from an empirical evaluation of the Slovak Republic's Regional Investment Aid Scheme

In 2022, the Slovak Ministry of Labour, Social Affairs and Family Policy concluded an empirical evaluation of the Regional Investment Aid scheme, which explored the impact of investment incentives on the unemployment rates in districts to which these incentives were targeted as well as potential spatial spillover effects into other districts. The study relies on the assumption that, while the incentives target only a single firm, the extra spending on wages or contractors will be absorbed into the district economy and, through its multiplier effect, will contribute to district-wide economic performance, in particular in economically lagging regions. The assumption invites a hypothesis that if there are fewer possibilities to affect growth and employment in economically lagging regions directly, the next best option might be to invest in districts with which these have the strongest ties and stimulate the local economies and employment rates by leveraging spatial spillover effects and inter-regional interdependencies.

By comparing districts, in which a firm has successfully applied for investment incentives to those which had no successful applicants, the study found that the effect of these incentives on regional unemployment varies by the level of development of the recipient district. While no significant effects were found in most Slovak districts, investment incentives directed into one of the twelve “least developed districts” (LDDs) shows significant improvements in unemployment within the treated LDDs compared to the treated non-LDDs. Investing in non-LDDs has not been shown to be effective in reducing unemployment in those districts and there do not seem to be spillover effects into other linked (non-treated) districts. These findings are consistent with the economic intuition of diminishing marginal returns, which would indicate that investing into districts that had enjoyed more investment and development in the past will not be as impactful as investing into districts with less investment in the past.

Source: (OECD, 2022<sup>[46]</sup>) (ISP, 2022<sup>[47]</sup>)

The government has conducted evaluations on some incentive policies in the past, though not to the incentives provided under the Investment Promotion Act. The government commissioned the Institute of Economics in Zagreb (EIZ) to assess the effectiveness of entrepreneurial zones over the years 2003-2014. The study aimed to examine whether entrepreneurial zones stimulate economic development. While the results did not draw a clear causal relationship between the zones and local economic outcomes, the findings suggest positive effects of entrepreneurial zones on economic activity. Local self-government units with entrepreneurial zones were more successful than units without entrepreneurial zones. However, local units with zones also had a younger population, higher average income and lower unemployment (Alibegović, Bakarić and Slijepčević, 2019<sup>[48]</sup>) (Ekonomski institut zagreb, 2018<sup>[49]</sup>).

Finally, to support evaluation of policies as well as policy coherence, the government could enhance data sharing across departments working on investment. The Sector for Incentives could share data on applications and approvals, and data collection methodology, with other Sectors and Directorates of the MESD, and could consider making some of the data publicly available. Czechia, for example, provides detailed information on incentive uptake on the investment promotion homepage “Czech Invest”. The website features a tool that highlights in which regions and to what extent incentives are used, including information on the business sector, the origin country of investors and number of new jobs created. Greater transparency on the benefits of incentives can help governments promote incentive policies to investors and ensure to the public prudent spending of public funds.

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## Notes

<sup>1</sup> Based on data from the Ministry of Finance provided by MESD.

<sup>2</sup> The government, including the Ministry of Finance, have addressed administrative issues with the Action Plan for administrative relief of the economy for 2018 and relieved the economy by EUR 76 million (or 11.8%) in administrative costs out of the total measured EUR 650 million in administrative costs. Through the Action Plan for administrative relief of the economy for 2019, business costs were reduced by EUR 30.6 million (or 18.7%) out of the total measured EUR 136.6 million.

<sup>3</sup> This chapter focuses on the maximum aid intensity caps for large investors (60%). However, maximum aid caps can be increased by 10% for investments made by medium-sized enterprises and by 20% (except in Sisak-Moslavina, where the increase is limited to 15%) for investments made by small enterprises.

<sup>4</sup> The substance-based income exclusion (SBIE) allows 5% of the value of tangible assets and payroll to be subtracted from the profits to which the top-up tax applies. For more, see OECD 2022.

# FDI Qualities Review of Croatia

## ADVANCING THE STRATEGIC FRAMEWORK FOR INVESTMENT PROMOTION AND FACILITATION

The FDI Qualities Review of Croatia provides policy recommendations on the design and implementation of a new strategic framework for investment promotion and facilitation in Croatia. It provides an assessment of how foreign direct investment (FDI) contributes to sustainable development, including productivity and innovation, job quality and skills development, decarbonisation and regional development. It also examines the institutional and policy framework for investment promotion and facilitation at national and subnational levels. It gives an overview of Croatia's investment incentives regime, focusing on the effective design and implementation of tax incentives. The report indicates potential areas for institutional and policy reform to improve Croatia's investment climate and strengthen the economic, social and environmental benefits of FDI.



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