

A background image of a modern industrial factory floor. Several yellow robotic arms are visible, working on a production line. The scene is filled with complex machinery, pipes, and structural elements of the factory. The lighting is bright, and the overall color palette is dominated by the yellow of the robots and the metallic grays of the equipment.

COUNTRY BRIEFING CROATIA

Vienna Institute for International Economic Studies

Industrial Policy for a New Growth Model

Country Briefing Croatia

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FES programme »European Economies of the East«

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Please find all the publications of the programme under its webpage:

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CENTRAL AND EASTERN EUROPE NEEDS INDUSTRIAL POLICY TO ESCAPE THE MIDDLE INCOME TRAP

Since the early 2000s, the EU member states of Central and Eastern Europe (EU-CEE) have achieved an impressive economic catch-up process. However, the previously successful model of taking over labour-intensive production steps as an 'extended workbench' of Western corporations has reached its limits. Combined with major global challenges such as decarbonisation and digitalisation, this makes it essential for EU-CEE to develop a new, innovation-based economic model. Only then will these states be able to complete the catch up with Western Europe in terms of productivity and living standards. The situation is exacerbated by the economic consequences of the war in Ukraine, such as permanently higher energy prices and higher inflation, which pose grave challenges for the region's external competitiveness.

The problem is that the central technological competences and those parts of production with the highest added value are located in the 'headquarter economies' of Western Europe. Meanwhile, the EU-CEE countries – Poland, Czechia, Slovakia, Hungary, Slovenia, Croatia, Romania, Bulgaria and the three Baltic states – are still extremely specialised in labour-intensive production. They depend heavily on lower labour costs, and this restricts their prospects of catching up economically with Western Europe. A good example of this is the car industry, which is so important for the region as indicated by its high share of value added, jobs and exports, especially in the Visegrád states, Romania and Slovenia.

The study shows that the EU-CEE countries have so far lacked a constructive approach to industrial policy in their development trajectories. They have had a very broad ranging FDI promotion policy, weak investment environments for start-ups, and the activities of state-owned enterprises have not been aligned with the greater development goals. In general, there is a lack of state entrepreneurship in these countries that could nurture promising industries. This is particularly challenging for regions that are lagging behind within countries, as they lack the technical capacities for industrial policy. Due to these factors, the study argues that the EU-CEE countries are struggling to get out of their middle income trap.

Their EU membership offers unique opportunities for industrial policy, but also challenges. On the plus side are access to funds, participation in research networks and the opportunity to shape industrial policy on the EU level. Important-

ly, industrial policy in the EU has taken a much more prominent role in recent years as shown by initiatives such as the European Chips Act or the Important Projects of Common European Interest (IPCEI). This provides some momentum for the development of industrial policy in the EU-CEE countries. Strict state aid rules and an EU competition policy that gives preference to free market principles, on the other hand, are challenges for an effective industrial policy.

As discussed above, the growth model of the EU-CEE countries must be made fit for the future. Decarbonisation, digitalisation and a shrinking labour force require massive efforts to be made. For countries like Poland, the green transition is a major challenge. This transition can only be managed through huge public investments in green technologies and digitalisation, combined with the right conditions for private enterprise to thrive, to create a fully joined-up approach combining the best of the public and private sectors and academia. This means more money for education, research and development, as well as active labour market policies to manage the transition.

Above all, however, the countries of the region need a strategically oriented industrial policy to support the emergence of more globally competitive companies and to emphasise their own economic strengths. While a true "entrepreneurial state" may be too ambitious for many EU-CEE countries in the coming years, steps in this direction are the way to go. We propose eight steps, that should be taken:

1. Create a national innovation system in each country, bringing together the private sector, universities, key ministries, and business agencies. Within this biotope, new ideas can be developed, tested, and financed. Each country should define which sectors and specialisations are promoted, rather than relying solely on external market forces.
2. Make full use of EU funds and maximise participation in EU research initiatives to advance industrial policy goals. Governments should also get more involved in industrial policy debates at the EU level. Greater participation in the EU's Horizon Europe research funding programme or in the EU's Important Project of Common European Interest (IPCEI) initiative would also be particularly important for the region's technologically less advanced countries.

3. Learn from each other's successes stories to emerge as frontrunners in the digital economy. Estonia is generally well prepared in this area and often raised as an example. However, there are also other positive cases in the region. Romania and Croatia have a particularly high proportion of graduates in ICT, relevant for digitalisation. Czechia shines with its digital start-ups, the Baltic states with the quality of their digital public services. The Visegrád countries and Slovenia have highly digitalised and automated industries.
4. Harmonise investment schemes to attract foreign companies with national industrial policy. Instead of providing blanket support for all investments by foreign companies, national governments should strategically consider which sectors and parts of the value chain they want to attract, and create incentives that maximise the potential for spillovers from foreign giants to domestic firms.
5. Identify and exploit promising niches. Given the lack of technological experience, the establishment of the semiconductor industry in the EU-CEE countries, for example, would not be very promising. However, each country has traditional strengths that should be built upon.
6. Institutional reforms. In some states of the region, the quality of public institutions has declined significantly in recent years. This is worrying. Countries in East Asia have a lot of experience in building adequate institutions for an active industrial policy, even if the framework conditions there partly do not meet Northwest European standards. This experience should be used.
7. Structural change must be cushioned socially in order not to lose the support of the population. EU-CEE countries should aim for a flexible labour market to ease the transition from old to new jobs, but underpin this with extensive retraining programmes and a social safety net that means that workers themselves do not bear the costs of the transition.
8. Each country needs a tailor-made industrial strategy adapted to its specific needs. While the Baltics, for example, are well positioned for the digital transformation, they are struggling above all with distribution problems and a shrinking population. Czechia, Poland or Slovenia are industrially the most advanced, but must make the transition from 'extended workbench' to innovative economy. For the less developed parts of EU-CEE such as Bulgaria and Romania, the priority should be on maximising the transfer and knowledge and innovation from big foreign investors.

COUNTRY BRIEFING CROATIA

COUNTRY OVERVIEW

With its EU membership, Croatia further integrated its economy into Western and Central Europe since 2013. However, its industrial competitiveness and labor productivity still lags behind economically advanced countries in the EU-CEE region. The share of employment and value added claimed by manufacturing in Croatia is below the EU average. Human capital quality is slightly higher than the EU-CEE average, but below the EU average. Croatia has also showed promising signs of improvement in its innovation performance, as seen by the growing share of R&D expenditures relative to GDP over the past decade.

Tourism is one of the main pillars of the Croatian economy, comprising 20% of the country's GDP. Presently, manufacturing in Croatia is largely based on food and beverage production, which account for some 24% of the total manufacturing revenue in the country. The most represented industrial branches in exports include processing of petroleum products (11.8%), motor vehicles (11.2%), chemical products (8.3%), food products (8.1%) and electrical equipment (7.8%). Agriculture in Croatia is carried out in less than 25% of the country's land area, accounting for less than 10% of the country's GDP.

The automotive industry within the country employs some 10,000 people in over 130 companies. This may be a small

number in absolute terms, but offers growth opportunities for the Croatian economy to industrially upgrade: The Croatian Rimac producer of electric hypercars can be regarded as a prime example of a major innovator in the country's automotive sector. However, on the macro level electromobility in Croatia is limited: Eurostat data from 2018 showed that the share of energy from renewable sources in transport was less than 4 per cent.

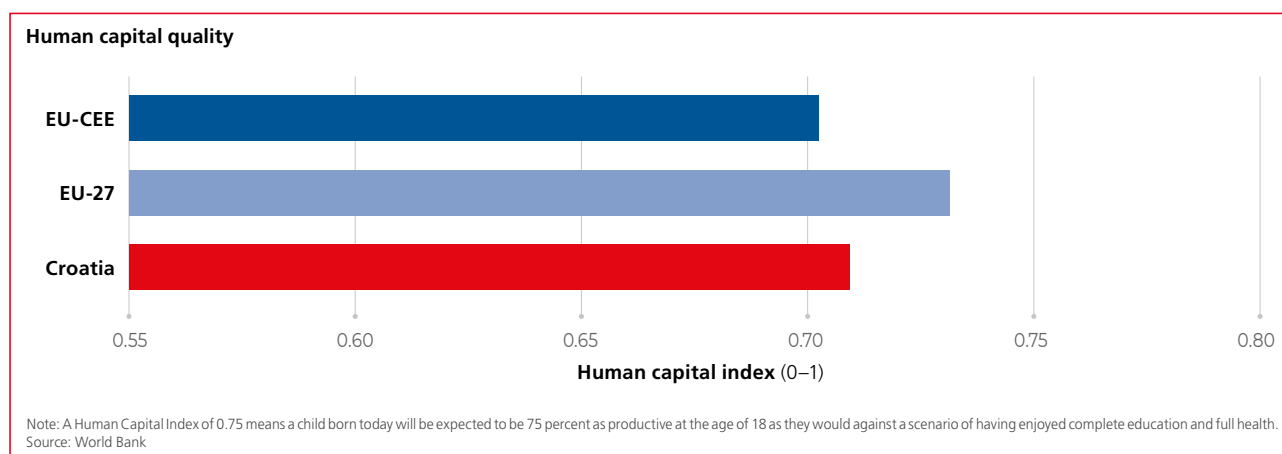
Croatia is currently in transition to an energy powerhouse and power hub in the Western Balkan region, with its floating liquefied natural gas (LNG) regasification terminal on the island of Krk and with investments in green energy, including wind, solar and geothermal energy. The Krk terminal provides an additional source of natural gas for the Croatian market, which relies on natural gas for 48 per cent of its energy needs. The terminal will also be a natural gas distribution point for surrounding markets, including Italy, Austria, Hungary, Romania and Slovenia.

Croatia lacks a foreign investment screening mechanism and does not differentiate between foreign and domestic investors. Nevertheless, foreign investors face challenges in the investment climate, due to administrative barriers and corruption. Given the megatrends, the economy's main shortcomings lie in inefficient bureaucracy, heavy reliance on tourism, low competitive industrial performance, and in negative demographic development.

Industrial development – I

	Competitive industrial performance index	Manufacturing value added (MVA) (% of GDP)	Medium- and high-tech MVA (% of total MVA)
Croatia	0.05	13	31
EU-27	0.14	15	41
EU-CEE	0.10	17	38

Note: 2020 values. The CIP index assesses the strength and complexity of an economy's industry, with Germany claiming the maximum score in 2020 at 0.42.
Source: UNIDO



INDUSTRIAL COMPETITIVENESS – SWOT

Strengths

- Attractive destination for investors despite being one of the less economically developed EU-CEE countries, due to the country's geostrategic location¹
- Well educated workforce – above average information and communications technology (ICT) skills of young people, in comparison to other EU countries
- Well maintained traffic and transport infrastructure network; functional comparative advantage in logistics
- High public spending potential: the government facilitated investments in the amount of some 5.6 per cent of the country's GDP in 2020 (the third-highest share in the EU); despite COVID-19 related recession, Croatia's absolute figure dedicated to R&D expenditure surged to EUR 626 mn in 2020.

Weaknesses

- Poor vertical policy coordination between the government and ministries (including national and local public administration) as well as inefficient bureaucracy prone to corruption and weak judiciary
- Large regional disparities – rural regions bordering Serbia and BiH have a larger proportion of citizens at risk of poverty and social exclusion; high rural/urban divide in terms of internet access
- Negative demographic development, causing labor shortages
- High economic reliance on tourism sector and relatively low level of industrialisation compared to other EU-CEE economies

Opportunities

- Croatia is one of the biggest beneficiaries of the EU's Multiannual Financial Framework (MFF) scheme (EUR 14bn) in the 2021–2027 period
- Growing share of investments aimed at facilitating the digitalization of Croatia's administration, industry, agriculture, transport, courts, hospitals, and schools

- Changes in immigration policy implemented to alleviate the scarcity of skilled workers within the country, as of 2021, no more quotas for foreign workers exist

Threats

- Shortage of a specialised workforce due to brain drain, adversely affecting innovation potential as well as the integration of green/digital technologies
- Slow reform progress of Croatia's administrative sector
- Complex legislative framework, non-responsive public administration and contradictory and complex legislative framework inhibit green transition – over 60% of local businesses do not perceive the green transition agenda as an opportunity, according to the Croatian Chamber of Commerce

INDUSTRIAL POLICIES AND STRUCTURAL REFORM DEVELOPMENTS

FDI promotion and value chain upgrading

- The government passed in 2015 an "Investment Promotion Act" and amended it several times since to increase FDI through various promotional instruments. With this bill, newly created companies registered within Croatia can claim a reduced corporate tax rate. In addition, the government pledged to subsidise the costs of jobs created through foreign investment projects. The government also allocated additional grants for capital-intensive projects with an investment volume of EUR 5mn.
- A bill on strategic investment projects was introduced in 2018 to provide accelerated approval mechanisms and to facilitate the removal of administrative hurdles for investment projects in the country's mining, energy, tourism, transport, or infrastructure sectors, with a minimum value of EUR 10mn.
- Despite those bills, Croatia still lacks a tailored FDI promotion policy tasked with abolishing Croatia's reliance on its tourism sector.

New technologies, digitalisation, innovation

- Croatia is to receive EUR 1.7bn from the European Regional Development Fund to support the country's innovative and smart economic transformation and to increase the competitiveness and internationalisation of local SMEs.

¹ According to a 2021 survey by the German-Croatian Chamber of Industry and Commerce

- Croatia earmarked some 20.4% of the country's Recovery and Resilience Facility (RRF) to invest into the digital transformation of the country's economy and to increase the efficiency of public sector bodies. To achieve this, the government established management and coordination structures to plan and implement digital transformation projects, financed by the RRF.
- In 2022, Croatia received the first tranche from the Next Generation EU (NGEU) instrument in the amount of EUR 700mn to boost the country's innovation and digitalization agenda.
- In 2018, the government introduced Croatia's National Development Strategy, tasked with launching initiatives aimed at developing digital competencies and promoting the availability of digital jobs for citizens in the 2018–2030 period.

Green transformation of industry

- Croatia's 2018–2030 National Development Strategy aims to support the country's green transition by facilitating energy self-sufficiency and transition to clean energy by 2030. Next to green and digital transition, Croatia's National Strategy also focuses on the protection of natural resources and the fight against climate change
- Croatia earmarked 39 per cent of EU Cohesion Policy funds to facilitate the country's green energy efficiency by increasing the share of renewables in energy production to 60 per cent by 2030. In addition, some EUR 179 mn from the EU's Just Transition Fund (JTF) was earmarked to mitigate the economic and employment effects of Croatia's green transformation. The government also earmarked some EUR 500 mn in EU Cohesion Policy funds to facilitate the industrial transition of Croatian regions, as a measure to mitigate regional disparities within the country.

COUNTRY-SPECIFIC RECOMMENDATIONS

In the main report, we identify Croatia as one of the EU-CEE countries falling most behind the technological frontier. However, we see positive signs that the country is starting to move in a more innovative direction, and policymakers should use all possible levers to capitalize on these trends. The priority should be to import knowledge and capabilities in a strategic and targeted way via targeted FDI policies and greater participation in EU research and innovation networks.

- **Implement a tailored FDI promotion policy to import innovation and drive the expansion of promising niche sectors apart from tourism.** The country's tourism sector is likely to remain the focus of foreign investors, nevertheless, the government's future economic and investment support should focus on industrialisation and a greater diversification of Croatia's economy. As part of this, the government should aim to attract more investment to Croatia's poorer regions, to help them to catch up with the country's more economically and socially developed counties,

such as the capital Zagreb or the Zagreb County. Two elements of policy will be key to achieve these goals. First, identifying niches within the economy where promising innovation is already occurring on a micro level, and which can be expanded, such as the ICT sector (see policy recommendation 5.5 in the main report). Second, the government should tailor FDI attraction policy to incentivise foreign capital flows into these potential niche areas, and to attract investment that will also generate domestic spillovers (see policy recommendation 5.4 in the main report).

- **Upgrade institutions to enable them to support innovation, including at the local level, and the maximise participation in EU programmes.** As we highlighted in the main report (see section 4), less-than-perfect institutions are not, per se, a barrier to effective industrial policy and the development of smart specialisation strategies. Nevertheless, Croatia's relative institutional weakness, despite improvements in recent years, is a barrier to these goals. Both the national government and the EU should continue to prioritise improving the capacity of institutions, including by tackling ineffective public administration. Upgrading of institutions, including at the local level, could unlock significant growth potential in the economy (see policy recommendation 5.6 of the main report), allowing for both the expansion of more successful smart specialisation strategies to boost innovation (see policy section 5.1 of the main report), and also helped to improve the absorption capacity of EU funds. Meanwhile, Croatia's inefficient public sector have a negative impact on the overall attractiveness of the country's economy for domestic and foreign investors, and the rigid business environment limits entrepreneurial activity and fuels the country's brain drain.
- **Address skills shortages and increase labour market participation.** Like most of EU-CEE, Croatia faces severe demographic challenges, and these will become an ever more binding constraint on the economy's growth potential in the future. A shortage of labour in general, and particular skills shortages in key sectors, are already an issue. The shortage of specialists is significantly affecting the integration of digital and green technologies into local businesses and prevent local enterprises from tapping the full potential offered by Croatia's digital and green transformation. Part of the reason for this is that the country suffers from low labour force participation rates. The government introduced reforms to tackle rigidities in employment protection legislation and abolished the quota for foreign workers in 2021. Nevertheless, active labour market policies (including those listed in Croatia's 2018–2030 National Development Strategy) remain insufficient. To address the issue and to improve Croatia's industrial outlook, additional upskilling and reskilling programmes – in line with long-term industrial policies (such as digitalization and green transition) – should be implemented as soon as possible (see policy recommendation 5.7 of the main report).

- **Introduce a minimum wage at a higher share of Croatia's median wage.** Eurostat data from 2020 showed that over 20 per cent of Croatian workers earn less than two-thirds of the median wage. Introducing higher minimum wages will incentivise the automation of low productivity jobs, and create additional labour supply for more productive parts of the economy. Nevertheless, this process will require direct policy interven-

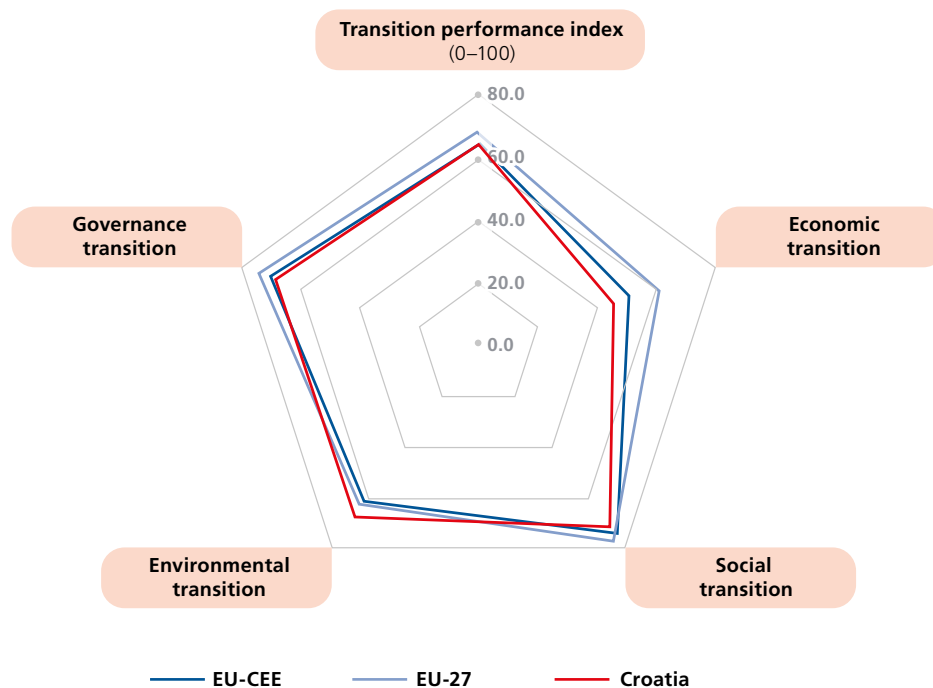
tions to both ensure its success and to minimise the negative social fallout. The government should pursue an active labour market policy to ensure retraining of workers for the needs of a more digital and green economy, while also providing an adequate social safety net for the transition period (see policy recommendation 5.7 of the main report). Frictions on job entry and exit should also be minimised to speed up the transition.

Industrial development – II

Sector	% of manufacturing employment
Food products	19.2
Fabricated metal products, except machinery and equipment	13.0
Wood and of products of wood and cork (excl. furniture)	6.7
Wearing apparel	5.3
Rubber and plastic products	4.7
Machinery and equipment n.e.c.	4.7

Note: 2018 values.
Source: Eurostat Structural Business Statistics

Transition performance scorecard



Note: 2020 values. The TPI scores countries based on 4 pillars of a transition to a more sustainable, inclusive and resilient economy.
Source: European Commission

Croatia



COUNTRY OVERVIEW

Croatia's industry lags behind advanced countries in EU-CEE. The share of employment and value added of manufacturing is below the EU average.

Manufacturing is largely based on food and beverage production. Main industrial exports are processed petroleum and chemical products, motor vehicles, food products and electrical equipment.

Croatia is in transition to become an energy powerhouse in the region with investments in LNG and green energies.

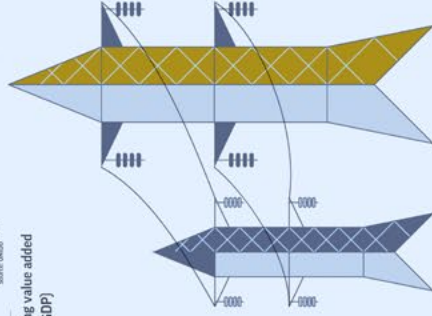
INDUSTRIAL DEVELOPMENT

CROATIA	0.05	13%
EU-27	0.14	15%
EU-CEE	0.10	17%

Year: 2020 values.
The CEE values are the average of the EU-27 and EU-CEE values.
Source: UNIDO

Competitive industrial performance index

Manufacturing value added (MVA) (% of GDP)



INDUSTRIAL COMPETITIVENESS – SWOT



STRENGTHS

- Attractive destination for investors due to the country's geostrategic location.
- Well educated workforce - above average information and communications technology (ICT) skills of young people.
- Well maintained traffic and transport infrastructure network; functional comparative advantage in logistics
- High public spending potential and serious efforts on R&D.



WEAKNESSES

- Poor vertical policy coordination between the government and ministries as well as inefficient bureaucracy prone to corruption and weak judiciary.
- Large regional socio-economic disparities and high rural/urban divide in terms of internet access.
- Negative demographic development.
- High economic reliance on tourism sector and relatively low level of industrialisation.



OPPORTUNITIES

- One of the biggest beneficiaries of the EU's Multiannual Financial Framework - scheme.
- Growing share of public and private investments aimed at digitalization.
- Changes in immigration policy implemented to alleviate the scarcity of skilled workers within the country.



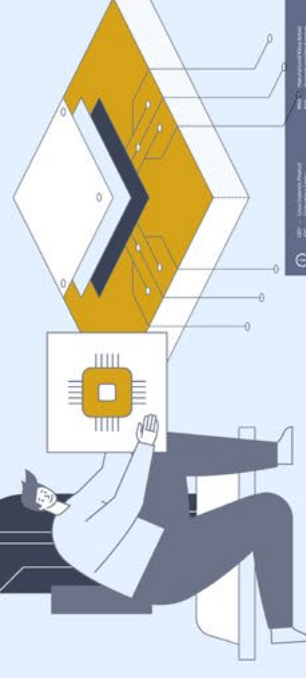
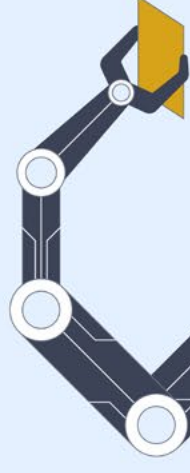
THREATS

- Shortage of a specialised workforce due to brain drain.
- Slow reform progress of Croatia's administrative sector.
- Complex legislative framework, non-responsive public administration and contradictory and complex legislative framework inhibit green transition.

WHAT SHOULD BE DONE?

COUNTRY-SPECIFIC RECOMMENDATIONS

- Implement a tailored FDI promotion policy to import innovation and expand niche sectors apart from tourism, focusing on industrialisation and a greater diversification of the economy.
- Upgrade institutions to support innovation, including at the local level, and maximise participation in EU programmes.
- Address skills shortages and increase labour market participation by upskilling and reskilling programmes.
- Set minimum wage at a higher level to incentivise the automation of low productivity jobs, create additional labour supply for more productive parts of the economy.



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Industrial Policy for a New Growth Model: A Toolbox for EU-CEE Countries

This country briefing is a short summary of a much broader study that deals with the perspectives of industrial policies in Central Eastern and Southern Eastern Europe and the question how these countries can avoid to get stuck in a middle-income trap. The study has been authored by a team of experts from the Vienna Institute for International Economic Studies on behalf of Friedrich-Ebert-Stiftung.

The study argues that the EU-CEE countries have so far lacked a systematic approach to industrial policy in their development trajectories. They have had a very broad ranging FDI promotion policy and weak investment environments for start-ups, while the activities of state-owned enterprises have not been aligned with the greater development goals.

Hence, the growth model of the EU-CEE countries must be made fit for the future. Decarbonisation, digitalisation and a shrinking labour force require massive efforts to be made. This transition can only be managed through public investments in green technologies and digitalisation, education and infrastructure, combined with the right conditions for private enterprise to thrive.

The study includes eleven country profiles that analyse the economic and industrial structures for their strengths and weaknesses and identify possible courses of action for an active industrial policy.

The full study can be found here:

<http://library.fes.de/pdf-files/bueros/budapest/20260.pdf>



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