

# Attracting FDI in the Republic of Croatia

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American Chamber of Commerce in Croatia *Američka gospodarska komora u Hrvatskoj*

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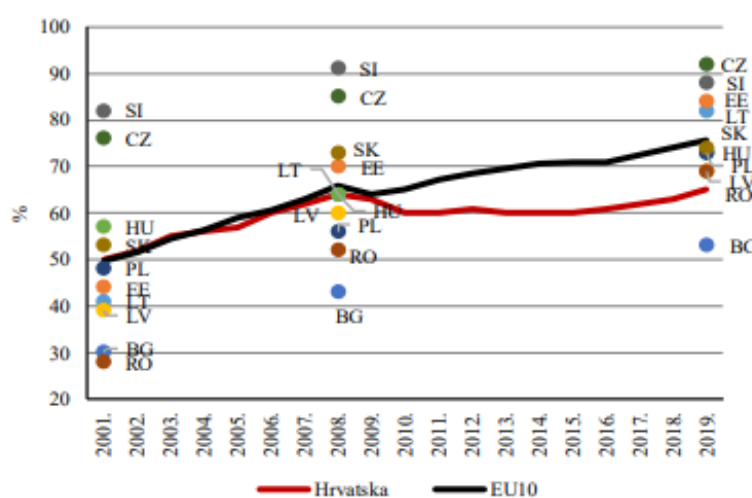
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# Introduction

As a member of the European Union, the Republic of Croatia – despite the renewed economic growth achieved since 2015 – is at the bottom of the list of Member States in most economic indicators.

Croatia's convergence, approaching the EU development average, has stagnated over the last decade, while most comparable countries in Central and Eastern Europe, the so-called New Europe, have achieved better results:

**Picture 1 - GDP per capita in PPS, % percent of EU average**



Source: *The 2030 National Development Strategy of the Republic of Croatia*

**The 2030 National Development Strategy of the Republic of Croatia** additionally indicates a significant lag in the productivity of the Croatian economy, low rates of the share of exports in GDP, as well as low activity and employment of the population compared to these countries.

The development strategy also defines clear targets for these indicators for 2030 – including an increase in the employment rate from the current 67% to 75%, which requires the creation of an additional 200,000 (!) new jobs in addition to current employment in the next 10 years.

The development strategy also mentions the importance of internationalization, the key importance of strengthening the export part of the economy, and private sector investment in achieving these goals.

In this position, the American Chamber of Commerce in Croatia wants to further emphasize the importance of **private sector investment and foreign direct investment** that includes the Croatian economy in global value chains as a

significant prerequisite for growth and development in the next decade, without which the goals of the National Development Strategy will be difficult to achieve. In doing so, AmCham reaffirms its continued commitment to improving the business environment and increasing investment in Croatia.

An important development difference of comparable countries in Central and Eastern Europe lies in their significantly greater involvement in the European and global economy, by entering international production and service chains. This involvement has been largely achieved over the last 20 years through the attraction, realization, and development of foreign direct investment of private companies.

Such investments have taken place in manufacturing in various sectors, such as the automotive and aeronautical sector, as well as in various service industries, through, for example, the opening of centers for business services, information technology, or research and development.

This type of investment positively impacts economies through the creation of significant additional employment, the transfer of new technologies, knowledge, and methods of work, growth in exports and international competitiveness, and consequently the crucial growth of overall productivity of businesses and the economy as well.

Example of employment in the automotive and business services sector:

#### **CEE Direct automotive manufacturing employment 2018**

| <b>Country</b> | <b>Direct manufacturing employment</b> |
|----------------|--|
| Bulgaria       | 23,777                                 |
| Croatia        | 2,919                                  |
| Czech Republic | 181,415                                |
| Estonia        | 2,880                                  |
| Hungary        | 101,865                                |
| Latvia         | 2,317                                  |
| Lithuania      | 6,163                                  |
| Poland         | 213,708                                |
| Romania        | 190,848                                |
| Slovakia       | 81,273                                 |
| Slovenia       | 15,887                                 |
| <b>Total</b>   | <b>823,052</b>                         |

*Source: European Automobile Manufacturers' Association (ACEA) Automobile Industry Pocket Guide 2020-2021*

## CEE Business Services landscape 2019

BPO, SSC/GBS, IT, R&D centers

| Country        | Total employment in the sector |
|----------------|--------------------------------|
| Bulgaria       | 72,200                         |
| Czech Republic | 112,000                        |
| Estonia        | 10,000                         |
| Hungary        | 72,700                         |
| Latvia         | 9,000                          |
| Lithuania      | 16,900                         |
| Poland         | 330,000                        |
| Romania        | 131,000                        |
| Slovakia       | 37,000                         |
| <b>Total</b>   | <b>790,800</b>                 |

Source: ABSL EMEA Business Services Landscape 2020

Investments of this type are in principle long-term and over time, on the one hand, they affect the development of skills and knowledge of employees, and on the other, they increase the complexity of the work the employees perform, and as a result, the added value to local economies.

By creating jobs, they also provide an opportunity for greater choice, more complex and better-paid jobs for local employees, thereby reducing the need for economic emigration. They can also have a positive impact on more balanced regional development – service investments of the technological or research type most often come to large cities and university centers, but on the other hand, manufacturing investments choose places outside large cities.

The recent emergence of global tensions relating to trade flows, the introduction of protectionist measures, and the impact of the Covid-19 pandemic on business have prompted companies to think more about moving parts of production or provision of services closer to the markets in which they operate (nearshoring), which opens up new opportunities for Croatia to attract investment given its membership in the EU and the Single European Market.

# State of play in Croatia

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In the first period before entering the European Union, foreign direct investment in the Republic of Croatia was mainly related to service activities related to finance and insurance, telecommunications, retail, real estate, media, and partly in tourism, energy, and the food and beverage manufacturing sector. These foreign investments were primarily oriented towards the provision of services or manufacturing for the internal domestic market. By their characteristics, they were largely brownfield investments, i.e. they were realized through the acquisition of existing companies.

After Croatia acceded to the EU, there was a visible increase in the interest of potential international investors for other types of investments, those focused primarily on manufacturing or provision of services for large European or global markets, by joining global value chains. These are more often greenfield investments, i.e. investments in establishing and growing new companies that bring more significant job creation and greater stability to the economic growth of the host country given their broader export orientation.

A part of this type of investments was realized, mostly in the northwestern part of Croatia and the area of Istria and the littoral, specifically in production and service activities where the IT sector proved to be the most dynamic, especially in software development activities. The results of investments in manufacturing can also be seen through their contribution to the growth of the share of exports of goods in GDP, which has grown faster since 2013 and has become higher than the share of tourism in Croatia's GDP.

However, the number of utilized opportunities is still relatively small, and Croatia still significantly lags behind in attracting and realizing such investments in comparison to other New Europe countries.

Interest and opportunities for attracting new export-oriented investments still exist, due to, among other things, the saturation of traditional countries-locations with already realized investments, but it is necessary to prepare and actively work on their attraction.

Experience and research show that the following criteria are crucial to potential investors in making a decision on choosing a location for investment:

- 1) Availability of employees with different skills** – including regional and educational structure of potential employees, education system, knowledge of foreign languages, work and cultural compatibility.
- 2) Cost competitiveness** – including total cost of employees, infrastructure use costs, tax, and regulatory costs as well as available incentives for new investments.
- 3) Business environment** – assessment of the business environment related to the transparency of business regulations and their application, the speed

in launching investment, the predictability of business conditions and legal certainty (e.g. intellectual property protection, data protection and competition regulations). The development of infrastructure is also important, such as the availability of business premises and transport connectivity, but also the perceived business compatibility, standard of living and safety of a particular location.

**4) Digital readiness** – the latest criterion within which the existing digital infrastructure, the general level of digital skills, the level of use of digital tools and processes in the public and private sector, and the level of digital security are assessed.

Currently, Croatia can be competitive in:

- The potential availability of required employee profiles, in part due to the still small number of realized investments;
- Parts of operating costs and investment incentives – where the labor costs of employees, as an important element of site selection, can be assessed as generally competitive compared to mature investment locations and as higher, but with a tendency of approaching the new-generation locations in Central and Eastern European countries;
- One part of the business environment related to membership in the European Union, partly the infrastructure, compatible approach to work and business, positive living standards and security;
- Parts of digital readiness – such as digital skills of young people and partially digitalized processes and services.

Negative impression and obstacles to attracting new foreign direct investments relate primarily to the part of the business environment regarding the transparency of business regulations and their application, the predictability of business conditions, the speed of investment, insufficient legal certainty, low efficiency of the judiciary and the risk of corruption. Continuous improvements in these areas should be the focus of the Republic of Croatia in order to improve the investment business environment and attract new investments.

It should also be noted that Croatia is still not perceived as an existing and successful investment destination in activities of interest to investors. That is to say, the concept of an investment destination implies a certain number of pre-existing investments in a particular type of business activity that show positive experiences of investors, an existing distribution of required knowledge and skills, and the understanding of the way business is conducted in such activities. Such a perception of the destination serves as a reference and attracts additional investments in that type of activity and in general.

# Examples of good practice from the EU

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## *Poland*

According to data provided by the Canadian government, between 2004 and 2015, the stock of Foreign Direct Investment in Poland has increased from \$41.4 billion to \$143.8 billion<sup>1</sup>. There are several reasons why foreign companies view Poland as an attractive location for their investment:

- Poland was one of few countries in the EU where real unit labor costs have decreased since 2004;
- Poland has access to the EU Single Market of over 500 million customers, as well as a large domestic market of approx. 38 million customers;
- Poland is a source of a young, skilled workforce with good knowledge of foreign languages;
- Poland has built a system of incentives (both domestic and EU sources) to encourage foreign investment.

There are many opportunities for foreign companies to obtain financial support for projects in Poland both from European Union funds and domestic sources. Various sources and types of support may be available, depending on the scope of the project. Therefore, when considering a new investment in Poland, it is important for each case to be analyzed individually and the Polish Investment and Trade agency is providing such information and support to investors.

According to OECD data from 2017, over one third (34% in 2014) of economic activity (GDP) in Poland depends on foreign markets, the same as in Austria and Belgium<sup>2</sup>. Foreign-owned firms play a significant role in driving exports, accounting for 56% of Poland's gross exports of goods. Poland's inward investment (equivalent to 40% of GDP in 2015) was eight times the size of its outward investment (5%).

The top manufacturing exporting industries in Poland are motor vehicles (MTR) and food and beverages (FOD). In the former, inward investment plays an important role in GVC integration, with foreign owned firms accounting for 90% of total exports in value-added terms. Poland has a comparatively low service content in its exports, and this is correlated with a relatively low share of its inward investment going to the services sector.

The Polish Investment and Trade agency (PAIH) has representative offices in many markets that are rated as strategically important for attracting investment or presentation of the domestic economy. These representative offices are educated and equipped to brand Poland as a desirable investment destination and

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<sup>1</sup> <https://www.tradecommissioner.gc.ca/poland-pologne/market-facts-faits-sur-le-marche/0001856.aspx?lang=eng#fnb1>

<sup>2</sup> <http://www.oecd.org/investment/POLAND-trade-investment-statistical-country-note.pdf>



to attract foreign direct investment. Also, representative offices are available to Polish entrepreneurs who want to realize their investments in foreign markets. According to data from 2019, PAIH has so far realized or supported more than 800 foreign direct investment projects, attracted more than EUR 20 billion in investments and helped create more than 200,000 new jobs.

## *Czech Republic*

Foreign Direct Investment has played a major role in Central and Eastern Europe (CEE) in general and in the Czech Republic in particular. According to the Eurostat, i.e. Foreign affiliates statistics (FATS) from 2019, almost one-third of all jobs in the Czech Republic are provided by multinational corporations (MNCs), more than in any other CEE country<sup>3</sup>. These MNCs can provide higher wages as they have around 25% higher costs per employee than the national average. On the same note, employees in MNCs have a 60% higher apparent labor productivity, while the turnover per person is almost twice as high.

The inward FDI stock has grown significantly in the Czech Republic in the past 25 years. It increased from around 10% of GDP in early 1990s to over 60% in the 2010s. Among the V4 countries, the Czech Republic and Hungary have the highest FDI stocks as a share of GDP. Motor vehicle manufacturing, financial services, wholesale and retail are the key sectors targeted by FDI in the Czech Republic. Foreign investment in services has increased over the last two decades, reaching 60% of the FDI stock. Financial and insurance services represent the largest share, growing from 15% in 2000 to 27% of the total stock in 2016, followed by wholesale and retail with around 10%. Motor vehicle manufacturing represents around 8% of the FDI stock and a quarter of all manufacturing investment. This level has stayed more or less constant over the years (it represented 6.3% of the total stock in 2000).

The Czech Republic has provided various incentives for attracting FDI, greenfield and brownfield investments. MNCs can get an income tax relief for up to 10 years, subsidies for creating employment and discounted prices for land. Grants and subsidies have been higher in regions with higher unemployment and investments in manufacturing and technological centers received additional benefits. Certain large investments obtained strategic investment status and, instead of tax relief, got a higher portion of incentives in cash, the so-called Cash Grant.

Like Poland, the Czech Republic also has a state agency with a similar goal and tasks. CzechInvest actively participates in strategic foreign markets through its representative offices in the USA, Canada, China, Russia, Germany, Japan and many other countries around the world. Their task is also to brand and promote the Czech Republic as a preferred market for foreign direct investment, but also to provide support to foreign investors. In 2019 alone, CzechInvest participated in the conclusion of 94 investment projects, organized 479 specialized events in the Czech Republic and 164 abroad. In addition, CzechInvest claims that in 2019,

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<sup>3</sup> [https://ec.europa.eu/info/sites/info/files/economy-finance/eb042\\_en.pdf](https://ec.europa.eu/info/sites/info/files/economy-finance/eb042_en.pdf)

their activities abroad stimulated serious interest in investing in the Czech Republic with 132 foreign companies and investors<sup>4</sup>.

We would like to further emphasize, and as McKinsey reports, that tax regulations are important in investment location decisions for companies and people, but it is important to note that tax breaks by themselves don't attract businesses and people<sup>5</sup>. They tend to play a role after the establishment of other, more important, nonfinancial factors. Nonfinancial incentives can include workforce training, infrastructure investment, fast-tracked processes, and access to development sites. A 2019 survey of corporations considering expansion or relocation found that they ranked labor availability as the top priority in scouting locations, several spots ahead of tax exemptions and incentives. The same survey also found that quality of life ranks above incentives. In short, corporations select locations based first on overall fit and qualities, and then they may consider incentives to finalize the choice.

Nonfinancial incentives are critical to gaining entry into the consideration set. Furthermore, these investments are good for communities: they tend to be "sticky," in that they have long-term impact that outlasts an individual company. For example, as part of the incentives and investments necessary to attract BMW and create an automotive-manufacturing cluster, South Carolina promised and delivered on more capacity at its Charleston International Airport. According to research, highlighting nonfinancial incentives in a package to attract companies can be persuasive, and most often that is what makes the difference.

## Recommendations

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For Croatia to be included in the map of desirable investment destinations, it is necessary to focus on improving access, methods of work, and achieving better results in attracting foreign direct investment.

We propose to define a strategic plan of goals and activities for attracting foreign investment with an emphasis on export-oriented investments that bring more significant job creation – as a document derived from the 2030 National Development Strategy.

We propose to additionally analyze and compare the current organization and the method of work of the Directorate for Internationalization of the Ministry of Economy and Sustainable Development with best practices in comparable countries of New Europe, such as the Czech Republic, Slovakia, and Poland.

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<sup>4</sup> <https://www.czechinvest.org/getattachment/91097f2c-2856-45b2-8a22-14e9ac74fa5a/Vyrocnni-zprava-2019>

<sup>5</sup> <https://www.mckinsey.com/industries/public-and-social-sector/our-insights/how-state-and-local-governments-win-at-attracting-companies?cid=other-soc-lkn-mip-mka-oth-1909--&sid=2652640307&linkId=73893839>

## ***Improving the organization and process of working with investors***

### ***Establishing a single contact point for investors***

We suggest that the re-establishment of the Agency for Attracting Investments and Working with Investors be considered. Through such a single point of contact, the transparency and comprehensibility for potential investors would be increased. At the same time, the importance which Croatia attaches to attracting international investments would be emphasized.

### ***A sectoral approach to attracting investment***

We propose to refine the sector-focused approach to attracting investment by regions – with a clear plan for attracting investment in defined priority economic activities of a particular county given their existing competitive advantages.

### ***Modernizing the process of application, approval, and monitoring of investment projects***

In order to speed up the procedure of application for investment projects for incentives prescribed by the Investment Promotion Act, we propose to modernize the process of application, approval, and monitoring of investment projects in such a way to:

- digitalize all document formats, the submission of all requests and monitoring of approval status through a single application with Internet access;
- optimize the content of the documentation for the investment project application in such a way that, for example, it is not necessary to submit detailed long-term plans at the very beginning of the project. Subsequent reports and applications for aid are based on the realized investment and results.
- Optimize the content and amount of documentation for annual reports and requests for payment of the aid with the elimination of duplication of the requested documentation and integration with existing e-services such as eHZMO, ePorezna, etc.

Given that attracting investment takes place in a competitive environment with other EU Member States and neighboring countries, it is important to establish a comprehensive service approach to investors that shows Croatia's desire, ambition, and professionalism of intentions and that of all the institutions involved in the promotion and working with investors.

## ***Amending the Investment Promotion Act***

Although we believe that Croatia has a competitive model of investment incentives prescribed by law, we propose to analyze and compare the model of investment incentives offered by the countries of the New Europe with an emphasis on the details of the model by production and service activity and by the specific sector to be attracted.

Based on the analysis, we propose to consider possible changes to the Croatian regulatory framework in order to use all the possibilities allowed within the EU legislation for this area.

## ***Preparation and availability of information for potential investors***

In order to better inform potential investors about Croatia's competitive advantages, we propose to establish and regularly update databases related to:

### ***Investment information***

All information about Croatia as an investment destination:

- already realized investments in Croatia, by sector and county
- existing business zones and technology parks with detailed information on their readiness to accept investors
- available suppliers in Croatia, especially for investments in manufacturing
- regional and micro-location conditions for business operations, such as local business environment, infrastructure, cost levels, available additional local incentives, etc.

### ***Human resources***

Given that the availability of human resources is one of the key elements in selecting an investment destination, we propose the creation and publication of a map of human resources, i.e. profiles of employees in Croatia, with information on:

- regional and educational structure of potential employees
- knowledge of foreign languages and other skills
- expected outcomes of the education system
- regional labor cost levels

## ***Overview of possible financing from the EU funds***

We propose the development of an overview of available funds for EU financing which is transparent and clear for users, and of the opportunities that exist for potential investors in addition to those prescribed by the Investment Promotion Act.

All the databases should be unified on a single communication site intended for investors. The access to prepared databases should be developed in the form of a digital application with active updating and the possibility of transparent access for existing and potential new investors.

## ***Improving promotional activities***

### ***Modernizing the central website for attracting investment***

Given that the website aimed at investors already exists and contains some information intended for investors, we suggest to redesign and refine the central website for attracting investment in Croatia so as to include all relevant information, including links to proposed digital applications for using prepared databases and for submission and approval of all applications relating to investment projects.

### ***Active promotion in international markets***

We suggest planning and participating in all available international events, cooperating with institutions, and involvement in processes that provide communication platforms for promoting Croatia as a desirable business location and offer the possibility of contacting potential investors.

### ***Promoting Croatia as a desirable investment destination***

In all promotional, marketing, and other activities aimed at attracting investment to Croatia, we consider that one should continuously communicate the image of Croatia as a country that wants to transform into a modern and ambitious EU Member State, focused on its economic development, participation in the Single European Market, economic partnerships around the world, and attracting quality international investments – and at the same time, as a country with comfortable and safe living and working conditions.

We believe that funds should be provided and that regular communication of the achieved investment results and goals and reasons for intensified work on attracting foreign direct investment should be organized, for both the domestic public and the international public and business circles.

We suggest trying to secure funds needed to prepare and maintain the improved organization of work, tools, and activities related to attracting investment through the **European Financial Perspective 2021-2017**, and to include them in the preparation of strategic documents such as the **National Recovery and Resilience Plan and Operational Programs of the Multiannual Financial Framework**.

## Conclusion

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With this position, AmCham wants to emphasize the importance and role of private sector investment – especially foreign direct investment focused on export markets – in the economic growth and modernization of the Croatian economy.

Such investments bring important inclusion in global value chains, the creation of a significant number of jobs, the transfer of technologies, knowledge, and work models – which further results in growth in productivity and competitiveness of the national economy.

The positive economic results of comparable countries of the New Europe clearly show that these investments are indispensable for achieving accelerated and stable economic growth and approaching the development average of the European Union.

The recommended additional activities for attracting and developing international direct investments would also directly contribute to the achievement of goals set out in the National Development Strategy.

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For additional information, please contact:  
American Chamber of Commerce in Croatia  
Andrea Doko Jelušić,  
Executive Director T: +385 01 4836 777  
E: [andrea.doko@amcham.hr](mailto:andrea.doko@amcham.hr)