



**European Bank**  
for Reconstruction and Development

## **Croatia: Background study on state-owned enterprises**

### **Economic and financial performance of SOEs: Significant room for efficiency gains (February 2018)<sup>1</sup>**

#### *Executive summary*

This paper discusses some economic characteristics of state-owned enterprises (SOEs), which still have a more pronounced role in Croatia than in many peer countries. The paper gives a fresh perspective, focusing more on cross-country comparisons and economic efficiency.<sup>2</sup>

The main policy implications from the paper's empirical findings related to SOEs are the following:

- Croatian SOEs are economically and financially less efficient than CEE peers.
- Efficiency improvements or privatisation can raise budgetary revenues or reduce subsidies and thus can support much-needed fiscal consolidation.
- In some sectors (especially in utilities, e.g., water and waste water) there might be opportunities for savings from potential mergers through efficiencies of scale.

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<sup>1</sup> Paper prepared by Peter Tabak (Lead Economist, Department of Economics, Policy and Governance) and Emir Zildzovic (former economic analyst at the EBRD). Sanja Borkovic provided valuable research assistance. We are grateful for comments by Marko Primorac from the Institute of Public Finance in Zagreb, Laura Bardone, Gerrit Bethuyne, Arian Perić, Maria Pletikosa, Kristian Orsini, Vukašin Ostojić and Nora Strähle from the European Commission, Sanja Madžarević-Šujster and Moritz Meyer from World Bank as well as Vedrana Jelusić-Kašić, Alexander Plekhanov, Artur Radziwill, Mattia Romani and Peter Sanfey from the EBRD. The views presented in this paper are those of the authors only and not of the EBRD.

<sup>2</sup> For an alternative approach, see Bajo, A., and Primorac, M. (2015): Major Public Enterprises in Croatia (No. 1509), CIRIEC-Université de Liège <http://www.ciriec.ulg.ac.be/wp-content/uploads/2015/12/WP15-09.pdf>.

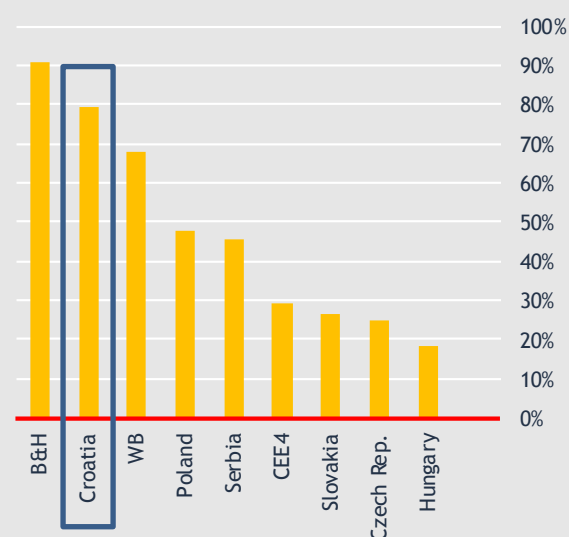
### *SOEs in the Croatian economy: Strong presence with low efficiency*

**SOEs are still an important part of the Croatian economy.** They are present in many sectors (and usually more prominently than in CEE4), including transport (air, roads, railway and maritime transport, airports and ports), energy (generation, distribution and storage), post and communication, forestry and utilities where public participation may be explained by public interest or market failure, but also in agribusiness or manufacturing. The value of Croatian SOEs' assets is high by regional standards. In the absence of large privatisations over the past years, assets of Croatian state-owned enterprises remained stable at almost 80 per cent of the country's GDP (Figure 1). In addition, SOEs employ 73,000 workers or five per cent of the total workforce (Figure 2). These are, in general, higher figures than in CEE4 and closer to that of the Western Balkan countries.

**Figure 1**

#### **Assets of SOEs**

(share in GDP, 2014)

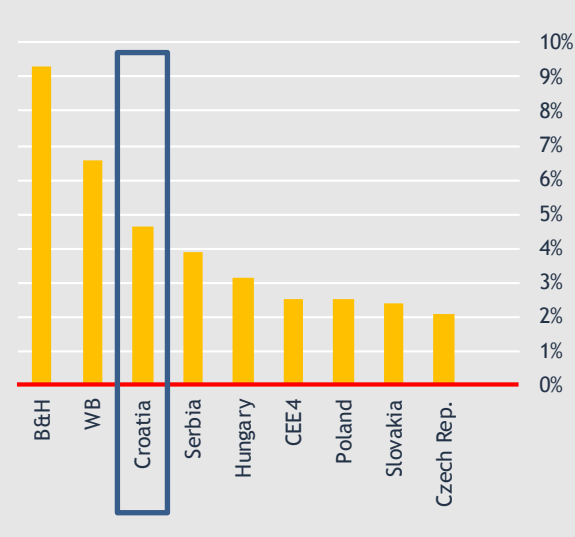


Source: Authors' calculations based on ORBIS BVD.

**Figure 2**

#### **Employment in SOEs**

(share in total, 2014)

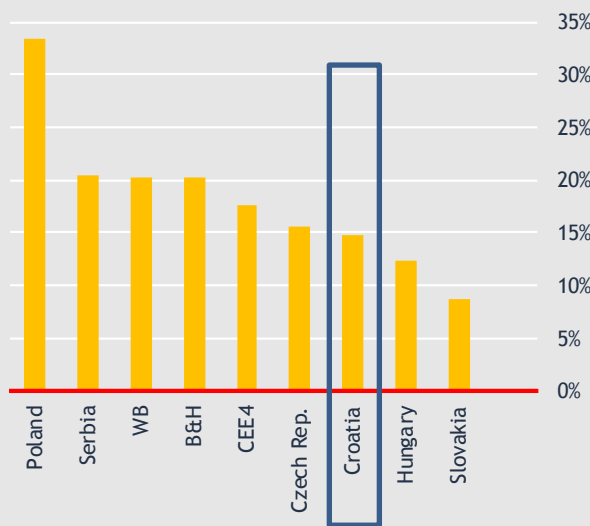


Sources: ORBIS, Eurostat and national statistical offices.

### **The revenue generating capacity of SOEs in Croatia is low by regional standards.**

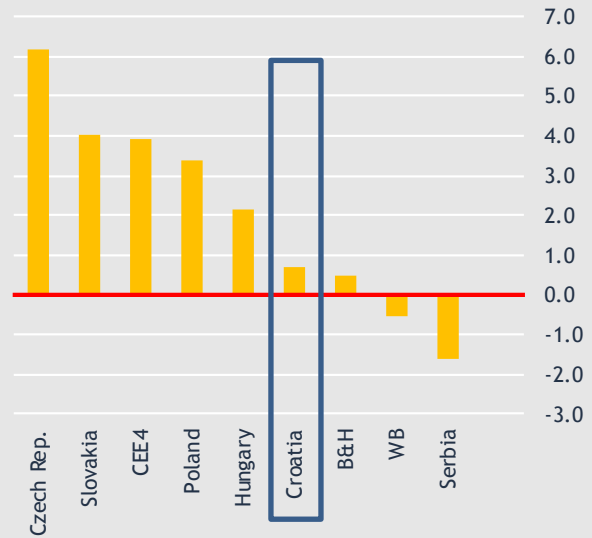
Despite the high value of SOE assets in Croatia, SOE revenues stand at only 15 per cent of GDP, below the levels for most comparator countries (Figure 3). Profitability, with an average return on assets (ROA) of 0.7 per cent over 2012-2014, is also behind CEE peers (Figure 4), although the 6-year long recession (2009-2014) may have contributed to that to some extent.

**Figure 3**  
Revenues of SOEs, share in GDP, 2014



Source: Authors' calculations based on ORBIS BVD.

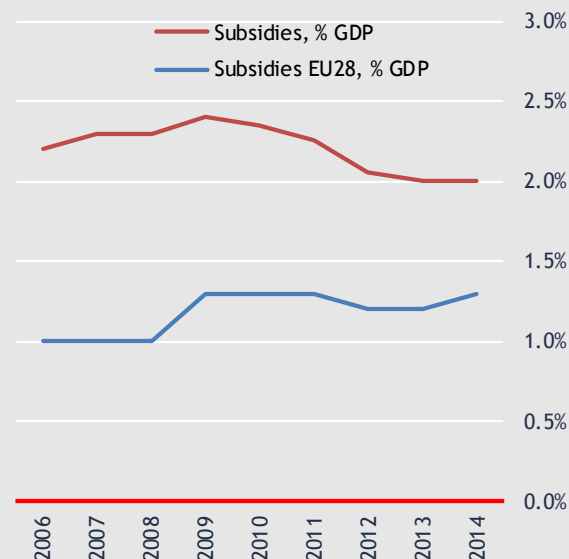
**Figure 4**  
ROA of SOEs, 2012-2014



Source: Authors' calculations based on ORBIS BVD.

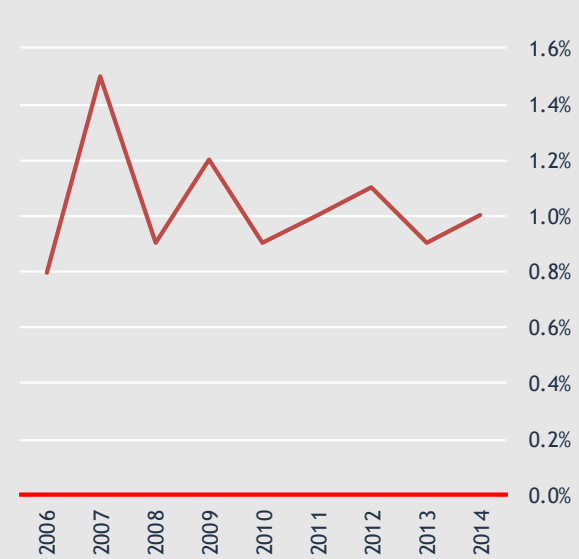
**Weak SOE performance is a considerable burden on public finances.** Despite some decline over the past decade, to 2 per cent of GDP, subsidies to SOEs remain significantly above the EU average (Figure 5), thus contributing to the high fiscal imbalances. On the other hand, despite the high value of state-owned assets, payments of SOEs into the budget remain around 1 per cent of GDP (Figure 6).

**Figure 5**  
Budgetary subsidies to SOEs  
(share in GDP)



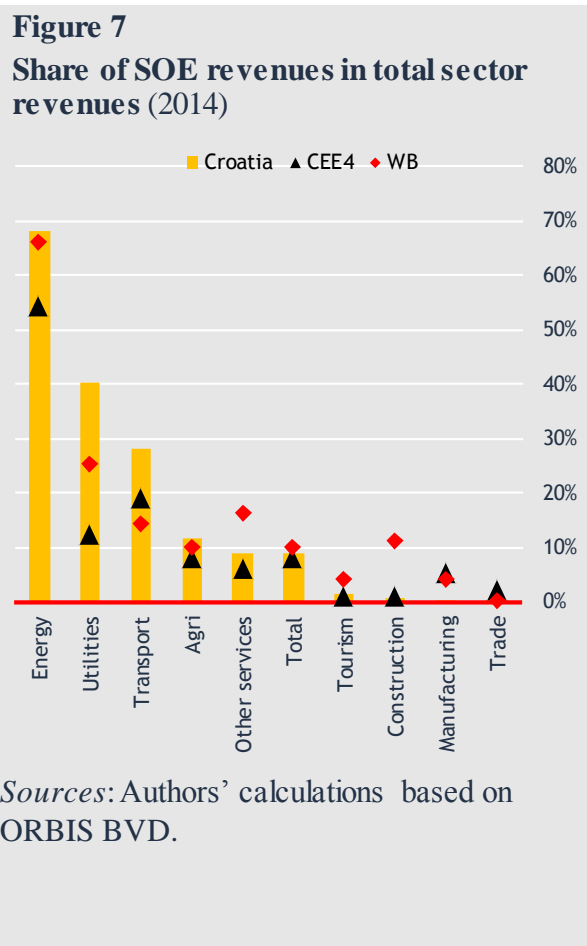
Sources: Bajo-Primorac (2015).

**Figure 6**  
Payments of SOEs into the budget  
(share in GDP)

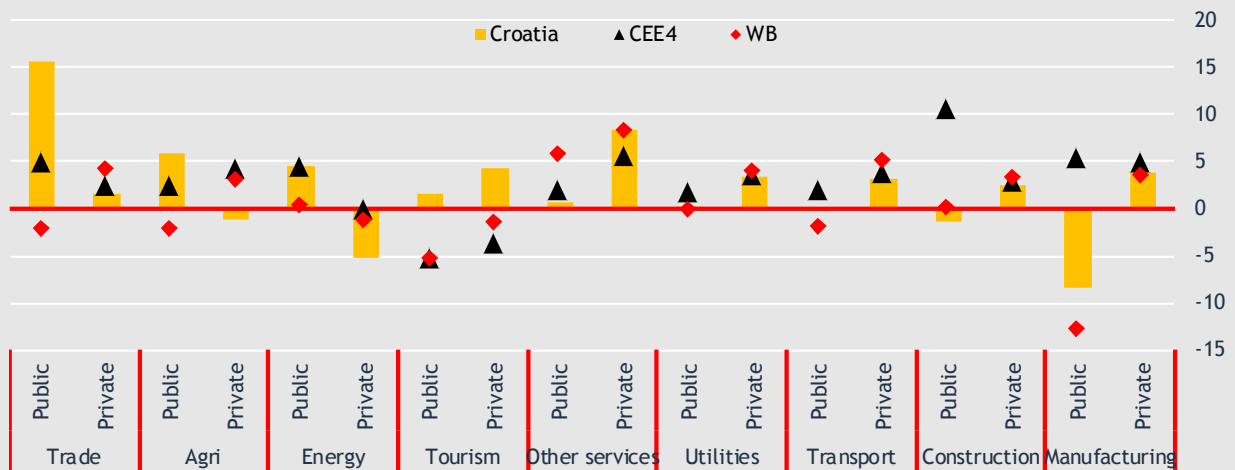


Sources: Bajo-Primorac (2015).

**The profitability of state-owned enterprises has been low in most sectors.** The bulk of the revenues in the energy sector and a large share of revenues in the utilities and transport sectors comes from SOEs, in line with the region (Figure 7). Other than energy, these are also the sectors exhibiting negative average profitability over 2012-2014. In addition, Croatian SOEs in manufacturing, construction and services are lagging behind their peers from CEE in terms of profitability. SOEs operating in trade and agriculture, however, are more profitable than their regional and private sector peers (Figure 8).



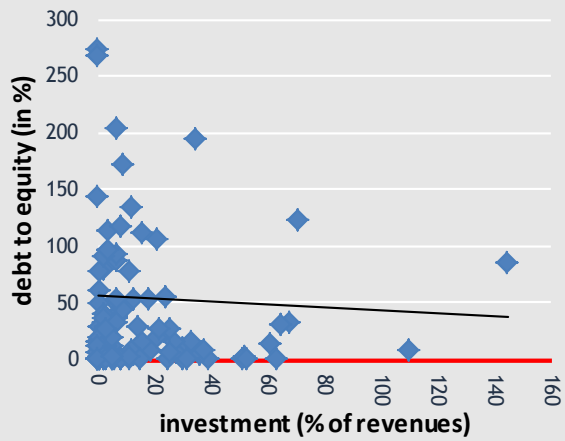
**Figure 8**  
**Return on assets of SOEs and private enterprises by sector**  
 (2012-2014 average)



Sources: Authors' calculations based on ORBIS BVD.

**The high leverage of Croatian SOEs hampers investments (Figure 9), while the high interest burden weighs on profitability.** The leverage of SOEs is particularly high in transport, construction, trade, services and utilities (Figure 10) and is also reflected in high interest costs (Figure 11), in particular in tourism, construction, trade and agriculture. Reducing leverage (e.g. by internal capital accumulation through improved cash-flow generating capacities or by raising equity) may help lower funding costs through decreasing the risk premium and/or the debt level. On the other hand, the share of long-term funding of Croatian SOEs is relatively high in most sectors, helping reduce refinancing and interest rate risks (Figure 12).

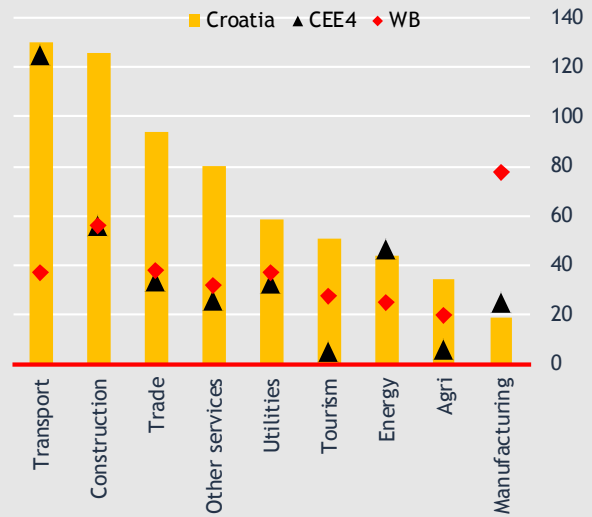
**Figure 9**  
**Impact of leverage on investments of state-owned enterprises**



*Note: We filtered out companies with D/E higher than 300% and companies where investments exceeded 200% of revenues.*

*Source: Authors' calculations based on ORBIS BVD.*

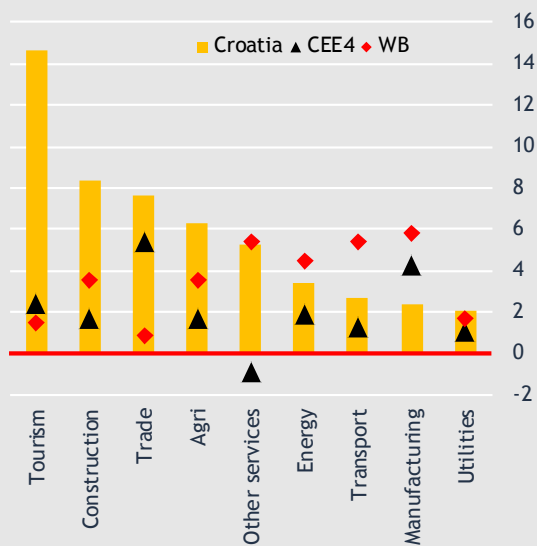
**Figure 10**  
**Leverage (debt to equity ratio) of SOEs (2014)**



*Note: Transport sector leverage in Croatia is calculated by excluding the value of roads from the capital of HC to ensure consistency across countries.*

*Sources: Authors' calculations based on ORBIS BVD.*

**Figure 11**  
**Implied interest costs\* for SOEs**  
 (2012-2014)

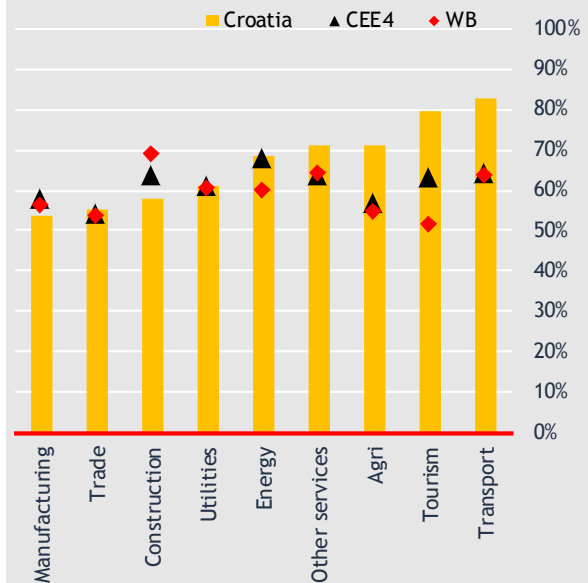


\* *Financial Expenses / Liabilities*

Note: For utilities in the Czech Republic 2014 data are used.

Sources: Authors' calculations based on ORBIS BVD.

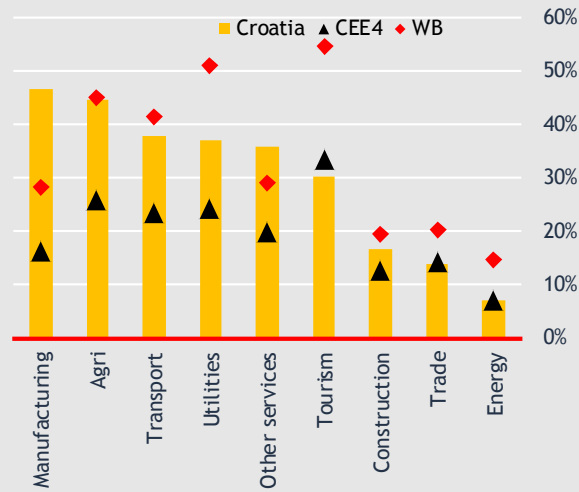
**Figure 12**  
**Long-term/total liabilities of SOEs**  
 (2014)



Source: Authors' calculations based on ORBIS BVD.

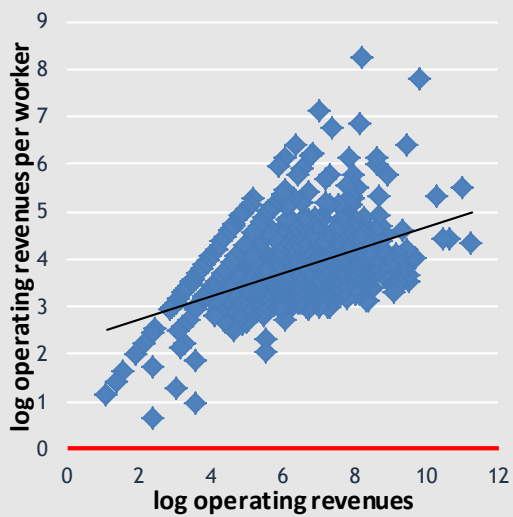
**High labour costs negatively affect the profitability of SOEs.** Costs of employees in total revenues are higher than in CEE peers across all sectors (Figure 13), indicating opportunities for efficiency gains (Figures 14 and 15). Further commercialisation of SOE activities can help increase revenues and/or bring down costs, thus improving profitability or reducing the need for subsidies.

**Figure 13**  
**Cost of employees/operating revenues of SOEs**  
 (2014)



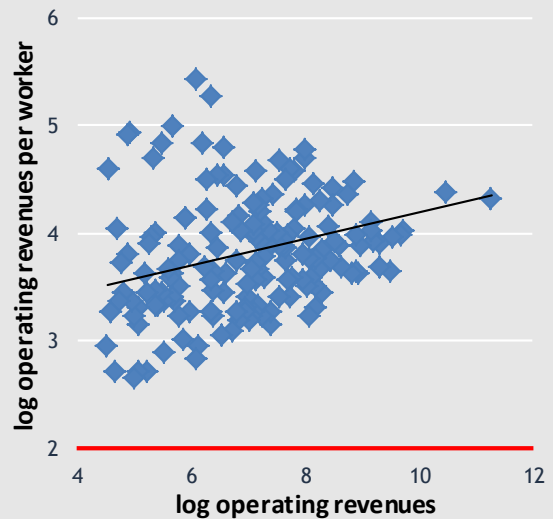
Sources: Authors' calculations based on ORBIS BVD.

**Figure 14**  
**Economies of scale in utilities sector**



Sources: Authors' calculations based on ORBIS BVD.

**Figure 15**  
**Economies of scale in water sector**



Sources: Authors' calculations based on ORBIS BVD.

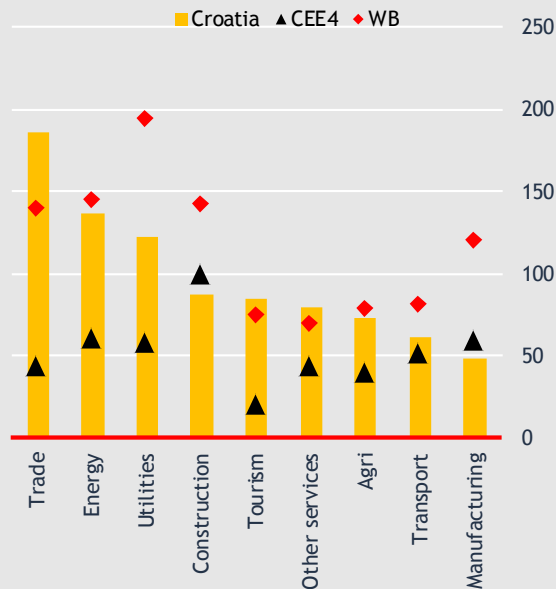
**Croatian SOEs face serious problems collecting their claims.** The average number of days needed to collect receivables is significantly longer than in CEE4 countries.<sup>3</sup> The differences

<sup>3</sup> The difficulty of collecting receivables might also be due to general illiquidity in the economy.



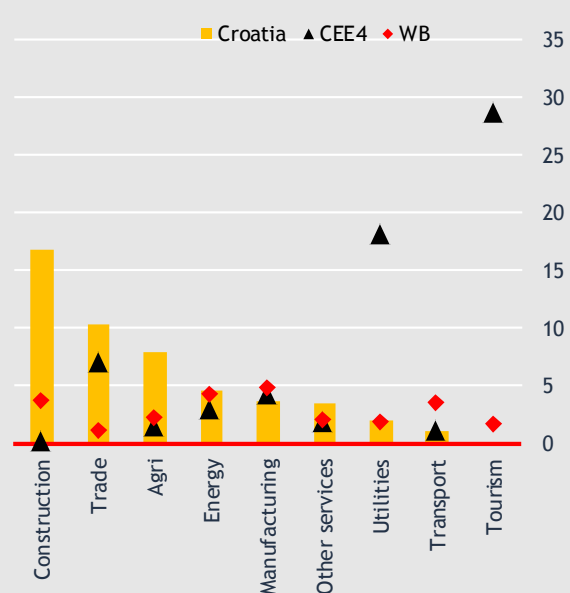
are largest for trade (where on average receivables are collected after 185 days vs. 43 days in CEE4), energy (136 days vs. 60 days in CEE4) and utilities (121 days vs. 57 days in CEE4) (Figure 16). On the other hand, the average number of days it takes for SOEs to pay their dues is much shorter and more in line with regional averages (except for construction, trade and agriculture) (Figure 17). Improving collection would also help reducing leverage as debt is partly used to finance high receivables.

**Figure 16**  
Accounts receivable days of SOEs  
(2014)



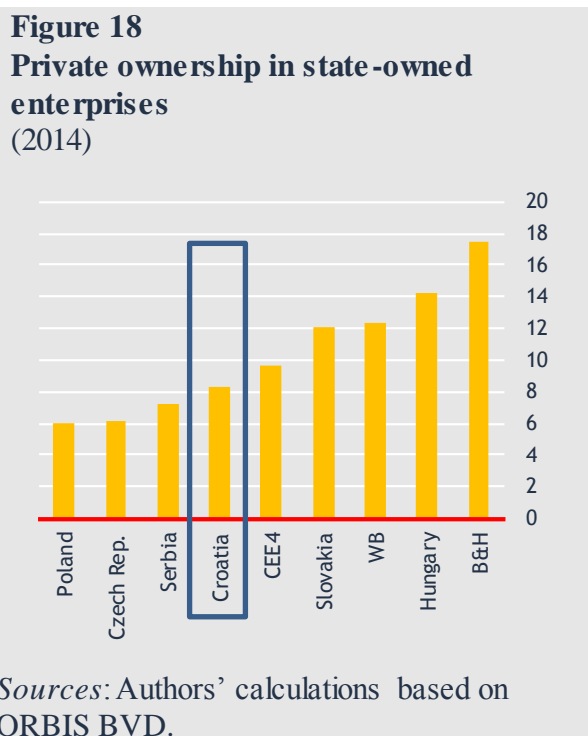
Source: Authors' calculations based on ORBIS BVD.

**Figure 17**  
Accounts payable days of SOEs  
(2014)



Source: Authors' calculations based on ORBIS BVD.

**Improving corporate governance and increasing the private share in Croatian SOEs may improve their economic efficiency.** Poor corporate governance might have been one of the drivers of weak profitability of SOEs in the EBRD region. International evidence shows that the larger the share of the state in a company the lower its profitability and productivity (Xu-Wang 1999). Higher private sector ownership can improve corporate governance through stronger influence and control. Private ownership in Croatian SOEs is relatively low (less than 10 per cent) and may remain insufficient to affect corporate strategies and governance (Figure 18). Another way to improve corporate governance and reduce political influence is to appoint professional boards with independent members.



***Suggested directions for action: How to boost SOE efficiency?***

SOEs in Croatia (with some exceptions) are highly (often over-) leveraged,<sup>4</sup> exhibit operational inefficiencies and face serious issues with collection of their claims. Besides strengthening the regulatory framework in the area of competition and state aid policies, government action, with potential support from international financial institutions, should focus on making them more efficient. Better operational efficiency would contribute to fiscal sustainability by increasing fiscal revenues or reducing the need for budgetary transfers. An additional benefit could be the higher quality of their services, improving customer satisfaction. More specifically:

1. High leverage, investment costs and operational inefficiencies hamper SOEs profitability and investment potential. A stronger focus on enhancing operational and financial performance, corporate governance and reducing competitive distortions could result in fiscal savings or higher revenues. Careful analysis of experiences from other (EU) countries could help in finding best practices that can work for Croatia.
2. High leverage could be tackled by, among others, public-private partnerships whereby, through appropriate allocation of risks, the private sector could carry out capital investments by reducing the immediate funding need from the municipal and government entities.

<sup>4</sup> A recent assessment shows that the share of long-term debt of over-leveraged companies (at above 35 per cent of GDP) is the highest in Croatia among the analysed CESEE countries. Around one third of this debt can be attributed to several large SOEs. See Borkovic, S. – Tabak, P.: Deeply indebted: Corporate over-indebtedness and potential consequences in Croatia, Serbia and Slovenia, in *Regional Economic Prospects in EBRD Countries of Operations (May 2017): Growth picking up despite political uncertainty*, EBRD, p. 14. <http://www.ebrd.com/cs/Satellite?c=Content&cid=1395256204290&d=&pagename=EBRD%2FContent%2FDownloadDocument>

3. Utilities exhibit weak profitability. Analysis shows the potential for efficiencies of scale in some sectors, thus suggesting possible efficiency improvements through merging smaller, less efficient entities into larger ones, based on a thorough assessment.
4. Raising EU fund absorption can also ease fiscal pressures and help raise the investment level.